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SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549



Form 19b-4

Proposed Rules

By

Public Company Accounting Oversight Board

In accordance with Rule 19b-4 under the
Securities Exchange Act of 1934

1. Text of the Proposed Rules

(a) Pursuant to the provisions of Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act"), the Public Company Accounting Oversight Board (the "Board" or the "PCAOB") is filing with the Securities and Exchange Commission ("SEC" or "Commission") a proposed new standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to PCAOB standards (collectively, the "proposed rules"). The proposed rules are attached as Exhibit A to this filing. In addition, the Board is also requesting the SEC's approval, pursuant to Section 103(a)(3)(c) of the Act, of the application of these proposed rules, other than the requirements related to critical audit matters, to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934. Section 104 of the Jumpstart Our Business Startups Act provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGSs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." *See* Exhibit 3.

(b) Not applicable.

(c) Not applicable.

2. Procedures of the Board

a) The Board approved the proposed rules, and authorized them for filing with the SEC, at its open meeting on June 1, 2017. The Board also adopted related amendments to several of its other auditing standards, including technical amendments to reflect, among other things, standards in effect as of June 30, 2017. No other action by the Board is necessary for the filing of the proposed rules.

(b) Questions regarding this rule filing may be directed *to* Martin F. Baumann, Chief Auditor (202/207-9192, baumannm@pcaobus.org); Jennifer Rand, Deputy Chief Auditor (202/207-9206, randj@pcaobus.org); Jessica Watts, Associate Chief Auditor (202/207-9376, wattsj@pcaobus.org); Karen Wiedemann, Associate Counsel (202/591-4411, wiedemannk@pcaobus.org); Elena Bozhkova, Assistant Chief Auditor (202/207-9298, bozhkovae@pcaobus.org); and Ekaterina Dizna, Assistant Chief Auditor (202/591-4125, diznae@pcaobus.org), or Jennifer G. Williams, Associate General Counsel (202/591-4173).

3. Board's Statement of the Purpose of, and the Statutory Basis for, the Proposed Rules Change

(a) Purpose

The Board has adopted a new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and related amendments to its auditing standards that will require the auditor to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters—matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and

(2) involved especially challenging, subjective, or complex auditor judgment;

- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor; and
- Other improvements to the auditor's report—a number of other improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

The Board believes that adopting these requirements responds to the strong interest of investors for enhanced communication about the audit and is consistent with its mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[1] *See* Exhibit 3 for additional discussion of the purpose of the project.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

4. <u>Board's Statement on Burden on Competition</u>

Not applicable. The Board's consideration of the economic impacts of the standard and amendments are discussed in Exhibit 1.

5. <u>Board's Statement on Comments on the Proposed Rules Change Received from Members, Participants or Others</u>

The Board initially released the proposed rules for public comment on June 21, 2011, August 13, 2013 and May 11, 2016. *See* Exhibit 2(a)(A). The Board received 491

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[1] Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7211(a).

written comment letters relating to its initial proposed rules. *See* Exhibits 2(a)(B) and 2(a)(C). The Board's Standing Advisory Group and Investor Advisory Group also discussed the proposed rules at meetings on November 10, 2011, November 15-16, 2012, October 16, 2013, November 13-14, 2013, June 24-25, 2014, October 20, 2014, May 18, 2016, October 27, 2016. The Board also held public roundtables on its proposed rules on September 15, 2011 and April 2-3, 2014. *See* Exhibit 2(a)(D)

6. Extension of Time Period for Commission Action

The Board does not consent to an extension of the time period specified in Section 19(b)(2) of the Securities Exchange Act of 1934.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rules Based on Rules of Another Board or of the Commission

Not applicable.

9. Exhibits

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| Exhibit A – | Text of the Proposed Rules. |
| Exhibit 1 – | Form of Notice of Proposed Rules for Publication in the Federal Register. |
| Exhibit 2(a)(A) – | PCAOB Release No. 2011-003 (Concept Release). |
| | PCAOB Release No. 2013-005 (Proposing Release). |
| | PCAOB Release No. 2016-003 (Reproposing Release) and related materials. |
| Exhibit 2(a)(B) – | Alphabetical List of Comments on the rules proposed in PCAOB Release Nos. 2011-003, 2013-005, and 2016-003. |

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| Exhibit 2(a)(C) – | Written comments on the rules proposed in PCAOB Release No. 2011-003, 2013-005, and 2016-003. |
| Exhibit 2(a)(D) - | Transcripts and Slides from Board, SAG or IAG meetings on Sept. 15, 2011, Nov. 10, 2011, Nov. 15-16, 2012, Oct. 16, 2013, Nov. 13-14, 2013, April 2-3, 2014, June 24-25, 2014, Oct. 20, 2014, May 18, 2016, and Oct. 27, 2016. |
| Exhibit 3 – | PCAOB Release No. 2017-001 (Adopting Release) and related materials. |

10. Signatures

Pursuant to the requirements of the Act and the Securities Exchange Act of 1934, as amended, the Board has duly caused this filing to be signed on its behalf by the undersigned thereunto duly authorized.

Public Company Accounting Oversight Board

By: 

Phoebe W. Brown
Secretary

July 19, 2017

**EXHIBIT A – TEXT OF THE PROPOSED RULES**

The Board adopted a new standard, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, to replace portions of AS 3101, Reports on Audited Financial Statements. The remaining portions of AS 3101 are redesignated as AS 3105, Departures from Unqualified Opinions and Other Reporting Circumstances. The Board also adopted related amendments to several of its other auditing standards, including technical amendments to reflect, among other things, standards in effect as of June 30, 2017.

Proposed new language is underlined. Proposed language that is deleted by the amendments is struck through. Proposed language that is being moved without being modified, such as changes to the illustrative auditor's report to conform to the required order in the new standard, is double underlined. The text of these proposed rule changes is set forth below.

* * * * *

**AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

***Introduction***

.01 The auditor's report contains either an expression of opinion on the financial statements,[1] taken as a whole,[2] or an assertion that an opinion cannot be expressed. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the

[1] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. *See* Regulation S-X Rule 1-01(b), 17 CFR 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; *see*, *e.g.*, AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[2] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

"auditor's unqualified report").[3]

.02 The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[4] in conformity with the applicable financial reporting framework.[5]

.03 When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements and state the reasons for the departure from the unqualified opinion. AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

***Objectives***

.04 The objectives of the auditor when the auditor concludes that an unqualified opinion is appropriate are to:

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[3] Paragraphs .85-.98 and Appendix C, *Special Reporting Situations*, of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

[4] AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

[5] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters,**[6] when required, relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

***The Auditor's Unqualified Report***

.05 The auditor's unqualified report includes:[7]

a. The basic elements,[8] as described in paragraphs .06-.10;

b. Communication regarding critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs .11-.17, unless such requirements do not apply;

Note: Communication of critical audit matters is not required for audits of (1) brokers[9] and dealers[10] reporting under Exchange Act Rule 17a-5; (2) investment companies registered under the

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[6] This term is defined in Appendix A, *Definitions*, and is set in **boldface type** the first time it appears.

[7] Appendix B provides an illustrative auditor's unqualified report.

[8] Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. *See*, *e.g.*, Sections 30(g) and 32(a)(4) of the Investment Company Act; Regulation S-X Rule 2-02, 17 CFR 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR 240.17a-5. Auditor's reports on financial statements filed with the SEC are subject to all such applicable requirements.

[9] *See* PCAOB Rule 1001(b)(iii).

[10] *See* PCAOB Rule 1001(d)(iii).

Investment Company Act of 1940 ("Investment Company Act"),[11] other than companies that have elected to be regulated as business development companies;[12] (3) employee stock purchase, savings, and similar plans;[13] and (4) emerging growth companies.[14] Auditors of these entities may consider voluntarily including communication of critical audit matters as described in this standard.

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs .18-.19; and

d. Information about certain audit participants, if the auditor decides to provide this information in the auditor's report, as described in paragraph .20.

**Basic Elements**

*Title*

.06 The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

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[11] *See* Section 8 of the Investment Company Act.

[12] *See* Section 54 of the Investment Company Act.

[13] *See* Exchange Act Rule 15d-21, 17 CFR 240.15d-21.

[14] *See* Section 3(a)(80) of the Exchange Act.

.07 The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Financial Statements*

.08 The first section of the auditor's report must include the section title "Opinion on the Financial Statements" and the following elements:

a. The name of the company whose financial statements were audited;

b. A statement identifying each financial statement and any related schedule(s) that has been audited;[15]

c. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

d. A statement indicating that the financial statements, including the related notes and any related schedule(s), identified and collectively referred to in the report as the financial statements, were audited; and

e. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then

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[15] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. *See*, *e.g.*, Regulation S-X Rules 5-04, 6-10, 6A-05, and 7-05, 17 CFR 210.5-04, 210.6-10, 210.6A-05, 210.7-05. *See generally*, Regulation S-X Rule 12-01, 17 CFR 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

ended in conformity with the applicable financial reporting framework.[16] The opinion should also include an identification of the applicable financial reporting framework.

*Basis for Opinion*

.09 The second section of the auditor's report must include the section title "Basis for Opinion" and the following elements:

a. A statement that the financial statements are the responsibility of the company's management;

b. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

c. A statement that the audit was conducted in accordance with the standards of the PCAOB;

d. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

e. A statement that the audit included:

[16] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and financial statements being audited.

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

(2) Examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

(4) Evaluating the overall presentation of the financial statements;

f. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion; and

g. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

*Signature, Tenure, Location, and Date*

.10 The auditor's report must include the following elements:

a. The signature of the auditor's firm;[17]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;[18]

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[17] *See* Regulation S-X Rule 2-02(a), 17 CFR 210.2-02(a).

[18] For an investment company that is part of a group of investment companies, the statement contains the year the auditor began serving consecutively as the

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[19] and

d. The date of the auditor's report.[20]

## Critical Audit Matters

*Determination of Critical Audit Matters*

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are not a substitute for the

auditor of any investment company in the group of investment companies. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act.

[19] *See* Regulation S-X Rule 2-02(a).

[20] *See* AS 3110, *Dating of the Independent Auditor's Report.*

auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

*Communication of Critical Audit Matters*

.13 The auditor must communicate in the auditor's report critical audit matters[21] relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period. This may be appropriate, for example, when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

.14 For each critical audit matter communicated in the auditor's report the auditor must:

a. Identify the critical audit matter;

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

c. Describe how the critical audit matter was addressed in the audit; and

[21] Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical audit matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections.

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

d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

*Language Preceding Critical Audit Matters in the Auditor's Report*

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

Critical Audit Matters

Critical audit matters are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*

.17 For each matter arising from the audit of the financial statements that:

a. Was communicated or required to be communicated to the audit committee; and

b. Relates to accounts or disclosures that are material to the financial statements;

the auditor must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.[22]

**Explanatory Language Added to the Auditor's Report**

.18 Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report, while not affecting the auditor's opinion on the financial statements. These circumstances include when:

a. There is substantial doubt about the company's ability to continue as a going concern;[23]

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[22] Consistent with the requirements of AS 1215, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determinations made to comply with the provisions of this standard.

[23] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern.*

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[24]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[25]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[26]

e. A material misstatement in previously issued financial statements has been corrected;[27]

f. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[28]

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[24] *See* paragraphs .06-.09 of AS 1205, *Part of the Audit Performed by Other Independent Auditors.*

[25] *See* paragraphs .08 and .12-.15 of AS 2820, *Evaluating Consistency of Financial Statements*.

[26] *See* AS 2820.06.

[27] *See* AS 2820.09 and .16-.17.

[28] *See* AS 2201.88. AS 2201 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, AS 2201 notes that the auditor should consider those circumstances as well.

g. Management is required to report on the company's internal controls over financial reporting but such report is not required to be audited,[29] and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of the company's internal control over financial reporting;[30]

h. Certain circumstances relating to reports on comparative financial statements exist;[31]

i. Selected quarterly financial data required by Item 302(a) of Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[32]

j. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial

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29 *See* Item 308 of Regulation S-K.

30 *See* AS 3105.59-.60.

31 *See* AS 3105.52-.53 and .56-.58.

32 *See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information.*

doubts about whether the supplementary information conforms to the requirements of the applicable financial reporting framework;[33]

k. There has been a change in an investee year end that has a material effect on the company's financial statements;[34] and

l. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements.[35]

**Emphasis of a Matter**

.19 The auditor may emphasize a matter regarding the financial statements in the auditor's report ("emphasis paragraph").[36] The following are examples of matters, among others, that might be emphasized in the auditor's report:[37]

a. Significant transactions, including significant transactions with related parties;

b. Unusually important subsequent events, such as a catastrophe that has had,

[33] *See* paragraphs .03 and .08 of AS 2705, *Required Supplementary Information*.

[34] *See* paragraph .32 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35] *See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

[36] Emphasis paragraphs are never required and are not a substitute for required critical audit matters described in paragraphs .11-.17.

[37] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" in the opinion paragraph when an emphasis paragraph is included in the auditor's report.

or continues to have, a significant effect on the company's financial position;

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

e. That the entity is a component of a larger business enterprise.

If the auditor adds an emphasis paragraph in the auditor's report, the auditor should use an appropriate section title.

**Information about Certain Audit Participants**

.20 The auditor may include in the auditor's report information regarding the engagement partner and/or other accounting firms participating in the audit that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*.[38] If the auditor decides to provide information about the engagement partner, other accounting firms participating in the audit, or both, the auditor must disclose the following:

a. *Engagement partner*—the engagement partner's full name as required on Form AP; or

b. *Other accounting firms participating in the audit*:

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[38] If the auditor decides to include information regarding certain audit participants in the auditor's report, the auditor should use an appropriate section title.

i. A statement that the auditor is responsible for the audits or audit procedures performed by the other public accounting firms and has supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards;

ii. *Other accounting firms individually contributing 5% or more of total audit hour*s—for each firm, (1) the firm's legal name, (2) the city and state (or, if outside the United States, city and country) of headquarters' office, and (3) percentage of total audit hours as a single number or within an appropriate range, as is required to be reported on Form AP; and

iii. *Other accounting firms individually contributing less than 5% of total audit hours*—(1) the number of other accounting firms individually representing less than 5% of total audit hours and (2) the aggregate percentage of total audit hours of such firms as a single number or within an appropriate range, as is required to be reported on Form AP.

***APPENDIX A – Definition***

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matter – Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

Note: Required audit committee communications are set forth in PCAOB standards, including AS 1301, *Communications with Audit Committees*, and Appendix B of that standard which refers to other PCAOB rules and standards.

***APPENDIX B – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters***

**Report of Independent Registered Public Accounting Firm**

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements*, *e.g.*, *income*, *comprehensive income*, *stockholders' equity*, *and cash flows*], for each of the three years in the period ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company *as of* [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company

Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[*Include critical audit matters*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

* * *

**~~AS 3101: Reports on Audited Financial Statements~~ AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances***

**Introduction**

~~.01 This section applies to auditors' reports issued in connection with audits[1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs .85-.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201, for direction on reporting on internal control over financial reporting. In addition, *see* AS 2201.86-.88, which includes an illustrative combined audit report.~~

~~[1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with the standards of the PCAOB in effect at the time the audit is performed. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~.02 This section does not apply to unaudited financial statements as described in AS 3320, *Association with Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in AS 3305, *Special Reports*.~~

~~.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with the standards of the PCAOB and on the findings. This section is concerned primarily with the relationship of the requirements in paragraph .04 to the language of the auditor's report.~~

~~.04 The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~.05 The objective of the requirements in paragraph .04 is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in paragraph .04 to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the requirements in paragraph .04 as it applies to comparative~~

~~financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

**~~The Auditor's Standard Report~~**

~~.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with the standards of the PCAOB.~~

~~.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

~~*a*. A title that includes the word *independent*~~[3]

~~[3] This section does not require a title for an auditor's report if the auditor is not independent. *See* AS 3320 for guidance on reporting when the auditor is not independent.~~

~~*b*. A statement that the financial statements identified in the report were audited~~

~~*c*. A statement that the financial statements are the responsibility of the Company's management[4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~[4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~*d*. A statement that the audit was conducted in accordance with the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States))~~

~~*e*. A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~*f*. A statement that an audit includes~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~

~~(2) Assessing the accounting principles used and significant estimates made by management~~

~~(3) Evaluating the overall financial statement presentation[5]~~

~~[5] Paragraphs .03 and .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* discuss the auditor's evaluation of the overall presentation of the financial statements.~~

~~*g*. A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h*. An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles)~~

~~*i*. The manual or printed signature of the auditor's firm~~

~~*j*. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[6A]~~

~~[6A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

~~*k*. The date[7] of the audit report~~

~~[7] For guidance on dating the auditor's report, *see* AS 3110, *Dating of the Independent Auditor's Report*.~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~The form of the auditor's standard report on comparative financial statements~~[8] ~~is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~[8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."~~

~~*l.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

> ~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case,~~

~~the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

~~.09A The auditor may include in the auditor's report information regarding the engagement partner and/or other accounting firms participating in the audit that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*. If the auditor decides to provide information about the engagement partner, other accounting firms participating in the audit, or both, the auditor must disclose the following:~~

~~a. *Engagement partner* – the engagement partner's full name as required on Form AP; or~~

~~b. *Other accounting firms participating in the audit*:~~

~~i. A statement that the auditor is responsible for the audits or audit procedures performed by the other public accounting firms and has supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards;~~

~~ii. *Other accounting firms individually contributing 5% or more of total audit hours* – for each firm, (1) the firm's legal name, (2) the city and state (or, if outside the United States, city and country) of headquarters' office, and (3) percentage of total audit hours as a single number or within an appropriate range, as is required to be reported on Form AP; and~~

~~iii. *Other accounting firms individually contributing less than 5% of total audit hours* – (1) the number of other accounting firms~~

~~individually representing less than 5% of total audit hours and (2) the aggregate percentage of total audit hours of such firms as a single number or within an appropriate range, as is required to be reported on Form AP.~~

.01~~0~~ The auditor's report contains either an expression of opinion on the financial statements, taken as a whole,[1] or an assertion that an opinion cannot be expressed. This standard ~~section~~ ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[2] and provides reporting guidance in the following circumstances: ~~This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:~~

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~
- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~
- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements

present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .02 -.39.

- *Adverse opinion.* An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .40 -.43.
- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. *See* paragraphs .44 -.47.

~~These opinions are discussed in greater detail throughout the remainder of this section.~~ This standard also discusses other reporting circumstances, such as reports on comparative financial statements.

[1] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[2] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"), including when explanatory language is added. Paragraphs .85–.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201 address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting. *See also* AS 2201.87, which includes an illustrative combined audit report.

**~~Explanatory Language Added to the Auditor's Standard Report~~**

~~.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory[9] paragraph (or other explanatory language) to the standard report.[10] These circumstances include:~~

~~[9] Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.~~

~~[10] *See* footnote 3.~~

~~*a*. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~

~~*b*. There is substantial doubt about the entity's ability to continue as a going concern.[11]~~

~~[11] AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions.~~

~~*c*. There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~

~~*d*. A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~

~~*e*. Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~

~~*f*. Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (*See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)~~

~~*g*. Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (*See* paragraph .02 of AS 2705, *Required Supplementary Information*.)~~

~~*h*. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (*See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19).~~

~~**Opinion Based in Part on Report of Another Auditor**~~

~~.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for~~

~~performance of the audit. (*See* AS 1205, *Part of the Audit Performed by Other Independent Auditors*.)~~

~~.13 An example of a report indicating a division of responsibility follows:~~

<u>~~Report of Independent Registered Public Accounting Firm~~</u>

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the~~

> ~~overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~
>
> ~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[.14-.15] [Paragraphs deleted.]~~

~~**Lack of Consistency**~~

~~.16 The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

- ~~*a*. A change in accounting principle.~~
- ~~*b*. An adjustment to correct a misstatement in previously issued financial statements.~~

~~**Change in Accounting Principle**~~

~~.17A As discussed in AS 2820, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is~~

~~preferable.~~[~~12~~] ~~A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

[~~12~~] ~~The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles.~~ ~~*See*~~ ~~FASB Statement 154, paragraph 14.~~

~~.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [~~~~*describe accounting method change*~~~~] in [~~~~*year(s) of financial statements that reflect the accounting method change*~~~~] due to the adoption of [~~~~*name of accounting pronouncement*~~~~].~~

~~.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [~~~~*describe accounting method change*~~~~] in [~~~~*year(s) of financial statements that reflect the accounting method change*~~~~].~~

~~.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

~~**Correction of a Material Misstatement in Previously Issued Financial Statements**~~

~~.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

> ~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

~~.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

**~~Emphasis of a Matter~~**

~~.19 In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are~~

- ~~That the entity is a component of a larger business enterprise.~~
- ~~That the entity has had significant transactions with related parties.~~
- ~~Unusually important subsequent events.~~

~~—Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

**Departures From Unqualified Opinions**

**Qualified Opinions**

.02~~0~~ Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

*a.* There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion (paragraphs .05~~22~~–.17~~34~~).

*b.* The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion (paragraphs .18~~35~~–.39~~57~~).

.03 When the auditor expresses a qualified opinion, the auditor's report must include the same basic elements and communication of critical audit matters, if requirements of critical audit matters apply, as would be required in an unqualified auditor's report under AS 3101.

.04~~21~~ When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the auditor's report. The auditor should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph that discloses all of the substantive reasons for the qualified opinion. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

Note: The auditor should refer to AS 3101 to determine if the matter for which the auditor qualified the opinion is also a critical audit matter.

**Scope Limitations**

.05~~22~~ The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with the standards of the PCAOB and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

.06~~23~~ The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.07~~24~~ Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.[3~~14~~] Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient appropriate evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

[3~~14~~] Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that AS 2510, *Auditing Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.08~~25~~ When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the ~~situation~~ auditor's report should ~~be~~ describe~~d~~ the basis for departure from an unqualified opinion in a~~n~~ ~~explanatory~~ separate paragraph ~~preceding~~ immediately following the opinion paragraph and refer~~red~~ to that description in both the ~~scope~~ Basis for Opinion section and opinion paragraph~~s~~ of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client.

.09~~26~~ When an auditor qualifies his or her opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

~~[*Same first paragraph as the standard report*]~~

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of ~~such~~ the adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, as described below, the financial statements ~~referred to in the first paragraph above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as discussed ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures included~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also include~~s~~d ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.10~~27~~ ***Other scope limitations.*** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he or she deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he or she considers necessary, the auditor should qualify his or her opinion or disclaim an opinion because of a limitation on the scope of the audit.

.11~~28~~ If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that AS 3110, *Dating of the Independent Auditor's Report*, states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, the auditor's only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

.12~~29~~ ***Uncertainties and scope limitations.*** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and matters related to estimates covered by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.13~~30~~ Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.14~~31~~ If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.15~~32~~ Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. Paragraphs .28~~45~~ to .32~~49~~ provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties.

.16~~33~~ ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows.

These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

.17~~34~~ An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statement

We have audited the accompanying balance sheet of X Company (the "Company") as of December 31, 20XX, and the related notes [*and schedules*] (collectively referred to as the "financial statement"). In our opinion, ~~the balance sheet referred to above~~ the financial statement presents fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit. We are a public accounting firm registered with the Public Company

Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures included~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement. ~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Departure From a Generally Accepted Accounting Principle**

.18~~35~~ When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with the standards of the PCAOB, he or she should express a qualified (paragraphs .19~~36~~ through .39~~57~~) or an adverse (paragraphs .40~~58~~ through .43~~60~~) opinion. The basis for such opinion should be stated in the report.

.19~~36~~ In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magnitude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.20~~37~~ When the auditor expresses a qualified opinion, he or she should disclose, in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph ~~of the report~~ should include the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion.

.21~~38~~ The ~~explanatory~~ paragraph(s) immediately following the opinion paragraph that describe the substantive reasons that led the auditor to conclude that there has been a departure from generally accepted accounting principles should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.[4]~~[15]~~ If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion may be shortened by referring to it.

[4]~~[15]~~ In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information. For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the report.

.22~~39~~ An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the ~~preceding~~ following paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.23~~40~~ If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (~~preceding~~ immediately following the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .22~~39~~ might read as follows:

> As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

.24~~41~~ ***Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable,[5~~16~~] unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard.

[5~~16~~] *See* footnote 4~~15~~.

.25~~42~~ Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the omission of the information discussed in the ~~preceding~~ following paragraph, . . .

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.26~~43~~ If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

.27~~44~~ ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of operations and stockholders' equity for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").~~income and retained earnings for the years then ended.~~ In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.28~~45~~ ***Departures from generally accepted accounting principles involving risks or uncertainties, and materiality considerations.*** Departures from generally accepted accounting principles involving risks or uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraphs .29~~46~~ and .30~~47~~)
- Inappropriate accounting principles (paragraph .31~~48~~)
- Unreasonable accounting estimates (paragraph .32~~49~~)

.29~~46~~ If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, the auditor should express a qualified or an adverse opinion.

.30~~47~~ The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements.

.31~~48~~ In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates ordinarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 23 and 25, describes situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

.32~~49~~ Usually, the auditor is able to satisfy himself or herself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (*see* paragraph .13 of AS 2810, *Evaluating Audit Results*) and that its effect is to cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

~~[.50]~~

.33~~51~~ ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph .07 ~~.17A~~ of AS 2820, *Evaluating Consistency of Financial Statements*, ~~states~~ includes the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

.34~~52~~ The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the change in accounting principle discussed in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[6]~~[17]~~

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

6~~17~~ Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ separate paragraph on consistency, an ~~separate~~ explanatory paragraph (immediately following the opinion paragraph) as required by ~~paragraphs .17A thorough .17E of this section~~ AS 2820.08 and .12-.15 is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.35~~53~~ Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, the auditor should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .36~~54~~ through .39~~57~~.

.36~~54~~ If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his or her reservations with respect to the statements for the year of change.

.37~~55~~ If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.38~~56~~ If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.39~~57~~ If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .34~~52~~, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

**Adverse Opinions**

.40 When the auditor expresses an adverse opinion, the auditor's report must include the opinion as described in paragraph .41 and the same other basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

> Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor expresses an adverse opinion.

.41~~58~~ An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42~~59~~ When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[7~~18~~] If the effects are not reasonably determinable, the report should so state.[8~~19~~]

[7~~18~~] *See* footnote 4~~15~~.

[8~~19~~] When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in ~~paragraph 11, subsection (*b*), (*c*), (*d*), and (*e*) of~~ AS 3101.18 ~~this section~~.

.43~~60~~ When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.~~,~~ An example of this is ~~as~~ shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, because of the effects of the matters discussed in the ~~preceding~~ following paragraphs, the financial statements ~~referred to above~~ do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended. As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided. Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Disclaimer of Opinion**

.44~~61~~ A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

.45~~62~~ A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.~~[209]~~ A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (*see* paragraphs .18~~35~~ through .39~~57~~). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles.

[~~20~~9] AS 3320.05 provides guidance to an accountant who is associated with the financial statements of a public entity, but has not audited such statements.

.46 When the auditor disclaims an opinion, the auditor's report must include the basic elements as would be required in an unqualified auditor's report under AS 3101, modified as follows:

a. The first section of the auditor's report must include the section title "Disclaimer of Opinion on the Financial Statements" and the following elements:

   (1) The name of the company whose financial statements the auditor was engaged to audit;

   (2) A statement identifying each financial statement and any related schedule(s) that the auditor was engaged to audit;

b. The second section of the auditor's report must include the title "Basis for Disclaimer of Opinion."

c. Elements in paragraphs .09b-f of AS 3101 should be omitted.

Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor disclaims an opinion.

.47~~63~~ An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Disclaimer of Opinion on the Financial Statements

We were engaged to audit the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows for the years then ended~~, and the related notes [*and schedules*] (collectively referred to as the "financial statements").[10]~~[21]~~ ~~Since~~ As described in the following paragraph, because the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements ~~the scope of our work was not sufficient to enable us to express~~, and we do not express, an opinion on these financial statements.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $________ as of December 31, 20X2, and at $_________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Basis for Disclaimer of Opinion

These financial statements are the responsibility of the Company's management. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

[~~*Second paragraph of standard report should be omitted*~~]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[10~~21~~] The wording in the ~~first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The~~ first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with the standards of the PCAOB. In addition, the ~~last~~ sentence ~~of the first paragraph is also deleted, because of the scope limitation, to eliminate the~~ that references ~~to~~ the auditor's responsibility to express an opinion is deleted.

**Piecemeal Opinions**

.48~~64~~ Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

**Reports on Comparative Financial Statements**

.49~~65~~ The report shall ~~Paragraph .04 requires that an auditor's report contain~~ either contain an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference ~~in paragraph .04~~ to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor[11]~~[22]~~ should update[12]~~[23]~~ the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.[13]~~[24]~~ Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (*See* AS 3110.01.)

[11]~~[22]~~ A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period. If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .49~~65~~ through .53~~69~~ and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .54~~70~~ through .58~~74~~ should be followed.

[12]~~[23]~~ An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (*see* AS 3110.06 through .08), since in issuing an updated report the continuing auditor considers information that he or she has become aware of during his or her audit of the current-period financial statements (*see* paragraph .52~~68~~) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

[13]~~[24]~~ A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

.50~~66~~ During the audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (*see* paragraph .52~~68~~) or the adequacy of informative disclosures concerning those statements. (*See* AS 2810.31.) In updating his or her report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his or her attention.

**Different Reports on Comparative Financial Statements Presented**

.51~~67~~ Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for the year ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the balance sheets of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America. Because of the matter discussed in the ~~preceding~~ following paragraph, ~~the scope of our work was not sufficient to enable us to express~~ we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[14]~~[25]~~

Basis for Opinion [~~Same first paragraph as the standard report~~]

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as explained ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[14]~~25~~ It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. *See* AS 2820 for a discussion of consistency.

**Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed**

.52~~68~~ If, during the current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he or she should consider such matters when updating his or her report on the financial statements of the prior period. For example, if an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.53~~69~~ If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) ~~preceding~~ immediately following the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of ~~an explanatory~~ a report ~~paragraph~~ that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [15]~~[26]~~

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

[*Include critical audit matters*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[15]~~[26]~~ *See* footnote 6~~17~~.

**Report of Predecessor Auditor**

.54~~70~~ A predecessor auditor ordinarily would be in a position to reissue his or her report on the financial statements of a prior period at the request of a former client if he or she is able to make satisfactory arrangements with the former client to perform this service and if he or she performs the procedures described in paragraph .55~~71~~.[16]~~[27]~~

[16]~~[27]~~ It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

**Predecessor Auditor's Report Reissued**

.55~~71~~ Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (*a*) read the financial statements of the current period, (*b*) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (*c*) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[17~~28~~] The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in paragraphs ~~AS 1205~~.10 through .12 of AS 1205, *Part of the Audit Performed* *by Other Independent Auditors.* However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

[17] ~~28~~ *See* AS 2805, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

.56 ~~72~~ A predecessor auditor who has agreed to reissue his or her report may become aware of events or transactions occurring subsequent to the date of his or her previous report on the financial statements of a prior period that may affect his or her previous report (for example, the successor auditor might indicate in the response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he or she considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). The auditor should then decide, on the basis of the evidential matter obtained, whether to revise the report. If a predecessor auditor concludes that the report should be revised, he or she should follow the guidance in paragraphs .52~~68~~, .53~~69~~, and .57~~73~~ of this section.

.57~~73~~ A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report. (*See* AS 3110.05.)

**Predecessor Auditor's Report Not Presented**

.58~~74~~ If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory~~ paragraph immediately following the opinion paragraph of his or her report (a) that the financial statements of the prior period were audited by another auditor,[18]~~[29]~~ (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than an ~~standard~~ unqualified report, the substantive reasons therefor.[19]~~[30]~~ An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheet of ABC Company (the "Company") as of December 31, 20X2, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows for the year then ended~~, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~ In our opinion, the 20X2 financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The financial statements of ~~ABC~~ the Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

If the predecessor auditor's report contained an explanatory paragraph or was other than an ~~standard~~ unqualified report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

. . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Opinion on the Financial Statements section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[18] ~~[29]~~ The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

[19] ~~[30]~~ If the predecessor's report was issued before the effective date of this section and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date hereof should not make reference to the predecessor's previously required explanatory paragraph.

**Management Reports on Internal Control Over Financial Reporting**

.59 In situations in which management is required to report on the company's internal control over financial reporting but such report is not required to be audited, and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in documents containing audited financial statements and the independent auditor's report under AS 2710, *Other Information in Documents Containing Audited Financial Statements.*

.60 In situations described in paragraph .59, the auditor must include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;
- As part of the audit, the auditor is required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and
- The auditor expresses no such opinion.

Following is an example of the Basis for Opinion section in the auditor's report that contains such statements:

> [Basis for Opinion]
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material

misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

**~~Effective Date and Transition~~**

~~.75 This section is effective for reports issued or reissued on or after February 29, 1996. Earlier application of the provisions of this section is permissible.~~

~~.76 An auditor who previously included an uncertainties explanatory paragraph in a report should not repeat that paragraph and is not required to include an emphasis paragraph related to the uncertainty in a reissuance of that report or in a report on subsequent periods' financial statements, even if the uncertainty has not been resolved. If the auditor decides to include an emphasis paragraph related to the uncertainty, the paragraph may include an explanation of the change in reporting standards.~~

**AS 1205, *Part of the Audit Performed by Other Independent Auditors***

* * *

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Opinion on the Financial Statements and Basis for Opinion sections, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor.

* * *

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of X Company (the "Company") and subsidiaries as of December 31, 20...., and the related consolidated statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income and retained earnings and cash flows~~ for the year then ended, and the related notes [*and schedules*] (collectively referred to as the "consolidated financial statements"). In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

*Basis for Opinion*

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit~~s~~. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate.

* * *

**Other Auditor's Report Departs From ~~Standard~~ the Auditor's Unqualified Report or Includes an Explanatory Paragraph**

.15 If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report or includes explanatory language, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report or the explanatory language is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

**Restated Financial Statements of Prior Years Following a Pooling of Interests**

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (*see* paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the opinion paragraph ~~standard~~

~~introductory, scope and opinion paragraphs~~ covering the consolidated financial statements for the current year:[*]

* * *

**AS 1210, *Using the Work of a Specialist***

* * *

**Effect of the Specialist's Work on the Auditor's Report**

.13 If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (*See* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

.14 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (*See* AS 3105~~1~~.18~~35~~, .19~~36~~, and .24~~41~~.)

**Reference to the Specialist in the Auditor's Report**

.15 ~~Except as discussed in paragraph .16 the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.~~ Reference to the use of a specialist may be made in the auditor's report in the following situations:

a. *Critical Audit Matters*—If such a reference will facilitate an understanding of the matter, the principal considerations that led the auditor to determine that the matter was a critical audit matter, or how the critical audit matter was addressed in the audit;[7] or

b. *Explanatory language or departure from an unqualified opinion*—If such a reference will facilitate an understanding of the reason for the explanatory paragraph or departure from an unqualified opinion.

Otherwise the auditor should not refer to the work or findings of the specialist in the auditor's report.

[7] Critical audit matters are described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

~~.16 The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.~~

* * *

**AS 1220, *Engagement Quality Review***

* * *

.10 In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate the engagement team's determination, communication, and documentation of critical audit matters in accordance with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

**AS 1301, *Communications with Audit Committees***

* * *

**~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

.21 The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

[39] *See* paragraphs .05~~22~~-.15~~32~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for a discussion of scope limitations.

* * *

**AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

* * *

**Reporting on Internal Control**

.85 The auditor's report on the audit of internal control over financial reporting ~~must~~ includes the following elements[18] -

*Title*

.85A The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

.85B The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Internal Control over Financial Reporting*

.85C The first section of the auditor's report on the audit of internal control over financial reporting must include the section title "Opinion on Internal Control over Financial Reporting" and the following elements-

~~a. A title that includes the word *independent*;~~

a. The name of the company whose internal control over financial reporting was audited; and

b. ~~k.~~ The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria.

*Basis for Opinion*

.85D The second section of the auditor's report on the audit of internal control over financial reporting must include the section title "Basis for Opinion" and the following elements:

a~~b~~. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

b~~c~~. An identification of management's report on internal control;

c~~d~~. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

d. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

e~~f~~. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

f~~g~~. A statement that the standards of the PCAOB ~~Public Company Accounting Oversight Board~~ require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

g~~h~~. A statement that an audit included~~s~~ obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances; and

h~~i~~. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion~~;~~.

*Definition and Limitations of Internal Control Over Financial Reporting*

.85E The third section of the auditor's report on the audit of internal control over financial reporting must include the section title "*Definition and Limitations of Internal Control Over Financial Reporting* " and the following elements:

a~~e~~. A definition of internal control over financial reporting as stated in paragraph .A5;

b~~j~~. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate~~;~~.

*Signature, Location, and Date*

.85F The auditor's report must include the following elements:

a~~l~~. The ~~manual or printed~~ signature of the auditor's firm;[18A]

b~~m~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

c~~n~~. The date of the audit report.

[18A] *See* Regulation S-X Rule 2-02(a).

* * *

.87 The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of W Company

[~~*Introductory paragraph*~~] *Opinions on the Financial Statements and Internal Control over Financial Reporting*

We have audited the accompanying balance sheets of W Company (the "Company") as of December 31, 20X8 and 20X7, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, stockholders' equity and comprehensive income, and cash flows~~ for each of the years in the three-year period ended December 31, 20X8, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). We also have audited ~~W~~ the Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal*

*Control - Integrated Framework: (20XX) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ~~W~~ the Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, ~~W~~ the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by ~~the Committee of Sponsoring Organizations of the Treadway Commission (~~COSO~~)~~."*].

Basis for Opinion

~~[*Scope paragraph*]~~

~~W~~ The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the ~~c~~Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements.~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

~~[~~*Definition* *and Limitations of Internal Control Over Financial Reporting* ~~*paragraph*]~~

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

~~[*Inherent limitations paragraph*]~~

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.88 If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (immediately following the opinion paragraph) to the auditor's report on the financial statements –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), ~~W~~ the Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (immediately following the opinion paragraph) to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the [ *identify financial statements* ] of ~~W~~ the Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

* * *

.B16 In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis for Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AS 4105, *Reviews of Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

* * *

.C4 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph .85D f, g, and h~~, and i~~); to do so might overshadow the disclaimer.

* * *

**AS 2405, *Illegal Acts by Clients***

* * *

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.[2]

[2] *See* AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2410, *Related Parties***

* * *

***Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions***

.18 If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[20]

[20] *See* AS 2805.06l, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. *See also* paragraphs .18~~35~~ .19~~36~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern***

* * *

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

> *c.* After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

* * *

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to reflect that conclusion.[4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13.

[4] The inclusion of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (*see* paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (*see* paragraphs .44-.47 of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

.13 An example follows of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.[5]

> [*Appropriate Title*]
>
> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AS 3105~~1~~.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in AS 3105~~1~~.

* * *

**AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***

* * *

.32 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph, including an appropriate title, should be added to the auditor's report because of the change in reporting period.[15]

[15] *See* ~~paragraphs .16-.18 of AS 3101,~~ ~~*Reports on Audited Financial Statements*~~ AS 2820, *Evaluating Consistency of Financial Statements.*

* * *

**AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments***

* * *

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (*see* paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (*see* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (*see* paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in AS 3105~~1~~.28~~45~~ through .32~~49~~ to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AS 2510, *Auditing Inventories***

* * *

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see paragraphs .07~~24~~ and .51~~67~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors***

* * *

[9] *See* paragraphs .54~~70~~ through .58~~74~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for reporting guidance.

* * *

**AS 2705, *Required Supplementary Information***

* * *

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph, including an appropriate title, in his report on the audited financial statements a disclaimer on the information. The following is an example of a disclaimer an auditor might use in these circumstances:

> [*Appropriate Title*]
>
> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

* * *

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in any of the following circumstances:[7] (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs, including appropriate titles, an auditor might use in these circumstances.

* * *

**AS 2710, *Other Information in Documents Containing Audited Financial Statements***

* * *

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph, including an appropriate title, describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

* * *

**AS 2801, *Subsequent Events***

* * *

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an ~~explanatory~~ emphasis paragraph directing the reader's attention to the event and its effects. (*See* paragraph .19 of AS 3101, ~~*Reports on Audited Financial Statements,*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*)

* * *

**AS 2805, *Management Representations***

* * *

[15] *See* paragraph .55~~71~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[18] *See* AS 3105~~1~~.05~~22 –~~.17~~34~~.

* * *

**AS 2810, *Evaluating Audit Results***

* * *

[7] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

.31

* * *

Note: According to AS 3105~~1~~, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18]

[18] AS 3105~~1~~.24~~41 –~~.27~~44~~.

* * *

.35 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AS 3105~~1~~ indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21]

[21] AS 3105~~1~~.05~~22~~ .17~~34~~ contains requirements regarding audit scope limitations.

* * *

**Appendix B**

[1] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**Appendix C**

[2] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (*See* AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

* * *

**AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"***

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the applicable financial reporting framework c~~ountry of origin of~~

~~those generally accepted accounting principles also~~ is required (*see* ~~paragraph .08*h* of AS 3101~~paragraph .08e of the AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

[1] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (*see* AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, and AS 3105~~1~~.19~~36~~).

* * *

**AS 2820, *Evaluating Consistency of Financial Statements***

* * *

.06 The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph, including an appropriate title, in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

* * *

.08 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph .07 have been met, the auditor should add an explanatory paragraph, including an appropriate title, to the auditor's report, as described in ~~AS 3101, *Reports on Audited Financial Statements*~~ paragraphs .12-.15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AS 3101~~.[8A]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to the auditor's report, as described in ~~AS 3101~~ paragraphs .12-.15.

[8A] AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.09 The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title, as described in ~~AS 3101~~ paragraphs .16 and.17 of this standard.

.10 The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph .31 of AS 2810, *Evaluating Audit Results*, and AS 3105~~1~~*, Departures from Unqualified Opinions and Other Reporting Circumstances*.

**Change in Classification**

.11 Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs .07, ~~and~~ .08, and ~~AS 3101~~ .12-.15. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs .09, ~~and~~ .10, ~~and~~ ~~AS 3101~~ .16 and.17.

**Reporting on Consistency of Financial Statements**

**Change in Accounting Principle**

.12 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph). The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

.13 The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.14 The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

.15 The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.16 Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph).[10] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. The following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10] AS 3105.52-53 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.17 This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

* * *

**AS 3110, *Dating of the Independent Auditor's Report***

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, *see* AS 4101 as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and *see* paragraphs .54~~70 -~~.57~~73~~ of AS 3105~~1~~, *~~Reports on Audited Financial Statements~~* *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period.

*** * ***

**AS 3305, *Special Reports***

.01 This section applies to auditors' reports issued in connection with the following:

*** * ***

*e.* Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

Note: In situations in which an auditor's report described in this section is filed with the U.S. Securities and Exchange Commission, the auditor is required to include in the auditor's report the basic elements and, for reports under subparagraph .01a, communication of critical audit matters, as would be required in an unqualified auditor's reporting under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[2] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (*see* paragraph .08 of AS 3101, Reports on Audited Financial Statements) modified as appropriate~~ because of the departures from generally accepted accounting principles (*see* AS 3105).

* * *

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. ~~With the exception of the requirement in AS 3101.08*h*, t~~The standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. ~~AS 3101.08*h*, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when~~ If the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles, the requirements for the auditor's report, as described in AS 3101 and AS 3105, are applicable.

* * *

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (*see* AS 3105~~1~~.48~~64~~). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement**

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

*** * ***

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

.17 The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in AS 3101.18~~1~~, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

.21 When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ in the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

*a.* *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,[35] the auditor should add an explanatory paragraph, including an appropriate title, to the report (immediately following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon[36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~AS 3101.16 through .18~~ AS 2820, *Evaluating Consistency of Financial Statements*.

*b.* *Going Concern Uncertainties*. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph, including an appropriate title, after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.[39]

*c.* *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in ~~section AS 3101.12 and .13~~ AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

*d.* *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph ~~preceding~~ immediately following the opinion paragraph of the report. Guidance on reporting in this situation is contained in AS 3105~~1~~.52~~68~~ and .53~~69~~.

* * *

**AS 3310, *Special Reports on Regulated Companies***

* * *

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (For example, public utilities and insurance companies.) Accordingly, the requirement in paragraph .08e~~*h*~~ of AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.[1] Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

* * *

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (*see* AS 3101.08), modified~~ modify the auditor's report as appropriate (*see* paragraphs .18-.43 of AS 3105~~1.35-.60~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

* * *

**AS 3315, *Reporting on Condensed Financial Statement and Selected Financial Data***

* * *

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in paragraphs .24~~41~~ through .27~~44~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, AS 3305, *Special Reports,* or other applicable PCAOB standards.[2]

* * *

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Report of Independent Registered Public Accounting Firm

> We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows~~ for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. ¶ In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~[6]~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[7]

~~[6] If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (*See* AS 3101.41 through .44) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Report of Independent Registered Public Accounting Firm.~~

~~We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.~~

> ~~We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended.~~

* * *

.10 The following is an example of an additional paragraph included in the Opinion on the Financial Statements section of the auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Report of Independent Registered Public Accounting Firm~~

> ~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the~~

~~responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

<u>Opinion on the Financial Statements</u>

<u>*[Same basic elements in the Opinion on the Financial Statements section as the auditor's unqualified report in AS 3101]*</u>

In our opinion, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of the ~~ABC~~ <u>the</u> Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with the standards of the Public Company Accounting Oversight Board <u>(United States) ("PCAOB")</u>, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for the years ended December 31, 20X2, and 20X1, and the related notes [*and schedules*] (collectively referred to as the "20X3, 20X2, and 20X1 consolidated financial statements") (none of which are presented herein); and we expressed unqualified opinions on those 20X3, 20X2, and 20X1 consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

* * *

**AS 3320, *Association with Financial Statements***

* * *

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in AS 4105, *Reviews of Interim Financial Information*.

* * *

**AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes***

* * *

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

*a.* Read pertinent portions of the prospectus and of the registration statement.

*b.* Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (*see* AS 3105~~1~~, ~~Reports on Audited Financial Statements~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

**AS 4105, *Reviews of Interim Financial Information***

* * *

**Form of Accountant's Review Report**

* * *

.37 The accountant's review report accompanying interim financial information ~~should consist of~~ must include the title, "Report of Independent Registered Public Accounting Firm."

.37A If the accountant's review report is included in a filing with the SEC or another regulatory agency, the report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The accountant's review report may include additional addressees.

.37B The first section of the accountant's review report must include the section title "Results of Review of Interim Financial Information" and the following elements:

~~a. A title that includes the word independent.~~

a. The name of the company whose interim financial information was reviewed.

b. A statement that the interim financial information identified in the report was reviewed.

c~~g~~. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying interim financial information for it to conform with generally accepted accounting principles. The statement should include an identification of the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

.37C The second section of the accountant's review report must include the section title "Basis for Review Results" and the following elements:

a~~c~~. A statement that the interim financial information is the responsibility of the entity's management.

b~~d~~. A statement that the review of interim financial information was conducted in accordance with the standards of the PCAOB.

c~~e~~. A description of the procedures for a review of interim financial information.

d~~f~~. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

e. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

.37D The accountant's review report must include the following elements:

a~~h~~. The ~~manual or printed~~ signature of the accountant's firm.[24A]

b~~i~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.[24~~A~~B]

c~~j~~. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures.[25])

In addition, each page of the interim financial information should be clearly marked as unaudited.

[24A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

[24~~A~~B] *Id.*~~*See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

.38 The following is an example of a review report:[26]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [27]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the condensed consolidated balance sheet of ABC Company (the "Company") and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of ~~ABC~~ the Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.[28]

Basis for Review Results

These financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

[28] If the auditor's report on the preceding year-end financial statements was other than unqualified, referred to other auditors, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the ~~last~~ second paragraph of the illustrative report in paragraph .39 should be appropriately modified.

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.[29] The following is an example of report including such a reference:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of

September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

<u>Basis for Review Results</u>

<u>This (These) interim financial information (statements) is (are) the responsibility of the Company's management.</u> We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) <u>("PCAOB")</u>. A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the <u>PCAOB</u> ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.41 The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,~~[30]~~ which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. *See* paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~[30] If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in paragraph .15 of AS 3101, Reports on Audited Financial Statements.~~

.42 *Departure from generally accepted accounting principles.* If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. Following is an example of such a modification of the accountant's report.

> ~~[*Concluding paragraph*]~~
>
> Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.
>
> ~~[*Explanatory third paragraph*]~~
>
> Based on information furnished to us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that we believe should be capitalized to conform with

accounting principles generally accepted in the United States of America. This information indicates that if these lease obligations were capitalized at September 30, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively, for the three-month and nine-month periods then ended.

* * *

.43 *Inadequate disclosure*. The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30, which is applicable to summarized financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.[31] If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles[32] is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information in the report. The following is an example of such a modification of the accountant's report:

~~[*Concluding paragraph*]~~

Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

~~[*Explanatory third paragraph*]~~

Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 20X1 through 20X3 in the aggregate amount of approximately $_____, and that the extent of the company's liability, if any, and the effect on the accompanying information (statements) is not determinable at this time. The information (statements) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with accounting principles generally accepted in the United States of America.

.44 *Going-concern paragraph was included in the prior year's audit report; conditions giving rise to the paragraph continue to exist.* If (*a*) the auditor's report for the prior year end contained an explanatory paragraph indicating the existence of substantial doubt about the entity's ability to continue as a going concern, (*b*) the conditions that raised such doubt continued to exist as of the interim reporting date covered by the review, and (*c*) there is adequate and appropriate disclosure about these conditions in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report,~~ after the concluding paragraph,~~ including an appropriate title (immediately following the paragraph describing the results of the review), emphasizing the matter disclosed in the audited financial statements and the interim financial information. The following is an example of such a paragraph.

> [Appropriate Title]
>
> Note 4 of the Company's audited financial statements as of December 31, 20X1, and for the year then ended discloses that the Company was unable to renew its line of credit or obtain alternative financing at December 31, 20X1. Our auditor's report on those financial statements includes an explanatory paragraph referring to the matters in Note 4 of those financial statements and indicating that these matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 3 of the Company's unaudited interim financial statements as of March 31, 20X2, and for the three months then ended, the Company was still unable to renew its line of credit or obtain alternative financing as of March 31, 20X2. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

.45 *Going-concern paragraph was not included in the prior year's audit report; conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern.* If (*a*) conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern, and (*b*) there is adequate and appropriate disclosure about these conditions or events in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the~~

~~concluding paragraph~~, including an appropriate title (immediately following the paragraph describing the results of the review), emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

> [Appropriate Title]
>
> As indicated in Note 3, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

* * *

.50 The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

c. The selected quarterly financial data required by item 302(a) of Regulation S-K is omitted. The auditor should add an explanatory paragraph, including an appropriate title, to the report, ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) is omitted. The following is an example of such a paragraph.

> [Appropriate Title]

The company has not presented the selected quarterly financial data specified in item 302(a) of Regulation S-K that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The auditor should add an explanatory paragraph, including an appropriate title, to the report, ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) has not been reviewed. The following is an example of such a paragraph.

[Appropriate Title]

The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

**AS 6101, *Letters for Underwriters and Certain Other Requesting Parties***

* * *

.27 When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory~~

~~paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report,~~ the accountants should refer[18] to that fact in the comfort letter and discuss the subject matter of the paragraph.[19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (*See also* paragraph .35*f*.)

* * *

.30 An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which AS 4105 pertains or (*b*) required supplementary information, to which AS 2705 pertains. AS 4105 and AS 2705 provide that the accountants should expand the ~~standard~~ <u>auditor's unqualified</u> report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ <u>auditor's unqualified</u> report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (*see also* paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by AS 4105 and AS 2705, the accountants may do so and report their findings.

* * *

.35

* * *

*f.* When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

* * *

**AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210***

* * *

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.[14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with paragraphs .18~~35~~ through .43~~60~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with AS 3105~~1~~.05~~22~~–.09~~26~~ and AS 3105~~1~~.44~~61~~–.47~~63~~.

* * *

**AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501***

* * *

.03 *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an emphasis-of-matter paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (*see* paragraph .19 of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

**AI 17, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505**

* * *

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in paragraphs .28~~45~~ through .32~~49~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AI 20: *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710***

* * *

.08 *Interpretation*—If the auditor has been engaged to ~~examine and report on management's assertion, the guidance in AT section 501,~~ ~~*Reporting on an Entity's Internal Control Over Financial Reporting*~~~~, should be followed~~ perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirement of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.09 If the auditor has not been engaged to <u>perform an audit of management's assessment of the effectiveness of internal control over financial reporting</u> ~~examine and report on management's assertion~~, the auditor should follow the <u>requirements in AS 3105.59-60.</u> ~~guidance in AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact.[5]~~

~~[5] Unless information on internal control over financial reporting appears in the financial statements, which is not common, a management assertion on the effectiveness of internal control over financial reporting could not be inconsistent with information appearing in financial statements.~~

~~.10 Although not required, the auditor may consider adding the following paragraph to the standard auditor's report: "We were not engaged to examine management's assertion about the effectiveness of [*name of entity's*] internal control over financial reporting as of [*date*] included in the accompanying [*title of management's report*] and, accordingly, we do not express an opinion thereon."~~

* * *

**AI 23, ~~Reports on Audited Financial Statements: Auditing Interpretations of AS 3101~~ <u>Departures from Unqualified Opinions and Other Reporting Circumstances</u>: Auditing Interpretations of AS 310<u>5</u>~~1~~**

* * *

.01 *Question*— Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

.36 ~~Examples of~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[1A] ~~with such an explanatory paragraph follow.~~

~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~

Opinion on the Financial Statements

~~"~~We have audited the statement of net assets in liquidation of XYZ Company (the "Company") as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2~~.~~, ~~In addition, we have~~ and audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the net assets in liquidation of ~~XYZ~~ the Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below. ~~in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~-~~We are a public accounting firm registered with the Public Company

Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

"We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audit included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit provides a reasonable basis for our opinion.

[1A] The auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~ An example of the Opinion on the Financial Statements and the Basis for

Opinion sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:[1B]

Opinion on the Financial Statements

~~"~~We have audited the balance sheet of XYZ Company (the "Company") as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and~~. In addition, we have~~ audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~XYZ~~ the Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below. ~~in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audits included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[1B] *Id.*

* * *

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

.51 *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

**14. Reporting on Audits Conducted in Accordance with the Standards of the**

**PCAOB and in Accordance with International Standards on Auditing**

* * *

.56 *Question*—AS 3101 requires ~~states that a basic element of the auditor's report is~~ a statement that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

.57 *Interpretation*—Yes. AS 3101 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~; however, AS 3101 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.

* * *

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. ~~An~~ Our audit included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of

> the financial statements. We believe that our audit provides a reasonable basis for our opinion.

* * *

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to AS 3105~~1~~.58~~74~~ the successor auditor should indicate in the ~~introductory paragraph~~ Opinion on the Financial Statements section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 18~~29~~ of AS 3105~~1~~ indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Opinion on the Financial Statements section of the successor auditor's report is presented as follows:

> The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

* * *

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

* * *

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

* * *

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to 3105~~1~~.58~~74~~?

.75 *Interpretation*—No. AS 3105~~1~~.58~~74~~ is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

* * *

**AI 24, *Special Reports: Auditing Interpretations of AS 3305***

* * *

[10] Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in AS 3105~~1~~.18~~35 -~~.27~~44~~ and .40~~58 -~~ .43~~60~~.

* * *

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105~~1~~.18~~35 -~~.27~~44~~ and .40~~58 -~~.43~~60~~.

* * *

***AI 25, Association with Financial Statements: Auditing Interpretations of AS 3320***

* * *

.15 *Question*—Paragraph .01~~.04~~ of ~~AS 3101, *Reports on Audited Financial Statements,*~~ AS 3320, *Association with Financial Statements*, states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." ~~Paragraph .03 of~~ AS 3320.03~~, Association with Financial Statements,~~ states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

* * *

**AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations***

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.10 Auditing standards require the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph .35 of AS 2810, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, AS 2805, *Management Representations*, requires the auditor to obtain written representations from management. AS 2805.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

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EXHIBIT 1

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-XXXXX; File No. PCAOB-2017-01)

[Date]

Public Company Accounting Oversight Board; Notice of Filing of Proposed Rules on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Departures from Unqualified Opinions and Other Reporting Circumstances, and Related Amendments to Auditing Standards

Pursuant to Section 107(b) of the Sarbanes-Oxley Act of 2002 (the "Act" or "Sarbanes-Oxley Act"), notice is hereby given that on [Date of Form 19b-4 Submission], the Public Company Accounting Oversight Board (the "Board" or "PCAOB") filed with the Securities and Exchange Commission (the "Commission" or "SEC") the proposed rules described in Items I and II below, which items have been prepared by the Board. The Commission is publishing this notice to solicit comments on the proposed rules from interested persons.

I. Board's Statement of the Terms of Substance of the Proposed Rules

On June 1, 2017, the Board adopted new rules and amendments to auditing standards (collectively, the "proposed rules") to make the auditor's report more informative and relevant to investors and other financial statement users. The text of the proposed rules appears in Exhibit A to the SEC Filing Form 19b-4 and is available on the Board’s website at https://pcaobus.org/Rulemaking/Pages/Docket034.aspx and at the Commission’s Public Reference Room.

II. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

In its filing with the Commission, the Board included statements concerning the purpose of, and basis for, the proposed rules and discussed any comments it received on the proposed rules. The text of these statements may be examined at the places specified in Item IV below. The Board has prepared summaries, set forth in sections A, B, and C below, of the most significant aspects of such statements. In addition, the Board is requesting that the Commission approve the proposed rules and related amendments, with the exception of the requirements related to critical audit matters, pursuant to Section 103(a)(3)(C) of the Sarbanes-Oxley Act, for application to audits of emerging growth companies ("EGCs"), as that term is defined in Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act"). The Board's request is set forth in section D.

A. Board's Statement of the Purpose of, and Statutory Basis for, the Proposed Rules

(a) Purpose

Summary

The Board has adopted a new auditor reporting standard, AS 3101, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "final standard" or "AS 3101") and related amendments to its auditing standards that will require the auditor to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters—matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and

(2) involved especially challenging, subjective, or complex auditor judgment;

- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor; and
- Other improvements to the auditor's report—a number of other improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

The Board believes that adopting these requirements responds to the strong interest of investors for enhanced communication about the audit and is consistent with its mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[1]

The Board has adopted the final standard after more than six years of outreach and public comment, including comments from members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG"). The Board has taken into consideration all comments and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate.

Investors are the beneficiaries of the audit and the auditor's report is the primary means by which the auditor communicates with them. Currently, however, the auditor's report conveys little of the information obtained and evaluated by the auditor as part of the audit. And while the auditor's report has generally remained unchanged since the

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[1] Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7211(a).

1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates, including fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, but the auditor's report does not communicate this information to investors. Stated differently, the auditor's report does little to address the information asymmetry between investors and auditors,[2] even though investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for their benefit.[3] The Board believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. Outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed

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[2] Economists often describe this imbalance, where one party has more or better information than another party, as "information asymmetry." As part of the system of financial reporting, the audit of the financial statements helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

[3] *See* PCAOB IAG survey, *Improving the Auditor's Report* (Mar. 16, 2011) ("IAG 2011 survey"). *See also* CFA Institute's *Usefulness of the Independent Auditor's Report Survey Results* (May 4, 2011), *Independent Auditor's Report Survey Results* (Mar. 31, 2010), and *Independent Auditor's Report Monthly Poll Results* (Mar. 12, 2008) ("CFA survey and poll results"). *See also* Board public meeting transcripts and participant statements (Apr. 2-3, 2014), available on the Board's website in Rulemaking Docket Matter No. 034, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* ("Docket 034").

these matters. The Board believes that these matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements. The final standard is designed to elicit more information about the audit directly from the auditor. The Board believes that the critical audit matter requirements will respond to requests from investors for more information from the auditor while appropriately addressing concerns raised by other commenters.

Investors and investor advocates have suggested a variety of ways in which investors can use the information provided in critical audit matters. In the view of some investors, critical audit matters will add to the total mix of information, providing insights relevant in analyzing and pricing risks in capital valuation and allocation, and contributing to their ability to make investment decisions. Investors also stated that critical audit matters will focus their attention on key financial reporting areas and identify areas that deserve more attention, enhancing the efficiency of investors and others in the consumption of financial information. Some investors believe that critical audit matters will highlight areas that they may wish to emphasize in their engagement with the company and provide important information that they can use in making proxy voting decisions, including ratification of the appointment of auditors.

The final standard also includes a new required statement in the auditor's report disclosing the year in which the auditor began serving consecutively as the company's auditor, as well as a number of other improvements to the auditor's report, such as a statement regarding the requirement for the auditor to be independent. Requiring disclosure of auditor tenure in the auditor's report will make this information readily accessible in a timely way for investors who find it useful. The other improvements to the auditor's report are intended to enhance the user's understanding of the auditor's role and responsibilities related to the audit of the financial statements, make the auditor's report easier to read, and provide a consistent format.

The final standard will generally apply to audits conducted under PCAOB standards. However, communication of critical audit matters is not required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 (the "Exchange Act") Rule 17a-5; investment companies other than business development companies; employee stock purchase, savings, and similar plans ("benefit plans"); and emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act. Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily. The other requirements of the final standard will apply to these audits.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit.

The Board has adopted a phased approach to the effective dates for the new requirements to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the additional improvements to the auditor's report. Subject to approval by the Securities and Exchange Commission ("SEC"), the final standard and amendments will take effect as follows:

- All provisions other than those related to critical audit matters will take effect for audits of fiscal years ending on or after December 15, 2017; and

- Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

(b) Statutory Basis

The statutory basis for the proposed rules is Title I of the Act.

B. Board's Statement on Burden on Competition

Not applicable.

C. Board's Statement on Comments on the Proposed Rules Received from Members, Participants or Others

The Board released the proposed rule amendment for public comment in *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-003 (June 21, 2011) ("concept release"), *Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (Aug. 13, 2013) ("proposal"), *Proposed Auditing Standard—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and*

*Related Amendments to PCAOB Standards*, PCAOB Release No. 2016-003 (May 11, 2016) ("reproposal"). See Exhibit 2(a)(A). A copy of Release Nos. 2011-003, 2013-005, 2016-003 and the comment letters received in response to the PCAOB's requests for comment are available on the PCAOB's website at https://pcaobus.org/Rulemaking/Pages/Docket034.aspx. The Board received 491 written comment letters. The Board's response to the comments it received and the changes made to the rules in response to the comments received are discussed below.

Discussion of the Final Standard

*Critical Audit Matters*

Under the final standard, the auditor will be required to communicate critical audit matters in the auditor's report in order to provide more information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users.

Investor, investor advocate, and analyst commenters generally supported the reproposed requirement to communicate critical audit matters. Some of them stated that the communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor, focusing attention on issues that would be pertinent to understanding the financial statements, and enhancing investor confidence in the financial statements.

The larger and some smaller accounting firms generally supported including critical audit matters in the auditor's report with some modification of the reproposed requirements. Other commenters, including other smaller accounting firms, companies, and audit committee members, did not support the requirements. Some of these commenters asserted that critical audit matters would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit.

Other commenters suggested that the Board align the definition of critical audit matters with the International Auditing and Assurance Standards Board's ("IAASB") definition of key audit matters to enhance overall consistency.

Consistent with the Board's statutory mandate under Section 101(a) of Sarbanes-Oxley and in response to the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommendation and continued investor support for expanded auditor reporting, the final standard includes the requirement to communicate critical audit matters substantially as reproposed. The Board has taken into consideration all comments, including concerns raised by some commenters, which are described in more detail below, and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate. The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed those matters.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

*Determination of Critical Audit Matters*

Definition of Critical Audit Matter

The reproposed standard defined a critical audit matter as any matter arising from the audit of the financial statements that was *communicated or required to be communicated to the audit committee* and that *relates to accounts or disclosures that are material to the financial statements* and *involved especially challenging, subjective, or complex auditor judgment*. For the reasons explained below, the Board is adopting the definition as reproposed.

Communicated or Required to be Communicated to the Audit Committee

Most commenters agreed that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters. These commenters stated that matters communicated to the audit committee are the most meaningful to users of the financial statements and using them as the source of critical audit matters would assist the auditor in determining critical audit matters in the most efficient and effective manner.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;
- Certain matters regarding the company's accounting policies, practices, and estimates;

- Significant unusual transactions;
- Certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Several commenters suggested revising the source of critical audit matters. Some suggested narrowing the source of critical audit matters only to matters required to be communicated to the audit committee, on the basis that this would avoid chilling communications regarding non-required matters and reduce the burden of documentation. Other commenters suggested that the Board consider, as an alternative, selecting critical audit matters only from critical accounting policies and estimates disclosed by management, which some said would eliminate the potential for the auditor to become the original source of information, as well as the potential for conflicting disclosures between the auditor and management. Some commenters also recommended not specifying the source for critical audit matters and leaving it up to auditor judgment. Other commenters suggested broadening the source of critical audit matters to include matters documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated with management and other members of the board of directors, as the Board had originally proposed in 2013.

The final standard retains the source of critical audit matters as reproposed. Critical audit matters will be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). The source will include auditor communication requirements under

AS 1301, *Communications with Audit Committees*, other PCAOB rules and standards,[4] and applicable law,[5] as well as communications made to the audit committee that were not required. This approach scopes in the broadest population of audit committee communications and will not require the auditor to determine whether matters communicated to the audit committee were required to be communicated. However, it seems likely that matters that meet the definition of a critical audit matter will usually relate to areas that are required to be communicated to the audit committee, either under a specific communication requirement or the broad provisions of paragraph .24 of AS 1301, which requires communication of matters arising from the audit that are significant to audit committee oversight of the financial reporting process.

Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements.

The final standard does not limit the source of critical audit matters to critical accounting policies and estimates because the Board does not believe this would be an appropriate starting point in light of investor interest in a broader range of topics related to the audit. Additionally, the final standard does not broaden the source, as proposed in

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[4] *See* Appendix B of AS 1301, which identifies other PCAOB rules and standards that require audit committee communication, such as AS 2410, *Related Parties*, and AS 2502, *Auditing Fair Value Measurements and Disclosures*.

[5] *See*, *e.g.*, Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Exchange Act Rule 10A-3, 17 CFR 240.10A-3.

2013, to also include matters documented in the engagement completion document and reviewed by the engagement quality reviewer because it is unlikely that a matter that is determined to be a critical audit matter would not have already been communicated to the audit committee.

Some commenters suggested that using audit committee communications as the source for critical audit matters could impair the relationship between auditor, management, and the audit committee (e.g., chill communications, give rise to conflict, or cause auditors to communicate more than they otherwise would). However, other commenters argued that critical audit matters would enhance, not impair, communications between auditors, investors, and those charged with governance (including audit committees). For matters required to be communicated to the audit committee, the Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing. It would seem that any chilling effect would more likely relate to matters that are not explicitly required to be communicated to the audit committee, although given the broad requirements of AS 1301 (particularly paragraph .24), the Board believes that there may be few, if any, relevant communications affected by that possibility.

Some commenters suggested excluding certain required audit committee communications from the source of critical audit matters, generally because these communications relate to sensitive areas and may result in the auditor communicating information not disclosed by management. Suggestions included: corrected and uncorrected misstatements, qualitative aspects of significant accounting policies and practices, alternative treatments within generally accepted accounting principles ("GAAP") for policies and practices related to material accounts, violations or possible violations of law or regulation, independence considerations, disagreements with management, other material written communications between the auditor and management, overall planned audit strategy, delays encountered in the audit, and competency issues of management. Other commenters argued that no audit committee communications should be specifically excluded from consideration as a source of potential critical audit matters.

The final standard does not exclude any required audit committee communications from the source of critical audit matters. To the extent that any such communication met the critical audit matter definition (including that it (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment), the Board believes it will be an appropriate subject for an auditor to communicate as a critical audit matter.

Relates to Accounts or Disclosures That Are Material to the Financial Statements

The materiality component of the reproposed definition of critical audit matters—that the matter "relates to accounts or disclosures that are material[6] to the financial

[6] The definition of materiality is established under the U.S. federal securities laws. In interpreting those laws, the U.S. Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *See also Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ." *TSC Industries*, 426 U.S. at 450.

statements"— was intended to respond to investor requests for informative and relevant auditor's reports while, at the same time, addressing other commenters' concerns regarding auditor communication of immaterial information that management is not required to disclose under the applicable financial reporting framework and SEC reporting requirements.

Some investor commenters suggested removing the materiality component of the reproposed definition of critical audit matters, arguing that it made the definition too narrow and would unnecessarily exclude relevant information. Some of these commenters observed that many cases of material accounting problems or fraud started as 'immaterial' to the financial statements and built over time, and that such matters may not meet the reproposed definition of a critical audit matter because of the materiality component.

Other commenters, primarily companies and accounting firms, argued that the reproposed definition was too broad and suggested modifying the materiality component such that a critical audit matter would itself have to be material to the financial statements as a whole, rather than relating to accounts or disclosures that are material to the financial statements. These commenters expressed concern that the phrase "relates to accounts or disclosures that are material to the financial statements" could apply to too many matters, resulting in the auditor disclosing immaterial matters that would not otherwise be disclosed by management, or give the impression of a piecemeal opinion.

After consideration of comments, the Board has determined to adopt the materiality component in the final definition of critical audit matter as reproposed. In the Board's view, the purpose of the standard—making the auditor's report more useful and informative to investors—is better served by auditor communication of matters related to accounts or disclosures that are material to the financial statements. As one commenter noted, limiting the source of critical audit matters and adding a materiality component that directly relates to accounts and disclosures "would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of [critical audit matters] within the auditor's report that could deemphasize their importance."[7]

At the same time, in the Board's view, limiting critical audit matters to those that are, in and of themselves, material to the financial statements as a whole would not serve the intended purpose of the standard. If the auditor were required to determine that a critical audit matter itself is material, rather than related to an account or disclosure that is material, it is likely that fewer matters would meet the definition of a critical audit matter and, thus, investors would likely receive less, and less audit-specific, information than under the standard as adopted.

Accordingly, as in the reproposal, the final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Consistent with the reproposal, "relates to" clarifies that the critical audit matter could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter if goodwill was material to the financial statements, even if there was

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[7] *See* letter from Dixon Hughes Goodman, LLP (Aug. 15, 2016) at 2, available on the Board's website in Docket 034 (also noting that there is a continuing risk that the auditor could disclose information about the company that was not previously disclosed by the company).

no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. For example, the auditor's evaluation of the company's ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit.

On the other hand, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. For example, a potential loss contingency that was communicated to the audit committee, but that was determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter; it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter would not relate to an account or disclosure that is material to the financial statements.

For the same reason, the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, cannot be a critical audit matter; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a critical audit matter.[8]

Involved Especially Challenging, Subjective, or Complex Auditor Judgment

Many commenters supported including "matters that involved especially challenging, subjective, or complex auditor judgment" in the reproposed definition of a critical audit matter. Other commenters argued that the phrase "especially challenging, subjective, or complex auditor judgment" is broad and subjective and would lead to inconsistent application of the reproposed definition. For example, some commenters said that critical audit matters would vary based on the experience and competence of the auditor, even if the underlying facts and circumstances were the same. One commenter urged disclosure of the auditor's perspective on material related party transactions. Another commenter suggested that the standard include a note stating that it is expected that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment.

Several commenters suggested using the IAASB's definition of key audit matters, which includes those matters that were of most significance in the audit of the financial statements and that required significant auditor attention. One commenter argued that this would avoid reliance on the auditor's determination of whether a matter involved especially challenging, subjective, or complex auditor judgment, which the commenter said would give auditors too much discretion.

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[8] *See* below for additional considerations related to auditor disclosure of original information.

After consideration of comments, the Board is adopting this component of the definition of critical audit matter as reproposed, namely "matters that involved especially challenging, subjective, or complex auditor judgment." This grounds the definition in the auditor's expertise and judgment, which is directly responsive to investor requests for information from the auditor's point of view. Thus, the Board believes that this definition will focus critical audit matters in areas where investors will particularly benefit from expanded reporting by the auditor.

The determination of critical audit matters is principles-based and the final standard does not specify any items that would always constitute critical audit matters. For example, the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be critical audit matters.[9] Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. To illustrate, improper revenue recognition is a presumed fraud risk and all fraud risks are significant risks;[10] however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it will not be a critical audit matter. Similarly, the final standard does not provide, as some commenters suggested, that material related party transactions or matters involving the application of significant judgment or estimation by management always constitute critical audit matters. The auditor must determine, in the context of the specific audit, that a matter involved

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[9] A significant risk is a "risk of material misstatement that requires special audit consideration." Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[10] *See* AS 2110.71.

especially challenging, subjective, or complex auditor judgment. In addition, focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. To the extent that critical audit matters reflect differences in auditors' experience and competence, this in itself should also be informative.

Factors

The reproposal included the following nonexclusive list of factors for the auditor to take into account, together with audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

c. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

d. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

e. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

f. The nature of audit evidence obtained regarding the matter.

Commenters in general agreed that including such factors would assist the auditor in determining critical audit matters.

Some commenters suggested changes to better align the factors with areas of complex management judgment, to reduce the risk that the auditor would be the source of original information, to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures, and to focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence rather than audit strategy decisions. Some commenters suggested harmonizing the factors with the IAASB's factors for determining key audit matters.

After considering the comments received, the Board has modified the factors by reordering them and revising the factor relating to the degree of auditor subjectivity (factor b above) to refer to the application (rather than determination) of audit procedures, which focuses it more clearly on the performance of the audit rather than audit strategy.

Some commenters suggested that the factor pertaining to the nature and extent of the audit effort (factor c) be revised to relate to the nature and extent of audit effort required to obtain sufficient appropriate audit evidence to address a matter and the factor pertaining to the nature of audit evidence (factor f) be deleted to clarify that obtaining audit evidence is a component of audit effort. The final standard does not change factor c as suggested because it would inappropriately narrow the factor exclusively to considerations related to obtaining audit evidence rather than the nature of the overall audit effort. Additionally, the Board determined to retain factor f as a stand-alone factor because, as stated in the reproposal, in the limited implementation trial conducted by several accounting firms, this factor appeared to be one of the most useful in determining critical audit matters.[11]

A commenter recommended including a factor based on the extent of interaction with the audit committee. The final standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or subjectivity of the matter and it could create incentives to limit communication between the auditor and the audit committee.

One commenter did not agree with elimination of two proposed factors that related to the severity of control deficiencies and corrected and uncorrected misstatements. These factors were eliminated from the reproposal in response to comments that the factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework. For these reasons, the final standard does not include these factors.

Under the final standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor should take into account the following nonexclusive list of factors, as well as other audit-specific

[11] *See* letter from the Center for Audit Quality (June 19, 2014) at 5, available on the Board's website in Docket 034.

factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

f. The nature of audit evidence obtained regarding the matter.

The determination should be made in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. The factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective, or complex auditor judgment. Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on one or more of these factors, other factors specific to the audit, or a combination.

Audit Period Covered by Critical Audit Matters

The reproposal would have required the auditor to communicate critical audit matters for the audit of the current period's financial statements. Because the communication of critical audit matters for prior periods might also be useful to investors and other financial statement users in certain situations, the reproposed standard provided that the auditor may communicate critical audit matters relating to a prior period when: (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

Some commenters generally supported communicating critical audit matters for only the current period's financial statements or for all periods if audited financial statements have not been made public previously. Other commenters supported communication of critical audit matters for all periods presented along with an explanation if prior year critical audit matters are not repeated in the current year. Yet another commenter stated that the auditor should be encouraged to use judgment as to whether to include critical audit matters for prior periods and not limit the consideration only to the circumstances described in the reproposal.

The final standard retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most auditor's reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, will provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users will be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor could choose to include critical audit matters for prior periods. The final standard clarifies that the two situations relating to a prior period are examples rather than the only situations in which a critical audit matter for a prior period may be communicated.

As noted in the reproposal, if the auditor's report is dual-dated, the auditor will determine whether the new information for which the auditor's report is dual-dated gives rise to any additional critical audit matters.

In situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated because it is only required for the current year. However, the predecessor auditor could choose to include prior year critical audit matters in the reissued auditor's report.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* Under the IAASB's standard, "key audit matters" are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are determined using a two-step process. First, the auditor identifies the matters communicated with those charged with governance[12] that required significant auditor attention in performing the

[12] *See* paragraph 8 of ISA 701. *See also* ISA 260, *Communication with Those Charged with Governance*, which provides requirements for auditor communications with those charged with governance.

audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks;
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect on the audit of significant events or transactions that occurred during the period.[13]

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.[14] The IAASB requires the communication of key audit matters for the current period only.[15]

*European Union ("EU").* The EU requires the auditor to describe the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud.[16] The EU does not specify the period for which these need to be described.

*Financial Reporting Council in the United Kingdom ("FRC").* The FRC requires the auditor to describe the risks of material misstatement that had the greatest effect on:

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[13] *See* paragraph 9 of ISA 701.

[14] *See* paragraph 10 of ISA 701.

[15] *See* paragraphs 8 and 10 of ISA 701.

[16] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

(1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team.[17] The FRC does not specify the period for which these need to be described.

*Communication of Critical Audit Matters*

Under the reproposal, the auditor would have been required to include introductory language in the auditor's report preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor's principal considerations for determining that the matter was a critical audit matter, describing how the critical audit matter was addressed in the audit, and referring to the relevant financial statement accounts and disclosures.

Comments varied on the reproposed requirements for communication of critical audit matters and the level of detail the auditor should provide, including whether the auditor should be permitted to provide information about the company that has not been previously disclosed by the company (which commenters referred to as "original information"). Commenters generally agreed with identifying each critical audit matter and referring to the relevant financial statement accounts and disclosures. One commenter suggested removing the requirements to describe the considerations for determining that a matter was a critical audit matter and how the critical audit matter was addressed in the audit. While some commenters stated that the proposed requirements regarding auditor's communication of critical audit matters are sufficiently clear, many suggested improvements to some of the components of the communication requirements.

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[17] *See* paragraph 19A of UK ISA 700 (2013).

After consideration of comments, the Board has made some enhancements to the communication requirements, as described below.

Introductory Language

The reproposed standard provided introductory language to be included in the "Critical Audit Matters" section of the auditor's report indicating that critical audit matters did not alter the opinion on the financial statements and that the auditor was not providing a separate opinion on the critical audit matters. Some commenters supported the introductory language on the basis that it could minimize users' potential misunderstanding of the critical audit matters.

Some commenters suggested additions to the introductory language to emphasize that critical audit matters are subjective and may not represent the most important aspects of the financial statements, to clarify that the description of procedures should not be taken as indicative of results of any individual procedure, or to limit reliance on critical audit matters by adding language similar to that used in a report on an audit of internal control over financial reporting ("ICFR").[18] The introductory language in the final standard does not include the suggested additions because such language could be interpreted as disclaiming or inappropriately minimizing the communication of critical audit matters.

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[18] The auditor's report on the audit of internal control over financial reporting requires a paragraph stating that, "because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate." *See* paragraph .85j of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Other commenters suggested minor revisions in the introductory language to refer to the "communication of critical audit matters" rather than the critical audit matters themselves. In response to this comment, the required introductory language in the final standard has been revised as follows (additions are *in italic* and deletions are in {brackets}):

> The critical audit matters communicated below are matters arising from the current period audit *of the financial statements* that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. *The communication of* {C}*c*ritical audit matters do*es* not alter in any way our opinion on the financial statements, taken as a whole, and we {do} *are* not, *by communicating the critical audit matters below*, {provide} *providing* separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Communication Requirements

The reproposal required that, for each critical audit matter, the auditor would:

- Identify the critical audit matter;
- Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describe how the critical audit matter was addressed in the audit; and

- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

As discussed in more detail below, these requirements have been adopted substantially as reproposed.[19]

*Identify the Critical Audit Matter and Describe the Principal Considerations that Led the Auditor to Determine that the Matter is a Critical Audit Matter*

Many commenters who addressed this topic supported the identification of the critical audit matter and limiting the description to "the principal considerations" that led the auditor to determine that the matter is a critical audit matter, and those aspects of the communication requirements are adopted as reproposed. The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication will be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

*Describe How the Critical Audit Matter was Addressed in the Audit*

The reproposed standard included a new requirement for the auditor to describe how the critical audit matter was addressed in the audit. While the standard did not

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[19] The reproposing release included two illustrative examples of the communication of critical audit matters. *See* PCAOB Release No. 2016-003, Section IV.A.2.b. Given the principles-based nature of the requirements for critical audit matters and the objective of providing tailored, audit-specific information, the examples were intended to function as illustrations of how critical audit matters could be communicated, and not as templates for how critical audit matters should be communicated. Comments received on these examples were taken into account in the Board’s consideration of the final standard. Illustrative examples do not appear in the adopting release because the Board believes auditors should provide tailored, audit-specific information when communicating critical audit matters in the auditor’s report.

specify how this should be done, the reproposing release provided four examples of potential approaches to such descriptions: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements.[20]

Many commenters were supportive of a requirement to describe how each critical audit matter was addressed in the audit. Some commenters asserted that a description of how a critical audit matter was addressed would benefit investors by providing insights on how and on what basis the auditor developed the opinion or the rigor that underlies the audit procedures performed. For example, one investor commenter stated that including audit procedures in the description of a critical audit matter would make the auditor's report more informative and useful. Several investors suggested that the auditor should be required or encouraged to provide informative, company-specific findings when describing how the critical audit matter was addressed in the audit, such as whether management's significant accounting estimates and judgments were balanced, mildly optimistic, or mildly pessimistic.

One commenter suggested that the description of how the critical audit matter was addressed in the audit should be optional. Several commenters objected to the auditor including audit procedures in the description of critical audit matters because it would not provide any incremental value or actionable information to investors, investors may not have the expertise or context to understand audit procedures, or the description of audit

[20] These elements are similar to the IAASB's elements described in paragraph A46 of ISA 701. The EU also requires that the auditor describe key observations with respect to the most significant assessed risks of material misstatement.

procedures would become boilerplate. One commenter suggested adding a note to clarify that the purpose of describing audit procedures is to provide information about the audit but not specific details that would compromise the effectiveness of audit procedures. Other commenters suggested that only the principal audit procedures should be provided.

The final standard includes the requirement for the auditor to describe how the critical audit matter was addressed in the audit because it is consistent with the Board's objective of providing more information about the audit and, if developed with an appropriate focus on the intended audience, should be of interest to users. Similar to the reproposal, the final standard does not prescribe a specific way to meet this requirement. Several commenters suggested that the four examples provided in the reproposing release be included in the standard because they provide helpful guidance on how the requirement could be met. The final standard includes a note incorporating these examples, which should clarify the Board's expectations while providing flexibility in describing how a critical audit matter was addressed in the audit.

While the description of how the critical audit matter was addressed in the audit will require judgment, the auditor should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that will be useful to investors. A brief overview of the audit procedures performed is one of the alternatives for describing how the critical audit matter was addressed. If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of how the matter was addressed in the audit. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

In its comment letter, a working group of the IAG stressed the importance to investors of auditor findings, which they described as "the one item that [they] believe would provide the greatest value to investors."[21] Acknowledging the difficulty of mandating reporting of findings, the working group recommended that the Board encourage auditors to include them voluntarily. Under the final standard, communication of the auditor's findings is not required; however, in describing the audit response, the auditor may choose to include findings as an indication of the outcome of audit procedures or key observations about a matter. The Board shares the working group's view that the inclusion of informative, company-specific audit findings related to critical audit matters may, in appropriate circumstances, be valuable to investors and encourages auditors to consider including such findings in their auditor's reports. However, in describing findings, the language used should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

*Refer to the Relevant Financial Statement Accounts or Disclosures that Relate to the Critical Audit Matter*

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[21] Letter from the IAG's auditor's report working group (Aug. 15, 2016) at 1, available on the Board's website in Docket 034. The working group made a presentation regarding its comment letter at the IAG meeting in October 2016, available on the Board's website.

The reproposed standard would have required the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. There were few comments on this requirement. One commenter suggested that, to avoid duplication, reference should be made only to the disclosures and not the financial statement accounts. In response to this suggestion, the final standard clarifies that the auditor could refer to either the relevant account or disclosure, rather than both, to avoid potential duplication.

The reproposal also solicited comment on whether, in addition to referring to the relevant financial statement accounts and disclosures, the auditor should refer to relevant disclosures outside the financial statements. Commenters that addressed this question generally opposed the auditor referencing disclosures outside the financial statements when describing a critical audit matter because it may incorrectly suggest that such information is audited or cause readers to misinterpret the auditor's role in relation to such information. The final standard only requires the auditor to refer to the relevant financial statement accounts or disclosures.

### Additional Considerations Related to the Communication Requirements

#### Auditor Disclosure of "Original Information" about the Company

The reproposed standard included a note to indicate that, when describing critical audit matters in the auditor's report, the auditor is not expected to provide original information unless it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Investor commenters, including the auditor's report working group of the IAG, argued that there should not be any limitation on the auditor providing original information and that the reproposal went too far in constraining the auditor from providing original information in response to concerns expressed by other commenters (which were primarily companies and accounting firms).

Other commenters expressed the view that auditors should not provide original information about the company or should be limited to providing information about the audit and not the company. These commenters stated that the auditor providing original information about the company would be inconsistent with the traditional U.S. regulatory framework, whereby management provides information about the company and the auditor attests to compliance with the applicable financial reporting framework. However, one investor commenter noted that auditor reporting should not be limited by "original information," a term that is undefined in auditing literature.

No PCAOB standard, SEC rule, or other financial reporting requirement prohibits auditor reporting of information that management has not previously disclosed. Rather, there are areas under current law and auditing standards that require auditor reporting that goes beyond attesting to the compliance of management disclosures (e.g., substantial doubt about a company's ability to continue as a going concern[22] or illegal acts[23]). As

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[22] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern.* The auditor is required to include a going concern explanatory paragraph if the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time (*see* AS 2415.12). If management's disclosure with respect to the company's ability to continue as a going concern is inadequate, the auditor's reporting responsibility regarding going concern remains and the report includes either a qualified or an adverse opinion (*see* AS 2415.14).

[23] Auditors may be required, under certain circumstances, pursuant to the

discussed in more detail below, auditors may have professional or state law obligations to maintain client confidentiality, but these obligations should not apply to, or should be preempted by, reporting obligations arising under federal law and regulations, including under PCAOB standards. Accordingly, the requirement to communicate critical audit matters is not, as some commenters have suggested, inconsistent with the existing U.S. financial reporting framework and auditors' other obligations.

Commenters also said that the role of the audit committee or management would be undermined by requiring the auditor to disclose information about the company's financial statements, since in their view it is solely management's responsibility to determine what disclosure is appropriate. Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management, and that management would likely modify its disclosure in response to the communication of critical audit matters in the auditor's report so the auditor would not be a source of original information. While some commenters said that this would improve management disclosures, others said it would be an inappropriate expansion of the auditor's role or would add significant costs. Other commenters stated that companies could be harmed by the disclosure of confidential or competitively sensitive information. Another commenter expressed concern that investors could be confused or misled if auditor reporting lacked context or appeared to conflict with management disclosures. One commenter suggested that the auditor should disclose

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Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the Exchange Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

original information only if a disclosure matter continues to be unresolved after discussion with management and the audit committee.

The Board acknowledges these concerns and, in developing the auditor's communication requirements, has sought to strike an appropriate balance between investor demands for expanded auditor reporting and the costs and potential unintended consequences associated with providing it. While auditor reporting of original information is not prohibited, it is limited to areas uniquely within the perspective of the auditor: describing the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the matter was addressed in the audit. The objective of critical audit matters—helping investors to focus on identified areas of the audit and understand how the auditor addressed them—may not be accomplished if the auditor is prohibited from providing such information. Moreover, prohibiting the auditor from providing such information could make critical audit matter communications incomplete in a way that could be confusing to or misunderstood by investors.

It seems likely, as one commenter observed, that auditors will generally not have incentives to provide information about the company that the company has not already made public. Another commenter noted that, in current practice, disclosure is already guided by an iterative process between management and the auditor, and expected that a similar process would occur for critical audit matters, reducing the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.[24] To the extent that an auditor's decision

[24] It should be noted, however, that critical audit matters are not a substitute for disclosures required of the company under the applicable financial reporting framework.

to communicate a critical audit matter incents the company to expand or supplement its own disclosure, the Board believes this may improve the quality of public disclosures, which would be an indirect benefit of the standard. However, if the company does not provide additional disclosure, and the information is necessary to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter or how it was addressed in the audit, the Board believes it is in the public interest for the auditor to include that information in the auditor's report. The final standard therefore retains the note from the reproposal explaining that the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Of course, any matter that will be communicated as a critical audit matter will already have been discussed with the audit committee, and the auditor will be required to provide a draft of the auditor's report to the audit committee and discuss the draft with them.[25] In addition, as the auditor determines how best to comply with the communication requirements, the auditor could discuss with management and the audit committee the treatment of any sensitive information.

Some commenters also stated that, in areas where there are specific reporting obligations under the applicable financial reporting framework or SEC reporting requirements but the matter falls below the disclosure threshold (for example, a significant deficiency), auditor communication could, in effect, impose a lower disclosure

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[25] *See* AS 1301.21, as amended.

threshold. With regard to such areas, it is likely that the nature of a critical audit matter and its description would be broader than, for instance, focusing on a significant deficiency. In addition, while the auditor is required to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, (which may include, if relevant, information about the company's processes and controls) and how the overall matter was addressed, it is not necessary for the auditor's description to use the terminology of the other auditing standard, such as "significant deficiency" within the broader context of a critical audit matter. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a critical audit matter, the auditor would describe the relevant control-related issues over revenue recognition in the broader context of the critical audit matter without using the term "significant deficiency."[26]

Some commenters suggested that any expanded disclosure requirements should come from the SEC and the Financial Accounting Standards Board ("FASB"), in the form of additional management disclosures, rather than from the Board expanding requirements for auditor reporting. However, investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for the investor's benefit. As one commenter noted, the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. The final standard is designed to elicit information about the audit directly from the auditor's perspective.

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[26] It should be noted that the determination that a matter was a significant deficiency in internal control over financial reporting, on its own, could not be a critical audit matter.

If auditors can adequately convey to investors the principal considerations and how the auditor addressed the matter without including previously undisclosed information, it is expected that they will. However, the standard provides that even when management has not disclosed information, the auditor is not constrained from providing such information if it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

The Board intends to monitor implementation of the critical audit matter requirements to determine if additional guidance is needed in this area.

Potential Compliance Issues Related to Critical Audit Matters

Some commenters suggested that the reporting of critical audit matters could create compliance challenges for companies.

Two commenters expressed concern that companies' SEC filings may have to be amended because of changes in the description or reporting of critical audit matters. In principle, auditors should approach errors and misstatements in the communication of critical audit matters in the same way they would approach any other error or misstatement in the auditor's report that does not affect the auditor's opinion or the ability of market participants to rely on the opinion.[27] It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as incorrect auditor's report dates or missing explanatory paragraphs.

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[27] The final standard indicates that the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole.

Another commenter expressed concern that management may be asked to respond to investor questions regarding issues described in critical audit matters and may not be in a position to do so, particularly in light of their responsibilities under Regulation FD. Given the auditor's responsibility to communicate with the audit committee, and the likelihood of extensive discussions between auditors and management regarding critical audit matters, it seems likely that management will be prepared to respond appropriately and in compliance with their legal obligations (including Regulation FD), as they would with regard to any other question about information included in an SEC filing.

Ability to Communicate No Critical Audit Matters

The reproposal provided that the auditor could determine there were no critical audit matters and provide a statement to that effect in the auditor's report. Commenters generally supported the auditor's ability to determine that there are no critical audit matters. Two commenters suggested that the auditor should not have to make a statement in the auditor's report that there were no critical audit matters because the absence of a critical audit matter should be sufficient without the definitive statement, similar to an emphasis paragraph. The final standard includes the possibility that the auditor could determine, and state in the auditor's report, that there are no critical audit matters.[28] The statement that there are no critical audit matters is required because unlike an emphasis paragraph, critical audit matters are a required element of the auditor's report.

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[28] Since communication of critical audit matters will not be required for the audits of EGCs, brokers and dealers reporting under Exchange Act Rule 17a-5, 17 CFR 240.17a-5, investment companies other than business development companies, and benefit plans, the auditor's report for the audits of these entities will not be required to include the statement that there are no critical audit matters.

The determination of critical audit matters is based on the facts and circumstances of each audit. The Board expects that, in most audits to which the requirement to communicate critical audit matters applies, the auditor will determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor will communicate that there were no critical audit matters.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* For each key audit matter, the IAASB requires the auditor to reference the related disclosures, if any, in the financial statements and address: (1) why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter and (2) how the matter was addressed in the audit.[29] The IAASB allows the auditor to determine that there are no key audit matters to communicate in the auditor's report and, if so, requires a statement to this effect.[30]

*EU.* The EU requires the auditor to include in the auditor's report: (1) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; (2) a summary of the auditor's response to the risks; and (3) where relevant, key observations arising with respect to the risks.[31]

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[29] *See* paragraph 13 of ISA 701.

[30] *See* paragraphs 14 and 16 of ISA 701.

[31] *See* requirements in 2(c) of Article 10, Audit Report, of Regulation (EU)

*FRC.* The FRC requires the auditor, among other things, to: (1) describe those assessed risks of material misstatement that were identified by the auditor and (2) provide an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement.[32] The explanations of the matters set out in the auditor's report should be described in a way that: (1) enables a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements; (2) enables the matters to be related directly to the specific circumstances of the audited entity and are not therefore generic or abstract matters expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.[33]

*Documentation of Critical Audit Matters*

The reproposed standard required documentation of the basis for the auditor's determination whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved or did not involve especially challenging, subjective, or complex auditor judgment. Some commenters supported a documentation requirement only for matters that were determined to be critical audit matters. Some of these commenters asserted that documentation about matters determined not to be critical audit matters would add costs and primarily benefit PCAOB inspections rather than audit

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No 537/2014.

[32] *See* paragraph 19A of UK ISA 700 (2013).

[33] *See* paragraph 19B of UK ISA 700 (2013).

quality. Others stated that the requirement is not aligned with the IAASB's documentation requirement, which, in their view, focuses on rationale for inclusion as a key audit matter rather than exclusion. However, another commenter argued that the determination that a matter was not a critical audit matter would seem to be an important audit judgment that ought to be documented for review by the engagement quality reviewer. This commenter suggested that documentation be required only for matters required to be communicated to the audit committee (which would already have been documented) and not for those that are communicated otherwise. One auditor argued that the reproposed requirement would lead auditors to document all audit committee communications even if not required, and that this would disproportionately affect smaller companies whose audit committees more commonly request information not required to be communicated under PCAOB standards.

The final standard substantially retains the approach from the reproposal of requiring the auditor to document the basis for determining critical audit matters.[34] The objective of the requirement is to document how the determination of critical audit matters (or the determination that there are no critical audit matters) was made from among the matters communicated or required to be communicated to the audit committee that relate to accounts or disclosures that are material to the financial statements. The documentation requirement will also facilitate review by the engagement quality reviewer.[35]

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[34] The language of the documentation requirements has been redrafted to improve clarity, based on a commenter's suggestion.

[35] Under the existing audit documentation requirements, audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis

The amount of documentation required could vary with the circumstances. For example, the auditor's basis for the determination may be so clear for some matters that a single sentence will be sufficient. This situation may arise, for instance, when the auditor's documentation prepared in the course of the audit includes sufficient detail about whether or not the matter involved especially challenging, subjective, or complex auditor judgment. Other matters may require more extensive documentation.

As noted in the reproposing release, for matters determined to be critical audit matters, the description in the auditor's report (which, among other things, must describe the principal considerations that led the auditor to determine that it was a critical audit matter) will generally suffice as documentation.

The auditor could comply with the documentation requirement in a variety of different ways. For example, the auditor could start with the communications to the audit committee, which are already documented, identify which of those matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether or not each matter involved especially challenging, subjective, or complex auditor judgment. In documenting the basis for the determination, the auditor may include the factors the auditor took into account. This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation.

*Requirements of Other Regulators and Standard Setters*

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for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. *See* paragraph .02 of AS 1215, *Audit Documentation*.

The IAASB requires the auditor to document the matters that required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.[36] The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.[37]

*Liability Considerations Related to Critical Audit Matters*

In both the proposal and the reproposal, the Board acknowledged that including critical audit matters would change the auditor's report in ways that could affect auditors' potential liability. As discussed in those releases, liability may be imposed on auditors under a number of different legal theories depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, and various state law causes of action. The critical audit matters would themselves be new statements that could be the basis for asserted claims. In addition, information provided regarding critical audit matters could affect other aspects of securities fraud claims against either the issuer, the auditor, or both (for example, by being described in pleadings in an effort to plead fraud with particularity or as a basis to seek to undercut a claim of reliance). The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.

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[36] *See* paragraph 18(a) of ISA 701.

[37] General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

A number of companies and accountants responded to this request for comment. While several of these commenters noted that changes from the proposal had addressed certain of their liability concerns, most continued to express varying degrees of concern about the potential for increased liability, either for auditors or for both auditors and companies.

In particular, commenters expressed concern that investors who suffer a financial loss could assert legal claims against the auditor based on statements made in identifying and describing critical audit matters. As with the proposal, commenters expressed general concerns that communication of critical audit matters would encourage baseless litigation, would likely lead to increased audit fees, raise the settlement value of spurious claims, or potentially undermine the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Some commenters argued that auditors, to avoid being second-guessed, would have the incentive to communicate matters to the audit committee that were not otherwise required or to identify too many critical audit matters in an effort to protect themselves from liability. Several commenters expressed concern that communicating critical audit matters might compromise their ability to argue that the statements in the audit report are opinions which, one commenter argued, were "less vulnerable to challenges that they are false or misleading."[38] However, at least one of these commenters noted that the revised definition of a critical audit matter in the reproposal mitigated their concern on that point. Other commenters argued that the information communicated in describing critical audit

[38] Letter from PricewaterhouseCoopers LLP (Aug. 15, 2016) at 7, available on the Board's website in Docket 034.

matters could potentially be used to attack the audit by challenging the procedures performed or the adequacy of audit evidence obtained by the auditor. On the other hand, one commenter noted that the communication of critical audit matters is about disclosure of risks and challenges and expressed the belief that non-communication of such matters would be more problematic from a litigation point of view.

Some commenters argued that the risk of liability would be heightened if the auditor were providing original information about the company. In particular, several commenters contended that doing so would conflict with accountants' professional obligation to maintain client information in confidence, which could give rise to claims by the company against the auditor under state law.

Some commenters argued that critical audit matters could increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, could be misinterpreted as acts of negligence on the part of the company, or could be used by plaintiffs as a "road map" for litigation against the company. One commenter argued that, because the underlying work papers are subject to discovery, critical audit matters would be used as a source for potential litigation against both auditors and companies.

Some of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the reproposal that they maintained would reduce the liability impact of determining and communicating critical audit matters. For example, as previously discussed, several commenters suggested substantially similar changes to modify the materiality component of the definition of critical audit matters and to prohibit or discourage auditor communication of original information.

The Board has carefully considered commenters' concerns about potential liability throughout this standard-setting process, including the comments received on the reproposal. While mandating disclosure of critical audit matters will, by design, entail new statements in the auditor's report, the Board notes that any claim based on these new statements would have to establish all of the elements of the relevant cause of action (for example, when applicable, loss causation and reliance). Critical audit matters will not replace or alter the fundamental requirement that the auditor's report include the auditor's opinion that the financial statements are fairly presented in accordance with the applicable financial reporting framework, which has been, and the Board expects will continue to be, the primary statement at issue in most private securities litigation under federal law involving auditors.

Throughout this standard-setting process, the Board has carefully considered commenters' suggestions to alter the terms of its proposal to mitigate their concerns about potential liability for omitting a critical audit matter. As discussed in the reproposal, the Board limited and clarified the process for determining critical audit matters, including by narrowing the source of critical audit matters to matters communicated or required to be communicated to the audit committee, adding a materiality component to the critical audit matter definition, and refining the factors used to determine critical audit matters. Those changes, as well as the critical audit matter definition's focus on the auditor's judgment, should mitigate concerns about potential liability for omitting a critical audit matter. With respect to suggestions to further narrow the definition of critical audit matters and the related communication requirements, it is not clear, and commenters did not explain, how those changes would mitigate liability concerns other than by reducing the number and content of required communications of critical audit matters. As described above, the Board has determined not to incorporate those suggested changes because they appear likely to significantly reduce the number of potential critical audit matters and the informativeness of auditor communication of critical audit matters.

With respect to potential state law claims by companies against their auditors for disclosing original information, the Board notes that, as discussed above, it does not expect that, in general, critical audit matters will provide sensitive information that has not been disclosed by the company. With respect to the potential for a claim based on a situation in which the auditor found such disclosure necessary, the Board notes that auditors already have preexisting duties to disclose original information in certain circumstances.[39] Commenters did not cite any specific examples in which these requirements have resulted in unwarranted claims against auditors for disclosing client confidences. Because the auditor's obligations under PCAOB standards arise under federal law and regulations, professional or state law duties of client confidentiality

[39] For example, for at least the last 20 years, auditors have had duties to disclose in their auditor's reports when they have substantial doubt about the company's ability to continue as a going concern. *See* Section 10A of the Exchange Act and AS 2415. In addition, when in an audit of internal control over financial reporting, the auditor identifies a material weakness that has not been included in management's assessment, the auditor must modify its report to, among other things, "include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements . . .". *See* Note to paragraph .91 of AS 2201; *cf*. Statement of Gaylen R. Hansen, CPA, at the PCAOB public meeting (Apr. 2, 2014) ("Client confidentiality has a long-standing and important place in the accountancy profession. However, it doesn't serve investors well when it is parlayed to obfuscate the important obligation to call things as they are seen.").

should not apply to,[40] or should be preempted by,[41] the obligation to communicate critical audit matters.[42]

While the Board takes seriously the prospect of potential increases in auditors' or companies' liability, the Board believes it has appropriately addressed commenters' concerns regarding liability in a manner compatible with the objectives of this rulemaking, and in view of the rulemaking's anticipated benefits. Indeed, the Board notes that at least one of the commenters that expressed concern about potential liability, noted that those concerns "should not stand in the way of moving forward" on the reproposed standard.[43] At the same time, the Board acknowledges that a variety of claims can be raised related to the statements in the audit report and that litigation is inherently uncertain. If the final standard is approved by the SEC, the Board will monitor the standard after implementation for any unintended consequences.

*Additional Improvements to the Auditor's Report*

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[40] For example, the relevant AICPA rule provides that auditors "shall not disclose any confidential client information without the specific consent of the client," but further provides that the confidentiality obligation shall not be construed "to prohibit … compliance with applicable laws and government regulations." *See* paragraphs .01 and .02 of 1.700.001 *Confidential Client Information Rule* of the AICPA Code of Professional Conduct (as of Dec. 15, 2014).

[41] *See Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000); *New York v. FCC*, 486 U.S. 57, 64 (1988).

[42] Some commenters suggested that safe harbor rules be created to protect auditors and companies from liability for statements about critical audit matters. While, as noted above, the Board will monitor the effects of critical audit matters should the requirements be approved by the SEC, the Board is not convinced at this time that any such safe harbor is necessary and, in any event, such a safe harbor is beyond the Board's authority.

[43] *See* letter from Deloitte & Touche LLP (Aug. 12, 2016) at 5, available on the Board's website in Docket 034.

The reproposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as auditor tenure, would be new elements in the auditor's report. Other basic elements, such as the auditor's opinion, identification of the financial statements audited, and management's and auditor's responsibilities, were drawn from the existing auditor reporting standard.[44] Yet other basic elements, such as the name of the company under audit and the date of the financial statements, were incorporated from existing illustrative auditor's reports.

*Auditor Tenure*

The reproposal included a required statement in the auditor's report of the year the auditor began serving consecutively as the company's auditor. The Board also sought comment on whether auditor tenure should be disclosed in Form AP, *Auditor Reporting of Certain Audit Participants* ("Form AP"), rather than in the auditor's report.[45]

Disclosure of Tenure

Investor commenters stated that information regarding auditor tenure would be useful to financial statement users, for example, in deciding whether to vote to ratify the appointment of the auditor. Investors that expressed a preference supported tenure disclosure in the auditor's report, some on the basis of reducing investor search costs by ensuring a consistent location for the disclosure. One commenter representing a group of investors asserted that since the auditor's report is the primary means by which the

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[44] *See* existing AS 3101.06–.08.

[45] In December 2015, the Board adopted Form AP, which provides investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. *See Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008 (Dec. 15, 2015).

auditor communicates with investors, it is appropriate for auditor tenure to be included in the auditor's report. This commenter further stated that disclosure of auditor tenure on Form AP would be an acceptable alternative to disclosure in the auditor's report only if the timeliness, accessibility, searchability, and overall functionality of the information disclosed on Form AP were at least equivalent to having the information disclosed in the auditor's report. Another commenter suggested that, if disclosure were required in the auditor's report, a specific location should be designated.

Currently, information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.[46] However, there is a growing trend toward voluntary disclosure of auditor tenure. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,[47] presumably due to interest from investors.

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[46] In certain instances, investors may be able to manually calculate tenure by reviewing company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when a company changed auditors. However, the information is not available prior to 1994 and may not be available for certain entities, such as investment companies and brokers and dealers, that are not required to file Form 8-K. *See* 17 CFR 249.308, Item 4.01 *Changes in Registrant's Certifying Accountant*. Accordingly, currently available information is neither complete nor a readily accessible alternative to auditor tenure disclosure.

[47] The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2016, 2015, and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2016, 2015, and 2014 auditor tenure was disclosed in the annual proxy statements of 59, 54, and 47 percent of the S&P 500 large-cap companies, respectively, 45, 44, and 42 percent of the S&P MidCap 400 companies, respectively, and 48, 46, and 50 percent of the S&P SmallCap 600 companies, respectively. *See* Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 63 percent of the companies reviewed voluntarily disclosed auditor tenure in 2016 compared to 62 percent in 2015, 51 percent in 2014, 29 percent in 2013, and 24 percent in 2012. *See* Ernst & Young, *Audit Committee Reporting to Shareholders in 2016*

However, voluntary disclosure is not provided for a significant number of audits subject to the Board's jurisdiction. Additionally, if disclosed, such information may not be provided in the same location in the proxy statement; for instance, some disclosures are in the audit committee report while others are in another section of the proxy.[48] Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, many companies whose securities are not listed on a national securities exchange, and most investment companies are not required to prepare proxy statements.

Some commenters, primarily companies, did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors. Other companies and accounting firms raised a concern that tenure disclosure could result in inferences that, in their view, would be inappropriate about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. Some commenters also suggested that auditor tenure is a corporate governance matter and that disclosure should be provided by management or the audit committee rather than the auditor. A few commenters suggested that tenure disclosure should be addressed by SEC rulemaking or provided only voluntarily. Some commenters, many of whom generally opposed auditor tenure disclosure, suggested that Form AP would be a preferable location for disclosing tenure if the Board proceeded with requiring the disclosure.

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(Sept. 2016).

[48] *See* Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016).

The SEC's Investor Advocate stated that he "strongly support[s] requirements for public disclosure of auditor tenure," recognizing that there were different opinions about the best party and location to make that disclosure.[49] Noting that the SEC had issued a concept release asking whether auditor tenure should be disclosed in the audit committee report,[50] the SEC's Investor Advocate stated that he believed the SEC should ultimately decide these questions. In light of these considerations, the SEC's Investor Advocate recommended that the PCAOB act to require disclosure of auditor tenure (either in the auditor's report or in Form AP), but also consider including a contingent sunset clause such that the auditor disclosure requirement would expire if and when the SEC imposed any form of a company disclosure requirement.

The Board believes that public disclosure of auditor tenure is important and in the public interest, and that it is appropriate to require disclosure in the auditor's report because it is the primary means by which auditors communicate with investors. This will ensure that the disclosure is in a readily accessible and consistent location—the auditor's report—for all companies. It will make auditor tenure information immediately available to investors upon filing with the SEC of a document containing the auditor's report. Disclosure of auditor tenure in the auditor's report will also reduce search costs for investors who are interested in auditor tenure, relative to the current environment of

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[49] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 4, available on the Board's website in Docket 034. The letter noted that the views of the Investor Advocate do not necessarily reflect the views of the SEC, the Commissioners, or staff of the SEC, and the SEC disclaims responsibility for the letter and all analyses, findings, and conclusions contained therein. Additional information about the Office of the Investor Advocate is available on the SEC's website.

[50] *See* SEC, *Possible Revisions to Audit Committee Disclosures*, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015).

voluntary reporting. Disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The Board is not persuaded by commenters' concerns that disclosure of auditor tenure in the auditor's report necessarily suggests a specific correlation between auditor tenure and audit quality, or between auditor tenure and auditor independence. In the Board's view, auditor tenure is another data point about the auditor, in addition to the firm name and the office issuing the auditor's report, for which there is demonstrable investor demand.

The standard does not specify a required location within the auditor's report for the statement on auditor tenure; auditors that are concerned about the inferences readers may draw based on the placement of the disclosure in the auditor's report have discretion to present auditor tenure in the part of the auditor's report they consider appropriate. Consistent with the reproposal, the illustrative auditor's report in the final standard includes the statement on auditor tenure at the end of the report.

The Board considered disclosure of auditor tenure in Form AP, which requires disclosure of the name of the engagement partner and of the names and percentage of participation of other accounting firms in the audit for all issuer audits. Form AP was developed primarily to respond to commenter concerns about the potential liability consequences of naming persons in the auditor's report, the potential need to obtain consents from those named persons in connection with registered securities offerings, and the additional time needed to compile information about the other accounting firms. The Board's determination to require disclosure in Form AP, rather than in the auditor's report, was a means to address these concerns. Disclosure of auditor tenure does not have the same potential liability or other consequences as disclosure of the name of the engagement partner or other accounting firms, so such an approach is unnecessary in this case.

The Board acknowledges that the SEC, given its broader authority and responsibility for the financial reporting process, could in the future determine that auditor tenure should be disclosed by some other party or in some other location, in addition to or instead of in the auditor's report. Accordingly, the Board is adopting its requirement for tenure disclosure in the auditor's report today. The Board anticipates that, if the SEC undertook rulemaking for disclosure of auditor tenure, the Board would work with the SEC to ensure that PCAOB standards coordinate appropriately with any new SEC requirements.[51]

Determination of Tenure

The reproposal contemplated that tenure would be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure, and it included a note providing that if the auditor is uncertain as to the year the auditor became the company's auditor, the auditor should so state and provide the earliest year of which the auditor has knowledge. Some commenters objected to this approach, saying that it could confuse investors and its relevance is unclear. The Board believes that the disclosure of tenure should reflect the entire relationship between the company and the auditor,

[51] Of course, the SEC also has authority to abrogate or modify PCAOB rules at any time, to, among other things, further the purposes of the securities laws. Section 107(b)(5) of Sarbanes-Oxley, 15 U.S.C. 7217(b)(5).

including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. No changes have been made to the note in the final standard.

Additionally, if a company went public and maintained the same auditor, auditor tenure will include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Because of the unique structure of investment companies, which typically includes common accounting, internal control, and oversight functions at the group level, the reproposed standard required that, for an investment company that is part of a group of investment companies,[52] the auditor's statement regarding tenure will contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.[53] For example, if Firm A has been auditing investment companies in XYZ group of investment companies since 1980, the current auditor's report for XYZ fixed income fund, whose inception date was in 2010, will state that Firm A has served as the auditor of one or more XYZ investment companies since 1980.

A commenter asserted that measuring auditor tenure from the first year of service to the group of investment companies might confuse or even mislead the reader of the auditor's report for a new fund, especially if the auditor has served the group for several years. Another commenter supported the reproposed methodology for measuring tenure

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[52] A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included.

[53] The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

for investment companies stating that it is appropriate given the common accounting system, system of internal control over financial reporting, and board oversight for a group of investment companies.

After considering the comments received, the Board is adopting the requirement regarding auditor tenure for an investment company that is part of a group of investment companies as reproposed. The Board believes that the length of an auditor's relationship with the group is more relevant than the relationship with an individual fund, since funds can be started and merged over time but the auditor's relationship with the group continues.

*Requirements of Other Regulators and Standard Setters*

The EU requires a statement in the auditor's report that indicates the total uninterrupted engagement period, including previous renewals and reappointments of the statutory auditors or the audit firms.[54] The IAASB and the FRC do not include a similar requirement.

*Clarification of Existing Auditor's Responsibilities*

The reproposed standard included requirements that would enhance standardized language of the auditor's report by clarifying the nature and scope of the auditor's existing responsibilities, such as a new statement regarding auditor independence and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the reproposed standard

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54 *See* requirements in 2(b) of Article 10, Audit Report, of Regulation (EU) No 537/2014.

included a requirement intended to promote uniformity with respect to the addressee of the report.

Auditor Independence

The reproposed standard included a required statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC[55] and the PCAOB.[56]

Commenters generally supported the required statement regarding auditor independence. Some said that the statement would reinforce financial statement users' understanding of the auditor's existing obligations to be independent and serve as a reminder to auditors of these obligations. Some commenters preferred a more definitive statement, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. A few commenters questioned whether the statement will improve an investors' understanding of the auditor's independence responsibilities, yield any incremental benefits or insight to investors, or have any impact on auditor behavior. Some of these commenters pointed out that independence is already included in the title of the auditor's report and including an additional statement in the auditor's report is redundant and unnecessary.

After consideration of comments, the statement regarding auditor independence is adopted as reproposed. The Board believes that the independence statement in the auditor's report will both enhance investors' and other financial statement users'

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[55] *See* Regulation S-X Rule 2-01, 17 CFR 210.2-01.

[56] *See* PCAOB Rule 3520, *et seq*.

understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations. The statement regarding auditor independence is not intended to, and will not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.[57] The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.[58] The FRC requires the auditor to state that the auditor is required to comply with the United Kingdom's ethical standards for auditors, which include requirements regarding auditor independence.[59]

Addressee

Under the existing standard, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[60] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for

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[57] *See* paragraph 28(c) of ISA 700.

[58] *See* requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[59] *See* paragraph 15 of UK ISA 700 (2013).

[60] *See* existing AS 3101.09.

issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[61]

To promote consistency in addressing the auditor's report to the company's investors, the reproposed standard included a requirement for the auditor's report to be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The reproposed standard stated that the auditor's report may include additional addressees.

Commenters generally supported the addressee requirement as reproposed stating that it is appropriate and will create consistency in practice. A commenter suggested limiting the required addressees to the shareowners of corporations or equivalents for companies not organized as corporations because investors are the key customers of the auditor's report. A few commenters stated that the auditor's report is intended for general use and the requirement for the auditor's report to be addressed to a specific party is not necessary. A commenter expressed concern that retaining the option for the auditor's report to be addressed to third parties could inadvertently result in increased auditor liability and cost.

In response to comments, and to promote greater uniformity in the addressees of the auditor's report, the Board is adopting the addressee requirement as reproposed. Since inclusion of additional addressees is voluntary, auditors could assess, based on the individual circumstances, whether or not to include additional addressees in the auditor's report. In addition, the Board believes that it is appropriate for the auditor's report to be

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[61] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers and brokers and dealers.

addressed to the board of directors and not just to the shareholders, because of the role of the board of directors in the governance of the company.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report be addressed as appropriate, based on the circumstances of the engagement.[62] The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required by the circumstances of the engagement.[63] UK auditor's reports are typically addressed to either the members or the shareholders of the company.[64]

Other Enhancements to the Basic Elements

The reproposal would have changed the language for certain elements in the existing auditor's report. These elements included:

- *Financial statement notes*—The identification of the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.[65] Under the existing standard, the

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[62] *See* paragraph 22 of ISA 700.

[63] *See* paragraph 13 of UK ISA 700 (2013).

[64] *See* paragraph A5 of UK ISA 700 (2013).

[65] The final standard uses the term "financial statements" to include all notes to the statements and all related schedules, as used under SEC rules that apply to issuers. *See* Regulation S-X Section 1-01(b), 17 CFR 210.1-01(b), which states in part, "the term financial statements . . . shall be deemed to include all notes to the statements and all related schedules." The final standard will not apply to schedules included as supplemental information, as defined in AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, because those schedules are not considered part of the financial statements. The auditor should continue to look to the requirements of AS 2701 for the auditor's reporting responsibilities regarding supplemental information accompanying audited financial statements.

notes to the financial statements and the related schedules are not identified as part of the financial statements.

- *Error or fraud*—A description of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.[66] The existing standard does not require the auditor's report to contain the phrase *whether due to error or fraud*.
- *Nature of the audit*—The description of the nature of the audit reflected the auditor's responsibilities in a risk-based audit and aligned the description with the language in the Board's risk assessment standards, including:
    - Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
    - Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
    - Evaluating the accounting principles used and significant estimates made by management; and
    - Evaluating the overall presentation of the financial statements.

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[66] *See* paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

Commenters generally supported the reproposed language for these basic elements of the auditor's report. These elements are adopted as reproposed.

*Additional Basic Elements Suggested by Commenters*

In addition to the changes proposed by the Board, commenters on the reproposal suggested additional elements to be included in the auditor's report.

Several commenters suggested that the PCAOB consider additional standardized language in the auditor's report to describe the responsibilities of the auditor, management, and the audit committee. In doing so, some of these commenters suggested that the PCAOB consider additional language adopted by the IAASB, in order to promote consistency in reporting and to help users understand more fully the separate responsibilities of each of the parties with respect to the audited financial statements. In contrast, another commenter cautioned that a thorough description of everyone's roles and responsibilities would further add to repetitive boilerplate language. This commenter suggested instead that the auditor's report provide a cross reference to a more complete description of the roles and responsibilities of the auditor, management, and the audit committee. This commenter did not indicate where such cross-referenced material would appear. Given little interest from investors in such additional language during the Board's initial outreach and the risk that it would be boilerplate, the final standard does not include these additional elements.

Two accounting firms suggested describing the meaning of reasonable assurance. The final standard requires a statement in the "Basis for Opinion" section of the auditor's report that the auditor "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as a high level of assurance, although not absolute assurance.[67] During the Board's initial outreach such additional language was considered, but there was no investor demand for it. As a result, the final standard does not expand the description of reasonable assurance in the auditor's report.

Some commenters also suggested that the auditor's report should include disclosure of the materiality measures used by auditors in planning the audit. These commenters asserted that it could help inform investors' proxy voting process for auditor ratification, as such disclosure could be a valuable supplement to an audit fee analysis and used to compare materiality over time to trends in restatements and adjustments. These commenters also observed that materiality disclosures are provided in the auditor's reports in the U.K. Other commenters from the Board's initial outreach stated that disclosing materiality levels in the auditor's report could have negative implications on audit quality by reducing the element of surprise necessary in an audit.[68] One commenter opposed a disclosure of materiality on the basis that it may encourage disclosure of quantitative materiality levels and ignore qualitative aspects of materiality, which cannot be described in a meaningful way in the auditor's report. The Board has decided not to include this additional element in the auditor's report at this time because disclosure may reduce the element of surprise in the audit and overstate the importance of quantitative rather than qualitative factors in the auditor's overall consideration of materiality. However, the Board will monitor the implementation of the final standard, as well as the

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[67] Paragraph .10 of AS 1015, *Due Professional Care in the Performance of Work.*

[68] *See* PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

developments of expanded auditor reporting in other jurisdictions, to determine if future enhancements to the auditor's report may be warranted in this area.

Additionally, some commenters suggested that the auditor's report should define the auditor's responsibility for other information in documents containing audited financial statements so that financial statement users have a clear understanding. The Board's proposal included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board has not taken any further action since the proposal.

A few commenters suggested including other elements, such as the date when the auditor completed fieldwork, a statement that the auditor looked for material fraud, disclosure when alternative dispute resolution clauses are included in engagement letters, and disclosure of reasons for change in the engagement partner prior to mandatory rotation. The final standard does not include these elements because the Board believes they would not add meaningfully to the information already provided in the final standard or the elements go beyond what was considered in this standard-setting project and, thus, the Board is not including these elements at this time.

*Explanatory Language and Emphasis of a Matter*

*Explanatory Language Required by Other PCAOB Standards*

The reproposed standard, similar to the existing standard,[69] provided a list of circumstances in which the auditor is required to add explanatory language to the

[69] *See* existing AS 3101.11.

auditor's report and included references to other PCAOB standards in which these circumstances and related reporting requirements are described. These circumstances included when there is substantial doubt about the company's ability to continue as a going concern and a restatement of previously issued financial statements, among others.

The list of circumstances from the Board's reproposal did not attract much comment, although one commenter affirmed support for including the list. Commenters on the Board's proposal supported providing a list in the standard of the circumstances that require explanatory language in the auditor's report on the basis that keeping this information in a single place would facilitate consistency in execution. The final standard includes the list of explanatory paragraphs and related references as reproposed.

The reproposed standard included a requirement for the auditor to add explanatory language in cases where the company is required to report on ICFR but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.[70] The reproposed standard included a reference to a new proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the auditor to add such explanatory language. Some commenters were supportive of the reproposed requirement, while one commenter did not believe such a requirement was necessary but did not object to its inclusion.

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[70] This may be the case for companies that are subject to Section 404(a) of Sarbanes-Oxley, which mandates management ICFR reporting, but not Section 404(b), which mandates auditor ICFR reporting. Section 404(a) generally applies to companies that are subject to the reporting requirements of the Exchange Act, other than registered investment companies. Certain categories of companies that are subject to Section 404(a), such as nonaccelerated filers and emerging growth companies, are not subject to Section 404(b).

The Board also sought comment on whether the requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR should apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies. Several commenters supported expanding the requirement to all instances in which the auditor is not engaged to opine on ICFR, and not limit it to only when management is required to report on ICFR.

In the Board's view, it is appropriate to add explanatory language to the auditor's report when management has a reporting responsibility on ICFR but the auditor is not engaged to opine on ICFR, in order to clarify the auditor's responsibilities in this situation. For companies for which management is not required to report on ICFR, the Board does not believe that the auditor should have a separate reporting responsibility. Accordingly, the final standard retains the requirement as reproposed.[71] The auditor may, however, choose to include such a paragraph in the auditor's report voluntarily.

*Interaction between critical audit matters and explanatory paragraphs*. The reproposed standard clarified that critical audit matters are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a critical audit matter and also requires an explanatory paragraph, such as going concern. For these situations, the reproposal contemplated that both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor could include the communication required for a critical audit matter in the explanatory paragraph, with a cross-reference in the critical audit

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[71] *See* amendments to AS 3105.59–.60.

matter section to the explanatory paragraph. Alternatively, the auditor could choose to provide both an explanatory paragraph and the critical audit matter communication separately in the auditor's report, with a cross-reference between the two sections.[72] While the information reported in a critical audit matter may overlap with some of the information already provided in the explanatory paragraph, the critical audit matter would provide incremental information, such as how the matter was addressed in the audit.

Commenters were generally supportive of the interaction between the communication of critical audit matters and required explanatory paragraphs as described in the reproposed standard. Some alternative views, however, were expressed. One commenter thought that if a required explanatory paragraph is also a critical audit matter, disclosure in the auditor's report should be limited to one place in the auditor' report. The commenter suggested that the communication requirements for both a critical audit matter and an explanatory paragraph be reported in the critical audit matter section of the auditor's report with a cross reference in the explanatory paragraph section. Another commenter suggested that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. Finally, another commenter thought that critical audit matter communications should not be permitted to be integrated with explanatory paragraphs, on the basis that explanatory paragraphs are about matters in the financial statements to which the auditor wants to draw the reader's attention and are not necessarily critical audit matters.

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[72] When both an explanatory paragraph and a critical audit matter communication are provided, the critical audit matter description should not include conditional language that would not be permissible in the explanatory paragraph. *See* footnote 5 of AS 2415.

The final standard retains the interaction between critical audit matters and explanatory paragraphs as reproposed. The approach provides flexibility on auditor disclosure, yet also ensures that the communication requirements are met.

*Emphasis of a Matter*

The reproposed standard, similar to the existing standard, provided the ability for the auditor to add a paragraph to the auditor's report to emphasize a matter regarding the financial statements ("emphasis paragraph").[73] Emphasis paragraphs are not required, but may be used by auditors to draw the reader's attention to matters such as significant transactions with related parties and unusually important subsequent events.

The reproposed standard provided a list of potential matters that the auditor may emphasize in the auditor's report, although the auditor may also decide to emphasize other matters.

Commenters were supportive of emphasis paragraphs as described in the reproposed standard and did not suggest any additional matters to be included in the list of potential emphasis paragraphs. The final standard includes emphasis paragraphs as reproposed.

*Interaction between critical audit matters and emphasis paragraphs*. The reproposed standard stated that emphasis paragraphs are not a substitute for required critical audit matters. If a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would provide the information required for critical audit matters, and would not be expected to include an emphasis paragraph in the auditor's report. Although this did not generate much comment, one commenter

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[73] *See* existing AS 3101.19.

affirmed support for the interaction between critical audit matters and emphasis paragraphs. The final standard retains the interaction between critical audit matters and emphasis paragraphs as reproposed.

*Requirements of Other Regulators and Standard Setters*

Under the requirements of other regulators and standard setters, there are no analogous explanatory paragraphs, except for reporting on going concern. The Board's reproposed approach is similar to the IAASB's approach to the interaction between a paragraph regarding the company's ability to continue as a going concern and key audit matters, although the underlying requirements for auditor reporting on going concern vary.[74] Under the IAASB's approach, an emphasis of matter paragraph is not required for a matter that was determined to be a key audit matter.[75] The EU and the FRC have separate requirements related to going concern reporting that do not specifically address the interaction with their expanded auditor reporting.[76] The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

*Information about Certain Audit Participants*

On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other

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[74] *See* paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

[75] *See* paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

[76] *See* ISA (UK and Ireland) 570, *Going Concern*, and *see* Article 28, *Audit Reporting*, of Directive 2014/56/EU of the European Parliament and of the Council (Apr. 16, 2014).

accounting firms that participate in audits of issuers.[77] Firms will be required to file Form AP with the PCAOB for each issuer audit, disclosing this information. In addition to filing Form AP, firms will also have the choice to include this information in the auditor's report.[78] The final standard incorporates the adopted amendments to AS 3101 for situations in which the auditor decides to include information about certain audit participants in the auditor's report. The final standard requires the auditor to use an appropriate section title when providing this information in the auditor's report, but does not require a specific location in the auditor's report.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities.[79] Under EU law, the engagement partner is required to sign the audit report in all EU countries, including the United Kingdom.[80] Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB, FRC, or the EU.

*Form of the Auditor's Report*

The reproposed standard required the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The reproposed standard did not specify an order for the remaining

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77 *See* PCAOB Release No. 2015-008.

78 When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors*, the auditor's report must acknowledge the involvement of the other auditor.

79 *See* paragraph 45 of ISA 700.

80 Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allowed for consistency in the location of the opinion and basis for opinion sections, with flexibility for the other elements of the auditor's report. The reproposed standard also required titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report.

Commenters were generally supportive of the proposed changes to the form of the auditor's report, because the changes will:

- Enhance the clarity and comparability of disclosures;
- Make it easier for investors to find the opinion since it will be listed first;
- Help facilitate a comparison between auditor's reports; and
- Allow for an appropriate level of flexibility and ease of use without being overly prescriptive.

Some commenters suggested the PCAOB should be consistent with other standard setters in the ordering of section titles in the auditor's report. One commenter expressed concern that the ordering of the components of the opinion and the heading of the critical audit matter section of the report may be misunderstood to imply that critical audit matter communications are separate and distinct from the auditor's opinion, which could be misinterpreted as a piecemeal opinion. In light of the commenter support described above, the Board is adopting the form of the auditor's report as reproposed. As previously discussed, the final standard includes revised introductory language in the auditor's report to avoid the potential misperception that the communication of critical audit matters provides piecemeal opinions.

*Requirements of Other Regulators and Standard Setters*

The reproposed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.[81] The EU and FRC do not specify an order to the auditor's report.

*Application to Other Audits Performed Under PCAOB Standards*

There are situations in which an auditor may be required by law or regulation, or voluntarily agrees, to perform an audit engagement in accordance with PCAOB standards for a company whose audit is not subject to PCAOB oversight.[82] For example, SEC rules permit audits under PCAOB standards in connection with offerings under Regulation A and Regulation Crowdfunding.[83] In these situations, certain elements of the auditor's report required under the final standard, such as the use of "registered public accounting firm" in the title or the statement regarding independence requirements, may not apply. Additional guidance for these situations will be provided.

Amendments to Other PCAOB Standards

The Board has adopted amendments to several of its existing auditing standards solely to conform to the final standard. The Board is not adopting any further changes to

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81 *See* paragraphs 23–28 of ISA 700.

82 Under the Sarbanes-Oxley Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB oversees the audits of "issuers" and brokers and dealers reporting under Exchange Act Rule 17a-5. *See* Sarbanes-Oxley Act Section 101. An "issuer" under the Sarbanes-Oxley Act is an entity whose securities are registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed a Securities Act registration statement that has not yet become effective and that it has not withdrawn. *See* Sarbanes-Oxley Section 2(a).

83 *See* Securities Act Form 1-A, Part F/S (b)(2) and (c)(1)(iii); Regulation Crowdfunding Rule 201(t) instruction 9, 17 CFR 227.201(t).

these existing auditing standards at this time, although the Board recognizes that some of the existing auditing standards, such as the redesignated standard AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

*AS 3105, Departures from Unqualified Opinions and Other Reporting Circumstances*

Existing AS 3101.10 and .20-.76 address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion, and other reporting circumstances, such as reporting on comparative financial statements. These paragraphs are redesignated as AS 3105.[84] Commenters who addressed this topic generally supported the reproposed amendments to AS 3105, including amending the example auditor's reports to conform with the example auditor's report in the final standard. The Board also received some comments suggesting further changes to AS 3105, such as updating descriptions of and references to accounting requirements that are no longer current[85] and updating certain terminology (e.g., changing references from "entity" to "company"). The Board may consider such updates as part of a separate standard-setting project.

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[84] AS 3101.01-.09 and .11-.19 are amended and restated as AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

[85] The Board has issued guidance regarding the status of outdated descriptions of and references to U.S. GAAP in PCAOB standards. *See* PCAOB, *Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards* (Sept. 2, 2009). Among other things, this guidance provides that auditors should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the FASB Accounting Standards Codification ("ASC").

The Board has adopted final amendments to AS 3105 that are substantially similar to the reproposal. The amendments to AS 3105 are not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard will primarily: (1) require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the final standard; and (3) amend the illustrative reports for the basic elements of the final standard and the required order of certain sections of the auditor's report.

AS 3105 includes:

*Communication of Critical Audit Matters in Reports Containing Other than Unqualified Opinions*

a. *Qualified opinion*—Amendments to AS 3105 will require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if critical audit matter requirements apply.

b. *Adverse opinion*—The existing requirements related to an adverse opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the adverse opinion.

c. *Disclaimer of opinion*—The existing requirements related to a disclaimer of an opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the disclaimer of opinion.

*Requirements of Other Regulators and Standard Setters*

Under the IAASB's approach, a matter giving rise to a qualified, adverse, or disclaimer of opinion is by nature a key audit matter.[86] However, in such circumstances: (1) the matter should not be described in the key audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the key audit matter section to the basis for modified opinion section where the matter is reported.[87] The requirements to determine and communicate key audit matters, other than the matters giving rise to the modified opinion, would still apply when the auditor expresses a qualified or adverse opinion, but not when the auditor disclaims an opinion on the financial statements.[88] The FRC and the EU do not include specific requirements for expanded auditor reporting when the auditor's report contains other than an unqualified opinion.

*Other Amendments to PCAOB Standards*

The amendments to other PCAOB standards are substantially as reproposed. These include:

- AS 1220, *Engagement Quality Review*—amending to require the engagement quality reviewer to evaluate the engagement team's

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[86] *See* paragraph 15 of ISA 701.

[87] *Id*.

[88] *See* paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

determination, communication, and documentation of critical audit matters;

- AS 1301, *Communications with Audit Committees*—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report;
- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example auditor's report to conform with the example auditor's report on the financial statements in the final standard;
- AS 2820, *Evaluating Consistency of Financial Statements*—amending to include the existing reporting requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105; and
- AS 4105, *Reviews of Interim Financial Information*—amending to include the basic elements of the final standard, where applicable.

Conforming amendments were also made to every PCAOB standard that refers to the auditor's report. Commenters generally supported the amendments as reproposed.

A commenter suggested revising AS 3305, *Special Reports*, to conform to the example auditor's report in the final standard. Since reports pursuant to AS 3305 are rarely filed with the SEC, as noted by this commenter, the Board does not believe these reports should be updated at this time. As described above, the Board may consider updating this standard as part of a separate standard-setting project.

## D. Economic Considerations and Application to Audits of Emerging Growth Companies

The Board is committed to analyzing the economic impacts of its standard setting. The following discussion addresses the potential economic impacts, including potential benefits and costs, considered by the Board. The Board has sought information relevant to economic consequences several times over the course of the rulemaking. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data or quantified estimates of the costs or other potential impacts of the standard. The potential benefits and costs considered by the Board are inherently difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature.

Commenters who discussed the economic analysis in the Board's reproposal provided a wide range of views. Some commenters pointed to academic research for the Board to consider in support of their views. One commenter asserted that the Board's release did not provide a true economic analysis of the pros and cons of mandating the reporting of critical audit matters, but only referenced academic studies on the purported benefits of such reporting. Another argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. The SEC's Investor Advocate said that the Board's economic analysis made a compelling case as to why the required reporting of critical audit matters would reduce informational asymmetries and add to the total mix of information available to investors.[89] The Board has considered all comments received and

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[89] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016)

has sought to develop an economic analysis that evaluates the potential benefits and costs of the final standard, as well as facilitates comparisons to alternative Board actions.

Need for the Rulemaking

*Critical Audit Matters*

Generally, investors and other financial statement users know less about a company's financial performance than do others closer to the financial reporting process, particularly management. This information asymmetry[90] can result in situations where capital is allocated suboptimally. The system of financial reporting in the United States, which requires periodic reporting of information, including annual financial statements, helps address the information asymmetry between investors and management. Board of directors and audit committee oversight of the financial reporting process can further reduce this information asymmetry by enhancing the quality of the information disclosed to the public. As part of this system, the audit of the financial statements also helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Companies' operations continue to become more complex and global. In addition, over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.[91] These estimates and fair

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at 3, available on the Board's website in Docket 034.

[90] Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

[91] *See* PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

value measurements, which are important to a financial statement user's understanding of the company's financial position and results of operations, can be highly subjective, require significant judgment, and can result in increased measurement uncertainty in financial statements.[92] The increased complexity of financial reporting, including the growing use of complex accounting estimates and fair value measurements, may contribute to the information asymmetry between investors and management, despite the fact that management is required to provide significant disclosures to investors and other financial statement users. Some commenters on the reproposal have stated that investors would find information provided by the auditor, an independent third party, particularly relevant in this setting.

As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, the auditor's report has not been expanded to provide this information to investors and generally provides only a standardized pass/fail opinion. Because the auditor's report generally does not contain audit-specific information, it provides very little of the information the auditor knows about the company, its financial reporting, and the challenges of the audit. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the

[92] *See* IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Mar. 2016).

current form of the auditor's report does little to address the information asymmetry between investors and auditors.

The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments will help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, in the Board's view, an expanded auditor's report will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Reducing information asymmetry about the company's financial reporting should lead to a more efficient allocation of capital.

Some commenters supported the reporting of critical audit matters as a means of reducing the information asymmetry between investors and auditors. Other commenters disagreed with the Board's approach and questioned whether the Board could or should attempt to reduce information asymmetry by requiring expanded auditor reporting. The Board believes that requiring expanded auditor reporting as a means of reducing the information asymmetry between investors and auditors is consistent with its statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[93] Investors are the intended beneficiaries of the audit, but investors do not receive information about specific work performed during the audit. The final standard seeks to enhance the form and

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93 Section 101(a) of Sarbanes-Oxley.

content of the auditor's report to make it more relevant and informative to investors and other financial statement users.

Increasing the Informativeness of the Auditor's Report to Address Information Asymmetry

The communication of critical audit matters will reduce the information asymmetry between investors and auditors by informing investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgment, including the principal considerations for determining the matters and how the matters were addressed in the audit. The Board believes that auditor reporting of critical audit matters will provide investors with audit-specific information that should facilitate their analysis of the financial statements and other related disclosures. The communication of critical audit matters in the auditor's report should also help investors and analysts who are interested in doing so to engage management and the audit committee with targeted questions about these issues.[94] Ultimately, while not every critical audit matter will be useful for every investor, broadly, the Board believes that having the auditor provide investors and other financial statements users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing additional insights on the financial statements.

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[94] The FRC observes that, in some instances, investors have begun to use the information provided in the expanded auditor's reports in the U.K. to engage with audit committees. *See* FRC, *Extended Auditor's Reports, A Further Review of Experience* (Jan. 2016) ("FRC 2016 Report").

The communication of critical audit matters should also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality.[95] For example, the description of how the auditor addressed the critical audit matter will help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which should allow a deeper and more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have consistently stated that having the auditor rather than the company, provide this type of information would be of added value to investment decision making.[96] Commenting on the reproposal, the SEC's Investor Advocate noted that investors want to hear directly from the auditor and that this point is confirmed by surveys of professional investors, as well as by certain academic research.[97] This commenter agreed with the premise in the reproposal that, because the auditor is required to be independent, information provided by the auditor may be viewed

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[95] It is often not possible to observe the difference between financial reporting quality and audit quality. An academic study conceptually models the path through which the financial reporting and audit processes result in audited financial reporting outcomes. The authors postulate that although audit quality and pre-audit financial reporting quality are distinct constructs, the two processes are often inseparable in terms of observable financial reporting outcomes in archival research. *See* Lisa Milici Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri Lombardi Yohn, *Understanding the Relation between Financial Reporting Quality and Audit Quality*, 35 Auditing: A Journal of Practice & Theory 1, 1-22 (2016).

[96] *See* IAG 2011 survey and CFA survey and poll results.

[97] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's website in Docket 034 (citing Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* 33 Auditing: A Journal of Practice & Theory 71, 71–93 (2014)).

by investors as having greater credibility than information provided by management alone.

Reporting of critical audit matters should provide insights that will add to the mix of information that could be used in investors' capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;
- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and
- Enabling comparison of these aspects of the audit for the same company over time.

Many companies commenting on the reproposal argued that the reporting of critical audit matters would not increase the informativeness of the auditor's report. For example, several of these commenters claimed that the reporting of critical audit matters would simply duplicate management disclosure without adding additional information, or that critical audit matters would not provide value-relevant information. Other commenters asserted that the reporting of critical audit matters would result in the auditor's report becoming a lengthy list of boilerplate disclosures, which would contribute to disclosure overload or run contrary to the SEC's disclosure effectiveness initiative. Several commenters said that critical audit matters could confuse investors if the information in the auditor's report was duplicative of management's disclosures but was presented in a different manner, or if the critical audit matter presented information without appropriate context.

By contrast, investor commenters overwhelmingly agreed that the communication of critical audit matters would make the auditor's report more informative. One commenter said that, although critical audit matters in themselves would not provide investors with all the information needed in the face of growing financial complexity, critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies, form a multifaceted understanding of them, and make informed investment decisions. Another commenter noted that, in jurisdictions where the expanded auditor's report is available, it is one of the earliest elements of the company's annual report that they read because it typically highlights the more judgmental elements of the company's accounting, which often provides insights that form a basis for discussions with management.

Mandated Rather than Voluntary Reporting

Auditors have not developed a practice of providing information in the auditor's report beyond what is required, even though investors have consistently requested that the auditor's report become more informative. Current standards provide a framework for auditors to provide limited additional information through emphasis paragraphs,[98] but in general these only point to a disclosure in the company's financial statements without providing any additional description of the matter and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not prohibited in an emphasis paragraph, but current standards do not encourage auditors to include such information in their report and do not provide a framework for doing so.

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[98] *See* existing AS 3101.19.

There are many other potential reasons why auditors are not providing information voluntarily in the auditor's report, whether about the financial statements or the audit. For example, the historical model of management disclosing information and the auditor attesting to the information may lead companies to resist voluntary additional reporting by the auditor, either through emphasis paragraphs or with respect to information about the audit, which the auditor would be better positioned to communicate than management. Further, auditors may believe that providing additional information could potentially expose them to liability or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the identified matters. Finally, in general, there may be disincentives to voluntary reporting if the disclosing party is not able to fully capture the benefits of the disclosures,[99] and parties may also exhibit a bias toward the *status quo.*[100] All of these factors disincentivize auditors from voluntarily providing further information about the audit, even if investors and other financial statement users would respond favorably to receiving additional information.

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[99] Academic research finds that there are certain situations in which disclosure may be socially optimal but not privately optimal. Auditors and companies may resist voluntary expanded auditor reporting because of concerns that certain types of spillover effects (or externalities) may create a competitive disadvantage. For a summary of this line of research, *see* Luigi Zingales, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, 394-395 (2009). Professor Zingales is the founding director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited above was published before he joined the PCAOB.

[100] Research in behavioral economics suggests that when facing a set of decisions, individuals are more likely to stick to the known outcome (*status quo*) than would be expected based on the theory of rational decision making under uncertainty. There are a variety of reasons why individuals may choose the status quo outcome in lieu of an unknown outcome, including aversion to the uncertainty inherent in moving from the status quo to another option. *See* William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 Journal of Risk and Uncertainty 7, 7-59 (1988).

The Board believes that the required reporting of critical audit matters will promote more complete and consistent disclosure of audit-specific information to financial statement users who may be interested in it.[101] Mandatory disclosure can also improve the allocative efficiency of capital markets by decreasing the costs associated with gathering information, or by providing market participants with information that otherwise would have been difficult or impossible for them to gather.[102]

*Additional Improvements to the Auditor's Report*

The final standard requires auditors to disclose in the auditor's report the number of years they have served consecutively as the auditor for the company. Although some commenters dispute the value of this information, investor commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point. The growing trend toward voluntary disclosure of this information by companies suggests that increasing numbers of companies believe that the market finds the disclosure useful.[103] Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.[104]

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[101] Academic research on disclosure explores these types of positive externalities, as well as certain negative externalities. *See, e.g.*, Ronald A. Dye, *Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities*, 65 The Accounting Review 1, 1-24 (1990); or Anat R. Admati and Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 The Review of Financial Studies 479, 479-519 (2000).

[102] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review 717, 717–753 (1984).

[103] *See* Center for Audit Quality and Audit Analytics, 2016 Audit Committee Transparency Barometer (Nov. 2016). See also Ernst & Young, Audit Committee Reporting to Shareholders 2016 (Sept. 2016).

[104] *See* below for a discussion of academic research regarding auditor tenure.

Although investors may be able to determine auditor tenure by, for example, reviewing past auditor's reports, for many companies the information is not readily available even through a manual search process. Furthermore, while some companies voluntarily provide information about auditor tenure in the proxy statement, many do not. Many companies are also not subject to the proxy rules (for example, most investment companies, foreign private issuers, and many companies whose securities are not listed on a national securities exchange). In cases where the information is provided voluntarily, it is not provided in a consistent location. The Board believes that these issues create unnecessary search costs for investors who wish to evaluate information about auditor tenure. Mandatory disclosure of auditor tenure in the auditor's report will provide a consistent location for this information and will reduce search costs relative to the current baseline for investors who are interested in auditor tenure, especially in the case of companies that do not voluntarily provide such information or for which the information is not available through the EDGAR system. Mandatory disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The existing auditor's report also does not describe important aspects of the auditor's responsibilities under existing auditing standards, such as the auditor's responsibility to detect material misstatements, whether due to error or fraud; the auditor's responsibility for the notes to the financial statements; and the auditor independence requirement. This may contribute to misperceptions by investors and other financial statement users about the auditor's role and responsibilities, including with respect to these matters. Academic research suggests that there are a number of ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.[105] In addition, the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report, which may increase the time and costs of processing the information in the auditor's report. The final standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

Commenters generally supported the reproposed changes to these basic elements of the auditor's report. Some commenters noted that the enhanced descriptions of the auditor's responsibility to detect material misstatements would clarify the auditor's responsibilities for financial statement users, other commenters offered suggestions for refinement, such as aligning the requirements to the IAASB model or amending the description to more clearly define the auditor's role within the context of the financial reporting regulatory framework.

Commenters also generally supported including a statement on the auditor's independence requirement. For example, some commenters stated that adding a statement by the auditor on their independence would reinforce investors' understanding of the auditor's requirement to remain independent and objective in expressing the audit

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[105] *See, e.g.*, Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 69-90 (2008); Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); or Theodore J. Mock, Jean Bédard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing: A Journal of Practice & Theory 323, 323-351 (2013).

opinion. Other commenters said that the enhanced description of the independence requirement could provide a meaningful reminder of the importance of auditor independence. However, other commenters said that the enhanced description of auditor independence was either unnecessary, or would not have a significant impact on auditor behavior. Based on broad commenter support, the Board is adopting these additional improvements to the auditor's report as reproposed.

*Baseline*

*Critical Audit Matters*

The auditor's report in the United States today generally consists of three paragraphs that include limited audit-specific information. The existing auditor's report identifies the company's financial statements that were audited, provides a standardized description about the nature of an audit, and provides an opinion on whether the company's financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework. The auditor's report is often described as a pass/fail model because the report only conveys the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail) and typically provides limited information about the nature of the work on which the opinion is based.

The Board's current standards also require that the auditor add explanatory paragraphs to the auditor's report under specific circumstances, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements. When included, these paragraphs generally consist of standardized language that provides limited audit-specific information.

The auditor may also, at his or her discretion, include emphasis paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Generally, an emphasis paragraph only points to a disclosure in the company's financial statements without providing any additional description. Under current practice, emphasis paragraphs are infrequent.[106] Auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[107]

Academic research confirms the view of the Board and many commenters that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.[108] Academic research also finds that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified because it does not provide much additional informational value about a particular audit.[109] These findings align with the consistent

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[106] In the audit reports of approximately 6,350 issuers with fiscal year 2014 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 2 percent of the filings.

[107] *See* paragraph .10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710*.

[108] *See* Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis* 69-90.

[109] *See* Gray et al., *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors* 659–684; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications* 323–351.

call from investors, over the course of the Board's rulemaking process, for a more informative auditor's report.[110]

*Additional Improvements to the Auditor's Report*

The existing auditor's report is not required to have a specified addressee but it may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[111] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[112]

The current auditor's report also includes the report title, the date, and the name and location of the accounting firm's office issuing the report. The auditor is not currently required to disclose in the auditor's report the number of years it has served as auditor for the company. However, as noted earlier, many larger companies have begun voluntarily disclosing auditor tenure in the proxy statement.

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110 Academic research has found that, in some instances, the inclusion of explanatory language in the auditor's report may provide investors with additional value-relevant information. A recent academic study suggests that auditor's reports containing certain types of explanatory paragraphs required under existing standards may provide information about the likelihood that financial statements will be subsequently restated. The authors argue that the inclusion of such an explanatory paragraph in the auditor's report can provide a signal to investors about the risk of misstatement of the company's financial statements. *See* Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?* 89 The Accounting Review 2115, 2115–2149 (2014).

111 *See* existing AS 3101.09.

112 This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers, benefit plans, and brokers and dealers.

Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence.

*Benefits*

*Critical Audit Matters*

Economic theory commonly attributes two benefits to mandatory disclosure. First, the disclosure of previously unknown, value-relevant information directly benefits the market because it allows market participants to make better-informed decisions. Second, the disclosure of such information may indirectly benefit the market because some parties may change their behavior in positive ways after information is disclosed.

Direct Benefit: More Informative and Useful Auditor's Report

The Board believes that auditor communication of critical audit matters will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Some commenters on the reproposal agreed that the information provided in critical audit matters would be used by various types of investors in a number of different ways that are consistent with the framework outlined in the reproposal:

- *Informing*—Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, or complex, together with a description of how the auditor addressed those matters, which should provide valuable information. For example, some commenters said that:

    - Critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies and make investment decisions;
    - Investors would use critical audit matters in the same way that they use any other financial disclosure; critical audit matters would add an additional perspective to management's disclosures;
    - Insights on critical audit matters may be relevant in analyzing and pricing risks in capital valuation and allocation;
    - Critical audit matters would inform investor models of company financial performance;
    - Critical audit matters would augment and add more dimension to the information provided by the financial statements and the critical accounting policies and estimates; and
    - The communication of critical audit matters would lower the cost of acquiring information for financial statement users.
- *Framing*—Critical audit matters should provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which should

facilitate their analysis of the financial statements, and help them assess financial performance, for example by highlighting potentially relevant information or by reducing the costs to process or search for the information. For example, some commenters said that:

   - Critical audit matters would focus investors' attention on key financial reporting issues and identify areas that deserve more attention;
   - In jurisdictions where expanded auditor reporting is available, it focuses users' attention on issues that would be pertinent to understanding a company as a long-term investor; and
   - Information in critical audit matters would contribute to investor understanding and consumption of information in the financial statements.

- *Monitoring*—The ability to identify and evaluate the matters identified as critical audit matters should also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor. For example, some commenters said that:

   - Critical audit matters would facilitate the ability of investors to monitor management's and the board of director's stewardship of the company by highlighting accounting and auditing issues and other matters that investors may wish to emphasize in their engagement with management; and

- Critical audit matters would provide important information on how the auditor has addressed an issue, which investors can use in evaluating the rigor of the audit and making proxy voting decisions, including ratification of the audit committee's choice of external auditor.

Critical audit matters may be used by different types of investors in different ways. For example, retail investors (or others who may act on their behalf, such as analysts, credit rating agencies, or the financial press) may use the additional information to help them identify and analyze important aspects of the financial statements. Larger investors, on the other hand, may also use critical audit matters as a basis for engagement with management.

The communication of critical audit matters aims to provide investors and financial statement users with specific information about the audit of a company's financial statements. Some commenters were concerned, however, that the communication of critical audit matters could lead to a reduction in comparability of auditor's reports. Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, to the extent the information provided is useful in evaluating the financial performance, highlighting these differences should contribute to the overall mix of information. Further, some commenters on the proposal said that investors are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditor's reports across companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or MD&A that is specific to a company or a reporting period.

A body of academic research regarding the possible effects of expanded auditor reporting is emerging.[113] The Board has been monitoring this research with a view towards assessing its potential relevance to this rulemaking. The Board is mindful of several issues that limit the extent to which this research can inform its decision making. Much of this research is unpublished and at a relatively early stage. The current conclusions may be subject to multiple interpretations and it is possible that results from this research may be revised during the peer review process. Moreover, it may be difficult to generalize results outside the context of specific studies. For example, in considering the implications of academic studies based on data from other jurisdictions, differences between the Board's final standard and the requirements in other jurisdictions must be taken into account. In addition, specific characteristics of the U.S.-issuer audit market may make it difficult to generalize observations made in other markets because of differences in baseline conditions (for example, market efficiency, affected parties, policy choices, legal environment, and regulatory oversight). As to experimental research in particular, it should be noted that the experimental setting may not provide study participants with information that is representative of the information environment in which market participants actually operate; for instance, if new information appeared more salient to study participants than it would to a market participant, the impact of

[113] For a review of relevant academic research, *see* Jean Bédard, Paul Coram, Reza Espahbodi, and Theodore J. Mock, *Does Recent Academic Research Support Changes to Audit Reporting Standards?* 30 Accounting Horizons 255, 255-275 (2016).

expanded auditor reporting would be overstated in an experimental setting. In addition, some of these studies were conducted based on earlier versions of rule text that differs from the final standard, which may affect the extent to which the results can inform the Board in evaluating potential effects of the final standard.

As discussed in more detail in the economic analysis contained in the reproposal, the results from early research analyzing the informational value of expanded auditor reporting are inconclusive.[114] Some studies found that expanded auditor reporting could provide investors with new and useful information, while other studies found that the benefits attributable to expanded auditor reporting were not statistically significant, but that it could produce unintended consequences. These limited findings may be due to the fact that the results of the studies represent averages for large samples of companies. On average, investors may already have access to a variety of information sources (such as annual reports, news media, and analyst research reports) which may contain similar information about a company. However, expanded auditor reporting may be relatively more informative for companies where alternative sources of information are less available (e.g., those companies with less analyst coverage).

In response to the reproposal, two commenters submitted studies suggesting that expanded auditor reporting has increased the informative value of the auditor's report. One experimental study tested the communicative value of expanded auditor reporting by analyzing how key audit matters affected investment professionals' assessment of a company's business economics, as well as their confidence in making that assessment.[115]

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[114] *See* PCAOB Release No. 2016-003, Section VI.C.1.a.

[115] *See* Annette Koehler, Nicole Ratzinger-Sakel, and Jochen Theis, *Does the*

The authors found that specific informational content of the key audit matter affected the study participants' perceived level of trust associated with the auditor's report, which then affected the perceived level of trust associated with the financial statements and their assessment of the company's business economics. Another study analyzed whether the communicative value of auditor's reports changed following the implementation of expanded auditor reporting in the United Kingdom.[116] The author found that the readability of auditor's reports increased in the post-implementation period, and that the use of negative and uncertain words in expanded auditor's reports captured more client-specific audit risk.[117] In addition, the author found limited evidence that the dispersion of analysts' EPS forecasts decreased following the implementation of expanded auditor reporting, suggesting an improved information environment. The author argued that expanded auditor reporting was successful at increasing the communicative value of the auditor's report, and that analyst behavior changed accordingly. In contrast, another recent experimental study found that including critical audit matters reduced the readability of the auditor’s report but did not incrementally inform nonprofessional investors’ valuation judgments. However, the study suggested that the reporting of a critical audit matter lowers nonprofessional investors' perceptions of management's

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*Reporting of Key Audit Matters Affect the Auditor's Report's Communicative Value? Experimental Evidence from Investment Professionals* (working paper submitted as comment letter No. 18, available on the Board's website in Docket 034).

[116] *See* Kecia Williams Smith, *Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom* (working paper submitted as comment letter No. 71, available on the Board's website in Docket 034).

[117] The author uses several measures designed to assess the readability of texts which, the study notes, have been used in several other published academic studies addressing the readability of financial disclosure. *See id.* at 5.

credibility when earnings just meet analysts' expectations. The study was designed and implemented using the definition of critical audit matters and related reporting requirements from the Board's proposal, which differ from the final standard.[118]

In addition, in reviewing the experience of expanded auditor reporting in the United Kingdom, the FRC observed that investors greatly value the information provided in expanded auditor reporting.[119] This view is confirmed by UK investors that commented on the reproposal. The FRC noted that, in the two years following the implementation of the new requirements, an association of investment managers has recognized in an annual awards ceremony those specific auditor's reports found to be most clear and most innovative in providing insight into the audit of the company's financial statements.[120] In addition, the FRC notes that users of the new auditor's reports identified certain descriptions of risks that they found to be more useful—such as descriptions that are specific to the entity being audited. Further, the FRC report noted that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.[121] As noted above, the FRC's requirements for expanded auditor reporting are different from the final standard, and the baseline legal and regulatory environment is not the same as in the United States.

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[118] *See* Brian Carver and Brad Trinkle, *Nonprofessional Investors' Reactions to the PCAOB's Proposed Changes to the Standard Audit Report* (March 2017) (working paper, available in Social Science Research Network).

[119] *See* FRC 2016 Report.

[120] *See* FRC, *March 2015—Extended Auditor's Reports, A Review of Experience in the First Year*; and FRC 2016 Report.

[121] *Id*.

Nevertheless, the Board believes that there are sufficient similarities for the UK experience to be generally informative in its decision-making.

While it is too early for the body of academic research on expanded auditor reporting to provide a conclusive answer, investors commenting during the Board's standard-setting process have consistently affirmed the usefulness of expanded auditor reporting and the FRC's observations on the early experience of investors in the United Kingdom are consistent with this view. Accordingly, the Board believes that auditor communication of critical audit matters will add to the mix of information that investors can use.

Indirect Benefit: Improved Audit and Financial Reporting Quality

In general, information asymmetry can lead to situations in which an agent (such as an auditor) takes actions that do not coincide with the best interests of the principal (such as an investor), if the agent's incentives are misaligned.[122] This type of problem is the result of the inability of the principal to observe or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior, or punish sub-optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.[123] In the context of expanded

[122] Economists use principal-agent theory to analyze situations where one party (the principal) hires another party (the agent) to perform certain tasks and decision-making ability is delegated to the agent. For a general discussion of principal-agent theory, *see, e.g.*, Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics 305, 305-360 (1976), or Bengt Holmstrom, *Moral Hazard and Observability*, 10 The Bell Journal of Economics 74, 74-91 (1979).

[123] *See, e.g.*, George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 Annual Review of Economics 391, 391-419 (2014).

auditor reporting, the additional information provided in the auditor's report could be beneficial to investors by providing more information about the audit, which could affect their voting decisions. To the extent that this could influence the terms of the auditor's engagement, academic research suggests "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."[124]

This suggests that making aspects of the audit more visible to investors through the communication of critical audit matters should provide some auditors, management, and audit committees with additional incentives to change their behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters could lead:

- Auditors to focus more closely on the matters identified as critical audit matters;
- Audit committees to focus more closely on the matters identified as critical audit matters and to engage the auditor and management about the adequacy of the related disclosures; and
- Management to improve the quality of their disclosures because they know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters.

The communication of critical audit matters could lead auditors to increase their focus on the matters identified in the auditor's report as critical audit matters. As suggested by commenters, the communication of critical audit matters could further

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[124] *See* Holmstrom, *Moral Hazard and Observability* at 75.

incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. Other commenters stated that the reporting of critical audit matters could result in increased audit quality. For example, auditors could feel that the potentially heightened scrutiny of the matters identified as critical audit matters may warrant additional effort to satisfy themselves that they have obtained an appropriate amount of audit evidence to support their opinion.

The communication of critical audit matters could also heighten management's attention to the relevant areas of financial statements and related disclosures. Several commenters stated that the reporting of critical audit matters would lead management to improve the quality of their disclosures or adopt more widely accepted financial reporting approaches in these areas.[125]

An experimental study analyzed the joint effect of expanded auditor reporting and audit committee oversight on management disclosure choices.[126] The author found that the study participants, who were currently serving as public company financial executives, chose to provide the greatest level of disclosure when they knew that the auditor's report would provide a more detailed description of the accounting estimate, and the audit committee exhibited strong oversight. The author argued that, similar to what

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[125] To substantiate this point, one commenter cited a memo prepared for the clients of an international law firm that noted management should consider revising or supplementing their own disclosures relating to issues raised in expanded auditor's reports to ensure that the totality of disclosures around the issue are complete and accurate. *See* Sullivan & Cromwell LLP, *Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard* (May 25, 2016).

[126] *See* Stephen H. Fuller, *The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions* (working paper submitted as comment letter No. 49, available on the Board's website in Docket 034).

other academic research has found regarding the resolution of audit adjustments, information presented in critical audit matters would be the outcome of a negotiation process between the auditor and management.

Increased management attention to the related aspects of the financial statement accounts and disclosures described in the critical audit matters should, at least in some cases, lead to an incremental increase in the quality of the information presented. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[127]

In addition, the communication of critical audit matters may enhance the audit committee's oversight efforts by providing an additional incentive for the audit committee to engage with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures. Although some commenters stated that the required communication of critical audit matters would "chill" communications between the auditor and the audit committee, others said that it would enhance communications between these parties. Further, it should be noted that the final standard does not change the Board's existing requirements on audit committee communications, other than requiring the auditor to provide the audit committee with a draft of the auditor's report.

To the extent changes in the behavior of auditors, audit committees, and management occur, they could lead to an incremental increase in audit quality and financial reporting quality, which should increase investors' confidence in the reliability

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[127] *See, e.g.*, Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2012). Professor Leuz is an economic advisor at the PCAOB. The research cited above was published before he joined the PCAOB.

of the financial statements. Some commenters stated that a more transparent and informative auditor's report could heighten user confidence in the audit and the audited financial statements. Academic research suggests that an increase in investor confidence should decrease the average cost of capital.[128] As discussed in the economic analysis of the reproposal, some empirical studies conducted in other jurisdictions provide evidence that expanded auditor reporting increased audit quality, while other studies found that it did not have a measurable effect on audit quality.[129] The Board is not aware of any empirical studies indicating that expanded auditor reporting had a negative effect on audit quality.

Indirect Benefit: Differentiation among Auditor's Reports

If investors and other financial statement users perceive and respond to differences in the quality and usefulness of the information communicated by auditors regarding critical audit matters, expanded auditor reporting should serve as a potential means of greater differentiation among accounting firms and engagement partners.[130] One commenter stated that the reporting of critical audit matters would allow auditors to

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[128] *See* Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Trusting the Stock Market*, 63 The Journal of Finance 2557, 2557–2600 (2008). Professor Zingales is the Founding Director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited here was published before he joined the PCAOB.

[129] *See* PCAOB Release No. 2016-003, Section VI.C.1.b, footnotes 154-156 and accompanying text.

[130] On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. *See* PCAOB Release No. 2015-008.

differentiate themselves, and that this differentiation would provide useful information to investors and other financial statement users. If expanded auditor reporting allows investors to differentiate among accounting firms and engagement partners, it should provide a more nuanced signal of audit quality and financial reporting reliability.

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements.[131] For example, one firm went beyond the FRC's requirements by including audit findings for the risks of material misstatement in the majority of its auditor's reports in the second year of implementation, which other firms did far less frequently. The FRC's observations may suggest that accounting firms took different approaches to expanded auditor reporting as a means of distinguishing themselves based on the quality and usefulness of the information provided in their auditor's reports. Furthermore, as discussed in the economic analysis of the reproposal, an academic study argued that investors found the auditor's reports issued by some accounting firms to be more useful than others.[132] One commenter specifically noted that mandatory auditor rotation was introduced in the UK at the same time as expanded auditor reporting, and that this may have provided accounting firms with motivation to differentiate themselves.

In addition to relying on the audit committee (which, at least for exchange-listed companies, is charged with overseeing the external auditor), in the absence of differentiation based on the auditor's report, users of financial statements may rely on proxies such as the reputation of the accounting firm issuing the auditor's report,

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[131] *See* FRC 2016 report.

[132] *See* PCAOB Release No. 2016-003, Section VI.C.1.b, footnote 161 and accompanying text.

aggregated measures of auditor expertise (for example, dollar value of issuer market capitalization audited or audit fees charged), or information about the geographic location of the office where the auditor's report was signed as signals for audit quality. Academic research finds, however, that these are imperfect signals of audit quality.[133]

The identification and description of critical audit matters should permit differentiation among auditor's reports based on investor perceptions of their informativeness and usefulness. In some instances it may also provide a signal of audit quality. Because the determination and communication of critical audit matters may reflect a variety of considerations, however, critical audit matters may not bear directly on audit quality. For example, the choice of which critical audit matters to communicate or how to describe them may reflect considerations such as the company's business environment and financial reporting choices, accounting firm methodology, engagement partner characteristics, and legal advice. Thus, a more detailed description of critical audit matters may not necessarily reflect a higher quality audit than a less informative description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters should provide insight into the extent and appropriateness of the auditor's work. Moreover, it is possible that thoughtful, audit-specific, and useful critical audit matters (or, conversely, generic and uninformative critical audit matters) could affect investor perceptions of the auditor's work and willingness to provide useful information. As a result, the communication of critical audit matters, potentially in conjunction with

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[133] *See, e.g.*, Jere R. Francis, *A Framework for Understanding and Researching Audit Quality*, 30 Auditing: A Journal of Practice & Theory 125, 125–152 (2011) and Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 Journal of Accounting and Economics 275, 275–326 (2014).

disclosures regarding the identity of the engagement partner and other accounting firms that participated in the audit,[134] and other relevant information should enable differentiation among engagement partners and accounting firms on that basis.

*Additional Improvements to the Auditor's Report*

The final standard will introduce new requirements regarding auditor tenure, the addressee of the auditor's report, and statements in the auditor's report related to auditor independence and the auditor's responsibility for reporting on ICFR.[135] In addition, the final standard contains other changes to the form of the auditor's report, which are intended to improve and clarify the language for certain elements, such as statements related to the auditor's responsibilities regarding the notes to the financial statements, and to promote a consistent presentation of this information across auditor's reports.

Investor commenters have consistently supported disclosing tenure in the auditor's report. In the Board's view, which is consistent with the views of some commenters,[136] disclosing information about auditor tenure in the auditor's report will provide a consistent location for this information and decrease the search costs, relative to the current environment of voluntary reporting, for some investors and other financial statement users who are interested in this information.

The statement regarding the auditor's existing obligation to be independent of the company is intended to enhance investors' and other financial statement users'

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[134] *See* PCAOB Release No. 2015-008.

[135] In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the final standard requires a statement to that effect in the auditor's report.

[136] *See* below for a discussion of academic research regarding auditor tenure.

understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. By requiring the auditor's report to be addressed to certain parties, the Board will be promoting uniformity in the addressees of the auditor's report.

Commenters were generally supportive of the reproposed changes to the form of the auditor's report. For example, some commenters stated these enhancements would make the auditor's report easier to read and would facilitate comparisons between auditor's reports for different companies by providing a consistent format.

*Costs and Potential Unintended Consequences*

*Costs*

Commenters on the reproposal raised concerns that the rule would impose various types of costs, but generally did not quantify those costs. Even those that, at an earlier stage of the rulemaking, conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Given lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis.

As an additional means of assessing potential cost implications of the final standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.[137] As discussed below, staff analyzed a variety of data points that may be associated with potential costs, including audit fees, days required to issue the auditor's report, and the content of the expanded auditor's report. It should be noted that it may be difficult to generalize observations from the UK

[137] *See* PCAOB, *White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard* (UK and Ireland) 700 ("PCAOB White Paper") (May 2016), available on the Board's website in Docket 034.

experience. For example, the reporting and documentation requirements relating to expanded auditor's reports in the United Kingdom differ from those in the final standard, the baseline legal environments are different, and the UK requirements apply only to companies with a premium listing on the London Stock Exchange and not, for example, to smaller companies that list on London's AIM market.

*Critical Audit Matters*

The Board anticipates that the final requirements regarding critical audit matters will have potential cost implications for auditors and companies, including their audit committees. Such costs will likely relate to additional time to prepare and review auditor's reports, including discussions with management and audit committees, as well as legal costs for review of the information provided in the critical audit matters. In addition, auditors may choose to perform more audit procedures related to areas reported as critical audit matters (even though performance requirements have not changed in those areas), with cost implications for both auditors and companies.

For auditors, costs might represent both one-time costs and recurring costs. One-time costs could be incurred as a result of: (1) updating accounting firm audit and quality control methodologies to reflect the new reporting requirements; and (2) developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms will likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters. One commenter suggested that the initial implementation costs could place a significant and possibly disproportionate burden on smaller accounting firms.

Recurring costs will primarily reflect additional effort expended in individual audits. The final standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which will be based on work the auditor has already performed. However, there will be some additional recurring costs associated with drafting descriptions of critical audit matters and related documentation. It is likely that senior members of the engagement teams, such as partners and senior managers, will be involved in determining the critical audit matters and developing the language to be included in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office, will also result in recurring costs. Additional time might also be incurred by the auditor as a result of discussions with management or the audit committee regarding critical audit matters.

Companies, including audit committees, will likely also incur both one-time and recurring costs as a result of the final standard. One-time costs could be incurred, for example, in educating audit committee members about the requirements of the new standard and in developing management and audit committee processes for the review of draft descriptions of critical audit matters and the related interaction with auditors. Recurring costs will include the costs associated with carrying out those processes, as well as any increase in audit fees associated with the new reporting requirements or legal fees stemming from a review of critical audit matter communications.

If the drafting and review of critical audit matter reporting takes place towards the end of the audit, there will also be an opportunity cost associated with the time constraints on the parties involved (including, for example, management, the engagement partner, the audit committee, and the auditor's and company's respective legal counsel).

The end of the audit is a busy period in which multiple issues may need to be resolved before the auditor's report can be issued. At the same time, companies and management may also be in the process of finalizing the annual report. Time spent drafting and reviewing the communication of critical audit matters could occur at the same time as other important work in the financial reporting and audit process, and would likely involve senior management that command relatively high annual salaries or experienced auditors and lawyers with relatively high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in more effort and cost in the financial reporting process.

Several commenters on the reproposal claimed that the required reporting of critical audit matters would lead to increased audit fees, but none provided data or estimates regarding the magnitude of the increases they expected. Commenters on the proposal had differing views about the likely magnitude of direct costs associated with auditor reporting of critical audit matters. Some commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been communicated to the audit committee. This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit.

One commenter argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. Some commenters noted that investors would be expected to ultimately bear the cost of the audit, and these commenters have voiced strong support for expanded auditor reporting since the project's inception. This suggests that they consider the benefits of expanded auditor reporting to justify the costs, and would support additional fees for additional useful information.

Audit fees do not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms choose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting. Subject to those limitations, in its review of the implementation of expanded auditor reporting in the United Kingdom, the PCAOB staff did not find evidence of statistically significant increases in audit fees following the first year of expanded auditor reporting.[138] For 53 percent of the companies analyzed, audit fees for the year of implementation remained the same or decreased as compared to the prior year's audit fees. Audit fees increased for the remaining companies. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent, roughly consistent with the findings of academic research described in the economic analysis in the reproposal. However, the staff found that the median change in audit fees was zero. Collectively, these results seem to suggest that outlier companies with relatively large increases in audit fees drove the result for the average change in audit fees. It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, changes in the economic environment and corporate risk, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees.

One commenter on the reproposal noted that the caveats described above are important because the inability to fully gauge the costs of expanded auditor reporting

[138] *Id*.

could lead the Board to underestimate the costs associated with the rule, which may bear disproportionately on smaller companies and their auditors. Another commenter also asserted that the costs of expanded auditor reporting are likely to be disproportionately borne by smaller companies because the reproposed rule had, in their estimation, limited scalability. The Board believes that the complexity and costs associated with determining, documenting, and communicating critical audit matters should generally depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

Additional Improvements to the Auditor's Report

The changes adopted to the basic elements of the auditor's report do not represent a significant departure from the reproposal. Some of the enhanced basic elements will have cost implications for auditors, although these costs are not expected to be significant. One-time costs will primarily relate to updating methodology and training and the initial determination of the first year the auditor began serving consecutively as the company's auditor. Based on comments received, it does not appear that the changes adopted to the basic elements will impose significant recurring costs, because the year in which tenure began will not change and the other amendments involve standardized language that, once implemented, will be the same or very similar across different auditor's reports every year.

*Potential Unintended Consequences*

Time Needed to Issue the Auditor's Report

As a result of the additional effort required to determine, communicate, and document critical audit matters, some commenters said that it would take auditors longer to issue their reports. On this point, the PCAOB staff study did not find evidence that compliance with the United Kingdom's expanded auditor reporting requirements delayed the issuance of auditor's reports in the first year of implementation. Based on the study, for companies that had three years of financial statements, a new form auditor's report was issued, on average, in 63 days from the company's fiscal year end date in the year of implementation, as compared to 64 days in the prior year and 65 days two years earlier. Further, academic research cited in the economic analysis of the reproposal similarly did not find that the UK reporting requirements led to delays in financial reporting.[139]

Number and Content of Critical Audit Matters

Some commenters indicated an expectation that the auditor's report would include a long list of critical audit matters or that auditors would have incentives to communicate an overly long list of critical audit matters. For example, some commenters said that this would occur because the auditor would be motivated to communicate as much as possible in an effort to mitigate any future liability for unidentified critical audit matters, or as a means to avoid potential consequences of being second-guessed by regulators or others. Other commenters asserted that such a development could make the auditor's report overly long, contributing to disclosure overload and conflicting with the SEC's disclosure effectiveness project. Other commenters indicated that expanded auditor reporting could lead to boilerplate language that would diminish the expected value of the critical audit matters and obscure the clarity of the auditor's opinion. If auditors fail to provide audit-specific information, the communication of critical audit matters will not decrease

[139] *See* PCAOB Release No. 2016-003, section VI.D.2.a, footnote 169 and accompanying text.

information asymmetry about the audit, and may obscure other important information included in the auditor's report and the audited financial statements.

The final requirements aim to provide investors with the auditor's unique perspective on the areas of the audit that involved the auditor's especially challenging, subjective, or complex judgments. Limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Also, while some commenters argued that liability concerns would increase the number of critical audit matters auditors communicate, others suggested that liability concerns would minimize the additional statements auditors make.

The PCAOB staff study did not find evidence that expanded auditor reporting in the United Kingdom resulted in a very large number of risk topics or none at all in the first year of implementation.[140] On average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight. Additionally, the descriptions of the risks of material misstatement in the auditor's reports in the first year of implementation were not presented in standardized language, but included variations in content length, description, and presentation. The most frequently described risk topics related to revenue recognition, tax, and goodwill and intangible assets. The FRC report on the first two years of expanded auditor reporting in the United Kingdom finds a similar range and average number of risk topics disclosed

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[140] *See* PCAOB White Paper.

in both the first and second year of implementation.[141] The FRC report also finds disclosure of similar risk topics in the second year of implementation of expanded auditor reporting in the United Kingdom.[142]

Further, the FRC found that, in the second year of expanded auditor reporting in the United Kingdom, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's reports provided discussion of risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.[143] These findings suggest that, thus far, expanded auditor reporting has not become standardized in the United Kingdom.[144]

Effects of Increased Attention to Critical Audit Matters

The communication of critical audit matters could lead auditors, company management, and the audit committee to spend additional time and resources on reviewing the adequacy of the work performed on the related financial statement accounts and disclosures. While this could lead to an incremental improvement in audit and financial reporting quality for the identified critical audit matters, it is also possible that there may be increased costs for auditors as a result of the requirements. For example, even though the final standard does not mandate the performance of additional audit procedures other than with respect to communication of critical audit matters, it is

141 *See* FRC 2016 Report.

142 *Id*.

143 *Id*.

144 The Board finds the UK experience instructive, although it is, of course, possible that differences between the UK and US litigation and regulatory environments may influence the extent to which these findings would generalize to the US market.

possible that some auditors may perform additional procedures. If that occurs, the associated costs may be passed on—in whole, in part, or not at all—to companies and their investors in the form of higher audit fees. Further, increased procedures may also require additional time from the company's management to deal with such procedures. Some commenters suggested that the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality if other material aspects of the financial statements and disclosures receive less attention.

Some commenters argued that including critical audit matters in the auditor's report would impair the relationship between auditors and management or auditors and the audit committee. Other commenters suggested that the required reporting of critical audit matters would inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in the auditor's report. One commenter also suggested that auditors may include additional matters in audit committee communications out of concern that an omission could lead to regulatory sanctions or liability. Other commenters have said that it would enhance communication among the participants in the financial reporting process.

An experimental study analyzed how the strength of audit committee oversight of the financial reporting process varied with the presence of sophisticated investors and knowledge of forthcoming expanded auditor reporting.[145] The author found that study participants, most of whom were experienced audit committee members, asked fewer probing questions if they knew that the auditor would be providing a discussion of the

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[145] Yoon Ju Kang, *Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?* (working paper submitted as comment letter No. 17, available on the Board's website in Docket 034).

significant accounting estimate in the auditor's report. The author argued that by asking fewer probing questions audit committee members subconsciously insulated themselves from potential challenges mounted by investors regarding the appropriateness of the company's financial reporting. The Board is not aware of evidence this has occurred in the jurisdictions that have adopted expanded auditor reporting. Moreover, it may be difficult in an experimental setting to recreate the actual legal responsibility and potential liability that audit committee members face, which may limit the extent to which the experimental results would generalize to actual behavior in real-world settings.

Similarly, as described in the economic analysis of the reproposal and asserted by at least one commenter, management may have an incentive to withhold information from the auditor in order to prevent an issue from being described in the auditor's report. It seems unlikely, however, that management would or could withhold information from the auditor on the most critical issues in the audit because it could result in a scope limitation. On the contrary, it may be just as likely that management would communicate more information to the auditor as a means of demonstrating that an issue is not challenging, subjective, or complex, and, therefore, would not need to be described in the auditor's report.

Under the final standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. As noted earlier, with respect to any matters already required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. Therefore, it would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee, although, as previously described, given the breadth of current communication requirements, the Board believes there will likely be few communications affected by that possibility.

Potential Impact on Management Disclosure

Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management. While some commenters asserted that this would be beneficial, others claimed it would be an unintended negative consequence of requiring the communication of critical audit matters. Several commenters characterized this as inappropriately expanding the role of the auditor in the financial reporting process, while undermining the role of management and the audit committee. In their view, this would be especially problematic if the final standard permitted the auditor to communicate information that was not otherwise required to be disclosed (for example, because it did not meet a specified threshold for disclosure, such as a significant deficiency in internal control over financial reporting). Commenters claimed that auditor communication of this "original information" would cause a number of unintended consequences, including significant costs, disclosure of confidential or competitively sensitive information, and potentially misleading or incomplete information.

Investors and other commenters pointed out that, although expanded auditor reporting would give the auditor additional leverage over management's disclosure choices, this could result in improvements in the usability of financial statements and increases in financial reporting quality. One of these commenters cited academic research noting that, in current practice, disclosure is already guided by an iterative process between management and the auditor. This commenter reasoned that concerns regarding "original information" were misplaced because the iterative process would reduce the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.

Another commenter pointed out that auditors would not have incentives to interpret the Board's rule to require disclosure of original information in most situations. For example, concerns about the limitations of their knowledge and expertise, potential liability implications, and friction in the relationship with the company are likely to discourage auditors from going beyond management disclosures. Nevertheless, the final standard contemplates that the auditor will do so only when it is necessary to describe the principal considerations that led the auditor to determine that a matter was especially challenging, subjective, or complex and how the matter was addressed in the audit. The Board believes that this provision is needed in order to ensure that the fact that management did not provide a disclosure would not prevent the auditor from communicating a critical audit matter.

Although the communication of critical audit matters may lead to changes in the incentives for the auditor, company management, and the audit committee to communicate with each other, initial anecdotal evidence from the Board's outreach activities suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

<u>Changes in Perceived Assurance on the Auditor's Report, Including Perceptions of Auditor Liability</u>

The communication of critical audit matters could have liability implications for auditors. In addition, because the communication of critical audit matters requires auditors to discuss aspects of the audit that they found to be especially challenging, subjective, or complex, it is possible that some investors and financial statement users may misconstrue the communications to mean that auditors were unable to obtain reasonable assurance about the matters identified as critical audit matters. Some commenters have said that the communication of critical audit matters could lead to changes in the way investors and financial statements users perceive the level of assurance provided by the auditor on matters identified as critical audit matters, including that it could undermine the basic pass/fail opinion. This could lead investors to erroneously conclude that there is a problem with the audit either in the areas identified in critical audit matters or other areas, or that auditors are providing separate assurance about the presentation of the financial statements, which may have implications for perceptions of auditor responsibility in the event of an audit failure.

As discussed in the economic analysis of the reproposal, several academic papers analyze certain risks associated with communicating critical audit matters, including perception of auditor responsibility.[146] If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some academic research, and this in turn reduced auditor liability, it is possible that auditors may feel that less audit work is needed on the matters identified as critical audit matters, which could adversely affect audit quality (although the Board's other auditing standards, reinforced through firm quality control and Board inspections and enforcement activity, should provide a disincentive for auditors to decrease the amount or quality of audit work performed). It is difficult to draw generalizable conclusions based on the findings of these

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[146] *See* PCAOB Release No. 2016-003, Section VI.D.2.d, footnotes 182-186 and accompanying text.

studies. In part, this is because their results vary and are sometimes contradictory, with some studies finding that expanded auditor reporting increases perceived auditor responsibility and others finding that it decreases perceived auditor responsibility. This may suggest that the results are sensitive to the experimental design and the context in which information is presented to study participants. In addition, it is not clear how the findings would correlate with changes in auditor behavior, because perceptions of auditor responsibility may be a poor proxy for actual auditor responsibility or liability.

To address the risk that the communication of critical audit matters could result in the perception of separate assurance, the final standard requires the following statement in the auditor's report:

> The communication of critical audit matters does not alter in any way [the auditor's] opinion on the financial statements, taken as a whole, and [the auditor is not] by communicating the critical audit matters… providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

The purpose of this statement is to make clear that the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters. In this regard, the Board also notes the view of some commenters that critical audit matters are likely to be used by institutional investors that are unlikely to misinterpret the information.

Auditor Tenure

Many commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about correlations between auditor tenure and/or independence and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. For instance, some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[147] Other academic research suggests that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit quality.[148] Still other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality.[149]

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, commenters other than investors did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors or could result in false conclusions about correlations between auditor tenure and audit quality or between auditor tenure and auditor independence. Many of these commenters recommended that, if the Board determined to require

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[147] *See, e.g.*, Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 Auditing: A Journal of Practice & Theory 55, 55–69 (2004) and Timothy B. Bell, Monika Causholli, and W. Robert Knechel, *Audit Firm Tenure, Non–Audit Services, and Internal Assessments of Audit Quality*, 53 Journal of Accounting Research 461, 461–509 (2015).

[148] *See, e.g.*, Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517–548 (2009).

[149] *See, e.g.*, Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297–314 (2008).

disclosure of auditor tenure, it should be disclosed in Form AP rather than in the auditor's report as a means of avoiding these inferences.

*Alternatives Considered, Including Policy Choices under the Final Standard*

After considering the comments received, the Board is adopting a new auditor reporting standard, AS 3101 and related amendments to its standards. The final standard retains the pass/fail model while expanding auditor reporting to include the communication of critical audit matters. Investor commenters have consistently asked for additional information in the auditor's report to make it more informative about the audit of the company's financial statements.

As described below, the Board has considered a number of alternative approaches to achieve the potential benefits of enhanced auditor reporting.

*Alternatives Raised by Commenters*

Only Cross-Reference to Management's Disclosures

Some commenters suggested that, instead of communicating critical audit matters as reproposed, auditors should only identify the critical audit matters and provide a cross-reference to management disclosures (i.e., not describe the principal considerations that led the auditor to determine a matter is a critical audit matter or how it was addressed in the audit), or refer to or list critical accounting policies and estimates as disclosed by management. The Board believes that communicating the principal considerations that led the auditor to determine that a matter is a critical audit matter and how it was addressed in the audit will provide useful information beyond simply referencing existing management disclosure, and is more responsive to investor requests for more information from the auditor's perspective.

Auditor Association with Other Company Disclosures

Other commenters suggested more specific auditor assurance on particular management disclosures, such as inclusion of a statement in the auditor's report that the audit included evaluation of the accounting policies and significant estimates, with a cross-reference to management's disclosures, or a statement of auditor concurrence with the critical accounting policies and estimates of the company. One commenter suggested that audit committees should disclose critical audit matters with a corresponding confirmation from the independent auditor.

Several commenters on the proposal also suggested that the Board should consider auditor association with, or attestation on, portions of MD&A, specifically management's critical accounting policies and estimates, as an alternative to expanded auditor reporting. These commenters have argued that such an association could increase the quality and reliability of the information subject to the procedures.

Some commenters on the concept release, including investors, said that they were not supportive of separate assurance by the auditor on information outside of the financial statements as an alternative to expanded auditor reporting, primarily because the related auditor reporting would have appeared in a standardized form and would not provide audit-specific information. Requiring such reporting might necessitate action by the SEC, as well as the PCAOB, to implement, including new SEC rules regarding management reporting and auditor attestation. In addition to reporting requirements, the PCAOB might have to develop new performance requirements and auditors would be required to undertake additional audit work in order to provide attestation in these areas.

Based on concerns about the complexity of such an approach, as well as the comments received as to its limited benefits, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting at this time. The Board believes that this approach would fail to deliver the audit-specific information requested by investors, while also raising potential concerns about separate assurance on the identified matters.

No Change to Auditor Reporting Requirements

The Board considered whether changes to the existing auditor reporting requirements were needed. Auditor reporting under the current model has been criticized by many commenters as providing limited information. Auditors have not voluntarily provided more information in the auditor's report in response to investors' requests. A number of factors described above, such as potential costs and uncertainties related to voluntary auditor reporting and the potential for auditor status quo bias, may explain why voluntary reporting would not be expected to become prevalent. These factors suggest that voluntary reporting, with or without guidance to encourage it, could also create uncertainty about the content of auditor's reports because auditors would be able to choose whether to provide information about the audit, what information to provide, and the form in which to provide it. On that basis, the Board believes that standard setting is appropriate.

Consideration of Analogous Requirements of Other Regulators and Standard Setters

In developing the final standard, the Board took into account the requirements for expanded auditor reporting of other regulators and standard setters, such as the IAASB, the FRC, and the EU. Changes to the auditor's report that other regulators and standard setters have adopted include some commonality, such as communicating information about audit-specific matters in the auditor's report. Several commenters suggested that the Board align its requirements for expanded auditor reporting more closely with the requirements of the IAASB to provide more consistent global auditor reporting requirements.

However, the Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Because the Board's standards have the force of law, the Board aims to make them as clear and easy to apply as it can. For example, the factors that the auditor considers in determining whether a matter involved especially challenging, subjective, or complex auditor judgment are included in the standard; by contrast, while the IAASB approach includes similar factors, they appear in the application and other explanatory material.

In addition, there are differences between requirements and terminology of the Board's auditing standards and those of other regulators and standard setters that may cause inconsistent application, even if the Board were to adopt the approach of another standard setter. For example, the Board's requirements for communications to the audit committee are not identical to the analogous requirements of the IAASB. Therefore, although both critical audit matters and the IAASB's key audit matters are derived from such communications, the matters ultimately discussed with the audit committee under each framework would not necessarily be the same, which could result in differences in which matters are reported even if the language in the auditor reporting standards were identical. Also, the component of the definition of critical audit matter in the final standard, namely "matters that involve especially challenging, subjective, or complex auditor judgment" grounds the definition in the auditor's expertise and judgment. Although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.

Auditor Assessment and Descriptions of Certain Financial Statement Areas

Several commenters on the concept release suggested that investors would be most interested in auditor reporting on the categories of information identified by investor respondents to the 2011 survey conducted by a working group of the IAG: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them; (2) areas of high financial statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[150] This request was reiterated by several commenters on the proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters on the reproposal have requested that the auditor provide a "grade" on management's significant accounting estimates and judgments.

The Board believes that the final critical audit matter definition will likely cover many of the topic areas requested by investors. For example, the auditor may

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150 *See* IAG 2011 survey.

communicate critical audit matters related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor will not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

The final standard seeks to strike an appropriate balance between the value of the information being provided and the costs of providing it. Requiring auditors to report their qualitative assessments in a manner that appears very precise (for example, describing an estimate as "conservative" or "aggressive" or assigning the financial statements an "A" or a "B") may impose significantly greater costs and unintended consequences than the principles-based reporting of critical audit matters. For example, although the reporting of qualitative assessments would appear to be precise, these qualitative assessments are likely to be applied inconsistently because there is no framework for such assessments and the determinations are inherently subjective. In addition, such assessments may heighten concerns related to the perceived level of assurance provided by the audit or the perception that separate assurance is being provided as to the assessed areas. Also, the reporting of such qualitative assessments may subject auditors and companies to additional litigation risk beyond what may result from the principles-based reporting of critical audit matters because the apparent precision of the reporting may facilitate plaintiffs' claims.

*Policy Choices*

Definition of Critical Audit Matters

The Board considered a variety of possible approaches to the definition of critical audit matters suggested by commenters. *See* above for a discussion of the Board's considerations of the final standard.

Communication of Critical Audit Matters

The Board considered a variety of possible approaches to the communication requirements for critical audit matters. *See* above for a discussion of the Board's considerations of the final standard.

Auditor Tenure

The final standard retains the reproposed requirement to include a statement in the auditor's report about auditor tenure.

In the reproposal, the Board solicited comment on whether disclosure of auditor tenure should be made on Form AP instead of in the auditor's report. Form AP was developed as a means to address commenter concerns about the potential liability implications of naming persons in the auditor's report. Because the disclosure of auditor tenure does not have the same potential liability consequences, such an approach is unnecessary in this case. In addition, some commenters preferred tenure disclosure on Form AP because of a concern that disclosure in the auditor's report could result in inappropriate inferences about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. The Board is not persuaded by such concerns. Further, the final standard allows the auditor flexibility in the location of the auditor tenure disclosure in the auditor's report.

The Board determined that disclosure will be better achieved through the auditor's report because the information will be more readily accessible upon the filing with the

SEC of a document containing audited financial statements and poses lower search costs, particularly for those investors who may prefer to have the information provided in the auditor's primary means of communication. In addition, disclosing tenure in the auditor's report will make information available earlier to investors, which may assist in their voting on auditor ratification. However, disclosing auditor tenure in the auditor's report rather than Form AP could result in higher costs to investors that wish to accumulate tenure data for a large number of companies or compare data across companies because these investors will have to acquire tenure data from each company's auditor's report separately or from a data aggregator.

Additional Improvements to the Auditor's Report

The final standard includes a number of requirements that will enhance the standardized content of the auditor's report by clarifying the auditor's role and responsibilities related to the audit of the financial statements. These include, for example, statements regarding auditor independence requirements and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the final standard includes requirements intended to promote uniformity in the form of the auditor's report. These include requirements as to the addressee, a specific order of certain sections of the auditor's report, and required section headings.

Many commenters generally supported these enhancements and suggested that such enhancements will increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports.

Applicability of Critical Audit Matter Requirements

*Brokers and Dealers, Investment Companies, and Benefit Plans*

The reproposed standard did not require communication of critical audit matters for audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies ("BDCs"), and benefit plans. The reproposing release described the Board's rationale, including economic considerations, for such exclusions from the critical audit matter requirements and noted that auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

Commenters generally supported these exclusions, pointing to the same or similar reasons to those described by the Board in the reproposing release. Some commenters asserted that the communication of critical audit matters should apply to all companies. One commenter supported voluntary communication of critical audit matters for the exempted entities. Another commenter disagreed with providing auditors the ability to voluntarily communicate critical audit matters for brokers and dealers and investment companies. This commenter also suggested that all broker-dealers, including broker-dealers that are issuers, should be excluded from the requirement.

After considering the comments received and evaluating benefits and costs, the final standard excludes the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans, from the critical audit matter requirements as reproposed.[151] Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily.

The Board's rationales for these exclusions are described below.

*Brokers and Dealers Reporting under Exchange Act Rule 17a-5*

Pursuant to Exchange Act Rule 17a-5, the annual reports that brokers and dealers file with the SEC are public, except that if the statement of financial condition in the financial report is bound separately from the balance of the annual report, the balance of the annual report is deemed confidential and nonpublic.[152] In this situation, the auditor would generally issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete financial report that, except as provided in paragraph (c)(2)(iv) of Exchange Act Rule 17a-5, would be confidential and not available to the public.[153] Research by the PCAOB's Office of Economic and Risk Analysis ("ERA")[154] indicates that, for approximately half of brokers and dealers, the complete financial report and the related auditor's report are confidential and not available to the public.

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[151] The other requirements of the final standard will be applicable to audits of these entities.

[152] *See* Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

[153] *See also* Exchange Act Rule 17a-5(c)(2), 17 CFR 240.17a-5(c)(2), regarding audited statements required to be provided to customers.

[154] ERA's research was conducted on brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014 that included audit reports issued by firms registered with the PCAOB.

In 2013, the Board adopted new standards related to brokers and dealers that enhanced the auditor's performance and reporting responsibilities for financial statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.[155]

Some commenters on the proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by the closely held nature of brokers and dealers; the limited number of users of their financial statements; and the fact that, in many cases, only the statement of financial condition is available publicly. Some commenters also recognized that both the SEC and PCAOB recently updated their rules to further enhance reporting by brokers and dealers and their auditors.

Research by ERA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by a holding company, an individual, or a group of individuals that holds a controlling interest. The owners of brokers and dealers are generally part of the management of the entity and therefore would have direct access to the auditor. Given that, in many cases, there is much less separation of ownership and control in brokers and dealers than in issuers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors.

Although there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers,

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[155] *See Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

certain aspects of broker and dealer financial reporting may limit the benefits of requiring the communication of critical audit matters. For example, while other financial statement users, such as customers of brokers and dealers, may benefit from increased information about the audit, the ability for brokers and dealers to file certain financial statements and schedules confidentially would require the auditor to identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This may reduce the value of communicating critical audit matters for brokers and dealers relative to issuers. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer but may not benefit from audit-specific information in the same way as investors in an issuer.

The communication of critical audit matters may also impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies, as they would have to identify critical audit matters that apply exclusively to the publicly available financial information, which may be difficult in some situations.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received on the proposal and reproposal, and the Board's recent standard-setting activities related to brokers and dealers, the Board does not believe that reporting of critical audit matters for brokers and dealers will provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters is not required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5. If a broker or dealer were an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.

*Investment Companies*

The Investment Company Act generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[156] Most investment companies registered under the Investment Company Act are required to file with the SEC annual reports on Form N-CSR containing audited financial statements.[157] The Investment Company Act includes specific requirements for investment companies, intended to reduce investors' risks, in areas such as an investment company's portfolio diversification, liquidity, leverage, and custody of securities.[158]

In an SEC rulemaking, the SEC observed that commenters believed the key information that investors use in deciding to invest in an investment company includes an investment company's investment objectives, strategies, risks, costs, and performance.[159] The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.[160] Changes to investment objectives and strategies require shareholder approval or disclosure.[161]

Several commenters on the proposal noted that an investor's decision to invest in an investment company is primarily based on the investment objectives, risks,

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156 *See* Section 3(a)(1) of the Investment Company Act.

157 *See* SEC Rules under Section 30(e) of the Investment Company Act.

158 *See, e.g.,* Sections 12, 13, and 17 of the Investment Company Act.

159 *See* SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies,* Securities Act Release No. 8998, 74 FR 4546 (Jan. 26, 2009). *See also* Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006) at 2–3.

160 *See* SEC Rules under Section 30(e) of the Investment Company Act.

161 *See* Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

performance, and fees, and critical audit matters are not expected to provide information about these items and therefore would not be relevant. These and other commenters generally stated that investment companies are designed for the sole purpose of trading in and holding investments and auditor judgment would arise primarily with respect to valuation of investments, which would tend to be repeated as a critical audit matter. One of these commenters noted that, since the strategies of investment companies do not change significantly over time, the critical audit matters identified could become standardized from one reporting period to the next and also across funds with similar objectives.

Even though the disclosures required under the Investment Company Act and other federal securities laws provide investors with useful information, they may not fully substitute for the communication of critical audit matters. The required communication of critical audit matters contemplates that auditors would provide investors with audit-specific information, which is unlikely to appear in the disclosures provided by management. In addition, some academic research documented a difference in the perceived usefulness and reliability of information depending on the location of the disclosure and whether it was disclosed by management or by the independent auditor.[162] This academic research suggests that the auditor's communication of information similar to critical audit matters may provide value to investors because it comes from the auditor, even if the same information is disclosed by management in the experimental design of the study.

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[162] *See, e.g.*, Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

The benefits of providing critical audit matters, however, may be smaller for investment companies, other than BDCs, relative to other types of companies because of their purpose and structure. Unlike companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. This creates the potential for critical audit matters of investment companies to become excessively repetitive, making them uninformative.

There may also be additional costs of applying critical audit matter requirements to audits of investment companies, other than BDCs, as compared to audits of other types of companies. For example, in some cases, annual shareholder reports of affiliated investment companies with the same fiscal year-end might be filed with the SEC in one document, which generally contains a single auditor's report that covers multiple audited investment companies. In these situations, communicating critical audit matters specific to each investment company may require the auditor to prepare separate auditor's reports. This could increase costs for these types of investment companies.

After consideration of the purpose and reporting characteristics of investment companies and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of most investment companies, although they will apply to audits of investment companies regulated as BDCs.[163] Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments generally involves complexity and auditor judgments due to the nature of the BDCs' portfolios. Also, because of the more diverse operations of BDCs, such as providing managerial assistance and involvement with more complex debt

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163 *See* Section 54 of the Investment Company Act.

and equity instruments than other investment companies, communication of critical audit matters in a BDC audit could be more informative to investors. Additionally, BDCs follow a reporting regime under the Exchange Act that is more closely aligned with that of companies to which the Board is applying the requirements for critical audit matters. For these reasons, the Board believes it is appropriate for audits of BDCs to be subject to critical audit matter requirements.

*Benefit plans*

Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[164] that includes the benefit plan's audited financial statements and the related auditor's report.[165] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[166]

Participation in a benefit plan is limited to eligible employees of the plan sponsor. Each plan participant in a defined contribution benefit plan is responsible for selecting,

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164 *See* Section 15(d) of the Exchange Act.

165 A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. *See* Exchange Act Rule 15d-21, CFR 240.15d-21.

166 ERISA Section 103(a)(3)(A) requires a plan administrator to engage an independent auditor to conduct an examination of the plan's financial statements and required schedules in accordance with generally accepted auditing standards. *See* 29 CFR 2520.103-1. Benefit plans subject to ERISA also file with the DOL an annual report on Form 5500, including audited financial statements and an auditor's report. *See also* FASB ASC 960-10-05-6.

from the investment options made available by the plan sponsor, the specific investments in which the participant's funds are invested.

Employee stock benefit plans are generally less complex than other types of companies because they are designed for the sole purpose of holding the plan's investments for the participants' benefit. A plan's financial statements reflect summary information about the plan's assets and liabilities by aggregating the balances of all plan participants. However, only the individual account statements that plan participants receive periodically provide information specific to each participant's investments.

Several commenters on the proposal suggested excluding audits of benefit plans from the requirement for reporting critical audit matters due to the unique characteristics of these entities and their differences from other types of companies. For example, some commenters indicated that benefit plans are designed for a specific purpose and, as a result, would likely have similar critical audit matters from one reporting period to the next. Other commenters noted that benefit plans are inherently less complex and entail fewer estimates and judgments.

The communication of critical audit matters could provide information about any complex issues that were identified during the audit and how the auditor addressed them. However, since a benefit plan's assets and liabilities aggregate the balances of all plan participants, the financial statements or related critical audit matters would not provide actionable information about a plan participant's specific investment. Further, given the nature of benefit plans, there is a chance that the same critical audit matters would be communicated each year. For example, the valuation of investments is likely to be the most complex area in the audit of a benefit plan and therefore may be a critical audit matter in each reporting period, making the information less useful.

After consideration of the structure and reporting characteristics of benefit plans and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of benefit plans.

*Smaller Companies*

The reproposal sought comment on whether the critical audit matter requirements should not apply to audits of other types of companies, in addition to the exempted entities discussed above. Some commenters asserted that the communication of critical audit matters should apply to all companies. Other commenters recommended that the Board give consideration to not applying the critical audit matter requirements to audits of smaller reporting companies[167] and nonaccelerated filers[168] due to their smaller size and because, in the commenters' view, communication of critical audit mattes would not provide sufficient benefits for these companies to justify the costs.

Academic research suggests that smaller companies have a higher degree of information asymmetry relative to the broader population of companies. Although the

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[167] In general, a "smaller reporting company" means an issuer with less than $75 million in public float or zero public float and annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available. *See* Exchange Act Rule 12b-2, 17 CFR 240.12b-2. Smaller reporting companies currently make up approximately 42 percent of Form 10-K filers. The SEC recently proposed changes to the definition of smaller reporting companies, which would increase the percentage of smaller reporting companies to approximately 52 percent of Form 10-K filers. *See* SEC, *Amendments to Smaller Reporting Company Definition*, Release No. 33-10107 (June 27, 2016), 81 FR 43130 (July 1, 2016).

[168] Nonaccelerated filers are not defined in SEC rules but are generally understood to be companies that do not meet the definition of large accelerated filer or accelerated filer.

degree of information asymmetry surrounding a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.[169] To the extent that a smaller company can be characterized as exhibiting one or more of these properties, this may suggest that it has a greater degree of information asymmetry relative to the broader population of companies. This would suggest that there is a higher likelihood that critical audit matters could provide new information about a smaller company than a large one for which there already exists a variety of information sources (such as annual reports, news media, and analyst research reports).

After consideration of comments, academic research, and data regarding the number of such companies, the final standard does not exclude smaller companies from the critical audit matter requirements. However, as discussed below, the Board has determined that it is appropriate to give auditors of smaller companies additional time to implement the new requirements. If approved by the SEC, auditors of companies that are not large accelerated filers will have an additional 18 months to implement the requirements for critical audit matters and will be able to benefit from the experiences of auditors of larger companies.

*Requirements of Other Regulators and Standard Setters*

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169 *See, e.g.*, David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 The Journal of Finance 2747, 2747-2766 (2000), Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 Journal of Financial Economics 361, 361-381 (1995), Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 Journal of Financial Economics 101, 101-121 (1988), and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A note*, 43 The Journal of Finance 1041, 1041-1048 (1988).

Under the IAASB's standard, the communication of key audit matters applies to listed entities.[170] The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.[171] The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.[172]

Considerations for Audits of Emerging Growth Companies

Section 104 of the Jumpstart Our Business Startups ("JOBS") Act imposes certain limitations with respect to application of the Board's standards to audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company . . ."[173] Auditor discussion and analysis ("AD&A") does not exist in auditing standards. The idea was introduced in the concept release, which described AD&A as one of several conceptual alternatives for changing the auditor's reporting model.[174]

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[170] *See* paragraph 5 of ISA 701.

[171] *See* requirements in 1 of Article 2, Audit Report of Regulation (EU) No 537/2014.

[172] These include companies with a premium listing of equity shares on the London Stock Exchange regardless of whether they are incorporated in the U.K. or elsewhere.

[173] *See* Pub. L. No. 112-106 (Apr. 5, 2012). *See* Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act.

[174] *See* PCAOB Release No. 2011-003 (June 21, 2011) at 2 (describing one alternative as "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements

Section 104 of the JOBS Act further provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[175] As a result of the JOBS Act, the final standard and amendments are subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

*Critical Audit Matters*

The reproposal solicited comment on the application of critical audit matter requirements to the audits of EGCs. Commenters on this issue generally favored applying the standard to audits of EGCs, primarily because investors in these companies would benefit from the additional information communicated in the auditor's report in the same way that investors in larger companies would. Two commenters recommended that the critical audit matter requirements not apply to audits of EGCs because there would not be sufficient benefits to justify the costs.

Three commenters addressed the legal question of whether the JOBS Act provision on AD&A would prohibit the Board from applying critical audit matter requirements to audits of EGCs. Two of these commenters suggested that this would be prohibited, on the basis that critical audit matters "appear substantively similar to"[176] or

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(an 'Auditor's Discussion and Analysis')"). Section IV.A., *Auditor's Discussion and Analysis*, of the proposal further described AD&A and related comments received on the concept release.

[175] *See* Section 103(a)(3)(C) of Sarbanes-Oxley.

[176] *See* letter from the U.S. Chamber of Commerce, Center for Capital

"closely resemble"[177] AD&A. The SEC's Investor Advocate stated that, from a policy perspective, critical audit matter requirements should apply to audits of EGCs, and recommended that the PCAOB adopt the standard for policy reasons and let the SEC determine the legal question.[178] This commenter also recommended that, "to prepare for any outcome of the SEC's determination," the PCAOB should encourage auditors, on a voluntary basis, to include critical audit matter communications in the auditor's reports on EGCs."[179]

The requirements for critical audit matters share characteristics with two of the alternative approaches described in the concept release: required and expanded explanatory paragraphs and AD&A. Similar to critical audit matters, required and expanded explanatory paragraphs involved additional paragraphs in the auditor's report that would have highlighted areas of critical importance to the financial statements, with auditor comment on key audit procedures and a reference to relevant financial statement accounts and disclosure. AD&A, by contrast, envisioned a supplemental report in addition to the auditor's report that could cover a broad range of issues, including the auditor's views regarding the company's financial statements, material matters as to

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Markets Competitiveness (Aug. 15, 2016) at 10, available on the Board's website in Docket 034.

177 *See* letter from Robert N. Waxman (Aug. 15, 2016) at 24, available on the Board's website in Docket 034.

178 *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 5-6, available on the Board's website in Docket 034 (noting that "the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of" the JOBS Act).

179 *Id.* at 6.

which the auditor believed disclosure could be enhanced, and areas where management could have applied different accounting or disclosure approaches.

However, critical audit matters go beyond the content of a required and expanded explanatory paragraph by including a discussion of the principal reasons the auditor determined that a matter was a critical audit matter. Further, although this is not required, critical audit matters could potentially include a discussion of auditor findings. These additional elements may make critical audit matters resemble AD&A in some respects. This potential similarity, together with the fact that there has been no authoritative interpretation of Section 104 of the JOBS Act, creates some uncertainty as to whether it is legally permissible for critical audit matter requirements to be mandated for EGC audits. In view of this uncertainty, the Board has determined not to apply the requirements regarding critical audit matters to audits of EGCs at this time.

As with other audits where critical audit matter requirements do not apply, voluntary application is permissible. EGCs and their auditors can consider whether investors would benefit from additional information about the audit from the auditor's point of view.

*Additional Improvements to the Auditor's Report*

The additional improvements to the auditor's report contained in the final standard and amendments do not raise concerns under the AD&A provisions of the JOBS Act, but instead fall within the category of "additional rules" that may not be applied to audits of EGCs unless the SEC determines that doing so "is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." The Board is providing this analysis to assist the SEC in making this determination.

To inform consideration of the application of auditing standards to audits of EGCs, the staff has also published a white paper that provides general information about characteristics of EGCs.[180] The data on EGCs outlined in the white paper remains generally consistent with the data discussed in the reproposal. A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.[181]

The reproposal solicited comment on whether the elements of the reproposed standard and amendments other than the requirements for critical audit matters should apply to the audits of EGCs. As noted above, one commenter supported application of the entire standard and amendments to EGCs (without differentiating between critical audit matters and other elements), and one commenter opposed application of the entire standard and amendments. In addition, one commenter supported applying some of the reproposed improvements to the auditor's report to audits of EGCs (the requirement as to

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[180] *See White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's website in Docket 034.

[181] *See* SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (Apr. 23, 2006) at 73.

addressee and the clarifications of existing auditor responsibilities, as well as a modified version of the statement regarding auditor independence), but generally opposed the other aspects of the reproposal for both EGCs and other companies.

As described above, the additional improvements to the auditor's report are intended to provide a consistent location and decrease search costs with respect to information about auditor tenure, enhance users' understanding of the auditor's role, make the auditor's report easier to read and facilitate comparison across companies by making the format consistent. As described above, the costs associated with these changes are not expected to be significant and are primarily one-time, rather than recurring, costs.

For the reasons explained above, the Board believes that the additional improvements to the auditor's report contained in the final standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the SEC determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the final standard and amendments, other than the provisions relating to critical audit matters, to audits of EGCs. The Board stands ready to assist the SEC in considering any comments the SEC receives on these matters during the SEC's public comment process.

## III. Date of Effectiveness of the Proposed Rules and Timing for Commission Action

Within 45 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the Board consents, the Commission will:

(A) by order approve or disapprove such proposed rules; or

(B) institute proceedings to determine whether the proposed rules should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing, including whether the proposed rules are consistent with the requirements of Title I of the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (http://www.sec.gov/rules/pcaob.shtml); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number PCAOB-2017-01 on the subject line.

Paper comments:

- Send paper comments in triplicate to Brent J. Fields, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number PCAOB-2017-01. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (http://www.sec.gov/rules/pcaob.shtml). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rules that are filed with the Commission, and all written communications relating to the proposed rules between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing will also be available for inspection and copying at the principal office of the PCAOB. All comments received will be posted without charge; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number PCAOB-2017-01 and should be submitted on or before [insert 21 days from publication in the Federal Register].

By the Commission.

Brent J. Fields
Secretary

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| CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS<br><br>AND RELATED AMENDMENTS TO PCAOB STANDARDS<br><br>NOTICE OF ROUNDTABLE | PCAOB Release No. 2011-003<br>June 21, 2011<br><br>PCAOB Rulemaking<br>Docket Matter No. 34 |

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing a concept release to solicit public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements. The Board will also convene a public roundtable meeting in the third quarter of 2011, at which interested persons will present their views. Additional details about the roundtable will be announced at a later date.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted via email to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 34 in the subject or reference line. Comments should be received by the Board no later than 5:00 PM EDT on September 30, 2011.

Board Contacts: Martin F. Baumann, Chief Auditor (202/207-9192, baumannm@pcaobus.org), Jennifer Rand, Deputy Chief Auditor (202/207-9206, randj@pcaobus.org), and Jessica Watts, Associate Chief Auditor (202/207-9376, wattsj@pcaobus.org).

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## I. Purpose

The Board is issuing this concept release to seek public comment on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users. Auditors, as a result of the performance of required audit procedures, often have significant information regarding a company's financial statements and the audit of such financial statement, that is not today reported in the standard auditor's report to the financial statements users. This information might be useful to investors and other financial statement users and could lead to more efficient markets and improved allocations of capital.

The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements. This concept release seeks direction and comment for a possible standard-setting project that could result in either amendments to AU sec. 508, *Reports on Audited Financial Statements,* and Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*,[1/] or the development of a new auditing standard that would supersede or amend the Board's current standards on auditors' reports.

The objective of this concept release is to discuss several alternatives for changing the auditor's reporting model that could increase its transparency and relevance to financial statement users, while not compromising audit quality. To that end, these alternatives include (1) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements (an "Auditor's Discussion and Analysis"), (2) required and expanded use of emphasis paragraphs in the auditor's report, (3) auditor reporting on information outside the financial statements, and (4) clarification of certain language in the auditor's report. These alternatives are not mutually exclusive. A revised auditor's report could include one or a combination of these alternatives or elements of these alternatives. Additionally, there may be other alternatives to consider that this concept release does not present.

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1/ Potential changes to the standard auditor's report might result in amendments to the report on internal control included in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements.* In an integrated audit, information related to the audit of the company's financial statements discussed in this concept release could also include matters related to the audit of internal control over financial reporting.

Many of these alternatives are focused primarily on enhancing communication to investors through improving the content of the auditor's report rather than on changing the fundamental role of the auditor in performing an audit of financial statements in accordance with PCAOB standards as established and interpreted by the Board. However, depending on the nature and extent of additional information to be communicated by the auditor in the auditor's report, new auditing requirements and coordination with the Securities and Exchange Commission ("SEC") would likely be necessary. Further, certain alternatives might result in an increase in the scope of audit procedures beyond those currently required. An increase in the scope of audit procedures would require new auditing standards.

This concept release also describes the history of the auditor's report, as well as the results of outreach conducted by the staff of the Board's Office of the Chief Auditor ("staff") to investors, auditors, financial statement preparers, audit committee members, and others. The outreach was undertaken to obtain insight into possible changes that could be made to the auditor's reporting model. This concept release does not include an exhaustive discussion of all views regarding the auditor's reporting model. Rather, it presents the salient views obtained on possible changes to the auditor's report and other considerations as part of the staff's outreach and which inform this solicitation of comment on possible changes to the auditor's report.

In addition to inviting comments in response to a number of specific questions, the Board invites any interested person to provide comments on any issues related to topics discussed in this concept release or directed at improving the auditor's reporting model. The Board will hold a public roundtable in the third quarter of 2011 to discuss the alternatives addressed herein or other alternatives. Additional details about the roundtable will be announced at a later date.

## II. History and Outreach

For decades, the standard auditor's report has identified the financial statements that were audited, described the nature of the audit, and presented the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. The standard auditor's report has been commonly described as a pass/fail model because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).

This section of the concept release provides a brief history of the auditor's report and a summary of the outreach recently conducted by the staff.

## A. History

In the 1940s, a standardized form of the auditor's report was adopted to provide uniform report language that would make audit reports more readily comparable and make qualifications in audit reports easily recognizable. For more than half a century, many groups have considered changes to the standard auditor's report to enhance the auditor's overall communication to financial statement users. For example, in 1974, the Commission on Auditors' Responsibilities[2/] ("Cohen Commission"), and in 1985, the National Commission on Fraudulent Financial Reporting[3/] ("Treadway Commission"), reexamined both the auditor's responsibilities and the form of the auditor's report. The Cohen Commission noted that "evidence abounds that communication between the auditor and users of his work – especially through the auditor's standard report – is unsatisfactory." These commissions made many recommendations to change the auditor's report; however, the only change resulting from the recommendations was the addition of a paragraph explaining the scope of the audit.[4/] There have been two changes to the standard auditor's report since the 1980s: the adoption of Auditing Standard No. 1 that requires reference to the standards of the PCAOB, and the

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2/ In response to congressional and public scrutiny of the accounting profession, the American Institute of Certified Public Accountants ("AICPA") established the Commission on Auditors' Responsibilities (known for its chairman as the "Cohen Commission") to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." AICPA, *Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (New York: 1978), p. xi.

3/ The Treadway Commission was established in June 1985 during a period of congressional and public scrutiny of the accounting profession after certain significant business failures. See SEC Speech: "The Treadway Commission Report: Two Years Later," by Joseph A. Grundfest and Max Berueffy (January 26, 1989). From October 1985 to September 1987, the Treadway Commission studied the financial reporting system in the United States. The Treadway Commission's mission "was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *Report of the National Commission on Fraudulent Financial Reporting* (October 1987), p. 1 ("Treadway Commission Report").

4/ Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts to Influence the Auditing Standards Board*, 1 (Greenwich, CT:JAI Press Inc., 1993), p. 38.

establishment of requirements for auditors to report on internal control over financial reporting as directed by Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act").[5/]

More recently, members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG") suggested, and the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommended, that the Board undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.[6/] Results of surveys conducted by the Chartered Financial Analysts Institute ("CFA") in 2008, 2010, and 2011, support these suggestions. In particular, the majority of survey respondents noted that the independent auditor's report needed to provide more specific information about how the auditor reaches his or her opinion on whether the company has fairly presented its financial statements in accordance with the required financial reporting standards.[7/]

Additionally, other standard-setters and regulators, such as the International Auditing and Assurance Standards Board ("IAASB"),[8/] the International Organization of Securities Commissions ("IOSCO"),[9/] the United Kingdom's Financial Reporting Council

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5/ Auditing Standard No. 5, which superseded Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, establishes requirements for auditors to report on internal control over financial reporting.

6/ U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), available at: http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf.

7/ CFA Institute, *Independent Auditor's Report Survey Results* (February 2008, March 2010, March 2011), available at: www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf.

8/ The IAASB has an active project on the auditor's report. On May 16, 2011, the IAASB issued a consultation paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change,* available at: http://www.ifac.org/Guidance/EXD-Details.php?EDID=0163 ("IAASB's Consultation Paper").

9/ Technical Committee of IOSCO, *Auditor Communications: Consultation Report* (September 2009), available at: http://www.iosco.org/library/index.cfm?CurrentPage=2&section=pubdocs&criteria=none&year=2009&rows=10.

("FRC"),[10/] and the European Commission have been working on similar projects to consider changes to the auditor's report.[11/]

The Board is evaluating the PCAOB's auditing standards for reporting on audited financial statements in response to investors' and other financial statement users' historical concerns, including recent concerns highlighted by the financial crisis related to preparing and auditing financial statements for complex global businesses, as well as the active international debate in this area. (See Appendix A for a more detailed discussion of the history of the auditor's reporting model; and see Appendix B for an overview of current auditor reporting requirements pursuant to PCAOB standards.)

## B. Overview of the Staff's Outreach

To obtain insight into the changes that investors and others are seeking to the auditor's report and how those changes could be incorporated into the auditor's report or the overall auditor's reporting model, the staff conducted outreach to investors, preparers, auditors, audit committee members, regulators and standard-setters, and representatives of academia from October 2010 through March 2011. The participants in the staff's outreach represented a diverse group of domestic and international organizations and companies, ranging in size from small to large entities. The investors included individuals representing money managers, asset management funds, pension funds, wealth management funds, and organizations that represented institutional investors; investor advocates; buy- and sell-side analysts from some of the largest investment firms; and analysts from the largest credit rating agencies. The dialogue among the outreach participants helped to inform the staff regarding potential changes in the auditor's report, and how those changes could be presented, as well as the benefits and challenges of making such changes. Additionally, the staff read and reviewed publicly available information related to the auditor's reporting model from U.S. and international sources, including academic research, surveys, and other publications, as well as auditors' reports from more than 30 other countries.

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10/ FRC, *Effective Company Stewardship. Enhancing Corporate Reporting and Audit (*January 2011), available at: http://www.frc.org.uk/press/pub2485.html.

11/ European Commission, *Green Paper. Audit Policy: Lessons from the Crisis* (October 2010), available at: http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm.

The staff reported its findings to the Board at an open meeting on March 22, 2011.[12/] The Board concluded from this outreach that changing the auditor's report could hold the key to the relevance of the auditor's reporting model. The findings from the outreach are summarized in the following two sections regarding the content and the form of the auditor's report and are discussed in more detail in Appendix C.

1. Content of the Auditor's Report

During the staff's outreach, many investors expressed their belief that the audit is a valuable process. The staff observed that there was consensus among investors that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful. Investors varied in their views on the types of information, as well as the level of detail that should be included in the auditor's report. Investor perspectives often were influenced by their role in the capital markets (i.e., retail investors, institutional investors, issuers making decisions regarding potential acquisitions) and how they intended to use that information for making investment decisions.

During the staff's outreach, many investors indicated that the auditors are in a unique position to provide relevant and useful information, because of the auditors' extensive knowledge of the company and industry obtained through the audit process and the auditors' experiences with other companies in similar industries. Some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party. The recent financial crisis was cited as an example of a situation in which expanded auditor reporting in advance of the crisis might have been helpful in assessing the quality of the financial statements, and providing early warning signals regarding potential issues by, for example, including a discussion of off-balance sheet contingencies or the sensitivity of loan loss estimates.

During the staff's outreach, some consistent themes emerged. Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the risks of material misstatement in a company's financial statements.[13/]

[12/] PCAOB Board Meeting. March 22, 2011, available at: http://pcaobus.org/News/Events/Pages/03222011_OpenBoardMeeting.aspx.

[13/] Auditing Standard No. 8, *Audit Risk*, states that the "risk of material misstatement" refers to the risk that the financial statements are materially misstated and provides further discussion about the term "risk of material misstatement."

Additionally, some investors indicated that the auditor should provide information about the company's financial statements, such as the auditor's views regarding the quality of the company's financial statements. Because accounting frameworks provide for significant management judgments and estimates in the company's application of accounting policies and practices, these judgments and estimates could be susceptible to management bias. Since reasonable estimates might vary significantly, there could be a wide range of acceptable results within a company's applicable financial reporting framework. Further, this range of acceptability is not mentioned in the auditor's report and might not be fully reflected in the financial statements. Some investors believed that more relevant insight into the financial statements, through the eyes of the auditor, might better enable them to assess how changes in the economy might affect a company's future financial performance or condition.

Some participants in the staff's outreach recommended expanding the auditor's reporting model to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis ("MD&A"), earnings releases, or non-GAAP information. The basis of this recommendation is that this type of financial information is often highly relevant to investment decisions, and that auditor association may increase the quality and reliability of such information. Finally, some participants in the staff's outreach suggested that certain language within the standard auditor's report should be further clarified or explained to improve the financial statement user's understanding of what an audit represents and the responsibilities of the auditor and management in the audit and financial reporting process.

Some preparers, auditors, and audit committee members also expressed concern regarding certain changes to the auditor's report. For example, some indicated that an auditor's discussion about matters related to the audit (e.g., significant risks and related audit procedures) might be taken out of context without the benefit of the related dialogue about these matters among management, auditors, and the audit committee.

Most preparers, auditors, and audit committee members indicated in the staff's outreach that management or the audit committee, rather than the auditor, should provide additional information about the company; although, there were some who expressed less concern about the auditor providing this type of information. Additionally, some expressed concern that if the auditor were required to communicate information about the company in the auditor's report, the communication among auditors, preparers, and audit committee members might suffer as a result. They pointed out that as part of the audit, auditors have regular and free-flowing dialogue with management and the audit committee. They also cautioned that if the auditor were to provide additional information, then the nature and candor of that dialogue could be affected, with adverse consequences for the audit. Some preparers and audit committee members also are concerned that auditor discussion about the company's financial statements may blur the lines regarding the roles of the auditor, preparer, and the audit committee as it relates to financial reporting.

Some preparers, auditors, and audit committee members also expressed a concern that auditor discussion about the financial statements could differ from the disclosures that management provides, and therefore might not convey a consistent communication to investors, which could result in confusion. These outreach participants pointed out that when an unqualified opinion is issued, all material matters related to an audit have been resolved; therefore, they stated that additional discussion in the auditor's report is unnecessary, or even potentially misleading.

2. Form of the Auditor's Report

In periodic filings with the SEC, companies are required to include an auditor's report with respect to the company's financial statements.[14/] Many investors indicated that the pass/fail model and standardized language of the auditor's report provides consistency, comparability, and clarity of auditor reporting. However, many of these investors indicated that the standard auditor's report is too "boilerplate," does not convey the significant judgments made by the auditor in forming the audit opinion, and limits the auditor's ability to convey to the investor the subtleties that underlie the opinion in his or her report on the company's financial statements. Accordingly, many of these investors supported a reporting format in which a standard auditor's report is retained, with certain language in the report clarified, but supplemented with discussion by the auditor about the audit and the company's financial statements.

Some investors indicated that the standard auditor's report does not provide the auditor with the necessary leverage to effect appropriate change in the company's financial statements. While the auditing standards allow for circumstances in which the auditor can provide emphasis of certain matters,[15/] explanatory language regarding certain matters,[16/] a qualification, or even a disclaimer of the opinion, these options, when used, are not effective in providing transparency into the financial reporting process. Therefore, when an auditor identifies and communicates to management a significant matter that is not necessarily material to the financial statements, and management does not adequately address that matter in the financial statements, the

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[14/] Rule 2-02 of Regulation S-X, 17 CFR §210.2-02.

[15/] AU sec. 508.19.

[16/] AU sec. 508.11.

auditor does not have a practical alternative. Accordingly, as previously mentioned, while many investors supported retaining the pass/fail opinion, they recommended supplementing it with additional information about the audit and the company's financial statements to enable the auditor to add commentary on significant matters.

Some preparers, auditors, and audit committee members support retaining the current pass/fail model and also support clarification of certain language in the report. Some of these outreach participants also are supportive of including some additional information in the auditor's report about the audit or auditor reporting on MD&A or portions thereof, such as "Critical Accounting Estimates."

Questions

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

   a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

   b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

   c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

   a. Should the auditor's report retain the pass/fail model? If so, why?

   b. If not, why not, and what changes are needed?

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?

## III. <u>Potential Alternatives for Changes to the Auditor's Report</u>

Input from the staff's outreach reinforces the view that many investors are supportive of changing the auditor's reporting model. Investor demands for such change are expressed in terms of making the auditor's reporting model, and thus audits, more relevant to investors and other users of financial statements. Though the auditor's reporting model has been studied by many groups that have provided recommendations over time, they were not in a position to effect change as they did not have standard-setting authority. The Board has an opportunity to change the auditor's reporting model under its statutory mandate to protect the interests of investors in the preparation of informative, accurate and independent audit reports. Therefore, the Board is in a position to promote the transparency and continued relevance of the audit and the related auditor's reporting model, in collaboration with the SEC. The Board is soliciting the views of commenters on the concerns that have been expressed about the auditor's reporting model, potential alternatives for change to the auditor's report, the potential direction of a possible standard-setting project, and potential other considerations associated with changes to the auditor's report.

This concept release presents several alternatives and seeks specific comment on these or other alternatives that could provide investors with more transparency into the audit process and more insight into the company's financial statements or other information outside the financial statements. These alternatives are not intended to alter, in any way, the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. Nor are these alternatives intended to qualify or piecemeal the auditor's opinion or to shift the requirement to assess the risk of material misstatement of the financial statements from the auditor to investors or other users of financial statements.

The alternatives presented in this concept release are:

- Auditor's Discussion and Analysis,
- Required and expanded use of emphasis paragraphs,
- Auditor assurance on other information outside the financial statements, and
- Clarification of language in the standard auditor's report.

These alternatives are not mutually exclusive, nor do these alternatives include all the views expressed by the outreach participants.[17/] A revised auditor's report could include one or a combination of these alternatives, elements within the alternatives, or alternatives not currently presented in this concept release.

All of the alternatives presented would retain the pass/fail opinion of the standard auditor's report. Some of the alternatives presented in the concept release (e.g., Auditor's Discussion and Analysis, required and expanded use of emphasis paragraphs, and clarification of language in the standard auditor's report) are designed to improve communication of the auditor's current responsibilities related to a financial statement audit based on existing auditing standards. The alternative for auditor assurance on other information outside the financial statements would require an expansion of the auditor's current responsibilities, which would likely necessitate the development of a management reporting framework and additional auditing standards through collaboration with the SEC. Most of these alternatives would likely require the development of additional suitable and objective criteria for auditors to prepare consistent and comparable auditors' reports.

## A. Auditor's Discussion and Analysis

A revised auditor's reporting model could include a supplemental narrative report, which some have described as an Auditor's Discussion and Analysis ("AD&A"). An

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17/ Appendix C provides a detailed discussion of the views of the outreach participants.

AD&A could provide investors and other financial statement users with a view of the audit and the financial statements "through the auditor's eyes."

The intent of an AD&A would be to provide the auditor with the ability to discuss in a narrative format his or her views regarding significant matters. The AD&A could include information about the audit, such as audit risk identified in the audit,[18/] audit procedures and results, and auditor independence. It also could include a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." Additionally, an AD&A could provide the auditor with discretion to comment on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements. An AD&A could also highlight those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures.

An AD&A, as contemplated herein, is not intended to provide separate assurance on individual balances, disclosures, transactions, or any other matters discussed. Rather, an AD&A is intended to facilitate an understanding of the auditor's opinion on the financial statements taken as a whole.

An AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors. An AD&A could provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis, and provide the auditor with the ability to communicate to investors and other users of financial statements the auditor's significant judgments in forming the audit opinion. An

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[18/] Auditing Standard No. 8, *Audit Risk,* describes audit risk as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and detection risk. Some investors have defined risk more broadly to include not only audit risk, but also business risks, operating risks, or strategic risks. The discussion of risk addressed in this alternative is limited to audit risk that the auditor is required to identify under current auditing standards (see detailed discussion in Appendix C). Discussion of risk other than audit risk would require an expansion of the auditor's current responsibilities. This would be a major undertaking requiring additional education, training, standard-setting, and collaboration with the SEC.

AD&A also could provide the auditor with an adaptable report that he or she can tailor to a company's specific risks, facts, and circumstances.

Because an AD&A provides the auditor's perspectives about the audit and the company's financial statements, the perspectives in the AD&A on certain matters could differ from those that management has provided in the MD&A. As a result, additional time might be incurred by management, the audit committee, and auditors to seek to resolve such differences before any views are reflected in the AD&A or MD&A. If the AD&A and the MD&A expressed different views on certain matters, the financial statement user might need to reconcile these differing views. Further, there is a risk that the language in an AD&A might become boilerplate in nature over time.

An AD&A would likely be among the most expansive form of reporting of the alternatives presented since it would provide auditor commentary on significant matters to the users of financial statements. An AD&A also could require the auditor to communicate some of the same information that the auditor communicates to the audit committee. Many of the matters that could be discussed in an AD&A are part of the audit performed pursuant to current auditing standards. However, the PCAOB, in collaboration with the SEC, would likely need to develop new auditing standards to provide standard, objective criteria to the auditor regarding the appropriate content and level of detail to be reported in an AD&A. For example, reporting on difficult or contentious issues, including "close calls" would require additional direction to auditors in identifying and reporting on such matters.

The Board is seeking comment on an AD&A as a potential supplemental report to the standard auditor's report. The following illustrates a potential framework for an AD&A report, including the types of potential criteria that might assist the auditor in preparing an AD&A. This illustrative report does not include certain matters raised in the staff's outreach, such as materiality levels, engagement statistics, and information communicated to the audit committee, although such matters, as well as other matters, could be included in an AD&A.[19/]

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[19/] See Appendix C for a detailed discussion of the staff's outreach regarding materiality levels, engagement statistics and information communicated to the audit committee.

**Illustration of Possible Revised Standard Auditor's Report and Auditor's Discussion and Analysis**

Report of Independent Registered Public Accounting Firm

[Standard Introductory Paragraph]

[Standard Scope Paragraph]

[Standard Opinion Paragraph]

Our audits were conducted for the purpose of forming an opinion on the financial statements, including related disclosures, taken as a whole. The accompanying Auditor's Discussion and Analysis provides additional analysis.

[Signature]
[City and State or Country]
[Date]

**Auditor's Discussion and Analysis**

This discussion should be read in conjunction with the accompanying auditor's report on the financial statements. We considered the matters discussed below in rendering our opinion on the financial statements taken as a whole. This discussion does not represent separate assurance on individual account balances, disclosures, transactions, or any other matters discussed below. It is not a substitute for the user's full reading and review of such financial statements, including related disclosures, and the auditor's report.

[Auditor discussion concerning the audit or the company's financial statements could be included under headings or in sections of an AD&A such as those set out below. Following each heading is the concept for a possible instruction for drafting the discussion. The potential drafting instructions are intended only to illustrate the possible content of each section; if the Board pursues an AD&A approach, complete requirements would be proposed for public comment.]

**Information about the Audit**

**Audit Risk**

[Provide a discussion of significant risks identified by the auditor.[20] This discussion should include the factors the auditor evaluated in determining which risks are significant (see paragraphs 70-71 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*). Describe why the risks are considered significant to the company's financial statements.]

**Audit Procedures and Results**

[Provide a discussion of the audit procedures responsive to the significant risks discussed in the audit risk section above, why the procedures are responsive to such significant risks, and the results of those procedures (see Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement)*.]

**Auditor Independence**

[Provide a discussion of matters that were reported and discussed with the audit committee concerning independence under PCAOB Rule 3526, *Communication With Audit Committees Concerning Independence,* and the related resolution of those matters. Provide affirmation of auditor independence.]

**Information about the Company's Financial Statements**

**Management's Judgments and Estimates**

[Provide a discussion of the critical accounting estimates that were communicated to the audit committee and assumptions underlying the critical accounting estimates (see proposed Auditing Standard,

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[20] Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, describes significant risk as a risk of material misstatement that requires special audit consideration.

*Communications with Audit Committees*[21/]). The discussion also should address how the critical accounting estimates are susceptible to change.]

**Accounting Policies and Practices**

[Provide a discussion of the company's critical accounting policies and practices, including significant unusual transactions that were communicated to the audit committee. This discussion should include the reasons the auditor considers certain policies and practices to be critical, including those that management does not consider critical. Also, provide a discussion of alternative accounting treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor.[22/]]

**Difficult or Contentious Issues, Including "Close Calls"**

[Provide a discussion of the difficult or contentious issues or "close calls" that arose during the audit and the final resolution of the issue. These issues might include, among other things, the following –

- Those accounting matters that required significant deliberation by the auditor and management before being deemed acceptable within the applicable financial reporting framework.

- Those matters related to internal control over financial reporting that required significant deliberation by the auditor and management.

- A financial statement issue that had a potential material impact to the financial statements and was corrected prior to the end of the period.]

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[21/] See proposed auditing standard related to communications with audit committees at: http://pcaobus.org/Rules/Rulemaking/Pages/Docket030.aspx.

[22/] See Rule 2-07(a)(1) of Regulation S-X, 17 CFR §210.2-07(a)(1), which requires the auditor to report the critical accounting policies and practices and alternative accounting treatments to the audit committee.

**Material Matters**

[Describe those material matters that are in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their effect on the financial statements, or those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures.]

Questions

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

   a. If you support an AD&A as an alternative, provide an explanation as to why.

   b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

   c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

   d. If you do not support an AD&A as an alternative, explain why.

   e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates,

accounting policies and practices, and difficult or contentious issues, including "close calls")?

8. Should a standard format be required for an AD&A? Why or why not?

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

11. What are the potential benefits and shortcomings of implementing an AD&A?

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

## B. Required and Expanded Use of Emphasis Paragraphs

Another alternative to enhance the auditor's report could be to require and expand the use of emphasis paragraphs in all audit reports. Emphasis paragraphs are not currently required under existing PCAOB standards but may be added, solely at the auditor's discretion, to emphasize a matter regarding the financial statements.[23/] Examples of emphasis paragraphs given in the current auditing standards include –

- That the entity is a component of a larger business enterprise.
- That the entity has had significant transactions with related parties.
- Unusually important subsequent events.

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[23/] AU sec. 508.19. Additionally, AU sec. 508.11 describes certain circumstances that, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory paragraph to the standard auditor's report.

- Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.[24/]

This alternative would mandate the use of emphasis paragraphs in all audit reports and further expand the emphasis paragraph to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements. Emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation. With respect to each matter of emphasis under this alternative, the auditor also could be required to comment on key audit procedures performed pertaining to the identified matters.

This alternative is somewhat analogous to the French auditor's report. French law requires the auditor's report to contain a "justification of the auditor's assessments."[25/] The auditor is required, in an explanatory paragraph, to explain the procedures the auditor performed with respect to relevant areas of the audit, such as accounting policies, accounting estimates, and overall presentation of the financial statements.

Required emphasis paragraphs could be beneficial to financial statement users through the auditor's identification of significant matters and referencing where those matters are disclosed in the financial statements. An auditor's emphasis of certain aspects of the financial statements in the auditor's report also could potentially increase the quality of management's disclosures in the financial statements because of specific reference to such disclosures in the auditor's report. However, the content might not provide investors with the full extent of detail that some investors indicated that auditors should provide in the auditor's report, and the language in required emphasis paragraphs might become boilerplate in nature over time.[26/]

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[24/] Ibid.

[25/] On August 1, 2003, article L823-9 of the French Code of Commerce Financial security laws required that the statutory auditor include in the auditor's report a "justification of the auditor's assessments."

[26/] The IAASB's Consultation Paper, p.19, stated that the disclosures in the justification of the auditor's assessments paragraphs "may become standardized (or boilerplate) over time in relation to an entity, and the way they are presented in the auditor‘s report may detract from the readability of the report."

This alternative primarily communicates those matters that the auditor is required to address as part of an audit pursuant to current auditing standards. However, the Board may need to develop additional auditing standards to direct the auditor in determining which matters are of the most importance to emphasize in an auditor's report.

The following illustrates a potential auditor's report with required emphasis paragraphs, including the types of potential criteria that might assist the auditor in preparing the report.

**Illustration of Possible Revised Standard Auditor's Report with Required Emphasis Paragraphs**

Report of Independent Registered Public Accounting Firm

[Standard Introductory Paragraph]

[Standard Scope Paragraph]

[Standard Opinion Paragraph]

<u>Required Emphasis Paragraph[s]</u>

[Emphasize those matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty. Discuss the audit procedures performed on these significant matters. This discussion should not include matters that the company has not disclosed in the financial statements and should make reference to the notes in the financial statements that disclose each matter.]

[Signature]
[City and State or Country]
[Date]

Questions

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

    a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

    b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

## C. Auditor Assurance on Other Information Outside the Financial Statements

Another alternative to enhance the auditor's reporting model could be to require auditors to provide assurance on information outside the financial statements, such as MD&A or other information (for example, non-GAAP information or earnings releases). An auditor providing assurance on information outside of the financial statements could improve the quality, completeness, and reliability of such information, providing investors and other users of financial statements with a higher level of confidence in information about the company that is provided by management. Further, many investors and other financial statement users often comment on the importance to their investing decisions of the information outside the financial statements. Their view is that investors use and rely on MD&A and other financial information (e.g., non-GAAP information and earnings releases) for their investing decisions, in addition to historical audited financial statements. Therefore, this additional reporting could make an audit and auditor reporting more relevant to investors and other users of financial statements.

Providing assurance on information outside the financial statements would increase the scope of the auditor's responsibilities, require the development of new auditing standards, and might result in projects separate from the auditor's reporting model project. Additionally, to provide a basis for auditor assurance on information outside the financial statements, a reporting framework would likely need to be developed for management's presentation of such information in collaboration with the SEC. The SEC maintains disclosure and reporting requirements for MD&A, which may need to be changed, including filing requirements to include the auditor's reporting on MD&A.[27/] Also, if auditors were required to provide assurance on non-GAAP information and non-GAAP information, the SEC would likely need to develop new management reporting requirements.

Currently, there is no requirement for the auditor to provide assurance on earnings releases, non-GAAP information, or MD&A. Although the company has the ability to retain the auditor to provide some level of assurance under PCAOB standards,[28/] the auditor is rarely retained to provide any assurance on such information. Current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., MD&A). These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact.[29/]

The PCAOB has an attest standard which provides requirements for the auditor concerning the performance of an attest engagement with respect to MD&A, if the auditor is engaged to attest on MD&A.[30/] In an attest engagement under PCAOB

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27/ In the SEC's 2002 proposal regarding critical accounting estimates, the SEC specifically requested comment on auditor involvement in MD&A. See *Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies,* Securities Act Release No. 8098 (May 10, 2002).

28/ See AT sec. 201, *Agreed-Upon Procedures Engagements* and AT sec. 701, *Management's Discussion and Analysis.*

29/ Paragraph .04 of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*.

30/ AT sec. 701.

standards, the auditor performs procedures to express an opinion on the MD&A presentation taken as a whole by reporting whether the –

- Presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC,
- Historical financial amounts have been accurately derived, in all material respects, from the entity's financial statements, and
- Underlying information, determinations, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.[31/]

The additional reporting by the auditor on earnings releases, non-GAAP information, the entire MD&A, or portions thereof, could be based on certain aspects of the current attest standard and report, which is illustrated below, or other attest standards. However, the current attest standard and this illustration are not intended to represent the only alternative for reporting on MD&A or portions thereof, earnings releases or non-GAAP information.

**Illustration of Attachment to Possible Revised Standard Auditor's Report − Standard Examination Report on Management's Discussion and Analysis ("MD&A")**[32/]

AT sec. 701, *Management's Discussion and Analysis,* establishes requirements concerning the performance of an attest engagement with respect to MD&A prepared pursuant to the rules and regulations adopted by the Securities and Exchange Commission, which are presented in annual reports to shareholders and in other documents.[33/]

Independent Accountant's Report

[Introductory paragraph]

We have examined XYZ Company's Management's Discussion and Analysis taken as a whole, included [incorporated by reference] in the

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31/ AT sec. 701.05.

32/ AT sec. 701.114.

33/ AT sec. 701.01.

Company's [insert description of registration statement or document]. Management is responsible for the preparation of the Company's Management's Discussion and Analysis pursuant to the rules and regulations adopted by the Securities and Exchange Commission. Our responsibility is to express an opinion on the presentation based on our examination. We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the financial statements of XYZ Company as of December 31, 20X5 and 20X4, and for each of the years in the three-year period ended December 31, 20X5, and in our report dated [Month] XX, 20X6, we expressed an unqualified opinion on those financial statements.

[Scope paragraph]

Our examination of Management's Discussion and Analysis was conducted in accordance with attestation standards established by the Public Company Accounting Oversight Board (United States) and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and disclosures in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that our examination provides a reasonable basis for our opinion.

[Explanatory paragraph]

The preparation of Management's Discussion and Analysis requires management to interpret the criteria, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information. Management's Discussion and Analysis includes information regarding the estimated future impact of transactions and events that have occurred or are expected to occur, expected sources of liquidity and capital resources, operating trends, commitments, and uncertainties. Actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

[Opinion paragraph]

In our opinion, the Company's presentation of Management's Discussion and Analysis includes, in all material respects, the required elements of the rules and regulations adopted by the Securities and Exchange

Commission; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

[Signature]
[City and State or Country]
[Date]

Questions

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

    a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

    b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

    c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

    d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

    e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

    f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

    g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

## D. Clarification of the Standard Auditor's Report

Another potential enhancement of the auditor's reporting model could involve clarifying language in the existing standard auditor's report. While this alternative would not significantly expand the content of the auditor's report, it could provide additional explanation about what an audit represents and the related auditor responsibilities. Possible language that could be clarified in the auditor's report includes –

- *Reasonable Assurance* – The standard auditor's report explicitly asserts that the audit was conducted in accordance with auditing standards and states that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as being a "high level of assurance, but not absolute assurance." Such language could be added to the auditor's report or reasonable assurance could be further explained.

- *Auditor's Responsibility for Fraud* – The standard auditor's report does not mention "fraud" and is silent about the auditor's responsibility to detect fraud. The auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[34/] Such language could be added to the auditor's report or the auditor's responsibility could be further explained.

- *Auditor's Responsibility for Financial Statement Disclosures* – The auditor's report identifies the balance sheets, related statements of operations, stockholders' equity and cash flows as the financial statements. As it relates to financial statements under Regulation S-X, the SEC's rules provide that "financial statements" include all notes to the financial statements and all related schedules.[35/] The auditing standards require auditors to perform procedures to test the financial statement disclosures

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[34/] AU sec. 230, *Due Professional Care in the Performance of Work,* and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

[35/] Rule 1-01(b) of Regulation S-X, 17 CFR §210.1-01.

and to evaluate whether the financial statements contain the information essential for fair presentation of the financial statements in conformity with the applicable financial reporting framework.[36/] Auditing standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional;[37/] to identify and test significant disclosures;[38/] and, in integrated audits, to test controls over significant disclosures.[39/] The auditor's report could be revised to provide clarification regarding the auditor's responsibility for financial statement disclosures.

- *Management's Responsibility for the Preparation of the Financial Statements* – The auditor's report includes a statement that the financial statements are the responsibility of the company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.[40/] The Act requires corporate officers to certify in periodic filings with the SEC that "based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer, as of, and for, the periods presented in the report."[41/] The auditor's report could be further clarified to state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

- *Auditor's Responsibility for Information Outside the Financial Statements* – As described in the section above, the auditor has a responsibility to read

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[36/] Paragraphs 30-31 of Auditing Standard No. 14, *Evaluating Audit Results*.

[37/] See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

[38/] See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

[39/] Paragraph 26 of Auditing Standard No. 5.

[40/] AU sec. 508.08c.

[41/] Section 302(a)(3) of the Act.

the other information in documents containing audited financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact.[42/] Such information might be financial or non-financial information and includes the Chairman's or CEO's letter to shareholders, risk disclosures, MD&A, and the other portions of documents containing audited financial statements. The auditor's report could be clarified to describe the auditor's responsibility with respect to such other information.

- *Auditor Independence* – The title of the standard auditor's report is "Report of Independent Registered Public Accounting Firm." Aside from the title, the auditor provides no further information regarding the auditor's independence or otherwise provides assurance that the auditor has complied with the applicable independence requirements of the PCAOB and SEC. The auditor's report could be clarified to include a statement in the auditor's report, in addition to the title, that the auditor has a responsibility to be independent of the company and has complied with applicable independence requirements of the PCAOB and SEC.

Questions

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

    - Reasonable assurance
    - Auditor's responsibility for fraud
    - Auditor's responsibility for financial statement disclosures
    - Management's responsibility for the preparation of the financial statements
    - Auditor's responsibility for information outside the financial statements
    - Auditor independence

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42/ AU sec. 550.04 - .06.

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

<u>Questions Related to all Alternatives</u>

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

25. What alternatives not mentioned in this concept release should the Board consider?

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

29. What effect would the various alternatives have on audit quality? What is the basis for your view?

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

## IV. <u>Considerations Related to Changing the Auditor's Report</u>

During the staff's outreach, various participants suggested that there may be practical challenges and unintended consequences that would result from additional auditor reporting. These challenges and consequences are discussed throughout this concept release and described further below. The Board is interested in comment on these and other issues in connection with its deliberations on potential changes to the auditor's report.

### A. Effects on Audit Effort

Some outreach participants expressed concern regarding the effect of changing the auditor's report on the overall timing and extent of the audit effort. Since many of the alternatives presented in this concept release focus on auditor reporting and do not require additional audit procedures by the auditor in forming the opinion on the financial statements, some expressed a view that the auditor's incremental efforts and cost to report such information should be minimal. However, a movement away from using standardized language in the auditor's report could also require additional audit effort, such as the auditor's time and effort in preparing and reviewing the report, which could result in an increase in cost. If auditors were required to prepare and issue a non-standardized report, each engagement might be required to have a centralized quality control review of all such reports for appropriateness and consistency among the firm's various audit clients. Additionally, audit firms might need to develop training for individual auditors on how to prepare non-standardized reports, particularly since auditors may not have experience writing narrative reports for public use.

Including additional information in an auditor's report could necessitate extensive discussion and potential debate among management, the auditor, and the audit committee regarding the nature and extent of the information. This discussion, combined with drafting narrative-type auditor's reports and enhanced quality control procedures, could increase the time to complete the audit and issue an opinion, and present challenges in terms of the preparer's ability to meet public reporting deadlines.

Some of the alternatives presented in this concept release also could involve an increase in the scope of the auditor's responsibilities, thereby increasing audit requirements and procedures. For instance, if auditors were required to attest on MD&A, or portions thereof, auditors would need to perform additional work, requiring greater time and cost.

## B. Effects on the Auditor's Relationships

Some of the outreach participants expressed a concern that discussing potentially sensitive matters in the auditor's report could impair transparency and openness in discussions among auditors, management, and the audit committee. They are of the view that this, in turn, could create more tension in the overall relationship and could stifle communications. For example, comments or presentations made in private, such as in an audit committee executive session or an audit committee communication, could be tempered if the speakers or recipients have concerns that such comments or presentations could eventually become public. As another example, some indicated that an auditor providing information that conflicts with management-prepared information may result in additional stress on the overall relationships, which could lead to other unintended consequences. Management and the audit committee also might be compelled to change the financial statements, in order to eliminate differences between the company's disclosures and the auditor's discussion in the audit report.

## C. Effects on Audit Committee Governance

Some outreach participants expressed concerns that if the auditor were to provide information directly to investors regarding the company's financial statements, then this could undermine the governance role of the audit committee, since the audit committee's role is to provide oversight of the financial reporting process on behalf of investors. Some questioned the audit committee's relevance in the financial reporting process if auditors were to provide the same information to investors as is provided to audit committees.

## D. Liability Considerations

Some outreach participants expressed concern that changes to the auditor's reporting model could result in increased liability for auditors and issuers. These participants noted that in a new model auditors might provide additional information about the audit or the company's financial statements, make additional public statements, or examine or report on more or different types of information. These outreach participants also were concerned that auditor reporting regarding information about the company's financial statements or about the audit could create confusion about those financial statements or about the meaning of an auditor's unqualified opinion, resulting in negative market reaction that could, in turn, lead to litigation against the issuer or auditor.

Liability may be imposed on auditors, issuers, and other securities market participants under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, as well as various state law causes of action. This concept release is intended to generate a broad-based discussion of ways to make the audit report more relevant to investors. At this stage of the process, the Board is interested in views on how it might do so and has reached no conclusions about whether to propose any particular approach.

## E. Confidentiality

Some outreach participants encouraged the Board, in considering changes to the auditor's report, to consider maintaining the confidentiality of company information if the auditor is required to discuss additional information about the audit or the preparation of the company's financial statements. They stated that there is a possibility that management and others may be concerned about auditors discussing information about the company in the auditor's report that might be deemed proprietary or highly sensitive to the company's competitive industry position.

<u>Questions</u>

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

## V. Opportunity for Public Comment

The Board is interested in the views of commenters on the potential direction of a proposed standard-setting project and whether the Board should consider any other approaches. While this concept release includes a number of specific questions for which the Board would like to obtain feedback, the Board welcomes all comments related to enhancing the auditor's reporting model.

The Board will seek comment on this concept release for a 101-day period. Interested persons are encouraged to submit their views to the Board. Written comments should be sent to Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by e-mail to comments@pcaobus.org or through the Board's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 34 in the subject or reference line and should be received by the Board no later than 5:00 PM EDT on September 30, 2011.

On the 21st day of June, in the year 2011, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ J. Gordon Seymour

J. Gordon Seymour
Secretary

June 21, 2011

PCAOB
Public Company Accounting Oversight Board



**CONCEPT RELEASE**

**Appendix A – History**

There has been a longstanding discussion and debate among users of financial statements regarding the form and content of the auditor's report dating back to the early 1900s, when there was an initial attempt to define accounting and auditing practices in the United States.[1/] In the early 1900s, no authoritative accounting or auditing standards existed, and auditors wrote narrative audit reports (free-form) for every company.[2/] These narrative audit reports often described the audit procedures performed during the audit.[3/] By the early 1920s, the narrative auditor's report was reduced to one paragraph in length and was referred to as an audit of the "accounts and records" whereby the independent auditor would "certify" the "balance sheet" as being "correct."[4/]

By the early 1930s "the term 'certify' began to disappear from reports in an attempt to clarify that the auditor's report was an opinion and not a guarantee."[5/] The auditor's report of 1934 was "the first report to have *required* as opposed to *suggested* report wording."[6/] A Securities and Exchange Commission ("SEC") investigation of

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[1/] A discussion of significant historical developments in the evolution of the U.S. Standard Auditor's Report is available on the PCAOB Web site as part of the April 2010 Standing Advisory Group ("SAG") briefing paper at: http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx.

[2/] Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts To Influence the Auditing Standards Board*, 1 (Greenwich, CT:JAI Press Inc., 1993), p. 38.

[3/] Ibid., pp. 5-6.

[4/] Vincent M. O'Reilly, et al., *Montgomery's Auditing,* 11th ed. (New York: John Wiley & Sons Inc., 1990), p. 636.

[5/] Geiger, *The New Auditor's Report*, p. 15.

[6/] Ibid., p. 17. According to a special committee of the American Institute of Accountants ("AIA," now known as the American Institute of Certified Public Accountants ("AICPA")), the accounting profession adopted a standard audit report to accomplish two objectives: (1) to institute uniform report language across firms, thus making reports more readily comparable and consequently reducing deficient report quality and misunderstandings due to ambiguous or vague wordings and (2) to make

McKesson & Robbins resulted in the 1941 issuance of *Accounting Series Release No. 21*.[7/] This release amended Regulation S-X to require changes in the auditor's report to "state whether the audit was made in accordance with generally accepted auditing standards [("GAAS")] applicable in the circumstances."[8/] The AIA formally adopted the GAAS standards in 1948, which resulted in several revisions to the auditor's report.[9/]

In 1979, based on recommendations from the Commission on Auditor's Responsibilities ("Cohen Commission"),[10/] the AICPA's Auditing Standards Board ("ASB") analyzed the standard auditor's report and concluded that "a substantial departure from the existing report, as suggested by [the Cohen Commission] was not needed."[11/] The Cohen Commission had specifically recommended expanding the

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qualifications in audit reports more easily recognizable. See D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," *Proceedings of the 1982 Touche Ross/University of Kansas Symposium on Auditing Problems* (Lawrence, KS: University of Kansas, 1982), p. 6.

7/ For a summary of the findings and conclusions in the SEC's investigation, see *In the Matter of McKesson & Robbins, Inc.,* Accounting Series Release No. 19, Exchange Act Release No. 2707 (December 5, 1940).

8/ Accounting Series Release No. 21; Securities Act Release No. 2460 (Feb. 5, 1941).

9/ D.R. Carmichael and A.J. Winters, "The evolution of audit reporting," pp. 20-21. For example, "[r]eference to review of internal control, lack of 'making a detailed audit of transactions,' and 'other supporting evidence' were all deleted in the new report."

10/ In response to congressional and public scrutiny of the accounting profession, the American Institute of Certified Public Accountants ("AICPA") established the Commission on Auditors' Responsibilities (known for its chairman as the "Cohen Commission") to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish." AICPA, *Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (New York: 1978), p. xi.

11/ Geiger, *The New Auditor's Report*.

auditor's report to include a discussion about four distinct areas: (1) financial statements, (2) other financial information (unaudited), (3) internal control, and (4) other matters (such as the company's policy statement on employee conduct and meetings with the audit committee). The Cohen Commission also recommended the auditor describe those areas using a series of standardized alternative phrases or paragraphs.

As a result of congressional hearings leading up to, and recommendations from, the National Commission on Fraudulent Financial Reporting ("Treadway Commission"), a new paragraph, now commonly referred to as the "scope paragraph" was added to the auditor's report in the 1980s.[12/] The scope paragraph states the respective responsibilities of management and the independent auditor, describes the work performed by the auditor, and indicates that sufficient evidence is gathered to provide a reasonable basis for the auditor's opinion. There have been no substantial changes to the required wording of the standard auditor's report since the addition of the scope paragraph. In April 2003, the PCAOB adopted AU sec. 508, *Reports on Audited Financial Statements,* as part of its interim auditing standards.[13/] Subsequently, the PCAOB also adopted Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*, which requires that auditors refer in the auditor's report to "the standards of the Public Company Accounting

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[12/] The Treadway Commission was established in response to the congressional and public scrutiny of the accounting profession after significant business failures such as Drysdale Government Securities, Washington Public Power Supply System, Baldwin-United Corp, and E.S.M. Government Securities [SEC, "The Treadway Commission Report: Two Years Later," News Release (January 26, 1989)]. From October 1985 to September 1987, the Treadway Commission studied the financial reporting system in the United States. The Treadway Commission's mission "was to identify causal factors that can lead to fraudulent financial reporting and steps to reduce its incidence." *Report of the National Commission on Fraudulent Financial Reporting* (October 1987), p. 1 ("Treadway Commission Report").

[13/] References to the PCAOB's interim auditing standards consist of generally accepted auditing standards, as described in the American Institute of Certified Public Accountants ("AICPA") Auditing Standards Board's Statement on Auditing Standards No. 95, as in existence on April 16, 2003, to the extent not superseded or amended by the Board. These standards are available on the PCAOB's Web site at www.pcaobus.org.

Oversight Board (United States)"[14/] and adopted Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, that establishes requirements for auditors to report on internal control over financial reporting.

In February 2005, the SAG discussed the standard auditor's report, including the advantages and disadvantages of the auditor's reporting model and whether there was a need for a form of auditor reporting other than the pass/fail model.[15/] Several SAG members expressed support for maintaining the pass/fail element of the standard auditor's report, stating that it is "clear," "simple," "consistent," "comparable," and "easy for the investing public to digest."[16/] They also expressed a need for more information and less boilerplate language in the auditor's report.[17/]

In 2008, the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") issued a report ("ACAP Final Report") urging the Board "to undertake a standard-setting initiative to consider improvements in the auditor's standard reporting model and to clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards."[18/] The ACAP Final Report also noted that the "increasing complexity of global business operations are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting."[19/] In addition, the

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[14/] See Appendix B for an illustrative example of an auditor's standard report on an audit of financial statements according to PCAOB standards.

[15/] See February 16, 2005 SAG briefing paper at: http://pcaobus.org/News/Events/Documents/02162005_SAGMeeting/Auditors%20Reporting%20Model.pdf.

[16/] See February 16, 2005 SAG Webcast at: http://pcaobus.org/News/Webcasts/Pages/02162005_SAGMeeting.aspx.

[17/] Ibid.

[18/] U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (October 6, 2008), available at: http://www.treas.gov/offices/domestic-finance/acap/docs/final-report.pdf, p. VII:13.

[19/] Ibid, p. VII:17.

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ACAP Final Report suggested that this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a "relevant discussion about the audit of the financial statements."[20/]

The ACAP Final Report further recommended that the PCAOB consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal, and foreign regulators.[21/] Consistent with the ACAP's recommendation, the Board held follow-up discussions with the SAG regarding the auditor's reporting model in April and July 2010.[22/] While there was no consensus on what additional information should be included in the auditor's report, there was general support for improvements to the standard auditor's report.[23/] Similar views were expressed during the PCAOB's Investor Advisory Group ("IAG") meetings in May 2010[24/] and March 2011.[25/] Several SAG members also suggested that the PCAOB perform additional outreach to gain further input from investors and others.

From October 2010 through March 2011, the staff of the Office of the Chief Auditor (the "staff") conducted outreach to investors, auditors, preparers, audit committee members, representatives of academia, and others to further explore

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[20/] Ibid.

[21/] Ibid, p. VII:18.

[22/] April and July 2010 SAG meetings. Webcasts available at: http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx and http://pcaobus.org/News/Events/Pages/07152010_SAGMeeting.aspx, respectively.

[23/] Ibid.

[24/] In May 2010, the IAG provided views related to providing greater transparency of the audit process, including making changes to the auditor's report. Available at: http://pcaobus.org/News/Events/Pages/05042010_IAGMeeting.aspx.

[25/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

potential improvements to the auditor's reporting model.[26/] The staff reported its findings to the Board at an open meeting on March 22, 2011.[27/]

Separately, a working group of the IAG held a discussion regarding the auditor's reporting model in March 2011.[28/] The discussion included the results of a survey the working group conducted to solicit views regarding changes to the auditor's report. The group surveyed investors in investment banks, mutual funds, pension funds, and hedge funds representing over $8 trillion under management. Also, in March 2011, the SAG discussed the results of the staff's outreach regarding the auditor's reporting model.[29/]

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[26/] See Appendix C for a detailed discussion on the staff's outreach.

[27/] PCAOB Board Meeting. March 22, 2011, available at: http://pcaobus.org/News/Events/Pages/03222011_OpenBoardMeeting.aspx.

[28/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

[29/] SAG meeting, March 24, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03232011_SAGMeeting.aspx.

**CONCEPT RELEASE**

**<u>Appendix B</u> − Overview of Current Reporting Requirements in PCAOB Standards**[1/]

The primary PCAOB auditing standard that applies to audit reports issued in connection with audits of financial statements is AU sec. 508, *Reports on Audited Financial Statements*. AU sec. 508 requires that the standard auditor's report identify the financial statements audited in the introductory paragraph, describe the nature of an audit in the scope paragraph, and include the auditor's opinion in the opinion paragraph.

AU sec. 508 also describes the following types of opinions that the auditor may issue in connection with an audit of the financial statements:

- *Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles ("GAAP"). Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with GAAP.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with GAAP.

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[1/] Excerpted from AU sec. 508 and Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board.* Paragraphs 85-88 of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* provide additional elements to be included in the auditor's report and related report examples for situations in which the auditor is engaged to perform an audit of the effectiveness of internal control over financial reporting that is integrated with an audit of financial statements.

- *Disclaimer of opinion*. A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.[2/]

Although AU sec. 508 provides for different types of audit reports, the Securities and Exchange Commission ("SEC") does not accept qualified, adverse, or disclaimer opinions.[3/]

In certain circumstances, AU sec. 508 and Auditing Standard No. 6, *Evaluating Consistency of Financial Statements,* permit or require the auditor to add an explanatory paragraph to the standard auditor's report.[4/] Circumstances in which the auditor may be required to use an explanatory paragraph include, among other things, situations in which the auditor believes there is substantial doubt about the company's ability to continue as a going concern, there has been a material change between periods in accounting principles or in the method of their application, and there has been a correction of a material misstatement in previously issued financial statements.[5/] Standard auditors' reports with explanatory paragraphs are accepted by the SEC.

AU sec. 508 also permits the auditor to use an emphasis paragraph.[6/] An emphasis paragraph is never required; however, a paragraph may be added solely at the auditor's discretion.[7/] AU sec. 508 provides examples regarding the potential use of an emphasis paragraph, such as situations in which the entity had significant transactions with related parties, there were unusually important subsequent events, and there were specific accounting matters affecting the comparability of the financial statements.[8/]

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2/ AU sec. 508.10.

3/ See Accounting Series Release No. 90 (1962); *see also* Codification of Staff Accounting Bulletins, Topic I.E.2.

4/ See AU sec. 508.11 and paragraphs 7-8 of Auditing Standard No. 6.

5/ Ibid.

6/ AU sec. 508.19.

7/ Ibid.

8/ Ibid.

**CONCEPT RELEASE**

The following is an illustrative report of an unqualified opinion on an audit of financial statements:[9/]

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

[Signature]
[City and State or Country]
[Date]

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[9/] Excerpted from Auditing Standard No. 1. Paragraph 87 of Auditing Standard No. 5 provides an example of a combined report (i.e., one report containing both an opinion on the financial statements and an opinion on internal control over financial reporting.)

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**CONCEPT RELEASE**

**Appendix C − Overview and Results of the Staff's Outreach Activities**

The staff of the Office of the Chief Auditor (the "staff") conducted a series of discussions with various investors and other users of the auditor's report from October 2010 to March 2011. The objective of the discussions was to assess whether changes to the auditor's reporting model may be necessary and, if so, to identify the changes or additional information that investors recommend including in the auditor's report. Conducting outreach was particularly important to the staff's efforts in formulating the potential alternatives presented.

Some investors who participated in the outreach included individuals representing money managers, asset management funds, pension funds, and wealth management funds, and organizations that represent institutional investors; investor advocates; buy- and sell-side analysts from some of the largest investment firms; and analysts from the largest credit rating agencies. The funds, institutions, and companies represented by investors in the staff's outreach represented trillions of dollars of assets under management.

After meeting with investors, the staff extended the outreach to others, including preparers, audit committee members, auditors, and representatives from academia. Participants in the preparer discussions included representatives from several Fortune 50 companies, Fortune 250 companies, Fortune 500 companies, and some smaller public companies. Participants in the audit committee discussions included audit committee members of companies ranging from small non-accelerated filers to Fortune 50 companies. The staff then conducted several discussions with auditors representing leaders from large and small accounting firms who audit both accelerated and non-accelerated filers. The staff also obtained the perspectives of individuals who previously held leadership roles in the accounting profession, at regulatory organizations, or standard setters. Some of these individuals contributed to discussions and commissions that made recommendations regarding improving the auditor's report, such as the American Assembly, the Commission on Auditors' Responsibilities (the "Cohen Commission"), the National Commission on Fraudulent Financial Reporting, the Panel on Audit Effectiveness, and U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP").

Additionally, the staff read and reviewed publicly available information related to the auditor's reporting model from U.S. and international sources, including academic research, surveys, and other publications, to compile a list of matters that investors requested the auditor to include in the auditor's report. The staff has considered this information during the staff's outreach to investors and others, and recognizes that broad investor participation in the U.S. securities markets may differentiate the U.S. markets from the capital markets in some other countries.

During the staff's outreach, many investors suggested that the auditor's reporting model should provide greater transparency into the audit process and the auditor's views regarding the company's financial statements. These investors believe that the audit process is robust, but that the standard auditor's report does not adequately communicate the results of such an extensive audit process.[1/]

## A. Value of an Audit and Information to Investors

Many investors generally indicated that the audit is valuable and that auditors have unique and relevant insight into the company, and therefore should provide more information in the auditor's report to make the report more relevant and useful. The staff's outreach to investors indicated that the increase in the complexity and global nature of business and the recent financial crisis have contributed to the demands by some investors for more transparency into the audit process and the company's financial statements. Therefore, during the staff's outreach many investors supported retaining the pass/fail model of the auditor's report due to its clarity, consistency, and comparability. However, many investors also supported supplementing the pass/fail model with additional auditor reporting.

According to the March 2011 investor survey of a working group of the Board's Investor Advisory Group ("IAG"), some investors indicated that transparency can lead to less uncertainty and therefore, potentially more investor confidence in, and more efficient functioning of, the capital markets. Consistent with the staff's outreach, investor respondents to the March 2011 IAG survey agreed that additional information in the auditor's report would enhance the investment process and allow investors to better analyze financial information.[2/]

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[1/] As the Cohen Commission noted, "for the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into relatively few words and paragraphs."

[2/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

During the staff's outreach, some investors also indicated that additional information from auditors could help investors in their investment analysis process to more accurately –

- Assign and attribute risks to the quality of the financial reporting of the underlying company, the company's projections, and disclosures.

- Develop investment valuation models, including assigning a value to a company and projecting future results of the company. This development process would include selecting a range of discount rates to apply to a company's earnings to derive a current market value and determine whether a stock is potentially under or overvalued in the market.

Additionally, some investors suggested that additional information in the auditor's report could –

- Identify the areas that might warrant more consideration in making investment decisions,

- Serve as a roadmap to other areas of focus in the financial statements,

- Provide early warning signals to investors regarding potential issues with the company,

- Assist in comparison of companies across an industry, and

- Inform corporate governance decisions regarding auditor and board member retention.

## B. Information Related to the Audit

During the staff's outreach, the staff heard from some investors that an auditor's discussion in the auditor's report about the audit and how the audit was conducted could provide financial statement users with a better perspective regarding audit risk.[3/] In

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[3/] Auditing Standard No. 8, *Audit Risk,* describes audit risk as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are other words, the auditor has relevant insight into the key risks of material misstatement of the company's financial statements, and knowledge of these risks would be useful to investors.

As part of its outreach, the staff explored the information that might be included in the auditor's report regarding how an audit is conducted.

*1. Risks*

Some investors indicated that the audit report should discuss information about risks in the following areas and the related auditor responses to those risks –

- Financial statement areas with an increased level of risk of material misstatement based on the nature of the company, industry, and economic conditions;
- Risks related to management's judgments and estimates and management's application of critical accounting policies and practices and estimates;
- Areas in which the auditor exercises an increased level of judgment and/or spends a significant amount of time, including matters about which the auditor had significant consultation outside the engagement team;
- Risks the auditor communicated to the audit committee;
- Risks regarding the company's financial viability, including the company's ability to continue as a going concern for a reasonable period of time; and
- Business, operational, governance, and enterprise risks.

Many outreach participants noted that this discussion of risks may not align with management's discussion and analysis of business risks in Management's Discussion

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materially misstated. Audit risk is a function of the risk of material misstatement and detection risk.

and Analysis ("MD&A") and therefore not provide a consistent communication to users of financial statements.

Auditing standards require the auditor to identify and assess the risk of material misstatement, including determining significant risks. The auditing standards also provide factors that assist the auditor in considering which risks represent significant risks, such as –

- The degree of complexity or judgment in the recognition or measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and

- Whether the risk involves significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature.[4/]

As part of determining which risks are significant risks, the auditor is required to obtain an understanding of the company and its environment, which includes the company's objectives, strategies, and related business risks, to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement of the financial statements.[5/]

In other words, business risks could affect the risk of material misstatement at the financial statement level. For example, a company's loss of financing or declining conditions in a company's industry could affect its abilities to settle its obligations when due. This, in turn, could affect the risks of material misstatement related to items such as the classification of long-term liabilities or the valuation of long-term assets, or it could result in substantial doubt about a company's ability to continue as a going concern. Auditing standards require the auditor to obtain an understanding of the company and its environment to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. The requirement for the auditor to obtain an understanding of

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[4/] See paragraph 71 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement,* for a more detailed list of factors relevant to identifying significant risks.

[5/] See paragraphs 7-14 of Auditing Standard No. 12 for the auditor's responsibilities related to understanding business risks.

the company and its environment, including related business risk, is intended to focus the auditor on the degree of the "knowledge of the company" that is necessary for a risk-based audit and to explain how knowledge of the company informs the auditor's identification and assessment of audit risk.

As noted above, while some investors have defined risk more broadly, e.g., business risks, operating risks, or strategic risks, the auditor's responsibilities are limited to considering the company's risks only as they relate to informing their assessment of the risk of material misstatement of the financial statements. For example, an auditor is not required to evaluate whether a new product would be successful or not; rather, the auditor is required to consider how an unsuccessful product might affect the risk of material misstatement of inventory and other related assets. The discussion of risk addressed in this concept release is limited to audit risks that the auditor is required to identify under current auditing standards. The risks of material misstatement of the financial statements are the same for both the audit of financial statements and the audit of internal control over financial reporting.[6/]

In the March 2011 IAG investor survey, "77% of the respondents indicated that the auditor should disclose areas with greatest financial statement and audit risk and the audit work performed in those areas."[7/]

*2. Audit Procedures and Results*

Some outreach participants suggested that the auditor could summarize the procedures that the auditor performed related to audit risks and management's judgments and estimates, including testing of management's key assumptions that form the basis for these estimates. These outreach participants suggested that the auditor's report should include more information about the procedures the auditor performed related to the detection of fraud.

Some outreach participants suggested that providing a more robust discussion of audit procedures (i.e., procedures in a financial statement audit or procedures in an audit of internal control) would better inform investors as to what an audit represents relative to a particular company or industry. Others suggested that they could use this

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[6/] See footnote 1 to paragraph 1 of Auditing Standard No. 8.

[7/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

information to separately evaluate whether the auditor has adequately identified and responded to the risks of material misstatement.

Some outreach participants also indicated that they are interested in obtaining more information about the results of the audit, including the auditor's findings. Some outreach participants described such audit results or findings to include –

- The results of audit procedures performed on audit risk areas or areas requiring significant auditor judgment,
- Information on misstatements the auditor communicated to the audit committee, either corrected or uncorrected,
- Significant control deficiencies communicated to the audit committee and the audit procedures performed by the auditors to satisfy themselves that the risk of material misstatement to the financial statements has been appropriately mitigated,
- Areas in which there were difficulties encountered in performing the related audit procedures,
- The auditor's findings with respect to fraud as communicated to the audit committee, and
- Qualitative aspects of the company's accounting practices, financial statements, and disclosures discussed with the audit committee.

Some outreach participants suggested that the auditor provide more discussion about the nature of the results and findings from the audit or the resolution of issues that arose during the audit.

Other outreach participants expressed concern that providing a list of the audit procedures performed might not provide investors with information that would be useful in making an investment decision. These outreach participants also pointed out that the reference to PCAOB auditing standards in the scope paragraph signifies that the auditor has applied a comprehensive set of required audit procedures. Some outreach participants expressed concern that without the proper two-way dialogue regarding audit results, information about audit results might be taken out of context. Certain outreach participants indicated that the issuance of an unqualified opinion signifies the final results of an audit (i.e., the financial statements present fairly, in all material respects, in accordance with the applicable financial reporting framework) and that all material issues identified during the audit have been resolved.

*3. Materiality Levels*

During the staff's outreach, some outreach participants expressed an interest in knowing the auditor's quantitative and qualitative materiality levels and the factors the auditor considered in establishing the materiality levels. These outreach participants acknowledged that the auditor makes an assessment of materiality based on the needs of a reasonable investor.[8/] In that regard, some outreach participants suggested the auditor's report should describe the quantitative materiality level established in the audit as well as the basis the auditor used in establishing that materiality level (e.g., net income or percentage of net income). Some outreach participants indicated that the auditor also should discuss the qualitative factors the auditor used in evaluating the materiality of misstatements.

Some outreach participants indicated that trying to select one number to be discussed in the auditor's report could be especially difficult because there are many measurements and assessments of materiality throughout an audit. For example, some outreach participants indicated that the auditor should discuss in the auditor's report materiality considered in planning the audit, while other outreach participants indicated the auditor should discuss in the auditor's report the actual, final materiality level used to evaluate the financial presentation as a whole. Further, others expressed concern that providing materiality levels (qualitative or quantitative) in the auditor's report might result in an inconsistent communication due to a lack of comparability among companies. For example, depending on the company, its industry, and its financial results in a given year, materiality levels might be based on different criteria, such as net income, revenue, or stockholders' equity. Some outreach participants suggested that disclosing materiality levels in the auditor's report could have negative implications on audit quality. For example, they noted that discussing materiality levels in an auditor's report could reduce the element of surprise necessary in an audit.

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[8/] See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

According to the March 2011 IAG investor survey, "56% of respondents believe the auditor should disclose quantitative and qualitative materiality thresholds and considerations, while 17% of respondents disagree with requiring such disclosure."[9/]

*4. Auditor Independence*

Some outreach participants suggested that the auditor should discuss in the auditor's report information regarding the auditor's independence. According to the March 2010 CFA survey, "72% of respondents would like to see information on circumstances or relationships that might bear on the auditor's independence."[10/] The staff's outreach participants indicated that the type of auditor independence matters that could be included in the auditor's report are –

- The nature and extent of non-audit services the auditor provided to the company,
- Information regarding the auditor's independence as provided to the audit committee,
- Information describing the process the auditor used to assess the auditor's independence, and
- Information describing any mutuality of interests or conflicts of interest between the auditor and the company.

Some outreach participants indicated that they could benefit from such information in order to assess the auditor's relationship and independence with respect to the company. Some outreach participants further indicated that an understanding of auditor independence might help inform their voting decisions on the election, approval or ratification of the auditor in the proxy.

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[9/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

[10/] CFA Institute, *Independent Auditor's Report Survey Results*, (March 2010), available at: www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf.

Other outreach participants indicated that audit committees play a critical role in monitoring auditor independence, for example, pre-approving audit and non-audit services. Some outreach participants indicated that the title of the standard auditor's report (i.e., "Report of Independent Registered Public Accounting Firm") conveys compliance with the independence rules and suggested that additional discussion regarding independence could be redundant, and possibly ineffective without the benefit of the dialogue between the auditor and the audit committee about matters affecting the auditor's independence.

*5. Engagement Statistics*

Some outreach participants indicated that an understanding of key engagement statistics would provide useful information in assessing the quality of the audit. The key engagement statistics have been described as follows –

- Information regarding the composition, tenure, and quality of experience of the audit engagement team (particularly the engagement partner and senior manager);

- The number of hours and fees spent on the engagement in aggregate or spent in significant audit risk areas;

- The percentage of the aggregate audit hours spent, or the percentage of the aggregate hours spent by the engagement partner and managers, on significant audit risk areas; and

- The number of hours and changes in hours year-over-year and significant reasons for such changes.

Some outreach participants suggested that information regarding the composition of the engagement team could provide a sense of the level of expertise and the engagement team's institutional knowledge regarding the company. They further indicated that information regarding the number of hours spent by significant audit risk area could be useful in assessing the auditor's effort. Finally, some outreach participants indicated that a more thorough understanding of the hours and fees could be relevant in considering whether the auditor inappropriately reduced its audit scope due to fee pressures. For example, they noted that, in a recessionary economic environment, the risk of material misstatement and fraud risk could increase;

consequently, some expressed an interest in knowing whether auditors spent more time in certain audit risk areas.

Others expressed a view that the level of hours on a particular engagement or audit area within an audit is not necessarily an indicator of audit quality. For example, an audit of a company with primarily manual controls or a decentralized accounting system typically would require more audit hours than an audit of a similar company with primarily automated controls or a centralized accounting system. Further, some outreach participants suggested that the number of audit hours does not necessarily address the quality of a company's audit.

## C. Information Related to the Company's Financial Statements

Although the current auditor's report provides the auditor's opinion on whether the financial statements are fairly presented in conformity with the applicable financial reporting framework, some outreach participants indicated that not all financial statements that are "presented fairly" may be considered equivalents, or of equal quality. In other words, accounting frameworks provide for various management judgments and estimates in the company's application of accounting policies and practices. The increased levels of judgments and estimates are susceptible to management bias and could result in a wide range of acceptability within the company's applicable financial reporting framework. This range of acceptability is not reflected in the auditor's opinion.

Many preparers, audit committee members, and auditors are not supportive of adding company-specific information to the auditor's report. They noted that management should be the primary source of the company's financial information or such information should come from the audit committee, which is responsible for the oversight of the financial reporting process.

### *1. Management's Judgments and Estimates*

Many outreach participants indicated that it would be useful if the auditor were to provide relevant information, including the auditor's views, on management's assumptions, methodologies, and accounting policies related to accounting estimates that involve a high degree of complexity or judgment. They indicated that financial statements include many estimates that are based on management's judgments regarding assumptions, methodologies, and accounting policies. For example, items in the financial statements involve fair value accounting for which there may be a relatively wide range of potential estimation, and some outreach participants would like to know information about the ranges as well as the auditor's views on the appropriateness of the estimate recorded within the range. Some outreach participants further recognize that management's judgments and estimates inherently include management bias. Therefore, more information regarding the reasonableness and consistency of, changes in, and ranges of possible outcomes and management's selection within those ranges could be useful to the users of financial statements. This additional information might include the reasonableness and consistency of, and changes in, assumptions, inputs, methodologies and accounting policies.

This request is consistent with the March 2011 IAG investor survey that indicated that "79% of respondents believe the auditor should discuss significant estimates and judgments made by management, the auditor's assessment of their accuracy, and how the auditor arrived at that assessment (14% disagree with requiring this disclosure)."[11/]

With regard to management's estimation process, some outreach participants said that they would benefit from knowing more about the process that management used to determine an estimate, the key assumptions used, and other factors that management considered in developing an estimate. Because estimates by their nature are not exact, the auditor's description of the process that management used to determine the estimates, as well as other factors management considered, would better inform the investor in evaluating the overall presentation of the financial statements.

Some outreach participants suggested that the auditor's discussion could focus on the most critical accounting estimates with assumptions that have a potential material impact on the financial statement results. They also suggested that the auditor's discussion could focus on the ranges used in the estimates. This discussion could be aligned with management's discussion of critical accounting estimates in the MD&A.

Other outreach participants indicated that it is management's responsibility to discuss the company's financial information, including the judgments and estimates that embody the financial statements. Some outreach participants are concerned that information provided by the auditor regarding his or her views about management's judgments might differ from the disclosures management makes in the MD&A, which includes management's views about the financial statements. These sources of information might suggest inconsistencies to the investor. Therefore, if auditors are

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[11/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

required to provide their views in the auditor's report about management's judgments and estimates, then management might be compelled to make changes to its judgments and estimates solely based on the auditor's views (i.e., management might be influenced to use judgments or estimates suggested by the auditor). Some outreach participants further indicated that if the auditor were to provide information about the company's financial statements, then this could cause preparers to default to "auditor preference" for judgments and estimates. In other words, it may not always be appropriate for the auditor to provide this information, because management, not the auditor, is in the best position to make assumptions and judgments about its business.

*2. Accounting Policies and Practices*

Some outreach participants recommended that the auditor provide his or her views regarding the appropriateness of the company's application and consistency of the company's critical accounting policies and practices. They suggested that this discussion should align with the critical accounting policies and practices that management disclosed in its MD&A. The Securities and Exchange Commission ("SEC") describes critical accounting policies and practices as a company's accounting policies and practices that are most important to the presentation of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain.[12/] Other outreach participants suggested that the auditor discuss which accounting policies management used that are considered acceptable, but not preferable, under the applicable financial reporting framework.[13/]

According to the March 2011 IAG investor survey, "65% of respondents believe the auditor should discuss quality, not just acceptability, of the accounting policies and practices employed as well as the consistency of their application, while 15% disagree with requiring this disclosure."[14/]

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[12/] See *Cautionary Advice Regarding Disclosure About Critical Accounting Policies,* Securities Act Release No. 8040 (December 12, 2001).

[13/] The SEC currently requires a "preferability letter" from the auditor when a company changes accounting principles or practices. See Item 601(b)(18) of Regulation S-K, 17 CFR § 229.601(b)(18); Rule 10-01(b)(6) of Regulation S-X, 17 CFR § 210.10-01(b)(6).

[14/] IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

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Additionally, some outreach participants suggested that the auditor should discuss alternative accounting policies that the auditor discussed with management or policies that are different from other companies in the company's industry. Some outreach participants said that when there are alternative accounting treatments, the auditor should describe the alternative accounting treatment available under the applicable financial reporting framework and could indicate the treatment that the auditor preferred.[15/]

Some outreach participants indicated that when an auditor has agreed that a company's policy is acceptable, then providing additional information on alternative policies may be misleading. This is due to the fact that the full context of the reasons behind the company's accounting policy decisions, and reasons for their acceptability based on the company's facts and circumstances, are not provided. Further, some cautioned that the auditor should not indicate a preference for or against the company's particular policies and providing this information in the auditor's report could result in management adopting policies or practices that reflect the auditor's view rather than management's view.

Some outreach participants indicated that the auditor also should discuss in the auditor's report significant unusual transactions to enhance investors' understanding of how those transactions impact the financial statements. According to the March 2011 IAG investor survey, "67% of respondents believe the auditor should disclose unusual transactions while 14% disagree with requiring this disclosure."[16/]

*3. Difficult or Contentious Issues, Including "Close Calls"*

Some outreach participants recommended that the auditor identify in the auditor's report the most difficult or contentious issues discussed with management. Difficult or contentious issues might arise in various stages of the audit, including in the auditor's evaluation of management's judgments, estimates, and accounting policies. Many

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15/ The SEC currently requires a "preferability letter" from the auditor when a company changes accounting principles or practices. See Item 601(b)(18) of Regulation S-K, 17 CFR § 229.601(b)(18); Rule 10-01(b)(6) of Regulation S-X, 17 CFR § 210.10-01(b)(6).

16/ IAG meeting, March 16, 2011. Event details and webcast available at: http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

outreach participants described difficult or contentious issues as those critical matters that concerned the auditor when making the auditor's final assessment of whether the financial statements are presented fairly. A difficult issue might not always be synonymous with a contentious issue. Rather, a difficult issue might be a matter that requires significant consideration or consultation; however, the auditor might agree with management's conclusions regarding the issue. A contentious issue might be a matter that not only requires significant consideration or consultation but also leads to significant points of disagreement, debate or deliberation between the auditor and management. Regardless of whether the issue is difficult or contentious, some outreach participants indicated that they would like information concerning how management and the auditor ultimately resolved the issue in order for the auditor to issue an unqualified opinion.

In addition, some outreach participants suggested the auditor should discuss the "close calls" encountered by the auditor in performing the audit. Some investors described close calls to include matters such as –

- Those accounting decisions that required significant deliberation by the auditor and management before being deemed to be acceptable within the applicable financial accounting framework,

- Those matters related to internal control over financial reporting that required significant deliberation by the auditor and management, and

- A financial statement issue that had a potential material impact to the financial statements and was corrected prior to the end of the period.

Some outreach participants indicated that knowing the difficult or contentious issues or the close calls would provide insight into the auditor's significant judgments. Others suggested that the auditor provide a listing of the issues in the auditor's report (e.g., difficult, contentious, or close calls) without the auditor's views. Based on this information, financial statement users could determine if further investigation is warranted as part of their investment analysis.

However, other outreach participants believe that if the difficult or contentious issues, or "close calls" are resolved to the auditor's satisfaction then description of them in the auditor's report would not provide relevant and useful information and could be misleading regarding the meaning of the auditor's opinion (i.e., the issuance of an unqualified opinion demonstrates that the auditor has satisfactorily resolved all material matters).

Some outreach participants indicated that due to the financial complexity of most public companies and their many accounting policies and estimates, there are typically a significant number of difficult or contentious issues or close calls in the normal course of the audit. Therefore, it may be hard for the auditor to determine which particular issues are most important to be discussed in the auditor's report.

*4. Information Communicated to the Audit Committee*

Some outreach participants indicated that the auditor should include in, or attach to, the auditor's report the auditor's communications with the audit committee. Much of the information communicated to the audit committee includes matters previously discussed, such as risks, audit procedures and results, and the quality of the financial statements. Some outreach participants indicated that the audit committee communication could provide key insights into the quality of the financial statements and internal control over financial reporting, and provide the auditor's views regarding significant accounting matters.

Other outreach participants, however, expressed concern that the two-way dialogue that takes place between the auditor and the audit committee cannot be replicated in the auditor's report, and a written report would not provide sufficient context to aid understanding of the matters presented in the audit committee communications by someone outside the company. For example, audit committee members have the opportunity to ask probing questions of the auditor regarding the information provided to enhance their understanding of the communications, when needed. Some outreach participants noted that having an auditor provide all audit committee communications to investors might stifle the communications between the auditor and the audit committee and undermine the governance role of the audit committee.

Other outreach participants said that the nature and extent of the audit committee communications vary considerably. The communications may be oral or written and may vary in length from an executive summary to a 100-page detailed document. These outreach participants indicated that disclosure of these communications may lead to a lack of comparability among companies. Further, audit committee communications often include company- and industry-specific terms that audit committee members understand in their oversight role, but might require greater context or explanation in order for these terms to be understood outside of the company.

**CONCEPT RELEASE**

5. *Other Information Outside the Financial Statements*

Many outreach participants have indicated that the auditor should provide some level of assurance on information outside the financial statements (e.g., MD&A, earnings releases, non-GAAP information). Their view is that investors use and place reliance on other financial information (e.g., earnings releases), in addition to the historical financial statements. Some outreach participants indicated that other information outside the financial statements contains valuable information about the company, and provides additional context for understanding and interpreting the audited financial statements. Some indicated that an auditor providing some level of assurance on this information would improve the quality, completeness, and credibility of such information.

Under auditing standards the auditor has certain responsibilities with respect to other information (i.e., MD&A) in documents containing the audited financial statements (i.e., annual report). In this case, AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* requires the auditor to read the other information and to consider whether that information is materially inconsistent with the information appearing in the audited financial statements and whether there is a material misstatement of fact.[17/] However, under existing auditing standards the auditor does not have responsibility with respect to certain information not contained in the annual report, such as in a company's earnings releases. Although, the audit committee could retain the auditors to perform agreed-upon procedures on this information.[18/]

The MD&A, earnings releases, and other documents often include non-GAAP information. Some outreach participants suggested that if an auditor were required to provide some level of assurance on such information, then suitable criteria would need to be developed for the preparation and presentation of non-GAAP information to ensure the integrity and consistency of the reporting. These participants are concerned that auditors would constrain management's discussion to only matters that can be objectively verified by the auditor, and therefore limit management in its communication with the investor.

Some outreach participants acknowledged that various recommendations might require collaboration with the SEC, to mandate changes to current financial reporting

17/ AU sec. 550.

18/ See AT sec. 201, *Agreed-Upon Procedures Engagements.*

requirements and development of a management reporting framework. These recommendations include expanding the auditor's responsibility related to other financial information to include an audit or review of MD&A, press releases, and non-GAAP information.

## D. Clarification of the Standard Auditor's Report

Many investors suggested that certain language within the standard auditor's report should be further clarified or explained. These investors suggested that clarifying the language in the standard auditor's report could improve the user's understanding of what an audit represents and the various responsibilities of the auditor and management as part of the audit process.

### *1. Reasonable Assurance*

Some outreach participants indicated that the concept of an auditor's report providing "reasonable assurance" that the financial statements are free of material misstatement is not clearly understood. The auditor's report explicitly asserts that the audit was conducted in accordance with professional standards and states that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."

Some outreach participants suggested that the auditor's report should describe the meaning of reasonable assurance consistent with how it is described in the auditing standards (i.e., clarify the language in the auditor's report that reasonable assurance is a high level of assurance, but not absolute assurance).

The term "reasonable assurance," as used in auditing standards, describes the level of assurance that auditors are required to obtain by performing audit procedures and evaluating the resulting audit evidence when expressing an audit opinion. The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Therefore, an audit may not detect a material misstatement.[19/]

[19/] Paragraph 10 of AU sec. 230, *Due Professional Care in the Performance of Work.*

*2. Auditor's Responsibility for Fraud*

Many outreach participants indicated that the auditor's report should provide clarification regarding the auditor's responsibility related to fraud. For example, the current standard auditor's report does not mention "fraud" and is silent about the auditor's responsibility to detect fraud.[20/]

The auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[21/]

*3. Auditor's Responsibility for Disclosures*

Many outreach participants suggested that it would be beneficial to clarify in the auditor's report that audited disclosures are part of the financial statements and therefore are equally subject to the audit. The standard auditor's report identifies the balance sheets, related statements of operations, stockholders' equity and cash flows as the financial statements. Additionally, the SEC rules provide that "financial statements" include all notes to the financial statements and related schedules.[22/]

Some outreach participants indicated that the auditor's evaluation of audit results should include evaluation of the presentation of the financial statements, including disclosures.[23/] Many outreach participants indicated that the increasing level of disclosures required due to the complexity of business transactions, off-balance sheet transactions, non-recognition of assets and liabilities, and the increased use of fair value and other accounting estimates underscore why the auditor's report should explicitly state that the audit opinion also extends to audited disclosures.

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20/ ACAP Final Report, p. VII.14.

21/ AU sec. 230 and AU sec. 316, *Consideration of Fraud in a Financial Statement Audit.*

22/ Rule 1-01(b) of Regulation S-X, 17 CFR §210.1-01.

23/ Paragraph 4.e. of Auditing Standard No. 14, *Evaluating Audit Results.*

**CONCEPT RELEASE**

Overall there is consensus among outreach participants that the auditor's report should explicitly state that the financial statements, including the related disclosures, are subject to the audit and auditor's opinion.

Under auditing standards, auditors are required to perform procedures to test the financial statement disclosures and to evaluate whether the financial statements contain the information essential for fair presentation of the financial statements in conformity with the applicable financial reporting framework.[24/] Auditing standards also require auditors to perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional[25/] to identify and test significant disclosures;[26/] and, in integrated audits, to test controls over significant disclosures.[27/]

*4. Management's Responsibility for the Preparation of the Financial Statements*

Many outreach participants suggested that the auditor's report should make clear that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

The Sarbanes-Oxley Act of 2002 (the "Act") requires corporate officers to certify in periodic filings with the SEC that "based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer, as of, and for, the periods presented in the report."[28/] This requirement denotes that management is responsible for the fair presentation of the company's financial statements.

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[24/] Paragraphs 30-31 of Auditing Standard No. 14.

[25/] See, for example, paragraphs 49, 52, and 67 of Auditing Standard No. 12.

[26/] See, for example, paragraphs 59-64 of Auditing Standard No. 12 and paragraph 9 and footnote 6 of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*. A disclosure is a significant disclosure if there is a reasonable possibility that the disclosure could contain a misstatement that, individually or when aggregated with others, has a material effect on the financial statements.

[27/] Paragraph 26 of Auditing Standard No. 5.

[28/] Section 302(a)(3) of the Act.

**CONCEPT RELEASE**

*5. Auditor's Responsibility for Information Outside the Financial Statements*

Some outreach participants indicated that users of financial statements misinterpret the auditor's responsibilities regarding information presented outside the financial statements. Such information might be financial or non-financial information included in the MD&A or presented in other portions of documents containing audited financial statements. These outreach participants suggested that the auditor specifically state in the auditor's report the auditor's responsibility and procedures, if any, related to such information.

While the audit does not extend to information outside the financial statements, the auditor has certain responsibilities with respect to such information. Specifically, auditing standards require the auditor to read the information and to consider whether that information is materially inconsistent with the information appearing in the audited financial statements and whether there is a material misstatement of fact.[29/] However, they indicated that the auditor has no obligation to perform any procedures to corroborate the other information contained in the document. If no material inconsistencies or material misstatements of fact are found, the auditor's report would not address this information.

*6. Auditor Independence*

Some outreach participants indicated that it would be useful if the auditor explicitly stated in the auditor's report that he or she is independent with respect to the company. An explicit statement in the auditor's report could clarify for the investor the auditor's responsibility to be independent.

Other outreach participants indicated that the title of the standard auditor's report (Report of Independent Registered Public Accounting Firm) conveys compliance with the independence rules and suggested that additional discussion regarding independence could be redundant.

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[29/] AU sec. 550.

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| PROPOSED AUDITING STANDARDS –<br><br>THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;<br><br>THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;<br><br>AND RELATED AMENDMENTS TO PCAOB STANDARDS | PCAOB Release No. 2013-005<br>August 13, 2013<br><br>PCAOB Rulemaking<br>Docket Matter No. 034 |

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing two new auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which would supersede portions of AU sec. 508, *Reports on Audited Financial Statements,* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, which would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements.* The Board also is proposing related amendments to PCAOB standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 034 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on December 11, 2013.

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## I. Introduction

The auditor's report is the primary means by which the auditor communicates with investors and other financial statement users information regarding his or her audit of the financial statements. As it exists today, the auditor's report identifies the financial statements that were audited, describes the nature of an audit, and presents the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. This type of auditor's report has been commonly described as a pass/fail model because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).[1/]

The auditor's report in the United States has changed very little since the 1940s. The existing pass/fail model is thought by many to be useful because it provides a clear indication of whether the financial statements are presented fairly.[2/] However, while the existing auditor's report provides important information about an audit in general, it does not provide information that is specific to a particular audit.

Academic research suggests that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified

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[1/] If the financial statements are not fairly presented, the standards of the PCAOB provide that an auditor may issue a qualified opinion, adverse opinion, or disclaimer of opinion.

[2/] See paragraph (c) of U.S. Securities and Exchange Commission ("SEC") Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02. SEC rules require the accountant to clearly express an opinion on the audited financial statements that are required to be filed as part of registration statements under the Securities Act of 1933 ("Securities Act") and Section 12 of the Securities Exchange Act of 1934 ("Exchange Act"), annual or other reports under Sections 13 and 15(d) of the Exchange Act, proxy and information statements under Section 14 of the Exchange Act, and registration statements and shareholder reports under the Investment Company Act of 1940. See also paragraph (a) of SEC Rule 1-01 of Regulation S-X, 17 C.F.R. § 210.1-01.

because it does not provide any other informational value about the particular audit.[3/] During the Board's outreach activities over the last three years, many investors have expressed dissatisfaction that the content of the existing auditor's report provides little, if any, information specific to the audit of the company's financial statements to investors or other financial statement users. During a financial statement audit, auditors obtain and evaluate important information concerning the company, the company's environment, and the preparation of the company's financial statements. Many investors have indicated that they would benefit from additional auditor reporting because they do not have access to, or may not be aware of, much of this information. Additionally, many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the reports more relevant and useful.[4/]

Several commissions examined both the auditor's responsibilities and the form of the auditor's report in the 1970s and 1980s.[5/] These commissions made several recommendations to change the auditor's report; however, only a limited number of changes were made in response to these recommendations.[6/] In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession ("ACAP") recommended that the PCAOB undertake a standard-setting initiative to consider

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3/ See, e.g., Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); and Theodore J. Mock, Jean Bedard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing 323, 323-351 (2013).

4/ See survey, *Improving the Auditor's Report*, which was presented by the working group of the IAG on Auditor's Report and The Role of the Auditor, (March 16, 2011), available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

5/ For example, in 1978, the Commission on the Auditors' Responsibilities (known as the "Cohen Commission") and in 1987, the National Commission on Fraudulent Financial Reporting (known as the "Treadway Commission") recommended changes to the auditor's report.

6/ The changes expanded the discussion of attributes of an audit and management's responsibility. See Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts to Influence the Auditing Standards Board*, 1 (1993), 38.

improvements to the auditor's standard reporting model.[7/] The ACAP report noted that "some believe…[that the] standardized wording does not adequately reflect the amount of auditor work and judgment."[8/] Similar sentiments were expressed more recently by members of the Board's Standing Advisory Group ("SAG")[9/] and IAG.[10/]

Additionally, ACAP noted that the auditor reporting model developed in the 1940s did not address the increasing complexity of global business operations that are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting.[11/] It was further noted that this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.[12/] ACAP concluded that an improved auditor's report likely would lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit.[13/]

During the Board's outreach activities, some investors noted that auditors gain knowledge about the company's financial statements during the audit that is not known to investors. These investors stated that they believe such knowledge would assist them when making their investment decisions. Academic research finds that the existing

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7/ U.S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP report"), at VII:13 (October 6, 2008), available at http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

8/ Id. at VII:13.

9/ See SAG meeting details and webcast for April 2010 available at http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx.

10/ See IAG meeting details and webcast for May 2010 and March 2011 available at http://pcaobus.org/News/Events/Pages/05042010_IAGMeeting.aspx and http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

11/ See ACAP Report at VII:17.

12/ Id.

13/ Id.

auditor's report has symbolic value in that it represents the auditor's work but that it provides little communicative value.[14/]

Additionally, the auditor's report is undergoing change globally. Several international standard setters and regulators, such as the International Auditing and Assurance Standards Board ("IAASB"), the United Kingdom's Financial Reporting Council ("FRC"), and the European Commission ("EC") have been working on similar projects to change the auditor's report.[15/]

After extensive outreach conducted over the last three years, the Board is proposing two standards under its statutory mandate to "protect the interests of investors and further the public interest in the preparation of *informative*, accurate and independent audit reports"[16/] [emphasis added]. The proposed standards are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. At the same time, the Board sought a balanced approach that would not unduly burden the financial reporting process.

The two proposed standards are: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"). The Board also is proposing related amendments to other PCAOB auditing standards (the "proposed amendments"). This release collectively refers to the proposed auditor reporting standard, proposed other information standard, and proposed amendments as "the proposed standards and amendments."

Briefly, the Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that

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[14/] See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008).

[15/] See further discussion regarding the projects of these standard setters and regulators in Section II., *Board Outreach*.

[16/] Section 101(a) of the Sarbanes-Oxley Act of 2002 (the "Act").

would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

The auditor's report as currently designed, and as confirmed by academic research, conveys to investors and other financial statement users little of the information obtained and evaluated by the auditor.[17/] The proposed auditor reporting standard is intended to provide investors and other financial statement users with potentially valuable information that investors have expressed interest in receiving but have not had access to in the past.[18/]

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[19/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[20/] The Board is

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[17/] See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008).

[18/] See CFA Institute's surveys: *Usefulness of the Independent Auditor's Report* (May 4, 2011), *Independent Auditor's Report Survey Results* (February 26, 2010), and *Independent Auditor's Report Monthly Poll Results* (March 12, 2008), available at http://www.cfainstitute.org/about/research/surveys/pages/index.aspx.

[19/] Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

[20/] See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

seeking comment on whether the information communicated in critical audit matters would be valuable to investors and could reduce information asymmetry.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. In considering the nature and form of auditor reporting on other information, the Board evaluated the existing auditing standard related to the auditor's responsibilities with respect to other information and determined it was appropriate to update the other information standard to support a description in the auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. "Other information" in the proposed other information standard refers to information in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed enhancements to the required auditor's procedures in the proposed other information standard are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[21/] or intentional misreporting.[22/] As a result of the

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[21/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting*, Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[22/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[23/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.[24/] Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[25/] The Board is seeking comment on whether the proposed other information standard would increase the quality of information available to investors.

The Board anticipates that the proposed auditor reporting standard and proposed other information standard will have cost implications for both auditors and companies, including audit committees, as further discussed in this release and Appendices 5 and 6.

The remaining sections of this release describe the outreach conducted by the Board in considering possible changes to the auditor's report, the development and overview of the proposed standards and amendments, and alternatives considered. Additionally, this release includes a discussion of the applicability of the proposed standards and amendments to the audits of brokers and dealers and considerations regarding audits of emerging growth companies ("EGCs").

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[23/] The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[24/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

[25/] Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, refer to Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital*, 9 Review of Accounting Studies 233, 233-259 (2004).

## II. Board Outreach

Over the last three years, the Board has conducted extensive outreach with investors, auditors, financial statement preparers, and others to better understand the nature of improvements that could be made to make the auditor's report more informative. In developing its proposals, the Board also sought to better understand issues related to implementing improvements, including potential costs and other economic considerations involved.

From October 2010 through March 2011, the staff of the Board's Office of the Chief Auditor ("staff") met and held discussions with investors, financial statement preparers, auditors, audit committee members, other regulators and standard setters, and representatives of academia. During this outreach, some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party. Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the potential risks of material misstatement in a company's financial statements. The staff reported its findings to the Board at an open meeting on March 22, 2011.[26/] The Board concluded from its initial outreach that changing the auditor's report could improve the informational value of the auditor's report and enhance the relevance of the auditor's reporting model. During this same period at an IAG meeting, the recent financial crisis was mentioned as an example of a situation in which expanded auditor reporting in advance of, and during, the crisis might have been helpful in assessing a company's financial statements and providing early warning signals regarding potential issues.[27/]

Subsequently, on June 21, 2011, the Board issued *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release")[28/] to seek public

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[26/] See meeting details and webcast for PCAOB Board Meeting on March 22, 2011, available at http://pcaobus.org/News/Webcasts/Pages/03222011_OpenBoardMeeting.aspx.

[27/] See Investor Advisory Group ("IAG") meeting details and webcast for March 2011 available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

[28/] PCAOB Release No. 2011-003 (June 21, 2011) available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

comment on potential changes to the auditor's reporting model. The objective of the concept release was to seek comment on several alternatives for changing the auditor's reporting model in order to make auditor reporting more relevant and useful to investors and other financial statement users. The alternatives presented were:

- A supplemental narrative report, described as an auditor's discussion and analysis ("AD&A");
- Required and expanded use of emphasis paragraphs;
- Auditor assurance on other information outside the financial statements; and
- Clarification of the standard auditor's report.

The concept release indicated that each of the alternatives presented would retain the pass/fail opinion of the existing auditor's report and was not intended to alter the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. The concept release also indicated that the alternatives were not mutually exclusive and that other alternatives could be considered.

The Board received 155 comment letters on the concept release.[29/] Additionally, on September 15, 2011, the Board held a public roundtable ("roundtable") to obtain insight from a diverse group of investors and other financial statement users, preparers of financial statements, audit committee members, and auditors on the alternatives presented in the concept release.[30/] The topic was further discussed at the November 2011 and 2012 SAG meetings.[31/]

Commenters generally supported the Board updating and enhancing the auditor reporting standard and largely agreed that the existing auditor's report provided little informational value about a specific audit to investors and other financial statement

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[29/] See comment letters on the concept release available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034Comments.aspx.

[30/] See transcript of the roundtable available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[31/] See SAG meeting transcripts for November 2011 and 2012 available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

users beyond the pass/fail opinion. However, there were widely diverse views among different constituencies about the nature and extent of changes that should be made to the existing auditor's report and the potential costs associated with those changes.

Investors strongly supported the Board's initiative to enhance the existing auditor's report to provide more informative reporting about the audit, the financial statements, or both. This group of commenters generally expressed the view that the existing auditor's report was not sufficiently informative to meet the needs of investors who would benefit from further insights obtained by the auditor during the audit of the financial statements. Investors most frequently suggested additional auditor reporting on the following information:

- Areas of high financial statement and audit risk;
- Areas of significant auditor judgment;
- The most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty;
- The quality, not just the acceptability, of accounting policies and practices, for instance, management's application of accounting policies that are acceptable under the applicable financial reporting framework but are not the preferred practice;
- Significant changes in or events affecting the financial statements, including unusual transactions; and
- Identification of where significant matters are disclosed in the financial statements for investors' further information.

Some investors recognized that, if the auditor's report included this information, audit costs could increase due to the time required to draft and review such communications. However, these investors also expressed the belief that these costs, which are ultimately paid for by investors, likely would be modest since the communication would be based on the work already performed by the auditor. These commenters indicated that the benefits in terms of increased confidence in corporate reporting outweighed the costs.

Financial statement preparers, in general, did not object to the clarifications to the auditor's report described in the concept release if such clarifications would be useful to financial statement users and would increase the transparency into the audit process. The majority of these commenters, however, believed that there was little need for changes to the existing auditor's report and believed it was the responsibility of the company, not the auditors, to provide information about the company's financial statements to financial statement users. Audit committee members expressed similar views.

Auditors generally were supportive of changes to the existing auditor's report but believed that any additional auditor reporting should be objective and factual. This group of commenters also believed that certain changes to the auditor's report could provide benefits to users of the financial statements by providing additional clarification about the audit and audit process. Auditors noted that the alternatives presented in the concept release for changing the auditor's report would require additional effort, primarily related to drafting and reviewing the auditor's report, and as a result would increase audit costs and the potential for auditor liability.

Other commenters, including academics, other regulators, and other individuals and organizations, expressed a variety of views about changes to the existing auditor's report. For example, one commenter indicated that the existing auditor's report is not particularly informative and does not provide information regarding the nature and type of procedures, processes, and information used in forming the auditor's opinion. Other commenters indicated that the current pass/fail model is sufficient and that it is the responsibility of the company, and not the auditors, to provide additional disclosures about the company to investors.

One of the alternatives presented in the concept release was to require auditor assurance on other information outside the financial statements. Some commenters noted that they were uncertain as to the level of the auditor's responsibility for other information outside the financial statements. Some of those commenters supported changes to the auditor's report that describe the auditor's existing responsibilities related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information outside the financial statements.

In developing the proposed auditor reporting standard, the Board considered recent developments of (1) the IAASB's project on auditor reporting;[32/] (2) the EC's

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[32/] See IAASB project summary at http://www.ifac.org/auditing-assurance/projects/auditor-reporting. The IAASB issued an exposure draft, *Reporting* legislative proposal and subsequent European Parliamentary report that relate to audits of public interest entities;[33/] and (3) the FRC's recently adopted revision of its auditing standard on the auditor's report.[34/] The IAASB's project, the EC's proposal and subsequent amendments, and the FRC's revised auditing standard would require auditor reporting on certain additional matters.

In developing the proposed other information standard, the Board considered the IAASB's recent proposal, *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*.[35/]

## III. Development and Overview of the Proposals

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches (which are discussed in Section IV., *Alternatives Considered*); (5) current developments in similar projects by other standard setters; (6) relevant academic

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*on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*, for public comment in July 2013 available at https://www.ifac.org/publications-resources/reporting-audited-financial-statements-proposed-new-and-revised-international.

[33/] See proposal for a *Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities* (November 30, 2011) available at http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf. See amendments to the EC proposal that were approved on May 14, 2013, by the Parliamentary committee with principal jurisdiction over the proposal at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bREPORT%2bA7-2013-0171%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN.

[34/] See FRC's revised auditor reporting standard at http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised).aspx.

[35/] See IAASB project summary at http://www.ifac.org/auditing-assurance/projects/auditors-responsibilities-relating-other-information-documents-containin.

research; and (7) significant comments received by the Board from its outreach efforts, including comments received on the concept release. In considering the nature and extent of changes to the existing auditor's report, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding undue burden to the financial reporting process.

## A. Proposed Auditor Reporting Standard

The proposed auditor reporting standard, among other things, would make the following significant changes to the existing auditor's report:

- Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements. If the auditor determines that there are no critical audit matters, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.

- Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.

- Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.

The proposed auditor reporting standard would retain the pass/fail model of the existing auditor's report. The proposed auditor reporting standard would also retain explanatory paragraphs that are required in certain circumstances and the auditor's ability to emphasize a matter in the financial statements.

### *1. Auditor Reporting of Critical Audit Matters*

In developing the proposed requirements for the communication of critical audit matters, the Board considered many investors' requests for information regarding matters related to the audit and the most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty. The concept release described as alternatives for providing additional information to financial statement users about the audit and the financial statements: (1) an AD&A and (2) required and expanded emphasis paragraphs. The

Board, however, is not proposing any of these alternatives, which are described further in Section IV., *Alternatives Considered*.

The Board, instead, is proposing requirements for the auditor to communicate in the auditor's report "critical audit matters." Critical audit matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Use of the word most is not intended to imply that only one matter under each criteria would qualify as a critical audit matter.

The Board is proposing communication of critical audit matters in response to the requests of many investors to improve the relevance of the auditor's report by providing more insight about the most significant matters that the auditor addressed in the audit. Communicating critical audit matters likely would provide meaningful information to investors and other financial statement users about the auditor's work in performing the audit and in forming an opinion on the financial statements, taken as a whole.

The auditor would determine which matters to communicate as critical audit matters. The proposed auditor reporting standard indicates that critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document,[36/] which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer;[37/] (3) communicated to the audit committee;[38/] or (4) any combination of the three. The Board would not expect that each matter included in any one or more of these sources would be a critical audit matter. Referring to these sources can provide a cost-effective and efficient means of determining critical audit matters. Additionally, the proposed auditor reporting standard provides a list of factors for the auditor to take into account in determining the critical audit matters. The factors are intended to help the auditor determine, from the results of the audit or evidence obtained, which matters are critical audit matters.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit. Thus, the proposed auditor reporting standard does not modify the

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[36/] Auditing Standard No. 3, *Audit Documentation*.

[37/] Auditing Standard No. 7, *Engagement Quality Review*.

[38/] Auditing Standard No. 16, *Communications with Audit Committees*, and other PCAOB standards.

objective of the audit of the financial statements or impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

The proposed auditor reporting standard would require the auditor to determine critical audit matters in the audit of the current period's financial statements, based on the results of the audit or evidence obtained. The proposed auditor reporting standard also provides that in situations in which the auditor determines there are no critical audit matters to communicate, the auditor would state that conclusion in the auditor's report. Critical audit matters would be determined based on the facts and circumstances of each audit. It is expected that in most audits the auditor would determine that there are critical audit matters.

The description of critical audit matters in the auditor's report would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[39/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Improving the auditor's report through the communication of critical audit matters also would address some commenters' concerns that it is the company's or the audit committee's responsibility, not the auditor's, to provide information, including any analysis, about the company's financial statements to financial statement users. The

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[39/] See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management. Rather, the auditor would be communicating information about the audit, based on audit procedures the auditor performed.

The Board intends for the proposed communication of critical audit matters to be responsive to cost issues raised by commenters. Because critical audit matters are based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that reporting of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees. In addition to the potential cost implications, there could be potential unintended consequences associated with requiring that auditors communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit which might reduce the time available to the auditor for review and completion of the audit work. The Board seeks comments on the nature and extent of those costs, as well as regarding any potential unintended consequences.

*2. Basic Elements of the Auditor's Report*

The existing auditor's report identifies the financial statements audited, describes the nature of an audit, and expresses the auditor's opinion using standardized language. The existing auditor reporting standard also provides a list of basic elements that are required to be in the auditor's report.[40/]

The concept release sought comment on whether the standardized language in the auditor's report required by the existing auditing standard is useful, whether any of the language could be clarified, and whether the auditor's report should describe the auditor's responsibilities for other information outside the financial statements. Several commenters indicated that clarifying language and certain other matters in the auditor's report could improve financial statement users' understanding of the nature of an audit, the auditor's responsibilities, and the purpose of the auditor's report. Some commenters, however, indicated that additional boilerplate language to clarify language already in the report would not be helpful. After considering the comments, the Board is proposing certain clarifications of the language in the report that the Board believes would enhance users' understanding about the audit and the auditor, including the auditor's responsibilities for other information outside the financial statements.

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[40/] See AU secs. 508.06-.08.

The proposed auditor reporting standard primarily retains the basic elements of the auditor's report contained in existing auditor reporting standards,[41/] incorporates certain elements from existing illustrative auditor's reports, and further describes some of the auditor's existing responsibilities, such as the auditor's responsibility for the notes to the financial statements and fraud.

Additionally, the proposed auditor reporting standard adds the following new elements to the auditor's report to provide investors and other financial statement users with information about the audit and the auditor:

- Auditor independence − a statement regarding the auditor's existing requirements to be independent of the company, intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations;

- Auditor tenure − the year the auditor began serving as the company's auditor, to provide investors and other financial statement users with information about the length of the relationship between the auditor and the company; and

- Other information – the auditor's responsibilities for, and the results of, the auditor's evaluation of other information in annual reports filed with the SEC containing the financial statements and the related auditor's report, to provide investors and other financial statement users with an understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board anticipates that these proposed changes to the auditor's report likely would have some cost-related implications for auditors and companies, including audit committees. The Board seeks comments on the nature and extent of those costs.

*3. Explanatory Language*

Under existing PCAOB standards, certain circumstances require that the auditor include explanatory language or paragraphs in the auditor's report, such as when there

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[41/] See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board*.

is substantial doubt about the company's ability to continue as a going concern[42/] or the correction of a material misstatement in previously issued financial statements. These circumstances are described in other PCAOB standards, which generally provide standardized language to be included in the auditor's report. Similar to the existing auditor reporting standard, the proposed auditor reporting standard describes those circumstances and provides references to the relevant PCAOB standards.

Additionally, the proposed auditor reporting standard retains from the existing standard the auditor's ability to include explanatory paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Currently, such explanatory paragraphs are not required and may be added solely at the auditor's discretion.[43/] As described in the proposed auditor reporting standard, these explanatory paragraphs would refer only to information presented or disclosed in the financial statements. The proposed auditor reporting standard provides several examples of when an auditor might include such explanatory paragraphs.

### B. Auditor's Responsibilities Regarding Other Information

Other information outside the financial statements may be relevant to an audit of the financial statements or to the auditor's decision to be associated with the company's annual report. The proposed other information standard describes "other information" as information, other than the audited financial statements and the related auditor's report, included in a company's annual report that is filed with the SEC under the Exchange Act[44/] and contains that company's audited financial statements and the related auditor's report. For example, other information in an annual report filed by a company on Form 10-K would include, among other items, Selected Financial Data, Management's Discussion & Analysis ("MD&A"), exhibits, and certain information incorporated by reference.

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[42/] The Board is considering a separate standard-setting project to enhance performance requirements and auditor reporting related to a company's ability to continue as a going concern.

[43/] See AU sec. 508.19.

[44/] Consistent with existing AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, the proposed other information standard would not apply to documents filed with the SEC under the Securities Act that contain audited financial statements and the related auditor's report. See further discussion regarding Securities Act documents in Appendix 6.

Under existing PCAOB standards, the auditor has a responsibility to "read and consider" other information in certain documents that also contain the audited financial statements and the related auditor's report; however, there is no related reporting requirement to describe the auditor's responsibility with respect to other information.

The Board began considering the existing other information standard, AU sec. 550, as part of an effort to better explain to investors and other financial statement users the auditor's responsibilities related to other information outside the financial statements. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

As a result of the link between the proposed auditor reporting standard and the proposed other information standard, the financial statement user would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description of the results of the auditor's evaluation of the other information.

Under the existing other information standard, the auditor considers whether the other information is materially inconsistent with information in the financial statements. If the auditor concludes there is a material inconsistency between the other information and the financial statements, the existing standard provides the auditor with certain procedures to respond to the material inconsistency. Additionally, the existing standard provides that, if while reading the other information for a material inconsistency, the auditor becomes aware of a material misstatement of fact in the other information, the auditor would discuss this with management and perform other procedures based on the auditor's judgment.

The proposed other information standard, among other things, would:

- Apply the auditor's responsibility for other information specifically to a company's annual reports filed with the SEC under the Exchange Act that contain that company's audited financial statements and the related auditor's report;

- Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;

- Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and

- Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board's existing standard has no requirements for the auditor beyond "read and consider" with respect to the other information. In contrast, the proposed other information standard includes procedures that auditors consistently would perform in evaluating the other information. The Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard.

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

In developing the proposed other information standard, the Board considered the additional effort and cost of implementing changes in the auditor's responsibilities regarding other information. The Board believes that the proposed approach represents a cost-sensitive approach that would be scalable to less complex companies based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees. The Board requests comments regarding the nature and extent of those costs.

## IV. Alternatives Considered

Before developing the proposed standards and amendments, the Board explored alternatives through extended outreach with investors, companies, auditors, audit committee members, and others. This outreach effort was followed by issuing the concept release in 2011, analyzing comment letters, holding a roundtable, and discussions with the SAG and IAG.

The concept release described alternatives for providing additional information to financial statement users about the audit and the financial statements, specifically: (1) an AD&A; (2) required and expanded emphasis paragraphs; (3) auditor assurance on other information outside the financial statements; and (4) clarification of the standard auditor's report. The following paragraphs explain the alternatives in the concept release. The Board, however, is not proposing any of these alternatives. The Board believes that its proposed approach, which includes communicating critical audit matters, provides many of the benefits described in the concept release while, at the same time, substantially reducing the challenges and costs mentioned by commenters, as explained in Section E., *Approach Proposed by the Board*, below.

The Board also considered retaining existing AU sec. 508 related to the unqualified report and issuing a staff practice alert or other guidance regarding the potential use of existing emphasis paragraphs. The Board believes, however, that proposing a new standard with changes to the auditor's report is appropriate in relation to its mandate under the Act to promote *informative*, accurate, and independent audit reports[45/] [emphasis added]. Additionally, the Board considered retaining AU sec. 550 and describing the auditor's responsibilities under AU sec. 550 in the auditor's report. The Board believes that issuing a new standard regarding the other information is appropriate because the proposed other information standard would provide a consistent basis for the auditor's evaluation of the other information and related auditor reporting.

## A. Auditor's Discussion and Analysis

As described in the concept release, an AD&A could provide investors with a view of the audit and the financial statements "through the auditor's eyes." The intent of the AD&A alternative was to provide the auditor with the ability to write a separate, supplemental narrative report that would follow the auditor's report on the financial statements and contain an open-ended discussion of the auditor's perspectives about the audit and the company's financial statements. The concept release describes the AD&A as being among the most expansive forms of auditor reporting.

According to the concept release, an AD&A could include information about the audit, such as audit risk identified in the audit, audit procedures and results, and auditor independence, and provide the auditor with the ability to communicate to investors and other users of the financial statements the auditor's significant judgments in forming the audit opinion. The AD&A, however, also could include the auditor's perspectives regarding the company's financial statements, such as management's judgments and

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[45/] See Section 101(a) of the Act.

estimates, accounting policies and practices, and difficult or contentious issues. Also, as described in the concept release, an AD&A could provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis. In that regard, the concept release noted that the auditor's perspectives in an AD&A on certain matters could differ from those management might provide in its MD&A,[46/] possibly requiring additional time by management, the auditor, and the audit committee to resolve those differences before any views could be reflected in an AD&A or the MD&A.

Many investors indicated that additional information through an AD&A would provide more transparency into the audit and the financial statements. One commenter suggested that factors that would affect the way an auditor assesses risks of material misstatement in the financial statements might also affect how an investor views risks of investing in the company. Some commenters indicated that an AD&A would heighten the perceived value of the audit, increase competition among auditors based on audit quality, particularly with respect to auditor skepticism, and provide the firms more leverage to affect change and enhance management disclosure in the financial statements.

Other commenters, however, expressed reservations about an AD&A, as described in the concept release, primarily because they saw this form of supplemental narrative reporting as fundamentally changing the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information. These commenters were also concerned about possible undue reliance by financial statement users on an AD&A-type report to make investment decisions and the additional effort by auditors to write and review an AD&A in a compressed reporting timeframe. Some commenters were concerned that this type of auditor reporting could diminish the governance role of the audit committee over the company's disclosure of financial information by allowing auditors to make independent disclosures about the company's financial statements. Some commenters noted that an AD&A-type reporting would require auditors to draft customized language in a supplemental free-form report for public use. Additionally, commenters also noted that absent an extension from the SEC of filing and reporting deadlines, an AD&A would reduce the time available to the most senior members of the audit team for review and completion of audit work in order to identify matters to be included in an AD&A, draft customized language, and work with centralized review personnel to complete the review process.

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[46/] See SEC Regulation S-K, Item 303; 17 CFR § 229.303.

## B. Required and Expanded Emphasis Paragraphs

Emphasis paragraphs are not currently required under existing PCAOB standards but may be added, solely at the auditor's discretion, to emphasize a matter regarding the financial statements.[47] As described in the concept release, required and expanded emphasis paragraphs could highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements. The concept release indicated that emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation. The alternative in the concept release for required and expanded emphasis paragraphs was intended to provide investors with enhanced auditor reporting on much of the information investors indicated they want about the audit and the financial statements. As also explained in the concept release, for each matter of emphasis the auditor could be required to comment on the key audit procedures performed pertaining to the identified matters. The concept release indicated that this alternative was somewhat analogous to the French requirement that the auditor's report contain a "justification for the auditor's assessments."[48]

Many commenters were supportive of using emphasis paragraphs to highlight significant matters to a reader, such as areas with significant management judgments and estimates or a high level of measurement uncertainty. Some commenters supported an emphasis paragraph approach that would inform financial statement users about important matters on which to focus in the financial statements for purposes of their investment decisions.

Many investors indicated that they did not support an auditor's report that only references the relevant financial statement disclosures because no incremental information would be provided in the emphasis paragraphs regarding the company's financial statements or the audit beyond what is already disclosed by management. Some other commenters noted that emphasis paragraphs raised concerns regarding the auditor's disclosure of original information that is not otherwise publicly known.

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[47] See AU sec. 508.19.

[48] On August 1, 2003, article L823-9 of the French Code of Commerce Financial security law was enacted, which requires that the statutory auditor include in the auditor's report a "justification of the auditor's assessments."

Additionally, at the November 2012 SAG meeting, SAG members discussed a potential approach to amending the auditor's reporting model that would include required emphasis paragraphs, based on the matters communicated to the audit committee under Auditing Standard No. 16.[49/] Some SAG members were supportive of linking auditor reporting in expanded emphasis paragraphs to matters communicated to the audit committee under Auditing Standard No. 16.[50/] Other SAG members did not support expanded emphasis paragraphs that would be specifically linked to communications with the audit committee because, in their view, it might affect the nature and extent of the communications between the auditor and the audit committee.[51/]

## C. Auditor Assurance on Other Information Outside the Financial Statements

The concept release indicated that an alternative for enhanced auditor reporting could be auditor examination of, and reporting on, information outside the financial statements, such as MD&A or other selected information (for example, non-GAAP information or earnings releases). Some commenters indicated that certain information outside the financial statements, especially the MD&A, is important to investors to provide context within which the financial results and financial position can be interpreted.

However, investors generally were not supportive of auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model because it would not be responsive to their information needs, and they saw little benefit with this type of auditor assurance. Several commenters expressed concern that auditor assurance on information outside the financial statements would increase the time needed to perform these procedures and would not provide greater benefit than the auditor's current responsibilities related to other information outside the financial statements.

Several commenters suggested that they would support changes to the auditor's report that described the auditor's existing responsibilities related to other information and the auditor's conclusions related to the other information.

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[49/] See Briefing Paper: Auditor's Reporting Model available at http://pcaobus.org/Rules/Rulemaking/Docket034/2012_11_15_SAG_BP_ARM.pdf.

[50/] See SAG meeting transcripts for November 2012 available at http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

[51/] Id.

## D. Clarification of Terms and Responsibilities in the Auditor's Report

### *1. Reasonable Assurance*

In the concept release, the Board sought comment on whether the term "reasonable assurance" should be further described in the auditor's report. Under existing AU sec. 508, the auditor's report explicitly asserts that the audit was conducted in accordance with the standards of the PCAOB and that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." An existing auditing standard describes reasonable assurance as being a "high level of assurance, but not absolute assurance."[52/]

Commenters generally did not support adding additional language to the auditor's report that would further explain the term "reasonable assurance." Commenters suggested that adding additional language would not significantly enhance financial statement users' understanding of the meaning of the term "reasonable assurance."

### *2. Management's Responsibility for the Preparation of the Financial Statements*

In the concept release, the Board sought comment on whether the auditor's report should state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

Under existing auditing standards, the standard auditor's report includes a statement that the financial statements are the responsibility of the company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.[53/]

Some commenters supported clarification in the auditor's report with respect to management's responsibility for the preparation of the financial statements. These commenters indicated that some clarifying language could improve investors' and other financial statement users' understanding of management's responsibilities for the preparation of the financial statements. Conversely, other commenters were against such a clarification, stating that additional language is unnecessary because similar language is already included in the auditor's report and the SEC requires corporate officers' certification of the financial statements.

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52/ See paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

53/ See AU sec. 508.08.c.

Because the existing language in the auditor's report is generally understood to encompass management's responsibility for both the preparation and fair presentation of the financial statements, the Board is not proposing to modify the auditor's report in this regard.

## E. Approach Proposed by the Board

The Board believes the proposed auditor reporting standard and the proposed other information standard provide many of the benefits described in the concept release regarding an AD&A, required and expanded emphasis paragraphs, and auditor assurance on information outside the financial statements. The Board also believes that its proposed approach should eliminate or reduce some of the challenges mentioned by commenters in connection with the alternatives described in the concept release.

Unlike emphasis paragraphs as described in existing AU sec. 508 that generally just point to a disclosure in the company's financial statements, the proposed auditor reporting standard would require the auditor to communicate a wider range of information about the audit. Specifically, the proposed communication of critical audit matters would provide information regarding the reason the matter or matters were considered critical.

The proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information, which was one of the concerns expressed by commenters about an AD&A. Since the auditor would be communicating information regarding the audit, the communication of critical audit matters should not diminish the governance role of the audit committee over the company's disclosure of financial information. In addition, the proposed auditor reporting standard is intended to represent a cost-sensitive approach, because the auditor's determination of critical audit matters is based on the audit already performed.

The description in the auditor's report about the auditor's responsibilities for, and results of, the auditor's evaluation of other information is intended to provide greater clarity regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of other information. Finally, the proposed other information standard would provide a specific basis for the auditor describing in the auditor's report the auditor's responsibilities for, and results of, the auditor's evaluation of other information.

## V. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[54] expanded the authority of the Board to oversee the audits of brokers and dealers that are required under SEC rules. On July 30, 2013, the SEC amended SEC Rule 17*a*-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.[55] At the publication date of this release, the final SEC rules have not been published in the Federal Register.

The Board will consider, and is soliciting comments on, whether the proposed standards and amendments are appropriate for audits of brokers and dealers. Appendices 5 and 6 include specific questions on the applicability of the proposed standards and amendments to the audits of brokers and dealers.

## VI. Economic Considerations

Economic considerations related to the proposed standards are noted in this release with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard. Appendix 7 provides further discussion of economic considerations specifically related to the audits of EGCs.

## VII. Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[56]

In connection with its proposals, the Board solicits views of commenters on the application of the proposed standards and amendments to audits of EGCs. As part of

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54/ Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

55/ See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf.

56/ See Section 103(a)(3)(a) of the Act.

considering the potential application of the proposed standards to the audits of EGCs, the Board specifically requests comments, including information and data, to the extent available, relevant to issues relating to efficiency, competition, and capital formation, as well as the benefits and costs associated with its proposals.

## VIII. Effective Date

The proposed standards and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board seeks comment on the effective date related to each proposed standard in Appendices 5 and 6. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments.

## IX. Appendices

The Board's proposal includes this Release ("Release") and the following appendices:

- Appendix 1 contains the text of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

- Appendix 2 contains the text of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

- Appendix 3 contains amendments related to the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to other PCAOB standards.

- Appendix 4 contains amendments related to the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, to other PCAOB standards.

- Appendix 5 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the related amendments. Specific questions for commenters are included throughout this Appendix.

- Appendix 6 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and the related amendments. Specific questions for commenters are included throughout this Appendix.

- Appendix 7 discusses certain other considerations related to audits of EGCs. Specific questions for commenters are included at the end of this Appendix.

Appendices 5 and 6 discuss significant comments received during the Board's outreach, provide additional background information regarding the requirements in the proposed standards and proposed amendments, and contain specific questions for commenters. Appendix 7 contains a discussion of certain considerations regarding the applicability of the proposed standards and the related amendments to the audits of EGCs and also includes specific questions for commenters.

## X. Opportunity for Public Comment

The Board is seeking comment on all aspects of the proposed standards and amendments as well as on the specific questions included in Appendices 5, 6, and 7. Among other things, the Board is seeking comment on economic considerations relating to the proposed standards and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters, regarding the proposed standards and amendments. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is also requesting that commenters prepare, and forward to the Board for its consideration, examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.[57/]

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 034 on the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on December 11, 2013.

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[57/] Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

The Board will consider all comments received. The Board is considering holding a public roundtable in 2014 to discuss the proposed standards and comments received. If the Board decides to hold a public roundtable, the Board will reopen the comment period related to the proposed standards and amendments.

Following the close of the comment period(s), the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act.

* * *

On the 13th day of August, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown

Secretary

PCAOB
Public Company Accounting Oversight Board

## APPENDIX 1

## Proposed Auditing Standard

## *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

### *Introduction*

1. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements[1/] (the "auditor's unqualified report").[2/]

2. The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[3/] in conformity with the applicable financial reporting framework.[4/]

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[1/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; see, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[2/] Paragraphs 85-98 and Appendix C, "Special Reporting Situations," of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

[3/] AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

[4/] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

3. When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements. AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

## *Objectives*

4. The objectives of the auditor when the auditor concludes that an auditor's unqualified opinion is appropriate are to:

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters**[5/] relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

## *The Auditor's Unqualified Report*

5. The auditor's unqualified report includes:[6/]

a. The basic elements, as described in paragraph 6;

b. Communication of critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs 7-14; and

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs 15-16.

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5/ This term, as defined in Appendix A, "Definitions," is set in **boldface type** the first time it appears.

6/ Appendix B provides an illustrative auditor's unqualified report.

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## Basic Elements

6. The auditor must include the following basic elements in the auditor's report:[7/]

   a. The title, "Report of Independent Registered Public Accounting Firm";

   b. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;[8/]

*Introduction*

   c. The name of the company whose financial statements were audited;

   d. A statement identifying each financial statement and related schedule, if applicable, that has been audited;[9/]

   e. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

   f. A statement indicating that the financial statements, including the related notes and, if applicable, schedules, identified and collectively referred to in the report as the financial statements, were audited;

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[7/] Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. See, e.g., Investment Company Act § 30(g) and § 32(a)(4); SEC Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 C.F.R. § 240.17a-5. Auditor reports on financial statements filed with the SEC are required to comply with all such applicable requirements.

[8/] For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

[9/] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. See, e.g., SEC Rules 5-04, 6-10, 6A-05, and 7-05 of Regulation S-X, 17 C.F.R. §§ 210.5-04, 210.6-10, 210.6A-05, 210.7-05. See generally, SEC Rule 12-01 of Regulation S-X, 17 C.F.R. § 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

g. A statement that the financial statements are the responsibility of the company's management;

h. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB;[10/]

i. A statement containing the year the auditor began serving consecutively as the company's auditor;

> Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

*Basis of Opinion*

j. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

k. A statement that the audit was conducted in accordance with the standards of the PCAOB;

l. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

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[10/] The term "United States federal securities laws" has the same meaning as "securities laws" as defined in PCAOB Rule 1001(s)(ii).

m. A statement that an audit includes:

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

(2) Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

(4) Evaluating the overall presentation of the financial statements;

n. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion;

*Opinion on the Financial Statements*

o. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.[11/] The opinion should also include an identification of the applicable financial reporting framework;

*The Auditor's Responsibilities Regarding Other Information*

p. When other information is included in an annual report filed with the SEC under the Exchange Act that contains both the audited financial statements and the related auditor's report, a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements of paragraphs 13 and 14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain*

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[11/] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. If the financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the Introduction section of the auditor's report. It need not be reported on separately in the opinion paragraph.

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*Documents Containing Audited Financial Statements and the Related Auditor's Report*;[12/]

*Signature and Date*

q. The signature of the auditor's firm;[13/]

r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[14/] and

s. The date of the auditor's report.[15/]

## Critical Audit Matters

*Determination of Critical Audit Matters*

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.[16/]

Note: It is expected that in most audits, the auditor would determine that there are critical audit matters.

8. Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion

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12/ The Auditor's Responsibilities Regarding Other Information section follows the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section.

13/ See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

14/ Id.

15/ See AU sec. 530, *Dating of the Independent Auditor's Report*.

16/ Auditing Standard No. 15, *Audit Evidence*, describes what constitutes evidence obtained in the audit and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

document;[17] (2) reviewed by the engagement quality reviewer;[18] (3) communicated to the audit committee;[19] or (4) any combination of the three.

9. Certain factors might affect whether a matter addressed during the audit of the financial statements (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. In determining whether a matter is a critical audit matter, the auditor should take into account the following factors, as well as other factors specific to the audit:

a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

b. The nature and extent of audit effort required to address the matter;

c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;

d. The severity of control deficiencies identified relevant to the matter, if any;[20]

e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;

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[17] See Auditing Standard No. 3, *Audit Documentation*.

[18] See Auditing Standard No. 7, *Engagement Quality Review*.

[19] See Auditing Standard No. 16, *Communications with Audit Committees,* and other PCAOB standards.

[20] Other PCAOB standards provide auditing and reporting requirements related to the company's internal control over financial reporting. See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements.*

f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;

g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and

h. The nature of consultations outside the engagement team regarding the matter, if any.

*Communication of Critical Audit Matters*

10. The auditor must communicate in the auditor's report critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

> Note: When the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

11. For each critical audit matter communicated in the auditor's report the auditor must:[21/]

a. Identify the critical audit matter;

b. Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and

> Note: For example, if the auditor identified the valuation of financial instruments with little, if any, market activity at the measurement date as a critical audit matter because the valuation involved the most difficult, subjective, or complex auditor judgments, then communication of that critical audit matter in the auditor's report must describe the considerations that led the auditor to determine that the

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[21/] The Critical Audit Matters section follows the Opinion on the Financial Statements section and any explanatory paragraphs.

matter is a critical audit matter, which might relate to the high degree of measurement uncertainty or the significant judgments and estimates involved.

c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Note: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used.

*Language Preceding Critical Audit Matters in the Auditor's Report*

12. The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

13. In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*

14. In accordance with Auditing Standard No. 3, the auditor must document the determination of critical audit matters. Auditing Standard No. 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached.[22/] To provide sufficient detail for a clear understanding of the conclusions reached[23/] regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters.

Note: For example, if an audit matter was included in the engagement completion document, reviewed by the engagement quality reviewer, communicated to the audit committee and, after considering the factors in paragraph 9, otherwise would appear to an experienced auditor having no previous connection to the engagement to meet the definition of a critical audit matter, then the auditor would document the basis for the determination that the matter was not a critical audit matter.

## Explanatory Language Added to the Auditor's Report

15. Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report.[24/] These circumstances include when:

[22/] See paragraph 4 of Auditing Standard No. 3.

[23/] Id.

[24/] An explanatory paragraph follows the Opinion on the Financial Statements section, unless otherwise required by other standards of the PCAOB.

a. There is substantial doubt about the company's ability to continue as a going concern;[25/]

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[26/]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[27/]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[28/]

e. A material misstatement in previously issued financial statements has been corrected;[29/]

f. Certain circumstances relating to reports on comparative financial statements exist;[30/]

g. Selected quarterly financial data required by Item 302(a) of SEC Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[31/]

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25/ See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

26/ See paragraphs .06-.09 of AU sec. 543*, Part of Audit Performed by Other Independent Auditors*.

27/ See paragraphs 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (as proposed to be amended by this standard).

28/ See paragraph 6 of Auditing Standard No. 6.

29/ See paragraphs 9 and 16-17 of Auditing Standard No. 6 (as proposed to be amended by this standard).

30/ See AU secs. 508.68-.69 and .72-.74.

31/ See paragraph .50 of AU sec. 722, *Interim Financial Information*.

h. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to the requirements of the applicable financial reporting framework;[32/]

i. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[33/] and

j. There has been a change in an investee year end that has a material effect on the company's financial statements.[34/]

16. The auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements.[35/] This explanatory paragraph refers only to information presented or disclosed in the financial statements. The following are examples of matters, among others, that might be emphasized in the auditor's report:[36/]

a. Significant transactions with related parties;

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[32/] See paragraphs .03 and .08 of AU sec. 558, *Required Supplementary Information*.

[33/] See paragraph 88 of Auditing Standard No. 5. Auditing Standard No. 5 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, Auditing Standard No. 5 notes that the auditor should consider those circumstances as well.

[34/] See paragraph .32 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35/] These explanatory paragraphs follow the Opinion on the Financial Statements section in the auditor's report.

[36/] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" when an explanatory paragraph to emphasize a matter regarding the financial statements is included in the auditor's report.

b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. Retroactive application of the prospective change in accounting principle that will result in the restatement of the current year's financial statements in the future, and the effects of the prospective change are expected to be unusually material;

e. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

f. That the entity is a component of a larger business enterprise.

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## *APPENDIX A – Definition*

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matters – Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

> Note: Use of the word "most" is not intended to imply that only one matter under each criteria would qualify as a critical audit matter. Depending on the facts and circumstances of the audit, there could be several critical audit matters. Also, an audit matter could meet one, two, or all three of the criteria in the definition.

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## *APPENDIX B – An Illustrative Auditor's Unqualified Report*

**[Changes from the current illustrative report are underlined]**

**Report of Independent Registered Public Accounting Firm**

To the shareholders and board of directors of X Company

[*Introduction*]

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [*year*].

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

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[*Opinion on the Financial Statements*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Critical Audit Matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[*Include critical audit matters*]

The Auditor's Responsibilities Regarding Other Information

In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[*Signature*]

[*City and State or Country*]

[*Date*]

## APPENDIX 2

## Proposed Auditing Standard

## *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*

### *Introduction*

1. This standard establishes requirements regarding the auditor's responsibilities with respect to information, other than the audited financial statements[1/] and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act")[2/] and contains that company's audited financial statements and the related auditor's report (hereafter "other information").[3/]

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[1/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

[2/] This standard does not apply to documents filed under the Securities Act of 1933 ("Securities Act"). When the audited financial statements and the related auditor's report are included in a registration statement under the Securities Act, the auditor has responsibilities under the federal securities laws and under AU sec. 711, *Filings Under Federal Securities Statutes*. This standard also does not modify the auditor's responsibilities under the federal securities laws or AU sec. 711. See, e.g., Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1.

[3/] This standard does not apply to supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*; required supplementary information addressed by AU sec. 558, *Required Supplementary Information*; and management's assertion on internal control over financial reporting in an integrated audit addressed by Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Note: For purposes of this standard, other information in an annual report[4/] that is filed with the SEC under the Exchange Act includes information, other than the audited financial statements and the related auditor's report, contained in the annual report and also includes (1) information incorporated by reference in that annual report that is available to the auditor prior to the issuance of the auditor's report and (2) when the annual report is a Form 10-K, information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.[5/]

## *Objectives*

2. The objectives of the auditor are:

   a. To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");[6/] (2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and

   b. When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the

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[4/] With respect to a company's amended annual report that contains the company's previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard. When the company's amended annual report contains (1) revisions to amounts or disclosures in the previously issued audited financial statements and (2) a related auditor's report, the auditor would apply all paragraphs of this standard.

[5/] With respect to other information that is incorporated by reference into an annual report on Form 10-K from a proxy statement that is filed subsequent to the issuance of the auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard.

[6/] The requirements of this standard related to material inconsistency apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an annual report containing other information.

audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

## *Auditor's Responsibilities*

### Evaluating the Other Information

3. The auditor must evaluate whether the other information contains (1) a material inconsistency; (2) a material misstatement of fact; or (3) both by performing the procedures in paragraph 4.

4. The auditor should read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the:

a. Consistency of amounts in the other information, and the manner of their presentation, that are intended to be the same as, or to provide greater detail about, the amounts in the financial statements, with the amounts in the financial statements and relevant audit evidence;

b. Consistency of any qualitative statement in the other information, and the manner of its presentation, that is intended to represent or provide greater detail about information in the financial statements, with the financial statements and relevant audit evidence;

c. Other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit; and

d. Amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence, by recalculating the amounts for mathematical accuracy.

Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula.

5. If, based on the evaluation in paragraph 4, the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, the auditor

should discuss the matter with management. The auditor also should perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both.

**Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both**

6. If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor should request management to revise the other information to address the material inconsistency, the material misstatement of fact, or both.

7. If management does not appropriately revise the other information and:

a. The other information is available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 8 and 9.

b. The other information is not available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 10 and 11.[7/]

*Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*

8. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner and prior to the issuance of the auditor's report.

9. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

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[7/] Information incorporated by reference into a Form 10-K from the company's definitive proxy statement, filed within 120 days after the end of the fiscal year covered by the Form 10-K, might not be available to the auditor prior to the issuance of the auditor's report. Additionally, other information included in an amended annual report that contains previously issued audited financial statements and the related auditor's report, would not be available to the auditor prior to the issuance of the auditor's report.

a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; and AU sec. 317, *Illegal Acts by Clients*; and

b. Should determine whether to:

(1) Issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both; or

(2) Withdraw from the engagement.

Note: In addition, the auditor may withhold the use of the auditor's report for a prior reporting period.

*Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*

10. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner.

11. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; and

b. Should apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

**Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements**

12. If, as a result of procedures performed under this standard, the auditor determines that there is a potential misstatement in the audited financial statements, the auditor should refer to the requirements of:

a. Auditing Standard No. 14, *Evaluating Audit Results,* and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, if the auditor's report on the financial statements has not been issued; or

b. AU sec. 561 if the auditor's report on the financial statements has been issued.

## *Reporting in the Auditor's Report*

13. When issuing an auditor's report, the auditor must include, in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information,"[8/] the following:

a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB"), the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;

c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;

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8/ This reporting requirement applies to an auditor's report other than a report to disclaim an opinion. See AU sec. 508.61.

d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and

e. A statement that, based on the evaluation, the auditor:

(1) Has not identified a material inconsistency or a material misstatement of fact in the other information;[9/] or

(2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

14. The following is an example of "The Auditor's Responsibilities Regarding Other Information" section of the auditor's report:

a. Illustrative language for paragraphs 13.a.–d.:

*The Auditor's Responsibilities Regarding Other Information*

In addition to auditing the company's financial statements [and internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the [*period end date*] financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information.

b. Illustrative language for paragraph 13.e.(1) when the auditor has not identified a material inconsistency or a material misstatement of fact in the other information:

Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

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[9/] This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified a material inconsistency, a material misstatement of fact, or both that management has revised appropriately prior to the issuance of the auditor's report.

c. Illustrative language for paragraph 13.e.(2) when the auditor has identified a material inconsistency, a material misstatement of fact, or both in the other information:

Based on our evaluation, we identified [*a material inconsistency, a material misstatement of fact, or both*] in the other information that has not been appropriately revised. [*Describe the material inconsistency, the material misstatement of fact, or both.*] We have not identified [*a material inconsistency or material misstatement of fact* (this statement would indicate the situation that was not identified in the sentence above)] in the other information.[10/]

[10/] This sentence is appropriate only when the auditor has identified a material inconsistency or a material misstatement of fact, but not both. If the auditor identifies both a material inconsistency and a material misstatement of fact, the auditor's report should describe both the material inconsistency and the material misstatement of fact.

PCAOB
Public Company Accounting Oversight Board

## APPENDIX 3

## *Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard*

In connection with the proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed auditor reporting standard.[1/]

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board’s proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect changes to the auditor's unqualified report. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed auditor reporting standard would include:

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1/ PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), PCAOB Release No. 2013-004, *Related Parties* (May 7, 2013), PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), and PCAOB Release No. 2011-007, *Improving Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2* (October 11, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed auditor reporting standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed auditor reporting standard.

- Changing the title of AU sec. 508 from "Reports on Audited Financial Statements" to [new proposed title] "Departures from Unqualified Opinions and Other Reporting Circumstances."

- Updating illustrative reports in AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* for the proposed basic elements of the proposed auditor reporting standard;

- Updating other reporting standards that result in the issuance of the auditor's report on the financial statement filed with the SEC for the proposed basic elements of the proposed auditor reporting standard;

- Updating references to "the auditor's standard report" and "introductory, scope, and opinion paragraphs" to reflect new terms referenced in the proposed auditor reporting standard;

- Updating Auditing Standards Nos. 7 and 16 and AU sec. 336 as a result of the new reporting requirement for critical audit matters in the auditor's report;

- Moving explanatory paragraph reporting examples from existing AU sec. 508 to the respective auditing standards that contain the related performance requirements for those circumstances; and

- Updating references to auditing standards that are being amended or superseded.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 5 of this release.

## Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*

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**~~APPENDIX~~**

**~~Illustrative Reports~~**

~~The following is an illustrative report on an audit of financial statements:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.~~

~~[ *Signature* ]~~

~~[ City and State or Country]~~

~~[ *Date* ]~~

~~The following is an illustrative report on a review of interim financial information:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have reviewed the accompanying [ *describe the interim financial information or statements reviewed* ] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.~~

~~We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than~~

~~an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.~~

~~Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.~~

~~[ *Signature* ]~~

~~[City and State or Country]~~

~~[ *Date* ]~~

## Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

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85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/]

a. ~~A~~ The title ~~that includes the word *independent*~~, "Report of Independent Registered Public Accounting Firm";

a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;[18A/]

[18A/] For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

a-2. The name of the company whose internal control over financial reporting was audited;

a-3. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

a-4. A statement containing the year the auditor began serving consecutively as the company's auditor;

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

f. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

* * *

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of W Company

[ ~~*Introductory paragraph*~~ *Introduction* ]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8, and the related notes (collectively referred to as the "financial statements"). We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~[ *Scope paragraph* ]~~ [ *Basis of Opinion* ]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the company's internal control over financial reporting based on our audits. We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[ *Definition* ~~*paragraph*~~ ]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[ *Inherent ~~limitations~~ Limitations ~~paragraph~~* ]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[ *Opinions on the Financial Statements and Internal Control Over Financial Reporting ~~paragraph~~* ]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [ *Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."* ].

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[*Include critical audit matters*]

*The Auditor's Responsibilities Regarding Other Information*

In addition to auditing the financial statements and the Company's internal control over financial reporting, in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X8 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (following the Opinion on the Financial Statements section) to the auditor's report on the financial statements -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board ~~(United States)~~, W Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (following the opinion) to the report on internal control over financial reporting -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [ *identify financial statements* ] of W Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

* * *

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis of Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

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## Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

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8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in ~~AU sec. 508, *Reports on Audited Financial Statements*~~ proposed paragraphs 12-15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AU sec. 508~~.[8A/]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to the auditor's report, as described in ~~AU sec. 508~~paragraphs 12-15 of this standard.

[8A/] AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in ~~AU sec. 508~~paragraphs 16-17 of this standard.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results,* and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

**CHANGE IN CLASSIFICATION**

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7,~~ and~~ 8, and ~~AU sec. 508~~12-15 of this standard. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9,~~ and~~ 10, and ~~AU sec. 508~~16-17 of this standard.

**REPORTING ON CONSISTENCY OF FINANCIAL STATEMENTS**

***Change in Accounting Principle***

12. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the Opinion on the Financial Statements section. The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

13. The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

14. The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

15. The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

***Correction of a Material Misstatement in Previously Issued Financial Statements***

16. Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the Opinion on the Financial Statements section.[10/] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10/] AU secs. 508.68-69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

17. This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to

correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

## Auditing Standard No. 7, *Engagement Quality Review*

* * *

10. In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate whether appropriate critical audit matters are communicated in the auditor's report in accordance with Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

## Auditing Standard No. 14, *Evaluating Audit Results*

* * *

[7/] If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

### APPENDIX B

[1/] If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**APPENDIX C**

[2/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

## Auditing Standard No. 16, *Communications with Audit Committees*

* * *

**~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

21. The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

[39/] See paragraphs .22-.32 of AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* for a discussion of scope limitations.

* * *

## AU sec. 315, *Communications Between Predecessor and Successor Auditors*

* * *

[fn 9] See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .70 through .74, for reporting guidance.

* * *

## AU sec. 317, *Illegal Acts by Clients*

* * *

**fn 2** See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

## AU sec. 9326, *Evidential Matter: Auditing Interpretations of Section 326*

* * *

**.10** The third standard of field work requires the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .24, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, section 333 on *Management Representations* requires the auditor to obtain written representations from management. Section 333.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and section 333.08 states that a materiality limit does not apply to that representation. Section 333.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

* * *

## AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

* * *

**fn 15** See ~~section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18.~~ Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*

* * *

## AU sec. 333, *Management Representations*

* * *

fn 15 See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .71. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

* * *

## AU sec. 336, *Using the Work of a Specialist*

* * *

**.13** If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .22 and .23.)

* * *

**.15** Except as discussed in paragraphs .16 and .16A, the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

**.16** The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to ~~his or her standard~~ the auditor's unqualified report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.

**.16A** Reference to the use of a specialist also may be made in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter.[fn 7]

[fn 7] Critical audit matters are described in paragraphs 7-13 of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

## AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*

* * *

**.21** *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer. [fn 14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508.22–.26 and 508.61–.63.

* * *

## AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

* * *

**.03** The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

* * *

**.12** If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to reflect that conclusion. [fn 4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13. [As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

**fn 4** The inclusion of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .61-.63).

**.13** An example follows of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time. [fn 5]

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

**.14** If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**.16** If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) on the financial statements of the prior period should not be repeated.

* * *

## AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*

* * *

**.03** *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an ~~emphasis-of-matter~~ explanatory paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (see paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

## AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410*

* * *

**.15** Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .41 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include related notes)." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 508.41.

* * *

**.18** Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see ~~section 508.19~~paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

* * *

## AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*

**.01** An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the country of origin of those generally accepted accounting principles also is required (see ~~section 508.08h~~paragraph 6.o. of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

## AU sec. 504, *Association With Financial Statements*

* * *

**.04** An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and AU sec.~~tion~~ 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722, *Interim Financial Information*.

* * *

## AU sec. 508, ~~Reports on Audited Financial Statements~~ ~~[fn *]~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*

~~[fn *] This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.~~

**INTRODUCTION**

~~**.01** This section applies to auditors' reports issued in connection with audits [fn 1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of*~~

~~*Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for direction on reporting on internal control over financial reporting. In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which includes an illustrative combined audit report.~~

~~[fn 1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~**.02** This section does not apply to unaudited financial statements as described in section 504, *Association With Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in section 623, *Special Reports*.~~

~~**.03** Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with generally accepted auditing standards and on the findings. Generally accepted auditing standards include four standards of reporting. This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.~~

~~**.04** The fourth standard of reporting is as follows:~~

~~The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~**.05** The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on~~

~~one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~**.06** The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

**~~THE AUDITOR'S STANDARD REPORT~~**

~~**.07** The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.~~

~~**.08** The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

~~*a.* A title that includes the word *independent* [fn 3]~~

~~*b.* A statement that the financial statements identified in the report were audited~~

~~*c.* A statement that the financial statements are the responsibility of the Company's management [fn 4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~*d.* A statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards)~~

~~*e.* A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~f. A statement that an audit includes—~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~

~~(2) Assessing the accounting principles used and significant estimates made by management~~

~~(3) Evaluating the overall financial statement presentation [fn 5]~~

~~*g.* A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h.* An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles [fn 6] )~~

~~*i.* The manual or printed signature of the auditor's firm~~

~~j. The date [fn 7] of the audit report~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Independent Auditor's Report~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence~~

~~supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

[~~*Signature*~~]

[~~*Date*~~]

~~The form of the auditor's standard report on comparative financial statements [fn 8] is as follows:~~

~~Independent Auditor's Report~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

[~~*Signature*~~]

[~~*Date*~~]

~~*k.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~[fn 3] This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.~~

~~[fn 4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~[fn 5] Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [As amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]~~

~~[fn 6] A U.S. auditor also may be engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country. In those circumstances, the auditor should refer to the guidance in section 534, *Reporting on Financial Statements Prepared for Use in Other Countries.* [Footnote added, effective for reports issued or reissued on or after June 30, 2001 by Statement on Auditing Standards No. 93.]~~

~~[fn 7] For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~[fn 8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such~~

~~as "for each of the three years in the period ended [date of latest balance sheet]." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

**.09** ~~The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

**.10** This section ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[fn8A] and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~

- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

~~These opinions are discussed in greater detail throughout the remainder of this~~ This section also discusses other reporting circumstances such as reports on comparative financial statements.

[fn8A] The Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). Paragraphs 85-89 and Appendix C of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

**~~EXPLANATORY LANGUAGE ADDED TO THE AUDITOR'S STANDARD REPORT~~**

~~**.11** Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory [fn 9] paragraph (or other explanatory language) to the standard report. [fn 10] These circumstances include:~~

~~a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~

~~*b.* There is substantial doubt about the entity's ability to continue as a going concern. [fn 11]~~

~~*c.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~

~~*d.* A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~

~~*e.* Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~

~~*f.* Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Interim Financial Information*, paragraph .50.)~~

~~*g.* Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect~~

~~to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)~~

~~*h.* Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19). [As amended, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79. Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]~~

~~**fn 9** Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**fn 10** See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**fn 11** Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

**~~Opinion Based in Part on Report of Another Auditor~~**

~~**.12** When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Audit Performed by Other Independent Auditors*.)~~

~~**.13** An example of a report indicating a division of responsibility follows:~~

~~Independent Auditor's Report~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~

~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

*** * ***

**~~Lack of Consistency~~**

**~~.16~~** ~~The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

*~~a.~~* ~~A change in accounting principle.~~

*~~b.~~* ~~An adjustment to correct a misstatement in previously issued financial statements.~~

~~**Change in Accounting Principle**~~

~~**.17A** As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.[fn 12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~[fn 12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.~~

~~**.17B** Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~**.17C** Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~**.17D** The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial~~

~~statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

**~~.17E~~**

~~If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

**~~Correction of a Material Misstatement in Previously Issued Financial Statements~~**

**~~.18A~~** ~~Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.~~[fn 13] ~~The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

[fn 13] ~~The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

**~~.18B~~** ~~This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

**~~.18C~~** ~~The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

**~~Emphasis of a Matter~~**

**~~.19~~** ~~In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing~~

~~[following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are—~~

- ~~That the entity is a component of a larger business enterprise.~~
- ~~That the entity has had significant transactions with related parties.~~
- ~~Unusually important subsequent events.~~
- ~~Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

**DEPARTURES FROM UNQUALIFIED OPINIONS**

**Qualified Opinions**

* * *

**.20A** When the auditor expresses a qualified opinion, the auditor's report must include the basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.[fn13A]

**fn13A** When the auditor expresses a qualified opinion, the section titled "The Auditor's Responsibilities Regarding Other Information"(described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has qualified the opinion.

**.21** When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph in the Opinion on the Financial Statements section of the auditor's report. The auditor should also include, in the Opinion on the Financial Statements section ~~opinion paragraph~~, the appropriate qualifying language and a reference to the ~~explanatory~~ "basis for departure from an unqualified opinion paragraph." A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

> Note: The auditor would refer to Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.

**Scope Limitations**

**.22** The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with ~~generally accepted auditing~~ the standards of the Public Company Accounting Oversight Board ("PCAOB") and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

* * *

**.25** When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the auditor's report ~~situation~~ should ~~be~~ describe~~d~~ ~~in an explanatory~~ the basis for departure from an unqualified opinion in a paragraph preceding the opinion paragraph in the Opinion on the Financial Statements section and refer~~red~~ to in both the ~~scope~~ Basis of Opinion and the ~~opinion~~ Opinion on the Financial Statements ~~paragraphs~~ sections of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.26** When an auditor qualifies his or her opinion because of a scope limitation, the wording in the ~~opinion paragraph~~ Opinion on the Financial Statements section should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first paragraph as the standard report*~~ *Includes the same basic elements as the Introduction section of the auditor's unqualified report*]

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as discussed ~~in the following paragraph~~ below, we conducted our audits in accordance with ~~auditing~~ the standards of the PCAOB ~~generally accepted in the (United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.34** An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related notes (collectively referred to as the "financial statement"). This financial statement is the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatements of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement. ~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

[*Opinion on the Financial Statement*]

In our opinion, the ~~balance sheet~~ financial statement referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**Departure from a Generally Accepted Accounting Principle**

**.35** When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, he or she should express a qualified (paragraphs .36 through .57) or an adverse (paragraphs .58 through .60) opinion. The basis for such opinion should be stated in the report.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.37** When the auditor expresses a qualified opinion, he or she should disclose in the Opinion on the Financial Statements section of the report, in a separate ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ preceding the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the ~~opinion paragraph~~ Opinion on the Financial Statements section of the report should include the appropriate qualifying language and a reference to the ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s).~~"~~ [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.38** The ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ that discloses the reasons for the qualified opinion should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable. [fn 15] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ in the auditor's report may be shortened by referring to it. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.39** An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America.

If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.40** If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph in the Opinion on the Financial Statements section) of the auditor's report in the circumstances illustrated in paragraph .39 might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.42** Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America. In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.44** ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audit.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as Company's auditor consecutively since [ *year* ].

[~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis of Opinion section of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.51** ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph ~~.17A~~ 7 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* includes ~~states~~ the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

**.52** The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[fn 17]

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**fn17** Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ "basis for departure from an unqualified opinion paragraph" on consistency, a separate explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) as required by paragraphs ~~.17A thorough .17E of this section~~ 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

* * *

**.58A** When the auditor expresses an adverse opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the opinion as described in paragraph .58 and the basic elements included in the following sections of the auditor's unqualified report:[fn17A]

a. Introduction section;

b. Basis of Opinion section;

c. The Auditor's Responsibilities Regarding Other Information section;[fn17B] and

d. Signature and Date section.

Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports with adverse opinions.

**fn17A** Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

**fn17B** When the auditor expresses an adverse opinion, the section titled "The Auditor's Responsibilities Regarding Other Information" (described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has issued an adverse opinion.

**.59** When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph in the Opinion on the Financial Statements section of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[fn18] If the effects are not reasonably determinable, the report should so state. [fn19] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**fn19** When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in paragraph ~~.11~~15~~,~~ ~~subsection (*b*), (*c*), (*d*), and (*e*)~~ of ~~this section~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

**.60** When an adverse opinion is expressed, the opinion paragraph in the Opinion on the Financial Statements section of the report should include a direct reference to a separate "basis for departure from an unqualified opinion paragraph" ~~that discloses the basis for the adverse opinion~~, as shown below:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~Same first and second paragraphs as the standard~~ _Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report_]

[_Opinion on the Financial Statements_]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

_The Auditor's Responsibilities Regarding Other Information_

[_Signature_]

[_City and State or Country_]

[_Date_]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.62** A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements. **[fn 20]** A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (see paragraphs .35 through .57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the ~~scope paragraph of the auditor's standard~~ Basis of Opinion section of the auditor's unqualified report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

**.62A** When the auditor disclaims an opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the basic elements included in the following sections of the auditor's unqualified report,[fn20A] modified appropriately as shown in an example report in paragraph .63:

a. Introduction section; and

b. Signature and Date section.

Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports that disclaim an opinion.

**fn20A** Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

**.63** An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. [fn 21]

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[~~*Second paragraph of standard report*~~ *Basic elements in the Basis of Opinion section of the auditor's unqualified report should be omitted*]

[*Opinion on the Financial Statements*]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*City and State or Country*]

[*Date*]

[fn21] The wording in the ~~first paragraph~~ Introduction section of the auditor's ~~standard~~ unqualified report is changed in a disclaimer of opinion because of a scope limitation.

The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with ~~generally accepted auditing~~ the standards of the PCAOB. ~~In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.~~ [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

* * *

## REPORTS ON COMPARATIVE FINANCIAL STATEMENTS

**.65** The fourth standard of reporting[fn21A] requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor [fn 22] should update [fn 23] the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period. [fn 24] Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

**fn21A** See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*.

* * *

### Different Reports on Comparative Financial Statements Presented

**.67** Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first paragraph as the standard*~~ *Includes the same basic elements as the Introduction section of the auditor's unqualified report*]

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as explained in the ~~following~~ first paragraph in the Opinion on the Financial Statements section, we conducted our audits in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[fn 25]

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.69** If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph(s) preceding the opinion paragraph in the Opinion on the Financial Statements section of his or her report.[fn 29] The ~~explanatory~~ paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of a~~n~~ ~~explanatory~~ paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [fn 26]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.74** If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory paragraph~~ Basis of Opinion section of his or her report (a) that the financial statements of the prior period were audited by another auditor,[fn 29] (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor.[fn 30] An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements. We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosure in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

[~~*Same second paragraph as the standard report*~~ *Opinion on the Financial Statements*]

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

If the predecessor auditor's report was other than ~~a standard~~ an auditor's unqualified report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

> . . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Basis of Opinion section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

~~[Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]~~

*** * ***

## AU sec. 9508, ~~Reports on Audited Financial Statements~~ [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of Section 508

* * *

**.01** *Question*—Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .24 states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

**.36** ~~Examples of~~ An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[fn 1A] ~~with such an explanatory paragraph follow.~~

~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~

[*Introduction*]

~~"~~We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audit.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~"We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence~~

~~supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

[*Opinion on the Financial Statements*]

~~"~~As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

**fn1A** The auditor's report must include other basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~
An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows: [fn1B]

[*Introduction*]

~~"~~We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audits.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~"We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

[*Opinion on the Financial Statements*]

~~"~~As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

~~"~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.~~"~~

[fn1B] *Id.*

* * *

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

**.51** *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

**.52** *Interpretation*—No. The statement about management's responsibilities for the financial statements required by ~~section 508, *Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

**14. Reporting on Audits Conducted in Accordance With the Standards of the PCAOB (United States) ~~Auditing Standards Generally Accepted in the United States of America~~ and in Accordance With International Standards on Auditing**

**.56** *Question*— ~~*Section 508, Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires ~~states that a basic element of the auditor's report is~~ a statement that the audit was conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB ~~generally accepted in the United States of America~~ and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

**.57** *Interpretation*—Yes. ~~Section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~; however, ~~section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing. ~~fn 1~~

~~fn 1 Appendix B, *Analysis of International Standards on Auditing*, identifies sections and paragraphs, if applicable, within the International Standards on Auditing that may require procedures and documentation in addition to those required by U.S. auditing standards.~~

**.58** When reporting on an audit performed in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States of America~~ and International Standards on Auditing, the auditor should comply with the standards of the PCAOB ~~reporting standards generally accepted in the United States of America~~.

**.59** An example of reporting on an audit conducted in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States~~ and in accordance with International Standards on Auditing follows:

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States of America~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

~~An~~ Our audits included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audits also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. We believe that our audits provide~~s~~ a reasonable basis for our opinion.

* * *

**.61** *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title]

*Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .74, the successor auditor should indicate in the ~~introductory paragraph~~ Introduction section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 29 of section 508 indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Basis of Opinion section of the successor auditor's report is presented as follows:

The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor’s report.

* * *

**.78** AU sec. ~~Section~~ 508.42 provides an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate). ~~as follows:~~

~~Independent Auditor's Report~~

~~[*Same first and second paragraphs as the standard report*]~~

~~The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.~~

~~In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .~~

* * *

**.83** Following is an illustration of a ~~report that expresses a~~ qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of the Guide:

~~Independent Auditor's Report~~

[~~*Same first and second paragraphs as the standard report*~~ *Opinion on the Financial Statements section*]

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods)

- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, …

**.84** An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows. [fn 6] This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

~~Independent Auditor's Report~~

[~~*Same first and second paragraphs as the standard report*~~ *Opinion on the Financial Statements section*]

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods) [fn 7]

- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [*describe the nature of the information that it is not practicable to present in the auditor's report*].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, …

## AU sec. 543*, Part of the Audit Performed by Other Independent Auditors*

* * *

**.07** When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ <u>the Introduction, Basis of Opinion, and Opinion on Financial Statements sections</u> the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor. [fn 3]

* * *

**.09** An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

~~Independent Auditor's~~ <u>Report of Independent Registered Public Accounting Firm</u>

<u>*To the shareholders and board of directors of X Company*</u>

<u>[*Introduction*]</u>

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20...., and the related consolidated statements of income and retained earnings and cash flows for the year then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audits.~~

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audit in accordance with the ~~auditing~~ standards of the PCAOB ~~generally accepted in the (United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate. ~~[Revised, April 1998, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

**Procedures Applicable to Both Methods of Reporting**

**.10** Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

* * *

c. Ascertain through communication with the other auditor:

* * *

(ii)That he or she is familiar with accounting principles generally accepted in the United States of America and with the ~~generally accepted auditing~~ standards of the Public Company Accounting Oversight Board ~~promulgated by the American Institute of Certified Public Accountants~~ and will conduct his or her audit and will report in accordance therewith.

* * *

* * *

**Other Auditor's Report Departs From ~~Standard~~ Auditor's Unqualified Report**

**.15** If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

* * *

## AU sec. 544, *Lack of Conformity with Generally Accepted Accounting Principles*

* * *

**.04** When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph),~~ ~~modified~~ modify the auditor's report as appropriate (see section 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60 ~~.35-.60~~) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989. As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]

## AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*

* * *

**.02** The auditor's ~~standard~~ unqualified report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

* * *

**fn 4** See paragraph .10 for guidance when there is a modification of the auditor's ~~standard~~ unqualified report on the basic financial statements.

* * *

**.10** The auditor should consider the effect of a departure ~~any modifications in his standard~~ from the auditor's unqualified report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information. [fn 5] An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 508.64 and section 623.14.)

* * *

**.21** The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his audit in the ~~standard~~ auditor's unqualified report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

* * *

## AU sec. 552, *Reporting on Condensed Financial Statement and Selected Financial Data*

* * *

**.02** In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .41 through .44, section 623, *Special Reports*, or other applicable Statements on Auditing Standards. [fn 2]

* * *

**.06** The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

**.07** A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~fn 6~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate. [fn 7]

~~**fn 6** If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 508, *Reports on Audited Financial Statements*, paragraphs .41 through .44.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Independent Auditor's Report. We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the~~

~~preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

**.10** The following is an example of an additional paragraph included after the opinion paragraph in the Opinion on the Financial Statements section of the ~~an~~ auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Independent Auditor's Report~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

Opinion on the Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1, and the related notes (collectively referred to as the "financial statements") (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

~~[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

## AU sec. 560, *Subsequent Events*

* * *

**.09** Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his or her report an explanatory paragraph directing the reader's attention to the event and its effects. (See ~~section 508.19~~paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.)

* * *

## AU sec. 623, *Special Reports*

**.01** This section applies to auditors' reports issued in connection with the following:

*** * ***

Note: If any of the auditor's reports described in this section are filed with the U.S. Securities and Exchange Commission, the auditor's report is required to include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

fn 2 In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

**.06** Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08) modified as appropriate~~ because of the departures from generally accepted accounting principles (see AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

**.14** The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .64). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**.15** When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

*** * ***

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

* * *

**.17** The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in ~~section 508, *Reports on Audited Financial Statements*,~~ paragraph ~~.11~~15 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

**.21** When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ following the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

**.31** Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

*a.* *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application, [fn 35] the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon [fn 36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~section 508,~~ ~~*Reports on Audited Financial Statements*~~, ~~paragraphs .16 through .18~~Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. [fns 37–38]

b. * * *

*c.* *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in section ~~508~~543, ~~*Reports on Audited Financial Statements*~~ *Part of Audit Performed by Other Independent Auditors*, paragraphs .~~12 and .13~~06-.09.

*d.* *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .68 and .69.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof). [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

* * *

fn 22 When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the ~~opinion paragraph~~ Opinion on the Financial Statements section of the auditor's report on the financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

* * *

## AU sec. 9623, *Special Reports: Auditing Interpretations of Section 623*

* * *

**.45** *Interpretation*~~—Section 420.06~~ Auditing Standard No. 6, *Evaluating Consistency in Financial Statements* states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's unqualified report on the audited financial statements. Section 623.16 states that, if applicable, any departures from the auditor's ~~standard~~ unqualified report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

* * *

fn 10 Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AU sec~~tion~~. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the applicable industry audit guide.

* * *

**.83** *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and*

Other Reporting Circumstances, paragraphs .35–.44 and .58–.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

* * *

## AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties*

* * *

**.27** When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report~~, the accountants should refer [fn 18] to that fact in the comfort letter and discuss the subject matter of the paragraph. [fn 19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (See also paragraph .35*f*.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

**.30** An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which section 722 pertains or (*b*) required supplementary information, to which section 558, *Required Supplementary Information*, pertains. Section 722 and section 558 provide that the accountants should expand the ~~standard~~ auditor's unqualified report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ auditor's unqualified report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see also paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by sections 722 and 558, the accountants may do so and report their findings. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

**.35** Comments included in the letter will often concern (*a*) unaudited condensed interim financial information (see paragraphs .36 through .38), [fn 27] (*b*) capsule financial information (see paragraphs .36 and .39 through .41), (*c*) pro forma financial information (see paragraphs .42 and .43), (*d*) financial forecasts (see paragraphs .36 and .44), and (*e*) changes in capital stock, increases in long-term debt, and decreases in other specified financial statement items (see paragraphs .36 and .45 through .53). For commenting on these matters, the following guidance is important:

*** * ***

f. When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

## AU sec. 722, *Interim Financial Information*

* * *

### Form of Accountant's Review Report

**.37** The accountant's review report accompanying interim financial information should consist of:

a. ~~A~~ The title ~~that includes the word *independent*~~, "Report of Independent Registered Public Accounting Firm".

a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body.[fn24A]

a-2. The name of the company whose interim financial information was reviewed.

a-3. The date of, or period covered by, the interim financial information and each related schedule, if applicable, identified in the report.

*** * ***

d. A statement that the review of interim financial information was conducted in accordance with the standards ~~established by the AICPA~~ of the Public Company Accounting Oversight Board ("PCAOB") (United States).

e. * * *

f. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

g. * * *

h. * * *

h-1. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.

* * *

In addition, each page of the interim financial information should be clearly marked as unaudited.

**fn24A** For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

**.38** The following is an example of a review report: [fn 26]

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") (United States) ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the ~~generally accepted auditing~~ standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*City and State or Country*]

[*Date*]

**.39** An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [fn 27]

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB")~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~United States of America~~, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended, and the related notes (collectively referred to as the "consolidated financial statements") (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived. [fn 28]

[*Signature*]

[*City and State or Country*]

[*Date*]

**.40** The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review. [fn 29] The following is an example of report including such a reference:

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*City and State or Country*]

[*Date*]

**.41** The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles, ~~[fn 30]~~ which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. See paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~fn 30 If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in section 508, *Reports on Audited Financial Statements*, paragraph .15).~~

* * *

**.50** The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The following is an example of a paragraph that should be added to the auditor's report if the selected quarterly financial data required by item 302(a) has not been reviewed.

   The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards ~~established by the American Institute of Certified Public Accountants~~ of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

**APPENDIX 4**

## *Proposed Amendments to PCAOB Standards Related to the Proposed Other Information Standard*

In connection with its proposed auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed other information standard.[1/]

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board's proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect requirements of the proposed other information standard. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed other information standard primarily include updating references to auditing standards that are being amended or superseded, changing references to AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* applied by analogy, and moving the reporting example from AU sec. 9550, *Other Information in Certain Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550,* to AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, related to considerations in the auditor's report

[1/] PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), and PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed other information standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed other information standard.

regarding a report by management on an audit of internal control over financial reporting.

The following standard and interpretation would be superseded by this proposal:

- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, and

- AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 6 of this release.

## Auditing Standard No. 7, *Engagement Quality Review*

* * *

[5/] See ~~paragraphs .04-.06 of AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding* *Other Information in* *Certain* *Documents Containing Audited Financial Statements* *and the Related Auditor's Report*; AU sec. 711, *Filings Under Federal Securities Statutes*.

* * *

## Auditing Standard No. 16, *Communications with Audit Committees*

* * *

[27/] *See, e.g.*, ~~AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding* *Other Information in* *Certain* *Documents Containing Audited Financial Statements* *and the Related Auditor's Report* ("proposed other information standard")*.* In addition to ~~AU sec. 550~~ the proposed other information standard, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information,* and AU sec. 711, *Filings Under Federal Securities Statutes.*

* * *

**APPENDIX B**

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

* * *

- ~~AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, paragraphs ~~.04 and .06~~8 and 10.

* * *

## AU sec. 9324, *Service Organizations: Auditing Interpretations of Section 324*

* * *

**.37** If the service organization includes information about the design deficiencies in the section of the document titled "Other Information Provided by the Service Organization," the service auditor should read the information and ~~consider applying by analogy the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements.* In addition, the service auditor should~~ include a paragraph in his or her report disclaiming an opinion on the information provided by the service organization. The following is an example of such a paragraph.

> The information in section 4 describing XYZ Service Organization's plans to modify its disaster recovery plan is presented by the Service Organization to provide additional information and is not a part of the Service Organization's description of controls that may be relevant to a user organization's internal control. Such information has not been subjected to the procedures applied in the examination of the description of the controls applicable to the processing of transactions for user organizations and, accordingly, we express no opinion on it.

A service auditor also may consider communicating information about the design deficiencies in the section of the service auditor's document titled "Other Information Provided by the Service Auditor."

* * *

## AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*

* * *

**.09** When the unaudited voluntary disclosures are included in a client-prepared document and are located on the face of the financial statements, the footnotes, or in a supplemental schedule, the voluntary disclosures should be ~~labelled~~ labeled "unaudited." When such unaudited information is not presented on the face of the financial statements, the footnotes, or in a supplemental schedule, the auditor should consider the ~~guidance~~ auditor's responsibilities in ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

* * *

## AU sec. 508, *Reports on Audited Financial Statements*

* * *

**CONSIDERATIONS IN THE AUDITOR'S REPORT REGARDING REPORT BY MANAGEMENT ON AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING**

**.74A** In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in annual reports filed with the SEC under the Securities Exchange Act of 1934 that contain audited financial statements and the related auditor's report in Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

**.74B** If the auditor has not been engaged to examine and report on management's assertion about the effectiveness of the company's internal control over financial reporting, the auditor may include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;
- The audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the

circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis of Opinion section in the auditor's report that contains such statements:

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

*** * ***

## AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*

* * *

**.04** When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's report is included in a client-prepared document [fn 2] and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (*a*) ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and (*b*) other sections covering particular types of information or circumstances, such as section 558, *Required Supplementary Information*.

* * *

## AU sec. 558, *Required Supplementary Information*

* * *

**fn2** This section is not applicable to entities that voluntarily present supplementary information not required by GAAP. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

* * *

**.03** Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information. [fn3]The following is an example of a disclaimer an auditor might use in these circumstances:

> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other entities, the provisions of ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, apply, only if the annual report containing the financial statements and the related auditor's report is an annual report filed with the SEC under the Securities Exchange Act of 1934.

* * *

**.05** The auditor's responsibility for other information not required by the FASB, GASB, or FASAB but included in certain annual reports—which are client-prepared documents [fn4]—is specified in ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB, GASB or FASAB (called *required supplementary information*) is discussed in the paragraphs that follow. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

* * *

**.09** In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the ~~audit~~ auditor's report to express such an opinion. ~~in accordance with section 550.07~~. ~~[Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]~~In those circumstances, the auditor's report should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking regarding the supplementary information. The auditor may report on the supplementary information using the following examples:

a. Required supplementary information to which no qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The [*identify the required supplementary information*] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

b. Required supplementary information to which a qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The required supplementary information included in [*Schedules 1 and 2*] on page(s) [*XX and XX*] as of December 31, 19XX, is presented for purposes of additional analysis and is not a required part of the financial statements. The required supplementary information in such schedules has been subjected to the auditing procedures applied in the audit of the financial statements; and, in our opinion, except for [*describe reason for qualification*], such information is fairly stated in all material respects in relation to the financial statements taken as a whole.

* * *

## AU sec. 9634, *Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of Section 634*

* * *

**.04** The auditor may affirm to the board of directors that under generally accepted auditing standards, ~~the auditor is required to read the information~~ in addition to ~~audited~~ auditing the financial statements contained in the Form 10-K, the auditor is required to ~~for the purpose of considering~~ evaluate whether ~~such~~ the other information included in such annual reports filed with the SEC under the Securities Exchange Act of 1934 and contain audited financial statements and the related auditor's report contains (1) a material inconsistency, (2) a material misstatement of fact, (3) or both**,** and, if so, to respond appropriately, and to communicate in the auditor's report whether the other information contains a material inconsistency, a material misstatement of fact, or both (see Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*). ~~may be materially inconsistent with information appearing in the financial statements (see section 550)~~. ~~However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.~~

* * *

## AU sec. 722, *Interim Financial Information*

* * *

**.18** *Inquiries and other review procedures.* The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

*** * ***

f. Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider whether such information or the manner of its presentation is materially inconsistent with the interim financial information or there is a material misstatement of fact in the other information.[fn 12] If the accountant concludes that there is a material inconsistency~~,~~ or ~~becomes aware of information that he or she believes is~~ a material misstatement of fact, ~~the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action,~~ the accountant should consider the ~~guidance~~ requirements of ~~in~~ ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.* ~~paragraphs .04 through .06)~~

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PCAOB
Public Company Accounting Oversight Board

## APPENDIX 5

### *Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release*

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), presented in Appendix 1, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments"), presented in Appendix 3. This Appendix collectively refers to the proposed auditor reporting standard and proposed amendments as the "proposed auditor reporting standard and amendments."

Following the Board's initial outreach from October 2010 to March 2011,[1/] the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").[2/] Additionally, the Board held a public roundtable[3/] on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")[4/] and Standing Advisory Group ("SAG") meetings.[5/]

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1/ See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

2/ *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011-003 (June 21, 2011), is available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

3/ A transcript of the public roundtable discussions is available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

4/ IAG meeting details and webcasts for March 2011 and 2012 are available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx and http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx.

5/ See SAG meeting transcripts for November 2011 and 2012, available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

This Appendix discusses significant comments received during the Board's outreach regarding the auditor's reporting model and also provides additional background information regarding the requirements in the proposed auditor reporting standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, to assist the Board in evaluating the clarity of the Board's proposal relating to the communication of "critical audit matters,"[6/] the Board requests that commenters prepare and forward to the Board for its consideration examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.[7/]

Further, the Board is seeking comment on economic considerations related to the proposed auditor reporting standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to specific entities, including the audits of brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans. Considerations related to the applicability of the proposed auditor reporting standard and amendments to audits of emerging growth companies ("EGCs") are discussed in Appendix 7.

The following sections describe the requirements in the proposed auditor reporting standard and amendments. The Exhibit to this Appendix provides three illustrative examples of communications of critical audit matters.

## I. <u>Introduction (Paragraphs 1 – 3 of the Proposed Auditor Reporting Standard)</u>

The proposed auditor reporting standard establishes requirements for the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted

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[6/] <u>See</u> Section V., *Critical Audit Matters*, of this Appendix for discussion of the proposed critical audit matters.

[7/] Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

an audit in accordance with the standards of the PCAOB and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

The proposed auditor reporting standard would supersede portions of existing AU sec. 508, *Reports on Audited Financial Statements*, ("existing AU sec. 508") that primarily relate to an unqualified opinion.[8/] When the auditor is unable to express an unqualified opinion on the financial statements, resulting from, for example, a scope limitation or from the financial statements containing a material departure from the applicable financial reporting framework, the auditor would continue to refer to the requirements in existing AU sec. 508. Existing AU sec. 508 would be retitled to "Departures from Unqualified Opinions and Other Reporting Circumstances" and also would include proposed amendments resulting from issuance of the proposed auditor reporting standard.[9/]

## II. Objectives (Paragraph 4 of the Proposed Auditor Reporting Standard)

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed auditor reporting standard to highlight the overall context for the requirements of the standard. The proposed auditor reporting standard states that when the auditor concludes that an auditor's unqualified opinion is appropriate, the objectives of the auditor are to:

- Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and
- Communicate in the auditor's unqualified report critical audit matters relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

The Board's existing AU sec. 508 does not include an objective for the auditor when expressing an opinion on the financial statements. However, existing AU sec. 508 states that the report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed, and, where an auditor's name is associated with financial

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[8/] AU secs. 508.01-.09 and .11-.19 would be superseded.

[9/] See Section VII., *Amendments to Other PCAOB Standards*, for a discussion of how the requirements of the proposed auditor reporting standard relate to a qualified opinion, adverse opinion, and disclaimer of opinion.

statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.[10/] The objectives of the proposed auditor reporting standard include the auditor's expression of the opinion on the financial statements. Additionally, the basic elements that describe the nature of the audit and the auditor's responsibilities are similar to an indication of the character of the auditor's work.[11/]

Question Related to Section II:

1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?

## III. The Auditor's Unqualified Report (Paragraph 5 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard provides the overall framework for the auditor's unqualified report. This framework would include:

- Basic elements;
- Communication of critical audit matters; and
- Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances.

Because of changes being proposed to the auditor's report, the proposed auditor reporting standard uses the term "auditor's unqualified report" to differentiate it from the "auditor's standard report" described in existing AU sec. 508. The auditor's unqualified report, as described in the proposed auditor reporting standard, not only would include certain standardized language but also would include tailored language related to the auditor's communication of critical audit matters specific to the individual audit.

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[10/] See existing AU sec. 508.04.

[11/] See Section IV., *Basic Elements*, of this Appendix for discussion of the proposed basic elements.

## IV. Basic Elements (Paragraph 6 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard retains the basic elements from existing auditor reporting standards[12/] and incorporates elements from existing illustrative reports that accompany the existing auditor reporting standards. Additionally, the proposed auditor reporting standard improves the language for certain elements in the existing auditor reporting standards. Finally, the proposed auditor reporting standard adds new elements that provide more information about the audit and the auditor, such as information regarding auditor tenure and the auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information.

The proposed auditor reporting standard retains the pass/fail model of the existing auditor's report. Many commenters supported retaining the pass/fail model because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Additionally, commenters indicated support for the concise and useful message of the pass/fail model.

The proposed basic elements are intended to improve investors' and other financial statement users' understanding about the auditor, the nature of an audit, and the auditor's responsibilities. Except for the new proposed requirement regarding the auditor's responsibilities for other information outside the financial statements, the proposed changes to the basic elements do not represent a significant departure from existing requirements and the Board does not anticipate that they would impose significant additional costs.[13/] The Board, however, would expect audit firms to incur minimal one-time costs that relate primarily to updating a firm's methodology regarding auditor reporting. These changes might not result in significant recurring costs because they involve standardized language that, once implemented, would be the same or very similar across different auditors' reports.

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12/ See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board.*

13/ Costs related to reporting regarding the auditor's responsibilities for other information outside the financial statements and the results of the auditor's evaluation of the other information are discussed in Appendix 6.

## A. Basic Elements Retained from Existing Standards and Incorporated from Existing Illustrative Reports

### *1. Basic Elements Retained from Existing Standards*

The proposed auditor reporting standard retains the existing basic elements that are currently included in the auditor's report. Commenters indicated that these elements remain important for an understanding of the audit and the auditor's opinion and provide consistency and comparability among auditors' reports.

The basic elements retained from the existing auditor reporting standards include:

- A statement identifying each financial statement and related schedule, if applicable, that has been audited (paragraph 6.d. of the proposed auditor reporting standard);
- A statement that the financial statements are the responsibility of the company's management (paragraph 6.g. of the proposed auditor reporting standard);
- A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit (paragraph 6.j. of the proposed auditor reporting standard);
- A statement that the audit was conducted in accordance with the standards of the PCAOB (paragraph 6.k. of the proposed auditor reporting standard);
- A statement that an audit includes evaluating the overall presentation of the financial statements (paragraph 6.m.(4) of the proposed auditor reporting standard);
- A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion (paragraph 6.n. of the proposed auditor reporting standard);
- An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then

ended in conformity with the applicable financial reporting framework.[14/] The opinion should also include an identification of the applicable financial reporting framework (paragraph 6.o. of the proposed auditor reporting standard);

- The signature of the auditor's firm[15/] (paragraph 6.q. of the proposed auditor reporting standard);
- The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[16/] (paragraph 6.r. of the proposed auditor reporting standard); and
- The date of the auditor's report (paragraph 6.s. of the proposed auditor reporting standard).[17/]

*2. Basic Elements Incorporated from Existing Illustrative Reports*

In addition to the basic elements retained from the existing auditor reporting standards, the proposed auditor reporting standard also incorporates basic elements from the illustrative reports accompanying the existing reporting standards.[18/] Although these elements were not specifically required by existing auditor reporting standards,

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14/ The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. For example, in an audit of an investment company, the auditor might use such terms as "the financial position," "the results of its operations," and "changes in its net assets" in the Opinion on the Financial Statements section of the auditor's report.

15/ See also U.S. Securities and Exchange Commission ("SEC") Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

16/ Id.

17/ See AU sec. 530, *Dating of the Independent Auditor's Report*.

18/ See illustrative reports on an audit of financial statements in existing AU sec. 508.08 and the Appendix of Auditing Standard No. 1.

the Board understands that, in practice, these elements generally are incorporated by auditors in the auditors' reports on financial statements filed with the SEC.[19/]

The proposed auditor reporting standard incorporates the following elements from the existing illustrative reports:

- The title, "Report of Independent Registered Public Accounting Firm" (paragraph 6.a. of the proposed auditor reporting standard);[20/]
- The name of the company whose financial statements were audited (paragraph 6.c. of the proposed auditor reporting standard); and
- The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report (paragraph 6.e. of the proposed auditor reporting standard).

The basic elements retained from the existing auditor reporting standards and incorporated from existing illustrative reports are generally understood by investors and other financial statement users and would continue to promote consistency among auditors' reports.

## B. Changes to Certain Language in the Existing Auditor's Report

The proposed auditor reporting standard would change the language for certain elements in the existing auditor's report. As further described below, the changes are being proposed in response to comments and to align the language with other PCAOB standards.

### *1. Addressees (Paragraph 6.b. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. The proposed auditor reporting standard indicates

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[19/] Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, all auditors' reports incorporated these basic elements.

[20/] An auditor, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards of a non-issuer. If the proposed auditor reporting standard is adopted, PCAOB staff may issue guidance regarding such situations.

that addressees might include other appropriate parties depending on, for example, the legal and governance structure of the company. Accordingly, the auditor's report also could be addressed to others, such as bondholders.

Under existing AU sec. 508, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[21/] Because the auditor is not required to address the auditor's report to a specific group, the auditor's report is not consistently addressed to the company's investors.[22/] In some instances, auditors address the auditor's report to the board of directors, or the company, rather than the company's investors.

Many commenters referred to investors as the "key customers" of the auditor's report, "the real client of the auditor," or "ultimately the ones paying for the auditor's opinions."[23/] Additionally, commenters suggested that the auditor's report should be addressed to the shareholders of the company in addition to the board of directors. In order to promote consistency in the addressees included in the auditor's report, the Board is proposing to require the auditor's report be addressed to investors in the company. The requirement for the auditor's report to be addressed to investors might serve as a reminder to the auditor that the auditor's ultimate customer is the investor.

*2. The Auditor's Responsibility for the Financial Statements, Including the Related Notes and, if Applicable, Schedules (Paragraph 6.f. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to identify the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.

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[21/] See existing AU sec. 508.09.

[22/] Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, there were approximately 5 percent of auditors' reports not addressed to investors.

[23/] See comments at the September 15, 2011 public roundtable on the alternatives presented in the concept release for changing the auditor's reporting model. See also United States v. Arthur Young, 465 U.S. 805, 819 note 15 (1984), which states, in part, "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries."

The proposed auditor reporting standard uses the term "financial statements" as used by the SEC, which includes all notes to the statements and all related schedules. The notes to the financial statements provide additional information about the financial statements, such as a summary of the significant accounting policies. The proposed auditor reporting standard also includes a sentence to clarify that the proposed auditor reporting standard and other PCAOB standards often refer to the notes as disclosures.[24/]

The schedules identified as part of the financial statements depend on the SEC's requirements for the type of issuer. For example, auditors of registered investment companies would refer to SEC Regulation S-X, 17 C.F.R. § 210.6-10, for the list of schedules required to be filed with the SEC, such as the summary schedule of investments in securities of unaffiliated issuers.

The proposed auditor reporting standard would not apply to supplemental schedules pursuant to AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, because those schedules are not considered part of the financial statements.[25/] The auditor should continue to look to the requirements of AU sec. 551 for the auditor's reporting responsibilities regarding supplemental schedules accompanying audited financial statements.[26/]

Under existing AU sec. 508, each financial statement audited is specifically identified in the auditor's report. Existing AU sec. 508 also describes the basic financial statements as the balance sheet, statement of income, statement of stockholders' equity, and statement of cash flows.[27/] The notes to the financial statements and, if applicable, the related schedules, are not identified as part of the financial statements under existing AU sec. 508. The proposed auditor reporting standard would require specific references to the related notes and, if applicable, schedules because those are

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24/ See, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

25/ See AU sec. 551.03.

26/ On July 12, 2011, the Board issued Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements,* PCAOB Release No. 2011-005 (July 12, 2011) available at http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB_Release_2011-005.pdf, which, if adopted, would supersede AU sec. 551.

27/ Existing AU sec. 508.06 describes these as the basic financial statements.

identified as part of the financial statements pursuant to SEC Rule 1-01(b) of Regulation S-X.

Many commenters supported the addition of language in the auditor's report regarding the auditor's responsibilities for financial statement notes. Some commenters noted that this change would bring the auditor's report more in line with the actual responsibilities of auditors as set out in existing auditing standards and would give more prominence to the auditor's responsibility for such disclosures.

Since the related notes and, if applicable, schedules are an integral part of the audited financial statements, the Board is proposing to make clear in the auditor's report the auditor's responsibilities for the notes to the financial statements and related schedules.

The proposed auditor reporting standard also recognizes that not every company is required by the SEC to include related schedules as part of the financial statements. If, however, these schedules are required by the SEC to be included as part of the audited financial statements, the auditor's report also would identify these schedules.

*3. The Auditor's Responsibility for Fraud (Paragraph 6.l. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would revise the auditor's report to recognize the auditor's existing responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.[28/]

Existing AU sec. 508 does not require the auditor's report to describe the auditor's responsibility related to error or fraud in planning and performing the audit. This proposed change does not modify the auditor's existing responsibilities with respect to fraud in a financial statement audit.

Many commenters supported describing the auditor's responsibility for fraud in the auditor's report. Those commenters generally suggested modifying the language in the auditor's report to add the phrase "whether caused by error or fraud." Another commenter specifically noted that this description would help achieve the objective of enhancing communication between auditors and users of the auditors' reports.

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[28/] See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

In the report by the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP"), ACAP requested the PCAOB to clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards.[29/] Additionally, academic research suggests that some users might benefit from a specific statement in the auditor's report regarding fraud.[30/]

*4. Description of the Nature of an Audit (Paragraph 6.m. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit but revises that description to align it better with the requirements in the Board's existing standards.

Under existing standards, the nature of an audit is described in the auditor's report as follows:[31/]

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- Assessing the accounting principles used and significant estimates made by management; and
- Evaluating the overall financial statement presentation.

In 2010, the Board adopted eight standards (Auditing Standard Nos. 8-15) that improve the effectiveness of the auditor's identification of, assessment of, and response to the risks of material misstatement in an audit ("risk assessment standards"). The proposed auditor reporting standard updates the description related to the nature of the

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29/ U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP report"), at VII:2 (October 6, 2008), available at http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf. See generally, ACAP report, at VII:13-VII:19.

30/ See Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011).

31/ See existing AU sec. 508.08.f.

audit to reflect the auditor's responsibilities in a risk-based audit and to align the description with the language in the Board's risk assessment standards.

The proposed auditor reporting standard includes the following description of an audit:

- Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
- Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
- Evaluating the accounting principles used and significant estimates made by management; and
- Evaluating the overall presentation of the financial statements.

## C. New Proposed Basic Elements Requirements

The proposed auditor reporting standard adds new basic elements to the auditor's unqualified report that would enhance investors' and other financial statement users' understanding about the auditor and an audit.

### 1. *Auditor Independence (Paragraph 6.h. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws[32/] and the applicable rules and regulations of the SEC and the PCAOB.

Currently, the only indication of auditor independence in the auditor's report is in the title of the report "Report of Independent Registered Public Accounting Firm." Aside from the title, the auditor's report provides no further information regarding auditor

32/ The term "United States federal securities laws" has the same meaning as "securities laws" in PCAOB Rule 1001(s)(ii), *General Provisions*. "United States federal" has been added to distinguish for investors the country and governmental level (federal, state or local) of the referenced laws.

independence. The statement regarding auditor independence is not intended to affect auditor independence requirements under the securities laws, SEC rules,[33/] or PCAOB rules.[34/]

In the concept release, the Board sought comments on whether to include a statement in the auditor's report, in addition to the title, regarding the auditor's responsibilities related to independence. In general, commenters were supportive of this change with one commenter specifically noting that a stronger statement regarding auditor independence would both be informative for investors and a reminder to auditors of their obligation to be independent of the company.

According to a January 2008 U.S. Government Accountability Office report, "investors and other users of financial statements expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies' audited financial statements, which is key to the efficient functioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as independent and expert professionals who will conduct thorough audits."[35/] In the Board's view, adding a statement relating to auditor independence in the auditor's report could (1) enhance investors' and other financial statement users' understanding of the auditor's obligations to be independent and (2) serve as a reminder to auditors of these obligations.

*2. Auditor Tenure (Paragraph 6.i. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Currently this information is not required to be communicated by the auditor (or by management or the audit committee) to investors and other financial statement users.

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[33/] See SEC Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01.

[34/] See PCAOB Rule 3520, *Auditor Independence, et seq*.

[35/] See U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, 7 (Jan. 2008), available at http://www.gao.gov/new.items/d08163.pdf.

Auditor tenure has been the subject of discussion for decades[36/] and continues to be a topic of discussion today.[37/] Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[38/] Meanwhile, other academic research indicates that investors that participated in a study view long-term auditor-company relationships as adversely affecting audit quality.[39/] Other academic research suggests that both short and long tenure can have detrimental effects on audit quality.[40/]

Disclosure of auditor tenure also has been considered by other regulators and standard setters. For example, under rules adopted by the United Kingdom ("UK")

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[36/] See, e.g., Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95th Cong., *The Accounting Establishment iii* (Comm. Print 1977), at 21, available at http://archive.org/download/accstabl00unit/accstabl00unit.pdf; see also AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 108, available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

[37/] See, e.g., Richard Crump, *FTSE 100 Providing More Audit Tenure Information*, Accountancy Age, June 14, 2013, available at http://www.accountancyage.com/aa/news/2274992/ftse-100-providing-more-audit-tenure-information.

[38/] See, e.g., Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting,* 23 Auditing: A Journal of Practice and Theory 55, 55–69 (2004); and Bin Srinidhi, Sidney Leung, and Ferdinand A. Gul, *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge,* (2010), unpublished working paper available at http://dx.doi.org/10.2139/ssrn.1590811.

[39/] See, e.g., Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297-314 (2008).

[40/] See, e.g., Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517-548 (2009).

Financial Reporting Council, UK-listed companies are required to provide information on the length of auditor tenure in a separate section of the annual report.[41/]

Regardless of whether auditor tenure is viewed as a positive or negative influence on audit quality, investors and other financial statement users have indicated strong interest in this information.[42/] In developing the proposed requirement, the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure. The Board's inspection process has not been designed to determine a relationship between audit quality and auditor tenure. In light of the public interest in the subject of auditor tenure, the Board is proposing to include auditor tenure as a data point in the auditor's report.

In determining the year the auditor began serving consecutively as the company's auditor, the auditor would look to the year beginning when the firm signs an initial engagement letter to audit a company's financial statements or when the firm begins the audit, whichever is earlier. For example, if the auditor is appointed in January 2012 to audit a company's financial statements for the year ended December 31, 2012, and the auditor's report is dated February 28, 2013, the auditor would state 2012 as the year the auditor began serving consecutively as the company's auditor. In another example, if the auditor is appointed in January 2013 to audit a company's financial statements for the years ended December 31, 2010, 2011, and 2012, the auditor would state 2013 as the year the auditor began serving consecutively as the company's auditor.

The intent of the proposed requirement is to disclose the duration of the auditor's relationship with the company. For example, in a situation in which a company acquires another company, if the acquirer's current auditor continues serving subsequently as the company's auditor, the auditor tenure would continue. If the acquired company's auditor is selected to serve as the acquirer's auditor, the auditor tenure would begin anew.

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41/ See UK - Financial Reporting Council Corporate Governance Code and Auditing Standards at http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

42/ On April 19, 2013, the Council of Institutional Investors revised its corporate governance policies to state that "boards retaining an auditor beyond 10 years should be required to explain why doing so is in shareholders' interest." The revisions made to the Council of Institutional Investors' Policies on Corporate Governance are available at: http://www.cii.org/corp_gov_policies.

Additionally, the auditor's relationship with the company is not affected by the company's status as a public company. For instance, if a company went public but maintained its auditor, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to the SEC financial reporting requirements.

The Board understands that, in some cases, the auditor may have difficulty determining the year the auditor began serving as the company's auditor, due to firm or company mergers, acquisitions, or changes in ownership structure. If the auditor is unaware of the year it became the company's auditor, the auditor could refer to publicly available information, such as the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") for determining the year the auditor or the auditor's predecessor firm began serving as the company's auditor.[43/] EDGAR also may be used by investors to assess whether a company has filed a current report on Form 8-K to disclose a change in the company's auditor.[44/]

If the auditor is unable to obtain information regarding the year the auditor began serving consecutively as the company's auditor, the auditor would be required to state in the auditor's report that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge. As noted above, this might apply in situations in which other firms were acquired by the auditor's firm or were merged with the auditor's firm, or in situations in which the company's ownership structure changed. The following is an example of such a statement that could be included in the auditor's report:

> We are uncertain as to the year we [or our predecessor firms] began serving consecutively as the auditor of the Company's financial statements; however, we are aware that we [or our predecessor firms] have been Company X's auditor [or Company X's auditor subsequent to the Company's merger] consecutively since at least 19XX.

The auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor, but once the year has been determined the cost to include the disclosure about tenure should be minimal.

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[43/] Many company's filings are available via EDGAR starting in 1994.

[44/] See Form 8-K, 17 C.F.R. § 249.308, Item 4.01 Changes in Registrant's Certifying Accountant.

*3. Other Information (Paragraph 6.p. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to refer to the reporting requirements contained in the Board's companion Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, (the "proposed other information standard") when the auditor's report is included in a company's annual report filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") that includes other information outside the company's audited financial statements as well as the audited financial statements and the related auditor's report.

When issuing an auditor's report, the reporting requirements of the proposed other information standard would require the auditor to include in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information" the following:

a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;

c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;

d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and

e. A statement that, based on the evaluation, the auditor:

    (1) Has not identified a material inconsistency or a material misstatement of fact in the other information;[45/] or

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[45/] This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified

(2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

In the concept release, the Board requested comments on whether the auditor's report should describe the auditor's responsibility with respect to other information. Some commenters supported including a description of the auditor's responsibilities with respect to other information outside the financial statements in the auditor's report. Some of these commenters indicated that a description of the auditor's responsibilities would be helpful for investors' and other financial statement users' understanding of the auditor's responsibilities with respect to other information and would address any misperception that the other information is audited. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The proposed other information standard would strengthen the audit procedures the auditor would perform related to other information outside the financial statements when such information is included in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed other information standard would provide a basis for enhancing the auditor's report regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of the other information. These changes are intended to make the auditor's report more informative.[46/]

## D. Form of the Auditor's Unqualified Report

The basic elements of the proposed auditor's unqualified report are organized and categorized into introduction, basis of opinion, opinion on the financial statements, auditor's responsibilities regarding other information, and signature and date sections in the proposed auditor reporting standard. This categorization would replace previous references in PCAOB standards to introductory, scope, and opinion paragraphs. The purpose for this change is primarily to assist readers of the proposed auditor reporting

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a material inconsistency, a material misstatement of fact, or both, that management has revised appropriately prior to the issuance of the auditor's report.

[46/] See Appendix 6 for proposed changes related to the auditor's responsibilities regarding other information.

standard to understand the standard as well as to provide easy reference to specific sections within the auditor's report.

One proposed change in the form of the report involves the replacement of the "scope paragraph" in existing AU sec. 508, which describes the nature of an audit,[47/] with a "Basis of Opinion" section. The proposed change in terminology is based on the statement in the auditor's unqualified report that "we believe our audits provide a reasonable basis for our opinion."

The proposed auditor reporting standard does not require that the basic elements appear in a specific order in the auditor's report, nor does it require that section titles be included, except for the section titles regarding the auditor's responsibilities for other information and critical audit matters. The proposed auditor reporting standard does not preclude the auditor from including section titles for other sections in the auditor's report.

Questions Related to Section IV:

2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?

3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?

4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?

5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.

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[47/] See existing AU sec. 508.08.

a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?

b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?

c. Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?

6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?

7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?

8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?

9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.

## V. Critical Audit Matters (Paragraphs 7 – 14 of the Proposed Auditor Reporting Standard)

The current version of the auditor's report includes the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail). Beyond the pass/fail nature of the report, the report provides little, if any, information specific to the audit of the company's financial statements. The proposed auditor reporting standard would require the auditor to communicate specific information through the auditor's report regarding "critical audit matters," which would result in information in auditors' reports tailored to the audit.[48/]

The Board developed its proposal for communicating critical audit matters in the auditor's report in a way that should provide greater insight regarding the audit, without unduly burdening the financial reporting process. The auditor is well positioned to communicate this type of information to investors and other financial statement users through the auditor's report. Under the proposed auditor reporting standard, the auditor would determine critical audit matters by leveraging audit work already required to be performed under existing standards. The proposed auditor reporting standard does not intend to change the auditor's traditional role of attesting to matters in the financial statements and will not require auditors to provide analysis of the matters in the financial statements when communicating critical audit matters. Notably, the auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements. Therefore, the communication of critical audit matters is not intended to, and should not, detract from, disclaim, or qualify the auditor's opinion.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[49/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown

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48/ The communication of critical audit matters also would be required in an auditor's report with a qualified opinion. See further discussion in Section VII, F. *Amendments to Existing AU sec. 508*.

49/ See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[50/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[51/]

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee to matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information[52/] in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[53/]

Communication of critical audit matters under the proposed auditor reporting standard, however, could result in additional effort involving both one-time costs and

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50/ Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

51/ See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

52/ The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

53/ See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

recurring costs in each individual audit relative to the determination, preparation of language for communication, and documentation of critical audit matters in the auditor's report. Companies, including audit committees will likely also incur additional costs in reviewing the critical audit matters in the auditor's report. Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix provides a more detailed discussion regarding costs and related questions associated with the requirements for critical audit matters.[54/]

There also could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand the meaning of a critical audit matter. Further, investors may not understand that information important to an investment decision may not be highlighted as a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

## A. Definition of Critical Audit Matters (Paragraph A2 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard defines critical audit matters as those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

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54/ In addition, the discussion regarding costs for auditors related to critical audit matters appears in two different areas as follows: (1) recurring costs are discussed under each proposed requirement for critical audit matters throughout this Section and (2) one-time costs are discussed in Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix.

The auditor might identify either one matter or a number of matters that meet the definition of a critical audit matter. It is expected that, in most audits, there could be several matters that would meet the definition of a critical audit matter. Use of the word "most" in the definition of a critical audit matter does not imply that only one matter under each criteria would qualify as a critical audit matter. The word most also is not intended to imply that there is only one matter that surpasses all other matters; but rather to refer to the matter or matters that would stand out from the other numerous matters addressed during an audit in terms of difficulty, subjectivity, or complexity, as stated in the critical audit matters definition. Additionally, an audit matter could meet one, two, or all three of the criteria in the definition.

*1. Involved the Most Difficult, Subjective, or Complex Auditor Judgments*

The auditor exercises judgment in a variety of ways throughout an audit of financial statements. For instance, auditor judgment is used in determining the nature, timing, and extent of audit procedures; evaluating sufficient appropriate audit evidence; and forming an opinion on the financial statements.

The proposed auditor reporting standard anticipates that the auditor would determine what matters addressed during the audit involved the most difficult, subjective, or complex auditor judgment for communication in the auditor's report. The degree of difficulty, subjectivity, or complexity of auditor judgments can vary depending on the matter. For instance, matters that are subjective in nature generally would require a greater degree of auditor judgment than matters that are objective. Similarly, matters that are difficult or complex might require a greater degree of auditor judgment than matters that are relatively straightforward. For example, the auditor might determine that auditing the allowance for loan losses of a bank represented one of the areas that involved the most difficult, subjective, or complex auditor judgments because of (1) the high degree of complexity and subjectivity associated with evaluating the determination of the allowance for loan losses; (2) the significance of the assumptions in the accounting estimate, including the possibility of reasonable alternative assumptions; and (3) the high degree of uncertainty associated with the assumptions.

*2. Posed the Most Difficulty to the Auditor in Obtaining Sufficient Appropriate Evidence*

Audit evidence may be obtained by the auditor from several different sources, for example, from management; third parties, such as through confirmation; or from the auditor's own procedures, such as observation. The sufficiency of audit evidence is the measure of its quantity, whereas the appropriateness is the measure of its quality, that is, its relevance and reliability.[55/]

The auditor might experience difficulty in obtaining sufficient appropriate evidence in several ways. For instance, difficulty might result from unexpected extensive effort required by the auditor to obtain evidence. Difficulty could also result when the auditor obtains information that conflicts with audit evidence previously obtained, thereby raising questions about the reliability of the audit evidence.

Those matters arising in the audit that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that auditing fair value measurements of certain financial instruments represented one of the areas that posed the most difficulty in obtaining sufficient appropriate evidence because the auditor encountered difficulties in obtaining relevant and reliable evidence regarding observable inputs in an inactive market. In situations where there is little market activity, the auditor may need to evaluate unobservable inputs to measure fair value, which requires the auditor's assessment of the assumptions that market participants would use to price an asset or liability.[56/]

3. *Posed the Most Difficulty to the Auditor in Forming the Opinion on the Financial Statements*

Matters that posed the most difficulty to the auditor in forming the opinion on the financial statements are those matters arising from the audit that commenters described

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[55/] See paragraphs 5 and 6 in Auditing Standard No. 15, *Audit Evidence*.

[56/] See Financial Accounting Standard Board's ("FASB") Accounting Standard Codification ("ASC") Topic 820, *Fair Value Measurements*, and International Accounting Standards Board's International Financial Reporting Standard No. 13, *Fair Value Measurement*, which define Level 3 inputs as unobservable inputs that are used to estimate the fair value of the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing a fair value measurement in situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the assumptions (including assumptions about risk) that market participants would use when pricing the asset or liability.

as "close calls" or matters that "kept the auditor up at night."[57] The types of matters that would meet this criteria represent matters that concerned the auditor when the auditor was making the final assessment of whether the financial statements present fairly the company's financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework.[58]

Those matters arising in the audit that posed the most difficulty to the auditor in forming the opinion on the financial statements would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that revenue recognition represented an area that posed the most difficulty to the auditor in forming the opinion on the financial statements because the authoritative revenue recognition guidance is not directly applicable to the company's product sales raising challenges for the auditor in determining if revenue recognition principles were properly applied.

## B. Determination of Critical Audit Matters (Paragraphs 7 – 9 of the Proposed Auditor Reporting Standard)

### *1. Requirement to Determine Critical Audit Matters (Paragraphs 7 and 8 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to determine the critical audit matters addressed in the audit of the current period's financial statements based on the results of the audit or evidence obtained.

Under the proposed auditor reporting standard, it is expected that, in most audits, the auditor would determine that there are critical audit matters. The proposed auditor reporting standard does not provide for an explicit exception from determining whether there are any critical audit matters for audits of certain types of entities. Since no two audits are alike, there may be critical audit matters even in an audit of a company with no operations or activities.

In determining the critical audit matters the auditor addressed during the audit, the auditor would leverage the work he or she already performed when conducting an

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[57] See, e.g., comments made during the PCAOB's Roundtable on the Auditor's Reporting Model. The transcript is located at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[58] See paragraph 1 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

audit under the Board's existing standards. Those standards currently require the auditor to perform various procedures to provide a foundation for the auditor's significant judgments and conclusions on which the auditor's opinion on the financial statements is based. The audit procedures applied throughout the audit are based primarily upon an auditor's identification of, assessment of, and response to the risk of material misstatement. The proposed auditor reporting standard would result in the auditor reporting on the most difficult and challenging aspects of the audit. The proposed auditor reporting standard does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

Because critical audit matters ordinarily are matters of such importance, they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. The auditor's documentation and activities under these standards could provide the auditor with sources for identifying critical audit matters. However, the Board would not expect that each matter included in any one or more of these sources would be a critical audit matter.

The auditor's determination and communication of critical audit matters is not intended to take the place of the auditor's existing responsibilities under other audit performance and reporting standards. For example, the auditor's responsibilities associated with the auditor's consideration of an entity's ability to continue as a going concern and the related reporting requirements,[59/] and the auditor's communication of control deficiencies related to an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only,[60/] among other audit performance and/or reporting requirements, continue to exist unchanged. In addition, the communication of critical audit matters is not intended to function as an alternative to a departure from an unqualified opinion on the financial statements in difficult or challenging situations.

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[59/] See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and paragraph 15.a. of the proposed auditor reporting standard, which is being retained from the existing standard (AU sec. 508.11.b).

[60/] See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements.*

Although the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards, it could increase the auditor's focus on critical audit matters, which could result in enhancing the quality of the audit. Previous research has found that auditors increase audit hours and/or billing rates in response to audit risks.[61/] Although an increase in audit hours and/or billing rates likely would increase audit fees, an increase in focus on critical audit matters could also result in increased audit quality.[62/]

In determining critical audit matters under the proposed auditor reporting standard, auditors likely would incur recurring costs due to additional effort expended in individual audits. It is likely that senior members of the engagement teams, such as partners and senior managers, would be involved with determining the critical audit matters to be communicated in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office could also result in recurring costs.[63/]

*2. Factors (Paragraph 9 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard includes a list of factors intended to help the auditor determine, from the results of the audit or evidence obtained, which matters in the audit would meet the definition of critical audit matters. Depending on the matter and its circumstances, the applicability and related degree or scope of just one factor might lead an auditor to conclude that a matter is a critical audit matter. In other cases, however, the auditor might take into consideration a combination of factors in determining that a matter is a critical audit matter.

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[61/] See Jean C. Bedard and Karla M. Johnstone, *Earnings Manipulation Risk, Corporate Governance Risk, and Auditors' Planning and Pricing Decisions*, 79 The Accounting Review 277, 277-304 (2004). See also Mark F. Zimbleman, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions*, 35 Journal of Accounting Research 75, 75-97 (1997).

[62/] See Gerald Lobo and Yuping Zhao, *Relation Between Audit Effort and Financial Report Misstatements: Evidence from Quarterly and Annual Restatements*, 88 The Accounting Review 1385,1385-1412 (2013).

[63/] See also Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.

In addition, the factors in the proposed auditor reporting standard are not intended to represent an all-inclusive list of factors pertaining to whether a matter meets the definition of a critical audit matter. There could be other factors that may be specific to the audit, which are not listed in the proposed auditor reporting standard, that affect whether a matter involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or posed the most difficulty to the auditor in forming an opinion on the financial statements.

The factors listed in the proposed auditor reporting standard are:

a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures (paragraph 9.a. of the proposed auditor reporting standard)

A high degree of subjectivity may be involved in auditing matters that are complex or unusual, or both. For example, the arrangements pursuant to which a company recognizes revenue might be complex and require significant judgments regarding the development of estimates, such as the fair value of certain deliverables pursuant to a multiple element sales contract. In this example, determining or applying the appropriate audit procedures to test management's fair value measurements, or to evaluate whether management's estimates are reasonable, might involve one of the most subjective auditor judgments during the audit.

b. The nature and extent of audit effort required to address the matter (paragraph 9.b. of the proposed auditor reporting standard)

The nature and extent of audit effort relates to the time spent by the engagement team members performing the audit procedures; the level of knowledge, skill, and ability of engagement team members necessary to audit the matter;[64/] the extent of supervision needed based on the assessed risks of material misstatements;[65/] and the extent of discussions with management or within the firm,[66/] such as the firm's national office, or consultations outside the firm.

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[64/] See paragraph 6.d. of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

[65/] See paragraph 5.b. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[66/] See paragraph 19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

An area that requires extensive audit effort might be an indicator that the matter was among the most difficult during the audit or required a significant amount of judgment. Matters that required extensive audit effort could include the significant involvement of more experienced engagement team members or an increase in the amount of time incurred in (1) supervising the auditing of the matter; (2) discussing the matter with management and the audit committee; or (3) consulting with the firm's national office about the matter.

c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence (paragraph 9.c. of the proposed auditor reporting standard)

The sufficiency and appropriateness of the audit evidence obtained to support the matter, such as when the auditor identifies contrary evidence, might contribute to the degree of difficulty in applying audit procedures to address the matter.

Delays by management, the unavailability of company personnel, or unwillingness by management to provide information needed for the auditor to perform his or her audit procedures also could create challenges associated with obtaining relevant and reliable audit evidence.[67/]

d. The severity of control deficiencies identified relevant to the matter, if any (paragraph 9.d. of the proposed auditor reporting standard)

In both an audit of the financial statements and an audit of internal control over financial reporting that is integrated with an audit of financial statements, the auditor is required to obtain a sufficient understanding of internal control over financial reporting.[68/] In an integrated audit, the auditor would be required to audit the effectiveness of internal control over financial reporting.[69/] And in a financial statement audit, the auditor would be required to reach an understanding of the internal control over financial reporting and the company's control activities sufficient to assess the risk

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[67/] Difficulties encountered by the auditor during the audit could represent a scope limitation, which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement. See AU secs. 508.22-.32.

[68/] See paragraphs 18-40 of Auditing Standard No. 12.

[69/] See paragraph 1 of Auditing Standard No. 5.

of material misstatement in the financial statements and to design further audit procedures.[70/]

Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.

Although an auditor might determine a matter to be a critical audit matter because of the severity of an internal control deficiency, the communication of such a critical audit matter would not relieve the auditor from the auditor's existing auditing and reporting responsibilities under other PCAOB standards related to a company's internal control over financial reporting.[71/] This factor is intended to help the auditor determine which matters are critical audit matters and is not intended to supplement, replace, or create new audit requirements for matters related to internal control over financial reporting.

e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any (paragraph 9.e. of the proposed auditor reporting standard)

The Board's risk assessment standards require the auditor to modify, among other things, the audit strategy, materiality levels, and the assessment of the risks of material misstatement if circumstances change during the course of the audit. Such changes could result from the discovery of a previously unidentified risk of material misstatement or audit evidence that contradicts the auditor's initial risk assessment. Also, the number of misstatements found by the auditor might be indicative that other misstatements might exist.

Since a matter that resulted in changes to the planned audit strategy or to changes to the risks initially identified could involve significant auditor judgment, it might be a critical audit matter.

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70/ See paragraph 34 of Auditing Standard No. 12.

71/ See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325.

f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any (paragraph 9.f. of the proposed auditor reporting standard)

In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor's evaluation of audit results should include an evaluation of misstatements accumulated during the audit, including uncorrected misstatements.[72/] Misstatements can arise from error (that is, unintentional misstatement) or fraud.[73/]

A matter in which misstatements, either corrected or uncorrected, have been identified might lead the auditor to conclude that the matter is a critical audit matter.

g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any (paragraph 9.g. of the proposed auditor reporting standard)

In auditing matters that are complex or subjective, the auditor may determine that using the work of a specialist to obtain sufficient appropriate evidence is necessary. For example, specialized skill or knowledge might be needed by the auditor in areas such as the valuation of complex financial instruments, determination of mineral reserves, actuarial determinations, or interpretation of technical requirements.

An auditor's determination that a matter required specialized skill or knowledge to obtain sufficient appropriate evidence might be an indication that the matter involved difficult, subjective, or complex auditor judgments. In such situations, the matter might be a critical audit matter.

h. The nature of consultations outside the engagement team regarding the matter, if any (paragraph 9.h. of the proposed auditor reporting standard)

Issues that are complex or unusual can arise in various stages during the audit. In such situations, the auditor might consult with the firm's national office, industry specialists, or external parties. For example, matters related to the auditor's evaluation of management's judgments, estimates, or accounting policies might lead to

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[72/] See paragraphs 3-4 and 10-23 of Auditing Standard No. 14, *Evaluating Audit Results*.

[73/] See paragraph A2 of Auditing Standard No. 14.

consultation with others who might assist the auditor in arriving at the conclusions on which the auditor's opinion is based. Such matters might involve the most subjective or complex auditor judgments during the audit or might pose the most difficulty in forming an opinion on the financial statements. Consultation with others on a particular matter, therefore, might be an indication that the matter is a critical audit matter.

## C. Audit Period Covered by Critical Audit Matters (Paragraph 10 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard would require the auditor to communicate critical audit matters for the audit of the current period's financial statements. While most companies' financial statements are presented on a comparative basis, and thus most audit reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented in the financial statements, would provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users would be able to look at prior years' filings to analyze critical audit matters over time.

Because the communication of critical audit matters for prior periods also might be useful to investors and other financial statement users, the proposed auditor reporting standard states that, when the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

In situations in which a predecessor auditor has been asked to reissue his or her audit report on the financial statements of a prior period, existing standards require the auditor to consider whether the auditor's report on those statements is still appropriate after certain required procedures are performed.[74/] If the predecessor auditor determines that the auditor's report is still appropriate and is reissued, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for one year, the proposed auditor reporting standard would not require the communication of critical audit matters in the reissued report of the predecessor auditor for prior years.

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[74/] See AU secs. 508.70-.73, which discusses the report of a predecessor auditor.

## D. Communication in the Auditor's Report of Critical Audit Matters (Paragraphs 11 – 13 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard would require that, for each critical audit matter communicated in the auditor's report, the auditor (1) identify the critical audit matter; (2) describe the considerations that led the auditor to determine that the matter is a critical audit matter; and (3) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

The Board expects that the auditor's communication of critical audit matters in the auditor's report would be presented in language and in a format that is clear, concise, and understandable to a financial statement user. The Board also expects that the communication would be tailored to the audit and thus would avoid boilerplate language and reflect the specific circumstances of the matter in relation to the audit of the company's financial statements. While the same audit matter may be determined to be a critical audit matter from one year to the next or from one audit to another, the auditor would be expected to tailor the communication of the critical audit matter to the specific facts and circumstances that existed during that particular current period's audit.

As noted previously, the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements taken as a whole. Accordingly, the proposed auditor reporting standard indicates that the auditor should not use language in the auditor's report that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements. In issuing an unqualified opinion on the financial statements, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements, taken as a whole, are fairly presented in all material respects. Critical audit matters in the auditor's report are matters that have been addressed by the auditor and, therefore, should not be described to imply that a critical audit matter disclaims or qualifies the auditor's opinion on the financial statements.

The following discussion presents the proposed elements of the communication in the auditor's report relative to critical audit matters in more detail.

### *1. Identify the Critical Audit Matter (Paragraph 11.a. of the Proposed Auditor Reporting Standard)*

In communicating the critical audit matter, the auditor would identify each audit matter that the auditor determined met the definition of a critical audit matter. For example, the audit of the valuation of certain complex financial instruments could be identified as a critical audit matter in the auditor's report because the matter posed the most difficulty to the auditor in obtaining sufficient appropriate evidence.

*2. Describe the Considerations That Led the Auditor to Determine That the Matter is a Critical Audit Matter (Paragraph 11.b. of the Proposed Auditor Reporting Standard)*

To enhance investors' and other financial statement users' understanding of the audit, the proposed auditor reporting standard would require the auditor to describe the considerations that led the auditor to determine that the matter is a critical audit matter. The description of considerations that led the auditor to determine a matter is a critical audit matter may be derived from one or more of the factors; however, the auditor would not be limited to the factors listed in the proposed auditor reporting standard, which also could include other factors specific to the audit. Additionally, the auditor's description should be specific to the circumstances. For instance, using the same example from above regarding certain complex financial instruments that are identified as a critical audit matter, the communication in the auditor's report might describe the auditor's considerations related to the lack of observable inputs, a high degree of measurement uncertainty, and significant judgments needed to audit the fair value assumptions. Further, when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so.

*3. Refer to the Relevant Financial Statement Accounts and Disclosures That Relate to the Critical Audit Matter, When Applicable (Paragraph 11.c. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard also would require the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable. Since the audit is of the company's financial statements, the auditor would be able to refer to the relevant financial statement accounts and disclosures in most cases. Following through on the example from above in which the critical audit matter was the valuation of certain complex financial instruments, the auditor would refer to the relevant financial statement account for financial instruments and the corresponding disclosure.

There also may be instances when a critical audit matter has a pervasive effect on the financial statements, such as an entity level control deficiency or circumstances in which there is no related financial statement account or disclosure. In such cases, the auditor would describe the matter and its effect on the audit of the financial statements, taken as a whole.

With regard to each of the proposed elements of the communication in the auditor's report, developing the language of critical audit matters to include in the auditor's report likely would result in additional recurring costs related to individual audits. These recurring costs likely would include additional time incurred by senior members of engagement teams, such as partners and senior managers. In addition, other recurring costs might relate to additional time incurred by others, such as the engagement quality reviewer and consultations with others, including national office. Further, additional time also might be incurred by the auditor as a result of discussions with management or the audit committee regarding the critical audit matters to be communicated in the auditor's report under the proposed auditor reporting standard.[75/]

*4. Illustrative Examples of Critical Audit Matters*

The Exhibit to this Appendix includes illustrative examples of communications of critical audit matters in the auditor's report. The Board has developed three different scenarios that contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.[76/]

The Board is interested in obtaining other illustrative examples of communications of critical audit matters under the proposed auditor reporting standard. Thus, the Board is requesting that commenters prepare examples of communications of critical audit matters that could appear in an auditor's report under the proposed auditor reporting standard and provide those examples to the Board.[77/]

*5. Language Preceding Critical Audit Matters (Paragraphs 12 and 13 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a section titled "Critical Audit Matters" and include specific language in the auditor's report both when critical audit matters are being communicated and when the auditor has determined that there are no critical audit matters to communicate. In both situations,

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[75/] See also Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.

[76/] The examples contained in the Exhibit to this Appendix are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

[77/] Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

the language in the auditor's report is intended to inform investors and other financial statement users of the auditor's requirement to communicate critical audit matters and whether the auditor has determined there are any critical audit matters.

When the auditor determines that there are critical audit matters, the specific language for such situations notifies investors and other financial statement users that the auditor's communication of critical audit matters is not intended to affect the auditor's opinion on the financial statements and related disclosures, taken as a whole, and therefore, does not represent individual opinions for each critical audit matter.

In situations in which the auditor determines that there are no critical audit matters, the proposed specific language in the auditor's report would describe the auditor's responsibilities and indicate that the auditor determined that there are no critical audit matters.

## E. Documentation of Critical Audit Matters (Paragraph 14 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard requires the auditor to document the auditor's determination of critical audit matters and refers the auditor to the documentation requirements for audits conducted under PCAOB standards (that is, Auditing Standard No. 3). To provide sufficient detail for a clear understanding of the conclusions reached by the auditor, the auditor's documentation related to critical audit matters should contain sufficient information to enable an experienced auditor,[78/] having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

As noted previously, in determining critical audit matters, the proposed auditor reporting standard anticipates that auditors would leverage the audit work already performed under existing auditing standards. This includes the information documented in the engagement completion document, matters reviewed by the engagement quality reviewer, or matters communicated to the audit committee. The auditor's documentation and activities under existing standards could provide the auditor with sources for identifying critical audit matters.

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[78/] See note to paragraph 6 of Auditing Standard No. 3, which states that "[a]n *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

In fulfilling the documentation requirements under the proposed auditor reporting standard, the auditor would not be expected to provide an explanation for each matter documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee. The Board recognizes that documenting whether each such matter was a critical audit matter could result in an extensive amount of documentation that might be unnecessary. Accordingly, the auditor would be expected to document only those matters that were either communicated as critical audit matters or that would appear to meet the definition of a critical audit matter that were not communicated as such in the auditor's report.

*1. Audit Matters Reported as Critical Audit Matters*

As noted previously, the documentation of those matters the auditor communicated as critical audit matters would be required to meet the documentation requirements of Auditing Standard No. 3. That standard requires an auditor to prepare audit documentation that is in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached.[79/] In addition, Auditing Standard No. 3 requires that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the conclusions reached.[80/]

*2. Audit Matters Not Reported as Critical Audit Matters*

The Board is proposing a documentation requirement that is intended to encourage auditors to consider in a thoughtful and careful manner whether all matters that meet the definition of a critical audit matter are communicated in the auditor's report. The proposed auditor reporting standard would require the auditor to document why audit matters that would appear to meet the definition of a critical audit matter were not communicated as such by the auditor in the auditor's report.

Additionally, the Board is proposing this requirement to help the auditor and other reviewers, such as the engagement quality reviewer, have a better understanding of the basis for the auditor's determination of matters that would appear to meet the definition of a critical audit matter and were not communicated. Further, requiring documentation of the auditor's determination of such matters not communicated might have the indirect effect of preventing the omission of a critical audit matter due to potential management pressure to exclude the matter from the auditor's report.

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[79/] See paragraph 2 of Auditing Standard No. 3.

[80/] See paragraph 6 of Auditing Standard No. 3.

The proposed documentation requirement of why audit matters that would appear to meet the definition of a critical audit matter were not communicated by the auditor in the auditor's report would reflect the requirements of Auditing Standard No. 3. For instance, if a matter was included in the engagement completion document, reviewed by the engagement quality reviewer, and communicated to the audit committee, it could appear to an experienced auditor having no previous connection to the audit, after also considering the factors in paragraph 9 of the proposed auditor reporting standard, that the matter met the definition of a critical audit matter. If the auditor determined that such a matter was not a critical audit matter, then the auditor would document the basis for the determination in the auditor's working papers with sufficient detail to explain the basis of the conclusions reached.

The auditor's documentation of critical audit matters under the proposed auditor reporting standard likely would result in additional recurring costs to the firm due to efforts expended in individual audits. These recurring costs likely would include additional time incurred to prepare documentation in sufficient detail to address the proposed requirements. This also might include additional review time incurred by others, such as senior members of the engagement team or the engagement quality reviewer.

## F. Other Considerations for Critical Audit Matters

Enhancing auditor reporting requirements necessarily will involve changes in practice, related cost implications and other challenges. Discussed below are potential economic considerations that might be relevant to auditors and companies, including audit committees. Also, discussed below are potential effects of disclosing information through the communication of a critical audit matter that otherwise would not be required to be disclosed under existing auditor or financial reporting standards, and liability considerations for auditors.

### *1. Effects of Additional Effort by Auditors and Companies, Including Audit Committees*

Based on its outreach to date, the Board anticipates that the communication of critical audit matters likely would have potential cost implications for auditors and companies, including their audit committees. Such costs would include those related to additional time to prepare and review auditors' reports.

*Auditors*

For auditors, costs might represent both one-time costs and recurring costs. The recurring costs for auditors regarding critical audit matters under the proposed auditor reporting standard have been discussed previously.[81] The one-time costs for auditors could be incurred as a result of (1) updating firm audit and quality control methodologies to reflect the new reporting requirements and (2) developing and conducting training of firm personnel on the new reporting requirements. When updating methodologies, some firms also likely would develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters in the draft auditor's report, which also would result in incremental one-time costs.

*Companies, Including Audit Committees*

Companies, including audit committees, could incur additional recurring costs as a result of the proposed auditor reporting standard. For instance, audit fees may increase due to the new reporting requirements in the Board's proposal. Additionally, companies might incur one-time costs in developing, and recurring costs in performing, internal processes for the review of critical audit matters in the draft auditor's report and the related interaction with auditors and others.

Audit committees might also incur additional time for the review of critical audit matters to be communicated in the auditor's report and related discussions with the auditor and management.

Companies, including audit committees, also could spend additional time comparing their auditor's report to the auditors' reports of similar companies. Even though comparability regarding the pass/fail model will continue to be maintained, the communication of critical audit matters in the auditor's report that is specific to the audit of the company's current period financial statements would make the auditor's report less comparable among companies.

The communication of critical audit matters would result in differences among auditors' reports. For instance, the communication of critical audit matters is intended to

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[81] See Sections V.B., *Determination of Critical Audit Matters;* V.D., *Communication in the Auditor's Report of Critical Audit Matters;* and V.E., *Documentation of Critical Audit Matters,* of this Appendix for discussion of recurring costs.

be tailored to the audit of the company; therefore, auditors' reports are not expected to be comparable from one auditor's report to the next. Such differences would relate to the auditor's determination of the matters that involved difficult judgments and difficulty in obtaining evidence or forming the opinion for a company based on that audit's particular facts and circumstances.

Company management and the audit committee might be concerned with the differences in auditors' reports because of investors' and other users' perceptions of the potential differences between the company's current period critical audit matters and those of prior periods or those of the company's competitors. However, investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or Management's Discussion & Analysis ("MD&A") that is specific to a company or a reporting period.

*2. Potential Effects of Disclosing Information that Otherwise Would Not be Required to be Disclosed*

The proposed auditor reporting standard would require the auditor to describe in the auditor's report the considerations that led the auditor to determine that the matter is a critical audit matter, in addition to identifying the matter and referencing the matter to the relevant financial statement accounts and disclosures, when applicable. The description of the considerations regarding the critical audit matter could include information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework.

For example, under the proposed auditor reporting standard, the auditor could determine that a matter met the definition of a critical audit matter because it involved the most difficult, subjective, or complex auditor judgments, and, therefore, would be communicated as a critical audit matter in the auditor's report. However, under existing auditor reporting standards or requirements of the applicable financial reporting framework, such matter would not otherwise be required to be disclosed. Examples of such occurrences that might result in the communication of a critical audit matter could include situations involving (1) a deficiency in internal control over financial reporting that was not otherwise determined to be a material weakness and therefore, not required to be disclosed by management or the auditor; (2) a difficult decision by the auditor regarding a company's ability to continue as a going concern even though the auditor's ultimate decision was that substantial doubt did not exist, and therefore, did not require reporting by the auditor; or (3) a loss contingency, for which there was significant difficulty in obtaining audit evidence but that ultimately was decided by management and the auditor to not warrant disclosure by the company in the financial statements under existing financial reporting standards.

Although the Board is not seeking to constrain the information the auditor would communicate for critical audit matters under its proposal,[82/] it is seeking comments on whether there are potential issues raised by the auditor's reporting of information to investors as a result of communicating critical audit matters that otherwise would not have required disclosure under existing auditor and financial reporting standards.

*3. Liability Considerations*

Some commenters expressed concern that changes to the auditor's reporting model could result in increased liability for auditors and issuers. Liability may be imposed on auditors and issuers (as well as other securities market participants) under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, as well as various state law causes of action. In discussing their concerns regarding potential liability, a number of commenters raised particular aspects of the Board's concept release that they viewed as troublesome from a liability perspective. For example, some commenters were critical of the auditor providing a supplement to the auditor's report containing an open-ended analysis or a discussion that could result in the auditor providing new information regarding the company, independent of the company's own disclosures in its financial statements. Further, other commenters, while recognizing potential liability concerns, suggested that the Board take a balanced approach in its rulemaking related to changes to the auditor's report.

In developing its proposal for communication of critical audit matters, the Board has sought a balanced approach that would promote more informative reporting about the audit (1) in a focused way and (2) that would not fundamentally change the auditor's current role of attesting on information prepared by management. Under the proposed auditor reporting standard, the auditor would be communicating information about the audit, based on audit procedures the auditor performed. The proposed auditor reporting

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[82/] However, the proposed auditor reporting standard would provide that auditors should not use language that can be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for critical audit matters or the opinion on the financial statements. See further discussion regarding language in the auditor's communication of critical audit matters in Section V.D., *Communication in the Auditor's Report of Critical Audit Matters,* of this Appendix.

standard regarding critical audit matters would be guided by criteria and factors, rather than a separate free-form analysis. However, the determination of critical audit matters and the nature and extent of the communication in the auditor's report would be guided by the auditor's judgment, and the Board is not seeking to constrain the information the auditor would communicate for critical audit matters.[83/] The auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements and is not intended to detract from, disclaim, or qualify the auditor's opinion.

The Board recognizes, however, that under its proposal, the auditor would be making new statements in the auditor's report that could raise potential liability concerns.

Questions Related to Section V:

10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?

11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?

12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?

13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?

14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?

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83/ Id.

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?

16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?

17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?

18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?

19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?

20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?

21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?

22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?

23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?

24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an

auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?

26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.

27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?

28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?

## VI. Explanatory Language (Paragraphs 15 – 16 of the Proposed Auditor Reporting Standard)

Under existing PCAOB standards certain circumstances require that the auditor add explanatory language (or an explanatory paragraph) to the auditor's report. The proposed auditor reporting standard references those circumstances. Additionally, the auditor may add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements.[84/] This type of explanatory paragraph is not required by the

[84/] AU sec. 508.19 describes these types of explanatory paragraphs as "emphasis of a matter paragraphs" or "emphasis paragraphs."

proposed auditor reporting standard or other PCAOB standards. Explanatory language is added to the auditor's report to provide information about the financial statements or the audit without affecting the auditor's opinion on the financial statements. This approach is retained from existing AU sec. 508.[85/]

## A. Explanatory Language Required by Other PCAOB Standards (Paragraph 15 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard, similar to existing AU sec. 508,[86/] provides a list of circumstances in which the auditor is required to add explanatory language to the auditor's report and provides references to other PCAOB standards in which these circumstances and related reporting requirements are described. In certain circumstances, the auditor might communicate this information in a separate paragraph, called an explanatory paragraph.

The circumstances under which the auditor is required to add an explanatory language would occur, for example, when there is substantial doubt about the company's ability to continue as a going concern,[87/] when the auditor's opinion is based in part on the report of another auditor and the auditor decides to refer to that report,[88/] or when there has been a material change between periods in accounting principles or in the method of their application.[89/] The list of circumstances that require explanatory language can serve as a single reference source for auditors regarding when explanatory language is required in the auditor's report.

The proposed requirement to communicate critical audit matters does not alter the existing requirements to add explanatory language. However, a matter that requires explanatory language, such as a restatement, also might be a matter that involved the most difficult judgments or posed the most difficulty to the auditor in forming the opinion. Therefore, the same matter – the restatement in this case – would require an explanatory paragraph in the auditor's report in accordance with Auditing Standard No.

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[85/] See existing AU secs. 508.11 and .19.

[86/] See existing AU sec. 508.11.

[87/] See AU sec. 341.

[88/] See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

[89/] See Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

6 and also would be communicated as a critical audit matter in accordance with the proposed auditor reporting standard. The auditor may include a cross-reference in the auditor's report as appropriate.

Further, recent academic literature finds that companies that receive unqualified audit reports containing explanatory language as described in AU sec. 508, such as a change between periods in accounting principles,[90/] are more likely to subsequently restate their financial statements.[91/] More specifically, the study states that audit reports with explanatory language could indicate a heightened risk of financial statement misstatement and that standard setters should be cautious to not require additional reporting without considering the potential of diluting information provided by currently required explanatory language in auditor reports.[92/] The proposed auditor reporting standard retains the provisions of AU sec. 508 with respect to explanatory language, such as a change between periods in accounting principles and stipulates that the communication of critical audit matters would be in addition to any explanatory language included in the auditor's report. Accordingly, the communication of critical audit matters is not intended to dilute the information that would be provided by the required explanatory language but would provide more information about the audit that might also be informative to investors and other financial statement users.

## B. Paragraphs to Emphasize a Matter Regarding the Financial Statements (Paragraph 16 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard retains from AU sec. 508 the ability for the auditor to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. Such explanatory paragraphs are currently used by auditors to emphasize (1) accounting matters, other than those involving a change in accounting principles, affecting the comparability of the financial statements and (2) other matters, such as the use of an accounting framework other than U.S. GAAP,

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[90/] Id.

[91/] See Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor 'Commentary' in Unqualified Audit Reports Reflect Financial Misstatement Risk?* Unpublished working paper (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245855.

[92/] Id.

litigation or regulatory matters, and certain fair value matters.[93/] Generally, an explanatory paragraph that emphasizes a matter in the financial statements points to a disclosure in the company's financial statements that discloses the matter without providing any further information.

Consistent with existing AU sec. 508, the proposed standard would not require the auditor to emphasize a matter but permits the auditor to add such explanatory paragraphs when the auditor determines that a matter presented or disclosed in the financial statements would be important to a user's understanding of the financial statements, such as a significant subsequent event.

The proposed requirement to communicate critical audit matters does not alter the auditor's ability to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. The auditor's communication of a critical audit matter may provide more information about the auditing aspect of the matter emphasized in the auditor's report.

Existing AU sec. 508 provides examples of matters the auditor may emphasize in the auditor's report.[94/] The proposed auditor reporting standard similarly provides a list of examples, which have been retained or enhanced from existing AU sec. 508, incorporates an additional example from the existing PCAOB standard,[95/] and adds new examples. While examples of potential matters that the auditor may emphasize in the auditor's report are provided in the proposed auditor reporting standard, the auditor also may decide to emphasize other matters in the financial statements if the auditor determines it is appropriate to do so.

<u>Questions Related to Section VI</u>:

29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?

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93/ In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 4.5% of the filings.

94/ <u>See</u> existing AU sec. 508.19.

95/ <u>See</u> paragraph .18 of AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410*.

30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?

31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?

32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?

## VII. Amendments to Other PCAOB Standards

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed auditor reporting standard. Appendix 3 contains the proposed amendments to existing PCAOB auditing standards related to the proposed auditor reporting standard. Significant amendments are described below.

### A. Amendments to Auditing Standard No. 5

Auditing Standard No. 5 establishes requirements and provides direction when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

The Board is proposing to amend the auditor's report on internal control over financial reporting to include the following amendments to conform to the proposed auditor unqualified report:

- Conform certain required elements of the auditor's report on the audit of internal control over financial reporting[96/] to the auditor's report on the audit of the financial statements; and

- Amend the example combined report.[97/]

The proposed amendments to the required elements of the auditor's report on the audit of internal control over financial reporting, as well as to the example combined report, would require:

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96/ See paragraph 85 of Auditing Standard No. 5.

97/ See paragraph 87 of Auditing Standard No. 5.

- The title, "Report of Independent Registered Public Accounting Firm" (this title is included in the example combined report in Auditing Standard No. 5; however, the existing requirement in Auditing Standard No. 5 only specifies that the title include the word "independent");

- Addressees that include, but are not necessarily limited to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;

- Name of the company whose internal control over financial reporting was audited;

- Statement that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB; and

- Statement containing the year the auditor began serving consecutively as the company's auditor.

Since the statements regarding the auditor's requirement to be independent and the auditor tenure are included as the proposed basic elements of the auditor's unqualified report, they also might be useful to the users of the auditor's report on the audit of internal control over financial reporting.

Additionally, the example combined report in Auditing Standard No. 5 would include a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements related to auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information. In addition, the proposed auditor reporting standard states that if the auditor performs an audit of internal control over financial reporting that is integrated with an audit of the financial statements and chooses to issue a combined report, the paragraph in the auditor's report describing the auditor's responsibilities regarding other information should be updated to indicate that the auditor audited both the financial statements and the company's internal control.

## B. Amendments to Auditing Standard No. 6

Auditing Standard No. 6 establishes requirements for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements and the effect of that evaluation on the auditor's report. Auditing Standard No. 6 requires the auditor to include explanatory language in the auditor's report to recognize a change in accounting principle or a correction of a material misstatement in previously issued financial statements if the change has a material effect on the financial statements.[98/] The related reporting requirements and illustrative paragraphs, however, are currently included in existing AU sec. 508.[99/]

The proposed auditor reporting standard would amend Auditing Standard No. 6 to include the reporting requirements and illustrative paragraphs from existing AU sec. 508.[100/] This change was made because, except for a few circumstances, the reporting requirements for explanatory language are contained in the respective standards requiring such reporting.

## C. Amendments to Auditing Standard No. 7

The proposed amendments to Auditing Standard No. 7 would require the engagement quality reviewer to evaluate whether appropriate critical audit matters are communicated in the auditor's report. The engagement quality reviewer's evaluation could be facilitated by the documentation requirement of the proposed auditor reporting standard. The proposed auditor reporting standard requires the audit documentation to include the determination of critical audit matters in accordance with Auditing Standard No. 3, which would require the auditor's documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

Auditing Standard No. 7 currently requires the engagement quality reviewer in an audit engagement "to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report."[101/] Therefore, the engagement

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98/ See paragraphs 5-10 of Auditing Standard No. 6.

99/ See existing AU secs. 508.17A through .18C.

100/ See existing AU secs. 508.17B-.17D and .18A-.18B and the proposed amendments to paragraphs 12 through 17 of Auditing Standard No. 6. In previous PCAOB standard-setting projects, the substance of current AU sec. 508.17A has been repeated in existing paragraphs 7 and 8 of Auditing Standard No. 6 and the substance of current AU sec. 508.18C has been placed in existing paragraph 10 of Auditing Standard No. 6. Therefore, the Board is proposing to supersede AU secs. 508.17A and .18C without corresponding changes to Auditing Standard No. 6.

101/ See paragraph 9 of Auditing Standard No. 7.

quality reviewer is likely to discuss the matters determined to be critical audit matters with the engagement team. The proposed amendment would require the engagement quality reviewer to evaluate the engagement team's compliance with the requirements of the proposed auditor reporting standard regarding the auditor's communication of the critical audit matters.

**D. Amendments to Auditing Standard No. 16**

Auditing Standard No. 16 requires auditors to communicate certain significant audit and financial statement matters to the audit committee. Among other things, Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee matters related to departures from the auditor's unqualified report. Under the Board's existing standard, the auditor is required to communicate certain information when the auditor expects to (1) modify the opinion in the auditor's report and (2) include explanatory language or an explanatory paragraph in the auditor's report.[102/]

The proposed amendments to Auditing Standard No. 16 would delete the existing communication requirement regarding the auditor's report and would replace it with a requirement to provide to and discuss with the audit committee a draft of the auditor's report. Providing and discussing a draft of the report would inform the audit committee about the language in the audit report for tenure, critical audit matters, explanatory language (or explanatory paragraphs), and departures from an unqualified report. The proposed amendment to Auditing Standard No. 16, however, would not preclude the auditor from communicating with the audit committee any changes to the auditor's report prior to the preparation of the draft auditor's report.

**E. Amendment to AU sec. 336**

The proposed amendment to AU sec. 336, *Using the Work of a Specialist*, would enable the auditor to reference the use of a specialist in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter. Currently, existing AU sec. 336 states that the auditor should not refer to the work or findings of a specialist, except for situations in which the auditor decides to add explanatory language to his or her report or depart from an unqualified opinion.[103/] The proposed amendment is intended to explain that the auditor is not precluded from

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[102/] See paragraph 21 of Auditing Standard No. 16.

[103/] AU secs 336.15-.16.

referencing the specialist if the reference is related to a critical audit matter. Because of the statement in the auditor's report that communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole, the auditor's reference to the use of specialists should not be misunderstood as a qualification of the auditor's opinion or a division of responsibility.

## F. Amendments to Existing AU sec. 508

The proposed auditor reporting standard would supersede portions of existing AU sec. 508 that primarily relate to an unqualified opinion.[104/] The remaining portions of existing AU sec. 508 primarily address departures from the auditor's unqualified report, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion. Accordingly, existing AU sec. 508 would be retitled from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances."

The proposed amendments to the remaining portions of AU sec. 508 are not intended to change the substance of the remaining provisions of AU sec. 508. The proposed amendments would primarily consist of (1) requiring the communication of critical audit matters in certain circumstances; (2) revising certain terminology to align with the proposed auditor reporting standard; and (3) amending the illustrative reports. Further updating and revision may be required to existing AU sec. 508, as amended by this proposal, which would be considered by the Board in a separate standard-setting project.

The proposed amendments to AU sec. 508 include:

### *1. Communication of Critical Audit Matters in Opinions Other Than Unqualified*

*Qualified Opinion*

A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with generally accepted accounting principles.[105/] Existing AU sec. 508 requires that when the auditor expresses a qualified opinion, he or she discloses all of the substantive reasons in a separate paragraph.

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[104/] AU secs. 508.01-.09 and .11-.19 would be superseded.

[105/] See AU sec. 508.20.

The proposed amendments would require that when the auditor expresses a qualified opinion, the auditor's report also include, among other things, communication of critical audit matters. The Board would expect in most circumstances that the reason for the qualification of the auditor's report would also give rise to a critical audit matter. In that case, the auditor may include a cross-reference in the auditor's report as appropriate. However, in such an audit, there may be other matters meeting the criteria of a critical audit matter; therefore, requiring the communication of critical audit matters would be considered appropriate.

*Adverse Opinion*

An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.[106/] The existing requirements related to an adverse opinion were not amended to require the auditor to communicate critical audit matters. If the financial statements are not presented fairly, existing AU sec. 508 requires the auditor to explain the auditor's reason for the adverse opinion. Requiring the auditor to communicate additional critical audit matters was not considered necessary because the most important matter to investors and other financial statement users would be the reason for the adverse opinion.

*Disclaimer of Opinion*

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.[107/] The existing requirements related to a disclaimer of an opinion were not amended to require the auditor to communicate critical audit matters because the auditor is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements. Because the auditor is not able to complete the audit and form an opinion on the financial statements, the auditor would not be able to determine the matters that involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty in obtaining sufficient appropriate audit evidence, or posed the most difficulty in forming the opinion on the financial statements.

*2. The Term "Explanatory Paragraph"*

Existing AU sec. 508 includes references to the term "explanatory paragraph" that describe the auditor's responsibility to provide the reason for a departure from an

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106/ See AU sec. 508.58.

107/ See AU sec. 508.61.

unqualified opinion. This term would be amended to "basis for departure from unqualified opinion paragraph" to differentiate this paragraph from an explanatory paragraph, as described in the proposed auditor reporting standard.

*3. Illustrative Reports*

Existing AU sec. 508 includes illustrative reports related to qualified opinions, adverse opinions, and disclaimers of an opinion. These reports would be amended to reflect the proposed basic elements of the auditor's unqualified report, as applicable in the particular reporting circumstances.

## G. Amendments to AU sec. 623

AU sec. 623, *Special Reports*, includes the reporting requirements for various types of special reports, such as reports on specified elements, accounts, or items of a financial statement. Since many of these reports are not required to be filed with the SEC, the Board did not amend the illustrative reports included in AU sec. 623. However, a note is proposed to be added to AU sec. 623 indicating that if any of the reports are to be filed with the SEC, the auditor would include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-14, respectively, of the proposed auditor reporting standard. For qualified, adverse, and disclaimer of opinion reports, AU sec. 623 also would be amended to include a reference to the requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

## H. Other Amendments

The proposed amendments to other PCAOB standards primarily relate to:

- Updating references as a result of auditing standards that are being amended or superseded. For example, for references in the auditing standards to AU sec. 508, the proposed amendment would change the title from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances;"

- Updating illustrative reports for the basic elements of the proposed auditor reporting standard for the reports that are filed with the SEC. For example, updating the example report in AU sec. 543 that illustrates appropriate reporting by the principal auditor indicating the division of responsibility when the auditor makes reference to the audit of the other auditor; and

- Updating AU sec. 722, *Interim Financial Information*, for the basic elements of the proposed auditor reporting standard.

Questions Related to Section VII:

33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?

34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.

## VIII. Considerations Related to Audits of Specific Entities

The Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to the audits of specific entities, including brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans.

### A. Brokers and Dealers

*1. Background Information*

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,[108/] the proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements.[109/] All of the statements contained in the annual audited financial statements of the broker or dealer are public, except that if the statement of financial condition is bound separately from the balance of the annual audited financial statements, the balance of the annual

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108/ See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

109/ See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

audited financial statements is deemed confidential and thus available for use only by the SEC and others to whom the SEC gives authorization.[110/] Therefore, in situations in which the broker or dealer binds separately the statement of financial condition from the balance of the annual audited financial statements, the auditor generally would issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete audited financial statements that, along with the audited financial statements, would be confidential and not available to the public.[111/]

There were approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012.[112/] Based on research conducted by the PCAOB's Office of Research and Analysis ("ORA"), approximately 45% of these brokers and dealers filed a statement of financial condition that was bound separately from the balance of the annual audited financial statements. For those brokers and dealers, only the statement of financial condition, with the related auditor's report, is publicly available, while the complete annual audited financial statements, with the related auditor's report, are confidential. For the remaining 55% of the population of brokers and dealers, the complete annual audited financial statements and the related auditor's report are publicly available.[113/]

ORA's research also indicates that there are no issuers among the approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 9% of the 4,230 brokers and dealers are subsidiaries of issuers. The remainder are not owned by issuers.

According to ORA's research, for the population of brokers and dealers that are not subsidiaries of issuers (1) approximately 90% are directly owned by an individual or an entity that owns more than 50% of the broker or dealer and (2) approximately 75% have five or fewer direct owners. A review of the title or status of the brokers' or dealers'

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110/ See SEC Rule 17a-5(e).

111/ See also SEC Rule 17a-5(c)(2) regarding audited statements required to be provided to customers.

112/ This information is based on the number of brokers and dealers that filed annual audited financial statements with the SEC through May 1, 2013 for fiscal periods ended during 2012.

113/ ORA obtained information from the SEC's EDGAR database on brokers and dealers that filed public and confidential annual audit reports with the SEC.

direct owners who are individuals suggests that these owners are generally part of the broker's or dealer's management.

In summary, ORA's research indicates that ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team.

*2. Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. Other commenters thought that certain changes, for example clarifications to language in the auditor's report, may be applicable to auditors' reports for brokers and dealers, but other changes to the auditor's report should not apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

**B. Investment Companies**

*1. Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of investment companies. The Investment Company Act of 1940 ("Investment Company Act") generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[114/] Investment companies registered with the SEC under the Investment Company Act are required to file with the SEC, on Form N-CSR, annual reports containing audited financial statements.[115/]

[114/] See Section 3(a)(1) of the Investment Company Act.

[115/] See SEC Rules under Section 30(e) of the Investment Company Act.

An investment company (1) is generally organized by an outside "sponsor" (also known as promoter[116/]), such as a bank or an insurance company and (2) has an investment adviser,[117/]which manages the investment company's portfolio securities for a fee. A sponsor might register many investment companies that generally would have the same or related investment advisers. Such investment companies are referred to as affiliated. Annual shareholder reports of affiliated investment companies that have the same fiscal year-end might be filed with the SEC in one Form N-CSR. This document generally contains a single auditor's report that refers to the financial statements of each audited investment company. The financial statements of the affiliated investment companies might contain some disclosures that would be similar across the affiliated investment companies, such as the management fee arrangements, because of the common investment adviser. Other disclosures might be different, such as disclosures related to the use of derivatives, because of the different investment strategies of each investment company.

Investment companies can also be part of master-feeder or fund of funds capital structures.[118/] In master-feeder structures, feeder investment companies invest all their assets in another investment company, known as the master fund, and own proportionate shares of the net assets of the master fund. Master-feeder accounting involves allocating the master's income, expenses, and realized and unrealized gains and losses among the feeder funds. Additionally, accounting policies of the master fund, such as valuation of investments of the master fund, may affect the feeder funds. A master and feeder fund may not be affiliated, may have different auditors, and different fiscal year ends. As described in SEC staff guidance, the annual report of each feeder fund generally contains the financial statements of both the master and the feeder fund.[119/]

Funds of funds are investment companies that invest in other investment companies. A fund of funds' structure is similar to that of a master-feeder, except that it

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116/ See Section 2(a)(30) of the Investment Company Act.

117/ See Section 2(a)(20) of the Investment Company Act.

118/ See Section 12(d)(1) of the Investment Company Act, which describes investment companies involved in such structures as acquiring company and acquired company.

119/ See SEC "Dear CFO" letters at http://www.sec.gov/divisions/investment/noaction/1997/cfo110797.pdf and http://www.sec.gov/divisions/investment/noaction/1995/accountingcomment110295.pdf.

generally invests its assets in more than one other fund. Because of certain limitations under the Investment Company Act,[120/] an issuer fund of funds and the investee funds are often affiliated, but may have different auditors and fiscal year ends.

In January 2009, the SEC adopted amendments to Form N-1A that require every open-end management investment company prospectus to include a summary section consisting of key information about the investment company.[121/] The SEC described these amendments as intended to help investors to access key information that is important to an informed investment decision.[122/] In describing the rationale for the adopted amendments, the SEC stated that there was consensus among roundtable participants and other commenters that the key information that investors need to make an investment decision about an investment company includes information about the investment company's investment objectives and strategies, risks, costs, and performance.[123/] The investment company's costs and performance calculations are subject to audit and are included in the financial highlights, which are referred to in the auditor's report.

*2. Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of investment companies. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of investment companies from a small number of commenters. Those commenters generally expressed the view that additional auditor reporting should not apply to audits of investment companies. These commenters viewed investment companies' financial

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[120/] See Section 12(d)(1) of the Investment Company Act.

[121/] See SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies,* Securities Act Release No. 8998 (Jan. 13, 2009), at 7.

[122/] See SEC Release No. 8998, at 14-15.

[123/] See SEC Release No. 8998, at 9-11. See also ICI, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006), at 2-3, available at http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

statements as inherently less complex than operating companies' financial statements and argued that the limited nature of an investment company's operations entails fewer estimates and judgments.

## C. Employee Stock Purchase, Savings, and Similar Plans

### *1. Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of employee stock purchase, savings, and similar plans ("benefit plans"). Benefits plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[124/] that includes the benefit plan's audited financial statements and the related auditor's report.[125/] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[126/]

In general, the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits. Defined-contribution benefit plan participants do not invest directly in a benefit plan; rather they select their investments outside of the benefit plan, with the plan holding the investments as its assets.

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[124/] See Section 15(d) of 1934 Act.

[125/] A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. See SEC Rule 15d-21, C.F.R §240.15d-21.

[126/] See FASB ASC 960-10-05-6. Benefit plans subject to ERISA also file with the DOL an annual report on form 5500, including audited financial statements and an auditor's report. Pursuant to DOL requirements, the audit of the financial statements is performed under auditing standards generally accepted in the U.S., that is, not under PCAOB standards. ERISA-related information is available at the DOL website at http://www.dol.gov/compliance/laws/comp-erisa.htm#applicable_laws.

*2. Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of benefit plans from a small number of commenters. One commenter thought the Board should proceed with caution regarding employee benefit plans that file a Form 11-K. Another commenter said that users of pension plans' financial statements are not requesting or in need of an expanded auditor reporting model.

<u>Questions Related to Section VIII</u>:

35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?

36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?

37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?

38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?

39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?

40. Should audits of certain companies[127/] be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?

## IX. Considerations Related to Effective Date

The proposed auditor reporting standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposal as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed auditor reporting standard, such as for the audits of smaller companies.

Questions Related to Section X:

41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?

42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

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127/ See Appendix 7 for a discussion on costs and other considerations related to EGCs.

## Exhibit – Illustrative Examples of Critical Audit Matters

This Exhibit contains three illustrative examples of communications of critical audit matters in an auditor's report. Each of the three illustrative examples contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.

All three examples are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

### A. Hypothetical Auditing Scenario #1 – Allowance for Sales Returns

#### *1. Background*

In the year ended January 31, 2013 ("fiscal 2013"), an established brick-and-mortar retail company ABC Retailer ("ABC" or the "Company") implements a strategic decision to expand its product offerings concurrent with developing a significant on-line sales channel. Simultaneously, it lengthens its existing 30-day sales returns policy to 60 days. This change in returns policy, along with the expanded product offerings and new on-line presence, are announced in a fiscal 2013 advertising campaign.

ABC's management projects a significant increase in sales and an increase in returns in fiscal 2013 as a result of these changes. The Company designs and implements new or enhanced procedures, processes, and systems during fiscal 2013 to address the product expansion, the on-line distribution channel, and the expected increase in customer returns.

ABC has significant historical experience to estimate sales allowances based on its traditional products and sales channel. Because of the strategic changes and longer sales return period, management performs an in-depth analysis of how changes in product mix, customer demographics, and the use of on-line "stores" to sell merchandise are likely to affect historical experience in sales returns. Management uses industry data and other sources, including the results of its own market research, to perform this analysis. Management also implements new systems to improve the identification, processing, and tracking of sales returns and develops a statistical model to estimate future returns. The statistical model relies on a number of inputs and assumptions derived from the sales return tracking system. As a result, management believes its historical experience in combination with the new systems and statistical model allow management to make reasonable estimates of sales returns for fiscal 2013.

During fiscal 2013, ABC's management decides to significantly lengthen the 60-day returns policy without publicly announcing a change to the stated policy. In response to on-line customer complaints about the Company's returns policy in the past, full refunds are given "no questions asked" for returns within 90 days and in specific circumstances for returns within 120 days. To reflect the lengthened sales returns policy, management makes adjustments to the sales returns allowance determined by the statistical model. These adjustments are partly based on data generated by the sales returns tracking system and partly based on management's judgment about how recent sales activity and other factors such as seasonality, recent promotions, and the nature and frequency of customer complaints are affecting ABC's application of its stated sales returns policy. Disclosure of management's actions regarding its sales returns policy was made in the MD&A.

*2. Excerpts From the Company's Notes to the Financial Statements*[128/]

***Note 1: Accounting Policies***

***Revenue Recognition***

We recognize revenue when the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the selling price is fixed or determinable; and collectability is reasonably assured. For sales made at our retail stores, we generally recognize revenue at the time of a sale to a customer. For sales made through our website, we generally recognize revenue at the time the merchandise is shipped to a customer. As part of our customer service strategy, we offer customers the right to return undamaged merchandise for a full refund if they are not satisfied with their purchase. We record an allowance for estimated returns as a reduction of gross revenues and cost of goods sold, and as an accrued current liability based on historical experience and trends. If we are unable to make reasonable estimates of future returns, revenue is deferred until the return period expires. In fiscal 2011, 2012, and 2013, no revenues were deferred due to an inability to make reasonable estimates of future returns.

Beginning in fiscal 2013, we use a statistical model that utilizes our historical experience to estimate future returns. Inputs and assumptions to our model include, among other factors: historical experience based on sales of similar products; the

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[128/] Only financial statement information relating to the disclosure and determination of the revenue recognition relative to the allowance for sales returns is presented. Other required notes to the financial statements have been omitted from this example.

relative risk of returns based on the nature of the product, such as susceptibility to changes in technology or changes in demand due to new product introductions; historical data related to the effect that special promotions and/or seasonality has on returns; and the relative risk of returns based on the selling price of the merchandise and the sales channel that the customer used to make a purchase. We also incorporate expected changes, if any, in our returns policies and practices as well as changes in economic and buying trends that might impact customer demand and behavior. If actual returns are not consistent with our estimates, we factor the new information into our statistical model and adjust our previous estimate in the period new information becomes available.

*3. Determination of the Critical Audit Matter*

The auditor determined that the evaluation of the allowance for sales returns is a critical audit matter in the audit of ABC's fiscal 2013 financial statements.

Specific considerations, which led the auditor to determine that the auditor's evaluation of the allowance for sales returns is a critical audit matter, included:

- Extensive changes to the Company's business strategy, including changes to the Company's distribution channel through the use of on-line "stores" to sell merchandise;

- Significant lengthening of the Company's sales return policy (from 30 to 60 days) and flexible application of it (90 – 120 days);

- The development of a new statistical model to estimate future sales returns, which included management adjustments to the statistical model to reflect the flexible application of the sales return policy;

- Significant increase in the Company's expected sales returns;

- The extensive amount of consultation with the audit firm's national office regarding the design of appropriate audit procedures, evaluation of the results of those procedures, and assessment of compliance with U.S. GAAP relative to the audit of the allowance for sales returns;

- The significant difficulty in obtaining sufficient appropriate audit evidence to support management's subjective adjustments to the allowance computed by the statistical model; and

- The complexity and difficulty of evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

We determined that our evaluation of the Company's allowance for sales returns was a critical audit matter in the audit of the Company's financial statements as of and for the fiscal year ended January 31, 2013. The Company developed a new on-line sales channel. This new sales channel could have significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy. The Company developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, a key element in recording revenue. The lack of historical experience with the new assumptions resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns.

Because of these changes in the Company's distribution channel and sales return policy, our audit of the Company's allowance for sales returns (1) involved our difficult and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns and (2) posed difficulty to us in obtaining sufficient appropriate evidence to support management's adjustments to the allowance for sales returns. We consulted with our national office on (1) the design and performance of audit procedures to test the data underlying management's assumptions used to estimate future sales returns and (2) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments regarding the effect that changes in the Company's return policies and practices, as well as changes in economic and buying trends that affect customer behavior, have on the estimate of future sales returns. The Company's accounting policy for sales returns is discussed in Note 1 to the financial statements.

## B. Hypothetical Auditing Scenario #2 – Valuation Allowance for Deferred Tax Assets

### *1. Background*

As of the year ended June 30, 2013 ("fiscal 2013"), XYZ Technology Company ("XYZ" or the "Company") has been in business for 10 years. In its first three years, as its "first generation" products were being developed and commercialized, the Company incurred losses for both financial reporting and federal income tax purposes. For income tax purposes, the losses are carried forward and subsequently utilized to reduce federal income taxes that otherwise would have been payable. By its sixth year of operations, XYZ is profitable for tax purposes, has no remaining net operating loss carryforwards, and has repaid its borrowings. Cash flows from operations are strong.

By fiscal 2010 (its seventh year of operations), competition begins to erode the Company's market share. XYZ reports breakeven results for financial reporting purposes and a small loss for income tax purposes in fiscal 2010. The loss is carried back for income tax purposes. The Company returns to profitability in fiscal 2011 by carefully controlling costs and by offering some "add-ons" to its "first generation" products that boost revenues.

During fiscal 2012 (its ninth year of operations), XYZ raises equity capital to provide additional liquidity for its ongoing development of "next generation" products (targeted to be introduced in fiscal 2014-2015). Due to the significant increase in development costs combined with continuing pressure on sales prices and unexpected cost increases in a critical component, XYZ reports a loss for both financial reporting and federal income tax purposes in fiscal 2012. A portion of the loss in fiscal 2012 creates a net operating loss carryforward. The Company's cash position remains strong.

During the year ended June 30, 2013, XYZ recalls one of its products due to a defect in a component supplied by a third party. Although the supplier is contractually obligated to reimburse the Company for the costs to recall and repair the defective products, the supplier disputes the role its component played in the product failure that led to the recall. Product development and marketing costs increase in preparation for the targeted 2014-2015 introduction of the "next generation" products. Additionally, costs are incurred (1) to exit certain unprofitable, peripheral product lines that are no longer consistent with XYZ's strategy and (2) to relocate its corporate office. The Company is able to somewhat mitigate the fiscal 2012 cost increase in a critical component but does not expect the cost of the component to return to historic levels in the near term.

As a result of these various circumstances, the Company incurs a significant pre-tax loss in the year ended June 30, 2013, for both financial reporting and federal income tax purposes. In combination with other book-tax differences and the net operating loss carryforward from fiscal 2012, XYZ reports net deferred tax assets as of June 30, 2013.

As required by U.S. GAAP, management evaluates whether the recorded amount of deferred tax assets as of June 30, 2013 is realizable. In evaluating the need for a valuation allowance, management evaluates both negative and positive evidence to determine whether it is more likely than not that its deferred tax assets will be realized. From management's perspective, negative evidence includes losses in 2013 and 2012. However, management determined that it has not incurred cumulative losses in recent years[129/] when evaluated over a three-year time frame.[130/] Management's positive evidence includes the Company's historical ability to utilize operating loss carryforwards, a 15-year carryforward period, and a forecast of increased revenues and profits in the next three years. That forecast includes the following expectations: (1) favorable settlement with the supplier related to the recall; (2) elimination of certain unprofitable, peripheral product lines; (3) decline in the level of product development spending; and (4) commercialization of the "next generation" products.

Management also considers that some of the current year loss is the result of the product recall, the exiting of certain product lines, and the relocation of the corporate office, events that are not expected to recur in the future. Further, management considers XYZ's strong cash position. Lastly, management does not identify any qualifying tax-planning strategies. Based on the weight of all available evidence, both positive and negative, management concludes that no valuation allowance is required.

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[129/] See FASB ASC paragraph 740-10-30-16 through 30-24, *Income Taxes – Overall – Initial Measurement – Establishment of a Valuation Allowance for Deferred Tax Assets*, for the accounting requirements of a valuation allowance for deferred income tax assets including discussion regarding "cumulative losses in recent years."

[130/] ASC Topic 740-10-30-23 indicates that "[a]n entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome."

2. *Excerpts From the Company's Notes to the Financial Statements*[131]

***Note 2: Accounting Policies***

**Income Taxes**

We account for income taxes under the asset and liability method. Deferred taxes are determined based on the temporary differences between the financial statement and tax basis of existing assets and liabilities using tax rates that under current tax law would be in effect in the years in which the differences are expected to reverse. The effect of a change in tax rates on deferred taxes is recognized in the period that includes the enactment date.

We make judgments regarding the realizability of our deferred tax assets. We consider our deferred tax assets to be realizable when we believe it is more likely than not that we will generate sufficient future taxable income to realize our deferred tax assets after consideration of all available evidence. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe more than 50 percent likely to be realized. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including the expected timing of reversals of existing temporary differences, projected future taxable income, tax planning strategies, and recent financial performance. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is generally a significant piece of negative evidence that is difficult to overcome in determining that a valuation allowance is not needed.

***Note 12: Income Taxes***

As of June 30, 2013, our deferred tax asset of $XXX million related to federal net operating loss carryforwards will expire in approximately 14 to 15 years if not utilized. The determination of whether it is more than 50 percent likely that we will realize the full benefit of all our deferred tax assets, including the deferred tax asset related to the net operating loss carryforwards, requires significant judgment. That judgment includes evaluation of negative evidence, such as recent losses, and positive evidence, including projections of future taxable income during the carryforward period. As required by the accounting literature, more weight is given to objective evidence. Negative objective

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[131] Only financial statement information relating to the disclosure and determination of deferred tax assets is presented. Other required notes to the financial statements have been omitted from this example.

evidence includes our losses in 2013 and 2012. However, we do not have cumulative losses in recent years when evaluated over a three-year time frame. Positive objective evidence that we considered in making our judgment included: (1) the effect of eliminating certain product lines and (2) the expectation that product recall costs and relocation costs will not recur in the future. Projections of future taxable income are subject to uncertainty due to various factors, including the general economic environment, industry and competitive conditions, timing of product enhancements and new product introductions, and the length of time of the projections included in the analyses. If our actual results are less favorable than current estimates and we revise our projections downward in future analyses, a valuation allowance may be required with a corresponding adjustment to earnings in the period in which such determination is made. As of June 30, 2013, based upon our estimates, we believe it is more likely than not that the Company will realize the full benefit of the existing deferred tax assets.

*3. Determination of the Critical Audit Matter*

The auditor determined that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter.

Specific considerations, which led the auditor to determine that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter, included:

- The auditor's prior experience with management's forecasts of future revenues and costs, which indicated that actual revenues and income typically differed from forecasted amounts;

- The subjectivity involved in evaluating whether the weight of the Company's positive evidence is sufficient to overcome the negative evidence;

- The extensive amount of consultations with the firm's National Office regarding: (a) the design and evaluation of the results of its audit procedures related to management's forecasts of improved profitability; (b) the appropriate application of the criteria under U.S. GAAP for recording a valuation allowance; (c) the assessment of management's judgments regarding the identification and evaluation of negative and positive evidence; and (d) the adequacy of XYZ's disclosure regarding risks and uncertainties that could significantly affect deferred tax assets in the near term; and

- High degree of difficulty auditing management's forecast of future revenues and income due to significant difficulty in obtaining objective evidence to support management's key judgments about (1) the timing, demand and pricing of "next generation" products, (2) the ongoing demand for (and the life cycle of) existing products, (3) the level of future development spending, (4) the amount of marketing costs associated with the commercialization of new products, (5) the outcome of the supplier dispute regarding recall costs, and (6) future cost increases or decreases in the cost of critical components.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

We determined that our assessment of the Company's evaluation of the realizability of deferred tax assets was a critical audit matter in the audit of the Company's financial statements for the fiscal year ended June 30, 2013. Considerations that led to our determination, included the following:

- The Company exercised significant judgment in weighing positive and negative evidence regarding the realizability of the company's deferred tax assets, including in developing forecasts of projected future taxable income.

- The Company continues to experience increased competition with its "first generation" products which reduced revenue growth, sales prices and profitability. Further, the Company experienced an unexpected cost increase in a critical product component and does not anticipate that cost returning to historical levels;

- A return to profitability by the Company is dependent upon launching "next generation" products in the future; and

- The Company is experiencing increases in product development and marketing costs in preparation for its "next generation" products.

Because of these considerations, our assessment of the Company's evaluation of the realizability of deferred tax assets: (1) involved subjective auditor judgments in evaluating whether management's judgments regarding the weight given to positive and negative evidence is appropriate; (2) involved difficult auditor judgments in designing audit procedures to test the data underlying management's forecasts of its future taxable income; (3) posed difficulty in obtaining sufficient appropriate evidence to support management's forecasts of the timing and amount of future taxable income due to the lack of objective evidence; and (4) posed difficulty in forming an opinion on the financial statements because of the significance to the financial statements, taken as a whole, of the Company's determination regarding the recognition of a valuation allowance for its deferred tax assets.

We consulted with others outside the engagement team regarding: (1) compliance with U.S. GAAP; (2) the design and performance of audit procedures to test management's forecasts; and (3) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments and forecasts in light of independent assessments of future trends in the industry, analyst reports and publicly available information regarding relevant trends by key competitors. The Company's accounting policy for deferred taxes and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial statements.

## C. Hypothetical Auditing Scenario #3 – Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded

### *1. Background*

JLE Financial Institution ("JLE" or the "Company") holds fixed maturity securities in its investment portfolio. As of December 31, 2012 ("fiscal 2012"), the Company's investment portfolio includes U.S. corporate and state and local government securities. In addition, approximately 35% of the portfolio consists of private label mortgage-backed securities and collateralized loan obligations, which have very little or no trading activity. All of these securities are classified as "available for sale" and reported at fair value in the Company's statement of financial position under U.S. GAAP.

In measuring the fair value of available for sale securities, the Company utilizes third party pricing services for its U.S. corporate and state and local government securities. JLE's process requires that it obtain an understanding of the pricing service's valuation techniques, assumptions, and other inputs important to the fair value estimate. Further, JLE has controls over information received from third party pricing services.

The process to determine the fair value of the Company's private label mortgage-backed securities and collateralized loan obligations valued primarily using in-house valuation models involves a significant amount of judgment, in large part because of the inherent imprecision in measuring the fair value of securities for which observable market prices are not available and the subjective nature of some of the inputs to the valuation model. In testing JLE's controls related to fair value estimates determined by in-house valuation models the auditor noted a control deficiency less severe than a material weakness relating to the controls employed by the pricing and valuation committee. As a result of the control deficiency, the auditor expanded the planned audit procedures for securities for which the control applied. In performing additional audit procedures on the population of securities for which the control applied, the auditor identified several misstatements due to JLE's recorded amounts falling outside of the range of reasonable estimates developed by the auditor's specialist.

*2. Excerpts From the Company's Notes to the Financial Statements*[132/]

***Note 6: Fair Value***

**Recurring Fair Value Measurements**

When observable inputs are not available, JLE's valuation methodologies rely on inputs that are significant to the estimated fair value that are not observable in the market or cannot be derived principally from, or corroborated by, observable market data. These unobservable inputs can be based in large part on management's judgment or estimation and cannot be supported by reference to recent market activity. Even though these inputs are unobservable, management believes they are consistent with what other market participants would use when pricing such securities and are considered appropriate given the circumstances. Securities that are valued using significant unobservable inputs or assumptions are classified as Level 3 in the fair value hierarchy.

While JLE believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. During fiscal 2012, there were no changes to the valuation techniques that had a material impact on the Company's consolidated financial position or results of operations.

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[132/] Only financial statement information relating to the disclosure and determination of the fair value of Level 3 fixed maturity investment securities is presented. Other required notes to the financial statements have been omitted from this example.

*U.S. corporate securities*

Valuations are based primarily on matrix pricing or other similar techniques that utilize observable inputs that are derived from, or corroborated by, observable market data, including quoted prices for identical or similar securities. In other cases, valuation is based primarily on quoted prices for identical or similar securities.

*State and local government securities*

These securities are principally valued using the market approach. Valuation is based primarily on matrix pricing using market observable inputs, including benchmark U.S. Treasury yields or other yields, issuer ratings, broker-dealer quotes, credit spreads and reported trades of similar securities.

*Private label mortgage-backed securities and collateralized loan obligations*

Valuation is based on in-house valuation models, discounted cash flow methodologies, or other techniques that utilize inputs that cannot be derived from, or corroborated by, currently observable data, including credit spreads that reflect specific credit-related issues. The pricing and valuation committee review the inputs used for each security for which the fair value is determined based on in-house valuation models.

*3. Determination of the Critical Audit Matter*

The auditor determined that the evaluation of management's fair value estimates of private label mortgage-backed securities and collateralized loan obligations measured using valuation models, is a critical audit matter.

Specific considerations, which led the auditor to determine that evaluation of management's fair value estimates of these securities, measured using valuation models, is a critical audit matter, included:

- The materiality of the private label mortgage-backed securities and collateralized loan obligations;

- The valuation techniques used to estimate the fair value of these securities which were based primarily on in-house models to estimate fair value;

- The control deficiency relating to the review by the pricing and valuation committee;

- The highly subjective nature of the judgments involved regarding unobservable inputs to the fair value measurements for these securities;

- The extensive amount of audit work required to obtain sufficient appropriate evidence to form a conclusion, including significant involvement of senior members of the engagement team;

- The use by the auditor of the work of a third party specialist with expertise in the valuation of complex financial instruments to develop independent estimates of fair value for corroborative purposes;

- The auditor's expansion of the planned audit procedures relating to the valuation of the mortgage-backed securities and collateralized loan portfolio as a result of contradictory evidence obtained from those audit procedures; and

- The auditor's proposed adjustments to the valuation of the mortgage-backed securities and collateralized loan obligations.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. Our audit of the Company's fair value of these securities in the audit of the Company's financial statements as of and for the fiscal year ended December 31, 2012 involved difficult and complex auditor judgments because these securities (1) trade less frequently and (2) were valued using in-house valuation models based on unobservable inputs, which are subject to a wide range of measurement uncertainty. Our audit of these securities required an extensive amount of audit work, including significant involvement of senior members of the engagement team and the involvement of a third party valuation specialist. Further, it was necessary to expand the planned audit procedures due to a control deficiency less severe than a material weakness noted in the Company's internal control system regarding fair value estimates, valued using in-house valuation models. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee. Our audit procedures resulted in our identification of several misstatements that were corrected by the Company. The Company's disclosures related to nature and fair values of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.

## APPENDIX 6

### *Additional Discussion of the Proposed Other Information Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release*

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), presented in Appendix 2, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments") presented in Appendix 4. This Appendix collectively refers to the proposed other information standard and proposed amendments as the "proposed other information standard and amendments." The proposed other information standard would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* and AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

Following the Board's initial outreach from October 2010 through March 2011,[1/] the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").[2/] Additionally, the Board held a public roundtable[3/] on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")[4/] and Standing

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[1/] See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

[2/] *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011-003 (June 21, 2011) is available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

[3/] A transcript of the public roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[4/] IAG meeting details and webcasts for March 2011 and 2012 are available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx and http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx.

Advisory Group ("SAG") meetings.[5/] Some commenters supported changes to the auditor's report that describe the auditor's existing responsibility related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report.

This Appendix discusses significant comments received during the Board's outreach regarding other information in documents containing audited financial statements and the auditor's report. It also provides additional background information regarding the requirements in the proposed other information standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, the Board is seeking comment on economic considerations related to the proposed other information standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed other information standard and amendments to the audits of brokers and dealers. Considerations related to the applicability of the proposed other information standard and amendments to audits of emerging growth companies are discussed in Appendix 7.

The following sections describe the requirements in the proposed other information standard and amendments.

## I. Introduction (Paragraph 1 of the Proposed Other Information Standard)

The proposed other information standard establishes requirements regarding the auditor's responsibilities with respect to the other information in certain documents containing audited financial statements and the related auditor's report. As more fully described later in this section, the introduction to the proposed other information standard provides a description of "other information," as used in the proposed other

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5/ SAG meeting transcripts for November 2011 and 2012 are available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

information standard, including (1) the documents to which the proposed other information standard would apply and (2) the information to which the proposed other information standard would not apply.

## A. Description of Other Information and Applicability of the Proposed Other Information Standard

### *1. Description of Other Information*

The proposed other information standard describes "other information" as information, other than the audited financial statements[6/] and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") and contains that company's audited financial statements and the related auditor's report. The auditor's responsibilities with respect to other information outside the financial statements would thus focus on other information contained in annual reports filed with the SEC, such as Form 10-K. Annual reports filed with the SEC contain other information that is relevant and of interest to investors and other financial statement users.

Annual reports filed with the SEC under the Exchange Act may include information incorporated by reference from other SEC filings. Under the proposed other information standard, other information includes information contained in the annual report that is filed with the SEC under the Exchange Act as well as specific information that is incorporated by reference into the annual report.

Specifically, a note to the introduction of the proposed other information standard clarifies when information that is incorporated by reference would be included in the scope of the proposed other information standard. The note provides that other information includes information incorporated by reference into the Exchange Act annual report when the information is available to the auditor prior to the issuance of the auditor's report. Additionally, when the annual report is a Form 10-K, the other information in the annual report includes specific information incorporated by reference that is available to the auditor subsequent to the issuance of the auditor's report when that information is contained in the company's definitive proxy statement filed within 120

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[6/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

days after the end of the fiscal year covered by the Form 10-K. No other information incorporated by reference in the annual report that is not available to the auditor prior to the issuance of the auditor's report is included in the scope of the proposed other information standard.

Annual reports filed with the SEC under the Exchange Act may be amended from time to time, including when there are revisions to amounts or disclosures in the previously issued audited financial statements. Amended annual reports, such as the Form 10-K/A, that contain the company's audited financial statements and the related auditor's report, are included in the scope of the proposed other information standard.

When an amended annual report contains revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the amended annual report would be treated similar to an initial filing on Form 10-K. In this situation, because the auditor essentially is considering whether to update or issue a new auditor's report,[7/] the auditor would perform all the procedures under the proposed other information standard.

When an amended annual report does not contain revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the auditor would treat the other information in the amended filing as not available prior to the issuance of the auditor's report.[8/]

The scope of the proposed other information standard contains some similarities to, and some differences from, the Board's existing auditing standard relating to other information, AU sec. 550.

AU sec. 550 currently applies to other information contained in (1) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Exchange Act or (2) other documents to which the

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[7/] See AU sec. 530, *Dating of the Independent Auditor's Report*.

[8/] See Section IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*.

auditor, at the client's request, devotes attention.[9/] Existing AU sec. 550 does not specifically mention information incorporated by reference into an annual report.

Thus, consistent with existing AU sec. 550, the proposed other information standard would apply to annual reports filed under the Exchange Act. However, certain other annual reports included in the scope of the existing standard, such as a company's annual report to security holders that is provided to, but not filed with, the SEC (sometimes referred to as the "glossy" annual report because it may appear as a glossy publication) would not be within the scope of the proposed other information standard. As discussed further below, in some cases, a glossy annual report may be incorporated by reference, either in whole or in part, into a company's Form 10-K prior to the issuance of the auditor's report. In those circumstances, the portions of the glossy annual report, other than the financial statements, that are incorporated by reference would be considered other information under the proposed other information standard.

Additionally, unlike existing AU sec. 550, the proposed other information standard would not apply to other documents to which the auditor, at the company's request, devotes attention. The proposed other information standard does not preclude the auditor from applying the procedures in the standard to such other documents. Also, the proposed other information standard does not preclude the auditor from applying additional procedures not described in the proposed other information standard to the other information.

Finally, the proposed other information standard is consistent with existing AU sec. 550 in that it would not apply to documents filed with the SEC under the Securities Act of 1933 ("Securities Act").[10/] The proposed other information standard, like AU sec. 550, refers the auditor to AU sec. 711, *Filings Under Federal Securities Statutes*, and the auditor's responsibilities for Securities Act filings under the federal securities laws.[11/] The Board recognizes, however, that certain Securities Act filings may incorporate by reference annual reports containing audited financial statements and audit reports that are filed with the SEC under the Exchange Act. For a further discussion regarding the Board's considerations related to Securities Act documents, see Section XII, *Considerations Related to Securities Act Documents*.

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9/ See AU sec. 550.02.

10/ See AU sec. 550.03.

11/ See, e.g., Section 11(a) of the Securities Act, 15 U.S.C. § 77k(a).

*2. Applicability to Annual Reports Filed with the SEC under the Exchange Act That Contain Other Information*

As noted above, the proposed other information standard would apply to annual reports that are filed with the SEC under the Exchange Act that contain audited financial statements and the related auditor's report.

The proposed other information standard would apply to the version of the annual report document filed with the SEC either electronically using the Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system[12/] or as a paper filing.[13/] Because the proposed other information standard is limited to annual reports that are filed with the SEC, the auditor's responsibilities would not extend to annual reports that are distributed by other means, such as corporate websites or social media. Information on websites, such as a company's own website, might contain audited financial statements, the related auditor's reports, or data derived from SEC filings. Consistent with existing AU sec. 9550,[14/] the proposed other information standard would not require auditors to evaluate information contained in electronic sites.

The annual reports covered by the proposed other information standard would include annual reports filed on Forms 10-K, 20-F, 40-F, and N-CSR, among others. The other information contained in these annual report filings can vary depending on the requirements of the SEC form on which the filing is made. For example, other information in a company's annual report filed on Form 10-K would include, among other items, Risk Factors; Selected Financial Data; Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"); Certain Relationships and Related Transactions, and Director Independence; and exhibits.[15/]

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12/ See SEC Rule 301 of Regulation S-T, 17 C.F.R. § 232.301. EDGAR currently provides an electronic filing process for submitting documents under the Securities Act, the Exchange Act, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

13/ See SEC Rule 101 of Regulation S-T, 17 C.F.R. § 232.101. For example, employee stock purchase, savings and similar plans may choose to file their annual reports with the SEC in electronic or paper format.

14/ See AU secs. 9550.16-.18.

15/ Any documents contained in the list of exhibits to the annual report would be considered other information in an annual report under the proposed other

Other information filed by an investment company issuer on Form N-CSR would include, among other items, Code of Ethics and Management's Discussion of Fund Performance ("MDFP").[16/]

Additionally, under the proposed other information standard, management's assertion on internal control over financial reporting would be considered other information when that assertion is included in an annual report filed with the SEC that contains audited financial statements and the related auditor's report, and management's assertion is not subject to an auditor's attestation under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The auditor's responsibilities under the proposed other information standard regarding management's assertion on internal control over financial reporting generally would be consistent with existing AU sec. 9550.[17/] AU sec. 9550 states that, because an auditor is required to consider internal control in an audit of the financial statements, the auditor may be familiar with matters covered in management's assertion on internal control over financial reporting.

*3. Applicability to Information Incorporated by Reference in Annual Reports Filed with the SEC under the Exchange Act*

In many cases, the information incorporated by reference into an annual report filed with the SEC is available to the auditor prior to the issuance of the auditor's report. For example, as discussed above, the entire or portions of a company's glossy annual report may be incorporated by reference[18/] into a company's Form 10-K.[19/] Under the

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information standard. The proposed other information standard would not apply to information formatted in eXtensible Business Reporting Language ("XBRL") that is furnished with the SEC as an exhibit or otherwise. See SEC, *Interactive Data to Improve Financial Reporting*, Release No. 33-9002 (Jan. 30, 2009) at 94-95 and 101.

16/ See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP. Form N-2, which sets reporting requirements for closed-end funds, does not require MDFP.

17/ See AU sec. 9550.07-.11.

18/ See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (2). See also SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23.

19/ Glossy annual reports may also be included as part of a combined report filed on Form 10-K. In this case, information from glossy annual reports, other than the proposed other information standard, information incorporated by reference that is available to the auditor prior to the issuance of the auditor's report would be considered other information and covered by the proposed other information standard. The auditor's responsibilities for other information that is incorporated by reference and is available prior to the issuance of the auditor's report would be the same as the auditor's responsibilities for other information contained in the document filed with the SEC.

Under the proposed other information standard, with one exception, the auditor would not be responsible for information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report. Specifically, the proposed other information standard would apply to information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.[20/] Though this information may be filed subsequently, it is an essential part of the company's annual report on Form 10-K and is necessary to make the document complete.[21/]

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audited financial statements, would be considered other information under the proposed other information standard. See Form 10-K, 17 C.F.R. § 249.310, General Instructions H, "Integrated Reports to Security Holders."

[20/] The information required by Part III of Form 10-K (i.e., Item 10. Directors, Executive Officers and Corporate Governance; Item 11. Executive Compensation; Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters; Item 13. Certain Relationships and Related Transactions, and Director Independence; and Item 14. Principal Accountant Fees and Services) may be incorporated by reference from a proxy statement. See SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23. See also Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," Paragraph (3).

[21/] The standard also would apply to the other information that was to be incorporated by reference from the proxy statement but was instead filed as an amendment to the Form 10-K. If a proxy statement is not filed with the SEC within 120 days after the end of the fiscal year covered by the Form 10-K, the information that was to be incorporated by reference from the proxy statement is instead filed as an amendment to the Form 10-K. See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (3).

## B. Information Included in Annual Reports Containing Audited Financial Statements and the Related Auditor's Report to Which the Proposed Other Information Standard Would Not Apply

Consistent with AU sec. 550,[22/] the proposed other information standard would not apply to (1) supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,[23/] and (2) required supplementary information addressed by AU sec. 558, *Required Supplementary Information*. The proposed other information standard also would not apply to management's assertion on internal control over financial reporting in an audit of internal control over financial reporting that is integrated with an audit of the financial statements.[24/] The information described in these circumstances would be subject to audit or other procedures under other PCAOB standards named above. Therefore, there is no need to impose the requirements of the proposed other information standard on that information because the auditor's responsibilities are already described in the other PCAOB standards.

The proposed other information standard would apply to the other information in the annual report of the company that is making the filing. Audited financial statements of an entity other than the company, such as a business acquired or to be acquired, may be required to be included in the company's annual report.[25/] The Board does not intend for the other entity's financial statements to be considered other information in the company's annual report, under the proposed other information standard, because they are not the company's financial statements and were already subject to a separate audit. Although the Board does not intend for the proposed other information standard to apply in such situations, the Board is seeking comment on whether the proposed other information standard should apply to audited financial statements of another entity that are required to be filed in a company's report under Article 3 of Regulation S-X and whether there are practical issues of doing so.

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[22/] See AU sec. 550.03.

[23/] See *Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements, and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-005 (July 12, 2011).

[24/] See Auditing Standard No. 5.

[25/] See Article 3 of Regulation S-X.

Questions Related to Section I:

1. Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?

2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?

3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?

4. Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?

## II. Objectives (Paragraph 2 of the Proposed Other Information Standard)

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed other information standard to highlight the overall context for the requirements of the standard. Providing an overarching concept as audit objectives for the auditor to take into account can assist the auditor in performing the procedures required by the proposed other information standard and evaluating the results of those procedures.

The proposed other information standard states that the objectives of the auditor are:

- To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");

(2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and

- When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

The Board's existing standard, AU sec. 550 does not specifically identify an objective for the auditor regarding other information.

Question Related to Section II:

5. Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?

## III. Evaluating the Other Information (Paragraphs 3 – 5 of the Proposed Other Information Standard)

The proposed other information standard would require the auditor to evaluate whether the other information contains (1) a material inconsistency, (2) a material misstatement of fact, or (3) both. As more fully described later in this section, the auditor's evaluation would include reading the other information and performing specific procedures based on relevant audit evidence obtained and conclusions reached during the audit.

AU sec. 550 currently requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[26/] Additionally, if, while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact, that is not a material inconsistency, the auditor is required to discuss the matter with management.[27/] Existing AU sec. 550 does not specify the procedures that the auditor should perform when considering the other information, but the standard describes the auditor's responsibilities for responding to identified material inconsistencies or material misstatements of fact.

26/ See AU sec. 550.04.

27/ See AU sec. 550.05.

## A. Material Inconsistency (Paragraph 3 of the Proposed Other Information Standard)

The proposed other information standard generally retains the description of material inconsistency under existing AU sec. 550. A material inconsistency would exist under the proposed other information standard when the other information is materially inconsistent with amounts or information, or the manner of their presentation, in the audited financial statements. The other information often includes amounts or qualitative statements that are directly related to the financial statements because they are intended to be the same as, or to provide greater detail about, amounts or information in the financial statements.

A material inconsistency would involve an inconsistency between amounts in the financial statements and amounts in the other information that have a direct relationship to the company's financial statements, such as quantitative information in the Selected Financial Data or MD&A sections, among others, of an annual report on Form 10-K, but would not be limited to only quantitative information. Qualitative statements, such as the description of the company's critical accounting policies, estimates, and related assumptions in the other information of an annual report on Form 10-K, also would be directly related to accounts and disclosures in the financial statements and thus might involve a material inconsistency.

## B. Material Misstatement of Fact (Paragraph 3 of the Proposed Other Information Standard)

The proposed other information standard also retains the concept of material misstatement of fact in AU sec. 550. Similar to the existing standard, the proposed other information standard does not define material misstatements of fact, but describes the concept of material misstatements of fact in the context of the auditor's responsibilities.

Material misstatements of fact could relate to, among others, statements about the company's competitive environment, technological developments, or supplier relationships. Although such statements in the other information do not directly relate to the accounts and disclosures in the financial statements, the auditor might have knowledge of such information as part of obtaining audit evidence or reaching conclusions during the audit.[28/] Such statements also might be an important driver of the company's stock market value or be of particular importance to investors.

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[28/] For example, during the audit, the auditor may obtain such information as audit evidence in connection with obtaining an understanding of the company and its

For example, management might state in the other information that the company has the largest market share in the company's industry. This information could be material to an investor's decision about the company. The auditor might be aware, based on relevant audit evidence obtained during the audit, that the company does not have the largest share in the relevant industry. The proposed other information standard would require the auditor to evaluate whether management's statement represents a material misstatement of fact.

## C. Auditor's Responsibility to Evaluate (Paragraph 4 of the Proposed Other Information Standard)

The proposed other information standard would require the auditor to read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the other information. In order to strengthen the auditor's performance responsibilities to provide a basis for the auditor to evaluate the other information, the proposed other information standard provides specific procedures the auditor would perform related to the other information. The procedures set forth in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence.

In evaluating whether the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor would refer to the definition of materiality under the federal securities laws. In interpreting those laws, the United States Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[29/] As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . .."[30/]

Since the purpose of evaluating the other information is to assess whether the other information contains a material inconsistency, a material misstatement of fact, or

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environment. See paragraph 9 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[29/] TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also, Basic, Inc. v. Levinson, 485 U.S. 224, 231 to 232 (1988).

[30/] TSC Industries, 426 U.S. at 450.

both, the Board believes that it is appropriate for the auditor to use the established definition of materiality under the federal securities laws applicable to corporate reporting for this evaluation. Auditors should be familiar with this definition because, among other things, it is used to evaluate whether uncorrected misstatements detected during the audit are material.[31/] The Board understands that MD&A and other parts of the other information may contain information that does not reach the quantitative materiality level established for purposes of planning the audit[32/] and that the auditor accordingly may not have obtained audit evidence concerning those matters. As discussed above, the auditor's responsibility to evaluate such information would be based on relevant audit evidence obtained and conclusions reached during the audit. If, however, on that basis, the auditor identifies a potential inconsistency or misstatement of fact in the other information, the auditor should assess its materiality under the federal securities laws' definition of that term.

*1. Auditor's Responsibility to Read*

As noted above, the proposed other information standard retains the requirement of existing AU sec. 550 for the auditor to read the other information. The requirement "to read" in the proposed other information standard has the same meaning as in AU sec. 550 and other PCAOB standards, such as reading interim financial information,[33/] board minutes,[34/] prospectuses and registration statements,[35/] and other information by the engagement quality reviewer or during a review of interim financial information.[36/]

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[31/] See paragraph 17 of Auditing Standard No. 14, *Evaluating Audit Results.*

[32/] See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

[33/] See, e.g., paragraphs .11 and .18.e. of AU sec. 722, *Interim Financial Information*.

[34/] See, e.g., AU secs. 722.18.a. and .19.

[35/] See, e.g., AU secs. 711.08-.11.

[36/] See, e.g., paragraphs 10.g. and 15.e. of Auditing Standard No. 7, *Engagement Quality Review,* and AU sec. 722.18.f.

*2. Auditor's Responsibility to Evaluate*

The proposed other information standard describes the auditor's responsibility as "should evaluate" the other information. Existing AU sec. 550 states that the auditor "should consider" whether the other information is materially inconsistent with the financial statements. AU sec. 550 further indicates that if the auditor concludes that there is a material inconsistency with the financial statements based on the auditor's reading and considering, then the auditor should perform certain procedures.[37/]

The proposed other information standard does not retain the term "should consider." PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards,* indicates that if a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory while the action or procedure is not. As used in AU sec. 550, "should consider" is not followed by a specific action or procedure, but rather is described as a stand-alone requirement without further context regarding the action or procedure. "Should evaluate" is used in other PCAOB standards when the auditor is expected to come to a conclusion based on the performance of certain procedures.[38/]

The proposed other information standard differs from AU sec. 550 in that it requires the auditor to evaluate the other information for both a material inconsistency and a material misstatement of fact. Under existing AU sec. 550, the auditor's responsibility for a material misstatement of fact is conditioned on the auditor "becoming aware" of a material misstatement of fact while reading the other information for a material inconsistency. AU sec. 550 also currently states that, if the auditor becomes aware of information that he or she believes is a material misstatement of fact, that is not a material inconsistency, the auditor should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion.[39/]

The proposed other information standard would require the auditor to evaluate the other information for a material inconsistency and for a material misstatement of fact

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[37/] See AU sec. 550.04.

[38/] See, e.g., Auditing Standard No. 7 and Auditing Standard No. 12.

[39/] See AU sec. 550.05.

based on relevant audit evidence obtained and conclusions reached during the audit. A consistent requirement to evaluate the other information for both material inconsistencies and for material misstatements of fact is appropriate because the auditor's evaluation would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit.

*3. Performing Procedures to Evaluate the Other Information*

In addition to reading the other information, the auditor's evaluation under the proposed other information standard would include performing procedures intended to help the auditor identify whether the other information contains material inconsistencies and material misstatements of fact. Existing AU sec. 550 does not specify any procedures for the auditor to perform in considering the other information.

The required procedures in the proposed other information standard set forth the nature and extent of the auditor's work to evaluate the other information. The procedures in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence. Specifically, the auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. Under other PCAOB standards, the auditor is required to obtain sufficient appropriate audit evidence[40/] and reach conclusions during the audit.[41/] These existing responsibilities provide the basis for the auditor's evaluation of the other information under the proposed other information standard.

Some commenters on the concept release indicated that they are aware that some auditors perform certain procedures related to the other information, such as comparing numbers in the other information to the audited financial statements, recalculating percentages, and providing input to management regarding the other information. Similarly, the Commission on the Auditors' Responsibilities established by the American Institute of Certified Public Accountants (known as the "Cohen Commission"), which examined the auditor's responsibilities and the form of the auditor's report, recommended in 1978 – prior to the establishment of the PCAOB – that the auditing standard for other information be revised to require the auditor to (1)

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40/ See Auditing Standard No. 15, *Audit Evidence*.

41/ See Auditing Standard No. 14 and paragraphs 62-73 of Auditing Standard No. 5.

compare the other information to the financial statements and the audit work papers for inconsistencies with the auditor's knowledge as a result of the audit and (2) recompute percentages or information presented in a manner different from that in the financial statements.[42/] These recommendations of the Cohen Commission have never been adopted as requirements for the auditor.

Because existing AU sec. 550 does not require procedures other than to "read and consider" the other information, the application of the auditor's responsibilities regarding other information among accounting firms may not be consistent. While the Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard, the Board's proposal is designed to promote a consistent basis for the auditor's evaluation of other information. The required procedures are discussed in Subsections a.–d. of this Section.

The proposed procedures are more specific than the "read and consider" approach in existing AU sec. 550 and thus likely would increase auditor effort and, therefore, costs for firms, particularly those firms that might not currently be performing similar procedures on the other information. Also, enhancing the auditor's responsibilities from "becoming aware" of a material misstatement of fact under existing AU sec. 550[43/] to performing specific procedures to evaluate whether the other information contains a material misstatement of fact might result in additional auditor effort. It is also anticipated that auditors would incur one-time costs related to the proposed other information standard, such as updating firm audit methodologies to reflect the new performance and reporting requirements and training firm personnel.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact, based on relevant audit evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors

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[42/] See AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

[43/] See AU sec. 550.05.

and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[44/] or intentional misreporting.[45/] As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[46/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.[47/] Academic research has shown that the increased quality of information could result in a reduction in the average cost of capital.[48/]

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[44/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting,* Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[45/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

[46/] The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[47/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

[48/] Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of*

a. Amounts in the Other Information Related to the Financial Statements (Paragraph 4.a. of the Proposed Other Information Standard)

For amounts in the other information that are intended to be the same as, or provide greater detail about, amounts in the financial statements, the auditor would be required to evaluate the consistency of the amounts and the manner of their presentation with the financial statements or relevant evidence obtained during the audit. If the amounts in the other information are at the same level of detail as those in the financial statements, for example, amounts in the Selected Financial Data section, among others, of an annual report on Form 10-K, the auditor would evaluate the consistency of the amounts with amounts in the financial statements.

The other information also might contain amounts that are more disaggregated than the amounts in the financial statements. For example, amounts related to Results of Operations in the MD&A section, among others, of Form 10-K might be presented in a way that provides greater detail on a geographic or product basis than the amounts presented in the financial statements. In those situations, the auditor would evaluate the consistency of the amounts in the other information and the manner of their presentation with relevant evidence obtained during the audit that includes disaggregated information.

b. Qualitative Statements in the Other Information Related to the Financial Statements (Paragraph 4.b. of the Proposed Other Information Standard)

For any qualitative statement in the other information that is intended to represent, or provide greater detail about, information in the financial statements, the auditor would evaluate the consistency of the information and the manner of its presentation with the financial statements, including the financial statement disclosures, and with relevant audit evidence. Such qualitative other information might appear in the MD&A section, among others, of Form 10-K and relate to, for example, critical accounting policies, practices, and estimates or the description of off-balance sheet arrangements.

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*Information Precision in Determining the Cost of Equity Capital,* 9 Review of Accounting Studies 233, 233-259 (2004).

c. Other Information That Is Not Directly Related to the Financial Statements (Paragraph 4.c. of the Proposed Other Information Standard)

With respect to other information that is not directly related to the financial statements, the auditor would compare the information to relevant audit evidence obtained and conclusions reached during the audit. Other information that is not directly related to the financial statements might appear in the Business, Risk Factors, or Quantitative and Qualitative Disclosures about Market Risk sections, among others, of an annual report on Form 10-K[49/] or the MDFP section of an annual report on Form N-CSR.[50/]

d. Recalculation of Amounts in the Other Information (Paragraph 4.d. of the Proposed Other Information Standard)

The proposed other information standard also would require the auditor to evaluate certain amounts in the other information by recalculating the amounts for mathematical accuracy. The amounts that would be subject to this procedure would be amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence.

For example, this requirement of the proposed other information standard would apply to amounts in the other information that the auditor can recalculate without the need to refer to a formula or when the formula is generally understood. The above-mentioned requirement would include amounts, such as totals or percentages, which are ordinarily calculated using simple mathematical operations that do not require a formula, as well as generally understood ratios, such as the current ratio. If the auditor needs to refer to a formula for the recalculation of an amount, such as for return on capital employed, the auditor would be required to recalculate the amount only when the formula is provided or described in the annual report. However, the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.

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[49/] See Instructions to Form 10-K available at http://www.sec.gov/about/forms/form10-k.pdf.

[50/] See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP.

## D. Responding When the Auditor Identifies a Potential Material Inconsistency, A Potential Material Misstatement of Fact, or Both (Paragraph 5 of the Proposed Other Information Standard)

As a result of performing the evaluation procedures under paragraph 4 of the proposed other information standard, the auditor might identify a potential material inconsistency, a potential material misstatement of fact, or both. If so, the proposed other information standard would require the auditor to discuss the matter with the company's management. The proposed other information standard also would require that the auditor perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both. Such additional procedures might include (1) requests for additional documentation and (2) consultations outside of the engagement team, such as a national office or other parties with appropriate expertise. The procedures would vary based on the auditor's evaluation of the relevant facts and circumstances.

It is anticipated that, in many situations, the auditor's discussion with management and the results of the additional procedures would provide the auditor with additional information that could be sufficient to enable the auditor to determine if there is a material inconsistency, a material misstatement of fact, or both. If the auditor determines that there is a material inconsistency between the other information and the audited financial statements, the auditor also would determine whether the financial statements or the other information would require revision. A material misstatement of fact generally would require revision of the other information, not the financial statements, because a material misstatement of fact in the other information is not directly related to the financial statements.

Existing AU sec. 550 does not specify the procedures to be performed when the auditor identifies a potential material inconsistency but has not reached a conclusion about the material inconsistency. AU sec. 550 describes the auditor's responsibilities once the auditor has reached a conclusion that a material inconsistency exists. However, when the auditor becomes aware of information that the auditor believes is a material misstatement of fact, and prior to reaching a conclusion about the material misstatement of fact, AU sec. 550 currently requires the auditor to discuss the matter with management.[51/] The requirement in the proposed other information standard to discuss the matter with management is similar to the requirement in AU sec. 550 regarding a material misstatement of fact.

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[51/] See AU sec. 550.05.

If the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, and the auditor performs additional procedures, as necessary, the additional procedures likely would result in additional auditor effort as compared to the existing requirements in AU sec. 550.

Questions Related to Section III:

6. Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?

7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?

8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?

9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?

10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?

11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?

12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?

13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?

## IV. Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both (Paragraphs 6-11 of the Proposed Other Information Standard)

### A. Communication with Management (Paragraph 6 of the Proposed Other Information Standard)

If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the proposed other information standard would require the auditor to request management to revise the other information. This requirement was retained from AU sec. 550 with respect to a material inconsistency.[52/] However, with respect to a material misstatement of fact, AU sec. 550 does not include an explicit requirement for the auditor to request that management revise the other information. Rather, AU sec. 550 includes a requirement for the auditor to propose that management consult with other parties, such as legal counsel.[53/]

### B. The Auditor's Response If Management Does Not Appropriately Revise the Other Information (Paragraph 7 of the Proposed Other Information Standard)

If management does not appropriately revise the other information, the auditor's response under the proposed other information standard would vary depending on whether the other information had been available to the auditor prior to the issuance of the auditor's report. When the other information is available to the auditor prior to the issuance of the auditor's report and management, in response to a request by the auditor, does not revise appropriately the other information to address a material inconsistency, a material misstatement of fact, or both, then the auditor would be required to perform certain procedures that are described in paragraphs 8 and 9 of the proposed other information standard and in Section IV.C., *Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*, below. Additionally, when the other information is not available to the auditor prior to the issuance of the auditor's report and the other information is not appropriately revised by management, then the auditor would be required to perform other procedures described in paragraphs 10 and 11 of the proposed other information standard and in Section

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52/ See AU sec. 550.04.

53/ See AU sec. 550.05.

IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report* below.

## C. Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report (Paragraphs 8-9 of the Proposed Other Information Standard)

Paragraphs 8-9 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that the other information available to the auditor prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both and (2) the information is not appropriately revised by management. When the other information is available prior to the issuance of the auditor's report, the auditor's response would be the same whether the information is contained in the annual report or is incorporated by reference in it.

### *1. Communication with the Audit Committee (Paragraph 8 of the Proposed Other Information Standard)*

If management does not appropriately revise the other information after the auditor's request, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both, to the audit committee in a timely manner and prior to the issuance of the auditor's report.

Under existing AU sec. 550, if the other information is not revised to eliminate the material inconsistency, the auditor is required to communicate the material inconsistency to the audit committee.[54/] Additionally, if the auditor has concluded that a material misstatement of fact remains after communication to management, AU sec. 550 states that the auditor should communicate the material misstatement of fact to the audit committee, in writing.[55/]

The proposed other information standard would retain the requirements for the auditor to communicate to the audit committee, but would not require the communications regarding a material misstatement of fact to be in writing. This is consistent with the approach taken to communications to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees,* which allows the

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[54/] See AU sec. 550.04.

[55/] See AU sec. 550.06.

communication to be oral or written.[56/] Auditing Standard No. 16, however, requires the auditor to document communications with the audit committee in the work papers, whether such communications took place orally or in writing.[57/]

*2. Responding When the Other Information Is Not Appropriately Revised (Paragraph 9 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication with the audit committee, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A of the Exchange Act ("Section 10A");[58/] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; and AU sec. 317, *Illegal Acts by Clients*. This would direct the auditor to his or her responsibilities under federal securities laws and other PCAOB standards.

Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.[59/] AU sec. 316 provides requirements regarding the auditor's responsibilities related to fraud in the audit of financial statements. AU sec. 317 provides the nature and extent of the auditor's consideration in the audit of financial statements of the possibility for an illegal act by the company.

Additionally, if the other information is not appropriately revised after the auditor's communication to the audit committee, the proposed other information standard would require the auditor to determine whether to (1) issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both or (2) withdraw from the engagement. In determining whether to issue an auditor's report when the other information is not appropriately revised after the auditor's communication to the audit committee, the auditor would consider, among other things, the implications of being associated with an annual report that contains a material inconsistency, a material

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56/ See paragraph 25 of Auditing Standard No. 16.

57/ Id.

58/ 15 U.S.C. § 78j-1.

59/ See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

misstatement of fact, or both. The Board is seeking comments regarding the appropriateness of issuing an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both.

The proposed other information standard requires the same response and reporting by the auditor for both a material inconsistency and a material misstatement of fact in the other information because the auditor's evaluation of other information would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit. Investors are likely to be interested in matters that the auditor determined are material inconsistencies or material misstatements of fact in the other information. Additionally, investors might consider the other information that is directly related to the financial statements, as well as the other information that is not directly related to the financial statements, important in their investment decision making.[60/] Therefore, the proposed other information standard aligns the reporting responsibilities for both a material inconsistency and a material misstatement of fact.

There may be circumstances in which the auditor determines that issuing an auditor's report is not appropriate. Similar to existing AU sec. 550,[61/] such circumstances may arise when the nature of the material inconsistency or material misstatement of fact is such that it may affect the auditor's decision to be associated with the annual report. Under the proposed other information standard, such circumstances would require the auditor to determine whether to withdraw from the

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[60/] See, e.g., IAG survey, *Role, Relevancy, and Value of the Audit.* The responses to survey question 13 indicate that investors often use other information, such as (1) MD&A, (2) Business Description, (3) Risk Factors, and (4) Proxy Information, to make investment decisions. The survey results were presented at the March 2012 IAG meeting and are available at http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Audit_Firm_Practice_Survey_Summary.pdf.

[61/] See AU sec. 550.04, which states, in part, that "[o]ther information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report." It further states that if the other information is not revised to eliminate the material inconsistency "[t]he action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information."

engagement. Consideration of similar actions is currently required by AU sec. 550 with respect to material inconsistency,[62/] but that standard does not specify the auditor's responses with respect to a material misstatement of fact.

The proposed other information standard notes that the auditor may withhold the use of the auditor's report for a prior reporting period. If the auditor determines that it is not appropriate to issue an auditor's report for the current reporting period, the auditor also may withhold the use of the auditor's report for a prior reporting period. This is similar to existing AU sec. 550, which states that the auditor should consider actions such as withholding the use of the auditor's report in the annual report, if the other information is not revised to eliminate the material inconsistency.[63/] AU sec. 550, however, does not specify the period for which the report may be withheld.

**D. Responding When the Other Information is Not Available Prior to the Issuance of the Auditor's Report (Paragraphs 10-11 of the Proposed Other Information Standard)**

Paragraphs 10-11 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that certain other information, that is not available to the auditor prior to the issuance of the auditor's report, contains a material inconsistency, a material misstatement of fact, or both and (2) the information has not been appropriately revised by management.[64/]

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62/ See AU sec. 550.04.

63/ Id.

64/ With respect to other information in an amended annual report that contains previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of the proposed other information standard. Those paragraphs also would apply to (1) information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K and (2) other information that was to be incorporated by reference from the company's definitive proxy statement but was instead filed as an amendment to the Form 10-K.

*1. Communication with the Audit Committee (Paragraph 10 of the Proposed Other Information Standard)*

If, after the auditor's request, management does not appropriately revise the other information that was not available prior to the issuance of the auditor's report, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner. This requirement is similar to the requirement when the other information is available prior to the issuance of the auditor's report.

*2. Responding When the Other Information Is Not Appropriately Revised (Paragraph 11 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication of the material inconsistency, material misstatement of fact, or both to the audit committee, and the auditor's report has been issued, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A.[65/] Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.[66/]

Additionally, the proposed other information standard would require the auditor to apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.* AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date which might have affected the auditor's report if the auditor had been aware of them.[67/]

The procedures in AU sec. 561 would apply in a situation in which the other information that was not available prior to the issuance of the auditor's report was not revised to eliminate a material inconsistency, a material misstatement of fact, or both.[68/]

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65/ 15 U.S.C. § 78j-1.

66/ See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

67/ See AU sec. 561.01.

68/ See AU secs. 561.05 and .08-09.a.

For example, if the auditor identified a material inconsistency, a material misstatement of fact, or both in the related party information in a proxy statement covered by this standard, the auditor would:

- Determine the effect on the auditor's report if (1) the material inconsistency between the information about related parties in the other information and the audited financial statements, (2) the material misstatement of fact in the other information about related parties, (3) or both had been known to the auditor prior to the issuance of the auditor's report;[69/] and

- Notify each member of the company's board of directors of the material inconsistency, material misstatement of fact, or both, in the related party information and that if the other information is not appropriately revised, the auditor would take steps to prevent future reliance on the auditor's report.[70/]

If the other information is not appropriately revised after the auditor's notification to the board of directors, in this example the auditor would:

- Notify management and the audit committee that the auditor's report must no longer be associated with the financial statements;[71/] and

- Notify the SEC that the auditor's report should no longer be relied upon.[72/] This notification also would describe the effect the material inconsistency, material misstatement of fact, or both in the related party information would have had on "The Auditor's Responsibility Regarding Other Information" section in the auditor's report if it had been known to the

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69/ See AU sec. 561.05.

70/ See AU sec. 561.08. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.

71/ See AU sec. 561.08a.

72/ See AU sec. 561.08b. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.

auditor prior to the issuance of the auditor's report and describe the material inconsistency, material misstatement of fact, or both.[73/]

The auditor's responsibilities under AU sec. 561 are not affected when the auditor has resigned or been discharged.[74/] The auditor's responsibilities under the proposed other information standard to apply the procedures in AU sec. 561 similarly would not be affected by the auditor's resignation or dismissal.

Questions Related to Section IV:

14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?

15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?

16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?

## V. Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements (Paragraph 12 of the Proposed Other Information Standard)

The procedures in the proposed other information standard would require the auditor to evaluate the consistency of the other information to the audited financial

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[73/] See AU sec. 561.09a.

[74/] See AU sec. 9561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561*.

statements. These procedures would provide an increased auditor focus on other information, which could improve the auditor's identification of potential misstatements in the financial statements. Academic research indicates that comparing non-financial measures commonly found in the other information, such as number of properties and employee headcount, among others, to audited financial statements can help the auditor identify red flags for fraudulent financial reporting.[75/] To the extent that discrepancies between non-financial measures and reported financial performance are red flags for possible financial reporting issues, including fraud, requiring auditors to evaluate other information could help them detect misstatements.

As a result of procedures performed under paragraphs 4 and 5 of the proposed other information standard, the auditor might determine that there is a potential misstatement in the audited financial statements. If the auditor's report on the financial statements has not been issued, the auditor would refer to the requirements of Auditing Standard No. 14 and amended AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* in this situation.

Auditing Standard No. 14 establishes requirements regarding the auditor's evaluation of audit results and the determination of whether the auditor has obtained sufficient appropriate audit evidence. The auditor's evaluation includes, among other things, an evaluation of misstatements accumulated during the audit.[76/] Proposed amendments to AU sec. 508, as reflected in Appendix 3, would describe the reporting requirements related to departures from an unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion.

If the auditor's report has already been issued, the proposed other information standard refers the auditor to the procedures in AU sec. 561. AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date that might have affected the auditor's report if the auditor had been aware of them.[77/] Under AU sec. 561, the auditor is required to perform procedures to determine whether the information

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75/ See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

76/ See paragraph 4 of Auditing Standard No. 14.

77/ See AU sec. 561.01.

is reliable and whether the facts existed at the date of the auditor's report, including discussing the matter with company management and the board of directors.[78] The auditor's further responsibilities under AU sec. 561 depend on several factors, including, among others, the effect on the audited financial statements and the auditor's report.[79]

Question Related to Section V:

17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?

## VI. Reporting in the Auditor's Report (Paragraphs 13-14 of the Proposed Other Information Standard)

The proposed other information standard provides a basis for the auditor to report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. Reporting on the results of the auditor's evaluation of the other information would provide potentially significant information to investors.

The proposed other information standard would require that, when issuing an auditor's report, the auditor include specific statements regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of other information. The auditor would be required to make these statements in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information."[80]

Regardless of whether the auditor identifies a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide in the report the following:

- A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)],

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[78] See AU sec. 561.05.

[79] See AU secs. 561.05-.08.

[80] The proposed auditor reporting standard refers the auditor to the reporting requirements of the proposed other information standard related to the auditor's responsibilities for and results of the auditor's evaluation of the other information.

in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

- Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and period end date of the financial statements;

- A statement that the auditor's evaluation was based on relevant audit evidence obtained and conclusions reached during the audit of the financial statements; and

- A statement that the auditor did not audit the other information and does not express an opinion on it.

In addition, depending on whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide a statement that:

- The auditor has not identified a material inconsistency or a material misstatement of fact in the other information; or

- The auditor has identified a material inconsistency, a material misstatement of fact, or both, in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

A statement in the auditor's report that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information is appropriate in situations in which (1) the auditor has not identified a material inconsistency or a material misstatement of fact based on the auditor's evaluation of the other information and (2) the auditor has identified a material inconsistency, a material misstatement of fact, or both, that the auditor requested management to revise and management appropriately revised prior to the issuance of the auditor's report. In situations when management has revised the other information at the auditor's request because the auditor identified material inconsistencies or material misstatements of fact, and the auditor determines that appropriate revisions have been made, then the auditor's report would state that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information since the annual report that is ultimately filed with the SEC no longer contains such inconsistencies or misstatements.[81/]

The proposed other information standard also provides illustrative language for the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The reporting requirements under the proposed other information standard are generally new. Existing AU sec. 508 does not require any statement in the auditor's report regarding the auditor's responsibilities with respect to other information. However, the proposed reporting responsibility when the auditor identified a material inconsistency that was not appropriately revised is similar to existing AU sec. 550 regarding a material inconsistency.[82/] Under AU sec. 550, if the other information is not revised to eliminate a material inconsistency, then the auditor is required to consider actions such as revising the report to include an explanatory paragraph describing the material inconsistency.

AU sec. 550 does not include a reporting responsibility regarding explanatory language for a material misstatement of fact in the other information. However, as noted above, the auditor's evaluation of the other information that is not directly related to the financial statements also might be important to investors in their investment decision making. Therefore, the proposed other information standard proposes the same reporting responsibilities for both a material inconsistency and a material misstatement of fact.

Some commenters supported including in the auditor's report a description of the auditor's responsibilities for other information. They generally indicated that such a description in the auditor's report would help users understand the auditor's responsibilities with respect to other information and address the misperception that the other information is audited. Additionally, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's

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[81/] In a situation in which the auditor identified a material inconsistency, a material misstatement of fact, or both that management subsequently revised, the auditor also has other responsibilities under other PCAOB standards, such as paragraphs 20-22 of Auditing Standard No. 14.

[82/] <u>See</u> AU sec. 550.04. <u>See</u> <u>also</u> existing AU sec. 508.11.h.

conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The report of the Cohen Commission states that "[t]he lack of explicit acknowledgement of the auditor's responsibility for other information in the annual report has the potential to create user confusion . . .."[83/] Similar to the Board's proposal, the Cohen Commission recommended auditor reporting that includes a description of the auditor's work performed over the other information and the auditor's conclusions.[84/]

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

Requiring the auditor to state that he or she has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised would result in additional costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including the cost of conducting procedures to resolve and to report on such matters. Also, costs likely would arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing AU sec. 550 because the requirements of the two standards are similar in this respect. Currently, the Board is not aware of any specific instance of an auditor's report being issued under the existing auditing standards[85/] and filed with the SEC that contains

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83/ AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

84/ Id.

85/ See AU sec. 550.04. See also existing AU sec. 508.11.h.

explanatory language regarding a material inconsistency.[86/] This suggests that instances of material inconsistency generally are resolved between the auditor and the company. Therefore, the related reporting costs might be low.

Questions Related to Section VI:

18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?

19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.

20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?

21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?

22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?

## VII. Responsibilities of a Predecessor Auditor

Under existing auditing standards, before reissuing an auditor's report on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent

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[86/] In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff did not identify any audit report containing explanatory language regarding a material inconsistency in the other information. PCAOB staff performed additional searches of SEC filings for other fiscal years and did not identify any audit report containing explanatory language regarding a material inconsistency in the other information.

period, a predecessor auditor should consider whether the auditor's report is still appropriate.[87/] Prior to reissuing the auditor's report the predecessor auditor is required to (1) read the current period financial statements; (2) compare the current period financial statements to the prior period financial statements being presented; and (3) obtain representation letters from management and the successor auditor.[88/]

In connection with the reissuance of a predecessor auditor's report, the proposed other information standard notes that the requirements of the standard related to a material inconsistency would apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an Exchange Act annual report containing other information filed with the SEC.[89/] The proposed other information standard would apply to a predecessor auditor only with respect to a material inconsistency between the other information and the financial statements for the period audited by the predecessor auditor. The requirements in the proposed other information standard with respect to a predecessor auditor are similar to those of AU sec. 550.[90/]

As described in existing AU sec. 508.73, a predecessor auditor's knowledge of the current activities of the company would be limited in the absence of a continuing relationship. Additionally, the procedures required of the predecessor auditor prior to reissuing the auditor's report[91/] do not provide the predecessor auditor with additional audit evidence or new conclusions related to the previous audit. Therefore, the predecessor auditor would not be able to evaluate other information not directly related to the prior period financial statements that is contained in the current period Exchange Act annual report filed with the SEC. For this reason, the proposed other information standard, consistent with existing AU sec. 550,[92/] does not include a responsibility for the predecessor auditor with respect to a material misstatement of fact.

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87/ See AU sec. 508.71.

88/ Id.

89/ See footnote 6 of the proposed other information standard.

90/ See footnote 2 of AU sec. 550.

91/ See existing AU sec. 508.71.

92/ See footnote 2 of AU sec. 550.

The proposed other information standard would require the predecessor auditor to perform the procedures with respect to a material inconsistency based on relevant audit evidence obtained and conclusions reached during the predecessor auditor's previous audit. Therefore, the predecessor auditor's procedures would include reading and evaluating the other information in the current period annual report filed with the SEC for any material inconsistencies with the audited financial statements for the prior period. The predecessor auditor's procedures are not intended as an evaluation, with the benefit of hindsight, of the accuracy of the estimates and assumptions used in preparing the prior period's financial statements.

If the predecessor auditor concludes that there are no material inconsistencies, the predecessor auditor's report may be reissued. If, after communication with management and the audit committee, the predecessor auditor determines that the other information contains a material inconsistency, the predecessor auditor would be required to determine his or her responsibilities under federal securities laws and PCAOB standards. The predecessor auditor also may withhold the use of the auditor's report for the prior period.

Question Related to Section VII:

23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?

## VIII. Other Considerations

Liability may be imposed on auditors and issuers (as well as other securities market participants) under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act,[93/] Section 10(b) of the Exchange Act, as well as various state law causes of action. The Board is interested in the effect of such liability considerations and, accordingly, requests comments on the potential legal liabilities associated with the performance and reporting requirements under the proposed other information standard.

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[93/] For example, the proposed reporting of the results of the auditor's evaluation of the other information may raise for auditors possible liability considerations under Section 11 of the Securities Act when the document filed under the Exchange Act that contains the proposed enhanced auditor's report is incorporated by reference into a registration statement filed under the Securities Act.

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report. The following discussion is intended to highlight some key Board considerations in developing each element.

The first element of the Board's proposal would require the auditor to describe, in the auditor's report, the auditor's responsibilities for other information in annual reports containing audited financial statements and the related auditor's report filed with the SEC under the Exchange Act. Many commenters suggested that including a description in the auditor's report would provide useful information to investors.

The second element of the Board's proposal involves specific procedures, based on relevant audit evidence and the auditor's conclusions, for (1) assessing the consistency of the other information with the amounts, information, and presentation of the financial statements and (2) identifying material misstatements of fact. Under the proposed other information standard, the auditor would evaluate the other information for consistency with the financial statements and for potential misstatements of fact because the auditor is knowledgeable about the company's financial statements and the audit evidence obtained during the audit.

In developing this aspect of its proposed approach, the Board took note of relevant comments on the concept release. Some commenters noted that auditors have responsibilities under existing PCAOB standards to read and consider information outside of the financial statements and that auditors have developed procedures and routinely review other information for consistency with the financial statements. Other commenters suggested that performing procedures over information prepared by the company is a traditional role for the auditor that maintains the appropriate line of accountability between the auditor and the company. The Board's proposal (1) incrementally strengthens the auditor's traditional role with respect to other information and (2) provides a specific basis for describing the auditor's responsibilities in the auditor's report.

Third, the Board is proposing specific responses and reporting based on the results of the auditor's evaluation. For example, when the auditor has not identified a material inconsistency or material misstatement of fact as a result of the evaluation of the other information, the auditor's report would describe the auditor's responsibilities and note that no material inconsistencies or material misstatements of fact were identified. However, when the auditor has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised by management, the auditor would be required to describe the material inconsistency, material misstatement of fact, or both in the auditor's report, if the auditor determined it was appropriate to issue the auditor's report. The proposed other information standard also would refer the auditor to existing PCAOB standards, such as AU secs. 316 and 317, and to federal securities law requirements that are already familiar to auditors. The proposed other information standard also includes other responses for the auditor.

While the Board did not specifically seek comment in the concept release related to reporting on other information in the auditor's report, the Board received some related comments during its outreach and considered them in developing the proposed other information standard. In connection with adding the description of the auditor's responsibilities in the auditor's report, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information. A commenter on the auditor assurance alternative presented in the concept release noted that auditors today would not permit their audit opinion to be included in a filing if the other information was inappropriate or incomplete.

The Board received other comments suggesting that reporting relating to the auditor's involvement with other information should be in a separate section of the auditor's report and include an introduction that described the different nature of the auditor's work and that the auditor was not auditing the other information. Accordingly, the Board is proposing that the auditor's statements regarding other information be in a separate section of the auditor's report, and also is proposing language to make it clear that the auditor is not expressing an opinion on the other information.

The Board recognizes, however, that, under its proposal, the auditor would be making new statements in the auditor's report about the auditor's responsibilities for evaluating other information and the results of the evaluation of the other information, which could raise potential liability considerations.

<u>Questions Related to Section VIII</u>:

24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the

other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?

25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?

## IX. Proposed Amendments to PCAOB Standards

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed other information standard. Appendix 4 provides the proposed amendments related to the proposed other information standard. Significant amendments are described below.

### A. Amendments to Existing AU sec. 508

In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, AU sec. 9550 states that the auditor may consider adding statements to the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's assertion.[94/] Because AU sec. 9550 would be superseded by the proposed other information standard, existing AU sec. 508 would be amended to allow the auditor to continue including such statements in the auditor's report.[95/] Existing AU sec. 508 also would be expanded to include an example of the "Basis of Opinion" section in the auditor's report that contains such statements.

In order to make this information consistently available to investors, the Board is interested in commenters' views about requiring, rather than allowing, statements in the auditor's report that the auditor was not engaged to examine management's assertion

94/ See AU sec. 9550.10.

95/ See proposed paragraphs .74A-B of AU sec. 508 in Appendix 4.

on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report.[96/]

## B. Amendments to AU sec. 558

AU sec. 558 includes a reference to AU sec. 550, which permits the auditor to express an opinion on certain other information if that information has been subjected to auditing procedures. If the auditor decides to report on such information, AU sec. 558 references the reporting requirements of AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

Since the proposed other information standard would supersede AU sec. 550 and the Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,[97/] would supersede AU sec. 551, the Board is proposing to add the relevant substantive requirements, which otherwise would be superseded, directly to AU sec. 558. Accordingly, the Board is proposing to amend paragraph .09 of AU sec. 558 to include the elements of paragraph .07 of AU sec. 550 and paragraphs .12 and .14 of AU sec. 551 related to expressing an opinion on other information that has been subjected to auditing procedures. Because AU sec. 550 would be superseded, the proposed amendment to AU sec. 558 would apply only to situations involving required supplementary information.

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96/ In July 2013, the U.S. Government Accountability Office ("GAO") issued a report in which it recommended that the SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls. The GAO's report concluded that "explicit disclosure would increase transparency and investor protection by making investors readily aware of whether a company has obtained an auditor attestation on internal controls. The disclosure could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions." See GAO, *Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation* (GAO-13-582) (July 3, 2013) at 37, available at http://www.gao.gov/assets/660/655710.pdf.

97/ See PCAOB Release No. 2011-005 (July 12, 2011).

## C. Amendments to AU sec. 722

AU sec. 722 includes a list of interim review procedures the auditor should perform when conducting a review of interim financial information. AU sec. 722 requires the auditor to "read and consider" the other information that accompanies the interim financial information and directs the auditor to consider AU sec. 550, which would be superseded by the proposed other information standard. AU sec. 722 would be amended to direct the auditor to consider the requirements of the proposed other information standard, if the auditor concludes that there is a material inconsistency, a material misstatement of fact, or both.

Questions Related to Section IX:

26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?

27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?

## X. Considerations Related to Audits of Brokers and Dealers

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,[98/] the proposed other information standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

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[98/] See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements on form X-17A-5.[99/] Form X-17A-5 includes, as part of the broker or dealer's filing, an oath or affirmation signed by an officer of the broker or dealer[100/] that the financial statements and supporting schedules[101/] are true and correct. Auditors of a broker's or a dealer's financial statements would read the oath or affirmation as part of the annual report filed with the SEC under the Exchange Act that contains audited financial statements and the related auditor's report, and evaluate the information in that oath or affirmation in accordance with the procedures in the proposed other information standard, as appropriate.

Rule 17a-5 also requires the broker or dealer to file a compliance report or an exemption report.[102/] The proposed other information standard would not apply to compliance or exemption reports by brokers or dealers as those reports and the related auditor reporting are addressed by *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*.[103/]

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

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99/ See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

100/ See SEC Rule 17a-5(e)(2) of the Exchange Act, 17 C.F.R. § 240.17a-5e2.

101/ The proposed other information standard would not apply to supporting schedules required by Rule 17a-5. These schedules are addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements.* See PCAOB Release No. 2011-005 (July 12, 2011).

102/ See SEC Rule 17a-5(d)(1)(i)(A) and (B), 17 C.F.R. § 240.17a-5d1iA and B.

103/ See *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission,* PCAOB Release No. 2011-004 (July 12, 2011).

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

Question Related to Section X:

28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?

## XI. Considerations Related to Effective Date

The proposed other information standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed other information standard, such as for the audits of smaller companies.

Questions Related to Section XI:

29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?

30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

## XII. Considerations Related to Securities Act Documents

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information contained in an annual report that includes audited financial statements and related auditor's report filed under the Exchange Act; (2) specifying procedures for the auditor to perform with respect to evaluating this other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report of the results of the auditor's evaluation. The proposed other information standard would supersede AU sec. 550 and AU sec. 9550. The proposed other information standard would not apply to documents containing audited financial statements and the related auditor's report that are filed with the SEC under the Securities Act, which is consistent with the approach in AU sec. 550.

Currently, AU sec. 550 refers the auditor to AU sec. 711 with respect to the auditor's responsibilities for filings under the Securities Act.[104/] AU sec. 711 refers the auditor to the provisions of Section 11 of the Securities Act.[105/] Section 11 imposes liability, subject to a due diligence defense, for material misstatements and omissions in a registration statement on "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement . . . which purports to have been prepared or certified by him."[106/] Separately, Section 7 of the Securities Act[107/] requires issuers to file the consent of any accountant who is named as having prepared or

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[104/] See AU sec. 550.03. This paragraph also refers the auditor to AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties,* which provides guidance to auditors for performing and reporting on the results of engagements to issue letters (commonly referred to as "comfort letters") regarding the other information contained in registration statements filed with the SEC.

[105/] See AU sec. 711.02. See also AU sec. 711.03 regarding the auditor's responsibilities as an expert and the burden of proof that the auditor must meet under Section 11(b) of the Securities Act when the auditor's report is included in a registration statement.

[106/] 15 U.S.C. § 77k(a)(4).

[107/] 15 U.S.C. § 77g.

certified any part of the registration statement or any valuation or report included in the registration statement.

Audit procedures contained in AU sec. 711 require the auditor to read relevant portions of the prospectus to make sure that (1) the auditor's name is not being used in a way that indicates greater responsibility than intended, and (2) the prospectus does not imply that the financial statements have been prepared by the auditor.[108/] Additionally, auditors perform certain procedures described under AU sec. 711 to identify any subsequent events that may impact the auditor's report included in the company's registration statement from the date of the auditor's report up to or shortly before the effective date of the registration statement as part of conducting a "reasonable investigation" pursuant to Section 11 of the Securities Act.[109/] When a company's annual report on Form 10-K is incorporated by reference into a shelf registration statement on Form S-3, AU sec. 711 requires that the auditor perform procedures with respect to subsequent events to a date as close to the date of the filing of the Form 10-K as is reasonable and practicable in the circumstances.[110/]

As previously described in this release, the proposed auditor reporting standard and the proposed other information standard are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. Specifically, the proposed other information standard would respond to investor's interests in obtaining information regarding the auditor's responsibilities for other information that is contained in documents that include the audited financial statements and the related auditor's report. The Board began considering the existing auditing standard on other information in documents containing audited financial statements, specifically AU sec. 550, as part of its effort to develop a

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[108/] See AU sec. 711.08.

[109/] See AU secs. 711.10-.11. See also AU secs. 711.12-.13 regarding the auditor's responsibilities if the auditor discovers or becomes aware of facts upon performing procedures subsequent to the date of the auditor's report.

[110/] See AU secs. 711.10-.11 and paragraph .07 of AU sec. 9711, *Filings Under Federal Securities Statutes: Auditing Interpretations of Section 711*. See also AU sec. 9711.05 regarding the auditor's responsibility to perform the procedures in AU secs. 711.10 and .11 when (1) a post-effective amendment to the shelf registration statement is filed as allowed under SEC Rule 430B of Regulation C, 17 C.F.R. § 230.430B or (2) an Exchange Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

description in the auditor's report regarding the auditor's responsibilities for other information in certain documents filed with the SEC. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

The Board considered proposing to extend the applicability of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act. However, the Board has identified obstacles to applying the reporting requirements under the proposed other information standard to documents filed under the Securities Act. For example, a company will file a registration statement on Form S-1 with the SEC containing information required under the Securities Act and SEC rules and regulations as well as the company's audited financial statements and the related auditor's report. The SEC may require the company to file several amendments to the Form S-1 to update the information disclosed in the registration statement before it is declared effective by the SEC. Under current Securities Act rules, the auditor's report is not required to be updated for amendments to the registration statement, unless certain circumstances occur.[111/] Rather, the auditor consents to the continued use of the auditor's report in the registration statement.[112/] The filing of the auditor's consent with the company's registration statement does not change the date or content of the auditor's report filed with the original registration statement. Because an auditor is not required to update the auditor's report prior to the effective date of the company's registration statement, the auditor's report contained in the registration statement would reflect only the evaluation performed under the proposed other information standard of the other information as of the date of the auditor's report and not reflect the auditor's procedures under AU sec. 711 between the date of the auditor's report and the effective date of the registration statement.

The Board recognizes that a similar obstacle with the proposed other information standard would apply in the case when a company files a registration statement and incorporates by reference information from the company's annual report previously filed with the SEC. For example, under the proposed other information standard, an auditor

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[111/] Under PCAOB standards, the auditor would be required to update the auditor's report under certain circumstances.

[112/] See SEC Rules 436 and 439 of Regulation C, 17 C.F.R. §§ 230.436 and 230.439.

would evaluate the other information contained in a company's annual report filed on Form 10-K and include a separate section in the auditor's report that stated the auditor's responsibilities for, and the results of, the auditor's evaluation of other information contained in the company's annual report. When the company later files a shelf registration statement on Form S-3 and incorporates by reference the company's previously filed annual report into the registration statement, the auditor would perform procedures on the other information contained in the shelf registration statement, as required under AU sec. 711. Similar to the reporting framework described above, the auditor is not required to update the auditor's report on the financial statement contained in the company's previously filed annual report that is incorporated by reference into the company's registration statement, but rather, the auditor consents to the continued use of the auditor's report.[113/] Therefore, the auditor's report that is part of the company's registration statement would reflect only the results of the auditor's evaluation under the proposed other information standard of the other information contained in the company's previously filed annual report and not reflect the auditor's procedures under AU sec. 711 on the portions of the shelf registration statement other than the previously filed annual report. As such, it is difficult to propose a meaningful auditor reporting requirement for the results of the auditor's evaluation of other information under the existing SEC reporting framework for Securities Act filings.

The Board acknowledges that investors and other financial statement users may believe that the auditor's level of involvement with, and related reporting on, other information in a document filed under the Securities Act, such as a registration statement for an initial public offering, should be no different than the auditor's responsibilities regarding other information contained in an annual report filed under the Exchange Act. The Board continues to assess whether it is possible to propose applying some of the elements of the proposed other information standard regarding the auditor's responsibilities over other information contained in documents filed under the Securities Act. For example, the Board considered proposing only the performance aspects of the proposed other information standard to Securities Act filings. However, the enhancements proposed in the other information standard were driven largely to enable auditor reporting on other information in annual reports filed under the Exchange Act. Additionally, the auditor already has responsibilities to perform procedures under AU sec. 711 for Securities Act filings. As such, the Board is requesting comments and information on the application of the proposed other information standard to Securities Act filings, including possible approaches to applying the reporting aspects of the proposed other information standard or the possible need for additional procedures regarding the auditor's responsibility for other information. The Board is particularly

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[113/] Id.

interested in receiving comments on whether or not additional procedures under AU sec. 711 are necessary or appropriate.

Questions Related to Section XII:

31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?

32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?

33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?

# APPENDIX 7

## *Considerations Regarding Audits of Emerging Growth Companies*

### I. Introduction

The Board is proposing two new standards and related amendments[1/] pursuant to its mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The proposed standards and amendments are intended to (1) increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report and (2) improve the auditor's procedures and enhance the auditor's responsibilities with respect to information outside the financial statements.

The Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

Other proposed changes in the auditor's report would require a description of certain of the auditor's responsibilities, such as the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The proposed auditor reporting standard

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[1/] The Board's proposals include: (1) Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"); (2) Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"); and (3) related proposed amendments to PCAOB standards (the "proposed amendments"). The Board's proposals are also referred to collectively as the "proposed standards and amendments."

also would add to the auditor's report new information regarding the audit and the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements.

As more fully described in the Release and Appendix 5, the Board is proposing an approach that it believes would increase the relevance and informational value of the auditor's report, including by requiring the auditor to provide specific insight into the audit of the company's financial statements.[2/] The proposed approach would be aligned with the Board's mission and is intended to be implemented in a cost-effective way. For example, because critical audit matters are determined based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees.[3/]

The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to "other information," that is, information other than the audited financial statements and the auditor's report, in a company's annual report filed with the U.S. Securities and Exchange Commission ("SEC" or "Commission") under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed enhancements to the required auditor's procedures are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. As a result of the linkage between the proposed auditor reporting standard and the proposed other information standard, investors and other financial statement users would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description

[2/] The Board's approach to increase the relevance and informational value of the auditor's report is discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*; V., *Critical Audit Matters*; and VI., *Explanatory Language*.

[3/] The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*, and V.F., *Other Considerations for Critical Audit Matters*.

of the results of the auditor's evaluation based on the auditor's procedures on the other information.

As described in the Release and Appendix 6, the required procedures under the proposed other information standard are intended to provide consistency and improve the auditor's evaluation of other information, which could be of importance to investment decision making.[4/] The Board believes that the proposed approach to the auditor's responsibilities for other information would be scalable to less complex companies, based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, also anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees.[5/]

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches; (5) current developments in similar projects by other standard setters;[6/] (6) relevant academic research; and (7) significant comments received by the Board from its outreach efforts. In considering the nature and extent of changes to the existing

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4/ The Board's approach to improve the auditor's evaluation of other information is discussed more fully in Appendix 6, specifically Sections III., *Evaluating the Other Information*; and V., *Responding When the Auditor Determines That There is a Potential Misstatement in the Audited Financial Statements*.

5/ The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate the Other Information*; VI., *Reporting in the Auditor's Report*; and VIII., *Other Considerations*.

6/ The International Auditing and Assurance Standards Board ("IAASB") has similar projects related to changes to the auditor's report and the auditor's responsibilities regarding other information. In addition, there are a legislative proposal by the European Commission ("EC") and a subsequent European Parliamentary report that relate to audits of public interest entities. Most recently, the United Kingdom's Financial Reporting Council ("FRC") adopted revisions to its auditor reporting standard. The IAASB's projects, the EC's proposal and subsequent report, and the FRC's revised standard would require auditor reporting on certain additional matters.

auditor's report and the auditor's responsibilities for other information, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding unnecessary burden to the financial reporting process.

## II. Statutory Background

The Board is considering the proposed standards and amendments pursuant to its authority under the Sarbanes-Oxley Act of 2002 ("Act").[7/] If ultimately approved by the Board, the proposed standards and amendments will be filed for approval by the Commission. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")[8/] to provide that any additional rules adopted by the Board subsequent to April 5, 2012 do not apply to the audits of "emerging growth companies" ("EGCs")[9/] unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of

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[7/] Pub. L. No. 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audits of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Pub. L. No. 111-203. The term "registered broker or dealer" is defined in Section 3(a)(48) of the Exchange Act.

[8/] Pub. L. No. 112-106 (April 5, 2012).

[9/] Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

investors and whether the action will promote efficiency, competition, and capital formation."[10/]

In addition, the JOBS Act specified that "[a]ny rules of the Board requiring…a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company…".[11/] The proposed standards and amendments, if adopted, will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs. Before adoption, the proposed standards and amendments will be subject to an evaluation as to whether the Board should recommend to the SEC that the proposed standards and amendments be applicable to the audits of EGCs and the SEC will make a separate determination regarding the applicability of the proposed standards and amendments to the audits of EGCs. At this time no determination has been made about the applicability of the proposed standards and amendments to the audits of EGCs.

This Appendix contains a discussion of considerations relating to EGCs and includes data on EGCs. This Appendix also includes specific questions and requests relevant information, including potential costs, and empirical data, to the extent available to commenters, regarding the potential application of the proposed standards and amendments to the audits of EGCs. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is requesting commenters' views on the applicability of the proposed standards and amendments to the audits of EGCs and responses to specific questions in order to provide information to enable the Board to assist the SEC in making its determination regarding the applicability of the proposed standards and amendments to the audits of EGCs.

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[10/] See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.

[11/] Id. An auditor's discussion and analysis ("AD&A") currently does not exist in auditing standards but was described as one of several conceptual alternatives for changing the auditor's reporting model in the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release"), PCAOB Release No. 2011-003 (June 21, 2011). Section IV.A., *Auditor's Discussion and Analysis,* of this Release describes an AD&A and related comments received on the concept release.

The Board's Release, as well as Appendices 5 and 6, provide related information regarding the proposed standards and amendments, including discussions of the following areas (1) the background of and reasons for the proposed standards and amendments; (2) the Board's approach, including consideration of alternatives; (3) key changes and improvements from existing requirements; and (4) potential costs related to the proposed standards and amendments. Economic considerations related to the proposed standards and amendments are noted in the Release and this Appendix, with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard.

## III. Characteristics of Self-Identified EGCs

The PCAOB has begun to monitor implementation of the JOBS Act in order to better understand the characteristics of EGCs[12/] and inform the Board's considerations regarding whether it should request that the SEC apply the proposed standards and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.[13/]

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12/ In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than $1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the issuer retains its EGC status until the earliest of: (1) the first year after it has total annual gross revenue of $1 billion or more (as indexed for inflation every five years by the SEC); (2) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (3) the date on which the company issues more than $1 billion in non-convertible debt during the prior three-year period; or (4) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, a company that has been public for at least one year and has an equity float of at least $700 million). See Section 3(a)(80) of the Exchange Act.

13/ To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and May 15, 2013, for disclosures by companies related to their EGC status. Companies with filings indicating that they are no longer EGCs are not included in this analysis. Any filings subsequent to May 15, 2013 are not included in this analysis. The PCAOB has not validated these companies' self-identification as EGCs. The information presented also does not include data for

As of May 15, 2013, based on the PCAOB's research, 909 SEC registrants have identified themselves as EGCs in SEC filings.

These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are: blank check companies; pharmaceutical preparations; real estate investment trusts; prepackaged software services; and computer processing/data preparation services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are: federally chartered savings institutions; real estate investment trusts; national commercial banks; state commercial banks; and natural gas transmission. Total assets of EGCs in these five SIC codes represent approximately 42% of the total assets of the population of EGCs. EGCs in three of these five SIC codes represent financial institutions (that is, federally chartered savings institutions, national commercial banks, and state commercial banks) and the total assets for these three SIC codes represent approximately 28% of the total assets of the population of EGCs.

A majority of the companies that have identified themselves as EGCs have begun reporting information under the securities laws since 2012. Of these companies, approximately:

- 25% identified themselves in registration statements and were not reporting under the Exchange Act as of May 15, 2013.
- 55% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later.
- 20% of the companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these companies have securities listed on a U.S. national securities exchange as of May 15, 2013.

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companies that have filed confidential registration statements and have not subsequently made a public filing.

Approximately 65% of the companies that have identified themselves as EGCs and filed an Exchange Act filing indicated that they were smaller reporting companies.[14/]

Audited financial statements were available for nearly all of the companies that have identified themselves as EGCs.[15/] For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of May 15, 2013:

- The reported assets ranged from zero to approximately $18.2 billion. The average and median reported assets were approximately $183.7 million and approximately $0.3 million, respectively.[16/]

- The reported revenues ranged from zero to approximately $959.1 million. The average and median reported revenues were approximately $56.3 million and zero, respectively.

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[14/] The SEC adopted its smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 8876 (Dec. 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than $75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below $50 million in the previous year.

[15/] Audited financial statements were available for 897 of the 909 self-identified EGCs. Audited financial statements were not available for some EGCs that have filed registration statements that have not been declared effective.

[16/] For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 were approximately $12.1 billion and approximately $1.5 billion, respectively. The average and median reported revenues from the most recent audited financial statements filed as of May 15, 2013 of issuers in the Russell 3000 were approximately $4.6 billion and $717.2 million, respectively.

- The average and median reported assets among companies that reported revenues greater than zero were approximately $365.8 million and $59.9 million, respectively. The average and median reported revenues among companies that reported revenue greater than zero were approximately $113.5 million and $17.2 million, respectively.
- Approximately 48% identified themselves as "development stage entities" in their financial statements.[17/]
- Approximately 35% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued audit reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms. Approximately 65% were audited by triennially inspected firms (that is, firms that have issued audit reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.
- Approximately 55% had an explanatory paragraph included in the auditor's report on their most recent audited financial statements describing that there is substantial doubt about the company's ability to continue as a going concern.[18/]

Approximately 40% of the self-identified EGCs that provided a management report on internal control over financial reporting stated in the report that the company's internal control over financial reporting was not effective.[19/]

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17/ According to Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.

18/ Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern.

19/ Approximately 4% of the population of companies in the Russell 3000 Index provided a management report on internal control over financial reporting stating that the company's internal controls over financial reporting were not effective.

The JOBS Act includes a provision that allows Securities Act registration statements of EGCs to include two years of audited financial statements instead of three years for the initial public offering of common equity securities. Approximately 750 of the self-identified EGCs would not be required to present more than two years of financial statements regardless of the JOBS Act relief.[20/] Approximately 75% of the remaining portion of the EGC population have opted out of the provision by providing in their registration statements audited financial statements for three years instead of two. Some of the EGCs that opted out of this provision described in their filings risks related to taking advantage of some of the JOBS Act provisions. Risks described included the company's common stock becoming less attractive to investors and their financial statement disclosures not being comparable to those of similar companies.

## IV. Economic Considerations

The economic considerations summarized below are addressed in the Release, Appendix 5, and Appendix 6, and could apply to both small and large companies. A number of these considerations are relevant to efficiency, competition, and capital formation.

### A. Proposed Auditor Reporting Standard

The proposed auditor reporting standard would require the auditor to communicate in the auditor's report critical audit matters. Critical audit matters ordinarily are matters of such importance in the audit that they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. Thus, the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards and does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

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[20/] Some EGCs (1) are already afforded such relief as smaller reporting companies, (2) have existed for less than three years, (3) follow the reporting requirements of development stage entities which require an income statement since inception, or (4) have not filed a Securities Act registration statement yet, and thus have not availed themselves of this relief.

The Board believes that auditor reporting linked to matters identified during the audit that involved the most difficult judgments or the most difficulty in obtaining evidence or forming the opinion is responsive to the requests of many investors for information that should provide a greater degree of insight into the audit. Communication of critical audit matters is expected to result in information specific to each audit of a company's financial statements, and would highlight important aspects of the audit.

Additionally, the proposed auditor reporting standard would add to the auditor's report new information regarding the audit or the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements. This new information generally would be standardized language about the audit or the auditor and would be the same or very similar among different auditors' reports.

The proposed auditor reporting standard retains from the existing standard[21/] the use of explanatory paragraphs in the auditor's report, including the auditor's ability to emphasize a matter regarding the financial statements.

The Board also anticipates that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees, such as:[22/]

- One-time costs that relate primarily to updating an audit firm's methodology and training regarding auditor reporting for basic elements and critical audit matters. Additionally, the auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor;
- Recurring costs in each individual audit relative to the determination, communication in the auditor's report, and documentation of critical audit matters; and

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[21/] AU sec. 508, *Reports on Audited Financial Statements*.

[22/] The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements,* and V.F, *Other Considerations for Critical Audit Matters*.

- Recurring costs for the company, including the audit committee, for reviewing the critical audit matters included in the draft auditor's report.

There could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[23/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[24/]

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information[25] in the financial statements. Academic research has indicated that

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23/ Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

24/ See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

25/ The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[26/]

Auditor's reports that include critical audit matters would be specific to the audit of the company. Therefore, auditors' reports would be different between the company's current period critical audit matters and those of prior periods or those of the company's competitors. Some investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Critical audit matters, however, would not necessarily include all the information important to an investment decision.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand a critical audit matter or the meaning of a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

Some comments regarding alternatives presented in the concept release indicated that more information about the audit in the auditor's report could lead to more efficient pricing of equity securities, either through changes in expected future earnings or changes in the discount rate used to value future earnings, or both.

As previously noted, the Board anticipates that the communication of critical audit matters would result in auditor's reports that could vary significantly – both among companies and reporting periods. Academics that conducted a study of financial

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signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[26/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

analysts to assess how they use an auditor's report as part of a company evaluation found that the variability of information content would mean that the information would not be just confirming prior beliefs about financial statement quality but would be more likely to affect user decision making and increase the perceived quality of the audit.[27/]

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[28/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. Making the auditor's report more informative can benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the amount or quality of the information in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[29/]

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[27/] See Paul J. Coram, Theodore J. Mock, Jerry L. Turner, and Glen L. Gray, *The Communicative Value of the Auditor's Report*, 58 Australian Accounting Review 235, 235-252 (2011).

[28/] See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

[29/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

## B. Proposed Other Information Standard

The proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. The proposed other information standard includes specific procedures designed to improve the auditor's evaluation of the other information. These procedures are intended to provide consistency in practice among auditors when evaluating the other information or responding to material inconsistencies or material misstatements of fact identified in the other information. These proposed procedures also are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. The Board, however, also anticipates that the proposed other information standard would have some cost implications for auditors and companies, including audit committees, such as:[30/]

- One-time costs, for example, updating audit firm methodologies to reflect the new performance and reporting requirements and training firm personnel;

- Recurring costs related to increased auditor effort to evaluate the other information, particularly for firms that might not currently be performing evaluation procedures on the other information similar to those in the proposed other information standard;

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[30/] The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate*; VI., *Reporting in the Auditor's Report;* and VIII., *Other Considerations*.

- Costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including costs related to performing procedures to respond to, and report on, such material inconsistency, material misstatement of fact, or both;[31/] and

- Costs that might also arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

The enhanced reporting requirements regarding other information are designed to provide investors and other users of financial information with an understanding of the auditor's responsibilities related to the other information as well as the results of the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[32/] or intentional misreporting.[33/] As a result of the auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the

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[31/] Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing standard because the requirements of the two standards are similar in this respect.

[32/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting,* Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[33/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[34/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors could also facilitate more efficient capital allocation decisions.[35/] Academic research has shown that the increased quality of information could also result in a reduction in the average cost of capital.[36/]

## V. Request for Comment on the Applicability of the Proposed Standards and Amendments to Emerging Growth Companies

The Board is in the process of considering how the proposed standards and amendments might affect audits of EGCs.

Based on the data outlined in Section III, *Characteristics of Self-Identified EGCs*, above, EGCs generally appear to be smaller and newer public companies. Although it may be often assumed that such companies would have operations, and respectively audits, that are less complex, this may not be true for many EGCs.

As noted in Section III above, financial institutions represent approximately 28% of the total assets of EGCs. Given the nature of the operations of financial institutions, the audits of these EGCs might involve subjective or complex areas, such as the auditor's evaluation of the determination of the allowance for loan losses or the valuation of financial instruments with little market activity. Therefore, in the audits of these EGCs, the auditor might be addressing matters that meet the definition of critical audit matters because they involved difficult, subjective, or complex auditor judgments.

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[34/] See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[35/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

[36/] Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital,* 9 Review of Accounting Studies 233, 233-259 (2004).

The data presented in Section III above also suggests that EGCs are 10 times more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. As a result, in the audits of EGCs, the auditor might be presented with control deficiencies of high severity which likely would be a consideration in the auditor's determination of critical audit matters because the control deficiencies might, for example, pose difficulty to the auditor in obtaining sufficient appropriate audit evidence.

Further, the data presented in Section III above indicates that for 55% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index. This suggests that for the majority of EGCs the auditor is evaluating whether there is substantial doubt about the company's ability to continue as a going concern. Depending on the facts and circumstances, the auditor's evaluation might meet the definition of critical audit matters.

As described in Section III above, a review of SEC filings of EGCs indicates that three quarters of the EGCs that could have taken advantage of a JOBS Act provision to present two years of financial statements in their registration statements have chosen not to avail themselves of this provision and instead presented three years, which is generally required of non-EGC companies. Discussion included in EGC filings suggests that taking advantage of JOBS Act provisions that allow more limited disclosures in a company's filings is viewed by at least some EGCs as presenting risks that they are unwilling to take.

The application of the proposed auditor reporting standard, specifically the requirement to communicate critical audit matters, may be beneficial to EGCs because critical audit matters would provide more information about the company's audit to investors and other financial statement users. In general, there is less information available in the market about smaller and newer companies than there is about larger, more established companies. For example, smaller companies have very little, if any, analyst coverage which lessens the entire mix of information made available to investment bankers, fund managers, and individual investors which makes markets less efficient.[37/] The communication of critical audit matters would provide more information

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[37/] See SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, (April 23, 2006) at 73, available at http://www.sec.gov/info/smallbus/acspc.shtml.

to investors and provide insight about the most difficult, subjective, or complex matters that the auditor addressed in the audit. Providing meaningful information about the audit, such as the communication of critical audit matters in the auditor's report, could thus be particularly beneficial to smaller and newer companies. The availability of such information could contribute toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital.

As noted in Section III above, many EGCs have identified themselves as smaller reporting companies. Smaller reporting companies generally apply the SEC's scaled disclosure rules.[38/] Therefore, these companies have less other information for the auditor to evaluate under the proposed other information standard than larger companies. Thus, EGCs that are smaller reporting companies may incur less cost related to the evaluation of the other information than larger companies.

As the Board's considers whether it should request the SEC to apply the proposed standards and amendments to the audits of EGCs, the Board reviewed relevant comments received in response to the concept release and from the Board's Standing Advisory Group ("SAG"). The concept release, which was issued before the JOBS Act became law, included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others. Commenters diverged on whether certain types of companies should be excluded from the scope of changes to the auditor reporting model.

Some commenters that responded to this question in the concept release suggested that, depending on the nature and extent of changes to the auditor's report, the Board give different consideration to the auditors' reports of smaller companies, which would include many EGCs. Suggested examples of such considerations include a phased-in implementation depending on the size of the company; application of any new requirements only to larger companies followed by consideration of expanding the requirements to smaller companies; and total exemption for companies under certain market capitalization. The reasons for the suggested different considerations include

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[38/] The SEC adopted a new system of disclosure rules for smaller reporting companies. The new rules were effective February 4, 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. See SEC, *Smaller Reporting Company Regulatory Relief and Simplification,* Securities Act Release No. 8876 (Dec. 19, 2007).

greater cost constraints typically experienced by smaller companies; differences in corporate structure, complexity, and the types of users of smaller companies' financial information; and statutory exemptions for certain smaller companies from the requirement for an auditor's report on internal control over financial reporting.

In contrast, other commenters that responded to this question in the concept release supported requiring the same reporting for all companies regardless of nature or size. The primary reason of these commenters' views was better consistency and comparability of auditors' reports across companies.

Likewise, some participants at the May 2012 SAG meeting commented that they do not support the development of separate auditing standards for EGC and non-EGC public companies because it would be very difficult for the auditor to apply an "on/off switch" with respect to the auditor's responsibilities.[39/] Those participants described a differential approach to EGCs as challenging and resulting in unnecessary complications for audits of EGCs. These participants did not clarify whether their comments relate to audit performance standards, reporting standards, or both. This concern of having different auditing standards for EGCs may be mitigated to the extent that reporting on critical audit matters is a discrete and separable task.

As noted previously, approximately 65% of EGCs were audited by triennially inspected firms that are not affiliated with annually inspected firms. Approximately 76% of triennially inspected firms audit 10 or fewer issuers[40/] which could indicate that these are small firms with more limited resources. Therefore, developing and maintaining different methodologies for audits of EGCs and non-EGCs, as well as the related staff training, could have a disproportionately negative effect on triennially inspected firms because of higher costs in relation to their income.

Exempting EGCs from the proposed standards and amendments might put them at an informational disadvantage compared to larger and more established companies that would be subject to the proposed standards and amendments. For example, if the

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39/ See May 2012 SAG meeting available at http://pcaobus.org/News/Webcasts/Pages/05172012_SAGMeeting.aspx.

40/ See Exhibit 1 of *Report on 2007-2010 Inspections of Domestic Firms That Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013) available at http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf.

standards do not apply to audits of EGCs, but are applicable to audits of larger and more established companies, the potential disparity between the two groups of companies in the amount and quality of public information available for investment decision making could increase. To the extent that market participants perceive adoption of the proposed standards and amendments as a step toward lowering information asymmetry between company management and investors, exempting EGCs from the proposed standards and amendments may also put them at a disadvantage. Exempting EGCs from the proposed standards and amendments could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a competitive disadvantage compared to non-EGCs in attracting available capital.

The Board is interested in commenters' views on the impact of the proposed standards and amendments on audits of EGCs. The Board is soliciting comments generally on issues it should consider relating to the applicability of the proposed standards and amendments to EGCs, as well as responses to the specific questions below.

Questions:

1. Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?

2. Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?

3. Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?

4. Would audits of EGCs be more, less, or equally likely to have critical audit matters?

5. Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?

6. What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?

7. What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?

8. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?

9. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?

10. For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

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| PROPOSED AUDITING STANDARD—<br><br>THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION<br><br>AND RELATED AMENDMENTS TO PCAOB STANDARDS | PCAOB Release No. 2016-003<br>May 11, 2016<br><br>PCAOB Rulemaking<br>Docket Matter No. 034 |

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is reproposing a standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which would supersede portions of AS 3101, *Reports on Audited Financial Statements*, and related amendments to PCAOB standards.

Public Comment: Interested persons may submit written comments to the Board. Comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 034 in the subject or reference line and should be received by the Board by August 15, 2016.

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## I. Summary

The Board is reproposing the auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("reproposed standard" or "reproposal"). The reproposal would retain the pass/fail model of the existing auditor's report, which is generally acknowledged to be a useful signal as to whether the audited financial statements are presented fairly. Consistent with the Board's statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports,"[1] the reproposal also seeks to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users. In particular, the auditor's report would include a description of "critical audit matters," which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures.

The reproposal builds on more than five years of Board outreach, in which many investors and other financial statement users have consistently urged the Board to make the auditor's report more relevant and informative. Outside the United States, other regulators and standard setters have also moved toward expanded auditor reporting.

The auditor's report is the primary means by which the auditor communicates information regarding the audit of the financial statements to investors and other financial statement users. As currently designed, however, the auditor's report conveys very little of the information obtained and evaluated by the auditor as part of the audit. And while the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates and fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, this information is not known to investors. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry[2] between investors and auditors. This may

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1 Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

2 Economists often describe this imbalance, where one party has more or better information than another party, as "information asymmetry." As part of the system of financial reporting, the audit of the financial statements helps reduce the information

limit the extent to which the auditor's report can address the information asymmetry between investors and management.

In recent years, many investors and others have stated that auditors should provide additional information in the auditor's report to make the report more relevant and useful.[3] At the same time, other commenters, primarily issuers and accounting firms, have argued that it would be inappropriate for the auditor to provide financial analysis or disclosures on behalf of the company being audited. The reproposed standard is intended to respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's expertise or mandate.

The communication of critical audit matters would inform investors and other financial statement users of matters arising from the audit that required especially challenging, subjective, or complex auditor judgment, and how the auditor responded to those matters. The Board believes that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; unusual transactions; and other significant changes in the financial statements.

In addition to informing investors and other financial statement users about areas of the audit that were especially challenging, subjective, or complex and helping them understand how the auditor addressed these areas, the Board believes that the communication of critical audit matters should help focus investor attention on these matters and provide a new perspective on the financial statements. For instance, additional reporting by the auditor could facilitate analysis of the financial statements and help investors and analysts engage management with targeted questions about

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asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

[3] *See* survey, *Improving the Auditor's Report*, which was presented by the working group of the PCAOB's Investor Advisory Group ("IAG") on the Auditor's Report and The Role of the Auditor (Mar. 16, 2011) ("IAG 2011 survey"). *See also* CFA Institute's *Usefulness of the Independent Auditor's Report Survey Results* (May 4, 2011); *Independent Auditor's Report Survey Results* (Mar. 31, 2010); and *Independent Auditor's Report Monthly Poll Results* (Mar. 12, 2008) ("CFA survey and poll results"). *See also* transcripts and participant statements from the Board's April 2014 public meeting, available on the Board's website in Rulemaking Docket Matter No. 034, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* ("Docket 034").

critical audit matters. To the extent the identification and communication of critical audit matters increases focus by auditors, audit committees, and management on the matters identified as critical audit matters, it may also lead to an incremental increase in audit quality and the quality of information presented in the financial statements and related disclosures.

In addition to critical audit matters, the reproposal includes other improvements to the existing auditor's report under AS 3101 (currently AU sec. 508[4]), *Reports on Audited Financial Statements*, primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements and make the auditor's report easier to read.

The reproposed standard would include the following significant changes to the existing auditor's report:

- *Critical audit matters*—would require communication in the auditor's report of any critical audit matters arising from the audit of the current period's financial statements.
    - *Definition of a critical audit matter*—any matter that was communicated or required to be communicated to the audit committee and that:
        - Relates to accounts or disclosures that are material to the financial statements, and
        - Involved especially challenging, subjective, or complex auditor judgment.
    - *Factors in determining critical audit matters*—the auditor would take into account a nonexclusive list of factors in determining whether a matter

[4] In 2015, the PCAOB adopted and the U.S. Securities and Exchange Commission ("SEC") approved the reorganization of PCAOB auditing standards using a topical structure and a single, integrated numbering system. *See Reorganization of PCAOB Auditing Standards and Related Amendments to PCAOB Standards and Rules*, PCAOB Release No. 2015-002 (Mar. 31, 2015); SEC, *Public Company Accounting Oversight Board; Order Granting Approval of Proposed Rules To Implement the Reorganization of PCAOB Auditing Standards and Related Changes to PCAOB Rules and Attestation, Quality Control, and Ethics and Independence Standards*, Exchange Act Release No. 75935 (Sept. 17, 2015), 80 FR 57263 (Sept. 22, 2015). The reorganized amendments will be effective as of December 31, 2016, but may be used and referenced before that date. *See* PCAOB Release No. 2015-002, at 21.

involved especially challenging, subjective, or complex auditor judgment, such as the auditor's assessment of the risks of material misstatement, including significant risks.

- o *Communication in the auditor's report*—the auditor would identify the critical audit matter, describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures. If there are no critical audit matters, the auditor would so state in the auditor's report.
- o *Documentation*—the auditor would document the basis for its determination of whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved especially challenging, subjective, or complex auditor judgment.

- *Additional Improvements to the Auditor's Report*
  - o *Clarifications of existing auditor responsibilities*—enhance certain standardized language in the auditor's report, including adding a statement about auditor independence and the phrase "whether due to error or fraud," when describing the auditor's responsibilities under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements;
  - o *Tenure*—add a basic element of the auditor's report related to auditor tenure; and
  - o *Standardized form of the auditor's report*—require the opinion be the first section of the auditor's report and require section titles to guide the reader.

The reproposal has been informed by comments received on the 2013 proposal,[5] the Board's April 2014 public meeting,[6] analysis of economic considerations, academic research, and international developments. In particular, while the concept of critical

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[5] *See Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (Aug. 13, 2013) ("2013 proposal" or "proposed standard").

[6] *See* transcripts and participant statements from the public meeting, available on the Board's website in Docket 034.

audit matters has been carried forward from the 2013 proposal, the reproposed requirements have been narrowed in a number of respects, including by:

- Limiting the source of potential critical audit matters to matters communicated or required to be communicated to the audit committee;
- Adding a materiality component to the definition of critical audit matter;
- Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment; and
- Revising the related documentation requirement.

In addition, the reproposed communication requirement has been expanded to require the auditor to describe how the critical audit matter was addressed in the audit. As under the 2013 proposal, the reproposed communication of critical audit matters would not change the auditor's current role of attesting to information prepared by management.

The reproposed standard would generally apply to audits conducted under PCAOB standards. However, unlike the 2013 proposal, communication of critical audit matters would not be required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5; investment companies other than business development companies; and employee stock purchase, savings, and similar plans ("benefit plans").[7]

The 2013 proposal also included another new auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements.[8] The Board is not reproposing the "other information" auditing standard at this time but plans to determine next steps at a later date.

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[7] The other requirements of the reproposed standard would be applicable to audits of these types of entities.

[8] *See* PCAOB Release No. 2013-005.

## II. Background

### A. Rulemaking History

Changes to the auditor's report have been discussed by several commissions and committees, including the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP").[9] ACAP recommended that the PCAOB consider improvements to the auditor's report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and also contributes to greater complexity in financial reporting.

The PCAOB commenced its standard-setting project on the auditor's reporting model in 2010 with outreach to different stakeholders, including investors, financial statement preparers, and auditors. During that outreach, many investors expressed dissatisfaction with the content of the existing auditor's report because it provides to investors little, if any, information specific to the audit of the company's financial statements. Generally, preparers, audit committee members, and auditors were not supportive of adding company-specific information to the auditor's report, arguing that the company, through its management or audit committee, should be the primary source of the company's financial information. Changes to the auditor's report were also discussed at the March 2011 IAG meeting.[10] Some investors who participated in that meeting suggested that expanded auditor reporting would have been helpful before and during the 2008 financial crisis.[11] Later in March 2011, the Board held an open meeting to discuss findings from its outreach.[12]

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[9] *See* ACAP, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (Oct. 6, 2008), at VII:17. *See also* The 103rd American Assembly, *The Future of the Accounting Profession* (Nov. 2003); *Report of the National Commission on Fraudulent Financial Reporting* (Oct. 1987); and American Institute of Certified Public Accountants, *Commission on Auditor's Responsibilities: Report, Conclusions, and Recommendations* (1978).

[10] *See* IAG meeting details and webcast for March 2011, available on the Board's website.

[11] *See* presentation by the working group of the IAG on *Lessons Learned from the Financial Crisis* (Mar. 16, 2011).

[12] *See* meeting details and webcast for PCAOB Open Board meeting on March 22, 2011, available on the Board's website.

In June 2011, the Board issued a concept release to solicit comment on a number of potential changes to the auditor's report.[13] The Board also held a public roundtable in September 2011 to obtain additional insight on the alternatives presented in the concept release.[14] Changes to the auditor's report were also discussed at the November 2011 and 2012 meetings of the Board's Standing Advisory Group ("SAG").[15]

After considering the results of its outreach and comments on its concept release, in August 2013, the Board proposed an auditing standard that included, among other things, new requirements for auditors to communicate critical audit matters, as well as additional improvements to the auditor's report.[16] The Board received 248 comment letters on the 2013 proposal. Most commenters to the 2013 proposal generally supported the Board's objective to improve the auditor's report to make it more informative and relevant to financial statement users, but commenters' views varied on the nature and extent of such changes, particularly as to critical audit matters.[17] Commenters generally supported changes to the basic elements; however, commenters' views varied as to critical audit matters, with investors and large accounting firms generally supporting communication of critical audit matters, with some modifications, smaller accounting firms being less supportive, and preparers and audit committee members generally opposing communication of critical audit matters.

In April 2014, the Board held a public meeting to obtain further input on the 2013 proposal from a diverse group of investors and other financial statement users, preparers, audit committee members, auditors, and others.[18] The 2013 proposal was

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[13] *See Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards; Notice of Roundtable*, PCAOB Release No. 2011-003 (June 21, 2011) ("concept release").

[14] *See* transcript of the roundtable, available on the Board's website in Docket 034.

[15] *See* SAG meeting transcripts, available on the Board's website in Docket 034.

[16] *See* PCAOB Release No. 2013-005.

[17] *See* comment letters on the 2013 proposal, available on the Board's website in Docket 034.

[18] *See* transcripts and participant statements from the public meeting, available on the Board's website in Docket 034.

further discussed at the November 2013 and June 2014 SAG meetings, and the October 2013 and October 2014 IAG meetings.[19]

## B. Initiatives of Other Regulators and Standard Setters

### *1. Overview of the Requirements of the IAASB, the EU, and the FRC*

The form and content of the auditor's report is undergoing change globally. In recent years, several international regulators and standard setters, including the International Auditing and Assurance Standards Board ("IAASB"), the European Union ("EU"), and the Financial Reporting Council in the United Kingdom ("FRC"), have adopted requirements for expanded auditor reporting that go beyond the binary pass/fail model. While their underlying requirements for expanded auditor reporting differ in the details, there is a common theme in these initiatives: communicating information about audit-specific matters in the auditor's report. In addition to expanded auditor reporting, many of these initiatives also include other changes to the form and content of the auditor's report.

Several commenters have urged the Board to work together with these other regulators and standard setters to improve the auditor's report. The Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Even so, the Board is considering carefully the efforts undertaken in other jurisdictions, and, as described in more detail below, the Board's reproposal is analogous in many respects to auditor reporting requirements recently established in other jurisdictions.

*IAASB*. In September 2014, the IAASB adopted changes to the requirements for the auditor's report, including a new requirement for the auditor to communicate "key audit matters" for audits of listed companies.[20] Key audit matters are selected from matters communicated with those charged with governance and are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.[21] The IAASB requires that the description of each key audit matter in the auditor's report include: (1) why the matter

[19] *See* SAG and IAG meeting transcripts, available on the Board's website in Docket 034.

[20] The IAASB changes to the auditor's report are effective for audits of financial statements for periods ending on or after December 15, 2016.

[21] *See* paragraph 8 of International Standard on Auditing ("ISA") 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

was considered to be a key audit matter, (2) how the matter was addressed in the audit, and (3) reference to the related disclosures, if any, in the financial statements.[22]

As part of its auditor reporting project, the IAASB also adopted additional changes to the form and content of the auditor's report. These include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit,[23] an enhanced description of the responsibilities of the auditor,[24] and requiring the auditor's opinion to be the first paragraph of the auditor's report.[25]

*EU*. In April 2014, the EU adopted legislation creating a number of new requirements, including expanded auditor reporting requirements, for audits of public-interest entities ("PIEs"), such as listed companies, credit institutions, and insurance companies.[26] Under the EU reforms, the auditor's report for a PIE is required to include a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, as well as a summary of the auditor's response to those risks and, where relevant, key observations arising with respect to those risks. In addition, the EU reforms require a statement that the auditor remained independent of the audited entity and disclosure of auditor tenure.

*FRC*. In June 2013, the FRC revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code.[27] The auditors of those entities

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[22] *See* paragraph 13 of ISA 701.

[23] *See* paragraph 28(c) of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

[24] *See* paragraph 37 of ISA 700.

[25] *See* paragraph 23 of ISA 700.

[26] *See* Article 10, *Audit Report*, of Regulation (EU) No 537/2014 of the European Parliament and of the Council ("Regulation (EU) No 537/2014"). EU member states have until June 2016 to adopt the provisions of the EU legislation into their own national laws and rules. Information on member state implementation is available at http://ec.europa.eu/finance/auditing/reform/index_en.htm.

[27] These entities include companies with a premium listing of equity shares on the London Stock Exchange, regardless of whether they are incorporated in the U.K. or elsewhere. The changes made to the auditor's report were designed to complement other changes made to the UK Corporate Governance Code that require the audit

are required, among other things, to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team. In addition, auditors are required to provide an explanation of how the scope of the audit addressed the risks.[28]

In April 2016, the FRC adopted a final rule updating its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements.[29] Under the final rule, the FRC adopted the IAASB's definition of key audit matters. In the application and other explanatory material on the definition of key audit matters, the FRC identified risks of material misstatement, as determined under both its existing requirements and those of the EU, as key audit matters under that definition. When the FRC proposed these rule changes in September 2015, it stated that it did not expect the incorporation of its own requirements and those of the EU to result in an increase in the number of key audit matters communicated in the auditor's report over what would be required by the IAASB standard alone.[30]

*2. Comparison of the Board's Reproposal to Other Requirements*

Even though the underlying auditor reporting requirements of other regulators and standard setters are different in the details, in many respects, the initiatives are analogous to the Board's reproposal. All of these initiatives would result in expanding the auditor's report beyond the traditional pass/fail model to communicate information specific to the particular audit. Although the processes of identifying these matters would vary across jurisdictions, there are commonalities in the underlying criteria

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committee to describe significant issues it considered relating to the financial statements. *See* Section C.3.8 of FRC UK Corporate Governance Code (Sept. 2012).

[28] *See* paragraphs 19A–B of ISA (UK and Ireland) 700 (Revised June 2013), *The Independent Auditor's Report on Financial Statements* ("UK ISA 700 (2013)"). The FRC 2013 requirements became effective for audits of financial statements for periods beginning on or after October 1, 2012.

[29] *See* the FRC's Final Draft, International Standards on Auditing (UK and Ireland) 701*, Communicating Key Audit Matters in the Independent Auditor's Report* (Apr. 2016). This rule is effective for audits of financial statements for periods beginning on or after June 17, 2016.

[30] *See* the FRC's *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance on Audit Committees* (Sept. 2015).

regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches. The Board will continue monitoring developments of expanded auditor reporting in other jurisdictions throughout the rulemaking process and will continue to consider their relevance to its own standard-setting project.[31]

Section IV, *Discussion of the Reproposal*, includes descriptions of IAASB, EU, and FRC 2013 requirements that are analogous to the key provisions of the reproposed standard. The FRC recently adopted a final rule that updates its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, which has not yet gone into effect. Because the FRC 2013 requirements govern the expanded auditor reporting that has occurred in the United Kingdom and is the subject of the FRC reports and academic studies described elsewhere in this release, the FRC 2013 requirements are used as a basis for comparison.

The IAASB's standard is most similar to the Board's reproposal since it requires the auditor to communicate key audit matters selected from matters communicated with those charged with governance. The FRC, under its 2013 requirements, and the EU start with the risks of material misstatement and contemplate a different process for determining matters to be communicated than the Board's reproposal. The FRC stated, however, that key audit matters under the IAASB standard are broadly equivalent to the assessed risks of material misstatement included in the UK ISA 700 (2013).[32]

The IAASB and the FRC 2013 requirements are also accompanied by application and other explanatory materials that provide further guidance on the standards. These materials are excluded from the descriptions that follow of the IAASB, EU, and FRC provisions because they are not part of the requirements.

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[31] For example, the Board and PCAOB staff had discussions with representatives from the IAASB, EU, and FRC regarding their initiatives, and the April 2014 public meeting included representatives from these organizations.

[32] *See* the FRC's *Extended Auditor’s Reports, A Further Review of Experience* (Jan. 2016) ("FRC 2016 Report"), at 7.

## III. Overview of the Reproposal

The Board is reproposing the auditor reporting standard, which would retain the pass/fail opinion[33] of the existing auditor's report but would make significant changes to the existing auditor's report, including the following:

- *Critical audit matters*—would require the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit or state that the auditor determined that there are no critical audit matters (*see* Figure 1):
  - o A critical audit matter would be defined as a matter that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.
  - o In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor would take into account, alone or in combination, factors specific to the audit, including:
    - ▪ The auditor's assessment of the risks of material misstatement, including significant risks;
    - ▪ The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
    - ▪ The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
    - ▪ The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

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[33] This type of opinion has been commonly described as pass/fail because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).

- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

- The nature of audit evidence obtained regarding the matter.

o The communication of each critical audit matter would include:

- Identifying the critical audit matter;

- Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter;

- Describing how it was addressed in the audit; and

- Referring to the relevant financial statement accounts and disclosures.

o The documentation of critical audit matters would include the basis for the auditor's determination of whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved especially challenging, subjective, or complex auditor judgment.

- *Additional Improvements to the Auditor's Report* – the reproposal also includes a number of other improvements to the auditor's report that are primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the auditor, or make the auditor's report easier to read:

o *Independence*—include a statement regarding the requirement for the auditor to be independent;

o *Auditor tenure*—include a statement regarding the auditor's tenure;

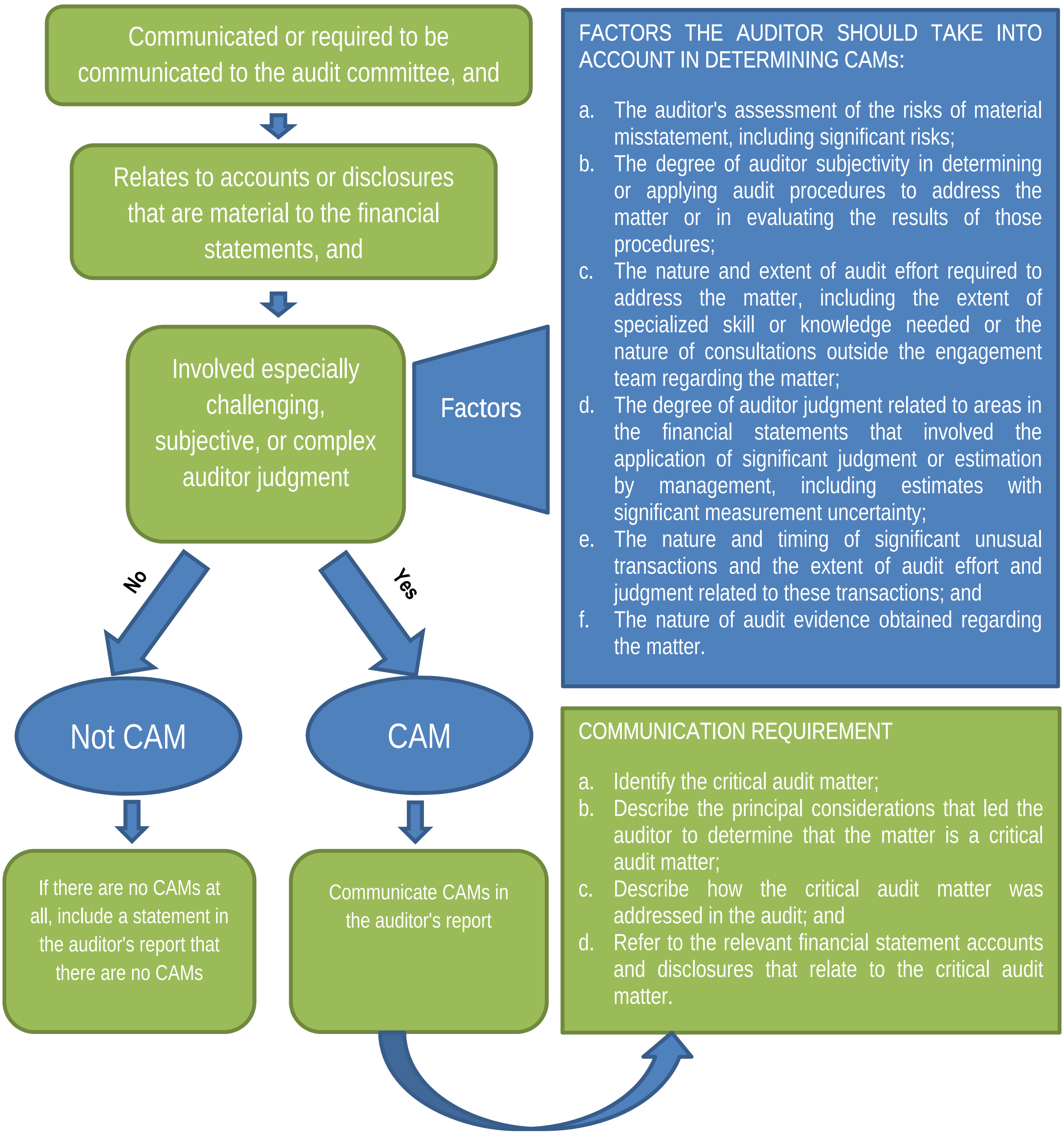
o *Addressee*—include a requirement to address the auditor's report to the company's shareholders and board of directors or equivalents, and expressly permit additional addresses;

o *Enhancements to basic elements*—enhance certain standardized language in the auditor's report, including adding the phrase *whether due to error or fraud*, when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements; and

- *Standardized form of the auditor's report*—require the opinion to be the first section of the auditor's report and require section titles to guide the reader.

The reproposed standard is attached as Appendix 1.

***Figure 1*. Determining and Communicating Critical Audit Matters ("CAMs")**



## IV. Discussion of the Reproposal

### A. Critical Audit Matters

The 2013 proposal introduced the concept of "critical audit matters," which the auditor would have been required to communicate in the auditor's report. Communication of critical audit matters in the auditor's report was intended to provide more information about the audit and therefore make the auditor's report more informative and relevant to investors and other financial statement users.

Investors, investor advocates, and analysts generally supported the proposed requirement to communicate critical audit matters. Some of them stated that the communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor and focusing their attention on issues that would be pertinent to understanding the financial statements. The larger accounting firms generally supported including critical audit matters in the auditor's report, with some modification of the proposed requirements, while smaller accounting firms and associations of accountants were generally less supportive and suggested that critical audit matter reporting may be misunderstood by investors and other financial statement users. Some commenters, primarily companies and audit committee members, did not support the requirements. These commenters asserted that critical audit matters would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit. The Board has taken into consideration all comments, including those received from investors, accounting firms, companies, audit committee members, and others in reproposing auditor communication of critical audit matters.

Under the reproposal, the concept of critical audit matters is similar to the one introduced in the 2013 proposal.[34] However, the definition of critical audit matter and other requirements have been modified based on comments and other considerations. Critical audit matters would be determined using a principles-based framework leveraging the work already performed by the auditor under existing PCAOB standards. Since critical audit matters are determined using a principles-based framework, the Board anticipates that the critical audit matters would be scalable based on the size, nature, and complexity of the audit.

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[34] Communication of critical audit matters would not be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies other than business development companies; and benefit plans. *See* Section VII.

*1. Determination of Critical Audit Matters*

a. Definition of Critical Audit Matter

The definition of critical audit matters in the 2013 proposal included those matters the auditor addressed during the audit of the financial statements that:

(1) Involved the most difficult, subjective, or complex auditor judgments;

(2) Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or

(3) Posed the most difficulty to the auditor in forming the opinion on the financial statements.

Under the 2013 proposal, critical audit matters ordinarily would have been included in matters required to be: (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three.

In the reproposal, the standard has been revised to define a critical audit matter as any matter arising from the audit[35] of the financial statements that was *communicated or required to be communicated to the audit committee* and that *relates to accounts or disclosures that are material to the financial statements* and *involved especially challenging, subjective, or complex auditor judgment*.

i. Communicated or Required to Be Communicated to the Audit Committee

Commenters generally suggested that the matters communicated to the audit committee should be the source for the auditor's determination of critical audit matters. A commenter stated that, given the audit committee's oversight of the audit and role in representing the interests of shareholders, this would be an appropriate starting point for consideration of critical audit matters. In a limited implementation trial by several accounting firms of auditor reporting requirements under the 2013 proposal, engagement teams observed that using matters communicated to the audit committee

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[35] Rather than referring to "matters addressed during the audit," the reproposed definition refers to matters "arising from the audit." This aligns with the terminology used in AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees,* regarding matters required to be communicated to the audit committee.

as the only source for identification of critical audit matters "might be more effective and may result in the identification of those matters important to the audit in a more effective and efficient manner."[36]

Some commenters stated that matters documented in the engagement completion document and reviewed by the engagement quality reviewer would have already been considered when determining which matters to communicate to the audit committee. Some of these commenters also asserted that it is unlikely that a matter that is determined to be a critical audit matter would not have already been communicated to the audit committee. Other commenters noted that limiting the source of critical audit matters to matters communicated to the audit committee would limit the possibility of considering and communicating too many matters as critical audit matters.

In response to comments, the reproposed standard narrows the source of critical audit matters to matters communicated or required to be communicated to the audit committee. This approach would build on auditor communication requirements under AS 1301, other PCAOB rules and standards,[37] and applicable law,[38] and would also include communications made to the audit committee that were not required as a source of potential critical audit matters.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;

- Certain matters regarding the company's accounting policies, practices, and estimates;

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[36] This limited implementation trial (described by the Center for Audit Quality as a "field test") was initiated and conducted by nine registered public accounting firms under the auspices of the Center for Audit Quality. *See* letter from the Center for Audit Quality (June 19, 2014), at 4, available on the Board's website in Docket 034.

[37] *See* Appendix B of AS 1301, which identifies other rules and standards that require audit committee communication, such as AS 2410 (currently Auditing Standard No.18), *Related Parties*, and AS 2502 (currently AU sec. 328), *Auditing Fair Value Measurements and Disclosures*.

[38] *See, e.g.*, Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Rule 10A-3 under the Exchange Act, 17 CFR 240.10A-3.

- Significant unusual transactions;
- Certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report.

Under the reproposal, critical audit matters would be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). It seems likely that especially challenging, subjective, or complex auditor judgments would relate to areas that are required to be communicated to the audit committee, either under a specific requirement or more broadly as a matter that is significant to audit committee oversight of the financial reporting process.[39] The approach under the reproposal scopes in the broadest population of audit committee communications and would not require the auditor to determine whether matters communicated to the audit committee were required to be communicated.

Some commenters expressed concerns that requiring communication of critical audit matters could have a chilling effect on auditor communications with the audit committee. With respect to any matters required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. It would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee. Given the broad scope of communications required under AS 1301, there should be few communications affected by that possibility. Moreover, other factors, including the two-way dialogue between the audit committee and the auditor, should mitigate the risk of reduced communications.

ii. Relates to Accounts or Disclosures That Are Material to the Financial Statements

Some commenters suggested limiting critical audit matters to matters that are material to the financial statements. These commenters were concerned that the auditor otherwise may be required to communicate information that management is not required to disclose under the applicable financial reporting framework and SEC

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[39] *See* AS 1301.24.

reporting requirements. Some commenters also stated that communicating immaterial matters would: (1) lead management to revise its disclosures to include a discussion of any matter identified as a critical audit matter, regardless of materiality or (2) weaken and obscure the auditor's opinion because such matters would be irrelevant to investors and other financial statement users.

In response to comments, the reproposed definition of critical audit matters requires that the matter relate to accounts or disclosures that are material to the financial statements.[40] "Relates to" clarifies that the critical audit matter could be an element of an account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter; it would relate to goodwill because impairment is an element of that account. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements or relate to many accounts or disclosures. For example, the auditor's evaluation of the company's ability to continue as a going concern or the risk of management's override of internal control could also represent critical audit matters depending on the circumstances of a particular audit.

Because the definition of critical audit matters has been narrowed to include only those matters that relate to accounts or disclosures that are material to the financial statements, there may be certain matters that would have been critical audit matters under the 2013 proposal that would not be critical audit matters under the reproposed standard. For example, a loss contingency that was communicated to the audit committee, but that was determined to be remote and thus not to warrant disclosure under the applicable financial reporting framework, would not meet the reproposed definition of a critical audit matter even if it involved especially challenging auditor judgment. However, matters that would not themselves constitute critical audit matters under the reproposed definition, such as information about the company's processes and controls, could be included, for example, in the description of the principal considerations that led the auditor to determine that a matter is a critical audit matter.

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[40] The definition of materiality is established under the U.S. federal securities laws. In interpreting those laws, the U.S. Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *See also Basic, Inc. v. Levinson*, 485 U.S. 224, 231 to 232 (1988). As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ." *TSC Industries*, 426 U.S. at 450.

iii. Involved Especially Challenging, Subjective, or Complex Auditor Judgment

While some commenters generally supported the proposed definition of critical audit matters, other commenters were concerned that including the second and third criteria of the proposed definition (matters that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence or in forming the opinion on the financial statements) could lead to the reporting of unimportant matters or to misinterpretation by users of the financial statements that the auditor is uncomfortable with the related accounting or disclosure of the matter identified as a critical audit matter.

In response to comments, the reproposed standard retains only the first criterion of the proposed definition, but revises it from "involved the most difficult, subjective, or complex auditor judgments" to "involved especially challenging, subjective, or complex auditor judgment." The proposal included a note clarifying that the word "most" did not imply that only one matter would qualify as a critical audit matter. The use of the word "especially" in the reproposal is intended to convey more clearly that there could be multiple critical audit matters and that the matters are assessed on a relative basis within the specific audit. Further, the word "difficult" was replaced with "challenging" in the reproposed definition based on a commenter's suggestion that "difficult" has negative overtones that suggest critical audit matters are necessarily problematic.

Several commenters suggested that investors would be most interested in auditor reporting on: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them; (2) areas of high financial statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[41]

The reproposed critical audit matter definition would likely cover issues raised in auditing many of the areas identified by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, areas of the financial statements with a higher risk of material misstatement and audit risk, and significant unusual transactions. However, communication of auditor's assessments of the quality of a company's accounting practices and policies, while not precluded, is not required under the reproposal because there is no framework for such assessments and the determinations are inherently subjective.

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[41] These are the same categories of information identified by investor respondents to the IAG 2011 survey.

b. Factors

The 2013 proposal included the following nonexclusive list of factors for the auditor to take into account when determining whether a matter involved the most difficult, subjective, or complex auditor judgment:

- The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
- The nature and extent of audit effort required to address the matter;
- The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;
- The severity of control deficiencies identified relevant to the matter, if any;
- The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;
- The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;
- The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and
- The nature of consultations outside the engagement team regarding the matter, if any.

Commenters in general stated that including factors to consider would assist the auditor in determining critical audit matters.

In the limited implementation trial conducted by several accounting firms, engagement teams observed that the factors that appeared to be most useful in determining critical audit matters were those relating to the degree of auditor subjectivity in determining or applying audit procedures, the nature and extent of audit effort required to address the matter, and the nature and amount of available audit evidence.[42] Under the reproposed standard, these three factors would be retained substantially as proposed. The limited implementation trial also suggested that factors related to the extent of specialized skill or knowledge needed to apply audit procedures and the nature of consultations were also relevant to the determination of critical audit matters. Under the reproposed standard, these factors were retained but combined to create one factor on the nature and extent of audit effort.

Some commenters questioned the usefulness of two factors included in the 2013 proposal: the severity of relevant control deficiencies and the nature and significance of corrected and uncorrected misstatements. Some of these commenters stated that these factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, such as control deficiencies less severe than material weaknesses, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework, such as uncorrected misstatements that were deemed immaterial. In response to comments and to align the factors with the revised definition of critical audit matters, the reproposed standard does not retain these as separate factors. However, aspects of these factors could still be relevant in the auditor's consideration of other factors, such as the nature and extent of audit effort required to address the matter.

Additionally, the Board modified the factor related to the auditor's assessment of risks of material misstatement, which under the 2013 proposal had focused on changes from the auditor's initial risk assessment. A commenter stated that the proposed factor was less relevant than other proposed factors in determining critical audit matters. Some commenters stated that determination of critical audit matters should focus on audit risk or significant risk. Recognizing the importance of the auditor's entire risk assessment process and in response to comments, the reproposed factor encompasses more broadly the auditor's assessment of risks of material misstatement, including significant risks, rather than just changes in the auditor's risk assessment.

The Board also modified the factor related to the auditor obtaining available relevant and reliable evidence. A commenter stated that matters for which the auditor had the most difficulty in obtaining relevant and reliable audit evidence may not be relevant to users of the financial statements. However, as noted above, in the limited implementation trial conducted by several accounting firms, engagement teams observed that this factor appeared to be one of the most useful in determining critical audit matters.[43] After considering comments, the proposed factor was retained but

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[42] *See* letter from the Center for Audit Quality (June 19, 2014), at 4, available on the Board's website in Docket 034.

[43] *Id*.

aligned with the reproposed definition of critical audit matters, which no longer includes matters that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, and focused on the nature of audit evidence obtained regarding the matter.

Some commenters suggested new areas that could be of particular interest to investors and useful in the determination of critical audit matters. In addition, a commenter on the PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014), suggested that significant measurement uncertainty be added as a consideration in determining critical audit matters. In response to these comments, the reproposed standard includes the following new factors:

- *The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty*—Areas of the financial statements in which management has to apply significant judgment and estimation are likely to include highly uncertain matters or matters that are susceptible to significant measurement uncertainty.

- *The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions*—A company's significant unusual transactions can create complex accounting and financial statement disclosures and could pose increased risks of material misstatement.

Some commenters also recommended a factor based on the extent of interaction with the audit committee. The reproposed standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or significance of the matter and it may create incentives to limit communication between the auditor and the audit committee.

Under the reproposed standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor would take into account the following nonexclusive list of factors when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

- The auditor's assessment of the risks of material misstatement, including significant risks;

- The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

- The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

- The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

- The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

- The nature of audit evidence obtained regarding the matter.

The determination should be made in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. The reproposed factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective, or complex auditor judgment. Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on only one factor, a combination of the factors, or other factors specific to the audit.

Because the determination of critical audit matters is principles-based, the standard does not contemplate circumstances or matters that, if present, would always constitute critical audit matters. For example, the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be critical audit matters.[44] Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. To illustrate, revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks;[45] however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it would not be a critical audit matter.

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[44] A significant risk is "a risk of material misstatement that requires special audit consideration." Paragraph .A5 of AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*.

[45] *See* AS 2110.71.

c. Audit Period Covered by Critical Audit Matters

The 2013 proposal would have required the auditor to communicate critical audit matters for the audit of the current period's financial statements. Because the communication of critical audit matters for prior periods might also be useful to investors and other financial statement users in certain situations, the proposed standard provided that the auditor should consider communicating critical audit matters relating to prior periods when: (1) the prior period's financial statements are made public for the first time, such as in an initial public offering ("IPO"), or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon, such as a reaudit.

Some commenters generally supported communicating critical audit matters for only the current period's financial statements or for all periods if audited financial statements have not been made public previously. Other commenters stated that critical audit matters should be communicated for all periods presented.

The reproposal retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most audit reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, would provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users would be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor would not be precluded from including critical audit matters for prior periods.

The reproposed standard changed the "should consider" requirement for prior periods in IPO and reaudit situations to "may" communicate critical audit matters for prior periods. This change allows the auditor to include critical audit matters for prior periods when the auditor decides it is appropriate to do so.

If the auditor's report is dual dated, the auditor would determine whether the new information for which the auditor's report is dual dated gives rise to any additional critical audit matters.

Additionally, consistent with the 2013 proposal, in situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for the current year, it is not required in the reissued report of the predecessor auditor for prior years. Commenters generally supported this approach.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* Under the IAASB's standard, "key audit matters" are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are determined using a two-step process. First, the auditor identifies the matters communicated with those charged with governance[46] that required significant auditor attention in performing the audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks;
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect on the audit of significant events or transactions that occurred during the period.[47]

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.[48] The IAASB requires the communication of key audit matters for the current period only.[49]

*EU.* The EU requires the auditor to describe the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud.[50] The EU does not specify the period for which these need to be described.

*FRC*. The FRC requires the auditor to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of

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[46] *See* paragraph 8 of ISA 701. *See also* ISA 260, *Communication with Those Charged with Governance*, which provides requirements for auditor communications with those charged with governance.

[47] *See* paragraph 9 of ISA 701.

[48] *See* paragraph 10 of ISA 701.

[49] *See* paragraphs 8 and 10 of ISA 701.

[50] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

resources in the audit; and (3) directing the efforts of the engagement team.[51] The FRC does not specify the period for which these need to be described.

*Questions*:

1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.

    a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?

    b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.

    c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?

    d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?

2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than

[51] *See* paragraphs 19A of UK ISA 700 (2013).

only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?

*2. Communication of Critical Audit Matters*

Under the 2013 proposal, the auditor would have been required to include introductory language preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor's considerations for determining that the matter was a critical auditor matter, and referring to the relevant financial statements accounts and disclosures.

Comments varied on the proposed communication of critical audit matters in the auditor's report and the level of detail the auditor should provide. While some commenters stated that the proposed requirements regarding auditor's communication of critical audit matters are sufficiently clear, many suggested improvements to some of the components of the communication requirement. Other commenters were concerned that financial statement users would not understand critical audit matters due to the lack of sufficient context about a matter briefly described in the auditor's report and the lack of knowledge regarding certain terms used to describe a critical audit matter. After consideration of comments, the Board has made a number of changes, as described below.

a. Introductory Language

The reproposed standard retains the requirements to include in the auditor's report a section titled "Critical Audit Matters" and specific language preceding the description of critical audit matters. However, the specific language has been simplified and aligned with the reproposed definition of a critical audit matter.

Some commenters stated that the communication of critical audit matters in the auditor's report could undermine the auditor's pass/fail opinion on the financial statements, taken as a whole, by leading some investors to believe that the auditor is qualifying the report in the areas of the critical audit matters or expressing a separate opinion on each critical audit matter. In response to comments and to reduce the risk of such a misunderstanding, the introductory language in the critical audit matter section of the auditor's report has been modified in the reproposed standard to expressly state that the auditor is not providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

The reproposed standard retains the note contained in the 2013 proposal stating that language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. In response to comments, the note also clarifies that the language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates. In addition, the reproposed standard makes clear that the auditor's report contains an expression of opinion on the financial statements, taken as a whole.

b. Communication Requirement

Under the 2013 proposal, for each critical audit matter, the auditor would have been required to:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

The communication requirements are retained from the 2013 proposal, with the addition of a requirement to describe how the critical audit matter was addressed in the audit. Additionally, certain language has been modified in response to commenters and aligned with the reproposed definition of a critical audit matter.

Under the reproposed standard, the auditor would be required to:

- Identify the critical audit matter;
- Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describe how the critical audit matter was addressed in the audit; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

*Identify the Critical Audit Matter and Describe the Principal Considerations that led the Auditor to Determine that the Matter is a Critical Audit Matter*

Some commenters stated that a requirement to describe all the considerations that led the auditor to determine that a matter is a critical audit matter could lead to a checklist approach, which could result in standardized or boilerplate language and diminish the value of critical audit matters. These commenters suggested that the description should be limited to the principal or primary considerations.

In response to comments, the reproposed standard clarifies that the auditor is required to describe only the principal considerations that led the auditor to determine that the matter is a critical audit matter. The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication would be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

*Describe How the Critical Audit Matter was Addressed in the Audit*

Some commenters suggested adding a requirement to describe how each critical audit matter was addressed in the audit because this would be of interest to users and consistent with the objective of providing more information about the audit. However, other commenters stated that including audit procedures in the description of a critical audit matter would not necessarily make the auditor's report more informative and useful. Additionally, some commenters suggested that certain specific procedures, such as consultations with the auditor's national office or the use of specialists, should not be mentioned.

In response to comments, the reproposed standard includes a new requirement for the auditor to describe how each critical audit matter was addressed in the audit. Because of differing commenter views about the description of how each critical audit matter was addressed in the audit, the reproposed standard does not prescribe a specific way to meet this requirement. For example, in describing how the critical audit matter was addressed in the audit, the auditor may describe: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements.[52] If the auditor provides an indication of the outcome of the auditor's procedures in the description of a critical audit matter, language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates. It is also not appropriate for the auditor to use language that could call into question the auditor's opinion on the financial statements, taken as a whole.

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[52] These elements are similar to the IAASB's elements described in paragraph A46 of ISA 701. The EU also requires that the auditor describe key observations with respect to the most significant assessed risks of material misstatement.

While the description of how the critical audit matter was addressed in the audit would require judgment, the auditor should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that would be useful to investors. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

*Refer to the Relevant Financial Statement Accounts and Disclosures that Relate to the Critical Audit Matter*

The reproposed auditor reporting standard also would require the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

*Illustrative Examples of the Communication of Critical Audit Matters*

The examples below are based on hypothetical situations for two different companies and have been prepared for illustrative purposes only to show how a critical audit matter could be communicated in the auditor's report. They are not intended to provide guidance or any suggestions regarding the number of critical audit matters or the accounting or auditing in the circumstances presented. Additionally, the description of a critical audit matter is not intended to provide a list of all audit procedures performed.

**Company A**
**Critical Audit Matter**

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

*Allowance for Loan Losses – New Loan Product*

As more fully described in Note 7 to the financial statements, during 2014, the Company [a mid-size regional bank] began actively marketing a nine-year auto loan in addition to the three- and five-year auto loans historically marketed. At December 31, 2015, the nine-year loans represented approximately 18% of the auto loan portfolio. The Company estimates and records an allowance for loans that are impaired but are not yet specifically identified (collective impairment allowance) by developing a loss rate based on historical losses and other factors, including qualitative adjustments to historical loss rates based on relevant market factors. Since management has limited historical loss data for the nine-year loans, it developed a new model to estimate this allowance using historical loss data from its auto loans of shorter terms and loss data from external sources for auto loans of longer terms to model a loss rate for the nine-year loans. In addition, management made qualitative adjustments to the historical loss rates to reflect lower borrower quality and higher risk of collateral impairment compared to its shorter term loans and for economic factors, primarily due to increasing unemployment in the markets served. There was a significant amount of judgment required by management when developing the model, which in turn involved our significant judgment.

The principal considerations for our determination that the allowance for loan losses for nine-year auto loans is a critical audit matter are that it is a new loan product with limited historical loss data and auditing the estimated allowance for losses on these loans involved our complex and subjective judgment.

Our audit procedures related to the collective impairment allowance for the nine-year loans included the following procedures, among others.

We tested the effectiveness of controls over the Company's new model, historical loss data, and the calculation of a loss rate. We also evaluated the qualitative adjustment to the historical loss rates, including assessing the basis for the adjustments and the reasonableness of the significant assumptions. We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.

We used a specialist to assist us in evaluating the appropriateness of the new model and to review the loss data from external sources used by the Company to determine its relevance to the Company's nine-year loan portfolio and consistency with external data from other sources. Finally, with the assistance of the specialist, we evaluated the incorporation of the applicable assumptions into the model and tested the model's computational accuracy.

**Company B**
**Critical Audit Matter**

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

*Accounting for Acquisitions*
Refer to Notes 2 and 13 to the financial statements

The Company's strategy includes growth by acquisition. Acquisitions represent a significant component of the Company's sales growth through the addition of new customers and new products. During 2015 the Company completed eight acquisitions for net consideration of $2.1 billion. The most significant of these were (1) the acquisition of all outstanding equity of ABC Inc. for net consideration of $1.1 billion and (2) the acquisition of all outstanding equity of XYZ Corp. for net consideration of $0.5 billion.

Auditing the accounting for the Company's 2015 acquisitions involved a high degree of subjectivity in evaluating management's estimates, such as the recognition of the fair value of assets acquired and liabilities assumed. We planned and performed the following procedures in connection with forming our overall opinion on the financial statements. We tested controls over the accounting for acquisitions, such as controls over the recognition and measurement of assets acquired, liabilities assumed, and consideration paid and payable, including contingent consideration. For each of the acquisitions, we read the purchase agreements, evaluated the significant assumptions and methods used in developing the fair value estimates, and tested the recognition of (1) the assets acquired and liabilities assumed at fair value; (2) the identifiable acquired intangible assets at fair value; and (3) goodwill measured as a residual.

More specifically, for the acquisitions of ABC and XYZ, we assessed whether (1) intangible assets, such as acquired technology, customer lists, and noncompetition agreements, were properly identified, and (2) the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable. Specifically, when assessing the assumptions related to the revenue growth rate and projected profit margins, we evaluated whether the assumptions used were reasonable considering the past performance of ABC and XYZ and the Company's history related to similar acquisitions and considered whether they were consistent with evidence obtained in other areas of the audit, such as assumptions used by the Company in its budget.

The purchase consideration for the acquisitions of ABC and XYZ also reflected, in part, the estimated fair value of significant contingent consideration arrangements based on attainment of product development milestones and patent approvals. In testing the valuation of contingent consideration, we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable. Finally, we evaluated management's classification of contingent payments to continuing employees as either contingent consideration in the business combination or employee compensation.

c. Additional Considerations Related to the Communication Requirement

Some commenters expressed concerns that the proposed requirement to communicate critical audit matters would undermine the role of the audit committee or management by requiring the auditor to disclose information about the company's financial statements that would typically be management's responsibility to disclose. Since the auditor would be communicating information regarding the audit rather than information directly about the company and its financial statements, the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for the company's disclosure of financial information. In addition, communicating critical audit matters is not a substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

Many commenters also stated that the communication of critical audit matters in areas where the company has no current reporting obligation could result in the auditor disclosing confidential information about the company or effectively imposing on management a lower disclosure threshold that would go beyond the applicable financial reporting framework or SEC reporting requirements. Some commenters raised concerns that the communication of critical audit matters would cause harm by requiring auditors to disclose confidential information about the company.

In addition to revising the definition of a critical audit matter to require that the matter relate to accounts and disclosures that are material to the financial statements, the reproposed standard adds a note to address commenters' concerns about the auditor becoming the source of original (and potentially confidential) information about the company. The note indicates that when describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company[53] unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit. For example, in describing the principal considerations that led the auditor to determine that revenue recognition is a critical audit matter, it is possible that the auditor could provide more information than is provided in management's disclosures. In circumstances when information about the company has not previously been made publicly available, management may decide that additional management disclosures would be useful to

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[53] Companies make information publicly available in a variety of ways, including the annual report, press releases, or other public statements.

financial statement users. However, management's decision about whether to disclose additional information does not affect the auditor's responsibility to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Some commenters suggested that the standard should provide guidance on how the auditor should correct errors or misstatements in the reporting of critical audit matters, such as an incorrect or incomplete description of a critical audit matter or the omission of a critical audit matter from the auditor's report. In principle, auditors should approach such errors and misstatements in the same way they would approach any other error or misstatement in the auditor's report that does not affect the auditor's opinion or the ability of market participants to rely on the opinion.[54] It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as missing firm signatures, incorrect auditor's report dates, or missing explanatory paragraphs.[55]

d. Ability to Communicate No Critical Audit Matters

The reproposed standard retains from the 2013 proposal the possibility that the auditor could determine that there are no critical audit matters and, if so, would include a statement to that effect in the "Critical Audit Matters" section of the auditor's report.[56] A commenter suggested that having no critical audit matters should be rare and that each auditor's report should have at least one critical audit matter to communicate.

The determination of critical audit matters would be based on the facts and circumstances of each audit. The Board expects that, in most audits to which the requirement to communicate critical audit matters would apply, the auditor would

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[54] The reproposed standard indicates that the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole.

[55] PCAOB staff reviewed amended annual report filings on SEC Form 10K/A from 2011–2013 and identified 52 instances where the company disclosed that it amended the annual report solely to correct errors in the auditor's report without other changes to the financial statements or other disclosures.

[56] Since communication of critical audit matters would not be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5; investment companies other than business development companies; and benefit plans, the auditor's report for the audits of these entities would not be required to include the statement that there are no critical audit matters.

determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor would communicate that there were no critical audit matters.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* For each key audit matter, the IAASB requires the auditor to reference the related disclosures, if any, in the financial statements and address: (1) why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter and (2) how the matter was addressed in the audit.[57] The IAASB allows the auditor to determine that there are no key audit matters to communicate in the auditor's report and, if so, requires a statement to this effect.[58]

*EU.* The EU requires the auditor to include in the auditor's report: (1) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; (2) a summary of the auditor's response to the risks; and (3) where relevant, key observations arising with respect to the risks.[59]

*FRC.* The FRC requires the auditor, among other things, to: (1) describe those assessed risks of material misstatement that were identified by the auditor and (2) provide an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement.[60] The explanations of the matters set out in the auditor's report should be described in a way that: (1) enables a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements; (2) enables the matters to be related directly to the specific circumstances of the audited entity and are not therefore generic or abstract matters

[57] *See* paragraph 13 of ISA 701.

[58] *See* paragraphs 14 and 16 of ISA 701.

[59] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[60] *See* paragraph 19A of UK ISA 700 (2013).

expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.[61]

*Questions*:

5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?

6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:

   a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and

   b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?

   Are there other steps the Board could take to address these concerns? If so, what are they?

7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?

8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?

*3. Documentation of Critical Audit Matters*

Under the 2013 proposal, documentation would have been required for each reported critical audit matter, as well as matters that "appeared to meet" the definition of

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[61] *See* paragraph 19B of UK ISA 700 (2013).

a critical audit matter but were determined not to be critical audit matters and thus not reported. Some commenters generally supported documenting the matters that were determined to be critical audit matters. One of these commenters stated that the documentation should focus on why matters are of such importance that they are included in the auditor's report. Several commenters expressed concern that the documentation requirement for non-reported matters, which are matters that would appear to meet the definition of a critical audit matter but were determined not to be critical audit matters, was too broad and not aligned with current audit documentation requirements.

The reproposed definition of a critical audit matter narrows the source of critical audit matters to matters communicated or required to be communicated to the audit committee and adds a materiality component. Thus, under the reproposed standard, auditors would be required to document the basis for the auditor's determination whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved or did not involve especially challenging, subjective, or complex auditor judgment. This approach should address, at least in part, commenters' concerns about the proposed documentation requirement because the potential population of matters that may need to be documented has been narrowed. The documentation requirement would also facilitate the review by the engagement quality reviewer.[62]

The auditor could comply with the documentation requirement in a variety of different ways. For example, the auditor could start with the communications to the audit committee, which are already documented, identify which of those matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether each matter involved especially challenging, subjective, or complex auditor judgment. In documenting the basis for the determination, the auditor may include the factors the auditor took into account. This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation.

The amount of documentation required could vary with the circumstances. For example, the auditor's basis for the determination may be so clear for some matters that

[62] Under the existing audit documentation requirement, audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. *See* paragraph .02 of AS 1215 (currently Auditing Standard No. 3), *Audit Documentation*.

a single sentence would be sufficient, while other matters may require more extensive documentation. Additionally, the description of a critical audit matter in the auditor's report would generally suffice as documentation for matters determined to be critical audit matters.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires the auditor to document the matters that required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.[63] The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.[64]

*Question*:

9. Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?

*4. Liability Considerations Related to Critical Audit Matters*

In the 2013 proposal, the Board acknowledged that, by disclosing critical audit matters, the auditor would be making new statements in the auditor's report that could raise potential liability concerns. As discussed in that release, liability may be imposed on auditors under a number of different legal theories depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, and various state law causes of action. The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.

The potential for increased auditor liability was cited as a concern by a number of commenters on the Board's 2013 proposal. Several commenters expressed concerns that investors who suffer a financial loss could assert legal claims against the auditor based on their reliance on the auditor's statements in the auditor's report regarding critical audit matters. These commenters suggested, for example, that an investor that

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[63] *See* paragraph 18(a) of ISA 701.

[64] General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

suffered a loss following a decline in the issuer's stock price could assert that the auditor made a material misstatement regarding a critical audit matter, made a statement about a critical audit matter that made the auditor's other statements in the auditor's report misleading, or omitted a critical audit matter from the auditor's report. It should be noted that any such claimant would have to establish all of the elements of a claim (for example, when applicable, loss causation and reliance).

Some commenters raised more specific liability concerns about critical audit matters. One commenter argued that plaintiffs may attempt to use critical audit matters as de facto admissions of uncertainty or even error. Several commenters asserted that the lack of clarity or elements of judgment in the process of determining critical audit matters would make it easy for a plaintiff to claim in hindsight that an audit matter should have been disclosed as a critical audit matter. Others argued that auditors, to avoid being second-guessed, would have the incentive to identify too many critical audit matters in an effort to protect themselves from liability.

Other commenters claimed that the fact-specific nature of critical audit matters or of certain potential elements of the description of critical audit matters, such as the audit procedures used, would make it difficult to obtain early dismissal of claims. In their view, this could support meritless claims, potentially undermining the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail nonmeritorious claims against auditors and avoid the costs and burdens associated with them. Information provided regarding critical audit matters could also affect other aspects of securities fraud claims (for example, by potentially undercutting a claim of reliance).

Several commenters highlighted the proposed requirement to document the auditor's determination that a matter was not a critical audit matter as increasing litigation risk with respect to such matters. As one of these commenters explained, the proposed documentation requirement could create a detailed documentary record of the auditor's determination that a matter was not "critical" and therefore give rise to increased litigation risk with respect to any "identified but not determined to be critical" matter.

Some commenters argued that critical audit matters could also increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, and plaintiffs may attempt to use critical audit matters as a "road map" for litigation against the company.

On the other hand, one commenter asserted that communicating critical audit matters conceptually could decrease auditor and company legal exposure when the accounting in the areas of the critical audit matters is subsequently challenged, because the communication of critical audit matters is about disclosure of risks and challenges.

The commenter further stated that the noncommunication of such matters would be more problematic from a litigation point of view.

Many of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the 2013 proposal that, in their view, would reduce the liability impact of critical audit matters determination and communication. For example, several commenters suggested ways to limit and clarify the process for determining critical audit matters, such as narrowing the source of critical audit matters to matters communicated to the audit committee, incorporating the concept of materiality, and refining the factors used to determine critical audit matters. Commenters also suggested changes to the proposed communication requirements, such as requiring communication of only the principal considerations that led the auditor to determine a matter was a critical audit matter, rather than all considerations; prohibiting auditor reporting of information not required to be disclosed by the company; and clarifying the auditor's statements about the nature of critical audit matters. The Board has taken these commenter suggestions for reducing potential incremental liability into account in formulating the reproposal (for example, modifying the source of critical audit matters, adding a materiality component, refining the factors, and modifying the communication requirement).

*Questions*:

10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?

11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?

12. Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?

## B. Additional Improvements to the Auditor's Report

The 2013 proposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as the auditor's opinion, identification of the financial statements audited, and management's and auditor's responsibilities, were drawn from the existing auditor reporting standard.[65] Other basic

[65] *See* AS 3101.06–.08.

elements, such as the name of the company under audit and the date of the financial statements, were incorporated from existing illustrative auditor's reports. Commenters broadly supported these basic elements and they are being reproposed substantially as proposed.

*1. Clarification of Existing Auditor's Responsibilities*

The 2013 proposal included requirements that would enhance standardized language of the auditor's report by clarifying the nature and scope of the auditor's existing responsibilities, such as a new statement regarding auditor independence and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the proposal included a requirement intended to promote uniformity with respect to the addressee of the report.

a. Auditor Independence

The proposed standard would have required the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC[66] and the PCAOB.[67]

Some commenters stated that the statement regarding auditor independence would provide useful information to investors and other financial statement users and could enhance an investor's understanding of the auditor's role. Other commenters preferred a more definitive statement on auditor independence, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. Yet other commenters stated that the statement would be redundant with the title of the auditor's report or could distract from the main objective of the auditor's report.

The Board considered the comments and is retaining the statement regarding auditor independence as originally proposed.[68] The independence statement in the

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[66] *See* SEC Rule 2-01 of Regulation S-X, 17 CFR 210.2-01.

[67] *See* PCAOB Rule 3520, *et seq*.

[68] In situations in which an auditor that is not registered with the Board is required by law to, or voluntarily agrees to, perform an audit in accordance with PCAOB standards, there may be certain modifications to the auditor's report, such as the title and the statement regarding independence requirements. If the Board adopts the

auditor's report could both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations. The statement regarding auditor independence is not intended to, and would not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.[69] The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.[70] The FRC requires the auditor to state that the auditor is required to comply with the United Kingdom's ethical standards for auditors, which include requirements regarding auditor independence.[71]

*Question:*

13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?

b. Addressee

Under the existing standard, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[72] Under current practice, the auditor's report is generally addressed to

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reproposed standard, the staff will provide guidance for these situations, such as by updating Staff Questions and Answers, *Audits of Financial Statements of Non-Issuers Performed Pursuant to the Standards of the Public Company Accounting Oversight Board.*

69 *See* paragraph 28(c) of ISA 700.

70 *See* requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

71 *See* paragraph 15 of UK ISA 700 (2013).

72 *See* AS 3101.09.

one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[73]

To promote consistency in addressing the auditor's report to the company's investors, the proposed standard would have required the auditor's report to be addressed to: (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. The proposed standard stated that addressees would not necessarily be limited to these parties and might include other appropriate parties depending on, for example, the legal and governance structure of the company.

Some commenters generally supported the requirement as proposed. Other commenters expressed concerns that requiring or suggesting that the auditor's report be addressed to other parties besides the board of directors and shareholders, such as bondholders, could adversely affect auditors' legal posture in some types of legal proceedings. In particular, these commenters were concerned that the additional addressees might gain the ability to assert direct state law claims against the auditor in some circumstances.

In response to these comments and to promote greater uniformity in the addressees of the auditor's report, the reproposed standard would limit required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations.[74] Auditors would retain the option to include additional addressees.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report be addressed as appropriate, based on the circumstances of the engagement.[75] The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required

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[73] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers and brokers and dealers.

[74] For example, for benefit plans, an addressee equivalent to shareholders is the plan participants; for issuers organized as trusts, an addressee equivalent to the board of directors is the board of trustees.

[75] *See* paragraph 22 of ISA 700.

by the circumstances of the engagement.[76] UK auditor's reports are typically addressed to either the members or the shareholders of the company.[77]

*Questions:*

14. Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?

15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?

c. Enhancements to the Basic Elements

The 2013 proposal would have changed the language for certain elements in the existing auditor's report. These proposed elements included:

- *Financial statement notes*—The identification of the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.[78] Under the existing standard, the notes to the financial statements and the related schedules are not identified as part of the financial statements.

- *Error or fraud*—A description of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the

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76 *See* paragraph 13 of UK ISA 700 (2013).

77 *See* paragraph A5 of UK ISA 700 (2013).

78 The proposed and reproposed standards use the term "financial statements" to include all notes to the statements and all related schedules, as used under SEC rules that apply to issuers. *See* Section 1-01(b) of Regulation S-X, 17 CFR 210.1-01(b), which states in part, "the term financial statements . . . shall be deemed to include all notes to the statements and all related schedules." The reproposed standard would not apply to schedules included as supplemental information, as defined in AS 2701 (currently Auditing Standard No. 17), *Auditing Supplemental Information Accompanying Audited Financial Statements*, because those schedules are not considered part of the financial statements. The auditor should continue to look to the requirements of AS 2701 for the auditor's reporting responsibilities regarding supplemental information accompanying audited financial statements.

financial statements are free of material misstatements, whether caused by error or fraud.[79] The existing standard does not require the auditor's report to contain the phrase *whether due to error or fraud*.

- *Nature of the audit*—The description of the nature of the audit reflected the auditor's responsibilities in a risk-based audit and aligned the description with the language in the Board's risk assessment standards, including:
    - o Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
    - o Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
    - o Evaluating the accounting principles used and significant estimates made by management; and
    - o Evaluating the overall presentation of the financial statements.

Commenters generally supported the proposed language for these basic elements of the auditor's report. Some commenters objected to the inclusion of the phrase *whether due to error or fraud*, saying it could provide a false sense of security to financial statement users and a perceived transfer of responsibility from management in preventing and detecting fraud, thus exposing companies to greater risk of fraud and unintentionally increasing auditor liability. However, under existing standards, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.[80] Therefore, this element is retained in order to clarify the auditor's existing responsibilities in this area.

The reproposed standard retains these basic elements substantially as proposed.

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[79] *See* paragraph .02 of AS 1001 (currently AU sec. 110), *Responsibilities and Functions of the Independent Auditor*.

[80] *See* AS 1001.02.

*2. Auditor Tenure*

The 2013 proposal would have required the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Currently information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.[81] However, as discussed below, there is a growing trend toward voluntarily disclosure of auditor tenure. The intent of the reproposed requirement, consistent with the 2013 proposal, is to require consistent reporting of the duration of the auditor's relationship with the company and have this information in a consistent location—the auditor's report.

a. Disclosure of Tenure

Some commenters opposed a requirement to disclose auditor tenure in the auditor's report on the basis that such disclosure could result in false conclusions about correlations between auditor tenure and audit quality. These and other commenters suggested that tenure could be disclosed in the firm's annual report filed with the PCAOB, the company's proxy statement, or elsewhere. Some commenters were concerned that, in the illustrative report, auditor tenure placed next to the statement on auditor independence may imply a relationship between auditor independence and tenure of service.

Other commenters asserted that information regarding auditor tenure would be useful to financial statement users, for example, in understanding the audit committee's oversight of the auditor or in deciding whether to vote to ratify the appointment of the auditor. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,[82] presumably due to interest from investors. However, such voluntary

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[81] Investors may manually review company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when the company changed auditors. For example, although company filings are not available via EDGAR prior to 1994, investors may review a company's periodic filings since that time or any Form 8-K filings in EDGAR. *See* 17 CFR 249.308, Item 4.01 Changes in Registrant’s Certifying Accountant. Not all companies are required to file Form 8-K. Information about auditor tenure may be less accessible for investment companies and brokers and dealers, which have different SEC filing requirements.

[82] The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2015 and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2015 and 2014 auditor tenure was disclosed in the annual proxy statements of 54 and 47 percent of the

information may not be disclosed in the same location in the proxy statement; for instance, some disclosures are in the audit committee report while others are in another section of the proxy.[83] Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, brokers and dealers, and most investment companies are not required to prepare proxy statements. The SEC has explored through a concept release the potential of requiring disclosure of auditor tenure in the audit committee report.[84] The Board will continue to monitor developments on the SEC concept release.

While commenters' views and academic research[85] continue to be divided on the relationship of auditor tenure and audit quality, the Board is reproposing to include auditor tenure[86] to make this data point readily available in the auditor's report. Requiring the disclosure of auditor tenure in the auditor's report would ensure that the disclosure is in a consistent location—the auditor's report—for all companies and would reduce search costs for investors and other financial statement users who are interested in this piece of information. The standard does not specify a required location within the auditor's report for the statement on auditor tenure. The illustrative report in the reproposed standard includes the statement on auditor tenure at the end of the

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S&P 500 large-cap companies, respectively, 44 and 42 percent of the S&P MidCap 400 companies, respectively, and 46 and 50 percent of the S&P SmallCap 600 companies, respectively. *See* Center for Audit Quality and Audit Analytics, *2015 Audit Committee Transparency Barometer* (Nov. 3, 2015). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 59 percent of the companies reviewed voluntarily disclosed auditor tenure in 2015 compared to 50 percent in 2014, 30 percent in 2013, and 25 percent in 2012. *See* Ernst & Young, *Let's Talk: Governance—Audit Committee Reporting to Shareholders 2015 Proxy Season Review* (Sept. 2015).

[83] *See* Center for Audit Quality and Audit Analytics, *2015 Audit Committee Transparency Barometer* (Nov. 3, 2015).

[84] *See* SEC, *Possible Revisions to Audit Committee Disclosures*, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015) ("SEC concept release").

[85] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

[86] The statement regarding the auditor's tenure would include the year the firm, rather than the engagement partner, began serving consecutively as the company's auditor.

auditor's report, after the signature of the firm. However, the auditor may choose another location in the auditor's report.

The Board is also seeking comment on whether disclosure of auditor tenure would be more appropriately made by the auditor in another location, specifically the Board's Form AP, *Auditor Reporting of Certain Audit Participants*, ("Form AP") rather than in the auditor's report. Recently, the Board adopted Form AP, which, assuming final approval by the SEC, will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.[87]

b. Determination of Tenure

Some commenters stated that histories of mergers and acquisitions, involving both audit firms and companies, may make it challenging for the auditor to determine auditor tenure. The reproposed standard retains a note from the 2013 proposal that states that if there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

Additionally, the auditor's relationship with the company is not affected by the company's status as a public company. For instance, if a company went public but maintained its auditor, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Several commenters stated that clarification should be provided regarding applying the auditor tenure disclosure to investment companies because of the unique structure of investment companies, which are often organized as an investment company complex.[88] These commenters suggested that, since an investment company complex may include many investment companies with different inception dates,

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[87] *See Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008 (Dec. 15, 2015).

[88] *See* SEC Rule 2-01(f)(14)(i) of Regulation S-X, 17 CFR 210.2-01(f)(14)(i) for the definition of an investment company complex, which includes not only investment companies but also investment advisers, private investment companies, and other entities.

disclosure of auditor tenure should be the same for each investment company in the investment company complex and measured from the date the auditor first audited any investment company in the complex. In response to comments, the reproposed standard requires that, for an investment company that is part of a group of investment companies,[89] the auditor's statement regarding tenure would contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.[90] For example, if Firm A has been auditing investment companies in XYZ group of investment companies since 1980, the current auditor's report for XYZ fixed income fund, whose inception date was in 2010, would state that Firm A has served as the auditor of one or more XYZ investment companies since 1980. This disclosure would provide information on the length of the auditor's relationship with the group of investment companies because of common control at the group level.

*Requirements of Other Regulators and Standard Setters*

The EU requires a statement in the auditor's report that indicates the total uninterrupted engagement period, including previous renewals and reappointments of the statutory auditors or the audit firms.[91] The IAASB and the FRC do not include a similar requirement.

*Questions:*

16. Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information

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[89] A group of investment companies means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"). The term "group of investment companies" is used to indicate that auditor tenure would be measured from the start of the relationship between the auditor and the management of any registered investment company in the group and not with respect to other entities that may be part of an investment company complex, such as investment advisers or private investment companies.

[90] The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

[91] *See* requirements in 2(b) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

in the auditor's report which the Board should consider? If so, what are they?

17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?

18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?

19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?

*3. Additional Basic Elements Suggested by Commenters*

As part of the proposal, the Board considered potential additional elements in the auditor's report. The Board received little comment on additional elements; however, two commenters suggested that the following elements should be included in the auditor's report:

- A statement that the procedures performed and the audit evidence obtained provide a reasonable basis for the opinion;
- A statement that the references to the financial statements throughout the auditor's report relate to the financial statements, taken as a whole;
- An expanded description of the responsibilities of management, including a description of the responsibilities of the audit committee with respect to the financial statements;
- A description of the meaning of reasonable assurance; and
- A description of the auditor's use of professional judgment and professional skepticism throughout the audit.

Since it may not be practical to describe these elements concisely, adding these to the auditor's report would unnecessarily lengthen it without providing additional useful information to investors. As a result, the reproposed standard does not include these additional elements.

A commenter also suggested that the auditor's report should include a discussion of materiality and how it is used by the auditor in the audit as well as the related dollar amount.[92] Other commenters from the Board's initial outreach stated that disclosing materiality levels in the auditor's report could have negative implications on audit quality by reducing the element of surprise necessary in an audit.[93] In addition, investors did not evidence a strong demand for reporting materiality levels in the auditor's report.[94] For these reasons, the reproposed standard does not require this element.

*Question*:

20. Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?

## C. Explanatory Language and Emphasis of a Matter

### *1. Explanatory Language Required by Other PCAOB Standards*

The proposed standard, similar to the existing standard,[95] provided a list of circumstances in which the auditor would have been required to add explanatory language to the auditor's report and included references to other PCAOB standards in which these circumstances and related reporting requirements are described. These circumstances include when there is substantial doubt about the company's ability to continue as a going concern and a restatement of previously issued financial statements, among others.

Commenters generally supported providing in the proposed standard a list of circumstances that require explanatory language in the auditor's report on the basis that keeping this information in a single place would facilitate consistency in execution. The

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[92] Such a requirement would be similar to the FRC requirement that the auditor provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. *See* paragraph 19A of UK ISA 700 (2013).

[93] *See* PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

[94] *Id.*

[95] *See* AS 3101.11.

reproposed standard retains the list of explanatory paragraphs and related references substantially as proposed.

In the 2013 proposal, the Board sought comment on whether to require new explanatory language in the auditor's report in cases where the company is required to report on internal control over financial reporting ("ICFR") but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.[96] Commenters supported such a requirement because it would help to clarify the auditor's responsibility when there is no auditor's report on ICFR. Under current standards, auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[97] The Board understands that, in practice, the auditor often includes a statement in the auditor's report to clarify the auditor's responsibilities when the company has not engaged the auditor to perform an audit of the company's ICFR.[98] The reproposed standard includes a reference to a new proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*,[99] for the auditor to add such explanatory language.

PCAOB staff has also observed that auditor’s reports of investment companies often include similar statements. The Board is seeking comment whether the auditor should be required to include an explanatory paragraph in all cases, even in situations when management has no requirement to report on ICFR.

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[96] This may be the case for companies that are subject to Section 404(a) of Sarbanes-Oxley, which mandates management ICFR reporting, but not Section 404(b), which mandates auditor ICFR reporting. Section 404(a) generally applies to companies that are subject to the reporting requirements of the Exchange Act, other than registered investment companies. Certain categories of companies that are subject to Section 404(a), such as non-accelerated filers and emerging growth companies, are not subject to Section 404(b).

[97] *See* paragraph 10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710* (currently AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*).

[98] Based on the PCAOB's staff review of a sample of 1,169 auditor's reports for nonaccelerated filers for fiscal year 2014, approximately 83 percent included a statement generally consistent with the reproposed requirement.

[99] *See* reproposed amendments to AS 3105.59–.60.

*Interaction between critical audit matters and explanatory paragraphs*. The 2013 proposal stated that communication of critical audit matters would not alter existing requirements to add explanatory language and that the same matter could be described both in the critical audit matter section and using explanatory language with a cross-reference, as appropriate. A commenter stated that, in a circumstance in which a matter constitutes a critical audit matter and requires an explanatory paragraph, the discussion in the auditor's report should be integrated to avoid duplication and repetitiveness. Other commenters suggested not requiring an explanatory paragraph if the same matter is already communicated as a critical audit matter.

The reproposed standard clarifies that critical audit matters are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a critical audit matter and also requires an explanatory paragraph, such as going concern. For these situations, both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor may include the communication requirements of a critical audit matter in the explanatory paragraph with a cross-reference in the critical audit matter section to the explanatory paragraph. Alternatively, the auditor may choose to provide both an explanatory paragraph and the critical audit matter communication separately in the auditor's report with a cross-reference between the two sections. While the information reported in a critical audit matter may be redundant of some of the information already provided in the explanatory paragraph, the critical audit matter would provide incremental information, such as how the matter was addressed in the audit.

*2. Emphasis of a Matter*

The 2013 proposal, similar to the existing standard, provided the ability for the auditor to add a paragraph to the auditor's report to emphasize a matter regarding the financial statements ("emphasis paragraph").[100] Emphasis paragraphs are not required but may be used by auditors to draw the reader's attention to matters, such as significant transactions with related parties and unusually important subsequent events. Under the proposal, emphasis paragraphs would have referred only to information presented or disclosed in the financial statements. The proposed standard provided a list of examples primarily from existing standards.

Commenters broadly supported retaining the auditor's ability to emphasize a matter in the financial statements. The reproposed standard retains emphasis paragraphs substantially as proposed and retains most of the proposed examples.[101]

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[100] *See* AS 3101.19.

[101] The reproposed standard does not retain the example emphasis paragraph regarding retroactive application of the prospective change in accounting

While the reproposed standard provides examples of potential matters that the auditor may emphasize in the auditor's report, the auditor may also decide to emphasize other matters in the financial statements if the auditor determines it is appropriate to do so. Additionally, the reproposed standard removes the sentence stating that an emphasis paragraph refers only to information presented or disclosed in the financial statements since this is not specified under the existing standard and the reproposed standard does not intend to change current practice.

*Interaction between critical audit matters and emphasis paragraphs*. Under the 2013 proposal, communication of critical audit matters would not have altered the auditor's ability to add an emphasis paragraph to the auditor's report. Some commenters suggested that the standard should address the relationship between critical audit matters and emphasis paragraphs. The reproposed standard states that emphasis paragraphs are not a substitute for required critical audit matters. The Board notes that critical audit matters are required and emphasis paragraphs are included only at the discretion of the auditor. The reproposed standard provides a list of examples of matters that the auditor may emphasize regarding the financial statements. However, if a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would be required to identify the matter as a critical audit matter in the auditor's report and would be subject to the other communication requirements for critical audit matters. The auditor would not be expected to include an emphasis paragraph in the auditor's report about a matter that meets the definition of a critical audit matter.

*Requirements of Other Regulators and Standard Setters*

Under the requirements of other regulators and standard setters, there are no analogous explanatory paragraphs, except for reporting on going concern. The Board's reproposed approach is similar to the IAASB's approach to the interaction between a paragraph regarding the company's ability to continue as a going concern and key audit matters, although the underlying requirements for auditor reporting on going concern vary.[102] Under the IAASB's approach, an emphasis of matter paragraph is not required

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principle. This example was included in AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretation of Section 410*, which has been rescinded as part of the reorganization of PCAOB auditing standards. *See* PCAOB Release 2015-002.

[102] *See* paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

for a matter that was determined to be a key audit matter.[103] The EU and the FRC have separate requirements related to going concern reporting that do not specifically address the interaction with their expanded auditor reporting.[104] The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

*Questions*:

21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?

22. Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?

23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?

24. Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?

## D. Information About Certain Audit Participants

On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.[105] Firms will be required to file Form AP with the PCAOB for each issuer audit, disclosing this information. In addition to filing Form AP, firms will also have the choice to include this

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[103] *See* paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

[104] *See* ISA (UK and Ireland) 570, *Going Concern*, and *see* Article 28, *Audit Reporting*, of Directive 2014/56/EU of the European Parliament and of the Council.

[105] *See* PCAOB Release No. 2015-008 (Dec. 15, 2015).

information in the auditor's report.[106] The reproposed standard incorporates the adopted amendments to AS 3101 for situations in which the auditor decides to include information about certain audit participants in the auditor's report. The reproposed standard would require the auditor to use an appropriate section title when providing this information in the auditor's report, but does not require a specific location in the auditor's report.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities.[107] Under EU law, the engagement partner is required to sign the audit report in all EU countries, including the United Kingdom.[108] Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB, FRC, or the EU.

## E. Form of the Auditor's Report

The proposed standard did not require that the basic elements appear in a specific order in the auditor's report, although as part of the proposal the Board sought comment on whether to require a specific order. The proposed standard only required a title for the "Critical Audit Matters" section, but did not preclude the auditor from including section titles for other sections in the auditor's report.

Some commenters suggested that, to allow for a more effective delivery of key messages and enhance comparability between reports for different companies, the Board should require a specific order of the sections in the auditor's report. Other commenters suggested that there should be flexibility. Some commenters recommended that section titles be required for all sections of the auditor's report.

In response to comments, the reproposed standard would require the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The reproposed standard does

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[106] When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors*), the auditor's report must acknowledge the involvement of the other auditor.

[107] *See* paragraph 45 of ISA 700.

[108] Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allows for consistency in the location of the opinion and basis for opinion sections, with flexibility for the other elements of the auditor's report. The reproposed standard would also require titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report.

*Requirements of Other Regulators and Standard Setters*

The reproposed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.[109] The EU and FRC do not specify an order to the auditor's report.

*Question*:

25. Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?

## V. <u>Amendments to Other PCAOB Standards</u>

The Board is reproposing amendments to several of its existing auditing standards solely to conform to the reproposed standard.[110] The Board is not proposing any further changes to these existing auditing standards at this time, although the Board recognizes that some of the existing auditing standards, such as the standard proposed to be redesignated as AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

### A. Proposed AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

AS 3101.10 and .20-.76 primarily address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion. These paragraphs also address other reporting circumstances, such as

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[109] *See* paragraphs 23–28 of ISA 700.

[110] The reproposed amendments are contained in Appendix 2.

reporting on comparative financial statements. These paragraphs are proposed to be redesignated as AS 3105.[111]

Similar to the 2013 proposal, proposed AS 3105 is not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard would primarily: (1) require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the reproposed standard; and (3) amend the illustrative reports for the basic elements of the reproposed standard and the required order of certain sections of the auditor's report.

Proposed AS 3105 includes:

1. *Communication of Critical Audit Matters in Reports Containing Other than Unqualified Opinions*

   a. *Qualified opinion*—Similar to the 2013 proposal, proposed AS 3105 would require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if applicable for the company under audit.

   b. *Adverse opinion*—Similar to the 2013 proposal, the existing requirements related to an adverse opinion are not proposed to be amended to require the auditor to communicate critical audit matters because, in such circumstances, the most important matter to investors and other financial statement users would be the reason for the adverse opinion.

   c. *Disclaimer of opinion*—Similar to the 2013 proposal, the existing requirements related to a disclaimer of an opinion are not proposed to be amended to require the auditor to communicate critical audit matters because, in such circumstances, the most important matter to investors and other financial statement users would be the reason for the disclaimer of opinion.

2. *Considerations in the Auditor's Report Regarding Report by Management on Audit of ICFR*

As noted previously, in the 2013 proposal, the Board sought comment regarding requiring an explanatory paragraph in situations in which the company has determined

[111] AS 3101.01-.09 and .11-.19 would be amended and restated as provided in Appendix 1.

that it is not required to obtain, nor did the company request the auditor to perform, an audit of ICFR. Commenters supported such a requirement.

The Board is proposing to amend AS 3105 to provide the reporting requirements and appropriate language to be added to the auditor's report in such situations.[112]

*Requirements of Other Regulators and Standard Setters*

Under the IAASB's approach, a matter giving rise to a qualified, adverse, or disclaimer of opinion is by nature a key audit matter.[113] However, in such circumstances (1) the matter should not be described in the key audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the key audit matter section to the basis for modified opinion section where the matter is reported.[114] The requirements to determine and communicate key audit matters, other than the matters giving rise to the modified opinion, would still apply when the auditor expresses a qualified or adverse opinion, but not when the auditor disclaims an opinion on the financial statements.[115] The FRC and the EU do not include specific requirements for expanded auditor reporting when the auditor's report contains other than an unqualified opinion.

## B. Other Amendments to PCAOB Standards

The reproposed amendments to other PCAOB standards are substantially as proposed. These include:

- AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example report to conform to the reproposed auditor's report on the financial statements;

- AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*—amending to include the existing reporting

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[112] *See* reproposed amendments to AS 3105.59–.60.

[113] *See* paragraph 15 of ISA 701.

[114] *Id*.

[115] *See* paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105;

- AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review*—amending to require the engagement quality reviewer to evaluate the engagement team's determination, communication, and documentation of critical audit matters;

- AS 1301—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report; and

- AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*)—amending for the basic elements of the reproposed standard.

Commenters generally supported the proposed amendments.

*Question*:

26. Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?

## VI. Economic Considerations

### A. Need for the Rulemaking

#### *1. Critical Audit Matters*

Investors and other financial statement users know less about a company's financial performance than do others closer to the financial reporting process, particularly management. This information asymmetry[116] can result in situations where capital is allocated suboptimally. The system of financial reporting in the United States, which requires periodic reporting of information, including annual financial statements, helps address the information asymmetry between investors and management. Board of directors and audit committee oversight of the financial reporting process can further reduce this information asymmetry by enhancing the quality of the information disclosed to the public. As part of this system, the audit of the financial statements also helps

[116] Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Companies' operations continue to become more complex and global. In addition, over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.[117] These estimates and fair value measurements, which are important to a financial statement user's understanding of the company's financial position and results of operations, can be highly subjective, require significant judgment, and can result in increased measurement uncertainty in financial statements.[118] The increased complexity of financial reporting, including the growing use of complex accounting estimates and fair value measurements may contribute to the information asymmetry between investors and management, despite the fact that management is required to provide significant disclosures to investors and other financial statement users. Investors may find information provided by an independent third party (i.e., the auditor) particularly relevant in this setting.

As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, the auditor's report has not been expanded to provide this information to investors and generally provides only a standardized pass/fail opinion. Because the auditor's report generally does not contain audit-specific information, the auditor knows more about the company and its financial reporting and the challenges of the audit than is reflected in the auditor's report. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry between investors and auditors. This may limit the extent to which the auditor's report can address the information asymmetry between investors and management.

Although commenters on the Board's rulemaking have consistently affirmed the usefulness of a pass/fail auditor's opinion, many have also advocated for a more relevant and useful auditor's report that provides additional information from the

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[117] *See* PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

[118] *See* IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Mar. 2016).

auditor's perspective. For example, one commenter argued that an expanded auditor's report "will facilitate better analysis and heighten user confidence in the audited financial statements."[119] The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments should help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, an expanded auditor's report should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance.

a. Increasing the Informativeness of the Auditor's Report to Address Information Asymmetry

The communication of critical audit matters would inform investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgment, including the principal considerations for determining the matters and how the matters were addressed in the audit. The Board believes that the communication of critical audit matters should help focus investors' and other financial statement users' attention on these matters by making them more prominent, which could facilitate their analysis of the financial statements and other relevant disclosures. The communication of critical audit matters in the auditor's report would also help investors and analysts who were interested in doing so engage management with targeted questions about these issues.[120] While not every critical audit matter would be useful for every investor, broadly, the Board believes that having the auditor provide investors and other financial statements users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing a new perspective on the financial statements.

The communication of critical audit matters may also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality.[121] For example, the description of how the auditor addressed the critical

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[119] *See* letter from the CFA Institute (Dec. 30, 2013), at 2.

[120] The FRC observes that, in some instances, investors have begun to use the information provided in the expanded auditor's reports in the U.K. to engage with audit committees. *See* FRC 2016 Report.

[121] An academic study explores the relationship between audit quality and pre-audit financial reporting quality, and notes that, although they are distinct constructs, the two processes are interdependent and jointly determine financial reporting outcomes. *See* Lisa Milici Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri

audit matter may help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which may allow a more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have stated that having the auditor, a third-party expert, rather than the company provide this type of information would be of added value to investment decision making.[122] Because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility.[123]

Reporting of critical audit matters would add to the mix of information that could be used in investors' capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;

- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and

- Enabling comparison of these aspects of the audit for the same company over time.

b. Mandated Rather than Voluntary Reporting

Auditors have not developed a practice of providing information in the auditor's report beyond what is required, even though investors have consistently requested that the auditor's report become more informative. Current standards provide a framework for auditors to provide limited additional information through emphasis paragraphs,[124] but in general these only point to a disclosure in the company's financial statements without providing any additional description and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not

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Lombardi Yohn, *Understanding the Relation Between Financial Reporting Quality and Audit Quality*, Auditing: A Journal of Practice and Theory (Forthcoming).

[122] *See* IAG 2011 survey and CFA survey and poll results.

[123] *See, e.g.*, Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* 33 Auditing: A Journal of Practice & Theory 71, 71–93 (2014).

[124] *See* AS 3101.19.

prohibited in an emphasis paragraph, but current standards do not encourage auditors to include such information in their report and do not provide a framework for doing so.

There are many other potential reasons why auditors are not providing information voluntarily in the auditor's report, whether about the financial statements or the audit. Auditors may believe that providing additional information could expose them to potential legal liability[125] or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the disclosed matters. Furthermore, the historical model of management disclosing information and the auditor attesting to the information may lead companies to resist voluntary additional reporting by the auditor, either through emphasis paragraphs or with respect to information about the audit, which the auditor would be better positioned to communicate than management. Finally, in general, there may be disincentives to voluntary reporting if the disclosing party is not able to fully capture the benefits of the disclosures,[126] and parties may also exhibit a bias toward the *status quo.*[127] All of these factors disincentivize auditors from voluntarily providing further information about the audit, even if investors and other financial statement users would respond favorably to receiving additional information.

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[125] Section IV.A.4 contains a discussion about potential auditor liability concerns stemming from expanded auditor reporting.

[126] Academic research finds that there are certain situations in which disclosure may be socially optimal but not privately optimal. For example, it is possible that management chooses not to disclose some information that may be useful to investors if that information also benefits a competitor. Auditors and companies may resist voluntary expanded auditor reporting because of similar concerns that these types of spillover effects (or externalities) may create a competitive disadvantage. For a summary of this line of research, *see* Luigi Zingales, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, 394-395 (2009). Professor Zingales is the founding director of the PCAOB's Center for Economic Analysis. The research cited above was published before he joined the PCAOB.

[127] Research in behavioral economics suggests that when facing a set of decisions, individuals are more likely to stick to the known outcome (*status quo*) than would be expected based on the theory of rational decision making under uncertainty. There are a variety of reasons why individuals may choose the status quo outcome in lieu of an unknown outcome, including aversion to the uncertainty inherent in moving from the status quo to another option. *See* William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 Journal of Risk and Uncertainty 7, 7-59 (1988).

Mandatory disclosure helps promote more complete and consistent disclosure of specified categories of information to all users who may be interested in it.[128] Mandatory disclosure can also improve the allocative efficiency of capital markets by decreasing the costs associated with gathering information, or by providing market participants with information that otherwise would have been difficult or impossible for them to gather.[129]

*2. Additional Improvements to the Auditor's Report*

The existing auditor's report does not describe important aspects of the auditor's responsibilities under existing auditing standards, such as the auditor's responsibility to detect material misstatements, whether due to error or fraud; the auditor's responsibility for the notes to the financial statements; and the auditor independence requirement. This may contribute to misperceptions by investors and other financial statement users about the auditor's role and responsibilities, including with respect to these matters. Academic research suggests that there are a number of ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.[130]

In addition, the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report. The reproposed standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

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[128] Academic research on disclosure explores these types of positive externalities, as well as certain negative externalities. *See, e.g.*, Ronald A. Dye, *Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities,* 65 The Accounting Review 1, 1-24 (1990); or Anat R. Admati and Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 The Review of Financial Studies 479, 479-519 (2000).

[129] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review 717, 717–753 (1984).

[130] *See, e.g.,* Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008); Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); or Theodore J. Mock, Jean Bedard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing: A Journal of Practice & Theory 323, 323-351 (2013).

The reproposed standard would also require auditors to disclose the number of years they have served as the auditor for the company. Some commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point, and the growing trend toward voluntary disclosure of this information suggests that increasing numbers of companies believe that the market will find the disclosure useful. Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.[131]

Although investors can determine auditor tenure information using, for example, past auditor's reports, the information is not always readily available to investors.[132] Furthermore, while some issuers voluntarily provide information about auditor tenure in the proxy statement, many do not. Many issuers are also not subject to the proxy rules (for example, investment companies, foreign private issuers and many companies whose securities are not listed on a national securities exchange). In cases where the information is provided voluntarily, it is not provided in a consistent location. Disclosing information about auditor tenure in the auditor's report would provide a consistent location for this information and would reduce search costs, especially for companies that do not voluntarily provide such information or for which the information is not readily available through the EDGAR system.

## B. Baseline

The auditor's report in the United States today generally consists of three paragraphs that include limited audit-specific information. The existing auditor's report identifies the company's financial statements that were audited, provides a generic description about the nature of an audit, and provides an opinion on whether the company's financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework. The auditor's report is often described as a pass/fail model because the report only conveys the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail) and typically provides limited information about the nature of the work on which the opinion is based.

The Board's current standards also require that the auditor add explanatory paragraphs to the auditor's report under specific circumstances, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements. When included, these paragraphs

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[131] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

[132] *Supra* note 81.

generally consist of standardized language that provides limited audit-specific information.

The auditor may also, at his or her discretion, include emphasis paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Generally, an emphasis paragraph only points to a disclosure in the company's financial statements without providing any additional description. Under current practice, emphasis paragraphs are infrequent.[133] Auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[134]

Academic research finds that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.[135] Academic research also finds that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified because it does not provide much additional informational value about a particular audit.[136] The inclusion of explanatory language may provide investors with additional information. A recent academic study suggests that auditor's reports containing certain types of explanatory paragraphs required under existing standards may provide information about the likelihood that financial statements will be subsequently restated.[137] The authors argue that the inclusion of such an explanatory paragraph in the auditor's report can provide a signal to investors about the risk of misstatement of the company's financial statements.

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133 In the audit reports of approximately 6,350 issuers with fiscal year 2014 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 2 percent of the filings.

134 *See* AI 20.10*.*

135 *See* Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*.

136 *See* Gray et al., *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications*.

137 *See* Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?* 89 The Accounting Review 2115, 2115–2149 (2014).

The existing auditor's report is not required to have a specified addressee but it may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[138] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[139]

The current auditor's report also includes the report title, the date, and the name and location of the accounting firm’s office issuing the report. Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence. The auditor is not currently required to disclose in the auditor's report the number of years it has served as auditor for the company. However, as noted earlier, some companies have begun voluntarily disclosing auditor tenure in the proxy statement.

## C. Benefits

### *1. Critical Audit Matters*

Economic theory commonly attributes two benefits to mandatory disclosure. First, the disclosure of previously unknown value-relevant information directly benefits the market because it allows market participants to make better-informed decisions. Second, the disclosure of such information may indirectly benefit the market because some parties may change their behavior in positive ways after information is disclosed.

#### a. Direct Benefit: More Informative and Useful Auditor's Report

The Board believes that auditor communication of critical audit matters should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. For example:

- *Informing*: Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, and complex, together with a description of how the audit addressed those matters,

[138] *See* AS 3101.09.

[139] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers, benefit plans, and brokers and dealers.

which could provide valuable information about, for example, the company's business environment or financial reporting choices;

- *Framing*: Critical audit matters could provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which could facilitate their analysis of the financial statements, and help them assess financial performance, for example, by reducing the costs to process or search for the information; and

- *Monitoring*: The ability to identify and evaluate the matters identified as critical audit matters may also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor.

Some commenters stated that the communication of critical audit matters would focus users' attention on issues that would be pertinent to understanding the financial statements for purposes of investment decisions or financial analysis. For example, long-term investors, such as asset or pension plan managers that maintain their own analytical models, commented that critical audit matters would be of value to them in identifying areas specific to each company that may require further analysis or discussion with management in order to be properly understood and reflected in analyst models. One commenter also said that additional insights on how a firm has addressed critical audit matters could bear on investors' decisions on ratifying the audit committee's choice of external auditor.

The communication of critical audit matters aims to provide investors and financial statement users with specific information about the audit of a company's financial statements. Some commenters were concerned, however, that the communication of critical audit matters could lead to a reduction in comparability of auditor's reports. Their concerns related primarily to how investors and other financial statement users may interpret differences in critical audit matters between the company's current period and prior periods, or between the company and its competitors. Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, to the extent the information provided is useful in evaluating financial performance, highlighting these differences should be informative. Further, some commenters said that investors are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditor's reports across companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or MD&A that is specific to a company or a reporting period.

A body of academic research regarding the possible effects of expanded auditor reporting is emerging.[140] The Board is monitoring this research with a view towards assessing its potential relevance to the Board's consideration of the reproposal. The Board is mindful, however, of several issues that limit the extent to which this research can inform its decision making. Much of this research is unpublished and at a relatively early stage; the current conclusions may be subject to multiple interpretations and it is possible that results from this research may be revised during the peer review process. Moreover, it may be difficult to generalize results outside the context of specific studies. For example, in considering the implications of academic studies based on data from other jurisdictions, differences between the Board's reproposed rule and the requirements in other jurisdictions must be taken into account. In addition, specific characteristics of the U.S.-issuer audit market may make it difficult to generalize observations made in other markets because of differences in baseline conditions (for example, market efficiency, affected parties, policy choices, legal environment, and regulatory oversight). As to experimental research in particular, it should be noted that the experimental setting may not provide study participants with information that is representative of the information environment in which market participants actually operate; for instance, if new information appeared more salient to study participants than it would to a market participant, the impact of expanded auditor reporting would be overstated in an experimental setting.

One experimental study conducted prior to the 2013 proposal concluded that nonprofessional investors who were provided with an auditor's report with a paragraph similar to a critical audit matter paragraph were more likely to change their investment decision relative to nonprofessional investors who were provided with (1) a standard auditor's report and standard financial statement disclosures or (2) a standard auditor's report and information in the financial statement disclosures that would have been included in a critical audit matter paragraph.[141] Two unpublished academic studies have

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[140] For a review of relevant academic research, *see* Jean Bédard, Paul Coram, Reza Espahbodi, and Theodore J. Mock, *Does Recent Academic Research Support Changes to Audit Reporting Standards?* Accounting Horizons (Forthcoming).

[141] *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* This study was conducted prior to the PCAOB's 2013 proposal but was published subsequent to it. Although the authors' findings suggest that there is informational value in critical audit matters provided by the auditor, it is unclear whether other potentially relevant results identified in the paper were affected by certain assumptions, such as negative assurance or a separate opinion related to the matters identified as critical audit matters.

also found that the inclusion of critical audit matters in the auditor's report may have an informational effect on investment decision making.[142]

While these studies analyze potential effects of expanded auditor reporting on the perception of financial reporting quality, at least one study analyzes how the IAASB's expanded auditor's report influenced perceptions of audit quality.[143] The authors did not find evidence that key audit matters had an effect on the participants' perception of audit quality.

Several unpublished studies have analyzed how investors reacted to the implementation of expanded auditor reporting in other jurisdictions. One study did not find a financial market reaction to expanded auditor reporting in France, where a form of such reporting has been required since 2003.[144] Other studies have analyzed data from the United Kingdom. Lennox et al. found that expanded auditor reporting did reliably reflect the financial reporting risks of companies listed on the London Stock Exchange,

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[142] One study found that critical audit matters in the auditor's report regarding management's estimates are value-relevant to users' investment decisions. *See* Marcus Doxey, *The Effects of Auditor Disclosures Regarding Management Estimates on Financial Statement Users' Perceptions and Investments* (June 2014) (working paper, available in Social Science Research Network ("SSRN")). The second study concluded that additional reporting in the auditor's report can increase investors' attention to financial statement disclosures mentioned in the auditor's report, but that the communication of critical audit matters led to a decrease in the perceived level of audit quality and a perception that the level of assurance provided by the audit was not uniformly applicable across all aspects of the financial statements. *See* Louis–Philippe Sirois, Jean Bédard, and Palash Bera, *The Informational Value of Key Audit Matters in the Auditor's Report: Evidence from an Eye–Tracking Study (*Dec. 2015) (working paper, available in SSRN).

[143] *See* Pran Krishansing Boolaky and Reiner Quick, *Bank Directors' Perceptions of Expanded Auditor's Report*, International Journal of Auditing (Forthcoming).

[144] The study did not find evidence that the information provided in the expanded auditors' reports was associated with a significant change in cumulative abnormal returns measured during an event window around the filing of the auditor's report. *See* Jean Bédard, Nathalie Gonthier–Besacier, and Alain Schatt, *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience* (Jan. 2014) (working paper, available in Docket 034).

but did not result in an improvement to the information available to investors.[145] Gutierrez et al. analyzed market prices and trading volume, but did not find evidence that investors reacted to the implementation of expanded auditor reporting in the United Kingdom.[146] However, Reid et al. found a significant increase in trading volume particularly for companies about which there is less information available to investors as measured by lower analyst coverage.[147] Although there could be other explanations for the increase in trading volume, the authors argue that, "as the information environment weakens (i.e., analyst following decreases), there is a greater increase in the usefulness of the reports as a result of the additional auditor and audit committee disclosures."[148] That the documented increase in trading volume was particularly salient for less-followed companies may have important implications for the Board's proposed rule because, if adopted, it would apply to a wider range of U.S. public companies than does the FRC's rule, which applies only to companies with a premium listing on the London Stock Exchange. However, it should be noted that the FRC implemented rules requiring both the auditor and the audit committee to disclose additional information in their respective reports. As the auditor's report is issued concurrently with the audit committee's report, it is difficult to separately identify the effects of the two reforms.

Overall, the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements. The Board will continue to monitor academic research in this area during the rulemaking process.

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[145] The authors concluded that investors were already able to assess the financial reporting risks prior to the auditor's communication. *See* Clive S. Lennox, Jaime J. Schmidt, and Anne Thompson, *Is the Expanded Model of Audit Reporting Informative to Investors? Evidence from the UK* (June 2015) (working paper, available in SSRN).

[146] *See* Elizabeth Gutierrez, Miguel Minutti–Meza, Kay Tatum, and Maria Vulcheva, *Consequences of Changing the Auditor's Report: Evidence from the U.K*. (Mar. 2016) (working paper, available in SSRN).

[147] The authors argued that the additional information provided in the expanded format of the auditor's report was useful to investors. *See* Lauren C. Reid, Joseph V. Carcello, Chan Li, and Terry L. Neal, *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom* (July 2015) (working paper, available in SSRN).

[148] *Id.* at 25.

b. Indirect Benefit: Improved Audit and Financial Reporting Quality

In general, information asymmetry can lead to situations in which an agent (such as an auditor) takes actions that do not coincide with the best interests of the principal (such as an investor), if the agent's incentives are misaligned.[149] This type of problem is the result of the inability of the principal to understand or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.[150] Academic research suggests that "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."[151]

In the context of the audit, providing investors and other financial statement users with information about the audit through the communication of critical audit matters may provide auditors, management, and audit committees with additional incentives to change their respective behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters may lead:

- Auditors to focus more closely on the matters identified as critical audit matters;
- Management to improve the quality of their disclosures because they would know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters; and

[149] Economists use principal-agent theory to analyze situations where one party (the principal) hires another party (the agent) to perform certain tasks and decision-making ability is delegated to the agent. For a general discussion of principal-agent theory, *see, e.g.*, Michael C. Jensen and William H. Meckling. *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics 305, 305-360 (1976), or Bengt Holmstrom, *Moral Hazard and Observability*, 10 The Bell Journal of Economics 74, 74-91 (1979).

[150] *See, e.g.*, George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 Annual Review of Economics 391, 391-419 (2014).

[151] Holmstrom, *Moral Hazard and Observability*, at 75.

- Audit committees to focus on the matters identified as critical audit matters and to engage management about the adequacy of the related disclosures.

The communication of critical audit matters may lead auditors to increase their focus on the matters identified in the auditor's report as critical audit matters. As suggested by commenters, the communication of critical audit matters may further incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. In addition, auditors may feel that the potentially heightened scrutiny of the matters identified as critical audit matters may warrant additional effort to satisfy themselves that they have obtained an appropriate amount of audit evidence to support their opinion.

The communication of critical audit matters may also heighten management's attention to the relevant areas of financial statements and related disclosures. Some commenters said that communication of critical audit matters may serve as an incentive for management to provide better disclosure or adopt more widely accepted financial reporting approaches in these areas. This may be especially true if the communication of critical audit matters prompts analysts and others to engage management about the related financial statement accounts and disclosures. Increased management attention on the related aspects of the financial statements described in the critical audit matters in response may lead to an incremental increase in the quality of information presented in the financial statements and related disclosures. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[152]

In addition, the communication of critical audit matters may help focus the audit committee's oversight efforts by providing information allowing the audit committee to engage more effectively with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures.

To the extent these changes in behavior occur, they may lead to an incremental increase in audit quality and financial reporting quality, which could increase investors' confidence in the reliability of the financial statements. Some commenters stated that a more transparent and informative auditor's report could heighten user confidence in the

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[152] *See, e.g.*, Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2012). Professor Leuz is an economic advisor at the PCAOB. The research cited above was published before he joined the PCAOB.

audit and the audited financial statements. Ultimately, an increase in investor confidence could decrease the average cost of capital.[153]

One academic study analyzed whether expanded auditor reporting in France lead to increased audit quality.[154] The authors did not find evidence that a proxy for audit quality was affected by the introduction of expanded auditor reporting. In addition, two unpublished studies conducted using data from the United Kingdom analyze whether audit quality improved after the implementation of expanded auditor and audit committee reporting. Gutierrez et al. did not find evidence that the absolute value of discretionary accruals changed following the implementation of expanded auditor and audit committee reporting in the United Kingdom, and therefore concluded that the new reports did not have an impact on audit quality.[155] However, Reid et al. found that expanded auditor and audit committee reporting is associated with several commonly used proxies for audit quality.[156] The authors of the study noted that it is difficult to disentangle the effects of the two reports, however their analysis suggests an increase in audit quality following the introduction of the expanded auditor's report in conjunction with the expanded audit committee report.

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[153] *See* Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Trusting the Stock Market*, 63 The Journal of Finance 2557, 2557–2600 (2008). Professor Zingales is the Founding Director of the PCAOB's Center for Economic Analysis. The research cited here was published before he joined the PCAOB.

[154] *See* Bédard et al., *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience*.

[155] *See* Gutierrez et al., *Consequences of Changing the Auditor's Report: Evidence from the U.K*.

[156] Specifically, the authors of this study found that abnormal accruals and the propensity to meet or beat analysts' earnings expectations declined for companies that implemented the new reporting regime. Because the authors observed an increase in proxies for audit quality, but did not observe an associated increase in audit fees or financial reporting delays, the authors argued that the increase in audit quality may have been driven by an incremental increase in the leverage that auditors and audit committees have over management stemming from the enhanced audit reporting requirements. *See* Lauren C. Reid, Joseph V. Carcello, Chan Li, and Terry L. Neal, *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom* (Aug. 2015) (working paper available in SSRN).

c. Indirect Benefit: Differentiation Among Auditor's Reports

If investors and other financial statement users perceive and respond to differences in the quality and usefulness of the information communicated by auditors regarding critical audit matters, expanded auditor reporting may serve as a potential means of greater differentiation among accounting firms and engagement partners.[157]

In the United Kingdom, there is evidence that some investors recognize the progress that auditors are making to improve transparency in their auditor's reports through their implementation of the FRC reporting requirements. The FRC notes that investors greatly value the information provided in expanded auditor reporting.[158] For example, in the two years following the implementation of these requirements, an association of investment managers has recognized in an annual awards ceremony those specific auditor's reports found to be most clear and most innovative in providing insight into the audit of the company's financial statements.[159] In addition, the FRC notes that users of the new auditor's reports identified certain descriptions of risks that they found to be more useful—such as descriptions which are specific to the entity being audited. Further, the FRC report notes that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.[160]

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements. For example, one firm went beyond the FRC's requirements by including audit findings for the risks of material misstatement in the majority of its auditor's reports in the second year of implementation, which other firms did far less frequently. The FRC's observations may suggest that accounting firms took different approaches to the requirement and could distinguish themselves based on the quality and usefulness of the information provided in the expanded auditor's reports. Motivated in part by differences in the approaches used by accounting firms in the United Kingdom, an academic study analyzed whether investors responded differently to the auditor's reports issued by certain accounting

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[157] The Board has adopted final rules that, assuming final approval by the SEC, will require identification of the engagement partner on issuer audits on a new PCAOB form. *See* PCAOB Release No. 2015-008 (Dec. 15, 2015).

[158] *See* FRC 2016 Report.

[159] *See* the FRC's *Extended Auditor's Reports, A Review of Experience in the First Year* (Mar. 2015); and FRC 2016 Report.

[160] *Id.*

firms.[161] The authors of the study found that the auditor's reports issued by certain accounting firms were associated with larger differences in abnormal trading volume. The authors argued that the results suggested that investors found the auditor's reports issued by some accounting firms to be more useful than others.

In addition to relying on the audit committee (which, at least for listed companies, is charged with overseeing the external auditor), in the absence of differentiation based on the auditor's report, users of financial statements may rely on proxies such as the reputation of the accounting firm issuing the auditor's report, aggregated measures of auditor expertise (for example, dollar value of issuer market capitalization audited or audit fees charged), or information about the geographic location of the office where the auditor's report was signed as signals for audit quality. Academic research finds, however, that these are imperfect signals of audit quality.[162]

The identification and description of critical audit matters could permit differentiation among auditor's reports based on investor perceptions of their informativeness and usefulness. In some instances it may also provide a signal of audit quality. Because the determination of critical audit matters may reflect a variety of considerations, however, critical audit matters may not bear directly on audit quality. For example, the choice of which critical audit matters to communicate or how to describe them may reflect considerations such as the company's business environment and financial reporting choices, accounting firm methodology, engagement partner characteristics, and legal advice. Thus, a robust description of critical audit matters may not necessarily reflect a higher quality audit than a less detailed description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters could provide insight into the extent and appropriateness of the auditor's work. Moreover, it is possible that thoughtful, audit-specific and useful critical audit matters (or, conversely, generic and uninformative critical audit matters) could affect investor perceptions of the auditor's work and willingness to provide useful information. As a result, the communication of critical audit matters, potentially in conjunction with disclosures regarding the identity of the engagement partner and other accounting firms

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[161] *See* Reid et al., *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom*.

[162] *See, e.g.*, J.R. Francis, *A Framework for Understanding and Researching Audit Quality*, 30 Auditing: A Journal of Practice & Theory 125, 125–152 (2011) and Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 Journal of Accounting and Economics 275, 275–326 (2014).

that participated in the audit,[163] and other relevant information could enable differentiation among auditors on that basis.

*2. Additional Improvements to the Auditor's Report*

The reproposed standard contains other changes to the auditor's report intended to improve and clarify the language for certain elements, such as statements related to the auditor’s responsibilities regarding the notes to the financial statements, and promote a uniform presentation of this information across auditor's reports. Additionally, the reproposed standard would introduce new requirements regarding the addressee of the auditor's report and statements in the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for reporting on ICFR.[164]

The statement regarding the auditor's existing obligation to be independent of the company is intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. By requiring the auditor's report to be addressed to certain parties, the Board would be promoting uniformity in the addressees of the auditor's report.

Disclosing information about auditor tenure in the auditor's report would provide a consistent location for this information and decrease the search costs for investors and other financial statement users who are interested in this piece of information.[165] The disclosed information could also prompt investors and other financial statement users to engage management, and ultimately the audit committee, about issues related to auditor tenure.

For most of these changes to the auditor's report, commenters on the 2013 proposal generally agreed that the proposed changes would enhance the description in the auditor's report of the auditor's responsibilities under existing auditing standards and would facilitate comparisons between auditor's reports for different companies. Commenters' views were mixed with respect to the statement regarding auditor tenure.

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[163] *See* PCAOB Release No. 2015-008.

[164] In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the reproposal would require a statement to that effect in the auditor's report.

[165] *See* Section VI.D.2.e for a discussion of academic research regarding auditor tenure.

## D. Costs and Potential Unintended Consequences

### *1. Costs*

Commenters on the 2013 proposal generally did not quantify the cost to implement the proposal. Several commenters indicated that at this point it is hard to quantify the costs that would be incurred to implement the proposal. Even those that conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Therefore, based on the comments and the lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis.

As an additional means of assessing potential cost implications of the reproposed standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.[166] As discussed below, staff analyzed a variety of data points that may be associated with potential costs, including audit fees, days required to issue the auditor's report and the content of the expanded auditor's report. It should be noted that it may be difficult to generalize observations from the UK experience. For example, the reporting and documentation requirements relating to expanded auditor’s reports in the United Kingdom differ from those in the reproposal, the baseline legal environments are different, and the UK requirements apply only to companies with a premium listing on the London Stock Exchange and not, for example, to smaller companies that list on London's AIM market.

a. Critical Audit Matters

Based on comments to date, the Board anticipates that the reproposed requirement regarding critical audit matters would have potential cost implications for auditors and companies, including their audit committees. Such costs would primarily relate to additional time to prepare and review auditor's reports, including high-level discussions with management and audit committees as well as legal costs for review of the information provided in the critical audit matters. In addition, even though no performance standards are being amended, as discussed earlier in this release, auditors may choose to perform more audit procedures related to areas reported as critical audit matters, with cost implications for both the auditor and management.

For auditors, costs might represent both one-time costs and recurring costs. One-time costs could be incurred as a result of: (1) updating accounting firm audit and quality control methodologies to reflect the new reporting requirements and (2)

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[166] *See White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700*, available on the Board's website in Docket 034.

developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms would likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters.

Recurring costs would primarily reflect additional effort expended in individual audits. The reproposed standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which would be based on work the auditor has already performed. However, there would be some additional recurring costs associated with drafting descriptions of critical audit matters and related documentation. It is likely that senior members of the engagement teams, such as partners and senior managers, would be involved in determining the critical audit matters and developing the language to be included in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office, would also result in recurring costs. Additional time might also be incurred by the auditor as a result of discussions with management or the audit committee regarding critical audit matters.

Companies, including audit committees, could also incur both one-time and recurring costs as a result of the reproposed standard. One-time costs could be incurred, for example, in educating audit committee members about the requirements of the new standard and in developing management and audit committee processes for the review of draft descriptions of critical audit matters and the related interaction with auditors. Recurring costs would include the costs associated with carrying out those processes, as well as any increase in audit fees associated with the new reporting requirements or legal fees stemming from a review of critical audit matter communications.

If the drafting and review of critical audit matter reporting takes place towards the end of the audit, there may also be an opportunity cost associated with the time constraints on the parties involved (including, for example, management, the engagement partner, the audit committee, and the auditor's and company's respective legal counsel). The end of the audit is a busy period in which multiple issues may need to be resolved before the auditor's report can be issued. At the same time, companies and management would also be in the process of preparing the annual report. Time spent drafting and reviewing the communication of critical audit matters could occur at the same time as other important work in the financial reporting and audit process, and would involve management that command high annual salaries or auditors and lawyers with high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in a longer and more expensive financial reporting process.

Commenters' views varied significantly about the likely magnitude of direct costs associated with auditor reporting of critical audit matters. Some commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been reviewed by the engagement quality reviewer, documented in the engagement completion memo, and communicated to the audit committee. This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit. On the other hand, some companies said that critical audit matters would result in substantial additional costs for auditors and companies. One commenter surveyed accounting executives of 63 publicly-traded manufacturing companies; one-third believed that audit fees would rise by 6 to 10 percent, while another third said that fees could rise by more than 10 percent. Several companies stated that, in their view, the total costs associated with critical audit matters outweigh the perceived benefits that investors may get from the information provided. Other commenters stated that while audit fees would increase as a result of the communication of critical audit matters, investors would support additional fees for additional useful qualitative information.

In its review of the implementation of expanded auditor reporting in the United Kingdom, the PCAOB staff did not find evidence of statistically significant increases in audit fees following the first year of expanded auditor reporting.[167] The median fee change was zero and for the majority of companies, audit fees for the year of implementation remained the same or decreased as compared to the prior year's audit fees. Audit fees increased for the remaining companies. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent.[168] It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees, or whether audit firm profitability was affected. Also, audit fees would not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms chose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting.

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[167] *Id.*

[168] Academic research also finds an approximately 4 percent increase in audit fees two years after the implementation of expanded auditor's reporting in the United Kingdom. *See* Gutierrez et al., *Consequences of Changing the Auditor's Report: Evidence from the U.K.* The authors of another unpublished academic study that examined only the first year of implementation also found that audit fees increased marginally. They argued that the increase was likely due to the continuation of an upward trend in fees that was unaffected by the new reporting requirements, although they were unable to conclusively state that the enhanced audit reporting requirements had no effect on audit fees. *See* Reid et al., *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom*.

b. Additional Improvements to the Auditor's Report

The reproposed changes to the basic elements of the auditor's report do not represent a significant departure from the 2013 proposal. Some of the enhanced basic elements would have cost implications for auditors. One-time costs would primarily relate to updating methodology and training and the initial determination of the first year the auditor began serving consecutively as the company's auditor. Based on comments received, it does not appear that the reproposed changes to the basic elements would impose significant recurring costs, because they involve standardized language that, once implemented, would be the same or very similar across different auditor's reports every year.

2. *Potential Unintended Consequences*

a. Time Needed to Issue the Auditor's Report

As a result of the additional effort required to determine, communicate, and document critical audit matters, some commenters said that it would take auditors longer to issue their reports. Other commenters were concerned that the quality of the audit may be negatively affected if auditor's reports, including critical audit matters, were issued within the current timeframe.

The PCAOB staff study did not find evidence that compliance with the United Kingdom's recently implemented expanded auditor reporting requirements delayed the issuance of auditor's reports in the first year of implementation. Based on the study, for companies that had three years of financial statements, a new form auditor's report was issued, on average, in 63 days from the company's fiscal year end date in the year of implementation, as compared to 64 days in the prior year and 65 days two years earlier. Academic research conducted using data from the United Kingdom also did not find evidence that the new reporting requirements led to delays in financial reporting.[169]

b. Number and Content of Critical Audit Matters

Some commenters indicated an expectation that the auditor's report would include a long list of critical audit matters. They said that this would occur because the auditor would be motivated to communicate as much as possible in an effort to mitigate any future liability for unidentified critical audit matters. In their view, such a development could make the report more difficult to navigate and less useful and may result in duplicative communications if the auditor provides information already

[169] *See* Reid et al., *Impact of Auditor and Audit Committee Report Changes on Audit Quality and Costs: Evidence from the United Kingdom*.

disclosed by management. Other commenters indicated that expanded auditor reporting could lead to a checklist approach, which could result in standardized language and diminish the expected value of the critical audit matters.[170] At the same time, other commenters thought that, at least for certain types of issuers, the auditor may not identify any critical audit matters to communicate in the auditor's report. If auditors choose to provide only generic information about the audit, the communication of critical audit matters would not decrease information asymmetry about the audit, and may obscure other important information included in the auditor's report and the audited financial statements.

The reproposed requirements aim to provide investors with the auditor's unique perspective on the areas of the audit that involved the auditor’s especially challenging, subjective, or complex judgments. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Further, limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized.

The PCAOB staff study did not find evidence that expanded auditor reporting in the United Kingdom resulted in a very large number of risk topics or none at all in the first year of implementation.[171] On average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight. Additionally, the descriptions of the risks of material misstatement in the auditor's reports in the first year of implementation were not presented in standardized language, but included variations in content length, description, and presentation. The most frequently described risk topics related to revenue recognition, tax, and goodwill and intangible assets. The FRC report finds a similar range and average number of risk topics disclosed in both the first and second year of the implementation of expanded auditor reporting in the United Kingdom.[172] The FRC report also finds disclosure of similar risk topics in the second year of implementation of

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[170] These commenters generally suggested that the auditor provide the "principal" or "primary" considerations, but not all considerations, that led the auditor to determine that the matter is a critical audit matter. The reproposed requirement for critical audit matters incorporates this suggestion.

[171] *See White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700*, available on the Board's website in Docket 034.

[172] *See* FRC 2016 Report.

expanded auditor reporting in the United Kingdom.[173]

Further, the FRC found that, in the second year of expanded auditor reporting in the United Kingdom, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's reports provided discussion of significant risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.[174] These findings suggest that, thus far, the expanded UK auditor reporting has not become standardized in the United Kingdom.

As described earlier, academic research conducted in other jurisdictions has had inconclusive findings so far regarding the usefulness of information provided in expanded auditor reporting. Although some papers found that the communications may be predictable or redundant,[175] there is some evidence of abnormal trading volume stemming from the disclosed information.[176] However, results from experimental research on the communication of critical audit matters suggested that investors do read and value the communication in the auditor's report, even if management made similar disclosures in the financial statements.[177]

c. Effects of Increased Attention to Critical Audit Matters

The communication of critical audit matters could lead auditors, company management, and the audit committee to spend additional time and resources on reviewing the adequacy of the work performed on the related financial statement accounts and disclosures. While this could lead to an incremental improvement in audit and financial reporting quality for the identified critical audit matters, it is also possible that there may be increased costs for auditors as a result of the reproposed requirements. For example, even though the communication of critical audit matters does not mandate the performance of additional audit procedures, it is possible that

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[173] *Id.*

[174] *Id*.

[175] *See* Lennox et al., *Is the Expanded Model of Audit Reporting Informative to Investors? Evidence from the UK*, or Bédard et al., *Costs and Benefits of Reporting Key Audit Matters in the Audit Report: The French Experience*.

[176] *See* Reid et al., *Are Auditor and Audit Committee Report Changes Useful to Investors? Evidence from the United Kingdom*.

[177] *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

some auditors may perform additional procedures. If that occurs, the associated costs may be passed on—in whole, in part, or not at all—to companies and their investors in the form of higher audit fees. Further, increased procedures may also require additional time from the company's management to deal with such procedures. In addition to increased costs, the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality of other material aspects of the financial statements and disclosures if they receive less attention.

The communication of critical audit matters could also lead to changes in auditor incentives and behavior that negatively affect audit quality. For example, an unpublished academic study suggests that changes in auditor incentives could cause audit quality to decrease under certain circumstances.[178] However, some commenters suggested that such changes in incentives could improve auditor skepticism and audit quality.

Some commenters indicated that including critical audit matters in the auditor's report could also inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in the auditor's report. A recent academic paper also explored this possibility and found in an experimental study that participants acting as management chose to share less private information about key accounting estimates in a regime in which their auditors were able to disclose information about management's estimates as a critical audit matter.[179]

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[178] This study developed a theoretical model to analyze how expanded auditor reporting affects auditor effort, audit quality, and investment decisions. In the model, investors use signals of audit quality provided by expanded auditor reporting as a means to assess the likelihood that they could recover damages from the auditor in the event of an audit failure. The authors of the study found that while expanded auditor reporting enhances the decision usefulness of financial reports for investors, it can also adversely affect the auditor's incentives and consequently lower the expected level of audit quality if the underlying level of financial reporting quality is high and investors only use the auditor's report to verify the auditor's pass/fail opinion about the presentation of the financial statements. The authors concluded by noting that arguments in favor of disclosing critical audit matters are weakened if the underlying level of financial reporting quality is high. *See* Qi Chen, Xu Jiang, and Yun Zhang, *Does Audit Transparency Improve Audit Quality and Investment Efficiency?* (Dec. 2014) (working paper, available in SSRN).

[179] The authors argued that managers who sense that they are losing control over the company's disclosures will choose to disclose less information to the auditor in an effort to limit any negative investor reaction to auditor reporting. *See* Nicole Cade and Frank D. Hodge, *The Effect of Expanding the Audit Report on Managers' Communication Openness* (Aug. 2014) (working paper, available in SSRN).

PCAOB standards require the auditor to communicate to the audit committee information about management's estimates, among other matters.[180] Additionally, although management may have an increased incentive to withhold information from the auditor when the auditor is required to communicate critical audit matters, if management actually chose to provide the auditor with less information than requested, under the Board's existing standards[181] the auditor may determine that there is a scope limitation and qualify the auditor's opinion. Under the reproposed standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. With respect to any matters required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. It would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee, although, as described above, there should be few communications affected by that possibility.

Although the communication of critical audit matters may lead to changes in the incentives for the auditor, company management, and the audit committee to communicate with each other, initial anecdotal evidence suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

d. Changes in Perceived Assurance on the Auditor's Report, Including Perceptions of Auditor Liability

The communication of critical audit matters could have liability implications for auditors. For a more detailed discussion of liability, *see* Section IV.A.4. In addition, because the communication of critical audit matters requires auditors to discuss aspects of the audit that they found to be especially challenging, subjective, or complex, it is possible that some investors and financial statement users may misconstrue the communications to mean that auditors were unable to obtain reasonable assurance about the matters identified as critical audit matters. Some commenters have said that the communication of critical audit matters could lead to changes in the way investors and financial statements users perceive the level of assurance provided by the audit on matters identified as critical audit matters. This could result in a situation in which investors believe that auditors are providing separate assurance about the presentation

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[180] AS 1301.12(c).

[181] *See* AS 3101.20-.26.

of the financial statements and may have implications for perceptions of auditor responsibility in the event of an audit failure.[182]

Several academic papers analyze certain risks associated with communicating critical audit matters, including perceptions of auditor responsibility.[183] Each paper relies on an experiment in which participants were presented with information about financial statement misstatements and critical audit matters. Researchers evaluated the impact of expanded auditor reporting on participants' perceptions of auditor responsibility. The results of these studies vary and are sometimes contradictory.[184] While some papers suggest that expanded auditor disclosure could result in a perception of decreased

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182 Academic research on financial statement users' perceptions of critical audit matters suggests that these unintended consequences may be possible. *See* Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* or Marcus Doxey, *The Effects of Auditor Disclosures Regarding Management Estimates on Financial Statement Users' Perceptions and Investments*.

183 *See* Tim Brown, Tracie M. Majors, and Mark. E. Peecher, *The Impact of a Judgment Rule and Critical Audit Matters on Assessments of Auditor Legal Liability—The Moderating Role of Legal Knowledge* (Dec. 2014) (working paper, available in SSRN); Kelsey R. Brasel, Marcus M. Doxey, Jonathan H. Grenier, and Andrew Reffett, *Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability*, The Accounting Review (Forthcoming); Ann G. Backof, Kendall Bowlin, and Brian M. Goodson, *The Impact of Proposed Changes to the Content of the Audit Report on Jurors' Assessments of Auditor Negligence* (Feb. 2016) (working paper, available in SSRN); Christine Gimbar, Thomas Bowe Hansen, and Michael E. Ozlanski, *The Effects of Critical Audit Matter Paragraphs and Accounting Standard Precision on Auditor Liability: Can Anything the Auditor Says Be Used Against Them?* The Accounting Review (Forthcoming); and Steven J. Kachelmeier, Jaime J. Schmidt, and Kristen Valentine, *The Disclaimer Effect of Disclosing Critical Audit Matters in the Auditor's Report* (Dec. 2015) (working paper, available in SSRN).

184 For a more detailed description of the methodologies and results of several of the above-referenced studies, see Christine Gimbar, Bowe Hansen, and Michael E. Ozlanski, *Early Evidence on the Effects of Critical Audit Matters on Auditor Liability*, 10 Current Issues in Auditing A24, A24-A33 (2016).

auditor responsibility,[185] other papers suggest the opposite effect.[186] Most of the studies acknowledge that findings may depend on the design of the experiment, the particular hypotheses being tested, the specific facts and circumstances presented to the experiment participants, and the background of the participants themselves.

Therefore, while this type of research can have important implications for how critical audit matters are viewed in relation to the overall level of assurance provided by an audit, it is difficult to draw generalizable conclusions based solely on these papers. If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some of the working papers, and this in turn reduced auditor liability, it is possible that auditors may feel that less audit work is needed on the matters identified as critical audit matters. This could lead to a decrease in audit quality. The Board will continue to monitor emerging research related to expanded auditor reporting in the U.S., as well as research in other jurisdictions in which such reporting is already occurring.

On the point of whether the communication of critical audit matters could result in the perception of separate assurance, the reproposed standard would require the following statement in the auditor’s report that "Critical audit matters do not alter in any way [the auditor’s] opinion on the financial statements, taken as a whole, and [the auditor does not] provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate." The purpose of this statement is to make clear that the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters.

e. Auditor Tenure

Some commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about

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185 *See, e.g.*, Brasel et al., *Risk Disclosure Preceding Negative Outcomes: The Effects of Reporting Critical Audit Matters on Judgments of Auditor Liability*; Kachelmeier et al., *The Disclaimer Effect of Disclosing Critical Audit Matters in the Auditor's Report*; or Brown et al., *The Impact of a Judgment Rule and Critical Audit Matters on Assessments of Auditor Legal Liability—The Moderating Role of Legal Knowledge*.

186 *See, e.g.*, Backof et al., *The Impact of Proposed Changes to the Content of the Audit Report on Jurors' Assessments of Auditor Negligence*; or Gimbar et al., *The Effects of Critical Audit Matter Paragraphs and Accounting Standard Precision on Auditor Liability: Can Anything the Auditor Says Be Used Against Them?*

correlations between auditor tenure and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[187] Other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality.[188] Still other academic research suggests that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit quality.[189]

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital and could also result in conversations that are an inefficient use of management and audit committee time.

**E. Alternatives Considered, Including Policy Choices Under the Reproposal**

In developing the reproposal the Board considered alternative approaches to the proposed critical audit matters. The Board also considered certain policy decisions in developing critical audit matters and other changes to the auditor's report.

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[187] *See, e.g.*, Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 Auditing: A Journal of Practice & Theory 55, 55–69 (2004) and Timothy B. Bell, Monika Causholli, and W. Robert Knechel, *Audit Firm Tenure, Non–Audit Services, and Internal Assessments of Audit Quality*, 53 Journal of Accounting Research 461, 461–509 (2015).

[188] *See, e.g.*, Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297–314 (2008).

[189] *See, e.g.*, Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517–548 (2009).

*1. Alternative Approaches*

a. No Change to Auditor Reporting Requirements

The Board considered whether changes to the existing auditor reporting requirements were needed. Auditor reporting under the current model has been criticized by many commenters as providing limited information. Auditors have not voluntarily provided more information in the auditor's report in response to investors' requests. A number of factors described above, such as potential costs and uncertainties related to voluntary auditor reporting and the potential for auditor status quo bias, may explain why voluntary reporting would not be expected to become prevalent. These factors suggest that voluntary reporting, with or without guidance to encourage it, could also create uncertainty about the content of auditor's reports because auditors would be able to choose whether to provide information about the audit, what information to provide, and the form in which to provide it. On that basis, the Board believes that standard setting is appropriate.

b. Consideration of Analogous Requirements of Other Regulators and Standard Setters

In developing the reproposal, the Board took into account the requirements for expanded auditor reporting of other regulators and standard setters, such as the IAASB, the FRC, and the EU. Changes to the auditor's report that other regulators and standard setters have adopted include some commonality, such as communicating information about audit-specific matters in the auditor's report. Adopting the expanded auditor reporting requirements of another standard setter could provide more consistent global auditor reporting requirements.

However, the Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Because the Board's standards have the force of law, the Board aims to make them as clear and easy to apply as it can. For example, the factors that the auditor would consider in determining whether a matter involved especially challenging, subjective, or complex auditor judgment are included in the standard; by contrast, while the IAASB approach includes similar factors, they appear in the application and other explanatory material.

In addition, there are differences between requirements and terminology of the Board's auditing standards and those of other regulators and standard setters that may cause inconsistent application, even if the Board were to adopt the approach of another standard setter. For example, the Board's requirements for communications to the audit committee are not the same as the analogous requirements of the IAASB. Therefore, although both critical audit matters and the IAASB's key audit matters are derived from such communications, the matters ultimately discussed with the audit committee under each framework would not necessarily be the same, and could result in differences in which matters are reported. Also, terminology used in the rules of other regulators and standard setters to describe matters subject to the expanded auditor reporting, such as IAASB's "areas of higher assessed risks of material misstatement" or EU's "most significant assessed risks of material misstatement," is not used in PCAOB auditing standards. As a result, adopting the same standard as another regulator or standard setter would not necessarily yield the same result.

c. Auditor's Association with Portions of MD&A

Several commenters suggested that the Board should consider auditor association with, or attestation on, portions of MD&A, specifically management's critical accounting policies and estimates, as an alternative to expanded auditor reporting. These commenters have argued that such an association could increase the quality and reliability of the information subject to the procedures. The Board solicited comment on this approach in the 2011 concept release and some commenters raised it again in relation to the 2013 proposal.

Some commenters on the 2011 concept release, including investors, said that they are not supportive of separate assurance by the auditor on information outside of the financial statements as an alternative to expanded auditor reporting, primarily because the related auditor reporting would have appeared in a standardized form and would not provide audit-specific information. Requiring such reporting might necessitate action by the SEC, as well as the PCAOB, to implement, including new SEC rules regarding management reporting and auditor attestation. In addition to reporting requirements, the PCAOB might have to develop new performance requirements and auditors would be required to undertake additional audit work in order to provide attestation in these areas. Based on concerns about the relative benefits and costs and the comments received, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting.

d. Auditor Assessment and Descriptions of Certain Financial Statement Areas

As previously discussed, several commenters suggested that investors would be most interested in auditor reporting on the categories of information identified by investor respondents to the 2011 survey conducted by a working group of the IAG: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them;[190] (2) areas of high financial

[190] Some commenters suggested that the auditor should grade their assessments.

statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[191] This request was reiterated by several commenters on the 2013 proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters have requested that the auditor provide a "grade" assessing the quality of the financial statements as a whole.

The reproposed critical audit matter definition would likely cover many of the topic areas requested by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor would not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

In this standard setting, the Board seeks to strike an appropriate balance between the value of the information being provided and the costs of providing it. Requiring auditors to report their qualitative assessments in a manner that appears very precise (for example, describing an estimate as "conservative" or "aggressive" or assigning the financial statements an "A" or a "B") would likely impose significantly greater costs and unintended consequences than the principles-based reporting of critical audit matters. For example, although the reporting of qualitative assessments would appear to be precise, these qualitative assessments are likely to be applied inconsistently because there is no framework for such assessments and the determinations are inherently subjective. In addition, such assessments may heighten concerns related to the perceived level of assurance provided by the audit or the perception that separate assurance is being provided as to the assessed areas. Also, the reporting of such qualitative assessments would likely subject auditors and issuers to additional litigation risk beyond what may result from the principles-based reporting of critical audit matters because the apparent precision of the reporting may facilitate plaintiffs' claims.

*2. Policy Choices*

a. Definition of Critical Audit Matters

The Board considered a variety of possible approaches to the definition of critical audit matters suggested by commenters. *See* Section IV.A.1 for a discussion of the

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[191] *See* IAG 2011 survey.

Board's considerations. Under the reproposal, the Board anticipates that the initial population of matters that could potentially be determined to be critical audit matters would be smaller than those under the proposal, which should reduce the auditor's effort in determining which matters may be critical audit matters. With a materiality component, however, matters that are not material to accounts or disclosures in the financial statements but may be important to investors would not be included as critical audit matters in the auditor's report.

b. Communication of Critical Audit Matters

The Board considered a variety of possible approaches to the communication requirements for critical audit matters. *See* Section IV.A.2 for a discussion of the Board's considerations. Under the reproposal, auditors would be required to describe how each critical audit matter was addressed in the audit, but are given flexibility in formulating the description, which should enable them to avoid standardized language and tailor the description to the specific circumstances for a particular audit. In addition, when describing critical audit matters in the auditor's report, the auditor would not be expected to provide information about the company that had not been made publicly available by the company unless such information were necessary to describe the principal considerations that led the auditor to determine that a matter was a critical audit matter or how the matter was addressed in the audit.

c. Documentation of Critical Audit Matters

In response to commenters' concern about the proposed requirement to document matters that appeared to meet the definition of critical audit matters, the documentation requirement in the reproposal was narrowed. *See* Section IV.A.3 for a discussion of the Board's considerations. In general, the reproposed documentation requirement is intended to facilitate review of the auditor's determinations by others, such as the engagement quality reviewer and through the Board's oversight activities. This should foster enhanced compliance and greater consistency in the application of the requirements. However, there would be additional time and effort related to the documentation requirement.

d. Auditor Tenure

The reproposal retains the requirement to include a statement in the auditor's report about auditor tenure. *See* Section IV.B.2 for a discussion of the Board's considerations. The reproposed requirement to disclose auditor tenure in the auditor's report would eliminate search costs stemming from duplicative efforts of investors and other financial statement users to individually gather the information, and would reduce search costs relative to manual review of Form 8-Ks and annual reports filed over time or locating *ad hoc* voluntary disclosure in the proxy statement. Under the reproposal, information about auditor tenure would be consistently available in one location, including with respect to companies that are not subject to the proxy rules.[192] Some commenters noted that the easier it is for investors to locate information about auditor tenure, the more useful such information would be. As a result, although there are varying views about the link between auditor tenure and audit quality, the Board's reproposal retains this requirement as another element in the mix of information used by investors in their decision making.

The Board is also soliciting comment on whether auditor tenure should be disclosed on Form AP rather than in the auditor's report. Relative to mandated disclosure in the auditor's report, disclosure on Form AP could further reduce search costs for market participants in some instances, particularly in aggregating data across audits and over time. However, under the reproposal, the required information would be disclosed in the auditor's report, the primary vehicle by which the auditor communicates with investors and where other information about the audit is already found, and would be available to investors immediately when a company files its audited financial statements and the accompanying auditor's report with the SEC.

e. Additional Improvements to the Auditor's Report

The reproposal includes a number of requirements that would enhance the standardized content of the auditor's report by clarifying the auditor's role and responsibilities related to the audit of the financial statements. These include, for example, statements regarding auditor independence requirements and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the reproposal includes requirements intended to promote uniformity in the form of the auditor's report. These include requirements as to the addressee, a specific order of certain sections of the auditor's report, and required section headings.

These enhancements should increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports.

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[192] The proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, brokers and dealers, and most investment companies are not required to prepare proxy statements.

*Questions:*

27. How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?

28. How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?

29. Would critical audit matters be useful in assessing company financial performance? If so, how?

30. Would critical audit matters be useful in assessing audit quality? If so, how?

31. Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?

32. Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?

33. Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?

34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?

35. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

36. Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?

## VII. Exclusions from Critical Audit Matter Requirements

Under the 2013 proposal, the standard would have applied to all audits conducted under PCAOB standards, although the Board sought comment on the applicability of critical audit matters to the audits of specific types of entities, including brokers and dealers; investment companies; and benefit plans. Some commenters supported applying the communication of critical audit matters to the audits of all types of entities. Others commented that audits of certain entities should be excluded from critical audit matter reporting. The Board has taken into consideration comments received and evaluated benefits and costs to assess the applicability of critical audit matters to the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies and benefit plans. This section describes the Board's rationale, including economic considerations, for reproposing to exclude audits of these entities, other than business development companies, from the critical audit matter requirements.[193] However, auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

### A. Brokers and Dealers

Pursuant to Exchange Act Rule 17a-5, brokers and dealers are generally required to file annual reports with the SEC and other regulators. The annual reports include, among other things, a financial report, either a compliance report or exemption report, and reports by the auditor covering the financial report and the compliance report or exemption report. The annual reports are public, except that if the statement of financial condition in the financial report is bound separately from the balance of the annual report, the balance of the annual report is deemed confidential and nonpublic.[194] In this situation, the auditor would generally issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete financial report that, except as provided in paragraph (c)(2)(iv) of Exchange Act Rule 17a-5, would be confidential and not available to the public.[195] Research by the

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[193] The other requirements of the reproposed standard would be applicable to audits of these types of entities.

[194] *See* Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

[195] *See also* Exchange Act Rule 17a-5(c)(2), 17 CFR 240.17a-5(c)(2), regarding audited statements required to be provided to customers.

PCAOB's Office of Research and Analysis ("ORA")[196] indicates that, for approximately half of brokers and dealers, the complete financial report and the related auditor's report are confidential and not available to the public.

The SEC adopted new rules for brokers and dealers[197] and the Board adopted new standards most recently in 2013, after the issuance of the 2013 proposal. The Board's new standards enhanced the auditor's performance and reporting responsibilities for financial statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.[198]

Research by ORA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by an individual or entity that holds a controlling interest. The owners of brokers and dealers are generally part of the management of the entity and therefore would have direct access to the auditor. Given that there is much less separation of ownership and control in non-issuer brokers and dealers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors. Additionally, other financial statement users, such as counterparties or regulatory agencies, are in a position to obtain needed information from the brokers and dealers, suggesting that the communication of critical audit matters may be less beneficial for them.

However, there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers. But certain aspects of broker and dealer financial reporting may limit the benefits of requiring the communication of critical audit matters. For example, while other financial statement users, such as customers of brokers and dealers, may benefit from increased information about the audit, the ability for brokers and dealers to confidentially file certain financial statements and schedules would require the auditor to

[196] ORA's research was conducted on brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014 that included audit reports issued by firms registered with the PCAOB.

[197] *See SEC*, *Broker-Dealer Reports,* Exchange Act Release No. 70073 (July 30, 2013), 78 FR 51910 (Aug. 21, 2013).

[198] *See Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard on Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This would impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies, as they would have to identify critical audit matters that apply exclusively to the publicly available financial information. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer and may not benefit from audit-specific information in the same way as investors in an operating company.

Some commenters on the 2013 proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by: (1) the closely held nature of brokers and dealers; (2) the limited number of users of their financial statements; and (3) the fact that, in many cases, only the statement of financial condition is available publicly. Some commenters also recognized that both the SEC and PCAOB recently updated their rules to further enhance reporting by brokers and dealers and their auditors.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received, and the Board's recent standard-setting activities related to brokers and dealers, the Board does not believe that reporting of critical audit matters for brokers and dealers would provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters would not be required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5. If a broker or dealer were an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.

## B. Investment Companies

The Investment Company Act generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[199] Most investment companies registered under the Investment Company Act are required to file with the SEC annual reports on Form N-CSR containing audited financial statements.[200] The Investment Company Act includes specific requirements for investment companies, intended to reduce investors' risks, in areas such as an investment company's portfolio diversification, liquidity, leverage, and custody of securities.[201]

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[199] *See* Section 3(a)(1) of the Investment Company Act.

[200] *See* SEC Rules under Section 30(e) of the Investment Company Act.

[201] *See, e.g.,* Sections 12, 13, and 17 of the Investment Company Act.

In an SEC rulemaking, the SEC observed that commenters believed the key information that investors use in deciding to invest in an investment company includes an investment company's investment objectives, strategies, risks, costs, and performance.[202] The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.[203] Changes to investment objectives and strategies require shareholder approval or disclosure.[204]

Several commenters on the 2013 proposal noted that an investor's decision to invest in an investment company is primarily based on the investment objectives, risks, performance, and fees, and critical audit matters are not expected to provide information about these items and therefore would not be relevant. Several commenters generally stated that investment companies are designed for the sole purpose of trading in and holding investments and auditor judgment would arise primarily with respect to valuation of investments, which would tend to be repeated as a critical audit matter. A commenter noted that, since the strategies of investment companies do not change significantly over time, the critical audit matters identified could become standardized from one reporting period to the next and also across funds with similar objectives.

Business development companies ("BDCs"), which are a type of investment company, differ from other investment companies in several important ways.[205] Other investment companies generally invest at least 85 percent of their assets in liquid investments, such as securities of public companies listed on a national securities exchange. BDCs, by contrast, are required to hold at least 70 percent of their assets in investments such as securities purchased in transactions not involving any public offering and eligible portfolio companies, e.g., private companies or small public companies that have no liquid securities.[206] As a result, BDCs' portfolios primarily

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[202] *See* SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998, 74 FR 4546 (Jan. 26, 2009). *See also* Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006), at 2–3.

[203] *See* SEC Rules under Section 30(e) of the Investment Company Act.

[204] *See* Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

[205] BDCs make an election to be regulated under sections 55 through 65 of the Investment Company Act. *See* Section 54 of the Investment Company Act.

[206] *See* Sections 2(a)(46), 2(a)(48), and 55(a) of the Investment Company Act.

consist of securities that are highly illiquid, are often subject to sale restrictions, and are typically valued using unobservable inputs and valuation models.

Also, unlike other investment companies, BDCs are required to offer significant managerial assistance and can offer equity and loan financing to the companies they invest in.[207] BDCs are also able to use more leverage in their operations and issue types of debt and equity securities generally not issued by other investment companies.[208] Finally, BDCs are subject to registration and periodic reporting requirements under the Exchange Act, file their annual reports on Form 10-K,[209] and can qualify as emerging growth companies.[210] The Board did not receive any comments specific to BDCs.

Even though the disclosures required under the Investment Company Act and other federal securities laws provide investors with useful information, they may not fully substitute for the communication of critical audit matters. The required communication of critical audit matters contemplates that auditors would provide investors with audit-specific information, which is unlikely to appear in the disclosures provided by management. In addition, some academic research documented a difference in the perceived usefulness and reliability of information depending on the location of the disclosure and whether it was disclosed by management or by the independent auditor.[211] This academic research suggests that the auditor's communication of information similar to critical audit matters may provide value to investors because it comes from the auditor, even if the same information is disclosed by management in the experimental design of the study.

The benefits of providing critical audit matters, however, may be smaller for investment companies, other than BDCs, relative to other types of companies because

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[207] *See* Section 2(a)(47) of the Investment Company Act.

[208] *See* Section 61 of the Investment Company Act.

[209] *See* Section 54 of the Investment Company Act.

[210] Under SEC staff interpretation, BDCs can qualify as emerging growth companies. *See* Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions*, Q. 21. Other investment companies cannot qualify as emerging growth companies. *See* Division of Corporation Finance, *Jumpstart Our Business Startups Act Frequently Asked Questions*, Q. 20.

[211] *See, e.g.*, Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

of their purpose and structure. Unlike companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. This creates the potential for critical audit matters of investment companies to become excessively repetitive, making them uninformative.

There may also be additional costs of applying critical audit matter requirements to audits of investment companies, other than BDCs, as compared to audits of other types of companies. For example, in some cases, annual shareholder reports of affiliated investment companies with the same fiscal year-end might be filed with the SEC in one document, which generally contains a single auditor's report that covers multiple audited investment companies. In these situations, communicating critical audit matters specific to each investment company may require the auditor to prepare separate auditor's reports. This could increase costs for these types of investment companies.

After consideration of the purpose and reporting characteristics of investment companies and the comments received, the communication of critical audit matters would not be required for audits of most investment companies. The requirements would apply, however, to investment companies regulated as BDCs.[212] Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments would generally involve complexity and auditor judgments due to the nature of the BDCs' portfolios. Also, because of the more diverse operations of BDCs, such as providing managerial assistance and involvement with more complex debt and equity instruments than other investment companies, communication of critical audit matters in a BDC audit could be more informative to investors. Additionally, BDCs follow a reporting regime under the Exchange Act that is more closely aligned with that of companies to which the Board is applying the requirements for critical audit matters. For these reasons, the Board believes it would be appropriate for audits of BDCs to be subject to critical audit matter requirements.

## C. Benefit Plans

Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[213] that includes the benefit plan's audited financial statements and the

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[212] *See* Section 54 of the Investment Company Act.

[213] *See* Section 15(d) of the Exchange Act.

related auditor's report.[214] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[215]

Participation in a benefit plan is limited to eligible employees of the plan sponsor. Each plan participant in a defined contribution benefit plan is responsible for selecting, from the investment options made available by the plan sponsor, the specific investments in which the participant's funds are invested.

Employee stock benefit plans are generally less complex than other types of companies because they are designed for the sole purpose of holding the plan's investments for the participants' benefit. A plan's financial statements reflect summary information about the plan's assets and liabilities by aggregating the balances of all plan participants. However, only the individual account statements that plan participants receive periodically provide information specific to each participant's investments.

Several commenters suggested excluding audits of benefit plans from the requirement for reporting critical audit matters due to the unique characteristics of these entities and their differences from other types of companies. For example, some commenters indicated that benefit plans are designed for a specific purpose and, as a result, would likely have similar critical audit matters from one reporting period to the next. Other commenters noted that benefit plans are inherently less complex and entail fewer estimates and judgments.

The communication of critical audit matters could provide information about any complex issues that were identified during the audit and how the auditor addressed them. However, since a benefit plan's assets and liabilities aggregate the balances of all plan participants, the financial statements or related critical audit matters would not provide actionable information about a plan participant's specific investment. Further, given the nature of benefit plans, there is a chance that the same critical audit matters

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[214] A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. *See* SEC Rule 15d-21, CFR 240.15d-21.

[215] *See* FASB ASC 960-10-05-6. Benefit plans subject to ERISA also file with the DOL an annual report on Form 5500, including audited financial statements and an auditor's report. Pursuant to DOL requirements, the audit of the financial statements is performed under auditing standards generally accepted in the United States, that is, not under PCAOB standards.

would be communicated each year. For example, the valuation of investments is likely to be the most complex area in the audit of a benefit plan and therefore may be a critical audit matter in each reporting period, making the information less useful.

After consideration of the structure and reporting characteristics of benefit plans and the comments received, the communication of critical audit matters would not be required for audits of benefit plans.

*Requirements of Other Regulators and Standard Setters*

Under the IAASB's standard, the communication of key audit matters applies to listed entities.[216] The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.[217] The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.[218]

*Questions*:

37. Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?

38. For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?

39. While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?

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[216] *See* paragraph 5 of ISA 701.

[217] *See* requirements in 1 of Article 2, *Audit Report* of Regulation (EU) No 537/2014.

[218] These include companies with a premium listing of equity shares on the London Stock Exchange regardless of whether they are incorporated in the U.K. or elsewhere.

40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies?[219] Why or why not?

## VIII. Considerations for Audits of Emerging Growth Companies

Section 104 of the Jumpstart Our Business Startups ("JOBS") Act imposes certain limitations with respect to application of the Board's standards to audits of emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company . . ."[220] In addition, Section 104 further provides that any other rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[221] As a result of the JOBS Act, the reproposed standard and amendments, if adopted by the Board, would be subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

The 2013 proposal solicited comment on the application of the proposed standard to the audits of EGCs. Two commenters suggested that it would violate the JOBS Act provisions regarding AD&A for the Board to apply critical audit matter requirements to the audits of EGCs, on the basis that critical audit matters are

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[219] A shell company is defined as a company, other than an asset-backed issuer, with no or nominal operations; and either: no or nominal assets; assets consisting of cash and cash equivalents; or assets consisting of any amount of cash and cash equivalents and nominal other assets. *See* Exchange Act Rule 12b-2.

[220] *See* Pub. L. No. 112-106 (Apr. 5, 2012). *See* Section 103(a)(3)(C) of Sarbanes-Oxley, (15 U.S.C. 7213(a)(3)), as added by Section 104 of the JOBS Act. An auditor's discussion and analysis ("AD&A") does not exist in auditing standards but was described as one of several conceptual alternatives for changing the auditor's reporting model in the 2011 concept release. Section IV.A., *Auditor's Discussion and Analysis,* of the 2013 proposal described an AD&A and related comments received on the concept release.

[221] *Id*.

"substantially similar"[222] or "appear substantively similar"[223] to AD&A. One of these commenters further asserted that applying the critical audit matters standard to audits of all issuers, regardless of EGC status, would violate the spirit of the "IPO On-Ramp" embedded in the JOBS Act by applying a one-size-fits all compliance burden, with potentially significant costs, to smaller issuers.

Other commenters, including accounting firms that commented on this issue, asserted that the proposed standard should apply to audits of EGCs. Some of these commenters argued that EGCs exhibit characteristics similar to other public companies and that financial statement users would benefit from similar auditor reporting requirements. Some commenters asserted that the proposed standard should be applicable to EGCs on a deferred basis, after its implementation by larger companies has been evaluated for effectiveness.

Academic research suggests that EGCs may have a higher degree of information asymmetry relative to the broader population of issuers. Although the degree of information asymmetry surrounding a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.[224] The extent to which EGCs can be characterized as exhibiting one or more of these properties may suggest that they have a greater degree of information asymmetry relative to the broader population of issuers. As a result, the benefits of reducing the degree of information asymmetry about audit and financial reporting quality may be incrementally larger for EGCs relative to the broader population of operating companies. For example, in a UK study using analyst following as a proxy for a company's information environment, the authors found that

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[222] *See* letter from the Biotechnology Industry Organization (Dec. 9, 2013), at 2.

[223] *See* letter from the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Dec. 9, 2013), at 4.

[224] *See*, *e.g.*, David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 The Journal of Finance 2747, 2747-2766 (2000), and Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 Journal of Financial Economics 361, 361-381 (1995), and Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 Journal of Financial Economics 101, 101-121 (1988), and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A note*, 43 The Journal of Finance 1041, 1041-1048 (1988).

companies with low analyst following experienced a statistically significant increase in abnormal trading volume following the implementation of the enhanced audit reporting requirements. The authors of the study argued that enhanced audit reporting produced greater benefits for companies with weaker information environments.

The data on EGCs outlined in Appendix 3, *Characteristics of Self-Identified EGCs*, remains generally consistent with the data discussed in the 2013 proposal, although the number of EGCs has more than doubled since 2013. A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.[225]

If the reproposed standard does not apply to audits of EGCs but is applicable to audits of larger and more established companies, there could be potential disparity between the two groups of companies in the amount and quality of public information available for investment decision making. Excluding EGCs from the reproposed standard could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a competitive disadvantage compared to non-EGCs in attracting available capital.

The Board must also take into account the potential costs of applying critical audit matter requirements to EGCs. A detailed discussion of the potential costs, including unintended consequences, of critical audit matter requirements appears in Section VI. It should be noted that because EGCs tend to be smaller than the broader population of operating companies, the costs of compliance could affect EGCs disproportionately.

At this time, no determination has been made about the applicability of the reproposed standard and amendments to the audits of EGCs; such a determination would be made at adoption, based on the provisions of the final auditing standard and related amendments. If all or part of the standard and amendments were not to apply to the audits of EGCs, this determination would not preclude auditors of EGCs from applying such provisions voluntarily.

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[225] *See* SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, (Apr. 23, 2006), at 73.

*Questions*:

41. Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?

42. If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?

43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?

## IX. <u>Considerations Related to Effective Date</u>

The 2013 proposal sought comment on whether any special consideration should be given to a delayed compliance date for the proposed standard, such as for the audits of smaller companies. Some commenters stated that the Board should consider delaying effectiveness for audits of smaller companies, including smaller reporting companies and nonaccelerated filers.

The Board continues to seek comment on the effective date related to the reproposed standard and amendments. The Board's final decision on the effective date would take into account the nature and extent of comments received on the reproposal and the timing of Board adoption of any final standard and amendments, subject to approval by the SEC.

*Question*:

44. If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies? Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?

## X. Opportunity for Public Comment

The Board is seeking comment on all aspects of the reproposed standard and amendments as well as on the specific questions included in this reproposal. Among other things, the Board is seeking comment on economic considerations relating to the reproposed standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters, regarding the reproposed standard and amendments. Commenters providing cost estimates are requested to provide the basis for their estimates.

Studies, memoranda, or other substantive items may be added by the Board or staff to Docket 034 during this rulemaking. A notification of the inclusion in the comment file of any such materials will be made available on the Board's website. To ensure direct electronic receipt of such notifications via email, subscribe to PCAOB updates at http://pcaobus.org/About/Pages/PCAOBUpdates.aspx.

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, NW, Washington, DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket No. 034 on the subject or reference line and should be received by the Board by August 15, 2016.

The Board will consider all comments received. After the close of the comment period, the Board will determine whether to adopt final rules, with or without changes from the reproposal. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of Sarbanes-Oxley, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under Sarbanes-Oxley.

* * *

On the 11th day of May, in the year 2016, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

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## APPENDIX 1

[Paragraph .10 and paragraphs .20 through .76 of AS 3101 (currently AU sec. 508),[1] *Reports on Audited Financial Statements*, are proposed to be redesignated as AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances.* AS 3101 is proposed to be retitled and the remaining paragraphs are amended as follows:]

## Proposed AS 3101*, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

## *Introduction*

.01 The auditor's report contains either an expression of opinion on the financial statements,[2] taken as a whole,[3] or an assertion that an opinion cannot be expressed. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report").[4]

.02 The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and

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[1] Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final standard.

[2] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. *See* SEC Rule 1-01(b) of Regulation S-X, 17 CFR 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; *see*, *e.g.*, AS 2110 (currently Auditing Standard No. 12), *Identifying and Assessing Risks of Material Misstatement*.

[3] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[4] Paragraphs .85-.98 and Appendix C, *Special Reporting Situations*, of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[5] in conformity with the applicable financial reporting framework.[6]

.03 When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements and state the reasons for the departure from the unqualified opinion. AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* (currently AU sec. 508, *Reports on Audited Financial Statements*), describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

## *Objectives*

.04 The objectives of the auditor when the auditor concludes that an unqualified opinion is appropriate are to:

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters,**[7] relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

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[5] AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"* (currently AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*), describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

[6] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

[7] This term is defined in Appendix A, *Definitions*, and is set in **boldface type** the first time it appears.

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### *The Auditor's Unqualified Report*

.05 The auditor's unqualified report includes:[8]

a. The basic elements,[9] as described in paragraphs .06-.10;

b. Communication regarding critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs .11-.17, unless such requirements do not apply;

Note: Communication of critical audit matters is not required for audits of (1) brokers[10] and dealers[11] reporting under Exchange Act Rule 17a-5; (2) investment companies registered under the Investment Company Act of 1940 ("Investment Company Act");[12] other than companies that have elected to be regulated as business development companies;[13] and (3) employee stock purchase, savings, and similar plans.[14]

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs .18-.19; and

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8 Appendix B provides an illustrative auditor's unqualified report.

9 Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. *See*, *e.g.,* Sections 30(g) and 32(a)(4) of the Investment Company Act; Rule 2-02 of Regulation S-X, 17 CFR 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR 240.17a-5. Auditor's reports on financial statements filed with the SEC are subject to all such applicable requirements.

10 *See* PCAOB Rule 1001(b)(iii).

11 *See* PCAOB Rule 1001(d)(iii).

12 *See* Section 8 of the Investment Company Act.

13 *See* Section 54 of the Investment Company Act.

14 *See* Exchange Act Rule 15d-21, 17 CFR 240.15d-21.

d. Information about certain audit participants, if the auditor decides to provide this information in the auditor's report, as described in paragraph .20.

## Basic Elements

*Title*

.06 The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

.07 The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Financial Statements*

.08 The first section of the auditor's report must include the section title "Opinion on the Financial Statements" and the following elements:

a. The name of the company whose financial statements were audited;

b. A statement identifying each financial statement and any related schedule(s) that has been audited;[15]

c. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

d. A statement indicating that the financial statements, including the related notes and any related schedule(s), identified and

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[15] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. *See*, *e.g.,* Rules 5-04, 6-10, 6A-05, and 7-05 of Regulation S-X, 17 CFR 210.5-04, 210.6-10, 210.6A-05, 210.7-05. *See generally*, Rule 12-01 of Regulation S-X, 17 CFR 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

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collectively referred to in the report as the financial statements, were audited; and

e. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.[16] The opinion should also include an identification of the applicable financial reporting framework.

*Basis for Opinion*

.09 The second section of the auditor's report must include the section title "Basis for Opinion" and the following elements:

a. A statement that the financial statements are the responsibility of the company's management;

b. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

c. A statement that the audit was conducted in accordance with the standards of the PCAOB;

d. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

e. A statement that an audit includes:

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

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[16] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and financial statements being audited.

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(2) Examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

(4) Evaluating the overall presentation of the financial statements;

f. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion; and

g. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

*Signature, Tenure, Location, and Date*

.10 The auditor's report must include the following elements:

a. The signature of the auditor's firm;[17]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;[18]

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership

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[17] *See* Rule 2-02(a) of Regulation S-X, 17 CFR 210.2-02(a).

[18] For an investment company that is part of a group of investment companies, the statement contains the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act.

structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[19] and

d. The date of the auditor's report.[20]

## Critical Audit Matters

*Determination of Critical Audit Matters*

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

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[19] *See* Regulation S-X Rule 2-02(a).

[20] *See* AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report*.

c. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

d. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

e. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

*Communication of Critical Audit Matters*

.13 The auditor must communicate in the auditor's report critical audit matters[21] relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2)

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[21] Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical audit matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections.

issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

.14 For each critical audit matter communicated in the auditor's report the auditor must:

a. Identify the critical audit matter;

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

c. Describe how the critical audit matter was addressed in the audit; and

d. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

*Language Preceding Critical Audit Matters in the Auditor's Report*

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

Critical Audit Matters

Critical audit matters are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*

.17 The auditor must document the basis for the auditor's determination whether each matter that both:

a. Was communicated or required to be communicated to the audit committee; and

b. Relates to accounts or disclosures that are material to the financial statements

involved especially challenging, subjective, or complex auditor judgment.[22]

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[22] Consistent with the requirements of AS 1215, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determinations made to comply with the provisions of this standard.

## Explanatory Language Added to the Auditor's Report

.18 Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report. These circumstances include when:

a. There is substantial doubt about the company's ability to continue as a going concern;[23]

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[24]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[25]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[26]

e. A material misstatement in previously issued financial statements has been corrected;[27]

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[23] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (currently AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*).

[24] *See* paragraphs .06-.09 of AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors).*

[25] *See* paragraphs .08 and .12-.15 of AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements,* (as proposed to be amended).

[26] *See* AS 2820.06.

[27] *See* AS 2820.09 and .16-.17 (as proposed to be amended).

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f. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[28]

g. Management is required to report on the company's internal controls over financial reporting but such report is not required to be audited,[29] and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of the company's internal control over financial reporting;[30]

h. Certain circumstances relating to reports on comparative financial statements exist;[31]

i. Selected quarterly financial data required by Item 302(a) of Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[32]

j. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether

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[28] *See* AS 2201.88. AS 2201 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, AS 2201 notes that the auditor should consider those circumstances as well.

[29] *See* Item 308 of Regulation S-K.

[30] *See* AS 3105.59-.60 (as proposed to be amended).

[31] *See* AS 3105.52-.53 and .56-.58.

[32] *See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*).

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the supplementary information conforms to the requirements of the applicable financial reporting framework;[33]

k. There has been a change in an investee year end that has a material effect on the company's financial statements; and[34]

l. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements.[35]

## Emphasis of a Matter

.19 The auditor may emphasize a matter regarding the financial statements in the auditor's report ("emphasis paragraph").[36] The following are examples of matters, among others, that might be emphasized in the auditor's report:[37]

a. Significant transactions, including significant transactions with related parties;

b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;

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[33] *See* paragraphs .03 and .08 of AS 2705 (currently AU sec. 558), *Required Supplementary Information*.

[34] *See* paragraph .32 of AS 2503 (currently AU sec. 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35] *See* paragraph .04 of AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements*.

[36] Emphasis paragraphs are never required and are not a substitute for required critical audit matters described in paragraphs .11-.17.

[37] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" in the opinion paragraph when an emphasis paragraph is included in the auditor's report.

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

e. That the entity is a component of a larger business enterprise.

If the auditor adds an emphasis paragraph in the auditor's report, the auditor should use an appropriate section title.

## Information about Certain Audit Participants

.20 The auditor may include in the auditor's report information regarding the engagement partner and/or other accounting firms participating in the audit that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*.[38] If the auditor decides to provide information about the engagement partner, other accounting firms participating in the audit, or both, the auditor must disclose the following:

a. *Engagement partner*—the engagement partner's full name as required on Form AP; or

b. *Other accounting firms participating in the audit*:

   i. A statement that the auditor is responsible for the audits or audit procedures performed by the other public accounting firms and has supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards;

   ii. *Other accounting firms individually contributing 5% or more of total audit hours*—for each firm, (1) the firm's legal name, (2) the city and state (or, if outside the United States, city and country) of headquarters' office, and (3) percentage of

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[38] If the auditor decides to include information regarding certain audit participants in the auditor's report, the auditor should use an appropriate section title.

total audit hours as a single number or within an appropriate range, as is required to be reported on Form AP; and

iii. *Other accounting firms individually contributing less than 5% of total audit hours*—(1) the number of other accounting firms individually representing less than 5% of total audit hours and (2) the aggregate percentage of total audit hours of such firms as a single number or within an appropriate range, as is required to be reported on Form AP.

## *APPENDIX A – Definition*

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matter – Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

> Note: Required audit committee communications are set forth in PCAOB standards, including AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees*, and Appendix B of that standard which refers to other PCAOB standards.

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## *APPENDIX B – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters*

**[Changes from the current illustrative report are underlined]**

### Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company *as of* [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[*Include critical audit matters*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

# APPENDIX 2

## *Amendments to Other PCAOB Standards Related to the Proposed Standard*

In connection with the proposed standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "reproposed standard"), the Board is proposing amendments to several of its other auditing standards as set out below.[1] Language that would be deleted by the proposed amendments is struck through. Language that would be added is underlined. Language proposed to be moved without being modified, such as changes to the illustrative auditor's report to conform to the required order in the proposed standard, is double underlined.

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[1] Some of these auditing standards, such as AS 3105, may need further updating, which the Board may consider under separate standard-setting projects. If, prior to the conclusion of this rulemaking, the Board has adopted amendments related to other standard-setting projects that affect the amendments reproposed in this release, the Board may make conforming changes to the reproposed standard and amendments. The reproposed amendments would amend specific auditing standards to reflect changes to the auditor's unqualified report.

## I. Proposed Amendments to AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

~~**AS 3101: Reports on Audited Financial Statements**~~ **AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances (currently AU sec. 508, Reports on Audited Financial Statements)*[2]**

## Introduction

~~.01 This section applies to auditors' reports issued in connection with audits[1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs .85-.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201, for direction on reporting on internal control over financial reporting. In addition, *see* AS 2201.86-.88, which includes an illustrative combined audit report.~~

~~[1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with the standards of the PCAOB in effect at the time the audit is performed. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~.02 This section does not apply to unaudited financial statements as described in AS 3320, *Association with Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in AS 3305, *Special Reports*.~~

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[2] Parenthetical citations to current auditing standards of the PCAOB are provided for reference purposes and would not appear in the final amendments.

~~.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with the standards of the PCAOB and on the findings. This section is concerned primarily with the relationship of the requirements in paragraph .04 to the language of the auditor's report.~~

~~.04 The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~.05 The objective of the requirements in paragraph .04 is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in paragraph .04 to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the requirements in paragraph .04 as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

## ~~The Auditor's Standard Report~~

~~.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with the standards of the PCAOB.~~

~~.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope~~

~~paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

~~*a.* A title that includes the word *independent*[3]~~

~~[3] This section does not require a title for an auditor's report if the auditor is not independent. *See* AS 3320 for guidance on reporting when the auditor is not independent.~~

~~*b.* A statement that the financial statements identified in the report were audited~~

~~*c.* A statement that the financial statements are the responsibility of the Company's management[4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~[4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~*d.* A statement that the audit was conducted in accordance with the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States))~~

~~*e.* A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~*f.* A statement that an audit includes~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~
~~(2) Assessing the accounting principles used and significant estimates made by management~~
~~(3) Evaluating the overall financial statement presentation[5]~~

~~[5] Paragraphs .03 and .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* discuss the auditor's evaluation of the overall presentation of the financial statements.~~

~~*g.* A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h.* An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles)~~

~~*i.* The manual or printed signature of the auditor's firm~~

~~*j.* The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[6A]~~

~~[6A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

~~*k.* The date[7] of the audit report~~

~~[7] For guidance on dating the auditor's report, *see* AS 3110, *Dating of the Independent Auditor's Report*.~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as~~

~~evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~The form of the auditor's standard report on comparative financial statements~~[8] ~~is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~[8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."~~

~~*l.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

> ~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

.01~~0~~ The auditor's report contains either an expression of opinion on the financial statements, taken as a whole,[1] or an assertion that an opinion cannot be expressed. This standard ~~section~~ ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[2] and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented~~; this section describes what is meant by the various audit opinions~~:

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~

- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .02 -.39.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .40 -.43.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. *See* paragraphs .44 - .47.

~~These opinions are discussed in greater detail throughout the remainder of this section.~~ This standard also discusses other reporting circumstances, such as reports on comparative financial statements.

[1] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[2] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). Paragraphs .85–.98 of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and

Appendix C, *Special Reporting Situations*, of AS 2201 address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting. *See also* AS 2201.86–.88, which includes an illustrative combined audit report.

## ~~Explanatory Language Added to the Auditor's Standard Report~~

~~.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory[9] paragraph (or other explanatory language) to the standard report.[10] These circumstances include:~~

~~[9] Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.~~

~~[10] *See* footnote 3.~~

- ~~*a.* The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~
- ~~*b.* There is substantial doubt about the entity's ability to continue as a going concern.[11]~~

~~[11] AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions.~~

- ~~*c.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~
- ~~*d.* A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~
- ~~*e.* Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~
- ~~*f.* Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (*See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)~~

~~*g.* Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (*See* paragraph .02 of AS 2705, *Required Supplementary Information*.)~~

~~*h.* Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (*See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19).~~

**~~Opinion Based in Part on Report of Another Auditor~~**

~~.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (*See* AS 1205, *Part of the Audit Performed by Other Independent Auditors*.)~~

~~.13 An example of a report indicating a division of responsibility follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those~~

> ~~statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~
>
> ~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~
>
> ~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[.14-.15] [Paragraphs deleted.]~~

**~~Lack of Consistency~~**

~~.16 The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

- ~~*a.* A change in accounting principle.~~
- ~~*b.* An adjustment to correct a misstatement in previously issued financial statements.~~

**~~Change in Accounting Principle~~**

~~.17A As discussed in AS 2820, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are~~

~~adequate, and (4) the company has justified that the alternative accounting principle is preferable.[12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~[12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. *See* FASB Statement 154, paragraph 14.~~

~~.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a~~

~~departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

**~~Correction of a Material Misstatement in Previously Issued Financial Statements~~**

~~.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

> ~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

~~.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

**~~Emphasis of a Matter~~**

~~.19 In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are~~

- ~~That the entity is a component of a larger business enterprise.~~

- ~~That the entity has had significant transactions with related parties.~~

- ~~Unusually important subsequent events.~~

- ~~Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

## ~~Departures From Unqualified Opinions~~

### Qualified Opinions

.02~~0~~ Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

*a.* There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion (paragraphs .05~~22~~–.17~~34~~).

*b.* The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion (paragraphs .18~~35~~–.39~~57~~).

.03 When the auditor expresses a qualified opinion, the auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101.

.04~~21~~ When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the auditor's report. The auditor should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph that discloses all of the substantive reasons for the qualified opinion. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

Note: The auditor should refer to AS 3101 to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.

**Scope Limitations**

.05~~22~~ The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with the standards of the PCAOB and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

.06~~23~~ The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.07~~24~~ Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.[3~~14~~] Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient appropriate evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

[3~~14~~] Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that AS 2510, *Auditing Inventories*, states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.08~~25~~ When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the ~~situation~~ auditor's report should ~~be~~ describe~~d~~ the basis for departure from an unqualified opinion in a~~n~~ ~~explanatory~~ separate paragraph ~~preceding~~ immediately following the opinion paragraph and refer~~red~~ to that description in both the ~~scope~~ Basis for Opinion section and opinion paragraph~~s~~ of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client.

.09~~26~~ When an auditor qualifies his or her opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

~~[*Same first paragraph as the standard report*]~~

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of ~~such~~ the adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, as described below, the financial statements ~~referred to in the first~~

~~paragraph above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as discussed ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures include~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also include~~s~~d ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.10~~27~~ ***Other scope limitations.*** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he or she deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he or she considers necessary, the auditor should qualify his or her opinion or disclaim an opinion because of a limitation on the scope of the audit.

.11~~28~~ If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report,* states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, the auditor's only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

.12~~29~~ ***Uncertainties and scope limitations.*** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and matters related to estimates covered by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.13~~30~~ Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.14~~31~~ If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.15~~32~~ Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. Paragraphs .28~~45~~ to .32~~49~~ provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties.

.16~~33~~ ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

.17~~34~~ An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statement

We have audited the accompanying balance sheet of X Company (the "Company") as of December 31, 20XX, and the related notes [*and schedules*] (collectively referred to as the "financial statement"). In our opinion, ~~the balance sheet referred to above~~ the financial statement presents fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatements of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures include~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement.

~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Departure From a Generally Accepted Accounting Principle**

.18~~35~~ When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with the standards of the PCAOB, he or she should express a qualified (paragraphs .19~~36~~ through .39~~57~~) or an adverse (paragraphs .40~~58~~ through .43~~60~~) opinion. The basis for such opinion should be stated in the report.

.19~~36~~ In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magnitude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.20~~37~~ When the auditor expresses a qualified opinion, he or she should disclose, in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph ~~of the report~~ should include the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion.

.21~~38~~ The ~~explanatory~~ paragraph(s) immediately following the opinion paragraph that describe the substantive reasons that led the auditor to conclude that there has been a departure from generally accepted accounting principles should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.[4~~15~~] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion may be shortened by referring to it.

[4~~15~~] In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information. For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the report.

.22~~39~~ An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the ~~preceding~~ following paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.23~~40~~ If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (~~preceding~~ immediately following the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .22~~39~~ might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

.24~~41~~ ***Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable,[5~~16~~] unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard.

[5~~16~~] *See* footnote 4~~15~~.

.25~~42~~ Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the omission of the information discussed in the ~~preceding~~ following paragraph, . . .

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.26~~43~~ If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

.27~~44~~ ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of operations, and stockholders' equity for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").~~income and retained earnings for the years then ended.~~ In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.28~~45~~ ***Departures from generally accepted accounting principles involving risks or uncertainties, and materiality considerations.*** Departures from generally accepted accounting principles involving risks or uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraphs .29~~46~~ and .30~~47~~)
- Inappropriate accounting principles (paragraph .31~~48~~)
- Unreasonable accounting estimates (paragraph .32~~49~~)

.29~~46~~ If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, the auditor should express a qualified or an adverse opinion.

.30~~47~~ The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements.

.31~~48~~ In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates ordinarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 23 and 25, describes situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

.32~~49~~ Usually, the auditor is able to satisfy himself or herself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (*see* paragraph .13 of AS 2810, *Evaluating Audit Results*) and that its effect is to cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

~~[.50]~~

.33~~51~~ ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph .07 ~~.17A~~ of AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*, ~~states~~ includes the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

.34~~52~~ The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the change in accounting principle discussed in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[6] ~~[17]~~

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[6~~17~~] Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ separate paragraph on consistency, an ~~separate~~ explanatory paragraph (immediately following the opinion paragraph) as required by ~~paragraphs .17A thorough .17E of this section~~ AS 2820.08 and .12-.15 (currently Auditing Standard No. 6) is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.35~~53~~ Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, the auditor should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .36~~54~~ through .39~~57~~.

.36~~54~~ If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his or her reservations with respect to the statements for the year of change.

.37~~55~~ If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.38~~56~~ If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.39~~57~~ If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .34~~52~~, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

**Adverse Opinions**

.40 When the auditor expresses an adverse opinion, the auditor's report must include the opinion as described in paragraph .41 and the same other basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

> Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor expresses an adverse opinion.

.41~~58~~ An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42~~59~~ When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[7]~~[18]~~ If the effects are not reasonably determinable, the report should so state.[8]~~[19]~~

[7]~~[18]~~ *See* footnote 4~~15~~.

[8]~~[19]~~ When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in ~~paragraph 11, subsection (*b*), (*c*), (*d*), and (*e*) of~~ AS 3101.18 ~~this section~~.

.43~~60~~ When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.~~,~~ An example of this is ~~as~~ shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, because of the effects of the matters discussed in the ~~preceding~~ following paragraphs, the financial statements ~~referred to above~~ do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *This section includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Disclaimer of Opinion**

.44~~61~~ A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

.45~~62~~ A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.[~~20~~9] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (*see* paragraphs .18~~35~~ through .39~~57~~). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles.

.46 When the auditor disclaims an opinion, the auditor's report must include the same basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor disclaims an opinion.

.47~~63~~ An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Disclaimer of Opinion on the Financial Statements

We were engaged to audit the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").[10]~~[21]~~ ~~Since~~ As described in the following paragraph, because the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Basis for Opinion

These financial statements are the responsibility of the Company's management. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

[~~*Second paragraph of standard report should be omitted*~~ *The remaining basic elements in the Basis for Opinion section of the auditor's unqualified report*]

[*Signature*]

We have served as the Company's auditor since [ *year* ].

[*City and State or Country*]

[*Date*]

[10~~21~~] The wording in the ~~first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The~~ first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with the standards of the PCAOB. In addition, the ~~last~~ sentence ~~of the first paragraph is also deleted, because of the scope limitation, to eliminate the~~ that references ~~to~~ the auditor's responsibility to express an opinion is deleted.

**Piecemeal Opinions**

.48~~64~~ Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

**Reports on Comparative Financial Statements**

.49~~65~~ The report shall ~~Paragraph .04 requires that an auditor's report contain~~ either contain an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference ~~in paragraph .04~~ to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor[11~~22~~] should update[12~~23~~] the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.[13~~24~~] Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (*See* AS 3110.01. (currently AU sec. 530))

[11~~22~~] A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period. If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .49~~65~~ through .53~~69~~ and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .54~~70~~ through .58~~74~~ should be followed.

12~~23~~ An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (*see* AS 3110.06 through .08), since in issuing an updated report the continuing auditor considers information that he or she has become aware of during his or her audit of the current-period financial statements (*see* paragraph .52~~68~~) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

13~~24~~ A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

.50~~66~~ During the audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (*see* paragraph .52~~68~~) or the adequacy of informative disclosures concerning those statements. (*See* AS 2810.31.) In updating his or her report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his or her attention.

**Different Reports on Comparative Financial Statements Presented**

.51~~67~~ Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the balance sheets of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America. Because of the matter discussed in the ~~preceding~~ following paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[14]~~[25]~~

Basis for Opinion [~~Same first paragraph as the standard report~~]

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as explained ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [ *year* ].

[*City and State or Country*]

[*Date*]

[14]~~25~~ It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. *See* AS 2820 for a discussion of consistency.

**Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed**

.52~~68~~ If, during the current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he or she should consider such matters when updating his or her report on the financial statements of the prior period. For example, if an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.53~~69~~ If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of ~~an explanatory~~ a paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements ~~referred to above~~

present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report.[15][26]

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[15][26] *See* footnote 6~~17~~.

## Report of Predecessor Auditor

.54~~70~~ A predecessor auditor ordinarily would be in a position to reissue his or her report on the financial statements of a prior period at the request of a former client if he or she is able to make satisfactory arrangements with the former client to perform this service and if he or she performs the procedures described in paragraph .55~~71~~.[16~~27~~]

[16~~27~~] It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

### Predecessor Auditor's Report Reissued

.55~~71~~ Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (*a*) read the financial statements of the current period, (*b*) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (*c*) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[17~~28~~] The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in paragraphs ~~AS 1205~~.10 through .12 of AS 1205 (currently AU sec. 543), *Part of the Audit Performed by Other Independent Auditors*. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

[17~~28~~] *See* AS 2805, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

.56~~72~~ A predecessor auditor who has agreed to reissue his or her report may become aware of events or transactions occurring subsequent to the date of his or her previous report on the financial statements of a prior period that may affect his or her previous report (for example, the successor auditor might indicate in the response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he or she considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). The auditor should then decide, on the basis of the evidential matter obtained, whether to revise the report. If a predecessor auditor concludes that the report should be revised, he or she should follow the guidance in paragraphs .52~~68~~, .53~~69~~, and .57~~73~~ of this section.

.57~~73~~ A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report. (*See* AS 3110.05.)

**Predecessor Auditor's Report Not Presented**

.58~~74~~ If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory~~ paragraph immediately following the opinion paragraph of his or her report (a) that the financial statements of the prior period were audited by another auditor,[18]~~[29]~~ (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than an ~~standard~~ unqualified report, the substantive reasons therefor.[19]~~[30]~~ An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheet of ABC Company (the "Company") as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~ In our opinion, the 20X2 financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The financial statements of ~~ABC~~ the Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

If the predecessor auditor's report was other than an ~~standard~~ unqualified report, the successor auditor should describe the nature of and reasons for the ~~explanatory~~ paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

. . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Opinion on the Financial Statements section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[18] ~~[29]~~ The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

[19] ~~[30]~~ If the predecessor's report was issued before the effective date of this section and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date hereof should not make reference to the predecessor's previously required explanatory paragraph.

## Management Reports on Internal Controls Over Financial Reporting

.59 In situations in which management is required to report on the company's internal control over financial reporting but such report is not required to be audited, and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in documents containing audited financial statements and the independent auditor's report under AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements.*

.60 In situations described in paragraph .59, the auditor must include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;
- As part of the audit, the auditor is required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis for Opinion section in the auditor's report that contains such statements:

> [Basis for Opinion]
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.
>
> Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

## Effective Date and Transition

.61~~75~~ This section is effective for reports issued or reissued on or after February 29, 1996. Earlier application of the provisions of this section is permissible.

.62~~76~~ An auditor who previously included an uncertainties explanatory paragraph in a report should not repeat that paragraph and is not required to include an emphasis paragraph related to the uncertainty in a reissuance of that report or in a report on subsequent periods' financial statements, even if the uncertainty has not been resolved. If the auditor decides to include an emphasis paragraph related to the uncertainty, the paragraph may include an explanation of the change in reporting standards.

## II. Proposed Amendments to Auditing Standards

### AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors*)

* * *

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Opinion on the Financial Statements and Basis for Opinion sections, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.[3]

* * *

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of X Company (the "Company") and subsidiaries as of December 31, 20...., and the related consolidated statements of income and retained earnings and cash flows for the year then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

*Basis for Opinion*

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit~~s~~. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate.

* * *

**Other Auditor's Report Departs From ~~Standard~~ the Auditor's Unqualified Report**

.15 If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

**Restated Financial Statements of Prior Years Following a Pooling of Interests**

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (*see* paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the opinion paragraph ~~standard introductory, scope and opinion paragraphs~~ covering the consolidated financial statements for the current year:[*]

* * *

**AS 1210 (currently AU sec. 336), *Using the Work of a Specialist***

* * *

**Effect of the Specialist's Work on the Auditor's Report**

.13 If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (*See* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

.14 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (*See* AS 3105~~1~~.18~~35~~, .19~~36~~, and .24~~41~~.)

**Reference to the Specialist in the Auditor's Report**

.15 ~~Except as discussed in paragraph .16 the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.~~ Reference to the use of a specialist may be made in the auditor's report in the following situations:

a. *Critical Audit Matters*—If such a reference will facilitate an understanding of the matter, the principal considerations that led the auditor to determine that the matter was a critical audit matter, or how the critical audit matter was addressed in the audit;[7] or

b. *Explanatory language or departure from an unqualified opinion*—If such a reference will facilitate an understanding of the reason for the explanatory paragraph or departure from an unqualified opinion.

Otherwise the auditor should not refer to the work or findings of the specialist in the auditor's report.

[7] Critical audit matters are described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~.16 The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.~~

* * *

**AS 1220 (currently Auditing Standard No. 7), *Engagement Quality Review***

* * *

.10 In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate the engagement team's determination, communication, and documentation of critical audit matters in accordance with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

**AS 1301 (currently Auditing Standard No. 16), *Communications with Audit Committees***

* * *

**~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

.21 The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

[39] *See* paragraphs .05~~22~~-.15~~32~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances,* for a discussion of scope limitations.

* * *

**AS 2201 (currently Auditing Standard No. 5),** ***An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

* * *

## Reporting on Internal Control

.85 The auditor's report on the audit of internal control over financial reporting ~~must~~ includes the following elements[18] -

*Title*

.85A The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

.85B The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Internal Control over Financial Reporting*

.85C The first section of the auditor's report on the audit of internal control over financial reporting must include the section title "Opinion on Internal Control over Financial Reporting" and the following elements-

~~a. A title that includes the word *independent*;~~

a. The name of the company whose internal control over financial reporting was audited; and

b. ~~k.~~ The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria.

*Basis for Opinion*

.85D The second section of the auditor's report on the audit of internal control over financial reporting must include the section title "Basis for Opinion" and the following elements:

a~~b~~. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

b~~c~~. An identification of management's report on internal control;

c~~d~~. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

d~~e~~. A definition of internal control over financial reporting as stated in paragraph .A5;

e. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

f. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

g. A statement that the standards of the PCAOB ~~Public Company Accounting Oversight Board~~ require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

h. A statement that an audit includes obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;

i. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion; and

j. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

*Signature, Tenure, Location, and Date*

.85E The auditor's report must include the following elements:

a~~l~~. The ~~manual or printed~~ signature of the auditor's firm;[18A]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;

> Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c~~m~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

d~~n~~. The date of the audit report.

[18A] *See* Regulation S-X Rule 2-02(a).

* * *

.87 The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of W Company

[~~*Introductory paragraph*~~] *Opinions on the Financial Statements and Internal Control over Financial Reporting*

We have audited the accompanying balance sheets of W Company (the "Company") as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). We also have audited ~~W~~ the Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ~~W~~ the Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, ~~W~~ the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by ~~the Committee of Sponsoring Organizations of the Treadway Commission (COSO)~~."*].

Basis for Opinion

~~[*Scope paragraph*]~~

~~W~~ The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the ~~c~~Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements.~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[*Definition paragraph*]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[*Inherent limitations paragraph*]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.88 If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (immediately following the opinion paragraph) to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (immediately following the opinion paragraph) to the report on internal control over financial reporting –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the [ *identify financial statements* ] of the Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

* * *

.B16 In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis for Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*). If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

* * *

.C4 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph .85D g, h, and i); to do so might overshadow the disclaimer.

* * *

**AS 2405 (currently AU sec. 317), *Illegal Acts by Clients***

* * *

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.[2]

[2] *See* AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2410 (currently Auditing Standard No. 18), *Related Parties***

* * *

***Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions***

.18 If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[20]

[20] *See* AS 2805.06l, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. *See also* paragraphs .18~~35~~–.19~~36~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern* (currently AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*)**

* * *

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

*c.* After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to reflect that conclusion.[4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13.

[4] The inclusion of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (*see* paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (*see* paragraphs .44-.47 of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

.13 An example follows of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.[5]

[*Appropriate Title*]

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AS 3105~~1, *Reports on Audited Financial Statements*~~.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in AS 3105~~1~~.

* * *

**AS 2503 (currently AU sec. 332), *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***

* * *

.32 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph, including an appropriate title, should be added to the auditor's report because of the change in reporting period.[15]

[15] ~~*See* paragraphs .16–.18 of AS 3101, *Reports on Audited Financial Statements*~~ AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements.*

* * *

**AS 2505 (currently AU sec. 337), *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments***

* * *

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (*see* paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (*see* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (*see* paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in AS 3105~~1~~.28~~45~~ through .32~~49~~ to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AS 2510, *Auditing Inventories* (currently AU sec. 331, *Inventories*)**

* * *

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see paragraphs .07~~24~~ and .51~~67~~ of AS

3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors,* (currently AU sec. 315, *Communications Between Predecessor and Successor Auditors*)**

* * *

[9] *See* paragraphs .54~~70~~ through .58~~74~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for reporting guidance.

* * *

**AS 2705 (currently AU sec. 558), *Required Supplementary Information***

* * *

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph, including an appropriate title, in his report on the audited financial statements a disclaimer on the information. The following is an example of a disclaimer an auditor might use in these circumstances:

> [*Appropriate Title*]
>
> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

* * *

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in any of the following circumstances:[7] (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs, including appropriate titles, an auditor might use in these circumstances.

* * *

**AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements***

* * *

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph, including an appropriate title, describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

* * *

**AS 2801 (currently AU sec. 560), *Subsequent Events***

* * *

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an ~~explanatory~~ emphasis paragraph directing the reader's attention to the event and its effects. (*See* paragraph .19 of AS 3101, ~~*Reports on Audited Financial Statements*,~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*)

* * *

**AS 2805 (currently AU sec. 333), *Management Representations***

* * *

[15] *See* paragraph .55~~71~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[18] *See* AS 3105~~1~~.05~~22~~–.17~~34~~.

* * *

**AS 2810 (currently Auditing Standard No. 14), *Evaluating Audit Results***

* * *

[7] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

.31

* * *

Note: According to AS 3105~~1~~, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18]

[18] AS 3105~~1~~.24~~41~~–.27~~44~~.

* * *

.35 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AS 3105~~1~~ indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21]

[21] AS 3105~~1~~.05~~22~~–.17~~34~~ contains requirements regarding audit scope limitations.

* * *

**Appendix B**

[1] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**Appendix C**

[2] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (*See* AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

* * *

**AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"* (currently AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*)**

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the applicable financial reporting framework ~~country of origin of those generally accepted accounting principles also~~ is required (*see* ~~paragraph .08*h* of AS 3101~~paragraph .08e of the AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

[1] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (*see* AS 2105 (currently Auditing Standard No. 11), *Consideration of Materiality in Planning and Performing an Audit*, and AS 3105~~1~~.19~~36~~).

* * *

**AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements***

* * *

.06 The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph, including an appropriate title, in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

* * *

.08 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph .07 have been met, the auditor should add an explanatory paragraph, including an appropriate title, to the auditor's report, as described in ~~AS 3101, *Reports on Audited Financial Statements*~~ paragraphs .12-.15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AS 3101~~.[8A]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to the auditor's report, as described in ~~AS 3101~~ paragraphs .12-.15.

[8A] AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.09 The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title, as described in ~~AS 3101~~ paragraphs .16 and.17 of this standard.

.10 The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph .31 of AS 2810, *Evaluating Audit Results,* and AS 3105~~1~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

**Change in Classification**

.11 Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs .07,~~ and~~ .08, and ~~AS 3101~~ .12-.15. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs .09,~~ and~~ .10, ~~and~~ ~~AS 3101~~ .16 and.17.

**Reporting on Consistency of Financial Statements**

**Change in Accounting Principle**

.12 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph). The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

.13 The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.14 The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

.15 The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.16 Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph).[10] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. The following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10] AS 3105.52-53 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.17 This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

*** * ***

**AS 3110 (currently AU sec. 530), *Dating of the Independent Auditor's Report***

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, *see* AS 4101 as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and *see* paragraphs .<u>54</u>~~70–~~.<u>57</u>~~73~~ of AS 310<u>5</u>~~1~~, ~~*Reports on Audited Financial Statements*~~ <u>*Departures from Unqualified Opinions and Other Reporting Circumstances*</u>, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period.

*** * ***

**AS 3305 (currently AU sec. 623), *Special Reports***

.01 This section applies to auditors' reports issued in connection with the following:

*** * ***

*e.* Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

<u>Note: In situations in which the auditor's reports described in this section are filed with the U.S. Securities and Exchange Commission, the auditor's report is required to include the basic elements and communication of critical audit matters, if applicable, as would be required in an unqualified auditor's reporting under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.</u>

* * *

[2] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (*see* paragraph .08 of AS 3101, Reports on Audited Financial Statements) modified as appropriate~~ because of the departures from generally accepted accounting principles (*see* AS 3105).

* * *

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. ~~With the exception of the requirement in AS 3101.08*h*, t~~The standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. ~~AS 3101.08*h*, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when~~ If the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles, the auditor's opinions, as described in AS 3101 and AS 3105, are applicable.

* * *

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (*see* AS 3105~~1~~.48~~64~~). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement**

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

* * *

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

.17 The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in AS 3101.18~~1~~, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

.21 When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ in the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

- *a.* *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,[35] the auditor should add an explanatory paragraph, including an appropriate title, to the report (immediately following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon [36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~AS 3101.16 through .18~~ AS 2820 (currently Auditing Standard No. 6), *Evaluating Consistency of Financial Statements*.

- *b.* *Going Concern* Uncertainties. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph, including an appropriate title, after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.[39]

- *c.* *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in ~~section AS 3101.12 and .13~~ AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec, 543, *Part of Audit Performed by Other Independent Auditors*).

*d. Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph

~~preceding~~ immediately following the opinion paragraph of the report. Guidance on reporting in this situation is contained in AS 3105~~1~~.52~~68~~ and .53~~69~~.

* * *

**AS 3310, *Special Reports on Regulated Companies* (currently AU sec. 544, *Lack of Conformity With Generally Accepted Accounting Principles*)**

* * *

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (For example, public utilities and insurance companies.) Accordingly, the requirement in paragraph .08e~~*h*~~ of AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.[1] Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

* * *

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (*see* AS 3101.08),~~ ~~modified~~ modify the auditor's report as appropriate (*see* paragraphs .18-.43 of AS 3105~~1.35–.60~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

* * *

**AS 3315 (currently AU sec. 552), *Reporting on Condensed Financial Statement and Selected Financial Data***

* * *

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in paragraphs .24~~41~~ through .27~~44~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, AS 3305, *Special Reports*, or other applicable PCAOB standards.[2]

* * *

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Report of Independent Registered Public Accounting Firm

> We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~[6]~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[7]

~~[6] If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (*See* AS 3101.41 through .44) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Report of Independent Registered Public Accounting Firm.~~

> ~~We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with~~

~~accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

.10 The following is an example of an additional paragraph included in the Opinion on the Financial Statements section of the auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

Opinion on the Financial Statements

*[Includes the same basic elements in the Opinion on the Financial Statements section as the auditor's unqualified report in AS 3101]*

In our opinion, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of the ~~ABC~~ the Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended

December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1, and the related notes [*and schedules*] (collectively referred to as the "financial statements") (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

* * *

**AS 3320 (currently AU sec. 504), *Association with Financial Statements***

* * *

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and AS 3105~~1~~,~~ *Reports on Audited Financial Statements* ~~*Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in AS 4105, *Reviews of Interim Financial Information*.

* * *

**AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes* (currently AU sec. 711, *Filings Under Federal Securities Statutes*)**

* * *

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

*a.* Read pertinent portions of the prospectus and of the registration statement.

*b.* Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (*see* AS 3105~~1~~, ~~Reports on Audited Financial Statements~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

**AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*)**

* * *

**Form of Accountant's Review Report**

* * *

.37 The accountant's review report accompanying interim financial information ~~should consist of~~ must include the title, "Report of Independent Registered Public Accounting Firm."

.37A The accountant's review report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The accountant's review report may include additional addressees.

.37B The first section of the accountant's review report must include the section title "Results of Review of [Financial Information or Statements]" and the following elements:

~~a. A title that includes the word independent.~~

a. The name of the company whose interim financial information was reviewed.

b. A statement that the interim financial information identified in the report was reviewed.

c~~g~~. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying interim financial information for it to conform with generally accepted accounting principles. The statement should include an identification of the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

.37C The second section of the accountant's review report must include the section title "Basis for Review Results" and the following elements:

a~~c~~. A statement that the interim financial information is the responsibility of the entity's management.

b~~d~~. A statement that the review of interim financial information was conducted in accordance with the standards of the PCAOB.

c~~e~~. A description of the procedures for a review of interim financial information.

d~~f~~. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

.37D The accountant's review report must include the following elements:

a~~h~~. The ~~manual or printed~~ signature of the accountant's firm.[24A]

b~~i~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.[24A~~B~~]

c~~j~~. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures.[25])

In addition, each page of the interim financial information should be clearly marked as unaudited.

[24A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

[24~~A~~B] *Id.*~~*See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

.38 The following is an example of a review report:[26]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [27]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of [*Financial Information or Statements*]

We have reviewed the condensed consolidated balance sheet of ABC Company (the "Company") and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of ~~ABC~~ the Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.[28]

Basis for Review Results

These financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

[28] If the auditor's report on the preceding year-end financial statements was other than unqualified, referred to other auditors, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the ~~last~~ <u>second</u> paragraph of the illustrative report in paragraph .39 should be appropriately modified.

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.[29] The following is an example of report including such a reference:

Report of Independent Registered Public Accounting Firm

<u>To the shareholders and the board of directors of ABC Company</u>

<u>Results of Review of [*Financial Information or Statements*]</u>

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company <u>(the "Company")</u> and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. <u>Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.</u>

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

<u>Basis for Review Results</u>

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.41 The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,~~[30]~~ which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. *See* paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~[30] If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in paragraph .15 of AS 3101, Reports on Audited Financial Statements.~~

.42 *Departure from generally accepted accounting principles.* If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. Following is an example of such a modification of the accountant's report.

> ~~[*Concluding paragraph*]~~
>
> Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.
>
> ~~[*Explanatory third paragraph*]~~
>
> Based on information furnished to us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that we believe should be capitalized to conform with accounting principles generally accepted in the United States of America. This information indicates that if these lease obligations were capitalized at September 30, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively, for the three-month and nine-month periods then ended.

* * *

.43 *Inadequate disclosure*. The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30, which is applicable to summarized financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.[31] If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles[32] is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information in the report. The following is an example of such a modification of the accountant's report:

~~[*Concluding paragraph*]~~

Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

~~[*Explanatory third paragraph*]~~

Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 20X1 through 20X3 in the aggregate amount of approximately $_____, and that the extent of the company's liability, if any, and the effect on the accompanying information (statements) is not determinable at this time. The information (statements) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with accounting principles generally accepted in the United States of America.

.44 *Going-concern paragraph was included in the prior year's audit report; conditions giving rise to the paragraph continue to exist.* If (*a*) the auditor's report for the prior year end contained an explanatory paragraph indicating the existence of substantial doubt about the entity's ability to continue as a going concern, (*b*) the conditions that raised such doubt continued to exist as of the interim reporting date covered by the review, and (*c*) there is adequate and appropriate disclosure about these conditions in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the concluding paragraph,~~ emphasizing the matter disclosed in the audited financial statements and the interim financial information. The following is an example of such a paragraph.

[Appropriate Title]

Note 4 of the Company's audited financial statements as of December 31, 20X1, and for the year then ended discloses that the Company was unable to renew its line of credit or obtain alternative financing at December 31, 20X1. Our auditor's report on those financial statements includes an explanatory paragraph referring to the matters in Note 4 of those financial statements and indicating that these matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 3 of the Company's unaudited interim financial statements as of March 31, 20X2, and for the three months then ended, the Company was still unable to renew its line of credit or obtain alternative financing as of March 31, 20X2. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

.45 *Going-concern paragraph was not included in the prior year's audit report; conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern.* If (*a*) conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern, and (*b*) there is adequate and appropriate disclosure about these conditions or events in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the concluding paragraph,~~ emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

[Appropriate Title]

As indicated in Note 3, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

* * *

.50 The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

c. The selected quarterly financial data required by item 302(a) of Regulation S-K is omitted. The auditor should add an explanatory paragraph, including an appropriate title, to the report, immediately following the opinion paragraph, ~~The following is an~~

~~example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) is omitted. <u>The following is an example of such a paragraph.</u>

> <u>[Appropriate Title]</u>
>
> The company has not presented the selected quarterly financial data specified in item 302(a) of Regulation S-K that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. <u>The auditor should add an explanatory paragraph, including an appropriate title, to the report immediately following the opinion paragraph,</u> ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) has not been reviewed. <u>The following is an example of such a paragraph.</u>

> <u>[Appropriate Title]</u>
>
> The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

**AS 6101 (currently AU sec. 634), *Letters for Underwriters and Certain Other Requesting Parties***

* * *

.27 When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ <u>includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements</u>, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report,~~ the accountants should refer[18] to that fact in the comfort letter and discuss the subject matter of the paragraph.[19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (*See also* paragraph .35*f*.)

* * *

.30 An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which AS 4105 pertains or (*b*) required supplementary information, to which AS 2705 pertains. AS 4105 and AS 2705 provide that the accountants should expand the ~~standard~~ <u>auditor's unqualified</u> report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ <u>auditor's unqualified</u> report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (*see also* paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by AS 4105 and AS 2705, the accountants may do so and report their findings.

* * *

.35

* * *

> *f.* When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ <u>unqualified</u> report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

* * *

## III. Proposed Amendments to Auditing Interpretations

**AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210* (currently AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336)***

* * *

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.[14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with paragraphs .18~~35~~ through .43~~60~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with AS 3105~~1~~.05~~22~~–.09~~26~~ and AS 3105~~1~~.44~~61~~–.47~~63~~.

* * *

**AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501* (currently AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*)**

* * *

.03 *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an emphasis-of-matter paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (*see* paragraph .19 of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

**AI 17, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505 (currently AU sec. 9337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of Section 337*)**

* * *

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in paragraphs .28~~45~~ through .32~~49~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AI 23, ~~Reports on Audited Financial Statements: Auditing Interpretations of AS 3101~~ Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 3105~~1~~ (currently AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*)**

* * *

.01 *Question*— Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

.36 ~~Examples of~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[1A] ~~with such an explanatory paragraph follow.~~

> ~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~
>
> Opinion on the Financial Statements
>
> ~~"~~We have audited the statement of net assets in liquidation of XYZ Company (the "Company") as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2~~.~~, ~~In addition, we have~~ and audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the net assets in liquidation of ~~XYZ~~ the Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below. ~~in the preceding paragraph."~~
>
> ~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.
>
> Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audit included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit provides a reasonable basis for our opinion.

[1A] The auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:[1B]

Opinion on the Financial Statements

~~"~~We have audited the balance sheet of XYZ Company (the "Company") as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and~~. In addition, we have~~ audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~XYZ~~ the Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below.~~ in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audits include~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also include~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[1B] *Id.*

* * *

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

.51 *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

**14. Reporting on Audits Conducted in Accordance with the Standards of the PCAOB and in Accordance with International Standards on Auditing**

* * *

.56 *Question*—AS 3101 requires ~~states that a basic element of the auditor's report is~~ a statement that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

.57 *Interpretation*—Yes. AS 3101 requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with the standards of the PCAOB ~~and an~~

~~identification of the United States of America as the country of origin of those standards~~; however, AS 3101 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.

* * *

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

> Basis for Opinion
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. ~~An~~ Our audit included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

* * *

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to AS 3105~~1~~.58~~74~~ the successor auditor should indicate in the ~~introductory paragraph~~ Opinion on the Financial Statements section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 18~~29~~ of AS 3105~~1~~ indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Opinion on the Financial Statements section of the successor auditor's report is presented as follows:

> The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

* * *

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

* * *

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

* * *

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to 3105~~1~~.58~~74~~?

.75 *Interpretation*—No. AS 3105~~1~~.58~~74~~ is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

* * *

**AI 20: *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710* (currently AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*)**

* * *

.08 *Interpretation*—If the auditor has been engaged to ~~examine and report on management's assertion, the guidance in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, should be followed~~ perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirement of AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.09 If the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ~~examine and~~

~~report on management's assertion~~, the auditor should follow the requirements in AS 3105.59-60. ~~guidance in AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact.[5]~~

~~[5] Unless information on internal control over financial reporting appears in the financial statements, which is not common, a management assertion on the effectiveness of internal control over financial reporting could not be inconsistent with information appearing in financial statements.~~

~~.10 Although not required, the auditor may consider adding the following paragraph to the standard auditor's report: "We were not engaged to examine management's assertion about the effectiveness of [*name of entity's*] internal control over financial reporting as of [*date*] included in the accompanying [*title of management's report*] and, accordingly, we do not express an opinion thereon."~~

~~.11 Because an auditor is required to consider internal control in an audit of the financial statements, he or she would often be familiar with matters covered in a management report on internal control over financial reporting. As a result, the auditor may become aware of information that causes him or her to believe that management's assertion on the effectiveness of internal control over financial reporting contains a material misstatement of fact as described in AS 2710.[6] If the auditor becomes aware of information in the report by management that conflicts with his or her knowledge or understanding of such matters, he or she should discuss the information with the client. If, after discussions with the client, the auditor concludes that a material misstatement of fact exists, the auditor should follow the guidance in AS 2710.06.~~

~~[6] For example, the auditor has communicated to management a material weakness in internal control over financial reporting and management states or implies there are no material weaknesses.~~

* * *

**AI 24, *Special Reports: Auditing Interpretations of AS 3305* (currently AU sec. 9623, *Special Reports: Auditing Interpretations of Section 623*)**

* * *

**10** Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in AS 3105~~1~~.18~~35~~–.27~~44~~ and .40~~58~~–.43~~60~~.

* * *

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105~~1~~.18~~35~~–.27~~44~~ and .40~~58~~–.43~~60~~.

* * *

***AI 25, Association with Financial Statements: Auditing Interpretations of AS 3320* (currently AU sec. 9504, *Association With Financial Statements: Auditing Interpretations of Section 504*)**

* * *

.15 *Question*—Paragraph .01~~.04~~ of ~~AS 3101, *Reports on Audited Financial Statements*,~~ AS 3320, *Association with Financial Statements*, states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." ~~Paragraph .03 of~~ AS 3320.03~~, Association with Financial Statements,~~ states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

* * *

**AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations* (currently AU sec. 9326, *Evidential Matter: Auditing Interpretations of Section 326*)**

* * *

.10 Auditing standards require the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph .35 of AS 2810, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, AS 2805, *Management Representations,* requires the auditor to obtain written representations from management. AS 2805.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

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## APPENDIX 3

### *Characteristics of Self-Identified EGCs*

The PCAOB has been monitoring implementation of the Jumpstart Our Business Startups Act ("JOBS Act") in order to understand the characteristics of EGCs[1] and inform the Board's consideration of whether it should request that the SEC apply the reproposed standards and related amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.[2]

As of November 15, 2015, based on the PCAOB's research, there were 2,229 companies that had filed audited financial statements and identified

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[1] Pursuant to the JOBS Act, an EGC is defined in Section 3(a)(80) of the Exchange Act. In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than $1 billion during its most recently completed fiscal year and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011. *See* JOBS Act Section 101(a), (b), and (d). An issuer retains its EGC status until the earliest of: (i) the first year after it has total annual gross revenue of $1 billion or more (as indexed for inflation every five years by the SEC); (ii) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (iii) the date on which the company issues more than $1 billion in non-convertible debt during the prior three year period; or (iv) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, an entity that has been public for at least one year and has an equity float of at least $700 million).

[2] The staff of the PCAOB's Office of Research and Analysis identified the population of EGCs using Audit Analytics data on companies that, as of the calculation date, self-identified as EGCs in SEC filings. The data excludes companies that, as of the calculation date, had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness and, in each case, did not subsequently file audited financial statements with the SEC. It also excludes companies that reported more than $1 billion in annual revenues or self-identified as a large accelerated filer. PCAOB staff has not otherwise attempted to validate these companies' self-identification as EGCs.

themselves as EGCs in at least one SEC filing. Among the 2,229 EGCs, there were 259 that did not file audited financial statements within the 18 months preceding November 15, 2015.[3] Because of lack of current data regarding these 259 companies, the information below focuses on the remaining 1,970 companies that filed audited financial statements with the SEC in the 18 months preceding November 15, 2015.

**General Characteristics**

These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are: (i) pharmaceutical preparations; (ii) blank check companies; (iii) real estate investment trusts; (iv) prepackaged software services; and (v) computer processing and data preparation.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are codes for: (i) real estate investment trusts; (ii) state commercial banks; (iii) crude petroleum or natural gas; (iv) national commercial banks; and (v) pharmaceutical preparations. Total assets of EGCs in these five SIC codes represent approximately 45 percent of the total assets of the population of EGCs. EGCs in two of these five SIC codes (state commercial banks and national commercial banks) represent financial institutions, and the total assets for these two SIC codes represent approximately 17 percent of the total assets of the population of EGCs.

[3] Approximately 24 percent of these 259 companies are blank check companies according to the Standard Industrial Classification (“SIC”) code. This is the most common SIC code among the 259 companies; the next most common SIC code (6 percent) is that for metal mining. The remaining SIC codes each represent less than 5 percent. Approximately 80 percent of these 259 companies had an explanatory paragraph included in the last auditor's report filed with the SEC stating that there is substantial doubt about the company's ability to continue as a going concern. Approximately 10 percent of these 259 companies were audited by firms that were annually inspected firms in 2015 and 90 percent of these 259 companies were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (85 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (3 percent), and other non-U.S. firms (2 percent).

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Approximately 14 percent of the EGCs had identified themselves in Securities Act registration statements and had not reported under the Exchange Act as of November 15, 2015. Approximately 74 percent of EGCs began reporting under the Exchange Act in 2012 or later. The remaining 12 percent of these companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 56 percent of EGCs that filed an Exchange Act filing indicated that they were smaller reporting companies.[4]

Approximately 41 percent (802) of the 1,970 EGCs have common equity securities listed on a U.S. national securities exchange ("publicly listed EGCs").[5] These EGCs represent approximately 16 percent of all publicly listed companies and approximately 1 percent of the total market capitalization of publicly listed companies.

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[4] The SEC adopted its current smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 33-8876 (December 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than $75 million in public equity float. Companies without a calculable public equity float will qualify if their annual revenues were less than $50 million during the most recently completed fiscal year for which audited financial statements are available. Scaled disclosure requirements generally reduce the compliance burden of smaller reporting companies compared to other issuers.

[5] To compare the publicly-listed EGC population with the broader public equity market, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with a benchmark derived from data from Standard & Poor's on companies that have at least one class of common equity securities (common-ordinaries, units with a common share component, and depository receipts) listed on a U.S. national securities exchange. The benchmark population is limited to companies that are not investment companies and that, according to Audit Analytics data, have filed audited financial statements with the SEC in the 18 months preceding the calculation date. From a total population of 5,119 such companies, the 802 publicly listed EGCs are excluded to avoid double counting. Using this methodology, PCAOB staff identified 4,317 companies in the benchmark population (referred to as "other publicly listed companies") as of November 15, 2015.

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**Financial Data**

The information in this section is derived from the most recent audited financial statements filed as of November 15, 2015 for the 1,970 EGCs. The descriptions in this section also include tabular information for all EGCs, EGCs that are not publicly listed ("non-listed EGCs"), and publicly listed EGCs. To enable comparison of publicly listed EGCs with the broader public equity market, the information also includes data about the other publicly listed companies.

***Assets***. The reported assets of all EGCs ranged from zero to approximately $12.9 billion. The average and median reported assets were approximately $223 million and $3.4 million, respectively. Publicly listed EGCs had significantly higher average and median assets (approximately $468 million and $141 million, respectively) as compared to non-listed EGCs (approximately $55 million and $100,000, respectively). Other publicly listed companies had even higher average and median assets (approximately $ 18.5 billion and $1.3 billion, respectively).

| **Reported Assets ($ millions)** | **All EGCs** | **Non-listed EGCs** | **Publicly Listed EGCs** | **Other Publicly Listed Companies** |
|---|---|---|---|---|
| Minimum | 0.0 | 0.0 | 0.0 | 0.0 |
| Maximum | 12,859.4 | 12,859.4 | 9,798.7 | 2,634,139.0 |
| Average | 223.0 | 54.6 | 468.3 | 18,486.8 |
| Median | 3.4 | 0.1 | 141.4 | 1,299.2 |

***Revenues***. The reported revenues ranged from zero to approximately $926 million. The average and median reported revenue were approximately $55 million and $81,000, respectively. Publicly listed EGCs had significantly higher average and median revenues (approximately $118 million and $33 million, respectively) as compared to non-listed EGCs (approximately $12 million and $0, respectively). Other publicly listed companies had even higher average and median revenues (approximately $5.1 billion and $580 million, respectively).

| **Reported Revenues ($ millions)** | **All EGCs** | **Non-listed EGCs** | **Publicly Listed EGCs** | **Other Publicly Listed Companies** |
|---|---|---|---|---|
| Minimum | 0.0 | 0.0 | 0.0 | 0.0 |
| Maximum | 926.4 | 910.2 | 926.4 | 485,651.0 |
| Average | 54.9 | 11.5 | 118.2 | 5,124.2 |
| Median | 0.081 | 0.0 | 33.2 | 579.6 |

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***Companies Reporting Zero Revenues***. The table below provides information about the percentage of all EGCs and the other categories of companies that reported zero revenues.

| | All EGCs | Non-listed EGCs | Publicly Listed EGCs | Other Publicly Listed Companies |
|---|---|---|---|---|
| Companies Reporting Zero Revenues | 42% | 56% | 21% | 2% |

***Companies Reporting Revenues Greater than Zero***. The table below provides information about the percentage of all EGCs and the other categories of companies that reported revenues greater than zero.

| | All EGCs | Non-listed EGCs | Publicly Listed EGCs | Other Publicly Listed Companies |
|---|---|---|---|---|
| Companies Reporting Revenues Greater than Zero | 58% | 44% | 79% | 98% |

The average reported assets and revenues of EGCs that reported revenues greater than zero were approximately $371 million and $94 million, respectively. Publicly listed EGCs had significantly higher average assets and revenues (approximately $573 million and $149 million, respectively) as compared to non-listed EGCs (approximately $121 million and $26 million, respectively). Other publicly listed companies had even higher average assets and revenues (approximately $18.9 billion and $5.2 billion, respectively).

| Reported Assets and Revenues ($ millions) | All EGCs | Non-listed EGCs | Publicly Listed EGCs | Other Publicly Listed Companies |
|---|---|---|---|---|
| **Assets** | | | | |
| Minimum | 0 | 0 | 0 | 0 |
| Maximum | 12,859.4 | 12,859.4 | 9,798.7 | 2,634,139.0 |
| Average | 370.8 | 121.4 | 573.3 | 18,889.6 |
| Median | 71.0 | 1.1 | 200.8 | 1,371.7 |

| | | | | |
|---|---|---|---|---|
| **Revenues** | | | | |
| Minimum | 0.00002 | 0.00002 | 0.00391 | 0.002 |
| Maximum | 926.4 | 910.2 | 926.4 | 485,651.0 |
| Average | 93.9 | 25.9 | 149.0 | 5,237.0 |
| Median | 12.7 | 0.5 | 67.2 | 602.9 |

**Going Concern Reporting**

The table below provides information about the percentage of all EGCs and the other categories of companies that had an explanatory paragraph included in the auditor's report on their most recent audited financial statements stating that there is substantial doubt about the company's ability to continue as a going concern.

| | **All EGCs** | **Non-listed EGCs** | **Publicly Listed EGCs** | **Other Publicly Listed Companies** |
|---|---|---|---|---|
| Companies With Going Concern Paragraph | 49% | 76% | 9% | 3% |

**Management Reporting on ICFR**

Generally, EGC management is required to report on the effectiveness of internal control over financial reporting ("ICFR"), although auditor attestation is not required.[6] Approximately 50 percent of the 1,970 EGC companies provided a management report on ICFR. Of those companies that provided a management report, approximately 53 percent stated in the report that the company's ICFR was not effective. Publicly listed EGCs reported material weaknesses at a significantly lower rate (14 percent) as compared to non-listed EGCs (71

[6] The management report on ICFR is required in annual reports, starting with the second annual report filed by the company. *See* Instruction 1 to Item 308(a) of Regulation S-K. EGCs that have not yet filed at least one annual report are therefore not required to provide it. EGCs are exempt from the requirement for auditor attestation of ICFR. *See* Section 404(b) of the Sarbanes-Oxley Act.

percent). Other publicly listed companies reported material weaknesses at an even lower rate (7 percent).

| **ICFR Reporting** | **All EGCs** | **Non-listed EGCs** | **Publicly Listed EGCs** | **Other Publicly Listed Companies** |
|---|---|---|---|---|
| Number of Companies | 1,970 | 1,168 | 802 | 4,317 |
| Companies with Management ICFR Report | 993 (50%) | 680 (58%) | 313 (39%) | 4,157 (96%) |
| Material Weakness in ICFR Noted by Management | 525 (53%) | 480 (71%) | 45 (14%) | 284 (7%) |

**Auditors**

Approximately 39 percent of EGCs were audited by firms that were annually inspected in 2015 and 61 percent of EGCs were audited by firms that are subject to inspection at least every three years by the PCAOB, containing U.S. firms (48 percent), firms that are non-U.S. affiliates of annually inspected firms in 2015 (9 percent), other non-U.S. firms (4 percent).

# White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700 (Revised June 2013)

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[1] This white paper was prepared by PCAOB staff and provides summary data and factual information for one of the Board's current standard-setting projects. The views expressed herein are those of the authors and do not necessarily reflect the views of the Board, individual Board members or PCAOB staff.

## SUMMARY

This white paper provides information about the auditor's reports of certain UK companies for the first year of implementation of expanded auditor reporting in the UK. The UK Financial Reporting Council ("FRC") revised International Standard on Auditing (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statement*, (Revised June 2013) ("UK ISA 700 (Revised)") to require that auditor's reports for a select group of companies[2] include a description of the risks of material misstatement identified by the auditor, and how the audit scope addresses each risk.

Our observations about the expanded auditor's reports of these UK companies are intended to inform the PCAOB's standard-setting project on the auditor's reporting model. On August 13, 2013, the Public Company Accounting Oversight Board ("PCAOB" or "Board") issued for public comment a proposed auditing standard and related amendments on the auditor's report. The proposed auditor reporting standard was intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. For example, the proposed auditing standard, among other things, required auditors to communicate "critical audit matters" ("CAMs") that are specific to each audit. At the same time, the Board sought a balanced approach that would not unduly burden the financial reporting process. The approach to CAMs, as described in the Board's 2013 proposal, is different from the approach to expanded auditor reporting in the UK. Our observations related to UK auditor's reports reflect only the approach taken to comply with UK ISA 700 (Revised).[3]

We reviewed 225 annual reports published by FTSE 350 companies with a fiscal year end date from September 27, 2013 to December 31, 2013. Among the auditor's reports contained in these annual reports obtained from corporate websites, 218 included the expanded reporting required under UK ISA 700 (Revised) (the "observable group").[4] The analysis presented in this report is limited to our factual observations of the expanded auditor's reports and does not make causal inferences about the requirements of UK ISA 700 (Revised). Based on our review of the expanded auditor's reports required under UK ISA 700 (Revised) and the auditor's reports issued in the prior fiscal year, we addressed the following questions:

[2] The expanded auditor reporting requirements of UK ISA 700 (Revised) apply to entities that report on the application of the UK Corporate Governance Code (see Paragraph 19A of UK ISA 700 (Revised)). In the UK, these are companies with a Premium listing of equity shares on the London Stock Exchange. This population includes FTSE 350 companies.

[3] The FRC also released its own reports covering a review of the first and second year of extended auditor's reports. See FRC, March 2015- Extended Auditor's Reports, A Review of Experience in the First Year, and January 2016- Extended Auditor's Reports, A Further Review of Experience.

[4] We observed that seven of the 225 annual reports did not include the additional information related to audit risk and scope in the auditor's reports. The auditor's reports for all seven companies where issued in jurisdictions outside the UK and Ireland.

- *What new information did the expanded auditor's reports provide to users of the financial statements about the risks of material misstatement and audit scope compared to the prior year's auditor's report?*

  The new information in expanded auditor's reports included the descriptions of assessed risks of material misstatement identified by the principal auditor as having the greatest effect on overall audit strategy. Auditor descriptions of how the audit scope addressed each assessed risk also represented new information in the expanded auditor's reports. These descriptions provided users of the financial statements with information on how the audit scope addressed each risk topic, and in some instances, what audit procedures were performed.

- *What was the presentation and style of the expanded auditor's reports with respect to the descriptions of the assessed risks of material misstatement and how the scope of the audit addressed each risk?*

  Risk descriptions were presented in one of three formats: in single sentences, in paragraphs, or in a summary table format. Descriptions of how scope of the audit addressed each risk were either presented next to the risk description or in a separate section of the auditor's report.

- *What were the most frequently mentioned risk topics in the expanded auditor's reports?*

  The five most frequently mentioned risk topics were related to: revenue recognition (59% of the companies), tax (43% of the companies), goodwill and intangible assets – valuation and impairment (42% of the companies), accounts receivable and investments (35% of the companies), and management override of internal controls (30% of the companies).

- *How many risk topics were included in the expanded auditor's reports?*

  The average number of risk topics included in an auditor's report was four. Companies with lower market capitalizations (under £2 billion) included three risk topics on average, and auditor's reports for companies with larger market capitalizations (£5 billion and over) included five risk topics on average.

- *Was there a significant difference in the amount of time auditors took to issue the expanded auditor's reports compared to the auditor's reports issued for the prior fiscal year?*

  The expanded auditor's reports were issued on average in 63 days as compared to an average of 64 days for prior year's reports which we found not to be a statistically significant difference.

- *Was there a significant difference in audit fees for the year expanded auditor's reports took effect compared to the prior fiscal year?*

  We did not find a statistically significant difference in audit fees. The average audit fee increased 4.6%; however, the median change was 0.0% with a majority of the companies (53%) reporting no change or a decrease in audit fees.[5]

[5] We caution readers not to interpret the measures of audit fees change as an assessment of the impact of the revised UK ISA 700 (Revised) on audit fees. While the UK ISA 700 (Revised) may have been a consideration during the negotiation of audit fees, it would not have been the only factor to account for the fee changes measured for this paper.

## BACKGROUND

In 2013, the UK's FRC adopted new requirements for annual reports published by Premium listed companies[6] on the London Stock Exchange. The new requirements reflect changes to the UK Corporate Governance Code[7] and UK auditing standards[8], and impact the audit committee report and the independent auditor's report, respectively, both of which are contained in UK companies' annual reports. The new requirements apply to FTSE 350 companies, among others, and became effective for financial statement fiscal years beginning on or after October 1, 2012 (i.e., September 30, 2013 fiscal year end).

The UK Corporate Governance Code (the "Code") requires a company's board of directors to "explain in the annual report their responsibility for preparing the annual report and accounts, and state that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy."[9] In addition, the Code requires audit committee reports to include a description of "the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed."[10]

Paragraph 19A of the UK ISA 700 (Revised)[11] requires the auditor's reports, among other things, to:

- "Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;" and

- "Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed"

In order to be useful to users of the financial statements, paragraph 19B of UK ISA 700 (Revised) requires, in part, the assessed risk of material misstatement and explanation of the audit scope presented in the auditor's report to be:

"[I]n a manner that complements the descriptions of significant issues relating to the financial statements, required to be set out in the separate section of the annual report describing the work of the audit committee in discharging its responsibilities. The auditor seeks to coordinate descriptions of overlapping topics addressed in these communications, to avoid duplication of reporting about them, whilst having appropriate regard to the separate responsibilities of the auditor and the board for directly communicating information primarily in their respective domains." (See Appendix A)

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[6] According to the London Stock Exchange website, "A Premium Listing means the company is expected to meet the UK's highest standards of regulation and corporate governance."
[7] See FRC, September 2012 - UK Corporate Governance Code
[8] See FRC, June 2013 - International Standard on Auditing (UK and Ireland) 700 – June 2013
[9] See Code Provision C.1.1 of the UK Corporate Governance Code
[10] See Code Provision C.3.8 of the UK Corporate Governance Code
[11] See Paragraph 19A of UK ISA 700 (Revised)

In reviewing the initial period of implementation of UK ISA 700 (Revised), the focus of our analysis was limited to observations based on public sources of data related to the reporting process. The UK company annual reports provide information that allows us to identify features of the auditor's risk topics descriptions such as, how the risk topics were presented, how many topics were mentioned by auditors, and the extent of new information provided in the auditor's reports for users of the financial statements. We were also able to observe the amount of time it took auditors to issue the expanded auditor's reports and any changes in audit fees compared to the prior year. These observations are intended to inform the PCAOB's standard-setting project on the auditor's reporting model.

## COMPANY CHARACTERISTICS

*Market Capitalization*

Among the FTSE 350 companies, we identified 218 companies that published annual reports with a fiscal year end date from September 27, 2013 to December 31, 2013 that included expanded auditor's reports with the new risk topic descriptions required under UK ISA 700 (Revised).[12] Market capitalizations of the companies range from £81.6 million to £137.3 billion.[13] Table 1 provides additional summary measures for the companies.

**Table 1: 218 FTSE 350 companies**

| | Low | High | Mean | Median |
|---|---|---|---|---|
| Market Capitalization - millions | £ 82 | £ 137,258 | £ 7,534 | £ 1,704 |
| Sales FYE 2013 - millions(a) | £ 0 | £ 272,546 | £ 6,641 | £ 921 |
| Total Assets FYE 2013 - millions(a) | £ 39 | £ 1,613,476 | £ 37,444 | £ 1,797 |
| Audit Fees FY 2013 | £ 19,000 | £ 41,000,000 | £ 2,694,516 | £ 702,948 |

| | |
|---|---|
| # of companies audited by a Big Four firm: | 210 |
| # of companies audited by a Non-Big Four firm: | 8 |
| # of Companies that Changed Auditors from FY2012 to FY 2013: | 7 |

(a) The reporting currency for the 218 companies was one of four currencies: British Pound, Euro, US Dollar, or Georgian Lari. Sales and total assets reported in Euros, US Dollar, or Georgian Lari were converted into British Pounds at their closing December 31, 2013 exchange rates, respectively 0.831, 0.604, and 0.349.

For this analysis, we reviewed the observable group in its entirety, and in four sub-groups based on the company's market capitalization. This approach allowed for analysis of whether our observations were consistent for companies of different sizes. We identified natural thresholds for market capitalization that allowed us to divide the 218 companies into four similarly-sized groups. The four groups have the following market capitalization thresholds:

**Group A** – market capitalization under £1 billion (63 companies),
**Group B** – market capitalization equal to or greater than £1 billion and under £2 billion (52 companies),
**Group C** – market capitalization equal to or greater than £2 billion and under £5 billion (59 companies), and
**Group D** – market capitalization £5 billion and over (44 companies)

[12] September 30, 2013 fell on a Monday. We identified four companies with 2013 fiscal year end dates of September 27th, 28th or 29th, and included these companies in our study due to their immediate proximity to the effective date.
[13] Market capitalization for each company is as of January 7, 2014, and was obtained from Capital IQ using London Stock Exchange ticker symbols.

*Industry Breakdown*

For the companies in the observable group, the industry sector weightings are similar to the sector weightings for the overall FTSE 350 (see Table 2). Among the 75 financial sector companies, 32 are from the Asset Manager and Custody Bank industry (see Appendix B for a primary industry breakdown of the 218 companies).

**Table 2: Industry Sector Breakdown - 218 FTSE 350 Companies**

| | Observable Group | | All FTSE 350 Companies | |
|---|---|---|---|---|
| Industry Sector | Count | % of Total | Count | % of Total |
| Consumer Discretionary | 35 | 16% | 62 | 18% |
| Consumer Staples | 7 | 3% | 20 | 6% |
| Energy | 15 | 7% | 16 | 5% |
| Financials | 75 | 34% | 116 | 33% |
| Healthcare | 8 | 4% | 12 | 3% |
| Industrials | 37 | 17% | 60 | 17% |
| Information Technology | 14 | 6% | 22 | 6% |
| Materials | 24 | 11% | 30 | 8% |
| Telecommunications | 1 | 0% | 7 | 2% |
| Utilities | 2 | 1% | 8 | 2% |
| Total | 218 | 100% | 353 | 100% |

*Source: Capital IQ*

A large majority of the industry sector weightings for the companies within each market capitalization group are within two percentage points of the weightings for all FTSE 350 companies. Only a few notable variances in the industry sector weightings were observed. These include consumer discretionary and energy in Group B, and consumer staples and financials in Group D (see Appendix C).

*Auditors*

The auditor's reports included in annual reports published by the 218 companies were issued by affiliates of the Big Four global networks, BDO International, and Grant Thornton International Limited (see Table 3). Member firms of Deloitte Touche Tohmatsu Limited issued the most auditor's reports (63).

**Table 3: Auditors of 218 Companies in the FTSE 350**

| **Auditor** | **Number of Companies** | **% of Total** |
|---|---|---|
| BDO International | 7 | 3% |
| Deloitte Touche Tohmatsu Limited | 63 | 29% |
| EY Global Limited | 39 | 18% |
| Grant Thornton International Limited | 1 | 0% |
| KPMG International Cooperative | 52 | 24% |
| PricewaterhouseCoopers International Limited | 56 | 26% |
| | 218 | 100% |

*Source: Company Annual Reports*

AUDITOR'S REPORT OBSERVATIONS

We collected public information about the auditor's reports from the companies' annual reports to address the following questions:

***What new information did the expanded auditor's reports provide to users of the financial statements about the risks of material misstatement and audit scope compared to the prior year's auditor's report?***

The new information in the expanded auditor's reports, as required under UK ISA 700 (Revised), included descriptions of the assessed risks of material misstatement identified by the auditor as having the greatest effect on overall audit strategy. In many, but not all instances, the annual reports also included discussions by management and the audit committee related to the risk topic identified by the auditor as an assessed risk of material misstatement. Several of the auditor's reports refer readers to the page(s) of the annual report where the location of the management and audit committee discussions can be found. (see Appendix E, Examples 2 and 3)

The new information in the expanded auditor's reports, as required under UK ISA 700 (Revised), also included descriptions of how the audit scope addressed each assessed risk. These descriptions provided users of the financial statements with information on how the audit scope addressed each risk topic, and in some instances, what audit procedures were performed. Information on audit scope was not provided elsewhere in the annual report.

***What was the presentation and style of the new auditor's reports with respect to the descriptions of risks of material misstatement and how the audit scope addressed each risk?***

We observed variation in how the auditors presented the risk topic descriptions. For example, risk descriptions were presented in one of three formats: in single sentences, in paragraphs, or in a summary table format (see Appendix E for examples of each format). The number of risk descriptions in an auditor's report ranged from one to ten.[14] While most auditor's reports included the word "risk" in the label of this section of the auditor's report, some auditors referred to this description as an "area of focus" instead (see Appendix E, Example 3).

The required descriptions of how audit scope addressed a risk (or area of focus) were presented either next to the risk topics or in another section of the auditor's report.

[14] This count is based on an auditor's discrete presentation of a risk as opposed to our count of risk topics.

### *What were the most frequently discussed risk topics in the new auditor's reports?*

Table 4 provides a list of the ten most frequently mentioned risk topics.[15] These topics represent 690 of the 836 risks descriptions in the auditor's reports of the observable group. The percentages in the far right column show that the auditor's reports did not consistently list the same risk descriptions.

**Table 4: Ten Risk Topics Mentioned Most Frequently**

| Risk Topic | Number of Auditor's Reports with Risk Topic | % of Auditor's Reports with Risk Topic |
|---|---|---|
| Revenue Recognition | 129 | 59% |
| Tax | 93 | 43% |
| Goodwill and Intangible Assets - Valuation and Impairment | 92 | 42% |
| Accounts Receivables and Investments Valuation | 77 | 35% |
| Management Override of Internal Controls[(a)] | 66 | 30% |
| Fixed Assets - Valuation and Impairment | 58 | 27% |
| Off-balance Sheet Liabilities | 47 | 22% |
| Pension and Other Post-Retirement | 36 | 17% |
| Liabilities and Reserves | 33 | 15% |
| Mergers & Acquisitions | 31 | 14% |

(a) All 56 auditor's reports issued by one firm included this risk topic.

We observed that the ten risk topics in Table 4 were also common to each of the four market capitalization sub-groups. In additional to the topics in Table 4, there were three additional risk topics that were among the top ten topics for the sub-groups: Asset Disposals (see Appendix F, Table 4C), Capitalization of Expenditures Issues (see Appendix F, Table 4A), and Financial Derivatives/Hedging Issues (see Appendix F, Table 4D). These risk topics were ranked 11, 12, and 13 respectively for the overall observable group.

[15] The number of risk descriptions in the auditor's reports (where there is a discrete description for each risk) ranged from one to ten. The descriptions were not presented with a consistent level of granularity. As a result, it was necessary for us to map these risk descriptions into risk topics to facilitate a summary analysis. For example, when describing impairment of goodwill and intangible assets, some auditors combined them into a single topic, while others separated them into two discrete topics, one for goodwill impairment and one for intangible assets impairment. In our analysis, we grouped all these descriptions into one topic – Goodwill and Intangible Assets – Valuation and Impairment.

***How many risk topics were included in the new auditor's reports?***

Among the observable group, auditors identified one to eight risk topics per company. Most auditor's reports contained three to five risk topics, and the average was four. A breakdown of the number of risks described in each of the 218 auditor's reports, based on the risk topics we identified, is provided in Table 5.

**Table 5: Number of Auditor Risk Topics Per Auditor's report**

| Number of Risk Topics in an Auditor's Report | Number of Auditor's Reports |
|---|---|
| 1 | 12 |
| 2 | 23 |
| 3 | 54 |
| 4 | 62 |
| 5 | 44 |
| 6 | 15 |
| 7 | 6 |
| 8 | 2 |
| Total | 218 |

| | |
|---|---|
| Mean Number of Risk Topics per Auditor's report: | 4 |
| Median Number of Risk Topics per Auditor's report: | 4 |

Among the four market capitalization groups, companies with market capitalizations under £2 billion have an average of three risk topics in their auditor's reports (see Appendix G, Tables 5A and 5B). Companies with market capitalizations of £5 billion or more have an average of five risk topics (see Appendix G, Table 5D).

***Was there a significant difference in the amount of time auditors took to issue the expanded auditor's reports compared to the auditor's reports issued for the prior fiscal year?***

Using the auditor's report date, we measured the number of days it took auditors to issue a financial statement auditor's report.[16] We found that on average auditors took 63 days to issue the new expanded auditor's reports, one day less than the average of 64 days for the prior year's reports. There are 210 companies in the observable group with auditor's reports for the past three years ("adjusted observable group").[17]

Table 6 provides summary measures for the 210 companies. We found no statistically significant[18] difference in the average time to issue an auditor's report after implementation of the new rules.

**Table 6: Number of Days from a Company's Fiscal Year End Date to Auditor's Report Date - 210 Companies in the FTSE 350**

| | Days to Issue Auditor's report | | |
|---|---|---|---|
| | Fiscal Year 2013 | Fiscal Year 2012 | Fiscal Year 2011 |
| Mean | 63 | 64 | 65 |
| Median | 60 | 63 | 62 |
| Range - low | 28 | 29 | 25 |
| Range - high | 119 | 120 | 121 |

*Source: Company Annual Reports*

We also found that, for each market capitalization group, the new expanded auditor's reports were issued in fewer days than it took for the prior year's auditor's report (see Appendix H, Tables 6A to 6D), but these changes were not statistically significant.

[16] Days to Issue Auditor's report is calculated as the number of days between the company's fiscal year-end date and the auditor's report date.
[17] Among the observable group, eight companies completed their initial public offerings in calendar years 2012 or 2013. As a result, annual reports for prior years are not available for these eight companies, so they were excluded from the analysis.
[18] A statistical tool, Student's t-test, shows that fiscal year 2013 and prior years' data are not statistically different from each other (see Appendix J).

***Was there a significant difference in audit fees for the year expanded auditor's reports took effect compared to the prior fiscal year?***

Among the 210 companies in the adjusted observable group, the average audit fees increased by 4.6%,[19] but the median change was 0.0% as fewer than half (99 companies) reported an increase in audit fees.[20] The remaining companies reported no change in audit fees (59 companies) or a decrease in audit fees (52 companies).

Table 7 provides a summary of changes in audit fees for the adjusted observable group. We found no statistically significant[21] difference in audit fees reported for fiscal year 2013 and audit fees reported for the prior fiscal year.

**Table 7: Changes in Audit Fees - 210 Companies in the FTSE 350**

| | % Change in Audit Fees |
|---|---|
| Mean | 4.6% |
| Median | 0.0% |
| Range – low | -46.6% |
| Range – high | 91.0% |

| | |
|---|---|
| Number of Companies with an Increase in Audit Fees: | 99 |
| Number of Companies with No Change in Audit Fees: | 59 |
| Number of Companies with a Decrease in Audit Fees: | 52 |

*Source: Company Annual Reports, Capital IQ*

For the four market capitalization groups, we found in Group C (market capitalization greater than or equal to £2 billion and under £5 billion) that 64% of the companies reported an increase in audit fees. As a result, the mean and median changes for this group were higher than those observed for Groups A, B, and D (see Appendix I). For

[19] Two companies with the largest increases in audit fees in the adjusted observable group also reported events during the fiscal year 2013 that may have contributed to the change in their audit fees. One of these companies made a large acquisition and changed auditors (the reported audit fees increased by 91.1%); and the other company completed a large acquisition in 2013, which contributed to an increase in total assets by approximately 50% (the reported audit fees increased by 82.4%). When the audit fees increases of the above two companies are removed from the analysis, the adjusted average increase in audit fees for the remaining companies in the adjusted observable group was 3.8%.

[20] The percent change in audit fees needs to be interpreted with caution. We found many instances in which audit fees were not reported to the single-unit value. For example, a company with £515,245 in actual audit fees alternatively could report £0.5 million or £515 thousand in its annual report. Audit fee changes in this report are based solely on the as-reported amounts. .

[21] A statistical tool, Student's t-test, shows that fiscal year 2013 and prior year's data are not statistically different from each other (see Appendix K).

the other three groups – A, B, and D – a majority of the companies reported no change or a decrease in audit fees. We did not find statistically significant differences in audit fees for these three groups. (See Appendix K)

The adjusted observable group includes 18 investment trusts, most of which have market capitalizations under £1 billion. Since audits of investment trusts may differ from audits of operating companies in the index, Tables 7A to 7D in Appendix I provide a breakdown of changes in audit fees for the 18 investment trusts versus the operating companies.

We caution readers not to interpret the measures in Table 7 as an assessment of the impact of the revised UK ISA 700 (Revised) on audit fees. Academic research has shown that many factors affect the amount of fees paid by listed companies for a financial statement audit. For example, Hay, Knechel, and Wong (2006) [22] evaluated and summarized 147 research studies on audit fees conducted over a 27-year period and published in more than 20 countries and used meta-analysis to test the combined effect of the most commonly used independent variables, including attributes related to the auditor, audit client and audit engagement. The meta-analysis found mixed results on how independent variables affect audit fees, including conflicting results on the relationship between corporate governance and audit fees.[23] In addition, the FRC simultaneously implemented new requirements in the UK that resulted in changes to the audit committee report which may also impact audit fees. Also, we are aware that the UK experienced an inflation rate of 2.0% for calendar year 2013.[24] Therefore, the measures in Table 7 should not be viewed as an observation of the change in audit fees solely due to the implementation of UK ISA 700 (Revised).

[22] Hay, David C., Knechel, W. Robert, Wong, Norman, *Audit Fees: Meta-analysis of the effect of Supply and Demand Attributes*, Contemporary Accounting Research Vol. 23 No. 1 (Spring 2006) pp.141-91. Meta-Analysis is a quantitative analysis of several separate but similar experiments or studies in order to test the pooled data for statistical significance.

[23] In a subsequent research paper published in 2013, Hay used meta-analysis to examine the accumulated effect of the drivers of audit fees identified in the 2006 study and found, among other things, that corporate governance variables are positively associated with audit fees. *See* Hay, David, *Further Evidence from Meta-Analysis of Audit Fee Research*, International Journal of Auditing 17: 162-176 (2013).

[24] UK Office for National Statistics (www.ons.gov.uk)

**Appendix A:** International Standard on Auditing (UK and Ireland) 700 – June 2013, paragraphs 19A and 19B

*Entities that Report on Application of the UK Corporate Governance Code*

19A. In the case of entities[6] that are required, and those that choose voluntarily, to report on how they have applied the UK Corporate Governance Code, or to explain why they have not, the auditor's report shall:

(a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;

(b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit. Such explanation shall specify the threshold used by the auditor as being materiality for the financial statements as a whole; and

(c) Provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risks of material misstatement disclosed in accordance with (a) and was influenced by the auditor's application of materiality disclosed in accordance with (b). (Ref. Para A13A – A13C)

19B. In order to be useful to users of the financial statements, the explanations of the matters required to be set out in the auditor's report by paragraph 19A shall be described:

- So as to enable a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements.
- In a way that enables them to be related directly to the specific circumstances of the audited entity and are not, therefore, generic or abstract matters expressed in standardised language.
- In a manner that complements the description of significant issues relating to the financial statements, required to be set out in the separate section of the annual report describing the work of the audit committee in discharging its responsibilities. The auditor seeks to coordinate descriptions of overlapping topics addressed in these communications, to avoid duplication of reporting about them, whilst having appropriate regard to the separate responsibilities of the auditor and the board for directly communicating information primarily in their respective domains.

[6] In the UK, these include companies with a Premium listing of equity shares regardless of whether they are incorporated in the UK or elsewhere. In Ireland, these include Irish incorporated companies with a primary or secondary listing of equity shares on the Irish Stock Exchange.

**Appendix B**: Primary Industry Breakdown of 218 companies in the FTSE 350 with auditor's reports that conform with the new rules

| Primary Industry | Number of Companies | Industry Sector |
|---|---|---|
| Advertising | 1 | Consumer Discretionary |
| Auto Parts and Equipment | 1 | Consumer Discretionary |
| Broadcasting | 1 | Consumer Discretionary |
| Casinos and Gaming | 4 | Consumer Discretionary |
| Distributors | 1 | Consumer Discretionary |
| Home Furnishing Retail | 1 | Consumer Discretionary |
| Homebuilding | 4 | Consumer Discretionary |
| Hotels, Resorts and Cruise Lines | 5 | Consumer Discretionary |
| Internet Retail | 1 | Consumer Discretionary |
| Leisure Facilities | 1 | Consumer Discretionary |
| Movies and Entertainment | 1 | Consumer Discretionary |
| Publishing | 6 | Consumer Discretionary |
| Research and Consulting Services | 1 | Consumer Discretionary |
| Restaurants | 6 | Consumer Discretionary |
| Specialized Consumer Services | 1 | Consumer Discretionary |
| Household Products | 1 | Consumer Staples |
| Packaged Foods and Meats | 3 | Consumer Staples |
| Soft Drinks | 1 | Consumer Staples |
| Tobacco | 2 | Consumer Staples |
| Integrated Oil and Gas | 3 | Energy |
| Oil and Gas Equipment and Services | 4 | Energy |
| Oil and Gas Exploration and Production | 7 | Energy |
| Oil and Gas Storage and Transportation | 1 | Energy |
| Asset Management and Custody Banks | 32 | Financials |
| Consumer Finance | 2 | Financials |
| Diversified Banks | 6 | Financials |
| Diversified Real Estate Activities | 2 | Financials |
| Diversified REITs | 1 | Financials |
| Industrial REITs | 2 | Financials |
| Insurance Brokers | 1 | Financials |
| Investment Banking and Brokerage | 1 | Financials |
| Life and Health Insurance | 8 | Financials |
| Multi-line Insurance | 1 | Financials |
| Office REITs | 1 | Financials |
| Other Diversified Financial Services | 1 | Financials |
| Property and Casualty Insurance | 7 | Financials |
| Real Estate Development | 1 | Financials |
| Real Estate Operating Companies | 3 | Financials |
| Real Estate Services | 3 | Financials |
| Retail REITs | 2 | Financials |
| Thrifts and Mortgage Finance | 1 | Financials |
| Healthcare Distributors | 1 | Healthcare |
| Healthcare Equipment | 1 | Healthcare |
| Healthcare Facilities | 2 | Healthcare |
| Pharmaceuticals | 4 | Healthcare |

| | | |
|---|---|---|
| Aerospace and Defense | 5 | Industrials |
| Airlines | 1 | Industrials |
| Airport Services | 1 | Industrials |
| Construction and Engineering | 5 | Industrials |
| Diversified Support Services | 2 | Industrials |
| Electrical Components and Equipment | 1 | Industrials |
| Environmental and Facilities Services | 3 | Industrials |
| Human Resource and Employment Services | 2 | Industrials |
| Industrial Machinery | 9 | Industrials |
| Research and Consulting Services | 1 | Industrials |
| Security and Alarm Services | 1 | Industrials |
| Technology Distributors | 1 | Industrials |
| Trading Companies and Distributors | 4 | Industrials |
| Trucking | 1 | Industrials |
| Application Software | 2 | Information Technology |
| Communications Equipment | 2 | Information Technology |
| Computer Storage and Peripherals | 1 | Information Technology |
| Electronic Components | 1 | Information Technology |
| Electronic Equipment and Instruments | 2 | Information Technology |
| Home Entertainment Software | 1 | Information Technology |
| Internet Software and Services | 2 | Information Technology |
| IT Consulting and Other Services | 1 | Information Technology |
| Semiconductors | 2 | Information Technology |
| Coal and Consumable Fuels | 1 | Materials |
| Commodity Chemicals | 1 | Materials |
| Construction Materials | 1 | Materials |
| Diversified Metals and Mining | 5 | Materials |
| Gold | 3 | Materials |
| Metal and Glass Containers | 1 | Materials |
| Paper Products | 1 | Materials |
| Precious Metals and Minerals | 3 | Materials |
| Specialty Chemicals | 6 | Materials |
| Steel | 2 | Materials |
| Alternative Carriers | 1 | Telecommunication Services |
| Independent Power Producers and Energy Traders | 1 | Utilities |
| Multi-Utilities | 1 | Utilities |
| Total | 218 | |

## Appendix C: Industry Sector Breakdown by Market Capitalization

**Table 2A: Industry Sector Breakdown - 63 Companies with Market Capitalization under £1 billion**

| | Observable Group | | All FTSE 350 Companies | |
|---|---|---|---|---|
| Industry Sector | Count | % of Total | Count | % of Total |
| Consumer Discretionary | 9 | 14% | 16 | 15% |
| Consumer Staples | 2 | 3% | 5 | 5% |
| Energy | 1 | 2% | 2 | 2% |
| Financials | 30 | 48% | 48 | 45% |
| Healthcare | 2 | 3% | 5 | 5% |
| Industrials | 7 | 11% | 13 | 12% |
| Information Technology | 6 | 10% | 8 | 8% |
| Materials | 6 | 10% | 8 | 8% |
| Telecommunications | 0 | 0% | 1 | 1% |
| Utilities | 0 | 0% | 0 | 0% |
| Total | 63 | 100% | 106 | 100% |

**Table 2B: Industry Sector Breakdown - 52 Companies with Market Capitalization greater than or equal to £1 billion and under £2 billion**

| | Observable Group | | All FTSE 350 Companies | |
|---|---|---|---|---|
| Industry Sector | Count | % of Total | Count | % of Total |
| Consumer Discretionary | 7 | 13% | 18 | 20% |
| Consumer Staples | 1 | 2% | 2 | 2% |
| Energy | 7 | 13% | 7 | 8% |
| Financials | 15 | 29% | 25 | 28% |
| Healthcare | 1 | 2% | 1 | 1% |
| Industrials | 11 | 21% | 17 | 19% |
| Information Technology | 4 | 8% | 9 | 10% |
| Materials | 6 | 12% | 6 | 7% |
| Telecommunications | 0 | 0% | 2 | 2% |
| Utilities | 0 | 0% | 1 | 1% |
| Total | 52 | 100% | 88 | 100% |

**Table 2C: Industry Sector Breakdown - 59 Companies with Market Capitalization greater than or equal to £2 billion and under £5 billion**

| | Observable Group | | All FTSE 350 Companies | |
|---|---|---|---|---|
| Industry Sector | Count | % of Total | Count | % of Total |
| Consumer Discretionary | 11 | 19% | 14 | 16% |
| Consumer Staples | 0 | 0% | 2 | 2% |
| Energy | 3 | 5% | 3 | 3% |
| Financials | 18 | 31% | 28 | 32% |
| Healthcare | 1 | 2% | 2 | 2% |
| Industrials | 15 | 25% | 21 | 24% |
| Information Technology | 3 | 5% | 4 | 5% |
| Materials | 6 | 10% | 8 | 9% |
| Telecommunications | 1 | 2% | 2 | 2% |
| Utilities | 1 | 2% | 4 | 5% |
| Total | 59 | 100% | 88 | 100% |

**Table 2D: Industry Sector Breakdown - 44 Companies with Market Capitalization £5 billion and over**

| | Observable Group | | All FTSE 350 Companies | |
|---|---|---|---|---|
| Industry Sector | Count | % of Total | Count | % of Total |
| Consumer Discretionary | 8 | 18% | 14 | 20% |
| Consumer Staples | 4 | 9% | 11 | 15% |
| Energy | 4 | 9% | 4 | 6% |
| Financials | 12 | 27% | 15 | 21% |
| Healthcare | 4 | 9% | 4 | 6% |
| Industrials | 4 | 9% | 9 | 13% |
| Information Technology | 1 | 2% | 1 | 1% |
| Materials | 6 | 14% | 8 | 11% |
| Telecommunications | 0 | 0% | 2 | 3% |
| Utilities | 1 | 2% | 3 | 4% |
| Total | 44 | 100% | 71 | 100% |

## Appendix D: Auditors by Market Capitalization

**Table 3A: Auditors of 63 Companies in the FTSE 350 with Market Capitalization under £1 billion**

| Auditor | Number of Companies | % of Total |
|---|---|---|
| BDO International | 4 | 6% |
| Deloitte Touche Tohmatsu Limited | 17 | 27% |
| EY Global Limited | 15 | 24% |
| Grant Thornton International Limited | 1 | 2% |
| KPMG International Cooperative | 15 | 24% |
| PricewaterhouseCoopers International Limited | 11 | 17% |
| | 63 | 100% |

**Table 3B: Auditors of 52 Companies in the FTSE 350 with Market Capitalization Greater Than or Equal to £1 billion and Under £2 billion**

| Auditor | Number of Companies | % of Total |
|---|---|---|
| BDO International | 0 | 0% |
| Deloitte Touche Tohmatsu Limited | 19 | 37% |
| EY Global Limited | 12 | 23% |
| Grant Thornton International Limited | 0 | 0% |
| KPMG International Cooperative | 13 | 25% |
| PricewaterhouseCoopers International Limited | 8 | 15% |
| | 52 | 100% |

**Table 3C: Auditors of 59 Companies in the FTSE 350 with Market Capitalization Greater Than or Equal to £2 billion and Under £5 billion**

| Auditor | Number of Companies | % of Total |
|---|---|---|
| BDO International | 3 | 5% |
| Deloitte Touche Tohmatsu Limited | 18 | 31% |
| EY Global Limited | 6 | 10% |
| Grant Thornton International Limited | 0 | 0% |
| KPMG International Cooperative | 14 | 24% |
| PricewaterhouseCoopers International Limited | 18 | 31% |
| | 59 | 100% |

**Table 3D: Auditors of 44 Companies in the FTSE 350 with Market Capitalization of £5 billion and over**

| Auditor | Number of Companies | % of Total |
|---|---|---|
| BDO International | 0 | 0% |
| Deloitte Touche Tohmatsu Limited | 9 | 20% |
| EY Global Limited | 6 | 14% |
| Grant Thornton International Limited | 0 | 0% |
| KPMG International Cooperative | 10 | 23% |
| PricewaterhouseCoopers International Limited | 19 | 43% |
| | 44 | 100% |

**Appendix E:** Examples of Auditor's Report Risk Description Presentations

1. Single sentence

## Our assessment of risks of material misstatement

The assessed risks of material misstatement described below are those that had the greatest effect on our audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team:

- the assessment of the carrying value of goodwill and intangible assets;
- the valuation of inventory including appropriateness of judgements applied within the obsolescence provision; and
- the recoverability of trade receivables.

2. Paragraph

**2. Our assessment of risks of material misstatement**

The risks of material misstatement detailed in this section of this report are those risks that we have deemed, in our professional judgement, to have had the greatest effect on: the overall audit strategy; the allocation of resources in our audit; and directing the efforts of the engagement team. Our audit procedures relating to these risks were designed in the context of our audit of the financial statements as a whole. Our opinion on the financial statements is not modified with respect to any of these risks, and we do not express an opinion on these individual risks.

In arriving at our audit opinion above on the Group financial statements, the risks of material misstatement that had the greatest effect on our Group audit were as follows:

Assessment of goodwill for impairment (€317.2m)

*Refer to page 35 (Audit Committee Report), page 75 (accounting policy) and pages 88 and 89 (financial disclosures)*

*The risk*

There is a risk that the carrying value of the Group's goodwill balance may not be recovered from future cash flows. As detailed in the summary of significant accounting policies on page 75, an impairment review of goodwill is performed at each reporting date by the Group. There is inherent uncertainty involved in preparing forecasts and discounted future cash flow reports for this purpose and significant judgement is involved in relation to the assumptions used in the Group's goodwill impairment model.

*Our response*

In this area, our audit procedures included, among others, interrogating the Group's goodwill impairment model, evaluating the assumptions and methodologies used by the Group, in particular those relating to revenue growth, operating profit and the discount rate and terminal growth rate applied to the forecasted cash flows in the model. We compared the Group's assumptions with externally derived data as well as our own assessment in relation to key inputs into the model. We examined the sensitivity analysis performed by Group Finance management and performed our own sensitivity analysis around the key assumptions. We also assessed whether the disclosures in note 10 presented the Group's assumptions in relation to goodwill impairment and the sensitivities of the outcome of the impairment assessment appropriately.

3. Summary table

*Areas of particular audit focus*

In preparing the financial statements, the directors made a number of subjective judgements, for example in respect of significant accounting estimates that involved making assumptions and considering future events that are inherently uncertain. We primarily focused our work in these areas by assessing the directors' judgements against available evidence, forming our own judgements, and evaluating the disclosures in the financial statements.

In our audit, we tested and examined information, using sampling and other auditing techniques, to the extent we considered necessary to provide a reasonable basis for us to draw conclusions. We obtained audit evidence through testing the effectiveness of controls, substantive procedures or a combination of both.

We considered the following areas to be those that required particular focus in the current year. This is not a complete list of all risks or areas of focus identified by our audit. We discussed these areas of focus with the Audit Committee. Their report on those matters that they considered to be significant issues in relation to the financial statements is set out on page 65.

| Area of focus | How the scope of our audit addressed the area of focus |
|---|---|
| **Impairment assessment**<br>We focused on this area due to the size of the goodwill balance, and because the directors' assessment of the carrying value of the Group's cash generating units ("CGUs") involves judgements about the future results of the business and the discount rate to apply to the future cash flow forecasts. | We tested the directors' future cash flow forecasts, including comparing them to the latest Board approved budgets and comparing the current year results with the equivalent figures included in the prior year forecast. We challenged the directors' key assumptions for discount and long-term growth rates by comparing rates used to available external data. We also performed sensitivity analysis around the key drivers of the cash flow forecasts, being the discount rates, revenue growth rates and operating margins. |
| **Exceptional items**<br>Exceptional items relating to the disposal of non-core products were considered to be an area of focus due to the magnitude of the charge in the income statement. | We tested the component parts of the loss on disposal calculation to source documentation including the proceeds received, the net assets disposed of and the costs associated with the disposal, including goodwill allocation. We held detailed discussions with management regarding the methodology applied to allocate goodwill to the loss on disposal calculation and tested the supporting calculations, checking compliance with IAS 36 "Impairment of Assets". |
| **Archer Capital litigation**<br>A compensation claim against the Group by a third party for a material sum is currently the subject of legal proceedings. We focused on this issue as there is uncertainty as to the likely outcome. | We discussed this issue with internal and external legal counsel in order to understand the latest position of the proceedings and assess the directors' views as to the strength of the claim against the Group and their conclusion that no provision is required. |
| **Revenue recognition**<br>We focused on this area because the timing of revenue recognition and its presentation in the income statement has inherent complexities. These complexities mainly involve accounting for "bundled" transactions where software and maintenance and support elements are purchased together, with a portion of the fee being recognised immediately and the remainder of the revenue deferred and recognised over the contractual period.<br><br>In addition, ISAs (UK & Ireland) presume there is a risk of fraud in revenue recognition for every audit conducted under these auditing standards. | We tested the timing of the recognition of revenue, which included testing the allocation of revenue in sales transactions including both software and maintenance and support elements and that the maintenance and support element was appropriately deferred and recognised over the contractual period.<br><br>Additionally, in response to the presumptive risk of fraud, where revenue was recorded through journal entries we performed testing to establish whether a service had been provided or a sale had occurred in the financial year to support this recognition. |
| **Risk of management override of internal controls**<br>ISAs (UK & Ireland) require that we consider this and hence it is an area that receives heightened focus on every audit conducted under these auditing standards. | We assessed the overall control environment of the Group, including the arrangements for staff to "whistle-blow" inappropriate actions, and interviewed senior management and the Group's internal audit function.<br><br>We examined the significant accounting estimates and judgments relevant to the financial statements for evidence of bias by the directors that may represent a risk of material misstatement due to fraud.<br><br>We also tested manual journal entries to determine the rationale for manual adjustments. |

## Appendix F: Most Frequent Risk Topics by Market Capitalization

**Table 4A: Ten Risk Topics Mentioned Most Frequently – 63 Companies with Market Capitalization Under £1 billion**

| Risk Topic | Number of Auditor's reports with Risk Topic | % of Auditor's reports with Risk Topic |
|---|---|---|
| Revenue Recognition | 38 | 60% |
| Accounts Receivables and Investments | 31 | 49% |
| Goodwill and Intangible Assets - Valuation and Impairment | 24 | 38% |
| Tax | 20 | 32% |
| Fixed Assets - Valuation and Impairment | 18 | 29% |
| Management Override of Internal Controls | 13 | 21% |
| Off-balance Sheet Liabilities | 11 | 17% |
| Pension and Other Post-Retirement | 9 | 14% |
| Capitalization of Expenditures Issues* | 6 | 10% |
| Mergers & Acquisitions | 6 | 10% |
| Inventory | 5 | 8% |

**Table 4B: Ten Risk Topics Mentioned Most Frequently - 52 Companies with Market Capitalization Greater Than or Equal to £1 billion and Under £2 billion**

| Risk Topic | Number of Auditor's reports with Risk Topic | % of Auditor's reports with Risk Topic |
|---|---|---|
| Revenue Recognition | 24 | 46% |
| Goodwill and Intangible Assets - Valuation and Impairment | 21 | 40% |
| Tax | 19 | 37% |
| Accounts Receivables and Investments Valuation | 16 | 31% |
| Fixed Assets - Valuation and Impairment | 15 | 29% |
| Pension and Other Post-Retirement | 11 | 21% |
| Management Override of Internal Controls | 10 | 19% |
| Inventory | 9 | 17% |
| Liabilities and Reserves | 9 | 17% |
| Off-balance Sheet Liabilities | 7 | 13% |
| Mergers & Acquisitions | 5 | 10% |

**Table 4C: Ten Risk Topics Mentioned Most Frequently - 59 Companies with Market Capitalization Greater Than or Equal to £2 billion and Under £5 billion**

| Risk Topic | Number of Auditor's reports with Risk Topic | % of Auditor's reports with Risk Topic |
|---|---|---|
| Revenue Recognition | 36 | 61% |
| Tax | 31 | 53% |
| Goodwill and Intangible Assets - Valuation and Impairment | 25 | 42% |
| Management Override of Internal Controls | 24 | 41% |
| Accounts Receivables and Investments | 17 | 29% |
| Fixed Assets - Valuation and Impairment | 13 | 22% |
| Off-balance Sheet Liabilities | 12 | 20% |
| Asset Disposals* | 12 | 20% |
| Liabilities and Reserves | 11 | 19% |
| Pension & Other Post-Retirement | 10 | 17% |
| Inventory | 10 | 17% |

**Table 4D: Ten Risk Topics Mentioned Most Frequently - 44 Companies with Market Capitalization of £5 billion and Over**

| Risk Topic | Number of Auditor's reports with Risk Topic | % of Auditor's reports with Risk Topic |
|---|---|---|
| Revenue Recognition | 31 | 70% |
| Tax | 23 | 52% |
| Goodwill and Intangible Assets - Valuation and Impairment | 22 | 50% |
| Management Override of Internal Controls | 19 | 43% |
| Off-balance Sheet Liabilities | 17 | 39% |
| Mergers & Acquisitions | 15 | 34% |
| Accounts Receivables and Investments | 13 | 30% |
| Fixed Assets - Valuation and Impairment | 12 | 27% |
| Liabilities and Reserves | 10 | 23% |
| Financial Derivatives/Hedging Issues* | 7 | 16% |
| Pension & Other Post-Retirement | 6 | 14% |

*These risk topics were not included in Table 4

## Appendix G: Number of Risk Topics by Market Capitalization

**Table 5A: Number of Auditor Risk Topics Per Auditor's Report - 63 companies in the FTSE 350 with Market Capitalization Under £1 billion**

| Number of Risk Topics in an Auditor's Report | Number of Auditor's Reports |
|---|---|
| 1 | 7 |
| 2 | 12 |
| 3 | 12 |
| 4 | 19 |
| 5 | 11 |
| 6 | 2 |
| 7 | - |
| 8 | - |
| Total | 63 |

| | |
|---|---|
| Mean Number of Risk Topics per Auditor's Report: | 3 |
| Median Number of Risk Topics per Auditor's Report: | 4 |

**Table 5B: Number of Auditor Risk Topics Per Auditor's Report - 52 companies in the FTSE 350 with Market Capitalization Greater than or Equal to £1 billion and Under £2 billion**

| Number of Risk Topics in an Auditor's Report | Number of Auditor's Reports |
|---|---|
| 1 | 4 |
| 2 | 8 |
| 3 | 18 |
| 4 | 11 |
| 5 | 9 |
| 6 | 1 |
| 7 | 1 |
| 8 | - |
| Total | 52 |

| | |
|---|---|
| Mean Number of Risk Topics per Auditor's Report: | 3 |
| Median Number of Risk Topics per Auditor's Report: | 3 |

**Table 5C: Number of Auditor Risk Topics Per Auditor's Report - 59 companies in the FTSE 350 with Market Capitalization Greater than or Equal to £2 billion and Under £5 billion**

| Number of Risk Topics in an Auditor's Report | Number of Auditor's Reports |
|---|---|
| 1 | 1 |
| 2 | 3 |
| 3 | 16 |
| 4 | 21 |
| 5 | 11 |
| 6 | 4 |
| 7 | 3 |
| 8 | - |
| Total | 59 |

Mean Number of Risk Topics per Auditor's Report: 4
Median Number of Risk Topics per Auditor's Report: 4

**Table 5D: Number of Auditor Risk Topics Per Auditor's Report - 44 companies in the FTSE 350 with Market Capitalization of £5 billion and Over**

| Number of Risk Topics in an Auditor's Report | Number of Auditor's Reports |
|---|---|
| 1 | - |
| 2 | - |
| 3 | 8 |
| 4 | 11 |
| 5 | 13 |
| 6 | 8 |
| 7 | 2 |
| 8 | 2 |
| Total | 44 |

Mean Number of Risk Topics per Auditor's Report: 5
Median Number of Risk Topics per Auditor's Report: 5

## Appendix H: Number of Days to Issue Auditor's Report by Market Capitalization

**Table 6A: Number of Days from a Company's Fiscal Year End Date to Auditor's Report Date - 58 Companies in the FTSE 350 with Market Capitalization Under £1 billion**

| | Days to Issue Auditor's Report | | |
|---|---|---|---|
| | Fiscal Year 2013 | Fiscal Year 2012 | Fiscal Year 2011 |
| Mean | 67 | 68 | 71 |
| Median | 63 | 66 | 67 |
| Range - low | 38 | 39 | 41 |
| Range - high | 115 | 120 | 121 |

**Table 6B: Number of Days from a Company's Fiscal Year End Date to Auditor's Report Date - 50 Companies in the FTSE 350 with Market Capitalization Greater Than or Equal to £1 billion and Under £2 billion**

| | Days to Issue Auditor's Report | | |
|---|---|---|---|
| | Fiscal Year 2013 | Fiscal Year 2012 | Fiscal Year 2011 |
| Mean | 60 | 61 | 63 |
| Median | 59 | 59 | 60 |
| Range - low | 28 | 29 | 25 |
| Range - high | 98 | 100 | 115 |

**Table 6C: Number of Days from a Company's Fiscal Year End Date to Auditor's Report Date - 58 Companies in the FTSE 350 with Market Capitalization Greater Than or Equal to £2 billion and Under £5 billion**

| | Days to Issue Auditor's Report | | |
|---|---|---|---|
| | Fiscal Year 2013 | Fiscal Year 2012 | Fiscal Year 2011 |
| Mean | 62 | 64 | 64 |
| Median | 59 | 62 | 62 |
| Range - low | 44 | 45 | 48 |
| Range - high | 101 | 114 | 115 |

**Table 6D: Number of Days from a Company's Fiscal Year End Date to Auditor's Report - 44 Companies in the FTSE 350 with Market Capitalization of £5 billion and Over**

| | Days to Issue Auditor's Report | | |
|---|---|---|---|
| | Fiscal Year 2013 | Fiscal Year 2012 | Fiscal Year 2011 |
| Mean | 60 | 61 | 61 |
| Median | 58 | 62 | 60 |
| Range - low | 36 | 30 | 32 |
| Range - high | 106 | 112 | 111 |

## Appendix I: Change in Audit Fees by Market Capitalization

**Table 7A: Changes in Audit Fees - 58 Companies with Market Capitalization Under £1 billion(a)**

| | % Change in Audit Fees | | |
|---|---|---|---|
| | All 58 companies | 44 companies, excluding investment trusts | 14 investment trusts |
| Mean | 3.7% | 5.5% | -2.1% |
| Median | 0.0% | 0.0% | 0.0% |
| Range - Low | -26.2% | -25.0% | -26.2% |
| Range - High | 91.0% | 91.0% | 18.4% |
| # of Companies with an Increase in Audit Fees: | 25 | 20 | 5 |
| # of Companies with No Change in Audit Fees: | 15 | 12 | 3 |
| # of Companies with a Decrease in Audit Fees: | 18 | 12 | 6 |

**Table 7B: Changes in Audit Fees - 50 Companies with Market Capitalization greater than or equal to £1 billion and under £2 billion(a)**

| | % Change in Audit Fees | | |
|---|---|---|---|
| | All 50 companies | 47 companies, excluding investment trusts | 3 investment trusts |
| Mean | 2.5% | 2.5% | 1.6% |
| Median | 0.0% | 0.0% | 0.0% |
| Range - Low | -46.6% | -46.6% | 0.0% |
| Range - High | 60.4% | 60.4% | 4.8% |
| # of Companies with an Increase in Audit Fees: | 20 | 19 | 1 |
| # of Companies with No Change in Audit Fees: | 21 | 19 | 2 |
| # of Companies with a Decrease in Audit Fees: | 9 | 9 | 0 |

**Table 7C: Changes in Audit Fees - 58 Companies with Market Capitalization greater than or equal to £2 billion and under £5 billion(a)**

| | % Change in Audit Fees | | |
|---|---|---|---|
| | All 58 companies | 57 companies, excluding investment trusts | 1 investment trust |
| Mean | 7.2% | 7.2% | 9.8% |
| Median | 6.4% | 6.3% | 9.8% |
| Range - Low | -22.2% | -22.2% | - |
| Range - High | 57.1% | 57.1% | - |
| # of Companies with an Increase in Audit Fees: | 37 | 36 | 1 |
| # of Companies with No Change in Audit Fees: | 12 | 12 | 0 |
| # of Companies with a Decrease in Audit Fees: | 9 | 9 | 0 |

**Table 7D: Changes in Audit Fees - 44 Companies with Market Capitalization £5 billion and over(a)**

| | % Change in Audit Fees | | |
|---|---|---|---|
| | All 44 companies | 44 companies, excluding investment trusts | 0 investment trust |
| Mean | 4.9% | 4.9% | - |
| Median | 0.0% | 0.0% | - |
| Range - Low | -26.4% | -26.4% | - |
| Range - High | 82.4% | 82.4% | - |
| | | | |
| # of Companies with an Increase in Audit Fees: | 17 | 17 | - |
| # of Companies with No Change in Audit Fees: | 11 | 11 | - |
| # of Companies with a Decrease in Audit Fees: | 16 | 16 | - |

(a) The percent change in audit fees needs to be interpreted with caution. Some companies report audit fees rounded in large unit values relative to the actual audit fee amount. This can create rounding errors which can result in overstating or understating changes in audit fees. For example, a company with actual audit fees of £549,000 in 2012, may report £0.5 million in the annual report for that year. If the fees increased to £551,000 in 2013, the company would report £0.6 million for this year. The amounts reported in the annual report would indicate a 20.0% increase in audit fees when the actual increase is 0.36%.

**Appendix J**: Student's T-test results for statistical significance for differences in days to issue an auditor's report

**Group A: Changes in days to issue new audit report - Companies with Market Capitalization Under £1 billion**

| | One-tailed Test | | Two-tailed Test | |
|---|---|---|---|---|
| | 1 Yr Prior | 2 Yrs Prior | 1 Yr Prior | 2 Yrs Prior |
| Paired | 0.150 | 0.009*** | 0.300 | 0.017** |
| Homoskedastic | 0.370 | 0.119 | 0.741 | 0.238 |
| Heteroskedastic | 0.370 | 0.119 | 0.741 | 0.238 |

*** p<0.01, ** p<0.05, * p<0.1

**Group B: Changes in days to issue new audit report - Companies with Market Capitalization greater than or equal to £1 billion and under £2 billion**

| | One-tailed Test | | Two-tailed Test | |
|---|---|---|---|---|
| | 1 Yr Prior | 2 Yrs Prior | 1 Yr Prior | 2 Yrs Prior |
| Paired | 0.437 | 0.055* | 0.874 | 0.029** |
| Homoskedastic | 0.444 | 0.049 | 0.946 | 0.315 |
| Heteroskedastic | 0.451 | 0.052 | 0.946 | 0.315 |

*** p<0.01, ** p<0.05, * p<0.1

**Group C: Changes in days to issue new audit report - Companies with Market Capitalization greater than or equal to £2 billion and under £5 billion**

| | One-tailed Test | | Two-tailed Test | |
|---|---|---|---|---|
| | 1 Yr Prior | 2 Yrs Prior | 1 Yr Prior | 2 Yrs Prior |
| Paired | 0.011** | 0.004*** | 0.022** | 0.008*** |
| Homoskedastic | 0.108 | 0.100* | 0.217 | 0.201 |
| Heteroskedastic | 0.108 | 0.101 | 0.217 | 0.201 |

*** p<0.01, ** p<0.05, * p<0.1

**Group D: Changes in days to issue new audit report - Companies with Market Capitalization £5 billion and over**

| | One-tailed Test | | Two-tailed Test | |
|---|---|---|---|---|
| | 1 Yr Prior | 2 Yrs Prior | 1 Yr Prior | 2 Yrs Prior |
| Paired | 0.054* | 0.207 | 0.108 | 0.415 |
| Homoskedastic | 0.304 | 0.357 | 0.608 | 0.715 |
| Heteroskedastic | 0.304 | 0.357 | 0.608 | 0.715 |

*** p<0.01, ** p<0.05, * p<0.1

## **Appendix K:** Student's T-test results for statistical significance for changes in audit fees

**Group A: Changes in Audit Fees - Companies with Market Capitalization Under £1 billion**

| | One-tailed Test | Two-tailed Test |
|---|---|---|
| Paired | 0.206 | 0.412 |
| Homoskedastic | 0.478 | 0.955 |
| Heteroskedastic | 0.478 | 0.955 |

*** p<0.01, ** p<0.05, * p<0.1

**Group B: Changes in Audit Fees - Companies with Market Capitalization greater than or equal to £1 billion and under £2 billion**

| | One-tailed Test | Two-tailed Test |
|---|---|---|
| Paired | 0.170 | 0.340 |
| Homoskedastic | 0.426 | 0.853 |
| Heteroskedastic | 0.426 | 0.853 |

*** p<0.01, ** p<0.05, * p<0.1

**Group C: Changes in Audit Fees - Companies with Market Capitalization greater than or equal to £2 billion and under £5 billion**

| | One-tailed Test | Two-tailed Test |
|---|---|---|
| Paired | 0.009*** | 0.018** |
| Homoskedastic | 0.379 | 0.758 |
| Heteroskedastic | 0.379 | 0.758 |

*** p<0.01, ** p<0.05, * p<0.1

**Group D: Changes in Audit Fees - Companies with Market Capitalization £5 billion and over**

| | One-tailed Test | Two-tailed Test |
|---|---|---|
| Paired | 0.141 | 0.282 |
| Homoskedastic | 0.452 | 0.904 |
| Heteroskedastic | 0.452 | 0.904 |

*** p<0.01, ** p<0.05, * p<0.1

# Why change the auditor's report?

Investors asked for more information about the audits of public companies. The current auditor's report has gone largely unaltered for 70 years, while public companies and their audits have become increasingly complex. The PCAOB invited public comment on a reproposal to enhance the auditor's report issued.

Download the PCAOB release to learn more about the proposed enhancements to the auditor's report.

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***In today's complex economy, and particularly in light of lessons learned after the financial crisis, investors want a better understanding of the judgments that go into an opinion … the specific judgments that were most critical to the auditor in arriving at the opinion.***

-- Chairman James R. Doty in his statement at the open Board meeting to consider the reproposal of the auditor's report

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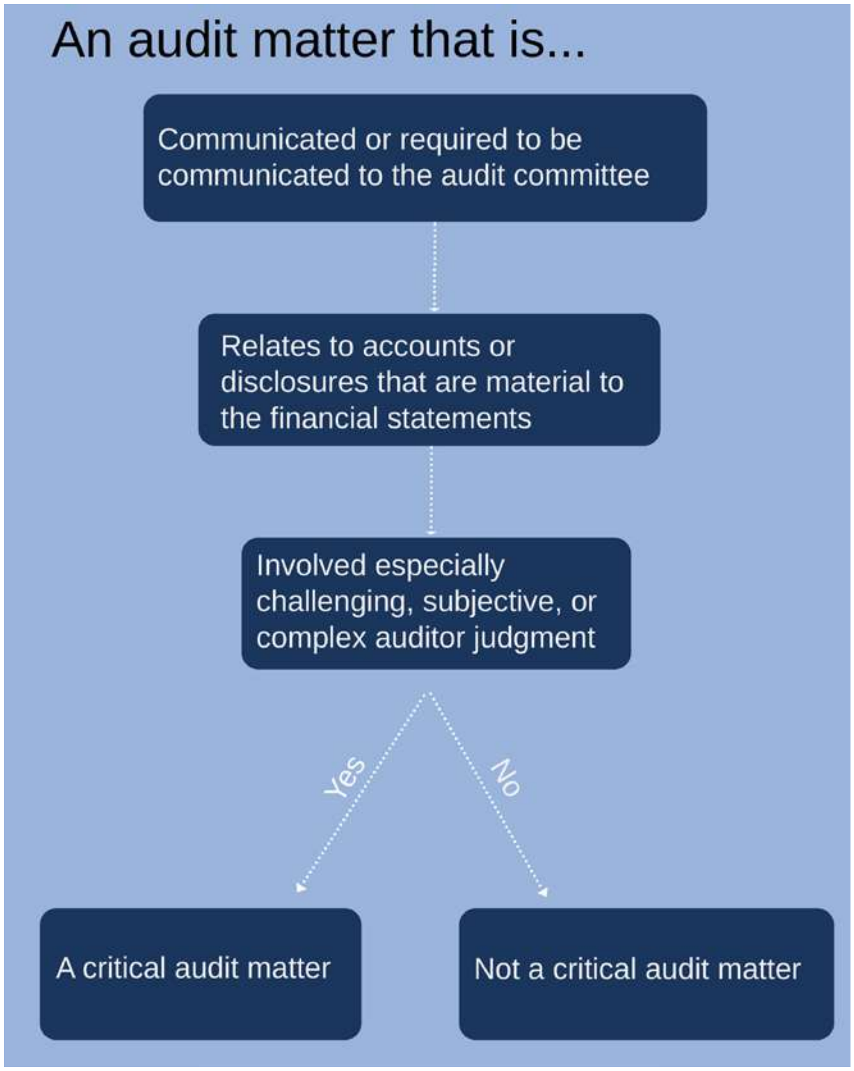
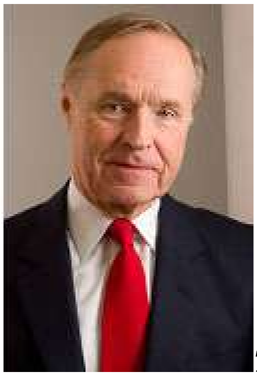
## What is a critical audit matter?

The reproposed standard would require auditors to communicate in the auditor's report the critical audit matters arising from an audit of a company's financial statements. When would an audit matter become a critical audit matter?



***The reproposed standard is meant to better arm investors with insight previously available to, and considered by, the auditors, but not ultimately evident in the auditor's report.***

-- Board Member Lewis H. Ferguson in his statement at the open Board meeting talking about the reproposal of the auditor's report

***The Board is taking another step forward in addressing questions about the relevance and usefulness of the standard auditor's report. This action … deals with one of the many elements contributing to the long-standing and multifaceted "expectations gap" between what investors and other financial statement users expect of independent auditors and what auditors deliver. Although this is a significant step forward in auditor reporting, it is a small step forward when considering the overall expectations gap related to auditor performance and reporting.***

-- Board Member Jeanette M. Franzel in her statement at the open Board meeting talking about the reproposal of the auditor's report

# Additional resources and information


PCAOB's reproposal was discussed at the May 18, 2016, Standing Advisory Group meeting. The Standing Advisory Group includes investors, auditors, public company executives, and others.


PCAOB staff described the reproposal at this open Board meeting. The meeting included Board member statements, as well as questions from Board members and PCAOB staff answers.

- Press Release: PCAOB Reproposes Standard to Enhance the Auditor's Report for Investors with Refined Requirements for Critical Audit Matters
- Fact Sheet on the Reproposed Standard on the Auditor's Report

Public comments are made available on the PCAOB website.

View the comments

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***The Board's statutory mandate is direct: "To protect the interest of investors ... in the preparation of informative, accurate and independent audit reports." In pressing to assure that audit reports are sufficiently explanatory and useful to investors, we are simply doing what Congress charged us to do and expected us to do -- namely provide "informative" reports, which is currently not the case in the view of most investors.***

-- Board Member Steven B. Harris in his statement at the open Board meeting talking about the reproposal of the auditor's report

PCAOB
Public Company Accounting Oversight Board

**Exhibit 2(a)(B)**

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| 1 | Aerospace Industries Association |
| 2 | Aetna Inc., CIGNA Corporation, Humana Inc., UnitedHealth Group Incorporated, and WellPoint Inc. |
| 3 | Fatima Alali, California State University Fullerton |
| 4 | American Academy of Actuaries |
| 5 | American Bankers Association |
| 6 | American Electric Power Company, Inc. |
| 7 | American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) |
| 8 | American Federation of State, County and Municipal Employees |
| 9 | American Gas Association |
| 10 | Douglas J. Anderson, CPA, CIA |
| 11 | Apple, Inc. |
| 12 | Association of Chartered Certified Accountants (ACCA) |
| 13 | Auditing and Assurance Standards Board |
| 14 | Auditing Standards Committee, Auditing Section - American Accounting Association |
| 15 | Bank of New York Mellon Corporation |
| 16 | Chris Barnard, Actuary |
| 17 | BDO USA, LLP |
| 18 | Dennis R. Beresford, Ernst & Young Executive Professor of Accounting, The |

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| | University of Georgia, J.M. Tull School of Accounting |
| 19 | BerryDunn |
| 20 | Biotechnology Industry Organization |
| 21 | BKD, LLP |
| 22 | BlackRock, Inc. |
| 23 | California Public Employees' Retirement System (CalPERS) |
| 24 | California Society of Certified Public Accountants |
| 25 | Canadian Public Accountability Board |
| 26 | Capital Research and Management Company (2 Letters) |
| 27 | CC Media Holdings, Inc. |
| 28 | Center for Audit Quality (2 Letters) |
| 29 | Certain members of the PCAOB's Investor Advisory Group |
| 30 | CFA Institute |
| 31 | Vanessa C.L. Chang |
| 32 | Chevron Corporation |
| 33 | Cleary Gottlieb Steen & Hamilton LLP |
| 34 | CMS Energy Corporation and Consumers Energy Company |
| 35 | CNA Financial Corporation |
| 36 | Cole Real Estate Investments |
| 37 | Colorado Public Employees' Retirement Association |
| 38 | Core Mark Holding Company, Inc. |
| 39 | Council of Institutional Investors |
| 40 | CPA Australia |
| 41 | Crowe Horwath LLP |
| 42 | Deloitte & Touche LLP |
| 43 | Dodge & Cox |
| 44 | Edison Electric Institute |
| 45 | Eide Bailly LLP |
| 46 | Eli Lilly and Company |

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| 47 | Emerson |
| 48 | Endurance Specialty Holdings Ltd. |
| 49 | Ernst & Young LLP |
| 50 | Express, Inc. |
| 51 | Exxon Mobil Corporation |
| 52 | Federal Deposit Insurance Corporation; Board of Governors of the Federal Reserve System; National Credit Union Administration; Office of the Comptroller of the Currency |
| 53 | Federal Housing Finance Agency |
| 54 | Federated Investors, Inc. |
| 55 | Federation of European Accountants (FEE) |
| 56 | Financial Executives International |
| 57 | Financial Reporting Council |
| 58 | FirstEnergy |
| 59 | Florida Institute of Certified Public Accountants |
| 60 | FMR LLC (Fidelity) |
| 61 | James L. Fuehrmeyer, Jr., Associate Teaching Professor, Mendoza College of Business, University of Notre Dame |
| 62 | Goodrich Corporation |
| 63 | Grant Thornton LLP |
| 64 | Scott E. Green, CPA, CMA |
| 65 | Hansen, Barnett & Maxwell, P.C. |
| 66 | Michael Hemingway |
| 67 | Hermes Equity Ownership Services Limited |
| 68 | Hess Corporation |
| 69 | Hilton Worldwide, Inc. |
| 70 | Illinois CPA Society |
| 71 | Independent Community Bankers of America |
| 72 | Independent Directors Council |
| 73 | Institute Der Wirtschaftsprüfer |

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| 74 | Institute of Chartered Accountants Australia |
| 75 | Institute of Internal Auditors |
| 76 | Institute of Management Accountants |
| 77 | Integrys Energy Group, Inc. |
| 78 | Intel Corporation |
| 79 | Invacare Corporation |
| 80 | Investment Company Institute |
| 81 | Jacobs Engineering Group Inc. |
| 82 | KPMG LLP |
| 83 | Liberty Global, Inc. |
| 84 | Liberty Mutual Group |
| 85 | Limited Brands, Inc. |
| 86 | Markel Corporation |
| 87 | Massachusetts Society of Certified Public Accountants, Inc. |
| 88 | Maxim Integrated Products, Inc. |
| 89 | Mayer Hoffman McCann P.C. |
| 90 | Mike Mayo, CFA; Chris Spahr, CFA |
| 91 | McGladrey LLP |
| 92 | Meritor, Inc. |
| 93 | MetLife, Inc. |
| 94 | National Association of Corporate Directors |
| 95 | National Association of State Boards of Accountancy (NASBA) |
| 96 | National Retail Federation |
| 97 | New Jersey Society of Certified Public Accountants |
| 98 | New York State Society of Certified Public Accountants (NYSSCPA) |
| 99 | NextEra Energy, Inc. |
| 100 | Nike, Inc. |
| 101 | Northrim Bank |
| 102 | Northrop Grumman |

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| 103 | Nucor Corporation |
| 104 | Oakwood Enterprises |
| 105 | Thomas P. O'Connor, Certified Public Accountant |
| 106 | Mary Ellen Oliverio, CPA |
| 107 | PAA Natural Gas Storage |
| 108 | Pfizer Inc. |
| 109 | Piercy Bowler Taylor & Kern, Certified Public Accountants |
| 110 | Plains All American Pipeline, L.P. |
| 111 | Plum Creek Timber Company, Inc. |
| 112 | PNM Resources, Inc. |
| 113 | PPL Corporation |
| 114 | Praxair, Inc. |
| 115 | PricewaterhouseCoopers LLP |
| 116 | R.G. Associates, Inc. |
| 117 | Radin, Glass & Co., LLP |
| 118 | Retail Industry Leaders Association |
| 119 | Rockwell Collins, Inc. |
| 120 | Rosen Seymour Shapss Martin & Company LLP |
| 121 | Ralph S. Saul |
| 122 | Suzanne Hamlet Shatto |
| 123 | Senior Resource Group |
| 124 | Arthur Siegel |
| 125 | William W. Sihler, MBA, DBA, Ronald E. Trzcinski Professor of Business Administration, University of Virginia |
| 126 | Edward F. Smith, MBA and CPA, Adjunct Professor, St. John's University |
| 127 | Society of Corporate Secretaries & Governance Professionals |
| 128 | Robert J. Sonnelitter, CPA |
| 129 | State Street |
| 130 | Sullivan & Cromwell LLP |
| 131 | SwissHoldings |

| Alphabetical List of Commenters on the Concept Release in PCAOB Release No. 2011-003 | |
|---|---|
| 132 | Synopsys, Inc. |
| 133 | Tesoro Corporation |
| 134 | The AES Corporation |
| 135 | The Financial Reporting Committee and the Securities Regulation Committee of the Association of the Bar of the City of New York |
| 136 | The Hertz Corporation |
| 137 | The Home Depot, Inc. |
| 138 | The Institute of Chartered Accountants in England and Wales (ICAEW) |
| 139 | The South African Institute of Chartered Accountants (SAICA) |
| 140 | TRW Automotive Holdings Corp. |
| 141 | U.S. Chamber of Commerce, Center for Capital Markets Competitiveness |
| 142 | UHY LLP |
| 143 | United Parcel Service, Inc. |
| 144 | United States Government Accountability Office (GAO) |
| 145 | United Therapeutics Corporation |
| 146 | Unum Group |
| 147 | USG Corporation |
| 148 | Vanguard |
| 149 | Gilbert F. Viets |
| 150 | ViewPoint Bank |
| 151 | Virginia Society of Certified Public Accountants |
| 152 | Tomasz Walkosz |
| 153 | Stephen A. Zeff, Rice University |
| | |
| | |

PCAOB
Public Company Accounting Oversight Board

**Exhibit 2(a)(B)**

**Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005**

| | |
|---|---|
| 1 | Acuity Brands |
| 2 | Aerospace Industries Association |
| 3 | Agrium |
| 4 | AK Steel Corporation |
| 5 | American Bankers Association |
| 6 | American Council of Life Insurers |
| 7 | American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) |
| 8 | American Funds |
| 9 | American Gas Association |
| 10 | Hasan Andalib |
| 11 | Annaly Capital Management, Inc. |
| 12 | Anworth Mortgage Asset Corporation |
| 13 | Apple, Inc. |
| 14 | ARK Global LLC |
| 15 | Arrow Investments, Inc. |
| 16 | Association of Chartered Certified Accountants (ACCA) |
| 17 | Association of the Bar of the City of New York |
| 18 | Audit Committee of the Board of Directors, Microsoft Corporation |
| 19 | Auditing and Assurance Standards Board (Canada) |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 20 | Autodesk |
| 21 | AutoNation, Inc. |
| 22 | Chris Barnard, Actuary |
| 23 | Barnard/Montague Capital Advisors |
| 24 | Theresa Barnett, CPA |
| 25 | BBD, LLP |
| 26 | BDO USA, LLP |
| 27 | Carolyn D. Beaver |
| 28 | Dennis R. Beresford, Executive in Residence, The University of Georgia, J.M. Tull School of Accounting |
| 29 | Biotechnology Industry Organization |
| 30 | BlackRock, Inc. |
| 31 | Booz Allen Hamilton |
| 32 | BP p.l.c. |
| 33 | Bridge Street Advisors |
| 34 | California Public Employees' Retirement System (CalPERS) |
| 35 | California Society of Certified Public Accountants |
| 36 | California State Teachers' Retirement System |
| 37 | Canadian Bankers Association |
| 38 | Canadian Public Accountability Board |
| 39 | Capital Group |
| 40 | Joseph V. Carcello, EY and Business Alumni Professor, Executive Director-Corporate Governance Center, The University of Tennessee |
| 41 | Pw Carey (2 Letters) |
| 42 | Catapult Advisors LLC |
| 43 | Center for Audit Quality (3 Letters) |
| 44 | CFA Institute |
| 45 | Cherry Bekaert LLP |
| 46 | Chevron Corporation |
| 47 | Cirrus Logic Inc. |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 48 | Cisco Systems, Inc. |
| 49 | Citrin Cooperman & Company, LLP |
| 50 | Peter Clapman |
| 51 | Cleary Gottlieb Steen & Hamilton LLP |
| 52 | CMS Energy Corporation and Consumers Energy Company |
| 53 | Coca-Cola Enterprises, Inc. |
| 54 | CohnReznick LLP |
| 55 | Colorado Financial Service Corporation |
| 56 | Colorado Public Employees' Retirement Association |
| 57 | Comcast Corporation (2 Letters) |
| 58 | Committee on Capital Markets Regulation |
| 59 | Compagnie Nationale des Commissaires Aux Comptes (CNCC), Conseil Superieur de l'Ordre des Experts-Comptables (CSOEC) |
| 60 | ConocoPhillips Company (2 Letters) |
| 61 | Consumer Federation of America |
| 62 | Coordinated Capital Securities, Inc. |
| 63 | John Cornish |
| 64 | Costco Wholesale Corporation |
| 65 | Council of Institutional Investors (2 Letters) |
| 66 | Lauren Craft |
| 67 | Crowe Horwath LLP |
| 68 | CUSO Financial Services LP; Sorrento Pacific Financial, LLC |
| 69 | Cutter & Company, Inc. |
| 70 | Cytec Industries Inc. |
| 71 | Rick Dahl, EVP, Sorrento Pacific Financial, LLC; Chief Compliance Officer, CUSO Financial Services, LP |
| 72 | Davis Polk & Wardwell LLP |
| 73 | Deloitte & Touche LLP |
| 74 | Denning and Company, LLC |
| 75 | Boh A. Dickey, CPA |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 76 | DIRECTV |
| 77 | Dorsey & Company, Inc. |
| 78 | DTE Energy Company |
| 79 | Edison Electric Institute |
| 80 | Edison International and Southern California Edison Company |
| 81 | J. Edmunds |
| 82 | Eide Bailly LLP |
| 83 | Eli Lilly and Company |
| 84 | Emerson |
| 85 | Entergy Corporation |
| 86 | Ernst & Young LLP |
| 87 | Express Scripts Holding Company |
| 88 | Exxon Mobil Corporation |
| 89 | FBL Financial Group, Inc. |
| 90 | Federal Deposit Insurance Corporation; Board of Governors of the Federal Reserve System; National Credit Union Administration; Office of the Comptroller of the Currency |
| 91 | Federal Housing Finance Agency |
| 92 | Federation of European Accountants (FEE) |
| 93 | FedEx Corporation |
| 94 | Financial Executives International |
| 95 | Financial Telesis Inc. |
| 96 | FirstEnergy Corp. |
| 97 | Fitzgibbon Toigo & Co. LLC |
| 98 | Florida Institute of Certified Public Accountants |
| 99 | FMR LLC (Fidelity Investments) |
| 100 | FMV Capital Markets, Inc. |
| 101 | James L. Fuehrmeyer, Jr., Associate Teaching Professor, Mendoza College of Business, Department of Accountancy, University of Notre Dame |
| 102 | GCA Savvian Advisors |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 103 | Dr. Steven Glover, Accounting Professor, Brigham Young University; Dr. Christopher Wolfe, Accounting Professor, Texas A & M University; Brant Christensen, Ph.D candidate, Texas A & M University |
| 104 | Goal Consulting LLC |
| 105 | Goldcorp, Inc. |
| 106 | Kevin Gomez |
| 107 | GrandFund Investment Group, LLC |
| 108 | Grant Thornton LLP |
| 109 | Hamersley Partners |
| 110 | Havener Capital Partners LLC |
| 111 | Jack Henry |
| 112 | Healthcare Realty Trust |
| 113 | Hermes Equity Ownership Services |
| 114 | Higgins Capital Management, Inc. |
| 115 | Host Hotels & Resorts, Inc. |
| 116 | Husky Energy Inc. |
| 117 | IDACORP, Inc.; Idaho Power Company (2 Letters) |
| 118 | Illinois CPA Society |
| 119 | Independent Community Bankers of America |
| 120 | Independent Directors Council; Investment Company Institute |
| 121 | Informatica Corporation |
| 122 | Institut der Wirtschaftsprufer (IDW) |
| 123 | Institute of Chartered Accountants Australia |
| 124 | Institute of Management Accountants |
| 125 | Intel Corporation |
| 126 | Invesco Advisers, Inc. |
| 127 | Investment Company Institute |
| 128 | Karim Jamal, CA Chair Professor; Shyam Sunder, James L. Frank Professor, University of Alberta, Alberta School of Business; Yale University, Yale School of Management |
| 129 | Philip Johnson |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 130 | Kentucky Society of Certified Public Accountants |
| 131 | Tae Kim, MBA student |
| 132 | KPMG LLP |
| 133 | L Brands, Inc. |
| 134 | Leon J. Level |
| 135 | Yoobin Liang |
| 136 | Ivy Liao |
| 137 | Joseph A. Maffia, CPA, Professor, Hunter College Graduate Program |
| 138 | Manufacturers Alliance for Productivity (MAPI) |
| 139 | Marcum LLP |
| 140 | MasterCard Incorporated |
| 141 | Maxim Integrated Products, Inc. |
| 142 | Mayer Hoffman McCann P.C. |
| 143 | Blythe J. McGarvie |
| 144 | McGladrey LLP |
| 145 | Medtronic, Inc. |
| 146 | MetLife, Inc. |
| 147 | MFS Investment Management |
| 148 | Theodore J. Mock, University of California, Riverside; Jean Bedard, Universite Laval; Paul Coram, University of Melbourne; Reza Espahbodi, Washburn University; Rick C. Warne, George Mason University |
| 149 | Monahan & Roth, LLC |
| 150 | C.H. Moore, Jr., CPA |
| 151 | Mutual Fund Directors Forum |
| 152 | National Asian American Coalition |
| 153 | National Association of Corporate Directors |
| 154 | National Association of Real Estate Investment Trusts |
| 155 | National Association of State Boards of Accountancy (NASBA) |
| 156 | Natural Alternatives International, Inc |
| 157 | New Jersey Society of Certified Public Accountants |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 158 | New York State Society of CPAs (NYSSCPA) |
| 159 | NextEra Energy, Inc. |
| 160 | Nike, Inc. |
| 161 | Nordstrom & Associates, P.C. |
| 162 | Nucor Corporation |
| 163 | Mary Ellen Oliverio |
| 164 | Svitlana Orekhova |
| 165 | Pennsylvania Institute of Certified Public Accountants |
| 166 | Pfizer Inc. |
| 167 | PGP Capital Advisors, LLC |
| 168 | John L. Pierschbacher, Investor |
| 169 | Plains All American Pipeline, L.P. |
| 170 | PNC Financial Services Group, Inc. |
| 171 | PNM Resources, Inc. |
| 172 | PPL Corporation |
| 173 | S. Prabhakaran |
| 174 | Praxair, Inc. |
| 175 | PricewaterhouseCoopers LLP |
| 176 | Tyler L. Prince |
| 177 | Pursuit Capital Marketing, LLC |
| 178 | Q Advisors |
| 179 | Qualcomm Incorporated |
| 180 | R.G. Associates, Inc. |
| 181 | Radin, Glass & Co., LLP |
| 182 | Renee Della Ratta |
| 183 | Regional Brokers Inc |
| 184 | Regions Financial Corporation |
| 185 | Daniel C. Regis |
| 186 | Rhodes Securities Incorporated |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 187 | John R. Roberts |
| 188 | RW Smith |
| 189 | Faraz Saleem |
| 190 | Geoff Sanders, Jacobs Engineering Group, Inc. |
| 191 | Arnold Schanfield, CIA, CPA |
| 192 | Sempra Energy |
| 193 | Sentinel Brokers Company, Inc. |
| 194 | SIFMA |
| 195 | Society of Corporate Secretaries & Governance Professionals |
| 196 | Sorrento Pacific Financial, LLC |
| 197 | Southwestern Energy Company |
| 198 | Standard & Poor's Ratings Services |
| 199 | State Board of Administration of Florida |
| 200 | State Street Corporation |
| 201 | Sullivan & Cromwell LLP |
| 202 | Greg Swalwell |
| 203 | Targa Resources Corp; Targa Resources Partners LP |
| 204 | Teachers Financial Investment Corporation |
| 205 | Tesoro Corporation |
| 206 | Tessera Capital Partners, LLC |
| 207 | Texas Society of Certified Public Accountants |
| 208 | The Clearing House Association L.L.C. |
| 209 | The Goodyear Tire & Rubber Company |
| 210 | The Institute of Chartered Accountants in England and Wales (ICAEW) |
| 211 | The Japanese Institute of Certified Public Accountants |
| 212 | The Laclede Group, Inc. |
| 213 | The Ohio Society of CPAs, Accounting & Auditing Committee, and Public Company Subcommittee |
| 214 | The Travelers Companies, Inc. |
| 215 | The Walt Disney Company |

| Alphabetical List of Commenters on the Proposal in PCAOB Release No. 2013-005 | |
|---|---|
| 216 | TIAA-CREF |
| 217 | Tim Hortons Inc. |
| 218 | Transocean Ltd. |
| 219 | TRW Automotive Holdings Corp. |
| 220 | Tullett Prebon |
| 221 | Tyco International Ltd. |
| 222 | Tyson Foods, Inc. |
| 223 | U.S. Chamber of Commerce, Center for Capital Markets Competitiveness |
| 224 | Union First Market Bankshares, Corporation |
| 225 | United Continental Holdings, Inc. |
| 226 | United States Government Accountability Office (GAO) |
| 227 | UNS Energy Corp. |
| 228 | Vanguard |
| 229 | Verizon Communications Inc. |
| 230 | Gilbert F. Viets |
| 231 | Visa Inc. |
| 232 | Washington Real Estate Investment Trust |
| 233 | Robert N. Waxman, CPA |
| 234 | WeiserMazars LLP |
| 235 | Wells Fargo & Company |
| 236 | Williams |
| 237 | Wolf & Company, P.C. |
| 238 | Woodruff-Sawyer & Co. |
| 239 | Wulff, Hansen & Co. |
| 240 | XT Capital Partners |
| 241 | Emily Zhang |
| | |
| | |

PCAOB
Public Company Accounting Oversight Board

**Exhibit 2(a)(B)**

**Alphabetical List of Commenters on the Reproposal in PCAOB Release No. 2016-003**

| | |
|---|---|
| 1 | Aberdeen Asset Management PLC |
| 2 | American Bankers Association |
| 3 | American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) |
| 4 | American Funds |
| 5 | ArcBest Corporation |
| 6 | Auditing Standards Committee, Auditing Section - American Accounting Association |
| 7 | BDO USA, LLP |
| 8 | Dennis R. Beresford, Executive in Residence, The University of Georgia, J.M. Tull School of Accounting |
| 9 | CA, Inc. |
| 10 | California Public Employees' Retirement System (CalPERS) |
| 11 | California Society of Certified Public Accountants |
| 12 | California State Teachers' Retirement System |
| 13 | Career Education Corporation |
| 14 | Center for Audit Quality |
| 15 | CFA Institute |
| 16 | Cherry Bekaert LLP |
| 17 | Chevron Corporation |
| 18 | Ciro E. Adams, CPA, LLC |

| Alphabetical List of Commenters on the Reproposal in PCAOB Release No. 2016-003 | |
|---|---|
| 19 | Cleary Gottlieb Steen & Hamilton LLP |
| 20 | CME Group |
| 21 | CMS Energy Corporation and Consumers Energy Company |
| 22 | Colorado Public Employees' Retirement Association |
| 23 | ConocoPhillips Company (2 Letters) |
| 24 | Council of Institutional Investors |
| 25 | Crowe Horwath LLP |
| 26 | Deloitte & Touche LLP |
| 27 | Sean A. Dennis, Assistant Professor, University of Kentucky; Jeremy B. Griffin, Assistant Professor, University of Mississippi; Karla M. Johnstone, EY Professor of Accounting, University of Wisconsin-Madison |
| 28 | Dixon Hughes Goodman LLP |
| 29 | Edison Electric Institute (EEI); American Gas Association |
| 30 | Edison International and Southern California Edison Company |
| 31 | Eli Lilly and Company |
| 32 | Entergy Corporation |
| 33 | Ernst & Young LLP |
| 34 | Federation of European Accountants (FEE) |
| 35 | FedEx Corporation |
| 36 | Financial Executives International |
| 37 | Florida Institute of Certified Public Accountants |
| 38 | Stephen H. Fuller, Visiting Assistant Professor, Lehigh University |
| 39 | Dr. Steven Glover, Associate Dean and K. Fred Skousen Professor, Brigham Young University; Dr. James Hansen, Associate Professor, Weber State University; Dr. Timothy Seidel, Assistant Professor, Brigham Young University |
| 40 | Grant Thornton LLP |
| 41 | Hermes Equity Ownership Services |
| 42 | Hess Corporation |
| 43 | Illinois CPA Society |
| 44 | Independent Directors Council; Investment Company Institute |
| 45 | Independent Regulatory Board for Auditors |

| Alphabetical List of Commenters on the Reproposal in PCAOB Release No. 2016-003 | |
|---|---|
| 46 | Institut der Wirtschaftsprufer (IDW) |
| 47 | Institute of Management Accountants |
| 48 | International Corporate Governance Network |
| 49 | Yoon Ju Kang, University of Massachusetts, Amherst |
| 50 | Annette G. Koehler, Professor, University of Duisburg-Essen; Nicole V. S. Ratzinger-Sakel, Professor, University of Hamburg; Jochen C. Theis, Assistant Professor, University of Duisburg-Essen |
| 51 | KPMG LLP |
| 52 | MFS Investment Management |
| 53 | David Moskowitz |
| 54 | Richard H Murray |
| 55 | National Association of Corporate Directors |
| 56 | National Association of Real Estate Investment Trusts |
| 57 | National Association of State Boards of Accountancy |
| 58 | New Jersey Society of Certified Public Accountants |
| 59 | New York State Society of Certified Public Accountants (NYSSCPA) |
| 60 | Nordstrom & Associates, P.C. |
| 61 | Northrop Grumman Corporation |
| 62 | PCAOB Investor Advisory Group, Auditor's Report Working Group |
| 63 | Pennsylvania Institute of Certified Public Accountants |
| 64 | Pfizer Inc. |
| 65 | Phillips Edison & Company |
| 66 | Plante & Moran PLLC |
| 67 | PricewaterhouseCoopers LLP |
| 68 | R.G. Associates, Inc. |
| 69 | Retail Industry Leaders Association |
| 70 | John R. Roberts |
| 71 | RSM US LLP |
| 72 | RSR Corporation |
| 73 | Securities Industry and Financial Markets Association (SIFMA) |

| Alphabetical List of Commenters on the Reproposal in PCAOB Release No. 2016-003 | |
|---|---|
| 74 | Kecia Williams Smith, Assistant Professor, Virginia Polytechnic Institute and State University, Pamplin College of Business, Department of Accounting and Information Systems |
| 75 | Thomas H. Spitters, C.P.A. |
| 76 | State Street Corporation |
| 77 | Greg Swalwell |
| 78 | Texas Society of Certified Public Accountants |
| 79 | The Capital Group Companies, Inc. |
| 80 | The Institute of Chartered Accountants in England and Wales (ICAEW) |
| 81 | The Marco Consulting Group |
| 82 | U.S. Chamber of Commerce, Center for Capital Markets Competitiveness |
| 83 | United States Government Accountability Office (GAO) |
| 84 | United States Securities and Exchange Commission, Office of the Investor Advocate |
| 85 | UnitedHealth Group, Inc. |
| 86 | Robert N. Waxman, CPA |
| 87 | Wells Fargo & Company |

AEROSPACE INDUSTRIES ASSOCIATION

September 27, 2011

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

Re: Request for Public Comment on Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards and Notice of Roundtable (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34)

Dear Members and Staff of the Public Company Accounting Oversight Board:

Thank you for providing the Aerospace Industries Association ("AIA") an opportunity to share our view on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards ("the Concept Release"), issued by the Public Company Accounting Oversight Board ("the Board") on June 21, 2011. AIA is the premier aerospace industry trade association representing the nation's major manufacturers of commercial, military and business products such as aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment.

We are supportive of the Board's efforts to address the financial reporting concerns of investors and other users of financial statements, especially in light of the recent global financial crisis. We believe that improvements to financial reporting can best be achieved through clarifying changes to the audit report by the PCAOB coupled with continued targeted standard-setting by the Financial Accounting Standards Board ("FASB") and Securities and Exchange Commission ("SEC"). It would be most helpful to investors to clarify the purpose of an audit, the responsibilities of management, and the responsibilities of the auditor. Further, it would be useful to clarify the auditor's existing responsibility with respect to financial information presented outside of the financial statements and provide reference to PCAOB audit standards. Both FASB and the SEC have been responsive to investor needs since the financial crisis of 2008, as evidenced by, among other things, FASB requiring additional disclosures regarding the credit quality of financing receivables and the SEC requiring comprehensive disclosure of short-term borrowings.

We believe that additional, targeted standard-setting could promote greater transparency in disclosure for complex transactions. Furthermore, ongoing standard-setting projects at the FASB are focused on improving disclosures. For example, according to FASB, the desired result of its Disclosure Framework project is a "net reduction in disclosure volume and a net increase in the utility of the information disclosed." We understand that FASB is creating a decision process that will result in financial statement disclosures focused on matters that are most important to the users of a particular entity's financial statements. It is important for this project to be completed and implemented so that its impact on financial reporting can be determined.

Aerospace Industries Association of America, Inc.
1000 Wilson Boulevard, Suite 1700 Arlington, VA 22209-3928 (703) 358-1000 www.aia-aerospace.org

In the following paragraphs, we provide additional feedback on the ideas presented in the Concept Release:

The form of the auditor's report should be limited to providing an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows of reporting companies in conformity with the applicable financial reporting framework. We would support changes to the audit report that would clarify the purpose of an audit, the responsibilities of management, and the responsibilities of the auditor. Additionally, we support changes that would clarify the auditor's existing responsibility with respect to financial information presented outside of the financial statements (e.g., AU sec. 550) and provide reference to PCAOB audit standards or other summary documents that provide additional information about public company audits and auditors (e.g., Center for Audit Quality's recently published "*In-Depth Guide to Public Company Auditing: The Financial Statement Audit*").

Management's responsibility for the financial information of a company and the current segregation of responsibility among management, the audit committee and the auditor should be preserved. Management should be the original source of financial information about a company. Management of a company has a very deep knowledge and understanding of its industry, business strategy, and risk factors and their impact on current and future financial results. While an auditor learns about a company's accounting policies and procedures through an audit, their focus is on whether the financial statements are presented in conformity with prescribed accounting rules rather than the broader business risks (e.g. supply chain, environmental, operational, etc.) that can impact future financial results. A discussion of the company's financial information by the auditor could result in greater confusion for the investor and give the impression that the auditor is providing something other than an unqualified audit opinion. The issuance of an unqualified audit opinion should remain a statement to the investor that all material matters related to the audit have been resolved to the mutual satisfaction of management, the audit committee, and the auditor. Further analysis would be required to determine how an affirmative disclosure obligation might impact auditors' independence and objectivity. For example, might direct disclosure responsibilities, and the associated liability risk, impact the way auditors analyze corporate transactions?

We are concerned with the addition of an Auditor's Discussion and Analysis ("AD&A") supplement to the auditor's report for several reasons:

- First, we believe that a discussion of the company's financial information provided by the auditor could result in greater confusion for the investor and give the impression that the auditor is qualifying its audit opinion. As previously stated, the issuance of an unqualified opinion should be a signal to investors that all material items have been resolved and fairly presented in the financial statements.

- Second, investors are inundated with financial information in the form of audited financial statements and disclosures, Management Discussion and Analysis (MD&A), and Earnings Releases. We do not believe that the introduction of additional information through an AD&A will help investors better understand the company's financial statements or associated audit risks, audit procedures and results of audit procedures.

Rather, we feel that additional information presented by the auditor may lead to confusion as to which party is responsible for financial information and introduce additional risk to the company and audit firm.

- Third, the AD&A as presented in the Concept Release would be similar to the communications that currently take place between the auditor and the audit committee. While this sounds like a good solution, the two-way communication that takes place between the auditor and audit committee would be missing. We believe this dialogue is a key element of the communication process and that without it, the written words could be taken out of context and used incorrectly in making investment decisions. The auditor's views should be shared with the Audit Committee through the existing communication process -- it is ultimately management's responsibility to ensure that disclosures are transparent and fair.

- Fourth, the drafting of an AD&A supplement by the auditor could take a significant amount of the auditor's time. It could also lengthen the timetable between when a company closes its books and files its financial statements with the SEC, increasing audit costs and delaying the release of much anticipated financial information that would help investors manage their portfolios.

- Fifth, it is critical that open dialogue between auditors and audit committees be preserved, and this proposal could limit those discussions. In order to protect themselves against liability from eager plaintiffs' attorneys who seek comprehensive discussions of all deliberations, auditors will be incentivized to "over-disclose" in AD&A supplements, and include records of all discussions with management and audit committees. This practice would, in turn, convert audit committee meetings into formulaic, compliance-driven "check-the-box" sessions and eliminate the dynamic of open dialogue that is critical to effective governance.

Likewise, we are concerned with the proposed use of emphasis paragraphs. We believe that required use of emphasis paragraphs may give investors the impression that the audit opinion is being qualified in some manner and would unduly focus investors on certain components of the financial statements. We also believe that the use of emphasis paragraphs would result in a de facto "super-materiality" standard for corporate disclosures, in which plaintiffs' lawyers seek damages not only when risks are undisclosed, but when they are disclosed "only" in a company's filings but not called out specifically for emphasis by auditors. The end result, of course, would be longer auditor reports and even less attention paid to making the primary disclosures accurate and transparent. We believe that investors should be reading financial statements and notes thereto along with the MD&A and Earnings Releases in their entirety to gain a full picture of the financial health and risks of the company rather than focusing on specific aspects highlighted by the auditor. We believe that risk of misinterpretation of auditor's comments would introduce even greater risk to the capital markets.

We are concerned about auditor assurance requirements for information outside the financial statements. While some of the information comes directly from the financial statements, much of the information contained in the MD&A and Earnings Release is not derived from or coming directly from the financial statements or the information is forward looking in nature, which would be very difficult, if not impossible, to audit. We believe that if the scope of information contained in these documents were limited to what can be independently verified by the auditor, management would be forced to limit its communications with investors. This would be a negative consequence given that investors are able to gain an independent understanding of management's ability to estimate through its comparison of actual results versus the guidance that is currently provided in Earnings Releases. As with the AD&A and required emphasis paragraphs, requiring assurance on management's forward-looking financial information contained in the MD&A and Earnings Release would lengthen the timetable between when a company closes its books, releases earnings and files its financial statements with the SEC. This would increase audit costs and divert management's attention to past financial results for a longer period of time when they should be focused on current operations. In addition, requiring auditor assurance on these disclosures could deter companies from including forward-looking analysis or management perspective in these documents in the first place. Furthermore, auditors cannot take advantage of the SEC's safe harbor rules applicable to forward-looking information, with the result being that auditors' liability for inaccuracies in such disclosures would actually go beyond those of the issuers themselves. Such a result could put further pressure on issuers to eliminate such statements entirely, reducing transparency for investors.

We also believe it is noteworthy that current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., MD&A). As described in the release, these responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact. As mentioned above, it may be helpful to investors to describe the auditor's responsibilities related to financial information outside the financial statements in the auditor's report.

In summary, we are supportive of the Board's efforts to introduce alternatives to the audit reporting model that would meet the needs of investors and be practical for management, audit committees and audit firms to adopt in a cost-effective manner. We believe that the focus should not be on providing more information to investors but improving the quality of information to investors. We believe that better information can be provided through a combination of clarifying changes to the audit report by the PCAOB coupled with targeted standard-setting by the FASB or SEC.

We appreciate the opportunity to present our views on this subject and welcome the opportunity to meet in person to review them with you. Thank you for your attention and consideration.

Best regards,

Susan K. Tonner

Susan K. Tonner
Assistant Vice President
Acquisition Policy

September 28, 2011

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

**RE: Rulemaking Docket Matter No. 34**
**Concept Release on Possible Revisions to PCAOB Standards**
**Related to Reports on Audited Financial Statements**

Dear Members of the Board,

We are the five leading publicly-traded managed care companies in the United States: Aetna Inc., CIGNA Corporation, Humana Inc., UnitedHealth Group Incorporated, and WellPoint Inc. As a group, we provide health insurance products and related services to more than 100 million medical members. Our customers include employer groups, individuals, seniors, college students, part-time and hourly workers, governmental units, government-sponsored plans, labor groups, and expatriates. We also provide other insurance products, such as dental, vision, term life, short-term and long-term disability, and supplemental health insurance coverage as well as a variety of healthcare-related services that do not involve insurance products. Collectively we reported annual revenues of approximately $242 billion in 2010 (equivalent to 1.7 percent of the gross domestic product of the United States). We primarily report financial information under the generally accepted accounting principles in the United States ("U.S. GAAP"), and we file public financial statements in accordance with the regulations of the United States Securities and Exchange Commission (the "SEC").

We appreciate the opportunity to provide our comments in response to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release"). The views expressed in this letter and the attached appendix on behalf of our collective group do not necessarily represent the positions of any specific company or individual.

It is our understanding that the Board is seeking feedback on several alternatives for changing the auditor's reporting model in an effort to increase transparency and relevance to financial statement users. Specifically, the proposed alternatives include one or a combination of the following: 1) a supplement to the auditor's report in which the firm would be required to provide additional information about the audit and our financial statements (an "Auditor's Discussion and Analysis" or "AD&A"), 2) required and expanded use of emphasis paragraphs in the auditor's report, 3) auditor reporting on information outside the financial statements, and 4) clarification of certain language in the auditor's report. The detailed discussions and illustrative examples in the Concept Release were useful in helping us understand exactly how the Board envisions these alternatives taking shape. Although we are not in the business of performing audits and providing assurance, and therefore might have different views than the firms that audit our public financial statements, the types of changes presented in the Concept Release nonetheless have the potential to significantly alter the public financial reporting landscape in which we operate.

Under the current distinct frameworks that govern financial reporting and auditing, the roles of all parties involved are clear. *Companies* are responsible for compiling and disclosing financial information in accordance with U.S. GAAP and SEC reporting requirements for the purpose of providing users of financial statements with relevant, useful information about our businesses. *Auditors* are responsible for forming independent, informed opinions about whether or not we have fulfilled that responsibility. Finally, a*udit committees and boards of directors* are responsible for active and independent oversight of management regarding the adequacy of internal controls, integrity of the financial statements, compliance with legal and regulatory requirements, and risk management; and a significant component of this role involves dialog and discussion with the auditors regarding the results of their audit procedures.

Our primary concern is that the types of changes presented in the Concept Release could alter the balance of duties within this framework by partially shifting responsibilities for reporting on the financial status of our businesses to our auditors, who are necessarily removed from the actual management and operations of those businesses. Additionally, enacting any of the proposed changes could have the effect of implying, in a subtle way, that audit committees are not capable of, or effective in, carrying out the responsibilities traditionally reserved for them. We believe that the Board's intention is to find a way to *supplement* our existing financial reporting; but in practice we believe that the proposed changes would have the effect of *diluting*, and potentially *supplanting* our own reporting to varying degrees to the detriment of users of our financial statements.

We do not believe that implementation of new forms of auditor reporting such as an AD&A is appropriate as contemplated in the Concept Release. An AD&A would undermine the role of the audit committee, which is independent from management and already represents the shareholders in its oversight of and direct communications with the auditors. Furthermore, an AD&A would ultimately provide little incremental value to users of financial statements since, over time, "boilerplate" language would be unavoidable and the information provided in such reports would likely gravitate towards the lowest level of acceptable disclosure for the purpose of minimizing legal exposure. At the same time, auditors would face significant risks by deviating in any meaningful way from the statements and commentary provided by management (or by choosing to highlight different areas), so their reporting would most likely mirror the company's reporting. The creation of duplicative disclosures would not add value or provide decision-useful information to our investors.

We also believe that requirements to expand the use of emphasis paragraphs in the auditor's report will not be helpful to users of our financial statements and should not be pursued. Emphasis paragraphs would likely shift users' reliance from more qualified sources (i.e., management) to less qualified sources (i.e., auditors). Users of our financial statements should understand our industry and operations, and therefore be able to assess which matters are most significant to their decision-making processes without an auditor's emphasis paragraph directing them where to focus their attention. We believe that the proposals in this Concept Release would actually lessen the incentives for users to perform thorough reviews of our financial statements and notes. Users should read the notes to our financial statements in full, not rely on our auditors to tell them which notes to read, which notes they can consequently ignore, and which estimates are important. If users, after thorough review of the financial statements and notes, have questions about specific disclosures, they may contact a company's dedicated investor relations department for clarification.

While certain investors may demand more transparent disclosure from public companies, we believe that reforms in that area should appropriately come from the standard-setters best positioned to enact them: the Financial Accounting Standards Board ("FASB") and the SEC. If financial information that is currently outside of our financial statements is deemed to be of such importance to investors and other users that auditor assurance is necessary, then GAAP should be amended and the information should be included in the notes to our financial statements and covered directly by the auditor's report. Our auditors are already associated with information outside of our financial statements that is included in various filings or other documents and they perform procedures to assess its consistency with information in the financial statements or information obtained in the course of the audit. Providing assurance on it will not change its quality, relevance, or usefulness.

Finally, we do not believe that clarification of the auditor's report is necessary. The report could not be expanded sufficiently to explain the detailed, nuanced concepts presented in the Concept Release. At the same time, all of these concepts and information on the auditor's responsibilities are fully described in existing public documents that can easily be read and understood by interested users.

Each of the four proposed alternatives adds costs and complexity without meaningfully adding value. In some instances, the proposed concepts may even introduce confusion about the role of management and the integrative nature of the current financial reports, including their MD&A and risk factors. Furthermore, the proposed changes would likely require additional time, delaying quarterly earnings release dates. Many investors would regard a delay in the availability of timely information for assessing company performance to be a significant step *backwards* in the financial reporting process.

Thank you for your attention to our concerns. Attached to this letter is an appendix that contains our responses to the detailed questions posed by the Board in the Concept Release. We hope that these perspectives are of value to you in your deliberation processes. If we can provide further information or clarification of our comments in the meantime, please call any of the signatories listed below.

Sincerely,

Rajan Parmeswar
Aetna Inc.
Vice President, Controller and Chief Accounting Officer
(860) 273-7231

Mary T. Hoeltzel
CIGNA Corporation
Vice President and Chief Accounting Officer
(215) 761-1170

Steven E. McCulley
Humana Inc.
Vice President, Controller and Principal Accounting Officer
(502) 580-3921

Eric S. Rangen
UnitedHealth Group Incorporated
Senior Vice President, Chief Accounting Officer
(952) 936-5778

John E. Gallina
WellPoint, Inc.
Senior Vice President, Controller, Chief Accounting Officer and Chief Risk Officer
(317) 488-6109

## APPENDIX – Responses to the Board's Questions

This appendix presents our responses to the questions interspersed throughout the Board's Concept Release. In preparing this document, we read the Concept Release along with the included illustrations, solicited feedback from various groups and individuals within our companies, and read available comment letters that have already been submitted to the Board and made public. In some instances, we agreed strongly with points made by other commenters and have made similar suggestions; in other cases, our views differed and we commented accordingly. Overall, these responses represent the current views of our five-company group and are not intended to align us with any particular commenter or subset of commenters.

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

No. We believe that the FASB and the SEC, which are responsible for setting standards to ensure that public financial information is relevant and useful to investors, are better suited to consider and propose any such initiatives. We believe the Board should focus its finite resources on overseeing the conduct of auditors within the existing reporting framework in which *companies report* and *auditors attest*, rather than on remaking a framework that is overseen by the FASB and the SEC.

Fundamentally, we do not believe that "the inability of users to understand the auditors' report" is a problem that should be solved by the Board. Sophisticated users of public financial information (e.g., institutional investors) generally have the insight and experience to fully understand the roles and responsibilities of auditors without an expanded auditors' report. At the same time, less-sophisticated users of companies' financial statements likely would not benefit from expanded auditor disclosures or know how to interpret such disclosures in context. While certain investors may desire more transparent public disclosure, we believe that reforms in this area should come from the standard-setters, like those mentioned above, that are best positioned to enact such reforms.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

We believe the standard auditor's report provides the appropriate amount of information. Although some level of informed understanding regarding the purpose and nature of the report is necessary to fully benefit from its contents, the same is true of financial reporting in general. It is important that users of financial statements accurately understand the scope of an audit – what it is intended to do and what it is **not** intended to do. However, we believe that expanding the auditor's report into a much longer and more detailed explanation of the audit process may detract from this central goal.

Furthermore, we do not believe that the purpose of an auditor's report is to "provide relevant and useful information to investors and other users of financial statements." The auditor's function is to independently opine on the financial statements and related notes disclosed by the companies that they audit – not to generate original commentary or content. If the Board believes that information currently presented in public filings is insufficient or irrelevant, the Board should work through standard-setters and regulators to help highlight these deficiencies and effectuate changes to U.S. GAAP. It should not seek to expand the role of auditors' reports from one of assurance to one of direct financial reporting.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

The Board should not require that the auditor provide assurance on matters in addition to the financial statements. Our periodic SEC reports contain a significant amount of financial information and discussion outside of the financial statements; and our auditors currently perform additional procedures to gain comfort that all of these additional elements are consistent with the audited financial statements and their understanding of our respective businesses. We believe that most users of financial statements are aware of this and rely on that implicit assurance.

We do not believe that requiring auditors to give **explicit** assurance on these additional elements will improve quality, relevance, or usefulness of the existing disclosures for investors. At the same time, broadening the scope of the auditor's report would expand the auditor's legal exposure. The additional amount of work auditors would need to do (the cost of which would be borne by preparers through increased audit fees) to sufficiently protect their firms against this added legal exposure could be staggering. We do not believe that creating significant additional amounts of audit work with little to no improvement in the quality, relevance, or usefulness of the underlying financial information is worth pursuing.

The SEC already has an active role in establishing regulations over MD&A and other sections of public filings with the goal of encouraging companies to provide sufficiently meaningful and detailed information to investors. It is their responsibility to enact changes to reporting requirements when this objective is not being met.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

Yes. The auditor's responsibility is to independently opine on whether or not the financial statements are presented fairly in all material respects, while rendering the appropriate opinion based on that conclusion. The users of financial statements should be able to confidently rely on the opinion issued by an auditor.

We believe that characterizing the current model as "pass/fail" is somewhat misleading. For most public companies, issuing financial statements with a qualified opinion would not be acceptable due to the broad range of users who need reliable information about our businesses. Creating a spectrum of potential levels of auditor comfort (e.g., auditor reporting of information that might conflict with management's filing or reporting of "close calls" – which would call into question the overall audit opinion on the financial statements as a whole) would be confusing and therefore unfair to the users of financial statements. Financial statements of public companies should comply with U.S. GAAP or they should not be filed with the SEC; and the current model accomplishes this by essentially forcing companies to "pass." Other alternatives would result in the public getting less reliable information than they currently receive.

*b. If not, why not, and what changes are needed?*

As discussed above, the current model incents companies to prepare financial statements that will receive unqualified opinions from their auditors. We believe that this dynamic benefits users of financial information and should not be changed.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

We do not believe that changes to the auditor's report or supplemental reporting are necessary, primarily because we feel that the current roles of companies and auditors in financial reporting are appropriate and are well understood by users of our financial statements.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

Additional information, if any, about a company's financial statements and the underlying estimates, judgments, business plans, and expectations for the future should be provided by its management team, with oversight by the company's audit committee, and not by the auditor. The management team is in the best position to accurately and meaningfully explain results of operations and forward-looking information, and the audit committee assists the full board of directors in its oversight of the integrity of the company's financial statements. While auditors have significant, unique knowledge regarding company management and its business and financial information, such knowledge is derived second-hand. A fundamental premise underpinning an audit is seeking objectively verifiable evidence, which can only be gathered from historical financial reporting and not through a focus on forward-looking information. Consequently, management, with the oversight of the audit committee is the only group that can appropriately provide historical context and forward-looking information. In this regard, as discussed above, the FASB and the SEC are the appropriate agencies to implement any enhanced disclosure requirements.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

As discussed throughout our responses, we do not believe that amendments to the standard auditor's report are necessary. Likewise, we believe the current auditor's report on internal controls clearly and concisely serves the purpose for which it was intended and does not need to be changed.

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

We do not support the creation of an AD&A.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

N/A. Refer to response in question 5a.

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

The framework for ensuring that public-company financial statements provide investors with the relevant, useful information they need in order to make informed decisions already exists in the form of U.S. GAAP and SEC regulations. The implication that investors need more or different types of information is really an implication that this existing framework needs to be reformed by the entities that have authority over public financial reporting. Users of the financial statements are best served by enabling auditors to focus on their job of ensuring that the existing financial reporting framework is being applied appropriately; not by requiring auditors to provide their own original commentary.

For example, the notes to our financial statements that describe estimates for medical costs incurred but not reported (IBNR) explain how these liabilities are subject to uncertainty and are the product of complex actuarial models and judgments that consider many factors. We provide substantial disclosures about the risks associated with this process in the notes to our financial statements, as well as in the MD&A and Risk Factors sections of our Forms 10-K. If, after review by management, our audit committees, *and our auditors*, they are deemed to be in accordance with GAAP, there should be nothing else our auditors could add (in an AD&A or elsewhere) that would make that information more useful or relevant. If our current disclosures under GAAP are deemed inadequate, the SEC and the FASB should undertake a project to amend GAAP accordingly.

Any commentary by our auditors on these IBNR disclosures would likely result in investors reducing the time they devote to reading and understanding our disclosures and increasing the extent to which they ignore other notes to the financial statements that are not highlighted in the auditors' report. Although our auditors do a significant amount of work to gain comfort that our IBNR estimates are not materially misstated, they have neither the time nor the resources to analyze and understand our reserves at the same level of detail that our own companies do.

*d. If you do not support an AD&A as an alternative, explain why.*

Our current financial reporting framework is intended to provide investors and other stakeholders with financial statements that convey useful, relevant information about our businesses. If the Board does not believe that U.S. GAAP or SEC disclosure requirements serve this purpose, the Board should work with the FASB or the SEC, as applicable, and other relevant stakeholders to ensure that they are achieving the desired objectives. Regardless, the auditor's report should not be expanded into a mechanism that is used to fix perceived shortcomings in our current accounting and reporting models.

The volume of publicly disclosed financial information could seem overwhelming to users of that information. From that standpoint, we can understand the surface appeal of an AD&A or emphasis paragraphs in auditors' reports, which could serve almost as 'executive summaries' of the related reports – directing users to focus on certain information while potentially giving them comfort that they can safely ignore areas that are not highlighted. However, as we discussed in our response to question 3, these determinations about the relative importance of different parts of the financial statements simply cannot and should not be made by our auditors.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

We believe that the current auditor's report appropriately focuses on the audit scope and responsibilities and that no changes are necessary. We do not believe that the auditor should be required to further comment on the audit or companies' financial statements. The auditor's job has historically been, and should continue to be, to assess whether or not our financial statements are fairly presented in accordance with GAAP. Requiring auditors to publicly comment on the audit process and financial statements could also create a much more adversarial environment between auditors and management and could inhibit the free flow of information from one to the other.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

We do not believe that any of the information proposed for inclusion in a potential AD&A would provide added benefits to users of our financial statements because a report of this type would, in practice, consist of standardized boilerplate language.

Audit risk is conceptually different than business risk, and not all of the risks businesses face impact the scope and conduct of an audit. More reporting on how and when specific audit procedures were conducted will not change how a strategic investor assesses the future prospects of our businesses, and will instead increase audit costs with no corresponding benefits to the investing community.

Furthermore, the Board's existing standards and other publicly-available resources (we agree with other commenters that have highlighted the CAQ Guide as a worthwhile example) already provide in-depth guidance on the techniques and terminology employed by auditors in their evaluations of companies' assertions in public financial statements. These centralized resources obviate the need for additional requirements that could essentially result in thousands of audit reports repeating the same information in a condensed and likely less meaningful format.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, including "close calls")?*

A report presenting an auditor's views on a company's financial statements based on established audit procedures is not appropriate and will not achieve the Board's desired objectives. First, out of necessity we believe that these reports will largely become boilerplate language with little, if any, substantive content that would provide additional value to users (as further discussed in our response to question 10).

Second, without significant dialog and context, any information presented will not be useful and may even be misleading. For example, materials presented by auditors to audit committees regarding their views of the financial statements are almost always accompanied by significant discussion and take place within the context of a continuous dialog between those two groups. Third, based on our experiences, we: a) review and discuss with our auditors our disclosures and accounting for material matters, including judgments and estimates that may be considered “close calls” and b) resolve any significant differences in judgment on those matters prior to disseminating our financial information. Therefore, we would not expect any significant additional information that would be useful or relevant to investors to be provided in an AD&A. Rather, any auditor reporting on such matters would be unnecessary and repetitive of information already disclosed by management. Finally, any disclosures of an auditor’s views of management’s judgments or estimates that could be seen as “close calls” would undermine management’s financial reporting and the auditor’s own “unqualified” opinion, creating confusion for users of financial statements and a diluted or piecemeal audit opinion.

Additionally, audit committees, which are independent from management and represent our shareholders, have responsibility for assisting our boards of directors in their oversight of the integrity of our financial reporting, including the topics raised in this question. We believe users, auditors, and others do not have, and should not attempt to exercise, that responsibility. If the Board is of the opinion that audit committees are not effective in that role, it should work with the appropriate regulatory agencies to propose alternatives and take action.

*8. Should a standard format be required for an AD&A? Why or why not?*

We do not believe that an AD&A is appropriate. If required, AD&A reports would likely become standard boilerplate formats (whether or not standard parameters are required) driven by, among other things, an effort by audit firms to manage their legal exposure.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

For the reasons previously stated, we do not agree that an AD&A is necessary. Our companies already discuss, in considerable detail, these types of risks in the Risk Factors sections of our Forms 10-K and other SEC reports. Adding such discussion to the auditors’ report is unnecessary, repetitive, and could be construed as an indication that the risk factor disclosures made by management are inadequate or misleading in some way. As previously stated, if there is significant concern that the current financial reporting standards and regulations are not resulting in relevant and useful information, the Board should help communicate these concerns to the SEC and the FASB so that the standard-setters responsible for financial reporting can take action to reform the framework.

If investors have questions pertaining to business, strategic, or operational risks, we believe that they should raise such questions with us rather than looking to our auditors to highlight or discuss those risks for them. Because different users of the financial statements will likely have different interests or concerns when reading our financial information, we currently present and discuss all material risks to our business so that those users can make informed decisions based on their needs. Auditors have traditionally evaluated risk from the standpoint of providing reasonable assurance on the financial statements, not from the viewpoint of a potential investor. Requiring auditors to discuss risks other than audit risk would essentially be asking them to take on an advisory role for which they do not have the necessary experience or qualifications.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

Boilerplate language could likely not be avoided in an AD&A given the legal and regulatory environment in which businesses, auditors, and investors operate. We believe this environment will necessarily drive such reporting to the lowest level that would technically meet the applicable requirements in an effort to minimize legal exposure.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

We do not believe there would be any potential benefits to users of financial statements in implementing an AD&A.

The very concept of an AD&A undermines our management teams' reporting in MD&A as well as the Risk Factors section of our public filings. Requiring auditors to offer opinions on the same topics that we already discuss implies that company disclosures are somehow 'biased,' incomplete, or imperfect information that needs further clarification by an independent party. As previously noted, comments or concerns as to the completeness or quality of disclosure should be under the purview of the SEC. Attempting to cure perceived inadequate reporting under Regulation S-K by means of the auditor's report is both illogical and inappropriate. If users believe that our reporting under Regulation S-K is inadequate, they should discuss that with the SEC, not the Board.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

We believe that any new language in an auditor report or AD&A will almost certainly conform to company disclosures because the legal and regulatory environments in which we operate effectively require us to agree on common language to minimize legal exposure. The end result would be unnecessary duplication and increased costs with no improvement in audit quality or in the information presented to users. Any unreconciled 'inconsistent or competing information' could be a source of great tension and disagreement between management, audit committees, and auditors and could lead to breakdowns in communication that would diminish the quality of financial reporting and auditing as a whole.

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

We do not believe the matters described in the illustrative paragraphs would be relevant or useful.

The Concept Release suggests that required emphasis paragraphs could highlight the most significant matters in the financial statements, including significant management judgments and estimates and areas with significant measurement uncertainty. In practice, emphasis paragraphs would simply shift users' reliance from more qualified sources (i.e., management disclosures) to less qualified sources (i.e., auditors). Users of our financial statements should understand our industry and operations, and thus be able to assess which matters are most significant to their decision-making processes. We believe that requirements proposed in this Release may cause investors and other users to rely on the auditor's report as a roadmap to limit their review of our public filings, including our financial statements and notes. Users should read the notes to our financial statements in full, not rely on our auditors to tell them which notes to read, which notes they can consequently ignore, and which estimates are important.

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

We do not believe that audit reports should be required to contain such emphasis paragraphs or discussion of key audit procedures. Auditors' descriptions of their procedures would be necessarily brief and general for the purpose of limiting legal exposure, and the inclusion of only certain audit procedures absent a more thorough discussion of the audit strategy, scoping, and risk-assessment could potentially confuse or mislead users. Auditors' reports included with our financial statements are not an appropriate vehicle for delivering long, detailed descriptions of an audit.

*15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs*?

None – for the reasons discussed in question 14.

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

None – for the reasons discussed in question 14.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

As with an AD&A, we believe that boilerplate language will be unavoidable. Standard language will develop in response to the threat of legal challenges and as a result of the Board's inspection process.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

We see no significant benefits.

In addition, serious shortcomings exist insofar as: 1) these emphasis paragraphs could divert users away from information that auditors deem unworthy of emphasis, but which may very well be relevant to the users; and 2) there would likely be a great deal of second-guessing related to matters that were not emphasized.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model*?

No. As previously noted by us and by other respondents, the volume of information outside the financial statements exceeds the amount of information inside the financial statements, which are already complex and potentially daunting to many users. If financial information that is currently outside of our financial statements is deemed to be relevant and useful to investors and other users such that auditor assurance is necessary, then by implication GAAP has not met its objective of providing relevant and useful information in the financial statements. If that is the case, then GAAP should be changed and the information should be included in the notes to our financial statements covered directly by the auditor's report. As stated previously, our auditors are already associated with such information and perform procedures to assess whether any of it is inconsistent with information in the financial statements or obtained in the course of the audit. Providing assurance on it will not change its quality, relevance, or usefulness.

The Board might consider the quality of quarterly reports on Forms 10-Q for comparison. Certain of our companies' auditors do not issue review reports on those statements; but users still know that a filing cannot occur if the auditors object to any inclusions or exclusions from those documents. The same situation exists with respect to the information outside the financials but included in the Form 10-K. Just as requiring a review report in the 10-Q filing would not improve the quality of the quarterly report, including some form of assurance on the other information in a 10-K would not improve its quality.

Auditors may be willing to provide written assurance on information outside the financial statements as a means of expanding the scope of the services they sell to their audit clients. Given the question of whether additional assurance would actually change the quality, relevance, or usefulness of our financial information to users, it seems an unnecessary diversion of resources – both auditors' time and companies' money – to require such assurance.

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

Refer to our overall response to question 19.

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

Our views on MD&A are in the responses to questions 11, 12, 13, and 19.

Our auditors generally do read and perform limited procedures on earnings releases prior to their issuance; but since these releases occur prior to the completion of the audits, the firms are typically not in a position to provide assurance to the public.

As noted by other commenters, it would likely be difficult for auditors to provide meaningful assurance on non-GAAP information since there are often no standards that govern its form or composition. Different industries and companies within those industries may have different definitions of a non-GAAP metric like EBITDA, for example. Without a governing standard for non-GAAP information, auditors would only be able to opine on the consistent or inconsistent use of a particular concept. We include in our periodic filings certain metrics and statistics that are not defined or considered by GAAP, including membership counts and medical cost ratios. Since there are no GAAP definitions for these terms, our auditors would have no basis in which to ground an opinion on their presentation.

Furthermore, the information outside the financial statements often includes forward-looking statements and estimates, which auditors would not have an ability to opine on considering the difficulty in identifying or obtaining objectively verifiable support for this type of information.

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

None. We believe that the current procedures performed by our auditors over information outside of the financial statements are adequate and are well understood by sophisticated users of financial statements. We suggest that the Board consider additional educational initiatives to help less sophisticated users better understand the role and responsibilities of auditors.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

As noted above, we believe that requiring auditors to provide assurance on MD&A is inappropriate. To the extent that information in MD&A is derived from our financial statements or is subject to our internal controls over financial reporting, our auditors are already performing audit procedures that are tied to MD&A reporting.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

We do not believe that auditor reporting on MD&A would significantly change either the form or content of those disclosures. Auditors already evaluate MD&A disclosures for consistency with the financial statements and our underlying records. We would expect to make no significant changes to our MD&A as a result of any auditor attestation.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

As discussed above, we do not believe auditors should be required to provide assurance on information outside the financial statements. If the Board, with the assistance of the SEC, concludes that auditor assurance on certain financial information outside the financial statements is necessary, then we believe (similar to other commenters) that such information should be required to be included in the notes to the financial statements and covered by the auditor's report. Requiring an auditor's report to cover specific discrete sections of a public filing located at various places throughout the document would be unnecessarily confusing for users.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

See our comments above.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

We see no significant benefits.

The major shortcoming, discussed above, would be the diversion of both companies' and auditors' time and resources to facilitate changes that would not improve the quality, relevance, or usefulness of financial reporting to users.

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

• *Reasonable assurance*

• *Auditor's responsibility for fraud*

• *Auditor's responsibility for financial statement disclosures*

• *Management's responsibility for the preparation of the financial statements*

• *Auditor's responsibility for information outside the financial statements*

• *Auditor independence*

> *a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*
>
> We do not believe that attempts to clarify these areas in the auditor's report would be appropriate or helpful to users of our financial statements. As we (along with other commenters) have previously suggested, clarifications on all of these topics can already be found in publicly available documents including the Board's own publications. Discussions of these topics are usually necessarily precise, complex, and nuanced and are more suitably presented in robust stand-alone guides where they can be fully developed. Users of financial statements are better served by the availability of centralized, standardized literature describing the prevailing audit framework than by condensed, varying versions dispersed among thousands of auditors' reports.
>
> We believe that the Board should consider further developing, advertising, and distributing these centralized resources as part of an initiative to help train and educate users of financial statements about the roles and responsibilities of auditors.
>
> *b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*
>
> No. We agree with a previous commenter who suggested that users of financial statements should be responsible for making reasonable efforts to understand the role and responsibilities of an auditor by way of understanding the applicable auditing and financial reporting frameworks. Our auditors' current reports on our financial statements clearly state that they have conducted their audits in accordance with PCAOB standards and that our financial statements are fairly presented in accordance with U.S. GAAP. Anything beyond that would amount to boilerplate language that would simply be repeated in every audit report.
>
> *c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

None are needed.

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

These clarifications relate to the content of the auditor's report, not to the processes and procedures actually employed by auditors. Attempts at "clarification" should not drive changes in the auditor's role or responsibilities.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

As discussed above, we only see potential shortcomings. The language in the standard auditor's report is already very clear and expanding or changing the report would only introduce more opportunities for misinterpretation.

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

We do not believe that any of the alternatives are appropriately addressed through changes to the auditor's report or its roles and responsibilities.

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

No. As discussed throughout our responses, an auditor only needs to be able to communicate whether or not a company's financial statements are fairly presented in accordance with GAAP and are materially free of errors. The current form of the auditor's report accomplishes these two objectives clearly and concisely.

*25. What alternatives not mentioned in this concept release should the Board consider?*

The Board should consider removing this project from its agenda. We believe that our companies' management teams are the most qualified, most appropriate, and most reliable sources for first-hand financial information, discussion, and analysis about the businesses they operate. It is not clear to us how investors and other users of the financial statements would benefit from requirements that would shift the responsibility for financial reporting away from our companies and onto our auditors.

Our companies have had a great deal of experience fielding questions about our businesses and our financial statements from analysts, investors, regulators, and other users of our financial statements. Very few, if any, of these inquiries have dealt with the roles of our auditors, their audit reports, audit procedures, audit risks, or other topics presented in this Concept Release. Based on this experience, it is not apparent to us that any of this additional information needs to be included in an auditor's report.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

As discussed throughout our responses, we are not supportive of any attempts by the Board to modify the existing auditor reporting framework or fundamentally change or expand the current roles and responsibilities of auditors. The Board should also refrain from implementing processes that deal with the reporting of financial information (as opposed to the auditing of reported financial information) since other regulatory agencies are primarily responsible for such reporting.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

Yes. To the extent that information presented in auditors' reports: 1) conflicts with either our disclosures or the overall audit opinion on the financial statements or 2) otherwise indicates that certain accounts or disclosures are incorrect or inadequate, the perception of a qualified, piecemeal opinion will be unavoidable. Uncertainty as to whether or not the financial statements are fairly stated as a result of the perceived piecemeal opinion would be a significant problem, because users of the financial statements may determine that they are not able to rely on them despite what is technically an unqualified audit opinion.

Additionally, as noted above, we do not believe that users would rely on an expanded report any more than they rely on the current report. On the other hand, it is possible that any addition of emphasis paragraphs or risk discussion paragraphs would be used as a means to shortcut their responsibilities to read our entire financial statements and the related notes.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

It is not necessary to pursue changes to the standard auditor's report that would likely result in the repetition of boilerplate language that would still fail to be robust enough to fully convey the role and responsibilities of auditors to users who are unfamiliar with the current system. Our recommendation would be for the Board to consider focusing its efforts on providing education about audits and audit requirements to investors and promoting the currently available resources.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

We see no basis to conclude that the types of auditor reporting discussed in the Concept Release will improve audit quality. On the other hand, expanding the auditor's role into one of financial reporting could instead have the unintended effect of deteriorating the quality of audits and significantly increasing audit costs. As discussed throughout our responses, these proposals would effectively create significant new roles and risks for audit firms. Therefore, the most senior auditors would be required to spend significant amounts of time addressing these new reporting requirements. By distracting these experienced auditors from their core competencies (i.e., auditing) and their most significant responsibilities with the added responsibilities for generating original financial commentary (while attempting to minimize legal exposure) and providing assurance on areas that would be difficult to audit (e.g., Risk Factors, MD&A, etc.), the Board's proposals would likely dilute the limited resources available to audit firms.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others?*

Although we do not support significant changes to the auditor's reporting model, any changes made should apply to all registrants regardless of size or industry. Applying different changes to different industries or registrants would likely confuse users of financial statements, and may have unintended consequences on capital markets.

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

> *a. Are any of these considerations more important than others? If so, which ones and why?*
>
> As we and other commenters have already suggested, the proposed changes could potentially undermine the responsibilities and credibility of management teams and audit committees; adversely affect relationships among auditors, audit committees, and our management teams; and increase auditor legal exposure (which therefore increases costs to companies and investors with no added benefits). These are all very significant potential effects that we strongly urge the Board to avoid.
>
> *b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*
>
> Since we see no significant benefits, we see no justification of additional costs. Many of these proposals would likely increase audit time and expense due to increased consultation, enhancements to quality control procedures, and the possibility of increased future litigation costs. Without concrete benefits or added value to offset these additional costs, changes to the auditor reporting model are simply not warranted.
>
> *c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*
>
> No.
>
> *d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*
>
> N/A

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial* *statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

As only one of the three parties involved in that equation, it is hard for us to fully evaluate how the relationship would change in practice. From our perspective, knowing that auditors would be providing first-hand discussions of our businesses independent of our own could alter the way in which we interact with them. Due to the fact that our current auditing and reporting frameworks are very clear in establishing unique, well-defined roles and responsibilities for both management and auditors, we believe that our relationships with our auditors are strong and open, yet necessarily separate to a healthy degree. Any negative changes to these otherwise effective relationships as a result of the blurring of roles and responsibilities would be harmful to investors.

Docket 034: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Fatima Alali
California State University Fullerton

September 24, 2011

Based on my observations as a researcher and classroom discussions as an educator, please consider the following:

Changing the reporting model of the auditor's report may consider the following factors that are integral to the auditors' communication to the public reflecting both auditor's responsibilities and audit procedures' limitations:

First, due to the concept of reasonable assurance changes in auditor's reporting model would integrate clarification of reasonable assurance so the new reporting format and wording do not reflect beyond reasonable assurance, but it clarifies it. In addition, the report may indicate the level of assurance, this "very high level but not absolute assurance".

Second, in the current wording audit report, auditor's judgment is potentially only reflected in three locations while judgment involved in evaluating accounting estimates, principles and presentation and disclosure of financial statements would need great deal of explanation to reduce the expectation gap. This is important because public should not infer more than reasonable assurance, judgment and thus reducing expectation gap not increasing it.

Third, auditor's legal liability exposure is high and probably the highest in the last decade. The suggested "auditor's discussion & analysis" must be clear and beneficial to the public. However, the content of this communication is not-cost free to the auditor. The benefits to public must outweigh the costs of preparation and yet reduce expectation gap not increase it and provide a clearer understanding that "in auditor's judgment", conclusions reached are "fairly presented" or "true and fair". Therefore, integral to changes in auditor reporting model is agreeably concept of reasonable assurance, emphasizing the independent competent expert's judgment.

The auditors' discussion and analysis is beneficial to public as long as it does not hints a level of assurance above reasonable assurance that is assessed based on auditor's judgment and as long as it is clearly written and does not exposure auditors to increased liability. One alternative is then the emphasis of matter report in which the auditor would describe issues that may need special attention.

AMERICAN ACADEMY *of* ACTUARIES

September 30, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
Via email: comments@pcaobus.org

*Re: PCAOB Rulemaking Docket Matter No. 34*

The American Academy of Actuaries'[1] Financial Reporting Committee offers the following comments on the PCAOB's Concept Release.

We applaud the PCAOB's willingness to reach out and consult on the issues surrounding the auditor's report based on recent investor feedback. We believe most of the concerns of investors and other financial statement users stem from the need for enhanced disclosure of information regarding the risk and uncertainty of elements included in financial statements and reports which contain those (Financial Reports). Risk and uncertainty is the area of practice of actuaries and is a subject with which we deal constantly.

There is a dichotomy between the world of Financial Reports with its specific numbers and the world of economic reality in which there is a great deal of risk and uncertainty resulting in a range of possible values for a significant quantity of balance sheet items. Systems of financial security, such as the insurance industry, are excellent examples.

Accordingly, we strongly endorse steps to provide more disclosure by management about these matters to users of Financial Reports. Comments by management concerning the ranges of certain values shown in the Financial Statements, the methods used to determine those ranges, the methods of selecting the values shown, and the methods which might be used and reasoning for the selection of the methods chosen are some examples. However we do not believe that this information should come from the auditor. The auditor should assess the reasonableness of management's judgments without supplanting management's judgment. We instead endorse limited additional information being provided in the auditor's report as to the significant estimates in the Financial Reports, the key assumptions behind those significant estimates and the use of any internal or external specialists by the auditors to assist them in evaluating the reasonableness of management's estimates.

[1] The American Academy of Actuaries ("Academy") is a 17,000-member professional association whose mission is to serve the public on behalf of the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

Overall, we believe it will enhance the user's appreciation of Financial Reports as well as enhancing the usefulness of the Financial Reports to have at the user's disposal a description of the efforts made by management, auditors, and others to provide assurance that the information used by management and others to reach conclusions is correct.

Below we provide additional comments on certain questions posed in the Concept Release.

Questions

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

**Yes, we believe the Board should undertake such an initiative to provide investors with more detail beyond the pass/fail model currently employed.**

b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

**We believe the key improvement would be for the auditor to provide limited additional information regarding significant estimates in the Financial Reports, the key assumptions behind those significant estimates and the use of any internal or external specialists by the auditors to assist them in evaluating the reasonableness of management's estimates.**

c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

**No, we do not think that the auditor should provide assurance on additional items like management's discussion and analysis (MD&A). MD&A gives management the opportunity to reflect on recent operations and discuss future goals and projects. While limited assurance could be given on factual information, MD&A will reflect the current management's style and judgment. This is something we do not think the auditor should supplant.**

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

a. Should the auditor's report retain the pass/fail model? If so, why?

**Yes, we believe investors are looking for a clear signal that the financial statements are fairly stated. We would discourage any change that would bring ambiguity to such a statement, including moving away from the pass/fail model.**

b. If not, why not, and what changes are needed?

**N/A**

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

**Please see our response to question 1b.**

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

**We believe management, executives and the Board of Directors (including the audit committee) are the appropriate sources of information within the financial statements.**

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

a. If you support an AD&A as an alternative, provide an explanation as to why.

**Yes, but only to the extent that it permits the auditors to comment on procedures performed, communicate what they consider significant estimates and their use of specialists to assist them in evaluating the reasonableness of recorded estimates.**

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

**It should focus solely on the audit. See our response to question 5a.**

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

**See our response to question 5a.**

d. If you do not support an AD&A as an alternative, explain why.

**N/A**

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

**Yes, increased use of emphasis paragraphs may be another method by which the items we discussed in our response to question 1b could be communicated.**

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

**See our response to question 1b.**

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?

**Management, not the auditor, should be communicating on these issues.**

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

**Business risks, strategic risks, or operational risks are best left for management to discuss. These should not be the purview of the auditor.**

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

**Please see our response to question 1b.**

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

**No**

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

**We are concerned that it would lead to conflict between management and the auditor on what is effectively business judgment rather than accounting judgment.**

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:
• Reasonable assurance
• Auditor's responsibility for fraud
• Auditor's responsibility for financial statement disclosures
• Management's responsibility for the preparation of the financial statements
• Auditor's responsibility for information outside the financial statements
• Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

**Yes we believe the first two bulleted items would be appropriate for clarification. The third and fourth items listed might deserve some limited clarification. We have already stated our objection to auditing information outside of the financial statements and therefore do not believe clarification is appropriate. Finally, auditor independence is to be expected and therefore clarification would add little value.**

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

**This could be detrimental to the relationship between the company and its auditors if the auditor supplants management's judgment on the business with the auditors' own judgment.**

We would be happy to participate in further discussions on this issue. If you have any questions, please contact Tina Getachew, Senior Policy Analyst, Risk Management and Financial Reporting Council by phone (202/223/8196) or email getachew@actuary.org).

Sincerely,

William C. Hines

Chair, Financial Reporting Committee

Risk Management and Financial Reporting Council

American Academy of Actuaries

American Bankers Association

Building Success. Together.

Michael L. Gullette
Vice President – Accounting and Financial Management
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September 30, 2011

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

Via website submission: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 34 – *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

To Whom It May Concern:

The American Bankers Association (ABA) appreciates the opportunity to comment on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release). ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

The Concept Release seeks comments on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users. The changes being considered include: (1) a required Auditor's Discussion and Analysis (AD&A) to be included with an auditor's report, (2) required and expanded use of emphasis paragraphs within the current format of the auditor's report, (3) auditor assurance on other information outside the financial statements (for example, information within Management's Discussion and Analysis (MD&A), non-GAAP information presented, and information within earnings releases), and (4) clarifying language within the current auditor's report that explains what the audit represents and the related auditor responsibilities.

ABA believes that auditor reporting should not be expanded as proposed in the Concept Release. Instead, the audit expectation gap should be narrowed. ABA fully supports efforts that lead to more efficient markets and the effort to provide better information for improving the level of knowledge needed in the allocation of capital. Representing lenders that collectively comprise a significant share of financial statement users in the U.S., we understand that external audits are important to many users of financial statements in effective decision-making related to the allocation of capital. Capital is efficiently allocated by those who have sufficient knowledge of the related reporting entities and their business models. However, we believe that the focus should be on continuing to enhance the quality of financial reporting in areas where investors perceive there are gaps, rather than expanding the role of the external auditor. . Investors are, thus, best served by direct communication from the companies themselves.

We disagree with those who believe that the value derived from expanding auditor procedures to include an AD&A or to provide auditor assurance on other information outside the financial statements will exceed the massive costs that would be required to perform the procedures. Such approaches will only lead to more user confusion between the different reports issued by the auditors and management and will likely increase the already-existing "expectation gap" of what audit assurance actually provides to the investor. For example, discussion of audit "close calls" may actually cause the financial statement user to question the quality of the audit work and why the amounts actually recorded should be relied upon. Considering that "close calls" do not necessarily mean that final decisions made by management or by the auditor are wrong, it is critical to clarify the overall audit process and specific concepts related to it. However, the focus of the audited financial statements should not be on the auditor, but on the related reporting entity.

Underlying the Concept Release is the notion that auditors often have significant information regarding how a company's financial statements were prepared that might be useful to investors and other financial statement users. ABA believes that this information from the auditor, at best, will only confirm what is already disclosed in footnotes to the financial statements or the MD&A. Over time, investors may become frustrated with the auditors' language, which is likely to be carefully-crafted and self-protecting. This could eventually render most of the additional reporting as irrelevant. At worst, such reporting, especially since it relates to highly judgmental areas, could result in uncertainty among users that is unwarranted.

Within the Concept Release, it was pointed out by some that the recent financial crisis is an example of how expanded auditor reporting might be useful in assessing the quality of the financial statements. Discussions of off-balance sheet contingencies and of the sensitivity of loan loss estimates were specifically cited. In our outreach to various banking analysts, we found that the vast majority do not list changes to the auditor report as a significant matter (and none believe it would adequately address the two issues just cited). While we understand that there are those who believe that the related disclosures within the notes to the financial statements or within the MD&A were insufficient prior to the financial crisis, those are issues that should be addressed (and, in fact, have been – or are currently being – addressed) by the Financial Accounting Standards Board and the Securities Exchange Commission. We question how expanded auditor reporting, especially that contemplated within an AD&A or by expanding procedures over the MD&A, would have adequately addressed such concerns. The judgmental nature of the valuation of loan loss estimates, contingencies, and fair values, is central to the commercial banking business. This is why detailed disclosure of those key areas of estimates and management judgment is normally included within the first notes to the financial statements, as well as within the risk sections of the MD&A.

Financial statements of any company include judgments and estimates at a specific point in time. No matter what kind of emphasis is put on this fact, volatility in the markets (especially the volatility experienced in the last four years) will often greatly reduce the relevance of these estimates by the time the report is issued. Further, bank financial performance (and, thus, bank equity prices) is often influenced by factors that cannot be adequately reflected in financial statements. Liquidity management and the business impact of regulation, which are commonly addressed in quarterly filings, are among examples. These types of disclosures would be impractical to audit. Attempting to provide additional investor comfort and focus in the financial statements through increased auditor communication will likely only add to the confusion over what those statements mean to future bank performance.

Instead, ABA believes that the PCAOB should consider solely how the auditor report can be revised to reduce the expectation gap. We caution the PCAOB on the expansion and requirement of the use of emphasis paragraphs. As bank audited financial statements often include scores of pages of footnote disclosures, the emphasis paragraphs could also turn the auditor report into one of similar length, thereby diluting the emphasis objective. We agree that these paragraphs could further turn into "boilerplate" wording over time (or be understood that way).

We believe that it may be useful to add additional clarifying language to the auditor report as to what the audit represents. This is the most direct way to lower the expectation gap. However, since most of the concern on this project addresses management's judgments and estimates, we admit that, practically speaking, the resulting language may end up merely advising the user to carefully read the whole report. While we are not confident that this will have significant impact on user understanding of the company, it is perhaps the best the auditor can do to help.

As was experienced during the implementation of the Sarbanes-Oxley Act, expansion of audit rules and processes can result in significant concerns about costs versus benefits. We realize that this is outside the purview of the PCAOB, but we believe that the expenses of implementing the Concept Release would be better spent, and investors would be better served, by reducing the complexity of financial reporting or clarifying the risks reporting companies face, rather than significantly expanding the requirements of the external auditor. These costs and benefits should also be considered in light of significant current efforts by both auditors and reporting entities to comply with existing reporting deadlines.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette

AEP
AMERICAN ELECTRIC POWER

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Joseph M. Buonaiuto
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September 30, 2011

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

Subject: PCAOB Rulemaking Docket Matter No. 34

*Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Board Members:

American Electric Power Company, Inc. (AEP) appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB) "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards", dated June 21, 2011. AEP, a Columbus, Ohio based energy company, is one of the largest investor-owned utilities operating in the United States, with revenues of over $13 billion and more than 19,000 employees. We provide energy to approximately 5 million customers in Arkansas, Indiana, Kentucky, Louisiana, Michigan, Ohio, Oklahoma, Tennessee, Texas, Virginia and West Virginia.

We appreciate the opportunity to respond to the Concept Release and have addressed each of the major alternatives below.

***Auditor's Discussion and Analysis***

We agree that investors need relevant information. We also strongly believe management and the company's board should be the source of information regarding the company's financial statements and disclosure about a company's finances, policies and judgments. External auditors are independent, and their role is to provide assurance on reported information, not to be the original source. To expect them to step into the role of management for the purpose of preparing an Auditor's Discussion and Analysis (AD&A) would jeopardize their independence and expose them to inappropriate risk that will come with a significant cost. If there is a perceived need for improved reporting about judgments, estimates and uncertainties affecting a company's financial statements, then that need should be addressed through the accounting standards set by the SEC and the FASB.

***Required and expanded use of emphasis paragraphs***

We believe that required use of emphasis paragraphs could provide meaningful information to investors, but they should be limited to identification and location of the most significant items considered by the auditor. For many of the same reasons discussed above, there should be no auditor commentary on these items.

***Auditor assurance on other information outside the financial statements***

We are concerned about expanding the auditor's responsibility to forward looking statements within the MD&A and certain other non-GAAP information. Forward looking information is intrinsically dependent on management judgment, assumptions, economic indicators and other estimates. As such, forward looking information does not lend itself to an audit based upon independently verifiable evidential matter or specific guidelines such as generally accepted accounting principles. Auditors are not currently trained to opine on forward looking information, nor is there a framework on which to base their conclusions. The reasonableness of forward looking information should be judged in the marketplace by analysts and other market forces. An auditor's responsibility should be limited to historical financial statements and related disclosures.

***Clarification of language in the standard auditor's report***

We support the inclusion of clarifying language in the auditor's report to facilitate the readers' understanding of scope and the auditor's responsibilities. We believe the "pass/fail" nature of the report on historical information should be maintained.

Sincerely,

Joseph M. Buonaiuto

cc: Michael G. Morris, Chairman and CEO
Brian X. Tierney, CFO
Lionel L. Nowell III, Board of Directors

# American Federation of Labor and Congress of Industrial Organizations

815 Sixteenth Street, N.W.
Washington, D.C. 20006
(202) 637-5000
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September 30, 2011

***Sent via Electronic and U.S. Mail***

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

**Re: *Rulemaking Docket Matter No. 34 Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements***

Dear Mr. Seymour:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") concept release on possible revisions to PCAOB standards related to reports on audited financial statements. The AFL-CIO is the largest labor federation in the United States and represents 12.2 million union members. Union-sponsored pension and employee benefit plans hold more than $480 billion in assets.

The ability of investors to rely on accurate and reliably audited financial statements is fundamental to ensuring the integrity of the capital markets. We commend the PCAOB for its initiatives to reform the audit process, including the report by auditors to shareholders on company financial statements. The auditor's report is the primary means through which auditors communicate with investors regarding the audit of a company's financial statements. But auditors' reports that consist of boilerplate are of little value to investors.

The auditor's report should include a discussion of the auditor's assessment of the estimates and judgments made by management in preparing the financial statements, and how the auditor arrived at the assessment. Financial statements have become increasingly complex and dependent on management's estimates of subjective values. We believe that auditors should be required to disclose their assessment of significant judgments and estimates made by management.

The auditor's report should also include a discussion of unusual transactions, restatements and other significant changes in the financial statements. Investors would benefit from knowing more about accounting misstatements, including failures in internal controls that permitted the misstatement to occur, whether those weaknesses in internal controls had been fixed, and other changes that have occurred as a result. Investors should also be provided more information about unusual transactions such as those made toward the end of a quarter, or at fiscal year-end, in order to meet financial targets. Other unusual transactions that would fall under this category would be tax-shelters, and related party transactions.

The auditor's report should also discuss the quality, not just the acceptability of the issuer's accounting practices and policies. For example, auditors should describe those instances in which a management's application of accounting principles, while acceptable under GAAP, was not the preferred practice. Differences in how companies apply GAAP can have a significant impact on their financial statements. In addition, we believe that the auditor's report should indicate the auditor's responsibility for detecting material fraud. The auditor's report should clearly state that the auditor provides reasonable (i.e., a high level of) assurance that financial statements are free of material misstatements.

Although there is some merit to the binary nature of the current audit report, we would prefer the audit report to have more levels than simply unmodified and modified – particularly since the large majority of audit reports issued are unmodified. For example, auditors could evaluate the quality of the issuer's accounting policies and practices (including its estimates and judgments) by assigning one of four grades: conservative, above average, average and aggressive. There will not be a failing grade because such a grade would denote non-GAAP reporting and would require the auditor to issue a modified opinion.

Requiring audit firms to issue reports using a forced curve could serve to meaningfully differentiate between issuers in the quality of their accounting policies and practices. Such differentiation would be useful to investors in making investment decisions, and could represent an efficient means of communicating the auditor's overall judgment about the issuer's accounting quality. Moreover, unlike other alternatives being considered by the PCAOB, expanding the audit report choice from two to four categories, and requiring auditors to issue reports based on a forced curve, virtually eliminates the risk that auditor reporting devolves into boilerplate language which would obviate any benefit to investors from changing the auditor reporting model.

The auditor's report should identify the role of any affiliated firms in conducting the audit. We believe this is important because investors currently have no information about the extent to which the audit was performed by a foreign affiliate of a U.S. auditing firm. Investors would also benefit from the development of an information clearinghouse that identified auditors attached to public company audit engagements worldwide, listing any sanctions, suspensions and litigation against them. Investors can already obtain this type of information about brokers and investment advisers.

Substance should take precedence over form in how this new information is presented to investors. If presented in an Auditor Discussion and Analysis section, the PCAOB should take steps to ensure this new section is not boilerplate. We also believe that the engagement partner should be required to sign his or her name on the auditor's report in addition to the audit firm's name. We find the absence of the engagement partner's signature inexplicable given that CEOs and CFOs must personally certify company financial statements.

Investors deserve more information about company audits and the auditors whose job is vital to preventing accounting fraud. Thank you again for the opportunity to comment on the proposal. If you need any additional information, please contact me at 202-637-3900.

Sincerely,

Damon A. Silvers
Director of Policy & Special Counsel

DAS/mdg
opeiu # 2, afl-cio

AFSCME®
We Make America Happen



September 30, 2011

Via Email
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

RE: PCAOB No. 2011-003, Rulemaking Docket Matter No. 34

Dear Sir/Madam,

The American Federation of State, County and Municipal Employees ("AFSCME") submits this letter in response to the Concept Release of the Public Company Accounting Oversight Board (the "Board") on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, Release No. 2011-003 (the "Concept Release"). AFSCME is the largest union in the AFL-CIO, representing 1.6 million state and local government, health care and child care workers. AFSCME members participate in over 150 public pension systems whose assets total over $1 trillion. In addition, the AFSCME Employees Pension Plan (the "Plan") is a long-term shareholder that manages $850 million in assets for its participants, who are staff of AFSCME and its affiliates.

At the outset, we wish to emphasize that we view the Concept Release as one part of a larger suite of important reforms under consideration by the Board. In particular, we believe that some of the objectives of the measures proposed in the Concept Release cannot be fully realized in the absence of mandatory auditor rotation. Decades-long relationships between auditors and clients are likely to impair auditor independence. We therefore applaud the Board for issuing the Concept Release on Auditor Independence and Audit Firm Rotation, Release No. 2011-006, to explore this issue. Our support for the reforms proposed in this Concept Release does not indicate that we believe those changes would, by themselves, be sufficient.

American Federation of State, County and Municipal Employees, AFL-CIO
TEL (202) 429-1000 FAX (202) 429-1293 TDD (202) 659-0446 WEB www.afscme.org 1625 L Street, NW, Washington, DC 20036-5687

The Concept Release outlines several possible changes to the standard auditor's report. Before discussing the specifics of potential reforms, it is worth noting the importance of the auditor's report to investors. As the Treasury Department's Advisory Committee on the Auditing Profession stated, "The auditor's report is the primary means by which the auditor communicates to the users of financial statements regarding its audit of financial statements."[1]

In 2008, 2010 and 2011, the CFA Institute, a global, not-for-profit association of investment professionals, surveyed its members regarding the independent auditor's report. Seventy-two percent of respondents to the 2010 survey said that the auditor's report was important or very important to their analysis and use of financial reports in the investment decision making process.[2] These findings are consistent with the feedback the Board received from investors in the course of its outreach that the audit is a "valuable process" giving the auditor "significant insight into the company."[3]

The needs of investors and other users of financial statements should be the Board's highest priority as it decides whether to undertake the standard-setting initiative outlined in the Concept Release. The CEOs of the six largest accounting firms concurred with this notion in a 2006 white paper, which stated that "The new (reporting) model should be driven by the wants of *investors and other users of company information* . . . ." (emphasis in original)[4]

For several decades, influential voices have criticized the auditor's report. Numerous reports of expert panels have concluded that the auditor's report conveys insufficient information to public company investors. In the 1970s, the Commission on Auditors' Responsibilities (the Cohen Commission) called for the auditor's report to be expanded to report on the entire audit function.[5] The National Commission on Fraudulent Financial Reporting (the Treadway Commission) recommended in 1987 that the auditor's report provide additional information on the auditor's role, the extent to

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1 U.S. Department of the Treasury, Advisory Committee on the Auditing Profession, Final Report,"at VII: 13 (Oct. 6, 2008) (available at http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf) (hereinafter "ACAP Report").

2 "Independent Auditor's Report Survey Results," CFA Institute, at 5 (Mar. 2010) (available at http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf) (hereinafter, "2010 Survey").

3 Concept Release, at 7.

4 S.A. DiPiazza et al., "Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks" at 17 (2006) (available at http://www.iasplus.com/resource/0611visionpaper.pdf).

5 Commission on Auditors' Responsibilities, "Report, Conclusions and Recommendations," at 75 (1978).

which users can rely on the audit and limitations on the audit process.[6] Most recently, the Treasury Advisory Committee on the Auditing Profession recommended in 2008 that the Board undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.[7]

Negative feedback has also come from the investor community. CFA Institute members were dissatisfied with the amount and type of information contained in the auditor's report. Some respondents characterized the auditor's report as "boilerplate."[8] Sixty percent said that the report should contain more information about the audit process itself and matters related to the audited financial statements.[9]

Key Disclosure Topics

In our view, requiring discussion in the auditor's report on four topics would substantially improve the report's usefulness to investors:

1. The auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment;
2. Areas of high financial statement and audit risk and how the auditor addressed these high-risk areas;
3. Unusual transactions, restatements and other significant changes in the financial statements, including the notes; and
4. The quality, not just the acceptability, of the company's accounting practices and policies.

None of these areas require the auditor to become an "original source of information about the company," a concern raised by the Center for Capital Markets Competitiveness in its comment letter.[10] Instead, they primarily relate to the auditor's professional judgments about the audit and particular aspects of the company's accounting policies and practices. Moreover, they involve communicating to investors material the auditor already obtains and communicates to others.

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[6] National Commission on Fraudulent Financial Reporting, "Report of the National Commission on Fraudulent Financial Reporting" (1987).
[7] ACAP Report, supra note 1, at IV:13.
[8] 2010 Survey, supra note 2, at 5-6.
[9] Id. at 11.
[10] Comment of the Center for Capital Markets Competitiveness, at 9 (available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/PCAOB-Concept-Release-9.14.2011.pdf).

*Estimates and Judgments*

We disagree with the assertion of the Center for Capital Markets Competitiveness that investors expect a single "right answer."[11] On the contrary, investors understand the role of estimates and judgments in applying accounting principles. The importance of estimates and judgments supports conveying the auditor's view on this subject to investors.

Auditors are already communicating with the audit committee of the board about estimates and judgments. AU section 380.08 requires that "The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates."[12] Thus, including a discussion on this topic in the auditor's report would not require additional information gathering by the auditor.

Discussion regarding accounting estimates and judgments has support within the investor community. In the 2011 survey, 86% of respondents said they believed that it was important or very important that the auditor's report include information about the auditor's assessment of management's critical accounting judgments and estimates.[13] Respondents to the 2010 CFA Institute survey, which did not ask the specific question posed in the 2011 survey, cited "comments about accounting judgments and control issues" and "significant judgments and estimates made by management and how the auditors audited them" as examples of additional information that would be helpful.[14]

*Financial Statement and Audit Risk*

We believe that the auditor's report should discuss areas of high financial statement and audit risk and how the auditor addressed these areas. Fundamental to the performance of a GAAS audit is the identification of high-risk areas in the financial statements. Auditing Standard No. 12(4) requires that "The auditor should perform risk assessment procedures that are sufficient to provide a reasonable basis for identifying and

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11 Id. at 7.
12 AU section 380.08 (available at http://pcaobus.org/Standards/Auditing/Pages/AU380.aspx).
13 "Usefulness of the Independent Auditor's Report," CFA Institute, at 6 (Mar. 2011) (available at http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_march_2011.pdf)(hereinafter "2011 Survey").
14 2010 Survey, supra note 2, at 11-12, 19.

assessing the risks of material misstatement, whether due to error or fraud, and designing further audit procedures."[15]

An evaluation of audit risk—the risk that the auditor expresses an inappropriate audit opinion—is also part of normal auditing procedures. Audit Standard No. 8(3) provides that "To form an appropriate basis for expressing an opinion on the financial statements, the auditor must plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements due to error or fraud. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence."[16]

The audit committee is already receiving much of this information in the course of its oversight of the audit process. Thus, disclosing it to investors would not, we think, impose a significant information collection burden. Respondents to the CFA Institute's 2010 survey indicated that more information about high-risk areas would be useful to investors.[17] As one respondent noted, "Having been an auditor I know that certain areas of the balance sheet and income statement are much higher risk than others. If we as users know this information we can better understand the risks in using and analyzing the financial statements as presented."[18]

*Unusual Transactions, Restatements and Other Significant Changes*

In our view, the auditor's report should communicate information about unusual transactions, restatements and other significant changes. The auditor obtains information about unusual transactions, which have the potential to increase the risk of financial misstatements (see Auditing Standard 12(46)), in the regular course of performing the audit. Auditors are clearly very involved in accounting restatements. Significant changes in the company, including changes in internal control over financial reporting (see Auditing Standard No. 12(8)), plus changes in the company's accounting principles and related policies and disclosures (see Auditing Standard No. 12(13)), are currently noted by the auditor as part of its risk assessment procedures.

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[15] PCAOB Auditing Standard No. 12(4) (available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_8.aspx).
[16] PCAOB Auditing Standard No. 8(3) (available at http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_8.aspx).
[17] 2010 Survey, supra note 2, at 12-13
[18] Id. at 13.

As well, these matters are already communicated to the audit committee. AU section 380.11 requires the auditor to discuss with the audit committee items that have a significant impact on the representational faithfulness, verifiability and neutrality of the accounting information included in the financial statements; examples of such items are unusual transactions and selection of new or changes to existing accounting policies.

The CFA Institute survey supports including this discussion in the auditor's report. Respondents cited changes in accounting standards and related party transactions as areas on which more information would aid investors.[19]

*Quality of Accounting Policies and Practices*

The auditor's report should discuss the quality, not just the acceptability, of the company's accounting policies and practices. Companies have significant discretion in applying GAAP; however, some alternatives are considered to be higher quality than others. Investor feedback to the Board indicates that information on the auditor's views regarding the quality of the company's financial statements would be useful.[20] Similarly, responses to the 2011 CFA Institute survey support such a requirement: 90% of respondents stated that information regarding the quality, not just the acceptability, of management's selection and application of accounting principles is important or very important to have in the auditor's report.[21] Numerous additional comments by respondents supported the value of such discussion.[22]

As with the other areas discussed in this comment, auditors are currently required to communicate this information to the audit committee. AU 380.11 requires the auditor to discuss with the audit committee the auditor's judgments about the quality of the company's accounting principles as applied in its financial reporting.

<u>Additional Items</u>

In our view, clarification in the auditor's report of the auditor's role would be valuable to investors. There has been much discussion of the "expectations gap" between what the audit actually does and what users of financial statements believe it does, especially in the area of fraud detection. The auditor's report should state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements

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19 Id. at 13, 20.
20 Concept Release, at 8.
21 2011 Survey, supra note 14, at 6.
22 See id. at 6-7.

are materially misstated. Whether caused by error or fraud, and that this represents a high, though not absolute, level of assurance.[23] Responses to the CFA Institute survey indicate that investors are interested in more specific disclosure on this topic.[24]

Format for Additional Discussion

The Concept Release asks for comment on whether additional discussion by the auditor should appear in a separate supplemental report that has been described as an Auditor's Discussion and Analysis ("AD&A")(akin to the Management Discussion and Analysis section of a 10-K or a Compensation Discussion and Analysis section of a proxy statement). We believe that the AD&A would have the benefit of allowing fulsome discussion of key matters by the auditor, with the opportunity to place that discussion in context.

The format in which additional discussion takes place is less important, however, than the substance of that discussion. Accordingly, we would be open to other mechanisms, such as requiring and expanding the use of emphasis paragraphs in all audit reports.

* * * *

We appreciate the opportunity to share our views with the Board on these important issues. If you have any questions, or need additional information, please do not hesitate to contact Lisa Lindsley at (202) 429-1275.

Sincerely,

Gerald W McEntee

GERALD W. McENTEE
INTERNATIONAL PRESIDENT

[23] See AU 230.10 (available at http://pcaobus.org/Standards/Auditing/Pages/AU230.aspx).
[24] 2010 Survey, supra note 2, at 12-13.

American Gas Association

September 29, 2011

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

**Rulemaking Docket No. 34**

The American Gas Association (AGA) respectfully submits our comments on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* No. 2011-003 (the "Release"). The AGA, founded in 1918, represents 199 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which 91 percent — more than 64 million customers — receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international natural gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.

Based on the response to the PCAOB's outreach efforts preceding the Release, the AGA acknowledges that investors and other financial statement users expressed concerns about the information provided in the auditor's report in light of increasing complexity in preparing and auditing financial statements and ongoing dialogue both in the United States and in Europe on the role of the auditor and the form of the auditor's report. The AGA appreciates investors and other users' desire for more information on issuers' financial statements from the auditor, particularly given the auditor's independent oversight role. However, we have a number of concerns regarding the alternatives proposed in the Concept Release. The four alternatives proposed in the Concept Release are as follows:

1. Auditor's Discussion and Analysis (AD&A),
2. Required and expanded use of emphasis paragraphs,
3. Auditor assurance on other information outside the financial statements, and
4. Clarification of language in the standard auditor's report.



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The Release notes that these alternatives are not mutually exclusive, and also asks for respondents to offer other alternatives that may provide further insight into entities' financial statements.

**Summary**

Highlights of our comments are summarized as follows:

- Reported financial results are management's responsibility. Commentary regarding what constitutes significant matters, areas of uncertainty, and critical management judgments and estimates are most appropriately provided by those in a position to have the best and most complete understanding of the basis and intent underlying these areas, which we believe to be the role of management. Additionally, the disclosure of critical and significant matters, uncertainties, and judgments is required by SEC regulation and by disclosure rules otherwise established under U.S. GAAP. If investors require changes to the disclosure and reporting requirements promulgated under current GAAP, this should be completed through the standard setting process of the FASB and SEC and provided by management.

- Due to the inherently limited nature of an audit of financial statements, the auditor may not possess a complete understanding of the above areas for which management is responsible, although they may nonetheless have obtained sufficient understanding to satisfy their audit requirements. Providing such information could result in conflicts with the information already required to be disclosed by management, thereby creating confusion amongst investors and other users and potentially subjecting the auditor and the entity to increased risks.

- Increasing the scope of the audit to include assurance on other information outside the financial statements will substantially increase the cost and effort to complete an audit, which could risk the timely filing of financial statements in compliance with regulatory deadlines while not providing a commensurate benefit for financial statement users.

- Clarification of terms in the audit report and explanation of auditor responsibilities could be beneficial to users of the financial statements. This information should be either provided by 1) issuing clarifying guidance (to the extent not already incorporated in existing guidance) without adding language to the standard auditor's opinion or 2) amending the standard auditor's opinion by providing standard language to be used in all auditor' reports.

- If additional information is to be provided by the auditor, it should be limited to information related to the audit process, such as significant audit risks identified by the auditor and audit procedures responsive to these significant risks.



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**Auditor's Discussion and Analysis (AD&A) and Emphasis Paragraphs**

The Release discusses that the intent of an AD&A section would be a supplemental narrative report for the auditor to provide a view of the audit and financial statements "through the auditor's eyes". The AD&A could include information regarding significant matters, including management's judgments and estimates, difficult or contentious issues and areas where management could have applied different accounting. The proposal to expand the use of emphasis paragraphs would mandate the use of such paragraphs (not required today except in certain circumstances) in all audit reports. Such paragraphs would highlight the most significant matters in the financial statements (in the auditor's judgment), where these matters are disclosed in the financial statements, information related to significant management judgments and estimates, areas of significant uncertainty, and other areas the auditor deems important to emphasize.

While the auditor possesses enough understanding of the entity's financial statements to conclude for purposes of the audit, the financial statements are management's responsibility. The auditor's responsibility is to obtain reasonable assurance about whether the financial statements are free from material misstatement by executing appropriate audit procedures on a test basis (and in the case of public companies, to opine on the design and effectiveness of internal control over financial reporting in line with that objective). However, as a result of not being involved in the day-to-day analyses and decision-making of running the business, the auditor is unlikely to have a complete understanding of the rationale behind all of management's decisions, judgments and estimates. Therefore, we believe that information provided by the auditor to the public about an entity's financial statements should not include subjective information, such as the auditor's opinion of which matters are most important to a user, opinions about which areas involve the highest relative degree of uncertainty, or opinions about which judgments and estimates are the most important or subject to debate. Management's disclosure of critical and significant matters, uncertainties, and judgments is already required by the SEC. The auditor may provide information as to what are deemed areas of significant audit risk and the procedures executed in response to those risks, as this analysis is indeed part of the auditor's purview and responsibility. However, the reasons for deeming an audit risk as "significant", or including information on the results of related audit procedures, may not have a direct correlation to what would be most material or meaningful to an understanding of the financial statements and may serve to distract from the overall opinion and understanding of users.

Because of the limited nature of an audit, we are also concerned that an auditor providing subjective information through an AD&A or emphasis paragraphs could result in conflicting statements between management and the auditor, which may further confuse financial statement users. There is also a risk of the auditor disclosing information that is confidential to an entity. If an auditor provides subjective information that is later proved to be incorrect or of a confidential



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nature, management has born the risk of this information negatively impacting the decisions of financial statement users, and the auditor may be subject to the additional risk of litigation. In order to effectively mitigate these risks, the auditor may need to significantly expand the scope and nature of procedures required by current auditing standards, which may be difficult to adhere to given the subjective nature of the information in question. At a minimum, expanding audit requirements in this manner would have a direct impact on the cost, effort, and timing to complete an audit of the financial statements for which we do not see a commensurate benefit. If the auditor were required to present subjective information in the form of an AD&A, the transparency of communications between the auditor and management and the Audit Committee could be compromised. Effective communication between these parties is important to uphold the transparency and quality of an audit. The Audit Committee is already charged with the authority and responsibility to oversee the financial reporting process on behalf of investors and to resolve any specific accounting treatments or judgmental financial reporting matters that they are not comfortable with, thereby providing assurance that these areas have been adequately addressed within the financial statements.

If additional disclosures are necessary they should be provided by management. GAAP prescribes the standards that must be followed by management when producing financial statements, which are then reviewed by the SEC. If investors require changes to the disclosure and reporting requirements promulgated under current GAAP, this should be accomplished through the standard setting process of the FASB and SEC and provided by management.

**Auditor Assurance on Information Outside the Financial Statements**

The Release states that another alternative to enhance the auditor's reporting model would be for the auditor to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis (MD&A), earnings releases, and/or non-GAAP information. Guidance already exists for attestations of MD&A (although these engagements are not frequently performed), which the auditor can be engaged to perform by a particular entity's investors and other key stakeholders, if deemed necessary by those parties. Mandating an increase in the amount of information for which the auditor is asked to provide assurance would increase the scope and thus the cost of the audit and could negatively impact an entity's ability to comply with quarterly financial statement filing deadlines, which are increasingly compromised with each additional compliance requirement. Auditors already perform certain limited procedures related to this information. In our view the cost of providing assurance on this information would outweigh any benefits investors would receive from the additional information.

**Clarification of Language in the Standard Auditor's Report**

The fourth alternative discussed in the Release is the clarification of certain terms in the standard auditor's report, such as reasonable assurance, and the clarification of auditor responsibilities (such as the auditor's responsibility to detect fraud). The AGA does not object to the audit community providing the factual information proposed by this alternative.



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If guidance is issued directing auditors to clarify terms and their responsibilities, the AGA recommends either 1) issuing clarifying guidance (to the extent not already incorporated in existing guidance) without adding language to the standard auditor's opinion, or 2) amending the standard auditor's opinion by providing standardized language to be used in all auditors' reports. If additional information is to be provided in the auditor's report, the information should be consistent for all auditors and entities. If guidance is issued that is left open for auditors to interpret what should be included in the auditor's report, varying language in reports could confuse financial statement users.

**Conclusion**

We appreciate the opportunity to comment on the Release. We understand the investment community's desire for further insight into entities' financial statements and the knowledge of these financial statements that an auditor obtains during an audit. We support the proposal to clarify the language in the standard auditor's report, if it is deemed necessary, by providing standardized language to be used by the auditing community. However, we believe the financial statements are management's responsibility and do not support proposals that allow or require an outside party to present subjective information on an entity's financial statements. If such additional disclosures are necessary, we believe they should be established through the FASB and/or SEC's standard setting process and provided by management. If an auditor has concerns with the information provided under such standards, they should be addressed with the Audit Committee whose role is to address those concerns.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Jose Simon [s]

Jose Simon, Vice President and Controller, Piedmont Natural Gas
Chairman of the American Gas Association Accounting Advisory Counci



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September 29, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington D.C. 2006-2803

RE: Response to the Public Company Accounting Oversight Board (PCAOB) – Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (Ref Docket matter No. 34)

Members of the Board,

I appreciate the opportunity to submit comments to the Board with respect to the concept release addressing potential revisions to the external auditor's report on financial statements. To put my comments in context, I worked for ten years as an external auditor, 16 years as an internal auditor, and four years in other roles within a large publicly-held company. I have also had the privilege of being involved in a variety of standard setting and governance activities related to accounting and auditing over my career. These experiences have led me to have some clear views on the subject of this concept release. However, the comments in this letter are mine personally and should not be attributed to any organization or entity.

I believe the most of the potential changes outlined in the concept release are misguided and will not accomplish the intended result. They will create more of an expectations gap, create more confusion, and increase cost with little benefit. Below are my overall comments followed in an attachment with specific answers to some of the questions asked in the concept release.

1. The financial statements are management's communication to investors and other stakeholders. If there are gaps in the information being presented, management should be the source to fill those gaps. If more information is needed regarding treatment of judgmental accounting issues, significant risks, how changes in the economy will impact future financial performance, etc., the SEC should modify its financial statement requirements. The PCAOB should not use a "back door" mechanism of requirements on the external auditor to provide this information to the public.
2. The boards of directors and their audit committees are charged with representing the interest of the investor in financial reporting matters. Many of the potential changes in the concept release go around the audit committee and replace communication between the external auditors and the audit committee with communication between the external auditor and investors directly. If there has been a failure of audit committees to adequately represent investors, correct this deficiency. The PCAOB should not fundamentally change the nature of corporate governance structures.
3. Most of the potential changes in the concept release involve topics that are currently discussed between the audit committee and the external auditor. These communications are fundamentally different than what is possible through a published written report. Discussions in a meeting involve context of prior discussions, ability for dialogue over unclear points, knowledge of the competency of the persons in the discussion, and an ability for each party to ensure they are meeting the desired information needs of the other party. None of these are available in a written report. The somewhat subjective

nature of many of these communications needs the context of a setting like an audit committee meeting to be successful. Attempting to substitute this rich venue of discussion with a written report will only leave questions unanswered, requests unmet, and confusion for the readers.

4. If the intent of the potential changes outlined in the concept release is to provide the reader with an ability to judge the sufficiency of the audit work performed, this will be unsuccessful. An audit is a complex effort requiring deep understanding of the company, its financial reporting risks, and nature of available audit evidence. If quality of audit work is a concern, the response should improvements in audit standards and inspections performed by the PCAOB.
5. The potential changes outlined in the concept release have external auditors providing previously unreleased information about a company to the public. This puts the external auditor in the role of a principle information source to the public. In this role the external auditor loses as aspect of their independence from the company.
6. Much of the information that is suggested should be included in the external auditor's report is already addressed, at least in part, by management reports. The requests for the external auditor to opine on this information looks to be an attempt by investors to shift to the external auditors the hard work of understanding a business' financial statements. Investors should be expected to read financial statements, do the hard work to analyze them, and participate in the many avenues available to obtain additional information from the company instead of trying to shift this task on the external auditor.
7. An AD&A will be long and be interpreted as providing separate opinions on the elements addressed in the AD&A. While this may not be the intention of the concept release, I believe this will be the inevitable result. This will necessarily increase the legal risk assumed by the external auditor which will further increase their efforts and the length of the AD&A. In the end, costs will be very high to produce the AD&A.
8. The PCAOB should focus its efforts on establishing robust audit standards and enforcing compliance with them, rather than trying to force the eternal auditor into a role that is extremely unlikely to succeed in accomplishing what is expected.

Sincerely,

Douglas J. Anderson, CPA, CIA

## Attachment - Responses to Specific Questions

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

    a. **Should the board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

    No. None of the potential changes outlined in the concept release merit a major undertaking to revamp the auditor's reporting model. Minor adjustments can be made if necessary without a major project.

    b. **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**

    Additional guidance could be provided as to the appropriate circumstances for explanatory paragraphs in an auditor's report for highly unusual or material items.

    c. **Should the board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

    No. The external auditor's focus, training, competencies, and role relates to financial statements. Expanding to other matters pushes the external auditor into roles best addressed by management or others with the appropriate competencies.

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

    a. **Should the auditor's report retain the pass/fail model? If so, why?**

    Yes. This model removes the potential confusion over the final view of the external auditor. If a change was made to a purely subjective discussion, it could become very unclear what the external auditor believed.

    b. **If not, why not, and what changes are needed?**
    N/A

    c. **If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

Additional guidance on the use of explanatory paragraphs in the auditor's report to highlight material or unusual items included in the financial statements could be beneficial.

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

   Management has the responsibility to provide sufficient information to financial statement users to understand the financial position and performance of the company. If additional information is required by users, the SEC should amend their requirements for the content of financial statements as prepared by management.

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

   No response

5. **Should the board consider an AD&A as an alternative for providing additional information in the auditor's report?**

   No. Management should be the primary provider of information about the financial position and performance of a company. The description of the AD&A leads to having the external auditor take a larger than appropriate role in providing original information to the reader. If information is needed about accounting positions and performance of the company, management should be required to provide that. If the concern is inadequate audit quality, this is best addressed through high quality audit standards and the PCAOB inspection process, not a written report from the external auditors.

   a. **If you support an AD&A as an alternative, provide an explanation as to why.**

      Do not support an AD&A

   b. **Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**

      Do not support an AD&A

c. **Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**

Do not support an AD&A

d. **If you do not support an AD&A as an alternative, explain why.**

Answered above

e. **Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

Answered above

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

   Do not support an AD&A

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

   Do not support an AD&A

8. **Should a standard format be required for an AD&A? Why or why not?**

   Do not support an AD&A

9. **Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**
   Do not support an AD&A, however, if one is included, it should focus only on areas of competency of the external auditors. Such competencies are in the realm of financial reporting, not generalized business and strategic risks. If investors desire an insurance policy against any and all potential negative consequences from their investment, they should look to an insurance company, not the external auditor.

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

In the current litigation environment of the United States, one of two outcomes is highly likely. Either the AD&A would be boilerplate, or an extensive rambling of information, some useful and much not useful.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

The shortcomings are numerous: (1) requiring external auditors to supplant management as the source of original information about a company's financial performance and position, (2) providing information in a method that ensures it would not be fully understood as the reader would not have context for the information in the report nor the ability to dialogue with the external auditor, (3) increasing costs of the audit significantly.

No benefits identified.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

Over time the AD&A would likely result in management saying less and the external auditor saying more. Inconsistencies would likely not be tolerated so the solution will be for management to stop providing information that is required to be provided by the external auditor.

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

None identified

**14. Should the board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

a. **If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**
   Areas of emphasis paragraphs should be included in an external auditor's report when they add useful information for the reader. Requiring them for all audits, even when they provide no meaningful information, in inappropriate.

b. **If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

Additional audit guidance could be prepared outlining those situations where areas of emphasis paragraphs are useful and encourage their use in more situations than is current practice.

15. **What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

    Requirement not supported

16. **What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

    Requirement not supported

17. **How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

    Requirement not supported

18. **What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

    Discussed above

19. **Should the board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

    a. **If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why. Subject to the caveat and suggestion above, assurance over other important components of information provided by management is a form of assurance commonly provided by the internal audit activity and a reasonable extension of financial statement auditors, to the extent it is cost justified and can be related to the financial statements and information considered in connection with the audit of the financial statements.**
    b. **On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**

    While question (a) above asserts expanding the external auditor's work over other information is a "reasonable extension", I disagree. The MD&A, earnings releases, press releases, non-GAAP information and others all involve subject matter that is either management judgment of future events or involves matters outside of the field of financial reporting. The external auditors do not currently have the competency to adequately address these matters by providing assurance. Extension of their mandate into these areas would require extensive costs with no demonstrated benefit.

c. **What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**

   Proposal not supported

d. **If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**

   Proposal not supported

e. **Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**

   If the auditor needed to provide assurance on the MD&A, management would limit their disclosures to historical, factual information.

f. **Are the requirements in the board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered? The cost of AT 701 form of assurance may exceed the benefits. We suggest a compromise position. As exists today, the auditor are required to read such disclosures, including MD&A, we suggest the auditor include a paragraph in the auditor's report that the auditor has read [add specific areas] and found such information and disclosures to be materially consistent with information the auditor learned as part of the audit of the financial statements. That is, have the auditor's report disclose what is essentially in effect today.**

   Disclosing what the external auditor is doing today to comply with audit standards is acceptable. However, this assumes investors are unaware of this requirement and are not able to read the audit standards.

g. **If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

   Discussed above

20. **What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

Discussed above

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**
- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

There is no harm in expanding the auditor's report for these items. However, none are changing the requirements on the external auditor, merely stating the current standard. It is unclear that investors do not understand these long-established audit standards and cannot learn about them with limited amount of effort.

**b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**

See answer above

**c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**

See answer above

d. **What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

See answer above

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

The benefits are speculative and assume investors currently do not know this information and cannot read the audit standards. The shortcomings, however, are nil.

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

The best alternative is for the PCAOB to focus its efforts on producing high quality auditing standards and enforcing those standards.

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

See answer for Q23 above

**25. What alternatives not mentioned in this concept release should the board consider?**

See answer for Q23 above

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

There would need to be a substantial level of effort to develop the framework and criteria. The PCAOB should not underestimate the extent of this effort or try to complete too quickly. Explicit consideration of costs and benefits of any specific proposals must be considered.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the board take to mitigate the risk of this perception?**

No response

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

The external auditor's current role is already well defined in the audit standards.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

Audit quality would likely diminish is the external auditor were to provide assurance on other financial material outside of the financial statements. This is because of the current lack of competency of the external auditors with this material. If the external auditor were to produce an AD&D, it is hard to conclude on the effect on audit quality. However, I suspect most external auditors would devote substantial resources to this effort that would likely result in acceptable audit quality, but extremely high cost.

**30. Should changes to the auditor's reporting model considered by the board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

I am generally not in support of the potential changes proposed in the concept release. I don't believe my position would be different for different types of filers.

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

**a. Are any of these considerations more important than others? If so, which ones and why?**

The most important impact is requiring the external auditors to take away from management primary responsibility for reporting certain aspects of financial information.

**b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

The costs will increase significantly for marginal benefits. Before these initiatives move forward a much more robust cost benefit analysis would be required.

**c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**

No

**d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

As most of the potential changes are not supported, no measures by the PCAOB would be necessary.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in**

**the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

The nature of relationships between management, Audit Committee and the external auditors has certain inherent friction points. This is good and by design. However, the potential changes to the auditor's reporting model outlines in the concept release would substantially increase the pressure on these relationships, especially those between the external auditors and management. This increased pressure would substantially increase cost, potentially delay the reporting processes, and reduce the openness management may have with the external auditors. None of this improves the quality of financial reporting.

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

September 30, 2011

Re: PCAOB Rulemaking Docket No. 34

Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's "Concept Release on Possible Revisions to PCAOB Standards Related to Report on Audited Financial Statements and Related Amendment to PCAOB Standards" dated June 21, 2011.

We acknowledge the concerns addressed in the concept release and agree that investors should receive useful and relevant financial information on a timely basis. We support providing investors with the information necessary to make informed decisions. However, we believe management, as opposed to auditors, is the most appropriate and knowledgeable source for providing investors with information on the company's business risks and strategy, operating performance, and accounting judgments and policies, which is information management currently is required to disclose. If the independent auditors' report is expanded to include the alternatives outlined in the concept release, careful assessment should be made on whether such changes will create confusion for investors and blur the line between the important and unique responsibilities of management and auditors.

Overall, we believe the current financial reporting structure has clearly defined roles and responsibilities for the key groups involved in financial reporting including a company's management, its audit committee, and independent auditors. Each of these groups is required to have appropriate controls in place to ensure financial reporting is accurate and complete.

Company management is responsible for preparing the financial statements and related disclosure information in accordance with the accounting and disclosure requirements defined by the various standard setting regulatory agencies, including the Financial Accounting Standards Board and the Securities and Exchange Commission. A company's management is the most knowledgeable resource with respect to business and operational risks and serves as the primary source of information to investors. Additionally, the Chief Executive Officer and Chief Financial Officer approve and certify the integrity of the company's quarterly and annual financial reports.

The audit committee consists of independent members of a shareholder-elected Board of Directors, and includes at least one financial expert. The audit committee oversees management's financial statements and related disclosure reporting, monitors the appropriateness of accounting policies, and appoints and supervises the external auditors. The audit committee plays an integral role in the financial reporting process by monitoring that all material accounting issues and critical accounting transactions have been appropriately accounted for and disclosed.

Independent auditors are hired by the audit committee and that appointment is ratified by the shareholders. The independent auditors are required to plan and perform an audit of the company's financial statements and related disclosures in order to express an opinion as to whether the financial statements are free from material misstatement and are in conformity with generally accepted accounting principles. Additionally, the independent

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auditors attest to the effectiveness of the company's internal controls. The independent auditors' expertise is in the application of accounting principles and the assessment of financial controls, as well as in the process for auditing financial statements and related information based on an accepted framework. The independent auditors provide assurance on the reliability of financial statements being free of material misstatements. Auditors also serve to independently review management's financial statements and disclosures and read the MD&A and consider whether it is materially consistent with their understanding of the facts or with information appearing in the financial statements.

Certain of the proposed alternatives in this concept release would significantly alter these roles and responsibilities in a way that we believe would be expensive, not provide investors with significant incremental information, and could lead to investor confusion and inhibit open communication between management, the audit committee and auditors.

Our comments on each of the proposed alternatives discussed in the concept release are as follows:

**Auditor Discussion and Analysis ("AD&A")**

We do not support the AD&A alternative described in the concept release. The AD&A would significantly expand the auditors' role in the financial reporting process and would reach outside the bounds of their current expertise, and for which they have an established framework against which their work can be measured. Management currently has responsibility for informing the investing public. We believe the AD&A creates a conflict between the distinct roles and responsibilities of auditors and management that could only serve to confuse investors without providing them any beneficial information. In our opinion, the auditors should not be placed in the position of determining and disclosing subjective information that could be contradictory to the disclosures provided by management.

The concept release also contemplates the disclosure of "close calls," a requirement that is likely to confuse investors rather than provide them with additional beneficial information. An auditors' unqualified opinion means all material matters were resolved and the financial statements are fairly stated. Highlighting additional information about accounting issues that required consultation or involved evaluation of alternative accounting treatments would put an unnecessary spotlight on accounting matters that are appropriately accounted for and reflected in the financial statements. Currently, management openly discusses complex accounting issues with its auditors, and requiring auditors to disclose any such matters that they considered to be "close calls" could inhibit the open and dynamic communication that currently exists between management, audit committees and auditors. Under the current disclosure requirements for public companies, management is already required to assess and disclose its significant and critical accounting policies and estimates in periodic filings, which is reviewed by auditors and audit committees. We believe that management is the most well informed to make such assessments, and adding a discussion of the auditors' alternative views will only confuse financial statement users.

The concept release also proposes auditors provide the same level of information as communicated to the audit committee within their audit report. Independent auditors and the audit committee have a relationship whereby the auditors report on the results of their audit to the audit committee, and the audit committee oversees the auditors on behalf of the company and its shareholders. This dynamic relationship requires extensive two-way communication and periodic reporting. If the audit report included all the same information as communicated to the audit committee in a static reporting manner, we believe this could lead investors to misinterpret or misunderstand the information being provided since such disclosure would lack the interactive dialogue that exists between auditors and audit committees. Without this continuous two-way discussion, AD&A could be taken out of context and create investor confusion. This would also likely have a negative impact on the transparency of communications between auditors and audit committees.

We believe that many of the other aspects of the proposed AD&A outlined in the concept release pose similar concerns, including the proposal that auditors provide descriptions of specific audit procedures. Most readers of the financial statements will not have an appropriate level of expertise to understand the complexities of audit procedures, thus such disclosure will be of limited use to investors. Additionally, we believe the proposed AD&A will result in filing delays due to the extensive reviews and discussions that will be required by audit firms to issue customized reports for each client. Finally, issuance of AD&As would significantly increase both the scope of audit procedures and the overall cost of public company compliance, without providing significant incremental information.

**Emphasis Paragraphs**

We also do not support the alternative proposal to require the expanded use of emphasis paragraphs in the audit report. Within quarterly and annual reports, companies are required to disclose important business and accounting information, including information on the company's strategy, risks factors, legal proceedings, management's perspective on operating results, critical accounting policies and material business transactions. To fully understand the risks associated with investing in a company, these disclosures must be read in totality, rather than just focusing on identified areas of emphasis. We believe all the information currently provided in quarterly and annual reports, when taken as a whole and read in totality, provide sufficient information to investors about the material aspects of a company's business and accounting policies.

Without an established framework that provides specific identification criteria, the emphasis paragraph alternative will lead to inconsistent application and reporting across companies. Further, we believe the proposed scope increase to include emphasis paragraphs in audit reports will unduly focus attention on a limited number of accounting issues, which are already identified by management within the financial statements and related disclosure, and will de-emphasize all other information and disclosures provided. Appropriately prepared financial reports already identify critical accounting and judgment areas. Further emphasis in the audit report will only serve to provide repetitive information to investors. If investors believe the current financial statement disclosures and other information contained in periodic filings are deficient in certain areas, work should be undertaken by the various standard setting regulatory agencies to modify the current reporting requirements.

**Financial Information Outside of the Financial Statements**

We do not support the proposed alternative to require auditors to report on information outside of the financial statements as the costs would far exceed the benefits. Auditors currently have the responsibility to read non-financial statement information in public filings to ensure such information is materially consistent with the audited financial statements. There is a variety of information that falls outside of the financial statements, including earnings releases, management's discussion and analysis and non-GAAP reporting. We believe the current level of review over information that is outside of the financial statements is sufficient to ensure information is materially accurate. Requiring an audit over areas that are not based on authoritative accounting requirements or forecasted amounts would be unreasonably burdensome and create significant timing delays and excessive costs that would negatively impact investors' ability to obtain timely information.

**Clarification Language**

We support all efforts to clarify the language used in the audit report to ensure investors clearly understand the specific roles and responsibilities of management and auditors. Careful consideration should be made to ensure the proposed changes truly clarify the nature of an audit and the auditors' responsibility. As discussed previously, we believe it is important to support the usage of consistent language in audit reports so they are comparable company to company and are based on objective information.

* * *

In conclusion, we support improving communication to investors, while maintaining the scope and nature of an audit and the related responsibilities of auditors. We do not support making changes to the audit report that would require auditors to make subjective determinations or merely repeat information provided elsewhere in the financial statements and related disclosures. We believe the current roles and responsibilities of management, the audit committee and the auditors are the fundamental basis for the financial reporting infrastructure and certain of the proposed alternatives in this concept release would negatively impact this structure.

Thank you for your time and consideration. If you have any questions regarding our letter, you may contact me at (408) 862-1401.

Very truly yours,

Betsy Rafael

Betsy Rafael
Vice President and Corporate Controller

ACCA

Ref: TECH-CDR-1050 September 2011

By email to comments@pcaobus.org

The Office of the Secretary
PCAOB
1666 K Street
N.W. Washington, D.C.
20006
United States of America

Dear Sirs

**PCAOB Rulemaking Docket Matter No. 34: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements**

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 147,000 members and 424,000 students throughout their careers, providing services through a network of 83 offices and centres. Our global infrastructure means that exams and support are delivered – and reputation and influence developed – at a local level, directly benefiting stakeholders wherever they are based, or plan to move to, in pursuit of new career opportunities.

ACCA is pleased to provide comments relating to *Rulemaking Docket Matter No. 34*. Our comments are consistent with those we have recently provided to the International Auditing and Assurance Standards Board (IAASB) on their Consultation Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change*[1]. That paper correctly identifies significant trends: the 'modernisation' of disclosures in the financial statements and user interest in disclosures that are arguably not part of the financial statements (or at least which are not addressed by the financial reporting framework). The overarching

[1] ACCA's response may be viewed at: http://www2.accaglobal.com/general/activities/technical/archive_v2/subject/auditing/cdr1021

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question is whether such disclosures are understood by users without an expectations gap? Furthermore, is there an appropriate user understanding of the limits of assurance when the subject matter is narrative and unrelated to traditional financial disclosures?

ACCA has been arguing for the past two years that, while the audit is not 'broken' as it adds real value by enhancing trust in financial statements, auditors could do much more. We believe audit needs to evolve to address not just the financial statements but also to give an opinion on more forward-looking, qualitative and non-financial data. There needs to be less focus on out-of-date figures and more on risk information. Nevertheless, the starting point should be improving corporate reporting not just auditor reporting.

We have previously published suggestions as to how the auditor's role and report should be improved and we have recently commissioned associated research to inform the unfolding debate in the European Union. We provide details of those publications in the body of our attached answers to the specific questions posed in the concept release.

Should you have any questions regarding this response, or require further information, please do not hesitate to contact me.

Yours sincerely

David York
Head of Auditing Practice

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ACCA

**Question 1**
*Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

Given that the IAASB and others have begun initiatives it seems sensible for the PCAOB to similarly consider improvements to the auditor's reporting model. Such a project should be undertaken in close collaboration with others, however, to ensure that national differences are understood and reconcilable. We caution that, when participating in international initiatives, the PCAOB should recognise that the IAASB has to have considerable regard to the needs of engagements on financial statements for smaller entities.

b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

Explaining better the audit methodology employed may help change user perceptions of audit, but users have different needs and levels of understanding; necessitating different approaches to meet those needs. Audit methodology can be highly complex and clarity of communication to users will be difficult to achieve. Users can always refer to the standards to which the auditor is required to comply and related materials but these extend to many hundreds of pages. It is unlikely, therefore, that any audit report can itself go into sufficient detail on the audit methodology employed to properly inform users. It would be feasible, however, to use the report to communicate what the auditor has done, the major factors considered during the audit and why the auditor has arrived at a particular opinion.

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ACCA believes that there should be consideration of incorporating into the standard auditor's report a clear statement of responsibilities for reviewing and/or reporting on companies' risk management and corporate governance arrangements, indeed we have suggested that the auditor should report on an extended audit committee report. We also believe the auditor is well-placed to assess and report on the client's business model, or at least on the financial assumptions underlying that model. We accept that taking on such responsibilities – which would meet demands from users for more useful information from the audit – would require commensurate legal protection for auditors.

c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

There are essentially two ways to bridge the expectations gap: moving the audit closer to the public perception, or changing that perception. ACCA believes that it is now necessary to undertake an evolution of the auditor's role within the reporting process. The economic crisis has shown that there is still room for improvement within the audit and risk management functions and there is a legitimate debate that should take place about the role of audit, involving all stakeholders in the process. Reporting entities and auditors must pay heed to the deeper and wider needs of stakeholders and hence meet the reasonable demands of the market. All extensions of the auditor role have cost implications and the market would have to be suitably informed in making demands. The starting point should be improving corporate reporting not just auditor reporting.

ACCA is committed to identifying ways of closing the audit expectations gap and we have recently carried out a considerable body of work in response to the challenges presented to the auditing profession by the business environment. As part of ACCA's *Accountancy Futures* programme, in the year to September 2010 we researched the views of audit committee chairmen and hosted an international series of ten round-table discussions on the value of audit. The report *Reshaping the audit for the new global economy*[2] presents our findings including those in relation to expanding the scope of the audit.

[2] http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/pol-af-rtf2.pdf

Within the above programme, during 2011 we would particularly draw attention to *The Value of Audit: Views from Retail (Private) Investors*[3], a report prepared by ACCA for the Singapore Accounting and Corporate Regulatory Authority (ACRA) which examines the value of audit as perceived by private investors and *A Framework for Extended Audit Reporting*[4] a report by Maastricht Accounting, Auditing and Information Management Research Center (MARC) of Maastricht University, Netherlands, commissioned by ACCA to examine a possible framework for extended audit reports.

**Question 2**

*The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

Given the widespread support for the direct signalling of the pass/fail model we believe that it should be continued. The PCAOB faces special national circumstances in that the Securities and Exchange Commission does not accept qualified or adverse opinions or disclaimers of opinion. Such circumstances may fundamentally affect the auditor/auditee interactions concerning identified issues but in the absence of reliable research findings it is not possible to draw informed conclusions as to the effect this might have on the need for change to reporting models; also, as noted in the concept release, *'coordination with the Securities and Exchange Commission ("SEC") would likely be necessary'*.

b. *If not, why not, and what changes are needed?*

In view of our answer to part (a) of this question, we do not answer part (b).

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[3] http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/views_from_retail.pdf

[4] http://www2.accaglobal.com/pubs/general/activities/library/audit/audit_pubs/extended_audit_reporting.pdf

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

It is important that the auditor continues to have available a means of emphasising matters in the financial statements that are fundamental to users' understanding of the financial statements.

Please refer to our answer to question 1, concerning possible changes to the report or supplemental reporting that would be beneficial.

**Question 3**

*Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

We believe that it is the role of management and those charged with governance (as appropriate) to provide additional information regarding the company's financial statements to financial statement users.

We are attracted to the model of reporting whereby the audited entity is free to report matters that the auditor has raised with the audit committee / those charged with governance. Auditing standards currently drive auditor communication, but entities may consider that they need the equivalent of financial reporting standards to govern the way in which they report externally, so that there is a degree of consistency and comparability between reporting entities. We fully support the development of such reporting and indeed targeted assurance engagements on it designed to achieve appropriate objectives; as these are more likely to be directly responsive to user needs and the value they place on them (as such assurance may be relatively costly).

**Question 4**
*Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

We recognise that information related to the audit of the company's financial statements discussed in the concept release could also include matters related to the audit of internal control over financial reporting. Unless there was prescribed content relating to the latter, however, we believe that the elements of reporting required by Auditing Standard No. 5 would continue to be relevant whether presented separately or in a combined report. It might be appropriate, therefore, to restrict any changes to standards to those other than Auditing Standard No. 5.

**Questions 5 to 32 concerning potential alternatives for changes to the auditor's report**
Questions 5 to 32 explore elements of reporting by means of presenting certain alternatives:

- Auditor's Discussion and Analysis,
- Required and expanded use of emphasis paragraphs,
- Auditor assurance on other information outside the financial statements, and
- Clarification of language in the standard auditor's report.

As the concept release notes, these alternatives are not mutually exclusive, and a revised auditor's report could include one or a combination of these alternatives, elements within the alternatives, or alternatives not currently presented in this concept release. We do not provide views on best presentation as to do so, before knowing what changes are to be made to the individual elements, would be premature. Accordingly, we answer individually below only those questions most relevant to the positions we wish to advocate.

In general, we prefer brevity and simplicity in reporting as both encourage users to read auditors' reports and both facilitate comprehension. Thus, a primary test for the inclusion of material has to be whether it is sufficiently important to counterbalance the attendant lengthening and complication of the report. We also believe that the overall impact of the report has to be considered even though, for the purposes of the concept release, elements of it are separately discussed.

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**Question 5 (and 6 to 12)**
*Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

- a. *If you support an AD&A as an alternative, provide an explanation as to why.*
- b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*
- c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*
- d. *If you do not support an AD&A as an alternative, explain why.*
- e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

We do not believe that it is the auditor's role to provide detailed commentary on the financial statements, as management should provide all necessary disclosures. Accordingly, we do not support the concept of an Auditor's Discussion and Analysis which would be regarded mainly as commentary on the financial statements. This perception would persist even if the AD&A included commentary on the audit, or indeed on matters such as the auditor's relevant competencies.

We prefer the model under which the auditor reports to those charged with governance / the audit committee and the latter uses those insights to inform its own reporting in conjunction with the financial statements.

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**Question 14 (and 13, and 15 to 18)**
*Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*
a. *If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*
b. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

We see considerable difficulty in producing a list of required areas for comment, as circumstances will differ between entities and a one-size-fits-all approach is unlikely to be effective. A principles-based approach would seem to be preferable. We believe that auditors will seek to demonstrate that a consistently rigorous approach has been taken in relation to each area on which they comment. This can result in repetition of disclosures, or at least very similar wording in relation to several commented matters. Moreover, with the expectation of comment, auditors are likely to address more, rather than less, matters, diluting the value of the information for users.

If such statements were to become extensive it would raise concerns over the brevity of reporting and we see, therefore, more scope for informative reporting where the auditor positively wishes to comment. This should continue to be allowed under reporting standards, rather than introduce a required separate section of the report.

Requiring emphasis paragraphs similar to the approach of the French *'justification of the auditor's assessments'* is likely to promote the emergence of boilerplate language. This has happened in practice.

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**Question 19 (and 20)**
*Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

a. *If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*
b. *On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*
c. *What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*
d. *If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*
e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*
f. *Are the requirements in the Board's attestation standard, AT sec.701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

We believe that a balance must be struck between extending the audit of the financial statements and the provision of assurance on related matters. While ACCA has identified significant demand for change, through the body of work referred to earlier in this response, it is important that sufficient detailed research is carried out to explore the views of preparers, users and auditors to determine the demand and the acceptable cost; as experience has shown that, when cost is fully appreciated, the price to be paid may be considered too high.

When determining the relative priority of options to explore, we caution against focusing on matters close to the area of standard setting for auditors when more valuable progress may be made by working together with others in the financial reporting supply chain.

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**Question 21**
*The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

a. *Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

The proposed clarifications may be subdivided into those dealing with what might be regarded as technical terms and those where ‘responsibility’, a word that takes its normal meaning, is being explained. We are sympathetic to the complaint that certain technical concepts are not understood by report users. Reasonable assurance is not explained by existing reports and we believe it is important that users understand that while the target might be absolute assurance, that is not achievable given the inherent limitations of the financial reporting and auditing processes and the need for timely reporting at a reasonable cost. Because auditing standards merely direct the process there is no direct link to the degree of confidence that a standards-compliant audit should provide. Nevertheless, users are entitled to demand the same level of assurance that financial statements are fairly presented as they demand that the next flight they take will arrive safely. Auditors must not be able to use the concept of reasonable assurance as a shelter against justified criticism of, for example, gathering insufficient evidence or exercising insufficient professional scepticism.

We have never found convincing the argument that mentioning ‘independent’ in the title of a report communicates sufficiently with users. We are sympathetic to the view that the auditor's report should disclose that the auditor has a responsibility to be independent of the audited entity and has complied with applicable independence requirements of the PCAOB and SEC. Moreover, where there are significant factors concerning independence that ought to be appreciated by users, we would support a requirement that such matters should be disclosed.

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It is important that users understand the difference between information that is within the financial statements and is audited and the auditor's responsibilities towards other information. We believe that it would be generally beneficial for auditors to indicate, therefore, the precise scope of their responsibilities regarding 'other information'. This would be particularly important in cases where there are separate opinions on some other matters in addition to the general responsibility to consider other information in relation to the audit of the financial statements.

We discuss management and auditor responsibilities further in our answer to question 21.b below.

b. *Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

There has been academic research on the usefulness of generically-worded paragraphs concerning the responsibilities of management and auditors[5]. Recitations of the respective responsibilities of the auditor and management can be regarded as communication of their respective roles, but some regard the material as risk management by the auditing profession. We believe that the report of the auditor can best add to user understanding by setting out clearly the scope of the auditor's work. It is important to say what the auditor has done rather than what the auditor has not done. It is important to communicate the auditor's responsibilities precisely rather than make statements about who has assumed other related responsibilities.

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[5] As reported in the IAASB Consultation Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change*

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ACCA

**Question 22**

*What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

The benefits of clarifications of the language in the standard auditor's report are that users have an increased understanding of the report and hence greater precision in the extent to which they derive assurance from the audit. However, it is not simply a matter that adding to the standard report increases understanding. A balance must be struck between brevity and the need to include wording to clarify the language in the standard auditor's report. There is also a dilemma because expert users will already understand the matters for which clarification is proposed, whereas other users may find brief explanations insufficient for their purposes. For example, the concept of independence – which is a matter of degree rather than an absolute – is not easily explained.

**Question 24**

*Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

As we indicated in our general remarks concerning questions 5 to 32, the way that certain elements are presented or combined is a secondary consideration. Each improvement to the standard auditor's report has to be assessed in relation to the needs of users. Only when that has determined the matters to be included in the report should the best form of presentation be itself decided. Having said that, in view of the different needs of expert and other users (mentioned in our answer to question 22 above) we see some merit in presenting further communications in a manner that clearly indicates their supplementary nature.

**Question 29**

*What effect would the various alternatives have on audit quality? What is the basis for your view?*

We see no causal link between the form of reporting and audit quality. Nevertheless, user perceptions of audit quality may be influenced by the inclusion of wording that better exposes the rigour of the process, the relevance of its outcomes and the competencies and relevant qualities of the auditor.

ACCA

**Question 30**
*Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

While the entities referenced in the question differ, they are ones in which there is considerable public interest and hence ones for which improvements in auditor reporting would be most valuable. This is not to say that all reports must be the same as, by promoting a flexible approach by auditors, the PCAOB would encourage tailoring to the particular circumstances rather than the application of perhaps boilerplate wording.

We suggest that some consideration should be given to the potential burden on smaller companies as their relative simplicity means that investors and indeed audit committees have less need of detailed information from auditors.

**Question 31**
*This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality*

a. *Are any of these considerations more important than others? If so, which ones and why?*
b. *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*
c. *Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

We suggest that users of auditor's reports would benefit from increased transparency concerning the auditor, for example by including options to allow the auditor to present appropriate credentials. In several jurisdictions large audit firms are required to adopt publicly visible governance arrangements and publish 'transparency reports' containing information about their governance and capabilities. They are also subject to regulatory review that is in the public domain. User demand for equivalent levels of information might be satisfied in part by the auditor's report but also might require different regulatory action to achieve such transparency.

d. *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

We comment on those circumstances where users demand assurance on disclosures related to, but outside, the financial statements. In relation to such matters, the prime movers must necessarily be the users, preparers, regulators and standard setters concerned with the provision of subject matter information that is suitable for assurance.

The PCAOB needs to reach a satisfactory position on standards for assurance / attestation and perhaps related services (and quality control) to support such developments.

The issue of auditor liability must necessarily be resolved in parallel with other actions to develop further reporting of assurance or related services on disclosures related to, but outside, the financial statements.

**Question 32**
*The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

The answer to this question depends on the nature of the information disclosed by the auditor. We draw a distinction between primary provision of information and auditor commentary on disclosures already made by management. The latter is already familiar, albeit in restricted circumstances, and we do not see that expansion of that would change the interaction between the auditor, management and the audit committee. If auditors were to become primary disclosers, the relationship between the auditor, management and the audit committee would be affected by the blurring of roles and hamper the effectiveness of communication between them. Because the interaction is determined by the primary roles of each participant (which are unchanged), however, we do not see that the potential effects would be overly significant.

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September 30, 2011

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

Sent via email to comments@pcaobus.org

Dear Office of the Secretary:

**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 034**

The Canadian Auditing and Assurance Standards Board (AASB) is pleased to provide its comments on the Public Company Accounting Oversight Board (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 034 (the concept release). We commend the PCAOB for soliciting public comment in connection with your proposed project to deal with possible revisions to the content and form of reports on audited financial statements and we appreciate the opportunity of responding to you.

By way of general background, the AASB's mission is to serve the public interest by setting high-quality standards and guidance that enable the Canadian public accounting profession to provide effective auditing, other assurance and related services. The AASB has the authority, as reflected in federal and provincial Business Corporations Acts, and other legislation and securities regulations, to set generally accepted auditing standards (GAAS) for financial statement audits in Canada. The activities of the AASB are overseen by the Auditing and Assurance Standards Oversight Council (AASOC), an independent body consisting of business leaders and regulators and having the oversight responsibility to ensure that the public interest is properly taken into account in the development of auditing and assurance standards in Canada by the AASB.

The AASB adopts International Standards on Auditing (ISAs) and International Standards on Quality Control (ISQCs) as Canadian Auditing Standards (CASs) and Canadian Standards on Quality Controls (CSQCs) respectively on the same timetable as the International Auditing and Assurance Standards Board (IAASB). CASs and CSQCs are Canadian GAAS for audits of financial statements. The AASB only makes amendments to ISAs and ISQCs that may affect how a practitioner performs an audit of financial statements in circumstances that meet specific criteria. These criteria allow the AASB to make very limited amendments, for example, to meet Canadian rules of professional conduct and to incorporate joint protocols for communicating with the Canadian legal and actuarial professions. When amendments are made, they are clearly identified in the standards. The AASB strongly believes in the consistent application of these standards and promotes their adoption globally.

**Our key comment**
In writing this response letter to you, we would like to focus on only one particular aspect of this project which is the importance of the PCAOB coordinating and collaborating with other global standard setters such as the IAASB on the auditor reporting model.

**Background to our key comment**
Canadian entities, like those in other countries, participate in today's global capital markets. However, Canada is also in a special position in that it has approximately 350 public companies registered and reporting with the Securities and Exchange Commission (SEC) as of December 31, 2010. This is well over twice the number from any other country and over a third of all foreign registrants.

Canadian securities regulators permit Canadian SEC registrants to have their audits conducted in accordance with PCAOB standards, recognizing the strong interrelationship between Canadian and US capital markets. Although there are differences between PCAOB reporting standards and Canadian GAAS, the auditors for some SEC foreign registrants are still able to prepare a single audit report that refers to both Canadian and PCAOB GAAS. This would not be possible if the reporting standards set by the PCAOB and IAASB were to diverge significantly.

While some flexibility between PCAOB reporting standards and those of the IAASB may be needed, we are concerned that significant differences in the form and content of reports resulting from the two sets of standards would create confusion for readers of auditor's reports on financial statements of Canadian SEC registrants, particularly as these comprise many of Canada's largest companies. We believe that significantly different auditor reporting models are not in the public interest.

The AASB responded to the IAASB's Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change,* on September 16, 2011 and we attach a copy of our response for your information. We note that there are many overlapping areas of interest between the concept release and the IAASB's Consultation Paper. For example, we believe that the approach we used to develop our response to the IAASB, which included applying a series of boundaries to guide our responses to questions posed, would be equally applicable to the concept release.

We hope that our view will be useful to the PCAOB in developing the possible revisions to PCAOB reporting standards. If you have any questions or require additional information, please contact Greg Shields at (416) 204-3287.

Yours very truly,

Bruce Winter, FCA
Chair, Auditing and Assurance Standards Board (Canada)

c.c. Canadian Auditing and Assurance Standards Board Members
Canadian Auditing and Assurance Standards Oversight Council Members
enc. AASB response on IAASB Consultation Paper, dated September 16, 2011

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September 16, 2011

Mr. James Gunn
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
545 Fifth Avenue – 14th Floor
New York, NY 10017
U.S.A.

Dear Mr. Gunn,

**Re: Consultation Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change***

The Canadian Auditing and Assurance Standards Board (AASB) is pleased to provide its comments on the Consultation Paper (CP) *Enhancing the Value of Auditor Reporting: Exploring Options for Change.* In developing this response, we considered comments provided to us by our stakeholders who showed a strong interest in this topic. Over 100 stakeholders participated in ten face to face and conference call meetings we held with various user groups, including company management, audit committees, directors, regulators, auditors and others. Nearly 300 participants also provided input to polling questions presented during an interactive webinar. We would be pleased to provide you with access to this data should this be of interest to you.

## GENERAL COMMENTS

We support the efforts of the IAASB as it seeks to obtain a better understanding about views on the issues raised in this CP as a pre-requisite to considering possible improvements in auditor reporting. We agree that it is appropriate to monitor and maintain the value and relevance of auditor reporting including, as appropriate, enhancing the auditor's report on the financial statements. In our view, there are opportunities for enhancing auditor reporting that will help meet the information needs of financial statement users and reduce the expectations gap.

The auditor's report is the key output from the audit process. We believe it is important that an international solution be developed on the form and content of the auditor's report and the auditor reporting model so that users around the world can understand and compare auditor's reports on a consistent basis. For example, many Canadian entities have operations in the United

States and other international markets. We believe it would be confusing to users of Canadian financial statements if there are significant differences among auditor's reports in major jurisdictions. For this reason, we urge the IAASB to work together with other bodies that are taking an interest in auditor reporting, such as the European Commission and the United States Public Company Accounting Oversight Board.

Having reviewed the results of the consultations referred to above, we noted a diverse range of views on many of the options presented in the CP. To put these views in perspective in a response letter to you, we developed a series of "boundaries" – a set of guidelines set out in the Appendix to this letter covering:

- cost/benefit considerations;
- maintaining and communicating the respective responsibilities of the auditor, management and those charged with governance in an audit of financial statements;
- other form and content issues; and
- the auditor's ability to provide assurance on information.

We have used these boundaries to guide our responses to each question posed in the CP and we believe that this has enabled us to present you with responses based on a rationale framework for moving forward. We commend this approach to you and hope that it may be of assistance as you consider the responses to the CP.

Where appropriate, we have included in our response to a question additional views presented to us by our stakeholders that provide support for our response.

## RESPONSES TO QUESTIONS

### Issues Identified

1. **Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?**

   We agree that there is an expectations gap between what users expect from the auditor and the reality of what an audit is. This has been recognized, discussed and debated for many years. There continues to be a lack of understanding about the scope of an audit.

   As noted in the Preface to the CP, the IAASB recently made improvements to the auditor's report that were intended to address the expectations gap. We strongly supported those changes. In particular, we note that the expanded description of the auditor's responsibilities with respect to internal control have been well-received in Canada.

We also support the IAASB considering how the expectations gap can be narrowed. However, we believe that it is unlikely that further changes to the auditor's report, regardless of their nature and extent, will be able to completely eliminate the expectations gap. In our view, continuing work needs to be done to educate stakeholders about the nature and value of an audit. In our discussions with our stakeholders about the CP, we noted that many of them were not only unfamiliar with what an audit is, but also were unfamiliar with the broader context of the financial reporting process and the different measures in place in many jurisdictions to safeguard the quality of audits. We support and encourage the IAASB to continue its work in this area.

We also agree that there may be an information gap between what information about the entity and the audit is available and what is provided through the audited financial statements and other corporate disclosure mechanisms. At the same time, stakeholders informed us that in Canada there is sufficient information available in the financial statements and Management's Discussion and Analysis (MD&A) to assist users with their decision making. But in many cases, users are unwilling to read this information or they do not understand it. Users therefore question whether the information gap can be addressed by simply providing more and more information. Some users already feel overwhelmed by the volume of information provided in financial statements and other documents. For them, providing more information would not be helpful.

Many users have also indicated that they neither want nor value the additional commentary that auditors might make on the entity's financial information. In their view, such commentary would not likely be particularly helpful because users are not convinced that auditors have the competencies, nor are there available suitable criteria, for them to provide insightful comments that would affect users' decision making. Based on these comments from our stakeholders, we are not convinced that providing additional information about the entity in the auditor's report will address the expectations gap.

We noted that most of our stakeholders agreed that some changes to auditor reporting would be beneficial. For example, over 88% of respondents in our webinar strongly agreed or agreed with the statement "Keeping in mind benefits, costs, potential challenges and other implications at least some proposed options to enhance auditor reporting in the IAASB's Consultation Paper should be pursued."

**2. If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?**

We believe that the following are the critical issues that need to be addressed when considering changes to auditor reporting:

- The format and structure of the auditor's report should effectively communicate what the auditor has done and the conclusions the auditor has reached.
- The auditor's communications with those charged with governance should assist those

charged with governance in playing an appropriate corporate governance role.

- Auditor reporting should support other changes that would strengthen the role of those charged with governance. In this respect, the IAASB can play a role in working with international bodies such as the International Corporate Governance Network and the International Organization of Securities Commissions.

The following are some key considerations in developing a revised format and structure of the auditor's report:

(a) *Meeting the divergent needs of users of financial statements*. It is evident that different users have different information needs with respect to understanding the audit and the auditor's report. On the one hand, there are many retail investors, for example, whose interests are limited to understanding who has done the audit, what has been its scope, what the auditor's conclusion is from it, and that the report is a standard report. A simple pass/fail report with standardized wording often meets their needs. Significantly expanding the auditor's report may only serve to confuse such users. On the other hand, there are users, for example institutional analysts, who want more information about the audit, including what were the areas of audit focus, how the auditor addressed significant risks and so on. For these users, the current form and content of the standard auditor's report does not appear to meet their needs. They are looking for a report that is more entity specific and nuanced. Finding the appropriate balance among different users appears to be one of the most challenging issues in making changes to auditor reporting.

(b) *Agreeing on what can reasonably be communicated in the auditor's report in order to provide value and enhance audit quality.* There is the potential to dramatically increase the amount of information that is contained in the auditor's report. However, as the auditor's report is incrementally increased, it is difficult to determine whether and to what extent the benefits of such additional information are counteracted by the lack of willingness of many users to read longer reports and the risk that they will be more rather than less confused. Simply increasing the quantity of information will likely not improve the quality of information.

(c) *Demonstrating that benefits exceed costs. For the options presented in the CP, there is a need for a clear articulation of the related costs and benefits.* We believe that the IAASB needs carefully to consider which stakeholders will bear the associated costs, which stakeholders will receive the benefits of the various options and whether the benefits exceed costs. Because some of the options may not have been implemented previously, there may not be factual information available that demonstrates costs and benefits. In addition, there may be unanticipated consequences for certain options that may not be identified until they are implemented.

We believe that all users are affected by these issues. However, there is a need to consider providing guidance on enhancing the auditor's communications with those charged with governance in smaller entities, especially smaller listed entities.

**3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities**

We believe in the principle that "an audit is an audit" and that the form of auditor's report on the financial statements should be the same irrespective of the entity being audited. We would be concerned that different forms of auditor's report for different entities would create unintended differentiation of the perceived relative quality of their financial statements; for example, the financial statements of unlisted entities might be considered to be second rate as compared with those of listed entities solely on the basis of the different form of auditor's report. Accordingly, we believe that changes are needed for audits of all types of entities.

As a result, the implications of potential changes to the auditor reporting model need to be considered in this light so that unnecessary burdens are not placed on small and medium sized entities, particularly private companies. At the same time, we recognize that auditors of financial statements of listed entities, for example, may have additional responsibilities that need to be reflected in the auditor's report.

**Format and Structure of the Standard Auditor's Report**

**4. Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor's report described in Part A.**

Our stakeholders strongly supported including the explanation of management's and the auditor's responsibilities either within the report or as an appendix to it. Several respondents told us that they believed that the audit opinion should receive greater prominence because it is the key element of the auditor's report.

The following summarizes our reaction to the different options described in Part A as discussed in more detail below:

| | |
|---|---|
| Relocate the management and auditor responsibility paragraphs to a separate document. | We do not support this option because we believe that the auditor's report would not be complete without a description of management's and the auditor's responsibilities. We believe that readers of the auditor's report will not take the time to read a separate document. Because of this, under this option there may be confusion as to management's and the auditor's responsibilities. |
| Remove these paragraphs | We do not support this option for the same reasons as |

| | |
|---|---|
| entirely from the auditor's report. | above. |
| Retain these paragraphs in the auditor's report (and, as appropriate, expand their content) | We support this option. We believe that these paragraphs are important because they address the expectations gap. There may be opportunities to improve the wording in these paragraphs. |

We believe there is merit in considering an enhanced format, structure and content for the auditor's report as reflected in Appendix 1 of the CP. We also believe there is merit in considering whether wording used in the auditor's report can be made less technical, without significantly expanding the length of the report.

In summary, we support retaining a brief description of the auditor's and management's responsibilities within the auditor's report, possibly with a reference to an appendix to the auditor's report or a separate document that expands on these descriptions.

5. **If the paragraphs in the current standard auditor's report dealing with management and the auditor's responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?**

We believe that removal of these paragraphs from, or relocation of them outside, the auditor's report would have unintended consequences of widening the expectations gap. We believe that many users, particularly in smaller entities, do not understand the different roles of management and the auditor. An explanation of these roles therefore needs to be readily available. Their removal from the auditor's report or their relocation outside the auditor's report, for example on a website, would, in our view, make it much less likely that users would read the information.

We would not object to re-positioning the management and auditor responsibility paragraphs within the auditor's report. These paragraphs are not as important as other paragraphs, such as the auditor's conclusion, which should be located in a more prominent position.

We believe that there may be benefit in expanding the paragraphs to clarify them. There may also be benefit in expanding the paragraphs to clarify the auditor's role with respect to the assessment of the ability of the entity to continue as a going concern. At the same time, we note that some stakeholders also indicated that they prefer a simplified form of report and that making the report longer may make it difficult to understand.

We believe that it is important for readers that they understand the auditor's role not only with respect to the audit of the financial statements but also with respect to other information in documents containing financial statements. Accordingly, we support expanding the auditor's responsibility paragraph to include a statement about the auditor's responsibilities for such other information.

**Other Information in Documents Containing Audited Financial Statements**

**6. Respondents are asked for their reactions to the possibility that the standard auditor's report could include a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?**

Many users do not appear to understand what involvement the auditor has had with other information. For example, some financial reporting frameworks permit the entity to include certain financial statement disclosures in the MD&A (or a similar document) outside of the financial statements. Such disclosures are often subject to audit. However, the MD&A includes other information not specifically referenced from the audited financial statements. Therefore, there may be confusion about what information in the MD&A has been audited and what has not. It would benefit users if this could be explained.

While we support including in the auditor's report a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements, we also recognize that sometimes such documents may be produced at a later date than the audited financial statements and that it may be impractical for the auditor to make such a statement about these responsibilities in the auditor's report in every case. An option to consider is whether the statement about the auditor's responsibilities for other information could be included in the document itself.

**7. If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor's responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?**

We believe that the statement could be based on paragraph 1 of ISA 720, The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements, and explain that:

- The auditor is required to read the other information that is included in a document containing audited financial statements and the auditor's report thereon;
- The auditor reads the other information because the credibility of the audited financial statements may be undermined by material inconsistencies between the audited financial statements and other information;
- The auditor's opinion does not cover other information; and
- The auditor has no specific responsibility for determining whether or not the other information is properly stated.

Our stakeholders were strongly in favour of the auditor including a statement indicating whether the auditor has anything to report with respect to the other information. We believe that the IAASB should consider developing guidance so that auditors can do so. In our view, such a statement would effectively close the loop with respect to the auditor's involvement with respect to that information. However, such a statement should not provide assurance on the information because the auditor has not performed procedures to obtain such assurance.

**Auditor Commentary on Matters Significant to Users' Understanding of the Audits or the Audited Financial Statements**

**8. Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditor's report on the financial statements.**

We are not in favour of the auditor providing additional information about the audit in the auditor's report on the financial statements for the following reasons:

1 It is unclear what the benefits of this information would be to users and whether these benefits would exceed the related costs. Due to the potential for increased legal liability, additional information may become standardized and boilerplate, not resulting in any positive benefit to users.

2 The CP notes that expanding the auditor's reporting responsibilities may enhance perceptions of audit quality. We are not aware of any evidence that this is the case.

3 Such additional disclosure by the auditor may give rise to the problem of "dueling" information about the entity – information about the entity being provided from two sources – with the consequence of blurring the responsibilities of the auditor and management.

4 It would likely result in a significant expansion of the auditor's report and move the report away from a standardized format. There is a danger that companies, for example in the same industry, will expect that their auditor's reports should contain similar information to those of their competitors. There will therefore be pressure on auditors to make their reports consistent with those of other entities. There will also be pressure for auditors to present this information consistently from year to year.

5 It is likely that only a limited number of users would understand the information being provided; other users may find the information confusing, misinterpret the information or find that it obscures other parts of the auditor's report. The audit committee has a detailed understanding of the entity and can ask the auditor questions on the auditor's commentary. Placing such commentary in the public domain, however, would be of limited value because users do not have the necessary background to understand the context nor can they question the auditor on it.

6 Suitable criteria may not be available for auditors to make consistent judgments about the areas being reported on. For example, how would the auditor make judgments about the quality and effectiveness of management unless there were appropriate criteria for making such judgments?

9. **Respondents are asked for their reactions to the example of use of "justification of assessments" in France, as a way to provide additional auditor commentary.**

We are not convinced that the benefits of this approach have been fully realized to justify it being adopted internationally. As explained in the CP, there is the potential for confusion about what information is being provided by the entity and what information is being provided by the auditor. This may cause confusion as to the separate responsibilities of the management, those charged with governance and the auditor.
We believe that this approach also suffers from many of the drawbacks listed in our response to question 8.

10. **Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor's report.**

Paragraph 61 of the CP notes that some hold the view that more frequent use of Emphasis of Matter paragraphs could contribute to the quality of financial reporting. In considering whether we support this approach, we acknowledge the statement in ISA 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report, paragraph A2, that "A widespread use of Emphasis of Matter paragraphs diminishes the effectiveness of the auditor's communication of such matters." Increased use of the proposed approach for Emphasis of Matter paragraphs would therefore serve to dilute the usefulness of such paragraphs.

We also note that ISA 706 is a relatively new standard. We believe that before considering expanding the use of Emphasis of Matter paragraphs, the IAASB should study the extent of use of such paragraphs in practice and the effect their use is having on the quality of financial reporting.

Increased use of Emphasis of Matter paragraphs would also suffer from many of the disadvantages included in our response to question 8. Also, we believe that the determination of when to use Emphasis of Matter paragraphs should remain with the professional judgment of the auditor.

In addition, we believe that it is management's responsibility to focus on matters that may be significant to users' understanding, not the auditor's. Increasing the use of Emphasis of Matter paragraphs is not the appropriate tool to improve the quality of financial reporting. This should be addressed directly in the applicable financial reporting framework. Responsibility for improving the quality of financial reporting should not be placed at the feet of auditors.

Finally, paragraph 72 of the CP calls for the auditor to share insights and perceptions about the entity or the quality of its financial reporting based on the work done for the financial statement audit. We do not support these proposals for the reasons included in our response to question 8.

**An Enhanced Corporate Governance Reporting Model: Role of Those Charged with Governance Regarding Financial Reporting and the External Audit**

11. **Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Part D.**

    We agree that the interaction between those charged with governance and the auditor offers a sound platform for exploring further enhancement of corporate governance reporting. We support building on the existing two-way communication and dialogue about the audit between the audit committee and the independent auditor. In Canada, many auditors already provide the audit committee with information for it to understand fully the factors the auditor has relied upon in exercising professional judgment in the course of the audit and in reaching the audit opinion. We believe that such communication assists the audit committee in fulfilling its oversight responsibilities for the financial reporting process. We recognize, however, that the IAASB does not have the authority to mandate this sort of communication by audit committees but may have a role in working with others who do have such a mandate.

    In Canada, many audit committees already report publicly on their oversight responsibilities. We believe that extending this type of reporting to include more detail about how these responsibilities have been discharged would improve corporate governance.

12. **To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?**

    We see the following challenges that may be faced in promoting its acceptance:

    - There may be resistance from audit committees in some jurisdictions from accepting the additional reporting responsibilities and the related additional legal liability.
    - In some jurisdictions, the corporate governance regime may not be strong. As a result, audit committee members may not have the skill sets required to prepare the kind of public reports contemplated by the enhanced model.
    - Auditors will likely require more detailed guidance on how to meet the additional communication requirements of the enhanced model.
    - The model may not work well for smaller entities where corporate governance arrangements are less formal and there is less need for communications between those charged with governance and shareholders.

13. **Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?**

    We do not support the auditor reporting on the completeness and reasonableness of the audit committee's report for the following reasons:

- It is unclear what the benefits of such a report would be and whether they exceed the related costs.
- It appears to be contradictory to have the auditor, who is appointed by and reports to the audit committee, reporting publicly on the activities of the audit committee. It puts the auditor in a position of conflict by having to challenge the body that appoints the auditor.
- The auditor may not have the background knowledge and competencies to question the judgments of the audit committee.
- Such a reporting role could prejudice the ongoing two-way communication between the audit committee and the auditor. The audit committee may become reluctant to discuss issues with the auditor for fear of being contradicted publicly on the judgments it is making.
- It may undermine the accountability of the audit committee to the shareholders.

**Other Assurance or Related Services on Information Not Within the Current Scope of the Financial Statement Audit**

**14. Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Part E.**

We have not seen evidence of a need for, or benefit from, auditors providing such services. By way of example, the US requires that auditors report on an entity's internal control over financial reporting. When this was enacted in the US, Canadian regulators considered carefully whether this form of reporting was appropriate in Canada due to its close proximity with the US. In the end, regulators did not require such reporting. There is no clear evidence that the requirement to report on internal control over financial reporting, or the lack of such a requirement, has had any significant effect on the expectations gap or the information gap. This may be an area that merits further study.

We also believe that auditors may not have all the required competencies to provide assurance in some of the areas suggested in paragraph 88 of the CP. For example some Canadian stakeholders question whether auditors have the competencies to provide assurance about the business model or enterprise risk management.

It is not clear to us whether appropriate criteria could be developed in other areas suggested in paragraph 88 of the CP. For example, key performance indicators are often industry-specific and are not necessarily based on an applicable financial reporting framework. It seems unlikely that it would be possible to develop generic criteria for such indicators.

We note that in the United States a standard for providing assurance on MD&A has been in place for many years but understand that it has rarely been used in practice. We believe it might be beneficial for the IAASB to consider the US experience with this form of assurance before embarking on a project to develop a similar assurance standard. In this respect, our stakeholders did not support auditors reporting on the MD&A. They believe that doing so will stifle the useful reporting that currently takes place in such documents because it will inhibit management from making forward-looking and other qualitative statements on which it is difficult for auditors to provide assurance.

**15. What actions are necessary to influence further development of such assurance or related services?**

We believe further study needs to take place to determine the costs and benefits of any of these services as a prelude to considering more detailed issues such as the availability of suitable criteria, and whether auditors have the competencies to perform such engagements.

**Implications of Change**

**16. Respondents are requested to identify benefits, costs and other implications of change, or potential challenges they believe are associated with the different options explored in Section III.**

Addressed in responses to other questions.

**17. Do respondents believe the benefits, costs, potential challenges and other implications of change, are the same for all types of entity? If not, please explain how they may differ.**

We believe that for many smaller entities the benefits of the various options may differ significantly from those for larger entities because of differences relating to the types of users (institutional analysts are more involved with listed entities) and corporate governance structure (often there are overlaps between management, those charged with governance and shareholders).

**18. Which, if any, of the options explored in Section III, either individually or in combination, do respondents believe would be most effective in enhancing auditor reporting, keeping in mind benefits, costs, potential challenges, and other implications in each case. In this regard, do respondents believe there are opportunities for collaboration with others that the IAASB should explore, particularly with respect to the options described in Section III, Parts D and E, which envisage changes outside the scope of the existing auditor reporting model and scope of the financial statement audit?**

In summary, we support the following options as being the most effective in enhancing auditor reporting while falling within the boundaries that we defined in the Appendix to our response letter:

- Improving the format and structure of the auditor's report by:
  - Repositioning the opinion paragraph to a more prominent position in the report;
  - Reporting on audit procedures required by ISA 720;
  - Retaining a brief description of the auditor's and management's responsibilities within the auditor's report, possibly with a reference to an appendix to the auditor's report or a separate document that expands on these descriptions;

    - o Using less technical language in the report.
- Enhancing the auditor's communication to those charged with governance.
- Public reporting by the audit committee explaining how it discharged its responsibilities. In this respect, we believe the IAASB may need to explore with other international bodies, such as the International Corporate Governance Network and the International Organization of Securities Commissions, ways to improve corporate governance models worldwide.

**19. Are there other suggestions for change to auditor reporting to narrow the "information gap" perceived by users or to improve the communicative value of the auditor's report?**

In considering several of the options presented in the CP, the AASB noted that in many cases there did not appear to be clear evidence that such options would meet the needs of financial statement users. As a result, it may not be possible for the IAASB to conclude whether or not to begin related standards projects. In reviewing responses to the CP, we suggest that the IAASB consider undertaking further research on the more promising options identified by stakeholders to provide evidence of the merits of such options. Further, as indicated in our response to question 1, we support and encourage the IAASB to continue its work to educate stakeholders about the nature and value of an audit.

We hope that these comments will be useful to the IAASB in finalizing the CP. If you have any questions or require additional information, please contact Greg Shields at (416) 204-3287.

Yours very truly,

Bruce Winter

Bruce Winter, FCA
Chair, Auditing and Assurance Standards Board (Canada)

c.c. Canadian Auditing and Assurance Standards Board Members
Philip Cowperthwaite, FCA

## Appendix – Boundaries applied by the AASB in developing responses to questions in the Consultation Paper

### Cost/benefit Considerations

1. **The benefits of each proposed change to users are clearly identified and there is an appropriate value proposition when these benefits are considered in relation to expected costs.**

   Costs would include those resulting from increased work effort by auditors, management and those charged with governance, including the ability to complete the financial reporting process within a reasonable time period.

   Potential benefits (e.g., clarity and completeness in reporting to reduce the "expectations gap") may be more difficult to measure than related costs. However, an effort should be made to identify explicit benefits to a wide range of users.

   In weighing benefits versus costs, the types and numbers of users of the auditor's report and financial statements will be a key consideration. However, this may need to be nuanced. For example, some evidence shows that analysts are significantly more likely to read the auditor's report than the average investor (many of whom may never read the report). On the other hand, as the number of retail investors increases, there may be a cost associated with developing an auditor's report that is difficult for the average investor to understand.

2. **Any change should at least maintain, if not improve audit quality.**

   Audit quality is a key to the financial reporting process. Changes in the form and content of the auditor's report may result, for example, in the need for the auditor to focus more specifically on certain matters of relevance to users, which may result in improved audit quality. On the other hand, the matters to be reported on should not be so extensive as to dilute the auditor's primary focus on detecting material misstatements of the financial statements should they exist.

### Maintaining and communicating the respective responsibilities of the auditor, management and those charged with governance in an audit of the financial statements

3. **The separate responsibilities of the auditor, management and those charged with governance should be maintained in the auditor reporting model. The roles and responsibilities of management and the auditor should be described in the auditor's report.**

   There are three distinct responsibilities for auditors, management and those charged with governance. An audit is conducted on the premise of a three-party relationship between the auditor, the accountable party and the user. All of these roles need to be respected and kept separate in order for the financial reporting process to operate effectively. Maintaining and communicating the distinct roles of management and the auditor is essential to reducing the "expectations gap".

4. **The auditor's responsibility (or absence of responsibility) for information that is perceived to be closely related to the financial statements should be clearly communicated.**

   Users should be informed as to what has been done or not done by the auditor regarding information such as MD&A which users typically associate with financial statements. There is an expectation gap regarding auditor's association with such information that needs to be narrowed.

## Other form and content issues

5. **The auditor's report should have standardized form and content, but allow some customization through use of emphasis of matter and other matters paragraphs when fundamental to users' understanding.**

   To facilitate consistent global audit reporting, the auditor's report should contain certain key elements that help users understand what has been audited and the outcome of the audit, and meet the expectations gap.

6. **The auditor's report should not be too long, while containing the essential information the auditor is required to communicate.**

   Anecdotal evidence suggests most readers have little patience with long documents. Changes will have little impact on the expectations gap if users do not read the report. Accordingly, changes need to balance the need to provide additional information with the dangers of providing too much information.

7. **Informed users should be able to understand and use the information contained in the auditor's report.**

   To reduce the expectations gap, the information in the auditor's report should be written in a language that users understand. A key goal should be to improve the quality of the auditor's report rather than simply the quantity of information it contains. Further, the objective of information contained in the auditor's report should be to meet users' needs.

## The auditor's ability to provide assurance on the information

8. **The information on which auditors are asked to provide assurance should be capable of being audited or reviewed in accordance with the applicable framework for assurance.**

   The applicable assurance framework sets out specific parameters under which auditors and reviewers can provide assurance on information. For example, there needs to be: a three-party relationship, suitable criteria, sufficient appropriate evidence, the subject matter should be within the collective expertise of the practitioner and other persons performing the engagement, etc.

*Auditing Standards Committee*
*Auditing Section – American Accounting Association*

September 1, 2011

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

Via email to comments@pcaobus.org

**RE: PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2011-003; Concept Release on Possible Revisions to PCOAB Standards Related to Reports on Audited Financial Statements**

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the *PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2011-003; Concept Release on Possible Revisions to PCOAB Standards Related to Reports on Audited Financial Statements.*

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section - American Accounting Association

Committee Members:
Chair – Joseph Brazel, North Carolina State University
Paul Caster, Fairfield University
Shawn Davis, Emory University
Steven Glover, Brigham Young University
Diane Janvrin, Iowa State University
Thomas Kozloski, Saint Mary's University
Mikhail Pevzner, George Mason University

**Responses to Specific Questions in the Release**

**1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

**a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

The Board should undertake a standard-setting initiative to consider improvements to the auditor's reporting model. The existing format of the auditor's report lacks communicative value by not providing enough information regarding the nature and types of procedures, processes and information used in the determination of the auditor's opinion, etc. Therefore, the current report simply reflects a pass or fail outcome and is mostly standard or "boilerplate" wording.

In our view, the current format of auditor's report is not particularly informative. Empirically, we know that the majority of audit opinions are unqualified.

According the most recent version of the Compustat database, the following is the breakdown of opinion types over 2000-2011 period:

| Opinion Type | Number | Percentage |
|---|---|---|
| UNQUALIFIED | 53,834 | 62.45% |
| UNQUALIFIED WITH EMPHASIS OF A MATTER | 32,337 | 37.50% |
| ADVERSE, QUALIFIED, NO OPINION | 32 | 0.05% |
| | | 100% |

In effect, virtually all firms receive unqualified opinions or unqualified opinions with an emphasis of a matter paragraph. As such, because they are all very similar, it is very difficult to infer anything with respect to the information content of such opinions (i.e., their individual signaling value is questionable, except for perhaps going concern opinions).

Research shows that the market negatively reacts to going concern opinion announcements, suggesting they are informative and signal future financial distress (Jones 1996). Thus, it is likely that some forms of additional assurance on intuitive information (e.g., the validity of nonfinancial measure disclosures discussed below) will be useful to the users of financial statements.

**b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**

Academic research findings suggest that users might benefit from materiality disclosures, auditor's findings in relation to fraud or illegal acts, disclosure of the engagement partner's name in the auditor's report, and disclosure of the communications between the auditor and audit committee (Church et al. 2008). On the other hand, due to the complexity involved with applying materiality in practice, the disclosure of materiality amounts or measures could be very difficult as a practical matter, and would probably be more confusing than informative. This is especially the case since magnitude is only one dimension of materiality. Quantitatively small misstatements can be material due to qualitative characteristics.

In addition, modified wording for clarification, as suggested later in the Concept Release, and increased disclosure about audit risks, as discussed in response to subsequent questions, could be useful.

The report could also emphasize the inherent uncertainty and risk associated with both financial accounting and auditing, it should clarify the auditor's responsibility regarding the detection of fraud, should clarify what is meant by the terms "reasonable assurance" and "materiality", and should clarify the auditor's responsibility for information outside the financial statements.

Other disclosures for the Board to consider include: a summary of proposed adjustments that auditors waived and the client did not record, a summary of adjustments the client agreed to record, a discussion of any significant disagreements with management, a discussion of inherent uncertainties facing different areas of financial reporting (in particular, as it is related to critical accounting policies), the potential effects of measurement errors in those areas, and a comparison of budgeted and actual audit fees charged and a discussion of significant differences between those two amounts. For example, recent research shows that changes in negotiated audit fees represent potential leading indicators of future significant negative events. Comparing negotiated fees to the actual fee charged could provide information about the financial reporting quality of a particular company and/or the likelihood of a negative event in the future (Hackenbrack et al. 2011).

Several issues have to be considered when determining whether to enhance information required to be reported in an auditor's report (or elsewhere): 1) auditor litigation and client confidentiality concerns inherently limit the amount of information an auditor can make publicly available about the audit, and clients have a vested interest in minimizing the extent of such disclosures; 2) markets are not necessarily good processors of "diffuse" and "soft" information or information not stated in binary fashion due to cognitive limitations present in investors (Hirshleifer and Teoh 2003)**;** 3) the readability of information could affect investors' ability to interpret it (Li 2008); and 4) auditors' unique perspectives on financial information and managers' attitudes towards the financial reporting process are potentially quite valuable to investors.

Concerns (2) and (3) suggest that the "pass/fail" format of the auditor report has some value since it gives investors' the ability to assess financial statements' credibility, taken as a whole, and in a straightforward manner. This is most likely the case for nonprofessional investors. Nonprofessional investors are likely to have more difficulty processing more "diffuse" information (e.g. in MD&A), and therefore are more likely to prefer shorter, more salient reports. However, given that qualified and adverse opinions are rarely if ever issued (as discussed above), the current pass/fail model communicates to investors that the final grade of virtually every company's audit was a "pass." For professional investors, any extra information might be valuable. However, there is empirical evidence that suggests that professional investors have difficulty processing accounting-related information as well (e.g., Picconi 2006). Overall, the Board should consider that any additional auditor disclosures may actually widen the information gap between nonprofessional and professional investors (and if widening that gap is good or bad for the functioning of our capital markets).

Christensen et al. (2011) suggest that financial reporting and auditing standards should be revised to produce more transparency in financial statements and audit reports in order to clearly convey the level of uncertainty in fair value and other estimates in the financial statements. They report that public company financial statements contain estimates with reasonable ranges that may be many multiples of materiality amounts. They argue that standards may be requiring a level and nature of assurance that auditors cannot provide for estimates with extreme uncertainty. They suggest that those who set standards for auditing consider the nature of assurance that auditors should be required to provide for highly uncertain estimates. Changes to auditing standards could result in a more appropriate representation of the uncertainty inherent in amounts reported in financial statements and can clarify the assurance auditors are able to provide. They further indicate that if more complete information were to be provided on estimates, including a reasonable range, auditors may be able to provide assurance that the reasonable range is fairly stated.

**c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

Professional standards (e.g., AICPA 2002), auditing texts (e.g., Messier et al. 2010), and prior research (e.g., Brazel et al. 2009) suggest that an abnormal inconsistency between a company's financial performance and related nonfinancial measures (e.g., number of retail outlets, warehouse space, employee headcount) represents a red flag with respect to financial statement fraud. For example, for companies that have committed fraud, Brazel et al. (2009) find that revenue growth exceeds nonfinancial measure (NFM) growth by approximately 25% whereas revenue growth exceeds NFM growth by approximately 8% for non-fraud firms.

Prior research has demonstrated that investors find both financial and NFMs to be value relevant (e.g., Callen et al. 2010; Brazel et al. 2011a). However, it appears that auditors are not apt to identify instances when substantial inconsistencies exist between their client's financial data and related NFMs (Brazel et al. 2011b). Thus, we believe that investors would benefit from management disclosing and discussing the comparison between (1) key financial measure growth (e.g., revenue, total assets) and (2) growth in related/key NFMs (e.g., number of patents, number of distribution centers). Management's discussion could be limited to instances where the financial measure growth is abnormally inconsistent (based on company history or industry norms) with growth in related NFMs. The reliability of such a disclosure (and the level of audit quality for that matter) would be tremendously enhanced if the auditor's role was expanded to provide assurance on these measures and management's explanation of any abnormal inconsistencies. Auditors already provide assurance related to the financial data (e.g., revenue, total assets) and the vast majority of NFMs are verifiable (e.g., confirming the number of retail outlets). In addition, financial measures and NFMs (albeit typically presented in paragraph form and provided only for the current year) are already disclosed in 10-K filings. Thus, the increased cost to management and the auditor to provide this disclosure would likely be negligible.

In addition, the SEC recently mandated that publicly traded companies assign eXtensible Business Reporting Language (XBRL) tags to each financial statement item and furnish this information, known as XBRL-related documents, along with their 10-K and 10-Qs (SEC 2009). Although the mandate explicitly states that public accountants are not required to provide assurance on these XBRL-related documents, early research (i.e., Bartley et al. 2009, 2011; Debreceny et al. 2010; Du et al. 2011; Weirich and Harrast 2010) finds that several documents contain errors. Further, new interactive data visualization software allows for the presentation of individual values from the financial statements (Dilla et al. 2010; Janvrin et al. 2011). Without assurance that these tags are appropriately mapped to each value, investors may be misled. To summarize, providing assurance that companies have properly assigned XBRL tags and that individual values attached to each tag are reasonable may be an important role for auditors in the near future.

Auditors could also provide their opinion on the quality of voluntary disclosures. For example, most of the market reaction to financial reporting news is around an earnings press release, not around the release of the 10-K (Stice 1991). Press releases are voluntary disclosures that vary greatly in their format and content (e.g., some provide balance sheet information, while some do not). Press releases also contain forward-looking information and non-GAAP disclosures. Moreover, the SEC has been concerned with the fact that sometimes the information in a press release or a conference call is not consistent with the disclosures in 10-K. Hence, it is only reasonable that auditors have some role in providing assurance that this information is not misleading to investors. Some evidence exists that auditors already look at this additional information (Black et al. 2011; Chen et al. 2011).

As noted in 1b, there may also be a role for auditors in providing information or assurance on the level of uncertainty of fair value and other estimates with estimation uncertainty greater than materiality.

Some additional areas beyond traditional financial statements where the Board may consider the need for expanding the auditors' role include:

1) Pro-forma disclosures, Reg G reconciliations, and assessments of whether any pro-forma exclusions are truly non-recurring.
2) Uniformity of information reported in press releases. (Assurance in this area would need to be preceded by a regulator decision as to whether all press releases should contain balance sheet and cash flow statement information.).
3) Reasonableness of earnings guidance contained in press releases and an explanation as to why auditors feel this guidance is reasonable.
4) Providing assurance regarding consistency between information reported in a press release, conference call, and the 10-K.
5) Provide details regarding the application of the audit risk model. Auditors could be required to report their separate assessments of inherent risk and control risk for each engagement. Categories, such as "low," "moderate," or "high" would be sufficient. Further, in an emphasis paragraph, or an expanded scope paragraph, auditors could explain how audit procedures were adjusted to deal with "high" inherent and/or control risks. Some members of the committee voiced the concern that inherent and control risk assessments are performed at the assertion level and vary between accounting/accounting cycles. Thus, the level of detail required to disclose these assessments could lead to more confusion amongst investors.
6) Fair value and other estimates.

Concerning all of these possible additional roles, the Board should consider if auditors have the levels of knowledge and expertise required to provide assurance on matters in addition to the financial statements (e.g., Management's Discussion and Analysis, earnings forecasts, or non-GAAP information). In addition, the Board should consider the extent to which any additional work required of the auditor (related to additional roles) might substantially reduce the amount of post-fiscal year-end audit time available to the auditor. In other words, if any additional roles require substantial time and effort, the possibility exists that post year-end audit effort related to the traditional audit may be sacrificed. Lambert et al. (2011) find that SEC mandated accelerations of 10-K filings that required a substantial ($\geq$ 10 days) reduction in post-fiscal year-end audit time led to reductions in earnings quality. This effect was more pronounced for smaller, accelerated filers (vs. large accelerated filers).

**2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

**a. Should the auditor's report retain the pass/fail model? If so, why?**

The general consensus of the committee was that the pass/fail model is a practical model that clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Given the uncertainties involved with the application of GAAP and GAAS (i.e., the risk associated with interpreting and applying accounting and auditing standards), and the nature of the audit itself (i.e., testing, sampling, reasonable assurance, materiality, etc.), this is the only basic expression of assurance on the financial statements that is plausible and workable. However, additional disclosures, as described above are needed to improve the value relevance of auditor services, disclosures, and assurances.

Also as noted in 1b, recent research suggests that some of the current "pass" reports may not actually meet the required standards as the level and type of assurance required by auditing standards may not be possible, for example, for estimates with extreme uncertainty.

**c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

We provide suggested changes above.

**3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

Management is most appropriate to provide additional information regarding the company's financial statements to financial statement users. Existing standards clearly state that management is responsible for the financial statements and the auditor is responsible for determining whether management's financial statements are fairly presented. The audit committee's role is to help the auditor in making that determination. Also, we believe a move away from this current model would increase the likelihood of impaired independence on the part of the auditor.

**4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

As stated above, auditors could disclose their separate assessments of inherent risk and control risk as part of their standard audit report. They could also disclose examples of steps taken to adjust detection risk in response to high inherent and/or control risk. Also, if the auditor's report on the financial statements is modified, and it becomes a longer report, the option for the auditor to provide one report that covers both the audit of the financial statements and the audit of internal control should be eliminated, and the auditor should provide two separate reports. This may improve the clarity of both reports.

**5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

**a. If you support an AD&A as an alternative, provide an explanation as to why.**

The consensus of the committee was that an AD&A would prevent a lengthy auditor's report and provide the additional disclosures about the audit that are described above. However, the Board should consider if such a requirement would put the auditor in the position of a preparer, and not an assurer, and would damage the financial reporting system that is in place. In addition, potential legal issues might all but ensure that an AD&A would over time be reduced to uninformative boilerplate language. In that case, it is hard to imagine an AD&A that would read much differently or provide additional content over that information which is presented in the scope paragraph of the current audit report.

**8. Should a standard format be required for an AD&A? Why or why not?**

A standard format should be required for an AD&A for general consistency and clarity of purpose. However, the content of an AD&A should be solely based on the discretion of the auditor in terms of the types of material or significant matters disclosed.

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

The Committee asks how different would these disclosures be or become from the current discussion, by management, of the risks disclosed in a Form 10-K or in a Prospectus for an initial public offering? We believe it is important for investors to consider business risks, strategic risks, and operating risks. However, we do not think assessments of those risks or reporting of those risks should be the responsibility of the auditor. Again, we fear a blurring of the roles of preparer and assurer and the possible impairment of independence if auditors are required to report these additional risks that may go beyond the audit risk model.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

Benefit: Investors may be able to better quantify the various risks faced by the entity, depending on what additional information is disclosed.

Shortcoming: It may add cost to the audit, with little added benefit, particularly if the ADA is reduced to boilerplate language. In addition, the AD&A might overshadow the MD&A and thus, cause management to disclose very little information in the MD&A. This may be especially the case if the AD&A is purposed to make comments regarding estimates, forecasts, and other items discussed by management in the MD&A.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

The Committee offers this thought: suppose the auditor disagrees with management. What then are management's options for increased disclosure/rebuttal? The concept release is silent about this. We believe that the potential for competing information is reasonably high and, in such cases, it would probably lead to higher auditor turnover due to "opinion shopping." Also, because the auditor may not have all of the information used by management in reporting on components in the MD&A and/or the financial statements, there is in the Committee's opinion a high risk that the AD&A could indeed present inconsistent or competing information and consequently impact users' assessments and evaluations of the financial statements, of the assertions made by management, and of the competence and integrity of management.

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

Consistent with the Board's illustrative emphasis paragraph, areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation could be discussed in emphasis paragraphs. These types of matters would be used to effectively highlight areas (e.g., the uncertainty surrounding management estimates and judgments) that might not be immediately apparent to financial statement users. However, if these disclosures become boilerplate they will be of little benefit to interested users.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

The Board should consider a requirement to include areas of emphasis in each audit report, but only to the extent that the auditor determines such disclosures are important for a better understanding of the financial statements. However, disclosure of the related key audit procedures may or may not be necessary.

**a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

The consensus of our committee was that required and expanded emphasis paragraphs could benefit financial statement users by highlighting those matters deemed as significant and could potentially increase the quality of management's disclosures in the financial statements. For example, research generally reveals that going-concern opinions have information value, serving as an effective early warning of financial distress or entity failure and reducing the surprise associated with bankruptcy announcements. They are also useful in evaluating firm valuation and IPO securities (Asare 1990; Davis 2011).

In addition, providing assurance on XBRL-tagged financial statements may be one additional area of emphasis. As noted above, research has noted that current XBRL-related documents often contain errors (Bartley et al. 2009, 2011; Debreceny et al. 2010; Du et al. 2011; Weirich and Harrast 2010). As interactive data visualization software that presents financial statement values becomes readily available, investors will be more likely to rely on XBRL-related data. Assurance on XBRL-tagged financial statements may serve a vital role in the future.

Also, auditors often define materiality based on total values in the financial statements. To provide assurance on the individual values underlying each XBRL tag, auditors may need to change how they define materiality. This change may be needed since academicians and regulators argue that the advent of XBRL-tagged information will allow investors to examine individual data-centric financial items without requiring the items to be viewed within the context of the financial statements (e.g., Lowe and Locke 2011). For example, an investor may view the total inventory value differently if the value is shown alone vs. when it is shown as a component of total assets on the balance sheet.

**b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

Some of the committee members believe that the auditor should continue to have the option to employ emphasis paragraphs in the auditor's report, but do not believe that such paragraphs should be required. Again, it is perceived that this will risk having the auditor adopt the role of preparer, instead of assurer. Other concerns, similar to those raised by the possible AD&A, also apply: time delays, boilerplate language, etc. To further illustrate this concern, suppose management records an Allowance for Doubtful Accounts of $1 million. Further, suppose the auditors believe an allowance of $1.5 million would be appropriate, and they propose an audit adjustment to management for $.5 million. Management disagrees with the auditor’s estimate and refuses to record the adjustment. The auditors decide to go along with management’s lower estimate, and the $.5 million is deemed “borderline” material. What exactly would the expanded emphasis paragraph say in this situation? Estimates for the allowance may be more or less conservative and therefore a wide range of acceptable numbers may be applied. A discussion of this would likely be confusing to investors and would most likely be ignored. Further, a high potential for the use of boilerplate language exists in this situation.

In contrast, if management is consistently aggressive in its assumptions and consistently chooses income raising alternatives, the auditor most likely assigns a high degree of risk to the engagement. As stated above, disclosure by the auditor of their overall risk assessment of the client would be informative to investors without confusing them with additional emphasis paragraphs that most likely would evolve into boilerplate language.

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

Regarding assurance on XBRL tags, a statement should be included indicating that the auditors have conducted appropriate audit procedures to provide reasonable assurance that the XBRL-related documents follow four XBRL principles (recently proposed by the AICPA (2011)): (1) tags are complete (i.e. all required information has been tagged at the required levels), (2) mapping (or selection of elements) is appropriate, (3) values are accurate (i.e., the amounts, dates, monetary units, and calculation relationships in the XBRL-related documents are consistent with the source financial statements), and (4) XBRL files are structured for their intended use (e.g., regulatory requirements).

Further, if the auditor did not change his/her definition of materiality, the auditor may want to acknowledge that he/she performed only assurance as to XBRL tag selection; materiality considerations were not affected.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

Potential shortcomings are that the paragraphs could end up having little or no communicative value if they are too boilerplate, or the information content of the paragraphs might not be fully incorporated by the market on a timely basis (or might be incorrectly incorporated). The obvious benefit to investors is the provision of additional information regarding the performance of the audit and quality/risks associated with the financial statement data. However, as stated previously, the provision of such information may have the consequence of increasing the information gap between nonprofessional and professional investors.

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

**b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**

As noted above, providing assurance on XBRL-related documents is important as investors are now using interactive data visualization software to display XBRL-related documents when making investment decisions. Unfortunately, early research (Bartley 2009, 2011; Debreceny et al. 2010; Du et al. 2011; Weirich and Harrast 2010) indicates that several XBRL-related documents contain errors.

Also, we describe above how assurance related to the consistency between financial data and related NFMs may enhance the auditor's reporting model. Similarly, we discussed earlier the information and assurance that could be provided on fair values and other estimates (see 1b).

**20. What are the potential benefits and shortcoming of implementing auditor assurance on other information outside the financial statements?**

Several benefits and shortcomings of providing assurance on XBRL-related documents exist as noted below.

Benefits: Given that both the SEC and PCAOB have the core mission to protect the interests of investors, providing assurance on XBRL-related documents allows investors to rely on XBRL tagged information with fewer opportunities to be misled by incomplete, inappropriately mapped, inaccurate, or improperly structured data (Gunn 2007; Plumlee and Plumlee 2008; Srivastava and Kogan 2010; AICPA 2011).

Shortcomings: Auditors generally define materiality based on total values in the financial statements. To provide assurance on the individual values underlying each XBRL tag, auditors may need to change how they define materiality. Specifically, academicians and regulators argue that the advent of XBRL-tagged information will allow investors to examine individual data-centric financial items without requiring the items to be viewed within the context of the financial statements (Lowe and Locke 2011). For example, an investor may view the total inventory value differently if the value is shown alone vs. when it is shown as a component of total assets on the balance sheet.

Further, some opponents of XBRL assurance argue that the process may be cost prohibitive. However, recent work by Alles and Gray (2011) suggests that the cost of providing XBRL assurance will be fairly low compared to its benefits.

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. Do you believe these clarifications are appropriate? Why or why not?**

These clarifications are appropriate as research evidence tends to suggest that users of the financial statements are confused about the auditor's responsibilities and level of assurance provided by the auditor's report (Church et al. 2008).

**b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why.**

Yes, see 21(a) above.

**c. Should the auditor's report clarify all or some of the above areas? Why?**

The auditor's report should clarify all of the above areas as there appears to be an "expectation gap" related to the level of responsibility that is assumed by the auditor, as well as the level of assurance provided (Church et al. 2008).

**d. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**

In terms of the nature of the audit, as stated above, users might benefit from an explanation of the uncertainty and risk associated with financial accounting and auditing, materiality disclosures, auditor's findings in relation to fraud or illegal acts, disclosure of the engagement partner's name in the auditor's report, and disclosure of the communications between the auditor and audit committee (Church et al. 2008).

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's reporting?**

Clarifications of the language (e.g., use of more straightforward and explanatory language (Robertson 1988), and minor wording modifications (Hermanson et al. 1991)) in the auditor's report would improve the communicative value of the report. The suggested clarifications would provide investors with a better understanding of the role of the auditor and the nature of an audit. The clarifications are extremely low cost and we see no shortcomings for investors or management.

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative or combination of alternatives is most appropriate and why?**

Auditor's Discussion and Analysis and clarification of language in the standard auditor's report would immediately improve communication to the users of financial statements based on comments obtained during the Board's outreach efforts. In addition, the content of the AD&A could expound on the emphasis paragraphs and/or auditor's assurance on other information outside the financial statements, if these two alternatives are adopted.

Revising the audit report to include the auditor's separate assessments of inherent risk and control risk, and the steps taken by the auditor to adjust the nature, timing, and extent of audit procedures to achieve an appropriate level of detection risk would be the useful.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

In developing an auditor reporting framework and criteria the Board should work closely with the FASB to ensure that such framework is fully reflective of GAAP standards, and perhaps to influence GAAP standards to improve the transparency and auditability of fair value and other estimates.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

Clarification of language in the standard auditor's report better conveys to the users of the financial statements the auditor's role in the performance of an audit as it would more clearly outline the auditor's responsibilities in conducting the audit relative to management's responsibilities, and would more accurately describe the level of assurance provided by the auditor.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

A revised report that included the auditor's separate assessments of inherent risk and control risk, plus an explanation of appropriate adjustments regarding detection risk would lead to better quality audits. This is based on the examination of audit failures using the audit risk model to determine why the audit failure occurred. When auditors simply state they are assuming control risk at the highest level, or, when they combine inherent risk and control risk into a single assessment, they invariably do not make the necessary adjustments to the nature, timing, and extent of audit procedures to achieve an appropriately low level of detection risk. In other cases, they simply assess inherent risk and/or control risk too low for the circumstances.

In addition, requiring auditors to explicitly express their independence in the audit report, and perhaps having them explain, in brief, the measures they take to ensure independence, may also lead to perceptions of higher audit quality due to perceived higher auditor independence.

Finally, improvement in financial and audit standards around fair value and other estimates would improve audit quality (Christensen et al. 2011).

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on quality control procedures, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

**b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes outweigh the potential cost? Why or why not?**

As with most new reporting standards, we believe that the benefits will outweigh the potential costs over time. Improving the communicative value of the auditor's report through additional disclosures will definitely involve additional audit costs but should improve audit quality and users' decision-making in the long run.

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BNY MELLON

September 30, 2011

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

Filed via Electronic Submission: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 34 – *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Auditing Financial Statements and Related Amendments to PCAOB Standards*

Dear Sir/Madam,

The Bank of New York Mellon Corporation ("BNY Mellon") wishes to comment on the PCAOB Rulemaking Docket Matter No. 34 – *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Auditing Financial Statements and Related Amendments to PCAOB Standard.*

BNY Mellon is a global financial institution with $305 billion in assets, $1.3 trillion in assets under management and $26.3 trillion in assets under custody and administration. We are a U.S. SEC Registrant and have also been subject to the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and the Sarbanes Oxley Act of 2002 for many years.

BNY Mellon believes that an independent audit needs to remain objective and that no bias or different qualitative perspective should be introduced. Independent auditors are not trained analysts, although they do possess many analytical skills, by the nature of their profession such analytical skills are (and should be) more directed towards the negative. Well trained and experienced auditors should be asking themselves "what am I missing?", "is this too good to be true?" and their professional skepticism is to be applauded and nurtured by the PCAOB and the accounting firms and their professional bodies. In light of this, we do not believe that an Auditor's Discussion and Analysis ("AD&A") report is necessary, because such matters as contemplated in the PCAOB proposal are generally already communicated to the Audit Committee of the Board of Directors prior to the issuance of the independent auditor's report. Any matters of significant disagreement would therefore have been addressed with management, the independent auditors and the Audit Committee during the preparation of the financial statements and management's discussion and analysis ("MD&A"), otherwise a qualified audit opinion may be rendered by the audit firm with respect to any material deficiencies in the audited financial statements or any inconsistencies between the MD&A and the financial statements.

BNY Mellon does not believe that an expanded emphasis paragraph should be required in all independent auditors' reports. While we understand that there is a view that expanded emphasis paragraphs may assist users in focusing on matters that could impact their investing decisions, we are concerned that auditors do not have the appropriate perspective or expertise to provide such guidance. Under today's auditing standards the auditors can write an emphasis paragraph if necessary, and we do not believe that this should be a requirement.

BNY Mellon, however, does believe that it would be an improvement if independent auditors were required to provide written assurance on financial information disclosed outside of the audited financial statements, such as MD&A or other information. In our view, we believe that such assurance procedures should equate to the same level of assurance typically provided by auditors in comfort letters associated with 1933 Act filings with the U.S. Securities and Exchange Commission.

BNY Mellon believes that clarifying language about what an audit represents and the related auditor responsibilities, in areas such as reasonable assurance, auditor's responsibility for matters such as fraud, financial statement disclosures, management's responsibility for the preparation of the financial statements, and auditor independence in the standard auditor's report would be helpful to users and may assist in ensuring that the "expectation gap" is closed further. We are concerned, however, that only "boilerplate" language will develop over time and that such additional language may not be fully understood or appreciated by the users and other constituents who read audited financial statements.

If you have any questions or are in need of any further information, please contact me at (212) 635-7080.

Sincerely,

John A. Park

John A Park
Corporate Controller

Please note that the comments expressed herein are solely my personal views

Public Company Accounting Oversight Board
1666 K Street, N.W.
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United States

Chris Barnard
Actuary

21 July 2011

- **Release No. 2011-003**
- **PCAOB Rulemaking Docket Matter No. 034**
- **Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Sir.

Thank you for giving us the opportunity to comment on your Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards. This concept release (release) raises some important issues concerning the auditor's role with respect to audited financial statements. I have already commented on similar issues that were raised in the International Auditing and Assurance Standards Board's consultation paper "Enhancing the Value of Auditor Reporting: Exploring Options for Change".[1] For completeness I would suggest that you could also consider those comments in addition to these presented here.

In general I support improving the relevance and usability of the auditor's report. I would caution that we must clearly delineate the auditor's role and responsibilities in this context. For example it would be unacceptable under current responsibility structures and expectations if the auditor were to take on a governance role with respect to an entity it is

[1] See IAASB consultation paper Enhancing the Value of Auditor Reporting: Exploring Options for Change, available at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0163.

auditing. That is not, nor should it be, the job of the auditor, who is independent from the audited entity. It would also not be appropriate for the auditor to take on an ongoing oversight, or pseudo-regulatory role regarding the entity. Such responsibilities lie elsewhere. Despite this, the release is rich in ideas and possibilities, many of which would certainly benefit users of audited financial statements (users). I have some specific comments, which I will address in answer to your specific questions.

**Answers to specific questions raised by the PCAOB**

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

*Yes. Such initiative should address the legitimate concerns of users outlined in the release, and from the results of your staff's outreach activities.*

b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

*The communicative value of auditor reporting could be substantially improved by altering and optimising the layout of the report. For example, the auditor's opinion should be prominent, and the majority of backup or supporting material should be presented in appendices. The auditor's report should also include greater disclosure of the tasks and procedures carried out in performing the audit, and that this should be included preferably in an appendix to the report. Users would then be able to better appreciate the completeness of the auditor's investigative work, and would therefore give greater credence to the auditor's views and opinions. I think that this would also help to manage users' expectations about the role and duties of the auditor in this context. Finally I would suggest that the auditor's report should including a clearer statement about the auditor's responsibilities regarding other information outside the financial statements. This would help to better manage users' expectations about the auditor's role and responsibilities here, and the extent of the auditor's duties pertaining to such other information*

c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

*Possibly. This depends on the "matters" in question. The auditor's role and responsibilities must be clearly delineated, otherwise the auditor risks taking on a governance or ongoing oversight role with respect to the entity.*

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

a. Should the auditor's report retain the pass/fail model? If so, why?

*Yes. This is clear and sufficient to indicate that the entity has fairly presented its financial statements.*

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

*As a minimum, I would suggest that expanded use of emphasis paragraphs, where relevant, could provide more meaningful and complete information to users, by highlighting significant matters that could help to manage users' expectations regarding the auditor's report and opinions therein.*

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

*This depends on the information and to what it relates. Opinions on consistency or completeness of information, rather than just disseminating information, should ideally be provided by an independent auditor.*

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

a. If you support an AD&A as an alternative, provide an explanation as to why.

*In general I support an expanded auditor commentary such as an AD&A. Such commentary should only be provided when necessary to aid understanding. In this sense it should not become boilerplate over time. At the end of the day, the auditor's report should be* *informative and useful as a whole, rather than just section-by-section, and any commentary that aids users' understanding in this regard should be beneficial.*

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

*I would suggest that an AD&A should comment primarily on the audit. Open commentary on the financial statements would otherwise need to be structured within a clear delineation of the auditor's role and responsibilities, in order to manage the expectations of users.*

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

*The AD&A should comment on material issues in order to better manage the expectations of users regarding the audit and risks thereon. The illustrative report on page 16 of the release provides a good framework.*

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?

*Please see my responses to your questions 5.b and 6.*

8. Should a standard format be required for an AD&A? Why or why not?

*A standard framework would be useful in order to better delineate the role and responsibilities of auditors and to better manage the expectations of users.*

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

*I support expanded auditor commentary on the entity's internal controls, including any significant internal control deficiencies identified during the audit. I am not convinced of the* *need or appropriateness of expanding the auditor's responsibilities to include commentary on general business risks, strategic risks etc.*

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

*This is difficult. However, I would recommend that the auditor should only comment on material issues, highlighting in particular difficult or contentious issues. This should reduce the use of boilerplate language.*

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

*This is a risk. It is critical that the auditor should not take on a governance role with respect to the entity, nor should the auditor discuss matters that the entity has not disclosed in the financial statements. However, the auditor is also a professional with a public interest role. I would only expect to see such inconsistent or competing information in very difficult or extreme circumstances, when such disclosure could possibly better manage the expectations of users regarding the audit.*

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

*Possibly. See also my responses to your questions 2.c and 5.*

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

*In answer to this and your questions 15, 16 and 17, please see my responses to your questions 2.c and 5.*

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

*I would support an auditor's opinion on the consistency and completeness of information outside the financial statements, and their relation to the audited financial statements. However, auditor assurance on "other information outside the financial statements" is too* *broad and vague an objective, and negates a clear delineation of the auditor's role and responsibilities, especially as the nature and contents of such "other information" changes over time.*

*In principle I support auditor assurance on the MD&A. The illustration on page 24 of the release provides a starting point for further discussion.*

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

• Reasonable assurance
• Auditor's responsibility for fraud
• Auditor's responsibility for financial statement disclosures
• Management's responsibility for the preparation of the financial statements
• Auditor's responsibility for information outside the financial statements
• Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

*I agree that these clarifications are appropriate, and would help to delineate roles and responsibilities regarding the audit.*

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

*Yes. They should help to better manage the expectations of users. The results of your staff's outreach activities support this view.*

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

*One of management's and the auditor's most important responsibilities is to communicate with investors and users in a clear and straightforward manner. Anything which helps in this regard is worthy of further consideration.*

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

*All of these considerations are important. Changing the content or form, or extending the scope of the audit report, must be considered in total, rather than piecemeal, along with a global, cumulative, credible and coherent analysis of the potential benefits and costs at the end of the process.*

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

*This is a business case, and users, preparers and others should be convinced that the additional and incremental benefits derived from such changes would outweigh the initial and ongoing costs of the changes and additional burdens thereafter.*

Yours faithfully

C.R.B.

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September 30, 2011

Via e-mail: comments@pcaobus.org

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

**Re: PCAOB Release No. 2011-003, Rulemaking Docket Matter No. 034,**
*Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO USA, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Concept Release, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the Concept Release). We note that the International Auditing and Assurance Standards Board (IAASB) has issued a consultation paper on the same subject matter, so we encourage the PCAOB to work with the IAASB to ensure convergence on auditor reporting so differences are minimized to the extent possible.

We support the Board's initiative to reassess the appropriateness of the current form and scope of the auditor's report. The increased complexity of financial reporting, recent events in the financial markets and the current economic environment have renewed interest in enhancing the transparency and relevance of auditor reporting. We strongly support objective consideration of changes that could enhance the transparency and relevance of auditor reporting to financial statement users[1] in recognition of the Board's mission to protect the interest of investors. As described below, we are confident that certain changes could be implemented in the short term, which have the potential to enhance auditor reporting in a relatively cost effective manner. Other changes that have the potential to positively impact auditor reporting may require significant training of professionals, regulatory rulemaking, and/or participation by other standard setters and, as such, could be considered as a subsequent phase of any project.

In conjunction with this initiative, we believe it is important to also consider how changes in the auditor's reporting model might impact the profession's liability risks.

Our comments to the specific questions posed in the Concept Release are presented below and have been developed consistent with the following overarching principles that we believe are essential to preserve the integrity of the auditor's report:

[1] In the context of this letter, the term "users" refers to investors and other financial statement users.

i) Management and the audit committee, rather than the auditor, should be the original source of information about the company;

ii) Auditor reporting should focus on objective matters;

iii) Changes should not detract from audit quality; and

iv) Changes should enhance transparency in a way that does not promote information overload.

In addition, we believe that any changes to the reporting model should be responsive to the underlying objectives of reasonable user demands and be cost-beneficial and practical to implement.

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**
   a. **Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**
   b. **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**
   c. **Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

We support the Board's initiative to consider improvements to the auditor's reporting model. The recent calls by some investor groups to increase the transparency and relevance of this model emphasize the importance of the auditor's report to their decision making process. The more clearly the auditor's report can communicate the results of the audit, in accordance with the fundamental role of the auditor in performing an audit, the more valuable the auditor's report will be to users.

As set out above, consistent with the overarching principles on which our comments are based, we strongly believe that management is responsible for providing information about the company, since it is in the best position to provide such information. If the auditor were required to provide original information about the company, it could create a situation where competing or inconsistent disclosures about the company, by management and the auditor, reduce rather than promote clarity. Our suggestions for improvements to the auditor's reporting model are grounded on the principle that management is the original source of information on which the auditor provides assurance.

While we believe the standard auditor's report in its current pass/fail form provides value to users, we recognize that improvements can be made to the report to provide more relevant and useful information to them. We believe significant improvements can be made through various means such as: clarification of the standard auditor's report, inclusion of emphasis of matters paragraphs, and auditor reporting on certain matters outside of the financial statements, which we discuss in detail in our responses to the questions set out below.

We believe suggestions to expand the auditor's role to provide assurance on certain matters in addition to the financial statements, specifically Management's Discussion and Analysis (MD&A) or portions thereof such as "Critical Accounting Estimates," merit further consideration. As noted in the Concept Release, auditor reporting on MD&A is currently available under the Interim Attestation Standards, AT Section 701 – *Management's Discussion and Analysis* (AT 701), although it is rarely used. This guidance could be refined such that a report on the examination of specific portions of the MD&A could be issued, if users considered that auditor association on such information provided sufficient value to warrant the extra cost.

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**
    a. **Should the auditor's report retain the pass/fail model?**
    b. **If so, why? If not, why not, and what changes are needed?**
    c. **If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

We believe that the current form of reporting, referred to above as the pass/fail model, provides a clear mechanism to highlight the results of the audit and should be retained. We understand that the perceived value of this core model is shared by most constituents of the financial reporting community, although there are divergent views as to the degree to which that model should be expanded to provide supplemental reporting. Current auditing standards already allow for circumstances in which the auditor may provide emphasis of matters and explanatory language regarding certain matters and we believe this reporting can be mandated in certain circumstances and expanded into other areas, as discussed below.

We note that the Concept Release explains that some investors believe that when an auditor identifies and communicates to management a significant matter that is not necessarily material to the financial statements, and management has not fully addressed that matter in the financial statements, the auditor does not have a mechanism to communicate such information to investors. However, we believe that, by definition, immaterial matters do not impact the "fair presentation" of the financial statements to a reasonable user, so communication of such matters is not necessary and could possibly attribute greater importance to the matter than warranted.

To provide clarity about what the audit report conveys, we suggest providing definitions of the following terms:

- Present fairly
- Reasonable assurance
- Materiality
- Material misstatement

In this regard, rather than including these definitions in the report itself, it may be useful to include a cross reference to a glossary of technical terms used, in a manner similar to the approach adopted by the Auditing Practices Board in the UK that provides a dedicated area for information about the scope of the auditor's report.

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

As noted earlier, we strongly believe that management is responsible for providing information about the company and that the auditor's responsibility is to provide assurance on that information, rather than providing such information to users directly. Any requirement for the auditor to provide additional information directly to users about the company has the potential to (1) blur the lines of responsibility as it relates to financial reporting, (2) result in competing or inconsistent disclosures from the auditor and management that could create confusion and/or the perception of a qualified opinion, and (3) depending on the nature and extent of information disclosed/reported on, negatively impact the effectiveness of communication between management, the audit committee, and the auditor.

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

If changes to the audit report on the financial statements are made, consideration of how those changes might impact the report on internal control will also need to be assessed. For example, if the auditor's report on the financial statements is modified to explain the responsibility of management and the audit committee as it relates to the financial statements, the report on internal control over financial reporting should be similarly modified. Please see our response to question 2 and 21, where we have outlined other revisions to the auditor's report, which would also need to be assessed for applicability to reporting on internal control over financial reporting.

**Auditor's Discussion and Analysis**

5. **Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**
   a. **If you support an AD&A as an alternative, provide an explanation as to why.**
   b. **Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**
   c. **Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**
   d. **If you do not support an AD&A as an alternative, explain why.**
   e. **Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

We do not support an AD&A alternative because such an approach is inconsistent with the overarching principles described in our introductory comments.

While we appreciate the rationale behind some investors' calls for additional information about the audit, certain of the matters mentioned in the Concept Release, such as audit risk, areas of significant audit judgment, and areas of significant difficulty encountered during the audit, are highly subjective and cannot be explained succinctly in any meaningful manner. Accordingly, these matters are typically discussed in depth between the auditor and management and the audit committee in the context of a dialogue where all of the relevant considerations can be explored in proper context. The PCAOB's proposed Auditing Standard, *Communications with Audit Committees,* paragraph 1 states, "Effective two-way communications throughout the audit assist the auditor and the audit committee in understanding matters related to the audit." In contrast, any additional information provided in the audit report is unlikely to be understood by others who would not possess a comprehensive knowledge of all of the attendant facts and circumstances, including expert knowledge as to how to conduct an audit.

Moreover, even if the matters that are set out as examples in question 7 below were required to be disclosed, they would necessitate development of disclosure frameworks to enable consistent assessments to be made in an infinite variety of circumstances. In that regard, it is also likely that auditor disclosures would differ in some respects from those of management, which could result in competing and inconsistent disclosures that may create confusion and/or the impression that the difference of views represents a qualified opinion. Further, to the extent that management would feel pressure to provide disclosures that mirror those of the auditor, this would seem to dilute management's primary responsibility for financial reporting.

We also believe any additional information about the company for which users require an associated auditor attestation should be provided in the context of auditor reporting on information already provided by management. In this way, the need to include additional information about the audit would not drive the information that the company describes within the financial statements. Rather, the auditor would comment on information that the company provides. This approach preserves the distinction between the company and the auditor, whereby management prepares the financial statements and the auditor expresses an opinion through the auditor's report.

We would also be concerned with the unintended consequences of disclosing sensitive information about the company that may limit the robustness and candor of discussions between the auditor and management/the audit committee. Such candid discussions are essential for the auditor to understand the company and its financial information and are critical to properly assess audit risk and therefore preserve the quality of the audit.

While we believe that certain important improvements to the auditor reporting model could be achieved in a relatively cost effective manner, the AD&A approach, to be effective, would require significant additional auditor effort to prepare and additional time for quality review and approvals, all of which would add cost and time to the financial reporting process.

We have provided our suggestions for improvements to the auditor reporting model that we believe are more cost effective and avoid the adverse unintended consequences of the AD&A approach. These suggestions are included in our responses to the questions below relating to the mandated use of emphasis of matters paragraphs, auditor assurance on other information outside the financial statements, and clarification of the standard auditor's report.

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

See our response to question 5.

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

See our response to question 5.

8. **Should a standard format be required for an AD&A? Why or why not?**

As previously stated, we do not support an AD&A alternative and therefore have no comment regarding the format of such a report.

9. **Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational**

**risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

As previously stated, we do not support an AD&A alternative. The areas mentioned in question 9 are even more subjective than audit-related areas and are outside the usual expertise of an auditor. Communication of the above-referenced matters is best left to company management or the audit committee, as they are in the best position to communicate these matters in the context of their company and the industry in which they operate.

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

As noted in our response to question 5 above, the requirement to report under this alternative would necessitate development of disclosure frameworks to enable consistent assessments to be made in an infinite variety of circumstances, which would not be feasible. Further, we believe the need to avoid competing or inconsistent disclosures between management and the auditor will likely result in these disclosures becoming boilerplate.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

There are a number of challenges to implementing this alternative that we believe would substantially outweigh any perceived benefits. These challenges include:

(1) possible delays in filing documents with regulators because of (i) additional internal review processes within audit firms necessary to provide an appropriate degree of consistency, given the highly judgmental analyses that would be susceptible to varying degrees of interpretation, and (ii) extensive additional discussions among auditors, the company, the audit committee, and the company's counsel that will likely need to take place with respect to the more judgmental types of matters;

(2) the potential to adversely impact the robust communications that would otherwise take place between the auditor and management or the audit committee;

(3) excessive information that could obfuscate rather than clarify meaningful information to users;

(4) shifting the respective roles of the auditor and management in terms of the responsibility for providing original information; and

(5) increasing the liability exposure of auditors, management, and the audit committee to the extent that certain information is highly subjective and subject to wide variations in interpretation.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

Our comments relating to this matter are included in our response to question 5 above.

**Required and Expanded Use of Emphasis Paragraphs**

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

We agree that requiring this approach would be relevant and could be useful in making investment decisions since we believe pointing out areas of audit emphasis that are described in the financial statements would likely sharpen users' focus on these matters and could provide additional context for users to understand the more significant matters included in the financial statements.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

- **a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**
- **b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

We believe that the required use of emphasis of matters paragraphs is an appropriate approach to provide users with additional information by drawing attention to those disclosures in the financial statements that the auditor believes are most significant to an understanding of those statements. Accordingly, we favor mandating such disclosures provided that a suitable framework and implementation guidance is developed to ensure consistency in identification of relevant matters for inclusion therein. In crafting the framework, care should be taken to ensure that users understand that such paragraphs are written in the context of the financial statements taken as a whole.

While we support the use of emphasis of matters paragraphs, we are not in favor of describing key audit procedures within the auditor's report. A description of audit procedures, without a full understanding of the audit process, would not likely be understandable to users without the full context of the complex conduct of an audit, such as information on the risks, controls, and quality of audit evidence obtained. This would present an incomplete and potentially misleading picture of the auditor's response to the assessed risks of material misstatement and detract from, rather than enhance, transparency. Further, describing audit procedures relating to specific accounts or disclosures may inappropriately convey a higher level of assurance on those items than is actually the case. The auditor's report needs to be clear that audit procedures related to any particular area are performed in the context of an audit of the financial statements taken as a whole, and do not provide assurance on individual accounts or disclosures. An example of an auditor's report that includes an illustration of the use of emphasis paragraphs, which is consistent with our suggestions described above, is set out in the Center for Audit Quality's (CAQ) letter to the PCAOB, dated June 9, 2011, which has been posted on the Board's website as part of the CAQ's June 28, 2011 comment letter submission.

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

We believe that required and expanded use of emphasis paragraphs should focus attention on those areas of the audit that were of such importance that, in the auditor's judgment, they are fundamental to a user's understanding of the financial statements, even though those matters were considered to be appropriately presented and disclosed. While auditor judgment will be essential to assessing which matters to emphasize, we believe additional standard setting in this area would be needed to provide a framework within which the auditor can exercise his or her judgment and to ensure a level of consistency among practitioners in the types of matters identified and the extent and content of the auditor's emphasis of those matters.

Matters that may be appropriate to emphasize, if they represent the most significant matters to a user's understanding of a specific company's financial statements, could include: highly subjective accounting estimates, particularly those estimates that reflect significant unobservable inputs that are based on management assumptions or expectations; significant unusual or infrequent transactions; significant related party transactions; material weaknesses in internal control; and material uncertainties.

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

As noted above, we believe emphasis paragraphs should draw attention to matters presented or disclosed in the financial statements and be an objective, fact-based discussion. It is also important that any additional commentary within an emphasis paragraph not undermine the auditor's opinion on the financial statements as a whole.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

We believe the key to providing information that is meaningful and specific to the circumstances of the reporting entity is through the development of principles based standards and implementation guidance that provide a framework to guide the auditor in identifying the types of matters appropriate for an emphasis paragraph, and the nature and extent of the discussion required.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

The potential benefits of implementing required and expanded emphasis paragraphs are that they potentially:

- Enhance the communicative value of the auditor's report;
- Provide a roadmap to focus users of the financial statements on the key areas that are included in the financial statements that have become increasingly long and complex;
- Highlight the accounts and disclosures that are based on subjective judgments; and
- Improve the quality of financial statement disclosures in the areas emphasized.

The potential shortcomings of implementing required and expanded emphasis paragraphs are that:

- Users may inappropriately assume a greater level of assurance on an account or disclosure than is appropriate;
- Users may focus solely on those areas of emphasis and not the rest of the financial statement disclosures;
- Judgment will be needed to identify the appropriate items for emphasis and such judgments may be inappropriately and/or inconsistently applied; and
- Auditor's liability may increase as a result of judgments applied in selecting disclosures for emphasis. This in turn raises the costs of providing such services.

**<u>Auditor Assurance on Other Information Outside the Financial Statements</u>**

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

  **a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**
  **b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**
  **c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**
  **d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**
  **e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**
  **f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**
  **g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

We support consideration by the Board of auditor assurance on other information outside the financial statements as an alternative to, or in conjunction with, other auditor reporting enhancements. In particular, we believe that auditor assurance on MD&A, or on a portion thereof, may be appropriate. As noted in the Concept Release, the PCAOB currently has an attest standard relating to MD&A, AT 701. In such an engagement, the auditor performs procedures to express an opinion on the MD&A presentation taken as a whole by reporting whether the:

- Presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC;
- Historical financial amounts have been accurately derived, in all material respects, from the company's financial statements; and
- Underlying information, determinations, estimates, and assumptions of the company provide a reasonable basis for the disclosures contained therein.

While we believe reporting under AT 701 could provide the basis for further standard setting to more broadly address information outside the financial statements, it is our understanding that AT 701 engagements are rarely requested by issuers.

One approach that we believe would furnish investors with useful information, while also offering a cost effective alternative, would be the development of an examination level service on a specific portion of the MD&A that investors have suggested is important to their investment decisions — the disclosure relating to critical accounting estimates. Reporting on this portion of the MD&A would likely improve the quality of such disclosures as a result of the increased attention given to these matters by management.

If this approach is implemented, the SEC would need to consider whether amendments to Regulation S-X are necessary to require the report or otherwise describe the circumstances when such a report would be required. Further, the supplemental report would need to clearly identify the applicable section of MD&A covered by the report. In addition, safe harbors may be necessary with respect to this type of reporting for both issuers and auditors, given the lack of precision generally inherent in such disclosures.

With respect to other types of information on which auditor reporting may be appropriate, we are generally in agreement that some form of auditor assurance on such matters as earnings releases and non-GAAP information should be considered. Providing assurance on such information would potentially improve the quality, completeness and reliability of such information and would likely provide users with an increased level of confidence therein.

Further, the level of assurance that an auditor will be able to provide on this other information will depend on the nature of the other information and the degree of assurance required by market participants. In this regard, consideration should be given to amending AT 201, *Agreed-Upon Procedures Engagements (AUP),* to permit its use in general purpose reporting, if such AUP reporting would be the appropriate mechanism for reporting in a particular area.

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

We believe that requiring an auditor to provide assurance on certain information (e.g., critical accounting estimates) outside the financial statements has the potential to improve the quality of such information. We are also open to exploring the feasibility and benefits of providing assurance on other areas as described in question 19 above. However, it is important to recognize the potential for unintended consequences in that regard. For example, some have suggested that auditor reporting on matters such as earnings releases would provide users with a higher level of confidence in the information. However, we believe that it is important to recognize that this financial information is often communicated prior to the completion of the audit, and that there is a trade-off between the timeliness of the information provided to the public and the level of assurance that can be provided. The different levels of assurance may not be apparent to users and this has the potential to expand the expectation gap. Moreover, there is a risk that providing a form of assurance on earnings releases may result in unwarranted pressure on auditors to reach premature conclusions on elements of the financial statements without subjecting them to sufficient audit procedures to support those conclusions.

**<u>Clarification of the Standard Auditor's Report</u>**

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

**b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**

**c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**

**d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

We support clarifying the auditor's report and agree that the areas specified above would be appropriate and enhance transparency. In particular, we suggest:

1. Add titles to highlight the various sections of the auditor's report, similar to the International Auditing and Assurance Standards Board's ISA 700, *Forming an Opinion and Reporting on Financial Statements*
2. Include a section in the report that states the auditor is independent under all relevant SEC and PCAOB standards
3. Where applicable, include a section that explains the firm network structure and the responsibility of the member firm signing the audit report. Additionally, describe whether any component auditors participated in the engagement
4. Emphasize that management is responsible for establishing and maintaining adequate internal control over financial reporting to support the preparation of financial statements, including the notes, that are free from material misstatement, whether due to error or fraud
5. Include a section that describes the audit committee's responsibility for oversight of the financial reporting process
6. Include within the description of the auditor's responsibility that the auditor is responsible to obtain reasonable assurance about whether the financial statements, which include the notes, are free from material misstatement *whether due to error or fraud* and a description of the meaning of reasonable assurance
7. Include within the report itself a section that defines the technical terms used or provide a link to where such definitions are maintained
8. Emphasize the importance and integral nature of the notes to the financial statements, especially as disclosures are now more likely to include a broad range of types of information, some of which may not be derived from the accounting system and include more forward looking information
9. Add a section that describes the auditor's responsibility for other information presented outside the financial statements

We do not believe these clarifications would have any significant implications to the scope of the audit or the auditor's responsibilities.

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

In general, we believe clarifying the language in the standard auditor's report would be beneficial in that it sets the foundation for all users of the report to more fully understand the auditor's conclusion and level of assurance provided. The shortcoming of adding such clarifying language would be that the increased length of the report may lead to information overload. However, these shortcomings could be partially overcome through the use of links to a central location where such clarifications are maintained, similar to the reporting model used in the UK.

**Questions Related to all Alternatives**

23. **This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

We believe a combination of the alternatives may be the most appropriate approach to meeting investors' information needs and narrowing the expectations gap. The use of emphasis paragraphs to highlight and focus investors' attention on the significant areas of the financial statements would potentially benefit users by providing insights about these accounts and disclosures in the financial statements.

Another cost effective alternative to improving auditor communication, which could be implemented in conjunction with the use of emphasis paragraphs, would be to include additional clarification in the auditor's report regarding certain terms and concepts and revise the form of the report to provide more clarity about the audit process and the responsibilities of each of the parties involved in that process.

Auditor reporting on selected other information is another way to inform investors about the integrity of the information provided to investors by management. For example, providing for an examination engagement on the Critical Accounting Estimates disclosure in MD&A would potentially improve disclosures in this area and be responsive to suggestions by investor groups for auditors to emphasize the important judgments made by management in the preparation of the financial statements. Since this type of reporting would likely require some additional auditor effort, incremental to the work performed to report on the financial statements, it may be appropriate to first apply any requirements to larger issuers to evaluate the results of such reporting before considering the advisability of expanding such reporting requirements to smaller issuers.

24. **Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

As set out in our response to question 23 above, we believe the most effective approach to improving auditor communication would likely include a combination of alternatives.

25. **What alternatives not mentioned in this concept release should the Board consider?**

The IAASB's Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change,* describes an alternative that is not mentioned in the Concept Release. This alternative is referred to as the "Enhanced Corporate Governance Reporting Model." The Consultation Paper explains that the existing interaction between those charged with governance of an entity and the external auditor provides a platform to explore further enhancements in corporate governance reporting and expanded auditor reporting on such information. Under this alternative, the audit committee would issue a report to investors with information about its oversight of the financial reporting process, accompanied by some level of assurance provided by the auditor. We would support further consideration of the development of a framework to support this type of reporting. In conjunction with the development of such a framework, and in light of the importance of the audit committee in overseeing financial reporting, we suggest further consideration be given to ways to strengthen the role of the audit committee in the financial reporting process.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

Those areas that we support and that would require more standard setting relate to clarifying the language in the auditor's report, the expanded use of emphasis paragraphs, and separate reporting on the Critical Accounting Estimates disclosure. Additionally, action by the SEC would likely be needed to require auditor reporting and to develop guidance for management regarding the preparation of MD&A relating to these estimates.

With respect to the expanded use of emphasis paragraphs alternative, additional guidance would be required to provide the auditor with criteria with which to assess the matters requiring emphasis and to determine the nature and extent of the auditor's discussion relating to such matters.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

As auditors, we cannot say definitively how users may perceive any of the alternatives suggested to enhance auditor reporting. However, we believe certain of the alternatives are subject to greater susceptibility to misinterpretation than others and for this reason we caution the PCAOB to ensure that any changes to auditor reporting clearly describe the auditor's responsibility to provide an opinion on the financial statements as a whole so as to avoid any perception that a qualified or piecemeal opinion has been provided.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

We believe the modifications to the auditor's report, as described in our response to questions 2 and 21, particularly changes calling for descriptions of the role of management, the audit committee, and the external auditor best clarify the role of the auditor in the financial reporting process.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

While the concept of audit quality is often discussed, it is not easily defined and may be perceived differently depending on the unique position of the stakeholder. The IAASB's recent publication, *Audit Quality, An IAASB Perspective,* explores the meaning of audit quality and explains that "perceptions of audit quality vary amongst stakeholders depending on their level of direct involvement in audits and on the lens through which they assess audit quality." Certain academic research suggests that user perceptions of audit quality are influenced by the communicative value of the auditor's report. Accordingly, improvements to the auditor's report that provide increased transparency about the audit process could be considered a contributing input to enhancing audit quality.

We believe that certain alternatives discussed in the PCAOB Concept Release would potentially improve the communicative value of the auditor's report and advance audit quality, while others may have a detrimental effect. For example, the alternatives that (1) clarify the terms used in the auditor's report, (2) emphasize the importance of certain matters reflected in the financial statements, (3) explain the auditor's responsibility for the audit of the financial statements and other financial information presented in a document containing the audited financial statements, and (4) provide for reporting on the Critical Accounting Estimates disclosure section of the MD&A all serve to improve communication and will potentially improve the related disclosures, thereby enhancing audit quality in a relatively cost effective manner.

On the other hand, we believe other alternatives that do not meet the overarching principles described in the introductory section of our letter would tend to reduce the communicative value of the auditor's report.

Further, we believe any alternative auditor reporting that has the potential to impede the candid two-way communication between the auditor and the audit committee could negatively impact audit quality. Examples include the alternatives that call for a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues including "close calls."

**30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

While we believe that a broad based initiative to enhance the communicative value of the auditor's report and its relevance to the investing public is appropriate, there may be different approaches from those contemplated within this Concept Release to enhance the auditor reporting model with respect to the specific entities listed above. For this reason, we would support further consideration by the PCAOB of how best to enhance audit reports for these entities as part of a separate project.

**Considerations Relating to Changing the Auditor's Report**

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

- **a. Are any of these considerations more important than others? If so, which ones and why?**
- **b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**
- **c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**
- **d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

All of the considerations set out above are important and interrelated, and as such, it would be difficult to assess the relative importance of one consideration over another. We believe that any changes to the auditor reporting model need to be considered in tandem with how the interrelationships impact audit quality and cost.

Many of the suggested changes would be unlikely to increase audit costs significantly; for example, modifying the form and content of the audit report would potentially provide enhanced clarity with little additional associated costs. However, other alternatives, such as auditor reporting on Critical Accounting Estimates disclosures, would likely require additional work by both management and the auditor, with a corresponding increase in costs. Cost implications of other changes would be dependent on the specific nature of the change and their relevance to the entities concerned.

As the Board considers the comments received on this Concept Release, in advance of any standard setting project, we encourage the Board to consider the most effective way to implement any changes to accommodate smaller public companies and provide a way forward that considers user needs, while recognizing the cost constraints facing many of these companies. Additionally, other than those that could be easily implemented (such as changes to the format of the standard auditor's report), we believe that it would be reasonable to consider a phased in approach where larger public companies would implement any changes before applying the changes to smaller public companies.

We encourage the Board to collaborate with the IAASB, investors and other users of the financial statements, preparers, audit committees, auditors, and academics to flesh out the implications of the various options expressed in the Concept Release and to identify any others that should be considered. We believe that the Roundtable held on September 15th was an excellent step in that direction.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

As stated elsewhere in our letter, we believe that inclusion in the auditor's report of qualitative insights and perceptions gleaned during the audit, which are of the kind usually communicated to management and the audit committee in the context of an extensive dialogue among all parties, would not be practical to communicate in an external communication. In addition, disclosure of this type of information would likely discourage a candid and robust dialogue that we believe is essential to the performance of a high quality audit.

******

In summary, we are supportive of the Board's initiatives to explore options to enhance the transparency and relevance of the auditor's report to financial statement users in response to their calls for change. As part of the Board's assessment of the various alternatives proposed within the Concept Release, in addition to any other alternatives that may be suggested as a result of outreach efforts, we strongly encourage the Board to ensure that any proposed standards meet the overarching principles set out in our introductory comments. In addition to ensuring costs are balanced against the need for additional/enhanced reporting, we also believe a project to educate users about the audit process and the meaning of the auditor's report would further the Board's goals of improving the transparency and relevance of auditor reporting and reducing the expectation gap.

We appreciate your consideration of our comments and suggestions, and would be pleased to discuss these with you at your convenience. Please direct any questions to Chris Smith, Audit and Accounting Professional Practice Leader, at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing, at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP

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July 21, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Rulemaking Docket No. 34

Board Members:

I write to comment on your concept release on "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements." To put my comments in context, I spent 26 years in public accounting, ten years as an accounting standard setter, and have been an accounting faculty member for 14 years. Also, I am now or formerly have been chairman of the audit committee of five large, publicly-held companies. My comments are influenced by all those experiences, but particularly by the more recent ones as an audit committee chairman. However, these comments are personal and should not be attributed to any other entity.

As the concept release notes, the form and content of the auditor's report has been the subject of much debate over the past 75 years or so. During my 50 year professional career, in each case where the issue was thoroughly and thoughtfully debated, the result has been modest, incremental improvement. One such case was the Cohen Commission hearings in the 1970's in which I participated. I have followed this topic with interest since that time.

As noted early in the concept release, "The objective of this concept release is to discuss several alternatives for changing the auditor's reporting model that could increase its transparency and relevance to financial statement users, while not compromising audit quality." However, on page 6 of the release the PCAOB states that it wishes, "To obtain insight into the changes that investors and others are seeking to the auditor's report ...." As noted throughout the release, some investors continue to request all sorts of changes to the auditor's report. However, it is my impression that a large majority of the "others" referred to by the PCAOB (e.g., corporate officers, auditors, audit committee members) are not seeking changes as they believe they would be counterproductive for the reasons cited in the release and otherwise. I trust that the PCAOB will take into consideration all of the various views on this important topic and I'm pleased to provide mine in this letter.

OVERVIEW

The auditor's report provides assurance to those who read it that the accompanying financial statements have been fairly presented in accordance with generally accepted accounting principles. Those audited financial statements are most often included in annual reports to shareholders or Forms 10-K. The assurance provided to users of those reports is an important element in the efficient operation of our capital markets but it should be recognized that this is far from the only form of assurance that users receive. For example, they also rely on audit committees of the board of directors they elect and in most cases companies have internal audit functions that help provide assurance.

Further, the annual report is only one form of financial communication with shareholders and other users. Equally important are the quarterly reports on Form 10-Q that are of increasing length and detail. While auditors are required to review such quarterly information, their reports are seldom made public. So any assurance that shareholders receive from the auditors thereon is implicit rather than explicit.

Financial management of public companies (with oversight by the CEO) is responsible for the accuracy of financial reporting – hence the certifications required of the CFO and CEO on both annual and quarterly financial information. These people spend full time designing the systems, collecting the data, researching the difficult accounting judgments, etc. that are necessary to develop information that is summarized in quarterly and annual reports. As noted, internal auditors and audit committees can provide some level of assurance that these activities are functioning properly but their efforts (particularly the audit committee) are limited by the relatively small amount of time they spend as compared to the original activities.

The same is true to a large extent for the independent auditor. While he or she must design the audit to provide reasonable assurance that no material misstatements are present in the financial statements, because of cost/benefit considerations the amount of the auditor's work is a tiny fraction of the original finance work. I certainly don't intend to denigrate the purpose of the audit as I believe this independent assurance does add considerably to the integrity of our capital markets. But I also think it's important to keep in mind what's reasonable for management and auditors to bring to this process. When I speak to auditors about this matter, I analogize to the Motion Picture Academy Awards (Oscars) and describe their role as qualifying for the "Supporting Role" category while management is in the "Leading Role."

Another important point to keep in mind is that the financial statements subject to the auditor's procedures are historical in nature, providing information as of a point in time or for a period then ended. After the recent financial crisis some critics expressed concern that earlier financial statements and audit reports did not disclose to users that "things were going to get a lot worse in the near future," and that led them to argue for some of the changes suggested in the PCAOB concept release. However, neither GAAP financial statements nor GAAS auditor reports are intended to predict the future, with the possible exception of the "going concern" concept. Some companies do provide earnings guidance, "warnings" about forthcoming business difficulties, and certain other disclosures about future expectations – but those matters are outside of the financial statements and subject to significant caveats about their reliability.

I am also concerned that the concept release does not seem to take into consideration the realities of today's public markets wherein large, sophisticated institutional investors (who own a high percentage of U.S. public equity) already have reasonable access to companies in order to ask questions about the financial statements. On the other hand, the very small "mom and pop" type investors for the most part likely wouldn't know what to do with many of the types of greatly expanded information from auditors suggested in the concept release.

The above is by way of background to explain my concern that too many of the suggestions for changes in the auditor's report would fall into one or the other of the following categories:

New disclosures that should more appropriately be considered by the SEC or FASB as part of management's reporting and should not be separately reported by the auditor

New disclosures of audit procedures that would add bulk to the auditor's report but would be confusing and not helpful to most users

Thus, I strongly believe that suggestions for change that fall into the above categories should not be adopted by the PCAOB. In summary, my belief is that only the following changes would improve the current form and content of the auditor's report:

Incorporate the substance of AU 550 so as to inform investors and other readers of the report of the extent of the auditor's responsibility for the other information in 10-Ks, etc.

Add words to clarify that the auditor is required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.

While the many other suggestions to change the auditor's report are well intentioned, I do not support them in general and have provided reasons for the most important ones in the remainder of this letter. As an audit committee chairman, I'm particularly concerned that many of the suggestions could make the committee's oversight of the audit and communications with the external auditors more difficult without providing the promised benefits to ordinary investors.

It may be possible that certain of the "transparency" concerns of users raised in the concept release can be addressed by enhancement of Management's Discussion & Analysis or other non-financial statement sections of SEC filings. It is also possible that reports from Audit Committees, which are presently only included in proxy statements, could be included in Forms 10-K and their content could be improved. I would be pleased to provide further thoughts on these matters, particularly with respected to enhanced Audit Committee reports, when appropriate.

RESPECTING THE ROLES OF THE AUDITOR AND THE CLIENT

AU Section 508.09 currently states that, "The (auditor's) report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders." While I haven't done research on this, my limited experience is that for large, public companies, the report is generally addressed to the board of directors and the stockholders. It's interesting that the literature doesn't require this at present and the PCAOB might consider doing so as part of this project.

However, my real point in mentioning the addressing of the report is to note that the board of directors acts as representatives of the shareholders through the audit committee and in general. Thus, it seems to me that some of the things that the PCAOB says that investors wish to have included in or attached to auditor's reports more properly belong in the category of communications between independent auditors and audit committees. The most obvious example of this would be the required communications between the two groups, which sometimes run into dozens of pages as noted in the concept release. Based on my experience in dealing with these communications over the past ten years a written report made available annually or quarterly to all shareholders would not provide sufficient context for it to be generally useful to most investors. It would have to be completely re-programmed for purposes of reasonable external communication, thus undermining its principal purpose as an effective tool to facilitate auditor/audit committee dialogue.

Some of the other matters that the release suggests could be included in the auditor's report are:

> Risks identified by the auditor (including factors evaluated in determining which risks are significant)
>
> Audit procedures responsive to the identified risks, why they were considered responsive, and what the results of the procedures were
>
> Independence matters discussed with the audit committee
>
> Critical accounting estimates communicated to the audit committee and assumptions underlying the estimates (and how the estimates are susceptible to change)
>
> Critical accounting policies, including significant unusual transactions that were communicated to the audit committee (including ones that management doesn't consider critical)

Permissible alternative accounting treatments and the treatment preferred by the auditor

Difficult or contentious issues, including "close calls"

Material matters where disclosures could be enhanced or different accounting could have been applied

Some of these are already required to be communicated to the audit committee, as noted, and all of the others could be as well if audit committees felt such information was useful and could be provided in a reasonable manner and at a reasonable cost. In fact, the PCAOB has just such a subject on its agenda and presumably will be considering in the next few months whether to move forward with its proposal to expand the list of items auditors are required to communicate to audit committees. I provided comments on that proposal in my letter dated April 23, 2010 and suggested the Board not broaden the required disclosures as much as it proposed.

But disclosing this information to shareholders and other users of financial statements is an entirely different matter. If information such as the above and certain other matters covered in the concept release is sufficiently useful to investors and other users of public company financial statements and can be provided at a reasonable cost, then appropriate standard setters (SEC, FASB) should consider requiring companies to make such disclosures. The disclosure system should not be "back doored" through a PCAOB process that requires auditors to provide information that the issuers did not provide and possibly don't even agree with.

Also, some of the information requested by investors (e.g., with respect to critical accounting policies and estimates) is already provided by companies but apparently certain investors don't trust what they now receive. According to the concept release, "Some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party." Or the investors believed they would receive "... more relevant insight into the financial statements, through the eyes of the auditor..." Again, asking auditors to do the initial reporting of certain information because investors don't trust registrants seems to reverse the normal "company reports and auditor attests" relationship.

While the auditor is required to be independent and should adopt a skeptical mindset when evaluating management judgments and estimates, as noted earlier in this letter the auditor will often have less information available to him and will often spend less time in reaching an opinion on the issues in question. The time and resources needed to support the initial representations for financial statement matters are management's and, therefore, those representations logically should come from management not from the auditor.

I think it would be a dangerous precedent for the PCAOB to begin requiring auditors publicly to disclose company information that hasn't already been provided by the company. This is a fundamental change in the issuer/auditor relationship and surely raises legal issues about which party is actually accepting responsibility for all of the audited financial statement information in an SEC filing.

POTENTIAL ALTERNATIVES FOR CHANGES TO THE AUDITOR'S REPORT

Auditor's Discussion and Analysis

My first comment with respect to the notion of an AD&A is that I don't think people can truly appreciate this proposal without a fully developed illustration. The illustration on pages 15-18 is pretty meaningless in that it does not include realistic examples of what companies would actually have to report. For a reasonable size company, I could envision this illustration going on for 20 pages or more (for one of my current public company boards it takes about nine pages in our annual report to just list the critical accounting policies and estimates and that's without letting the auditors express their views on alternatives, etc.). I strongly urge the PCAOB to field test the notion of an AD&A by asking a few companies and their auditors to prepare illustrations that could then be shared with the public on a no names basis before the end of the official comment period. Otherwise, the comments you receive on this matter will not be fully informed.

I also have a general concern about the notion of "an adaptable report that he or she can tailor to a company's specific risks, facts, and circumstances." This would likely lead to an administrative nightmare in trying to wrap up the audit given that each report would be "custom made" and would likely have to be cleared with a firm's national office accounting and auditing technical experts and perhaps even legal staff. Also, assuming that the AD&A included matters that the company would otherwise report, such as the auditor's views on significant estimates, those matters would require extensive discussion and negotiation with company finance and legal staff at a time when meeting SEC deadlines is quite challenging. Rather than spending time on procedures that really matter, audit partners would find themselves haggling over wording issues that could serve as an unnecessary distraction. This factor alone should persuade the PCAOB not to advance the notion of an AD&A as Board members should already know that too much partner time is involved in pinning down minor details of financial statement footnotes and other matters that take away from involvement in more important audit tasks.

I will not comment on each of the possible items that could be included in an AD&A. But, for example, with respect to critical accounting policies and estimates, this matter is properly covered in the current communications between auditors and audit committees. Investors should be able to assume that a company's disclosures adequately address these matters or else the auditor would have insisted on changes. See my later comments on improved reporting on non-financial sections of the SEC filings also.

The concept release suggests that investors would like the auditor to give his own reasons why accounting policies are considered critical, including those that management doesn't consider critical. The release goes on to say that investors would like the auditor to discuss situations where alternative treatments are available and say which approach the auditor preferred, including situations where the auditor believe alternative disclosures could have been applied. This would seem to require that each large firm develop a preferred alternative for every accounting policy and apply it uniformly for all of their clients or at least industry by industry. It would also mean that any particular company could easily have a large number of accounting policies for which alternatives are available, which would be confusing to say the least.

In general, requiring an AD&A is a bad idea.

It could require auditors to disclose information not already being disclosed by companies, which is contrary to the normal auditor/client relationship

The resulting reports would be very long, would probably lack comparability with other companies, and would likely not be in a format that easily improves communications with users

The process of arriving at the content of such a report would be highly inefficient and damaging to auditor/issuer relationships

The suggested contents are better left to communications between auditors and audit committees or possible future improvements in company disclosures

Required and Expanded Use of Emphasis Paragraphs

I believe that emphasis paragraphs can be useful in certain relatively limited circumstances and for one of my current boards (Fannie Mae) the auditors include an emphasis paragraph to describe the controlling relationship of the Federal government and the dependence of the entity on the government's continuing support. However, I do not support a requirement to require and expand the use of emphasis paragraphs in all audit reports.

In discussing this possible expansion of the auditor's report the concept release seems to suggest that it could help investors identify the most significant matters and where they are disclosed in the financial statements. If there is a need for such a "road map" to the financial statements (I'm not sure there is – perhaps this should be studied separately by the SEC or another group), it would be far better for the company to provide it, with appropriate review by the auditor.

Another suggestion for the emphasis paragraphs is for the auditor to explain the procedures performed with respect to relevant areas of the audit. As noted more generally earlier, this seems more appropriate as a communication between the auditor and the audit committee. Also, I think that most shareholders and other readers would be confused rather than informed by the addition of several paragraphs describing detailed audit procedures. They simply don't have the background to properly evaluate the appropriateness of particular audit procedures.

The use of added emphasis paragraphs to explain audit procedures for relevant areas of the audit sounds like the old "long-form audit report" that was still used to a limited extent when I entered the accounting profession half a century ago. Back then I believe it was an alternative to the short-form report and my memory as a young staff member is that our firm issued very few such reports. While I didn't try to research whether the current literature would permit auditors to issue a long-form report, it seems that the long-form report fell out of use for good reasons and there's no reason to bring it back.

Auditor Assurance on Other Information Outside the Financial Statements

I support limited auditor "assurance" on other information outside the financial statements. By that I mean that I believe the standard auditor's report would be enhanced by incorporating the substance of AU 550 so as to inform investors and other readers of the report of the extent of the auditor's responsibility for the other information in 10-Ks, etc. The auditor presently reports this to the audit committee and this is one matter that can be added to the external report that would aid communications with investors with little or no change in procedures.

Reading the non-financial statement information and considering whether it is materially consistent with the audited financial statements seems sufficient to me and an attest engagement on MD&A or all of the non-financial statement data in an SEC filing would usually not pass a reasonable cost-benefit test. As noted in the concept release, the literature has provided guidelines for attestations of MD&A for many years yet it's my understanding that there have been very few, if any, of these engagements. So companies don't see the usefulness and investors haven't made a sufficient case to compel companies to incur the cost.

I feel the same way about earnings releases. An auditor generally indicates the progress in performing the year-end audit or quarterly review at the time of the release and, accordingly, provides limited verbal assurance on the press release information, subject to completion of the work in process. An attest engagement would almost surely slow down the release of that information to the market. While it is at a minimum quite embarrassing to have to revise a preliminary earnings release, on balance the current system seems to be working adequately and I see no reason to change it. Those who are overly concerned about the reliability of information that might be released too soon can simply take more time to complete the regular audit or review process before announcing to the public.

Clarification of the Standard Auditor's Report

Reasonable assurance – Expanding the report to say that "reasonable assurance means a high level of assurance, but not absolute assurance" seems like just adding words to say the same thing.

Auditor's responsibility for fraud – I do agree that modest wording changes to the standard auditor's report should be made to clarify this responsibility. This can be done by simply modifying the language in the second paragraph of the standard report that now states, "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement" by adding the words "whether caused by error or fraud."

Auditor's responsibility for financial statement disclosures – I am fairly ambivalent about this matter. The disclosures certainly are part of the "package" that is being examined by the auditors. However, when the audit report describes what the various financial statements fairly present (financial position, results of operations, cash flows) it's hard to see how the footnotes represent a different category – aren't they just integral to the rest of the financial statements? On balance, this seems like one of those "leave well enough alone" type of matters although it wouldn't really bother me either way.

Auditor's responsibility for information outside the financial statements – See my comments above about providing auditor negative assurance on non-financial statement data in 10-Ks, etc.

Auditor independence – As noted in the concept release, the title of the report includes the auditor's implicit representation of independence. Further, auditors are required to communicate about this matter with audit committees on a regular basis. This is sufficient.

Thank you for the opportunity to comment on this important topic. I would be pleased to provide further comments if you have any questions about my letter.

Sincerely,

Dennis R Beresford

Dennis R. Beresford
Ernst & Young Executive Professor of Accounting

BerryDunn



August 5, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (Board) "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," dated June 21, 2011.

We are a regional registered public accounting firm that currently audits six issuers. We believe that, given the quantity of feedback the Board has received regarding the inadequacy of the current audit reporting model, it is appropriate for the Board to undertake this project, and to consider potential changes that are likely to enhance the usefulness of issuer audit reports to users.

At the same time, we believe it is critical to maintain recognition of the respective responsibilities of issuer management and the auditor. Information regarding the issuer, including that regarding its accounting policies and the application thereof, is appropriately the responsibility of issuer management. Information regarding the audit, and the auditor's opinion regarding the conformity of information provided by management with applicable standards and regulations, is the appropriate purview of the auditor.

We also believe that, in the context of seeking input from users of audit reports, it is a tendency of human nature to respond affirmatively whenever one is asked whether additional disclosure or other information would be useful. Accordingly, while effective communication with audit report users is crucial to the effectiveness of the audit process, and is important to the broader objective of facilitating communication of decision-useful information to users of financial statements, we believe the natural bias toward seeking more information should be balanced with:

1. The cost of providing that information, which is ultimately borne by the shareholders of issuers; and
2. The risk of providing <u>too much</u> information, such that users get confused about the conclusions the auditor has reached regarding the fairness of presentation of the financial statements in accordance with U.S. generally accepted accounting principles (GAAP).

Based on these considerations, we offer the following feedback regarding the four alternatives described in the Concept Release:

**<u>Auditor's Discussion and Analysis</u>**

We do not believe the inclusion of an Auditor's Discussion and Analysis (AD&A) would achieve the objective of enhancing communication between auditors and the users of audit reports. We do not believe that the majority of users have sufficient expertise regarding the audit process to make effective use of this information, and we are concerned that there is a significant risk an AD&A might have the following unintended consequences:

1. Discussion of the significant risks the auditor identified, and the procedures undertaken to address those risks, would at times likely include language reinforcing complex audit concepts such as reasonable assurance, materiality, sampling risk, and the like. Adequate explanation of such concepts to nonauditors would likely require a very lengthy AD&A, and we believe would create a significant risk of confusing users regarding the clarity of the conclusions reached by the auditor (i.e., could be perceived as "hedging" the auditor's unqualified opinion).

2. An independent discussion of the auditor's views regarding, for example, the critical accounting policies of the issuer and how they have been implemented, which varies from similar discussion by management in Management's Discussion and Analysis (MD&A), is likely to confuse a user regarding these matters. We can appreciate that such a requirement would enhance the likelihood of a dialogue between management and the auditor that would reduce such differences; however, we believe requiring the auditor to report on that component of MD&A, as discussed below, is a better route to achieving that goal, while maintaining the distinction in responsibilities between management and the auditor and reducing the likelihood of confusing users.

## Required and Expanded Use of Emphasis Paragraphs

We do not believe required and expanded use of emphasis paragraphs would achieve the objective of enhancing communication between auditors and the users of audit reports. As with the Auditor's Discussion and Analysis concept, we have the following concerns regarding two areas that the Concept Release discusses as the potential subject of such paragraphs:

1. Discussion regarding matters included in the financial statements. We believe it is of critical importance that communication of matters related to the financial statements that are deemed to be important to users thereof remain the responsibility of management. The auditor's responsibility to communicate such matters should be limited to situations in which the financial statements are not in conformity with GAAP in all material respects. Requiring the auditor to provide an independent commentary on matters such as significant financial reporting risks will result in either a) a recapitulation of information already communicated by management in public filings, or b) communication different from that provided by management, despite an opinion by the auditor that the financial statements, including disclosures, comply with GAAP in all material respects. We believe the first of these would be of little value to users, while the second would be confusing to them.

2. Discussion regarding details of audit procedures. As noted above, due to the complexity of audit concepts and the audit process, we believe such discussion would need to be extensive in order to provide sufficient information for users who are not auditors to be able to understand it and place it in context. We believe an extensive written commentary on such matters would likely either a) tend toward boilerplate over time or b) provide insufficient value to users to justify the cost of its development. This information is already required to be communicated by the auditor to the audit committee, in which context the audit committee has the responsibility to oversee the audit and to engage in a dialogue where it deems additional information is needed; we believe this is the appropriate setting for such a requirement, and evidence such

communication is taking place as required by Board standards is an appropriate focus for Board inspection activity.

**Auditor Assurance on Other Information Outside the Financial Statements**

We believe requiring auditor assurance on certain information outside the financial statements is the most appropriate way to achieve the objective of enhancing communication between auditors and the users of audit reports. It is our observation that the primary driver of users' interest in additional information from auditors relates to the application of accounting principles involving significant estimates and uncertainty. As management is required to communicate information regarding critical accounting estimates in MD&A (pursuant to Securities and Exchange Commission (SEC) Release No. 33-8350, *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*), requiring the auditor to provide assurance on this component of MD&A is an appropriate means of enhancing communication to users of the primary topic for which they have requested more information. This is because it leverages the auditor's current responsibility of providing assurance on information communicated to users, while retaining management's responsibility for communicating such information.

The Board's current attestation standards for MD&A (AT Section 701) provide an appropriate framework for auditor assurance on the "critical accounting estimates" component of MD&A required by SEC Release No. 33-8350. Accordingly, we believe a requirement that auditors provide such assurance would be operational without extensive additional rulemaking by the Board.

**Clarification of the Standard Auditor's Report**

The concept release describes the following potential enhancements to the audit report itself:

- Clarification that "reasonable assurance" is a high level of assurance, but not absolute assurance
- Clarification that the auditor is required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud
- Clarification that the auditor's responsibility with respect to the financial statements includes required disclosures
- A statement that management prepares, and is responsible for the fair presentation of, the financial statements
- A description of the auditor's responsibility for information outside the financial statements
- A statement regarding the auditor's responsibility to be independent

We are supportive of the inclusion of this information in the auditor's report, and believe it would help achieve the objective of enhancing communication between auditors and the users of audit reports, provided it can be included without lengthening the auditor's report to the point that its effectiveness is diminished. Attached to this letter is illustrative language, indicated with underlining, that we believe would achieve this goal.

We appreciate the opportunity to submit these observations for the Board's consideration, and look forward to its continued deliberations in this important area.

Sincerely,

BerryDunn

BERRYDUNN

**Illustrative Auditor's Report Modifications to Incorporate Clarification's Described in the Board's Concept Release**

Report of Independent Registered Public Accounting Firm

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8. We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [ *Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."* ]. W Company's management prepares these financial statements, and is responsible for ~~these financial statements~~their fair presentation, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report]. Our responsibility is to express an opinion on these financial statements and an opinion on the company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements, including required disclosures, are free of material misstatement, whether caused by error or fraud, and whether effective internal control over financial reporting was maintained in all material respects. Reasonable assurance is a high level of assurance, but is not absolute assurance. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We are also required to be independent of W Company pursuant to applicable independence requirements of the Public Company Accounting Oversight Board (United States) and the U.S. Securities and Exchange Commission, and we have complied with these requirements. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [ *Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."* ].

We have a responsibility to read, and have read, the other information contained in this Form 10-K, *Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934*, to consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact, and to discuss any identified potential inconsistencies or misstatements with management. However, such information has not been subjected to the auditing procedures applied in the audit of the basic financial statements, and, accordingly, we express no opinion on it.

[ *Signature* ]
[ *City and State or Country* ]
[ *Date* ]

September 30, 2011

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

RE: *PCAOB Release No. 2011-003, Rulemaking Docket Matter No. 34*

Dear Members and Staff of the Public Company Accounting Oversight Board:

The Biotechnology Industry Organization (BIO) appreciates the opportunity to comment on *Possible Revisions to Reports on Audited Financial Statements.*

BIO is a not-for-profit trade association that represents more than 1,100 biotechnology companies, academic institutions, state biotechnology centers, and related organizations across the United States and in 31 other nations. BIO members are involved in the research and development of healthcare, agriculture, industrial, and environmental biotechnology products.

BIO fully appreciates and agrees that strong auditing standards can enhance investor protection and confidence. BIO members strongly support this goal. However, additional regulatory requirements could put emerging biotech companies in a situation wherein funds and efforts that would be otherwise spent for core research and development of new therapies for patients would instead be used to meet these additional requirements. Growing biotechnology companies face a constant struggle to access working capital to fund operations, especially in these companies' development stage of operations. It takes 8 to 12 years and in excess of $800 million for a breakthrough company to bring a new medicine from discovery through Phase I, Phase II, and Phase III clinical trials and on to FDA approval of a product. Diverting effort and funding from research and development to addressing more stringent regulatory requirements could lead to research programs being delayed; clearly, this is not in our companies' investors' best interest.

Furthermore, the true value of biotech companies is embedded in their development technologies, pipeline of product candidates, and their progress in advancing those product candidates toward regulatory approval and product sales. Investors often make decisions based on these parameters rather than a biotech company's operating results and financial disclosures;

therefore, higher costs to comply with new standards related to financial statements would outweigh the benefits.

With this in mind, below are BIO's positions on different aspects of the release:

1. **BIO does not believe that the inclusion of an auditor's discussion and analysis in our companies' SEC filings would warrant the additional cost or enhance disclosures already provided to investors.**

   Requiring an auditor's discussion and analysis will almost certainly make our companies' audits more expensive, duplicate management's discussion and analysis of its business, operations, and financial results (MD&A), and potentially confuse investors and analysts.

   Currently, auditors review and provide comments and feedback to management and the audit committee on a company's financial statement disclosures and MD&A. During the course of this dialogue, management, the audit committee, and external auditors correspond in detail about identified risks, financial disclosures, management's judgments, estimates, and accounting policies and practices. Management and/or the audit committee address these auditor comments and feedback and, as required, engage in collaborative discussions regarding the appropriate depth and breadth of the company's disclosures. Auditors, whose opinion is included in with a company's financial statements and incorporated into the company's SEC filings, would not permit their audit opinion to be included with such financial statements if a company's disclosures and discussion of its operating results were inappropriate, inconsistent, or incomplete. Thus, the addition of an auditor's discussion and analysis section to an SEC filing would appear to be duplicative, of no additional value, and potentially confusing.

   Allowing auditors to provide information directly to investors could result in investors receiving disclosures without pertinent qualifying information that only management could provide. The auditors have limited involvement in the day-to-day operations and management of the business, so it would be difficult for them to provide more relevant information than management has already provided in the MD&A.

   In addition, the concept of "close calls" could become a point of contention between companies and their auditors because it is only generally defined in the proposal and would require significant judgment. The subjectivity of the matter combined with the vague definition raises questions about whether the requirement to disclose such "close calls" could be consistently applied.

2. **BIO believes that requiring the use of emphasis paragraphs in the auditor's report would not add value and perhaps cause confusion or misunderstanding by investors.**

Emphasis paragraphs would not be relevant or useful, as incomplete information/disclosure would be provided through the requirement for short emphasis paragraphs in an auditor's report. Highlighting significant matters in the financial statements without providing the appropriate and sometimes lengthy contextual background and basis for conclusion would create greater confusion – not better understanding – for investors.

Furthermore, it would not be appropriate to describe specific audit procedures performed in emphasis paragraphs, since readers would scrutinize and potentially criticize the auditor's described procedures, thereby potentially increasing the auditor's liability. In addition, with the added requirement for emphasis paragraphs, we are concerned that auditors will institute the practice of providing "boilerplate" language to help minimize the auditor's risk/liability, thereby adding negligible additional value to investors. Therefore, BIO does not support the required use of emphasis paragraphs in the standard audit report.

3. **BIO believes that requiring auditors to provide assurance on information outside of financial statements, such as the MD&A, would increase audit scope and cost without providing improvements to the quality and reliability of such information.**

Similar to our response in #1 above related to the auditor's discussion and analysis, this proposal would make our companies' audits more expensive by increasing the auditor's scope of work while adding, in our opinion, negligible value to investors. Furthermore, auditors would likely charge companies a premium to cover the potential additional liability associated with the providing assurance on other information outside of the financial statements.

As noted above, currently, auditors review and provide comments and feedback to management and the audit committee on a company's MD&A. Furthermore, in practice, for other financial information included outside of a company's financial statements, such as a company's earnings release, the auditor will perform certain procedures to satisfy themselves that the information is accurate and not inconsistent with the company's financial statements. As such, it is a company's expectation that their auditor will provide comments and feedback to management and the audit committee on other issued financial information such as an earnings release. Management and/or the audit committee address auditor comments and feedback as appropriate. In addition, for other information included within an SEC filing that contains an audit opinion, auditors would not permit their audit opinion to be included if the other financial information was inappropriate, inconsistent or incomplete. As a result, we feel strongly that there is no added benefit or value to investors in having such other financial information audited and opined upon by a company's external auditors.

Additionally, the increase in audit scope resulting from this proposal could jeopardize a company's timely issuance of its earnings releases and SEC filings. A company would be forced to provide drafts of other financial information to its auditor at an earlier stage in the process to ensure that the auditor has sufficient time to conduct their additional audit procedures. This will stress (and potentially stretch) a company's internal resources and, in turn, could have a negative impact on the quality of the information provided to investors. This could apply to a public company of any size, but will certainly impact our small public biotech companies with limited staff who are already operating at full capacity.

4. **BIO concurs with the PCAOB proposal to clarify certain language in the auditor's report.**

   BIO supports amending the auditor's report to better articulate and clarify the responsibilities of management and the external auditor. Furthermore, BIO supports providing additional descriptive language in the auditor's opinion for various terms, such as "reasonable assurance." Such clarifications would be a more cost-efficient way to enhance the auditing reporting model.

BIO looks forward to working with the PCAOB to maintain effective auditing standards that provide value to financial statement users without significantly increasing costs to biotech (and other) companies. If you have further questions or comments, please contact me or Tooshar Swain, Policy and Research Manager, at (202) 962-9200.

Sincerely,

Alan F. Eisenberg
Executive Vice President
Emerging Companies and Business Development
Biotechnology Industry Organization (BIO)

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September 26, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 034, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*

Dear Office of the Secretary:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release").

We commend the PCAOB and its staff ("Staff") for its outreach to explore whether changes to the auditor's reporting model would increase transparency and relevance to financial statement users, and we fully support the Staff's goal of enhancing communication with financial statement users. It is evident based on the responses from investors to the Staff's outreach that there is a desire for increased communication from the auditor to the financial statement user. We recognize the need for change to improve the relevance of the current auditor's reporting model, and we support changes that are guided by the following overarching principles set forth by the Center for Audit Quality ("CAQ") in their recent letter to the PCAOB:

1. Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.

2. Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.

3. Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.

4. Any changes to the auditor's reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.

5. Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however, it is important that auditor communications provide objective information about these highly subjective matters.

We are submitting for the Board's consideration our views on the four alternatives described in the Concept Release.

**Auditor's Discussion and Analysis (AD&A)**

The Concept Release contemplates an AD&A as a supplemental narrative to the standard auditor's report to provide investors and other financial statement users with a view of the audit and the financial statements "through the auditor's eyes." We do not support the inclusion of an AD&A with the auditor's report, as we believe it would be counter to the goal of enhancing communication with financial statement users.

The analysis contemplated in an AD&A regarding the auditor's views about significant matters includes discussion of audit risks identified, audit procedures and results, and views on management's judgments and estimates, accounting policies and practices, and difficult or contentious issues. This analysis without the proper context and absent the robust dialogue necessary to understand the information would likely result in misunderstanding and misinterpretation of the auditor's communication. Specifically, we are concerned that inclusion of an AD&A as a supplement to the auditor's report could result in the following:

1. As contemplated in the Concept Release, information in an AD&A is very similar to that discussed with the audit committee. The auditor communication with the audit committee is designed to include a robust dialogue on key matters and allows the auditor to provide sufficient context for the information being communicated. We believe that presenting information about auditor risk assessments, choice of audit procedures and views on estimates and management judgments without the accompanying dialogue with investors would create confusion among investors and other financial statement users.

2. Auditor disclosure about significant audit risks identified and audit responses to those risks to investors who lack the proper education and training about those matters would create investor confusion as opposed to increased transparency. We are concerned that it would not be possible to provide enough information to adequately educate financial statement users about the risk evaluations and procedures that encompass the audit process. Such confusion may result in the improper use of the information provided in an AD&A for decision making by investors.

3. In an AD&A, an auditor would provide subjective views about risks and estimates embodied in the company's financial statements. We believe the source of information about the company should be provided by management, not the auditor. Management has far more insight and greater knowledge of the company, making them better equipped to provide the most meaningful information to investors. Discussion about the company by the auditor could result in conflicting information with that presented by management and, ultimately, lead to investor confusion.

4. Developing a disclosure framework for AD&A that can be consistently followed would be very difficult given the subjectivity involved in the analysis. Without such a framework, information disclosed in an AD&A would lack comparability between companies and potentially result in misinterpretation by users and create confusion. Variations would exist in how auditors determine what matters reach the level of significance to be included in an AD&A and the extent to which such matters are discussed. AD&A wording would be carefully crafted by auditors to limit exposure to litigation. The result would likely be a diluted message that is not easily understood by financial statement users and, thus, not achieving its intended purpose. We believe it would be inappropriate and potentially harmful for investors to use AD&A as a tool for analyzing risks and for investment decisions to be influenced by the writing skills of auditors and by the volume of information and level of detail auditors choose to disclose.

5. Drafting an AD&A would be time consuming due to necessary quality control reviews and could result in difficulty meeting filing deadlines and would certainly result in increased costs for issuers.

**Required and Expanded Use of Emphasis Paragraph**

The Concept Release outlines an alternative to require expanded emphasis paragraphs in all audit reports to highlight the most significant matters in the financial statements along with key audit procedures performed pertaining to the identified matters. While we do not support the inclusion of a required emphasis paragraph as outlined in the Concept Release, we do believe a slightly modified alternative would be beneficial to financial statement users.

We support including an emphasis paragraph in the auditor's report to call attention to significant accounting estimates used in the preparation of the financial statements that are subject to material change in the near term and require difficult subjective judgments by management and auditors. Highlighting significant estimates used in the preparation of the financial statements would allow investors to easily identify the related financial statement disclosures made by management as well as the discussion of critical accounting estimates included in Management's Discussion and Analysis (MD&A). We believe emphasizing significant estimates in the auditor's report would likely result in improved disclosures about accounting estimates thereby increasing transparency. In order to be effective in enhancing communication with investors, we believe it is critical that the scope of emphasis paragraphs be sufficiently narrow to limit inconsistencies based on the subjectivity of auditors. We believe the most effective means of ensuring consistent application in practice is to establish parameters for emphasis paragraphs that mirror the disclosure requirements for significant estimates in the current disclosure framework under U.S. GAAP.

At your request, we would be happy to provide an example auditor's report illustrating our proposed changes.

**Clarification of Language in Standard Auditor's Report**

We support including the following clarifying language to the auditor's report as suggested in the Concept Release along with other clarifications that we believe would enhance the auditor's report and help users to better understand the nature of an audit and auditor and management responsibilities.

1. *Reasonable Assurance* - Add clarifying language to explain that reasonable assurance is a high level of assurance, but not absolute assurance.

2. *Auditor's Responsibility for Fraud* - Highlight that the auditor is responsible to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

3. *Auditor's Responsibility for Financial Statement Disclosures* - Add clarifying language regarding the auditor's responsibility for financial statement disclosures.

4. *Management's Responsibility for the Preparation of the Financial Statements* - State that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

5. *Auditor's Responsibility for Information Outside the Financial Statements* - Describe the auditor's responsibility with respect to such information.

6. *Auditor Independence* - Include statement regarding the auditor's responsibility to be independent and compliance with the independence requirements.

7. *Audit Committee Responsibilities* - Describe the responsibilities of the audit committee.

In addition, we believe further enhancing investor understanding of what an audit represents and the auditor's responsibilities would best be accomplished by including reference in the auditor's report to a supplemental document that describes the audit process similar to the CAQ's *In-Depth Guide to Public Company Auditing*.

**Auditor Assurance on Other Information Outside the Financial Statements**

We support expanding the auditor's role to provide assurance on matters in addition to the financial statements that provide value to investors if the matter is within the skill set of auditors and could be applied within a framework that balances benefits and costs. One area that may provide a cost/benefit balance is an examination of issuer disclosures about significant accounting estimates within MD&A.

We believe reporting on issuer disclosures about critical accounting estimates could improve the quality of the information disclosed, thereby enhancing communication with investors. We believe enhanced communication also could be achieved by increased enforcement of the current disclosure requirements prescribed by SEC regulations related to critical accounting estimates and critical accounting policies without further imposing additional costs to issuers by requiring auditor assurance on this information.

*****

We appreciate the opportunity to express our views for the Board's consideration. If you have any questions or would like to discuss these matters further, please contact Steve Rafferty or Doug Bennett at 417.831.7283, or by email at srafferty@bkd.com or dbennett@bkd.com, respectively.

Sincerely,

BKD, LLP

**BKD, LLP**

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55 E. 52nd Street
New York, NY 10055
Tel 212.810.5300

September 30, 2011

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

**RE: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Rulemaking Docket No. 034**

Members of the Board,

BlackRock, Inc. ("BlackRock") appreciates the opportunity to comment on Public Company Accounting Oversight Board ("Board" or "PCAOB") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* dated June 21, 2011 ("Concept Release"). BlackRock is a global investment manager, overseeing $3.66 trillion of assets under management at June 30, 2011. BlackRock and its subsidiaries manage approximately 3,400 investment vehicles, including registered investment companies, hedge funds, private equity funds, exchange-traded funds and collective investment trusts, in addition to separate accounts. Certain of BlackRock's wholly-owned subsidiaries operate as U.S. registered broker/dealers, U.K. registered life insurance companies, a U.S. registered bank trust company and numerous investment advisory companies registered in jurisdictions throughout the world.

As an investment manager, BlackRock is in the position to provide commentary on the Concept Release from the perspectives of a) a corporate preparer, b) an investment fund preparer and c) a user (i.e., BlackRock's research analysts). As such, our comments take into account all three of these distinct perspectives.

**Overview**

BlackRock's analysts and many investors believe that the auditor's report could be enhanced to provide more informative reporting. The auditor's report currently includes a statement on the financial statements and periods covered, the scope of the audit, and a "binary" opinion as to whether such statements present fairly, in all material respects, the financial position and results of operations and cash flows of the company. The current reporting model does not provide additional context or insight around the audit or significant matters that the auditor may have addressed during the course of their audit. However, the current model does provide consistency, clarity of reporting and comparability and normally is taken in the context of other available information, including other disclosures accompanying the financial statements and management oral and written communications.

The goal to provide additional information to investors can be met in part by changes in the auditor reporting framework, with a focus on objective rather than subjective reporting, as noted below. However, financial statement preparers also have a responsibility to disclose information that meets professional and regulatory standards and that enhances understanding of a company's financial position and results of operations. We believe it is preferable for preparers, and not the auditor, to be the original source of such disclosures about the company. We are

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concerned that contradictory disclosures by a company and its auditor would undermine the financial statements and their utility; the onus should be on management to prepare such information and for the auditors to determine whether it is fairly stated in all material respects. Further clarification by the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") on existing disclosure requirements would help achieve this objective.

The Concept Release requested comments on whether certain information communicated to the audit committee should be conveyed in an auditor discussion and analysis ("AD&A"). As noted below, we believe that management may elect to make such disclosures but it would be difficult to communicate in an audit report the full context of those discussions. Accordingly, we encourage the SEC and FASB to clarify existing management disclosure requirements over certain items, such as accounting judgments, or to suggest additional management disclosures. For example, the SEC could require expanded discussion by management of any significant deficiencies related to internal controls over financial reporting that are unremediated for an extended period of time.

BlackRock prepares corporate and subsidiary financial statements in many jurisdictions. Additionally, each of our sponsored investment company reports may be filed with regulators in multiple countries. Given the nature of global markets, it is critical that the PCAOB work with the International Auditing and Assurance Standards Board ("IAASB") and the American Institute of Certified Public Accountants to minimize the confusion and expectation gap that may be created if different auditor reporting models are adopted.[1]

The PCAOB proposed four alternatives in its Concept Release, which we address in the remainder of this letter.

**Clarification of the language in the standard auditor's report**

We encourage the Board to undertake a standard-setting initiative to provide clarity about what an audit represents and the auditor's responsibilities, including the following items:

- The definition of "**reasonable assurance**." The auditor's report should explicitly state that reasonable assurance is a "high level of assurance, but not absolute assurance."
- Auditor's **responsibility for fraud**. We support inclusion of language in the auditor's report that is consistent with AU section 230 that clarifies that professional auditing standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.
- **Auditor's responsibility for financial statement disclosures**. We support inclusion of a statement in the audit report that clarifies the auditor's responsibility for financial statement disclosures, including all notes to the financial statements and all related schedules.
- **Management's responsibility for preparation of the financial statements.** The auditor's report should be further clarified to state that management prepares the financial statements and has responsibility for their fair presentation.
- **Auditor responsibility for information outside the financial statements**. When other information is contained in documents containing audited financial statements, the audit report should note that the auditor has a responsibility to read the other

[1] The IAASB has undertaken a similar project, entitled *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, dated May 2011.

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information and consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact.[2]

- **Auditor independence.** We support inclusion of a statement that the auditor has a responsibility to be independent of the company and has complied with the applicable independence requirements of the PCAOB and SEC.

We note that including all of the aforementioned information would significantly lengthen the auditor's report and accordingly suggest that such information could be presented in separate and subsequent paragraphs to not overwhelm the core audit opinion. These clarifications should not result in a significant change in audit scope or increase in audit fees.

**Required and expanded use of emphasis paragraphs**

The Board should consider providing additional guidance that encourages, but does not mandate, emphasis of matter paragraphs in the auditor's report that focus the reader on the location in the financial statements of:

- Significant new financial statement disclosures,
- Significant transactions, including related party transactions,
- Significant management judgments, estimates and areas with significant measurement uncertainty, and
- Information about a significant acquisition and related financing.

This approach is similar to the "justification of opinion" required in auditor reports in France. We would not object to expansion of the emphasis of matter paragraph to reference the location of critical disclosures outside the financial statements, such as in management's discussion and analysis ("MD&A"). Certain additional objective, fact-based matters may be included in the emphasis paragraph at the discretion of the auditor, if not disclosed by management.

**Auditor assurance on other information outside the financial statements**

BlackRock supports auditor assurance on information outside the financial statements, such as earnings releases or MD&A, at the discretion of management. As noted above, auditors already are required to read information that is associated with the financial statements to be satisfied that such information is consistent with the financial statements.[2] We do not support mandatory assurance on such information, because of the incremental cost, which we believe may exceed the benefit, and the potential to delay earnings releases and other time-sensitive information. Our analysts have not routinely observed situations where such information has been improperly presented or where the disclosures are misleading. However, we recognize that some information outside the core financial statements, such as non-GAAP measures, may be important tools to users of financial statements and therefore assurance may be cost-beneficial. Some companies also may find value in having assurance on specific aspects of MD&A, such as critical accounting estimates, key performance indicators, key drivers of revenue (such as assets under management) or certain non-financial measures of performance. This approach would be consistent with our fundamental thesis that management should be the original source of financial statement disclosures.

[2] Procedures currently required by AU section 550.04-.06.

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**Auditor's Discussion and Analysis ("AD&A")**

A supplemental AD&A that provides objective additional information could facilitate understanding of the financial statements taken as a whole. However, it may be difficult to provide enough context around certain issues, such as audit procedures performed and subsequent discussions with management and the audit committee. For example, many areas may require significant judgment and complex assumptions and calculations, including loan loss reserves, fair valuation of certain complex and illiquid financial instruments, litigation reserves, uncertain tax positions, or impairment analyses. However, there are some matters for which an AD&A discussion could be beneficial to financial statement users, including the following:

- Significant new accounting principles and whether they are preferable in the context of authoritative and regulatory guidance,
- Considerations in evaluating entities with going concern uncertainties, including observations on declining or concentrated cash flows or upcoming material financial obligations,
- Significant external information or inputs in performing audit procedures on significant accounting estimates,
- Matters related to auditor independence, including disclosure of the length of time the audit firm has been engaged by the company and other significant services provided to related parties outside the corporate audit that may not be disclosed in the proxy (e.g., audit fees paid by sponsored investment companies), and
- Audit procedures in material areas requiring significant judgment or with significant uncertainty (e.g., fair valuation, impairment of intangible assets – see the following paragraph).

We would not object to the identification in an AD&A of those areas which were subject to significant management or auditor judgment or significant uncertainty given their complexity, and the attendant significant audit procedures performed. We also would not object to disclosure of key inputs on which the auditor relied in performing their audit of those areas if those inputs are not disclosed by management. However, we are concerned that it may be difficult to convey succinctly the nature of those procedures in a manner that may provide useful information. We do not support auditor disclosure of a range of possible outcomes or estimates or other information that would blur the responsibility of management to prepare financial information and of the auditor to perform audit procedures to determine the reasonableness of the financial statements taken as a whole. Similarly management, and not the auditor, should provide any forward-looking information on the business, its assessment of operational risks and where appropriate, any additional information on accounting estimates. An AD&A should not be required if the auditor does not have any significant matters to communicate. This caveat is particularly important to entities with less complex financial reporting, such as certain investment companies.

Note that many of the matters that might be covered in an Auditor AD&A also may be required pursuant to the critical accounting estimates guidance within FR-72 *Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*. The SEC could achieve some of the objectives of an auditor AD&A by clarifying and expanding management disclosure responsibilities in FR-72 or by requiring additional disclosures in the risk factors section of Form 10-K. They also could require that certain disclosures now contained in Regulation S-K be relocated to Regulation S-X where, as financial statement disclosures, they would be subject to greater scrutiny. To the extent that additional information would be useful to users of financial statements, such as disclosure of a range of estimates for significant accounting estimates, or ongoing significant deficiencies in internal controls, the SEC and FASB should work together to define the parameters.

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BlackRock does not support disclosure of "close calls" by management or auditors because the term and any such disclosures may imply a failure to adopt sound accounting principles or to make an appropriate accounting determination, when in fact preparation of financial statements involves judgment and use of estimates. We also do not support disclosure of a dollar materiality threshold used by management in preparing, and the auditor in auditing, the financial statements. However, we support further efforts by the PCAOB to determine how financial statement preparers can describe the factors they consider in assessing materiality in the context of specific financial statement items and disclosures (e.g., net income, certain significant accounts).

Auditors should not be required to disclose matters communicated to the audit committee given the confidential nature of those communications and the risk that such disclosures could be misinterpreted without proper perspective and background. Reports to the audit committee normally are in the context of communications over an extended period, are accompanied by written and oral materials, and involve questioning and detailed responses that could not be sufficiently conveyed in an AD&A. We are concerned that mandatory disclosure in an AD&A of matters communicated to the audit committee could have the undesirable effect of limiting those communications.

Given the significance and breadth of the proposed changes, we strongly urge the PCAOB to perform field tests to help ensure that any proposed changes are practical and useful to users of financial statements and that they can be implemented in a cost-effective manner. It also would be useful to obtain input from auditors as to whether they are able to develop AD&A disclosures that would meet their internal quality control guidelines. Finally, we reiterate the need for a coordinated approach between the PCAOB, AICPA, SEC, FASB and IAASB to ensure consistency and due consideration of the implications of any changes to users and preparers of financial statements.

*****

We appreciate the opportunity to share our viewpoints relating to the possible revisions to the PCAOB standards related to reports on audited financial statements. We hope our comments are helpful to the Board. If the Board has any questions regarding our comments, please contact Steven Buller at (212) 810-3501.

Sincerely,

Steven E. Buller
Managing Director

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October 20, 2011 Via E-Mail: comments@pcaobus.org

J. Gordon Seymour
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006

Dear Mr. Seymour:

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

CalPERS is the largest public pension fund in the United States with approximately $225 billion in global assets in more than 9,000 public companies worldwide within 47 markets. CalPERS invests these assets on behalf of more than 1.6 million public workers, retirees, their families, and beneficiaries in order to fund retirement and health benefits.

Thank you for this opportunity to comment on the concept release on the auditor's reporting model following CalPERS participation in the September 15 roundtable on this topic. We applaud the PCAOB's work to improve the auditor's report in order to increase its transparency and relevance to financial statement users.

CalPERS is fundamentally a long-term, fiduciary investor, with a vested interest in the stability of the markets and the integrity of financial reporting. We believe financial reporting should provide users the information needed to make informed capital allocation decisions. The integrity and quality of financial reports is strengthened by a robust external independent audit, carried out objectively and undertaken with appropriate professional skepticism on the part of the auditor.

The auditor's assurance is critical to investors' confidence in the integrity of financial reporting and its consistency with U.S. Generally Accepted Accounting Principles (GAAP). We also support the development of global best practice in this arena.

We outline in the attached Appendix CalPERS responses to the questions in this release which includes comments on: (1) Auditor's Discussion and Analysis (AD&A), (2) Required and Expanded Use of Emphasis Paragraphs, (3) Auditor Assurance on Other Information Outside the Financial Statements, and (4) Clarification of Language in the Standard Auditor's Report and Other Alternative.

We believe the PCAOB has the opportunity to make some substantive, robust changes that will improve auditor reporting and provide real value to investors and other users of financial reporting.

If you have any questions or concerns, please call me at 916-795-9672 or my colleague Mary Hartman Morris at 916-795-4129.

Sincerely,

ANNE SIMPSON
Senior Portfolio Manager
Investment Office
Head of Corporate Governance

cc: Board Members - PCAOB
Mary L. Schapiro, Chairman - SEC
Jim Kroeker, Chief Accountant - SEC
Joe Dear, Chief Investment Officer – CalPERS
Janine Guilliot, Chief Operating Investment Officer – CalPERS

# Appendix – Responses to Questions in PCAOB Release No. 2011-003

***Content of the Auditor's Report***

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

Yes, we believe improvement to the auditor's reporting model is necessary. CalPERS believes information provided in an AD&A would provide more congruent disclosures and provide a better tool for investors in their capital allocation decisions.

A study done in September 2009 "Investors', Auditors', and Lenders' Understanding of the message conveyed by the Standard Audit Report (SAR)"[1] highlighted group differences within three patterns:

I. Type I communication gap – whether the user groups investors and lenders differ from the auditor group.
II. Type II gap - The user groups differ from each other.
III. Type III gap – the user groups differ from each other as well as from the auditor group.

The purpose of the study was to evaluate the congruence or alternatively the communication gap between the three groups in their understanding of the objectives and limitations of the SAR and secondly, to evaluate the congruence in the interpretation of the technical language used in the SAR.

Participants rated the SAR as important in investing and lending decisions as well as for assessing whether financial statements are free from material fraud. This study showed that the SAR provided relatively lower level of confidence that a company is well managed, a sound investment or that the company would meet its strategic goals. Overall the results showed that the current Standard Auditor Report results in communication gaps and expectations between users and the auditor. We believe expanding the auditor's report through a narrative AD&A would narrow this gap.

[1] Report prepared for the AICPA Auditing Standards Board (ASB) and International Auditing and Assurance Standards Board (IAASB) to better understand communications conveyed in the standard audit report. http://web.ifac.org/download/Study__3_AICPA_IAASB_Paper.pdf, Sept. 2009.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

The Auditor is in a unique position, and as an independent financial expert could provide an unbiased view of the audit and financial statements. See response to 2c.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

Discussed in auditor assurance on page 11 question 19.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

*b. If not, why not, and what changes are needed?*

We believe the current model needs improvement though better disclosure. We see where the current pass-fail model provides some value in expressing a standard opinion.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

We believe there is some value in the pass/fail model but support expansion of the auditor’s report. The specific model should be determined by the PCAOB.

We suggest this expanded report focus on:

I. Key financial statement and audit risks the auditor has considered when conducting the audit, and the extent, if any, as to how the auditor addressed those risks.
II. The auditor’s assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment.

III. The quality of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry.
IV. Unusual transactions and significant changes to accounting policies.

Other items should be considered in expanding the narrative reporting, such as:

V. The methods and judgments made in valuing assets and liabilities (with discussion of sensitivity analyses, and any stress tests).
VI. Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of the audit.
VII. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum to the audit committee.
VIII. Quality and effectiveness of the board governance structure and risk management.
IX. The completeness and reasonableness of the audit committee report.
X. The effectiveness of the company's internal controls over financial reporting.[2]
XI. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

CalPERS believes the auditor should provide from their perspective expanded information. We do not discount the value and the fiduciary responsibility of the Audit Committee. We recognize the auditor is in a unique position. The auditor has extensive knowledge of the company and industry which is obtained through the audit process and experiences; is an independent third party; and we believe the auditor can provide an unbiased view of the company's financial statements.

We also emphasize that in our opinion, the auditor could use the disclosure requirement to leverage change and enhance management disclosure in the financial statements. This impetus to change would provide better disclosures and transparency to investors.

We also support greater transparency by Audit Committees on how as an effective monitor and fiduciary on behalf of shareowners, does the Audit Committee discharge

[2] Although required in the US, this is not required outside the US. We list here as global regulators will be reviewing comment letters with the IAASB also considering the auditor's report.

their responsibilities in relation to the integrity of the Annual Report, including oversight of the external auditors.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

We supported during the comment period the development of Auditing Standard No. 5 (AS5), "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements". We support and believe the proposed changes to the audit report do not increase the scope of the audit but provide better clarity of the work performed through AS 5. AS5 already requires the auditor to address the role of risk assessment, the risk of fraud, identifying significant accounts and relevant assertions, understanding the likely sources of misstatement, identifying and assessing risks of material misstatement, relationship of risk to the evidence to be obtained, evaluating identified deficiencies, indicators of material weaknesses, and forming an opinion based on this work. The work performed as required by AS5 should be the basis on which the auditor should provide additional information through a narrative format in an AD&A. We are unsure of what additional amendments are necessary to AS5 as it currently covers information that investors are requesting.

***Potential Alternatives for Changes to the Auditor's Report – Auditor's Discussion and Analysis***

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

*d. If you do not support an AD&A as an alternative, explain why.*

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

Yes, we support an AD&A as an alternative for providing additional information in the auditor's report. We believe an expansion of the auditor's report will provide added value to investors. CalPERS supports the auditor reporting on the financial statement, on broader company information and on the audit process itself. We believe a narrative format would not be too prescriptive and would allow the auditor to explain the mitigation of financial statement and audit risks and how the auditor formed their overall opinion.

We do not see any alternatives other than an AD&A where the auditor could provide robust discussion and analysis.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

We have highlighted the main areas of interests (Response to question 2c) that we believe would provide added value to investors and other users of financial reporting. We believe a narrative format would allow the auditor to customize an AD&A report appropriately to the specific company. Investors are interested at a high level where are the financial statement and audit risks; what conceptually was the work performed to understand those risks; and how did the auditor become comfortable in their testing to come to the conclusion in the opinion expressed.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

CalPERS supports the PCAOB developing certain criteria the auditor should always include and other criteria the auditor should consider in providing an AD&A. We believe there is a qualitative aspect that the auditor will provide through a narrative on the company, the work performed and how they came to their conclusions. See response to question 2c.

*8. Should a standard format be required for an AD&A? Why or why not?*

We do not believe the format should be standardized as we would not encourage boiler plate language. We do suggest specific criteria be required and others considered in developing an AD&A.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

It is the responsibility of management to comment on business, strategic and operational risks through the Management Discussion and Analysis (MD&A). The auditor should focus on risks associated with the audit, internal controls and risks that impact financial statements such as risks that may impact the valuation of assets and liabilities, critical accounting judgments and estimates and communicate how the auditor assessed these risk factors through their audit program and in their opinion.

CalPERS believes through lessons learned from the financial crisis that management, the board and the auditor should identify all risks, determine the impact of these risks, how to mitigate these risks and the appropriate oversight and disclosure of these risks.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

CalPERS recommends the PCAOB articulate the objective of an AD&A and expectations on how the auditor should respond and develop a customized narrative on each company they audit.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

Investors would benefit from an expanded report including:

I. Greater objectivity and possibly improved audit quality.
II. Increased transparency into the audit process and the significant judgments made in forming the auditor's opinion.
III. Better understanding of the auditor's opinion taken as a whole and how the auditor reached that opinion.
IV. Improved perception of the integrity of reporting.
V. Improved usefulness of the audited financial statements in making informed investment decisions.
VI. Better information to inform shareowners with respect to their auditor ratification decision.

The one shortcoming of implementing an AD&A may be the issue of who is the customer of the auditor? Shareowners are the customers of the audit, although a potential conflict may exist, as auditors are paid by the company and may not want to challenge management.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management's and the board's perspective along with an independent auditor's would provide a better understanding from different perspectives on the stewardship of the company

***<u>Required and Expanded Use of Emphasis Paragraphs (Questions 13-18</u>***

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

*a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

*15. What specific information should require and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

As emphasis paragraphs are already permitted but not required, CalPERS does not believe this would be the optimum area for additional disclosure.

Currently Emphasis paragraphs are allowed and can be used to expand on significant:

I. Issues in the financial statements, and how disclosed in the financials.
II. Measurement uncertainty.
III. Management judgments and estimates.
IV. Areas where in the opinion of the auditor, need additional clarification for a better understanding of the financial statements.

The issue is that most auditors do not use emphasis paragraphs.

Providing this type of information in emphasis paragraphs may need additional disclosures on procedures the auditor performed relating to each of these matters.

It is our belief that the PCAOB should remain focused on making the necessary and immediate changes to the existing auditor's reporting model. However, if the Board decides against an AD&A, then emphasis paragraphs should be required and should address:

I. Key financial statement and audit risks the auditor has considered when conducting the audit, and the extent, if any, as to how the auditor addressed those risks.
II. The auditor's assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment.
III. The quality of the accounting policies and practices adopted by management including accounting applications and practices that are uncommon to the industry.
IV. Unusual transactions and significant changes to accounting policies.

Other items should be considered if emphasis paragraphs are required, such as:

V. The methods and judgments made in valuing assets and liabilities (with discussion of sensitivity analyses, and any stress tests).
VI. Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of the audit.
VII. Key audit issues and their resolution, which the audit partner documents in a final, summary audit memorandum to the audit committee.
VIII. Quality and effectiveness of the board governance structure and risk management.
IX. The completeness and reasonableness of the audit committee report.
X. The effectiveness of the company's internal controls over financial reporting.[3]

[3] Although required in the US, this is not required outside the US. We list here as global regulators will be reviewing comment letters with the IAASB also considering the auditor's report.

XI. Policies regarding the provision of non-audit services to avoid compromising auditor independence.

***<u>Auditor Assurance on Other Information Outside the Financial Statements</u>***

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

Currently the auditor's assurance is critical to investor confidence in the integrity of financial reporting and its comparability based on US Generally Accepted Accounting Principles (GAAP). It has long been recognized that financial statements alone are not sufficient to communicate the overall performance of an entity. In particular, MD&A has become a core element of the communication package for external reporting purposes. We utilize other information such as MD&A, earnings releases, to obtain a better understanding of a company and its peers.

The MD&A is a very important section of an annual report, especially to investors in our review of a company's fundamentals. MD&A proves a context within which the financial results and financial position can be interpreted. As underscored by the Principles for Ongoing Disclosure and Material Development Reporting by Listed Entities by the IOSCO Technical Committee, an issuer should provide all information that would be material to an investor's investment decision, including disclosures in the MD&A. The

MD&A requirements are intended to satisfy four principal objectives which benefit investors and other users of the MD&A:

I. Enables investors to see the company "through the eyes of management."
II. Improves financial disclosure overall and provides the context within which financial statements should be analyzed.
III. Provides information about the different components of earnings and cash flow and the extent to which they are recurring elements, thereby enabling investors to make a better prediction about the sustainability of earnings and cash flow in the future.
IV. Provides information about the risks to a company's earnings and cash flow.

MD&A proves a context within which the financial results and financial position can be interpreted. Currently auditors as part of their engagement review the MD&A and consider whether such information or the manner of its presentation is materially inconsistent with the financial restatements or represents a material misstatement of fact. We believe the auditor could provide a statement based on their current responsibilities as it relates to MD&A within the AD&A. Although the auditor would not be providing assurance on future performance, CalPERS believes the auditor could through an AD&A provide a statement whether the MD&A is reasonable, whether assumptions and conclusions are rational based on the current work of the auditor and its review of a company's financial performance.

We recommend the PCAOB focus on the AD&A and address additional assurance in a separate project.

CalPERS would support a fuller discussion of the MD&A, specifically as a framework for integrated reporting is developed further. The International Integrated Reporting Committee released a request for comment on an integrated reporting framework in September 2011.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

Investors, like CalPERS would recommend the PCAOB focus on the AD&A and provide clarity within the AD&A on the responsibilities of the auditor on MD&A. We see the value of additional assurance but would need to understand what additional work will be performed and what additional assurance means to investors.

We agree if assurance on other information such as the MD&A is recommended – we would defer to the current attestation engagement procedures as issuers currently have the option to engage the auditor to attest on MD&A.

This would be a great opportunity to determine which issuers if any, currently request their external auditor firms to attest to the MD&A. If an issuer requested an attestation, then the benefits and challenges should have been outlined to the audit committee and discussion of the benefits may be well articulated. We believe the greatest benefit of reviewing the auditor's role in other assurance would be the impetus to issuers, specifically management in fulfilling the current SEC standards for appropriate disclosures in the MD&A.

***Clarification of the Standard Auditor's Report***

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*
- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence 42/ AU sec. 550.04 - .06.*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

CalPERS supports providing additional clarification of each of the areas listed above. We agree that language should be further clarified as these areas are not necessarily fully articulated and understood.

CalPERS as a part of its testimony to the US Treasury Department Advisory Committee on the Auditing Profession (ACAP) in February 2008, provided comments on auditors' responsibility for detecting fraud and auditor independence. We believe that the responsibility of auditors to detect fraud and improve the timely communication of these frauds to current shareowners and potential investors is critically important. We believe the standard audit report should indicate the auditor's responsibility for detecting material fraud and define that the auditor has a responsibility to obtain reasonable assurance (defined as a high, although not absolute, level of assurance) as to whether the financial statements are materially misstated, whether caused by error or fraud.

We also believe in defining the auditor's responsibility relating to fraud that "inherent limitations" be defined in detecting material misstatements resulting from fraud. In our opinion, there may not necessarily be inherent limitations, but rather time and cost limitations. In our view fraud detection would improve the quality of the audit and with time and effort may have detected many of the major frauds during the last few years. We believe that if during an audit if it is found that the control environment is weak and presents opportunities for fraud, auditors should highlight this to management and the audit committee and offer to undertake additional work.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We do not see any shortcomings to providing clarification of the language in the standard auditor's report. CalPERS believes better articulation and clarity will provide better transparency, understanding and narrow existing expectation gaps.

CalPERS does not see clarification as an alternative to the expansion of the auditor's report through an AD&A. We support clarification as it would be beneficial to investors to fully understand the role of the auditor and the extent of the work the auditor is performing during the financial statement review. We do not necessarily see this as an expansion of the auditor's report and support the focus on the AD&A.

***Questions Related to all Alternatives***

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

*25. What alternatives not mentioned in this concept release should the Board consider?*

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

CalPERS supports the expansion of the auditor's reporting through an AD&A. It is our belief that the PCAOB should remain focused on making the necessary and immediate changes to the existing auditor's reporting model.

Additionally, CalPERS believes corporate reporting needs to integrate key financial and non-financial information. We support that each company should consider an integrated report to identify risks related to the company's operational, financial, environmental, social, and governance status. Integrated reporting is necessary to understand risk management at a company and the drivers of value creation. CalPERS seeks financial and non-financial information that is relevant, timely, comparable, and of high quality.

As the International Integrated Reporting Committee has commented, "There is a need to develop more comprehensive and comprehensible information about an organization's total performance, prospective as well as retrospective, to meet the needs of the emerging, more sustainable, global economic model."[4]

CalPERS has a fiduciary duty of prudence, which requires that we take into account all information which identifies and enables the mitigation of risk and assists in identifying drivers of value creation. To fulfill this, investors require comprehensive financial and non-financial disclosures by investee companies. We mention this as we believe long-term, the auditor's reporting model, and framework should address the integration of financial and non-financial information, including relevant environmental, social and governance factors.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

The focus of any changes in auditor reporting should be the value to investors. Yes, we believe addressing emphasis paragraphs, other assurance and clarification of language would provide a piecemeal approach. CalPERS preference would be for the PCAOB to focus on expanding the auditor's report through an AD&A.

Additionally, CalPERS supports changes to the auditor report or changes that may include a new style of auditor report, such as the AD&A. We suggest the PCAOB consider the current work on integrated reporting in its assessment of the auditor's reporting model.

[4] "Why we Need Integrated Reporting", Discussion Paper, by Sir Michael Peat, Chairman of the IIRC, IIRC website http://iirc.newsweaver.co.uk/newsletter/1ja775usz5leq5jjkzjymy.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

From our perspective we believe an AD&A would better convey to users of the financial statements the auditor’s role in the performance of an audit.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

We believe that an AD&A would improve audit quality as its preparation would strengthen dialogue between the auditor, management and the Audit Committee. We also believe enhancing this three-way dialogue may allow the auditor to leverage discussions with management in accepting potential best practice reporting alternatives.

As we expressed in our response to question #12, CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management’s and the board’s perspective along with an independent auditor’s would provide a better understanding from different perspectives on the stewardship of the company

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

We support application to all SEC registrants. We do not support exemptions or application scaling based on company size in public markets. We support moving all audits of public companies in a direction which provides better disclosure and insight into the valuable work performed by auditors.

**Considerations Related to Changing the Auditor's Report**

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

CalPERS believes that additional transparency will increase the quality of the audit and provide better disclosure of the added value which currently exists in the work performed by the auditor. We do not see where there would be additional cost as the AD&A would not increase the amount of audit work performed, it would be articulating the current work performed by an auditor, and how they came to the conclusion in the audit opinion.

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

CalPERS believes this will strengthen and expand more robust discussions between management, the audit committee and the auditor.

As previously stated, CalPERS does not believe having inconsistent or competing information between the auditor and management is necessarily a concern. Shareowners are the owners of a company and obtaining both management’s and the board’s perspective along with an independent auditor’s would provide a better understanding from different perspectives on the stewardship of the company

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September 27, 2011

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

Submitted via email to: comments@pcaobus.org

Re: PCAOB Release No. 2011-003
Concept Release on Possible Revisions to PCAOB Standards
Related to Reports on Audited Financial Statements

The Accounting Principles and Auditing Standards Committee (the "Committee" or "We") of the California Society of Certified Public Accountants ("CalCPA") is grateful for the opportunity to comment on the Concept Release referred to above. The Committee is the senior technical accounting and auditing committee of CalCPA. CalCPA has approximately 35,000 members. The Committee is comprised of 43 members, of whom 56% are from local or regional firms, 21% are from large multi-office firms, 12% are sole practitioners in public practice, 9% are in academia and 2% are in an international firm.

We have provided our comments in response to the questions set forth in the Concept Release within the main body of this letter. However, we wanted to present certain overall comments which reflect the tone of the Committee's views.

The Committee supports the Board's proposal to clarify certain basic elements of the auditor's report because to do so would not expand audit scope and would retain the current "pass/fail" model. The Committee does not support any of the other alternatives proposed by the Board in this Release as they ultimately seek to place the auditor into a role that cannot be fulfilled, and that can best be met by the entity's management. It should not be the auditor's role to function as a financial analyst and attempt to predict the future prospects of the entity under audit.

Many of the Board's proposals presume that auditors know as much (or more) about an entity as management of the company. This is worst exemplified in the discussion of an "Auditor's Discussion and Analysis." Auditor's knowledge of a company comes from four basic sources: Industry knowledge, what management tells them voluntarily, what management tells them in response to questions, and what auditors discover through audit procedures. The totality of this knowledge does not, and cannot, equal what management knows from dealing with the business day-to-day. Quite often, if management in good faith does not think the auditor needs knowledge of something and the auditor does not ask about it of find it, the auditor will not know about it, and in this case if the auditor prepares an AD&A, it will likely be deficient.

## PCAOB Concept Release: Audit Report. Staff Questions

### History and Outreach

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

The Committee does not oppose an initiative to consider improvements to the auditor's reporting model. However, a clear distinction needs to be made between improvements in the report based on the existing scope of services and expansion of reporting based on an expanded scope of services. The Committee supports a better articulation of the overall audit process and certain significant findings. The Committee does not support the expansion of audit services and reporting on them.

Auditors should not be asked to report on the "quality" of an entity's financial statement. That quality is impacted by mandated accounting principles, which some believe underlie some complaints about the quality of financial statements. Auditors cannot be reasonably asked to critique mandatory accounting principles. Other aspects of "quality" are very subjective and what is good quality for some may be poor quality for others. There are bound to be inconsistencies among companies and even auditors within the same firm as to what is good vs. poor quality. What is needed is a clear disclosure of accounting principles followed, so users can draw their own conclusion about quality.

b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

The Committee believes that clarification of the auditor's report, as highlighted in the PCOAB Concept Release, merit further study. The Committee further recommends this study be done in conjunction with the AICPA to avoid establishing different reporting standards for public and non-public entities.

A number of things can be better articulated, including reasonable assurance, responsibility for fraud, clarification of management's responsibility and auditor's lack of responsibility for preparation of the financial statements, responsibility for information outside the financial statements, and the meaning of independence. All of this can be done with no expansion of audit scope.

Another area for study is determining how to effectively communicate the fact the audit process is by definition predominately about the past. The exception is where the future is so clear that the auditor adds going concern language. One might argue that financial statements should contain more forward looking content; perhaps, but that is not the auditor's issue, that is a financial framework issue, which makes it a management disclosure issue. Should forward looking information be made obligatory in the notes, the auditing profession will have to come to grips with the question of what is, AND what is not auditable.

c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

The Committee says "no", unless it is to report on information derived from the financial statements or prepared from records used to prepare the financial statements. Management has the responsibility for providing interpretation and analysis of historical and other business data, and this requires far more intimate knowledge of the entity, its business and its industry than an auditor has or is likely to be able to achieve.

The Committee is concerned that some of the responses described in the results of the staff's outreach activities demonstrate a complete lack of understanding of the role of the auditor, and worse, a desire to have the auditor perform analyses that should be performed by investors and analysts. Some responses seem to be based on the premise that the auditor has extensive knowledge of risks concerning the financial statements and the entity's business; the auditor clearly has some knowledge, but management is in the best position to assess and disclose risks, and is already required to do so in "risk factors." The Committee sees no point in having the auditor, with incomplete knowledge; attempt to provide information that is already within the purview of management's disclosure obligation.

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

a. Should the auditor's report retain the pass/fail model? If so, why?

Yes. It is the auditor's basic role, and is expected by users.

b. If not, why not, and what changes are needed?

See the Committee's response to Question 2.a. No change needed or desirable regarding the overall "pass/fail model."

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

Please refer to the Committee's response to Question 1.b., above.

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

Additional information that may be provided should be provided by management. Management would have the information. The audit committee best serves in an independent oversight role, and does not have the same access to information that management has; further, if the audit committee is cast in the role of providing information, it can be perceived as losing its independence. Similarly, the auditor's role is independent verification. The auditor does not have the same access to information that management has and if the auditor is cast in the role of providing information, it can be perceived as losing its independence.

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?

Most of the focus on internal controls has been oriented toward the financial statements. Internal controls and processes around information outside the financial statements may have differences from those related to the financial statements, but there are likely significant similarities. Differences will need to be identified before consideration can be given to the need for amendments to audit and reporting standards.

**Potential Alternatives for Changes to the Auditor's Report**

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

No.

a. If you support an AD&A as an alternative, provide an explanation as to why.

The Committee does not support an AD&A.

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

It should comment on neither.

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

Any information relevant and useful to making investment decisions should be furnished by management. The auditor's role is one of verification; expansion beyond this would jeopardize the auditor's independence and confuse the auditor's role with that of a financial analyst.

d. If you do not support an AD&A as an alternative, explain why.

The Committee opposes any AD&A. Auditors cannot achieve the level of knowledge of the audited entity that management has, and is, therefore, not in a position to report its own analysis of the entity's affairs. Commentary on audit procedures is not appropriate; the totality and interdependence of audit procedures is difficult, if not impossible, to communicate in a brief report and little constructive purpose is served in explaining procedures that, no matter how comprehensive, are likely to be "second-guessed" by parties less knowledgeable.

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

Any commentary should be included in the auditor's report. See the Committee's response to Question 1.b., above.

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

There should not be an AD&A.

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?

There should not be an AD&A. The matters that might be discussed, per the PCAOB Release, should be covered by management in the financial statements, and perhaps in the MD&A as well. Better accounting standards may be needed as to what needs to be included, and to the extent required in the financial statements, audit standards should have a clear statement of the auditor's responsibility for auditing that data and reporting if the auditor concludes it is materially deficient.

8. Should a standard format be required for an AD&A? Why or why not?

No. An AD&A should not be required.

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

The discussion of these items is management's responsibility. The auditor's role is independent verification, based upon an objective evaluation of an entity's past performance, measured against a meaningful financial framework. The current audit framework is not meant to support providing an overall assessment of the "quality of the financial statements". The auditor does not have the same access to information that management has and is not able to perform the comprehensive analysis that is required for this risk analysis. Some of these risks are considered by the auditor in setting audit scope and procedures, but this is a far different context that providing such information to investors. Further, if the auditor is cast in the role of providing information and analysis of this type, it can be perceived as losing its independence.

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

An AD&A should not be required. "Boilerplate" language is one risk, as auditors would likely find it necessary to heavily caveat the scope and conclusions of any such analysis.

11. What are the potential benefits and shortcomings of implementing an AD&A?

See the Committee's responses to Questions 5.d., 7, and 9. and 10. above.

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

While the Committee rejects the use of an AD&A for auditors, the Committee would expect that any differences between management's and the auditor's information would normally be resolved before either side finalizes their views, just as it is now with presentation and disclosures in financial statements. The difficulty with an AD&A is that the knowledge bases of management and the auditor are different and the information is subjective, so it may be impossible to resolve differences between the AD&A and other information provided by management. Further, a complete discussion could lead the auditor to make statements which, in effect, second guess or criticize management's decisions; differences such as that may not be resolvable, and may reflect lack of business knowledge and perspective by the auditors, rather than a basis for differences with management. As for different or competing information in the financial statements themselves, the Committee would expect these to be resolved in most cases, since if the differences are not resolved, they would likely lead to a reporting exception by the auditor, and management usually seeks to avoid that.

**Required and Expanded Use of Emphasis Paragraphs**

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

The Committee does not support the "required" use of emphasis paragraphs in the audit report. The types of information proposed to be included in an emphasis paragraph are best left to management and be presented in the notes to the financial statements. Management, not the auditor, should have the responsibility of identifying significant risks, estimates and uncertainties about the accounting information. The accounting standards should deal with any such requirements.

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

No. The totality and interdependence of audit procedures is difficult, if not impossible, to communicate in a brief report and little constructive purpose is served in explaining procedures that, no matter how comprehensive, are likely to be "second-guessed" by parties less knowledgeable.

a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

The Committee does not support the required use of emphasis paragraphs for the reasons set forth in our response to Question 13

b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

Please refer to the Committee's response to Questions 13. and 14. above.

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

Please refer to the Committee's responses to Questions 13. and 14 above.

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

Please refer to the Committee's responses to Questions 13. and 14 above.

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

Please refer to the Committee's responses to Questions 13. and 14 above.

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

Please refer to the Committee's responses to Questions 13. and 14 above.

**Auditor Assurance on Other Information Outside the Financial Statements**

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

The Committee believes there may be aspects of "other information" on which auditors could provide assurance. However, The Committee questions whether the auditor should be placed in a role that ***requires*** him to provide assurance, directly or indirectly, that the information is complete or complies with applicable rules and regulations. Some of this requires legal perspective beyond the scope of the auditor's expertise. Some requires knowledge and perspective that management gains from running the business and that the auditor, as an independent outsider, cannot achieve. The current attest procedures to express an opinion on MD&A at AT sec. 701.05 et seq. in part require this, which may explain why auditors seldom report on the MD&A in practice.

a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

The Committee does not support providing any assurance on a required basis.

b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

None. See the Committee's response to Questions 19. and 19.a.

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

None.

d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

Information derived directly from the financial statements or accounting records underlying that information that is subject to audit procedures employed in the audit of the financial statements.

e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

If the reporting is limited to information derived directly from the financial statements or accounting records underlying that information that are subject to audit procedures employed in the audit of the financial statements, there should be no effect. However, if the information reported on includes other less objective and interpretative information, it may lead to a reduction of the amount of such information included because it may be difficult or expensive, or impossible for the auditor to audit it; this result would be undesirable.

f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

AT 701 was written to deal specifically with the MD&A. The entire attestation standard would need to be re-examined under the Board's proposed expansion of reporting. If the Board moves in this direction, we suggest a comprehensive examination be done to determine why so few reports are currently rendered in practice under AT 701.

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

Please refer to the Committee's responses to Questions 19. 19.a. and 19.e.

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

A potential benefit may be some enhanced reliability of the information. However, for the reasons stated in the Committee's response to Questions 19. and 19.a. the shortcomings outweigh this small benefit.

**Clarification of the Standard Auditor's Report**

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:
• Reasonable assurance
• Auditor's responsibility for fraud
• Auditor's responsibility for financial statement disclosures
• Management's responsibility for the preparation of the financial statements
• Auditor's responsibility for information outside the financial statements
• Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

The Committee supports the Board's proposal for clarifications. However, they are likely to lead to more boilerplate.

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

Yes. It is apparent that, after years of trying to communicate the meaning of the auditor's report, users still do not understand it.

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

The suggestions in the PCAOB Release are sufficient.

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

Within the current scope of the auditor's responsibility, there would be no effect since the auditor would merely be articulating what he is doing now.

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

See the Committee's response to Questions 1.b. and 21.b. However, the Committee sees little merit in trying to clarify the auditor's responsibility for financial statement disclosures; we believe it is well understood that the note disclosures are part of the financial statements, and it is not necessary to say more.

Questions Related to all Alternatives

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

The Committee supports the suggestion to consider clarifying the current auditor's report, and does not support the other suggested alternatives for the reasons previously set forth herein.

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

See the Committee's response to Question 23.

25. What alternatives not mentioned in this concept release should the Board consider?

None. However, the Committee believes that many of the issues set forth in this Release can be better solved by asking the accounting standard setters to address these issues, and by making changes to the current financial reporting model.

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

The Committee's suggestions presented in our response to Question 1.b. may be relatively easy to implement with additional reporting requirements, without significant changes to the auditor reporting framework beyond the additional requirements themselves.

The Committee has no comments on the other alternatives in the Release, as we do not support them.

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

The Committee's suggestions presented in our response to Question 1.b. are unlikely to cause any confusion. The clarification of the auditor's standard report would not be directed to any specific financial data, so would not cause any misperception.

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

The alternatives in the PCAOB Release item III.D. "Clarification of the Standard Auditor's Report" are sufficiently comprehensive. The Committee has no other recommendations.

29. What effect would the various alternatives have on audit quality? What is the basis for your view?

The answer to this is very dependent on the clarity of any standards written to implement the alternatives. Limiting changes to clarifications, as the Committee suggests in our response to Question 1.b. would likely have no negative effects on audit quality.

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports

related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.

Yes. the Committee sees little basis for differentiation.

**Considerations Related to Changing the Auditor's Report**

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, and effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

See the Committee's response to Question 3. above. It is important to maintain the separate roles of management, the audit committee and the auditors. Any incursion of the audit committee or auditors into functions of management will create confusion for all and compromise the independence and effectiveness of the audit committee and the auditors.

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

No. Please see the Committee's response to Question 29. above.

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

The Committee strongly recommends the Board evaluate the cost benefit relationship of implementing any of the alternatives except for the audit report clarification process, which the Committee supports, as any expansion of the auditor's overall reporting responsibilities are likely to drive smaller registered auditing firms away from public company work. This will further restrict choices among a dwindling supply of qualified firms.

d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

The AD&A and auditor reporting on information outside the financial statements are fraught with potential litigation exposure for the auditor. A "safe harbor" is not likely to provide adequate insulation, assuming one would even be acceptable to all.

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

Please see the Committee's responses to Questions 9 and 12. It could create an adversarial relationship between the auditor and management, and that would seriously impair communications between management and the auditor.

The Committee would be glad to discuss our comments further should you have any questions or require additional information.

Very truly yours,

Howard Sibel

Howard Sibelman, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants

CPAB
CCRC

CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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October 6, 2011

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

Dear Sir:

**Request for Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34**

The Canadian Public Accountability Board (CPAB) is pleased to comment on the Public Company Accounting Oversight Board (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release"). We believe now is the time for a fundamental review of the auditor reporting model (the "Reporting Model") and we commend the PCAOB for engaging with stakeholders on how to enhance the quality, relevance and value of auditor reporting.

CPAB is Canada's independent audit regulator responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into the application of auditing standards and how they might be improved.

## Transparency of the Audit

Many investors are asking for more transparency from the auditor with respect to communications addressing the audit process and the auditor's views on the underlying risks impacting the financial statements. The results of recent investor outreach show that many investors believe the current, largely boilerplate, audit report is not meeting their needs and they want deeper insights from the auditor. There is a perception that while the audit process is robust, the standard audit report does not adequately communicate the results of an extensive audit process.

In our view the status quo, with respect to auditor reporting, is not acceptable. Auditors need to provide greater value by sharing more information, related to the audit performed, directly with financial statement users ("Users"). Change needs to be responsive to the needs of Users, and should be implemented in a thoughtful, responsible way such that audit quality is enhanced and in no way diminished.

Since CPAB's mandate relates to listed entities in Canada our comments to follow are intended to apply solely to listed entities.

**Auditor Commentary- Supplemental Reporting**

The Reporting Model should retain the current pass/fail opinion but should be expanded to include a supplemental auditor commentary (the "Commentary"). The Commentary should be targeted at areas that will provide the greatest insights to Users without negatively impacting the three-way interaction between the auditor, audit committee and management.

We suggest the following areas could be included in the Commentary:

- Comments on key areas of audit risk identified by the auditor, including a description of why the risks are significant, and the related audit approach;
- A summary of areas of significant auditor judgement, including the auditor's assessment of management's critical accounting judgements and qualitative aspects of the entity's accounting policies;
- A discussion of key inputs for significant assumptions and the basis for concluding that these were appropriate;
- A discussion of unusual transactions and significant non-recurring transactions, including the basis for the accounting adopted; and
- A description of the extent of reliance on auditors in foreign jurisdictions.

We believe the increased transparency provided by a Commentary as described above will improve audit quality and ultimately lead to improved disclosures in financial information, thereby benefiting Users. Clearly, the challenge will be to write reporting standards that provide appropriate guidance to auditors to ensure that any such Commentary does not become boilerplate over time or lead to investor confusion. Reporting standards will also need to be appropriately field tested prior to finalization.

We recognize many will resist this approach as being a substantive change from existing practice and there will be concerns with respect to consistency, legal liability and confidentiality. In our view this is a necessary change if audits are to continue to provide value and relevance to Users of financial reporting in the 21st century.

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**Emphasis of Matter Paragraphs in the Audit Report**

We support the expanded use of Emphasis of Matter paragraphs in areas of critical importance to the financial statements, including significant management judgements and estimates and areas of significant measurement uncertainty. This will assist Users in navigating their way through increasingly complex financial reporting by drawing attention to information within the financial statements that the auditor believes is critical to the Users understanding of the financial statements. We see the Emphasis of Matter Paragraphs as complementing and being cross-referenced to the more extensive Commentary described above. Emphasising these matters in the audit report should cause the auditor to focus more on the related audit procedures while focusing management more on the related significant judgements and disclosures, which should improve audit quality.

**Other Information in Documents Containing Audited Financial Statements**

We support efforts to explore how the auditor can provide assurance on information outside the financial statements such as Management's Discussion and Analysis ("MD&A") or other information such as non-GAAP measures or key performance metrics. However, it is important that auditors have the necessary competence and skill set to provide such services in a cost effective and timely manner that adds value to Users. We see this as a longer term project that needs further study and should be incorporated into a more holistic review of the corporate reporting framework. In our view, the more pressing issue in the short term is determining how the auditor can provide Users with more relevant and better information related to the financial statement audit.

**Global Auditor Reporting**

It is important for bodies such as the PCAOB, European Commission and International Auditing and Assurance Standards Board (IAASB) to work together to devise one global solution to the perceived deficiencies in auditor reporting. Since many audit reports are read globally; a more coordinated approach will improve consistency and mitigate investor confusion. Greater divergence in auditor reporting is not in the public interest.

In concluding we again commend the PCAOB for engaging with stakeholders on this important topic. Changes to the Reporting Model should be implemented in a cost effective way, ensuring that audit quality is enhanced and in no way diminished. In a global business environment that is continually changing and with increasingly complex financial reporting requirements, it is critical that auditor reporting evolves in a way that better meets the needs of financial statement users.

CPAB responded to the IAASB's Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, and we attach a copy of our response for your information (see Attachment A). Our response to the IAASB Consultation Paper covered many of the areas where comments are requested in the Concept Release, and we believe these responses would be equally applicable to the Concept Release.

We appreciate the opportunity to respond to the Concept Release, and would be pleased to discuss further any of the above comments.

Yours very truly,

Brian Hunt, FCA
Chief Executive Officer

cc. Mr. Bruce Winter, FCA
Chair, Auditing and Assurance Standards Board (Canada)

Mr. Greg Shields, CA
Director, Auditing and Assurance Standards
The Canadian Institute of Chartered Accountants

CPAB
CCRC

CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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**ATTACHMENT A**

September 29, 2011

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear Sir:

**Re: Consultation Paper on Enhancing the Value of Auditor Reporting: Exploring Options for Change**

The Canadian Public Accountability Board (CPAB) is pleased to comment on the International Auditing and Assurance Standards Board's (IAASB's) Paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change* (the "Consultation Paper"). We believe now is the time for a fundamental review of the auditor reporting model and we commend the IAASB for engaging with stakeholders on how to enhance the quality, relevance and value of auditor reporting.

CPAB is Canada's independent audit regulator responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into the application of auditing standards and how they might be improved.

**Corporate Reporting Framework**

While our comments focus on improvements to the auditor reporting model (the "Reporting Model"), we believe there is a need for a more holistic review of the corporate reporting framework in order to provide greater value to stakeholders. In our view, improvements to the Reporting Model should be part of a more comprehensive initiative to reform the corporate reporting framework which will require the active involvement of all stakeholders, including policy makers, investors, regulators, standard setters, corporate directors, company management and auditors.

**Transparency of the Audit**

Many investors are asking for more transparency from the auditor with communications addressing the audit process and the auditor's views on the financial statements. The results of recent investor outreach show that many investors believe the current, largely boilerplate, audit report is not meeting their needs and they want deeper insights from the auditor. There is a perception that while the audit process is robust, the standard audit report does not adequately communicate the results of an extensive audit process.

In our view the status quo, with respect to auditor reporting, is not acceptable. Auditors need to provide greater value by sharing more information, related to the audit performed, directly with financial statement users ("Users"). Change needs to be responsive to the needs of Users, and should be implemented in a thoughtful, responsible way such that audit quality is enhanced and in no way diminished.

Since CPAB's mandate relates to listed entities in Canada our comments to follow are intended to apply solely to listed entities.

**Auditor Commentary- Supplemental Reporting**

The Reporting Model should retain the current pass/fail opinion but should be expanded to include a supplemental auditor commentary (the "Commentary"). The Commentary should be targeted at areas that will provide the greatest insights to Users without negatively impacting the three-way interaction between the auditor, audit committee and management.

We suggest the following areas could be included in the Commentary:

- Comments on key areas of audit risk identified by the auditor, including a description of why the risks are significant, and the related audit approach;
- A summary of areas of significant auditor judgement, including the auditor's assessment of management's critical accounting judgements and qualitative aspects of the entity's accounting policies;
- A discussion of key inputs for significant assumptions and the basis for concluding that these were appropriate;
- A discussion of unusual transactions and significant non-recurring transactions, including the basis for the accounting adopted; and
- A description of the extent of reliance on auditors in foreign jurisdictions.

We believe the increased transparency provided by a Commentary as described above will improve audit quality and ultimately lead to improved disclosures in financial information, thereby benefiting Users. Clearly, the challenge will be to write reporting standards that provide appropriate guidance to auditors to ensure that any such supplemental commentary does not become boilerplate over time or lead to investor confusion. Reporting standards will also need to be appropriately field tested prior to finalization.

We recognize many will resist this approach as being too radical a change from existing practice and there will be concerns with respect to consistency, legal liability and confidentiality. In our view this is a necessary change if audits are to continue to provide value and relevance to Users of financial reporting in the 21st century.

**Emphasis of Matter Paragraphs in the Audit Report**

We support the expanded use of Emphasis of Matter paragraphs in areas of critical importance to the financial statements, including significant management judgements and estimates and areas of significant measurement uncertainty. This will assist Users in navigating increasingly complex financial reporting by drawing attention to information within the financial statements that the auditor believes is critical to the Users understanding of the financial statements. We see the Emphasis of Matter Paragraphs as complementing and being cross-referenced to the more extensive Commentary described above. Emphasising these matters in the audit report will make the auditor focus more on the related audit procedures and focus management more on the related significant judgements and disclosures.

**The Role of the Those Charged with Governance**

Audit committees have a key oversight role to play with respect to audit quality and high quality financial reporting. Continuous improvement in the two-way communications between the auditor and audit committees contributes significantly to audit quality, particularly given the increasing complexity and greater use of judgement in financial reporting. We believe it is important to further explore how communication between auditors and audit committees can be more forthright and transparent, particularly with respect to reporting of significant audit risks and related judgements. In our experience this is more of a challenge for smaller listed entities where corporate governance arrangements can be less formal.

In our view there is merit in considering having more transparent public reporting by audit committees on how they have discharged their responsibilities.

However, given the varying corporate governance models and practices used in different countries around the world it will be a challenge to implement an international model of enhanced corporate governance reporting to Users.

**Other Information in Documents Containing Audited Financial Statements**

We support efforts to explore how the auditor can provide assurance on information outside the financial statements such as the Management's Discussion and Analysis ("MD&A") or other information such as non-GAAP measures or key performance metrics. However, it is important that auditors have the necessary competence and skill set to provide such services in a cost effective and timely manner that adds value to Users. We see this as a longer term project for the IAASB that needs further study and should be incorporated into a more holistic review of the corporate reporting framework. In our view, the more pressing issue in the short term is determining how the auditor can provide Users with more relevant and better information related to the financial statement audit.

**Format and Structure of the Standard Auditor's Report**

We support the need to improve the format and structure of the existing standard audit report. We believe the explanations of management and auditor responsibilities should be retained within the audit report so that the report will be read with the appropriate context. However, the auditor's opinion should be given greater prominence and moved to the front of the audit report.

We agree that the technical language in the audit report could also be clarified, including terms such as "fair presentation", "materiality" and "reasonable assurance". Initially, such definitions should be included in the audit report with consideration to migration into a separate document or appendix over time.

**Global Auditor Reporting**

It is important for bodies such as the IAASB, European Commission and United States Public Company Accounting Oversight Board to work together to devise one global solution to the perceived deficiencies in auditor reporting. Since many audit reports are read globally; a more coordinated approach will improve consistency and mitigate investor confusion. Greater divergence in auditor reporting is not in the public interest.

In concluding we again commend the IAASB for engaging with stakeholders on this important topic. Changes to the Reporting Model should be implemented in a cost effective way, ensuring that audit quality is enhanced and in no way diminished. In a global business environment that is continually changing and with increasingly complex financial reporting requirements, it is critical that auditor reporting evolves in a way that better meets the needs of financial statement users.

In addition to our comments above, our responses to the questions posed in the Consultation Paper are included in the Appendix to this letter.

We would be pleased to discuss further any of the above comments.

Yours very truly,

Brian Hunt, FCA
Chief Executive Officer

cc. Mr. Bruce Winter, FCA
Chair, Auditing and Assurance Standards Board (Canada)

Mr. Greg Shields, CA
Director, Auditing and Assurance Standards
The Canadian Institute of Chartered Accountants

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**APPENDIX**

1. **Do respondents have any comments about the issues identified in Section II regarding the perceptions of auditor reporting today?**

   Many investors are asking for more transparency from the auditor with communications addressing the audit process and the auditor's views on the audited financial statements. The results of recent investor outreach show that many investors believe the current, largely boilerplate, audit report is not meeting their needs and they want deeper insights from the auditor. There is a perception that while the audit process is robust, the standard audit report does not adequately communicate the results of an extensive audit process.

   In our view the status quo, with respect to auditor reporting, is not acceptable. Auditors need to provide greater value by sharing more information directly with financial statement users ("Users") related to the audit performed. Change needs to be responsive to the needs of Users, and should be implemented in a thoughtful, responsible way such that audit quality is enhanced and in no way diminished.

2. **If respondents believe changes in auditor reporting are needed, what are the most critical issues to be addressed to narrow the information gap perceived by users or to improve the communicative value of auditor reporting? Which classes of users are, in the view of respondents, most affected by these issues? Are there any classes of users that respondents believe are unaffected by these issues?**

   **Auditor Commentary- Supplemental Reporting**

   The auditor reporting model (the "Reporting Model") should retain the pass/fail opinion but should be expanded to include a supplemental auditor commentary (the "Commentary"). The Commentary should be targeted at areas that will provide the greatest insights to Users without negatively impacting the three-way interaction between the auditor, audit committee and management.

   We suggest the following areas could be included in the Commentary:

   - Comments on key areas of audit risk identified by the auditor, including a description of why the risks are significant, and the related audit approach;
   - A summary of areas of significant auditor judgement, including the auditor's assessment of management's critical accounting judgements and qualitative aspects of the entity's accounting policies;
   - A discussion of key inputs for significant assumptions and the basis for concluding that these were appropriate;

- A discussion of unusual transactions and significant non-recurring transactions, including the basis for the accounting adopted; and
- A description of the extent of reliance on auditors in foreign jurisdictions.

We believe the increased transparency provided by a Commentary, as described above, will improve audit quality and ultimately lead to improved disclosures in financial information, thereby benefiting Users. Clearly, the challenge will be to write reporting standards that provide appropriate guidance to auditors to ensure that any such supplemental commentary does not become boilerplate over time or lead to investor confusion. Reporting standards will also need to be appropriately field tested prior to finalization.

**Emphasis of Matter Paragraphs in the Audit Report**

We support the expanded use of Emphasis of Matter paragraphs in areas of critical importance to the financial statements, including significant management judgements and estimates and areas of significant measurement uncertainty. This will assist users in navigating increasingly complex financial reporting by drawing attention to information within the financial statements that the auditor believes is critical to the users understanding of the financial statements. We see the Emphasis of Matter Paragraphs as complementing and being cross-referenced to the more extensive Auditor Commentary described above.

We believe these proposed changes will benefit all classes of users.

**3. Do respondents believe that changes are needed for audits of all types of entities, or only for audits of listed entities?**

Our comments are made in the context of listed entities.

**4. Respondents are asked for their reactions to the options for change regarding the format and structure of the standard auditor‘s report described in Part A. Do respondents have comments about how the options might be reflected in the standard auditor‘s report in the way outlined in Appendix 1 of this Consultation Paper?**

We support the need to improve the format and structure of the existing standard audit report. We believe the explanations of management and auditor responsibilities should be retained within the audit report so that the report will be read with the appropriate context. However, the auditor’s opinion should be given greater prominence and moved to the front of the audit report.

We agree that the technical language in the audit report could also be clarified, including terms such as “fair presentation”, “materiality” and “reasonable assurance”. Initially, such definitions should be included in the audit report with consideration to migration into a separate document or appendix over time.

5. **If the paragraphs in the current standard auditor‘s report dealing with management and the auditor‘s responsibilities were removed or re-positioned, might that have the unintended consequence of widening the expectations gap? Do respondents have a view regarding whether the content of these paragraphs should be expanded?**

   See response to #4.

6. **Respondents are asked for their reactions to the possibility that the standard auditor‘s report could include a statement about the auditor's responsibilities regarding other information in documents containing audited financial statements. Do respondents believe that such a change would be of benefit to users?**

   We believe it would be appropriate for the audit report to explicitly address the auditor's responsibility with respect to other information in documents containing audited financial statements. Many users may not understand the extent of auditor involvement with such information and clarification would benefit users.

7. **If yes, what form should that statement take? Is it sufficient for the auditor to describe the auditor‘s responsibilities for other information in documents containing audited financial statements? Should there be an explicit statement as to whether the auditor has anything to report with respect to the other information?**

   There should be an explicit statement describing the extent to which the auditor has been involved with other information outside the financial statements. A starting point for developing such a statement should be ISA 720 "The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements."

8. **Respondents are asked for their views regarding the auditor providing additional information about the audit in the auditor‘s report on the financial statements.**

   **Auditor Commentary- Supplemental Reporting**

   Please see response to #2.

   We recognize many will resist this approach as being too radical a change from existing practice and there will be concerns with respect to consistency, legal liability and confidentiality. In our view this is a necessary change if audits are to continue to provide value and relevance to users of financial reporting in the 21st century.

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**Emphasis of Matter Paragraphs in the Audit Report**

Please see response to #2.

**9. Respondents are asked for their reactions to the example of use of —justification of assessments in France, as a way to provide additional auditor commentary.**

We support the use of a model that provides expanded use of Emphasis of Matters paragraphs in the audit report, similar to the justification of assessments in France but with expanded auditor commentary in a supplemental report. The challenge will be to ensure that the expanded disclosure adds value to Users without becoming boilerplate.

Please also see responses to #2 and #8.

**10. Respondents are asked for their reactions to the prospect of the auditor providing insights about the entity or the quality of its financial reporting in the auditor's report.**

Please see responses to #2 and #8.

**11. Respondents are asked for their reactions to the options for change relating to an enhanced model of corporate governance reporting, as described in Section III, Part D.**

Audit committees have a key oversight role to play in ensuring both audit quality and high quality financial reporting. Continuous improvement in the two-way communications with audit committees contributes significantly to audit quality, particularly given the increasing complexity and greater use of judgement in financial reporting. We believe it is important to further explore how communication between auditors and audit committees can be more forthright and transparent, particularly with respect to the reporting of significant audit risks and related judgements. In our experience this is more of a challenge for smaller listed entities where corporate governance arrangements can be less formal.

In our view there is merit in considering having more transparent public reporting by audit committees on how they have discharged their responsibilities.

However, given the varying corporate governance models and practices used in different countries around the world it will be a challenge to implement an international model of enhanced corporate governance reporting to Users.

**12. To the extent that respondents support this model, what challenges may be faced in promoting its acceptance? Also, what actions may be necessary to influence acceptance or adoption of this model, for example, by those responsible for regulating the financial reporting process?**

Please see response to #11.

**13. Do respondents believe assurance by the auditor on a report issued by those charged with governance would be appropriate?**

Please see response to #11.

**14. Respondents are asked for their reactions to the need for, or potential value of, assurance or related services on the type of information discussed in Section III, Part E.**

Investors are increasingly using information outside the financial statements in their decision making. We believe there is merit in exploring how the auditor can provide assurance in areas such as the MD&A, non-GAAP measures or key performance metrics. However, it is important that auditors have the necessary competence and skill set to provide such services in a cost effective and timely manner that adds value to Users. For example, auditors may have limited expertise to provide assurance on such items as enterprise risk management and business models.

Standards will also need to be developed for auditors to provide assurance in these areas.

**15. What actions are necessary to influence further development of such assurance or related services?**

We see this as a longer term project for the IAASB which needs further study and should be incorporated into a more holistic review of the corporate reporting framework. In our view, the more pressing issue in the short term is determining how the auditor can provide Users with more relevant and better information related to the financial statement audit.

**16. Respondents are requested to identify benefits, costs and other implications of change, or potential challenges they believe are associated with the different options explored in Section III.**

These are addressed in the main body of the letter and our detailed responses above.

**17. Do respondents believe the benefits, costs, potential challenges and other implications of change are the same for all types of entity? If not, please explain how they may differ.**

Changes to the Reporting Model should be applied consistently across all listed entities. For smaller entities the reporting will generally be less complex. The challenges and costs will vary given differences in corporate governance structure and types of Users for smaller entities.

**18. Which, if any, of the options explored in Section III, either individually or in combination, do respondents believe would be most effective in enhancing auditor reporting, keeping in mind benefits, costs, potential challenges and other implications in each case? In this regard, do respondents believe there are opportunities for collaboration with others that the IAASB should explore, particularly with respect to the options described in Section III, Parts D and E, which envisage changes outside the scope of the existing auditor reporting model and scope of the financial statement audit?**

We believe Supplemental auditor reporting in the form of an **Auditor Commentary** and expanded use of **Emphasis of Matters paragraphs** in the Audit Report will be most effective in enhancing auditor reporting. Please also see our responses to #1 and #2 above.

We agree there should be greater collaboration with others by the IAASB. The IAASB, European Commission and United States Public Company Accounting Oversight Board should work more closely together to devise one global solution to the perceived deficiencies in auditor reporting. Since many audit reports are read globally; a more coordinated approach will improve consistency and mitigate investor confusion. Greater divergence in auditor reporting is not in the public interest.

**19. Are there other suggestions for change to auditor reporting to narrow the —information gap perceived by users or to improve the communicative value of the auditor's report?**

We have no other comments.

Capital Research and Management℠

Capital Research and Management Company
333 South Hope Street
Los Angeles, California 90071-1406

Phone (213) 486-9200
Fax (213) 486-9455

***VIA ELECTRONIC DELIVERY***

September 30, 2011

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

**RE: Request for Public Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter #34**

Dear Office of the Secretary:

Capital Research and Management Company ("Capital") serves as investment adviser to the American Funds, one of the oldest and largest mutual fund families in the nation. We appreciate the opportunity to provide comments on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards ("Concept Release"). These comments are our own views and not necessarily those of Capital or other Capital associates; these comments are informed by our experiences as preparers of audited financial statements related to both the adviser (and related companies) of the American Funds and the mutual funds themselves.

Although there may be ways to improve the existing auditor's report, the Auditor's Discussion and Analysis ("AD&A") could negatively impact audit committees and, ultimately, audit quality for several reasons. Proponents of the AD&A may argue that the concept simply requires that existing communication between the auditors and audit committee be added to the auditor's report.

However, the written communication between the auditors and the audit committee is highly structured and much of the value comes from the contextual discussion that takes place in the audit committee meetings. Audit committee members have the opportunity to question and clarify their understanding in these discussions. Attempting to capture the entire discussion between the audit committee and auditors, without opportunity for the further clarification that occurs in the context of Board interactions with the auditors, reduces the value of the disclosure and may lead to erroneous conclusions on the part of the financial statement user. Additionally, audit committees would likely spend significant resources reviewing the AD&A and negotiating the exact language rather than discussing substantive oversight of controls and financial reporting. If apprehension over how audit committee discussions will ultimately be characterized in the public disclosure inhibits audit committee discussion in any way, audit quality will decline.

We don't believe that the benefits of the AD&A will outweigh the costs. We expect that the disclosure will evolve to "boiler plate" language due to the scrutiny that the text will receive from the audit firms, the audit committees, and management. In our opinion, this standardized language may not provide the benefits intended. Additionally, the concept of an auditor disclosing "close calls" could be interpreted very broadly, resulting in meaningless and overwhelming disclosure. For instance, Accounting Standards Codification 740-10-50-15 does not require disclosure of uncertain tax positions that are "more likely than not" (i.e., greater than 50% chance) to be upheld upon examination by a tax authority. However, an auditor could view any uncertain position at the more likely than not standard (but not at a higher level of assurance, such as "should") as relevant for disclosure in the AD&A; such a list could be extensive, and in our opinion, of little value to a financial statement user.

The proposals are not designed to have any impact on audit quality and the benefit is expected to be for the end users. Based on the above points, we don't expect users to experience this benefit, but we do anticipate higher audit costs as well as higher external legal review costs related to the disclosures. Additionally, as mentioned above, we also expect non-monetary costs such as audit committee time and focus, and the potential degradation of audit quality. For the reasons listed above, we do not support the AD&A alternative as discussed in the Concept Release.

We do support further PCAOB staff research into the expanded use of emphasis paragraphs, and encourage the staff to perform a full cost/benefit analysis of this alternative. As noted in the Concept Release, emphasis paragraphs, though currently not required, can be included at the auditor's discretion in certain circumstances. We support the idea to use emphasis paragraphs to highlight significant matters related to financial statement presentation and/or areas with significant management judgments and estimates. We believe including discussion of key audit procedures performed around the areas discussed, though including no additional information not already in the financial statements and related notes, will help focus investors on key sections of information and risk in the financial statements. In addition, we believe such discussion may result in improved audit quality as auditors may audit any emphasized areas with increased testing. However, we believe that there is a risk once again that such disclosure could become boiler plate for similar issuers in the same industry and thus be of limited value to users, and for this reason we encourage the Board and its staff to continue to study the recommendation of emphasis paragraphs and to do a more complete cost/benefit analysis.

Finally, we wish to respond to a specific question asked in the Concept Release concerning the application of any changes to the auditor's reporting model for all financial statements filed with the SEC, including those of investment companies. We believe that the unique characteristics of an investment company, and the specific requirements of the auditors of investment companies, would make the cost of complying with any changes to the auditor reporting model far larger than any potential benefits. Currently, an auditor is required to verify the existence and amount of shares/par for each investment, as well as to audit each investment's valuation. Management estimates, though required in certain cases related to valuation, typically are immaterial to the overall financial presentation of the investment company. As such, similar to the requirements of Section 404 of the Sarbanes-Oxley Act which registered investment companies were not required to comply with, we would suggest that investment companies be excluded from any changes to auditor reporting model.

*     *     *     *     *

Thank you for considering these comments. Please feel free to contact any of us should you have any questions or wish to discuss our thoughts on the Concept Release.

Sincerely,

James M. Brown
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Capital Research and Management®

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Paul G. Haaga, Jr.
Chairman of the Board

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September 29, 2011

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

**Re: PCAOB No. 2011-003 Rulemaking Docket #34**

Dear Messrs. Doty, Ferguson, Goelzer, Hanson and Harris:

Thank you very much for the opportunity to participate in the Roundtable on September 15, 2011 in Washington. This will be a brief summary of my remarks at the Roundtable and serve as my comments on the Public Company Accounting Oversight Board's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements No. 2011-003, PCAOB Rulemaking Docket Matter #34.*

Capital Research and Management Company serves as investment adviser to the American Funds, one of the oldest and largest mutual fund families in the nation. As I pointed out at the Roundtable, I have reached out within Capital to our investment analysts who use financial statements extensively in evaluating prospective investments, as well as to our accounting associates who prepare financial statements for the funds and the advisory organization and who interact with our independent auditors. Although my comments were clearly informed by the experiences of my colleagues, the views expressed at the Roundtable and in this letter are mine alone.

1. It seems clear that something additional can and should be communicated by auditors beyond the current pass-fail opinion. My analyst colleagues cited numerous occasions on which a brief perspective from the auditors about some aspect of the financial statements or the audit would have been extremely useful to the analysts in evaluating a company or anticipating material issues. In each case it was a perspective that would have been uniquely within the knowledge of the auditors and also would not have required extensive effort or expense to bring to the attention of the investing public.

2. The auditor's perspective should be very brief and simply point out sensitive areas, material assumptions, material disagreements with management, material measurement issues, etc. It need not-- and should not-- be "transparent" by attempting to reflect every matter on which the auditors spent extra time or about which they communicated with the audit committee.

3. The additional commentary need not-- and should not-- change the respective roles of management, the auditors and the audit committee with respect to the financial statements.

4. The additional commentary should be brief. Among other things, this would help reduce expense, address any liability concerns and prevent it from becoming boilerplate, each of which was properly cited as a concern by several commentators at the Roundtable.

5. While I do not feel strongly about the location of the additional auditor's commentary-- Standard Auditor's Report (SAR), Auditor's Discussion and Analysis (ADA) or elsewhere-- I do tend to favor use of an emphasis paragraph within the SAR. The disclosure is more likely to remain brief and pointed if it is simply an additional paragraph within a letter that currently contains only three or four paragraphs.

6. I do not believe that the auditors should expand their opinion to cover unaudited disclosures such as Management's Discussion and Analysis (MDA) or earnings guidance; current rules regarding disclosure of direct conflicts between these statements and the financials are sufficient.

7. Additional disclosures about the nature of an audit are unnecessary, although probably harmless.

8. Finally, it is my view that some form of additional auditor commentary likely would result in a modest strengthening of the hand of auditors relative to management and audit committees, to the overall benefit of financial disclosure. While "tilting the playing field" is not clearly part of PCAOB's mandate, I hope this benefit can be recognized as you go forward to consider next steps.

Thank you again for inviting me to participate in the Roundtable and for accepting my comments on these important issues.

Sincerely,

Paul G. Haaga Jr.

September 29, 2011

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

Re: Rulemaking Docket Matter No. 34, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Members of the Board:

CC Media Holdings, Inc. ("we" or the "Company") is pleased to respond to the Board's request for comments on the above referenced concept release. We acknowledge that the Board seeks to improve the current auditor's reporting model in response to concerns from investors and financial statement users and we fully support the Board's efforts to increase the transparency and relevance of the financial statements without compromising audit quality. However, we do have significant concerns about the proposed revisions to reporting by auditors, as summarized below.

***Auditor's Discussion and Analysis ("AD&A")***

We believe that the auditor should not be permitted or required to include in periodic filings of companies subjective commentary about the audit and the company's financial statements. We believe that providing an auditor's view about audit-related items, such as those included in required communications to audit committees, without the benefit of the related dialogue around these topics may result in unclear disclosure which may be confusing to readers. The subjective discussion of close calls in the proposed AD&A would likely result in inconsistent application and may limit open communication between management, audit committees, and their auditors. Commentary from the auditors including discussion of alternative accounting treatments is likely to compete with and potentially undermine the disclosures provided by management. As a result, it is likely the AD&A will evolve toward boiler-plate language and will not provide additional insight for readers.

It is our belief that the auditor's primary responsibility should remain unchanged: to opine on the financial statements and not provide subjective views on management's judgments or estimates, accounting policies and practices or other issues. The current relationship between the auditor, management and the audit committee is important, and potentially conflicting disclosures of judgmental matters by an auditor in an AD&A may jeopardize it. The issuance of an unqualified opinion indicates that the financial statements are fairly presented in accordance with GAAP and provides sufficient assurance to warrant investor reliance in its current form, without the addition of an AD&A. We believe the inclusion of an AD&A will result in significantly more work and higher audit fees, will confuse readers and will not accomplish the goal of providing additional insight.

***Required and Expanded Use of Emphasis Paragraphs***

We believe the proposal to revise and expand the use of emphasis paragraphs will result in the need for additional auditing standards to provide the auditor an objective framework to follow in determining the most significant matters to be reported. The additional work to be performed by auditors conforming to the standards will result in additional time and fees to complete the audit. Subjective use of emphasis paragraphs will likely result in inconsistent application of such paragraphs, reducing the comparability of financial statements between companies. Emphasis paragraphs mandated to highlight significant matters, referencing their disclosure within the financial statements, may require reporting of audit procedures performed which, taken out of the context of the audit, are unlikely to provide significant insight beyond that already included in management's disclosures. Accordingly we do not support the proposal to require and expand the use of emphasis paragraphs.

***Auditor Assurance on Other Information Outside the Financial Statements***

We believe auditors should not be required to provide assurance on information outside of the financial statements. Current audit standards require the auditor to read and consider whether the manner of presentation is materially inconsistent with the financial statements or presents a material misstatement of fact. In the course of performing the audit under current standards, auditors read the information associated with the financial statements and hold discussions with management and the audit committee regarding the disclosures. Requiring the auditor to attest to information such as MD&A or earnings releases will not improve the quality or relevance of the information but will result in increased time and expense to complete the audit. As a result of the application of attest standards to the disclosure, the MD&A discussion by management will likely become more boilerplate in nature instead of including a robust discussion of management's perception of the results and financial condition. We strongly disagree with the proposal that auditors provide assurance on information outside the financial statements because we believe it would drive significantly higher audit expenses and would result in companies providing less robust MD&A disclosure.

***Clarification of the Standard Auditor's Report***

We support clarification of the standard audit report and believe that the auditor's report could be improved to explain the auditor's responsibility with regard to information outside of the audited financial statements.

We appreciate the Board's consideration of our comments on this topic and welcome the opportunity to provide further comments if requested. In summary, the auditor should remain objective in reporting and modification of the standard report should provide benefits to investors without significant costs to the audited companies. If you have any questions in regard to this letter, please don't hesitate to contact Scott Hamilton, Senior Vice President and Chief Accounting Officer at (210) 822-2828.

Sincerely,

/s/ Scott D. Hamilton
Scott D. Hamilton
Senior Vice President and Chief Accounting Officer
CC Media Holdings, Inc.

**CENTER FOR AUDIT QUALITY**
*Serving Investors, Public Company Auditors & the Markets*



June 28, 2011

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

**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket No. 034**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the concept release). This letter and enclosures represent the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

The CAQ wants to thank the PCAOB for its outreach to the profession and other stakeholders prior to publication of the June 21st concept release on the auditor's reporting model. The CAQ congratulates the PCAOB and its staff on the process and thoughtful content put forward for public consideration. In partial response to the concept release, the CAQ is formally submitting the ideas we discussed and shared with the staff on June 9th as part of the PCAOB's outreach efforts (see enclosed illustrative example reports and accompanying letter). In addition, the CAQ will be submitting further comments on the concept release on or prior to the September 30th due date.

The auditing profession would be happy to meet with the staff to discuss the content of the illustrative example reports in greater detail, or answer any questions.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Enclosures

cc: PCAOB
Martin Baumann, Chief Auditor and Director of Professional Standards

CENTER FOR AUDIT QUALITY
*Serving Investors, Public Company Auditors & the Markets*



June 9, 2011

Mr. Martin Baumann
Chief Auditor and Director of Professional Standards
Public Company Accounting Oversight Board
1666 K Street
Washington, DC 20006-2803

**Re: Changes to the Auditor's Report - Model Approach for Consideration**

Dear Marty:

The Center for Audit Quality (CAQ) was formed in 2007 and is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high quality performance by public company auditors, convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocating policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. We are a membership organization with nearly 700 public company auditing firm members that are registered with the Public Company Accounting Oversight Board (PCAOB). Our member firms are committed to the public interest role that auditors play in our markets.

As a public policy organization, we strive to assure that our efforts are infused with a public interest perspective. The members of our Governing Board (which includes the CEOs of the eight largest accounting firms, the American Institute of Certified Public Accountants, and three independent public members) have a keen understanding and appreciation of the important role the public company auditing profession has in serving the public interest and honoring the public trust. Our three independent public board members strengthen our focus on the public interest and also bring us expertise in financial reporting, securities law and corporate governance.

To realize our vision, the CAQ works with investors, academics, audit committee members, preparers, internal auditors, and policy makers to explore issues and collaborate on initiatives that can advance audit quality.

The CAQ consistently has supported the implementation of the Sarbanes-Oxley Act of 2002 and, working in collaboration with others with responsibility for financial reporting, has a number of initiatives underway to advance the deterrence and detection of financial reporting fraud. We also support research on issues relating to investor confidence, public company auditing and the capital markets in part by issuing grants that fund independent academic research. In all that we do, we are particularly interested in investors' views, as they are the ultimate users of the audited financial statements.

Recent views expressed by investors convey their need for further information on a number of different matters including, but not limited to, additional insight into accounting policies, particularly critical accounting estimates; information about the activities of public company audit committees, including discussions on critical matters with management and the external auditors; and more information about the independent audit.

In response to these calls for change, the PCAOB announced a standard-setting initiative focused on possible changes to the auditor's reporting model. The profession also recognizes that change is needed, is prepared to embrace the responsible calls for change in this area, and believes that a holistic approach where all stakeholders agree on a way forward will best serve investors and is a requirement if such change is to be meaningful. In this regard, the CAQ established a working group in 2010, comprised of members of the profession, to consider how to best serve investors given their information needs as we understand them.

The working group explored a variety of possible alternatives for communicating additional information about the audit, including changes to the auditor's report combined with expanded management disclosures and audit committee reporting to shareholders with corresponding auditor association. Members of this working group met with you and your staff on February 7, 2011 to discuss these possible alternatives, which were also the subject of my February 11, 2011 letter. CAQ member firm representatives have also participated in recent Standing Advisory Group discussions on this important topic.

Subsequent to our meeting on February 7, 2011, the PCAOB staff identified a number of possible changes to the auditor's reporting model under current consideration. In line with your efforts to identify changes that are both responsive to the needs of investors and can be practicably implemented, the CAQ working group has developed a model approach, described below for your consideration. The model provides examples of potential revisions to the auditor's reporting model that we believe: (i) are responsive to many of the information needs we have heard from investors (ii) can be practically implemented in a relatively short time frame and (iii) are consistent with the overarching principles discussed with you at our February meeting and outlined below.
In presenting this potential reporting model for your consideration, we recognize that refinements in the actual language used may be necessary to align with other PCAOB professional standards, and that implementation guidance will need to be developed to address some of the concepts included in the model, such as the communication of component auditors and the "areas of audit emphasis" section.

***Overarching Principles***

In evaluating this topic, the CAQ working group established the following overarching principles, with investors in mind, to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model:

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.
- Any changes to the reporting model need to enhance, or at least maintain, audit quality.
- Any changes to the reporting model should narrow, or at least not expand, the expectations gap.
- Any changes to the reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.
- Auditor reporting should focus on the objective rather than the subjective.

Conceptually, we understand the suggestion that an auditor deliver to investors the same information that is provided to the issuer's audit committee. However, it is important to understand (as is made clear in the PCAOB's proposed auditing standard on this topic) that such communication is prepared with the expectation that a dynamic two-way discussion between the auditor and audit committee will occur and that questions will arise and additional context and perspectives will be communicated during the course of this discussion. Such interaction can often clarify the specific points raised, particularly around certain accounting and financial reporting matters involving a high degree of subjectivity. This important two-way dialogue will not take place in connection with the general distribution of a report. Additionally, the audit committee obtains insight by virtue of its financial reporting oversight responsibilities which provide additional context for such communications from the auditor. Consequently, we believe that providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue may be incomplete, generate greater confusion and not enhance the overall understanding of the readers of such a report.

***Illustration of a Potential Approach***

After evaluating various alternatives, the CAQ working group determined that the following approach would improve the auditor reporting framework, would help serve the interests of investors, and could be pragmatically implemented in relatively short-order. We recognize this is but one approach and there may be others that meet the objectives we have outlined above. In addition, while we have illustrated the approach in three separate reports; the reports could be combined.

1. Amend the standard financial statement audit report to include the following:

    a. Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report (highlighted in the scope section)
    b. Identify that the auditor is independent under all relevant U.S. Securities and Exchange Commission (SEC) and PCAOB standards
    c. Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audits
    d. Provide an expanded discussion covering management and audit committee responsibilities for the financial statements and the Form 10-K
    e. Highlight that the auditor is responsible for planning and performing the audit to obtain reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, "whether due to error or fraud"
    f. Identify what is meant by the term "reasonable assurance," "material misstatement," and the approach used by the auditor to assess "materiality"
    g. Highlight the necessity of using professional judgment in making audit risk assessments and in the selection of audit procedures and the consideration the auditor gives to the issuer's internal control over financial reporting when making such determinations
    h. Outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not in accordance with Generally Accepted Accounting Principles or in situations where the audit scope has been limited
    i. Describe the auditor's responsibility for information outside of the financial statements (including Management's Discussion & Analysis (MD&A))
    j. Address the audit report to the shareholders of the company in addition to the Board of Directors
    k. Include a reference and link to where more information about public company audits and auditors can be found. For purposes of the illustrative reports attached, we have utilized as an example of this approach the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the CAQ and available on our website.

    We have illustrated in Example A, attached to this letter, how the above suggestions would revise the current financial statement audit report. We believe these changes are responsive to many of the comments that have been raised.

2. Using an emphasis-of-matter like approach, the audit report would identify specific topics or events, unusual transactions or other matters that were viewed to be areas of audit emphasis by the auditor. Consistent with the overarching principles, we believe these descriptions should be objective, fact-based discussions and make specific reference to where such items appear in the financial statements. We have illustrated in Example A how this approach might look in practice. We believe this approach responds to the request that the auditor indicate areas of audit emphasis, and directs the user to where such matters are discussed in the financial statements. As noted above, we recognize that standard-setting activity and resulting implementation guidance will be necessary to help guide the auditor in assessing and consistently determining the type of

matters that should be identified in this section of the revised report, and the extent of the auditor's discussion relating to such matters.

3. Prepare a new report on the examination of the issuer's Critical Accounting Estimates disclosure in its MD&A. We have illustrated this new report in Example B attached to this letter. We believe auditor attestation will serve to continue to improve disclosures in this important area and will be responsive to the various suggestions that have been raised with respect to the need for more emphasis on the important judgment calls made in preparing the financial statements. The SEC would likely need to amend Regulation S-X to require this new report. Likewise, MD&A would need to clearly identify the Critical Accounting Estimates section that will be covered by the examination report. This may also likely require some SEC amendments, but we believe such changes should not be complex or time-consuming. (We note that Example B may also be written to include language from Example A, for example, language relating to the performance of procedures by member firms.)

4. Amend the standard audit report on internal control over financial reporting to reflect many of the changes outlined in 1. above. We have illustrated in Example C attached to this letter how these suggestions would change the present internal control over financial reporting audit report. We believe these changes are responsive to many of the comments that have been raised. (We note again that this Example C may also be written to include additional language from Example A, such as member firm considerations, when appropriate.)

While we have included in our model both an emphasis-of-matter like approach for specific areas of audit emphasis to be included in the financial statement auditor's report, and a separate examination report on the Critical Accounting Estimates disclosure, we appreciate that both of these enhancements may not be necessary. While we believe that the examination report is the enhancement most likely to address investor's needs, we recognize that each of these enhancements or a combination of the two has merit for consideration.

***Other Thoughts***

We also believe that an expanded audit committee report, which includes matters discussed with the auditor that the audit committee considered significant in discharging its responsibilities, accompanied by auditor association therewith, is worthy of further consideration as another means of providing additional information called for by certain investors. We continue to give thought to this idea, and would be pleased to collaborate with the PCAOB, SEC and others (importantly, representatives from the audit committee community) on the further consideration of this concept.

In connection with the potential expansion of the auditor's reporting model, we continue to have concerns about increasing the profession's liability risks. This is, of course, a matter that has been discussed in numerous forums for many decades, but we believe it would be a necessary component on any proposal for revised auditor reporting.

We appreciate the opportunity to share our views regarding possible revisions to the auditor's reporting model. We understand the PCAOB is working toward the issuance of a concept release on this topic by the end of June, and we look forward to reviewing and commenting on that document. At the same time, we want to go on record that we are fully committed to making progress and stand ready to embrace calls for responsible change in this important area. We sincerely believe the approach outlined above serves these purposes, will help serve investors, and can be implemented in a relatively quick time frame.

We also welcome the opportunity to work with the PCAOB staff following the issuance of the concept release and in your further evaluation of the auditor's reporting model. We stand ready to assist you in any way we can, including participation in any meetings or roundtables you are planning.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Member
Daniel L. Goelzer, Member
Jay D. Hanson, Member
Steven B. Harris, Member

SEC
James L. Kroeker, Chief Accountant
Paul A. Beswick, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
J.W. Mike Starr, Deputy Chief Accountant

**Example A**

**Revised Auditor's Report on the Financial Statements with Reference to Separate ICFR and Critical Accounting Estimates Reports**

**Report of Independent Registered Public Accounting Firm on the Consolidated Financial Statements of Sample Company**

To the Board of Directors and Shareholders of Sample Company

We have audited the accompanying consolidated balance sheets of Sample Company and subsidiaries (the Company) as of December 31, 201Y and 201X, the consolidated statements of income, stockholders' equity, comprehensive income and cash flows for each year in the three year period ended December 31, 201Y, and the related notes to the consolidated financial statements for all periods presented (collectively referred to below as the "consolidated financial statements").

We are an independent registered public accounting firm with respect to the Company within the meaning of the Securities Act of 1933 and the applicable rules and regulations thereunder adopted by the United States Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (United States) (PCAOB). XYZ LLP is the principal auditor for the Company for the periods cited above. XYZ LLP is the US member firm of XYZ Limited, a global network of affiliated auditing firms. [Each member firm in the network is a separate legal entity, and all member firms follow a common audit methodology and consistent quality control policies.][1] Certain network member firms participated in our audits of the Company and such participation, in the aggregate, covered approximately Y% and X% of the Company's consolidated assets as of December 31, 201Y and 201X and approximately X%, Y% and Z% of the Company's consolidated revenues for each year in the three year period ended December 31, 201Y. We (XYZ LLP) take responsibility for the work performed by our member firms in connection with our audits.

**Management and Audit Committee Responsibilities for the Financial Statements and Other Information**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), and for establishing and maintaining adequate internal control over financial reporting to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to error or fraud.

Management is also responsible for the preparation and presentation of the Company's Annual Report on Form 10-K in accordance with the rules and regulations of the SEC, including

[1] Each firm would describe their member network affiliation.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) appearing in Item 7 of the Annual Report.

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Audit of the Financial Statements**

Our responsibility is to express an opinion on these consolidated financial statements, taken as a whole, based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement, whether due to error or fraud. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit conducted in accordance with PCAOB standards may not always detect a material misstatement. Our judgments about materiality are affected by our understanding of the financial information needs of investors and other users of the consolidated financial statements. A material misstatement represents an omission or misstatement that would be viewed by a reasonable investor as having significantly altered the 'total mix' of information presented in the consolidated financial statements, taken as a whole.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. In the course of completing our audit, the audit evidence we obtain is often persuasive rather than conclusive. The procedures selected for performance depend on our judgment, including our assessment of the risks of material misstatement of the consolidated financial statements, whether due to error or fraud. In making those risk assessments, we consider internal controls relevant to the Company's preparation and fair presentation of the consolidated financial statements in accordance with U.S. GAAP in order to design audit procedures that we believe are appropriate in the circumstances. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and related financial statement disclosures. Our audits also included such other procedures as we considered necessary in the circumstances.[2]

PCAOB standards require that we modify our report if we determine that the consolidated financial statements are materially misstated. If there are significant restrictions placed on the scope of our audit PCAOB standards prohibit us from expressing an opinion on the financial statements.

We believe that the procedures performed and the audit evidence obtained provides a reasonable basis for our opinion.

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[2] Additional information about public company audits and auditors can be found in the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the Center for Audit Quality and available on the organization's website at http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf.

**Auditor Responsibility for Other Information Presented Outside of the Financial Statements**

We have separately examined the Critical Accounting Estimates disclosure included as part of MD&A in the Company's December 201Y Annual Report on Form 10-K. Our responsibility with respect to all other information presented outside of the consolidated financial statements (including all other sections of the MD&A) is to read this other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements. We are required to follow up on any material inconsistencies and material misstatements of fact of which the auditor becomes aware with management, and with the Audit Committee if necessary, until properly resolved, but are not otherwise required to express an opinion on the other information, including all other sections of MD&A. Other than where identified in this report, our responsibility with respect to the other information in the Form 10-K does not extend beyond the financial information identified in our report, and we have no obligation to perform any procedures to corroborate information presented outside of the consolidated financial statements.

**Opinion on the Consolidated Financial Statements**

In our opinion, the consolidated financial statements, taken as a whole, present fairly, in all material respects, the consolidated financial position of Sample Company and subsidiaries as of December 31, 201Y and 201X, and the consolidated results of their operations and cash flows for each year in the three year period ended December 31, 201Y, in conformity with U.S. GAAP.

**Areas of Audit Emphasis**

In connection with our audits, we also bring to your attention the matters listed below. This is not intended to be a complete list of all areas that our audit procedures addressed in response to identified risks of material misstatement.

1. In December of 201Y, the Company completed the acquisition of ABC Company. As of December 31, 201Y, the Company has completed the allocation of the purchase price on a preliminary basis, assigning approximately $XXX million to goodwill and other intangible assets with indefinite lives. The Company will finalize the purchase price allocation during 201Z, and the amounts assigned as of December 31,201Y could change. See Note B for further details.

2. In connection with the financing required to complete the ABC acquisition, the Company borrowed $XXX million from a consortium of banks. The borrowing has a maturity date of March 31, 201A, or fifteen months from the date of the balance sheet. As of December 31, 201Y, the borrowing is classified as long-term debt, since it has a maturity date beyond the end of the 201Z fiscal year. The Company is in the process of exploring alternatives to refinance this borrowing on a longer-term basis. See Note D for further details.

3. The Company provides financing to certain customers of its [Example Segment]. Business conditions in this Segment led to a slow-down in collections and an increase in potential uncollectible balances. At December 31, 201Y, the gross financing balance

approximated $X,XXX million and the Company maintained a reserve for uncollectible accounts of $XXX million. The balance of accounts that were 90 or more days past due at that date approximated $XX million. This compares to a gross financing balance, reserve for uncollectible accounts and amounts 90 or more days past due of $X,XXX million, $XXX million and $XX million at December 31, 201X respectively. The net expense recorded for estimated uncollectible amounts approximated $XXX million during 201Y. See Note E for further details.

4. The Company has goodwill of $X,XXX attributable to its [Example Segment] reporting unit as of December 31, 201Y. The Company performed its annual impairment testing as of October 31, 201Y. No impairment was recognized because the Company's estimated fair value of this reporting unit exceeded its carrying value at that date; however, the comparison was close and a further decline in the fair value of this reporting unit could give rise to an impairment of the goodwill balance in the future. See Note H for further details.

5. The Company is exposed to various claims and contingencies in the normal course of business. We note two significant matters outstanding as of December 31, 201Y. The Company is a defendant in litigation involving a patent claim that has been ongoing for several years. The Company is also liable for the costs of remediating an environmental claim relating to a business that was sold in 201X. See Note J for further details surrounding these matters.

We highlight the above matters because they represent some of the areas of audit emphasis during the periods covered by our report. Our audits included performing procedures designed to address the risks of material misstatement associated with the above matters. Such procedures were designed in the context of our audit of the consolidated financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures. As noted above, our audits also included procedures in response to identified risks and those required by professional standards that have not been specifically identified herein.

**Other Reports**

We also have examined, in accordance with the standards of the PCAOB, Sample Company's Critical Accounting Estimates disclosure included as a part of MD&A in the Company's December 31, 201Y Annual Report on Form 10-K, and our report dated [*date*] expressed an unqualified opinion that the Company's presentation of the Critical Accounting Estimates disclosure includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; that the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and that the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

In addition, we have audited, in accordance with the standards of the PCAOB, Sample Company's internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated [*date*] expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

XYZ LLP

[City, State]
[Date]

**Example B**

**New Report on Critical Accounting Estimates**

## Report of Independent Registered Public Accounting Firm on the Critical Accounting Estimates Disclosure of Sample Company

To the Board of Directors and Shareholders of Sample Company

We have examined the Critical Accounting Estimates disclosure of Sample Company and subsidiaries (the Company) included as a part of the Company's Management's Discussion and Analysis (MD&A) that is included in the Company's December 31, 201Y Annual Report on Form 10-K.

**Nature of the Critical Accounting Estimates Disclosure**

The Critical Accounting Estimates disclosure is designed to present the Company's analysis of the uncertainties involved in applying its adopted accounting principles and policies at a given time or the variability that is reasonably likely to result from its application over time. The subjectivity of these disclosures is influenced by the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with such assumptions. Consequently, actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

**Management and Audit Committee Responsibilities for the Critical Accounting Estimates Disclosure**

Management is responsible for the preparation of the Company's Critical Accounting Estimates disclosure pursuant to the rules and regulations adopted by the U.S. Securities and Exchange Commission (SEC), and for such disclosure controls and procedures designed to ensure that information required to be disclosed pursuant to the securities laws is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. The preparation of the Critical Accounting Estimates disclosure requires management to interpret the criteria for disclosure, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information.

The Company's audit committee oversees the financial reporting process (including the Company's Critical Accounting Estimates disclosure) and its disclosure controls and procedures (which include internal control over financial reporting), areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Examination of the Critical Accounting Estimates Disclosure**

Our responsibility is to express an opinion on the Critical Accounting Estimates disclosure presentation based on our examination. Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB) and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and other information disclosed in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that the procedures performed and the examination evidence obtained provides a reasonable basis for our opinion. In forming our opinion, we exercised professional judgment in evaluating the reasonableness of the disclosures based on information that was available at the time of our examination. In the course of completing our examination, the evidence we obtain is often persuasive rather than conclusive.

**Opinion on the Critical Accounting Estimates**

In our opinion, the Company's presentation of the Critical Accounting Estimates disclosure referred to above includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's consolidated financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

**Other Report**

We have audited, in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [*date*], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]
[Date]

**Example C**

**Revised Report on Internal Control over Financial Reporting**

**Report of Independent Registered Public Accounting Firm on Sample Company's Internal Control over Financial Reporting**

To the Board of Directors and Shareholders of Sample Company

We have audited Sample Company's (the Company) internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**Management and Audit Committee Responsibilities for Internal Control over Financial Reporting**

Sample Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Audit of Internal Control over Financial Reporting**

Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit of internal control over financial reporting conducted in accordance with PCAOB standards may not always detect a material weakness. Our judgments about materiality are affected by our understanding of the financial information needs of users of this Report. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, giving rise to a reasonable possibility that a material misstatement of the Company's annual or interim financial results will not be prevented or detected by the Company on a timely basis. If one or more material weaknesses exist, the Company's internal control over financial reporting cannot be considered effective, and we are required to include in our report an opinion that the Company's internal control over financial reporting is not effective. If there are restrictions placed on the scope of our audit, we are prohibited from expressing an opinion on the effectiveness of the Company's internal control over financial reporting.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe <u>that the procedures performed and audit evidence obtained</u> provides a reasonable basis for our opinion.

**Definition and Limitations of Internal Control over Financial Reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

**Opinion on Internal Control over Financial Reporting**

In our opinion, Sample Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 201Y, based on the criteria established in *Internal Control – Integrated Framework* issued by COSO.

**Other Report**

We have audited in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [date], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]
[Date]

CENTER FOR AUDIT QUALITY

*Serving Investors, Public Company Auditors & the Markets*



September 30, 2011

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

**Re: Request for Public Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA).

The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board (PCAOB or the Board) on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ commends the PCAOB and its staff on the unprecedented outreach to investors, issuers, audit committee members, the auditing profession, and other stakeholders to inform the Concept Release and the thoughtful content put forward for public consideration. We are submitting for the Board's consideration our comments on the issues raised within the Concept Release which supplement the views expressed in our comment letter dated June 28, 2011 (Attachment A to this letter).

We have organized our observations into the following sections:

I. Profession's Commitment to Responsible Change
II. Holistic Approach Necessary for Responsible Change
III. Value of Standardized Language
IV. Reaffirmation of Suggested Approaches in the CAQ's June 28, 2011 Letter
   a. Retention of the Pass/Fail Opinion
   b. Addition of Clarifying Language to the Standard Auditor's Report
   c. Supplemental Reporting in Addition to the Standard Auditor's Report
      i) Separate Attestation Report on Critical Accounting Estimates in Management's Discussion & Analysis
      ii) Use of Emphasis Paragraphs in the Standard Auditor's Report
V. Views on Auditor's Discussion and Analysis (AD&A)
VI. Other Considerations
VII. Views on Auditor Assurance on Information Presented Outside the Financial Statements

## I. Profession's Commitment to Responsible Change

Recent views expressed by investors convey their desire for further information on a number of different financial reporting matters including, but not limited to, additional insight into accounting policies, particularly critical accounting estimates; more information about the independent audit; and information about the activities of public company audit committees, including their discussions of critical matters with management and the external auditors. The CAQ undertook the efforts described below in response to these calls for change.

***CAQ Auditor's Reporting Model Working Group***

The profession recognizes that change is needed to improve the information communicated to investors and supports change that would enhance the information available to financial statement users and the value of the audit. Accordingly, the CAQ established an auditor's reporting model (ARM) working group in 2010, comprised of members of the auditing profession, to consider how to best serve investors given their evolving information needs. The ARM working group explored a variety of possible alternatives for communicating additional information about the audit, including changes to the auditor's report combined with expanded disclosures by management or the audit committee.

Members of this working group met with PCAOB staff on February 7, 2011, to discuss the possible alternatives developed. Subsequent to this meeting, the ARM working group continued its efforts to identify and evaluate potential changes to the auditor's reporting model. On June 28$^{th}$, the CAQ submitted a comment letter to the PCAOB that addressed certain ideas raised in the Concept Release. The letter describes suggested approaches for potential revisions to the auditor's reporting model that are believed to be: (i) responsive to the information needs we have heard from investors, (ii) practically implementable in a relatively short time frame and (iii) consistent with the overarching principles developed and used by the ARM working group as a framework for its deliberations (see details below). These overarching principles were discussed with the PCAOB staff in February, reiterated in the CAQ's June 28$^{th}$ comment letter, and are a basis for our views in this letter.

***Overarching Principles***

In evaluating this topic, the ARM working group established the following overarching principles, with investors in mind, to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model:

1. Auditors should not be an original source of disclosure about the entity; management's responsibility should be preserved in this regard. As explored further in this letter, a fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.
2. Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.
3. Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
4. Any changes to the auditor's reporting model should add value and not lead to investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.
5. Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however it is important that auditor communications provide objective information about these matters.

## II. <u>Holistic Approach Necessary for Responsible Change</u>

As discussed above, the CAQ recognizes the fundamental role of the auditor in serving the needs of investors and is prepared to embrace responsible calls for change related to the auditor's reporting model. We also believe that a holistic approach where all stakeholders agree on a way forward will best serve investors, and is a requirement if such change is to be lasting and meaningful. Such an approach should examine the roles and responsibilities of all members of the financial reporting supply chain to identify opportunities where changes can be made to better meet the needs of investors. Possible areas for further consideration include whether disclosures could be expanded or improved by preparers, whether audit committees could provide further information about oversight activities, how auditors could improve the information provided to investors through changes to the reporting model, and whether more useful information would be provided to investors through enhanced compliance efforts and/or additional rulemaking on the part of regulators/standard setters.

Pursuant to this approach, the ARM working group evaluated how auditors could better serve the needs of investors. We set forth below a suggested approach for improvements to the auditor's reporting model that we believe can be implemented in the shorter-term and are responsive to the needs of investors as articulated at the March 2011 PCAOB Investor Advisory Group (IAG) meeting and the CAQ's role of the auditor (RoA) roundtable discussion series (see further information below).

Our suggested approach includes the addition of clarifying language to the current auditor's report and a separate examination report on management's Critical Accounting Estimates (CAE) disclosure in Management's Discussion and Analysis (MD&A) and/or an emphasis-of-matter (EOM) approach anchored to the most significant matters in the financial statements.

The CAQ also believes that the PCAOB should further consider whether investors could benefit from auditor involvement with other information provided by management (including earnings releases, non-GAAP information, etc.) given the value that investors place on such information in making investment decisions. To this end, the CAQ has established a separate RoA working group to further evaluate what additional services auditors might provide beyond their current responsibilities to better meet the needs of investors. Through a series of discussion roundtables, the RoA working group sought feedback from investors, analysts, audit committee members, preparers, attorneys and academics regarding how the auditor's role could evolve. We have published a summary report[1] which highlights observations from the discussion series and includes areas for further consideration related to possible improvements to the corporate reporting framework and the role of the auditor. Certain observations derived from these roundtable discussions have contributed to the views set forth in this letter which we describe in further detail below. We would be pleased to discuss the observations made in this report with the Board at a future date.

## III. Value of Standardized Language

In the course of discussions around possible improvements to the auditor's report, some have questioned the role of standardized language, and in some cases disparaged it as "boilerplate." This term connotes a lack of substance and unfairly diminishes the importance of the work and the resulting opinions reached by public company auditors. In contrast, we believe there is significant value in using standardized language in the auditor's report. As the PCAOB acknowledges in the Concept Release and in its Standing Advisory Group (SAG) briefing paper on this topic for the April 2010 SAG meeting, standardized language was implemented to provide consistent, comparable, and easily recognizable audit reports.[2]

We observe that the sentence that begins "[i]n our opinion" in the current standard report is carefully considered and represents the conclusion, in many cases, of thousands of hours of audit work. As mandated by the Sarbanes-Oxley Act (SOX), that audit work is monitored and approved by audit committees. It represents a significant investment by public companies on behalf of their shareholders, not only in financial terms but also in terms of time spent by the audit committee, management, and employees of the company at all levels in order to meet the demands of the audit. The auditor's opinion represents a professional conclusion reached only after compliance with extensive PCAOB auditing standards--standards that would not be met if the audit were off-the-shelf or otherwise failed to be appropriately tailored to the specific facts and circumstances of the individual company being audited.

We note that standardized language plays an important role in other settings in the securities markets as well. Further to that point, we would highlight the "negative assurance" letters that lawyers provide their clients in connection with securities offerings and the standard certifications that chief executive and chief financial officers must provide with their companies' periodic U.S. Securities and Exchange Commission (SEC) reports.

1. Lawyers provide so-called "negative assurance" letters containing standardized language in connection with securities offerings. Preparation of these letters requires hundreds of hours of work by the attorney but the letter itself is short and conclusory. The letters do not express the lawyer's subjective views on the quality and specifics of the disclosure in the offering materials but rather provide a standardized statement that the lawyer has no reason to believe that the disclosure violates the anti-fraud provisions of the securities laws. These letters play an important role in the "due diligence" process contemplated for securities offerings by the Securities Act of 1933 and are valuable, not in spite of containing standardized language, but because of it.

[1] The CAQ report "Observations on the Evolving Role of the Auditor – a Summary of Stakeholder Discussions" is incorporated into this comment letter by reference, and is available at www.thecaq.org/publications/EvolvingRoleoftheAuditor.pdf

[2] See SAG Briefing Paper, *ACAP Committee's Recommendation Relating to the Auditor's Reporting Model* (April 2010). Available at: http://pcaobus.org/News/Events/Documents/04072010_SAGMeeting/Auditor%27s_Reporting_Model.pdf

2. Section 302 of SOX requires that an issuer's principal executive officer and principal financial officer provide an express certification in each annual and quarterly report filed with the SEC. These certifications assert that the signing officers have reviewed the report, that the report does not contain any material false statements or omissions, that the officers are responsible for the issuer's internal controls and that the financial statements included in the report "fairly present in all material respects the financial condition and results of operation of the issuer." The SEC, in adopting rules implementing Section 302, has prescribed the exact wording of the "302 certifications" and has made it clear that executives may not vary the wording. In fact, if a certification is modified, a revised "clean" certification will be required by the SEC reviewers. This standardization, however, does not make the certifications any less powerful or meaningful to investors.

We make these points to remind all stakeholders in the financial reporting process that there is a purpose for standardized language in audit reports – it was instituted to provide comparability and assurance to investors regarding the audit process and financial reporting, and it continues to have value today. While we are supportive of responsible changes to the auditor's reporting model, we encourage the Board to consider the important benefits of standardized language as it develops any modifications to the auditor's reporting model.

## IV. Reaffirmation of Suggested Approaches in the CAQ's June 28, 2011 Letter

### *a. Retention of the Pass/Fail Opinion*

The Concept Release questions whether the current pass/fail model for the auditor's report (i.e. whether the financial statements are fairly presented in all material respects with the applicable accounting framework) should be retained. We support the retention of the pass/fail model, but also believe the Board should consider enhancements to the auditor's reporting model as discussed further below. Participants at the CAQ's RoA roundtable discussion series agreed that the audit is valuable and the current pass/fail model for the auditor's report should be retained.

### *b. Addition of Clarifying Language to the Standard Auditor's Report*

The Concept Release also asks whether potential enhancements to the auditor's reporting model should include the addition of clarifying language to the standard auditor's report. As noted in the CAQ's June 28th comment letter, we believe the addition of such language would be beneficial in narrowing the expectation gap by enhancing the understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain. We believe the addition of clarifying language will promote consistency in practice across audit reports. The CAQ does not believe that the addition of the clarifying language noted below will result in an increase in either the scope of the audit or the auditor's responsibilities but rather will promote a better understanding of the auditor's role and responsibilities.

We agree that the addition of clarifying language related to the following concepts is appropriate as described in the Concept Release and our June 28th comment letter:

1. *Reasonable Assurance* - Identify what is meant by the term "reasonable assurance."
2. *Auditor's Responsibility for Fraud* - Highlight that the auditor is responsible for planning and performing the audit to obtain reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, "whether due to error or fraud."

3. *Auditor's Responsibility for Financial Statement Disclosures* - Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report.
4. *Management's Responsibility for the Preparation of the Financial Statements* - Provide an expanded discussion covering management's responsibilities for the financial statements and the Form 10-K.
5. *Auditor's Responsibility for Information Presented Outside the Financial Statements* - Describe the procedures performed by auditors on information outside of the financial statements, including MD&A.
6. *Auditor Independence* - Identify that the auditor is independent within the meaning of all relevant SEC and PCAOB standards.

Further, as noted in our June 28th comment letter, we believe the following additional language not identified in the Concept Release will also provide added clarification for investors and is appropriate for further PCAOB consideration.

7. *Material Misstatements & Assessment of Materiality* - Identify what is meant by the term "material misstatement" and discuss the approach used by auditors to assess "materiality."
8. *Audit Committee Responsibilities* - Provide an expanded discussion covering audit committee responsibilities.
9. *Addressing the Audit Report* - Address the audit report to the shareholders of the company in addition to the Board of Directors.
10. *Professional Judgment* - Highlight the necessity of using professional judgment in assessing audit risk, selecting audit procedures and considering the issuer's internal control over financial reporting when responding to such risks.
11. *Additional Information About Public Company Audits* - Include a reference and link to where more information about public company auditing can be found (for example, the CAQ's *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*[3]), similar to the approach utilized in the United Kingdom.
12. *Scope Limitations and Non-Compliance with U.S. Generally Accepted Accounting Principles (GAAP)* - Outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not presented in accordance with GAAP or situations where the audit scope is limited.
13. *Firm Network Structure and Responsibilities* - Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audits.

### *c. Supplemental Reporting in Addition to the Standard Auditor's Report*

In addition to adding clarifying language to the standard auditor's report, the CAQ's June 28th comment letter provides examples of supplemental reporting that could be made by the auditor including a separate attestation report on CAE disclosure in MD&A and the use of EOM paragraphs within the standard auditor's report. The CAQ believes that these approaches are responsive to many of the information needs heard from investors and can be practically implemented in a relatively short timeframe. While we describe both approaches below, we appreciate that adopting both of these alternative enhancements may not be necessary. We believe that the attestation report on CAE disclosure in MD&A is the enhancement most likely to address

[3] See Center for Audit Quality's *In-Depth Guide to Public Company Auditing* (2011).
Available at: http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf

the needs of investors, but we recognize that each approach or a combination of the two also merits further consideration.

### *i) Separate Attestation Report on Critical Accounting Estimates in MD&A*

The Concept Release questions whether there are other alternatives the Board should consider that are not contemplated in the Concept Release. The CAQ believes a new, separate attestation report on the examination of the issuer's CAE disclosure in its MD&A is an appropriate alternative for consideration, as illustrated in Example B in the CAQ's June 28th comment letter. This approach is similar to that suggested in the Concept Release with respect to providing assurance on a portion of MD&A. Benefits and considerations of this approach are discussed below.

***Benefits***

We believe auditor examination of management's CAE disclosure in the MD&A, communicated in a separate attestation report is responsive to the needs of investors and avoids many of the unintended consequences that we believe would result from the AD&A approach described in the Concept Release and discussed further below.

At the PCAOB's March 2011 IAG meeting, participants presented the results of an investor survey indicating a desire for further information including, among other things: the auditor's evaluation of significant estimates and judgments, the auditor's evaluation of accounting policies and practices, the disclosure of sensitivity analyses performed by the audit engagement team, and the disclosure of unusual transactions, restatements and other significant changes. Participants at the CAQ's RoA roundtable discussions also identified a number of disclosures that could first be improved by management and might be appropriate for further auditor association. The disclosures most commonly identified related to financial information contained in MD&A, including the company's critical judgments and accounting estimates. We believe much of the information sought by investors, including those areas noted in the IAG presentation, should be disclosed by management in the CAE section of MD&A in compliance with SEC Financial Reporting Codification Section 500 – *Information Outside of the Financial Statements*[4] (SEC Codification); however, we also believe that such disclosure could be improved through auditor association as we discuss further below.

According to the SEC Codification, "[w]hen preparing disclosure under the current requirements, companies should consider whether they have made accounting estimates or assumptions where:

- The nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
- The impact of the estimates and assumptions on financial condition or operating performance is material."

Any CAEs or assumptions meeting those criteria should be disclosed in a company's MD&A. The SEC Codification requires that CAE disclosures include "to the extent material, such factors as how they arrived at the estimate, how accurate the estimate/assumption has been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future. Since CAEs and assumptions are based on matters that are highly uncertain, a company should analyze their specific sensitivity to change, based on other outcomes that are reasonably likely to occur and would have a material effect."

[4]See SEC Financial Reporting Codification: 501.14. *Critical Accounting Estimates*

We believe that auditor attestation on CAE disclosure in MD&A will lead to an increased focus in this area by both management and the auditor and will result in more robust disclosure and improved information provided to investors. In addition, auditor attestation on the CAE disclosure will provide users of the financial statements with additional confidence in management's disclosures.

***Other Considerations***

Should the PCAOB determine that the attestation report on CAE disclosure in MD&A is a viable option, the SEC would need to further consider whether amendments to Regulation S-X are necessary to require this new attestation report. Likewise, SEC consideration of whether the consolidation of existing CAE guidance into Regulation S-K is necessary in order to encourage better management disclosure and assist the auditor's examination, including a clear identification of the CAE section in MD&A that would be covered by the examination report. While we appreciate that the adoption of this alternative includes incremental SEC actions, the CAQ believes this approach best addresses the evolving information needs of investors, while being more practicable and cost effective than auditor attestation on MD&A in its entirety.

***ii) Use of Emphasis Paragraphs in the Standard Auditor's Report***

The Concept Release seeks comment on requiring the expanded use of emphasis paragraphs in all audit reports to highlight matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty, and to identify where those matters are disclosed in the financial statements.

As discussed in our June 28th comment letter, the CAQ believes the EOM approach is a viable method for highlighting such matters. In contrast to the Concept Release, however, the CAQ does not believe that emphasis paragraphs should include a reference to the audit procedures performed for the areas emphasized. The deliberations of the CAQ's ARM working group, which included challenging itself to develop examples of how such an approach would be implemented in practice, resulted in the determination that emphasis paragraphs should not describe audit procedures, since: (i) it may be difficult for users of the financial statements to understand these audit procedures without further context derived from dialogue with the auditor, (ii) succinct descriptions would not adequately describe significant and often complex audit procedures, and (iii) more thorough descriptions of audit processes could contribute to "disclosure overload" and detract from the purpose of providing useful information to investors.

We believe the emphasis paragraphs should be objective, fact-based discussions and should make specific reference to where such items appear in the financial statements. Example A in our June 28th comment letter illustrates how this approach might appear in practice. Below, we discuss further the importance of developing an appropriate auditor reporting framework for this approach.

***Benefits***

We believe an approach that requires emphasis paragraphs in audit reports as described above has several benefits. First, this approach responds to requests from investors at the PCAOB's March 2011 IAG meeting for the auditor to indicate in the audit report areas that are most significant in the financial statements and direct the user to where those matters appear in the financial statements and related disclosures. Similar requests were heard at the CAQ RoA discussion roundtables. Second, this method would retain the established role of the auditor attesting to information provided by management. Third, the reference within the auditor's report to management's financial statement disclosures could drive better disclosure practices, improving the quality of information provided to investors. Finally, this approach avoids many of the unintended consequences that we believe would result from the AD&A approach described in the Concept Release and discussed further below.

***Importance of Auditor's Reporting Framework***

Subsequent to the issuance of our June 28th comment letter, the ARM working group has given further thought to a possible framework for an EOM approach and would be pleased to explore this subject further with the Board at a future date. The CAQ strongly believes that the most important element of a successful EOM approach is the development of an appropriate framework, with sufficient detail, to guide the auditor's determination of what matters should be emphasized in the auditor's report. We believe the most significant matters are those that, in the auditor's judgment, are viewed to be the most important to a reader's understanding of the financial statements. Such matters should not necessarily represent all matters that may be material to the financial statements, have been the subject of significant audit effort or have involved the use of judgment in determining the accounting conclusions.

Moreover, the most significant matters should relate to items appearing in the financial statements, and not to risks that may be inherent in the company's business model, industry, or the broader business environment (the disclosure of which are covered by other requirements in the federal securities laws). Specific facts and circumstances should dictate how many items the auditor determines require emphasis; however, the CAQ believes that an overly broad framework resulting in a large number of EOM paragraphs would minimize the overarching objective of emphasizing the most important matters.

For items that meet the criteria of the framework, we recommend that the auditor communicate the following:

- A brief, factual and objective description of the item, which should not include information that is not otherwise reflected in the company's financial statements and related disclosures; and
- The identification of where the item has been accounted for and disclosed in the financial statements.

The auditor's report should be revised to include language regarding the auditor's responsibility with regard to the items emphasized; at the same time, the language in the auditor's report addressing the financial statements taken as a whole should be retained (i.e., no separate form of opinion or conclusion should be provided for any specific item emphasized).

Lastly, during the PCAOB roundtable held on September 15, 2011, some participants seemed to view the EOM approach and the AD&A approach as interchangeable solutions. In our view, AD&A is not similar to and is, in fact, inferior to the EOM approach. As described in more detail below, AD&A runs contrary to each of the five overarching principles established by the ARM working group. An appropriately designed EOM approach, however, would retain management's role in providing original information about the company, focus auditor reporting on the objective rather the subjective, enhance audit quality, narrow the expectation gap, and enhance communication to investors.

## V. <u>Views on AD&A</u>

The Concept Release seeks views on the possibility of a supplemental narrative from the auditor via an AD&A as a way to "provide investors and other financial statement users with a view of the audit and financial statements through the auditor's eyes." The CAQ does not support the AD&A approach for the reasons outlined below. We believe the AD&A approach runs contrary to the overarching principles previously articulated, could result in significant unintended consequences that could be detrimental to audit quality, and differs from the views expressed by participants at the CAQ's recent RoA discussion series. We believe the unintended consequences associated with this approach outweigh any potential benefits of an

AD&A. Further, we believe our suggested approaches noted above (i.e., a separate auditor attestation report on management's CAE disclosure in MD&A and/or required EOM paragraphs in the auditor's report) are superior alternatives to an AD&A as they serve the information needs of investors and avoid the unintended consequences associated with AD&A.

***Consequences of Auditors Focusing on the Subjective Rather than Objective***

The AD&A approach would require auditors to communicate subjective rather than objective information. While financial reporting matters assessed by the auditor through the performance of the audit are often highly subjective, it is important that auditor communications provide objective information about these matters. We are concerned that such a shift in the nature of information communicated by auditors may result in several unintended consequences which may negatively impact investors. Our view is consistent with those of participants at the CAQ's RoA roundtable discussions who strongly resisted the notion of auditors providing their views regarding the quality of a company's accounting policies and practices through a mechanism such as an AD&A.

The contemplated AD&A approach would require the auditor to provide "perspectives" or "impressions" on matters related to the audit as well as on the company's financial statements, including management's judgments and estimates, accounting policies and practices, and difficult or contentious issues such as "close calls." The Concept Release acknowledges, that as intended, the AD&A could result in the auditor communicating some of the same information that the auditor communicates to the audit committee regarding these matters. The CAQ has significant concerns regarding any revisions to the auditor's reporting model that would require the auditor to issue a public general-use report communicating information similar to that provided to the audit committee. When such matters are communicated by the auditor to the audit committee, the audit committee has the benefit of further discussion with the auditor to explore complex matters at the appropriate level of detail. Additionally, the audit committee has the benefit of periodic communications with the auditor throughout the year as well as information derived through its oversight of the financial reporting process, which also provide further context. Since investors lack this context, the CAQ believes that an auditor's public communication to investors of such complex and subjective matters (e.g. through an AD&A) may not be constructive and could be misleading.

Additionally, we believe it would be very difficult for audit firms to provide consistency in reporting related to auditor's "perspectives" or "impressions" on management's reporting. Without consistency in what is communicated, the AD&A requirement would diminish the comparability between companies, including those in similar industries. One audit partner's subjective opinion regarding a "close call" or "preferable accounting treatment" may differ significantly from that of another, which could result in unintended consequences for an issuer in comparison to its peers.

Further, we believe that efforts to ensure AD&A consistency, which would likely include the need for consultations at a crucial time during audit conclusion, would most likely strain valuable audit firm quality control resources. Participants at the CAQ's RoA roundtable discussions and the PCAOB's September 15th roundtable expressed similar concerns regarding the ability of the auditor to prepare a tailored narrative and complete the necessary reviews within current SEC filing deadlines.

***Consequences of Auditors Communicating Original Information about the Company***

The AD&A approach would result in auditors communicating original information about the company, creating a fundamental shift from the auditor attesting to information provided by management to the auditor providing original information about the company. We believe this could result in several unintended consequences including undermining the roles and responsibilities of the audit committee, management, and the auditor and a further widening of the expectation gap.

The CAQ believes that an AD&A requirement could undermine the established governance role of the audit committee. SOX strengthened the role of the audit committee by specifically vesting it with the authority and responsibility to oversee a company's auditor, including appointments, compensation, and resolution of disagreements between management and the auditor related to financial reporting. As a result, oversight of the financial reporting process and external audit on behalf of investors has improved through more frequent dialogue between the audit committee and auditor via periodic meetings, including executive sessions. Further, we also believe a requirement for auditors to discuss sensitive matters in AD&A, as contemplated in the Concept Release, could undermine the governance function of the audit committee by resulting in less robust discussions between the auditor, management and the audit committee for fear that such information would be communicated publicly in the AD&A. Any breakdown in this communication would negatively impact the effectiveness of the audit committee's oversight as well as audit quality, to the detriment of investors.

Additionally, we believe the responsibility of management for the preparation of the financial statements, including disclosures may also be undermined. Auditor communication of original information about the company, including information regarding management's judgments and estimates, accounting policies and practices and material matters, could create "dueling disclosures" between management and the auditor. If the potential for "dueling disclosure" compels management to change its disclosure in the financial statements to align with the auditor's communication in AD&A, this may effectively shift responsibility for the financial statement preparation from management to the auditor. It is unclear what impact this could have on overall management responsibilities as well as the quality of financial reporting. Additionally, it is unclear how this shift in roles could impact the independence of the auditor – who under current rules is prohibited from taking on any role that leads to acting or functioning as management. Audit committee members, preparers, and attorneys who participated in the CAQ's RoA roundtable discussions generally agreed.

Lastly, we believe that "dueling disclosures" could be subject to misinterpretation by investors in instances where there are differing views between management and the auditor. This concern was echoed by participants at the CAQ's RoA roundtable discussions who strongly believed that the auditor should not communicate original information about the company; rather, the auditor's established role of attesting to information provided by management should be retained. Further, there is also the risk that AD&A could contribute to the current state of "disclosure overload" as management and the auditor could often report identical or nearly identical information in separate communications. This is also consistent with what we heard from participants at our RoA discussion series.

***Auditor Independence***

The Concept Release contemplates an AD&A requirement for the auditor to discuss specific independence matters communicated to the audit committee under PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. We believe a public discussion regarding such matters in an AD&A is unnecessary due to the existing governance function of the audit committee to assess auditor independence on behalf of investors, the external monitoring of auditor independence (by the PCAOB, SEC, and the firm itself), and existing means by which the auditor can communicate independence to investors. Under current PCAOB standards, the auditor is required to be independent, and every auditor's report is required to be titled, "Report of Independent Registered Public Accounting Firm." The CAQ also supports adding clarifying language to the standard auditor's report explicitly stating that the auditor is independent, as discussed in Section IV.b. of this letter.

For the reasons outlined above, we do not support the AD&A approach but, as discussed elsewhere in this letter, we fully support other alternatives that we believe are superior to the AD&A approach and would meet the needs of investors without creating significant unintended consequences.

## VI. Other Considerations

We offer further views below regarding liability, cost, and other considerations related to changes to the auditor's reporting model.

### *Liability Considerations*

We believe the concerns outlined by the PCAOB in the Concept Release related to the potential for increased litigation risk are warranted. Auditor liability has been discussed in numerous forums for decades, and we continue to believe it should be an important area for consideration by all stakeholders, including the PCAOB, as potential changes to the auditor's reporting model are evaluated.

### *Cost Considerations*

The CAQ believes the Board should determine whether the potential benefits of receiving certain information through changes to the auditor's reporting model outweigh the associated costs. The CAQ acknowledges that alternatives presented in the Concept Release as well as the CAQ's suggested attestation report on CAEs in the MD&A will require additional audit effort and increase audit cost.

### *Suggested PCAOB Actions to Determine if Potential Changes Meet Investor Needs*

We believe the PCAOB should consider several actions to ensure that any changes to the auditor's reporting model meet the needs of investors. First, it is important for the PCAOB to define clear objectives for any changes to the auditor's reporting model and to communicate these objectives to all stakeholders. Second, we believe the PCAOB should develop examples of how changes to the auditor's report could be incorporated (similar to the examples presented in the Concept Release) and that these examples be shared with a wide variety of investors to determine if the proposed changes will improve the usefulness of auditor reporting. Lastly, we believe the PCAOB could consider field testing as a mechanism to assess the feasibility and effectiveness of any changes prior to full-scale implementation in order to determine whether the needs of investors are being met by such changes. Without definition and communication of clear objectives, sharing of examples prior to implementation, and field testing to assess effectiveness, there is a risk that investors will remain dissatisfied despite the changes that are implemented.

### *Preparing for Changes to the Auditor's Report*

The CAQ believes that consideration should be given to the time and effort required to prepare and educate investors and other financial statement users on any changes that are ultimately adopted in order to reduce the risk of investor misunderstanding or widening the expectation gap. For instance, the PCAOB may consider holding investor forums, similar to the small business forums currently held, to help ready the market for any changes. In addition, the PCAOB may consider implementing certain changes to the auditor's report in tranches – requiring certain changes to be adopted for audits of the largest issuers first.

**VII. Views on Auditor Assurance on Information Presented Outside the Financial Statements**

As discussed previously, the CAQ believes that further consideration regarding auditor involvement with other information provided by management (e.g., earnings releases, non-GAAP information) is warranted, given the value that investors place on such information in making investment decisions. However, in the near term, the CAQ believes the Board should focus on improvements to the information communicated to investors through the addition of clarifying language to the standard auditor's report, a separate auditor attestation report on CAE disclosure in MD&A and/or an EOM approach.

With regard to the potential for auditor involvement with earnings releases, we note that the auditor often performs procedures on these management communications prior to public distribution to assess the consistency of the financial information contained therein with the audit in process. However, some investors may not be aware that these procedures are performed. Auditor issuance of the equivalent of an agreed-upon procedures (AUP) report for general use could potentially provide investors with added visibility in this area. Existing PCAOB standard AT 201, *Agreed-Upon Procedures Engagements*, which governs AUP reports, requires that this type of report be restricted for use by specified parties. Participants at the CAQ's RoA discussion series agreed that further auditor association with certain information communicated by management, such as earnings releases could add value, and is an area deserving of further exploration.

****

The CAQ recognizes that change is needed to enhance the information communicated by the auditor and is committed to embracing responsible calls for change. We continue to believe that a holistic approach examining opportunities for improvement in the roles and responsibilities of all members of the financial reporting supply chain will best serve the interests of investors over the long term. In the near term, as a result of our examination of possible improvements to the auditor's reporting model, we believe the addition of clarifying language to the standard auditor's report, a separate auditor attestation report on CAE disclosure in the MD&A and/or an EOM approach would improve the information communicated by auditors to investors while minimizing the unintended consequences associated with other alternatives such as AD&A.

The CAQ appreciates the opportunity to comment on the Concept Release and welcomes the opportunity to respond to any questions regarding the views expressed in this letter. Further, we stand ready to assist the PCAOB staff in any way we can as potential changes to the auditor's reporting model are further evaluated.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Attachment A – CAQ Comment Letter Dated June 28, 2011

cc: PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Daniel L. Goelzer, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor

SEC
Chairman Mary L. Schapiro
Commissioner Luis A. Aguilar
Commissioner Troy A. Paredes
Commissioner Elisse B. Walter
James L. Kroeker, Chief Accountant
Paul Beswick, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Mike Starr, Deputy Chief Accountant

CENTER FOR AUDIT QUALITY

*Serving Investors, Public Company Auditors & the Markets*

June 28, 2011



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

**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket No. 034**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants (AICPA). The CAQ appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the concept release). This letter and enclosures represent the observations of the CAQ, but not necessarily the views of any specific firm, individual or CAQ Governing Board member.

The CAQ wants to thank the PCAOB for its outreach to the profession and other stakeholders prior to publication of the June 21st concept release on the auditor's reporting model. The CAQ congratulates the PCAOB and its staff on the process and thoughtful content put forward for public consideration. In partial response to the concept release, the CAQ is formally submitting the ideas we discussed and shared with the staff on June 9th as part of the PCAOB's outreach efforts (see enclosed illustrative example reports and accompanying letter). In addition, the CAQ will be submitting further comments on the concept release on or prior to the September 30th due date.

The auditing profession would be happy to meet with the staff to discuss the content of the illustrative example reports in greater detail, or answer any questions.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

Enclosures

cc: PCAOB
Martin Baumann, Chief Auditor and Director of Professional Standards

**CENTER FOR AUDIT QUALITY**

*Serving Investors, Public Company Auditors & the Markets*

June 9, 2011



Mr. Martin Baumann
Chief Auditor and Director of Professional Standards
Public Company Accounting Oversight Board
1666 K Street
Washington, DC 20006-2803

**Re: Changes to the Auditor's Report - Model Approach for Consideration**

Dear Marty:

The Center for Audit Quality (CAQ) was formed in 2007 and is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets by fostering high quality performance by public company auditors, convening and collaborating with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocating policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. We are a membership organization with nearly 700 public company auditing firm members that are registered with the Public Company Accounting Oversight Board (PCAOB). Our member firms are committed to the public interest role that auditors play in our markets.

As a public policy organization, we strive to assure that our efforts are infused with a public interest perspective. The members of our Governing Board (which includes the CEOs of the eight largest accounting firms, the American Institute of Certified Public Accountants, and three independent public members) have a keen understanding and appreciation of the important role the public company auditing profession has in serving the public interest and honoring the public trust. Our three independent public board members strengthen our focus on the public interest and also bring us expertise in financial reporting, securities law and corporate governance.

To realize our vision, the CAQ works with investors, academics, audit committee members, preparers, internal auditors, and policy makers to explore issues and collaborate on initiatives that can advance audit quality.

**601 13th Street NW, Suite 800N, Washington, DC 20005, (202) 609-8120 www.thecaq.org**

The CAQ consistently has supported the implementation of the Sarbanes-Oxley Act of 2002 and, working in collaboration with others with responsibility for financial reporting, has a number of initiatives underway to advance the deterrence and detection of financial reporting fraud. We also support research on issues relating to investor confidence, public company auditing and the capital markets in part by issuing grants that fund independent academic research. In all that we do, we are particularly interested in investors' views, as they are the ultimate users of the audited financial statements.

Recent views expressed by investors convey their need for further information on a number of different matters including, but not limited to, additional insight into accounting policies, particularly critical accounting estimates; information about the activities of public company audit committees, including discussions on critical matters with management and the external auditors; and more information about the independent audit.

In response to these calls for change, the PCAOB announced a standard-setting initiative focused on possible changes to the auditor's reporting model. The profession also recognizes that change is needed, is prepared to embrace the responsible calls for change in this area, and believes that a holistic approach where all stakeholders agree on a way forward will best serve investors and is a requirement if such change is to be meaningful. In this regard, the CAQ established a working group in 2010, comprised of members of the profession, to consider how to best serve investors given their information needs as we understand them.

The working group explored a variety of possible alternatives for communicating additional information about the audit, including changes to the auditor's report combined with expanded management disclosures and audit committee reporting to shareholders with corresponding auditor association. Members of this working group met with you and your staff on February 7, 2011 to discuss these possible alternatives, which were also the subject of my February 11, 2011 letter. CAQ member firm representatives have also participated in recent Standing Advisory Group discussions on this important topic.

Subsequent to our meeting on February 7, 2011, the PCAOB staff identified a number of possible changes to the auditor's reporting model under current consideration. In line with your efforts to identify changes that are both responsive to the needs of investors and can be practicably implemented, the CAQ working group has developed a model approach, described below for your consideration. The model provides examples of potential revisions to the auditor's reporting model that we believe: (i) are responsive to many of the information needs we have heard from investors (ii) can be practically implemented in a relatively short time frame and (iii) are consistent with the overarching principles discussed with you at our February meeting and outlined below.
In presenting this potential reporting model for your consideration, we recognize that refinements in the actual language used may be necessary to align with other PCAOB professional standards, and that implementation guidance will need to be developed to address some of the concepts included in the model, such as the communication of component auditors and the "areas of audit emphasis" section.

***Overarching Principles***

In evaluating this topic, the CAQ working group established the following overarching principles, with investors in mind, to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model:

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.

- Any changes to the reporting model need to enhance, or at least maintain, audit quality.

- Any changes to the reporting model should narrow, or at least not expand, the expectations gap.

- Any changes to the reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.

- Auditor reporting should focus on the objective rather than the subjective.

Conceptually, we understand the suggestion that an auditor deliver to investors the same information that is provided to the issuer's audit committee. However, it is important to understand (as is made clear in the PCAOB's proposed auditing standard on this topic) that such communication is prepared with the expectation that a dynamic two-way discussion between the auditor and audit committee will occur and that questions will arise and additional context and perspectives will be communicated during the course of this discussion. Such interaction can often clarify the specific points raised, particularly around certain accounting and financial reporting matters involving a high degree of subjectivity. This important two-way dialogue will not take place in connection with the general distribution of a report. Additionally, the audit committee obtains insight by virtue of its financial reporting oversight responsibilities which provide additional context for such communications from the auditor. Consequently, we believe that providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue may be incomplete, generate greater confusion and not enhance the overall understanding of the readers of such a report.

***Illustration of a Potential Approach***

After evaluating various alternatives, the CAQ working group determined that the following approach would improve the auditor reporting framework, would help serve the interests of investors, and could be pragmatically implemented in relatively short-order. We recognize this is but one approach and there may be others that meet the objectives we have outlined above. In addition, while we have illustrated the approach in three separate reports; the reports could be combined.

1. Amend the standard financial statement audit report to include the following:

   a. Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report (highlighted in the scope section)
   b. Identify that the auditor is independent under all relevant U.S. Securities and Exchange Commission (SEC) and PCAOB standards
   c. Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audits
   d. Provide an expanded discussion covering management and audit committee responsibilities for the financial statements and the Form 10-K
   e. Highlight that the auditor is responsible for planning and performing the audit to obtain reasonable assurance that the financial statements, taken as a whole, are free of material misstatement, "whether due to error or fraud"
   f. Identify what is meant by the term "reasonable assurance," "material misstatement," and the approach used by the auditor to assess "materiality"
   g. Highlight the necessity of using professional judgment in making audit risk assessments and in the selection of audit procedures and the consideration the auditor gives to the issuer's internal control over financial reporting when making such determinations
   h. Outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not in accordance with Generally Accepted Accounting Principles or in situations where the audit scope has been limited
   i. Describe the auditor's responsibility for information outside of the financial statements (including Management's Discussion & Analysis (MD&A))
   j. Address the audit report to the shareholders of the company in addition to the Board of Directors
   k. Include a reference and link to where more information about public company audits and auditors can be found. For purposes of the illustrative reports attached, we have utilized as an example of this approach the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the CAQ and available on our website.

   We have illustrated in Example A, attached to this letter, how the above suggestions would revise the current financial statement audit report. We believe these changes are responsive to many of the comments that have been raised.

2. Using an emphasis-of-matter like approach, the audit report would identify specific topics or events, unusual transactions or other matters that were viewed to be areas of audit emphasis by the auditor. Consistent with the overarching principles, we believe these descriptions should be objective, fact-based discussions and make specific reference to where such items appear in the financial statements. We have illustrated in Example A how this approach might look in practice. We believe this approach responds to the request that the auditor indicate areas of audit emphasis, and directs the user to where such matters are discussed in the financial statements. As noted above, we recognize that standard-setting activity and resulting implementation guidance will be necessary to help guide the auditor in assessing and consistently determining the type of

matters that should be identified in this section of the revised report, and the extent of the auditor's discussion relating to such matters.

3. Prepare a new report on the examination of the issuer's Critical Accounting Estimates disclosure in its MD&A. We have illustrated this new report in Example B attached to this letter. We believe auditor attestation will serve to continue to improve disclosures in this important area and will be responsive to the various suggestions that have been raised with respect to the need for more emphasis on the important judgment calls made in preparing the financial statements. The SEC would likely need to amend Regulation S-X to require this new report. Likewise, MD&A would need to clearly identify the Critical Accounting Estimates section that will be covered by the examination report. This may also likely require some SEC amendments, but we believe such changes should not be complex or time-consuming. (We note that Example B may also be written to include language from Example A, for example, language relating to the performance of procedures by member firms.)

4. Amend the standard audit report on internal control over financial reporting to reflect many of the changes outlined in 1. above. We have illustrated in Example C attached to this letter how these suggestions would change the present internal control over financial reporting audit report. We believe these changes are responsive to many of the comments that have been raised. (We note again that this Example C may also be written to include additional language from Example A, such as member firm considerations, when appropriate.)

While we have included in our model both an emphasis-of-matter like approach for specific areas of audit emphasis to be included in the financial statement auditor's report, and a separate examination report on the Critical Accounting Estimates disclosure, we appreciate that both of these enhancements may not be necessary. While we believe that the examination report is the enhancement most likely to address investor's needs, we recognize that each of these enhancements or a combination of the two has merit for consideration.

***Other Thoughts***

We also believe that an expanded audit committee report, which includes matters discussed with the auditor that the audit committee considered significant in discharging its responsibilities, accompanied by auditor association therewith, is worthy of further consideration as another means of providing additional information called for by certain investors. We continue to give thought to this idea, and would be pleased to collaborate with the PCAOB, SEC and others (importantly, representatives from the audit committee community) on the further consideration of this concept.

In connection with the potential expansion of the auditor's reporting model, we continue to have concerns about increasing the profession's liability risks. This is, of course, a matter that has been discussed in numerous forums for many decades, but we believe it would be a necessary component on any proposal for revised auditor reporting.

We appreciate the opportunity to share our views regarding possible revisions to the auditor's reporting model. We understand the PCAOB is working toward the issuance of a concept release on this topic by the end of June, and we look forward to reviewing and commenting on that document. At the same time, we want to go on record that we are fully committed to making progress and stand ready to embrace calls for responsible change in this important area. We sincerely believe the approach outlined above serves these purposes, will help serve investors, and can be implemented in a relatively quick time frame.

We also welcome the opportunity to work with the PCAOB staff following the issuance of the concept release and in your further evaluation of the auditor's reporting model. We stand ready to assist you in any way we can, including participation in any meetings or roundtables you are planning.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc: PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Member
Daniel L. Goelzer, Member
Jay D. Hanson, Member
Steven B. Harris, Member

SEC
James L. Kroeker, Chief Accountant
Paul A. Beswick, Deputy Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
J.W. Mike Starr, Deputy Chief Accountant

**Example A**

**Revised Auditor's Report on the Financial Statements with Reference to Separate ICFR and Critical Accounting Estimates Reports**

**Report of Independent Registered Public Accounting Firm on the Consolidated Financial Statements of Sample Company**

To the Board of Directors and Shareholders of Sample Company

We have audited the accompanying consolidated balance sheets of Sample Company and subsidiaries (the Company) as of December 31, 201Y and 201X, the consolidated statements of income, stockholders' equity, comprehensive income and cash flows for each year in the three year period ended December 31, 201Y, and the related notes to the consolidated financial statements for all periods presented (collectively referred to below as the "consolidated financial statements").

We are an independent registered public accounting firm with respect to the Company within the meaning of the Securities Act of 1933 and the applicable rules and regulations thereunder adopted by the United States Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (United States) (PCAOB). XYZ LLP is the principal auditor for the Company for the periods cited above. XYZ LLP is the US member firm of XYZ Limited, a global network of affiliated auditing firms. [Each member firm in the network is a separate legal entity, and all member firms follow a common audit methodology and consistent quality control policies.][1] Certain network member firms participated in our audits of the Company and such participation, in the aggregate, covered approximately Y% and X% of the Company's consolidated assets as of December 31, 201Y and 201X and approximately X%, Y% and Z% of the Company's consolidated revenues for each year in the three year period ended December 31, 201Y. We (XYZ LLP) take responsibility for the work performed by our member firms in connection with our audits.

**Management and Audit Committee Responsibilities for the Financial Statements and Other Information**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America (U.S. GAAP), and for establishing and maintaining adequate internal control over financial reporting to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to error or fraud.

Management is also responsible for the preparation and presentation of the Company's Annual Report on Form 10-K in accordance with the rules and regulations of the SEC, including

[1] Each firm would describe their member network affiliation.

Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) appearing in Item 7 of the Annual Report.

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Audit of the Financial Statements**

Our responsibility is to express an opinion on these consolidated financial statements, taken as a whole, based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement, whether due to error or fraud. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit conducted in accordance with PCAOB standards may not always detect a material misstatement. Our judgments about materiality are affected by our understanding of the financial information needs of investors and other users of the consolidated financial statements. A material misstatement represents an omission or misstatement that would be viewed by a reasonable investor as having significantly altered the 'total mix' of information presented in the consolidated financial statements, taken as a whole.

An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. In the course of completing our audit, the audit evidence we obtain is often persuasive rather than conclusive. The procedures selected for performance depend on our judgment, including our assessment of the risks of material misstatement of the consolidated financial statements, whether due to error or fraud. In making those risk assessments, we consider internal controls relevant to the Company's preparation and fair presentation of the consolidated financial statements in accordance with U.S. GAAP in order to design audit procedures that we believe are appropriate in the circumstances. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation and related financial statement disclosures. Our audits also included such other procedures as we considered necessary in the circumstances.[2]

PCAOB standards require that we modify our report if we determine that the consolidated financial statements are materially misstated. If there are significant restrictions placed on the scope of our audit PCAOB standards prohibit us from expressing an opinion on the financial statements.

We believe that the procedures performed and the audit evidence obtained provides a reasonable basis for our opinion.

[2] Additional information about public company audits and auditors can be found in the *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*, published by the Center for Audit Quality and available on the organization's website at http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf.

**Auditor Responsibility for Other Information Presented Outside of the Financial Statements**

We have separately examined the Critical Accounting Estimates disclosure included as part of MD&A in the Company's December 201Y Annual Report on Form 10-K. Our responsibility with respect to all other information presented outside of the consolidated financial statements (including all other sections of the MD&A) is to read this other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the consolidated financial statements. We are required to follow up on any material inconsistencies and material misstatements of fact of which the auditor becomes aware with management, and with the Audit Committee if necessary, until properly resolved, but are not otherwise required to express an opinion on the other information, including all other sections of MD&A. Other than where identified in this report, our responsibility with respect to the other information in the Form 10-K does not extend beyond the financial information identified in our report, and we have no obligation to perform any procedures to corroborate information presented outside of the consolidated financial statements.

**Opinion on the Consolidated Financial Statements**

In our opinion, the consolidated financial statements, taken as a whole, present fairly, in all material respects, the consolidated financial position of Sample Company and subsidiaries as of December 31, 201Y and 201X, and the consolidated results of their operations and cash flows for each year in the three year period ended December 31, 201Y, in conformity with U.S. GAAP.

**Areas of Audit Emphasis**

In connection with our audits, we also bring to your attention the matters listed below. This is not intended to be a complete list of all areas that our audit procedures addressed in response to identified risks of material misstatement.

1. In December of 201Y, the Company completed the acquisition of ABC Company. As of December 31, 201Y, the Company has completed the allocation of the purchase price on a preliminary basis, assigning approximately $XXX million to goodwill and other intangible assets with indefinite lives. The Company will finalize the purchase price allocation during 201Z, and the amounts assigned as of December 31,201Y could change. See Note B for further details.

2. In connection with the financing required to complete the ABC acquisition, the Company borrowed $XXX million from a consortium of banks. The borrowing has a maturity date of March 31, 201A, or fifteen months from the date of the balance sheet. As of December 31, 201Y, the borrowing is classified as long-term debt, since it has a maturity date beyond the end of the 201Z fiscal year. The Company is in the process of exploring alternatives to refinance this borrowing on a longer-term basis. See Note D for further details.

3. The Company provides financing to certain customers of its [Example Segment]. Business conditions in this Segment led to a slow-down in collections and an increase in potential uncollectible balances. At December 31, 201Y, the gross financing balance

approximated $X,XXX million and the Company maintained a reserve for uncollectible accounts of $XXX million. The balance of accounts that were 90 or more days past due at that date approximated $XX million. This compares to a gross financing balance, reserve for uncollectible accounts and amounts 90 or more days past due of $X,XXX million, $XXX million and $XX million at December 31, 201X respectively. The net expense recorded for estimated uncollectible amounts approximated $XXX million during 201Y. See Note E for further details.

4. The Company has goodwill of $X,XXX attributable to its [Example Segment] reporting unit as of December 31, 201Y. The Company performed its annual impairment testing as of October 31, 201Y. No impairment was recognized because the Company's estimated fair value of this reporting unit exceeded its carrying value at that date; however, the comparison was close and a further decline in the fair value of this reporting unit could give rise to an impairment of the goodwill balance in the future. See Note H for further details.

5. The Company is exposed to various claims and contingencies in the normal course of business. We note two significant matters outstanding as of December 31, 201Y. The Company is a defendant in litigation involving a patent claim that has been ongoing for several years. The Company is also liable for the costs of remediating an environmental claim relating to a business that was sold in 201X. See Note J for further details surrounding these matters.

We highlight the above matters because they represent some of the areas of audit emphasis during the periods covered by our report. Our audits included performing procedures designed to address the risks of material misstatement associated with the above matters. Such procedures were designed in the context of our audit of the consolidated financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures. As noted above, our audits also included procedures in response to identified risks and those required by professional standards that have not been specifically identified herein.

**Other Reports**

We also have examined, in accordance with the standards of the PCAOB, Sample Company's Critical Accounting Estimates disclosure included as a part of MD&A in the Company's December 31, 201Y Annual Report on Form 10-K, and our report dated [*date*] expressed an unqualified opinion that the Company's presentation of the Critical Accounting Estimates disclosure includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; that the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; and that the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

In addition, we have audited, in accordance with the standards of the PCAOB, Sample Company's internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated [*date*] expressed an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

XYZ LLP

[City, State]
[Date]

**Example B**

**New Report on Critical Accounting Estimates**

**Report of Independent Registered Public Accounting Firm on the Critical Accounting Estimates Disclosure of Sample Company**

To the Board of Directors and Shareholders of Sample Company

We have examined the Critical Accounting Estimates disclosure of Sample Company and subsidiaries (the Company) included as a part of the Company's Management's Discussion and Analysis (MD&A) that is included in the Company's December 31, 201Y Annual Report on Form 10-K.

**Nature of the Critical Accounting Estimates Disclosure**

The Critical Accounting Estimates disclosure is designed to present the Company's analysis of the uncertainties involved in applying its adopted accounting principles and policies at a given time or the variability that is reasonably likely to result from its application over time. The subjectivity of these disclosures is influenced by the availability and reliability of relevant data, the number and significance of assumptions that are made, and the degree of uncertainty associated with such assumptions. Consequently, actual results in the future may differ materially from management's present assessment of this information because events and circumstances frequently do not occur as expected.

**Management and Audit Committee Responsibilities for the Critical Accounting Estimates Disclosure**

Management is responsible for the preparation of the Company's Critical Accounting Estimates disclosure pursuant to the rules and regulations adopted by the U.S. Securities and Exchange Commission (SEC), and for such disclosure controls and procedures designed to ensure that information required to be disclosed pursuant to the securities laws is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. The preparation of the Critical Accounting Estimates disclosure requires management to interpret the criteria for disclosure, make determinations as to the relevancy of information to be included, and make estimates and assumptions that affect reported information.

The Company's audit committee oversees the financial reporting process (including the Company's Critical Accounting Estimates disclosure) and its disclosure controls and procedures (which include internal control over financial reporting), areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Examination of the Critical Accounting Estimates Disclosure**

Our responsibility is to express an opinion on the Critical Accounting Estimates disclosure presentation based on our examination. Our examination was conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB) and, accordingly, included examining, on a test basis, evidence supporting the historical amounts and other information disclosed in the presentation. An examination also includes assessing the significant determinations made by management as to the relevancy of information to be included and the estimates and assumptions that affect reported information. We believe that the procedures performed and the examination evidence obtained provides a reasonable basis for our opinion. In forming our opinion, we exercised professional judgment in evaluating the reasonableness of the disclosures based on information that was available at the time of our examination. In the course of completing our examination, the evidence we obtain is often persuasive rather than conclusive.

**Opinion on the Critical Accounting Estimates**

In our opinion, the Company's presentation of the Critical Accounting Estimates disclosure referred to above includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's consolidated financial statements; and the underlying information, determinations, estimates, and assumptions of the Company provide a reasonable basis for the disclosures contained therein.

**Other Report**

We have audited, in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [*date*], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]
[Date]

**Example C**

**Revised Report on Internal Control over Financial Reporting**

**Report of Independent Registered Public Accounting Firm on Sample Company's Internal Control over Financial Reporting**

To the Board of Directors and Shareholders of Sample Company

We have audited Sample Company's (the Company) internal control over financial reporting as of December 31, 201Y, based on criteria established in *Internal Control – Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

**Management and Audit Committee Responsibilities for Internal Control over Financial Reporting**

Sample Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying [title of management's report].

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment, compensation, and oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

**Auditor Responsibility for the Audit of Internal Control over Financial Reporting**

Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) (PCAOB). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit of internal control over financial reporting conducted in accordance with PCAOB standards may not always detect a material weakness. Our judgments about materiality are affected by our understanding of the financial information needs of users of this Report. A material weakness is a deficiency, or combination of deficiencies, in internal control over financial reporting, giving rise to a reasonable possibility that a material misstatement of the Company's annual or interim financial results will not be prevented or detected by the Company on a timely basis. If one or more material weaknesses exist, the Company's internal control over financial reporting cannot be considered effective, and we are required to include in our report an opinion that the Company's internal control over financial reporting is not effective. If there are restrictions placed on the scope of our audit, we are prohibited from expressing an opinion on the effectiveness of the Company's internal control over financial reporting.

Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances.

We believe that the procedures performed and audit evidence obtained provides a reasonable basis for our opinion.

**Definition and Limitations of Internal Control over Financial Reporting**

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. GAAP, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

**Opinion on Internal Control over Financial Reporting**

In our opinion, Sample Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 201Y, based on the criteria established in *Internal Control – Integrated Framework* issued by COSO.

**Other Report**

We have audited in accordance with the standards of the PCAOB, the consolidated financial statements of Sample Company and subsidiaries as of December 31, 201Y and 201X, and for each of the years in the three-year period ended December 31, 201Y, and in our report dated [date], we expressed an unqualified opinion on those consolidated financial statements.

XYZ LLP

[City, State]
[Date]

September 29, 2011

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

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

**Executive Summary**

As members of the PCAOB's Investor Advisory Group, we believe that the current auditor's report is deficient as a communication vehicle, and that significant changes to the auditor's report are needed to remediate these deficiencies. The only communication between the auditor and investors is typically a standard three-paragraph report that is essentially identical for the overwhelming majority of all public companies.

We believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer's accounting practices and policies. We believe that the disclosure of this information will improve investors' ability to make informed buy/sell decisions, which should result in higher returns to investors and improved capital allocation within society.

We believe that an Auditor Discussion & Analysis is the best means for providing this information. However, we are not opposed to the required use of emphasis-of-matter paragraphs, as long as the above information is included within these paragraphs.

In addition, we believe that the audit report should explain the auditor's responsibility for detecting material fraud. The standard audit report should clearly state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that "reasonable" assurance represents a high, although not absolute, level of assurance.

**RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Messrs. Doty, Ferguson, Goelzer, Hanson, and Harris:

> "Rather than managing investors' expectations about the auditor's opinion, a better approach would be for the auditing profession, with the support of standard setters and market regulators, to take on a greater level of responsibility than they have today."[1]

1. As members of the PCAOB's Investor Advisory Group (IAG), we are writing to provide comments on the PCAOB's June 21, 2011 Concept Release entitled *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. The undersigned members of the PCAOB's IAG have collaborated in drafting this comment letter to the Board.[2] We discuss below the results of an investor survey we recently conducted on the topic of the auditor's report, and offer numerous suggestions regarding possible changes to the format and content of the report that would provide much greater value to investors than the current auditor's report provides.

2. The IAG is an "expert advisory group" that the PCAOB has convened under the statutory authority of Section 101 of the Sarbanes-Oxley Act. The IAG's mandate is to "provide its views and advice to the Board on broad policy issues, and other matters that affect investors and are related to the work of the Board."

3. The IAG believes that the current auditor's report is deficient as a communication vehicle, and that significant changes to the format and scope of the auditor's report are needed to remediate these deficiencies.[3] The IAG has devoted substantial efforts to improving the auditor's report throughout its limited life. In May 2010, at the initial IAG meeting, we identified improvements

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[1]DiPiazza, S. A., Jr., and R. G. Eccles. 2002.*Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons. Mr. DiPiazza is a former CEO of PricewaterhouseCoopers (PwC).

[2]Hereafter when we refer to a position of the IAG, we are only referring to those IAG members who have chosen to sign this letter. The views expressed herein are those of the individual IAG members who have signed this letter and do not necessarily reflect the opinions of the companies or associations with which they are affiliated or any other officers, employees, or members thereof.

[3]Other international auditing standard setters recognize this deficiency in the communications value of the auditor's report. For example, the International Auditing and Assurance Standards Board (IAASB) has noted, "Users recognize there is richer information about the entity and about the audit itself than is currently being provided through the audited financial statements and other corporate disclosure mechanisms, and through the auditor's report." (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 7.)

to the audit report as one of our highest priorities. Moreover, in advance of our March 2011 meeting, we conducted a survey of investors to measure their perceptions of the value of the current audit report and to solicit their input as to needed changes. We presented our findings at the PCAOB's March 2011 IAG meeting and discuss the survey results in greater detail below.

4. Audits of public companies can involve scores of auditors, thousands of hours, and millions in fees. The documentation in support of the auditor's opinion is voluminous. Indeed, with the possible exception of senior financial management, in most cases the auditor knows more about the financial statements and financial reporting risk of the audited company than other individuals, both inside and outside the company (including members of the audit committee). Notwithstanding this significant accumulated knowledge, the only communication between the auditor and investors is typically a boilerplate three-paragraph letter (hardly a "report," despite the commonly used title) that is essentially identical for the overwhelming majority of all public companies.

5. The members of the IAG believe that this reporting model fails to meet the legitimate needs of investors. PCAOB board member Steve Harris succinctly summarized our position in his comments at the PCAOB's June 21 open board meeting -- the IAG "believes public company auditors know much more about their audit clients than they currently are telling investors."[4]The IAG isn't asking for auditors to gather more audit evidence. We aren't asking for a fundamental change to the audit process. We are simply asking auditors to share with investors more of what they already know.

6. It is worth noting that a number of other parties agree that the current form of the auditor's report fails to meet the legitimate needs of investors. First, the U.S. Treasury Advisory Committee on the Auditing Profession (ACAP) called for the PCAOB to undertake a standard-setting initiative to consider improvements to the standard audit report. The ACAP members support "… improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements."[5] Second, surveys conducted by the CFA Institute in 2008 and 2010 indicate that research analysts want auditors to communicate more information in their reports.[6] Finally, even leaders of the accounting profession have acknowledged that the audit report needs to become more relevant. In testimony before ACAP, Dennis Nally, Chairman of PwC International stated, "It's not difficult to imagine a world where the … trend to fair value measurement -- lead one to consider whether it is

[4]Steve Harris' statement at the PCAOB open board meeting on June 21, 2011.

[5]U.S. Department of the Treasury Advisory Committee on the Auditing Profession. 2008. *Final Report of the Advisory Commission on the Auditing Profession*.

[6]CFA Institute. 2008. February Monthly Question Results. Cited in *Final Report of the Advisory Committee on the Auditing Profession*. VII: 16; CFA Institute. 2010. *Independent Auditor's Report Survey Results*.

necessary to change the content of the auditor's report to be more relevant to the capital marketsand its various stakeholders."[7] Finally, leaders of the accounting profession have previously stated that changes to the audit report should reflect investor preferences. In their 2006 White Paper, the CEOs of the six largest accounting firms stated, "The new (reporting) model should be driven by the wants of *investors and other users of company information …*" (their emphasis).[8]

7. Before we turn to a discussion of the IAG investor survey, we believe it is important to underscore the fundamental but often overlooked fact that the issuer's *investors*, not its audit committee or management team or the company itself, are the auditor's client. It is therefore not only appropriate, but essential, that investors' views and preferences take center stage as the PCAOB considers possible changes to the format and content of the audit report.

Information Desired by Investors and How Such Information Might Affect Decisions

8. The IAG survey of investors identified the following as the four most highly desired changes to the audit report: (1) a discussion of the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit; (3) discussion of unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discussion of the quality, not just the acceptability, of the issuer's accounting practices and policies.[9]

*Auditor Assessment of Estimates and Judgments*

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[7]Written testimony of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers, LLP Before the Federal Advisory Committee on the Auditing Profession, United States Department of the Treasury, December 3, 2007.

[8]DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks.*

[9]Some might argue that this type of information should be communicated to investors by management and not by the auditor. However, the Companies Act in the United Kingdom requires additional narrative disclosures by management. The Financial Reporting Council (FRC) finds that these narrative disclosures have not been particularly forthcoming. The FRC states, "… the majority of risk reporting is a list of boilerplate disclosures which do not provide a meaningful discussion …" and, based on work by Deloitte referred to by the FRC, "… descriptions of principal risks are too generic, that there is a lack of detail on trends and factors, and that there are too many KPIs and no explanation of the link between strategy and objectives" (FRC, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*, p. 9). There may be a role for the audit committee in communicating some of the information desired by investors, but audit committee communication should not be a substitute for communication from the auditor. The arguments for and against requiring expanded audit committee communications are beyond the scope of this letter, as any such policy decision rests with the SEC and not the PCAOB.

9. Investors who responded to the IAG survey want the auditor to provide an assessment of the estimates and judgments made by management in preparing the financial statements and to describe the process the auditor followed in arriving at that assessment. Seventy-nine percent of the respondents to the IAG survey want the auditor to provide this information. As one representative example of investor sentiments on this issue, the chief investment officer of a large mutual fund stated, "There are many judgments that ultimately determine the data on the financial statements. It's critical to understand how estimates were made and how much margin of error there might be in the estimates."[10] In addition, the CFA Institute's 2008 survey of research analysts found that 84 percent of their respondents wanted the auditor to communicate additional information about management's estimates and judgments.[11]

10. As financial reporting has become more subjective -- as evidenced through the expanded use of fair value measurement, more complex revenue recognition issues, evaluation of impairments with respect to investments, fixed assets, intangible assets, and deferred tax assets -- the ultimate reliability of an issuer's financial statements depends increasingly on management's estimates and judgments. As a result of these changes in financial reporting, the FASB has increased the nature and scope of required disclosures about estimates and judgments. Some will argue that if investor needs are not being met, then the FASB should simply require more disclosures from management. However, this argument ignores the expressed desire of investors for additional, independent communication on these issues *from the auditor*.[12]

11. Obtaining an independent evaluation of management's estimates and judgments would add significant value to the audit process in several respects. First, management's evaluations of its own estimates and judgments are inherently biased; the auditor is uniquely positioned to provide an independent, objective assessment.[13]The rationale for obtaining the auditor's evaluation of management's estimates and judgments is the same as that which applies to the entire process of obtaining the auditor's assessment of the overall fairness of the financial statements. In other words,management's self-interest inherently precludes them from reporting in an unbiased fashion on either the financial statements taken as a whole or on the reasonableness of their material estimates and judgments. As the CEOs of the global network firms stated in their White

[10]The IAG survey was primarily composed of Likert-scaled questions, but also afforded respondents the opportunity to provide narrative comments.

[11]The CFA Institute's 2008 survey was based on 1,474 respondents.

[12]The IAASB recognizes the value in having information about estimates and judgments communicated directly by the auditor. The IAASB states, "Some investors and analysts in particular, however, view the auditor's insight into the entity and its business obtained through the audit of the entity's financial statements as being especially relevant information for their needs" (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 9).

[13]AU ¶ 342.12 indicates that the auditor may independently develop an expectation of the estimate when evaluating the reasonableness of the issuer's estimates.

Paper, "Given our independence and experience, we are in an ideal position to provide value to investors throughout the world."[14] Also, the IAASB states in its Consultation Paper on the auditor's report: "… the fact that such information would be communicated by the independent auditor adds a degree of credibility to the information communicated."[15]We believe that financial statement users would be willing to pay incremental audit feesto obtain information to which they attach high value.[16]

12. Finally, the auditor already gathers and communicates much of the information investors wish to obtain relating to estimates and judgments. Under AU ¶ 380.08, "[t]he auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates." Since the auditor already gathers and communicates this information to the issuer's audit committee, there is no reasonable basis, in the IAG's view, for the auditor not to share this information with investors, who as the owners of the corporation are the auditor's true client.

*Financial Statement and Audit Risk*

13. Investors who responded to the IAG survey also expressed a strong desire that the auditor communicate areas of high financial statement and audit risk and explain how the auditor addressed these risk areas in planning and conducting the audit.[17] Seventy-seven percent of the respondents to the IAG survey want this information. As an equity analyst from a large mutual fund stated, "This would make me read the report instead of just skim it." The chief investment officer of another large mutual fund stated, "This would be very helpful. Understanding the issues the auditor recognizes as being difficult to measure enables us to focus our analysis on these issues." In addition, the CFA Institute's 2008 survey indicated that 84 percent of their respondents wanted the auditor to communicate additional information about risks.

14. Beyond the audit risks associated with management's estimates and judgments, overall financial statement and audit risk may be elevated because of: (a) the existence of certain

[14]DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks.*

[15]IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 10.

[16]Investors' willingness to pay for additional auditor disclosures presupposes that the auditor's communication would serve to meaningfully *differentiate* between the estimates and judgments made by different companies. If all companies' estimates and judgments are treated as equally reasonable, then this new communication will devolve into boilerplate that is of little use to investors. Differentiation is key.

[17]The failure of the audit report to communicate information about audit and financial reporting risks and how they were addressed is a perceived deficiency by other auditing standard setters as well (IAASB Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*, p. 8).

structured transactions (e.g., special purpose entities, particularly those where the business purpose is suspect);(b) related party transactions;(c) weak corporate governance structures, including concerns about tone-at-the-top or inadequate management oversight; and (d) the challenges involved in discovering suspect transactions in businesses where a particular type of transaction occurs in high volumes. As an example of the last category of risk, an unusually large amount of revenue recognized near period-end -- particularly if the transactions are not recorded through normal channels, involve new customers, and/or are recorded in round dollar amounts -- significantly raises the risk of fraudulent financial reporting.[18]

15. The auditor already gathers and assesses information relating to financial statement risks; in fact, it would be impossible to perform an audit in compliance with PCAOB standards without assessing risks (e.g., see PCAOB Auditing Standards No. 12 and 13). More importantly, under existing rules and practices the auditor already communicates most, if not all, of the desired risk-related information to the audit committee. AU ¶ 316.81 requires that “[t]he auditor also should consider communicating other fraud risks, if any, identified by the auditor. Such a communication may be part of an overall communication to the audit committee of business and financial statement risks affecting the entity and/or in conjunction with the auditor communication about the quality of the entity’s accounting principles.” Moreover, the auditor is required to document significant findings and issues, which would include significant risks and how the auditor addressed these risks, in an engagement completion document.[19]

16. Some parties believe that providing this information to investors would introduce new risks into the audit process. This concern is grounded in a belief that because the auditor and the audit committee have the opportunity to engage frequently in a private, two-way discussion, the auditor has more of an opportunity to provide additional context around its process and findings in its interactions with the audit committee than it would if periodic public disclosures were required. For example, the Center for Audit Quality (CAQ) states, “… we believe that providing investors with the same information that is provided to the audit committee, without the context obtained from a two-way dialogue may be incomplete, generate greater confusion and not enhance the overall understanding of the readers of such a report” (Center for Audit Quality comment letter on PCAOB Release No. 2011-003, p. 3). However, since all investors are invited to attend the Annual Shareholder Meetings, and given that the external auditor typically attends this meeting as well, it would seem that a productive two-way dialogue between investors and the auditor could occur in this context. And although the CAQcautions against providing the same information to investors that is provided to the audit committee, the former CEO of one major accounting firm envisions a world where auditors communicate to investors about risks and estimates and judgments. DiPiazza and Eccles state:

[18] Beasley, Carcello, Hermanson, and Neal. 2010.*Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies*.COSO.

[19]AS #3, *Audit Documentation*, ¶ 13.

> "Making the future better requires responding to the market's demand for audit opinions that say more about the information on the health of the business. Today, a great deal of this information is already reported by management, and for certain purposes is considered in the course of the audit, including such issues as management estimates, the possibility of fraud, risks, liquidity, and future scenarios. *The audit opinion could be expanded to address this information, as well as how all the pieces fit together as a whole*."[20]

17. To summarize, the substantial majority of investors who participated in the IAG survey would derive great value from receiving the same communications from the auditor regarding audit and financial statement risk which the auditor provides to the investors' representatives – the members of the issuer's audit committee. In our view, this change to existing practices would introduce significantly improved transparency into the audit process, which would benefit investors, the capital markets, and corporate governance generally.

*Unusual Transactions, Restatements, and Other Significant Changes*

18. The IAG survey respondents also want the auditor to report to investors any unusual transactions, restatements, and other significant changes. Sixty-seven percent of the respondents to the IAG survey want this information. A state government official stated regarding this proposed change, "An unbiased and objective discussion of these issues by the auditor may provide the investor with information necessary to make an informed investment decision."

19. In addition to the potentially fraudulent transaction types previously discussed (revenue transactions that are not recorded through normal channels, that involve new customers, and/or that involve even dollar amounts), unusual transactions in general may increase the risk of material misstatements in the financial statements. For example, round-trip transactions involving revenue, aggressive capitalization of expenditures, and transactions without a clear business purpose (particularly if entered into in a country with a weak rule of law and opaque disclosure regime), all pose heightened risk. Investors would benefit from knowing if an entity meets its earnings targets only as a result of engaging in these types of transactions, and also from understanding the auditor's evaluation of the economic substance of such transactions and how the auditor reached its conclusion.

20. The auditor already gathers and communicates information about unusual transactions to the audit committee. AU ¶380.07 requires the auditor to "… determine that the audit committee is informed about the methods used to account for significant unusual transactions …"

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[20] DiPiazza, S. A., Jr., and R. G. Eccles. 2002. *Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons. (Emphasis added.)

21. The auditor already communicates information about restatements. Auditing Standard No. 6, ¶ 9 requires that, "The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in AU sec. 508." However, rather than relying only on the relatively uninformative boilerplate language currently required, investors would benefit from knowing more about the auditor's views regarding the nature and consequences of the misstatement, including, for example, the failures in internal control that permitted the misstatement to occur, whether in the auditor's judgment these internal control weaknesses have been satisfactorily remediated, whether the responsible parties for the misstatement remain in their positions, and whether the issuer's governance mechanisms have changed as a result of the misstatement. This type of information istypically not disclosed. Even when it is disclosed, the disclosure is not provided by the auditor.

22. Investors told us also that they want the auditor to discuss significant changes in the financial statements, especially those that are not apparent from reading the financial statements. For example, an entity may have changed its sales distribution channel from selling directly to end users to selling through value added resellers. Such a change increases the complexity of revenue recognition and hence raises financial statement and audit risk. Or perhaps a financial institution that historically has invested in conservative securities is now investing in structured debt instruments. The risk profile of these investment choices is quite different. The list of potentially significant changes is endless; the important point is that investors want the auditor to communicate its evaluation of significant changes, an assessment that the auditor would already have completed as a result of performing the audit.

*Quality of Accounting Policies and Practices*

23. The IAG survey respondents also want the auditor's report to include a discussion of the quality, not just the acceptability, of the issuer's accounting policies and practices. Sixty-five percent of the respondents to the IAG survey want this information. A senior portfolio manager at a money management firm stated regarding this proposed change, "This is very key. Substance over form is a lost auditing principle."

24. Critical accounting policies are likely to vary by company and industry, in areas including, for example, revenue recognition, asset capitalization and amortization, asset impairment, and investments. In these and other areas, companies often have discretion in applying GAAP. This discretion can have a material effect on reported amounts in the financial statements. For example, companies can have very different policies for when they begin to capitalize software development costs and how they amortize such capitalized costs to expense. Although various alternatives may be acceptable under GAAP, not all alternatives are of equal "quality" in terms

of reasonableness, transparency, and accuracy. The auditor's judgment on the quality, not just the acceptability, of an entity's critical accounting policies would be useful to investors. This issue is particularly relevant when management decides to make a discretionary accounting change – the auditor's opinion as to the quality of the change would be of significant relevance to investors.

25. As noted previously, auditors already gather and communicate significant information about the issuer's critical accounting policies. Section 204 of the Sarbanes-Oxley Act, and the resulting SEC implementation rules, require the auditor to communicate to the audit committee the entity's critical accounting policies. Moreover, AU ¶ 380.11 requires that, "In connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting." This rule further provides that "… the discussion should be open and frank …" and should include discussion of "estimates, judgments, and uncertainties" and "unusual transactions."

26. Thus, AU ¶ 380.11 already requires the auditor to communicate his or her*judgment* about the quality, not just the acceptability, of the entity's accounting principles. Since the auditor is forming his or her own professional judgment about this issue, this puts the auditor in the position of communicating new information, rather than simply attesting to a statement made by management (i.e., management does not opine on the quality of its accounting choices). The distinction between the auditor communicating new information, which we believe is required by AU ¶ 380.11, and attesting to information reported by others is important because some parties have argued that auditors should not be placed in the position of being the original source of information provided to financial statement users. For example, according to the Center for Audit Quality (CAQ), the following overarching principle should guide any change to the auditor's report, "Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard."[21] However, we find it curious that the CAQ, an entity that speaks for the public accounting firms that audit public companies, would oppose a standard that required the auditor to be the original source of information about the entity when the present and former CEOs of the global accounting firms essentially advocated such direct reporting in their 2006 White Paper. The CEOs stated:

> "… users of financial information may demand from public companies the ability to receive more finely nuanced opinions from auditors about the *degree* of a company's compliance with a given set of standards, or the relative conservatism of judgments

[21]Center for Audit Quality. 2011. Comment letter on PCAOB Release 2011-003.

compared to peer groups. Or more boldly, investors even may want the auditor's views about the overall health and future prospects of the companies they audit."[22]

27. AU ¶ 380.11 already requires the auditor to be the *original source*in assessing the quality, not just the acceptability, of the entity's accounting principles. However, under current rules and practice the auditor delivers this assessment only to the audit committee, not to investors. Since both audit committees and investors are users of financial statements, the existing framework requires the auditor to communicate new information to some users of the financial statements but not to others. In this Orwellian-manner of thinking, all financial statement users are equal, some are just more equal than others. As representatives of the investor community, either as individuals or in our institutional capacities, we urge the PCAOB to include in any new rules relating to the audit report a requirement that the auditor discuss its assessment of the quality of the issuer's accounting policies and practices.[23]

*How an Improved Audit Report Would Add Value to the Investment Process*

28. A company's stock price reflects primarily the market's assessment of its future earnings stream discounted at a risk-adjusted rate. A key predictor of future earnings is current earnings, and the quality of currently reported earnings affects the reliabilityof investors' projections of future earnings. Disclosures about financial reporting risks, estimates and judgments, unusual transactions, and accounting policies would enable investors to better assess the quality of current earnings. Moreover, these disclosures would better inform investors' perceptions of the entity's risk, which may affect the discount rate used to value future earnings. Therefore, enhanced auditor disclosures should lead to more efficient pricing of equity securities, either through changes in expected future earnings and/or changes in the discount rate used to value future earnings. The present and former CEOs of the global public accounting firms agree, stating, "Better information about public companies … in a more user-friendly format, will improve the ability of investors to assess the value of companies. In this process, markets will become more efficient, and improve the allocation of capital and talent …".[24]

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[22]DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks.*

[23]Although we believe that the auditor should communicate much of the same information now communicated to audit committees, we recognize that certain communications between the auditor and audit committee should be confidential. For example, communication between the auditor and audit committee involving information that is proprietary, or that involves unresolved legal or personnel issues, among other items, should not be disclosed in the auditor's report.

[24]DiPiazza, S. A., D. McDonnell, W. G. Parrett, M. D. Rake, F. Samyn, and J. S. Turley. 2006. *Global Capital Markets and the Global Economy: A Vision from the CEOs of the International Audit Networks.*

29. Perhaps more fundamentally, we believe thatcreating substantive disclosure requirements for the auditor's report will enhance investors' efforts to price debt and equity securities and improve their and other stakeholders' ability to assess management's stewardship, risk management practices, and overall corporate governance effectiveness. These outcomes would promote more informed investment decisions and create a further incentive for management of corporations to adhere to sound practices in managing the company's business and reporting its results of operations.

Other Desired Changes

30. Other proposed changes to the audit report that our survey respondents support include auditor discussions of: (a) sensitivity analyses in significant areas of judgment; (b) quantitative, and especially qualitative, materiality thresholds; (c) the key issues discussed in the auditor's summary audit memorandum; and (d) the nature and extent of work performed by other audit firms, including global affiliate firms of the primary auditor.

31. In addition, we believe that the audit report should explain the auditor's responsibility for detecting material fraud. Auditing standards currently require the auditor to plan and perform the engagement to detect material misstatements, whether caused by error or fraud.[25] Yet in the scope paragraph of the standard audit report, the auditor simply states, "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement."[26] The standard audit report should clearly state that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that reasonable assurance represents a high, although not absolute, level of assurance.[27]

32. We further believe that the audit report should indicate the auditor's responsibility for auditing the financial statement disclosures (notes) as well as the primary financial statements.[28] Additionally, the auditor's report should indicate that the auditor is independent of the company and that the auditor has complied with the independence requirements of the SEC and PCAOB.

[25]AU ¶ 110.02, AU ¶ 230.10, and AU ¶ 316.01

[26]AU ¶ 508.08

[27]AU ¶230.10

[28]Since note disclosure is far too often boilerplate, auditors should specifically indicate why a disclosure has remained the same in a given year compared to the previous year when there has been a substantial change in the financial statements – e.g., a significant increase (decrease) in the allowance for doubtful accounts or warranty repairs with little or no additional disclosure by management. Such a lack of incremental disclosure should prompt a review by the auditor and the results of that inquiry should be communicated to users of the financial statements.

We are not opposed to amending the audit report to indicate that management has the primary responsibility for the fairness of the financial statements, nor to clarifying the auditor's responsibility with respect to other information in documents containing audited financial statements.

Manner in Which Additional Information Should be Communicated

33. We believe that investors would be best served if new auditor reporting requirements were communicated to investors in a new report that the PCAOB's Concept Release describes as an Auditor Discussion and Analysis (AD&A). The majority of respondents to the IAG survey believe that additional substantive communications should be included in an AD&A rather than in required explanatory paragraph(s) appended to the existing auditor report.[29] In addition, we believe, and our survey respondents supported, a requirement that the engagement partner sign his or her name (in addition to the firm name) to the audit report.

34. Even if the PCAOB adopts an AD&A requirement, we believe that the standard three-paragraph audit report shouldstill be revised to more clearly communicate the results of an audit (e.g., referring to reasonable assurance, and discussing the auditor's responsibility for detecting material misstatements whether caused by error or fraud).

35. In our view, the key challenge to the PCAOB is to prevent an AD&A from reverting into boilerplate disclosure – in other words, becoming only a lengthier version of the existing auditor's report, which, as our survey respondents overwhelmingly believe, provides no useful substantive information. If this initiative results in nothing more than additional boilerplate disclosure, then itwill have failed and any additional costs will represent a dead weight loss to investors and society. But that is not areason for abandoning the effort, but rather for ensuring that it is implemented effectively.

36. We believe that the best way to prevent an outbreak of boilerplate disclosure is by setting clear expectations for auditor behavior through adopted standards and upholding them through a rigorous inspection and enforcement program. Toward that end, we suggest that the Board require certain topics to be addressed in the AD&A (e.g., financial statement and audit risk,

[29] The key issue to investors is that the additional communication between auditors and investors occurs, the mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor's report). However, in order to be an adequate substitute for an AD&A, emphasis paragraphs would have to be used very differently than how they are currently used. Professor Carcello analyzed the most recent audit report for every company in the S&P 500 and only five emphasis paragraphs existed. Even more troubling, these emphasis paragraphs were quite limited in their information content (see Appendix 2 where the five audit reports containing emphasis paragraphs are reproduced). Moreover, simply using emphasis paragraphs to highlight important matters already disclosed by the issuer – i.e., to provide a roadmap to the financial statements – would clearly fail to meet the needs of investors for incremental disclosures from the auditor.

estimates and judgments, accounting policies, unusual transactions, etc.), but that it not prescribe the required language within each section. The accounting profession has expressed concern about "free writing" audit reports, but investors are well positioned to efficiently process and analyze such additional disclosures.[30] Investors' interests will be best served by designing a new AD&A in a manner that requires the auditor to express judgments and assessments in a relatively subjective manner, based on the unique facts and circumstances of each audit, rather than in accordance with tightly prescribed language. We agree with Mark Newsome, Managing Director of ING Capital, who stated during the PCAOB's Roundtable on the Auditor's Reporting Model: "And so, if management financials are different even within peer groups, then why should the audit opinion be identical for companies within a peer group?"[31]

Challenges to Changing the Audit Report

37. PCAOB board member Jay Hanson has expressed concern about the ability of audit firms to provide additional disclosures, particularly in view of the 60-day filing deadline for the Form 10-K for large accelerated filers. To examine this issue, Professor Carcello gathered the most recent annual earnings announcement date for each company in the S&P 500 (a good proxy for the universe of large accelerated filers). The median earnings announcement lag – the number of days from year-end to the earnings announcement date – was 33 days. Given that the auditor often "signs off" on earnings before the earnings announcement, this suggests that much of the work involved in auditing the financial statements (or at least of the income statement and balance sheet) is completed within this time period. We also gathered the most recent 10-K filing date for the same S&P 500 companies. The median filing date was 21 days longer than the median earnings announcement date. Therefore, if the audit of the earnings number is substantially complete within 33 days after year end, we see no reason for concern about the ability of the auditor to write an AD&A in the remaining 15 days, especially since much of the information that would be included in an AD&A would already have been gathered in conducting the audit of the financial statements and communicated by the auditor to the audit committee.[32]

38. PCAOB board member Lew Ferguson has expressed concern about the cost associated with changing the standard audit report and whether any additional cost would be justified by the

[30]Indeed, our entire system of securities regulation is premised on investors' ability to effectively process complex disclosures. Those investors who read financial statements are arguably those most likely to be able to make such judgments.

[31]Transcript of the PCAOB's Roundtable on Auditor's Reporting Model (September 15, 2011).

[32]We recognize that substantial audit evidence is gathered before year end (i.e., interim testing). But as this interim testing is performed, the information needed for the AD&A will be gathered as well and the firm could begin drafting the AD&A well in advance of year end.

anticipated benefits. As we have emphasized, the investors we surveyed aremerelyasking thatauditors communicate more of the information they already have compiled and, in many cases, have already communicated to the audit committee. Any cost associated with communicating additional information should reflect only the time required to draft and review the communication. We expect these costs to be relatively modest given that the information to be communicated already exists and, more importantly, in our view the benefits of additional disclosure clearly outweigh the costs.

39. The PCAOB, with its passage of AS #5 and its statements at that time, established a precedent for evaluating both the effectiveness and efficiency with which audit services are provided. If the Board can evaluate, and hold firms accountable, for their efficiency in auditing internal control, the Board presumably could exercise its authority in a similar fashion with respect to the drafting an AD&A.[33]

Conclusion

40. We believe that expanding communications between auditors and investors in the manner described above will offer other salutary effects for both investors and auditors. Requiring the auditor to discuss risks, estimates and judgments, accounting policies, and unusual transactions should strengthen the auditor's position in negotiations[34] with management and lead to an improvement in the quality of the numbers reported in the financial statements. Areas of disagreement between the auditor and management that are not material enough to result in a qualified opinion, but which would be discussed in an AD&A, would provide the auditor with additional leverage to encourage management to improve its reporting.[35] In fact, DiPiazza and Eccles make this very argument: "More expansive audit opinions would provide a greater level of assurance to stakeholders, while creating an incentive for companies to improve their

[33]Much, if not all, of what has been proposed as AD&A content should be data and inferences used by auditors to evaluate the level and change in client risk. Therefore, the incremental cost of an AD&A should be limited to the cost of internal drafting, review, and discussion with management and the audit committee of the final content of the AD&A.

[34]During an audit, areas of disagreement related to how transactions are recognized, measured, and disclosed can sometimes arise between the auditor and the issuer. If the disagreement is not material enough to require the auditor to issue a qualified opinion, the resolution of these disagreements is the result of a negotiation process between the auditor and the issuer.

[35]Some representatives of the public accounting profession have argued that if the auditor prepares an AD&A then management will simply adopt whatever estimates, judgments, and policies that the auditor prefers, and this may be suboptimal because management may have greater insight into these issues than the auditor. Although this argument can't be conclusively refuted, we would ask one simple question in reply – in today's reporting environment, does management or the auditor have more leverage? In our view, the existence of an AD&A would simply put the two parties on more equal footing.

corporate reporting practices."[36] Moreover, as the United Kingdom's FRC argues, more transparent auditor reporting to investors should lead to enhanced auditor skepticism, which is a bedrock trait of effective auditing.[37]

41. We also believe that expanded communication between the auditor and investors would provide a recurring reminder to auditors that investors are their true clients. As a result, the auditor should disclose in the AD&A what investors need to know to understand the entity's financial position, results of operations, and cash flows, including related financial reporting risks. The resulting change in mindset would, in the words of PCAOB Chairman James Doty, "… change auditing from a culture that emphasizes client service to a culture that emphasizes public service."[38] Such a change in culture aligns with the PCAOB's mission "… to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."

We, as members of the PCAOB's Investor Advisory Group, jointly submit this comment letter.

Sincerely,

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[36] DiPiazza, S. A., Jr., and R. G. Eccles. 2002. *Building Public Trust: The Future of Corporate Reporting*. New York, NY: John Wiley & Sons.

[37] FRC. 2011. *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*, p. 14.

[38] James Doty's statement at the PCAOB open board meeting on June 21, 2011.

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Appendix 1 – Response to the Questions Posed in PCAOB Release No. 2011-003

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other financial statements.

   a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

**We believe that the Board should undertake a standard-setting initiative to improve the auditor's report. We believe that the current auditor's report is deficient as a communication vehicle, and that significant changes to the auditor's report are needed to remediate these deficiencies. See paragraphs 4-6 for an elaboration of our position.**

   b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

**We believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer's accounting practices and policies.**

   c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

**The IAG did not consider this issue in our investor survey related to the auditor's report and, as such, we do not take a group position on this issue at this time.**

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

   a. Should the auditor's report retain the pass/fail model? If so, why?

**The auditor's report should retain the pass/fail model. There was not a consensus among the investors we surveyed as to whether removing the pass/fail model would improve the quality of the auditor's report. A number of our survey respondents found the binary nature of the audit report to be of use to them.**

b. If not, why not, and what changes are needed?

**We believe that the current pass/fail model should be retained.**

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

**We believe that the standard audit report, with the pass/fail model being retained, should be supplemented with an Auditor Discussion and Analysis (AD&A). The additional information that should be communicated by auditors to investors (see our response to question 1b) would be included in an AD&A.**

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

**As the Board recognizes, some preparers and audit committee members argue that additional information about the company's financial statements should be provided by management (or by the audit committee). But the investors who responded to the IAG survey indicated that they want to receive additional communications about the company's financial statements from the auditor. Investors want direct communication from auditors because management's evaluations of its own estimates and judgments are inherently biased, whereas the auditor is an independent, objective third party. See paragraphs 9-11 for an elaboration of our position.**

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and are they necessary?

**The IAG did not consider this issue in our investor survey related to the auditor's report and, as such, we do not take a group position on this issue at this time.**

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

**We believe that investors would be best served if additional auditor reporting were to take the form of a new report that the PCAOB's Concept Release describes as an Auditor Discussion and Analysis (AD&A). However, the key issue to the investors surveyed by the IAG is that the additional communication between auditors and investors occurs. The mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor's report). The respondents to the IAG survey believe that additional substantive communications should be included in an AD&A rather than via required explanatory paragraph(s) appended to the existing auditor report.**

a. If you support an AD&A as an alternative, provide an explanation as to why.

**The additional communications that investors want from auditors involves the analysis and discussion of various financial statement issues. As such, it appears most appropriate to include this communication in a new narrative document, designed for this purpose, rather than to include these disclosures in a required emphasis of matter paragraph. Moreover, under current auditing standards, emphasis-of-matter paragraphs are used to elaborate on information that is already disclosed in the financial statements. We believe that auditors should communicate to investors information that is already communicated to audit committees but that is not generally communicated to investors. Therefore, since the additional communication contemplates information that is not currently disclosed in the financial statements, an emphasis-of-matter paragraph may not be the best method of auditors communicating this information to investors.**

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

**We believe that an AD&A should comment on both the audit and the company's financial statements, although commentary on the company's financial statements would predominate. For example, investors want the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; and (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas. Both of these disclosures include information about the company's financial statements and the audit of that information.**

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

**As stated previously, we believe the information most useful in making investment decisions, and that should be included in an AD&A, would require the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer's accounting practices and policies.**

**The types of disclosures desired by investors would be used to assess the company's future earnings potential, to assess the company's risk, and to evaluate the stewardship of management and the board of directors in overseeing the company's affairs. See paragraphs 28-29 for an elaboration of our position.**

d. If you do not support an AD&A as an alternative, explain why.

**We support an AD&A.**

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

**Although we believe that an AD&A is the best medium for auditor commentary on the audit and the financial statements, the key issue to investors is that the additional communication between auditors and investors occurs. The mechanism for this additional communication is of secondary import (i.e., the additional communication could be through our preferred AD&A or through required emphasis of matter paragraphs in the standard auditor's report).**

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

**An AD&A should indicate areas of high financial statement and audit risk and how the auditor addressed these risk areas. The appropriate content and level of detail should reflect, subject to legitimate confidentiality concerns, the current structure of a summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?

**We believe that the auditor should communicate the following about the company's financial statements: (1) the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (3) the quality, not just the acceptability, of the issuer's accounting practices and policies. Again, the appropriate content and level of detail should reflect, subject to legitimate confidentiality concerns, the current structure of a summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

8. Should a standard format be required for an AD&A? Why or why not?

**We believe that the Board should require certain topics to be addressed in the AD&A (e.g., financial statement and audit risk, estimates and judgments, accounting policies, unusual transactions, etc.), but that it should not tightly define the required language within each section.**

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

**We believe that auditor reporting on risks be limited to those that affect audit and financial statement risk, at least at the current time. Auditor reporting on business, strategic, and operational risk would represent a significant expansion of audit scope, and it is not clear to us whether auditors currently have a comparative advantage in reporting on this type of information or whether investors would attach significant value to the auditor's perspective on these categories of risk.**

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

**In our view, the key challenge to the PCAOB is to prevent an AD&A from devolving into boilerplate disclosure. The best way to prevent boilerplate disclosure is by setting clear expectations for auditor behavior through adopted standards and upholding them through a rigorous inspection and enforcement program.**

**We are less concerned about the consistency of AD&A reports than are certain other parties. All partners and firms could report in a very consistent manner and the end result may be boilerplate disclosure. We believe that the marketplace can process, and would in fact benefit from, some variability in disclosure formats and practices.**

**Investors are well-positioned to analyze these additional disclosures. See paragraph 36 for further detail.**

11. What are the potential benefits and shortcomings of implementing an AD&A?

**The primary benefit is substantial incremental disclosure to investors from an independent and objective source. The primary shortcoming is that there will be a cost to this disclosure, and an AD&A will be more subjective and have a greater variance than existing auditor reports.**

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

**We believe that the threat that the auditor's communication would diverge from that of management would strengthen the auditor's bargaining position and lead to an improvement in the recognition, measurement, and disclosure practices followed by management. See paragraph 40 for further detail.**

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

**Investors might benefit from having the auditor highlight significant related party transactions and accounting matters affecting the comparability of the financial statements in an emphasis-of-matter paragraph. However, since these matters are already disclosed in the financial statements, we expect that any benefit would be modest. However, if the Board decides against requiring an AD&A, we would support requiring emphasis paragraphs to discuss significant estimates and judgments, financial statement and audit risk, unusual transactions and other significant changes, and the quality of the entity's accounting policies and practices.**

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

**Only if the Board decides against requiring an AD&A.**

   a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

**We prefer an AD&A to emphasis paragraphs.**

   b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

**See our response to question #13.**

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

**See our response to question #13.**

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

**The appropriate content and level of detail should be patterned after the disclosure in the summary audit memorandum prepared by the engagement partner at the conclusion of the engagement.**

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

**See our response to question #10.**

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

**See our response to question #13.**

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

**The IAG did not consider this issue in our investor survey related to the auditor's report and, as such, we do not take a group position on this issue at this time. We therefore do not respond to questions 19a-19g and 20.**

a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of the financial statements
- Auditor's responsibility for information outside the financial Statements
- Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

**We believe that the audit report should indicate the auditor's responsibility for detecting material fraud. The standard audit report should clearly explain that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud. In addition, the report should indicate that reasonable assurance represents a high, although not absolute, level of assurance.**

**We further believe that the auditor should describe its responsibility for auditing the financial statement disclosures (notes) as well as the primary financial statements. Additionally, the auditor's report should indicate that the auditor is independent of the company and that the auditor has observed the independence requirements of the SEC and PCAOB. We are not opposed to amending the audit report to indicate that management has the primary responsibility for the fairness of the financial statements, nor to clarifying**

**the auditor's responsibility with respect to other information in documents containing audited financial statements. See paragraphs 31 and 32 for further details.**

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

**Yes. These clarifications would better explain to financial statement users the auditor's responsibility for detecting material misstatements due to fraud, would provide an acknowledgement that the auditor is responsible for auditing the financial statement notes, and would indicate that reasonable assurance is a high level of assurance (although not absolute assurance).**

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

**The audit report should disclose the nature and extent of work performed by other audit firms, including affiliate firms of the primary auditor (see paragraph 30). Also, the engagement partner should be required to sign the audit report (see paragraph 33).**

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

**We believe that the foregoing clarifications would not change the auditor's responsibilities, as they would simply clarify for the reader of the audit report the auditor's responsibilities under existing professional standards.**

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

**The benefit is that financial statement readers will have a better understanding of the auditor's current responsibilities. We are not aware of any major downside from requiring these clarifications.**

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

**We prefer an AD&A for the reasons previously articulated.**

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

**We prefer adding clarifying language to the standard audit report (see our response to #21a), and to requiring an AD&A to communicate new information to financial statement users.**

25. What alternatives not mentioned in this concept release should the Board consider?

**We believe that the changes in auditor reporting advocated in this comment letter would serve investors well at the current time.**

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

**We believe that the Board should write rules in a way that will encourage, or require, narrative commentary that is specific to the audit rather than formalized, non-specific recitations that fail to provide meaningful information.**

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

**The perception of a qualified or piecemeal opinion should not exist if the standard audit report is maintained (with modifications) and is supplemented with an AD&A. Moreover, the auditor would not be expressing an opinion in the AD&A.**

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

**The clarifying language we suggest would better convey the auditor's role in the performance of an audit. The problem isn't the auditor's role in the performance of the audit. The problem is that the auditor doesn't communicate enough about what he or she did and found. An AD&A addresses this problem.**

29. What effect would the various alternatives have on audit quality? What is the basis for your view?

**We believe that an AD&A would improve audit quality as its preparation would strengthen the auditor's position in negotiations with management relating to appropriate accounting treatments and disclosures. See our response to question #12.**

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain

entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

**We believe that the changes we advocate should be applied to all SEC registrants, unless a compelling case can be made for an exclusion. However, given that an AD&A would be a new requirement and there will almost certainly be a learning curve, implementing the requirement on a staggered basis depending on the issuer's size would be reasonable.**

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

    a. Are any of these considerations more important than others? If so, which one and why?

**We are most concerned about the impact of any change on audit quality, and audit effort and audit quality are positively correlated. However, as previously articulated, we believe that the changes we advocate will improve audit quality.**

    b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

**We believe that the benefits of an AD&A, assuming the AD&A includes the type of information we advocate and assuming boilerplate can be avoided, will exceed any reasonable level of incremental costs. See paragraphs 38 and 39 for additional detail.**

    c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

**None that we want to raise at this time.**

    d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

**Not applicable given our response to question # 31c.**

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

**As stated previously, we believe that providing additional information, either in an AD&A or in emphasis-of-matter paragraphs will strengthen the auditor's position in negotiations with management. We also believe that since audit committees oversee the financial**

**reporting process, that requiring the auditor to communicate additional information to investors will encourage the audit committee to become more actively engaged in overseeing the financial reporting process.**

Appendix 2 – Most Recent Audit Reports for S&P 500 Companies Containing an Emphasis-of-Matter Paragraph

"Other Emphasis of Matter"

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of American International Group, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of American International Group, Inc. and its subsidiaries (AIG) at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedules listed in the accompanying index present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, AIG maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). AIG's management is responsible for these financial statements and financial statement schedules, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A in the 2010 Form 10-K. Our responsibility is to express opinions on these financial statements, on the financial statement schedules, and on AIG's internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As described in Note 2 to the consolidated financial statements, AIG changed the manner in which it accounts for other-than-temporary impairments of fixed maturity securities as of April 1, 2009, as well as the classification of non-controlling interests in partially owned consolidated subsidiaries as of January 1, 2009. Also, as of January 1, 2008, AIG adopted a new framework for measuring fair value and elected an option to report selected financial assets and liabilities at fair value.

As described in Note 1 to the consolidated financial statements, AIG completed a series of integrated transactions to recapitalize AIG with the Department of Treasury, the Federal Reserve Bank of New York and the AIG Credit Facility Trust on January 14, 2011.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. As described in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A in the 2010 Form 10-K, management has excluded Fuji Fire & Marine Insurance Company, from its assessment of internal control over financial reporting as of December 31, 2010 because AIG acquired a controlling interest in Fuji Fire & Marine Insurance Company in 2010. We have also excluded Fuji Fire & Marine Insurance Company from our audit of internal control over financial reporting. The total asset and total revenues of Fuji Fire & Marine Insurance Company constitute approximately 2 percent and less than 2 percent, respectively, of the related consolidated financial statement amounts as of and for the year ended December 31, 2010.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ PricewaterhouseCoopers LLP

New York, New York February 24, 2011

"Other Emphasis of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders of Morgan Stanley:

We have audited the accompanying consolidated statements of financial condition of Morgan Stanley and subsidiaries (the "Company") as of December 31, 2010 and 2009 and the consolidated statements of income, comprehensive income, cash flows, and changes in total equity for the calendar years ended December 31, 2010 and 2009, the one month ended December 31, 2008, and the fiscal year ended November 30, 2008. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2010 and 2009, and the results of their operations and their cash flows for the calendar years ended December 31, 2010 and 2009, the one month ended December 31, 2008, and the fiscal year ended November 30, 2008, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 1 to the consolidated financial statements, the Company changed its fiscal year end from November 30 to December 31.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated February 28, 2011 expresses an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP New York, New York February 28, 2011

"Other Emphasis of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders

Scripps Networks Interactive, Inc.

We have audited the accompanying consolidated balance sheets of Scripps Networks Interactive, Inc. and subsidiaries (the "Company") as of December 31, 2010 and 2009, and the related consolidated and combined statements of operations, accumulated other comprehensive income (loss) and shareholders' equity, and cash flows for each of the three years in the period ended December 31, 2010. Our audits also included the financial statement schedule at Page S-2. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated and combined financial statements present fairly, in all material respects, the financial position of Scripps Networks Interactive, Inc. and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, such financial statement schedule, when considered in relation to the basic consolidated and combined financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

As discussed in Note 1 to the consolidated and combined financial statements, prior to its separation from The E.W. Scripps Company ("E.W. Scripps"), the Company reflects the combined financial position, results of operations and cash flows of the Scripps Networks and Interactive Media businesses of E.W. Scripps. The combined financial statements also include allocations of certain general corporate overhead expenses from E.W. Scripps. These costs may not be reflective of the actual level of costs which would have been incurred had the Company operated as a separate, stand-alone public company apart from E.W. Scripps.

As disclosed in Note 3 to the consolidated and combined financial statements, the consolidated and combined financial statements have been adjusted for the retrospective application of Accounting Standards Codification (ASC) 810, Consolidation (formerly Statement of Financial Accounting Standards (SFAS) No. 160, Noncontrolling Interests in Consolidated Financial Statements), which became effective January 1, 2009.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

Cincinnati, Ohio

March 1, 2011

"Other Emphasis of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Dr Pepper Snapple Group, Inc.

We have audited the accompanying consolidated balance sheets of Dr Pepper Snapple Group, Inc. and subsidiaries (the "Company") as of December 31, 2010 and 2009, and the related consolidated statements of operations, stockholders' equity and other comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Dr Pepper Snapple Group, Inc. and subsidiaries at December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

As discussed in the notes, the consolidated financial statements of the Company include allocation of certain general corporate overhead costs through May 7, 2008, from Cadbury Schweppes plc. These costs may not be reflective of the actual level of costs which would have been incurred had the Company operated as a separate entity apart from Cadbury Schweppes plc.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2011 expressed an unqualified opinion on the Company's internal control over financial reporting.

/s/ Deloitte & Touche LLP Dallas, Texas February 22, 2011

"Other Emphasis of Matter"

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders and Board of Directors of Marshall & Ilsley Corporation

We have audited the accompanying consolidated balance sheets of Marshall & Ilsley Corporation and subsidiaries (the "Corporation") as of December 31, 2010 and 2009, and the related consolidated statements of income, equity, and cash flows for each of the three years in the period ended December 31, 2010. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Marshall & Ilsley Corporation and subsidiaries as of December 31, 2010 and 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 26 to the consolidated financial statements, on December 17, 2010, the Corporation and Bank of Montreal announced that they had entered into a definitive agreement under which Bank of Montreal will acquire all outstanding shares of common stock of the Corporation in a stock-for-stock transaction.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Corporation's internal control over financial reporting as of December 31, 2010, based on the criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2011 expressed an unqualified opinion on the Corporation's internal control over financial reporting.

/s/ Deloitte & Touche LLP Milwaukee, Wisconsin March 1, 2011

Setting the global standard for investment professionals

September 30, 2011

PCAOB
Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 2006-2803

*Reference:* PCAOB Rulemaking Docket Matter No. 34

CFA Institute[1], in consultation with its Corporate Disclosure Policy Council ("CDPC")[2], appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.*

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets, and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

## General Comments

*CFA Institute Support for Changes to the Auditor's Reporting Model*

CFA Institute supports the efforts of the PCAOB to improve the independent auditor's reporting model. We have long expressed the need to improve the Standard Auditor's Report (SAR) as a means of communicating important information to investors and other users regarding the audit of a company's financial statements. It is our belief that the SAR along with the financial statements and management's discussion and analysis should be considered part of a holistic communication of valuable information to investors to make informed capital allocation decisions. Significant efforts and costs go into an audit, yet investors are provided very little information in the three paragraph report provided by the current SAR. Through increased

[1] With offices in Charlottesville, VA, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 100,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 133 countries, of whom nearly 83,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 135 member societies in 57 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

transparency, a revised auditor's reporting model should heighten user confidence in the audited financial statements and better inform them about the auditor's role.

The current SAR contains largely "boilerplate" language which has contributed to an "expectations gap", commonly understood as the gap between the auditor's performance, the auditor's communication of what they did, and the users' expectations regarding the audit process and findings. It is our belief that enhancements to the SAR hold the greatest promise to narrow this expectations gap and to provide decision-useful information to investors.

We are hopeful that the PCAOB will not delay enacting significant changes to the auditor's reporting model.

*CFA Institute Surveys Support Changes to the Auditor's Reporting Model*
CFA Institute has conducted multiple surveys[3] of our membership over the last few years on the importance of the SAR to investors and its information content. These surveys have consistently shown that the auditor's report is important to the analysis of financial statements but that it should provide more information about the basis for the auditor's opinion.

Among the more significant survey findings are:

- Seventy-two percent of respondents indicated that the auditor's report is important to the analysis and use of financial statements in the decision-making process.
- Fifty-eight percent of respondents indicated that the auditor's report needs to provide more specific information about how the auditor reaches their opinion.
- A large majority of respondents indicated that more information regarding materiality, auditor's independence, management's critical accounting judgments and estimates, and key areas of risk is important.

These surveys indicate that investors desire more qualitative information about the audit findings and audit process.

*CFA Institute Observations on the Pass/Fail Reporting Model*
The SAR has been commonly described as a pass/fail model since the auditor expresses an opinion on whether the financial statements are fairly presented (pass) or not (fail). This aspect of the SAR is beneficial because it is brief, clear, consistent and comparable. It benefits those investors who want to quickly scan the SAR for departures from the unqualified report. However, it has limited utility for those who desire a more thorough and complete understanding of the audit findings and the audit process. For this reason we believe that the pass/fail element of the model should be retained but, as explained in our responses to the specific questions from the PCAOB, it should be supplemented with additional information.

[3] CFA Institute, Usefulness of the Independent Auditor's Report, March 2011
http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_march_2011.pdf
CFA Institute, Independent Auditor's Report Survey Results, March 2010
http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf

*Auditor's Discussion and Analysis vs. Emphasis of a Matter*
The principal consideration regarding expanded disclosure of the audit findings and audit process should be the content, irrespective of where the information is reported. We preface our remarks, however, with the assumption that in either form (i.e. AD&A or emphasis of a matter) the additional disclosure will be a component of an auditor's report that will include the audit opinion. Whether the information is presented in AD&A or in emphasis of a matter paragraphs should not be a barrier to requiring the auditor to report the information, provided that in either situation it should carry the same level of professional accountability for quality.

Furthermore, while auditor reports are required to be delivered annually, we believe that the AD&A requirement should extend to quarterly financial statements as well. Although registrants are required to have quarterly reviews, there is generally no associated report. Investors would benefit from the auditor's perception of the quarterly financial statement reviews through disclosure of many of the same reporting attributes we specify in our response to Question 6.

*Improvements to the Current Auditor's Reporting Model will Require a Cultural Shift*
Investor needs should be paramount when considering revisions to the auditor's reporting model. Requirements should be set with a view toward providing the highest quality and most comprehensive information possible for investors. We draw attention to the PCAOB mission statement, which places investor interests in its first line:

> *The PCAOB mission is to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.*

We believe that for meaningful changes to be effective the reporting responsibilities of the audit committee, management, and independent auditors will need to undergo a cultural shift in reporting mindset. The historical reporting relationship has tended to be viewed as the auditor reporting to the audit committee and to management, rather than as a communication to investors. Instead, the reporting considerations of the auditor should be directed to the user, since it is the users (i.e. investors) who contract with the auditor, not management.

Shifting from the current mindset will take time and, given liability concerns, many audit firms are likely to oppose the alternatives in the concept release. Moreover, there is the potential that, even with a new and expanded audit reporting model, liability concerns will quickly cause any new disclosure requirement to revert to boilerplate reporting. *We urge the PCAOB to bear in mind that the investor pays for and is the ultimate consumer of the auditor's report and that the boilerplate nature of the existing model requires improvement and use of boilerplate in the revised report, should be discouraged by issuing a well-written standard that is rigorously enforced.*

*Audit Committee Reporting*
Although the matter of audit committee reporting is not part of the Concept Release, we believe that investors would also benefit from enhanced reporting directly from audit committees. It is our belief that requiring greater reporting to investors by the audit committee would enhance the overall value of the audit and provide useful information to investors. We suggest that the

PCAOB work with the appropriate governing bodies in a separate initiative to enhance the audit committee reporting requirements for the benefit of investors.

*CFA Institute Responses to Specific Questions*
CFA Institute responses to specific questions are presented in the **Appendix** to this letter.

**Closing Remarks**

We thank the PCAOB for the opportunity to express our views on the Auditor's Reporting Model. If the PCAOB have questions or seek further elaboration of our views, please contact Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

*/s/Kurt N. Schacht*
Kurt N. Schacht, JD, CFA
Managing Director
Standards & Financial Markets Integrity Division
CFA Institute

*/s/ Gerald I. White*
Gerald I. White, CFA
Chair
Corporate Disclosure Policy Council

cc: CFA Institute Corporate Disclosure Policy Council

**Appendix**

## Responses to Specific Questions

1. ***Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.***
   a. ***Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?***
   b. ***Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?***

CFA Institute supports the PCAOB initiative to improve the independent auditor’s reporting model. The current standard auditor’s report (SAR) is in need of enhancement to provide additional information beneficial to investors regarding the audit findings and audit process beyond what is provided by the current pass/fail model. The auditor provides a valuable service for the users of financial statements regarding the reliability of reported operating results, cash flows, and asset/liability balances. However, the current three paragraph, largely boilerplate, report is not sufficiently informative to meet the needs of investors who would benefit from further insights into the auditor’s perspective on the audit findings and the audit process. Changing the auditor’s reporting model, which has been largely unchanged for decades, holds the greatest promise of providing relevant and decision-useful information to investors, provided that it does not revert to uninformative boilerplate language.

We are not in favor at this time of expanding the auditor’s role to include assurance on matters outside of the financial statements beyond what is already presently required by the auditing and attestation standards. It is our belief that the PCAOB should remain focused on making the necessary and immediate changes to the existing auditor’s reporting model.

2. ***The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cashflows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."***
   a. ***Should the auditor's report retain the pass/fail model? If so, why?***
   b. ***If not, why not, and what changes are needed?***
   c. ***If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.***

As noted in our opening remarks, CFA Institute supports retention of some form of the existing pass/fail model. However the model should be supplemented with additional reporting requirements regarding the audit findings and the audit process as noted in our answer to Question 6. The pass/fail model provides a clear and consistent means for a user to assess the results of the audit and the auditor's opinion. There are many investors who mainly scan the SAR to identify departures from the unqualified opinion and the pass/fail model meets their needs. However, the information needs of those who desire more information regarding the audit findings and audit process are not met. A model that combines both a pass/fail opinion with additional reporting requirements is optimal and would satisfy the needs of most investors.

See our response to Question 6 for the additional information we believe should be added to the auditor's report.

3. ***Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.***

We believe that the information regarding audit findings and audit process is best provided by the auditors, not management. The auditors are in the best position to provide information about their perspective on the reported financial results and the audit process since they are an independent third party and can offer an objective unbiased assessment of the financial statements. Furthermore, an independent assessment of the accuracy of the financial statements is necessary in order to maintain the integrity of the financial reporting process.

4. ***Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?***

   No response.

5. ***Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?***
   a. ***If you support an AD&A as an alternative, provide an explanation as to why.***
   b. ***Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?***
   c. ***Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?***
   d. ***If you do not support an AD&A as an alternative, explain why***.
   e. ***Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?***

   As noted in our opening remarks, we believe that either an AD&A or emphasis of a matter paragraphs would be acceptable means of communicating additional information regarding the audit findings and audit process provided that both locations carry the equivalent level of professional accountability for quality. Our principal concern is that the information should be reported by the auditor in such a way that it is not construed to be reported by management.

We also urge the PCAOB to consider requiring an AD&A on quarterly and interim financial information since investors rely on these periodic filings and currently often do not receive a report on the reviews conducted by the auditor. An AD&A on interim filings would provide much needed transparency regarding these reviews.

See our response to Question 6 regarding type of information to be reported to users.

**6.** ***What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?***

In accordance with the PCAOB Auditing Standard No. 3 paragraph 13, the auditor must identify all significant findings or issues in an engagement completion document. This document identifies and discusses the significant findings or issues and the basis for conclusions reached in connection with each engagement. The information in the completion document would be of interest to investors because it provides the auditor's perspective on significant risks and other matters associated with the audit. Much of this information is already documented in the auditor's working papers in connection with the issuance of the auditor's report. We believe that the auditor should report these same matters in plain, non-boilerplate language. We are not suggesting any change in audit scope or additional procedures, but that the auditor simply report what was done in conducting the audit, using information already largely contained in the audit completion memo.

We believe that the PCAOB's Concept Release illustration starting on page 15 includes the following elements in addition to others that we would consider important:

- <u>Audit Risk</u>- Provide a discussion of significant risks identified by the auditor and include factors the auditor evaluated in determining which risks are significant and how they were audited and assessed. This risk assessment should include not only specific financial statement risks, but also the auditor's overall client risk assessment factors. Also discuss why the auditor views these risks as significant.
- <u>Auditor Independence</u>- Provide a discussion of any matters that were reported and discussed with the audit committee concerning independence.
- <u>Auditor Materiality</u>- Provide details about the quantitative and qualitative materiality levels and factors the auditor considered in establishing materiality levels.
- <u>Assessment of Management's Critical Accounting Judgments and Estimates</u>- Provide a discussion of the critical accounting estimates that were discussed with management or the audit committee, the assumptions underlying the critical accounting estimates, and the auditor's assessment of and findings associated with the evaluation of these critical estimates. This could also include a discussion of movements and ranges around critical estimates.

- Accounting Policies and Practices- Provide a discussion of:
  a. Discretionary changes in accounting principles or estimates affecting the consistency of reported amounts.
  b. Qualitative aspects of the company's accounting practices, financial statements and disclosures discussed with the audit committee or management.
  c. Material matters that, while in technical compliance with the financial reporting framework, could have enhanced disclosures to improve investor understanding of the matters.
  d. Significant unusual transactions in the current reporting period.

This discussion should focus on the reasons why the auditor considers changes in critical accounting policies to be significant and include a statement that they found no inconsistencies in their review. The auditor should also discuss any changes in accounting policies and practices not deemed critical by the auditor and/or management. The auditor should opine on any accounting policies and practices that represent a significant departure from policies and practices commonly applied by comparable firms in relevant industries.

- Summary of Unadjusted Audit Differences- List and discuss all unadjusted audit differences by financial statement line item.
- Audit Scope Changes & Unique Management Representations- Discuss audit scope limitations or expansion in audit scope and the impact on the financial statements. Additionally, include a description of any unique/non-standard representations included as a part of the management representation letter.
- Difficult or Contentious Issues, Including "Close Calls"- Discuss any difficult or contentious issues or "close calls" that arose during the audit and the final resolution of each issue.

***7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?***

See response to Question 6. However, it is worth reiterating that the appropriate level of detail would be that which is documented in the auditor's completion memo, but written in plain English.

***8. Should a standard format be required for an AD&A? Why or why not?***

We believe that there should be some overall guidance regarding the format and content, however, we caution against an overly prescriptive format that could lead to the reporting requirements becoming boilerplate. The main objective should be to communicate information about the audit findings and audit process tailored to a company's particular circumstances.

9. ***Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?***

   To the degree that business risks, strategic risks or operational risks have a direct bearing on the financial statements – such as those that may impact the valuation of assets and liabilities, the related critical accounting judgments and estimates or the entities ability to continue as a going concern – then the auditor should provide information about how those risk factors were assessed and the overall impact on the financial statements and their audit process and findings. It is our belief that the auditor should also be expected to communicate information with respect to risks associated with the audit and internal controls.

   We are not in favor of the auditor reporting on business risks, strategic risks or operational risks outside of those with direct impact on the reported amounts in the financial statements as noted above. Commenting on these areas would require the auditor to be more fully embedded in the management of the company on a more contemporaneous basis in order to have a complete understanding of the matters. This is not, in our view, the role of the independent auditor. Management on the other hand should comment on the business, strategic and operational risks through the MD&A.

10. ***How can boilerplate language be avoided in an AD&A while providing consistency among such reports?***

    Boilerplate language can be avoided if the auditor identifies and reports on the unique issues facing the company. Audits are customized to address these issues and the investors would benefit from an auditor report in similar terms.

    As previously mentioned, while we think there should be some overall guidance about the form and content of the additional reporting requirements, we do not think it should be overly prescriptive which could lead to boilerplate language in the report.

11. ***What are the potential benefits and shortcomings of implementing an AD&A?***

    We believe that the benefits of implementing additional disclosure by the auditor are clear; an enhanced understanding of the auditor's perspective on the critical issues of the audit findings and audit process which will result greater transparency for the benefit of investors is long overdue.

    The shortcomings in implementing AD&A are rooted in the cultural shift in the current auditor's reporting model. A switch from the current mindset that the auditor is reporting to management and the audit committee to a user focused reporting relationship may pose challenges. We believe that, through proper review and enforcement of the auditor's reporting by the PCAOB, the content and quality should improve.

12. ***What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?***

    There is the potential for the additional disclosure to present inconsistent or competing information between auditor and management. There are some who argue that this would only confuse investors and other users which is not the case. We believe that on balance it should improve management's presentation of the financial results. With the added transparency provided by the new reporting requirements, management and the auditor would be expected to work together to resolve differences in advance of issuing the audited financial statements.

    We also do not believe that undue consideration should be devoted to this concern. The point of the additional reporting requirements is for the auditor to communicate to the investor. There is informational value to the investor if the auditor and management report inconsistent or competing information. As an example, any audit difference is a reflection of a difference of opinion between the auditor and management. Disclosure of such differences will not confuse investors.

13. ***Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?***

    See response to Question 6.

14. ***Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?***
    a. ***If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.***
    b. ***If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.***

    See response to Question 6. If it is decided that emphasis of a matter paragraphs should be used, it should be made a requirement rather than be permitted and the contents of the emphasis of matter paragraphs should not be substantively different from contents of an AD&A.

15. ***What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?***

    See responses above.

16. ***What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?***

    See responses above.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

We believe that the audit committee and the PCAOB are in the best position to ensure that audit reports do not include boilerplate language. Additionally, we think there should be guidance issued about the objective and preparation of the additional reporting requirements noted in our response to Question 6 and that it not be overly prescriptive but rigorously enforced.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

See responses above.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*
*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*
*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*
*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*
*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*
*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*
*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

See response to Question 1.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

See response to Question 1.

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

a. ***Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?***

b. ***Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.***

c. ***What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?***

d. ***What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?***

We believe that clarification of the auditor's responsibilities will assist investors to understand better the auditor's role and narrow the expectations gap. We draw particular attention for the need to clarify the auditor's responsibility for detecting and reporting material fraud, which would be especially beneficial to users. It is our belief that further explanation of the extent of the auditor's fraud detection responsibilities combined with clarification of the auditor's responsibilities under the reasonable assurance standards will help narrow the expectations gap.

Additionally, the auditor's responsibilities for matters outside of the financial statements should be clarified since currently there is some confusion regarding these responsibilities.

22. ***What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?***

The benefit is that the expanded language will close the expectations gap by clarifying the auditor's responsibilities and perspective on the financial statements. For example, auditor independence is not mentioned in the main body of the auditor's report aside from the reference to the "Independent Registered Public Accounting Firm" in the title. The report could be strengthened by additional wording to describe exactly that the auditor has the duty to be independent of the company.

Also, in the case of the auditor's responsibility for information outside the financial statements for example, the auditor is required to read the other information accompanying the financial statements. This responsibility is not contained in the audit report and, if included, would alert investors to this responsibility.

23. ***This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?***

See response below.

24. ***Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?***

As mentioned in our responses above, we are indifferent to whether an AD&A or emphasis of a matter paragraphs are used if the contents are the same and the degree of professional responsibility is identical. The most important considerations are that the investors receive the expanded disclosures directly from the auditor.

***25. What alternatives not mentioned in this concept release should the Board consider?***

As stated in our opening remarks, we believe that the PCAOB should consider a separate initiative on requiring that audit committees report directly to investors. However, this should come at a later date and not delay the immediate and necessary changes to the current auditor's reporting model.

***26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?***

In order to minimize the potential for boilerplate reporting we believe that the guidance should not be overly prescriptive. However, we do believe a framework is necessary in order to guide the preparation of the report.

***27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?***

We do not believe that investors would perceive any of the alternatives as qualified or piecemeal opinions. Rather, it would be seen as a more thorough and transparent basis for the audit opinion, especially by retaining the pass/fail element of the existing model.

***28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?***

The additional descriptive language regarding the auditor's responsibilities in the auditor's report is the most effective means of conveying to investors the auditor's role in performing the audit.

***29. What effect would the various alternatives have on audit quality? What is the basis for your view?***

We believe that the avoidance of boilerplate language and clear qualitative descriptions of the audit findings and the audit process directly by the auditor, including enhanced descriptions of the responsibility of the auditor, should improve audit quality.

***30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities?***

***If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.***

We believe that the requirements should apply to all entities given that the information is equally relevant and important to investors regardless of the type of entity. We also note that the distinction between public and private enterprises has become increasingly blurred in recent years due to the growth of private equity.

***31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.***

***a. Are any of these considerations more important than others? If so which ones and why?***

***b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?***

***c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?***

***d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?***

While we understand the challenges presented by changing relationships, audit effort, auditor liability, etc. we believe that they should not either individually or in the aggregate override the need to improve the auditor's reporting model. The auditor provides a key service on behalf of the investor and revision of the current ineffective model is essential to adding transparency to the audit process and purpose.

We are aware that there are those in company management and in the audit committee who will object to changes for a variety of reasons. For instance they will argue against changes to the already well entrenched auditor's reporting model because of increased exposure to legal actions and increased audit fees. However, investors and other users have been disadvantaged by the lack of transparency and the uninformative auditor's report currently in place. Investors pay either way, through increased costs for additional information or through lacking information to assist them in making informed investment decisions. We do not believe that requiring the auditor to describe the audit findings and the audit process is an expansion of scope. We are simply asking that auditor's report on what they did and their findings, including the factors unique to the company that influenced the auditor's process and decisions.

***32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?***

We believe that including the additional information in the auditor's report will strengthen the interaction among the auditor, management, and the audit committee. It will change the reporting model that is currently grounded solely in the auditor-to-management reporting relationship to one focused more on investors and other users of the financial statements. The resulting change in auditor mindset can only increase *de facto* independence.

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September 28, 2011

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

**Rulemaking Docket #34**

Sirs:

I am a member of the Board of Directors of the following:

- Edison International (NYSE:EIX) and member of the Audit and Finance Committees,
- EuroPacific Growth Fund ("AEPGX"), New Perspective Fund, Inc., ("ANWPX") and New World Fund ("NEWFX"), all members of the American Funds family of mutual funds advised by Capital Research and Management Company ("CRMC"), Chair of the Audit Committees, designated Audit Committee Financial Expert and member of the Contracts Committees,
- Blue Shield of California, a not-for-profit health plan covering approximately three million members in California, Chair of the Audit Committee and member of the Finance and Compensation Committees,
- Forest Lawn Memorial Parks Association, a not-for-profit mortuary and cemetery business, member of the Audit, Risk Management and Investment Committees.

I was a partner of KPMG from 1986 to 1997 and an auditor and consultant to various public and private companies from 1976 to 1997.

My comments on the Public Company Accounting Oversight Board's ("PCAOB") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements No. 2011-003, PCAOB Rulemaking Docket Matter #34* contained in this letter are mine alone and do not represent those of my fellow board members nor management of the above named companies.

I commend the Public Company Accounting Oversight Board ("PCAOB") for its efforts in evaluating the status quo to improve both understanding of the auditor's responsibility and written communication between financial statement users and the auditors. However, efforts towards improvement should not change the fundamental roles and responsibilities of a Board of Directors ("Board"), its Committees or the auditors.

Our system of corporate governance consists of shareholders electing a Board to provide management oversight. The Board delegates the oversight of financial reporting, including the system of internal controls and risk management to the Audit Committee. The companies I am involved with are well managed, ethical organizations resulting from "tone at the top", with open, honest and transparent communication between management, the Board, its Committees and the auditors. Each of the companies' management respond positively to Board or committee requests for information and to challenging questions asked with respect and a healthy dose of skepticism. My fellow Audit Committee members in each of the above organizations are professional, financially literate, diligent and very engaged.

The **Auditor Discussion and Analysis ("ADA")** contemplates public disclosure of much of what already occurs between the auditor and the Audit Committee (e.g. the auditor's Required Communications to the Audit Committee). Our Audit Committee discussions with management and the auditors, and in executive session with the auditors only, are very valuable. These discussions involve the auditor's assessment of significant audit risks; management's bias with respect to judgments, estimates, significant accounting policies and disclosures; any difficulties encountered during the audit and other issues pertinent to the situation. The Audit Committee members probe, ask follow-up questions and pursue other topics. The Audit Committee exercises judgment built up from years of personal experiences and education as well as knowledge of the company obtained over time. Requiring public disclosure of what have heretofore been private discussions would severely limit these discussions, if for no other reason than fear of litigation, reducing the effectiveness and benefit of an active audit committee process. I believe the ADA would undermine the role and responsibility of the Audit Committee by substituting the auditor for the Audit Committee's judgment and change the fundamental concept of corporate governance of a Board.

In addition, The PCAOB's ADA proposal may require delays in providing information to investors or at a minimum require changes to the year-end approval process if the ADA conflicts with the MD&A. Currently the schedule for large accelerated filers requires annual reports on Form 10-K to be filed within 60 days from the end of the year. Due to complexity of the accounting and reporting requirements, meeting these deadlines require significant time and resource commitments with little flexibility for resolving conflicts. It would be unlikely for the Audit Committee to accept an unqualified opinion with an ADA in conflict with the MD&A without additional meetings with management and the auditors to understand both parties' rationale and resolve the conflicts between management and the auditors. If resolution is unsuccessful, the Audit Committee will be in an untenable position because of the confusing message that this will send to investors.

The financial statements for SEC registered investment management companies are less complex than operating companies because there are fewer judgments and estimates. The most significant audit risk, existence and valuation of the investment portfolio, is determined fairly routinely because of the nature of the investments at least with respect to the afore mentioned mutual funds—large cap securities traded on major exchanges around the world. Management, utilizing third parties, values the investment portfolio daily and retains third party custodians to maintain safe-keeping of the assets. Annually, the auditors independently price 100% of the portfolio and confirm their existence with the custodians. Mutual funds are also exempt from MD&A requirements. It would seem that an ADA for mutual funds is not applicable because it does not improve current disclosure and would negatively impact shareholders due to increased audit costs.

As a result, I strongly oppose the requirement that auditors issue an ADA for the reasons mentioned above.

The Concept Release proposes mandating an **Emphasis Paragraph** in the auditor's report to highlight significant matters. Management is responsible for the financial statements and disclosures, which include all significant matters. The auditor's report with an unqualified opinion affirms that the financial statements and disclosures are fairly presented and free from material misstatement—confirmation that the auditor agrees with management's disclosures. An Emphasis Paragraph would appear to be redundant.

All investors are not equal and the Emphasis Paragraph could clarify for the individual or unsophisticated investor that the auditor's unqualified opinion means that they agree with management's disclosures. Although the Emphasis Paragraph does not appear to involve significant additional cost, it is likely to evolve into standardized language without improving current disclosure.

The auditor currently performs limited procedures on **Information Outside the Financial Statements** to assure that the information is materially consistent with the financial statements. The proposal to expand the auditor's limited procedures to assurance would not only be costly but also require the auditor to provide assurance on areas not within their expertise. MD&A guidance is not prescriptive and allows management the flexibility and judgment to decide what to disclose based upon their day-to-day working knowledge of operations, liquidity and capital resources, regulatory risk, legal matters, etc.

SEC registered investment management companies are exempt from MD&A and do not issue earnings releases. Mutual funds are required to provide Management's Discussion of Fund Performance in shareholder reports addressing subjects such as, market trends and portfolio strategies.

I oppose expanding the auditor's scope of work to Information Outside the Financial Statements because the auditor does not have the expertise nor have the same depth of knowledge as management. As a result, it seems likely that this approach would add more confusion rather than clarity to the reporting process and ultimately the disclosures.

**Clarification of The Auditor's Report** may help the individual or unsophisticated investor understand what an audit represents and the limitations to the auditor's responsibility, for example the detection of fraud. However, the sophisticated investor may not see any benefit. Although this alternative does not appear to involve additional cost, I believe that any proposed language should be standardized, consistent for all auditors and across all entities.

Thank you for considering my views.

Yours truly,

Vanessa C. L. Chang

Vanessa C. L. Chang

Chevron

**Matthew J. Foehr**
Vice President and
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September 21, 2011

Via email to comments@pcaobus.org

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

**Re: PCAOB Rulemaking Docket Matter No. 34**

Chevron Corporation (Chevron) appreciates the opportunity to provide comments to the Public Corporation Accounting Oversight Board (PCAOB) on the concept release regarding possible revisions to PCAOB standards related to reports on audited financial statements – Rulemaking Docket Matter No. 34.

Chevron is a global, integrated energy company based in San Ramon, California. The company explores for, produces and transports crude oil and natural gas; refines, markets and distributes transportation fuels and other energy products; manufactures and sells petrochemical products; generates power and produces geothermal energy; provides energy efficiency solutions; and develops the energy resources of the future, including biofuels. The company's activities are widely dispersed geographically with operations in North America, South America, Africa, Asia, Australia and Europe.

We appreciate the PCAOB's consideration as to what might enhance communications to investors and what might lead to more efficient markets and improved allocations of capital. While there may be some opportunity for improvement within the current auditor's report to clarify what an audit represents and what an auditor's responsibility is, we strongly believe that it is management's responsibility to provide investors with information about the company and the financial statements. Many of the proposals in the concept release infringe upon this principle, which we believe should be protected and strengthened. If there are shortcomings in disclosure identified through the PCAOB's outreach efforts, we believe they should be addressed through additional rule-making by the appropriate authority (e.g. FASB or the SEC) to enact changes to management's reporting requirements. Additionally, we would like to note that we are not aware that our investors have asked for, or are asking for, any expansion in auditor communications. We believe that providing significant additional information in the auditor's report would impose real costs that will ultimately be borne by the company's shareholders, and therefore, that the incremental costs associated with providing this information should be carefully balanced with the perceived benefits.

Please see detailed responses below to selected questions, which provide further background and clarification of our position.

***Question 1.*** *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*
*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe the auditor's role should be expanded to provide assurance on matters in addition to the financial statements. The current scope of the auditor's role is adequate and functioning appropriately. Additionally, for a large, accelerated filer such as Chevron there may not be sufficient time for the auditor to complete the audit of the financial statements and provide assurance in additional areas. This could distract the auditor from their primary responsibilities and potentially reduce the quality of the audit of the financial statements. We do not believe that additional assurances from the auditor would be sufficiently useful to offset this risk and the incremental costs.

***Question 2.*** *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*
*a. Should the auditor's report retain the pass/fail model? If so, why?*

We believe that the current "pass/fail model" is adequate for the same reasons identified by investors in the PCAOB's outreach. The standardized language of the auditor's report provides consistency, comparability, and clarity of auditor reporting. We do not share the concerns about the standard auditor's report being "boilerplate"; in our view, a standard is the natural and predictable end result of a pass/fail process that is consistent and comparable. For most companies, the report quickly conveys the necessary information to investors. The greatest strengths of the report could be quickly lost, and confusion unnecessarily created, if auditors were to attempt to convey subtleties that underlie their opinion. This type of information should be documented in the auditor's workpapers and conveyed to the audit committee (as per existing requirements), but should not be communicated by the auditor directly to the investing community.

***Question 3.*** *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

Financial reporting standards are very clear that the financial statements are the responsibility of the company's management. Management bears responsibility and certifies to the completeness and accuracy of the financial statements. Any additional information that is deemed necessary should be provided by management.

***Question 5.*** *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*
*d. If you do not support an AD&A as an alternative, explain why.*

We are strongly opposed to the Auditor's Discussion & Analysis (AD&A) as an alternative. As noted in our response to Question 3, providing information about the financial statements is the responsibility of management. There would be significant effort involved in preparing and reviewing an AD&A, discussing it with management and the board audit committee, and resolving potentially confusing differences between it and management's report. All of these activities would divert attention from each party's critical and distinct responsibilities regarding the financial statements and would blur duties between preparer and auditor.

Furthermore, all the key points noted as potential topics for the AD&A already have an established forum for their communication that does not distort the lines of responsibility. For example, the auditor's views regarding the company's financial statements - such as management's judgments and estimates, accounting policies and practices, and where the company could have applied different accounting or disclosures - is already required to be communicated by the auditor to the board audit committee. Management is already required to discuss its significant accounting policies in the notes to the financial statements and its critical accounting estimates and assumptions in Management's Discussion and Analysis (MD&A). The auditor audits the notes and reads the MD&A for consistency with the audited financial statements.
The auditor's significant judgments in forming the audit opinion should be documented in its working papers. These are subject to scrutiny through peer and PCAOB reviews and are not intended for the general public because of the confidentiality of the information, the high level of detail and the significant judgments involved. We do not believe that dissemination of this information should extend beyond existing frameworks.

In the concept release there is mention of significant, but not material, items using various characterizations: "close calls", "significant deliberations", and "potential material impact." The existing financial reporting and internal controls frameworks generally only require reporting of material items in the financial statements. All of the aforementioned characterizations begin to shift and distort those reporting requirements as more attention is paid to significant, but not material, items. Many existing standards and rules would have to be rewritten to further clarify this expansion of reporting. We do not believe this is necessary or efficient. While a healthy dialogue exists between management and the auditors regarding all types of significant items, it would be very difficult under existing reporting deadlines to develop useful and understandable discussions of those items for financial reports. We feel that existing reporting requirements regarding material items are adequate and functioning appropriately. Any move into partial reporting of some significant, but not material, items would only add cost and create potential confusion and overly expansive and confusing disclosures.

***Question 14.*** *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*
*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

We do not support a requirement to include areas of emphasis in each audit report. We believe this will result in "boilerplate" language. Furthermore, existing standards already allow the auditors to add areas of emphasis at their discretion. We believe this is functioning as appropriate and preserves the auditor's ability to include or exclude references, as necessary, based on the circumstances involved.

***Question 19.*** *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*
*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

We do not support auditor assurance on other information outside the financial statements. Under existing standards, the auditor already reviews the other information in documents containing audited financial statements and considers whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact. Management carefully considers any comments on this information provided by the auditor. Expanding the audit assurance effort to include the MD&A and earnings releases would substantially increase audit fees and there may not be adequate time to complete the additional procedures within existing reporting deadlines. Moreover, we believe this expansion of effort would not add meaningful value beyond that currently provided by the auditor's review of this information to ensure its consistency with the audited financial statements. If there are misunderstandings within the investing community about the scope and role of the auditor with regard to information outside the financial statements, we would support some inclusion in the auditor's report, which clarifies the existing role. See further discussion below.

***Question 21.*** *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We do not have any significant concerns with additions to the auditor's report to clarify terms or the auditor's existing responsibilities. Of the items noted, we believe it may be most useful to provide clarifications on the auditor's responsibility for monitoring fraud, the auditor's and management's responsibilities regarding the financial statements, and the auditor's responsibility for information outside the financial statements. Clarifying the definition of reasonable assurance and providing additional commentary on auditor independence would not add value. The auditor's independence is directly stated in the title of the report, "Report of Independent Registered Accounting Firm."

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

A succinct clarification of some of the above items could augment investors' understanding of what an audit is and what responsibilities the auditor has. We would expect that, with any new additions, a standard, unqualified auditor's report should still fit on a single page within the financial report.

***Question 23.*** *This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

The only option that Chevron supports is the clarification of certain items in the auditor's report. All of the other alternatives weaken the core principle that communicating information regarding the financial statements is the responsibility of management. The auditor should focus on completing the audit effectively and improving its communication with management and the board audit committee, within existing standards, which we believe to be adequate. The auditor should not have an expanded role in communicating information to investors and financial statement users beyond the inclusion of its opinion in the financial report. It is not surprising that the PCAOB would discover in its outreach efforts that investors would like to receive more information from the auditors. Likewise, they would certainly like to receive additional information from the company's external legal counsel, regulators, and other entities, which have access to information about the company that is not in its financial reports. However, we believe the confidential nature of much of this information and the complexity of the auditor's judgments underlying their opinion are most appropriate for their workpapers.

* * *

If you have any questions on the content of this letter, please contact Al Ziarnik, Assistant Comptroller, at (925) 842-5031.

Very truly yours,

Matthew J. Foehr

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October 14, 2011

Mr. Martin F. Baumann, Chief Auditor
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Release No. 2011-003; Rulemaking Docket Matter No. 034; Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Dear Mr. Baumann:

In Release No. 2011-003 (the "Release"), the Public Company Accounting Oversight Board (the "Board" or "PCAOB") solicited public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements. We compliment the Board on its outreach in connection with the preparation of the Release and urge it to continue its efforts to make the financial statements and the auditor's report more transparent and relevant to investors. We welcome the opportunity to comment on the Release and on this important issue.

## I. Introduction

Our perspective in considering the auditor's report is informed by our role as legal advisers that represent issuers and others in connection with a wide variety of matters that are intimately involved with the financial reporting process. Among those matters are the following:

- We advise issuers in the preparation of their disclosure, including, in particular, financial reporting, during which we work closely with management, audit committees and auditors.

- We advise issuers and underwriters in a wide variety of capital markets transactions for which financial reporting is a critical element.
- We advise issuers, investors, acquirors and other participants in a wide variety of corporate transactions, including mergers and acquisitions, in which financial reporting is also critical.
- The transactions in which we participate (both capital markets and corporate) include public transactions involving disclosure to a broad range of investors and private transactions involving sophisticated institutional investors.

In all of these contexts, we are dedicated to the full and fair disclosure – and in particular financial disclosure and reporting – called for by the federal securities laws, transparency to investors and markets, and the improvements in financial disclosure and reporting that are fostered by the application of robust auditing standards by independent external auditors.

The Release correctly acknowledges the investment community's concern that auditors might have information useful to investors and other financial statement users that is not communicated under the existing pass-fail model of the auditor's report. While we think some modifications to the auditor's report may be desirable, we believe the Board should keep four principles in mind as it considers any changes to the auditor's report.

First, any change to the auditor's role or report must have a significant probability of improving the financial reporting process and its results. Most of the alternatives discussed in the Release relate to providing investors more information about the audit process and the decisions of management, the audit committee and the auditors in connection with the audit and financial statements. Such disclosure only provides benefits if it in fact improves the quality of financial reporting. For example, the Release suggests consideration of whether to propose an Auditor Discussion & Analysis ("AD&A") where, among other topics, auditors would provide discussion of alternative accounting treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management. We do not think a discussion of alternative accounting treatments necessarily improves investors' understanding of an issuer's financial statements, because it risks burdening investors with too much information that may obscure what is truly important. If the treatment adopted and disclosed by management conforms to generally accepted accounting principles ("GAAP"), then, by definition, such treatment is acceptable accounting and, under the standard of the auditor's report, must fairly present the issuer's financial position. Further, a voluntary change to applicable accounting principles generally requires the issuer to conclude, and the auditor to agree, that application of the new principle is preferable.

Second, if there is additional information regarding an issuer that should be disclosed, that disclosure should be the responsibility of, and should come from, the issuer and not the auditor or any other third party. As noted in the Treadway Commission's 1987 report,

> the responsibility for reliable financial reporting resides first and foremost at the corporate level. . . . Independent public accountants play a crucial, but secondary role. They are not guarantors of the accuracy or the reliability of financial statements. . . . [M]anagement's primary responsibility for reliable financial reporting should be emphasized, so that public understanding of the relative and complementary obligations of corporate management and independent public accountants is improved.[1]

While the Release notes that as a result of the performance of audit procedures, auditors have significant information regarding a company's financial statements, it is nonetheless the case that management has the best insight into the financial statements and financial condition of a company and has the greatest ability to make judgments about market conditions, risks and other factors that might be relevant to the future performance of a company. If the Board believes additional financial disclosure is useful to investors, efforts should be made with the Securities and Exchange Commission (the "Commission") to address such concerns, which we believe are beyond the scope of the auditor's report.

As an illustration of this principle, continuing with the example discussed above, if one were to conclude that it is sufficiently beneficial to include additional information about alternative accounting treatments in an issuer's disclosure document (a conclusion as to which we are skeptical), the issuer and not the auditor should be responsible for providing that disclosure. Issuers – not auditors – are responsible for what accounting principles are applied and should be responsible for explaining those choices if an explanation is necessary. Under current auditing standards, the auditors would be required to read that disclosure and determine that it is not in conflict with the financial statements (including the Significant Accounting Policies Note). This is consistent with the primary and secondary roles of the company and its auditors, respectively, in connection with financial reporting.

Third, any change to the auditor's reporting model should not alter the relationship and the structure of interactions among management, the audit committee and auditors as they have developed since the enactment of the Sarbanes-Oxley Act of 2002 and the related implementation of regulations and standards adopted by the Commission and the PCAOB ("Sarbanes-Oxley"). In our view, based on considerable personal observation of both the processes of these interactions and the results, the Sarbanes-Oxley reforms have significantly enhanced the financial reporting system and the quality and reliability of financial reporting by

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[1] *See* National Commission on Fraudulent Financial Reporting, Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987).

empowering audit committees and mandating communication among management, the audit committee and auditors in ways that have expanded the discussion well beyond the mandated matters and have in other respects enhanced the audit process. We think the regular and free-flowing dialogue of auditors with management and the audit committee, as well as the robust application of GAAP and generally accepted auditing standards, have resulted in better and more reliable financial disclosure to investors. The reforms also paved the way for additional opportunity and leverage for auditors to influence the financial statements (one of the potential benefits cited for the AD&A proposal discussed in the Release). Based on our direct experience, we are concerned that requiring auditors to make public disclosure about issuers would have a chilling effect on communications among management, audit committees and auditors. If management and audit committees believe auditors will be required to make communications public, they may be reluctant to engage in the honest and open dialogue encouraged by Sarbanes-Oxley that has resulted in more robust financial disclosure. In our view, such a development carries with it a serious risk that the quality of the overall audit process would decline and with it the quality and reliability of financial reporting. The Board should therefore evaluate proposals based on whether they are likely to encourage or discourage open dialogue among management, audit committees and auditors.

Fourth, the benefits of any path pursued by the PCAOB should of course outweigh the costs. We do not believe the purpose of cost-benefit analysis should be to stifle appropriate regulation. Rather, it is a widely held view that our current disclosure system, accounting principles and auditing standards are overly complicated and burdensome. High quality, reliable financial reporting is pressured by market and regulatory demand for timely information. In this environment, there are genuine benefits to focusing on narrow and incremental changes that have the greatest likelihood of improving disclosure and providing investors better information in a cost effective manner. Moreover, while the costs that should be considered include monetary costs, burdens on management and auditors, and increased length and complexity of financial statements and other financial disclosure, there are others, some of which are noted above. In particular, the risk of reducing the quality of both the financial statements and the internal control audit posed by adversely affecting the steadily improving structure of relations among auditors, audit committees and management is in our view an unacceptable cost. Moreover, we are concerned that many of the alternatives suggested in the Release to expand the role of the auditor or the breadth of the auditor's report will impose costs without accompanying benefits, because they will take time and money to implement but may merely lead to additional boilerplate language that provides little additional information.

Finally, in considering changes to the auditor's report, we should not undervalue the current audit process and the significance of the report under the pass-fail model. The pass-fail determination has value for investors because it clearly reflects that an audit has taken place under the current robust standards and provides reasonable assurance that the issuer has both financial statements in accordance with GAAP and internal controls that, except as disclosed, do not suffer from material weaknesses. Other information surrounding the audit may be useful, but we believe nothing about the audit process is as important to investors and markets as making the audit process (and the resulting pass-fail conclusions) as reliable as possible. In our professional judgment, a robust pass-fail auditing system contributes significantly to the accuracy and reliability of financial statements.

## II. Auditor's Discussion and Analysis ("AD&A")

An AD&A of the sort described in the Release would be inconsistent with the principles described above. Our primary concern is that AD&A asks auditors to provide disclosure that is the responsibility of the issuer. Not only are issuers appropriately responsible for disclosure about themselves, but they also are in a better position than auditors to reach conclusions about their financial reporting and craft disclosure even as to financial matters. And issuers are certainly in a better position than auditors to draft disclosure regarding other, non-financial matters. If investors perceive shortcomings in issuer disclosure, those gaps arise in the application of GAAP, the Commission's disclosure rules and guidance or the reporting practices of issuers. We do not think changing the role of the auditor, adding auditor-authored sections to disclosure documents or altering the auditor's report is the best way to address concerns regarding the need for additional or enhanced financial disclosure. Rather a discussion of such concerns should include the Commission and the PCAOB in a broader dialogue with issuers and other market participants.

We understand that some investors believe auditors can provide insight into an issuer's financial statements due to the auditors' independence or familiarity with industry participants other than the issuer in question. The fact that auditors are independent, however, does not address whether they should provide disclosure regarding the issuer. The Commission's independence standards under Rule 2-01 of Regulation S-X speak to whether an auditor is objective in carrying out its audit of an issuer's financial information. We do not believe independence is probative of an auditor's ability to analyze or provide disclosure regarding an issuer or industry or supplant the judgments of an issuer. Any proposals should be careful not to confuse independence with expertise in crafting better disclosure.

We also believe the premise that industry familiarity provides auditors with an advantage that allows them to provide significantly better disclosure than issuers should be closely examined. In our experience, management is generally very familiar with industry practices. While industry familiarity can provide auditors an experience base for the current discussions that go on between auditors and management, it is difficult to see how it would translate into better disclosure. As a matter of professional confidentiality, an auditor will not be able to disclose that client Company A follows more or less preferable accounting than client Company B (or C or D). Instead, we believe internal discussions among management, audit committees and auditors regarding industry practice are more likely to lead to better financial reporting than disclosure regarding industry practice in a specified area of accounting.

Another issue with AD&A is that the proposed topics for disclosure may be of limited use to investors. For instance, the illustrative AD&A included in the Release suggests that auditors would provide discussion of difficult or contentious issues or "close calls" that arose during the audit and the final resolution of such issues, such as accounting matters that required significant deliberation by the auditor and management before being deemed acceptable within the applicable financial reporting framework. In our experience, when we focus on difficult financial disclosure questions with issuers, a matter often requires significant deliberation because it is extraordinarily important to the financial statements or is in an area where it is difficult to apply accounting principles because, for example, of the subjective judgments and estimates required. Put another way, as a general matter, extensive focus and deliberation may not be indicative of an issuer trying to "push the envelope" in application of accounting principles. The fact that the parties carefully thought about an issue for an extended period of time does not necessarily mean investors gain greater clarity into the company's financial statements from disclosure of those discussions. On the other hand, if the focus on difficult questions in the application of accounting principles or the use of accounting estimates is intended to illuminate the most important and challenging accounting judgments reflected in a company's financial reporting, we believe this is an area where, as further discussed below, disclosure enhancements can productively be considered.

The Board should also consider the effect AD&A would have on the Sarbanes-Oxley reporting framework. Any requirement that auditors make substantive public disclosures about the issuer will adversely affect the audit process, and the related corporate governance process, by inhibiting candid discussion and exchange among management, the audit committee and the auditor. Furthermore, the Sarbanes-Oxley reforms included measures, such as the CEO and CFO certifications as to disclosure and internal controls and the auditor's report on the effectiveness of internal control over financial reporting, to address concerns over the reporting process. The financial reporting process and related corporate governance have improved in the wake of Sarbanes-Oxley, and as discussed above, we fear this "chilling" effect carries with it a significant risk of adversely affecting the quality of audits and the accuracy and reliability of financial reporting.

A final concern we have with AD&A as proposed is our strong belief that it will devolve into boilerplate. Issuers and auditors alike fear that increased disclosure will lead to increased liability. There is a high degree of probability that AD&A will result in standardized disclosure and not meaningful company-specific individualized disclosure. Individualized disclosure will continue to be left to issuers. To the extent disclosure enhancements would be beneficial, issuer disclosure under the Commission's rules should be the focus.

## III. Modifications to the Auditor's Report

### A. Critical Accounting Policies and Estimates

At the September 15, 2011 Roundtable, during the discussion of AD&A, the possibility was raised of considering an important but more narrowly focused report on critical accounting policies and estimates, where additional attention by issuers and additional involvement by auditors would be both beneficial to investors and cost effective. While we do not believe a targeted discussion of critical accounting policies and estimates is appropriate within the broad rubric of AD&A (with the defects inherent in that approach described above), we do believe consideration should be given to focused auditing standard-setting on critical accounting policies and estimates. This area is ripe for auditor review because, as investors indicated in the Board's outreach effort, there remains a need for better disclosure of the impact of estimates and judgments by issuers. As noted in the Release:

> [s]ince reasonable estimates might vary significantly, there could be a wide range of acceptable results within a company's applicable financial reporting framework. Further, this range of acceptability is not mentioned in the auditor's report and might not be fully reflected in the financial statements.[2]

We believe, in connection with the PCAOB considering a new auditing standard, it would be valuable for the Commission to provide further guidance with respect to critical accounting policies and estimates disclosure. After two releases discussing critical accounting policies in December 2001 and January 2002, the Commission issued proposed rules on critical accounting policies in May 2002.[3] The Commission did not complete the process of a formal rulemaking. Instead it offered guidance on critical accounting policy disclosure in its December 2003 interpretive release on Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A").[4] If auditors are to assist in a process of improving disclosure to investors, the Commission should consider whether it would be beneficial to consolidate the existing disclosure guidelines and give further guidance through additional formal rulemaking. In our view, it is important that any new guidance not provide for increased disclosure (in what are already overly lengthy disclosure documents) but rather improved disclosure. Ideally, the Commission guidance would focus on the methods for determining critical accounting policies and estimates and appropriate disclosure of such policies to investors, including uncertainties inherent in the estimation process and the impact of estimates on financial statements.

A new auditing standard, which we think would be best crafted through the joint efforts of the Commission and the PCAOB, could create a narrowly enhanced role for auditors to review an issuer's disclosure of critical accounting policies and estimates in MD&A to confirm whether it is consistent with the Commission's disclosure requirements. In an unqualified auditor's report, then, the auditor could attest to the issuer's compliance with requirements for the fair presentation of its critical accounting policies and estimates. We think in the narrowly focused context of critical accounting policies and estimates, the adoption of an auditor review standard could both improve issuer disclosure in MD&A and be beneficial to investors' understanding of such disclosure. The auditor's statement of compliance could also include an opportunity for the auditor, at its discretion, to emphasize matters within critical accounting policies and estimates that the auditor thinks worth highlighting, similar to the emphasis

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[2] PCAOB Release No. 2011-03 (Jun. 2011) at 6.

[3] SEC Release Nos. 33-8040; 34-45149; FR-60 (Dec. 2001). SEC Release Nos. 33-8056; 34-45321; FR-61(Jan. 2002). SEC Release Nos. 33-8098; 34-45907; International Series Release No. 1258 File No. S7-16-02 (May 2002).

[4] SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

paragraph framework. For the reasons we describe below, we do not think auditor review of all of MD&A would improve disclosure or be beneficial to investors.

As discussed above, instead of styling a new standard in an AD&A format as discussed at the September 15, 2011 Roundtable, we believe an auditor attestation with respect to critical accounting policies and estimates should be included in the auditor's report. This focused review and report is not dissimilar to the auditor's review and report on internal control over financial reporting, but we think this proposal fits more squarely within the existing auditor's report framework rather than calling for a separate auditor report.

B. Clarification of the Standard Auditor's Report

Clarifying the language in the standard auditor's report may be worth pursuing. If investors do not understand the auditor's role in providing reasonable assurance on the accuracy of the issuer's financial statements or that auditors are not guarantors against fraud, there is indeed an expectation gap between what investors expect and the reality of what an audit provides. Participants in the disclosure and financial reporting process, including auditors, should think of ways to provide investors with better information about what auditors are, and are not, responsible for and what they do and do not do. Additional explanation and clarification within the auditor's report may be a reasonable way to address this issue and can be introduced without changing the basic reporting framework.[5]

We wonder, however, if additional explanation in the auditor's report is the best way to addresses this expectation gap. Placing the same boilerplate in every auditor's report for thousands of issuers every year may not be the most efficient or effective way to educate investors about the auditor's role in the financial reporting process. Placing that information on the websites of the Commission, the PCAOB and audit firms may be a better solution than altering the auditor's report. However the Board proceeds, it should do so in the most cost effective and efficient way possible, mindful that the benefits must outweigh the costs.

C. Required and Expanded Use of Emphasis Paragraphs

Before mandating an expanded use of emphasis paragraphs, we believe it would be useful for the Board to reexamine the current framework surrounding such paragraphs. Under AU Section 508.19, auditors may, at their discretion, emphasize a matter regarding the financial statements. That said, as discussed at the September 15, 2011 Roundtable, auditors almost never

[5] As noted in the AICPA's clarifying Statement on Auditing Standards "Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report" (the "Clarifying SAS"), "Other Matter" paragraphs in the auditor's report can be used to provide explanation "relevant to users' understanding of the audit, the auditor's responsibilities, or the auditor's report." *See* AICPA, *Statement on Auditing Standards: Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report* (2010), available at: http://www.aicpa.org/Research/Standards/AuditAttest/ASB/DownloadableDocuments/Clarified_SAS_EOM_OM.pdf at §5.

use emphasis paragraphs. In our opinion, this lack of use may point more to an issue of implementation of the current standard than to a need for new standard setting.

As noted in the AICPA's Clarifying SAS "Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report," emphasis paragraphs should be used

> [i]f the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to user's understanding of the financial statements . . . .[6]

We believe it may be helpful for the Board, as part of its regular inspection of auditor's reports, to consider where emphasis paragraphs could have been used and then to provide additional guidance to auditors to encourage the inclusion of emphasis paragraphs where useful.

If the Board determines instead to move forward with consideration of a proposal to mandate emphasis paragraphs, we believe the Board should consider two concerns. First, if not carefully constructed, the mandatory emphasis paragraphs will likely devolve into additional boilerplate, which would not provide the desired insight to investors. Second, any proposal for mandated emphasis paragraphs must also include clear, objective standards for auditors to follow in determining how and when to include those paragraphs.

## IV. Auditor Review of Other Information Outside the Financial Statements

### A. <u>MD&A</u>

In our view, requiring auditors to comment on information outside the financial statements, in particular on MD&A, is inconsistent with the auditor's role and core expertise. Auditor expertise centers on financial information, financial reporting, auditing and related matters and does not extend to evaluating business strategy and trends, analyzing risk (except for risks regarding financial reporting) or predicting future performance. The purpose of MD&A should be considered against this backdrop. The Commission has made it clear on several occasions that the principal value of well-crafted MD&A is that it provides information about the issuer through management's eyes, gives a sense of the overall context within which financial information should be analyzed and provides relevant information to investors about the issuer's past and future performance.[7] Good MD&A disclosure contains information with regard to the

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[6] *Id.* at §6.

[7] *See* SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

quality of earnings and known trends and uncertainties.[8] The Commission has also made clear that good MD&A should not consist merely of the regurgitation of information in the financial statements but should focus on analysis.[9] Asking auditors to attest to management assessments of the explanations for financial performance or condition, assessments of the impact of trends or uncertainties or forward-looking assessments of future performance or condition not only puts auditors well outside their core expertise, but also carries with it a significant risk that the audit process would lead to less rather than more "good" MD&A. Enhanced auditing standards should contribute to good disclosure under the Commission's rules and not work at cross-purposes, as we fear would be the case with application of auditing standards to MD&A.

Granted, MD&A does include financial information derived from an issuer's financial statements and other financial metrics, but auditors already review financial statement numbers in the MD&A as part of their audit procedures. The Board could consider whether the auditor review of such financial information similar to what they do as part of the standard comfort process under Statement on Auditing Standards 72, Letters for Underwriters and Certain Other Requesting Parities ("SAS 72") ought to be formally embodied in the audit and review process. In fact, a number of large issuers already request their auditors to conduct a SAS 72 review when those issuers prepare their Annual and Quarterly Reports on Forms 10-K and 10-Q in order to facilitate shelf offerings. We would be very concerned, however, that requiring smaller entities, especially those that do not regularly access the capital markets, to follow such procedures would be an unwarranted additional burden. Given that auditors already check the MD&A for consistency with the financial statements, we feel that requiring additional review procedures for financial information derived from the issuer's financial records might well add cost with little countervailing benefit. Furthermore, we are concerned that requiring additional procedures will make timely reporting more difficult and may cause issuers to reduce the financial information they include in MD&A.

B. <u>Earnings Releases</u>

A related subject that was not discussed at length in the Release but received much attention at the September 15, 2011 Roundtable was the idea of providing for additional auditor involvement in issuer earnings releases and Quarterly Reports on Form 10-Q. Certain participants seemed concerned that the results of an audit (in the case of annual earnings) or review under Statement on Auditing Standards 100 Interim Financial Statements ("SAS 100") (in the case of earnings in the first three quarters of the issuer's fiscal year) become available several weeks after earnings and other financial information are made available through an

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[8] *See* SEC Nos. 33-6835; 34-26832; IC-16961; FR-36 (May 1989) and SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

[9] In the 2003 Release, the SEC noted that in approaching MD&A "[m]anagement has a unique perspective on its business that only it can present. As such, MD&A should not be a recitation of financial statements in narrative form or an otherwise uninformative series of technical responses to MD&A requirements, neither of which provides this important management perspective." SEC Release Nos. 33-8350; 34-48960; FR-72 (Dec. 2003).

earnings release. Certain participants also queried whether the information and value conveyed by the audit and accompanying auditor's report or SAS 100 interim review, as the case may be, was as timely as it could be for the benefit of investors.

In our experience, management and audit committees almost always have auditors consider and review the financial information included in earnings releases. In particular, issuers in our experience recognize the dangers of a change from results reported in an earnings release in subsequent periodic Commission filings, and involve their auditors at the earnings release stage to help reduce that risk. We are concerned that formalizing this process would not be feasible within the current time constraints and that the costs would outweigh the benefits.

In addition, with respect to increasing the auditor's involvement in the review of Quarterly Reports on Form 10-Q, our experience is that the auditor involvement in a review of quarterly filings under SAS 100 does lead to enhanced quality and reliability of interim financial reporting. In particular, the process of auditor review, the communications of the auditor to the audit committee and the dialogue between the auditor and audit committee all contribute to this result. We believe these same factors were extensively considered at the time the mandatory quarterly review process was adopted in SAS 100, and we do not believe there have been significant developments since then that should favor moving to an audit of interim financial statements. Furthermore, requiring an audit of quarterly financial statements would no doubt delay quarterly reporting and add significantly to expense such that the increased burdens would, in our view, clearly outweigh the benefits. Indeed, the additional burden on issuers following the acceleration of filing deadlines for Quarterly Reports on Form 10-Q for larger issuers in 2004, while by only five days, would suggest that any change that introduces further time constraints in this area should not be made.

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We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Leslie N. Silverman, Alan L. Beller or Nicolas Grabar (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: <u>Public Company Accounting Oversight Board</u>
Hon. James R. Doty, Chairman
Hon. Lewis H. Ferguson, Member
Hon. Daniel L. Goelzer, Member
Hon. Jay D. Hanson, Member
Hon. Steven B. Harris, Member

Securities and Exchange Commission
Hon. Mary L. Schapiro, Chairman
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Hon. Luis A. Aguilar, Commissioner
Hon. Troy A. Paredes, Commissioner

Securities and Exchange Commission – Division of Corporation Finance
Ms. Meredith B. Cross, Director

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***Glenn P. Barba***
*Vice President, Controller and Chief Accounting Officer*

September 29, 2011

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

RE: PCAOB Rulemaking Docket Matter No. 34

We appreciate the opportunity to comment on Public Company Accounting Oversight Board (PCAOB) Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release). This letter contains the comments of both CMS Energy Corporation and Consumers Energy Company.

CMS Energy Corporation, whose common stock is traded on the New York Stock Exchange, is a domestic energy company engaged in electric and natural gas utility services and independent power production, operating through subsidiaries in the U.S., primarily in Michigan. CMS Energy Corporation's consolidated assets are $16 billion and annual operating revenues are $6.4 billion. Consumers Energy Company, the principal subsidiary of CMS Energy Corporation, provides electricity and/or natural gas to more than 6 million of Michigan's 10 million residents and serves customers in all 68 counties of Michigan's Lower Peninsula.

**Overall Assessment** – We recognize that some investors have suggested that auditors' reports would be more relevant and transparent if they contained more information. In response, the PCAOB has proposed establishing requirements for an Auditor's Discussion and Analysis (AD&A), emphasis paragraphs in audit opinions, auditor reporting on information outside the financial statements, and/or clarification of certain language in the auditor's report. For the reasons given below, we believe that management, not the auditor, is best positioned to provide investors with information and commentary on a company's financial statements. In our opinion, any concerns that companies' disclosures are incomplete or unreliable should be addressed through the existing standard-setting, enforcement, and audit processes, rather than through a change to the auditor's reporting model.

Auditor's Discussion and Analysis and Required and Expanded Use of Emphasis Paragraphs

The Concept Release proposes that the auditor provide a supplemental AD&A, which would be a narrative report offering a view on the audit and financial statements, and/or include emphasis paragraphs in the auditor's report that highlight significant matters. We understand that these proposals are in response to some investors' desire for more information and commentary from auditors on companies' financial statements. These investors have stated that the auditor is uniquely positioned to provide such information and commentary because of the knowledge gained through the audit process combined with the auditor's independence.

We believe that commentary on a company's financial statements should come from a single source, rather than from both management and the auditor. Providing two perspectives on a single set of financial statements has the potential to confuse users and to reduce confidence in reported information. Moreover, if investors desire further commentary on a company's financial statements, then the best source of this information is the company's management. Though an auditor's understanding of a company's financial statements is more extensive than that of other third parties, it is still less complete than that of management. The degree to which the auditor must gain an understanding of the company's business, industry, transactions, and financial statements in order to render an audit opinion is substantially less than the depth of understanding required of the company's management. Correspondingly, the time the auditor devotes to gaining an understanding of these matters is a small fraction of the time invested by management. For these reasons, commentary on the financial statements should come from management, not the auditor.

The concerns of investors described in the Concept Release are best addressed through existing regulatory structures and roles. Any perceived deficiencies in existing disclosure requirements regarding such matters as significant risks and uncertainties, critical accounting estimates, unusual transactions, or alternative accounting policies should be addressed through the established standard-setting and rulemaking structures at the Financial Accounting Standards Board and the Securities Exchange Commission (SEC), rather than through a change to the auditor's reporting model. Further, any concerns that companies are not complying with existing disclosure requirements, or that the associated disclosures are unreliable, should be addressed through audits or through the SEC's review of company filings.

Such concerns should not lead to a requirement that the auditor publish information or commentary on a company's financial statements independently of management. Today, management is accountable for the quality and content of its SEC filings. In our opinion, the inclusion of commentary from the auditor in a company's SEC filings would represent an inappropriate departure from the auditor's attestation role, and a blurring of the present lines of responsibility according to which management prepares the financial statements and the auditor opines on these statements. The proposal would cast the auditor into the role of co-preparer, together with management, of public disclosures about a company; however, the auditor's public statements would not be subject to independent verification, except perhaps informally by the company's own management. Such a role reversal seems analogous to requiring the company's management to publish interpretive commentary on the design and execution of the audit engagement.

Additionally, as proposed in the Concept Release, the information that would be communicated in the AD&A and emphasis paragraphs would be similar to the information that the auditor now provides to the audit committee, whose role includes overseeing financial reporting and monitoring accounting policies on behalf of the company's investors. In many instances, the information reported in the AD&A would relate to complex issues that involve significant management judgment and that require a deep understanding of the company's business, industry, and specific transactions, as well as of complex accounting literature. Audit committee members have the expertise and background for this analysis. If such information were provided to investors with the full context needed to make it comprehensible, the extensive background details and technical explanations could ultimately create confusion and uncertainty among investors rather than provide insight.

Auditor Assurance on Other Information Outside of the Financial Statements

The Concept Release also proposes that the auditor provide assurance on information outside the financial statements, such as management's discussion and analysis (MD&A), earnings press releases, and non-GAAP information. The objective would be to give investors more confidence in the information that management provides in these communications.

As the SEC has stated in its guidance, "MD&A should be a discussion and analysis of a company's business as seen through the eyes of those who manage that business. Management has a unique perspective on its business that only it can present." Accordingly, much of the information contained in MD&A is highly subjective. We believe that the auditor's present responsibilities with respect to this information – reading and considering whether such information is materially inconsistent with the financial statements or represents a material misstatement of fact – are appropriate. Today, auditing standards contain guidelines for attestation engagements regarding MD&A. If investors had a compelling need for such assurance, then shareholders would put pressure on companies to incur the costs of attestation engagements. The number of such engagements now performed, however, does not support the view that a universal requirement for auditor assurance regarding MD&A would justify the cost.

Regarding earnings press releases, the capital markets offer sufficient disincentives for companies to issue press releases that contradict their audited financial statements, and auditor assurance would add little value to the earnings-release process. Moreover, existing standards regulate the use of non-GAAP information in such communications, and require that non-GAAP information be reconciled to the GAAP information in the audited financial statements.

Clarification of the Standard Auditor's Report

We do not oppose the proposal to add language to the standard auditor's report clarifying what an audit represents and describing the related auditor responsibilities, if there is sufficient evidence that many investors do not understand these concepts.

**Final Considerations** – In conclusion, while we appreciate the PCAOB's effort to respond to investor concerns, we believe that any information or commentary on a company's financial statements should originate from management, not the auditor. Furthermore, any concerns that disclosure of such information is inadequate should be addressed through normal standard-setting, enforcement, and audit processes, rather than through a change to the auditor's reporting model. Thank you for the opportunity to comment on the Concept Release.

Sincerely,

Glenn P. Barba

Glenn P. Barba
Vice President, Controller and Chief Accounting Officer
CMS Energy Corporation and Consumers Energy Company

CNA

333 S. Wabash Ave. Chicago IL 60604

**Lawrence Boysen**
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September 29, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Board,

CNA Financial Corporation (CNA) appreciates the opportunity to comment on the PCAOB's proposed changes to the auditor's reporting model. CNA is the seventh largest commercial insurance writer and the thirteenth largest property & casualty writer in the United States. CNA has insurance operations in both North America and Europe. Loews Corporation (Loews) owns approximately 90% of CNA's outstanding common stock.

The Board's concept release proposes four alternatives to the current auditor's reporting model. The four proposed changes, Auditor's Discussion and Analysis (AD&A), required and expanded use of emphasis paragraphs, reporting on information outside the financial statements, and clarification of certain language in the auditor's report, vary in the degree to which they would impact and change the current reporting process. While we understand the Board's goal of improving the transparency and relevance of an auditor's report to investors, both the AD&A and emphasis of matter paragraphs will result in the auditor, not management, being a source of financial information. In our view, this would undermine management's responsibility of its financial statements and disclosures. With the exception of clarification of certain language in the auditor's report, all the other proposals constitute a significant audit scope change. We believe the increased time and cost incurred to provide the proposed disclosures will far outweigh the benefit and usefulness of the additional information to the investor.

Management, as the owner of the financial statements and the financial reporting process, is in the best position to disclose the company's financial position and comment on its operations. Auditors are not the owners of the financials and are not decision makers within the company, thus making supplementary disclosure on their part less effective than similar disclosure made by management. However, auditors, as an independent third party, are in an appropriate position to express an opinion on the fair representation of the financial statements. Additionally, with management as the sole provider of financial information, a certain level of trust is established with investors and competing disclosures could serve to undermine this trust. The current auditor's reporting model provides the investor with the required level of assurance while not compromising management's message and trust with investors. Any effort to improve the transparency and usefulness of financial statements and related disclosures to investors should be more appropriately addressed by the FASB.

Furthermore, the proposed auditor disclosure, specifically in the AD&A and the emphasis paragraphs, would inevitably become boilerplate in nature due to auditor's liability concerns which would significantly limit the disclosure's usefulness to investors. We are concerned that subjective disclosure from the auditor would not be beneficial to investors that lack an understanding of audit methodology to appropriately comprehend the proposed auditor's disclosure. As a result, we believe that the inclusion of such information could be confusing to certain investors and in some cases be perceived as conflicting with management's disclosure. The unintended consequence of which would be diminished investor confidence in management and reduced reliance on the financial statements.

The clarification of certain language in the auditor's report is the only proposal presented in which we believe the perceived benefit justifies the cost of implementation. While the clarification is somewhat redundant as sophisticated investors are well versed in the terms and phrases to be clarified, improved understanding on the part of less informed readers warrants the clarification. The cost of implementing such disclosure would be minimal.

In summary, we do not support the proposed changes presented within the concept release, except for the clarification of certain language discussed above. The other proposed changes would come at a significant cost to the company, but would fall short of the intended benefit of improving transparency into the financial performance of the company, the underlying key judgments, and the related risks and uncertainties.

If you have any questions, please feel free to call me at 312-822-5653.

Sincerely,

Lawrence Boysen
*Senior Vice President and Corporate Controller*
*CNA Financial Corporation*

◆ COLE ◆
REAL ESTATE INVESTMENTS

September 30, 2011

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

**Reference:** Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 34.

Dear Office of the Secretary:

Cole Real Estate Investments ("Cole", "we", "our", "us") appreciates the opportunity to provide comments to the Public Corporation Accounting Oversight Board ("PCAOB") on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release"), PCAOB Rulemaking Docket Matter No. 34.

By way of background, Cole is one of the most active investors and owners of core real estate assets and manages one of the country's largest portfolios of retail properties. Cole primarily targets net leased single tenant and multi-tenant properties under long-term leases with high credit quality tenants, as well as, single tenant office and industrial properties. Cole related entities own or manage 51.3 million square feet of commercial real estate in 45 states with a combined acquisition cost of approximately $9.0 billion.

We appreciate the PCAOB's effort to make improvements to reports on audited financial statements and have provided detailed responses below addressing selected questions from the Concept Release.

***Question 1:*** *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*
*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe the auditor's role should be expanded to provide assurance on matters outside the financial statements, because it may create investor confusion about the auditor's role versus the role of the Company's management and the audit committee.

***Question 5:*** *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*
*d. If you do not support an AD&A as an alternative, explain why.*

We oppose an Auditor's Discussion and Analysis ("AD&A") as an alternative for providing additional information in the auditor's report. Providing information about the financial statements is the responsibility of management. We believe the auditors should not provide information about a Company's financial statements directly to investors, because doing so could cause confusion if the information "competes" or is subject to different interpretations then what management discloses on areas outside the financial statements. In addition, we believe that between the company and its auditors there would be significant effort and incremental costs involved for the auditor to prepare, review and provide an AD&A. We believe the additional discussions with management and the audit committee, together with additional procedures auditors may perform in preparing their AD&A, could distract each party from their primary responsibilities of financial statement preparation. Completing an AD&A may not give the auditor, in particular audit partners and managers, sufficient time to complete a quality audit of the company's financial statements and would require the auditor to split its focus between completing the AD&A and performing the audit procedures required to detect material misstatement in the financial statements. We believe this added cost in recurring audit fees for the preparation of the AD&A and potential time constraints which could reduce the audit's effectiveness outweigh the limited benefit it may provide to investors and users of the financial statements. Also, the Concept Release mentions the AD&A would include "close calls," or items the auditor ultimately deemed acceptable, but which required significant discussion by the auditor, management and the audit committee. We are concerned about the definition of "close calls" and the auditor's interpretation thereof. Because of the subjectivity involved in managing and providing information specific to the company, we question how a disclosure framework can be developed and consistently applied. In addition, we are concerned about a possible strain on auditor communications with management and the audit committee. As the PCAOB points out in the Concept Release, discussing potentially sensitive matters in an AD&A could create tension, stifle communication and hinder audit quality. We are also concerned about whether investors and other users of the financial statements would have the appropriate context for the information contained in the AD&A and the ability to evaluate the technical nuances typically associated with sensitive financial accounting and reporting matters. Typically, auditor's communications are prepared with the expectation of a dialogue with the audit committee in which additional context and perspectives are communicated.

***Question 14:*** *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*
*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

Existing standards already allow the auditors to add areas of emphasis at their discretion. We believe this is functioning as appropriate and preserves the auditor's ability to include or exclude references, as necessary, based on the circumstances involved. If new standards require inclusion of an expanded emphasis paragraph, we believe the appropriate content and level of detail should be limited to objective and factual information with reference to the footnotes to the financial statements for more detailed disclosure.

***Question 19:*** *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*
*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

We do not support auditor assurance on other information outside the financial statements. Information outside of the financial statements such as Management's Discussion and Analysis ("MD&A") contains forward looking statements, subjective information and non-financial data. Auditors provide assurance that a Company's financial statements present fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). It is unclear to us how auditors would be able to perform and support assurance procedures on such forward looking or projected information in order to report on such matters. We believe reporting on areas outside of the financial statements is outside of the auditor's core competencies of opining on GAAP based financial statements. Also, we have concerns that requiring auditor assurance on other information outside the financial statements, such as the MD&A, could lead to required auditor assurance on other reports or press releases publically provided to users of the financial statements by management (e.g. earnings releases and Form 8-Ks), which also contain subjective information, forward looking statements, and non-financial data and are not required to be reported on by auditors. Further, auditors currently review other information outside the audited financial statements but included in filings containing their audit reports, such as the MD&A, to determine whether there are material inconsistencies included therein, when compared to amounts and other matters disclosed in the audited financial statements. If material inconsistencies are identified the auditor discusses them with management and the audit committee, when appropriate. If there are misunderstandings among investors about the scope and role of the

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auditor with regard to information outside the financial statements, we would support some inclusion in the auditor's report, which clarifies the existing role.

***Question 21:*** *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We do not have significant concerns with additions to the auditor's report to clarify terms or the auditor's existing responsibilities. We believe it may be most useful to provide clarifications on the auditor's responsibility for monitoring fraud, the auditor's and management's responsibilities regarding the financial statements, and the auditor's responsibility for information outside the financial statements.

We thank you for your consideration of these comments and we appreciate the opportunity to provide our comments on this Concept Release.

Best Regards,

Matthew J. Peel

Matthew J. Peel, CPA
Director of Accounting Research
Cole Real Estate Investments

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COLORADO PERA®

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September 29, 2011

Public Company Accounting Oversight Board
1666 K Street, NW Suite 800
Washington, DC 20006

RE: PCAOB Rulemaking Docket Matter No. 34

Dear PCAOB:

I am submitting the following comments for the PCAOB's consideration based on a request for guidance on potential revisions to the standards of auditor's reports. These comments represent my perspective as an institutional investor of a large public pension plan.

**Pass/Fail Model:** We appreciate and understand the concerns regarding the current auditor's pass/fail model. However, we have not yet seen a revised model that would significantly improve how financial statements are presented to investors without offsetting drawbacks. We do believe that some adjustments to the information provided by auditors to investors can bolster the pass/fail model, and should be explored.

**Auditor's Discussion & Analysis**: Of all the potential changes to the current auditor reporting model, we are most supportive of adding an Auditor's Discussion & Analysis (AD&A) section. An auditor's ultimate responsibility is to investors, and therefore we believe it is critical to increase the ability for auditors and investors to communicate. Investors crave information, and there is currently little information provided by the current Pass/Fail model. We also believe there is a misunderstanding by the investor community on how audits are conducted, and therefore, how the results of the pass/fail model should be interpreted. This misunderstanding can be remedied through both educational efforts by the PCAOB and details provided within an AD&A section.

An AD&A section will give auditors the ability to point out areas in the financial statements where companies have followed the standards of GAAP, but where significant areas of judgment and estimation were required to report financial results. In addition to highlighting areas where judgment and estimation were required, we would like for auditors to provide data points, when possible, that would allow us to calculate sensitivity analyses on the more opaque sections of financial statements. We believe this information will greatly improve visibility into some of the most problematic sections of the financial statements, particularly:

- Revenue Recognition and Accounting Methodology Changes
- Asset Valuation and Unusual Transactions
- Special Purpose Vehicle (SPVs) Assets and Liabilities
- Off-Balance Sheet Items
- Restatements and Charge-Offs
- Non-Performing Assets

Like all proposed changes to auditor reporting standards, the addition of an AD&A section provides challenges and drawbacks. We view obstacles to implementation of the AD&A section to include cost, particularly potential legal challenges to AD&A statements, and standardization of AD&A reports. Legal challenges to auditor's AD&A reports are likely to arise and may ultimately be paid by investors through higher auditor fees. We also recognize that the addition of an AD&A will require more auditor billing hours. However, we are not asking auditors to expand their audit activities. We simply want auditors to provide investors more of the information they have gathered during their audit process and a reasonable subset of the audit details they already provide corporate audit committees.

As for the standardization of AD&A reports, we have no easy answer, and believe a fully developed AD&A process will take years, similar to the addition of Management Discussion and Analysis (MD&A) reports. When MD&As were first published, the information provided to investors was underwhelming, prompting the SEC to issue a series of rules in order to require and encourage companies to improve their disclosure of financial information. After decades of work by the SEC, we now believe the MD&A to be one of investor's most valuable pieces of information. We feel that the AD&A could rival the MD&A for importance to investors, yet we would hope and expect the AD&A to develop faster than the decades required for the MD&A. For faster development of the AD&A, it will be critical for PCAOB to initially set a strong standard of quality and adopt new standards quickly as the AD&A develops over time.

We appreciate the opportunity to comment on the potential changes to the auditor's reporting model, and would welcome additional opportunities to provide input to the PCAOB as this process continues.

Sincerely,

Jennifer Paquette

Jennifer Paquette
Chief Investment Officer
Colorado PERA

Core·Mark

September 30, 2011

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

Via email:commnents@pcaobus.org

Re: PCAOB Release No. 2011-003
PCAOB Rulemaking Docket Matter No. 34
*Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Board Members:

We appreciate the opportunity to respond and comment to the PCAOB (the Board) regarding Concept Release No. 2011-003 (the Concept Release) which presents four proposed alternatives for supplementing the current auditor's report and to increase its transparency and relevance to financial statement users.

**Summary Comments**

Core-Mark is one of the largest marketers of fresh and broad-line supply solutions to the convenience retail industry in North America in terms of annual sales (approximately $7.3 billion in 2010), providing sales and marketing, distribution and logistics services to customer locations across the U.S. and Canada.

We agree with the Board's decision to undertake the initiative to consider possible changes and improvements to the auditor's reporting model and to enhance the communication to investors through improving the content of the auditor's report. We support those changes to the auditor's report which ultimately add meaningful value to investors and at the same do not add significant costs to issuers.

We do not agree with the proposed approach of expanding the auditor's role in the reporting and disclosure process. We strongly believe that management should retain responsibility and be the source of disclosures related to reporting information for the company's financial statements. The auditors should not become a source of disclosure about the company's financial information. The auditor's role should remain that of an independent auditor attesting that the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows of the company. Otherwise by changing the Auditor's role, we believe there could be blurred lines between management and the auditor. The lack of clearly defined roles may create investor confusion on potentially different perspectives related to the financial information being presented. Management is the most appropriate party to provide additional information about the company's financial statements and therefore we believe it is imperative to retain the distinction in responsibilities between management and the auditor.

Following are our comments related to the four alternatives presented in the Concept Release:

**I. Auditor's Discussion and Analysis**

It is our understanding that the intent of including a supplemental Auditor's Discussion and Analysis (AD&A) report is to provide auditors with the ability to discuss their views regarding significant matters. It is further intended to facilitate an understanding of the financial statements taken as a whole. While we are not necessarily opposed to auditors discussing current audit procedures as required by the PCAOB, we are strongly opposed to an AD&A which discusses alternative accounting or disclosure treatment and auditor views regarding significant matters and difficult and/or contentious issues including "close calls". We believe the addition of an AD&A discussing these items would confuse users regarding the conclusions reached by the auditor (i.e. was it really an "unqualified opinion"?). Further, two competing discussions, one from the independent auditor and the other from management, whether related to an accounting principle contained in the financial statements, footnotes or a disclosure item, is likely to confuse investors.

In addition to creating investor confusion, we believe the addition of the AD&A would significantly increase the scope and time requirement for completing audits, which would lead to significant increases in audit fees while putting even more pressure on meeting already tight filing deadlines. Also according to the Concept Release, if an AD&A were adopted it would lead to new auditing standards regarding the appropriate content and level of detail to be reported on. We believe this would also likely result in higher fees to the issuer.

Overall, we do not believe the AD&A brings greater clarity or value to investors. There is already substantial financial information and disclosures which are made by management in the Quarterly 10-Q and Annual 10-K Reports. In addition, the current auditor report generally states that the audit of the issuer's financial statements includes an assessment of the accounting principles used and significant estimates made by management, as well as, evaluating the overall financial statement presentation. If the auditor's opinion states that the financial statements present fairly, in all material respects, the financial position of a company for the respective period, we do not believe that providing an AD&A would add meaningful value to investors and that the incremental cost related to preparing it would be justified.

**II. Required and Expanded Use of Emphasis Paragraphs**

This alternative would mandate the use of emphasis paragraphs in all audit reports and further expand the emphasis paragraph to highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements.

We do not support the required and expanded use of emphasis paragraphs, as we do not believe it would achieve the objective of providing relevant and useful information to allow investors to make better investment decisions. We strongly believe that matters related to the financial statements including the discussion and disclosure of significant items should remain the responsibility of management. The auditor's responsibility should be focused on whether the financial statements are in conformity with GAAP in all material respects. We believe any separate auditor commentary inconsistent from that provided by management, despite a "clean" opinion by the auditor that the financial statements are in conformity with GAAP, would be confusing to investors.

The Concept Release suggests a couple of areas where emphasis paragraphs could be required with one of those being a discussion of audit procedures for certain areas. As audit procedures are specific to each company and each specific matter, any discussion or disclosure of procedures within the audit report would have to be detailed and lengthy in order to provide sufficient information for users who are not auditors to be able to understand it. Any detailed discussion of audit procedures and concepts could add confusion to the readers of the financial statements who are not generally financial experts. We believe a lengthy description of such procedures would likely detract and lessen the impact of the emphasis paragraphs and/or provide insufficient value to users. We believe it is more appropriate to provide a general overview of how an audit is conducted and perhaps refer investors to the PCAOB in the event they would like more specific information on auditing standards.

**III. Auditor Assurance on Other Information Outside the Financial Statements**

This alternative would require auditors to provide assurance on information outside the financial statements, such as MD&A, or other information (for example, non-GAAP information or earnings releases). We are strongly opposed to requiring auditors to provide assurance on information outside the financial statements. We do not think it is appropriate nor would it significantly enhance the respective disclosures.

The financial statements and disclosures are the responsibility of management and as such the information included within those financial statements should be that of management. Having auditors provide assurance on information outside of the financial statements would likely create confusion related to the auditor's role in regard to the financial statements and whether they were truly acting as an independent party. Furthermore, providing assurance on information contained within the MD&A, or certain other non-GAAP information where such information is often forward looking and judgmental, could be very difficult and provide for contentious debate between management and auditors. This approach would likely result in a significant increase in time and costs and we do not believe it would enhance or improve the quality of the information being communicated to the reader.

**IV. Clarification of the Standard Auditor's Report**

In general we agree with this alternative which proposes to clarify the auditor's report in the areas of reasonable assurance; the auditor's responsibility for fraud, financial statement disclosures and information outside of the financial statements; management's responsibility for the preparation of the financial statements and auditor independence.

We believe that improving or enhancing the above areas of the auditor's report provides a straight-forward approach in clarifying important areas in the report. It is an effective manner to enhancing the auditor's reporting model. We are supportive of the inclusion of this information in the auditor's report, and believe it would help achieve the objective of clarifying roles between auditors and management thereby increasing clarity for the readers of the audit report.

**Considerations Related to Changing the Auditor's Report**

The Board specifically asked for comments related to the practical challenges presented by the proposed auditor report alternatives including the effects on; audit effort, auditor relationships, audit committee governance, liability considerations and confidentiality.

As discussed above we believe the addition of an AD&A, requiring and expanding emphasis paragraphs and/or requiring auditors to provide assurance on information outside the financial statements would significantly increase the scope and work of auditors. This would likely translate into significant fee increases passed on to users. In addition, we are concerned about the impact that the additional work would have on meeting annual and interim filing deadlines which are already very tight. We suggest that a cost/benefit analysis be utilized for each alternative under consideration. In doing so, we believe the costs would be significantly higher than the benefits for the first three alternatives proposed in the Concept Release.

It seems certain proposed alternatives and ideas within this Concept Release would make auditor liability considerations a legitimate concern, especially if auditors were required to provide assurance on information outside the financial statements. Additionally, we believe any of the first three proposed alternatives could lead to negative effects and strained relationships between the auditor, management, and the Audit Committee, which may inhibit the lines of communication and ultimately not enhance the overall auditor reporting model.

While we support enhancing auditor communications to investors and increasing transparency related to the auditor's reporting model, we believe there must be a cost effective approach to achieve these goals, while minimizing the overall potential challenges and unintended consequences related to additional auditor reporting. We believe the proposed alternative which best achieves this goal is for auditors to provide clarification of the standard auditor's report.

We appreciate the opportunity to respond and the willingness of the PCAOB board members to exchange views with issuers during the comment period.

Please contact us at (650) 589-9445 with any follow-up questions you may have on our comment letter.

Sincerely,

CORE-MARK HOLDING COMPANY, INC.

By:

Stacy Loretz-Congdon
Chief Financial Officer

Christopher Miller
Chief Accounting Officer

Council of Institutional Investors
The Voice of Corporate Governance

Via Email

September 19, 2011

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

***Re: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (PCAOB Rulemaking Docket Matter No. 34)***[1]

Dear Office of the Secretary:

I am writing on behalf of the Council of Institutional Investors ("Council"), a nonprofit association of public, corporate, and union pension funds with combined assets of over three trillion dollars. Member funds are major shareowners with a duty to protect the retirement assets of millions of American workers.[2]

The Council appreciates the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Concept Release on Possible Revisions to the PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("Release"). Our detailed responses to the questions contained in the Release are included as an Attachment to this letter.

The Council wants to thank the PCAOB for its outreach to investors and other stakeholders in connection with the development of the Release. We congratulate the Board on its leadership and courage in exploring issues that have long been debated and remain controversial with some stakeholders. As you may be aware, the Council's membership approved policies contain a statement that expresses the widely held view that "investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs."[3]

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[1] Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-003, 34 PCAOB Rulemaking Docket Matter 1 (June 21, 2011), http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf [hereinafter Release].

[2] For more information about the Council of Institutional Investors ("Council") and its members, please visit the Council's website at http://www.cii.org/.

[3] Council of Institutional Investors, Statement on Independence of Accounting and Auditing Standard Setters 2 (adopted Oct. 7, 2008), http://www.cii.org/UserFiles/file/Statement%20on%20Independence%20of%20Accounting%20and%20Auditing%20Standard%20Setters.pdf.

Moreover, as indicated in the Release, the "auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements."[4] Thus, from the perspective of Council members, the Release raises two core issues: (1) whether the current auditor's reporting model satisfies investors' information needs; and (2) if not, how the model might be improved so that it is more responsive to those needs.

### *1. The current auditor's reporting model does not satisfy investors' information needs*

The evidence indicates that there is a strong consensus among investors' that the auditor's report no longer satisfies their information needs. In just the past four years that view has been reflected in, among other sources: the recommendations and conclusions of the Department of the Treasury's Advisory Committee on the Auditing Profession ("Advisory Committee");[5] the surveys of members of the CFA Institute, the global not-for-profit association of more than 100,000 investment professionals;[6] a survey of investors by the PCAOB's Investor Advisory Group ("IAG Survey");[7] and in the PCAOB staff's own extensive research in connection with the development of the Release.[8]

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[4] Release, *supra* note 1, at 2.

[5] U.S. Department of the Treasury, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury VII:13 (Oct. 6, 2008), http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf ("**Recommendation 5: Urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model**.") [hereinafter Treasury Report].

[6] CFA Institute, Usefulness of the Independent Auditor's Report, Survey to the CFA Institute Financial Reporting Survey Pool 6 (Mar. 2011), http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_march_2011.pdf ("58% think that the independent auditor's report needs to provide more specific information about how the auditors reach their opinion . . . .") [hereinafter 2011 CFA Survey]; CFA Institute, Independent Auditor's Report Survey Results 4 (Mar. 2010), http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf ("94 percent of respondents would like to see additional information in the auditor's report"); CFA Institute, CFA Institute Member Poll on the Independent Auditor's Report 1 (Mar. 2008), http://www.cfainstitute.org/Survey/independent_auditors_report_poll_results_march_2008.pdf (80% responding that the "independent external auditors report [should] provide specific information about how the auditors reach their unqualified opinion").

[7] Joseph Carcello *et al*., Improving the Auditor's Report (Mar. 16, 2011), http://pcaobus.org/News/Events/Documents/03162011_IAGMeeting/Role_Of_The_Auditor.pdf ("23% of respondents believe the current auditor report provides valuable information") [hereinafter IAG Survey].

[8] Release, *supra* note 1, at 7 ("The staff observed that there was consensus among investors that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful.").

***2. The current auditor's reporting model should be improved by supplementing the auditor's report with an auditor's discussion and analysis ("AD&A") that includes, at a minimum, the auditor's assessment of management's critical accounting judgments and estimates***

An AD&A is an ideal approach to improving the current auditor's report so that it provides information more responsive to investors' needs. An AD&A that supplements, rather than expands or replaces the current auditor's report, would retain the value of the existing report while responding to the needs of investors for more relevant and useful information from the auditor. We note that the recent IAG Survey revealed that a majority of investors responding "believe there should be a separate Auditor's Discussion and Analysis section in the 10-K."[9]

An AD&A should include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. Such disclosure was supported by 86% of the respondents to the 2011 CFA Institute survey[10] and 79% of the respondents to the IAG Survey.[11] Other disclosures highly valued by many investors that should also be considered for inclusion in the AD&A, include: (1) areas of high financial statement and audit risk; (2) unusual transactions, restatements and other significant changes to the financial statements; and (3) the quality—not just acceptability—of the issuer's accounting policies and practices.[12]

The potential benefits of an AD&A approach as we have proposed are many. In addition to preserving the value of the current auditor's report, the AD&A would provide investors with critical information from an independent expert relevant to analyzing and pricing risks and making investment and voting decisions. An AD&A would also heighten the perceived value of the work of audit firms, increase quality competition among the firms, particularly with respect to auditor skepticism, and provide the firms more leverage to affect change and enhance management disclosure in the financial statements. The result would be increased transparency to investors and an overall boost to investor confidence in audited financial reports.

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[9] IAG Survey, *supra* note 7.
[10] 2011 CFA Survey, *supra* note 6, at 6 ("[i]nformation about the independent auditor's assessment of management's critical accounting judgments and estimates (86% felt this was important to include)").
[11] IAG Survey, *supra* note 7 ("79% of respondents believe the auditor should discuss significant estimates and judgments made by management, the auditor's assessment of their accuracy, and how the auditor arrived at that assessment").
[12] *Id.*

The costs of an AD&A approach should not be particularly burdensome for public companies or their auditors. The type of information we propose to be included in an AD&A is already collected by auditors for a summary memorandum included in their work papers describing the major risks of the audit, or is required to be provided by the auditor to the audit committee. In any event, we believe the evidence indicates that investors, who ultimately pay the auditor's bill, have concluded that the benefits of the additional information they seek would outweigh the incremental costs.

Finally, we would like to take this opportunity to reiterate to the Board our strong support, consistent with the recommendation of the Advisory Committee and the existing requirements of the European Union's Eight Directive,[13] for requiring the engagement partner's signature on the auditor's report.[14] We continue to endorse the findings of the Advisory Committee that "the engagement partner's signature on the auditor's report would increase transparency and accountability."[15]

We are disappointed that more than two years have passed since the Board issued a concept release on requiring the engagement partner to sign the audit report and a proposed rule has not yet been issued. We would respectfully request that the Board either promptly release a timeline for issuing a proposed rule, or provide investors and the public with an explanation as to why this important improvement is no longer under active consideration.

[13] Treasury Report, *supra* note 5, at VII:19-20.
[14] Letter from Jonathan D. Urick, Analyst, Council of Institutional Investors to J. Gordon Seymour, Secretary and General Counsel, Public Company Accounting Oversight Board 3 (Sept. 4, 2009), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2009/CII%20Comments%20on%20PCAOB%20Rulemaking%20Docket%20Matter%20No%20%2029%20(3)%20doc%20(final).pdf ("In light of the enhanced transparency and accountability resulting from the signature of the engagement partner on the auditor report, the Council strongly supports the PCAOB's Concept Release.").
[15] Treasury Report, *supra* note 5, at VII:20.

The Council appreciates the opportunity to comment on the Release. We thank you for considering our views and we stand ready to assist you in your efforts to improve the auditor's report so that it is more responsive to the information needs of its key customer—investors.

Sincerely,

Jeff Mahoney
General Counsel

Attachment

ATTACHMENT

***Concept Release on Possible Revisions to PCAOB Standards Related To Reports on Audited Financial Statements and Related Amendments to PCAOB Standards***

**Council of Institutional Investors**

**Responses to Questions**

**September 19, 2011**

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

   a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

   b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

   c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?[1]

**The Public Company Accounting Oversight Board ("PCAOB" or "Board") should undertake a standard-setting initiative to consider improvements to the auditor's reporting model because the standard auditor's report no longer satisfies the information needs of its key customer—investors.**

**As an initial matter, we note that the membership approved policies of the Council of Institutional Investors ("Council") recognize that "investors are the key customer of audited financial reports, and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs."[2] Moreover, the "auditor's report is the primary means by which the auditor communicates to investors regarding**

[1] Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-003, 34 PCAOB Rulemaking Docket Matter 1 (June 21, 2011), http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf [hereinafter Release].

[2] Council of Institutional Investors, Statement on Independence of Accounting and Auditing Standard Setters 2 (Adopted Oct. 7, 2008), http://www.cii.org/UserFiles/file/Statement%20on%20Independence%20of%20Accounting%20and%20Auditing%20Standard%20Setters.pdf.

**its audit of the financial statements."[3] In our view, the evidence indicates that the standard auditor's report, which has had few alterations since the 1930's, no longer satisfies the information needs of its key customer.**

**The failure of the standard auditor's report to satisfy the information needs of investors was reflected in the PCAOB's outreach in connection with the development of the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("Release").[4] More specifically, the PCAOB staff "observed that *there was consensus among investors* that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful."[5]**

**The PCAOB staff observations that the primary customers of the standard auditor's report believe the report should be improved to make it more relevant and useful should not have been a surprise to anyone who is interested in, or follows, investor views on issues relating to accounting and auditing. As early as 1978, the Commission on Auditor's Responsibilities, one of the most significant studies of the auditing profession in U.S. history, concluded:**

> **Evidence abounds that communication between the auditor and the users of his work—*especially through the auditor's standard report*—is unsatisfactory.[6]**

**Since 1978, the evidence that investors demand more information from the auditor's report has only grown. As indicated in the Release, a March 2008 poll of the members of CFA Institute, the global not-for-profit organization of over 100,000 investment professionals, found that more than 80% of members responding agreed that the "independent external auditors report**

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[3] U.S. Department of the Treasury, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury VII:13 (Oct. 6, 2008), http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf [hereinafter Treasury Report].
[4] Release, *supra* note 1, at 7.
[5] *Id.* at 7 (emphasis added).
[6] The Commission on Auditor's Responsibilities: Report, Conclusions, and Recommendations 71 (1978) (emphasis added) (on file with Council of Institutional Investors). The Commission on Auditor's Responsibilities was chaired by Manuel F. Cohen, partner in the law firm of Wilmer, Cutler & Pickering and a former chairman of the Securities and Exchange Commission. *Id*. at xiv. Other members included: Lee J. Seidler, professor of accounting of New York University and a consulting financial analyst; Walter S. Holmes, Jr., chairman of the board and chief executive officer of C.I.T Financial Corporation; William C. Norby, senior vice president of Duff & Phelps, Inc., an independent investment research firm, and former president of the Financial Analysts Federation; LeRoy Layton, a retired managing partner of the public accounting firm of Main Lafrentz & Co., former president of the American Institute of Certified Public Accountants, and former chairman of the Accounting Principles Board; Kenneth W. Stringer, senior technical partner of the public accounting firm of Haskins & Sells; and John J. van Benten, managing partner of the public accounting firm of Geo. S. Olive & Co. *Id.*

**[should] provide specific information about how the auditors reach their unqualified opinion indicating that a company has fairly presented its financial statements in accordance with the required financial reporting standards."[7]**

**In October 2008, an advisory committee to the U.S. Department of the Treasury ("Advisory Committee") completed a comprehensive study on the auditing profession ("Treasury Report").[8] That study, "reflecting nearly one year's efforts of a philosophically diverse, talented, and committed group of investor, business, academic, and institutional leaders,"[9] including a chairman and CEO of one of the big four auditing firms,[10] explicitly recommended that the PCAOB "undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model."[11]**

**In August 2009, a research paper authored by Professors Gray, Turner, Coram, and Mock was issued entitled "User Perceptions and Misperceptions of the Unqualified Auditor's Report"("Gray Paper").[12] The Gray Paper findings included, based on a series of focus groups, that**

[7] CFA Institute, CFA Institute Member Poll on the Independent Auditor's Report 1 (Mar. 2008), http://www.cfainstitute.org/Survey/independent_auditors_report_poll_results_march_2008.pdf.
[8] Treasury Report, *supra* note 3, at I:1.
[9] *Id*. at II.2.
[10] *Id*. at III:1. The advisory committee members included: Arthur Levitt, Jr., Co-Chair, Senior Advisor, The Carlyle Group; Donald T. Nicolaisen, Co-Chair, Board Member, Morgan Stanley Corporation, MGIC Investment Corporation, Verizon Communications Inc., and Zurick Financial Services; Alan L. Beller, Counselor to the Co-Chairs, Partner, Cleary Gottleib Steen & Hamilton LLP; Amy Woods Brinkley, Global Risk Executive, Bank of America Corporation; Mary K. Bush, Board Member, Briggs and Stratton Corporation, Discover Financial Services, ManTech Corporation, and United Airlines Inc.; H. Rodgin Cohen, Chairman, Sullivan & Cromwell LLP; Timothy P. Flynn, Chairman and Chief Executive Officer, KPMG LLP; Robert R. Glauber, Board Member, Moody's Corporation, XL Capital Ltd., and Quadra Realty Trust; Ken Goldman, Chief Financial Officer, Fortinet Inc.; Gaylen R. Hansen, Board Member, National Association of State Boards of Accountancy, and Principal, Director of Accounting and Auditing Quality Assuance, Ehrhardt Keefe Steiner & Hottman PC; Barry C. Melancon, President and Chief Executive Officer, American Institute of Certified Public Accountants; Anne M. Mulcahy, Chairman and Chief Executive Officer, Xerox Corporation; Richard H. Murray, Managing Director and Chief Claims Strategist, Swiss Re; Gary John Previts, President, American Accounting Association, and E. Mandell de Windt Professor, Weatherhead School of Management, Case Western Reserve University; Damon A. Silvers, Associate General Counsel, The American Federation of Labor and Congress of Industrial Organizations; Richard A. Simonson, Executive Vice President and Chief Financial Officer, Nokia Corporation; Sarah E. Smith, Controller and Chief Financial Officer, Goldman Sachs Inc.; William D. Travis, Director and Former Managing Partner, McGladrey & Pullen LLP; Lynn E. Turner, Former Chief Accountant, Securities and Exchange Commission, and Senior Advisor, Kroll Zolfo Cooper LLC; Paul A. Volcker, Vice-Chair, Former Chairman, Board of Governors, Federal Reserve System; and Ann Yerger, Executive Director, Council of Institutional Investors. *Id* at III:1-2.
[11] *Id.* at VII:13.
[12] Glen L. Gray, *et al*., User Perceptions and Misperceptions of the Unqualified Auditor's Report 11, 31 (Aug. 30, 2009), http://aaahq.org/meetings/AUD2010/UserPerceptionsAndMisperceptionsUnqualifiedAuditorsReport.pdf [hereinafter Gray Paper].

**because of its limited informational content "[u]sers generally do not read the auditor's report and auditors do not expect that they do."[13]**

**In March 2010, the CFA Institute conducted a second survey of its members "to gather feedback on topics associated with the independent auditor's report."[14] That survey found that "94 percent of respondents would like to see additional information in the auditor's report."[15] One of the respondents provided the following elaborative comments consistent with the survey results:**

> ***Because the auditor's report has become rather "boiler-plate" it is not very useful to investors. That being said, the "auditor's report" should be extremely valuable. The auditors possess much information which could be useful to investors.[16]***

**In April 2010, the Financial Services Faculty of the Institute of Chartered Accountants in England and Wales ("FSF") released the results of their interviews with investors and other stakeholders in connection with their research on the financial crisis and "ways in which bank auditors can more effectively support confidence."[17] The FSF's paper, entitled "Audit of Banks: Lessons from the Crisis," included the following observation summarizing the investor views on the audit reports of banks:**

> **The audit report itself, however, was not viewed as providing useful information to users. It was variously described as a statement of compliance with accounting standards and lacking in information content, since unqualified audit reports use standardized wording. This can make it difficult for investors to assess the quality of individual auditor performance and differentiate between audit firms.[18]**

**In January 2011, the Financial Reporting Council issued a paper entitled "Effective Company Stewardship, Enhancing Corporate Reporting and**

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[13] *Id.* at 31.
[14] CFA Institute, Independent Auditor's Report Survey Results 4 (Mar. 2010), http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf [hereinafter 2010 CFA Survey].
[15] *Id.* at 3.
[16] *Id.* at 5.
[17] ICAEW Financial Services Faculty, Audit of Banks: Lessons from the Crisis § 1 (Apr. 2010), http://www.icaew.com/~/media/Files/technical/Financial-services/audit-of-banks-stakeholder-feedback [hereinafter FSF Paper].
[18] *Id.*

**Audit"("FRC Paper")[19] The FRC Paper describes the potential benefits to enhancing auditor skepticism if auditors provide "greater transparency . . . [of their assessments to] the Audit Committee and *investors*."[20]**

**In March 2011, the Investor Advisory Group ("IAG") of the PCAOB released their survey of investors' views on improving the auditor's report ("IAG Survey").[21] The IAG Survey included responses from multiple representatives from six institutional investors whose combined assets under management exceeded six trillion dollars.[22]**

**The IAG survey revealed that "45% of respondents believe the current audit report does *not* provide valuable information that is integral to understanding financial statements."[23] Perhaps more telling, only "23% of respondents believe the current audit report provides valuable information."[24] Some comments from those respondents include the following:**

> **"Over the years, the report has evolved into something that really communicates as little new information as possible." –Head of Fixed Income Portfolio Management, Money Management Firm**
>
> **"The audit report is largely boilerplate, and only provides meaningful information in extreme circumstances, usually around going concern issues." – Chief Investment Officer, Mutual Fund.[25]**

**Finally, also in March of this year, the CFA Institute issued a third survey of its members relating to the auditor's report ("2011 CFA Survey").[26] Entitled "Usefulness of the Independent Auditor's Report," the 2011 CFA Survey found that "58% think that the independent auditor's report needs to**

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[19] Financial Reporting Council, Effective Company Stewardship, Enhancing Corporate Reporting and Audit 1 (Jan. 7, 2011), http://www.frc.org.uk/images/uploaded/documents/Effective%20Company%20Stewardship%20Final2.pdf [hereinafter FRC Paper].

[20] *Id.* at 14 (emphasis added).

[21] Joseph Carcello *et al.*, Improving the Auditor's Report (Mar. 16, 2011), http://pcaobus.org/News/Events/Documents/03162011_IAGMeeting/Role_Of_The_Auditor.pdf [hereinafter IAG Survey].

[22] *Id.* (Multiple responses were received from representatives of BlackRock, Vanguard, Capital Group, TIAA-CREF, Legg Mason, and Breeden Capital).

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] CFA Institute, Usefulness of the Independent Auditor's Report 1 (Mar. 2011), http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_march_2011.pdf. [hereinafter 2011 CFA Survey]

**provide more specific information . . . ."[27] Some comments from those respondents include:**

> ***Current opinion is boilerplate.***
> ***. . . .***
> ***Not a lot of confidence in current auditor's report.***
> ***Report now contains no information.***
> ***Right now it is boilerplate wording.***
> ***. . . .***
> ***Some highly legalised text that is the same for pretty much every company (as it is today) is not very useful.***
> ***. . . .***
> ***The current boilerplate language is simply not sufficient.***
> ***. . . .***
> ***The final presentation of the statements is very boilerplate and explains nothing that was encountered during the audit.***
> ***. . . .***
> ***The language is too boilerplate. The company is still the customer of the auditor.***[28]

**In our view, and generally consistent with the results of the PCAOB staff outreach, the evidence indicates investors believe the standard auditor's report should be improved to provide more relevant and useful information by supplementing the existing "pass/fail model and standardized language of the auditor's report."[29] More specifically, the standard auditor's report should be supplemented with, at a minimum,[30] "the independent auditor's assessment of management's critical accounting judgments and estimates."[31]**

**We note that our view is supported by 86% of respondents to the 2011 CFA Survey[32] and 79% of respondents to the IAG Survey.[33] One of the respondents to the 2011 CFA Survey explained:**

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[27] *Id.*
[28] *Id*. at 2-3.
[29] Release, *supra* note 1, at 9 ("Accordingly, many of these investors supported a reporting format in which a standard auditor's report is retained, with certain language in the report clarified, but supplemented with discussion by the auditor about the audit and the company's financial statements.").
[30] Other disclosures highly valued by many investors that should also be considered for inclusion in the AD&A, include: (1) areas of high financial statement and audit risk; (2) unusual transactions, restatements and other significant changes to the financial statements; and (3) the quality—not just acceptability—of the issuer's accounting policies and practices. IAG Survey, *supra* note 21.
[31] 2011 CFA Survey, *supra* note 26, at 6 ("Information about the independent auditor's assessment of management's critical accounting judgments and estimates (86% felt this was important . . . .))."
[32] *Id*.

> ***Careful accounting analysts know that there is some discretion about which principle to apply and how to apply it. We can reach our own assessment of whether these principles are conservative or aggressive, but it would be nice if there was some way to indicate how much discretion the auditor believed had been taken, and in theory, in which direction.[34]***

**Similarly, a respondent to the IAG Survey, identified as a Chief Investment Officer of a Mutual Fund, commented:**

> **"There are many judgments that ultimately determine the data on the financial statements. It's critical to understand how estimates were made and how much margin of error there might be in the estimates."**

**Our view is also generally supported by the FRC Paper's observations that the auditor should enhance the transparency of their assessments of "material assumptions and estimates,"[35] and the Advisory Committee findings that "some institutional investors believe an expanded auditor's report would enhance investor confidence in financial reporting and recommended exploring a more 'narrative' report in areas, such as 'estimates, judgments . . . .'"[36]**

**Finally, we do not object to the Board considering the expansion of the auditor's role to provide assurance on matters in addition to the financial statements. We, however, currently have no basis for concluding that such an expansion would necessarily be responsive to the information needs of the key customer of the auditor's report.[37]**

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash

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[33] IAG Survey, *supra* note 21 ("79% of respondents believe the auditor should discuss significant estimates and judgments made by management, the auditor's assessment of their accuracy, and how the auditor arrived at that assessment (14% disagree with requiring this disclosure)").
[34] 2011 CFA Survey, *supra* note 26, at 7.
[35] FRC Paper, *supra* 19, at 14.
[36] Treasury Report, *supra* note 3, at VII:17.
[37] One prominent accountant/analyst/investor has indicated that an expansion of the auditor's role to provide assurance on matters in addition to the financial statements, while not necessarily responsive to the information needs of investors, may be responsive to some audit firms' desire to increase audit fees. Jack T. Ciesielski, A PCAOB Proposal: Not Your Father's Audit Opinion, 20(9) Analyst Acc. Observer 4 (July 16, 2011) (on file with Council) ("Auditing firms would likely favor this approach: by increasing the reach of the auditor's responsibilities, audit prices should increase.") [hereinafter Ciesielski].

flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

a. Should the auditor's report retain the pass/fail model? If so, why?

b. If not, why not, and what changes are needed?

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.[38]

**As indicated in response to question 1, and consistent with the results of the PCAOB staff outreach to investors[39] and other available evidence,[40] the auditor's report should retain the pass/fail model, but be supplemented, at a minimum, with the independent auditor's assessment of management's critical accounting judgments and estimates. The pass/fail model, while clearly insufficient to meet investors' information needs, provides investors some value by allowing them to "skim [the] report quickly [and easily identify] . . . departures from the standard unqualified report."[41] As further explained by one respondent to the IAG Survey:**

> **"Either a qualified opinion or not. Not a lot of incremental information once a company gets an unqualified opinion."[42]**

**Similarly, a respondent to the 2010 CFA Survey commented:**

> ***Clean vs. not clean. Otherwise, not important, since it is boilerplate*.[43]**

**Finally, the Gray Paper included the following similar results form its series of focus groups on the auditor's report:**

> **When asked how they use the auditor's report, the most common response by users indicate they look at the third paragraph to see if there is an**

[38] Release, *supra* note 1, at 10-11.
[39] *Id*. at 9 ("Many investors indicated that the pass/fail model and standardized language of the auditor's report provides consistency, comparability, and clarity of auditor reporting.").
[40] *See, e.g.*, 2010 CFA Survey, *supra* note 14, at 3 (indicating that 72 percent of respondents believe that the existing "auditor's report is important to their analysis and use of financial reports in the investment decision making process").
[41] IAG Survey, *supra* note 21 ("73% of respondents skim report quickly for departures from the standard unqualified report while 18% believe it is of no use to them at all").
[42] *Id.*
[43] 2010 CFA Survey, *supra* note 14, at 5.

> **unqualified opinion and then they look to see which audit firm signed the report. If the report is unqualified and signed by a Big 4 firm, they do not consider the report again and move on to analyze the financial statements.[44]**

**Thus, in our view, supplementing the current auditor's report, rather than expanding or replacing it, preserves the value of the pass/fail model while at the same time responding to the needs of investors for more relevant and useful information from the auditor.**

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.[45]

**As indicated in response to question 1, and consistent with the results of the PCAOB staff outreach to investors,[46] and other available evidence,[47] investors are demanding that the auditor provide additional information about the company's financial statements for several reasons. First, the auditor would be in a unique position to provide investors with information relevant to analyzing and pricing risks and making informed investment decisions because (a) the auditor's extensive knowledge of the company and industry obtained through the audit process and the auditor's experiences with other companies in similar industries;[48] (b) the auditor is an independent third party that could provide an unbiased view of the company's financial statements;[49] and (c) the auditor could use the disclosure requirement to "leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."[50]**

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[44] Gray Paper, *supra* note 12, at 11.
[45] Release, *supra* note 1, at 11.
[46] *Id*. at 7-8.
[47] *See, e.g.,* Treasury Report, *supra* note 3, at VII:13-19.
[48] Release, *supra* note 1, at 7 ("During the staff's outreach, many investors indicated that the auditors are in a unique position to provide relevant and useful information, because of the auditors' extensive knowledge of the company and industry obtained through the audit process and the auditors' experiences with other companies in similar industries.").
[49] *Id*. ("Some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party.").
[50] *Id.* at 13.

**Second, additional information from the auditor could increase quality competition among audit firms,[51] particularly in the area of professional skepticism,[52] and, thereby, enhance the value of the audit to investors and the confidence in audited financial reports.[53] Third, investor/shareowners would have more information to assist them in their responsibilities for overseeing company directors and management.[54] For example, information provided by the auditor providing insight into any disconnect between the company's and the auditor's assumptions would provide investor/shareowners a better sense of management, and perhaps management's willingness to engage in aggressive accounting.[55] Finally, investor/shareowners would have more information to assist them in making an informed vote on the board's choice of the external independent auditor.[56]**

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?[57]

**No response.**

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

   a. If you support an AD&A as an alternative, provide an explanation as to why.

   b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

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[51] *See, e.g.*, 2011 CFA Survey, *supra* note 26, at 9 ("This [more transparency from the auditor] would increase quality competition between auditors.").

[52] *See, e.g.*, FRC Report, *supra* note 19, at 14 ("Such scepticism would be enhanced by greater transparency, with the assessments made by auditors being open to effective challenge by the Audit Committee and investors.").

[53] *See, e.g.*, Treasury Report, *supra* note 3, at VII:17 ("One witness noted that some institutional investors believe an expanded auditor's report would enhance investor confidence in financial reporting and recommended exploring a more 'narrative' report in areas, such as 'estimates, judgments, sufficiency of evidence and uncertainties.'").

[54] *See, e.g.*, IAG Survey, *supra* note 21 ("'[a]ny insight into the disconnect between the company's and the auditor's assumptions gives a better sense of management, and management's willingness to engage in aggressive accounting'").

[55] *Id.*

[56] *Cf.* FSF Paper, *supra* note 17, at § 1 (noting that the standard auditor's report makes "it difficult for investors to assess the quality of individual auditor performance and differentiate between audit firms").

[57] Release, *supra* note 1, at 11.

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

d. If you do not support an AD&A as an alternative, explain why.

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?[58]

**The Board should consider an AD&A as an alternative for providing additional information in the auditor's report. As indicated in response to question 2, an AD&A as a supplement to the standard auditor's report is the best of the alternatives presented in the Release because it provides a vehicle to satisfy the information needs of investors for more relevant and useful information from the auditor without diminishing the value of the pass/fail model derived from investors' ability to quickly discern whether the report departs from the standard unqualified report.**

**We note that our view finds support in the results of the IAG Survey which found that "52% [of institutional investors responding] believe there should be a separate Auditor's Discussion and Analysis section in the 10-K . . . ."[59] We agree with the view expressed by a respondent to the IAG Survey who stated:**

> **This [an AD&A] would be a preferable approach to enhancing auditor information available versus changing the audit report rating system.[60]**

**As indicated in response to question 1, an AD&A should include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. The evidence demonstrates that such a disclosure is strongly supported by investors.**

**As indicated in response to question 3, an AD&A disclosure about the independent auditor's assessment of management's critical accounting judgments and estimates would be relevant and useful in making investment decisions and would also be used for several other important purposes, including as an additional piece of relevant information to assist investor/shareowners in making an informed vote on the board's choice of the external independent auditor. Finally, of the four alternatives presented in the Release, the only alternative (other than an AD&A) that could potentially be responsive to investors' information needs is a "[r]equired**

[58] *Id.* at 18.
[59] IAG Survey, *supra* note 21.
[60] *Id.*

**and expanded use of emphasis paragraphs" to the extent that the emphasis paragraphs could accommodate, at a minimum, the auditor's assessment of management's critical accounting judgments and estimates.[61] In our view, the location of the information is less important than the existence, source and content of the information.**

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?[62]

**As indicated in response to question 1, the AD&A should include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. The appropriate content and level of detail regarding this, and potentially other, financial statement related matters presented in the AD&A should generally be consistent with the information currently required to be communicated to the audit committee, or the information required to be included in the summary memorandum prepared by the engagement partner for the audit work papers describing the major risks of the audit.[63]**

7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?[64]

**See response to question 6.**

8. Should a standard format be required for an AD&A? Why or why not?[65]

**While we do not oppose a standard format for an AD&A, we would be concerned with any overly prescriptive format requirements that might cause the AD&A disclosures to become boilerplate and, thereby, limit the potential benefits to investors resulting from the information we have proposed to be included in the AD&A. As described in response to question 3, two of the potential benefits of the information would be to: (1) increase the quality competition among audit firms and, thereby, enhance the value of the audit to investors and the confidence in audited financial**

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[61] Release, *supra* note 1, at 12.
[62] *Id*. at 18.
[63] *See*, *e.g.*, Ciesielski, *supra* note 37, at 3 ("The ADA might be a forum where auditors could give investors the same information they provide to a firm's audit committee.").
[64] Release, *supra* note 1, at 18-19.
[65] *Id.* at 19.

**reports; and (2) assist the investor/shareowners in making an informed vote on the board's choice of the external independent auditor. These and other potential benefits could be diminished if the AD&A is subject to a rigid standard format.**

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?[66]

**As indicated in response to question 1, we believe the standard auditor's report should be supplemented with, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. We are not, at this time, advocating that the auditor's current responsibilities be expanded beyond their current level of expertise and training.**

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?[67]

**In our view, boilerplate language might best be avoided in an AD&A through vigorous enforcement of requirements that are not overly prescriptive. Our view is generally consistent with that of prominent accountant/analyst/investor Jack Ciesielski who opined that "[v]igorous enforcement by the PCAOB, through the inspection process, might discourage auditors from making the AD&A a boilerplate document."[68]**

**We are not overly concerned with "consistency among such [AD&A] reports."[69] As indicated in response to question 3, if the information contained in AD&A reports is always consistent, the potential benefits to investors would be diminished.**

11. What are the potential benefits and shortcomings of implementing an AD&A?[70]

**See responses to questions 3 and 5 for our views on the potential benefits to investors of implementing an AD&A. In addition, as indicated in response to question 10, one of the likely shortcomings of implementing an AD&A is the need for vigorous enforcement of the requirements to avoid an AD&A that produces only boilerplate information.**

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[66] *Id.*
[67] *Id.*
[68] Ciesielski, *supra* note 37, at 3.
[69] Release, *supra* note 1, at 19.
[70] *Id.*

**We acknowledge that an AD&A would add to the cost of an audit.[71] We, however, note that the cost should be somewhat limited under our proposed AD&A because the information to be disclosed is already required to be collected by the auditor. Moreover, as indicated in response to question 1, we believe the evidence suggests that investors, who ultimately pay the auditor's bill, are willing to incur the added cost of receiving more relevant and useful information from the auditor.**

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?[72]

**As indicated in response to question 3, if an AD&A presents inconsistent or competing information between the auditor and management that information would be of significant benefit to investors by assisting them: in making an informed investment decision; by increasing quality competition among audit firms; in their responsibilities as investor/shareowners for overseeing company directors and management; and in making an informed vote as investor/shareowners on the board's choice of external independent auditor. If, in contrast, management's financial statement presentation is changed or enhanced to avoid potentially inconsistent or competing information between the auditor and management, investors would still benefit as a result of the "enhanced management disclosure in the financial statements, thus increasing transparency . . . ."[73]**

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?[74]

**As indicated in response to question 1, we believe the standard auditor's report should be supplemented with, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. In addition, in response to question 5, we explain why including the independent auditor's assessment in an AD&A would be superior to including the information in the emphasis paragraphs. If, however, the PCAOB ultimately rejects the AD&A alternative, we would not object to having the independent auditor's assessment or assessments be described in the emphasis paragraphs. In our view, the location of the**

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[71] *See, e.g.*, Ciesielski, *supra* note 37, at 4 ("*Of the four alternatives presented in the concept release, it's the most expansive form of communication to investors – and one that would certainly add to the cost of an audit.")*.
[72] Release, *supra* note 1, at 19.
[73] *Id*. at 13; *see, e.g*., Ciesielski, *supra* note 37, at 3 (noting that one benefit of an AD&A is that management "might be more likely to knuckle under to auditors when contentious issues develop").
[74] Release *supra* note 1, at 22.

**information is less important than the existence, source and content of the information.**

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

    a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

    b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.[75]

**See response to questions 5 and 13.**

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?[76]

**See response to questions 5 and 13**.

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?[77]

**See response to questions 6 and 13.**

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?[78]

**See response to questions 10 and 13.**

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?[79]

**See response to questions 11 and 13.**

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

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[75] *Id.*
[76] *Id.*
[77] *Id.*
[78] *Id.*
[79] *Id.*

a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.[80]

**We do not support the Board considering auditor assurance on other information outside the financial statements *as an alternative* for enhancing the auditor's reporting model because it would not be responsive to investors' information needs. As indicated in response to question 1, we believe the standard auditor's report should be supplemented with, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates.**

**We also note that if the Board were to pursue a project that considers auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's report, that project would not be responsive to the explicit recommendation of the Advisory Committee "[u]rging the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model."[81] We believe it is relevant that the Advisory Committee spent a significant amount of time and effort on issues surrounding potential improvements to the auditor's reporting model, and yet the findings of the Advisory Committee give no**

[80] *Id.* at 26.
[81] Treasury Report, *supra* note 3, at VII:13.

**indication that any member of the Advisory Committee, or any of the many prominent investors, preparers, members of audit committees, and auditors that provided input to the Advisory Committee, advocated auditor assurance on other information outside the financial statements as an alternative to improving the auditor's reporting model.[82]**

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?[83]

**No response.**

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of the financial statements
- Auditor's responsibility for information outside the financial statements
- Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?[84]

**We believe the clarifications described in the Release are generally not appropriate with the exception of the clarification in the area of the "[a]uditor's responsibility for fraud."[85] Our support for that clarification is**

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[82] *Id.* at VII:13-19.
[83] Release, *supra* note 1, at 27.
[84] *Id*. at 29-30.
[85] *Id*.

**based on the recommendation of the Advisory Committee that urged "the PCAOB and the SEC clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards and further that the PCAOB periodically review and update these standards."[86] As the basis for this recommendation, the Advisory Committee found "that expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud would help narrow the 'expectation gap.'"[87] We agree.**

**The remaining five clarifications in the Release appear designed more to benefit auditors, rather than investors, by clarifying the limits of the auditor's responsibilities.[88] In addition, as indicated in response to question 1, the clarifications are not responsive to investors' information needs regarding the auditor's reporting model. Finally, as indicated in response to question 2, the clarifications, at least in combination, would likely diminish the value of the existing auditor's report by making it more difficult for investors to quickly discern whether the report departs from the standard unqualified report.**

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?[89]

**See response to question 21 for a discussion of the potential benefits of providing a clarification of the language in the standard auditor's report on the auditor's responsibility for fraud. We are presently unaware of any shortcomings of providing this clarification.**

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?[90]

**As indicated in response to question 5, we believe an AD&A is the most appropriate of the several alternatives presented in the Release for improving auditor communication to the users of financial statements.**

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than

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[86] Treasury Report, *supra* note 3, at VII:13.
[87] *Id*. at VII:18.
[88] *Cf.* Ciesielski, *supra* note 37, at 5 (commenting that the clarification for reasonable assurance "doesn't really add much value to the information supplied to investors - but it does the auditor more good in that it establishes more limits on what they're seeking in an audit and puts investors on notice").
[89] Release, *supra* note 1, at 30.
[90] *Id*.

any one of the alternatives alone? What are those combinations of alternatives or elements?[91]

**As indicated in response to questions 5 and 21, we believe an AD&A alternative with, at a minimum, a required disclosure of the independent auditor's assessment of management's critical accounting judgments and estimates, together with clarification of the auditor's report in the area of the auditor's responsibility for fraud, would be the most appropriate combination of alternatives or elements contained in the Release for improving auditor communication to investors.**

25. What alternatives not mentioned in this concept release should the Board consider?[92]

**We would like to take this opportunity to reiterate to the Board that the Council strongly believes, consistent with the recommendation of the Advisory Committee and the existing requirements of the European Union's Eight Directive,[93] that improvements to the auditor's reporting model should include requiring the engagement partner's signature on the auditor's report.[94] We endorse the findings of the Advisory Committee that "the engagement partner's signature on the auditor's report would increase transparency and accountability."[95]**

**We are disappointed that more than two years have passed since the Board issued a concept release on requiring the engagement partner to sign the audit report and a proposed rule has not yet been issued.[96] We would respectfully request that the Board either promptly release a timeline for issuing a proposed rule, or provide investors and the public with an explanation as to why this important improvement is no longer under active consideration.**

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should

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[91] *Id.*
[92] *Id.*
[93] Treasury Report, *supra* note 3, at VII:19 ("**Recommendation 6: Urge the PCAOB to undertake a standard-setting initiative to consider mandating the engagement partner's signature on the auditor's report**.").
[94] Letter from Jonathan D. Urick, Analyst, Council of Institutional Investors to J. Gordon Seymour, Secretary and General Counsel, Public Company Accounting Oversight Board 3 (Sept. 4, 2009), http://www.cii.org/UserFiles/file/resource%20center/correspondence/2009/CII%20Comments%20on%20PCAOB%20Rulemaking%20Docket%20Matter%20No%20%2029%20(3)%20doc%20(final).pdf ("In light of the enhanced transparency and accountability resulting from the signature of the engagement partner on the auditor report, the Council strongly supports the PCAOB's Concept Release.").
[95] Treasury Report, *supra* note 3, at VII:20.
[96] PCAOB, Docket 029: Concept Release on Requiring the Engagement Partner to Sign the Audit Report (July 28, 2009), http://pcaobus.org/Rules/Rulemaking/Pages/Docket029.aspx.

the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?[97]

**As indicated in response to question 8, in developing an auditor reporting framework and related criteria the Board should take care to not be overly prescriptive so as to reduce the risk of boilerplate disclosures that would limit the benefits of our proposed alternative.**

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?[98]

**We are currently unaware of any basis for a financial statement user to perceive the AD&A alternative we have proposed as providing a qualified or piecemeal opinion. In our view, the AD&A alternative would include information that clearly supplements, rather than qualifies, the opinion in the standard auditor's report. If the Board disagrees with our view and concludes that an AD&A would result in some users perceiving the AD&A as providing a qualified or piecemeal opinion, the Board could potentially mitigate the risk by simply requiring an explanatory paragraph in the AD&A clearly describing the purpose of AD&A disclosures.**

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?[99]

**As indicated in response to question 21, the alternative clarifying the auditor's responsibility for fraud would better convey to users of the financial statements the auditor's role in the performance of an audit. That alternative, however, would not be fully responsive to investor information needs regarding improvements to the auditor's reporting model.**

29. What effect would the various alternatives have on audit quality? What is the basis for your view?[100]

**As indicated in response to question 3, we believe the evidence indicates that the AD&A alternative with, at a minimum, a required disclosure of the independent auditor's assessment of management's critical accounting judgments and estimates, could increase quality competition among audit firms, particularly in the area of professional skepticism.**

[97] Release, *supra* note 1, at 30.
[98] *Id.* at 31.
[99] *Id.*
[100] *Id.*

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.[101]

**We are currently unaware of any basis for excluding an AD&A alternative, as we have proposed, from the audit reports of any entity subject to the Board's rulemaking authority that files financial statements that include management's critical accounting judgments and estimates.**

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

    a. Are any of these considerations more important than others? If so, which ones and why?

    b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

    c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

    d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?[102]

**As indicated in response to question 1, in our view, none of the considerations described in the Release relevant to changing the auditor's report are individually or collectively more important than the goal of improving the auditor's reporting model to satisfy the information needs of its key customer—investors. Moreover, as indicated in response to questions 1, 3, 5, and 11, we believe the evidence suggests that investors, who ultimately pay the auditor's bill, are willing to incur the added cost of receiving more relevant and useful information from the auditor.**

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[101] *Id.*

[102] *Id.* at 33-34.

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?[103]

**As indicated in response to question 3, one of the many potential benefits of having the auditor's report be supplemented, at a minimum, with the independent auditor's assessment of management's critical accounting judgments and estimates, is that the requirement would provide the auditor with leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors. We, therefore, are not particularly troubled by the concern expressed by some that providing additional information in the auditor's report could "create more tension" or "result in additional stress" in the relationships among the auditor, management, and the audit committee.[104] In our view, the greater concern is that the current level of tension and stress among the three parties may in fact be too low.**

[103] *Id*. at 34.
[104] *Id.* at 32.

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30 September 2011

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Dear Board Members

**Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (PCAOB Rulemaking Docket Matter No. 34)**

CPA Australia welcomes the opportunity to comment on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (the Concept Release). CPA Australia is one of the world's largest accounting bodies and represents the diverse interests of more than 132,000 members in finance, accounting and business in 111 countries throughout the world. Our vision is to make CPA Australia the global professional accountancy designation for strategic business leaders. We make this submission on behalf of our members and in the broader public interest.

CPA Australia supports developments in auditor reporting that serve the evolving needs of users and safeguard effectiveness in the core function of auditing. Varying degrees of assurance are achieved through engagements such as agreed upon procedures, limited assurance and reasonable assurance. Audit is expected to deliver a reasonable level of assurance over the subject matter and a comprehensive framework exists in most jurisdictions to achieve this, including standards, criteria for auditor registration and other audit quality measures.

Proposals around auditor reporting on information outside the financial statements and clarification of certain language in the auditor's report are promising and may if sufficiently explored and developed, complement the audit function. In our view users perceive real value in the current form of auditor reporting; where the auditor exercises their expertise independently to reach a clear view, and issues a concise report to express their conclusions. Proposals for an "Auditor's Discussion and Analysis" and expanded use of emphasis paragraphs in the audit report may pose a risk of impacting negatively on this value.

Under the current reporting model, management are responsible for the preparation and presentation of financial and other information, whilst auditors add credibility by providing assurance over that information to users. This setup is fundamental to the effectiveness of the financial reporting supply chain. Issues that exist in the current corporate reporting model are being explored more appropriately in the standards and practice of financial (and non-financial) reporting. This includes examining increased reporting complexity and the comprehensive solutions such as integrated reporting. It is important to dedicate resources within the audit profession, and oversight bodies to developing the capability and frameworks required to meet the assurance needs of evolving financial (and non-financial) reports and disclosures.

We have appended to this letter, our responses to the questions raised.

If you require further information on any of our views, please contact Amir Ghandar, CPA Australia by email at amir.ghandar@cpaaustralia.com.au.

Yours sincerely

Alex Malley FCPA
Chief Executive Officer

cc: A Ghandar

**Form and content of the auditor's report (Questions 1 – 4)**

The binary approach of the current standard auditor's report is of value to stakeholders. This allows the user to take assurance that the auditor has applied their expertise and judgement to the audit and reached a level of confidence that allows them to form a clear opinion. Supplementary reporting could require the user to form their own opinion about the additional information and the audit itself. This could have the effect of diminishing the value inherent in the current core audit role. The current auditor reporting model does provide scope for emphasis of additional information without qualifying the opinion where the auditor considers this necessary for the user.

Under the current system, disclosures and other information within financial statements are the responsibility of management and the auditor's role is to provide assurance in respect of that information to users. We strongly believe that these two roles need to be kept separate and we concur with the views of some of the preparers and audit committee members who have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Any proposals to the contrary could seriously prejudice the current position of an auditor in carrying out their core role.

**Auditor's Discussion and Analysis (Questions 5 – 12)**

Some of the content proposed under this alternative could cause a blurring of roles and responsibilities between those charged with the preparation of financial statements and the auditors. Proposals to expand the auditor's role to analyse and interpret financial information could detract from their primary role of providing assurance to the users of the information as to its integrity. Specifically, this includes discussing their views regarding management's judgements and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls". These matters should be addressed by those responsible for the preparation of the financial statements.

It is understandable that a more transparent audit process could lead to a better understanding of the financial statements, provided relevant information is delivered in a reliable and understandable way. A number of questions arise in considering the proposals surrounding the disclosure of further information about the audit. What level of detail will be appropriate, and who should make this judgment? There are concerns that financial reporting today is increasingly complex, and the AD&A could add to this if not appropriately calibrated. Secondly, recognising auditors' significant legal accountabilities, how can such information be disclosed in a technically precise way while still being understandable by a wide group of users? These competing objectives can lead to standardised and cautious disclosures that don't add value.

**Emphasis of Matter Paragraphs (Questions 13 – 18)**

The Concept Release points to the French "justification of the auditor's assessment" as an approach similar to this alternative. Whilst some support exists for the French model, we note observations from practice that suggest a tendency for the disclosures being boilerplate.

One of the factors that can give rise to boilerplate disclosures are competing accountabilities and objectives. Auditors are accountable for a core role of providing assurance on financial reports which carries significant legal ramifications. Current auditor reporting is concise and technical for the purpose of delivering on this accountability in a way that does not create further risk through discursiveness in language.

In our view the current approach to emphasis paragraphs adequately addresses the intended purpose of these paragraphs.

**Other information outside the financial statements (Questions 19 – 20)**

As outlined in the paper, information outside the financial statements, including non-GAAP information and earnings releases, are increasingly prominent in investor decision making. We concur that the capability of providing meaningful assurance on this information is important and would be of value to the users. In addition to developing standards there would be a need for developments in practice and methodology.

As the Concept Release highlights, auditing standards presently describe the auditor's responsibilities regarding other information outside the financial statements, and developments in this area would require separate projects addressing the standards and practice of assurance engagements on other information outside the financial statements.

**Clarification of Language (Questions 21 – 22)**

As a document, the audit report has significant legal implications for both auditors and management, and their respective responsibilities. Precision in language used is therefore essential and this is achieved through use of professional terminology and standardised text. Clarity over the language used could be achieved through linking to more explanatory and discursive information that supports the audit report, held at another location (for example, a website).

In Australia, a separately headed Independence section has been included in the audit report, which requires the auditor to declare their compliance with independence requirements outlined in regulations/legislation. There is also a requirement in the Australian *Corporations Act* 2001 to furnish to the audited entity an "Independence declaration" which is made publicly available in the entity's annual report. This makes the status of the audit firm clear with respect to independence.

Crowe Horwath.

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September 29, 2011

Office of the Secretary
Public Company Accounting Oversight Board
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RE: **PCAOB Rulemaking Docket Matter No. 34,**
**Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" (Concept Release). We have provided summarized comments below, and provided responses to selected questions included in the Concept Release in Attachment A to this letter.

We support the pursuit of methods for auditors to better serve the needs of investors. We believe it is critically important that the value of the work performed by auditors is understood by the investing public and believe that certain improvements could be made to the current reporting model to improve that understanding. In considering the alternatives for changes to the auditor's report and questions in the Concept Release, we reached several underlying conclusions that influence our view of each of the alternatives suggested. Specifically, we concluded:

1) It is the role of the auditor to provide assurance on financial information provided by management; thus, the auditor's requirements for disclosure should not exceed those of management. This long-standing auditor role is the foundation of auditing standards, the development of auditor skills, the nature of the relationship between companies and their auditor, the cost of audit services, and a wide variety of related issues. We believe management is best suited to understand their business and future plans and to evaluate what is the most relevant information for investors; whereas the auditor's competency is providing independent assurance on information, not providing commentary on the business. We also believe requiring the auditor to provide additional information about the company may reduce audit quality by detracting from open communication between the auditor, management and the Audit Committee, while shifting some responsibility for financial reporting from management to the auditor could create the perception the auditor is an advocate for the client. Further, any requirements for auditor disclosure of client information would need to be reconciled with prohibitions on auditor disclosure of confidential client information.

2) There is value to standard reporting language that provides consistency and clarity of information. An auditor's report should provide clarity such that different investors will consistently interpret the meaning of the report content. As such, we believe the auditor's report should communicate objective information, not subjective information such as the auditor's views on the audited entity.

3) Often disclosure provided by public companies is written in a very detailed style, making it difficult to separate the truly differentiating risks and transactions from those which are less critical. We believe that an appropriately designed structure using the emphasis of a matter model could permit the auditor to point to the most significant and/or sensitive matters during the period under audit.

4) We believe matters regarding audit procedures, including matters within the scope of AU Section 380, "Communications With Audit Committees, " are most meaningful when discussed in a format of two-way communication, by parties who possess knowledge of the company's internal operations (the audit committee) and the full context of all audit work (the auditor). As such, we believe many communications related to the audit do not lend themselves to general use reporting and may create confusion.

5) An expansion of the auditor role to report on additional information involves not only additional standards for auditor reporting, but will necessitate issuance of clear management disclosure requirements.

<u>Clarification of the Standard Auditor's Report</u>
We support revisions to the standard auditor's report to provide clarifying language as suggested in the Concept Release. We believe such clarifications will lead toward more consistency in investor understanding of an auditor's report. We believe clarification regarding the auditor's responsibility for information outside the financial statements would be particularly helpful, in light of the expressed investor interest in that topic. We do not believe it necessary to add new language specifying auditor independence or relevant standards, as the title of the standard report states that the auditor is independent, and it is well understood that the auditor must be independent. Adding verbiage about independence requirements introduces risk of misunderstanding; the current brevity is clear.

<u>Auditor's Discussion and Analysis (AD&A)</u>
We do not support the AD&A alternative. As previously discussed, we believe the auditor's requirements for disclosure should not exceed those of management, and the AD&A would conflict with this criterion. Since the AD&A would inherently result in unique language for each audit report and also include subjective information about the auditor's views, we believe it would not provide sufficient consistency and clarity to investors; rather, different investors reading the same auditor's report may reach differing conclusions about the meaning of the report content, resulting in confusion. We believe matters regarding audit procedures are most meaningful when discussed in a format of two-way communication, by parties who possess knowledge of the company's internal operations and the full context of all audit work. In addition, we believe a discussion of "close calls" could vary widely, even between similar issuers that addressed similar matters. As such, we believe many communications related to the audit do not lend themselves to general use reporting and may create significant confusion. As the AD&A would be unique for each company and relatively lengthy, it would require significant effort to prepare, and would involve significant time from the more senior audit staff and a firm's quality control function. As a result, the AD&A would be a costly alternative.

<u>Required and Expanded use of Emphasis Paragraphs</u>
Properly designed emphasis paragraphs may communicate useful information to investors. While some additional requirements might be useful, we would encourage the PCAOB to retain auditor discretion and limit the number of required emphasis paragraphs or topics.

To the extent that the required use of emphasis paragraphs is expanded, we would suggest the following be considered:

- The paragraphs should contain a concise, objective reference to matters disclosed in the financial statements, and should not discuss the auditor's views on such matters or discuss matters that are not disclosed in the financial statements because the auditor's disclosure requirements should not exceed those of management.

- The paragraphs should not contain a discussion of audit procedures because a discussion of audit procedures may not be clearly understood by an investor. Understanding of the audit procedures is the responsibility of the audit committee.
- We believe required paragraphs or topics should be relatively limited, as the addition of numerous required topics to be discussed in emphasis paragraphs may unduly lengthen the auditor's report and increase the amount of "boilerplate" content. A longer auditor's report with numerous required emphasis paragraphs may not be more useful to investors.
- The standard report should explain the nature of the emphasis paragraphs, including that the information includes matters that may be, in the auditor's judgment, most important to users; that the information does not include all matters that are material, involved judgments and estimates, or involved significant auditing effort; that the information does not address business risks that are not required to be disclosed in the financial statements; and that the user is responsible for reading the entire financial statements.
- The requirements for emphasis paragraphs may need to specify a separate materiality level than overall financial statement materiality, since not all material matters should be included in emphasis paragraphs.
- Additional auditing standards and examples of potential emphasis paragraphs would be needed.

Auditor Assurance on Other Information Outside the Financial Statements
We support providing assurance on other information outside the financial statements, provided such reporting is useful to investors and there are appropriate underlying standards for both auditor reporting and management disclosure requirements. Should auditor assurance on other information outside the financial statements be determined to be useful, we believe assurance on Critical Accounting Policies (CAP) would be more relevant than assurance on the Management's Discussion and Analysis (MD&A), as CAP relate to significant financial statement estimates that are of concern to investors, and the CAP are closely related to the auditor's expertise and role as financial statement auditor. Before requiring an attestation on the CAP or MD&A, consideration should be given to ensuring the CAP and MD&A requirements are sufficiently clear to facilitate comparability in attestation results.

Some investor comments related to this Concept Release seem to be based on the assertion that auditors have information about companies that is not currently being disclosed, and the desire appears to be for disclosure of additional information, rather than additional assurance on existing information. Accordingly, before requiring additional auditor assurance, we suggest careful consideration be given to whether investor needs are better met by additional disclosure of information. We believe needs for additional disclosure of information are best met by revision of management disclosure requirements.

Cost/Benefit Considerations
Any new auditor reporting requirement to provide additional information will result in increased cost. We encourage the Board to perform a thorough cost/benefit analysis to determine that any perceived benefits will meaningfully exceed the initial and annual costs to comply with the contemplated new requirements.

Application
We recommend that revisions to the standard auditor's report on the financial statements, such as additions of clarifying language or required emphasis paragraphs, should apply to all auditor reports to promote consistency.

However, any new reporting requirements, such as an AD&A or assurance on information outside the financial statements, should be considered for application to only those companies subject to audits of internal control over financial reporting. For those audits, the auditor inherently has a better understanding of the company. Additional assurance requirements will require more audit effort in the absence of an audit of internal control and will add cost to the audit. Further, companies not subject to an audit of internal control may have different investor needs than larger companies such that the cost of additional reporting requirements may exceed the benefits.

At a minimum, we suggest a phased-in approach where the additional reporting would first apply to those audits subject to an internal control audit. This would allow for an evaluation to determine if investor needs are indeed being met and whether the additional benefit outweighs the cost. Further, a phased-in approach would allow auditors to avail themselves of best practices observed from audits that include an audit of internal control over financial reporting.

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Crowe Horwath LLP supports the Board's efforts to improve its auditing standards and the reporting for investors. We hope that our comments and observations will assist the Board in its consideration of the matters in the Concept Release. If the Board has questions on the above comments, please contact Michael Yates or Wes Williams at (574) 232-3992.

Cordially,

Crowe Horwath LLP

Crowe Horwath LLP

**Attachment A**
**Responses to Selected Concept Release Questions**

**Question 2.a. Should the auditor's report retain the pass/fail model? If so, why?**

We believe the current opinion model should be retained. We believe an auditor's report should provide clarity such that different investors will consistently interpret the meaning of the report content. Accordingly, we believe the auditor's report should communicate objective information, not subjective information about the auditor's views. We believe the standard opinion wording with a definitive indication of conformity with established standards provides objective information with clarity.

**Question 3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

We strongly believe it is the role of management to provide information regarding the company's financial reporting to financial statement users, and it is the auditor's role to provide assurance on information. The question of the appropriate role of the auditor is fundamental; impacting auditing standards, development of auditor skills, the nature of the relationship between companies and their auditor, the cost of audit services, etc. As such, fundamental changes to the role of the auditor would impact a wide variety of issues, and could result in unintended consequences. If undertaken, we believe such a change in role would require significant due process over an extended period of time. However, we believe such a change from long-standing practice is not appropriate. We believe management is best suited to understand their business and future plans and to evaluate what is the most relevant information for investors; whereas the auditor's competency is providing independent assurance on information, not providing commentary on the business. We also believe requiring the auditor to provide additional information about the company may reduce audit quality by detracting from open communication between the auditor, management and the Audit Committee, while shifting some responsibility for financial reporting from management to the auditor could create the perception the auditor is an advocate for the client. Further, any requirements for auditor disclosure of client information would need to be reconciled with prohibitions on auditor disclosure of confidential client information.

**Question 5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

We do not support the AD&A alternative discussed in the Concept Release.

**b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why.**

We do not believe it is appropriate to comment on audit risks and procedures in an AD&A. We do not believe a discussion of audit risks and procedures is appropriate in a general use report, since, to be meaningful, such requires a detailed knowledge about the internal operations of the company and a full context of all audit work, including audit scopes. We believe these issues lend themselves to a two-way discussion, such as those held with Audit Committees, but not to general use reporting. We believe the disclosure of audit procedures or audit scopes could decrease audit quality by providing a road-map of audit strategies and by reducing the element of unpredictability in the audit.

**d. If you do not support an AD&A as an alternative, explain why.**

As previously discussed, we believe the auditor's requirements for disclosure should not exceed those of management, and the AD&A would conflict with this criterion. Since the AD&A would inherently result in unique language for each audit report and also include subjective information about the auditor's views, we believe it would not provide sufficient consistency and clarity to investors. Rather, different investors reading the same auditor's report may reach differing conclusions about the meaning of the report content, resulting in confusion. We believe matters regarding audit procedures, including matters within the scope of AU Section 380, "Communications With Audit Committees, " are most meaningful when discussed in a format of two-way communication, by parties who possess knowledge of the company's

**Attachment A**
**Responses to Selected Concept Release Questions**

internal operations (the audit committee) and the full context of all audit work (the auditor). In addition, we believe a discussion of "close calls" could vary widely between similar issuers that addressed similar matters, due not only to differing judgments about what comprises a close call, but also due to previous experience a company or their auditors may have had with an issue; in other words, two companies may have addressed the same issue and reached the same correct conclusion, but one might consider it a close call while the other does not. As such, we believe many communications related to the audit do not lend themselves to general use reporting and may create significant confusion. As the AD&A would be unique for each company and relatively lengthy, it would require significant effort to prepare, and would involve significant time from the more senior audit staff and a firm's quality control function. As a result, the AD&A would be a costly alternative.

**Question 8. Should a standard format be required for an AD&A? Why or why not?**

We do not support the AD&A alternative, but if it were to be required, the Board should seek to standardize the format as much as possible to increase the comparability and clarity of the report.

**Question 9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

We strongly oppose including discussion of the issuer's risks, such as business risks, strategic risks or operational risks. As previously discussed, we believe the auditor's requirements for disclosure should not exceed those of management. We believe management is best suited to understand their business and future plans and to evaluate what is the most relevant information for investors; whereas the auditor's competency is providing independent assurance on information, not providing commentary on the business.

**Question 10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

We believe this would be very difficult to achieve, and the lack of comparability is one of the reasons we do not support the AD&A alternative.

**Question 14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

Properly designed emphasis paragraphs may communicate useful information to investors, and current auditing standards provide the auditor with the discretion to use such paragraphs. While some additional requirements might be useful, we would encourage the PCAOB to retain auditor discretion and limit the number of required emphasis paragraphs or topics.

To the extent that the required use of emphasis paragraphs is expanded, we would suggest the following be considered:

- The paragraphs should contain a concise, objective reference to matters disclosed in the financial statements, and should not discuss the auditor's views on such matters or discuss matters that are not disclosed in the financial statements because the auditor's disclosure requirements should not exceed those of management.
- The paragraphs should not contain a discussion of audit procedures because a discussion of audit procedures may not be clearly understood by an investor. Understanding of the audit procedures is the responsibility of the audit committee.
- We believe required paragraphs or topics should be relatively limited, as the addition of numerous required topics to be discussed in emphasis paragraphs may unduly lengthen the auditor's report and increase the amount of "boilerplate" content. A longer auditor's report with numerous required emphasis paragraphs may not be more useful to investors.
- The standard report should explain the nature of the emphasis paragraphs, including that the information includes matters that may be, in the auditor's judgment, most important to users; that the information does not include all matters that are material, involved judgments and estimates,

or involved significant auditing effort; that the information does not address business risks that are not required to be disclosed in the financial statements; and that the user is responsible for reading the entire financial statements.

- The requirements for emphasis paragraphs may need to specify a separate materiality level than overall financial statement materiality, since not all material matters should be included in emphasis paragraphs.
- Additional auditing standards and examples of potential emphasis paragraphs would be needed.

**Question 15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

We do not believe it is appropriate to include information about audit procedures in the auditor's report. We believe matters regarding audit procedures are most meaningful when discussed in a format of two-way communication, by parties who possess knowledge of the company's internal operations and the full context of all audit work. As such, we believe communications related to the audit do not lend themselves to general use reporting and may create confusion.

We believe that identification of matters of greatest significance and sensitivity in the historical financial statements presented could provide investors with additional value as they attempt to assess a company's future prospects.

**Question 16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

See the response to Question 14 above.

**Question 17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

This will be difficult to achieve, and is one reason we urge caution against creating a large number of required paragraphs. However, we also believe standard, objective language has value in providing consistency and clarity in auditor's reports. As previously discussed, we do not believe emphasis paragraphs should contain discussion of audit procedures or the auditor's views; rather, they should contain a concise, objective reference to matters further disclosed in the financial statements, and, as such, standard language is not necessarily a negative attribute.

**Question 19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

We support providing assurance on other information outside the financial statements, provided it is useful to investors and there are appropriate underlying standards for both auditor reporting and management disclosure requirements.

Some investor comments related to this Concept Release seem to be based on the assertion that auditors have information about companies that is not currently being disclosed, and the desire appears to be for disclosure of additional information, rather than additional assurance on existing information. Accordingly, before requiring additional auditor assurance, we suggest careful consideration be given to whether investor needs are better met by additional disclosure of information. We believe needs for additional disclosure of information are best met by revision to management disclosure requirements.

While Item 303 of Regulation S-K contains the requirements for Management's Discussion and Analysis (MD&A), the requirements are relatively general, are impacted by various SEC communications issued over a long period of time, and require management to interpret what information is relevant, including estimated future impacts of transactions and events that have occurred or are expected to occur. As a result, in practice there can be diversity in MD&A content between similar companies. Critical Accounting Policies (CAP) are a component of the MD&A, and some have suggested that CAP could also be subject to auditor assurance. However, the requirements for Critical Accounting Policies have not been

**Attachment A**
**Responses to Selected Concept Release Questions**

formalized into SEC rules. Accordingly, before requiring an attestation on the MD&A (or CAP), we believe consideration should be given to ensuring the MD&A and CAP requirements are sufficiently clear to facilitate comparability in attestation results (we recognize there is currently an attestation standard regarding MD&A, but we observe it is not widely used at present).

Should auditor assurance on other information outside the financial statements be determined to be useful, we believe assurance on Critical Accounting Policies would be more relevant than assurance on the MD&A. CAP relate to significant financial statement estimates that are of concern to investors, and the CAP are closely related to the auditor's expertise and role as financial statement auditor.

**Question 21.a. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

We support revisions to the standard auditor's report to provide clarifying language as suggested in the Concept Release. We believe such clarifications will lead toward more consistency in investor understanding of an auditor's report. To provide such clarity, we believe the revisions should be concise language derived from the auditing standards. Since there seems to be some investor interest in the role of the auditor with information outside the financial statements, we believe clarification regarding the auditor's responsibility for information outside the financial statements would be particularly helpful. We do not believe it necessary to add new language specifying auditor independence or relevant standards, as the title of the standard report states that the auditor is independent, and it is well understood that the auditor must be independent. Adding verbiage about independence requirements introduces risk of misunderstanding; the current brevity is clear.

**Question 23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

The addition of clarifying language to the standard auditor's report is an appropriate alternative, as it is consistent with the auditor's current role, promotes clarity in reporting, would be less costly than the other alternatives in the Concept Release, and is less likely to be detrimental to audit quality.

Properly designed emphasis paragraphs may communicate useful information to investors. While some additional requirements might be useful, we would encourage the PCAOB to retain auditor discretion and limit the number of required emphasis paragraphs or topics.

We support providing assurance on other information outside the financial statements, provided it is useful to investors and there are appropriate underlying standards for both auditor reporting and management disclosure requirements. Should auditor assurance on other information outside the financial statements be determined to be useful, we believe assurance on Critical Accounting Policies would be more relevant than assurance on the MD&A.

**Question 24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

We believe the addition of clarifying language to the standard auditor's opinion would be useful. We believe there would be redundancy between the alternative of emphasis paragraphs related to significant accounting estimates and the alternative of a separate attestation report on critical accounting policies or the MD&A; and, therefore, requiring both emphasis paragraphs and a separate attestation report would seem unnecessary.

**Question 29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

Three of the alternatives (clarifying language, AD&A, emphasis paragraphs) primarily involve additional communication and would not significantly improve audit quality. Alternatives that require auditor disclosure in excess of management disclosure requirements or disclosure of audit procedures could reduce audit quality by detracting from open communication between the auditor, management and the audit committee, and by providing a road-map of audit strategies, reducing the element of unpredictability. A separate engagement to provide assurance on information outside the financial statements would have a significant impact on overall financial reporting quality, which may positively impact audit quality.

**Question 30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

Revisions to the standard auditor's report on the financial statements, such as additions of clarifying language or required emphasis paragraphs, should apply to all audit reports to promote consistency.

However, any new reporting requirements, such as an AD&A or assurance on information outside the financial statements, should be considered for application to only those companies subject to audits of internal control over financial reporting. For those audits, the auditor inherently has a better understanding of the company, which could impact the comparability of reporting compared to similar companies that are not subject to an audit of internal control. Additional assurance requirements will require more audit effort in the absence of an audit of internal control and will add cost to the audit. Further, companies not subject to audits of internal control may have different investor needs than larger companies such that the cost of additional reporting requirements may exceed the benefits.

At a minimum, we suggest a phased-in approach where the additional reporting would first apply to those audits subject to an audit of internal control. This would allow an evaluation to determine if investor needs are indeed being met and whether the additional benefit outweighs the cost. Further, a phased-in approach would allow auditors to avail themselves of best practices observed from audits that include an audit of internal control over financial reporting.

Ideally, field testing would be performed prior to implementation for any changes to auditor reporting. This would provide a vehicle to assess the cost implications as well as evaluate whether investor needs are being served.

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September 30, 2011

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

**Re: PCAOB Rulemaking Docket Matter No. 034, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards***

Deloitte & Touche LLP appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release") (PCAOB Release No. 2011-003 June 21, 2011, PCAOB Rulemaking Docket Matter No. 034). Our comments on the Concept Release address the following areas:

- *I. Overall Comments*
- *II. Recommendations for Changes to the Auditor's Report*
- *III. Concerns with an Auditor Discussion and Analysis*
- *IV. Other Considerations*

## I. OVERALL COMMENTS

We commend the PCAOB for undertaking to solicit views regarding potential changes to the auditor's report in connection with the audit of financial statements. We particularly commend the PCAOB and Chief Auditor Martin Baumann and his staff for the unprecedented outreach that preceded the publication of the Concept Release. It is inevitable that, as the information needs of users of financial statements and the amount of information available to such users evolve, reporting (by auditors, management and the audit committee) would also evolve to meet those needs.

***A Holistic Approach to Changes in Financial Reporting:***

While we support the PCAOB's project to consider revisions to the auditor's report, we also strongly believe a holistic approach to improving financial reporting is necessary and warranted. The audit is only one piece of the financial reporting process. Reporting obligations on the part of the auditor should not be considered in isolation; changes to financial-related reporting and disclosures by management, the audit committee and auditors should all be considered together in order to achieve the best outcome for users. This holistic approach, and related coordination among regulators, will allow a more complete review of the allocation of responsibility among those who participate in the financial reporting process. We understand, however, that all of these changes would not be within the mandate of the PCAOB, and we encourage communication with accounting standard setters and the Securities and Exchange Commission ("SEC") in such an effort to improve the quality of financial reporting.

***Objectives of Potential Changes to the Auditor's Report:***

We encourage and support an evolution in auditor reporting that results in responsible changes that improve the relevance and information value of what auditors produce and helps to achieve high quality financial reporting. As part of the process of developing such changes, it is important to clearly link any proposed changes with the objectives of the project. We believe the objectives are to (1) meet the needs of users and (2) enhance audit quality. As the PCAOB weighs the merits of any proposed changes, we request that the Board assess the extent to which each option can help achieve these objectives.

***Principles for Changes:***

We believe there are fundamental principles that the PCAOB should keep in mind when considering changes to the auditor's report, as follows:

1. Any proposal that would increase the information gap or expectation gap or detract in any way from audit quality should not be considered.

2. The respective roles and responsibilities of the auditor, management and the audit committee should remain unchanged. Auditors should not be the original source of disclosure about an entity; the responsibilities of management and the audit committee should be preserved in this regard.

3. Any changes to the auditor's report should avoid user confusion. Specifically, any revisions should not require users to sort through different or duplicative information provided by the auditor, management and the audit committee. This would not improve financial reporting.

4. Auditor reporting should focus on the objective rather than the subjective.

5. Changes should be market driven, add value, and be made with appropriate consideration of costs and benefits.

## II. <u>RECOMMENDATIONS FOR CHANGES TO THE AUDITOR'S REPORT</u>

We have participated in many open discussions regarding potential changes to the auditor's report, including those at PCAOB Standing Advisory Group meetings, the PCAOB's roundtable, as well as dialogues undertaken by the profession through the Center for Audit Quality ("CAQ"). We have also observed other open PCAOB meetings on this topic, including the PCAOB's Investor Advisory Group ("IAG") meetings and public Board meetings. Throughout these discussions the common themes have been the following:

- More information about and a better understanding of management's estimates and judgments and areas involving significant measurement uncertainty would be useful;

- There is a lack of understanding regarding what an audit is and how it is performed; and

- There is a lack of awareness of the audit committee's responsibilities.

We support effective and responsible changes to the auditor's reporting model that address these common themes and will be most helpful to users, while at the same time meeting the principles identified in the "Overall Comments" section above. The approaches which we believe might be most effective are:

1) Including an additional paragraph in the auditor's report that references those footnotes in the financial statements which the auditor has determined are the most important to a user's understanding of the financial statements. In most cases, these will include the footnotes in which the entity identifies and discusses significant management estimates and judgments, as well as areas of significant measurement uncertainty;

2) Requiring the auditor to provide assurance on the portion of Management's Discussion and Analysis ("MD&A") related to critical accounting estimates;

3) Providing more information in the auditor's report, in a form prescribed for all audits, about what an audit is and the responsibilities of the auditor, management and the audit committee. This could be achieved by clarifying certain terms and adding some specific information regarding responsibilities.

These approaches, which are further discussed below, are designed to meet the needs of users, without imposing the unintended consequences and significant costs of other options, including requiring an Auditor's Discussion & Analysis ("AD&A") also discussed further below.

***Additional Paragraph Referencing the Footnotes:***

We support including an additional paragraph to the auditor's report which would reference those footnotes to the financial statements which the auditor has determined are most important to a user's understanding of the financial statements. As noted above, in most cases, these will include the footnotes in which the entity has identified and discussed its significant management judgments and estimates, and areas with significant measurement uncertainty. The objective of the paragraph would be to highlight matters that are in the financial statements. It would not describe audit procedures performed (refer to discussion in section III below) related to those financial statement disclosures.

We believe that this alternative would not blur the line of responsibility between the auditor and management (management is still the provider of information); however, it will often focus users on more important aspects of the entity's financial statements. We also believe that an increase in focus on these footnotes will improve management's disclosures in these areas.

We recognize that the PCAOB currently has standards with respect to emphasis of a matter paragraphs; however, a new standard would need to be promulgated by the PCAOB with an appropriate framework and guidance in order to make the above recommendation regarding an additional paragraph operational. In addition, we believe that the wording of the additional paragraph should be prescribed by the PCAOB (through the new audit standard), in part, to provide consistency in disclosure from audit to audit, and so that a user does not incorrectly assume that the auditor has provided additional assurance on the referenced footnotes.

***Assurance on MD&A Related to Critical Accounting Estimates:***

For several reasons, we support the auditor providing assurance on the portion of MD&A in which management discusses the entity's critical accounting estimates. Such an alternative is consistent with the principles outlined in the "Overall Comments" section above, including the fact that providing assurance on this portion of MD&A would not blur the line between auditor and management responsibility. Also, it may have the effect of enhancing management's disclosures in this area as auditors engage in increased dialogue with management on the content of the disclosures.

Additional benefits of auditors providing such assurance include:

- It would be responsive to what has been heard from investors regarding further information on management's significant estimates;
- It would avoid many of the unintended consequences associated with AD&A; and
- Although, to some extent, this will increase the costs and burdens associated with the audit process, it will focus on a particularly important aspect of MD&A from a financial reporting perspective, and avoid the undue cost and burden of auditing MD&A in its entirety.

In order for the auditor to provide assurance on the critical accounting estimates that are disclosed in MD&A, the SEC will need to first develop applicable disclosure and reporting rules, and the PCAOB will need to develop an auditing standard on how the auditor would provide such assurance.

***Additional Information on What Is an Audit:***

On a broad level, we support clarifying what an audit is and how it is performed. This can be achieved through supplementing the current form of the auditor's report and can be implemented in a cost-effective and practical manner. Specifically, similar to the CAQ[1], we support the following detailed recommendations for clarifying what an audit is and how it is performed:

1. Provide additional standard information on what an audit is, including an explanation of technical terms such as reasonable assurance, materiality and material misstatement. This standardized wording should include an explicit statement that the footnotes are an integral part of the financial statements that are covered by the audit report.

2. Clarify the auditor's responsibility. This could be achieved by adding descriptions of the auditor's responsibility with respect to:

    a. *Other information in documents containing audited financial statements.* We believe that some users of financial statements place undue reliance on other information in documents containing the audited financial statements because they are of the belief that, because such information is included with the financial statements, it has been audited.

[1] CAQ letter to the PCAOB, June 28, 2011.

b. *Being independent under all relevant standards.* In addition to the title that the auditor's report is performed by an independent audit firm, we believe the report could include a specific statement that the auditor is independent under all relevant independence standards.

c. *Using professional judgment in making risk assessments and selecting audit procedures.* We believe it is important to clarify the role of professional judgment within an audit, to inform users that procedures selected and performed go beyond simple adherence to a checklist, and may vary from audit to audit.

d. *Planning and performing the audit to obtain reasonable assurance about whether the financial statements taken as a whole are free of material misstatement "whether due to error **or fraud**."*

e. *Situations in which a conclusion is reached that the financial statements are not in accordance with GAAP or in situations where the audit scope has been limited.*

3. Provide expanded discussion on the responsibilities of management and the audit committee for financial statements and the Form 10-K.[2]

4. Where applicable, describe the accounting firm network structure, the responsibility of the member firm signing the audit report, and the level of participation by other member firms in the audits.

The forgoing changes could be implemented by including additional standardized language, prescribed by the PCAOB, either:

- As an appendix to the report;
- Within the audit report itself; or
- Through a link in the audit report to a document provided by a third party (e.g., the PCAOB; the CAQ).

The PCAOB prescribed language would be used by all auditors for all reports for audits of public companies.

## III. CONCERNS WITH AN AUDITOR DISCUSSION AND ANALYSIS

***Introduction:***

We believe there are several significant obstacles to an AD&A that would result in problematic, unintended consequences. First, it would result in auditors disclosing original information about the entity, causing a departure from the foundational concept that the auditor should give assurance on information provided by management. Such a change will likely result in unnecessary challenges with

[2] The SEC may also consider revising its rules concerning the form and content of an audit committee report and requiring the audit committee report to be included with the 10-K, rather than in the proxy statement. Depending on the form and content of the audit committee report, the SEC and the PCAOB might consider requiring the auditor to provide assurance on the accuracy and completeness of that report.

respect to aspects of the audit such as confidentiality, independence and auditor-management-audit committee communications, ultimately imposing significant burdens on the auditor and the entity. Additionally, it would be extremely difficult for the PCAOB to establish standards that would provide for the requisite consistency, and thus comparability, in AD&A from audit report to audit report. There is a significant risk that the AD&A would result in inconsistent or competing information coming from the auditor and management, resulting in unnecessary additional disclosure in Form 10-Ks, and likely causing user confusion. These issues are discussed further below.

***AD&A is Inconsistent with Our Basic Precepts for Any Change:***

The idea of an AD&A as set forth in the Concept Release is contrary to the principles outlined in the "Overall Comments" section above in several important respects:

- <u>Auditor becomes the original source of information.</u> The auditor, through the AD&A, would become a source of original disclosure about the entity and its financial reporting, thereby blurring the role of the auditor and management. The role of the auditor is to provide assurance, not information about the entity. It is the role of management to provide that information. The AD&A proposal in the Concept Release does not recognize the extent to which the AD&A proposal would involve the auditor becoming an original source of entity information and the impact such a change would have on the roles of the auditor, management, and the audit committee.

  If the auditor becomes a provider of original information, the following issues would have to be addressed:

  - *Uncertainties regarding the responsibilities of the auditor and management.* Where would the line be drawn between the responsibility of auditor and management for financial information about the entity, if entity information is initially disclosed by the auditor? There would likely be significant confusion on the part of readers of the financial statements who may believe the auditor is responsible for the financial statements -- and not management or the audit committee. Currently there is a clear distinction between the reporting and disclosure responsibilities of the auditor and of management, respectively.

  - *Impact on the responsibilities of the audit committee.* How would AD&A impact the role and responsibilities of the audit committee? Would the audit committee believe they are less responsible for financial reporting?

  - *Coordination and consistency with other regulatory requirements.* How would auditor requirements under PCAOB standards be reconciled with requirements for disclosure by issuers -- now governed by the SEC and the Financial Accounting Standards Board?

  - *Potential auditor independence issues.* SEC rules state that the auditor is not independent if the auditor acts as an employee of an audit client or performs any decision making, supervisory, or ongoing monitoring function for the audit client. Further, PCAOB independence rules preclude the auditor from preparing source documents or reporting on behalf of management. Writing an AD&A, determining which matters to include in the AD&A, and obtaining sufficient information about the matters to be included arguably puts the auditor in the position of performing impermissible management functions, including preparing source documents, decision making, monitoring, or reporting on behalf of management.

- o *Confidentiality issues.* Will confidentiality issues arise if the auditor is disclosing entity information not disclosed by management?

- Reduction in audit quality. Requiring AD&A has the potential of reducing audit quality. Auditor disclosure of original information about the entity could erode the robustness of discussions between the auditor and management and/or the audit committee and disrupt what should be a free flow of information among them. For example, management and the audit committee may be reluctant to candidly share with the auditor information with respect to the entity because of a concern that what is shared will be considered for inclusion in the AD&A. A level of distrust may develop as management and the audit committee are concerned about what the auditor is going to discuss in the AD&A.

  Additionally, establishing and maintaining a system of quality control to ensure a reasonable level of consistency in AD&A across firms and the profession would be a challenge. Consistency in content and presentation is important so that reports are comparable for users. Efforts to ensure consistency in the AD&A within a particular firm which would likely include the need for national office review of all AD&As, and would tax audit firm national office/quality control resources at the time they would be focusing on audit quality and reporting matters.

  Also, AD&A might detract auditors from effective completion of the audit. The ability of the auditor to prepare a tailored narrative and complete the necessary reviews within current SEC filing deadlines will be challenging. Once the auditor has completed the AD&A, management will want to review it for accuracy and completeness and will reconcile the AD&A to financial statements, MD&A and other entity disclosures. This will take significant time during a period that is already compressed. Creating this additional burden on management and the auditor will create added pressures and could keep auditors from focusing on other audit procedures.

  Further, a public discussion in AD&A regarding the audit procedures performed with respect to areas of significant risk has the potential to lessen the value and effectiveness of the audit procedures performed. Such discussion of particular audit procedures may better equip management to anticipate the procedures that will be performed going forward, potentially reducing audit effectiveness and quality to the detriment of users. (See further discussion below regarding disclosing audit procedures.)

- Creation of user confusion. Requiring an AD&A could easily create user confusion due to competing, duplicative, potentially inconsistent, and lengthy information contributed by both management and the auditor. Discussing matters in AD&A such as (1) difficult or contentious issues, (2) close calls, and (3) matters that are in technical compliance with the applicable financial reporting framework but could be enhanced through additional disclosure, would undermine the auditor's opinion reached on the financial statements as a whole. Further, the ability to appropriately distill, into a few sentences, the hundreds of hours spent auditing a complex area will be difficult, and cannot conceivably convey the audit effort, including all the procedures performed, evidence gathered and judgments made, relating to a particular area.

Additionally, when the auditor's views on complex items such as judgments, estimates, accounting policies and practices, difficult or contentious issues or close calls, are communicated with the audit committee, the audit committee has been provided with an appropriate context for these complex matters through:

- Live interaction with the auditor;
- Follow-up and two-way discussions with the auditor to review the information presented;
- Extensive background knowledge derived from their responsibility to oversee the financial reporting process.

This dialogue works quite well in practice as a means of discussing issues, assessments and conclusions. Such a dialogue cannot be meaningfully conveyed by way of AD&A reporting.

- Introduction of subjectivity and lack of comparability of reports. An AD&A would be a very subjective presentation by the auditor. As discussed earlier, achieving comparability of reports including subjective information, both within firms and across firms, would be a formidable challenge, and it is unclear how a firm would design and implement an effective system of quality control to achieve appropriate consistency regarding the reporting of such information, without having multiple layers of review at levels above the engagement team. Comparability between reports on different entities, including those in similar industries, would be sacrificed without consistent auditor reporting, potentially confusing the marketplace. For instance, one audit partner's subjective view regarding the inclusion or exclusion of a "close call" or "preferable accounting treatment" may differ from that of another, which could result in unintended consequences for an issuer in comparison to its peers.

  Ultimately, the expectations of those who support an AD&A will not be realized in practice, as consistency, comparability, and the legal environment will prevent the auditor from providing unique, narrative discussions regarding the public companies they audit.

***Discussing Audit Procedures is Inappropriate:***

In addition to being contradictory to the principles we presented in the "Overall Comments" section above, we do not support discussing risks, judgments and procedures specific to the audit performed within the audit report for the following reasons:

- It would be difficult to understand this information without further context derived from dialogue with the auditor;
- Succinct descriptions would not adequately describe significant and often complex audit judgments and procedures;
- It would reduce the element of unpredictability of audit procedures, which is required by PCAOB Auditing Standard No. 13, paragraph 5(c);[3] and

[3] PCAOB Auditing Standard No. 13, states the following: "*Incorporating elements of unpredictability in the selection of audit procedures to be performed.* As part of the auditor's response to the assessed risks of material

- More thorough descriptions could contribute to disclosure overload and detract from the ability to provide useful information to users.

***User Support for an AD&A is Uncertain at Best:***

The surveys[4] that have been referenced by proponents of AD&A do not support the more significant change that an AD&A would impose on the auditor reporting model, and, based on the input provided to date, there does not appear to be a mandate for such a change. For example:

- Consider information from the informal IAG survey as follows:
  - Respondents were asked to react to the following statement "The audit report as currently written, provides valuable information and is integral to understanding the financial statements." The results did not show support for drastic change: 55% of the respondents said either "strongly agree", "agree", or "neither agree or disagree." [5]
  - Respondents were also asked to react to the following statement: "The audit report (either in an AD&A or elsewhere) should include a narrative summary of the various items that the auditor communicated, both orally and in writing, to the entity's audit committee (relating, for example, to significant accounting policies, management's judgments and estimates, and significant audit adjustments) as required under existing PCAOB regulations." The results did not show overwhelming support for such a narrative, with 44% stating they "strongly disagree," "disagree," or "neither agree nor disagree."[6]

- Consider the following from the CFA's informal survey regarding the auditor's report:
  - When asked "What additional information, if any, would you like to see in the auditor's report," none of the respondents said they wanted the auditor to provide information about audit risks, audit procedures and results, discussion of critical accounting policies, significant unusual transactions, or "close calls" and other matters the Concept Release is suggesting be included in a potential AD&A.[7]

- Consider the following statements made at the PCAOB's roundtable on September 15, 2011:
  - Mr. Peter Nachtwey, Chief Financial Officer, Legg Mason, Inc., when speaking about the potential concept of an AD&A stated the following: "…when I go talk to the guys that run our funds and run our affiliates, and these are very, very seasoned guys and

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misstatement, including the assessed risks of material misstatement due to fraud ("fraud risks"), the auditor should incorporate an element of unpredictability in the selection of auditing procedures to be performed from year to year."

[4] The surveys put forth by some to support the creation of the AD&A have not been comprehensive in terms of outreach or in response rates. The survey conducted by members of the PCAOB IAG in March 2011 resulted in 73 responses from at least 330 individuals surveyed. Additionally, the survey conducted by the CFA Institute in March 2010 resulted in 106 responses from approximately 500 individuals surveyed; however, it is not clear how many of the CFA survey respondents are from the United States. The related report explains that 27% of those surveyed were from Europe, the Middle East, and Africa, and 19% were from Asia Pacific. The remaining 54% surveyed are from the Americas; the CFA does not specifically provide a figure for those surveyed in the United States, but it would seem to be less than 54% of those surveyed.

[5] IAG Survey presented at the March 2011 IAG meeting, page 1.

[6] Ibid, page 7.

[7] CFA Institute Independent Auditor's Report Survey Results, March 2010, page 20.

gals who've been around for decades, they are not clamoring for a change in the auditor's report."[8]

- Mr. Alan Beller, Partner, Cleary Gottlieb Steen & Hamilton LLP and former Director of the Division of Corporation Finance of the SEC, when also speaking about AD&A stated, "It actually will be less productive than some of the more modest suggestions that have been made around the table."[9]

Based on the foregoing, we strongly oppose the concept of the auditor providing an AD&A. The options we have suggested in section II above would better meet the needs of users, without imposing the unintended consequences and significant costs of requiring an AD&A.

## IV. OTHER CONSIDERATIONS

If the PCAOB moves forward with its consideration of possible changes to the auditor's report, it should first perform a cost/benefit analysis, including consideration of the practical challenges related to the time, effort and resources required to implement any new requirements and complete them within the current SEC Form 10-K filing deadlines. The analysis should also include a comparison of the costs and benefits of instituting any required changes to the auditor's report versus requiring issuers to provide additional disclosure.

Additionally, like the CAQ, we believe the concerns articulated by the PCAOB in the Concept Release with respect to the potential for increased litigation risk are warranted, particularly if the Board proceeds with the AD&A alternative and such an approach is adopted. Auditor liability has been discussed in many forums over many decades, and it is an important issue for consideration as potential changes to the auditor's reporting model are evaluated.

Finally, as part of the process to develop proposed standards for changing the auditor's reporting model, we recommend that the PCAOB:

- Contemplate whether the changes make sense in the context of audits of employee benefit plans (EBP) of public companies, the financial statements of which are filed with the SEC through an 11-K. We do not believe users of EBP financial statements are requesting or in need of an expanded auditor's reporting model. Further, the alternatives the PCAOB is considering for audit reports on financial statement audits of public companies would not be meaningful in the context of reporting on EBP financial statement audits. As a result, the PCAOB may decide that the changes proposed and adopted may not apply in the context of an EBP audit report.

- Consider how any changes to the auditor's report would be managed to educate investors and other users.

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[8] PCAOB unofficial transcript of the September 15, 2011 roundtable, page 97.
[9] Ibid, page 122.

We would welcome an opportunity to further discuss these matters with the Board and the staff. If you have any questions or would like to discuss these matters further, please contact John Fogarty at (203) 761-3227 or Bob Kueppers at (212) 492-4241. We thank you for your consideration of these matters.

Very truly yours,

/s/ Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Fergusson, PCAOB Member
Daniel L. Goelzer, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

Mary L. Schapiro, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Troy A. Paredes, SEC Commissioner
Elisse B. Walter, SEC Commissioner
James L. Kroeker, SEC Chief Accountant
Brian T. Croteau, SEC Deputy Chief Accountant

DODGE & COX

Investment Managers

September 30, 2011

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

**RE: PCAOB Rulemaking Docket Matter No. 34**

By way of background, I have worked at Dodge & Cox, an investment firm managing approximately $175 billion in public equity and fixed income assets, since 1997. Dodge & Cox has been in business since 1930 using a long-term, value oriented, style of investing. Prior to business school, I practiced as a CPA at Arthur Andersen. I have reviewed financial statements as a former auditor and used them as an investor. I agree that the current auditor's report is deficient as a communication vehicle, and that it needs significant changes to remediate those deficiencies.

I believe that the root causes of the overall deficiency result from 1) a litigious environment causing auditors to limit disclosure, 2) the fact that auditors are paid by the company's management and 3) the different priorities of auditors and investors. With respect to the third cause, auditors spend the majority of their time auditing the client's balance sheet while performing much less work on the other statements and footnotes. Investors, on the other hand, are more concerned about the quality of earnings, cash flow and footnote disclosures. The audit report should be expanded to offer more insights to investors than just the simplistic "pass or fail" model we have today.

I recommend that the PCAOB consider requiring a supplemental auditor's discussion and analysis (AD&A) section in addition to the basic opinion which could include the following:

- The auditor's assessment of the estimates, principles and judgments made by management in preparing the financial statements and how they arrived at their assessment. Statistics regarding the testing that supported the opinion would be useful.

- Add disclosures detailing areas of high financial statement audit risk or significant measurement uncertainty as well as procedures performed to render the opinion . A description of materiality thresholds for financial statements taken as a whole should be disclosed, e.g., 5% of reported net income materiality standard for adjustments.

- An assessment of the *quality*, not just the acceptability, of the audit client's accounting practices and policies could be required. For example, the AD&A section of the audit opinion could include information which summarizes the following analysis demonstrating the quality of reported results:

a. An assessment of the effectiveness of internal controls used by the client.
b. A description of the impact that material changes to accruals (e.g., *reserve reversals*), non-recurring or non-operating items and capitalized expenses had on reported results.
c. Auditor commentary on trends *between* financial statements, e.g., a comparison of net earnings to reported cash flow.
d. Discussion of unusual accounting related changes such as restatements that might cloud comparability and any other material changes in the financial statements or footnotes.
e. A comparison over a multi-year period of write-offs to cumulative reported earnings, if applicable.
f. *Qualitative* risk factors such as management's use of non-GAAP reporting of results, serial use of restructuring charges, expense write-offs, material M&A transactions etc. should be addressed along with quantitative factors.

- I also believe that there is a need for improved disclosure regarding the independence of the auditor. For example, the auditor should disclose if it is providing consulting services to the audit client in addition to the audit. They should have to disclose whether former auditors that worked on the audit engagement are now in senior finance roles at the client company. The nature and extent of involvement by other auditors should also be noted.

- Finally, we agree that the audit report should more clearly describe the auditor's responsibility for detecting material fraud.

We appreciate the opportunity to provide feedback to your committee and look forward to positive future changes that might result from your efforts. Please do not hesitate to contact me if you have any questions. I can be reached at 415-273-7672.

Sincerely,

John N. Iannuccillo
Vice President
Research Analyst
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Power by Association℠

Edison Electric Institute

Richard F. McMahon, Jr.
*Vice President*

September 30, 2011

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

**Rulemaking Docket No. 34**

The Edison Electric Institute (EEI) respectfully submits our comments on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* No. 2011-003 (Concept Release). EEI is the association of United States shareholder-owned electric companies. Our members provide service to 95 percent of the ultimate customers in the shareholder-owned segment of the industry, and represent approximately 70 percent of the United States electric power industry.

EEI and its member companies have several concerns about the alternatives proposed in the Concept Release as discussed further below. Our comments are organized in the following sections as set forth in the Concept Release:

1. Auditor's Discussion and Analysis (AD&A),
2. Required and expanded use of emphasis paragraphs,
3. Auditor assurance on other information outside the financial statements, and
4. Clarification of language in the standard auditor's report.

**Auditor's Discussion and Analysis**

The Concept Release discusses that the intent of an AD&A would be for the auditor to provide in a narrative format his or her views regarding significant matters, including management's judgments and estimates, difficult or contentious issues and areas where management could have applied different accounting. We believe that management is responsible for the financial statements and the disclosures set forth therein. The Audit Committee of a Board of Directors (Audit Committee) is the appropriate governance body, as discussed below, to provide oversight of management and to engage the auditors in open and transparent communication of their work and the quality of a company's financial statements and disclosures. The auditor's responsibility is to obtain reasonable assurance about whether the financial statements present fairly, in all material respects, the results of an entity in conformity with U.S. GAAP and with larger public companies, to opine on an entity's internal control over financial reporting. An auditor exercises professional judgment in accordance with the auditing standards in the design and execution of an audit plan to opine on the accuracy and completeness of the financial statements as a whole. The auditor does not opine on individual matters. Accordingly, subjective information about an entity's financial statements presented by an auditor, such as a discussion of management's judgments and estimates, could create greater confusion, and in our view, would not result in providing decision useful information to investors.

An AD&A would significantly increase the cost of and time to complete the audit due to the additional effort that would be required for the auditor to obtain the understanding necessary of the day-to-day operations of the company and management's decisions and estimates required to be able to provide meaningful disclosures. In addition, an increase in effort would be required to resolve and clarify differences between the AD&A and the other information in the financial statements and potentially require further time to make information available to investors. Further, if an auditor provides subjective information that is relied upon for investor decisions and is later proved to be incorrect, the auditor and the company could be subject to litigation.

Current auditing standards already require the auditor to report the items proposed in the Concept Release to the Audit Committee. The Audit Committee, as a part of the shareholder elected Board of Directors, has the authority and responsibility to oversee the financial reporting process on behalf of investors and to resolve any specific accounting treatments that they are not comfortable with. This auditing standard should provide the level of assurance that these judgmental areas have been adequately addressed within the financial statements. The auditor also reporting these items to the investors could not only potentially confuse an uninformed investor, but would also appear to undermine the governance role of the Audit Committee.

If the auditor is required to present subjective information in the form of an AD&A, communications between the auditor, management and the Audit Committee could become less transparent. Effective communication between these parties is important to uphold the transparency of the audit resulting in a quality audit. There is also a risk of disclosing information that is confidential to the company in an AD&A. GAAP prescribes the standards that must be followed by management when producing financial statements, which are then reviewed by the SEC. If the investors require changes to the disclosure and reporting requirements under

GAAP, this should be completed through the standard setting process and not via the proposed AD&A.

**Emphasis Paragraphs**

The Concept Release proposes that emphasis paragraphs could be required and their use expanded, in which the auditor would discuss such things as significant management judgments and estimates and areas with significant measurement uncertainty. The PCAOB's auditing standard AU 580.11 already requires an auditor to include an emphasis paragraph in certain situations and allows auditors to include them when the auditor wishes to emphasize a matter in the financial statements. Requiring and expanding the use of emphasis paragraphs may lead to standardized disclosures in the auditor's opinion that are not meaningful to investors. As discussed above, significant management judgments and estimates and significant risks are already discussed with the Audit Committee. We believe the existing guidance for the use of emphasis paragraphs in the audit report is appropriate.

We believe that ASC 275, *Risks and Uncertainties,* provides guidance for disclosures in the footnotes that addresses some of the concerns in this area. However, to the extent that these disclosures should be expanded to address significant judgments and estimates in the financial statements and footnotes, we believe that the accounting standard setting process is the appropriate forum as opposed to the auditor's opinion.

**Auditor Assurance on Other Information**

Another alternative presented in the Concept Release is for the auditor to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis (MD&A), earnings releases, and/or non-GAAP financial information. Increasing the scope of the audit to include this other information could significantly increase the costs of the audit and could also put at risk the company's ability to timely file its financial statements in compliance with regulations.

Current auditing standard AU 550 already requires that auditors review other information accompanying the audited financial statements, such as MD&A, to ensure consistency with the audited financial statements. Simply providing assurance on other information outside the financial statements would not provide additional useful information for investors. We note there is a PCAOB attest standard detailing the requirements for attest engagements with respect to MD&A (AT 701), however, these engagements are typically not performed. Rather than a mandate, we believe that the Audit Committee is the appropriate place to make a judgment whether such undertaking is beneficial to their investors. Lastly, we believe that a regulatory mandate to audit additional information should only be made if a comprehensive analysis shows compelling evidence that the benefits outweigh the costs.

**Clarification of Language in the Standard Auditor's Report**

The fourth alternative discussed in the Concept Release is the clarification of certain terms in the standard auditor's report, such as reasonable assurance, and the clarification of auditor responsibilities, such as the auditor's responsibility to detect fraud. We appreciate the investment community's desire for additional understanding and do not object to the audit community providing the factual information proposed by this alternative.

If guidance is issued directing auditors to clarify their responsibilities and certain terms in the audit opinion, to avoid confusion, the EEI recommends amending the standard auditor's opinion by providing standardized language to be used in all auditor reports to maintain consistency between all auditors and all entities.

**Conclusion**

We appreciate the opportunity to comment on this Concept Release. As discussed above, we do not support the alternatives set forth in the Concept Release, including a requirement of the auditor to present subjective information on an entity's financial statements in their opinion. The auditor's views regarding significant matters, such as permissible alternative accounting treatments, could undermine the entity's financial statement presentation and disclosures and create greater confusion with the investor public. Furthermore, we do not support increasing mandates by the PCAOB of auditors that increase cost of operations of U.S. registrants, without measureable benefits to investors. If additional disclosures are necessary, we believe they should be established through the standard setting process and provided by management. If an auditor has concerns, they should be addressed with the Audit Committee whose role is to address those concerns.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Sincerely,

Richard F. McMahon, Jr.

EideBailly®

CPAs & BUSINESS ADVISORS

September 30, 2011

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

**Re: Request for Public Comment:** ***Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standard***

We commend the Board's effort to make improvements to the auditor reporting model and appreciate the opportunity to provide our comments on this Concept Release.

Following are our responses to the specific questions noted in the Release.

**Content and Form of the Auditor's Report**

1. *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

   a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

   We believe that the Board should undertake a standard-setting initiative to consider improvements to the auditor's report, with the goal of providing investors with more information about the audit process, including a clear understanding by the users of the financial statements as to the different responsibilities of the auditor and management. However, we do not believe that this initiative should result in an expansion of the basic responsibilities of the auditor.

   b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

   We believe that the standard auditor's report could be improved by further explaining the difference in responsibility of the auditor and that of management, and perhaps that of the Audit Committee, as well as further explaining the level of responsibility the auditor takes with respect to the financial statements as opposed to other information included outside of the financial statements.

c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe that the auditor's role should be expanded to provide assurance on matters other than the financial statements, as we believe that this is an assumption of the responsibilities of management by the auditor, which may potentially result in additional confusion as to the respective roles and responsibilities of the auditor and management.

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

Yes, as the current model provides consistency, comparability, and clarity for users of the related financial statements.

b. *If not, why not, and what changes are needed?*

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

We believe that the following changes to the auditor's report would be beneficial:

- A clear explanation of the responsibilities of the auditor, that of management, and that of the Audit Committee
- Information regarding the concept of "reasonable assurance"
- A clear explanation as to the responsibility of the auditor with respect to information outside of the financial statements, including Management Discussion and Analysis
- Expanded use of emphasis of matter paragraphs related to significant disclosures or other significant matters.

3. *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

We believe that additional information about the company's financial statements is most appropriately provided by management and/or the Audit Committee. The auditor's responsibility is to express an opinion on the financial statements and related disclosure, rather than to communicate to users of the financial statements information about the company.

4. *Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

Similar to our comments above related to changes in the auditor's report on the financial statements, we suggest that information communicating the responsibility of the auditor vs. management related to internal control over financial reporting also be included in this report.

**Auditor's Discussion and Analysis**

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

   a. *If you support an AD&A as an alternative, provide an explanation as to why.*

   b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

   c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

   d. *If you do not support an AD&A as an alternative, explain why.*

   e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

We do not believe that and auditor's discussion and analysis should be pursued as an alternative for the following reasons:

- Auditor's discussion of their views on topics such as management judgments and estimates, accounting policies and practices, and so-called "close calls" offer the opportunity to provide greater confusion as to the relative roles and responsibilities of auditors, management, and Audit Committees, rather than to reduce this confusion. The evaluation of these types of issues in the conduct of an audit involves considerations of specific facts and circumstances that would be nearly impossible to communicate to a user of the financial statements while providing the necessary context to fully understand that evaluation. To do so would likely result in an analysis that would be so lengthy and/or include boilerplate language such that it would not be useful to readers. We do believe that these topics should continue to be discussed by the auditor with the Audit Committee, the difference being that members of an Audit Committee have a knowledge base about the company and the opportunity for continuing dialogue with the auditor that can result in a meaningful discussion.

- The auditor discussion and analysis, as contemplated, appears to be such that may offer opportunities for users of the financial statements to either question the conclusions reached by the auditor, or at a minimum, provide less clarity, rather than more as to the basis for the auditor's opinion.

- We do not believe that it is or should be the auditor's responsibility to provide further context to management's discussion and analysis to users of the financial statements. We do not believe that a failure by management to provide the information necessary to investors or other users of the financial statements in the management discussion or analysis, or by other means, warrants a transfer of this responsibility to the auditor. This transfer of responsibility also may result in the auditor disclosing information that management did not, thus again creating confusion as to the responsibilities of each, and potentially calling into question the independence of the auditor.

- We believe that if investors and others believe that financial disclosure is not adequate at present, that this be addressed through changes to generally accepted accounting principles by the FASB and SEC, rather than attempting to address this through changes to the auditor's report.

- We believe that the auditor discussion and analysis contemplated would result in multiple levels of review not only by audit firms, but also by management, the audit committee, and the company's legal counsel. Considering the current time pressure currently experienced in many issuer engagements, we believe that this review process may result in time being taken away from the audit process, at the risk of decreased audit quality. We do not believe that the potential advantages of such an analysis outweigh the potential costs.

6. *What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

   As noted above, we do not believe that information about the audit should be disclosed in an auditor discussion and analysis.

7. *What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

   As noted above, we do not believe that information about the audit should be disclosed in an auditor discussion and analysis.

8. *Should a standard format be required for an AD&A? Why or why not?*

9. *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

   We do not believe that it is the responsibility of the auditor; rather it is management's responsibility to communicate information related to business, strategic or operational risks to investors or other users of the financial statements. If this information is not currently being provided to users as it is expected to be, we do not believe that addressing this shortcoming through changes to the auditor's reporting model is the appropriate way to address this problem.

10. *How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

    Should an auditor discussion and analysis model be adopted, we believe that liability considerations would ultimately push the wording toward boilerplate language, similar to what has occurred over time with respect to management's discussion and analysis.

11. *What are the potential benefits and shortcomings of implementing an AD&A?*

    See our response to Question #5 above.

12. *What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

    Practically speaking, we do not believe that there would be significant differences between auditor discussion and analysis and management discussion and analysis, as these differences would be debated and addressed in the review process we have discussed above, with any differences ultimately being resolved via discussions between the auditor, management, company legal counsel, and possibly the Audit Committee. As we have mentioned above, we are concerned that the additional time that this would add to the audit process may have the effect of actually decreasing audit quality, at the expense of providing information that may or may not actually benefit users of financial statements.

**Required and Expanded Use of Emphasis Paragraphs**

13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

    We believe that the use of emphasis paragraphs related to the types of matters described in the illustrative examples would be relevant to users, as they would draw attention to matters deemed by the auditor to be significant to users of the financial statements.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

    a. *If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

       As noted above, we believe that the use of emphasis paragraphs can be effectively used to draw attention to significant matters in the financial statements and related disclosures. However, we also believe that the designation of topics which would require the use of an emphasis paragraph be relatively limited, as this would allow a measure of consistency to the types of items being discussed in these paragraphs. By ensuring a level of consistency in the types of issues included, the current negative connotation of the inclusion of such a paragraph in an auditor's report would be eliminated.

       We do not believe that related audit procedures should be required to be discussed in the emphasis paragraphs. The auditor's decision to perform certain audit procedures is the result of a risk assessment process and significant judgments. To require the auditor to disclose those procedures, particularly in areas which are as significant as those deemed necessary to provide additional auditor reporting in the form of an emphasis paragraph, creates the risk of decreasing audit quality due to the increased risk of management being able to manipulate information based upon their knowledge of planned procedures in key audit areas.

    b. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

15. *What specific information should be required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

    We believe that areas in which emphasis paragraphs be required be limited to a relatively few number of topics, and that the type of discussion be areas which are fact-based, rather than judgment-based. For example, we believe that it would be reasonable to require emphasis paragraphs that refer to disclosures of significant related party transactions, significant subsequent events, going concern, or accounting matters that impact the comparability of information between periods (significant acquisitions, discontinued operations, etc.). We also believe that the emphasis paragraphs be relatively brief, as their purpose will be to direct users of the financial statements to the relative matters, rather than to suggest that those specific matters are being separately reported on.

16. *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

    See our response to Question 15.

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

    As noted above, we believe that the content of emphasis paragraphs be relatively brief, with the purpose of referring a user of the financial statements to significant disclosure, rather than repeating or providing an analysis of the specific matter. As such, it is likely that the language of these paragraphs will become boilerplate in nature. We do not view this as a negative consequence as this will result in a level of consistency in the reporting for these types of matters that will reduce the current negative connotation that exists for this type of auditor reporting.

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

    The potential benefit of required and expanded emphasis paragraphs is the clear direction that would be provided to users of financial statements with respect to significant financial reporting and disclosure issues. To maximize this benefit, we believe that the range of matters which would require emphasis paragraphs be relatively limited.

**Auditor Assurance on Other Information Outside the Financial Statements**

19. *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

    a. *If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

    b. *On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

    c. *What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

    d. *If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

f. *Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

We do not than the auditor's responsibility should be expanded to provide assurance on other information outside of the financial statements. Similar to the proposal for an auditor discussion and analysis, we believe that this proposed solution is an unnecessary shift in responsibility from management to the auditor in an attempt to improve the quality of management discussion and analysis.

Additionally, there are certain components of this information that would be difficult to audit, if auditable at all, particularly the so-called forward-looking information. As a result, users of the financial statements and related other information may be unclear as to which portions of the other information is audited and which is not.

Lastly, we question the demand for this type of assurance from the auditor, whether from management of investors, as standards currently exist to provide for this reporting, however we do not believe that auditors are routinely engagement to provide this service.

20. *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

We do not believe that there are significant benefits in requiring this information to be audited, and as any requirement to provide assurance on any of all of this information would increases audit costs and increase time pressures; we do not believe that an appropriate cost/benefit relationship exists.

**Clarification of the Standard Auditor's Report**

21. *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

a. *Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We believe that each of these clarifications are appropriate, as a better understanding of each of these concepts by users of the financial statements should result in a clearer understanding of the roles and responsibilities of the auditor, management, and possibly also that of audit committees.

b. *Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Yes, as evidence suggests that users of financial statements do not have a clear understanding of the nature of the audit as it relates to the concept of reasonable assurance, nor do they have a clear understanding of the separate responsibilities of the auditor and management with respect to the financial statements.

c. *What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

We believe that similar clarifications be made in auditor’s reports on internal controls over financial reporting. Additionally, clarification of the role of audit committees may be of value to users of financial statements.

d. *What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

We do not believe that the clarification in the auditor’s report for the types of matters discussed will have a significant impact on the scope of the audit.

22. *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We believe that the proposed clarifications will result in a better understanding of the audit report, as well as a better understanding of the responsibilities of the auditor, management, and possibly audit committees with respect to the financial statements and the auditor’s report. We do not believe that there are significant shortcomings that would result from the inclusion of these clarifications.

**Questions Related to all Alternatives**

23. *This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

We believe that the possible reporting described in *Clarification of the Standard Auditor’s Report* can provide effective and meaningful enhancements to auditor reporting without a significant increase in the cost of audits.

24. *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

We believe that the combination of the considerations noted in *Clarification of the Standard Auditor’s Report*, along with those discussed in the *Form of the Auditor’s Report* have the potential for the most benefit with limited cost. We also believe that consideration of required emphasis paragraphs may improve auditor reporting, depending upon the nature and extent of what matters the Board would deem to be “required”.

25. *What alternatives not mentioned in this concept release should the Board consider?*

None specific, other than that we believe that many of the considerations discussed also have applicability to the auditor’s reports on internal controls over financial reporting.

26. *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

    The development of an auditor reporting framework needs to be such that the framework will appropriately consider the cost/benefit relationship of any expansion in auditor reporting. In addition, the Board needs to consider the impact of any changes on smaller issuers and smaller firms.

27. *Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

    We do not believe that the considerations discussed in *Clarification of the Standard Auditor's Report* would be perceived to result in a qualified or piecemeal opinion. Also, if appropriately scoped and applied, the concepts discussed in *Required and Expanded Use of Emphasis Paragraphs* may result in these paragraphs being perceived more favorably than they are currently.

    However, we believe that the concepts discussed in *Auditor's Discussion and Analysis* and *Auditor Assurance on Other Information Outside the Financial Statements* may well result in more confusion as to the auditor's responsibilities than what currently exists, in addition to adding significant time and cost to the audit process.

28. *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

    See our response to Questions 23 and 24.

29. *What effect would the various alternatives have on audit quality? What is the basis for your view?*

    We believe that the considerations discussed in *Clarification of the Standard Auditor's Report* can be implemented at minimal cost with no effect on audit quality, other than an improvement in auditor reporting.

    As discussed in response to previous questions, we believe that the considerations discussed in both *Auditor's Discussion and Analysis* and *Auditor Assurance on Other Information Outside the Financial Statements* have the potential to decrease audit quality as a result of taking time away from the audit process to prepare and review auditor discussion and analysis and/or complete procedures necessary to provide assurance on other information, while still requiring timely reporting of financial information.

30. *Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

    In order to appropriately achieve the goal of consistency and comparability in auditor reporting, we believe that changes in the auditor reporting model apply equally to all reports covered by the standards of the Board. We do recommend, however, that the Board properly consider the impact of any changes to the reporting model to smaller issuers and smaller firms.

**Considerations Related to Changing the Auditor's Report**

31. *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

    a. *Are any of these considerations more important than others? If so, which ones and why?*

    b. *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

    c. *Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

    d. *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

32. *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

    We do not believe that the auditor should be placed in the position of being the source of information about the company to users of the financial statements. We believe that any proposed changes that would place the auditor in this position will result in a lesser understanding of the auditor's responsibility by users, rather than to clarify it.

Once again, we appreciate the opportunity to comment on this Concept Release. Please feel free to contact us if you have questions on any of our comments or would like to discuss them further.

Sincerely,

Eide Bailly LLP

Brian Bluhm, CPA
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September 30, 2011

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

Re: Rulemaking docket matter No.34: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Dear Board Members:

Eli Lilly and Company ("Lilly") appreciates the opportunity to comment to the Public Company Accounting Oversight Board ("PCAOB") on the Concept Release No. 2011-003 on Reports on Audited Financial Statements. Lilly is a large, multinational pharmaceutical company, with presence in over 50 country jurisdictions, and creates and delivers innovative medicines that enable people to live longer, healthier, and more active lives.

Lilly commends the PCAOB for working to revamp the existing Auditor's Reporting Model in an effort to increase transparency and relevance to financial statement users ("users") while not compromising audit quality. We agree that any changes to the auditor's report should be based upon the principles of maintaining audit quality and adding value to the users while also focusing on objective communications from the auditors and being cost effective. While we believe the current "pass/fail" model is effective, we do agree with the PCAOB that there are some potential enhancements that could make the auditor's report more transparent and relevant for the users. We believe that certain proposed changes could potentially add value to the reporting model and enhance communication to users by improving the content of the auditor's report while retaining the current "pass/fail" model.

However, we believe that certain proposed changes, in particular the Auditor's Discussion and Analysis ("AD&A") and assurance on information outside of the financial statements, could have a significant adverse impact to companies, auditors and users. We appreciate that the PCAOB has taken into consideration the issues raised by stakeholders through the outreach that was conducted. Yet, we are very concerned that these particular proposed changes, if adopted, could change the fundamental role of the auditor, impact transparency between auditors and management and/or lead to confusion of users among other concerns addressed throughout this response.

We address each of the alternatives and our thoughts and concerns in further detail below.

**Alternative 1: Auditor's Discussion and Analysis**

We strongly oppose the AD&A alternative proposal, which would include a supplemental narrative report with the intent of providing investors and other users with a view of the audit and the financial statements "through the auditor's eyes." The alternative would allow the auditor to discuss views regarding significant matters such as audit risk identified in the audit, audit procedures and results, auditor independence, auditor's views on the company's financial statements including management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls". In addition, the auditor could highlight areas where the auditor believes management could have applied different accounting or disclosures.

Management's role is to determine the appropriate accounting policies and estimates and communicate through the financial statements while the audit committee's role is to provide governance and oversight. The auditor's role is to audit the financial information provided by management to ensure that it is materially accurate and not to act on behalf of management or the audit committee. The proposal, as described by the PCAOB, appears to be mixing the roles within these groups which would be unacceptable under current guidance and is contradictory to the roles that currently exist. This alternative would require that the auditor take on more of a governance and oversight role for the company that they are auditing, which could impair independence and naturally bring rise to a number of other issues. We strongly believe that the communication described within this alternative is the responsibility of management under the oversight of their audit committee and not that of the auditor.

We also question who would truly benefit from these additional details being provided when it is concluded that the financial statements are "presented fairly in all material respects." There are numerous estimates and judgments inherent in our financial statements. The role of the auditor is to opine on the reasonableness and consistent application of accounting principles to arrive at an appropriate conclusion. If there are unresolved differences presented to an audit committee then that should be disclosed, however, if there are no differences, we see no value for added discussion.

It is important to understand that many accounting issues are very complex and unique requiring much discussion and research to determine the appropriate accounting treatment. In fact, many times with complex accounting issues, local audit teams must reach out to their national accounting experts because the answers are not obvious. Thus, we believe this alternative is very dangerous. Management is responsible for the financial statements, accounting policies, financial estimates, etc. and there has been a significant effort to ensure that auditors are not making decisions on behalf of management. However, if the auditors are required to disclose their views and their process to understand, discuss and conclude on the accounting policies and estimates, there is a risk that the auditors become the ones who ultimately make the accounting policy and estimate decisions.

If this alternative were adopted it could require a considerable amount of time between management and the auditor to reconcile differences between company disclosures and the AD&A. If the differences are not able to be reconciled this would cause confusion among users. Additionally, requiring the auditor to provide this type of information to investors will likely impair transparency and openness in discussions and increase tension among auditors, management, and the audit committee thereby inhibiting information that is provided to users.

The preparation of an AD&A would substantially increase the scope of the auditor's responsibilities and could adversely impact the auditor's financial statement focus. Additionally, this alternative would bring about the potential for auditors to discuss information about the company that might be deemed proprietary or highly sensitive to a company's competitive industry position which would lead to increased liability for the auditors. As a result of the increased liability, significant expertise and time from auditors, involvement of their national offices and legal counsel would be required in order draft the narrative for public use to mitigate potential legal exposure, which would serve as a significant distraction from the audit. With the already tight reporting deadlines, attempting to complete this additional report would present challenges in terms of our ability to meet current reporting deadlines. All of these factors would promote the use of boilerplate language within the AD&A to avoid legal issues and create efficiency in the reporting process, which would undermine the purpose of providing the additional commentary.

Additionally, we believe that it would be very difficult for the PCAOB to develop an appropriate framework and once developed, whether the framework could be consistently followed by auditors when disclosing information of such a highly subjective nature. Requiring auditors to present information of this nature could result in misleading reports; making it difficult to have comparability among financial statements and causing confusion about the auditor's pass/fail opinion. In today's pass/fail model the unqualified opinion implies that all material matters were resolved and the financial statements are materially accurate and presented fairly. Highlighting this additional information (e.g. close calls, contentious issues, etc.) would suggest a higher level of importance to the issue(s) than is warranted since users would not be privy to the dialogue that occurs between the auditor, audit committee and management in which additional context and perspectives are communicated. This also raises the question of who would be responsible for "auditing" the information provided by the auditor within an AD&A to ensure that it is reliable and not misleading.

We do not believe this proposal meets the defined principles of maintaining quality, adding value, providing objective communication and being cost effective. Our most significant concern identified with this proposal is the impact to the auditor's independence, which may be impaired, if the auditor takes on a role in governance, deciding on accounting policies and making complex accounting judgments. Additionally, the AD&A proposal is potentially confusing to users due to the mixed messages of having an unqualified opinion but a lengthy and complex discussion in the AD&A regarding accounting issues that may be difficult to explain to users that are not experts in those areas. In addition, the AD&A may result in different disclosures between management within MD&A and the auditors within AD&A as well as negatively impacting the relationship between the auditors, audit committee and management. The results will reduce the audit quality and reduce the value to the users. Also, the AD&A is extremely subjective in nature potentially leading to inconsistent and incomparable financial statements which does not meet the principle of providing objective auditor communication. We believe that this proposal will result in significant increase in auditor scope and thus, increase in auditor time and costs which does not meet the principle of being cost effective. Lastly, we strongly believe it is management's role to communicate information to investors and users through the financial statements. Only if there is a disagreement between the auditors and the audit committee should the auditor communicate in this nature with investors, similar to the current requirements under SOx for material weaknesses. Therefore, we urge the PCAOB to eliminate this alternative from the proposal.

**Alternative 2: Required and expanded use of emphasis paragraphs**

We believe that this may be a reasonable approach depending on the scope of the expanded use of emphasis paragraphs. This alternative would mandate the use of emphasis paragraphs in all audit reports and would expand paragraphs to highlight the most significant matters in the financial statements and where these matters are disclosed. Emphasis paragraphs could be required in areas such as significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that an auditor determines to be of critical importance. The auditor may also be required to comment on key audit procedures performed for each matter of emphasis.

Today the auditor communicates the areas of audit emphasis to the audit committee. We would be supportive of limiting the emphasis paragraphs to parallel what is currently communicated to the audit committee as to the areas of emphasis. This should also mirror, in part, the company's critical accounting policies and significant events which are currently disclosed in the Management's Discussion and Analysis ("MD&A") section of the annual report. These should be objective, fact-based descriptions that reference the specific areas of the financial statements where this information is disclosed. We believe that emphasis paragraphs whereby the auditor identifies the areas of audit emphasis, including critical accounting policies and significant events and where they are disclosed could potentially be helpful for users by providing users with a reference to the areas deemed significant by the auditors and impact the financial statements during the period.

However, we do have significant concerns that the emphasis paragraphs, as the proposal currently describes, are too broad and would be used inconsistently if not clearly defined. Similar to our concerns addressed in alternative 1, we believe that it would be very difficult for the PCAOB to develop an appropriate framework outside of the critical accounting policies and significant events discussion, and once developed, whether the framework could be consistently followed by auditors when disclosing information of such a highly subjective nature. Requiring auditors to emphasize areas that don't necessarily require emphasis could result in misleading reports, make it difficult to have comparability among financial statements and cause confusion about the auditor's pass/fail opinion. In today's pass/fail model the unqualified opinion implies that all material matters were resolved and the financial statements are materially accurate and presented fairly.

Additionally, we believe that requiring auditors to comment on key audit procedures performed pertaining to the identified matters would be difficult to communicate in a concise manner and would not provide the user with the full context of the audit strategy thereby confusing the reader rather than providing useful insight. An audit must be evaluated as a whole, not based on individual procedures. Thus, it would make it very difficult for users to understand an auditors overall assessment when highlighting only a few areas. In addition, many of the users do not have the background, understanding or context to properly evaluate the audit procedures. It is important to understand that many significant audit issues and the audit procedures are complex, resulting in local audit teams consulting with their national experts and if the users are not experts in the area, the additional information may be more confusing and potentially, even misleading.

While we do believe that the emphasis paragraphs may provide value and meet the defined principles, we urge the PCAOB to carefully consider the scope of the emphasis paragraphs. We propose that the emphasis paragraphs be limited to the areas of audit emphasis reported to the audit committee, which would include critical accounting policies and significant events during the period, to provide users with a summary of the most impactful areas to the financial statements for the period. This proposal would maintain audit quality, add value to the users by have one place to find the information, provide objective communications from the auditors, while still being cost effective.

**Alternative 3: Auditor assurance on other information outside of the financial statements**

We object to this alternative which would require auditors to provide assurance on information outside of the financial statements such as the MD&A disclosures, non-GAAP financial measures, and/or information contained in earnings releases.

The information outside of the financial statements allows management to comment on future plans, estimates and goals. Due to the nature of the information provided, the information outside of the financial statements is often times not an area on which the auditor's could effectively provide assurance. We do not believe that this alternative would add value to the process or provide additional comfort to users; however it would substantially increase the scope of the auditor's responsibilities as well as the time and cost of completing the audit. The increase in scope would shift the auditor's focus away from the financial statements, negatively impacting audit quality. Additionally, this alternative would lead to companies needing to furnish periodic filings at an earlier stage of the process, in order to provide the auditors with a chance to complete their procedures prior to the filing deadline which could put a severe strain on companies and auditors during the already tight reporting timelines and could lead to the delay of information being released to the public.

Also, we are specifically not supportive of requiring auditor assurance on the MD&A to cover the critical accounting policies as some proposals have suggested. The information typically included in the critical accounting policies section either discusses policies that do not require audit procedures or covers information that has already been audited within the footnote disclosures. We would be supportive of the auditor report referencing the critical accounting policies, indicating that they have been included in their overall audit procedures. However, we do not believe that providing a separate attestation report on the critical accounting policies within the MD&A would provide any additional benefit to the users.

There are situations where we rely on outside SEC counsel to provide our independent review consistent with Regulation FD. To include the auditors further within this process would require us to provide a significant amount of documentation for their work papers to meet PCAOB documentation standards on areas that do not have any significant impact on the reliability of the financial statements.

We would be supportive of the PCAOB expanding the current external auditor requirements for other information in documents containing audited financial statements as outlined in AU 550 (responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact) to cover the press release and other Non-GAAP measures. In addition, we would be supportive of including language within the audit report that communicates the current requirements under AU 550 in order to help users to better understand the procedures being performed and address the points raised by participants in the staff outreach that auditor association may increase reliability and quality of the information provided by management.

We do not believe this proposal meets the defined principles of maintaining quality, adding value, and being cost effective. As a significant portion of the information outside the financial statements, such as MD&A, is subjective, judgmental and forward looking, we do not believe that requiring auditors to provide assurance is value adding or in the spirit of maintaining quality. In fact, there may be numerous pieces of information that are un-auditable. The auditors would also need to spend a significant amount of time and resources on areas that are outside the risks related to the financial statements. In addition, this proposal will result in significant increase in auditor scope and thus, increase in auditor time and costs which does not meet the principle of being cost effective. Therefore, we urge the PCAOB to eliminate this alternative from the proposal, with the exception of considering expansion of current requirements outlined in AU 550 to cover the press release and other Non-GAAP measures.

**Alternative 4: Clarification of language in the standard auditor's report**

We are supportive of amending the standard audit report with clarifying language that would serve to enhance the report and help users better understand the responsibilities of the auditor and what an audit represents. This alternative would require auditors to provide additional disclosures in the standard audit report to clarify key terms used in the report. Below are the proposed alternatives and our view on each of them as to whether the language around these topics within the auditor's report should be revised to provide clarification on the auditor's responsibilities.

- Reasonable assurance – We are supportive of clarifying the language around reasonable assurance to correspond with the current auditing standard in order to reinforce the concept that an audit provides a "high level of assurance, but not absolute assurance."
- Auditor's responsibility for fraud – We believe that the auditor's responsibility for the detection of fraud should be addressed within the standard auditor's report in order to be more transparent to users. We are supportive of expanding the current language within the report of, "…Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, to include the words, "whether caused by error or fraud" as is consistent with the current auditing standard.

- Auditor's responsibility for financial statement disclosures – We are supportive of revising the auditor's report to provide clarification on the auditor's responsibility for the financial statement disclosures that is consistent with the current auditing standard.
- Management's responsibility for the preparation of the financial statements – We are supportive of further clarifying the auditor's report to state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.
- Auditor's responsibility for information outside the financial statements – As discussed within the response to Alternative #3, we believe that providing the users with an understanding of the auditor's current responsibilities under AU 550 would be beneficial and help users to better understand the procedures being performed, which could address the recommendation made during the staff outreach that auditor association with the this information may increase its quality and reliability.
- Auditor independence – We are supportive of clarifying this concept as we believe this could provide users with a better understanding of the auditor's role and provide more confidence in their judgments and process. Additionally, this could address the belief that auditors are in a unique position to provide relevant and useful information because of the extensive knowledge of the company and industry. While the auditor's may be in a unique position to provide this inside information, this could potentially undermine the independence of the auditor.

These clarifications outlined above would not alter the scope of the audit nor impact the auditor's responsibilities; they would however provide additional information to users without changing the fundamental role of the auditor. We believe that this alternative is most closely aligned with the PCAOB's goal of increasing transparency and relevance to users while not compromising audit quality. We also believe that this alternative is aligned with the principles of maintaining quality, adding value, providing objective communication and being cost effective. The more the users understand of the auditor's role, the better informed they can be when making decisions.

**Conclusion**

Again, Lilly supports the PCAOB's efforts to provide transparency and relevant information to users and believe that certain proposed changes could add value to the reporting model and enhance communication to users through improving the content of the auditor's report while retaining the current "pass/fail" model. However, we are concerned that certain options, particularly the AD&A and assurance on information outside of the financial statements, could result in a number of unintended consequences and negatively impact that audit process. We again urge the PCAOB to carefully consider and evaluate the impact that each of the proposals and/or combination of proposals would have on the companies and the auditors who would be required to comply with any new standards issued and the related implications. We also urge the PCAOB to carefully consider the cost/benefit of all of the proposed alternatives prior to implementing any new standards.

As part of our conclusion, we would like to suggest that the PCAOB urge the Securities and Exchange Commission ("SEC") to reconsider the definition of an audit committee financial expert as defined under Section 407 of the Sarbanes-Oxley Act of 2002. We believe that it would be beneficial if the definition were clarified to indicate that the individual must possess significant GAAP accounting experience obtained through public accounting experience at the Senior Manager or Partner level or from serving as a Controller, Chief Accounting Officer or similar role that is involved with the preparation of the financial statements. We strongly believe that modifying the definition of an audit committee financial expert could foster more robust conversations and lead to higher quality financial statements.

We appreciate the opportunity to express our views and concerns regarding the concept release. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 276-2024.

Sincerely,

ELI LILLY AND COMPANY

/s/Arnold C. Hanish

Arnold C. Hanish
Vice President, Finance and
Chief Accounting Officer

EMERSON.

Richard J. Schlueter
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September 28, 2011

Mr. Martin F. Baumann
Chief Auditor
Public Company Accounting Oversight Board (PCAOB)
1666 K Street NW
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Docket Matter No. 34 – Concepts Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Emerson Electric is a global manufacturing entity with 2011 sales of more than $24 billion. The Company appreciates the opportunity to comment on the PCAOB's recent Concept Release re: Reports on Audited Financial Statements.

In spite of the Release's reference to the auditor's "unique" role in public company financial reporting, an auditor's insight is largely limited to what has already occurred and the resulting financial statement impact. No one has a better understanding of or is more qualified to discuss an entity's results of operations, financial position, risks, control environment and future prospects than that entity's management. Creating a role for auditors to publicly comment on a company's financial statements beyond matters currently addressed by management under Rules S-X and S-K requirements is unnecessary and fraught with potential pitfalls. In such an environment, we envision auditor commentary quickly becoming boiler plate recitals that meet industry-determined requirements but provide no real value to investors. In a worst-case scenario, auditor discussions of matters that have been satisfactorily resolved with management (an everyday occurrence given the complexity of issues in today's business environment) are interpreted by investors as a disclosure of accounting "problems," due to a lack of understanding of the interaction between auditors, management and the audit committee, or of the audit process itself. This will unintentionally and inappropriately impact market expectations and valuations.

The basic premise of the PCAOB's question of whether the auditor's report should be expanded to provide more useful and relevant information to investors implies that the current U.S. GAAP and SEC financial reporting regime does not currently provide financial statements that are sufficiently relevant or useful. If there truly are shortcomings in the current financial reporting model, as implied by the Release, any perceived deficiencies should be addressed through appropriately targeted FASB and SEC rulemaking, not through an expansion of the auditor's reporting responsibilities. Management, with Audit Committee oversight, would then ultimately be responsible for meeting these revised SEC requirements, as they are currently. Expanded auditor discussion, if any, should be limited to matters concerning the auditor and the planning, conduct and inherent limitations of the audit itself. We believe the best role for the PCAOB with regard to shareholders is to remain focused on a strong audit inspection process and ultimately improving audit quality.

We are not altogether sure what deficiency in the financial reporting regime the Release aims to correct, as it is difficult to imagine the recent financial crisis could have been averted through additional financial reporting. Business is inherently risky, as is equity investing, and no amount of financial reporting will ever replace the responsibility of investors to fully research and understand the risks associated with the markets, industries and companies in which they invest. Financial reporting looks backward to explain how an entity was impacted by economic events and circumstances and cannot be expected to eliminate investment risk by forewarning of the next recession or financial crisis. Ever greater amounts of financial disclosure will not alter this dynamic, whether the risks arise from macroeconomic changes or from micro industry- and/or company-specific developments. We also believe that to some degree, the perceived demand for auditor identification of important disclosures results directly from the current disclosure overload, where every nuance is discussed in depth and tabular roll-forwards of detailed account activity make it difficult for investors to know what is relatively more or less important for their particular risk tolerance. In effect, investors might be saying that due to the already heavy volume of disclosure, they are having trouble separating what is genuinely important from what is perfunctory compliance.

Following are additional, specific comments on various items discussed in the Release:

- The current Pass / Fail model of audit reporting functions properly and does not require revision. If all accounting matters are satisfactorily resolved, then there simply are no issues to report. Either the financial statements are fairly presented and acceptable for filing with the SEC or they are not. There is no place for a hypothetical discussion of what might have happened. Further, what will be the definition of a contentious issue, or a "close-call," as the Release terms it? A lengthy or highly technical discussion between management and auditors, even where positions differ significantly, does not mean the matter is *contentious*; it does not even mean the transaction is especially risky. Whether it is simply a new transaction, evolving circumstances requiring extra time, or a complex matter elevated to the SEC for Staff consideration, once resolved the background and mechanics of resolution are not important. It is commonly understood that unaddressed or unresolved material issues could lead to a qualified opinion, which should rightfully be accompanied by additional disclosure. But added discussion of resolved matters is just not necessary. And we note there is already a requirement for management to report disagreements with auditors to the Audit Committee and publicly disclose the nature of such disagreements under Rule S-X. An auditor rendering an unqualified opinion and then discussing transactions that might have resulted in a qualified opinion had the accounting not been satisfactorily resolved can only confuse, and potentially mislead investors.

- We are very concerned an Auditor's Discussion and Analysis (AD&A), or other qualitative auditor assessments of financial reporting, will quickly push disclosures toward Big 4-decided standards, as management will want to avoid disclosures that appear to conflict with the view of their auditors. Investors will then lose critical nuance and perspective as seen through management's eyes as disclosures ultimately become subject to the limitations of an auditor's disclosure checklist. Management is far more experienced than any auditor and is the only appropriate source of meaningful qualitative disclosures regarding risk management or accounting alternatives. Requiring auditor reporting on these matters will ultimately result in the Big 4, instead of management or the SEC, collaborating to make decisions on accounting and reporting policies, including choosing preferability among GAAP-allowed accounting approaches.

- Investors will not necessarily understand the substantive differences between AD&A and MD&A, and instead will likely assume the auditor is "right" and management is "wrong," based on the public perception of auditors as corporate watchdogs. However, the key considerations in an auditor's decision on AD&A content will most likely not be what is in the best interests of shareholders, but instead will be what best avoids litigation for the auditor. This approach will limit auditor disclosures to something less than useful and we foresee AD&A being formulaic and filled with the caveats and disclaimers common in auditor procedural reporting. This will not create the independent expert "comfort" sought by the PCAOB or certain investors. It will simply increase auditor fees and add to disclosure overload.

- To ensure consistency with financial statement disclosures, auditors commonly review and provide input to management on other financial information in MD&A, press releases and analyst call information. We believe that in general auditors' views are respected and incorporated into the overall communication approach when appropriate. Additionally, auditors can withhold their opinion when there are material differences between the financial statements and other financial information. We therefore do not believe that auditors need an official and expanded role regarding the form or content of other financial information, as we are concerned that auditor involvement will quickly limit management's discussion to only matters that can be objectively verified by the auditor. Additionally, we believe that under the current U.S. regulatory and legal environment, auditor and management language regarding risks or MD&A will quickly conform to one another in lowest common denominator disclosure. This will sacrifice management candor and insight for the sake of procedural consistency, especially as it relates to forward-looking information.

- The Release discusses the possibility of the auditor pointing out specific elements of an entity's financial disclosures for emphasis. Financial statements and footnotes are integral to one another and designed to be read together, in their entirety. An auditor highlighting specific sections for reader emphasis will inappropriately elevate these matters and simultaneously diminish the non-emphasized disclosures. By what standard is the auditor to gauge significance? Will emphasized items be consistent across companies and industries? Will they be considered key by all shareholders? Would they be the same items to which management might assign emphasis? A detailed analysis by management of business risk factors is already required in annual 10-K reporting and these disclosures are a key element of investor understanding of an entity. Asking auditors to highlight what they believe are the most significant risk factors is effectively having them advise investors on which risks to focus, and conversely, which to ignore. It is the investor's responsibility to be fully informed about any company in which he might invest, prior to committing resources. Financial disclosures are provided in their entirety, without bias, so that investors can decide which elements have more importance, based on the investor's investment objectives and risk tolerance. More disclosure, regardless of the source, can never replace this responsibility.

- Outside of the accounting profession, the process of conducting an audit is largely unknown and investors might benefit from having a better understanding of the auditor's role, responsibilities and obligations, and the inherent limitations of an audit. The auditor's report already provides a solid summary of the auditor's and management's responsibility regarding their respective roles in the current financial reporting regimen. Additionally, PCAOB auditing standards plus the Center for Audit Quality's guide to public company auditing are public information and readily available to any investor who wants an in-depth understanding of audit requirements, approaches and techniques. Individual investors must have some responsibility for fully understanding the auditor's role, including the responsibility for detecting material misstatements, whether resulting from fraud or unintentional error. If investors will not avail themselves of this easily accessible information, then it seems doubtful auditor reporting in this area will advance investor understanding.

**Conclusion**

It is not clear to us exactly what malady the PCAOB is attempting to cure with this Release, as it is difficult to imagine the recent financial crisis could have been averted through additional financial reporting. Management, auditors and investors each have specific, interdependent but ultimately individual responsibilities in the financial reporting and investing regime. Management's responsibility, with proper audit committee oversight, is to report on its operations, risks, and outlook based on existing U.S. GAAP and SEC requirements. The auditor's responsibility is to plan and perform an audit, and render an opinion on the financial statements based on U.S. GAAP and industry and PCAOB auditing standards. Investors have a responsibility to gain an in-depth understanding of a company, its competition, and the markets in which they compete prior to committing their resources. Equity investing involves risks and uncertainties and that risk cannot be regulated away. No amount of disclosure, regardless of its source, will be a substitute for thorough investor research. A new disclosure role for auditors will not provide investors predictability regarding the depth or breadth of future industry- or company-specific impacts from adverse economic circumstances.

We appreciate the opportunity to respond and trust our comments will be taken seriously in future Board deliberations on this issue.

Sincerely,

Richard J. Schlueter

Richard J. Schlueter
Vice President & Chief Accounting Officer

cc: Frank J. Dellaquila
Senior Vice President & Chief Financial Officer

Endurance

September 30, 2011

Office of the Secretary
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Re: Request for Public Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket No. 34

Dear Office of the Secretary:

Endurance Specialty Holdings Ltd. ("Endurance") appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board ("PCAOB") on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards released June 21, 2011 ("Concept Release").

Endurance is a global specialty provider of property and casualty insurance and reinsurance. Through its operating subsidiaries, Endurance writes property, casualty, healthcare liability, agriculture and professional lines of insurance and property, catastrophe, casualty, aerospace and marine, and surety and other specialty lines of reinsurance. We prepare our consolidated financial statements in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). Our gross premiums written were $2.1 billion for the year ended December 31, 2010 and our shareholders' equity was $2.8 billion at December 31, 2010.

Endurance supports the PCAOB's efforts to improve the current auditor reporting model. However, we have some concerns regarding the alternatives discussed in the Concept Release. Our views on each of the alternatives presented in the Concept Release are described below. We believe that the Auditor's Discussion and Analysis ("AD&A") and Auditor Assurance on Other Information Outside the Financial Statements alternatives would be costly to implement and the resulting benefits to investors would not justify the cost. We also believe that these alternatives may result in unintended consequences, as we believe management will change their accounting policies and disclosures to avoid investor confusion and reduce the information they disclose to ensure the disclosures are auditable.

**Changes to the Auditor's Reporting Model**

Endurance supports retaining the current "pass/fail" auditor's report model. This model is clear, consistent and comparable among all audited companies, and is therefore useful to investors. However, we also support expanding the auditor's report to incorporate additional information that would be useful for investors. We believe that any additional information regarding the company's financial statements should come from management, not the auditors. The financial statements are the responsibility of management,

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Endurance

not the auditors, and therefore it is inappropriate for the auditor to provide information regarding the financial statements. Management is in the best position to comment on the business and to provide any additional information regarding the financial statements. Although the auditors have a detailed understanding of the business, they are still a third party and their views of the business may not be entirely complete.

**Auditor's Discussion and Analysis**

Overall, Endurance believes that in practice, an AD&A would not provide useful information to investors. Instead, the AD&A would likely cause confusion in the investor community. This confusion could come from a number of different areas. If the auditor provides information that management has not disclosed, this could cause confusion for users of the financial statements, as clear, consistent information is not being provided. If management's discussion and analysis ("MD&A") and the AD&A are not consistent, investors may not know which version is correct. Requiring the auditors to discuss alternative accounting policies, practices and disclosures that the company could have chosen could also create confusion, as investors may be unsure as to which alternative is correct. If management chose one acceptable alternative and the auditors indicated a preference for another acceptable alternative, investors may question whether the financial statements (and the auditor's opinion on those financial statements) are accurate. Even knowledgeable, experienced investors may question management's choices in this situation. Even worse, we believe that in practice companies would attempt to reduce the number of differences between the MD&A and AD&A by adopting the auditor's preferred accounting policies, practices and disclosures, including those related to significant judgments and estimates, rather than having a disconnect between the MD&A and the AD&A. This would reduce the quality of the financial statements, as management should be making appropriate accounting policy and disclosure decisions based on their knowledge of the business, not based on auditor preferences.

We believe that auditors discussing "close calls" in their audit report would not be appropriate. Close calls are highly subjective, and what is considered a close call by the auditor may not be considered a close call by management. Also, due to the subjective nature of a close call, there is the potential for variability between auditors on what is considered a close call, which would reduce the comparability of this disclosure among different companies. Discussing close calls in the auditor's report would also be confusing for investors. If a contentious issue is being highlighted in the report, investors would wonder if it was resolved to the satisfaction of both parties or not. If it was resolved, why would it be highlighted in the auditor's report? Investors may also question the auditor's opinion in light of the issue – why would the opinion be unqualified when this issue was identified? Also, investors may not understand why the issue was highlighted or why it is being discussed in the auditor's report, and may infer that the financial statements are correct except for this issue. Other investors may wonder whether the final resolution was one that all parties agreed to, or if one party was forced to concede by the other.

Unfortunately, another unintended consequence of an AD&A may be less free-flowing discussions between management and the auditor, or less trust and more tension in the relationship with the auditor, as companies would be less willing to disclose sensitive or confidential information, fearing it will end up disclosed in the AD&A.

Overall, Endurance does not believe that the AD&A alternative suggested in the Concept Release would provide useful information to investors. Rather than assisting investors, the AD&A would in fact result in

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more confusion in the investor community. The AD&A is also one of the more extensive alternatives suggested in the Concept Release and would require a significant amount of effort by the audit firms to produce the AD&A and also to gather, audit and document the information required to support it. This would in turn result in increased audit costs for issuers. We believe that the additional cost of the AD&A would outweigh any benefits, therefore we do not support this alternative.

**Required and Expanded Use of Emphasis Paragraphs**

Endurance generally supports this alternative. We would encourage expanded use of the emphasis paragraphs, although we would like to see these kept optional rather than required. Some very small, simple audits may not have any significant items to highlight, and requiring the auditors to include insignificant details of the audit in emphasis paragraphs in the audit report would not be useful for users. We believe that the use of the emphasis paragraphs should be limited to truly significant issues or areas of judgment. Otherwise, overuse or frivolous use would dilute the importance of discussing a significant item. For example, if auditors were required to discuss the revenue recognition policies of all companies (as revenue is generally a significant audit area), those companies with truly significant revenue recognition or estimation issues would not stand out compared to those companies with standard revenue recognition policies. We agree that each of the issues discussed in the emphasis paragraphs should be referenced to the financial statements where these significant items are discussed by management.

We believe that emphasis paragraphs could lead to investor confusion if certain areas are discussed by the auditors in the auditor's report but not by management in the financial statements. This should be rare if the emphasis paragraphs are optional rather than required.

The language in the emphasis paragraphs is likely to become boilerplate over time, as this would increase consistency and comparability among companies. We believe it would be difficult to ensure these emphasis paragraphs are consistent among various companies without standard language.

**Auditor Assurance on Other Information Outside the Financial Statements**

Endurance believes that requiring the auditor to provide assurance on information outside of the financial statements will result in management disclosing less information to investors. We believe that management will scale back their disclosures in the MD&A to verifiable information, to ensure they can be audited by the auditors. Therefore, this alternative would result in less useful information for investors, as management would likely remove most forward-looking information and other important details which are less readily auditable. This is the opposite of the stated purpose of this project, which is to enhance transparency and relevance of the information provided to investors.

We are also concerned that this alternative would cause a significant increase in scope for the auditors. We believe that the auditors will need to spend a significant amount of time to audit the MD&A, and we are concerned that due to already tight reporting deadlines, this may cause a significant time crunch at the end of the reporting cycle. This increase in scope will also result in a corresponding increase in cost for issuers. As we do not believe that this alternative would result in better information for investors, the benefit does not exceed the cost and therefore we do not recommend this alternative.

Endurance

**Clarification of the Standard Auditor's Report**

Endurance supports each of the clarifications proposed in the Concept Release. We believe that these additions will provide additional valuable information to investors. However, as these items are not directly related to the opinion on the financial statements, we propose that this additional information is provided in a separate letter from the auditors to the readers of the financial statements, which issuers would then attach as an appendix to their filing. As these additions will not require additional work by the audit firms, nor by financial statement preparers, this alternative will provide additional information for little additional cost to auditors and issuers.

**Conclusion**

Endurance generally supports the Expanded Use of Emphasis Paragraphs and the Clarification of the Standard Auditor's Report alternatives discussed in the Concept Release. We believe that the AD&A and Auditor Assurance on Other Information Outside the Financial Statements alternatives would be costly to implement and benefits , if any, to investors related to the additional disclosures would not justify the cost. Also, these alternatives would have unintended consequences such as investor confusion and management disclosing less information to investors to ensure it is auditable. We therefore do not support the AD&A and Auditor Assurance on Other Information Outside the Financial Statements alternatives.

Thank you for consideration of our comments.

Yours sincerely,

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30 September 2011

**PCAOB Rulemaking Docket Matter No. 34**
**Concept release on possible revisions to PCAOB standards related to reports on audited financial statements**

Dear Mr. Seymour:

Ernst & Young LLP (Ernst & Young) is pleased to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) concept release on possible revisions to the auditor's reporting model (the Concept Release). We believe that some change is clearly necessary and fully support responsible change in this area. This letter provides our views on the Concept Release and outlines a possible approach to revising the auditor's reporting model that would provide useful information to investors and other financial statement users. In the Appendix to this letter, we respond to the questions posed in the Concept Release.

1. **A General observation — a measured approach to changes to the auditor's reporting model would be more productive at this stage**

   Some financial statement users have expressed dissatisfaction with the current reporting by auditors and have suggested a variety of changes to the model, some of which would represent fundamental changes to the auditor's role. Some financial statement users also have expressed dissatisfaction with corporate financial reporting, saying annual reports are becoming too complex and, in some cases, appear to be more focused on compliance than on effectively communicating key information and performance trends.

   While we recognize that there are clear calls for improvements to auditor reporting, we believe the auditor's report is just one element in the suite of information provided to users of the financial statements. We believe it is important to consider changes to the auditor reporting model in the context of other initiatives aimed at enhancing overall corporate financial reporting. Attempts to address concerns with corporate financial reporting solely through changes in the auditor's reporting model will not be successful and could result in significant change to or expansion of the auditor's role, which we do not believe is appropriate or cost-effective.

   We note that both the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) have ongoing projects, or have expressed an intention to undertake projects, to address perceived weaknesses in financial reporting. Therefore, we suggest the Board take a measured approach to changing the auditor's reporting model at this time. We recommend that the PCAOB and its staff collaborate with the SEC and the FASB to consider how changes in reporting by both issuers and auditors can better address the needs of users of the financial statements over the longer term.

However, we don't believe a collaborative longer-term effort on this front should prevent some needed improvements to the auditor's reporting model in the near-term. In the following sections, we propose an approach, which uses certain of the ideas outlined in the Concept Release, that could be developed and applied in a practical, cost-effective manner and would represent a constructive change to the information auditors currently provide to investors and other financial statement users.

In addition, we encourage the Board to consider the efforts of other standard setters, such as the International Auditing and Assurance Standards Board (IAASB) and the AICPA's Auditing Standards Board (ASB), which are also exploring changes to the auditor reporting model. We believe that users would be better served if the nature of information communicated by the auditor is generally consistent, regardless of the jurisdiction. Although we recognize that certain differences in auditor reporting standards will continue to exist, unnecessary differences in IAASB, ASB and PCAOB requirements will cause confusion and could lead to inappropriate inferences about a company's financial statements, audit quality and the nature of assurance provided.

2. **The overarching principles described by the CAQ must be addressed when considering any changes to the auditor's reporting model**

On 9 June 2011, the Center for Audit Quality (CAQ) submitted a letter[1] outlining five overarching principles that should guide the development of any changes to the auditor's reporting model. These principles are:

1. Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard. A substantive shift in responsibility from the auditor attesting to information prepared by management to the auditor providing original information about the company being audited could result in unintended consequences that are not in the best interest of investors and other financial statement users.

2. Any changes to the reporting model need to enhance, or at least maintain, audit quality.

3. Any changes to the reporting model should narrow, or at least not expand, the expectations gap.

4. Any changes to the reporting model should add value and not create investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee and independent auditors.

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[1] For the full text of the Center for Audit Quality's letter to the PCAOB dated 9 June 2011, go to http://pcaobus.org/Rules/Rulemaking/Docket034/001_CAQ.pdf

5. Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by an auditor can be highly subjective; however, it is important that auditor commentary, communicated in a widely distributed report, provide objective information about such matters. Requests for an auditor's subjective views or impressions on financial reporting matters cannot be effectively communicated and understood without the existence of an appropriate two-way discussion protocol. Without such dialogue, the communication of subjective views and impressions could lead to a misunderstanding and harmful consequences.

We firmly agree with these principles and believe the Board should evaluate any proposed changes to the auditor reporting model against each of them. Our approach adheres to these principles.

3. **We continue to support the current pass/fail opinion**

Users have consistently noted that a concise conclusion as to whether the financial statements, taken as a whole, are presented fairly in accordance with the applicable financial reporting framework is meaningful information. Therefore, we support maintaining the pass/fail framework in the current auditor's report.

4. **Changes to the current pass/fail opinion are needed to help investors and other financial statement users — summary of a proposed approach to revising the auditor reporting model**

Based on the principles noted above and views expressed by a number of participants in the Board's outreach, we believe the following approach, which incorporates certain of the ideas reflected in the Concept Release, would be a meaningful and practical change to the existing auditor reporting model:

- Adding certain clarifying language to the auditor's report
- Requiring the expanded use of emphasis paragraphs in the auditor's report

We believe this approach, while not addressing all of the calls for change, would be responsive to many of the suggestions and provide a meaningful enhancement to the information provided to investors and other financial statement users. Additional thoughts on this approach follow:

<u>**Adding certain clarifying language to the auditor's report**</u>

Many investors and other users of financial statements have suggested that adding certain clarifying language to the standard auditor's report could enhance users' understanding of an audit. We agree and strongly support adding new text or clarifying the existing language in the following areas of the standard auditor's report:

- *Reasonable assurance* — The report should clarify that reasonable assurance represents a high level of assurance, but reasonable assurance is not absolute assurance and an audit conducted in accordance with PCAOB standards may not always detect a material misstatement.

- *Auditor's responsibility for fraud* — The report should clarify, as set forth in PCAOB Interim Standard AU 316, that the auditor's responsibility is to plan and perform the audit to provide reasonable assurance about whether the financial statements are free of material misstatement, *whether caused by error or fraud*.

- *Auditor's responsibility for financial statement disclosures* — The report should explicitly state that the footnotes are an integral part of the financial statements, are subject to audit procedures and are covered by the auditor's report.

- *Management's responsibility for the preparation of the financial statements* — The report should provide an expanded discussion covering management's responsibilities for the financial statements and other information provided to users of the financial statements.

- *Auditor's responsibility for information outside of the financial statements* — The report should describe the auditor's responsibility to read certain other information in documents containing the audited financial statements for inconsistencies with the audited financial statements and to identify whether there are material misstatements of fact pursuant to PCAOB Interim Standard AU 550. We also believe it would be appropriate for an auditor to state in the audit report his or her conclusion on the results of these procedures (i.e., whether any inconsistencies or material misstatements of fact exist in the information containing audited financial statements).

- *Auditor independence* — The report should explicitly state that the auditor is independent under all relevant standards of the SEC and PCAOB.

We also believe the PCAOB should consider adding the following clarifications:

- *Material misstatements and assessment of materiality* — The report should identify what is meant by "material misstatement" and provide more qualitative information about the auditor's consideration of materiality when planning the audit and evaluating the financial statements. We do not believe that it would be appropriate to include specific quantitative measures of materiality in the auditor's report.

- *Audit committee responsibilities* — The auditor's report should provide an expanded discussion of the audit committee's responsibilities.

- *Addressing the audit report* — The report should be addressed to the shareholders of the company as well as the Board of Directors.

- *Professional judgment* — The report should highlight the need to use professional judgment in assessing audit risk, selecting audit procedures and considering the issuer's internal control over financial reporting.

- *Additional information about public company audits* – The report should include a reference and link to more information about public company auditing (e.g., the CAQ's *In-Depth Guide to Public Company Auditing: the Financial Statement Audit*[2]), similar to the approach used in the United Kingdom.

- *Scope limitations and non-compliance with US Generally Accepted Accounting Principles (GAAP)* – The report should outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not presented in accordance with GAAP or the audit scope is limited.

- *Firm network structure and responsibilities* – The report should describe the accounting firm network structure, the responsibility of the member firm signing the audit report and, where applicable, the participation of other member firms in the audits.

We believe these clarifications would provide users with meaningful perspective on the auditor's responsibilities. We also believe the clarifications represent a cost-effective step that could be performed under the current PCAOB standard-setting process and be adopted by auditors in a timely manner.

**Requiring the expanded use of emphasis paragraphs in the audit report**

Outreach conducted by the PCAOB indicated that many users want additional information from the auditor about significant matters affecting the financial statements. Users noted that, because the number and variety of disclosures continue to grow, it is often difficult to identify the matters that have the most significant effects on a company's financial results and that auditors could help users better focus their analyses. In addition, users have requested additional insights into the auditor's communications with the audit committee on significant matters affecting the financial statements.

We believe the required and expanded use of emphasis paragraphs could help address certain of these requests. As outlined in the Concept Release, the approach could be used to highlight matters that, in the auditor's judgment, are the most significant matters in the financial statements and to point users to where those matters appear in the financial statements and related disclosures. This approach would draw attention to important items that may warrant a detailed review by financial statement users. We also believe identifying these matters in the auditor's report may increase preparer focus on these areas, thereby improving the quality of disclosures provided to investors.

The objective of this approach would be for the auditor to answer the following basic question: "What, in your view, are the most important matters affecting the financial statements this year?" Developing the criteria for the auditor to use to consistently determine the types of matters to include in the report will be challenging, but we believe it can be accomplished. Selecting the most

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[2] See Center for Audit Quality's *In-Depth Guide to Public Company Auditing* (2010). Available at: http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf

important matters will require the use of judgment. We believe the auditor should start by evaluating the material areas that involve an accounting policy or practice that has a significant effect on the issuer's financial reporting, a highly subjective accounting estimate, a material uncertainty, a significant unusual or infrequent event or transaction, or information about the structure of an entity that is significant to understanding the assertions made in the financial statements. The auditor should then evaluate whether these matters were the subject of significant discussion with the audit committee, required significant audit effort, underwent significant change or were unique to the company or the industry during the period. We believe these matters are the types of topics that users would like to see identified in the audit report.

Care would need to be taken to encourage auditors to highlight only the most important matters. Including too many areas would risk minimizing the intended emphasis. In addition, the report would need to clarify that while the audit included the performance of specific procedures designed to address the risks of material misstatement associated with these areas (1) no separate form of assurance has been given for any specific item emphasized and (2) the matters included in the report do not represent a complete list of all areas addressed in the audit. Finally, it should be clear that matters emphasized in the report are based on the auditor's professional judgment and may change from year to year based on a company's particular facts and circumstances.

Consistent with the CAQ's overarching principles noted above, we do not believe that the auditor should provide subjective views or impressions about financial statement matters in the audit report. We believe the emphasis paragraphs should be objective, fact-based descriptions of the items and should direct the reader to where such matters appear in the financial statements, including the related disclosures. Based on investor input provided at the PCAOB's recent roundtable on the Concept Release, we would also support the suggestion that the auditor identify why the matters emphasized were selected for specific emphasis in the audit report.

We do not believe the emphasis paragraphs should include a summary of "key audit procedures" performed in these areas. For important areas, it would be difficult to summarize the hundreds of audit hours spent into a few crisp sentences. We also do not believe that an expansive description of the audit procedures carried out in a particular area would be helpful to users. In addition, since specific procedures performed in a particular area are developed in the context of the overall audit, it may be difficult to effectively convey how such procedures relate to the auditor's evaluation of the financial statements taken as a whole.

Finally, we believe the required emphasis paragraph approach could be implemented timely.

5. **The value of standardized language**

As noted in the Concept Release and in the Board's outreach, users of financial statements have said that standardized (or boilerplate) language lacks substance. These users have said any modifications to the auditor's report that allow for additional standardized language would not be as useful as modifications requiring the communication of subjective views or impressions.

We believe there is significant value in using standardized language. For example, investors and other users have said they appreciate the clarity and simplicity of the current pass/fail opinion, which provides a succinct, objective conclusion about whether the financial statements are presented fairly in accordance with GAAP. We believe that modifications to the report should be clear, concise and objective. In addition, the use of consistent and objective language facilitates user comparisons across companies and minimizes the risk of user misunderstanding.

6. **Our views on other alternatives outlined in the concept release**

**Reporting on other information outside the audited financial statements—this may be a viable approach, but the cost-benefit analysis is important**

Users have noted that they use sources of financial information beyond a company's financial statements, such as management's discussion and analysis (MD&A), earnings releases and investor presentations to evaluate a company and that auditor reporting on this information could improve the quality, completeness and reliability of the information. This reporting would provide users with a higher level of confidence in the information. As noted above, professional standards require auditors to read information in documents containing the audited financial statements for any inconsistencies with the audited financial statements or any material misstatements of fact. We believe the audit report clarifications above would help users better understand the auditor's involvement with information in documents that contain the audited financial statements and the auditor's conclusion related to the procedures performed in this area.

We note that auditors often perform certain procedures on information such as earnings releases before public distribution to assess whether the information is consistent with the audit in process. We recognize that some investors may not be aware that these procedures are performed. Having auditors issue the equivalent of agreed-upon procedures reports for general use, describing the procedures performed on this information, could potentially provide investors with added visibility in this area.

Auditor reporting on information outside the financial statements would increase the scope of the auditor's responsibilities, would require the development of new auditing standards and would potentially require additional regulatory efforts. For example, if auditor attestation were deemed appropriate for earnings releases, preparer guidance would also need to be developed. We believe certain of these alternatives would require careful study.

As with all alternatives, the costs will need to be weighed against the benefits. As contemplated in the Concept Release, auditor attestation on a company's entire MD&A disclosure is an alternative. Such an attestation would be a significant undertaking and we do not believe financial statement users have requested this level of auditor involvement.

Given users' requests for more explicit auditor involvement in the most critical, subjective matters affecting a company's financial statements, we believe that separate auditor attestation on an issuer's critical accounting policies/estimates disclosure in MD&A may be a more modest step in this broad area. It would direct auditor effort to those areas that appear to be of the highest interest to investors, and could be a more cost-effective alternative. We also believe additional auditor involvement would likely lead to preparer focus and improved disclosures. While we believe requiring the expanded use of emphasis paragraphs may be a preferable alternative, consistent with the CAQ's June letter to the Board, we believe that auditor involvement with a company's critical accounting policies/estimates disclosure in MD&A is also a viable approach that merits further consideration by the Board.

**Auditor's Discussion and Analysis—we do not support this concept**

We do not support an Auditor's Discussion and Analysis (AD&A) approach as an alternative to address user requests for auditor's views on the company's financial statements and on the audit.

We strongly believe an AD&A would have adverse consequences for a variety of reasons, including the following:

**Auditor commentary on a company's financial statements**

A requirement for the auditor to provide subjective comments on a company's financial statements would be inconsistent with several of the overarching principles. For example, we do not believe auditor views on issues as subjective as the "quality" of the company's accounting policies and practices, difficult or contentious matters or "close calls" can be effectively communicated in a widely distributed report where no two-way dialogue will exist. In addition, inconsistencies in the areas emphasized in an AD&A between companies in the same industry may be difficult for users to reconcile and potentially result in inappropriate judgments related to the company or the audit. Moreover, the subjective nature of such matters could result in the presentation of information by the auditor that is not consistent with the information presented by management (as overseen by the audit committee). Providing information that may "compete" with information reported by management would likely be difficult for users to reconcile, particularly without the existence of a two-way discussion protocol.

Moreover, we do not believe the auditor should be the original source of information about the entity. The longstanding role of the auditor is to attest to information prepared and presented by management in accordance with an established framework. If the Board were to require an auditor to provide subjective impressions, it might inappropriately expand the role of the auditor into financial reporting, rather than opining on the company's financial statements. While the Concept Release notes that an AD&A may encourage management to improve a company's financial statements to prevent disclosure of conflicting information, such pressure could give the auditor undue influence on the presentation of matters in the financial statements. If management defers to the views of the auditor, this could effectively place the auditor in the role of the preparer, which would be contrary to the auditor's responsibility to provide an independent, objective evaluation of the financial statements.

Such an outcome could also adversely affect the auditor's relationship with management and the audit committee, which could have a negative effect on the audit. For example, it may discourage the company and its audit committee from engaging in robust discussions with the auditor of matters related to the financial statements for fear of that discussion being reported by the auditor. As the Board recognized in its proposed standard on the auditor's communications with the audit committee, open communication with both management and the audit committee is integral to the execution of a quality audit.

We are also concerned that an AD&A requirement could place significant additional pressure on the audit process and the company's ability to meet its regulatory filing deadlines. Due to the nature of issues that might be included in an AD&A, it would need to be developed during the completion phase of the audit. The effort to develop the AD&A could potentially divert attention away from the audit at a crucial time. In addition, audit firms would need to develop robust quality control processes to review the subjective views and impressions contained in an AD&A before the report is released. These processes would take time, which could place further strain on the challenging reporting timetable facing issuers and auditors.

**Auditor commentary on the audit**

The Concept Release considers whether an AD&A could present information about the audit, such as audit risk assessments, audit procedures performed and the results of those procedures, and auditor independence. Some users have suggested that additional information about the audit would enhance their understanding of what an audit represents and perhaps better equip them to evaluate the quality of the audit. We believe that subjective areas such as audit risk assessments and the related audit responses would be difficult to communicate in a widely distributed report.

Some users have also suggested that providing additional information about the audit would help them evaluate audit issues and efforts across companies in a particular industry. An audit is tailored to an assessment of the risks of material misstatement at the specific company under audit, takes into account the company's internal control structure, and is influenced by the audit team's perspectives and experience. As such, there may be disparity in information presented in an AD&A about the risks identified and audit procedures employed between audits of similar companies, even for two companies in the same industry. Investors would need to reconcile why different procedures were performed, even if the risks of material misstatement highlighted were similar. These differences may cause investors to inappropriately question the quality of the audits.

As previously discussed, we believe it would be very difficult for an auditor to concisely describe the procedures performed to inform its conclusion on an individual area or matter in the context of its evaluation of the financial statements taken as a whole. While this type of information is typically discussed with the audit committee, the opportunity for a two-way dialogue is critical to this communication. This dialogue would not exist with a widely distributed public report. In addition, while an auditor designs and performs procedures to identify material misstatements of significant accounts and assertions, the auditor's report provides an opinion on the financial statements taken as a whole. We fear that having auditors provide significant details on audit risks and related procedures in specific areas could result in users misinterpreting this communication as an opinion, or separate form of assurance, on the particular audit area being discussed.

While we understand that investors want more information about the audit and the company's financial statements, we do not believe an AD&A is an effective means of providing such information. As noted in the Concept Release, it would likely be the most expansive form of reporting and would likely be the most costly alternative. We doubt the benefits would exceed the cost and believe other alternatives could provide meaningful improvements to auditor reporting in a more cost effective manner.

* * * * *

We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Sincerely,

Ernst + Young LLP

**Responses to questions raised in the Concept Release**

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of the financial statements.**

   a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

   *We fully support the Board undertaking a standard-setting initiative to consider responsible change to the auditor's reporting model to continue to provide investors and other users of a company's financial statements with relevant reports. As more fully described in our response, we believe certain changes to the auditor's report can provide benefits to users of the financial statements by providing additional clarification about the audit and audit process, as well as additional input on significant matters affecting a company's financial statements.*

   b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

   *Overall, we support enhancing auditor reporting by including information that is objective and adds value. We believe that the five principles expressed in the letter from the Center for Audit Quality (CAQ) to the PCAOB should guide the development of any alternatives. Specifically, as more fully detailed in our response to Question 21, we support modifying the standard financial statement audit report to better articulate the role of the auditor, highlight the professional judgment auditors exercise in making audit-risk assessments and selecting audit procedures and, where applicable, describe the accounting firm network structure and the participation of other member firms in audits. This type of information also could be included in reports on audits of internal control over financial reporting.*

   *We also support using an expanded emphasis paragraph approach in which an auditor would identify specific topics or events, unusual transactions or other matters viewed to be most significant to the financial statements. Such an approach would provide additional transparency related to important areas of the financial statements and the audit that may help users analyze a company. Consistent with the June 2011 CAQ letter, we also believe that auditor reporting on management's critical accounting estimates disclosure in MD&A is a viable approach that deserves further consideration by the Board.*

   c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

   *Many parties play a role in reporting to investors — management, the audit committee and auditors, as well as regulators and standard setters who establish the framework for each party's reporting responsibilities. In addition to suggestions for improvements to auditor reporting, some financial statement users have expressed dissatisfaction with the corporate financial reporting model. We believe that any changes to auditor reporting should be made in the context of other initiatives aimed at enhancing overall corporate financial reporting. Attempts to address investor dissatisfaction with corporate financial reporting solely through changes in the auditor's reporting model would significantly expand the auditor's role, which we do not think is* *appropriate or cost-effective. Therefore, we suggest the Board take a measured approach to changing the auditor's reporting model at this time. We also believe the Board should work with the SEC and the FASB to consider how changes in reporting by both issuers and auditors can better address the needs of users of the financial statements over the longer term.*

*However, we believe that meaningful enhancements to the auditor reporting model can and should be achieved in the near term without expanding the role of the auditor. Such changes could provide users with additional perspective on the role of the auditor, highlight the professional judgment auditors exercise in making audit-risk assessments and selecting audit procedures, describe, where applicable, the accounting firm network structure and the participation of other member firms in audits and indicate the most significant matters affecting a company's financial statements.*

*Auditor attestation over other matters outside of the financial statements, such as a company's MD&A, would expand the role of the auditor and therefore we believe that careful consideration needs to be given to the costs and benefits, including consideration of the additional regulatory/standard-setting activity needed to implement such expansion. Given user requests for additional auditor involvement with significant matters affecting a company's financial statements, separate attestation over a company's critical accounting policy/estimate disclosure within MD&A may be a cost-effective alternative that should be considered by the Board.*

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

   a. Should the auditor's report retain the pass/fail model? If so, why?

      *We support maintaining the current pass/fail model. This model provides a concise conclusion as to whether the financial statements, taken as a whole, are presented fairly in accordance with the applicable financial reporting framework. Users have consistently noted that they find this overall conclusion useful.*

   b. If not, why not, and what changes are needed?

      *Not applicable*

   c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

      *As more fully described in our responses to Questions 21 and 22, we believe it would be beneficial to clarify a number of areas in the standard auditor's report, such as the role of the auditor, the auditor's responsibility for footnote disclosures, management and audit committee responsibilities for financial reporting, the concepts of reasonable assurance and material misstatement, the auditor's responsibility for fraud, and the professional judgment auditors exercise in making audit-risk assessments and selecting audit procedures, among others.*

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

   *Management has overall responsibility for the preparation of the financial statements. Consistent with the overarching principles previously noted, we strongly believe that auditors should not be the original source of disclosure about the entity; management is in the best position to provide information about the company and their responsibility should be preserved in this regard. The longstanding role of the auditor is to attest to information prepared and presented by management in accordance with an established framework. As more fully discussed in our responses to Questions 5 and 12, we believe that auditors providing additional information about the company's financial statements would fundamentally change the role of the auditor and could have adverse effects on audit quality, the auditor's relationship with management and the audit committee and the clarity of information provided to investors.*

   *We also note that the Board's outreach indicated that additional reporting by a company's audit committee related to significant matters addressed with the company and the auditor may provide users with meaningful information. Users indicated that auditor attestation of such enhanced audit committee reports may be useful in providing additional comfort that such reports accurately represent the interaction and conclusions of the matters discussed. Consistent with our previous comments, we are supportive of the PCAOB working with the SEC and other relevant organizations to evaluate whether modifications to audit committee reports, including potential auditor association with such reports, would be a cost-effective enhancement to the information provided to users.*

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

   *To the extent auditors are required to report additional information about a company's financial statements and such information is inconsistent in some respects with information provided by management, we believe investors may make inferences about a company's internal control over financial reporting (ICFR) that may not be appropriate. For example, to the extent AD&A emphasizes different areas across companies in the same industry, users may make inappropriate inferences about a company's controls compared to another. In addition, to the extent an auditor provides information that is somewhat different from information provided by management, an investor may inappropriately infer that those inconsistencies represent internal control deficiencies, rather than resulting from reasonable differences in judgment between the auditor and management that do not result from a deficiency in the company's ICFR. Given these potential outcomes, the Board will need to evaluate any proposed changes to the auditor reporting model to determine if clarifications are also needed to the auditor's report on ICFR.*

<u>Questions related to the auditor's discussion and analysis</u>

5. **Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

   a. If you support an AD&A as an alternative, provide an explanation as to why.

      *As more fully explained in our response to Question 5(d), we do not support an AD&A as a responsible change to the auditor reporting model.*

   b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

      *As more fully explained in our response to Question 5(d), we do not support an AD&A as a responsible change to the auditor reporting model.*

   c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

      *As more fully explained in our response to Question 5(d), we do not support an AD&A as a responsible change to the auditor reporting model.*

   d. If you do not support an AD&A as an alternative, explain why.

      *We do not support an AD&A as an alternative and strongly believe an AD&A would have adverse consequences to users of the financial statements and audit quality. While we acknowledge that investors want more information about a company's financial statements and the audit process, we do not believe an AD&A is an effective means of providing that information for a variety of reasons, including the following:*

      <u>Auditor commentary on a company's financial statements</u>

      *A requirement for the auditor to provide subjective comments on a company's financial statements would be inconsistent with several of the overarching principles. For example, we do not believe auditor views on issues as subjective as the "quality" of the company's accounting policies and practices, difficult or contentious matters or "close calls" can be effectively communicated in a widely distributed report where no two-way dialogue will exist. In addition, inconsistencies in the areas emphasized in an AD&A between companies in the same industry may be difficult for users to reconcile and potentially result in inappropriate judgments related to the company or the audit. Moreover, the subjective nature of such matters could result in the presentation of information by the auditor that is not consistent with the information presented by management (as overseen by the audit committee). Providing information that may "compete" with information reported by management would likely be difficult for users to reconcile, particularly without the existence of a two-way discussion protocol.*

      *Moreover, we do not believe the auditor should be the original source of information about the entity. The longstanding role of the auditor is to attest to information prepared and presented by management in accordance with an established framework. If the Board were to require an auditor to provide subjective impressions, it might inappropriately expand the role of the* *auditor into financial reporting, rather than opining on the company's financial statements. While the Concept Release notes that an AD&A may encourage management to improve a company's financial statements to prevent disclosure of conflicting information, such pressure could give the auditor undue influence on the presentation of matters in the financial statements. If management defers to the views of the auditor, this could effectively place the auditor into the role of the preparer, which would be contrary to the auditor's responsibility to provide an independent, objective evaluation of the financial statements.*

*Such an outcome could also adversely affect the auditor's relationship with management and the audit committee, which could have a negative effect on the audit. For example, it may discourage the company and its audit committee from engaging in robust discussions with the auditor of matters related to the financial statements for fear of that discussion being reported by the auditor. As the Board recognized in its proposed standard on the auditor's communications with the audit committee, open communication with both management and the audit committee is integral to the execution of a quality audit.*

*We are also concerned that an AD&A requirement could place significant additional pressure on the audit process and the company's ability to meet its regulatory filing deadlines. Due to the nature of issues that might be included in an AD&A, it would need to be developed during the completion phase of the audit. The effort to develop the AD&A could potentially divert attention away from the audit at a crucial time. In addition, audit firms would need to develop robust quality control processes to review the subjective views and impressions contained in an AD&A before the report is released. These processes would take time, which could place further strain on the challenging reporting timetable facing issuers and auditors.*

Auditor commentary on the audit

*The Concept Release considers whether an AD&A could present information about the audit, such as audit risk assessments, audit procedures performed and the results of those procedures, and auditor independence. Some users have suggested that additional information about the audit would enhance their understanding of what an audit represents and perhaps better equip them to evaluate the quality of the audit. We believe that subjective areas such as audit risk assessments and the related audit responses would be difficult to communicate in a widely distributed report.*

*Some users have also suggested that providing additional information about the audit would help them evaluate audit issues and efforts across companies in a particular industry. An audit is tailored to an assessment of the risks of material misstatement at the specific company under audit, takes into account the company's internal control structure, and is influenced by the audit team's perspectives and experience. As such, there may be disparity in information presented in an AD&A about the risks identified and audit procedures employed between audits of similar companies, even for two companies in the same industry. Investors would need to reconcile why different procedures were performed, even if the risks of material misstatement highlighted were similar. These differences may cause investors to inappropriately question the quality of the audits.*

*We believe it would be very difficult for an auditor to concisely describe the procedures performed to inform its conclusion on an individual area or matter in the context of its evaluation of the financial statements taken as a whole. While this type of information is typically discussed with the audit committee, the opportunity for a two-way dialogue is critical* *to this communication. This dialogue would not exist with a widely distributed public report. In addition, while an auditor designs and performs procedures to identify material misstatements of significant accounts and assertions, the auditor's report provides an opinion on the financial statements taken as a whole. We fear that having auditors provide significant details on audit risks and related procedures in specific areas could result in users misinterpreting this communication as an opinion, or separate form of assurance, on the particular audit area being discussed.*

*While we understand that investors want more information about the audit and the company's financial statements, we do not believe an AD&A is an effective means of providing such information. As noted in the Concept Release, it would likely be the most expansive form of reporting and would likely be the most costly alternative. We doubt the benefits would exceed the cost and believe other alternatives could provide meaningful improvements to auditor reporting in a more cost effective manner.*

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?

*We believe that any modifications to the auditor's report should focus on the objective rather than the subjective and should maintain the auditor's role of attesting to assertions made by management. An auditor's views or impressions on financial reporting matters cannot be effectively communicated and understood without a two-way dialogue. Without such a dialogue, the communication of subjective views could lead to investor misunderstanding and harmful consequences.*

*However, we believe that adding certain clarifying language in the auditor's report and requiring the expanded use of emphasis paragraphs in the auditor's report would represent a constructive change to the auditor's reporting model. For more details of our rationale for both of these alternatives, see our responses to Questions 13, 21 and 22.*

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

   *See our response to Question 5(d).*

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

   *See our response to Question 5(d).*

8. **Should a standard format be required for an AD&A? Why or why not?**

   *We do not support an AD&A as a responsible change to the auditor reporting model. We do not believe that requiring the auditor to provide his or her subjective views on information about the company's financial statements or the audit is appropriate. In addition, we do not believe the disadvantages of the AD&A approach can be mitigated through the use of a standardized report.*

9. **Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

   *We do not support an AD&A as a responsible change to the auditor reporting model. We do not believe that requiring the auditor to provide his or her subjective views on information about the company's financial statements or the audit is appropriate.*

10. **How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

    *We do not support an AD&A as a responsible change to the auditor reporting model. We do not believe that requiring the auditor to provide his or her subjective views on information about the company's financial statements or the audit is appropriate. In addition, we do not believe the disadvantages of the AD&A approach can be mitigated through the use of a standardized report.*

11. **What are the potential benefits and shortcomings of implementing an AD&A?**

    *See our response to Question 5(d).*

12. **What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

    *As discussed in our response to Question 5(d), we believe the potential to present information that may not be consistent (and could compete) with information provided by management would prove to be a strong incentive for management to conform its disclosures to the auditor's. We believe such a situation would represent a fundamental shift in the auditor's role from attesting to information provided by management to that of a preparer.*

    *Such an outcome could also adversely affect the auditor's relationship with management and the audit committee, which could have a negative effect on the audit. For example, it may discourage the company and its audit committee from engaging in robust discussions with the auditor of matters related to the financial statements for fear of that discussion being reported by the auditor. Open communication with both management and the audit committee is integral to the execution of a quality audit.*

<u>Questions related to required and expanded use of emphasis paragraphs</u>

13. **Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

    *Outreach conducted by the PCAOB indicated that many financial statement users want additional information from the auditor about significant matters affecting the financial statements. Users noted that, because the number and variety of disclosures continue to grow, it is often difficult to identify the matters that have the most significant effects on a company's financial results. Some users have suggested that further input from the auditor could help better focus their analyses. In addition, users have requested additional insights into the auditor's communications with the audit committee on significant matters affecting the financial statements. We believe the emphasis* *paragraph approach, based on suitable, well-defined criteria that are understood by the users of the financial statements, would be responsive to user requests and would help users analyze a company's financial statements.*

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

*See our response to Question 13. We believe the required and expanded use of emphasis paragraphs could help address certain user requests by highlighting matters that, in the auditor's judgment, are the most significant matters in the financial statements and by pointing users to where those matters appear in the financial statements and related disclosures. This approach would draw attention to important items that may warrant a detailed review by financial statement users. We also believe identifying these matters in the auditor's report may increase preparer focus on these areas, thereby improving the quality of disclosures provided to investors.*

*However, we do not believe the auditor should comment on key audit procedures performed in these areas. As expressed in the CAQ letter, the Auditor's Reporting Model Working Group challenged itself to develop examples of how such an approach could be implemented in practice and determined that emphasis paragraphs should not include audit procedures for the following reasons:*

- *Audit procedures, particularly those performed for the most significant areas in a company's financial statements, rarely consist of a few, easily described procedures. We believe that it is unreasonable to expect the auditor to summarize the audit approach in a few sentences in the audit report.*
- *The audit procedures for a particular area are developed in the context of the audit of the financial statements taken as a whole. It may be difficult to appropriately convey to users how the audit strategy for a particular area relates to the audit as a whole. Without such context, users may not find a summary of the audit procedures useful.*
- *Users may perceive the additional discussion as representing a separate form of assurance on the individual areas included in the report.*
- *Users may also make inappropriate inferences to audit quality. For example, an auditor rarely has a single approach to addressing audit risk in an area, and the methods employed by the auditor depend on the company's internal controls and the auditor's assessed level of risk for the particular area relative to the financial statements taken as a whole. Without such context, users may inappropriately make assessments of audit quality based solely on differences in the audit procedures performed described.*
- *More thorough descriptions of audit processes could contribute to disclosure overload and detract from the purpose of providing useful information to investors.*

b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

*We support required and expanded use of emphasis paragraphs. See response to Question 13.*

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

*Consistent with the overarching principles discussed previously, we believe emphasis paragraphs should be objective and factual and direct the user to the related disclosures within the financial statements. We believe the emphasis paragraphs should include the following:*

- *A brief factual and objective description of the item that should not include information that is not otherwise reflected in the company's disclosures.*
- *The identification of where the item has been accounted for and disclosed in the financial statements.*
- *The reason why the auditor identified the matters for emphasis.*
- *Clarification that no separate form of assurance has been given for any specific item emphasized and that the items identified do not represent a complete list of all significant areas addressed in the audit. The following is an example of language that could convey this clarification: "We highlight the above matters because they represent, in our judgment, important financial statement matters. While we have brought these specific matters to your attention, we note that such items do not represent a complete list of the matters that should be considered when evaluating the company's financial statements. Our audits included performing procedures designed to address the risks of material misstatements associated with the above matters. However, such procedures were designed in the context of our audits of the financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures."*

*As discussed in our response to Question 14(a), we do not believe that emphasis paragraphs should include discussions of the audit procedures performed.*

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

*As discussed in our response to Question 15, users have requested additional information on the most significant matters affecting a company's financial statements. We believe criteria should be developed to help the auditor determine the matters that, in the auditor's judgment, are viewed to be the most significant/important to a user's understanding of the financial statements. Such criteria should not require emphasis of all matters that may be material to the financial statements, that were the subject of significant audit effort or that involved the use of judgment in determining the accounting conclusions for such areas.*

*We believe the following criteria may provide a foundation for the auditor's selection of matters to emphasize:*

- *An item initially considered for inclusion in an emphasis paragraph should be material to the financial statements in the current period and have one or more of the following characteristics:*
  - *The item involves an accounting policy or practice having a significant effect on the company's financial reporting. This may involve a policy or practice in a controversial or emerging area for which there may be a lack of authoritative guidance or consensus.*
  - *The item involves a highly subjective accounting estimate — an area requiring significant judgment and with substantial measurement challenges, including an estimate or assumption that could be susceptible to significant change in future periods*
  - *The item involves a material uncertainty (for example, an uncertainty about the ability of the entity to continue as a going concern or the existence of significant litigation)*
  - *The item is a significant unusual or infrequent event or transaction affecting the financial statements and related disclosures in the current period (for example, a significant subsequent event or a significant acquisition completed during the period)*
  - *The item involves information about the structure of the entity that is significant to understanding assertions made in the financial statements (for example, the existence of significant related party transactions or a parent/sub relationship)*
  - *The item is a matter not otherwise covered in one of the categories above, but is viewed by the auditor as a significant matter in the financial statements that may be worthy of emphasis in the audit report*
- *For items meeting one or more characteristics above, an auditor should also consider the following indicators to determine whether a particular item should be included in an emphasis paragraph:*
  - *The item was the subject of significant discussion with the audit committee.*
  - *The item underwent a significant change in the current period.*
  - *The item was the subject of significant audit effort or audit challenges/difficulties.*
  - *The item is unique to the company or its industry and has a significant bearing on a company's financial statements.*

*Care would need to be taken to encourage auditors to highlight only the most important matters. Including too many areas would risk minimizing the intended emphasis. We believe the Board should consider providing general guidelines about the number of items to be emphasized in the auditor's report. We note that similar guidance exists in accounting standards, most notably in ASC 280, Segment Reporting.*

17. **How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

*We believe that the main objective, and primary benefit, of this approach would be the identification of the items that are most significant to a user's understanding of the financial statements. This identification may help users better focus their analyses of a company. We believe objective, factual emphasis paragraphs that direct the reader of the financial statements to the related disclosure within the financial statements would help accomplish this objective. We believe these types of emphasis paragraphs would also be consistent with an overarching principle that the auditor not be the original source of information about the company.*

*We believe there is significant value in using standardized language in the auditor's report. For example, investors and other users have said they appreciate the clarity and simplicity of the current pass/fail opinion, which provides a succinct, objective conclusion about whether the financial statements are presented fairly in accordance with GAAP. We believe that modifications to the report that are clear, concise and objective provide for a more effective communication by the auditor. In addition, the use of consistent, objective language would minimize the risk of user misunderstanding and would allow for easier comparison of companies by users.*

18. **What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

*As noted in our response to Question 13, we believe that a required and expanded use of emphasis paragraphs would respond to user requests for additional input on the most significant matters affecting the financial statements. We also believe identifying these matters in the auditor's report may increase preparer focus and improve the quality of disclosures provided to investors. Such an approach could also be implemented in a timely manner.*

*Shortcomings to such an approach would be the potential for users to interpret the areas emphasized as subject to separate auditor assurance or as some form of "guarantee" as to the accuracy of the specific areas. Such inferences would be inappropriate given the auditor's responsibility to conclude on the fair presentation of the financial statements taken as a whole. Users could also interpret the areas included in the emphasis paragraphs as the only items that warrant further understanding/analysis when evaluating a company's financial statements. We believe that both of these shortcomings can be overcome by well defined and understood criteria, as well as appropriate explanatory language in the auditor's report.*

<u>Questions related to auditor assurance on other information outside the financial statements</u>

19. **Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

    a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

    *Users have noted that they use sources of financial information beyond a company's financial statements, such as MD&A, earnings releases and investor presentations to evaluate a company and that auditor reporting on this information could improve the quality, completeness and reliability of the information. This reporting would provide users with a higher level of confidence in the information. Professional standards require auditors to read* *information in documents containing the audited financial statements for any inconsistencies with the audited financial statements or any material misstatements of fact. We believe the audit report clarifications noted above would help users better understand the auditor's involvement with information in documents that contain the audited financial statements and the auditor's conclusion related to the procedures performed in this area.*

*We note that auditors often perform certain procedures on information such as earnings releases before public distribution to assess whether the information is consistent with the audit in process. We recognize that some investors may not be aware that these procedures are performed. Having auditors issue the equivalent of agreed-upon procedures report for general use, describing the procedures performed on this information, could potentially provide investors with added visibility in this area.*

*Auditor reporting on information outside the financial statements would increase the scope of the auditor's responsibilities, would require the development of new auditing standards and would potentially require additional regulatory efforts. For example, if auditor attestation were deemed appropriate for earnings releases, guidance would also need to be developed. We believe certain of these alternatives would require careful study.*

*As with all alternatives, the costs would need to be weighed against the benefits. As contemplated in the Concept Release, auditor attestation of a company's entire MD&A disclosure is an alternative. Such an attestation would be a significant undertaking and we do not believe financial statement users have requested this level of auditor involvement.*

*Given users' requests for more explicit auditor involvement in the most critical, subjective matters affecting a company's financial statements, we believe that separate auditor attestation on an issuer's critical accounting policies/estimates disclosure in MD&A may be a more modest step in this broad area. It would direct auditor effort to those areas that appear to be of the highest interest to investors, and could be a more cost-effective alternative. We also believe additional auditor involvement would likely lead to preparer focus and improved disclosures. While we believe requiring the expanded use of emphasis paragraphs may be a preferable alternative, consistent with the CAQ's June letter to the Board, we believe that auditor involvement with a company's critical accounting policies/estimates disclosure in MD&A is also a viable approach that merits further consideration by the Board.*

*As previously noted, we believe that any changes to auditor reporting should be made in the context of potential improvements to the total package of information provided to users of the financial statements. Expanded reporting by the audit committee, on which the auditors could report, may be an enhancement to the overall corporate reporting model.*

b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

   *See our response to Question 19(a).*

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

*AT Section 701 includes guidance for both review and examination engagements on a company's MD&A. We believe the Board should consider the costs and benefits of these alternatives. In general, we believe an examination approach would be more responsive to user requests in this area.*

d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

*See our response to Question 19(a).*

e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

*As mentioned above, we believe that auditor involvement could enhance the quality, completeness and the reliability of MD&A disclosures.*

f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

*We believe that the guidance in AT section 701 would be sufficient if a review or examination engagement related to a company's critical accounting estimates/policies is determined appropriate.*

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

*See our response to Question 19(a).*

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

*With respect to potential benefits, we believe that auditor reporting on a company's critical accounting policies/estimates could improve the company's disclosures in areas users have noted are important to their evaluation of a company. However, this alternative would require coordination with the SEC, which would need to undertake a rule-making process to require issuers to obtain auditor attestation on the information.*

*With respect to auditor involvement with other information outside of MD&A, such as earnings releases, investor presentations and non-GAAP measures, we question whether it is feasible to develop frameworks in the short term for these communications (that would provide issuers with the required flexibility).*

<u>Questions related to clarification of the standard auditor's report</u>

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

    - Reasonable assurance
    - Auditor's responsibility for fraud
    - Auditor's responsibility for financial statement disclosures
    - Management's responsibility for the preparation of the financial statements
    - Auditor's responsibility for information outside the financial statements
    - Auditor independence

    a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

    *By clarifying and defining certain terms and phrases, auditors can provide useful information to investors about the audit process and the auditor's responsibilities in an audit. We strongly support clarifying each of these terms in the standard auditor's report as follows:*

    - *Reasonable assurance — The report should clarify that reasonable assurance represents a high level of assurance, but reasonable assurance is not absolute assurance and an audit conducted in accordance with PCAOB standards may not always detect a material misstatement.*
    - *Auditor's responsibility for fraud — The report should clarify, as set forth in PCAOB Interim Standard AU 316, that the auditor's responsibility is to plan and perform the audit to provide reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.*
    - *Auditor's responsibility for financial statement disclosures — The report should explicitly state that the footnotes are an integral part of the financial statements, are equally subject to audit procedures and are covered by the auditor's report.*
    - *Management's responsibility for the preparation of the financial statements — The report should provide an expanded discussion of management's responsibilities for the financial statements and other information provided to users of the financial statements.*
    - *Auditor's responsibility for information outside of the financial statements — The report should describe the auditor's responsibility to read certain other information in documents containing the audited financial statements for inconsistencies with the audited financial statements and to identify whether there are material misstatements of fact pursuant to PCAOB Interim Standard AU 550. We also believe it would be appropriate for an auditor to state, in the audit report, his or her conclusion on the results of these procedures performed (i.e., whether any inconsistencies or material misstatements of fact exist in the information containing audited financial statements).*

- *Auditor independence — The report should explicitly state that the auditor is independent under all relevant standards of the SEC and PCAOB.*

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

*We believe the Board's outreach confirmed that users of the financial statements would like additional information about the auditor's responsibilities and the audit process. We believe clarifications of the items noted above would provide users with meaningful information about the type of assurance provided in an audit, the inherent limitations of an audit and the responsibilities of management and the auditor's as they relate to the financial statements.*

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

*We also believe the PCAOB should consider adding the following clarifications:*

- *Material misstatements and assessment of materiality — The report should identify what is meant by "material misstatement" and provide more qualitative information about the auditor's consideration of materiality when planning the audit and evaluating the financial statements. We do not believe that it would be appropriate to include specific quantitative measures of materiality in the auditor's report.*

- *Audit committee responsibilities — The auditor's report should provide an expanded discussion of the audit committee's responsibilities.*

- *Addressing the audit report — The report should be addressed to the shareholders of the company as well as to the Board of Directors.*

- *Professional judgment — The report should highlight the need to use professional judgment in assessing audit risk, selecting audit procedures and considering the issuer's internal control over financial reporting.*

- *Additional information about public company audits — The report should include a reference and link to where more information about public company auditing (e.g., the CAQ's In-Depth Guide to Public Company Auditing: the Financial Statement Audit3), similar to the approach used in the United Kingdom.*

- *Scope limitations and non-compliance with US Generally Accepted Accounting Principles (GAAP) — The report should outline the auditor's responsibility in the event a conclusion is reached that the financial statements are not presented in accordance with GAAP or the audit scope is limited.*

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[3] See Center for Audit Quality's In-Depth Guide to Public Company Auditing (2010). Available at: http://www.thecaq.org/publications/In-Depth_GuidetoPublicCompanyAuditing.pdf

- *Firm network structure and responsibilities — The report should describe the accounting firm network structure, the responsibility of the member firm signing the audit report and, where applicable, the participation of other member firms in the audits.*

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

*Because the clarifications noted above would largely explain to users information already resident in PCAOB standards, we do not believe these alternatives would have any significant implications on the scope of the audit or the auditor's responsibilities. We also believe auditors would be able to implement this alternative in a timely manner.*

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

*We believe that the clarifications discussed above would respond to users' requests for additional information about the audit and audit process. In addition, we believe that this alternative could be implemented timely.*

*We do not believe the clarifications discussed above have any significant shortcomings, although we recognize that modifications to the auditor's reporting model that consist solely of the above clarifications would likely not satisfy users.*

Questions related to all alternatives

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

*For the reasons stated above, we believe that an approach that includes clarifications of the auditor's current responsibilities and the audit process, as well as the required and expanded use of emphasis paragraphs would provide some insights into the audit and the audit process and would be cost-effective enhancements that could be implemented in a timely fashion.*

*We also believe that additional auditor involvement with an issuer's critical accounting estimates/policies disclosure in MD&A deserves further consideration by the Board based on users' views on the importance of such disclosures to their understanding and analysis of a company's financial statements.*

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

*See our response to Question 23.*

**25. What alternatives not mentioned in this concept release should the Board consider?**

*As discussed in our letter, we believe that changes to auditor reporting should be made in the context of other initiatives aimed at enhancing overall corporate financial reporting. We believe the Board should work with the SEC, FASB and others to consider how changes in reporting by both* *issuers and auditors can better address the needs of users of the financial statements over the longer term. We believe this effort should also address whether enhanced audit committee reporting, which was noted by users in connection with the Board's outreach, might also respond to user requests for additional information on significant areas affecting the financial statements.*

*We also encourage the Board to consider the efforts of other standard setters, such as the IAASB and the ASB, which are also exploring changes to the auditor's reporting model. We believe that users would be better served if the nature of information communicated by the auditor is generally consistent, regardless of the jurisdiction. Although we recognize that certain differences in auditor reporting standards will continue to exist, unnecessary differences in IAASB, ASB and PCAOB requirements will cause confusion and could lead to inappropriate inferences about a company's financial statements, audit quality and the nature of assurance provided.*

26. **Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

*See our responses to Questions 14, 15, 16 and 21 related to considerations for criteria and reporting for alternatives related to clarifications to the auditor's report and the required and expanded use of emphasis paragraphs.*

*With respect to an AD&A, as more fully discussed in our responses to Questions 5, 6 and 12, we do not believe a reasonable and practical framework can be developed to drive consistency both within and across firms (given such disclosure would result from a free-writing exercise in which the auditor would share his or her views on a variety of topics related to the company's financial statements and the audit).*

27. **Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

*As discussed in our response to Questions 5(d) and 18, there is a risk that a user would interpret the auditor's discussion in an AD&A and the emphasis of certain matters in the audit report as constituting an opinion on the particular area being discussed. While we believe that such risk can be mitigated in an emphasis paragraph approach, we believe it would be significantly more challenging to mitigate the risk of this perception in an AD&A given the more expansive discussion and the wide disparity of disclosures.*

28. **Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

*We believe that clarifying terms in the standard auditor's report is the alternative that would best inform users of the financial statements about the audit process and the role of the auditor in financial reporting. As described in our response to Questions 21(a) — (c), this alternative would provide users with additional input on the professional standards governing the conduct and performance of the audit, as well as the role of management, the audit committee and the auditor as it relates to information provided to users of the financial statements.*

29. **What effect would the various alternatives have on audit quality? What is the basis for your view?**

    *We believe clarifying terms in the standard auditor's report, expanding and requiring the use of emphasis paragraphs and auditor involvement with information outside of the financial statements would not have a meaningful effect on audit quality, but would have a meaningful effect on a user's understanding of significant matters affecting a company's financial statements, the role of the audit and the audit process.*

    *As further detailed in our response to Question 5(d), we believe an AD&A could adversely affect audit quality.*

30. **Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and deals, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such a conclusion.**

    *With respect to whether changes to the auditor reporting model apply to all reports filed with the SEC, we believe further analysis of the how financial statements, including the audit report, are used by both users and regulators is necessary to answer this question.*

    *In addition, with respect to domestic and foreign private and listed companies, we note that other standard setting bodies, such as the AICPA's ASB and the IAASB, are undertaking initiatives to clarify the standard auditor's report issued in connection with the standards set by those bodies. As those changes take effect, there would be a variety of forms of auditor reporting. We believe users would find significantly different reports confusing. This could potentially result in inappropriate inferences as to audit quality and the level of assurance provided in an audit of companies in different jurisdictions around the world. As previously discussed, we encourage the Board to work with the AICPA's ASB, IAASB, the SEC and other securities regulators to consider the effects of varying auditor reporting on users of the financial statements. They should consider the fact that users of financial statements may have different needs depending on the nature and type of company (e.g., regulated vs. non-regulated).*

<u>Questions related to changing the auditor's report</u>

31. **This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations and confidentiality.**

    a. Are any of these considerations more important than others? If so, which ones and why?

       *We believe all of these matters should be carefully considered when evaluating potential changes to the auditor reporting model.*

       *With respect to audit effort, as discussed previously, we believe an approach that includes adding clarifying language to the auditor's report and requiring the expanded use of emphasis paragraphs is a viable approach that would respond to many of the suggestion made by users of the financial statements, could be implemented in the near term and would be cost-effective. We also believe that auditor attestation on an issuer's critical accounting policy/estimate* *disclosure in MD&A merits further study and could be cost-effective. We do not believe any benefits of an AD&A approach or auditor attestation on an issuer's complete MD&A disclosure outweigh the costs.*

*As described in our response to Question 5(d), we believe that an AD&A alternative is the most expansive alternative that would likely have the most significant effect on the audit committee's governance role and the auditor's relationships with management and the audit committee. In addition, we believe that an AD&A approach where the auditor expresses his or her views about the company's financial reporting matters could raise confidentiality concerns at a company if the auditor provides information that has not been disclosed by the company. This concern could discourage management and the audit committee from engaging in robust discussions of matters related to the financial statements for fear of additional disclosure by the auditor.*

*With respect to liability considerations, we believe that all alternatives should be analyzed to evaluate their potential effect on auditor liability. For example, areas identified in either an AD&A or emphasis paragraph approach could be misinterpreted as an opinion or separate form of assurance on the particular area being discussed. In addition, under both approaches, users may inappropriately question whether the auditor should have emphasized particular areas or the adequacy of the audit procedures with the benefit of hindsight. We believe this risk would be particularly acute in an AD&A approach, under which an auditor may be required to provide subjective views or impressions on the company's financial statements. Finally, auditor attestation on other information, such as earnings releases, would expand the auditor's role and therefore, the auditor's exposure to litigation.*

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

*We believe the alternatives to clarify terms in the standard auditor's report and expand and require the use of emphasis paragraphs would provide users of financial statements with enhanced understanding of significant matters affecting a company's financial statements as well as the role of the audit and the audit process. We also believe that such changes would respond to user requests for such information and could be implemented cost effectively.*

*For the reasons stated in our response to Question 5(d), we believe the potential costs of the AD&A approach would outweigh any benefits associated with this alternative.*

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

*As discussed in our letter, we believe that changes to auditor reporting should be made in the context of other initiatives aimed at enhancing overall corporate financial reporting. We believe the Board should work with the SEC, FASB and others to consider how changes in reporting by both issuers and auditors can better address the needs of users of the financial statements over the longer term. We believe this effort should also address whether enhanced audit committee reporting, which was noted by users in connection with the Board's outreach, might also respond to user requests for additional information on significant areas affecting the financial statements.*

d. What requirements and other measures should the PCAOB or others put into place to address the potential effects of these considerations?

   *Not applicable.*

32. **The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

    *See our response to Question 5(d).*

EXPRESS

September 30, 2011

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

Re: Request for Public Comment on Release No. 2011-003, PCAOB Rulemaking Docket Matter No. 34: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Board Members:

Express, Inc. ("Express") is a nationally recognized specialty apparel and accessory retailer offering both women's and men's merchandise. Express operates over 600 stores across the United States, in Puerto Rico, and in Canada.

Express appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (the "concept release").

While Express respects the recent views of investors regarding the need for further information about companies' financial statements and other related matters; and we appreciate the diligence performed by the PCAOB in providing this concept release; we do not believe that the concept release's suggested solutions will result in improved financial reporting, nor do we believe that they will improve auditor communications. **Conversely, we feel as though the concept release undermines the function of management and the audit committee, could deteriorate the relationship between the auditor and the company, and will only create confusion within the investment community. Furthermore, this creates an administrative burden by adding an unnecessary additional layer of procedures and reporting, which will result in significant additional costs incurred by the companies being audited.**

We agree that the auditors, through their experience, gain valuable insight into the significant business decisions contemplated and made by management, as well as the thought process behind establishing accounting policies and procedures. However, it is not appropriate for an auditor to be responsible for reporting behind the scenes information regarding business or financial reporting related decisions, as the concept release suggests. The auditor is hired by the audit committee on behalf of investors and serves the function of ensuring the integrity of the company's financial statements and ensuring the company is compliant with legal and regulatory reporting requirements. This includes transparency in financial reporting. The auditor is currently required to communicate to the audit committee any significant matters of judgment, significant estimates, and items of disagreement, among other items. Likewise, if there are items within the auditor's communication to the audit committee that are of interest to investors, and those items are not already disclosed in the financial statements or management's discussion and analysis, it is the audit committee's duty to request of management that such information be added. This process is well-designed and functions appropriately to ensure financial statements and related disclosures are complete, accurate, and transparent. Adding a layer of reporting into the auditor's report only adds a duplicative and unnecessary process, and inappropriately puts the auditor in the position of reporting information to the public that is not theirs to report. Requiring the auditors to report on significant matters suggests that audit committees are not functioning properly and undermines the audit committees' decision-making authority regarding items worthy of disclosure to the investment community.

**Auditor's Discussion and Analysis ("AD&A")**

*Audit Risk* and *Audit Procedures and Results*
The proposed requirement that the auditor disclose significant risks to the company's financial statements within an AD&A would provide only one piece of a very big puzzle. While every set of financial statements come with a certain amount of risk, there is diversity in how well companies address and respond to this risk. The AD&A, as proposed, does not address the additional context necessary to give investors comfort that the company's management has addressed the identified risks internally, which should be equally as important as how the auditor has addressed those risks. Additionally, what a knowledgeable businessperson considers a risk will vary from person to person. This leaves the process open to the subjectivity of the auditor, and opens the auditing firms up to even further scrutiny. Further scrutiny will result in the potential for inclusion of risks that aren't necessarily significant, as to avoid a "miss" in their report. We also believe additional scrutiny and additional procedures could result in increased costs.

*Management's Judgments and Estimates* and *Accounting Policies and Practices*
Critical accounting estimates and significant or judgmental accounting policies are already discussed within the financial statements and management's discussion and analysis. Further, the auditor currently reports these matters to the audit committee. Should the audit committee find that management has not provided adequate or transparent disclosure regarding an estimate or policy communicated by the auditor, the audit committee is responsible for recommending additional information be added to the financial statements or management's discussion and analysis. Mandating that the auditor also disclose such information to the public would add a duplicative layer of reporting to what is already included within the company's public filings. While we recognize the intent of the Board is to give the auditor further ability to influence financial reporting, that influence is already present and sufficient via the requirement of the auditor to ensure there are no material inconsistencies between the knowledge gained and conclusions reached during the audit and the disclosures within the financial statements and management's discussion and analysis. Therefore, the additional reporting requirement of Management's Judgments and Estimates and Accounting Policies and Practices within an AD&A will in practice provide no additional value or information to the investor.

*Difficult or Contentious Issues, Including Close Calls* and *Material Matters*
Every company employs a different style in trouble-shooting, brain-storming, and decision-making. Issues considered significant by a company may be given only a small amount of deliberation as there may be historical practice and GAAP knowledge leading to the proper accounting treatment, while items of little significance may be given a large amount of deliberation due to lack of experience on a given topic. Further, some decisions are made over the course of months. Further context would be necessary in order for the auditor to fully understand whether an issue is contentious or not. While some of this knowledge will be gained naturally through the audit process, there will still be a significant amount of additional time incurred to walk the auditor through the decision-making process. In reality, the end result is far more important than the process the company took to get there. This would require another unnecessary layer of auditor subjectivity. Investors will naturally attempt to compare contentious issues or close calls between companies within the same industry. We do not believe this will be possible or meaningful given the subjectivity involved in deciding what to include. Lastly, material items of significance to the investor should already be disclosed within the financial statements or management's discussion and analysis.

**Emphasis Paragraphs**

We believe mandating the use of emphasis paragraphs in all audit reports to highlight the most significant matters in the financial statements and key audit procedures performed would be confusing to investors as they will not have a full understanding of the audit process and reasoning behind judgments made by the auditors without the addition of lengthy explanations. Further, the mandated use of emphasis paragraphs will dilute the impact of the current emphasis of a matter model and could result in investors overlooking significant items of interest.

**Auditor Assurance on Other Information**

The concept release also includes a proposed model that auditors provide assurance on information outside of the financial statements. This includes management's discussion and analysis and non-GAAP information. We feel the current model whereby the auditor is required to ensure there is no misleading, inconsistent or inaccurate information within management's discussion and analysis and non-GAAP information is a working model that does not need to be corrected. Expanding the auditor's responsibility to include procedures on management's discussion and analysis or non-GAAP information would result in increased time and costs which we believe outweigh the benefits these procedures would provide and would diminish investor returns.

**Clarification of the Standard Auditor's Report**

While clarification of the standard auditor's report is certainly the most cost efficient model suggested within the concept release, it is not necessary. The definition of reasonable assurance, the auditor's responsibility for fraud, the auditor's responsibility for financial statement disclosures, management's responsibility for the preparation of the financial statements, the auditor's responsibility for information outside of the financial statements, and auditor independence are already concepts that are understood by the well-seasoned and well-versed investor. We believe additional language to define these terms will only serve to lengthen the auditor report and will not provide any additional value or information to the investor.

In closing, there are various challenges to be faced with each of the proposed models within the concept release. **Express believes that each proposed model undermines the responsibilities of management and the audit committee and creates an administrative burden by adding an unnecessary additional layer of procedures and reporting, which will result in significant additional costs incurred by the companies being audited. This will in turn reduce returns to investors. We do not believe that these measures are appropriate given the minimal benefit that would be derived.** The cost-benefit model should be carefully considered when evaluating each alternative. Ultimately, the concept release suggests a shift in responsibility from those directly responsible for the financial statements (management and audit committee) to a subjective third party (auditor), which does not appear to be the best solution for investors. Thank you for your consideration of our position.

Sincerely,

D. Paul Dascoli

D. Paul Dascoli
Senior Vice President, Chief Financial Officer and Treasurer

**Exxon Mobil Corporation**
5959 Las Colinas Boulevard
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972-444-1202 Telephone
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**Patrick T. Mulva**
Vice President and Controller

ExxonMobil

September 29, 2011

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

**Re: Concept Release 2011-003, Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, Rulemaking Docket Matter No. 34**

Exxon Mobil Corporation appreciates the opportunity to provide the PCAOB with our views on the Concept Release dated June 21, 2011, "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements "(the "Release"). We agree that both high quality financial reporting and high quality audits are necessary to sustain investor confidence. Efforts to make real improvements in these areas should receive all due consideration from preparers, auditors, and regulators. As such, we support the comment letter recently submitted to the PCAOB by the Financial Executives International (FEI) Committee on Corporate Reporting (CCR).

The PCAOB standard setting initiative should not change the fundamental responsibilities of management, the audit committee or auditors. Management is responsible for preparation and reporting of the financial statements. Management has more perspective, knowledge, and detailed information about the entity than the auditor or audit committee. Management's responsibilities in these areas should be preserved. In addition, audit committee oversight responsibilities should be maintained, including oversight of management's conduct in the financial reporting process and the integrity of the financial statements and other financial information. The independent auditor's responsibility should continue to be auditing the financial statements and internal controls over financial reporting and providing an opinion on the financial statements taken as a whole.

Where the PCAOB's Release aligns with and strengthens the principles noted above, we provide our support. However, to the extent alternatives within the Release blur the responsibilities described above and could promote investor and user confusion, we take strong exception. Our specific comments and observations are noted below.

## Auditor's Discussion and Analysis

ExxonMobil does not support the Auditor's Discussion and Analysis (AD&A) alternative presented in the Release. The expansion of the auditor's role in developing an AD&A is inconsistent with the expectation that the auditor should not be the original source of disclosures about an entity. We are concerned that the AD&A would give undue prominence to items of lesser significance and ultimately be confusing to investors and other users. Variability in the AD&A across entities in the same industry will cause investors to misinterpret the inclusion or exclusion of a matter in a particular entity's audit report and draw erroneous conclusions. As a result, we suspect the disclosures would become "boilerplate" as entities and auditors work to reduce the inconsistency of AD&A disclosures.

## Use of Emphasis Paragraphs

We do not support a requirement to include emphasis paragraphs in each audit report. We expect this requirement would lead to "boilerplate" disclosures, similar to the situation described above. Auditing standards currently allow auditors to include an emphasis paragraph in their opinions on the financial statements, therefore no cause for action exists.

ExxonMobil does not support disclosure of the nature or extent of audit procedures in emphasis paragraphs for any matter, including matters of critical importance. The nature and extent of audit procedures can vary widely from company to company based on the auditors' risk assessments, professional judgment, and the entities' control environments. Putting the audit procedures in the proper context would require extensive discussion whose meaning would be lost on most users.

## Auditor Assurance Outside of Financial Statements

We do not support auditor assurance on other information outside the financial statements. The auditor currently reviews the information outside the financial statements and considers whether the information is consistent with its knowledge of the entity. Disclosures outside of financial statements include forward-looking statements, discussion of operations, and analysis of the business environment based on management's perspective, none of which an auditor would be reasonably able to attest. However, we do support including a statement in the auditor's report clarifying what its role is regarding other parts of a filing.

## Clarification of the Standard Auditor's Report

ExxonMobil is supportive of the Board's alternative to include clarifying language in the existing standard auditor's report. While such information is readily and publicly available through many other sources, including additional language within filings may enhance investors' and other users' understanding of the auditor's roles and responsibilities. The clarifying language around the auditor's responsibility for information outside the financial statements should be limited to items included in the annual report on Form 10-K.

Prior to proceeding with any of the proposed changes, the PCAOB should perform a robust cost / benefit analysis that clearly articulates the benefits expected to be realized from each of the proposals as well as the related costs.

We thank the PCAOB for undertaking the effort to consider improvements to the Audit Report and for providing an opportunity for stakeholders to comment. We would be pleased to discuss our observations and suggestions in further detail as the project progresses.

Sincerely,

Patrick T. Mulva

Vice President and Controller

cc: Ms. Mary Schapiro, Chairman Securities and Exchange Commission

**Federal Deposit Insurance Corporation**
**Board of Governors of the Federal Reserve System**
**National Credit Union Administration**
**Office of the Comptroller of the Currency**

November 7, 2011

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

RE: PCAOB Rulemaking Docket Matter No. 34 – Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Dear Office of the Secretary:

The staffs of the four federal regulatory agencies (the agencies) responsible for supervising the safety and soundness of U.S. financial institutions appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the Concept Release). The information provided in the auditor's report is relevant to the agencies given our requirements regarding independent audits and assessments of the effectiveness of internal control over financial reporting for financial institutions with total assets above certain thresholds. The auditors' reports for these institutions are available to the public.

In general, the agencies support changes to the auditor's reporting model that would bridge the information and expectations gaps of investors and other users of audited financial statements as long as the changes do not alter the auditor's fundamental role of opining on the financial statements or impair the auditor's independence. We believe that communicating additional information in the auditor's report on public company financial statements as a result of audit procedures performed may aid the agencies, investors, and other users in earlier identification of potential problems at individual public financial institutions. Furthermore, improvements to the auditor's reporting model may enhance the agencies' supervision of public financial institutions through better market discipline.

We offer the following comments and suggestions for your consideration as you evaluate possible changes to the auditor's reporting model.

Pass/Fail Model

Since the fundamental role of the auditor is to opine on the fairness of the presentation of the financial statements prepared by management, we recommend retaining a pass/fail model for the auditor's report that reflects a clear and unambiguous opinion on the audited financial statements. Additional disclosures or changes to the auditor's reporting model should be based on the results of the audit procedures performed by the auditor in accordance with the applicable auditing standards and should not result in the auditor assuming or performing management functions or responsibilities.

Emphasis Paragraphs and Clarifying Language

The Concept Release discusses the benefits and possible expanded use of emphasis paragraphs, including required paragraphs for certain important matters, as well as the addition of clarifying language to better explain the auditor's responsibilities and what an audit represents. Expanded use of emphasis paragraphs and the use of clarifying language in the standard auditor's report may reduce the information and expectations gaps and could also increase the readability of the auditor's report. For example, emphasis paragraphs could address critical management representations relied upon in arriving at the audit opinion. To avoid overreliance on such emphasis paragraphs by financial statement users, care should be taken within the body of the auditor's report to refer the reader to important information contained in the body of the financial statements and in the notes thereto. We recommend that any proposed expanded use of emphasis paragraphs and clarifying language focus on providing decision-useful information. The auditor's report should not become too lengthy and obscure its primary purpose, which is to disclose the auditor's opinion on the audited financial statements.

Disclosure of Material Weaknesses in Internal Control Over Financial Reporting

When an auditor conducts an audit of financial statements only, we encourage the PCAOB to consider requiring disclosure in the auditor's report of material weaknesses in internal control over financial reporting identified by the auditor during the audit. The auditor is currently required to communicate this information in writing to the audit committee and, in an integrated audit, to disclose the material weaknesses in the auditor's report on internal control over financial reporting. However, material weaknesses identified by the auditor during an audit of financial statements only are not currently required to be disclosed in the auditor's report. A registrant that is a non-accelerated filer is required to provide a report of management on the registrant's internal control over financial reporting. However, such a registrant is not required to undergo an integrated audit that would result in its auditor's issuance of a report on the effectiveness of internal control over financial reporting. We believe that disclosure in the auditor's report of any material weaknesses noted during an audit of financial statements only would provide meaningful information to regulators, investors, and other users of audited financial statements.

Independence

A key contributor to the value of an auditor's report is the auditor's independence in both fact and appearance. Also, in carrying out his or her responsibilities in conducting an audit, an atmosphere of candid and open communication must exist between the auditor, management, and the audit committee. In this regard, we encourage the PCAOB to consider the effects of any changes in the auditor's reporting model on the auditor's independence as well as the communication flow between the auditor, management, and the audit committee.

Outreach Efforts

The agencies encourage the PCAOB to continue its outreach efforts, particularly with the American Institute of Certified Public Accountants' Auditing Standards Board and the International Auditing and Assurance Standards Board (IAASB), in order to promote international consistency in the auditor's reporting model. The IAASB's Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change,*[1] presents an opportunity to work toward international convergence.

Audit Quality

Finally, although the PCAOB's Concept Release discusses potential alternatives for changing and improving the auditor's report, it does not directly address the quality of the audit work performed that forms the basis for the information provided in the auditor's report. Changes to the auditor's reporting model, in and of themselves, will not ensure that audits are conducted in accordance with the PCAOB's auditing standards and are of high quality. If audits are not performed in this manner, any changes to the auditor's reporting model will not reduce the expectations gap. We believe that the quality and sufficiency of the audit procedures performed has a direct correlation to the degree of reliance that can be placed on the auditor's report. Thus, while we support and commend the PCAOB for its efforts to improve the value of the auditor's report, we also encourage the PCAOB to continue its work to improve audit quality, and the role of auditing standards in promoting it. We believe that the PCAOB's inspection program has helped improve audit quality.

We appreciate your consideration of our comments and we would be pleased to discuss in more detail our views on the Concept Release.

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[1] The IAASB's Consultation Paper, released May 16, 2011, is available at http://www.ifac.org/Guidance/EXD-Details.php?EDID=0163.

Sincerely,

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Steven P. Merriett
Assistant Director and
Chief Accountant – Supervision
Board of Governors of
the Federal Reserve System

Larry Fazio
Director
Office of Examination and Insurance
National Credit Union Administration

Kathy K. Murphy
Chief Accountant
Office of the Comptroller of the Currency

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September 30, 2011

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

Dear Office of the Secretary:

The Federal Housing Finance Agency (FHFA) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Concept Release on *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standard,* PCAOB Rulemaking Docket Matter No. 34 (the Concept Release).

As the regulator of the Federal Home Loan Bank System and the regulator and conservator of Fannie Mae and Freddie Mac, we consider audited financial reports by our regulated entities an important input to our safety and soundness supervision process. Therefore, we are interested in high-quality accounting and auditing standards that promote the reporting of unbiased, transparent and relevant information about the performance and condition of these entities. We support the Board's efforts to improve audit quality and provide users of the financial statements with relevant and useful information about audit results.

As stated in the Concept Release, "the auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements." However, the current format and content of the standard auditor's report, besides communicating the auditor's overall conclusion in "boilerplate" wording, provides users of financial statements with too little relevant and useful information. We believe some of the alternatives discussed in the Concept Release could significantly increase the transparency and communicative value of the auditor's report. We recommend the following alternatives for the Board's consideration:

- Require an Auditor's Discussion and Analysis (AD&A) as a supplement to the standard auditor's report;
- Amend the format and content of the current standard auditor's report to improve understandability and clarify certain audit-related concepts and
- Require auditor's assurance on other information outside of the financial statements, such as the Management's Discussion and Analysis (MD&A), earnings releases and other non-GAAP information.

**I. Require an AD&A as a supplement to the standard auditor's report:**

The current standard auditor's report that employs the "pass/fail" model is a straightforward and practical way to inform users of financial statements about the audit opinion and therefore should be retained albeit with some minor modifications that we discuss in Item II below.

The external auditor, as an independent expert who spends a significant amount of time and effort to understand a company and audit its books and records, is uniquely positioned to provide valuable insights and observations about the company and the quality of its financial reporting. As noted in the Concept Release, including the AD&A as a supplement to the auditor's report could improve the understanding of the basis for the auditor's opinion and "could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."

The Concept Release noted that some preparers, auditors and audit committee members expressed concerns that requiring an AD&A could impair the transparency and openness of discussions among the auditors, management, and the audit committee and could create more tension in the overall relationship between these parties. However, since the AD&A would be supported by evidence obtained during the audit, it would continue to be in the company's best interests to be transparent with its auditor so that the auditor's insights and observations presented in the AD&A faithfully reflect the company's basis for its financial reporting policies and practices. A company's decision to temper discussions with its auditor would not only risk causing the auditor to misunderstand the perspectives behind the company's financial reporting practices but also could lead to higher audit costs if the auditor concludes that the inherent and control risks around the audit are higher due to management's lack of candor.

To provide relevant information, improve understandability and facilitate the timely filings of company's financial reports, we propose that the Board require that:

1. The AD&A be written in plain English;
2. The AD&A's audit and financial reporting issues be limited to the following important subject matters:
    - Significant audit risks identified by the auditor;
    - Management's critical accounting policies including accounting treatments for significant unusual transactions;
    - Management's significant judgments and estimates and
    - Difficult and contentious issues, including "close calls" and "material matters" as described in the Concept Release.
3. The AD&A format be standardized similar to that of the MD&A and consist of two sections:
    a. Executive Summary: We suggest limiting this section to approximately two pages and including a bullet-point list of only the most significant audit and financial reporting issues to be described in details in the Discussion and

Analysis section. Each bullet would also provide a reference to the page number in the Discussion and Analysis section where in-depth description of the issue is presented.

b. Discussion and Analysis: For each of the audit and financial reporting issues discussed and analyzed in this section, the auditor should provide information similar to that included in the illustrated example of the Concept Release. For instance, the auditor should discuss:
   - The nature of the issue;
   - The reasons the auditor considers the issue to be most significant;
   - The permissible alternative accounting policies or possible range of accounting estimates;
   - The auditor's assessment of the company's critical accounting policies or estimates including where each of the critical policies or estimates falls within a range of possible views or results, respectively.

## II. Amend the format and content of the current standard auditor's report to improve understandability and clarify certain language

We recommend the following incremental modifications to the standard auditor's report to enhance its transparency and clarity:

a. In the first (introductory) paragraph, require the auditor to explicitly identify the information audited. This means identifying, in addition to the financial statements, the notes to the financial statements, the related schedules and other supplemental information that have been audited.
b. At the end of the second (opinion) paragraph, refer readers to the AD&A for more in-depth discussions and analyses on significant issues identified during the audit.
c. In the final (scope) paragraph, include additional language to clarify concepts such as "reasonable assurance," "the auditor's responsibility for fraud," "fair presentation in conformity with GAAP" and "the level of materiality applied by the auditor in performing the audit."
d. At the end of the auditor's report, require both the firm and the engagement partner to sign the report.

## III. Require auditor's assurance on other information outside of the financial statements, such as the MD&A, earnings releases and other non-GAAP information

Management's Discussion and Analysis, earnings releases and other non-GAAP information are currently not required to be audited. However, information included in these documents is increasingly used by management to communicate the company's views on its financial results to users of financial statements. Also according to the Concept Release, "investors use and rely on MD&A and other financial information (e.g., non-GAAP information and earnings releases) for their investing decisions, in addition to historical audited financial statements."

Therefore, we agree with the Concept Release that having the auditor provide assurance on these disclosures "could improve the quality, completeness and reliability of such information, providing investors and other users of financial statements with a high level of confidence in information about the company."

However, we also concur with the recommendation expressed by some participants at the PCAOB's roundtable on the Concept Release in September 2011 that the Board consider creating a separate long-term project to develop reporting and auditing standards for this alternative. Arguments for a separate long-term project for this alternative include:

- This alternative expands the current scope of the auditor's responsibilities and therefore would require the Board to develop auditing standards to determine (1) what disclosures documents outside of the financial statements (MD&A, non-GAAP information or earnings releases) and which portions of these documents should be audited (2) what level of assurance would be appropriate for the auditor to provide;
- The reporting framework to prepare earnings releases and other non-GAAP information would need to be developed by the Securities and Exchange Commission (SEC) to provide relevant and consistent information; and
- A requirement for an auditor's assurance would likely increase costs to prepare, and to audit, disclosures on a timely basis in compliance with all applicable financial reporting and auditing standards, respectively. Costs and efforts would be compounded since companies currently provide these disclosures on a quarterly, not yearly, basis.

Accordingly, even though we believe in the important benefits of having the auditor providing assurance on information outside of the financial statements, given the potentially lengthy rulemaking process and the substantial compliance costs, we urge the Board to focus first on improving the auditor's report by requiring the AD&A as a supplement to the modified standard auditor's report per our suggestions in Items I and II.

Thank you for the opportunity to provide our views. We hope the Board and staff find our comments and suggestions helpful. If the Board and staff have any questions or comments regarding this letter, please feel free to contact me at 202-343-1832.

Sincerely,

N. Satriano

Nicholas J. Satriano
Chief Accountant
Federal Housing Finance Agency

Federated Investors, Inc.
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Federated
WORLD-CLASS INVESTMENT MANAGER®

September 30, 2011

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

**Re: PCAOB Release No. 2011-003**
**PCAOB Rulemaking Docket Matter No. 34**
**Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements**

Dear Board Members:

Federated Investors, Inc. (Federated) is a component of the S&P 500 and is one of the largest investment managers in the United States of America with $349 billion in managed assets as of June 30, 2011. The majority of Federated's revenue is derived from advising and administering Federated's 129 registered domestic mutual funds as well as various offshore investment funds and numerous separate accounts in both domestic and international markets.

Federated appreciates the opportunity to comment on the proposed Public Company Accounting Oversight Board's (PCAOB) Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (Concept Release).

Federated acknowledges the efforts by the PCAOB to identify ways to enhance an investor's understanding of the auditor's reporting model including the level of assurance given by their report. We understand that your outreach efforts indicated that financial statement users are desirous of more information. We believe a financial statement user, if polled, will always be in favor of more information. However, the request for more information must be balanced with the cost of providing additional information, as well as the potential for redundancies and information overload. Management is responsible for communicating information about the financial condition of the company and does so primarily through financial statement disclosures including Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A). If the auditor disagrees with management, they should report the disagreement under existing standards. If there is a perceived shortfall in information regarding business risks and areas of management judgment, these issues should be addressed by standard setters through the requirement of more disclosure and vigilant review of adherence to current reporting standards.

We strongly support retaining the current pass/fail model of auditor reporting and would support clarification of certain language in the auditor's report. With regard to the other proposals in this Concept Release, we have serious concerns which are outlined in the remainder of this letter.

Auditor's Discussion and Analysis

The Concept Release proposes an outline for an Auditor's Discussion and Analysis (AD&A) that would include the auditor's discussion on items such as Audit Risk, Audit Procedures and Results, Auditor Independence, Management's Judgment and Estimates, Accounting Policies and Practices and Difficult or Contentious Issues, including "Close Calls."

We believe that there is very little benefit with tremendous downside to the proposed AD&A. By introducing the auditor's perspective on the company in an AD&A, we are concerned that it could diminish the focus on the MD&A. We believe that management should be the source of information about a company. The discussion by the auditors of such sensitive topics could be taken out of context by readers. Discussion regarding "Close Calls" would be nothing more than a distraction to readers because such matters would be immaterial. If any matters of contention were material, they would have ultimately been reflected in the financial statements and/or footnotes or a qualified audit opinion would have been rendered.

When MD&A is properly written, areas such as business risk and management estimates in the AD&A would be repetitive disclosures. The other items suggested to be included in the AD&A that may not be included in the MD&A are items that are discussed with the Audit Committee through the required communications. In order to have an unqualified audit opinion, the parties involved would have reached a consensus or resolution on these items prior to finalizing the audit report.

An AD&A would exponentially increase time expended for both management and auditors and therefore further significantly increase costs associated with the audit. The increased time for both management and auditors will also increase the pressure in an already tight reporting timeline which could possibly delay SEC filings. In addition to Federated's corporate filing, it has 129 domestic mutual funds that require annual audits. In any given month, there could be as many as 27 mutual funds with audited financial statements due. The increased time to review the AD&A for each of these filings would create a significant burden to management. The increased time spent by the auditors to draft the AD&A would result in increases estimated to be 15 percent or more of current audit fees, which would be expensive to the company or mutual fund and ultimately to the underlying shareholder.

This lengthy, complex disclosure would also make comparability between companies difficult as each company's auditors would focus their attention on different matters. Alternatively, if a standard format was prescribed, we believe that the language would become boilerplate. We believe that the current audit opinion is appropriate and that a boilerplate AD&A would provide no incremental benefit to the reader.

Report on information outside the financial statements

The Concept Release proposes auditor assurance on other information outside the financial statements.

Under AU 550, Auditors are currently required to read information outside the financial statements to identify material inconsistencies. We would support a revision to the standard auditor's report to inform investors and other readers of the extent of the auditor's responsibility for the other information included in the filing. However, Federated does not support audit assurance on this information. We question the value this would provide given the increased costs and time expended for both management and the external auditors in an already tight reporting timeline.

We appreciate your consideration of this letter and we welcome the opportunity to talk through our comments and observations with the PCAOB Staff. Please contact Sally Lion at (412) 288-8342 to discuss any questions you may have regarding the comments in this letter.

Sincerely,

/s/ Thomas R. Donahue
Thomas R. Donahue
Chief Financial Officer

/s/ Denis McAuley III
Denis McAuley III
Principal Accounting Officer

/s/ Sally Lion
Sally Lion
Manager, External Reporting

Federation of European Accountants
Fédération des Experts comptables Européens

30 September 2011

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

Email: comments@pcaobus.org

Ref.: AUD/PRJ/HBL/LAN/SHA

Dear Sir or Madam,

**Re: PCAOB Rulemaking Docket Matter No. 34: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

FEE is pleased to provide you with its comments on the PCAOB Rulemaking Docket Matter No. 34: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards.

The recent debate regarding auditor communication has highlighted the need to provide the public with more details of what an audit is and more information on audit performance. FEE believes that it is important to carefully consider the arguments put forward and to reflect on which lessons can be learned from the financial crisis, as the debate has shown that the way that auditors communicate is a political issue as well as a technical issue. Even if auditors have been criticised during the financial crisis for not being sufficiently sceptical, audit remains of essential value to society in today's changing economy as an independent check of the validity of the financial information provided to users in the markets. Undoubtedly, now is the right time to consider whether there is scope for enhancing the role of the audit and of the auditor to maximise their contribution to the world economy.

As the PCAOB will be aware, the IAASB is currently also discussing this topic of improvements to auditor reporting in their recently published Consultation Paper on "Enhancing the Value of Auditor Reporting: Exploring Options for Change". It would be preferable that a truly global solution for these improvements is found, to the benefits of investors and other users of financial statements and audit reports. Therefore, FEE encourages the PCAOB to closely cooperate with the IAASB when deciding on the improvements that will be introduced.

FEE has only responded to the questions in the PCAOB Concept Release that are relevant from a European or international perspective, and has not expressed views on issues that focus on purely national US matters. Our detailed responses to the relevant questions, set out below, can be summarised as follows:

1. Changes are welcome and should be introduced to improve the communicative value of audit reports by carefully considering the comments made by various stakeholders of the current audit report being too generic and containing boilerplate language. The aim should be to provide better information, instead of merely providing more information to the users.
2. The key principle is that it is the responsibility of management and those charged with governance of an entity to provide the information on an entity that is required by users. The audit report only accompanies the information provided by the audited entity itself.
3. More company specific information about the audit could be provided by the auditor, such as information on audit risks. It will be essential to clearly specify which audit risks should be disclosed. Should it be the key audit procedures that have been performed in response to the key business risks of the company or the risks of material misstatements identified by the auditor as part of the risk assessment which might not be related directly to the key business risks of the company?
4. The auditor could provide more assurance outside the current scope of audit. This should be based on a generally accepted framework and on market requests for such additional assurance.

**Question 1 Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**
**a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

An important role of the audit profession is to contribute to add transparency and provide comfort as to the reliability of corporate reporting. Audit and auditor communication should develop alongside corporate reporting. Auditors should also explore the opportunities to fulfill their role of providing assurance in areas such as governance, sustainability reporting, corporate governance statements, etc. which bring together financial and non-financial reporting. Since the audit is an integral part of the financial system operating in today's rapidly changing world, it is essential to consider the role of the auditor in the financial reporting system, as well as the way that auditors communicate, in a dynamic way rather than in isolation.

It should be ensured that any solutions are sought in a global context, aiming at harmonisation, and taking note of the explicit views of the users of auditor's communication. Close cooperation between the audit profession at global level and its stakeholders, including users and various regulators, is therefore needed to achieve a truly sustainable solution that will be perceived as bringing considerable added value to audit communication.

**Question 2 The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**
**a. Should the auditor's report retain the pass/fail model? If so, why?**

Retaining the clear "pass/fail" nature of the audit report has received great support in recent consultations, including in the European Commission Green Paper on Audit Policy. Any changes should therefore ensure that this clear message from the auditor to the users of the financial statements and the audit report remains as it is today.

**Question 3 Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

FEE agrees that disclosures about the entity should be provided by the company itself and not by the auditor. It is first and foremost the responsibility of the company to meet the needs of the users of financial information and they should therefore provide the relevant disclosures regarding for example critical accounting policies. The audit report only accompanies the information provided by the audited entity itself.

<u>**Auditors Discussion and Analysis - Questions 5-12**</u>

FEE believes that the auditors could be responsive to the request from users of financial statements and could therefore provide more company specific information about the audit.

Given the rapid developments in technology, providing additional information has become easier, although it may still entail additional costs to do so. FEE fully subscribes to the aim of improving the quality of the information provided to users of financial statements. Increasing the quality of the information provided rather than the quantity would be most efficient for all market participants, and would, in our view, be a more appropriate way to support investors in their decision-making process.

However, the proposed Auditors Discussion and Analysis would in our view be too extensive and risks resulting in duplication of information in already lengthy reports, as some of the information should already have been provided by the company itself, as for instance in the MD&A. FEE strongly believes that the aim should be to provide <u>better</u> information and not just <u>more</u> information.

Also, the auditor already provides this information to those charged with governance. The information needs of external users will differ from those charged with governance and it is important to ensure the proper balance of information disclosed to the various user groups in order to facilitate their decision making process in the best way possible.

Although there could be merit in providing some of the information suggested within this model, for instance in relation to audit risks, which may or may not be related directly to the key business risks of the company, FEE believes that the model as proposed would not serve the needs of the users due to its duplication of information. Also, more attention within the model is needed to clearly distinguish between the reporting responsibilities of management and of the auditor, respectively.

**Required and Expanded Use of Emphasis Paragraphs - Questions 13-18**

In the recent debate, investors and other users have expressed a desire for more reporting from companies as well as from auditors. Taking note of these requests from users of financial statements and audit reports, such additional information could contribute to the important aim of reducing the current information gap between the information needs of users and the information provided by the auditors.

FEE believes that emphasis paragraphs should remain as paragraphs that are used to draw users' attention to matters that are of such importance that they are fundamental to users' understanding of the financial statements and the audit. Emphasis paragraphs should therefore remain as they are today and their application should be in situations of major importance.

Emphasis paragraphs should not be misused to compensate for the increasing complexity of financial statements. This increasing complexity is an issue that should be addressed as a matter of urgency, but this should be done by those responsible for the financial reporting framework and by preparers so that readable and understandable financial information is provided to stakeholders. This problem can not and should not be solved by the auditing standard setter through imposing additional reporting responsibilities on auditors.

The French requirement of "*justification of opinion*" is one example of how to approach the reduction of the information gap. The current French requirement states that the justification must "*… enable the user of the report to obtain a better understanding of the reasons behind the statutory auditor's opinion on the financial statements"*.

This principle appears appropriate and could be further explored. In doing so, comments and suggestions for improvement due to the diversified and inconsistent application seen in French audit reports should be carefully considered in order to avoid generic boilerplate language and to ensure that the request from users of providing more decision-useful company-specific information related to the specific audited company in question is de facto met.

It should be made sufficiently clear that this additional "*justification of opinion*" acts in conjunction with the pass/fail nature of the opinion as well as with qualifications and emphasis paragraphs in the audit reports. To avoid any confusion between "justification of opinion" paragraphs and "Emphasis" paragraphs, a term such as "Expanded emphasis paragraphs" should be avoided.

## Auditors Assurance on Other Information Outside the Financial Statements - Questions 19-20

The areas suggested are in relation to non-GAAP information, which could be in relation to, for example, corporate governance arrangements, the sustainability of the business model and key performance indicators.

FEE believes that the company could extend their reporting on such matters. The auditor could then provide additional assurance provided that there is a general request from the market to deliver such assurance services. The information may not necessarily be included in the financial statements, but could be provided outside the financial statements. The assurance given by the auditor on these matters should be separated accordingly.

The level of involvement could vary from no involvement to the auditor providing assurance on the entire content of the annual report and should depend on what users require. Further debate with all relevant stakeholders on proposals for additional management reporting on these matters would be needed to balance the information needs of the investor community. The additional disclosed business information should also not be detrimental to the commercial interests of the company. It is important that the assurance services are developed in response to these market requests for additional information.

## Clarification of the Standard Auditor's Report - Questions 21-22

The audit report is the core deliverable from the auditor. In order to preserve this core service, the comments on the usefulness of the audit report and suggestions for improvements from the users should be carefully considered. Changes made should be sustainable to allow for continuous changes to reporting and society in general.

FEE believes that the criticism of the current audit report being too long and defensive with too much boilerplate information is valid and there is clearly merit for rethinking the format and the structure of it. This could be done by reducing the technical jargon to a minimum with the aim of making it as understandable as possible for the reader.

Reducing this generic information in the audit report will also underline that an audit is not a generic product, but is a service that, although based on the same principles, is tailored to each specific audited entity. It will underline that the audit report is the result of a process conducted by the auditor that is based on the knowledge and experience of the auditor of that particular audited entity.

**Question 23 This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

Comments made by various preparer and user groups in other consultations[1] indicate that the changes that appear to be most responsive to the comments made on the current audit report appears to be related to the format and structure of the audit report itself. This could be done by reducing the amount of generic information in the audit report, also by communicating through using less audit technical language.

Retaining the clear “pass/fail” nature of the audit report has received great support. Any changes should therefore ensure that this clear message from the auditor to the users of the financial statements and the audit report remains as it is today.

The focus should be on reducing the “information gap” rather than the “expectation gap”. Without disregarding the expectation gap, there may be greater value in such a prioritisation, as the expectation gap will most likely continue to exist. Instead, the clear aim should be to enhance the value of audit through better, instead of more, communication. Changes regarding the audit report would most likely have the greatest impact on the perception of the value of audit, if they focus on matters related to format and structure.

**Question 24 Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

It should be carefully considered whether and how the changes explored in the Concept Release operate in conjunction with each other. For instance, an AD&A in a more limited format than proposed in the Concept Release and increased use of Emphasis paragraphs or combined with introducing “justification of opinion” as in France may result in duplication of requirements and of information disclosed.

**Question 29 What effect would the various alternatives have on audit quality? What is the basis for your view?**

It is essential that any initiatives to improve auditor reporting do not impact or impair audit quality, as any changes should only be introduced if they add value for the users of financial statements. Although it may not be possible to serve all user needs, the aim should be that the majority of users perceive the changes to be an improvement and that their information needs are better served.

[1] See the outcome of the consultation in the EC Green Paper on Audit Policy and the summary of responses on the IOSCO Consultation Paper on Auditor Communication, both in 2010.

For further information on this FEE[2] letter, please contact Hilde Blomme at +32 2 285 40 77 or via email at hilde.blomme@fee.be or Lotte Andersen at +32 2 285 40 80 or via email at lotte.andersen@fee.be from the FEE Secretariat.

Yours sincerely,

Philip Johnson
FEE President

[2] FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all of the 27 European Union (EU) Member States. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 500.000 professional accountants, working in different capacities in public practice, small and big firms, government and education, who all contribute to a more efficient, transparent and sustainable European economy.

FEE's objectives are:

- To promote and advance the interests of the European accountancy profession in the broadest sense recognising the public interest in the work of the profession;
- To work towards the enhancement, harmonisation and liberalisation of the practice and regulation of accountancy, statutory audit and financial reporting in Europe in both the public and private sector, taking account of developments at a worldwide level and, where necessary, promoting and defending specific European interests;
- To promote co-operation among the professional accountancy bodies in Europe in relation to issues of common interest in both the public and private sector;
- To identify developments that may have an impact on the practice of accountancy, statutory audit and financial reporting at an early stage, to advise Member Bodies of such developments and, in conjunction with Member Bodies, to seek to influence the outcome;
- To be the sole representative and consultative organisation of the European accountancy profession in relation to the EU institutions;
- To represent the European accountancy profession at the international level.

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financial executives international

COMMITTEE ON CORPORATE REPORTING

September 30, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 34**

Dear Board:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" ("the Release"). FEI is a leading international organization of senior financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

High quality financial statements accompanied by high quality audits are essential to investor confidence and we appreciate the Board's efforts in undertaking a standard-setting initiative to consider improvements to the current auditor's reporting model. We also want to thank the staff for their extensive outreach efforts leading up to the publication of the Release.

We agree with the Board that some improvements to the auditor's reporting model may enhance investors' and users' understanding of the audit process, its benefits and limitations. We are concerned, however, that the Board is considering possible changes, as illustrated in some of the alternatives, without clearly identifying the underlying problem.

Overall, we believe the following principles should be integral to the Board's decision around possible changes to the current auditors reporting model:

- Any standard-setting initiative should not change the fundamental responsibilities of management, the audit committee or the auditors. That is, management owns and is responsible for preparing the financial statements, for adopting sound accounting policies and for establishing and maintaining internal controls that will report transactions, events and conditions consistent with management's assertions embodied in the financial statements as a company's transactions, assets, liabilities and equity are within the direct knowledge and control of management; the audit committee has the responsibility to oversee management's financial reporting process; and the auditor has the responsibility to express an opinion on whether the financial statements and disclosures taken as a whole are presented in conformity with GAAP in all material respects. While an auditor may make suggestions around the form or content of the financial statements, their responsibility remains confined to the expression of an opinion on them.

- Given those responsibilities, we believe that the audit report should provide objective information, rather than subjective opinions on specific items which lack the context or balance that is achieved when forming an opinion on the overall financial statements. The outreach performed by the Board indicates that there is a significant gap between what the auditor's responsibility actually is and what the investor perceives that responsibility to be and therefore, the presentation of subjective opinions would increase the audit "expectation gap" by blurring the line between management and the auditor's responsibility. In particular, we observe that the Release contemplates the auditor possibly providing their views on contentious issues, close calls, and matters in which management is in technical compliance with GAAP but in the auditor's view, the disclosure of such matters could be enhanced. This subjectivity or second-guessing of management's decisions would suggest, if implemented, that the auditor has the responsibility to prepare financial statements and disclosures in compliance with GAAP. The current audit opinion already requires an explanation if the disclosures are materially deficient.

- The financial reporting process, as overseen by the audit committee, not the audit report, should be used to resolve any differences between management and the auditor. The audit report should not be an avenue, or a "lever," in which resolved issues are redistributed for public consumption without the depth of understanding necessary to develop an informed opinion about the meaningfulness of the issue and the associated views. We believe that such reporting would inhibit open communication between auditors, management and audit committees. Rather than using the audit report as a means to address users concerns, we recommend that the Board work with the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary, to address specific concerns about perceived shortcomings in the current financial reporting model.

- Finally, any possible standard-setting changes must be accompanied by a comprehensive cost-benefit analysis. Costs should include increased legal exposure for auditors, management, the company's board members and the company that may be the result of the proposed reporting. While we understand that certain of the Board's alternatives utilize models from other countries, the unique U.S. litigation environment needs to be considered carefully in this analysis. Costs should also include an analysis of incremental audit efforts and whether these efforts will require filing deadlines to be extended. Changes to the auditor's reporting model will require additional audit time to prepare and conduct necessary reviews, as well as discuss with management and audit committees. The accelerated filing timelines, coupled with other reporting requirements, such as SOX, XBRL as well as increased reporting requirements included in the Board's Proposed Auditing Standard on Communications with Audit Committees, may create additional difficulties for some companies to maintain timely reporting. The audit reporting model initiative also comes at a time of significant pending changes in accounting standards as a result of the FASB and IASB's convergence projects, and the SEC's evaluation of the use of IFRS as the reporting framework in the United States. This should also be considered in the Board's analysis.

We believe the current pass/fail opinion is well understood by investors and users of financial statements. An unqualified opinion means that all material matters have been resolved and that the auditors are in agreement with management that the financial statements do not contain any material misstatements. We are in support of the Board's alternative to include clarifying language in the existing standard auditor's report and believe it will enhance investors' and users' understanding of the audit process. We are also of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. We do not support the auditor's discussion and analysis alternative and we do not believe that auditor assurance on other information outside the financial statements is appropriate. We believe these alternatives would result in more confusion and have unintended adverse effects on the auditor-client relationship, auditor independence and audit costs, and give certain information undue prominence.

**Auditor's Discussion and Analysis**

We are not in support of the Auditor's Discussion and Analysis (AD&A) alternative presented in the Release. The AD&A alternative would significantly expand the auditor's role beyond their current attestation responsibility and may impair the auditor's independence. Management owns and is responsible for the preparation of the financial statements and disclosures in compliance with GAAP, not the auditor. Further, it is the audit committee's responsibility to provide oversight of the financial reporting process on behalf of investors. Management, coupled with the oversight of the audit committee, is in the best position to provide understandable, accurate and insightful information regarding the company's historical results of operations and current financial position, and objectives and challenges for the future. An AD&A would confuse investors and users as to who is actually responsible for the company's financial reporting and damage the existing financial reporting system. We believe specific concerns about shortcomings in the current financial reporting model should be addressed to the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary.

An AD&A requirement would create a barrier to productive and candid communications between management, auditors and the audit committee. Also, we believe that the AD&A could evolve into boilerplate disclosure. Consistent with an appropriate auditor-client relationship, management diligently works through highly subjective and judgmental issues to arrive at the appropriate GAAP accounting and disclosure, and the open and transparent discussion with auditors naturally results in the auditor's report to the audit committee summarizing matters upon which management and the auditor are in agreement. That is, the "contentious issues" that are contemplated for reporting in the AD&A are generally resolved by management and the auditor. In fact, items that investors and users might label as "contentious" are not generally disagreements or arguments, but are issues requiring discussion due to their highly complex nature. Such information in the AD&A may inappropriately highlight items that would raise unwarranted concerns and evolve into boilerplate disclosure.

We are also concerned that the AD&A would give undue prominence to items that are of lesser importance or immaterial. The intention of the AD&A is not to provide separate assurance on individual balances, disclosures, or transactions; however, we have difficulty reconciling that intention with our expectation that such granularity may result in order for the auditor to fully report on audit procedures and results, the auditor's views regarding management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." Such AD&A disclosures would naturally be associated with balances, disclosures or transactions, while the auditor's knowledge would be limited to that acquired during the audit.

Finally, an AD&A would result in significant reporting delays and an increase in audit fees. A substantial amount of time would be required for the auditor to prepare the report, conduct national office consultations, and obtain the necessary reviews and agreement with management. We do not believe the reporting delays and additional cost will result in any beneficial information to the investor. Instead, as stated above, we recommend that the Board work with the FASB or the SEC to develop or enhance financial reporting disclosures, if necessary, to address specific concerns about shortcomings in the current financial reporting model.

**Required and Expanded Use of Emphasis Paragraphs**

We are of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. We are, however, concerned that this may over time evolve into a standard boilerplate section of the auditor's report that will eventually diminish the importance of the matters that we believe should be included in such paragraphs. In most cases, we do not believe the addition of emphasis paragraphs to the auditor's report will be particularly valuable to investors and users. We remain convinced that an educated investor and user of financial statements should be able to identify all the critically important matters by thoroughly reviewing the Management Discussion and Analysis ("MD&A") and the financial statements and related footnotes.

The auditor's report should only include emphasis paragraphs if there are matters that the auditor determines are of critical importance to the financial statements and there is the risk that a well informed investor and user will not reach the appropriate conclusion from their review of the financial statements. The auditor should highlight such matters and refer to management's disclosure regarding the matters as management is responsible for the financial statements and for maintaining effective internal control over financial reporting. Matters of critical importance not currently required by auditing standards may include critical accounting policies, areas of critical accounting estimates, changes to the financial statements that impact comparability to prior years, and significant transactions. It is important that the Board provides adequate guidelines to assist auditors in their determination of the matters that should be included in emphasis paragraphs, if any (e.g., material mergers or dispositions with materiality determined consistent with Form 8-K disclosure requirements).

We do not believe emphasis paragraphs should be required on an extensive basis. This would result in auditors developing lengthy checklists to determine which items should be included in emphasis paragraphs to ensure consistent application across all offices, and expect that the disclosures would become boilerplate over time. We are also concerned that auditors may include items that are not necessarily of critical importance, diminishing any potential benefit emphasis paragraphs may provide to the investor.

Further, if audit reports for companies in the same industry include different items in emphasis paragraphs, we are concerned that investors may misinterpret the inclusion or exclusion of a matter in a particular company's auditor's report and potentially draw erroneous conclusions.

We do not support the disclosure of the nature and/or extent of audit procedures in emphasis paragraphs for any matter, including matters of critical importance. The nature and extent of audit procedures appropriately vary significantly from company to company based on risk assessments and the control environment. Further, the complexity of audit procedures varies significantly from one area to the next. It would require extensive discussion to put the audit procedures for an item referred to in an emphasis paragraph in the proper context for an investor and user.

**Auditor Assurance on Other Information Outside the Financial Statements**

We do not believe it is appropriate for an auditor to provide assurance on any information outside the financial statements for the following reasons:

- The information contained outside the financial statements is of a more subjective nature, in particular with regards to the MD&A. Information presented in the financial statements is based on detailed and largely prescriptive GAAP rules, which dictate the accounting treatment and disclosure requirements. The auditors currently focus on auditing the accuracy of the information presented in the financial statements and the adequacy of disclosures in compliance with GAAP. However, the rules governing the MD&A disclosures are less prescriptive and encourage management to provide their views on the historical and future business performance "through the eyes of management." The MD&A information is intended to be more qualitative and forward-looking than those contained in the financial statements and requires significant judgment and understanding of the registrant's business. Much of the information provided represents management's analysis and insights based on their detailed current knowledge of their businesses. We believe it would be extremely difficult for the auditors to audit this information effectively to enable them to provide meaningful value to investors and users. We are also concerned that this may affect the independence of the auditors.

- We are concerned that the requirement to audit MD&A could lead to less transparent, boilerplate content. As noted above, the MD&A is intended to provide an analysis of performance (both past and forward-looking) through the eyes of management. By necessity, this involves the inclusion of items that may not be objectively verifiable. To the extent certain items are not auditable, we are concerned that there may be a tendency to exclude the related discussion rather than deal with the consequences of potential scope limitations in the auditor's report on the MD&A. This would reduce the overall value of the MD&A to shareholders.

- We expect that the cost to provide additional assurance would be high compared to the benefit investors and users may derive from such assurance. We are not aware of strong support from any relevant stakeholder groups for this alternative based on our interaction with such groups. It is likely that the auditors performing these types of engagements would generally be more experienced resulting in costs exceeding the existing average audit rates. The subjective nature of the information and lack of prescriptive guidelines would likely result in extensive additional discussions between senior management and auditors, as well as documentation supporting management's thought process and conclusions. The combination of higher rates and extensive hours would likely mean a significant increase in audit fees, which we believe would be completely disproportionate to any benefits received.

- The requirement to provide assurance on information outside of the financial statements would require significant additional time, and would almost certainly lead to a later release of Form 10-K filings, in most cases by at least several days. For some companies, SEC filing deadlines would become unachievable.

- To the extent that information in the MD&A is derived from financial statements or is subject to internal control over financial reporting, auditors are already performing procedures to ensure the information is materially consistent with the information presented in the audited financial statements and footnotes.

With respect to critical accounting policies and estimates, we do not believe separate assurance is appropriate for the reasons outlined above; however, as discussed earlier, we support an emphasis paragraph highlighting these. Further, we believe that clarification of the auditor's responsibilities with respect to MD&A in the standard auditor's report is desirable.

**Clarification of the Standard Auditor's Report**

We are in support of the Board's alternative to include clarifying language in the existing standard auditor's report and believe it will enhance investors' and users' understanding of the audit process.

We believe the clarifying language around the auditor's responsibility for information outside the financial statements should be limited to the items included in the annual report on Form 10-K as required by the SEC.

**Other Questions and Considerations**

In the attached appendix, we have included additional information on our views with respect to certain questions in the Release.

* * * * * * * *

We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have questions, please contact Lorraine Malonza at (973) 765-1047 or lmalonza@financialexecutives.org.

Sincerely,

Loretta V. Cangialosi
Chair, Committee on Corporate Reporting
Financial Executives International

cc: Martin F. Baumann, Chief Auditor and Director of Professional Standards

**Appendix**

**Form of the Auditor's Report**

**Question 3:**

Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

Management is in the best position to provide additional information regarding the company's financial statements. Management is closest to the daily operations and has direct knowledge and control of assets, liabilities, equity and activities of the company and has the responsibility to prepare financial statements and disclosures in compliance with GAAP. Management is responsible for making the necessary judgments and estimates, and has a far better understanding than the auditor of the industry, business strategy and results of operations.

We are concerned that if the auditor was responsible for providing additional information, they could be seen as acting in the capacity of management, thus impairing their independence.

**B. Required and Expanded Use of Emphasis Paragraphs**

**Question 18:**

What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

We are of the opinion that the required and expanded use of emphasis paragraphs in certain limited instances may be of some value to certain investors and users. However, we do not believe that the required emphasis "could potentially increase the quality of management's disclosures in the financial statements because of specific reference to such disclosures in the auditor's report." Management has the responsibility to provide high quality disclosures, and it is the auditor's responsibility to opine as to whether those disclosures are prepared in accordance with GAAP. Making reference to those disclosures in the auditor's report would only tend to highlight specific disclosures that are made in the financial statements, but we do not believe that this reference should change the content of those disclosures.

**D. Clarification of the Standard Auditor's Report**

**Question 22:**

What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

We believe this alternative has some benefits without altering the scope of the audit or impacting the auditor's responsibilities. Further, the cost associated with this alternative would be minimal. It will enable investors and users to obtain a better understanding of the scope of the audit and the role of the auditor.

**Question 27:**

Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

We believe the AD&A (alternative 1) and emphasis paragraph (alternative 2) may confuse the users of financial statements, who may possibly perceive the opinion to be qualified.

Alternative 1: We believe that it would be very difficult to develop an appropriate framework for an AD&A, and once developed, it would be very difficult for a framework to be consistently followed by auditors when disclosing information of such a highly subjective nature. Requiring auditors to present information of this nature could result in misleading reports, make it difficult to have comparability among financial statements, and cause confusion about the auditor's pass/fail opinion. An unqualified opinion means that all material matters have been resolved and that the auditors are in agreement with management that the financial statements do not contain any material misstatements. Highlighting additional information (e.g., close calls, contentious issues, etc.) would likely suggest a higher level of importance to the issue(s) than is warranted since users would not be privy to the dialogue that occurs between the auditor, management and the audit committee in which additional context and perspectives are communicated.

Alternative 2: Requiring auditors to emphasize certain areas could result in misleading reports, make it difficult to have comparability among financial statements, and cause confusion about the auditor's pass/fail opinion. For this reason, we believe it is vital that required emphasis paragraphs are limited to only include matters of critical importance.

We believe auditor assurance on other information outside the financial statements (alternative 3) could lead to the opinion being perceived as piecemeal, if this assurance is combined in one report with the audit pass/fail opinion.

We do not believe the clarification of the standard auditor's report (alternative 4) will result in the opinion being perceived as qualified or piecemeal. We believe it will enhance investors' and users' understanding of the audit process

**Question 28:**

Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

We believe the clarification of the standard auditor's report alternative is the most appropriate way to improve the auditor's reporting model. Providing clarifying language for the items outlined in the Release would serve to enhance the auditor's report and help users better understand the responsibilities of the auditor and what an audit represents. Providing clarifying language for each of these items will be beneficial as discussed below.

- Reasonable assurance – This will reinforce the concept that an audit provides a "high level of assurance, but not absolute assurance."

- Auditor's responsibility for fraud – We believe that the auditor's responsibility for the detection of fraud should be addressed within the standard auditor's report. We are supportive of expanding the current language within the report to include "…Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" as is consistent with the current auditing standard.
- Auditor's responsibility for financial statement disclosures – This will bring the standard auditor's report more in line with the actual responsibilities of auditors as set out in current auditing standards. This will provide assurance to users that the auditors have a responsibility to plan and perform their audit to obtain reasonable assurance that misstatements of items that are material to the financial statements are detected and that the financial statements cover both the basic statements and related footnotes.
- Management's responsibility for the financial statements – This language should reiterate that management has responsibility for preparing the financial statements and management has the responsibility for adopting sound accounting policies and for establishing and maintaining internal controls that will report transactions, events and conditions consistent with management's assertions embodied in the financial statements as a company's transactions, assets, liabilities and equity are within the direct knowledge and control of management. This will enhance the view that an auditor is an independent party responsible for evaluating the accuracy of management's presentations.
- Auditor's responsibility for information outside the financial statements – We believe that providing the users with an understanding of the auditor's current responsibilities under AU 550 would be beneficial and help users to better understand the procedures being performed on other information outside the financial statements. We believe the clarification should be limited to sections of the Form 10-K.
- Auditor independence –We believe this could provide users with a better understanding of the auditor's role and provide more confidence in their judgments and the audit process.

**Question 29:**

What effect would the various alternatives have on audit quality? What is the basis for your view?

We believe alternative 1 and 3 could have a serious negative effect on audit quality due to the additional time and resources these alternatives would require in today's accelerated filing timelines, which already includes an opinion on internal control over financial reporting. These alternatives would divert audit resources and the audit partner's attention away from required work needed to support a conclusion on the financial statements.

We also believe that requiring disclosure of audit procedures performed in connection with items discussed in the emphasis paragraphs could have a similar impact on audit quality for the reasons stated above.

**IV. Considerations Related to Changing the Auditor's Report**

**Question 31:**

This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

*a. Are any of these considerations more important than others? If so, which ones and why?*

All of these considerations are significant and could individually justify a conservative approach to the decisions to be made with respect to the alternatives before the Board. Some of the alternatives present significant consequences for the cost of the audit, particularly the AD&A and attestation to the MD&A. Some of the alternatives could raise very significant concerns about liability and confidentiality, especially the AD&A.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

We believe that the AD&A and assurance on information outside the financial statements alternatives would likely result in significant audit cost increases. We also believe that these alternatives, especially the AD&A, would significantly increase legal exposure for auditors, companies, management and Boards of Directors. Further, we believe that these alternatives would result in significant unforeseen consequences and costs that would far outweigh the intended benefits.

**RESPONSE TO PCAOB RULEMAKING DOCKET MATTER No. 34**

**FINANCIAL REPORTING COUNCIL**
**SEPTEMBER 2011**

## 1. Introduction and main points

1.1 The Financial Reporting Council (FRC) welcomes the opportunity to respond to the PCAOB's Concept Release on potential changes to the auditor's reporting model. We are pleased to see the PCAOB consulting on this topic and we support the objectives that the PCAOB seeks to achieve through its proposals. Recent initiatives in the UK and Europe have also sought to address this and related issues. Whilst we believe that it is helpful where possible for there to be international consistency in substance if not always in form, alternative proposals to address similar issues will assist withan assessment of the relative effectiveness of different approaches.

1.2 The FRC is the United Kingdom's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and its operating bodies have a number of responsibilities in relation to audit, including policy, standards, monitoring and investigations. These functions are carried out with the primary goal of improving audit quality.

1.3 Since the financial crisis the question has arisen as to whether the audit report is fit for purpose. Commentators have pointed to banks and other financial institutions which failed shortly after receiving clean audit reports. Whilst some of these comments are based on a misunderstanding of the purpose, scope and limitations of an audit, an attempt must be made to close the expectation gap if audit is to be considered fit for purpose.

1.4 In January 2011 the FRC published a discussion paper entitled Effective Company Stewardship – enhancing corporate reporting and audit. The aim of the paper was to consider how companies and auditors could better serve investors by providing more valuable and relevant information.

1.5 There are differences in UK and US approaches to corporate governance and reporting. For example, in respect of corporate governance matters the UK relies on a "comply or explain" approach rather than mandating disclosures. Nonetheless we believe that many of the principles in Effective Company Stewardship are applicable internationally.

1.6 In the event that different approaches are agreed in the UK, US and Europe consideration will need to be given to how best to deal with companies which are listed in more than one jurisdiction. We would suggest that, provided that the company's management provides the required information in the annual report, auditors are not obliged to duplicate it. This will ensure that companies with dual or multiple listings do not find themselves caught between different regulatory regimes.

1.7 Our submission concentrates on what we see to be the key issues and expands upon our preferred solutions.

**2. Narrative reporting**

2.1 The concept release identifies a number of issues with the audit report, including:

- The limitations of the pass/fail model.
- The prevalence of boilerplate language.
- Limited information about matters specific to the company.

2.2 The paper goes on to make a number of suggestions as to how the audit report could be improved and made more valuable to users.

2.3 The FRC agrees with the contention that the audit report does not always deliver the assurance that investors would like to see. However we believe that the audit report should not be seen in isolation from corporate reporting more generally. Some of the suggestions in the concept release, in particular the "AD&A" option, rely heavily on the auditor providing information some of which is in our view properly the responsibility of management. We appreciate that the PCAOB regulates auditors and not companies, and so an approach providing for the company to give further information may not be available to it.

2.4 It is a company's directors and executive management who have responsibility for running that company and reporting on its performance. Management should, in the first instance, decide what information should be communicated to investors and the wider public. The auditor has a vital role to play in validating and challenging management's views, and in assessing whether there are material inaccuracies or omissions.

2.5 The first step in improving the quality of information provided to investors and others should therefore be to make reporting by large companies more effective. Feedback received on our Effective Company Stewardship consultation indicates widespread dissatisfaction with current narrative reporting across all stakeholder groups. Investors in particular noted that annual reports have become longer and longer in recent years, without a corresponding increase in the relevance and value of the information disclosed.

2.6 The FRC is working with the UK Government to develop solutions to make improve narrative reporting. Likely solutions include:

- Introduction of a strategic report providing an overview of the business.
- Disclosure as part of that strategic report of an explanation of the links between company performance and the remuneration of directors and senior management.

- Greater transparency from directors about the activities of the company and disclosure of key operational risks.

**3. Role of the audit committee**

3.1 An enhanced role for the audit committee is at the heart of the FRC's proposals. In recent years the audit committee has grown in strength and influence, and we believe that audit committees are well placed to deliver effective governance and oversight of the audit process.

3.2 Much of the work done by audit committees remains invisible to investors, with the result that a key opportunity to build confidence in financial statements is missed.

3.3 We propose that audit committees should report to the full board on the approach that they have taken to the discharge of their responsibilities, describing in such terms as they consider appropriate, and having regard to the commercial interests of the company concerned:

- The key sensitivities or risks, including the choice of accounting policies, that they identified to the integrity of the annual report, including the financial statements, and how they arranged for those to be addressed.
- Any matters of material significance identified by the audit committee that are not addressed elsewhere in the annual report and which, in the directors' view, should be known to users if the annual report, taken as a whole, is to be fair and balanced.
- The steps they took and the judgements they made to assess the effectiveness of the audit.
- The policies that they adopted to avoid the independence of the company's auditors being compromised through the provision of non-audit services.
- The process by which they reached their recommendation to appoint or reappoint (as the case may be) the company's external auditors and the reasons for that recommendation.
- Any dialogue that they may have had with investors in relation to any material audit issues (not addressed elsewhere in their report).

3.4 The full audit committee report should be published in the annual report.

**4. Auditors and the audit report**

4.1 As noted above, it is the FRC's view that the primary responsibility for communicating key information on historical performance and future opportunities and risks lies with the company's directors and executive management. Substantive involvement by the auditor in direct reporting in this area runs the risk that the auditor takes on a management role.

4.2 For these reasons we do not believe that the auditor should be responsible for the provision of information on a company's business strategy or key risks. We do, however, believe there is scope for the auditor to add greater value in this area.

4.3 Firstly, we propose that auditors provide a fuller report to audit committees aimed at ensuring that the committee understands fully the factors that the auditors relied upon in exercising their professional judgement in the course of the audit and, in particular, in reaching their audit opinion. At a minimum, these are likely to include:

- The effectiveness of the company's system of control.
- The judgements made in the audit plan about what is material and the implications of those judgements for the level of assurance provided by the audit.
- The appropriateness of the accounting policies (viewed individually and in aggregate).
- Their overall conclusions on the valuations of the company's assets and liabilities provided by management (with particular reference to those that are significant to the financial statements).
- Any other matters identified in the audit plan or by the audit committee as material to the proper presentation of the company's financial position.

4.4 The audit report itself should then be expanded to provide:

- A new section on the completeness and reasonableness of the audit committee's report.
- Identification of any matters in the annual report that the auditors believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

4.5 Our proposals most closely resemble Option C in the concept release. The FRC will shortly launch a consultation on changing UK auditing standards to reflect our proposals.

**5. Conclusion**

5.1 In conclusion, we believe that the audit report cannot be treated in isolation and that attempts to improve the usefulness of the auditor reporting model must begin with improvements to corporate reporting more generally.

5.2 The primary responsibility for providing information to investors should rest with the company's management. The auditor should review that information and supplement or correct it as necessary; the auditor should not be obliged to duplicate management disclosures. Our preference therefore is that the PCAOB to proceed with Option C.

5.3 For further information please contact Paul George, Director of Auditing, on +44 20 7492 2340 (email: p.george@frc-pob.org.uk).

FirstEnergy

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***Harvey L. Wagner***
*Vice President, Controller*
*and Chief Accounting Officer*

*330-384-5296*
*Fax: 330-384-5299*

September 23, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Ladies and Gentlemen:

FirstEnergy Corp. is pleased to submit its views in response to the PCAOB's request for comments on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.

FirstEnergy is a diversified energy company with approximately $48 billion of assets, $19 billion in annual revenues and an equity market capitalization currently exceeding $18 billion. Our ten electric distribution companies comprise the nation's largest investor-owned electric system. FirstEnergy's generating fleet features non-emitting nuclear, scrubbed base load coal, natural gas, and pumped-storage hydro and other renewables, and has a total generating capacity of approximately 23,000 megawatts.

We commend the PCAOB for reaching out to stakeholders through its Staff's outreach activities, the solicitation of comments and the recently concluded public roundtable addressing these issues. Chairman Doty's stated objective to "enhance the relevance of audits to the investing public" is important and we believe some of the ideas identified in the Concept Release may achieve that objective. Other alternatives included in the Concept Release could be very costly to execute and impede effective corporate governance. Our views on the major alternatives included in the Concept Release are summarized below.

<u>Auditor's Discussion and Analysis (AD&A)</u>

The proposed inclusion of an AD&A is the most troublesome of all of the alternatives put forth in the Concept Release. In addition to adding potentially significant costs to the financial reporting process, a requirement to include an AD&A accompanying the auditor's report would serve to dilute the corporate governance process.

The role of the auditor in the financial reporting process – attesting to the financial statements that have been prepared by management – would be drastically altered by requiring an AD&A. The Concept Release seeks a view of the audit and the financial statements "through the auditor's eyes". Providing commentary on management's estimates, judgment, accounting policies, "close calls" and other matters places the auditor in a very different position. PCAOB Board Member Hanson was correct when he stated that, "They [auditors] are not trained to evaluate and communicate the overall business and strategic risks of the companies they audit." It is clear that if an AD&A were required, more auditor education and training would be necessary, the cost of which would ultimately be borne by audit clients.

Audit committees represent the interests of shareholders appropriately through an effective corporate governance process and as such serve as the shareholders' representatives in their communications with the auditors and management. Much of what has been proposed to be communicated in the AD&A is communicated by auditors to audit committees on a regular basis. From that, audit committees are in the best position to determine if management's financial statements and related disclosures need to be supplemented, based on communications from the auditors, before completion and distribution to shareholders and other investors. Requiring an AD&A is counterproductive to effective and efficient corporate governance and could introduce a "chilling" element to the open and robust discussions that currently exist among auditors, audit committees and management.

Accompanying financial statements and related disclosures with an AD&A may be more confusing to investors and could call into question the credibility of the financial statements for which the auditors have attested. The current disclosure system, which also includes Management's Discussion and Analysis (MD&A) can be overwhelming to investors – adding an AD&A will exacerbate that issue and could be potentially misleading to all but the most sophisticated analysts.

From a practical standpoint, the addition of an AD&A would add significantly to the financial reporting timeline, which is already challenged with fairly accelerated Securities and Exchange Commission filing deadlines. Based on our experience with drafting any document that requires review from our auditors, the review process of an AD&A within the accounting firm will be intense – involving not only the local engagement team, but likely secondary field and national office reviews followed by legal reviews and final national office sign-off. That process would be very costly to companies and their shareholders.

Emphasis Paragraphs in Auditors' Reports

We believe that requiring emphasis paragraphs in auditors' reports could enhance investor understanding by providing guidance on where the most significant estimates, risks, judgments, etc. are located in the notes to the financial statements. It would be advisable to limit the additional information to no more than five of the most significant items considered by the auditor and should be limited to identification and location only, with no commentary on the items identified. Care should be taken to avoid expanding the auditor's report so much that its usefulness becomes diminished.

Auditor Assurance of Information Outside of the Financial Statements

The Concept Release requests views on whether the auditor's report should be expanded to include information outside of the financial statements (e.g., MD&A, earnings releases, non-GAAP financial information). We do not support extending the auditor's regular attest function beyond the financial statements. The auditors currently review this supplemental information to ensure that it is materially consistent with the financial statements – auditing this supplemental information is a very costly alternative that provides no incremental benefit to investors. Beyond the additional costs, practical considerations similar to those discussed above with the AD&A are applicable here. It is not inconceivable that management's timeline for communicating with the investment community could become hostage to the auditor's calendar.

Clarification of the Standard Auditor's Report

We believe that investors would benefit from changes to the standard auditor's report that would describe in "plain English" what an audit entails, clarification of management's responsibility for preparing the financial statements, the auditor's responsibility for providing assurance and the auditor's responsibility to detect fraud. We believe that the report should remain concise and be easy for investors to quickly assess the "pass/fail" nature of the auditor's opinion.

Summary

Investors' needs are paramount in the financial reporting process. We believe that some of the frustration that the PCAOB Staff may have heard in their outreach process is a function of the incredible amount of information currently disclosed in the notes to financial statements – investors may understandably have a difficult time discerning what is important. Our recommendation to require the emphasis paragraphs in the auditor's report to identify the more significant issues may help ease those frustrations.

Thank you for the opportunity to comment on the Concept Release and we look forward to participating further as the process unfolds.

Sincerely,

FLORIDA INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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TELEPHONE (850) 224-2727 • FAX (850) 222-8190

July 15, 2011

Office of the Secretary
PCAOB
1666 K Street N.W.
Washington, D.C. 2006-2803

VIA Email Sent to: comments@pcaobus.org

Re: PCAOB Release No. 2011-003
PCAOB Rulemaking Docket Matter No. 34

*Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Board Members:

The Accounting Principles and Auditing Standards Committee of the Florida Institute of Certified Public Accountants (the "Committee") has reviewed and discussed the above Concept Release.

The Concept Release presents four proposed alternatives which are not mutually exclusive and the Board has requested responses to each separate alternative and general matters. Addressing these areas, the Committee has the following comments related to this release:

***Overview***

We agree with the Board's decision to undertake the initiative to consider improvements to the auditor's reporting model; however not to the extent of expanding the auditor's role in the auditing and reporting process. We believe that management should retain responsibility for their financial statements and disclosures, and that auditors should not become a source of disclosure within the reporting process. The auditor's role should remain that of an independent auditor attesting to the fairness, in all material respects, of the financial statements presented.

***Auditor's Discussion and Analysis***

While we do concur there is merit for the ability to discuss or highlight significant matters in a narrative form, we feel that other alternatives would better serve this intention and do not suggest that the Board consider an Auditor's Discussion and Analysis, (AD&A) as an alternative for providing additional information in the auditor's report for commenting on the audit, the company's financial statements or both.

The financial statements are the responsibility of management and as such the information included within those financial statements should be that of management. While the AD&A, as contemplated, is not intended to provide separate assurance on individual balances, disclosures, transactions, or any other matters discussed in the AD&A, it could create confusion to the readers of the financial statements and would increase the auditor's role related to the disclosure of non-financial information.

If required, the AD&A could eventually result in boilerplate language due in part to the potential for increased audit costs and increased auditor exposure to liability. The requirement to disclose matters such as difficult or contentious issues and close calls could impair relationships or limit open communications between the auditor, management and the Audit Committee.

***Required and Expanded Use of Emphasis Paragraphs***

This alternative would mandate the use of emphasis paragraphs in all audit reports and would further expand the emphasis paragraph to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements. The Concept Release suggests, among other items, disclosure of audit procedures performed on significant matters. Since audit procedures should be customized specifically to address these specific matters, discussion and disclosure of such procedures within the audit report could add confusion to the readers of the financial statements if they do not have an in-depth understanding of the specific entity and of the auditing process. They may not understand the reasoning supporting the judgments and procedures unless lengthy explanations are added which will then lead to readers bypassing the emphasis paragraphs.

Additionally, if the expanded emphasis paragraphs are required, the broad use of emphasis paragraphs may serve to lessen the impact and effect of emphasis paragraphs.

***Auditor Assurance on Other Information Outside the Financial Statements***

This alternative would require auditors to provide assurance on information outside the financial statements, such as MD&A, or other information (for example, non-GAAP information or earnings releases).

The proposed alternative would expand the auditor's responsibility beyond the scope of the financial statements. Providing assurance to forward looking statements, such as those contained within the MD&A or certain other non-GAAP information could be very difficult unless limited to historical and current financial related disclosures. Since this approach would result in increased time and costs and could possibly constitute a new engagement, the additional potential costs compared to the potential benefits derived does not appear to support this option as the best approach for improving the quality, completeness and reliability of the financial statements and auditor's report.

***Clarification of Language in the Standard Auditor's Report***

We feel this proposed approach would provide a more cost efficient and meaningful manner for enhancing the auditor's reporting model. The ability to clarify and explain the auditor's responsibility and role in the audit would serve to enhance the auditor's report and would increase the readers of the financial statements knowledge of the audit process. The suggested areas of clarification are matters that are already being communicated to the Audit Committee and management, and as such should not result in significant increases of time or cost.

We believe that all of the proposed clarifications within this approach are appropriate and we did not note any potential implications to the scope of the audit or the auditor's responsibilities resulting from such clarifications. To facilitate the ease of reading and understanding the expanded auditor's report, consideration of headings for each significant paragraph within the report is suggested.

***Considerations Related to Changing the Auditor's Report***

Concerned about potential challenges and unintended consequences that could result from additional auditor reporting, the Concept Release requested comments related to certain effects on: audit effort; auditor relationships; audit committee governance; liability considerations; and confidentiality.

We feel the considerations presented are overall equally important as the effect and impact could vary from company to company. We suggest that a cost/benefit analysis be considered related to any changes in the auditor's reporting model and changes should be implemented only if the cost benefit is justified for the majority of the affected entities.

With some of the proposed ideas within this concept, increased auditor liability considerations are a legitimate concern especially as it would relate to assurance on information outside the financial statements.

The proposed disclosures of sensitive matters in the auditor's report do appear to offer the potential for negative effects on the relationship between the auditor, management, and the Audit

Committee, which in response could erode the overall audit effectiveness by inhibiting open communication.

We commend the PCAOB Board for their efforts and we support enhancing the communications to investors and increasing transparency related to the auditor's reporting model. Overall, we believe that the proposal for Clarification of Language in the Standard Auditor's Report presents the most cost efficient method to achieve these goals, while minimizing the overall potential challenges and unintended consequences related to additional auditor reporting.

We appreciate the opportunity to respond.

Best regards,

Robert P. Bedwell, CPA, Chair

FICPA Accounting Principles and Auditing Standards Committee

Committee members coordinating this response:

Deborah R. Fabbri, CPA
Edward Eager, CPA

FMR, Co.
Office of the Fund Treasurer

Mail: 82 Devonshire Street V10F
Boston, MA 02109-3614
Office: 617-563-7000

Fidelity INVESTMENTS

September 30, 2011

**VIA ELECTRONIC MAIL**

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

RE: **PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2011-003; Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to the PCAOB Standards**

Ladies and Gentlemen:

FMR LLC, which is commonly known as Fidelity Investments ("Fidelity")[1], appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board's ("PCAOB") with respect to its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("Concept Release"). Our comments are intended to address the application of the four alternatives proposed for changes to the auditor's reporting model in the Concept Release on open-end investment companies (or "mutual funds") registered under the Investment Company Act of 1940 ("1940 Act") and clearing and introducing broker-dealers ("broker-dealers") registered with the U.S. Securities and Exchange Commission under the Securities Exchange Act of 1934 ("1934 Act").

Overall, Fidelity agrees with the PCAOB's objective of improving the auditor's reporting model to increase transparency into the audit process and the relevance of the auditors report to users of financial statements, while maintaining the quality of the financial statement audit. Fidelity believes that the PCAOB's approach to rulemaking in this area should be guided by the principle that the financial statements, including disclosures regarding significant estimates and judgments, are management's responsibility. Consistent with this principle, any changes to the audit opinion should (i) help clarify information about the audit and not create confusion about the opinion rendered by the auditor and (ii) balance the benefits of these changes, notably the value added to the users of the report, with the potential costs of these changes, such as the additional burdens placed

[1] Fidelity Investments is one of the world's largest providers of financial services, with assets under administration of $3.4 trillion, including managed assets of more than $1.5 trillion, as of August 31, 2011. Fidelity Investments is a diversified, privately held financial services company that includes Fidelity Management & Research Company ("FMR"), which serves as the investment advisor for the 411 registered investment companies in the Fidelity Group of Funds with aggregate net assets of over $1 trillion, as well as several FINRA registered broker-dealers, including Fidelity Brokerage Services LLC, an introducing broker-dealer with the nation's largest fund supermarket offering that provides services to over 12 million customer accounts with over $1.5 trillion in assets under administration, and National Financial Services LLC, a clearing broker-dealer that serves approximately 300 unaffiliated broker dealers. In addition, Fidelity is one of the largest retirement plan service providers, providing investment management, recordkeeping, brokerage, consulting, directed trustee and custodial services to over 18,000 defined contribution plans that cover more than 12 million participants.

on financial statement preparers that could increase the risk of meeting regulatory deadlines. Below, Fidelity comments on each of the four alternatives discussed in the Concept Release.

The first alternative presented in the Concept Release is the inclusion of a supplemental narrative by the auditor (described as an "Auditor's Discussion and Analysis" or "AD&A") as part of its report. Fidelity sees little benefit of the inclusion of an AD&A in the auditor report for mutual funds and broker-dealers in which the auditor would be required to provide additional information about the audit and the company's financial statements. The preparation of mutual fund financial statements requires few significant estimates and judgments. The key audit risks relate to the existence and valuation of the investment portfolio, which for most mutual funds is comprised of securities valued based on observable inputs. FASB Topic 820 *Fair Value Measurements* ("Topic 820") sets forth measurement and disclosure principles and requires management to provide extensive disclosure on its valuation policies. Recent updates to Topic 820 have expanded the disclosures about fair value measurements to include more information about transfers between Levels and the sensitivity of Level 3 securities.[2] Fidelity believes that inclusion of additional information from the auditors about the procedures performed to support the opinion rendered by the auditor would add little benefit in light of the recent updates to Topic 820 and may create investor and shareholder confusion about such opinion.

For broker-dealers, the objectives of the financial statement audit are discussed in Rule 17a-5 under the 1934 Act. Rule 17a-5 currently requires broker-dealers to file an annual report with the SEC that includes financial information and supporting schedules which are audited by an independent public accountant. An audit of a broker-dealer not only requires the auditor to express an opinion on the financial statements as a result of procedures performed in accordance with generally accepted auditing standards, but to report on the adequacy of internal controls in accordance with Rule 17a-5 and compliance with specific rules addressing financial responsibility and recordkeeping. Fidelity believes that the amendments recently proposed by the SEC[3] and the resulting PCAOB proposed guidance[4] concerning Rule 17a-5 provide the users of the broker-dealer financial statements with sufficient information such that the inclusion of an AD&A to the audit opinion would not be required. In addition, Fidelity believes that the enhancements to significant accounting policies through changes made to accounting guidance[5] and changes that are in the

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[2] FASB ASC 820-10-50-2.

[3] *Proposed Amendments to Rule 17a-5 Under the Securities Exchange Act of 1934; Release No. 34-64676, 76 Fed. Reg. 37572; File No. S7-23-11 (the "Release")* that would become effective for annual reports filed with the SEC for fiscal years ending on or after December 15, 2011.

[4] PCAOB Rulemaking Docket Matter No. 035 - *Proposed Standards for attestation engagements related to broker and dealer compliance or exemption reports required by the U.S. Securities and Exchange Commission and related amendments to PCAOB standards* and PCAOB Rulemaking Docket Matter No. 036 – *Proposed Auditing Standard Related to Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards.*

[5] Recent enhancements to Topic 820 as noted above as well as enhancements to *Transfers and Servicing (Topic 860) Reconsideration of Effective Control for Repurchase Agreements* which improved the accounting for repurchase agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity.

process of being addressed by the FASB[6] will increase the already transparent significant transactions reflected in the broker-dealer financial statements to the users of those statements.

The second alternative would require use of expanded emphasis paragraphs in all audit reports. Fidelity believes this additional disclosure could be beneficial to financial statement users by highlighting matters of significance to the auditor and where they are disclosed in the financial statements. This would increase the transparency of the audit. Fidelity recommends, however, that the PCAOB develop guidance on the auditor's use of emphasis paragraphs to ensure that there is consistency in application across industries and audit firms. As an example, certain audit risks are very specific to broker-dealers[7]; therefore, guidance should be provided for preparing the use of emphasis paragraph to ensure that it is consistently used by these entities.

The third alternative would require auditors to provide assurance on information outside the financial statements, such as management discussion and analysis ("MD&A") and earnings releases. SEC registered mutual funds are not required to present an MD&A (or earning releases), but instead provide a management discussion of fund performance ("MDFP"). The MDFP is limited to a discussion of factors that materially impacted fund performance, such as market conditions and investment strategies, and returns for the fund. Given the purpose of the MDFP for mutual funds, we see limited benefit of auditor assurance on this disclosure.

SEC registered broker-dealers are also not required to present an MD&A or earning releases. The only information provided outside the financial statements are the schedules currently required by Rule 17a-5, on which the SEC has recently proposed amendments.[8] We believe that the changes already proposed by the PCAOB in Docket Matter 36 would provide the users of the financial statements with sufficient assurance regarding the schedules.[9]

Fidelity believes that the fourth alternative, which would seek to include in the standard auditor's report clarifying language about what an audit represents and the related auditor responsibilities, could benefit users of mutual fund and broker-dealer financial statements by providing a better understanding of the terms used in the report and by illustrating the responsibilities of management and the auditor. In implementing this approach, Fidelity recommends that the PCAOB consider the addition of clarifying language in the audit opinion regarding the auditor's responsibility on evaluating internal controls for purposes of planning the audit procedures to be performed. For example, mutual fund financial statements represent the culmination of a large volume of investment and shareholder transactions that are executed for the period covered by the audit based

[6] Current FASB/IASB joint projects such as (but not limited to) Consolidation, Revenue Recognition, and Accounting for Financial Instruments.
[7] Risk primarily relates to obtaining and maintaining physical possession and control of all fully paid and excess margin securities, complying with Regulation T, and making the quarterly securities examinations, counts, verifications, and comparisons and recordation of differences required by Exchange Act Rule 17a-13 as well as significant accounting policies specific to the industry such as fair value measurements, derivatives, and repurchase agreements.
[8] *See, infra,* footnote 3.
[9] *See, infra,* footnote 4.

on GAAP. As part of the audit, the auditor evaluates internal controls relevant to the preparation and fair presentation of the financial statements, including the controls around the processing of these types of investment and shareholder transactions. We believe additional information on how the auditor evaluated controls around these transactions to plan procedures to be performed for the audit will provide more context for shareholders or investors in these types of entities.

* * * * * * * *

In closing, Fidelity appreciates the opportunity to respond to the Concept Release and welcomes the opportunity to meet with you to discuss any of the issues addressed in this letter. Fidelity also urges the PCAOB to perform a cost/benefit analysis of the alternatives considered before implementing any changes to the auditor report to help demonstrate why a particular alternative was chosen.

Very truly yours,

Kenneth B. Robins
Treasurer
Fidelity Equity and High Income Funds

John R. Hebble
Treasurer
Fidelity Fixed Income and Asset Allocation Funds

Jeffrey Jarczyk
Executive Vice President, Chief Accounting Officer
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July 5, 2011

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

**RE: Rulemaking Docket Matter No. 34**
**Concept Release on Possible Revisions to PCAOB Standards**
**Related to Reports on Audited Financial Statements**

Members of the Board,

I appreciate the opportunity to submit my comments to the Board with respect to the proposed auditing standard on engagement quality review. I retired from public accounting in 2007 after 27 years at Deloitte & Touche LLP and am currently a full-time faculty member at the University of Notre Dame teaching undergraduate and graduate courses in accounting and auditing.

My comments are as follows:

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

> *a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*
>
> No; the Board would better spend its time setting standards for the conduct of the audit rather than on reporting. I believe users, particularly those managing large investment portfolios, are intelligent business people who have the ability to fully understand what auditors do without an expanded auditors' report. PCAOB Standards are a matter of public record and available to any who want to understand the meaning of specific terminology or what auditors do in evaluating managements' assertions in the financial statements. The level of detail that should be added to the auditors' report would likely expand it to four or five pages, and yet the expanded report would be less comprehensive than the Center for Audit Quality's recently published "In-Depth Guide to Public Company Auditing: The Financial Statement Audit" (CAQ Guide). Any user who does not have the time or inclination to read the PCAOB standards but who reads the CAQ Guide once will have the information necessary to understand the

auditors' report. Those who participated in your outreach process would have invested much less time reading the introductory chapters to an undergraduate auditing textbook than they invested preparing to meet with the Board were they truly interested in understanding what auditors do. I do not believe this issue is about users' inability to understand the auditors' report.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

Investors and other users must be expected to do some homework. Understanding what auditors do in sufficient detail to read an auditors' report does not take as much effort as understanding the workings of the market place or the Black-Scholes model. The auditors' report should not contain a detailed explanation of the audit; it would further reduce users' incentives to understand what auditors do and what the report means. Furthermore, the premise of this question is that the information in the financial statements is not sufficiently relevant and/or useful. If the Board agrees, it should not use the auditors' report as a vehicle to supplement GAAP but should pursue improvements to GAAP to address any perceived shortcomings.

In the more than three decades since I became a CPA, business has become increasingly complex and, accordingly, the accounting and disclosure model has become more complex (e.g., fair value, derivatives, hedging, variable interest entities, securitizations, impairments, etc.). Those who read financial statements have to be expected to do some homework and not expect the notes to the financial statements to be self-study materials explaining all they need to know to understand them.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

Annual reports on Forms 10-K contain financial information well beyond what is required to be directly included in the notes to the financial statements. For example, in Citigroup's 2010 Form 10-K, the financial statements comprise about 50 pages of the filing. MD&A comprises about 45; Risk Factors another 10; global risk management, loan information, and other financial instrument information another 55; information about significant accounting policies and management estimates another 9 pages. Much of that information is detailed information that expands on that required to be reported in the notes to the financial statements. As the Board is aware, auditors are associated with all of that information and as part of the audit perform procedures to satisfy themselves that this additional detail is not inconsistent with the audited financial statements. Further, as the Board is aware, the vast majority of that information is "comforted" by the auditors in connection with any registration statements issued by Citigroup. I'm sure most of the sophisticated users who participated in the Board's outreach are also aware of that.

Requiring the auditors to give some form of assurance on that information would probably not result in much more work on the part of the auditors than they already do on Citigroup's Form 10-K. However, requiring the auditors to give explicit assurance on that information would neither improve its quality nor would it make it any more relevant or useful than it already is. Through the pressure of its review process over the past decades, the SEC has lifted MD&A from surface commentary to meaningful discussion in most instances. Assurance by independent auditors would not improve its quality, but would certainly give plaintiffs one more area to cite the auditors in any legal complaint.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

As the Board recognizes, the auditors' report for registrants is not "pass/fail"; either the financials "pass" or the auditors do not issue a report and the registrant does not file its financials. In the absence of support from a strong, independent audit committee, this situation does put added pressure on auditors in areas that are marginally material as the auditor must choose between an unqualified opinion and refusing to allow filing. Qualified opinions are acceptable on private company financial statements as owners and lenders are often indifferent to technical departures from GAAP if those departures do not impact their primary areas of interest. Such cannot be the case with public markets due to the broad range of users. Accordingly, discussion of any departures from a pass/fail reporting model for registrants is moot; the financials are both fair and acceptable for filing with the SEC or they are not.

*b. If not, why not, and what changes are needed?*

N/A

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

Many users have expressed a belief that a third option between an unmodified opinion and one that is modified for a going concern uncertainty would be useful to investors. This third reporting option exists internationally. Such reporting option has been resisted in the past due to the belief that it would allow auditors to avoid the going concern paragraph when it is necessary. However, having that option would allow the auditor to avoid the all-or-nothing situation currently in place. It would likely reduce the number of reports with the going concern language we see now, but would likely increase the overall number of reports with some level of uncertainty language; many that have unmodified reports now might receive a middle ground report of this nature.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

I preface this with the observation that the size of annual reports now makes it hard to believe that more information will be useful to investors and other users. I question whether they do read all the information they receive currently. I believe the information desired is not information that is being audited and disclosed but information that would impact their assessments of future cash flows, e.g., managements' plans, budgets, expectations and so on; the sort of "forward looking information" the SEC encourages but that management does not disclose for competitive reasons.

That being said, additional information about estimates, judgments, plans and expectations should come from those who generate them – management – and those who are directly responsible for their oversight – the audit committee. Auditors have much knowledge based on their access to management and company information, however, their knowledge is not as broad as management's; it is knowledge in the context of financial reporting and is tied to what has already happened, not what management hopes or believes will happen in the future. Thus, management and to some extent the audit committee, are the only ones with sufficient overall information to judge what is not included in the financial statements that should be or the relative importance among those disclosures that are included.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

Prior to my retirement from public accounting in 2007, I observed first-hand the impact of the Board's inspection process on the conduct of audits. Based on that experience, I believe the Board has had a tremendous impact on the audit profession and on the overall quality of audits. I also believe the level of detail that is reported to audit committees by the auditors and management that is not reported publicly has been instrumental in improving the quality of systems of internal control. The "threat" that significant deficiencies that go un-remediated for an extended period of time could become material weaknesses forces some attention be paid to those deficiencies. Accordingly, the Board should consider working with the SEC to require that managements' reports included in Item 9A of Forms 10-K be expanded to include a discussion of any significant deficiencies that have been un-remediated for an extended period of time (e.g., three years) and managements' explanation for its decision not to undertake remediation efforts. However, the Board should resist the urge to amend AS No. 5 to simply require auditors to include such information in their reports. The improvements to internal control have come because management throughout the organization has taken ownership of the system. Expanding managements' reporting would keep that ownership with management.

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

No I do not.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

I do not support the concept of an AD&A.

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

N/A

*d. If you do not support an AD&A as an alternative, explain why.*

The objective of financial reporting is for the financial statements to provide information that is useful to investors and other users. If the GAAP financial reporting model does not do that, it should be changed so that it does. If additional information related or supportive of the financial statements needs to be reported that is not currently included in requirements under Regulation S-K, the SEC should be requested to consider changing those requirements. In either case, the auditors' report should not be the vehicle used to fix perceived shortcomings in GAAP or Regulation S-K.

That being said, over the years investors and other users have clamored for more and more information to the point that the amount of information provided appears to be overwhelming. Consequently, the call for AD&A or emphasis paragraphs in auditors' reports may be an attempt to have the auditors determine what information users should read and consequently what information they can ignore. Those determinations cannot be made by the auditors. Disclosures about complex financial investments may be important to some equity investors; disclosures about asset impairments may be important to a secured mortgage lender; alleged patent infringement litigation may be important to a purchaser of the subject components. If the auditors address the first two in their report, the user most interested in the third item may not read the financial statements, suffer a loss, and attempt to find fault with the auditors who did not address such matters in the AD&A.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

None. The auditors' job should be to assess whether or not the financial statements are fair and presented in accordance with GAAP. Users may wish to know whether the company's financial management is performing well or not; they should ask the Audit Committee. If they believe additional information should be included, they should comment on FASB/IASB exposure drafts of new reporting standards and express that belief or request the SEC consider expanding Regulation S-K requirements. Investors already have incentives not to read the financial statements in their entirety; the Board should not take actions that might increase those incentives.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

None. Any reports of this type will be boilerplate in nature just as the annual written reports to audit committees. Audit risk is only partly related to the registrant's business risk and not all of those business risks are related to the conduct of an audit. Whether inventory was observed at year end or the end of the third quarter will not change how a strategic investor assesses the registrant's future cash flows. Auditors' internal independence policies are far more restrictive than minimum professional requirements; auditors are either independent or they're not. The level of non-audit service is a small fraction of what it was a decade ago and PCAOB oversight of partner performance assessment (i.e., cross-selling pressures) has effectively put a stop that. As stated previously, an AD&A will only serve to cause users to further limit their reading of the financial statements.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, including "close calls")?*

None. This sort of information is communicated to the audit committee and that body has responsibility for oversight of managements' financial reporting; users, auditors and others do not have, and should not attempt to exercise, that responsibility. If the message to the Board is that audit committees are not effective in that role, the Board should refer that to the SEC for action.

*8. Should a standard format be required for an AD&A? Why or why not?*

No, as discussed above.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

As noted above, I do not agree with the inclusion of an AD&A. The matters discussed in this question are included in the Risk Factors section of the registrant's 10K and comprise many pages of information. My expectation is that the Risk Factors section is not read by users, though some may have word recognition software that searches for key risk terms. Adding that to the auditors' report is unnecessary and may be taken as a negative comment on the SEC's monitoring of the quality of registrant reporting in the risk section of filings. Furthermore, asking auditors to select the most significant of those Risk Factors for inclusion in their reports is tantamount to asking the auditors to advise investors and other users which of the many reported risk factors they should care about. Users will not all place equal weighting on identified risks as they likely have different needs and corresponding sensitivities to various risks. Auditors identify areas of risk for the purpose of designing an audit not for the purpose of advising users as to which risks might be important to them.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

It can't be avoided. Our legal and regulatory systems will drive such reporting to a lowest common denominator.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

As discussed above. This concept undermines management's reporting in MD&A as well as the risk section of registrant filings. Comments as to the level of quality in those areas should be made to the SEC; attempting to cure perceived inadequate reporting under Regulation S-K by means of the auditors' report is both illogical and inappropriate. If users believe managements' reporting of under Regulation S-K is inadequate, they should report that to the SEC not the Board.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

It will result in the transference of portions of MD&A and certain Risk Factors from the legal part of the filing to the auditors' report. The language in the auditors' reports will conform to the language in registrants' Risk Factors and/or MD&A. Our legal and regulatory environments will drive them to agree on common language and thus drive such reporting to a lowest common denominator.

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

They would neither be relevant nor useful. The descriptions of procedures would be necessarily brief. Users who want to understand how auditors assess managements' estimates and judgments should read PCAOB standards or the CAQ Guide. They should also read the notes to the financial statements, not rely on the auditors to tell them which notes to read, which notes they can consequently ignore, and which estimates are important. For example, the note describing Level 3 fair value estimates and changes therein is subject to significant uncertainty as is explained in the note and in the significant accounting policies section of MD&A. If the disclosures are inadequate, they should be expanded. If they're in accordance with GAAP there should be nothing else the auditor could add that would make that information more useful. Any comment by the auditors' on these fair value disclosures would likely result in investors reducing the extent to which they read this note and increasing the extent to which they ignore other notes to the financial statements that are not highlighted in the auditors' report.

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

No. As discussed above this will cause investors and other users to rely on the auditors' report as a source to limit the extent to which they read financial statements and notes. This would also facilitate the development of software that would read the auditors' report, extract the related notes to the financial statements, and effectively eliminate the user's incentive to read the financial statements in their entirety. This implicitly places the auditor in the position of having to guess which areas are important to which users. The auditors' determination of what matters to emphasize would likely differ from those areas that would be emphasized by users and likely different from those areas the Board's inspectors would emphasize subjecting the auditors to additional litigation exposure from the former and criticism from the latter.

*15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

None as discussed above.

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

None as discussed above.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

Boilerplate language cannot be avoided. Language would develop in response to legal challenges and to challenges from the Board's inspection teams; it would seek to limit the inevitable exposure the auditors would face from users who did not read those notes to the financials that would have been relevant to them because such notes and disclosures were not highlighted by the auditors.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

I see no benefits. The inevitable second guessing related to that which was not emphasized is a serious shortcoming.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No. As noted above, the volume of information outside the financial statements exceeds the amount of information inside the financial statements and that volume is such that I question whether users actually use all the information they receive. That being said, if certain information outside the financial statements is deemed to be useful and relevant, and should be the subject of auditor assurance, that suggests that GAAP is currently not adequate to address the needs of investors and other users.

The Board should therefore discuss with the SEC the relocation of such information from Regulation S-K to Regulation S-X. The SEC has the authority to determine what GAAP is for annual reporting by registrants and can therefore require that some or even all MD&A be included as a disclosure in the financial statements. If the Board and the SEC believe that the quality of managements' reporting could be improved by having auditors render a report on MD&A, then relocating MD&A to the first note to the financial statements and having it covered directly by the auditors' report is the best way to accomplish that. This would also help encourage users to read MD&A in conjunction with the financial statements and related notes.

> *a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*
>
> See the comment above.
>
> *b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*
>
> Providing meaningful assurance on non-GAAP information is problematic as there are often no standards that govern its form or composition; one need only read six different loan agreements to see six different definitions of EBITDA to understand that problem. MD&A is addressed above. The continuing evolution of sustainability reporting will likely result in some of this information being included in annual reports to shareholders and any meaningful assurance on such information by auditors is still dependant on real standards as to its nature and composition. In my experience, auditors do read earnings releases prior to their issuance however earnings releases are issued prior to the

completion of the audit. Accordingly, the auditor is not in a position to provide assurance to the public on an earnings release. However, the Board should consider explicitly including preparation and issuance of earnings releases as an activity subject to the system of internal control over financial reporting. Material errors or omissions in such releases would be reported by management in Item 9A and the auditors in their report as resulting from material weaknesses in internal control.

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

None. If information is relevant and useful, it should be included in the financial statements and related disclosures either as a requirement under GAAP as defined by the FASB or a requirement under Regulation S-X (or GAAP as defined by the SEC).

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

As noted above, any assurance on MD&A should be done only if MD&A is included in the financial statements and directly covered by the auditors' report as are the notes to the financials. Information on which auditors routinely provide "comfort" in letters to underwriters is most appropriate for consideration as such information is derived from the registrant's records and subject to the system of internal control over financial reporting.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

I do not believe reporting on MD&A would change either the form or content of those disclosures. Since it is included in the 10-K and auditors are therefore "associated" with that information, they already test those disclosures for consistency with the financial statements and underlying records; for 10-Ks incorporated by reference into registration statements, they are "comforted" in letters to underwriters. I have no expectation that the quality of MD&A would improve as a result of its inclusion in the financial statements and direct coverage by the auditors' report. The SEC has spent decades working to increase the quality of MD&A and the SEC certainly has all the leverage it needs in this area.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

Just as the Board did not look to Attestation Standards for reporting on internal control, it should not look to them in reporting on MD&A. As noted above, if the Board and the SEC conclude that auditor assurance on certain financial information outside the statements is really necessary, then such information should be included in the notes to the statements and covered by the auditors' report.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

See comments above.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

I see no real benefits. If financial information that is currently outside of the financial statements is deemed to be relevant and useful to investors and other users such that auditor assurance is necessary, then by implication

GAAP has not met its objective of providing relevant and useful information in the financial statements. If that is the case, then GAAP should be changed, the information should be included in the notes to the financial statements, and thus covered directly by the auditors' report. As stated previously, auditors are already associated with such information and perform procedures to assess whether any of it is inconsistent with information in the financial statements or obtained in the course of the audit. Providing assurance on it will not change its quality, relevance or usefulness.

The Board might consider the quality of quarterly reports on Forms 10-Q for comparison. The auditors generally issue no review reports on those statements, but users know that a filing cannot occur if the auditors object to any inclusions or exclusions from those documents. The same situation exists with respect to the information outside the financials but included in the Form 10-K. Just as including a review report in the 10-Q filing would not improve the quality of the quarterly report, including some form of assurance on the other information in a 10-K would not improve its quality.

That being said, it may be that auditors are more than willing to provide written assurance on information outside the financial statements as a means of expanding the scope of the services they sell to their audit clients. This would likely not significantly impact larger registrants who are regularly in the market and pay fees for comfort letters as a matter of course. However, smaller registrants would likely see increases in their audit fees to essentially capture the equivalent of comfort letter procedures.

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

• *Reasonable assurance*

• *Auditor's responsibility for fraud*

• *Auditor's responsibility for financial statement disclosures*

• *Management's responsibility for the preparation of the financial statements*

• *Auditor's responsibility for information outside the financial statements*

• *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

I do not. The auditors' report could not be expanded sufficiently to adequately explain these topics. All of these concepts and responsibilities are fully described in PCAOB standards, which are a matter of public record and available at no cost to users. For those who do not choose to invest the time to read those standards in their entirety, there is adequate information available in publications such as the CAQ Guide. The CAQ Guide contains 15 pages of text. Reading that guide one time would not require much effort on the part of investors or other users who are really interested in understanding what auditors' do. My personal belief is that users do not currently read the auditors' 3-paragraph report and none would therefore read a 5-page report.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

No. For a user who reads the CAQ Guide or who actually reads the PCAOB standards all the auditors' report would need to say is "We've audited these financial statements in accordance with PCAOB standards and they are fairly presented in accordance with GAAP." All the rest is just boilerplate.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

None.

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

None.  All of this discussion is about the content of the report, not what auditors actually do.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

I only see shortcomings.  I believe those who take the time to understand what an audit is and what the auditors' report means do not need additional clarifying language in the report.  Those who have not taken the time will not read an expanded auditors' report, at least not more than once.  Therefore I do not believe the matter of auditors' reports is a substantive issue and I do not believe it has been worthy of the Board's time and effort. The longer the report, the less likely users are to invest any time in understanding what the underlying audit process entails.

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

Inclusion of some portion of MD&A in the financial statements appears to be the most appropriate.  The SEC has already determined that the information included in MD&A is both useful and relevant to investors and other users.  Therefore, that information should be included in the financial statements and covered directly by the auditors' report.

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

No.

*25. What alternatives not mentioned in this concept release should the Board consider?*

The Board should consider dropping this project in its entirety. To some extent I believe the Board is being used by those who have come forward on this topic.  Specifically, I believe some are trying to use the auditors' reporting process as a shortcut to reduce the amount of time they should spend reading financial statements and related disclosures.  As noted above, those who are intelligent enough to invest in public companies, especially those who manage large funds, are intelligent enough to read a summary document such as the CAQ Guide and understand what an auditors' report means.  Those individuals would not need an expanded auditors' report after spending an hour reading such a document.

I believe the Board's inspection program has had tremendous impact on the profession and has substantially improved the quality of audits.  The Board should spend its time and attention not only on the inspection program but on the education and training of auditors by means of implementing "best practices" identified by the Board's inspection teams.  The Board should consider using the SEC's model of "standard setting", i.e., directly influencing the private sector standard setters (e.g., IASB and IAASB) and "interpreting" standards set by them.  I note that the ASB and IAASB are in the midst of a reporting project.  The Board could leverage its resources greatly by using that process as a base on which to make any really meaningful changes to the auditors' report.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

No further comments.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

As noted above, I don't believe they will actually read an expanded report any more than they read the current report. However, also as noted above, I believe any addition of "emphasis" paragraphs or "risk discussion" paragraphs would be used as a means to shortcut their responsibilities to read the financial statements and related notes. So yes, we would end up with the equivalent of piecemeal opinions.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

I suggest the Board tell investors and other users to read its standards or read a document such as the CAQ Guide. They would only have to do this once and it would take them less time than they spent telling the Board that they did not understand the auditors' role or the auditors' report.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

Reporting changes will not impact audit quality. Based on my personal experience prior to my retirement from public practice in 2007, the Board's inspection program has been the single biggest factor improving audit quality since I became a CPA over 30 years ago. The Board should spend its time and resources on that program.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

Any changes made should apply to all registrants regardless of size or industry.

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

I agree with those who have commented to the Board already that some of the suggested changes would undermine the credibility of audit committees and would hamper relationships among auditors, audit committees and management. My comments here are meant to augment those observations by others. However, I would note that any changes that would cause users to take less responsibility for understanding the audit process and, more importantly, spend less time reading and understanding the financial statements in their entirety, will result in more instances of poor decisions by those users and increased litigation against auditors, directors and management consistent with our cultural tendency to seek others to blame for our own shortcomings.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

Since I see no benefits, I see no advantages. However, I agree with the Board's observations that many of these proposals would increase time and expense due to increased consultation and quality control procedures not to mention the increase in litigation cost in the future. In addition, the Board should consider the increased time commitments for its own inspectors who will likely spend considerable time evaluating documentation of decisions related to any enhancements or, more likely, lack of enhancements to auditors' reports.

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

None beyond that previously noted.

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

N/A

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

I find it difficult to assess this. For some registrants, it could increase tensions among the three constituencies. However, for some others it could lead to a process whereby they seek to reach a common understanding of what to include and not include. That would likely result in reporting that strives for the lowest common denominator rather than the highest quality reporting possible. As stated previously, I believe that if financial information needs to be improved it should be improved, not circumvented by inclusion in the auditors' report. The financial statements are managements' responsibility and nothing should be done to undermine that. Oversight of management is the audit committee's responsibility and nothing should be done to undermine that. Most of the proposals in the Concept Release would undermine both.

I appreciate the opportunity to offer my comments.

Sincerely,

s/ James L. Fuehrmeyer, Jr.

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Executive Vice President &
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December 13, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 2006-2803

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Board:

Thank you for the opportunity to respond to the Public Company Accounting Oversight Board's Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements."

We believe that the standard of quality financial statements and audits is essential for investor confidence. Therefore, it is critical that auditors need to be independent for their role in the integrity of the audit of a Company's financial statements. However, we do not believe that mandatory audit firm rotation would improve audit quality for the following reasons:

- The expanded role of the Company's audit committee under the Sarbanes-Oxley law is adequate to monitor and evaluate auditor independence. Our annual Proxy Statement includes an "Audit Review Committee Report" that includes our Committee's evaluation of the qualifications and independence of our independent registered public accounting firm and the performance of the independent registered public accounting firm. Our audit committee also has the sole authority and responsibility to select, determine the compensation of, evaluate, and when appropriate, replace the independent registered public accounting firm.
- Mandatory partner rotation requirements are adequate to maintain auditor independence. The rotation brings a new perspective to high risk and to high exposure accounting matters.
- The PCAOB inspection process to monitor audit quality and independence is adequate.
- Audit quality would most likely suffer in the first few years of an audit as the successor auditors begin to understand the business model and the applicable accounting.
- The cost of the audit would most likely increase significantly as more audit hours would be required to learn the accounting and processes at the new client. Likewise, the cost of client support would also increase to support the auditors. We do not believe that the benefit of mandatory auditor rotation would exceed the cost.
- Competition for non-audit services (e.g., tax, valuation, etc.) could be intense and become difficult to meet the independence criteria.

We are also not in support to the Auditor's Discussion and Analysis alternative presented in the Release or auditor assurance on other information outside of the financial statements. We believe that this requirement is not in the scope of an audit and may impair the auditor's independence. We believe that management should be responsible for the quality and transparency of Management's Discussion and Analysis of the Results of Operations and Financial Condition.

We appreciate the Board's consideration of our position on the proposed changes.

Sincerely,

Scott E. Kuechle

Scott E. Kuechle

/mah

September 30, 2011

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Re: PCAOB Rulemaking Docket Matter No. 34, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Board Members and Staff:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release) and respectfully submit our observations and recommendations thereon.

We commend and support the Board on its standard-setting initiative to amend the auditor's reporting model to address the expressed needs of investors and other users of financial information (collectively referred to herein as "investors"). Throughout history and through recent profession research and outreach, we have noted that there are concerns as to the suitability of the current reporting model. We acknowledge and agree that revisiting the reporting model is warranted at this time due to the recent dramatic changes in the global economic environment, as well as the increasing complexity of financial and regulatory reporting, among other factors.

We generally support a combination of the potential reporting alternatives described in the Concept Release. However, we are concerned that focusing changes solely on the auditor's reporting model without considering potential issues or exploring opportunities for improvements in other aspects of the financial reporting model may result in marginal improvements in the usefulness of the auditor's report, as well as unintended consequences for investors and the financial markets. Our participation in profession outreach and firm discussions indicate that many of the areas for potentially increasing the quality of the financial reporting model go beyond the auditor's report. These areas generally include the current financial and regulatory reporting framework, the role and communication responsibilities of the audit committee, the transparency of management's disclosures within and outside of the financial statements, including Management's Discussion and Analysis (MD&A), and overall investor education and awareness. As discussed below, we believe that broader initiatives and outreach are needed to assess and inform recommendations in each of these areas.

The Concept Release describes the current auditor's report as a pass/fail model. Although this is true with respect to the fairly standardized language used by accounting firms, we would note that for a public company, only an unqualified opinion (pass) is accepted by the U.S. Securities and Exchange Commission (SEC or Commission). Unlike the views expressed by certain investors, we believe that, in consideration of this standardized language, the SEC's position provides ample leverage for the auditor to "effect appropriate change in the company's financial statements" (page 9 of the Concept Release) based on the applicable financial reporting framework. Certain of the Board's potential reporting alternatives attempt to address this investor view by requiring auditors to disclose their views regarding the sufficiency and appropriateness, among other matters, of certain of management's financial reporting decisions and disclosures. We believe that such commentary, on what also may be deemed confidential company information, could essentially provide information that management may not agree with nor find necessary to meet their reporting requirements. Other proposed alternatives contemplate an auditor's discussion about audit risks, related audit procedures and results, and auditor independence for investors to, in effect, assess the adequacy of the audit engagement and the accuracy of the related financial statements. While we believe that it may be possible to devise a standard that prescribes such reporting, we question whether this would truly address investor needs. In our view, the lack of transparency into the specific audit process details may not be a key investor concern and would be better relegated to the audit committee and the PCAOB to assess. We note that the implications of this aspect of auditor reporting also seem to imply a lack of trust or obfuscation inherent in management's reporting process and a possible need for assurance on other types of information communicated to investors. We believe that the latter would come at a greater cost and delay the timely reporting of financial information to the marketplace.

The value of the current auditor's report is that it provides an objective and independent opinion on financial statement compliance with an applicable financial reporting framework. The auditor is not in a position to serve as an analyst, which would blur the lines between the financial statement and the business and operational risks. Nor do we believe that an investor can accurately make allowances or adjustments for auditor subjectivity in assessing and making investment decisions based on their limited understanding of audit precision and processes. We do not believe that moving in this direction will address the issues with the current financial reporting model.

Stakeholders have continued to express concerns relating to the increasing complexity of financial reporting and the foundational aspects of auditing, including auditor objectivity and skepticism. Some form of enhanced reporting could improve the reliability of information used for investment decision making, while increasing investor trust and confidence. However, we note that challenges to the transparency and accuracy of financial information could arise from many factors, including the need for more timely information, deception or fraud, complexity of the underlying framework and significant changes thereto, and familiarity to name a few. The Board and the SEC may need to explore other opportunities to address such factors.

As expressed previously, we note that there are other standard-setter and regulator initiatives to assess the various auditor reporting models used today. In that context, we believe that it is imperative for the Board to work closely with other organizations, including the International Auditing and Assurance Standards Board (IAASB), to propose a global solution, including recommendations to other parties involved in the financial reporting process. Although the Board oversees the audits of public companies, as well as certain other organizations, to protect investor interests, we believe that those interests exist worldwide. Inconsistent approaches could bring about additional confusion among investors.

The following provides our specific views on the potential reporting alternatives and the Board's considerations related to changing the auditor's reporting model.

## Potential alternatives for changes to the auditor's report

Our views as to each of the potential reporting alternatives are expressed below. Overall, we support a short-term solution that includes a combination of certain elements of the alternatives proposed in the Concept Release: clarifying language in the standard auditor's report and the required use of emphasis of matter paragraphs. This specific combination should generally improve auditor communications to investors, while allowing more time for the Board to consider additional outreach along with other professional bodies. We encourage the Board to consider other alternatives, including the feasibility of an Auditor's Discussion and Analysis (AD&A), in a separate workstream that would also benefit from continued outreach and coordination with other regulators and standard-setters.

With respect to whether the changes being considered should apply equally to all audit reports filed with the SEC, we believe that the Board should proceed with caution, particularly for non-issuer affiliated entity audit reports filed as part of an issuer's filing or even employee benefit plans that file a Form 11-K. We suggest that the Board seek additional guidance on this matter upon issuing its proposed standards, as views may differ depending on the alternatives that are ultimately adopted.

### Auditor's Discussion and Analysis

We acknowledge that investors demand and need certain information for their investment decision making and that those needs should be addressed not only by the Board but also the SEC and the Financial Accounting Standards Board (FASB). The nature and extent of the information that is needed and by whom it should be provided is a vital consideration. We acknowledge the views expressed in various profession outreach and discussion forums that expanding the role of the auditor and leveraging the auditor's knowledge obtained throughout the audit process and other auditor related interactions could be valuable to investors. Thus, we support further evaluation by the Board and other standard-setters of the auditor's role and reporting responsibilities, including the use of an AD&A. Our comments below highlight some challenges both in mindset and current responsibilities that would need to be assessed and considered in further evaluating the feasibility of an AD&A within the context of the current financial and regulatory reporting framework.

Several Board members have indicated that an AD&A could be very costly in addition to other auditor requirements (refer to our comments below regarding the effects on audit effort). The Board also acknowledges that new auditing standards would need to be developed in collaboration with the SEC. We agree that this deserves much more attention and discussion so that information is appropriately provided to investors. In consideration of the potential costs and litigation risks involved, however, a more viable approach may be to strengthen the financial reporting requirements allowing management to provide the necessary information and the auditor to provide assurance on such information, such as enhanced MD&A. Generally, auditor involvement would drive better behavior. This is discussed further below

First and foremost, however, it is currently not the auditor's responsibility, nor does the auditor have the appropriate authority, to disclose information related to the company or its financial statements without specific consent (refer to our specific comments on confidentiality below). We believe that management has and would have the primary and sole responsibility to disclose such information, including the matters concerning management's judgments and estimates and accounting policies and practices described on pages 16 and 17 of the Concept Release, to users of the company's financial statements. Management's disclosures are also considered and approved by the audit committee. If investors believe that management's disclosures related to these or other matters are currently inadequate or obfuscated, it would be the FASB's and the SEC's responsibility to appropriately modify the accounting and regulatory presentation and disclosure requirements to meet investor needs. Disclosures made directly by the auditor to *fill the gap* could be seen by investors as likely more important or reliable than management's required disclosures. Such a change in focus would diminish the value of management's disclosures – those made by the people in the best position to enlighten investors – and elevate inappropriately the value of the auditor's disclosures, which are based on inherently inferior information.

Also, as previously noted, an auditor does not serve as, and is not trained to be, an analyst. Because an auditor reports on historical financial information, the Board cannot reasonably expect that an AD&A would enable investors "… to assess how changes in the economy might affect a company's future financial performance or condition" (page 8 of the Concept Release). This is clearly beyond the scope of an audit and could potentially conflict with the requirements therewith. We have the same view as it relates to any required discussion regarding business, strategic, or operational risks; however, we acknowledge that further exploration for auditor attestation in such areas, pursuant to an appropriate framework for management to operate in, would be worthwhile. In addition, performing an analyst-type role would require extensive training and significant costs for audit firms. We are concerned that an AD&A might be viewed as an alternative for the investor to perform a thoughtful review of MD&A. One of the objectives of MD&A is to provide information about the quality and potential variability of the company's earnings and cash flows so that investors can ascertain the likelihood that past performance is indicative of future performance (see Commission Statement About Management's Discussion and Analysis of Financial Condition and Results of Operations, Release No. 33-8056 issued Jan. 22, 2002). We believe that auditor assurance on some aspects of MD&A would provide greater value to investors by enhancing the quality and reliability of the information presented, as further described in our comments below.

Further, as proposed, certain potential AD&A content, particularly content related to difficult or contentious issues and "close calls," seems to undermine the convictions inherent in the auditor's opinion on the financial statements from two different but related perspectives. The first relates to the discussion about matters that are deemed acceptable within the applicable financial reporting framework or were appropriately corrected to comply with that framework but required significant deliberation or audit effort. We believe that such discussion can convey an inappropriate message that the auditor may not be objective by actually being a part of the company's system of internal control as it relates to the matters corrected. Additionally, matters that require significant deliberation or audit effort ordinarily would be those with significant risks that easily could be highlighted through the use of an emphasis of matter paragraph, as discussed in our subsequent comments. The second relates to the discussion about matters that are in technical compliance but "could be enhanced to provide the investor with an improved understanding," matters where the auditor believes that management "could have applied different accounting or disclosures," and *significant* matters that are "not necessarily material to the financial statements, and management does not adequately address the matter" (pages 9, 13, and 18 of the Concept Release). In this regard, another area that would need to be explored and assessed by the Board would be the education of and communication with the users of such information. It is possible that, if not properly understood or explained, such disclosures could raise doubts or uncertainties as to the appropriateness of the auditor's unqualified opinion by indirectly promoting the use of an AD&A as a substitute for a modified opinion for a departure from the framework, including a lack of fair presentation by omitting or providing incomplete disclosures.

In regards to changes in accounting principles and the application of different accounting principles or disclosures, we believe that the SEC's filing requirements related to preferability letters effectively eliminate the need for additional discussion in an AD&A. In either of the two aforementioned scenarios, we believe that the auditor's perspectives should not differ from those of management, as implied on page14 of the Concept Release, for to do so could result in challenges to the validity of the auditor's opinion. We do, however, acknowledge that additional discussion or disclosure by management may be beneficial related to areas where estimates or fair value determinations are necessary. Recent FASB issuances and SEC comments to issuers have focused on expanding such disclosures to highlight key assumptions, methods, and the like. But, such expanded disclosures may be difficult for an investor to factor into their assessment. In our experience, we have noted, for example, that the application of *FASB Accounting Standards Codification®* (ASC) 820 "Fair Value Measurements and Disclosures" allows for application of differing valuation methods. While the standard suggests certain implementation criteria, preparers and valuation experts may differ in selecting the most appropriate method or when multiple methods provide a better answer. We believe more clarity around such disclosures, and auditor involvement, particularly in MD&A, may be beneficial to investors.

We believe that the Board also should consider the following additional matters in the context of evaluating the operability and appropriateness of an AD&A:

- A standard report format would be necessary, along with clear and concise criteria related to its content. It is apparent to us that there are differing views as to what is expected in an AD&A and what an AD&A may encompass. We generally believe that introducing subjective assessments can undermine the overall quality of the auditor's opinion on the financial statements. In addition, such assessments would often relate specifically to the issuer without providing the investor with the benefit of a total view of the marketplace. For example, commenting on an issuer's specific estimate with regard to a warranty reserve would be limited to the auditor's knowledge of that particular issuer's methods and assumptions; so, in that context, the auditor commentary would be limited to that assessment. It would be difficult for an investor to put such an assessment into context or compare it across like companies in the same industry.

- Discussions in an AD&A regarding independence could be misused from an investment perspective causing undue harm to the company (refer to our comments below regarding auditor independence). We believe that the audit committee is appropriately charged with the appointment and oversight of the auditor and that the assessment of the auditor's relationships and independence is best left to the audit committee. If proxy materials need to be enhanced to include discussions regarding auditor independence for purposes of making voting decisions, we believe that the SEC should be charged with considering whether amendments to their disclosure rules are necessary.

- With regard to matters related to internal control over financial reporting, we believe that the internal control disclosures, including those related to material weaknesses, that are currently required are sufficient. We do not fully understand what is intended by a discussion about *significant deliberations* in this area and whether such discussion would include the communication of significant deficiencies or other significant internal control processes that may be effective. By no means do we believe that the Board should require auditor discussions in this area beyond the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and the related SEC rules and regulations. However, we do recognize that adopting certain reporting alternatives may require conforming amendments to an audit report on the effectiveness of internal control over financial reporting. For example, if the financial statement audit report was amended to describe the auditor's responsibility for other information, similar modifications may be needed in the internal control audit report. At this time, we do not envision any other needed amendments to that report.

For additional considerations, we refer the Board to our comments on the use of emphasis of matter paragraphs with respect to auditor discussions regarding significant risks and audit procedures. For an AD&A, we believe that the Board would need to develop suitable criteria that will strike an appropriate balance between providing relevant information to investors and describing the significant risks and related audit procedures and results. In addition, we believe that investors will be challenged to make adequate judgments about the sufficiency and appropriateness of the audit, including its precision, from one report to another, without having a full understanding of each individual audit engagement. Lengthy audit reports that provide significant details would seem to defeat the purpose of focusing investor attention on significant matters in the financial statements and also increasing investor confidence as to the reliability of information outside the financial statements. Language that summarizes the procedures would be too general in nature to be useful.

As an aside, we do not understand the language used in the Concept Release as to whether the Board foresees the need for a discussion of immaterial matters, which we think would make an AD&A ineffective. For example, we do not believe that a matter can be both significant but not necessarily material. This type of language challenges the notion of fair presentation and the fact that matters can be qualitatively material.

Overall, we recognize that there are many challenges to an AD&A approach for the Board to consider and overcome. Accordingly, we believe that the potential use of an AD&A would benefit from further dialogue and outreach, as part of a longer term project.

### Required and expanded use of emphasis paragraphs

We believe that defining situations requiring the use of emphasis of matter paragraphs in all audit reports may result in improvements to auditor reporting and investor analysis. Although we continue to believe that investors must read the financial statements as a whole, we also believe that emphasis of matter paragraphs may assist investors in analyzing those financial statements by directing them, or providing a *roadmap*, to the more significant matters. The usefulness of such paragraphs, however, will depend on the matters to be emphasized and the detail provided by management in the underlying financial statements. However, as with an AD&A, there is a potential increase in the risk of litigation against audit firms (see our comments below on liability considerations).

The Concept Release notes on page 21 that the auditor could emphasize "…those matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty." We believe that this *criteria* may be too broad and could result in drawn out audit reports that do not necessarily focus investors on significant matters, particularly as certain significant matters are quite common across various industries. We believe that the matters to be emphasized should not include all significant management judgments and estimates or all matters with complex or subjective measurements. To do so, could overshadow the importance of other matters, such as those listed above. Thus, it will be necessary for the Board to develop suitable criteria to assist auditors in determining the matters to be emphasized.

Matters that we believe may be most useful to investors are those that, based on auditor judgment, are not only significant but are unusual or non-recurring. Significant matters to be emphasized also could be similar to, but not the same as, those deemed by the auditor as significant risks. These matters could include:

- recent significant economic or other developments
- complex transactions or significant transactions with related parties

- measurements involving a wide range of measurement uncertainty, such as litigation
- transactions outside of the normal course of business or outside of industry norm.

Additionally, since we believe that the primary purpose of an emphasis of matter paragraph is to direct investors to significant matters, such paragraphs should simply identify the matter being emphasized and refer to the note to the financial statements that describes the matter. The auditor's emphasis of matter paragraph should not attempt to recreate or summarize the company's disclosure because investors should read the entire disclosure in context. In this regard, the auditor's required use of emphasis of matter paragraphs could generally improve management's disclosures.

Further, we believe that an emphasis of matter paragraph should not include a description of the audit procedures performed on the particular matter for several reasons. Audit procedures can vary significantly and are particularly dependent on the nature and depth of management's processes and supporting documentation. Consequently, investors, particularly those that are unfamiliar with audit standards and related guidance, may be unable to properly use such information in a logical or consistent manner. Inappropriate conclusions also can be reached as to the assurance expressed by the auditor (that is, a piecemeal opinion on the matter, rather than on the financial statements as a whole) and the appropriateness and sufficiency of the procedures between companies and audits. We do not believe that investors are seeking long form reports that include drawn out descriptions of audit procedures and results. Accordingly, the auditor's description may be at a higher level resulting in fairly boilerplate language that may not be deemed useful. In some respects, audit procedures also should remain confidential and unpredictable.

### Auditor assurance on other information outside the financial statements

In addition to modifying the standard auditor's report for the purpose of enhancing investment making decisions, we support a separate Board initiative, jointly with the SEC, to consider auditor assurance on information outside the financial statements and whether there is investor and market demand for such assurance. We genuinely believe that auditor assurance could enhance the quality and reliability of such information, in particular MD&A, which is used and relied on by investors today. In addition, unlike the AD&A reporting alternative, auditor assurance on information outside the financial statements maintains the appropriate lines of accountability between the auditor and management.

We believe that auditor assurance on information outside the financial statements generally would start with exploring additional involvement in certain areas of the issuer's MD&A. Auditor assurance would be difficult for information containing forecasts, projections, and subjective assertions due to its measurability and subjectivity, without the development of an appropriate framework and criteria. Thus, much of the information in earnings releases may not be conducive to auditor assurance. If the auditor were to report on only a portion(s) of MD&A, we believe that the information not covered by the auditor's report would need to be clearly differentiated and that the quality and reliability of that information could vary.

AT sec. 701, *Management's Discussion and Analysis*, provides a starting point for guidance for an assurance engagement related to MD&A. However, because AT sec. 701 has not been updated since 2001 and is rarely used, modifications may be necessary based on changes in the MD&A requirements. The framework and criteria for AT sec. 701 is based on SEC presentation and disclosure requirements. If the auditor were to report on other types of information outside the financial statements, suitable criteria against which the auditor would evaluate the information may need to be developed depending on the information presented.

To develop the standards and potential regulations necessary to facilitate auditor assurance on information outside the financial statements, we believe that additional outreach will be critical. Issues to be addressed might include the following:

- the sufficiency of the information presented. Changes in regulations may be necessary to modify or expand the disclosures to meet investor needs.
- the performance of an examination or a review engagement. The nature of a review may not necessarily boost investor confidence as to the information presented or it may be misunderstood as to the level of assurance provided.
- the form of opinion. An opinion on MD&A differs from an opinion as to *fair presentation* on audited financial statements. Investors may need to be well-informed on this matter.
- the nature, timing, and extent of related Board inspections. If AT sec. 701 were to be used in the short term, inspections could inform decisions about whether changes are necessary.
- the costs involved and whether the benefits outweigh those costs. Refer to our comments below regarding the effects on audit effort, including the potential impact on the ability for auditors to complete such work within the current issuer filing deadlines.

### Clarification of the standard auditor's report

Overall, we believe that adding certain clarifying language in the standard auditor's report is both appropriate and in the public interest. Considering the fact that there is a wide range of investors with various levels of knowledge, we support the general investor view that such language could enhance an investor's understanding of an audit and of the auditor's and management's responsibilities. We do not believe that any of the potential clarifications would affect either the scope of the audit or the auditor's responsibilities. Our specific views as to each of the potential clarifications follow.

- *Reasonable assurance* – Because the concept of reasonable assurance may not be fully understood by all investors, we understand the impetus to provide additional clarification around this term. However, we believe that simply adding a statement indicating that reasonable assurance is a *high level of assurance, but not absolute assurance* would not fully address the concern, particularly for less sophisticated investors. The Concept Release notes on page C-18: "Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. Therefore, an audit may not detect a material misstatement." We believe that combining the concept that reasonable assurance, although a high level of assurance, is not absolute assurance with the notion that a material misstatement, due to error or fraud, may remain undetected would provide much better clarity to an investor. We understand, however, that such language may be erroneously viewed as self-serving. As such, addressing the auditor's risk assessments, as described below, may be a more appropriate change.

- *Auditor's responsibility for fraud* – We support clarifying the standard auditor's report to indicate that the auditor is required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement, due to error or fraud. Management, however, has the same responsibility as it relates to preparation and fair presentation. Accordingly, we believe that the description of management's responsibility also should refer to both error and fraud. In addition, because the risks of material misstatement due to fraud differ from those due to error, a discussion in the auditor's report indicating that the audit procedures are based on the auditor's assessment of risks might be helpful. This discussion could be similar to that included in an auditor's report issued in accordance with International Standards on Auditing (ISA).

- *Auditor's responsibility for financial statement disclosures* – We also support referring to the related notes to the financial statements within the introductory paragraph of the standard auditor's report. Such reference will more clearly identify the financial statements subject to audit and covered by the auditor's opinion and will give more prominence to the auditor's responsibility for disclosures.

- *Management's responsibility for the preparation of the financial statements* – To more fully describe what is currently meant by the phrase *these financial statements are the responsibility of the company's management*, we agree with clarifying management's responsibility by stating that management is responsible for the preparation and fair presentation of the financial statements in accordance with generally accepted accounting principles (or other applicable financial reporting framework). Management, however, also is responsible for establishing and maintaining effective internal control over financial reporting. As such, we believe that management's responsibility for such internal control should be included within that description. To visibly separate management's responsibility from that of the auditors, we believe that the description of management's responsibility should be included in a separate paragraph following the introductory paragraph of the standard auditor's report.

- *Auditor's responsibility for information outside the financial statements* – We understand how some unsophisticated investors may misinterpret the auditor's responsibility regarding other information presented outside the financial statements. Although clarifying such responsibility within the standard auditor's report could benefit those investors, we believe that there are certain drawbacks to be considered by the Board. Today's electronic environment can pose various challenges, particularly in describing the auditor's responsibility to read the other information and to consider whether the information is materially inconsistent with the financial statements. Although such description may be appropriate in a specific document or filing, it can be misconstrued when the same financial statements and related auditor's report are included on a website or otherwise distributed with additional information that was not subjected to these procedures. Also, depending on the form and content of the description, there may be other unanticipated consequences when the financial statements are included or incorporated by reference in a subsequent filing under the Securities Act of 1933, particularly for predecessor auditors.

Further, by indicating that the auditor has a responsibility to read the other information and to consider material inconsistencies, a user of the auditor's report may gain more comfort than what is intended by these procedures. Accordingly, what we believe needs to be clear to a user is that the auditor does not corroborate other information contained outside the financial statements and related notes and schedules and that the auditor does not express an opinion on such information. This form of description would be appropriate regardless of where the financial statements and related auditor's report are filed, included, or otherwise distributed. We view such a description as an additional communication that would be included in a separate paragraph following the opinion paragraph. That said, we encourage the Board to work with the IAASB with regard to the auditor's responsibility for other information to ensure a practical and operational approach.

- *Auditor independence* – We concur with the outreach participants views that the title of the standard auditor's report conveys compliance with the relevant independence rules and that additional discussion about independence could be redundant. Accordingly, we believe that an explicit statement regarding independence, in addition to the report title, does not seem warranted. If the Board were to consider requiring such a statement, it is important for the Board to consider the nature and extent of that statement and how it may be perceived by investors. Differing independence rules may apply, including their application to affiliated entities, depending on the circumstances. Because the rules are quite complex, investors may not fully understand these differences and may wrongly perceive a greater or lower level of assurance from one report to another. In which case, a general statement regarding compliance with the *applicable* rules may be more appropriate.

We believe that other potential clarifications or improvements to the standard auditor's report could include the use of headings, similar to the ISAs. Not only will such report format converge internationally promoting investor's understanding worldwide, it would also facilitate the potential additional reporting alternatives described in the Concept Release by differentiating the auditor's additional communications. As you may have noted, our views on report clarifications are based on achieving consistency between standard report language worldwide.

## Considerations related to changing the auditor's report

As the Concept Release describes, there could be practical challenges as well as unintended consequences related to certain potential reporting alternatives. Our views on these matters are discussed in more detail below.

### Effects on audit effort

As previously indicated, we generally believe that adding certain clarifying language in the standard auditor's report would not affect either the scope of the audit or the auditor's responsibilities. Other than the timing and costs involved in updating firm materials, this reporting alternative would have the least effect on audit effort. On the other hand, auditor assurance on other information would greatly affect audit effort and substantially increase audit costs because this would constitute a separate engagement that is rarely being performed today due, historically, to market demand and cost. For this type of engagement, in addition to considering the benefits to investors and the costs to companies and their auditors, consideration would need to be given to the ability to meet filing deadlines, which were accelerated to provide more timely information to investors.

We believe that the AD&A and the required and expanded use of emphasis paragraphs, particularly if such paragraphs describe the audit procedures performed, also would affect audit effort and costs, even though these reporting alternatives are not intended to affect audit scope or audit procedures. Obviously, the AD&A would have a greater affect, as we agree with the issues described in the Concept Release related to the need for increased quality control procedures over non-standardized reports, as well as the potential for significant discussions and debates with management and the audit committee. We also believe that an AD&A would require extensive training and quality monitoring by audit firms.

Effects on the auditor's relationships

We think it is important for the Board to consider the potential effects that requiring an AD&A might have on auditor relationships with management and the audit committee and whether such effects could result in possible audit quality challenges. We believe that the effectiveness of the audit could be affected primarily by the nature of the information that would be expected to be disclosed and commented on in the AD&A. Because the audit committee represents the interests of investors, we believe that there needs to be a further assessment of the audit committee's role in this proposed approach. It is critical that the responsibility of the audit committee be defined with respect to overseeing the auditor in their process of developing an AD&A, in particular, and also in the other areas of expanded auditor disclosure and potential involvement.

On page 32, the Concept Release indicates that management and the audit committee "…might be compelled to change the financial statements, in order to eliminate differences between the company's disclosures and the auditor's discussion in the audit report." Consistent with our previous concerns, it appears that the Board is concerned that without requiring an AD&A, a company's disclosures may be deemed deficient. We note that the auditor must evaluate the appropriateness of the company's disclosures against the requirements of the applicable financial reporting framework. As we previously expressed, an AD&A should not be used to disclose information that management should have otherwise disclosed in the financial statements in order to preclude a modified opinion.

Effects on audit committee governance

The audit committee plays an important role by challenging the company's activities in the financial arena and overseeing the auditor. We do not necessarily believe that information provided by the auditor would undermine the governance role of the audit committee. We do, however, believe that management and the audit committee have the primary responsibilities to communicate company matters to investors. Expanding that responsibility to allow the auditor to make assertions about the company would be a significant shift, and the impact of that shift would need to be considered and vetted against the current role of the audit committee, including the need to be cautious so as not to inappropriately suggest that governance disclosures may exist. We believe that the PCAOB could join efforts with other regulators and industry groups, including for example the SEC and National Association of Corporate Directors, to enhance the current reporting model for audit committees. Such reporting model, for example, could include the audit committee's views on significant matters, not necessarily the auditor's procedures on those matters.

Liability considerations

As recognized by the Board, changes in the role of the auditor and related reporting could have significant repercussions to auditor liability. Whether such information is furnished or filed or whether the auditor disclosures or involvement in other information could be accompanied by legal disclaimers are key questions that need answering. What might be perceived to be minor modifications might result in more time in the courtroom. With regard to an AD&A, we believe that it is highly likely that investors would place more weight on the auditor's perspectives about the company's financial statements, which could, in the glare of hindsight, result in allegations of harm by investors against the audit firm claiming inadequate, incomplete, or inaccurate auditor discussions. Furnishing, rather than filing, such information may be a factor with respect to the litigation exposure of these allegations and the auditor's liability related thereto.

Potential litigation also may result from the use of emphasis of matter paragraphs, particularly since such paragraphs are included within the auditor's report and would be deemed filed, rather than furnished. Regardless of whether suitable criteria are developed for the inclusion of such paragraphs in the standard auditor's report, we believe that there will always be some element of auditor judgment as to the significance of the particular matter. The auditor's judgment may be questioned by those who view a particular matter to be significant but not emphasized. Over time, any type of litigation increases audit costs.

Confidentiality

We are concerned that some aspects of the proposed AD&A could cause the auditor to violate professional ethical requirements relating to confidential client information by requiring the auditor to disclose information that has not been previously disclosed by the company. This could also be viewed as a breach of trust and confidence. Further, it could potentially jeopardize the auditor's independence and objectivity by performing this management function and by communicating matters that may be perceived as the auditor being a company advocate. While this discussion highlights what may be somewhat extreme implications of the disclosures, we think these are important considerations, which any proposed rulemaking would need to address.

In summary, we strongly support the Board's efforts to assess possible revisions to the auditor's reporting model to enhance the relevance and usefulness of the current financial reporting model. We also support moving with measured caution in that regard due to the potentially significant change in the role and expectations of the auditor that certain of the proposed amendments would entail. We have noted certain short-term amendments that could be implemented and encourage more study and collaborative efforts with other regulators and standard-setters on the more challenging proposals.

We would be pleased to discuss our letter with you. If you have any questions, please contact Karin A. French, National Managing Partner of Professional Standards, at (312) 602-9160.

Sincerely,

Grant Thornton LLP

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2011 Sep 26

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 34

Dear PCAOB Members and Staff:

I appreciate the opportunity to comment on the 2011 Jun 21 PCAOB Release No. 2011-003 (PCAOB Rulemaking Docket Matter No. 34), *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. Please note that the views expressed in this comment letter are my own and not those of any past employers or other parties.

My opinions are informed by a career of more than twenty years in accounting. My first six years in accounting were spent in the audit (assurance) practices of two Big X accounting firms. The remainder of my accounting career included financial reporting and/or corporate controller positions at three small to mid-sized international companies which were headquartered in the United States and whose common stock traded publicly in the United States; therefore, these companies were domestic SEC registrants subject to SEC filing and financial reporting requirements. I am now retired from accounting, so my present relationship to the financial reporting process is primarily as an investor (a financial statement “user”).

Before presenting my answers to the various questions proposed by the Board about possible changes to the financial reporting model, I think it is important to briefly state my perspective on two underlying matters.

First, since the auditors’ report is on external financial statements, I think it is important to note my perspective on the purpose of external financial statements. I think that the purpose of external financial statements is to provide information to investors and potential investors in a business enterprise (a “company”) about the company’s financial position at a point in time and about changes in that financial position from the last time it was reported. For the matters at hand—possible changes to the auditor's reporting model, I do not think it is necessary in this letter to further discuss the definition of a "business enterprise" or "company". I think that the Board and I generally have the same conception of these terms, while sharing an awareness of the difficulties in many marginal situations of determining what is or is not a business enterprise and what its extent is (see, for example, the discussion at FASB Accounting Standards Codification (ASC) 805-10-55 regarding the definition of a "business").[1] I define "investors" as persons or entities that contribute resources of financial value to a company in the form of debt or equity. For the matters at hand, I do not think it is necessary in this letter to further consider the categorization of contributions of resources between debt, equity, or something in between.

Second, I think it is important to state my perspective on the purpose of the auditors' report on external financial statements. These are as follows:

1. To document that the financial statements were audited.
2. To document who performed the audit and whether or not they were independent of the company.
3. To specify which financial statements were audited and whether any limitations were placed on the scope of those audits.
4. To specify the standard against which the financial statements were evaluated by the audit. For public companies registered in the United States, this is almost always U.S. generally accepted accounting principles (GAAP).
5. To specify the standard under which the audit procedures were conducted. For public companies registered in the United States, this is the standards of the Public Company Accounting Oversight Board (PCAOB).
6. To present the auditor's opinion about the compliance of the financial statements with GAAP based on the audit.

My responses to your questions in the concept release are based on these two perspectives.

**Questions and Responses:**

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

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[1] My comments in this letter also do not pertain to financial statements and the associated auditors' reports for not-for-profit and governmental entities because I do not have recent extensive experience with the accounting for or auditing of these types of entities. However, I understand that auditor's reports for these types of entities are not within the scope of the concept release and are generally outside the Board's purview.

Yes, the Board should undertake a standard-setting initiative to consider improvements to the auditor's reporting model. It has been over 20 years since the auditor's reporting model has been comprehensively revised, and continuous improvement of the model is a worthwhile activity.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

I think the auditor's report could be revised to better inform readers of what a financial statement audit entails and what the auditor's opinion on those financial statements means (and, to some extent, does not mean). My thoughts on these matters are further elaborated in my responses to the additional questions below.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

No, I do not think that the Board should consider expanding the auditor's role to provide assurance on matters in addition to the financial statements. I think that this matter is a consideration for the U.S. Securities and Exchange Commission (SEC), not the Board. Jurisdictional issues aside, I am opposed to requirements to expand the role of the auditor to provide assurance on matters in addition to the financial statements. My thoughts on this topic are further described in my responses to the additional questions below.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

Yes, the auditor's report should retain the pass/fail model. Financial statements used for external financial reporting under U.S. securities laws and regulations must be prepared, in all material respects, in accordance with GAAP. Either they are so prepared or they are not. Trying to make sense of the myriad of possible points in the middle is an auditing, regulatory, and reporting quagmire best avoided.

*b. If not, why not, and what changes are needed?*

N/A.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

For those financial statements that are not prepared, in all material respects, in accordance with GAAP, it would be useful for users of the financial statements for the auditor's report to, as briefly as possible, note the areas of material departure from GAAP.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

It is appropriate for management to provide additional information regarding the company's financial statements to financial statement users. Management is responsible for communicating all relevant information regarding the matters addressed in the financial statements to users in accordance with legal and regulatory requirements and in accordance with sound business practice. The audit committee may provide information about its role with respect to the financial statements and relevant comments arising from its performance of that role.

The role of auditor is to audit the financial statements for conformity with GAAP and to express an opinion about the conformity of those financial statements with GAAP. Other communications regarding the financial statements are beyond the scope of the auditor's association with the financial statements, and may also involve matters that are beyond the auditor's areas of expertise.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

I have no comment on this question at this time.

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

No, the Board should not consider an AD&A as an alternative for providing additional information in the auditor's report.

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

N/A.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

No, I do not think that there should be an AD&A commenting on either the audit or the company's financial statements.

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

I do not think an AD&A is an appropriate forum for the communication of information for making investment decisions.

*d. If you do not support an AD&A as an alternative, explain why.*

The matters suggested in the concept release for discussion in the AD&A are not appropriate to this type of report from a financial statement auditor:

- *Audit risk* – The auditor is responsible for reducing audit risk to a sufficiently low level to provide reasonable assurance that the auditor's opinion on the financial statements is correct. This fact should be described in the auditor's report. For many, if not all, audit engagements, it is not possible for the auditor to meaningfully address audit risk in a report of reasonable length, and attempts to do so could be misleading to the reader. For example, the idea of discussing audit risk in the AD&A seems to suggest a discussion of inherent risk and internal control risk. However, these risks are not relevant to the financial statement user's reliance on financial statements on which the auditor has rendered an unqualified opinion, because when designing audit procedures, the auditor will consider the level of inherent and internal control risks in order to perform an audit that provides reasonable support for his or her opinion. In any case, the Sarbanes Oxley Act and related regulations already prescribe requirements for management and auditor reporting of material matters with respect to internal control risk.
- *Audit procedures and results* – The auditor's report should provide a high-level (one paragraph) summary of the basic steps and types of procedures performed in a financial statement audit. The second paragraph of the current standard auditor's report attempts to do this, but perhaps this discussion could be slightly deepened to give a clearer sense of the general types of procedures used in a financial statement audit. However, the purpose of this explanation is to

provide some context for the statement that an audit provides *reasonable*, but not *absolute* assurance, that the financial statements are free of material misstatement. Actually, the most important point in the discussion of audit procedures in the auditor's report is documenting the auditing standards applied, rather than any digression into the details of audit procedures; the financial statement user can then consult these standards to obtain a deeper understanding of the audit process. The existing standard auditor's report already gives the results of the audit—the auditor's opinion. The suggestion to provide more information about the audit procedures seems to shift some responsibility for ensuring the auditor has done adequate work to support his or her opinion from the auditor to the financial statement user. This is inappropriate. In summary, the suggestion noted on page 13 of the concept release that an AD&A could "provide the auditor with the ability to communicate to investors and other users of financial statements the auditor's significant judgments in forming the audit opinion" is misguided.

- *Auditor independence* – The auditor's report should state that the auditor is independent and refer to the standard by which "independence" is determined. There is no need for further elaboration in an AD&A; independence standards are readily available for review by any interested party.
- *Auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues (including "close calls")* – Accounting policies and practices and the use of judgments and estimates are financial reporting issues that should be addressed in the relevant places in the financial statements. If there exists a general opinion in financial statement user community that present disclosure of such matters is inadequate in general or in certain particular circumstances, this issue should be taken up with the accounting standard setters. The auditor's responsibility is to determine whether the financial statements adequate address and disclose these matters in accordance with GAAP, not to present what the auditor considers to be a "better" disclosure than what is prescribed by duly adopted accounting standards. In any case, I note that the SEC requires discussion in MD&A of "critical accounting policies", which include policies that involve significant judgments and estimates. I discuss "difficult and contentious issues and 'close calls'" in detail with my response to question 7 below.
- *Enhanced disclosure of material matters that are in technical compliance with the applicable financial reporting framework* – Page 13 of the concept release suggests that AD&A could include comment by the auditor "on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditors' view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements." The accounting standard setters are responsible for providing accounting standards that provide for adequate disclosure of all material financial matters to financial statement users, and management is responsible for complying with these standards, in all material respects, in its financial reporting. The auditor is responsible for assessing management's compliance with these standards, not for providing additional disclosures that he or she thinks would be "improvements" to the duly adopted accounting standards. If compliance—"technical" or otherwise—with the applicable

financial reporting framework and associated accounting standards does not provide investors with adequate understanding of the related matters and their impact on the financial statements, these concerns should be addressed to the accounting standard setters.

- *Areas in which management could have applied different accounting or disclosures* – This is a financial reporting matter, not an audit matter. If the accounting standard setters believe that the understanding of the financial statements by the financial statement users could be significantly enhanced by discussion of accounting or disclosure alternatives, they should require this discussion in specific, duly adopted accounting standards. It is not the responsibility or business of the auditor to amend accounting or disclosures made under the duly adopted accounting standards based on the auditor's own opinion about what accounting or disclosures should be.

Page 13 of the concept release notes a suggestion that "an AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors." This suggestion is senseless. Accounting standard setters are responsible for establishing the accounting and disclosure framework and standards, management is responsible for preparing accounting and disclosure in accordance with those standards, and the auditor is responsible for auditing and, based on the auditing, opining on management's application of the accounting framework and accounting and disclosure standards. If the auditor "effects change" and "enhances" disclosure, the auditor would be taking on a management responsibility. It is unclear from the concept release how this responsibility would be shared, or how liability if mistakes were made would be allocated. Furthermore, if the auditor took on responsibility for changing and enhancing disclosure, the auditor would no longer be independent with respect to that disclosure and would, therefore, not be qualified to audit it.

Page 13 of the concept release also notes a suggestion that an "AD&A could provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis …" It is not clear what "further context" means. Accounting standard setters (including the SEC for management's discussion and analysis) are responsible for prescribing disclosure standards that are adequate to allow financial statement users to understand the financial statements (and management's related discussion and analysis), and management is responsible for faithfully following these standards. If financial disclosures are unclear, the accounting standard setters must improve the standards, or if the standards are already adequate, management must better adhere to them. It is not the role of auditors to unilaterally decide that additional disclosure of financial matters beyond what is required by the duly adopted standards should be made. On the other hand, if management fails to materially comply with those standards, the auditor should disclose that in his or her report and cannot conclude that the financial statements were prepared, in all material respects, in accordance with GAAP. However, even in that case, it is not the responsibility of the auditor—and likely beyond the capability of the auditor—to provide sufficient additional disclosures in any auditor's report to remedy management's failure to follow GAAP in its financial statement disclosures.

On page 14, the concept release says, “An AD&A also could provide the auditor with an adaptable report that he or she can tailor to a company’s specific risks, facts, and circumstances.” On the same page the concept release says, “An AD&A would likely be among the most expansive form of reporting of the alternatives presented …” The release could have substituted *expensive* for *expansive*. Presenting an AD&A will add substantially to the cost of an audit. Beyond mere preparation time, the auditor will also need to charge for time enhancing audit procedures to adequately support statements made in the AD&A and for time sending this work and the draft report through multiple layers of review. Management will also need to spend time reviewing the draft report with the auditor and attempting to reconcile any differences of opinion. Also, I think it should be obvious even to non-lawyers that the AD&A will provide a lightning rod for litigation. Besides the direct costs associated with this inevitable litigation, all the preissuance processes I have just mentioned will likely have to be performed with even more care than they would on the face suggest due to the litigation risk involved.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

An auditor can comment on the audit and its result in the auditor’s report. An auditor has no business making other comments about the financial statements.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

An auditor should not provide an AD&A. If there are matters that an auditor considers critical to understanding the audit process and/or the auditor’s opinion on whether or not the financial statements were prepared in accordance with GAAP—including matters related to audit risk, audit procedures and results, and auditor independence—the auditor can provide the necessary communication, as briefly as is reasonable, in the auditor’s report.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

The only information about the auditor’s views on the company’s financial statements based on an audit that the auditor should communicate in any report that will be delivered to users with the financial statements is the auditor’s opinion about whether or not those financial statements are prepared, in all material respects, in accordance with GAAP and, if the auditor concludes that the financial statements are not prepared in accordance with GAAP, an explanation of the significant GAAP departures noted.

The financial statements themselves should include all information needed by users to understand them, including relevant information about accounting policies and practices, areas involving significant management judgment and estimates, and matters to which application of accounting standards is particularly difficult.

The discussion of "difficult and contentious" issues on pages 17 and C-14-15 of the concept release shows confusion and misunderstanding by many parties interested in financial statements about how decisions are made by companies about the application of accounting standards to real world balances and transactions. This confusion and misunderstanding involves matters of technical knowledge and expertise that cannot be adequately resolved in any report by an auditor of reasonable length, and to attempt to do so would cause further confusion among financial statement users.

An accounting issue can be difficult for one or both of two reasons. First, the nature of the transaction or balance that is the subject of the issue could be such that it is difficult to report the transaction or balance in the financial statements in accordance with the conceptual framework used to develop those statements. This difficulty could arise from the complex nature of the transaction or balance or just some aspect of the transaction or balance that does not clearly accord with the financial reporting framework. This source of difficulty is a matter that should be clearly noted in the financial reporting standards that guide the application of the financial reporting framework to various types of transactions and balances. Of course, no financial reporting standard, or the framework that underlies it, can contemplate all the complexities of real world financial transactions and balances, but this inability is still an aspect of the financial reporting framework development and standard-setting process. Therefore, the existence and nature of these types of accounting difficulties should be addressed in the authoritative literature associated with complex transactions and measurements. This source of accounting difficulty is not an aspect of the auditing processes, although it does affect the application of the audit processes since they will be applied to balances and transactions involving these accounting difficulties.

The second reason an accounting issue can be difficult is that the accounting standard guiding application of the financial reporting framework to the particular transaction or balance is written in such a manner that the standard itself leaves itself open to multiple reasonable interpretations of what guidance it is giving. Again, this is an aspect of the accounting standard-setting process and should be addressed as part of the continuous improvement of the clarity of the guidance developed from that process. And again, this source of accounting difficulty is not an aspect of the auditing processes, although it does affect the application of the audit processes since they will be applied to balances and transactions involving these accounting difficulties.

The financial statements should assist the users in identifying material difficult accounting issues. This is done by specifically calling attention to the subject balances or transactions, summarizing the difficulties in applying the accounting framework to the balance or transaction or in interpreting the meaning of the accounting guidance, and referring to the relevant accounting guidance for further information on the technical issues involved. The financial statements should also clearly and succinctly explain how management resolved the difficulties. Note, again, that this is a financial reporting matter, and the auditor's opinion applies to this information that should be stipulated in the relevant accounting standards and provided by management. If the auditor concludes that management's disclosures related to difficult accounting and financial reporting issues are not in accordance with GAAP and believes that the matter is material to the financial statements taken as a whole, the auditor should not render an unqualified opinion on the financial statements and only then should provide a discussion in the audit report about the difficult issue—in order to justify the impact on the audit opinion.

The discussion of "contentious issues" on page C-15 clearly reflects a deep misunderstanding about how difficult accounting issues are resolved, both internally by management, and during the audit process. Points of contention are constantly arising at all stages of the resolution of difficult accounting issues. Generally, accountants close to the transaction, often assisted by the company's internal technical accounting experts, will make the first attempt to frame the accounting issue and its resolution. Operational management frequently will challenge these early attempts at resolution, usually on grounds that the accountants did not completely and adequately understand the substance of the underlying transactions. Higher levels of financial management also often contest initial attempts at resolving an accounting difficulty. This may also be on the grounds of an incomplete or inadequate understanding of the substance of the underlying transaction, but also often based on a differing understandings of the meaning of the relevant accounting standards, the underlying accounting framework, and the application of both of these to the substance of the underlying balance or transaction. Once a solid working resolution is made internally, the matter is discussed with the auditor. Initially, the accounting may be reviewed by a staff auditor, and then an engagement manager and engagement partner. The more difficult issues are given a first pass at each of these levels within the auditor's organization, with auditors' opinions beginning to be formed along the way. Each level of auditor will ask questions of management and offer indications of their own opinions. Management will provide more information about the balances and transactions and its decisions on the application of accounting standards and frameworks to the various audit levels. Continuous back and forth discussion and debate is common. For particularly difficult accounting applications and material balances, the audit engagement team will often seek support from firm-wide experts who may have their own views and opinions. In my experience, disagreements (or at least concerns) are quite common, especially in the initial vetting of transactions. Often, these are fairly easily resolved, but some issues do require more work, including substantial involvement by audit firm experts. In a long career in accounting and auditing, I have never been associated with any issued financial statements in which management or the auditors did not reach a resolution of any material matter which they did not agree was the best application of accounting principles and standards to the subject balance or transactions. I can see no clear level in this long process at which a meaningful line can be drawn for an issue to be considered "contentious" in a way providing useful disclosure to financial statement users.

No resolution of any difficult accounting issue can ever be made with absolute certainty, but to fill auditor's reports with discussion of all significant matters of debate in the preparation and audit of financial statements would be to provide users of financial statements with information that they would have no basis for understanding, evaluating, or using. And my discussion in the preceding paragraph should amply demonstrate the difficulty of defining what really characterizes a "contentious" accounting issue. There may be more judgment involved in deciding what is a "contentious" issue requiring disclosure in the auditor's report than is involved in making some of the underlying accounting decisions. And in the end, the auditor who issues an unqualified opinion on the financial statements must be as comfortable as any reasonable accounting expert can be on the resolution of all material difficult accounting issues in the preparation of the financial statements.

The concept of a "close call" needs to be discussed, and I will do so now.

Practitioners of accounting and financial statement auditing frequently speak among themselves about close calls, but they do so when communicating informally. If we are to discuss formal reporting about something that is a "close call", we need to clearly define what this means.

A "close call" is a decision made about an accounting matter where it seems that other reasonable decisions could have been made. Thus, it is a decision made as a resolution of a difficult accounting issue. I have already discussed the nature of "difficult accounting issues" in several paragraphs above.

Contrast my definition of "close call" to the attempts documented on page C-15 of the concept release, which evince a limited understanding of the actual level of difficulty and judgment involved in applying accounting concepts and standards to many financial balances and transactions. For many companies, it is a common occurrence every quarter to have several accounting decisions "that required significant deliberation by the auditor and management before being deemed to be acceptable within the applicable financial accounting framework." This effort often involves substantial communication about the facts surrounding the financial balance or transaction and further discussion of those facts to achieve an understanding of the substance of the balance or transaction. The effort also often involves identification of and agreement upon the relevant accounting principles and practices based on the substance of the balance or transaction and how those principles and practices are to be interpreted and applied. Again, in my experience, as difficult as these issues may have sometimes appeared at the outset of the accounting and auditing process, all parties involved always ultimately became comfortable with the final financial statement presentation.

Based on my views of the nature of so-called "close calls", I do not think they are relevant for discussion in reporting from the financial statement auditor to financial statement users. Either the auditor is satisfied that the financial statements reflect, in all material respects, a reasonable resolution of all the accounting difficulties involved in their preparation or the auditor is not. Those who are interested in how transactions and balances, including those that are complex, are accounted for and presented in the financial statements under GAAP should refer to that GAAP and the ample commentary thereon.

In concluding my discussion of "close calls", I want to make something very clear. If management selects its accounting approach from an apparent array of permissible choices under relevant accounting standards for any purpose other than an attempt to provide financial statement users with the most meaningful presentation of the subject transaction or balance in accordance with the conceptual framework underlying GAAP—reasonable cost-benefit considerations aside—this is not a “close call”. An accounting approach selected for any purpose other than the clearest possible presentation to financial statement users is by definition deceptive and, therefore, fraudulent. Some people may have the idea that “close calls” include selection of permissible, but not the best, accounting approaches from alternatives. Aside from reasonable cost-benefit considerations, selection of a permissible approach that management does not truly believe is the best accounting is fraudulent. The auditor should object to this accounting and cannot merely accept it as a “close call”. Therefore, situations in which these types of financial statement presentations and disclosures are made should not exist and, therefore, are not relevant to discussion of possible auditor disclosures of “close calls”.

Page 17 of the concept release includes “[a] financial statement issue that had a potential material impact to the financial statements and was corrected prior to the end of the period” under the category of “difficult or contentious issues, including ‘close calls’”. I am not sure whether this is to be viewed as a “difficult issue”, a “contentious issue”, or a “close call”, but these matters are irrelevant for disclosure, unless they indicate a material weakness in internal controls over financial reporting requiring disclosure in management and the auditor’s reports on those controls. What is relevant for disclosure to users of the financial statements is whether the financial statements as ultimately presented were prepared, in all material respects, in accordance with GAAP. It is *inevitable* that errors, occasionally material, will be made during the process of preparing financial statements. There is an inherent risk of error in all accounting processes; the level of this risk depends on the nature of the transactions, including the types of processes that can be applied to identify and record them. The point here is that errors are a routine part of accounting processing, and even material errors occur from time to time in a well-designed accounting system. Usually, but not always, any errors resulting from this inherent risk will be detected and corrected by the company’s system of internal controls over financial reporting. However, even the best designed system of internal control over financial reporting will have some small internal control risk—that is risk that a material error will occur and not be detected by the internal controls. Auditors assess inherent and internal control risk of accounting errors and tailor their audit procedures so that the likelihood of a material error occurring, not being detected and corrected by internal controls, and not being detected and corrected during the audit is minimal. Financial statements are intended to present important financial information to financial statement users. Financial statement users have a right to have faith in the processes used to prepare and audit these statements. They do not need to be bothered with the details of this process—that is other peoples’ jobs—and most financial statement users are ill-equipped to interpret details about the operation of those processes.

Even making the suggestion for this disclosure indicates how ill-equipped financial statement users are to draw appropriate conclusions from the requested information. The suggestion gives no indication of how the auditor would determine which “errors” to include in the AD&A, including from what level of the financial statement preparation process the disclosed “errors” could be drawn. Furthermore, the suggestion shows a misunderstanding of what an auditor is doing during a financial statement audit. The auditor does not perform procedures to systematically search for corrected errors (although the auditor will, of course, come across error corrections from time to time while performing normal procedures in areas such as internal control testing and journal entry review and may indeed detect material errors that were not detected by management's internal controls). Therefore, this suggestion would require a more significant expansion of the scope of standard audit procedures than I think the requestors realized. If the request is only to disclose potentially material errors that were detected by the auditor and subsequently corrected by management before issuing the financial statements, that should be clearly stated. However, this information is, by itself, irrelevant and potentially misleading; the implications of errors that are not detected by internal controls is already considered in management and the auditor's reporting on internal controls over financial reporting.

The general idea that matters related to internal controls over financial reporting are relevant to a financial statement user's understanding of the auditor's opinion on the financial statements evinces a fundamental misunderstanding about the relationship between internal controls and the quality of the financial statements on which the auditor has rendered an unqualified opinion. An auditor, when choosing the nature, timing, and extent of auditing procedures to perform, decides whether a company's particular internal control procedures are adequate to rely on to reduce the nature, timing, and extent of audit procedures needed. If the adequacy of internal controls are—shall we say—a "contentious" issue, the auditor will simply choose not to rely on them and perform additional audit procedures to compensate for the perceived deficiency. Typically, the auditor is able to perform sufficient compensating audit procedures to permit rendering an unqualified opinion on the financial statements, although the audit may require more time and expense to complete and may result in more auditor-proposed financial statement adjustments than if internal controls were better. However, deficiencies in internal controls over financial reporting are only relevant to the auditor's report on the audit of the financial statements if they were so extensive as to prevent the auditor from performing adequate audit procedures to render an unqualified opinion on the financial statements. Of course, auditors have additional reporting requirements related to internal controls over financial reporting under the Sarbanes-Oxley Act and related regulations. Financial statement users who are interested in gaining insight into the internal controls implemented by management can refer to that report and the related report by management, but this reporting model is not the subject of this concept release.

*8. Should a standard format be required for an AD&A? Why or why not?*

No. An AD&A itself should not be required.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

Any report by a financial statement auditor is the wrong forum by the wrong people for a discussion of matters such as business risks, strategic risks, and operational risks. Financial statement auditors have no particular qualifications to comment on these matters with any suggestion of sufficient authoritativeness to inform investment decisions. Frankly, suggestions like this strike me as attempts by investors and investment advisors to offload their responsibilities to understand the businesses of actual and potential investees to some other party (the auditor).

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

I do not know how boilerplate language can be avoided while maintaining consistency among AD&A reports. However, I am unclear how the concept of “boilerplate” language is distinct from standardized best practices in written communication.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

I see no potential benefits to implementing an AD&A. The shortcomings are that an AD&A would involve a party making comments about a company’s matters that the commentator has neither the qualifications nor responsibility to make, and which might actually be seen relieve those who do have such qualifications and responsibilities from their obligations to do so. This would likely not only cause confusion among financial statement users if information from sources of different veracities conflict, but also would increase confusion about which parties are responsible for providing what information about a company. As a matter of fact, the suggestion that an AD&A be considered indicates confusion among at least some interested parties about who is responsible for providing them various types of information about a company’s financial matters.

Some of the suggestions related to AD&A seem to almost reflect a magical thinking. They seem based on an underlying idea that the auditor’s workpapers—and minds—contain mystical insights about whether a company will or won’t work out as an investment idea. I have been an auditor and worked with many others. They are, by and large, bright, competent people. However, the nature of their work, and the expertise they need to do it, are not directed toward assessing the soundness of their client companies as investments. The auditor’s work is directed toward an evaluation of historical financial information, which, along with other information, investors and their advisors can apply to draw conclusions about the company’s future prospects. I am sure that the answers investors seek are not in the auditor’s workpapers.

I close my remarks on the proposed content of an AD&A by acknowledging the suggestions from investor groups documented on pages C-2-8 (some of which might also apply to emphasis paragraphs, the subject of questions 13-18 of the concept release). I have numerous detailed criticisms of most of these suggestions. However, I agree with the comments critical of those suggestions documented on these same pages of the concept release, and I have provided significant criticism of these suggestions in my own responses to the Board's questions documented in this letter. Therefore, I will not include a point-by-point critique of these suggestions in this response letter.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

In my response to question 11, I noted the potential for an AD&A to present information that is different than that presented by management (or other sources of financial analysis). From a practical standpoint, however, I expect that management and auditors will work to carefully align their messages. The word "work" in the preceding sentence is significant, because this effort will likely cause significant additional work for management and the auditor. In the end, this effort will usually result in aligned information being released, but with a confusing message about which party should really be responsible for delivering this information (again see my response to question 11).

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

Information about significant management judgments and estimates and areas with significant measurement uncertainty are financial reporting matters that should be presented in the financial statements themselves, not the auditor's report on those financial statements. Information about audit procedures performed on significant matters should also not be presented in the auditor's report. By expressing an opinion on the financial statements, the auditor is responsible for the adequacy of the audit procedures performed. The auditor's opinion refers to the audit standards used, which users can reference if they want a more complete understand about how financial statement auditors are supposed to approach they tasks. Also, there is ample literature about auditing techniques that is available to interested financial statement users. I see no way that an auditor's report on financial statements can adequately convey meaningful details about audit procedures performed on significant matters.

Before addressing the question of matters in the illustrative emphasis paragraphs, I offer a few comments regarding matters requiring emphasis paragraphs in the current audit reporting model (AU sec. 508):

- Substantial doubt about a company's ability to continue as a going concern is a financial reporting matter that should be clearly presented in the financial statements, not in the auditor's report.
- Material changes between periods in accounting principles or in the method of their application is a financial reporting matter that should be clearly presented in the financial statements, not in the auditor's report.

- Correction of material misstatements in previously issued financial statements is both an auditing and financial reporting matter, so discussion in the auditor's report is appropriate. The discussion in the auditor's report should be oriented toward auditing matters, which are how the presence of undetected errors in previously issued financial statements reflects on the quality of the audit of those financial statements and, by implication, the auditor's ability to provide a reliable opinion on the current period financial statements. However, these corrections should also be discussed in detail in the financial statements. That discussion should focus on the financial reporting implications of the misstatements, such as how their correction changes the previously issued financial statements and the implications of such misstatements for management's ability to presently prepare reliable financial statements.
- Specific accounting matters affecting the comparability of the financial statements is a financial reporting matter that should be clearly presented in the financial statements, not in the auditor's report.
- The financial statements should indicate if the entity audited is a component of a larger business enterprise, but including this information in the auditor's report as well is an important aspect of clearly indicating the scope of the audit.
- Significant related party transactions are a financial reporting matter that should be clearly presented in the financial statements. These transactions are not relevant to the auditor's report unless the nature and extent of these transactions are such as to prevent the auditor from forming a reasonably supported opinion on the financial statements. In that case, the auditor should not express an opinion on the financial statements and should clearly document the presence of these transactions as the reason why no opinion was rendered. Therefore, only if they impact on the auditor's ability to render an audit opinion, would related party transactions rise to an audit matter requiring discussion in the auditor's report.
- The auditor's report should note unusually important subsequent events in order to provide financial statement users with a clear understanding of the time period covered by the financial statements and the audit thereon.

Page 20 of the concept release notes a suggestion to "further expand the emphasis paragraph to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements." This suggestion is completely misguided. First, if it is unclear from the financial statements which matters are "most significant" and where they are disclosed, the accounting standard setters should modify their standards to provide for clearer disclosure and/or management should improve its financial statement presentation to more clearly disclose significant matters in accordance with duly adopted accounting standards. This applies to—again quoting from page 20—"significant management judgments and estimates" and "areas with significant measurement uncertainty". It is not the responsibility of auditors to unilaterally determine an appropriate manner to disclose significant financial information in circumvention of the disclosure requirements in duly adopted accounting standards. On the other hand, if the auditor believes that management's method of disclosure is so unclear as to materially depart from GAAP, the auditor should modify his or her opinion on those financial statements accordingly—a far different response than trying to compensate for the inadequate financial statement disclosure with supplemental disclosures in the audit report. Second, the auditor is not in a position to identify "the most significant matters in the financial statements". Auditors are not investment advisors and have a different skill set and training than these professionals, and the significance of various matters in the financial statements will vary from user to user in any case. It is the responsibility of the financial statement user to read the financial statements and determine what matters are significant for him or her. It is irresponsible to suggest that this work be passed off onto the auditor, including disclosure of "other areas that the auditor determines are important for better understanding of the financial statement presentation". If the financial statement users are having difficulty understanding certain types of disclosures in financial statements, they should take up these concerns with accounting standard setters, or management for company-specific disclosure difficulties. Third, the notion from page 20 that the auditor's report would serve as a sort of navigation aid to significant disclosures in the financial statements ("specific references to such disclosures in the auditor's report") implies that it is difficult to find significant information in the financial statements. If this is the case, again it should be addressed with accounting standard setters and, for company-specific difficulties, with company management. I will close this point by offering two pieces of investment advice of my own (although they are by no means original): (1) If you cannot understand a company's financial statements, do not invest in it except upon the advice of a trustworthy investment advisor who can, and (2) if you are the trustworthy investment advisor and cannot understand the company's financial statements, do not recommend that anyone invest in it.

Finally, a quick rhetorical question about a remark from page 21 of the concept release: "However, the Board may need to develop additional auditing standards to direct the auditor in determining which matters are of the most importance to emphasize in an auditor's report." Is the Board comfortable taking it upon itself to review GAAP (and international financial reporting standards) and issuing its own standards specifying which of these accounting standards "are of the most importance"—and therefore by implication which are not?

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

No.

*a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

N/A.

*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

Areas of difficulty in measurement or application of GAAP are financial reporting matters and should be discussed in the financial statements, not the auditor's report. The auditor is responsible for performing adequate audit procedures on these areas to support the audit opinion. Financial statement users generally do not have the expertise in auditing necessary to evaluate the adequacy of these procedures, but attempting to document or summarize these procedures in the auditor's report would suggest that they have some responsibility to do so. Furthermore, the auditor's report is not a forum that can accommodate a meaningful presentation of these procedures. As I noted in my response to question 13, interested financial statement users have ample information available to them about auditing standards and procedures.

*15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

The purpose of emphasis paragraphs should be for the auditor to communicate to financial statement users unique circumstances related to the audit that the users should be aware of to properly understand the auditor's opinion on the financial statements. They are not an appropriate forum for communicating financial and business information about the company. An auditor should include emphasis paragraphs in the audit report for the following reasons:

- To explain why an audit opinion was not rendered or why an opinion was rendered that the financial statements did not conform with GAAP in all material respects.
- To describe limitations on the scope of the audit.
- To clarify the time period covered by the audit when particularly significant transactions or events related to the company occurred after the date of the financial statements but before the audit report was issued.
- To further clarify the entity whose financial statements were audited, if the entity is part of an organizational structure that is so complex that the usual wording of the auditor's report is not adequate to properly identify it to financial statement users.

In response to this question, I add that I am opposed to suggestions, documented on page C-16 of the concept release, to include in or attach to the auditor's report the auditor's communications with the audit committee. I agree with the objections documented on that page.

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

Emphasis paragraphs should be as succinct as possible while still communicating the essential information to the financial statement users.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

I do not know how boilerplate language can be avoided while maintaining consistency among audit reports. However, I am unclear how the concept of "boilerplate" language is distinct from standardized best practices in written communication.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

I do not believe that emphasis paragraphs should be required except in situations such as I describe in my response to question 15. In those situations, emphasis paragraphs would help financial statement users better understand the meaning and context of the auditor's opinion. On the other hand, excessive use of emphasis paragraphs could circumvent the financial reporting purpose of the financial statements themselves, encroach on communication matters that are management's responsibility, and involve the auditor in communicating about matters beyond his or her knowledge or expertise.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No, the Board should not consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model. Any assurance on this material would be voluntary (until and unless prescribed by the SEC). Therefore, the auditor and company can presently tailor the audit scope and procedures for any such assurance as they agree, and the auditor's report would reflect the unique decisions made during this tailoring.

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

N/A.

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

N/A.

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

N/A.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

N/A.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

Auditor reporting on a portion or portions of the MD&A should not affect the nature of MD&A disclosures because those disclosures are management's responsibility and must be prepared in accordance with SEC regulations. Auditing standards are not an appropriate forum for establishing financial (and nonfinancial) reporting requirements.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

N/A.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

I urge caution about requiring auditor assurance on other information outside the financial statements. Expanding the scope of the audit could be very costly, and I am not aware of instances in which financial statement users have been mislead about a company's financial situation by materially misstated information delivered with, but outside, financial statements that were not themselves also materially misstated. This is not surprising since existing audit standards already require auditors to review information outside financial statements to make sure it is consistent with any financial statements that accompany it. This connection between information presented inside and outside the financial statements is strong in both directions. Any information presented outside the financial statements that is inconsistent with information in the statements has serious implications for the propriety of those statements and the audit of them. In my many years of experience as a financial statement auditor and preparer, I have consistently given and received ample substantive auditor comments on the information outside the financial statements.

Although I think the current negative assurance given on the material outside the financial statements is strong, shifting to the auditor providing positive assurance would still result in substantial extra cost in checking details, delving further into operating metrics, and vetting disclosures. I also note that providing positive assurance on operating metrics might require expertise not normally possessed by a financial statement auditor.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

See my response to question 19, which I summarize as high marginal costs and low marginal benefits.

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

Yes, clarifications are appropriate for all the areas noted. I have comments on several of them.

Language clarifying the concept of “reasonable assurance”, like that suggested on p. 27 of the concept release, would be helpful. Financial statement users must be aware that an auditor can only design and carry out an audit to provide reasonable, but not absolute, assurance that material errors in the financial statements will be detected. The following are some reasons why absolute assurance cannot be provided. The Board should consider these while drafting any succinct language changes to the standard auditor’s report explaining reasonable assurance.

- The process of preparing financial statements involves processes, measurements, estimates, and judgments that are subject to error (“inherent risk”).
- The company’s internal control systems for detecting errors in financial statements have some risk of failing to operate adequately to detect an error in the financial statements even if the systems are properly designed (“control risk”).

- Planning an audit involves making choices about the depth in which various elements of the financial statement will be examined and the particular procedures to apply to the elements of the financial statements that will be examined. An auditor does not have unlimited financial and time resources to “examine everything”. Therefore, even a properly planned audit will have some risk that the chosen procedures will not be adequate to detect all possible errors in the financial statements. Furthermore, the choices the auditor makes in planning the audit involve judgment and are therefore subject to error. These unavoidable limitations on the audit planning process are one aspect of “audit risk”.
- Audit procedures are carried out by human beings and are therefore subject to error. This is another aspect to “audit risk”.
- Audit quality control procedures involve judgments as to their adequacy and are carried out by human beings. Therefore, they are subject to error. This is another aspect to “audit risk”.

Although it is a topic widely discussed, at least within the accounting profession, I think there is still widespread misunderstanding of the auditor’s responsibility for detecting fraud among financial statement users (and also company managements). Because the popular conception of an audit is so associated with forensics, I think it is necessary to clearly address the extent of the auditor’s responsibility for detecting fraud when performing a financial statement audit. Specifically, the auditor’s report should clearly articulate that the purpose of the financial statement audit is to express an opinion about whether financial statements are, in all material respects, prepared and presented in accordance with GAAP. Therefore, the auditor will design his or her procedures only to detect instances of fraud that materially impact the preparation and presentation of the financial statements in accordance with GAAP. Therefore, the auditor will only perform audit procedures that would detect types of fraud that could materially impact the financial statements *and* then only instances of those types of fraud that are substantial enough to actually be material to the financial statements. In other words, only certain types of fraud would be detected and even then only occurrences in amounts greater than some threshold value. (And as I mention in my response to question 21 c. below, I do not support disclosure of materiality thresholds used in the audit.)

Language regarding auditor independence merely needs to be a statement that the auditor is independent and reference to the standard of independence underlying that assertion.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Yes, these potential clarifications would serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities. In particular, I think that financial statement users are often unclear about the level of assurance offered by an auditor’s opinion, the auditor’s responsibility for detecting fraud, and the auditor’s responsibility for information outside the financial statements that is delivered with the financial statements.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

I do not offer any other clarifications or improvements to the auditor's reporting model that can be made to better communicate the nature of an audit and the auditor's responsibilities. I think the list given is ample. I reiterate my opinion that information in the auditor's report should be limited to information about the audit. I think the auditor's report should be clear and cover all relevant points, but it should also be succinct. Auditing standards are available for interested parties to read, and numerous books on auditing are available. Also, classes on auditing are available, both through colleges and universities and through professional organizations (like the AICPA). Those who are interested in understanding the details of what goes behind an auditor's opinion should consult those resources. The Board oversees inspections of auditors to make sure that appropriate standards and practices are followed, providing comfort in audit quality to financial statement users, and financial statement users also have recourse to litigation if appropriate standards and practices are not followed, leading to financial losses.

At this point, I will comment on the discussion on pages C-8-9 about disclosure of materiality levels. I agree with the remarks critical of this suggestion. It is unclear what meaningful use financial statement users could make of this information or how the auditor could provide in any reasonably succinct manner the context needed to understand any benchmark quantitative measures the auditor may have used during the course of the audit.

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

Clarifications to the standard auditor's report should not affect the scope of the audit or the auditor's responsibilities; they should result in better communication of the matters addressed to financial statement users.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

The major potential benefit of providing clarifications of the language in the standard auditor's report is that financial statement users will be able to better understand what they are "getting" with the audit opinion. The main shortcoming is the risk that the auditor's report will become too long to be clear or will creep in scope to include matters not directly related to the audit and its results.

Pages C-10-11 of the concept release document suggestions for including various engagement statistics in the auditor's report. However, the statistics suggested are inadequate to draw a reasonable conclusion about the quality of the audit, as the critical examples documented on page C-11 suggest. If financial statement users really want to get insight into an auditing firm's audit quality, they should press for release of more information about auditing firm quality control review results. I will not comment further here on that contentious subject. Financial statement users can also review information about lawsuits involving auditing firms and can review statistics about which firms were involved with failed audits.

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

The only alternatives discussed in this concept release that I think are appropriate are judicious improvement of the use of emphasis paragraphs and clarification of the standard auditor's report.

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

A combination of the alternatives that I noted in my response to question 23 would be effective.

*25. What alternatives not mentioned in this concept release should the Board consider?*

I am not aware at this time of any alternatives not mentioned in this concept release that the Board should consider.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

I am not able to provide detailed guidance for an auditor reporting framework and criteria at this time. However, I direct the Board to my comments in the introduction to this response letter for my ideas about the purpose of the auditor's report.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

I believe that it is very likely that financial statement users might perceive many of the alternatives suggested in this concept release as a piecemeal opinion. I recommend avoiding this by only implementing the changes that I have commented favorably on in this response letter.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

Improvements to the standard auditor's report and improved guidance for emphasis paragraphs will better convey to the users of the financial statements the auditor's role in the performance of an audit.

The other alternatives suggested by this concept release would reduce clarity. This is particularly true of some possibilities for an AD&A, which could cause the auditor to appear to be a source of financial information about the company beyond what management provides (in the financial statements and elsewhere) and also to be an arbiter of whether or not the company is a good investment. Even emphasis paragraphs should be used judiciously to avoid encroaching on the realm of the financial statement preparer and users.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

An AD&A might marginally increase audit quality, since it would subject key aspects of the audit to the scrutiny of yet more parties and because its preparation would require the auditor to do yet one more pass through his or her work (including having another look by the quality control layer). However, the cost of this marginal improvement would be great, both in terms of time to issue the auditor's report and AD&A (and therefore the financial statements with which they are associated) and the expense of preparation. Ultimately, the monetary costs would all inure to the company being audited. Incremental audit costs would be billed to the company, and management would also incur additional costs of its own review of the draft AD&A and work with the auditor to resolve issues and reconcile inconsistencies between the AD&A and management communications (including the financial statements). Another "cost" would be increased financial statement user confusion about the nature and purpose of the financial statement audit and possible misdirection away from the financial statements as the primary source of information about the company's financial position and changes therein.

Assurance on information outside the financial statements might also provide a slight improvement in audit quality; any further understanding of the company that the auditor gains from this work would inure to the benefit of the financial statement audit, but this minor benefit would come with substantial costs from the additional audit and management work required for the added auditor assurance.

More liberal use of emphasis paragraphs would likely have little effect on audit quality. Clarification of the standard auditor's report would also likely have little effect on audit quality. Properly implemented, though, these changes would improve the quality of communication between the auditor and financial statement user about the audit work done and opinion rendered.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

I am not familiar enough with these topics to provide an informed opinion.

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

I think all five considerations are important and deserve careful attention before making any changes to the auditor's reporting model. However, I draw specific attention to the last sentence of "B. Effects on the Auditor's Relationships" on page 32: "Management and the audit committee also might be compelled to change the financial statements, in order to eliminate differences between the company's disclosures and the auditor's discussion in the audit report." I caution the Board to be avoid making changes to the auditor's reporting model that might inappropriately shift decision-making about financial reporting from management to the auditor. This could institutionalize an impairment of the auditor's independence.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

For some types of changes, I believe that the benefits would justify the cost, and for some not. I have included discussion of cost-benefit issues in my detailed responses to the preceding questions. In general, I think the higher cost proposals offered in this concept release would not provide sufficient benefits to justify their implementation.

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

I am not aware of any other considerations at this time.

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

N/A.

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

I have documented my thoughts on this matter in my responses to the previous questions.

**Closing Comments:**

I note that the proposals in this concept release are more extensive than mere continuous improvement of the auditor's reporting model. This suggests a perception that there is a serious problem with the current model. However, the release does not attempt to identify this problem. I suggest that the Board consider answering the following clarifying questions before pursuing any significant changes to the auditor's reporting model:

1. Is there a problem with audit quality? If so, would changing the auditor's reporting model be an effective element of the correction of this problem?
2. Is there a problem with communication of audit results to financial statement users?
3. Is there a problem with the relevance and understandability of the financial statements? Are users looking for help from auditors to understand the financial statements? If so, is the auditor's reporting model the appropriate place to address these problems, or should financial accounting standard setters address these problems?

Pages 7-8 of the concept release notes that some parties have suggested to the Board that auditors could have helped assess the quality of the financial statements and provided early warning signals about potential issues like off-balance sheet contingencies and the sensitivity of loan loss estimates. The concept release does not specify a suggestion that off-balance sheet contingencies and the sensitivity of loan loss estimates in financial statements were not presented in accordance with GAAP in financial statements that received unqualified opinions in auditors' reports. Therefore, I am left to assume that the financial statements, including the related required disclosures, that the commentator's had in mind were prepared in accordance with GAAP, and if there is a problem with their understandability or disclosure about the limitations or sensitivity to economic conditions of the amounts disclosed, this is a criticism of the GAAP itself. The variability and other limitations of the judgments and estimates required for financial reporting under GAAP is a financial reporting issue. Proper financial statement disclosure of these inherent limitations on judgments and estimates should be considered by the accounting standard setters when they promulgate accounting standards requiring their use. It is not the responsibility, or business, of an auditor to criticize or expound on the auditor's perceptions of the limitations of GAAP in the auditor's report. Determination of GAAP and how its limitations are to be presented to financial statement users is the responsibility of the accounting standard setters. They meet these responsibilities through a rigorous process (although not without its criticisms as to particulars), not through ad hoc dissemination of opinions, as those who made the suggestion for auditor commentary to the Board seem to be requesting from auditors. The fact that "reasonable estimates might vary significantly" and that "there could be a wide range of acceptable results" is a financial reporting matter associated with the particular estimates and should be appropriately disclosed with them in the financial statements. Guidance for such disclosures should be developed through the established accounting standard setting process, not based on the opinions of any particular auditors.

I hope that you find my comments helpful as you consider improvements to the auditors' reporting model.

Sincerely,

/s/ Scott E. Green

Scott E. Green, CPA, CMA

pcaob - auditors' report dp - 201107 r02.doc

**From:** Doug Hawkes [mailto:dhawkes@hbmcpas.com]
**Sent:** Friday, July 01, 2011 5:32 PM
**To:** Comments
**Subject:** PCAOB Release No. 2011-003 Proposed Changes to the Audit Report

We have reviewed the proposals and the example changes to the audit reports. We strongly disagree with each proposed change on the basis that each proposed change does not add any value to the information included in an issuer's financial statements. The issue for an investor is to identify risks to investing and those are unchanged by the proposal. The focus should remain on the quality of the issuers' financial statements.

In addition, the proposal significantly increases the risk to the auditing firm because of the proposed subjective comments to be made by the auditing firm. We believe the current audit reporting standards clearly communicates with the investor all of the information needed to understand whether the financial statements are accurate and sufficient, and whether internal controls over financial reporting are effective. Accordingly, we respectively request the proposals not be adopted.

**Douglas D. Hawkes, CPA**
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**From:** Michael Hemingway [mfrancshems@netscape.net]

**Sent:** Saturday, September 24, 2011 4:04 PM

**To:** Comments

**Subject:** Proposed standard-setting project on content and form of reports on audited financial statements

CONCEPT RELEASE ON POSSIBLE
REVISIONS TO PCAOB STANDARDS
RELATED TO REPORTS ON AUDITED
FINANCIAL STATEMENTS
AND RELATED AMENDMENTS TO PCAOB
STANDARDS
NOTICE OF ROUNDTABLE

The Public Company Accounting Oversight Board ("PCAOB" or "Board") is issuing a concept release to solicit public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements. The Board will also convene a public roundtable meeting in the third quarter of 2011, at which interested persons will present their views. Additional details about the roundtable will be announced at a later date.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted via email to comments@pcaobus.org

**Questions**

**1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

**a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

Firstly, although my experiential background is less extensive with public accounting or auditing engagements than with general accounting, accounting cycle specialties, tax and financial statement preparation work, the academic work completed at Syracuse University for the attainment of my Bachelor of Science in Accounting degree was comprised of the necessary auditing courses for the completion of credit hours necessary for my graduation.

Still yet another standard-setting initiative at this level of professional oversight seems superlative when considering the historical development of Sox-Orbanes which at that time was developed to reduce the possibilities of management's blind reliance upon the inconsistencies and deficienceis of the public auditors and conversely, reassure investors and stockholders of auditors' due diligence when auditing management's financial records.

The current pass/fail auditing reporting model still seems sufficient to convey this reliance to financial statement users because theoretically it does utilize and comply with SAS guidelines and reporting for attestation to GAAP based upon relevant auditing and fiancial reporting requirements. It is incumbent upon investors and stockbrokers to readily understand this information, format, and reporting model whether they actually believe that the information is insufficient for their further investment and company performance information. The type of additional information implied by this new standard setting project seems more relevant from financial analysts than auditors and yet if also required by the public accounting and auditing community at some additional prohibitive cost at the further perils and burdens of corporate America.

**b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**

The standard auditor's report or other auditor reporting could generalize financial operations by industry and report to the various shareholders and users of financial information the trends, similarities, differences, anomalies, and practices among companies as they affect profits and losses or other financial data while citing their clients' needs for improvements and variations from the normal operations, activities, and practices of other companies.

**c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

The pass/fail opinion attestation auditing role is currently sufficient for the assurance of all information reported upon financial statements for users including investors and shareholders. The recurring redundancy of auditors' assurance than management's assurance than auditors' assurance again seems to trivialize any legitimate process by which any oversight can remain authoritarian.

Yet matters of financial operation, planning, budgeting, logistics, and the normal strategic objectives as conducted by the executive level of companies would seem too proprietary and confidential to be revealed or audited by even a private entity

**2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

**a. Should the auditor's report retain the pass/fail model? If so, why?**

Yes, more relevant for cost benefit analysis

**b. If not, why not, and what changes are needed?**

**c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

**3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

Preparers and management are most appropriate to submit any additional financial information because they are more involved with the day-to-day operations of the company

**4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

Broader scope and more aggressive audting of internal control with the necessary compliance testing to satisfy financial statement users like investors and stockholders

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

**RE: PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2011-003; Concept Release on Possible Revisions to PCOAB Standards Related to Reports on Audited Financial Statements**

Dear Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," dated June 21, 2011

By way of background, Hermes is one of the largest asset managers in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including the Lothian Pension Fund, Northern Pension Fund of Ireland, PNO Media (Netherlands), Canada's Public Sector Pensions Investment Board, and VicSuper of Australia (only those clients which have expressly given their support to this response are listed here). In all, EOS's advises clients with regard to assets worth more than $140 billion.

We firmly welcome the PCOAB's attention to the important issue of audit report quality and are extremely supportive of much needed reform in this area.

Users of financial statements have become increasingly aware that the matters that determine the scope and effectiveness of the audit and which are therefore important to the auditors in reaching their opinion are not expressly addressed in the audit opinion. The audit opinion contains nothing more than a pro-forma statement about the auditing and ethical standards that the auditor has complied with, and does not relate those standards to the actual work that has been done in the course of the particular engagement. Nor does the audit committee report on such matters. As a result users lack the information to enable them to assess the extent to which it is appropriate for them to rely on the financial statements. As importantly, the audit report, by not discussing the substance of the audit work that has actually been done, does nothing to reinforce perceptions of audit quality and so does not provide a vehicle to increase audit quality. We believe that increasing the focus on audit quality is vital to increase investor confidence and to improve standards within the profession.

At present the audit report contains much that is not a report from the auditor. Rather, it is a defensive outline more of what the auditor does, and indeed, does not do – apparently designed solely to limit the auditor's liability rather than enlighten investors with regard to the audit or audited entity in question. Even the outline of what an audit involves seems designed from this negative perspective rather than a positive one. We believe that this sort of audit report not only does not provide value to investors, it does a significant disservice to the audit profession by emphasizing not the value that the auditor brings through the audit but rather highlighting what investors should not expect from the auditor. We believe that this 'perceptions gap' is more important than the expectations gap these days: through such poor reporting to investors, they are invited to expect nothing of value from an audit. If the profession genuinely wishes to foster its own future we need to ensure that rather than emphasizing what little can be expected from an audit, the audit report needs to highlight the positive value that an audit brings for investors.

HERMES

We believe that a refocusing on the positive value added by the audit is needed and that will require a removal of the excess verbiage which emphasizes more what an audit does not do than the value that it brings
More useful disclosures on the audit process and audit quality will help start addressing the perception gap around the audit and emphasise audit quality in a way which over time will increase competition over audit quality. We would welcome better disclosures by all parties to corporate reporting. This is both necessary and important. But it is extremely important to focus on which parties have the primary responsibility for disclosure. We provide a brief table which we think provides a helpful insight into our thinking on this matter.

| | **Management** | **Those charged with governance** | **Auditor** |
|---|---|---|---|
| **Financial accounts** | Primary responsibility | | Audit opinion |
| **True and fair view** | Primary responsibility | | Audit opinion |
| **Neutrality** | | | Primary responsibility |
| **Associated narrative reporting** | Primary responsibility | | Read requirement – negative assertion ("we have nothing to add") |
| **Adequate books and records/internal controls** | Primary responsibility | | Positive statement |
| **Going concern** | Primary responsibility, including to disclose key risks and process for arriving at going concern view | | Secondary responsibility – exceptions opinion |
| **Key accounting judgements** | Primary responsibility | | Highlighting existing disclosures, negative assertion ("we have nothing to add") |
| **Key assumptions and estimates** | Primary responsibility | | Highlighting existing disclosures, negative assertion ("we have nothing to add") |
| **Key auditing judgements** | | Commentary on auditor disclosure and discussion of role in assisting auditor in reaching those judgements | Primary responsibility |
| **Key areas of debate & discussion between auditor and those charged with governance** | | Primary responsibility | Commentary, negative assertion ("we have nothing to add") |

This implies that there are indeed matters which those charged with governance - very usually the audit committee - have the primary responsibility for disclosing, and we strongly encourage the development of regulatory regimes which facilitate and encourage such disclosure, though we recognise that such matters are not directly within the control of the PCAOB.

We have taken the opportunity to respond below to a select number of individual questions presented in the consultation but generally feel that the table above reflects our overall position on the types of enhancements we hope to see implemented in order to address the severe deficiencies present in the current audit report.

**1c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

We do not believe that expanding the auditor's current role is warranted. We would welcome rather a focus on the current role and delivering effectively - and transparently - what is currently required. We firmly believe that a 'read requirement' is the appropriate level of auditor oversight of narrative reporting which accompanies the audited financial statements, and as the table indicates we welcome this work being made explicit in auditor reports. But we believe taking any further auditor assurance oversight of other matters is not warranted, and we fear it might significantly intrude into the reporting processes of audited entities.

**2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model.**
**a. Should the auditor's report retain the pass/fail model? If so, why?**
**b. If not, why not, and what changes are needed?**
**c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

We would welcome audit reports becoming much more discursive and qualitative. We believe that the current binary nature of the audit opinion – in effect either a ' pass' or a 'fail'– leads to audits being less effective because companies can argue that as long as an accounting treatment is within the boundaries of acceptability they should receive a 'pass'. An audit report which gave an indication of how far the company is pushing the boundaries of accounting standards would provide much more useful information to investors, and be a basis for encouraging companies to take less aggressive stances - we believe that the alternative to this that would be most acceptable to the profession is our proposed auditor statement that the accounts do provide a neutral presentation. While this statement is a change, it is simply putting in writing an assertion that auditors make about accounts by signing them off; we also believe it is a more realistic request to make of auditors than a view as to degrees of accounting aggression. Its impact on the dynamic between the auditor and management and those charged with governance ought to be substantial and powerful. This process ought to lead to much more consistently appropriate reporting and so to less systemic risk. The sort of discursive and qualitative audit reports that this implies would avoid the all-or-nothing response to which qualifications currently give rise.

**3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

As the table indicates, we agree that in the first instance it should be for management, or those charged with governance (or indeed the two in combination) who have the primary responsibility for the disclosures we highlight in the table. However, we recognize that setting requirements for corporate disclosure is beyond the PCAOB's remit and we therefore believe that the PCAOB may need to require auditors to make such disclosures where the audited entity has not done so.

This is a fall-back because we would most welcome enhanced disclosure requirements of management and also those charged with governance, and we would also welcome enhanced requirements of the auditors to respond to these disclosures, probably in terms of highlighting where the disclosures are contrary to evidence highlighted in the audit, or a statement that there was no such evidence identified. The areas on which we would welcome further company disclosure, and auditor assurance in response to, would be: the up to five key areas of accounting judgment and why the relevant accounting choices have been made; which are the key assumptions embedded within the corporate reporting and what impact would alternative assumptions have made; significant changes to the business, including segmentation, capital structure, M&A divestments, and the reasons for these; risk management appetite and approach.

We believe that the auditor should have primary responsibility for disclosures on the key auditing judgments - such as the significant risks identified at the start of the audit, materiality thresholds (particularly such matters as which subsidiaries were audited directly and which not - and how this decision was reached), and the extent of reliance on another auditor or on the work of internal audit. We would welcome those charged with governance having the responsibility of commenting and responding to this disclosure.

We believe that the table provides a ready outline of our thinking in this area.

**5. Should the Board consider an AD&A as an alternative for providing? additional information in the auditor's report? a. If you support an AD&A as an alternative, provide an explanation as to why.**

While we are not fundamentally opposed to the possibility of the introduction of an AD&A we do not feel that it is necessarily the most effective way of bridging the communications gap which currently exists. We believe that the enhancements we are proposing to the audit report would address the bulk of current concerns and that more drastic steps are not yet warranted.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

We believe that there would be real value in considering enhancing auditor reports in this way. However, we believe that this needs to be done with real care to strike the right balance of ensuring fuller more useful disclosures to investors while also leaving the balance of responsibilities placed appropriately between the auditor and the board. We understand there is a real risk that the auditing firms will seek to have standard language, which undermines the intent of developing audit reports which are genuinely bespoke to the individual company. It is for this reason that we are proposing auditor disclosures which are narrow and specific, requiring few words, but which cut to the heart of the judgements which investors need the auditors to be making.

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

We do not see any potential shortcomings in the provision of clarifications around the language in the standard auditors report provided the additional clarity is provided in a meaningful manner and accompanied by genuine enhancements to the quality and content of the audit report as discussed above. We do not believe though that this goes to the core of current concerns with audit reports and so do not believe that this warrants significant attention.

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

We believe that three things are fundamentally necessary:

- Audit reports need to drop any and all language which highlights what the audit does not do and what the auditor has not done.
- Audit reports need to include a report on the auditor’s conclusion in respect of all the elements that the standard audit delivers, whether these are matters of positive or negative assurance. All too often the breadth of the auditor’s work is not made apparent in the report, which again does the profession a disservice.
- The auditor should provide more discussion that is specifically relevant to the company. Our thoughts in this respect are considered in more depth below.

We believe that audit reports which deliver this will be of substantially more value to all users of financial reporting. We do not believe that there are users for whom such communication would not be of value – though because of the perception gap there are many who currently ignore audit reports.

In addition we ask you to refer to the table above for a more detail description of the types of enhancements we would like to see.

**31 b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

While the proposed enhancements may result in marginally increased costs we firmly believe that the benefits in terms of increased confidence in corporate reporting outweigh the costs involved in such additional regulation.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

We make the proposals outlined in this response, and particularly in the table, in the fundamental belief that this will change the dynamic in the relationship between the auditor and the audited entity, and both its management and those charged with governance. We believe that enhanced disclosure requirements of the various parties on the crucial areas of accounting and audit judgment will ensure that these issues receive greater and more appropriate attention from all parties, including investors. The dynamic this will introduce to improve reporting quality will be significant, and it will have a similar upwards pressure on audit quality also. This will increase investor confidence in individual company reporting and the market as a whole. We firmly encourage the PCAOB to take these steps to capture these very significant benefits.

Yours faithfully

Darren Brady
Manager

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September 28, 2011

J. Gordan Seymour
Secretary
PCAOB
1666 K Street N.W.
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Mr. Seymour:

Hess Corporation ("Hess" or "the Corporation") appreciates the opportunity to comment on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements ("Concept Release"). Hess is a global integrated energy company primarily engaged in the exploration for and production of crude oil and natural gas, the manufacturing of refined petroleum products and the purchasing, trading and marketing of refined petroleum products, natural gas and electricity. The Corporation is a registrant with the U.S. Securities and Exchange Commission and is classified as a large accelerated filer.

The Concept release presents four possible alternatives for increased auditing and disclosure responsibilities by the auditor and recommends changes to the auditor's report. The concept release proposals are grouped into the following four broad categories which are not intended to be mutually exclusive.

– Auditor's discussion and analysis,
– Expanded use of emphasis paragraphs,
– Auditor assurance on other information outside of the financial statements, and
– Clarification of language in the standard auditor's report.

The Corporation's comments on the proposals in the Concept Release below were primarily based on our views of whether the benefits of the proposals exceed the likely increase in costs, whether the proposed auditor requirements would enhance a reader's understanding of a registrant's underlying accounting and disclosures and how the proposed requirements might interplay with governance procedures already in place under the direction of the audit committee.

Auditor's discussion and analysis ("AD&A")

The concept of the AD&A would be to provide a supplemental narrative report in which the auditor would have the ability to discuss:

- their views regarding the audit process (audit risks and procedures);
- their views regarding the company's financial statements, such as judgements and estimates, "close calls" and potential alternative accounting or disclosure options; and,
- other matters that the auditor might choose to discuss.

We believe that the adoption of this proposed requirement would result in a very time consuming process for both the auditor and management, which would significantly increase costs. We believe that readers of financial statements would not benefit from an additional detailed discussion of complex accounting policy matters, since they are already described in the critical accounting policy and estimate disclosures. Detailed information on accounting or disclosure alternatives in an AD&A would be difficult to describe in a concise and understandable fashion. Discussions of these matters among management, auditors and audit committee members are already taking place in audit committee meetings, which we believe is the proper venue for these discussions. Once final decisions have been reached about the company's accounting policies and disclosures, we do not believe anything more is to be gained from having them further discussed in an AD&A.

Expanded use of emphasis paragraphs

The concept of the expanded use of emphasis paragraphs would be an attempt to emphasize the most significant matters disclosed in the financial statements, as well as to highlight significant management judgements, estimates and potential uncertainties.

While the proposal for added emphasis paragraphs is well-meaning, the Corporation believes that generally accepted accounting principles already requires material transactions to be reported and significant estimates and judgements to be disclosed. The auditor already has the responsibility to evaluate management's disclosures of significant transactions and related disclosures. Members of management and audit committees routinely consider auditor comments on accounting decisions and disclosures and the auditor's view would have already been incorporated into the disclosure. The emphasis paragraph in the auditor's report would likely be a duplication of disclosures appearing elsewhere in the document. Therefore, an emphasis paragraph would be redundant, potentially confusing, or even misleading, since it may be viewed as an area of disagreement with management's presentation. Given the proliferation of required disclosures in the financial statements, we are opposed to additional disclosures in the auditor's report of the same facts likely already described in several places in filed documents.

Auditor assurance on other information outside the financial statements

The purpose of this proposal would be to provide additional assurance on information outside of the financial statements, including MD&A or other non-GAAP information in filed documents and earnings releases. Although there is currently no requirement for the auditor to provide assurance on such information, current auditing standards require the auditor to review such disclosures to determine if the information is misstated or inconsistent with the financial statements.

We believe the current audit guidance is sufficient, as the auditor would be required to report to management and the audit committee any material inconsistency or misstatement in information appearing outside of the financial statements. We believe that any additional auditing requirements would significantly increase costs without a corresponding benefit. Since the SEC requirements for MD&A require discussion of the Corporation's results of operations and financial position "through the eyes of management," we question whether the auditor would bring additional value to the discussion. We would also oppose an audit requirement governing disclosures made by managements in the quarterly earnings release. We believe the existing governance over earnings releases is sufficient and should be the responsibility of the audit committee and not the auditor.

Clarification of language in the standard auditor's report

The purpose of this proposal would be to add clarifying language to the auditor's report that would provide additional information about what the audit represents and the related auditor responsibilities. While we believe that the nature of the audit and the auditor's responsibilities are already well understood by users of financial statements, we have no objection to some limited additional clarifying language if the auditing profession deems it necessary.

Summary

It is important to note that these proposals would be incremental to other standard setting initiatives already underway at the FASB and SEC and do not appear to be coordinated with those efforts. We believe these competing priorities will result in disclosure overload and could potentially create confusion for users of the financial statements. Therefore, we question both the timing and the need for the proposed additional auditor disclosures.

Hess Corporation appreciates the opportunity to comment on the PCAOB's Concept Release and would be happy to discuss these comments with the appropriate staff members.

Sincerely yours,

John P. Rielly
Senior Vice President and
Chief Financial Officer

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Hilton Worldwide
7930 Jones Branch Drive
McLean, Virginia 22102

September 30, 2011

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

***Re: PCAOB Rulemaking Docket Matter No. 34***

Dear Board Members:

Hilton Worldwide, Inc. (referred to herein as we, us, our, Hilton or the Company) is pleased to respond to the Public Company Accounting Oversight Board's (PCAOB) Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (the Concept Release).

Hilton is one of the world's largest lodging companies based on system-wide room count and is engaged in the ownership, leasing, management, development, marketing and franchising of hotel, resort and timeshare properties. The Company was formed through the acquisition, in 2006, of Hilton International Company by Hilton's predecessor Hilton Hotels Corporation, which was subsequently acquired by a private equity fund in 2007. As of June 30, 2011, our system included over 3,700 hotels and resorts, totaling 611,000 rooms in 85 countries and territories.

While Hilton is currently a private company domiciled in the U.S. and not currently registered on any securities exchange, we may, at some point in the future, be a registrant. We, therefore, review the implementation of all guidance in a manner that would allow us to report under public company guidelines.

Based on the questions raised by the PCAOB Release No. 2011-003, our comments focus on certain key questions, and provide a discussion on key concepts within each section of the questions raised. Our responses are as follows:

**Questions:**

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of opinion is sometimes referred to as the "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

The pass/fail model should be retained for public companies. Due to the wide range of potential users of public company financial statements, the statements should either be fair and acceptable for filing with the SEC or not. The pass/fail model allows users to have a clear understanding of whether there is risk in using the information contained in the financial statements. A graduated model would put much more burden on the users to interpret what a specific grade would mean as related to a company within a specific industry

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and within a specific geographical operating area. This would inevitably lead to a lower level of trust on the reliance of financial statements overall. A clear pass/fail model allows the investment community and users of the financial statements to place comparable reliance when evaluating companies' quarterly and annual financial reporting. We believe moving away from this model would result in decreased confidence by all engaged constituents, thereby undermining reliability of the financial reporting of companies within the U.S.

b. *If not, why not, and what changes are needed?*

N/A

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

We believe the current model best serves users of financial statements and the public. Departure from the pass/fail model may result in audit reports that are misunderstood, to the detriment of an unsophisticated user or the issuer. Additionally, the departure would put more burden on the user to assess the level of reliance that could be placed on financial statements issued in the U.S. This could result in U.S. companies being disadvantaged as compared to Companies reporting in other countries. We do not believe changes to the report or supplemental reporting would be beneficial but instead may cause confusion and create subjective and inconsistent interpretation of financial results of Companies.

**III. Potential Alternatives for Changes to the Auditor's Report**
**A. Auditor's Discussion & Analysis (AD&A)**

We do not believe that an AD&A will increase transparency and provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis. As identified by the Board in its Concept Release, because an AD&A provides the auditor's perspectives about the audit and the issuer's financial statements, the perspectives in the AD&A on certain matters could differ from those that management has provided in the Management's Discussion & Analysis (MD&A). The presentation of differing views (both of which presumably would be acceptable under US GAAP and result in an unqualified audit opinion) would needlessly detract from investors' and other financial statement users' confidence in management and/or reliance on the financial statements. As such, an AD&A may cause users to decrease their reliance on information provided by management which we believe is an unintended consequence of the concept release.

Potentially requiring auditors to comment on certain topics (below) may result in the presentation of financial information not reported by management:

- Critical accounting estimates, assumptions underlying the estimates and how susceptible the estimates are to change

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- Critical accounting policies including a discussion of permissible alternative accounting treatments, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor
- Material matters that are in technical compliance with the applicable financial reporting framework but, in the auditor's view, disclosures could be enhanced or those areas where the auditor believes management could have applied different accounting or disclosures.

These suggestions would represent a fundamental shift in the current roles of management (preparer of financial information) and its auditors (attest). Such changes would further confuse users and raise legal questions regarding who is responsible for all of the audited information in filings with the Securities Exchange Commission (SEC). Allowing the auditor to provide commentary in this manner that may differ from the information presented by an issuer would undermine the reliability and quality of the financial statements.

Further, the public presentation of the AD&A reduces the authority of audit committees who currently receive, have oversight, and engage in dialogue over such matters with the auditors and management. Investors rely on the audit committee to review the financial statements and related information prepared by management in light of the required auditor communications. The authority and governance of the audit committee could be seen to be undermined when auditor communications are presented to the larger audience served by the audit committee. Investors wishing for further clarity have the ability to consult the audit committee and/or management. Information provided in the AD&A may be taken out of context by the broader audience, and could provide users of the financial statements with information the issuer does not agree with and may be misleading.

The AD&A would also add significantly to the financial reporting timeline as a result of increased review time by the auditors, and increased review and sign-off by national office. This process would be costly to companies and their shareholders, without providing the intended benefits of reliability and transparency.

**B. Required and Expanded Use of Emphasis Paragraphs**

This proposal is to expand emphasis paragraphs to highlight the most significant matters, and possibly provide additional information on significant management judgments and estimates, areas of significant measurement uncertainty and other areas of importance determined by the auditor.

We believe this places the onus on the auditor to determine those significant matters necessary to understand the financial statements, which if different from what Management has focused on, could undermine the credibility of financial statements prepared by Management. In addition, significant accounting policies are required disclosures, which highlight Management's use of estimates and the underlying principals under which such financial statements are prepared and presented. Any changes deemed necessary should not be addressed in an emphasis of matter paragraph, but should rather follow revisions to current standards under which companies report.

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In addition, when the auditor emphasizes only certain notes to the financial statements, financial statement users may focus solely on the information referenced by the auditor. All notes included in the financial statements are required under the financial statement reporting framework and are integral to the financial statements taken as a whole. If auditors emphasize only certain portions of the notes to the financial statements, users may be misguided.

Emphasis paragraphs may require the auditor to comment on key audit procedures performed related to the matters emphasized. For non-auditor users of the financial statements to obtain value from such a discussion, the language would have to be very detailed and precise, limiting its effectiveness. Such information could also become boilerplate over time. In addition, key audit procedures are currently communicated to the audit committee which has the responsibility to oversee the audit process.

**C. Auditor Assurance on Other Information Outside the Financial Statements**

We do not believe that an auditor providing assurance on information outside of the financial statements will improve the quality, completeness, and reliability of such information, or provide investors and other users of financial statements with a higher level of confidence in information about the issuer than that which is provided by management. As the Concept Release noted, an auditor's current "responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact." As such, auditors currently perform procedures to review the information outside of financial statements and reconcile that information to the audited financial statements. Also noted within the Concept Release was the existing attest standard whereby an auditor engaged to attest on MD&A would express an opinion on the MD&A presentation. However, in our experience such engagements are not utilized, which indicates that investors and financial statement users do not find substantial added value when attestation reports on MD&A are issued.

The MD&A is required to conform to the rules and regulations adopted by the SEC, and the SEC performs reviews of companies' filings to monitor such compliance. We believe requiring auditors to attest on the completeness of the MD&A may not provide incremental value since this task is executed by the SEC and may be seen to represent only incremental effort and cost to investors.

Lastly, when registrants issue securities, underwriters require comfort letters from the registrants' auditors. Such comfort letter procedures would appear to duplicate certain procedures auditors would perform to provide assurance on information outside of the financial statements. This would be inefficient and costly to the registrant. However, it appears that such duplicate procedures would continue to be performed if this alternative were to be put in effect as the level of assurance gained from a comfort letter versus the opinion would be different.

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**D. Clarification of the Standard Auditor's Report**

We do not have any concerns with clarifying language being added to the auditor's report. However, the expanded wording could result in the auditor's report becoming lengthy and cumbersome. We believe the report should remain concise and easy for investors to determine quickly the "pass/fail" nature of the auditor's opinion. In addition, the possible language that could be clarified in the auditor's report is fully described in PCAOB standards that are readily available at no cost to the public.

We appreciate the opportunity to comment on this Concept Release. We would be pleased to discuss our views with you at your convenience.

Very truly yours,

/s/ Paula A. Kuykendall

Paula A. Kuykendall
Senior Vice President and Chief Accounting Officer
Hilton Worldwide, Inc.

ILLINOIS CPA SOCIETY.

September 30, 2011

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

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society ("Committee") is pleased to comment on the Concept Release on Possible Revisions to PCAOB Standards Related To Reports On Audited Financial Statements (Docket Matter No. 34) dated June 21, 2011. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

***Executive Summary***

Our Committee is in favor of adding clarity to the auditor's report so that the responsibilities of the auditor, management and the audit committee are better understood by financial statement users. As described further in the following responses, our Committee is opposed to any mandatory expansion of the auditor's role into areas that we believe are the responsibility of management. Accordingly, we oppose a requirement to include an AD&A and have certain reservations regarding the required use of expanded emphasis of matter paragraphs and auditor reporting on information outside of the financial statements.

1. *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*
   a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

      Yes. If investors or other users feel the current reporting model is becoming less relevant, then the Board should seek to increase the auditor's relevancy and communication to them. However, extreme caution should be exercised so that the objective of the initiative and resulting standards solely improves relevancy and communication of the auditor and the results of the audit. We believe many of the potential changes described in the concept release have the ultimate impact of shifting the responsibility of due diligence about an entity for investment purposes from the investor to the auditor; or shifting the responsibility for full financial statement disclosure and analysis about significant matters from management to the auditor. Transferring these responsibilities must be avoided as it could lead to an adverse effect on the

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credibility of financial reporting and ultimately impair the auditor's objectivity and independence as well as its ability to perform a cost-effective audit in a timely manner. Further, many of the potential changes in the concept release seem to change the definition of an audit. If changing the definition of an audit is the desire of the Board, the Board should consider exposing a specific model describing such changes rather than having such overarching changes to auditor responsibility be an unintended consequence of this proposal.

b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

As further described in our responses to Questions 21 and 22, we believe that the language in the auditor's report could be clarified. Also as further described herein, we believe that management should be responsible to provide much of the additional information that investors and others claim they need by means of additional note disclosures in an entity's financial statements or expanded MD&A requirements. Auditor reporting should continue to primarily focus on communicating whether the auditor considers the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

In general, the Committee is not opposed to mandatory auditor reporting on information outside of the financial statements as long as there is appropriate, objective guidance on how the auditor is to accomplish such reporting. We believe, in particular, that one reporting option should include a report that simply indicates the auditor's current AU 550 responsibility in regards to information outside of the financial statements.

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*
   a. *Should the auditor's report retain the pass/fail model? If so, why?*

   While we do not necessarily agree that the characterization of the current model of reporting as simply "pass/fail" is appropriate, we do believe that the auditor's report should retain the current model. Changing the model would result in ambiguous auditor opinions that could easily be misinterpreted by the users of the financial statements. The current model provides consistency and comparability in opinions.

We do note that the current model of reporting provides for numerous variations in reporting, such as scope limitations, departures from generally accepted accounting principles and adverse opinions. We believe the variety of responses provided for in the literature is sufficient to cover the needs of users.

b. *If not, why not, and what changes are needed?*

Not applicable based on prior response.

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

As set forth in our answers to Questions 21 and 22 herein, the clarification of language in the standard auditor's report could be appropriate. However, although we agree with the Board's suggestion for clarification to include an enhanced discussion about the "auditor's responsibility for fraud," we also believe that the discussion of "management's responsibility" should also include a statement that management is ultimately responsible for the prevention and detection of fraud.

3. *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g. management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

As stated throughout our response to the Concept Release, management and the audit committee members are the most appropriate parties to provide additional information to financial statement users regarding the entity's financial statements. They are intimately involved with the business on a day-to-day basis and have knowledge of all information affecting it, including business risks, strategic risks, and operational risks.

4. *Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

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Based upon our answers to the questions throughout this document, the current guidance included in Auditing Standards No. 5 is appropriate when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements. We do not support the reporting alternative that includes an AD&A and therefore, we believe that no changes to Auditing Standards No. 5 are necessary.

***Auditor's Discussion and Analysis***

Our Committee does not believe that the Board should consider an AD&A as a means of providing additional information to the auditor's report.

If additional information is needed specifically for investment decisions, it should be prepared and presented by management to the extent that current or revised disclosure rules require or as management deems appropriate. Relevant investment information is readily and easily available from a variety of different sources, such as company web sites, company press releases, company investor calls, industry publications and web sites, and the like that would be appreciably more useful to investors than information provided in regards to historical financial statements by the auditors. These other communication vehicles could provide management a means to enhance relevant information to investors.

One of the basic underlying principles of auditing is that the auditor performs audit services for the benefit of ALL of the people, not necessarily or specifically for one group, e.g. the investment community. Furthermore, the auditor stands between management and the investment community and must be viewed as independent of each. The auditor should not be viewed as an advocate of either party. In addition, auditing standards should not force the auditor into a position of addressing investment risk. While the auditor's role certainly includes a focus on investor protection, that role is, as it should be, limited to assessing management's historical financial statements' compliance with the appropriate financial reporting framework. Auditors do not have the necessary training or experience with investment principles to best determine what information is most appropriate to an investment decision.

The investment community, in its desire for enhanced auditor reporting, such as the reporting considered in an AD&A, appears to be attempting to shift its own investment due diligence responsibilities to the auditor.

In addition, we believe that the incremental cost of providing the type of information proposed for an AD&A could be substantial in terms of efforts by the auditor, efforts by management in 'negotiating' with the auditor the extent of the AD&A disclosures, timeliness of reporting and ultimate financial burden to the company.

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*
   a. *If you support an AD&A as an alternative, provide an explanation as to why?*

The Committee does not support AD&A as an alternative.

b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

As described above, our Committee does not support an AD&A alternative. The responsibility of providing additional information about a company's financial statements should reside with the company itself. As described in other parts of this response letter, to provide audit-related comments in sufficient detail to be well understood by readers who are not educated and experienced with the audit process is impractical.

c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

Information about how management views its financial statements and the risks it faces in operating its business are inherent in the estimates it makes to prepare those financial statements would be relevant and useful in making investment decisions. However, as described above, we do not believe it is the auditor's role to provide such information.

d. *If you do not support an AD&A as an alternative, explain why?*

We do not support an AD&A as an alternative for providing additional information in the auditor's report. The Concept Release suggests that the intention of having an AD&A is to facilitate an understanding of the auditor's opinion on the financial statements taken as a whole. We believe that the current auditor's report is quite clear as to whether the auditor considers management's financial statements are presented fairly in all material respects in conformity with the applicable financial reporting framework. Further explanation of that opinion would necessitate significant additional guidance in the auditing standards to provide the auditor with instructions as to what particular aspects to consider in this explanation and how to describe such matters. Absent such guidance, the auditor would be asked to incur significant litigation risk by determining, on its own, what matters should be considered and described. Ultimately, this atmosphere will create additional market turmoil and distrust, the very environment the PCAOB wants to avoid with the current Concept Release. Management, and not the auditor, is responsible for the financial statements. As described, the AD&A appears to place responsibility for interpreting the financial statements with the auditor or, at a minimum, place the auditor as an investment analyst.

Auditing is an art, not a science. Auditors form their opinion on the financial statements based on judgments that require an evaluation of many relevant factors at one time. These factors include information widely available to the public, such as the

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general economic environment and industry climate, as well as factors specific to the company, such as corporate culture, management's operating style and competency, the specific findings from auditor procedures and auditor inquiries.

The judgments auditors form are so involved that to explain only specific portions of the audit in the AD&A will lead to more investor confusion, incorrect expectations and misleading conclusions. Audit risk and procedures performed as a response to those risks require years of training and experience to properly understand and assess. Most users of the financial statements do not have experience performing audits to determine whether the audit judgments are appropriate or comparable between entities - even between entities in the same industry or of the same size. A proper audit response will be different for two entities in the same industry because of the totality of each entity's specific processes, internal controls, culture, strategy, and people. For example, auditors may correctly designate different risks for two different companies in the same industry, located in the same city, operating under similar economic and other conditions because one of the two companies has highly qualified professionals using well designed and operating internal controls while the other may not. These differences do not necessarily translate into one company's audited financial statements being any more or less reliable than the other's. If both sets of financial statements received unmodified auditor's reports, then the investor has reasonable comfort that – regardless of the specific risks to each company – the audited financial statements are fairly stated in all material respects in accordance with the appropriate financial reporting framework.

An AD&A cannot realistically present the myriad of nuances involved in making auditor judgments, particularly without providing the audited company with too much insight into the audit process, including fraud procedures and rotation of audit procedures. The Concept Release states the AD&A is "not intended to provide separate assurance" on the financial statements. However, the typical investor could easily believe that the auditor is, in fact, providing incremental assurance or doubts as to the financial statements by its comments in an AD&A. Investors struggle with understanding the meaning of an audit opinion as is. Adding this additional requirement will likely increase the expectation gap. This confusion might also be compounded by making this AD&A requirement only applicable to U.S. public companies. Users of financial statements of non-U.S. and/or private companies will be less certain that the auditor's role is as robust in those circumstances and thereby reduce investor confidence.

Additionally, the AD&A requirement may add tension between management and the auditor. The AD&A adds an element of management bargaining with the auditor to limit its disclosures in the AD&A – almost all of which will serve to heighten investor concern about the company. Such bargaining might include management changing what it otherwise believes to be appropriate accounting or disclosure to appease the auditor in an effort to avoid adversarial auditor disclosures in the AD&A.

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Ultimately, AD&A disclosures regarding estimates in the company's financial statements will allude to the likelihood of future events and trends. The auditor should not be in a position – even if just in appearance – to comment or provide any assurance on such forward-looking matters, unless specifically engaged to report on projections in a restricted report.

e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

Alternatives already exist for the auditor to provide its more detailed assessment of management's financial statements, including consideration of internal controls, acceptability and appropriateness of selected accounting policies, critical accounting policies and the like. PCAOB standards require such communications between the auditor and the company's audit committee. As management is typically present when such communications are made, either the audit committee or management can leverage those communications into whatever public disclosures they deem necessary or are required by current or revised SEC or financial reporting framework standards. We note that the two-way dialogue explicit in the auditor/audit committee communication is critical to its complete understanding by all parties. Trying to put such communications into an AD&A is not feasible. As such, we suspect that it would be similarly difficult for management to make public disclosures regarding some of the auditor/audit committee communications. However, if the investors demand additional information in this regard, we believe that enhanced accounting and footnote or other disclosure requirements to which the company would be bound might serve that objective.

6. *What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

Overall, we do not support the addition of an AD&A. However, if the AD&A is incorporated into professional standards, it should focus on items that the auditor noted of relevance, not those items deemed to be relevant from management's point of view. Items in this category include independence issues and any disagreements with management and their resolution. An AD&A should not include items considered audit team judgments requiring an auditor's breadth and depth of knowledge and experience to understand. Such matters include audit team decisions, audit risks, and audit procedures. Furthermore, auditor disclosure of some of these matters could jeopardize the effectiveness of future audits by informing management of the auditor's plan.

7. *What types of information should an AD&A include about an auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and procedures, and difficult or contentious issues, including "close calls")?*

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Overall, we do not support the addition of an AD&A. As described above, we believe that the auditor's overall view on the company's financial statements is already clearly articulated in the current standard auditor's report. Publicly providing more detailed views could be interpreted as adding piecemeal qualifications of the auditor's overall opinion on the financial statements taken as a whole. Such auditor disclosures could also be perceived to impact its independence. An AD&A should not include the auditor's views or opinions of the financial statements because it may leave an impression that the auditor "approves" all items not specifically mentioned in the AD&A. "Close calls" should not be disclosed as it would not be practical to adequately explain the full spectrum of information used in the judgment. As such, investors will interpret items out of context and potentially make inappropriate investment and other decisions, particularly if they compare auditor comments between companies and even between periods.

8. *Should a standard format be required for an AD&A? Why or why not?*

   Regardless of whether or not a standard AD&A format is released, audit firms will gravitate to a common presentation within their own firm and amongst each another – perhaps even as a means to be able to issue the financial statements timely. Firms will want to work together to find a similar method for communicating the AD&A in an effort to minimize perceived litigation risks associated with such disclosures. Investors will more readily understand a common format and consistent wording if the AD&A is standardized. Additionally, there is less risk of an auditor being scrutinized only because its AD&A is formatted or worded differently.

9. *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

   The benefit of increased information for investors is enhanced decision making ability. However, an AD&A, in this capacity, will expand the responsibilities and role of an auditor while reducing those of management. Allowing management less culpability will only increase the likelihood of corporate corruption and investor insecurity. The auditor is not in the best position to provide this information; management and the audit committee should communicate such matters. Management best understands the entity and its operating environment. To a certain extent, some of this information should remain confidential within the company. Companies are at a distinct disadvantage if they have to disclose business and operational risks to competitors that are not public registrants. Ultimately, such AD&A disclosures may dissuade U.S. security market participation.

10. *How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

    We hypothesize that firms will adopt boilerplate language as described above.

11. *What are the potential benefits and shortcomings of implementing an AD&A?*

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As indicated throughout our response, we see minimal, if any, benefit and significant shortcomings in this proposal. An additional shortcoming is the likely continued overreliance by the user community on the literal wording in the financial statements as opposed to users utilizing their own knowledge and experience in reading and analyzing management's financial statements and commentary, including the MD&A. Additionally, the AD&A will increase the cost of an audit and the time it takes to provide investors with the audited financial statements.

12. *What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

    The AD&A could provide competing views of the financial statements. The differences in disclosures will reduce investor's confidence in management and create an adversarial relationship and atmosphere between the auditor and management. This tension is already apparent even in the auditor's communications with the audit committee whereby management often tries to dissuade auditors from raising potentially concerning matters with the audit committee. Additionally, AD&A disclosures could confuse investors and decrease the credibility of audit opinions in general.

***Required and Expanded Use of Emphasis Paragraphs***

In general, the consensus of the Committee is that the required and expanded use of emphasis paragraphs, while providing another means to highlight and reference certain matters that are deemed significant to the financial statements, will not necessarily provide a user of the financial statements with appreciably more information than is already provided in current financial reporting. Having the auditor make such highlights and references in its report does indicate what another informed constituent believes is significant to the financial statements, but the matters that are likely to be highlighted will already be described in the U.S. GAAP compliant financial statements and related disclosures, Management's Discussion and Analysis (including Critical Accounting Policies) and elsewhere in current reporting. In many if not most cases, the matters that an auditor would highlight in its report will not be different than the matters management describes in fulfilling its responsibility in preparing such reports.

A strong consensus of the Committee was that any required or expanded use of emphasis paragraphs should not include a discussion of audit procedures performed by the auditor in regards to the matters described therein. It is impractical to expect the whole body of audit procedures that serve to mitigate audit risk in any single particular area to be adequately described in such paragraphs and incomplete descriptions (which will result particularly if the requirement is to describe only *key* procedures) will only serve to cast doubt in a reader's mind as to the adequacy of such procedures. For this and several other reasons, the Committee is opposed to any requirements to describe audit procedures.

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13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

Yes. However, the description of such matters in the auditor's report would necessarily not be sufficiently comprehensive to provide adequate information to help make such decisions. As the auditor's report would also reference further descriptions of the identified matters, the report merely acts as a cross reference guide to information that should otherwise already be more detailed in the footnotes and elsewhere in the filing. It can certainly be envisioned that the auditor's description of such matters in its report may contain incremental information about the matter that is not part of the required disclosure under US GAAP; however, such limited incremental information is not likely to completely address the matter in any case.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

The Committee is not convinced that providing highlights of matters deemed to be significant to the financial statements will appreciably serve the purpose of better informing readers of the financial statements. If such a requirement is mandated, it must be flexible enough to allow adequate auditor judgment as to what matters to include in these paragraphs, including not describing any such matters if none are deemed significant to warrant more heightened identification.

If such a requirement is not mandated, there is a risk that audit committees, when selecting their independent auditing firm, begin to consider whether an auditor does or does not routinely include such paragraphs in its reports.

As described above, the Committee is opposed to describing any audit procedures in the emphasis paragraphs or any other communication.

15. *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

In addition to the matters included in the illustrative emphasis paragraphs (excluding key auditing procedures) and as already provided as examples in current PCAOB standards, other matters that an auditor might consider identifying include significant non-routine transactions, selection of alternative new accounting policies or practices that might have significant alternative impacts, changes in prior period estimates that resulted in a significant impact on earnings and that the audit process does not mitigate all risk that future events and developments will not result in material adjustments in the financial statements.

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The level of detail in which to describe such matters should be limited to objective facts and only a brief description sufficient to provide a basic understanding of the applicable matter and a specific reference to the footnote where more comprehensive detail can be found. Auditor judgment will be required as to whether specific account balances, if applicable, are required to convey that basic understanding. A requirement for the auditor to specifically describe the particular risks that a specific matter might raise in the financial statements would necessitate lengthy descriptions and potentially dilute the confidence in the auditor's overall opinion regarding the financial statements taken as a whole.

16. *What is the appropriate content and level of detail regarding the matters presented in the required emphasis paragraphs?*

See above response 15.

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

With the potential conflicts that might arise between auditors and management about the descriptions of matters in this paragraph and the litigation risk that auditors will try to avoid, it is difficult to contemplate that a certain amount of the language will not become boilerplate. It is possible that the resulting boilerplate language will adequately provide the required information and thereby not be a detriment. Unique matters that effect different companies' and different industries' financial statements should naturally prompt unique descriptions in some areas. The more prescriptive the Staff's requirements are (and some prescription will be required to drive some appreciable level of consistency as to what descriptions are required), the greater the tendency to become boilerplate.

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

Potential Benefits:

- Highlighting matters the auditor considers significant to the company's financial statements will provide readers with direction on where to focus their attention
- Footnote disclosures may improve if auditors insist or encourage additional description of the matters in the footnotes to avoid lengthy descriptions in the auditor's report
- Simply describing the significant matters should not significantly increase efforts or cost of auditing the financial statements
- Potential decreased liability to companies and auditors as significant matters are more prominently highlighted and less likely to be overlooked by users of the financial statements.

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Potential Shortcomings:

- Increase conflicts between auditors and management in regards to what matters to disclose and how they are described in the auditor's report
- Potential dilution of the confidence of the auditor's opinion on the financial statements as a whole due to the highlighting of risk areas
- Determining what and how to disclose matters in the auditor's report and discussing those decisions with management and audit committees may appreciably increase auditor efforts and audit costs and delay financial statement issuance.
- Duplication of descriptions in the footnotes and/or other parts of the periodic reports will decrease the effectiveness of the proposed model
- Potential increased liability to companies and auditors if matters not included in recent reports eventually have significant adverse impact on investors

***Auditor Assurance on Other Information Outside the Financial Statements***

In general, the Committee is not opposed to mandatory auditor reporting on information outside of the financial statements as long as there is appropriate, objective guidance on how the auditor is to accomplish such reporting. We believe, in particular, that one reporting option should include a report that simply indicates the auditor's current AU 550 responsibility in regards to information outside of the financial statements.

19. *Should the Board consider auditor assurance on other information outside of the financial statements as an alternative for enhancing the auditor's reporting model?*
    a. *If you support assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

       Auditor assurance on other information outside of the financial statements would provide users some additional comfort regarding the completeness and appropriateness of the information presented as compared to the SEC or other requirements for disclosure of such information. However, this auditor reporting must stop short of providing the auditor's detailed views on the company's financial statements and of describing audit procedures. The auditor reporting must be limited to no more than an examination or review of the other information, generally as contemplated by AT Sec. 701 for auditor reporting on MD&A.

    b. *On what information should the auditor provide assurance e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why?*

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Auditor reporting should be limited to financial statement-related information. However, great care must be taken not to associate auditor reporting on information that includes forward looking statements or expectations. Even limited auditor assurance on such areas of information can be inappropriately perceived as the auditor providing its views on such forward looking statements or expectations. In any case, applicable auditing standards would need to be developed to provide guidance to auditors as to how to accomplish the required reporting (other than for MD&A). We also recommend that auditor reporting on other information outside of the financial statements be available, but not required in most circumstances.

c. *What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

The level of assurance contemplated in AT Sec. 701 appears appropriate, or, as suggested in the introduction to this section of our response, assurance equivalent to the current AU 550 requirements can be provided.

d. *If the auditor were to provide assurance on a portion of the MD&A, what portion or portions would be most appropriate and why?*

As the current MD&A requirements contemplate significant forward looking statements and expectations, it does not seem appropriate to mandate auditor reporting on all of MD&A. However, the Critical Accounting Policies and Contractual Obligations section of MD&A is generally important to investors and could be subject to auditor reporting. Additionally, reporting on strictly historical comparisons of operating results and liquidity could be possible.

e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, why?*

The Committee does not believe auditor reporting will significantly affect the nature of MD&A disclosures. Management is already aware of the auditor's responsibility to read the MD&A and consider whether such information or the manner of presentation is materially inconsistent with the financial statements or represents a material misstatement of fact. However, we do believe that specific reporting on MD&A could prompt management to better comply with the spirit of MD&A disclosure requirements thereby improving the final product.

f. *Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

We do believe that the current requirements are sufficient. As described above, reporting only on auditor responsibilities as contemplated under AU 550 would also be appropriate.

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g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why?*

Management is responsible for information presented in MD&A, earnings releases, and other communications about their company and that responsibility should not be shifted in any way to the auditor. Management should be responsible to its investors first and foremost. However, as long as auditor reporting on such information is limited as described above and does not serve to shift responsibility, the Committee is not opposed to certain mandatory auditor reporting on such information.

20. *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

Potential benefits

- Investors gain incremental comfort in the other information because of the auditor's reporting thereon
- Users would be more conscious of the auditor's requirement to review MD&A for consistency with the audited financial statements
- Filers may become more conscientious in preparing their filings

Potential shortcomings

- Increased audit effort and increased fees
- Increase time to release the filing because of the additional procedures
- Decrease in market participation due to the prior shortcomings
- Possibility that investors assume more auditor assurance than is actually given on such information
- Increased responsibility and increased legal liability for auditors

***Clarification of the Standard Auditor's Report***

In general, the consensus of the Committee was that clarification of the standard auditor's report is appropriate. Information that might enhance a financial statement user's understanding of the audit process and auditor's, management's and the audit committee's roles in regards to the audited financial statements would be beneficial. We concur with the specific items that the staff suggests might be clarified, subject to two caveats. First, the clarifications will need to be succinct so as not to lengthen the standard auditor's report to an extent that it distracts the reader from the auditor's opinion on the financial statements. Second, the clarifications will need to be worded such that they do not read as if the auditor is attempting to relinquish or diminish its responsibilities to accurately report on the financial statements.

Another alternative, or perhaps a supplemental alternative, is for the auditor's report to provide a cross reference to a more complete description of what a public company auditor's role and

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responsibilities are and what level of assurance a compliant audit might provide. The referenced materials can be either a standard exhibit in all filings or available to the general public on a free basis from a named web-site.

21. *a. Do you believe some or all of {the clarifications described in the concept release} are appropriate? Is so, explain which of these clarifications is appropriate? How should auditor's reports be clarified?*

We agree that each of the noted matters should be clarified in the standard auditor's report. We make reference to the Center for Audit Quality's June 9, 2011 letter addressed to Mr. Martin Bauman of the PCAOB. The clarifications of these matters provided in the example standard auditor's report in that letter are adequate – both succinct and appropriately tailored to not appear to diminish the auditor's responsibilities. That example report also provides clarity as to a) the audit committee's responsibility for financial statements, b) the audit firm network structure and related matters, c) what is meant by 'material misstatement' and the auditor's general approach to determining 'materiality', d) the auditor's professional judgment in making audit risk assessments and in selecting audit procedures, e) the auditor's responsibility if the financial statements are not in accordance with the appropriate financial reporting framework or when audit scope has been limited and f) the addressees of the report. We have no objections to clarifying these matters or the manner in which the example report does so.

21. *b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not?*

These clarifications would serve the indicated purpose. As noted above, an even more comprehensive description of these matters as cross referenced from the auditor's report would be even more valuable (absent undue length which might reduce its impact). The more financial statement users understand about the public company auditor and its responsibilities in regards to the audited financial statements, the more informed they will be as to the level of assurance the auditor provides in its report as to the fair presentation of the financial statements. While this incremental understanding does not necessarily translate into a better understanding of what risks might reside in those financial statements, it nonetheless allows the user to better appreciate how the auditor may have addressed such risk as part of its audit.

21. *c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

See responses above. In addition, although we agree with the Board's suggestion for clarification to include an enhanced discussion about the "auditor's responsibility for fraud," we also believe that the discussion of "management's responsibility" should also include a statement that management is ultimately responsible for the prevention and detection of fraud.

21. *d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

We do not believe the clarifications described or referred to above would significantly impact the scope of the audit or the responsibilities of the auditor.

22. *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

Potential Benefits:

- Enhanced understanding by audited financial statement users of the differing roles and responsibilities between management, audit committees and auditors in the presentation of those statements
- Enhanced understanding by audited financial statement users of the audit process and the level and areas of assurance provided in an auditor's report

Potential Shortcomings:

- Either the additional length of the auditor's report necessary to more fully clarify its terms and other matters or the need to obtain and read a separate document
- In an attempt to cover all areas of importance, the clarifications are truncated to reduce length, thereby reducing – rather than increasing – clarity
- Reduced focus on the auditor's opinion regarding the financial statements

***All Alternatives***

23. *The concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alterative is most appropriate and why?*

Our Committee believes the most appropriate alternatives are clarification of certain language in the auditor's report and potentially the expanded use of the emphasis paragraphs in the auditor's report. We believe that the current "pass/fail" model of reporting continues to be the best method to communicate the auditor's conclusion. Therefore, clarification of the terms used in the report and the concepts and limitations of the auditor's opinion would be helpful to the users of the financial statements. We also believe that expanded use of the emphasis paragraph could improve the auditor's report by directing users of the statements to footnotes where management describes issues that are essential for the reader to be aware of when evaluating the financial information. We believe that expanded

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footnote and other management-provided disclosures that provide more completely the information that investors are requesting is the best way to inform the reader of risks related to the financial statements.

24. *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

See prior response. We believe that a combination of clarification and an expanded use of the emphasis paragraph would be the best combination of improving auditor communication.

25. *What alternatives not mentioned in this concept release should the Board consider?*

The historical approach to communicating the auditor's findings through a "pass/fail" auditor's report continues to be an acceptable overall approach.

Should one of the alternatives described in the Concept Release or a combination of them and/or other alternatives become PCAOB standards, the Board might consider whether any of them should be limited to only specific issuers – for example, just for large accelerated filers or just for issuers in certain industries.

26. *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

Auditors are not and should not be financial advisors; therefore, reporting frameworks should be based on a concept that the auditor tested management's financial information. The conclusions of the auditor should be easy for a reader to clearly understand and be based on independently verifiable evidence. This basic concept precludes an auditor from giving its perspective on the reasonableness of information provided in MD&A that cannot be independently verified.

27. *Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

Our Committee believes that users could perceive that the auditors are providing a qualified or piecemeal opinion such as:

- The AD&A discussion of audit issues changes the users' perception of the value of the auditor's opinion.

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- A report that includes multiple emphasis paragraphs could also devalue the auditor's opinion.
- The auditor reporting on other information could be perceived, when combined with the auditor's report, as a piecemeal opinion.
- The clarification of terms in the auditor report reach the level that it appears the auditor is attempting to diminish its responsibility and/or lengthens the report to the point it becomes unreadable.

The Board should remain cognizant of the fundamental principles on which an auditor's opinion is based. Any changes to the auditor's reporting model should continue to emphasize auditor independence from management and be based on information obtained through auditor procedures.

28. *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey? What is the basis for your view?*

Further clarification in the auditor's report of the auditor's role in the performance of an audit could, if properly written, convey a better understanding of the auditor's role to the users of financial statements.

The other alternatives could lead the user to the conclusion that the auditor's opinion has too many caveats and therefore cannot be relied upon.

29. *What effect would the various alternatives have on audit quality? What is the basis for your view?*

AD&A and auditor's reporting on other information could reduce audit quality since management and the audit committee would be more guarded about sensitive information because of the risk that the auditor's interpretations of the facts would be reported to the public. Such measures could lead to a) less open discussions between the auditor, management and the audit committee about significant audit issues and b) more boilerplate disclosures in an attempt to avoid issues and limit litigation risk.

30. *Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisors, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports of other entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

Our Committee has not formed an opinion on this question.

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31. *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, affects on audit committee governance, liability considerations, and confidentiality.*

   a. *Are any of these considerations more important than others? If so, which ones and why?*

      All of these considerations are important. Attempting to identify the "most" important should not be seen as relegating the other considerations to an "unimportant" category. Perhaps the most important consideration is the credibility of the auditor's opinion. The "pass/fail" approach to providing an opinion on financial statements has been in place for decades for a good reason, it works effectively. Although different auditors interpret the "pass/fail" line at somewhat different points, and decisions such as a company's ability to continue as a going concern, remain subjective, there is a well-established framework within which a user of financial statements can have a significant level of confidence in the auditor's opinion.

      The Board's efforts to enhance the auditor's reporting model seem to focus primarily on the needs of users in the investment community. These users have a higher level of "competence" in evaluating information available to them from a myriad of sources in making investment decisions. The audited financial statements are a key, but not the only, component in making their decisions. As auditors expand the scope of information over which they opine, the question of competency to do so will be an element in how investors evaluate such information. As historical information more appropriately subject to the audit process becomes combined with forward-looking information which is less subject to that process, sophisticated users will begin to question the auditor's overall opinion on all information. This dilution of credibility would likely have the impact of cheapening the value of the auditor's opinion and ultimately, market confidence.

      The existing relationship between the auditor and management will also likely change significantly under certain of the options presented in this proposal. Currently, the auditor depends on ongoing, open, honest communications with management. Certain matters that impact the decisions that frame an auditor's opinion are shared by management because it understands much of that information – which may include confidential information as well as competitive information – will remain out of the public domain. Under the current model, there is proper and appropriate exposure to the audit committee and those charged with governance; and the "pass/fail" framework serves to protect the confidentiality where warranted. For example, assume that in the course of the audit, the auditor becomes aware of certain weaknesses in internal controls, and management is not required to obtain an auditor's report on controls. The auditor, under current auditing standards, is

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obligated to inform those charged with governance of his or her concerns about the impact those weaknesses might have on the presentation of financial statements and/or the conservation of the entity's assets. This creates a positive atmosphere wherein the auditors can express their concerns, and management can evaluate the seriousness of the auditor's concerns and take appropriate actions. This is a "win-win" situation for the auditor and management. However, in a scenario where such control weakness(es) are made public, there would be a win-lose or a lose-lose scenario. The open communication that both auditor and management need to identify and evaluate the control weakness(es) suffers in management's attempt to keep the issues private. The users of the financial statements are left to wonder how the control deficiency impacts their investment decision. More information is not always better information. And what happens when management has a response to the auditor's findings? What weight does the auditor give to that response in his report, and how does the user evaluate it? This becomes problematic and likely not useful information to the user.

Finally, cost and timing of the audit can only suffer from requiring additional efforts from the auditor, and exposing the auditor to increased liability.

b. *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

The justification depends on the nature of the changes. A relatively simple change requiring the use of emphasis paragraphs in the auditor's report which functions like an "index" to information provided elsewhere in the financial statements and the accompanying disclosures, would not significantly increase costs and might be worth the additional information. Given the concerns we identified in our response to Question 31 a., above, we have significant doubts as to the cost justification for any of the other proposals. If credibility is harmed, as we suspect it would be, then <u>any</u> additional cost would not be justified.

c. *Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

Enhanced usefulness of financial statements is most likely to involve more meaningful disclosures within the financial statements and MD&A. Some of the current information required in these disclosures borders on the incomprehensible to many readers. The sheer volume of information can distract from the most important issues on which a user should be focused. One suggestion for enhancing disclosures would be to have a separate footnote that identifies all significant risks associated with use of the financial statements. This could include the sensitivity of certain key estimates, the impact on going concern should certain key assumptions not prove as positive as projected, etc. On the other hand, certain disclosures should be evaluated

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to determine if they could either be eliminated or reduced to convey only the most meaningful and relevant information to users.

d. *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

The additional effort required to add the "financial statement risk" disclosure would likely be offset by reduction in other less meaningful disclosures. Any addition to the auditor cost becomes problematic due to competitive pressures in acquiring large audit clients. This price competition will not, in the long run, prove to be motivation on the auditor's part to improve the audit process.

32. *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

We do not agree with the concept of the auditor providing additional information on the company's financial statements in auditor reporting. We do agree, as the release describes in detail, that there may be many practical challenges and unintended consequences that would result from additional auditor reporting. The working dynamics of the triangle of the auditor, management, and the audit committee is typically fragile at best, with each member of the triangle having its own direct responsibilities which at times may not be consistent with that of the other members. As a result, this additional information should not become a corroborative effort nor should it ever become an integrated type of reporting method. The nature, timing, cost, content and extent of the additional information would most certainly weigh heavily on the interaction of the auditor, management, and the audit committee. As we have previously indicated, any additional information regarding the company's financial statements that is to be required should not be included in the auditor's report but rather should be included in expanded note disclosure and /or expanded MD&A required topics of discussion, both of which are management's responsibilities.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

Kevin V. Wydra, CPA
Chair, Audit and Assurance Services Committee

James J. Gerace, CPA
Vice Chair, Audit and Assurance Services Committee

ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2011 – 2012

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to more than 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

| | |
|---|---|
| **Public Accounting Firms:** | |
| **Large:** (national & regional) | |
| James J. Gerace, CPA | BDO USA, LLP |
| William P. Graf, CPA | Deloitte & Touche LLP |
| Howard L. Gold, CPA | LarsonAllen LLP |
| Jeremy L. Hadley, CPA | McGladrey & Pullen LLP |
| Jon R. Hoffmeister, CPA | Clifton Gunderson LLP |
| James R. Javorcic, CPA | Mayer Hoffman McCann P.C. |
| Michael J. Pierce, CPA | McGladrey & Pullen LLP |
| Elizabeth J. Sloan, CPA | Grant Thornton LLP |
| Kevin V. Wydra, CPA | Crowe Horwath LLP |
| **Medium:** (more than 40 professionals) | |
| Jennifer E. Deloy, CPA | Frost, Ruttenberg & Rothblatt, P.C. |
| Sharon J. Gregor, CPA | Selden Fox, Ltd. |
| Timothy M. Hughes, CPA | Wolf & Company LLP |
| Andrea L. Krueger, CPA | Corbett, Duncan & Hubly, P.C. |
| Matthew G. Mitzen, CPA | Blackman Kallick LLP |
| Stephen R. Panfil, CPA | Bansley & Kiener LLP |
| Richard D. Spiegel, CPA | Steinberg Advisors, Ltd. |
| **Small:** (less than 40 professionals) | |
| Scott P. Bailey, CPA | Bronner Group LLC |
| Julian G. Coleman, Jr., CPA | Horwich Coleman Levin LLC |
| Patrick J. Dolan, CPA | CJBS LLC |
| Robert D. Fulton, CPA | Mulcahy, Pauritsch, Salvador & Co Ltd |
| Loren B. Kramer, CPA | Kramer Consulting Services, Inc. |
| Ludella Lewis | Ludella Lewis & Company |
| Carmen F. Mugnolo, CPA | Philip + Rae Associates, CPA's |
| Jodi Seelye, CPA | Jodi Seelye, CPA |
| **Staff Representative:** | |
| Ryan S. Murnick, CPA | Illinois CPA Society |

# ICBA
INDEPENDENT COMMUNITY BANKERS *of* AMERICA



September 29, 2011

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

Re: Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the concept release on possible revisions to Public Company Accounting Oversight Board (PCAOB) standards related to reports on audited financial statements. This concept release establishes alternatives to the current auditor reporting model with the goal of improving auditor communication to stakeholders by increasing the transparency of the current model and its importance for users. The release includes four alternatives that would supplement the current auditor's report to increase investor communication by the auditor without changing their role in the audit. The main impact of the implementation of the alternatives provided on reporting companies would be the increased use of auditor guidance to accompany currently issued opinions associated with audits of the financial statements and an expansion of the scope of the audit and the associated audit procedures.

**Background**

The current auditor's report represents a pass or fail model that discusses whether or not an organization fairly presents its financial statements in accordance with generally

[1] The Independent Community Bankers of America represents nearly 5,000 community banks of all sizes and charter types throughout the United States and is dedicated exclusively to representing the interests of the community banking industry and the communities and customers we serve. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.

With nearly 5,000 members, representing more than 20,000 locations nationwide and employing nearly 300,000 Americans, ICBA members hold $1 trillion in assets, $800 billion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

accepted accounting principles (GAAP). In order to provide increased transparency into the audit and to move beyond the pass or fail opinion of presentation, the PCAOB has introduced the following four alternatives in the concept release:

- Auditor's discussion and analysis
- Required and expanded use of emphasis paragraphs
- Auditor assurance on other information outside the financial statements
- Clarification of language in the auditor's report

*Auditor's Discussion and Analysis.* This supplement to the auditor's report would be used by the auditor to discuss significant items associated with the audit. The goal of the auditor's discussion and analysis would be to give the reader an understanding of the auditor's opinion over the financial statements. Items covered here could include audit risks, procedures and results, and the auditor's views on management judgments and estimates. The discussion could also include areas where the auditor believes management could have used different disclosures or accounting practices.

*Required and Expanded Use of Emphasis Paragraphs.* Currently emphasis paragraphs can be added to the auditor's report at the discretion of the auditor to bring emphasis to a specific matter regarding the presentation of the financial statements. Under the concept release emphasis paragraphs would be used to highlight the most significant matters in the financial statements with the location of their disclosure. Further use of emphasis paragraphs could be required for materially large management estimates and measurement uncertainty.

*Increased Auditor Assurance.* The auditor's assurance could be broadened to include information outside the financial statements supplied by management including the management's discussion and analysis and non-GAAP financial measures. Expansion of auditor assurance to include information outside the financial statements would be used to provide increased confidence for stakeholders in the supplemental information provided by management.

*Clarification of Language in the Standard Auditor's Report.* This proposal involves expanding the explanation of what the audit is meant to represent and which responsibilities are with the auditor. Topics for inclusion here could include explanations for reasonable assurance, auditor's responsibility for fraud, auditor independence, and the auditor's responsibility for financial statement disclosures.

**Impact on Community Banks**

Of the four alternatives discussed in the concept release, ICBA supports the clarification of language in the standard auditor's report. Expanding the auditor's report to cover a discussion by the auditor of what the audit represents and the responsibilities of the auditor helps to further educate the users of the financial statements on the purpose and scope of the audit and the expectations of the auditor. Specific focus should be placed on the fact that management is fully responsible for the preparation of the financial statements and that the auditor expresses an opinion based on the findings of the audit. Additionally, the importance of the independence of the auditor and the requirement to comply with applicable independence requirements should be highlighted.

ICBA cautions against implementing any of the remaining proposed alternatives in the concept release without due consideration to the costs involved and their economic impact on smaller reporting companies including financial institutions. The introduction of the auditor's discussion and analysis, required use of emphasis paragraphs, and an increase in auditor assurance would almost certainly increase the costs of the audit substantially for these smaller reporting companies as it would require additional time and effort on the part of the auditor as well as the hiring and training of new personnel to complete the required procedures. Additionally, the auditor would face increased legal liability, with new incremental costs that would be passed on directly to the audit client in the form of higher fees. Implementation of the alternatives proposed would not result in any added benefits to financial statement users that are worth the increased costs of the audit since any need for increased disclosures could be fully integrated by the management of the reporting company. The role of management includes providing the disclosures necessary to inform the user of the financial statements of all relevant circumstances surrounding the company's performance and risks. Replacing the role of management with the independent auditor does not properly serve the needs of investors since they serve two different roles.

ICBA believes that the role of the independent auditor should remain limited only to the scope of the audit and its underlying assurance procedures. Expanding the role of the independent auditor is costly for the company, requires more time and resources for the auditor, and provides no incremental benefit to the stakeholder. Rather than increase the audit burden on reporting companies with no clear benefits, the PCAOB should focus its attention on keeping the auditor independent of the management of the organization to ensure that the role of the auditor retains its independent nature.

ICBA appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 659-8111 or james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
Vice President, Accounting & Capital Policy

INDEPENDENT DIRECTORS COUNCIL

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September 30, 2011

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

Re: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements; PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

The Independent Directors Council[1] appreciates the opportunity to comment on the Public Company Accounting Oversight Board concept release seeking public comment on several alternatives for enhancing the auditor's reporting model. The release encompasses a range of options aimed at increasing the transparency and relevance of auditor reports to financial statement users, while not compromising audit quality. We are commenting to express a general concern that we have on the potential adverse impact of these options on the relationship between fund board audit committees and fund auditors.

As an initial matter, we believe that the options discussed in the release, for the most part, should not apply to SEC-registered investment companies.[2] As the Investment Company Institute

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[1] IDC serves the fund independent director community by advancing the education, interaction, communication, and policy positions of fund independent directors. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of almost $13 trillion and serve over 90 million shareholders, and there are almost 1,900 independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] We do, however, support the option to provide clarification of concepts included in the auditor's report. We agree with the recommendation contained in the letter from the Investment Company Institute that, for audits of SEC-registered investment companies, the clarification should describe the auditor's consideration of the fund's internal control over financial reporting, including controls relating to security valuation, for purposes of designing audit procedures to be performed and expressing an opinion on the financial statements. *See* Letter from Gregory M. Smith, Director– Operations/Fund Accounting, Investment Company Institute, to Office of the Secretary, Public Company Accounting Oversight Board, regarding Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (Sept. 30, 2011) (ICI Letter).

explains more fully in its comment letter, these options would provide little, if any, benefit to fund investors because fund financial statements are inherently less complex than operating company financial statements and entail fewer estimates and judgments than operating company financial statements.[3]

In the event these options are applied to registered funds, we oppose any required disclosure about the details of the communications between a fund's audit committee and the fund's auditor relating to the audit and the fund's financial statements. As part of their role to promote the interests of shareholders, fund directors oversee a fund's financial reporting process and therefore have a keen interest in preserving the effectiveness of the relationship between the board's audit committee and the auditor. We agree with those who have expressed concern that if the auditor were required to provide certain additional information about the audit and the company, such as details of communications between the audit committee and auditor, the discussions would suffer as a result.[4] As noted in the release, auditors "have regular and free-flowing dialogue with management and the audit committee as part of the audit." We are concerned that a requirement to disclose information about these communications could have a chilling effect both on the nature and the content of these discussions.

Disclosing potentially sensitive discussions in an auditor's report, either in an auditor's discussion and analysis or an emphasis paragraph, could impair the transparency and openness that contributes to the effective working relationship between a fund's audit committee and its auditor. This relationship is marked by a give-and-take that cannot effectively be captured in disclosure. If audit committee members are concerned that their questions and comments may eventually be made public, their discussion with the auditors could be stifled, impairing the work of the audit committee to the detriment of fund investors. Accordingly, we urge the PCAOB to be mindful of this concern and proceed cautiously in developing audit standards that could impact the relationship between fund board audit committees and fund auditors.

If you have any questions about our comments, please contact Amy B.R. Lancellotta, Managing Director, at (202) 326-5824.

Sincerely,

Dorothy A. Berry

Dorothy A. Berry
Chair, IDC Governing Council

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[3] *See* ICI Letter *supra* n. 2.

[4] *See* PCAOB Release No. 2011-003 (June 21, 2011).

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Washington, D.C. 20006-2803
USA

By E-mail: comments@pcaob.org

September 30, 2011
494/541/584

Dear Sir(s),

**Re.: PCAOB Rulemaking Docket Matter No. 034**
**PCAOB Release No. 2011-003, June 21, 2011**
**Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements And Related Amendments to PCAOB Standards**

We would like to thank you for the opportunity to provide the Public Company Auditor's Oversight Board (PCAOB) with our comments on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements And Related Amendments to PCAOB Standards (hereinafter referred to as the "release").

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany], is the professional body that represents public auditors in Germany. We are responding to this release not only because certain of our members are registered with the PCAOB and therefore may undertake engagements in which they are required to apply PCAOB Auditing Standards, but also because the issue of auditor reporting is currently subject to debate by a number of other parties worldwide, including the IAASB, IOSCO and the European Commission, and therefore the PCAOB's discussions on this matter are relevant in this context.

Given the questions about the value of auditing that have arisen in the aftermath of the financial crisis, we consider the initiative by the PCAOB to consult on the

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA

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options for enhancing the value of auditor reporting to be timely and appropriate. We therefore commend the PCAOB for addressing this issue at this time. However, the discussion of the value of auditor reporting cannot be delinked from an exploration of the added value of audits, which relates not only to reporting, but also the scope of the audit. The release recognizes this – particularly when discussing expanding the scope of the audit to information not currently within the scope of the audit – but, in the context of the European Commission's Green Paper on the role of the audit, further exploration of the scope of the audit beyond that in the paper is necessary.

We note that consultation with stakeholders on changes to auditor reporting is necessary because the issues relating to enhancing audit reporting and the scope of financial statement audits are foremost *political and legal* issues – not technical issues. Clearly, even political decision-making can only occur in the context of technical reality and therefore must be technically appropriate, but the questions about what, when, how (in a general sense) and to whom auditors should report given a particular audit scope, and whether the scope of audits should be enhanced, are public policy issues that require political resolution implemented by legal or regulatory means. **Such selection of public policies in relation to enhancing audit reporting ought to be decided on the basis of the public interest, which involves consideration of the costs and benefits to the public of potential policies, including the incidence of such costs and benefits among affected stakeholders.**

In this respect, we are concerned about suggestions that the auditor provide further "insights" into the audited entity or the audit. Without in any way suggesting that further exploration of audit reporting and audit scope issues to increase the added value of audits is not necessary – in our view, it is – we would like to note that some sophisticated investors, per se, always want more rather than less information, especially since potential (as opposed to existing) investors in entities perceive the provision of additional information as being virtually costless, and as not having an impact on the timing of communications. Hence, potential investors do not perceive that they are bearing the cost of additional information provided, which leads to a "free rider" syndrome among them. Once having obtained more information by means of regulation, such investors would still not be satisfied and then ask for even more, regardless of the cost. This is why it is important that **the selection of public policies in relation to audit reporting and scope needs to involve consideration of who all of the users of financial statements are and the actual demand for more information, as well as of the costs and benefits to the public (not just to certain investor groups) and the incidence of such costs and benefits.**

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It should also be recognized that the provision of additional information in audit reports, particularly, but not limited to, information obtained by extending the scope of the audit, involves greater work effort and hence the incurrence of additional cost by auditors, which must ultimately be borne by preparers and then indirectly by other stakeholders, including investors. Calls for more information under the assumption that this would not involve significant increases in cost are not serious propositions. Nevertheless, there may be cases where the provision of more information may involve the benefits of that information exceeding the cost of providing it. **It is therefore important that legislators and regulators perform serious cost-benefit analyses to determine the need for additional information prior to prescribing its provision.**

Current discussions in the International Accounting Standards Board (IASB) and in other bodies about reducing the extent and complexity of disclosures in financial reporting suggest that most investors, other than a comparatively small group of financial analysts in certain larger financial institutions and funds, are already subject to information overload from, and have difficulty understanding, the information already provided to them. In this context, the call for "more" information may need to be interpreted as a call for "better" information by less sophisticated investors, rather than for "more". Furthermore, the provision of additional or better information may require more time, which may decrease its relevance to users. **It is therefore important for public policy decisions in relation to both financial and audit reporting to consider whether "better" information needs to be provided, rather than just "more", and the impact of additional information provided by auditors on the timing of the communication of information and the ability of most investors to process that information and understand it given the increasing complexity of financial reporting.** However, as the nature and sophistication of investors that use financial statements and auditor reporting vary considerably, it will be challenging to have concise and clear auditor's reports that meet certain investors' desires for additional information without causing information overload for most investors.

Audits are complex services that are difficult for many investors to understand, even though audits play an important role in the economy and in financial markets. Given the nature of some of the suggestions in the paper for more information from auditors, it seems that many investors may not fully appreciate what an audit involves or what the role of the auditor currently is, which contributes to the expectations gap. Some of the demands for more information from auditors – in particular "soft" information, such as the suggested "auditor's insights" – may in part be driven by the desire of investors to transfer investment risks from investors to other parties. Investors seek to minimize the risks arising from their investments without sacrificing returns, and ideally, would like "riskless" investments with high returns. To this effect, calls for more "soft" information from the auditor may in part reflect investors' desires to unreasonably narrow the expectations gap, which in its extreme form would involve closing the expectations gap by having auditors provide information that in effect represents a "guarantee" (i.e., have the auditors provide their views on audited entities, but make the auditors fully liable for those views). However, despite government support of financial institutions in the last financial crisis, and Eurozone support for Eurozone countries with sovereign debt difficulties to prevent greater private sector participation in losses, it is still a fundamental principle of free enterprise that those making investment decisions ought to bear the risks of those decisions. Disregarding this principle leads to moral hazard in investment decisions, which in turn leads to the gross misallocation of capital in economies, with the attendant negative macroeconomic consequences. **It is therefore important that public policy decisions in relation to audit reporting (including other communications in relation to the audit) and scope consider the proper delineation of the roles and responsibilities of audit stakeholders, including management, those charged with governance, auditors, and investors, and the appropriate nature and extent of the risks that ought to be borne by each in those roles and responsibilities to facilitate the efficient and sustainable operation of capital markets.**

In this context, communication by auditors with those charged with governance, and, in particular, audit committees, represents an important factor in aiding those charged with governance in meeting their oversight responsibilities, including their oversight responsibilities over financial reporting and the audit. Reporting by auditors to investors plays an important role in conveying to investors the credibility that they can attribute to financial reporting by the entity. However, the role of those charged with governance is significantly different from that of investors, and therefore when making public policy decisions, legislators, audit regulators and auditing standards setters need to consider the appropriate nature and extent of information to be conveyed by the auditor to those charged with governance compared to investors. Just because information is made available by auditors to aid decision-making by those charged with governance, who are subject to confidentiality requirements, does not mean it is appropriate for all of that information to be made publicly available for investors. A requirement for auditors to provide additional information about their findings to the general public may even unduly impair the effectiveness of audit procedures. The obligation of an auditor to treat information obtained as part of an audit as

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confidential is an important prerequisite for management or other representatives of an entity to provide auditors with the information requested, even if it is regarded as highly sensitive or confidential. If new reporting requirements result in an auditor's obligation to disclose such confidential or sensitive audit evidence to the general public, this may undermine the willingness of management or others to provide auditors with information and thus endanger the effectiveness of an audit. **It is therefore critical that, when considering enhancements to the nature and extent of audit reporting to investors based on information that is made available by the auditors to those charged with governance, policymakers consider the nature and extent of that information that is important for investors without having auditors make public information that may unduly impair the operations of the entity or the effectiveness of the audit.**

At a technical level, public policy decision-making in relation to audit reporting and scope also needs to take into account that some of the "softer" information that some investors would like to have does not have the same quality of evidence available to support that information and therefore may not be as reliable as information currently subject to audit under PCAOB Auditing Standards. If an audit of some of the "softer" information is nevertheless desired by expanding the scope of an audit, **it needs to be recognized that the "reasonable assurance" obtained in these circumstances is less than that obtained for "harder" information for which there is better quality evidence available, that the nature of this part of the audit engagement may be different, and that therefore the audit opinion in relation to such information would also need to be different to convey to investors these differences. In some cases, even if it is considered valuable to have certain additional "softer" information provided by management, it may not always be useful to the public (i.e., it is a cost-benefit consideration) or possible (i.e., adequate evidence is generally not available to support an audit opinion in that respect) to have an audit of some of that information in every case.** Some jurisdictions (such as Germany) do have experience with the audit report extending to softer information, such as in the management report. However, it is important that additional "softer" information opined on in an auditor's report be clearly separated from the opinion on the financial statements and be supported by an introduction that describes the different nature and level of assurance associated with such "softer" information.

However, we note that the quality of an individual audit is not apparent from the auditor's report, which often leads to the value of the audit not being properly recognized, and at worst may lead to the audit being viewed as a commodity.

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Including more information pertinent to each individual audit within the auditor's report may be a means of customising audits for certain issues. **There is an opportunity for the PCAOB to consider improvements to commoditized audit reporting by customizing audit reports for individual audits.**

In summary, the principles upon which we base the responses to the questions posed in the paper are:

- The selection of public policies in relation to enhancing audit reporting and audit scope ought to be decided on the basis of the public interest (not just the interests of certain investor groups), which involves consideration of who all of the users of financial statements are as well as of the costs and benefits to the public of potential policies, including the incidence of such costs and benefits among affected stakeholders.
- It is important for public policy decisions in relation to audit reporting to consider whether "better" information needs to be provided, rather than just "more", and the impact of additional information provided by auditors on the timing of the communication of information and the ability of most investors to process that information and understand it given the increasing complexity of financial reporting.
- It is important that legislators and regulators perform serious cost-benefit analyses to determine the need for additional information prior to prescribing its provision.
- Public policy decisions in relation to audit reporting (including other communications in relation to the audit) and audit scope must consider the proper delineation of the roles and responsibilities of management, those charged with governance (in particular, audit committees), auditors and investors, and the appropriate nature and extent of the risks that ought to be borne by each in those roles and responsibilities to facilitate the efficient and sustainable operation of capital markets. In this context, when considering enhancements to the nature and extent of audit reporting to investors based on information that is made available by the auditors to those charged with governance, it is critical that policymakers consider the nature and extent of that information that is important for these users without having auditors make public information that may unduly impair the operations of the entity or the effectiveness of the audit.
- When auditors opine on "softer" information, the nature of this part of the audit engagement may be different, and therefore the audit opinion in re-

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lation to such information would also need to be different; in some cases, there may be no net public benefit to having some "softer" information audited, or some "softer" information may not be auditable due to a general lack of adequate available evidence.

- There is an opportunity for the PCAOB to consider improvements to commoditized audit reporting by customizing audit reports for individual audits.

We do recognize that the release on auditor reporting, and its relationship to the scope of the audit, is an opportunity to seek to enhance the value of audits by considering whether better information can be provided in audit reports about the current audit, and to consider whether it may be appropriate to expand the scope of the audit. To this effect, we make some specific recommendations in the Appendix to this comment letter to the questions posed in the release. We based our responses in this Appendix to the questions posed in the release on the principles that we have described in this letter above.

Various parties are currently deliberating on audit reporting and the scope of the audit, including the International Auditing and Assurance Standards Board (IAASB) and the European Commission. We would encourage both the IAASB and the PCAOB to strive for consistency between their respective future standards in this regard. It is crucial that the PCAOB consult on auditor reporting, and in particular, the scope of the audit, with regulators in the world's major jurisdictions – especially with the European Commission.

We hope that our views will be helpful to the PCAOB. If you have any questions relating to our comments in this letter, we would be pleased to be of further assistance.

Yours very truly,

| | |
|---|---|
| Klaus-Peter Feld | Wolfgang P. Böhm |
| Executive Director | Director, International Affairs |

<u>Appendix</u>

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# APPENDIX:

## Responses to Questions Raised in the Release

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

   a) **Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

   We believe that the Board should undertake an initiative to consider improvements to auditor reporting because it is important that audit reports are valuable to users. However, the question arises whether it is appropriate to consider commencing a standards-setting initiative without having first examined the responses to the concept release. Because some matters in relation to form or wording of the report may be more easily resolved than matters that extend to the content of the report given the current scope of the audit, which in turn may be more easily resolved than matters that extend the scope of the audit, it may be appropriate to distil those responses to the concept release by issuing a series of discussion papers or a similar vehicles in which the PCAOB makes general proposals to improve auditor reporting based on those responses prior to developing detailed exposure drafts of standards about the noted different aspects of auditor reporting. Given the importance of these issues, it would be inappropriate to seek "quick fixes" without having undertaken a serious cost-benefit analysis for each type of change.

   b) **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**

   Without extending the scope of an audit, matters that might be addressed to improve the standard auditor's report relate to:

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- The format and structure of the report given its current content
- The wording of the report given its current content
- The provision of additional information about the audit given the current audit scope

*Format and Structure of the Report Given Its Current Content*

We believe that one of the main purposes of the auditor's report is to reduce the expectations gap by clarifying to users what the role and responsibilities of the auditor are. The fact that even some sophisticated users are not sufficiently well informed about matters addressed in such paragraphs lends support to this view. This is especially the case if the auditor's report were to be expanded to provide additional auditor commentary. In this case, there may even be a need to include further clarification of responsibilities so that users do not misperceive the role of the auditor.

One of the main issues in this respect is that the financial statements are management's financial statements – not the auditor's financial statements. Consequently, a description of management's responsibilities is crucial to contrast the responsibility of the auditor from that of management. Likewise, removing the description of what an audit involves would only serve to increase the expectations gap. We would therefore not support removing the paragraphs on the responsibilities of management or the auditor. We are less concerned about their positioning within the auditor's report, as long as there is a logical structure to the components of the report such that users are not confused by the report. However, we would not support repositioning these paragraphs to an appendix outside of the body of the report, which has been suggested by some commentators, because it diminishes the delineation of responsibilities between management and the auditors, which would serve to increase the expectations gap.

In respect of placement of the opinion paragraph, we tend towards the view that although it is a key element in the report, it does need to be understood in the right context. Moving the opinion right after the introductory paragraph, which has been suggested by some, also leads to the strange situation that in the case of modified opinions, the Basis for Modifications Paragraph would immediately precede the introductory paragraph. Where would emphasis and other matter paragraphs be placed so as to not indicate that they affect the opinion? Will users understand the change, especially for reports with modified opinions or emphasis or other matters paragraphs? It is not clear whether placing the opinion paragraph (almost) first rather than (almost) last really adds anything to the readability or understandability of the report and it may cause other difficulties as noted: in such a case, it is probably better to stick with tradition on format and structure, rather than moving things around for changes sake.

On the whole, we believe that instruments such as emphasis and other matter paragraphs have worked well because they have not been overused. We believe that these paragraphs ought to be clearly distinguished from any other additional "auditor commentary" that might be provided in the report, if the PCAOB were to choose to include such an item in the report. Their current positioning within the report serves to improve clarity about their meaning.

While changes to the format and structure of the standard auditor's report cause the least direct costs to auditors, such changes are not costless. The templates for auditor's reports would need to be changed across the entire firms and their networks and for standards issued by national standards setters. Such changes also increase the likelihood of errors in the reports, which will likely cause greater quality control costs. We also note some other costs that may result from the changes proposed. In many cases, the benefits of changes, other than the suggestions we make below, are likely to be marginal at best. We therefore recommend that the PCAOB not make changes to the format and structure of the report simply for the sake of change, but consider the direct and indirect costs that we address together with the rather marginal benefits that arise from such changes.

*Wording of the Report Given Its Current Content*

Complexity of the standardized language used is also an issue that means that many users lacking specialized technical skills may find the text hard to understand. However, we note that the terminology often regarded as overly technical language (fair presentation, materiality, misstatement) in fact stems from financial reporting frameworks such as US GAAP (the first two) or from law (negligent or gross "misstatement") and is not solely "auditor jargon". To this extent, users' misunderstanding of the auditor's report due to the use of technical language is actually indicative of a lack of understanding by users of the applicable financial reporting framework and basic legal concepts underlying

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financial statements, which is not something that enhancing audit reporting would resolve. However, where pure "auditing jargon" (e.g., "reasonable assurance") is used, further clarification, or use of plain language to the extent possible, may need to be considered.

Given user misconceptions about the inherent limitations of an audit and what the role of an audit is, the explanation of the auditor's responsibilities ought to be enhanced by referring to these inherent limitations (which has the added benefit of helping to explain the meaning of "reasonable assurance"), and the third sentence of ISA 200.A1 or it's equivalent ought to be added to clarify what an audit does not do.

*The provision of additional information about the audit given current audit scope*

The provision of additional information about the entity or the audit given the current audit scope appears appealing at first glance. However, there are limitations on the dissemination of entity information that represent a real barrier to some of the suggestions made by some users that the auditor provide more information about the entity and its financial statements. In many jurisdictions, management or those charged with governance have legal control over the information about an entity or its financial statements obtained from within the entity: it is the entity's information and only management or those charged with governance have the legal right to determine which information from the entity may be made available to third parties unless such information is clearly required to be made available by law or regulation.

Even if management consents to the auditor providing additional information, data protection laws in the EU member states and other jurisdictions may hinder the provision of certain entity information. Hence, in these jurisdictions, auditors providing more information not provided by management or those charged with governance about the entity or its financial statements would likely be illegal without the introduction of specific laws or regulations to change this situation. The successful introduction of such laws or regulations is very unlikely because business and other enterprises would not be in favour of such legislation or regulation. This legal situation may also present a barrier to the auditor being able to provide information about the audit performed, including key areas of audit risk, because this information is often indistinguishable from information about the entity or its financial statements. It will therefore be very difficult for the PCAOB to promulgate an effective standard requiring such disclosures by the auditor internationally without a provision for an exception due to law or regulation, which would essentially cause that requirement to be ineffective in many jurisdictions.

Legal considerations aside, having the auditor provide information about the entity or its financial statements is not in consonance with the role of auditors vs. management or those charged with governance. An audit is, by definition, an attestation engagement in which the auditor opines on information provided by management or those charged with governance; an audit is not a direct engagement (see current Exposure Draft of ISAE 3000), in which the practitioner performs the measurement or evaluation and reports the resulting subject matter information about the entity. Hence, by suggesting that auditors provide information about the entity or its financial statement directly, users are confusing the relative roles of auditors vs. management or those charged with governance.

This is not to say that some information that is clearly audit-related may not be useful to users, but the costs and benefits as a whole need to be considered, including the impact on information overload of users, as we note in the body of our comment letter. <u>On this basis, consideration might be given to exploring as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. However, it would have to be clear from the report that any such information did not represent any form of piecemeal opinion on isolated aspects of financial statements – the auditor opines the financial statements as a whole – and not individual financial statement items.</u>

c) **Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

We believe it to be appropriate for the PCAOB to consider expanding the auditor's role to provide assurance on matters in addition to the financial statements. However, as we pointed out, issues in relation to information overload for investors as well as the costs and benefits would need serious consideration.

We would like to point out that this question goes beyond "audit reporting", and actually deals with the scope of the audit of financial statements. Extension to scope are possible as long as there are suitable criteria (i.e., criteria against which the entity's performance can be reliably measured or evaluated) for such areas such as prospective financial information, corporate governance, (sustainable) business models, risk management, and key performance indicators, an auditor cannot perform an audit on these matters without such criteria. A subjective assessment by the auditor would be inappropriate because it would neither be in line with AT sec. 101, nor sufficiently consistent to be of benefit to users.

Consequently, this question really represents a consultation for 1. the PCAOB to consider whether certain information accompanying the financial statements ought to be required, and to consider the suitable criteria for that information and the underlying subject matter, and 2. the PCAOB to consider the nature and extent of an auditor's responsibilities for any such information accompanying the financial statements.

Two potential extensions of financial reporting and consequent potential extensions of audit scope include auditor involvement in prospective financial information and in information about business risks (as opposed to risk management), prepared by management. To the extent that prospective information were, in future, required to be disclosed in the financial statements or in information accompanying the financial statements, auditors are able to opine on whether the assumptions used by management are plausible in the circumstances, and whether the information has been appropriately prepared on the basis of those assumptions, but not on whether such forecasts will actually occur. However, if an audit engagement were to be extended to cover prospective financial information, care would be needed not to widen the expectations gap in view of the auditor's limited ability to predict the future. For example, including statements by the auditor as to the future profitability and the sustainability of the entity's business model in the auditor's report would involve the danger of increasing the expectations gap as to the ability of the auditor to predict future events. Auditors are often loath to accept assurance engagements with respect to such information in some jurisdictions because of legitimate liability concerns: therefore, liability reform is a prerequisite for auditor involvement with prospective financial information. In our comment letter to the EU Commission dated December 8, 2010 in respect of the Green Paper on auditing, we also suggested that expanding financial reporting, specifically the management report (also called "management commentary" by IFRS or "annual report" in the Fourth and Seventh EU Directives), by requiring the inclusion of more prospective information – without requiring preparers to perform impracticable tasks, or prompting so-called self-fulfilling prophecies – might also contribute to a fair presentation of the entity's actual economic situation. We also suggested that the scope of the audit in Europe include the management report, provided any legislation in this respect also includes appropriate limitation of auditor liability in this respect.

We comment in turn on the four examples of financial reporting and consequent potential audit scope extensions:

a) Corporate Governance Arrangements

We suspect that users' expectations as to what information might be included in the auditor's report in respect of corporate governance arrangements could vary widely, such that an expectations gap in this respect would be unavoidable. The differences in corporate governance frameworks and requirements world-wide mean that this is an area that does not lend itself to standards setting by the PCAOB.

b) Business Model, Including the Sustainability Thereof

An entity's business model is one aspect that auditors will consider in obtaining the understanding of the entity required by PCAOB Auditing Standards. The auditor also considers the viability of an entity to continue as a going concern for a period of at least 12 months subsequent to the date of the financial statements. However, this is an area upon which auditors do not form an opinion specifically; rather it is considered as part of the opinion on the financial statements as a whole.

We are open to reasonable suggestions relating to legal requirements to have the auditor examine the impact of the entity's business model on the economic development of its business and how related risks are disclosed in the financial statements or in accompanying information. Provided there are appropriate financial reporting requirements (suitable criteria) in this area, the auditor may be able to consider management's assessment of the opportunities and risks that result from the applied business model and consider whether their presentation in the financial statements or in accompanying information is adequate.

c) Enterprise-Wide Risk Management

In some jurisdictions there may be legal requirements for certain entities to have systems to manage risk, whilst in others there may not be. However, PCAOB Auditing Standards do require the auditor to obtain an understanding of whether the entity has a risk assessment process and – in the absence of such a process – to hold certain discussions with management and consider whether it represents a significant deficiency in internal control.

In Germany the IDW has had such an auditing standard since 1999, as certain German entities are required pursuant to the German Aktiengesetz (Stock Corporation Act) to have in place a Risikofrüherkennungssystem (risk early recognition system), which, in respect of listed entities, the auditor is required to address within the audit of the financial statements. The auditor is required to evaluate whether the entity's management has complied with the legal requirement to establish this risk early recognition system in a suitable form and also whether that system is capable of fulfilling its role. The auditor is required to report internally (in the German long form audit report) thereon. Those entities that are not listed entities, but which have such a system because of their size or complexity, often elect to have the auditor cover this aspect on a voluntary basis.

Furthermore, under banking legislation, financial institutions are required to have the appropriateness (that is, the design and implementation, but not the operating effectiveness) of certain aspects of the institution's risk management system as required by banking legislation and regulation audited by their auditors as part of the financial statement audit.

The IDW also has a standard on assurance engagements in relation to parts of enterprise compliance management systems, which, however, is not a part of the financial statement audit.

We would like to point out that in all of these engagements, the subject matter is not the entire enterprise-wide risk management system. Due to the comprehensiveness of enterprise-wide risk

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management systems, extending an audit of financial statements to the entire enterprise risk management system would involve considerably greater cost. Consequently, if an audit were to be extended to risk management, cost-benefit considerations may involve considering the scope of such an engagement in relation to certain aspects of risk management.

d) Key Performance Indicators

As financial reporting becomes more complex, users seek greater simplicity by reverting to key performance indicators (KPIs). Many of these KPIs are so-called "non-GAAP measures" – that is, they are developed by specific enterprises or represent loose industry practice. Prerequisites for auditor involvement with KPIs are suitable criteria for the development of appropriate KPIs and for their disclosure. At the present time, such suitable criteria are not yet available. However, once such criteria are available, auditor involvement may be beneficial to users.

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

   a) **Should the auditor's report retain the pass/fail model? If so, why?**
   We believe that many users continue to find the "binary opinion" (the pass/fail model) useful, and would therefore support its retention. We believe that the pass/fail model is facilitates good audit reporting ,and in this context accept that some standardization in wording is unavoidable.

   b) **If not, why not, and what changes are needed?**

   c) **If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

   As noted in our response to a) above, we believe retention of the pass/fail model is appropriate, and therefore no changes are needed in this regard.

However, as noted in our response to Question 1 b) above, we do believe that it may be worthwhile to consider supplemental reporting. In particular, consideration might be given to exploring as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. However, it would have to be clear from the report that any such information did not represent any form of piecemeal opinion on isolated aspects of financial statements – the auditor opines the financial statements as a whole – and not individual financial statement items.

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

   We believe that management is the most appropriate party to provide additional information regarding the company's financial statements to financial statement users. Please note our detailed response to Question 1 b) above on *the provision of additional information about the audit given current audit scope* for an explanation as to why.

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

   We have no comments on this issue at the present time.

5. **Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

   We do not believe that the PCAOB ought to consider an AD&A as an alternative for providing additional information in the auditor's report.

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**a) If you support an AD&A as an alternative, provide an explanation as to why.**

We do not support an AD&A as an alternative.

**b) Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**

If an AD&A were to be provided, as noted in our response to Question 1 b) above on the provision of additional information about the audit given current audit scope, the AD&A should comment on the audit, but not on the financial statements because 1. of the legal issues involved in having the auditor originating information on the financial statements and 2. the fact that having the auditor originate information in the financial statements blurs the respective roles of management and the auditor.

**c) Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**

As noted, we believe that information about an entity that would be most relevant and useful in making investment decisions ought to be provided by the management of an entity. It is only appropriate that auditors provide more information about the audit – not the financial statements.

**d) If you do not support an AD&A as an alternative, explain why.**

We do not support an AD&A as an alternative because only management should be originating information about the entity. As noted in our response to Question 1 b) above on the provision of additional information about the audit given current audit scope, it is difficult to distinguish the provision of information about the audit from the provision of information about the entity. The concept of and AD&A presumes that a considerable amount of auditor commentary is possible or desirable, which is not necessarily the case.

e) **Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

As noted in our response to Question 1 b) above on the provision of additional information about the audit given current audit scope, consideration might be given to exploring as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. This approach would not involve the provision of information by the auditor that did not originate with management. However, it would have to be clear from the report that any such information did not represent any form of piecemeal opinion on isolated aspects of financial statements – the auditor opines the financial statements as a whole – and not individual financial statement items.

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

As we pointed out above, we do not consider an AD&A to be an appropriate vehicle to improve auditor reporting. We believe that, at most, consideration might be given to exploring as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management.

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

As noted above, the AD&A should not include the auditor's views on the company's financial statements based on the audit, but rather highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. Therefore, there is not appropriate content or level of detail regarding the auditor's views on the financial statements – it is not clear what "the auditor's views" means in this context. What criteria are to be applied for such "views"?

**8. Should a standard format be required for an AD&A? Why or why not?**

Since we do not support the use of an AD&A, we would not support either a standard or non-standard format.

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

We would like to point out that it is unclear what such a discussion of other risks would entail because such a discussion would need to be prepared on the basis of suitable criteria, which do not exist at the present time. If suitable criteria were developed, then applying these criteria to such a discussion would not be a part of the current audit scope, but would involve broadening the current audit scope (i.e., the expansion of the auditor's current responsibilities as noted). Having the auditor apply criteria to these matters means that the auditor is actually obtaining assurance on these matters. The PCAOB would need to consider the costs and benefits of extending the scope of the audit beyond the financial statements and internal control.

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

Without in any way favoring the introduction of an AD&A, in general, the way to avoid boilerplate language is to have auditors address matters that are specific to an individual audit. However, it should be noted that when matters are addressed that are specific to an individual audit, by definition the reports cannot be consistent in these matters. The advantage of such inconsistency is however a reduction in the commoditization of audits. This is why we would support exploring as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

We see few, if any, potential benefits of implementing an AD&A because the shortcomings that we noted above would negate those benefits. These potential shortcomings include having auditors originate entity information (which may not be legally possible or blur the role of auditors and management), and extending the scope of the audit without having the criteria in place so that assurance can be obtained.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

We believe that having the AD&A present inconsistent or competing information between the auditor and management would serve to confuse investors, and would therefore not be desirable: we therefore would expect no such inconsistent or competing information to remain in the AD&A and the financial statements, as auditors and management would seek to minimize such inconsistent or competing information to prevent such confusion.

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

We believe that the release appears to confuse the justification used in France with emphasis of matter paragraphs as conceived in PCAOB Auditing Standards and emphasis of matter and other matter paragraphs as conceived in the ISAs. The French justification is an altogether different concept.

As noted in our previous responses above, it would be inappropriate for auditors to provide information in the auditor's report that originates solely from the entity or its financial statements. It is management's responsibility to help users "navigate" through complex financial reporting. As a matter of principle, the auditor's report should not be used to supplement financial reporting or mitigate poor financial reporting. However, emphasis of matter paragraphs remain a useful tool as long as their use remains exceptional. We therefore believe that increased use of emphasis of matter paragraphs blurs the distinction between the responsibilities of management and of the auditor, would inappropriately change the nature of those paragraphs and their impact, and therefore the costs of increasing the use of these paragraphs are greater than the benefits. Emphasis of matter paragraphs should be used in rare circumstances when the auditor believes there is a need to highlight a matter that is appropriately disclosed and presented in the financial statements that is fundamental to users' understanding of those financial statements.

On this basis, we believe that the PCAOB should make a clear distinction between emphasis of matter paragraphs for exceptional circumstances, and ordinary additional "auditor commentary" that would be provided in every audit, as we suggest in our response to Question 1 b) above, which involves supplemental reporting as to whether the auditor's report might highlight a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

**a) If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

**b) If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

We do not believe that the PCAOB ought to consider a requirement to include areas of emphasis in each audit report in an emphasis of matter paragraph because, as we noted in our response to Question 13, emphasis of matter paragraphs should be used in rare circumstances to highlight matters that are appropriately disclosed and presented in the financial statements but that are fundamental to users' understanding of the financial statements. This should be distinguished from an "auditor commentary" that is included in every audit report that highlights a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. In this case, it would not be appropriate to provide information on key audit procedures because the procedures would either need to be described at such a high level so as to not be useful for users, or be described in such detail that the report would lead to information overload.

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

As noted above, we do not support requiring an expanded emphasis of matter paragraph on the audit; it should be distinguished from an "auditor commentary" that is included in every audit report that highlights a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management.

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

In our view, the appropriate content and level of detail regarding an "auditor commentary" as noted above would be a *summary* of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management. As noted, such a commentary should be distinguished from an emphasis of matter paragraph.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

In general, the way to avoid boilerplate language is to have auditors address matters that are specific to an individual audit. However, it should be noted that when matters are addressed that are specific to an individual audit, by definition the reports cannot be consistent in these matters. The advantage of such inconsistency is however a reduction in the commoditization of audits. This is why we would support exploring as to whether the auditor's report might highlight a summary of significant risks of material

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misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

The primary advantages of implementing an auditor commentary that highlights a summary of significant risks of material misstatement identified during the audit that are identified as significant financial reporting issues in the financial statements by management is the fact that such reporting would reduce the commoditization of audits by having a part of the audit report customized for matters that are specific to a particular audit. Furthermore, by addressing only those matters that are identified as significant financial reporting issues in the financial statements by management, the auditor would not be originating any entity information. This would help users understand the significant audit risks related to significant reporting issues. The shortcoming of implementing such commentary as a required and expanded emphasis of matter paragraph is the elimination of an instrument that enables the auditor to emphasis, in rare circumstances, matters of fundamental importance for users' understanding of the financial statements that have been appropriately disclosed and presented in those financial statements.

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

We believe that the PCAOB ought to consider auditor assurance on other information outside of the financial statements in addition to enhancing the auditor's reporting model. However, when considering to extend the scope of the audit in this way, the PCAOB must perform serious cost-benefit analyses of the potential impact of such extensions to ensure that there are significant net benefits to the public.

**a) If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**

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We support auditor assurance on other information outside of the financial statements, but not as an alternative to enhancing auditor reporting, but as an additional consideration that involves expanding the scope of the audit.

**b) On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**

Two potential extensions of financial reporting and consequent potential extensions of audit scope include auditor involvement in prospective financial information and in information about business risks (as opposed to risk management), prepared by management. To the extent that prospective information were, in future, required to be disclosed in the financial statements or in information accompanying the financial statements, auditors are able to opine on whether the assumptions used by management are plausible in the circumstances, and whether the information has been appropriately prepared on the basis of those assumptions, but not on whether such forecasts will actually occur. However, if an audit engagement were to be extended to cover prospective financial information, care would be needed not to widen the expectations gap in view of the auditor's limited ability to predict the future. For example, including statements by the auditor as to the future profitability and the sustainability of the entity's business model in the auditor's report would involve the danger of increasing the expectations gap as to the ability of the auditor to predict future events. Auditors are often loath to accept assurance engagements with respect to such information in some jurisdictions because of legitimate liability concerns: therefore, liability reform is a prerequisite for auditor involvement with prospective financial information. In our comment letter to the EU Commission dated December 8, 2010 in respect of the Green Paper on auditing, we also suggested that expanding financial reporting, specifically the management report (also called "management commentary" by IFRS or "annual report" in the Fourth and Seventh EU Directives), by requiring the inclusion of more prospective information – without requiring preparers to perform impracticable tasks, or prompting so-called self-fulfilling prophecies – might also contribute to a fair presentation of the entity's actual economic situation. We also suggested that the scope of the audit in Europe include the management report, provided any legislation in this respect also includes appropriate limitation of auditor liability in this respect.

We comment in turn on the four examples of financial reporting and consequent potential audit scope extensions:

a) Corporate Governance Arrangements

We suspect that users' expectations as to what information might be included in the auditor's report in respect of corporate governance arrangements could vary widely, such that an expectations gap in this respect would be unavoidable. The differences in corporate governance frameworks and requirements world-wide mean that this is an area that does not lend itself to standards setting by the PCAOB.

b) Business Model, Including the Sustainability Thereof

An entity's business model is one aspect that auditors will consider in obtaining the understanding of the entity required by PCAOB Auditing Standards. The auditor also considers the viability of an entity to continue as a going concern for a period of at least 12 months subsequent to the date of the financial statements. However, this is an area upon which auditors do not form an opinion specifically; rather it is considered as part of the opinion on the financial statements as a whole.

We are open to reasonable suggestions relating to legal requirements to have the auditor examine the impact of the entity's business model on the economic development of its business and how related risks are disclosed in the financial statements or in accompanying information. Provided there are appropriate financial reporting requirements (suitable criteria) in this area, the auditor may be able to consider management's assessment of the opportunities and risks that result from the applied business model and consider whether their presentation in the financial statements or in accompanying information is adequate.

c) Enterprise-Wide Risk Management

In some jurisdictions there may be legal requirements for certain entities to have systems to manage risk, whilst in others there may not be. However, PCAOB Auditing Standards do require the auditor to obtain an understanding of whether the entity has a risk

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assessment process and – in the absence of such a process – to hold certain discussions with management and consider whether it represents a significant deficiency in internal control.

In Germany the IDW has had such an auditing standard since 1999, as certain German entities are required pursuant to the German Aktiengesetz (Stock Corporation Act) to have in place a Risikofrüherkennungssystem (risk early recognition system), which, in respect of listed entities, the auditor is required to address within the audit of the financial statements. The auditor is required to evaluate whether the entity's management has complied with the legal requirement to establish this risk early recognition system in a suitable form and also whether that system is capable of fulfilling its role. The auditor is required to report internally (in the German long form audit report) thereon. Those entities that are not listed entities, but which have such a system because of their size or complexity, often elect to have the auditor cover this aspect on a voluntary basis.

Furthermore, under banking legislation, financial institutions are required to have the appropriateness (that is, the design and implementation, but not the operating effectiveness) of certain aspects of the institution's risk management system as required by banking legislation and regulation audited by their auditors as part of the financial statement audit.

The IDW also has a standard on assurance engagements in relation to parts of enterprise compliance management systems, which, however, is not a part of the financial statement audit.

We would like to point out that in all of these engagements, the subject matter is not the entire enterprise-wide risk management system. Due to the comprehensiveness of enterprise-wide risk management systems, extending an audit of financial statements to the entire enterprise risk management system would involve considerably greater cost. Consequently, if an audit were to be extended to risk management, cost-benefit considerations may involve considering the scope of such an engagement in relation to certain aspects of risk management.

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d) Key Performance Indicators

As financial reporting becomes more complex, users seek greater simplicity by reverting to key performance indicators (KPIs). Many of these KPIs are so-called "non-GAAP measures" – that is, they are developed by specific enterprises or represent loose industry practice. Prerequisites for auditor involvement with KPIs are suitable criteria for the development of appropriate KPIs and for their disclosure. At the present time, such suitable criteria are not yet available. However, once such criteria are available, auditor involvement may be beneficial to users.

**c) What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**

Whether reasonable or limited assurance would be appropriate depends upon the needs of investors and consideration of the relative costs and benefits of reasonable vs. limited assurance to support the credibility of the information in question. As a matter of principle, users generally prefer reasonable assurance unless the cost is prohibitive relative to the benefits.

**d) If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**

Those portions of the MD&A for which sufficient appropriate evidence is available can be subject to assurance procedures, whereas those for which no such evidence is available should not be subject to assurance.

**e) Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**

We expect subjecting the MD&A to assurance procedures would have the effect of causing the MD&A to distinguish more clearly between those parts that can be subjected to assurance procedures because sufficient appropriate evidence is available and those parts that cannot be subject to assurance procedures because such evidence is not available.

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**f) Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**

We believe that AT sec. 701 is outdated: it does not reflect the progress that has been made in the IAASB for extant ISAE 3000, which was issued at the end of 2003. Furthermore, considerable progress is being made in further improving ISAE 3000 (see IAASB Exposure Draft to ISAE 3000). For these reasons, be believe that AT sec. 701 is not sufficient to have auditors obtain the appropriate level of auditor assurance on other information outside the financial statements. In particular, ISAE 3000 clarifies that practitioners do not "provide assurance": they obtain assurance that they then convey in their report (i.e., the assurance conveyed may not be that which users attribute). We suggest that the PCAOB consider revising AT sec. 701 to update it.

**g) If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

Since we do support the PCAOB exploring auditor assurance on other information outside the financial statements, we need not provide an explanation to this question.

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

The benefits of implementing auditor assurance on other information is that investors would have greater comfort that this information is credible. The shortcomings would be the potential cost of such assurance. Consequently, it is critical that the PCAOB consult with all stakeholders (preparers, auditors, investors and those charged with governance) to enable the PCAOB to perform serious cost-benefit analyses of potential assurance on other information.

**21. The Concept Release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**

- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a) Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

**b) Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**

We will address each of the clarifications in turn:

*Reasonable Assurance*

We are not convinced that stating that reasonable assurance is "high but not absolute" really provides any help whatsoever for users of audit reports other than explaining that an audit is not a guarantee (i.e., "not absolute"). As we noted in our comment letters to the PCAOB on proposed AS-5 and AS-2 dated February 26, 2007 dated November 21, 2003, respectively, and to the SEC on May 17, 2004), and as is noted in the FEE Papers "Principles of Assurance" from 2003 and "Selected Issues in Relation to Financial Statement Audits" from 2007, the use of the word "high" begs the question of "high in relation to what"? Certainly not in relation to absolute, because the evidence available and that thereof obtainable by the auditor varies by assertion, and the level of assurance is only an expression of the strength (that is, the combination of quality and quantity) of the evidence obtained. Consequently, using the phrase "high, but not absolute" misleads users into believing that auditors are able to obtain the same level of assurance for all of the assertions in the financial statements, which is ludicrous. The fact that current PCAOB auditing standards state that reasonable assurance is a high level of assurance doesn't make it any more true than having a regulator or standards setter claim that the sky is green rather than blue. If the PCAOB were to address the issue of reasonable assurance, then it would only be appropriate to do so by explaining the inherent limitations of an audit (see the above-noted FEE paper from 2007) to users.

*Auditor's responsibility for fraud*

We agree that, like the auditor's report under ISA 700, reference should be made to obtaining "reasonable assurance about whether the financial statements are free of material misstatement, *whether due to fraud or error*". This would clarify the nature of the auditor's responsibility.

*Auditor's responsibility for financial statement disclosures*

It may be useful to clarify to users in the auditor's report that the financial statements include the related notes (see ISA 700).

*Management's responsibility for the preparation of the financial statements*

We believe that one of the main purposes of the auditor's report is to reduce the expectations gap by clarifying to users what the role and responsibilities of the auditor are. The fact that even some sophisticated users are not sufficiently well informed about matters addressed in such paragraphs lends support to this view. This is especially the case if the auditor's report were to be expanded to provide additional auditor commentary. In this case, there may even be a need to include further clarification of responsibilities so that users do not misperceive the role of the auditor.

One of the main issues in this respect is that the financial statements are management's financial statements – not the auditor's financial statements. Consequently, a description of management's responsibilities is crucial to contrast the responsibility of the auditor from that of management and we would therefore support its inclusion with wording similar to that in ISA 700. Likewise, removing the description of what an audit involves would only serve to increase the expectations gap. We would therefore not support removing the paragraphs on the responsibilities of management or the auditor.

*Auditor's responsibility for information outside the financial statements*

A statement of an auditor's responsibilities with respect to other information may be useful, provided it clarifies precisely the information for which the auditor has a particular responsibility and the nature and extent of that responsibility to prevent a widening of the expectations gap.

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In our view, the auditor should report only when there is something to report, rather than also reporting that there is nothing to report. The costs of such a change are likely to be minimal: there may be an added benefit to have users understand the auditor's responsibilities in this regard, as long as these are clearly stated to prevent a widening of the expectations gap.

*Auditor independence*

Reference to auditor independence may provide useful information to users, and therefore is worthy of further consideration.

**c) What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**

It may be useful to also include short statements on the following to better communicate the nature of an audit and an auditor's responsibilities:

- Given user misconceptions about the inherent limitations of an audit, the explanation of the auditor's responsibilities ought to be enhanced by referring to the inherent limitations of an audit (which has the added benefit of helping to explain the meaning of "reasonable assurance")
- Given user misconceptions about what the role of an audit is, the third sentence of ISA 200.A1 or its equivalent ought to be added to clarify what an audit does not do, since some users believe that audits cover these matters.

**d) What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

There should be no implications to the scope of the audit or the auditor's responsibilities because these explanations serve only to clarify the scope of the audit and the auditor's responsibilities to users.

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

The benefits of providing the clarification noted in our response to Question 22 are that users would have a better understanding of what the respective responsibilities of management and the auditors are, and have a

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better understanding of the nature of an audit. The only drawback is that the audit report would be somewhat more lengthy with some more standard wording. However, we believe that this cost is worth the added benefit.

**23. This Concept Release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

In our view the most effective options that can be addressed by the PCAOB without needing to expand audit scope would be:

- Addressing user misconceptions about audits by enhancing the explanation of auditor responsibilities in the auditor's report by referring to inherent limitations (which has the added benefit of helping to explain the meaning of "reasonable assurance"), and adding the third sentence of ISA 200.A1 or it's equivalent to clarify what an audit does not do.
- Including a statement of an auditor's responsibilities with respect to other information that clarifies precisely the information for which the auditor has a particular responsibility and the nature and extent of that responsibility to prevent a widening of the expectations gap.
- Consideration of providing auditor commentary that highlights a summary of significant risks of material misstatement that are identified as significant financial reporting issues in the financial statements by management.
- Furthermore, the PCAOB ought to consider strengthening auditor reporting to those charged with governance, which does not affect audit scope.

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**25. What alternatives not mentioned in this Concept Release should the Board consider?**

One matter that we have not addressed in the body of our letter or in the responses to the questions above is whether management ought to be required by financial reporting standards to provide an assessment of its use of the going concern assumption in every financial statement. Auditors' reports could then be required to include disclosure by the auditor of the auditor's consideration of management's use of the going concern assumption in the financial statements. However, as this is a financial reporting matter in the first instance, this issue would need further discussion with legislators, accounting regulators and financial reporting standards setters before being placed on an audit standards setting agenda.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

We agree that the development of an auditor reporting framework would be advantageous. However, we would like to point out that the development of an auditor reporting framework depends on the development of a conceptual framework for auditing, which as yet no standards setter has attempted. We therefore suggest that without such a conceptual framework for auditing, the PCAOB should first seek to be less ambitious by developing reporting criteria.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

We agree that users may perceive some or all of the alternatives as providing a qualified or piecemeal opinion. Consequently, it is critical that it be clear from the report that any such information did not represent any form of piecemeal opinion on isolated aspects of financial statements – the auditor opines the financial statements as a whole – and not individual financial statement items. Therefore, the PCAOB would need to consider wording in the report that clarifies the nature of any assertions made by the auditor in, for example, an auditor's commentary, by stating that these

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are not audit opinions, but conclusions reached in forming the audit opinion.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

We believe that the alternatives that we have provided in response to Question 24 would be best in conveying to users the auditor's role in the performance of an audit. The other alternatives proposed would either not convey the auditor's role or, in some cases, just expand the scope of the audit.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

Since the various alternatives deal with the form, structure, wording and content of the report, or extending the scope of the audit, none of the alternatives ought to have an impact on the quality of the audit disregarding reporting. However, improved auditor reporting will increase audit quality in the eyes of users.

**30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the Concept Release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

In our view, the changes to the reporting model as we suggest ought to be considered for financial statements of public companies. We do not comment on whether the changed reporting model is appropriate for investment companies, investment advisors, brokers and dealers, and others. We expect the effect of applying our suggestions to the audit of public companies would lead to users valuing the audit more than previously.

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31. **This Concept Release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

    a) **Are any of these considerations more important than others? If so, which ones and why?**

    In our view, all of these considerations need to be balanced – that is audit effort, and hence cost, needs to be balanced with the expected benefits of increased communication or expansion of audit scope. Likewise, liability considerations are important when considering expanding audit scope beyond the financial statements to other information – particularly when that other information is "soft" in character or lacks evidence. It is also critical not to blur the distinction between the roles of management and those of the auditor when seeking to convey entity information to users, which may violate legal confidentiality requirements in some jurisdictions. It is also important not to confuse information needed by users with that needed by audit committees in their governance role.

    b) **If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

    Changes to the standardized wording of the auditor's report are not costless, but if done judiciously the cost of those changes can generally be easily justified by the benefits. With respect to expanding auditor reporting as we suggested, or to expand the scope of the audit, we believe that the PCAOB must engage in a rigorous cost-benefit analysis to ensure that the benefits of proposed changes exceed the cost.

    c) **Are there any other considerations related to changing the auditor's report that this Concept Release has not addressed? If so, what are these considerations?**

    d) **What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

    We are not aware of any other considerations that we have not already mentioned in our responses to the other Questions.

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**32. The Concept Release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

As we had noted previously, we believe it to be inappropriate for the auditor to originate in the auditor's report information on the company's financial statements: such information should be provided by management.

The Institute of Chartered Accountants in Australia

29 September 2011

The Office of the Secretary,
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Sir / Madam,

**PCAOB Rulemaking Docket Matter No. 34**
**CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS**

The Institute of Chartered Accountants in Australia (Institute) is pleased to have the opportunity to respond to the above Concept Release. The Institute is Australia's premier accounting body, which represents over 55,000 professional accountants. Our members work in diverse roles across public practice, commerce, industry, government and academia throughout Australia and internationally.

The Institute is a founding member of the international accounting coalition called the Global Accounting Alliance (GAA), which provides reciprocal arrangements with ten other leading accounting bodies in the world. The Institute is the only Australian accounting body within the alliance. The GAA represents more than 780,000 members world-wide and includes professional accounting organisations from the USA, Canada, Hong Kong, England/Wales, Ireland, Scotland, Japan, Germany, New Zealand and South Africa.

We welcome the PCAOB's paper as an important component of the discussion regarding the auditor's role, the appropriate vehicle for the auditor's communication to stakeholders and the content of that communication.

In our view the role of auditors is vital to the functioning of a modern economy. And it is arguably more important now than ever, as economic activity develops and stakeholders seek further information on which to base policy and other decisions.

We have not attempted to address all the issues raised in the Concept Release, but have instead opted to offer comment in those areas we view as being of the greatest importance and where we might be able to add most value to the Board.

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Some particular themes we believe are important for us collectively to consider follow:

**Auditors' Access to Significant Information**

The Concept Release contains the following statement:

*"Auditors, as a result of the performance of required audit procedures, often have significant information regarding a company's financial statements and the audit of such financial statement, that is not today reported in the standard auditor's report to the financial statements users. This information might be useful to investors and other financial statement users and could lead to more efficient markets and improved allocations of capital."*

There is no doubt that auditors, in the conduct of the audit could, and should, have knowledge of all relevant and significant information. However, in our view the primary obligation must be on the company, its Board and management to make that information available to financial statement users. Introducing the concept of the auditor disclosing information directly to financial statement users is fraught with danger. It has the potential to add to confusion and exacerbate the expectation gap, rather than the reverse.

It would be helpful to understand if the PCAOB, in reviewing the files of auditors, has seen any indications of significant information which the auditor has, but which has not been communicated to the Board and / or management of the client company; and to also understand what was communicated to the audit firm being inspected at that time.

Alternatively, if the significant information has been communicated to the Board and / or management, our view is that the preferred course of action should be for the regulator to ensure that the company makes the information available to the users of the financial statements and empower the auditor to report egregious failure to include matters of significance to the reports on which they are opining.

**The Role and Future of Audit**

A great deal of work has been conducted over a number of years on the clarity of communication, but it is evident that many stakeholders continue not to understand the role of external auditors in general – even by groups who have regular on-going contact with their auditors. The 'expectation gap' is very much alive, and potentially growing wider. The statutory audit report, a primary output of an audit, is important to stakeholders in terms of the fundamental assurance it provides, enhancing the credibility of information reported on.

The current model of audit needs to change and expand. Part of this change lies in the general frustration that audit is seen to be only focused on the past and the question asked as to 'why didn't the auditor see this beforehand?'

However, the primary obligation for reporting must remain with the company and its audit committee. It is first and foremost the responsibility of the company to report in accordance with a reporting framework. If there is information of value to stakeholders which is not currently being reported, the reporting and regulatory frameworks need to address this.

The role of the auditor has been, and continues to be, to provide an independent professional opinion on whether the financial report of the company present fairly its state of affairs and financial results for the period in accordance with the reporting framework. The financial position and operating results directly reflect the results of the decisions of management and the Board of Directors of the entity.

We believe that the role of the auditor should be expanded to focus on providing assurance around the reporting by management of risks to the business model – bearing in mind that the responsibility for reporting in accordance with a recognised framework remains with the company.

***Continuous Assurance***

Enabling technology now permits business to be conducted 24 hours a day, every day of the year. While this dramatic change has occurred in the business environment, the financial reporting and assurance model continues to focus on the past, reporting in accordance with a historical financial reporting framework. In our view there is merit in exploring changes to this model to permit 'closer to the event' assurance in order to align the assurance model more closely to the business model. The term 'continuous assurance' is used to describe such a model. It may well be that this type of assurance is complementary to, but does not replace the current historical financial reporting framework. We attach a copy of our recent thought leadership paper on continuous assurance titled *Continuous Assurance for the Now Economy*.

**Expectation and Information Gaps**

Consensus seems to be that the global events of recent years have revealed that more work needs to be done by all stakeholders to identifying, analysing and responding to 'systemic risk', stemming from the size and complexity of institutions and their relationships with other parts of the financial system. Proposals about systemic risk have been numerous. Current practice is for auditors to identify risk within the company. We foresee much greater emphasis internationally, at country level as well as industry and company level on business risks. Auditors are well placed to be involved with reporting on risks to the business model and the potential for that model to fracture.

However, we need to make sure that we understand as clearly as possible what actually failed. Once we know that, appropriate policy and other responses become easier to determine. Feedback from an Institute-sponsored round table discussion on this topic was that we need to be very careful we do not build a solution to yesterday's problems.

More detail in financial reports is not necessarily the solution. The Institute hears regularly from members and other stakeholders that financial reports are already far too voluminous, complicated and intelligible to only a few. Much of the detailed information that tends to be 'boiler plate' could, for example, be web-based only and not reproduced in the financial report itself. Stakeholders who require this information would thus continue to have access to it, albeit on the internet.

Further, the expectation gap is not necessarily confined only to external stakeholders. There are many in the director community who appear not to have a clear understanding of the auditor's role and how it relates to those charged with governance of the entity. Having more words in the auditor's report will not necessarily address this issue.

**The Role of the Audit Committee**

An independent audit committee is a fundamental component of a sound corporate governance structure. Importantly it brings together in one place non-executive directors, management, external audit, internal audit and advisors. The role of the audit committee has evolved significantly in the last decade and will continue to evolve. It has moved from being a fairly narrow function focused primarily on completion of the audited financial statements, involving limited interaction with the external auditors, to a much broader and integrated focus of responsibilities. Drivers of this evolution include regulatory expectations, market expectations and better practice initiatives the committee members and auditors gain in closer working relationships.

We are of the view that further enhancements can and should be made to the role of the audit committee. An essential element of the audit committee's role is to interact effectively with the external auditor towards obtaining a quality audit. In order for this to happen the audit committee needs to be equipped to understand what a quality audit entails and to engage with their auditor meaningfully. We are assisting with this goal and have a range of initiatives underway to assist the director and audit committee community. To support these initiatives we have used *The Benefit of Audit: A Guide to Audit Quality*. We attach a copy of our Guide.

We also believe further analysis needs to be undertaken about potential barriers to effective audit committees and how those barriers may be overcome. This could include consideration of potential changes which could be made to relevant laws (if any) to allow auditors to provide more meaningful reports for the better performance of the audit committee.

The rigour and nature of director and audit committee questions of auditors and the willingness and capacity of auditors to deal with those questions should be considered. What are the factors inhibiting a free and frank exchange between auditor and audit committee (or directors), which may be about business models, or also about individuals and other business stresses? Some of the barriers to a better and more fluent discussion between auditors and audit committees include a fear of litigation, as well as the competencies of those involved.

One also needs to ask whether some aspects of independence requirements limit an auditor's capacity to provide useful insights and engage in useful conversations with the audit committee or directors.

Communication between auditors and the audit committee is important, as is communication between the audit committee and the company's stakeholders. In our view there is merit in exploring an enhanced role for the audit committee in external communication and contributing to an improved understanding of what auditors do.

**Audit Quality**

Shareholders, company directors, audit committee members, auditors and regulators all agree that quality external auditing is fundamental to capital market confidence.

In only a few years the concept of audit quality has evolved from the somewhat esoteric, loosely discussed and poorly acknowledged, to having substance and involving all stakeholders. The pace of evolution of Audit Quality is accelerating, as evidenced by the establishment of the International Auditing and Assurance Standards Board's task force on this topic. There are great opportunities for standard setters, audit firms and professional bodies to influence the ongoing enhancement for the benefit of all.

For example in recent years there has been significant work in clearly understanding the drivers of audit quality. That work is being used by participants and stakeholders with the common goal of continuing to improve audit quality. We produced *The Benefit of Audit – A Guide to Audit Quality* based upon these drivers of audit quality to enhance communication (in plain English) between the audit committee and the external auditor.

We have also produced the *Framework for Managing Audit Quality Sustainability* to provide a structure for continuous improvement in audit quality and to stimulate further discussion on this important topic. We attach a copy of this Framework.

The Institute is of the view that the above themes are of sufficient importance that we will continue to devote substantial resources in their further development.

We would welcome the opportunity to provide further evidence to the Board if required.

Lee White
Executive General Manager – Members
Institute of Chartered Accountants in Australia

# Continuous Assurance for the Now Economy

by Miklos A. Vasarhelyi, Michael Alles and Katie T. Williams

The Institute of Chartered Accountants in Australia

**The Institute of Chartered Accountants in Australia**

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 65,000 of today's and tomorrow's business leaders, representing some 53,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world-class post-graduate program.

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The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. The GAA has a membership of 788,000 and promotes quality professional services to share information and collaborate on international accounting issues. The Institute is constituted by Royal Charter and was established in 1928.

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# Continuous Assurance for the Now Economy

by Miklos A. Vasarhelyi, Michael Alles and Katie T. Williams

The Institute of Chartered Accountants in Australia

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# Foreword

The Institute of Chartered Accountants in Australia (the Institute) is delighted to bring to you *Continuous Assurance for the Now Economy* the second in a series of academic research papers. This series of papers is designed to provide and promote thought provoking debate on key issues relevant to the academic accounting community.

The IT revolution of the late 1980s early 1990s paved the way for information to be available upon demand. Over the years the demand by the users of information has grown stronger. As a result businesses, shareholders and sophisticated market analysts are demanding and are now receiving data in real-time.

The key question of what assurance could, and should, be provided over this stream of real time data needs to be addressed. The concept of ‘real-time’ or Continuous Assurance attempts to better match internal and external auditing practices with IT systems that provide stakeholders with more timely and accurate results.

This thought leadership paper is written to promote discussion on continuous assurance as a concept. All stakeholders, standard setters, regulators, government users, and the profession have a role to play.

Importantly, Continuous Assurance is in its infancy, and no standards have yet been put into place around it. What this does create is a unique opportunity for the profession and stakeholders to consider the ramifications of potentially widespread applications of Continuous Assurance; what users’ needs are; how the concept is to be applied; what standards are to be created; what the education needs are and any regulation that may be needed.

*Continuous assurance for the now economy* has been written by leading continuous assurance scholars, Prof Miklos A. Vasarhelyi, Assoc Prof Michael Alles and, Ms Katie T. Williams. The Institute would like to thank the authors for their dedicated time and assistance in producing this paper.

**Michael Spinks**
President
Institute of Chartered Accountants in Australia

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# Executive summary

Over the last few decades businesses in Australia and around the world have been utterly transformed by powerful information technologies, from the PC and the internet to email and cellular phones – to the extent that a new type of economy is said to have been created: the 'Now Economy' which is characterised by 24/7/365 globalised operations, customer interaction and management decision making. By contrast, the way in which these entities are audited has not experienced an equivalent evolution. Over the last century, external auditors have tended to examine an entity only once a year and listed entities themselves only report quarterly in many parts of the world and half yearly in Australia, even though the capability exists for both reporting and auditing on a much timelier basis. The emerging field of Continuous Assurance attempts to better match internal and external auditing practices to the reality of the IT-enabled entity in order to provide stakeholders with more timely assurance. The dramatic collapse of leading banks around the world makes it all the more important that external and internal auditors take full advantage of modern technology to provide shareholders and managers with the most timely and relevant assurance.[1]

Our experience with the emerging Continuous Assurance industry over the last decade indicates that traditional auditing will give way to a progressive form of 'close to the event' assurance. The obvious economic benefits to be gained from better matching internal and external assurance with the pace of their operations, combined with lower costs and increasing capabilities of the driving technologies, fosters the emergence of Continuous Assurance. However, it is likely that first, professional organisations and then, standard setters, as well as governments, will issue guidelines for progressively real-time assurance procedures.

External auditing involves an assessment by the auditor that reports prepared by the entity are in accordance with the relevant framework. Responsibility for recognition, measurement and disclosure is clearly the responsibility of those charged with the governance of the entity: senior management and the board of directors. Hence, the auditor's job is to assess if the entity has met its obligations by examining the entities' transactions and other parameters. As those transactions increasingly only exist in digital form, the audit process will have to change accordingly. The question is whether that change will be minimal – with the formerly manual procedures simply redone electronically – or whether auditing will be re-engineered fundamentally, to rethink how auditing can be done most effectively when it no longer needs to be done manually, and hence only periodically and with limited data.

Continuous Assurance is a progressive shift in audit practices towards the maximum possible degree of audit automation as a way of taking advantage of the technological basis of the modern entity in order to reduce audit costs and increase audit automation. Given the emphasis on the transformation of the entire system of auditing, the development of Continuous Assurance requires a fundamental rethink of all aspects of auditing, from the way in which data is made available to the auditor, to the kinds of tests the auditor conducts, how alarms are dealt with, what kinds of reports are issued, how often and to whom they are issued, and many other factors, the importance of some of which will only become apparent as Continuous Assurance is implemented. It is important for the profession and other stakeholders to start thinking about the impact of Continuous Assurance on auditing now, when it is easier to put in place the foundations for this change, rather than when technologies and practices have already become established.

1. Bear Stearns received an unqualified audit opinion on 28 January 2008. However, by 10 March 2008 its financial problems hit the headlines and on 14 March 2008, with state support, it was sold to JP Morgan Chase (Sikka, 2009).

While audit standard setters are letting Continuous Assurance reach a more mature level before developing standards around it, Continuous Assurance has already been the subject of white papers by several important professional bodies. The Canadian Institute of Chartered Accountants (CICA) jointly with the American Institute of Certified Public Accountants (AICPA) issued their 'red book' – entitled *Continuous Auditing* – in 1999. The US-based Institute of Internal Auditors issued a Global Technology Audit Guide (GTAG) entitled *Continuous Auditing: Implications for Assurance, Monitoring, and Risk Assessment* in 2005[2], while Information System Audit and Control Association (ISACA) International has also recently issued an exposure draft on Continuous Assurance, written in part by an Australian, Kevin Mar Fan, CISA, CA, of the Brisbane City Council.[3] It is important to recognise, however, that there are no established procedures for Continuous Assurance at this time, and this is not the time for anything to be considered settled. Rather, it is a time for experimentation, to 'let a thousand flowers bloom', in order for auditors to figure out what they should be doing in this new technological business age, and how they should be doing it. Standard setters and other regulators, accounting bodies and the government have to continue to play more of an educational and advocacy role at this stage, to encourage the adoption of Continuous Assurance and its continuing evolution. The rapid rise of the Continuous Assurance industry following the 1999 'red book' indicates that this strategy has paid dividends and that there is evidently no rush by any of these bodies to change their role.

Another key role in the evolution of Continuous Assurance will be played by the universities and accounting bodies that train the next generation of accountants. This next generation will spend much of their working lives in an environment where Continuous Assurance will no longer be an emerging audit methodology, but simply the everyday way in which auditing is done. However, much of current audit education reflects a manual, periodic accounting paradigm. Accounting information systems, for example, are often dispatched with a single support course, rather than being integrated into all aspects of the curriculum. The mindset and skill set of an auditor who uses technology to enhance and expand auditing is very different from one who simply takes as given whatever technology their entity happens to choose to introduce, and whose IT infrastructure is often much less sophisticated than that of the clients whose processes they are auditing. Students need training not just in technology, but also in advanced statistics since that technology enables far more complex analytics than are utilised today. Vasarhelyi et al. (2009e) discuss how audit education will have to change in response to the shift of auditing to Continuous Assurance.

The external audit profession, internal auditors, software vendors and academics are all busily developing new procedures for taking advantage of access to a universe of data in close to real time. Although technology is advancing at a faster rate than the slower moving processes of change management within organisations, a discrepancy is visible both in audit entities and their clients, as well as in the standard setting process. Moreover, Continuous Assurance is emerging far faster than the real-time reporting which is an important complement[4] to more frequent assurance; again, a not unexpected development given that much of reporting is determined by legislation and risks of litigation. But the bottom line is that a fundamental shift is taking place, slowly but surely, in the way

2. Available at http://www.acl.com/pdfs/GTAG_ContinuousAuditing-05.pdf
3. http://www.isaca.org
4. Real-time or close to the event information feeds are essential to a continuous audit. Continuous reporting is desirable for many reasons but not a requirement for a continuous audit.

in which external and internal audits are carried out, and this document both explores those changes and hopes to drive it forward in Australia and internationally.

This monograph is intended to stimulate thinking about the issues that need to be addressed in a world where Continuous Assurance has become, or aims to become, the standard for auditing both externally and internally. It examines how the audit profession needs to respond if that vision of IT-enabled real-time auditing is to become a reality, and this requires an understanding of how IT is transforming the modern large entity and how internal and external auditors are dealing with these changes.

The recent development of data interoperability standards such as the extensible markup language (XML)-based Extensible Business Reporting Language (XBRL) promises a much needed interconnectivity in the information highway. Creative organisations are bringing many of their processes into real-time. The many processes being accelerated include financial-related processes such as business measurement, financial management, business reporting (continuous reporting) and business assurance.

In a typical medium or large enterprise today, the IT environment encompasses the potential for automatic event sensing, automatic generation of transactions, electronic feeds from everywhere, integrated business management software (enterprise resource planning [ERP]), standards of universal data transfer (eg. XBRL) and automation of many processes. This 'Now' or 'real-time' economy uses the above components to increase the speed through which processes are performed and data is shuttled among processes. This acceleration provides substantial economies to business as 'time is money'. Furthermore, it places pressure on all competitors to further their automations. The latencies (delays) that are being eliminated in the Now Economy include: 1) the time taken to perform a process; 2) the time it takes to transmit information from one process to the next; 3) the time taken to make a decision; and 4) the time it takes for the decision to have consequences.

Many processes can be classified in four different overlapping ways:

- Processes that are supported by real-time systems
- Processes which are monitored on a close to continuous basis
- Processes that are highly time dependent
- Processes where timely decisions give competitive advantage.

Continuous Assurance was first reported in 1991 at the well-known AT&T Bell Laboratories (Vasarhelyi and Halper, 1991) which was, at that point, one of the leading world research institutions where the transistor, much of lasers and modern telephony were developed. It encompassed the monitoring and real-time assurance of a large billing system focusing on the data being measured and identifying through analytics methods, faults in the data that lead both to control and process diagnostics. This is now called continuous data auditing (CDA).

It took another 10 years for the accounting entities to take notice of these developments and propose some guidelines/standards for Continuous Assurance. First the CICA/AICPA and the Institute of Internal Auditors (IIA) issued guidance. The collapse of Enron, Arthur Andersen and WorldCom in the early part of this decade brought the *Sarbanes Oxley Act* (Sarbox) into being in the United States and similar focuses on internal controls in other countries which not only distracted organisations from improving their accounting data assurance but also brought attention to internal controls, their measurement, and statutes requiring their assurance. The attention to Sarbox section 404, associated with the fact that most large organisations use ERP and their controls cannot be visually observed, brought in the need for monitoring and evaluating controls on close to a real-time basis. This is called continuous control monitoring (CCM). While much of the attention paid to Continuous Assurance in this period was undertaken by internal auditors responding to the need to improve their entity's financial reporting controls, external auditors are now benefiting from these technological advances. External auditors were always involved in the development of Continuous Assurance by internal auditors because of their need to rely on the work performed by internal auditors when issuing their own audit opinion. Hence, anticipating the needs of the external auditor was a major factor in the shape of Continuous Assurance systems created by internal auditors. What is different now in this third decade of Continuous Assurance is that external auditors are themselves taking the initiative in investing in Continuous Assurance practice and technology, with all the major audit firms having their own home-grown Continuous Assurance systems and procedures. In recent years we have also witnessed the emergence of an industry of software to support Continuous Assurance including ACL, Caseware, Approva, Oversight, and SAP governance, risk and compliance (GRC).

The meltdown of the financial system of 2008/2009 has focused attention on the lack of adequate risk measurement, modelling and evaluation. Modern technology allows for closer and more realistic measurements of risk and continuous risk monitoring and assessment (CRMA). Consequently what we call today 'continuous audit' is the conjunction of CDA, CCM and CRMA. CRMA, however, is far more than just the continuous monitoring of major risk factors. We foresee that one day it will evolve into a mechanism for evolving the entity's Continuous Assurance systems themselves to better focus on those risk factors. In other words, while the emphasis today is on developing a Continuous Assurance system in the first place, the focus will inevitably have to shift towards how to make those static systems dynamic in order to maintain their relevance to the auditor over time.

Continuous Assurance has been the subject of extensive experimentation and implementation. The authors of this paper have been involved in Continuous Assurance since its inception and have conducted a series of Continuous Assurance development projects in cooperation with the Big 4 accounting firms and leading internal audit (IA) organisations. These projects have helped define the emerging field of Continuous Assurance.

The first reported Continuous Assurance effort took place at Bell Systems (now AT&T) in the USA from 1986 to 1991 (Vasarhelyi & Halper, 1991). This gave rise to a series of questions about data, the architecture of Continuous Assurance, models to compare data, etc. Research work with a large health organisation allowed for experimentation of modelling the supply chain and the creation of mathematically-based adaptive standards. The developed rules served to detect and remove two types of data errors that are largely caused by many unmatched records among different business processes:

- Data integrity violations
- Referential integrity violations.

An example of Continuous Assurance in practice can be seen at Itau Unibanco, one of Brazil's largest private banks. Over the last five years it has monitored its network of 1400 branches on a daily basis using a set of 18 analytic tests. This monitoring has reduced the average time for an onsite branch audit from 160 hours to 40 hours and has changed the scheduling and oversight procedures of branches. Five auditors perform this monitoring and issue from 200 to 400 alerts a week. The bank feels that its savings on this effort are ten times its cost.

Over the last four years, the giant German firm Siemens has experimented with the concept of CCM through a joint research program with Rutgers University's CarLab[5]. Its project aims to investigate the extent to which Continuous Assurance techniques:

1. Can be applied to their existing audit process
2. Help implement an automated Continuous Assurance system that frees up IA work force
3. Enables established manual audit procedures by re-engineering them.

The two phases of this project, which focused on the automation of SAP-related audit actions, indicated that close to 68% of the traditional audit steps could be automated. Furthermore, many audit steps could be performed more frequently and remotely. These facts raise interesting issues about the need to re-engineer the entire audit process in view of more frequent evidence, the locus of the auditor, and new types of systems and architectures.

A wide variety of supporting software and experimental considerations has emerged in Continuous Assurance. Today we talk about continuous audit that brings assurance procedures closer to the moment of the event, but in reality the audit of the future will use continuous evidence gathering and much of the Continuous Assurance methodology discussed in this paper to gather its evidence into a timely semi-automated audit process.

In addition to the methodology issues discussed there are a series of practical steps that must be followed in the implementation of Continuous Assurance. Six steps are recommended:

1. Establish priority areas
2. Identify monitoring and continuous audit rules
3. Determine the process's frequency
4. Configure continuous audit parameters
5. Follow up
6. Communicate results.

5. Continuous Audit and Reporting Laboratory, http://raw.rutgers.edu

# Rethinking auditing

**Inspection Program Details**

New Jersey must comply with standards defined in the federal Clean Air Act by inspecting every vehicle's catalytic converter and emissions system. Several types of tests are now used in New Jersey. For vehicles manufactured before 1996, a treadmill is used to monitor emissions during acceleration. For vehicles manufactured in 1996 or later, New Jersey uses the On-board Diagnostics, or OBD, test. 1OBD allows technicians to download emissions information from an on-board computer found in most vehicles manufactured in 1996 or later. MVC analyses emissions data in this way to determine if the vehicle passes inspection. www.cleanairnj.org

New Jersey Driver Manual, pages 79-80

In Australia, as in most other countries, the government agencies tasked with inspecting motor vehicles and issuing licenses are usually held up as the epitome of inefficiency and archaic bureaucracy, the kind of organisations people wish to avoid interacting with. Yet the Department of Motor Vehicles (DMV) in the US state of New Jersey offers some very useful insights into the impact of technology on everyday life.

For instance, it is a requirement in New Jersey, as in many other jurisdictions in this environmentally conscious age, that drivers take their vehicles in every few years for an inspection of their safety and emissions controls. That inspection process has been revolutionised in recent years thanks to advances in technology in both the automobile and the inspection station.

Once entirely mechanical cars are now highly computerised, so much so that the backyard mechanics who once spent their weekends tinkering with vehicles are now officially discouraged from doing much more than checking the oil and tyre pressure. As a result, the DMV no longer has to run the engine of the vehicle and sample the exhaust air when inspecting its emissions; instead, the inspector plugs a handheld device into the car's computer and downloads records of the vehicle's performance which enables its emissions to be tracked more accurately and over a wider range of actual driving conditions. So much better are these measures – and so much better controlled are these computerised cars – that inspections are now only conducted every two years instead of annually as in the past, and new cars are not even required to be inspected in their first four years.

When one considers that the DMV is effectively evaluating the performance of cars against the clean air standards that they are required to meet by US national law, it is apparent that what is taking place here is analogous to auditing as it applies to the accounting realm. And just as the authorities had to rethink the way in which they do vehicle inspections to take advantage of modern technology, auditors around the world are developing new practices and modifying existing methodologies to exploit the power of the IT that underlies modern entities, especially the largest ones. It would make little sense for auditors to retain practices first developed when audits became mandatory 70 years ago when their clients have been driven by the competitive necessity to be more like a high-tech, high-performance sports car than the pioneer automotives preceded by a man holding a warning flag. As with any analogy, the parallels are not exact, but the point of making such a comparison is to encourage looking at auditing from a new and different perspective.

This paper discusses the emerging field of Continuous Assurance and places it within the context of the IT-enabled business world which facilitates and gives rise to Continuous Assurance It is a world where transactions are processed and tracked electronically, thus making business much faster than before, while the tagging of financial data with the XBRL promises to make business information communication equally rapid. And, as the speed of business increases, so does the demand for auditors, both external and internal, to provide assurance closer to the transaction date than is typically made available in traditional auditing which is currently centered on the annual audit of paper-based income statements.

A final recourse to our automobile analogy: over the last century of motoring, it is not only the technology of the automobile that has changed, but the entire system of roads, traffic management, petrol distribution, etc. that supports driving, that has altered in tandem. It would hardly make sense, for example, to replace a Model T Ford of the 1920s with a modern Jaguar XF if it were forced to drive on the 'macadamised' single lane roads of that earlier era, with petrol carried along in jerry cans to make up for the lack of refuelling facilities along the way. Similarly, Continuous Assurance is but one manifestation of the fundamental changes in the entire accounting environment that technology will make inevitable. It does not take much foresight to predict that in 20 years it will be incomprehensible to report only annually, when one day closing, ERP systems, the internet and XBRL will make continuous reporting trivial. The roles of all parties in the reporting and auditing fields will change accordingly, and now is the time to begin planning for this eventuality.

This paper begins by considering the 'real time' or 'Now Economy' and understanding the technological infrastructure of the modern, large, global entity. It is on this foundation that the future of auditing is in the process of construction.

# The Now Economy

## Introduction

### Defining and classifying latency

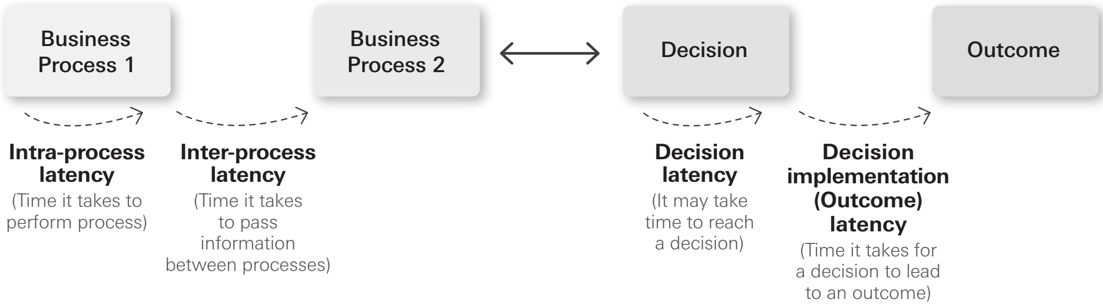
> In years to come, experts predict, many companies will use information technology to become a 'real-time enterprise' – an organization that is able to react instantaneously to changes in its business. And as firms wire themselves up and connect to their business partners, they make the entire economy more and more real-time, slowly but surely creating not so much a 'new' but a 'now' economy.
> *The Economist*, 1 February 2002.
>
> We have only just said goodbye to the new economy, yet it's time to say hello to the 'Now Economy'. Never heard of it? You're not alone. Even technology gurus sing different tunes when describing the newest buzzwords. The now, or real-time, economy is a complex set of enterprise software products and services that could transform the way companies work. This software could speed up supply chains, cut inventory costs, facilitate cross-company process reengineering, and put more oomph into CRM.
> *The McKinsey Quarterly Newsletter*, February 2002.

Four major types of latency (delay) are being addressed with improved incorporation of technologies:

- **Intra-process latency:** the time it takes for a process to be performed (eg. processing accounts payable). These latencies are addressed by increased automation of process steps. Automating the verification of ERP controls (Alles et al., 2006) falls into this category.
- **Inter-process latency:** the time it takes to pass data between processes. These latencies are addressed by the progressive adoption of methods of passing information between processes progressively adopting interoperability standards like XML. The financial value chain will be substantially accelerated by the inclusion of XBRL as the conduit for the financial value chain, when other XML-derivative language tagged transactions will flow coherently into XBRL/GL.[6]
- **Decision latency:** the time it takes for a decision to be made, reduced to nanoseconds if decisions are made automatically but rigidly in approach. Auditors make a series of examination decisions based on error detected in a sample or population. These decisions take time and human intervention. Rules can be developed to automatically highlight items for further examination or accept the sample as representative.
- **Decision implementation latency:** the time it takes for implementation of a decision, contingent on the nature of processes and about the types of interconnected processes. Once a sample is deemed to need more examination, original documents need to be scrutinised or subject to further analysis. Automation can reduce this latency by automatically submitting a sub-sample to increased filtering and analysis.

6. XBRL/GL is an XBRL dialect aimed at providing tagging at the ledger level and consequently allowing for direct postings of transactions tagged in other XML languages. For example, a transaction tagged in the XML standard for information on electronic tags can be directly converted to an entry on XBRL/GL and automatically feed the financial value chain.

**Figure 1: Intra, inter and decision latencies**




The essence of the progress towards the Now Economy is the reduction of latencies. Manual processes are very costly and time consuming but under certain conditions are necessary or unavoidable or render better outcomes than simple embedded computer-based rules. The balancing of these considerations and the progress in automation dramatically changes the competitive scenario.

## Some key concepts

Businesses are taking the lead in adapting to and accelerating the development of the Now Economy through the widespread adoption of integrated company software such as ERPs, modern communication technologies that ensure workers are on the job 24/7/365, and monitoring systems that give a greater range of managers the ability to track and control key business processes. All this allows businesses to manage their processes based on up-to-the-minute information and to achieve rapid adjustments of tactics and strategies.

Both *The Economist* and McKinsey (see quotes above) have adopted the terminology as a way to describe a complex set of evolving changes that are bringing the provisioning of information closer to the causal events. Their adoption of the term ‘Now Economy’ indicates its progressive understanding in the business community:

> Never mind New Economy vs. Old Economy industries. What matters is if your business enjoys intelligently revised and technologically enhanced business processes. Business process innovation is beginning to move in concert with accelerating technological evolution. Say goodbye to the New Economy; meet the Now Economy. We are witnessing the emergence of real-time enterprises (RTEs) that will comprise the bulk of the Now Economy. In the Now Economy, information flows rapidly through supply and demand chains, crossing corporate boundaries, ensuring maximum efficiency and responsiveness.

> The ideal vision of the RTE is one of companies where information moves without hindrance, and business processes are continuously monitored and trigger rapid reactions, usually automated according to embedded business rules. RTEs also sense shifts in tastes and practices and respond by offering new products and services. Automated processes easily traverse corporate boundaries, time zones, media and systems. Batch processes and manual input are minimized by ensuring that real-time information among employees, customers, partners and suppliers is current and coherent. The Now Economy is the instantaneous, frictionless economy of economists' legend – the mythical beast that may finally be emerging from the mist. The Now Economy is a web of RTEs that form a virtual supply and demand chain continually seeking information, monitoring, and responding, guided by humans, mostly at the highest strategic level (Fingar and Bellini, 2004).

The Now Economy is characterised by a substantive reduction in the latencies discussed above. For example, companies must manage their cash on a day-to-day basis to be able to apply it and borrow it overnight; manage receivables and payables on a day-to-day basis to take advantage and grant discounts; and manage inventories up to the minute to do just-in-time factory management. These are just a few examples of the advent of a real-time economy. Moreover, the effects of wireless technology, radio frequency identification and sensors and integrated software are just now starting to emerge. The coming years will bring in more nimble and adaptive companies integrated in the world. The evolution of these technologies, and their integration into business, also brings in behavioural effects that may accelerate or delay progress.

*The Economist* (30 April 2002) points out the issue of instant gratification:

> Instant Gratification: To advocates of the concept, the real-time enterprise is a giant spreadsheet of sorts, in which new information, such as an order, is automatically processed and percolates through a firm's computer systems and those of its suppliers. Thus a simple inquiry such as, 'When is my order being shipped?' can be answered immediately, and not six phone calls and three days later, explains Vinod Khosla, a partner with Kleiner Perkins Caufield & Byers and one of the most notable advocates of the real-time concept. Many consumers have already encountered real-time business without realizing it, for instance when they order a Dell computer. The firm's website allows customers to check the status of their order at any time.
>
> But the real-time enterprise is not simply about speeding up information flow. It is also, as GE's example shows, about being able to monitor a business continuously and react when conditions change. Today, businesses 'are mostly shooting in the dark', says Michael Maoz, a research director at Gartner, an IT consultancy, and one of the pioneers of the concept. Real-time technology, he predicts, will give firms a window into their business they never had before.

While the technological underpinnings of the Now Economy continue to evolve and emerge, it is also important to focus on the changes it brings about to the mentality of management, in particular, the decrease of latency between transaction and decision point, which means that processes have to be viewed with these delays in consideration. These real-time processes can be classified in at least four different overlapping ways, each with different implications for decision making, control and monitoring:

- Processes that are supported by real-time systems
- Processes that are monitored on a close to continuous basis
- Processes that are highly time dependent
- Processes where timely decisions give competitive advantage.

The classification of processes into these categories is not static, but dynamic with respect to technology, business process re-engineering and competitive pressures. Thus, as an increasing number of processes at more entities fall into the first and second categories, then the more likely they are to be used as sources of competitive advantage. Eventually, such practices become ubiquitous in an industry, at which point they stop providing a competitive advantage, but become a minimum necessary to stay competitive. Examples of such dynamics are the development of SABRE at American Airlines, the assignment of real-time seat choice on airline websites, the onslaught of online payment mechanisms, or the ability for consumers to track packages at UPS and FedEx and even the United States Postal Service (Wiseman, 1988).

The acceleration of business processes and their accompanying decision points necessitates access by a larger range of people within businesses to high quality data with the ability to drill down and search unconstrained by traditional data aggregation methods, such as into income statements. Thus, a large percentage of large entities today use ERP systems that integrate their information flows into one easily accessible data processing system. Add-on software, such as those providing increased business capabilities and customer relationship management, enables rapid and detailed analysis of that flood of data to allow decisions to be made at a level not possible before, such as treating each and every customer differently based on their individual profitability. Thus, the connection between technology and management use of that technology is clear:

> In the past, firms have faced a trade-off between being integrated and being flexible. New software technology promises to ease that trade-off, or even do away with it altogether. At the same time, new hardware, such as wireless sensors, makes it possible to gather ever more information about the physical world and feed it into a company's computer systems. Turbines made by GE are equipped with sensors that allow the firm to tell its customers online how efficiently their machinery is operating. Similarly, companies can now collect more data about people, even tracking their location. By themselves, these data would just contribute to the increasing information overload. But they present a new business opportunity: to develop software that analyses them and suggests ways of epitomising the supply chain, or even automates the response to certain kinds of new information (*The Economist*, 2002).

A more recent example from *The Economist*[7] (2009) demonstrates that these predictions about the use of real-time information to drive new businesses have come to pass:

> High above the Pacific, passengers doze on a long flight from Asia to America. Suddenly a bolt of lightning cleaves the air. Those startled by the flash and bang soon settle back into their dreams. But on the other side of the world, in Derby, in the English Midlands, engineers at Rolls-Royce get busy.
>
> Lightning strikes on passenger jets are common – a couple every hour – and usually harmless, but this one has caused a cough in one of the engines. The aircraft will land safely, and could do so even with the engine shut down. The question is whether it will need a full engine inspection in Los Angeles. That would be normal practice, but it would delay the return journey and keep hundreds of passengers waiting in the departure lounge.
>
> A torrent of data is beamed from the aircraft to Derby. Numbers dance across screens, graphs are drawn and technicians scratch their heads. Before the plane lands, word comes that the engine is running smoothly. The aircraft can take off on time.
>
> Rolls-Royce's global operations room in Derby, with 24-hour news channels, banks of computer screens and clocks showing the time around the world, looks and feels like a currency-trading floor. It seems far away from the grubby manufacturing that Derby has pioneered since the dawn of the industrial revolution. In fact, a few hundred yards down the road, furnaces roar, cutting tools whine and giant workhorses of the air take shape. The operations room is the heart of a vast industrial enterprise …
>
> The operations room … continuously assesses the performance of 3,500 jet engines around the world, raising an almost insurmountable barrier to any rival that hopes to grab the work of servicing them. The data collected can be invaluable to airlines: it enables Rolls-Royce to predict when engines are more likely to fail, letting customers schedule engine changes efficiently. That means fewer emergency repairs and fewer unhappy passengers. The data are equally valuable to Rolls-Royce. Spotting problems early helps it to design and build more reliable engines or to modify existing ones. The resulting evolution of its engines has steadily improved fuel efficiency and over the past 30 years has extended the operating life of engines tenfold (to about ten years between major rebuilds). 'You could only get closer to the customer by being on the plane,' says Mike Terrett, the company's chief operating officer.

It is obvious then that the Now Economy is driving major changes in the way in which businesses operate, beginning with the larger and more innovative entities and moving on to becoming a way of life for all types of entities. Not so long ago in most countries, and even today in some developing ones, buying a product meant going to a store, picking out the item and then going from counter to counter, getting a receipt from one clerk, paying another and picking up the purchase from a third. By contrast, consumers today buy many products online and expect immediate email confirmation of the transaction, its payment and order tracking, and would discontinue their business with the retailer if these services were not provided. And yet, while all this would have been utterly unfeasible even a

7. *The Economist*, Rolls-Royce, Britain's lonely high-flier, 8 Jan 2009.

decade ago, these consumer-oriented activities pale in comparison to the range of services provided in the business-to-business realm, as the Rolls Royce example shows.

But, as accountants, we can look back at these changes and recall that the reason for the labour intensive practices in that long-ago retailer was to ensure control and avoid pilfering of either products or cash. Thus, the electronisation of these business processes came about not only through the development of such technologies as the internet, but because of improvements in transactional control practices such as secure communications, digital cash management, seals of approval, privacy practices and regulations, and so forth. And that transition leads us to ask how the accounting profession, and in particular auditing, both external and internal, is responding to the arrival of the Now Economy.

## Automation

The electronisation of business is being driven by the need for latency reduction and is facilitated by progressive technological developments and their integration in the fabric of society, in particular, business processes. Automation is the core concept in electronisation and is composed of a large set of mechanisms. Experience with the early introduction of computers in business processes shows that highly formalised, repetitive, labour intensive processes are easier to automate and their economic benefits are simpler to quantify. On the other hand, more complex automation resulting in qualitative improvement is much more difficult to justify. For example, early labour replacement computer applications, such as billing for a large utility, were of obvious and dramatic justifiability. At first glance it was difficult to justify the replacement of a large number of spaghetti code legacy applications by cleaner but rigid and costly ERPs. For many entities it took the troubles of the Y2K bug to justify a serious data processing investment.

### Business versus audit automation

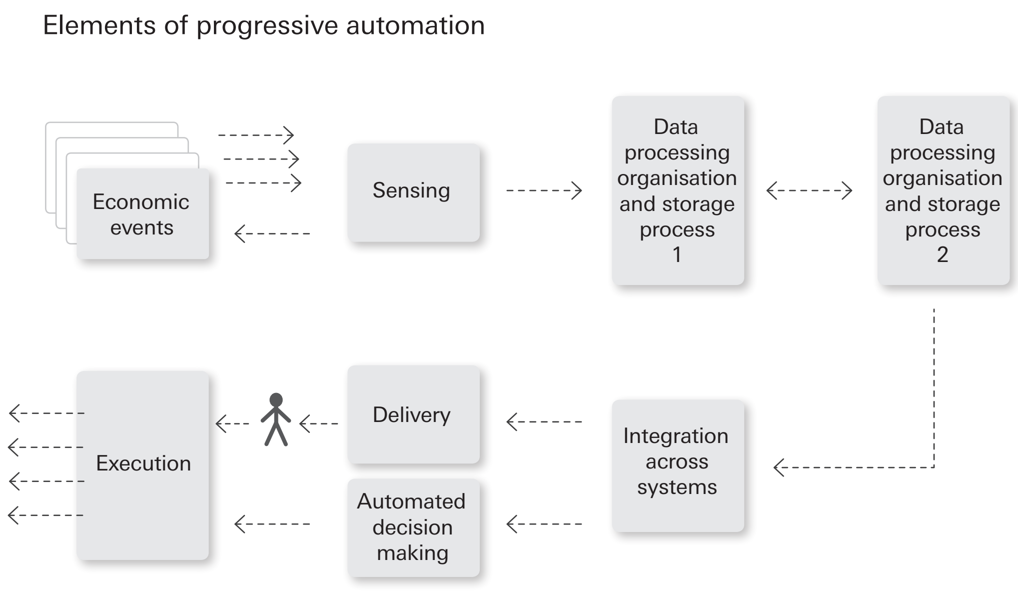
The auditing area has witnessed a similar phenomenon. It took little time from the introduction of PCs for the big audit firms to purchase masses of the devices replacing the much dreaded adding, extending and ticking by data extraction routines/software and a friendly spreadsheet. On the other hand, the next obvious step in automation of assurance which also entails integration of different steps of the assurance process, has lagged behind dramatically leaving the toolset of the auditor second generation in a fourth generation computer world.

While in business systems there is across application integration, in auditing there is software extraction (eg. using focus), which is cumbersome to import into spreadsheets and requires much manual manipulation. While in business there are dashboards and executive information systems spitting out status every six hours, in auditing there is a statute-driven manual reporting schema. The research projects at Siemens and Itau Unibanco described in this paper show useful paths in automatic data extraction and dashboarding for audit decisions. While in manufacturing there are fully automated paper pulp and iron ore mills mixing and controlling the output automatically, in auditing there is a failure prone manual judgment process where organisations are deemed healthy one month but fail the next. The economic crisis only makes it all the more urgent to recognise the reality that the current system of reporting and auditing is unable to keep up with the demands of the modern IT-enabled business, of which the financial service entities, with their continuous trading of derivative instruments whose value can only be calculated by computer, is the leading example.

## Components of audit automation

Some elements of the basic business process can be segregated and their automation discussed. A much deeper discussion of these factors is performed by Vasarhelyi et al. (2009d). Figure 2 displays some of the elements that in a socio-technical system are being progressively automated.

**Figure 2: Module integration**




The elements of Figure 2 are as applicable to computer-based corporate systems as they are to the evolving world of audit automation.

- The automation of data captures (sensing) floods corporate systems with large quantity of data with a quasi error-free data inflow. While this is progressively the norm in business the auditing area only in Continuous Assurance applications create automatic extractions and integration
- Corporations are progressively flowing these sensed data directly into applications. FedEx uses manually or automatically scanned barcodes all along its value chain to manage, distribute, decide and inform about its packages. Some vendors of Continuous Assurance software have created increased transitivity from systems such as SAP into some of their more integrated applications (eg. ACL CCM module)

- Discontinuities in the flow of data though business processes have created the frequent need for data re-keying which inserts large numbers of errors and costs in the data flow
- While ERPs bring together applications in common databases the area of automated work papers (and its obvious core database) is primitive to say the least. The natural evolution would make core work paper summaries the 'decision dashboard' for audit decisions
- Auditor reports of different types should be corporate shared documents leading to control management and improvements with inputs from CCM, CDA and CRMA. Increasingly Internal Auditors (IAs), organisations and auditees work in common documents across the audit domain. Much automation and technology could be used to improve these processes. The main sharing mechanisms currently used are office automation tools (eg. MS Office) which are powerful but not adapted to the dynamic needs of the assurance process.

Next we discuss in more detail the facilitators of automation necessary to the automation of audit.

## Making the Now Economy happen

Analogous to the DMV example above, new technologies have to be invented and developed causing substantive change in processes and human behaviour. The main technologies that are causing/facilitating the Now Economy are discussed next.

### Sensors

The manual capture of data is probably the main cause of delay and error in business processes. Modern technologies have progressively allowed business to detect and electronically record transactions, products, decisions and other business relevant business elements. In the early days it was telephone switches that collected telephone call information without human intervention. Today most e-commerce transactions are captured at the point of inception and executed with minimum human involvement.

### Enterprise Resource Planning systems

Enterprise Resource Planning (ERP) systems emerged in the late 1990s to integrate corporate applications. ERPs such as SAP, PeopleSoft, BAAN and Oracle Business Suite brought together a disparate set of corporate applications around a relational database system allowing corporations to have integrated systems that facilitated inter-functional management. These systems, associated with progressive sensing of economic events, provide a close to real-time environment accelerating the bases for (automated or not) business decision making.

### Extensible Markup Language dialects

The advent of the internet propitiated the development of tools to improve the use of this ubiquitous intercommunication platform. A very valuable set of tools is the extensible markup language (XML) defined by Wikipedia[8] as:

> The Extensible Markup Language (XML) is a general-purpose specification for creating custom markup languages.[1] It is classified as an extensible language, because it allows the user to define the mark-up elements. XML's purpose is to aid information systems in sharing structured data, especially via the Internet,[2] to encode documents and to serialize data; in the last context, it compares with text-based serialization languages such as JSON and YAML.[3]

Several hundred extension standards have been developed by different industry groups to facilitate interoperability in its domain. Extensible Business Reporting Language (XBRL) has been developed to facilitate the transmission of financial reports (XBRL/FR) among elements of the financial value chain as demonstrated in Figure 3. This figure incorporates XBRL/FR (which aims to facilitate the transmission of financial reports from the business to analysts, investors and policy makers) to the less mature XBRL XBRL/GL aimed to facilitate the exchange of information among modules/processes of the business enterprise as well as its outsourced entities. The development of XBRL is particularly important for external auditors who will face a world in which the financial statements they audit will be disseminated far more rapidly and widely than ever before and in a form in which the individual components of the statements will be disaggregated from the whole. New concepts of reporting and assurance will have to be developed to deal with XBRL as the primary means of reporting audited statements as opposed to the paper or pdf files of today.

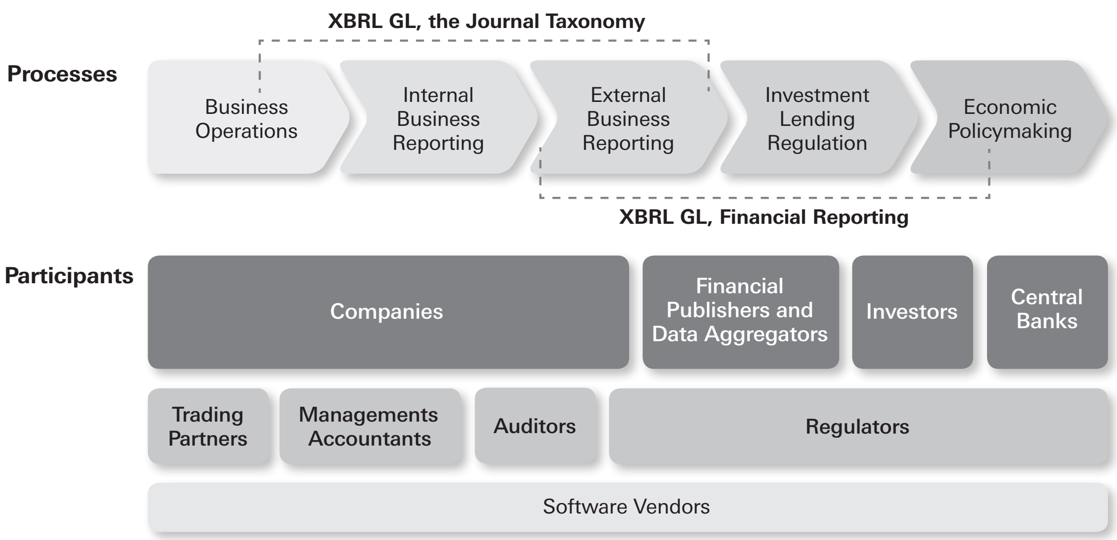
Over recent years several regulatory entities in different countries have progressed to require part of the corporate business report to be filed using this data interchange standard. Of special note is the Dutch effort on Standard Business Reporting (Burg, 2009) that brought together mandates by ministries, its required reporting function, the revenue services and their statistical gathering into a common set of data. This reduced the potential preparation of a couple of hundred thousand data fields to about eight thousand (Burg, 2009). The Dutch government and the governments of Australia, New Zealand and the United Kingdom have been progressing on forms of the XBRL Standard Business Reporting[9].

The Securities and Exchange Commission (SEC) mandate (effective mid April 2009) requires the filing of financials in XBRL format by all US public companies and foreign private issuers (this will affect all Australian SEC registrants directly in terms of corporate reporting). However, while mandatory XBRL for Australian companies is still some way off, Australia appears to be making considerable progress in taxonomy development.

While XBRL emerged as a voluntary standard it progressively became evident that it must be mandatory both for its adoption as well as for obtaining a commonality of standards. This approach will substantially facilitate the transmission of data downstream the financial value chain represented in Figure 3.

8. http://en.wikipedia.org/wiki/XML
9. Feb 2009, Sanders, F., XBRL Borders.

Figure 3: **The financial value chain**[10]




## Re-engineering

In addition to the actual technological elements of the Now Economy environment some major process changes are finally occurring. One of these is the process of re-engineering[11] where businesses are rethinking how they impound new technology into their processes. In general it is not a good idea to bring in substantive technological change without seriously rethinking business processes. For example, the inclusion of a data warehouse for data mining will require the rethinking of media acquisitions, contacts with clients and provisioning methods.

## Electronisation of business

The introduction of technology into business processes has often been the main driving force of change. Vasarhelyi & Greenstein (2003) define electronisation as:

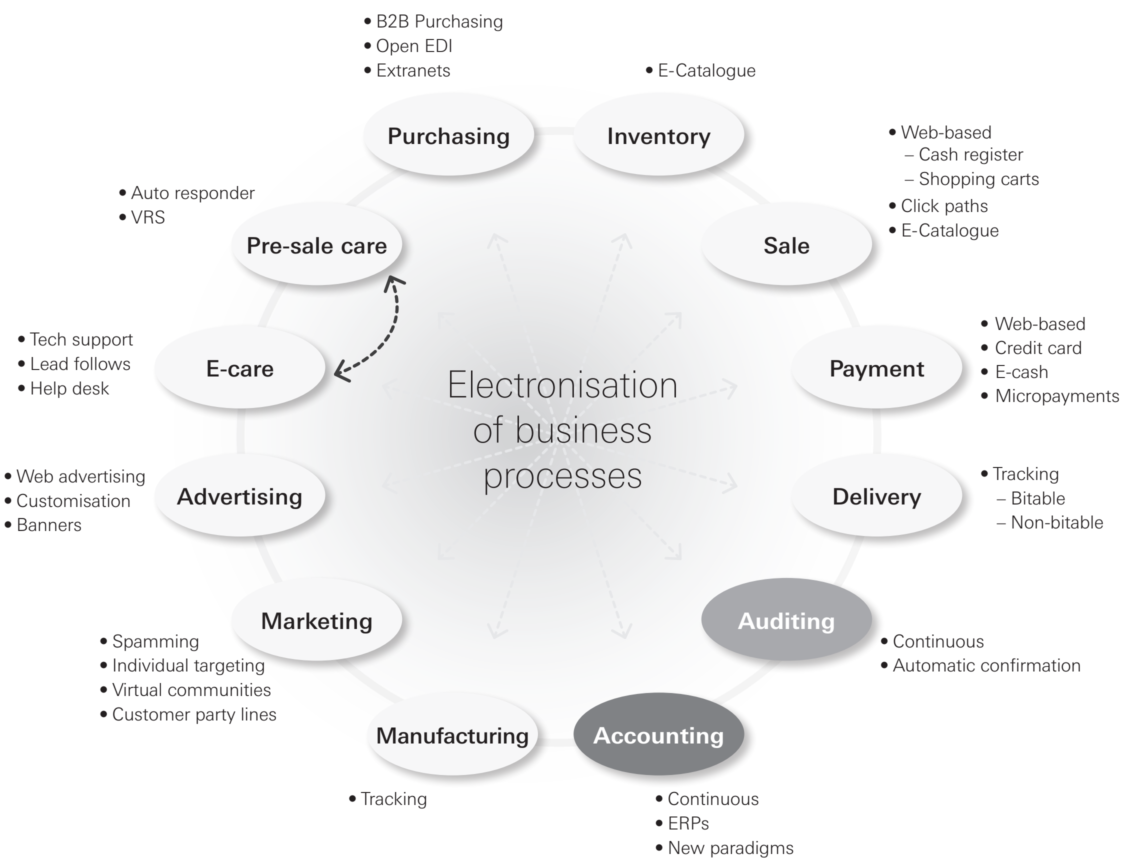
> The wider phenomenon of electronisation of economic activities encompasses the digitalisation of all processes of economic wealth generation including economic analysis, production, storage, information provisioning, marketing, etc. Consequently, within the more general phenomenon of digitalisation of modern life, we find a very important phenomenon – the increasing electronisation of business.

10. Picture adapted from http://www.xbrl.org
11. Davenport & Short, 1990.

General Electric[12] is known for its almost obsessive quest for perfection and its chief information officer heads the company's most important initiative: 'digitising' (to be used interchangeably with electronising) as much of its business as possible. That means that buying and selling most things online as well as setting up a digital nervous system connect anything and everything involved in the company's business: IT systems, factories and employees, as well as suppliers, customers and products.

Electronisation may be effected through the main areas of business as described in Figure 4. These main areas are: 1) e-commerce; 2) post-transaction care; 3) supply chain; 4) financial; 5) human resource; and 6) others.

**Figure 4: Electronisation of business processes**




12. 'Real time economy', *The Economist*, 31 January 2002.

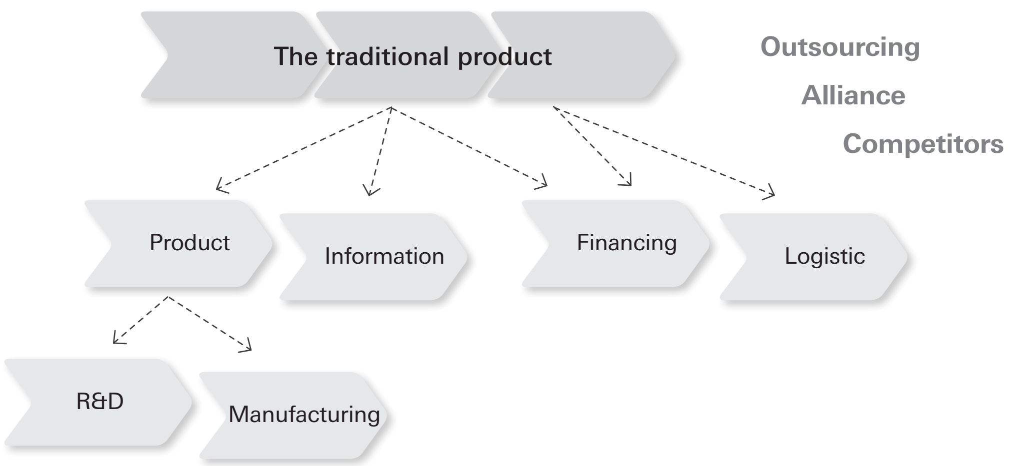
The electronisation of the financial area of business processes has affected everything from accounting recording (through sensors, standardised data collection screens on ERPs, and mostly the automatic importation of other types of XML-represented transactions), ledger posting (through XBRL/GL), system reports, data assurance (through continuous audit), financial reporting (through XBRL/FR), treasury function, corporate financial management, investment management, etc.

Continuous audit, part of the electronisation of the audit, will change the nature of this process, focusing on the improvement of data quality.

## Deconstruction of business

One of the key electronisation effects is the deconstruction of business where organisations focus on retaining key competitive advantage processes while passing over the ones in which they cannot excel. Organisations will focus on their strengths and attempt to garner the strength of other organisations to their advantage. If your organisation has inferior internal auditing and cannot provision it cheaply or competently why not go to your competitor and pay for such a service at a lower rate than it would cost you? The outsourcing argument has been adopted and used for a long time but the evolution of a ubiquitous communication platform (the internet) and a plethora of tools to make it more useful and functional have made this argument substantially stronger. In general deconstruction of business (Vasarhelyi & Greenstein, 2003) entails breaking down your business into key processes, keeping the processes that you consider the 'filet mignon' (core competencies) and passing the rest to better performers.

Figure 5: **Deconstruction of business**



Furthermore, with the emergence and evolution of Service Oriented Architecture (SOA), where the internet is fully utilised, many functions/sub-functions can be efficiently sub-contracted in a competitive advantage mode. For example:

- **Tax tables:** the United States has a wide set of taxing jurisdictions which have different tax rates and taxation rules. The collection and maintenance of these rules is expensive and cumbersome. It is to everyone's advantage that these be made into a SOA service feeding the many countrywide e-services.
- **Statutory reporting:** recent years have witnessed the emergence of potent organisations that as a service prepare filings for businesses. For example, R.R. Donnelley prepares SEC filings for many organisations and these services are going to be substantially stretched with XBRL filings.
- **General Ledger Fraud Examination:** several large audit firms are outsourcing the examination of audit trails to India as this part of the audit process that can be done off location.

In addition to the use of SOA, companies are delegating many of their key financial processes to subcontractors including data warehousing, ERPs, treasury, etc.

### Managing financial processes in real time

Modern corporations cannot survive well without managing certain processes on real time. Corporate Management Accounting is now the owner of a wide set of information. In the modern world, state-of-the-art companies have much online/real-time information. For example:

- No bank could live without their current daily financial balance closing as they would not be able to apply it overnight
- No manufacturing concern could live without real-time inventory information as they would not be able to practice just-in-time manufacturing
- Most companies would have great competitive difficulties if they did not have real-time payables and receivables information to collect or provide discounts based on time characteristics.

## Examples of companies in the Now Economy

Modern companies have developed a wide scope of applications in many domains to explore the benefits of the Now Economy. Vasarhelyi (2009b) has collected a wide array of examples.[13] Some of these examples include:

- **Advertising:** Doubleclick and Yahoo
- **Logistics:** Amazon, Boeing, Dell, FedEx
- **Customer relationship management (CRM):** Anheuser-Bush, E-Bay, Jet Blue Airways
- **Dashboards:** General Electric, California Heart Center Foundation
- **Financial:** Dow Chemical, Prestige Capital, Scottrade
- **Infrastructure:** AT&T, Sun Microsystems, Traffic.com, Xenogen
- **Others:** American Airlines (online reservations), Citrix Systems (per seat on demand jet travel), GM (in-vehicle safety), GN (advanced automatic crash notification), IBM (e-procurement).

13. Vasarhelyi, M.A. 2009 'Real time economy examples', http://raw.rutgers.edu/RTEexampls

Many of these applications were considered strategic information systems where they actually changed dramatically the nature of the business and forced competitors to copy or to perish. Real-time applications in financial systems such as real-time reporting, real-time monitoring, and Continuous Assurance will eventually fall into this classification.

## Comparing the Now Economy with the 'snail' economy

While the emergence of the Now Economy has provided us with startling new examples of efficiency and improved management, its emergence is a slow and confusing process. The level of electronisation of an entity often indicates its progress in moving towards the Now Economy. A diagnostic of its progress in this direction can be obtained by careful review of processes and their automation. Table 1 indicates some factors that compare a traditional (snail) economy to the Now Economy process.

Table 1: **Evolving towards the Now Economy**

| | Traditional | Evolutionary | Now Economy |
|---|---|---|---|
| **Medium** | Paper | Hybrid | All electronic |
| **Agent** | Human processing | Use computers | Automated processes |
| **Geography** | Local | Multinational | Integrated processes across countries |
| **Marketing** | Traditional marketing | | One-to-one database marketing |
| **Accounting** | Accounting – file systems | Accounting software | ERPs |
| **Auditing** | Ex-post facto auditing | IT audit procedures | Close to the event real-time audit |
| **Stock** | Large inventories | JIT | Integrated supply chain, JIT, supplier managed inventory |
| **Human resources** | Personnel management | | Real-time human resources, home work, extensive usage of labour pools |
| **Customer care** | Store-based technical support | | Real-time CRM with considerable automation, substantially outsourced |

Most processes evolving towards the Now Economy will go through an evolutionary process. Table 2 illustrates a view of the evolution of IA in a maturity model that evolves towards the Now Economy (Vasarhelyi and Kuenkaikaew, 2009c).

**Table 2: The internal audit maturity model**

| | Stage 1<br>Traditional audit | Stage 2<br>Emerging | Stage 3<br>Maturing | Stage 4<br>Continuous audit |
|---|---|---|---|---|
| **Objectives** | • Assurance on the financial reports presented by management | • Effective control monitoring | • Verification of the quality of controls and operational results | • Audit by exception<br>• Improvements in the quality of data<br>• Creation of a critical meta-control structure |
| **Tooling** | • Manual processes and separate IT audit | • Spots of IT and financial/OA audit integration | • Auditing links financial to operational processes | • Most of audit automated |
| **Approach** | • Traditional interim and year-end audit | • Traditional plus some key monitoring processes | • Use of alarms as evidence<br>• Continuous control monitoring | • Audit by exception |
| **IT/Data access** | • Case-by-case basis<br>• Data is captured during the audit process | • Repeating key extractions on cycles | • Systematic monitoring of processes with data capture | • Complete data access<br>• Audit data warehouse, production, finance, benchmarking and error history |
| **Audit automation** | • None | • Audit management software<br>• Work paper preparation software | • Automated monitoring module<br>• Alarm and follow-up process | • Continuous monitoring and immediate response |
| **Audit and management sharing** | • Independent and adversarial | • Independent with some core monitoring shared | • Shared systems and resources where natural process synergies allow | • Purposeful Parallel systems and common infrastructures |
| **Management of audit function** | • Financial organisation supervises audit and matrix report to the board of directors | • Some degree of coordination between the areas of risk, auditing and compliance<br>• IT audit works independently | • IA and IT audit coordinate risk management<br>• IA shares with IT audit automatic audit processes | • Centralised and integrates with risk management, compliance and SOX/ layer with external audit. High level of reliance |
| **Analytical methods** | • Financial ratios | • Financial ratios at sector level | • KPI level monitoring<br>• Structural continuity equations<br>• Monitoring at transaction, account and financial report account level | • Corporate models of the main sectors of the business<br>• Early warning system |

In Table 2 a series of elements of the audit process are related to an evolutionary framework of increasing audit automation (Vasarhelyi and Kuenkaikaew, 2009c). Vasarhelyi and Kuenkaikaew (2009c) examined four leading world organisations and rated them by levels of progress.

**Figure 6: The current level of the adoption of Continuous Assurance and continuous monitoring of the companies**

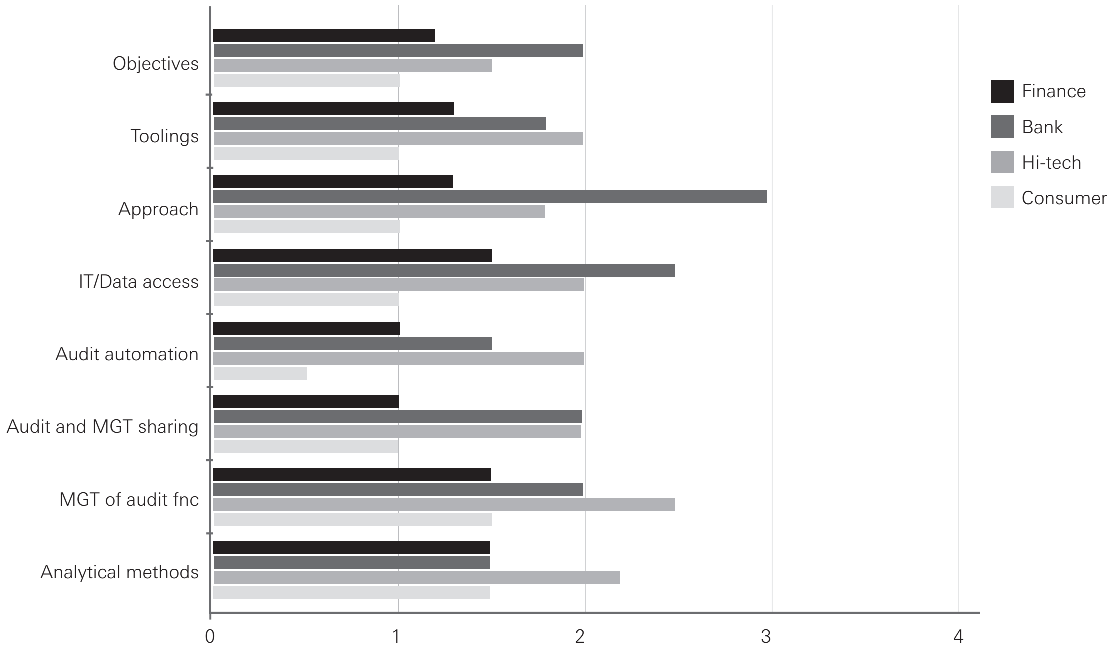



Figure 6 rates four different companies on a scale of IA maturity based on the Table 2 schema. Clearly companies are evolving progressively towards a substantial degree of maturity; however, with great differences among market players and industries. Financial companies were rated as the most mature while non-financial companies typically had substantive audit attention to core risk areas. It is noteworthy to observe the variables used to characterise the degree of maturity of an audit organisation. These variables could serve as the basis for developing objective analytics on audit maturity and a program of progress and self-assessment of the audit organisation.

It is worth asking how one should interpret the results of this study in the light of the credit crisis. The survey was conducted while the crisis was unfolding and as Figure 6 indicates, the financial services entity was among the leaders in Continuous Assurance adoption. This is hardly surprising since the nature of the transactions in that sector facilitate electronic controls and monitoring. Indeed, everyone is aware of how their credit card transactions are continuously monitored, leading to the occasional declined transaction because of the fear of fraud or a stolen card. But despite this head start, the fact that the crisis began and was centered on the financial services sector indicates that Continuous Assurance is no panacea for business failure. On the other hand, the adoption of continuous audit in the financial sector and other sectors is still incipient. Consequently it would be unreasonable to expect that a small degree of continuous audit adoption would have a large effect on the diffusion of the crisis.

There is a world of difference between issuing credit cards and credit default swaps, both in the scale and scope of the underlying risks and the complexity of the transactions that need monitoring. Most important of all, Continuous Assurance only works to the extent that its designers use it to monitor the correct sources of risk and provide it with the appropriate analytic engine to measure that risk. As we argue below, Continuous Assurance systems will need in the future to incorporate CRMA to dynamically adjust the scope of the Continuous Assurance system to emerging areas of entity risk, and ideally, will do so automatically with external sensing mechanisms, not subject to the human failure of assuming that the good times will continue forever, which is the handicap of any Continuous Assurance system subject to the need for manual adjustment to face new threats.

# Continuous Assurance for the Now Economy

## Measurement in the Now Economy (the accounting process)

In comparison to the changes that have been experienced in business, the fundamental practices of accounting have not changed for many decades. Thus, external accounting reports are presented quarterly and only audited annually; accounting standards are introduced in a reactive mode and are meant for purely manual application, with no directly formulated provision for tagging or automated referral; and auditing firms in general still retain billing practices developed for a highly manual audit process. In short, while businesses are moving on to the ‘Now’ economy, accounting and auditing remains in a ‘traditional’ mode.

This is only reinforced by the developments of the subprime crisis of 2007 – 2009. The financial institution crisis illustrates how the current accounting measurement methodologies fail to predict or detect serious crises. Many of the entities that failed during 2008, such as Bear Sterns, Lehman Brothers, Freddie Mac, Fannie Mae, and AIG had clean audit opinions with no going concern qualification issued just months prior to their failure. As we discussed above, Continuous Assurance by itself is only a technological/methodological tool and it is powerless to prevent catastrophic failures of this sort unless its designers have the imagination to foresee that such risks are present and need to be monitored. The key is to create a system of monitoring, external sensing and reporting rich enough that stakeholders, from investors, regulators and management to external auditors, receive advance warning of emerging threats to the entity’s business and operating environment.

However, accounting researchers and innovative practitioners are beginning to look forward to how the technologies that are already in widespread use elsewhere in business can be used to transform accounting practice. Conceptually it is important to position accounting measurement in relation to assurance. The Now Economy organisation uses a wide range of business measurements, from those that are highly automated and formalised, to wide-level estimates and capricious assumptions. While in order to conduct its business it needs to capture thousands of data flows in the different processes of business, and through ERPs use hundreds of thousands of controls to generate tens of thousands of reports, its external financial report uses arbitrary asset lives, meaningless goodwill estimates, etc.

On the other hand, a real monitoring process needs both an objective (and frequent) measure and comparison standards for detecting anomalies. These objective measurements run the business on a day-to-day basis and eventually will be reported to the different stakeholders of business in a meaningful, less anachronistic manner. Vasarhelyi and Alles (2007)[14] propose a set of new aggregate external reports. The Enhanced Business Reporting Consortium[15] has attempted to create additional reporting models to satisfy a wider audience and bring up to current some of the obsolete aspects of reporting.

14. http://raw.rutgers.edu/Galileo
15. http://www.ebr360.org

Current social and economic forces create a straitjacket for change in the business reporting process due to a series of factors:

- Reporting organisations must continue their day-to-day reporting so changes have to be evolutionary
- Business organisations consequently resist any serious attempt to change basic reporting guidelines
- The economics of the reporting tradeoffs (eg. level of aggregation, disclosure and materiality) have changed completely with automation but their reflection in reporting is still traditional
- External audit firms have little motivation to substantially change things in order to not antagonise their clients
- Governments, in particular in democratic countries, will be responsive to the grand public that, in general, does not understand the need for change.

While changing financial standards is necessary, their ineffectiveness does not stop IA organisations from innovating in order to provide better data quality and support to a trustworthy business organisation. Vasarhelyi and Kuenkaikaew (2009c) have documented some of these efforts. The particular focus of this monograph is on developments in the provision of assurance for business transactions, an area described by the general term of 'Continuous Assurance'. We typically consider assurance an umbrella of services while the traditional audit, WebTrust, SysTrust and an expanded set of auditor services exists. The Elliott Committee[16] of the AICPA has proposed 148 of these services and has chosen to develop six. Among these services are the WebTrust and SysTrust services. The AICPA's Assurance Services Executive Committee (ASEC)[17] is given the task to propose new services and create principles and criteria for these services. Under a wide umbrella of assurance services we find the 'traditional audit'. This monograph works on expanding the frame of the traditional audit towards a more timely and effective audit close to the event. While both the CICA/AICPA (1999) and the IIA (GTAG #3, 2005) have issued documents and some guidance in the United States, the state-of-the-art in audit is fluid and rapidly evolving.

The Australian Auditing and Assurance Standards Board (AUASB) continues to acknowledge the challenges created for auditors and standard setting in advancing the development of Continuous Assurance engagements. The AUASB will continue to monitor progress and develop guidance as necessary.

16. AICPA, 1997a, *Special committee on assurance services report*, available at: http://www.aicpa.org/assurance/index.htm, Accessed: March 2004.
17. http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/BRAAS/Assurance_Services_Executive_Committee.html#Task_Forces

## Evolving toward a more continuous assurance

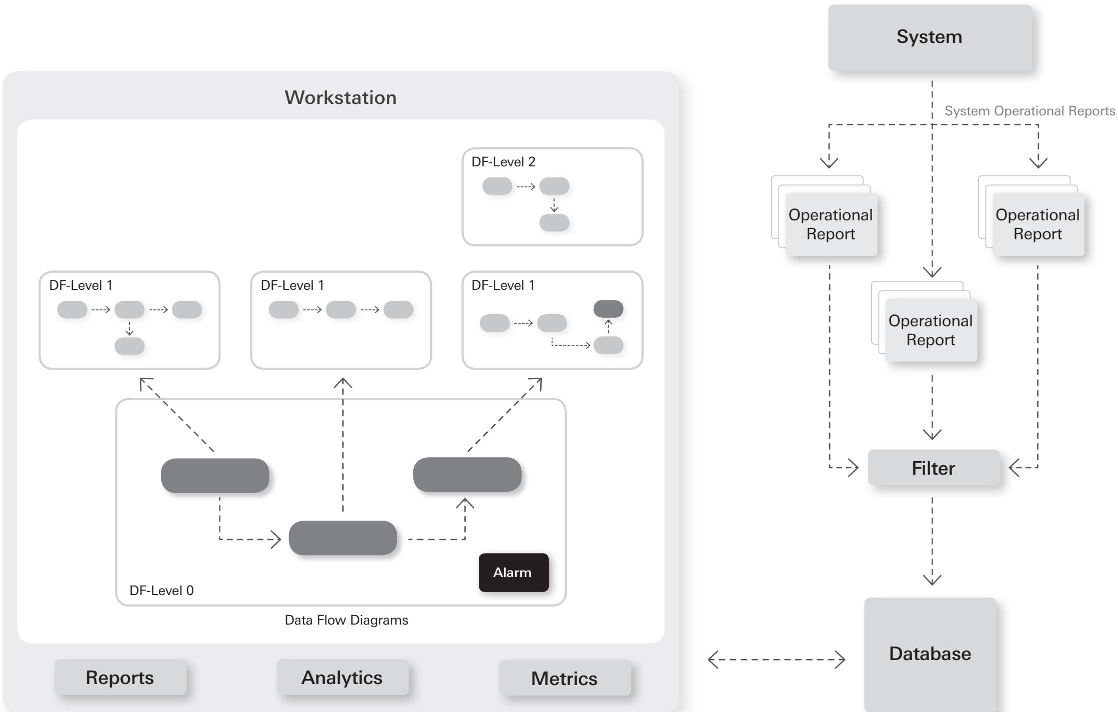
### Early Continuous Assurance

One of the first recognisable examples of what we now call 'Continuous Assurance/Continuous Auditing' was a large scale auditing system developed in the late 1980s at Bell Laboratories, the research arm of the giant US telecom firm American Telephone & Telegraph (AT&T). That project relied on the ground-breaking IT of the day (PCs, databases, corporate networks, but not yet the internet) to assure the reliability of the entity's billing systems through the automated acquisition and analysis of data and the electronic communication of alarms – no mean task when the entity's customer base comprised over one hundred million users. The tools available at the time would be considered primitive today, and yet that pioneering system, known internally as the Continuous Process Auditing System (CPAS), and its successors, were in use even as late as a few years ago to detect anomalies in billing and possible fraudulent use of long distance calling.

The system intended to monitor and audit the large biller initiative of AT&T. This was part of AT&T's 'take back' strategy where the billing for long distance services would not be done through the regional companies (as for local calls) but by a separate bill issued to the client by AT&T. The system was enormous and highly sensitive data extraction was through semantic processing where electronic versions of reports were captured through a remote job entry system and its content pattern scanned for specific content. Report BIL173 would have next to the word 'total' the value of a particular variable and next to 'date' the actual chronology of the event. In Figure 7 a symbolic view of this systems architecture shows the systems (four large data centres distributed throughout the United States) distributing electronic remote job entry (RJE) reports, these being filtered through the semantic extraction procedures discussed above, and placed in a relational database. This database was queried by screen-based reports that visually described the system in a 'flow-chart like' presentation comfortable to auditors.

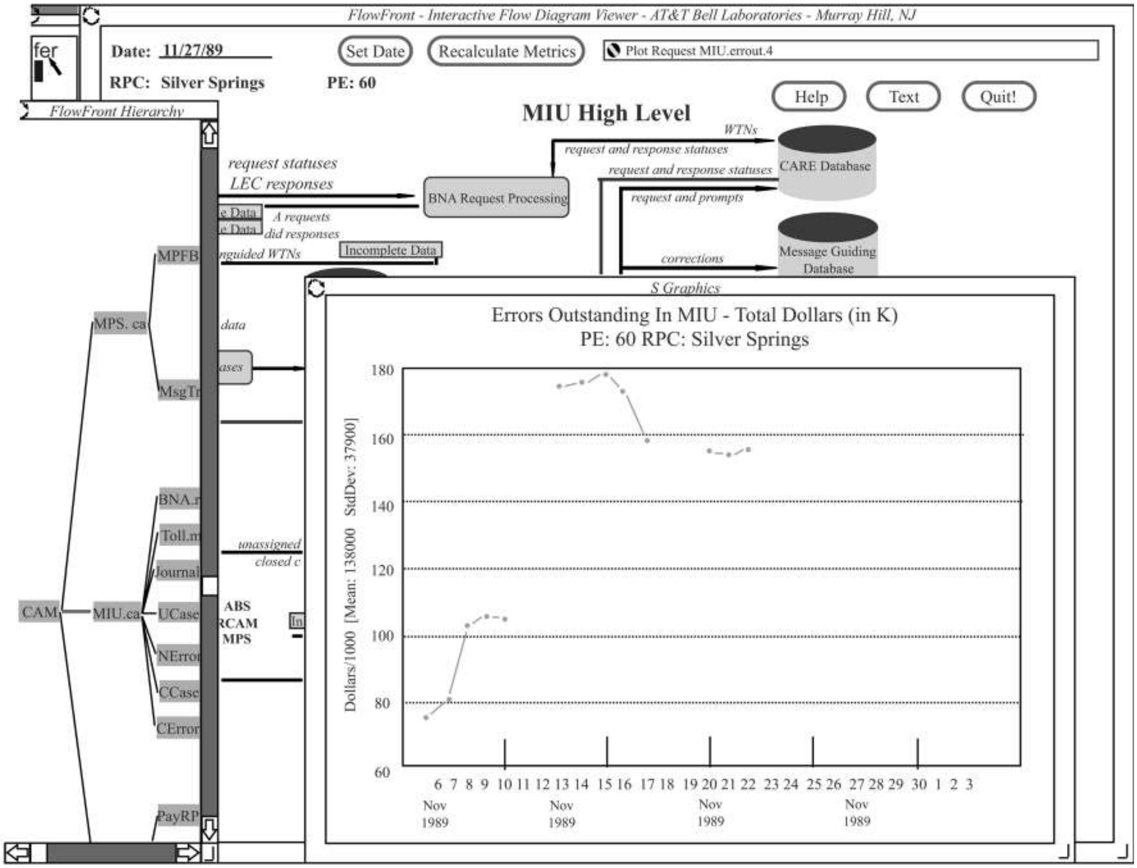
Internal auditors who intensively participated in the effort were 'knowledge engineered' to acquire information about many parts of the system and to capture audit rules to be impounded in the system. Furthermore, past audit reports were used to identify sources of data (metrics), types of analysis performed (analytics), and standards (models to compare against), as well as when an alarm should be issued (Vasarhelyi and Halper, 1991).

**Figure 7: CPAS architecture**




This effort in actual data monitoring to identify process flaws or data exceptions was termed 'continuous audit' but today would be known as 'continuous data audit'. Figure 8 displays a system screen with an error analytic report overlaid. Note the buttons on the top of the screen with date specification, time period specification, ability for requesting recalculation (data could change too rapidly so it was frozen for the display) and specific comments. Each screen had its own documentation and could be used for auditor or user training.

**Figure 8: CPAS screen with live flowchart and analytic graphic**




That first project clearly demonstrated that the ultimate point of Continuous Assurance is to bring auditing closer to the operational process, and away from the traditional backward looking annual examination of financial statements. The CPAS project was eventually paralleled by the 'Prometheus' project that used its infrastructure to deliver information to billing management analogous (but not identical) to the process monitoring features of CPAS.

## Developments and the status of Continuous Assurance

Despite this working example of Continuous Assurance, it took until 1999 before the accounting profession, in the form of a joint committee of the American Institute of Certified Public Accountants (AICPA) and the Canadian Institute of Chartered Accountants (CICA), took up the issue of Continuous Assurance and issued an often used definition of the term:

> A continuous audit is a methodology that enables independent auditors to provide written assurance on a subject matter, for which an entity's management is responsible, using a series of auditors' reports issued virtually simultaneously with, or a short period of time after, the occurrence of events underlying the subject matter (CICA/AICPA, 1999).

While parts of this definition, such as its emphasis on 'written assurance', have already been made obsolete by the progress of technology, the definition has helped jump start a thriving research and practice area in Continuous Assurance.

A June 2006 PricewaterhouseCoopers survey[18] found that:

> Eighty-one percent of 392 companies responding to questions about continuous auditing reported that they either had a continuous auditing or monitoring process in place or were planning to develop one. From 2005 to 2006, the percentage of survey respondents saying they have some form of continuous auditing or monitoring process within their internal audit functions increased from 35% to 50% – a significant gain.[19]

A similar survey jointly undertaken by ACL and the Institute of Internal Auditors (2006) also showed that interest in Continuous Assurance was increasing rapidly, with 36% of responding entities stating that they had adopted a Continuous Assurance approach across all of their business processes or within selected areas, and with another 39% planning to do so in the near future.[20] The latter survey concluded:

> Whatever the reasons organizations may have had for neglecting continuous auditing in the past, regulatory demands, the push for real time financial reporting and the drive to automate resource draining manual audits are nudging them to adopt it now.

Given the technological basis of Continuous Assurance, perhaps the best metric of the 'mainstreaming' of Continuous Assurance is the over 40,000 hits that the term generates on Google (as of January 2009). Practitioners and software vendors (such as SAP, ACL, Caseware, Approva and Oversight Systems) now outnumber academic researchers as attendees at the biannual global Continuous Assurance conferences organised by Rutgers University in the United States and internationally. Among those practitioners are representatives of the major audit entities, most of whom have ongoing Continuous Assurance initiatives.

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18. PricewaterhouseCoopers 2006, *State of the internal audit profession study: Continuous auditing gains momentum*, PWC Advisory, Internal Audit
19. http://www.pwcglobal.com/images/gx/eng/about/svcs/grms/06_IAState_Profession_Study.pdf
20. Business Finance Magazine, August 2006, http://www.businessfinancemag.com/magazine/archives/article.html?articleID=14670&highlight=acl

As befits a concept developed by academics, there is a large and dynamic research program into Continuous Assurance. A recent review paper (Brown et al., 2007) surveyed the extent of Continuous Assurance literature and classified over 60 papers discussing a wide range of topics and approaches into six major categories: 1) demand factors, meaning drivers of change; 2) theory and guidance; 3) enabling technologies; 4) applications; 5) cost benefit factors; and 6) case studies.

The issues discussed relative to the demand factors that are driving the creation of the emerging Continuous Assurance systems include: the increasing complexity and data-intensiveness of the business environment; the growing prevalence of electronic data interchange, etc.; the ever increasing usage of outsourcing; value chain integration; web-based reporting and the users' desire for reliable information to be disclosed more frequently, more timely and in more detail; XBRL-based reporting; and the fact that under Sarbanes Oxley (Section 409) companies must disclose certain information on a current basis.

As impediments, Brown et al. (2007) drew attention to Alles et al. (2002) who discussed independence issues such as who will pay for the large start-up costs and who owns work product. Under theory and guidance, Brown et al. (2007) cited articles describing Continuous Assurance concepts, proposing a framework and research agenda for the topic, and providing implementation guidance and discussing implementation challenges.

Vasarhelyi et al. (2004) discuss the enabling technologies including statistical methodologies such as belief functions, neural networks, as well as technologies from computer science such as database and expert systems, intelligent agents, and especially technologies for tagging data to facilitate transmission and comparison, most notably XBRL and XBRL/GL. In the applications domain, case studies now exist of Continuous Assurance implementations, such as the pilot implementation of the monitoring and control layers for continuous monitoring of business process controls (Alles et al., 2006), the formerly mentioned CPAS system developed at AT&T Bell Laboratories (Vasarhelyi and Halper, 1991), the Financial Reporting and Auditing Agent with Net Knowledge agent for finding accounting numbers in electronic data-gathering, analysis and retrieval filings (Bovee et al. 2005), and advanced analytics at a major health services provider (Alles et al., 2006).

There is also an emerging literature of product descriptions in the application domain driven by the emergence of packaged commercial Continuous Assurance software solutions. Such solutions are now actively developed both by established computer assisted auditing techniques (CAAT) vendors such as ACL and CaseWare IDEA, and by new software vendors, such as Approva and Oversight Systems, who are quickly establishing themselves in this emerging market.

The final category of cost benefit issues deals with possible paths along which Continuous Assurance will evolve, long-run operating cost of running database audit, benefits of timely discovery of errors, omissions, defalcations, cost-effectiveness of automated, software-driven audit procedures, discussion of economic feasibility of continuous audit, an experimental market and laboratory experiment for continuous online audit, and nine benefits of continuous business assurance analytics.

While not yet an established technology, it is clear that Continuous Assurance is maturing both in practice and in the research arena, as lessons learned in implementations are used in refining the underlying conceptual model.

# The scope of Continuous Assurance

As the technological drivers of Continuous Assurance continue to rapidly progress, it has proven difficult to reach consensus on what Continuous Assurance actually encompasses. What makes this problem of more than academic interest is that the perception of what Continuous Assurance can and cannot do significantly impacts the ease or difficulty of getting its usage accepted in practice. We have already discussed the need to update the AICPA/CICA definition of Continuous Assurance to do away with written audit reports, which are redundant in today's world of electronic communication. Even more importantly, the word 'continuous' undoubtedly would not be used today, because it implies a frequency of auditing that is both difficult to achieve technically without impacting the operations of the entity's IT systems, and probably beyond the needs of most users. The different elements of a corporate information system have different pulses and natural rhythms. The assurance process must be coherent with these rhythms to be useful and effective.

## A narrow view

The difficulty of delineating the area of Continuous Assurance is manifested by the significant efforts made in the academic literature (Vasarhelyi and Halper, 1991; Vasarhelyi et al., 2004; Rezaee et al., 2002) on defining the distinction between 'continuous assurance' and 'Continuous Assurance' and how both differ from the traditional audit. Alles et al. (2002) defined Continuous Assurance as the application of modern information technologies to the standard audit products, be they the mandated annual audit opinion or internal IT audit. In this view, Continuous Assurance is another step on the path of the evolution of financial audit from manual to systems-based methods. The literature on Continuous Assurance can restrict itself to technical matters, working under the assumptions that the demand for the mandated audit is a given and that the emerging technologies will be adopted because they are cheaper and more effective than the current audit methods.

## A wider view

By contrast, continuous assurance sees Continuous Assurance as only a subset of a much wider range of new, non-statutory products and services that will be made possible by these technologies. In particular, in this wider view, continuous assurance is seen as going hand-in-hand with continuous reporting, because more frequent assurance can obviously only have an impact when its availability is made known through some reporting mechanism that matches its timeliness. Elliott has been the most forceful proponent of this wide view of Continuous Assurance, stating as long ago as 1997 (Elliott, 1997) that 'On-line reporting based on databases updated in real time will be less wedded to current protocols for periodicity, creating a parallel evolution toward continuous auditing. Continuous auditing may lead to continuous reporting that supplements and eventually replaces the annual audit report'. Subsequently, with the scope of such services expanded by the AICPA from auditing to assurance, Elliott (2002, p. 7) went on to say that 'The advantages of electronic business reporting will provide a market for – indeed, the necessity of – continuous assurance'.

Alles et al. (2002) subjected this view to an economic analysis, and recognised that assurance is driven by business necessity rather than being an inevitable outcome of technology. They postulated that the best way of thinking about the benefits of Continuous Assurance is that it enables 'audit on demand', which implies a continuous capability to audit, but not the continuous provision of assurance.

Shortly after the publication of this paper, the passage of the Sarbanes Oxley Act in the United States and especially its Section 404 requirements for assurance over financial reporting controls validated the view that demand would be the driver of Continuous Assurance . However, what was not anticipated by Alles et al. (2002) and other writers prior to the passage of the Sarbanes Oxley Act was that it would be internal rather than external auditors who would be the main champions of Continuous Assurance The reasons were two-fold. First, external auditors were overwhelmed with doing 404 work and so had no time to spare for developing new Continuous Assurance methodologies, while internal auditors, who also had to find resources to take on new 404 responsibilities, saw in Continuous Assurance the means of reducing the headcount demands of their existing tasks. Second, Sarbanes Oxley Section 201 strengthened the independence standards on external auditors and there was great concern that Continuous Assurance would violate those constraints, while internal auditors obviously faced no such restrictions.

In particular, an important component of Continuous Assurance is what Alles et al. (2006) call ‘Continuous Control Monitoring’ (CCM) which is the application of technology to the continuous monitoring of internal controls of business processes. This is often driven by management needs, as opposed to the requirements of external auditors, and so typically it can only be carried out by internal auditors. However, in practice, the external auditor has a major influence on the design of these CCM systems. In all instances that we are familiar with, the internal auditor of the entity sought at least an implicit agreement beforehand with the entity’s external auditor that the systems they use would be relied on by the external auditor in the their statutory auditor or (in the United States) SOX 404 certification. Otherwise, the cost and efficiency considerations would have made the CCM system economically unfeasible. Indeed, all the Big 4 audit firms are now developing Continuous Assurance technologies they are seeking to sell to non-audit client customers, and an important selling point of these products relative to those sold by third party vendors is the ‘seal of approval’ of an external auditor.

## An evolutionary view

In the early days of the aforementioned CPAS effort and other examples, Continuous Assurance meant using close to the event data streams to identify faults or to give assurance of system/data reliability. The ensuing emphasis on controls, the requirement of independent assessment of controls, and the emergence of ubiquitous ERP systems (where controls cannot be directly observable) brought the expansion of the conceptualisation to bring in monitoring technology to observe adherence to controls in embedded software. This added CCM to CDA to make Continuous Assurance.

We are currently at a stage of potential expansion of the scope of Continuous Assurance. The subprime crisis of 2007-2009 made it obvious that the accounting measures in place did not accurately report economic health, the business model and risks to which entities were exposed. So the unforeseen series of trigger events was not considered or factored in. It is also obvious that corporate enterprise risk management (ERM) procedures were inaccurate and inadequate for a systemic set of problems and the complex business environment foreshadowed by financial engineering. At the planning stage of the audit, risks are assessed to the elements of the entity, and resources allocated for a ‘risk-based audit’.

If corporate ERM procedures were not adequate to assess business risk, obviously audit risk assessments are limited too. Thus it is proposed that a new set of CRMA procedures be brought forward to take advantage of close to real-time monitoring and hopefully advancements in analytics and alerting technology.

## A practice view

In contrast to the academic literature, practitioners attach less significance to what Continuous Assurance means, with definitions mattering less than the application of Continuous Assurance techniques and the value they create – but this only applies to those practitioners who are already convinced of the benefits of implementing Continuous Assurance within their organisations. For others, the term ‘continuous’ can still pose a conceptual problem that impedes acceptance and change management.

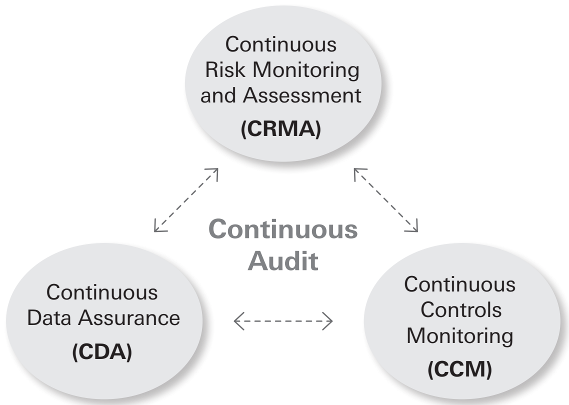
In the early days of Continuous Assurance, the ultimate goal was the development of the ‘push button audit’, in which auditing functions somewhat analogously to the way in which virus protection software automatically protects a PC today with little intervention from the user. This overly optimistic vision of the potential of Continuous Assurance is due to the focus on the extraordinary possibilities of modern IT and its rapid rate of change. But business practices, let alone the mindsets of the people involved, change far more slowly, and only in response to proven value added. That makes pilot implementations and the role of academics in creating and disseminating the lessons learned essential to the development of Continuous Assurance.

# Implementing Continuous Assurance

By analogy with conventional auditing, we divide Continuous Assurance into three distinct but complementary components:

- **Continuous controls monitoring (CCM)** which consists of a set of procedures used for monitoring the functionality of internal controls
- **Continuous data assurance (CDA)** which verifies the integrity of data flowing through the information systems
- **Continuous Risk Monitoring and Assessment (CRMA)** which is used to dynamically measure risk and provide input for audit planning.

**Figure 9: Three elements of Continuous Assurance**




Examples of CCM include procedures for monitoring:

- Access control and authorisations
- System configuration
- Business process settings.

Examples of CDA include procedures for verifying:

- Master data
- Transactions
- Key process metrics using analytics (including continuity equations [CEs]).

CRMA includes processes that:

- Measure risk factors on a continuing basis
- Integrate different risk scenarios into some quantitative framework
- Provide inputs for audit planning.

While continuous monitoring of access controls and authorisations is well developed in computer security applications, monitoring enterprise system configuration and business process settings is an emerging area of development. At present entities are implementing these Continuous Assurance components individually, but not as an integrated system of Continuous Assurance. Over time, there will be a need for better integration across all assurance platforms, in much the same way that the proliferation of stand-alone functional software across the entities eventually led to the development of ERP systems.

More fundamentally, creating a fully integrated Continuous Assurance system would require rethinking the conceptual framework for both assurance – and more frequent assurance is irrelevant without correspondingly timely reporting – and for reporting. There will be a need to re-engineer audit and reporting practices that were developed for a manual, annual procedure into ones that make sense for real-time, automated Continuous Assurance systems. Not only will new methodologies have to be created, along the lines of ones discussed in this paper, but new ways of thinking about such long accepted auditing and reporting principles as materiality, independence, recognition, measurement and disclosure will also have to be developed.

We now discuss implementation strategies of CCM and CDA. We also conceptually introduce CRMA and propose an integrated model.

## Continuous Control Monitoring of business processes

### Strategies for Continuous Control Monitoring

Continuous monitoring of business process (BP) controls relies on automatic procedures, and therefore presumes that both the controls themselves and the monitoring procedures are formal or are able to be formalised. Note that the latter is necessarily premised on the former. Formalisation of BP controls, while important in its own right, has been precipitated by ERP implementations and the ongoing Section 404 of Sarbanes Oxley compliance work. The verification of existence, suitability for purpose, and functioning of controls over BP can be accomplished in three different ways.

First, one can observe a BP and verify if the observations agree with the proposition that a control exists, is appropriate and functioning as intended. The benefit of this approach is that it can be applied even in those environments in which controls are not directly accessible by the auditor. The problem with this approach is that the observed behaviour of the BP may not completely cover the whole range of situations in which the control is expected to function, and therefore there is no assurance that this control will be functioning as expected under all circumstances.

Second, in the case of preventive controls, one can attempt to execute a prohibited BP behaviour (eg. run a prohibited transaction such as recording a large purchase order without proper authorisation) to verify that such behaviour cannot happen. In the case of detective or compensating controls, the auditor can verify that the prohibited behaviour is detected and compensated for. While such control testing provides much stronger evidence than the previous approach, it is highly unlikely that an auditor (even an internal one) will be allowed to execute such ‘penetration testing’ on the entity’s ERP system. Under most common circumstances, the best an auditor can count on is the read-only access to that system. Indeed, the most likely situation in our experience is that both internal and external auditors are reliant on the entity's IT personnel to install the interface which allows them to extract data from the ERP system on their behalf.

Finally, one can retrieve the control settings stored in the enterprise system and verify that they match the benchmark. The benefit of this approach is that it requires just read-only access to the enterprise system and provides very strong evidence since it actually confirms that the control is indeed what it has to be. The critical assumption in this approach is that the programming code of the control in the production enterprise system is correct, since what are verified in this approach are the control settings. This assumption seems to be reasonable with respect to the standard controls built into modern packaged ERP systems such as SAP R/3 or Oracle Business Suite. However, an ERP system can be customised, and in the case of customised controls, additional initial control verification work may be needed to complement the ongoing monitoring of BP control settings.

The analysis above implies that in the case of highly integrated and standardised enterprise system environments, the most appropriate approach to CCM is to implement continuous monitoring of BP control settings. Modern ERP systems make their automated BP control settings accessible online from the Continuous Assurance system. The process of monitoring itself falls within the general Continuous Assurance framework developed in Vasarhelyi et al. (2004) of obtaining assurance by continuously comparing the actual observations (in this case the control settings) against the benchmarks. Therefore, the determination of the appropriate benchmarks for the acceptable BP control settings constitutes a critical part of implementing a Continuous Assurance system. Clearly, such benchmarks are often enterprise-dependent. In the case of large multinational companies certain control setting benchmarks may depend on the country or a particular unit of an enterprise, which will complicate the setup of the Continuous Assurance system.

A critical parameter in the Continuous Assurance system is the frequency (eg. daily, hourly) of comparison of the actual BP control settings with the benchmarks. This is a generic issue in any Continuous Assurance system setup, and the optimal frequency may depend on many different features of the environment and the controls under consideration. Note that while higher frequency is indeed beneficial for achieving higher levels of assurance (since less time is available for undesirable adjustments or malfeasant transactions), the main problem with the excessive frequency is not the processing capability of the Continuous Assurance system, but rather the performance penalty imposed by such queries on the production enterprise system. While an hourly frequency will usually not present a problem, hitting a production system every second with a query to retrieve voluminous control settings may be problematic, especially during working hours.

The main task of a Continuous Assurance system is to take action in case the observed BP control values deviate from the benchmarks. We call such deviations 'exceptions'. A Continuous Assurance system has to automatically generate alarms in case of critical exceptions, such as individual accounts without passwords, or in case of numerous non-critical exceptions result in the aggregation of weaknesses in certain control areas (eg. segregation of duties). The alarms are always sent to the (internal and maybe external) auditors, and can optionally be sent to responsible enterprise personnel and/or enterprise managers, as well as other relevant parties.

### System architecture for Continuous Control Monitoring

Once an automated audit program for CCM has been created, it has to be implemented in audit software. This software can be categorised along its three dimensions: structure, access and platform.

In terms of structure, audit software can be either integrated or distributed. It is natural to mimic the structure of the enterprise software being audited: if it is tightly integrated, the auditing software can be a tightly integrated system as well, while in the case of loosely coupled enterprise applications, a distributed system consisting of multiple auditing software agents will be a better fit.

Auditing software's access to the enterprise system and data can be either direct or intermediated. As the word 'direct' suggests, in this case auditing software has access to the enterprise system implementing the business processes and containing source data being audited. Depending on the type of enterprise system, this interaction can be either with its database or the application layer. If the direct access is too cumbersome, expensive or unfeasible to set up, then intermediated access is in order, typically through a business data warehouse. This approach is usually the only option in the case of highly heterogeneous loosely coupled legacy enterprise system landscapes.

The platform of automated audit software can be either common with the enterprise system or completely separate. Modern integrated enterprise information systems have a three-tier architecture consisting of the presentation, application and database layers. While the database layer contains all the enterprise data, all the business logic is coded and executed in the application layer.

If the common enterprise platform hosts the audit software, the latter is usually referred to as an embedded audit module (EAM). Enterprise software vendors are naturally positioned to provide such software, even though until very recently they provided only rudimentary capabilities (Debreceny et al., 2005). If the audit software is hosted on a separate platform, it is usually referred to as monitoring and control layer (MCL), and this type of audit software is typically provided by third party vendors and audit firms. MCL can query the enterprise system through the application tier using its application program interfaces (eg. business application programming interface in the case of SAP R/3). This approach is usually well-supported by system vendors and the APIs are well-documented. Analogously, an EAM can be implemented as a sub-module of the application (eg. coded in advanced business application programming in the case of SAP R/3).

MCL can query the enterprise database directly (using structured query language [SQL] through open database connectivity). While in principle this approach is more versatile than querying through the application tier since it is not constrained by the structure of the enterprise business objects, in reality the schemas of enterprise databases are so complex and enormous (they are highly normalised and contain upwards of 20,000 tables) that digging out anything which is a not a well-documented business object is close to impossible. Analogously, EAM can be implemented as a trigger (written in SQL) and stored in the database. However, using triggers in transactional databases will have an adverse effect on the database performance, in some cases slowing down the enterprise transaction processing system to a standstill.

While EAMs are usually permanently installed on the enterprise platform, one can also utilise an automated audit software architecture based on mobile code. In this architecture, the code implementing certain automated audit procedures is transported over the network to the enterprise platform on an as needed basis to execute its procedures there, and the code remains there for as long as needed. The primary reasons for executing audit procedures (whether in the form of EAMs or mobile agents) on the common enterprise platform follow.

First, they protect against network connectivity outages. Since remote code critically relies on the availability of connection to the enterprise system for access, it will be effectively disabled if the connectivity is lost (whether accidentally or intentionally). While modern networks are increasingly more reliable, sporadic connectivity outages still present a significant problem.

Second, the execution of resident code can be triggered by events in the enterprise system, while remote procedures can execute only after they retrieve information at a scheduled time. Event-triggered execution of audit procedures potentially reduces their latency to zero. Additionally, their latency is not affected by possible network congestion, which can significantly increase the latency of remote procedures.

Third, it is usually more efficient to process large volumes of enterprise data on site as compared with moving that data over the network for remote processing. The tradeoff here will depend on the processing capabilities of the enterprise system and on its load at the moment when processing is needed.

While the benefits described above seem to provide strong support for basing the architecture of automated audit on EAMs or mobile agents, there are extremely difficult problems associated with relying on the enterprise system for audit code execution.

On the one hand, there is legitimate concern on the part of the enterprise platform owner about the possibly adverse impact of the auditing code on the enterprise system itself. This impact can be caused by simply imposing a taxing computational load that can lead to the degradation of response time of routine enterprise transaction processing. To mitigate this issue, the enterprise platform can limit the amount of processing it provides to the auditing code, thus somewhat limiting its abilities. An even more serious concern on the part of enterprise system owners is the possible interference by the code (either accidental or malicious) in the workings of the enterprise system. This is the reason for protecting the enterprise platform against a (possibly malicious) EAM or mobile agent. Modern IT provides well-developed facilities for dealing with this problem in the form of a strictly controlled execution environment (known as a 'sand box' or a virtual machine) which enables the auditor to experiment with implementing Continuous Assurance on a replica of the entity's ERP system without actually affecting the operating system itself. Only when the Continuous Assurance system has been exhaustively validated will it be allowed to be implemented on the real ERP system.

The other side of the issues discussed above is the necessity to protect the EAM or mobile agent auditing code against possible manipulation by the enterprise platform. Given that the super-user privileges for the enterprise system are held by the enterprise IT personnel, the integrity of the audit code processing is always in question since it is the objective of this code to check on the enterprise system and its personnel.

The extreme difficulty (if not impossibility) of protecting the EAM or mobile agent auditing code from possible manipulation by the enterprise platform puts in question the integrity of results provided by this auditing code. This lack of trust in the audit results outweighs the benefits of the resident code described above, and serves as one of the critical reasons for basing automated auditing architecture on remote monitoring of enterprise systems.

### Formalisation of audit action plans for Continuous Control Monitoring

Having explored the strategy and system architecture of CCM, the steps in implementing the Continuous Assurance system can now be laid out. The key to implementing Continuous Assurance easily is to already have a clear and formally specified audit action plan that the CCM system attempts to automate. Otherwise, the change management problem becomes compounded as the audit team has to determine both how to carry out the audit in the first place, and then how to automate it. The steps are as follows:

1. Determine the best mode for the continuous monitoring of the chosen business process controls
2. Develop the system architecture for this task, whether by using a monitoring and control layer or some sort of embedded audit module
3. Determine the interaction and integration between the CCM software and the entity's IT system, such as its ERP system
4. Develop guidelines for the formalisation of the audit action plan into a computer executable format. In particular, determine which aspects of the audit action plan are automatable and which require re-engineering
5. Create processes for managing the alarms generated by the automated Continuous Assurance system and put in place the required set of audit trails
6. Formulate a change management plan to move the project from the pilot stage to industrial strength software.

Of all these steps, the most critical is determining which aspects of the audit action plan are automatable. As Alles et al. (2006) indicated, before audit procedures can be automated, they must first be formalised:

> Automation requires formalisation of audit procedures. Approved audit programs are not highly formalised and most often reflect the legacy of the traditional manual audit/interview approach to auditing. Different human auditors interpret the same program somewhat differently. Our pilot study analysis of the approved internal IT audit program shows that certain parts of the program are formalisable while other parts are not.

Indeed, since the audit programs are designed by human auditors for execution by human auditors who are presumed to largely share their own knowledge and judgment, audit procedures in these programs are not completely formal and as such, they leave open significant room for interpretation. This is extremely problematic for the audit automation process though, since, as confirmed by experience, even highly qualified human auditors will at times disagree about the precise interpretation of a particular procedure. Whether this results in uneven audit quality is an empirical issue, and one outside the scope of this paper. What is undeniable though is that the resulting lack of consistency is one of the key barriers towards audit automation.

While formalisation is a prerequisite of automation, formalising an audit program has wide ranging benefits not limited to automation. By eliminating possible inconsistencies in program interpretation, the scope, scale and exact nature of audit procedures will be assured. Consequently, it can lead to the improved quality of results, and increased confidence in the audit as a whole, as was previously found to be the case after limited scope audit automation projects. It should also decrease long-run audit costs due to the elimination of the ongoing labour intensive task of interpreting an ambiguous audit program. Additionally, it will drastically simplify and improve training of new auditors.

One argument is that an audit process should not be formalised because of the need to retain the flexibility to interpret it suitably in differing future circumstances. The counter argument to that is to better specify what such circumstances of concern are and to systematically develop formal procedures to deal with them when they arise, as opposed to risking audit failure by building in excessive flexibility. Indeed, in our experience, auditors would simply leave out entire parts of the required audit manual by stating something like 'Well, I know that this was only intended to apply to our operations in China and so it is not relevant at this site'. While it may be acceptable for a very senior and highly experienced lead auditor to make such a judgment, what happens when the audit is carried out by someone less qualified, as will inevitably occur at some point due to resource constraints? The purpose of audit automation is to have areas of flexibility planned for rather than inserted haphazardly.

Formalising an audit program is a difficult endeavour. It can be very laborious and costly because a formal procedure has to be very specific and detailed, and it has to describe the precise modifications to be used in various conditions. This problem is compounded by the difficulties that many humans (even properly educated and trained ones) experience with logical reasoning and formal thinking. To address this problem, the audit automation project can utilise the methodology of knowledge engineering, especially knowledge elicitation, developed originally for expert systems and further enhanced as those evolved into modern knowledge-based systems.

Since manual audit programs were not designed for automation, formalisable and judgmental procedures are often intermixed. To formalise and automate such a program, a redesign is usually required to separate out formalisable and automatable audit procedures from the others. Such a redesign amounts to re-engineering the audit program and should be done systematically (as opposed to ad-hoc) and based on the top-down analysis of enterprise risks to make sure that the redesigned procedures appropriately address all exposure areas.

The objective of re-engineering is not only to enable automation by separating out the formalised audit procedures but, more significantly, to maximise the proportion of automatable procedures in the audit program, and thus to reduce the reliance of audit procedures on informal judgmental techniques. An additional argument in favour of increasing the proportion of automated procedures in a re-engineered audit program is due to the fact that these automated procedures can be performed much more frequently than the eliminated manual methods they substitute.

However, not everything can be made completely formal. Certain complex judgments are not amenable to formalisation. Formalisation is particularly difficult (if not impossible at the current state of technology) whenever audit procedures have to deal with the analysis of complex modern business contracts. At the same time, the possibility of formalisation is often underestimated, and when an earnest effort is made to formalise audit procedures, the results often exceed the most optimistic expectations.

### Example of Continuous Control Monitoring implementation: Siemens IT internal audit

In 2005, Siemens had over 460,000 employees and total global revenues exceeding US$95 billion. In the United States Siemens employs some 70,000 people in divisions spread throughout the country, generating in excess of US$20 billion in sales. Siemens US IT IA group works to:

- Investigate the extent to which Continuous Assurance techniques can be applied to their existing audit process
- Help implement an automated Continuous Assurance system that frees up the IA workforce
- 'Continuous Assurance-enable' established manual audit procedures by re-engineering them.

Siemens is one of the most SAP-enabled entities in the world. A downside as far as IA is concerned is that with over 60 SAP installations spread throughout the United States alone, each site can be audited no more than once every two years. The SAP IT audit process has to cover all the major SAP modules and is highly labour intensive. Each audit takes nearly 70 person days and requires a large audit team to travel to the site at great expense, both financial and personal.

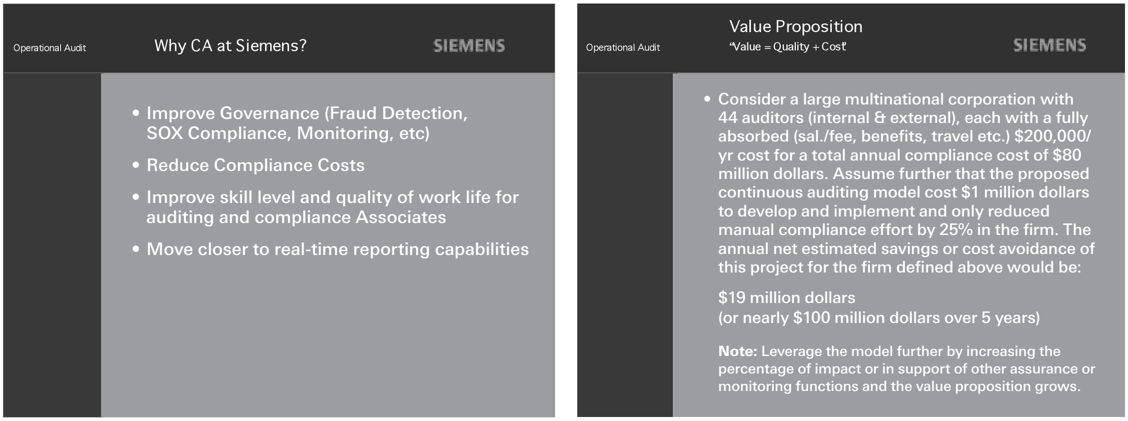
Apart from the obvious desire to increase the efficiency of this process, another key driver of interest in Continuous Assurance by Siemens was the anticipated demands of implementing Section 404 of the then recently passed Sarbanes Oxley Act. The challenge IT internal audit was presented with by senior management was to cope with the additional burden of 404 while not adding to headcount. Continuous Assurance was seen as a promising tool for at least reducing the workload of the audit team when carrying out the existing tasks, which could then be redeployed to Section 404 work. Ideally, the Continuous Assurance methodology would itself be considered 404 compliant, thus leveraging the value added.

Siemens' IA methodology for SAP facilities involves carrying out the procedures prescribed by hundreds of 'audit action sheets' by internal auditors at the entity site. Initially it was estimated that about 25% of the audit action sheets could be fully automated due to their deterministic nature. But this was always seen as a floor and not a ceiling as far as the scope of CCM was concerned because it presumed the use of a home-grown CCM software which was not industrial strength. More importantly, it was expected that far more audit action sheets would become automatable if they were rewritten on the presumption that they would be implemented by a computer rather than a human auditor; in other words, they would be formalised through re-engineering, removing ambiguity and missing instructions that would be filled by the judgment of the auditor.

In a more recent follow-up study of the Continuous Assurance initiative at Siemens based on its standard SAP platform and using Approva as an overlay control monitoring software (Teeter et al., 2008), it was concluded that about 68% of the actions could be automated to some extent. Considering that some of these automated steps would be performed in a daily monitoring mode (as opposed to the 18- to 24-month cycle of SAP audits) the strength of its evidence would be much stronger and conceivably could replace much of the residual 32% non-automated evidence.

As Siemens moves forward with extending CCM to all parts of their global operations, it is instructive to look back at the business case made by IT internal audit managers at the entity to senior management to justify the implementation of Continuous Assurance . Figure 10 is taken from a presentation prepared for internal and external audiences by Siemens' internal audit to explain why the project was undertaken. While the actual cost savings are difficult to determine, even achieving a fraction of these projections would give this project a very high return on investment.

**Figure 10: Continuous Assurance value propositions at Siemens Continuous Data Assurance**




## Continuous Data Auditing

### Strategies for CDA

Since its very inception, accounting has been shaped by the cost of obtaining and investigating data. Reports prepared and audited only once a year; sampling rather than examining the entire population; analysing at the trial balance level and using ratios: all these are outcomes of the fundamental constraint on the data accountants could gain access to and had the ability to analyse. What is common to all these responses to the constraint is the aggregation of data across time and space in order to reduce the data and analysis needs of the accountant. Moreover, aggregation at a level higher (often much higher) than the transactional level, has been a cost and capability-based limitation rather than the ideal process for assurance. Technology, auditor capabilities and the nature of auditee information have changed this constraint but accountants are still taught to follow these practices even though the underlying reason for them has not existed for some years now.

One area of accounting which has moved to exploit the capabilities of the new IT infrastructure of the entity is CDA. CDA uses powerful software to extract data from the entity's IT systems and then analyses it at the transactional level to provide more detailed assurance; on a more timely basis.

In developing a CDA system the assumption is that with access to transaction level data auditors will gain the ability to design expectation models for analytical procedures at the business process (BP) level, as opposed to the current practice of relying on ratio or trend analysis at a higher level of aggregation. Testing the content of an entity's data flow against such process level benchmarks focuses on examining both exceptional transactions and exceptional outcomes of expected transactions. With such benchmarks the Continuous Assurance software can continuously and automatically monitor company transactions, comparing their generic characteristics to observed/expected benchmarks, thus identifying anomalous situations. When significant discrepancies occur, alarms will be triggered and routed to the appropriate stakeholders.

An important innovation in the architecture of a CDA system is the utilisation of analytical monitoring as the second stage of data analysis, rather than the first one, as is the case in standard audit practice. Hence, the first component of the Continuous Assurance system utilises automatic transaction verification to filter out exceptions, which are transactions violating formal BP rules. The second component of the system creates and utilises benchmarks which model the fundamental business processes of an entity to serve as the expectation models for process-based analytical procedures.

Transaction verification will be found to be a necessity in most CDA implementations, especially in entities with disparate legacy IT systems rather than a single, integrated ERP system. When data is uploaded to the firm's data warehouse from the underlying legacy system the potential exists for errors to be introduced to the data set which have to be identified and removed before the data is suitable for automated testing, and that step is undertaken by the transaction verification component of a Continuous Assurance system. Potentially, in a very tightly integrated enterprise environment with automated BP controls, such data errors may be prevented by the client's ERP system.

Transaction verification is implemented by specifying data validity, consistency and referential integrity rules which are then used to filter the population of data. These rules are designed to detect and remove two types of data errors: first, data integrity violations which include, but are not limited to, invalid purchase quantities, receiving quantities and cheque numbers; and second, referential integrity violations which are largely caused by many unmatched records among different business processes. For example, a receiving transaction cannot be matched with any related ordering transaction. In other words, a payment was made for a non-existent purchase order.

While the verification of transactions relies on fairly straightforward business rules, entities implementing CDA often consider that just the exceptions identified at this stage are a major source of value added from the project. It is to be anticipated that as legacy systems are gradually superseded by the entity's ERP system with stronger automated controls, the transaction verification component of the Continuous Assurance system will be catching fewer and fewer problems. Conversely, the fact that any are caught at all indicates the value of this element of automated Continuous Assurance, since these transaction-level errors detected are only there because they have escaped detection by the standard manual practices being employed by the entity's internal auditors or control procedures.

The benchmarks for CDA can take a number of forms. The vendors of Continuous Assurance software all have proprietary tests of detail included in their packages, as well as (usually) the provision for the client to formulate their own tests. In addition, researchers are working on sophisticated statistical benchmarks called continuity equations (CEs) (Alles et al., 2010) that attempt to model the fundamental business processes of an entity to serve as the expectation models for process-based analytical procedures. Since those underlying business processes are probabilistic in nature, the CEs have to be data-driven statistical estimates. Once identified, CEs are applied to the transaction stream to detect statistical anomalies possibly indicating BP problems.

Recent research shows that for a given BP there is a variety of probabilistic models that differ in their statistical sophistication and ease of use. While these candidate CEs demonstrate differences in their predictive ability and anomaly detection performance, all models perform well and no single model performs better on all aspects. From this we can draw two important conclusions.

First, unlike in the traditional audit literature, the inability to clearly choose the ‘best’ across the candidate CE models is less important than the fact that all models yield efficient analytic procedure tests. Because of its automated and technology-driven nature, it is quite feasible and even desirable for the continuous data level audit system to use benchmarks based on multiple CE models instead of being forced to select only one, as would be necessary in a more manual system.

Second, the fact that all the CE models yield reasonably effective analytical procedures implies that it is the unconstrained data that matters the most. When auditors have access to transaction data, the richness of that disaggregate data makes error detection robust across a variety of expectations models. In other words, it is the nature of the data that serves as audit evidence which is the primary driver of audit effectiveness, with the selection of the specific analytical procedure a second order concern – not because the audit benchmark is not important, but because auditing at the process level makes errors stand out much more obviously in the data.

Thus the power of CDA comes from a variety of sources: the possibility of running automated tests closer to the event data; the ability of the auditor to access the population of data and to choose the level of aggregation for analytic procedures as opposed to being forced to accept constrained, highly aggregate and sample data; and the use of benchmarks for analytic procedure tests that model the business processes of the entity.

### Example of CDA implementation at a major bank

This section describes the CDA implementation at Itau Unibanco, a major full service bank in Brazil, which has had a very active Continuous Assurance initiative since 2000. The Continuous Assurance program is part of the bank’s Information Technology Internal Auditing and has over 10 people engaged in several roles. The CDA system currently monitors over five million customer accounts on a daily basis and sends out about six thousand alerts a month for detailed manual analysis by internal auditors.

The CDA program has as its motto achieving 'Productivity with Quality and Efficiency' and its mission statement includes:

- **Mission**
  - Automatically evaluate risks and controls on a continuous basis in order to identify exceptions and anomalies, trends and risk indicators
  - Issue opinions about controls, risk assessment for top management, audit committee and other interested parties. Contribute to corporate Governance of the Conglomerate
- **Scope**
  - All products, processes and services in the conglomerate that allow the systemic extraction and analysis of data generated by Information Technology
- **Approach**
  - Use of existing products, processes and services information analysis to improve timeliness and scope of the IA
  - Inform resulting non-compliance events, generating new products necessary to minimise risks and unforeseen events.

There are currently about 18 procedures that cover the following scope:

- **Detective:** Routines to detect potential errors
- **Deterrent:** Routines to inhibit inappropriate events and behaviours
- **Financial:** Routines to reduce or avoid financial losses
- **Compliance:** Routines to help compliance with existing laws, policies, norms and procedures.

The CDA routines were created from the knowledge and experience of senior internal auditors and bank examiners as to likely indicators of fraud, or situations where fraud could easily arise. For instance, in Brazil, federal tax payments are paid in over the counter to bank clerks. In some cases the clerk may pocket the cash and the client will not realise this until the tax authorities issue a writ for non-payment many months later. Not only is this a serious situation for the client, but also a liability for the bank that is responsible for paying both the overdue taxes and late fees, as well as incurring a reputational cost. The CDA system monitors federal tax payment cancellations at each bank branch and alerts auditors if there is an anomalous low amount in any given time period.

Another CDA test examines the balances of bank employees to detect overdrafts, an indicator of possible financial difficulties facing the employees and hence, of susceptibility to commit fraud. This particular test illustrates that the kinds of transactional testing in Continuous Assurance systems that are feasible in some jurisdictions are not possible, or may not even be legal, in others such as Australia, which have stronger privacy protections. But this example shows that having the ability to continuously test transactions allows very innovative and powerful tests to be devised, though doing so ultimately depends on the experience, skill and imagination of those implementing the Continuous Assurance application.

Figure 11 shows the scope of some of the CDA routines, while Figure 12 shows the benefits achieved through the automation of these tests:

**Figure 11: Sample CDA routines**

| | Approach | | | |
|---|---|---|---|---|
| **Daily Routines – Branches** | Detective | Deterrent | Financial | Compliance |
| 1. Check advances or Excess in account or overdrafts | X | X | X | X |
| 2. Returned cheques | X | X | X | |
| 3. Federal tax payment cancellations | X | X | X | |
| 4. TED (Electronic Funds Transfer) issue | X | X | X | X |

**Figure 12: Achieved benefits of sample CDA routines**

| | Achieved Benefits | | | | |
|---|---|---|---|---|---|
| **Daily Routines – Branches** | Time to detect | Inform to Business Area | Inform to Audit Staff | Before | Today |
| 1. Check advances or Excess in account or overdrafts | 1 day | 1 day | 1 day | 15 days | 1 day |
| 2. Returned cheques | 1 day | 1 day | 1 day | 30 days | 1 day |
| 3. Federal tax payment cancellations | 1 day | 1 day | 1 day | After Government Claims | 1 day |
| 4. TED (Electronic Funds Transfer) issue | 1 day | 1 day | 1 day | Never | 1 day |

Overall, the CDA program has enhanced the audit environment at the bank by increasing audit efficiency, detecting and reducing fraud incidence, and most important of all, creating a deterrence for future misbehaviour by bank employees who are aware that there is now continuous monitoring of transactions, combined with uncertainty about what the tests are looking at and how often they are carried out.

The tools used by the bank in creating its Continuous Assurance system include:

- Routines developed in FOCUS
- MS-Office (Access; Outlook; Word; Excel; Power Point; Visual Basic)
- Data Warehouse (SAS and BRIO)
- ACL
- Academic consultants.

The lessons from this CDA implementation are particularly pertinent in the light of the recent difficulties experienced by the banking sector worldwide. Continuous Assurance is closer to key bank controls, since it improves response time and risk management and increases IA involvement with the critical areas of the bank. In addition, it clearly improves audit effectiveness, efficiency and deterrence capability.

## Continuous Risk Monitoring and Assessment

### Strategies for CRMA

The focus so far in the development and implementation of Continuous Assurance has, understandably, been on creating initial Continuous Assurance systems. As audit automation matures, however, the focus will inevitably shift towards the question of how to keep the Continuous Assurance system relevant and efficient as the underlying audit environment changes. The audit planning process provides a template for how to make the Continuous Assurance system dynamic: by formally incorporating into it a risk assessment system that encompasses assessment of auditor perceptions of risks and allocation of audit resources to risky areas of the audit.

A recent PricewaterhouseCoopers study on the future audit of 2012 (Figure 13) found that while the primary focus of internal auditors was Continuous Assurance and monitoring, a close second was auditing of the entity’s enterprise risk management systems – a focus that surely has only increased after the experience of the ongoing credit crisis.[21] However, vital as auditing ERM is, it begs the question of how the entity’s auditors, both internal and external, will apply such risk management practices to the audit itself, to reflect changes in the business and audit environment that are more rapid than anything ever envisaged. The aim of CRMA is to give Continuous Assurance systems the robustness to deal with shocks to the audit environment and thereby to make the Continuous Assurance system dynamic rather than static.

21. http://www.pwc.com/us/en/internal-audit/publications/future-internal-auditing.html

**Figure 13: Internal audit responsibility**

Areas of greatest projected increases in internal audit's responsibility include:

| | |
|---|---|
| 1. Continuous auditing or monitoring | 95% |
| 2. Auditing the ERM process | 77% |
| 3. Auditing outsourced or off-shored operations | 75% |
| 4. Fraud detection | 66% |
| 5. Fraud risk assessments | 66% |
| 6. Auditing executive comp and disclosures | 65% |
| 7. Auditing operational efficiency/effectiveness | 64% |

Often entities focus their CCM and CDA resources on obvious but small-scale sources of risk (credit cards or employee fraud), while oblivious to the entity-destroying risks inherent in more glamorous parts of their operations. It is important to note that CRMA is not equal to continuous enterprise risk management, meaning that CRMA is distinct from, and has a different focus than, the auditing of the entity's ERM systems, whether or not that takes place continuously; clearly the former must be aligned with the latter.

As it stands, there is concern that audit risk planning is too episodic and constrained to remain relevant, as epitomised by the Bear Stearns collapse, which occurred only six weeks after its auditor issued a clean audit opinion. The stated justification for this was that while the audit opinion was valid, changes in that fortnight were beyond the scope of the audit. Whatever the merits of that argument, it only makes clear the need for a more dynamic, real-time risk management process for the Continuous Assurance audit system.

The good news is that just as continuous monitoring makes Continuous Assurance economically and politically feasible, the new emphasis on ERM will create the sensors and systems that will facilitate CRMA. But implementing CRMA will require that first the practice is formalised, for as we saw with CCM, only then can the degree to which it can be automated be meaningfully considered.

But can CRMA be automated? Does it need to be? A high degree of judgment will undoubtedly be called for when modifying Continuous Assurance systems. But key is to first have real-time information of changes in the business and audit environments, encompass new competitors and products, environmental and social impacts, new regulations and enforcement actions and so on. Again, as we saw with the credit crisis, it needs to be kept in mind that fundamental changes in an entity's risk profile can take place much faster than many expected. Even a Continuous Assurance system needs to adapt very rapidly while a manual audit system is bound to fail in the face of especially rapid changes in the risk environment. Thus, there is a need to think about different ways in which Continuous Assurance systems will have to change.

One useful analogy that can help illuminate the nature and scope of CRMA is to compare it to security software on a personal computer. In the latter setting there are different types of changes to the software possible, depending on changes in threat and technology. For example:

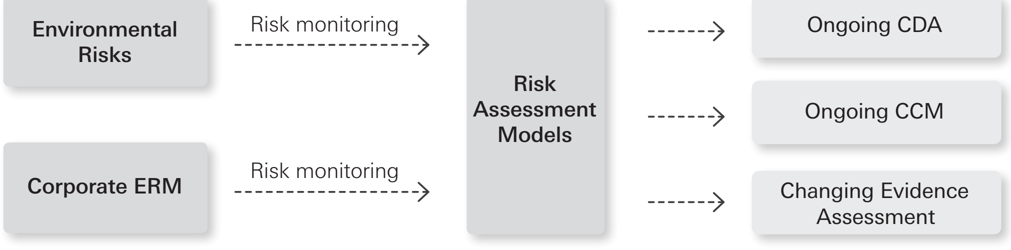
- Weekly updates of virus libraries
- New versions of the software
- New software altogether.

Similarly, Continuous Assurance systems will need continual updating as entity risks change, new CCM and CDA software and techniques are acquired or developed, and audit plans are changed. There is a clear requirement for auditors to create a formal model of CRMA and taxonomy of the stages and drivers of change in a Continuous Assurance system.

Analogous to CCM, risk assessment procedures have been an integral part of the traditional audit for many decades. The early audit planning process encompassed auditor perceptions of risks, and allocation of audit resources to areas of the audit. While there are many forms of guidance in the literature and statutes, this process is still vague and ad hoc. External audit firms have their own approaches and IA departments by and large use similar approaches, including:

- Divide the audit risk frame into manageable parts
- Understand the basic profile of risk of each of the parts
- Work on proposing joint risk profiles
- Create scenarios.

**Figure 14: CDA, CCM, and CRMA**



# Continuous Assurance software

While it is certainly possible to design, develop and implement a custom-made automated auditing system in-house, the expense and expertise requirements of such a project make it prohibitively expensive, if not outright unfeasible, for the vast majority of cases. It is therefore not surprising that there is an emerging industry of packaged software developed to support audit automation or at least some of its aspects.

A convenient way of categorising the current software offerings is in accordance with the breakdown of Continuous Assurance as consisting of CCM and CDA. While vendors are attempting to integrate in their packages as many features as possible, they still typically exhibit strength in one of the two components. The well-established (CAAT) vendors ACL and CaseWare IDEA have extended their products to position them as continuous monitoring solutions.[22] ACL, in particular, has invested significant efforts into providing what they call 'continuous controls monitoring' solutions.[23] Despite the name, in the terminology of this paper these solutions should be categorised as CDA since the substance of their tests is transaction verification and analysis focused on making inference about the functioning of controls (as opposed to direct tests of controls through monitoring of their settings). A relative newcomer to this area is Oversight Systems which also focuses on CDA and puts emphasis on providing hosted monitoring solutions.[24]

The common feature of CDA offerings is their utilisation of internal common data models to which enterprise data is mapped by the extract, transfer and load (ETL) subroutines. This system architecture allows for a relatively easy accommodation of many different enterprise systems (or even home-grown solutions) through the development of additional ETL modules to accommodate additional systems. The test libraries and the main processing sub-routines usually do not have to be changed.

While the common data model architecture is utilised successfully in CDA solutions, the systems that implement CCM directly do not use it. The reason is the great diversity of business process automation in enterprise systems. The very significant differences in the types of business objects, process configurations and controls seem to make the common model too complex to be cost-effectively designed and implemented in CCM solutions. This is why these solutions develop special CCM sub-routines targeted at specific enterprise systems. Not surprisingly, the two pioneering offerings in this field – Approva and VIRSA – were targeted at SAP R/3 (mySAP ECC). Approva has since extended its offerings to target other ERP systems, most notably Oracle E-Business Suite. Such extensions are quite laborious since they require the re-implementation of the CCM test libraries and processing for each new enterprise system. On the other hand, VIRSA has since been acquired by SAP itself, and has become the core of SAP's GRC offering. To keep up in its competition with SAP, Oracle acquired in the latter half of 2007 a major GRC and CCM vendor, LogicalApps, whose offerings were naturally targeted at the Oracle E-Business Suite.

The area of GRC is still maturing and has a very large number of vendors, many of them small, though some major vendors such as IBM, with its Workplace for Business Controls and Reporting do have a presence. Among other notable offerings in this market are Paisley Enterprise GRC, OpenPages, AXENTIS Enterprise, BWise, and Protiviti Governance Portal. Many of the solutions in this market are not much more than customised document management systems with GRC-specific templates, though there is a pronounced trend to enhance these offerings with automatic control testing and monitoring functionality that would bring these solutions closer to the fully developed CCM and/or CDA systems.

22. CaseWare IDEA is distributed in Australia and New Zealand through Audit and Fraud Software Pty Limited (see www.auditsoft.com.au) and Task Technology Pty Ltd (see http://www.task.com.au)
23. ACL services in Australia and New Zealand are provided through the partner firm Satori Group (see www.satoriassurance.com.au)
24. http://www.oversightsystems.com

# Practical steps for implementing Continuous Assurance

The audit profession is inherently conservative given that its entire benefit comes from the auditor's credible claims of professional independence, objectivity and reliability. As a consequence, auditing processes, even more so than other business processes, have a tremendous amount of inertia. It follows that any Continuous Assurance project, as with any major change initiative in such circumstances, will have numerous barriers to change and to overcome. As the large change management literature indicates, for a Continuous Assurance project to even get launched, let alone succeed, a senior executive has to champion the project, both at an IA level, and in their reporting level in top management or the audit committee. The fact that executives' positions with titles such as 'Associate Director, Continuous Assurance' are being created at entities indicates that such champions are becoming institutionalised as Continuous Assurance becomes mainstream.

The first critical task of audit automation champions will be to identify and engage project stakeholders. In addition to internal auditors, these stakeholders will include business process owners and IT personnel. Again, the use of such multifunctional teams is a standard recommendation of change management theory, but in the case of audit automation the problem is compounded by the need of internal auditors to be aware of the needs of the external auditor, while also balancing the demands of the IT process owners and line managers. The composition of audit automation teams must reflect the multifaceted nature of the task at hand.

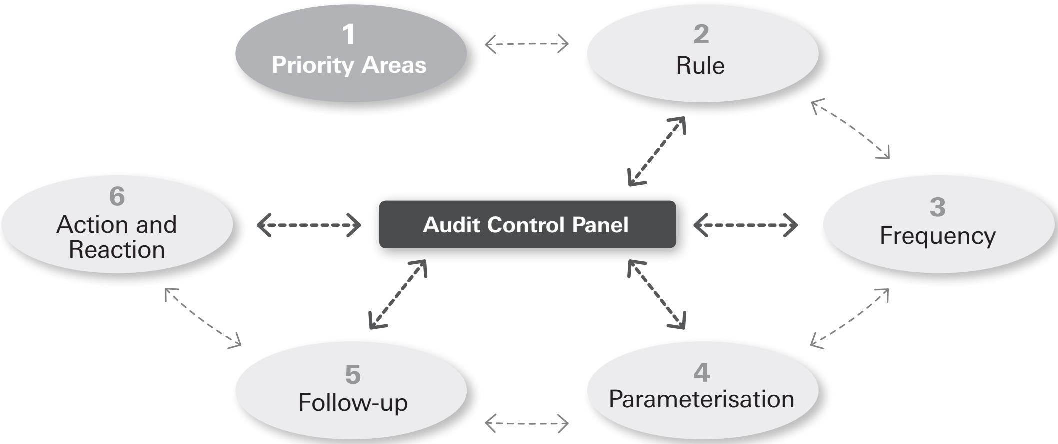
The reason for having a high powered team with a senior level champion is obvious when considering the complexity inherent in automating audit processes initially designed to be done largely manually. In our experience, even very experienced auditors differ in how such procedures are carried out in practice, which translates into differences in how to transform the process into an automated one, what the objective of the process should be and how much weight should be placed on a particular process or on a possible compensating control.

Once a champion has been found and the project receives the go-ahead with assured senior management support, actual implementation can begin. Implementing a Continuous Assurance system, be it CCM or CDA, consists of six procedural steps[25]:

1. Establishing priority areas
2. Identifying monitoring and Continuous Assurance rules
3. Determining the process's frequency
4. Configuring Continuous Assurance parameters
5. Following up
6. Communicating results.

25. Adapted from Vasarhelyi et al., 2008

**Figure 15: Steps in the Continuous Assurance implementation**[26]




## 1. Establishing priority areas

The activity of choosing which organisational areas to audit should be integrated as part of the annual IA plan and the company's risk management program. Many IA departments also integrate and coordinate with other compliance plans and activities, if applicable. (The remaining steps below are applicable to all of the priority areas and processes being monitored as part of the Continuous Assurance continuous audit program.)

Typically, while deciding priority areas to continuously audit, internal auditors and managers should:

- Identify the critical business processes that need to be audited by breaking down and rating risk areas
- Understand the availability of Continuous Assurance data for those risk areas.
- Evaluate the costs and benefits of implementing a Continuous Assurance process for a particular risk area
- Consider the corporate ramifications of continuously auditing the particular area or function
- Choose early applications to audit where rapid demonstration of results might be of great value to the organisation. Long extended efforts tend to decrease support for Continuous Assurance
- Once a demonstration project is successfully completed, negotiate with different auditees and IA areas, if needed, so that a longer-term plan is implemented.

When performing the actions listed above, auditors need to consider the key objectives from each audit procedure. Objectives can be classified as one of four types: detective, deterrent (also known as preventive), financial and compliance. A particular audit priority area may satisfy any one of these four objectives. For instance, it is not uncommon for an audit procedure to be put in place for preventive purposes to be reconfigured as a detective control once the audited activity's incidence of compliance failure decreases.

26. From Vasarhelyi et al., 2008

## 2. Monitoring and Continuous Assurance rules

This second step consists of determining the rules or analytics that will guide the Continuous Assurance activity, which need to be programmed, repeated frequently, and reconfigured when needed. For example, banks can monitor all chequing accounts nightly by extracting files that meet the criterion of having a debt balance that is 20% larger than the loan threshold and in which the balance is more than $1000.

In addition, monitoring and audit rules must take into consideration legal and environmental issues, as well as the objectives of the particular process. For instance, how quickly a management response is provided once an activity is flagged may depend on the speed of the clearance process (ie. the environment) while the activity's overall monitoring approach may depend on the enforceability of legal actions and existing compliance requirements.

## 3. Determining the process frequency

Although the process is called 'Continuous Assurance', the word 'continuous' is open to interpretation. Auditors need to consider the natural rhythm of the process being audited, including the timing of computer and business processes as well as the timing and availability of auditors trained or with experience in Continuous Assurance For instance, although increased testing frequency has substantial benefits, extracting, processing and following up on testing results might increase the costs of the Continuous Assurance activity. Therefore, the cost-benefit ratio of continuously auditing a particular area must be considered prior to its monitoring.

Furthermore, other tools used by the manager of the Continuous Assurance function include an audit control panel in which frequency and parameter variations can be activated. Hence, the nature of other Continuous Assurance objectives, such as deterrence or prevention, may determine their frequency and variation.

## 4. Configuring Continuous Assurance parameters

Rules used in each audit area need to be configured before the continuous audit procedure (CAP) is implemented. In addition, the frequency of each parameter might need to be changed after its initial set-up based on charges stemming from the activity being audited. Hence, rules, initial parameters, and the activity's frequency – also a special type of parameter – should be defined before the CAP begins and is reconfigured based on the activity's monitoring results.

When defining a CAP, auditors should consider the cost benefits of error detection and audit and management follow-up activities. The choice of a threshold of filtering implies a trade-off between false positives and false negatives, and consequently increases or decreases the follow-up effort. If the threshold is low it creates a larger number of false positives (items identified as problematic that after examination were found to be correct); however, if the threshold is high it allows more items that actually were incorrect not to be selected (false negatives). Because follow-up costs would go up as the number of false positives increases and the presence of false negatives may lead to high operational costs for the organisation, internal auditors should regularly re-evaluate if error detection and follow-up activities need to be continued, reconfigured, temporarily halted or used on an ad hoc basis.

## 5. Following up

Another type of parameter relates to the treatment of alarms and detected errors. Questions such as who will receive the alarm (eg. line managers, internal auditors, or both – usually the alarm is sent to the process manager, the manager's immediate supervisor or the auditor in charge of that CAP) and when the follow-up activity must be completed, need to be addressed when establishing the Continuous Assurance process.

Additional follow-up procedures that should be performed as part of the Continuous Assurance activity include reconciling the alarm prior to following up by looking at alternate sources of data and waiting for similar alarms to occur before following up or performing established escalation guidelines. For instance, the person receiving the alarm might wait to follow up on the issue if the alarm is purely educational (ie. the alarm verifies compliance but has no adverse economic implications), there are no resources available for evaluation or the area identified is a low benefit area that is mainly targeted for deterrence.

## 6. Communicating results

The final item to be considered is how to communicate with auditees. When informing auditees of Continuous Assurance activity results, it is important for the exchange to be independent and consistent. For instance, if multiple system alarms are issued and distributed to several auditees, it is crucial that steps 1 to 5 take place prior to the communication exchange and that detailed guidelines for individual factor considerations exist. In addition, the development and implementation of communication guidelines and follow-up procedures must consider the risk of collusion. Much of the work on fraud indicates that the majority of fraud is collusive and can be performed by an internal or external party. For example, in the case of dormant accounts, both the clerk who moves the money and the manager who receives the follow-up money may be in collusion since the manager's key may have to be used for certain transactions.

# Assurance in a changing world

The preceding sections focused on the progressive evolution towards the Now Economy and the body of research that is progressively showing ways to automate and accelerate the evolution toward a more frequent, more automatic and more close-to-the-event assurance process.

This section is even more speculative as it attempts to imagine a context of structural changes necessary to facilitate or allow the above changes. The context includes changes on: standards; standard setting; the structure of the audit professions; and the skills, behavioural attributes and competencies of the auditors.

A set of studies in the literature tries to anticipate the evolution of the assurance profession. Many of these use the Delphi method to anticipate, based on converging expert opinions, the future. The method utilises a set of questions provided to a panel of experts and shares their answers to obtain convergence. Delphi (Baldwin-Morgan [1993]; Brancheau et al. [2001]; Rowe & Wright [1999]), is suited to assessing the likelihood of future events and trends, and has been suggested as an appropriate technological forecasting tool for predicting the effect of technological changes on auditing.

Delphi is deemed to be particularly useful when understanding the problem benefits from subjective judgements on a collective basis and the rationales given by the panellists for their predictions providing insight into the reasons for the predictions and their implications. Parente et al. (1984) claim that these consensus forecasts are more accurate than 95% of individual forecasts, and iteration reveals more reflective opinions than single surveys. Mock et al. (1988), in a study for the Institute of Internal Auditors, also used the Delphi technique. Many of the considerations introduced in the ensuing discussion are based on Vasarhelyi & Lombardi (2010) who performed a 'modified' Delphi which aimed at creating a wider set of questions and inserting some flexibility into the methodology.

## Changing external reporting and external auditing standards

Earlier we discussed the difficulties with traditional measurement and the assurance model. Here we present a few thoughts with illustrative tools to further this discussion. The basic problems around the existing standards and standard setting process are multiple. In general the standard setting process tends to be slow and rules stay in place much beyond their usefulness. This said, political and economic frames change but some basic rules that served society well are changed causing serious problems for the economy. For example, in the United States many argue that the rescission of the Glass Steagall Act (1933)[27, 28] was one of the accelerating factors in the subprime crisis creating a perverse motivation scheme for bank executives and placing banks in areas where they had little or no competence.

Two other stalwart legislations, the SEC's FD rule (2000)[29] and the Sarbanes Oxley Act of 2002 can cause major difficulties, or substantive social costs in the emerging Now Economy:

- The fair disclosure (FD) ruling aims at curbing selective information disclosure by management. However, in the progressive migration from paper to electronic reporting, whatever direction it may take, the essence of reporting will be not 'directed disclosure' but the provisioning of access and

27. http://topics.nytimes.com/topics/reference/timestopics/subjects/g/glass_steagall_act_1933/index.html
28. http://seekingalpha.com/article/144581-should-we-reinstate-glass-steagall
29. http://www.sec.gov/answers/regfd.htm

availability to large data stores and the ensuing discussion of competitive impairment. In essence 'selective disclosure' will be provisioned by necessity to the multiple stakeholders of business of information access (see the Galileo monograph database Figure 25).

- Sarbanes Oxley aims at auditor independence and forbids auditors to provide consulting services to their clients. One clear assurance product that could emerge, in addition to the traditional audit, is some form of continuous (evergreen) opinion issued by auditors where they provide assurance that filters are in place and certain types of transactions will be monitored; if alarms arise auditors will be immediately aware and will take appropriate action.

Figure 16 and Figure 17 present symbolic auditor opinions aimed at rethinking what auditors do and what they assert. These are probably in violation of Sarbanes Oxley and likely need clarification concerning FD. In essence they:

- Assume a yearly opinion
- Assume auditors also being independent monitors of their auditees
- Assume some commonality and disclosure of agreements concerning monitoring analytics
- Assume the possibility of 'paid reports or assurances' where stakeholders would pay extra for additional or different assurance
- Assume the co-existence of an 'evergreen opinion' with the more traditional opinion
- Assume parallel monitoring efforts by management and assurance (internal and external).

**Figure 16: An assurance opinion in a Continuous Assurance environment**

## Pseudo report 1

We have examined the reliability and financial reports of ABC corporation and have been engaged on a continuous assurance engagement for the fiscal year of XXXX. We will monitor the organisation's operations and strategic accomplishments using a wide set of analytics as described in http://www.ca.com/analytics and other analytics we deem appropriate and will report on an audit by exception basis when more than XX% variance is found in operational and strategic standards or when we deem it appropriate. This exception report will be issued to all customers registered (*paying*) at http://www.ca.com/analytics/customers.

These few assumptions depart substantively from the current model that has evolved for more than a century. It is difficult to imagine current entities and standard setters evolving easily to such a different schema. In essence, however, the schema is analogous but substantively expands the role of assurance; in essence it is also clear that the lack of observability in computer-based economic activity requires a dimensionally different assurance effort.

**Figure 17: Alternative assurance opinion with Continuous Assurance implying other assurance services**

## Pseudo report 2

We have been engaged on a continuous assurance engagement for the fiscal year of XXXX for the purpose of covenant monitoring. We will monitor the organisation's covenants as described in our agreement with bank XYZ using a specified set of covenant figures and wide set of analytics as described in http://www.ca.com/analytics and other analytics we deem appropriate and will report on an audit by exception basis when more covenants are violated by more than XX% for a day or when we deem it appropriate. This exception report will be issued to bank XYZ immediately when the variance day is completed and to all customers registered (*paying*) at http://www.ca.com/analytics/customers.

In addition to expanding the role of assurance to the above examples and to a much wider scope, it is important to expand the knowledge set and structure of the accounting profession.

## Changing the structure of the external audit profession

Vasarhelyi and Romero (2009d) examined four engagements in external audit firms and Vasarhelyi and Kuenkaikaew (2009c) surveyed nine major leading IA organisations for their adoption and use of technology. Furthermore, Vasarhelyi and Lombardi (2009e) used a modified Delphi method to make some predictions concerning the future of audit [30]. These studies taken together suggest a series of communalities/trends/patterns/problems that together may point towards the need for structural changes in the assurance function.

First, internal audit organisations are taking the leadership on complex audits and external audit organisations are placing a much increased reliance on these audits. Second, industrial and consumer goods organisations present a substantively lower risk profile than financial entities, creating a very different set of emphases in internal and external audit procedures. Third, most large organisations,

30. http://www.thefutureofaudit.com

in particular those that often have limited interaction and synergy, have several audits. IA, fraud, compliance, Basel II, quality assurance and other organisations have similar functions, very different infrastructures, very different levels of technology adoption, and often do not share findings and process understanding. Rationalisation of audit-like functions, closer coordination and technology integration with external audit, and common platforms for audit/compliance, etc. support would create efficiencies and substantial improvement in the handling of risk.

Many IA organisations have extensive rotation programs. While these programs are greatly beneficial to staff training and individual growth, they come at a serious cost of professionalism and quality of IA programs. These trade-offs are not often at the forefront of the IA management's thinking. In addition, IA organisations often have several levels of leaders who are not audit professionals but who bring in a set of specific concerns about the competence and quality of the audits. If the pattern of increased reliance on monitoring and audit of complex systems by IA continues, this may become a serious concern. The adoption of technology in external audit organisations has been heterogeneous across entities, audits and geography. While audit standards delve into minutiae of procedure it is pretty much up to the entity and the cooperating client as to the depth of audit, the technology to be adopted, the extent of sampling, etc. The more automated audit will require having these minutiae more formalised and attempt to clearly specify the context and nature of the related audit judgement. The comprehension of client systems, audit firm technology, risks of complex client systems has also become a major issue.

But the problem that offers the greatest concern for external audit engagements is the inability to acquire independent data. All the interviewees (Vasarhelyi & Romero, 2009d) report that when data is required for a process, the entity produces a script to retrieve the data, but it is the client who procures it and submits a file to the entity. Upon receiving the file, auditors perform checks for completeness of the data, mainly comparing trial balances, and control that the code was not modified, which gives them the assurance that they are working with the correct data. However, it would be clearly preferable to have immediate and direct access to the data. So, the adoption of electronic work papers to reduce the interchange of papers and files is a clearly desirable objective. Both external and internal auditors recognise this as a desirable route but of heterogeneous path. Finally, external auditors, of different entities, expect that when the subprime related crisis is over, companies will adopt Continuous Assurance/continuous monitoring, and that their entity will be able to offer additional services related to analysis of data or controls that they associate with the use of technology in auditing.

Based on the above considerations a few key changes regarding the structure of the external audit profession may happen or be desirable. Owing to the fact that auditor systems are progressively more complex and less human observable (eg. SAP integrated with legacy systems and middleware) the assurance process will evolve away from the traditional audit to an evidence-based continuous systems monitoring, and opinions that cover: (1) assurance that monitoring of relevant ('material') events are being supervised by an independent third party; (2) evergreen opinion on the fairness of the financial statement; and (3) a grid measuring and explaining reliance and reliability of third-party processes outsourced. While the types of assurance issued by the external auditor need to be increased as described above, the complexities of understanding system structure and its monitoring requires substantive local specialisation and consequently much of the monitoring and audit work will be performed by internal auditors and relied upon by the external audit firm.

The current model of the client entity paying directly variable fees (often hour-based) to the external auditor will evolve towards some form of fixed fee size and complexity-based arrangement. This arrangement may entail mandatory auditor rotation and outside entity choice of auditor. In general the size of the audit and other assurance fees will increase in relation to the current compensation owing to the complexity and scope of the future audit. On the other hand, some form of audit firm risk reduction process will evolve as it is highly undesirable to have audit firms fail and have very limited sources of auditor services. The US public would be better served with a larger number of entities that can comfortably audit large multinationals. Most likely, a trade-off between tort reform to reduce auditor liability and some sort of supranational audit regulator/auditor choice will occur.

Internally companies will rationalise audit-like organisations by streamlining organisation charts, providing common infrastructures, keeping experienced IA management with audit training, and hiring specialised support as third party servicers for narrow complex tasks. The provisioning of this specialised support will probably come from consulting and/or audit support organisations, and depending on how the societal trade-offs evolve (corporate rights vs public rights) some of Sarbanes Oxley 404 independence requirements may be relaxed. Finally, audit firms have progressively moved to outsource labour intensive processes out of the United States to (mainly) India. While the scope and nature of outsourced work is unclear, it is obvious that this will be part of the emerging auditing frame of work. This raises an issue of great importance – quality control and monitoring of outsourced work.

## Education

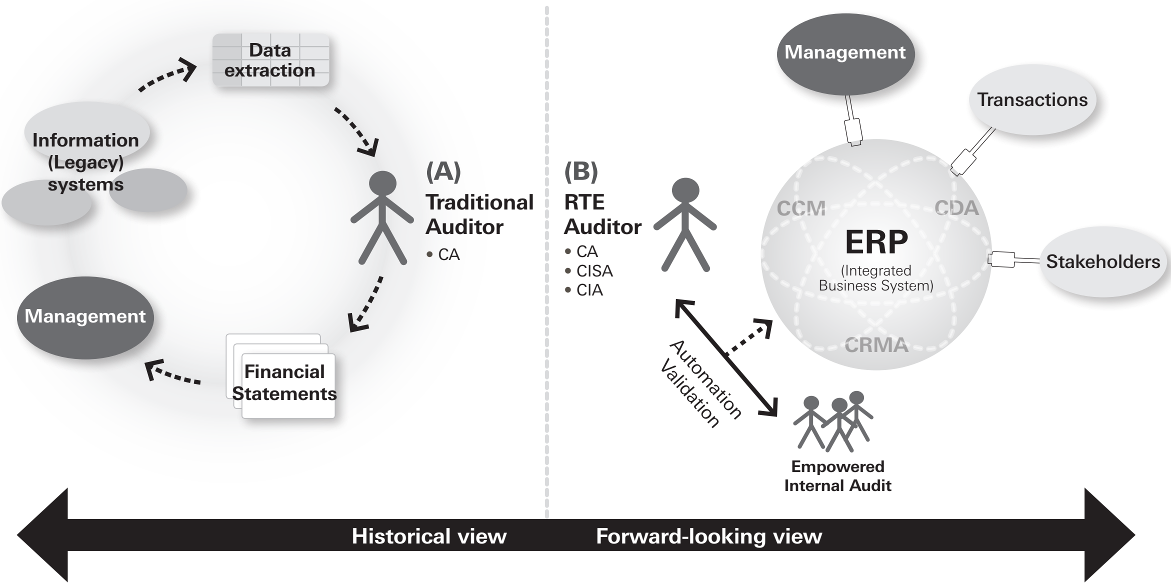
Vasarhelyi et al. (2009e) examine the issues concerning audit education and the Now Economy. They identify the motivation, skills (attitudes, behaviour and objective knowledge), and the necessary instructional artefacts.

### Skills for the 21st century auditor

To be better prepared to face the demands of the real-time economy, entrants into the audit profession will need to possess skills that will help them understand not only the technology that will be required while conducting their audits, but also the dynamics that involve working in a team and integrating work between the audit firm and the client. These tools will help them work effectively with clients and maximise this relationship.

Audit automation challenges the way that auditors have traditionally done their jobs. This is illustrated in Figure 18. The **traditional auditor (A)** focuses on the past. Armed with an accounting (CA, CPS, etc.) credential, (A) works to extract data from legacy and heterogeneous information systems, becomes a master of the spreadsheet and basic analytical tools, and certifies the financial statement prepared by management. Much of what (A) does is solitary; the numbers must fit within the bounds of IFRS or US GAAP, and the constant fear of litigation keeps (A) risk averse and resistant to change. All of the work (A) performs occurs several months after the occurrence of relevant events. Any material errors or fraud that have occurred in that period have had plenty of time to wreak havoc and create additional work (with the bonus of additional fees) for (As) client.

**Figure 18: The traditional vs the Now Economy auditor**[31]




| | | |
|---|---|---|
| Excel-focused, litigation fear, rigidity | **Attitude** | Proactive ethics, relevant tech, open to change, adaptability |
| Limited interface and team work, US GAAP | **Behaviour** | Client interfacing, remote team work, self-teach |
| Basic technology skills | **Technology** | IT audit tools, statistics/data analytics, ERPs, CCM/CRMA/CDA |

The **Now Economy auditor (B)**, on the other hand, is ready to work with today's information. Certainly past data can help model the future, but the forward-looking view allows (B) to react to problems as they occur and work with management to solve them. (B) may also possess a Chartered Accountant/Continuous Assurance certification, but also chooses to become a Certified Information Systems Auditor (CISA), Certified Internal Auditor, Certified Fraud Examiner or any combination of these and other certifications. (B) realises that events occur in real-time, so (B) is proactive in treating ethical dilemmas, open to change, and always searching for tools that will help (Bs) client remain a going concern. Working alongside an empowered IA team, (B) coordinates, delegates and evaluates the integrated ERP systems that ingest millions of transactions, ensure management knows that controls are working, and provides stakeholders with an accurate picture of (Bs) client's standing. In order to conceptualise, implement and operate these systems, the Now Economy auditor understands the technology and statistics that provide a continuous audit and assurance of the system. Finally, (B) has the ability to work remotely and to find solutions to problems if unsure.

31. From Vasarhelyi et al., *op cit* p.13.

The Now Economy auditor's skill set is the key to success. These skills include the attitudes, behaviour and objective knowledge resources that differentiate (B) from the traditional auditor. They are discussed further in this section.

## Attitudes

The following views and motivations will be the driving force behind the dynamic transition from traditional auditing to a Now Economy paradigm.

### Ethics

While the literature on ethics is extensive, and as one of the most noteworthy recent evolutionary changes in accounting education has been the progressive incorporation of ethical considerations, the Now Economy brings in a wide set of new considerations relative to the rapidity of information provisioning, the automation of entire subprocesses, the global nature of business activities, and the emergence of faceless technological threats (viruses, denial of service attacks, etc.). For a well-documented list of resources on ethics in accounting, see the work of Thomas (2004). One key attitude for the future is being proactive about ethical issues: identifying ethical issues in advance in relation to themselves, to the client, and to the environment, and taking action in advance of events as opposed to detecting ethical problems ex-post facto.

### Technology adoption

The acceleration of the introduction of technology into business requires auditors to have an attitude of constant learning towards technologies and their new features. Assisting this attitudinal posture is the rapid introduction of new devices (eg. mobile phones) in daily life and the need to learn their features and adapt life to their capabilities.

### Openness towards change

The popular perception is accountants are resistant to change, rigid and backward looking. But accountants and auditors must be receptive to changes in technology, social trends, business processes, accounting standards and accountant behaviour. Those who are not may survive by performing mundane tasks, but in order to prosper they will need to embrace change.

### Adaptability

Adaptability relates not only to openness to societal change but also to the ability to rapidly change behaviour in this dynamic environment. It can be reflected on the auditors' ability to navigate auditees' rapidly changing technology and understand its capabilities and needs. The same adaptability is required in relation to progressively dynamic standards, business activities and, most of all, changes in risk profile.

### Behaviour

Some key changes in underlying behaviour will go a long way to preparing students for the real-time economy. The primary focus should be on helping students foster an attitude of life-long learning. They should understand what the real-time economy is and how it will affect their function as an auditor.

### Client interaction

This relates to the interface with the client in the Now Economy, which will typically involve substantially more remote interaction, data transfer and remote presence with less face-to-face interaction. The auditor will have to learn to balance the needs of audit deterrence with the decreasing auditor presence in the facility, more frequent audit interface, increased 'audit by exception' approach instead of programmed dates, and pre-established audit plans.

As remote audits become more feasible, future auditors will also need to know how to deal with clients and team members when they are separated geographically.

### Working with a team

As is the case in many other business processes, virtual teams will turn from the exception to the norm aiming to explore narrow domain and scarce competencies (eg. extensive experience with Approva, an IT-audit SOD-oriented software), diverse geographic locations, not coordinated and often not predictable (due to alarms/alerts) audit actions and plans. The remote audit associated with real-time analytics and alarms will change the face of auditing.

### Dealing with standard setting entities and regulators

Inevitably, there will be an increased set of regulations and a much more frequent need to interface with government entities and standard setters. These will also eventually adopt a wide range of knowledge management and information provisioning tools. For example, the SEC has been provisioning an XBRL instance reader during the deployment of the rule in the United States.

### Managing the engagement

The virtual team, the virtual presence over a nearly continuous time set, and the existence of a large gamut of indigenous client technological tools all pose great audit engagement challenges. Furthermore, most audit entities will have engagement management tools that are expensive and complex and often not tailored to an individual auditor, company or client.

### Learning technology on the job

The auditor, owing to the large set of potential indigenous tools, will have to be constantly on a technology learning role. This could also force longer client tenures and could work against auditor rotation programs.

Students need to spend less time memorising the minutiae of standards and procedures and focus more on understanding what they mean. They should know how and where to locate auditing and accounting standards on the internet and through various other sources and how to extract information to formulate integrative knowledge. At this level the student/auditor has enough basic accounting/ auditing understanding/facts to knowledgeably search for information, but he is not overloaded with an over abundance of detail. Integrative knowledge uses basic and acquired information to formulate an integration of, for instance, accounting rules, audit evidence and relevant business facts to base judgement.

### Objective knowledge – accounting and technology competence

Understanding the underlying technology, or at least its functionality, is an additional necessary skill for future auditors. While they need not be IT professionals, students should know more than basic computer skills. They need to conceptually know what the 'black box' is doing to produce the evidence they are evaluating. This will require a more comprehensive analytics and statistics application. At a minimum, they should know what types of analytics are used. For example, many CCM procedures are rule-based. Understanding how monitoring of KPI provides insight into functioning controls is a critical skill.

Future auditors should possess the ability to keep up-to-date with the latest tools, and they need to be able to locate sources of information, such as professional association publications. Whether in auditing or accounting information system (AIS) courses, IT audit tools should be identified and implemented into the course instruction, identifying meta-controls, etc.

### Basic understanding of technology

Corporate IT encompasses a much wider set than pure PC and telephone/PDA manipulation competencies although these are highly related to attitudes vis-à-vis technology adoption and the ability to change. It basically involves a wide set of principles in hardware, software and business applications.

### IT audit

This includes a set of audit automation tools and more advanced software aimed at data extraction, manipulation, control evaluation, sampling, exception reporting, separation of duties, fraud detection, etc.

### Other audit-related tools

This encompasses software tools that are generic in nature and which are used in the audit. For example, software such as ACL and IDEA (IT audit packages) encompass sophisticated data extraction and statistical facilities. Auditors will often find the need to extract data from an ERP (eg. some knowledge of SAP and BAAP), use, for example, a statistical analysis system (SAS) to analyse the data and provide the output on a website where audit supporting documents are placed.

### Accounting

In general, accounting education in the Now Economy will de-emphasise factual details and emphasise principles and concepts that can be used to retrieve details in databases and knowledge bases that were not available in previous decades.

### Certifications

Rather than focusing entirely on professional qualifications such as the Chartered Accountant qualification, students should be shown alternatives and complementary certifications that may more accurately match their interests. Exams provided by these other associations require a similar level of comprehension but may be more relevant. Furthermore, if some of the considerations in this paper are taken to heart the Continuous Assurance/Chartered Accountant certificate will expand in scope to include IA, fraud examination and information audit certificates.

## The role of universities in preparing the Now Economy auditor

Given the rise of Continuous Assurance and the Now Economy, universities have to fundamentally rethink the audit education process. As with all re-engineering projects, the question they have to ask is whether, if they began teaching auditing for the first time today, in the 21st century, would they use the same approach and cover the same topics as the courses they currently have? It is hard to believe that they would answer this question in the affirmative, and while changing coursework is a time consuming affair, it is essential that universities at least begin the process of thinking about the skills, knowledge and attitudes that their graduates will need to thrive in the Now Economy.

Universities will need to change the content of educational offerings and learning methodologies to satisfy learners' forward-looking information educational needs. In general, accounting students are sensitive to their credentialing needs and expect to acquire the necessary knowledge during their university years without needing to take external courses to pass certification exams. Unfortunately, the certification exam delves into minutiae of the standards that are of small value in this age of accessible databases, search engines and archival knowledge. In general there is a basic conflict between the backward-looking nature of accounting standards and education and the forward-looking needs of the accountants of the 21st century.

Knowledge is much deeper and wider than it used to be, it takes longer to acquire and encompasses a much wider scope of quantitative and judgemental structures. While much of the archival knowledge (eg. codification of lease accounting) can be obtained over the internet, the utilisation of these queries, their efficiency and their availability has to be not only learned but kept current. It requires substantive actualisation and a dynamic learning attitude. In addition, learning of more quantitative techniques and their utilisation cannot be replaced by databases, as good as these may be. The learner must, to a certain degree, understand the analytic technology to be able to formulate the problem and choose key variables (eg. ratios, variables in a regression, optimisation function). Furthermore, the learner must be able to interpret the obtained results for the good of the client. And while Chartered Accountants are performing useful functions for their employer they are actually forgetting a large amount of basic knowledge. During these activities they are focusing on current work where they are acquiring a more in-depth and practical knowledge. However, there is a major need for currency in their integrative knowledge.

Like many other fields, education is going through a major process of electronisation (Vasarhelyi & Greenstein, 2003) where computer support of the classroom, distance learning and substantive automation are totally changing the landscape. Finally, the fact that most major accounting firms have extensive internal training that overlaps or supplants what students learned in the universities is an indictment of both the entities and the universities. It wastes social resources and misleads students and faculties in their quest to learn.

The above points lead to some obvious and speculative steps that could be undertaken by universities. With the use of real-time technologies some innovative programs could be developed to actually support the Chartered Accountant on the job and at the same time provide educational credits and substantive learning. These would be equivalent to the old 'cooperative programs' where students alternate between the job and the university but in this case would be less disruptive and more valuable to the employer. Universities would also have to redesign their curricula with the view that education is a lifelong process and that diplomas and certificates should be revalued if education is not continued. This same issue has implications for professional bodies.

Universities must rapidly improve their technological infrastructure to provide for this educational channel. They must understand that educational content requires substantive investment in development and updating. It is not clear if the university, or publishers, or major accounting firms, or suppliers of software and analytic technology or professional associations have the competitive advantage in developing knowledge packages. However, it is clear that major educational knowledge packages will exist and many educational institutions will become more content deliverers and administrators of the lifelong educational process.

Furthermore, universities must change the nature of their educational staff along the lines of modern knowledge structures. It is not clear that the traditional mix of teaching, research, service and external relationships that is currently required from faculties will make sense in the future. For a university to remain reputable it will have to establish narrow domain competencies that will be superior to others' and will enable it to provide the knowledge for knowledge packages.

Finally, universities should join the business of knowledge consulting where their lifelong learning partners can avail themselves of faculty knowledge to help them in their day-to-day jobs. The separation of the learning stage of life from the professional stage is now artificial. Companies and universities need to create knowledge support partnerships that are fully compensated. These of course would present a feed-forward effect where faculty would be more relevant but probably less independent and forward-looking.

## The role of professional bodies in preparing the Now Economy auditor

Professional bodies are a very important element of the mix for progress in the Now Economy. No other type of entity can drive the profession in a more positive way. While the government can enact laws and regulations that force activity, these rules do not respond well to the needs of the profession and/or for the proper advance of the state-of-the-art of accounting practice. Professional accounting organisations have the pulse of the profession and understand on-the-job needs as well as the shortcomings of instruction and professional knowledge. The following recommendations are closely related to the justifications and recommendations for universities.

First, professional bodies should tighten up and expand their continuous professional education (CPE) efforts and requirements. Education is a lifelong process and it must recognised as such. Furthermore, accountants at different stages of their career should have different CPE requirements and restrictions on what education satisfies a CPE requirement. The body should develop a service of education counselling and direction. Second, professional societies, standard setters, governments and universities must work together on curriculum, certification requirements and learning monitoring efforts. While there may be some competition among these entities the old stovepipes of separate and artificially separated efforts cause substantive harm to society Third, professional societies need to work together with international entities to facilitate the globalisation of accounting and auditing standards and recognise the fact that there will be differences in local practice, local tax considerations and implementation of standards. Finally, on a wider scope, professional bodies should take into consideration the multiple convergences described in the next section where currencies, economies, stock exchanges and standards will converge but not fully merge and will require a nimble professional, above the local specialisation, to help clients in a rapidly changing world. A profession that tightly holds on to its current turf will see this domain shrink into irrelevancy. However, a profession that holds on to the present will tend to keep current gains but shrink towards the future.

## The effects of globalisation

Over the last 50 years technology has enabled major advances towards a global economy. Consequently it has set into motion social change, economic re-balancing and an unprecedented degree of cross-country cooperation. However, this phenomenon of ubiquitous consequence has created a wave of challenges to the socio-technical structure of business and corporate policy making.

Friedman[32] has extensively discussed the effects of globalisation and what he calls the flattening of the world. He talks about triple convergence where hardware and software multifuctionality, the availability of a large set of software and infrastructure tools of cooperation, and three billion new people joining the markets (in India, China and Eastern Europe) have substantively changed the way we live. Symbolising these changes are political change (the falling of the Berlin Wall in 1989), change in fund raising and equity markets (Netscape went public in 1995), and structural change he labels 'flatteners' (work flow software, open sourcing, outsourcing and offshoring among several items).

These major structural changes will also drive what we call the 10 major convergences or flatteners of the financial reporting and assurance world. These are discussed in Vasarhelyi and Alles (2009e). To understand these one must place them into the following wider context frames:

- One man gets richer and the other gets poorer; it is a zero sum game
- The eco-system is highly taxed with its exploration
- More technological 'glue' brings all together
- There will be more change in the next 10 years than in the last century.

Financial convergences:

- Financial markets are interlinked and that is good and bad
- Substantial reduction on the number of currencies
- Development of real global stock exchanges
- International Accounting Standards, common but with some differences
- International Auditing Standards, common and similar
- Workforces will blend across market and countries
- A wider set of assurance products
- Accounting work outsourcing
- Closer to supranational real-time reporting
- A wider set of reporting products?

32. Friedman, T., The World is Flat, 2005, Farrar, Strauss & Giroux.

Friedman's view sees a wider flat world, with double its current economic population working more efficiently and harmoniously through the 21st century with substantial gains in quality of life and longevity for a larger sector of the world. Accountants can have a substantive and positive contribution in this vision. Substantive opportunities for the expansion of scope of services (eg. carbon audits), size of the economic pie and contributions to the good management of the enterprise (eg. monitoring) lay ahead for the profession.

## The effect of the financial crisis

The subprime market precipitated the most serious crisis in the United States since the Great Depression. But it is hard to characterise this solely as a crisis of the real estate markets. Since the Reagan era [33] an economic bubble has been brewing. Since the 1970s the relationship between the market valuation of companies and the financial reports measuring them has been deteriorating. In simple term this means that financial reports do not explain the value of companies perceived by the markets [34]. Confirming this perception, interviews with financial analysts reveal a much wider examination of information and events and financial analyst reports that are grandly uncorrelated with actual corporate outcomes.

Any shakeup in the dynamics of the situation would have sooner or later burst the bubble. It could have been the subprime or the failure of a large company driving uncontrolled swap betting or a crisis of confidence on some of the intermediate markets.

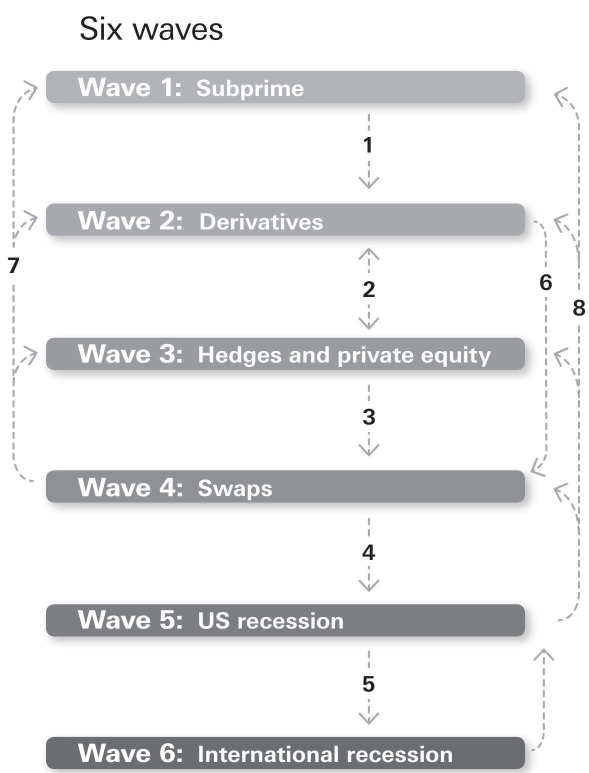
The initial burst of the bubble created a major misbalance in highly stretched markets. Investment banks at untenable leverage levels (between 30 to 50 to one) would go into negative equity with a bare 2% or 3% decrease in asset values. While the bubble kept growing, the equilibrium was maintained but the bad news created a crisis of confidence melting the intermediate markets. To summarise:

- Freezing of intermediate markets changed the short values of derivative financial assets
- These changes forced ill-capitalised investment banks to dump assets bellow their ongoing value
- Hedge funds and other parallel banking entities had abandoned strict hedging or hedges did not work when counterparties reneged or markets for the hedges did not exist
- Substantive de-leveraging aggravated the lack of credit
- The disappearance of the large US investment houses in the form we know them was a foregone conclusion
- The crisis can be represented by six waves (see Figure 19).

33. Paul Krugman, 'Reagan did it', *New York Times*, 31 May 2009

34. A set of meaningless financial reports makes the value of their assurance dubious for the financial market's purposes. Still these assurances have some value as they assert that the actual entities exist and perform transactions of economic value. Consequently to increase the social value of assurance much of this work has to revert to focusing on essential economic transactions not their meaningless obsolete aggregation.

**Figure 19: The cycles of the 'subprime' crisis**




## Effects of the six waves

### Wave 1: Subprime

Over the last two decades interest rates have been low in many countries propitiating a substantial increase in home ownership. Buyers tended to be totally cash-flow oriented and bought what they could afford to pay on a monthly basis. Over the last decade low interest rates allowed higher housing prices to be paid and a separation between loan origination (entity who sells the loan) and loan ownership (entity who carries the loan) created perverse incentives. The incentive to sell loans to those who could not afford it, the incentives by the government to increase home ownership without underlying wealth, and the incentives to the borrowers to buy above their means assumed an eternal growth in real estate values. With or without other factors such as swaps and derivatives eventually this would have led to a crisis. However, any of these three factors (and others) could have been the needle that pricked the bubble.

### Wave 2: Derivatives

Once the bubble is pricked all derivative assets that are stretched start giving way and it is only a matter of time before it bursts. The investment banks operating at very high leverages (over 30 times) have very little play when assets decrease in value. The Now Economy just accelerates this factor and 'panic' occurs unless there are 'fire breakers' in place to deal with rapid decreases in value as those instituted in the US stock markets. Real-time monitoring of hedging structures needs to be in place to rapidly detect waves of change and help in the prevention or attenuation of crises.

### Wave 3: Hedges and private equity

Hedge funds have become a large part of the 'shadow banking system', largely unregulated and the prime clients of investment banks. Over 20% of these 'shadow bank institutions' have been dissolved or failed but due to their smaller sizes have had less repercussion. If the US government had not stepped in to salvage the swap market and consequently salvage the large investment banks (eg. Goldman Sachs) the hedge funds would have been even further affected. In general hedge positions work well in well-behaved markets but with catastrophic change hedges are inoperative. While much of accountants' work has involved trying to measure the value of derivative positions and then the hedging strategies, a continuous audit would constantly map hedges and present aggregate positions measured under different scenarios. Purists would say that this is the role of management, but in a world of nanosecond transactions and rapidly changing economics, unless there is some continuous awareness of the matching of positions their actual hedge validity is questionable. A Now Economy will need substantial reigning in of these positions, shaded disclosure of all details of these positions, and rapidly functioning valuation dashboards with many alternative strategies available.

Private equity entities are another part of the 'shadow banking system' that have to be reigned in, placed in substantive disclosure, and subject to new rules of the game. In reality it is very difficult to assure a particular entity if their closely related party (private equity) is not publicly reporting and is privately held. Many European countries apply rules to a much wider set of organisations, many privately held, regarding disclosures. The emerging assurance and reporting environment must be aware of these issues and of the rapid set of regulation changes currently evolving.

### Wave 4: Swaps

There are many types of swaps. But in essence, as they are a form of barter transaction where, for example, an insurance company promises to pay another party the value of a bond if it fails, they have been kept out of the recording system. No economic transfer, except fees, occurs in most instances. Consequently this is a later event in most crises as it has to be caused by the original failure of the bond. The value of the swap markets, measured at face value, is in the 40 to 70 trillion dollars range but it cannot really be compared as it is low probability contingency compared with actual GNP numbers or bond being traded. Investors can't tell whether the people selling the swaps – known as counterparties – have the money to honour their promises. This clearly substantive market grew in the shadows and benefited from the difficulties and opacity of measuring and disclosing contracts.

On 8 May 2008 American International Group Inc. wrote down US$9.1 billion on the value of its certificates of deposit holdings. The world's largest insurer by assets sold credit protection on collateralised debt obligations (CDOs) that declined in value. In 2007, New York-based AIG reported US$11.5 billion in write downs on CDO credit default swaps. Ultimately the US government that intervened provided over US$130 billion to AIG in a bid to protect AIG's counterparties including Goldman Sachs and Morgan Stanley.

Once the marked liquidity diminished the probability of likely payout exploded and the US authorities felt obliged to rescue AIG which, in most of its areas, was a solid and profitable entity. Actually, the United States government was rescuing the investment banks that had not failed and their clients the hedge funds. The rapidly unfolding events was a consequence of absolute fear, investors, the government and financial entities not really understanding the reality of the situation. There were no overall maps that could give any of the main entities an aggregate view and an understanding of where the risks really were. If the modern world doesn't want to be the site of frequent and rapid meltdowns, measurement for all entities of their derivative and hedge positions is a must and its disclosure at least to a technologically enabled government must be full. Alternatively, an assured set of disclosure dashboards could be very useful in the monitoring and management of instruments and positions. Unless a real-time dashboarding and analytics framework exists, most likely the current mélange of risk instruments is unsustainable.

Supporting this view, billionaire investor George Soros indicated that a chain reaction of failures in the swaps market could trigger the next global financial crisis. The swap market is unregulated, and there are no public records showing whether sellers have the assets to pay out if a bond defaults.

### Wave 5: US recession

The United States moved into recession faster than the rest of the word in an ever increasing spiral. The government, remembering the Great Depression, worked very hard to stimulate the economy but these measures have been slow to take root in basic economic activity. On the other hand, by and large, the measures adopted to restore liquidity and calm the markets have worked and there has been a slow reignition of activity that has progressively slowed job losses and restarted sectors of the economy.

From measurement and assurance views the basic problems have not been addressed. On the contrary the standard setting authorities have been forced into poor regulation by skittish financial markets.

### Wave 6: Selective international recession

The interconnectivity of markets, a basis for their increased efficiency, becomes a compounding/accelerating factor. Different countries reacted different ways to the crisis but most of them eventually printed money (a symbolic expression) to stimulate the economy and increase liquidity. Again, even more than in the United States, the basic problems have not been addressed or resolved.

The interesting question is how would a Now Economy technology help in this situation? Clearly socio-technical systems cannot be modelled around technological innovation. Systems, with their human being components, are slow to adapt and follow economic motivation schema.

### How can Continuous Assurance and/or continuous monitoring help?

A Continuous Assurance environment can generate a forward looking environment in the following ways:

- By establishing a set of rules requiring all entities to report. Private, public, small, large, government, not-for-profit, all organisations must use their internal measurement tools (accounting packages) to prepare disclosures. Symbolic representation of all economic activity must be developed and to a certain degree monitored and assured
- The government or audit firms or independent internal auditors must monitor companies close to real-time and this will identify and prevent potential problems (ie. defaults in subprime)
- By using analytic CEs to create linkage
- By publishing process relationships and forward-looking metrics
- By considering the other technologies discussed in this monograph.

Transparent monitoring can create additional instability in the markets just like fair value regulations can be blamed for increased instabilities (clearly true but probably desirable in the long term) as it will reduce counterparty opacity and is necessary for long-term regulation and stability. Stabilising mechanisms must also be developed.

While monitoring and assurance can help reduce the size and consequences of bubbles they are not sufficient. Perverse incentives as described next must be reduced:

- Loan originators exploiting uneducated consumers and not caring if they fail as they are not the ones that carry the loan
- Derivative instruments that are too complex for client understanding
- Rating agencies being paid directly by the rated entities, if the rating is not good enough the issuer will not issue the title and the rating agency will not get income
- Accounting rules allowing ‘off balance sheet entities’ where entities may offload obligations for short or long periods of time
- Fair value valuations precipitating unintended consequences where frozen markets create temporary dramatic price drops… a cooling period with double reporting would help.

The credit crisis has choked off many of the markets that banks in recent years relied on to take assets off their balance sheets. Issuance of mortgage-backed securities has dropped sharply, while demand for more complex instruments such as collateralised debt obligations – packages of loans that have been sliced to create new securities – has dried up completely. Many bankers think it will be months, if not years, before they can start issuing these securities again. If and when they do, investors are bound to demand higher returns than before and are likely to require banks to demonstrate confidence in the securities by keeping a greater proportion to themselves. In short, this means that banks will be forced to fund more of their future loans from their own balance sheet resources. And it also means that Continuous Assurance could have helped but would not have, by any stretch of the imagination, avoided the subprime crisis of 2007/2009.

# Conclusions

This monograph first introduced an analogy to automotive inspections to stress the need for a fundamental reconstruction of the audit process. Then it defined and conceptualised the main elements of the Now Economy. The main driver towards the Now Economy is the need to reduce the latency within BPs or, in other words, to make the BP faster and more efficient. Any consumption of time costs money in a competitive framework may lead to competitive disadvantage.

A set of views on Continuous Assurance served to build a composite model where continuous data audit is complemented by continuous control monitoring, and a new view that we called continuous risk monitoring and assessment. Practice of the evolutionary audit field, and standard setting entities, will progressively consolidate practices that are experimental today.

The first recorded Continuous Assurance initiative was at AT&T (Vasarhelyi & Halper, 1991) and aimed to assure and monitor a large corporate customer relationship management system. There, high level monitoring of data led to increased system reliability and the detection of faults. Late in the 1990s and early 2000s first the CICA/AICPA and then the IIA issued guidelines on a more continuous audit. Surveys by ACL (a leading audit software vendor) and PricewaterhouseCoopers indicate that many companies have embraced some form of continuous audit. These definitions of 'continuous audit' are varied but the reality is that few companies are monitoring and assuring their processes in a timely fashion.

## Some experiences and some evolving questions

The Siemens effort described earlier is a leading edge experiment to expand the frame of Continuous Assurance. This effort is mainly aimed at assurance of large ERPs and their portion of audit automation. For this purpose the definition of Continuous Assurance was expanded to include CCM. ERPs encompass a large number of configurable and controls which may be active or inactive at a certain point in time. The Siemens project proposes a methodology to monitor and evaluate through base-lining the actual configuration of controls day by day. The second part of the Siemens project allowed for a wider evaluation of automation of Siemens' Audit Action Sheets and led to the conclusion that about 68% of the actions could be automated. Consequently instead of an 18- to 24-month cycle of internal audit evaluation of an SAP facility, daily, weekly and monthly evidence could be gathered automatically and fed to an audit evidence assessment mechanism. This rebalancing of audit evidence leads to the need to re-engineer the assurance function. Furthermore, the Siemens work raises interesting questions that must eventually be addressed. First, the current set of prescribed audit evidence is surely anachronistic. What is the type of evidence of the audit of the future? Second, the audit of the future can be heavily performed by automated means. Of the Siemens' audit actions only 32% could not be automated and the others would be provided automatically and frequently. In question was the need of the residual 32%, very often about existence of documentation, the execution of certain processes, the nature of certain facilities, etc. This type of 'soft' evidence, often just of perfunctory performance in traditional audits, may potentially be replaced or eliminated in the future. The question that arises is what evidence would be required in a new audit, of highly automated systems, if a new audit methodology is designed from scratch? Third, auditor presence, and the rituals of the repetitive audit, is clearly a deterrent for fraud and a mechanism whereby organisations increase data integrity.
What are the effects of a (visible or invisible) remote audit?

The modelling work performed at HCA (Vasarhelyi et al., 2004) modelled the supply chain of a major health organisation and aimed to improve the state-of-the-art in establishing the baseline against which to compare real-time data. Experience has shown that using static budget or estimates does not provide adequate comparison models. Consequently if we use sophisticated real-time data flows, we also need to improve the models against which we compare these streams of data. These models must incorporate provisions to account for seasonality, details in the value chain, special events and the inherent time delays in the process. Questions raised in this work include:

- Should monitoring be performed and at what level of aggregation? At the financial statement account level, at the general ledger level or at the individual transaction level?
- What kinds of faults do we find in streams of data? How can they be classified? How do these faults relate to weaknesses in internal controls?
- What are the intrinsic latencies in the value chain? How does one model the value chain integrating these latencies? For example, in average it takes 17 days to receive a delivery, three days to post a receivable, 29 days on average to collect a receivable (50% of events), and 60 days to collect (25% of events), etc.
- Can we automatically correct transactions that are estimated to be in error?

Several of the Itau Unibanco steps towards Continuous Assurance have helped understand the future of audit. The bank, as described above, created a monitoring of mechanism for its more than 1400 branches. Furthermore, it created a set of filters that brought up alarms in the areas of human resources, branch management, credit, etc. In its Continuous Assurance effort the bank proposed 56 potential Continuous Assurance projects, ranked these projects and made selections on their priority based on management perceptions for needs, the bank's corporate culture and expediency considerations. The 'low hanging fruit' approach, whereby the easiest projects take priority ahead of larger and more complex efforts, was considered vital:

- Auditor presence could be enhanced by constant monitoring (as at Itau-Unibanco) to replace the more extended presence of the auditor in the engagement. Itau-Unibanco replaced 160 audit hours annually for a 40-hour surprise audit driven by continuous monitoring-driven alerts, and a system of KPIs. What is the ideal mix of audit presence, remote human-manned auditing and automated auditing?
- This experience clearly indicates that Continuous Assurance can be applied across many areas of organisations. Also, the experience seems to indicate that banks and other financial organisations are particularly good targets to use continuous audit as their main product is easily abscondable cash.

Itau Unibanco chose to examine and monitor transitory accounts (Kim et al., 2009) in order to decrease their transaction risk and to create an infrastructure of enhanced data assurance. For this purpose it created an audit structure of four levels which encompassed: 1) analytical account review; 2) real-time monitoring for key events at the mainframe level; 3) detailed analysis of high risk accounts at daily cycles; and 4) business modelling of critical accounts using CE (Alles et al., 2010) analytic technology. At the same time Itau Unibanco hired IBM to create the necessary infrastructure to support these analytical processes, migrate the earlier mentioned branch monitoring and create the necessary audit dashboard for alarm and continuous audit management.

The Itau-Unibanco effort raises a series of important questions:

- What should be the methodology to choose Continuous Assurance applications?
- How should these be assigned priorities?
- What processes are to be monitored online, at the mainframe level, and at what level of detail?
- What is the depth of detail that account filters are to be developed to extract fallacious transactions? How does one make decisions at thresholds of filtering levels that would result in trading off false positives for false negatives?
- How should a Continuous Assurance dashboard be designed? Should the focus be on financial statements, processes or on particular variables, events, etc?

## Understanding some Continuous Assurance realities

The above discussion and examples of Continuous Assurance at several organisations indicate some commonalities that should serve as additional guidelines to establish a continuous audit effort. Our predictions include:

- Traditional auditing will give way to a progressive form of close to the event auditing without the need for special regulation. However, first professional organisations and then governments will need to identify the need for this and issue guidelines for a kit of progressively real-time assurance procedures
- Organisations must look in the domain of their processes to applications that are time sensitive and have material effects on their financial statements
- Organisations must balance application choices between their importance and ease of implementation
- Continuous Assurance implementation will happen over a range of companies but initially to companies that are highly sensitive to environmental change, have very liquid assets or must for legal reasons show high control in processes
- Financial organisations and corporate financial processes will have early priority but over time most industries will evolve towards real-time control and assurance basically to reduce latency and to improve data/product quality
- Advances in IT must be matched by advances in analytic modelling to bring Continuous Assurance to its full maturity
- The advent of XML, XBRL and other interoperability standards will accelerate Continuous Assurance and will allow for cooperative inter-organisational assurance processes. For example, a company and its banks will have automatic verification (confirmation) procedures for transactions and account balances. These will be established and regulated at the contractual date and follow eventually promulgated database-to-database confirmation standards
- The academic community has led the thinking in Continuous Assurance, and a small industry of software to support continuous audit has emerged. While external auditors have been very supportive of Continuous Assurance development it is the IA community that can invest in systems in loco, which is driving the development of Continuous Assurance
- While many of the Continuous Assurance solutions at large organisations will be ad hoc, it will take the integration of Continuous Assurance facilities in integrated software (ERPs) that will allow some of the benefits to flow to smaller organisations.

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# Glossary of acronyms and definitions

| | |
|---|---|
| **AICPA** | American Institute of Certified Public Accountants |
| **AIS** | Accounting Information System |
| **AUASB** | Australian Auditing & Assurance Standards Board |
| **ASEC** | Assurance Services Executive Committee |
| **BP** | Business Process |
| **CAAT** | Computer Assisted Auditing Techniques |
| **CAP** | Continuous Audit Procedure |
| **CCM** | Continuous Control Monitoring |
| **CDA** | Continuous Data Auditing |
| **CDOs** | Collateralised Debt Obligations |
| **CE** | Continuity Equation |
| **CICA** | Canadian Institute of Chartered Accountants |
| **CISA** | Certified Information System Auditor |
| **CPAS** | Continuous Process Auditing System |
| **CPE** | Continuous Professional Education |
| **CRM** | Customer Relationship Management |
| **CRMA** | Continuous Risk Monitoring and Assessment |
| **DMV** | Department of Motor Vehicles |
| **EAM** | Embedded audit module |
| **ERM** | Enterprise Risk Management |
| **ERP** | Enterprise Resource Planning |
| **ETL** | Extract, Transfer and Load |
| **FD** | Fair Disclosure |

| | |
|---|---|
| **GAAP** | Generally Accepted Accounting Principles |
| **GNP** | Gross National Product |
| **GRC** | Governance, Risk and Compliance |
| **GTAG** | Global Technology Audit Guide |
| **IA** | Internal Audit |
| **IFRS** | International Financial Reporting Standards |
| **IIA** | Institute of Internal Auditors |
| **ISACA** | Information System Audit and Control Association |
| **IT** | Information Technology |
| **JIT** | Just in Time |
| **JSON** | JavaScript Object Notation |
| **KPI** | Key Performance Indicators |
| **MCL** | Monitoring and Control Layer |
| **PDA** | Personal Digital Assistant |
| **RTE** | Real-Time Enterprises |
| **SEC** | Securities and Exchange Commission |
| **SOA** | Service Oriented Architecture |
| **SOX** | Sarbanes Oxley Act |
| **SQL** | Structured Query Language |
| **XBRL** | Extensible Business Reporting Language |
| **XBRL/FR** | XBRL Financial Reports |
| **XBRL/GL** | XBRL Global Ledger |
| **XML** | Extensible Markup Language |

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Katie Williams received her PhD in 2009. Her thesis explored the ways in which information security and risk management practices within Australian firms could be improved, enhancing overall effectiveness and efficiency. For the past two and a half years Katie has led the development of the Continuous Auditing and Continuous Monitoring project at KPMG's Global Services Centre. Katie is an Associate Director at KPMG's Perth office in Australia.

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# The benefit of audit

## A guide to audit quality

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in Australia

## The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia (the Institute) is the professional body representing Chartered Accountants in Australia. Our reach extends to more than 62,000 of today's and tomorrow's business leaders, representing more than 50,000 Chartered Accountants and 12,000 of Australia's best accounting graduates who are currently enrolled in our world class Chartered Accountants postgraduate program.

Our members work in diverse roles across commerce and industry, academia, government, and public practice throughout Australia and in 119 countries around the world.

We aim to lead the profession by delivering visionary leadership projects, setting the benchmark for the highest ethical, professional and educational standards, and enhancing and promoting the Chartered Accountant brand. We also represent the interests of members to government, industry, academia and the general public by actively engaging our membership and local and international bodies on public policy, government legislation and regulatory issues.

The Institute can leverage advantages for its members as a founding member of the Global Accounting Alliance (GAA), an international accounting coalition formed by the world's premier accounting bodies. With a membership of around 775,000, the GAA promotes quality professional services, shares information, and collaborates on international accounting issues.

Established in 1928, the Institute is constituted by Royal Charter. For further information about the Institute, visit **charteredaccountants.com.au**



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**The benefit of audit: A guide to audit quality**

First edition

The benefit of audit: A guide to audit quality
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# Foreword

Since the ASX Corporate Governance Council was formed in August 2002, we have been committed to developing and delivering practical guidance to boost corporate governance practices in Australia and to meet global expectations in this area.

A key component of good corporate governance in Australia and internationally is the role and responsibilities of the audit committee. Recognising that ultimate responsibility for the integrity of a company's financial reporting rests with the full board of the company, an audit committee provides an efficient mechanism for focusing on issues relevant to such reporting.

I welcome the initiative by the Institute of Chartered Accountants in Australia to produce *The benefit of audit: A guide to audit quality.* For the first time, there is practical, plain-English guidance available to fuel understanding of and communication on audit quality. This will be a valuable tool for directors and audit committees.

High-quality auditing is integral to capital market confidence. At times, the role of audit can be understated and undervalued. This guide will help ensure Australia remains focused on the benefit of audit.

**Eric Mayne**
Chairman
ASX Corporate Governance Council

# Contents

# Introduction

Given its significance, there have been various attempts to clearly define 'audit quality.' A good example is the following statement from the United Kingdom Financial Reporting Council's Audit Inspections Public Report:

> 'Undertaking a quality audit involves obtaining sufficient and appropriate audit evidence to support the conclusions on which the audit report is based and making objective and appropriate audit judgements… A quality audit [also] involves appropriate and complete reporting by the auditors which enables the Audit Committee and Board to discharge their responsibilities.' (June 2005)

While there can be differing views on the definition of audit quality, it is clear that shareholders, company directors, audit committee members, auditors and regulators all agree that quality external auditing is fundamental to business and capital market confidence.

Australia's auditing profession, along with the current framework of auditing standards, is among the world's best. However, we should be continually challenging ourselves to identify and develop actions that aim to improve auditing practices and outcomes.

To date, there has been little guidance available of which we are aware to help businesses understand the quality of the audit service being provided to them. This lack of information has compounded the concept of the 'audit expectation gap,' which we have seen emerge in the business and investor communities.

The Institute of Chartered Accountants in Australia is committed to addressing this expectation gap by raising awareness of the benefits of audit and by educating the marketplace on the specific drivers of audit quality. A follow-up to this guide will be released in 2010 and include the development of measures of audit quality and examples of external communication strategies for audit practitioners.

We hope this guide will foster better communication, interaction, and understanding between audit committee board members and their external auditor.

**Graham Meyer**
Chief Executive Officer
The Institute of Chartered Accountants in Australia

# Purpose of this guide

The purpose of this guide is to enhance communication between the audit committee and the external auditor. The guide provides assistance to audit committees and other relevant stakeholders to:

- Better understand the role and scope of an external audit
- Engage more effectively with the external auditor
- Consider the drivers of audit quality and the components of each driver.

This guide does not set out compliance requirements or override any existing requirements to which boards and committees may be subject, and it is not intended to deal with better practice of audit committees which is addressed in other publications, such as *Audit Committees: A Guide to Good Practice*[1].

Audit committees using this guide will need to determine when to communicate with the external auditor on the drivers of audit quality. For example, some discussion might occur at the initial planning phases of the external audit, while other communication will relate to the audit findings and conclusions. Audit committees could also consider using this guide during the proposal process to assist with auditor selection.

This guide addresses five drivers of audit quality, drawn from the Financial Reporting Council's (UK) Audit Quality Framework. This framework, the first of its kind, was developed following global consultation.

1. Auditing and Assurance Standards Board, Australian Institute of Company Directors, and the Institute of Internal Auditors in Australia (2008).

# Role of the audit committee

An independent audit committee is a fundamental component of a sound corporate governance structure.

Audit committee charters will typically focus on engagement with the external auditor and the quality of the external audit service. Examples of focus areas in audit committee charters include:

> ‘Review the performance of the external auditor’

> ‘Consider the overall effectiveness and independence of the external auditor’

> ‘Review, at least annually, the scope, results and performance of the external auditor’

> ‘Assess and monitor the performance and effectiveness of the external auditor’

> ‘The committee will progressively evaluate the performance of the external auditor during its term of appointment and the progress of the audit. The committee will ensure that the criteria for evaluation of performance extend to cover the value delivered to shareholders and the audit.’

This guide, and in particular the questions supporting each driver of audit quality, is designed to help audit committees meet the responsibilities of their charters.

# The five drivers of audit quality

1. The culture within an audit firm
2. The skills and personal qualities of audit partners and staff
3. The effectiveness of the audit process
4. Factors outside of the control of auditors
5. The reliability and usefulness of audit reporting.

This guide includes a practical range of questions to accompany this list. These questions are not designed to be comprehensive; rather they are intended to provide a foundation and will need to be tailored to the specific circumstances of each organisation and its auditing requirements.

## 1. The culture within an audit firm

### Points for consideration and discussion with your external auditor

> What are the core values of your auditor?
> Does your auditor's code of conduct include commitments to:
  – Honesty and integrity
  – Professional competence
  – Independence.
> How does your auditor regularly communicate the core values and principles of the code of conduct to staff?
> How does your auditor communicate to its staff about the importance of audit quality?
> How does your auditor assess compliance with independence requirements?
> Does your auditor create an environment where achieving high quality is valued, invested in and rewarded?
> Does your auditor have appraisal systems for partners and staff that promote audit quality?
> Does your auditor take appropriate action for poor ethical behaviour or poor decisions?
> Does your auditor have robust systems for client acceptance and continuation?
> Does your auditor promote and support consultations for exercising professional judgement in challenging circumstances? How?
> Does your auditor monitor audit quality across its firm and/or network? What actions would they take for shortcomings in these activities?
> Has any partner in your audit firm been the subject of regulatory action on the public record during the past year?
> How is your auditor structured to ensure appropriate focus on the quality of its audits? How does it commit to continuous improvement in audit quality?

## 2. The skills and personal qualities of audit partners and staff

### Points for consideration and discussion with your external auditor

> Do the partners and staff of your auditor demonstrate a thorough understanding of your business and the legal framework in which you operate?

> Do the partners and staff show technical competence and a thorough understanding of auditing and accounting standards, and professional and ethical standards? Do they receive regular training on these standards?

> Does your auditor provide you with details of your engagement team including the role and experience of the team and the way in which the team is managed and supervised?

> Where your audit requires specialised industry knowledge, have audit staff received adequate industry training?

> Are the partners or staff involved in relevant industry based groups?

> How do audit staff receive mentoring and on the job training?

> Do the partners and staff show appropriate professional scepticism and address issues identified during the audit in a robust manner?

## 3. The effectiveness of the audit process

### Points for consideration and discussion with your external auditor

> Do you understand what your auditor does and does not do, including how the auditor reviews the various operations of your business?

> Do you understand clearly the roles and responsibilities of each of the following groups: the audit committee, the board of directors, management, and the external auditor?

> Are the audit partner(s) and manager(s) closely involved in the planning of your audit?

> Is the external audit plan discussed at audit committee meetings well before year end?

> Are your reporting deadlines realistic and achievable for the delivery of reliable and relevant information to your auditor to allow a quality audit?

> Does your auditor's methodology, technology and/or tools:
  - Provide a framework and processes to obtain sufficient appropriate audit evidence?
  - Comply with all legal and professional requirements?
  - Require appropriate audit documentation?
  - Require an effective review of audit work?

> How does your auditor use technology to support its audit approach?

> Is sufficient technical support available to the audit team when required?

> How does your auditor review the work of experts, including assessing their terms of reference, competence, capabilities and objectivity?

> How does your auditor gain appropriate assurance on audits of group entities that operate overseas?

> How does your external auditor engage with, and use, the work of your internal auditor?

> Does your auditor have appropriate access to the audit committee, including 'in camera?'

## 4. Factors outside of the control of auditors

> Does your organisation attach appropriate importance to financial reporting and the audit process?

> What qualifications and level of experience do the preparers of financial statements have in your organisation?

> Is the composition of your audit committee sufficiently balanced in skills, experience and industry knowledge to ensure audit quality?

> Does your audit committee engage in a robust and professional manner with issues identified during the audit?

> How does your audit committee assess the quality of financial information provided by management?

> Is there sufficient capacity (nature, mix and size) in your organisation's financial reporting capability to meet your expectations?

> Are your organisation's financial reporting deadlines realistically focused to ensure quality financial reporting and auditing?

> Who in your organisation is responsible for communicating with investors?

> Does the audit committee approve releases to the market?

> What remuneration systems does your organisation have and how do they relate to key accounting judgements? Is there potential for bias and how is that monitored?

## 5. The reliability and usefulness of audit reporting

### Points for consideration and discussion with your external auditor

> Does your auditor communicate with sufficient detail on the scope of the audit and the accompanying report, including the way in which the risk of material misstatement in the financial statements has been addressed?

> Does your auditor report on the key judgements made by management in assessing the application of accounting standards and the auditor's assessment of these judgements?

> Are your auditor's reports written in a clear manner? How could they be improved?

> Does your auditor suggest potential ways of improving financial reporting and internal controls?

> Does your auditor provide the audit committee with a list of unadjusted differences identified during the course of the audit?

> Does your auditor seek feedback from its clients on a formal basis?

# Further reading

| | |
|---|---|
| **The Actuarial Quality Framework (2009)** | Financial Reporting Council (UK) www.frc.org.uk |
| **Audit Committees: A Guide to Good Practice (2008)** | Auditing and Assurance Standards Board<br>The Institute of Internal Auditors Australia<br>The Australian Institute of Company Directors |

# Glossary

| | |
|---|---|
| **Audit committee** | A sub-committee of the governing board of a corporate entity, normally with responsibility for interacting with the external auditor and monitoring the audit process. |
| **Audit opinion** | The auditor's overall conclusion. |
| **Audit report** | The auditor's formal report, normally addressed to the board of directors of a company (or the equivalent for other entities), containing a written expression of the auditor's overall conclusion. |
| **Auditor** | The independent external individual who leads a team responsible for conducting an audit of the annual financial statements of a corporate entity. The auditor is normally responsible for forming and expressing a professional opinion on whether or not the financial statements 'present fairly' (or are a 'true and fair' representation of) the state of affairs of the entity and the results of its operations, for the period being audited. |
| **Auditor independence** | The concept of independence is fundamental to compliance with the principles of integrity and objectivity. Auditors and their staff are required to be independent of their audit clients both in fact and in appearance. |
| **Audit committee charter** | A document that sets out the functions and powers that have been delegated to the audit committee by the board of directors or governing board. |

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**The Institute of Chartered Accountants in Australia**

GAA Global Accounting Alliance

**charteredaccountants.com.au**

This one page framework for managing audit quality sustainability has been designed to define the key components needed to manage a sustainable audit process.

It outlines the following 5 phases:

> Client acceptance and retention

> Strategy and policies

> People and tools

> Inspection

> Remediation.

We encourage you to refer to the framework's continuous cycle in your audit practice, and to work through the five phases to ensure that you are managing and maintaining audit quality.

If you have any comments on the framework, please email these to Lee White at lee.white@charteredaccountants.com.au

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# Continuous cycle of audit quality

GAA Global Accounting Alliance

The Institute of Chartered Accountants in Australia

The Institute of Chartered Accountants in Australia

# Framework for Managing Audit Quality Sustainability

| Phases | | Key Components | Implementation Steps | |
|---|---|---|---|---|
| Client Acceptance and Retention | 1 | Risk appetite | > Clearly defined | > Regularly reviewed and refined |
| | 2 | Values | > Clearly explained | > Embedded into processes and decisions |
| | 3 | 'Tone from the top' | > Leadership commitment | > Aligned words and actions |
| | 4 | Data | > On-going data gathering | > Timely analysis of, and appropriate responses, to risks |
| Strategy and Policies | 1 | Independence | > Aligned with values and culture | > Clear and concise in style |
| | 2 | Delivery of quality | > Encourage consultation for identified problems | > Exercise professional judgement and skepticism |
| | 3 | Remediation systems | > Emphasis on importance of remediation | > Alignment to remediation |
| | 4 | Acceptance of standards | > Monitored and updated | > Allow discussion |
| | 5 | Relevance | > Planned | > Evaluate regularly |
| People and Tools | 1 | Recruitment | > Competency and experience mix | > Partner involvement |
| | 2 | Development | > Performance Management/Succession planning | > Formal structure as well as on-the-job training |
| | 3 | Engagement | > Expert practitioners used | > Partner involvement |
| | 4 | Culture | > Encourage innovation | > Knowledge sharing |
| | 5 | Methodology / technology | > Ownership and resourcing | > Maintenance and development |
| Inspection | 1 | Commitment | > Understand value and importance | > Resourcing |
| | 2 | Collaboration | > Forward mapping of all inspections | > Understand integration of inspections |
| | 3 | Robustness | > Inspections use globally accepted approaches | > Identify and examine relevant risks |
| | 4 | Ongoing | > Breadth and coverage of inspections | > Environmental monitoring and proactive inspections |
| | 5 | Effective/efficient | > Prompt analysis of inspection results | > Use analysis in training and planning |
| Remediation | 1 | Commitment | > Recognise value and importance | > Owned by all |
| | 2 | Results/Consequences | > Distinction between short and long term | > Enforced and monitored |
| | 3 | Action | > Aligned to Strategy and Policies | > Timely and effective |
| | 4 | Systems | > Allows tracking and reporting | > Non-performance flagged promptly |
| | 5 | Accountability | > Understood by all | > Performance assessed |

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**Return to Client Acceptance and Retention Phase**

**Effective two-way communication with all stakeholders**

Chartered Accountants

NUMBER ONE IN NUMBERS

The Institute of Internal Auditors

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September 30, 2011

Office of Secretary
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1666 K Street, NW
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Response e-mailed to www.pcaobus.org

RE: Response to the Public Company Accounting Oversight Board (PCAOB) – Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (Ref Docket matter No. 34)

Dear Sir/Madam:

The Institute of Internal Auditors (IIA) appreciates the opportunity to respond to the PCAOB's proposed Concept Release on possible revisions to PCAOB standards related to reports on audited financial statements and related amendments to PCAOB standards. We applaud the PCAOB's effort in soliciting feedback from diversified stakeholders. Our comments are based on a thorough analysis and discussion, utilizing a core team of governance, compliance and audit experts who serve on The IIA's Professional Issues Committee. These individuals consist of Certified Internal Auditors, Certified Public Accountants, Chartered Accountants, audit executives and consultants who have worked in both public accounting and management positions in small, medium and large multinational companies.

The following are our principal comments regarding the Concept Release on possible revisions to PCAOB standards related to reports on audited financial statements and related amendments to PCAOB standards. Detailed responses to the questions posed are summarized in Attachment A.

1. The board should undertake a standard-setting initiative to consider improvements to the auditor's reporting model. The objective of continually improving relevance and usefulness of information provided to users of financial statements together with the auditor's report is worthy and appropriate. This initiative should address the information gap and expectation gaps in auditor reporting identified on surveys and outreach activities.
2. However, the solution should not cause the auditor to assume the responsibilities of management nor the audit committee by determining how much of the entity's competitively sensitive and not-yet public information should be disclosed. The financial statement auditors should remain independent and objective while pursuing assurance responsibilities and not be put in a position to make determinations on the timing of disclosure of certain information before management and the audit committee deem it appropriate.
3. An alternative which should be evaluated by the board and promulgated by others (e.g., SEC), is utilization of the entity's internal audit activity in a role supporting management and the audit committee in carrying out their responsibilities for disclosing to shareholders relevant information.

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The IIA is well-equipped to support those PCAOB projects that are related to the core competencies of internal auditing: governance, risk management and control. We value the opportunities to collaborate, share, contribute and learn. We welcome further discussion on any of these recommendations and offer our assistance in the continued development of these projects.

Best Regards,

Richard F. Chambers

Richard F. Chambers, CIA, CGAP, CCSA
President and Chief Executive Officer

**About The Institute of Internal Auditors**
The IIA is the global voice, acknowledged leader, principal educator, and recognized authority of the internal audit profession and maintains the International Standards for the Professional Practice of Internal Auditing (Standards). These principles-based standards are recognized globally and are available in 29 languages. The IIA represents more than 170,000 members across the globe and has 103 institutes in 165 countries that serve members at the local level.

**Attachment A**

**"Concept Release on possible revisions to PCAOB Standards related to reports on audited financial statements"**

Questions 1 through 32:

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

   **a. Should the board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

The board should undertake this initiative. The objective of continually improving relevance and usefulness of information provided to users of financial statements together with the auditor's report is worthy and appropriate. This initiative should address the information gap and expectation gaps in auditor reporting identified on surveys and outreach activities.

However, the solution should not cause the auditor to assume the responsibilities of management nor the audit committee by determining how much of the entity's competitively sensitive and not-yet public information should be disclosed. The financial statement auditors should remain independent, and **objective** while pursuing assurance responsibilities and not be put in a position to make determinations on the timing of disclosure of certain information before management and the audit committee deem it appropriate.

An alternative which should be evaluated by the board (and promulgated by others, e.g. SEC) is utilization of the entity's internal audit activity in a role supporting management and the audit committee in carrying out their responsibilities for disclosing relevant information to shareholders. It might also be appropriate to expand the internal audit activities' responsibility for providing assurance on other information contained within financial filings such as MD&A, so long as these expectations do not distract from other internal audit responsibilities. This would occur at the request of the audit committee to support expanded expectations for evaluation of disclosures and also at the request of management and the financial statement auditors, through the audit committee. As described later in our response, the board should consider the implications of more effective use of and higher expectations by the audit committee of the internal audit activity, including consideration of and coordination with financial statement audit needs. The internal audit activity could report to the audit committee on certain matters, in some cases in lieu of the financial statement auditor. These could include a) testing controls (financial reporting, operational), b) assurance provided on MD&A or other specified information (possibly in lieu of the financial statement auditor, c) Information bearing on the independence and objectivity of the internal audit activity, d) Earnings releases (in lieu of financial statement auditor).

**b. <u>In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?</u>**

We agree there is an apparent expectation gap (the difference between what users expect from the financial statement auditor and the audit and the reality of what an audit is); efforts should be taken to reduce or close the gap. There is of course a question of whose responsibility it is.

The gap can be closed by either side moving towards the other, or movement of both. While it is expected that users of financial statements are intelligent, knowledgeable people, who bear personal responsibility to be financially literate, it is reasonable to require the entity, through its audit committee, to more clearly disclose key processes, estimates, judgments, governance, and oversight for financial reporting. With respect to the disclosures of the independent financial statement auditor, we support disclosure of additional details of the nature of an audit, including the auditor‘s ability to detect financial statement fraud, the auditor‘s responsibilities relating to fraud under existing professional standards, and inherent limitations of a financial statement audit. The information should be communicated in plain English, free of technical jargon. This information could be placed as a disclosure in filings; the auditor’s report could reference that information.

It is extremely important that information that is deemed “more relevant and useful” be clearly defined by investors so the audit committee can execute the responsibility of accurately and completely disclosing such relevant and useful information. The audit committee and management should decide what information to disclose in the financial statements and/or related attachments, potentially including information which was disclosed by the auditor to management and the audit committee.

Potential inclusion of subjective information by an auditor to the public is not appropriate. The financial statement auditor role is differentiated from the current typical role of and disclosures by the internal audit activity which, while retaining objectivity, should share subjective judgments with management and the board, and as appropriate, unframed personal views with its constituents. The sharing of such subjective information in an external environment is inappropriate, because the users do not possess the same contextual knowledge, lack the ability to discuss information in a two-way dialogue to gain clarity, and do not know the competency and reliability of the person(s) expressing the judgments.

Lastly, there must be a consideration of costs and benefits related to levels of assurance. It would be reasonable to expect that if additional disclosures were required of the independent auditor, audit fees would surely rise. The board should consider who is paying the costs and who is deriving the benefits; there are many users of financial statements and related information who may seek to influence the board's views on assurance; some of those users may not be concerned with or consider the costs of such assurance.

**c. <u>Should the board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?</u>**

The board should consider whether this expanded role can be filled via an entity's own internal audit activity. Specifically, through direction of expected areas of actions, including information contained within financial presentations, such as (MD&A). While we believe there could be benefit in expanding the auditor's report as noted in our response in "b" above, the independent auditor's role and level of assurance related to information contained in a filing, but outside the financial statements, should be based upon what investors value and require, the source and level of assurance desired should carefully consider costs and benefits of such assurance. Auditors cannot be expected to determine what is important to the wide variety of users, in varying circumstances; therefore, standardization of what is reported by the financial statement auditor is prudent.

The incremental value of added assurance through the auditor's reporting on other information provided by management versus the level of assurance which exists today through the auditor's association with such information should be decided by investors or the audit committees representing investors, based on cost benefit analysis and determination of which elements warrant additional levels of assurance. Today, the auditor is required to read such information, including MD&A, and we recommend the auditor include a paragraph in the auditor's report that the auditor has read [auditor should note the specific areas] and found such information and disclosures to be materially consistent with information observed as part of the audit of the financial statements.

**2. <u>The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."</u>**

**a. <u>Should the auditor's report retain the pass/fail model? If so, why?</u>**

The current model should be retained. Without substantial additional guidance to both auditors and users of the auditor's report, additional information will exhibit subjectivity and create confusion.

**b. <u>If not, why not, and what changes are needed?</u>**

**c. <u>If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.</u>**

If the board believes there is insufficient understanding of the purpose and procedures of an audit, an explanation of an audit, including its purpose, procedures, techniques, and limitations, could be included in the auditor's report. This could be accomplished in a number of ways, including a reference in the auditor's report to a description elsewhere in the document containing the auditor's report. Also, users would benefit from an additional paragraph to the financial statement auditor's report describing their responsibility with respect to other information included in the document with the financial statement filing, their ability to detect financial statement fraud, their responsibilities relating to fraud under existing professional standards, and inherent limitations of an financial statement audit and a statement that the auditor has read [auditor should note the specific areas] and found such information and disclosures to be materially consistent with information the auditor observed as part of the financial statement audit.

**3. <u>Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.</u>**

We agree that the audit committee should have responsibility for ensuring the extent and timing of information disclosed publically. The shareholders have chosen an audit committee to oversee the reporting processes for disclosure of financial and operating results of the entity; they should continue to have the responsibility to see that accurate and complete disclosure of such relevant and useful information is achieved. The audit committee, together with full access to management which it has hired, has the greatest quantity of contemporaneous information, the greatest resources to analyze, validate, and seek clarity on such information and are closest to the investors who desire this information.

**4. <u>Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were</u>**

**made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

Changes necessary would be dependent upon the board's ultimate conclusions after considering public response to this exposure draft. The changes which seem evident at this point include reference to the nature of an audit and its limitations, financial statement auditor's ability to detect fraud and responsibilities relating to fraud under existing professional standards, along with a paragraph to describe the auditor's responsibilities for "other" information included with the financial statements.

**5. Should the board consider an AD&A as an alternative for providing additional information in the auditor's report?**

No.

**a. If you support an AD&A as an alternative, provide an explanation as to why.**

We do not support this.

**b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**

We do not support AD&A.

**c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**

**d. If you do not support an AD&A as an alternative, explain why.**

The auditor should retain the role of auditing financial statements and not be in the position where they create or are compelled to provide proprietary entity information. This could put independent auditors in direct contradiction of ethics and independence requirements (one because the auditor is not allowed to disclose confidential information and the other because the auditor should not be the source of information). The AD&A appears overly subjective, would likely confuse rather than inform readers and runs the risk of becoming boilerplate or watered down which would create yet a new and larger expectation gap. Much of the information suggested in the exposure draft (ED) discussion is already required of management in public filings (e.g., risk factors and processes to mitigate risks). If management does not provide appropriate information, the audit committee should require management to fill the void. We acknowledge that the auditor should comment if there is something materially missing or misstated.

If an AD&A was required by the board, how would the auditor know where to start and stop its commentary? What is the basis for including a comment on one item and not another? What rights to share entity information does the auditor have or need to acquire? What liability would the auditor be assuming, as the auditor could disclose information harmful to the entity (competitively or otherwise)? The auditor would likely encounter criticism for either saying too little and saying too much. Such an AD&A would put auditors in the role of formulating public reports and could, over time change the users' view of an auditor's objectivity, particularly if the auditor started to disclose in lieu of management. If all the auditor's views are open to public disclosure, information flows would be impacted. And of course there are cost considerations, both the immediate cost of extra time and effort to create, review and audit the information, but also the risk of litigation to the auditor and related costs would need to be built into ongoing fees. Lastly, haven't there been complaints by some users of public filings that there is too much information?

Of the four alternatives presented, some are good suggestions, while others would be problematic. Specifically:

- Auditor's Discussion and Analysis - We recommend limiting this to auditor's procedures to address the expectations gap of what an audit is and is not. It should not be used to disclose any information that management and its board has determined not to be appropriate for disclosure.
- Required and expanded use of emphasis paragraphs - We support this, with caution, it should be limited to include reference to the nature of an audit and its limitations, along with a paragraph to describe the auditor's responsibility with "other" information included together with the financial statements.
- Auditor assurance on other information outside the financial statements - We recommend limiting this to the procedures which auditors perform in conjunction with forming their opinion on the financial statements, and not expand any further. Requiring auditors to report on additional information would likely not be cost justified; it will likely increase audit fees and add additional complexity that in the end, might not provide improved relevant, useful information to investors.
- Clarification of language in the standard auditor's report - We support clarifying the terminology used to better explain to users the nature and extent of the procedures performed.

**e. <u>Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?</u>**

The auditor should have clear and robust communications with the audit committee on numerous matters; the audit committee is responsible for disclosing appropriate information that may be important to users of financial statements.

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

As stated previously, the auditor should not prepare an AD&A. The items listed could be incorporated into other expanded commentary.

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

Management, together with the audit committee should disclose areas of governance, judgments and estimates as they should know best the facts, risks and evaluations which were considered. As exists today, the auditor is required to read such disclosures, including MD&A; it would make sense to include a paragraph in the auditor’s report that the auditor has read [add specific areas] and found such information and disclosures to be materially consistent with information the auditor learned as part of his or her audit of the financial statements.

8. **Should a standard format be required for an AD&A? Why or why not?**

An AD&A should not be required.

9. **Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

Much of the information which the board is suggesting to be included in an AD&A is already required of management in public filings (e.g. risk factors and processes to mitigate risks). The audit committee also acknowledges their agreement, and the financial statement auditor associated with that information is required to comment if there is something materially missing or misstated.

**10. <u>How can boilerplate language be avoided in an AD&A while providing consistency among such reports?</u>**

Boilerplate in AD&A is best avoided by not requiring an AD&A. Given the potentially lengthy disclosures, which are likely to be confusing to users, the substantial risk to the auditor for such disclosures and the cost to entities being audited, it is likely many parties will ultimately influence reporting to a standard or boilerplate language; that is, boilerplate is likely unavoidable within current environment.

**11. <u>What are the potential benefits and shortcomings of implementing an AD&A?</u>**

Many have been mentioned in responses #5 - #10.

**12. <u>What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?</u>**

Because this potential exists and would be difficult to avoid, requiring an AD&A could force management and the auditor to work more closely together on their mutually exclusive and joint presentations, potentially impacting perceptions of auditor objectivity over time.

An AD&A could in many cases improve an entity's disclosures, however in a few cases, over time; it could instill passivity among management, under the presumption that whatever the entity does not cover the auditor will.

**13. <u>Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?</u>**

Reporting requirements are designed to require an entity to disclose important information, based upon what the various and varied users of the financial information require for making prudent investment decisions. Asking the auditor to prioritize which risks are most important requires judgment; akin to "beauty is the eye of the beholder". That is, no one other than a user can determine which areas suit the users' needs. That said, it may be useful for auditors to make greater use of additional paragraphs and draw a user's attention to specific management disclosures. The use of additional paragraphs should occur only in defined, prescribed circumstances, including where management's disclosure is deemed by the auditor to be inadequate.

**14. <u>Should the board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?</u>**

Under certain defined conditions, yes. For example, if the entity is a part of a larger enterprise, then a paragraph should state such. Another example would be if GAAP surrounding an area material to the entity is undefined, evolving or there are significant divergence in practice, those areas should be highlighted by management and the auditor's report should refer to them.

**a. <u>If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.</u>**

In the limited defined circumstances, it would help users focus their attention and provides a view towards what the auditor also considers important in a more defined and less confusing format than an AD&A.

**b. <u>If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.</u>**

N/A

**15. <u>What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?</u>**

In addition to areas already requiring mention (e.g., going concern), the items which would warrant specific auditor mention include the following (in each case, the auditor's report should refer to management's disclosure which would be expected to be adequate unless otherwise noted by the auditor):

1. If the entity is a part of a larger enterprise
2. If GAAP in an area material to the entity is undefined, evolving or there are significant divergences in practice.
3. Areas of significant leverage or exposure (derivatives, off balance sheet commitments, contingencies, etc.) which are not included in the gross figures displayed on the balance sheet.
4. Disclosures by the entity is deemed by the auditor to be inadequate
5. Material, unusual transactions impacting the financial statements.

**16. <u>What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?</u>**

The auditor's report should be limited to a) a few specific defined circumstances and b) reference to management's disclosure which would be deemed adequate unless otherwise noted by the auditor.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

Boilerplate is not necessarily a negative. Consistent format may facilitate user review; when the boilerplate form changes, that in itself may be an indication of an area of interest.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

Benefits include directing users' focus and require the financial statement auditor to emphasize significant matters. Shortcomings include the risks that a) the auditor is expected to know how each user will evaluate information presented, and each user's purpose in reading the financial information, b) users "assume" other information is not as important, and thus, a new expectation gap could form and litigation could increase if using hindsight about something not initially highlighted which ultimately turned significant.

**19. Should the board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

Yes, if investors believe the cost benefit analysis justifies auditor assurance on elements reported by management in addition to the financial statements. However, we believe it is unlikely that the cost justifies the benefits. However, a better and arguably more cost effective alternative might be to consider the use of an entity's internal audit activity to provide assurance to the audit committee or management where they deem appropriate.

> **a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why. Subject to the caveat and suggestion above, assurance over other important components of information provided by management is a form of assurance commonly provided by the internal audit activity and a reasonable extension of financial statement auditors, to the extent it is cost justified and can be related to the financial statements and information considered in connection with the audit of the financial statements.**
>
> **b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**

The incremental value of direct assurance through a financial statement auditor's reporting on components of information provided by management versus the level of assurance which exists today through the auditor's association with such information should be decided by investors or the audit committees representing investors, based on cost benefit analysis, considering which components warrant direct assurance by financial statement auditors.

Earnings releases seem to fall in a different category as they are generally not attached to audited financial statements. Requiring financial statement auditor assurance on quarterly, or other periodic releases, would increase costs dramatically, pending analysis of the level of assurance required; this may be an area where use of the entity's internal audit activity in a role supporting the audit committee would be beneficial.

**c. <u>What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?</u>**

See answers "a" and "b" above together with responses to earlier questions about auditors report.

**d. <u>If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?</u>**

**e. <u>Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?</u>**

While we do not believe direct reporting or assurance by the financial statement auditor over MD&A is appropriate, there is a general presumption that knowledge of auditor oversight will encourage an appropriate level of scrutiny by preparers of such information.

**f. <u>Are the requirements in the board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered? The cost of AT 701 form of assurance may exceed the benefits. We suggest a compromise position. As exists today, the auditor are required to read such disclosures, including MD&A, we suggest the auditor include a paragraph in the auditor's report that the auditor has read [add specific areas] and found such information and disclosures to be materially consistent with information the auditor learned as part of the audit of the financial statements. That is, have the auditor's report disclose what is essentially in effect today.</u>**

**g. <u>If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.</u>**

The cost of AT 701 form of assurance may exceed the benefits. We suggest a compromise position. As exists today, the auditor would be required to read such disclosures, including MD&A, and we suggest the auditor include a paragraph in the auditor's report that the auditor has read [add specific areas] and found such information and disclosures to be materially consistent with information the auditor learned as part of the audit of the financial statements. For areas where additional assurance is requested by shareholders, we suggest that management disclose its processes ensuring the reliability of such information and the internal audit activity could provide "assurance" to the audit committee, if deemed materially important.

**20. <u>What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?</u>**

Potential shortcomings include costs outweighing benefits, usurping responsibilities of management, internal audit and audit committee, and creating inconsistencies in use of auditors among reporting registrants.

**21. <u>The concept release presents suggestions on how to clarify the auditor's report in the following areas:</u>**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. <u>Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?</u>**

If the board believes user interests are not being served, or an expectation gap is a real issue, a clarification of all of the items is indeed appropriate. To achieve the goals of providing relevant, pertinent, user-friendly information and fuller disclosure, the auditor's report should include reference to a place where the terms are defined and clarifications are more fully explained.

**b. <u>Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.</u>**

As described in "a" above, numerous objectives would be met simultaneously.

**c. <u>What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?</u>**

A general explanation of the audit process would likely aid some readers, from considerations of risk, planning, execution (including some key techniques used), supervision and review of testing through to conclusion.

**d. <u>What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?</u>**

The implications to the scope of the audit, given our view of appropriate changes would be minimal.

**22. <u>What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?</u>**

Benefit is that users would have additional information more readily available. The major shortcoming, if the clarifications are provided within the report itself, is that the report would become very lengthy and other, arguably more crucial information could be lost in the morass.

Questions Related to all Alternatives:

**23. <u>This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?</u>**

If the board believes users interests are not being served, or expectation and information gaps are real issues, as discussed in more detail above, the auditor’s report should include a) additional explanatory information when warranted, b) state the auditor’s responsibility with respect to “other” information included with the financial statements (either as is current practice reading for material inconsistencies or omissions, or a higher level of assurance similar to AT 701, if investors and the audit committee believe such assurance is valuable) and c) reference to clarifications of various terms and concepts used in the auditor’s report and a description of an audit.

**24. <u>Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?</u>**

See answer to 23 above.

**25. <u>What alternatives not mentioned in this concept release should the board consider?</u>**

The board should consider use of the internal audit activity to support management and the audit committee in their responsibilities, as appropriate. Also, audit committee commentary to describe its governance process and as necessary information to supplement management's comments.

**26. <u>Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the board consider in developing such auditor reporting framework and related criteria for each of the alternatives?</u>**

If the board decides to require AD&A or other forms of reporting by the auditor, the board needs to carefully consider how to support the auditors' objectivity, avoid inconsistencies in disclosures provided by management and auditor, avoid inconsistencies among auditors, address potential perceptions of equivocation of the auditor's ultimate opinion, along with the costs and benefits to investors, including the potential for "information overload".

**27. <u>Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the board take to mitigate the risk of this perception?</u>**

Adoption by the board of all suggestions would make for a very lengthy auditor's report, one which likely would exacerbate the expectation and potentially the information gap, if indeed new information is to be provided by the financial statement auditor. As discussed in more detail above, if the board believes users interests are not being served, or expectation and information gaps are real current issues, the auditor's report should include a) additional explanatory information when warranted, b) state the auditor's responsibility with respect to "other" information included with the financial statements (either as is current practice reading for material inconsistencies or omissions, or a higher level of assurance similar to AT 701, if investors and the audit committee believe such assurance is valuable) and c) reference to clarifications of various terms and concepts used in the auditor's report and a description of an audit.

**28. <u>Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?</u>**

As discussed in more detail above, the auditor's report should state the auditor's responsibility with respect to "other" information included with the financial statements (either as is current practice reading for material inconsistencies or omissions, or a higher level of assurance similar to AT 701, if investors and the audit committee believe such assurance is valuable), the auditor‘s ability to detect financial statement fraud, the auditor‘s responsibilities relating to fraud under existing professional standards, and inherent limitations of an financial statement audit and provide a reference to clarifications of various terms and concepts used in the auditor’s report and a description of an audit.

**29. <u>What effect would the various alternatives have on audit quality? What is the basis for your view?</u>**

Audit quality is a key attribute which likely transcends the changes noted and suggested herein. Quality of reporting and financial statement audits could be enhanced through more effective use of and additional expectations by the audit committee of the internal audit activity, including consideration of and coordination with financial statement audit needs.

The AD&A and causing the auditor to be the original source of information could distract from the mission of a quality financial statement audit. The attention of key personnel could be diverted to creating, collecting, and writing their own disclosures. Crafting language which is clear, concise and meets the needs of various constituencies, determining the suitability for public consumption, while balancing audit risk will be time consuming and does not necessarily utilize the same skill set as auditing skills. We suggest keeping the financial statement auditor and management focused on their distinct roles and what they are good at: the auditors ”audit” and management creates disclosures.

**30. <u>Should changes to the auditor's reporting model considered by the board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.</u>**

The system benefits from consistency; there should be good reasons to allow for differences among types of companies, industries or other designations.

**31. <u>This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.</u>**

**a. <u>Are any of these considerations more important than others? If so, which ones and why?</u>**

All these considerations are relevant, which ones are more important are situational or contextually-based; that is, they will vary in importance in each individual circumstance.

**b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

As discussed in more detail above, the costs would appear to outweigh the benefits, in part because the benefits have not been well-defined. However, more appropriate cost benefit balance can be gained with more effective use of and higher expectations by the audit committee of the internal audit activity, including consideration of and coordination with financial statement audit needs. We caution that additional financial reporting matters should not distract from the internal audit activities' responsibilities.

Changes to the financial statement auditor's report should be limited to a) additional explanatory information when warranted, b) state the auditor's responsibility with respect to other information included with the financial statements (either as is current practice reading for material inconsistencies or omissions, or a higher level of assurance similar to AT 701, if investors and the audit committee believe such assurance is valuable), the auditor's ability to detect financial statement fraud, the auditor's responsibilities relating to fraud under existing professional standards, and inherent limitations of an financial statement audit, and c) reference to clarifications of various terms and concepts used in the auditor's report and a description of an audit.

**c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**

Please see response to item d below.

**d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

An entity's governance structure warrants further consideration and potential changes to regulations. These would include:

1. The audit committee - We suggest disclosure of its governance and responsibilities in documents which include management disclosures, interactions between the audit committee and financial statement auditor, and guidance to audit committees as to consideration of additional audit committee disclosures, and possibly of its interactions surrounding key

areas of discussion with management and with auditors, both financial statement auditors and the entity's internal audit activity.

2. Internal Audit - The board should consider the implications more effective use of and higher expectations by the audit committee of the internal audit activity, including consideration of and coordination with financial statement audit needs. The internal audit activity could report to the audit committee on certain matters, in some cases in lieu of the financial statement auditor. These could include a) testing controls (financial reporting, operational), b) assurance provided on MD&A or other specified information (possibly in lieu of the financial statement auditor, c) Information bearing on the independence and objectivity of the internal audit activity, d) Earnings releases (in lieu of financial statement auditor).

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

In general there will be greater confusion and relationships could be strained or deteriorate when roles and responsibilities are not clear and/or those roles overlap. Many of the proposals herein would exacerbate tensions since the financial statement auditor could end up with responsibilities which overlap those of management and the audit committee, in addition to maintaining its financial statement audit responsibilities. Additionally, the board should ensure whatever actions are taken promote clear, open dialogue with auditors, to avoid degradation of audit quality.

ima
The Association for
Accountants and
Financial Professionals
in Business

September 22, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket #34

Dear Sir:

The Financial Reporting and Small Business Financial and Regulatory Affairs Committees of the Institute of Management Accountants (the Committees) are pleased to provide their views on the Concept Release on "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" ("the Release"). Overall, the Committees do not believe that major modifications to the auditor's reporting model, as contemplated in the Release, will improve investors' understanding of the results of the audit in a manner that is actionable and material to their investment decisions. More importantly, we are concerned that the time and effort devoted to fulfilling the proposed new requirements may distract attention from the core deliverables of the audit and divert valuable resources of audit firms and audit committees. We ask the Board to be vigilant in preserving the readiness and capability of these important functions and that any improvements be focused on the core mission of ensuring the highest quality audit possible.

The FRC includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts.[1] The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. The SBFRC advocates on behalf of small business entities (both public and private) to ensure that financial standards, laws, rules and regulations do not proportionately burden or disadvantage such entities. The advocacy efforts of the SBFRC include reviewing and responding to consultative documents issued by standard-setters, legislators, regulators, and other organizations.

**Overview**

The Committees believe that the overall framework for the auditor reporting model should be consistent with the following principles:

1. The objective on an audit should remain as we know it today. It should provide an opinion on the financial statements, not MD&A or other areas of financial reporting.
2. Auditors should not be disclosing information for which they are not the original source. Rather, they should opine on information provided by management.
3. The auditor's report should provide transparency for investors as to what the audit provides for in terms of assurance (what it is) as well as what it does not address (what it is not).
4. Auditor involvement and attestation should be limited to areas for which they have the appropriate expertise.

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[1] Additional information about the IMA Financial Reporting Committee can be found at www.imafrc.org

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Montvale, NJ 07645
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We believe that the potential expansion of auditor reporting into some of the areas identified in the Release violates certain of these principles. We further believe that if these ideas are pursued they should not be folded in as part of the audit.

The Concept Release states that its objective is to increase the transparency and relevance of the auditor's reporting model while not compromising audit quality. It is our hope that the Board will be persuaded that audit quality may, in fact, be adversely affected by the diversion of auditor and audit committee focus and attention if certain of the more far-reaching and fundamental changes are carried forward to a final rule. We strongly encourage the Board to refine its objective in a manner that is more consistent with the true purpose of the auditor's opinion: providing investors with comfort that they can rely on the financial information provided in financial reports prepared by management in making investment decisions. In our view, the auditor's opinion regarding the resolution of the annual audit is a matter that requires an unambiguous and unqualified response. This objective is achieved with today's version of the auditor's opinion. If there is additional information that helps investors to better understand the scope of the audit and the meaning and limitations of the opinion, we would support these efforts. Beyond that, we have concerns that expanding the auditor's report to provide other information (e.g., the quality of management's choices of accounting policies) or redefining the purpose of the audit opinion may be potentially harmful to the core audit processes.

It is understandable that in the wake of the recent financial crisis, investors would desire improvements in financial reporting that would provide greater transparency, in a timely manner, into the depth and breadth of the impact of the crisis on the companies and the likely effect on their future results. However, the best source of this information is management not the auditor. If more transparency is desired, we believe that enhanced reporting by management in MD&A is the most appropriate and effective avenue to achieve this objective, as financial statements report on the effect of historical events and conditions at a point in time. Absent a situation that gives rise to the need for a going concern opinion, we do not believe the auditor's report should address these matters. If the Board decides further reporting is necessary, we believe it is important not to diminish the value of the core audit opinion by diffusing its focus and providing potentially non-comparable and subjective views on a wide variety of matters.

The Committees believe that it also is important to maintain a perspective on the relative ability of auditors and audit committees to provide the most relevant information in meeting investor needs for this kind of information. Corporate management has the requisite resources and regular, direct involvement in the core quarterly and annual processes to provide the insights that investors desire about their financial results and the difficult judgments and uncertain estimates contained therein. While the role of the auditors and audit committees is substantive and vital, they have less regular, direct involvement in these processes. Accordingly, they can only provide a level of assurance that is commensurate with the amount of time and resources they expend on these activities as compared to management.

We are concerned that the potential changes to the auditor's reporting model put forward in the Release do not fully contemplate these realities and endeavor to provide enhanced reporting through a less appropriate, and therefore less effective, channel.

We recommend that the Board consider more modest changes to the form and content of the auditor's report that would be limited to clarifying, at a summary level, the role of the auditor in planning and performing the audit in order to provide reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

Separately, the SEC may wish to consider whether certain of the transparency concerns of financial statement users raised in the Release should be addressed through enhancements to Management's Discussion & Analysis or other non-financial statement sections of SEC filings.

Our specific concerns related to the proposals in the Release follow.

**Proposals in the Concept Release**

The Release identifies four principal alternatives for improving the Auditor's Report: (1) institute a new component, Auditor's Discussion and Analysis (AD&A); (2) require use of emphasis paragraphs and expand the circumstances in which they would be used; (3) require auditor assurance in other areas of financial reporting; and (4) clarify certain aspects of the auditor's report. Our views on these alternatives follow.

*Auditor's Discussion and Analysis*

The Release describes AD&A as an adaptable report that the auditor can tailor to a company's specific risks, facts, and circumstances. We expect that a custom report of this type would consume a significant amount of time and effort by the audit engagement team and, given the proposed information content, significant review time for the Audit Committee and management. For a reasonably large company, we could envision that a fulsome discussion of the type contemplated in the Release might fill many pages if it were to thoroughly and appropriately provide context and meaning to the matters discussed.

Moreover, given that the proposed form of the AD&A is likely to include commentary on critical accounting policies, significant estimates, professional judgments and other matters that are the responsibility of management, we would envision extensive consultation would be required with the reporting entity's finance and legal personnel at what is likely to be the very peak of the closing cycle. It also is unclear what framework the audit firms and engagement teams would use to reach conclusions about which alternative accounting treatments/disclosures are preferable to those selected by management and the reasons why this is so, given that preferability often is highly dependent on the issuer's specific facts and circumstances. Even if the PCAOB were to develop supplemental guidance to assist auditors in reaching conclusions on these matters, they are inherently highly judgmental and unlikely to be comparable across companies and industries. Accordingly, we question whether they would accomplish the objectives that the Board has set for them.

In addition to concerns about diverting important resources from the audit process, the Committees believe that a new AD&A requirement will be a costly and time-consuming exercise added to an already heavily burdened closing process. We envision the cost of diverted resources and time from senior management, audit committees and audit partners to be very significant and, in our view, would exceed any potential benefit for investors. However, if the Board decides to move forward with its proposal, we strongly encourage further direct outreach to companies. We believe it would be valuable and instructive for the Board to field test this proposal with a range of different size companies to better understand the nature of what would be reported and the impact that this requirement would have on audit and closing processes. To assure a thorough, frank and specific discussion of the ramifications of this concept, we believe the research should be augmented through site visits at large and small companies, in addition to the roundtable discussions the Board has already scheduled.

*Emphasis Paragraphs*

While the Committees understand that emphasis paragraphs are provided today in certain relatively limited circumstances, we do not support making these a requirement and expanding the contemplated circumstances in which they would be included in audit reports.

The Release indicates that emphasis paragraphs would assist investors in identifying the most significant accounting matters and their location within the financial statements. We believe that this is the purpose of MD&A and that further revisions to the requirements in this area should be addressed through modifications to the SEC's rules.

The Release also contemplates that the matters covered in emphasis paragraphs could include detailed explanations of the procedures performed with respect to relevant areas of the audit. Without a thorough understanding of the audit process, we believe these explanations may confuse, rather than enlighten, the readers of the financial statements. If additional and more detailed explanations of audit procedures are warranted, this would seem more appropriate as a part of the communication between the auditor and the audit committee.

*Auditor Assurance on Other Information Outside the Financial Statements*

As discussed previously, the size and scope of auditor involvement in the financial reporting process is a fraction of the resources employed by the reporting entity, which makes it challenging for the auditor to provide additional assurance related to other information outside of the financial statements beyond what is currently required under AU 550, *Other Information in Documents Containing Audited Financial Statements.* In addition, areas such as MD&A involve relatively more analysis and forward looking disclosure, which are not within the normal scope of the audit. In our view, any changes in this area require services that are beyond the scope of the current audit and, accordingly, would require a more significant amount of audit resources than are allocated today which would significantly increase the cost of the audit. When mandatory auditor attestation for MD&A has been proposed in the past, we have heard investors say that such involvement might actually make this section of the report less useful as the auditor might limit or object to the amount of forward looking, judgmental information included by management.[2]

While the Committees do not support extending the auditor's opinion to cover other areas of filed reports (e.g., MD&A, other 10-K information) or earnings releases, we would agree that there may be some benefit to providing investors and other readers of the financial statements a clearer articulation of the extent of the auditor's responsibility for the other information in filed financial reports. This information is currently provided to the audit committee and could be added to the auditor's external report in a manner that would not be disruptive or otherwise detrimental to the audit and closing processes.

We continue to believe that the involvement of auditors should be limited to reading the non-financial statement information and considering whether it is materially consistent with the audited financial statements. We do not believe that requiring auditor assurance related to MD&A or other information outside the financial statements would be cost-beneficial. However, we would not object if the PCAOB required that a brief description be added to the Auditor's report to assist investors in understanding the nature and extent of auditor involvement in reviewing other areas of the reporting entity's filed information.

*Clarification of the Standard Auditor's Report*

We do not object to the proposed clarifications to the standard auditor's report, if these changes enhance the understanding of investors of the important aspects and limitations of the audit. For example, we understand that it could be helpful to further clarify the auditor's responsibilities with regard to detecting

[2] The Committees observe that auditing standards have, for some time, permitted auditor reporting on MD&A and set requirements for doing so and providing guidance on what the report would say. We note that, to the best of our knowledge, there has been little to no market demand for the service.

fraud. We would suggest that the Board conduct further investor outreach to better understand what aspects of the auditing process are not well understood and, based on the results, focus on ways in which those matters could be clarified.

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We believe that it is paramount that if the Board decides to move forward to a rule proposal, it conduct field visits with audit committees of large and small public companies to better understand how the proposed changes would affect their ability to meet their responsibilities to investors and other stakeholders. We strongly believe that any proposed changes that interfere with or otherwise adversely affect the work of auditors and audit committees should not be carried forward to a final rule.

We appreciate the opportunity to provide our views on the Concept Release. We would be pleased to answer any questions the Staff of the PCAOB may have on this response.

Sincerely,

Allan Cohen
Financial Reporting Committee
Institute of Management Accountants

Irvin Andre Alexander, III
Small Business Financial & Regulatory Affairs Committee
Institute of Management Accountants

integrys™

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September 29, 2011

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

**Rulemaking Docket No. 34**

Integrys Energy Group, Inc. respectfully submits our comments on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* No. 2011-003 (the "Release"). Integrys Energy Group is a diversified holding company with six wholly owned regulated utility subsidiaries, wholly owned nonregulated subsidiaries, and a 34% equity ownership interest in an electric transmission company operating in Wisconsin, Michigan, Minnesota, and Illinois.

Integrys Energy Group understands that investors and other financial statement users expressed concerns about the information provided in the auditor's report in light of increasing complexity in preparing and auditing financial statements. Integrys Energy Group appreciates investors and other users' desire for more information on issuers' financial statements from the auditor, particularly given the auditor's independent oversight role. However, Integrys Energy Group has a number of concerns about the alternatives proposed in the Release. The four alternatives proposed in the Release are as follows:

1. Auditor's Discussion and Analysis (AD&A),
2. Required and expanded use of emphasis paragraphs,
3. Auditor assurance on other information outside the financial statements, and
4. Clarification of language in the standard auditor's report.

The Release notes that these alternatives are not mutually exclusive and also asks for respondents to offer other alternatives that may provide further insight into entities' financial statements. Integrys Energy Group offers the following comments for your consideration.

**Auditor's Discussion and Analysis (AD&A)**

The Release discusses that the intent of an AD&A section would be a supplemental narrative report for the auditor to provide a view of the audit and financial statements from an auditor's perspective. The AD&A could include audit risks identified, audit procedures and results, and independence. It could also provide a discussion of the auditor's views regarding the financial statements, management judgments and estimates, accounting policies, difficult or contentious issues, and areas where the auditor believes different accounting or disclosures could have been applied.

The auditor is responsible to conclude on the material correctness of the financials taken as a whole, not to guide investors' views about the risks of the entity and its industry. While the auditor possesses an understanding of the entity's financial statements to conclude for purposes of the audit, the financial statements are management's responsibility. If additional disclosures are necessary, they should be provided by Management. The auditor is not involved in the day-to-day decisions or strategic discussions and, therefore, is unlikely to have a complete understanding of the rationale behind all of management's decisions and judgments. Integrys Energy Group believes that the auditor should not provide subjective information to the public about an entity's financial statements, such as the auditor's opinion of which matters are most important to a user, opinions about which areas involve the highest relative degree of uncertainty, or opinions about which judgments and estimates are the most important or subject to debate. The auditors may provide information as to what they believe are areas of significant audit risk, as this analysis is part of the auditor's responsibilities. However, the reasons for considering an audit risk as "significant" may not have a direct correlation to what would be most material to financial statements or useful to investors.

Integrys Energy Group has a number of concerns with auditors providing subjective information through an AD&A. Subjective information provided by the auditor could result in conflicting statements between management's already very detailed disclosures, which may confuse financial statement users. The information provided by the auditor could also be sensitive information that could impact the company's competitive industry position. If an auditor provides subjective information that negatively impacts the decisions of financial statement users and is later proved to be incorrect, the auditor may be subject to the additional risk of litigation. As a result of the auditor's ability to provide subjective information, the relationship between management, audit committee members, and the auditors may become strained, which may impair the transparency and openness in discussions between these groups.

The increased responsibility for auditors to provide information directly to investors may undermine the role of the Audit Committee. Under existing rules, the auditor is responsible for discussing with Audit Committees the items that would be required in the proposed AD&A. It is then the Audit Committee's responsibility to resolve matters of concern raised by the auditor as well as oversee the financial reporting process on behalf of investors. Requiring auditors to communicate directly to investors through AD&A has the potential to stifle the candid interaction between Audit Committees and auditors encouraged by existing rules. Furthermore, the Audit Committee would be unable to act on these accounting issues prior to the release of AD&A to the public.

Finally, this alternative would increase the scope, and thus, the cost of the audit and could negatively impact the timing of compliance with deadlines for filing audited financial statements. More time and effort would be required to resolve and clarify differences between the AD&A and the other information in the financial statements.

**Required and Expanded Use of Emphasis Paragraphs**

The Release states that a second alternative to enhance the auditor's reporting model would be to mandate the use of emphasis paragraphs. In these paragraphs, the auditor would discuss the most significant matters in the financial statements and identify where they are disclosed, information related to significant management judgments and estimates, areas of significant uncertainty, and other areas the auditor believes are important to emphasize.

Current auditing standards require the auditor to report significant management judgments, estimates, and significant risks with the Audit Committee. If this information is required to be provided in the emphasis paragraphs, the language could become too subjective and could lead to the same concerns Integrys Energy Group has outlined in the AD&A alternative above, leading to strained relationships between the company and the auditors. The PCAOB's existing auditing standards already require use of emphasis paragraphs in certain situations and allow auditors to include them when the auditor would like to discuss a significant matter. Integrys Energy Group believes the existing guidance for the use of emphasis paragraphs in the audit report is sufficient.

**Auditor Assurance on Information Outside the Financial Statements**

The Release states that a third alternative to enhance the auditor's reporting model would be for the auditor to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis, earnings releases, and/or non-GAAP financial information. Integrys Energy Group is concerned that mandating an increase in audit procedures over this type of information may not provide added value to financial statement users and could create delays in filing financial statements. This increase in scope of audit procedures would also add significant costs to the audit.

**Clarification of Language in the Standard Auditor's Report**

The fourth alternative discussed in the Release is the clarification of certain terms in the standard auditor's report and the clarification of auditor responsibilities as it relates to detecting fraud, testing financial statement disclosures, and information provided outside the financial statements. This alternative also requests clarification of management's responsibility for the preparation of financial statements.

Integrys Energy Group does not object to auditors providing the factual information proposed by this alternative. If guidance is issued directing auditors to clarify terms and their responsibilities, Integrys Energy Group recommends amending the standard auditor's opinion by providing standardized language to be used in all auditors' reports. If guidance is issued that is left open for auditors to interpret what should be included in the auditor's report, varying language in reports could confuse financial statement users.

**Conclusion**

Integrys Energy Group appreciates the opportunity to comment on the Release. Integrys Energy Group understands the investment community's desire for additional information about entities' financial statements from an independent auditor's perspective. Integrys Energy Group supports the proposal to clarify the language in the standard auditor's report by providing standardized language to be used by all auditors. However, Integrys Energy Group does not support proposals that allow or require an outside party to present subjective information on an entity's financial statements. Instead, Integrys Energy Group believes that additional disclosures should be provided by management.

Integrys Energy Group would be pleased to discuss its comments in further detail and provide any additional information that the PCAOB may find helpful in addressing these important issues.

Sincerely,

Integrys Energy Group, Inc.

Diane L. Ford

Diane L. Ford
Vice President and Corporate Controller

**Intel Corporation**
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Tel: 408-765-8080
Fax: 408-765-8871

September 30, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34.

Intel appreciates the opportunity to respond to the Public Corporation Accounting Oversight Board (PCAOB) on the concept release regarding possible revisions to PCAOB's standards related to Reports on Audited Financial Statements. We support the PCAOB's objective of increasing the transparency and relevance of the auditor's reporting model to financial statement users. We observe that the PCAOB has received numerous recommendations to help achieve that goal, without compromising audit quality. We are particularly interested in the recommendations set forth by the Center for Audit Quality (CAQ) in their letter dated June 28, 2011 and Financial Executives International's Committee on Corporate Reporting (CCR) in their letter dated September 30, 2011.

We agree with the overarching principles set forth in the CAQ and CCR letters. We firmly believe that any standard-setting initiative should not change the responsibilities of management, the audit committee or the auditors. It is for that reason that we do not support the Auditor's Discussion and Analysis (AD&A) presented in the Concept Release. With respect to auditor attestation related to a company's Management Discussion and Analysis (MD&A), we believe that MD&A requires significant judgment and understanding of our business to produce forward looking business insights. We believe it would be very difficult for the auditor to audit such statements and provide incremental value to financial statement users.

Unlike the CAQ and CCR letters, we believe that the auditor's report and quality of the financial statements could be improved by moving the critical accounting estimates disclosure from MD&A to the notes of the financial statements. Due to the importance of the areas identified as critical accounting estimates to our financial statements, auditors typically spend a significant amount of effort on those areas as part of their audit of the financial statements. Consistent with the auditor's professional responsibilities related to other information containing audited financial statements, auditors review the critical accounting estimate disclosure and provide comments based on their understanding of the areas from the audit as well as the consistency of the disclosures with those included in the financial statements. Auditors also discuss critical accounting estimates with the Audit Committee. While we recognize that auditor's current responsibilities do not require the same level of attention on the critical accounting estimates disclosure as would be required in an audit, given the emphasis in these areas in the audit, we believe incorporating the disclosure into the financial statements would be a cost-effective approach and would eliminate the need for a separate auditor's report. We recognize that this alternative would require action by the Securities and Exchange Commission or the Financial Accounting Standards Board.

Thank you for your consideration of our views. We would be happy to answer any questions that you might have and to assist you in the further development of the Concept Release. If you have any questions, please contact me at (971) 215-6270.

Sincerely,

James Campbell

Vice President, Corporate Controller

INVACARE

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September 8, 2011

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

Dear Sir/Madam:

The Public Company Accounting Oversight Board (PCAOB) is seeking comment on a concept release exploring possible changes to the form and content of the auditor's report on financial statements.

As a general principle, we believe that auditors should not provide information about a company's financial statements directly to investors, because doing so could cause confusion if the information "competes" with what management says. It is the company's responsibility to prepare the financial statements in accordance with GAAP to effectively communicate a company's financial results to investors. An auditor's communication about elements of the company's financial statements would confuse the auditor's role with that of management's.

As such, we are concerned with the potential approach outlined in the concept release associated with an Auditor's Discussion and Analysis (AD&A). In addition to providing competing information, we are concerned about the possible chilling effect that an AD&A might have on an auditor's communications with management and the audit committee. As the PCAOB points out, discussing potentially sensitive matters in an AD&A could create tension, stifle communication and hinder audit quality. We believe that an AD&A will challenge the role/independence of the auditor as this tension may ultimately force companies to align their disclosures with those of the auditors in order to minimize any potential confusion.

We are also concerned with the topics proposed to be included within an AD&A, such as those topics that are included in an auditor's communication with the audit committee. Typically, auditor's communications are prepared with the expectation of a dialogue with the audit committee in which additional context and perspectives will be communicated. We are also concerned about whether readers would have the appropriate context for the information without the benefit of the dialogue that takes place between the auditor and the audit committee. The PCAOB has long recognized the importance of that dialogue, but readers would not be privy to it.

Finally, we believe that a discussion of alternative accounting principles or disclosures in an AD&A presentation would be ill-advised because it could undermine the company's financial statement presentation and disclosures, and potentially confuse readers about the auditor's pass-fail opinion.

INVACARE CORPORATION

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Invacare's investors have not requested this change in any discussion we have had over years of meetings. We respectfully request that the PCAOB not pursue changes to the form and content of the auditor's report on financial statements.

Sincerely,

Robert K. Gudbranson
Senior Vice President and
Chief Financial Officer

RKG/djh

INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

September 30, 2011

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

Re: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*; PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

The Investment Company Institute[1] appreciates the opportunity to respond to the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release). The Concept Release describes four alternatives intended to enhance the information conveyed by auditors to investors in connection with the audit of financial statements. The alternatives under consideration are: 1) a supplement to the auditor's report in which the auditor would provide additional information about the audit and the company's financial statements (Auditor's Discussion and Analysis or AD&A); 2) required and expanded use of emphasis paragraphs in the auditor's report; 3) auditor reporting on information outside the financial statements (*e.g.* MD&A, earnings releases); and 4) clarification of certain concepts included in the auditor's report (*e.g.*, reasonable assurance, duty to detect fraud). Our comments below are from the perspective of SEC registered investment companies as issuers of audited financial statements.

We believe the first three alternatives described in the Concept Release would provide little, if any benefit to investors in SEC registered investment companies. We therefore recommend that the Board exclude audits of such companies from the scope of any rule-making that would implement these alternatives. We support the fourth alternative – clarification of concepts included in the auditor's report – and recommend that, for audits of SEC registered investment companies, the clarification describe the auditor's consideration of the fund's internal control over financial reporting, including controls relating to security valuation, for purposes of

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

designing audit procedures to be performed and expressing an opinion on the financial statements. We elaborate on our recommendations below.

*SEC Registered Investment Companies*

SEC registered investment companies pool investor funds in order to provide shareholders with professional investment management. Typically an investment company sells its capital shares to the public and invests the proceeds entirely in securities consistent with its stated investment objectives and policies.

SEC registered investment companies typically have no employees. Instead, their operations are conducted by various affiliated organizations and independent contractors, such as an investment adviser, administrator, underwriter, custodian, and transfer agent. As is the case for other types of companies, fund directors have oversight responsibility for the management of the fund's business affairs. Overlaying state law duties is the fundamental concept of the Investment Company Act of 1940 (1940 Act) that independent directors serve as watchdogs for the shareholders' interests and provide a check on the adviser and other persons closely affiliated with the fund. The 1940 Act requires that a majority of the fund's board of directors be persons who are entirely independent of the fund's investment adviser and principal underwriter.

The 1940 Act subjects publicly-offered funds to a comprehensive framework of substantive SEC regulation that goes far beyond the other federal securities laws. For example, the 1940 Act contains specific prohibitions against certain transactions between a fund and its investment adviser, underwriter, or other affiliated persons. These provisions are designed to regulate strictly the potential for affiliates to profit from the operations of the fund. In addition, the 1940 Act requires all funds to safeguard their assets by placing them in the hands of a custodian and by providing fidelity bonding of fund officers and others who may access the fund's securities.

SEC registered investment companies prepare their financial statements under the industry-specific reporting model described in FASB ASC 946. The overall objective of investment company financial statements is to present the investment portfolio, results of operations, changes in net assets, and financial highlights from investment activities. SEC registered investment company financial statements must also comply with Article 6 of Regulation S-X.

*Audits of SEC Registered Investment Company Financial Statements*

SEC registered investment company financial statements are inherently less complex than operating company financial statements due to the limited nature of the fund's operations (*i.e.*, issuing shares and investing the proceeds in a portfolio of investment securities). Fund financial statements entail fewer estimates and judgments than operating company financial statements. For example, SEC registered investment companies typically have no employees, employee pension plans, or post employment benefit plans. SEC registered funds typically have no intangibles, goodwill, loan loss reserves, or discontinued operations. Further, management of SEC registered investment companies has fewer choices in the application of accounting policies. For example, all securities are recognized at fair value with the change in fair value reflected in earnings (*i.e.*, no securities are classified as available for sale or held to maturity).

Finally, SEC registered investment companies typically have no items that give rise to other comprehensive income, and they generally are not required to provide a statement of cash flows.[2]

The limited nature of SEC registered investment company operations results in financial statement audits that are less complex than audits of operating company financial statements. For the reasons described above, we believe audits of SEC registered investment companies entail fewer judgments or close calls by auditors. Accordingly, we believe both an AD&A and an emphasis of matter paragraph would provide little, if any benefit to investors in SEC registered funds. In addition, given that investment company financial statements are less complex than operating companies, we are concerned that any requirement to provide an AD&A or emphasis of matter paragraph would quickly evolve into standard language, lengthening auditor reports without providing meaningful information to investors.

We note that the PCAOB has previously recognized that audits of investment companies are less complex than audits of operating companies. The Board and the FASB are funded through accounting support fees paid by public companies based on their market capitalization. Investment companies pay accounting support fees at a rate equal to 10% of the rate paid by operating companies. When adopting the 10% fee rate structure applicable to investment companies the PCAOB stated, "In recognition of the structure of investment companies and the relatively less-complex nature of investment company audits (as compared to operating company audits), investment companies would be assessed at a lower rate."[3]

*Auditor Reporting on Information outside the Financial Statements*

The Concept Release requests comment on requiring auditors to provide assurance on information outside the financial statements, such as MD&A, earnings releases, or non-GAAP information. SEC registered investment companies are exempt from the requirement to provide an MD&A (Item 303 of Regulation S-K) in their shareholder reports and other filings. Also, SEC registered funds do not issue earnings releases and they do not provide non-GAAP information (*e.g.*, earnings from continuing operations).

Open-end investment companies are required to provide a Management's Discussion of Fund Performance (MDFP) in their annual shareholder report.[4] MDFP requires 1) a discussion of the factors that materially affected fund performance, including relevant market conditions and investment strategies; 2) a line graph illustrating the change in value of an investment in the fund over a 10-year period; and 3) average annual total return over 1, 5, and 10 year periods. We are not aware of any concerns by investors that information provided in MDFP is inaccurate or incomplete. We see little benefit associated with auditor assurance on MDFP.

*Clarification of Concepts Included in the Auditor's Opinion*

The final potential enhancement to the auditor reporting model included in the Concept Release would involve clarifying concepts in the existing standard auditor's report. Such

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[2] *See* FASB ASC 230-10-15-4.

[3] *See* PCAOB Release No. 2003-003 (April 18, 2003).

[4] *See* Item 27(b)(7) of SEC Form N-1A. Money market funds are exempt from the requirement to provide MDFP.

enhancements could explain, for example, the meaning of "reasonable assurance," "material misstatement," or describe the auditor's responsibility to detect fraud. We believe such enhancements would provide investors with a better understanding of the audit of the financial statements and the auditor's responsibilities. We recommend that the Board consider an additional enhancement specific to investment companies not contemplated by the Concept Release as described below.

We believe the key audit risks for SEC registered investment companies relate to the existence and valuation of the investment portfolio. The auditor's opinion for a SEC registered investment company is unique in that it must state specifically that securities have been confirmed or physically examined to substantiate their existence.[5] The audit opinion, however, does not directly address the auditor's work with respect to confirming the value of securities at period end, or the auditor's consideration of internal controls relating to security valuation for purposes of planning the audit procedures to be performed.[6]

We believe SEC registered investment companies have well developed internal controls relating to valuation of their investment portfolios and that auditors perform extensive testing of these controls as part of the financial statement audit. We recommend that the Board consider, as part of the contemplated enhancements to the audit opinion, a more fulsome description of the auditor's work pertaining to evaluation of the internal controls for purposes of planning the audit procedures to be performed.[7] For example, the enhancements could require the opinion to indicate that the auditor considered the fund's internal control over financial reporting, including controls relating to valuation of investment securities, as a basis for designing its auditing procedures for the purpose of expressing an opinion on the financial statements.

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[5] *See* Section 30(g) of the 1940 Act and SEC Codification of Financial Reporting Policies, section 404.03a.

[6] SEC registered investment companies are exempt from the audit of internal controls over financial reporting required by Section 404 of the Sarbanes-Oxley Act of 2002.

[7] AU Section 314 requires the auditor to obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures.

If the Board pursues rule-making in this area, it should ensure that the benefits to fund investors exceed the related costs that will be incurred through increased audit fees. Any increase in fees billed to open-end funds will increase fund expenses and diminish fund returns. Finally, any rule-making should recognize that an AD&A or emphasis of matter paragraph may not be appropriate for all types of issuers in all instances. Please contact the undersigned at 202/326-5851 if you have any questions on our comments.

Sincerely,

/s/ Gregory M. Smith

Gregory M. Smith
Director – Operations/
Fund Accounting

cc: Jaime Eichen, Chief Accountant
Division of Investment Management
U.S. Securities and Exchange Commission

JACOBS

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September 29, 2011

Via email to *comments@pcaobus.org*

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

Re: PCAOB Rulemaking Docket Matter No. 34

Ladies & Gentlemen:

Jacobs Engineering Group Inc. ("Jacobs", "we" or "our") is one of the largest technical professional services firms in the United States. With fiscal 2010 revenues of $10 billion, our business focuses exclusively on providing a broad range of technical, professional, and construction services to a large number of industrial, commercial, and governmental clients around the world. Not only are our financial statements used by our shareholders and potential investors, but by our employees, clients, potential clients, bankers, sureties, vendors, suppliers, and other business partners as well. Accordingly, we have a tremendous interest in ensuring that the financial information we provide our stakeholders is accurate and fairly reflects the financial condition, results of operations, and cash flows of our company.

We therefore appreciate the opportunity to respond to Concept Release No. 2011-003 – *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the "Release") and hope that the PCAOB (the "Board") considers our comments in its deliberations.

**Summary**

Although we agree that there are certain practical enhancements that can be made to the auditor's report which the readers of our financial statements may find helpful in understanding better our auditor's scope of work and level of involvement with our financial statements, we believe that many of the alternatives suggested in the Release are unnecessary, impractical, and will not improve the readers' understanding of our financial condition, results of operations or cash flows.

Specifically, we believe that many of the alternatives suggested in the Release:

- Risk misrepresenting to the readers of our financial statements the responsibilities of companies and their auditors with respect to information contained in annual reports that include audited financial statements;
- Will not enhance the users' understanding of our financial statements; and
- Will increase significantly both the internal and external costs of annual audits, particularly in the earlier years after the Release is adopted as auditors struggle to understand the scope of their new responsibilities.

**The Need to Change the Auditor's Reporting Model**

As an issuer, we spend a considerable amount of time and resources responding to questions about our financial statements and the other financial information we file with the U.S. Securities and Exchange Commission. For as far back we can recall, none of the questions received have ever involved our auditor or their insights or perspectives as to the quality of our earnings, alternative accounting treatments for significant transactions, inherent risks in preparing financial statements, or "close calls" (a term that the Board does not define in the Release). Accordingly, we question whether there is a genuine need to change the auditor's reporting model so drastically as to include such things as an "Auditor's Discussion and Analysis" ("ADA") or expand the use of explanatory paragraphs in the auditor's opinion.

Undoubtedly, the Board has spent a lot of time conducting its outreach efforts. However, we feel it is incumbent upon the Board to challenge those outreach participants who are in favor of, for example, an ADA to explain what benefits they would derive from the information an ADA would provide.

"Disclosure overload", whether by an issuer or its auditors, is a real problem for companies such as Jacobs who continue to weather very challenging economic times and who must evaluate the cost of ***all*** new initiatives, including mandatory changes to disclosure requirements, against the benefits any such initiative would provide. The more such proposed changes are justified by loose references to achieving additional "transparency" or to provide additional information that "might be useful to investors", the more concerned we become that regulators may be overreacting to minority elements of the investing community, or are being victimized themselves by investor groups who subscribe to the "more is better" doctrine without pinpointing specific deficiencies within the existing reporting framework.

**The Role of Issuers and Auditors in Disseminating Financial Information**

We do not believe as a matter of principal that auditors should be the original source of information about an entity, its business or its financial condition and results of operations.

A company's financial statements are the result of applying uniform principles of accounting to thousands (or millions) of individual transactions. And although the majority of such transactions are relatively homogeneous in nature, other transactions occur so infrequently or, by their nature, are complex and therefore require management judgment in order to properly value and present them, together with their effects, in a complete set of financial statements. It is the job of the company and its management to ensure that its method of accounting for *all* transactions comply with applicable accounting rules on a consistent basis and fairly reflect the underlying economics of the various transactions.

It is the job of the company's auditor to test the results of the company's application of accounting principles to its transactions, and to challenge, with an attitude of professional skepticism, the assumptions and judgments made by company management. In certain instances where the auditor determines in his professional judgment that it is necessary or otherwise advisable, the auditor independently corroborates various aspects of selected transactions and/or the values assigned to them.

In the end:

- The issuer publishes a set of financial statements it believes fairly presents its financial condition and results of operations in accordance with GAAP. And to provide further assurance that its representations are genuine, the issuer's CEO and CFO certify the fairness, in all material respects, of the company's financial statement; and
- The entity's auditor issues a report on the entity's financial statements indicating whether or not, in the auditor's professional opinion, the financial statements fairly present, in all material respects, the company's financial condition, results of operations, and cash flows.

It is our experience that the above reports satisfy our shareholders' and other stakeholders' needs relating to our financial statements.

An ADA presents a tremendous risk that the auditor will disclose financial information about a company that will not have been disclosed previously by the company. We see potential for this situation to occur within the ADA if the auditor is required to discuss and describe:

- The critical estimates made and assumptions applied in preparing the financial statements;
- Alternative accounting treatments of transactions; and
- Financial statement issues that had a potential material impact to the financial statements but was adjusted or corrected prior to the end of the period.

We also see the adjacent risk that the auditor may feel compelled to disclose information that is confidential or which may put us at a competitive disadvantage. There is also the risk that the users of our financial statements will place undue weight on the matters discussed and described by the auditor – take such information out of context - and fail to appreciate the fact that the financial statements fairly present the entity's financial condition and results of operations, taken as a whole.

Accordingly, we believe an ADA will blur the line of responsibilities between issuers and their auditors. We understand that the concept behind an ADA is rooted in the notion that there would be some benefit by sharing with the users of our financial statements much of the information that our auditor discusses with and discloses to our Audit Committee. However, what will be lost in an ADA is the interactive communication that occurs between our auditor and our Audit Committee. That communication process is iterative and takes place throughout the fiscal period being audited. A simple "report" could not capture nor fairly present the substance of the auditor / audit committee communications.

We found it particularly concerning that the Board cites as a possible benefit of an ADA that, "An AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors" (page 13 of the Release).

At best, this statement demonstrates a fundamental lack of understanding of the relationship we have with our auditor. If our auditor believes that our financial statements or a particular disclosure can be improved, all they need to do is discuss the matter with us. And any suggestion that the management of Jacobs or our Audit Committee would be more receptive to listening to our auditor's perspectives regarding the proper application of GAAP simply because of what the auditor may write in his ADA is erroneous.

**The Users' Understanding of Our Financial Statements Will Not be Enhanced**

We do not see either an ADA or the mandatory use of emphasis paragraphs in the auditor's opinion as significantly enhancing the understanding of our financial statements by users.

The purpose of an audit is to support the auditor's opinion. The specific procedures performed by the auditor are selected based on professional judgment and the auditor's assessment of risk. The auditor may apply statistical sampling techniques to certain categories of transactions and, as we understand, add elements of unpredictability to their procedures by alternating tests, changing scope, or varying testing locations from one year to the next (again, based on auditor judgment).

We do not believe our shareholders in general have the technical expertise to extract meaningful information about the reliability of our financial statements from reading an ADA. Similarly, we believe that an explanatory paragraph embedded in an audit opinion that otherwise expresses an unqualified opinion on the fairness of the related financial statements will be very confusing to our shareholders.

By way of illustration, consider the accounting for asset retirement obligations ("AROs") as prescribed at ASC 410-20. Consider specifically the example the FASB provides at ASC 410-20-55-37. In this example, an entity constructs and places into service an off-shore oil platform that it is legally required to dismantle and remove after ten years. The fair value of the obligation to retire the asset at the end of the ten year period is estimated on the date the platform is placed into service using a present value technique that depends on a number of assumptions including labor costs; allocable overhead costs; the profit margins a contractor would typically demand for removing oil platforms; risk premiums; and rates of inflation.

For ten years, the entity diligently monitors the accuracy of its assumptions - adjusting them as necessary - to ensure that the ARO is fairly presented in its financial statements. And for those ten years, the entity's auditor tests the assumptions used by the entity to value the ARO as part of the work it determined was necessary to be able to opine on the fairness of the entity's financial statements taken as a whole.

Undoubtedly, during the ten years the platform was in operation, the auditor had numerous conversations with management of the entity as well as the entity's audit committee about the ARO and the manner by which it was being estimated. Assuming that for each of those ten years the auditor issued unqualified opinions on the entity's financial statements, one wonders what information the auditor could possibly provide in an ADA or in an explanatory paragraph to his opinion that would enhance or expand the user's understanding of the financial condition, results of operations or cash flows of the entity. The fact is that the entity's GAAP disclosures during those ten years combined with the auditor's standard report on the entity's financial statements is all the information most users need to properly assess the entity's financial condition and results of operations.

We believe ADAs will likely evolve to be long, tedious documents containing boilerplate language that will never provide meaningful insights to shareholders or other users of our financial statements. And throughout such evolutionary journey, issuers will incur costs that are purely additive without enhancing or providing decision-useful information to the users of our financial statements. We also believe that explanatory paragraphs will not provide meaningful information to the users of our financial statements who will very likely misinterpret whatever nuance the auditor is attempting to convey. To the extent such paragraphs are used to explain in more detail the audit procedures employed over certain areas of the audit, such information will be lost among our shareholders outside of the context of the purpose of an audit, which is to express an opinion as to the fairness of the financial statements *taken as a whole*.

**Increased Cost of Audits**

We believe that many of the changes to the auditor's reporting model proposed in the Release will result in increased audit effort, resulting in higher costs to issuers. These costs will manifest themselves in higher fees to our outside auditor as well as increased internal costs as we coordinate disclosures with our auditor. As mentioned above, we continue to weather very challenging economic times and are very concerned that the changes described in the Release will increase the cost of audits in the future.

**Practical Changes to the Reporting Model**

Although not in favor of an ADA or the mandatory use of explanatory paragraphs, we believe the following are changes to the standard auditor's report are worthy of consideration:

- Disclosing the auditor's responsibilities to ensure that the financial statements are not materially misstated, regardless of whether the misstatement is due to error or fraud;
- Disclosing the auditor's responsibilities for information contained in the filing but residing outside the financial statements; and,
- Discussing the necessity of using professional judgment in (i) assessing risk; (ii) determining the extent and level of testing conducted; and (iii) the extent of reliance on the issuer's system of internal control.

In addition, we believe the Board might consider expanding the report of the Audit Committee to include a description of those areas of audit significance that was communicated to them by their auditor. This method of disclosure will preserve the integrity of the relationship between audit committees and their auditors while reinforcing the concept that material disclosures about an entity's business, financial condition and results of operations should rest with the issuer and its audit committee.

**Conclusions**

Although modest changes to the auditor's standard report (as described above) will increase a reader's grasp of the audit process, we believe that requiring the issuance of ADAs or the use of explanatory paragraphs will not enhance or improve the user's understanding of that process. In fact, we believe such changes will confuse users about the relationship between the issuer and the auditor and will blur the lines of responsibilities between the parties. The preparation of an ADA in particular has the potential of significantly increasing the costs of an audit as both the auditor and the issuer would have to work together to ensure that statements made in the ADA are properly supported and do not divulge confidential information.

Lastly, we encourage the Board to consider strong safe harbor provisions in the any final rule that includes the requirement for either an ADA or explanatory paragraphs in audit provisions that will protect issuers and auditors from shareholder litigation.

* * * * *

Thank you for the opportunity to provide comments on the Release.

Very truly yours,

Joseph R. Bronson
Chair
Audit Committee of the
Board of Directors

John W. Prosser, Jr.
Executive Vice President
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September 30, 2011

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

**PCAOB Rulemaking Docket Matter No. 034**
***Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards***

Dear Mr. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" (Concept Release).

The Board has requested public comment on its Concept Release that discusses several alternatives for changing the auditor's reporting model in response to concerns from investors and other financial statement users. The objective of these alternatives is to increase the transparency of the auditor's reporting model and its relevance to financial statement users. Such alternatives include (1) a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements, (2) required and expanded use of emphasis paragraphs in the auditor's report, (3) auditor assurance on other information presented outside the financial statements, and (4) clarification of certain language in the auditor's report. In addition, the Board requested the consideration of other alternatives not specifically presented within the Concept Release.

## Overview

We support the Board's objectives reflected in the Concept Release to improve the auditor's reporting model and increase its relevance to financial statement users, and we encourage the Board to undertake a standard-setting initiative to consider improvements to the auditor's reporting model that both serve the interests of investors and provide benefits that outweigh

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their costs. The June 28, 2011 Center for Audit Quality (CAQ) letter to the Board[1], described several overarching principles for consideration when developing possible areas for further evaluation. These principles, with which we agree, are as follows:

- Auditors should not be an original source of disclosure about the entity; management's responsibility should be preserved in this regard. A fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.

- Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.

- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.

- Any changes to the auditor's reporting model should add value and not lead to investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.

- Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however it is important that auditor communications provide objective information about these matters.

In accordance with those principles, we believe the existing relationship between the auditor, audit committee and management is appropriate and should be retained, and that management should continue to be the original source of information about the company's financial position, results of operations and cash flows and related disclosure. Additionally, as further articulated below, we believe that the audit committee is in the best position to provide oversight of the auditor's risk assessment and audit response relative to the most significant matters affecting the financial statements and the audit. While the performance of audit procedures enables an independent auditor to attest to the fair presentation of an entity's financial statements, management who is tasked with supervising the entity's daily operations is in a superior position to provide enhanced disclosures of an entity's business or operations and is responsible for such information. The independent auditor is best positioned to add

[1] On June 28, 2011 the Center for Audit Quality provided the Board with a partial response to the Concept Release through the submission of ideas that were discussed and shared with the PCAOB staff on June 9, 2011, as part of the Board's outreach efforts. The letter is available at http://www.thecaq.org/newsroom/pdfs/CAQ_June28Letter_PCAOBRulemakingDocketMatterNo.34.pdf

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value to investors by providing assurance about the completeness and reliability of the information provided by management, and such assurance would provide a basis for increased confidence in the information.

**Suggested Enhancements to the Auditor's Reporting Model**

During the Board's outreach efforts to assess whether changes to the auditor's reporting model may be necessary, investors identified certain information they would recommend including in the auditor's report. Such information included (1) communication of areas with the most significant financial statement and audit risk and the audit work performed in those areas, (2) discussion of significant estimates and judgments made by management, the auditor's assessment of their accuracy and how the auditor arrived at that assessment, and (3) communication of results of sensitivity analyses in significant areas of judgment.

Current SEC rules and regulations require disclosures that substantially overlap with many of the items investors recommended to include in the auditor's report. For example, with respect to material estimates or assumptions with significant levels of subjectivity and judgment (e.g., Critical Accounting Estimates), management is directed to provide within management's discussion and analysis of financial condition and results of operations (MD&A) greater insight into the quality and variability of information regarding financial condition and operating performance and should include, to the extent material, such factors as how management arrived at the estimate, how accurate the estimate or assumption has been in the past, how much the estimate or assumption has changed in the past, and whether the estimate or assumption is reasonably likely to change in the future. Furthermore, the disclosures require analysis of the Critical Accounting Estimate's sensitivity to change, based on other outcomes that are reasonably likely to occur and could have a material impact[2]. Because these significant estimates and assumptions are typically in those areas with the most significant financial statement and audit risk, we believe that these disclosures in MD&A are designed to address the majority of the information requested by investors.

Given that there is such a significant overlap between investor requests for additional information relative to the most significant financial statement and audit risk and the incremental disclosures required within this portion of MD&A compared to what is required by GAAP, we believe that the most effective response to these requests is through a limited expansion of the auditor's role to provide assurance on a Critical Accounting Estimates portion of MD&A, in the form of an attestation examination report on such information.

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[2] Refer to Section 501.14 of Financial Reporting Codification, *Critical Accounting Estimates*, for a description of the required MD&A disclosure requirements for critical accounting estimates.

Auditor assurance potentially could serve as a means to improve the quality of these disclosures, increase compliance with the SEC staff's stated intent of the disclosures, and provide a basis for increased confidence in the disclosures. Accordingly, we support a limited expansion of the auditor's role to provide examination-level assurance on a Critical Accounting Estimates portion of MD&A. We discuss this preferred alternative further in the section "Auditor Assurance on Other Information Presented Outside of the Financial Statements" below.

We support the clarifications to the standard auditor's report described in the Concept Release and continue to support the retention of the pass/fail auditor's opinion on the financial statements. We believe that users of our reports understand and value the auditor's opinion, a clear and unambiguous statement as to whether the auditor believes the financial statements are presented fairly, in all material respects, in accordance with the identified accounting framework. The retention of the current pass/fail auditor's opinion on the financial statements serves as a focal point from which enhanced auditor communications are driven.

We believe we could implement some form of the alternative that includes the required and expanded use of emphasis paragraphs in the auditor's report. New standards and implementation guidance will be necessary, however, to implement this alternative and to drive consistency among auditors relative to both the population of matters to emphasize and the informational content of these communications. While we would support an approach based on the use of emphasis of matter paragraphs, we believe that an examination-level assurance of a Critical Accounting Estimates portion of MD&A is a more effective response to investor and other users needs, and that the adoption of both the Critical Accounting Estimates attestation and emphasis of matter paragraphs will, in large part, be redundant.

Given that the Auditor's Discussion and Analysis (AD&A) alternative described in the Concept Release would put the auditor in the position of providing original information about the company and its financial reporting that is more appropriately disclosed, or is already required to be disclosed, by management, we do not support this alternative.

The Concept Release suggests that, for both the AD&A and required and expanded use of emphasis paragraphs in the auditor's report, the auditor describe the key audit procedures performed over those areas with the most significant financial statement and audit risk. While we acknowledge the potential benefits of emphasizing in the auditor's report the most significant matters in the financial statements, we do not support the auditor attempting to describe the key audit procedures over these matters. We question whether it will be possible to sufficiently describe the procedures in a concise manner appropriate for the auditor's report that will both give a sufficiently complete description of the many procedures performed in these most difficult areas and be relevant to financial statement users who may not be familiar with auditing practice. The extent of the necessary discussion is likely to dwarf other components of the auditor's report and accordingly may place undue emphasis on the communicated procedures. Conversely, a brief description of the extensive and sometimes complex procedures performed is likely to raise concerns, or worse, misunderstanding, about the level of the auditor's work and response to risks. Accordingly, we believe that the audit committee is in the best position to assess the appropriateness of, and discuss with the auditor the auditor's response and approach to auditing the most significant and complex portions of the financial statements.

**Auditor's Discussion and Analysis**

The AD&A alternative presented in the Concept Release is intended to provide auditors with the ability to communicate in a narrative format their views about significant matters. The AD&A may include additional information about the audit, such as audit risks, audit procedures and results, and auditor independence, and a discussion of the auditor's views or impressions regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices and difficult or contentious issues, including "close calls." The Concept Release also indicates that the AD&A could provide the auditor with discretion to comment on material matters for which the auditor believes an issuer's disclosure could be enhanced to improve investor understanding and highlight areas in which the auditor believes management could have applied different accounting or disclosures.

We do not support the AD&A alternative presented in the Concept Release for the following principal reasons: (1) it would put the auditor in the position of providing original information about the company and its financial reporting that is more appropriately disclosed, or is already required to be disclosed, by management; (2) summary information about the audit process is not likely to be meaningful to financial statement users and could be misleading; (3) the potential lack of comparability and consistency between the AD&A of companies with similar risk factors could create further investor confusion; and (4) the information included within an AD&A may become standardized over time, further reducing its effectiveness.

Certain of the information described within the Concept Release for inclusion within the AD&A, such as audit risks, audit procedures and results, auditor independence and the quality of financial statements, is similar to the information that is communicated by the auditor to the audit committee, under existing requirements. Conceptually, we understand that investors may believe that an auditor's required communications with the audit committee could include information they would find relevant and useful. Those written communications, however, are usually a starting point for discussion and are supplemented by significant dialogue between the auditor and the audit committee, which typically provides necessary context and perspectives to these communications. This interaction can often clarify specific points raised, particularly relative to certain accounting and financial reporting matters involving a high degree of subjectivity. Additionally, the audit committee obtains insight by virtue of its financial reporting oversight responsibilities, which provide additional context for these communications from the auditor. Absent such two-way dialogue and additional context, this type of information communicated in a general purpose report is likely to be taken out of context or be subject to misinterpretation.

Furthermore, although certain communications currently are required to be prepared under existing auditing standards for purposes of communicating with the audit committee, a requirement to communicate such additional information for general use would impose a responsibility on the auditor with respect to those additional users. To make such communications public would likely result in significant incremental effort and cost to overcome the challenges that may arise in the absence of the dialogue between the auditor and the audit committee. Specifically, communicating such additional information absent the typical accompanying dialogue would require the auditor to substantially enhance these written communications to provide the additional context and explanation necessary to make the communication understandable to persons who do not have access to management, the audit committee and the auditor. Finally, registered public accounting firms would need to consider enhancements to their existing systems of quality control to address additional consultation and review protocols associated with these communications.

We also agree with the sentiment expressed in the Concept Release that disclosing potentially sensitive matters in the auditor's report could impair transparency and openness in discussions between the auditor, audit committee and management. Current auditing standards encourage a free flow of communication between the auditor and the audit committee and the use of executive sessions between the auditor and the audit committee is an effective procedure that allows the audit committee to carry out its statutory oversight responsibilities. Providing the auditor with the responsibility to report directly to the audit committee seeks to ensure the independence and objectivity of the auditor. The Board should consider the potential impact on audit quality and the governance role of the audit committee should comments or presentations made in an audit committee executive session become potential subject matter for inclusion in an auditor's AD&A supplemental report.

The AD&A alternative furthermore includes a discussion by the auditor of difficult or contentious issues, including "close calls." We believe that such matters are likely to be associated with the most complex financial statement accounts and disclosures and those with the highest level of estimation uncertainty. The required disclosures within a Critical

Accounting Estimates portion of MD&A are designed specifically to address these matters and a part of the auditor's responsibility, as suggested above, could rather be to provide assurance on whether management's required disclosures appropriately describe the factors that contribute to that complexity and uncertainty.

A further shortcoming of this alternative, in our view, is that management and the audit committee may be compelled to change their financial statements, in order to eliminate differences between the company's presentation and disclosures and the auditor's communication in the audit report, thereby defaulting to those judgments and estimates preferred by the auditor. It is not clear that this would result in improved financial reporting given the complexity of business, financial reporting and the nature of "close calls." Furthermore, by virtue of the subjectivity associated with defining a "close call," inconsistency in the nature and extent of these auditor communications would likely result.

Certain investors indicated they could benefit from the information that is provided to audit committees pursuant to PCAOB Rule 3526 that enables the audit committee to monitor the auditor's independence. Similar to other communications with the audit committee, as discussed above, we believe that the information required to be communicated pursuant to Rule 3526 serves as the starting point for the audit committee's consideration of whether the matters communicated have an effect on the auditor's independence. The auditor's written communication is only one part of a process that includes discussion between the auditor and the audit committee. We question the usefulness of this information to financial statement users, especially given the impracticality of communicating directly with the auditor about such matters. Because of this limitation, combined with the complexity of the independence rules, we believe there is a risk that such communications will expand rather than narrow the expectations gap. Furthermore, the suggested clarifications to the standard auditor's report highlight the auditor's responsibility to be independent of the company and that the applicable independence requirements of the PCAOB and SEC have been complied with.

Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. We believe it would be more appropriate for management to provide further disclosure about these risks as they are in a superior position to comment on such matters. We do, however, support the Board evaluating this topic further as a separate project and considering whether the auditor could attest to disclosures of this nature should an appropriate authority develop a framework for such disclosures.

**Required and Expanded Use of Emphasis of Matter Paragraphs**

This alternative would require inclusion of emphasis of matter paragraphs in all audit reports that would highlight the most significant matters in the financial statements and identify where such matters are disclosed. Based on the discussion in the Concept Release, we believe that the principles underlying the emphasis of matter paragraphs alternative are fundamentally different than the AD&A alternative. Specifically, in an emphasis of matter paragraphs approach, an auditor communicates objective information highlighting significant financial information presented in the financial statements, whereas an AD&A approach focuses on auditor communications of original information relative to significant financial information, or an auditor's impressions relative to that financial information. Accordingly, our comments on the emphasis of matter paragraphs alternative are based on this understanding.

We acknowledge that the auditor's identification of significant matters in emphasis of matter paragraphs and referencing where those matters are disclosed within the financial statements may be helpful to financial statements users. Provided that sufficient criteria exists to provide a basis for auditors to consistently determine which matters should be included in emphasis paragraphs, and the informational content of these communications, we believe that auditors can implement some form of this alternative. We do wish to highlight, however, that those matters identified within the Concept Release for potential discussion within the required emphasis of matter paragraphs are likely to be duplicative of disclosures within a Critical Accounting Estimates portion of MD&A. We believe that an examination of that portion of MD&A by the auditor would be a more effective way of improving disclosure of these important matters, especially given that these disclosures are more appropriately made by management rather than the auditor.

Consistent with feedback received on the French form of auditor's report, which requires similar emphasis of matter paragraphs as those suggested within the Concept Release, we believe these emphasis of matter paragraphs may become excessively standardized over time, which may limit their usefulness to the users of financial statements[3].

Should the Board pursue this alternative, additional standard-setting activity and resulting implementation guidance will be required to assist the auditor in consistently identifying those matters that should be included in emphasis of matter paragraphs and the nature and extent of the auditor's communication. We believe it will be important for users of the financial

[3]The French accounting body, Compagnie Nationale des Commissaires aux Comptes (CNCC), engaged an independent consultant to conduct a study on its behalf to examine the perception of the statutory auditor's "justification of assessments" by users of the French form of auditor's report. This study is available at http://www.cncc.fr/download/footprintconsultant_reportstudy_va_cncc_fev2011.pdf

statements of similar entities (e.g., mid-sized companies in the same industry that operate in similar geographic regions or who have similar products and customers) to expect consistency in the nature and extent of such communications to the extent that risks and other relevant factors affecting the companies are consistent.

We believe that the criteria within the SEC rules and regulations for determining Critical Accounting Estimates for disclosure within MD&A could serve as a basis to establish objective criteria for identifying those significant estimates and judgments that the auditor includes within expanded emphasis of matter paragraphs. With regard to the nature of the communications, we believe that a plain English description by the auditor of why a particular judgment or estimate is significant to the financial statements (e.g., to emphasize the measurement uncertainty disclosed by the issuer) would be more useful to users than a description of the auditing procedures performed over such judgment or estimate. (See also our discussion, above, with regard to the auditor communicating the nature and extent of the auditing procedures applied.) Guidance from the Board to help frame the nature and extent of the auditor's communication also would be necessary.

**Auditor Assurance on Other Information Presented Outside the Financial Statements**

This alternative would require an auditor to provide assurance on information presented outside the financial statements such as MD&A, a portion of MD&A or other information (e.g., non-GAAP information or earnings releases).

Under existing auditing standards, the auditor's responsibility for the information presented outside the financial statements is limited to reading the other information included in documents containing audited financial statements and considering whether such information, or the manner of its presentation, is materially inconsistent with information appearing in the financial statements, or includes a material misstatement of fact. Should the auditor identify material inconsistencies or material misstatements of fact within the other information, the auditor is then required to take the necessary steps to address these matters. Auditor assurance on such information, on the other hand, would require the auditor to evaluate whether the information conforms to the requirements for its presentation. Such an evaluation would substantially increase the likelihood that the auditor would identify non-compliance with the requirements and result in improvements to the disclosure. Because the performance of procedures necessary to provide such assurance can be extensive, the Board should take care to require such assurance only on the information that is most important to investors and where auditor assurance can provide increased confidence in such disclosures (i.e., the benefit to investors is greater than the cost).

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As described above, we believe that auditor association with a Critical Accounting Estimates portion of MD&A, in the form of an attestation examination report on such information, would be the most effective manner of addressing the disclosures of information identified by investors as being important to them by providing a basis for increased confidence in such disclosures. That said, based on the investor concerns we have observed, we are not supportive of a requirement for the auditor to attest to the entire MD&A. At this time, we believe that an examination of only a portion of MD&A, a Critical Accounting Estimates section, is the most cost effective approach to addressing investor and other user's needs.

We believe the benefits of an attestation of a Critical Accounting Estimates portion of MD&A will outweigh the incremental costs and will address the information that investors have identified as important. To implement this alternative, the SEC would likely need to amend Regulation S-X to require an auditor examination of the Critical Accounting Estimates. Additionally, a Critical Accounting Estimates section that would be covered by the auditor's attestation report would need to be clearly identified within MD&A and, accordingly, SEC action also may be necessary to effect this change. With respect to existing SEC staff interpretive guidance relative to Critical Accounting Estimates disclosures, we suggest that the Board request the SEC staff to consider the adequacy of this guidance, including whether the interpretive guidance should be formally adopted as a part of Regulation S-K. The PCAOB, in consultation with the SEC, also may wish to consider whether the guidance constitutes suitable criteria for purposes of the auditor's attestation. With respect to the extant PCAOB attestation standards (i.e., AT Section 101, *Attest Engagements*, and AT Section 701, *Management's Discussion and Analysis*), we believe that registered public accounting firms can use these standards to perform and report on an examination-level attestation of Critical Accounting Estimates; however, we would expect the Board to address these issues as a part of any standard-setting project. For both issuer guidance and auditor attestation requirements, we are prepared to assist the SEC and/or PCAOB in addressing the existing guidance and requirements.

The Concept Release further suggests potential auditor association with earnings releases and non-GAAP financial information. Assuming that the demand for the expansion of the auditor's role has market acceptance, we are supportive of further study and consideration (including a cost/benefit test) as a separate project of more precisely defining the auditor's expanded role relative to both earnings releases and non-GAAP financial information. Considerations that will need to be addressed would include:

- Development of an issuer framework for the presentation of earnings releases and auditor performance and reporting standards;

- Addressing the question of how an auditor would report on earnings release information that is effectively a work in progress (whether an audit or an interim review);

- Addressing, as part of the cost/benefit analysis, whether auditor association with earnings release information would delay the issuance of this information; and

- Consideration of the existing SEC rules and regulations relative to non-GAAP financial information (i.e., both Regulation G and Item 10(e) of Regulation S-K) and auditor performance and reporting standards.

We are prepared to assist the PCAOB and SEC in addressing these considerations and others that may be identified if an expansion of the auditor's role for this information is warranted.

**Clarification of the Standard Auditor's Report**

We support the suggestions included within the Concept Release to clarify language in the existing standard auditor's report. We furthermore agree that, while this alternative would not significantly expand the content of the auditor's report, the additional explanation of the matters outlined in the Concept Release is likely to provide users with an improved understanding of the audit and the responsibilities of the parties to the financial reporting process. We believe that the suggested clarifications to the standard auditor's report could require similar conforming clarifications within the report on internal control over financial reporting required by Auditing Standard No. 5. Such changes may include further describing reasonable assurance, and management and the audit committee responsibilities for internal control over financial reporting. Similar changes were included within the suggested changes to auditor's reports on the financial statements and internal control over financial reporting as provided by the June 28, 2011 CAQ letter to the Board, with which we are in agreement. Finally, the CAQ June 28 letter includes additional "clarifying language" beyond the areas identified in the Concept Release. We also are supportive of these additional auditor communications.

**Other considerations**

In addition to the alternatives described within the Concept Release, we would encourage the Board to further consider the following:

*Scope of enhancements to the auditor's reporting model.* The discussion in the Concept Release is principally focused on improving communications with investors. The Board should consider whether these changes will benefit other financial statement users before requiring such reporting for all types of entities whose audits must be conducted pursuant to the standards of the PCAOB. For example, it is not clear that all such communications would be important to the users of the financial statements of a broker-dealer who are not invested in the company.

*Field tests*. The Board should consider field testing the more significant of the proposed alternatives to evaluate the value and practicability of the alternatives. In particular, we believe a field test would be especially helpful in determining the feasibility of implementing the AD&A or required emphasis of matter paragraphs alternatives.

*Global coordination.* The issue of an auditor's reporting framework, and the broader financial reporting framework, are the subject of consultations in other jurisdictions. For example, the International Auditing and Assurance Standards Board (IAASB) has issued a Consultation Paper, *Enhancing the Value of Auditor Reporting: Exploring Options for Change*[4]; the U.K. Financial Reporting Council has undertaken a project on effective company stewardship; and the European Commission has issued its Green Paper that addresses the auditing profession, including the reporting framework. In addition to working with the regulators in the U.S., such as the SEC, we encourage the Board to participate in and consider these other consultations in assessing the appropriate changes under PCAOB professional standards.

*Other potential alternatives.* The IAASB Consultation Paper described above suggests as a possible option to enhance the quality, relevance and value of auditor reporting, an enhanced model of corporate governance reporting, which may include the audit committee issuing a report describing its oversight of the financial reporting process and the audit, accompanied by auditor assurance. We believe this potential alternative is worthy of further consideration as another means of providing additional information called for by certain investors.

*Impact of increased professional liability for auditors and issuers.* We believe it is incumbent on the Board to consider the potential that one or other of the proposed changes may open up new fronts of liability exposure to claims by users of the financial statements. The cost of responding to civil damage suits already represents a significant operating cost for registered public accounting firms. Incremental forms of assurance required to be provided by the auditor, especially those with a higher level of inherent subjectivity or which call on the auditor to provide information about the company that is independent of the company's own disclosures (such as an AD&A), are likely to result in exposure to novel litigation claims that may substantially increase such costs. We urge that the Board give close consideration to

[4]In May 2011, the IAASB issued their consultation paper to explore possible options to improve the communicative value of the auditor's report. The consultation paper is available at http://www.ifac.org/publications-resources/enhancing-value-auditor-reporting-exploring-options-change.

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balancing the perceived benefits to users of the financial statements with the resulting increased professional liability as the Board moves forward with its proposals.

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We appreciate the Board's careful consideration of our comments, and fully support the Board's efforts to enhance the auditor's reporting model and increase the value of the audit. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact Sam Ranzilla, (212) 909-5837, sranzilla@kpmg.com, or Tom Ray, (212) 909-5095, tray@kpmg.com.

Very truly yours,

KPMG LLP

Cc:

**PCAOB**
James R. Doty, Chairman
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Brian Croteau, Deputy Chief Accountant

LIBERTYGLOBAL

September 30, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Liberty Global, Inc. ("LGI") appreciates the opportunity to share our views on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the "Concept Release") issued by the Public Company Accounting Oversight Board ("PCAOB").

LGI is a leading international provider of video, voice and broadband internet services. These services are provided through our consolidated operating subsidiaries in 14 countries, primarily in Europe, Chile and Australia. Therefore, our views on the proposals presented in this Concept Release are from the perspective of a multi-national public company (a financial statement preparer) with complex accounting and reporting processes.

Overall, we don't believe that a fundamental change is required to the form or content of the audit report, and don't believe in a required expansion of auditor's assurance responsibilities to information outside of the financial statements. In this regard, our accounting, finance and investor relations groups have seen no evidence from the users of our financial statements that they desire such changes. In addition, we believe our financial statement users have a good understanding of the level of assurance provided by the current form of the audit report and the procedures performed by auditors in support of their audit reports.

**Content and Form of the Audit Report**

1. ***Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.***
    a. ***Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?***
    b. ***In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?***
    c. ***Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?***

We believe the roles of management of public companies, audit committees and auditors are currently correctly delineated. Management is responsible for providing accurate financial statements (including the notes thereto), selecting accounting policies that conform with Generally Accepted Accounting Principles ("GAAP"), and providing relevant and useful information to make sure investors make informed decisions. Audit committees of public companies serve an oversight role over management's function on behalf of shareholders along with the responsibility to engage and oversee the external auditor. The auditor's role is to provide reasonable assurance that financial statements have been presented fairly in accordance with generally accepted accounting principles. We believe the current form of the auditor report provides adequate information regarding the auditor's role and should be retained.

If added information is deemed necessary related to risks, judgments and estimates contained within the financial statements, it should be management's responsibility to provide such information. If auditors substantively disagree with management's treatment of any such risks, judgments or estimates, they already have the responsibility under current auditing standards to require changes to materially incorrect or misleading disclosures within the financial statements, and to disclosures outside of the financial statements that appear in the same documents as their audit reports.[1] If the auditor ultimately is not satisfied with such disclosures, the auditor is required to adjust or withhold their audit report as necessary. In the case of earnings releases, presentations and other company communications that do not fall under existing audit standards for auditors, we believe that the vast majority of companies are very diligent in verifying all information that is included in these communications and that there would not be sufficient added benefit that would outweigh the additional costs that companies would incur if auditors were to opine on all or any part of these company communications.

2. ***The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."***
    a. ***Should the auditor's report retain the pass/fail model? If so, why?***
    b. ***If not, why not, and what changes are needed?***
    c. ***If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.***

A pass/fail model provides the most objective and informative information to users of the financial statements in our opinion. If an audit "passes," a user is effectively notified that they can reasonably rely on the information presented in the financial statements. We strongly believe that the positive confirmation of a pass/fail model leads to the most efficient markets and appropriate allocations of capital. Burdening companies and their auditors with ever-increasing regulations and standards would have the opposite effect.

The potential solutions in the Concept Release for moving from a pass/fail model focus on allowing the auditor to supplement the audit report with their own discussions regarding the outcome of their audit. A model where an audit report is issued, but the auditor provides supplemental information regarding the audit, would likely be confusing to users of the financial statements. For example, if an auditor added commentary on a "significant matter" such as an accounting policy chosen by management, the commentary could be construed by users in multiples ways, including:

- The auditor did not really like the accounting policy choice made by management in the financial statements, but decided to issue an opinion anyway.
- There were other potentially preferable alternatives for the given accounting policy.

We believe the users of financial statements could easily misconstrue the purpose of the supplementary language, and in any event, any such supplemental information would likely not represent decision useful information for financial statement users, other than generally casting doubt, perhaps unwarranted, regarding the quality of companies' financial statements.

The current auditor reporting model is much more straightforward, because if an auditor has a substantive issue with a matter such as a managements' use of a particular accounting policy decision, the auditor either will not issue an opinion, or will issue a qualified opinion. If audit issues are driven by lack of clarity in accounting and reporting standards, the focus should be on correcting those standards.

[1] As set forth in AU Section 550

As noted in our prior response, we think the current form of the "pass/fail" report is appropriate and should be retained.

3. ***Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.***

As per our comments above, regarding the respective roles of prepapers, audit committee members and auditors, we strongly agree that any disclosure obligations should continue to reside with the preparers with oversight from the audit committee. In this regard, we believe that the expansion of the auditors' role to include the preparation of disclosures or analyses independent of management would create unnecessary conflicts between a company and its auditors and would not produce more reliable information for financial statement users. By definition, auditors are not involved in a company's day to day operations, and accordingly, are not in the best position to provide this type of information. We believe that, if auditors were to assume responsibility for these disclosure obligations, auditors would be at least partially assuming the role of management, which in our view would clearly conflict with the auditors' fundamental role and purpose. Further, additional information provided by the auditor that is in conflict with management's disclosures would simply add competing information. We do not understand how this competing information would serve investor's needs, and instead we believe would be incredibly confusing to investors as compared to the current financial reporting model. Overall, we strongly believe that all disclosure obligations should remain management's responsibility.

4. ***Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?***

As per our previous comments, our view is that the auditor reporting model as currently formulated is appropriate. We have no specific views on potential changes to the auditor's report on internal control over financial reporting until we first have more specific guidance on the nature of any proposed changes to the overall auditor reporting model.

**Auditor's Discussion and Analysis ("ADA")**

5. ***Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?***
    a. ***If you support an AD&A as an alternative, provide an explanation as to why.***
    b. ***Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?***
    c. ***Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?***
    d. ***If you do not support an AD&A as an alternative, explain why.***
    e. ***Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both?***

Consistent with our previous comments, we do not believe an AD&A should be added to the auditor's report. The AD&A would create a fundamental shift in the auditor/client relationship, with the auditor assuming certain disclosure obligations with respect to the audit and certain accounting and reporting decisions made by management. The types of matters up for discussion are better resolved through interaction between the auditor, management and the audit committee in their currently delineated roles. Public disclosures of such interactions would not be useful or beneficial because:

- The financial statements and disclosures are the responsibility of management, and presenting such information to the public should remain management's responsibility, with audit committee oversight.
- For a complex multinational company such as ours, we would expect that an AD&A could be a very long document, which would serve as more of a distraction to the financial statements than useful disclosure.
- Due to the significant level of judgment inherent in many complex accounting and auditing issues, there is not always a consistent view among audit firms or even partners within an audit firm on these matters, or even consistency between audit firms and partners on what would constitute a significant audit matter. As such, this public disclosure would likely provide very little decision usefulness since the disclosures would likely vary greatly from company to company.
- Time spent on generating such a report, along with the discussions with senior management and the audit committee, would require significant time and effort of the audit partner and senior company accountants. The result would likely lead to a significantly more expensive audit and would shift the audit partner away from more important issues relating to the conduct of an efficient and effective audit. In addition, we would envision significantly more expense related to national office inquiries as audit teams work to ensure that each and every AD&A is consistent across an audit firm.
- Finally, we are concerned that any added reporting obligations would extend the time required to file quarterly and annual reports with the U.S. Securities and Exchange Commission.

We have not specifically commented on questions 6 through 12 in the Concept Release as our full views on the AD&A are expressed above.

**Required and Expanded Use of Emphasis Paragraphs**

***13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?***
***14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?***
   ***a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.***
   ***b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.***
***15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?***
***16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?***
***17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?***
***18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?***

It is difficult for us to envision the exact nature and content of "required" auditor emphasis paragraphs. The Concept Release suggests the audit report could include emphasis paragraphs on significant management judgments and estimates, areas with significant measurement uncertainty, and other areas "that the auditor determines are important for a better understanding of the financial statement presentation". The Concept Release also states that the auditor may reference where such matters are disclosed in the financial statements and describe the audit procedures they employed.

Most of our concerns would be the same as our concerns with the AD&A, as we are not sure how added emphasis paragraphs would practically benefit users of the financial statements. We have the following specific concerns on requiring added auditor emphasis paragraphs:

- An audit report is not the proper place for a financial statement user to find information related to the location and content of significant judgments and estimates, and other areas with measurement uncertainty, or to obtain a better understanding of financial statement presentation. A user of the financial statements should be expected to read and understand the disclosures provided by management, and it should be management's responsibility to provide comprehensive and understandable financial statements. If there are specific concerns regarding the form or usefulness of financial statements, those issues should be addressed through corrections in accounting and reporting rules and regulations.
- A "requirement" for emphasis paragraphs will likely lead to the development of boilerplate language, and we believe it would be difficult if not impossible in practice to make sure boilerplate language is avoided ***while*** still maintaining consistency among audit reports. We would need to better understand how this might work, but our general assumption is that the auditors would only include emphasis paragraphs in audit reports in situations where PCAOB rules required auditors to do so, and that those PCAOB rules would include guidance on what the emphasis paragraphs should look like. Even if the PCAOB were able to achieve the goal of avoiding boilerplate language while maintaining consistency, the appearance of consistency in audit reports would not necessarily mean that the reports would in fact be consistent in terms of the scope and magnitude of the issue that is the subject of the emphasis paragraph. For example, if an emphasis paragraph were required to be added to address the impacts of acquisitions, the paragraph related to an acquisition that increased the size of the company by 10% would likely look the same as a paragraph related to an acquisition that doubled the size of another company.
- As the PCAOB recognizes, additional audit standards would likely be required to address the inclusion of required emphasis paragraphs in audit reports, which would add to the time and expense of audits, without providing information that would appear, in our view, to change the judgment of a reasonable investor.
- Finally, we are unclear what value would be derived by users if the PCAOB were to require emphasis paragraphs, mainly because we think sophisticated users already know their way around a set of financial statements without a roadmap, and unsophisticated users would not have the background to put emphasis paragraphs into proper perspective.

Overall, we believe the current model of the audit report is appropriate, where auditors are permitted to add emphasis paragraphs when they believe it is warranted in the circumstances.

**Auditor Assurance on Other Information Outside of the Financial Statements**

Questions 19 and 20 of the Concept Release discuss the expansion of auditor assurance to other information outside of the financial statements. Expanding auditor assurance to information outside of the financial statements, such as MD&A and press releases, would be a significant undertaking, and we believe should be addressed separately from the Concept Release, which specifically relates to possible revisions to reports on audited "financial statements". However, our general view is that such a large expansion of required auditor assurance would be cost prohibitive based on the need to establish new auditing standards, the need for the SEC to likely develop new management reporting requirements, and the added audit hours and fees that would result from these incremental attestation services. Also, as the PCAOB notes, companies currently have the ability to engage auditors to provide attestation services on information outside of the financial statements, including MD&A, through the Attestation Standards provided by the PCAOB. As far as we are aware, there is not widespread engagement of auditors to perform attestations outside of the financial statements, which would suggest there is not a large demand for these services either from preparers or users of the financial statements. A requirement for an auditor to attest to information outside of the financial statements would seem to be inconsistent with the lack of demand for these services from users of the financial statements. We believe this lack of demand is due, at least in part, to the fact that most stakeholders perceive that companies take great care to ensure that all communications with their stakeholders are accurate and complete.

While we don't agree with the idea of expanding the auditor's assurance responsibilities, we would not be opposed to expanding the current audit report to explain auditors pre-existing responsibilities related to information outside of the financial statements as contained in AU Section 550.

**Clarification of the Standard Auditor's Report**

Questions 21 and 22 of the Concept Release discuss certain revisions to the standard auditor's report in order to clarify certain matters. While we don't believe the clarifications are necessary, we don't have any specific objections to the proposed clarifications.

**Questions Related to All Alternatives**

Questions 23 through 30 of the Concept Release discuss which alternative or combination of alternatives would be best, whether there are any other alternatives, and other questions regarding the alternatives provided. We have not specifically addressed these questions because our views are fully expressed in our responses to the other questions, and our overall view is that there should be no change to the current form of the audit report or the current scope of auditor's responsibilities.

**Other Considerations Related to Changing the Auditor's Report**

Questions 30 and 31 of the Concept Release address various concerns and considerations related to changing the auditor's report and the potential effects of such changes. Concerns over increased costs, effects on relationships with auditors, effects on audit committee governance and liability considerations from changing the auditor's report are expressed in the Concept Release. While we have not had time to study any of these matters in-depth, we believe these considerations are all of great importance and must be thoroughly addressed before any major changes are made. Our preliminary views are as follows:

- Increased costs – costs will certainly increase if any of the major proposals in the Concept Release are made. The types of proposed changes would require substantive attention from the most senior audit engagement team members, primarily lead engagement partners and review partners. We would also expect that national office consultations would be much more prevalent in dealing with the specific form and content of any required supplementary reports, such as the proposed AD&A. Given the nature of personnel involved and the high billing rates for these personnel, we expect there would be pressure to significantly increase audit fees. In addition, we would expect companies to incur additional legal and accounting costs associated with the review of any additional auditor reporting.
- Effect on relationships with auditors – based on the current model, auditor communications with the audit committee are unconstrained by issues such as whether the content of the communications could end up in a public document. If such communications were required to be made public in some manner or form, the honest and frank discussions that occur now may become more constrained, or may become increasingly boilerplate as the auditor strives to avoid any inconsistency between clients.
- Effect on audit committee governance – oversight over key decisions made by management with regards to financial accounting and reporting is the responsibility of the audit committee. The proposals in the Concept Release would seem to have the practical impact of shifting some of that responsibility to the auditor, which in our view is inappropriate. If the PCAOB has concerns with respect to whether auditor communications with audit committees are ineffective and don't always

result in meaningful and proper disclosures in the financial statements, those concerns should be addressed separately and should have no bearing on the form and content of the auditor report.

- Legal/confidentiality issues – Certain of the proposed alternatives raise the risk of disclosure of confidential company-specific information and communications. In addition to the chilling effect on communications between the auditor and the company's management and audit committee, such disclosures would also violate long-standing legal and ethical obligations of auditors. When exceptions to these obligations have been imposed through legislation or regulation in the past, they have been narrowly tailored to address specific concerns (e.g. Section 10A(b)(1) of the Securities Exchange Act of 1934), rather than being left more broadly to the auditor's discretion as the Concept Release implies. Certain of the alternatives in the Concept Release may also increase the company's liability exposure. Public disclosure of conflicting views of management and the company's auditor, such as of "close calls" as contemplated by the release, may lead to investor confusion and resulting declines in the company's stock price based on erroneous impressions regarding the quality of the company's financial statements. Stock price declines of this nature may be expected to lead to meritless lawsuits which, in turn, may be expected to cite the disclosed conflicts as evidence of management or board failures resulting in a "fishing expedition" regarding the confidential discussions between and among the auditor, management and the audit committee.

In summary, we do not believe any significant elements of the PCAOB's proposals are warranted from a cost benefit perspective, and accordingly, we do not believe these proposals should be adopted.

We have discussed the contents of this letter with the chairman of our Audit Committee, who is in agreement with the views expressed herein. We appreciate the opportunity to comment on this Concept Release. We would welcome the opportunity to discuss these matters with you. I can be reached at 303 220 6603, or you can reach Leo Stegman at 303 220 6690.

Sincerely,

Bernard G. Dvorak
Senior Vice President & Co-Chief Financial Officer

cc Paul Gould (Director and Audit Committee Chairman, Liberty Global)
Elizabeth Markowski (Senior Vice President, Secretary & General Counsel, Liberty Global)
Leo Stegman (Vice President of Accounting and Reporting & Deputy Controller, Liberty Global)
Jason Waldron (Partner, KPMG)

Liberty Mutual.

**Liberty Mutual Group**

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September 30, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Liberty Mutual Group ("LMG" or "the Company") is a diversified global insurer and the sixth largest global property and casualty insurer in the world. As of June 30, 2011, LMG has approximately $116 billion in consolidated assets and $98 billion in consolidated liabilities. Our consolidated revenues were approximately $33 billion for the year ended December 31, 2010.

We appreciate the opportunity to provide the Public Company Accounting Oversight Board ("PCAOB") with our comments pertaining to Rulemaking Docket No. 34, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("the Concept Release").

**GENERAL COMMENTS**

First and foremost, we respect the time and effort the PCAOB and its Staff has put into consideration and development of the Concept Release and their desire for improving and increasing the transparency and relevance of the auditor's report on financial statements.

We do not support the alternative proposed for an Auditor's Discussion and Analysis ("AD&A"). Further examples and clarification has been provided below which indicate that this alternative could cause unnecessary conflict between management and the auditors, stifle communications, hinder audit quality, and send inconsistent messages to investors. We also do not support the alternative proposed that would require auditors to provide assurance on information outside of the financial statements. This would lead to increased time and money on the part of management, as well as the auditors. Confidentiality also arises as a concern with both proposed alternatives.

If the PCAOB concludes additional information is needed for the users of the financial statements, then we would support the alternatives that would require the use of emphasis paragraphs and/or clarification within the standard auditor's report. We feel that these alternatives would accomplish the PCAOB's objective to create more transparency and improve disclosures within the auditor's report, while not jeopardizing the relationship or adding unnecessary costs to the audit.

We appreciate the complexity of the project and would like to raise the following observations and recommendations in response to specific questions on the proposed alternatives for your consideration.

**Response to Question 5**

We do not support an AD&A as an alternative. Based on the points discussed within the Concept Release, we believe that implementing a requirement for an AD&A would potentially create unnecessary conflict between management and the auditors as a result of the subjective nature of the AD&A.

For example, the Concept Release notes that the AD&A would include what is referred to as "close calls." The documentation of these would involve significant discussion regarding difficult issues between management and the auditors. "Close calls" are usually debated during the course of the audit. Many hours are spent between management and the auditors to discuss such issues, and therefore, they have been resolved once the report is issued. The resolution or mutual agreement around such issues would indicate that it is no longer necessary to display the topic as a discussion point within the report. More definition needs to be placed around what would be classified as a "close call." Without a clear definition, "close calls" could encompass a variety of issues; furthermore, disclosure of these items could cause tension between the auditors and management, as having "close calls" disclosed within the auditor's report could lead to confusion and mixed messages for investors and ultimately have a negative impact on the market. Including "close calls" would not create any more transparency nor would it provide more relevance to the readers of the financial statements.

A similar instance in which conflict may arise would be related to the suggestion of highlighting within the AD&A those areas where the auditor felt that management could have applied different accounting or disclosures. The purpose of the auditor's report is to opine on the financial statements including the presentation and disclosures. It is contradictory to expect the auditor to opine on the financial statements and then include in the AD&A information on where they felt management could have presented their information differently. Again, this alternative could result in confusion for the users of the financial statements and a poor reaction by investors and analysts.

For those companies who produce an MD&A, it is important to consider the potential differences which could arise between this document and an AD&A. The auditor discussion about the financial statements could differ from disclosures that management provides and therefore might not convey a consistent communication to investors. Management would strongly insist that there is consistency between the two documents. Resolving discrepancies could require significant time to be spent between management and the auditors to ensure agreement has been reached on all topics discussed, thus increasing the cost to perform an audit. If for any reason the MD&A and the AD&A do not align, this inconsistent communication could again result in confusion and could lead to an unwarranted negative market reaction.

Additionally, we are concerned about whether the users would have the appropriate context for the information. Typically, auditors' communications are prepared with the expectation of a privileged dialogue with the audit committee. Any additional context and perspectives that are communicated are not intended to be shared with users.

**Response to Questions 6 & 7**

We believe that the audit information recommended to be included within the AD&A could pose a concern for management based on confidentiality issues. The information in the audit work papers is the property of the Company, and therefore, any information shared in the AD&A would have to be confirmed by management. Certain proprietary information is provided to the auditors during the audit, which is sensitive to the Company's competitive industry position and should not be disclosed to the public.

Additionally, the Company believes that including information about the auditor's views on the Company's financial statements based on the audit, such as management's judgments and estimates, could pose a confidentiality concern. As an insurance company, there is significant judgment used in preparing certain financial statement line items, specifically loss reserves. Disclosure of reserve ranges, or potential discussion of the reserve strength, are examples of metrics that could impact the Company's competitive position. Any potential for disclosure of these types of items would stifle the open-communication relationship between the management team and the auditors and could result in unnecessary tension between the two.

**Response to Question 8**

If the AD&A were to be implemented, we feel that a standard template must be created for all auditors to use in completing this document. The template should clearly define the information to be included in the document, who is to complete the document, and whether it would require a formal sign off. If a standard template is not implemented, the Company feels that the preparation of a document such as what has been described would result in added time to and increased cost for the audit and could lead to significant issues between the Company and the auditor for the inclusion of subjective disclosures.

**Response to Question 18**

The PCAOB has noted in the Concept Release that investors and analysts are requesting that there be more transparency and supplemental discussion in the auditor's report to provide additional clarity around the financial statements. In response to this, the Company supports the alternative that would require and expand the use of emphasis paragraphs in all audit reports.

This approach would help users identify significant events, unusual transactions, and other major items of the audit. The Company agrees that by requiring implementation of these types of paragraphs, the desired objective of creating more transparency and improved disclosures within the audit report would be achieved.

If this alternative is selected, the PCAOB must develop a standard template to be used to ensure consistency in the audit reports. Without a standard template, the emphasis paragraphs could again cause confusion among readers and would not operate as intended. In addition, the Company believes that all required descriptions should be objective, fact-based discussions and make specific reference to where such items appear in the financial statements. In the case where the emphasis paragraphs require comment on management judgments and estimates, it is specifically important that these descriptions contain strictly objective information. The Company believes that if the emphasis paragraphs were to contain any subjective information, similar to the AD&A, this could cause unnecessary conflict between management and the auditor and/or confusion for the reader.

**Response to Question 19**

The PCAOB is suggesting that auditor assurance be obtained on information outside of the financial statements. We believe that an increase in the amount of information for which auditor assurance may be obtained creates cause for concern as it would require an increase in time and money for the Company. Additional audit procedures would need to be put in place in order to opine on information that is separate from the core financial statements and disclosures. As a result, there could be a significant increase in the number of requests to which the Company must respond. There would be increases to staffing and additional time needed to work with the auditors on this new information, both of which could lead to an extended audit time frame and increased audit fees.

**Response to Question 21**

The Company agrees with the proposed alternative of clarification of certain language in the auditor's report. This would achieve the objective to better articulate certain matters (without incurring significant additional time or cost). This alternative provides the reader with a more transparent and relevant report by offering additional clarifying information on what the audit represents and a description of the auditor's responsibilities. We believe this type of information could be included in reports on audits of internal controls over financial reporting.

In summary, though we believe the current financial statement process is adequate, if the PCAOB feels the need to move forward with further clarification, we believe the alternative for clarification of emphasis paragraphs is sufficient. The Company cautions the PCAOB to be mindful of unintended consequences from the adoption of certain proposed alternatives, specifically as it pertains to the audit effort and the working relationship with management and the auditors. The Company looks forward to working with the PCAOB in future months to further discuss the project and to work collectively to determine a purposeful and appropriate resolution.

Sincerely,

John Doyle
*Vice President & Comptroller*
Liberty Mutual Group

Limitedbrands

September 29, 2011

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

Attn: Office of the Secretary

**Re: Rulemaking Docket Matter No. 34**
**Concept Release on Possible Revisions to PCAOB**
**Standards Related to Reports on Audited Financial Statements**

Members of the Board:

We appreciate the opportunity to respond to you regarding the Board's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release"), issued by the Board on June 21, 2011.

By way of background, Limited Brands, Inc. (NYSE: LTD) is a $10B global specialty retailer focused on intimate and other apparel, personal care and beauty and accessories. Our specialty retail brands include Victoria's Secret and Bath & Body Works. We have been in business for nearly 50 years and employ over 90,000 associates.

Our management team and our stakeholders value accurate and informative financial statements and financial information. As a result, we understand and value a quality audit. We appreciate and support the PCAOB's objective to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.

Based on our values and our experience, we commend the Board for examining how to improve audit firms and auditing standards. However, we believe that wholesale changes to auditing standards are not warranted. Changing the content and form of the audit report is not an effective way to address concerns about the quality or quantity of disclosures. In addition, increasing audit scope outside the financial statements is beyond the training and expertise of audit firms and, as a result, would not add incremental value to investors.

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We believe one of the most important areas for improvement with respect to financial information is to improve its timeliness. Many of the changes in the Concept Release would work contrary to this; the possible changes would increase the length of time necessary to complete an audit and, as a consequence, increase the length of time required to make audited financial information available to the public. Delaying the availability of information is contrary to the needs of investors and the financial markets. Following is a detailed discussion of our most significant concerns.

Content and Form of Auditor's Report

As described in the Concept Release, a standardized form of the auditor's report has been utilized since the 1940's. Although changes to the audit report have been debated or proposed since that point in time, the audit report has proved that it plays an important role in the financial markets and it is functioning effectively. If investors have a lack of understanding of what an audit means or how an audit works, those investors may have a gap in their financial expertise. This gap should be addressed by the investor, not the audit or the audit firm. If the investor believes that the financial statements have insufficient information with respect to risks, uncertainties or other matters or that certain disclosures require more prominence/emphasis, that is a discussion point for preparers, the accounting rule-making authorities, or the Securities and Exchange Commission. In addition, in the event that the financial statements would benefit from incremental disclosures, we believe that information is best provided by the preparer.

Secondly, we do not believe that a wholesale revision to the auditing standards is appropriate at this time. As an issuer, we are facing material changes to our financial reporting including rule changes around convergence and/or full transition to International Financial Reporting Standards. A significant revision to audit scope would place strain on our financial reporting resources. These resources are already constrained due to material changes in areas such as lease accounting and revenue recognition. Also, our audit firm will need to audit these material accounting changes. We do not believe that the audit firms can audit material accounting changes and concurrently absorb a material auditing standard change while still maintaining audit quality and timeliness. We would not object to minor improvement in the language in the Auditor's Report, but we believe this is not the right time to make wholesale changes to the auditing standards.

Thirdly, our financial leaders interact with investors and stakeholders frequently. We rarely receive requests for more information in our public financial statement filings. In our experience, unfortunately much of the published information is read by very few people. If we did receive a request for more information, we would seriously consider the request and incorporate it in future disclosures, if appropriate. Thus, the potential changes would only add incremental audit cost and not incremental value to our stakeholders.

Auditor's Discussion and Analysis ("AD&A")
As we state in our opening remarks, we value the service that our audit firm provides. Our management team and our investors count on accurate financial information to inform decisions. In order to provide an effective audit, auditors are well trained on accounting standards, auditing and audit risks. They are not trained on how to run our business. Although they have a thorough knowledge of audit risk associated with our financial statements, they do not have the deep comprehensive business knowledge that management possesses.

Audit firms are trained explicitly to obtain reasonable assurance that our financial statements are free of material misstatement. The auditors are not in a position to have a better point of view than management on judgments, estimates, accounting policies/practices, etc. The investor community must take ownership of understanding the risks and rewards of investing in a business. This ownership can not be delegated to an audit firm.

Some of the possible changes in the Concept Release, including potential disclosure of accounting "close calls," are problematic. In order to understand "close calls" and other similar areas, one needs context and thorough discussion. In many cases, the context is confidential. We believe that this is the role of the Audit Committee. In fact, if the financial statements are "free of material misstatement," close calls or debated items are not meaningful. An audit report that tries to summarize these types of items without adequate context would likely lead to increased litigation costs for both audit firms and preparers, further increasing total audit costs. In order to mitigate this risk, AD&A language would necessarily become boilerplate. As a result, the increased cost would not result in incremental value as the AD&A would not bring more valuable information or experienced perspective than management already provides.

Finally, the addition of an AD&A to the audit scope would add incremental time to complete the audit process. Completing the audit within today's reporting deadlines can already be a challenge. As we mention above, slowing the reporting process down is detracting value, not adding it.

Auditor Assurance on Other Information Outside the Financial Statements
Auditors are currently required to review information in documents containing the audited financial statements to consider whether such information, or the way that it is presented, is materially consistent with the financial statements or whether it constitutes a material misstatement of fact. We believe this scope is appropriate and well defined. We do not believe that the Board should consider additional auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model. As we discuss above, auditors are trained in accounting and auditing and their attest scope should focus on financial statements.

Conclusion

We appreciate the efforts and the outreach of the Board to protect the interests of investors. However, we do not believe that material changes as discussed in the Concept Release are necessary. In our opinion, the vast majority of changes discussed in the Concept Release would increase audit cost and the time necessary to complete an audit. However, these same changes would not improve the quality of audits or financial statements and disclosures.

We thank you for the opportunity to respond to the Concept Release and to provide our comments on these important topics.

Sincerely,

Stuart B. Burgdoerfer
*Executive Vice President,*
*Chief Financial Officer*

Wendy C. Arlin
*Senior Vice President,*
*Corporate Controller*

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September 28, 2011

Mr. Martin Baumann
Chief Auditor and Director of Professional Standards
Public Company Accounting Oversight Board
1666 K Street
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 34 - Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Mr. Baumann:

Markel Corporation (Markel) is a global, specialty property and casualty insurer traded on the New York Stock Exchange and headquartered in Richmond, VA. In response to the PCAOB's recently issued a concept release on the auditor's reporting model, Markel submits the following comments for your consideration.

We recognize and support the Board's goal of changing the auditor's reporting model in a way which would increase the transparency and relevance of financial statements and the audit process without compromising audit quality. However, of the four alternatives proposed, we believe the most effective approach to achieve this objective and to provide more relevant and useful information to investors and other financial statement users is to: (1) modify the current auditor's report to clarifying language about what an audit represents and what the related auditor responsibilities are; and (2) require inclusion of an expanded emphasis paragraph in all audit reports that would highlight the most significant matters in the financial statements and identify where these matters are disclosed. We believe these changes would enhance communication to investors by improving the content of the auditor's report rather than changing the fundamental role of the auditor in performing an audit of financial statements.

We do not support the proposal to require Auditor Discussion and Analysis as we believe this approach changes the role of the auditor in such a way as to increase the cost of audits and blurs the lines of accountability with management's. Auditors currently review Management's Discussion and Analysis to ensure that information presented there is consistent with the audit financial statements. During this review, auditors also have the opportunity to provide feedback, observations and comments regarding matters that they believe are relevant to the investors and other users of the financial statements.

We have reviewed the June 9, 2011 submission by the Center of Audit Quality and agree with the following "Overarching Principles":

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.
- Any changes to the reporting model need to enhance, or at least maintain, audit quality.
- Any changes to the reporting model should narrow, or at least not expand, the expectations gap.
- Any changes to the reporting model should add value and not create investor confusion. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.
- Auditor reporting should focus on the objective rather than the subjective.

We would like to encourage you to consider the above principles to guide the development of possible areas for further consideration related to revisions to the auditor's reporting model.

We appreciate the opportunity to share our views regarding possible revisions to the auditor's reporting model.

Sincerely,

Anne G. Waleski

Anne G. Waleski
Vice President, Chief Financial Officer and Treasurer
Markel Corporation

Cc: Stewart M. Kasen, Chairman, Markel Corporation Audit Committee
Nora N. Crouch, Controller and Chief Accounting Officer, Markel Corporation

Massachusetts Society of Certified Public Accountants, Inc.®

105 Chauncy Street • Boston, Massachusetts 02111

September 30, 2011

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

Re: **Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements**

PCAOB Release No. 2011-003
PCAOB Rulemaking Docket Matter No. 34

Ladies and Gentlemen:

The Accounting Principles and Auditing Procedures Committee is the senior technical committee of the Massachusetts Society of Certified Public Accountants. The Committee consists of members who are affiliated with public accounting firms of various sizes as well as members in both industry and academia. The Committee has discussed the above mentioned matter. The views expressed in this comment letter are solely those of the Committee and do not reflect the views of the organizations with which the Committee members are affiliated.

The Public Company Accounting Oversight Board ("PCAOB") has exposed for comments the document "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" (Concept Release) setting forth possible changes to the Independent Auditor's Report on Financial Statements.

**Overview**

The Committee feels it must express a concern up front before commenting on the Concept Release. The Committee feels that in considering the Concept Release that the PCAOB should keep in mind



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the concerns of the non-issuer companies. The majority of the Committee members represent small and medium sized companies.

It is the firm belief of the Committee that any changes from the adoption, implementation and transition to the reporting alternatives as presented in the Concept Release will trickle down to non-issuer companies. These small and medium sized companies will be forced to transition to whatever changes that are adopted by the PCAOB.

The Committee in concept only agrees with the PCAOB undertaking the initiative to consider improvements to the auditor's reporting model. The Committee however as detailed below believes the approach taken in the Concept Release is not the right approach. The Committee believes that if more information is needed by users that generally accepted accounting standards should be reviewed and amended to address the concerns of users of the financial statement.

The Committee does not agree that the auditor's role should be expanded in the auditing and reporting process. Management of the audit entity should be responsible for the financial statements and disclosures. The Committee believes that the financial statements should stand "on their own". The Committee believes that the responsibility for the financial statements should stay with management and that the auditor should not become a source of disclosure within the reporting process. The Committee strongly believes that the auditor's role and purpose should remain that of an independent auditor attesting to the fairness, in all material respects, of the financial statements presented.

The Committee is also concerned about the costs of implementing any changes to the Independent Auditor's Report as set forth in the Concept Release. Any changes would result in the auditor incurring additional costs that cannot necessarily be passed onto the audit client.

**Auditor's Discussion and Analysis ("ADA")**

The Committee does not support the adoption of an ADA section as an alternative for providing additional information.

As stated above the management of the audit entity should be responsible for the disclosure and information in the financial statements. The Committee believes by adding an ADA section that an expectation gap would be created. The readers/users of the financial statements could misunderstand the purpose and content of the ADA resulting in confusion. This expectation gap would be that users of the financial statement would expect that the auditor is responsible for the financial statements and the disclosure of non-financial information.

The Committee is particularly concerned about the disclosure of risks and "close calls".

This disclosure could lead to increased litigation generating by either disclosing or even not disclosing this information. Because of the concern of litigation the ADA would result in "boilerplate language" as defined in the Concept Release. The Committee, because of the possibility of litigation, sees no alternative to either the "boilerplate language" or language that is less than forthright.

The Committee further sees that the addition of an ADA and its requirement to disclose certain items could impair the relationship and limit open communication between the auditor, management and the Audit Committee.

The Committee finally is concerned about the timeframes required to put the ADA section together. Time frames to complete audits in many cases are already tight.

The Committee feels that the implementation of an ADA section would result in information not useful to the reader for the reasons detailed above.

**Required and Expended Use of Emphasis Paragraph**

The Committee does not support the adoption of expanding the emphasis of matter paragraph as presently detailed in auditing literature as a mean of making the Independent Auditor's Report more relevant and useful in making investment decisions.

The Committee does not see how this would improve the readers understanding without lengthy explanations of the specific matters involved. These lengthy explanations could result in the lessening of the impact and effect of the emphasis paragraph. The lengthy explanations could also result in the readers/users of the financial statements skipping the applicable paragraphs entirely.

The Committee believes that the current auditing literature as related to emphasis of a matter paragraphs is appropriate and should not be changed.

**Auditor Assurance on Other Information Outside the Financial Statements**

The Committee does not support the adoption of auditor assurance on other information outside the financial statements as an alternative for enhancing the Independent Auditor's Report.

Information outside the financial statements such as Management Discussion and Analysis could include forward looking or prospective material. The Committee is concerned about how the auditor would have the ability to judge these prospective materials.

The Committee, once again, is concerned about the timeframes required to gain and report assurance on information outside the financial statements. Time frames to complete audits in many cases are already tight.

The Committee finally sees this proposal as resulting in a separate required engagement between the auditor and the audit client. This would result in greater costs to both the auditor and the audit client.

The Committee finally does not believe only portions of other information outside the financial statement should be reported on because this could be misconstrued as providing assurance on all the information instead the intended purpose of providing assurance on only a portion.

Because of the costs, timeframe and the required expertise as detailed above, the Committee feels that the costs of this option outweigh the benefits.

**Clarification of Language in the Standard Auditor's Report**

The Committee feels that this proposed approach would povide a more cost efficient and meaningful manner for enhancing the auditor's reporting model. As detailed in this section of the Concept Release to have the auditor clarify and explain the auditor's responsibilites and role in the audit would serve to enhance the Independent Auditor's Report. These clarifications and explanations would also hopefully increase the financial statementsuser's knowledge of the audit process.

The suggested areas of clarification arealready those matters that are presently being communicated to the Audit Committee and management Therefore this should not result in any material increases of time or cost.

The Committee sets forth that the proposed clarifications within this approach are appropriate. The Committee does not foresee any potential implications to the scope of the audit or the auditor's responsibilities resulting from such clarifications.

The Committee does suggest that the PCAOB consider adding the use of headings for each significant paragraph within the Independent Auditor's Report in order to make the report better understood and easier to read should these clarifications be adopted.

**Considerations Related to Changing the Audit Report**

The Committee has tried to address this section of theConcept Release in eachthe above sections.

The Committee feels that the present auditing standards regarding Independent Auditor's Reports should be sufficient to address the concerns the users of financial statements have. The Committee believes the concerns may be that users do not fully understand the purpose and content of the Independent Auditor's Report. The Committee expresses the opinion that users of the financial statements are looking to the auditors to "do their job" for them at the expense of the auditors.

As stated above, the Committee believes that if more information in the financial statements is needed by users that generally accepted accounting standards should be reviewed and amended to address the concerns of users of the financial statement. The Committee takes the position that if more information is needed that additional disclosure via either footnotes to the financial statements or changes to the financial statement framework be contemplated.

Thank you for allowing us to comment on this matter.

Very truly yours,

Philip B. Pacino, CPA, Chairman
Accounting Principles and Auditing Procedures Committee
Massachusetts Society of Certified Public Accountants

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September 27, 2011

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Attention: Mr. J. Gordon Seymour

Dear Mr. Secretary,

I am Principal and Chief Executive Officer of The Bronson Group, LLC, and serve on the Board of Directors of Maxim Integrated Products ("Maxim") and currently chair the Audit Committee. Maxim is headquartered in Sunnyvale, CA. Maxim designs, develops, manufactures and markets a broad range of linear and mixed-signal integrated circuits for a large number of customers in diverse geographical locations. Maxim is traded on NASDAQ and has a market capitalization of approximately $7.5 billion as of September 15, 2011.

I appreciate the opportunity to respond to the Public Company Accounting Oversight Board's Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards ("Rulemaking Docket No. 034").

I share the following expectations or guiding principles stated by those expressing concerns against proposed changes to the auditor's reporting model as outlined in the Center for Audit Quality Letter dated June 9, 2011 issued by Cynthia M. Fornelli, Executive Director of Center Audit Quality.

- Auditors should not be the original source of disclosure about the entity. This should be the responsibility of the Company's management.
- Any changes to the reporting model should enhance, or at least maintain audit quality, as well as maintain the independence of the external auditors
- Any changes to the reporting model should add value, be useful to investors and improve investor understanding of a company's operations and financial statements - not create investor confusion. New standards should not create "dueling information" provided by management, the audit committee and the independent auditors.
- Auditor reporting should focus on objective measures rather than subjective measures.

For the purpose of this letter, I wanted to focus on the following questions identified by the PCAOB:

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**Question No. 1: Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**

The current auditor opinion standardizes the language for the investing public and the reader of the issuer's financial statements. The current format enables consistency, comparability and clarity of the audit report. However it is true that the investing public may not fully comprehend the meaning and intent of the auditor's opinion. The proposals of the board exceed the amount of information that the investing public can digest and the amount of information an auditor can provide in a manner that is meaningful to readers of financial statements.

The proposal to change the auditor's reporting model as discussed in Docket Matter No. 34 is problematical for the following reasons:

- Additional information and disclosures to be included in the auditor's report, e.g. discussion of off-balance sheet contingencies or sensitivity of loan loss estimates, can be provided by management in the notes to the financial statements if required to be disclosed by U.S. GAAP or other pertinent accounting guidance;

- The proposed change will require auditors to communicate subjective comments relating to significant auditing and accounting matters such as critical accounting estimates or contingencies. This proposed change increases risk to the auditing firm and will result in significantly higher costs to companies and financial statement readers. The auditors' subjective comments will not necessarily reduce investing risk; and

- An expanded auditors' report will likely not be able to alert users of an issuer's premeditated act of concealing material misstatements in the financial statements. In their current responsibilities and obligations, auditors are responsible for failing to detect material misstatement due to fraud.

**Question No. 5: Should the Board consider an Auditor Discussion & Analysis (AD&A) as an alternative for providing additional information in the auditor's report?**

I have significant concerns over a revised auditor's reporting model that includes a supplemental narrative report, such as an Auditor's Discussion and Analysis ("AD&A"). This would indeed be the most expansive form of reporting of the alternatives presented. An AD&A, as embodied in the current proposal is not appropriate for the following reasons:

- The AD&A could result in conflicting information for the reader / user of the financial statements, and potentially confuse the reader of financial statements. The disclosures in an AD&A would need to be consistent and factually correct in every respect with management's disclosures in its financial statements in order to not be confusing to the reader of the financial statements. Additionally, this will add significant redundant costs both internally

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and externally to the annual audit with absolutely no value to the user of the financial statements

- Management is responsible for the preparation of the financial statements, including related disclosures. The addition of an AD&A could confuse the user of the financial statements as to who has responsibility for the financial statements.
- The external auditor would be subjected to significant additional liability for the preparation of an AD&A and would therefore significantly increase audit fees to account for potential litigation that could arise from such disclosures.

The issuers' management is and should continue to be responsible for the reporting function and the original source of financial statement information and related disclosures.

Recommendation

It is intuitive that improvements to the Auditor's Report can provide value and information that enables the investing public to understand the nature and scope of the audit examination. Certain types of disclosures will add value and information to the Auditor's Report but the current proposals are highly problematical.

The types of disclosures that could be very helpful are similar to those that are made to audit committee chairs of public companies such as:

1. How the auditor determines the scope of the examination.
2. How the audit examination is conducted (i.e. types of procedures followed)
3. How the auditor determines risk areas and reviews management's assessment of risk
4. How the auditor meets its responsibilities in accordance with the appropriate SEC regulations in financial reporting and disclosures
5. Definition of the audit report and to what it is says and what it does say about the financial statements

Safe harbor provisions should be enacted to avoid any additional risk that the auditor currently has today in the release of an audit opinion on financial statements. These provisions along with progressive disclosure of the independent auditors approach to the examination of the financial statements of the issuers could be an effective bridge to the PCAOB is trying to achieve without the adverse impacts of significant issuer cost and expanded auditor liability.

Very truly yours,

Joseph Bronson

Joseph Bronson
Principal & CEO of the Bronson Group, LLC.
Chairman of the Audit Committee, Maxim Integrated Products, Inc.

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September 28, 2011

Office of the Secretary
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**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket No. 034**

Dear Board Members and Staff:

Mayer Hoffman McCann P.C. ("MHM") welcomes the opportunity to comment on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release").

MHM supports the Board's efforts to improve the relevance and contents of auditors' reports. We appreciate the Board's responsiveness to requests from the investment community for additional information from auditors. However, we are concerned that many of the concepts proposed would substantially revise the basic financial reporting relationship whereby management provides the needed information and the auditor provides an independent opinion on the fairness of the information provided.

MHM is also concerned that if The Public Company Accounting Oversight Board ("PCAOB" or the "Board") moves forward with the proposals in the Concept Release, there will be significant unintended consequences. Those unintended consequences include, but are not limited to:

- Confusion of the responsibilities of management and the auditor
- Contradictory and confusing messages to readers of audit reports
- Significantly increased litigation exposure for audit firms
- Significantly increased costs of audits to registrants
- Probable boilerplate language in audit reports
- Contraction of the number of firms competing for audits of registrants
- Potential effects on global competitiveness of U.S. capital markets

As a general comment, we have noticed that the Concept Release uses the term auditor in its singular form and seems to be directed toward an individual auditor. Of course this is rarely the case in audits of public companies, most of which are conducted by substantial firms consisting of many auditors and including quality control systems, consultation policies, risk management policies and national office oversight. It appears that these features have not been considered in the Concept Release which may be the cause of our expected unintended consequences. Additionally, the concept of "joint audits" whereby the audit would be conducted by multiple firms is currently being considered in Europe.

We will explain our concerns with each of these consequences and then address the proposals in the Concept Release.

## Confusion of the responsibilities of management and the auditor

The efficiency of our capital markets depends upon public trust in the financial information provided by the entities seeking that capital. That public trust results from adequate disclosure of financial information by management that is examined by independent auditors. Many of the proposals in the Concept Release would require the auditor to provide significant additional disclosures about the audit and consequently about the entity. Presumably the parties requesting these disclosures expect the auditor to provide them without respect to the views and opinions of management. That is both inconsistent with the traditional role of the auditor and unreasonable in light of the relative familiarity of the parties with the entity.

The persons in financial reporting oversight roles in public companies are responsible for the completeness and accuracy of financial reporting in their filings with the Securities and Exchange Commission ("SEC"). These individuals spend full time designing the systems; collecting the data; researching, consulting and solving complex accounting and disclosure issues, and summarizing the information that is ultimately presented in the SEC filings. Additionally, their efforts are overseen and reviewed by the Audit Committee and the Board of Directors of the entity. In contrast, in forming an opinion on the financial statements, the auditor only spends a fraction of the time that management spends in producing the financial statements and developing the disclosures.

Therefore, if additional disclosures are necessary and can be provided at a reasonable cost, they should be provided by management in conformity with requirements and standards issued by the SEC and/or the Financial Accounting Standards Board ("FASB").

The current reporting system should not be subverted through "back door" requirements by the PCAOB for auditors to provide information that is not required to be provided by management and with which they may not agree.

The concept that management discloses and auditors opine should be maintained.

## Contradictory and confusing messages to readers of audit reports

As noted in the Concept Release "The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a 'pass/fail model.'" Of course, in actuality for SEC registrants, the only acceptable alternative is to "pass" since the SEC will not accept a qualified opinion. If the financial statements do not "pass" the auditor does not issue a report and the registrant does not file the financial statements. While this model is very simplistic, it is also very easily understood.

The Concept Release asks whether or not the pass/fail model should be retained. MHM believes that it should. This model is a direct affirmation of the auditor's assurance as to the fair presentation of the financial statements. Further, we believe that it should be left intact. A number of years ago auditors were allowed to issue "subject to" opinions. In this form of opinion the auditor could issue a clean opinion subject to the resolution of certain uncertainties. The profession subsequently determined that this type of opinion was not useful to readers of the opinion and that the auditor should issue either a clean or modified opinion depending on how management accounted for or disclosed the uncertainties. MHM believes that was an improvement to the auditor's reporting model that required the auditor to take more responsibility for the type of opinion rendered.

Many of the proposals in the Concept Release would require the auditor to supplement the audit report with additional information related to:

- Difficult or contentious issues including "close calls"
- Material matters where disclosures could be enhanced or different accounting methods could be applied
- Permissible alternative accounting treatments and which one is preferred by the auditor
- Critical accounting policies and critical accounting estimates discussed with the audit committee
- Significant risks identified by the auditor and the audit procedures performed in response to those risks.

MHM believes that much of this additional information would contradict the auditor's opinion on the financial statements; could be viewed to be a piecemeal opinion, and would produce confusion rather than clarity as to the responsibility the auditor is taking for the opinion.

### *Significantly increased litigation exposure for audit firms*

The Concept Release refers to "...changes that investors and others are seeking to the auditor's report ...." MHM acknowledges that investors have long requested that auditors provide additional insight into the audit process. We are also aware that the PCAOB has recently established an Investor Advisory Group and that this group recommended that the Board undertake this initiative. We understand that large sophisticated institutional investors and analysts may understand the types of additional disclosures that are being requested of auditors. These sophisticated investors and analysts already have substantial access to companies and receive substantial information on which to base their investment decisions. We therefore feel that the sophisticated investors and analysts are primarily attempting to reduce the inherent risks associated with their profession by increasing the risks of the auditing profession. We also feel that individual investors, which make up the bulk of the investing public, would only be confused by the additional disclosures as noted above.

MHM is seriously concerned that the segment that will benefit the most from the proposed revisions to the auditor's report is the plaintiff's bar.

In addition to the matters noted above, the auditing profession is being asked to publicly disclose all of the areas of weakness in an audit. These disclosures include:

- Difficult or contentious issues including "close calls"
- Significant risks identified by the auditor and the audit procedures performed in response to those risks.
- The results of audit procedures performed on audit risk areas or areas requiring significant auditor judgment
- Material matters where disclosures could be enhanced or different accounting methods could be applied
- Areas in which there were difficulties encountered in performing the related audit procedures

With hindsight after a financial problem for a company, these types of disclosures by the auditor will provide a blueprint for the lawsuit against the auditor. This is tantamount to purchasing a gun and ammunition; loading the gun, and handing it to your assassin.

### *Significantly increased costs of audits to registrants*

Section IV. A. of the Concept Release includes the following statement. *"Since many of the alternatives presented in this concept release focus on auditor reporting and do not require additional audit procedures by the auditor in forming the opinion on the financial statements, some expressed a view that the auditor's incremental efforts and cost to report such information should be minimal."* The section then goes on to discuss a few reasons that this may not be the case.

MHM would point to the previous section of our comments and emphasize the fact that it may be impossible to do enough work to manage the litigation risk associated with the requested additional disclosures. Accordingly, we find it totally improbable that any CPA firm would allow individual line partners to provide the types of disclosures requested, particularly in a free-writing format, without an extensive review by regional and national quality control and risk management personnel. It would also, in many cases, probably require review by the firm's legal counsel as well.

Our Firm's experience in negotiating the wording of management letters and communications with audit committees, which are currently not public documents, indicates that significant amounts of time would be required to formulate additional disclosures in audit reports which would be available to the public. As noted in the Concept Release, this discussion and debate among the auditor, management and the audit committee will require additional time which will place significant additional pressure on preparers' ability to meet public reporting deadlines.

It is totally inconceivable that the proposals included in the Concept release would not result in substantial increases in the costs of audits and in the time required to complete the audit and issue the auditor's report.

### *Probable boilerplate language in audit reports*

MHM believes that in response to the significantly increased litigation risks and the accompanying significant increased costs of the audit, most firms will develop standardized forms for the new audit reports. It is impractical to think that any national firm will allow a line partner in a remote location to jeopardize the capital of the firm. Consequently, standardized or "boilerplate" reports will quickly be developed.

### *Contraction of the number of firms competing for audits of registrants*

We also believe that in response to the significantly increased litigation risks, many firms which each perform a relatively few number of public company audits will decide that the rewards no longer justify the risks associated with these engagements. This will of course increase the concentration of firms willing to accept these risks and reduce the competition for audits of registrants. This may also serve to increase the cost of audits of public companies.

### *Potential effects on global competitiveness of U.S. capital markets*

MHM believes the PCAOB should thoroughly assess the potential effects of the proposed regulation and the additional cost of compliance on the effects on the U.S. Capital Markets. Numerous graduate studies have concluded that the Sarbanes Oxley legislation has driven both foreign and domestic companies from the U.S. Capital Markets since its introduction in 2002. This factor was also noted by Treasury Secretary Paulson's Committee on Capital Markets Regulation which cited the role of Sarbanes Oxley in the decline of U.S. dominance in investment banking. The Board should consider that foreign registrants are either exiting or by passing entirely the U.S. capital markets and should reconcile this fact pattern with the SEC's desire that the U.S. capital markets remain an attractive destination of capital formation for foreign entities.

The Board should also consider that Sarbanes Oxley has been a frequent target of competing foreign capital formation centers. Given the global competition in capital markets, and that many of these companies are based in emerging growth markets, the Board should bear this in mind to ensure that individual investors which comprise a significant segment of the U.S. markets are being denied an opportunity to these high growth opportunities due to increased regulatory burden.

We fear that the increased cost of regulatory compliance that we have seen with Sarbanes Oxley would only continue under this proposal.

**Potential Alternatives for Changes to the Auditor's Report**

***Auditor's Discussion and Analysis***

The first alternative to the current form of the auditor's report presented in the Concept Release is a supplemental narrative report described as an Auditor's Discussion and Analysis ("AD&A"). The intent of an AD&A would be to provide the auditor with the ability to discuss in a narrative format his or her views regarding significant matters and to provide investors and other financial statement users with a view of the audit and the financial statements "through the auditor's eyes."

MHM is strongly opposed to an AD&A.

We are concerned that all of the unintended consequences previously discussed are embodied in an AD&A.

- Auditors should not disclose information not previously disclosed by the management of their client. This is contrary to the normal relationship where management discloses and the auditor opines.
- An unqualified audit opinion supplemented with an AD&A that includes information about audit risk, audit procedures and results, management's judgments and estimates, accounting policies and practices, difficult or contentious issues including "close calls" and areas where the auditor would have preferred that management had chosen different accounting policies or enhanced disclosures seems to be contradictory at best.
- An unqualified audit opinion supplemented with an AD&A that includes the suggested information will be confusing to the vast majority of readers of the report and users of financial statements.
- An unqualified audit opinion supplemented with an AD&A that includes the suggested information will require extensive interaction between auditors, management, audit committees and both parties legal counsel and will discourage cooperation and encourage animosity among the parties.
- An unqualified audit opinion supplemented with an AD&A that includes the suggested information will significantly increase the cost of audits due to the required extensive review by regional and national quality control and risk management personnel as well as the firms' legal counsel.
- An unqualified audit opinion supplemented with an AD&A that includes the suggested information will provide a blueprint to the plaintiff's bar for claims against the auditor in any subsequent legal actions.
- An unqualified audit opinion supplemented with an AD&A that includes the suggested information will result in boilerplate language that does little to provide additional information to investors due the firms' desire to maintain reasonable costs and to protect them from increased legal liability.

MHM believes requiring an AD&A to be a bad idea that should not be considered as an alternative for future changes to the auditor's report.

### *Required and expanded use of emphasis paragraphs*

Emphasis paragraphs are extremely useful in limited circumstances. They provide the auditor with a mechanism to point to certain disclosures within the financial statements providing information the auditor feels is particularly important to users of the statements. They might also allow the auditor to emphasize a matter that was particularly crucial in forming the auditor's opinion on the financial statements. Emphasis paragraphs are not required but are a tool that the auditor may use when judgment calls for it.

Expanded use of emphasis paragraphs might be useful with additional guidance as to when they would be beneficial. They are an effective means of directing the reader's attention to areas within the financial statements that the auditor feels are significant.

MHM does not support required and expanded use of emphasis paragraphs.

- Emphasis paragraphs should not be mandated in all audit reports. The vast majority of audit report will probably never need an emphasis paragraph.
- Required and expanded use of emphasis paragraphs, particularly including key audit procedures pertaining to the matters identified may be seen as contradictory to an unqualified opinion and result in confusion on the part of the readers of the auditor's report.
- Required and expanded use of emphasis paragraphs will require extensive interaction between auditors, management, audit committees and both parties legal counsel and will discourage cooperation and encourage animosity among the parties.
- Required and expanded use of emphasis paragraphs will significantly increase the cost of audits due to the required extensive review by regional and national quality control and risk management personnel as well as the firms' legal counsel.
- Required and expanded use of emphasis paragraphs will provide a blueprint to the plaintiff's bar for claims against the auditor in any subsequent legal actions.
- Required and expanded use of emphasis paragraphs will result in boilerplate language that does little to provide additional information to investors due the firms' desire to maintain reasonable costs and to protect them from increased legal liability.

If, in all cases, investors need a "road map" to the more significant matters included in the financial statements it should be provided by the company with appropriate review by the auditor.

### *Auditor assurance on other information outside the financial statements*

MHM agrees that an auditor providing assurance on information outside of the financial statements could improve the quality, completeness, and reliability of such information, providing investors and other users of financial statements with a higher level of confidence in information about the company that is provided by management.

As noted in the Concept Release, current standards (AT sec. 201, *Agreed-Upon Procedures Engagements* and AT sec. 701, *Management's Discussion and Analysis*) provide companies the ability to retain auditors to provide assurance on information outside the financial statements. However, auditors rarely perform these services since there is no SEC requirement for companies to engage auditors to perform these procedures.

If auditors are to be required to perform these types of engagements, the SEC should require registrants to engage auditors to provide the assurance needed. The requirement should not be "back-doored" by the

PCAOB with a requirement for auditors to perform without a requirement for the company to engage us for the service.

Additionally, if the service is to be required, the SEC must realize that it will take additional time and a determination will be needed regarding the timing of the service in relation to current filing deadlines.

MHM could also support clarifying the current auditor's report to disclose our responsibility to read the information outside the financial statements and consider whether it is materially consistent with the audited financial statements.

### *Clarification of language in the standard auditor's report*

MHM agrees that in certain cases clarification of the language in the current auditor's report might enhance the reader's understanding of what the report is trying to convey. While we agree this might help in some areas, we do not think it is necessary for each of the terms suggested in the Concept Release as follows:

- Reasonable Assurance – It seems that adding language to the effect that "reasonable assurance is a high level of assurance, but not absolute assurance" would merely be additional words without a real improvement to clarity.
- Auditor's Responsibility for Fraud – We would not object to adding the phrase "whether caused by error or fraud" to the statement regarding our responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement.
- Auditor's Responsibility for Financial Statement Disclosures – Although we realize that the notes to the financial statements are not specifically mentioned in the auditor's report, we find it hard to believe that any knowledgeable reader would not consider them covered by the report when the footer on each of the statements mentioned in the report states that the notes are an integral part of the statement. However, we are not opposed to adding the notes to the financial statements to the list of items examined.
- Management's Responsibility for the Preparation of the Financial Statements – We suggest that the PCAOB incorporate the wording used by the AICPA's Auditing Standards Board in its clarified standard on auditor's reports.
- Auditor's Responsibility for Information Outside the Financial Statements – See our comment above. We would not object to disclosing our responsibility for this information.
- Auditor Independence – Since the title of the standard auditor's report is "Report of Independent Registered Public Accounting Firm", we feel that further clarification within the body of the report would only be redundant.

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We appreciate the opportunity to provide comments on the Exposure Draft. Please contact Ernie Baugh (423-870-0511) if you have any questions.

Respectfully Submitted,

Mayer Hoffman McCann P.C.

MAYER HOFFMAN McCANN P.C.

**From:** Christopher Spahr [mailto:christopher.spahr@yahoo.com]
**Sent:** Wednesday, August 24, 2011 3:52 PM
**To:** Comments; Mayo
**Subject:** Rulemaking Docket Matter No. 34

**RE: PCAOB No. 2011-003**

We are two sell-side equity analysts that publish reports on publicly traded financial companies in the United States, but our comments below are solely submitted in our personal capacity. These views do not reflect those of our employer, Credit Agricole Securities or affiliated company, CLSA.

We rely on financial statements from the companies we cover to gauge two key items: past performance (on an absolute and relative basis) and as means to test the veracity and quality of management. These financial statements are the life blood of our profession—something that we cannot live without and, when not working well, make our jobs and, in our view, all of finance perform well below its potential.

We rely on auditor reports as the key tool for making sure financial statements are accurate and fair. We also rely on the external auditors to make sure that contingent liabilities (such as credit guarantees, legal considerations, and long-term compensation plans) are accurately reported and capture all relevant long-term risks. Finally, we rely on the auditors to make sure all material risks are reported in the company's quarterly and annual reports so independent analysts and investors can make sufficiently informed sensitivity analyses for both the short and long terms. In short, analysts and investors cannot do their jobs well without the auditors doing their jobs well too.

Yet, the only communication between auditors and investors is typically a standard three-paragraph report presented in a company's annual report. Moreover, these reports are essentially identical for the overwhelming majority of all public companies with little or no variation regardless of sector, geography, etc. It is difficult to gauge the quality of the reporting process, except after firms fail when shortcomings are typically found in the financial statements, risk disclosures, and often the auditing processes. We believe more comprehensive communication between the auditors and analysts would be helpful for all parties involved—investors, the reporting companies, and the auditors as well.

To that end, we believe that the four most important changes to the audit report would require the auditor to: (1) discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment; (2) disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas; (3) discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes); and (4) discuss the quality, not just the acceptability, of the issuer's accounting practices and policies.

In addition, we believe that the audit report should indicate the auditor's responsibility for detecting material fraud. The standard audit report should clearly define that the auditor has a responsibility to obtain reasonable assurance as to whether the financial statements are materially misstated, whether caused by error or fraud.  In addition, the report should indicate that reasonable assurance represents a high, although not absolute, level of assurance.

Please feel free to contact us for any more information.

Regards,

Mike Mayo, CFA

Chris Spahr, CFA

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McGladrey

September 29, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

McGladrey & Pullen, LLP appreciates the opportunity to offer our comments on the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release). Our comments are organized by those that are general in nature, followed by those that relate to the specific potential alternatives for changes to the auditor's report presented in the Concept Release.

## General Comments

We agree that the PCAOB should explore potential changes to the auditor's reporting model. Improvements should be considered for the auditor's communications to investors regarding the work performed by the auditor under the current framework for the audits of the financial statements and internal control over financial reporting. This should include communicating additional information to investors within the parameters of PCAOB auditing standards and SEC disclosure requirements. In that regard, we believe the PCAOB should first focus on improvements to the current auditor's reporting model. Consideration of areas where auditors could provide assurance on information outside of the financial statements should be a secondary future project.

While investors, analysts and other users of the financial statements have expressed a desire and need for more information regarding certain aspects of the issuer's financial statements and business operations, it is important that management or the audit committee remain the source of such information. As discussed below, we believe that the auditor should not be the original source of disclosure of information about the issuer. However, if changes were made to SEC disclosure requirements whereby management or the audit committee were required to disclose additional information about the issuer, or even the nature of discussions with the auditor, we would support the auditor reporting on the accuracy of those disclosures as long as the information was not overly subjective in nature.

Clear objectives for any changes to the auditor's reporting model should be established and clearly communicated to issuers, auditors and users of financial statements. Regardless of the changes ultimately made to the auditor's reporting model, it will be important that investors and other financial statement users are educated on the changes and the implications of those changes.

## Comments on Specific Potential Alternatives for Changes to the Auditor's Report

***Auditor's Discussion and Analysis***

Our Firm believes the PCAOB should not consider a revised auditor's reporting model that would include a supplemental narrative report, referred to in the Concept Release as an Auditor's Discussion and Analysis (AD&A). We believe the responsibility for disclosure of any information about an issuer's financial statements should continue to be initially communicated by management or the audit committee.

Any analysis of the financial statements by the auditor could compete with management's disclosures, or shift the responsibility for accounting and disclosure away from the issuer and to the auditor. Further, auditors should not be the original source of disclosure about an issuer as this is contrary to the auditor's established role of attesting to information that is provided by management or the audit committee.

Not only would an AD&A be contrary to the auditor's established role, it also could create uncertainty on the part of users if such analysis was contradictory to that of management. If, on the other hand, the AD&A was consistent or nearly consistent with management's discussion and analysis in the issuer's annual report, there would be redundancy in disclosures resulting in additional disclosure overload. It therefore seems that the time involved by the auditor in drafting and reviewing an AD&A about information in the issuer's financial statements would result in additional costs that may not be commensurate with the potential related benefits.

If the AD&A provided information about the audit as opposed to a discussion about the financial statements, such a narrative report also would have the potential for disclosure overload and investor confusion. It would be nearly impossible for the auditor to succinctly discuss audit procedures that were responsive to significant risks identified by the auditor, why the procedures were responsive to such significant risks, and the results of those procedures. A discussion of such matters at a high level would provide no meaningful information to investors as it would become boilerplate. In addition, the time required to draft and review the AD&A would further condense the limited time available under existing SEC filing deadlines for the execution of existing audit responsibilities. Whenever additional work is required to be performed in an unchanging timeframe, a higher likelihood of error and mistakes exists resulting in possible negative effects on overall audit quality.

***Required and Expanded Use of Emphasis Paragraphs***

The required and expanded use of emphasis paragraphs could be a viable approach to providing additional information that might be useful to investors and other financial statement users. We believe such emphasis paragraphs should be objective, fact-based discussions of the most significant matters in the financial statements and should make specific reference to where such items appear in the financial statements. This approach would be beneficial in that it would highlight areas of audit emphasis in the auditor's report so that investors could refer to the related financial statement disclosures made by management. This method retains the auditor's established role of attesting to information provided by management.

We do not believe emphasis paragraphs should include auditor's comments on the key audit procedures pertaining to the identified matters. It would be nearly impossible for the auditor to succinctly comment on such audit procedures, and a discussion of such matters at a high level would provide no meaningful information to investors as it would become boilerplate.

If the Board decides to adopt required and expanded use of emphasis paragraphs, the resulting standard would need to include clear implementation guidance to help the auditor in assessing and consistently determining the types of matters that should be identified for emphasis.

***Auditor Assurance on other Information outside the Financial Statements***

Another alternative to enhance the auditor's reporting model could be to require auditors to provide assurance on information outside the financial statements, such as MD&A. This approach would allow the auditor to continue in its established role of attesting to information provided by management and also could provide more information for investors. One alternative for consideration in providing assurance on information outside the financial statements would be to require auditors to provide a separate attestation report on the examination of the completeness and accuracy of the issuer's critical accounting estimate disclosures in its MD&A. This alternative would be responsive to suggestions made by investors regarding the need for more information about important judgment calls made by management in preparing the financial statements. It should be noted, however, that the time required to perform an examination of the completeness and accuracy of the issuer's critical accounting estimate disclosures in its MD&A could detract from the limited time available under existing SEC filing deadlines for the execution of existing financial statement audit responsibilities.

With regard to the potential for auditor involvement with earnings releases, often the auditor performs procedures on these management communications prior to public distribution to assess the consistency of the financial information contained therein with the audit in process. We believe that the only potential engagement that might be performed on earnings releases prior to completion of the audit would be pursuant to existing PCAOB standard AT 201, *Agreed-Upon Procedures Engagements.* Such engagements however require that this type of report be restricted for use to specified parties. Given that earnings releases are by their very nature intended for general distribution, the PCAOB attestation standards would have to be modified for such a report to be of value to users of the earnings releases.

***Clarification of Language in the Standard Auditor's Report***

In addressing whether there should be clarification of language in the existing standard auditor's report, the question of whether the current model for the auditor's report should be retained should first be addressed. We support the retention of the current auditor's report as the issuance of an unmodified opinion continues to provide investors a measure of comfort with respect to the issuer's financial statements. However, we believe the addition of clarifying language to the standard auditor's report would be beneficial in enhancing the understanding of the auditor's role and responsibilities. Such clarifying language should be standardized, rather than tailored, so as to not create inconsistency and potential investor uncertainty.

We believe the addition of clarifying language to the following matters identified in the Concept Release could be beneficial:

- "Reasonable assurance about whether the financial statements are free of material misstatement" – Define the terms "reasonable assurance" and "material misstatement."
- Auditor's responsibility for fraud – Include a statement that the auditor is responsible for planning and performing the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether caused by error or fraud.
- Auditor's responsibility for financial statement disclosures – Specifically state that the financial statement footnotes are an integral part of the financial statements and are covered by the audit report.
- Management's responsibility for the preparation of the financial statements – Expand this concept to include management's responsibilities for the Form 10-K. Also consider including a brief description of the audit committee's responsibilities.
- Auditor's responsibility for information outside the financial statements – Describe the auditor's responsibility for information outside the financial statements.
- Auditor's independence – Explicitly state that the auditor is independent of the issuer under all relevant SEC and PCAOB rules.

Also, we believe the addition of clarifying language to the following additional matters could be beneficial:

- Auditor judgment – Highlight the necessary use of professional judgment in making decisions regarding risk assessments and the selection of audit procedures.
- Scope limitations and non-compliance with U.S. generally accepted accounting principles (GAAP) – Summarize the auditor's responsibility in situations where the audit scope is limited or when it is determined that the financial statements are not in accordance with GAAP.
- Networks – If applicable, describe the accounting firm's network structure, the responsibility of the member firm signing the audit report, and the participation of other member firms in the audit.

We would be pleased to respond to any questions the Board or its staff may have about these comments. Please direct any questions to Bob Dohrer, National Director of Assurance Services at 919-645-6819.

Sincerely,

McGladrey & Pullen, LLP

McGladrey & Pullen LLP

MERITOR

Meritor, Inc.
2135 W. Maple Road
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**Kevin A. Nowlan**
*Vice President*
*and Controller*

**tel** **248-655-2382**
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September 30, 2011

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

**In regards to*: Request for Public Comment: Concept Release on Possible Revisions to PCAOB Standards related to reports on Audited Financial Statements and related Amendments to PCAOB Standards, PCAOB Rulemaking Docket No. 34***

Dear Public Company Accounting Oversight Board,

Meritor, Inc. ("We") appreciates this opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards related to reports on Audited Financial Statements and related Amendments to PCAOB Standards.* We are supportive of certain proposed clarifications to the auditor's report, however would like to share our reservations on the proposed rule.

The following are our comments on the potential direction of the proposed standard-setting project on the content and form of reports on audited financial statements:

***Form of the Auditor's Report***

We are in favor of the Board seeking input from investors, auditors, issuers, and other interested parties regarding their views on how to make the report more meaningful to users of financial statements. In the wake of the financial crisis, investors and independent commentators have been highly critical of the auditors for these failures and of regulators for failing to hold them accountable. The undertaking of improving the information provided and the language used in the auditor's report is recommended to improve investor confidence in the process.

In our opinion, the Board should retain the 'pass/fail' model on the auditor's report. The auditor's report is not the best place to go into details of operations, financial condition or other matters affecting a company's business in short and long-term periods. The purpose of a financial statement audit is to express an opinion on whether the financial statements meet the requirements of the underlying accounting framework and the auditor's report should continue to focus on the outcome of the audit performed with this purpose. If additional information is required to be presented in the auditor's report beyond what is currently provided in the 'pass/fail' model of the report, the auditors would generally be required to enhance the scope of their engagements significantly. The increase in the scope of audit engagements would result in significantly higher audit costs. In addition, auditor's responsibility with respect to financial statements would need to be further clarified if significant additional qualitative information is presented in the auditor's report.

Management is the most appropriate party to provide detailed information regarding a company's operations, financial condition and other matters to financial statement users. Management has the necessary insights into the industry in which the company operates, related risks and the company's business strategies to address those risks. The focus of financial statement auditors should continue to be on whether the financial statements are presented in accordance with the underlying accounting framework. While performing audit procedures on financial statements, an auditor gains significant insights into a company's operations. In our opinion, this information should be used by the auditor in assessing if the company has made appropriate disclosures required by the accounting framework and the Securities and Exchange Commission rules.

Investors should be able to obtain all necessary disclosure information about a company's results of operations, financial position and cash flows from the footnote disclosures that are required by the financial reporting framework. Investors should not be left to rely on an auditor for such information. We believe that company management is responsible for providing accurate and meaningful information to its investors.

The standard auditor's report could be modified to provide clarification on the following:

- Auditor's Responsibility: Clarification is needed to minimize the difference between how auditors perceive their role and how financial statement users perceive it. The standard report states the auditor's responsibility is to express an opinion on the financial statement based on their audit. We propose including additional language in the auditor's report stating auditors are responsible for detecting material misstatement due to errors or fraud.

- Reasonable Assurance: The standard auditor's report states an audit is performed to obtain reasonable assurance about whether the financial statements are free of material misstatements. Some users may not understand the level of assurance intended to be conveyed by this statement. Therefore, a definition of reasonable assurance could be included in the standard report to increase the comprehensibility of the report.

**Auditor's Discussion and Analysis**

We do not believe that the Auditor's Discussion and Analysis (AD&A) would be beneficial in providing any additional information about a company's operations, its financial condition or other matters. We believe that the incremental reporting in the form of AD&A is likely to cause confusion on the part of users of financial statements without a corresponding benefit. In addition, we believe the introduction of AD&A would lead to confusion among financial statement users about responsibility of the auditor vis-à-vis management.

Management's Discussion and Analysis (MD&A) currently provides most of the information utilized by investors, analysts and other interested parties. AD&A would not provide anything additional that is not currently available to investors. In case additional information is considered necessary for use by the investment community, this could be provided by enhancing discussion in the MD&A.

Auditors, by their training and experience, are best suited to provide assurance specific to accounting framework related matters and are not analysts, investment advisers or business commentators. In general, the auditors are not trained to evaluate and communicate a company's business and strategic risks. Therefore, adding AD&A to their reporting requirements would increase the complexity of the audits and would dilute and delay the timely delivery of financial statement audit services provided by the auditors.

Furthermore, the addition of AD&A to auditor reporting requirements would significantly increase the cost of a financial statement audit, which, in our opinion, will not justify the benefits provided to investors.

**Required and Expanded use of Emphasis Paragraphs in Auditor's Report**

We do not believe a required and expanded use of an emphasis paragraph in the auditor's report would enhance the usefulness of the auditor's report. Current accounting frameworks do include disclosure requirement about significant matters affecting a company's business, including the following:

- Significant accounting policies used in preparing the financial statements,
- Significant judgment and estimates made by management, and
- Areas with significant measurement uncertainty.

Any additional areas where enhanced disclosures are considered necessary should be included in the accounting framework rather than incorporating them in the auditor's report in the form of an emphasis paragraph. Such additions to the financial statement disclosure requirements could include areas where significantly diverse accounting treatments are available under the current accounting framework and are used by others in a company's competitive environment.

We are also not in favor of including discussion in the auditor's report about audit procedures performed by the auditor in arriving at their audit conclusions. We believe this information would not provide any useful information to the financial statement users since the independent auditor is engaged on behalf of investors as an expert in accounting and auditing.

**Auditor Assurance on Other Information Outside the Financial Statements**

Under the current auditing standards, auditors provide limited assurance on information disclosed in the MD&A. We do not believe auditors should be required to provide audit level assurance on information outside of the financial statements, including the MD&A, as an alternative for enhancing the auditor's reporting model. As discussed previously, the auditors by their training and experience are best suited to provide audit level assurance on matters reflected in financial statements as they relate to an accounting and financial reporting framework and those related to a company's internal control environment.

For information disclosed outside of the financial statements, it may be difficult to design and perform appropriate audit procedures and obtain sufficient audit evidence. These matters involve significant management judgment based on in-depth knowledge and experience accumulated over long periods of time. Requiring an audit of such matters would introduce significant challenges in the day-to-day business management processes and it may be difficult for the auditors to provide objective assurance on these matters.

We would welcome the opportunity to further discuss our comments in this letter.

Sincerely,

Kevin Nowlan

Kevin A. Nowlan
Vice President and Controller
Meritor, Inc.

1095 Avenue of the Americas
New York, NY 10036

**Peter M. Carlson**
Executive Vice President and
Chief Accounting Officer
pcarlson@metlife.com

September 30, 2011

Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, D.C. 2006-2803

**Re: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* [PCAOB Rulemaking Docket No. 34]**

Dear Office of the Secretary:

MetLife, Inc. (MetLife) appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board's (PCAOB) **Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*** (the concept release). MetLife is a leading global provider of insurance, annuities and employee benefit programs, serving 90 million customers in over 60 countries. Through its subsidiaries and affiliates, MetLife holds leading market positions in the United States, Japan, Latin America, Asia Pacific, Europe and the Middle East. Our responses incorporate consideration of our position not only as a preparer of audited financial statements for a widely-held public enterprise, but also as a significant financial statement user, with a general account investment portfolio of US corporate debt and equity securities of approximately $100 billion as of June 30, 2011.

Metlife supports the PCAOB's overall effort to undertake standard-setting initiatives to consider certain enhancements to improve the quality and content of the current auditor reporting model. However, any changes must provide useful and objective information to investors and other financial statement users, while continuing to acknowledge that the preparation of the financial statements and related disclosures are the responsibility of management and that the auditor's opinion is on the fair presentation of the financial statements taken as a whole.

In our view, it is management's role, and not that of the auditor, to disclose all financial information relevant to investors and other financial statement users to facilitate making informed decisions based on those financial statements. Management owns the financial information, is most familiar with it, and is in the best position to disclose it in the most complete and meaningful manner. The primary role of the auditor's report should remain in providing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in accordance with the applicable financial reporting framework. The auditor's opinion on the financial statements, in our view, must remain, and, perhaps more importantly, be perceived by financial statement users to remain, on the financial statements "taken as a whole". The moment the auditor's report begins to discuss specific audit risks, audit procedures, management judgment calls, etc. the perception of the opinion not covering the financial statements overall is compromised, which we believe will inevitably lead to lack of clarity, consistency and comparability for financial statement users.

In this regard, while MetLife does support the specific proposals in the concept release requiring the auditor's report to provide additional information to clarify what an audit represents and the auditor's specific responsibilities, we do not support the addition of an Auditor Discussion and Analysis (A, D&A) to the auditor's reporting model nor the required and expanded use of emphasis paragraphs in the auditor's report, as introduced in the concept release.

Certain disclosures suggested for the auditor's report in these areas are already required as part of financial statement prepared in accordance with Accounting Principles Generally Accepted in the United States (US GAAP), while others have traditionally been confined to communications between the auditor and the company's audit committee. Providing the latter information publicly, without the appropriate context or comparability, may lead to significant levels of confusion and potentially misinformation for financial statement users. Because any new disclosures in the auditor's report will most likely result in a company opting to make many of those disclosures themselves, it could result in the audit community being perceived as effectively dictating a new round of required financial statement disclosures. However, there would be no established framework to ensure consistency and comparability afforded financial statement disclosures that are subject to the full exposure and comment of the due process established by the Financial Accounting Standards Board (FASB). In this regard, if investors and other users feel the need for new or expanded disclosures in the audited financial statements to provide additional insight into areas of significant risk, uncertainty or judgment, management should be explicitly required to make those disclosures. Such disclosures should be established through the same standard-setting process as all other financial statement disclosures, and auditors would then encompass those disclosures in their overall opinion on the fair presentation of the financial statements.

The following pages present our more specific thoughts on each of the four potential alternatives for changes to the auditor's report outlined in the concept release: (1) A, D&A, (2) Required and Expanded Use of Emphasis Paragraphs, (3) Auditor Assurance on Other Information Outside the Financial Statements and (4) Clarification of the Standard Auditor's Report. We once again thank you for the opportunity to respond to your proposals and your consideration of our observations and comments. If you have any questions regarding the contents of this letter, please do not hesitate to contact me.

Sincerely,

Peter M. Carlson

cc: William J. Wheeler
Executive Vice President and
Chief Financial Officer

Karl Erhardt
Senior Vice President and
General Auditor

***Auditor's Discussion and Analysis and***
***Required and Expanded Use of Emphasis Paragraphs (Emphasis Paragraphs)***

In accordance with generally accepted auditing standards, auditors design the audit and, in turn, related audit procedures, taking into consideration, among other things, materiality, financial and non-financial risks, and the review and understanding of management judgments, including the application of alternatively permissible accounting treatments, all of which can vary significantly between companies. The consideration of all of this information, when taken as a whole, along with the results of their overall and unique set of audit procedures designed to address these risks and uncertainties, allows the auditor to form an opinion as to the fair presentation of the overall financial statements, including financial statement disclosures.

The proposals in this concept release contained in the A, D&A and/or the Emphasis Paragraphs involve potential disclosure by the auditor of specific audit risks and specific audit procedures to address those risks, difficult and contentious issues with management, significant management judgments and estimates, and alternative accounting treatments.

ASC 275, *Risks and Uncertainties*, currently requires management to disclose in the audited financial statements, risks and uncertainties that could significantly affect the amounts reported in the financial statements in the near term, or the near term functioning of the company, stemming from the nature of the company's operations, the use of estimates, and significant concentrations in the company's operations. Financial statements prepared in accordance with US GAAP, therefore, already contain audited footnotes addressing many of the potential suggested disclosures raised in the concept release.

We believe that the additional suggested disclosures already form part of the required "internal" disclosure today between the auditor and the company's audit committee and should not be considered for incorporation into the auditor's report for the following reasons:

a) There could be a wide variety of interpretations by financial statement users as to how the information should be interpreted and used unless the entire context to which this information relates in the overall formation of the auditor's opinion is discussed and disclosed.

b) Audit committees of public companies in the United States are required to have at least one "financial expert" with knowledge of accounting and experience in preparing, auditing, or analyzing financial statements with a level of complexity of accounting issues that are generally comparable to the complexity of issues that can reasonably be expected to be present in that particular company's financial statements. In contrast, most financial statement users do not have the requisite audit or accounting background to assess whether certain audit procedures performed were adequate to address the risks identified by the auditor, thus potentially creating confusion and misunderstanding if disclosed.

c) Certain audit risks and related audit procedures are common to many companies, for example, those in a particular industry. Without providing a framework that can be consistently reported that would allow differentiating one company's specific audit risks and related procedures from another will significantly diminish the usefulness of providing this information.

d) There are currently a significant number of accounting standards that allow more than one acceptable treatment for the same transaction, based on management's judgment. As accounting standards become more principles-based, alternatively permissible accounting treatments will only increase and potentially become more overwhelming to financial statement users to sort out. Also, without quantifying the effects of such differences, these disclosures will most likely create more confusion than clarity.

e) We believe that information regarding the difficult or contentious issues (including "close calls") faced by an auditor is best left for discussion with a company's audit committee in their governance role rather than inclusion in the auditor's report. Requiring this type of disclosure in the auditor's report could conceivably have the effect of stifling, constraining, and even eliminating often constructive dialogue between a company and its auditors on routine accounting matters, because of the natural tendency for this type of activity to be viewed negatively by the public, if ever disclosed by the auditor. At an extreme, over time this could have the unwanted effect of the auditor's views on all accounting matters unduly influencing management's view, putting pressure on the perception of auditor independence.

As an alternative to the A, D&A and Emphasis Paragraphs, so as not to diminish the current role of the audit committee, we believe that any new disclosures regarding risks and accounting practices and judgments, if any, should be made by management and developed through the appropriate accounting standard-setting process for inclusion in the audited financial statement footnotes. This will allow for appropriate consideration and input of users, preparers, and other stakeholders and provide a consistent framework to ensure comparability and usefulness. Current SEC Regulation S-X Management, Discussion and Analysis (M, D&A) disclosure requirements for public companies of critical accounting estimates, for example, could be formally incorporated into the audited financial statement footnotes and expanded or revised as needed to address many of the concerns raised in the concept release.

***Auditor Assurance on Other Information Outside the Financial Statements***

The concept release discussed another alternative to enhance the auditor's reporting model, which could be to require auditors to provide assurance on information outside the financial statements, such as M, D&A or other information (for example, non-GAAP information or earnings releases).

Current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., M, D&A). These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact.

Although we believe that an auditor providing assurance on information outside of the financial statements could potentially improve the quality, completeness, and reliability of such information, we are not sure that the benefits outweigh the costs. In addition, most companies accessing the equity and debt markets periodically provide “comfort letters” to underwriters and attorneys that represent investors’ interests. Although these letters outline specific procedures and provide support for underlying financial information contained outside the financial statements, they are not public reports and may not be issued very often by some companies. However, because they can be required unexpectedly at any time, it is not uncommon for companies to expect their auditors to perform a level of review each reporting period on the information outside of the financial statements in anticipation of potentially issuing a comfort letter at some later date. Current attestation reports outlined in the auditing standards with respect to M, D&A are not generally used in lieu of comfort letters, which could call into question whether the benefits of requiring such reports in some form or fashion will outweigh the cost.

Therefore, our recommendation is for the auditor’s report to contain clarifying language as to the auditor’s current responsibility for information outside the financial statements and not require the auditor to separately report on other information outside of the financial statements.

***Clarification of the Standard Auditor's Report***

MetLife supports the PCAOB's potential enhancement of the auditor's reporting model that would involve clarifying language in the existing standard auditor's report to provide additional explanations in order to help financial statement users understand the auditor's report and clearly understand the auditor's responsibility, as described more fully below:

• *Reasonable Assurance* – We do not believe the meaning of the term "reasonable assurance" is misunderstood, and therefore, no further clarification in the standard auditor's report is necessary.

• *Auditor's Responsibility for Fraud* – The standard auditor's report does not mention "fraud", language from the auditing standards should be added to the auditor's report to clarify the auditor's responsibility.

• *Auditor's Responsibility for Financial Statement Disclosures* – The auditor's report should be clarified to enumerate the auditor's responsibility with respect to footnote disclosures in forming an opinion on the financial statements taken as a whole. It is important for financial statement users to explicitly understand that the auditing standards require auditors to: (a) perform procedures to test the financial statement disclosures and to evaluate whether the financial statements contain the information essential for fair presentation of the financial statements in conformity with the applicable financial reporting framework, (b) perform procedures to assess the risk of omitted, incomplete, or inaccurate disclosures, whether intentional or unintentional; and (c) to identify and test significant disclosures and, in integrated audits, to test controls over significant disclosures.

• *Management's Responsibility for the Preparation of the Financial Statements* – The auditor's report already states Management's responsibility, so we do not believe that additional clarification is warranted here.

• *Auditor's Responsibility for Information Outside the Financial Statements* – With respect to SEC filings, the auditor has a responsibility to read the other information in documents containing audited financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact. We believe it would be beneficial for the audit report (at least for SEC registrants) to describe the auditor's responsibility with respect to such other information.

• *Auditor Independence* –We believe that the auditor's report could be clarified to include a statement in the auditor's report, in addition to the title, that the auditor has a responsibility to be independent of the company and has complied with applicable independence requirements of the PCAOB and SEC.

NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

September 27, 2011

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

Re: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (PCAOB Rulemaking Docket Matter No. 34)

Dear Office of the Secretary:

On behalf of the board of directors of the National Association of Corporate Directors (NACD), we are pleased to submit our comments on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" (Concept Release).

Founded in 1977, the NACD's mission is to advance exemplary board performance, and the only national membership organization created for and by directors. Given the close interaction between the auditor and the audit committee, and because a large number of our members are audit committee members and chairs, NACD believes it is appropriate to provide our views on the issues presented in the Concept Release. Our comments are as follows:

***Primary Role of Management to Assert and Auditors to Attest***

NACD believes that it is imperative that any change to the auditor's reporting model or expansion to the role of the auditor preserve the established role of management asserting information on which the auditor attests. We believe any change that would require or allow the auditor to disclose original information about the company may result in unintended consequences including potentially supplanting the role of the audit committee in overseeing both the financial reporting process and external audit on behalf of investors, and undermining management's responsibility for the financial statements, including disclosures. NACD does believe that some level of auditor assurance on additional information disclosed by management could result in heightened management focus on these areas; however, any such areas should be carefully chosen to ensure that the benefits of the additional work outweigh the costs.

***Views on Alternatives Presented in the Concept Release***

The Concept Release presents several alternatives for potential changes to the auditor's reporting model that could increase transparency and relevance to financial statement users. We present our views on each alternative below.

## I. <u>Auditor's Discussion & Analysis</u>

NACD has significant concerns regarding the auditor's discussion and analysis (AD&A) alternative presented in the Concept Release for the reasons described below.

First, and most importantly, we believe that the AD&A approach would undermine the governance role of the audit committee to oversee the financial reporting process. As described in the Concept Release, the AD&A would result in the auditor communicating, for public consumption, the equivalent of their required communications to the audit committee. Since the enactment of the Sarbanes-Oxley Act of 2002 and implementation of its corresponding provisions, NACD believes the role of the audit committee in overseeing the financial reporting process, including the external audit, has been strengthened and improved significantly. Public communication of such information in the AD&A or otherwise would supplant or confuse the fiduciary responsibility of the audit committee to oversee the financial reporting and external audit processes.

Second, we believe public communication of certain matters (e.g., auditor "perspectives" or "impressions" on matters related to the audit as well as on the company's financial statements, including management's judgments and estimates, accounting policies and practices, and difficult or contentious issues such as "close calls," etc.) in the AD&A could do more harm than good. When complex matters are communicated by the auditor to the audit committee, the audit committee has the benefit of ongoing discussion with the auditor and management to provide appropriate context to the complex matters. The audit committee also gains a further understanding of the issues that would be described in an AD&A through its oversight of the financial reporting process. Investors do not have the opportunity to hold further discussions with the auditor or management for a deeper understanding of issues derived through oversight of financial reporting process. As a result, NACD believes that the auditor's public communication of such matters could be misleading and counterproductive.

Third, a requirement for the auditor to provide an AD&A would require the auditor to provide original information about the company not previously provided by management, creating a fundamental shift in the established role of the auditor attesting to information provided by management. We believe such a shift would undermine management's responsibility for the financial statements, including respective disclosures, as well as the audit committee's role in overseeing the financial reporting and external audit processes. A requirement for auditors to discuss sensitive matters in the AD&A may reduce the robustness and candor of critical discussions between the auditor, audit committee and management for fear that such information would be communicated publicly. Such communication is critical to high-quality financial reporting and audit processes. Additionally, the potential for "dueling disclosures" between the auditor and company may prompt management to alter disclosures and/or accounting treatments to align with those of the auditor.

Fourth, we believe requiring auditors to provide their "impressions" on financial reporting matters could result in subjective, free-form AD&A, diminishing reporting comparability between companies. This would reduce the usefulness of the AD&A to financial statement users, who would be unable to evaluate investment alternatives due to a lack of comparability. Additionally, we are concerned that a lack of comparability in the AD&A could harm an issuer in comparison to its peers as a result of possible adverse market reactions to subjective communications provided by auditors.

Lastly, the AD&A appears likely to be one of the more costly alternatives, given the levels of review that would be required to draft and approve custom communications reflecting subjective views of the audit team. As such, it is hard to imagine that any potential benefits of the AD&A would outweigh both these direct costs and the "unintended consequences" described above. We believe the emphasis-of-matter approach described below would serve the needs of investors, but in a more cost-effective manner.

## II. Emphasis Paragraphs

The Concept Release suggests requiring emphasis paragraphs in all audit reports to highlight the most significant matters in the financial statements, identifying where these matters are disclosed in the financial statements and also identifying the corresponding audit procedures performed. NACD supports an approach that would inform financial statements users regarding important matters to focus on in the financial statements for purposes of their investment decision-making. However, we present the following views for further consideration when evaluating this alternative.

First, we believe it will be important for the PCAOB to develop a framework to ensure consistency in the determination of matters to be emphasized, as well as how such matters are emphasized to best serve the needs of investors. In particular, we are concerned that without such a framework, the number of matters emphasized could become too broad, in part to minimize litigation risk, detracting from the objective of emphasizing only the most significant matters for investors.

It is important to note that while auditors are expert in generally accepted accounting principles and their application, they are not expert in making investment decisions.

Second, NACD questions whether it is appropriate or practical for the auditor to describe audit procedures in the emphasis paragraphs. Given NACD's understanding of the comprehensive nature of most audit procedures, we believe it will present a significant challenge for auditors to provide a brief, user-friendly overview of the audit process and procedures that would convey the true depth and substance of their work. Consistent with our concerns noted on the AD&A, we question whether users of financial statements will have the appropriate context to understand the description of audit procedures included in emphasis paragraphs without the context the audit committee gains through dialogue with the auditor and the execution of its oversight responsibilities.

## III. Auditor Assurance on Other Information Outside of the Financial Statements

### *Management's Discussion and Analysis*

The Concept Release questions whether auditors should provide assurance on other information presented outside the financial statements such as Management's Discussion and Analysis (MD&A), or other information provided by management such as key performance indicators and earnings releases. NACD is not opposed to the auditor providing some level of assurance around management's assertions contained in the MD&A if—and only if—such information is auditable and within the expertise of the auditor. However, we believe cost and timeliness are important considerations and that the benefit provided would need to outweigh the cost of the auditor performing such procedures.

NACD believes that auditor attestation on management's critical accounting estimates, as suggested in the Center for Audit Quality's June 28, 2011, comment letter to the PCAOB, could be a mechanism to provide investors with greater clarity around management's accounting approaches and application of judgment. This seems to be an area where investors seek further information. This approach will also allow management to provide financial information, auditors to attest to it, and audit committees to oversee the process. NACD also believes that this approach could improve management's disclosures in this area and would also provide investors additional comfort based on further auditor assurance. While NACD has not evaluated the cost of such an approach, we believe it would be more cost conscious than auditor attestation on MD&A in its entirety.

***Other Information Provided by Management***

It is clear that investors and analysts rely on financial and nonfinancial information disclosed by management outside the annual report, including key performance indicators and information contained in earnings releases. NACD believes that further outreach and analysis is necessary to determine the precise management disclosures that could be subject to further procedures and whether it is appropriate for the auditor or some other expert to perform these procedures. We believe that any requirement for additional auditor assurance should be subject to clear standards, including the level of assurance to be provided. Further, we recognize that such a requirement would result in additional procedures. The Board should consider the additional cost such procedures would entail, the time and effort required on the part of the auditor and whether this would impact the issuer's ability to meet SEC filing deadlines.

With respect to earnings releases, we support further consideration of the extent to which auditors could have an explicit level of association with earning releases. Through the audit committee's oversight responsibilities it is aware of the procedures performed by auditors on the earnings release prior to public distribution. Explicit auditor association with earnings releases could provide investors with a better understanding of the auditor's procedures related to information communicated by management in the earnings release, though it would need to be clear that the audit had not been completed. However, we question whether the usefulness of information communicated in the earnings release would be reduced if the timeliness of distribution was delayed due to further auditor involvement. We encourage the Board to further explore this area and to include in these deliberations investors, audit committees, management, auditors and the SEC. NACD believes that auditor association with other types of communications provided by management (e.g., information provided in conference calls, etc.) would be more problematic, but we recognize that additional analysis may be necessary to better understand the needs of investors in this regard.

## IV. Addition of Clarifying Language to the Auditor's Report

NACD supports the proposed addition of clarifying language to the auditor's report as contemplated in the Concept Release including further explanation regarding the term "reasonable assurance," the auditor's responsibility for fraud, financial statement disclosures and information outside the financial statements, auditor independence, and management's responsibility for the preparation of the financial statements and disclosures.

While NACD believes that there is room for improvement to the auditor's reporting model, NACD urges the PCAOB, before proposing specific standards, to thoroughly consider how certain changes to the auditor's reporting model could impact how the audit committee and management—equally important parties in the financial reporting process—carry out their responsibilities to investors.

We applaud the PCAOB and its staff for seeking a wide range of views through outreach to all stakeholders to inform the development of this Concept Release. In particular, we believe clear consensus must be reached by the full spectrum of investors regarding what changes are necessary to provide the most relevant information for investment decisions. We, therefore, urge the Board to make special efforts to reach out to the investment community to ascertain clearly what changes to the auditor's report are most important, from the investor perspective, as well as the most cost-effective.

NACD appreciates the opportunity to comment on this Concept Release and would be pleased to respond to any questions regarding the views expressed in this letter.

Sincerely,

Barbara Franklin

Hon. Barbara H. Franklin
Chairman
NACD

Kenneth Daly
President and CEO
NACD

NASBA

National Association of State Boards of Accountancy

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September 28, 2011

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street N.W.
Washington D.C. 2006-2803

By mail and e-mail to: comments@pcaob.org

RE: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

To the Members of the Public Company Accounting Oversight Board:

We appreciate the opportunity to offer comments to the Public Company Accounting Oversight Board ("PCAOB") on its Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (the "Concept Release"). The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness of State Boards of Accountancy.

The PCAOB has undertaken an initiative to improve the present auditor's reporting model to make the model more responsive to the needs of users. NASBA's Regulatory Response Committee offers the following comments from a regulatory standpoint - not a practitioner's standpoint.

## Clarification of "Reasonable Assurance"

Auditing standards require that the auditor obtain reasonable assurance about whether the financial statements reported on are free of material misstatement, whether caused by error or fraud. The standards also state that, "Absolute assurance is not obtainable because of the nature of audit evidence and the characteristics of fraud. Although not absolute assurance, reasonable assurance is a high level of assurance."

The present auditor's report reads, in part: "The standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements."

We believe that the clarity would be enhanced if the phrase "a high level of assurance but not absolute assurance" be substituted in the auditor's report for "reasonable assurance," and that "whether caused by error or fraud" also be added after "material misstatements" in the auditor's report. These recommended changes would not change auditing standards or the responsibility of the auditor.

**Adding the Auditor's Responsibility for Detecting Fraud to the Auditor's Report**

The present auditor's report makes no mention of "fraud." Fraud is encompassed in the phrase "material misstatements."

We recommend that the auditor's report be changed to explicitly address fraud and the auditor's responsibility for detecting fraud in a manner that reflects current auditing standards and does not extend such standards, or the auditor's responsibility. We also believe that the commentary added include the language in auditing standards that "absolute assurance is not obtainable because of the nature of audit evidence and the characteristics of fraud."

**Other Information in Documents Containing Audited Financial Statements**

If a document contains information ("other information") in addition to the auditor's report and the financial statements reported on, auditing standards require the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with the information in the financial statements, or the manner of its presentation. However, the auditor's responsibility with respect to the other information does not extend beyond considering that the other information is not materially inconsistent with the financial statements covered by the auditor's report. The auditor has no obligation to perform any procedures to corroborate other information contained in a document. Management's Discussion and Analysis (MD & A) is required information in annual reports to the Securities and Exchange Commission ("SEC") on Form 10K and in annual reports to shareholders of publicly held companies. The MD & A is "other information" and the auditor's responsibility for such information is discussed above.

In discharging the auditor's responsibility to read and consider other information, typical practice includes comparing dollar amounts in the MD & A to dollar amounts in the financial statements to see if they are in agreement and to recalculate percentages, or to see if they are consistent with the financial statements. Dollar amounts appearing elsewhere in the document, if derived from the financial statements, are usually subjected to the same comparisons.

Auditing standards further provide that if the auditor becomes aware of information that the auditor believes is materially misstated and the discrepancy is not a material inconsistency as discussed above, the auditor should discuss the discrepancy with the client. If after discussion the auditor believes that the auditor is correct and the client takes no action, the auditor is required to take "appropriate action."

We believe that added assurance on MD & As and client releases should not be a part of the final changes to the auditor's report. We believe that the additional cost to provide such assurance would far outweigh the additional benefit received. Adding cost to an audit for little benefit is not in the public interest.

We recommend that a paragraph stating the auditor's responsibility for "other information" be included in the auditor's report. It is not likely that such responsibility is currently known by most of the readers of financial statements.

**Auditor's Discussion and Analysis ("AD & A")**

The Concept Release includes a section suggesting that consideration be given to adding an Auditor's Discussion and Analysis (AD & A) section to the auditor's report.

The Concept Release cites surveys by the Chartered Financial Analysts Institute in which a majority of the surveys' respondents note that audit reports need to provide more specific information about how the auditor reached his or her opinion on whether the company presented its financial statements in accordance with the required reporting standards. No indication is given as to what information is needed, or how it would be used by the surveys' participants in forming investment decisions about the reporting company. To only ask the participants if more information is needed about the audit is to ask for an easy "yes."

Such concerns may question the adequacy of the financial statements and the audit of such financial statements. Such concerns, however, would not be mitigated had the subject audit reports included more extensive disclosure-say in an AD & A-of the audit procedures used to establish a basis for the auditor's opinion.

The Concept Release cites the consensus among investors that the auditor has significant insight into the company, and the auditor's report should provide additional information based on that insight to make it more relevant. The Concept Release also notes that "some investors believe that more relevant insight into the financial statements through the eyes of the auditor might better enable them [the investors] to assess how changes in the economy might affect a company's future financial performance or condition."

The Concept Release also cites "recent concerns highlighted by the financial crisis related to preparing and auditing financial statements for complex global businesses" and comments that "reporting in advance of the crisis might have been helpful in assessing the quality of the financial statements, and providing early warning signals regarding potential issues including off-balance sheet contingencies or the sensitivity of loan losses." The Concept Release also cites views expressed by some investors that: (a) they would have a better perspective regarding the risks of material misstatements if they had a better understanding of how the audit was conducted; (b) the auditor should express the auditor's views regarding the quality of the financial statements reported on; and (c) the range of acceptability of judgments and estimates is not mentioned in the auditor's report and might not be fully reflected in the financial statements.

Further, the Concept Release notes that many investors want a discussion about the audit and the company's financial statements, and some want a discussion of risks, other than audit risk, such as business risks, strategic risks and operational risks.

The auditor's responsibility is to form an independent unbiased opinion, based on auditing standards, on whether the financial statements are fairly presented in accordance with the established reporting standards. The value of the audit rests on the independence of the auditor and the competence of the auditor. Management has the responsibility for preparing and issuing the financial statements, subject to the oversight of "those charged with governance," which group includes audit committees. Auditors are not the source of disclosures.

Some of the concerns noted in the Concept Release are concerns about the financial reporting model that could be considered by the setter of financial accounting standards. For example, how changes in the economy might affect a company's future financial performance or condition is a matter of financial reporting - not a matter for the auditor's report. Similarly, providing early warning signals regarding potential issues including off-balance sheet contingencies or the sensitivity of loan losses is a matter of financial reporting. Also, reporting in advance of the [financial] crisis might have been helpful in assessing the quality of the financial statements. Such a reporting issue is one that could be considered by the setter of financial reporting standards.

The request for discussion of risks other than audit risks is also a financial reporting issue that the setter of financial reporting standards might wish to consider. Such discussions are presently available in Form 10K, the annual report to the SEC, in items 1, 7 and 7a outside of the financial statements.

Regarding the commentary that the range of acceptability of judgments and estimates is not mentioned in the auditor's report and might not be fully reflected in the financial statements, the disclosure of the range of judgments and estimates is another financial reporting issue. If the reported estimates do not fall within the range of acceptability, then the results of the audit performed and the fairness of the financial statements could be questioned.

Requiring the auditor to have "more relevant insight," which is different from having an understanding of the client, its business and the business environment, could require development of an auditing standard that would by its very nature be vague and, therefore, unenforceable. As regulators, the enforceability of auditing standards is essential to the State Boards. Requiring the auditor to comment on the quality of earnings would compromise the independence of the auditor since such commentary is the responsibility of an analyst.

We believe that addressing issues in the auditor's report that should properly be included in financial statements would blur and undermine the very clear distinction between the responsibilities of the auditor and management. Such blurring of responsibility is not in the public interest.

We strongly disagree with the concept of an AD & A and believe that such addition to an auditor's report would not be in the public interest.

Information about the audit, how it was conducted, significant issues considered by the auditor, the independence of the auditor and other matters are required to be communicated to the audit committee by the auditor before the auditor's report is released. If additional information is desired for communication to the audit committee, the PCAOB has the authority to add to the current required communications, subject to approval of the SEC. We believe that this communication is the appropriate form for discussing audit performance - not an AD & A included in an auditor's report.

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.

Sincerely,

Michael T. Daggett, CPA
NASBA Chair

David A. Costello, CPA
NASBA President & CEO

National Retail Federation®
*The Voice of Retail Worldwide*

September 30, 2011

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

RE: PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Public Company Accounting Oversight Board:

The National Retail Federation (NRF) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release"). As the world's largest retail trade association and the voice of retail worldwide, NRF's global membership includes retailers of all sizes, formats and channels of distribution as well as chain restaurants and industry partners from the United States and more than 45 countries abroad. In the U.S., NRF represents an industry that includes more than 3.6 million establishments and which directly and indirectly accounts for 42 million jobs – one in four U.S. jobs. The total U.S. GDP impact of retail is $2.5 trillion annually, and retail is a daily barometer of the health of the nation's economy.

NRF fully supports financial statement transparency and sees value in the PCAOB's review of the auditor's reporting model. However, it is our opinion the current reporting mechanisms and processes in place provide ample information and assurance that the financial statements are presented fairly and accurately. The current process of open communication between management and auditors and the required communication between the auditors and the audit committee of significant accounting judgments and estimates is effective and any proposal that could interfere with this existing process would result in potentially more risk. Any changes to the auditor's report should only seek to clarify terminology and provide detail on the purpose of the audit and the role of the auditor, while leaving the reporting of company-specific information to management.

***Question 1:*** *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

   We believe the Board should undertake a standard-setting initiative to consider improvements to the auditor's reporting model; however we believe that those changes should be limited as discussed under b. below. While we feel the current reporting model is generally sufficient, there may be some benefit to further clarification of the purpose of an audit, the responsibilities of the auditor and management in the audit and financial reporting process and the work performed by the auditor on information outside the financial statements, including Management's Discussion and Analysis (MD&A).

b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

As discussed above, we support the inclusion of further explanatory language on the purpose of an audit, the responsibilities of the auditor and management in the audit and financial reporting process and the work performed by the auditor on information outside the financial statements, including MD&A. We also support discussion in the auditor's report of the significant management judgments and estimates in the company's application of accounting policies and practices, with reference to management's assessment of the company's critical accounting policies and the procedures performed by management and the auditor to determine the acceptability of these positions.

c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe the Board should consider expanding the auditor's role to provide assurance on matters in addition to the financial statements. Currently, auditors are required to review any supplemental information included with the financial statements to ensure that the information is consistent with information contained in the financial statements and notes thereto. For example, Item 303, Regulation S-K, Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) is intended to provide in one section of a filing, material historical and prospective textual disclosure enabling investors and other users to assess the financial condition and results of operations of the registrant. Disclosure is required of prospective information that involves material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. We believe it would be improper for auditors to opine on prospective information. We also believe that the intent of Item 303 is to obtain management's perspective, not the auditor's, and that there would be no additional benefit gained from audit comfort over the additional historical information provided in MD&A. Further, the inclusion of additional audit procedures and reporting around MD&A would significantly increase audit costs and place added pressure on the registrant to meet 10-Q and 10-K filing dates. This potential delay runs counter to the SEC's efforts to get information to investors in a more timely fashion.

As an alternative to providing additional assurance, we would support discussion in the audit report that describes the work undertaken by the auditor in reviewing the additional information for consistency with the financial statements. This serves to communicate work performed by auditors that is already taking place.

***Question 2:*** *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

Yes, we believe the auditor's report should retain the pass/fail model. We believe that anything more than pass/fail would be too judgmental and would add little value to readers of the financial statements. In addition, a more complicated model would certainly increase audit costs and pressure on filing deadlines. The auditor already has significant leverage to effect change in the financial statements via its communications with management and the audit committee. Additional information about the audit and the company's financial statements to enable the auditor to add commentary on significant matters in the audit report will not increase the auditor's leverage.

***Question 3:*** *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

Responsibility for a company's financial statements and the financial reporting process ultimately resides with management. Management makes the final decision on estimates, judgments, and financial statement content and presentation. Therefore, it is management's responsibility to provide additional information about the company's financial statements, as is current practice. Management reviews and discusses this additional information with the auditors and with the audit committee.

The auditor's responsibility is to express an opinion on the financial statements and report directly to the audit committee the audit procedures performed, areas of focus, key accounting policies, assumptions and estimates, as well as any potential alternative accounting treatments on any key matters found during the audit. The audit committee is responsible for providing oversight of the financial reporting and disclosure process. Requiring auditors to provide information directly to financial statement users undermines the governance role of the audit committee. In the interest of increasing the information shared with financial statement users, we would support the inclusion of explanatory language in the audit report stating that the auditor has communicated with the audit committee about the audit procedures performed, the company's critical accounting policies and its significant judgments and estimates.

***Question 5:*** *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

d. *If you do not support an AD&A as an alternative, explain why.*

We are concerned that the addition of an AD&A could potentially impact the open dialogue between auditors, management, and the audit committee concerning matters affecting the financial statements as well as financial statement content. Requiring auditors to report on potentially sensitive matters in the audit report or AD&A may limit these conversations due to concerns about confidentiality and in turn, possibly make the relationship more tenuous. A change in communication with management could reduce the effectiveness of an audit. It is important that management be able to have conversations with auditors when there are any gray areas without concern that these discussions will be taken out of context and included in the audit report.

Additionally, management currently discloses information about significant risks and critical accounting policies in the financial statements and MD&A, respectively, and the auditor reviews these disclosures for consistency as part of the normal audit process. Requiring the auditor to formally opine on these matters will increase legal risk and therefore the cost of the audit, with no added benefit. And, due to the additional work involved, the requirement of an AD&A will place unnecessary burden on companies in meeting applicable SEC reporting deadlines.

e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

As mentioned above, increased discussion in the auditor's report on the role of the auditor and the purpose of an audit should be considered. This could be accomplished with additional language in the audit opinion explaining, for example, that the auditors have reviewed the additional information accompanying the financial statements for accuracy and consistency. If financial statement users fully understand the role of the auditor and their interaction with management and the audit committee during the course of the audit, we believe that many of the concerns expressed to the Board in advance of this Concept Release will be addressed without the inclusion of an AD&A.

***Question 14:*** *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

a. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

NRF does not see the value in requiring the expanded use of emphasis paragraphs. The information cited in the Concept Release for inclusion in such paragraphs is included in the notes to the financial statements or MD&A.

***Question 15:*** *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

If the use of expanded emphasis paragraphs is required, we strongly believe they should serve to clarify the areas of focus for the audit without providing detail on the specific audit procedures performed. Providing this detail could encourage unwarranted comparisons of the audit approaches of other firms, which can vary based on the specific facts and circumstances of the client being audited. In addition, we think most investors and users of the financial statements would be confused by paragraphs providing detailed information on audit procedures.

***Question 19:*** *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

We support adding additional information in the auditor's report detailing the responsibilities of the auditor regarding other information outside the financial statements. However, we do not believe auditor assurance on the other information is warranted from a cost benefit perspective, as previously noted in the answer to Question 1 above.

***Question 21:*** *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We support clarification of the auditor's responsibility in short bullet point form outlining what was done and additional steps taken; in essence, laying out the process and defining for the financial statement user the work performed.

***Question 31:*** *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

The most important consideration is ensuring the audit is performed effectively so the financial statements are transparent and accurate. Openness and transparency between management, auditor, and audit committee are the keys to this goal.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

We do not believe the potential increase in audit costs associated with the proposed changes to the auditor's reporting model are justified, for the reasons stated above.

NRF agrees with the Board's commitment to financial statement transparency and thanks the PCAOB for their consideration of our comments and suggestions. We welcome any further discussion on the topic.

Sincerely,

Carleen C. Kohut

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Chief Operating Officer

NJCPA

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September 22, 2011

*Sent via regular mail*
*and electronically to: comments@pcaobus.org*

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

Reference: Request for Public Comment: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

The Accounting and Auditing Standards Interest Group of the New Jersey Society of Certified Public Accountants (NJSCPA) is pleased to offer its comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*. The NJSCPA represents over 15,000 certified public accountants. The comments herein represent those of some of the individuals of our Accounting and Auditing Standards Interest Group only and do not necessarily reflect the views of all members of the NJSCPA.

We commend the PCAOB's effort to make improvements to reports on audited financial statements, and appreciate the opportunity to provide the following comments on the questions contained in the Concept Release (CR).

As a result of our review of the concept release we have summarized our overall views in addition to addressing the PCAOB's specific questions below.

**Overarching Responses**

If more relevant and useful information is needed by investors and other users of the financial statements, then improvements to disclosures required by Generally Accepted Accounting Principles (GAAP) or SEC Regulation S-K should be considered and not changes to the auditor's report.

- Additional disclosures about forward looking information, expectations, estimates, judgments, plans, assessments, etc. should come from management since they developed that information and have the most knowledge.

- Auditors should not be the original source of any disclosure about a company. Nor should auditors determine which information about a company will be most useful or important to the investor.

- Additional lengthy disclosures by the auditor about significant risks, management's judgments and estimates, accounting policies and practices, difficult and contentious issues etc. may have the effect of confusing investors and may cause them to conclude that there are varying degrees of an unqualified audit opinion.

- Any changes made to the auditor's report should not "blur the line" or cause confusion among investors and other users of the financial statements about auditor responsibilities versus the responsibilities of management and the audit committee.

**Form of the Auditor's Report**

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

We believe the Board should undertake a standard-setting initiative to consider improvements to the auditor's reporting model on a limited basis, because it is important that users of financial statements have a better understanding of the auditor's report, as well as the different responsibilities of the auditor and management. For these reasons clarification of the standard auditor's report listed in the concept release would be beneficial.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

See our response to Question 2c below.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe that the auditor's role should be expanded to provide assurance on matters outside the financial statements, because it may create investor confusion about the auditor's role versus the role of the company's management and/or audit committee.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

We believe the auditor's report should retain the current model, and do not consider the current model to be a "pass/fail model" as described in the concept release. The model does currently provides for an unqualified opinion ("pass"), or and adverse opinion ("fail"), but it also provides for unqualified opinions with additional explanatory language (emphasis of a matter paragraphs, going concern issues, inconsistencies, etc.). Private companies also have the option of a qualified (GAAP departures and Scope limitations) or disclaimer of opinion. However, these options are not acceptable to the Securities and Exchange Commission (SEC). The current model provides auditors with sufficient ability to provide opinions which are not just "pass/fail".

*b. If not, why not, and what changes are needed?*

We believe the current model should be retained.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

If the current model is maintained, we believe the following changes would be beneficial:

i. Include language in the auditor's opinion stating that the footnotes are an integral part of the financial statements and have also been audited

ii. Include language stating that management is responsible for all information outside of the financial statements (including management's discussion and analysis), and that the outside information has not been audited, but has instead been read by the auditor for consistency to audited amounts.

iii. Define the terms "reasonable assurance" and "material misstatement" as used in the auditor's report

iv. Consider the expanded use of the current "emphasis of a matter" paragraphs to potentially include such things as recent acquisitions, environmental matters, other significant matters, etc. assuming authoritative guidance is provided for use in determining which of these matters should be included. Information in the emphasis of a matter paragraphs should be objective and fact based with reference to expanded disclosures in the financial statement footnotes.

v. Identify that the auditor is independent with respect to SEC and PCAOB standards

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

We believe that management and the audit committee are most appropriate to provide additional information about the company's financial statements. Management is in the best position to have this relevant information and the audit committee is in an ongoing role of monitoring management. Since management, with the oversight of the audit committee, is responsible for developing estimates, expectations and judgments, they should be the parties responsible for providing the additional information. We do not believe that auditors should be the source for any original disclosure about a Company. Additionally, providing original disclosure about a Company may be a threat to our independence. While the auditor may be privy to much of this information, the depth of that knowledge is not as broad or deep as management's and therefore could not provide any additional meaningful information to the investor. It is our suggestion that management is the most appropriate party to provide additional information regarding their company's financial statements with the oversight of the audit committee.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

In regards to reporting on internal control over financial reporting we suggest adding language related to the audit committee's role vs. management's responsibility for internal controls over financial reporting. In addition, we suggest that the terms "reasonable assurance" and "effective" be defined.

**Potential Alternatives for Changes to the Auditor's Report**

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

We do not believe that the Board should consider an auditor's discussion and analysis.

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

We do not believe that an auditor's discussion and analysis should be pursued.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

We do not believe that an auditor's discussion and analysis should comment on the audit or the company's financial statements.

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

We do not believe that this information would be relevant to investment decisions since it would provide users with confusing and potential conflicting information from that which is reported in management's financial statements.

*d. If you do not support an AD&A as an alternative, explain why.*

We do not believe that an auditor's discussion and analysis should be pursued for several reasons, as follows:

i. Investors needs for additional disclosures about a company's financial statements, should be addressed through changes to Generally Accepted Accounting Principles (GAAP) or SEC Regulation S-K and not through the auditor's reporting model.

ii. The inclusion of this information changes the existing auditor and client relationship by placing the auditor in the place of management. This can create a potential impairment of independence since the auditor will be expected to make decisions about what information should be disclosed, whether related to accounting policies, estimates, or operational matters. It could require that the auditor disclose information that management has not already disclosed which is inconsistent with the existing auditor/client relationship.

iii. Audit reports are fact based opinions based on the financial statements taken as a whole. Auditor roles have previously not been based on providing commentary and opinion on specific elements, unless engaged to do so on specific engagements or for "comfort letters" Typically, these engagement types have lower materiality levels. It is foreseeable that providing such specific commentary at a level lower than "the financial statements taken as a whole" will lower materiality levels and add significant time to audit engagements. This appears contrary to the new risk based auditing standards recently issued by the PCAOB.

iv. We do not believe that an auditor's discussion and analysis provides useful information to users of financial statements that are audited on the basis that the audit is performed on the financial statements taken as a whole. Most users of financial statements are not sufficiently familiar with auditing techniques to fully understand materiality, tolerable misstatement, audit procedures or the extent of audit procedures on specified areas, since those procedures are based on the financials taken as a whole and whether or not an informed user's judgment would be affected by items which are not material.

v. We believe that an auditor's discussion and analysis that discloses materiality levels, audit procedures, and the extent of those procedures creates additional opportunity for fraud in subsequent periods by reducing the element of unpredictability in audits. Thereby creating a roadmap for management's manipulation of those procedures in future periods.

vi. We also believe that detailed discussions regarding accounting estimates, alternative accounting policies considered, etc. could provide users with conflicting information that in the end would not be useful in their decision making. When auditors perform their audits there is an element of professional skepticism that innately causes auditors to consider various differing assumptions, estimates, and policies. These considerations are a normal part of auditing and were not developed with the contemplation that they would need to be disclosed to the public. Such disclosure could significantly impact how audits are performed in the future.

vii. There is an increase risk of additional liability upon auditors disclosing their various methods and decisions made throughout the audit, which could later be questioned. The potential threat of an auditor's increased risk of additional liability from the disclosure of such information may compromise overall audit quality thereby decreasing the value of the auditor's report to the investor.

viii. Initially, auditor's discussion and analysis would lack consistency and comparability to be useful for financial statement users. Over time these reports would become more standard as auditors begin to monitor how other auditors are preparing the discussion and analysis, which would also result in information that is not very useful to users of the financial statements.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

As mentioned in our response to Question #5d, we do not believe that auditors are in a position to provide any commentary on specified elements since auditors perform their engagements on the basis of the financial statements taken as a whole. Additionally, we believe that such commentary lacks comparability and consistency; and could damage client/auditor/audit committee relationships. We are also unclear as to how management would respond to the auditor's discussion and analysis and the manner in which disagreements with management would be handled regarding additional disclosures of information, or if it is the intent of the Board that disagreements in these additional disclosures are expected and permitted.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

We do not believe that any information should be disclosed in an AD&A.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

We do not believe that auditor commentary or views on management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls", would provide useful information to financial statement users, but would rather create investor confusion. Disclosure in Management's Discussion and Analysis already requires critical accounting policies and estimates, including the judgments and uncertainties that affect them. Auditors are currently required to read this information for material consistency with the audited financial statements. Investors may assume that these disclosures are sufficient or otherwise the auditor would have recommended changes. Therefore, we do not see the value of auditors commenting on the same information.

*8. Should a standard format be required for an AD&A? Why or why not?*

In the event that the PCAOB elects to require an auditor's discussion and analysis it should be in a standardized format. It would need to be objective and factual, rather than subjective and opinionated

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

We do not believe that expanding the auditor role provides a benefit to investors since the auditors are not in a position to provide relevant information. The auditing profession is not in a position to take on these additional responsibilities which would require significant training and or hiring from outside the auditor profession of non-certified public accountants with sufficient experience to provide commentary in these areas. Additionally, this information is already disclosed in the Risk Factors section of the 10-K and therefore no additional risk discussion by the auditors is necessary.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

Boilerplate language should be developed for consistency. Without sample language it would be difficult to have any consistency or comparability. Regardless, whether provided or not, over time due to the legal and regulatory systems, auditors will develop their own language for all of their engagements, and eventually the auditing profession as a whole will adopt similar language.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

See our response to Question 5d.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

An auditor discussion and analysis creates a high probability of inconsistent and competing information between the auditor and management. It is also unclear if this would be filed with the 10K and discussed with management, or whether or not management would provide a separate response within the 10K or if the AD&A would be a separate filing.

**Required and Expanded Use of Emphasis Paragraphs**

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

We believe that the current emphasis paragraphs draw sufficient attention to significant matters critical to the decision making of a financial statement users, however we do believe that if a limited list of a few additional items that are fact based and not based on judgment was developed (e.g., the company completed an acquisition), such information may be useful in summary or bullet form.

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

Auditor procedures should not be disclosed since audits are performed on the basis of financial statements taken as a whole, and are planned and designed on that basis. These procedures are proprietary on an auditor by auditor basis, based on overall engagement risks which are not disclosed. Additionally, such disclosures provide increased risks for management manipulation in the future, and would be counter-productive to users of financial statements. Auditors are likely to increase their audit procedures and move further away from risk based auditing as they will be disclosing their procedures to the public. The likelihood of "over auditing" specific areas will increase. Overall the time it takes to perform an audit will be extended and an equivalent increase in auditor fees should be expected.

*a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

We would support required and expanded emphasis paragraphs if authoritative criteria were provided to assist in determining what information to include and if the disclosure was factual and did not include the key audit procedures that were performed related to the identified item.

*b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

Current standards allow the use of emphasis paragraphs but their use is usually reserved for matters of critical importance. They should not be used as a substitute for financial statement disclosures required by GAAP. If new standards require inclusion of an expanded emphasis paragraph in all audit reports and the decision is left up to the auditor to decide which items to disclose that they believe are important for the users to better understand the financial statements, there is a significant risk that other important disclosures may be overlooked. There is a risk of requiring auditors to select which items to emphasis since different disclosures may be important to different investors. There would be undue influence placed on the disclosures that are included in this required emphasis paragraph which would detract from the other disclosures in the financials. Expanded emphasis paragraphs would lack consistency and comparability and also put the auditor in the position of management in determining and commenting on what is "significant" in terms of what should be included in the report unless there was authoritative criteria for determining which items to emphasis. This results in possible independence issues as well as increased auditor liability.

We also do not support the requirement for auditors to comment on key audit procedures performed related to the identified matters.

*15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

Primarily what is currently permitted.

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

The appropriate content and level of detail should be limited to objective and factual information referencing to the footnotes for more detailed disclosure.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

Boilerplate language should be developed for consistency. Without sample language it would be difficult to have any consistency or comparability. Regardless, whether provided or not, over time auditors will have their own language for all of their engagements, and eventually the profession as a whole will adopt similar language.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

On a very limited basis financial statement users can benefit from a summary of major items that are predefined to be reported by the auditors (e.g., going concern). The shortcomings relate to inconsistency and lack of comparability, which will render this information useless by financial statement users unless it is limited, objective, and factual with reference to management's footnotes to the financial statements.

**Auditor Assurance on Other Information Outside the Financial Statements**

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

The Board should not consider auditor assurance on the other information outside of the financial statements. Information outside the financial statements such as MD&A contains forward looking statements, subjective information, and non-financial data. It is unclear how auditors would be able to perform assurance procedures on such forward looking or projected information while maintaining independence under existing rules.

Also, as mentioned in the concept release, companies currently have the ability to retain the auditor to provide some level assurance on other information outside of the financial statements however; very few companies have engaged auditors to perform this service. We can assume that is because the cost of this assurance outweighs the benefits perceived by the investors.

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

We do not support auditor assurance on other information.

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

None.

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

Auditors currently read this information to determine that there are no material inconsistencies included in the MD&A as compared to amounts reported in the audited financial statements and we believe that level of assurance is most appropriate. We believe that adding clarifying language to the auditor's report disclosing the substance of the current PCAOB AU Section 550, *Other Information in Documents Containing Audited Financial Statements,* and auditor's responsibility related to information in documents containing audited financial statements would be useful to investors to understand the extent of auditor's responsibility on that information. This would be consistent with current practice and would not expand upon audit procedures, or the time required to complete the audit.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

We do not believe that the auditor is in a position to provide assurance on the MD&A, other than to compare specific dollar amounts that are already audited in the financial statements, as well as reading the MD&A for consistency.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

Yes, in many cases these disclosures include opinions, subjective information, sensitivity analysis, early warnings and forward looking statements. In order for the auditors to provide any level of assurance these disclosures would need to be changed to be more fact based, historical and objective, with less subjectivity, opinions, or forward looking statements.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

Due to the fact that historical data, forward looking statements, factual and subjective opinions are commingled within the MD&A additional guidance would be required.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

As previously mentioned (in Questions 19d), the MD&A contains information that auditors are not in a position to provide assurance on. Auditor's currently read this information to determine if there is materially inconsistent information as compared to the financial statements. The requirement to provide assurance on the MD&A would require significant additional procedures and possibly the use of additional specialists in order to provide such assurance. The degree of work required would be comparable to, or exceed auditor comfort letters.

Additionally, the SEC would need to consider restructuring the format of the MD&A so that the portions in which auditors are required to provide assurance upon are separate and distinct from the portions that assurance is not provided on. Due to this commingling of information it would be very difficult for users of the MD&A to ascertain which portions were subjected to auditor assurance and which were not.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

We do not see any benefit since the financial data in the MD&A is already audited in the financial statements and the auditors currently read the MD&A for material inconsistencies. Providing assurance on this information in a format that is commingled with opinion, forward looking-statements, and non-financial information will be too confusing for users of the MD&A, to determine what has assurance and what does not. The result would be users assuming that all of this information has been "audited", when it has not been. The additional time required in order to complete annual and quarterly filings would be substantial and it is unclear if the cost/benefit would be beneficial to investors.

**Clarification of the Standard Auditor's Report**

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*

- *Management's responsibility for the preparation of the financial statements*

- *Auditor's responsibility for information outside the financial statements*

- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

Yes, we believe that the auditor's report should be clarified to better define all of the suggestions listed in the concept release. It is critical that financial statement users understand the role of the auditor, management, and the audit committee, as well as concepts such as reasonable assurance, materiality, fraud, etc.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Yes, currently many users of financial statement do not have a sufficient understanding of the responsibility of the auditor and the true nature of an audit.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

- Management's responsibility related to internal control over financial reporting and fraud controls
- Role and responsibilities of audit committees
- Firm network structure including the responsibilities of the firm signing the report and the role of other member firms in the audit

*d. What are the implications to the scope of the audit, or the auditor's responsibilities. resulting from the foregoing clarifications?*

Improving the description of management's existing role, the role of the audit committee and the role of the auditor, as well as providing more accurate definitions of existing audit terminology would not have a material impact on the scope of audits or auditor's responsibilities.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We believe that all clarifications provide users of financial statements with a better understanding of the audit report. We do not believe that such clarifications would have any negative impact.

**Questions Related to all Alternatives**

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

We believe that *"Clarification of the Standard Auditor's Report"* is the most appropriate because it can efficiently and effective be implemented and provide the users of financial statements with the greatest benefit with limited additional cost.

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

A combination of considerations related to *"Clarification of the Standard Auditor's Report"* and *"Form of the Auditor's Report"* should be considered by incorporating the items suggested in our response to questions # 21c and #2c.

*25. What alternatives not mentioned in this concept release should the Board consider?*

Refer to our response to Questions #2c and #21c.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

There would need to be an auditor reporting framework that provides clear, comparable and consistent information to users of financial statements that is relevant, standardized, and understandable. The Board should also consider the relationship of cost and benefit to investors as well as potential implications on auditor independence, client confidentiality, and the additional time that would be required under certain initiatives as it would relate to existing SEC filing dates.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

*"Clarification of the Standard Auditor's Report"* would not be perceived as providing a qualified or piecemeal opinion. The use of *"Required and Expanded Use of Emphasis Paragraphs"* on a limited basis would also not likely impact user perception.

However, significant changes to the *"Form of the Auditor's Report"* from the current "pass/fail" model may be viewed as a piecemeal type opinion. Additionally, *"Potential Alternatives for Changes to the Auditor's Report"* would undoubtedly change the users perception of the financial statements as well as the reliance that can be placed on audits in general, if numerous items are discussed related to various scenarios that were contemplated during the process of an audit, which inevitably did not affect the opinion. The detailing of audit risks and procedures performed also is likely to harm the users in the long run and expose future audits to additional fraud risks. Lastly, *"Auditor Assurance on Other Information Outside the Financial Statement"*, as contemplated related to MD&A, would create significant confusion amongst users since the information that assurance can be provide upon would be comingled with information in which assurance could not be provide on, unless the intention exists to rearrange and reformat the existing MD&A by the Securities and Exchange Commission.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

*"Clarification of the Standard Auditor's Report" is* the best alternative to convey the auditor's role. Refer to our responses to previous questions in that section.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

We believe that sufficient audit quality exists related to the responsibilities of auditors. Audit quality will not be improved by the suggestions mentioned in "*Potential Alternatives for Changes to the Auditor's Report*" *or* "*Auditor Assurance on Other Information Outside the Financial Statement*" in regard to the financial statements since these suggestions do not add to existing auditing procedures related to the financial statements. The suggestions in these two areas will however, greatly increase the time required to complete audits, potentially require the extension of deadlines, increase the costs of audits, and provide users of financial information with information that will likely be confusing and not useful in their decision making process.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

In theory, all audit reporting models should be the same for consistency and comparability. However, given the SEC's willingness to exempt companies from audits of internal control over financial reporting based on market capitalization; we would suggest similar consideration be given to companies below a certain limit due to the significant additional cost associated with some of these proposals. Consideration should also be given to exempting broker-dealers.

**Considerations Related to Changing the Auditor's Report**

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

All effects listed above are important. Some of the suggested changes would significantly increase audit effort (and cost) with questionable additional benefit to investors. The changes could undermine the auditor's relationship with management and the audit committee and would increase auditor's liability.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

No. We do not believe that the substantial additional cost related to many of these proposals provide significant benefit and in certain instances will lessen users ability to make informed decisions related to audited financial statements as described above.

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

The concept release does not address forward-looking statements, and opinion verse fact based items in the MD&A. It also does not address any potential impact on independence. The proposals related to an AD&A do not consider how it will impact the user's perception of an unqualified opinion. when the AD&A highlights numerous significant "issues" and "close calls" to an investor. This will likely impact an investor negatively in cases where the opinion is truly an unqualified opinion without any reservations.

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

The PCAOB would need to heavily educate the investing public with regard to many of these proposals to avoid the likelihood that much of this additional information will be confusing and is not adding to audit quality or procedures.

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

For various reasons as described throughout our response, the auditor, management, and the audit committee relationship could be harmed in situations where the auditor is required to be the original source of disclosure about the Company. This could undermine the principle that the financial statements are the responsibility of management with the oversight of the audit committee. The relationship can also be harmed as a result of the substantial increase in time needed to complete the audit which will delay timely filings of annual and quarterly reports without commiserate benefit to the users.

Thank you for the opportunity to comment. We are available to discuss our comments at your convenience.

Respectively submitted,

Paula Young

Paula M. Young, CPA, Leader
Accounting and Auditing Standards Interest Group
New Jersey Society of Certified Public Accountants

Principal Drafter, Edward O'Connell, CPA

cc: Carole A. Hedinger, CPA, President
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September 27, 2011

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

Submitted via email to: comments@pcaobus.org

**Re: PCAOB Release No. 2011-003—Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

**Rulemaking Docket Matter No. 34**

The New York State Society of Certified Public Accountants, representing more than 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned release.

The NYSSCPA's Auditing Standards Committees deliberated the release and prepared the attached comments. If you would like additional discussion with us, please contact Jan C. Herringer, Chair of the Auditing Standards Committee at (212) 885-8133, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

N Y S S C P A

Richard E. Piluso
President

Attachment

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**NEW YORK STATE SOCIETY OF**

**CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON**

**PCAOB RELEASE NO. 2011-003—CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS**
**AND**
**RELATED AMENDMENTS TO PCAOB STANDARDS**

**RULEMAKING DOCKET MATTER NO. 34**

**September 27, 2011**

**<u>Principal Drafters</u>**

**Michele Amato**
**Robert W. Berliner**
**Jan C. Herringer**
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**William M. Stocker III**

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# New York State Society of Certified Public Accountants

**Comments on**

**PCAOB Release No. 2011-003—Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

We appreciate the opportunity to comment on the Public Company Accounting and Oversight Board's ("PCAOB" or the "Board") Concept Release, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*, (the "Concept Release or the release"). While we recognize the mission of the PCAOB is to protect the interests of investors and further the public interest in the U.S., we note that the International Auditing and Assurance Standards Board (IAASB) has issued a consultation paper on the same subject and we encourage the PCAOB and IAASB to work together to ensure convergence on auditor reporting so differences are minimized to the fullest extent possible.

**Responses to Specific Questions**

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**
    a. **Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**
    b. **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**
    c. **Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

We believe that audited financial statements are one of the primary sources of information investors use in making investment decisions. The auditor's report provides reasonable assurance that the financial statements do not contain material misstatement(s) and are presented fairly based on the financial reporting framework on which the auditor is reporting. However, we recognize that investors and other users of the financial statements have voiced concerns about the need for "richer" information available about the financial statements that they believe would be useful to them in making their investment decisions, and, as such, we support an initiative to explore how meaningful and cost efficient improvements can be made.

We do not believe that the current pass/fail audit report is deficient. If the objectives of the report are not readily understood in the marketplace, we suggest providing clarification through other means such as through education efforts. A glossary of terms could accompany the auditor's report until such time as users become more comfortable with the terms and concepts used.

Clarification of the following terms may be helpful to users:

- Reasonable assurance
- Fair presentation
- Materiality
- Material misstatement

We do not see an overriding need to substantively revise the format of the audit report, and believe that expanding the content and reorganizing the format would not impact the effectiveness of the audit report substantively.

We are generally supportive of auditor reporting on "other information" outside the financial statements that users may consider appropriate for their purposes.

**2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**
   **a. Should the auditor's report retain the pass/fail model? If so, why?**
   **b. If not, why not, and what changes are needed?**
   **c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

As stated above, we believe the pass/fail model of reporting should be retained.

Additionally, we have provided an illustration of an auditor's report (**Exhibit** attached) that provides for four main headings and includes report modifications, including some simplifications. We have added headings to make the audit report easier to understand, and to allow for those users only interested in the opinion paragraph a direct pathway. We believe that emphasis paragraphs can be used when deemed necessary; but not to be used for every report.

**3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

Information about the entity should be provided by management and/or the audit committee, as appropriate, because it is in the best position to provide such information.

**4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

If changes to the audit report on the financial statements are made, consideration of how those changes might impact the report on internal control will need to be assessed. For example, if the auditor’s report on the financial statements is modified to explain the responsibility of management and the audit committee as it relates to the financial statements, the report on internal control over financial reporting should be similarly modified.

**Auditor’s Discussion and Analysis**

**5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**
   - **a. If you support an AD&A as an alternative, provide an explanation as to why.**
   - **b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**
   - **c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**
   - **d. If you do not support an AD&A as an alternative, explain why.**
   - **e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

An auditor’s discussion and analysis (“AD&A” ), which as described in the Concept Release, would provide the auditor’s view of significant matters and how they were addressed in the audit engagement, is basically an affirmation of communications made to the audit committee and/or those charged with governance. There is a compelling difference when this information is provided to the audit committee as opposed to when it is issued to shareholders/investors. In the former situation there is a two way dialogue throughout the course of the audit; whereas in the latter situation it is a one way communication at a point in time.

Further, if there is competing or “dueling” information such that the communication results in a perceived difference about what is said and what is disclosed in the financial statements, a credibility issue for the entity and auditor could arise. The level of detail disclosed about the audit procedures employed might result in an inference of providing assurance at the account balance or assertion level for the issues discussed when the level of assurance is provided only on financial statements taken as a whole.

For these reasons, this initiative would be the most difficult to implement, the most problematic and the least beneficial. Although there is subjectivity in many pronouncements, if there is management bias or in the auditor's judgment an erroneous conclusion or evaluation were made, we believe this is best dealt with as a proposed adjustment and/or a communication to the audit committee. Further, a matter that is germane is that a discussion of the quality of financial reporting may dwell on the accounting standards at issue, and that such a discussion may be construed or implied as critical to those standards.

**6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

See our response to question 5.

**7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

We believe it is inappropriate for the auditor to provide their views on the company's financial statements. Any auditor reporting or other means of communication to investors or other users should be based on objective criteria; not subjective views.

**8. Should a standard format be required for an AD&A? Why or why not?**

We do not believe the AD&A form of reporting is appropriate; therefore we have no comment regarding the format of such a report.

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

We do not believe it is appropriate for the auditor to comment on matters that cannot be objectively evaluated or that are outside the auditor's expertise. Communication of the above-referenced matters is best left to company management or the audit committee as it is in the best position to communicate these matters in the context of its company and the industry in which it operates.

Further, requiring auditors to discuss these matters, separate from the company, has the potential to provide investors with information that may not correspond with the way such information is provided by the company, creating confusion, rather than enhancing financial reporting

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

We do not believe the AD&A form of reporting is appropriate; therefore we have no comment concerning the language to be used in such a report.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

There are a number of challenges to implement this alternative, and they include:

(1) possible delays in filing documents with regulators because of additional internal reviews;

(2) extensive additional discussions between auditors, the company, and the entity's counsel that will likely need to take place with respect to the more judgmental types of matters;

(3) the potential to inhibit communication between the auditor and management or the audit committee; and

(4) shifting the roles of the auditor and management in terms of the responsibility for providing the financial statement information.

Further, the additional costs associated with this alternative, due to the significant effort on the part of the auditor and the entity to provide such information would need to be considered to determine if such an alternative were appropriate from a cost/benefit perspective. This cost/benefit analysis is especially significant as it relates to smaller public companies.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

See our response to question 5 above.

**Required and Expanded Use of Emphasis Paragraphs**

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

The illustrative emphasis paragraph included on page 21 of the Concept Release explains that matters that are important in understanding the financial statement presentation, including significant management judgments and estimates and areas with significant measurement uncertainty, should be emphasized. We do not believe that the current audit report is deficient; nor that including mandatory emphasis paragraphs is appropriate.

A required emphasis paragraph would, in many cases, diminish the effect of the auditor's opinion. The current Standards appropriately provide for a qualification or disclaimer of opinion when the adequacy of disclosures and the suitability and implementation of Accounting Principles are inappropriate. Under current Standards, an auditor uses an emphasis paragraph to emphasize certain disclosure and/or very significant transactions and/or comparability if the financial information is not easily comparable. The scope and opinion paragraphs do not change. A qualified opinion would apply when there is a lack of sufficient appropriate evidence or a restriction on the scope in certain circumstances or there are material departures from Generally Accepted Accounting Principles. We assume that the use of a qualified opinion would not change with this initiative.

Historically, auditors use emphasis paragraphs to highlight such matters as:

- The entity is part of a larger business enterprise
- There are significant related party transactions
- A significant subsequent event has occurred
- An accounting matter other than a change in Accounting Principle occurred
- A matter affecting financial statement comparability has occurred

Under mandatory use of an emphasis paragraph, a significant expansion of the types of matters previously considered will be included and the intended effect of such an inclusion will dilute the financial reporting objectives.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**
   **a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**
   **b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

We believe it is inappropriate to require the use of emphasis paragraphs in each audit report. Please see our response to question 13.

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

We do not believe the use of emphasis paragraphs should be required.

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

We do not believe the use of emphasis paragraphs should be required; therefore we have no comment regarding the level of detail of matters to be presented in such paragraphs.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

As noted above in response to question 13, under the mandatory use of an emphasis paragraph, a significant expansion of the types of matters emphasized will dilute the financial reporting objectives and not increase transparency for users of the financial statements.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

Please see our response to question 13 above.

**Auditor Assurance on Other Information Outside the Financial Statements**

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**
   - **a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**
   - **b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**
   - **c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**
   - **d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**
   - **e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**
   - **f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**
   - **g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

We are generally supportive of auditor reporting on “other information” outside the financial statements. The standard for examining MD&A, AT 701, *Management’s Discussion and Analysis*, has been in place since 2001. Practitioners can examine such information and express reasonable assurance if:

- The presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC,
- The historical information has been derived accurately, in all material respects, from the entity’s financial statements, and
- The underlying information, estimates, and assumptions of the entity provide a reasonable basis for the disclosures contained therein.

While reporting under AT 701 could provide the basis for further standard setting to broadly address more information outside the financial statements, it is our understanding that AT 701 engagements are rarely requested by issuers for a variety of reasons which include cost/benefit analysis considerations.

One approach that would furnish investors with useful information, while also offering a cost-effective alternative, is the development of an examination level service on a specific portion of the MD&A that investors have suggested is important to their investment decisions: the disclosure relating to critical accounting estimates. Reporting on this portion of the MD&A is likely to improve the quality of such disclosures as a result of the increased attention given to these matters.

Should this approach be implemented, amendments to Regulation S-X might be needed to require the report or describe the circumstances in which such a report would be required. Further, the supplemental report would need to identify clearly the applicable section of MD&A covered by the report.

It is interesting to note that auditors of certain governmental entities communicate within the auditor’s report on MD&A that is required supplemental information in U.S. GAAP for governmental entities under a Government Accounting Standards Board opinion (GASB No. 34, *Basic Financial Statements—and Management's Discussion and Analysis—for State and Local Governments*).

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

We believe that requiring an auditor to provide assurance on certain information (*e.g.*, critical accounting estimates) outside the financial statements has the potential to improve the quality of such information. We also think it feasible to explore the benefits of providing assurance on other areas.

For example, some have suggested that auditor reporting on matters such as annual earnings releases would provide users with a higher level of confidence in the information. However, we believe that it is important to recognize that this financial information is often issued prior to the completion of the audit, and that there is a trade-off between the timeliness of the information and the assurance level that can be provided.

<u>**Clarification of the Standard Auditor's Report**</u>

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable Assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**
**b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**
**c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**
**d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

We believe the clarifications listed above would be appropriate. We have provided an illustration of an auditor's report that provides four main headings and includes report modifications including some simplifications (see attached **Exhibit**).

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

In general, clarifying the language in the standard auditor's report would be beneficial in that it sets the foundation for all users of the report to understand more fully the auditor's conclusion and level of assurance provided. The shortcoming of adding such clarifying language would be that the increased length of the report may add to "information clutter." This shortcoming could be overcome easily through the use of links to a central location where such clarifications are maintained. This approach is similar to the reporting model used in the U.K.

**Questions Related to all Alternatives**

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

We believe the most appropriate approach to improve auditor communication to users would be to revise the auditor's report and the description of the auditor's responsibility for the additional information outside the financial statements.

Auditor reporting on selected other information is another way to inform investors about the integrity of the information provided to investors by management. For example, providing an examination engagement on the Critical Accounting Estimates disclosure in MD&A would promote improved disclosures in this area and respond to suggestions by investor groups for auditor's to emphasize the important judgments made by management in the preparation of the financial statements.

In addition to these matters, the PCAOB should undertake a project to educate investors and other users of the financial statements about the meaning of the auditor's opinion on the financial statements and the terms used within the report.

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

See our response to question 23.

**25. What alternatives not mentioned in this concept release should the Board consider?**

See our response to question 23.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

While standard setting initiatives by the Board will likely be needed for all of the alternatives as it relates to the alternatives we support, the alternative requiring more significant standard setting relates to the separate reporting on the Critical Accounting Estimates disclosure.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

We believe certain of the alternatives are subject to greater susceptibility to misinterpretation than others, and, for this reason, we caution the PCAOB to ensure that any changes to auditor reporting clearly describe the auditor's responsibility to provide an opinion on the financial statements as a whole to avoid any perception that a qualified or piecemeal opinion has been provided.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

The modifications calling for descriptions of the role of management, the audit committee and the external auditor would clarify the role of the auditor in the financial reporting process sufficiently.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

We believe that certain alternatives discussed in the PCAOB Concept Release would improve the communicative value of the auditor's report and advance audit quality while others may have a detrimental effect. For example, the alternatives that (1) clarify the terms used in the auditor's report, (2) explain the auditor's responsibility for the audit of the financial statements and other financial information presented in a document containing the audited financial statements, and (3) provide for reporting on the Critical Accounting Estimates disclosure section of the MD&A all serve to improve communication and the related disclosures enhancing audit quality in a cost effective manner.

**30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

There are unique characteristics that necessitate different approaches to enhance the reporting model for investment companies, investment advisors, broker dealers and others such that a "one-size-fits–all" approach would be inappropriate. For this reason, we would support further consideration of how best to enhance other reports called for by the Board's standards as part of a separate project.

**<u>Considerations Relating to Changing the Auditor's Report</u>**

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's**

**relationships, effects on audit committee governance, liability considerations, and confidentiality.**

a. **Are any of these considerations more important than others? If so, which ones and why?**
b. **If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**
c. **Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**
d. **What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

All of the considerations set out above are important and interrelated, and it would be difficult to assess the importance of one consideration over the other. Any changes to the auditor reporting model need to be considered in tandem with consideration given to how the interrelationships impact audit quality and cost.

Some of the suggested changes would not increase audit costs significantly. For example, modifying the form and content of the audit report would provide enhanced clarity while it would have little additional costs associated with it. However, other alternatives such as auditor reporting on Critical Accounting Estimates disclosures are likely to require additional work effort by both management and the auditor with a corresponding increase in costs.

We encourage the Board to consider the most effective way to implement any changes to accommodate the needs of smaller public companies and provide a way that considers the needs of investors while recognizing the cost constraints facing many smaller public companies.

We believe that a phased-in approach would be appropriate, that is, one that provides that the larger public companies would implement changes initially (other than those changes that could be easily implemented such as changes to the format of the standard auditor’s report) in order to allow the smaller public companies and their auditors learn from the experience of their larger counterparts.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

As stated throughout our letter, management should be the source of original information about the company. We believe this position is consistent with the view of others integral to the financial reporting process (management and the audit committee). Our primary concern is that the candor and vigor of the interaction among the auditor, management and the audit committee would be impacted negatively if the auditor included information about the company's financial statements in the audit report with a corresponding negative impact on audit quality.

**Exhibit**

# Illustration of an Auditor's Report

## Independent Auditor's Report

### The Financial Statements that have been Audited

We have audited the accompanying Balance Sheet of X Company as of December 31, 20XX, and the related Statements of Income, Retained Earnings, and Cash Flows for the year then ended.

### Management's Responsibility versus Auditor's Responsibility

Management is responsible for the preparation and the fair presentation of these financial statements in accordance with U.S. Generally Accepted Accounting Principles. This responsibility includes the design, implementation and maintenance of effective internal control, adopting sound accounting policies, and making accounting estimates that are reasonable in the circumstances. Our responsibility is to express an opinion on these financial statements based on our audit, to be independent of X Company, and to comply with the applicable independence requirements of the [insert, as appropriate, the PCAOB and SEC or AICPA]. We have no responsibility for information in this document outside of the financial statements such as [identify the information, for example the CEO's letter to the shareholders, MD&A, *etc*.]

### Nature of Our Audit

We conducted our audit in accordance with auditing standards generally accepted in the U.S. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement , whether caused by error or fraud. Reasonable assurance is a high level of assurance; albeit not absolute assurance. Our audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

### Audit Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the U.S.

[*Signature*]

[*Date*]

NEXTera ENERGY

**VIA Email**

**September 27, 2011**

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

**RE: Rulemaking Docket Matter No. 34 Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards No. 2011-003**

Dear Members of the Board,

NextEra Energy, Inc ("NextEra Energy") is a public company with 2010 revenues of more than $15 billion. Its rate-regulated subsidiary, Florida Power & Light Company, serves approximately 4.5 million customer accounts in Florida. Additionally, NextEra Energy Resources, LLC, NextEra Energy's competitive energy business, is a leader in producing electricity from clean and renewable fuels in 28 states and Canada.

At NextEra Energy we are committed to integrity and accountability in all aspects of our business. Providing accurate and complete information - and having the proper internal controls in place to ensure appropriate oversight - is a responsibility that management and the audit committee has always taken seriously. We believe that our shareholders, as well as investors and potential investors of every other publicly held company, are entitled to no less.

While investors have voiced concerns around the lack of transparency in the financial statements of the large financial institutions involved in the recent financial crisis, it must be noted that these incidents represent a small percentage of the financial statements issued each year and should therefore be considered an exception to, rather than, the rule.

NextEra Energy appreciates this opportunity to provide its views for consideration by the Board in connection with the above referenced concept release.

**Overview**

Of particular interest and concern to us are the proposals regarding Auditor's Discussion and Analysis ("AD&A") and auditor assurance on information outside the financial statements.

NextEra Energy, Inc.
700 Universe Boulevard, Juno Beach, FL 33408

While the alternatives suggested in the Concept Release are well intended, we believe they would add significant cost, potentially distract management and auditors from more significant audit activities with minimal chance, in our view, of making financial reporting more relevant or useful to investors.

The Board has proposed that additional information about the audit and the financial statements, including the auditor's views on management's judgments and estimates, management's accounting policies and other matters commonly presented to the audit committee, should be provided directly to investors as part of AD&A. We believe that auditors should not provide new and/or subjective information about a company's financial statements directly to investors for the following reasons:

- Ultimately, management has the knowledge and business context for the information most relevant to financial statement users and they should retain responsibility for communicating this information to the public. The role of the auditors should remain that of an independent auditor attesting to the fairness, in all material respects, of the financial statements presented.
- The role of the audit committee is to provide direct oversight of the financial reporting process on behalf of investors and we are concerned that the proposed AD&A will undermine the audit committee's governance role. Further, this could diminish or restrict ongoing and open communication amongst auditors, management and audit committees.
- The commentary contained within AD&A could likely become 'boilerplate' over time due to the increased auditor legal exposure and the associated audit costs, therefore negating any potential benefits it might have for the investor.

The Board has stated that their goal in reevaluating the auditor's reporting model is to increase its transparency and relevance to financial statement users. As per FASB Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting,* the overall objective of financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decision about providing resources to the entity. We suggest that if current financial reporting is not meeting that objective and additional disclosures are considered necessary this matter should more appropriately be considered by the SEC and FASB as part of the financial reporting standard setting process.

Finally, the Board needs to consider the cost and additional time requirements associated with the proposals in the Concept Release. Many of the proposals will require significantly increased auditor consultation time and the development and testing of additional quality control procedures. As the Board is aware, significant pressures are already being placed upon company resources to ensure compliance with the provisions of the Dodd-Frank Act, undertaking the necessary preparation for the significant accounting rule changes in a number of key areas expected through the convergence of US GAAP and IFRS, and potentially the adoption of IFRS by US Companies. The Board should ensure that any proposals implemented as a result of this

Concept Release are weighed carefully against the associated costs as these will ultimately be borne by the shareholders. Also, any time spent on additional reporting could impact public reporting deadlines and, consequently, the ability of investors to obtain financial information in a timely manner.

Thank you for taking the time to consider the views of NextEra Energy on this important topic. We will be happy to respond to any questions or to participate in any discussions relating to the feedback request.

Sincerely,

Chris N. Froggatt

Chris N. Froggatt
Vice President, Controller and Chief Accounting Officer

September 30, 2011

Office of the Secretary
Public Accounting Standards Board
1666 K Street N.W.
Washington, DC 20006-2803

Via email to comments@pcaobus.org

**Re : PCAOB Rulemaking Docket Matter No. 34**

NIKE, Inc. ("NIKE") appreciates the invitation to comment on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements ("Concept Release") issued on June 21, 2011, by the Public Company Accounting Oversight Board ("PCAOB," "Board").

NIKE's principal business activity is the design, development, worldwide marketing and selling of high quality footwear, apparel, equipment, and accessory products. We are the largest seller of athletic footwear and athletic apparel in the world, employing over 38,000 people worldwide. Revenues for our fiscal year 2011 ended May 31, 2011, were over $20 billion. We sell our products to retail accounts, through NIKE-owned retail stores, internet sales, and through a mix of independent distributors and licensees, in over 170 countries around the world. NIKE prepares consolidated financial statements in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and files financial statements with the Securities and Exchange Commission ("SEC"). Our securities are listed and traded on the New York Stock Exchange.

We value the importance of a high-quality audit and are supportive of any changes that truly improve audit quality. Based on the stated objectives and remedies noted in the Concept Release, however, we do not believe changes to the current audit opinion will adequately address the noted objectives and therefore do not support any changes to the standard audit opinion. We believe the current audit opinion provides investors with a solid basis for understanding the accuracy and completeness of the financial statements and related disclosures. We believe investor education around the PCAOB auditing standards, inspection process, and auditor governance, in addition to the key terms stated in the standard audit opinion, would reduce some of the uncertainty investors feel about the audit.

We believe investor objectives could be effectively met by expressing the same concerns to the FASB and SEC as adjustments to disclosure requirements and accounting policy documentation would be a more effective means of meeting investor expectations. Our views on the alternatives presented in the Concept Release and the current audit opinion are summarized below.

## Current Audit Opinion

We believe the current audit opinion conveys all necessary information an investor would find useful in assessing the appropriateness and accuracy of the financial statements and the adequacy of the governing internal controls. We recognize investors have expressed concern the standard opinion is "boilerplate"; however, we believe that the current opinion allows for consistent analysis of audit results across all industries, companies, and auditing firms, leaving no grey area for investors in determining the outcome of the audit procedures. The opinion discloses the financial statements are presented fairly in all material respects in accordance with U.S. GAAP and we believe the opinion is adequate for investors to understand the auditor's view of the financial statements and related disclosures.

**Auditors Discussion and Analysis**

Of all the alternatives presented in the Concept Release, we believe the Auditors Discussion and Analysis ("AD&A") is the least appropriate way to meet investor expectations. Based on the commentary noted in the Concept Release, the AD&A is intended to facilitate an understanding of the auditor's opinion and provide the users of the financial statements with a view "through the auditor's eyes." We disagree with the intentions of the AD&A as we believe the view of the financial statements "through the auditor's eyes" is the current audit opinion. If the auditors did not believe the financial statements were presented fairly in all material respects in accordance with U.S. GAAP, an unqualified opinion would not be issued. The descriptions of each type of audit opinion and the PCAOB auditing standards that govern each audit are publicly available to investors who want an additional understanding of what the opinion represents. We do not see the added value in requiring the auditors to draft a response that summarizes the audit when the current opinion accomplishes the same in a clearer and more concise manner.

Additionally, we believe the auditor's role in an engagement is to independently attest that management's financial statements are presented fairly in all material respects in accordance with U.S. GAAP and that internal controls over financial reporting is effective in all material respects. We do not think the auditor's role should be expanded to provide additional disclosures regarding our business. The financial statements, associated MD&A, press releases, and other externally filed information is the responsibility of management, and all externally reported information regarding the company should come from management.

We are opposed to several of the disclosure items noted in the AD&A, including the disclosure of audit risk factors, audit procedures and results, and difficult or contentious issues, including "close calls." We believe the disclosure of each has the potential to create further confusion and we do not believe a reasonable investor would consider these disclosures to be important in making decisions about investments.

*Disclosure of Audit Risk Factors*

We disagree with the suggestion of disclosing audit risk factors in the AD&A. Audit risk factors do not necessarily align with the risks identified by the company and disclosed in our public quarterly and annual filings with the SEC. We believe disclosing these risks will not provide investors with useful decision making information and are uncertain how the investor will be able to reconcile the risks disclosed in our quarterly and annual filings with the SEC and the audit risks documented, as the audit risks are intended to drive the substantive procedures performed. The risk of creating confusion far outweighs the benefit of providing this information for investors.

*Disclosure of Audit Procedures Performed and Results*

We also disagree with the need to disclose audit procedures performed and the results of those procedures. The results of the audit are currently disclosed in the audit opinion and we do not believe it is worthwhile or necessary to require the results to be reported twice. The PCAOB auditing standards that govern the audit procedures performed are easily accessible for viewing by investors. The opinion states the audit was conducted in accordance with the PCAOB standards. We believe disclosure of the individual procedures is repetitive and do not see the value additional disclosure will provide investors considering the outcome of the procedures is summarized in the current opinion.

*Disclosure of Difficult or Contentious Issues, Including "Close Calls"*

We are opposed to the suggested disclosure of difficult or contentious issues, including "close calls." The auditor's view of our financial statements is stated in the opinion, which encompasses all of our judgments, estimates, and contentious issues. An unqualified opinion would not be issued if there were material errors, omissions, or differences between the auditors and management. We do not see the value of requiring the auditors to specifically state their opinion individually over these issues. There is more potential to create confusion among investors by disclosing this information.

**Required and Expanded Use of Emphasis Paragraphs**

We believe that the current use of emphasis of matter paragraphs is appropriate. Their intended purpose is to highlight situations or transactions that are material to the financial statements and disclosures and we do not believe that the mandatory use of these paragraphs provides any additional value to investors if there are no serious matters to emphasize. We believe the required use of these paragraphs would create confusion for investors who may not understand the technical nature of accounting estimates, judgments, and transactions that may be emphasized by the auditors.

The Concept Release noted that requiring emphasis paragraphs could persuade companies to improve their disclosures around the emphasized transactions. We do not see the perceived benefit, as disclosures must be presented in accordance with U.S. GAAP to receive an unqualified opinion, and unless U.S. GAAP disclosure requirements are changed, we believe it is highly unlikely that the disclosures will change.

**Auditor Assurance on Other Information Outside the Financial Statements**

We do not believe an auditor's opinion on other externally reported information will provide investors with the greater transparency they desire. Currently, under the anti-fraud rules and regulations promulgated and enforced by the SEC, issuers are liable for all externally reported information, including press releases and all public filings, which may include MD&A disclosures. Investors should have some comfort level that management is not intentionally providing misleading or incorrect information based on the governing SEC rules and regulations. Additionally, our auditors are required to review our MD&A and press release to ensure consistency with the reported financial statements. While review procedures are not as rigorous as audit procedures, we do not see the incremental benefit to investors by requiring this information to be audited. And, finally, we are concerned that adding this requirement could push back the filing time of our forms 10-K and 10-Q, earnings release calls, and investor meetings.

**Clarification of the Standard Auditor's Report**

We are not opposed to adding clarifying language to the standard audit opinion; however, we do not believe that the clarifications would add any value for an educated investor. The definitions and contextual meanings are available to the public and are consistent from opinion to opinion. If the investment community is mandating change and the Board believes that further clarification of the terms in the standard opinion will accomplish the stated objectives of investors, we would be supportive of this change to the opinion.

Each of these alternatives, and especially the proposed AD&A and Auditor Assurance on Other Information Outside the Financial Statements, will place significant additional burdens on both the auditors as well as issuers while providing only marginal, at best, value for investors. Adoption of any of these proposals will impose significant costs (both internal and external) to the issuers. While the PCAOB's proposals are well intended, they fail to strike the right balance between investor confidence and comfort versus issuer and auditor increased burden and cost.

Thank you for your consideration of the points outlined in this letter and we look forward to monitoring the project developments in the future. If you have questions or would like to discuss our responses further, please contact me at (503)671-6453.

Sincerely,

Bernard F Pliska

Bernard F. Pliska
Nike, Inc.
Vice President, Corporate Controller, Principal Accounting Officer

**Northrim Bank**
Customer First Service

December 1, 2011

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

Via website submission: comments@pcaobus.org

RE: PCAOB Rulemaking Docket Matter No. 34 – *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

To Whom It May Concern:

Northrim BanCorp, Inc. ("Northrim") appreciates the opportunity to comment on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("Concept Release"). Northrim is a community bank headquartered in Anchorage, Alaska.

The Concept Release seeks comments on potential changes to the auditor's reporting model based on concerns of investors and other financial statement users. The changes being considered include: (1) a required Auditor's Discussion and Analysis ("AD&A") to be included with an auditor's report, (2) required and expanded use of emphasis paragraphs within the current format of the auditor's report, (3) auditor assurance on other information outside the financial statements (for example, information within Management's Discussion and Analysis ("MD&A"), non-GAAP information presented, and information within earnings releases), and (4) clarifying language within the current auditor's report that explains what the audit represents and the related auditor responsibilities.

Northrim believes that auditor reporting should not be expanded as proposed in the Concept Release. Instead, the audit expectation gap should be narrowed. We understand that external audits are important to many users of financial statements in effective decision-making related to the allocation of capital. Capital is efficiently allocated by those who have sufficient knowledge of the related reporting entities and their business models. However, we believe that increasing the quality of financial reporting is far more important than expanding the role of the external auditor. Investors are best served by direct communication from companies themselves.

We disagree with the idea that the value derived from expanding auditor procedures to include an AD&A or to provide auditor assurance on other information outside the financial statements will exceed the massive costs that would be required to perform the procedures. Such approaches will only lead to more user confusion between the different reports issued by the auditors and management and will likely increase the already-existing "expectation gap" of what audit assurance actually provides to the investor. For example, discussion of audit "close calls" may actually cause the financial statement user to question the quality of the audit work and why the amounts actually recorded should be relied upon. The focus of the audited financial statements should be on the reporting entity, not the auditor.

Underlying the Concept Release is the notion that auditors often have significant information regarding how a company's financial statements were prepared that might be useful to investors and other financial statement users. Northrim believes that this information from the auditor, at best, will only confirm what is already disclosed in footnotes to the financial statements or the MD&A. Over time, investors may become frustrated with the auditors' language, which is likely to be carefully-crafted and self-protecting. This could eventually render most of the additional reporting as irrelevant. At worst, such reporting, especially since it relates to highly judgmental areas, could result in uncertainty among users that is unwarranted.

Within the Concept Release, it was pointed out by some that the recent financial crisis is an example of how expanded auditor reporting might be useful in assessing the quality of the financial statements. Discussions of off-balance sheet contingencies and of the sensitivity of loan loss estimates were specifically cited. In outreach done by the American Bankers Association to various banking analysts, they found none that list the auditor report as a significant issue, nor did they know of other analysts (buy-side or sell-side analysts) who did. While we understand that there are those who believe that the related disclosures within the notes to the financial statements or within the MD&A were insufficient prior to the financial crisis, those are issues that should be addressed by the Financial Accounting Standards Board. We question how expanded auditor reporting, especially that contemplated within an AD&A or by expanding procedures over the MD&A, would have adequately addressed such concerns. The judgmental nature of the valuation of loan loss estimates, contingencies, and fair values, is central to the commercial banking business. This is why detailed disclosure of those key areas of estimates and management judgment is normally included within the first notes to the financial statements, as well as within the risk sections of the MD&A.

Financial statements of any company include judgments and estimates at a specific point in time. No matter what kind of emphasis is put on this fact, volatility in the markets (especially the volatility experienced in the last four years) will often greatly reduce the relevance of these estimates by the time the report is issued. Further, bank financial performance (and thus bank equity prices) is often influenced by factors that cannot be adequately reflected in financial statements. Liquidity management and the business impact of regulation, which are commonly addressed in quarterly filings, are among examples. These types of disclosures would be impractical to audit. Attempting to provide additional investor comfort and focus in the financial statements through increased auditor communication will likely only add to the confusion over what those statements mean to future bank performance.

Instead, Northrim believes that the PCAOB should consider solely how the auditor report can be revised to reduce the expectation gap. We do not believe that the expansion and requirement of the use of emphasis paragraphs would be beneficial to users of financial statements. As bank audited financial statements often include scores of pages of footnote disclosures, the emphasis paragraphs could also turn the auditor report into one of similar length, thereby diluting the emphasis objective.

As was experienced during the implementation of the Sarbanes-Oxley Act, expansion of audit rules and processes can result in significant concerns about costs versus benefits. We realize that this is outside the purview of the PCAOB, but we believe that the expenses of implementing the Concept Release would be better spent, and investors would be better served, by reducing the complexity of financial reporting or clarifying the risks reporting companies face, rather than significantly expanding the role of the external auditor.

Thank you for your attention to these matters and for considering our views.

Sincerely,

Latosha Dickinson, CPA
Vice President, Controller of Financial Reporting
Northrim Bank
3111 C Street, Suite 235
Anchorage, AK 99524

NORTHROP GRUMMAN

Northrop Grumman Corporation
2980 Fairview Park Drive
Falls Church, VA 22042

September 29, 2011

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

R.E. Release No. 2011-003: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

PCAOB Rulemaking Docket No. 34

Dear Board Members:

We appreciate the opportunity to provide our comments on the Concept Release issued by the PCAOB entitled "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" (the "Concept Release"). The intent of this letter is to articulate our position on the Concept Release, from our perspective as a leading provider of systems, products, and solutions to U.S. Government and commercial customers.

We believe that, when fully understood by the user of the financial statements, the current model for the auditor's report works well and is effective in accomplishing its objective. That objective, however, is limited to informing the user that the auditor has performed an independent examination of the financial statements in accordance with a broad set of audit standards and has found that the financial statements fairly present the information shown in accordance with a defined set of accounting principles, but it does not include information relating to the broader objectives discussed in the Concept Release. We believe the current audit report says a great deal to users of the financial statements and that what it represents is of great value to those users when they fully understand its meaning. What it does not do, and what the Concept Release would seek to change, is that it does not attempt to point users in a certain direction by highlighting one portion of the financial statements over another, nor does it attempt to communicate other qualitative information about the financial statements, management's processes or judgments used in preparing the financial statements or other similar information that the PCAOB believes might be useful to certain users. The auditor's report does not cover these latter issues for a number of reasons.

First, the auditor's report already communicates a great deal because it says the auditor completed their examination, an activity that constitutes a great deal of effort and represents the principal area of expertise that the auditor brings to the table to provide value to financial statement users. An auditor is not trained for, and there are no audit standards that provide guidance to assist the auditor in determining which portions of the financial statements or disclosures are more valuable or of greater interest to users than others. Likewise, they are not trained and have no standards to guide them in determining which management judgments, processes or conclusions should be highlighted for disclosure to financial statement users. The primary reason that this training and the audit standards guidance is missing is that these areas are very subjective in nature and thus do not lend themselves to evaluation through training or the application of standard procedures. Subjectivity is in the eye of the beholder, and what might seem important to one user, might not be of value to others, so where does one draw the line? The essence of the auditor's opinion is its objectivity drawn from the independent aspect of the auditor's work and any deviation from this perspective will, in our view, lessen the value of the auditor's opinion to the broader set of financial statement users.

Second, while the language of the standard auditor's opinion may appear to some as a "pass/fail" model, we believe it demonstrates consistency in the outcome of an auditor's processes and this is valuable in and of itself. It means that management has done their work, the auditors have done their work, the Audit Committee has fulfilled its oversight responsibilities and the auditor's report is the outcome. This outcome represents the completion of a great deal of work, the fulfillment of the responsibilities of numerous parties and all completed within a well understood framework that has been relied upon year after year. Condensing this effort to a simple "pass/fail" designation is to trivialize an enormous amount of effort and a valuable process model that should not be simply taken for granted. Historically, the auditor's role and the conclusion derived from their work has been considered in relation to the financial statements and disclosures taken as a whole, while the concept of expanding the auditor's reporting to matters that are removed from the financial statements, as contemplated by the Concept Release, would depart from that foundation and expand the auditor's responsibilities to matters that are apart from the underlying financial statements.

Lastly, we are concerned about what the auditor's report could become if it were required to include consideration of the other areas contained in the Concept Release. We see a situation where the complete opposite of what exists today could occur and there would be little consistency in the form of the auditor's report as each auditor and company situation could result in different outcomes. All of these variations would then fall to the users of the financial information to interpret and understand, yet today the PCAOB believes that the very straightforward language of the standard auditor's report is not well understood by financial statement users. We can only wonder how users will evaluate and put into context this new information if they do not already have a sound foundation and understanding of what management has presented in the financial statement disclosures. We are also concerned that users will inappropriately place greater emphasis on the matters and viewpoints of the auditors than those of management which will increase the auditor's litigation exposure and related audit fees as investor's rely more heavily on the auditor. We do not believe this is the PCAOB's intention for seeking this expanded level of reporting and we view this as an unintended consequence.

We therefore do not believe that the auditor's report should become the venue for dealing with financial statement user's perceived shortcomings in financial statement disclosures or the interaction between the auditors and management. In the case of the former, we believe that the only appropriate solution is to increase disclosure in the financial statements which is beyond the charter of the PCAOB. With regard to the latter, we believe that the Audit Committee is charged with overseeing and administering the conduct of the audit and the relationship between management and the independent auditor. Furthermore, any changes in the auditor's reporting model that would disclose information that the Audit Committee is charged with evaluating will only serve to invite financial statement users to question the effectiveness of the Audit Committee's performance of its responsibilities.

The Concept Release discusses a number of areas and includes suggestions for revisions to the existing auditor's report as well as changes in the scope and extent of the auditor's involvement in the financial reporting and disclosure model that is presently in use. We have the following observations regarding the specific areas of concern contained in the Concept Release:

- Clarification of the Auditor's Standard Report – Although we believe that the current model is sufficient, we have no objection to the language expansion discussed in the concept release regarding the meaning of reasonable assurance, expanded discussion of the auditor's responsibility for fraud, financial statement disclosures and explicit acknowledgement of their independence and the clarification of the roles of management and the auditors. With regard to having the auditor report on other matters outside of the financial statements, we would support expanding the auditor's report to include assurance on matters for which they have the relevant expertise and so long as that assurance is limited to that which can be obtained through the application of agreed-upon procedures to the applicable information. We do not believe that the auditor's work should be expanded to enable them to express an opinion on these other matters as they are either outside of their areas of expertise, not covered by existing auditing standards or represent areas where a separate opinion would be confusing given management's responsibilities. Any such expansion of the auditors work beyond that which can be derived from a limited assurance model would unduly add audit costs and potentially delay the completion of the preparation of the financial statements. Thus, limited assurance language covering critical accounting policies, management's discussion and analysis of financial information and similar narrative information would be acceptable, however, we believe it would be inappropriate and potentially misleading for the auditors to provide any coverage over risk factors, business outlook and similar areas that we believe are outside of their areas of expertise.

- Use of the emphasis paragraph – We believe that the current requirements for the use of this paragraph are sufficient, and that many of the areas where this paragraph might be used should instead be dealt with by improved disclosure in the financial statements rather than by having the auditors direct the users of the financial statements to areas of importance. Greater use of this requirement could serve to cause users of the financial statements to unduly focus on matters in the auditor's report to the exclusion of other information in the financial statements that is essential for the user's overall understanding of the financial information. We also believe that if the conditions that might require the use of this paragraph were changed or enhanced, it would result in changed disclosure in the financial statements that would limit the extent and value of the emphasis paragraph, and could lead to greater use of "boilerplate" language in the emphasis paragraph which would be of little value to financial statement users. At the end of the day, the auditor's opinion on the financial statements indicates that the financial statements "fairly present" the information contained therein, so an emphasis paragraph might raise concerns about whether the financial statement disclosures are adequate, or whether there are other concerns that the auditor is trying to communicate to financial statement users.

- Auditor's Discussion and Analysis Report ("AD&A") – We strongly feel that the addition of an AD&A report is unnecessary, unwarranted and unwise and thus will only lead to creating confusion and concern on the part of financial statement users. Most of the areas of concern discussed in the Concept Release that cause the PCAOB to believe that such a report might be worthwhile deal with areas that are within the purview of the Audit Committee. Including disclosure of these matters would bring into question the effectiveness of the Audit Committee's governance process and essentially provide financial statement users with information that could be used to "second-guess" management and the Audit Committee. Furthermore, we question whether, in the normal conduct of an audit, the auditor would obtain the requisite knowledge and understanding of all of the relevant information and have the expertise necessary to make the judgments necessary to report upon the information expected to be contained in the AD&A narrative disclosure. The requirement for inclusion of an AD&A could also lead to increased tension between management, the Audit Committee and the auditors which will diminish the overall effectiveness of the audit process. The matters considered for disclosure in the AD&A discussion represent matters that management, the Audit Committee and the auditors should review, discuss and resolve in the conduct of the audit such that the financial statements and related disclosures reflect the outcome of the satisfactory resolution of these matters.

In the appendix to this letter we discuss our responses to the specific questions contained in the Concept Release. We would be happy to discuss our comments with you in more detail and would be pleased to meet with you in person if you so desire. Thank you again for the opportunity to comment on these matters and for your consideration of our points of view.

Respectfully,

K.N. Heintz

Kenneth N. Heintz

Corporate Vice President, Controller
and Chief Accounting Officer

Appendix

# Appendix
## Responses to Questions in the Concept Release

**Form of the Auditor's Report**
**1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

> **a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**
>
> **b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**
>
> **c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

We do not believe that it is necessary for the Board to consider a significant overhaul of the auditor's reporting model or expansion of the auditor's role to provide assurance on matters other than the financial statements and related footnote disclosures. We feel the current level of auditor involvement and communication is effective and that additional detail provided in the audit report would introduce a great deal of subjectivity, as well as create the false perception that auditors have the same level of insight as management.

The Concept Release states that investors perceive the standard auditor's report as being too "boilerplate." We feel, however, that the auditor's report needs to remain standardized in order to retain clarity and comparability between public companies. One example in the Concept Release's proposed changes would allow an auditor to disclose items that it has communicated to management but which management has chosen not to disclose because of immateriality. If the audit report is unqualified, then the auditor has already concurred with management's decision not to disclose the matter. We cannot think of any situation where separate disclosure by the auditor of matters that do not affect the auditor's report would result in more clarity. To the contrary, we feel such disclosures would result in the opposite effect, leaving users of the financial statements wondering why the auditor has chosen to highlight something that management considered immaterial and to which they had concurred.

The auditor's report provides relevant and useful information if the reader has a reasonable understanding of the auditor's role and the processes and procedures that must be performed in order for the auditor to issue their report. An audit performed in accordance with Generally Accepted Auditing Standards ("GAAS") requires that the auditor put forth a substantial effort to plan and conduct the audit. The audit report reflects the conclusions reached by the auditor as well as confirming that this effort was performed. We believe that this is the most relevant and useful information that a financial statement user should expect to obtain from reading the auditor's report.

Investors and other financial statement users have the responsibility to educate themselves on what an audit represents. By obtaining this understanding they will have a much better ability to put into context the roles of management, the audit committee and the auditors.

We do, however, support several improvements to the standard audit report such as those contained in our responses to questions 21 and 22.

Additionally, we have no objection to expanding the auditor's report to provide limited assurance on supplemental information outside of the financial statements where the auditor could apply limited or agreed upon procedures to determine that the supplemental information was consistent with the information contained in the audited financial statements. As we will indicate in our response to questions 19 and 20, we believe that the auditors should use the audited financial statements as the basis for their work on the other information contained in documents in which the audited financial statements are presented. We do not believe that it is appropriate for auditors to expand their audit scope to enable them to express some form of an opinion on such supplemental information for a variety of reasons. These include the absence of auditing standards relating to such information, the absence of any reporting standards for auditors to use in reporting on such information and the absence of any expectation that the auditors would have the requisite experience and expertise to enable them to express an opinion on such supplemental information.

**2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

**a. Should the auditor's report retain the pass/fail model? If so, why?**

**b. If not, why not, and what changes are needed?**

**c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

We feel strongly that the auditor's report should retain its current form of opinion and do not see this as a "pass/fail model". Reducing the opinion on the financial statements to such a simplistic outcome fails to acknowledge what an audit encompasses, and the substantial responsibilities of both management and the auditors that must be fulfilled in order to support the issuance of an opinion. The auditor's opinion has a much deeper significance than the words used to convey its outcome. The fact that few words are used to express the outcome of a substantial effort may, on its face, seem insufficient to provide comfort to an unsophisticated user of the financial statements having no knowledge about what is required by an audit or the role and responsibilities of the independent auditor. However, we feel that it is unrealistic to expect that the financial statements and the auditor's report should be designed to be relevant to such an unsophisticated user.

Additionally, the current model is universally understood. To modify that model would introduce a level of subjectivity into the process that will likely confuse readers and reduce comparability between companies and audit firms. Moreover, introducing subjectivity into the process will require the establishment of new auditing standards (assuming subjectivity can be standardized) and users will have to evaluate for themselves the meaning of the subjective determinations. Today's model contains an objective outcome that is not subject to the need for evaluation by financial statement users.

**3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

We believe management is the appropriate party to provide additional information about the company's financial statements. We further believe that any additional information that the PCAOB deems important through this comment process should be communicated and vetted as a proposal through the appropriate standard setters (i.e. the Financial Accounting Standards Board (FASB), or the Securities and Exchange Commission (SEC)). If deemed important, that information can be incorporated into current FASB or SEC disclosure requirements.

The audit committee is a governance body, and it devotes the time and effort necessary to oversee management's preparation of the financial statements. The audit committee's involvement is not sufficient to enable it to make its own judgments about financial statement matters and therefore it should not be responsible for providing financial information or disclosures to financial statement users. That responsibility clearly and appropriately rests with management.

**4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by -- Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

We do not believe that any changes to the report on internal control over financial reporting are necessary since we do not support substantive changes to the form of the auditor's report. Please refer back to our earlier comments. There is a much more detailed process that underlies the auditor's opinion on internal controls over financial reporting that should not be overlooked. Also, even sophisticated users of financial statements may not be technically knowledgeable enough to understand the nuances involved with internal control over financial reporting, and expanding the wording of this portion of the report may make it less useful to users.

**Auditor's Discussion and Analysis**

**5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

**a. If you support an AD&A as an alternative, provide an explanation as to why.**

**b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**

**c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**

**d. If you do not support an AD&A as an alternative, explain why.**

**e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

**8. Should a standard format be required for an AD&A? Why or why not?**

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

We do not support the concept of an AD&A. If there are perceived shortcomings with what is presented in management filings then this should be communicated to the SEC and FASB and addressed by them. Furthermore, an AD&A seems to have limited value due to the inherent limitations in the scope of activities that the auditor could comment on as well as the limited amount of work performed by the auditor to enable them to provide any meaningful commentary. Auditors are independent of their clients, spend a limited amount of time testing and evaluating the financial information prepared by the company outside of that used to prepare the financial statements, and have no responsibility for the outcomes of the decisions made by management. Thus we believe that any supplemental commentary that is provided by the auditors will necessarily contain severe limitations as to the basis upon which such commentary was developed.

In this context, we do not believe it is cost effective or practicable to attempt to expand the scope of the auditor's involvement with management's responsibilities in order to enable the auditor to issue some form of opinion on such matters. Management performs its responsibilities in the continuum of its day-to-day activities and makes judgments based upon the weight of its experience, the totality of the information available to management, and the expertise of management. Management shares with its auditor the rationale for its judgments to enable the auditor to reach a conclusion as to the reasonableness of management's judgments. The auditors are not in a position to make their own independent judgments on such matters because these would be purely hypothetical judgments that do not result in actions taken by the company. Therefore, we do not think it would be meaningful for a user of financial statements to attempt to weigh the hypothetical judgments of an auditor against the actual decisions and judgments of management because only management's decisions can be evaluated on the basis of the outcomes of the judgments.

The preparation of an AD&A may also discourage users from performing a comprehensive review of the complete financial statements and disclosures. The AD&A should not be a substitute for the user obtaining a full understanding of the financial statements and related disclosures. Additionally, because the AD&A comes from an independent source it may inappropriately be viewed as having more authority than the information provided by management. To avoid this outcome, the auditor will likely have to include qualifying language in the AD&A report that will be viewed by users as "boilerplate" language that will limit the effectiveness of the auditor provided information.

It is also likely that if an AD&A were put in place, it would result in a duplication of the information already provided by management. If for example, an audit firm approached management about including something in their AD&A report that is different from what management was planning to disclose, discussions would ensue and the two parties would come to a mutual agreement whereby management would likely adjust their disclosures to avoid or minimize the effect of the auditor disclosure. This outcome again points out the overall relevance and value of the financial statements and related disclosures as being the primary source of information for users.

Furthermore, we do not believe that the auditor should be singling out certain aspects of a company's financial reporting or other disclosures. This would expose the auditor to undue risk of litigation, if for example a risk factor or critical accounting policy that was highlighted by the auditor in their AD&A report became an issue. In practice, the auditor and management would likely work together to ensure that the information in both parties' reports is consistent to reduce the exposure to misinterpretation or misunderstanding by financial statement users. The end result of all of this is that no meaningful additional reporting by the auditors would occur, again resulting in information that would be viewed by financial statement users as "boilerplate".

**6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

**7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

Many of the items described in your questions relate to issues or matters that are discussed between management, the auditor and the audit committee. The idea of requiring disclosure of these communications assumes that the user of the financial statements has sufficient expertise to be able to understand and interpret the information that will be disclosed. Under requirements established by Sarbanes-Oxley, members of the audit committee are required to have a minimum level of accounting and financial expertise that cannot be assumed to exist for users of financial information. In addition, the information provided to audit committee members is intended to assist them in conducting their oversight responsibilities with respect to management's preparation of the financial statements and its selection and application of accounting principles. These communications from the auditors are supplemental information to that which is provided to the Audit Committee by management, and this information and these communications are incorporated into the dialog between the audit committee, the auditor and management as the committee fulfills its oversight responsibilities. Adding disclosure of the information contained in these communications without including the context in which such communications are evaluated by the audit committee will likely render the information of limited value to financial statement users.

Moreover, the addition of an AD&A section in which the auditor provides subjective commentary about the audit process, management's judgments, and the company's financial statement disclosures would significantly alter the role and relationship of the auditor to the company being audited, and may completely undermine the fundamental independence relationship that now exists. Today, auditors perform tests, examine underlying documentary evidence, and evaluate the reasonableness of the judgments made by management to enable them to conclude that the financial statements are fairly presented. Their primary area of focus is the financial statements and related disclosures. We do not understand how a user of the financial statements would benefit from understanding the auditor's risk assessments or what audit procedures were applied so long as the outcome was such that the auditor was able to render an unqualified opinion. Similarly, asking the auditor to provide color on their assessment of management's judgments, use of estimates, accounting policies and/or contentious issues, including close calls, in situations where an unqualified opinion is issued is of dubious value because such commentary would seem to detract from the fact that the auditor ultimately became satisfied with these matters such that they did not affect the opinion on the financial statements. Without an extensive knowledge of the overall audit process and the importance of the various aspects of that process, we do not believe users of the financial statements will benefit from the auditor highlighting certain elements of the audit process over others. Thus, we believe that the auditor would necessarily have to provide a thorough explanation of the limitations upon which their supplemental commentary is based. Once these limitations are understood, we believe that they will significantly limit the value of any supplementary information provided.

**Required and Expanded Use of Emphasis Paragraphs**

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

> **a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**
>
> **b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

We believe that the existing model for the use of an emphasis paragraph is sufficient. The fact that very few emphasis paragraph opinions occur in practice is due simply to the absence of matters necessary for such paragraphs.

The auditor's emphasis of additional matters that users may see as significant has a negative connotation given the current limited use of an emphasis paragraph. Thus expanding the use of an emphasis paragraph may be confusing to users since they have not been accustomed to seeing such disclosures. Users would have to become informed as to the changes in the standards regarding the use of an emphasis paragraph, and the meaning of any new emphasis paragraph disclosures.

Another concern is the quantity of emphasis paragraphs that an auditor may be required to provide. This would seem to merely increase the data in the report and further incentivize users to avoid reading the full financial statements and instead, look to the areas set forth in the auditor's opinion. We believe this would cause users to place more reliance on the auditor's work than on the information contained in the financial statements and related disclosures. Additionally, if a user sees one company with only one or two emphasis paragraphs and another with multiple paragraphs, they might mistakenly think that the company with more paragraphs is more risky, yet there are many other factors to consider when including multiple emphasis paragraphs (such as, complexity of the industry, degree of centralization of the accounting organization, geographical and jurisdictional dispersion of the company, etc.). Therefore, we are concerned that the greater use of emphasis paragraphs will be misinterpreted by financial statement users and thus lead to greater confusion over the meaning of the additional disclosures.

**Auditor Assurance on Other Information Outside the Financial Statements**

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

> **a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**
>
> **b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**
>
> **c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**
>
> **d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**
>
> **e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**
>
> **f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**
>
> **g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

We would support expanding the auditor's report to include assurance on matters for which they have the relevant expertise provided that such assurance is limited to that which can be obtained through the application of agreed-upon procedures or other limited scope work to the applicable information. We do not believe that the auditor's work should be expanded to enable them to express an opinion on these other matters as they are either outside of their areas of expertise, not covered by existing auditing standards or represent areas where a separate opinion would be confusing given management's responsibilities. Any such expansion of the auditor's work beyond that which can be derived from a limited assurance model would unduly add audit costs and potentially delay the completion of the preparation of the financial statements. Thus, limited assurance language covering critical accounting policies, management's discussion and analysis of financial information and similar narrative information would be acceptable to us. We question whether the auditors should provide any coverage on areas such as risk factors, business outlook and similar forward looking information which we believe are outside of their areas of expertise and knowledge.

We believe that the existing audit standards provide sufficient guidance to the auditor in determining the work scope and related reporting to utilize in reporting upon information outside of the financial statements and feel that this level of assurance would be beneficial to financial statement users. We do not feel that this level of reporting would unduly affect the timing of management's completion of the preparation of the financial statements, nor would it materially alter the form or content of such information as the auditor is already required to review this information today, and the primary change contemplated is to require the auditor to report on the review that was performed.

**Clarification of the Standard Auditor's Report**

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

**Reasonable assurance**
**Auditor's responsibility for fraud**
**Auditor's responsibility for financial statement disclosures**
**Management's responsibility for the preparation of the financial statements**
**Auditor's responsibility for information outside the financial statements**
**Auditor independence**

> **a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**
>
> **b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**
>
> **c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**
>
> **d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

We have no objection to expanding the language in the standard auditor's report in the areas listed above. We believe that these clarifications would enhance the auditor's report by addressing areas that are of particular interest to users and do serve to better communicate the nature of the audit, and the respective responsibilities of management and the auditor.

Because these items represent clarifications of language, they do not change the audit scope or responsibility of the auditor, nor would they be expected to have any significant cost impact. Clarification of these matters would serve to further support our views expressed earlier regarding the utility of the auditor's report to financial statement users. We do not foresee any shortcomings in providing these clarifications.

Alternatives

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

As described in our earlier responses, we support the auditor's reporting on certain matters outside of the financial statements using a limited-assurance model and certain clarifications to the standard auditor's reporting model. We do not support the expanded use of the emphasis paragraph in auditor reporting and also do not support the concept of adding the time delays, added cost, and uncertain value of the AD&A reporting model described in the Concept Release.

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

See our response to Question 23.

**25. What alternatives not mentioned in this concept release should the Board consider?**

No further comment.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

No further comment.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

We believe that the greater use of an emphasis paragraph and the use of an AD&A report runs the risk of confusing the user's understanding of the auditor's reporting in much the same way as would a qualified opinion or piecemeal opinion. Financial statement users would have a difficult time understanding the context of these different levels of reporting and which is more representative or meaningful for them to rely upon. Without an appropriate context, which may be very difficult to convey, financial statement users will have a difficult time understanding the meaning of an emphasis paragraph or certain AD&A disclosures at the same time that the company receives an unqualified opinion on the financial statements. As indicated in our earlier responses, we believe that one of the values of the current model of auditor reporting is that it sends a clear message to financial statement users who understand what the report represents. Changing the form of the report, and adding different auditor involvement and levels of reporting will only serve to confuse financial statement users and leave them wondering which reporting element is the most valuable.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

See our earlier comments.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

See our response to Question 23 regarding the alternatives that we would support. We do not believe that these alternatives would substantially improve the current audit quality as they do not significantly change the auditor's role. We do believe that the greater use of the emphasis paragraph and the potential inclusion of the AD&A report could create areas of greater tension between management and the auditor and thus affect the overall quality of the audit. We also believe that because many of the areas that the Concept Release suggests would be included in the AD&A report are either difficult for the auditor to perform or are beyond the expertise of the auditor, the overall quality of the audit would likely suffer.

**30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

Any changes made should apply to all registrants, no exception.

**<u>Confidentiality</u>**

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

> **a. Are any of these considerations more important than others? If so, which ones and why?**
>
> Audit committee governance is an important consideration as several of the alternatives suggested undermine their oversight role. The Sarbanes-Oxley Act significantly enhanced

and placed reliance upon the role of the audit committee in overseeing management's responsibilities related to internal controls over financial reporting and financial reporting in general. We believe that any changes that are contemplated in the auditor's report should be made in reliance upon and with a view towards strengthening the current role of the audit committee as opposed to diluting it or rendering it redundant.

**b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

The addition of an AD&A and/or increase in emphasis paragraphs will likely increase costs due to the increased effort and risk assumed by the auditor and delay the timing of the completion of the financial reporting process. We do not believe that the recommendations contained in the Concept Release provide sufficient benefits to justify the increased costs or the additional time delay for the completion of the financial statement reporting process.

**c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**

No further comment.

**d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

No further comment.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

We believe it has the potential of creating an adversarial relationship between the issuer and its auditor. If an auditor is required to include their subjective opinions on management's accounting practices or disclosures beyond what is currently required to satisfy themselves that the financial statements are fairly stated in accordance with GAAP, conflicts will be inevitable. We believe these conflicts will affect both the auditor's relationship with management and its relationship with the audit committee charged with overseeing the role of management.

Furthermore, as described in our earlier responses, we are concerned about the confusion that financial statement users would have in trying to understand the various reports and opinions that the auditor would issue. Without some meaningful context within which to evaluate the additional information we do not see how it could be useful in making judgments about the quality of the financial statement disclosures, the integrity of management and/or the effectiveness of the audit committee's oversight role. We see such incremental auditor disclosures as serving only to confuse users of financial statements as they would appear to indicate some conflict between the auditor, management and the audit committee notwithstanding the fact that the auditor will have issued an unqualified opinion on the financial statements.

* * *

NUCOR
CORPORATE OFFICE

September 30, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

Nucor Corporation appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board (PCAOB) on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.

Nucor is a manufacturer of steel and steel products, as well as a scrap processor, with operating facilities and customers located principally in North America. We are the largest recycler in North America, using scrap steel as the primary raw material in producing steel and steel products.

We have the following comments on the four proposed alternatives for changing the auditor's reporting model that are discussed in the concept release:

<u>Auditor's Discussion and Analysis (AD&A)</u>

We are strongly opposed to the inclusion of an AD&A. We believe that management, with oversight provided by the audit committee, is best suited to provide additional information about the company's financial statements. Since management, with the oversight of the audit committee, is responsible for making all judgments and estimates in a company's application of accounting policies and practices and resolving difficult issues, it should be exclusively responsible for communicating information about these matters to investors. Auditors should not be the original source of any disclosure about a company. Regardless of how extensive audit procedures are now or will be in the future, an auditor's knowledge about the company will never be as extensive as management's. In addition, since the auditor's comments in the AD&A could be different from management's comments in MD&A, investors could be confused or even, in some instances, misled. Further, such inconsistencies could cast doubt on the accuracy and reliability of the financial statements.

The current auditor report is based on the financial statements taken as a whole. If auditors are required to comment either on specific judgments and estimates made by management in applying accounting policies and practices or on contentious issues ("close calls"), which are both at a lower level than "financial statements taken as a whole," audit engagements will become more expensive and take additional time to complete.

Required and Expanded Use of Emphasis Paragraphs

This alternative would mandate the use of emphasis paragraphs in all audit reports and further expand the emphasis paragraph to highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements. The auditor could also be required to comment on key audit procedures performed pertaining to the identified matters.

Different disclosures may be important to different investors, and the expanded use of emphasis paragraphs could detract from other disclosures in the financial statements. This alternative would rely on the auditor, not management, to determine what information in the company's financial statements is most significant and should be emphasized in the report, which could potentially impair the auditor's independence.

Since many investors do not have an in-depth understanding of the auditing process, commenting on key audit procedures could result in confusion. Providing sufficient information on complex audit concepts would result in lengthy descriptions of the auditing process, which investors may be tempted to overlook. In addition, we believe their overuse could have the opposite effect and lessen the impact of emphasis paragraphs.

Under current standards, an unqualified opinion is an indication that all material matters related to an audit have been resolved. Additional discussion in the auditor's report in the form of multiple emphasis paragraphs is unnecessary and potentially misleading. The use of emphasis paragraphs would make it less obvious that a company was receiving an unqualified opinion and could be confusing to both sophisticated and unsophisticated investors alike.

Auditor Assurance on Other Information Outside the Financial Statements

We do not support requiring the auditor's assurance on information outside the financial statements (e.g., MD&A, non-GAAP information or earnings releases). Under current auditing standards, auditors are already required to read other information included in documents containing audited financial statements and ensure that such information is not materially inconsistent with the audited financial statements. Requiring that auditors provide any form of assurance on additional information would be costly while providing little, if any, incremental benefit to investors. In addition, requiring that this information be audited would require substantial additional time in an already tight reporting schedule.

Clarification of the Standard Auditor's Report

We believe that the auditor's report should remain concise and continue to follow the current "pass/fail" model. The language of the auditor's report should continue to use standardized language that provides consistency, comparability and clarity of auditor reporting. However, we do believe that investors would benefit from the following "plain English" changes that are discussed in section D of the concept release:

- Describe "reasonable assurance" as being a "high level of assurance, but not absolute assurance."
- Describe the auditor's responsibility to detect fraud.
- Provide clarification regarding the auditor's responsibility for financial statement disclosures.
- Describe the auditor's responsibility with respect to other information in documents containing audited financial statements.

Thank you for your consideration of these comments.

Very truly yours,

James D. Frias
Chief Financial Officer, Treasurer
and Executive Vice President

# OAKWOOD ENTERPRISES

William H. Baribault
Chairman

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October 6, 2011

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

Re: Rule Docket # 34

Dear Members of the PCAOB:

Thank you for your interest in receiving constructive comments on your proposed new rules, Rule Docket #34. My comments are based on more than 25 years as CEO and Chairman of various companies, including both public and private, Audit Committee and Financial Expert roles, and Board Chairman and CEO of a public financial institution regulated by the FDIC. I am an independent director and trustee of American Funds Insurance Series and American Funds Target Date Funds. I am also a shareholder in the American Funds.

The proposed ADA ("Auditor Discussion and Analysis") requirement introduces a new dynamic in corporate governance. My personal experience is that independent directors and audit committees communicate often with both management and the independent audit firm, pursue full disclosure and transparency, and fulfill their primary responsibility to represent and protect shareholder interests. I question whether the addition of an ADA will add anything new or, in fact, will more likely stifle open and candid discussion. It would seem that the outcome might also be the opposite of what is intended – the absence of material discussions by less engaged boards might be interpreted in the final report as a positive.

As a shareholder and investor in the American Funds, I also do not believe the added auditor scrutiny and separate disclosure will provide measurable benefits for me and other shareholders to warrant the certain increase in auditor and preparer costs.

Thank you for considering my input.

Sincerely,

W H Baribault

William H. Baribault

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

Reference: PCAOB Rulemaking Docket Matter No. 34

Members of the Board and Staff,

I appreciate the opportunity to submit my comments with respect to the proposed concept release (proposal) regarding the auditor's reporting model. I had been active in public accounting from 1980 through 2008, last at Ernst & Young LLP (audit and assurance) and am currently an actively licensed CPA providing public and privately held businesses consulting (value-added) services in the areas of external financial reporting, technical accounting research, policies and procedures, internal accounting controls and liaise technical issues on behalf of clients with their external auditors. The opinions and views expressed herein are my own and are not associated with any company or other organization that I have been associated with. My comments are as follows.

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

   Yes, the Board should consider and strive for improvements. I appreciate the Board's initiative in this matter. However, in my opinion the current proposal addresses changes in reporting without actual qualitative changes and or improved procedures. Additionally the proposal does not appear to result in significant practical cost/effective improvements to investors and users.

   Significant issues to date have not been due to the understandability of the information within the auditor's opinion. Issues have been that the opinion was in error due to lack of error detection and/or fraud resulting in material misstatements and/or omissions as well as lack of an appropriate assessment of management's accounting policies, significant estimates and overall financial presentation.

The current standard report articulates the auditor's opinion and describes an audit in a concise and accurate manner. That it is the planning and procedures performed, examining on a test-basis that the financial statements and disclosures are free of material error and/or omissions and includes an assessment of management's accounting policies, significant estimates and overall presentation.

The over-whelming communication in reading the opinion letter is to determine if the report has an unqualified opinion. Information overload within the opinion letter may result in less reliance in the opinion in that, the suggested "fine-print" may unintentionally implicitly disclaim audit scope and responsibility. I would further suggest that any needed expanded information either be included in the notes to the financial statements and/or as supplemental schedules as applicable. I would urge the Board to consider the *Federal Plain Writing Act of 2010* for any additional wording or schedules emphasizing the omission of unnecessary details as well as the elimination of redundant information.

Additions to improve the reporting model may unintentionally confuse and/or mislead the user that auditing procedures may have been expanded and/or improved. Until there is a change in the common understanding of what an audit is, or an actual change in the auditor role, there does not appear to be a need to consider significant changes to the current report model at this time.

In an ever-changing environment we should consider if the auditor's role is appropriate and what practical improvements could be implemented. However improving the reporting model in advance of actual qualitative changes in the auditor's role or procedures, in my opinion is putting the cart before the horse.

b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

Other auditor reporting information (as a separate supplement to the opinion letter) that may be of use is for the auditor/and the PCAOB to provide a summary profile of the auditing firm's basic information in the report. Such information could include, how long the firm has been in business, location of corporate headquarters and number of offices and employees, including those within the U.S. The annual number of audit reports issued for publicly traded clients. Past disciplinary actions, peer review report findings and/or other reports including past litigation.

To note, the three-person auditing firm that certified the reports of Bernard Madoff Investment Securities, LLC, may have provided a red-flag to investors. Additionally, the current popularity of foreign offshore reverse mergers and other fraudulent reports may be more easily detectable.

c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

No, the Board should not consider expanding the auditor's role to provide assurance (other than negative assurance which is currently implied) on matters in addition to the financial statements. Assurance in these other areas does not result in additional useful information or any further clarification. It only adds to the cost of the audit through additional audit effort and exposure. Auditor focus should remain on the fair and full presentation of the financial statements and the effectiveness of internal accounting controls. Those responsible for the other information and matters include, not limited to lawyers, underwriters, compliance officers and investor relations personnel. The auditor does not have near the interaction activity or a relationship with these groups as they do with financial personnel. The framework of the audit would require significant change with a practical learning curve provided. In my opinion, the cost would significantly exceed the benefit to have assurance on matters apart from the financial statements.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

Yes, the pass/fail model should be retained. Providing for additional allowable alternatives could potentially provide the users misleading and/or confusing information as to the overall opinion and result in decisions based on piecemeal selected financial information versus the overall financial presentation as intended. The opinion should remain as a black and white communication, not be in shades of gray.

b. *If not, why not, and what changes are needed?*

N/A

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

See 1b.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g. management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

Management and audit committees are the most appropriate parties to provide any potential additional information about the company's financial statements. These parties have the most insight and are most familiar with the issues and reports and have the best capacity to articulate and communicate that additional information. Management originates the information and periodically communicates key assumptions and decisions with the audit committee. it is the audit committee's responsibility to oversee the integrity of the company's financial statements and financial reporting process.
An auditor's understanding of these issues is indirect and often comes from management memorandums, inquiries and discussion with said parties. Additionally it is the responsibility of the preparers and audit committee members who should decide what information should and needs to be provided. If an auditor has significant issues or reservations with other information or omitted information, they have choices including not issuing an unqualified opinion. Auditors should not disclose additional information as it could result in a (real or perceived) breach of confidentiality that could result in a deterioration of communications with preparers and audit committee members. The roles should not overlap, management reports, auditors attest.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

See 1a.

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

No, see Item 3.

a. *If you support an AD&A as an alternative, provide an explanation as to why.*

   N/A

b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

   N/A

c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

N/A

d. *If you do not support an AD&A as an alternative, explain why.*

I don’t believe the AD&A would be practical and/or cost effective. It potentially allows for an overload (increased complexity) of information. If said information is consistent with the report, it is of no practical benefit. Inconsistencies with the report could cause confusion resulting in a misunderstanding by the users of the financial statements as well as the audit opinion. Additionally the AD&A may become an effort in legalese that would directly conflict with the objective of providing more useful information to investors and users.

e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

Any potential comments should be limited to the audit. Such comments could include clarifying issues that are unusual in nature to common practice as well as technical matters whereby there was a disagreement either between the auditors and the company or between audit team members that was ultimately decided by a consultation by a party outside the engagement team/company management.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

N/A, see Item 5.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

N/A, see Item 5.

*8. Should a standard format be required for an AD&A? Why or why not?*

While I don’t agree with the inclusion of an AD&A, a standard format should not be required. Companies and audits are unique. If it is truly the intent to provide specific information as to the audit and information therein, it would be difficult to achieve through a standard format.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

An AD&A addressing risks (other than audit) would not be practical and/or cost effective. These risk assessments are judgmental in nature. They are usually feted out by the assistance of both internal and external counsel. These risks are addressed in the MD&A. If said information is consistent with the MD&A, it is of no practical benefit. Inconsistencies with the MD&A could cause confusion resulting in a misunderstanding by the users of the financial statements as well as the audit opinion. If these risks were to be addressed by a third-party, external general counsel, insurance risk professionals or applicable regulators would be more appropriate parties.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

If the reports are consistent in format, they will appear to be boilerplate regardless.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

An AD&A may provide potential benefit to clarify audit risks and assessments of those risks. Shortcomings include increased resources, time and cost. Potential duplicity of information with the MD&A. Explicit and implicit conflicts with MD&A which may not result in an improved report to end-users. Increased legalese in the report similar to portions of the MD&A.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

It should not be the role of the auditor to provide competing and/or inconsistent information. Including said information results in less confidence in the report and the opinion letter. Management needs to be held solely responsible for the information within the report. Auditors should be responsible for the opinion. Advance oversight of management exists by the audit committee and the auditor attests. There would be no advance oversight or attestation over the auditor in terms of an AD&A. If as a result of inclusion of an AD&A, adverse litigation was to become an issue. The AD&A may unintentionally evolve into a disclaimer of the audit and opinion.

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

Any matters not disclosed that would be relevant and useful in making investment decisions needs to be addressed by the FASB, IASB and SEC. These organizations are responsible to establish the standards. It should not be left to auditor's judgment to opine on undisclosed matters for which no standard exists.

As to the illustrated examples, including related party transactions and subsequent events, these are already in scope of the standards. For example, SEC staff observed that:

> Rules 10b-5 and 12b-20 under the Securities Exchange Act of 1934 and General Instruction C(3) to Form 10-K specify that financial statements must not be misleading as of the date they are filed with the Commission. For example, assume that a registrant widely distributes its financial statements but, before filing them with the Commission, the registrant or its auditor becomes aware of an event or transaction that existed at the date of the financial statements that causes those financial statements to be materially misleading. If a registrant does not amend those financial statements so that they are free of material misstatement or omissions when they are filed with the Commission, the registrant will be knowingly filing a false and misleading document. In addition, registrants are reminded of their responsibility to, at a minimum, disclose subsequent events[1], while independent auditors are reminded of their responsibility to assess subsequent events[2] and evaluate the impact of the events or transactions on their audit report.[3]

Emphasis paragraphs appear to be a "work-around" or "back-door" approach. I believe we would be better served by the standard setters addressing any reporting gaps as to proper and presentation and disclosure in lieu of expanded emphasis paragraphs.

*14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

No

a. *If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

   N/*A*

b. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

   Areas of emphasis conflicts with "fairly stated as a whole". The intention of U.S. GAAP/IFRS as well as SX-reporting is to provide/disclose all applicable information to assess the overall financial results. These judgment decisions

[1] AU Section 560, Subsequent Events, paragraphs 5 and 8 and Section 855-10-50.
[2] AU 560 and AU Section 561, Subsequent Discovery of Facts Existing at Date of the Auditor's Report.
[3] AU Section 530, Dating of the Independent Auditor's Report, and AU 560, paragraph 9.

would be unclear to the user as to just how much weight should be applied. Additionally areas not emphasized may be incorrectly undervalued by users.

Auditors should not be required to disclose key audit procedures to the public and/or clients. It provides no increased understanding of the report and could lead to circumvention of the effectiveness of future audits.

*15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

In my opinion, none should be required.

*16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

In my opinion, none should be presented.

*17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

If the reports are consistent in format, they will appear to be boilerplate regardless.

*18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

No benefit with an increased audit effort and complexity.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No, the increased audit effort does not appear to result in improved information or understanding of the report. There are no existing standards or an authoritative standard-setter for this other information. It increases auditor exposure and would require additional auditing standards to be implemented as well as additional disclosures and reporting rules from the SEC.

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

N/A

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

None

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

Negative assurance, that nothing came to their attention that would materially conflict with said information.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

A piecemeal approach may cause more confusion. It should be for all of the MD&A or none.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

No opinion.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

N/A, in my opinion the auditor should not be required to attest or provide assurance as to other information outside the financial statements.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

See Item 19.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

See Item 19.

*21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

All, with the exception of Auditor's responsibility for information outside the financial statements may be of some benefit.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Clarification of definitions and responsibilities could result in a greater understanding to the end-users. The shortcoming may be increased complexity.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

See Item 1b.

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

May imply expanded procedures were performed when they were not. May incorrectly segment user's understanding of responsible parties.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

See Item 21b

*23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

See response to Item 1b

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

See responses to Item 1b and Item 21.

*25. What alternatives not mentioned in this concept release should the Board consider?*

Expanding the information for registered firms on the PCAOB's web site that would include the additional information suggested in Item 1b. Require firms to update and confirm the information as accurate annually. Provide a link to the information in the report.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

I disagree with the alternatives that would require an additional auditor framework. Any additional framework should directly relate to qualitative procedural improvements.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

Yes, retain the "pass/fail" model and exclude emphasis paragraphs.

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

See responses to Item 21.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

I would expect no significant change in audit quality as the proposal is reporting driven and does not include qualitative process improvements.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

Any changes should be consistently applied to all public registrants.

*31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

In my opinion the AD&A and assurance on other information outside the financial statements are most important. These areas have a significant impact for auditors, preparers as well as users and investors. However for the reasons stated throughout, these areas should not be implemented. In my opinion the clarification of language in the standard auditor's report is least important.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

No, cost/benefit has been addressed throughout my comments.

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

While comment is open to the public, I expect comments will be coming from mostly auditors and issuers. The objective is to expand and clarify information that might be useful to investors and other financial statement users and narrow the expectation gap. Therefore it is imperative that the PCAOB seek those comments and create a two-sided dialogue.

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

I would recommend that a PCAOB committee (with applicable external representation) review the comments and hold meetings available to the public to address said issues.

*32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

Auditors should not disclose additional information as it could result in a (real or perceived) breach of confidentiality that could result in a deterioration of communications with preparers and audit committee members.

***Overall***

Overall the proposal does not appear to result in achieving the objective of providing more useful and a better understanding of the information contained in the financial report and auditor's opinion.

- Does not appear to result in a cost/benefit;
- Unnecessarily expands the auditor role and exposure;
- Inappropriately expands the auditors role to areas better served by other professionals;
- Increases the complexity of the financial report and opinion letter;
- Results in duplicity and/or competing and conflicting information;
- Potentially compromises confidential information;
- Provides for (unclear) alternatives to current "pass/fail" model;
- May create confusion among end-users;
- Decisions may be made on piecemeal information and not the overall report;
- Disclosure of audit program, significant procedures and materiality thresholds could compromise audit integrity;
- Difficult or Contentious Issues, Including "Close Calls" could result in discounting the value and decreased confidence of the opinion as well as the audit profession.

The proposal does not specifically appear to be directly user/investor driven. The Commission on Auditors' Responsibilities (Cohen Commission) that was mandated by the American Institute of Certified Public Accountants (AICPA), to "develop conclusions and recommendations regarding the appropriate responsibilities of independent auditors." The Cohen Commission was directed to "consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish."

We need to sharpen our focus what those expectations and needs are and in my opinion would include:

1. The auditor is independent and qualified to perform the audit and provide the opinion;
2. There is adequate oversight of the auditor;
3. Reduced complexity and the use of *Plain English* to better understand the report and opinion;
4. Elimination of voluminous information that clouds the position and results;

5. That if errors and omissions exist that would impact the end-users opinion and conclusion of the financial position and operating results that the audit would detect, report and address.

I don't believe an auditor AD&A, assurance on other information and competing information meet these objectives or narrows the expectation gap. In my opinion, this should be a qualitative process project, not a reporting model project that results in increased costs with the potential of no significant improvement on reliance or confidence on either the financial report or the auditor's opinion.

We would be better served addressing the substance of an audit versus the form of an audit and assuming that providing additional by-product information from the audit will be useful.

I appreciate the progress and improvements made by the PCAOB to date as well as the opportunity to submit my comments to the Board with respect to the proposed concept release.

Respectfully Submitted,

/s/Thomas P. O'Connor

Comment Letter to PCAOB about the Proposed Reporting Model

9/24/11

I have read only 100 pages of the transcript provided for the September 15 meeting. I appreciate the immediate posting of this transcript. (I am merely an ordinary auditing faculty member who has great respect for the auditing process. I came into the field just after the U. S. Government report **on *The Accounting Establishment was published in 1977.)*** I was amazed at the lack of attention to that publication by public accountants. (My search was back in the late 1970's and possibly not sufficient to locate the discussions that followed.) I spent a week at the SEC in the Summer of 1980, when the POB was a common topic of discussion. I was at the SEC with a colleague; we had several meetings with the Chairman of the SEC, who, it appeared to us, was successful in supporting the POB under the direction of the professional body. That oversight board was disappointing; yet there was little criticism. When it was disbanded, there was virtually no comment.

I thought the Sarbanes-Oxley Act of 2002 was an appropriate step in establishing a new structure for oversight. It was wise that the Act did not require that audit standard setting be a task the new organization assumed, but the Board could determine to be the standard setter. When the April 2003 Board, with an Interim chair, voted "yes" to be the standard setter, I was somewhat surprised. Possibly, there was a long discussion that was considered private; what was disclosed on the Website was a straight forward conclusion;, only one question from a member of the Board that it was true that the Board did not have to be the standard setter ( the response to the Board Member's question was "yes") . . the board did not have to assume the task, and then the vote with no further questions. In a day or two the chief accountant was announced. (The vision statement of the CEOs of the Big 6 firms included, in a side bar a statement that the PCAOB was mandated to be the standard setter. That is an incorrect statement) Several accountants from out side the U. S. asked me about this decision . . they all felt that there could be a conflict of interest to have the standard setter and the oversight functions handled by the same organization.

Now, please understand that I don't have a comprehensive view of your organization and what you have determined to do. My comments are presented in a highly tentative manner. I am guessing that the interaction with those present on September 15 was far more extensive than what is presented in the transcript. My comments:

Possibly, there was a discussion that wasn't recorded that presented the auditing framework assumptions that guided the proposed new reporting model. I was looking for some discussion of critical postulates. (After a review of all the sets of postulates we could find, a colleague and I concluded that the tentative postulates of Mautz and Sharaf (*The Philosophy of Auditing, AAA, 1961, first date of issue)* were most impressive. One of their tentative postulates that we have continued to believe is a critical foundation is: No. 7: ***When examining financial data for the purpose for the purpose of expressing an independent opinion thereon, the auditor acts exclusively in the capacity of an auditor.***

What is being proposed as some participants interpreted what is stated in the new reporting model seems to set aside this powerful postulate. There were references in the pages I read to "direct communication between the auditor and the investor" and "say more about the health of the business." There are a number of comments that don't seem to reflect a thorough understanding of the need for objectivity in the performance of an audit.

The auditor, as you well know, is to *verify* what is presented by the client. That process is guided by both GAAS and the criteria, GAAP. Does it make sense that the auditor become a predictor of the future of a client? How reasonable are the wishes of investors?

I will say nothing more about this first point. I would like to see a reasoned rationale for setting aside the current role of the auditor. as stated in the above identified postulate. It is stunning that there is consideration that the auditor's task is to assure the investor about the company's future. I guess there is no need for an audit. A statement of one's prediction will be sufficient.

There were enough statements that appeared not to destroy the current postulate identified above, including some statements from Board members, that I shall be optimistic that the final proposal will be a wise one.

The last revision of the standard report included a statement at the end of the scope paragraph that states: *"We believe that our audit provides a reasonable basis for our opinion."* I was surprised at that sentence and thought that it would not be retained in the final version. It was, however. *Belief* is a somewhat ambiguous word; it can refer to faith without evidence or to careful attention to evidence. Given the responsibilities of auditors as they develop conclusions, I continue to wonder the value of that sentence in both the standard report of the ASB and of your Board.

Is there a way to inform interested parties of the nature of a *quality* audit? (To date, inspections provide no evidence of the quality of audits performed by the issuers.) There are, of course, explicit disclaimers about the use of the information in a publicly issued inspection report; the careful reader realizes that generalizations about the issuer are not warranted. The discussion of procedures implies that a random selection is not used; a typical empirical study of an issuer's audit behavior is not undertaken. When I learned that the first chairman of the Board indicated that the strategy for inspections would be a supervisory approach, because he believed that would be the effort that would lead firms to undertake quality audits. There was no detailed rationale provided for this strategy, but after reading the first two reports on the limited audits of the major 4 public accounting firms related to the financial audits and to the quality control assessment, I concluded that initial observations of the quality of audits motivated the supervisory approach. It is not clear why that approach is persisting until now – the latter segment of 2011. I have been unable to get an authoritative response to the question: Does a supervisory model for an inspection meet what the Act states re *determining compliance?*

The Center for Audit Quality issued a bulletin of limited pages entitled *Guide to Public Company Auditing. .* Consider page 9, headed *Finding Fraud.* Highlighted is: Because the audit goal is "reasonable assurance" a properly planned . . . . audit may not detect fraud. . . . " I asked 10 individuals, as individuals, not in a group who know virtually nothing about an audit to read this page and give me a guess about the value of an audit. (these are academic professors in fields distant from accounting and business who have TIAA-CREF pension plans and pay no attention to what their pension plans do; they just have confidence in the firm. . . ) Without exception, each said: "Well, it appears that the audit is worthless. . . obviously, reasonable assurance is not a very high level of assurance." I have distributed this page to students, who are surprised by the lack of explanations. (See the proposed revision to the *Yellow Book of GAO,* which includes a valuable explanation of *reasonable assurance, fpr example.)*

I guess what we hear from investors does vary. After I initially read the proposal for a new format for the auditor's report, I asked a number of investors, who know what an audit a simple question: What do you want from an auditor's report? The answer I got was: "I want to know that the financials audited are reliable. That is what is important." I can read what is of interest to me and make my own judgment. It seems completely out of "character" for an auditor to communicate directly with me. Apparently, that isn't what some of those who participated in your meeting recently learned from those with whom they spoke.

As I view (from a questionable perspective) the activities of PCAOB from its getting underway in early 2003 to the present, these are matters that seem critical:

1. Provide more information to the public. Just two illustrations:

   1.1 I read many inspection reports; some include a letter from the issuer. A common comment is that professional judgment is required in many instances and professional judgment can vary. . . . "and we have undertaken the steps you proposed; we found no need to change our earlier conclusion." . . however, the reader wonders: was the issuer right? Did the PCAOB follow up with acceptance of the explanation? What happened?

   Professional judgment is grounded in technical knowledge of GAAP and GAAS; variations provided by inspections must be as carefully identified as is the case of the auditors on the job. What is being done to resolve the differences, that appear to disappoint the issuers?

   1.2 I have wondered about the audit documentation for AU 380, a continuing interim statement. Is any audit documentation required related to the audit itself or is that matter considered a part of quality control? In the inspections I have read, I have never seen a reference to insufficiencies of reporting related to AU 380.

2. How do you justify the following:

   2.1 In early 2007, as I recall the Center for Audit Quality was established. From what I have learned that is an advocacy group with one of the highest paid lobbyists as its executive director. Before that first year ended, the CAQ had a celebration for the first five year anniversary of the PCAOB. .. An oversight board accepting such a celebration seemed surprising. Is it common for issuers to provide elegant parties for the audit team and the key national leaders of the public accounting firm that provides an unqualified report?

2.2 How is the independence of inspectors and that of the office of the chief accountant maintained? We talk so much about division of duties where there is potential conflict of interest. Now we have an oversight board that is also the standard setter. (My accounting friends from other countries find this status difficult to believe)

In my brief reading of the transcript, I was reminded of a newsletter I read at J. C Penny just months before the company left New York to establish their headquarters in Texas. I was studying materials in their archives to trace J. C. Penny's development of his code of ethics. However, I read some newsletters that include copies of letters the company received from their auditors when the audit was completed. One that I read noted that no adjustments were necessary at the conclusion of their audit. I haven't thought about this, but could the proxy statement about the audit committee say something far more substantive than is the case now? In reviewing four statements about audit committees in proxy statements, the class and I were disappointed at how little we learned. Would issuers be willing to present, in some appropriate form, some degree of explanation of those matters that are presented to the audit committee? (During the financial crisis of the last several years, there have been some amazing disclosures of ineffective boards . . and of audit committees. . . governance at the board level is likely to be worthy of improvement. )

I know that establishing a new organization is no simple task. I know it takes time. I dislike being critical. I believe that the 2002 Act was promising. It is not clear that the implementation is as effective as we had anticipated. I am sorry that I see the problem re reporting in a broader framework than is likely to be justified. . .

Is it really only the content of the auditor's report that needs attention? I doubt it. I wonder if what we need is a reliable conclusion by the auditors?

Mary Ellen Oliverio, CPA

moliverio@pace.edu

PAA NATURAL GAS STORAGE

September 29, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 2006

Re: Rulemaking Docket Matter No.34

As members of management of a publicly traded partnership, we are writing to comment on the concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, dated June 21, 2011. It is our opinion that the proposed revisions being considered have the potential to significantly alter the roles and responsibilities of both management and independent auditors in the financial statement reporting process. Given the potentially significant impacts of the proposed revisions, we believe that it is imperative that any changes are thoroughly analyzed and assessed from the perspectives of all impacted parties. We fully appreciate and support the need for financial statement transparency and the continually evolving need to provide financial statement users with a sufficient level of information for use in their applicable evaluation and decision-making processes. However, we also believe the manner in any changes made to facilitate achieving such objectives must be appropriately evaluated to ensure such changes will be effective and, at the same time, not result in any unintended, adverse consequences.

**Principles Underlying our Response**

As the preparation of a company's financial statements is ultimately the responsibility of the company's management, management should have the sole responsibility for financial statement reporting. If additional information regarding a company or its financial statements is determined to be necessary to be reported via a company's financial statements, the responsibility for providing such information should be placed upon management and not the company's auditor. Any communications provided by a company's auditor should be focused on the nature of audit procedures performed and the results of such procedures. These views are reflected in our responses to selected elements of the concept release further discussed below.

**Auditor's Discussion and Analysis**

We are not totally opposed to the concept of adding an Auditor's Discussion and Analysis ("AD&A"). However, we do believe that several respondents have raised compelling points regarding the sophistication of the investing community and the wealth, depth and sheer volume of information publicly available regarding auditing standards that cast doubt on the real benefit that will be gained in adding a significant amount of new disclosure. We also believe that the suggested alternatives will result in already lengthy audit reports and Form 10-Ks that may discourage investors and analysts from reading the reports and will be challenging for readers and difficult to compare between registrants. In



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addition, we believe there is a strong likelihood that the alternatives presented could result in significantly increased costs to issuers.

Although we do not have an outright opposition to the concept of an AD&A, we do feel strongly that if an AD&A were adopted, the focus should be on audit risk, procedures and results and not adding additional disclosure about the financial statements of the company. Understood and, at the heart of, the AD&A concept release is the belief that investors would benefit from the unique and relevant insights into the company provided by additional information in the auditor's report. The concept release goes on to mention that one alternative is for the AD&A to include the auditors discussion of the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues. It also suggests in the additional disclosure that auditors highlight where management could have applied different accounting approaches or disclosures. We believe that these alternatives create a fundamental shift in the responsibilities of the auditor away from performing an audit to provide reasonable assurance that the financial statements are free of material misstatement to a responsibility for disclosing any and all information about the company that they are auditing. We have several significant concerns with this.

Our foremost concern is the potential impact that this may have on communication. We believe that open communication between management, the auditor and the audit committee is vitally important to the audit process. We believe that this type of AD&A may reduce or hamper that important open communication.

The managements of public companies are responsible for the completeness and accuracy of the financial statements, footnotes and related disclosures. The company employs significant resources to ensure that the appropriate systems, policies, procedures and resources are in place to ensure that business activities are appropriately captured and reported in accordance with the applicable accounting standards. Underpinning these activities are significant time and resources dedicated to researching and concluding on the appropriate accounting for a number of matters. While we agree that the auditors expend a significant amount of time in the process of performing their audits and do gain insight and knowledge about the company that they are auditing, management remains the best and most appropriate source for information about the company and related accounting matters. To the extent that there is a real need by the investment community for additional disclosure regarding judgments and estimates used or the availability of alternate accounting methods, we believe that the Board should recommend that the FASB or the SEC consider amending the applicable disclosure requirements to meet those needs.

Further, a focus by the auditors on creating content and disclosure would require significant high-level input from the audit team which could distract the partner and manager from focusing on the audit itself, which could prove to be detrimental to the quality of the audit.

In addition, the illustration included in the concept release is difficult to assess for usefulness as it does not include any of the challenging concepts that are proposed in the AD&A concept release. The discussion of these matters would most likely extend to multiple pages and even at that length, be subject to confusion and potential undue concern without elaborate, detailed explanations. Also, there would be a significant challenge to the audit firms to determine the appropriate subjective wording that is appropriate for a specific company and yet still be consistent and comparable with similar fact patterns at other companies. There would be even more significant challenges for investors in attempting to compare and contrast disclosures made by different audit firms when attempting to appropriately consider the information provided in making their investment decisions. These conflicting issues would move us away the clear, concise and consistent audit report that provides investors reasonable assurance that the financial statements are materially free of misstatement to a lengthy, subjective, inconsistent report that potentially creates confusion.

**Required and Expanded Use of Emphasis Paragraphs**

We are not totally opposed to the required and expanded use of emphasis paragraph, but we do believe that certain principles should be maintained. Foremost, the alternate presentation style should focus on audit risks, procedures and results and should not extend to disclosing additional information about the company or the company's financial statements. The disclosure of information about the company and the financial statements should remain the responsibility of management. Current reporting standards require comprehensive disclosures covering a broad range of topics in an attempt to provide relevant information to financial statement users. To the extent more information is needed on certain topics, the relevant reporting standards should be amended to incorporate those requirements.

One practical downside to requiring auditors to disclose or summarize significant matters or risks highlighted, by designin an emphasis paragraph, is the potential increased exposure it would present to the auditor. We believe that a practical reaction would be for the auditor to provide laundry lists of lesser significant matters to mitigate that risk, which could eliminate or largely offset any meaningful intended benefit.

**Auditor reporting on information outside the financial statements**

The concept release includes alternatives for expanding auditor reporting to a wide range of areas ranging from MD&A to press releases. We believe that the costs of expanding the auditor's reporting responsibilities far outweigh the benefits associated with such changes. As noted in the concept release, the auditor's currently have responsibility to read and consider whether information outside the financial statements or the manner it is presented is materially inconsistent with the financial statements or represents a material misstatement of fact. To the extent there is real demand for additional assurance, a current PCAOB standard exists for the auditors to provide such assurance. We have not experienced demand for this level of assurance from investors and analysts and we do not believe that creating additional required reporting would be cost beneficial.

We understand that timely access to financial information is a key priority of the investment community regarding press releases. Any efforts to require an auditor report on press releases would necessitate a delay in the timing of disseminating that information to the public and would run contrary to the priority of timely access to that financial information.

**Clarification of language in the auditor's report**

We do not have any objections to the suggested alternatives to clarify the language in the auditor's report.

Thank you for the opportunity to comment on this concept release.

Sincerely,

Al Swanson
Executive Vice President and Chief Financial Officer

Don O'Shea
Chief Accounting Officer

Pfizer Inc.
235 East 42nd Street
New York, NY 10017-5755

**Loretta V. Cangialosi**
Senior Vice President and Controller

September 27, 2011

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

**Reference: Rulemaking Docket Matter No. 34**

Board Members:

Pfizer is a research-based, global biopharmaceutical company. We apply science and our global resources to improve health and well-being at every stage of life. We strive to set the standard for quality, safety and value in the discovery, development and manufacture of medicines for people and animals. Our diversified global healthcare portfolio includes human and animal biologic and small molecule medicines and vaccines, as well as nutritional products and many of the world's best-known consumer healthcare products. The Company's 2010 total revenues were $67.8 billion and its assets were $195.0 billion.

We appreciate the opportunity to present our comments on the Board's "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" and we recognize the Board's efforts in service to financial statement users. The concept release presents several alternatives for consideration – some quite far-reaching and problematic for both preparers and their auditors -- and others which would more clearly be seen as improvements.

While we understand that an expectation gap continues to exist between what auditors have responsibility for and what users perceive an audit to be, we agree with those investors who told the Board, during its outreach effort, that "…the pass/fail model and standardized language of the auditor's report provides consistency, comparability, and clarity of auditor reporting." In view of these positive characteristics of standardized language, we are less concerned than some about the use of so-called "boilerplate" of audit reports.

It is also not clear that standardized language can be avoided, given the cost in both time and effort, and the risk of confusion and liability that attends the notion of "custom-tailored" report language. However, we do appreciate and support the initiative to clarify the language of the auditor's report, and would support some of the changes discussed in the concept release.

In particular, we would agree that the audit report could be improved by adding standardized language that:

- defines the concept of reasonable assurance as it applies to the audit although we suggest that the definition of reasonable assurance be better defined than the current description of "high level of assurance but not absolute assurance" which is confusing

- explains that the audit is intended to provide reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud

- describes management's responsibility for the financial statements and related footnote disclosures

- clarifies the nature of footnote disclosures as an integral part of the financial statements, and that they are covered by the auditor's report

- explains the limited nature of the auditor's responsibilities regarding information outside of the financial statements. With respect to this, we find that AU 110 provides Plain English language that should be considered in crafting the language:

  - *The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by errors or fraud, that are not material to the financial statements are detected.*

  - *The financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements. Management is responsible for adopting sound accounting policies and for establishing and maintaining internal control that will, among other things, initiate, record, process, and report transactions (as well as events and conditions) consistent with management's assertions embodied in the financial statements. The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of these matters and internal control is limited to that acquired through the audit. Thus, the fair presentation of financial statements in conformity with generally accepted accounting principles is an implicit and integral part of management's responsibility. The independent auditor may make suggestions about the form or content of the financial statements or draft them, in whole or in part, based on information from management during the performance of the audit. However, the auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on them.*

- states explicitly that the auditor is independent of the company and has complied with all applicable independence requirements of the SEC and PCAOB.

We don't believe that any of the proposals listed above would have a negative impact on audit quality or cost, and could be informative and clarifying for some financial statement users.

However, the concept release includes other alternatives that, in our view, would have significant adverse impacts on cost, audit committee governance, the auditor relationship, and that would raise serious concerns about liability. In addition, some of the proposals would only blur the boundaries around who owns and is ultimately accountable for the financial statements (management, not the auditor) and who is the most knowledgeable about the business that the financial statements purport to represent (again, management, not the auditors). Furthermore, certain of these proposals would subject companies to the personal views of an individual audit partner. Judgments are generally around the most subjective areas which often incorporate assumptions and estimates and, which are of the greatest concern to investors, are made by people, not companies or firms. Therefore, they do tend to be less consistent and given to more variability. Attempting to place the auditor's judgment at a higher level than management's will likely result in an adversarial relationship and less constructive debate between auditors and preparers which we view as resulting in a decline in audit quality.

Moreover, we believe that users of financials already have a wide collection of information available to them regarding risks and quality controls inherent in the process (although we note that these are contained in multiple documents as a result of various rulemaking) including, but not limited to:

- Management's Discussion and Analysis which provides a discussion of the critical accounting policies, the strategy of the company, the operating environment of the company which highlights the key risks impacting the business, significant changes in the period including acquisitions and divestitures, and impacts to revenue and net income;

- Section 302 certification of CEO and CFO regarding the assertion that the financial statements fully comply and the information contained in the report fairly presents the financial condition and results of operations of the company;

- Section 404 representations of management as well as the Auditor's report on internal controls;

- The Audit Committee report included in the Proxy materials indicating the procedures they have undertaken around the financial reporting process and the independence of auditors;

- Discussion of Board of Director independence in the Proxy materials; and

- Investment Analyst reports wherein such analysts often cover a specific industry and can provide a more in-depth perspective on industry and the company and challenges and opportunities to better understand the business and strategic risks. Unlike the financial report which focuses on the past, analyst reports tend to focus on the future of the company.

We discuss each of these alternatives below:

**Required and Expanded Use of Emphasis Paragraphs**

The concept release explains that "required emphasis paragraphs could be beneficial to financial statement users through the auditor's identification of significant matters and referencing where those matters are disclosed in the financial statements." In short, auditors would now be asked to provide a guide to users so that they could easily and quickly get to the important parts. The literature already provides auditors with discretion to use such emphasis paragraphs, and there may be occasions when these paragraphs will be appropriate and useful. Our experience has been that users, as a population, vary widely and what is "important" to them varies widely and, in an effort to cover everything that is possibly "important", auditor emphasis paragraphs could become unwieldy with the user no better served. Alternatively, without strict guidance as to what should be included, differing matters may be emphasized within a single industry leading users to a possible inappropriate conclusion that the matter is not significant at various companies in the same industry. Moreover,if there is a perceived need for guides to significant matters and key disclosures to be provided for every set of audited financial statements, then the SEC should require management to provide such additional disclosures, if needed, within its Management's Discussion and Analysis.

We believe that the MD&A already requires these types of disclosures which are currently reviewed for consistency by the auditor and therefore, this would only serve to provide redundant information. We think this is an important matter of principle, and urge the PCAOB not to require the use of emphasis paragraphs for such purposes. Another important and relevant principle is that the auditor's opinion is based on the financial statements taken as a whole: for this reason, emphasis paragraphs, when used, should relate to matters that pertain to "the whole" as it would otherwise come to represent a piecemeal opinion.

**Auditor's Discussion and Analysis**

The concept release describes the AD&A as something ranging from descriptive and objective information, such as a discussion of areas of audit risk and the audit procedures performed in relation to these areas of risk, to more subjective discussions including evaluations of management's judgments and estimates, and "close calls". We view the AD&A as a significant expansion of the auditor's responsibility beyond his or her opinion of the reasonableness of the financial statements. This perception that financial statements and the judgments contained therein are extremely precise or that having them be fairly stated, in all material respects is not good enough indicates that the expectation gap between what preparers must contend with in the accounting rules (predicting future impacts in terms of certain reserves, predicting market participant views for fair value, predicting possible success rates for in-process research and development, etc), what auditors must do in performing an audit, and what users believe financial statements present continues to be wide.

The concept release indicates that "An AD&A could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements…." This statement in, and of itself, creates further confusion around the role of the auditor versus the role of management and actually increases the "expectation gap" between what an auditor's responsibilities actually are and what users of the financial statements think auditors do. As you are aware, management owns and is responsible for the financial statements, while the auditor's role is to provide assurance as to the reasonableness of the financial statements. The auditor assesses the reasonableness of the financial statements including the footnote disclosures but is not responsible for creating or enhanciing those disclosures. In practice, auditors provide comments to the preparers of the financial statements including suggestions for improvements in disclosures. Like most preparers, we give serious consideration to the comments we receive from our audit team, so we do not view this perceived need for leverage as something that needs to be fixed.

Including discussions of evaluations of management's judgments and estimates and "close calls" will only leave investors confused as to why varying views exist and why management is signing a Sec 302 assertion that the financial statements fully comply and the information contained within the report fairly presents the financial condition and results of operations of the company. We are not certain how the PCAOB will define "close calls" or "contentious issues", but our experience is that these matters are generally not negative conversations or arguments. Instead, robust dialog and debate is undertaken around issues that are very complex, subject to interpretation, or use multiple assumptions and judgments. This debate is critical to ensuring that the issues are well understood, the various interpretations are examined and a thoughtful and appropriate answer is reached by the registrant and the auditor. These disclosures would likely undermine investor confidence because they would not be well understood given the lack of context.

We believe that Audit Committees would take such public discussions very seriously and financial statements may no longer represent management's view, but rather, the auditor's views in an effort to avoid such public commentary. We do not believe that investors or preparers are served well by this. Preparers may wind up submitting financial statements using the auditor's assumptions or not enter into robust discussions of issues with their auditors to avoid getting a close call designation. This means that communication to the auditor may become more limited and that incorrect conclusions may be reached due to lack of discussion.

We believe that this is a giant step backwards in the gains reached since SOX 404 came into place and its interpretation immediately dampened communications between preparers and auditors around significant issues. Investors may "believe" that having the auditor's views embedded in the financial statements is better, but again, the auditor's view may not be the best or only view and without any context, the difference of views is likely to simply cause confusion and shift the responsibility for ownership of the financial statements to being jointly shared by management and the auditor. This of particular concern because such a view may not be standard, but rather, may be subject to the personal view of an individual audit partner who might be more, or even less conservative in his or her views than the company or other individuals in his firm based on his personal background, specific work issues, past dealings with the PCAOB, etc, none of which an investor could know.

We also believe that audit firms and individual partners would be subject to litigation from users. Again, it is important to remember that reasonable people can disagree, particularly when it relates to assumptions or estimates which are not black and white areas, or when it relates to areas that are so complex as to need multiple discussions between the auditor, preparer and, sometimes, the auditor's professional practice group to understand and evaluate the accounting rules which may be applicable. We note that, at times, the Big 4 accounting firms offer differing interpretations or guidance of rules and that these interpretations and guidance have all been made in good faith.

Because the auditor only gains limited knowledge through the audit, we do not believe that the auditor has more insight than management has provided within the MD&A or the financial statements. Finally, we believe that developing an AD&A report would be very inefficient for firms to have each partner preparing separate reports and ensure quality and consistency, and in fact, would likely result in a standardized, boilerplate report in the firm's attempt to control quality and limit litigation.

The concept release discusses potential disclosure by the auditor of "matters related to internal control over financial reporting that required significant deliberation by the auditor and management". This appears to re-open the definition of "material weakness" or to raise the question of whether "significant deficiencies" ought to be publicly disclosed. We believe that 2007 guidance from the SEC and PCAOB should be maintained, and would be very concerned to see such a fundamental change in the dynamics of SOX compliance and reporting.

A key principle that should be preserved is that the responsibility for the financial statements and related disclosures belongs to management, and that auditors should communicate their views on these matters to management and to the audit committee. If auditors are expected to disclose information that management deems to be confidential or inaccurate, there will be significantly less openness in communications with the auditors, as management will seek to minimize the impact of this problem. If auditors are required to express their viewpoint on management's estimates, judgments, disclosures, and selection of accounting policies/treatments, management and Audit Committees will often be faced with a difficult dilemma – conform to every preference of the auditor, or accept that auditor views may confuse users because they raise differences without context or how the auditor gained comfort with the financial statements being fairly stated in all material respects.

**Auditor Assurance on Other Information Outside the Financial Statements**

It is sufficient that the auditors read this information and consider whether such information or its presentation is materially inconsistent with the financial statements they have audited. A statement to this effect, clarifying the extent of the auditor's responsibilities for such information, should be included in the audit report, to enhance the understanding of users. However, we do not see any benefit in requiring auditor attestation to the earnings release, and an audit of the MD&A would be very costly, relative to the benefit of added assurance thereby obtained, and would add significantly to the time required to issue annual reports

As a point of reference, our MD&A is currently 48 pages long and we believe would take a significant amount of time to audit. Additionally, the PCAOB standards for documentation would be difficult to complete in a timely manner because many of the items discussed are not specifically related to financial matters but rather relate to, in our case, non-financial information around research and development. As such, auditors would wind up verifying what phase a clinical trial is in, obtaining and documenting FDA approvals, etc. These are not areas of expertise of an auditor and the auditor and are not subject to financial statement rules.

We also see additional downside risks in this proposal: first, that MD&A would morph into the Auditor's Discussion or that, to avoid conflicts and increase timeliness, registrants would put minimal information in their MD&A and investors would, in fact, receive less information than they do now. In the balancing of the possible benefits of increased auditor assurance against clear, concrete considerations of cost and timeliness of reporting, the benefits are, in our view, outweighed by a very wide margin.

* * * * *

In summary, as described above, we would welcome, if it will decrease the current expectation gap, the addition of limited, standardized, clarifying language to the auditor's report, to enhance user understanding of the report. We are very concerned that the other alternatives outlined in the concept release would be very costly and would adversely affect the timeliness of corporate reporting. More importantly, they would also undermine the important principle that management is responsible for the company's financial reporting and blur the responsibilities between auditors and management. The unintended effects and practical and legal consequences of such a fundamental change and expansion of auditor responsibilities are a significant cause of concern.

Once again, we appreciate this opportunity to comment on this concept release and encourage the Board to continue to engage its constituents. We would be pleased to discuss our perspective on these issues with you at any time.

Very truly yours,

Loretta V. Cangialosi

Loretta V. Cangialosi
Senior Vice President and Controller

cc: Frank D'Amelio
Senior Vice President and Chief Financial Officer

P B T K
PIERCY BOWLER
TAYLOR & KERN
Certified Public Accountants
Business Advisors

September 26, 2011

To: Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., Washington, D.C. 20006-2803
Transmitted by e-mail to: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 34
Release No. 2011-003, "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements"

We appreciate the opportunity to respond to the "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements" (the Release) that is contained in Release No. 2011-003 dated June 21, 2011, of the Public Company Accounting Oversight Board (the PCAOB or the Board). We note that many of our concerns are already mentioned in the Release and deserve the Board's continuing serious consideration.

We begin our discussion by setting forth our broad view of the four "alternatives" suggested in the Release as possible ways to achieve the objective expressed in the third paragraph of Part I thereof. Briefly summarized, the four alternatives (reporting Alternative Nos. 1-4) include (1) a required "Auditor's Discussion and Analysis" (AD&A) to provide information about the audit and the financial statements, (2) required expanded use of emphasis paragraphs, (3) reporting on information outside the financial statements, and (4) clarification of certain report language. In short, we would be in favor only of reporting Alternative No. 4. For reasons articulated in the attachment that follows, we would be vigorously opposed to any future proposal that would seek to revise PCAOB standards to include requirements for any of the suggestions in reporting Alternative Nos. 1-3. Moreover, we doubt the validity of the Board's apparent conclusions as to the significance of any investor needs or demand for any such action.

We present details of, and support for, our overriding concerns and reservations in Part 1 of the attachment. In Part 2 we briefly respond to the 32 specific questions posed in the Release. To reduce the need for redundancies, our responses to such questions consist to a large extent of cross-references to relevant paragraphs in Part 1

Thank you for this opportunity to comment. We hope the Board finds our comments useful in its deliberations on this matter. Please contact the undersigned at hlevy@pbtk.com or 702/384-1120 if there are any questions about these comments.

Very truly yours,

Piercy Bowler Taylor & Kern, Certified Public Accountants

Howard B. Levy, Sr. Principal and
Director, Technical Services

Attachment

6100 Elton Avenue, Ste. 1000 • Las Vegas, Nevada 89107 • 702-384-1120 • fax 702-870-2474 • pbtk.com

## Part 1 — Overriding Concerns and Reservations

1.1 The Release asserts that it is focused primarily on enhancing communication to investors rather than on changing the fundamental role of the auditor. However, as discussed below, most particularly in paragraph 1.8 (relative to the AD&A discussed as reporting Alternative No. 1), it is our view that new standards such as are under consideration in the Release, with the exception of reporting Alternative No, 4, would, indeed, have the unfavorable effect of fundamentally altering the auditor's role and function.

***Demand for change:***

1.2 We are far from persuaded and, in fact, have considerable doubt, that there is persuasive evidence currently available of any compelling need or demand among investors and other users for the kind of information that auditors might be required to report as a consequence of this project. We have read some of the early comment letters received from others (for example, the rather typical letter dated July 15, 2011, from the Florida Institute of Certified Public Accountants) and firmly believe that the comment letters ultimately will bear convincing evidence, to a much greater extent than the Board's initial "outreach" efforts did, of the highly controversial level of the conclusions and recommendations embodied in the Release, albeit presented as tentative. Moreover, we believe that the survey-based research about users' needs for possible revisions to PCAOB standards relating to auditor reporting appears most likely flawed seriously in many respects and has resulted in conclusions (again, albeit presented as tentative) that appear inherently biased and, therefore, unreliable. Accordingly, with the possible exception of reporting Alternative No. 4, without significantly more and credible research, we believe it would be extremely premature to take any action at this time on any proposal, even to formally propose such as in an exposure draft standard or series of standards relative to reporting Alternative Nos. 1-3. (See also paragraphs 1.22, 1 .24 and 1.26, below, with specific regard to the demand for reporting under reporting Alternative No. 3.)

1.3 Although not presented in the description of the PCAOB staff's "outreach" efforts (Appendix C) included in the Release, we have learned that the survey undertaken was distributed by mail to a relatively small population of 300 consisting primarily of leaders of institutional investors of which 73 (or 24%) responded. Although such a rate of response is not unusually small for any survey, only 45% of the respondents or 11% of the entire population surveyed (*i.e.*, only 33 respondents) expressed any dissatisfaction with the information provided by current audit report model. Accordingly, we believe the frequent use in the Release of the expression, "many investors," constitute a series of overstatements of the facts. We believe that 33 respondents is hardly a significant enough response to reasonably constitute a basis to justify the drastic changes in current practice suggested resulting in a fundamental and significant effect on issuers, their auditors and investors, alike. On the contrary, we believe that the survey results better supports an opposite conclusion because the 227 nonrespondents (or 76% of surveyed population) afford persuasive evidence of a high level of investor indifference to the prospect of introducing new reporting standards that would require such changes, rather than supporting an assertion that there is a substantial demand for it.

1.4 We find it extremely difficult to place any credence in Board's interpretation of these survey results when we factor into this analysis: (a) the probability that the 227 nonrespondents are likely satisfied with (or disinterested in) the content of the standard audit report, or as further evidence of probable investor indifference, considered themselves too busy to respond to the survey, (b) the fact that responses were inherently more likely to be received from those who are, in fact, dissatisfied with the *status quo* than from those who were not, and (c) that human nature being what it is, if you ask someone if (at no cost to them) they want more information than they are currently getting, they will likely respond in a knee-jerk reaction in the affirmative. We believe that the latter most likely accounts for the apparently unanimous support for the AD&A from large investor groups observed at the recent September 15th roundtable discussion – "If you build it, they will come!" This phenomenon may also explain why it is asserted in the Release only that the changes on the reporting model under consideration "might be useful to investors" and that "many investors ***are supportive*** of changing the auditor's model [emphasis added]" as opposed to more positive statements relative to perceived investor demand for such changes.

1.5 As is evident from the historical discussions in the Release, most particularly Appendix A, the evolution of the standard audit report has been slow and cautious over the past more than 100 years. In the early days of this evolution, standard-setters recognized the importance of eliminating or reducing opportunities for auditors to include vague and inconsistent language in their reports that would not effectively serve the needs of users. The most recent substantive changes in the standard audit report form (*i.e.*, excluding references to PCAOB standards for reporting on financial statements of issuers) were introduced in 1988 in SAS 58 as part of the so-called "expectation gap" standards and were primarily to clarify the auditor's responsibilities and distinguish them from management's. We believe these reporting objectives to be still valid today because sweeping, fundamental and sudden drastic changes in the audit reporting model would be inherently confusing to the investment community and, therefore, disruptive to the capital markets. We would oppose any recommendation, for example, such as for an AD&A, that would move audit reporting in any direction not consistent with the reporting objectives discussed in this paragraph. Accordingly, we believe considerably more evidence of the presence of a compelling demand should be necessary to support continuing efforts to produce a future proposal for such fundamental changes in the role of auditors and the nature of their reports.

***Role and authority of PCAOB:***

1.6 The Release causes one to question whether a forthcoming proposal from the PCAOB to adopt the suggested revisions to the standards might, in some ways, exceeds its statutory authority under the federal Sarbanes-Oxley Act of 2002 (the Act). It appears that Sections 101(a) and (c) (5) and 103(a)(1) and (4) of the Act contain broad enough language that could enable an interpretation that such action would be within the Board's authority. Nevertheless, it remains a question as to whether Congress ever intended the PCAOB's role or authority to go significantly beyond (a) setting the standards for performing audit and other services that issuers are already required under the federal securities laws or might optionally engage auditors to perform, (b) qualifying auditors through the registration process to perform such services, (c) monitor the performance of such services through its inspection process, and (d) impose disciplinary actions against noncompliant or incompetent auditors.

1.7 As discussed in more detail below, we believe that requirements such as those suggested for consideration by reporting Alternative Nos. 1 and 3 would be beyond our understanding of the probable intent of Congress as to the role and authority of the Board because they would set auditor's reporting responsibilities so far outside those requirements that are presently embodied in the federal securities laws, as now constituted, and the traditional auditor's role. Accordingly, if such requirements are ever to be included in standards applicable to auditors, we believe they should be initiated by actions of the U.S. Securities and Exchange Commission (SEC) under specific Congressional authority preferably to be derived from legislation not yet enacted.

***Alternative No. 1 (the AD&A):***

1.8 Expanding on the idea introduced above in paragraph 1.1, we believe any proposal to require auditors to issue AD&As under reporting Alternative No. 1 (clearly the most objectionable among the four presented) would likely have the generally undesirable effect of fundamentally changing and expanding the role of an auditor beyond that of an attester to the reliability of management's (*i.e.*, to add credibility to those assertions, most significantly, for example, as to fair presentation of the financial statements and accompanying note disclosures) to be more like that of a regulator, overseer, critic and/or whistleblower or adversary. This change in reporting responsibility would likely have the more specific undesirable effect, among others discussed below, of engendering management distrust of the auditors and consequently impairing working relationships and the open, unfiltered communications that are necessary to enable the effective and timely completion of a financial audit as we now know it. Further, we believe that public disclosure of matters that are now or should now be disclosed only to audit committees confidentially for them to act upon in exercising their oversight functions will likely put undue pressure on such committees and certain auditor disclosures might be viewed as providing a basis for criticizing audit committees, thus straining relationships between their members and the auditors as well.

1.9 Auditing is a highly complex professional discipline that requires years of education, training and experience to enable appropriate judgments as to risk assessment and audit scope in any given set of circumstances. Historically, we have seen countless examples of expert witnesses disagree on matters of risk assessment and audit scope adequacy and in recent years, substantial evidence of such disagreements between knowledgeable, experienced professionals is publicly available in the reports of PCAOB inspections and responses thereto. Accordingly, we believe that public disclosure of details of risk assessments and audit scope would not serve any useful purpose but rather would diminish the value of an audit report as such details would not only exceed the capabilities of investors and other users to make meaningful assessments and useful judgments about but also quite probably would be misunderstood and/or confusing to most of them. It is unreasonable, in our opinion, to create expectations that any form of written report, no matter how expanded it is from the current model, that is inherently limited by time and space, would enable lay users to make meaningful judgments as to such complex matters as would relate to the appropriate audit risks and scope.

1.10 Because of the almost endless variety of matters that might be included in an AD&A, if even a reasonably consistent structure or format were to be prescribed by a future standard, we firmly believe the language to be contained therein would necessarily be nonstandard. We also believe that, depending upon the writing style preferences and skills of individual auditors or their firms, such nonstandardized, free-form audit reports, in general (*i.e.*, even as to matters other than audit risk and scope), would not afford any measurable benefits to investors or other users because, at best, most likely, such reports would be readily misunderstood and extremely difficult for such users either to interpret or to make meaningful comparisons among reports on financial statements of different issuers that represent alternative investment opportunities under consideration.

1.11 It appears that an AD&A prepared under reporting Alternative No. 1 would be a throwback to an old, and similarly nonstandardized reporting format called the "long-form" report that was initially "officially" legitimized in 1957 in Statement on Auditing Procedure (SAP) No. 27 after many years of common use. In 1957, the long-form report was often issued either in addition to, or instead of, the so-called "short-form" report or "certificate," which was first formally standardized in 1948 in SAP 24 and designed to meet consistently the minimum requirements of the reporting standards contained in the nine (later expanded to ten) "generally accepted auditing standards" that were adopted that year. In connection with long-form reports, SAP 27 provided little or no specific guidance as to form and content except to caution auditors wisely against certain risks associated with such reporting by emphasizing (a) the need to maintain a "clear-cut distinction" between representations of management and the auditors (b) the fact that "comments or other data contained in the long-form report [may] lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations," and (c) that client financial information contained in such a report may "support a contention that the auditor has made *factual* representations rather than express an *opinion*... [on] management representations." We believe these risks would re-present themselves and would remain significant in the event any form of reporting Alternative No. 1 were to be required (or even made optional) for public reporting purposes.

1.12 Although required to maintain objectivity and be independent in both fact and appearance (as independence has effectively been defined in a long series of rules, interpretations, rulings and regulations of various bodies), it remains a fact of professional life that auditors compete with one another for clients. One way they are able to compete while remaining within the restrictive boundaries of independence, is to offer their clients value-added suggestions for improving, for example, their operating efficiency and, thus, profitability.* In the face of an AD&A reporting responsibility, as mentions in SAP 27, many such recommendations may likely bear a significant risk of being inappropriately viewed as exceptions or criticisms if included an AD&A and may, therefore, be withheld and be adverse to the economic best interests of the issuer and its investors.

1.13 Over time, following the issuance in 1957 of SAP 27, the use of long-form reports diminished quickly and greatly in practice, particularly as an alternative for what, in contrast, was still called a "short-form" report. However, beginning with Statement on Auditing Standards (SAS) No. 2, issued in 1974, the short-form report was formally redesignated the "standard" audit report, and effectively, use of the long-form report as an alternative to it was no longer deemed acceptable. Although the long-form report continued to be available for use as a type of supplemental report, it was rarely issued thereafter for distribution to other than a select group of users, its use has virtually vanished from modern practice largely, we believe, most likely in recognition of the risks set forth in SAP 27 and other reasons presented elsewhere in this discussion (not the least of which was likely a growing concern for the liability risk discussed in the next paragraph). We do not believe there is any compelling reason at this time to bring the long-form report back as an AD&A.

1.14 We see it as frightening to consider the enormous exposure to liability for auditors presented by long-form type reporting in our nation's highly litigious culture, and in today's economic and political environment that tends to generate extreme market price volatility, given the improbability of developing sufficiently rigid standards at least as to form and general content, if not specific standard language. Such risk relates not just to what an audit firm might include in, but to what it might exclude from, its report. In fact, we believe such risk is likely to result in firms, particularly the large firms, adding multiple layers of review to the audit reporting process so as to seriously impair their ability to issue reports timely and also would add costs that are not commensurate with any realizable benefits to issuers or others that would be better spent in operations, thus adding real value indirectly to the interests of investors.

1.15 Although we recognize as worthwhile the objective of making the standard audit report more informative (such as in accordance with reporting Alternative No. 4, if proposed), we believe that human nature is such that if audit reports were to become too long (say, more than one page), the probability of them being read and effectively achieving any meaningful communication objective would likely diminish severely. We note that in the PCAOB staff's outreach survey, it was determined that a large proportion of the investors who responded do not currently read standard audit reports, but we believe that phenomenon is more likely attributable to their familiarity than to dissatisfaction with its content or to or disinterest therein.

1.16 Audit committees generally have at least one member who qualifies under a regulatory definition of "financial expert," and as pointed out by Cynthia M. Fornelli on p. 3 of her letter that was issued on behalf of the Center for Audit Quality and dated June 9, 2011, (prior to issuance of the Release), are expected, as part of their oversight responsibilities, to engage in two-way dialog with auditors in which dialog questions are raised and written

* Depending on the outcome of the Board's audit firm rotation project now under way, the significance of the economic dynamics of auditor competition to this matter could decline materially with regard to SEC practice. We intend to present our views on the rotation matter in a future comment letter.

communications are clarified and elaborated upon with explanations as may be deemed necessary. Of course, public investors clearly do not have such access to auditors. Accordingly, we believe that auditor communications such as an AD&A as suggested by reporting Alternative No. 1 should be made only to audit committees.

1.17 The Release cites increased transparency for the benefit of investors and other users as an objective. Nevertheless, audit committees, which are charged with financial oversight responsibilities (undoubtedly for the primary purpose of protecting the interests of investors), including assessing the quality and scope of work performed by the independent auditors, have never been made accountable publicly so as to make transparent the scope and results of their oversight activities and provide assurance that investors may rely upon We believe, if there is determined, in fact, to be a significant demand among investors and other users for the type of information such as an AD&A might provide, it may be time to add some transparency to the work of audit committees by making them accountable with periodic reporting to the public for that which they are supposed to be held responsible. Of course, such a requirement could not come from the PCAOB but rather from Congress and/or the SEC.

***Alternative No. 2 (emphasis paragraphs):***

1.18 We believe it should continue to be management's, not the auditor's, responsibility to communicate adequately matters necessary to assure an understanding by users of the financial statements. It has long been the auditor's obligation, on the other hand, to assess the adequacy of management's disclosures not only with respect to the requirements of specific accounting standards applicable in the circumstances but to judge whether they are sufficiently clear, complete and not misleading, and to report any exceptions not corrected to the auditors' satisfaction. If this obligation is deemed not widely understood or appreciated by the investment community, we are in favor of expanding the standard audit report, as discussed in the Release in connection with reporting Alternative No. 4, to require clear articulation of this responsibility in the reporting model. We believe that if the auditor meets this responsibility effectively, there ordinarily should be no reason to summarize, supplement or emphasize matters adequately disclosed by management disclosures merely for the purpose of making audit reports unnecessarily "more informative."

1.19 Historically, in addition to the requirement for expressing substantial doubt as a result of a going concern uncertainty, auditors have generally limited the relatively rare use of optional emphasis paragraphs to highlight such potentially sensitive matters that, solely at the auditor's discretion, they have judgmentally deemed sufficiently important, to call to users' attention without an opinion qualification. In its so-called "clarity standards" (issued but not yet effective), the AICPA's Auditing Standards Board (ASB) has elevated the use of such discretion to be characterized in the future as a so-called "requirement" that nevertheless remains solely a matter of auditor judgment with these words: "If the auditor considers it necessary to draw users' attention to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor should include an emphasis-of-matter paragraph." However, although examples for consideration are presented in the ASB standard, it still does not require any specific type of matter to be the subject of an emphasis paragraph in audit reports on financial statements of nonisuuers. We believe such a requirement to use professional judgment without mandating emphasis paragraphs continues to be appropriate.

1.20 We believe that additional mandatory and expanded use of emphasis paragraphs, such as are suggested in the Release's discussion of reporting Alternative No. 2 would likely have the undesirable effect of diluting the auditor's message, confusing users and diminishing the apparent significance of matters more appropriately communicated by auditors, including the auditor's opinion, (see also paragraph 1.15, above).

1.21 Further, we believe that to mandate the expanded use of explanatory paragraphs would also likely have the undesirable effects of tending to (a) transfer the primary duty of clear disclosure of significant matters to the auditors from management (where it belongs) thus encouraging investors and other users to read only the auditors' most likely summarized discussions of such matters ignoring management's more comprehensive and fully detailed discussions, and (b) like the old long-form report (discussed in paragraphs 1.11-1.15), blur the distinction between representations of management and those of the auditors or be misconstrued by and confuse users as qualifications of, or contradictions to, an audit opinion, or in the absence of an qualified opinion, some comments might be misconstrued as a piecemeal opinion . Our comments above, objecting to public disclosure of matters of audit risk assessment and scope (relative to reporting Alternative No. 1) in paragraph 1.9 apply likewise to such disclosure if made in connection with Alternative No. 2.

***Alternative No. 3 (matters outside the financial statements):***

1.22 As mentioned in the Release, since 1998, auditors have had a standard (Statement on Standards for Attestation Engagements (SSAE) No. 8 [revised and recodified by SSAE 10 and now PCAOB Interim Attestation Standard AT 701) which we believe adequately governs and provides detailed guidance on the conduct of optional engagements and related reporting for providing assurance by auditors on a management's discussion and analysis (MD&A) included in an SEC filing. However, in the 13 years since the adoption of SSAE 8, very few such reports have been issued. Repeated requests of Congress and/or the SEC to require auditor attestation on the MD&A have been rejected or ignored over the years. Moreover, a succession of extensions of the effective date from the requirements of Section 404(b) of the Act for auditors' reports on internal control was eventually followed by a permanent exemption for smaller reporting companies. We believe a requirement for auditor attestation on data such as non-GAAP performance metrics would tend to present the undesirable risk of elevating the relevance and significance of such measurements while at the same time detracting from those of GAAP-consistent metrics.

1.23 It is certain that a requirement to extend auditor assurance to matters outside the financial statements would add considerable cost to issuers' compliance, depending on the nature and extent of the subject matter of such additional assurance (and with questionable benefits, as discussed at greater length in paragraphs 1.2-1.4). Also depending on the nature and extent of the subject matter, audit firms might likely have to hire and train additional staff and further disrupt issuers' operations by taking up additional space and time with the latter quite likely reducing their ability for timely financial reporting.

1.24 As discussed in the Release in connection with reporting Alternative No. 4, we are in favor of requiring auditors to better inform investors by including language in standard audit reports regarding their responsibility under AU 550, to read and consider whether information included in an SEC filing is materially inconsistent with the financial statements or other information obtained in the audit or is otherwise misleading. Of course, this responsibility is not applicable to earnings releases. We are not in favor of public auditor association with earnings releases, in large part because of an apparent perceived demand, in many cases, for timeliness of this kind of financial information such that it needs to be disseminated on a preliminary basis prior to the completion of the annual audit. User appetite for timeliness appears to override, and be with full understanding of, the risk that late adjustments might possibly arise that would cause the information to require modification. But we are in favor of a standard that would caution auditors in to read such releases (preferably prior to issuance) and to consider taking appropriate action in the event they appear to be unclear, inconsistent, false or misleading.

1.25 In the event it is ultimately deemed necessary to extend auditor attestation over disclosure matters currently presented outside the financial statements (*e.g.*, non-GAAP performance metrics), consistent with one of the comments of Dennis Beresford (most of which we are in full agreement with) contained in his letter to the Board of July 21, 2011, we assert that it would be relatively easy for the SEC to either cause the Financial Accounting Standards Board to sweep such disclosure matters into its current body of accounting standards or to supplement such accounting standards applicable to issuers as it has many times in the past. Thus, we believe there is no need to layer on additional auditor reporting as described under reporting Alternative No. 3 to cover matters that could be addressed in this fashion.

1.26 All of this, in our opinion, constitutes persuasive evidence of a relatively low level of investor demand or sense of need at this time to expand auditor reporting into information that is presented outside the financial statements. Accordingly, we do not believe a standard that would require such reporting should be proposed or adopted by the Board unless and until initiated by the SEC but only after duly considering and ruling out the alternative approach suggested in the preceding paragraph and following additional, more extensive research, including a period of experimentation through encouragement of voluntary compliance. The foregoing notwithstanding, we adequately would be in favor of developing and issuing performance and reporting standards for engagements to be entered into and conducted solely at the discretion of the client that would provide auditor assurance as to matters of disclosure made outside the financial statements.

***Alternative No. 4 (clarifying language):***

1.27 Although we are not in favor of altering the reporting model in any of the ways contemplated by reporting Alternative Nos. 1-3, we are in favor of clarifying matters auditors are already reporting upon that would improve the understandability of audit reports and, therefore, their usefulness for making investment decisions (provided the added report language does not speak directly to matters of specific audit risks and scope).

1.28 Consequently, in accordance with our afore-mentioned view (paragraph 1.5) that the evolution of the audit reporting model should remain (a) slow and cautious as it has been historically, and (b) consistent with the objectives of SAS 58 and the other "expectation gap" standards issued in 1988, we believe that reporting Alternative No. 4 has considerable merit and, thus, represents the only one of the four presented in the Release that clearly warrants further consideration at this time.

**Part 2 — Responses to Specific Questions Presented in the Release**

We believe we have addressed in the foregoing comments (Part 1) most, but not all, of the specific questions presented in the Release (and below). Nevertheless, in Part 2, to facilitate the analysis and summary by the PCAOB staff of the comments received, we have addressed these questions using parenthetical references to our relevant comments in Part 1, wherever applicable, that we believe are most directly responsive to the questions.

***Q1****. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

No. We believe the Board should undertake a standard-setting initiative at this time to consider improvements that would be limited only as set forth below under ***Q1b***. (1.1-1.17)

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

We believe any standard-setting initiative to be undertaken at this time should consider improvements only with regard to reporting Alternative No. 4. (1.1-1.17 and 1.27-1.28)

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

No. We do not believe the Board should consider expanding the auditor's role to require issuing assurance on matters presented outside the financial statements. (1.22-1.26)

***Q2***. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why? If not, why not, and what changes are needed?*

Yes. We believe that the current so-called "pass/fail" audit report form continues to be appropriate and should not be changed. We believe the introduction of gradations within the "pass" condition will likely be inherently difficult, if not impossible, for by users to interpret consistently as intended and, therefore, most probably will be misunderstood and of no value to the investment community.

*b. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

No. See our response to ***Q2b***.

***Q3****. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

As stated in the "overall philosophy" contained in the September 8, 2011, e-mail comments to the Board of Arthur Siegel (which, incidentally, contains many insightful comments with which we concur), we firmly believe that to maintain the proper clear distinction between representations of management and the auditors, reports of independent auditors should continue to be limited to matters relevant to attesting to the reliability of those management assertions. Accordingly, we believe that, to the extent information about the issuer's financial statements is not provided pursuant to the SEC's requirements for the MD&A, it should be provided by management and/or the audit committee, as appropriate. (1.8 and 1.18-1.21)

*Q4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

Our opposition to introducing details of auditor judgments about risk assessments and scope determination in an audit report would apply equally to reports that attest to the effectiveness of internal control over financial reporting (ICFR). The type of changes that we would favor (*i.e.*, those that are described in reporting Alternative No. 4) would not be necessary with regard to the ICFR portion of a combined report on financial statements and ICFR (the most prevalent choice) but might likely be applicable in some respects for a separate ICFR report issued pursuant to AS5.

Because of our views, we choose not to respond with regard to any changes that might be proposed and be related to reporting Alternative Nos. 1-3.

*Q5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

No. We are equally opposed to the AD&A whether as either a component of, or supplement to, a standard audit report. See our response to ***Q1a***. (1.8-1.17)

a. *If you support an AD&A as an alternative, provide an explanation as to why.*

Not applicable. See our response to ***Q5***. (1.8-1.17)

b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

Not applicable. See our response to ***Q5***. (1.8-1.17)

c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How* would such information be used?

Not applicable. See our response to ***Q5***. (1.8-1.17)

d. *If you do not support an AD&A as an alternative, explain why.*

See our response to ***Q5***. (1.8-1.17)

e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

No. We do not believe that public disclosure by auditors of details about judgments about risk assessments and scope is appropriate in any circumstances. We do believe, however, that audit committees should be required to disclose that they are satisfied with the significant auditor judgments about risk and scope and describe, in general terms, the basis for their conclusions. A requirement for such reporting by the audit committee should not come from the PCAOB. (1.9, 1.16-1.17)

For comments about the financial statements, see our response to ***Q3***. (1.8 and 1.18-1.21)

*Q6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (*i.e., *audit risk, audit procedures and results, and auditor independence)?*

Not applicable. See our responses to ***Q5a-f***. (1.8-1.17)

*Q7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (*i.e., *management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

As we have previously stated, we do not believe it is appropriate for an auditor to report publicly views on the issuer's financial statements beyond an opinion attesting to the fairness of management's assertions embodied therein or any reservation or exceptions thereto (which, of course, would not be acceptable to the SEC). We believe the capital markets would likely be disrupted and not be well served by either auditors or management reporting what might be called "close calls" once they have been resolved to the satisfaction of the auditors and the audit committee because such reporting might likely cause inappropriate doubts about the reliability of the management assertions embodied in their financial statements and likely be misconstrued as qualifications of, or contradictions to, an audit opinion (or, once again, in the absence of an qualified opinion, some comments might be misconstrued as a piecemeal opinion). (1.8, 1.11, 1.18-1.21)

***Q8.*** *Should a standard format be required for an AD&A? Why or why not?*

Not applicable. See our responses to ***Q5a-f.*** (1.8-1.17)

***Q9.*** *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

Even if an AD&A were to be required by a future standard, to which we are opposed, we would likewise be opposed to public disclosure of such additional risk matters as we believe it would not be understandable by investors or other users in a way that would help them make intelligent investment decisions. See our responses to ***Q5a-f.*** (1.8-1.17)

***Q10.*** *How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

Because of the wide variety of possible matters that would be reported in an AD&A contemplated by reporting Alternative No. 1, if adopted in a future standard, we are unable to the development of any significant "boilerplate" language imagine at this time for use in an AD&A or to otherwise provide for consistency in reporting therefor. (1.10)

**Q11.** *What are the potential benefits and shortcomings of implementing an AD&A?*

We believe there would be no meaningful benefit to investors or others if a requirement to issue AD&As were adopted. See our responses to ***Q1a-f.*** (1.8-1.17)

***Q13.*** *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

We believe that an emphasis paragraph regarding substantial doubt as to a going concern uncertainty should continue to be the only mandatory one. The use of other emphasis paragraphs should continue to be rare and at the reporting auditor's discretion based solely on judgmental considerations about sensitivity and significance. Emphasis paragraphs should not be used indiscriminately to supplement or explain management's disclosures once deemed to be adequate. (1.18-1.21)

***Q14.*** *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

No. See our response to ***Q13.*** (1.18-1.21)

a. *If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

Not applicable. See our response to ***Q13.*** (1.18-1.21)

b. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

See our responses to ***Q1a-b, Q5e*** and ***Q13.*** (1.1-1.21)

***Q15.*** *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

Not applicable. See our response to ***Q13.*** (1.18-1.21)

***Q16.*** *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

Although we do not believe the required use of emphasis paragraphs should be expanded, if they were, we would not be in favor of any level of detail that would exceed the level customarily in use in today's audit reporting model especially if there is a perceived risk that additional explanatory language might likely be misconstrued as qualifying or contradicting an audit opinion. (1.21)

***Q17.*** *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

Similar to our response to ***Q10*** relative to an AD&A, because of the wide variety of possible emphasis paragraphs contemplated by reporting Alternative No. 2, if adopted in a future standard, we are unable to the development of any significant "boilerplate" language imagine at this time for use in an AD&A or to otherwise provide for consistency in reporting therefor. See also our responses to *Q5a-f.* (1.10)

***Q18.*** What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

See our response to ***Q13***. (1.18-1.21)

***Q19.*** *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No. (1.22)

a. *If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

Not applicable. See our response to ***Q19***. (1.22)

b. *On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

None. See our response to ***Q19***. (1.22-1.26)

c. *What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

None. See our response to ***Q19***. (1.22)

d. *If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

We are in favor of permitting auditor association with the MD&A (pursuant to AT 701) to remain solely a matter of issuer discretion and, based on our response to ***Q19f***, below, we see no reason to divide it into segments that auditors would or would not be required to report upon. If, on the other hand, such a division were to be made, we would recommend that priority for auditor reporting be given (not necessarily in this order) to the comparative results of operations analysis, critical accounting policies and estimates, recent accounting pronouncements, and liquidity and capital resources portions of the MD&A.

e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

We understand the MD&A disclosure requirements to be determined by the SEC and its staff and do not understand how they should be affected by the nature and extent of auditor association as a result of attestation services except if divided, to organize the portions such that it is clear to readers which parts are covered by auditor assurance and which are not.

f. *Are the requirements in the Board's attestation standard, AT Sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

We believe AT 701 is appropriate and adequate for reporting on the entire MD&A, for which it was designed and intended, but that more tailored standards would likely be required for other applications, depending on the specific nature of other information to be reported on. (1.22)

g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

See our response to ***Q19***. (1.22-1.26)

***Q20.*** *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

We see no meaningful benefits likely to be realized by mandating auditor assurance on disclosures outside the financial statements, only shortcomings, principally the expenditure of company resources that would be unnecessary because of the absence of a demonstrable need. (1.22-1.26)

***Q21.*** *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

a. *Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We believe auditor communications would be improved by adding brief explanatory language in the standard report (say, one sentence or two) for each of the foregoing subjects. We also believe the Board should give consideration to requiring the addition of captions such as contained in the ASB's clarity standards" recently issued but not yet effective to aid users to understand and easily read auditor's reports. (ASB) (1.27)

b. *Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Yes. (1.9 and 1.27-1.28)

c. *What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

We believe that definitions of the terms, "fairly presented," and "material misstatement," should be considered in addition to the list presented in ***Q21***.

d. *What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

We believe that adding to the standard audit report the foregoing clarifications of such terms and responsibilities, as they are presently understood by auditors, should have no effect on the scope of an audit conducted in accordance with currently applicable auditing standards.

***Q22.*** *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We believe the suggested clarifying the language in a standard auditor's report, and possibly adding captions, would make considerable progress in closing the expectation gap. We see no shortcomings of such a change unless the prescribed clarifying language were include discussion of specific risks and matters of audit scope or otherwise be too long and complex so as to impair or diminish the probability of being read or easily understood by users.

***Q23.*** *This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

As we have stated in many previous responses, we are in favor only of reporting Alternative No. 4. In this case, see particularly our response to ***Q1a-b***. (1.1-1.17 and 1.27-1.28)

***Q24.*** *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

No. See our response to ***Q23***.

***Q25.*** *What alternatives not mentioned in this concept release should the Board consider?*

Not applicable. As we have stated in many previous responses, we are in favor only of reporting Alternative No. 4. In this case, see particularly our response to ***Q1a-b***. (1.1-1.2)

***Q26.*** *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

As we have stated in many previous responses, we are in favor only of reporting Alternative No. 4, to which we are limiting our response. In this case, see particularly our response to ***Q22***.

***Q27.*** *Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

See our responses to ***Q7*** and ***Q16***. (1.11-1.12 and 1.21)

***Q28.*** *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

As we have stated in many previous responses, we believe only reporting Alternative No. 4 effectively serves to better users' collective understanding of the auditor's role while Alternative Nos. 1-2 would most certainly add to users' confusion. (Alternative No. 3 would do neither.) See our responses to ***Q1a-b***, ***Q21a-b***, ***Q22*** and ***Q31a***. (1.5, 1.8-1.12, 1.15-1.18 and 1.20-1.21)

**Q29.** *What effect would the various alternatives have on audit quality? What is the basis for your view?*

We believe that none of the alternatives presented would have a measurable effect on audit quality relative to financial statements since, as presented, they would not add to or reduce audit procedures relative to the audit of the financial statement or, if applicable, ICFR. Only reporting Alternative No. 3 would require additional procedures to enable assurance on matters not now covered by an audit opinion. Our views on this matter (like all others expressed in this letter) are based primarily on decades of experience as auditors.

***Q30.*** *Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

Since it is our belief that only reporting Alternative No. 4 continue to be under consideration for any future proposed standard, we believe any standard that results from such continuing consideration should be applicable to all entities who are now or will become subject to the reporting requirements of PCAOB auditing standards, If such requirements are to be extended in the future to entities not yet covered, they should be limited to those whose securities are traded in the capital markets.

***Q31.*** *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

Yes. As we have stated in many previous responses, we are in favor only of reporting Alternative No. 4. See our responses to ***Q1b*** and ***Q31c***. We have ranked our responses to ***Q31c*** in categories in the order of importance with the considerations in category 1 seen as the most important primarily because of changing the fundamental role of auditors and their potential for confusing users. (1.1, 1.8-1.12, 1.15-1.18, 1.20-1.21 and 1.26)

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

We believe the costs associated with reporting Alternative No. 4 to be nominal and the benefits, therefore, worth in excess thereof. Although the costs that we believe would be associated with reporting Alternative No. 2 would likely be slightly greater, but probably still nominal, we see no significant benefit but rather several disadvantages (as previously stated) to be obtained from its adoption. On the other hand, we believe the costs that would be association with either of reporting Alternative Nos. 1 or 3 would be considerable, again with no significant benefits (and several disadvantages as previously stated) to be obtained from adoption of either. (1.14 and 1.23)

*c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

Among others addressed briefly in the Release, we have mentioned in Part 1 of this letter our reservations and concerns over such matters as may be grouped into four broad categories as follows:

1) Changing the fundamental role of the auditor *vs.* those of management and the audit committee, and the related risk of increasing rather than reducing user misunderstandings thereof (1.1, 1.8-1.12, 1.15-1.18, 1.20-1.21 and 1.26)

2) Questions as to reliability of the "outreach" efforts undertaken and the related conclusions drawn regarding investor demand for the types of auditor communications now under consideration (1.2-1.5)

3) Questions as to whether the Board is proceeding with too much haste and overstepping its role and authority, as intended by Congress (1.5-1.7)

4) Whether such new reporting responsibilities now under consideration (particularly under reporting Alternative Nos. 1-3) would likely damage relationships between auditors and management and between auditors and audit committees that would tend to impair communications and, hence, auditors' ability to conduct high quality audits. (See our response to ***Q32***.)

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

As we have stated in many previous responses, we are in favor only of reporting Alternative No. 4. In this case see particularly our response to ***Q1b***.

***Q32.*** *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

We believe that new public auditor reporting responsibilities such as are now being considered under reporting Alternative Nos. 1 and 2 have considerable potential for being viewed as providing investors with a basis for criticism or distrust causing relationships among auditors management and audit committees to become more adversarial and guarded thus impairing working relationships and the open, unfiltered communications that are necessary to enable the effective and timely completion of a financial audit, and additional costs likely to be associated primarily with reporting Alternative No. 3 will further strain such relationships. (1.8, 1.12, 1.14 and 1.23)

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September28, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 2006

Re: Rulemaking Docket Matter No.34

We write to comment on the concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, dated June 21, 2011. Our comments come from the perspective of management and the audit committee of the board of directors of a public registrant and are based on our experience, information included in the concept release and viewpoints expressed in the discussion to date. We have not previously participated in the rulemaking process of the PCAOB, but believe the concepts set forth in this concept release warrant broad participation and feedback.

**Background and Principles Underlying our Response**

We understand that the objective of the concepts set forth in the concept release is to increase transparency and relevance to financial statement users, while not compromising audit quality. We further understand that the alternatives presented are primarily intended to focus on enhancing communication to investors through improving the content of the auditor's report rather than on changing the fundamental role of the auditor. There are several points that we believe are important and should be maintained in all of the alternatives considered. These are:

- Management is responsible for reporting information about the company and that should not change.
- There are currently requirements to disclose a significant amount of information about the company and accounting related matters. To the extent additional information is needed, the applicable rules and regulations should be amended to require companies to provide that information rather than shifting that disclosure to the auditor's report.
- The responsibility for review and analysis of financial statements lies with financial statement users, not with auditors.
- To the extent that the auditor's reports are expanded the focus should be on communicating information about audit risk, procedures and results.

We are proponents of full and fair financial disclosure in financial statements and related communications by SEC registrants. While it is understandable that the PCAOB would like to enhance the utility of the financial statements and audit reports, we fear that there could be significant negative unintended consequences from the alternatives proposed. For example, expanding the amount of information that the auditor discloses through the inclusion of an AD&A, Emphasis Paragraphs or Auditor Reports on information outside the financial statements could realistically cause financial statement users to be less diligent in reviewing information by substituting an Audit Report for review and analysis.

Our comments on the following topics are focused on the points above and our understanding of the objectives of the concept release.

**Auditor's Discussion and Analysis**

We are not totally opposed to the concept of adding an Auditor's Discussion and Analysis ("AD&A"). However, we do believe that several respondents have raised compelling points regarding the sophistication of the investing community and the wealth of information publicly available regarding auditing standards that cast doubt on the real benefit that will be gained in adding a significant amount of new disclosure to already lengthy 10-Ks. We also believe that the suggested alternatives will result in lengthy audit reports that may discourage some investors from reading the reports, will be challenging for readers to get through and difficult to compare between registrants, further calling into question the value that will be achieved. In addition, we believe there is a strong likelihood that the alternatives presented could result in significant increased costs.

Although we do not have an outright opposition to the concept of an AD&A, we do feel strongly that if an AD&A were adopted, the focus should be on audit risk, procedures and results and not on adding additional disclosure about the financial statements of the company. One alternative included in the concept release is for the AD&A to include the auditors discussion of the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues. It also suggests that the auditors highlight where management could have applied different accounting or disclosures. We have several significant concerns with this primarily associated with the impact on the roles of the audit committee and of the auditors.

Audit committees, as representatives of the shareholders, currently have responsibility to provide oversight of the financial reporting process. The current process includes required communications and dynamic interaction between the audit committee and auditors. Expanded disclosures of matters that are included in this dialogue would be a less effective method for providing the oversight that already exists. In addition, we believe that these alternatives create a fundamental shift in the responsibilities of the auditor away from performing an audit to provide reasonable assurance that the financial statements are free of material misstatement to a responsibility for disclosing information about the company that they are auditing. We are concerned about the potential impact that a change in the role of the auditor may have on communication. We believe that open communication between management, the auditor and the audit committee is vitally important to the audit process. We believe that this type of AD&A may reduce or hamper that important open communication.

We also don't believe that the auditors are the best source of information about the company. The managements of public companies are responsible for the completeness and accuracy of the financial statements, footnotes and related disclosures. The company employs significant resources to ensure that the appropriate systems, policies, procedures and resources are in place to ensure that business activities are appropriately captured and reported in accordance with the applicable accounting standards. Included in these activities can be significant time and resources dedicated to researching and concluding on the appropriate accounting for a number of matters. While we agree that the auditors expend a significant amount of time in the process of performing their audits and do gain insight and knowledge about the company that they are auditing, management remains the best and most appropriate source for information about the company and related accounting matters.

Further, a focus by the auditors on creating content and disclosure would require significant high-level input from the audit team which could distract the partner and manager from focusing on the audit itself, which could prove to be detrimental to the quality of the audit.

In addition, the illustration included in the concept release is difficult to assess for usefulness as it does not include any of the challenging concepts that are proposed in the concept release. The discussion of these matters would most likely extend to multiple pages and even at that length, be subject to confusion and potential undue concern without elaborate, detailed explanations. Also, there would be a significant challenge to the audit firms to determine the appropriate subjective wording that is appropriate for a specific company and yet still be consistent and comparable with similar fact patterns at other companies. There would be even more significant challenges for investors in attempting to compare and contrast disclosures made by different audit firms when attempting to appropriately consider the information provided in making their investment decisions. This alternative would seem to be moving away from what some have described as a clear, concise and consistent audit report that provides investors reasonable assurance that the financial statements are materially free of misstatement to a lengthy, subjective, inconsistent report that potentially creates confusion.

**Required and Expanded Use of Emphasis Paragraphs**

Similar to our view on adding an AD&A, we are not totally opposed to this alternative, but we do believe that certain principles should be maintained. Foremost, the required and expanded use of emphasis paragraphs should focus on audit risks, procedures and results and should not extend to disclosing additional information about the company or the company's financial statements. The disclosure of information about the company and the financial statements should remain management's responsibility. Current reporting standards require comprehensive disclosures covering a broad range of topics in an attempt to provide relevant information to financial statement users. To the extent more information is needed on certain topics, the relevant reporting standards should be amended to incorporate those requirements.

One practical downside to requiring auditors to disclose or summarize significant matters or risks considered in an emphasis paragraph is the potential increased exposure it would present to the auditor. We believe that a practical reaction would be for the auditor to provide laundry lists of lesser significant matters to mitigate that risk.

**Auditor reporting on information outside the financial statements**

The concept release includes alternatives for expanding auditor reporting to a wide range of areas ranging from MD&A to press releases. We do not agree that the benefits of expanding the auditors reporting outweigh the costs associated with such changes. As noted in the concept release, the auditor's currently have responsibility to read and consider whether information outside the financial statements or the manner it is presented is materially inconsistent with the financial statements or represents a material misstatement of fact. To the extent there is real demand for additional assurance, a current PCAOB standard exists for the auditors to provide such assurance. We have not experienced demand for this level of assurance and we do not believe that creating additional required reporting would be cost beneficial.

Regarding press releases, we understand timely access to financial information to be a key priority of the investment community. Any efforts to require an auditor report on press releases would necessitate a delay in the timing of disseminating that information to the public and would run contrary to the priority of timely access to that financial information.

**Clarification of language in the auditor's report**

We do not have any objections to the suggested alternatives to clarify the language in the auditor's report.

Thank you for the opportunity to comment on this concept release.

Sincerely,

/s/ Everardo Goyanes

Everardo Goyanes
Chairman of the Audit Committee

/s/ J. Taft Symonds

J. Taft Symonds
Member of Audit Committee

/s/ Christopher M. Temple

Christopher M. Temple
Member of Audit Committee

/s/ Al Swanson

Al Swanson
Executive Vice President and Chief Financial Officer

/s/Chris Herbold

Chris Herbold
Vice President - Accounting and Chief Accounting Officer

Plum Creek Timber Company, Inc.
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206-467-3600

Plum Creek

September 30, 2011

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

RE: Rulemaking Docket Matter No. 34

Members of the Board,

I am writing this letter on behalf of the management of Plum Creek Timber Company, Inc. to comment on your concept release on "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements." As management, we are responsible for Management's Discussion and Analysis (MD&A) and the consolidated financial statements and footnotes included in our annual report filed with the Securities and Exchange Commission (SEC) on Form 10-K and our quarterly reports filed on Form 10-Q.

**Inclusion of an Auditor's Discussion and Analysis section in a supplement to the auditor's report**

We do not support the inclusion of an Auditor's Discussion and Analysis (AD&A) section as a supplement to the auditor's report. Management is responsible for determining the estimates and judgments used in the financial statements and the critical accounting policies for a company. Management is solely responsible for analyzing the overall information regarding a company's business and related operations in order to determine what information should be included in the financial statements and related footnotes in accordance with generally accepted accounting principles and SEC regulations.

In addition, there are numerous users of a company's financial statements, and each of those users may have a different interpretation as to what is important to them and what they are most concerned about as it relates to a company's current and future operations. As a result, it is not the place for an auditor to determine what information the users should read and what information they should ignore. An auditor identifies risk based on professional judgment for purposes of designing audit procedures, and those procedures are not for the purpose of advising the various users of a company's financial statements what might be important to them. Additionally, given the various needs and focus of users, certain information may not be included in an auditor's AD&A that a particular group of users would like included, and as a result, this group of users could find fault with the auditor for excluding such information. Accordingly, this could lead to increased and unnecessary litigation.

The annual financial statements included in a Form 10-K as filed with the SEC is the only time in a company's periodic reporting cycle that an audit opinion is issued with a set of financial statements. However, there are numerous other important forms of communication that management uses with its shareholders throughout the year. These communications discuss significant and important information (e.g. an acquisition of a company, the sale of a business, or a change in officer, etc.) about a company that is useful and meaningful for a knowledgeable investor as he or she makes investment decisions. These important communications include: i) quarterly reports on Form 10-Q (which in most cases are not accompanied by a review report issued by an auditor), ii) quarterly earnings press releases, iii) press releases for significant events (as noted in a Form 8-K), iv) quarterly conference calls with analysts, and v) the annual shareholders' meeting and related proxy filings. Given the vast amount of information that is made available by management to a company's investors, it would seem redundant to have auditors provide additional information that has already been communicated timely throughout the year.

Lastly, the objective of financial reporting is for the financial statements to provide information that is useful to the users of the financial statements. If generally accepted accounting principles or SEC regulations do not currently require the disclosure of information that is useful to the users of a company's financial statements, the financial reporting model should be updated by the Financial Accounting Standards Board and the SEC such that it provides the necessary information needed by the users of the financial statements.

**Required and expanded use of emphasis paragraphs**

We do not support the "required" use of emphasis paragraphs in the audit opinion. We believe that it is appropriate to include emphasis paragraphs only as it relates to certain circumstances, such as the adoption of a new accounting principle or in the event of a going concern consideration. However, the requirement to include an emphasis paragraph as it relates to the identification of the most significant matters is not appropriate. As discussed above, this is management's responsibility as they are the only ones with sufficient knowledge to understand what is truly considered significant and important to the users of the financial statements. In addition, a company's significant matters are covered in adequate and sufficient detail through its disclosures in MD&A in its Form 10-K and Form 10-Qs and related footnote disclosures.

Current audit opinions are standard in the event of a "clean" opinion, and if an emphasis paragraph is required, the language would eventually become standard as well. This type of language would not be beneficial to the users of the financial statements. In addition, the users of the financial statements should be knowledgeable investors, and a knowledgeable investor should not need an audit opinion to help them identify areas that are significant.

**Auditor reporting on information outside the financial statements**

We do not support auditor reporting on information (e.g. MD&A, earnings releases, non-GAAP information) outside of the financial statements. As stated previously above, there is a significant amount of information that management provides to its investors on a regular basis, and this amount of information far exceeds the amount of information required in financial statements and footnote disclosures. Much of this "extra" information represents non-GAAP measures, such as EBITDA, which could have different meanings for different users. For example, a debt agreement for one financial institution could define EBITDA one way, and another debt agreement with a different financial institution could define EBITDA another way. As a result, there would be no standard by which to compare and/or understand the non-GAAP measures, and this would only provide confusion to the users of the financial statements.

In almost every case, a company's auditors do read the "information outside the financial statements" that will be shared with the public in the form of press releases included in a Form 8-K or quarterly financial information as presented in a Form 10-Q. If information to be presented to the public is not accurate, a company's auditors would be required to communicate such inaccuracies to management. Although, no formal opinion is issued on this information, a user should be able to obtain some comfort that the auditor reads the information with knowledge of the audited financial statements.

**Clarification of certain language in the current standard auditor's report**

We are not opposed to adding clarification language in the current standard auditor's report. As this proposal would not significantly expand the content of the auditor's report, it could provide additional information about what an audit represents and related auditor responsibilities that would be beneficial to certain users of the financial statements.

Thank you for the opportunity to comment on this topic and for taking the time to read our concerns regarding this topic. If you would like to discuss any of our observations further or would like for management of Plum Creek to provide more information, please feel free to contact me.

Sincerely,

David W. Lambert

David W. Lambert
Senior Vice President and Chief Financial Officer
Plum Creek Timber Company, Inc.

PNM Resources

September 30, 2011

Via email to comments@pcaobus.org

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

Re: Concept Release on Possible Revisions to PCAOB Standards Related to Audit Reports on Audited Financial Statements; PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

PNM Resources, Inc. appreciates the opportunity to respond to the Concept Release proposed by the PCAOB.

PNM Resources, Inc. is a diversified energy company in the United States with approximately $5.3 billion of assets, $1.6 billion in annual revenues, and a market capitalization in excess of $1.4 billion. Our subsidiaries and affiliates are involved in the generation, transmission and distribution of electricity, as well as energy management and other energy-related services primarily in New Mexico and Texas.

We appreciate the PCAOB's efforts to enhance the current auditor's reporting model. We believe that there may be some room for improvement within the current auditor's reporting model that would help to clarify the purpose of an audit and the auditor's responsibility; however, providing information about the company, including financial information, is management's responsibility, and not the auditors. The PCAOB states in the Concept Release that these proposals are being made as a result of requests by the investment community to provide more information; however we have not experienced additional requests from our investors for additional information or an expansion in auditor communications. We believe that providing significant additional information in the auditor's report would greatly increase costs and little or no perceived benefit will be achieved.

Auditor's Discussion and Analysis (AD&A)
We are opposed to the AD&A as an alternative to strengthen the current auditor's reporting model. It is our belief that the financial statements are the responsibility of the company's management, and that any additional information that is deemed necessary to be provided to investors should be provided by management and not auditors. We are concerned that significant effort by the auditors would be required to prepare an AD&A. In addition, there would be significant effort by management of the company, as well as its audit committee. The additional review process and time involved by both the auditors and management will significantly increase costs of completing any reports that require an auditor's review. The additional time

required to complete and review the AD&A may also jeopardize the already compressed Securities and Exchange Commission (SEC) filing deadlines.

Emphasis Paragraphs in Auditor's Reports
We do not support a requirement to include additional emphasis paragraphs in the standard audit report, especially since auditing standards currently provide guidance on emphasis paragraphs. We believe that additional emphasis paragraphs will become "standard or boilerplate" that will not be meaningful and will not add additional value to the current audit report. It is our belief that the current auditors reporting model for the inclusion of emphasis paragraphs is functioning adequately and provides the auditors the opportunity to disclose additional significant information in the report as they determine to be appropriate.

Auditor Assurance of Information Outside the Financial Statements
We do not support expanding the auditor's regular attestation function beyond the financial statements. Currently, auditing standards require the auditor to review information outside of the financial statements for reasonableness and consistency with the financial statements. Requiring auditors to audit the information outside of the financial statements would only increase the audit fees and would add very little benefit to investors. Additionally, requiring auditors to attest to the information outside of the financial statements will make meeting required filing deadlines more difficult to attain due to the significant expansion of audit procedures. The nature of much of the information outside the financial statements is such that appropriate audit procedures can only be performed shortly before a document is filed rather than being subject to interim auditing.

Clarification of the Standard Auditor's Report
We do not have any objection with additions to the auditor's report to clarify terms or the auditor's existing responsibilities. We believe this could be accomplished without significant effort or cost. However, we believe that the clarifications should be standardized in the audit report guidance, written in "plain english" and should not be so prominent in the report that the clarifications distract from the purpose of the audit report.

*****

As set forth above, we do not support the proposal made surrounding an AD&A, additional emphasis paragraphs, and requiring auditors to attest to information outside of the financial statements. We believe that these additional requirements would significantly increase audit fees with little to no perceived benefit. It is also our belief that the proposed requirements would be extremely difficult, if not impossible, to complete within the already compressed filing requirements of the SEC.

Sincerely,

Henry A. Ingalls

Henry A. Ingalls
Director, SEC Reporting and GAAP Analysis
PNM Resources, Inc.

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September 30, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

PPL Corporation ("PPL") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (Release No. 2011-003, June 21, 2011) ("Concept Release"). PPL is an energy and utility holding company that, through its subsidiaries, owns or controls nearly 19,000 megawatts of generating capacity in the United States, sells energy in key U.S. markets, and delivers electricity and natural gas to about ten million end users in the United States and the United Kingdom.

We have several concerns about the alternatives proposed in the Concept Release as discussed further below. Our comments are organized in the following sections as set forth in the Concept Release:

1. Auditor's Discussion and Analysis (AD&A),
2. Required and expanded use of emphasis paragraphs,
3. Auditor assurance on other information outside the financial statements, and
4. Clarification of language in the standard auditor's report.

**Auditor's Discussion and Analysis**

The Concept Release discusses that the intent of the AD&A would be for the auditor to provide in a narrative format his or her views regarding significant matters, including management's judgments and estimates, difficult or contentious issues and areas where management could have applied different accounting. We believe that Management is responsible for the financial statements and the disclosures set forth therein and that the Audit Committee of a Board of Directors ("Audit Committee") is the appropriate governance body, as discussed below, to provide oversight of Management and to engage the auditors in open and transparent communication of their work and the quality of a company's financial statements and disclosures. The auditor's responsibility is to obtain reasonable assurance about whether the financial statements present fairly, in all material respects, the financial position and results of operations of an entity in conformity with U.S. generally accepted accounting principles ("GAAP") and, with larger public companies, to opine on an entity's internal control over financial reporting. An auditor exercises professional judgment in accordance with the auditing standards to design and execute an audit plan to opine on the accuracy and completeness of the financial statements as a whole. The auditor does not opine on individual matters as part of a standard financial statement audit. Accordingly, subjective information about an entity's financial statements presented by an auditor, such as their views on management's judgments and estimates, accounting policies and practices, and difficult or contentious issues could create greater confusion, and in our view, would not result in providing useful decision making information to investors.

An AD&A would significantly increase the cost of and time to complete the audit due to the additional effort that would be required for the auditor to obtain the understanding necessary of the day-to-day operations of the company and management's decisions and estimates required to be able to provide meaningful disclosures. In addition, an increase in effort would be required to resolve and clarify differences between information in the AD&A and information in the financial statements and potentially require further time to make information available to investors. Further, if an auditor provides subjective information that is relied upon for investor decisions and is later proved to be incorrect, the auditor and the company could be subject to litigation.

Current auditing standards already require the auditor to report the items proposed in the Concept Release to the Audit Committee. The Audit Committee, as a part of the shareholder elected Board of Directors, has the authority and responsibility to oversee the financial reporting process on behalf of investors and to resolve any specific accounting treatments that they are not comfortable with. This required involvement of the Audit Committee should provide the level of assurance that these judgmental areas have been adequately addressed within the financial statements. The auditor also reporting these items to the investors could not only potentially confuse an uninformed investor, but would also appear to undermine the governance role of the Audit Committee. A potential alternative to the auditor providing this information as part of an AD&A would be for the PCAOB to modify the standard audit opinion to state that management's significant judgments and estimates, critical accounting policies, alternative accounting treatments, etc., have been discussed with the entity's Audit Committee. This could provide the investor with additional assurance that the amounts and disclosures included in the financial statements related to these judgmental areas are appropriate without potentially confusing investors by discussing the actual alternatives.

If the auditor were required to present subjective information in the form of an AD&A, communications between the auditor, management and the Audit Committee could become less transparent. Effective communication between these parties is important to uphold the transparency of the audit resulting in a quality audit. There is also a risk of disclosing information that is confidential to the company in an AD&A. GAAP must be followed by management when producing financial statements. If investor needs require that changes be made to the current accounting and reporting framework under GAAP, those changes should be completed through the accounting standard setting process and not the auditing standard setting process.

**Emphasis Paragraphs**

The Concept Release proposes that emphasis paragraphs could be required and their use expanded, in which the auditor would discuss such things as significant management judgments and estimates and areas with significant measurement uncertainty. The PCOAB's auditing standard AU 580.11 already requires an auditor to include an emphasis paragraph in certain situations and allows auditors to include them when the auditor wishes to emphasize a matter in the financial statements. Requiring and expanding the use of emphasis paragraphs may lead to standardized disclosures in the auditor's opinion that are not meaningful to investors. As discussed above, significant management judgments and estimates and significant risks are already discussed with the Audit Committee. We believe the existing guidance for the use of emphasis paragraphs in the audit report is appropriate.

We believe that ASC 275, *Risks and Uncertainties*, provides guidance for disclosures in the footnotes that address some of the concerns in this area. However, to the extent that these disclosures should be expanded to address significant judgments and estimates in the financial statements and footnotes, we believe that the accounting standard setting process is the appropriate forum and not the auditing standard setting process.

**Auditor Assurance on Other Information**

Another alternative presented in the Concept Release is for the auditor to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis (MD&A), earnings releases, and/or non-GAAP financial information. Increasing the scope of the audit to include this other information could significantly increase the costs of the audit and could also put at risk the company's ability to timely file its financial statements in compliance with regulations.

Current auditing standard AU 550 already requires that auditors review other information accompanying the audited financial statements, such as MD&A, to ensure consistency with the audited financial statements. Simply providing assurance on other information outside the financial statements would not provide additional useful information for investors. We note there is a PCAOB attest standard detailing the requirements for attest engagements with respect to MD&A (AT 701), however, these engagements are typically not performed. We believe that a regulatory mandate to audit additional information should only be made if a comprehensive analysis shows compelling evidence that the benefits of performing procedures above those that are already required outweigh the financial costs and risk of untimely filings.

**Clarification of Language in the Standard Auditor's Report**

The fourth alternative discussed in the Concept Release is the clarification of certain terms in the standard auditor's report, such as reasonable assurance, and the clarification of auditor responsibilities, such as the auditor's responsibility to detect fraud. We appreciate the investment community's desire for additional understanding of the audit process and do not object to the audit community providing the factual information proposed by this alternative.

If guidance is issued directing auditors to clarify their responsibilities and certain terms in the audit opinion, to avoid confusion, we recommend amending the standard auditor's opinion by providing standardized language to be used in all auditor reports to maintain consistency between all auditors and all entities.

**Conclusion**

We appreciate the opportunity to comment on this Concept Release. As discussed above, we do not support the alternatives set forth in the Concept Release, including the requirement that auditors present subjective information on an entity's financial statements in their opinions. The auditor's views regarding significant matters could undermine the entity's financial statement presentation and disclosures, create greater confusion and not enhance the overall understanding of the investor. Furthermore, we do not support mandates by the PCAOB or other regulatory bodies that increase the cost of operations of U.S. registrants, without measureable benefits to investors. If additional accounting and reporting requirements are necessary, we believe they should be established through the accounting standard setting process and be provided by management. If an auditor has concerns with the amounts recorded or the disclosures made by management, they should be addressed with the Audit Committee, whose role is to address those concerns.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Vincent Sorgi

Vincent Sorgi
Vice President and Controller

cc: Mr. P. A. Farr
Mr. M. A. Cunningham
Mr. M. D. Woods

39 Old Ridgebury Road
Danbury, CT 06810-5113

September 27, 2011

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

**Re: PCAOB Concept Release ("Concept Release") on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements – PCAOB Release No. 2011-003 June 21, 2011**

We appreciate the opportunity to provide our comments on the PCAOBs Concept Release relating to Auditor's Reports on Audited Financial Statements. Praxair, Inc. is a Fortune 300 U.S. - based public company that produces, sells and distributes atmospheric, process and specialty gases, and high-performance surface coatings with 2010 sales of $10 billion. About 60% of our sales are non-U.S. and we operate in over 40 countries. As such, we are very concerned with any proposals which would change the audit scope and/or communications related to our business/financial statements and the relationship with our external independent registered public accounting firm.

Although we support the PCAOB's periodic evaluation of the auditors' reports on audited financial statements, we do not support many of the proposals included in the Concept Release. In general, we believe:

- Auditors should not be the original source of disclosure about an entity; instead, management's responsibility should be preserved.[1]

- Auditor reporting should focus on the objective rather than the subjective[1] i.e., auditors should report on the accuracy and/or appropriateness of management's presentations and disclosures as measured against a defined set of accounting, disclosure and auditing standards.

- Auditor reporting should be standardized, with limited flexibility to (i) disclose deficiencies, and/or (ii) emphasize significant matter(s) that typically would already be disclosed by management.

[1] Similar to comments made by the Center for Audit Quality, June 28, 2011.

- Any changes to the auditor reporting model should be narrow and should be focused on better communicating what is actually done in the audit, not expanding the scope or providing original disclosures about the entity being audited.

We will discuss each of the proposals below under the following topics (consistent with the Concept Release):

1. Supplement the audit report with a new "Auditor's Discussion and Analysis"
2. Required and expanded use of emphasis paragraphs in the auditor's report,
3. Expand the audit scope to include information outside of the financial statements e.g., MD&A, Non-GAAP presentations,
4. Clarification or addition of certain language in the auditor's report
5. Considerations Related to Changing the Auditor's Report

In an attachment to this letter, we have included additional comments addressing the specific questions requested in the Concept Release.

***1. Supplement the audit report with a new "Auditor's Discussion and Analysis".***

We do not support a separate "Auditor's Discussion and Analysis". As a basic principle, we believe management of an entity, with close oversight by its Board of Directors and Committees (e.g., Audit Committee), is and should be responsible for assuring the fair presentation of the company's financial statements, the maintenance of effective internal controls over financial reporting, and the adequacy of disclosure relating to other required information (e.g., Business Description, Risk Factors, and MD&A among much more). In fact, each quarter the senior management of all public companies are required to certify to this and annually the members of the Board of Directors are required to sign the Annual Report Form 10-K. Although it is true that auditors, as a result of their audit process, should have "significant insight into the company" we do not believe that it is or should be the auditor's responsibility to communicate his or her observations and/or beliefs in this regard, many which are necessarily of a subjective nature, to the general public - this is the responsibility of management. Instead, auditors should continue to report on the accuracy of management's presentations and disclosures as reasonably measured against a defined set of auditing standards.

Besides the basic principles involved, it would simply not be practical, or cost effective, to require auditors to prepare a separate "Auditor's Discussion and Analysis" for external disclosure.

***2. Required and expanded use of emphasis paragraphs in the auditor's report.***

We do not agree with this proposal **to require and expand** the use of emphasis paragraphs within the auditor's report. We understand that such paragraphs are already available to the auditor to emphasize a matter(s) regarding the financial statements – we support this approach. The Concept Release lists several of examples which we will not repeat herein.

We believe that the financial statements should stand on their own and should generally not require additional information to be added by the auditors, unless of course there are deficiencies in the entity's reporting or if there is a matter that is extremely critical and needs to be emphasized to the user. If the reporting entity does not prepare its financial statements or disclosures appropriately, then the auditor is currently required to address this in the audit report in an appropriate manner, including the use of an emphasis paragraph. **There is no need to require the auditors to include an emphasis paragraph just for the sake of having an emphasis paragraph.** In fact, by making such emphasis paragraphs routine, it would actually reduce their usefulness.

If there are other areas that the PCAOB wants the auditor to cover in the audit report then that is a different question (see proposal No. 3 following).

***3. Expand the audit scope to include information outside of the financial statements e.g., MD&A, Non-GAAP presentations.***

Although we do not believe the scope of the audit should be expanded to include information outside of the financial statements, we believe it may make sense to consider expanding the audit report to include a full description of the scope and results of what is already being done in the audit. The PCAOB Concept Release states on page 23:

> "Current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., MD&A). These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact."

We believe it may make sense to incorporate this thought within the standard audit report in an appropriate manner. Although we make no judgments on the adequacy of current guidance in this area, if the PCAOB concludes there needs to be additional guidance to auditors in this regard, such standards can easily be promulgated. For example, in such additional guidance, the PCAOB may want to specifically require the auditors to read the reporting entity's critical accounting policies and/or risk factors and positively express their agreement, or include an emphasis paragraph if it the entity's disclosures are not appropriate or complete. However, we do not believe there needs to be an increase in the audit scope to accomplish the goal or in the reporting if the entity's disclosures are appropriate.

***4. Clarification or addition of certain language in the auditor's report.***

Although we are not experts in this area, it may make sense to modify the audit report to include wording that best describes what is currently being done in an audit. Some of the examples presented in the PCAOB Concept Release seem reasonable but we will leave the words to the experts who are currently practicing in this field. In concept, we do not disagree with the PCAOB's Concept Release in this regard.

**Considerations Related to Changing the Auditor's Report**

Starting on page 31 of the Concept Release, the PCAOB lists several "practical challenges and unintended consequences" that were brought up during the staff's outreach efforts. We agree with these concerns and they are real. The "practical challenges and unintended consequences" listed in the Concept Release are:

1. ***Effects on the Audit Effort.*** The PCAOB should continue to require a "standardized" audit report and should not expand the scope of the audit to include information outside the financial statements. Instead, if changed, the audit report should be modified only to better communicate what an audit already is and the audit conclusions thereon – all in a standard way. It would be counterproductive if auditors were required to prepare and issue a non-standardized report such as the Concept Release suggests e.g., in an "Auditor's Discussion and Analysis"

2. ***Effects on the Auditor's Relationship.*** We agree with the concerns expressed in the Concept Release. The stifling of auditor communications would be a terrible result. Companies need to have open communications with their auditors – it is good for the company and it promotes an effective audit. We should all remember the unintended consequences of the initial ASB/SOX 404 requirements which had the effect of stifling communications between the auditor and the company until later corrected. None of us want to live through that again.

3. ***Effects on Audit Committee Governance.*** We agree with the outreach participant concerns. Communications about the entity are the responsibility of the reporting entity, and its management and Board of Directors. Auditors should audit and communicate the results of their audit in a standard, and therefore, understandable way.

4. ***Liability considerations.*** We believe the concerns are well founded. History shows that more rules and subjective disclosures will inevitably give birth to more lawsuits.

Thank you for the opportunity to express our comments. We would be pleased to discuss our views with members of the Commission or with its staff. Please contact me at 203-837-2158 (chuck_jacobson@praxair.com) or Liz Hirsch (VP & Controller 203-837-2354, liz_hirsch@praxair.com) if you have any questions.

Very truly yours,

Charles L. Jacobson
Assistant Controller and Chief Accountant

**Attachment Re: PCAOB Concepts Release ("Concept Release") on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements – PCAOB Release No. 2011-003 June 21, 2011**

**Form of the Auditor's Report**

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

**Response:** As noted in the attached letter, we support improvements to the auditor's reporting model that are focused on better communicating what is actually done in the audit. We do not support expanding the scope or providing original disclosures. Any improvement effort should be narrowly focused.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

**Response:** We do not have significant problems with the current auditor's report. However, as noted in the attached letter, if warranted we believe it may make sense to consider revising the audit report to include a full description of the scope and results of what is already being done in the audit. The audit report should not be the original source for disclosures about the entity and the scope of the audit should not be expanded

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

**Response:** As noted in the attached letter, we do not believe the scope of the audit should be expanded to include information outside of the financial statements. However, if warranted we believe it may make sense to consider expanding the audit report to include a full description of the scope and results of what is already being done in the audit. The PCAOB Concept Release states on page 23:

> "Current auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements (e.g., MD&A). These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact."

We believe it may make sense to incorporate this thought within the standard audit report in an appropriate manner. Although we make no judgments on the adequacy of current guidance in this area, if the PCAOB concludes there needs to be additional guidance to auditors in this regard, such standards can easily be promulgated. For example, in such additional guidance, the PCAOB may want to specifically require the auditors to read the reporting entity's critical accounting policies and/or risk factors and express their agreement, or include an emphasis paragraph if it not appropriate or complete. Because auditor's already do this, we do not believe there needs to be an increase in the audit scope to accomplish the goal or in the reporting if the entity's disclosures are appropriate.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so, why?*

**Response:** Yes. The purpose of an audit is to do exactly this and the "pass/fail" model presents a clear conclusion that is well understood. If the Board believes certain terms need to be better defined (e.g., material), this should be done outside of the auditor's report (e.g., by a website link to the literature that provides the appropriate definitions).

*b. If not, why not, and what changes are needed?*

**Response:** See response to a.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

**Response:** See response to items 1. And 2.a. above.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

**Response:** Management. As noted in the attached letter, we believe management of an entity, with close oversight by its Board of Directors and Committees (e.g., Audit Committee), is and should be responsible for assuring the fair presentation of the company's financial statements, the maintenance of effective internal controls over financial reporting, and the adequacy of disclosure relating to other required information (e.g., Business Description, Risk Factors, and MD&A among much more). Although it is true that auditors, as a result of their audit process, should have "significant insight into the company" we do not believe that it is or should be the auditor's responsibility to communicate his or her observations and/or beliefs in this regard, many of which are necessarily of a subjective nature, to the general public. This is the responsibility of management.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

**Response:** Amendments are not necessary. The current reporting is clear and well understood and does not need to be changed again.

### *A. Auditor's Discussion and Analysis*

*5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

**Response:** No. We do not support an AD&A. See attached letter.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

**Response:** We do not support an AD&A. However, if the Board continued with the AD&A concept it should definitely be limited to the audit and not include the financial statements.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

**Response:** As described in the attached letter, there is no need for the auditor to provide "supplementary comments" on the audit or the company's financial statements beyond expressing their required opinions and other disclosures that are already part of the reporting framework. There is no need for subjective comments, judgments, interpretations etc. as discussed in the Concept Release.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

**Response:** For the reasons stated in the attached letter, we do not support the need for an AD&A. Also, see our response to Question 1. C.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

**Response:** For the reasons stated in the attached letter, we do not support the need for an AD&A or the requirement for an auditor to discuss any of these subjective matters. There should be no AD&A.
The auditor should not be required to discuss its "views" on the company's financial statements except to provide the required opinions. Nor should the auditor be required to discuss management judgments and estimates, accounting policies, and difficult or contentious issues, including close calls.

If implemented, there would also be significant negative consequences, many of which are identified in the Concept Release. The stifling of auditor communications would be a step backward again. Companies need to have open communications with their auditors – it is good for the company and it promotes an effective audit. We all remember the unintended consequences of the initial AS2/SOX 404 requirements which had the effect of stifling communications between the auditor and the company until later corrected by AS5. None of us want to live through that again. Also, there would be significant costs associated with the preparation of such information, without the commensurate benefit.

*8. Should a standard format be required for an AD&A? Why or why not?*

**Response:** For the reasons stated in the attached letter, we do not support the need for an AD&A. Also as stated in the attached letter, we believe the Board should continue to require a standard audit report.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

**Response:** Such risks should not be included in any standard auditor reporting. Communications about the entity (e.g., business risks, strategic risks, operational risks, etc) are the responsibility of the reporting entity, and its management and Board of Directors. Auditors should audit and communicate the results of their audit in a standard, and therefore, understandable way.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

**Response:** For the reasons stated in the attached letter, we do not support the need for an AD&A. However, we believe boilerplate language would be almost impossible to avoid.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

**Response:** See attached letter.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

**Response:** For the reasons stated in the attached letter, we do not support the need for an AD&A. There should be no AD&A.

However, in a hypothetical world, we believe as a practical matter the potential for inconsistent or competing information is extremely low. The auditor is already required to read information that is disclosed outside the financial statements to be sure that it is consistent with the financial statements. This includes the business section, risk factors, the MD&A (including critical accounting policies), and much more. Through this process, entity management already has the benefit of the auditor's comments. Therefore, we do not believe management's disclosures would change significantly and I do not believe the auditor's would add anything new.

In part, this process is precisely why an AD&A is not needed.

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

30 September 2011

**RE: PCAOB Rulemaking Docket Matter No. 34, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards***

Dear Sir:

**Overview of our key message**

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's (the "Board") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release"). We commend the Board for its outreach to investors and others as a basis for developing the Concept Release and for its continued outreach via the public roundtable held on September 15, 2011. Results of that outreach clearly call for changes to the auditor's reporting model to increase its transparency and relevance. Recent projects undertaken by global standard-setters, in particular the International Auditing and Assurance Standards Board's (IAASB) consultation paper *Enhancing the Value of Auditor Reporting: Exploring Options for Change,*[1] and regulators further underscore the call for change. We also believe the time is right for changes to the auditor's reporting model, and further agree with the Board that any change cannot compromise audit quality. We believe:

- Changes should be driven by a clear set of principles to ensure all changes add value and increase relevance.
- Some changes can be made in the shorter term but any other reforms need to be framed as part of a wider consideration of the corporate reporting model.
- The public interest will be best served by different standard-setters working collaboratively to ensure that, as far as possible, consistent models are developed.

**Importance of corporate reporting context**

The fall-out of the financial crisis still reverberates around the world. In many ways, the crisis fundamentally shifted the way the world views the capital market systems. It also created a compelling case to consider reforming the corporate reporting model to better meet the information needs of users. Developing a relevant and valued corporate reporting model for the upcoming century will require the active engagement and collaboration of many — management, directors, investors, auditors, regulators, policy makers, legislators, as well as standard-setters.

[1] The IAASB consultation paper explores similar alternatives and the network of member firms of PricewaterhouseCoopers International Limited responded to this proposal on September 16, 2011.

*PricewaterhouseCoopers LLP, 400 Campus Drive, Florham Park, NJ 07932*
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The current audit report pertains only to the financial statements and, for certain issuers, internal control over financial reporting. As corporate reporting evolves, a more comprehensive assurance model can further enhance the relevance and value of the auditor's role, which may potentially include opinions that cover other aspects of the company's reporting. We believe the PCAOB collaborating with the IAASB can, and should, play a leading role in promoting that debate, and we stand ready to work collaboratively with all interested parties to actively drive this agenda forward.

The Concept Release is framed within the context of today's corporate reporting model. We believe that genuine enhancements in auditor reporting can be made in the shorter term even with that constraint. Such improvements alone may not provide the informational value and greater insights many are seeking and, therefore, we continue to emphasize the importance of longer-term consideration of the corporate reporting model. Options proposed that we believe are not practicable in the shorter term — as well as options not yet even considered — may become viable as the wider corporate reporting model evolves.

**Why change today's auditor reporting?**

Today's audit underpins confidence in financial reporting. Its value rests in the reliability of audited financial statements that is pivotal to the effective functioning of the capital markets.

The audit report inevitably influences users' perceptions of audit quality and relevance. Users tell us that the current auditor's report is not meeting their needs as well as it could. They greatly value the auditor's opinion on the financial statements, but they would like more informative reporting — greater insight into the company's financial reporting and the audit, as well as assurance or related services on other information not within the scope of today's financial statement audit — which forms the basis for the alternatives for change proposed in the Concept Release.

**Our overarching principles for effective auditor reporting**

As we evaluated the alternatives for additional auditor reporting in the Concept Release, we assessed them against the following principles. We found them to be useful guideposts to identifying constructive changes and avoiding changes that may not accomplish the stated objective in the Concept Release of increasing auditor transparency and relevance, while not compromising audit quality.

1. **Changes made to auditor reporting should:**

   - **Maintain or improve audit quality.** Audit quality is paramount and could be negatively affected if a proposed solution inadvertently reduced the auditor's ability to obtain sufficient appropriate audit evidence.
   - **Enhance the value of the audit to users**. Users should see substantive value from the changes. To be sustainable, the incremental benefits of that additional information should exceed the costs involved.
   - **Increase the reliability of information the company provides in public reports.** Providing assurance on information that previously was not subject to audit/assurance directly affects its reliability. Some of the options may also have an indirect positive impact if they serve to increase the attention that management and audit committees pay to those elements of their corporate reporting.

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2. **Changes should maintain or enhance the effectiveness of the relationships and interactions of auditors, audit committees and management in the financial reporting process.** The audit model depends on effective communication among the participants in the financial reporting process. Professional skepticism and challenge are key elements of an audit. Audit effectiveness also depends on the ability of the auditor to have effective communication with and obtain information from management and audit committees. The impact of the proposed solutions on the interrelationships among auditors, audit committees and management needs to be considered so that they do not have a negative impact on audit quality by impeding these important interactions.

3. **Auditor reporting should be sufficiently comparable**. Any move away from a completely standardized report and opinion will inevitably introduce some variation. Financial reporting and auditing also require significant exercise of professional judgment. Any solutions proposed must result in information that can further contribute to market confidence in audited financial statements. Auditor's reporting on information that is subjective or variable (such that two auditors given the same fact pattern and information could come to different conclusions and issue substantively different reports) will not meet this criterion.

4. **Auditor reporting can provide greater insight based on the audit but the auditor should not be an original source of factual data or information about the company.** Factual data or information about the company should be reported by the company (i.e., by management and/or audit committees) to avoid blurring the responsibilities of auditors, management and audit committees. This is also important to avoid confusion and disrupting capital markets by providing competing views of the true underlying picture of the company's ’s financial position and/or performance.

**Our vision of responsive changes in auditor reporting**

It is our understanding that today's pass/fail model contributes to the value placed on audited financial statements by market participants; therefore, we believe this model should be retained. Our vision of enhanced auditor reporting in the context of today's corporate reporting model retains what is working well but makes it better by:

- Highlighting the significant judgments disclosed by management in preparing the financial statements through the use of emphasis paragraphs in the auditor's report.
- Expanding auditor involvement to provide additional assurance on or other auditor association with other aspects of a company's corporate reporting (where the benefits of that additional assurance are agreed to exceed the costs).
- Clarifying certain aspects of, and adding additional information to, the standard auditor's report, principally to reduce any perceived expectations gap.

We also believe that some of the changes being sought with respect to the audit report — including, in particular, those that put the auditor in the position of reporting financial information for management — would be better met by changes to the broader corporate financial reporting model. Such proposals for change should be addressed holistically by all participants in the financial reporting supply chain to achieve meaningful change. This longer-term effort would involve examining opportunities for improvement in the roles/responsibilities of:

- Preparers – Consider whether disclosures should be expanded, streamlined and/or otherwise improved.
- Audit committees – Consider whether expanded and/or improved information about audit committee oversight activities should be provided. A secondary question exists regarding whether users believe additional benefits would be provided if the auditor provided assurance on or were otherwise associated with an expanded audit committee report.
- Regulators/ standard-setters – Consider whether enhanced disclosures by preparers could be achieved, where considered necessary.

This holistic approach is consistent with the feedback obtained from the Center for Audit Quality's (CAQ) role of the auditor (RoA)[2] working group.

Our comments on the specific alternatives outlined in the Concept Release follow.

**Required and expanded use of emphasis paragraphs**

As stated in the Concept Release, this alternative would mandate the use of emphasis paragraphs in all audit reports to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements. The Concept Release states emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation. With respect to each matter of emphasis under this alternative, the Concept Release also raises the possibility the auditor could be required to comment on key audit procedures performed pertaining to the identified matters.

We believe the required use of emphasis paragraphs could be a viable approach to enhance the navigability of management's disclosures by highlighting where the auditor believes management's significant judgments related to financial reporting, including areas with significant measurement/estimation uncertainty, are described in the financial statements.  In the short term, this improved navigation could be responsive to stakeholders' call in the CAQ's RoA working group for disclosures to be more streamlined and focus on what is significant.

Question 17 of the Concept Release asks how boilerplate language can be avoided in required emphasis paragraphs while providing consistency among audit reports. With respect to providing emphasis paragraphs highlighting management's significant judgments disclosed in the financial statements, we do not believe this would be a significant issue. First, the significant judgments may change from year to year, but even if they do not, standard language can still provide meaningful information to users of the financial statements if it draws attention to those accounting and disclosures areas of significance.

Subject to our comments below, we believe this alternative could be consistent with our overarching principles.

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[2] The Center for Audit Quality's (CAQ) role of the auditor (RoA) working group is evaluating what additional work auditors might perform beyond their current responsibilities to better meet the needs of users, and to that end has hosted a series of discussion roundtables seeking feedback from investors, analysts, audit committee members, preparers, attorneys and academics. The CAQ has published a summary report that highlights observations from participants in these roundtables.

***Population of matters to be emphasized***

As discussed in our overarching principles, we believe effective implementation of the emphasis paragraph alternative depends on auditor reporting that is sufficiently similar to facilitate users' comparison of such matters among different companies. Accordingly, we believe that auditing standards should provide a clear framework for identifying the matters to be referenced in the auditor's report. Clear guidelines should be established for the identification of matters to be emphasized in order to facilitate comparability, and also to avoid the emphasis of too many matters. In addition, the clear identification in auditing standards of what matters are required to be emphasized would help mitigate the potential unintended consequence that users would use emphasis paragraphs as an indicator that other financial reporting disclosures that are not emphasized are not important to an understanding of the financial statements. This approach is consistent with the feedback from the CAQ's RoA working group that believed it would be beneficial for the auditor to highlight the highest risk areas of financial statements which could result in improved disclosures throughout the annual report, including Management's Discussion and Analysis (MD&A).

The extent of disclosure in the auditor's emphasis paragraphs, as well as the population, should also be addressed in the Board's standards. In keeping with the auditor's role of attesting to management's assertions so that management, not the auditor, remains the original source of a company's disclosures, we also believe that emphasis paragraphs in the auditor's report, if required, should provide only a high level summary of the facts already presented within the financial statements and leave the details for the financial statement disclosure that is referenced.

***Disclosure of auditing procedures in response to matters identified***

The Concept Release raises the possibility of the auditor's disclosure of key audit procedures that are responsive to the areas emphasized in the auditor's report. Although providing this information seems reasonable conceptually, and the CAQ's auditor's reporting model (ARM)[3] working group efforts included developing examples of how such disclosure could be implemented, certain challenges cannot be overcome. In particular, identifying only certain procedures in the absence of sufficient context regarding the audit approach, auditor's risk assessment and methodology could diminish users' perception of the auditor's work effort, which may increase the expectations gap by exacerbating, rather than reducing, perceived misconceptions of audits. On the other hand, a more complete discussion of the audit procedures could result in "disclosure overload," and could easily become either too technical or lead to boilerplate descriptions of "standard" procedures. In addition, the auditor's discussion of audit procedures related to emphasis paragraphs may be misinterpreted by some as the auditor's expression of an opinion on the matters emphasized.

For these reasons we are not supportive of disclosing the key audit procedures performed pertaining to the areas emphasized; however, if such an approach is pursued, we believe a more appropriate approach to disclosure of auditing procedures is included in the CAQ response letter to the PCAOB dated June 28th which concludes the emphasis paragraph section of the illustrative auditor's report with the following statements: that our audits included performing procedures designed to address the risks of material

[3] The CAQ's auditor's reporting model (ARM) working group is exploring changes to the auditor's reporting model that could best serve users' needs for additional information from auditors without compromising audit quality. The initial results of this group were communicated in a comment letter to the PCAOB dated June 28, 2011, and an additional comment letter is expected to be issued for the Board's consideration.

misstatement associated with the above matters; such procedures were designed in the context of our audit of the consolidated financial statements taken as a whole, and not to provide assurance on individual accounts or disclosures; and that our audits also included procedures in response to other identified risks of material misstatement and procedures required by professional standards that have not been specifically included herein.

**Auditor assurance on other information outside the financial statements**

The Concept Release discusses, and we agree, that many users rely on MD&A and other financial information (e.g., non-GAAP information and earnings releases) in addition to historical audited financial statements. As a result, we believe, if there is market demand, additional auditor assurance on other aspects of the company's corporate reporting would improve the quality, completeness, and reliability of such information as discussed in the Concept Release. This alternative is also consistent with the feedback received from the CAQ's RoA working group.

We believe that auditor reporting on information outside the financial statements is a natural expansion of the role of the auditor — to enhance the reliability of information provided by management — into new areas and, as such, it may be viewed as a continuum building on the audit of financial statements and, for certain issuers, the audit of internal control over financial reporting. Importantly, it is consistent with the principles articulated above and preserves the auditor's core role of attesting to information provided by management.

In the shorter term, we support the proposal in the CAQ response letter dated June 28th for an examination engagement to provide an opinion on the Critical Accounting Estimates (CAE) disclosure in MD&A. The advantages to this approach include that it is responsive to calls for more emphasis on the important judgment calls made in preparing the financial statements, including accounting estimates. Auditor attestation should also serve to improve disclosures in this important area.

In addition, focusing on a specific aspect of MD&A provides some practical advantages for implementation. As a starting point, the SEC has provided guidance in disclosing critical accounting estimates for management. We acknowledge that the SEC would need to consider whether amendments to Regulation S-X are necessary to require this new attestation report, and whether further rulemaking would be necessary to consolidate existing CAE requirements into Regulation S-K. Other practical advantages of focusing on a *specific* aspect of MD&A, rather than *all* of MD&A, include easing the time pressure of meeting SEC filing deadlines and limiting the incremental costs of such reporting.

Assuming there is market demand for auditor assurance on or association with earnings releases and non-GAAP information, we believe the Board should consider these as a separate project (or projects) because more extensive development would be needed to enable such engagements. While we support further consideration of this topic, based on discussions during the PCAOB's September 15th roundtable, it is unclear how strong the demand would ultimately be even for more limited auditor involvement and communication, such as whether the historical financial information included in earning releases or non-GAAP information agrees to the books and records subject to audit. Regardless, the PCAOB would need to develop more specific guidance for auditors; accordingly, consideration of increased auditor involvement with such information should be addressed separately. In addition, any proposal that increases the level of auditor involvement with such information — examination-level or otherwise — would also need to consider the appropriate legal framework being in place.

**Clarification of the standard auditor's report**

The Concept Release also discusses proposals to clarify certain language in the standard auditor's report. As discussed above and consistent with views expressed in the Concept Release, we believe the pass/fail model and standardized language of the auditor's report provide consistency, comparability, and clarity in auditor reporting and should be retained.

We also believe the Concept Release proposals to clarify certain language in the standard auditor's report will result in enhanced understanding of what an audit represents and the related auditor responsibilities, thus narrowing the expectations gap. These enhancements are consistent with our overarching principles, do not change the scope of the audit, would be free of incremental costs to implement, and could be achieved in the short term through the Board's standard-setting activities.

We identify below certain changes that we support conceptually. For specifics of suggested language and its location in the report, we are supportive of the illustrative language provided by the CAQ in its June 28th response letter, which also includes some items not addressed by the Board in the Concept Release. Also, the IAASB has explored other alternatives to the "core" elements of the IAASB standard auditor's report on the financial statements, and we would encourage the Board to work with the IAASB to ensure consistency, to the extent possible, related to the content and format of these "core" elements.

We agree that the addition of clarifying language related to the following concepts is appropriate:

- *Reasonable Assurance* – Clarify that reasonable assurance is a "high level of assurance, but not absolute assurance; therefore, an audit may not always detect a material misstatement."
- *Auditor's Responsibility for Fraud* – Add the words in boldface italics to the following sentence in the standard auditor's report to clarify the auditor's responsibility for fraud: "Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement ***whether due to error or fraud***."
- *Auditor's Responsibility for Financial Statement Disclosures* – Explicitly identify that the footnotes are an integral part of the financial statements and are covered by the audit report.
- *Management's Responsibility for the Preparation of the Financial Statements* – Provide an expanded discussion covering management's responsibilities for the financial statements, internal control over financial reporting, and the 10-K.
- *Auditor's Responsibility for Information Outside the Financial Statements* – Describing the procedures performed by the auditor on information outside of the financial statements would clarify the auditor's responsibility with respect to such information, and help reduce the expectations gap by addressing the misperception that the auditor's opinion covers such information.
- *Auditor Independence* – Identify that the auditor is independent within the meaning of all relevant SEC and PCAOB standards.

Other changes to the standard audit report, highlighted in the CAQ example provided in the June 28th letter, that we would support as being more beneficial to reduce the expectations gap are as follows:

- *Audit Committee Responsibilities* – Provide an expanded discussion covering audit committee responsibilities.

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- *Addressing the Audit Report* – Address the audit report to the shareholders of the company in addition to the Board of Directors.
- *Professional Judgment* – Highlight the necessity of using professional judgment in assessing audit risks, in the selection of audit procedures, and the consideration the auditor gives to the issuer's internal control over financial reporting when responding to such risks.
- *Scope Limitations and Non-Compliance with U.S. Generally Accepted Accounting Principles (GAAP)* – Outline the auditor's responsibilities in the event a conclusion is reached that the financial statements are not in accordance with GAAP or in situations where audit scope is limited.
- *Material Misstatements & Assessment of Materiality* – Identify what is meant by the term "material misstatement" and discuss the approach used by the auditor to assess "materiality".
- *Clarifying that Audit Evidence is often Persuasive not Conclusive* – Clarify that the audit evidence the auditor obtains is often persuasive rather than conclusive.

**Auditor's discussion and analysis (AD&A)**

As discussed in the Concept Release, the AD&A alternative would require a supplemental narrative report that could provide users with a view of the audit and the financial statements "through the auditor's eyes."

We appreciate that additional insights or views related to the audit and the financial statements are desired by certain market participants but we believe the practical challenges and the unintended consequences that negatively impact audit quality and the overall financial reporting process cannot be overcome. As a result, we are not supportive of the AD&A alternative outlined in the Concept Release, as further discussed below. We also believe this would likely be the costliest and most time-consuming of the alternatives, diverting the attention of audit firms' resources from performing the audit to chronicling it, all at the risk of reducing audit quality. For the reasons described above, we believe the other alternatives are better solutions, without compromising audit quality.

***Auditor's views regarding the company's financial statements***

The AD&A approach would result in auditors communicating original information about the company, creating a fundamental shift from the auditor attesting to information provided by management to the auditor providing original information about the company. We believe this could result in several unintended consequences, including undermining the roles and responsibilities of the audit committee, management, and the auditor and further widening of the expectations gap.

Much of the information that the auditor would be required to disclose about the financial statements under the AD&A proposal, including, for example, management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls," is currently required to be discussed with audit committees. Communications between auditors and audit committees have become increasingly robust in recent years, improving the quality of both audits and financial reporting. We are concerned that a requirement for auditors to disclose their views about what are the more subjective areas of the financial statements may reduce the audit committee's and management's willingness to engage in an open and candid dialogue with the auditor, which is critical to the performance of a high-quality audit. Therefore, in our view, such a requirement has the potential to *reduce* audit quality and the quality of financial reporting. Such information, if required to be disclosed, should first be disclosed by the company. This is also consistent with the feedback received from the CAQ's RoA working group.

We also question what value users would find in the disclosure of matters that had been the subject of deliberation by the auditor and management, discussed with the audit committee and resolved. The key point from the perspective of users should be that such issues have been resolved to the satisfaction of the auditor in forming his or her opinion on the financial statements. If reported at all, such matters should be disclosed by the company.

The potential for an AD&A to present inconsistent or competing information between the auditor and management cannot, in our view, serve the public interest. On the other hand, as a practical matter, an AD&A requirement could force the resolution of inconsistent views prior to the issuance of the financial statements such that management and the auditor would make redundant, rather than competing, disclosures — resulting in increased disclosure overload.

Finally, we believe that AD&A disclosures would be highly susceptible to misinterpretation without the context of the dialogue that occurs between auditors, management, and audit committees. In requiring the auditor to provide the auditor's "perspectives" or "impressions" on management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls," the AD&A approach focuses on the subjective rather than the objective. When such matters are communicated by the auditor to the audit committee, the audit committee has the benefit of further discussion with the auditor to explore complex matters at the appropriate level of detail. Additionally, the audit committee has the benefit of periodic communications with the auditor throughout the year as well as information derived through its oversight of the financial reporting process, which also provide further context. Users lack the benefit of such information and periodic dialogue with the auditor to provide context for the information that would be communicated in an AD&A. As an example, AU 380.11 states that, "Objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting principles as applied in the financial statements." Auditor communications with audit committees on that topic necessarily rely on the important dynamics involving auditor and audit committee discussions—an opportunity for dialogue that is not available to readers of the auditor's report.

Additionally, we believe it would be very difficult for audit firms to ensure any consistency in reporting related to an auditor's “perspectives” or “impressions” on management's reporting. One audit partner's subjective opinion regarding a “close call” may differ significantly from that of another, which could result in unintended consequences for an issuer in comparison to its peers. Without consistency in what is communicated, the AD&A requirement would diminish the comparability between companies, including those in similar industries.

***Information about the audit***

Providing greater insight into the audit through a discussion of the significant risks identified by the auditor and the audit procedures and results responsive to those risks conceptually appears reasonable as discussed in the Concept Release. However, the practical challenges of implementing this type of reporting cannot be overcome. For example, fraud risks by definition are significant risks. In the auditing standards, the risk of management override and a presumption of improper revenue recognition are fraud risks for all engagements. Publicly disclosing the risks, procedures, and results related to these and other potential fraud risks may cause confusion and increase the expectations gap, as the auditor assessing fraud risks during an audit does not mean that fraud has occurred or even that the entity presents a heightened risk of fraud.

The disclosure of significant risks poses practical implementation challenges, regardless of whether they reflect fraud risks. Significant risks by definition are risks of material misstatement that require special audit consideration. This definition inherently and appropriately requires auditor judgment, both in terms of identifying significant risks and in terms of designing and performing procedures that are appropriately responsive. As a result, there could be multiple reasons why an auditor believes that something requires special audit consideration in the context of the particular circumstances of an engagement. This would lead to considerable variation in the risks disclosed among audit reports, and the lack of comparability would be confusing. These potential unintended consequences would have a negative impact on audit quality and, as discussed above, we believe that users would be better served by the auditor's use of emphasis paragraphs linked to significant judgments made by management instead of significant risks identified by the auditor.

For the same reasons discussed under the emphasis paragraph alternative above, we do not support disclosing audit procedures performed in response to significant risks. Such disclosures will either be too succinct and lead to misperception about the extent of the auditor's work, widening the expectations gap, or fully describe the auditor's response in a voluminous disclosure that would not be useful.

Lastly, the Concept Release contemplates an AD&A requirement for the auditor to discuss specific independence matters communicated to the audit committee under PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*. We believe a public discussion regarding independence in an AD&A is unnecessary due to the existing governance function of the audit committee to assess auditor independence, the external monitoring of auditor independence by the PCAOB, SEC and the firm itself, and existing means by which the auditor can communicate independence to users. Under current PCAOB standards, the auditor is required to be independent, and every auditor's report is required to be titled, "Report of Independent Registered Public Accounting Firm." We also support adding clarifying language to the standard auditor's report related to auditor independence as discussed in the "Clarification of the standard auditor's report" section of our letter. We believe a requirement to publicly communicate further detailed information regarding auditor independence could result in misinterpretations regarding the independence of the auditor.

Question 9 of the Concept Release discusses that some investors suggested that, in addition to audit risks, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks, and asks "what are the potential benefits and shortcoming of including such risks in an A&DA?" Auditing Standard 12, *Identifying and Assessing Risks of Material Misstatement*, requires the auditor to obtain an understanding of the company's objectives, strategies and related business risks to identify business risks that could reasonably be expected to result in material misstatement of the financial statements. Given the relatively limited scope of the auditor's consideration of business risks, strategic risks, or operational risks in comparison to management's knowledge, it's not clear how the auditor's discussion of these risks would add value to users. Further, this proposal is inconsistent with the principle that information about the company should be reported by management or the audit committee. As a result, we are not supportive of these disclosures.

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## Other considerations

***Cost considerations***

With the exception of changing language in the standard auditor's report, implementing any of the alternatives would involve increased costs. We believe the appropriate analysis is whether the benefits of any given alternative outweigh the costs. We believe AD&A, which would require significant resources both to draft and to review, would likely be the most costly, and in our view also poses a threat to audit quality. Assurance engagements to expand auditor reporting to other information outside the financial statements would be an added cost but the benefits may outweigh it if the result is increased perceptions of the reliability of the information received. As discussed above, the incremental cost of a separate assurance engagement on MD&A could be limited by focusing on the CAE aspect of MD&A. Even mandated emphasis paragraphs would require preparation and review time and increased discussion with management and audit committees, thus resulting in incremental costs. Whether the potential benefits of various options exceed the incremental costs is ultimately a matter for the marketplace to determine.

***Liability considerations***

We believe many of the alternatives being considered involve a potentially significant increase in legal risks for auditors. It is therefore important that appropriate auditor liability protections are also considered. In particular, auditor liability reform should be linked to proposals that increase auditors' responsibilities related to information outside of the annual financial statements and enhance auditor transparency, both of which increase auditor exposure to litigation risk.

***Suggested PCAOB Actions***

Except for changes related to clarifying the standard audit report, we believe the PCAOB should consider the following actions before requiring any changes to the auditor's reporting model:

- Further develop the content of any changes to the auditor's reporting model through more detailed examples. Share these examples with all stakeholders, including a wide variety of users.
- Consider field testing as a mechanism to assess the feasibility and effectiveness of any changes prior to full-scale implementation.

In responding to Q30, whether the proposed alternative(s) should be applied to all financial statements filed by public companies, investment companies, investment advisers, brokers and dealers, and others depends on which alternative(s) the Board chooses to pursue. We believe the clarifications to the standard auditor's report should apply to all companies but the other alternatives may need to first be field tested before determining which audits they should apply to.

## Conclusion

The time is right to enhance auditor reporting. Users' needs are more clearly articulated than ever before. Responding to those needs is critical to maintaining the value and relevance of the audit. Valuable enhancements can be made now that move us some way to achieving the goal of more informative and valuable auditor reporting.

As solutions are developed, it is critical that active, continuous and open dialogue among auditing standard-setters, regulators, investors, and other stakeholders occur. In particular, we urge the PCAOB to

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work in collaboration with the IAASB in relation to their respective consultation papers to develop solutions that work globally. Significantly different auditor reporting models in a global market is not in the public interest. Some flexibility between jurisdictions may be needed, but unnecessary differences in approach should be avoided.

* * * * *

We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (973-236-4328), Brian R. Richson (973-236-5615) or Marc A. Panucci (973-236-4885) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

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September 30, 2011

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

RE: PCAOB No. 2011-003, Rulemaking Docket No. 34 – Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Mssrs. Doty, Ferguson, Goelzer, Hanson, and Harris:

I commend the PCAOB for initiating its project on improvement of the auditor's reporting model. It's an effort worthy of the PCAOB's mission to strengthen the audit process for the benefit of investors. The current auditor's opinion, while concise, does not convey to investors any significant insights obtained by auditors during the audit process. Rather than perpetuating the audit reports investors rarely read, if ever, I think it is wise to consider if there are other ways the auditor can provide genuine value to the investor.

The chief information given to investors in the current auditor's opinion is that the financial statements are presented in accordance with generally accepted accounting principles. When you consider that there are thousands of pages of accounting standards, and often, alternative accounting treatments for one particular kind of transaction, the current auditor's opinion really says very little to the investor. It's even less information in comparison to the time spent on the job by the auditor and the kinds of insights the auditor should be obtaining.

<u>Investors – the real client of the auditor, not the firm audited - depend on the auditor to be their "eyes, ears and nose" when they are inside the audited firm.</u> Auditors executing their duties under PCAOB auditing standards should be aware of many more facts than are currently conveyed by the auditor's report, and if executed properly, these findings could help investors better understand the risks entailed in a particular investment, thereby enabling them to improve their investment decision-making.

Changes to the status quo will always make some parties uncomfortable. One defense of the status quo is likely to be that any modifications to the auditor's report will result in increased audit costs. If the information provided to investors is valuable, then investors – who are the ones actually bearing the costs of the audit - would be unlikely to complain about increases in audit fees. In fact, I have never encountered an investor who complained about the size of audit fees; if investors discuss audit fees at all, they might wonder sometimes how a legitimate audit was accomplished at such a low fee. Likewise, I have never encountered a company that blamed a poor earnings report on audit fees that were too high.

Auditing firms should be looking for ways to justify increases to their audit fees; putting more information into the auditor's report would be a good justification for increasing fees. It may sound odd to promote higher audit fees, but the audit profession needs to find auditing profitable in comparison to non-audit endeavors like consulting – or auditing will always be a second fiddle to more lucrative ventures, making it harder to attract and retain the most competent and motivated auditing talent. Investors do not benefit if auditing is a second-tier function in accounting firms, and improving communications to investors is an opportunity for audit firms to better their audit operations by improving the lot of investors.

<u>Suggesting that audit fees should increase (as long as value is given for an increase) is not a glib proposition.</u> Our firm has conducted a study of the audit fees, plus audit-related fees, for the 461 firms currently contained in the S&P 500 for which fee data is available for all of the years between 2002 and 2010. A summary compilation of audit and audit-related fees, by firm, appears at the top of the next page.

## S&P 500 Audit Fees By Auditor

| *($ in millions)* | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|---|---|---|
| PricewaterhouseCoopers | $1,659 | $1,665 | $1,582 | $1,551 | $1,517 | $1,482 | $1,468 | $997 | $795 |
| Ernst & Young | 934 | 920 | 940 | 912 | 874 | 776 | 698 | 525 | 481 |
| Deloitte & Touche | 914 | 905 | 979 | 1,003 | 961 | 886 | 756 | 489 | 432 |
| KPMG | 743 | 739 | 764 | 732 | 713 | 638 | 596 | 399 | 313 |
| BDO Seidman | 8 | 7 | 8 | 7 | 5 | 5 | 9 | 9 | 1 |
| Grant Thornton | - - | - - | - - | - - | - - | - - | 1 | 1 | 1 |
| Arthur Andersen | - - | - - | - - | - - | - - | - - | - - | - - | 2 |
| | $4,258 | $4,236 | $4,273 | $4,205 | $4,070 | $3,787 | $3,528 | $2,420 | $2,025 |
| **Annual % change:** | ***0.5%*** | ***-0.9%*** | ***1.6%*** | ***3.3%*** | ***7.5%*** | ***7.3%*** | ***45.8%*** | ***19.5%*** | |
| **Total change: 2002 - 2006** | ***101.0%*** | | | | | | | | |
| **Total change: 2006 - 2010** | ***4.6%*** | | | | | | | | |

*Table was constructed from the audit fees and audit-related fees listed in the proxies for 461 S&P 500 companies operating as separate independent entities for the entire period.*

Notice that audit and audit-related fees doubled between 2002 and 2006, due to the implementation of the Sarbanes-Oxley Act. From 2006 to 2010, however, audit and audit-related fees remained essentially flat, not even keeping pace with inflation – and this period encompasses the financial crisis, a period in which auditors would be expected to spend more time and effort in discharging their duties. One wonders if firms were able to keep audit performance high during this period: auditors' risk levels certainly didn't decrease, and investors would have to hope that they were spending the proper amount of time in conducting fieldwork. Did audit firms keep hours spent on fieldwork and audit quality high, and suffer their own decreased financial performance? Or did they cut corners on hours spent on fieldwork while preserving their own profitability? It's hard to tell because the audit firms do not present any of their own financial information to the public, but it's clear that in the long run, investors can't expect audit fees to stay low forever if they expect to benefit from high audit quality.

I hope all audit firms, both large and small, will support the concept release and work toward serving their investor clients better by trying to foment some of the suggested changes. The following is an expansion of the four proposed changes from the investor's point of view.

**Auditor's Discussion and Analysis (AD&A).** I believe the Auditor's Discussion & Analysis is the single best proposal in the concept release. Properly prepared as a supplemental report, this document would be the best means for auditors to communicate to investors as their agent inside the investee firm.

According to Auditing Standard No. 9, the planning of an audit requires the auditor to consider:

• Matters affecting the industry in which the company operates, such as financial reporting practices, economic conditions, laws and regulations, and technological changes;

• Matters relating to the company's business, including its organization, operating characteristics, and capital structure;

• Public information about the company relevant to the evaluation of the likelihood of material financial statement misstatements and the effectiveness of the company's internal control over financial reporting;

• Knowledge about risks related to the company evaluated as part of the auditor's client acceptance and retention evaluation; and

• The relative complexity of the company's operations.

During this planning process, the auditor should become aware of circumstances, both inside and outside of the firm, that will have an impact on the conduct of the audit. Those circumstances and/or risks would make an excellent discussion topic for the Auditor's Discussion & Analysis. They could include an identification of the factors that the auditor considered most important in planning the audit, and how the identified factors affected the allocation of auditor resources in conducting the audit. The factors that would affect the way an auditor thinks about risks of material misstatement of financial information might also affect the way that an investor views risks of an investment in the firm – if the risks were communicated to investors. I believe that many investors don't always adequately consider investment risks as much as they consider investment rewards. Adding more information about risks from another point of view – one coming from an advocate of the investor – might help some investors change their thinking before investing.

The AD&A could also be integrated with the "Risk Factors" section appearing in SEC filings. These are often useful to investors, but are also frequently so comprehensive that they seem to be developed as a sort of prophylaxis against legal liability, as if warning investors about any possible downside will neutralize a potential lawsuit. If the AD&A presents an informative discussion of the risks observed by the auditor from the inside of the firm, it could perhaps replace some of the boilerplate risk factors. Another possibility: the AD&A could be used to explain how the auditor evaluated the risk factors in formulating its audit plan.

A discussion of circumstances, risks, and how the auditor managed them would provide a context for investors that they don't currently receive in the financial statement package. It might make the AD&A a more engaging document for investors than the Management's Discussion & Analysis; it could certainly provide a contrast in the points of view provided by those who manage a firm and by those who examine the firm for the benefit of its owners.

The AD&A should also speak to the critical accounting policies and estimates appearing in the Management's Discussion & Analysis. These policies and estimates should have the auditor's attention in assessing risks and planning the audit. Investors would benefit from understanding the auditor's view on their significance and how they affected the conduct of the audit. They would also benefit from knowing if there were critical accounting policies and estimates that didn't appear in the Management's Discussion & Analysis that the auditor believes should have been included.

I do not believe that the AD&A should be a forum where the auditor is required annually to disclose disagreements with the management on issues that have been resolved to the auditor's satisfaction, as evidenced by the auditor's clean opinion. At the same time, the auditor should have the right to present their point of view in the AD&A when they believe the firm has employed accounting principles that fulfill the letter of the law but stray from the spirit of the law. Put another way, when the firm has engaged in "cute" or "clever" accounting that complies with GAAP but presents an unrealistic picture of performance of financial status, the auditor should be able to call out this behavior in the AD&A. Having that option available to the auditor might actually deter "clever" accounting practices in some companies.

*An example of "cute" accounting: under U.S. GAAP, firms are required to disclose in the financial statement footnotes, on a quarterly basis, the fair value of financial instruments. In the Accounting Standards Codification, there exists an example of such disclosures for originated loans, but the example incorporates a pre-Statement 157 concept of fair value – one that is not based on exit values, and is therefore not in conformity with the current standard. It exists in the codification erroneously. Yet firms will use that erroneous example as a template for their own disclosures, and they can claim conformity with GAAP. Auditor discussion of this treatment would be appreciated by investors – if it ever appeared in an AD&A.*

The AD&A should not be a document that's forced into a prefabricated mold. It should be primarily a text document, similar to the Management's Discussion & Analysis, and one that's flexible and adaptable to the situations encountered by the auditor. It could be based on the same information, albeit more highly summarized, that the auditors provide to a firm's audit committee.

The current auditor's report creates distance between the auditor and the party they are hired to serve – the investors. Being a standard formatted document, with only a black-and-white meaning, it does not effectively communicate the auditor's insights to the investors. The Auditor's Discussion & Analysis could go far beyond that binary "pass/fail" mentality; it could be a device that helps bridge the gap between auditors and investors. It would not have to be a document that will add hundreds of hours to an engagement: rather than requiring new or additional audit procedures, it would be more of an abstract and compendium of plans, communications and memos that are already compiled during the audit engagement.

There is the possibility that the AD&A could become a lame boilerplate document, year after year. The responsibility for seeing that this doesn't happen rests with the PCAOB. Inspections of the work papers on audit engagements give the PCAOB access to the same kinds of documents that should be the foundation for a well-written AD&A; the PCAOB inspectors should be able to make judgments as to whether reasonable attempts have been made to communicate relevant information to investors about the audit. Keeping the AD&A a focus of the inspection process will keep auditors vigilant in their development of the AD&A.

***If presented as a supplement to the basic auditor's report, I believe that the Auditor's Discussion & Analysis would be unparalleled in bringing investors more useful information about the audit.***

**Required and expanded use of emphasis paragraphs.** Relative to a required AD&A, I would consider required and expanded use of emphasis paragraphs to be a poor second choice for improving communications between auditors and investors. In theory, the same kind of information might be conveyed in emphasis paragraphs as in the AD&A, but I think it would be far less effective. The AD&A would be a more flexible document, one that could be lengthier than a paragraph on a particular topic. I believe that a requirement to use emphasis paragraphs would be far more likely to result in over-abbreviated information, and would be far more prone to becoming boilerplate talking points than would a full-fledged AD&A.

**Auditor Assurance on Other Information Outside the Financial Statements.** This is perhaps the most far-reaching alternative presented in the concept release, but it would provide less benefit to investors than the AD&A. I have not encountered investors who lament the lack of auditor assurance on the Management's Discussion & Analysis, or non-GAAP information, or earnings releases. They might want more or different non-GAAP information, more information drawn from the financial statements incorporated into earnings releases, or earlier earnings releases. I think if you were to poll a wide range of institutional investors, you would hear many ideas for improving non-financial statement information, but I believe all suggestions would relate to information content or timing.

***It's hard to see enough benefit resulting from this approach to justify the time and expense of developing new auditing standard for this kind of work. This simply does not seem to provide a more effective means of improving communications between auditors and investors than an AD&A.***

**Clarification of language in the standard auditor's report.** The concept release suggested these possible clarifications of the auditor's report:

- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of the financial statements
- Auditor's responsibility for information outside the financial statements
- Auditor independence

I endorse all of these proposed changes to the auditor's report. Investors should understand the concept of reasonable, not absolute, assurance and the role it plays in conduct and completion of an audit. At the same time, the auditor's opinion should inform investors that the auditor has a responsibility to determine that the financial statements are not materially misstated by either fraud or error. Furthermore, auditors have always applied audit procedures to financial statement disclosures, yet their opinion does not currently speak to disclosures. There is no reason to exclude the auditor's responsibility for disclosures from the auditor's report. Because the responsibility for the preparation actually resides with management, the auditor's report should make that clear, as well as defining the responsibility of the auditor for information outside of the financial statements. Finally, the current audit report barely speaks to the independence of the auditor. A stronger statement as to the auditor's independence would both be informative for investors and a reminder to auditors of their obligation to be independent of the audited firm.

***All of the proposed changes to the standard auditor's report are of a clarifying nature: they define more clearly the nature of an audit, an auditor's responsibilities to its investor clients, and the nature of management's responsibilities. Because they educate investors about the audit process and the fences around the different parties' responsibilities, they also provide incremental value to the communications between auditor and investors. I see no harm in incorporating them into the standard auditor's report.***

* * * * * * * * * * *

Those are my formal comments on the concept release. If I can provide any clarification or amplification, please do not hesitate to contact me. Best regards.

Sincerely,

Jack Ciesielski
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rg

September 19, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34

I am strongly opposed to these proposals. I believe the acceptance of these proposals would be expensive, useless to investors, and potentially damaging to client/auditor relations as we now understand them.

I believe that a major issue of our public security markets is the excessive expense incurred by being a public company. Over the last few years there has been a substantial expansion of the disclosure requirements of public companies and an increase in the cost of such disclosures, without a demonstrated value of the disclosure to the investing public.

The method used by the IAG to survey was to contact investors and their representatives as to information that could be requested. Not surprisingly, these individuals consistently asked for more information, although the information requested was not consistent. I have not seen a discussion as to whether any of the information is actually helpful to readers/users.

My article in the November 2007 issue of The CPA Journal, *Have We Created Financial Statement Disclosure Overload?*, discussed the huge increase in disclosure requirements, the equally huge increase of the size of annual reports and proxies, and the lack of evidence that anyone is actually using the information. It contained a plea to rationalize disclosures. Things have gotten worse.

I believe that before any new standard requiring additional disclosure is enacted, all of the following criteria should be met:

- The information is believed to be useful based on criteria other than someone would like it;
- The information is not available or reported elsewhere;

- The cost of preparing and reviewing the information must justify the requirement;
- The information is likely to be used by users of financial statements.

I do not believe that the suggested disclosures in the Concept Release meet these criteria. I will discuss the alternative suggestions from the Concept Release.

**Auditors Discussion & Analysis ("AD&A")**

The Concept Release states "The intent of an AD&A would be to provide the auditor with the ability to discuss in a narrative format his or her views regarding significant matters. " An alternative proposed approach is publication of the lead auditor's summary audit memorandum.

In evaluating these proposals, it is important to understand that documents written for an audit firm's internal use would be written entirely differently if their intended distribution was to the entire investment community. What if the lead partner's summary memorandum was to be included in AD&A? This document which may have taken originally an hour or two to produce, would require review by various levels first at the accounting firm, then by client management, and of course by the client's counsel, before it could be released to the public. A memorandum that was once useful would become a watered down document, committee produced, with a primary intent of not raising unwanted questions. Anyone suggesting that this document would not undergo such an evolution has not been in the loop of drafting a document for public distribution.

Much of the additional disclosure is already required in Management's Discussion and Analysis or elsewhere in a filing. Management's estimates, accounting policies and procedures, business risk factors are currently required to be disclosed. The rest is of questionable value. Information as to independence would invariably result in a statement that the auditor had followed all independence requirements. I believe that comments on difficult, contentious issues and close calls would be disclosed by the auditor by reference to the footnotes. Quantitative materiality would be disclosed by presentation of an amount. I do not believe that that information would be helpful to readers of financial statements.

Other suggestions for the AD&A include, but are not limited to, the following:

- Evaluation of the quality of the accounting principles used, as in are they "high quality" or "minimally acceptable"? The problem is a lack of definition of a high quality accounting principle, as opposed to those other, low quality ones. While the SEC has always said that it wants "high quality" accounting principles, I have never seen a definition. Would an auditor ever admit that its client was using one of those low quality accounting principles, whatever they are?
- There is a suggestion for a valuation as to whether the financial statements are "aggressive" or "conservative" on a 1 to 10 scale. Here again, the problem is one of definition. Is accelerated depreciation or LIFO, aggressive or conservative? Are high loss allowances aggressive or conservative? Hedge accounting? Is the use of current values aggressive or conservative? And, what about the use of IFRS?

- There is a request for a "sensitivity analysis" as to areas of significant judgment. Sensitivity analyses are useful, but are the province of management. Any used by management and included in a filing, are subject to auditor review as indicated above. The proposal appears to be a request for a separate, different analysis by auditors, which I believe would either be redundant or boilerplate.
- Disclosure of "unusual transactions". If such transactions occur and are material, they would be disclosed elsewhere in the filings. I doubt that there is a benefit to separate disclosure in AD&A

Among other suggested modifications to the standard audit report is one that would require the auditor to opine on whether, in addition to being in conformance with GAAP, the financial statements are, "true and fair". These code words imply that there should be two standards: GAAP and truth, with truth, like beauty, defined by the reader. For the last 75 years standard setters and the SEC have been working to write rules so that financial statements properly reflect underlying economic principles and are useful for readers. Believers in true and fair seem to claim that if auditors also had to say that the financial statements were "true and fair" all of the failings of GAAP would drop away. I do not expect that auditors will readily adopt the concept that they have to opine that the financial statements comply with an undefined standard.

**Required emphasis paragraphs in the auditors reports**

This alternative differs little from the suggestions made relating to the AD&A. Rather than a separate section, the auditor would add to its standard report paragraphs highlighting certain financial statement matters. All of the objections previously raised would apply to this proposal. The information that is suggested is generally required to be disclosed in the notes to the financial statements. It is unclear as to why financial statements would be improved by disclosure of such information in the auditor's report.

**Auditor's assurance on Management's Discussion and Analysis**

This suggestion is not new and was previously rejected by the SEC. Auditors are now required to read the entire filing, including the MD&A, and take action if it is believed that such information is either inconsistent with the financial statements or incorrect. My experience has been that auditors will challenge factual errors such as wrong numbers but will tend not to challenge management's judgments about why a trend or change has occurred. This proposal would require positive assurance. The SEC previously rejected this proposal as they believed that its adoption would limit the information presented, as auditors prefer opining on specific information and facts rather than on subjective judgments. For example, if management wished to state that the downward trend is a result of competition, auditors would appear to be required to challenge the response: are the client's projects approaching obsolescence; is the client not advertising enough or appropriately; is the market shrinking, etc. I believe that the result would be a less informative tabulation of statistics.

**Expansion of the standard auditor's report**

This issue has been around since our profession began. Seventy-five years ago the audit report was standardized so all of us use the same language. While great thought has gone into the exact words of the report, which have changed over the years, the basic concept of one-size-fits-all has continued. There are basically two approaches to what should be in a standard auditor's report:

- A concise, cogent description of the audit process and its weaknesses, auditor's and management's responsibilities, and the auditor's opinion on the financial statements , or
- A short document saying the auditor followed the rules and believes that the financial statements are in accordance with GAAP.

The proposals in the Concept Release suggest the following possible additions/changes:

- A definition of reasonable assurance
- Auditors responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of financial statements
- Auditors' responsibility for information outside of the financial statements
- Auditor's independence.

These are all educational suggestions for the readers of auditors' reports. And, education is good. The question is whether this is the place to educate readers and will they read the information. In the survey, 93% of respondents indicated they do not read audit reports in their entirety. I, of course, do not believe the result. Since the reports are all the same why would anyone read them, other than to scan for something difference or unusual? I believe that expanded opinions would also not be read. All the acceptance of the proposal would do is to drive up costs for paper and printing with no benefit.

I believe that each of the items would require two to three sentences. Not discussing the cost of drafting, to disclose in every report information that will not be read is not a productive enterprise. I would propose that the audit report be one sentence: "Based on our audit, which was performed in accordance with US auditing standards, in our opinion the financial statements on Pages __ to __ are presented in accordance with generally accepted accounting principles in the United States."

**Boilerplate issue**

The major problem with all of these disclosures is that they will quickly become boilerplate, carefully produced at great expense and providing no additional information to readers of financial statements. We have seen this with additional disclosures added over the years to financial statements and other areas of SEC filings. The Concept Release states that "these alternatives are focused primarily on enhancing communication to investors". I sincerely doubt that adoption of any of the proposals will have that effect. Public company annual financial and proxy statements now frequently run over 200 pages. The Concept Release proposes to add additional pages, substantially all of which will be repetitive information already presented or will quickly become boilerplate.

Another theory that runs through the Concept Release is that such disclosures will provide auditors "with the necessary leverage to effect appropriate change in the company's financial statement." I am not aware of any objective evidence that auditors do not already have such "leverage" or that additional disclosures will provide it. While the Concept Release looks forward to middle paragraphs or AD&A indicating positions different from those of management, I doubt it. I do not see auditing firms, after agreeing with management on the financial statements, differing with management as to the information discussed above.

Again, I am against all of the proposals in the Concept Release. I believe that we have more than enough disclosure, the bulk of which is not being read. The challenge is not more disclosure, but how do we make what we have useful to a reader.

Very truly yours,

Arthur J. Radin, CPA

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September 30, 2011

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

Attn: Office of the Secretary

Re: Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB
Standards Related to Reports on Audited Financial Statements

Members of the Board:

The Retail Industry Leaders Association ("RILA") and its Financial Leaders Council ("FLC") are pleased to submit the following comments on the Board's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release"), issued by the Board on June 21, 2011. RILA is the trade association of the world's largest and most innovative retail companies. RILA members include more than 200 retailers, product manufacturers, and service suppliers, which together account for more than \$1.5 trillion in annual sales, millions of American jobs, and more than 100,000 stores, manufacturing facilities, and distribution centers domestically and abroad.

RILA and its FLC commend the Board for the significant effort that has preceded the issuance of the Concept Release. Most of our members are public companies and all of our members recognize that the efficient operation of our markets mandates that financial statements present fairly the financial position of the company as of a particular date and provide sufficient transparency so that investors and other users of financial statements can make informed investment or other decisions.

We believe that issuers and audit firms are in the best position to provide the Board with relevant information as to whether the proposed changes would likely increase the cost of a financial audit, increase the burden on issuers and the audit firms, and whether any additional costs and burden would be justified. In our view, the proposed changes would fundamentally change the existing audit framework and, as a result, greatly increase the scope, timing, and cost of financial audits and increase the potential liability of auditors, all without significant benefit.

In addition, many of the suggested changes implicate privilege and confidential or competitive information concerns that cannot be overcome.

While the Board's effort is commendable and this topic is of considerable importance, to the extent the comments set forth in the Concept Release raise issue with Generally Accepted Accounting Principles ("GAAP"), including the rules governing management's estimates and judgments, or the requirements of Regulations S-X and/or S-K promulgated by the Securities and Exchange Commission ("SEC"), attempting to address these issues through a wholesale revision of the audit framework and reports on audited financial statements is not the appropriate solution. The Financial Accounting Standards Board ("FASB") and the SEC have robust processes for making changes to GAAP and SEC rules, including a public comment and outreach process. To the extent there are issues with corporate communication of risk factors, business decisions, etc., the SEC is already equipped to deal with such shortcomings. To the extent there are bad actors, our legal system is fully equipped to deal with those who deserve punishment.

Several of the proposed clarifications to the auditor's report would not, however, raise the important concerns outlined above. If such changes would give investors and other users of the financial statements greater comfort, we believe they could be required without any negative impact.

Our specific comments follow:

1. *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

   a. *Should the board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

   The Concept Release indicates that one of the primary rationales underlying such a project is the concern expressed by some to better understand the audit process and the auditor's report. The undertaking of a standard-setting initiative to address this basic educational concern would seem unnecessary. There already exists significant literature on this topic. Investors or other users of financial statements should already have a fulsome understanding of the auditor's role and various functions. However, to the extent they do not, they can avail themselves of the Board's Standards, all of which are publicly available. In addition, there are numerous other widely-available publications that address this concern. There also exist myriad educational programs and tutorials that focus on these areas, many of which are available free of charge.[1] As discussed in more detail below, while certain clarifications of the auditor's report would not be particularly

[1] For example, the Center for Audit Quality recently published its "In-Depth Guide to Public Company Auditing: The Financial Statement Audit," which provides a "plain English" explanation of the audit process and the auditor's report. This Guide is available free of charge on the Center for Audit Quality's website. See also http://www.investopedia.com/university/financialstatements/#axzz1XqGUV0SH for an example of on-line courses.

objectionable, we believe that any potential benefit that may result from wholesale changes to the auditor's reporting model would not outweigh the substantial costs of such a project.

Further, we do not believe that a standard-setting initiative would be appropriate at this time. As the Concept Release states, there is an ongoing and active international debate in this area that has gone on for decades. We would suggest deferral of any rulemaking until after the SEC has made a final determination as to whether or when to require SEC registrants to utilize International Financial Reporting Standards ("IFRS") rather than GAAP. Moreover, to the extent the use of IFRS is mandated, auditors, issuers, analysts, and investors will need time to learn and understand the implications of new financial accounting rules. Requiring significant changes now, in our view, would be premature and unnecessarily costly.

*b.* *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

To the extent the concerns that have been expressed relate to a lack of understanding about the meaning of the auditor's report, several of the potential additional "clarifications" set forth in the Concept Release could be added to the current standard auditor's report. For example, an additional sentence defining the term "reasonable assurance" or an additional sentence to more fully describe the auditor's responsibility for financial statement disclosures or other information (*e.g.*, MD&A, risk disclosures, etc.) may be helpful. Similarly, having the auditor's report state expressly that management prepares the financial statements and is responsible for their fair presentation and that the auditor has complied with applicable independence requirements of the PCAOB and the SEC also could be helpful. See also further discussion in response to question 21, below.

*c.* *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

Auditors already review information in documents containing the audited financial statements (*e.g.*, Form 10-K) and are required to consider whether such other information, or the way in which it is presented, is materially inconsistent with the financial statements or constitutes a material misstatement of fact. AU § 550.04-.06. Requiring auditors to provide express assurance on such non-financial statement matters would represent a fundamental change in the existing audit paradigm that would require development of a new and comprehensive audit framework. For example, there currently exists no framework for a comprehensive audit of MD&A. In our view, such a change would increase significantly the scope, cost, and time to complete an audit (potentially resulting in an increase in delayed filings) or, alternatively, discourage increased transparency and detail in certain corporate disclosures (*e.g.*, forward-looking information). Another factor which should not be ignored is the increased litigation risk to which the auditors would be subject. This further risk would inevitably lead to even greater audit costs to the company being audited to offset this risk. Increased audit costs will negatively impact shareholder value and increase consumer cost – all without any improvement in audit quality.

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

a. *Should the auditor's report retain the pass/fail model? If so, why?*

The phrasing of this question accepts the proposition that the current auditor's report is a pass/fail model. We disagree with this underlying premise. As the Concept Statement details, auditing standards allow for circumstances where the auditor can provide emphasis of certain matters, explanatory language, a qualification, or a disclaimer of the opinion. The apparent assertion by some that "the standard auditor's report does not provide the auditor with the necessary leverage to effect appropriate change in the company's financial statements"[2] does not take into consideration all of the reporting alternatives available to auditors under existing auditing standards. If the auditor does not believe that an unqualified opinion is appropriate, it should not, and we believe would not, be issued. This is significant "leverage," especially for public companies, because with out the auditor's opinion, filing with the SEC cannot occur.

The comments reflected in the Concept Statement also focus on concerns that may exist with respect to matters that are "not necessarily material to the financial statements."[3] If the matter is not material to the financial statements then it should not be a significant focus of the audit in general or of the auditor's report in particular. Materiality is an essential underpinning of our entire financial reporting system, as evidenced by the FASB's standard language at the end of each accounting pronouncement that "[t]he provisions of this Statement need not be applied to immaterial items." Education of the investor and user community would appear to be the more appropriate solution to the concerns that have apparently been expressed. A project to consider potentially wholesale changes to the auditor's reporting model, when the underlying issue appears to be one of education would, in our view, not be an appropriate use of time or resources.

b. *If not, why not, and what changes are needed?*

N/A

c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

2 Concept Statement at 9.
3 *Id.*

We believe that the current form of the auditor's report is appropriate and strikes the appropriate balance of all competing interests. We would not, however, object to some of the additional "clarifications" set forth in the Concept Release. See discussion in response to question 21, below.

3. *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation why.*

We question the premise of whether significant additional information about the company's financial statements is necessary, given the substantial (and often unread) amount information already contained therein.[4] In addition, today's MD&A contains considerable additional information regarding management's judgments, estimates, and expectations. Quarterly and additional SEC filings provide even more information, as do earnings calls and other company announcements. To the extent it is believed that additional information may be useful, then such information should be provided by management and, where appropriate, the audit committee. Auditors would not be the appropriate party to provide additional information regarding the company. They are not in the best position to evaluate the business and strategic risks faced by the companies they audit (including the attendant legal rules and risks) or to effectively communicate these items to the investing community.

4. *Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

AS 5 requires that the opinion specify whether the company maintained, in all material respects, effective internal control over financial reporting as so the specified date. We believe this is appropriate and that changes to the auditor's report on internal control over financial reporting are not necessary.

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

   a. *If you support an AD&A as an alternative, provide an explanation as to why.*

N/A

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[4] Even the SEC emphasizes the significant information contained therein. *See, e.g., Beginners Guide to Financial Statements*, found at www.sec.gov/investor/pubs/begfinstmtguide.htm (which notes that "A horse called 'Read The Footnotes' ran in the 2004 Kentucky Derby. He finished seventh, but if he had won, it would have been a victory for financial literacy.").

*b.* *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

N/A

*c.* *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

N/A

*d.* *If you do not support an AD&A as an alternative, explain why.*

The requirement to include an AD&A would substantially increase the scope of an audit and the time necessary to complete it. It would also require auditors to perform a function substantially different from those they currently perform. When many issuers are required to file with the SEC within 60 days of year end, and audit firms are already challenged in meeting this requirement, such a vast increase in scope would not be workable. Moreover, the requirement of an AD&A would expose auditors to additional potential liability if, for example, the auditors discussed certain items in an AD&A but failed to discuss others that resulted in an investor loss or if its discussion of an item were determined to be incomplete. All of this would necessarily increase the cost of the financial audit, which, in turn, would negatively impact shareholders and, ultimately, consumers and the economy as a whole.

While auditors perform a very important function – the assurance function – the financial statements are and should remain the responsibility of management. In our view, a required AD&A would blur the line of responsibility between the company's audit committee and the auditor.[5]

If the real concern is that GAAP allows companies too much flexibility, then the appropriate forum to raise that concern is with the FASB (and its Emerging Issues Task Force) or International Accounting Standards Board ("IASB"). To the extent disclosures are deemed insufficient, the SEC is the appropriate body to address those concerns. We note that there currently exists a joint project of the IASB and FASB on Financial Statement Presentation. To the extent users of financial statements have concerns about financial statement presentation, participation in this important project would be the appropriate means to voice any concerns and to seek redress.

*e.* *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

We believe that the auditor's report is the appropriate place and manner for the auditors to express their opinion on the financial statements.

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[5] An issue not addressed in the proposal is what recourse would be available to the company if management disagreed with some portion of the auditor's discussion or believed it was incorrect.

6. *What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

   N/A

7. *What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, including "close calls")?*

   N/A

8. *Should a standard format be required for an AD&A? Why or why not?*

   N/A

9. *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

   Because we do not believe that inclusion of an AD&A is appropriate in general, we disagree that it would be appropriate for auditors to step even further outsider their current functions and to comment on business risk, strategic risk, or operational risk. Discussing the nature and extent of such potential risks is more appropriately left to management, with oversight by the audit committee and the SEC. Moreover, management's discussion also is influenced by information that cannot be shared with the auditors because of privilege concerns. For this additional important reason, we do not believe that inclusion of an AD&A is appropriate.

   While the Concept Release notes that the Board, in conjunction with the SEC, would have to develop additional direction to auditors in identifying and reporting on such items, up front guidance alone would not be sufficient. Regulatory oversight by the SEC of the actual reporting also would be necessary. In our view, the increased cost and time commitment for the company, auditors, and the regulators, as well as the additional risk that would be placed on the auditors would greatly outweigh any perceived benefit from auditors expressing views on areas outside of their expertise. See also discussion in response to questions 11 and 12, below.

10. *How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

We do not believe that boilerplate language can be avoided.[6] If investors do not understand basic concepts like the assurance function and the audit process in general, it is unlikely that they would understand the nuances that would be necessary to understand an AD&A. For example, disclosure of other accounting methods that could have been, but were not, used could lead to confusion as to the propriety of the method that was used. If the method of accounting used is GAAP, it should not make any difference whether there are other, alternative GAAP-compliant methods that were not used.

11. *What are the potential benefits and shortcomings of implementing an AD&A?*

See discussion above. In addition, inclusion of an AD&A would require the creation of a detailed framework that does not currently exist. For example, there would have to be a mechanism to address which information can and cannot be disclosed in an AD&A. Disclosure in an AD&A of highly confidential competitive or proprietary information would be inappropriate and economically damaging to the company.

Further, to the extent there is concern that GAAP is too flexible, or financial statement presentation is ineffective, then the appropriate course is for those concerns to be expressed to FASB and/or the IASB and to participate in their robust deliberations. If the reporting under Regulation S-K is viewed as insufficient, the appropriate body to address such concerns is the SEC. We do not see any potential benefits. There would, however, be substantial additional costs, risks, and likely confusion that would result from such an expansion of the auditors' responsibilities.

12. *What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

If the AD&A were not subject to any regulatory review, the potential for inconsistent or competing information would be high. A lack of regulatory review, however, would make no sense given that the same types of disclosures when made by management are subject to the SEC's rigorous oversight. Further, as discussed above, if the auditor presents information that the SEC would deem appropriate for disclosure, it would beg the question of why such information was not presented by management. To the extent the SEC deems the information presented by management to be both appropriate and sufficient, there would be no need for any additional information to be presented by the auditor. In short, we do not believe that the concept of an AD&A is appropriate.

13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

We do not believe that the emphasis paragraphs would be relevant or more useful in making investment decisions. The necessary detail should be in the footnotes to the

[6] If the AD&A language were not boilerplate, the quality of AD&A between companies would not be consistent and could vary considerably.

financial statements or in MD&A. Anything else added by the auditor would be superfluous. In addition, there is also a chance, and perhaps likelihood, that emphasis paragraphs in an auditor's report may make it *less* likely that the information in MD&A and the footnotes will be considered in the investment decision-making process.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

    No. See response to question 13, above. In addition, given that the concerns that underlie the Concept Release apparently result in large part from a lack of understanding of financial statements and the financial auditing process, the suggestion to discuss the specific audit procedures used would likely be meaningless to those without a fulsome understanding of the audit process.[7]

15. *What specific information should be required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

    As discussed above, we do not believe that expanded emphasis paragraphs are appropriate.

16. *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

    As discussed above, we do not believe that expanded emphasis paragraphs are appropriate.

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

    Any additional emphasis paragraphs by the auditors, just like any AD&A, will inevitably lead to more litigation and challenges. This, in turn, will lead to standardization of the language used. As a result, we believe that boilerplate language is inevitable.

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

    We do not see any benefits from the use of additional emphasis paragraphs. See our prior responses for a summary of some of the more significant shortcomings of such a

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[7] For example, if a layperson wanted to know whether an operation was successful, a surgeon's explanation of the specific steps, actions, and procedures taken and the medical instruments used during the operation would not answer the question. While that information would be relevant to a medical review board in determining the quality of the operation, it would not provide meaningful information to a layperson. Similarly, while the detailed audit steps performed would be relevant to the Board's inspection of a public accounting firm that regularly performs audits, we do not believe that the information would be relevant or useful to the investment decision-making process.

proposal. We also note that a comprehensive framework would have to be developed if any such proposal were to be implemented.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No. The expertise of the corporate CEO and other corporate managers, in addition to the expertise of the finance, tax, legal, HR, and other corporate departments all contribute to the non-financial statement information. Having auditors opine on such matters will not lead to better or more transparent information. However, to the extent there is a belief that specific information currently contained in, for example, MD&A should be moved into the financial statements, the appropriate approach would be for the SEC to expand the scope of Regulation S-X (and reduce the scope of Regulation S-K). As discussed above, to the extent there is a perceived shortcoming in GAAP, the appropriate course of action to address any such issue is through FASB (including the EITF), and the IASB.

*a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

N/A

*b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

See discussion above and response to g, below.

*c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

In our view, this would be inappropriate.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

As discussed above, only if the SEC were to conclude that certain specific items should be moved from Regulation S-K to Regulation S-X, and therefore included in the financial statements, would any such assurance be appropriate. If this were done, the auditor's report would apply to that new information just as it does to the rest of the financial statements.

e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

We do not believe that any substantial changes are likely. The Form 10-K must already be signed by the company's principal officer(s), its principal financial officer(s), its controller or principal accounting officer, and by at least the majority of the board of directors or persons performing similar functions. In addition, the auditors already review the MD&A for material consistency with the financial statements that they are responsible for auditing.

f. *Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

See response to d, above.

g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why*

See discussion above. Moreover, as the Concept Release notes, providing assurance on matters outside the financial statements would "increase the scope of the auditor's responsibilities." This increase in scope will necessarily increase the risk faced by the auditor. The increased scope and increased risk will therefore necessarily increase the cost of the audit (both in terms of dollars and time) resulting in, at most, minimal related benefit, especially given the already tight filing deadlines to which issuers are subject. In addition, we believe it would be inappropriate for an auditor to provide assurance on earnings releases or on other significant management judgments, especially given that such judgments may take into account privileged information.

20. *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

See responses to question 19, and its subparts.

21. *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*

- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

As discussed above, we believe that many of the issues raised in the Concept Release are the result of a basic lack of understanding by some of the assurance function and of the mechanics of how and why an audit is conducted. Greatly expanding the role of the auditor will not correct this problem. That being said, certain, limited clarifications of the auditor's report that would not increase the scope and cost of the audit process may be of some value.

Several of the suggested additions to the standard auditor's report may be useful. Specifically, providing a definition of the term "reasonable assurance" could be helpful, although there still could be some uncertainty over the definition of the term "high level." We also agree that clarification that the financial statements under Regulation S-X include all notes to the financial statements and all related schedules could be helpful as it may cause the investing public to read more thoroughly this important information. Clarification of the auditor's role with respect to non-financial information also may be helpful. Finally, while we believe it is implicit, requiring the auditor to state that it has a responsibility to be independent of the company and has complied with applicable independence requirements of the Board and SEC is not objectionable.

On the other hand, we do not believe that any discussion regarding fraud would be appropriate. Fraudulent financial statements are not common. Having the auditor's report mention fraud could lead some to believe that fraud exists where it does not, or that the auditor's report is somehow being qualified when it is in fact not. Finally, we do not think it is necessary for the auditor's report to state specifically that management prepares the financial statements and has responsibility for the fair presentation of the financial statements. Such language would simply restate what is already contained in the standard auditor's report – that the financial statements are management's responsibility.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

See response to a, above.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

None.

d. *What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

To the extent the changes were only clarifications, there should be no change to the scope of the audit or the auditor's responsibilities.

22. *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

See discussion above.

23. *This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

We believe that some of the proposed clarifications could be of some marginal benefit. Also, to the extent there is a strong belief that certain portions of, for example, the MD&A, should be subject to the auditor's opinion, the appropriate body to make that determination would be the SEC through its rule-making process. Moving those discussions into the footnotes to the financial statements also would appear to be the appropriate action. In that way, such discussions would be subject to the auditor's opinion.

24. *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

For all of the reasons set forth above, we do not believe so.

25. *What alternatives not mentioned in this concept release should the Board consider?*

We do not believe that there is a strong reason for the Board to take action in this area. In our view, certain of the audit report clarifications suggested, while not objectionable, are of marginal benefit. Virtually all of the other suggestions would increase the cost of the audit without the corresponding and meaningful benefit of improved information. Further, given that the SEC has not yet determined whether or when IFRS will be mandated, any significant regulatory action would appear to be premature and needlessly increase costs.

26. *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

N/A

27. *Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

See discussion regarding fraud discussion above related to the perception of a qualified opinion. We believe that expansion of the auditors' role and scope of an audit, and corresponding increase in length and detail of the auditor's report, is likely to cause financial statement users to focus even more on the report rather than on the financial statements and footnotes themselves. Further discussion of certain items, such as significant risks, etc. could be perceived as a piecemeal opinion.

28. *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

To the extent any changes are perceived as being needed, the some of the clarifications to the auditor's report, as discussed above, would be appropriate.

29. *What effect would the various alternatives have on audit quality? What is the basis for your view?*

We do not believe that any of the suggestions will improve audit quality. The Board's oversight of the profession is the driving factor behind the improved quality of audits.

30. *Should the changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

We do not believe that distinctions should be drawn. Any changes should apply to all entities.

31. *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

    a. *Are any of these considerations more important than others? If so, which ones and why?*

Increased potential liability will undoubtedly impact audit effort and cost. Confidentiality also is a primary consideration. Management's decisions and judgments are based on many factors, including consideration of confidential, competitive, and sometimes privileged information. Some of the suggested changes could not be implemented without increasing the risk and harm to the company if competitive, privileged, or legally protecting information were disclosed. Privilege would be waived if privileged information were disclosed to the auditors or third parties and legally protected information could lose that protection if disclosed to the auditors and would lose that protection if disclosed to third parties. The Concept Release does not appear to have considered these very important issues. In addition, to the extent the distinction between the role of the auditor and the role of the audit committee is eroded, as we believe would result if many of the proposals in the Concept Release were implemented, it could be viewed as decreasing auditor independence.

*b.* *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

We do not believe that any perceived benefits would outweigh additional cost. See discussion above.

*c.* *Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

See discussion in a, above.

*d.* *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

With respect to the legal privilege issues, those concerns could not be addressed by the PCAOB.

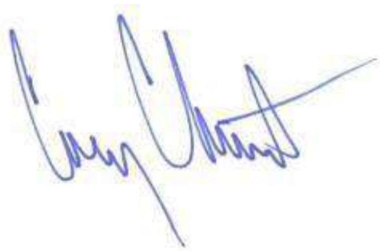
*32.* *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

We believe there already exists a strong and appropriate system of checks and balances: the financial statements are the responsibility of management; management is overseen by the audit committee; the SEC has regulatory authority over registrants; FASB and the SEC set the accounting standards that must be satisfied, and the PCAOB has regulatory authority over the auditors and reviews the quality of their audits.

In conclusion, we do not believe that the proposals in the Concept Release would result in an improvement of audit quality or transparency and many of the suggestions implicate privilege and confidential or competitive information concerns. Comprehensive changes to the existing audit framework would be required and the scope, timing, and cost of financial audits would increase substantially. In our view, many concerns underlying the proposals in the Concept Release would be more appropriately addressed by modifications to GAAP and/or Regulations

S-X and S-K, rather than through a major change to the existing financial audit paradigm. We thank you for the opportunity to comment on this proposal.

Sincerely,



Casey Chroust
Executive Vice President, Retail Operations

**Marsha A. Schulte**
Vice President, Finance and Controller

Rockwell Collins

400 Collins Road NE
Cedar Rapids, IA 52498

September 30, 2011

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

**RE: PCAOB Rulemaking Docket Matter No. 34, Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements**

Members of the Board:

Thank you for the opportunity to provide comments to the Board with respect to your recent Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (the concept release). As the Controller of a public company who works with our auditors on a regular basis, I read the concept release with great interest.

Rockwell Collins (the Company) is a pioneer in the development and deployment of innovative communication and aviation electronic solutions for both commercial and government applications. Our expertise in flight deck avionics, cabin electronics, mission communications, information management, and simulation and training is delivered by 20,000 employees and a global service and support network that crosses 27 countries.

Our Company recognizes the important role that audits play in providing assurance to users of financial statements and we have a long-standing and productive relationship with our external audit firm, Deloitte. Further, the Company is committed to providing relevant, accurate and timely disclosures to investors in the most cost effective and transparent manner possible.

The Company has concerns regarding the ideas presented in the concept release, which are discussed below.

**The proposed Auditor's Discussion and Analysis (AD&A) will confuse the auditor client relationship, increase costs and delay the financial reporting process**

Role Confusion

A primary strength of today's "pass or fail" audit reporting model is that it avoids role confusion; management is responsible for the preparation of financial statements and auditors are responsible for attesting to their conformity with Generally Accepted Accounting Principles (GAAP). The AD&A as contemplated in the concept release may unduly place shared accountability for some elements of the financial statements on the auditor.

The relationship between management and auditor is often characterized by healthy and robust debate. Financial reporting, by its very nature, often requires management to evaluate a wide variety of complex (and sometimes contradictory) accounting rules in order to determine the most appropriate accounting model for a given transaction. At times, a variety of accounting models may be plausible for a given set of facts and circumstances. In situations such as this, the “best” accounting model often becomes evident after an exhaustive and iterative research process that at times, appropriately includes collaboration with the audit team. Working closely with the auditors on a “real time” basis, it is entirely appropriate for management to research and evaluate the various accounting models prior to selecting the accounting treatment that is most appropriate and reflective of the substance of the transaction. In order for this type of analysis to be effective, management teams and audit teams must be able to discuss issues in a frank and open manner. This ongoing dialogue on important issues ensures that management and the auditors build an effective understanding of the complex and often confusing accounting and reporting requirements. In addition, this dialogue between management and the auditor ultimately results in higher quality financial statements that fairly present the financial condition of the issuer.

The proposed AD&A will inevitably complicate the relationship between management and the auditor, turning an often collaborative and healthy relationship where open dialogue is the norm into a potentially combative relationship more frequently. The AD&A is also likely to create a culture of confusion and indecisiveness as management may feel the need to “run every decision past the auditor.” The auditor, in turn, may feel the need to “run every decision” past the engagement quality review partner or various other individuals within the audit firm. In this environment, the auditors run the risk of becoming a stand-in for management as management may be pressured to minimize even the slightest difference in opinion with the auditor; to that end, management may be motivated to defer to the judgment of the auditor in a variety of routine areas. The auditor, fearing potential litigation or the constant threat of being “second guessed” by regulators, may be unreasonably biased towards overly conservative estimates.

There are several important problems with this outcome. First, it assumes that the judgment of the auditor is better than that of management. Lost in the discussion of management’s purportedly biased estimates is the fact that auditors may be biased toward the most conservative of possible estimates in order to manage their potential liability and mitigate the possibility of being "second guessed" by regulators. Financial statements that are overly conservative run the risk of not being representative of results and being a disservice to shareowners. In addition to the bias problem, the industry knowledge and experience of management far outweighs that of the auditor in most circumstances. Further, it is important to recognize that any information possessed by the auditor is by definition a mere subset of the "complete picture" of information possessed by management. Finally, in situations where management is motivated to simply defer to the judgment or estimate of the auditor, it creates the awkward situation of the auditor becoming the source of financial statement information. Put simply, the Board's concept of an AD&A undermines the fact that financial statements are management's responsibility.

Delays in Financial Statement Issuance and Increased Audit Fees

The concept release and feedback from investor representatives at the September 15, 2011 PCAOB Roundtable on Auditor's Reporting Model (the roundtable) imply that the AD&A, if issued as proposed, should be a highly customized report reflecting the specific risks facing the issuer and judgments of the auditor in light of those risks. If implemented, reporting of this nature will dramatically increase the cost of the audit and decrease the timeliness of the financial statements.

The consistency of today's audit report across public accounting firms is not an accident; consistency in format is an outcome of the regulatory and legal environment in which financial statements are prepared and issued to the public. A custom report specific to each issuer runs in stark contrast to this environment.

Ignoring the legal and regulatory issues, a report of this nature suitable for public issuance is certain to take hundreds of hours to prepare, depending on the size and complexity of the issuer. This time will inevitably result in significant delays to the issuance of the financial statements when compared to current timelines. Further delays in the issuance of audited financial statements runs in direct conflict with the goal of timely financial information as described in Statement of Financial Accounting Concepts No. 8, *Conceptual Framework for Financial Reporting*. Further, the audit partner's attention to this reporting task will inevitably detract from the traditional audit tasks performed by the partner, potentially resulting in decreased audit quality.

The draft AD&A prepared by the engagement partner will inevitably be reviewed and edited by the engagement quality review partner, national office and the firm's legal department resulting in additional delays. Further, the resources in question are the most expensive resources of the firm which will lead to a dramatic increase in engagement cost. Finally, management teams at the issuer will want to review the AD&A and this too will result in additional review cycles that slow down financial reporting and drain critical management resources. Drafts of Management's Discussion and Analysis (MD&A) will likely impact the AD&A and vice versa, causing additional delays and use of resources.

The audit firms will obviously seek to recoup the increased costs in the form of higher audit fees. A highly customized AD&A may also expose the firm to substantially increased liability to investors. The fee increases likely to be sought by the audit firms will compensate them not only for increased engagement costs, but for increased liability as well.

In summary, we believe that the increased audit fees and drain on management resources will not dramatically improve the information that is currently available to investors. The current state reporting model already requires issuers to evaluate and disclose their "Critical Accounting Policies" within the MD&A section of the financial statements, with similar disclosures typically found within the financial statement footnotes. Many of the issues raised by the PCAOB in its concept release could theoretically be addressed in a far simpler manner by revising some of the currently required disclosure areas as needed. If the Board feels that the current GAAP reporting model fails to accomplish key goals, then GAAP should be amended. If the Board feels additional information needs to be reported that is not currently contemplated in the financial statements by GAAP or SEC Regulations S-K / S-X, then we suggest the Board should develop proposals on how to improve those standards. In any case, financial statements are the responsibility of management, not auditors. Proposals to use the auditor's report or a forum like "AD&A" to fix any perceived short-comings in the current state reporting model are misguided.

**Required and Expanded Use of Emphasis Paragraphs in Auditor Reports**

<u>Lack of Consistency and Comparability</u>

Another strength of today's pass or fail audit reporting model is that it is consistent and easily comparable by investors; the introduction of mandatory emphasis paragraphs will drastically reduce comparability of audit reports across issuers. The concerns expressed here apply to the AD&A section as well.

Investors are likely to interpret the presence of each emphasis paragraph as a cause for concern. This concern could result in lower share prices if investors are unable to quickly reconcile their concern by fully understanding the issue. Given the complexity of some issues likely to be discussed in emphasis paragraphs, some investors may be unwilling or unable to spend the time necessary to fully reconcile the issue.

Given this outcome, the judgment of audit firm partners responsible for drafting the required emphasis paragraphs could have the unintended consequence of causing a direct impact on the share price of issuers. Given the same facts, circumstances and risk profile, some partners will exercise their judgment to include fewer emphasis paragraphs in the audit report, whereas other partners will likely include more emphasis paragraphs. This variability among auditors will be confusing to investors and will create unpredictable and inconsistent outcomes in situations with similar facts, circumstances and risks.

Audit firms are very likely to recognize this concern and will work to bring consistency across the emphasis paragraphs utilized across issuers. This effort may mitigate the concern discussed here to some degree, but will likely result in boilerplate reports. The Board will endeavor to draft specific rules governing when emphasis paragraphs must be presented; the need for detailed PCAOB guidance in this area was discussed at great length during the roundtable. Even if the PCAOB is able to provide exhaustive guidance to auditors regarding where emphasis paragraphs are required, subjectivity and significant judgment on the part of audit partners will inevitably be required in selecting the issues for inclusion in the audit report. Ultimately, there will be second guessing related to “what needs to be emphasized” which most certainly will result in confusion and inconsistency, and inappropriately imply that investors need not review the financial statements and accompanying footnotes in their entirety.

**Auditor Assurance on Other Information Outside the Financial Statements**

Forward Looking Data

In today’s audit reporting model, auditors are primarily responsible for testing and providing assurance on historical financial statements. While forward looking estimates are inescapably part of developing certain account balances, such as pension liabilities and impairment reviews, these situations are relatively rare and are generally limited to financial forecasts.

Audit assurance on MD&A and earnings releases as contemplated in the concept release would drastically increase the number and breadth of forward looking estimates under review by auditors. The nature of forward looking information contained in MD&A and earnings releases is based on a wide range of both financial and non-financial forecasts. This information is typically industry specific and outside the scope of the auditor’s current work. The auditor’s specialized training and experience, while critical to their role, is not as well suited to providing assurance on industry specific, non-financial forecasts. Given this training and experience gap, the cost of an audit opinion on forward looking data seems to outweigh the relatively little incremental value to investors.

Contemplated Enhancements are Already Substantially Performed

To the extent that historical information is included in MD&A, auditors are already required to review that data to ensure that it is not inconsistent with the historical data presented in the financial statements and notes. In our Company's experience, this process extends to earnings releases as well. So, with the exception of the forward looking data discussed above, auditors are, to some extent, completing much of the work contemplated by the exposure draft.

A substantial overlap already exists between the information required for presentation in the notes to the financial statements and in MD&A. To the extent that unique MD&A disclosures exist on which investors would like audit assurance, the SEC should explore whether to direct the FASB to incorporate those disclosure requirements into GAAP thereby ensuring the desired audit coverage.

**Clarification of the Standard Auditor's Report**

The clarifications of the standard auditor's report identified in the concept release are relatively modest in nature, will not result in enhancements to current audit procedures and will not drastically improve the understanding of most financial statement users. The vast majority of investors willing to review issuer financial statements have a relatively strong understanding of the language identified for enhancement in the concept release.

As suggested by other responders, the additional information to be conveyed by the contemplated enhancements is freely available today from other authoritative public sources. We suggest that it would be far more cost effective for the PCAOB to develop a resource page for investors conveying the additional information contemplated in the concept release. The audit report of every issuer could be enhanced with a common sentence directing the reader to the resource page on the PCAOB web site.

This resource page could include links to more detailed information for interested readers and could quickly and cost effectively be enhanced to meet the new information requirements without the time and expense associated with the rulemaking process.

**An Alternative**

We support the alternative approach suggested by others in comment letters and during the roundtable, which is to enhance management disclosures to address the reasonable requests for additional information from the investor community. We also support calls to simplify disclosure requirements where possible to avoid overly complex information that is not meaningful to financial statement users.

The FASB and SEC are empowered to respond aggressively to investor calls for improved information through additional rulemaking. Further, the SEC comment letter process can specifically address situations where issuers are not adhering to current disclosure requirements. The inspection program of the PCAOB also plays an important role in ensuring compliance with regulatory requirements by issuers and auditors alike. To the extent that concerns exist regarding ineffective disclosure, the SEC and PCAOB should respond through established review mechanisms to improve the information available to investors. This pointed approach will be far more cost effective than what is proposed in the concept release.

Again, thank you for the opportunity to provide comments on these matters.

Sincerely,

/s/ Marsha A. Schulte

Marsha A. Schulte
Vice President, Finance and Controller
Rockwell Collins, Inc.

RSSM ROSEN SEYMOUR SHAPSS MARTIN & COMPANY LLP
Certified Public Accountants & Profitability Consultants
1956 - 2006 50 Years Growth • Vision • Solutions

September 28, 2011

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

**Re: Request for Comment: Concept Release on Possible Revisions to PCAOB Standards Related to Reports in Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34**

Dear Office of the Secretary:

Rosen Seymour Shapss Martin & Company LLP ("RSSM," "We" or the "Firm") is a registered public accounting firm located in New York City. RSSM serves smaller reporting companies and non-accelerated filers. We appreciate the opportunity to respond to the Concept Release. Some general thoughts about the Concept Release and our comments on each of the four alternatives follow.

We do not believe that significant changes should be made to the auditor's report to assist investors in their investment decisions. An audit of the financial statements provides assurance as to the fair presentation of financial statements in accordance with a particular accounting framework. We believe, investment decisions are based on information related to the company being considered for an investment. While objective analytics may be performed, investment decisions are generally subjective. The investor generally decides on the extent to which he or she relies on objective analyses of the amounts presented in a company's financial statements and elsewhere, the extent of reliance placed on financial statement disclosures, and the extent of reliance placed on other available information about the prospective investment.

As stated in the Release, an audit of financial statements has long been recognized as a valuable process. Since the beginning of the twentieth century some form of assurance service has been provided by public accountants. Over time, both businessmen and public accountants have come to realize that assurance with respect to financial statements must be provided in relation to some form of standard or standards; hence the development of accounting standards. Assurance with respect to financial statements progressed from the 1902 "certification" that the financial statements were "correctly prepared from its books and records" to the present form of assurance which attests to whether a company's financial statements present financial position, results of operations, and cash flows fairly as that term is viewed under some framework of standards. Thus, historically, and currently, the purpose of the audit has been limited to being an attestation relating to the financial statements and the standards under which they have been prepared. The accounting principles underlying the financial statements facilitate the understanding of them:



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*Member of the AICPA Employee Benefit Plan Audit Quality Center*

the auditing standards simply provide assurance that the financial statements have been prepared using the stated accounting principles (e.g., GAAP or IFRS, etc.).

Generally accepted accounting principles ("GAAP") have been developed over the years, to provide investors with a wealth of information for use in making investment and other decisions and we believe that significant changes to the auditor's reporting model could or would dilute the preeminence of GAAP as the basis for assessing financial statements. Financial statements prepared in accordance with GAAP provide investors with an abundance of information about the preparation of financial statements which includes information about how the elements of the financial statements are derived. For example, disclosures with respect to the fair values of financial instruments include information about how the fair values are determined. Likewise, disclosures about share-based compensation include information about how the amounts of these expenses are computed. Therefore, while we concur that an audit of financial statements has value, the value does not relate to providing information about the financial statements. Information about the financial statements is provided by the financial statements themselves, including the related disclosures as required by GAAP. The value of an audit relates to the support it provides about the relevance and representational faithfulness[(1)] of the financial statements.

Because we believe that GAAP provides the best means for communicating information about a company's financial position, results of operations, and cash flows, we believe the current pass/fail model is appropriate. Auditors are expected to render their opinion with respect to fair presentation. In our opinion, the following should be considered:

- An opinion is a subjective judgment which, by its nature is singular. One can have an opinion on this matter or that matter; but one cannot have multiple opinions on the same item or matter of interest. Thus, an opinion is a yes or no proposition. Of course there may be areas of uncertainty to be considered in forming an opinion, but the opinion is not a definitive statement. So uncertainties affect the formation of an opinion but they are not part of the opinion; consequently the financial statement presentation is considered either fair or not fair under the applicable set of standards.
- Under present auditing standards, an auditor may add a paragraph emphasizing a matter that was considered in forming the opinion; however, the matter being emphasized is only one of many matters considered by an auditor in forming his or her opinion. Since the auditor's opinion is the result of his subjective judgment based on many factors, there is a danger that an emphasis on any particular matter may mislead or confuse the user of the financial statements.

To summarize the preceding remarks, RSSM believes that the role of an audit of financial statements should be limited to the objective stated in AU§110, *Responsibilities and Functions of the Independent Auditor*. That is, the expression of an opinion on the fairness of the financial statements presented by management.

The Concept Release observes that "The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements." We think that the auditor's report communicates information regarding the results of the audit as it relates to the financial statements, not about the financial statements. The Board may wish to clarify this understanding. We believe the scope paragraph explains the nature of what was done to enable the auditor to express his or her opinion.

The Concept Release also states "Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the risks of material misstatement in a company's financial statements." We believe this desire for better understanding about the audit is a request for information about unusual or complex transactions and potentially adverse situations encountered by the auditor during the engagement, and how such matters were resolved. Because the standard audit report does not disclose these and other matters, we understand the Board's decision to consider improvements to the auditors reporting model recommended by SAG, IAG and ACAP. However, after considering the information and viewpoints received from the comments to this Release, if the Board decides to pursue the notion of changing the auditor's report, we believe that more in-depth analysis should be made. While the PCAOB Staff (the "Staff") has conducted outreach activities, the degree to which those activities represent the attitudes of the population of users, preparers, and auditors of financial statements needs to be confirmed.

In considering the potential alternatives for changes to the auditor's report, we were mindful of the fact that the auditor's report should not be the original source of information or disclosure about the entity; that should remain the responsibility of the management of the entity. Accordingly, we offer the following comments regarding the proposed alternatives.

**A. Auditor's Discussion and Analysis ("ADA")**

We believe that having a supplemental narrative in the form of an ADA is not a good idea. In our view, such a supplemental report could confuse investors and shift their focus to the matters discussed in the ADA and away from the financial statements as a whole. As a result, we do not believe an ADA would facilitate an understanding of the auditor's opinion because it could bring about the loss of an investors primary perspective toward the financial statements as a whole.

Specifically, we do not believe that a discussion about the auditor's views with respect to estimates and judgments affecting the financial statements would be beneficial. The auditor's basic views with respect to such estimates and judgments are inherently part of the auditor's opinion on the financial statements as a whole. Any supplemental views that are either favorable or unfavorable could cause undue optimism or pessimism on the part of investors.

**B. Required and Expanded Use of Emphasis Paragraphs**

This alternative seems to be a shorter and less extensive version of an ADA that would be included in the auditor's opinion instead of as a supplemental narrative. Therefore, we do not believe that it's a good idea to expand the use of the emphasis paragraph to address matters of estimates and judgments affecting the financial statements. In other words, we do not believe that mandating the use of emphasis paragraphs in audit reports and to highlight the matters deemed to be most significant in the financial statements and to identify where these matters are disclosed in the financial statements would be of much benefit. However, emphasis paragraphs can amount to condensed footnotes and undermine the effectiveness of disclosures required by generally accepted accounting principles.

**C. Auditor Assurance on Other Information Outside the Financial Statements**

As pointed out in the Release[2]: "Providing assurance on information outside the financial statements would increase the scope of the auditor's responsibilities, require the development of new auditing standards, and might result in projects separate from the auditor's reporting model project." We fully agree with your statement.

The substantial increase in the cost of an audit should be carefully weighed against the added benefits that investors might receive. As the Board knows, Regulation S-K contains fairly detailed requirements about the content of the MD&A and much of the information includes management's subjective judgments and analysis about causes behind changes in operations and about the future. The Board should consider adding this subject matter to the requirement for discussion by management in MD&As. The reliability of this type of information, no matter how carefully it is prepared, is questionable due to its nature. Moreover, the cost of auditing it may well outweigh the perceived benefits.

**D. Clarification of the Standard Auditor's Report**

The standard auditor's report already has "built-in" explanations about an auditor's responsibility and what an audit represents. We think that any additional explanations, like an ADA, could be more confusing to the typical investor and, therefore, would not provide significant additional value to investors. We believe that auditor's reports should be as clear, concise, and to the point as possible. This approach supports the pass/fail structure of the opinion.

We appreciate the opportunity to express our views on this issue.

Respectfully submitted,

, PARTNER

Rosen Seymour Shapss Martin & Company LLP

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[1] Statement of Financial Accounting Concepts No. 8, Chapter 1, *The Objective of General Purpose Financial Reporting*, and Chapter 3, *Qualitative Characteristics of Useful Financial Information*. Paragraph QC 5 states: The fundamental qualitative characteristics [of financial statements] are *relevance* and *faithful representation*.

[2] Page 23.

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July 19, 2011

Mr. J. Gordon Seymour
Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Mr. Secretary:

I have the following comments on the Board's Concept Release on potential changes to the auditor's reporting model. In its comments on the potential changes, the Board has correctly stated that this effort is probably the most important task undertaken by the Board in its recent history.

I think that the Board will be inundated by comments on its Concept Release. My comments seek to help the Board in wading through the various comments and to single out those issues which need to be addressed before effecting any major change in the auditor's report.

It's probable that the accounting profession will by and large approve what the Board is trying to do but in fact will retreat from approving major changes in the auditor's report. The profession's comments will undoubtedly reflect its fear of liability and the disruptive effect on its auditors in changing what they report to the public. Many will retreat from any change in view of the additional costs that may be imposed on issuers pointing out that this impact would come at a time when issuers are increasingly overwhelmed by costs stemming from other Government regulations. They will seek to avoid changes that will place increasing burdens upon their clients.

Issuers will oppose the changes not only because of increasing costs but also because of further liability exposure. They will also see that increased disclosure of major issues in preparing their financial statements runs the risk of additional shareholder questions and concerns – something that they want to avoid in these times of economic upheaval.

Investor groups on the other hand will applaud the Board's efforts to seek greater transparency but they are not paying for the changes.

Seeking to reconcile these differences will not be easy.

I offer these suggestions to the Board in evaluating possible changes in the auditor's report. First, any changes should be limited in scope but should be positioned as a first step towards improving the report. The Board should signal that further changes will come in light of experience gained from this first step. Second, the Board should make every effort to limit the cost impact upon issuers.

Sincerely,

**From:** suzanne shatto [shamlet76@gmail.com]

**Sent:** Friday, September 30, 2011 1:09 AM

**To:** Comments

**Subject:** Docket 34, comments due 9/30/2011

Docket 034 : Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

http://pcaobus.org/Rules/Rulemaking/Pages/Docket034.aspx

i am an investor.
i have been watching the auditing controversy for some time.
in my opinion, the auditors have forgotten why they are going through this exercise.

someone has to comment on information presented to the SEC and investors and other stakeholders. it should be the auditors.

this is a business climate that is in a crisis brought about by the lack of truthfulness individually by companies and collectively by economic entities.

it is important to know:
if the commercial entity does not have the means to carry on the activities which are the subject of the audit. so far, only the "going concern" paragraph addresses this. auditors need to consider whether there might be events that would affect future revenues, such as the audit of a biotech that has an FDA submission in clinical trials, in the process of an FDA clearance process or an FDA drug submission process. in this case, future revenues certainly could be addressed by noting the possible application, the possible market for this submission. the investors can figure out whether they wish to invest in such a company.

it is important to know if the inventory is incorrect. the auditor should be required to do more than rubberstamp the inventory. the auditor should look at the inventory and verify that it is there. they should see that the inventory is not counterfeit. they might have to verify a count, whether by random sampling or counting it themselves or roughly estimating inventory. this same thing is true of accounts receivable, accounts payable. this issue might be particularly of concern in the securities business. i don't think an inventory reconciliation has been done in over 30 years. we all know what happens when we skip inventories. the clearinghouse has been "netting" long and short positions, has not been delivering particular stock certificates. if valid and legal stock certificates do not exist, what is the auditor going to do?

do customers exist? do vendors exist? is the inventory obsolete? are the accounts receivable to sold as to be uncollectable? how do these measures compare with the industry?

if there are "off-balance sheet items", i think an explanation of this should be required. in my view, anytime you take something off the balance sheet, you are creating a likely misstatement.

if management's discussion is misleading, what are auditors going to do?

if false records are presented or suspected, what would an auditor do?

i think resignation is not specific enough. as you know, the content of resignation letters that are filed with the SEC are notoriously blank about the causes of the resignation.

the reason that the auditors are hired is so that stakeholders can be assured that the financials fairly state the position of the entity and warrant that they are independent and impartial. auditors are often our eyes and ears. this is their role.

i also think that as audits become more complicated, they will need more time to complete the work.

i think auditors need a plan to address these items. the current model does not appear to address many possible situations that would impact the investment value or commercial interests in the marketplace. so at the very least, auditors need to redraft the current boilerplate statement.

while auditors are not in the law enforcement field, their work product might be required, should there be a legal/criminal question.

suzanne hamlet shatto

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**30 September 2011**

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

**Re: Docket # 34**

**Gentlepeople:**

**For the past 30 years I have been a director of several of the mutual funds managed by Capital Research and Management Company and have served as well as the Independent Chair of the Investment Company of America, American Mutual Fund, AMCAP Fund, American funds Insurance Series, American Target Date Funds and all the Fixed Income Funds. In addition I have been Chair of many Audit Committees and have served as the Audit Committee Financial Expert.**

**From 1959 until 1986 I worked for The Christiana Companies, NYSE, and stepped down as Chairman and CEO in the late 70s / early 80s.**

**My experience with auditors and audit committees is extensive and I am pleased to note that we never received a qualified opinion and rarely had any disagreements, ( however small ), with the five separate audit firms with whom I dealt over these years.**

**However, I have seen an increasing responsibility delegated to these boards and to audit committee members. Although well intentioned, such as Sarbanes Oxley, many of these requirements have not aided our oversight ability and effectiveness.**

**Without exception the relations with these audit firms was, and is, collegial and not confrontational. In the mutual fund business an equivalent relationship has existed with the adviser, Capital Research and Management.**

**As directors, now trustees, of the American Funds, our function has been one of oversight and our ultimate responsibility is to our fellow shareholders. All directors have been encouraged to own shares in the enterprises as my belief is that, as directors responsible to shareholders, we should have "skin in the game".**

Thus each of these entities through their auditors, advisers and directors/trustees, have a shared commitment to the success, both short and long term, of the entities.

This shared commitment enhances and insures that there are many lines of communication, both required and in meetings, between the parties.

The duties and responsibilities of directors/trustees and of the auditor and of the adviser are clear and distinct. In my opinion to require the auditor to issue an "ADA" in addition to an opinion is to require the auditor to comment on areas in which the auditor might not have expertise and is to incur extra costs that could significantly increase the cost of the audit without providing any real benefit.

By the same token a requirement to use "Emphasis Paragraphs" or to involve auditors in commenting on "Information Outside of the Financial Statements" is unnecessary and would be ill advised. Emphasis might raise concern rather than clarification.

One of the great benefits of the confidential executive sessions that conclude each audit meeting is that the time is often used to ask the auditor to opine on any subject or incident that might have arisen during the year and/or the audit that would necessitate further inquiry by the Audit Committee.

Thank you for the opportunity to express my views,

Martin Fenton
Chairman

From: Art Siegel [mailto:a.siegel55@gmail.com]
Sent: Thursday, September 08, 2011 6:36 PM
To: Comments
Subject: Docket Matter No. 34

I am pleased to comment on the Board's proposal.

Introduction

I am a retired partner of Price Waterhouse LLP (PW) and served for seven years as Vice Chairman of the Firm in charge of the audit practice. During my 37-year career with PW I also served as Chairman of both the AICPA's SEC Practice Section Executive Committee and AcSec's task force on risks and uncertainties. I was also a member of FASB's EITF, FASAC and other task forces.

After retiring from PW I was appointed executive director of the Independence Standards Board and served in that capacity throughout the Board's almost four years of operation.

For the last ten years I have been a director and chairman of the audit committee of an SEC registrant and a consultant and expert witness on various accounting and auditor independence issues.

Overall Philosophy

My overriding philosophy is that management, which is in possession of the most information that is relevant to users of financial statements and related SEC filings, should continue to have the sole responsibility to report such information publicly. However, the auditor plays a crucial role in reporting on the reliability of the financial statements and that role can be usefully expanded to include other information in SEC filings, financial press releases and similar management-prepared communications.

My comments which follow are predicated on that overall philosophy.

Detailed Response

My experience as a board member has made it abundantly clear that the auditor's knowledge of a client's affairs, while significant, is only a subset of the total information available to management. Moreover, while board members may be better informed on some matters, even their knowledge in many cases represents only the tip of the iceberg. This limited knowledge is the inevitable result of the part-time or highly-focused involvement of the auditor and audit committee vs. the full-time and broad-based involvement of the management team.

In particular, while the auditor has access to the financial records of the company, minutes, and other evidential matter, and holds discussions with officers and other personnel of the company, the auditor does normally not participate in internal discussions of strategic, operational, legal and accounting issues, does not routinely deal directly with vendors, customers, lawyers, bankers and other relevant third parties, nor does the auditor have access to emails and other communications between and among company officials and outsiders.

The implication of this knowledge gap is that it is unrealistic to assume that the auditor can independently report useful and credible information beyond what is required by GAAP and that management has decided is not otherwise required. In fact I predict that if such a proposal were adopted the information reported by the auditor will, in the vast majority of cases be wrong, incomplete, misleading or at best redundant to what the company has reported. The results will be users who are burdened with unnecessary and perhaps inaccurate disclosure. More importantly, it will result in a blurring of the very important distinction between the auditor who reports on the completeness and reliability of specified management assertions and management which must decide what public disclosures are required under both GAAP and the law.

Moreover, the proposal does not recognize that substantive discussions about what should be disclosed are normally conducted by the auditor with management and when necessary with the audit committee and legal counsel. As noted in the Concept Release, the auditor is already required to be satisfied that the disclosures in SEC filings that are outside the financial statements are not inconsistent with his knowledge and with the financial statements.

The AICPA's project on risks and uncertainties was intended to have management focus on and publicly report on the uncertainties facing the company which could materially affect the financial statements. If the standard now adopted is not accomplishing that purpose, then it should be revisited and improved, rather than trying out a new and highly problematic auditor reporting model.

The proposal raises a number of related issues. For example:

- what if the auditor and management discuss the same item differently? Will the SEC allow such disparities? If not, how will they be resolved? If the SEC insists on comparability what advantage is there to the user to reading similar information? On the other hand, If differences are allowed, which disclosure should the user to believe? And what role is envisioned for the audit committee in resolving such differences and what will that mean for audit committee and board liability?

- will the auditor resort to the kinds of laundry lists of risk factors that now bulk up SEC filings but in many cases do little to inform the user of relevant risks?

- will firms develop industry-specific risk factors that are not necessarily relevant to a particular client but get reported "to be on the safe side?"

- will the fact that auditors will be issuing their own AD&A impede or encourage communication among management, audit committees and auditors? Will the role of the auditor become more adversarial, without any resulting benefits to the integrity of the financial reporting process?

Other matters:

Expanding auditor reporting responsibilities - I strongly support requiring the auditor to explicitly report on MD&A and on financial press releases and similar information. The likely additional discipline and qualitative improvements in many cases would be worth any incremental cost, especially if the reporting were only to the audit committee (which should be sufficient if it were mandatory). The Board's standard for this reporting is appropriate for these purposes.

The Concept Release asks whether the auditor's report should state that the auditor "has complied with the applicable independence requirements of the PCAOB and SEC". I think this is the wrong question. It reinforces the "rules-compliance" mindset that prevails today in the auditing profession in dealing with accounting as well as with independence issues. ISB standard 1 (now incorporated with modification in Board standards) was intended to focus the auditor on his responsibility to maintain his objectivity. The Conceptual Framework issued by the ISB in 2001 and whose underlying principles are now reflected in independence standards adopted internationally as well as by the GAO and AICPA focus on threats to independence and possible offsetting controls. No set of rules can cover all situations. For example, can a partner maintain his objectivity while auditing a close friend? A cousin? Are there different threats if it is a friend or cousin of a manager or staff accountant? Are there any offsetting controls that might be effective? Who should be informed about potential impediments to objectivity at the client? Within the firm? The audit committee? Other examples: is there a level of fees from a client in relationship to total firm, office or department that would impair objectivity? What if it is fees paid to an office doing "branch work"? Are there controls that might mitigate such threats? A threats and safeguards approach requires the auditor, and management and the audit committee, to think about the nature of the auditor's objectivity, rather then whether he is in compliance with the detailed independence rules.

The Board should undertake a comprehensive project to consider a threats and safeguards, principles-based approach to auditor independence. It is the best way to ensure that all involved understand the goal of auditor independence - objectivity -

and to provide a methodology to resolve new issues that can be understood and debated by relevant stakeholders.

Finally, I do not believe that requiring the auditor to discuss the principal auditing procedures applied to relevant items would improve the usefulness of the auditor's report. The user is not in a position to assess the relevance of those procedures, their completeness or the effectiveness with which they were applied. As stated earlier, if the requirements by the company to disclose risks and uncertainties and other material information are inadequate, those requirements should be fixed. That would retain the responsibility for disclosure with management, where it belongs.

* * * * *

Please contact me if my comments require any amplification or clarification.

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**William W. Sihler**
The Ronald Edward Trzcinski
Professor of Business Administration

September 23, 2011

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

*Re: Rulemaking Docket No. 34*

Ladies and Gentlemen:

I am writing in response to your request for public comment on a variety of items covered in this Docket number related to the Auditor's Report. My comments are based on my 46 years teaching corporate and institutional finance at the graduate business school level and my involvement in the applied world—as a user rather than a generator of financial information. I have served as board member of three NYSE companies, audit committee member of each, chairing the audit committees of two, as well as a board and audit committee member of a small-cap private company.

Having reviewed some of the comments submitted on this Docket, I find myself in total agreement with Professor James L. Fuehrmeyer, Jr., of the Mendoza College of Business Administration of the University of Notre Dame, who wrote you on July 5, 2011. To avoid wasting time, therefore, I do not propose to repeat his and similar comments but rather to make a few broader points about the proposals.

First, the "many" and "some," whose desire for further information is frequently cited as a reason for this study, appear to confuse the task of the independent external auditor with that of the securities analyst. The former's task, dealing largely with the current and the past, is to determine whether management's presentation of an entity's financial statements are fairly stated, according to established principles and practices, in all material respects as of a specified date. The latter's task is to speculate and opine on what the future of the company and its value will be. The analysts performs their task with few established principles, practices, and standards against which their output can be measured. There is little legal requirement that the analysts perform their tasks with anything like the great care demanded of the independent auditor. Furthermore, the analyst's speculation and opinions are considered free speech and thus protected from challenge except in unusual instances.

The independent auditor, of course, has to consider the future in many instances, such as in validating depreciation assumptions and percent-of-completion calculations. These are technical items, however, distantly related to the concerns of the securities analyst. To think that the independent auditor should also function as a securities analyst or could effectively serve both functions suggests a misunderstanding of one function if not both. If implemented, many of these proposals would require independent auditors to set up the equivalent of a securities analysis department. Unless somehow held to new, more rigorous standards, the resulting opinions would be worth no more than those of a securities analyst. (For example, consider the analyst who recommended a company increase its market price by increasing its yield.)

Second, the "many" who are said to want more insight from the independent auditor in the form of additional comments or highlights to management's discussion and analysis appear to want someone else to do their research work. (The more cynical might think that the insights of the independent auditors are sought to replace the information provided hithertofore by the "expert" networks.) The pro forma example of an auditor's comments provided in the June 9, 2011, letter from Ms. Cynthia M. Fornelli on behalf of the Center for Audit Quality, are clearly merely restatements of what already would appear in the management discussion. At best, it is a sort of executive summary, adding nothing but perhaps enabling the careless reader to skip management's comments.

This result hardly reflects the aims and hopes of current security regulation. At worst, it is simply adding pages to documents that are already tedious to read and far too full of repetitions. The practice would also expose the independent auditor to litigation on the grounds that the auditor's comments did not emphasize something of importance in management's discussion that the "many," relying on the executive summary, did not find for themselves.

Third, many aspects of the proposals would alter the dynamics of the relationships among the auditors, the audit committee, and the management. At the moment, management proposes, the auditors either disagree, agree, or raise alternatives that should be considered. In the case of public companies, a disagreement is resolved in favor of the auditors because otherwise the required filings are not possible. Agreement presents no problem. The discussion of alternatives, presumably all of which fall within accepted accounting standards, should be helpful to the audit committee and, ultimately, to management.

If the auditors were required to disclose these discussions, concern about litigation would tend to eliminate the useful communication of alternatives. The resolution would become "my way or the highway" because the independent auditor could hardly allow potential litigation about not having insisted on an alternative that the audit committee did not select. The proposal might even result in "informal" discussions in advance of any formal meeting so that a consensus in advance would be established.

And, of course, considering the number of items in a set of financial statements, even for a small company, for which alternative reasonable approaches are possible under the accepted accounting policies, the list and explanation of these for each point would make the financial reports even more cumbersome than they are at present. At the extreme, financial statements would have to be prepared showing the effect, singly and in combination, of the alternatives discussed. The "many" would appear hardly to be able to make this analysis for themselves. Without these presentations, the simple discussion would be worthless. It is hard to believe this elaboration would provide any appreciable additional insight for the "many," who seem to seek the quick sound bite.

Third, for good reasons, the objective is that all the information the "many" request is to be provided without becoming boilerplate language. This objective seems very optimistic. The sample provided by the Center for Audit Quality runs to four solid pages of boilerplate. If I am correct that the type of information the "many" want is not the type of information an independent accounting firm is structured to provide, it is natural that the result will be boilerplate, constructed to comply in form while reducing the chance of litigation.

Nevertheless, it does make sense to allow the independent auditor to explain somewhat more completely in the attestation just what the independent auditor does not do and what is the responsibility of management. Thus, the addition of a few well-chosen phrases or words to the current rubric could help the uninformed investor understand that the independent auditor's role is a limited one and cannot guarantee one-hundred percent accuracy of the financial reports.

Fourth, I have a hard time imagining just what form the attestation by an independent auditor of any forward-looking statement would take. The existing boilerplate provided by management in the 10-K under SEC safe-harbor regulations indicates that statements dealing with the future are no more than best guesses as of a certain date. Securities analysts are not held to that high a standard. It appears that the "many" want a more formal certification by the independent auditor of those forward-looking comments. This requirement implies that the independent auditor would have to be at least as informed about a firm's business and its prospects as management is. One major reason for the independent auditor is that the auditor knows more about accounting principles than even the firm's financial managers, not because the independent auditor knows more about the firm's operations and prospects.

Finally, it would certainly be nice to have an independent party review the reports of management and, for that matter, of the independent auditors, if one could be found which would have better insights than the management and the independent auditors. And, of course, then a fourth party would be needed to vet the conclusions of the third party, and so on. I am reminded that not very long ago, it appeared that audit committees would have to engage their own independent auditors to review the work of the company's independent auditor. Fortunately, the idea was dropped by the wayside, apparently replaced by the PCAOB's responsibility to monitor the quality of independent auditing firms.

In conclusion, it strikes me that the "many" are trying to entice the PCAOB into doing the job of the SEC. If the "many" do not think that managements are presenting enough information or in the appropriate form, the proper body to address is the one responsible for public disclosure not the one responsible for proper accounting. Organizations tend to expand into adjacent turf when they do not have enough do to on their own field. The PCAOB certainly has many challenges in its own area. I urge the Board not to allow "many" to distract it from the excellent work it is doing where it has been given responsibility and thus to drop this study in favor of including a slightly more elaborate statement in the attestation of what the independent auditor cannot do.

Respectfully,

William W. Sihler, MBA, DBA
Ronald E. Trzcinski Professor
of Business Administration

st. john's UNIVERSITY

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September 28, 2011
Public Company Accounting Oversight Board
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Auditor's Reporting Model, Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Members of the Board;

I'm pleased to have the opportunity to present my comments on the PCAOB's initiative to reconsider the audit reporting model. My comments are my own based upon nearly forty years in the accounting profession, twenty-five as an audit partner with KPMG and now serving as an adjunct at St. John's University teaching auditing and ethics to graduate students.

With the large number of books, studies and articles devoted to analyzing the various aspects of the financial crisis, it is apparent that we suffered from a massive systemic failure whereby the belief that institutions we once thought we could trust is no longer true. These Include legislators, financial institutions, rating agencies, directors (who were thought to represent the shareholders), pension fund managers and so called large sophisticated investors, all of whom have reportedly high powered analysis tools and techniques for managing the investments of their members, and yes, auditors. All of who failed to forecast or see the magnitude of the problems presented by excessive leverage and an unsustainable housing bubble.

Improved audit quality should be the main goal of this PCAOB initiative, and not the peripheral issues of an auditor's discussion and analysis, firm rotation, and individual signatures on reports. These are

st. john's UNIVERSITY

distractions that take time from the main issue of improving audit quality. I agree that the auditor's report requires some changes and updating. I'll suggest some in the following paragraphs or express my agreement with others who have commented rather than repeat similar comments.

Financial Reporting Council and Center for Audit Quality

The approach being pursued by the UK's Financial Reporting Council and should be adopted by the PCAOB, including the FRC's guiding principles (some of the FRC's wording will need to be adapted for US usage):

- Preparers, audit committees and auditors must ensure that all material issues are reported in a manner that is complete, neutral, free from error, fair and balanced.
- Auditors must exercise professional judgment when undertaking audits and adapt a challenging or appropriately skeptical approach to key issues, assumptions and evidence.
- Both the company and its auditor must be satisfied that the annual report, taken as a whole, is fair and balanced.

The Center for Audit Quality has also proposed a set of overarching Principles well worth adopting:

- Auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved.
- Any changes to the reporting model need to enhance or at least maintain audit quality.
- Any changes to the reporting model should narrow, not expand, the expectation gap.
- Any changes to the reporting model should add value and not create investor confusion.
- Auditor reporting should focus on the objective rather than the subjective.

Although after reading the CAQ's proposed changes, it seems they violate some of their own principles with the examples presented.

While the FRC states that the primary responsibility for providing information rests with the company and its management, the FRC also proposes that the audit committee produce reports that fully describe those important judgments and other matters addressed during the course of the audit.

The FRC and CAQ's comments are consistent and present a clearly more productive avenue to pursue without introducing new reporting lines that would confuse the public as would an AD&A, which would most likely expand the expectation, gap, if not at initiation over time. As the FRC also plans to introduce standards governing the reports auditors provide to audit committees, the PCAOB also has this ability within its standard setting mandate and has taken some initial action to enhance the communications between auditor and audit committee. The audit committee's published report should also be addressed.

Adequacy of Management Disclosure

The issues at the center of this debate may well be the adequacy and credibility of the current information provided by management. Disclosures for public companies are an SEC matter and should be addressed accordingly, only if the SEC believes there is need for improved or more disclosure.

The issues related to other management disclosures such as those included in MD&A may be addressed by requirements to include GAAP and risk related information in the footnotes which will then be covered by the auditor's report. This is more desirable than opinions on individual pieces of management information scattered throughout a 10K. The premise is that if information is to be covered by some form of auditor assurance that information should be in the footnotes.

Audit Quality

Audit Quality is within the PCAOB's purview and may be greatly facilitated by increased transparency into what an audit involves, including the scope and generally accepted audit procedures. These should be addressed through PCAOB Auditing Standards and inspections processes. The PCAOB should also consider making public Part II of their reports on quality controls and related issues within the firms inspected on a timely basis.

The large US registered firms should adopt a form of transparency report similar to the UK and European Union to report on their efforts in the areas of governance, quality and internal control. I believe this will focus the firms on such controls and create an atmosphere in which all try to raise their game. Having been in charge of Risk Management and Quality Control for both the US and International network of a major firm for the last part of my career, I believe disclosing Part II and Transparency type reporting will help improve quality, if not initially over time as each of the major firms compete to demonstrate their controls are best.

The audit standard setting process should provide the definitional context for the current wording, principally reasonable assurance and materiality, so that the audit report need not always repeat. The belief being that once memorialized in a standard and clearly defined and discussed, the public including the investor community will have the context they desire.

Independence and Fraud Detection

Additionally, as I teach classes in both Ethics and Auditing, my students and I review the major investigations and studies regarding the profession dating back to the Metcalf Commission, the first significant investigation of the public accounting profession since the 1930's. It's interesting to note, that the profession, lawmakers and regulators have been debating independence (principally services related) and fraud detection for nearly the entire forty years of my career in public accounting and teaching. At some point a "reasonable person" might expect this debate to be concluded.

It now seems appropriate to conclude the debate on two points, independence and fraud detection. In so doing, it's recommended that some bright lines between auditing and advisory or consulting services be drawn, either by complete prohibition or separation into different legal entities with separate governance. During my long career in public accounting, I've observed that auditors and consultants have different mindsets, priorities and approaches to their relationship with their clients. There is also a cultural divide due principally to the auditors' education regimen and emphasis on professional standards. These differences cannot always be overcome and result in a divergence of priorities over competing business objectives centered around revenue growth and professionalism as manifested in the AICPA's Code of Conduct. Many auditing professionals would most likely applaud such a separation.

Concluding the fraud detection debate could be accomplished by explicitly identifying in the auditor's report the auditor's responsibilities for fraud detection. Consulting type skills are often used for valuation issues such a derivatives and IT controls. These skills could and should be imbedded in audit practices to avoid conflicting objectives and priorities.

Reporting Relationships

The PCAOB should thoroughly consider the all-important relationship triangle between shareholders as represented by the board and audit committee, the auditor and management. You should not confuse the participants by changing reporting responsibilities but strengthen those that already exist. Given the changes taking place in board and shareholder governance, investors, particularly large activist institutions, have access to management and the board that a retail investor does not. The NACD in fact encourages boards to communicate more often with their investors. This was the subject of an NACD Blue Ribbon Panel Report in 2008.

Audit Committee reports should be enhanced and include the key points that the auditor discusses with the committee including resolution. This may involve the SEC, NYSE and NASDAQ changing requirements for the audit committee report to shareholders. The PCAOB has embarked on improving auditor – audit committee communications and should continue to monitor and adjust based on inspections and conversations with audit committee members.

Standard Auditor Report

As for the current "pass/fail" report as it is dismissively referred to, such a report has met its purpose and objectives for comparability and reduced misunderstanding, as noted in the concept release, albeit, this is currently refuted by some. I confidently state the current reporting model was never a hindrance or constraint on reports I've signed and helped provide some leverage with clients in tenuous financial situations, particularly during the S&L crisis. However, it is most likely a good time to make changes and refresh the language, however, the goals of comparability and understandability remain; otherwise I fear a new level of confusion and expectation gap will be introduced. At that point, the investor groups will most likely be the first to note that the reports are confusing since they are no longer comparable.

As for the areas of emphasis and emphasis paragraphs, these are often discussed in the financial statements and footnotes, e.g. related party transactions, estimates and judgments; I see no purpose in repeating these in the auditor's report. This is true provided the initial disclosures are appropriate and informative, otherwise the auditor will comment to the audit committee or ultimately comment in the audit report. This reporting model works well in most cases and could be clarified for the investing public through an expanded audit committee report that addresses key elements of communications with the auditor. The PCAOB has the opportunity to observe compliance as part of the inspection process.

Costs

Costs will always be an issue. If the auditor's role and responsibilities are expanded, auditors should be compensated for any extra effort and responsibility assumed. A cost benefit analysis should be conducted. Most likely as a part of a test period for any proposed changes.

st. john's UNIVERSITY

Other comments

Lastly, I endorse the comments submitted by my academic colleagues and former industry professionals at the Universities of Georgia and Notre Dame and do not propose to comment further

I thank you for the opportunity to comment on Rulemaking Docket No. 34.

Sincerely,

Edward F. Smith

Edward F. Smith MBA and CPA
Adjunct Professor

SOCIETY OF CORPORATE SECRETARIES
& GOVERNANCE PROFESSIONALS

via e-mail to: comments@pcaobus.org

December 20, 2011

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

Re: PCAOB Concept Release (No. 2011-003) on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements (PCAOB Rulemaking Docket Matter No. 034)

Ladies and Gentlemen:

The Society of Corporate Secretaries and Governance Professionals (the "Society") appreciates the opportunity to provide comments on the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, PCAOB Release No. 2011-003, issued on June 21, 2011 (the "Concept Release") by the Public Company Accounting Oversight Board (the "PCAOB").

Founded in 1946, the Society is a professional membership association of more than 3,100 attorneys, accountants, and other governance professionals who serve approximately 2,000 companies of most every size and industry. Society members are responsible for supporting the work of corporate boards of directors and their committees and the executive managements of their companies regarding corporate governance and disclosure. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements.

The Society appreciates the PCAOB's efforts to improve the relevancy and quality of public company audit reports to investors. However, the Society believes that even though the proposals in the Concept Release will fundamentally change the auditor's role, they will not meet the PCAOB's stated goals. Furthermore, the Society believes that the Concept Release does not set forth evidence supporting an appropriate cost/benefit rationale for the proposed changes. Our detailed comments follow.

*The PCAOB Concept Release Would Fundamentally Change the Role of the Auditor*

While the Concept Release states that the alternatives for changing the auditor's reporting model are "focused…on…improving the content of the auditor's report rather than on changing the fundamental role of the auditor," we believe the proposals in the Concept Release, if adopted, would, in fact, fundamentally change the role of the auditor from an independent analyst to an original source of information for investors. The net effect of many of the suggestions in the Concept Release, including the development of new auditing standards, would make the auditor a guarantor of the accuracy and completeness of the financial statements and, indeed, of the company's historical results of operations and financial condition.

The Concept Release also states that "the alternatives presented would retain the pass/fail opinion of the standard auditor's report." However, the Society believes that the pass/fail approach would be vitiated by the alternatives set out in the release. Instead, depending upon the nature and extent of the auditor's comments in the AD&A (as defined below), and in any required "assurance" on disclosures outside the financial statements, the audit would yield the equivalent of "high pass," "medium pass," "low pass," and similar "grades" – which would add complexity and uncertainty for investors that does not exist with the current pass/fail system.

*The Concept Release Provides Neither Empirical Evidence nor a Cost/Benefit Analysis for the Proposed Changes*

Further, the Concept Release does not provide any empirical evidence supporting the need for the proposed changes or a cost/benefit analysis of the alternatives proposed. For example, the Concept Release states that the information proposed to be provided "*might* be useful to investors and other financial statement users and *could* lead to more efficient markets and improved allocations of capital" and that "[t]he objective of this concept release is to discuss several alternatives for changing the auditor's reporting model that *could* increase its transparency and relevance…" (emphasis added) (see paragraphs 1 and 3 under "Purpose" on page 2). Because the PCAOB does not have the authority to unilaterally change the standard audit report without rulemaking from the Securities and Exchange Commission (the "SEC"), and in the absence of such empirical evidence, we believe any rules adopted under the Concept Release would be invalid under the recent United States Court of Appeals decision in *Business Roundtable v. Securities and Exchange Commission*. Moreover, if a proper cost/benefit analysis were undertaken, we believe the costs would far outweigh any possible benefits derived from the proposals.

Consequently, and for the reasons discussed below, the Society's does not support the proposed specific alternatives in the Concept Release.

*The Proposed Auditor's Discussion and Analysis Would be Confusing and Costly*

The Concept Release proposes an Auditor's Discussion and Analysis ("AD&A") section in the audit report that would give the auditor:

> "[t]he ability to discuss in a narrative format his or her views regarding significant matters. The AD&A could include information about the audit, such as audit risk identified in the audit, audit procedures and results, and auditor independence. It also could include a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting

> policies and practices, and difficult or contentious issues, including "close calls." Additionally, an AD&A could provide the auditor with discretion to comment on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements. An AD&A could also highlight those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures. (Release, p. 13.)"

The Society strongly disagrees with requiring an AD&A because it would (i) be counterproductive to the goal of providing greater transparency to investors; (ii) greatly increase the cost of the audit to issuers with no corresponding benefit to investors; and (iii) substitute the auditor's judgment for management's judgment, which could ultimately undermine the auditor's independence and management's responsibility for the financial statements and related disclosures.

Providing more detailed disclosure by the auditor of the matters considered and underlying considerations with regard to an issuer's financial statements would not meet the PCAOB's stated objectives of "increasing transparency and relevance to financial statement users, while not compromising audit quality". Providing additional disclosure to already lengthy and granular disclosures would likely increase confusion and would substantially increase the length of disclosure documents without a corresponding benefit. In addition to reading the audited financial statements and notes and the Management Discussion & Analysis, which provides investors a detailed, comprehensive view of the business through management's eyes, investors would be expected to read and distill additional, and possibly competing, disclosure from the auditor, without the additional context provided to management and audit committees via regular dialogue between the two. Given the substantial increase in the size of disclosure documents over the past several years (Compensation Discussion & Analysis, Dodd-Frank Wall Street Reform and Consumer Protection Act disclosures, etc.), the Society believes additional disclosure would further exacerbate the overload of information to investors. At some point, the additional information will lead to either investors "tuning out" disclosures or material information becoming buried in overly lengthy disclosures. In addition, the nature and process of review and approval of the AD&A would greatly increase the difficulty of meeting tight time frames for filings under the securities laws, particularly filings of large, accelerated filers whose financial statements are generally complex.

As our collective experience with the attestation requirement of the Sarbanes-Oxley Act of 2002 demonstrates, a substantial increase in the auditor's workload is costly to issuers. While the attestation requirement over internal controls may provide investors with greater comfort on the validity and reliability of an issuer's financial statements, an AD&A would greatly increase the cost of the audit to issuers with no corresponding benefit. Discussion of audit risk, audit procedures and results, and auditor independence are likely, over time, to become boilerplate discussions that will be difficult for investors to fully appreciate without having a financial accounting and auditing background. Even if the AD&A does not become boilerplate, the lack of consistency and comparability among different issuers' AD&As would cause confusion and uncertainty. To add a discussion on difficult and contentious issues, particularly including "close calls" on the application of complex accounting standards, sets up the unproductive situation where there are two potentially competing views on accounting matters. Competing views can only lead to equally unsatisfactory conclusions by the investor – that either the auditor is wrong or the issuer, including possibly its audit committee, is wrong– which will ultimately lead to a loss of confidence in the reliability of the financial statements. The lack of any benefit combined with the expected cost of an auditor providing an AD&A would be particularly acute for small- and mid-cap public companies.

In addition, we strongly disagree that the PCAOB should require an AD&A, as it would substitute the auditor's judgment for management's judgment. Management is responsible for the preparation of the financial statements and related disclosures and is in the best position to understand its business and discuss its financial results. If an auditor were required to provide its own analysis of critical audit risks and "close calls", then the auditor would, in effect, be taking ownership of and become responsible for the financial statements and related disclosures. Having a stake, in this case its professional reputation, in the accounting treatment of an issuer would seem to ultimately undermine the independence of the auditor.

Finally, we believe that auditors will likely be concerned – possibly, justifiably – that the inclusion of an AD&A will increase their exposure to liability. This may cause auditors to draft AD&As in the most legally defensive boilerplate possible, which would result at best in ineffective communication and meaningless disclosure.

*Required and Expansive Use of Emphasis Paragraphs Would Not Result in Meaningful Information*

The Society disagrees with the proposal to require and expand use of emphasis paragraphs. The Society believes that requiring emphasis paragraphs would (i) provide no additional benefit to investors as the emphasis paragraphs will, over time, become boilerplate discussions and (ii) appear to "qualify" an otherwise clean audit opinion.

The Society expects the proposed AD&A to become boilerplate over time, resulting in emphasis paragraphs that become standardized. Issuers, depending on their industry, would receive the standard "revenue recognition", "goodwill", etc. emphasis paragraphs from its auditor that would merely make the audit opinion longer rather than provide any benefit to investors. Further, because of the need for the auditor to protect against future litigation, the auditor could be inclined to "emphasize" as many possible areas of accounting risk it can. Finally, due to the lack of consistency and comparability among issuers, readers of these emphasis paragraphs will have no context in which to view these paragraphs, which will render the emphasis paragraphs meaningless.

One of the strengths of having a "pass/fail" reporting model, a model that the PCAOB states that it is interested in maintaining, is its simplicity and understandability. Either an issuer receives a "clean" opinion or it does not. Investors can rely on financial statements with "clean" opinions and should not rely on financial statements without them. By adding emphasis paragraphs, the simple, understandable approach is eviscerated. Auditor opinions will be appear to be riddled with exceptions, and it would be unclear at what point multiple emphasis paragraphs would devolve, or be perceived as devolving, into an adverse or disclaimer of opinion.

*Auditor Assurance on Other Information Outside of the Financial Statements Would Not Be Beneficial*

The Society also does not support the proposed assurance on items outside of the financial statements because we believe that a model by which auditors would provide assurance on items such as MD&A, earnings releases and non-GAAP measures, has significant downsides. While auditors are familiar with the figures and disclosure upon which the MD&A, earning releases, and non-GAAP measures are based, the cost of requiring an auditor opinion on MD&A or these other disclosures would provide relatively little benefit compared to the cost. Auditors already routinely review and comment on these matters (and issuers routinely take such comments into account), and their responsibilities include consideration of whether such information is materially inconsistent with the financial statements. Thus, we believe that the scope and nature of these other disclosures is unlikely to materially change as a result of requiring a more formal assurance on the part of auditors, but would rather serve only to increase the cost. We note that the illustration of a possible attestation in the Concept Release appears to suggest that such an attestation would have to contain a legal opinion that the MD&A meets the SEC rules and regulations, as well as assurance or "comfort" regarding the amounts and numbers contained therein. We believe these requirements are well beyond the scope of auditors' duties and, among other things, would appear to require an auditor to develop expertise in areas not currently associated with auditing responsibility.

In addition, requiring such assurances is inconsistent with the existing pass/fail approach to auditor financial statement opinions because it would introduce additional numerous and complex requirements, which could be difficult to interpret without further context but which would not necessarily be comparable across issuers. Introducing additional procedures surrounding auditor sign-off on earnings releases, MD&As and the like into an already time-pressed process could delay the filing process. Among other things, the Society believes that the expected benefits of requiring these assurances should be more specifically identified and quantified prior to requiring any such assurances.

*Clarification of Language Would Improve the Standard Auditor's Report*

The Society supports the continued improvement of auditor reports and believes that enhancements to such reports that further their transparency and usefulness without introducing unnecessary disclosure, complexity, and cost are valuable for investors. To the extent that additional language in the standard auditor's report clarifies the respective responsibilities of the auditor and management that are not defined or addressed in other disclosures, the Society believes such additional clarifications could be useful. However, any such clarifications should be strictly limited to critical issues and set forth succinctly in plain English.

For all of these reasons, the Society does not support the alternative disclosures discussed in the Concept Release.

We thank the PCAOB for its efforts to improve audit reports and enhance investor insight into issuer financial statements, and we would be happy to provide you with further information to the extent you would find it useful.

Respectfully submitted,

The Society of Corporate Secretaries and Governance Professionals

Robert B. Lamm,
Chair, Securities Law Committee

cc: James R. Doty
Lewis H. Ferguson
Daniel L. Goelzer
Jay D. Hanson
Steven B. Harris

**Robert J. Sonnelitter, CPA**
**17 Hoyt Road**
**Bethel, CT 06801**

September 28, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Public Company Accounting Oversight Board:

This is to provide my comments on PCAOB Rulemaking Docket Matter No. 34 regarding PCAOB Release No. 2011-003, Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (the "Release").

I am a Certified Public Accountant who has experience auditing large and small public companies. I currently work in quality control for a New York City based registered public accounting firm that audits smaller reporting companies and non-accelerated filers; however, my comments are intended to relate to auditors' reports on the financial statements of all sizes of public companies. Some general comments about the release and my comments on each of the four alternatives follow.

I am not convinced that significant changes to an auditor's report would be useful for investment decisions. An audit of the financial statements provides assurance as to the fair presentation of financial statements in accordance with a particular accounting framework. However, investment decisions cannot be based on the auditor's report. Such decisions must be based on information related to the company being considered for an investment. In addition, while objective analytics may be performed, investment decisions are always subjective. The investor must chose the extent to which he or she relies on objective analysis of the amounts presented in a company's financial statements and elsewhere, the extent of reliance placed on financial statement disclosures, and the extent of reliance placed on other available information about the prospective investment.

As stated in the Release, an audit of financial statements has long been recognized as a valuable process. As indicated in the appendix to this response, since the beginning of the twentieth century some form of assurance service has been provided by public accountants. Over time, both businessmen and public accountants came to realize that assurance with respect to financial statements must be provided in relation to some form of standard or standards; hence the development of accounting standards. So assurance with respect to financial statements progressed from the 1902 "certification" that United States Steel's financial statements were "correctly prepared" from its books to the present form of assurance which attests to whether a company's financial statements present financial position, results of operations, and cash flows fairly as that term is viewed under some framework of standards. After 1934, auditor's reports began to refer to 'fair presentations' in accordance with 'accepted principles of accounting.'

Historically, and currently, the purpose of the audit has been limited to being an attestation relating to the financial statements and the standards under which they have been prepared. Over the last 100 years, attestations beginning with "verifications" and "certifications" and progressing to the modern audit have related to financial statements, not to any other information. The attestation has been confined to the financial statements and the basis (i.e., standards) under which the financial statements were prepared. The standards behind (or basis used in) the preparation of financial statements is the most important factor to be considered with respect to the financial statements and an investor's or other user's analysis. It is not a coincidence that accounting principles and auditing standards developed in tandem with one another as businesses became more sophisticated. The accounting principles underlying financial statements facilitate the understanding of them, the auditing standards simply provide assurance that the financial statements have been prepared using the stated accounting principles (e.g., U.S. GAAP, IFRS, etc.).

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Thus, the basis for analyzing a company's financial statements must be the accounting principles under which they were prepared. I believe that much of the so-called "expectation gap" results from the confusion of auditing standards with accounting principles. Frequently, I find clients and their attorneys referring to a "GAAP Audit." Such a reference indicates a confusion of auditing standards with accounting principles. In addition, I believe that misunderstandings/confusion exists over the difference between audit risk and investment risk.

Generally accepted accounting principles ("GAAP") have been developed, as intended, to provide investors with a wealth of information for use in making investment decisions and I believe that significant changes to the auditor's reporting model could or would dilute the preeminence of GAAP as the basis for assessing financial statements. Financial statements prepared in accordance with GAAP provide investors with an abundance of information about the preparation of financial statements which includes information about how the elements of the financial statements are derived. For example, disclosures with respect to the fair values of financial instruments include information about the fair values are determined. Likewise, disclosures about share-based compensation include information about how the amounts of these expenses are computed. Therefore, while I concur that an audit of financial statements has value, the value does not relate to providing information about the financial statements. Information about the financial statements is provided by the financial statements themselves, including the related disclosures as required by GAAP. The value of an audit relates to the support it provides about the relevance and representational faithfulness[1] of the financial statements.

Because I believe that GAAP provides the best means for communicating information about a company's financial position, results of operations, and cash flows, I believe that the so-called pass/fail model is appropriate. Auditors are expected to render their opinion with respect to fair presentation. In my opinion, the following should be considered:

- An opinion is a subjective judgment which, by its nature is singular. One can have an opinion on this matter or that matter; but one cannot have multiple opinions on the same item or matter of interest. Thus, an opinion is a yes or no proposition. Of course there may be areas of uncertainty to be considered in forming an opinion, but the opinion is not a definitive statement. So uncertainties affect the formation of an opinion but they are not part of the opinion; consequently the financial statement presentation is considered either fair or not fair under the applicable set of standards.
- Under present auditing standards, an auditor may add a paragraph emphasizing a matter that was considered in forming the opinion; however, the matter being emphasized is only one of many matters considered by an auditor in forming his or her opinion. Since the auditor's opinion is the result of his subjective judgment based on many factors, there is a danger that an emphasis on any particular matter would mislead or confuse the user of the financial statements.
- Under present auditing standards, an auditor's report may be qualified due to a limitation in the scope of the audit or due to a departure from generally accepted accounting principles.
  - The reference to a scope limitation in the auditor's report may mislead or confuse the user of the financial statements. The fact that the scope limitation is not so egregious as to cause a disclaimer of opinion implies that the auditor has overcome the limitation; therefore, the limitation should not need to be mentioned in the opinion.
  - The reference to a departure from generally accepted accounting principles in the auditor's report may also mislead or confuse the user of the financial statements. As above, the fact that the departure is not so egregious as to cause an adverse opinion implies that the auditor has overcome the materiality of the departure; therefore it should not need to be mentioned in the opinion.

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To summarize the preceding matters, I believe that the role of an audit of financial statements should be limited to the objective stated in AU§110, *Responsibilities and Functions of the Independent Auditor*. That is, the expression of an opinion on the fairness of the financial statements presented by management.[a]

[a] As the Board knows, fairness must be related to some set of standards of application. Fairness is not an absolute, it implies some degree of reasonable deviation as well as being a judgment related to matters that, by their nature, may only be applied by exercising some degree of judgment. Fairness includes the concept of importance or materiality.

The Release observes that "The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his or her audits of financial statements."[2] I disagree. The auditor's report is not intended to communicate information regarding the audit; it is intended to communicate the auditor's opinion on the financial statements.[3] The scope paragraph explains the nature of what was done to enable the auditor to express his or her opinion. The Release also states "Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the risks of material misstatement in a company's financial statements."[4] However, the standard audit report already states that the audit was performed in accordance with the standards of the PCAOB (or the "Board"). So it seems that providing "a better understanding about the audit and how the audit was conducted" could involve a treatise on the requirements contained in the auditing standards of the PCAOB as well as a copy of some key audit work papers. Satisfaction beyond referring to the auditing standards of the PCAOB is both not practical and ill advised.

Based on the above observations, I believe that the current and ever increasing disclosure requirements of GAAP provide investors and other users of financial statements with more than adequate information for making investment decisions. I also observe that the mission of the FASB relates to ensuring that financial statements provide useful information to investors and other users of financial reports for purposes of decision making.[5] Furthermore, the I believe that the expected benefits of providing more information about the audit as compared with the hindrance from providing excessive information must be considered. I believe that too much information about how the audit was conducted would lead to more confusion, especially with respect to distinguishing accounting principles from auditing standards. In my view, another aspect of the "expectation gap" that has often been discussed also stems from a misunderstanding about the purpose of an audit.

I understand that the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG") suggested, and the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommended, that the Board undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model; however, it is most important to consider why those suggestions and recommendations have made. That is, why do these and the other groups mentioned in the Release believe changes should be made and how widespread is that belief.

After considering the information and viewpoints received from the comments to this Release, if the Board decides to pursue the notion of changing the auditor's report, I believe that more in-depth analysis should be made. While the PCAOB Staff (the "Staff") has conducted outreach activities, the degree to which those activities represent the attitudes of the population of users, preparers, and auditors of financial statements is not clear. For example:

- Statements throughout the Release indicate the attitudes or viewpoints of "some," or "many." However, it is not clear how extensive the attitudes or viewpoints of "some," or "many" are by comparison to others who may have different attitudes or viewpoints.

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  - I believe that the perspectives of those financial statement users that were not part of the outreach activities as well the perspectives of those who were part of the outreach activities but did not participate or respond must be considered. In my view, such non-participation implies that there is no objection to the status quo.

- The Release provides an overview of the participants of the outreach, but no indication is given with respect to how extensive was the participation of each group by comparison to other groups. Certainly, there would be bias if the participation, attitudes or viewpoints of any one group (e.g., investors, preparers, auditors, audit committee members, regulators and standard-setters, and academics) was over or under weighted by comparison to other groups.

- The Release does not indicate or analyze the degree of weighting given to the perspectives of each of the above participating groups. In view of the goal of providing useful information to investors and other users of financial statements, I believe that:
  - the perspectives of investors and other users of financial statements should be given top priority,
  - the perspectives of a) audit committee members, b) preparers, and c) auditors should be given the next priority,
  - the perspectives of government, regulators and standard-setters, and academics should not be considered because those groups do not actively participate in the investment process. Government and regulators and standard-setters exist to serve investors and other users of financial statements and academics study the accounting, auditing, financial statement preparation, and investment processes.[b]

    [b] In my view, the role of regulators and standard-setters and academics should be to assist in determining the information desires of investors and other users of financial statements. Regulators and standard-setters must also balance those desires against what information can feasibly be provided.

I am also not convinced that there is widespread "grass roots" dissatisfaction.

A. Auditor's Discussion and Analysis ("ADA")

I believe that having a supplemental narrative is not a good idea. In my view, such a supplemental report could confuse investors and shift their focus to the matters discussed in the ADA and away from the financial statements as a whole. As a result, an ADA would not facilitate an understanding of the auditor's opinion because it could or would bring about the loss of an investors primary perspective toward the financial statements as a whole.

I especially do not believe that a discussion about the auditor's views with respect to estimates and judgments affecting the financial statements would be beneficial. The auditor's basic views with respect to such estimates and judgments are inherently part of the auditor's opinion on the financial statements as a whole. Any supplemental views that are either favorable or unfavorable could cause undue optimism or pessimism on the part of investors.

The Release states: "An ADA could give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."[6] To the contrary, an ADA could cause management to be less forthright with their auditors for fear of negative statements.

Generally, an ADA could reduce investors' focus on the financial statements and cause an inappropriate increase in their focus on the auditor's opinion and comments. That kind of shift in focus undermines the

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effectiveness of disclosures required by generally accepted accounting principles and can only increase an auditor's liability risk.

B. Required and Expanded Use of Emphasis Paragraphs

This alternative seems to be a watered down version of an ADA that would be included in the auditor's opinion instead of as a supplemental narrative. Therefore, I do not agree that it would be appropriate for the same reasons as above. Furthermore, I believe that mandating the use of emphasis paragraphs in audit reports and to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements is not or should not be necessary. Emphasis paragraphs like these can amount to condensed footnotes and, as above, undermine the effectiveness of disclosures required by generally accepted accounting principles.

A requirement that an auditor should "justify" the audit assessments made in forming an opinion on financial statements would shift the focus to individual matters relative to the financial statements at the expense of a focus on the financial statements as a whole.

C. Auditor Assurance on Other Information Outside the Financial Statements

As pointed out in the Release:[7] "Providing assurance on information outside the financial statements would increase the scope of the auditor's responsibilities, require the development of new auditing standards, and might result in projects separate from the auditor's reporting model project."

The substantial increase in the cost of an audit should be carefully weighed against the added benefits that investors might receive. Regulation S-K contains fairly detailed requirements about the content of the MD&A and much of the information includes management's subjective judgments and analysis about causes behind changes in operations and about the future. The reliability of this type of information, no matter how carefully it is prepared, is questionable due to its nature. Therefore, the cost of auditing it may well outweigh the perceived benefits. I believe that the cost would outweigh the benefits provided to investors.

D. Clarification of the Standard Auditor's Report

The standard auditor's report already has explanations about an auditor's responsibility and what an audit represents. I do not think that additional explanations about what an audit represents and the related auditor responsibilities would provide significant additional value to investors. I believes that auditor's reports should be as clear, concise, and to the point as possible.

I do not believe that any of the four alternatives presented in the release would provide substantial benefits.

- I especially believe that requiring an ADA or mandating the use of emphasis paragraphs would be detrimental for the reasons discussed above.
- Assurance on Other Information Outside the Financial Statements could cost more than the value of any expected benefits.
- In the interest of clarity, some modification to the standard auditor's report might provide some small benefit. Therefore, I have the following suggestion:

---

**Report of Independent Registered Public Accounting Firm**

In our opinion, the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3 present the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash

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flows for each of the three years in the period ended December 31, 20X3, in conformity with accounting principles generally accepted in the United States of America.

Our opinion is based on our audits which we conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States). The financial statements referred to above are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. Financial statements presented in conformity with accounting principles generally accepted in the United States of America are inherently free of material misstatement and require management to estimate the amounts of some of their elements.

Audits conducted in accordance with the standards of the Public Company Accounting Oversight Board (United States) require that auditors obtain reasonable assurance about whether the financial statements are free of material misstatement and that they assess the whether the accounting principles used are appropriate and appropriately applied. An auditors' assessment of the risks of material misstatement of the financial statements affects the type and amount of supporting evidence that is examined during the audit to reduce such risk to a minimum. Our audits did not extend to information presented outside of the financial statements; consequently, we have no opinion on any such information.

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Notes regarding changes to the form of opinion:

- The opinion paragraph is placed first because the opinion on the financial statements is the primary matter of interest.
- The second paragraph adds a brief explanation about the nature of financial statements when they are presented in conformity with GAAP.
- The third paragraph adds a brief explanation about how audit risk assessment affects the audit.

Thank you for the opportunity to express my views on this issue.

Sincerely,

*Robert J. Sonnelitter*

Robert J. Sonnelitter, CPA

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[1] See Statement of Financial Accounting Concepts No. 8, Chapter 1, *The Objective of General Purpose Financial Reporting*, and Chapter 3, *Qualitative Characteristics of Useful Financial Information*. Paragraph QC 5 states: The fundamental qualitative characteristics [of financial statements] are *relevance* and *faithful representation*.

[2] Page 2.

[3] See AU§110.03 and AU§508.

[4] Page 7.

[5] The mission of the FASB is to "establish and improve standards of financial accounting and reporting that foster financial reporting by nongovernmental entities that provides decision-useful information to investors and other users of financial reports. That mission is accomplished through a comprehensive and independent process that encourages broad participation, objectively considers all stakeholder views, and is subject to oversight by the Financial Accounting Foundation's Board of Trustees."

[6] Page 13.

[7] Page 23.

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**Appendix: Historical Auditor's Reports**

An audit of financial statements has long been recognized as a valuable process. Since the beginning of the twentieth century some form of assurance service has been provided by public accountants. Over time, both businessmen and public accountants came to realize that assurance with respect to financial statements must be provided in relation to some form of standard or standards; hence the development of accounting standards. So assurance with respect to financial statements progressed from the 1902 "certification" that United States Steel's financial statements were "correctly prepared" from its books to the present form of assurance which attests to whether a company's financial statement present financial position, results of operations, and cash flows fairly as that term is viewed under some set of standards.

The following are examples of two early reports, each without a scope paragraph.

---

> The 1902 Annual Report of United States Steel includes **a certificate** from Price Waterhouse which stated:
>
> We examined the books of the US Steel Corporation and its Subsidiary Companies for the year ended December 31, 1902, and certify that the Balance Sheet at that date and the Relative Income Account are correctly prepared therefrom.
>
> The 1915 Annual Report of Sears, Roebuck and Co. includes **a note placed at the bottom of the Statement of Net Profits** from The Audit Company of New York which stated:
>
> We have made an audit of the books and accounts of Sears, Roebuck and Co. for the fiscal year ending December 31, 1915, and in accordance therewith we certify that in our opinion the foregoing statements of Income and the General Balance Sheet are true exhibits of the results of operations of the Company for the said period and of its condition as of December 31, 1915.

---

I have observed that, in 1917, The Federal Reserve Board prepared A Tentative Proposal entitled "UNIFORM ACCOUNTING." The proposal was meant as tentative proposal for a uniform system of accounting which "suggested standard forms of statements for merchants and manufacturers" and recognized the need for "(1) The improvement in standardization of the forms of statements," and "(2) The adoption of methods which will insure greater care in compiling the statements and the proper verification thereof." This proposal included instructions for the auditing procedures necessary for a balance sheet audit which included also some account descriptions, instructions for what should be addressed in the accountants' certificate, a proposed form of accountants report, and a proposed form of presentation of an income statement and balance sheet. The instructions were:

> The balance sheet and certificate should be connected with the accounts in such a way as to ensure that they shall be used only conjointly. This rule applies also to any report or memorandum containing any reservations as to the auditor's responsibility; any qualification as to the accounts, or any reference to facts materially affecting the financial position of the concern.
>
> The certificate should be as short and concise as possible, consistent with a correct statement of the facts, and if qualifications are necessary the auditor must state them in a clear and concise manner.
>
> If the auditor is satisfied that his audit has been complete and conforms to the general instructions of the Federal Reserve Board, and that the balance sheet and profit and loss statement are correct, or that any minor qualifications are fully covered by the footnotes on the balance sheet, the following form is proper:

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I have audited the accounts of Blank & Co. for the period from .............. to .............. and I certify that the above balance sheet and statement of profit and loss have been made in accordance with the plan suggested and advised by the Federal Reserve Board and in my opinion set forth the financial condition of the firm at .............. and the results of its operations for the period.

(Signed) A. B. C.

The following is an example of an auditor's report issued after the above 1917 proposal:

---

The 1926 Annual Report of Abraham & Straus, Inc. includes **a note placed at the bottom of the Balance Sheet** from Touche, Niven & Co. which stated:

We have examined the books and account of Abraham & Straus, Inc. for the year ended January 31, 1926, and we certify that the above balance sheet and the accompanying income and surplus account are in accordance therewith and, in our opinion, exhibit a true and correct view of the financial condition of the Corporation at January 31, 1926, and its operations for the year then ended.

---

In 1929, a revision to the 1917 suggestions was issued by the American Institute of Accountants (now the AICPA) entitled "VERIFICATION OF FINANCIAL STATEMENTS" and submitted to The Federal Reserve Board. That document was oriented more toward auditing procedures necessary for a balance sheet audit, and included a proposed form of accountants report. The instructions in that document were:

The auditor's certificate should be as concise as may be consistent with a correct statement of the facts. If qualifications are necessary, the auditor must state them clearly.

The balance sheet, the profit-and-loss statement, the auditor's certificate, and any report or memorandum containing reservations as to the auditor's responsibility, any qualifications as to the accounts, or any reference to facts materially affecting the financial position of the concern should be connected in such a way as to insure their use conjointly.

If the auditor is convinced that his examination has been adequate and in conformity with these general instructions, that the balance sheet and the profit-and-loss statement are correct, and that any minor qualifications are fully stated, the following form of certificate may be used:

I have examined the accounts of ............................................................ company for the period from ........................... to ..........................

I certify that the accompanying balance sheet and statement of profit and loss, in my opinion, set forth the financial condition of the company a .................................. and the results of operations for the period.

The following is an example of an auditor's report, which includes an explanation about the scope of the audit work performed that was issued after the above 1929 proposal:

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The 1930 Annual Report of American Telephone and Telegraph Company includes **a note placed at the bottom of the Statement of Earnings and Expenses** from Lybrand, Ross Bros. & Montgomery which stated:

> We have audited the accounts of
> AMERICAN TELEPHONE AND TELEGRAPH COMPANY
> for the year ended December 31, 1930. We have reviewed reports for that year rendered to the company by the associated and controlled companies and find that the American Telephone and Telegraph Company's proportion of the aggregate net income of the associated and directly and indirectly controlled companies as shown by such reports exceeded the dividends of $148,178,885 this company received on stocks owned by about $10,000,000. We have not, however, audited the accounts of the associated and controlled companies.
>
> We certify that, in our opinion, the accompanying balance sheet (on pages 14 and 15) and the above statement of earnings and expenses (subject to the explanation in the preceding paragraph) set forth correctly the financial position of American Telephone and Telegraph Company as at December 31, 1930 and the results of its operations for the year 1930.

---

In 1934, a document entitled "AUDITS OF CORPORATE ACCOUNTS" was prepared that included correspondence from 1932 to 1934 between the Special Committee on Co-operation with Stock Exchanges of the American Institute of Accountants and the Committee on Stock List of the New York Stock Exchange. The correspondence included a "Statement of Certain Accounting Principles Recommended by the Committee of American Institute of Accountants on Co-operation with Stock Exchanges," a "Revised Suggestion of a Form of Accountants' Report," and discussions about auditing procedures. Correspondence from the New York Stock Exchange stated that after July 1, 1933 all listing applications from corporations must contain the certificate of independent public accountants. The correspondence includes a suggestion for a form of Accountants' Report which includes a statement describing some of what was done (i.e., a partial scope of the procedures) in performing the examination ("audit"), The suggested form of Accountants' Report is below:

> We have made an examination of the balance-sheet of XYZ Company as at December 31, 1933, and of the statement of income and surplus for the year 1933. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions.
>
> In our opinion, based upon such examination, the accompanying balance-sheet and related statement of income and surplus fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 1933 and the results of its operations for the year.

With this suggested form, accountants' reports became more comparable to the modern form of accountants' reports. The following is an example of an auditor's report that was issued after the above 1934 correspondence:

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The 1934 Annual Report of National Food Products Corporation includes the **Certificate** of Peat, Marwick, Mitchell & Co. which stated:

> We have made an examination of the Balance Sheet of National Food Products Corporation as at December 31, 1934, and of the Profit and Loss and Surplus Accounts for the year 1934. In connection therewith, we examined or tested accounting records of the Company and other supporting evidence and obtained information and explanations from officers and employees of the Company; we also made a general review of the accounting methods and of the operating and income accounts, but we did not make a detailed audit of the transactions.
>
> The securities representing the investments were confirmed by inspection or by acknowledgment from the holder; the investments in subsidiary and controlled companies and the other investment are stated at cost which was $1,322,424.37 in excess of their appraised value or quoted market price as indicated on the Balance Sheet. Sundry securities are carried at a net amount of $3000.00 after deduction of a reserve of $263,748.42 which was provided from Capital Surplus pursuant to resolution of the Board of Directors.
>
> In our opinion, based upon such examination and subject to the foregoing qualifications, the accompanying Balance Sheet and related Income and Surplus Accounts fairly present, in accordance with accepted principles of accounting consistently maintained by the Company during the year under review, its position at December 31, 1934 and the results of its operations for the year.

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In January 1936 the American Institute of Accountants published a bulletin: “Examination of Financial Statements by Independent Public Accountants.” This bulletin contained a discussion regarding accounting principles but did not mandate the application of any such principles. This bulletin was published as a revision to the 1929 pamphlet “VERIFICATION OF FINANCIAL STATEMENTS” and included a form of accountants’ report. The bulletin contained the following notes about the use of the suggested accountants’ report:

1. It is contemplated that, before signing a report of the type suggested, the accountant will be satisfied that his examination has been adequate and in conformity with the principles outlined in this bulletin.
2. The report should be addressed to the directors of the company or to the stockholders, if the appointment is made by them.
3. The statement of what has been examined would, of course, conform to the titles of the accounts or statements reported upon.
4. In the second sentence, any special forms of confirmation could be mentioned: e.g., "including confirmation of cash and securities by inspection or certificates from depositaries."
5. This certificate is appropriate only if the accounting for the year is consistent in basis with that for the preceding year. If there has been any material change either in accounting principles or in the manner of their application, the nature of the change should be indicated.
6. It is contemplated that the form of report would be modified when and as necessary to embody any qualifications, reservations or supplementary explanations.

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The non-binding reporting guidance was followed in the cases below:

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The 1936 Annual Report of Dow Chemical includes the **Accountants' Certificate** of Haskins & Sells which stated:

We have made an examination of the balance sheet of The Dow Chemical Company as of May 31, 1936, and of the related summary of income and surplus for the year ended that date. In connection therewith, we made a review of the accounting methods and examined or tested accounting records of the company and other supporting evidence in a manner and to the extent which we considered appropriate in view of the system of internal accounting control. We did not verify the quantities in the inventories but were furnished with a certificate of officials of the company as to quantities upon which the inventory values were based.

The accounts of subsidiary and affiliated companies carried as investments at cost of $1,155,580.00 in the accompanying balance sheet were not examined by us at May 31, 1936. Examinations of the accounts of three of the companies, the investment in which amounted to $341,579.00, are now in progress, and the accounts of another of the companies, the investment in which amounted to $665,001.00 were examined by us as of March 31, 1936. We have not made an examination of the accounts of one remaining company, the investment in which amounted to $149,000.00.

In our opinion, based upon such examination and subject to the foregoing, the accompanying balance sheet and related summary of income and surplus fairly present, in accordance with accepted principles of accounting consistently followed by the company, its financial condition at May 31, 1936 and the results of its operations for the year ended that date.

The 1938 Annual Report of the Radio Corporation of America includes a report of Arthur Young & Company which stated:

We have made an examination of the Consolidated Balance Sheet of RADIO CORPORATION OF AMERICA AND SUBSIDIARY COMPANIES as at December 31, 1938, and of the Consolidated Statement of Income and Earned Surplus Accounts for the year 1938. In connection therewith, we examined or tested accounting records of the Corporation and its Subsidiaries and other supporting evidence to the extent which we considered sufficient and obtained information and explanations requested by us from officers and employees of the Companies. We also made a general review of the accounting methods and of the operating and income accounts for the year, but we did not make a detailed audit of the transactions. Following the practice of prior years the Companies' methods of taking inventory were reviewed and approved by us; we satisfied ourselves as to prices and computations and made substantial physical tests of quantities at the various locations. For certain foreign subsidiaries, whose assets amount to 3% of the total assets, we have accepted and incorporated in the consolidated statements, after a scrutiny and review sufficient to satisfy ourselves as to their accounting principles followed, the audited accounts prepared by their public accountants as at either October 31st, or November 30th, 1938.

The changes explained in Notes 1 and 4 to the Statement of Income, while they depart from the practice of prior years, are entirely consistent with accepted principles of accounting.

In our opinion, based upon such examination, the accompanying Consolidated Balance Sheet and related Consolidated Statement of Income and Earned Surplus, together with the notes thereon, fairly present, in accordance with accepted principles of accounting which have been consistently maintained by the Corporation, its financial position at December 31, 1934 and the results of its operations for the year ended that date.

---

In 1939 the American Institute of Accountants' Committee on Accounting Procedure issued Accounting Research Bulletin ("ARB") No. 1, *General Introduction and Rules Formerly Adopted*. ARB 1 again adopted six basic accounting principles that were adopted in 1934. In the same year, the American

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Institute of Accountants' Committee on Auditing Procedure issued Statement on Auditing Procedure ("SAP") No. 1, *Extensions of Auditing Procedure*.

The Auditor's Reports below were issued after the AIA (now AICPA) began to issue ARBs and SAPs:

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The 1942 Annual Report of Humble Oil & Refining Company includes the report of Price Waterhouse & Co. which stated:

We have examined the consolidated balance sheet of Humble Oil & Refining Company and its wholly owned subsidiary, Humble Pipeline Company, as at December 31, 1942 and the consolidated statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards applicable in the circumstances, except that it was not practicable to confirm receivables from the United States Government, with respect to which we have satisfied ourselves by means of other auditing procedures. The examination included such tests of the accounting records, without detailed audit of the transactions, and other supporting evidence and such other procedures as we considered necessary.

We have accepted the balances of the fixed (capital) assets and relative reserves of the companies as at January 1, 1934 at the amounts shown on the books and records of the companies.

The income account for the year 1942 includes profits which were realized on sales to various departments and agencies of the United States Government. The profits realized therefrom are subject to renegotiation under the War Profits Control Act, but the amount of the adjustments, if any, which may result from such renegotiation is not presently determinable.

In our opinion, with the reservation in the preceding paragraph, the accompanying consolidated balance sheet of Humble Oil & Refining Company and its wholly owned subsidiary company and the related statements of income and surplus, together with the notes thereto, present fairly the consolidated position of the companies at December 31, 1942 and the consolidated results of their operations for the year, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The 1950 Annual Report of the American Express Company includes the **Accountants' Certificate** of Haskins & Sells which stated:

We have examined the balance sheet of American Express Company as of December 31, 1950, and the consolidated statement of income and surplus of the Company and consolidated subsidiaries for the year then ended. We have also examined the consolidated balance sheet of the Company's principal subsidiary, The American Express Company, Incorporated and consolidated subsidiaries, as of December 31, 1950. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances; as to American Express Company, it was not practicable to reconcile the individual liability balances of travelers cheques and drafts (money orders) with the respective related control accounts but, in view of the accounting procedures followed and the system of internal accounting control in effect, we satisfied with respect to the aggregate amounts of these liabilities by examination of the control accounts.

In our opinion, the accompanying balance sheets and statement of income and surplus, with their notes, present fairly the financial position of American Express Company and of The American Express Company, Incorporated at December 31, 1950 and the results of operations of American Express Company and consolidated subsidiaries for the year then ended, in conformity with generally accepted accounting principles applied on a consistent basis.

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The 1955 Annual Report of Boeing Airplane Company includes the **Accountants' Report** of Touche, Niven Bailey & Smart which stated:

We have examined the balance sheet of Boeing Airplane Company as of December 31, 1955, and the related statements of net earnings and earnings retained for use in the business for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. We were unable to obtain satisfactory confirmations of receivables from the United States by direct communication, but we satisfied ourselves as to such accounts by other auditing procedures.

In our opinion, the accompanying balance sheets and statements of net earnings and earnings retained for use in the business present fairly the financial position of Boeing Airplane Company at December 31, 1955 and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Also in our opinion, the action of the Board of Directors on December 12, 1955, in setting aside the sum of $3,250,000 for the year 1955 under the Incentive Compensation Plan for Officers and Employees, is in conformity with the provisions contained in the first paragraph of Section 2 of such plan.

The 1968 Annual Report of Magma Copper Company includes the **Auditors' Report** of Arthur Andersen & Co. which stated:

We have examined the consolidated balance sheet of MAGMA COPPER COMPANY (a Maine corporation) and subsidiaries as of December 31, 1968, and the related consolidated statements of income, retained earnings, and source and disposition of funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying consolidated balance sheet and consolidated statements of income, retained earnings, and source and disposition of funds present fairly the financial position of Magma Copper Company as of December 31, 1968, and the results of their operations and source and disposition of funds for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

STATE STREET.

**James J. Malerba**
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September 28, 2011

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

Via email: comments@pcaobus.org

**Re: Invitation to Comment:** ***Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34***

Dear Board Members:

State Street Corporation ("State Street") appreciates the opportunity to comment on the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the concept release). With $22.76 trillion in assets under custody and administration and $2.12 trillion in assets under management as of June 30, 2011, State Street is the world's leading provider of financial services to institutional investors.

We have a number of comments regarding the concept release that we believe need to be addressed in order to achieve the proper balance of ensuring that additional information in the form of auditor communications is both reliable and relevant to the users of financial statements. Our comments below are applicable to all of the alternatives proposed for changing the auditor's reporting model.

The proposals in the concept release appear to be inconsistent with the FASB and IASB objectives of encouraging more reasoned judgment instead of a prescriptive rules-based approach. We believe that requiring auditors to provide information on the company's financial reporting process either through the proposed Auditor's Discussion and Analysis (AD&A) or expanded use of emphasis paragraph alternatives would force independent auditors to consistently hold (or "assume") the most conservative view on matters of accounting judgment, effectively precluding reasoned judgment that might result in the most appropriate financial reporting outcome.

State Street believes that auditors should not be the original source of disclosure specifically related to management judgments and estimates, or accounting policies and practices, including areas of significant judgment, such as "close calls." Providing information to investors with respect to our accounting policies and their application is the responsibility of State Street's management, not the independent auditor. The auditor's role is to evaluate whether the financial statements taken as a whole are presented fairly in accordance with generally accepted accounting principles (GAAP). Requiring the auditors to disclose this information would create confusion for the readers of financial statements, as they would need to sort through information provided by both management and the independent auditors. The auditor's responsibility to communicate such matters should be limited to situations in which the financial statements are not in conformity with GAAP in all material respects.

Conceptually, requiring the independent auditors to summarize to investors the same level of detail and context that is provided to a company's Board of Directors would be difficult and potentially misleading. In the absence of appropriate context and two-way communication, we believe that such information would be incomplete, would generate greater confusion, and would not enhance the overall understanding of the readers of the auditor's report and financial statements. Additionally, we note that requiring supplemental reporting such as the proposed AD&A will likely lengthen the time to complete the audit as there may not be sufficient time for the auditor to complete the audit of the financial statements and provide assurance in additional areas and therefore adversely impact filing timelines for large accelerated filers.

We do not object to the concept of requiring auditors to provide assurance on certain information outside the financial statements, provided that the scope of such assurance is clearly defined. However, we are unclear on the incremental benefits to investors from the elevated level of assurance proposed to be provided by auditors over management's discussion and analysis (MD&A), including the critical accounting estimates currently discussed in MD&A, given the likely significant increase in audit procedures and audit-related costs that will ultimately be borne by our company's shareholders.

State Street believes that the current auditor's report ("pass/fail model") clearly communicates the nature of the audit and whether the financial statements are presented fairly, in all material respects, in accordance with GAAP. The concept of clarification of the standard auditor's report would further lengthen the auditor's report unnecessarily without achieving the objective of enhancing communication between auditors and the users of audit reports, thereby compromising the report's effectiveness. With respect to the proposed approach related to the required and expanded use of emphasis paragraphs, we note that existing standards allow auditors to add areas of emphasis at their discretion, based on circumstances. We believe that mandating the requirement for an emphasis paragraph would result in standardized language over time and would therefore not achieve the proposed objective.

We appreciate your consideration of these matters and welcome the opportunity to discuss them with you.

Sincerely,

James J. Malerba
*Executive Vice President and Corporate Controller*

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September 30, 2011

Via E-mail: comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 34 – Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements

Ladies and Gentlemen:

This letter is in response to the Concept Release issued by the Public Company Accounting Oversight Board (the "Board") relating to possible revisions to the Board's standards relating to auditors' reports on financial statements (the "Release").

We appreciate the opportunity to submit these comments for the Board's consideration. The Release discusses a wide range of possible revisions. One group of revisions would seek to address investors' understanding of the audit process in general, through clarification of language in the standard auditor's report; these changes seem to us unobjectionable in principle and worth pursuing. A second group of possible revisions would require the auditors to perform and report on additional procedures, leading to auditor assurance on additional information outside the financial statements. We believe that any revisions in this category would require rulemaking by the Securities and Exchange Commission, and should be subject to very rigorous cost/benefit analysis, but we do not have other comments on these measures at this time. The balance of the possible revisions – which include a required "auditor's discussion and analysis", or AD&A, and mandatory use of emphasis paragraphs in the audit report – would require the auditors to identify and disclose information about the particular issuer being audited and its results of operations and financial position, or about the particular audit being reported on. Such revisions would necessarily change significantly the auditor's traditional role of attesting to information prepared by management. From the perspective of lawyers regularly engaged in advising issuers on disclosure and reporting matters, we think that revisions of these sorts could raise serious governance and disclosure concerns for issuers and their auditors.

Our greatest concern relates to possible requirements that the auditor make disclosures about the issuer itself. The Release states that the purpose of these changes would be to provide investors with more transparency into the audit process and more insight into the issuer's financial statements or other information outside the financial statements. For reasons that have been well articulated, we think it is essential that the issuer should be the original source of any disclosure about the issuer or its results of operations or financial position. Although the auditor will generally have a well-informed perspective on these matters, that perspective is necessarily different from, and narrower than, management's perspective. Management is responsible for having the "complete picture" and making disclosure accordingly, while the auditor's knowledge of the issuer derives from what the auditor observes through the course of the audit. But the audit is designed for the specific purpose of supporting the audit report, not for the purpose of informing the auditor generally about the issuer and its affairs, or supporting general disclosures about the issuer (whether those disclosures relate to the financial statements or information outside the financial statements). So it seems to us fundamentally illogical to require the auditor to develop and publish substantive disclosures about the issuer itself. Such auditor comments will be subjective, raising potential comparability concerns, and therefore susceptible to a "boilerplate" approach, which will not further any transparency objectives. Part of the stated rationale for the proposed AD&A is that it would give the auditor greater leverage to convince the issuer to make changes. Given the differing roles and perspectives of the auditor, on the one hand, and management and the audit committee, on the other, we frankly think that this is an inappropriate objective for the Board to seek to advance. We are also concerned that new requirements for disclosure by auditors may expose the auditors to additional potential liability, unfairly in our view, since the auditor would be required to make comments on the basis of information acquired incidentally in the course of the audit, as opposed to as a result of procedures designed specifically to develop such disclosure. And we fear that auditor disclosures of the sort contemplated would likely enhance the issuer's liability profile, as well. In this regard, we question the benefit to investors of the reporting of so-called "difficult or contentious issues, including 'close calls'" that were resolved to the auditor's satisfaction based on its professional judgment, and believe such reporting would carry with it a particularly high risk of enhanced liability.

At the same time, we believe it is quite important that issuers (and derivatively, their shareholders) get the full benefit of the auditor's insights acquired through the course of the audit. But we feel strongly that requiring the auditor to make public substantive disclosures about the issuer will not promote that objective, and may well inhibit the governance processes now in place to oversee financial reporting. Governance changes over the past decade – such as the audit committee independence requirements of Rule 10A-3 under the Securities Exchange Act of 1934, the disclosure requirements with respect to "audit committee financial experts" and audit committee reports, and related practice developments – have enhanced the role of the public company audit committee and, we believe, audit committee effectiveness. Auditors should be encouraged to have the fullest and frankest conversations possible with the audit committee. The best way to promote that objective is to allow those conversations to be conducted, whenever the audit committee desires or the auditor so requests, on a confidential basis. We are quite concerned that if the auditor's discussions with the audit committee are conducted with the anticipation of subsequent public disclosures being made by the auditor, these auditor/audit committee discussions may be seriously inhibited. Auditors may be more cautious in raising concerns, and audit committee members may be more circumspect in probing such concerns with the auditor.

The audit committee, and the board of directors, have oversight responsibility for the issuer's disclosure, including its financial statements. We believe that public company audit committees generally seek to understand and address substantive concerns raised by auditors in the course of their interaction, but to the extent there are concerns about audit committee performance in this regard, that should be addressed as a governance matter, including through additional Securities and Exchange Commission or stock exchange rule making, if thought necessary, not by requiring auditors to make their own public disclosures about the issuer.

As noted, our greatest concern with the possible revisions relates to possible new requirements for the auditor to make disclosure about the issuer. Disclosure requirements relating to audit procedures and the audit itself might, as a theoretical matter, be less problematic, but we are concerned that in practice, the two sorts of disclosures may well overlap. For example, a disclosure by the auditor that it had followed enhanced procedures with respect to a particular item or matter might well lead the issuer to consider enhanced responsive disclosure about that same item or matter. In principle, we think that this raises the same concerns as requiring substantive disclosure by the auditor about the issuer itself. We also expect that such disclosure about the audit and audit procedures will be even more susceptible to "boilerplate" treatment, and less likely to be useful to investors.

* * *

We appreciate this opportunity to comment on the Release. You may direct any questions with respect to this letter to Robert E. Buckholz at (212) 558-3876, Robert W. Downes at (212) 558-4312 or William G. Farrar at (212) 558-4940.

Very truly yours,

Sullivan & Cromwell LLP

SULLIVAN & CROMWELL LLP

SwissHoldings

Verband der Industrie- und Dienstleistungskonzerne in der Schweiz
Fédération des groupes industriels et de services en Suisse
Federation of Industrial and Service Groups in Switzerland

30 September 2011

Office of the Secretary
U.S. PCAOB
1666 K Street, N.W.
Washington, D.C.
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USA

**PCAOB RULEMAKING DOCKET MATTER No. 34**
**CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS**
**PCAOB Release No. 2011-003 June 21, 2011**

Dear Sir / Madam,

SwissHoldings, the Swiss Federation of Industrial and Services Groups in Switzerland represents 53 Swiss groups, including most of the country's major industrial and commercial enterprises. As certain of our members are registered with the SEC as Foreign Private Issuers, they are audited in accordance with PCAOB standards. Our response below has been prepared in conjunction with our affected member companies. We have grouped our specific comments into broad categories rather than providing responses to each detailed question in the release.

**GENERAL COMMENTS**

We understand the concern to improve the audit report, especially at the present time. In our view, the right response should take into account that no change to the content of reporting, either by the auditor or the issuer, can totally eliminate risk for investors. Financial information which investors need about an issuer should come from the issuer and its management, not from the auditor. Reporting of judgements and estimates should focus on those made by management and not those made by the auditor. The benefit from the auditor's existing ability to include emphasis of matter remarks would be devalued were such remarks to become a routine part of every audit report. Any changes made to auditor reporting should preserve and not undermine what has been described as the "pass/fail model" of the audit report, with its associated clear accountability for both management and the auditor, nor should it impede communication between auditor and issuer. Direct communication between auditors and users, which some commentators have suggested, would complicate auditor-issuer communication.

We believe that the purpose of the audit report should be to state the result of the audit process, rather than describe the technical detail of the process itself. We would not object to adding a statement to the standard audit opinion wording which clarified how information outside of, but accompanying the financial statements, such as the Operating and Financial Review (MD&A), impacts the scope of the auditor's procedures. However, we believe that that impact should remain limited to reviewing such information for consistency with the financial statements and the

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understanding the auditor has gained from the audit. The auditor should not be required to report formally on information presented outside the financial statements.

In our opinion, the pass/fail audit report model works well because of its simplicity and clarity. Although it does not make the audit or the financial statements risk-free, because of the potential consequences of a ‘fail’, one can reasonably expect that the audit client will do anything in its power to avoid that outcome. It would also be regrettable if, as a consequence of expanding the audit report content, the completion of the audit was delayed, resulting in less timely provision of financial information to users. In our view, this is a very real risk for those issuers who currently complete their SEC filings before the prescribed deadline because management, audit committees and auditors would need to spend additional time discussing the extra information to be reported.

## SPECIFIC COMMENTS ON ALTERNATIVES CONSIDERED IN THE RELEASE

### 1. "Auditor's Discussion and Analysis (AD&A)"

We do not believe that the Board should consider publication of an AD&A as a means of providing additional information about the audit. In our view, the content of an AD&A would almost inevitably blur the discipline of the pass/fail opinion model, and lead to ambiguity. Different financial statement users would interpret AD&A comments in different ways. It would also complicate issuer-auditor discussions, leading to the risk that the quality of the audit might be reduced. The auditor would need to discuss the content of the AD&A report with the issuer. These discussions might be prolonged, delaying the issuance of the financial statements.

### 2. Required and Expanded Use of Emphasis Paragraphs in Audit Opinion

In our view, audit reports should not routinely contain emphasis paragraphs. They should be used only by exception, and only for information which by its nature cannot be provided through the financial statements. The examples of emphasis matters mentioned in the release contain information which, in our view, could be provided in the financial statements. As with the AD&A, the risk that routine emphasis matter paragraphs would introduce ambiguity into the opinion and would reduce the value of the pass/fail model would be significant. The most serious dangers are that users might be confused and the auditor’s responsibility for the pass/fail opinion might be diminished, or at least perceived to be diminished. The issuance of the financial statements might also be delayed while issuer and auditor discuss the content and wording of the emphasis paragraphs. With routine emphasis of matters, any benefit of providing additional information would likely be eroded by a tendency to use boilerplate language.

We would not support a separate formal auditor report on the issuer’s critical accounting estimates. Issuers who report in accordance with IFRS provide information about those estimates as part of their audited financial statements, in line with the disclosure requirements in IAS 1. The auditor’s work on that information is part of the standard audit, and fully covered in the existing report.

### 3. Auditor Assurance on Other Information Outside the Financial Statements

In our view, because the MD&A has to be presented through the eyes of management, the auditor can only review it for reasonableness and consistency; it is not possible for an independent auditor to express an opinion on its intrinsic accuracy, since it represents only one view, rather than being objectively verifiable. Any report would have to focus purely on formal compliance with the applicable regulations. As there is no objective benchmark of what non-GAAP information should be prepared or how it should be prepared, it is again not possible for the auditor to express a pass/fail opinion on it. Extension of the scope of reporting, by requiring a separate formal report on information outside the financial statements, may lead to that information being published later than it is now. As stated in paragraph 4 below, in our opinion a brief addition to the standard audit report mentioning the scope of the review of the other information could be considered instead of a separate formal report.

## 4. Clarification of the Standard Auditor's Report

Once again, the more the report is expanded, the greater the risk of reducing the significance of the pass/fail opinion. Any clarification of language in the audit report should avoid adding significantly to its length, especially with regard to the phrases which describe the audit procedures. Most financial statement users are neither auditors nor have they been trained as auditors. Including an extensive and detailed description of technical auditing matters in the report would likely not add significant value for them.

As the release states, the auditor carries out certain procedures on certain information outside the financial statements, such as the MD&A. We would not object to the audit opinion stating that the auditor has reviewed that information for consistency with the financial statements and with the auditor's knowledge, but has not performed an audit of it. However, if the auditor were to give a separate formal report on that information, this would carry some risk of diluting the value of the pass/fail opinion in the audit report on the financial statements.

SwissHoldings would like to thank you for the opportunity to comment on this project. We would be pleased to respond to any questions arising from the above comments and are available for further consultation if required.

Yours sincerely

**SwissHoldings**
Federation of Industrial and Service Groups in Switzerland

P. Baumgartner    D. Laufer

| | |
|---|---|
| Dr. Peter Baumgartner | Denise Laufer |
| Chair Executive Committee | Policy Manager |

**cc** SH Board

11-09-30-CL PCAOB Rulemaking Docket Matter No. 34

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September 30, 2011

Office of the Secretary
Public Company Accounting Oversight Board
PCAOB Rulemaking Docket Matter No. 34
1666 K Street,
N.W., Washington, D.C 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 34, Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements**

Dear Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards," (the "concept release") dated June 21, 2011.

Synopsys, Inc. is a world leader in the electronic design automation (EDA) market. We supply software, IP and services for semiconductor design, verification and manufacturing.

We appreciate the Board's efforts to consider changing the audit reports for financial statements to enhance the usefulness for the users (i.e. the investor community). However, we believe that the potential changes reflected in the concept release will not only fail to enhance the usefulness of financial statements, but will actually complicate the communication of the auditor's opinion, while driving the cost of audits significantly higher. **Hence, we strongly suggest retaining the existing format and language of the auditor's report.**

The current format of the auditor's report provides a clear and complete representation of the auditor's opinion on the financial statements. The format ensures no confusion for the reader since the report follows a pass/fail model. The "pass" grade is a high standard to achieve and auditors do not make the "pass" representation lightly. The auditors must represent, without any qualifications, that the financials present fairly, **in all material respects,** the financial position of the company. In our opinion, any expansion of the report to include discussions of factors such as those impacting the issues encountered during the audit or an Auditor Discussion and Analysis, would serve only to dilute the representation and confuse readers by forcing them to evaluate the interrelation of the additional disclosures, understand new terms and interpret various comments that may be included in the proposed auditor's report. In our opinion, while sophisticated investors with significant research resources, such as institutional investors, may be able to navigate through the maze of the additional disclosures, we believe most users will have significant difficulty in doing so.

In all of the years that we have been filing our financial statements, we have received no inquiry from the investor community seeking any clarification of either the audit report or the contents presented therein. Therefore, we believe that these proposed revisions are not required or expected by the investor community.

We are further concerned about the increased costs associated with audit firms providing the proposed additional disclosures such as an AD&A and assurances on information outside of the financial statements. Historical experience with the increased costs for the additional representations related to SOX suggests a large increase in costs would result from the expansion of the audit report. We believe the increased costs do not support the benefit, if any, that may exist from the increased disclosures.

With this background, we offer the following feedback regarding the various alternatives described in the Concept release:

**Auditor's Discussion and Analysis**

We do not believe that the inclusion of an AD&A would achieve the objective of improving the understanding of the financial information by the users. Instead, any discussion of deficiencies or alternative approaches for an accounting matter would contradict a clean opinion and confuse the investors. Furthermore, we believe that auditors will include voluminous boilerplate language in order to reduce their exposure to litigation on account of the additional information required in the report. This language will provide limited, if any, qualitative inputs to improve the readers' understanding.

We also believe that the AD&A will become the auditors' view of which part of the financial information is most useful, which we believe is beyond the responsibility of the auditors. Along with additional responsibility would come a significant increase of costs to complete the audit, which we believe are unnecessary.

**Required and Expanded Use of Emphasis Paragraphs**

We do not believe that including mandatory emphasis paragraphs improves the understanding of the financial statements. As mentioned above, investors might confuse emphasis discussions as potential issues with the financial statements. Therefore, extensive investor education may be required to prevent any such confusion. We also believe that the responsibility of determining which areas of the financial statements are important to the readers should not be that of the auditors; instead, that responsibility should remain with management. Finally, PCAOB standards and guides already provide detailed descriptions of how auditors should deal with matters such as management's estimates and judgments. We believe that the investor community understands and has knowledge that all the auditors follow such guidance while performing the audit. Therefore, we do not feel that disclosing these procedures is helpful to the investor community or adds any additional benefit to making investment decisions.

**Auditor Assurance on Other Information Outside of the Financial Statements**

We believe that requiring auditors to provide assurance on information outside of the financial statements is not appropriate and that such assurances would be cost prohibitive. For example, we believe that management, not the auditor, is the most competent authority to provide a qualitative discussion in the MD&A on key changes as they are deeply involved in the day-to-day running of the business. Similarly, requiring auditors to provide meaningful assurance on non-GAAP information would be cumbersome as there are no set standards to govern its form or composition. Most of the non-GAAP information provided is specific and unique to each company. This information is based on how management views its business and it would be unrealistic to expect a uniform set of audit procedures to assist in providing any positive assurance on the adequacy or content of non-GAAP information. Providing assurances on MD&A or non-GAAP information would entail extensive procedures by the auditors and the costs would certainly outweigh the benefits.

**Clarification of the Standard Auditor's Report**

We believe that the current auditor's report provides adequate information about each company's financial statements. We do not believe that the audit report is the appropriate medium to educate the investor community of the audit process, risks, and independence issues that exist in any audit situation. Such education, including clear and concise summaries of the various PCAOB standards, could be presented generally through various other mediums, such as pamphlets from the PCAOB.

Therefore, we request retaining the current format of the auditor's report as an adequate and complete representation of the auditor's opinion on the financial statements. We believe the appropriate approach to improve the quality of the audits performed on the financial statements by the audit firms should be through the mechanism of the Board continuing to carry out effective reviews and providing suggestions to improve audit procedures and disclosures by the company in the financial statements.

We would like to refrain from answering specific questions mentioned in the concept release, but hope that the above responses communicate our concerns. We request you to strongly consider these thoughts and resist making any changes to the auditor's report.

Sincerely,

Brian M. Beattie
Chief Finance Officer

Sujit Kankanwadi
Director, Accounting

September 30, 2011

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Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
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**PCAOB Rulemaking Docket Matter No. 34: Concept release on possible revisions to PCAOB standards related to reports on audited financial statements**

Dear Mr. Seymour:

Tesoro Corporation is pleased to submit comments on the Public Company Accounting Oversight Board's (PCAOB or the Board) concept release on possible revisions to PCAOB standards related to reports on audited financial statements (the Concept Release).

Tesoro Corporation ("Tesoro") is one of the largest independent petroleum refiners and marketers in the United States. We primarily manufacture and sell transportation fuels. We own and operate seven refineries in the western United States that refine crude oil and other feedstocks into transportation fuels, such as gasoline, gasoline blendstocks, jet fuel and diesel fuel, as well as other products, including heavy fuel oils, liquefied petroleum gas, petroleum coke and asphalt.

We support the Board's undertaking, and believe that certain, specific, objective changes could provide additional useful information to investors and other financial statement users; however the majority of options noted in the Concept Release are more likely to have negative consequences for the overall corporate governance structure. This letter provides our overall views of selected issues from the Concept Release including:

- Our belief that the auditor's role should not be expanded to incorporate any subjective commentary about the Company in any form, including an Auditor's Discussion and Analysis (AD&A);
- Our belief that the auditor's roles and report should not be expanded to include information outside of the financial statements; and
- Our belief that the current "pass/fail" audit opinion should be retained and should include information within the auditors' report that would clarify certain procedures already performed by auditors.

**Auditor's Discussion and Analysis (AD&A)**

*We do not believe that the auditor's role should be expanded to incorporate any subjective commentary about the Company in any form, including an Auditor's Discussion and Analysis (AD&A).*

The addition of an AD&A is clearly the most unsettling alternative noted in the Concept Release. First, this requirement for the auditor to provide subjective commentary on the company's financial statements would be inconsistent with the principle that management is responsible for preparing the financial statements and would likely have unanticipated repercussions for companies. The current disclosure control processes already require communications between management, the Board of Directors, the Audit Committee and the auditors and communications between these groups have made significant positive progress over the last decade. However, requiring that the topics discussed in such forums become the subject of AD&A will likely cause such open communication with the auditors to become much more restrained and significantly less effective.

There would be a substantial amount of time taken to prepare and review this type of disclosure with the appropriate parties in an already condensed reporting timeline. For example, a company may be ready to file their annual financial statements, but the AD&A section could delay that release. The lack of time to prepare documents could also lead auditors to focus on the preparation and review of the AD&A rather than on the audit of the financial statements. This could decrease overall audit quality.

Due to the subjective nature of matters to be included in AD&A, the information presented by the auditor may not be completely consistent with the information provided by management, which is overseen by the Audit Committee. Reconciling inconsistencies in the different styles and approaches used in Management's Discussion and Analysis ("MD&A") and AD&A could create tension between management, the Board of Directors, the Audit Committee and the auditors. Inconsistencies in the tone and writing styles of different audit partners and different audit firms could bring unintended difficulties in comparing the disclosures of different companies and their auditors. Discussion of "close calls" may bring unwarranted attention and confusion to areas that do not have specific inherent or audit risk. Investors would be left to subjectively decipher the message that the company is sending versus the message that the auditor is sending.

**Information Outside of the Financial Statements**

*We do not believe that the auditor's roles and report should be expanded to include information outside of the financial statements.*

Current PCAOB auditing standards describe the auditor's responsibilities regarding other information included in documents containing the audited financial statements. These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact. We take into consideration auditor comments on both the financial statements and the information outside the financial statements.

Furthermore, within the PCAOB attest standards, there is the option for the auditor to be engaged to attest on MD&A. Few companies engage their auditors to perform this service which indicates that financial statement users have not requested auditor involvement to that extent. If it is believed that such information outside of the financial statements should be subject to audit, it would be more appropriate to require the information to be included within the audited financial statements than to expand the auditor's scope and responsibilities to information outside of the financial statements.

In addition, providing assurance to forward looking statements, such as those contained within MD&A, or certain other non-GAAP information would result in increased time and costs, and may prove difficult unless limited to historical information. The additional potential costs compared to the potential benefits derived do not appear to support this option as the best approach for improving the quality, completeness and reliability of the financial statements and auditor's report.

**Clarification of Language in the Standard Auditor's Report**

*We continue to support the current pass/fail opinion and support adding information to the auditor's report that would clarify certain procedures already performed by auditors.*

Users have consistently noted that a concise conclusion as to whether the financial statements, taken as a whole, are presented fairly in accordance with the applicable financial reporting framework is meaningful information. Therefore, consistent with the Board's outreach and position in the Concept Release, we are supportive of maintaining the pass/fail framework included in the current auditor's report.

We believe there is significant value in using standardized language in the auditor's report. It provides clarity, comparability and simplicity, which provides for a succinct and objective conclusion. This opinion allows for a quick identification as to whether the financial statements comply with GAAP, which is helpful when evaluating a company's financial statements. In addition, the use of consistent, objective language minimizes the risk of investor confusion, which could lead to inefficient efforts by investors to reconcile information provided by the auditor to other information or inappropriate inferences about a company or the audit.

The ability to clarify and explain the auditor's responsibility and role in the audit would serve to enhance the auditor's report and would increase the readers of the financial statements knowledge of the audit process. The suggested areas of clarification are matters that are already being communicated to the Audit Committee and management and should not result in significant increases in time or cost. We support adding new text, or clarifying the existing language in, the following areas of the standard auditor's report:

- Reasonable assurance – the report should clarify that reasonable assurance represents a high level of assurance, but it is not absolute and that an audit conducted in accordance with PCAOB standards may not always detect a material misstatement;

- Auditor's responsibility for fraud – the report should clarify that the auditor's responsibility is to plan and perform the audit to provide reasonable assurance about whether the financial statements, taken as a whole, are free of material misstatement, whether caused by error or fraud;

- Auditor's responsibility for financial statement disclosures – the report should explicitly state that the footnotes are an integral part of the financial statements, are equally subject to audit procedures and are covered by the auditor's report;

- Management's responsibility for the preparation of the financial statements – the report should provide an expanded discussion covering management's responsibilities for the financial statements and other information provided to users of the financial statements;

- Auditor's responsibility for information outside of the financial statements – the report should describe the auditor's responsibility to read certain other information in documents containing the audited financial statements for inconsistencies with the audited financial statements; and

- Audit committee responsibilities – the auditor's report should provide an expanded discussion about the audit committee's responsibilities.

Clearly, investors are the primary users of financial statements and providing them the appropriate information to make sound investments is fundamental to our financial markets. It is imperative, however, that we provide them with clear, accurate and timely information rather than simply additional information. We believe that the majority of proposals in the Concept Release would hinder the ultimate goal of the preparation of financial statements by leading to mixed messages within the financial statements as well as a delay in the timeliness of providing that information. We would be pleased to discuss our comments with members of the Public Company Accounting Oversight Board or its staff.

Sincerely,

Arlen O. Glenewinkel
Vice President and Controller

September 26, 2011

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Re: PCAOB Rulemaking Docket Matter No. 34

Ladies and Gentlemen:

**Introductory Comments**

The AES Corporation (NYSE:AES) is a Fortune 200 global power company with generation and distribution businesses. Through our diverse portfolio of thermal and renewable fuel sources, we provide affordable and sustainable energy to 28 countries. Our workforce of 29,000 people is committed to operational excellence and meeting the world's changing power needs. Our 2010 revenue was $17 billion and we own and manage $41 billion in total assets.

Following the passage of the Sarbanes Oxley Act of 2002, AES went through significant changes and efforts to improve our controls, processes and reporting to investors. Management and our Board have been very supportive of the required changes and have fostered an environment which strongly supports and reinforces the importance of the auditor's role.

The recent financial crisis in the United States may lead some to suggest additional regulatory action is required around the conduct of audits and disclosures in financial statements. However, there have been no regulatory findings or enforcement actions that would suggest that the financial crisis could have been avoided by expanded audit scope and disclosure. It would be unreasonable to expect audit firms to have the ability to tame market exuberance or to predict market bubbles. This goes well beyond the role of an audit. To attempt to protect investors from any negative market action or reaction is not reasonable, realistic or cost effective.

However, we support efforts which will strengthen the quality of management reporting and the conduct of audits. We feel strongly that any future changes to the financial reporting requirements must be supported by improvements that have a tangible value to investors and users of the financial statements in order to justify the additional cost and other burdens required to provide them.

In addition we believe that any new information that would be provided to an investor as contemplated by some of the suggestions made by the PCAOB should not result in conflicting messages that would lead to investor confusion. We also feel it is in the investors' best interests for the roles of management, the Audit Committee and the auditor to be clearly defined and we are concerned that the proposed changes would blur those roles. We agree with the Center for Audit Quality that auditors should not be the original source of disclosure about the entity; management's responsibility should be preserved in this regard.

We appreciate the opportunity to provide a response to the Concept Release and provide the following responses to selected questions, which we hope you find helpful.

**Responses to Selected Questions**

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**
   a. **Should the Board undertake a standard-setting initiative to consider improvements to the auditor's report model? Why or why not?**
   b. **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**
   c. **Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

**Company's Response**
As discussed in the Concept Release, the auditor's role and report have evolved over time in response to investor needs in changing economic and legal environments. The most recent change was in response to instances of significant accounting fraud and inadequate audit detection which resulted in the passage of the Sarbanes-Oxley Act of 2002 ("the Act"). The Act drove a new form of governance within companies, a stronger focus on internal controls, a heightened focus on the accuracy of financial reporting, and an increased prominence in the role of the Audit Committee, which was charged with oversight of the auditor and the company's financial reporting. It also established the PCAOB and drove a significant expansion in the role and conduct of the auditor by requiring them to report on internal controls, expand disclosure and communication with the Audit Committee, and develop a more independent relationship with management. Our company has spent many millions in the implementation of the Act on processes, systems, people and increased audit fees. Many of these costs are ongoing.

Although the language in the auditor's opinion on the financial statements did not change, the conduct of the auditor has changed and expanded significantly. So has the quality and reliability of companies' financial statements, governance processes, and control systems. In evaluating a response to the question these changes should be put into context. In our opinion, expanding the mandated role of the auditor to require auditor's discussion and analysis is neither warranted nor appropriate. Expansion of the auditors' role as being considered by this Concept Release would effectively put the auditors in the role of management, significantly minimize the responsibility of the

Audit Committee and shift additional risk to the audit firms which would translate into significantly increased costs for companies and their shareholders.

We do however, support changes to the auditor's report that would provide additional clarity on the existing roles and responsibilities of the auditor, the Audit Committee and management, and that expand on the definition of certain concepts and terms. This could include the terms such as "reasonable assurance", "material misstatement", and "materiality". We believe additional clarity would further educate investors which would help minimize the expectation gap.

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach is sometimes referred to as a "pass/fail model."**
    a. **Should the auditor's report retain the pass/fail model? If so, why?**
    b. **If not, what changes are needed?**
    c. **If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

**Company's Response**
We believe the auditor's report should retain the pass/fail model. The complexities of accounting standards require many judgments which a company must evaluate and consider in formulating its position. The auditor's role is to challenge those judgments and ultimately determine if management had a reasonable basis for their conclusion as well as to determine whether, in their opinion, the company's financial statements are fairly presented in accordance with US GAAP. If the auditor does not agree there is a reasonable basis for the company's conclusion, the auditor's report is modified to note the affect of the issue on the auditor's opinion on the financial statements taken as a whole. When these situations arise, the company, the auditor and the Audit Committee actively engage in discussions to work through the issues and typically reconcile and remediate views such that modifications to the report are not needed. However, ultimately the auditor has final say in the audit report. The auditor either agrees that the judgments made by management are reasonable and that the accounting records are accurate or not. We believe that the auditor's conclusion as to whether the financial statements, taken as a whole, are presented in accordance with US GAAP is of significant value to investors. An approach other than the pass/fail model would put the investor in the position of evaluating judgments made without having the benefit of the context, facts and circumstances due to the significant dialogue that exists between the auditor, Audit Committee and the company. Investors do not have the benefit of that dialogue and no opportunity to resolve questions directly with the auditors; doing so would further increase the complexity of disclosure and communication requirements. Arguably, as more fully explained in our response to the other alternatives, we believe that moving away from the pass/fail model of auditor report has the potential to dilute

the value the auditor's report and the financial statements rather than enhance it to investors.

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g. management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

**Company's Response**
We believe it is management's responsibility and that management is most appropriate to provide additional information regarding the company's financial statements to financial statement users. The Audit Committee's role is to assure that the proper governance is in place to allow timely and accurate financial reporting. The auditor's role is to conduct procedures to allow them to provide assurance that the financial statements are fairly represented, including the adequacy and appropriateness of disclosures. But, it is only management, who has the best understanding of the business and what drivers impact the business, that can best anticipate and satisfy the informational needs of the investors and other financial statement users.

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

**Company's Response**
We do not believe changes should be made to the auditor's report on internal control over financial reporting. However, we would support changes to the report on internal control over financial reporting that would provide additional clarity on the role and responsibilities of the auditor, the Audit Committee and management, and that expand on the definition of certain concepts and terms.

5. **Should the Board consider an AD&A as an alternative for providing additional information on the auditor's report?**
   a. **If you support an AD&A as an alternative, provide an explanation as to why.**
   b. **Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**
   c. **What types of information in an AD&A would be most relevant and useful in making investment decisions. How would such information be used?**
   d. **If you do not support an AD&A as an alternative, explain why.**

**e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

**Company's Response**
No. We do not believe the Board should consider an AD&A or other alternatives to an AD&A for providing additional information in the auditor's report. We believe it exceeds the role and scope of an audit and would not be appropriate for the auditor to provide a narrative format of his or her views regarding significant matters, management's judgments and estimates, accounting policies and practices, and difficult or contentious issues about the audit.

Investors expect and SEC regulations already require management to disclose information about significant transactions, critical accounting policies and estimates in SEC periodic reports. It would place the auditor in the role of management who should be properly disclosing those matters in MD&A and the notes to the financial statements or otherwise resolving them with the auditor. It is also the responsibility of the auditor to communicate and provide input to the Audit Committee on these items so they can independently assess if management has provided sufficient and proper disclosure.

We do not believe that having the auditor provide separate information about the audit, audit procedures and results, and auditor independence would be useful to investors. We believe that this would undermine the credibility and usefulness of the auditor's report on the financial statements. Investors would be put in the position of interpreting the information without full context or understanding of all the facts. Auditors are hired to provide an independent opinion on the company's financial statements and ultimately make the final judgment. This responsibility should not be diluted or opened up for second guessing.

In addition, the level of auditor effort that would be required for the auditors to draft, discuss and review with management would be excessive and cost prohibitive with questionable benefits to be derived. It would put further pressure on already tight filing timelines. Because of the additional risk it would place on the auditor, they will respond by incurring more time leading to more fees which may produce results of questionable value to investors.

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

**Company's Response**
This question suggests that companies' current disclosures are not adequate. If so, additional disclosures should be required. Management has the responsibility to

provide the information that satisfies US GAAP disclosure requirements, while the auditors have the responsibility to evaluate that the financial statements contain sufficient disclosure in accordance with US GAAP disclosure requirements. Outside of the financial statements, management has the responsibility to provide information as required by the SEC which the auditors review to make sure there are no material misstatements of fact or inconsistencies with the financial statements.

We do not believe that there would be benefit from changing the respective roles of the FASB, SEC, management or the auditors in determining and providing required disclosures. Further, the expansion of the auditor's responsibilities into areas outside the fair presentation of the financial statements could be time consuming and costly as they would need to get more involved in the operations of the business and make judgments about decisions being made by management. Investors expect management with the requisite knowledge of the business and the factors influencing the business to provide a meaningful discussion of these risks. For the reasons outlined in the response to question 5, we do not believe auditor's responsibilities should be extended beyond those currently in place.

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

**Company's Response**
Given the broad proposed scope of an AD&A, the risk to the auditor will increase significantly. They will need to manage this risk as effectively as possible, which will lead to Audit Firm guidelines and strict quality control that will naturally lead to a more boilerplate "checklist" approach, which seems to conflict with the spirit of the suggestion. In addition, as this occurs the perceived value to the investor will diminish, however, the costs (time and money) to comply will continue.

Investors rely upon consistency of financial terms and calculated metrics in order to prepare accurate analysis and recommendations. If auditor discussions and disclosures lack common terms and metrics, investors will need to be provided an avenue to permit questioning of auditors. Investors do not have the benefit of the significant dialogue that exists between the auditor, Audit Committee and the company and no opportunity to resolve questions directly with the auditors. This will require yet another process to further complicate, and potentially confuse, communication with investors. Moving away from standards has the potential to dilute the value of the auditor's report and the financial statements rather than enhance it to investors.

**11. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

**Company's Response**
Although the potential exists for an AD&A to present inconsistent or competing information between the auditor and management, we expect most companies would be

very diligent to discuss and resolve such differences prior to issuing the financial statements. A company's goal is to provide financial statements that are fairly presented in accordance with US GAAP and that comply with SEC regulations. Any suggestion to the contrary by the auditors would need to be resolved; otherwise the credibility of the financial statements would be in question. The time and effort associated with reconciling the disclosure could be extensive for little net benefit. Since investors would not have access to this reconciliation process, and since the end result of these efforts would be auditor disclosures that were consistent with those provided by the company, the value of an AD&A would be diminished and lack value to investors.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

**a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

**b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

**Company's Response**

Although we do not believe it is necessary, we do not oppose the inclusion of emphasis paragraphs in the auditor's report to highlight the most significant matters in the financial statements with a reference to where these items are disclosed in the financial statements. However, we do not believe this discussion should deviate or expand on the company's disclosure. It should be a very objective statement serving to highlight matters of significance to a reader. If the auditor does not consider the company's disclosure adequate, it should be resolved with management and, if need be, the Audit Committee prior to the release of the financial statements.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

**Company's Response**

For the reasons discussed in response to question 10, it will be difficult to eliminate some level of boilerplate. Audit Firms will need to manage the additional risk associated with determining which items should be considered for emphasis which could lead to an emphasis paragraph on any item that could be of potential interest to an investor. As a result, there will be a risk of the emphasis paragraphs being over used leading to diminished value.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

**Company's Response**

The potential downside to this requirement is that due to the additional risk to the auditor from being required to make this judgment, the areas of emphasis could be lengthy and voluminous. In that case, the benefit to investors' of this section to the auditor's report would diminish as it becomes a laundry list of every disclosure that could have an interest to any reader of the financial statements.

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

- **If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**
- **On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**
- **What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**
- **If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**
- **Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**
- **Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**
- **If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

**Company's Response**

We recommend a cost and benefit analysis to determine if expanding the auditor's report to provide assurance on other information outside the financial statements would be warranted. Requiring the auditor to provide such assurance is not objectionable however it will result in higher audit fees for companies with no clear "return". To justify the cost there would need to be evidence that the lack of auditor assurance has resulted in misleading information being provided by companies that has led to shareholder losses. Absent such a correlation it would be difficult to justify adding this cost, especially considering auditors already review management's disclosures outside the financial statements as part of their audit process for any inconsistencies with the underlying financial statements.

The other challenge would be the highly judgmental nature of discussions outside of the financial statements. By design, many of these sections are intended to provide management's view of the company and its operations. If assurance were to be required, the SEC would need to provide much more prescriptive guidance on its content to provide audit firms a basis to determine if the company had correctly applied the standard. We believe this could lead to less meaningful disclosure for investors and more boilerplate language.

Finally, in addition to the cost element of expanding the areas of audit assurance, the time element would also be expanded. Filing deadlines are already very tight and adding another step to the process could result in delayed filings.

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of financial statements**
- **Auditor independence**

**a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

**b. Would these potential clarifications serve to enhance the auditor' report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**

**c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**

**d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

**Company's Response**

Any steps that can be taken to further educate and clarify the responsibilities of management and the auditor would be positive changes. We believe most investors do not read auditor's reports today other than to verify there is an unqualified opinion and that no matters of emphasis are noted. As pointed out in the Concept Release, there has not been a change to the auditor's report for a long period of time, so investors may not be as compelled to read it. We believe additional clarity would further educate investors which would help minimize the expectation gap.

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

**Company's Response**

The only shortcoming of providing clarifications of the language is its benefits may be short-lived when investors again begin to view the report as boilerplate. However, the ongoing educational benefit for new investors could support its inclusion.

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is appropriate and why?**

**Company's Response**

We do not believe the first alternative to require the auditor to provide AD&A disclosure is appropriate or useful to investors. If additional information is needed by investors to make informed decisions, management should be providing this information. The second alternative, expanded use of emphasis paragraphs would be of questionable value to investors. Due to the increased audit risk, the use of emphasis paragraphs could very easily expand to include a laundry list of topics resulting in limited value to investors. For the third alternative it would be necessary to demonstrate a strong benefit to support the cost associated with the requirement for the auditor to report on information outside the financial statements. It would also require more prescriptive guidance from the SEC on the content of the information to allow auditors to determine if the company has correctly applied the standard. However, the fourth alternative to clarify certain language in the auditor's report would be acceptable and could be helpful.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate this perception?**

**Company's Response**
We believe the risk that a financial statement user would perceive any of these alternatives as providing a qualified or piecemeal opinion as low. With proper language and education programs this risk should be easily mitigated.

**29. What affect would the various alternatives have on audit quality? What is the basis for your view?**

**Company's Response**
We believe audit quality under alternative four would remain high but would not drive significant changes to the audit approach. Further clarification would be for the benefit of the financial statement users to better understand the responsibilities of management and the auditors, and to better mange their expectations about the scope and limitations of audits.

Audit quality under the other three alternatives would put auditors under significant strain that could reduce their effectiveness. Assuming the timing for filing financial statements stays the same, auditors would be required to get significantly more work done in a limited time period. This will lead to larger audit teams which will require greater coordination and management. It would also require greater effort from companies accounting staff to provide the support and respond to the inquiries of the auditors.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial**

**statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

**Company's Response**
As discussed previously, expansion of the auditor's role and methods of communication could lead to a blurring of the lines between the roles of management, the Audit Committee and the auditor. Any steps taken to enhance a financial statement users understanding of each of the respective roles would be beneficial. However, to have the auditor take responsibility for communicating information to financial statement users in addition to management could result in conflicting information that the financial statement user is not in a position to evaluate correctly. More likely, communications made by the auditor would conform to management's discussion yielding no benefit to the financial statement user, but it would drive increased costs to shareholders.

**Closing Comments**
The PCAOB is to be commended for continuing to evaluate how to assure that investors and other financial statement users are being best served by the audit function. It is critical however that any such considerations be mindful of the purpose of an audit as well as the respective roles and responsibilities of management, the Audit Committee and the auditor. There also needs to be consideration of the costs and benefits to be achieved from any changes. Evidence should be collected and evaluated to determine if there are clear tangible benefits investors and other financial statement users would receive and if it would allow them to make better decisions about investments and a company's performance. Current accounting and SEC standards require extensive disclosures with a clear outlook to expand disclosures even further with current convergence and other projects. If such disclosures are not providing the information investors need to evaluate a company's performance, it is the role of the investment community to prompt management to provide additional disclosures, rather than the PCAOB require auditors to add their own disclosures. It is management's responsibility to provide investors and other financial statement users with the appropriate information in accordance with generally accepted accounting principles and SEC requirements and audit firms should continue to provide an independent conclusion as to the accuracy and completeness of such disclosures.

The auditor's professional responsibilities and management's conduct have changed significantly since the introduction of the Act and the establishment of the PCAOB. These changes were in response to significant shortcomings that existed in the conduct of management and auditors over accounting and financial reporting. Such changes have led to tangible enhancements in the entire process from which investors and other financial statement users should have benefited. Many of the changes being suggested in the Concept Release would drive another "seismic shift" that could be on the scale of the Act, but without the same level of benefits. We do not believe this would be in the best interest of users of the financial statements and especially not in the best interest of shareholders.

We appreciate the opportunity to provide comments on certain elements of the Concept Release and we look forward to your further deliberations.

Respectfully yours,

The AES Corporation

Victoria D. Harker
Executive Vice President and Chief Financial Officer

NEW YORK
CITY BAR

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October 7, 2011

Mr. Martin F. Baumann
Chief Auditor
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, D.C. 20006

Re: PCAOB Release No. 2011-003; Rulemaking Docket Matter No. 034; Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Dear Mr. Baumann:

This letter is submitted on behalf of the Financial Reporting Committee and the Securities Regulation Committee of The Association of the Bar of the City of New York in response to Release No. 2011-003, dated June 21, 2011 (the "Release"), of the Public Company Accounting Oversight Board (the "Board" or "PCAOB"). The Release solicits public comment on the potential direction of a proposed standard-setting project on the content and form of reports on audited financial statements.

Our Committees are composed of lawyers with diverse perspectives on financial reporting and securities issues, including members of law firms, counsel to corporations, investment banks and investors and academics. We regularly comment on regulatory initiatives in the area of financial reporting (although our comment letters do not necessarily reflect the individual views of all members of the Committee).

We recognize the concerns about the audit report that have led the Board to issue the Release, and we believe that some modifications in audit reports may be desirable. However, we believe there are several reasons why the Board should proceed cautiously.

- It is the responsibility of the issuer, and not its auditors, to provide disclosure to investors. Any requirement that auditors make substantive public disclosures about the issuer will likely adversely affect the auditing process, and the related financial reporting process, by inhibiting candid, confidential discussion and exchange among the auditor, the issuer and the audit committee. The financial reporting process and related corporate governance procedures have improved, partly as a result of the Sarbanes-Oxley Act of 2002 and other reforms, and this "chilling" effect could undermine some of that progress to the detriment of reporting and auditing quality.

- Some of the perceived shortcomings to which the Release draws attention are not attributable primarily to the audit reporting format. They arise from features of SEC disclosure rules, generally accepted accounting principles, corporate governance, internal controls or the reporting practices of issuers. If there are weaknesses in those areas, they should be addressed by institutions other than the Board.

- Some of the ideas in the Release would require auditors to cover matters they do not now cover. The Board is properly concerned with how auditors report, but the matters on which they report are determined by legislation and regulations. The Board should not pursue the suggestions in the Release that would in effect extend or expand the subjects for which auditor reporting is required.

- The specific procedures performed during the course of a particular audit, and the information gathered as a result, are not designed for public disclosure and do not readily lend themselves to it. They are complex and technical, and serve to support a delicate professional judgment. We are concerned that any potential benefit to investors from disclosure about the audit process is outweighed by the potential adverse effects on the auditing process.

- It will be very easy for new disclosure requirements to devolve into boilerplate – the repetition of formulaic disclosure, with little variation from one issuer to the next, and with little benefit for investors.

- If the Board pursues the suggestions raised in the Release, it should carefully consider potential implications including, in addition to those mentioned above, additional cost for issuers, implications for already tight reporting deadlines, potential delays in initial public offerings and increased liability risks for issuers and auditors.

***Auditor's Discussion and Analysis***

We do not believe the Board should pursue the idea of an Auditor's Discussion and Analysis ("AD&A"). As sketched in the Release, the AD&A would have two parts:

"Information about the Company's Financial Statements" and "Information about the Audit." In our opinion, auditors should not provide disclosure on either topic.

- The disclosure concerning the issuer's financial statements would change the auditor's role from reviewing the issuer's financial reporting to providing substantive disclosures to investors about the issuer. As discussed above, we believe this is inappropriate. Effective financial reporting requires a complex and open discussion among the auditor, the issuer and the audit committee, which will change in character if the auditor is required to make a public report. In all likelihood, auditor and issuer will provide closely similar disclosures, because both will see serious risks if their disclosures diverge. The issuer will likely seek to limit its disclosures to statements the auditor is comfortable making, too, which will ultimately provide investors with weaker and less useful disclosure.

- We believe the disclosure concerning the audit will be of limited use to investors. As noted above, auditing involves complex professional judgments. It would be very difficult either to summarize them or to describe them fully, and neither approach would be likely to provide sufficiently useful information for investors to warrant the potential adverse effect on the financial reporting process.

***Required and Expanded Use of Emphasis Paragraphs***

The required and expanded use of emphasis paragraphs could improve the auditor's report, and it merits further consideration, although the Release does not provide enough specifics to comment in detail. As the proposal develops, the Board should consider two concerns. First, the Board should not mandate emphasis paragraphs without providing clear standards for auditors to follow. Without standards, auditors cannot perform their review in an objective manner. Second, the Board should address the risk that mandatory emphasis paragraphs will lend themselves to the development of additional boilerplate. Such rote language could make the auditor's report more confusing and less useful for financial statement users.

***Auditor Assurance on Other Information Outside the Financial Statements***

We do not believe the Board should pursue the idea of requiring auditor assurance covering information outside the financial statements. It should in any case fall to the SEC, not to the Board, to determine when auditor assurance is required, but we would strongly oppose such a requirement.

- With respect to material outside of periodic reports (such as earnings releases), the idea of regulating its content presents much larger issues, and we question whether there is a need for such an initiative.

- With respect to material in periodic reports, particularly MD&A, we believe imposing auditor assurance would be counterproductive. Crafting meaningful MD&A requires issuers to evaluate extensive information from outside the financial statements and the financial reporting process, to develop a nuanced analysis and to provide analytical, sometimes prospective information. The auditor does not have the same information, obligations or capabilities. Requiring auditor assurance would drive issuers to make this disclosure auditable, and potentially narrower and less useful to users – for example, by limiting forward-looking information, discussion of trends and uncertainties or disclosure about corporate strategy. There is, moreover, no time within the current periodic reporting framework for an additional process of auditor assurance.

***Clarification of the Standard Auditor's Report***

The idea of clarifying the standard report is a welcome suggestion. The present practice is not particularly effective to communicate the nature of the auditor's role, the significance of independence, the risks of the process or other matters, and it is possible this contributes to the existence of an "expectations gap." We believe the Board could implement meaningful changes that would clarify the report and improve investor understanding of the audit, the auditors and the report.

* * * * *

We appreciate the opportunity to provide our comments on the Release, and we believe the public would be well served if the PCAOB gave additional consideration to some elements of the proposals, as described in this letter.

We would be pleased to respond to any inquiries regarding this letter or our views on the Release more generally. Please contact Nicolas Grabar at (212) 225-2414 or Robert Buckholz at (212) 558-3876.

Very truly yours,

The Financial Reporting Committee and the Securities Regulation Committee of the Association of the Bar of the City of New York

NEW YORK CITY BAR

**Annex A**

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Public Company Accounting Oversight Board
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PCAOB Rulemaking Docket Matter No. 34

Board:

The Hertz Corporation (Hertz), a subsidiary of Hertz Global Holdings, Inc. (NYSE: HTZ), operates the largest airport general use car rental brand, from approximately 8,000 locations in approximately 150 countries worldwide. Our Hertz brand name is one of the most recognized in the world, signifying leadership in quality rental services and products. Hertz operates both corporate and licensee locations in cities and airports in North America, Europe, Latin America, Australia, Asia and New Zealand. In addition, we have licensee locations in cities and airports in Africa and the Middle East. We and our predecessors have been in the car rental business since 1918 and in the equipment rental business since 1965. Product and service initiatives such as Hertz #1 Club Gold®, NeverLost® customized, onboard navigation systems, SIRIUS Satellite Radio, and unique cars and SUVs offered through the company's Adrenaline and Green Traveler Collections, set Hertz apart from the competition. In 2008, the Company entered the global car sharing market in London, New York City and Paris. Hertz also operates one of the world's largest equipment rental businesses, Hertz Equipment Rental Corporation, offering a diverse line of equipment, including tools and supplies, as well as new and used equipment for sale, to customers ranging from major industrial companies to local contractors and consumers from approximately 320 branches in the United States, Canada, China, France, Spain, Italy and Saudi Arabia.

We support the Board's efforts to develop high-quality standards that improve the transparency, usefulness and credibility of financial reporting. We appreciate the opportunity to comment on the Public Company Accounting Oversight Boards\'s (Board or PCAOB) "Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards" and respectfully submit the following thoughts/concerns regarding the Concept Release:

Questions

1. **Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**
   a. **Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?**
   b. **In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**
   c. **Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

Your release states that a "majority of survey respondents noted that the independent auditor's report needed to provide more specific information about how the auditor reaches his or her opinion on whether the company has fairly presented its financial statements in accordance with the required financial reporting standards". We think that, rather than undertake wholesale changes to the auditor's report, increased investor education efforts with respect to that group of respondents on what an audit entails would address these concerns. Your outreach group was said to be comprised of preparers, auditors, audit committee members, regulators and standard-setters, and representatives of academia. The investors group included money managers, asset management funds, pension funds, wealth management funds, and organizations that represented institutional investors. If readers of financial statements had a better understanding of the amount of work auditors must perform before they can issue their current audit opinion (planning, discussions with management, understanding of controls and the company's operating environment, compliance testing of those controls, substantive testing of transactions and account balances) they may realize that a change to the auditor's reporting is not necessary. Perhaps the AICPA, or the Board itself, should consider releasing some educational information, or conduct seminars, to explain what investors need to know about the conduct of an audit. This may relieve some of the perceived need for changes to the auditor's report.

As far as expanding the auditor's role, we believe that a comprehensive cost/ benefit analysis should be considered prior to pursuing.

2. **The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the**

**applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

a. **Should the auditor's report retain the pass/fail model? If so, why?**
b. **If not, why not, and what changes are needed?**
c. **If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.**

We believe that the pass/fail model should be retained. Either a company is presenting its financial statements fairly or they are not, which is currently the objective of the audit firm and its procedures to assess. It is the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. There is no such thing as "almost fairly", or fairly with an explanatory paragraph. Either the audit firm satisfies itself or it does not. We feel that any modification of this principle weakens the audit report.

3. **Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

Any, and all, information about a company's financial statements should be provided by the company. Auditors should not be placed in the position of preparing such information. They have been entrusted with the responsibility of opining on the financial statements. If they were now directed to prepare/ provide initial information, who would check *their* work? The Securities and Exchange Commission (SEC) has set the standards for the information that they expect public companies to report. If any additional information is required, the SEC has full authority to mandate companies to provide it. We see no reason for audit firms to assume preparer's roles.

4. **Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

We do not believe any changes are necessary.

5. **Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**
   a. **If you support an AD&A as an alternative, provide an explanation as to why.**
   b. **Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?**
   c. **Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**

d. **If you do not support an AD&A as an alternative, explain why.**

e. **Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both?**

**What are they?**

We do not support the idea of auditors providing additional information pertaining to a company's financial statements. The Hertz Global Holdings 2010 financial statements required 56 pages in our Form 10-K, and included all of the information the company (in consultation with its auditors) believed to be necessary to disclose in response to Regulation S-X. If investors do not believe this information is sufficient for them to make informed investment decisions, investors should request the SEC consider modifications to Regulation S-X.

Auditors should not be deciding what information an investor needs to make a decision. Their responsibility is to judge whether the financial statements are presented fairly in accordance with U.S. generally accepted accounting principles.

You suggest that an AD&A could give "the auditor greater leverage to effect change and enhance management disclosure in the financial statements". What greater leverage do they need than the ability to give a qualified opinion? If the auditor encountered difficult or contentious issues with management, they can take the matter to the Audit Committee to satisfy themselves. If they were satisfied, no further information is necessary.

We also have concerns about whether readers would have the appropriate context for the information. Auditor communications are typically prepared with the expectation of a dialogue with the Audit Committee/ management in which additional context and perspectives would be communicated. Readers would not be privy to that dialogue.

6. **What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

There should not be any.

Any information of this sort (audit risk, audit procedures, independence) will become boilerplate after a handful of audit cycles. Management already discloses Critical Accounting Policies and Estimates in their Form 10-K. An educated investor can surmise that these are the audit areas of most concern. The current opinion language already provides a high level explanation of what an audit entails. It is unlikely that any reader would spend much time perusing a detailed listing of audit procedures. An audit firm must assess that they are independent before accepting an audit engagement. We think it unlikely that any investor would gain comfort by having independence stated in a report.

7. **What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e.,**

**management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

If the auditor has already opined that the financial statements are presented fairly, then why should any comment about management's judgment and estimates (already disclosed in the filing) be required in an AD&A? This would be superfluous information that serves no purpose other than undermining the audit report. All "close calls" should have been satisfied prior to the auditor issuing their report. Presumably, the audit team shared their views with the Audit Committee, and the Audit Committee has gotten comfortable to approve the filing. We assume investors are not suggesting that Audit Committees are not fulfilling their responsibility.

**8. Should a standard format be required for an AD&A? Why or why not?**

As noted above, an AD&A is not necessary.

**9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?**

In 2010, management at Hertz devoted 12 pages of our Form 10-K to a discussion of the material risk factors impacting the company's business. Among others, the risks identified and described in detail, included the following:

- Competition
- seasonality of business
- tax liabilities due to downsizing of fleet
- declines in the value of fleet
- failure of manufacturers to fulfill obligations
- implementation of strategy to further reduce operating expenses
- impairment of goodwill
- increases in fuel prices
- safety recalls
- reliance on communications networks and centralized technology systems
- maintenance of favorable brand recognition
- loss of the services of senior management team members
- insurance, and
- environmental

As you can see, our discussion is very wide-ranging. Our audit team reads our entire Form 10-K and comments on non-financial disclosures when they believe it is appropriate to do so. In addition, our audit team provides "comfort" on what we present. We engage in dialogue with them as to additional items they feel should be included. We do not feel that any value would be added by having them undertake a separate discussion.

**10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

It likely would not be avoided, which is a major reason why we believe an AD&A would be of limited value.

**11. What are the potential benefits and shortcomings of implementing an AD&A?**

See our earlier comments.

**12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

In our view, this would be confusing to investors. Inconsistent or competing information where potentially neither is incorrect does not serve investors. The inevitable result would be the creation of a morass possible pitting auditors against their clients and shareholders.

**13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

While the types of matters described could be relevant and useful, it appears to us that investors are looking for a shortcut in reading the information presented. If the amount of information presented is too overwhelming, investors should solicit the SEC to reduce reporting requirements or request that management emphasize certain of the information that is already presented.

**14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

- **a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**
- **b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

We do not support the idea of an emphasis paragraph. This would place the burden on auditors for guessing the areas of emphasis for a broad spectrum of investors. Management is already tasked with drafting its reports with an emphasis on the most important information, therefore we believe an investor should be able to read the entire document and make their own evaluation of what is important to him / her.

**15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

None.

**16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

None.

**17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

If implemented, the accounting firms will develop language which strives to limit legal exposure. We believe this will inevitably lead to boilerplate.

**18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

We see no benefits and, as discussed above, substantial shortcomings, including increased legal risks, time and expense.

**19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

a. **If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**
b. **On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**
c. **What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?**
d. **If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?**
e. **Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**
f. **Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**
g. **If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

In our collective experience, auditors do read earnings releases before they are issued. Often, these releases are prior to the completion of the audit. If an auditor were required to implement procedures in order to provide assurance on earnings releases we believe this practice would make the rendering of an opinion or review on traditional SEC filings extraordinarily difficult, or require the issuance of rules delaying them.

As stated, the SEC maintains reporting requirements for MD&A. Throughout the year and through mechanisms such as comment letters, speeches, "Dear CFO letters" and releases, they advise on areas of emphasis they will be focusing on. We would not be opposed to a limited statement in the annual report where auditors include a statement regarding whether or not the information contained in a company's MD&A is not inconsistent with the financial statements.

We do not see value in auditors reporting on non-GAAP information. It is called non-GAAP for a reason. Although the SEC has rules regarding the presentation of non-GAAP information, there are currently no standards governing the composition of this info.

**20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

If we need auditors to give assurance on information outside the financial statements the implication is that the SEC model is flawed, which we do not believe is the case. The financial statements should include all information that is required to present fairly in accordance with GAAP. The SEC requires all other information not required by GAAP to make the information disclosed not misleading pursuant to Rule 12b-20.

**21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**
  - **a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**
  - **b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**
  - **c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?**
  - **d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

None of these clarifications is needed. It would merely be more boilerplate stating the existing auditing standards. The complete set of standards is available as a matter of public record, for anyone who is interested. None of these clarifications would have any impact on the work that an auditor performs. It is solely modification of the report.

**22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

We see no benefit.

Questions Related to all Alternatives

**23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

As stated in our reply to question 19, auditor assurance on MD&A, primarily Critical Accounting Policies and Estimates, seems to make the most sense. We believe the information included there is useful to investors and would understand if the Board proposed standards for auditors to give assurance with respect to that disclosure.

**24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

We do not believe the Board needs to take further action in this area.

**25. What alternatives not mentioned in this concept release should the Board consider?**

We do not believe the Board needs to take further action in this area.

**26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

No comment.

**27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

If any of these alternatives were to proceed further, the auditor's report must be integrated into one comprehensive form. The consequence of not taking this step would lead to piecemeal opinions in our view.

**28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

As stated earlier, we believe the Board, along with the AICPA, should embark on an education campaign for users of financial statements to convey to the users of the financial statements the auditor's role in the performance of an audit.

**29. What effect would the various alternatives have on audit quality? What is the basis for your view?**

Based on our experiences, none of these suggested report changes would result in meaningful changes to the conduct of an audit. We do believe that it will result in higher billable hours for the accounting firms, but not provide any greater assurance. It is mainly a matter of report structure.

Assuming filing deadlines are not extended, auditors would have an additional workload during a compressed time period and as a result registrants would be pressured to provide information and proposed disclosure at an earlier date. This will place pressure on the controls in place and increase the risk of mistakes. Alternatively, the SEC could extend filing deadlines, but with investors expecting access to information more quickly, we would not advocate extending the filing deadlines.

**30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

We see no reason for exceptions.

**31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.**

**a. Are any of these considerations more important than others? If so, which ones and why?**

**b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?**

**c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?**

**d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?**

As previously stated, we believe that the proposals suggested here would lead to higher audit fees without any visible benefits to investors. We also believe that some of the proposed changes would lead to the potential for increased legal exposure for the accounting profession. In the end, many of the proposed structural changes to the auditor's report would become additional boilerplate.

**32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?**

This would have to be judged on a company by company basis. We have open dialogue with our auditors and do not envision any change. Another company, with a more contentious relationship with their auditor, may encounter heated discussions or disagreements.

We appreciate the opportunity to comment on the Concept Release.

Respectfully,

Elyse Douglas

Elyse Douglas
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The Hertz Corporation

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**Carol B. Tomé**
Chief Financial Officer &
EVP - Corporate Services

September 29, 2011

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

Attn: Office of the Secretary

Re: Rulemaking Docket Matter No. 34
Concept Release on Possible Revisions to PCAOB
Standards Related to Reports on Audited Financial Statements

Members of the Board:

This letter is submitted on behalf of The Home Depot, Inc. ("The Home Depot," "the Company," or "We") in response to the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release"), issued by the Public Company Accounting Oversight Board (the "Board") on June 21, 2011. The Home Depot is the world's largest home improvement specialty retailer, employing more than 300,000 associates. The Company has over 2,200 retail stores in all 50 states, the District of Columbia, Puerto Rico, U.S. Virgin Islands, Guam, 10 Canadian provinces, Mexico, and China. In fiscal year 2010, The Home Depot had sales of $68.0 billion and consolidated net earnings of $3.3 billion. Our stock has been traded on the New York Stock Exchange (NYSE: HD) since 1984 and is included in the Dow Jones industrial average and Standard & Poor's 500 index.

The Home Depot would like to thank the Board for its significant efforts in examining alternatives for increasing the transparency and relevance of the auditor's reporting model to financial statement users. We also appreciate the Board's attention to the viewpoints of all stakeholders on this important issue. However, we believe the Concept Release represents a fundamental change to a central tenet of financial reporting – that the financial statements and related disclosures are the responsibility of management, with the auditor's role being to express an opinion on whether the annual financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Such a change overturns the basic structure of the financial reporting system and cannot be done without extensive involvement and action by the Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB"). Furthermore, any benefits of such a change to financial statement users are greatly outweighed by the many costs and the likely confusion that would result. Therefore, our strong belief is that the majority of the suggestions for change presented in the Concept Release should not be adopted by the Board. We explain our position in more detail below, including specific responses to applicable questions posed by the Board in the Concept Release.

Overview

The preparation of our financial information is the result of a rigorous process that involves the dedicated efforts of teams of trained and experienced employees whose responsibilities include designing effective systems and internal controls, collecting and analyzing large amounts of data, researching difficult accounting judgments, and undertaking all of the other necessary steps to prepare clear and accurate financial statements for our shareholders and investor community. A key underpinning of this process is the participation by The Home Depot's financial management team in multiple internal discussions of strategic, operational, legal and accounting issues integral to our business and routine interaction with our vendors, customers, shareholders, advisors and other relevant third parties. Our financial management team (including myself), with oversight by our Chief Executive Officer and Audit Committee, is responsible for the accuracy of our financial reporting, and the CEO and I certify both the annual and quarterly financial information.

As a result, management, with the oversight of and input from the Audit Committee, is in the best position to determine whether our financial disclosures are complete, accurate and provide our investor community with appropriate insight into our business. This role is recognized by the standards for disclosure of financial information adopted by the SEC and the FASB. These standards reflect the fact that the decisions and judgments required to be made under GAAP and related financial disclosures like MD&A can only be made by management based on its day-to-day, in-depth management of the Company's operations.

Our auditor's role is to provide, through the audit and ultimately the audit report, assurance to those who read the financial information that the accompanying financial statements have been fairly presented in accordance with GAAP. Because our auditor's responsibility is to design the audit to provide reasonable assurance that no material misstatements are present in our financial statements, the auditor must have significant knowledge of our affairs. However, the auditor does not have, nor does their role require, the extensive level of understanding and insight that comes from daily involvement at all levels of the business.

Because of the difference in the roles of the auditor and of management, the auditor is not well suited to independently report information about the Company beyond what is required to be disclosed by management under GAAP and SEC regulations. Any proposal requiring the auditor to do so, if adopted, would lead to the auditor reporting at best redundant information to what the Company has reported and potentially conflicting, confusing or misleading information. At the same time, such reporting would add considerable bulk to the Company's filings (at a time when financial statement users are already complaining of information overload) without measurable benefit but with significant additional cost. Furthermore, to enhance investor understanding and comparability between companies, the standard for disclosure should be consistent for all companies. The current auditor reporting model provides this consistency, whereas many of the proposals in the Concept Release would result in considerable subjectivity and lack of comparability.

Detailed Response Concept Release Questions Most Relevant to The Home Depot

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

Most of the proposals in the Concept Release would change the fundamental roles of Company management and the auditor with respect to financial disclosure, without clear benefits but with significant additional cost. Moreover, such a radical change does not appear to be necessary. If, as reflected in the Concept Release, a primary rationale for such an initiative is to provide users with a better understanding of the audit process and the auditor's report, there are many other, better tools to accomplish this goal. Significant literature designed to address this basic educational concern already exists, and the Board, working with other relevant stakeholders, would be well suited to develop and/or provide an easily accessible repository of additional "plain English" explanations designed to meet this need, to the extent they are not already available. As discussed in more detail below, while we do not particularly object to certain clarifications of the auditor's report, we believe that any potential benefit that may result from wholesale changes to the auditor's reporting model would not outweigh the substantial resulting costs.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

In accordance with applicable requirements[1], our auditor already reviews the information in our Forms 10-K and 10-Q outside of the financial statements and considers whether that information, or the way in which we present it, is materially inconsistent with the financial statements or constitutes a material misstatement of fact. Unlike many companies, we include a report from our auditors in our Forms 10-Q with respect to their review. Similarly, our auditor reviews our earnings releases for quantitative accuracy and consistency with our financial results. Our approach is to ensure that our earnings releases are consistent with our financial statements as reported in our Forms 10-K and 10-Q, to avoid creating any confusion for our investor community or raising unnecessary questions about the Company. We do not believe an additional assurance requirement is necessary nor that it would impact the content of our earnings releases. We believe that the current level of review of matters outside of the financial statements is sufficient for our Company and our shareholders, and any additional

[1] AU § 550.04-.06.

requirements would increase audit costs unnecessarily, negatively impacting shareholder value without any improvement in audit quality.

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

   a. *Should the auditor's report retain the pass/fail model? If so, why?*

We believe that the current form of the auditor's report is appropriate and strikes the proper balance of all competing interests. It provides the consistency necessary for better comparability between companies and reflects the appropriate role and expertise of the auditor. What is important is that financial statement users understand the meaning and significance of the language currently used in that report. Any perceived shortcomings in the language of the report are better addressed through proper education of the user community. That being said, as discussed in question 21 below, we would not necessarily object to some of the additional "clarifications" set forth in the Concept Release.

To the extent that the concern with the current model is due to a perceived lack of leverage by the auditor "to effect appropriate change in the company's financial statements,"[2] we disagree completely and believe that this represents a lack of understanding of the audit process. Our auditor has the ability to review all information it deems relevant to fulfilling its role and determining whether our financials meet the standard for an unqualified opinion, and it will not issue its opinion if it believes that we have not fairly presented our financial results. Because we must have an auditor's opinion in order to file our financial statements with the SEC, this provides the auditor with significant, and powerful, leverage. Furthermore, the auditor has direct access to our Audit Committee, with whom it can discuss any concerns about our financial results or their presentation. This access also provides significant leverage.

The Concept Release also reflects concerns of users about matters that are "not necessarily material to the financial statements."[3] Again, this appears to represent a misunderstanding of the audit process and of the financial reporting system in general. Materiality is a key precept for the financial reporting system and is necessary to the creation of useful and informative financial reporting. Management, with its deep understanding of the business, is in the best position to assess materiality, and if a matter is not material to the financial statements, then it should not be a significant focus of the audit in general or of the auditor's report in particular. Education of financial statement users would again appear to better address this concern than a wholesale change in the audit reporting model. And to the extent that there are questions about decisions regarding what is and is not material, as we note

[2] Concept Release at 9.
[3] *Id.*

above, if the auditor has significant concerns about the materiality of a matter, it also has significant leverage to ensure that the Company appropriately addresses those concerns.

3. *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation why.*

We firmly believe that the Company, whether through management or the Audit Committee, is best suited to provide information about the Company's financial statements. We also question whether significant additional information is necessary. We note that the repeated litany from the investor and user community is disclosure overload and that much of the information provided is not read. We believe that the footnotes and related financial information in our SEC filings already provide helpful and detailed information, together with earnings calls and other company announcements. To the extent that the SEC or FASB believes that this is not the case or that additional information is needed, we believe that they are in a better position to address any perceived disclosure gaps. Regardless, we do not believe that such information should come from auditors, whose role necessitates expertise in *auditing*, not in assessing the key business and strategic risks faced by our Company. It is our responsibility to effectively communicate these items to our shareholders, as reflected in the SEC's and FASB's rules and standards, and the importance of our relationship with our investing community, a relationship that does not exist between our auditors and investors, drives our efforts in this regard.

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

In short, no. An AD&A might provide more information to investors, but it would not necessarily be better information. Our auditors are not experts on the day-to-day workings of our business and industry and cannot have the same understanding of the business that our management and financial reporting team has.[4] The auditors are not trained to evaluate business risks faced by our Company or make necessary business judgments. If the purpose of the AD&A is to provide greater insight for financial statement users into these key aspects, management – with the tool it already has in the MD&A – is the best source of such insight. An AD&A would require audit firms to perform a judgmental function that is outside of their role and expertise. Furthermore, to have sufficient information upon which to render judgment on significant matters or evaluate key risks, the auditor would have to obtain that information from our financial management team. The result, therefore, would likely be redundant disclosure or potentially conflicting assessments of the same information that financial statement users would have to decipher and digest.

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[4] We note that this lack of expertise would be even further exacerbated if mandatory audit firm rotation were required, as considered by the Board in its Concept Release on Auditor Independence and Audit Firm Rotation.

Additionally, many of the matters proposed to be addressed in the AD&A are already discussed by the auditor with the Audit Committee. The Audit Committee, with both its understanding of the Company and of audit-related matters, is well-suited to digest, assess and discuss those matters with the auditor, for the benefit of the Company and its shareholders. In contrast, given the lack of user understanding reflected in the Concept Release and the comment responses above, adding more discussion of detailed audit matters to auditor reporting is likely to create further confusion and misunderstanding, which is the opposite of what the Board intends. This problem would only be exacerbated by the AD&A's inherent subjectively and lack of comparability between companies.

An AD&A also represents significant costs that are not justified by any clear benefits. It would substantially increase the scope of and time needed to complete an audit. We already face short deadlines to file our Form 10-K with the SEC, and each year we and our audit teams are challenged to meet those deadlines. Moreover, these short deadlines were driven by an investor community who desires the information in an increasingly short timeframe, and in fact pushes companies not just to meet, but to beat, these deadlines.

The requirement of an AD&A also would expose the auditors to considerable additional liability. The AD&A would be part of a filed document and would reflect an original statement of the *auditor*, not the Company, exposing the auditor to SEC review of and primary liability for those statements. In our litigious society, auditors would necessarily spend significant amounts of time and money on legal review of these disclosures, putting further stress on the process of meeting deadlines and likely resulting in carefully crafted boilerplate driven as much or more by liability concerns than investor understanding. The costs of this review, as well as many of the risks of such liability, will be passed through to the audited companies and ultimately their shareholders, without any real benefit to those shareholders.

Management would also need to devote additional time and effort to the audit and the AD&A, particularly to the extent that there are concerns about the propriety of additional disclosures in the AD&A or disagreements with portions of the discussion. Given the leverage that auditors have, management would be forced to address its concerns or disagreements with the AD&A in the Company's financial disclosures. This would result in more time, further disclosure overload and confusion for investors. We believe this would negatively impact the usefulness of financial reporting, not improve it.

*9.* *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

We reiterate our belief, expressed above, that an AD&A is inappropriate. A discussion of risks that are even further outside of the purview of the auditor's attest function and their area of expertise is best left to management, with oversight by the Audit Committee and the SEC.

Furthermore, there is already an extensive discussion of risks in our SEC filings, specifically tailored to our Company, that is derived from a comprehensive enterprise risk management process at The Home Depot. Again, to include similar discussion in the auditor's report would create, at best, redundant disclosure.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

As noted above, we believe boilerplate would be inevitable. We also believe that investor understanding would be further impaired by an AD&A. As we discuss above under question 1, if financial statement users do not currently understand basic audit concepts, we fail to see how they could understand or benefit from an AD&A full of detailed discussion of audit procedures undertaken or other accounting methods that could have been used.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

See our discussion above.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

We believe the potential for such inconsistencies is high. Many of the matters proposed to be discussed in the AD&A directly overlap with matters already addressed in financial reports, raising the question of why such information is necessary. As noted above in our response to question 5, because of the auditor's leverage, management would be forced to address concerns or disagreements with the AD&A in the Company's financial disclosures. For financial statement users, this would create confusion and further disclosure overload.

To the extent that a matter is important to the understanding of the financial statements and is not currently included in the financial report, it begs the question of why such information was not presented by the Company. The SEC is the better arbiter of this concern – if the SEC deems the Company's information to be appropriate and sufficient, there is no need for additional information from the auditor. If the SEC sees a need for more information, its rules governing the Company's disclosures are the best source for any additional requirements.

*13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

We do not believe that the emphasis paragraphs would be relevant or more useful in making investment decisions. We believe that the best location for such information is in the footnotes to the financial statements or in MD&A – both prepared by the people with the greatest understanding of the Company. Anything else added by the auditor reflects the same problems discussed above and may even detract from or distract users from the more important information in footnotes and MD&A. Given the apparent lack of understanding of the audit process implicit in the Concept Release, such a result is even more likely.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

No. See our response to question 13 above. In addition, any detailed discussion of specific audit procedures will likely be meaningless to many users, given the understanding gap that already exists.

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

Similar to the AD&A, we believe that additional emphasis paragraphs will inevitably lead to standardized, boilerplate language driven by liability concerns.

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

We do not believe additional emphasis paragraphs will provide benefits. See our responses above for a discussion of significant shortcomings.

19. *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No. The current scope of auditor assurance is appropriate and reflects their role, their training and their expertise in financial accounting and auditing. Having auditors opine on matters with respect to which they possess no (or at best limited) expertise will not lead to better or more transparent information. While we do not currently see such a need, if the SEC believes that certain specific items outside of the financial statements and notes should be subject to auditor assurance, they should be moved from Regulation S-K to Regulation S-X, and therefore included in the financial statements.

Moreover, as the Concept Release notes, such additional assurance would increase the scope of the auditor's responsibilities, resulting in increased risk and audit cost (both in terms of dollars and time). The benefits, however, would be minimal at best, especially given the reviews that are already performed by the auditor. For example, our auditor currently reviews our earnings releases for quantitative accuracy and for consistency with our financial results. We do not believe that adding an assurance requirement for the earnings releases would impact the content of those releases. We do believe, however, that it would increase the time prior to the release of the information, in direct contrast to the desires of our investor community, and it would clearly increase our audit costs.

e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

While we believe that any significant changes are unlikely, we also believe any such reporting is unnecessary and, in fact, inappropriate. Our auditors already test MD&A to assure that it is consistent with our financial statements and does not constitute a material misstatement of fact. Beyond these matters, the content of MD&A is specifically designed to present *management's* analysis of the financial condition and results of operations of the Company, to "give the investor an opportunity to look at the company through the eyes of management…."[5] Our disclosures reflect the input, review and oversight, as applicable, of our financial management, disclosure committee, senior management including the CEO, Audit Committee and Board of Directors. We believe that additional auditor reporting would not significantly impact this process, other than to add unnecessary time, effort and cost, and is not appropriate given the nature of what MD&A is designed to provide.

21. *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

a. *Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We believe that many of the issues raised in the Concept Release result from of a basic lack of understanding of the attest and audit function. We do not believe that fundamentally changing and expanding the role of the auditor will address this problem, and in fact is more likely to exacerbate it. We do not object, however, to limited clarifications of the auditor's report that would not increase the scope and cost of the audit process and may be of some value in addressing the understanding gap.

[5] Securities Act Release No. 6711 (April 24, 1987) [52 FR 13715] at 13717; cited in Securities Act Release No. 6835 (May 18, 1989) [54 FR 22427].

Specifically, providing a definition of the term "reasonable assurance," clarifying that the financial statements under Regulation S-X include all notes and all related schedules, and clarifying the auditor's role with respect to non-financial information could all be helpful to financial statement users. We would also not object to requiring the auditor to state that it has a responsibility to be independent of the company and has complied with applicable independence requirements of the Board and the SEC, although we note that this is both implicit in the title of the report and is already addressed in the Audit Committee report in the Company's proxy statement.[6]

We do not believe, however, that discussion regarding fraud would be appropriate, and believe it would have the negative effect of leading some to believe that fraud exists where it does not or that the report is somehow being qualified. Fraudulent financial statements are not common, and adding this language would seem to penalize the many for the bad actions of a few. Furthermore, assessment and detection of potential fraud is already addressed by the Company with the Audit Committee and the auditor on a quarterly basis through our robust internal controls and disclosure controls process and is better addressed in that forum. Finally, we do not think it is necessary for the auditor's report to state specifically that management prepares the financial statements and has responsibility for the fair presentation of the financial statements. We note that we already specifically address this in a statement by management that precedes our auditor's report and believe that it is better suited to that location.

c. *What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

None.

d. *What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

Because these changes only reflect clarifications, there should be no change to the audit scope or the auditor's responsibilities.

22. *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

See our discussion above.

25. *What alternatives not mentioned in this concept release should the Board consider?*

We do not believe that there is a strong need for action by the Board in this area. Resources would be better spent on reducing the understanding gap of users and better educating them

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[6] If there is a significant call among financial statement users for auditors to address their independence, it raises the question of whether investors are in fact reviewing the Audit Committee report and whether it might be better located in the Form 10-K rather than the proxy statement.

on the role of the auditor and the audit and the meaning and significance of the auditor's opinion. While certain of the audit report clarifications are not objectionable to us, we believe they provide minimal benefit. The other suggestions would result in significant increases in costs without meaningful improvements to financial information provided to investors.

29. *What effect would the various alternatives have on audit quality? What is the basis for your view?*

We do not believe that any of the suggestions will improve audit quality and, for many of the reasons discussed above, may actually impair it.

30. *Should the changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

We believe that any changes should apply to all entities.

31. *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

a. *Are any of these considerations more important than others? If so, which ones and why?*

As discussed above, we believe that increased liability is a primary consideration which will impact the amount of time spent, the level of review required by both the auditor and its legal counsel and the Company and its counsel, the costs of the audit, and the ultimate content and usefulness of any changes actually made.

b. *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

We do not believe that any perceived benefits would outweigh the inevitable additional costs.

32. *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

We believe that the right balance currently exists, both in the form and content of the audit report and in the leverage between the auditor and the Company. If the proposed changes are implemented, we foresee a disruption of this balance driven by the inevitable back and forth over the auditor's subjective assessment of what is important to the Company's investors, based on their more limited scope of expertise, and the corresponding assessment by management and the Audit Committee. As discussed above, the time that this process would take, including the need for each side to obtain additional legal review and, in the auditor's case, national office review, followed by the significant potential for conflicting disclosures or disagreements, cannot avoid straining the relationship. When viewed in light of the lack of measurable benefits, we do not believe this balance should be disrupted.

Thank you for the opportunity to comment on this important topic. I would be pleased to provide further comments if you have any questions regarding this letter.

Sincerely,

Carol Blome

30 September 2011

Our ref: ICAEW Rep 91/11

Mr Martin F. Baumann, Chief Auditor, PCAOB
1666 K Street, NW
Washington, D.C 20006
USA

Dear Mr Baumann

**Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

ICAEW is pleased to respond to your request for comments onthe PCAOB *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*.

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REP 91/11

ICAEW REPRESENTATION

# CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS

**Memorandum of comment submitted in September 2011 by ICAEW, in response to the PCAOB*Concept Releaseon Possible Revisions to PCAOB Standard Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*published in June 2011**

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## INTRODUCTION

**1.** ICAEW welcomes the opportunity to comment on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*published by the PCAOB on 21 June 2011, a copy of which is available from this link. We have prepared this response alongside our response to IAASB on its current consultation on auditor reporting *Enhancing the Value of Audit Reporting: Exploring Options for Change.*

## WHO WE ARE

**2.** ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter which obliges us to work in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 136,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

**3.** ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

**4.** The Audit and Assurance Faculty is a leading authority on external audit and other assurance activities and is recognised internationally as a source of expertise on audit issues. It is responsible for technical audit and assurance submissions on behalf of ICAEW as a whole. The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors. Members receive a range of services including the monthly Audit & Beyond newsletter.

## MAJOR POINTS

**5.** Key Messages

- The current auditor reporting model works well but there is room for improvement within the broader spectrum of auditor and corporate reporting. The demands for change from investors in larger listed companies need to be justified and there is no need for smaller companies to be subject to all of the reporting requirements of larger companies. Investors and other users are best served by better quality reporting by companies and more relevant reporting by auditors; more reporting for its own sake will not help anyone.

- Differing corporate governance regimes from which auditor reporting practices arise are likely to remain legally, culturally and economically highly jurisdiction-specific.Efforts should therefore be made by standard-setters towards the convergence of reporting requirements wherever possible, on the basis of high-level high-quality principles.

- The following principles should underpin any standard-setting activity in this area:

  – companies should provide high-quality information on which auditors report; auditors should only provide original information about companies in exceptional circumstances
  – the pass/failmodel should be retained
  – auditor reporting should be in sufficient detail to provide transparency about what auditors do and their findings, but not so detailed as to obscure key messages.

- The overall strategy for the evolution of auditor reporting should matchshort-term improvements to the format and content of the auditors' report with more ambitious longer term solutions in the form ofimprovements to the provision of wider-ranging auditor assurance.

## The Current Auditor Reporting Model and UK Reporting Initiatives

**6.** It is clear from research that the current auditor's report has value in the eyes of investors. It is also evident that auditor reporting has in fact changed substantially in recent years. What has not changed is the extent to which the current framework is a pass/fail model and the overarching opinion provided by auditors continues to be valuable to investors the world over. The significance of a 'clean' audit report to companies seeking listings on the world's stock exchanges is easily overlooked. More can certainly be done though and much of the rest of the debate is about who provides additional information, where, what sort of assurance, if any, can be provided on it, and indirectly about the need for improvements to corporate reporting, and how the quality of auditor reporting can be assessed.

**7.** The Audit Quality Forum (AQF), convened by ICAEW, considered the issue of auditor reporting in 2006, and its work was instrumental in stimulating the debate internationally. It considered the information that shareholders wished to see in the audit report, why they wanted it, barriers to change and ways to overcome them. The report noted that some shareholders want more discursive information within the audit report, covering uncertainties and risks and details of difficult, sensitive or contentious issues, for example, which would typically be discussed in the UK with the audit committee[1].

**8.** The AQF debated a number of other auditor reporting issues in subsequent years including reporting on the Internet and auditor signatures on audit reports, which widely influenced thinking of these matters. More recently, ICAEW responded to the FRC in the UK on its *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* consultation dealing with the content of and reporting on audit committee reports. We also responded to IOSCO on its auditor communications consultation. In both cases, we argued that one effective way forward in this area is in audit committee reporting, and auditor assurance on those parts not dealing with information provided by the auditor.

**9.** Most recently, ICAEW's Financial Reporting Faculty is about to publish a thought leadership work entitled *Reporting Business Risks: Meeting Expectations* as part of its *Information for Better Markets* series which deals with the current position in the USA, Canada, Italy and Germany as well as the UK, and with calls for enhanced reporting and the challenges and opportunities in meeting those demands.

**10.** Changes to auditor reporting are desirable and may involve reporting on areas of significant audit risks, but we believe that there is a strong case for addressing deficiencies in financial reporting, by better application of the requirements that already exist and by means of additional reporting requirements, if necessary. In the UK, the USA, and elsewhere, frameworks for risk reporting are in place but a minority of companies continue to provide a minimum and comply with the letter of the law only. We believe that regulators might seek to change behaviour *vis a vis* the existing framework before proposing new requirements, butinvestors will be disappointed if they expect auditors to remedy the provision of scant or poor quality information about business risks by requiring them to report on significant areas of audit risk. Business risks and significant audit risks are not the same.Auditors cannot disclose what they are not privy to and management will not furnish auditors with information that they are not prepared to disclose themselves. We encourage regulators to apply greater pressure to companies to provide better quality disclosures, even when they satisfy the minimum requirements. If the minimum requirements are in fact inadequate, they should be improved. In February 2011, the UK's Financial Reporting Review Panel highlighted the need for better reporting by companies of the principal risks and uncertainties they face.[2]

[1]The report of the working group can be found at www.icaew.com/en/technical/audit-and-assurance/audit-quality-forum-agf/fundamentals

[2]www.frc.org.uk/frrp/press/pub2503.html

**11.** The FRC's September 2011 papers *Boards and Risk – A Summary of Consultations with Companies, Investors and Advisors* and *Effective Company Stewardship - Next Steps*[3]propose that company narrative reports focus primarily on strategic and major operational risks rather than indiscriminate lists of risks that all companies face. It is proposed that the audit committee's remit should be extended to include consideration of the whole annual report and to ensure that the report, viewed as a whole, is fair and balanced. There are also proposals regarding auditor reporting on inconsistencies between the annual report and the financial statements and for a financial reporting laboratory in which preparers, auditors and other stakeholders experiment with novel forms of reporting.

**12.** While ICAEW is an international body, in this response we give a number of examples of changes that have been proposed or implemented in the UK. All of these examples are predicated on the UK corporate governance framework which is not in place elsewhere. We recognise this limitation. Nevertheless, we offer these examples in order to demonstrate the manner in which high-level principles might be applied at a local level.

## The Significance of Corporate Governance Regimes and the Desirability of Convergence

**13.** Auditor reporting is an area in which there is a pressing need for high-level principles which can be topped and tailed to meet local needs. We consider ourselves champions of international auditing standards in the UK and we engaged at a very early stage with investors through the AQF. Despite all of this, we struggled to adopt international standards on auditor reporting which reflects, among other things, the difficulties associated with prescription in this area. The diversity of practice in auditor reporting is more entrenched than diversity in audit practice generally not simply because auditor reporting is often legislated, but because of the incentives and disincentives to convergence arising from different corporate governance models and the different strengths, capabilities and focus of audit committees and auditors in different jurisdictions. Answers to auditor reporting questions depend on local governance frameworks and no auditing standard-setter or regulator is in a position to engineer change in this area without engaging all of the relevant stakeholders, and there are many. Attempts to do so by means of prescription in auditing standards are unlikely to be successful and may lead to unintended consequences, in the form of non-compliance with auditing standards and more defensive auditor behaviour which risk bringing standard-setters into disrepute. We encourage the PCAOB and IAASB to be diligent in their attention to each other's work in this area and urge them to co-operate as much as they can on their respective consultations. It would be a pity and a wasted opportunity if the two consultations resulted in further divergence which is a real risk, particularly if either or both bodies propose changes that are too prescriptive. We cannot avoid the impression that the number of questions in both consultations impliesa premature attention to detail, rather than a broader consideration of the higher-level and more important issues, and we emphasise the suggested principles needed to underpin standard-setting noted in our key messages above.

## Principles Underpinning Standard-Setting

**14.** Both the PCAOB and IAASB consultations propose two options: the first is enhancements to the current reporting regime without change to the fundamental premise of an audit in which independent auditors report on information prepared by companies; the second involves change to that fundamental premise whereby auditors produce original information about the company that is not already provided by management. We believe that auditors should only provide original information about companies in the exceptional circumstances in which it is required by law or regulation. The independent audit is predicated on this assumption and confusion will arise if the responsibility for reporting is split between auditors and management. Most audits are attest engagements which require independent auditors to report on

[3] http://www.frc.org.uk/press/pub2632.html

information provided by management. Their strength derives from a combination of auditor independence and the pass/fail model. Other models may be more fluid, may not require auditor independence and may permit original reporting by auditors. All have a place, but they should not be mixed together to avoid calling into question the all-important pass/fail assessment. Furthermore, we believe that it is likely that both options may lead, rightly or wrongly and whether intended or not, to changes in the conduct of audits and auditor behaviour, and that those changes may not necessarily be positive. The more detailed the proposals, the more likely it is that behaviour will change. The IAASB and the PCAOB need to be aware of the possibility of more defensive auditing whereby auditors perform procedures in order to mitigate the risk of claims rather than to improve the quality of the audit, of a greater level of involvement of lawyers in the reporting process, and of less frank exchanges with management and audit committees if more of what is discussed is likely to be reported.

**15.** There are calls for the demystification of the audit process and for information about both the audit and the audited entity to be provided. Some additional information may usefully be provided by auditors about the audit and by management about the audited entity. We believe that there is merit in careful consideration of the possibility of auditor reporting on significant audit risks, either within the audit report or elsewhere, however, we believe that there is a lot or work to be done if boilerplate is to be avoided. Business risks as reported by the entity are not the same as significant audit risks, although in many cases they cover similar ground, and it is important that all stakeholders are clear as to the difference to avoid confusion as to whose 'version of reality' is to be believed. Current auditing standards do not equip auditors to report on business risks and while they can be developed, for auditors to report on business risks that are not also audit risks would compromise their independence and result in them substitutingtheir judgement for, or subordinating their judgement to, that of management, instead of attesting to management's assertions.

**16.** Investors involved in this debate are already well aware that audit quality, on which they seek more information, comprises many elements and is not something than can be demonstrated quickly or easily. They are also aware that the provision of some of the information called for may be interesting, but that it will not enable informed decisions to be made about audit quality. Furthermore, investors are well aware that any information provided to the audit committee takes place in the context of an extended dialogue with the audit committee. To ask auditors to provide that information out of context is likely to cause confusion.

## Changes to the Format and Content of Auditor Reports and Longer- Lasting Improvements

**17.** While changes to the form and content of standard elements of the audit report may be relatively easy to achieve, and therefore attractive, we think it unlikely, on the basis of past experience, that they will significantly improve communications overall. Of themselves they are unlikely to have any significant effect on the information or expectation gaps. Equally, while we can support changing the placement and content of responsibility statements which might fulfil a desire among auditors to articulate their position more clearly, such changes are unlikely to make a significant impact on what users believe auditors are or should be doing, and any change risks an increasein the expectations gap.

**18.** While the need to cut clutter in financial reporting is not currently so much of an issue in the US as it is elsewhere, there are difficulties in reconciling calls for enhanced reporting made at the same time as calls to cut clutter. In some jurisdictions, continuing to add to the financial statements and auditor reporting has already resulted in overload and a complex navigation exercise to determine what is relevant, and what has been audited, reviewed or read and what has not. It is clear, at least in Europe, that investors want more relevant, better information which is sometimes already provided but can be difficult to find. Additional disclosures should not be provided merely to satisfy curiosity and investors in listed companies should explain how the information called for will be used in the decision making process. We support, as notedabove, the concept promulgated by the FRC of a financial reporting laboratory in which preparers, auditors and other stakeholders consider novel forms of reporting, how to avoid the natural tendency to revert to boilerplate, and how users of financial information can better navigate the information that is already made available to them.

**19.** We believe that both the PCAOB and the IAASB need to take a step back and consider the issue of auditor communications in a holistic manner. We are pleased that the IAASB has recognised the importance of corporate governance in this context but we believe that concrete proposals are premature. Both consultations focus heavily on the detail of auditor reporting and both are light on the need to balance the broad issues of investor needs, which are not homogenous, their desires, which are not necessarily the same as their needs, and what auditors and management are able to legitimately and usefully provide. Both consultations are also light on the inhibitory effects of the liability regime on auditor willingness to report.

**20.** Financial reporting has changed in recent years. There is a perception that auditor reporting has not kept up and there is certainly an appetite for change both in Europe and the US. We believe that it is essential that changes are real, that the costs are recognised, and that benefits can be measured. A great deal of heat and light may be generated in this debate but it is essential that change does in fact lead to greater investor satisfaction and convergence internationally, and that regulators and the profession do not simply make change in order to be seen to be doing so. We do not believe that, as has been suggested, that the benefits of the proposals can be realised at no cost, or are cost-neutral and we urge the PCAOB and the IAASB not to disregard this issue.

## PCAOB Proposals

**21.** We believe that there is merit in exploring the provision of assurance on additional information outside the scope of the financial statement audit provided that the information assured forms part of an acceptable financial reporting framework or meets criteria similar to those found in ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*.

**22.** In order of preference, we believe that the following proposals are likely to be most productive in improving investor understanding of the audit:

- clarifications to the audit report
- encouraging the proper use of emphases of matter
- assurance on information outside the financial statements, including assurance on audit committee reporting
- commentary on significant audit risks, however, we do not believe that an auditor's discussion and analysis (AD&A) is feasible.

While on the face of it an AD&A seems to nicely parallel the MD&A, the parallel is shallow. The proposals mix information about the audited entity and the audit and invite a comparison, between the auditors' account and that of management. Whilst this may be entertaining, briefly, it will not be helpful because it will cause confusion, encourage auditors and management to be excessively cautious, and force them even closer together when the annual report and AD&A are being prepared at the very time at which auditors should be and be seen to be independent. Investors will be unhappy if auditors and management report different things, and even unhappier if they report the same things.

## RESPONSES TO SPECIFIC QUESTIONS

**Q1: Many have suggested that the auditor's report, and in some cases, theauditor's role, should be expanded so that it is more relevant and useful toinvestors and other users of financial statements.**

**a. Should the Board undertake a standard-setting initiative to considerimprovements**

**to the auditor's reporting model? Why or why not?**

**23.** The Board should undertake an initiative to consider improvements to the auditor's reporting model. Standard-setting is only part of it. Financial reporting has changed in recent years and while auditor reporting has also done so, perhaps more than is generally acknowledged, there is a perception that further change is desirable. It is important that careful consideration is given to who provides additional information about the entity and the audit, where that information is provided, and to the need for the net result of change to be improved communication rather than more confusion which is a risk, particularly if the changes proposed are too prescriptive and do not converge with changes proposed by the IAASB.

**b. In what ways, if any, could the standard auditor's report or otherauditor reporting be improved to provide more relevant and usefulinformation to investors and other users of financial statements?**

**24.** We believe that clarifications to the audit report, encouraging the proper use of emphases of matter in limited circumstances, commentary on significant audit risks either within the auditors' report or outside it, andseparate assurance on other information outside the financial statements may help, to varying degrees, with improving investor understanding of what auditors have done.

**c. Should the Board consider expanding the auditor's role to provideassurance on matters in addition to the financial statements? If so,in what other areas of financial reporting should auditors provideassurance? If not, why not?**

**25.** Yes, the Board should consider expanding the auditor's role to provide assurance on matters in addition to the financial statements. There are many new areas in which non-audit assurance is being developed, including reporting on review engagements and CSR statements. In the context of this concept release we believe there is merit in considering the provision of assurance on audit committee reporting. This stands more of a chance of maintaining the proper relationship between auditors and management and of providing investors with more of the information they need, than some of the other proposals.AT 701 sets forth attestation standards and provides guidance to auditors concerning the performance of an attest engagement with respect to management discussion and analysis. Although issued more than 10 years ago we understand that there are very few examples of such reports being issued. This may be due to limited investor demand for such reports and the unwillingness of management to incur the additional costs associated with such engagements.

**26.** The FRC's January 2011 Consultation Paper *Effective Company Stewardship: Enhancing Corporate Reporting and Audit* recommends, among other things, that directors should describe in more detail the steps they take to ensure transparency about the activities of the business and any associated risks.Its September 2011 papers*Boards and Risk – A Summary of Consultations with Companies, Investors and Advisors* and *Effective Company Stewardship - Next Steps*note thatthe FRC proposes to ensure that company narrative reports focus primarily on strategic and major operational risks, rather than indiscriminate lists of risks that all companies face. It is possible that separate auditor assurance on these risks outside the main auditors' report will be considered.

**27.** While the US and UK models of corporate governance are not the same and the roles of audit committees are different, we believe that the high-level issues noted above are of an appropriate level to be considered by the Board in developing principles for auditor reporting.

**Q2: The standard auditor's report on the financial statements contains anopinion about whether the financial statements present fairly, in allmaterial respects, the financial condition, results of operations, and cashflows in conformity with the applicable financial reporting framework. Thistype of approach to the opinion is sometimes referred to as a 'pass/fail model.'**

**Should the auditor's report retain the pass/fail model? If so, why?**

**If not, why not, and what changes are needed?**

**c. If the pass/fail model were retained, are there changes to the reportor supplemental reporting that would be beneficial? If so, describesuch changes or supplemental reporting.**

**28.** The pass fail/model is one that investors are broadly happy withand the current model is not broken. It was developed because of inconsistency in auditor reporting and its success and significance should not be underestimated or obscured. Companies can neither obtain nor maintain listings on the world's stock exchanges if they 'fail' the audit test and a huge amount of effort goes into obtaining a 'pass'. Companies in transition economies often do not pass and the sometimes manifold reasons for their failure are listed in auditors' report. Audit reports give no indication as to the quality of the audit performed though, and there are calls for the demystification of the audit process and for the provision of more information about the audit and the audited entity. We believe that some additional information may usefully be provided by auditors about the audit and by management about the audited entity as indicated elsewhere in this response. Nevertheless, we believe that investors involved in this debate are already well aware that audit quality, like quality in other professions, comprises many elements and is not something than can be demonstrated quickly or easily.They are also aware that the provision of some of the information called for may be interesting, but that it will not enable informed decisions to be made whether a high quality audit has been performed.

**29.** Information provided by auditors to the audit committee is in the context of an extended dialogue, in which the information provided is sometimes only the starting point. To ask auditors to provide that information out of context is likely to cause confusion. It is important that if investors are provided with the information they ask for on significant audit risks, they accept that there is likely to be overlap with information provided by management on key financial reporting risks, that there will be different slants, and that they should not expect that auditors and management 'agree' on common wording.

**Q3: Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

**30.** It is clear from our discussions with some investors that while they understand the need for information about the entity to come from management, they do not always trust management to give a balanced view and would rather have the same information from the auditor. This lack of trust and the desire of some investors to exert better control over management underlie many of the calls for more information, rather than assurance, to be provided by auditors, but it calls into question the fundamentals of the relationships between management, auditors and investors.

**31.** Auditors are appointed to report on information provided by management, to, or for the benefit of, investors or the capital markets. In order for the audit to be credible, the auditor needs to be independent not only of management but of the audited information. Auditors should only provide original information about companies in the exceptional circumstances when it is required by law or regulation. Confusion is likely to arise if the responsibility for reporting is split between auditors and management. The auditor cannot provide information about the audited entity independently of management – the auditor relies on management for that – and if the auditor then puts his own slant on the information provided by management the auditor is no longer independent of the information he is reporting on. Furthermore, and perhaps even more importantly, if management is aware that auditors will take the information provided and alter it is some way they will be reluctant to provide it.

**32.** While additional information about the company's financial statements should come from management, and cannot come from auditors, it may also come from audit committees. We believe that investors should be turning their attention to the quality of people on audit committees and their processes and reporting functions. Much valuable information about the audited entity can be provided by audit committees which are in a better and more proper position than external auditors to provide and report on detailed information and explanations about the audited entity. External auditors are then in a position to provide assurance on this information.

**Q4: Some changes to the standard auditor's report could result in the need foramendments to the report on internal control over financial reporting, asrequired by Auditing Standard No. 5. If amendments were made to theauditor's report on internal control over financial reporting, what shouldthey be, and why are they necessary?**

**33.** We do not comment on this question.

**Q5: Should the Board consider an AD&A as an alternative for providingadditional information in the auditor's report?**

**a. If you support an AD&A as an alternative, provide an explanationas to why.**

**b. Do you think an AD&A should comment on the audit, thecompany's financial statements or both? Provide an explanation asto why. Should the AD&A comment about any other information?**

**c. Which types of information in an AD&A would be most relevant anduseful in making investment decisions? How would suchinformation be used?**

**d. If you do not support an AD&A as an alternative, explain why.**

**e. Are there alternatives other than an AD&A where the auditor couldcomment on the audit, the company's financial statements, or both?What are they?**

**34.** At first sight, the notion of an AD&A is an attractive one. It appears to parallel the MD&A and might offer scope for creativity in auditor reporting and provide something new for investors to read. We believe that the costs of an AD&A would be substantial, so much so as to significantly outweigh the benefits, not least because of the need to involve lawyers because of the liability regime. This in turn would lead to it reverting to boilerplate or near boilerplate over a very short space of time. The overlap with the MD&A would cause confusion and, certainly in Europe, it would very likely to be perceived as adding to the clutter. We do not believe that an AD&A is feasible.

**35.** There may be some scope for limited auditor reporting on areas that constitute significant audit risks, particularly on critical accounting policies and on auditor independence. This information could be provided either within the auditor’s report, although auditor’s reports are already very long in some cases, or outside it, either as a supplement or in a separate document.

**Q6: What types of information should an AD&A. include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

**36.** We note in our answer to question 5 above that we do not believe that an AD&A is feasible. We do believe however, that there is some scope for limited auditor reporting on significant audit risks, particularly on critical accounting policies and auditor independence. It would not be helpful for auditors to provide a wide spread of detail on all risks, nor a great depth of detail on the significant risks, because this would almost certainly serve to divert attention from what investors are really interested in, which are the broad areas to which auditors devoted their attention in which the big audit judgements were made. Less is increasingly more. Even less useful would be reporting on the extensive mechanics of audit procedures applied and the audit methodologies used as these, of themselves, are of little use in explaining how judgements are applied, which remains at the heart of auditing. Any such reporting would amount in any case to extensive boilerplate and it is helpful to remember in this context that it also for audit regulators consider auditor methodologies.

**Q7: What types of information should an AD&A include about the auditor'sviews on the company's financial statements based on the audit? What isthe appropriate content and level of detail regarding these matters presented in an AD&A (ie, management's judgments and estimates,accounting policies and practices, and difficult or contentious issues, including 'close calls')?**

**37.** Reporting the auditor's 'views' on the company's financial statements, if they could be articulated, would be highly subjective and vague at best. Reporting on management's judgements and estimates is likely to be covered by reporting on significant audit risks as noted in our answer to question 5 above, as are difficult and contentious issues which, if material, are almost by definition 'significant audit risks'.

**38.** It is clear that some investors trust neither management nor auditors and would like to be able to challenge auditors' judgements by effectively re-conducting the audit themselves, by micro-managing the auditor's work, or by reading the auditor's files. No amount of additional information is likely to satisfy such investors and the call for reporting on 'close calls' demonstrates the lack of understanding of how broad the range of acceptable management estimates can be in some cases. It also demonstrates the naïve belief that the pass/fail model that can be measure much like an exam script, in that 49% is a fail, and 51% is a pass, and auditors are failing to distinguish clearly between 51% passes and the 75% passes. The audit opinion is just that, an opinion and companies are not entered into a competitive audit examination in which their financial statements can be marked and one company's financial statements deemed better than another's. Audit qualifications represent a fail, albeit excused in some cases, and multiple qualifications, adverse opinions and disclaimers represent bad fails. But 'awards' bestowed by auditors for better or fairer application of accounting standards, say, would put the auditor in the position of reporting on management's performance which does not help investors who do this themselves, and who make it clear from time to time that they do not require auditor help with this.Investors require auditor expertise to report on the fairness of reporting *vis a vis* the company itself, not management.

**Q8: Should a standard format be required for an AD&A? Why or why not?**

**39.** If an AD&A is required, guidelines as to the main headings and the matters to be included might be helpful to auditors.

**Q9: Some investors suggested that, in addition to audit risk, an AD&A shouldinclude a discussion of other risks, such as business risks, strategic risks,or operational risks. Discussion of risks other than audit risk would requirean expansion of the auditor's current responsibilities. What are thepotential benefits and shortcomings of including such risks in an AD&A?**

**40.** It is inappropriate for auditors to provide original information about the entity as to do so would fundamentally alter the relationship between management, auditors and investors. Information on business, strategic and operational risks should come from management and should in any case already be included under most reporting frameworks in annual reports.

**Q10: How can boilerplate language be avoided in an AD&A while providingconsistency among such reports?**

**41.** Avoiding boilerplate and achieving consistency are antagonistic aims. To begin with, any new type of reporting that is not heavily prescribed will lack consistency, particularly across organisations. Over time, consistency will be achieved but boilerplate will have crept in. This is not of itself necessarily an evil, rather it is just one dynamic of reporting. The simple process of introducing new reporting requirements results in more reading of reports which helps user understanding, even if over time this drops off.

**Q11: What are the potential benefits and shortcomings of implementing anAD&A?**

**42.** Implementing an AD&A would provide something new for investors to read but the costs are likely to be substantial and its value limited for the reasons set out elsewhere in this response.

**Q12: What are your views regarding the potential for an AD&A to presentinconsistent or competing information between the auditor andmanagement? What effect will this have on management's financialstatement presentation?**

**43.** Investors are likely to make comparisons between an AD&A and the MD&A and it is inevitable that however diligent management and auditors are in trying to avoid inconsistency or competition, they will arise. This will further erode confidence in both management and auditors as investors would naturally seek to align, probably without much success, management and auditor views. If management and auditors provide the same view investors will have cause to question auditor independence and ask why they are paying for two identical reports.

**B. Required and Expanded Use of Emphasis Paragraphs**

**Q13: Would the types of matters described in the illustrative emphasisparagraphs be relevant and useful in making investment decisions? If so,how would they be used?**

**44.** It is important to ensure that the desire among investors for more information about emphases of matter does not result in the currency of emphases of matter being debased through over or inconsistent usage. The illustrative emphases of matter cover matters such as related parties, 'unusually important' subsequent events and certain accounting matters and are certainly of current interest, but it is likely over time that they will be routinely added to, creating substantial clutter in audit reports. The purpose of emphases of matter is not to remedy defective accounting but to draw users' attention to matters that are critical to the understanding of financial statements. One of the reasons that investors are unhappy with the status quo is because of how companies report. The remedy may be clarification of and better application of existing requirements and the enforcement thereof, not asking the auditors instead. Subsequent events and related parties will not always be critical, even though they are often important. It is also important to remember that emphases can easily be used in the place of or misconstrued as qualifications. This may be less of a problem for companies and investors than it is for auditors. Auditors may be tempted to abuse emphases of matter in circumstances in which a qualification may be more appropriate, enabling them to avoid the need to put pressure on management to change an accounting treatment or disclose a matter in order to avoid the qualification.

**Q14: Should the Board consider a requirement to include areas of emphasis ineach audit report, together with related key audit procedures?**

**a. If you support required and expanded emphasis paragraphs as analternative, provide an explanation as to why.**

**b. If you do not support required and expanded emphasis paragraphsas an alternative, provide an explanation as to why.**

**45.** The Board might consider a requirement to consider including areas of emphasis but to require auditors to do so will inevitably result in the re-iteration year after year of 'key areas'. This would be counter-productive to the extent that in some years, a key area would be critical and in other it would not, but users of financial statements are likely to miss the significance of any changes in wording as a result of habitual (over) exposure to a note about the same issue. Key audit procedures will only add to clutter and will not be helpful to investors for the reasons outlined in our answer to question 6 above.

**Q15: What specific information should required expanded emphasisparagraphs include regarding the audit or the company's financialstatements? What other matters should be required to be included inemphasis paragraphs?**

**46.** We believe that if the PCAOB wishes to increase the level of usage of emphases of matter and the level of detail provided therein, it would be better to police their existing use more effectively through regulatory measures than to changes the rules, which are adequate.

**Q16: What is the appropriate content and level of detail regarding the matterspresented in required emphasis paragraphs?**

**47.** A short and carefully crafted but clear description of the issue in appropriate circumstances that takes up a few lines is likely to be more helpful to investors than half a page of boilerplate written by lawyers.

**Q17: How can boilerplate language be avoided in required emphasisparagraphs while providing consistency among such audit reports?**

**48.** If emphases are mandated, boilerplate is inevitable. If more rather than less is encouraged, boilerplate can be put off for longer.

**Q18: What are the potential benefits and shortcomings of implementingrequired and expanded emphasis paragraphs?**

**49.** The potential benefits of implementing required and expanded emphasis paragraphs are very limited and the potential shortcomings are extensive. They include auditors misusing emphases where qualifications are more appropriate, boilerplate and the loss of distinction between routine key issues and non-routine critical issues. Better application and enforcement of the existing regime and clear regulatory steer might help encourage the appropriate use of emphases.

**Q19: Should the Board consider auditor assurance on other information outsidethe financial statements as an alternative for enhancing the auditor'sreporting model?**

**a. If you support auditor assurance on other information outside thefinancial statements as an alternative, provide an explanation as towhy.**

**50.** Yes, the Board should consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model.Assurance outside the financial statements will avoid the build-up of clutter in over-laden audit reports where it does not yet exist might ameliorate it where it does.

**b. On what information should the auditor provide assurance (eg,MD&A, earnings releases, non-GAAP information, or othermatters)? Provide an explanation as to why.**

**51.** Auditors are best able to report on and develop tools and techniques for reporting on information provided in the context of an acceptable financial reporting framework or information that meets criteria similar to those set out in ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information.*To the extent that the MD&A contains a fair amount of forward looking information that is only very loosely related to the financial statements, and may or may not meet criteria similar to those in ISAE 3000,providing assurance thereon is likely to prove difficult and, in practice, auditors are likely to report selectively thereon. Auditors may be able to provide assurance on earnings releases if they contain GAAP information and certain types of non-GAAP information outside the main financial statementsif they meet the aforementioned criteria.

**c. What level of assurance would be most appropriate for the auditorto provide on information outside the financial statements?**

**52.** In order to answer this question, it is necessary to have a framework for reporting such as IAASB's ISAE 3000. The most appropriate level of assurance depends on the work effort and this in turn depends on what the market is prepared to bear in terms of cost.

**d. If the auditor were to provide assurance on a portion or portions ofthe MD&A, what portion or portions would be most appropriate andwhy?**

**e. Would auditor reporting on a portion or portions of the MD&A affectthe nature of MD&A disclosures? If so, how?**

**f. Are the requirements in the Board's attestation standard, AT sec.701, sufficient to provide the appropriate level of auditor assuranceon other information outside the financial statements? If not, whatother requirements should be considered?**

**g. If you do not support auditor assurance on other informationoutside the financial statements, provide an explanation as to why.**

**53.** To add to the patchwork of reporting by reporting selectively on elements of the MD&A would be a regressive step and add to confusion in an already muddled area.

**54.** We note above our understanding that AT 701 which sets forth attestation standards and provides guidance to auditors concerning the performance of an attest engagement with respect to management discussion and analysis is not widely used. More tailored standards are likely to be required

**Q20:What are the potential benefits and shortcomings of implementing auditorassurance on other information outside the financial statements?**

**55.** It is possible that where financial reports are cluttered, the potential benefit of implementing auditor assurance on other information outside the financial statements is in improving the current situation in which it is difficult to determine which parts of annual reports have been audited, reviewed or read.

**Q21:The concept release presents suggestions on how to clarify the auditor'sreport in the following areas:**

**• Reasonable assurance**

**• Auditor's responsibility for fraud**

**• Auditor's responsibility for financial statement disclosures**

**• Management's responsibility for the preparation of thefinancial statements**

**• Auditor's responsibility for information outside the financialstatements**

**• Auditor independence42/ AU sec. 550.04 - .06.**

**a. Do you believe some or all of these clarifications are appropriate? Ifso, explain which of these clarifications is appropriate? How shouldthe auditor's report be clarified?**

**b. Would these potential clarifications serve to enhance the auditor'sreport and help readers understand the auditor's report and theauditor's responsibilities? Provide an explanation as to why or whynot.**

**c. What other clarifications or improvements to the auditor's reportingmodel can be made to better communicate the nature of an auditand the auditor's responsibilities?**

**d. What are the implications to the scope of the audit, or the auditor'sresponsibilities, resulting from the foregoing clarifications?**

**Q22: What are the potential benefits and shortcomings of providing clarificationsof the language in the standard auditor's report?**

**56.** The principal benefit, although it not a significant one, of clarifying the auditor's report in the areas noted in question 21 above is that the report will better articulate the auditor's position. But clarification is unlikely to serve any useful educational purpose as it is clear from IAASB's research that the boilerplate in auditors' reports is not read, in much the same way as any 'small print' is not read (and the more there is of it, the less likely it is that it will be read). The main function of the audit report is as a medium through which to transmit the all-important pass/fail assessment. All of the matters noted above are already dealt with in audit reports and the fact that there is more to read will neither encourage reading, nor will it enhance comprehension. The fact that auditors protest, even more vociferously than they do now, that the purpose of the audit is not to detect fraud *per se*, will do nothing to change the belief that auditors should do so. The principal shortcoming is that clarification will give the appearance of improved communication without actually doing so.

**Questions Related to all Alternatives**

**Q23: This concept release presents several alternatives intended to improveauditor communication to the users of financial statements through theauditor's reporting model. Which alternative is most appropriate and why?**

**Q24: Would a combination of the alternatives, or certain elements of thealternatives, be more effective in improving auditor communication thanany one of the alternatives alone? What are those combinations ofalternatives or elements?**

**57.** In order of preference, we believe that the following proposals are likely to be most productive in improving investor understanding of the audit:

- clarifications to the audit report
- encouraging the proper use of emphases of matter by regulatory means, among others
- assurance on information outside the financial statements, including providing assurance on audit committee reporting and
- commentary on significant audit risks and auditor independence, but we do not believe that an AD&A is feasible or practical for reasons we set out elsewhere in this response.

**Q25: What alternatives not mentioned in this concept release should the Boardconsider?**

**58.** We believe that the PCAOB and IAASB need to take a step back and consider the issue of auditor communications in a holistic manner. Both consultations focus heavily on the detail of auditor reporting and both are light on the need to balance the broad issues of investor needs, their desires, and what auditors and management are able to legitimately and usefully provide. Both consultations are also light on the inhibitory effects of the liability regime on auditor willingness to report.

**59.** The auditor's report has value and is not broken in the eyes of investors. It has changed substantially in recent years. What has not changed is the pass/fail model and it is clear that investors value the overarching opinion provided by auditors. More can certainly be done though and much of the rest of the debate is about who provides additional information, where, what sort of assurance, if any, can be provided on it, and indirectly about the need for improvements to corporate reporting and how the quality of auditor reporting can be assessed.

**Q26: Each of the alternatives presented might require the development of anauditor reporting framework and criteria. What recommendations shouldthe Board consider in developing such auditor reporting framework andrelated criteria for each of the alternatives?**

**60.** We strongly recommend that the Board consult with the IAASB on an auditor reporting framework. Both Boards and all of their stakeholders would benefit from such a dialogue because any framework needs to be able to accommodate different corporate governance regimes in order to be effective.

**Q27: Would financial statement users perceive any of these alternatives asproviding a qualified or piecemeal opinion? If so, what steps could theBoard take to mitigate the risk of this perception?**

**61.** There is always a risk that change results in misunderstanding but the risks of missing or underestimating the significance of auditor red flags are much more important than the risks of overestimating their importance.

**Q28: Do any of the alternatives better convey to the users of the financialstatements the auditor's role in the performance of an audit? Why or whynot? Are there other recommendations that could better convey this role?**

**Q29: What effect would the various alternatives have on audit quality? What isthe basis for your view?**

**62.** Auditor reporting is an integral part of audit quality and misconceptions regarding audit quality arise in part from a failure by auditors to communicate adequately. It is important to note the possibility that the demystification of the audit might result in its marginalisation or in calls for auditors to take on a radically different role to the one they play at present.

**Q30: Should changes to the auditor's reporting model considered by the Boardapply equally to all audit reports filed with the SEC, including those filed inconnection with the financial statements of public companies, investmentcompanies, investment advisers, brokers and dealers, and others? Whatwould be the effects of applying the alternatives discussed in the conceptrelease to the audit reports for such entities? If audit reports related tocertain entities should be excluded from one or more of the alternatives,please explain the basis for such an exclusion.**

**63.** We do not comment on this question.

**Q31:This concept release describes certain considerations related to changingthe auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liabilityconsiderations, and confidentiality.**

**a. Are any of these considerations more important than others? If so,which ones and why?**

**b. If changes to the auditor's reporting model increased cost, do youbelieve the benefits of such changes justify the potential cost? Whyor why not?**

**c. Are there any other considerations related to changing the auditor'sreport that this concept release has not addressed? If so, what arethese considerations?**

**d. What requirements and other measures could the PCAOB or othersput into place to address the potential effects of theseconsiderations?**

**64.** The concept release is light on the impact of liability considerations which actively inhibit what auditors are able to say. We note elsewhere in this response, and particularly in our answers to questions 5, 11 and 18 that in some cases, the costs may significantly outweigh the benefits of the proposed changes. We hope that overall that the changes arising from these discussions will result in more efficient audit effort. We also believe that the PCAOB should actively consider the benefits of convergence with IAASB in this area.

**Q32: The concept release discusses the potential effects that providingadditional information in the auditor's report could have on relationshipsamong the auditor, management, and the audit committee. If the auditorwere to include in the auditor's report information regarding the company'sfinancial statements, what potential effects could that have on theinteraction among the auditor, management, and the audit committee?**

**65.** We note in our answers to questions 3, 7 and 9 that while some investors understand the need for information about the entity to come from management, they do not always trust management to give a balanced view and would rather have the same information from the auditor. It is inappropriate for auditors to provide original information about the entity as it would fundamentally alter the relationship between management, auditors and investors.

**66.** Auditors are appointed to report on information provided by management and in order for the audit to be credible, the auditor needs to be independent of management and the audited information. The auditor cannot provide information about the audited entity independently of management and if the auditor puts his own slant on the information provided by management the auditor is no longer independent of the information he is reporting on. If management is aware that auditors will take the information they provide to them and alter it is some way they will be reluctant to provide it.

**67.** While additional information about the company's financial statements should come from management, and cannot come from auditors, we believe that going forward it is more likely to come from audit committees. Investors should focus on the quality of people on audit committees, their processes and reporting functions. Much valuable information about the audited entity can be provided by audit committees and external auditors are then in a position to provide assurance on it.

**68.** We also make it clear that while some investors trust neither management nor auditors and would like to be able to challenge auditors' judgements by effectively re-conducting the audit themselves by interrogating auditors, no amount of additional information is likely to satisfy such investors.

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03 October 2011

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
**E-Mail:** comments@pcaobus.org

Dear Sir/Madam

**PCAOBs CONCEPT RELEASE ON AUDITORs REPORTING MODEL – SEPTEMBER 2011**

In response to your request for comments on the PCAOB's Concept Release on Auditor's Reporting Model – September 2011, the Assurance Guidance Committee of the South African Institute of Chartered Accountants (SAICA).

We thank you for the opportunity to provide comments on this document.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours sincerely

**Ashley Vandiar**
**Project Director – Assurance, Ethics and Members Advice**


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**OVERALL COMMENTS**

We acknowledge that there is a need to provide more information in the auditor's report and that this should be fairly addressed to include views from various users. There are areas were an audit cannot provide assurance, such as management's projections and assumptions; however, there are some areas were additional information can be provided to add value to the auditor's report without compromising the auditor's independence or breaching confidentiality by divulging client information, for example by articulating risks in the report that may expose the auditor to undue litigation.

This concept release is based on the investors' perspective, yet investors are not using the auditor's report for their investment decisions. Investors use and rely on the MD&A and other financial information (e.g. non-GAAP information and earnings' releases) for their investing decisions, in addition to historical audited financial statements.
We believe it is important for investors to consider business risks, strategic risks and operating risks. However, we do not believe that assessment of those risks or reporting on those risks should be the responsibility of the auditor. We fear a blurring of the roles between the preparer and the assurer, and the possible impairment of independence if auditors are required to report on these additional risks, which may go beyond the audit risk model.

We need to distinguish between public interest and investor interest, and also acknowledge that users, other than investors, utilising the auditor's report may require an understanding of matters discussed in the auditor's report and the impact thereof on the financial statements, as well as education on what an audit is and what the limitations of an audit are.

According to the concept release, "some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party" and that "some investors believed that more relevant insight into the financial statements, through the eyes of the auditor, might better enable them to assess how changes in the economy might affect a company's future financial performance or condition". This will cause a self-interest threat for the auditor as the auditor is required to be independent and adopt a skeptical mindset when evaluating management judgments and estimates.

The resources required to support the initial representations for financial statements are management's and, therefore, those representations should come from management and not the auditor.

As noted in the concept release, "the objective of this release is to discuss several alternatives for changing the auditor's reporting model that could increase its transparency and relevance to financial statement users, while not compromising audit quality". Furthermore, on page 6 of the concept release, PCAOB states that it wishes "to obtain insight into the changes that investors and others are seeking to the auditor's report and how those changes could be incorporated into the auditor's report or the overall auditor's reporting model". Some investors, as noted throughout the concept release, continue to request all sorts of changes to the auditor's report while others, as referred to in the concept release, are not seeking changes as they believe it would be counterproductive for reasons cited in the release and otherwise. We believe that the PCAOB will take into consideration all various views on this concept release, as well as comments submitted, and that any improvements to the auditor reporting model will be principle-based and not rules driven.

**RESPONSES TO THE SPECIFIC QUESTIONS**

1. *Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

   a. *Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

   **Response:** Yes, but it should be subject to limitations. Any improvements to the auditor reporting model should be principle-based and should not be rules driven. It should also be noted that auditors cannot provide assurance on information that is not part of the financial statements and cannot disclose information in the audit report unless it constitutes instances of non-compliance.

   We also believe that no amendments should be made to the audit report per se; however, an additional assurance report, for example reporting on compliance matters and/or legislation requirements, should be provided contextualising additional information on which assurance is required by users.

   b. *In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

   **Response:** By providing a separate or additional assurance report on other information required by investors and other users.

   The audit report can also be modified by expanding on certain terminology used in the report by providing explanations to words such as "materiality", "independence" and "reasonable assurance".

   c. *Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

   .

   **Response:** No, the auditor's role to provide assurance should be limited to financial reporting and any other assurance should be addressed outside of this particular scope.
   Should the PCAOB decide to expand the auditor's role to provide assurance on matters in addition to the financial statements, education and training should be provided to users.

   Assurance on other matters in addition to the financial statements should be provided separately as required by the investors and users; however, it should be considered whether assuring such information may require certain skills that are not possessed by the auditors.

It should be noted that, in terms of ISA 720, auditors are associated with other information in documents that include audited financial statements and as part of the audit perform procedures to satisfy themselves that this additional detail is not inconsistent with the audited financial statements. The auditor is required to read other information in documents that include audited financial statements. If the auditor finds that such information contradicts the financial statements, they must investigate and resolve the differences to ensure the statements are correct. This process improves both the audited financial information and the unaudited company information, if done properly.

2. *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

    a. *Should the auditor's report retain the pass/fail model? If so, why?*

    **Response:** Yes, this is clear and sufficient to indicate that the entity has fairly presented its financial statements.

    b. *If not, why not, and what changes are needed?*

    **Response:** N/A with reference to our response to question 2(a).

    c. *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

    **Response:** Yes, these supplemental reporting should be limited to what has been supplied by management, that is information already disclosed by management. The 'emphasis of matter paragraph" highlights what is already in the notes to the financial statements. The audit report does not need to highlight items already in the financial statements as there is already an index to the financial statements.

3. *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g. management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

**Response:** This remains management's responsibility so they must make these assertions and the extent of assurance that is provided is effectively done by the audit committee.

4. *Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

   **Response:** We do not believe that they should be changes to the standard audit report hence no amendments to the report on internal control over financial reporting.

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

   **Response:** No, because the end result is what is important.

   The AD&A could require auditors to disclose information which should be left for internal communication between the auditor and the client as well as disclosing confidential information which may be contrary to the normal auditor-client relationship.
   This concept tends to confuse the role of management and the role of the auditor. Management is responsible for the business and the auditor is responsible for expressing an opinion on the financial statements.

   This response applies to question 5 until question 12.

   a. *If you support an AD&A as an alternative, provide an explanation as to why.*

      **Response:** Refer to the response under question 5 above.

   b. *Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

      **Response:** Refer to the response under question 5.

   c. *Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

      **Response:** Refer to the response under question 5.

   d. *If you do not support an AD&A as an alternative, explain why.*

      **Response:** Refer to the response under question 5.

   e. *Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

**Response:** Refer to the response under question 5.

6. *What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

   **Response:** Refer to the response under question 5.

7. *What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

   **Response:** Refer to the response under question 5.

8. *Should a standard format be required for an AD&A? Why or why not?*

   **Response:** Refer to the response under question 5.

9. *Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

   **Response:** Refer to the response under question 5.

10. *How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

    **Response:** Refer to the response under question 5.

11. *What are the potential benefits and shortcomings of implementing an AD&A?*

    **Response:** Refer to the response under question 5.

12. *What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

    **Response:** Refer to the response under question 5.

13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

    **Response:** We believe in a principle based approach therefore we don't agree with this as it is tailored rules.
    Management is required to disclose all major estimates and judgements because they are presenting the financial information. The emphasis of matter paragraph tends to highlight or repeat what has already been presented by management in the financial statements, hence it is not used judiciously to achieve the desired emphasis and this may also be seen as auditors taking the responsibility of management.

    We believe that the emphasis of matter paragraph would be used effectively only to highlight disagreements that warrant the attention of users but that does affect the fair presentation of the financial statements.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

    a. *If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

       **Response:** Refer to response to question 13

    b. *If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.*

       **Response:** Refer to response to question 13

15. *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

    **Response:** Refer to response to question 13

16. *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

    **Response:** Refer to response to question 13

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

    **Response:** Refer to response to question 13

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

    **Response:** refer to response to question 13

19. *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

    **Response:** Yes, as per users' needs and have a separate report for those needs. Identify users' needs and provide a relevant assurance service for that domain and develop a separate related assurance report. This will be on a case by case basis, where the auditor and management engage and agree on the type of assurance to be provided as well as the type of report required.

    a. *If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*

       **Response:** Refer to the response above.

    b. *On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*

       **Response:** This should be limited to financial information. There should not be a requirement for auditor to provide assurance on other information, however this will be on a case by case basis, where the auditor and management should engage and agree on the type of assurance to be provided as well as the type of report required, for example the reporting on financial information as required by the JSE Securities Exchange Listing Requirements.

    c. *What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*

       **Response:** The level of assurance would generally be negative assurance that is "nothing has come to our attention.......", however the most appropriate level of assurance will be guided by the needs of the user.

    d. *If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

       **Response:** No comment as we are not MD&A specialists.

    e. *Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

       **Response:** No comment as we are not MD&A specialists.

    f. *Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

**Response:** No comment as we are not MD&A specialists.

g. *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

**Response:** N/A, based on our responses above.

20. *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

**Response:** There are potential benefits as there will be more reliance on this information however assurance on other information in addition to the financial statements should be a separate engagement and a separate report should be issued.

The shortcomings of implementing auditor assurance on other information outside the financial statements include:

- The possibility of reports not addressing all stakeholders' needs depending on varying stakeholders.
- The cost implications of assuring this information.
- The expertise required should auditors not have specific skills, associated with assuring such information.

21. *The concept release presents suggestions on how to clarify the auditor's report in the following areas:*
    - *Reasonable assurance*
    - *Auditor's responsibility for fraud*
    - *Auditor's responsibility for financial statement disclosures*
    - *Management's responsibility for the preparation of the financial statements*
    - *Auditor's responsibility for information outside the financial statements*
    - *Auditor independence*

a. *Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

**Response:** Yes, we believe that these clarifications are appropriate and would help delineate roles and responsibilities of the audit. These clarifications should be principle-based and should be clarified by way of footnotes or an appendix.

b. *Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

**Response:** Yes, these clarifications will provide users with better understanding.

c. *What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*
**Response:** None.

d. *What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

**Response:** There will be no implications to the scope of the audit if the definitions in the auditing standards are used for this purpose.

22. *What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

**Response:** This will provide users with a better understanding of the language in the standard audit report; however these clarifications should be from the auditing standards and not individual definitions.

23. *This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

**Response:** We believe that the most appropriate alternative is the clarification of the language in the standard audit report because it will provide users with better understanding.

24. *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

**Response:** There could be combinations of these alternatives however, this should also depend on the needs of the users and separate assurance reports should be issued.

25. *What alternatives not mentioned in this concept release should the Board consider?*

**Response:** None.

26. *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

**Response:** For each of the alternatives, the Board should consider the needs of the users and the ability to provide assurance for those needs. There will be a need for the

Board to provide guidance on criteria to be used and what type of assurance would be provided as well as additional disclosures that may be required in the financial statements to facilitate this and the clarification of the auditor's responsibilities and management's responsibilities.

27. *Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

**Response:** There will be a definite risk of misunderstanding. There will be a need for user education. However, if you have separate assurance reports for all different areas, it will be self-explanatory and will not create different perceptions as it will indicate clearly the scope, objective, work performed and on what information the auditor is expressing an opinion on, hence alternative 3 in the concept release is favorable.

28. *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

**Response:** Alternative 3 will better convey the auditor's role in the performance of an audit to the users of financial statements as there will be separate assurance reports explaining clearly the scope, objective, work performed and on what information the auditor is expressing an opinion on.

29. *What effect would the various alternatives have on audit quality? What is the basis for your view?*

**Response:** Audit quality might be compromised due to time constraints, or clients may incur high audit costs due to the resources that may need to be employed to be able to complete the work within the set timeframes.

30. *Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such exclusion.*

**Response:** There will be no impact if audit reports are standardized, however, should the first two alternatives be implemented, then there would be a need to differentiate the audit reports for such entities.

31. *This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, and effects on audit committee governance, liability considerations, and confidentiality.*

a. *Are any of these considerations more important than others? If so, which ones and why*?
**Response:** All these considerations are important. The largest effect will be on the auditor's time and effort which will drive up costs for stakeholders, liability, relationships as well as maintaining confidentiality of company information. This will increase risk for negative impact on the profession.

b. *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

**Response:** There will be increased cost in changes to the auditor's reporting model. It is unknown at this stage whether the benefit will outweigh the cost over time.

c. *Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?*

**Response:** The recognition that it is management's responsibility to identify who the users/stakeholders are.

d. *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

**Response:** no comment.

32. *The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

**Response:** This will impact negatively on the relationships between the auditor, management and the auditor committee. It will also create confusion on the roles and responsibilities of all three parties as well as increase tension.

12001 Tech Center Drive
Livonia, MI 48150

September 30, 2011

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

TRW

Re: PCAOB Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, and Related Amendments to PCAOB Standards*

Dear Members and Staff of the Public Company Accounting Oversight Board:

TRW Automotive Holdings Corp. ("TRW") appreciates the opportunity to comment on the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements, and Related Amendments to PCAOB Standards* (the "Concept Release"). TRW is among the world's largest suppliers of automotive systems, modules, and components to global automotive manufacturers and related aftermarkets. TRW is also a large accelerated filer with the Securities and Exchange Commission ("SEC") and thus subject to audit under the standards issued by the PCAOB.

TRW supports the stated objectives of the Concept Release, and believes that improvements to the auditor's reporting model that would permit better user understanding of an audit would be beneficial to both users and management. However, as with any changes to auditing or accounting standards, the benefits to all parties under the proposed changes must also exceed the sum of the costs incurred by all parties to make the proposed improvements.

While TRW supports the stated objectives of the Concept Release, TRW does not support the Auditor Discussion & Analysis ("AD&A"), emphasis paragraph, or expansion of auditor responsibility alternatives, as we believe that the costs associated with each of these alternatives would substantially exceed the benefits that would be derived. In addition, while TRW supports some of the improvements associated with the clarification of the auditor's opinion, TRW is also concerned that, even with this alternative, the costs to make the changes would exceed the benefits yielded by investors. Given the tight filing deadlines currently mandated by the SEC, TRW is also concerned that adding additional responsibilities to the auditor could lead to significant delays in the reporting process, causing reporting entities to miss their filing deadlines.

In addition, the PCAOB should give serious thought to the potential implications of issuing any one of the four alternatives outlined in the Concept Release. In particular, TRW is concerned that, if any of the four alternatives are issued as a final standard (or, as the PCAOB has indicated, some combination of the alternatives), it could result in a significant increase in the litigation risk born by both auditors and management. Further, several of the alternatives (most notably the AD&A and emphasis paragraphs) call into question what the role of the auditor and management would be, and could result in damage to the auditor-management relationship.

A further explanation of our concerns follows.

**Role of Management and Auditors**

The Concept Release provides ideas as to how the auditor can provide additional information to users of financial statements. Several of the ideas that are included in the Concept Release include the potential for auditors to comment on the quality of the disclosures made by management, discussion of other risk factors that the auditor believes affect the reporting entity, and the discussion of matters that the auditors believe to be significant to the overall presentation of the financial statements.

As more fully enumerated in our responses to the specific questions asked by the Concept Release below, TRW is not supportive of auditor commentary on items that are specific to the reporting entity. TRW believes that, to the extent that the disclosures made by the reporting entity are in conformance with the applicable financial reporting framework, commentary indicating that the auditor believes that disclosures could be improved would, at best, be confusing to users of the financial statements, as the users of financial statements would have to spend additional time and resources to sort through conflicting information given by the auditors and by the reporting entity. More realistically, we believe that if any of the alternatives that call for auditor commentary on items specific to the reporting entity are approved, management and the auditors would see the costs of issuing financial statements increase, along with the risk of potential litigation (as further discussed below).

The Concept Release also raises, in several spots, an interesting question that the PCAOB should address prior to the issuance of a final standard. As noted above, several of the proposed alternatives would place the auditor in a position of commenting on the quality of the disclosures made by management. However, all applicable financial reporting frameworks and PCAOB auditing standards state that management is responsible for the financial statements; indeed, this is explicitly stated in the auditor's opinion. TRW is concerned that, in scenarios where the auditor is commenting on the financial statements, there could be significant confusion among users of financial statements as to who is ultimately responsible for the financial statements – management, or the auditors? In addition, several of the alternatives raise the question as to who is better equipped to inform users of financial statements about the reporting entity – management, or the auditors? Who is the best source of opinion on where the reporting entity is heading – management, or the auditors?

TRW's view is that management is the best situated to provide commentary in the financial statements on the reporting entity. Management has the broadest view of the specific risks and uncertainties that face the reporting entity, and should be permitted to provide whatever disclosures it feels are necessary in order to permit users of financial statements to understand those risks and uncertainties. TRW further believes that the only time that the auditors should be providing commentary on the disclosures made by the reporting entity is when those disclosures are not in compliance with the applicable financial reporting framework.

**Litigation**
Several of the alternatives presented in the Concept Release envision that the auditors will be candid in providing feedback about the reporting entity's financial statements. The Concept Release also envisions that the alternatives would, ideally, not result in additional boilerplate language being provided by the auditors, but rather that the auditors would provide users of financial statements with useful, relevant information.

This objective, however, needs to be balanced against the significantly increased risk of litigation that the auditors will face as a result of the increase in their responsibilities. TRW is concerned that litigation costs, for both auditors and management, could significantly increase under the AD&A and emphasis paragraph alternatives, due to differences between what the auditor and management have concluded and presented in their financial statements. In addition, TRW fears that, if these alternatives go forward as proposed, they could quickly devolve into a standardized form, resulting in more boilerplate language in the financial statements, which is exactly what the PCAOB is trying to avoid.

In order to combat this, the PCAOB, in concert with the SEC, should give serious thought as to how best to balance the desire for candor from the auditors and management with the need to ensure that auditors and management are not overly penalized for providing their opinion. Management is afforded Safe Harbor protections for disclosures made in reporting entities' MD&As in forms 10-K and 10-Q; no such Safe Harbor is proposed for auditors under the Concept Release covering the AD&A.

**Auditor-Management Relationship**
During the course of the audit, management and the auditors will frequently meet to discuss the significant issues that have arisen. During these meetings, management will ask questions of the auditors, will suggest ideas to the auditors on the proper accounting for certain types of transactions, and the auditors will ask questions of management in order to obtain a proper understanding of the transaction. Jointly, management works with the auditors to reach the appropriate accounting conclusion, which management then presents in its financial statements. TRW believes that this collaborative approach between management and the auditors works well.

To that end, TRW believes that certain of the alternatives could significantly jeopardize that collaborative relationship. In particular, the Concept Release envisions that the auditor provide feedback on the quality of the financial statements and on those matters that are deemed most significant by the auditor. Generally speaking, the matters that the Concept Release wants the auditors to disclose are the same matters that management is consulting with the auditors on, in order to ensure that the appropriate conclusions are being reached.

TRW believes that the Concept Release as a whole, and the AD&A and emphasis paragraph alternatives in particular, could lead to a significant chilling of the relationship between management and the auditor. If the auditor is going to disclose the nature of these conversations in its reporting on the financial statements, management will likely respond by consulting with the auditors on a less frequent basis, and would thereby cause management to be less candid, and less forthcoming, with questions and information than would otherwise be the case.

**Cost and Timing**
TRW observes that the AD&A, emphasis paragraph, and expansion of auditor responsibilities into other information would result in an increase in auditor effort to perform their required responsibilities, as the auditor will either need to provide new reporting to users of financial statements, or to expand assurance to users of financial statements to areas previously not audited. As such, should the PCAOB select one or more of these alternatives, TRW would expect the audit fees to rise, reflecting the auditor's additional work.

However, TRW further believes that the increase in audit fees is only one element of the potential increase in costs that would be felt by all participants in the financial reporting process. TRW would further expect that costs of management would rise indirectly through documenting processes and controls over the preparation of other information prepared simultaneously with the financial statements (expansion of auditor responsibility) or in answering users questions about differences between the financial statements/management discussion and analysis and the AD&A . Costs for users of the financial statements would also increase, as they will need to spend additional effort reconciling between management and auditor conclusions (AD&A), and determining whether the matters that the auditor chose to emphasize are important to them (emphasis paragraph).

In each of the first three alternatives presented by the Concept Release, TRW believes that the direct and indirect costs that would be borne by management, users, and the auditors would significantly exceed the benefits that would be generated by the alternative. TRW believes that, particularly under the AD&A and the expansion of auditor responsibilities alternatives, the costs of performing an audit will increase significantly.

In addition, TRW is concerned that the additional effort required under each of the first three alternatives, in addition to all of the other responsibilities that auditors have under PCAOB auditing standards, may cause delays in the issuance of financial statements by reporting entities, as they wait for auditors to complete their required reporting. Given that the SEC has imposed tight deadlines on public filers, TRW believes that a significant increase in auditor responsibility will correlate to a significant increase in delayed and/or non-timely filings by registrants, particularly in the first several years of a new audit reporting model. The PCAOB, in any final standard, should address the transition elements of ensuring that the auditors, while meeting the new guidelines, have sufficient resources to be able to add an additional element to their reporting requirements.

**Summary**
As noted above and in our detail responses to the questions in Appendix A, while TRW supports the stated objectives of the PCAOB's concept release, we nonetheless feel that the proposed changes as stated will not adequately address such objectives in a cost-efficient or effective manner for the constituents involved.

We thank the PCAOB for its consideration of our comments and recommendations, and would be pleased to discuss these issues with the PCAOB, or its staff, at your convenience.

Sincerely,

Tammy S. Mitchell

Tammy S. Mitchell
Vice President & Corporate Controller

Attachment:
Appendix A: Answers to Questions for Respondents

**Appendix A: Answers to Questions for Respondents**

**Question 1: Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.**

**a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor reporting model? Why or why not?**

**b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?**

**c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?**

In considering how to make the auditor's report and/or the auditor's role more relevant and useful to users of financial statements, TRW believes that the PCAOB should first examine why there is the perception that the auditor's report and/or auditor's role is currently not meeting the needs of users of financial statements. While we note that the PCAOB, in the Concept Release, has elaborated on some of the potential reasons why users of financial statements are not having their needs met, TRW questions whether the complaints levied against the current auditor reporting model reflect less specific complaints against the report itself but rather a lack of understanding by users of financial statements of what an audit comprises, what the auditor's and management's responsibilities are, what the audit opinion means, and the extent of procedures performed by the auditors in order to be able to reach the conclusion that the financial statements are presented fairly, in all material respects.

To that end, TRW would be supportive of improvements to the auditor reporting model that would seek to enhance user understanding of what an audit is, and what the audit opinion means, as further discussed below. In particular, we feel that enhancements to the audit opinion, particularly to provide a "plain English" version of the audit opinion, could produce the benefits that the PCAOB is seeking in the concept release, as further discussed in questions 21 and 22.

With regards to the expansion of the auditor's role to provide assurance on matters beyond the financial statements, TRW would be supportive of these efforts if the benefits to the users of financial statements exceed the additional costs that would be borne, by issuers of financial statements, users of financial statements, and the audit firms themselves, to provide the additional assurance. However, while TRW supports such efforts in a general manner, TRW is not supportive of the specific alternatives discussed in the Concept Release, as further discussed below.

**Question 2: The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."**

**a. Should the auditor's report retain the pass/fail model? If so, why?**

**b. If not, why not, and what changes are needed?**

TRW believes that the current "pass/fail" model of financial statements should be retained. A set of financial statements either conforms to the applicable financial reporting framework or it does not. Decisions to enhance the disclosures made in the financial statements beyond what is required by the applicable financial reporting framework should be made by management, as they best understand the business that they are reporting on, and the specific benefits and risks associated with such an expansion of disclosures. If management has chosen not to provide additional disclosure because disclosures are sufficient and are in compliance with the applicable financial reporting framework, then why should they be subject to further judgment from auditors on the adequacy of such disclosures?

TRW believes that asking the auditors to "grade" the financial statements or to provide commentary on the quality of the financial statements, other than in those situations where the financial statements are not in conformity with the applicable financial reporting framework, could lead users to question whether the applicable financial reporting framework is, itself, of sufficient quality. We believe that this could lead to conflict between the PCAOB and the governing bodies of the applicable financial reporting framework(s), and could create more problems than the PCAOB is trying to solve through this Concept Release. In addition, we believe that the "grading" of the financial statements, especially in situations where the financial statements are in conformance with the applicable financial reporting framework, could lead to questions as to who is ultimately responsible for the financial statements – management or the auditors.

**Question 3: Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.**

As we discuss more extensively in our responses to the questions surrounding the Auditor's Discussion and Analysis below, we believe that management would be the most appropriate group to provide additional information to the users regarding the Company's financial statements. Further, additional disclosure requirements should come from the financial reporting framework under US GAAP, not from auditors' discretion on what should be disclosed.

**Question 4: Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?**

Based on TRW's overall evaluation of the Concept Release, we believe that if the PCAOB supports the proposals made by TRW (i.e. only proceeds with the clarification of the auditor's report, and drops the other alternatives), no revisions would be necessary to the reporting required by Auditing Standard No. 5.

If, however, the PCAOB goes forward with other alternatives presented in the Concept Release, in particular, the expansion of auditor responsibilities over other financial information and the required use of emphasis paragraphs, TRW believes that the auditor report over internal control would need to be modified.

***Auditor Discussion and Analysis (AD&A)***

**Question 5: Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?**

- **a. If you support an AD&A as an alternative, provide an explanation as to why.**
- **b. Do you think an AD&A should comment on the audit, the company's financial statements, or both? Provide an explanation as to why. Should the AD&A comment about any other information?**
- **c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?**
- **d. If you do not support an AD&A as an alternative, explain why.**
- **e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?**

TRW does not support the proposal for the auditors to write an A&DA for multiple reasons. These reasons include investor confusion about the information presented in the AD&A, a worsening of the auditor-client relationship, increased litigation risk for both management and the auditors, a significant increase in audit fees to support the AD&A, and the time and effort that the auditor would expend in preparing the AD&A.

One of TRW's biggest concerns with the AD&A relates to the potential for significant investor confusion if the AD&A and the management discussion and analysis (MD&A) presented different information. Users of financial statements would have to reconcile the differing viewpoints between the information presented by management and the auditor, which would increase the costs of obtaining this information by users of financial statements (and would increase the costs incurred by preparers by having to provide this information to users). In addition, if the auditor presents different conclusions in the AD&A than those presented by management, and the auditor's report shows that the financial statements are presented in conformance with the applicable financial reporting framework, it may cause users of financial statements to call into question whether the auditor's report was correctly formulated and the proper audit opinion was reached.

In addition, the Concept Release envisions that the auditor, in the AD&A, would be reporting on those items that were the most judgmental, and required the most scrutiny, during the course of the audit. Frequently, these items are the subject of significant, lengthy discussions that occur between the auditors and management, as well as the auditor and the audit committee. The AD&A would likely require the auditor, who has previously not disclosed any information relating to these conversations and the ultimate decisions that are made for the financial statements, to disclose the nature of these conversations. This disclosure could significantly chill the auditor-client relationship, making management generally less willing to be open and candid with the auditors, thereby causing preparers to provide the auditors with the bare minimum information needed to perform their audit procedures.

The Concept Release also envisions that, in the AD&A, the auditor would provide candid feedback on the quality of the financial statements and the quality of the disclosures made. In addition to the concern, noted above, of users of financial statements calling into question whether the audit opinion was correctly formulated, if the auditors and management come to different conclusions about the level of disclosures provided, this difference of conclusions could lead to increased litigation faced by both management and the auditors, primarily through shareholder derivative suits (e.g., the presence of a different conclusion by the auditors may cause the market capitalization of the reporting entity to fluctuate, leading to lawsuits). In addition, the Concept Release envisions that the auditor would be providing their conclusions; TRW believes that the opinions expressed by the auditor in an AD&A, could lead to increased litigation risk to the auditors themselves. While management, when expressing its viewpoints in the MD&A, is protected by the Safe Harbor rules of the SEC, TRW observes that no similar protection exists for the auditors.

As with any increase in the scope of the responsibilities of, and deliverables from, the auditors, the potential benefits to be obtained from the AD&A must be measured against the increased costs. In the case of the AD&A, the increased costs would be felt by management (increased audit fees), auditors (increased work, potential for increased litigation risk), and by users (need to reconcile AD&A/financial statement differences). As the PCAOB notes, the AD&A represents the most expansive form of additional assurance that is proposed in the Concept Release; consequently, TRW believes that the AD&A would result in a significant increase in audit fees. As such, TRW believes that the costs incurred for the AD&A reporting model would far exceed any potential benefit derived from the AD&A.

Finally, as noted in the Concept Release, the AD&A would include many of the most significant transactions entered into by management, as well as conversations between management and the auditors. In many cases, the conclusions may be reached, by both management and the auditors, late into the audit of the reporting entity. TRW is concerned that, given the significant expansion of the reporting function for the auditor that is contemplated by the AD&A, and the tight deadlines that have been imposed by the SEC for public filers for forms 10-K and 10-Q, the reporting requirements of the AD&A (particularly the drafting of the AD&A, obtaining the appropriate concurring reviewer and national office approvals, etc.) could significantly impair a reporting entity's ability to timely meet the reporting deadlines set out by the SEC.

**Question 6: What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?**

While we do not support the creation of an AD&A, should the PCAOB choose to pursue the adoption of an AD&A, we believe that the inclusion of the items noted above, such as audit risk, audit procedures and results, and auditor information, at a sufficiently appropriate level (e.g., providing the users of financial statement information with sufficient information for them to understand, but not overburden them with meaningless detail), would be appropriate.

**Question 7: What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?**

TRW does not support the AD&A including commentary from the auditor on their views of the reporting entity's financial statements; TRW believes that the only appropriate place for this information is in the audit opinion, and should appear only in those circumstances where the financial statements of the reporting entity are not in conformance with the applicable financial reporting framework. As we stated in our response to question 2, a reporting entity's financial statements either comply with the applicable financial reporting framework or they do not comply. To that end, the auditor's opinion of management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, especially when the auditor states that the financial statements are in conformance with the applicable financial reporting framework, would either imply that (1) the auditor reached the wrong conclusion in their opinion or (2) the auditor believes that the applicable financial reporting framework is insufficient.

**Question 8: Should a standard format be required for an AD&A? Why or why not?**

While we do not support the creation of an AD&A, should the PCAOB choose to pursue its adoption, we would not support a standard format. However, as we further discuss in the response to question 10, we believe that a standard format, even if not mandated by the PCAOB, will quickly be adopted by accounting firms.

**Question 9: Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risk factors, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential shortcomings of including such risks in an AD&A?**

TRW does not support the inclusion of other risk factors in the AD&A. We believe that management has the best knowledge of the business, strategic, and operational risks that a reporting entity faces, not the auditors. While the auditor may, during the course of the audit, obtain an understanding of the business, strategic, and/or operational risks that are faced by the reporting entity, that knowledge will likely not be as complete, or as extensive, as the knowledge held by management, who runs the reporting entity.

Including this information in the AD&A, in a manner with equal prominence to that of management (which would presumably be included in the MD&A) would suggest that the auditor knows the reporting entity and its business just as well as, or better than, current management, which would not be true.

**Question 10: How can boilerplate language be avoided in an AD&A while providing consistency among such reports?**

TRW believes that, in the current legal and regulatory environment, the use of boilerplate language in an AD&A would be inevitable. As discussed in our response to previous questions, auditors who present information that conflicts with, or is presented differently than, the presentation of management could be subject to significantly higher litigation risk and legal costs. We believe that this factor, alone, would drive public accounting firms to standardize their reporting in an AD&A, leading to the boilerplate language that the Concept Release is trying to avoid. In addition, the desire of the public accounting firms (and, to a lesser extent, management, who is paying fees to the public accounting firms) to achieve standardization and cost savings in preparing the AD&A would also lead to boilerplate language.

To address the first point (increased litigation risk/legal costs) TRW believes that, should the PCAOB pursue the AD&A option, in order to avoid the risk of boilerplate language while reducing litigation risk, the PCAOB should petition the SEC to grant the public accounting firm some form of Safe Harbor protection on the AD&A. The Safe Harbor protection should be analogous to the Safe Harbor protections that reporting entities have in their MD&As in forms 10-K and 10-Q.

**Question 11: What are the potential benefits and shortcomings of implementing an AD&A?**

Please see our response to question 5 on the shortcomings of the AD&A, and to question 12 on the limited benefits we see the AD&A providing.

**Question 12: What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?**

While TRW believes that, in an AD&A, there is certainly the potential for the AD&A to present different or inconsistent information than that disclosed by management (either in MD&A or the footnotes), in practice TRW believes that this will not happen as often as would be expected in the Concept Release. While we believe that the PCAOB has identified one possible source that could lead to a reduction of differences (that is, pressure from the auditors by disclosing something in the AD&A leading to an improvement in the financial statements), we believe that this is only one factor among several that would drive greater conformity between the MD&A/financial statements and the AD&A.

In particular, TRW believes that the pressure that the auditor can bring to bear against the reporting entity, by including items in the AD&A, goes both ways; we believe that, under an AD&A scenario, the auditors would be subjected to significant pressure by management to conform their AD&A to the presentation presented by management. While the auditor may choose to not do this, the auditor would risk significant damage to the auditor-client relationship, up to and including management replacing the auditor. Further, as discussed in other responses above, we believe that the auditor would face significant litigation risk in the event that the AD&A is different than management's interpretation, particularly in those situations where the auditor opines that the financial statements are fairly presented in accordance with the applicable financial reporting framework.

To that end, TRW questions whether the perceived benefits that the PCAOB notes in the Concept Release behind an AD&A will materialize. While there may be some marginal improvements in reporting entity financial statements, TRW believes that the significant improvement that the PCAOB indicates that, in the Concept Release, they want to see will not be realized by an AD&A.

*Emphasis Paragraph*

**Question 13: Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?**

TRW believes that while the emphasis paragraphs, as described in the Concept Release, might serve to point users of financial statements to the relevant sections of the financial statements that contain the areas that the auditor chooses to emphasize, we do not believe that the presence of an emphasis paragraph, in and of itself, would provide relevant, useful information to users of financial statements.

TRW also believes that the inclusion of an emphasis paragraph, which emphasizes the matters that the auditor believes are significant, may also be misleading to users of financial statements, as the items that the auditors may find to require emphasis may differ from the items that the users of financial statements would like to have emphasis/additional information on.

**Question 14: Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?**

a. **If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

b. **If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.**

TRW does not support the use of required and expanded emphasis paragraphs, as proposed in the Concept Release. The reasons include investor confusion about the information presented in the emphasis paragraphs, a lack of clarity as to what a "significant" matter is and what the resolution process is if the auditor and management disagree, and increased litigation risk for both management and the auditors.

While, as we note in our response to question 13, the emphasis paragraph may serve as a reference to users of the financial statements to indicate the areas that the auditor chooses to emphasize, the Concept Release does not require the auditor to provide a rationale as to why the auditor chose to emphasize that matter. TRW acknowledges that, in some cases, the reason why the auditor chose to emphasize a particular matter will be obvious to most users of that reporting entity's financial statements (for example, an auditor may choose to highlight disclosures surrounding credit default swaps issued by the reporting entity) due to the highly complex, judgmental, or material nature of the topic to the reporting entity. However, in other instances, the rationale behind why the auditor chose to emphasize a matter may be less clear, or may not be clear at all, to the users of the financial statements. This will, in turn, cause users of financial statements to question why the auditor chose to emphasize a particular matter, leading to increased costs being borne by the users of the financial statements (in order to properly understand the financial statements) and by preparers (in answering the questions raised by users of financial statements).

The failure in the Concept Release to require the auditor to discuss why a particular topic was emphasized is compounded by the lack of clarity as to what a "significant matter" is. TRW observes that the word "significant" does not exist in either the accounting or auditing literature. Consequently, we are uncertain as to what a "significant matter" would be – is it a material matter (as defined in the auditing/accounting literature), a severe matter (as that term is defined in Accounting Standards Codification (ASC) Topic 275), something greater than a severe matter, or is it at some level in between?

Even ignoring the lack of definition as to what a "significant" matter is, TRW foresees that the required use of emphasis paragraphs to discuss these matters could result in significant disagreement between management and the auditor as to what constitutes a "significant" matter. For example, if management identifies a matter as being significant, and expends effort to appropriately disclose this in the MD&A and financial statements, but it is not identified as one by the auditor, the auditor may be questioned as to whether they performed adequate procedures to support the audit opinion issued. Similarly, if the auditor identifies a topic as being significant, but there is little disclosure made by management (either because the disclosures are in compliance with the applicable financial reporting framework or because management does not believe the matter to be significant or material), it may raise questions to management as to why their disclosures on the topic are short, but it may also raise questions to the auditors as to why they are focusing on areas that management deems to be less significant or immaterial. It further raises the question as to who is best suited to determine what provides the best insight and understanding to the users of financial statements – management or the auditors?

Finally, the requirement to have an emphasis paragraph in the audit opinion will lead to increased litigation risk faced by both auditors and management. The increased litigation risk borne by both auditors and management will occur if there is a disagreement between the auditors and management, as envisioned above, and could lead to a significant increase in derivative lawsuits filed against both the management of the reporting entity and the auditors for damaging shareholder value. In addition, the emphasis paragraph would effectively provide a "road map" to what the auditors felt are the most significant items in the audit; in the event that management or the auditor makes an oversight error in the identification of the significant items, or even if management and the auditor correctly identified the significant items and reached the right conclusions based on the facts and circumstances at the time, it would lead to greater litigation risk and a reduction of shareholder value.

**Question 15: What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?**

TRW does not support the required and expanded emphasis paragraphs that would be required in the audit opinion; however, should the PCAOB choose to pursue this option we believe that the required and expanded emphasis paragraphs should only cover those items which, if the accounting was deemed to be materially incorrect, would result in a severe impact to the reporting entity's financial statements, as that term is defined in ASC Topic 275. For example, a large lawsuit equal to 20% of revenues, a large business combination, non-compliance with debt covenants, or the bankruptcy of a material customer, could prompt the issuance of an emphasis paragraph.

**Question 16: What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?**

While TRW does not support the concept of a required emphasis paragraph in the audit opinion, should the PCAOB choose to pursue this option, we believe that the content should be at a sufficiently appropriate level to allow users of the financial statements to understand (1) why the matter was emphasized and (2) the procedures that the auditors performed to gain comfort that management's assertions were correct.

As to the level of detail, we believe that the emphasis paragraph should strike a balance between providing the users of financial statements with sufficient information to understand the points noted in the preceding paragraph, while not overburdening users of financial statements with meaningless detail.

**Question 17: How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?**

TRW believes that, if the PCAOB chooses to pursue the use of required emphasis paragraphs, boilerplate language in the emphasis paragraphs is inevitable, for many of the same reasons that we cited in our response to question 10 above (e.g., litigation risk, desire by both auditors and management to streamline/reduce amount of work needed).

Unlike the AD&A, TRW believes that, because the emphasis paragraph would be included in the audit opinion, the potential of offering the auditor a "Safe Harbor" provision, such as that discussed in question 10 above, would not be a viable solution for the emphasis paragraph. TRW acknowledges that, given the PCAOB's desire to have the auditors be candid in the required emphasis paragraph, some form of protection would need to be given to the auditors to promote that candor; however, TRW does not know, nor do we offer any suggestions on, how that form of protection can or should be given.

**Question 18: What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?**

Please see TRW's response to question 13 on the potential benefit of the required emphasis paragraph, and our response to question 14 on the shortcomings that we foresee with the required emphasis paragraph.

**Question 19: Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?**

a. **If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.**

b. **On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.**

c. **What level of assurance would be most appropriate for the auditor to provide on information outside of the financial statements?**

d. **If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate, and why?**

e. **Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?**

f. **Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?**

g. **If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.**

TRW does not support the PCAOB's proposals to extend auditor assurance on other information outside of the financial statements. While we do see some benefits associated with the proposals, as more fully discussed in question 20, TRW believes that the costs associated with the proposals would greatly exceed the benefits that users of financial statements would derive. In particular, TRW believes that the idea of extending auditor assurance would increase the workload on auditors, leading to higher audit fees, could create difficulties for the auditors in attempting to audit management opinions and forecasts, and could result in creating investor confusion about the suitability of the financial reporting framework under audit.

TRW believes that the expansion of the scope of the audit to cover all other information outside of the financial statements represents the most significant expansion of auditor responsibilities contemplated by the Concept Release, resulting in a potentially greater auditor effort than even the AD&A discussed above. Greater auditor effort would, necessarily, result in higher fees to be paid by preparers of financial statements to support the increased audit requirements. In addition, as the Board notes in the Concept Release, there is currently no guidance in the auditing or attestation literature for items that would be found outside of Form 10-K or Form 10-Q (e.g., earnings releases, non-GAAP measurements, etc.). TRW is concerned that the significant expansion of auditor responsibilities will lead to higher indirect costs for management, as they will be required to document and formalize controls that may be in place over the issuance of such information. While TRW does not support the expansion of auditor responsibilities outside of the financial statements, should the PCAOB choose to pursue this path, we would very strongly advocate that the additional responsibility given to auditors be limited to what would be found in Form 10-K or Form 10-Q.

Even if the PCAOB limits the expansion of the scope of the audit to just those items included in Forms 10-K and 10-Q, TRW would still have significant reservations about the expansion of responsibilities to these items. This is because, in many cases in the Form 10-K and 10-Q, management is giving their opinion about what has happened, or giving an estimate or forecast as to what may happen in the future. Under the premise of the Concept Release, TRW believes that these opinions, estimates, and/or forecasts would have to be subject to some form of auditor scrutiny, which raises the question of how would an auditor audit an opinion? How would an auditor provide assurance that management's forecast appears reasonable? TRW foresees, without a significant investment by the PCAOB in developing auditing standards to support auditors in making these significant decisions (or, perhaps, an exemption from attempting to audit management opinion), significant breakdowns in the audit process when management and the auditor disagree about the opinions, forecasts, or estimates that are presented outside of the financial statements, but elsewhere within Forms 10-K and 10-Q. Further, open communications between preparers and auditors may in fact deteriorate as a result. To this end, we believe that the PCAOB's attestation standard, AT 701, would not be sufficient by itself to cover the responsibilities of the auditor in such a scenario; however, TRW does acknowledge that it does represent a reasonable starting point for the creation of such a future standard.

Finally, we question whether extending auditor responsibilities to information presented outside of the financial statements would yield the benefits to users of financial statements that the PCAOB seems to believe would materialize. In particular, if the PCAOB extends auditor responsibilities to cover all information, as suggested in the Concept Release, it calls into question whether the PCAOB believes that the applicable financial reporting framework is sufficient. For example, if the PCAOB expands auditor responsibility into non-GAAP measurements, users of financial statements could infer that the auditors are providing just as much assurance on the non-GAAP measurements as they would on a measurement that is specified in the applicable financial reporting framework. This could, in turn, suggest that the auditors and/or the PCAOB believe that the applicable financial reporting framework is, itself, incomplete or deficient.

**Question 20: What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?**

TRW does believe that, if the expansion of auditor responsibilities is adopted as envisioned in the Concept Release, it may lead to a standardization of presentation of certain non-GAAP financial measurements; however, as noted in our response to the last question, we believe that this could create jurisdictional issues between the auditors/PCAOB and the governing bodies of the applicable financial reporting framework.

Please see our response to question 19 for the potential shortcomings of the expansion of auditor assurance to other information outside of the financial statements.

***Audit Report Clarification***

**Question 21: The concept release presents suggestions on how to clarify the auditor's report in the following areas:**

- **Reasonable assurance**
- **Auditor's responsibility for fraud**
- **Auditor's responsibility for financial statement disclosures**
- **Management's responsibility for the preparation of the financial statements**
- **Auditor's responsibility for information outside the financial statements**
- **Auditor independence**

**a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?**

**b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.**

**c. What other clarifications or improvements to the auditor's report can be made to better communicate the nature of an audit and the auditor's responsibilities?**

**d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?**

TRW believes that a number of the proposed clarifications could enhance the understanding of users of financial statements as to what exactly the auditor's report states. In particular, we would support the clarifications surrounding the definition of reasonable assurance, the auditor's responsibility for fraud, and the auditor's responsibility for information outside of the financial statements in the audit opinion, as we feel that having a clearer, or "Plain English," explanation could enhance user knowledge over these terms. At the same time, however, TRW also acknowledges that the PCAOB's auditing standards are publicly available on its web site and the AICPA (and, indirectly, the PCAOB) is currently participating in a "Clarity Project" to make the requirements of the auditing standards more "Plain English," such that users could, on their own, enhance their understanding by fully reading the auditing standards.

TRW does not believe that the proposed enhancements surrounding the auditor's responsibility for financial statement disclosures, management's responsibility for the preparation of the financial statements, and auditor independence would enhance the understanding of users of financial statements, as TRW feels that these are either clearly spelled out already in the audit report (in the case of management's responsibility and auditor independence) or would seem to logically flow from the audit report itself (in the case of the auditor's responsibility).

TRW does not believe that additional clarifications or improvements to the auditor's report, other than those already discussed above, are necessary or would be warranted, and believes that there would be no significant implications to the scope of the audit, or auditor's current responsibilities – as the PCAOB suggests, this would merely represent a clarification of what the auditor should already be doing.

**Question 22: What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?**

Please see our response to question 21.

*Questions Related to All Alternatives*

**Question 23: This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?**

As noted in our responses to questions above, TRW believes that all of the alternatives will significantly increase costs to preparers, auditors, and, in some cases, users of financial statements. In addition, as noted above, TRW does not support the proposed alternatives in the Concept Release surrounding the AD&A, required and expanded emphasis paragraphs, and expansion of auditor responsibilities to other information outside of the financial statements.

Based on this, TRW believes that the fourth alternative, the clarification of certain phrases in the audit report itself, comes closest to balancing the benefits to be obtained by the users of the financial statements with the costs associated with making the changes proposed in the Concept Release borne by preparers, auditors, or users of financial statements.

**Question 24: Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?**

Since, as noted above, TRW does not support three of the four alternatives, and only partially supports the fourth alternative, TRW believes that combining the alternatives would only exacerbate the problems that TRW foresees with the individual alternatives presented in the Concept Release. Even in a pared down scenario, such as we discuss in our response to question 19, we see significant difficulties in implementing any combination of the four alternatives.

**Question 25: What alternatives not mentioned in this concept release should the Board consider?**

We did not identify any alternatives that the PCAOB should consider.

**Question 26: Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?**

As noted in our responses to several of the questions above, TRW believes that, should the PCAOB pursue any one of the alternatives (even though, as noted above, TRW does not support three of the four alternatives), that the PCAOB should take a cue from the FASB in their development of the auditor reporting framework. That is, the overriding goal of the auditor reporting framework developed by the PCAOB should be to provide the user with sufficient information to understand the decisions made by the auditor and the procedures performed by the auditor, while not overburdening the users of financial statements with so much information to make the auditor's reporting irrelevant.

**Question 27: Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?**

TRW believes that, if the PCAOB pursues the first three of the alternatives presented in the Concept Release (that is, the AD&A, emphasis paragraph, or expansion of auditor responsibilities option), financial statement users could, and probably would, perceive the language in any of these alternatives as potentially providing a qualified or piecemeal opinion, regardless of the ultimate opinion expressed by the auditor over the financial statements. In particular, if the auditor is providing commentary on the quality of the disclosures, or emphasizes a matter for which management has not provided a lot of disclosure, TRW believes that users of the financial statements may interpret this commentary to suggest that the audit opinion is qualified or piecemeal. Further, an emphasis paragraph or matters discussed in AD&A could lead to greater user confusion based on the relative prominence given such matters as compared to the level of disclosure provided by preparers.

There are a couple of potential solutions that may partially ameliorate this problem that the PCAOB could implement. The first would be that, in any situation where the auditor may be commenting on the quality of disclosures or emphasizing a matter, the auditor should provide commentary indicating that the disclosures made by management are in accordance with the applicable financial reporting framework. While it will not completely inoculate the auditor from the perception that they are providing a piecemeal report, emphasizing management's compliance with the applicable financial reporting framework will provide users with assurance that the audit opinion can be relied upon.

Second, TRW feels that, should the PCAOB choose to pursue any of the four alternatives, that the level of assurance/reporting that should be performed should be at the same level as that provided to the financial statements; that is, the auditor should be providing reasonable assurance that the information being covered in each of the alternatives is correct (whether in an AD&A format, emphasis paragraph, or expansion of auditor's responsibilities). Any lower level of assurance to be provided by the auditors, in any of the proposed alternatives, could lead to the perception by users of financial statements that the work performed is of lower quality than the work performed on the financial statements. For the avoidance of doubt, it should be clearly indicated, and users must be educated to the fact, that no such lower level of quality exists. Otherwise, varying degrees of standards will lead to even greater confusion as to the level of assurance provided.

**Question 28: Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?**

TRW believes that the fourth alternative (clarification of phrases in the audit opinion) would have the most impact to the understanding of users of financial statements on the auditor's role, as it would help to clarify the roles and responsibilities of the auditor during this process. While the AD&A and the emphasis paragraphs may help users of financial statements to understand better the auditor's role, the understanding would be limited only to those matters that the auditor emphasized (in the emphasis paragraph) or covered in the AD&A.

**Question 29: What effect would the various alternatives have on audit quality? What is the basis for your view?**

TRW believes that the various alternatives proposed in the Concept Release would have a negligible impact on audit quality. Auditors should be obtaining sufficient, credible evidence to evaluate the totality of management's financial statement presentation and disclosures, regardless of the topic being presented. While including the matter in an emphasis paragraph, or in the AD&A, may create an improvement in audit quality, as the significant matter(s) would be on public display, TRW believes that the improvement that these alternatives may obtain would be marginal, at best.

We further believe that the expansion of auditor's responsibility to information outside of the financial statements, as well as clarification of the auditor's report, would have no impact on audit quality, and may even degrade audit quality in the initial period in which the alternatives are required, as the auditors may not have the capacity to support the additional reporting proposed in the Concept Release.

**Question 30: Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed by the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisors, brokers and dealers, and others? What would be the effect of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.**

While we do not support the AD&A, required use of emphasis paragraphs, or expansion of auditor responsibilities, and have offered qualified support for the clarifications to the audit report discussed in the Concept Release, TRW believes that if the PCAOB chooses to pursue these changes, the changes should be applied equally to all audit reports filed with the SEC.

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September 14, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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**Re: Request for Public Comment *on Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards and Notice of Roundtable (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34)***

Dear Members and Staff of the Public Company Accounting Oversight Board:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC recognizes the vital role external audits play in capital formation and supports efforts to improve audit effectiveness. We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") *Concept Release on Possible*

*Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release").

The CCMC has a number of concerns regarding the issues and concepts outlined in the Concept Release including those related to:

- The potential increase in financial reporting complexity;
- The apparent overturning of fundamental precepts of financial reporting;
- The conflict with other forms of mandated corporate disclosure;
- The fundamental shift in the role of the auditor and communications;
- The potential activities that may fall outside of the legal mandates of the PCAOB's powers and encroachment upon mandated powers of other regulators and standard setters;
- The potential increase in litigation harmful to investors and the capital markets; and
- The failure to weigh recommendations made by other entities to reduce financial reporting complexity.

In reviewing the intent and purpose behind the Concept Release, the CCMC believes that the PCAOB should work with the Securities and

Exchange Commission ("SEC") and Financial Accounting Standards Board ("FASB") to:

- Take a coordinated holistic approach to reducing financial reporting complexity;
- Create a Financial Reporting Forum allowing all stakeholders to work together to identify long-term financial reporting issues and solutions; and
- Follow transparency and disclosure standards, used by regulators, in the development of standards and concept releases.

**Discussion**

The stated objective of the Concept Release is to seek public comment on auditor reporting alternatives that could provide investors with more insight into the company's financial statements, or possibly other information outside the financial statements, and more transparency into the audit process.

The Concept Release presents four alternatives (auditor's discussion and analysis ("AD&A"), required and expanded use of emphasis paragraphs, auditor assurance on other information outside the financial statements, and clarification of the standard auditor's report). Nonetheless, the Concept Release makes clear that the PCAOB intends to retain the current ("pass/fail") approach of the standard auditor's report. Indeed, as recognized in the Concept Release, the PCAOB has heard overwhelming support from all stakeholder groups for retaining this long-standing approach to auditor reporting. Thus, the alternatives presented in the Concept Release would be additive to the current approach.

Before addressing any specifics in regards to the Concept Release, it is important to consider the threshold question of whether the PCAOB should undertake a standard-setting initiative. CCMC notes that standards related to auditor reporting are long-standing and have served the test of time. While this does not mean that improvements should not be considered by the PCAOB, it does suggest the need to exercise caution in doing so.

The CCMC has a number of concerns about the PCAOB's approach to this reporting project and the alternatives discussed in the Concept Release. These concerns are outlined in the remainder of this letter.

## I. Approach to Developing the Concept Release

An overarching concern is that, in developing the Concept Release, the PCAOB has not taken a comprehensive and holistic approach to considering the role of *both* auditors and audit regulators in achieving an optimal level of quality and clarity in public company financial reporting. The PCAOB has not clearly articulated the current structural audit weaknesses in public company financial reporting, which is a necessary predicate to address the threshold question of whether the PCAOB should undertake a standard-setting initiative on auditor reporting. In addition, the Concept Release does not appreciate that the PCAOB as the regulator of public company audits actually shares responsibility with auditors for audit quality. Instead, the Concept Release appears intent on transferring responsibilities to auditors when it comes to auditor reporting.

A more holistic approach to considering the interplay of audit and financial reporting regulation could likely have informed this PCAOB auditor reporting project in other ways, including by raising questions about some of the essential premises that underlie it. For example, in response to the 2008 economic crisis, FASB has promulgated new standards and the SEC has enacted new regulations. There is no indication that the PCAOB considered these FASB and SEC activities in developing the alternatives discussed in the Concept Release.

Furthermore, the project does not appear to have taken into account the insights and recommendations from prior blue-ribbon advisory committees, such as the SEC Advisory Committee on Improvements to Financial Reporting ("CIFiR"), the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP"), and the Panel on Audit Effectiveness.[1] For example, ACAP recommended that the PCAOB narrow the expectation gap and provided useful guidance to the PCAOB for exercising its responsibility to do so; whereas, the Concept Release seems intent on delegating this regulator responsibility to auditors, including through the assignment of new responsibilities.

Moreover, the reports and recommendations of previous advisory committees should have provided perspective on the feedback that the PCAOB received during its outreach activities. For example, it is financial reporting complexity, including disclosure overload, which is at the heart of some of what the PCAOB heard from its outreach activities. Calls by investors for "tell us what matters" and "give us a roadmap" should be less about asking auditors to weigh-in with their views (as the Concept Release suggests with alternatives such as AD&A and expanded and required use of emphasis of matter paragraphs), and more about the PCAOB working

[1] Recommendations of the Panel on Audit Effectiveness are discussed in a subsequent section of this letter on going concern reporting and disclosures.

with other regulators, including the SEC and FASB, to help fix the essential problem.

Disclosures for public companies and their investors are a triad that involves the SEC, FASB, and the PCAOB. It is imperative that this triad work in harmony to provide a rational coordinated system of disclosure for all public company stakeholders. A failure to do so will create competing disclosures and confusion, sowing uncertainty and doubt in the capital markets for investors and companies alike. The CCMC once again reiterates its call for a Financial Reporting Forum that will provide for coordination as well as the identification and resolution of problems that may drive complexity and obfuscation.[2]

Importantly, complexity challenges a premise for this project that expanded auditor reporting in advance of the 2008 economic crisis might have been helpful in assessing the quality of the financial statement and provided early warning signals regarding potential issues.

In its August 2008 Final Report, CIFiR recognized that over time "financial reporting has become a burdensome compliance exercise with decreasing relevance to investors" (p. 18). CIFiR identified financial reporting complexity as the key factor driving the disconnect between current financial reporting and the information necessary to make sound investment decisions. Thus, CIFiR made a number of recommendations to the SEC, FASB, and PCAOB to improve the usefulness and reduce the complexity in financial reporting. While some progress has been made, many of CIFiR's recommendations have yet to be taken up by the appropriate bodies – in particular the PCAOB.

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[2] See CCMC testimony provided to the U.S. Senate Subcommittee on Securities, Insurance and Investment's April 6, 2011 hearing: *The role of the accounting and auditing profession in preventing another financial crisis.*

One example of a CIFiR recommendation not yet addressed by the PCAOB relates to judgment. Whereas discussions in the Concept Release indicate that some participants in the PCAOB's outreach activities expect a single "right answer," CIFiR appreciated the role of judgment and understood that there is not necessarily one right answer in accounting and auditing matters. In turn, CIFiR recommended that the PCAOB develop and articulate guidance related to how the PCAOB, including in its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. CIFiR also recommended that the PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC to the extent that the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.[3]

To summarize, CIFiR understood the need to take a comprehensive and holistic approach to overcoming the problem of financial reporting complexity. The CCMC recommends that the PCAOB adopt such an approach and redirect its efforts and resources from initiatives that will only exacerbate the disclosure overload problem. All financial reporting stakeholders would be better served if the PCAOB worked with other regulators and standard-setters, such as the SEC and FASB, to implement the CIFiR recommendations; to help update and improve existing disclosure requirements and eliminate redundant and unnecessary disclosures; to facilitate the ability of management (rather than lawyers) to drive discussions in MD&A, including those around critical accounting estimates; and to help address issues around the auditability of GAAP.

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[3] CIFiR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. CIFiR then went on to suggest some components of an accounting policy statement related to the choice and application of accounting principles, as well as estimates and evidence related to the application of accounting principles. CIFiR's suggested components are consistent with advice on the SEC's website for consultations on accounting matters with the Office of the Chief Accountant and the Division of Corporation Finance. However, CIFiR made no such suggestions in regards to an audit judgment framework.

The CCMC also recommends that the PCAOB work with others such as the SEC and FASB to better understand the responsibilities of users when it comes to financial reporting. The Concept Release seems not to appreciate that users are heterogeneous and, therefore, their information needs vary. General purpose financial reporting, as represented by GAAP financial statements, is designed to meet the needs of the broad set of all users and not the demands of any particular special interest group.

## II. Overturning a Fundamental Premise of Financial Reporting

Another major CCMC concern is that the Concept Release overturns a fundamental premise of financial reporting—namely that the financial statements and disclosures are the responsibility of management. This premise likewise extends to other information that accompanies the financial statements, such as Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), which management prepares in accordance with SEC requirements, as well as other information outside the financial statements.

Management's financial reporting responsibility includes the selection and application of Generally Accepted Accounting Principles ("GAAP") and the determination of the many estimates and judgments required by GAAP and SEC financial reporting requirements, including MD&A disclosures. Management's responsibility for financial reporting extends beyond compliance with GAAP to determining the "quality" of the company's financial reporting within GAAP. In turn, the board of directors, largely through the audit committee, exercises oversight of management's financial reporting, including the company's annual (Form 10-K) and quarterly (Form 10-Q) filings with the SEC.

The independent audit firm's responsibility is to express an opinion as to whether the company's annual financial statements, including notes thereto, are presented fairly, in all material respects, in conformity with GAAP.[4] The auditor's report is the mechanism by which the audit firm communicates this opinion. The SEC does not accept filings that contain audited financial statements with qualified or adverse audit opinions.[5] Thus, for public companies, the auditor's unqualified audit opinion indicates that all material matters have been resolved.[6]

An essential element of the fundamental premise of financial reporting is that the auditor is not an original source of information about the company. Auditors' legal and ethical obligations recognize and reinforce this point by requiring that auditors treat all company-specific information as confidential.[7] Except in rare circumstances where management and the board of directors have failed to disclose certain information, as provided for under PCAOB auditing standards and SEC regulations,[8] auditors are *precluded* from disclosing any company-specific

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[4] Quarterly financials included in Form 10-Q filings with the SEC are reviewed by the auditor, rather than audited.
[5] The Concept Release does not explore the implications of this prohibition or suggest altering it.
[6] However, auditing standards provide that audit reports with unqualified opinions can contain additional explanatory or emphasis of matter language, including when there is substantial doubt about the entity's ability to continue as a going concern, there has been a material change between periods in accounting principles or their method of application, there are significant transactions with related parties, or unusually important subsequent events have occurred.
[7] Rule 301 of the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct states that "a member in public practice shall not disclose any confidential client information without the specific consent of the client." The PCAOB did not adopt Rule 301 as part of its interim standards. Apparently the PCAOB's decision was based on a determination that incorporation of Rule 301 was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of The Sarbanes-Oxley Act of 2002 ("SOX"). The PCAOB has assured that this determination did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. In adopting conforming amendments in conjunction with Auditing Standard No. 6 ("AS No. 6"), *Evaluating Consistency of Financial Statements*, the PCAOB reaffirmed that it sought neither to modify nor detract from existing confidentiality requirements. Nonetheless, in approving AS No. 6 in September 2008, the SEC encouraged the PCAOB to develop and adopt a rule addressing the auditor's responsibility with respect to maintaining the confidentiality of client information. The PCAOB has yet to do so.

[8] Examples include information under certain circumstances in reports in connection with the termination of the audit engagement and reports that may be required pursuant to Section 10A(b)1 of the Securities Exchange Act of 1934 relating to an illegal act that has a material effect on the financial statements.

information to outside parties. Nonetheless, the Concept Release includes alternatives, in particular an AD&A, that represent a radical departure from the bedrock premise of financial reporting.

Further, at first blush it would appear that the proposed AD&A would be in direct conflict with the MD&A required by the SEC. Accordingly it would seem that such a system would provide competing disclosures that will increase complexity and create confusion for investors. Seemingly, that would appear to be a situation that the SEC could not allow to develop.

As described in the Concept Release, an AD&A would provide financial statement users with a view of the audit and financial statements "through the auditor's eyes" (p. 13). Importantly, the Concept Release recognizes that the auditor's perspectives about the company's financial statements could differ from those of management.

According to the Concept Release, AD&A would give the auditor the ability to discuss significant matters, which could include such things as the auditor's views regarding management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." The Concept Release goes on to explain that:

> *Additionally, an AD&A could provide the auditor with discretion to comment on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements. And, AD&A could also highlight those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures* (p. 13).

Needless to say, providing auditor views and perspectives would represent a profound shift in the role and responsibilities of the independent auditor vis-à-vis management and the board of directors/audit committee. AD&A would necessitate the auditor becoming an original and competing source of company-specific information.[9] While it is not clear that the PCAOB would have the authority to enact this sea change, on principle, the CCMC strongly disagrees with any move by the PCAOB in this direction.

Investors need factual information to make decisions with their goal being a return on investment. Those decisions are premised on the health, direction and management of a company. An auditor's opinion in AD&A may be considered Monday morning quarterbacking that may not even be welcomed by investors generally. For that matter why not create a disclosure on the opinions of top financial reporter's opinions on management decisions. While everyone may have an opinion, it may not provide relevant facts or substance for investment decisions.

Moreover, any such change in the fundamental premise of financial reporting would likewise have significant implications for auditors from the standpoint of legal liability. AD&A may even create new avenues for legal actions against auditors. For example, the U.S. Supreme Court recently reaffirmed its decision in Central Bank[10] that precludes private securities fraud actions against secondary actors such as auditors. As described in the Concept Release, it appears that an AD&A would move the auditor into the position of being an original maker of statements. The auditor would have ultimate authority and control over AD&A, including its content and

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[9] As subsequently discussed, a similar argument can be made for required and expanded use of emphasis of matter paragraphs in all audit reports as this alternative would necessitate that the *auditor* determine significant matters to highlight and reference where those matters are further disclosed by management in the financial statements.

[10] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

whether and how to communicate it. As a consequence, Rule 10b-5 could then apply to auditors, as plaintiffs in private actions could allege the auditor directly or indirectly made an untrue statement of a material fact in connection with the purchase or sale of securities.

## III. Additional Practical Considerations

Setting aside disagreement on fundamentals, the Concept Release also does not appreciate the full range of practical implications from adding an AD&A requirement that go well beyond effects on the timing of the delivery of audit reports. For example, it seems unlikely that expressing auditor views on financial statement matters in an AD&A-type report could be the end of it. Investors and other third-parties would likely call for clarification, additional insights, and further explanations from auditors in order to understand the auditor's views and to help reconcile, as necessary, such views with those of management. Would auditors then need to issue press releases and hold conference calls to meet these demands for further information? Would SEC reviews by the Division of Corporation Finance come to involve reviewer comments addressed to auditors? Likewise, in putting the auditor in the position of being an original and competing source for financial information about the company, one can easily envision that an AD&A-type responsibility could create a material adverse interest with management and, therefore, raise questions about auditor independence under extant requirements.[11] And the list of problematic consequences goes on.

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[11] The Concept Release describes one rationale for an AD&A as being to "give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors" (p. 13). However, as previously discussed, this rationale involves transforming the role of the auditor vis-à-vis that of management and the board/audit committee. Additionally, the Concept Release fails to appreciate that under extant arrangements, the need for the financial statements to comply with GAAP to obtain an unqualified audit opinion provides auditors with powerful "leverage." Otherwise, extant auditing standards support the auditor's role in facilitating the operation of corporate governance mechanisms related to the quality of financial reporting, via requirements such as the one on auditor communications with audit committees about the "quality" of the company's accounting principles (within GAAP), in addition to their compliance with GAAP.

Other aspects of the AD&A alternative involve suggestions for an auditor narrative with information about the audit, including audit risks identified in the audit, audit procedures and results, and auditor independence. Regarding the latter, there is no indication in the Concept Release why current disclosures on auditor independence are inadequate, including proxy statement disclosures by audit committees. Indeed, it raises the question of whether investors participating in the PCAOB's outreach activities are even reading the information now available to them.

As to more information about the audit,[12] it is a difficult to envision how the auditor could condense all the work done on each engagement related to audit risks identified, audit procedures performed, and results obtained into a few sentences or even paragraphs. It is also a challenge to understand how any such condensation would be meaningful. PCAOB auditing standards, which are publicly available, provide the basis for performing audits. PCAOB inspections review the application of and adherence to such standards on individual engagements. The Concept Release does not make the case for why or how adding a reporting requirement for auditors to provide more details about their performance on each individual engagement would provide useful information to investors and other users.

Relatedly, the Concept Release is wanting when it comes to illustrating the alternatives. Illustrative examples that only contain placeholders for substantive information are unhelpful. The PCAOB should have developed substantive illustrations or even used field testing to assist in evaluating the usefulness and limitations of the various suggestions that emerged from their outreach activities *before* issuing a Concept Release.

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[12] More information about the audit is also suggested under the alternative for required and expanded use of emphasis of matter paragraphs. For example, the Concept Release states that "under this alternative, the auditor also could be required to comment on key audit procedures performed pertaining the identified matters" (p. 20).

Otherwise, legal considerations and the need for audit firms to maintain consistency across engagements and over time preclude alternatives involving auditor narratives from being "free-writing" exercises. Before mandating AD&A or the expanded use of emphasis of matter paragraphs on all audits, criteria would need to be developed by the PCAOB (and audit firms would likely need to further refine such criteria). Even information currently part of internal communications among auditors, management, and boards/audit committees cannot be moved to the public arena without such criteria. For example, PCAOB auditing standards related to auditor communications with audit committees recognize that "objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting principles as applied in its financial statements" (AU 380.11).[13]

All things considered, rather than meaningful information, requirements for AD&A and the expanded use of emphasis of matter paragraphs on all audits appear more likely to add boilerplate to that already cluttering SEC filings. Boilerplate is the tip of the financial reporting complexity iceberg.

As we previously discussed, because of overly complex and detailed periodic reporting, CIFiR likewise heard that investors want to be told "what matters." However, after extensive deliberations, CIFiR did *not* recommend that auditors step-in to fill the breach; it did not recommend such things as an AD&A or required and expanded use of emphasis of matter paragraphs on all audits.[14] Rather, CIFiR recognized the importance

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[13] Moreover, altering the auditor's responsibilities to involve external disclosure of AD&A-type information would likely transform current relationships and interactions among auditors, management, and boards/audit committees to the detriment of audit quality.

[14] Members of CIFiR included investors and representatives of other financial statement users along with financial executives and board members, auditors, and securities lawyers. In addition, the chairman of the PCAOB was an official observer on CIFiR.

of the fundamental premise of financial reporting, as previously discussed. Thus, CIFiR recommended that *management* provide a short executive summary at the beginning of a company's annual report on Form 10-K (with material updates in quarterly reports on Form 10-Q). CIFiR suggested the summary describe concisely the most important themes or other significant matters with which management is primarily concerned, along with a page index showing where investors could find more detailed information on particular subjects (p. 3).

## IV. Additional Assurance Services

The Concept Release presents another alternative that would *require* auditors to provide assurance on information outside the financial statements such as MD&A (or portions thereof, such as critical accounting estimates), non-GAAP information, and/or earnings releases. Current PCAOB auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements. These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact. The Concept Release fails to make the case for why this current arrangement is inadequate. Likewise, the Concept Release fails to identify the flaws in earnings releases that would be fixed with auditor assurances or how such assurances would otherwise be value-added in this context.

Moreover, extant PCAOB attest standards allow the auditor to be engaged to attest on MD&A and the standards provide requirements for such engagements. Yet, few if any public companies engage their auditors for this additional assurance service on MD&A. Further, CCMC is not aware of any instances where shareholders have requested a company to do so. The lack of any voluntary demand for additional assurance services is revealing and provides a basis for concluding that proposals to *mandate* such services fail cost/benefit considerations.

## V. Adding Clarifying Language to the Auditor's Report

The fourth alternative presented in the Concept Release would provide for adding clarifying language in the existing standard auditor's report. The Concept Release suggests that language around reasonable assurance, the auditor's responsibility for fraud, the auditor's responsibility for financial statement disclosures, management's responsibility for the preparation of the financial statements, the auditor's responsibility for information outside the financial statements, and auditor independence would be potential areas for clarification. These suggestions represent refinements to the current auditor's report and, overall, are not objectionable in concept, although it is hard to argue the need for all of them individually. For example, in regards to independence, currently the audit report is labeled as the "report of the independent registered public accounting firm" and, as previously noted, proxy statements provide disclosures on auditor independence. So, it is not clear why any further disclosures contemplated by the Concept Release would be useful information rather than added boilerplate.

## VI. Going Concern Reporting and Disclosures

At the PCAOB's open board meeting on June 21, 2011 to approve the Concept Release, one board member focused on going concern reporting by auditors. For example, the statement of Mr. Harris has an entire section on "Going Concern Opinions: A Rarely Used Tool." This is curious because the Concept Release is *silent* on this topic; and, it creates some confusion about the direction of this auditor reporting initiative.

Going concern is long recognized as an area in need of FASB attention. Although the financial statements are prepared on the assumption that the entity will continue as a going concern, auditing standards contain the only real guidance on going concern. More than a decade ago, the Final Report (August 31, 2000), of the Panel on Audit Effectiveness recommended that the FASB (1) define the going concern concept and clarify that management, not the auditor, has the primary responsibility to assess whether the entity has the ability to remain a going concern, (2) consider the appropriateness of the one-year time horizon in SAS No. 59 (i.e., the FASB should evaluate this time horizon and recognize its importance to auditors in framing their audit reports), and (3) promulgate explicit going concern disclosure requirements to fit various circumstances (pp. 61-62).

The FASB has had a going concern project on its agenda for a number of years now, but the FASB has yet to finalize any guidance in this area. If the PCAOB heard from its outreach activities in response to the 2008 economic crisis that this is an area of concern for investors, it would seem that this project should have provided a golden opportunity for the PCAOB board itself to become engaged in working with the FASB and SEC to overcome this perceived deficiency in GAAP and address other issues related to the auditability of GAAP.

## VII. Outreach, Transparency, and Cost/Benefit Considerations

Chairman Doty's statement at the PCAOB's open board meeting notes the "fluid" nature of feedback from the PCAOB's outreach activities on this project. However, this raises issues about the transparency of the PCAOB's outreach activities.

On one hand, the CCMC appreciates the extensive discussion of the feedback received by the PCAOB's staff from its outreach activities contained in the Concept Release, including Appendix C. On the other hand, the discussion is mostly confined to the alternatives pursued in the Concept Release rather than those considered but dropped along the way (e.g., going concern reporting).

In addition, it is difficult to interpret the information in the Concept Release because discussions with participants were private (no transcript is publicly available of the outreach discussions) and apparently informal (the PCAOB has provided no sample questionnaire or interview script).[15] Further, the Concept Release does not identify the number of participants in the PCAOB's outreach activities or list their names and organizations. And, while overall categories of participants are given, discussions of the various views, in particular those in Appendix C, mostly just combine all categories into "outreach participants," with only qualitative information on the degree of commonality in views noted by using terms such as "some" or "many" outreach participants.

The CCMC strongly agrees that the PCAOB should consult with and have access to a full range of perspectives among all users of financial statements. However, these activities need to have transparency. The CCMC appreciates that the PCAOB has included auditor reporting issues on the agendas at various public meetings of its advisory groups, including its Standing Advisory Group ("SAG") and IAG. Public roundtables are another mechanism for conducting public outreach with transparency and the PCAOB has announced plans to hold one or more roundtables in conjunction with this project. Nonetheless, as noted, the CCMC has

[15] CCMC understands that the PCAOB includes the March 2011 Investor Advisory Group ("IAG") survey as part of its outreach activities and some details of participants in that survey are publicly available, including that IAG members themselves were among the survey participants.

concerns about the lack of transparency around many of the PCAOB's outreach activities that produced this Concept Release, which are consistent with concerns the CCMC has previously expressed about the transparency of the PCAOB's activities and due process generally.[16]

Finally, most of the reporting alternatives presented in the Concept Release would involve additional costs. Feedback from the PCAOB's investor outreach that informed the alternatives presented in the Concept Release appears to underplay the existence and significance of any additional costs. Indeed, in the main, it does not appear that cost/benefit considerations played a major role in the discussions with outreach participants.[17]

## Conclusion

In conclusion, the CCMC appreciates the opportunity to comment on the Concept Release. In closing, we would like to reiterate that the CCMC supports working to achieve one set of global high quality auditing standards through the convergence of PCAOB auditing standards with those of the AICPA's Auditing Standards Board ("ASB") and the International Auditing and Assurance Standards Board ("IAASB"). In this regard, CCMC notes that the Concept Release gives short shrift to activities by other audit standard-setters related to auditor reporting and fails to provide any comparison of relevant portions of PCAOB auditor reporting standards with those of the ASB and IAASB as part of considering improvements to PCAOB auditing standards. The CCMC

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[16] For example, see the October 7, 2009 letter from the U.S. Chamber of Commerce CCMC to the Honorable Daniel L. Goelzer, Acting Chairman of the PCAOB.

[17] For example, during discussions at the March 2011 IAG meeting, some IAG members dismissed cost concerns for AD&A with assertions that no additional audit work would be required as auditors would just be disclosing to investors information currently communicated with audit committees.

encourages the PCAOB to reconsider its "go it alone" approach to audit standard-setting.

Thank you for your consideration and the CCMC stands ready to assist in these efforts.

Sincerely,

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September 29, 2011

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**PCAOB Rulemaking Docket Matter No. 34**

**BACKGROUND**

This letter is to comment on the PCAOB Release No. 2011-003 dated June 21, 2011, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.*

The PCAOB release referred to in the preceding paragraph requests comments on possible revisions or additions to the content of the auditor's report. Rather than responding to each of the thirty questions in that release document, we have chosen to articulate our views in the following few paragraphs.

**OVERALL VIEW OF PROPOSAL**

We believe that the appropriate order of events for the PCAOB in fulfilling its mission should be to first review the current audit requirements and then to compare them with what it believes the requirements for an audit should be. Only after the PCAOB has taken that critical step can there be any meaningful and logical discussion about the wording and content of the auditor's report. The wording can have no objective other than ensuring that the report faithfully represents to its readers the purpose, scope, and conclusion of the audit. Until the PCAOB is content with the objective of an audit, any meaningful changes to the report are premature and merely cosmetic. However, if immediate change to the auditor's report fulfills a sense of accomplishment for the PCAOB in responding to widely reported but nevertheless anecdotal comments made by those purporting to represent the user community, we offer our reaction to some changes that could take place without the need for the PCAOB to rethink the audit process. Those comments are in the section that follows.

Our overall reaction to this request for comments is that a change to the current auditor's report is simply unnecessary. In our view, the current auditor's report is clear in describing the objective, the scope, and the conclusion of an audit prepared in accordance with standards issued by the PCAOB in fairly understandable and unambiguous plain English. However, any language and description can be improved, and we certainly have no objections to attempts to make such improvements to the report.

We do want to be very clear that changes to improve the auditor's report should not become the driving force behind changes to the scope of the audit. If it is the PCAOB's desire to change what is required to be done in an audit, the proposed change should be addressed head-on by issuing a proposed auditing standard following the normal exposure rules of procedure for a change in auditing standards as now required for any change to auditing requirements. Such a change should not be attempted in a back-door manner by making an addition to the auditor's report to require reporting on an area not currently subject to an audit requirement. A vivid example that cries out from the discussion document is the sample discussion in the audit report of past and present company operations. We definitely believe any discussion of company operations along the lines of management's discussion and analysis has no place appearing in an auditor's report which is, after all, a report from the auditor and not the company's management. Current requirements are for the auditor to read management's discussion and analysis that is prepared by the company's management to ensure that nothing is being stated therein that conflicts with information about which the audit team has knowledge as a result of its audit.

Including a narrative discussion of the company's past and future operations to the auditor's report also indirectly imposes a new requirement to audit prospective information about company plans—something that has no place in an audit report.

We believe the PCAOB needs to decide whether it wants to change the core content of an audit or simply revise the auditor's report. If the latter is the intent, then the only changes to the auditor's report that can be considered are changes that add information about what already takes place in an audit performed in accordance with PCAOB standards. We provide our reaction to those in the following section.

**POSSIBLE *AD HOC* CHANGES THAT COULD BE MADE TO THE AUDITOR'S REPORT**

If the PCAOB should choose to simply make changes to the auditor's report based on no more than the anecdotal comments made by those who purport to represent the user community, then some changes can be made to the report without the PCAOB conducting a full study and evaluation of the audit process described in the second paragraph of our letter. Our reactions below are to some of the possible changes to the auditor's report that could be made by the PCAOB on an *ad hoc* basis:

- Firstly, we have no objection to any wording changes to the auditor's report that, in the view of the PCAOB, add clarity to readers' understanding of the audit process and the audit conclusion.

- Secondly, we have no objection to the addition of any language additions or changes in the audit report that, in the view of the PCAOB, adds clarity to the readers' understanding of the independence of the audit firm.

- Thirdly, we have no objection to adding to the audit report the significant audit risks required to be identified in the normal course of the audit, should the PCAOB conclude that such information adds to the report readers' understanding of the audit report. *However, we would caution whether such information really would be helpful or might simply lead to readers of the auditor's report wrongly concluding that the sheer number of audit risk areas identified by the auditor in some way correlates to the reasonableness of the financial statements that are the subject of the auditor's report.*

- Fourthly, we have no objection to adding affirmative statements to the audit report to indicate in general terms the specific and significant audit procedures employed by the audit firm in the course of the audit, whether those audit procedures are mandatory, presumptively mandatory, or elective, should the PCAOB conclude that such information adds to the audit report readers' understanding of that report. *However, we would again caution whether such information really would be helpful or might simply lead to readers of the auditor's report wrongly concluding that the sheer number of audit procedures identified by the auditor in some way correlates to the effectiveness of the audit and the reasonableness of the financial statements that are the subject of the auditor's report.*

- Finally, we have no objection to adding to the auditor's report the identity and extent of auditing services provided by the firm signing the report and others—both network and non-network firms, as well as identifying the domestic and foreign locations in which those other firms provided their audit services.

**CONCLUSION**

Thank you for the opportunity to comment on this topic. I would be pleased to provide further information and comments should you so wish. Also, please contact me at (203) 401-2101 should you have any questions.

Very truly yours,

Paul Rohan, CPA
Partner
Director of Financial Reporting and Quality Control

55 Glenlake Parkway, N.E.
Atlanta, GA 30328
404.828.6000 Tel

September 27, 2011

VIA email to: comments@pcaobus.org

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

**Reference: PCAOB Rulemaking Docket Matter No. 34**

United Parcel Service, Inc. (UPS) has reviewed the Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements issued in June 2011, and we appreciate the opportunity to comment on the proposal.

The concept release seeks input on alternatives for changing the auditor's reporting model, including (1) an "Auditor's Discussion and Analysis", requiring the auditor to provide additional information about the audit and the company's financial statements, (2) use of emphasis paragraphs in the auditor's report to highlight the most significant matters in the financial statements and the corresponding key audit procedures, (3) auditor reporting on information outside of the financial statements, and (4) clarification of certain language in the auditor's report. These alternatives are not mutually exclusive. A revised auditor's report could include one or a combination of these alternatives or elements of these alternatives.

We present our views from the perspective of a financial statement preparer. As noted, the proposed change in the auditor's disclosure or reporting may take various forms. We value the fundamental objective to improve the transparency and relevance of the auditor's report, however, we do not support some of the notions outlined in the concept release. Specifically we do not agree with the implied change in responsibility of the auditors to opine on information outside of the financial statements, an outline of terminology definitions and audit procedures performed, and the implied changes to disclosure requirements outside of the frame work established by the FASB and SEC.

**Increasing the Responsibility of Auditors**

The objective of an audit of financial statements by the independent auditor (auditor) is the expression of an opinion on the fairness with which they present, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States (GAAP). The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. As this concept release notes, the objective of the proposal is not to change the role of the auditor, however, some of the proposed changes in scope have implied changes that we believe crosses the line between the responsibility of management and the auditor. It is our opinion, that the scope of an audit should not include an opinion on forward looking information or non-financial data or a requirement for an auditor to become a professional expert in the economics of the business an entity operates. Further, the requirements of the auditor should not lead the investor community to imply that the auditor has the primary responsibility of disclosure or governance of an entity.

The financial statements as prepared by an entity are historical in nature. An auditor is given facts about a transaction that has transpired and has the responsibility to assess whether that transaction was recorded and disclosed appropriately. It is also often the case that the auditor has access to subsequent events that aid in the evaluation of certain transactions. This historical stance therefore puts the auditor in an objective position where use of accounting knowledge, industry trends and professional judgment aids in the assessment of management's accounting and disclosure. An auditor therefore is not, and should not, be required to opine on matters that have not transacted, with the exception of the going concern opinion, where knowledge of historical data is viewed in light of management plans to provide an indication, not a surety, of continuity risks. Expanding the auditor's reporting model to provide assurance on information outside the financial statements, such as Management's Discussion and Analysis ("MD&A"), earnings releases, or non-GAAP information is a significant deviation in the traditional role of an auditor, one that may create a sentiment of assurance on future events where none can truly exist.

An audit of financial data does not include an examination of all financial transactions of an entity. The auditor uses professional judgment in the selection of transactions, which are often done on a sample basis. Therefore, as noted in the concept release, the auditor may have insights that are not afforded the average investor but they do not have the same insights or skills as management. A requirement to gain logic and understanding of non financial data will increase engagement time, audit fees and surely liability exposure of the audit firm. Further, an audit firm has many clients and while it may have professionals that may be subject matter experts on accounting theory, those professionals should not be regarded as expert operational managers for that industry or company under audit. An auditor's expertise is in accounting and their responsibility should be limited to opining on the accuracy and completeness of financial information. Requirements for additional disclosure about operations or the outlook of the company should continue to be directed at management.

The financial statements are the responsibility of management. The shareholders govern the entity through the voted proxy of a board of directors. To recommend that auditors report items that have not already been disclosed by management, not only diminishes the role of the elected board, but also creates an impression that the auditors have the primary responsibility of disclosure. The issuance of a separate auditor's discussion and analysis report also suggests that the auditor does not have a current mechanism to highlight inconsistencies. In actuality, though the auditors do not opine on the management's discussion and analysis, they do review it for consistency with other information included in the financial statements. If there is an inappropriate disclosure made, it is reasonable to assume that a reputable auditor would require an edit before releasing the audit report. The value of the auditor/management relationship is in the ability to discuss difference in opinions, communications to the audit committee and the auditor's use of the audit report to highlight a qualified opinion or an emphasis paragraph. Further, an auditor's discussion and analysis will be subject to review by management and the audit committee before release and therefore the usual disclosure reviews and discussions will ensue. The end result will most likely be the same information, as already disclosed by management, reported in the auditor's discussion and analysis which does not provide the user of the financial statements with any additional insight and serves as a redundant exercise for both management and the auditor. Moreover, reaching a consensus on verbiage of such a report may detract time from performing relevant audit procedures within a time frame that is already stressed by accelerated reporting deadlines.

**Disclosure of Terminology Definitions and Audit Procedures Performed**

This concept release highlights a concern of the investor community that more guidance is needed to understand the meaning of certain terms used in the audit report and to gain more insight on the nature of the audit procedures performed.

We agree that defining the responsibility of the auditor to detect fraud may be beneficial to the user of the financial statements. However, we caution that the audit report should not be used to define all terminology used. The audit report should continue to be a pointed document that users can review to get a direct statement of the quality of the financial statements; adding boilerplate terminology will detract from that objective. Such information is better served in communications from the PCAOB and the AICPA to the investor community or a reference as to where such information can be located.

The consideration of the auditor's disclosure of the nature and timing of the audit procedures performed should be handled with caution due to the prerequisite knowledge needed to understand such a disclosure and the litigious environment we operate in. The average user of the financial statement may not understand the terminology used to describe the procedure or be able to effectively validate the appropriateness of the procedure to address the risk. This disclosure may also become a score card in which investors begin to compare the depth of the work performed by audit firms which will have an unintended effect of pressing audit firms to disclose detail audit programs. Further, this public document could also be used as a source for plaintiffs seeking a target for failed companies. Moreover, this requirement questions the validity and strength of the audit firm's quality review programs and the reviews performed by the PCAOB. The reason these reviews exist is to provide the investor community with assurance that there is an independent review of the auditors by professionals that have the appropriate knowledge to perform an assessment of the quality of the audit work being performed.

**Disclosure Requirements Outside of the Frame Work Established by the FASB and SEC**

The financial statements, which include the notes to the financial statements, should tell the investor a story of the operations of the company. Requiring an auditor to make a subjective highlight of only certain transactions, which viewed in isolation or taken out of context, may not provide a true representation of the financial information. Also, as the needs of the users of the financial statements vary, there is the potential for a subset to argue that what was most relevant to them was not appropriately highlighted by the auditor. If there are concerns that the story is incomplete, and additional disclosure is needed regarding the sensitivity of management's estimates, those issues should be resolved by the FASB and SEC to ensure consistent application of the accounting and disclosure requirements.

In conclusion, we value the role of the auditors and the PCOAB in the review of the quality of information we provide to the investing public. We continually strive to provide our investors with timely and transparent disclosure of our operating results and will continue to adhere to rules as prescribed by the FASB and SEC. We appreciate the opportunity to comment on this concept release and thank you for consideration of our comments.

Sincerely,

Kurt Kuehn

Kurt P. Kuehn
Chief Financial Officer

GAO
Accountability * Integrity * Reliability

**United States Government Accountability Office**
**Washington, DC 20548**

September 30, 2011

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

Subject: *PCAOB Rulemaking Docket Matter 034, PCAOB Release No. 2011-003: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

This letter provides GAO's comments on the Public Company Accounting Oversight Board's (PCAOB) concept release on possible revisions to PCAOB standards related to reports on audited financial statements.

We support the general premise of enhancing the auditor's report, and believe that this concept release is a positive step toward improving the transparency and relevance of these reports. We believe that several of the suggestions—specifically, those relating to clarification of wording in the auditor's report to help users understand management's and the auditor's responsibilities, and enhanced use of "Emphasis of Matter" and "Other Matter" paragraphs to identify specific issues to which the auditor wishes to draw the users' attention—would improve the usefulness of the auditor's report. While we believe that the current "pass/fail" reporting model should be retained as an effective means of encouraging management to provide appropriate disclosure, the above suggestions for improving the auditor's report, the auditor's primary means of communicating audit results, should be considered. GAO and others in the federal audit community have had significant experience in enhanced reporting, and we have attached an illustrative audit report from the GAO/President's Council on Integrity and Efficiency (PCIE) *Financial Audit Manual* (FAM).[1]

Although we support enhancing the auditor's report, we do not support the required use of "Emphasis of Matter" paragraphs in all cases or a requirement for an Auditor's Discussion and Analysis narrative report. In addition, we caution against an expansion

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[1] See FAM/PCIE Section 595 A - Example of Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity's Systems with FFMIA on GAO's special publications web page (http://www.gao.gov/special.pubs/gaopcie/).

of the auditor's reporting or assurance to include information outside the financial statements as part of the financial statement audit.

Consistent with both the auditing standards and years of accepted practice, management of the audited entity is responsible for the fair presentation of the entity's financial statements, including disclosure of all information required by the applicable financial reporting framework, and for the full, accurate, and timely disclosure of information required by federal securities laws and the Securities and Exchange Commission (SEC). Such disclosures include Management's Discussion and Analysis (and the critical accounting estimates or assumptions contained therein) and additional disclosures necessary to provide investors with a materially accurate and complete picture of an issuer's financial condition, results of operations, and cash flows. The role of the auditor is to assess the fair presentation of the financial statements, including the completeness of management's disclosures. If there is a situation in which management does not provide the required disclosures, or such disclosures are not fairly presented, then the auditor considers the effect on the auditor's opinion and report.

As we've stated in previous comment letters, we strongly believe that auditing standard setters should work together to achieve core auditing standards that are universally accepted. This issue is an especially timely subject for discussion, as the International Auditing and Assurance Standards Board (IAASB) has recently issued its consultation paper entitled *Enhancing the Value of Auditor Reporting: Exploring Options for Change*. We encourage the PCAOB, the IAASB, and the Auditing Standards Board to coordinate the development of potential new expanded auditor reporting requirements with a goal of harmonizing the auditor's report to the maximum extent possible, based on common core auditing and reporting requirements. We believe that having different audit reports in the marketplace will create significant confusion to the users of the financial statements and may lessen, rather than enhance, the users' understanding of the auditor's report. Only where there is a clear and compelling reason should the individual standard-setting bodies develop differential standards to meet the unique needs of their respective constituencies. The nature of any differences from core auditing standards and the basis for the differences also should be communicated.

We also encourage the PCAOB to seek ways to work with the Financial Accounting Standards Board (FASB) and the SEC on issues related to management disclosures. For instance, collaboration with the FASB and the SEC could provide valuable information in developing, as appropriate, management disclosure requirements or guidance that provides additional information to users, based on needs identified by the PCAOB (e.g., disclosure of risks, significant estimates and judgments, critical accounting issues, and audit committee views). Such disclosures could then be evaluated by the auditors, as appropriate, during the audit process.

We have specific comments related to the PCAOB's questions and potential changes to the auditor's reporting model, which are provided below.

**Questions 1-4: Content and Form of the Auditor's Report**

**Question 1: Auditor's Report and Role**
We support the general premise that the auditor's report should be improved so that it is more relevant and useful to the financial statement users. Specifically, we would be in favor of wording in the auditor's report that provides a fuller explanation and expanded description of the respective responsibilities of management and the auditor, especially with respect to fraud, risk, nonfinancial disclosures, the extent of internal control testing, and auditor independence.

**Question 2: Pass/Fail Option**
We believe that the current pass/fail reporting model should be retained, and we agree with several Standing Advisory Group members that the pass/fail model is clear, consistent, comparable, and easy for the investing public to digest. Further, we believe it is an important tool that encourages management to make all necessary and appropriate disclosures.

**Question 3: Additional Information**
We believe that management and the audit committee, rather than the auditor, should provide any additional information about the entity and that an auditor's discussion of these matters, as well as discussions of significant management judgments and estimates, may blur the lines regarding the roles of the auditor, preparer, and the audit committee. It is important that users clearly understand their respective roles. We believe that an expansion of this sort could potentially increase the auditor's role and could challenge users with competing disclosures about the entity from management and the independent auditor. Further, we are concerned that the audit report language would become "boilerplate" and not ultimately improve reporting, the descriptions of the audit procedures applied would lack context and not convey the significant judgment involved in an audit, and an expansion of the auditor's reporting would increase audit costs.

**Question 4: Internal Control**
Our envisioned modifications to the standard auditor's report would not result in the need for amendments to the report on internal control as auditors are currently able to report on internal controls as part of a financial audit.

**Questions 5-12: Auditor's Discussion and Analysis**

We do not support a requirement for an Auditor's Discussion and Analysis narrative report discussing auditor views on significant matters because, in addition to believing that disclosure of such information is management's responsibility, such a requirement may result in unintended consequences. For instance, it might present conflicting information and serve to confuse users. The auditor's view on critical accounting estimates may not necessarily correspond with the way such information is disclosed by management in the financial statements, and this conflicting information may confuse users and lead to a situation where users are faced with the challenge of interpreting competing disclosures. Further, we believe that a discussion providing insights about the entity and the quality of its reporting may not provide sufficient context, and we do not support such an expansion. If the auditor finds it necessary to provide commentary on matters significant to users' understanding, we support the expanded use of "Emphasis of Matter" paragraphs, as discussed below.

**Questions 13-18: Required and Expanded Use of Emphasis Paragraphs**

We support the greater use of "Emphasis of Matter" paragraphs, but we do not support the required use of such paragraphs in all cases. The use of "Emphasis of Matter" paragraphs is helpful to call users' attention to the most significant matters in the financial statements or any other matter that is significant to the users' understanding of the audit, the auditor's responsibilities, or the auditor's report. These issues might include reference to management's discussion of critical accounting judgments and estimates and other areas with significant measurement uncertainty. GAO has frequently used "Emphasis of Matter" paragraphs to highlight significant uncertainties and risks that are important to the users' understanding of the financial statements. If the PCAOB decides to expand the use of "Emphasis of Matter" paragraphs, we encourage the PCAOB to provide guidance on when the use of these paragraphs is appropriate.

We do not support the required use of "Emphasis of Matter" paragraphs in all cases, because they may not always be appropriate, necessary, or useful and could be confusing for report users. In some cases, a required "Emphasis of Matter" paragraph might be of little use to the users and may result in boilerplate paragraphs that provide little value and distract users from more relevant information contained in the report.

**Questions 19-20: Auditor Assurance on Other Information outside the Financial Statements**

We caution against requiring auditors to provide assurance or related services on information not within the current scope of the financial statement audit. We believe the ability to provide assurance fully depends on the nature of the information provided during a financial statement audit. Therefore, the scope of information reported by management would need to be expanded. Auditors would also need to be able to audit that information against objective criteria to sufficiently provide assurance. The feasibility will depend on the nature of the information and the availability of suitable criteria. Some information may be better suited for use in audit procedures. For example, an auditor may be able to determine whether performance measures have been properly calculated. The auditor can also provide reports on internal control. Other information, such as non-GAAP[2] financial information and whether an organization fosters strong governance, may not be auditable.

Another consideration is the cost to provide assurance on information outside the financial statements. Requiring the auditor to provide assurance on information outside the financial statements (e.g., corporate governance arrangements, internal controls, key performance indicators, and other information) may be challenging in practice, involving significant additional cost while providing limited additional user benefit.

[2] GAAP: Generally Accepted Accounting Principles.

**Questions 21-22: Clarification of the Standard Auditor's Report**

We support the clarification of wording in the auditor's report to help users better understand management's and the auditor's responsibilities for information in the report. This clarification of wording in the auditor's report may help reduce the "expectations gap" by more clearly explaining difficult concepts, such as reasonable assurance, and better explaining the auditor's responsibility for fraud, financial statement disclosure, and other information outside the financial statements. Such clarified wording should not change the concepts or the auditor's responsibilities but could help clarify the auditor's communication of this information.

**Questions 23-30: Alternatives**

We support (1) the clarification of wording in the auditor's report to help users understand management's and the auditor's responsibilities and (2) the enhanced use of "Emphasis of Matter" paragraphs to identify specific issues to which the auditor wishes to draw the users' attention. As noted above, we do not support requiring an "Emphasis of Matter" paragraph in all cases. Similarly, we do not support use of an Auditor's Discussion and Analysis narrative report that discusses the auditor's views on significant matters as it might present conflicting information and expand the auditor's reporting responsibilities. In addition, we caution against requiring auditors to provide assurance on information outside the financial statements.

**Questions 31-32: Other Considerations and Potential Effects**

If the board decides to undertake a standard-setting project on auditor reports to include consideration of the areas discussed above, we encourage it to develop enhanced guidance for implementing such new requirements and information in coordination with the FASB and the SEC, as necessary. For example, the FASB and the SEC could develop guidance concerning any additional required disclosures, and the PCAOB could develop guidance and criteria to help the auditor evaluate management's disclosures. Absent this guidance, there may be a lack of conformity across auditor reports that confuses the user and diminishes the usefulness of the report.

We thank you for considering our comments on this important issue as the PCAOB considers possible revisions to standards related to reports on audited financial statements.

Sincerely yours,

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

Auditor: This illustrative audit report from the GAO/PCIE *Financial Audit Manual* presents an example of GAO's enhanced reporting.

## Enclosure

## Example 1 - Unqualified Financial Statement, Internal Control Opinion, and Opinion on Substantial Compliance of Entity's Systems with FFMIA

[Addressee]

In accordance with [cite audit authority] we are responsible for conducting audits of [full name of entity]. In our audits of the [entity] for fiscal year(s) [cite], we found

- the financial statements are presented fairly, in all material respects, in conformity with U.S. generally accepted accounting principles,
- [entity] had effective internal control over financial reporting (including safeguarding assets) and compliance with laws and regulations,
- [entity's] financial management systems substantially complied with the requirements of the Federal Financial Management Improvement Act of 1996 (FFMIA),[3] [for CFO Act agencies, omit for non-CFO Act agencies] and[4]
- no reportable noncompliance with laws and regulations we tested.

The following sections discuss in more detail (1) these conclusions, (2) our conclusions on Management's Discussion and Analysis and other supplementary information, (3) our audit objectives, scope, and methodology, and (4) agency comments and our evaluation.

**<u>Opinion on Financial Statements</u>**

The financial statements including the accompanying notes present fairly, in all material respects, in conformity with U.S. generally accepted accounting principles, [entity's] assets, liabilities, and net position as of September 30, 20XX [and 20X1]; the financial condition of [entity's] social insurance programs (if applicable) as of [the specified date]; and net costs; changes in net position; budgetary resources; and custodial activity (if applicable)[5] for the year[s] then ended.

**<u>Opinion on Internal Control</u>**

[Entity] maintained, in all material respects, effective internal control over financial reporting (including safeguarding assets) and compliance as of [end of fiscal year] that provided reasonable assurance that misstatements, losses, or noncompliance material in relation to the financial statements would be prevented or detected on a timely basis. Our opinion is based on criteria established under 31 U.S.C. 3512 (c), (d), the Federal Managers' Financial Integrity Act, and the Office of Management and Budget (OMB) Circular No. A-123, *Management's Responsibility for Internal Control*, [or other criteria].

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[3] OMB audit guidance provides guidance for reporting on FFMIA compliance without expressing an opinion.
[4] Non-GAO auditors may combine bullets 3 and 4.
[5] This list assumes the entity follows U.S. GAAP issued by FASAB. If the entity follows U.S. GAAP issued by FASB (government corporations and others such as the U.S. Postal Service), modify the list accordingly.

**Systems' Compliance with FFMIA Requirements [Omit this section for non-CFO act entities]**

[Entity's] financial management systems, as of [end of fiscal year], substantially complied with the following requirements of FFMIA: (1) federal financial management systems requirements, (2) federal accounting standards, and (3) the *U.S. Government Standard General Ledger* (SGL) at the transaction level. Our opinion is based on criteria established under FFMIA, OMB Circular No. A-127, *Financial Management Systems* (which includes the Joint Financial Management Improvement Program/Office of Federal Financial Management series of system requirements documents), U.S. generally accepted accounting principles, and the SGL.[6]

**Compliance With Laws and Regulations**

Our tests of the [entity's] compliance with selected provisions of laws and regulations for fiscal year 20XX disclosed no instances of noncompliance that would be reportable under U.S. generally accepted government auditing standards or OMB audit guidance. However, the objective of our audit was not to provide an opinion on overall compliance with laws and regulations. Accordingly, we do not express such an opinion.

**Consistency of Other Information**

The [entity's] Management's Discussion and Analysis, required supplementary information (including stewardship information), and other accompanying information contain a wide range of information, some of which is not directly related to the financial statements.[7] We do not express an opinion on this information. However, we compared this information for consistency with the financial statements and discussed the methods of measurement and presentation with [name of entity] officials. On the basis of this limited work, we found no material inconsistencies with the financial statements, U.S. generally accepted accounting principles, or OMB guidance.

**Objectives, Scope, and Methodology**

[Entity] management is responsible for (1) preparing the financial statements in conformity with U.S. generally accepted accounting principles, (2) establishing, maintaining, and assessing internal control to provide reasonable assurance that the broad control objectives of the Federal Managers' Financial Integrity Act are met, (3) ensuring that the [entity's] financial management systems substantially comply with FFMIA requirements (for CFO Act agencies), and (4) complying with applicable laws and regulations.

We are responsible for obtaining reasonable assurance about whether (1) the [entity's] financial statements are presented fairly, in all material respects, in conformity with

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[6] Non-GAO auditors may combine this information with compliance with laws and regulations.

[7] The Annual Financial Statement that includes the MD&A, any RSSI, RSI, and OAI, may be included in a larger document such as a Performance and Accountability Report (PAR). Depending on the presentation of these items in the PAR, the auditor may find it useful to refer to the specific page numbers on which this information appears. Additionally, there may be additional information presented in the PAR on which the auditor may need to provide an additional disclaimer. This disclaimer may be worded as "The other accompanying information included on pages XX, XX, and XX of this PAR is presented for purposes of additional analysis and is not a required part of the financial statements. This information has not been subjected to the auditing procedures applied in the audit of the financial statements and, accordingly, we express no opinion on it."

U.S. generally accepted accounting principles and (2) [entity] management maintained effective internal control, the objectives of which are as follows:

- Financial reporting: Transactions are properly recorded, processed, and summarized to permit the preparation of financial statements in conformity with U.S. generally accepted accounting principles, and assets are safeguarded against loss from unauthorized acquisition, use, or disposition.
- Compliance with laws and regulations: Transactions are executed in accordance with (1) laws governing the use of budget authority, (2) other laws and regulations that could have a direct and material effect on the financial statements, and (3) any other laws, regulations, and government-wide policies identified by OMB audit guidance.

We are also responsible for (1) testing whether [entity's] financial management systems substantially comply with the three FFMIA requirements [omit for non-CFO Act agencies], (2) testing compliance with selected provisions of laws and regulations that have a direct and material effect on the financial statements and laws for which OMB audit guidance requires testing, and (3) performing limited procedures with respect to certain other information appearing in the Annual Financial Statement.

In order to fulfill these responsibilities, we

- examined, on a test basis, evidence supporting the amounts and disclosures in the financial statements;
- assessed the accounting principles used and significant estimates made by management;
- evaluated the overall presentation of the financial statements;
- obtained an understanding of the entity and its operations, including its internal control related to financial reporting (including safeguarding assets), and compliance with laws and regulations (including execution of transactions in accordance with budget authority);
- tested relevant internal controls over financial reporting and compliance, and evaluated the design and operating effectiveness of internal control;
- considered the design of the process for evaluating and reporting on internal control and financial management systems under the Federal Managers' Financial Integrity Act;
- tested whether [entity's] financial management systems substantially complied with the three FFMIA requirements [omit for non-CFO Act agencies]; and
- tested compliance with selected provisions of the following laws and regulations: [list laws and regulations]

We did not evaluate all internal controls relevant to operating objectives as broadly defined by the Federal Managers' Financial Integrity Act, such as those controls relevant to preparing statistical reports and ensuring efficient operations. We limited our internal control testing to controls over financial reporting and compliance. Because of inherent limitations in internal control, misstatements due to error or fraud, losses, or noncompliance may nevertheless occur and not be detected. We also caution that projecting our evaluation to future periods is subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with controls may deteriorate.

We did not test compliance with all laws and regulations applicable to [entity]. We limited our tests of compliance to selected provisions of laws and regulations that have a direct and material effect on the financial statements and those required by OMB audit guidance that we deemed applicable to the [entity's] financial statements for the fiscal year ended [date]. We caution that noncompliance may occur and not be detected by these tests and that such testing may not be sufficient for other purposes.

We performed our audit in accordance with U.S. generally accepted government auditing standards and OMB audit guidance.

**Agency Comments and Our Evaluation**

In commenting on a draft of this report (see appendix x), [entity] concurred [or partially concurred, or did not concur] with the facts and conclusions in our report. Discuss agency comments with auditor evaluation if agency partially concurred or did not concur. [8]

[Auditor's signature]

[Date of audit completion]

[8] If the entity's comments include discussions of corrective action plans or other matters as discussed in FAM 580.84, example wording is: "We did not perform audit procedures on [entity's] written response to the significant deficiencies [and material weaknesses, if applicable] and, accordingly, we express no opinion on it."

United Therapeutics
CORPORATION

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September 30, 2011

Via email to comments@pcaobus.org

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

Re: Rulemaking Docket Matter No. 34
*Concept Release On Possible Revisions To PCAOB Standards Related to Reports On Audited Financial Statements*

Dear Sirs,

We write to the Board to comment on its June 2011 Concept Release, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.* We appreciate the opportunity to share our views on the Concept Release.

United Therapeutics Corporation is a biotechnology company focused on the development and commercialization of unique products to address the unmet medical needs of patients with chronic and life-threatening conditions.

We appreciate that the Board has conducted extensive outreach in relation to the Concept Release, including soliciting input both before and after the issuance of the release and organizing a recent roundtable on this subject. As an initial matter, however, we question the premise on which the Concept Release is grounded: that investors and other users of financial statements actually desire "more" information about the financial statements. We have not heard and are not aware that our investors believe that additional information about company financial statements is vital. Investors already receive robust information about company financial results, including the financial statements and notes thereto and MD&A, and have the assurance on these results provided by the auditor through the audit report and have access to the auditor at the company's annual meeting. We recognize that some groups speaking on behalf of investors espouse this view, but we do not believe it is one generally held in the marketplace. In any event, empirical evidence on the actual benefits that investors might hope to attain from any of the ideas in the Concept Release is needed if the Board determines it is appropriate to proceed.

In addition, if there is in fact an information deficit that is caused by the current financial reporting framework, we urge the Board to work in coordination with the other standards-setters, particularly the SEC and FASB, to evaluate the manner in which the standards may need to be modified, rather than implementing sweeping changes to the audit report which would result in significant costs to companies.

## I. The Board Should Not Move Forward With The Auditor's Discussion & Analysis Concept.

We firmly believe that including an Auditor's Discussion & Analysis (AD&A) in an audit report would be a mistake. Management should remain the source of disclosure in the first instance about the company's financial statements; the auditor's role is and should remain to provide assurance about that information. Adopting an AD&A would fundamentally alter the role of an auditor by making the auditor an original source of information about the company. Indeed, there is a risk that the auditor's role could be transformed from that of an independent, objective third party to that of a party who can influence the operations and direction of a company by providing a platform to articulate inherently subjective judgments about a company and its financial statements. And disclosures about these judgments could be influenced by any number of external forces – the economic environment, the dynamic relationship between the auditor and the client, and even stylistic choices about disclosures, to name a few.

In addition, providing additional statements from the auditor on management estimates, judgments, accounting policies, and "close calls" encountered during the audit would not make company financial statements easier to understand. Instead, we believe an AD&A would only serve to burden users with additional disclosures that, at best, provide some limited information that has not already been presented by management and, at worst, risk confusing readers and perhaps causing a lack of confidence in both the company's management and the auditors. Investors and other users of a company's financial statements would have to weigh and reconcile information provided by the auditor, the company's management, and, in some cases, the audit committee. This would not provide clarity, but would generate additional complexity and confusion.

An AD&A also would complicate the interaction the auditor has with the audit committee and, as a result, would impede an effective corporate governance process. Currently, auditors, audit committees and management have robust discussion about financial reporting issues. The AD&A concept would require that the substance of these discussions should then be reflected in the AD&A prepared by the auditor. This could drastically alter the relationship and dampen the flow of communication among these parties. The healthy dialogue that occurs among audit committees, management and auditors on issues related to accounting judgments and management estimates could become adversarial and thus strained as the auditor may dominate conversations on considerations related to AD&A disclosures the auditor might have to make in order to protect themselves from potential legal and regulatory exposure.. At a minimum, demands on audit committees would increase as they would have to spend additional time analyzing and discussing the AD&A with the auditor. These foreseeable developments in the wake of an AD&A would undermine, rather than further, good corporate governance and would be detrimental to investors' interests.

Also, because an AD&A would place the auditor in the position of making original disclosures about the company, it would expose not only the auditor, but also the company, to new legal risks. For example, plaintiffs' attorneys inevitably will look to parse distinctions between statements made by the auditor and management and will seek to exploit these perceived distinctions.

Finally, although the empirical data to support any of the ideas in the Concept Release appears to be lacking, in the event such benefits are identified, the Board must rigorously examine those benefits against the extensive costs and the addition burdens that the concepts in the release would engender. This is particularly true in relation to the AD&A, which would require the auditor to expend extensive time and effort preparing the AD&A including multiple layers of internal review. As a predictive matter, it is reasonable to assume that these efforts to prepare an AD&A would result in considerable expense to the client. Given the accelerated reporting schedules that public companies now confront, the time and effort to fashion an AD&A also could put increased pressure on meeting these deadlines. Together, we believe these costs plainly outweigh any benefit that might be identified that the AD&A has to offer.

## II. The Board Should Not Require Auditors To Provide Assurance On Information Outside Of The Financial Statements.

The Concept Release also suggests that the Board may consider a proposal that would require auditors to provide assurance on information outside of the financial statements, such as information in Management's Discussion & Analysis (MD&A) and earnings releases. We do not support moving ahead with this concept. Current PCAOB standards require the auditor to review such information and consider whether it is inconsistent with the financial statements or constitutes a material misstatement of fact. This regime provides reasonable protection for investors while also appropriately balancing the costs that could arise from more intrusive requirements.

The costs of an attest engagement of the MD&A or other information outside of the financial statements would not be worth the marginal benefit that may be attained through conducting additional procedures. It may take considerable time and effort to complete these additional attest engagements. And, performing attest procedures in relation to earnings releases could delay the release of this information to the market. As noted in the Concept Release, the PCAOB standards currently permit such an engagement, but those engagements are rarely conducted. The fact that companies have not embraced this additional attest engagement suggests that the costs of the engagement generally outweigh any benefits.

To the extent that certain information currently presented in the MD&A is deemed useful and that assurance of such information by auditors would be desirable, the

PCAOB should work with other standards-setters to consider whether the financial reporting standards should be modified so that such information is presented as disclosure in the notes to the financial statements.

* * *

Thank you for the opportunity to offer our comments on this important issue. If you have any questions regarding these comments, please do not hesitate to contact me by email, jferrari@unither.com, or telephone, 301-608-9292, extension 1729.

Respectfully,

John M. Ferrari
Chief Financial Officer and Treasurer

unum

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423 294 1011

September 28, 2011

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

Re: PCAOB Rulemaking Docket Matter No. 34

Thank you for the opportunity to comment on the Public Company Accounting Oversight Board (PCAOB) Concept Release on possible revisions to PCAOB standards related to reports on audited financial statements. We appreciate the Board's efforts to address investors' needs regarding the auditor's reports on financial statements and agree that changes could be made to the current auditor reporting model to provide clarity around the auditor's responsibilities. We have addressed the applicable questions from the concept release in the appendix to this letter and have summarized our primary considerations below:

***Auditor's Discussion and Analysis (AD&A)***

We have concerns about auditors providing an analysis of financial information directly to financial statement users, as doing so could confuse the users as to who owns and prepares the financial statements. Management, not the auditors, is ultimately responsible for the accurate preparation, presentation, and distribution of financial information. Discussions of "close calls" or alternative accounting principles within the AD&A without the ability to capture the verbal discussions that are held between the auditor, company management, and/or the audit committee could lead to a misinterpretation by users and ultimately cause confusion. We believe that if the auditor's opinion states that financial statements and disclosures are in accordance with U.S. GAAP, then qualifying language to the contrary should not be presented by the auditors.

***Expanded use of emphasis paragraphs and clarification of the Standard Audit Report***

We support the expanded use of emphasis paragraphs to highlight important areas that the auditor specifically examines in forming their opinion on the financial statements, and we support clarifying the standard audit report regarding auditor responsibilities for fraud detection and independence. However, we are concerned about the inclusion of a discussion of audit procedures performed as we believe it would be difficult to succinctly and adequately capture the procedures that auditors perform during an engagement, especially when the audit pertains to a large and complex organization.

***Reporting on information outside of the financial statements***

We generally do not support a requirement for auditor attestation on information outside of the financial statements, such as the management's discussion and analysis (MD&A). Much of the MD&A contains information that is not contained in the financial statements and footnotes, such as sales data and sensitivity information, and therefore is not as clearly related to historical financial statement amounts in the financial statements and footnotes, which could prove difficult for the auditor to apply audit procedures in a practical manner in order to provide value to the user of the financial statements.

Although in principle we are not opposed to auditor attestation on earnings release information, we believe that having auditor involvement in this process would hamper our ability to provide this information on a timely basis. We do not believe that attestation of this information adds enough value for investors to warrant slowing this process especially in light of the fact that the majority of this information is subsequently contained in quarterly financial statements and audited annual financial statements which are subjected to auditor review.

We address the applicable questions contained in the concept release in the remainder of our response below.

Sincerely,

Vicki Corbett
Senior Vice President and Controller
Unum Group

## Responses to Concept Release Questions

**Form of the Auditor's Report**

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

***1a.** Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

**Company Response:**
Yes, we agree with the Board's view that the auditor's report should be expanded so that the auditor's report is more relevant and useful to financial statement users.

***1b.** In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

**Company Response:**
We believe that the following improvements to the standard auditor's report would provide more relevant and useful information to financial statement users:

- The use of emphasis paragraphs in identifying topics or events, unusual transactions or other matters in the financial statements.
- Revision of the standard auditor's report to clarify the auditor's responsibilities including fraud detection and independence.

***1c.** Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

**Company Response:**
We generally do not support a requirement for auditor attestation on information outside of the financial statements, such as the management's discussion and analysis (MD&A). Much of the MD&A contains information that is not contained in the financial statements and footnotes, such as sales data and sensitivity information, and therefore is not as clearly related to historical financial statement amounts in the financial statements and footnotes, which could prove difficult for the auditor to apply audit procedures in a practical manner in order to provide value to the user of the financial statements.

Although in principle we are not opposed to auditor attestation on earnings release information, we believe that having auditor involvement in this process would hamper our ability to provide this information on a timely basis. We do not believe that attestation of this information adds enough value for investors to warrant slowing this process especially in light of the fact that the majority of this information is subsequently contained in quarterly financial statements and audited annual financial statements which are subjected to auditor review.

**2.** *The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

**2a.** *Should the auditor's report retain the pass/fail model? If so, why?*

**Company Response:**
Yes, we believe that the pass/fail model of the standard auditor's report should be retained. An indication that the financial statements are presented fairly in conformity with the applicable financial reporting framework is helpful to financial statement users. Varying degrees of passing or failing would be confusing.

**2c:** *If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

**Company Response:**
While we believe that the pass/fail model of the standard auditor's report should be retained, we also believe that certain changes to the report would be beneficial. An expanded use of emphasis paragraphs and the clarification of standard language in the auditor's report would also provide financial statement users with more relevant and useful information.

**3.** *Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

**Company Response:**
We do not believe it is appropriate for auditors to provide financial information directly to financial statement users, as doing so could confuse these users as to who owns and prepares the financial statements. We agree with the delegation of responsibilities outlined in

Auditing Standard (AU) Section 110.03, which states that "the financial statements are management's responsibility. The auditor's responsibility is to express an opinion on the financial statements." We believe it is in the best interest of investors, auditors and financial statement preparers to maintain the requirement that management, not auditors, is responsible for the accurate preparation, presentation and distribution of financial information. While auditors have substantial knowledge based on their access to management and company records, their knowledge about a company is not as comprehensive as management's knowledge.

4. *Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

**Company Response:**
Depending on the alternatives chosen by the Board, certain changes to the report on internal control over financial reporting will be necessary:

- **AD&A**: Control issues that are required to be reported as a "close call" would require discussion in the report on internal control over financial reporting. We have concerns about the disclosure of these close calls, given the subjectivity involved, and whether an appropriate disclosure framework can be developed and consistently followed.
- **Required and expanded use of emphasis paragraphs:** We do not believe that any changes to the report on internal controls over financial reporting are necessary under this alternative.
- **Auditor assurance on other information outside the financial statements:** Because the scope of the auditors' procedures would be expanded under this alternative, additional internal control documentation and testing would likely be required.
- **Clarification of language in the standard auditor's report:** We do not believe that any changes to the report on internal controls over financial reporting are necessary under this alternative.

**Auditors Discussion and Analysis**

5. *Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?*

**Company Response:**
We do not support the AD&A as an alternative to the current auditor reporting model.

***5d**. If you do not support an AD&A as an alternative, explain why.*

**Company Response:**
The objective of financial reporting is to provide information that is useful to financial statement users. If standards promulgated by U.S. GAAP do not adequately provide this information, then those standards should be changed. If additional information related to the financial statements needs to be reported that is not currently included in requirements under Regulation S-K, the SEC should consider changing those requirements. We believe the AD&A is an inappropriate alternative for providing information to financial statement users.

***5e**. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

**Company Response:**
While we do not support the use of an AD&A, we do support the expanded use of emphasis paragraphs in identifying matters in the financial statements that are important for a better understanding of the financial statement presentation.

***9.** Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

**Company Response:**
We do not support the AD&A as an alternative to the current auditor reporting model. Please refer to our response to question 5d. Furthermore, we do not support the inclusion of the aforementioned risks in the auditor's report. These risks are already discussed at length in Item 1A (Risk Factors) of the Form 10-K. Auditors should not be required to select the most significant of those risk factors for inclusion in their reports, as this is tantamount to their advising financial statement users which of the reported risk factors are most important. As mentioned earlier, company management is most familiar with risks that the company faces and should be the source for such a discussion.

***11.** What are the potential benefits and shortcomings of implementing an AD&A?*

**Company Response:**

We do not support the AD&A as an alternative to the current auditor reporting model. Please refer to our response to question 5d. We believe that benefits gained from the AD&A are outweighed by its potentially detrimental impacts. An AD&A could potentially undermine management's reporting.

12. *What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

**Company Response:**
This alternative would require close coordination between auditors and company management to ensure that the MD&A and AD&A are aligned. It is doubtful that the AD&A would differ very much from the MD&A, as most companies already closely communicate with their auditors on topics related to significant accounting policies and practices and the adoption of new accounting guidance.

**Matter of Emphasis Paragraphs**

13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?*

**Company Response:**
We support the use of emphasis paragraphs in identifying topics or events, unusual transactions, or other matters in the financial statements that are important for a better understanding of the financial statement presentation. These emphasis paragraphs should be objective, fact-based discussions and should make specific references to the location of such items in the financial statements.

We do not support requiring auditors to comment on key audit procedures due to the risk of confusion that may be caused by disclosures that do not provide the full context of the audit strategy employed for a particular matter. We are concerned about how auditors might succinctly describe procedures performed in an audit on a large or complex engagement.

15. *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

**Company Response:**
We support inclusion of significant transactions, significant changes in accounting policy, etc. occurring during the period under audit and also believe that all emphasis paragraphs should make specific reference to the location of such items in the financial statements.

***16.*** *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

**Company Response:**
Please refer to our response to question 15 for the appropriate content that we believe should be required in emphasis paragraphs. We believe that the information presented should be at a more summarized level of detail than is presented in the footnotes to prevent unnecessary duplication.

***17.*** *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?*

**Company Response:**
It will be difficult for auditors to avoid boilerplate language when composing the emphasis paragraphs, as auditors will conform to specific guidelines and examples provided by the PCAOB. If the emphasis paragraphs are limited to material, important, or other unusual information, then the use of boilerplate language may be reduced.

**Auditor Assurance on Other Information Outside the Financial Statements**

***19.*** *Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

**Company Response:**
We do not agree with expanding the auditor's role to provide assurance on the MD&A, although we are not opposed to the auditor providing assurance on the quarterly earnings release. We do, however, question the value that investors would receive from auditor attestation on information contained in the quarterly earnings release in light of the fact that much of this information is contained in quarterly and annual financial statements and is eventually subjected to auditor review.

***19g.*** *If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

**Company Response:**
We do not support a requirement for auditor attestation on certain information outside of the financial statements, such as the MD&A. Much of the MD&A is forward looking and is not as clearly related to historical financial statement amounts reported in the financial

statements and footnotes. One example of this type of information is sales results, which are prominent in most insurance companies' MD&A. Sales results generally represent the annualized premium or annualized fee income on new sales which insurance companies expect to receive and report as premium income or fee income during the next 12 months, depending on the effective date of the new sale. Sales are not a GAAP measure and do not directly correspond to premium income or fee income reported as revenue in accordance with GAAP. This is because new annualized sales premiums reflect current sales performance and what companies expect to recognize as premium or fee income over a 12 month period, while premium income and fee income reported in financial statements are generally reported on an earned basis rather than an annualized basis and also include renewals and persistency of in-force policies written in prior years. Because of this difference between sales results and GAAP premium revenue, auditors would, in this example, need to expand their efforts to be able to provide assurance on sales data. This might involve providing assurance on reporting processes, including information systems, and financial controls that the auditor has little, if any, involvement with today and would result, in our opinion, in little additional value to the financial statement user as compared to the cost.

In addition, Item 7A (Quantitative and Qualitative Disclosures about Market Risk) of the MD&A contains sensitivity analyses, in which estimates of future performance and economic conditions are reflected assuming certain changes in market rates and prices were to occur. Because of the judgmental nature of this disclosure, we do not believe auditor assurance on this sensitivity analysis would provide significant value to the financial statement user.

***20.*** *What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

**Company Response:**
We appreciate the additional level of comfort to investors that auditor assurance on information outside the financial statements would provide. However, we believe that the cost of providing this additional assurance outweighs the benefits, as it would be difficult for the auditor to develop a practical approach for providing assurance on forward looking non-GAAP and estimated sensitivity information.

Please see our response to question 19g for this alternative's shortcomings.

**Clarification of the Standard Auditor's Report**

***21.*** *The Concept Release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*

- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

***21a.** Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

**Company Response:**
We believe that all of these clarifications are appropriate in describing the roles and responsibilities of auditors. These clarifications would enhance communication between auditors and financial statement users and would better manage the expectations of financial statement users on the limitations of audits.

***21d.** What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

**Company Response:**
We believe that the scope of the audit will remain the same, as this alternative primarily clarifies the auditor's current roles and responsibilities. The auditor's responsibilities may increase slightly, as the audit report would contain more information and would therefore require more time to prepare.

***22.** What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

**Company Response:**
These clarifications would enhance communication between auditors and the users of these audit reports and would better manage the expectations of financial statement users on the limitations of audits. The benefits of such clarifications outweigh any shortcomings.

**Questions Related to all Alternatives**

***23.** This Concept Release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

**Company Response:**

We believe the proposed clarifications of the auditor's report are the most appropriate alternative. Please refer to our response to question 22 for the benefits of this alternative.

***24.*** *Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

**Company Response:**
We support the following elements of the proposed alternatives, which would serve to improve auditor communication:

- The use of emphasis paragraphs in identifying topics or events, unusual transactions, or other matters in the financial statements that are important for a better understanding of the financial statement presentation.
- All of the suggested clarifications to the standard auditor's report.

***26.*** *Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

**Company Response:**
We request that the board consider the following in developing auditor reporting framework for each of the alternatives that we support:

- **The use of emphasis paragraphs in identifying topics or events, unusual transactions, or other matters in the financial statements.** These should be objective, fact-based discussions and should make specific references to the location of such items in the financial statements. Auditors should avoid merely repeating information in the financial statements, but instead should highlight areas that were specifically addressed in forming their opinion on the financial statements.
- **Clarification of the Standard Auditor's Report.** We believe the framework outlined on pages 27-29 of the Concept Release should be adopted by the Board.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

**Company Response:**
It is possible that financial statement users could perceive the emphasis paragraphs and the clarifying language as a qualified or piecemeal opinion. This risk could be mitigated by

retaining the standard auditor opinion and adding the other alternatives on a separate page as a supplemental report.

**28.** *Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

**Company Response:**
We believe the proposed clarifications of the standard auditor's report best conveys to financial statement users the auditor's role in the performance of an audit.

**29.** *What effect would the various alternatives have on audit quality? What is the basis for your view?*

**Company Response:**
Neither the use of emphasis paragraphs nor the clarifications to the standard auditor's report would impact audit quality.

**30.** *Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the Concept Release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

**Company Response:**
In order to promote consistency among all audit reports filed with the SEC, we believe that the changes to the auditor's reporting model should apply equally to all audit reports, regardless of industry.

**Considerations Related to Changing the Auditor's Report**

**31.** *This Concept Release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

**31a**. *Are any of these considerations more important than others? If so, which ones and why?*

**Company Response:**
We believe the most important of these considerations is the balance of usefulness to the financial statement user compared with the additional costs incurred by the auditor and

registrants. As we have stated in our responses above, carefully weighing this balance is important, and we believe the current auditor reporting model, with expanded use of emphasis paragraphs and clarifications of the auditor's role and responsibilities, is the most suitable model for both financial statement users and preparers.

***31b.*** *If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

**Company Response:**
We believe that the benefits of emphasis paragraphs in identifying specific items in the financial statements, as well as clarification of the standard auditor's report, will generally outweigh the costs. However, any benefits gained from the AD&A or auditor assurance on information outside the financial statements might be outweighed by the potentially detrimental impacts of these alternatives.

***31c.*** *Are there any other considerations related to changing the auditor's report that this Concept Release has not addressed? If so, what are these considerations?*

**Company Response:**
The Concept Release does not adequately address concerns we have with the AD&A. These concerns are addressed on the introduction page of this letter, as well as in our responses to questions 5-12. In addition, the Concept Release does not adequately address concerns we have on auditor assurance of information outside the financial statements. These concerns are addressed on the introduction page of this letter, as well as in our responses to questions 19 and 20.

***31d.*** *What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

**Company Response:**
We believe that neither the AD&A nor auditor assurance on information outside the financial statements are desirable alternatives and therefore both alternatives should be removed from consideration, except as noted in our response to question 19.

***32.*** *The Concept Release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

**Company Response:**

We are concerned about the possible impact that the AD&A would have on an auditor's communications with management and the audit committee. Discussing potentially sensitive matters in an AD&A could create tension, stifle communication, and thereby hinder audit quality.

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20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Sir/Madam,

We appreciate the opportunity to respond to the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (herein referred to as "Concept Release").*

USG Corporation (herein referred to as "we" and "our"), through our subsidiaries, is a leading manufacturer and distributor of building materials with annual revenues of approximately $3 billion. We produce a wide range of products for use in new residential, new nonresidential, and residential and nonresidential repair and remodel construction as well as products used in certain industrial processes. Our major product lines include SHEETROCK® brand gypsum wallboard and joint treatment products, DUROCK® brand cement board and FIBEROCK® brand gypsum fiber panels.

Overall, we do not support a standard-setting project to modify current auditing standards resulting in an increase in audit scope or a significant expansion of the independent auditor's reports. We do not believe that the proposals in the Concept Release will materialize into an increase in financial statement transparency or relevance as decisions by financial statement users are made throughout the year, and not made only in connection with annual filings. While we believe elements of the auditor's reports could be updated to clarify certain auditor responsibilities, we do not believe that clarification is necessary for financial statement users to understand the responsibility of the independent auditor. The proposed modifications will have the unintended consequence of absolving the financial statement user from the responsibility of developing an understanding of the auditor's role and the audit process independent of our auditor's reports.

*1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.*

*a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?*

We do not believe that changes to the auditor's reporting model are needed as they would not enhance investors' and other financial statement users' understanding of a public company. Rather, any expansion of the auditor's role could bring the auditor's independence into question as under the proposed changes they would have to effectively function as an auditor and analyst. The likelihood of this result would run counter to the Board's stated objectives of transparency and relevance. Therefore, unintended consequences should be seriously considered prior to any adoption or implementation. In addition, such considerations would likely increase the time and cost of an audit, increase other professional fees, and potentially delay a company's Securities and Exchange Commission ("SEC") filings. The auditor's role has always been to provide reasonable assurance that the financial statements are free of material misstatement and can be relied upon by investors and other users of the financial information. This assurance has been and should continue to be limited to the reasonableness of the financial statements in accordance with U.S. GAAP.

*b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?*

It is a responsibility of a public company to provide investors and other financial statement users with information to make investing, lending or other significant financial decisions about the company. Information that is relevant and useful in making significant financial decisions about a company should only be provided by management. In addition, this information is already provided in documents filed with the SEC, including (but not limited to) Form 10-K, Form 10-Q, Form 8-K, and the Proxy Statement, as well as press releases and earnings calls. The audit report is issued to provide reasonable assurance that the financial statements are free of material misstatement and in accordance with U.S. GAAP. We believe the current audit report sufficiently states the reasonableness of the financial statements and no improvements are necessary.

Investor relations departments field many inquiries from investors and analysts for which the answers could be found in the public filings. It is questionable that increasing content of already voluminous filings would create greater understanding of the financial statements or provide more transparency. Quite the contrary, we believe that this would merely create questions on the part of investors, as much of the proposal by the Board would add narrative that is boilerplate or information without the benefit of further elaboration or context.

*c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?*

We do not believe expanding the auditor's role on matters in addition to the financial statements would provide a greater amount of certainty to financial statement users, nor would it increase the amount of relevant information already provided. The cost of expanding the auditor's role would be significant and would outweigh the benefit. Information is presently communicated by management to investors, analysts and financial statement users through quarterly press releases, earnings calls and other webcast presentations, Form 10-Q filings and other event-driven filings; and investors, analysts and others are using this information to make investment decisions, despite not having an opinion or other commentary by an auditor. We do not see the benefit of an auditor providing assurance on information contained in the annual 10-K filing in addition to the annual financial statements when decisions are currently being made by financial statement users throughout the year.

*2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."*

*a. Should the auditor's report retain the pass/fail model? If so,why?*

An audit report should be retained as pass/fail. Any alternative to the pass/fail model will only create misunderstanding as to the quality of the financial statements. Suggesting that there could be varying degrees of quality within financial statements, or providing a "range of reasonableness" does not add valuable information to the user of the financial statements. If the standard the auditor is attesting to is "reasonable within all material respects," then any varying degree of reasonableness, by definition, would not be material to the user. Therefore, additional information provided in the audit report would not benefit financial statement users at a level that would outweigh the significant cost that would be incurred to provide that information. Financial statements are as of a point-in-time, and not necessarily indicative of future results. Users having knowledge of anything other than pass or fail will not provide more useful information on the expected future results of the company. Furthermore, it is not, and should not be, the auditor's responsibility to provide outlook to financial statement users.

*b. If not, why not, and what changes are needed?*

Not applicable. No changes to the pass/fail model are necessary.

*c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.*

Except for certain clarifications as described in our response to Question 21, we do not believe it is necessary to include any supplemental reporting by the auditor.

*3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.*

Information is presently communicated by management to investors, analysts and financial statement users through quarterly press releases, earnings calls and other webcast presentations, Form 10-Q filings and other event-driven filings; and investors, analysts and others are using this information to make investment decisions, despite not having an opinion or other commentary by an auditor. Investors frequently contact investor relations departments to discuss information already contained in public filings or to request additional information. It is the responsibility of management to ensure that information disclosed through a company's public filings and announcements and its investor relations department is accurate and consistent and is within the boundaries of what management is required, able and willing to disclose to financial statement users. Management is responsible and in the best position to ensure that enterprise risk is managed through any disclosure activity.

Management has the greatest knowledge regarding its company and related business and thus is in the best position to provide additional information regarding the company's financial statements. It is inconsistent to propose that a separate reporting model on information contained outside the financial statements or expansion of the auditor's reporting model in connection with the annual audit would provide users with a greater level of comfort over the financial statements when decision-making information is disseminated by management and is used by financial statement users throughout the year without any auditor assurance.

*4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?*

We do not believe any amendments are necessary to the audit report on internal control over financial reporting.

*5. Should the Board consider an Auditor Discussion and Analysis ("AD&A") as an alternative for providing additional information in the auditor's report?*

We do not support an AD&A as an alternative method of providing additional information in the auditor's report. Any proposal of AD&A will add significant time and cost and will materially alter the historical relationship of the independent auditor and management. In addition, it will undermine the audit committee and its responsibilities.

*a. If you support an AD&A as an alternative, provide an explanation as to why.*

We do not support the AD&A as an alternative because it does not promote the Board's objectives of transparency and relevance. We believe the auditor's responsibility is clearly defined in the existing PCAOB Audit Standards. Those standards state that "the auditor has the responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud" and that the "objective of an audit of the financial statements is the expression of an opinion on the fairness with which they present, in all material respects, financial position, results of operations, and its cash flows in conformity with generally accepted accounting principles."[1] The auditors are not, nor should they be, responsible for discussion and analysis. This responsibility is, and should continue to be, the role of management and the audit committee. If investors are looking for third party analysis for their determination of the risk and reward of investment in a certain company, they should contract with analysts to perform such tasks to their specifications based upon their assessed risk portfolio.

The auditor is to perform tasks to mitigate audit risk and to opine that management's financial statements are free from material misstatement in accordance with U.S. GAAP. The auditor should not opine on how the statements could be presented differently if they were management. If financial statements do not currently provide the proper transparency and relevance, then U.S. GAAP should be amended. The necessary transparency and relevance should not be achieved by the expansion of the auditor's role or report.

*b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?*

We do not believe that an AD&A should comment on the audit or the company's financial statements. We believe that the redundancy of such comments would not provide additional transparency or understanding for the financial statement users. We will continue to reference throughout our response the theme and goals of the Concept Release – of transparency and relevance without the sacrifice of audit quality. We continue to believe that the proposals to change the auditor's reporting model will not meet these goals but will hinder them.

The standards for conducting audits are available through various public means including the PCAOB, the SEC, and the Center for Audit Quality ("CAQ"). If the real objective of this proposal

[1] AU Section 110, *Responsibilities and Function of the Independent Auditor*

is education of the audit process, then the Board should engage in activities to enhance its own mission and not create additional costly reporting requirements.

The inherent nature of the additional auditor commentary will do little to promote relevance of reporting. On the contrary, this language will largely be repetitive of reporting already contained within existing financial statements and of publically available information which discusses the auditor roles and responsibilities. Furthermore, additional information would likely increase the current perception that the reporting is too dense, lengthy and obtuse to promote transparency.

*c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?*

We do not believe most investors would find an AD&A relevant or useful in making investment decisions. On the contrary, investment decisions and models for large institutional investors who rely on various, short, mid and long-term valuation models are made throughout the year, and not necessarily in conjunction with the audited financial statements or the corresponding information. Investors believe that an audit is an integral part of their trust in the reasonableness of the financial statements when making investment decisions, however, having an in-depth knowledge of the process on how that audit is conducted, we believe is not relevant in their decision making. In addition, if investors believe that having an understanding of the audit process is an integral part of their investment decisions, they can obtain that understanding through existing resources.

The auditor should not be tasked to analyze the company's results or to comment, specifically on management's forward-looking statements. This would materially change the auditor's historical role and may impair independence and negatively alter management's relationship with the auditor.

*d. If you do not support an AD&A as an alternative, explain why.*

We do not believe an AD&A promotes any of the objectives of the Board's Concept Release. Please see responses to questions 5a, 5b and 5c.

*e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both? What are they?*

We do not believe that there is a need for the auditor to further comment on either the audit or the company's financial statements. The audit report provides the necessary information relevant to convey the reasonableness of the financial statements, and information about the nature, purpose and scope of an audit is publically available to financial statement users through various channels.

*6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?*

We do not believe there is a need for an AD&A. The overall objectives of the Board are to assist and protect investors. The proposed AD&A is not in line with these objectives. The language of an AD&A would be boilerplate in order to discuss audit risk and independence in a comprehensive and consistent voice to demonstrate universal policies and procedures, or would be so voluminous in order to provide appropriate context to audit procedures and results that financial users would likely not read such a report.

Audit risk is addressed in the current auditing standards. If users of public financial information require education on audit risk and its relationship to the audit, then the PCAOB and the SEC in conjunction with the AICPA should plan and provide additional forums, such as literature, workshops and trainings to better disseminate the existing information. This process would be appropriate for audit procedures and auditor independence, as well.

Further, auditor independence is clearly defined in multiple existing sources and is referenced as part of the title of the audit opinion. We strongly believe that additional commentary on the topic of auditor independence would be redundant. This commentary would add more words to an already extensive and exhaustive reporting package without adding meaningful information.

Lastly, the auditor already comments on the results of the audit in the issuance of an unqualified audit opinion. If the auditor did not receive appropriate results from the audit procedures performed, the unqualified report would not have been issued. We do not believe that adding specific content about the audit procedures would provide financial statement users with any further comfort of the ultimate conclusion on the reasonableness of the financial statements, nor would knowledge of the procedures perform change their investment decisions.

*7. What types of information should an AD&A include about the auditor's views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?*

We do not recommend the use of an AD&A in total and in specific. Therefore, we do not recommend it include any content or level of detail. Information about management's judgments and estimates, accounting policies and practices is already a required disclosure in both the Form 10-K and the notes to the financial statements. We continue to assert that any further discussion by the auditor of management's judgments, estimates, accounting policies and practices, etc., would not increase transparency or relevance to the users of public financial reports.

In the existing auditor's opinion, the auditor provides reasonable assurance of the amounts and disclosures in the financial statements, the accounting principles used and significant estimates made by management, and the overall financial statement presentation. This opinion encompasses the areas that are considered to have "expanded" analysis and review. If the auditor determines that amounts or management's estimates are not properly disclosed in the financial statements in accordance with U.S. GAAP, the auditor would not issue an unqualified or 'pass' opinion. Therefore, we do not see the benefit in additional and repetitive information.

If the Board and its constituents are contending that U.S. GAAP and SEC rules do not adequately require the level of detail or clarity related to management's critical accounting measurements, auditor commentary is not the means to achieve those goals. The Board should collaborate with the FASB and SEC to clarify and/or modify U.S. GAAP through the appropriate channels.

Furthermore, the discussion of "difficult or contentious issues," including "close calls" should not be included in public disclosure. Such disclosure would certainly alter the historical management/auditor relationship and would create confusion to the users of the financial statements. It would inherently create an adversarial environment and lessen communication between management and auditor which would work contrary to the stated objectives of the Board. The disclosure would reduce transparency as management would need to manage the public disclosure risk of these items. Additionally, it is inherent in the issuance of the auditor's report that all "difficult or contentious issues" and/or "close calls" have been resolved.

Management has a responsibility to mitigate enterprise risk to preserve shareholder value. This responsibility includes the public disclosure risk, specifically reputational risk. If the disclosure of "close calls" is required, then management, in complying with its responsibilities, would become more cautious in its relationship and communication with its auditor. The result of the newly created adversarial relationship is a lengthened audit process and, consequently, increased professional fees incurred by management. Additional fees could also be incurred from other advisers engaged to reduce disclosure risk. Therefore, the transparency would be reduced by management's risk management responsibility and the relevance by the delay in public reporting. These incremental costs only detract from shareholder value without discernable benefit. Accordingly, these proposals do not meet the Board's stated objectives.

*8. Should a standard format be required for an AD&A? Why or why not?*

We do not believe that an AD&A should be required. If one was required, a standard format would be necessary for consistency and comparability. However, that in and of itself would compromise the value of the AD&A. We believe that it is moot on whether a standard format is required or not as public accounting firms would gravitate toward a standardized format that would have variations between firms based on style rather than substance, in order to mitigate their own risks associated with such disclosure.

*9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?*

As previously stated, the historical role of the auditor does not include a discussion of other risks and we believe that it should not be the future role of the auditor. Audit risk that applies to all public audit engagements is clearly defined in the auditing standards of the Board. If the Board does not believe that the current standards are adequate, then the Board should amend those standards accordingly.

As stated above, any discussion about specific audit risk related to a company would materially increase enterprise risk and alter the historical relationship between the auditor and management and run counter to the stated objectives of the Board in this Concept Release. Further, any discussions of other risks such as business, strategic and operational are management's responsibility and should remain their responsibility. These risks are already required to be disclosed in Item 1A of Form 10-K and in MD&A. Specifically, Regulation S-K 503 (c) requires that the disclosure of risks be specific to the entity. Management is required to evaluate the risks of the entity and disclose those specific risks along with an explanation of how those risks affect the Company. Furthermore, material changes in any risks disclosed in the Form 10-K are required to be disclosed in the Form 10-Q. Since an auditor is required to already read such information contained in the Form 10-K, any omission by management of a material risk would have been raised by the auditor under the requirements of Statement on Auditing Standards ("SAS") No. 8. We do not see the benefit of requiring the auditor to highlight certain or all of these disclosed risks in any separate report. Any further disclosure by the auditor of additional risks would suggest that management had not fulfilled their responsibility to properly identify and disclose the risks of the Company. Therefore, any reporting by the auditor would be redundant, or would refer to the relevant section of the 10-K where this information is already disclosed.

Further, investors should assess these risks independently of the auditor. The auditor is not tasked to be investors' advisor and it should not be in the future. Such changes to the role of the auditor would place additional material risk on the financial system as a whole, not reduce it, which we believe runs contrary to the stated objectives of the Board. The costs associated with such a change would significantly exceed any benefit.

*10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?*

We believe boilerplate language is unavoidable regardless of the regulations and/or guidance related to an AD&A. Audit firms would either likely require boilerplate language or material increases in fees to manage the additional risks associated with specific disclosures on a company by company basis. We do not believe the language would actually provide current and relevant information to investors prior to making investment decisions once interim period information was available and could increase litigation and its associated costs for companies and auditors. We also believe the threat of increased litigation risk could reduce transparency and relevance if it results in less meaningful disclosure.

*11. What are the potential benefits and shortcomings of implementing an AD&A?*

We do not anticipate any benefits in the implementation of an AD&A. Its shortcomings are numerous and delineated in detail in the previous responses. To summarize, the proposal would change the historical relationship of the financial statement auditor and management. An AD&A would also increase risk for both the company and the auditor, thus increasing compliance cost for the company and reducing enterprise value. An AD&A does not promote transparency or relevance and, therefore, should not be implemented.

*12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?*

We believe that inconsistent, or competing, information would be minimal over the long term. In general, management, which is tasked to minimize enterprise risk, will work toward virtual symmetry in the reporting of management and the auditor. There will be significant cost to companies to reach this long-term state. The result will be a less transparent disclosure by management.

13. *Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making decisions? If so, how would they be used?*

We believe that the types of matters suggested for emphasis paragraphs would not be relevant or useful. We question the extent to which financial statement users are presently reading the financial statements, related notes and other information contained in public filings. As such, a requirement by the auditor to emphasize certain aspects of the financial statements will further encourage financial statement users to focus only on what they will interpret as the most important aspects of the financial statements as highlighted by the auditor. The critical accounting policies and key estimates made by management are disclosed in detail in the critical accounting policies section of Management's Discussion and Analysis ("MD&A") and in the financial statement notes. Additionally, financial statement notes are required to explain management's significant accounting policies. These critical accounting policies and the notes referenced within, if completed in accordance with U.S. GAAP and SEC rules, sufficiently provide the reader of the financial statements with the information needed to understand the financial statement areas the auditor spends a significant amount of time on during the audit. Any other significant transactions that would be relevant during an accounting period would have been highlighted by management both in MD&A as well as the notes to the financial statements. Highlights from the auditor would not be necessary.

14. *Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?*

We do not believe that the Board should require the reporting of areas of emphasis together with key audit procedures. As discussed in our response to Question 13, the relevant and necessary information is already included in the financial statements, notes and MD&A. An emphasis paragraph would be redundant as it would be pointing out areas already discussed in the notes and MD&A. Also, this concept relies on the auditor to make key judgments as to what might be important to a financial statement user, which would likely differ from one financial statement user to the next. We do not believe that it is the auditor's responsibility to be making determinations on which matters to highlight separate and apart from the financial statements as a whole. Such emphasis, as we mentioned previously, could result in the financial statement user focusing on those areas highlighted by the auditor and encourage users not to read the financial statements and notes thereto in their entirety.

Additionally, any descriptions of the auditor's procedures could not provide sufficient detail to enable a reader to completely understand the depth of the audit procedures performed by the auditor. Those procedures without context, including a thorough understanding of internal controls over financial reporting, could be misunderstood as to sufficiency and completeness on the part of the financial statement user. The process of how the auditor assesses management's estimates and judgments is described in various publications available to the public and would not add value if disclosed in every auditor's report on a public company's financial statements. We believe that it would be more appropriate for the PCAOB and the SEC in conjunction with the AICPA to provide educational forums to better disseminate information already available to the public.

15. *What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?*

None, as noted above.

16. *What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?*

None, as noted above.

17. *How can boilerplate language be avoided in required emphasis paragraphs while providing consistency amount such audit reports?*

We believe that boilerplate language would be unavoidable. The potential legal ramifications of the auditor highlighting specific disclosures and not others would lead to high level, non-value added, boilerplate language used by every firm. Further, "boilerplate" language would be a necessity in order to promote relevancy to the financial statement users. The current comparability of the auditor's opinion is essential to financial statement users as to understand multiple companies under a common framework.

Additionally, emphasis paragraphs would change the historical role of the auditor into that of an analyst. The current marketplace already has individuals and firms who provide this market and analysis service.

18. *What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?*

We believe that there are no potential benefits, but there are numerous shortcomings to implementing required emphasis paragraphs. Most importantly, emphasis paragraphs would not provide additional value to the financial statement users because (1) they would likely be boilerplate, (2) they would encourage the financial statement users to focus on information that may or may not be relevant to them, and, (3) at best, they would be repetitive of the critical and significant accounting policies already reported. We believe that emphasis paragraphs could mislead readers by focusing the user on information the auditor believes would be most significant to a financial statement user and distract the users' attention from other important aspects of the financial statements as a whole.

*19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?*

No, we do not believe that auditor assurance on other information outside of the financial statements is necessary. Since the audit report is filed along with the financial statements in the Form 10-K, the auditor is already associated with the other information in the document containing the audited financial statements. Furthermore, the auditor is already required under SAS No. 8 to perform certain procedures. We believe that the level of responsibility under SAS No. 8 is sufficient and does not need to be expanded.

MD&A is intended to provide narrative explanation of the financial statements and other statistical data that management believes will enhance financial statement users' understanding of the financial results of the company, as well as the inclusion of forward-looking information. An auditor should not be expected to opine on forward-looking information, nor on management's judgment on what will enhance users' understanding of a company's results or what trends or uncertainties it faces. The MD&A is intended to be the view through the eyes of management, <u>not</u> the auditor. Any attempt to provide assurance of such disclosures may result in management eliminating such information that financial statements users find useful in developing their investment valuation models. An opinion by an auditor with respect to this information will not make it more reliable. In fact, an opinion by the auditor on such information would likely be misinterpreted by a financial statement user as to its reliability. Further, the cost associated with an auditor moving beyond verification of historical financial information to being responsible for forward-looking and other MD&A commentary would be burdensome, result in lengthier audits and detract from shareholder value. We believe that there is sufficient information in the financial statements and notes that provide investors with adequate disclosures about a company. If the Board does not believe that there is adequate disclosure in the current financial statement presentation, it should work through the FASB and the SEC to make the desired changes.

> *a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.*
>
> We do not support auditor assurance on other information outside the financial statements. We believe this has numerous negative consequences to the financial statement reporting process without any corresponding, cost effective benefit.
>
> *b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.*
>
> We do not support auditor assurance on information outside the financial statements.
> See comments above.
>
> *c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?*
>
> As we have previously discussed, the auditor is already required under SAS No. 8 to read the other information contained outside of the financial statements and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of presentation appearing, in the company's financial statements. We believe that this level of responsibility is sufficient and appropriate for the auditor. We do not believe that it is appropriate, nor do we see the cost benefit of having an auditor provide a higher level of assurance. We are unclear as to why the current responsibilities of the auditor under SAS No. 8 do not meet the Board's objectives for information outside of the financial statements.

*d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?*

We do not support the auditor providing assurance on MD&A in part or in whole. We believe that the auditor's responsibilities under SAS No. 8 currently provide the required level of review necessary. If the Board believes that the auditor's responsibilities under SAS No. 8 are unclear to financial statement users then we believe that the Board should address that in the appropriate education forum.

*e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?*

We do not believe that that auditor reporting on MD&A would affect the nature or quality of MD&A components that discuss the results of operations because those disclosures are addressing the historical financial statement results. However, if the auditor would be required to opine on forward-looking statements or other commentary in the MD&A, then we would anticipate less disclosure rather than more as companies felt more constrained on providing guidance or other market-related outlook information, which would reduce transparency to the financial statement users and run counter to the goals of the Concept Release.

*f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?*

We believe that the requirements in the Board's attestation standard, AT sec.701 are sufficient to provide appropriate level of auditor assurance on other information outside the financial statements.

*g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.*

Information is presently communicated by management to investors, analysts and financial statement users through quarterly press releases, earnings calls, Form 10-Q and Form 10-K filings, proxy statements and other event-driven filings. Investors, analysts and others are using this information to make investment decisions, despite not having an opinion or other commentary by an auditor. It is inconsistent to propose that a separate reporting model on information contained outside the financial statements, or expansion of the auditor's reporting model in connection with the annual audit would provide users with a greater level of comfort over the financial statements when decision-making information is disseminated by management and used by financial statement users throughout the year. To make this Concept Release relevant to financial statement users, a year-round reporting requirement would be necessary which would be neither cost effective nor result in the dissemination of timely information to the financial statement users.

*20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?*

We see no benefits of implementing auditor assurance on other information outside the financial statements. We believe the objectives of the Board and the Concept Release can be met without additional auditor assurance. The shortcomings include increased audit fees and workload. This will occur regardless of company size and available financial resources. The corresponding increased internal work will continue to strain limited resources while not adding any value. Furthermore a requirement to provide assurance on qualitative disclosures would add significant time and complexity to the audit. We do not believe these changes are necessary because adequate protocols, including SAS No. 8, currently exist that allow investors to rely on information outside the financial statements.

*21. The Concept Release presents suggestions on how to clarify the auditor's report in the following areas:*

- *Reasonable assurance*
- *Auditor's responsibility for fraud*
- *Auditor's responsibility for financial statement disclosures*
- *Management's responsibility for the preparation of the financial statements*
- *Auditor's responsibility for information outside the financial statements*
- *Auditor independence*

*a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?*

We believe that certain of the above items could be clarified in the audit report. However, we do not believe that these clarifications are necessary, as the responsibilities and role of the auditor are clearly defined in auditing standards. We do not support an overhaul of the report as an auditor's full responsibility cannot be meaningfully explained in such a report. As we have mentioned previously, information regarding auditor responsibility and the standards under which an audit is conducted, are publically available for interested parties. Including them as part of the audit report would only add volume, but not clarity to users of the financial statements.

We believe that the items underlined in the following example audit report could be included in the current report, with no incremental procedures required by the auditor. A discussion of our rationale for each inclusion follows the example audit report.

Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders of XYZ Company:

We have audited the accompanying balance sheets of XYZ Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. Our audits also included the notes to the consolidated financial statements and the financial statement schedule, Schedule II-Valuation and Qualifying Accounts. These financial statements, notes to the financial statements and financial statement schedule have been prepared by and are the responsibility of the Company's management. Our responsibility is to express an opinion on the financial statements, notes to the financial statements and financial statement schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above and the related notes and financial statement schedule present fairly, in all material respects, the financial position of the XYZ Company as of December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.

As required by Statement on Auditing Standards (SAS) No. 8, we read the information in the Company's 20X3 Form 10-K ("other information") in addition to the financial statements, notes to the financial statements and financial statement schedules covered by this report. The objective of the reading was to consider whether the other information was materially inconsistent with information appearing in the financial statements. SAS No. 8 does not require that we perform, and we did not perform, any procedures to corroborate the other information and therefore we do not express an opinion on the other information. However, as a result of reading the other information, we did not conclude that there were any material inconsistencies between the other information or the manner of its presentation, and the information appearing in the financial statements or its manner of presentation.

i. Reasonable assurance

If there is any confusion on the part of financial statement users with respect to the level of assurance that is being obtained from the audit report, then expanding the discussion on how reasonable assurance is defined will not provide financial statement users with any more comfort. We believe that it would be appropriate to define reasonable assurance by what it is not: absolute assurance.

ii. Auditor's responsibility for fraud

We believe that it is appropriate that the auditor's responsibility for fraud can also be described by stating that the auditors provide reasonable assurance that the financials and corresponding schedules and notes are free of material misstatement "whether due to error or fraud."

iii. Auditor's responsibility for financial statement disclosures

While each financial statement included in a company's financial statements is required to include the statement that "the notes to the financial statements are integral to the statements," we believe that additional language could be added to the auditor's report to explicitly identify that the notes to the financial statements are covered by the audit report.

iv. Management's responsibility for the preparation of the financial statements

Although it seems that the current statement contained within the audit report that "the financial statements are the responsibility of the Company's management" sufficiently denotes responsibility to a financial statement user and also implies that management would therefore have prepared such statements (or have been responsible for the oversight of their preparation), if financial statement users would find that an explicit statement would provide additional clarity as to the party responsible for preparation, then we do not object to such an inclusion.

v. Auditor's responsibility for information outside the financial statements

Because the audit report is included along with the financial statements in the Form 10-K, the auditor becomes associated with the other information in the document containing the audited financial statements. Consequently, the auditor is already required under current SAS No. 8 to perform certain procedures. We believe that inclusion of the proposed paragraph would delineate the responsibility of the auditor between the financial statements and the other information included in the document containing such financial statements and related audit report. Since an auditor is already performing the procedures required by SAS No. 8, we do not believe that any incremental time or costs would be associated with including this standard paragraph in the audit report.

vi. Auditor independence

We believe that *Auditor Independence* should not be included in the audit report. The audit report is titled "Report of Independent Registered Public Accounting Firm." Additional discussion of independence in the audit report is therefore redundant and provides no value to the financial statement user. Furthermore, an audit firm is either independent or it is not. If a firm is no longer independent, it cannot opine on the financial statements. It is the responsibility of the audit committee and the audit firm to evaluate the auditor's independence. Any other information not already disclosed in the proxy statement would therefore not be relevant to the conclusion on independence. Financial statement users interested in an audit firm's system of controls surrounding independence may obtain that information directly from the audit firm.

*b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.*

Overall, these clarifications would not materially enhance the audit report nor would it help readers understand the audit report and the auditor's responsibilities, as we question whether financial statement users are presently reading the audit report. As we have previously discussed, the responsibility of the auditor is clearly and succinctly explained in the audit report. Further information on the specifics of conducting an audit is publicly available to interested users through the PCAOB, the SEC and the CAQ. The audit report is not the forum to explain such roles and responsibilities.

*c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?*

No other clarifications or improvements should be made to the audit report.

*d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?*

For the changes that we support above, there would be no changes to the scope of the audit or to the auditor's responsibilities that would be necessary. We do not support changes to the audit report that will result in incremental audit time and expense.

*22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?*

We do not believe that there are significant benefits to adding language to the audit report. Clarifications are already available to financial statement users who have an interest or desire in understanding the role and responsibility of the independent auditor through the CAQ, SEC and PCAOB.

We believe that the audit report in its current form with unqualified opinions or those containing explanatory paragraphs is appropriate. Adding length and terminology to the report would further discourage readers from reading it.

*23. This Concept Release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?*

We believe that the desire to improve auditor communication in this Concept Release will have the unintended consequence of absolving the financial statement user from the responsibility to read information already contained in financial statements and the Form 10-K and to have a comprehensive understanding of the audit process. Except for certain clarifications to the existing auditor's report as previously discussed, we do not believe the alternatives presented are appropriate.

*24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?*

No. We do not believe that any of the alternatives would be more effective in improving the auditor communication.

*25. What alternatives not mentioned in this concept release should the Board consider?*

If the Board believes that financial statement users require additional understanding of the audit process, the Board should collaborate with the CAQ and SEC to provide education to users of the financial statements with respect to the role of the independent auditor. User-education would eliminate the need to add already publically-available information to the audit report, and would appropriately retain the responsibility of reading and understanding the financial statements and related notes with the financial statement user.

*26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?*

We do not believe that this is necessary based upon our responses to the questions in this letter.

*27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?*

As discussed above, this proposal under the guise of improving auditor communication will have the unintended consequence of absolving the financial statement user from the responsibility of having a comprehensive understanding of the audit process in addition to reading information already contained in financial statements and the Form 10-K. Hence, any incremental elements to the audit report merely add "noise" to the ultimate conclusion that, at a reasonable level of assurance, the financial statements and related notes are a fair presentation and in all material respects, in accordance with U.S. GAAP. To suggest otherwise undermines the pass/fail notion of an audit. If the auditor reached the appropriate conclusion based upon the audit procedures performed, then any spectrum of pass is already determined to be materially correct (i.e., the financial statements and notes do not contain or omit material information that would impact a financial statement user).

*28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?*

We do not believe that users of financial statements need to be educated about the auditor's role in the performance of an audit through the audit report. Auditing standards are available to the public, and information regarding the role of the independent auditor is provided through the PCAOB, the SEC and the CAQ. There is a presumption that users of financial statements are informed and educated about the information they are reading. There is also a presumption that they are reading the audit report. Should a user of the financial statements find him/herself uninformed about the information referenced in the audit report, financial statements or filings, there are a multitude of places one could research and find the information sought.

*29. What effect would the various alternatives have on audit quality? What is the basis for your view?*

We do not believe that any of the alternatives presented would have an effect on audit quality. Audit quality is monitored both internally by the large accounting firms as well as externally by the Board. Certain of the alternatives proposed by the Board will, however, add considerable time and costs. Audit quality would only be affected if sufficient time is not allowed for the auditor to complete the incremental procedures that would be necessary for certain of the alternatives.

*30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the Concept Release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.*

Any changes to the audit report should apply to all entities, regardless of industry, size or filing status. However, the alternatives presented by the Board that require an increase in audit scope and procedures would add significant audit time and expense for all entities.

*31. This Concept Release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.*

*a. Are any of these considerations more important than others? If so, which ones and why?*

All of these effects are significant considerations that should be considered carefully by the Board. We believe that the changes proposed in the Concept Release will reduce shareholder value through increased professional fees without discernable benefit and heighten enterprise risk, thus leading to increased liability considerations and potentially damaging a company's ability to control the release of confidential or competitive information. The proposals in this Concept Release combined with the Board's other proposal to require the rotation of auditors[2] will lead to a significant deterioration of the relationship between the auditor and management as there will be less incentive to the auditor to collaborate with a company's management to protect a company from risk associated with disclosure of competitively harmful information.

*b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?*

Any changes to the auditor's reporting model will result in increased time and expense associated with the audit. Expanded reporting would necessitate audit firms to create or expand an internal centralized review of such reports, which increases the time and expenses associated with issuance of an audit report. Contrast this to the current unmodified report, which does not create the incremental costs, yet has appropriately and succinctly reported the results of the audit for many years. These costs will reduce shareholder value with no actualized benefits.

*c. Are there any other considerations related to changing the auditor's report that this Concept Release has not addressed? If so, what are these considerations?*

No further comments.

*d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?*

Not applicable

*32. The Concept Release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?*

It is clear that the many aspects of the alternatives would result in a greater number of disagreements between management and the auditor than are currently experienced in practice. The difficulty with many of the alternatives in the Concept Release is that they rely on the judgment of the auditor without objective criteria by which to evaluate those judgments. We question whether the creation of objective criteria could be accomplished, as there are numerous examples where U.S. GAAP and SEC rules lack objective criteria. These differences of opinion could result in stalemates and an inability to resolve matters, ultimately impacting the timeliness of the completion of the audit, the information management

[2] PCAOB Release No. 2011-006 Concept Release on Auditor Independence and Audit Firm Rotation

is making publicly available to users of the financial statements, and certainly the relationship between the audit committee, management and the auditor. It is certain that many of the alternatives included in the Concept Release would result in increased time spent by both management and the audit committee, both of whom are already challenged on time.

If you have any questions about our comments or wish to discuss any of these matters further, please contact me at (312) 436-4282.

Yours sincerely,

Richard H. Fleming

Richard H. Fleming
Executive Vice President and Chief Financial Officer

Vanguard

P.O. Box 2600
Valley Forge, PA 19482-2600

October 12, 2011

*Submitted Electronically*

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

**Re: Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Rulemaking Docket Matter No. 34**

Dear Members of the Public Company Accounting Oversight Board:

Vanguard appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB") *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "Concept Release"). We appreciate the PCAOB's focus on the concerns of investors in relation to financial statements and proposed enhancements to the auditor's reporting model and we commend the PCAOB for seeking input from various stakeholders who participate in the audit and financial reporting process, including an issuing company's management, independent auditors and investors. As discussed below, we support meaningful disclosures in annual reports that focus on matters of critical importance to investors by means of enhancements that are workable within the current regulatory reporting framework. Accordingly, we recommend the expanded use of meaningful emphasis paragraphs which identify significant risks in the financial statements and how the auditors responded to those risks, as well as clarifying language in the standard auditor's report.

As both a *consumer* of financial information and *issuer* of hundreds of financial statements, we believe that Vanguard brings a special perspective to the debate. Vanguard offers more than 170 U.S. mutual funds holding assets of approximately $1.6 trillion at August 31, 2011. Each of these mutual funds is registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940 and their shares are registered with the SEC under the Securities Act of 1933. Investment companies, as issuers of securities, are required to file audited financial statements with the

SEC and mail annual and semi-annual reports to their shareholders within designated time frames under SEC rules. In addition, in their capacities as investors in the securities markets, investment companies review and analyze companies' financial statements that are filed with the SEC when making investment decisions on behalf of their investors.

Current roles of management and auditors should not change

We recognize that management is responsible for preparing a company's financial statements and, as such, management should continue to be the primary source of disclosure about the company with primary liability for errors and omissions in that disclosure. Financial statements are often lengthy and complex and typically include an extensive set of notes that describe in further detail items included on the balance sheet, income statement and cash flow statement. Because financial statements are so detailed, it can be difficult for investors reviewing financial statements to identify those areas of significant importance to understanding the results of operations and financial condition of issuers. Sophisticated investors who understand the detailed financial statements would also benefit from additional information about areas in the financial statements involving significant management estimates or judgments.

While management is responsible for preparing the financial statements, the audit process is valuable and during the course of that process auditors may gain unique and relevant insight into a company that could be useful to an investor in terms of helping the investor navigate and understand management's disclosures in the financial statements. The auditor's report is the means by which auditors communicate to investors. Given the valuable nature of the audit process, we believe that the auditor's report could be enhanced to be more informative for investors. That being said, any changes to the auditor's reporting model should be practical and implemented in a measured way that balances the benefits of any changes with the potential increased burdens on issuers and auditors within the established regulatory reporting framework. For example, on balance, it may not be practical to implement new requirements to include Auditor's Discussion and Analysis (AD&A) in annual reports. In our view, any changes that would impose significant and unnecessary burdens on issuers or auditors without meaningful disclosure enhancements would not ultimately benefit investors.

Vanguard supports meaningful emphasis paragraphs in the auditor's report

It is our view that the auditor's report accompanying the financial statements could be enhanced to the benefit of investors by expanding the use of so-called emphasis paragraphs, which direct readers of the report to areas of special interest and significance in the accompanying financial statements. Drawing on the auditor's unique insight into the company, expanded use of emphasis paragraphs, when applicable, would allow auditors to highlight for investors the area or areas that the auditor considers to be the most significant to a better understanding of the financial statements, and would identify for investors where these significant matters are more fully disclosed in the financial statements and the accompanying notes.

As proposed in the Concept Release, emphasis paragraphs could be used to highlight areas of the financial statements that include significant management judgments and estimates and areas with significant measurement uncertainty.[1] Within these emphasis paragraphs, auditors would be required to discuss the audit procedures performed on the emphasized matters. The emphasis paragraphs should be substantive and not reduced to boilerplate, which would not be helpful to investors. The expanded use of emphasis paragraphs in the auditor's report could also potentially increase the quality of management's disclosures in the financial statements.

Importantly, emphasis paragraphs would not undermine management's ultimate responsibility for the statements themselves and accompanying disclosure. The use of emphasis paragraphs would, rather, allow investors more transparency into those areas of the company's financial statements, if any, that involve significant management judgments and estimates or areas with significant measurement uncertainty. Emphasis paragraphs would provide useful guidance to investors as to how the auditors satisfied themselves that significant estimates are reasonable without being unduly costly or burdensome to either auditors or issuers.

<u>If no matters of emphasis exist, the auditor should make that affirmative statement</u>

To be useful to investors, emphasis paragraphs should be used to highlight areas in the financial statements that involve significant management judgments and estimates and areas with significant measurement uncertainty. However, the financial statements of many issuers may not be dependent upon significant management judgments and estimates and areas with significant measurement uncertainty, and under those circumstances, there will be nothing that the auditor should be *required* to emphasize. In these instances, it is our view that the use of emphasis paragraphs should not be imposed as a requirement. In addition, we believe that required emphasis paragraphs in auditor's reports could potentially cause investors to rely solely on auditors' reports, potentially limiting the extent to which investors otherwise read the financial statements, which should continue to be the primary source of investor information about the results of operations and financial condition of an issuer. Requiring emphasis paragraphs may serve to lessen the impact and effect of such paragraphs, resulting in unnecessary boilerplate that could detract from a better understanding of the accompanying financial statements, which would not benefit investors. In light of the fact that emphasis paragraphs may not be required in some annual reports, in those instances we recommend that the auditors be required to state affirmatively that the financial statements do not contain any significant management judgments and estimates or areas with significant measurement uncertainty.

[1] As acknowledged in the Concept Release, we recognize that PCAOB would need to develop new auditing standards in collaboration with the SEC and FASB to direct auditors in determining the specific types of matters that should be emphasized in the auditor's report.

We also support adding clarifying language to the existing standard auditor's report. We recognize that some investors may not fully understand the financial statement preparation process, or what an audit represents, or the related auditor responsibilities. Accordingly, we believe that providing investors with an explanation and clarification around what an audit represents, the auditor's responsibilities, and certain terminology could meaningfully increase financial statement users' understanding and knowledge of the audit process and the auditor's report.

* * * * *

Vanguard appreciates the opportunity to provide these comments on the PCAOB's Concept Release.

Sincerely,

/s/ Gus Sauter

Managing Director and
Chief Investment Officer

/s/ Glenn Reed

Managing Director,
Strategy and Finance Group

**September 9, 2011**

From:
Gilbert F. Viets
2105 North Meridian, Suite 400
Indianapolis, Indiana 46202

gilviets@aol.com
Phone: 317 513 5407

To:
**Office of the Secretary, PCAOB,**
**1666 K**
**Street, N.W., Washington, D.C. 20006-2803**

**Subject: Docket 034, PCAOB Release No. 2011-003, CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS**

To Members of the Public Company Accounting Oversight Board:

Thank you for your work and this opportunity to comment on concepts being considered for audit reports.

Most responders to this comment request have fundamental positions. Once that position is clear, the comments are better understood. My responses to each of the questions for which you seek comment are consistent with concerns I have about the public accounting profession. You may interpret my comments from the following convictions about audit firms reached several years ago:

a. Professional accounting firms are not properly governed or capitalized.
b. Nor are they committed to proper professional standards.
c. The public deserves financial and qualitative information about CPA firms.
d. Independence is routinely compromised in audit work.
e. CPA Firm ethics are diluted to the lowest level acceptable among organizations permitted to practice as part of CPA firms.
f. Regulation today is rationalization among friends, and
g. PACs and lobbying have no place in this profession.

Some of these concerns have been partially addressed. But other proposals, including those in the Concept Release, only burden a flawed foundation needing to be fixed fixed. The concept proposals will cost more in audit fees, non productive work for registrants and standard language in annual reports that satisfy legal protective concerns while blurring investors' vision. These likely results are not the objectives sought, whether or not you share my specific concerns about the profession.

The U. S. Treasury Advisory Committee on the Audit Profession had much discussion on some of the seven convictions and other structural concerns, but action to its recommendations appears to be dormant in many cases.

It is my avid wish the responses herein are taken as constructive suggestions, not criticism of efforts and ideas of others. The responses are my own, not of any organization with which I am affiliated. It would be a pleasure to discuss these observations with you if you desire. My contact information is shown above.

Sincerely,

Gilbert F. Viets

ATTACHMENT: 15 pages

**PCAOB Release No. 2011-003**
**CONCEPT RELEASE ON POSSIBLE REVISIONS TO PCAOB STANDARDS RELATED TO REPORTS ON AUDITED FINANCIAL STATEMENTS AND RELATED AMENDMENTS TO PCAOB STANDARDS**

**Answers of G. Viets**

QUESTIONS

1. Many have suggested that the auditor's report, and in some cases, the auditor's role, should be expanded so that it is more relevant and useful to investors and other users of financial statements.

a. Should the Board undertake a standard-setting initiative to consider improvements to the auditor's reporting model? Why or why not?

***Answer: No. "Fairly stated" and "in accordance with GAAP" are appropriate standards against which auditors should report. Stay focused on why failures occur in achieving these objectives.***

b. In what ways, if any, could the standard auditor's report or other auditor reporting be improved to provide more relevant and useful information to investors and other users of financial statements?

***Answer: Do not revise the standard audit report. Investors should look to management for information about the financial condition of the company. If the auditor disagrees with management, they should report the disagreement under existing standards.***

c. Should the Board consider expanding the auditor's role to provide assurance on matters in addition to the financial statements? If so, in what other areas of financial reporting should auditors provide assurance? If not, why not?

***Answer: No. The auditor reads other information in documents that include audited financial statements. If the auditor finds that such information contradicts the financial statements, they must investigate and resolve the differences to assure the statements are correct. The process improves both the audited financial information and the unaudited company information if done properly.***

2. The standard auditor's report on the financial statements contains an opinion about whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in conformity with the applicable financial reporting framework. This type of approach to the opinion is sometimes referred to as a "pass/fail model."

a. Should the auditor's report retain the pass/fail model? If so, why?

***Answer: Yes. It is simple. If the answer is "fail," the auditor can write as much as they want, and they should. If accounting principles result in unfair presentations, change those.***

b. If not, why not, and what changes are needed?

***Answer: Not applicable.***

c. If the pass/fail model were retained, are there changes to the report or supplemental reporting that would be beneficial? If so, describe such changes or supplemental reporting.

***Answer: The identification of the issuing office of the auditor is unnecessary and implies some limitation on the use of available firm resources and responsibility. Otherwise, there is nothing wrong with the report except that it is sometimes misapplied, i.e. it says the statements are correct when they are not; that is an auditor problem, not a language problem.***

3. Some preparers and audit committee members have indicated that additional information about the company's financial statements should be provided by them, not the auditor. Who is most appropriate (e.g., management, the audit committee, or the auditor) to provide additional information regarding the company's financial statements to financial statement users? Provide an explanation as to why.

   ***Answer: Management! If company management is incapable of communicating with investors, the board of directors should correct the problem. If management is prevented from communicating with investors because of some regulatory directive, it is a disservice to management and to investors. The more we look to auditors or the audit committee to provide the information, the less independent they become.***

4. Some changes to the standard auditor's report could result in the need for amendments to the report on internal control over financial reporting, as required by Auditing Standard No. 5. If amendments were made to the auditor's report on internal control over financial reporting, what should they be, and why are they necessary?

   ***Answer: Reports on internal controls are a noble objective, but need reconsideration. Consider eliminating required reports on internal control. It is a costly mandatory exercise, not based on established, commonly understood, acceptable standards, and performed by people untrained in control systems. Reports give false comfort, addressing only the past, not the future. Nearly all "material weaknesses" reports are based on material adjustments required after mistakes have occurred and damage done.***

***The requirement failed to disclose backdating of pricing stock options, large commitments on derivative instruments, bad credit standards of financial institutions, non existence of assets and non disclosure of real liabilities. Why mandate procedures that miss the obvious?***

***A change that could help companies and investors would be to orient the reports to the future, not the past. For example, if some experts were to do sufficient work to say:***

> ***"…We have studied this system and, considering what is planned and foreseeable during the next year by XYZ, Inc., the procedures provided in this system will identify all transactions and information necessary to currently and properly classify and report the necessary information for shareholder reporting under generally accepted accounting principles…"***

***Such a report, as paraphrased, may best be done by someone other than the traditional, historical financial statement auditor. This alternative, at least, reaches into the future attempting to anticipate and prevent bad things from happening rather than reporting what has already happened.***

***There should be no regulatory distinction among public companies, based on market capitalization, as to whether a review and report on internal controls is required. Complexity and risk have nothing to do with market capitalization. Public companies must accept the responsibility of timely, accurate and fair reporting.***

5. Should the Board consider an AD&A as an alternative for providing additional information in the auditor's report?

***Answer: No.***

a. If you support an AD&A as an alternative, provide an explanation as to why.

***Answer: N/A.***

b. Do you think an AD&A should comment on the audit, the company's financial statements or both? Provide an explanation as to why. Should the AD&A comment about any other information?

***Answer: N/A***

c. Which types of information in an AD&A would be most relevant and useful in making investment decisions? How would such information be used?

***Answer: N/A***

d. If you do not support an AD&A as an alternative, explain why.

***Answer: Today's financial statements for public companies are valuable documents with tremendous amounts of information if read thoroughly and thoughtfully. Good auditors test the information based on the auditor's determination of how much risk the auditor is willing to accept that something is incorrect and not discovered in the tests. An investor is challenged to digest the financial information, without also having to participate in evaluating auditors' testing decisions.***

***Unfortunately, auditors have made many bad testing decisions in the last fifteen years, and the rate of bad decisions seems to be increasing. The audit industry response is liability limitation through contracting, inadequate risk capital, entity diffusion (networks), legislation, confidential legal settlements and general lack of transparency about their own business models to investors and to their own partners. Better audit techniques have not been developed, or if developed, not applied.***

***This proposal tends to transfers auditor responsibility for scope decisions to the investor.***

e. Are there alternatives other than an AD&A where the auditor could comment on the audit, the company's financial statements, or both?
What are they?

***Answer: Yes. The present audit report is the best alternative. Also, auditors can and should comment to the audit committee. If the auditors disagree with management on important issues, they should report that disagreement. The necessary vehicles exist already if all parties do their job. Failures we have seen are not the result of lack of opportunity and responsibility to properly report and disclose what investors should be told. The PCAOB should hold audit firms responsible for doing what they are reasonably and professionally responsible to do now under existing reporting standards.***

***The PCAOB has made good progress in review of audit practices. But, the PCAOB and all would benefit from immediate attention to large known and suspected audit failures, similar to the approach used by the National Transportation Safety Board to review and preserve evidence following airplane accidents. The damage caused is great and the free market can't really afford to bury the causes in confidential legal settlements.***

6. What types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., audit risk, audit procedures and results, and auditor independence)?

***Answer: N/A.***

7. What types of information should an AD&A include about the auditor views on the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A (i.e., management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls")?

   ***Answer: N/A.***

8. Should a standard format be required for an AD&A? Why or why not?

   ***Answer: N/A.***

9. Some investors suggested that, in addition to audit risk, an AD&A should include a discussion of other risks, such as business risks, strategic risks, or operational risks. Discussion of risks other than audit risk would require an expansion of the auditor's current responsibilities. What are the potential benefits and shortcomings of including such risks in an AD&A?

   ***Answer: These risks should be discussed by management. If the auditor must be the one to discuss them, something is wrong with management's sense of responsibility to owners and investors.***

10. How can boilerplate language be avoided in an AD&A while providing consistency among such reports?

    ***Answer: N/A.***

11. What are the potential benefits and shortcomings of implementing an AD&A?

    ***Answer: There is no benefit. The shortcoming is that it makes the auditor discussion a primary focus when it should be secondary, used for exceptions to which the auditor must draw attention if management will not do so.***

    ***It is not correct to conclude that auditors do it anyway, so it shouldn't cost more. It will cost more. Wording will become crucial, and it will be diluted to defensive language that is uninteresting to read and difficult to understand. It will not be the frank memo that should exist in the file of the audit team that can and should openly discuss rumors, suspicions and other concerns and how the auditor determined disposition of the issues. Deliberations on what an AD&A should say will have a negative impact on the frankness of the memo that now exists in most audit team files for fear that conformance between the two is desirable; it isn't.***

12. What are your views regarding the potential for an AD&A to present inconsistent or competing information between the auditor and management? What effect will this have on management's financial statement presentation?

***Answer: The Annual Report to Shareholders or to the Securities and Exchange Commission is not a debate between the auditor and the company. If the auditor disagrees with management, there is ample opportunity to resolve the issue with the audit committee, and to disclose the issue if not resolved. If that is not happening, it is not because of the lack of an AD&A and it will not be corrected by adding one.***

13. Would the types of matters described in the illustrative emphasis paragraphs be relevant and useful in making investment decisions? If so, how would they be used?

    ***Answer: The opportunity for emphasis paragraphs exists now, but they should be used judiciously to achieve desired emphasis. Mandating emphasis dulls deserved attention.***

14. Should the Board consider a requirement to include areas of emphasis in each audit report, together with related key audit procedures?

    ***Answer: No.***

a. If you support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

   ***Answer: N/A.***

b. If you do not support required and expanded emphasis paragraphs as an alternative, provide an explanation as to why.

   ***Answer: Emphasis paragraphs should be used rarely.***

   ***It does little good to require auditors to give a partial explanation, at best, of what their procedures may have been. It would mislead investors to mandate emphasis paragraphs just for the sake of choosing something to say. Auditors are trained to make the choice of what and how to audit. Investors should not get into the position of blessing procedures disclosed, through lack of objection to auditor discussion of emphasis. Auditors are not restricted in choosing to do whatever they want to do to reach conclusions on information based on their own measurement of risk they might be wrong.***

15. What specific information should required and expanded emphasis paragraphs include regarding the audit or the company's financial statements? What other matters should be required to be included in emphasis paragraphs?

    ***Answer: N/A***

16. What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

    ***Answer: N/A.***

17. How can boilerplate language be avoided in required emphasis paragraphs while providing consistency among such audit reports?

***Answer:* Don't make emphasis paragraphs mandatory. As used today, emphasis paragraphs are not boilerplate. Consistency among audit reports is not necessarily a good objective. If something is said only because it is required of all, how does an investor recognize what is really different, requiring special attention?**

18. What are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

***Answer:* There would be little, more likely negative, benefit from mandating this reporting by auditors. It would result in misunderstanding of what the auditor does and what the full scope of the auditor responsibility is.**

***Implications of required emphasis could be personal and severe. At the extreme, an auditor might be required to discuss emphasis on individual executives because of their lifestyles, internal squabbles among executives or mental and physical health concerns of key executives. Auditors are not blind to social issues in setting their testing scopes.***

***On the other hand, is there any evidence that mandated emphasis paragraphs would have prevented the problems experienced in the last decade from back dated stock options, subprime lending, non disclosed liabilities and nonexistent assets? What could an investor have done if the audit report had discussed areas of emphasis?***

19. Should the Board consider auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model?

***Answer: No. The Board should consider the assurance that already exists. There are schedules in the Annual report to the Commission that require audit opinions and, in some cases, auditors are required to give specific procedure reports to major creditors, e.g. loan covenant compliance. Auditors review and sometimes audit quarterly financial information. Auditors must now read other information in documents containing their audit report to satisfy themselves that the other information does not contradict what is in the financial statements.***

***Further required intrusion by auditors into information and communication with shareholders shows incredibly low regard for the integrity and ability of company management and incredibly high regard for auditors' ability to be the gatekeeper for all information that anyone might want. We cannot audit our way to integrity. Auditing is a costly, non productive exercise, focused on the past rather than the future. Auditing should be used sparingly.***

a. If you support auditor assurance on other information outside the financial statements as an alternative, provide an explanation as to why.

***Answer: N/A.***

b. On what information should the auditor provide assurance (e.g., MD&A, earnings releases, non-GAAP information, or other matters)? Provide an explanation as to why.

***Answer: N/A.***

c. What level of assurance would be most appropriate for the auditor to provide on information outside the financial statements?

***Answer: Read it. Discuss it with management if it contradicts information in the audited financial statements to assure the financial statements are not misleading. Resolve issues with audit committee and report the issues in the audit report to shareholders if they are not resolved to auditor satisfaction. These procedures are already required.***

d. If the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why?

***Answer: N/A.***

e. Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? If so, how?

***Answer: No, not if the auditor is doing the job they are supposed to be doing in auditing the basic financial statements.***

f. Are the requirements in the Board's attestation standard, AT sec. 701, sufficient to provide the appropriate level of auditor assurance on other information outside the financial statements? If not, what other requirements should be considered?

***Answer: Yes, if it is to be done at all. In most cases, it is not necessary.***

g. If you do not support auditor assurance on other information outside the financial statements, provide an explanation as to why.

***Answer: A requirement that the auditor give formal opinions on peripheral information is a step toward further compromising auditor independence, making auditors part of management as primary providers of information. Management has a right, responsibility and fiduciary requirement to communicate with investors. Management representations in that communication are part of the evidence upon which auditors should base their conclusions about financial statements, and to a large degree evidence by which investors' should judge management. Results of following this proposal would be expensive. It would have negative value to investors by filtering managements' views through the eyes of the auditor. Investors have a right and need to know what management believes untainted by auditor authorization.***

20. What are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

    ***Answer: There is no benefit***.

    ***To find any benefit to this proposal, one must necessarily conclude that management cannot be trusted. Further, one must conclude that investors would be protected from management misinformation by having the external auditor review, correct and adjust the information to something closer to the truth. There is no study that supports such a conclusion, to my knowledge. The cost of audits would grow exponentially trying to accomplish this unsupported goal, and auditor independence would be further compromised by making it the auditors' information.***

    ***Consider, for example, would anyone benefit by having the audit partner sit on the stage at a shareholder meeting, nodding "yes" or "no" to statements by the CEO and CFO? Would it be helpful to have the audit partner deliver an "Auditor Response" in periodic investor conference calls, agreeing or disagreeing with management? These preposterous "over the top" examples are similar to what is being suggested.***

21. The concept release presents suggestions on how to clarify the auditor's report in the following areas:

    • Reasonable assurance

    • Auditor's responsibility for fraud

    • Auditor's responsibility for financial statement disclosures

    • Management's responsibility for the preparation of the financial statements

    • Auditor's responsibility for information outside the financial statements

    • Auditor independence

a. Do you believe some or all of these clarifications are appropriate? If so, explain which of these clarifications is appropriate? How should the auditor's report be clarified?

   ***Answer: No. The terms "reasonable assurance" and "independence" are good, time tested use of the words. Any attempt to clarify them produces more restrictive meaning than their common usage. Auditors may want to restrict implications of common usage for liability purposes, but that would be a disservice to investors, not an aid.***

   ***The other terms listed in the question are all preceded with the word "responsibility," by the auditor in three cases and management in another. There is abundant written material in the standards and case law about what they mean for both auditor and management. Trying to***

***further define the terms in the audit report for investors would result in narrowing responsibility, working to the benefit of auditors, not investors.***

***I respect The Center for Audit Quality but challenge its example of a new report that would supplement the efficient language of the current audit report by adding language like "…the 'total mix" of information presented in the consolidated financial statements, taken as a whole…" and "…audit evidence we obtain is often persuasive rather than conclusive…" Will the investor be even marginally enlightened to better understand "materiality" and "evidence" with these additions?***

***The auditor report is clear now and should not be changed.***

b. Would these potential clarifications serve to enhance the auditor's report and help readers understand the auditor's report and the auditor's responsibilities? Provide an explanation as to why or why not.

***Answer: The problems we have experienced are not because investors misunderstood a clear, simple audit report. The problems are because financial statements were wrong. The value of auditors' reports is diminished, not enhanced, with any attempt to clarify common terms.***

c. What other clarifications or improvements to the auditor's reporting model can be made to better communicate the nature of an audit and the auditor's responsibilities?

***Answer: As noted earlier, the identification of the issuing office of a national or international accounting firm is not necessary or helpful.***

***Consider, however, requiring disclosure of significant limitations in the auditor's contract. The contracts frequently define permitted legal avenues for the company to resolve disputes, e.g. no jury trials or that cases involving the auditor can only be prosecuted under the statutes of a state chosen by the auditor. Disclosure perhaps should include restrictions against holding non issuing network firms responsible for their portion of work by exempting the network firms from liability to third parties. As in the example report offered by the Center for Audit Quality, such restrictions usually are presented positively, e.g. "…the U.S. firm assumes full responsibility…," when the clear meaning may be that non U. S. firms cannot be held responsible even if they do the majority of the work, because only the U.S. firm signs the contract and the report. Occasionally, that disclosure is on the auditor website, unread by all who should know.***

***Consider if investors should be told of significant contractual restrictions agreed to by the company. If so, should the disclosures be relegated to the proxy statement, a separate 10-K item or some other remote location apart from the firm's report on the company financial statements? Is the website of the auditor OK?***

d. What are the implications to the scope of the audit, or the auditor's responsibilities, resulting from the foregoing clarifications?

***Answer: Clarifications of this type narrow the meaning of the words, reducing the auditor responsibility. Audit work may be reduced because audit risk becomes less. It does not serve investor interests to reduce the responsibility for auditors by narrowing the meaning of "reasonable assurance," "fairly stated" and "independent." It is reasonable for auditors to make their own judgments of risk they are willing to assume; but it is unreasonable to redefine words that otherwise broadly protect investors. If they have documented their reasoning, auditors are well down the road to convincing others of its reasonableness.***

22. What are the potential benefits and shortcomings of providing clarifications of the language in the standard auditor's report?

    ***Answer: Further clarification will dampen the creativity that auditors use to create audit plans for various scenarios that could be wrong with financial statements. Such creativity is best developed by auditors in the field who know the people, business model and controls of their clients.***

23. This concept release presents several alternatives intended to improve auditor communication to the users of financial statements through the auditor's reporting model. Which alternative is most appropriate and why?

    ***Answer: The alternatives of requiring an AD&A and emphasis paragraphs, clarifying language in the standard report and adding to the information required to be audited are all available to auditors and registrants without any action by the PCAOB. If an audit firm unilaterally decided to use the alternatives, the PCAOB would probably object to the alternative of clarifying language as too restrictive. The other three alternatives are not commonly done now for some good reason, if one believes in market driven answers: i.e. the three either do not add value or the cost is too great to justify any benefit that could be derived. Any proposal to require them in all instances, however, begins to sound like a marketing plan by accounting firms to get more work with the help of regulators.***

    ***Who believes that the Enron problem would not have happened if any or all of the alternatives had been done? Does anyone think that the backdating of stock options would not have occurred, but for lack of these alternatives? The same questions should be asked for the failure to discuss the impact of derivatives, repurchase agreements, bad loans and poorly securitized investments? All of these bad things occurred and continue to occur because management and the auditor did not do the things they are required to do under existing law, regulations and professional standards, using already existing tools.***

    ***None of these alternatives is necessary.***

24. Would a combination of the alternatives, or certain elements of the alternatives, be more effective in improving auditor communication than any one of the alternatives alone? What are those combinations of alternatives or elements?

***Answer: No.***

25. What alternatives not mentioned in this concept release should the Board consider?

***Answer: There are several.***

***Communication is far better if auditor independence is paramount and there is sufficient risk to the auditor for not communicating.***

***Anything the PCAOB can do to reinforce upon auditors their independence from company management, and the auditor's responsibility to investors, would be the first alternative. Consider how that can be done:***

> ***Should the check to pay the auditor come from a bank account maintained for the audit committee, and be signed by a member of the audit committee?***
>
> ***Should the audit fee be charged to shareholder equity, similar to a dividend, rather than be charged to operating expense, reinforcing who the customer of the auditor really is?***
>
> ***Should the audit team share all memoranda on discussions with key management with the audit committee?***

***Auditor independence is still hampered by the lack of appropriate financial commitment by audit partners in their own business. Audit partners at major firms have little capital at risk relative to the income they make and take each year from the limited liability entities in which they operate. They are driven far too much by the desire to generate cash income rather than by protecting their accumulated net worth and that of other partners in their firm. That situation did not exist until the late 1990's and it has had a very significant negative effect on audit quality. It is far too easy to "escape" from serious financial and ethical responsibility. Structuring for risk protection has been taken to the extreme by the major audit firms.***

***Auditor independence is weakened when audit firms expand their practices to include non audit, advocacy services. Any audit firm that offers lobbying services for political solutions for any industry or company or litigation support services, regardless of the merits of the issue, takes sides, compromising someone's interest. "Independence from" and "advocacy for" are concepts having significantly different approaches and they don't mix together. But, that's what the audit industry tries to do. The information developed in the U. S. Treasury Advisory Committee proceedings show the major audit firms are not primarily audit firms, but consulting firms.***

***These types of rationalization of true independence are dangerous and continue to plague this industry.***

***Finally, a deliberate focused effort should be made by the PCAOB to see if there is any possibility that communication to investors can be enhanced by reducing auditor work and words. The initiative in this concept release is totally directed at increasing communication by adding work for auditors and words to their reports. Maybe we are down the road too far trying to have auditors answer all perceived needs rather than focusing on real needs, diluting rather than improving effectiveness.***

26. Each of the alternatives presented might require the development of an auditor reporting framework and criteria. What recommendations should the Board consider in developing such auditor reporting framework and related criteria for each of the alternatives?

    ***Answer: This question assumes that an alternative or a combination of alternatives will be adopted. Today, the biggest shortfall in reporting and communication is lack of discipline following existing requirements. The best alternative is to eliminate the lack of and inconsistent application of discipline.***

27. Would financial statement users perceive any of these alternatives as providing a qualified or piecemeal opinion? If so, what steps could the Board take to mitigate the risk of this perception?

    ***Answer: This question implies there is something wrong with an auditor communication that has a qualification or is restricted to some particular fact. Qualified and piecemeal opinions can be good communication, better than communications that overstate reality. The question highlights concerns about the direction of this concept statement.***

28. Do any of the alternatives better convey to the users of the financial statements the auditor's role in the performance of an audit? Why or why not? Are there other recommendations that could better convey this role?

    ***Answer: No. The alternatives are well intended, but they attempt to over define and over report what ultimately is best left flexible and efficient. The result will be less assurance at greater cost. There are better answers including stronger enforcement of what is already required, coupled with enhanced auditor independence.***

29. What effect would the various alternatives have on audit quality? What is the basis for your view?

    ***Answer: The effect would not be good. Any of the alternatives would misdirect energy from foundational weaknesses that should be fixed. Cost would increase because hours required to do the alternatives increase. The alternatives would narrow the responsibility of auditors giving them more argument to deny responsibility where they should be responsible. The alternatives detract from necessary communication between management and investors by inserting a third party, the auditor, as a filter between the two who most need to communicate.***

***The basis for my views is thirty-five years as an auditor in a large firm including managing an office; teaching auditing at a major university; serving as an EVP and CFO at a public company; serving on two public boards; serving as chair of audit committee for two public entities; working to advise a state agency charged with auditing every agency, county, township and municipality in the state; and serving on a Special Litigation Committee for a closely held international private entity having disputes among shareholders. I experienced the personal loss and fallout of the death of Arthur Andersen after my retirement, a life changing and instructive development. These experiences cause focus on why bad things happen and what could be done better.***

30. Should changes to the auditor's reporting model considered by the Board apply equally to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others? What would be the effects of applying the alternatives discussed in the concept release to the audit reports for such entities? If audit reports related to certain entities should be excluded from one or more of the alternatives, please explain the basis for such an exclusion.

***Answer: If done at all, these changes should apply to all public entities. But, I do not support the proposed changes because they will have negative impacts on what the PCAOB is trying to achieve for investors.***

31. This concept release describes certain considerations related to changing the auditor's report, such as effects on audit effort, effects on the auditor's relationships, effects on audit committee governance, liability considerations, and confidentiality.

a. Are any of these considerations more important than others? If so, which ones and why?

***Answer: The largest effect will be on audit effort, liability and governance. Effort will increase, driving up costs to shareholders. Liability to auditors will be defined down by narrowing responsibility for auditor creativity and thoughtfulness. Governance will shift relatively from management to auditor. And, the impact to investors will be negative.***

b. If changes to the auditor's reporting model increased cost, do you believe the benefits of such changes justify the potential cost? Why or why not?

***Answer: The proposals will increase cost. Suggested benefits to investors will, in fact, be losses in terms of financial cost, without adding value to the business model of the company. Auditors' messages will be diluted.***

c. Are there any other considerations related to changing the auditor's report that this concept release has not addressed? If so, what are these considerations?

***Answer: Yes. The missing considerations are the fundamental structural changes that need to be made in the audit industry to enhance independence and what could be done to simplify meaningful auditor reporting with less work and fewer words, not more.***

d. What requirements and other measures could the PCAOB or others put into place to address the potential effects of these considerations?

***Answer: The considerations propose changes to the report of auditors. More regulatory required words from the auditor do not accomplish desirable objectives. The real objective for auditors is simple: make sure company financial statements are correct, as defined. This objective is best accomplished by insisting the auditor be completely independent and sufficiently exposed to risk of loss for not doing a good job.***

***Audit firms are private entities, generally partnerships with structurally limited risk confined to small pots of capital within geographic boundaries, seeking to privately settle all disputes using structured settlements from future earnings to ease partner pain. If the pain is too great, some form of liquidation of the small pots of capital follows. Audits continue under another banner. As presently structured, individual auditors are driven to generate revenue for the firm to be distributed currently.***

***We are running far too close to the edge with only four uninsured, undercapitalized organizations auditing nearly all public companies. This situation requires heavy external quality control, with clear, current reporting about audit failures and auditor financial information. The U. S. Treasury Advisory Committee on the Audit Profession had much good testimony on these weaknesses, but little was done with some of the key recommendations. The inevitable result is only clouded by questions of "when?" and "what will follow?"***

***We should try to answer those questions by eliminating them as a concern.***

32. The concept release discusses the potential effects that providing additional information in the auditor's report could have on relationships among the auditor, management, and the audit committee. If the auditor were to include in the auditor's report information regarding the company's financial statements, what potential effects could that have on the interaction among the auditor, management, and the audit committee?

***Answer: Confusion, redundancy and unhelpful tension would result. The proposal is a regulatory insult to management and audit committees, favoring the integrity of poorly capitalized, uninsured audit firms and showing universal disrespect to the ability of company governance to properly deal with communication between and among owners and management. That disrespect is sometimes deserved, but recent history and human nature suggest similar shortcomings at audit firms, law firms and investment banker advisors who have been involved. At great cost, the proposals in the concept release would shift responsibility from those directly responsible to investors, to those indirectly responsible to investors, not a good move for investors.***

ViewPoint Bank

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September 29, 2011

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

**Via website submission: comments@pcaobus.org**
**RE: PCAOB Rulemaking Docket Matter No. 34 – *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards***

To whom it may concern:

Our bank appreciates the opportunity to comment on the proposed revisions to the PCAOB Standards related to reports on Audited Financial Statements and Related Amendments to PCAOB Standard.

ViewPoint Bank is a community savings bank that is wholly-owned by ViewPoint Financial Group, Inc. We are based in Plano, Texas and have approximately $3.0 billion in assets and over $419 million in public float. We currently operate 25 community bank offices and 12 loan production offices.

We disagree that the proposed changes to the auditor's report will provide additional information that will be useful to investors, and in fact will only increase the cost of audits to community banks without any beneficial value. Our primary concerns are outlined below:

**Cost Benefit**

We disagree that the value derived from expanding auditor procedures to include an AD&A or to provide auditor assurance on other information outside the financial statements will exceed the massive costs that would be required to perform the procedures. Such approaches will only lead to more user confusion between the different reports issued by the auditors and management and will likely increase the already-existing "expectation gap" of what audit assurance actually provides to the investor. For example, discussion of audit "close calls" may actually cause the financial statement user to question the quality of the audit work (why the auditor "caved in" on this issue) and why the amounts actually recorded should be relied upon. The focus of the audited financial statements should not be on the auditor, but on the related reporting entity.

We agree with the outreach participants that a movement away from using standardized language in the auditor's report could also require additional audit effort, such as the auditor's time and effort in preparing and reviewing the report, which would result in an increase in cost as a result of the increase in the scope of the auditor's responsibilities, requirements, and procedures.

**Usefulness of additional disclosure**

We believe that this information from the auditor, at best, will only confirm what is already disclosed in footnotes to the financial statements or the MD&A. Over time, investors may become frustrated with the auditors' language, which is likely to be carefully-crafted and self-protecting. This could eventually render most of the additional reporting as irrelevant. At worst, such reporting, especially since it relates to highly judgmental areas, could result in unwarranted uncertainty among users. Additionally, just as bank audited financial statements often include scores of pages of footnote disclosures, the emphasis paragraphs could also turn the auditor report into one of similar length, thereby diluting the emphasis objective.

We believe the PCAOB should consider ***solely*** how the auditor report can be revised to add limited **clarifying** language at minimal cost to respond to the concerns identified with the pass/fail model currently used.

Thank you for considering our comments.

Sincerely,

Patti McKee

Patti McKee, CPA
EVP, Chief Financial Officer
ViewPoint Bank

Virginia Society of Certified Public Accountants

October 5, 2011

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

Submitted via e-mail to comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 34: *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards*

Dear Office of the Secretary:

On behalf of the Accounting & Auditing Advisory Committee of the Virginia Society of CPAs (VSCPA), we have reviewed the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the Concept Release). The VSCPA is Virginia's leading professional association dedicated to enhancing the success of all CPAs and their profession by communicating information and vision, promoting professionalism, and advocating members' interests. The VSCPA membership consists of more than 10,000 individuals who actively work in public accounting, private industry, government agencies and educational institutions. We appreciate the opportunity to respond to this Concept Release.

While we believe that changes in auditor reporting may be beneficial as a means to narrow the expectations gap and to improve the communicative value of auditor reporting, we believe that some of the changes discussed in the Concept Release downplay the role of management and the content for which management should have the sole responsibility to report. We believe that management should be required to consider the results of the audit and the content of the two-way dialogue between the auditor and those charged with governance in preparing and/or emphasizing financial statement disclosures and management's discussion and analysis.

Recommended changes to the Report on Audited Financial Statements

Based on the PCAOB's research efforts, we agree that changes to the auditor's report could enhance the users' understanding of the nature of the procedures performed and results of the audit. Therefore, we recommend the PCAOB consider the following changes to the report on audited financial statements:

- Reconsider the current positioning of information within the standard auditor's report to ensure that it places appropriate emphasis on key information.
- Provide additional information about the meaning of standard auditing terminology such as reasonable assurance and materiality.
- Include clarifying information that the auditor's responsibility to detect fraud is limited by materiality considerations under the auditing standards.
- Provide additional **general** information about the audit process such as the risk assessment process, consideration of internal controls over financial reporting and the level of assurance provided by the auditor but not at the company-specific level of detail included in the Concept Release.
- Require a statement about the auditor's responsibilities concerning financial statement disclosures and other information in documents containing audited financial statements.

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We do not believe it is appropriate to provide information to the extent included in the auditor's discussion and analysis illustration provided in the Concept Release. We believe the level of detail suggested in the Concept Release will add confusion to the reporting model rather than provide clarification to the financial statement users. We believe users of the financial statements will lack the necessary context to understand and utilize any description by the auditor regarding detailed audit procedures and results. Further, we believe confidentiality issues are a concern if information is to be provided at the level of detail shown in the proposed illustration.

Use of Emphasis Paragraphs

The Concept Release suggests mandating the use of emphasis paragraphs in all audit reports and further expanding the emphasis paragraph to highlight the most significant matters in the financial statements and to identify where these matters are disclosed in the financial statements. We believe that the PCAOB should consider developing additional guidance to auditors mandating further use of emphasis of matter paragraphs that reference management's footnote disclosures. Also, we have concerns about the proposal to provide descriptions of the related audit procedures within the auditor's report due to the lack of context and relative impossibility of summarizing the complexity of the audit processes into a short paragraph that would be meaningful to the users of the financial statements.

Again, the VSCPA appreciates the opportunity to respond to this Concept Release. Please direct any questions or concerns to VSCPA Government Affairs Director Emily Walker at ewalker@vscpa.com or 804-612-9428.

Sincerely,

Jamie C. Wohlert, CPA
2011–2012 Chair
VSCPA Accounting & Auditing Advisory Committee

2011–2012 VSCPA Accounting & Auditing Advisory Committee:
Audrey R. Davis, CPA
M. James Hartson, Jr., CPA
Daniel L. Haynes, CPA
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September 29, 2011
Office of the Secretary
PCAOB 1666 K Street
N.W. Washington, D.C. 20006-2803

Re: PCAOB Concept Release - Docket Matter No. 34

Ladies and Gentlemen:

As an accounting student at the University of Illinois at Urbana-Champaign, and as a hopeful future member of the auditing profession, I feel that it is my duty to express an opinion towards this concept.

I feel that all four proposed changes are valuable additions to the audit report and as a result financial statement users will feel more comfortable about the validity of the information provided. It is my assumption that auditors will not be in favor of this concept release for several reasons, but the PCAOB should be more concerned with what investors and users of financial statements want versus what the auditors want. Each of the four proposed changes will require auditors to provide their insights into the firm's inter-workings and firms will have to allow their auditors to reveal more information as compared to the current audit report format.

I feel that the PCAOB should allow publicly traded companies to choose which auditing report it wants to use. This will create a way for publicly traded companies to signal to its stakeholders that it has nothing to hide, by allowing the auditors to give a more in depth analysis. Publicly traded companies that are engaged in illegal and unethical activities will most likely decide to take cover behind the current and simple auditor's report. The article by DeFond & Lennox in the *Journal of Accounting and Economics* shows that when the Sarbanes-Oxley Act passed it placed greater regulations on auditing firms, and as a result several auditing firms left the market. The auditing firms that exited had a lower audit quality compared to those firms that remained in the market. I feel that allowing publicly traded companies the option of choosing which auditor's report to use will have the same effect. Again, publicly traded companies that are aware they are not representing all of their information fairly will most likely decide to use the current auditor's report, because it won't allow auditors to state any discrepancies they feel the publicly traded company has.

Thank you for the opportunity to comment on the Concept Release.

Sincerely yours,

Tomasz Walkosz

**Comment on PCAOB Concept Release dated June 21, 2011, PCAOB Release No. 2011-003,**

**PCAOB Rulemaking Docket Matter No. 34**

Stephen A. Zeff, Rice University

July 11, 2011

I will confine my comment to Question 2.

I have already argued in my article, "The Primacy of 'Present Fairly' in the Auditor's Report," *Accounting Perspectives*, Vol. 6, no. 1, (2007), that "present fairly" should be decoupled from "in conformity with U.S. generally accepted accounting principles." It should be the responsibility of the auditor to give a professional opinion on whether the financial statements "present fairly," without making that judgment contingent on the contents of 17,000 pages of rule-laden GAAP. Today's standard opinion is little more than an affirmation that the financial statements are in conformity with GAAP, because the quality of "present fairly" is not defined other than by reference to GAAP.

Between 1946 and 1962, Arthur Andersen & Co. gave the following decoupled opinions: the financial statements present fairly…and were prepared in accordance with generally accepted accounting opinions. See my article, "Arthur Andersen & Co. and the Two-Part Opinion in the Auditor's Report: 1946-1962," *Contemporary Accounting Research*, Spring 1992. Andersen believed that it was the professional responsibility of the auditor to give its opinion on "present fairly" without taking refuge in the rules of GAAP. Judge Henry J. Friendly, writing for the Second Court of Appeals in *U.S. v. Simon*, 425 F.2d 796 (1969), known as the Continental Vending case, ruled that the conformity of financial statements with GAAP does not necessarily mean that they present fairly. Friendly's ruling is still valid law today.

Rather than repeat my own views on this matter, I prefer to quote from Sir David Tweedie, the former Chairman (1990-2000) of the UK Accounting Standards Board and former Chairman (2000-2011) of the International Accounting Standards Board. From 1986 to 1988, he was Vice Chairman of the UK Auditing Practices Committee. In 1986, when he was the national research partner of KMG Thomson McLintock, he wrote as follows:

"The auditor's opinion in North America and in the United Kingdom in a given situation would probably be very similar. The North American position, however, appears to be more defensive and slightly more restrictive. 'Present fairly' can only be applied within the framework of generally accepted accounting principles which encompasses not only specific rules, practices and procedures relating to particular circumstances but also broad principles and conventions of general application. There appears to be less opportunity or incentive than in the UK and Ireland to use true professional judgment or to break with convention. …

"The British position makes clear, without ambiguity, the overriding importance of the true and fair view. The auditor is obliged to look not simply at the *rules* but at the *facts*. In the United Kingdom we do not relate the true and fair view to accounting standards or directly to the detailed provisions of the law.

The true and fair view is deemed to be a corpus of practices which are constantly changing and which are derived from sources similar to those of American GAAP. While the North Americans suggest that the auditor should look at substance over form, in the United Kingdom this should be rendered almost unnecessary by the fact that the true and fair view demands that the reality of a company's interaction with the economic environment is fairly portrayed in its financial statements." David Tweedie, "An International View," Chapter 5 in *APC – The First Ten Years* (London: Auditing Practices Committee of CCAB Limited, 1986), p. 57.

Tweedie's comparison between the auditor's affirmation in the UK and that in the United States is hardly flattering to the latter. It seems to me that the time has come to change the auditor's required affirmation from "present fairly" in accordance with the myriad rules of GAAP to "present fairly" standing by itself. It would be most unfortunate if the PCAOB were to ignore this challenge during its review of the auditor's reporting model.

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November 26, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

The Audit Committee of the Acuity Brands Board of Directors agrees with the views and concerns expressed by management in the attached letter on PCAOB Release No. 2013-005 dated August 13, 2013 ("the Proposal") which addresses two new proposed auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. We understand that the objective of the new auditing standards is to make the auditor's report more informative, and, as a result, more relevant and useful to investors and other financial statement users. However, we believe that certain aspects of the Proposal will not achieve this objective and will result in increased audit time and expense without proportionate benefit.

The audit committee is responsible for the oversight of the preparation of the financial statements and the performance of the auditors. Our committee, as I am sure is true of others, takes these responsibilities very seriously. As such, we examine the significant accounting policies, the critical accounting estimates, and the critical audit matters in some detail with management as the quarterly and annual financial statements are being finalized and we discuss each of these with the independent auditors on a regular basis. As such, the Proposal seems to disregard the importance we place on these reviews by requiring the auditors to disclose information they have no responsibility in preparing and does not give any attention to the review by the company's management or its audit committee.

Likewise, including the tenure of the audit firm in The Basic Elements of the Auditor's Report seems counterproductive for the reasons stated by management. This committee annually evaluates the performance of the audit firm before making the recommendation about reappointment. The Proposal seems to ignore this important step by suggesting that tenure will alert some outside stakeholder that time is more important in evaluating the performance of the audit firm than the responsibilities regularly performed by audit committees and the full board of directors.

We appreciate the opportunity to respond to the proposed auditing standards. We are available to discuss any questions or concerns raised by this response.

Sincerely,

Robert F. McCullough

Robert F. McCullough
Audit Committee Chair

AcuityBrands.
Expanding the boundaries of lighting™

Richard K. Reece
Executive Vice President
Chief Financial Officer

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November 26, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

We are writing to provide our views on PCAOB Release No. 2013-005 dated August 13, 2013 ("the Proposal") which addresses two new proposed auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. We understand that the objective of the new auditing standards is to make the auditor's report more informative, and, as a result, more relevant and useful to investors and other financial statement users. However, we believe that certain aspects of the Proposal will not achieve this objective and will result in increased audit time and expense without proportionate benefit. Please see below for additional information regarding our concerns related to the proposed auditing standards.

**Proposed Auditor Reporting Standard**

***Auditor Reporting of Critical Audit Matters***

The Proposal would require auditors to communicate critical audit matters ("CAMs") — defined as matters involving the most difficult, subjective, or complex auditor judgments, including areas that posed the most difficulty to the auditor in obtaining audit evidence and/or forming an opinion on the financial statements—in the auditor's report. We oppose the disclosure of CAMs in the auditor's report for the following reasons: (i) disclosure of CAMs would require auditors to potentially describe matters which are the responsibility of management to include in the financial statements and may potentially reference original information for which there are no current disclosure requirements (e.g. significant deficiencies or misstatements identified during the course of the audit), (ii) existing disclosures and review processes are sufficient to support the auditor's opinion, (iii) inconsistencies between required current disclosures and disclosures stipulated in the Proposal could result in financial statement user confusion, and (iv) additional auditor time and expense will be required to prepare the CAMs disclosure without proportional additional benefit.

We believe strongly that our financial statements and related disclosures are the sole responsibility of management, including the current disclosure requirements related to critical accounting estimates and significant accounting policies. The expansion of auditor reports to include CAMs would require the auditor to provide additional information regarding the financial reporting of the company related to specific audit areas, and potentially require the disclosure of matters affecting a company's financial reporting for which no current disclosure requirements exist. However, we believe that it is our role as management to provide all disclosure regarding the financial reporting of the company. Many respondents to the Concept Release on this same topic dated June 21, 2011 addressed the concern that the auditors should not be the original source of information about the company's financial statements. In addition, providing information regarding specific CAMs in the auditor's opinion may imply that audit opinions are rendered on specific areas rather than on the financial statements as a whole.

In compliance with existing auditing standards related to required communications with audit committees, our critical accounting estimates, significant accounting policies, and significant audit areas are evaluated by the audit committee of our board of directors. We believe current financial statement disclosures are adequate because these disclosures already provide robust information about our accounting policies and areas that require management to rely on significant estimates and judgment. These critical accounting areas are evaluated by management, the audit committee of our board of directors, and our auditors. As a result, we believe the disclosure of CAMs would not be useful to investors given the robustness of disclosures required today.

We are also concerned that the time and effort spent on completing these disclosures will result in additional and unnecessary work for management, the audit committee of the board of directors, and our auditors. Drafting and reviewing the CAMs disclosure will divert attention from completing final reviews in an already tight filing timeframe. As noted above, we believe the current process of review of significant audit areas with the audit committee of our board of directors is sufficient.

***Basic Elements of the Auditor's Report***

We support the following matters in this section of the Proposal:

- Addition of a statement regarding the auditor's independence;
- Addition of wording to clarify that a material misstatement means whether due to error or fraud.

We do not support the addition of auditor tenure as we believe there is no negative correlation between an audit firm's tenure and the quality of the audit performed, making the disclosure irrelevant to the financial statement users.

Regarding the addition of wording about the auditor's responsibilities concerning other information, we support the addition of this language to enhance the financial statement user's understanding of the obligations of the auditor; however, we believe the language in Appendix 5 of the Proposal expands the auditor's current responsibility which we will address in the next section. We believe this wording should be a disclaimer and more strongly state that the audit scope and procedures did not include the other information.

**Reporting on Other Information**

We do not support the requirement for the auditor to "read and evaluate" (rather than "read and consider") other information in certain documents, such as selected financial data, management discussion & analysis, and proxy information incorporated by reference. We believe that the shift from "consider" to "evaluate" would require the auditor to perform additional procedures in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit. As a result, we believe that substantial additional hours will be added to the audit engagement to evaluate the other information resulting in higher expense to the company without a significant enhancement to the assurance provided today.

In conclusion, we appreciate the opportunity to respond to the proposed auditing standards. We are available to discuss any questions or concerns raised by this response.

Sincerely,

Richard K Reece

Richard K. Reece
Executive Vice President and
Chief Financial Officer

AEROSPACE INDUSTRIES ASSOCIATION

December 9, 2013

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

Subject: **Proposed Auditing Standards –**

**The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion**

**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report**

**And Related Amendments to PCAOB Standards**

Dear Board:

Thank you for providing the Aerospace Industries Association ("AIA") an opportunity to share our views on your proposed auditing standards – *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and the Related Amendments to PCAOB Standards* (together the "Proposed Standards"), issued by the Public Company Accounting Oversight Board (the "Board") on August 13, 2013. AIA is the premier aerospace industry trade association, representing over 350 of the nation's major manufacturers of commercial, military and business products such as aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment. Many of the AIA member companies are suppliers to the U.S. Government. AIA previously commented on the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("Concept Release") issued by the Board on June 21, 2011.

As previously stated in our September 27, 2011 letter on the Concept Release, we are supportive of the Board's efforts to address the financial reporting concerns of investors and other users of financial statements. However, we continue to believe that improvements to financial reporting can best be achieved through clarifying changes to the audit report by the PCAOB coupled with targeted standard-setting by the Financial Accounting Standards Board ("FASB") or Securities and Exchange Commission ("SEC"). We believe investors and other financial statement users would benefit most from changes to the audit report that clarify the purpose of an audit, the responsibilities of management, and the responsibilities of the auditor. Further, it would be helpful for the audit report to clarify the auditor's existing responsibility with respect to financial information presented outside the financial statements and the applicable PCAOB standards governing their responsibility.

In the following paragraphs, we provide additional feedback on the Proposed Standards.

We believe that the form of the auditor's report should be limited to providing an opinion about whether the financial statements (inclusive of the related notes) present fairly, in all material respects, the financial condition, results of operations, and cash flows of reporting companies in conformity with the applicable financial reporting framework (i.e. pass/fail model).

We believe that the investor concerns cited in the Proposed Standards cannot be adequately addressed in the auditor's report. Rather, these concerns are best addressed by encouraging investors and other users of financial information to read the financial statements in their entirety including Management's Discussion and Analysis ("MD&A") in the 10-Qs and 10-Ks to obtain a complete understanding of the financial health of a company and key risks that could have an adverse impact on financial results. If information contained in the financial statements and MD&A is not useful or is difficult to understand, targeted standard setting should be considered to promote greater transparency and aid in investors' understanding of financial information.

We believe that any Proposed Standards must preserve management's ultimate responsibility for the quality of its financial information and the balance of responsibilities between management and the audit committee for reviewing and certifying the accuracy of that information. Audit committees play a critical role in providing independent review and oversight over a company's financial reporting system and its independent auditors. We firmly believe that management should be the original source of financial information about a company. Both the Management of a company and the audit committee have a very deep knowledge and understanding of its industry, business strategy, and risk factors and their impact on current and future financial results. While an auditor learns a lot about a company's accounting policies and procedures through an audit, their focus is appropriately limited to whether the financial statements are presented in conformity with prescribed accounting rules rather than identifying and classifying the broader business risks (e.g. supply chain, environmental, operational, etc.) that can impact financial results. Any proposal to expand the auditors' role must take care not to dilute or otherwise deemphasize this core responsibility of auditor firms, and it is our view that such a dramatic expansion of the auditor's report risks doing just that.

For many of these same reasons, we oppose the proposed requirement to add a discussion of Critical Audit Matters ("CAM") to the auditor's report. While we acknowledge that the CAM proposal is an improvement over the Auditor's Discussion and Analysis model presented in the Concept Release, we have significant concerns about the operability of the proposal and whether CAM will be useful to investors. Those concerns are as follows:

- We believe drafting of the CAM and documenting why other items weren't included in the CAM could take a significant amount of the auditor's and management's time at a critical point in the process. Furthermore, it could lengthen the timetable between when a company closes its books and files its financial statements with the SEC, increasing audit costs and delaying the release of much anticipated financial information. We believe the additional time and cost required to comply with the proposal would be of little or no benefit to investors.

- We believe discussion of the company's financial information by the auditor could lead to an increase in confusion for the investor by suggesting that the auditor is providing something other than an unqualified audit opinion. We believe that the issuance of an unqualified audit opinion should remain a statement to the investor that all material matters related to the audit have been resolved to the mutual satisfaction of management, the audit committee, and the auditor. We do not believe that discussion about the "most difficult" areas of an audit is relevant if all issues have been resolved to the auditor's satisfaction such that an unqualified opinion is issued. Furthermore, we feel that additional information presented by the auditor may lead to confusion as to which party is responsible for financial information and introduce additional risk for the company and audit firm.

- The definition of CAM is highly subjective and open to interpretation and the inclusion of CAM in an auditor's report may send mixed messages to investors and other users of financial statements. Different accounting firms will likely adopt different practices with respect to matters requiring disclosure as a CAM. Furthermore investors may perceive that an audit report containing no CAM suggests the company being audited has better controls, more transparent disclosures and/or less aggressive accounting positions than a company whose audit report contains multiple CAM. It could also suggest to investors that the accounting firm reporting fewer CAM is not conducting a rigorous audit. We believe that required disclosure of some number of "uncertainties" encountered during an audit – whether or not they are material – could ultimately undermine investors' confidence in financial reporting.

- We have a fundamental issue with a rule that would require the auditor to disclose certain information about a company (e.g. existence of significant deficiencies) that the company isn't required to disclose outside of the audit committee. As previously stated, we believe management should be the original source of all financial information about a company and the auditor's responsibility should be limited to ensuring that financial information is presented fairly and is materially correct.

- We believe that inclusion of CAM in the auditor's report will be, in most cases, duplicative of information already included in the financial statements and MD&A. For example, many companies disclose critical accounting estimates in MD&A based on the enhanced requirements included in a 2002 proposed SEC rule. We believe there is a sufficient amount of detail in those disclosures to let users know that these are highly judgmental areas that are sensitive to changes given certain assumptions. A user of financial statements should be able to infer from the identification of these items that the auditor will spend additional time testing the estimates and discussing assumptions and application of accounting rules with management, the audit committee and potentially the audit quality reviewer. As a result, it is unclear what incremental beneficial information the CAM would provide. Given that the SEC proposal on disclosure about the application of critical accounting policies (SEC Release No. 33-8098) was never issued, investors could benefit from targeted standard setting that would result in the issuance of a final rule applicable to all registrants.

- We believe that linkage of CAM to audit committee communications will potentially impede communications that currently take place between the auditor and the audit committee. We believe that this dialogue is a critical element of the communication process and that without it written words could be taken out of context and used incorrectly in making investment decisions. Furthermore, the knowledge that even discussing an audit matter could result in required audit report disclosure may result in accounting firms becoming more selective about the items they discuss with the audit committee. In Addition, audit committees and/or company officers may be reluctant, to raise concerns or even ask clarifying questions about audit or accounting issues. We believe that the auditor's views should be shared with the audit committee through the existing communication process and that it is ultimately up to management to ensure that disclosures are transparent and fair. Furthermore, we question the impact to the ongoing role of the audit committee if CAM is included in the auditor's report. We believe it could ultimately reduce the dynamic of open dialogue that is critical to effective governance and convert audit committee meetings into formulaic, compliance-driven "check-the-box" sessions.

- As noted above, we believe the CAM identified by the auditor for inclusion in the auditor's report is subjective in nature making it open to unnecessary, but inevitable, challenge by the PCAOB during the inspection process. We are concerned that companies could be required to re-file their financial statements due to a restatement of the audit report, which again will result in additional effort and cost to companies and the auditors, not to mention confusion and uncertainty among investors.

- Requiring disclosure of "challenging" audit matters would also expose companies to increased risk of frivolous lawsuits. Even in cases where generally accepted accounting principles were followed to the letter and any "challenging" issues were resolved to the auditors' satisfaction, the plaintiffs' bar will surely attempt to use any CAM disclosures as de facto admissions of uncertainty or even error in court proceedings. These proceedings, even if they result in no direct liability to the company or its auditors, resulting in increased legal fees to companies, higher audit fees, and investor confusion.

As noted earlier in this letter and in our September 27, 2011 letter on the Concept Release, we would support changes to the audit report that would clarify the auditor's existing responsibility with respect to financial information presented outside the financial statements (e.g., AU sec. 550) and provide reference to PCAOB audit standards or other summary documents that provide additional information about public company audits and auditors (e.g., Center for Audit Quality's published "*In-Depth Guide to Public Company Auditing: The Financial Statement Audit*"). We believe the proposal that the auditor "review and evaluate" other information outside the financial statements and the introduction of new audit procedures is problematic and a step change from what the auditor is responsible for under the current "read and consider" standard, without a demonstrated need for a change.

We are not supportive of these changes for the following reasons:

- We are concerned that the additional costs incurred by the auditor and company to comply with the proposal on other information would far outweigh any benefit received by investors and place an enormous amount of pressure on meeting already tight reporting deadlines. We believe the additional time required for the auditor to perform specific procedures will delay public filings and keep much anticipated financial information from reaching investors and other users of financial statements in a timely manner. It is also unclear as to the operability and cost of the rules as they relate to the proxy, which is typically filed after the 10-K. We are also concerned that this proposal could make the auditor and the company more vulnerable in the event of any future litigation and potentially result in increased audit and legal fees.

- We believe a change from "read and consider" to "read and evaluate" along with the introduction of specific procedures for the auditor to perform would be confusing to investors, perhaps indicating a change in auditor responsibility for other information. Frankly, we believe that this change would be misconstrued to indicate a higher level of assurance is being provided on other information, be it financial or non-financial. We believe that this could result in negative consequences for investors, auditors and registrants.

- We believe the proposals are duplicative of a company's disclosure review policies and procedures. Disclosures are already subject to multiple verification procedures, including CEO/CFO certifications, disclosure committee procedures, formal disclosure controls (subject to

SEC regulation), independent compensation committee certifications, and oversight by independent board committees. We do not understand how auditor review procedures would improve this process and, in fact, are concerned that an overreliance on the auditor could result in a less diligent internal review process.

- We believe the Proposed Standards may have an unexpected impact on the securities law liability rules. In particular, it is not clear whether the proposed "read and evaluate" requirements would expose auditors to additional liability for misstatement and omissions in non-financial disclosures, nor is it clear how new requirements might impact the ability of companies and auditors to rely on the SEC's safe harbor rules applicable to forward-looking information.

- We believe that the extension of auditor responsibility to non-financial information and information incorporated by reference (i.e. proxy) will add additional administrative burden and cost and result in little or no benefit to the investor. We are also concerned that a broadening of auditor focus to information outside their area of expertise or outdated information incorporated by reference could compromise the quality of their audit and reporting on financial information in the financial statements.

- We believe that the proposed expansion of the auditor's scope would be very difficult to implement and confusing for investors and other users. Many areas outside the financial statements are more subjective and less prescriptive than financial statements and as such pose additional challenges for auditors. We question how an auditor will evaluate forward looking information included in MD&A. For example if a company includes earnings guidance in its MD&A will investors be comforted that the auditor has "evaluated" that guidance for material misstatement of fact? Will the auditor be challenged by regulators or users of financial statements if the guidance ultimately proves unreliable? If the auditor has to consent to the reissuance of its report how will it update its commentary on CAM and areas outside of the financial statements?

With respect to auditor tenure, we oppose the proposed requirement to add a statement in the audit report regarding the year the auditor began serving consecutively as a company's auditor. Although the Board indicates that investors and other financial statement users have indicated strong interest in this information, we do not believe the information is relevant or useful in the auditor's report for the following reasons:

- We are not aware of any data indicating a correlation between audit tenure and audit quality, and believe the inclusion of this information in the audit report implies such a correlation exists. Without any context for a user regarding the relevance of this information, each user is left to determine what impact the auditor's tenure has on the conclusions reached by the auditor and expressed in their report. For some, this may simply result in confusion (i.e., they might simply pass over the information since they don't understand why it is being disclosed); however, for others, they may conclude one company's financial statements are more accurate than another's because of differences in audit quality based on one firm's tenure versus another's. In the former case, we don't believe tenure should be included in the report since confusion is certainly not an intended outcome, and in the latter case we don't believe tenure should be in the auditor's report because it could call into question the comparative quality of every audit performed by implying there are higher or lower quality audits performed by firms with different tenures. With mandatory lead and concurring partner rotations as well as the stringent internal quality mechanisms of the firms and external regulation by the PCAOB, we believe the quality of each audit should stand on its own merits regardless of the period of time one firm has been engaged consecutively with a company.

- We recognize that in some circumstances investors may have an interest in understanding the tenure of an audit firm (i.e., at a shareholder's meeting when voting on the engagement of an audit firm). In that circumstance, it would be more relevant in our view to include audit tenure information in a company's proxy statement or some other set of materials that are outside the audit report. Including such information in the audit report shifts a debate over auditor appointment decisions to a debate of the quality of the underlying audit. In our view, provided that an auditor has been engaged according to proper procedures and with adequate oversight, the audit report should be allowed to stand on its own.

With respect to auditor independence, we don't object to inclusion in the auditor's report of a statement stating that the auditor is independent but question the necessity given that the title of the report – "Report of Independent Registered Public Accounting Firm" – indicates that the auditor is independent.

Regarding the other proposed changes; we are supportive of reference to "the related notes" in the introduction paragraph, and clarifying that the financial statements are free of material misstatement, "whether due to error or fraud".

In summary, we are supportive of the Board's efforts to introduce enhancements to the audit reporting model that would meet the needs of investors and be practical for manag*ement, audit committees an*d audit firms to adopt in a cost-effective manner. We believe that the focus should not be on providing more information to investors but rather on providing a higher quality of information to investors. We believe that better information can be provided through a combination of the PCAOB clarifying changes to the audit report coupled with targeted standard-setting by the Financial Accounting Standards Board ("FASB") or Securities and Exchange Commission ("SEC").

We appreciate the opportunity to present our views on this subject and welcome the opportunity to meet in person to review them with you. Thank you for your attention and consideration.

Best regards,

Terrence R Marcinko
Director Finance & Accounting
Aerospace Industries Association

Agrium

December 1, 2013

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

Via email: comments@pcaobus.org

**PCAOB Rulemaking Docket Matter No. 34**
**PCAOB Release No. 2013-005 *Proposed Auditing Standards***

Dear Secretary:

We appreciate the opportunity to submit our comments to the Public Company Accounting Oversight Board on the above-noted proposed standards. We support the PCAOB's goal of promoting informative, accurate, and independent audit reports.

Agrium is a global producer and distributor of agricultural nutrients, generating over $15 billion in revenue annually. Listed on the Toronto and New York stock exchanges with a market capitalization of approximately $US13 billion, we employ over 14,500 people globally.

In this letter, we provide comments on certain of the PCAOB's proposals. We have based our comments on our concepts of the purpose and deliverables of the audit reporting model. These concepts are that: a) auditor's reports should be transparent as to the nature of assurance, b) management, and not auditors, are the source for financial reporting information; and c) auditors should provide assurance only on financial statements, as prepared by management. In applying these concepts in evaluating the PCAOB's proposals, we are concerned that the proposals would be confusing to readers of financial reports and auditor's reports. Readers could misinterpret the source, meaning, and significance of the proposed information. We are also concerned that some of the proposals duplicate information already required in financial reporting. Finally, we believe that the proposals will increase the cost of the audit without providing benefits, and without supporting the PCAOB's goals.

We provide below answers to selected questions from Appendix 5 and 6 of the release.

*Appendix 5*

*5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.*

*a) Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?*

We accept the belief, as expressed by members of the Board of Directors of the PCAOB, that there is no demonstrated correlation between audit tenure and audit quality. Accordingly, we do not believe that audit tenure is useful to investors and other financial statement users. We agree with the possible misconception expressed in the release by the PCAOB that audit tenure could unduly be perceived as affecting auditor independence. Accordingly we are strongly against the inclusion of this information.

Further, we meet with shareholders, potential investors and other stakeholders on a regular basis and we have not noted that the subject of auditor tenure is important to them. Investors that consider this information necessary to forming judgments about the relationship between an auditor and financial statement preparer can determine tenure on their own account through available public information.

*b) Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?*

We expect that companies with corporate histories that include mergers and acquisitions will face challenges in determining and reporting this information. Audit firms also have histories of mergers, which could complicate determination and presentation of this information.

*c) Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?*

We do not believe that this information provides any additional useful information to financial statement users. Further, we believe that information such as auditor tenure could distract the attention of readers of the auditor's report from the substance of the report.

*11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?*

Potential unintended consequences with communication of critical audit matters are:

*Investor confusion*

IFRS and U.S. GAAP currently require disclosure of critical accounting judgments and estimates in financial reporting. We believe that investors will be confused by further discussion of critical matters in the auditor's report.

Our regular interactions with our shareholders, financial statement analysts, creditors and other financial statement users have led us to believe that investors review the auditor's report to confirm that the financial statements have received a clean audit opinion. Investors may draw unwarranted inferences on the quality of the content of the financial statements from the inclusion of critical audit matters in the auditor's report.

*Impact on the relationship of financial statement preparers with auditors*

We believe that some preparers could become less forthcoming in discussing subjective or complex matters with auditors in an attempt to avoid disclosure of critical audit matters. This would impair existing relationships between auditors and their clients. Resulting impacts could be an increase in the amount of time necessary to complete the audit, and a decrease in materiality levels. Both of these impacts would increase audit costs.

*Auditor pressure*

To provide an impression of audit quality, auditors may perceive an obligation to report critical audit matters, regardless of audit complexity. Because the language in the standard defining critical audit matters is vague, i.e. matters which "involved the most difficult, subjective, or complex auditor judgments," we believe excessive latitude for interpretation of the standard exists. Accordingly, otherwise routine audit matters might be reported unnecessarily as critical audit matters.

*Potential for litigation*

We believe that the risk of litigation arising from inclusion of critical audit matters in the auditor's report could cause tension between auditors, management and the audit committee. We do not expect benefits would justify this risk.

*Appendix 6*

*2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?*

We do not believe it is appropriate to apply the proposed other information standard to information incorporated by reference. We expect significant unintended consequences with this proposal, outlined below:

*Role of the auditor*

In requiring that auditors opine on information other than the financial statements, the proposals introduce confusion as to the role of the auditor. Auditors currently audit financial statements; investors may assume that audit-level assurance applies unduly to the other information.

*Additional costs*

Requiring an auditor to expand their audit report to evaluate and comment on other information will add substantially to audit costs.

In conclusion, although we support the Board's goal to provide more useful information in the auditor's report and make the audit and auditor's report more relevant to investors, we feel the proposed amendments have significant unintended consequences which could have the opposite effect. We urge the PCAOB to consider our comments. We are encouraged by the news of a potential roundtable in early 2014 to address concerns of both auditors and preparers of financial statements.

Sincerely,

Stephen Dyer
Executive Vice President & Chief Financial Officer

Fredrick R. Thun
Vice President & Corporate Controller

**AK Steel Corporation**
9227 Centre Pointe Drive
West Chester, Ohio 45069

December 11, 2013

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

Via email

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Sir or Madam:

We appreciate the opportunity to comment on the proposed changes to audit standards in PCAOB Release No. 2013-005. AK Steel is a $6 billion producer of flat-rolled carbon, stainless and electrical steels, primarily for automotive, infrastructure and manufacturing, construction and electrical power generation and distribution markets.

We do not believe the proposal to disclose critical audit matters is appropriate. In our opinion, readers may misconstrue a listing of critical audit matters to represent a summary of the only important issues affecting the financial statements and, as such, may focus on those issues to the detriment of other important disclosures that may not be deemed to be a critical audit matter. The auditor's report should not become a summary of critical accounting issues in lieu of a thorough analysis of the financial statements and other disclosures. In addition, we believe a reader may conclude that the critical audit matters represent an opinion on a part of the financial statements at a higher level than the financial statements taken as a whole (e.g., "The financial statements have been audited, but [critical audit matter] has really been audited thoroughly and is 100% right.").

Further, the identification of critical audit matters will be subject to a great degree of judgment and the conclusion of what is and isn't a critical audit matter could differ greatly between different auditors and different companies. We are concerned that disclosure of critical audit matters might expose auditors and registrants to liability for not disclosing something as critical even though the auditors may have properly identified and audited the issue.

We believe that drafting the disclosures of the critical audit matters would also be overly time consuming and would introduce the potential for greater tension in the relationship between auditor and management and increase audit costs, outweighing any potential utility of the disclosure. In part, this may be caused by the need to disclose the considerations that led the auditor to determine that the matter is a critical audit matter. Because the auditor has greater access to privileged information than the general public, the considerations that the auditor relied on to determine a critical audit matter may include information that has not been publicly disclosed, either due to immateriality or sensitivity. For example, the existence of a significant control deficiency may increase the criticality of an audit matter in the eyes of the auditor, but that same fact is not required to be disclosed by management because it does not rise to the level of a material weakness. Thus, disclosure of critical audit matters may exceed the level of disclosures required by existing SEC requirements and U. S. generally accepted accounting principles. Attempts by the auditor and management to synchronize these disclosures will likely result in much greater time-intensive discussion and additional drafting of footnotes, audit report and other disclosures, as well as audit costs, without rendering significant benefit to the reader. Traditionally, the auditor's report has largely been standardized and generally consistent amongst audit firms. This proposal would raise the stakes of how critical matters are disclosed to the public and, as a result, management will be very concerned with how those messages are worded and whether they are consistent with how they are disclosed in other areas of the annual report. This would significantly change the process by which the auditor's report was drafted, reviewed and approved, with much greater management involvement in drafting the auditor's report. We believe a clear distinction of responsibility should be maintained—management's responsibility for preparation of the primary financial statements and related disclosures and the auditor's responsibility for testing management's financial statements and disclosures. The disclosure of critical audit matters would certainly blur that division of responsibilities due to disclosure of risk factors and other company-specific matters outside of the financial statements and notes.

If the Board proceeds with requiring a disclosure of critical audit matters, we believe that the requirement to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter may necessitate a reference to disclosures outside the audited financial statements and notes, such as reference to management's discussion and analysis or the critical accounting estimates section in the Form 10-K. The Board should consider how reference to disclosures that may not be included in the audited financial statements would affect the ability of the auditor to identify and describe critical audit matters in the auditor's report.

We note that the proposal suggests the communication of critical audit matters could help to alleviate the information asymmetry that exists between company management and investors. We believe that information asymmetry is not an issue between management and investors, but rather, an issue as to whether all investors are on equal footing. Management will *always* have more information than an investor because of their role. We believe that if a reduction of information asymmetry is desired, it is a financial reporting issue to be addressed by the FASB and the SEC, not through disclosures in the auditor's report.

We agree with your proposed additional standard language on registration with the PCAOB and the requirement for the auditor to be independent. We believe that the emphasis on the auditor's independence is desirable and hope that this helps to clarify the relationship between the company and the auditor. We also believe that the proposal to disclose the auditor's tenure may be valuable to some investors who might believe that a long tenure reduces auditor independence. However, we don't believe that including the auditor's tenure in the auditor's report is appropriate. We believe that this disclosure in the auditor's report may lead to questions of the credibility of the auditor or their conclusion if presented in this context. Ultimately, the company's audit committee and auditor must determine whether or not the auditor is independent prior to the audit and the issuance of the auditor's report. We believe that tenure information would be more appropriately disclosed in the proxy statement, where a discussion of tenure and fees can be placed in the proper context of addressing independence as part of the discussion of engagement/re-engagement of the auditor.

We believe the proposal would not make clearer the auditor's role in reviewing other information in annual reports filed with the SEC containing the financial statements and the related auditor's report. We believe that the "conclusion" proposed by the PCAOB would be misunderstood by the reader to represent a greater level of involvement by the auditor with that other information than intended. Also, we believe the incorporation by reference of the proxy statement and other items would leave the auditor in a strange position of having written a "blank check" for reporting on their involvement with other information that may not even have been drafted before the issuance of the auditor's report and that will be incorporated in the annual report in the future.

If you have any questions, please feel free to contact Roger K. Newport (513.425.5270 or roger.newport@aksteel.com) or Gregory A. Hoffbauer (513.425.2099 or greg.hoffbauer@aksteel.com).

Sincerely,

Roger K. Newport
Vice President, Finance and Chief Financial Officer

Gregory A. Hoffbauer
Controller and Chief Accounting Officer

American Bankers Association
Building Success. Together.

Michael L. Gullette
Vice President – Accounting and Financial Management
202-663-4986
mgullette@aba.com

December 11, 2013

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

Via website submission: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 034 – *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses and Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB standards*

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB standards (Proposed Standard*). Bankers are preparers of financial statements that are critical in the efficient functioning of the capital markets and overall economy. Bankers are also significant users of audited financial statements, as credit analysts must rely on the integrity of audited financial statements in their evaluation of overall credit risk. From a banker's perspective, there are two major aspects of the Proposed Standard: First, if approved, the Proposed Standard will change the auditor's reporting model by requiring the auditor to communicate in the auditor's report "critical audit matters" that were addressed during the audit of the current period's financial statements. Second, the Proposed Standard will add new elements to the auditor's report related to responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report. For all intents and purposes, this other information is included throughout a company's Form 10-K.

**Discussion of Critical Audit Matters (CAMs) Must be Reconsidered**

It is noted within the discussion related to the Proposed Standard that many investors have requested improvements in the relevance of the auditor's report and that communicating CAMs likely would provide meaningful information about the auditor's work in performing the audit. Examples of CAM in the document include the use of new financial models, a company's competitive position, the illiquid nature of relevant securities markets, and a company's internal control deficiencies. We believe providing such information as part of the auditor's report could

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees.

be misconstrued as reporting on problem areas that were not resolved to the auditor's satisfaction. Moreover, CAM documents maintained in auditor work papers currently serve largely as guidance for the audit engagement partner and the related reviewing partners to ensure that they are aware of the important audit risks. ABA believes the annual report should focus on the company and not on the difficulties individual auditors have in performing the audit. With this in mind, we believe these matters do not belong in the auditor's report[2] and are concerned that implementing the Proposed Standard will introduce unintended consequences.

The objective of a registrant's annual report on Form 10-K is to assist the investor in assessing the amount, timing, and uncertainty of future cash flows of the company by providing a comprehensive overview of the company's financial condition. We acknowledge that the quality of that assessment may depend upon whether a company's internal controls are sufficient. However, even if we assume the disclosures within the Proposed Standard work as intended, with the exception of centralizing the internal control information to help investors make the assessment, we see no incremental value for the investor from requiring additional CAM information. This is because, within the annual report, this information already exists. Currently, investors receive and evaluate this information through review of a company's critical accounting policies and significant estimates (located within the audited financial statements), as well as the company's business and operating trends and financial and operating risks, and the company's assessment and the auditor's attestation of internal controls over financial reporting in accordance with the Sarbanes-Oxley Act (included elsewhere in the Form 10-K). With that in mind, however, connecting the dots can be challengingfor investors, considering the hundreds of pages of disclosures and discussion within a typical bank's annual report. Therefore, as an alternative to the proposed auditor discussion of CAMs, we recommend that an index of relevant information (such as the information referred to above) be provided by the registrant within the annual report.

We also note that a "control deficiency less severe than a material weakness" will be a common issue among CAMs. This challenges the current definition of a significant deficiency in internal control, in which there is less than a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis[3]. We believe such an internal control deficiency – one that does not lead to a reasonable possibility of a material misstatement – is irrelevant to the investor's assessment regarding the reliability of the financial statements. Such a disclosure puts into question the auditor's opinion related to the overall financial statements and also, since significant deficiencies in internal controls are not necessarily disclosed in annual reports, changes the relationship the auditor and management

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[2] Because of the nature of issues proposed to be addressed within CAMs, we believe a discussion of CAMs within an auditor's report may necessitate additional footnote disclosures within the audited financial statements – disclosures that now exist within Management's Discussion and Analysis.

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[3] We assume that such control deficiencies that are less than material weaknesses will not qualify as significant deficiencies, as anything less than a significant deficiency would not merit attention by a company's audit committee. We, therefore recommend that, if the Proposed Standard is approved, any final guidance specifically refer to "significant deficiencies in internal control" to avoid any confusion as to its meaning.

have with investors. We believe that management should continue to be the contact point with investors related to relevant internal control issues within the annual report, rather than the auditor. The Proposed Standard appears to breach that relationship in this circumstance.

We believe these consequences are not intended by the PCAOB. We believe the PCAOB would agree with ABA that the registrant should be the focus of the annual report and that management (via the audit committee) is responsible for internal control oversight, based on information from auditors. Therefore, in order to address investor concerns about the risk of material misstatement, as we propose above, a new index of internal control-related information should enhance an investor's ability to assess the reliability of the financial statement assertions.

**Auditor Procedures Related to Other Financial Information Must be Field Tested**

A large expectation gap may currently exist with auditor procedures over other information included in a company's annual report that is outside the information included within the audited financial statements, and we support the PCAOB's efforts to examine the issue. However, we are concerned that, given the large amount of unaudited financial information found throughout an annual report which may be sourced from databases that have not been subjected to testing under Sarbanes Oxley, a greater expectation gap may be created as a result of the Proposed Standard.

Non-GAAP information, as well as subjective, forward-looking financial information may be perceived to be subject to auditor examination, when, in reality, there has only been a review for consistency with other information in the audited financial statements. Because of the Proposed Standard, we believe auditors will feel pressured to expand their review procedures, unnecessarily resulting in greater costs for auditors and preparers. We fear that an index may further be necessary to separate what has been subject to audit, what has been "evaluated" for consistency with audited information, and what is not objectively verifiable, even for consistency. Such a table would be voluminous, difficult to maintain, and, over time, provide very little incremental value to investors.

With this in mind, prior to approving a final standard, we recommend field testing be performed to determine how auditing firms will apply the guidance to publicly-held banking institutions of all sizes. While we understand that certain PCAOB staff members believe that auditor procedures related to most large banks will not increase as a result of the Proposed Standard, we are not as comfortable with that view and believe that a new standard will increase audit fees for all financial institutions. We urge the PCAOB to carefully weigh these costs and any unintended consequences identified in the field testing against the benefits the PCAOB believes investors will obtain.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette

*Michael Monahan*
*Senior Director, Accounting Policy*

December 11, 2013

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, D.C.  20006-2803

Re: PCAOB Release No. 2013-005 Rulemaking Docket Matter No. 034 (Auditor's Report and Responsibility)

Dear Ms. Brown:

The American Council of Life Insurers (ACLI)[1] appreciates the opportunity to comment on the PCAOB proposals for two new audit standards, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

We support the intention of the auditor report proposal to improve the informative value of the auditor's report and to promote the usefulness and relevance of the audit and the related auditor's report.  To that end, we support the following recommended changes to the auditor's report:

- Including a statement on the independence requirements of the auditor in accordance with U.S. federal securities laws and the rules and regulations of the PCAOB,
- Clarifying language that the financial statements "and related notes" are free of material misstatement "whether due to error or fraud," and
- Providing description of responsibilities relating to other financial information accompanying the audited financial statements.

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[1] The American Council of Life Insurers (ACLI) is a Washington, D.C.-based trade association with more than 300 member companies operating in the United States and abroad. ACLI advocates in federal, state, and international forums for public policy that supports the industry marketplace and the 75 million American Families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing more than 90 percent of industry assets and premiums. Learn more at www.acli.com.

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We do not, however, support the proposed requirement for the disclosure of critical audit matters, or CAMs, in the auditor's report. We believe that the audit report should maintain a simple, brief pass/fail approach that limits mention of items to "emphasis of a matter" in unqualified audit reports on financial statements and material weaknesses on internal controls over financial reporting. Expanding the auditor's report to include CAMs would duplicate management's disclosures on critical accounting estimates and risk factors, introduce unnecessary ambiguity to the auditor's opinion, potentially undermine the purpose of the audit committee, and increase the time and cost to develop audit reports. We are concerned about these increased costs to preparers for procedures that are duplicative to management's disclosures that already exist. Significant additional time will be incurred by audit firms, in consultation with their national professional practice offices, deliberating CAM wording, which will either detract from the time spent to perform audit procedures or result in significantly more hours and higher audit fees.

The CAMs illustrated in the proposal, included disclosure/reporting matters not promulgated by existing accounting or internal control guidance, such as:

- A control deficiency less severe than a material weakness.
- Identification of several misstatements that were corrected by the Company.

If these items were included in the auditor's CAMs, the auditor would be reporting on matters not currently required in reports to investors. There should not be information on accounting matters presented in the audit report that is not in the financial statements and there should not be information on control matters presented in the auditor's report that is not in management's report on internal control. We are also concerned that financial statement users would inappropriately view the auditor's report as a series of piece-meal opinions, which may lead to interpreting each matter as a qualification with respect to the identified critical audit matter. Furthermore, the identification of CAMs in the auditor's report could potentially be misleading to financial statement users by implying, in most cases inappropriately, that no other audit procedures were critical to the formation of their overall opinion on the financial statements. If a need for more disclosure of judgmental matters affecting the financial statements exists, those areas should be addressed within management's reporting or maintained as part of confidential communication to the audit committee and not through the auditor's report.

Finally, before issuing a standard that requires the auditor to report on more than the fairness of the financial statements, taken as a whole, and internal controls over financial reporting, we strongly recommend that field testing is performed where audit firms draft CAMs, and then auditors, preparers and users evaluate the usefulness of the information.

Further, we do not support the requirement to expand the auditor's responsibility over "other information" beyond the level of assurance given today. We also do not believe it is appropriate for the auditor to evaluate non-financial information or information that does not accompany the audited financial statements. The auditor's current responsibility is to review other financial information for material inconsistencies or material misstatements. That review includes evaluating whether quantitative and qualitative information is consistent with amounts and disclosures presented within the financial statements and audit evidence gathered in support of the audit. We have no objection for the auditor's report to include a description of the auditor's responsibility to this effect; however, "read and evaluate" may be a higher level of assurance than the "read and consider" requirement today and would, therefore, result in significantly more hours and higher audit fees. We believe increasing the level of assurance that the auditor provides over other information from "consider" to "evaluate" would provide little benefit to the users and does not justify the increased cost. Therefore, we encourage the

Board to ensure that the auditors will not be required to increase their level of assurance over other information relative to today's standard.

We hope that you will carefully consider our input and welcome your feedback and questions.

Sincerely,

M Monahan

Mike Monahan
Senior Director, Accounting Policy

American Federation of Labor and Congress of Industrial Organizations

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December 9, 2013

***Submitted by email to [comments@pcaobus.org](mailto:comments@pcaobus.org)***

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

***Re: Rulemaking Docket Matter No. 034 - Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information***

Dear Ms. Brown:

On behalf of the American Federation of Labor and Congress of Industrial Organizations ("AFL-CIO"), I appreciate the opportunity to comment on the Public Company Accounting Oversight Board (the "PCAOB") proposed auditor reporting standards as set forth in PCAOB Release No. 2013-005 dated August 13, 2013. The AFL-CIO is the umbrella federation for U.S. labor unions, including 57 unions representing more than 12 million union members. Union-sponsored and Taft-Hartley pension plans hold more than $540 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in pension plans sponsored by corporate and public-sector employers.

The ability of investors to rely on accurate and reliably audited financial statements is fundamental to ensuring the integrity of the capital markets. We commend the PCAOB for taking steps to improve the audit process, including efforts to make the report by auditors to shareholders on company financial statements more meaningful. The auditor's report is the primary means through which auditors communicate with investors regarding the audit of a company's financial statements. However, auditors' reports that consist of boilerplate are of little value to investors.

We believe that the proposed standards should be further strengthened to provide investors with useful new information. It is noteworthy that even audit firms support the need for audit reports to provide more relevant information to investors. As Dennis Nally, Chairman of PricewaterhouseCoopers, has said: “It’s not difficult to imagine a world where the combination of single reporting standards (and) more cohesive global auditing standards…lead one to consider whether it is necessary to change the content of the auditor’s report to be more relevant to the capital markets and its various stakeholders.”[1]

To reiterate the AFL-CIO’s previous comments on the PCAOB’s concept release, we believe that four key changes need to be made to the audit report. The report should include a discussion of the auditor’s assessment of the estimates and judgments made by management in preparing the financial statements, and how the auditor arrived at the assessment; a discussion of areas of high financial statement and audit risk, and how the auditor addressed those risks; a discussion of unusual transactions, restatements and other significant changes in the financial statements; and a discussion of the quality, not just the acceptability of a company’s accounting practices and policies.

While the PCAOB’s proposed auditing standards will require auditors to report on what they have identified as “critical audit matters,” we believe that reporting needs to be strengthened to address the three other areas addressed by the AFL-CIO’s previous comments. Moreover, the proposed auditing standards endorse a subjective standard of critical audit matters, leaving it to the auditor to determine what they are, rather than using an objective assessment. And, although it would be expected that there would be critical audit matters in most audits, the auditors would be free not to report any, so long as their work papers document the reasons.

Financial statements have become increasingly complex and dependent on management’s estimates of subjective values. We believe that auditors should be required to disclose their assessment of significant judgments and estimates made by management. Some might argue that by doing so, auditors are taking on the role of management. However, when an auditor has substantial doubt about a company’s ability to continue as a going concern, the auditor is required to issue a modified report – and, in so doing, the auditor is providing new information to the market. So it is not inconsistent to require auditors to disclose their assessment of significant judgments and estimates made by management.

We continue to believe that the auditor’s report should also include a discussion of unusual transactions, restatements and other significant changes in the financial

[1] Written testimony of Dennis Nally, Chairman and Senior Partner, PricewaterhouseCoopers, LLP before the Federal Advisory Committee on the Auditing Profession, U.S. Department of the Treasury, Dec. 3, 2007.

statements. Investors would benefit from knowing more about accounting misstatements, including failures in internal controls that permitted the misstatement to occur, whether those weaknesses in internal controls had been fixed, and other changes that have occurred as a result. Investors should also be provided more information about unusual transactions such as those made toward the end of a quarter, or at fiscal year-end, in order to meet financial targets. Other unusual transactions that would fall under this category include tax-shelters and related party transactions.

The auditor's report should also discuss the quality, not just the acceptability, of the issuer's accounting practices and policies. For example, auditors should describe those instances in which a management's application of accounting principles, while acceptable under GAAP, was not the preferred practice. Differences in how companies apply GAAP can have a significant impact on their financial statements.

In addition, we believe that the auditor's report should indicate the auditor's responsibility for detecting material fraud. The auditor's report should clearly state that the auditor provides reasonable assurance that the financial statements are free of material misstatement, and indicate in the report that reasonable assurance indicates a high level of assurance.

Although there is some merit to the pass/fail nature of current audit reports, we would prefer that audit reports provide more gradations than simply unmodified and modified – particularly since the large majority of audit reports issued are unmodified. For example, auditors could evaluate the quality of the issuer's accounting policies and practices (including its estimates and judgments) by assigning one of four grades: conservative, above average, average and aggressive. There will not need to be a separate failing grade because such a grade would denote non-GAAP reporting and would require the auditor to issue a modified opinion.

Requiring audit firms to issue reports with such grades could serve to meaningfully differentiate between issuers in the quality of their accounting policies and practices. Such differentiation would be useful to investors in making investment decisions, and could represent an efficient means of communicating the auditor's overall judgment about the issuer's accounting quality. Moreover, expanding the audit report choice to four categories will reduce the risk that auditor reporting devolves into boilerplate language which would provide less information to investors.

The auditor's report should identify the role of any affiliated firms in conducting the audit. We believe this is important because investors currently have no information about the extent to which the audit was performed by a foreign affiliate of a U.S. auditing firm. Investors would also benefit from the development of an information clearinghouse that identified auditors attached to public company audit engagements worldwide, listing any sanctions, suspensions and litigation against them. Investors can already obtain this type of information about brokers and investment advisers.

We are pleased that the PCAOB is also moving toward requiring lead audit engagement partners' names to be disclosed in company annual reports, although we believe it lacks the weight of requiring the engagement partner to sign his or her name on the auditor's report in addition to the audit firm's name. We find the absence of the engagement partner's signature inexplicable given that CEOs and CFOs must personally certify company financial statements.

Investors deserve more information about company audits and the auditors whose job is vital to preventing material misstatement in the financial statements of public companies, whether caused by fraud or error. Thank you again for the opportunity to comment on the proposal. If you need any additional information, please contact me at brees@aflcio.org or (202) 637-5152.

Sincerely,

Brandon Rees
Acting Director, Office of Investment

BJR/sdw
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December 11, 2013

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

Re: Request for Public Comment: Proposed Rule on the Auditor's Report and Responsibilities, PCAOB Rulemaking Docket Matter No. 034

Dear Office of the Secretary:

We are pleased to have the opportunity to provide comments on the Proposed Rule on the Auditor's Report and Responsibilities ("Proposed Rule"). The comments contained below are based upon our collective experiences as senior leaders in various business, governmental, legal, and academic organizations, including our roles as audit committee chairpersons for the indicated American Funds. The American Funds are one of the oldest and largest mutual fund families in the nation, whose investment adviser is Capital Research and Management Company. The views expressed here are our own and do not reflect those of Capital Research and Management Company.

Summary

As members of the audit committees, we are dedicated to our role of overseeing the Funds' financial statements. In carrying out this role, we exercise due care in engaging a qualified auditor to perform appropriate audit procedures in order to report to shareholders on the fairness of those financial statements. As such, we are supportive of the PCAOB's efforts to examine the rules surrounding the responsibilities of an auditor with respect to other information contained in an audited report, as well as the auditor's report itself. However, we believe that the proposed modifications to the auditor's report, in particular the disclosure of critical audit matters, will ultimately result in boilerplate disclosure, adding little value, while not recognizing the careful, thorough review and discussion that audit committee members have with the auditors during committee meetings. Furthermore, we believe the substantial disclosures surrounding critical audit matters will distract financial statement users from the central purpose of the auditor's report, which is to provide an opinion on the financial statements. As discussed in more detail below, we do not support the changes proposed in the new auditing standard on the auditor's report.

Auditor's report and critical audit matters

Audit committees have oversight over (1) the investment company's accounting and financial reporting policies, (2) its internal controls over financial reporting, and (3) the financial statements themselves. In order to carry out these oversight responsibilities, committees appoint and review the work of the auditors, as well as engage in discussions with management and in certain cases, outside counsel and/or experts. During committee meetings, members receive detailed information via written and verbal presentations from management to gain an understanding of critical accounting policies. These presentations often lead to larger, more focused comprehensive discussions with management and other parties, such as the auditors or fund custodians. In addition, committee members also meet in executive session with the auditors in order to continue to discuss the relevant issues the auditors have encountered, as well as their assessment of management.

We believe that these discussions and presentations provide committee members with the critical understanding needed to assess the complicated and detailed issues that present themselves during an audit. The proposed requirement to describe these matters in a summary fashion in the auditor's report we believe does not recognize the level of complexity or detail needed to understand the full context and resolution of an audit issue. Furthermore, we believe it ignores the valuable work done by audit committee members on behalf of the shareholders of an issuer to oversee the financial statements and auditors. We do, however, support the PCAOB's stated goal to maintain the "pass/fail" model of the existing auditor's report without this additional disclosure in order to communicate on the fairness of the financial statements.

Moreover, we are concerned about the expectation, as stated in the Proposed Rule, that most auditors would determine that there are critical audit matters that require disclosure in the new auditor's report. This expectation may create what we believe would ultimately become boilerplate language in each issuer's audit opinion that would cover a number of generic audit concepts relating to the issuer's industry. These may not provide any additional context for the reader to better understand the financial statements or the business of the issuer, and may distract the user from determining that an auditor is providing an unqualified opinion on the fairness of the financial statements and related footnotes. This may be especially true in the case of an investment company, where detailed information regarding key accounting policies, such as fair valuation (as required by ASC 820) and taxes (required by ASC 740) is already disclosed in the footnotes to the financial statements, and where a detailed schedule of investments is provided. Moreover, a comprehensive set of risk factors for investing in a fund are contained both in the annual report and in the fund's prospectus (and summary prospectus), which are sent to each shareholder. Accordingly, we do not believe the proposed additional disclosures to the auditor's report are beneficial to shareholders, and indeed bring a risk of distracting or confusing readers and thus frustrating the original intent of the Proposed Rule.

Other disclosure proposals for the auditor's report

The Proposed Rule also includes new requirements for the auditor to provide statements in the auditor's report concerning its independence, tenure, and responsibilities concerning other information. With regard to independence and tenure, we understand how users may benefit from the proposed disclosures, but would suggest more study of the exact nature of information required to be shown. We believe that audit committees are best positioned to ensure the independence of its auditors, and that financial statement users rightly assume this standard is being met by the auditor issuing an opinion. Additionally, disclosure of the tenure of the independent auditor is an easily misunderstood data point, does not consider the mandatory rotation of an audit partner, and most importantly is not indicative of audit quality. Audit committees, with their continual discussions with and assessments of the auditor, are in the best position to assess the quality of the audit; proposing to distill that to brief statements on independence and tenure for financial statement users would risk misinterpretation of the auditor's work product. Pursuant to the comments above, we believe that the PCAOB should continue to study the benefits of these proposed disclosures compared to the unintended consequences that these disclosures will be erroneously interpreted as a proxy for audit quality.

With respect to enhancing the responsibilities of auditors for other information included in documents that contain audited financial statements and an auditor's report, we recommend additional research into the cost and benefits of this approach. Under the current auditing standards, we understand that auditors currently review this "other information" (such as that contained in the adviser's letter to shareholders on fund results) to ensure consistency with audited information. In some cases, this review will include additional performed procedures to ensure consistency. We believe that creating additional responsibilities and disclosure over this information will result in significant added testing and costs to shareholders, while providing minimal additional value over the current standards. For example, investment companies annually provide information regarding the approval of its investment advisory and service agreement in the shareholder report. Review of the board proceedings and the related information, which consists of hundreds of pages of explanatory and analytical information, to approve this contract may require extensive procedures on the part of the auditor, with little relevance to the fairness of the financial statements. As such, we encourage the PCAOB to continue to study the costs and benefits of the proposed enhancements with regards to responsibilities of an auditor to review "other information."

* * * * *

Thank you for considering these comments and please feel free to contact any of us should you have questions or wish to discuss our thoughts on the Proposed Rule.

Sincerely,

Ronald P. Badie
Audit Committee Chairman –
Fundamental Investors, The Growth Fund of America, and SMALLCAP World Fund
Former Vice Chairman, Deutsche Bank Alex. Brown

Joseph C. Berenato
Audit Committee Chairman –
Capital Income Builder, The New Economy Fund, and Capital World Growth and Income Fund
Former Chairman & CEO, Ducommun Inc.

Vanessa C. L. Chang
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William D. Jones
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Leonard R. Fuller
Audit Committee Co-Chairman -
American Funds Insurance Series, American Funds Target Date Retirement Series, American Funds Portfolio Series, American Funds College Target Date Series, and the Fixed Income Funds of the American Funds
President & CEO, Fuller Consulting

James C. Miller III
Audit Committee Chairman –
The Washington Mutual Investors Fund, Tax-Exempt Fund of Maryland, and The Tax Exempt Fund of Virginia
Senior Advisor, Husch Blackwell LLP

AGA American Gas Association

December 11, 2013

Office of the Secretary
File Reference: Docket Matter No. 034
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803

**File Reference:** PCAO~~B Rulemaking Do~~cket Matter No. 034

Dear Ms. Brown:

The American Gas Association ("AGA") respectfully submits our comments on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed audit standards included in Release No. 2013-005 addressing both *The auditor's report on an audit of the financial statements when the auditor expresses an unqualified opinion* (the "proposed auditor reporting standard") and; *The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report* (the "proposed other information standard").

The American Gas Association, founded in 1918, represents 202 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which almost 93 percent – more than 65 million customers – receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.

**Overall concerns**

The AGA appreciates the PCAOB's efforts to enhance the information provided to investors and financial statements users. We agree that financial statement users should have access to timely, accurate, objective and relevant information for purposes of making investment decisions. However, we strongly disagree with the proposed auditor reporting standard and proposed other information standard included in PCAOB Release No. 2013-005. We believe a company's financial information and the communication of that information is management's responsibility. We believe the SEC and the FASB should continue to serve as the standard setters for establishing the requirements for information to be provided to investors, and that management should be the sole party responsible for communicating such information.

The SEC has enacted various regulations over time (including designation of FASB as the organization responsible for promulgating US GAAP) on *what* information needs to be disclosed. Importantly, these rules designate management as the responsible party to determine *how* to communicate this information to most accurately reflect a company's financial results and position. The role of the external auditor is to verify that the information presented by management complies with the applicable SEC / FASB requirements and is presented fairly in all material respects. The audit committee, comprised of a company's shareholder-elected Board of Directors, is charged with oversight of both the auditor and management's financial reporting.

The SEC and PCAOB provide additional oversight of management, the audit committee and external auditors by reviewing the financial statements and the audits thereof to ensure these parties are performing their duties appropriately. If management, the audit committee, and the external auditors fulfills their respective responsibilities to communicate timely, accurate, objective and relevant information to financial statement users that is audited in accordance with existing professional standards, we believe the additional communications and requirements outlined in the proposed auditor reporting standard and the proposed other information standard are unnecessary.

In addition to these overall concerns, we provide the following specific observations regarding each proposal.

**The proposed auditor reporting standard**

Of the various requirements proposed in the auditor reporting standard, we most strongly disagree with the requirement that the auditor disclose critical audit matters (CAMs) within the audit report. As such, we have limited our response on the auditor reporting standard to this matter. We believe the proposed standard would be detrimental to the usefulness and relevance of the audit report and would undermine the role of the audit committee. Further, we believe the proposed standard would result in lack of consistency and comparability of auditors' reports across companies while increasing the cost of regulatory compliance.

*The proposal would undermine the usefulness of the audit report and the role of the audit committee*

The auditor is expected to conduct an audit to obtain reasonable assurance that the financial statements are materially correct when taken *as a whole*. The auditor's report does not include, nor do we believe it would be appropriate or practical to include, all of the factors considered by an auditor when forming the overall audit conclusion. Therefore, without the full context of a company's financial transactions, business environment and internal controls obtained by the auditor throughout the audit process, an investor may inappropriately over-emphasize the importance of a CAM when making an investment decision. Likewise, highlighting CAMs in the audit report may lead investors to over-emphasize certain risks because they are disclosed as a CAM and under-emphasize other important business risks that may not meet the proposed CAM disclosure criteria. Additionally, disclosure by the auditor of the most difficult aspects of the audit may be interpreted by some as the auditor expressing reservations in their report on those transactions or accounts affected by a CAM, or as the auditor providing a "piecemeal" opinion on the financial statements which would undermine the usefulness, authority, and credibility of the audit report.

Currently the audit committee, as part of the shareholder-elected Board of Directors, has the authority to oversee the audit and ensure the financial statements contain appropriate disclosure on behalf of shareholders. Under current rules, the auditor already discusses difficult, judgmental, complex and other key aspects of the audit with the audit committee. With its access to auditors, management and the Board of Directors, the audit committee has the requisite knowledge, perspective and authority to ensure the various risks faced by the entity are disclosed in a manner commensurate to their materiality and relevance to investors. The Board's proposal would undermine this oversight role by requiring the auditor to effectively bypass the audit committee and disclose CAMs directly to shareholders in the audit report. We believe that the auditor's role should remain that of attesting on information prepared by management, and the Audit Committee should retain its function as providing primary oversight of the audit process.

*The proposal would undermine the relevance of the audit report/financial statement disclosures*

The matters that would be required to be disclosed as CAMs are already provided in the financial statements or are not relevant to investors in making investment decisions. The proposal states that CAMs are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Many of those matters meeting the criteria above relate to subjective or complex accounting areas which are already disclosed within the financial statements as required by US GAAP or SEC rules. Examples include critical management judgments, risks and uncertainties, and accounting estimates and policies. Repeating these disclosures in the audit report would result in duplicative disclosure and would undermine the relevance of either the audit report or the financial statement disclosures. Further, if the auditor identifies a significant lack of internal control as part of the audit, the audit report on internal control already describes it as a material weakness. If any additional information or disclosure is deemed necessary, such disclosure should be addressed by the SEC and the FASB as part of the financial reporting standard setting process.

The proposed standard would also require that auditors disclose certain audit matters that we do not believe would be considered relevant to investors when making investment decisions. Examples include the level of audit effort applied to a particular account, immaterial or corrected misstatements, change in auditor risk assessment, and an auditor's use of a specialist. Such items may provide information on a business's accounting operations or an auditor's approach, but do not impact the underlying economics of the business and therefore may not be considered relevant by investors.

*Auditor reporting would no longer be comparable or consistent across entities*

Under the proposed standard, the auditor's determination of what is considered to be a CAM will involve a considerable amount of professional judgment and will decrease comparability of the auditor's report. There is a risk that auditors may take a conservative approach and include numerous CAMs in order to avoid potential PCAOB inspection findings or litigation, resulting in voluminous disclosure within the audit report and thereby obscuring the overall opinion. Further, investors may incorrectly interpret longer auditors' reports as an indicator of higher investment risk rather than as a matter of an auditor's professional judgment or reporting policy. There is also the risk that each audit firm's interpretation of what meets the definition of a CAM will differ, resulting in lack of comparability between audit reports for similar companies or industries. We therefore have concerns that the auditor's subjective determination of what is considered to be a CAM could be used erroneously as the basis for, or at least influence, differences in investor decisions among otherwise comparable entities.

*Potential implementation challenges and cost considerations*

The increased costs of compliance with the proposal will outweigh any perceived benefit. A significant amount of additional time will be required by audit firms in order to develop, review and present CAMs, which will result in increased audit fees. Extensive discussion and consultation with Company management, legal and the audit committee would also be required, resulting in increased internal costs. Further, because some CAMs may not be identified until late in the audit process as the audit is performed, this additional work will be required during an already busy period within the audit and financial reporting cycle which would impact the timing of SEC filings and, consequently, the ability of investors to obtain financial information in a timely manner.

While we do not support the inclusion of CAMs in the auditor's report, if the Board ultimately determines to implement the rule as proposed, we request that the effective date be delayed to allow companies and auditors to field test how the CAM provision would be applied in practice and provide an opportunity to mitigate the potential issues identified above.

**The Other Information Standard**

We support adding language to the auditor's report that will *clarify* the auditor's procedures and responsibility for other information contained in SEC filings (such as the MD&A). We do not support *expanding* the auditor's responsibilities regarding other information, or including language in the auditor's report that could be perceived as an expansion of the auditor's responsibilities. We believe the proposal would lead to higher costs with no commensurate benefit to investors. Further, we believe the proposal as written would result in several practice issues that would result in inconsistent application among audit firms.

Management should continue to prepare and present the other information contained in the annual reports of public companies, with over-sight from the Audit Committee, without the additional costs of such information being subject to additional procedures by the auditors. We support the retention of existing procedures contained in AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* which require auditors to "read and consider" other information to ensure the information is consistent with the audited financial statements. We believe AU 550 provides an appropriate level of assurance for the other information considering both the costs and benefits of such assurance.

We believe the "read and evaluate" language included in the proposed standard implies, and is likely to result in, a level of additional procedures that is substantively different from and greater than the requirements set forth in AU sec. 550. We do not agree with this change in the proposed language as it will have far reaching impacts on the procedures currently being applied to other information. We believe that, in carrying out their professional responsibilities, auditors presently are conducting a sufficient level of review commensurate with the nature and purpose of that information.

In our opinion, the use of the term "evaluate" will prompt auditors to expand their procedures substantively beyond the existing requirements in AU sec. 550 resulting in unnecessary procedures and increased costs. Similar to the timing of CAMs, the additional work over other information will be required during an already busy period within the audit and financial reporting cycle and would lengthen the timing of a company's SEC filings to the detriment of investors.

Alternatively, we recommend that the Board retain the existing procedures in AU sec. 550 but ensure that the language presented in the auditor's report clearly communicates what those existing procedures entail. If the Board believes further clarity is warranted to differentiate the level of assurance provided within the financial statements, we request the Board consider a more cost effective approach. For example, the Board could consider adding headers or other disclaimers on each page of the audited financial statements that indicate if the information is audited.

While we disagree with the proposal, we believe several practice issues that would need to be addressed within the standard if the Board determines to adopt the standard as proposed. These practice issues include determining what information would be subjected to the expanded procedures, what procedures to perform on forward-looking statements, and how an auditor should determine materiality of non-financial information.

**Conclusion**

We appreciate the opportunity to comment on the Board's proposals. As discussed above, we do not support the inclusion of CAMs in the auditor's report or expanded audit procedures on other information contained in the annual report. We urge the Board to reconsider the proposals. We believe that auditor reporting of CAMs would decrease the relevance of the audit report, the role of the audit committee, decrease audit report comparability and increase costs of compliance all to the detriment of investors. Further, we believe guidance currently contained in AU sec. 550

appropriately addresses the audit procedures to be performed over other information contained in the financial statements and the benefits arising from any further audit scrutiny would not justify the costs.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Joseph L. Martin

Joseph L. Martin, Controller, American Gas Association

**From:** Hasan Andalib
**To:** Comments
**Subject:** RE: PCAOB Rulemaking Docket Matter No. 034 - Comments
**Date:** Monday, December 02, 2013 7:45:44 PM

December 02, 2013

Office of the Secretary

Public Company Accounting Oversight Board

1666 K Street NW

Washington, DC 2006-2803

United States

www.pcaobus.org

**Subject: Comments on Release No. 2013-005; PCAOB Rulemaking Docket Matter No. 034**

Dear Sir,

Thank you for giving us the opportunity to comment on your Proposed Auditing Standards - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor's Report; and Related Amendments to PCAOB Standards.* I am a banker by profession and a retail investor on the side. I have been working in banking for a number of years, have a MBA degree in finance and consider myself quite proficient in terms of identifying and analyzing investments.

As I understand that the recent proposals are designed to retain the current "pass/fail" audit report model while increasing the informational value and relevance of the report. Auditors would be required to communicate “Critical Audit Matters” (CAM) as determined by the auditor. These would be defined to be those addressed during the current-period financial statements audit that (1) involved the most difficult, subjective or complex auditor judgments, (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or (3) posed the most difficulty in forming the opinion on the financial statements. Presumably these would entail items such as allowance for sales returns, valuation allowance for deferred tax assets, and fair value of fixed maturity securities held as investments that are not actively traded.

The auditor, in compiling the report, would need to identify the critical audit matter, describe the considerations that led the auditor to determine that the matter is critical, and refer to the relevant financial statement accounts and disclosures related to that matter, when applicable. If it is determined that there are no critical audit matters, the auditor would state that in the report. However, this subjective nature of CAM is something that I cannot support from the perspective of an experienced investor. The risk of including additional disclosures regarding critical audit matters in the audit report is that users of the financial statements may not have enough context to appropriately interpret them. It would most likely be vague as there is no set standard or criteria. It would be open to interpretation and might vary from one auditor to another. Due to this, investors could get confused and make wrong investment decisions. Also, this brings up the possibility of raising unnecessary red flags and driving away potential investors.

On another note, public disclosure of CAM might end up driving company strategy and eventually lead to fraudulent financial report or manipulating internal controls geared to meeting analyst expectations and favorable audit reviews. It could also cause tension between auditors and their clients, by the virtue of being more subjective. Interestingly this conflicts with another new aspect of reporting tenure of auditors. It is quite possible that firms will frequent change auditors until they find the ones giving them favorable reviews even overlooking CAM section. Due to the highly subjective interpretation of critical matters, the CAM section could also instigate legal battles between competitors or for fuel the fire to existing litigations that a company might have.

With respect to each Critical Audit Matter the auditor would be required to identify the matter, describe the considerations that led the auditor to determine that the matter is critical and refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. This required disclosure would fundamentally change the content of an auditor report and could have significant implications on the audit process and the auditor/management/audit committee relationship. Currently, an auditor's judgments and views are communicated solely to management and the audit committee and the company is responsible for communicating accounting judgments to shareholders through disclosure of its accounting policies in the notes to the financial statements (which is audited). The Disclosure Proposal significantly alters this paradigm by requiring the auditor to communicate directly to shareholders its judgments with respect to these matters.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor already performed as part of the audit. Thus, the proposal does not modify the objective of the audit of a public company's financial statements or impose new audit performance requirements, other than the determination, communication and documentation of critical audit matters.

The proposed changes to the audit report would also add a requirement to include information in the report related to auditor tenure and independence. This is another item in the proposal that I disagree with, i.e requirement for an audit firm to disclose the year it began serving as a company's auditor. Personally I would express concern about including that information in the audit report because it has not been empirically proven that there is a correlation or relationship between audit quality and length of an audit firm's tenure.

Based on these factors, I am doubtful about the impact that disclosure of critical audit matters would have on the general investor community. On one hand it may provide additional clarity to professional investors and help them analyze more. But on the other hand, the subjective nature has the risk of driving away or confusing non-professional/retail investors.

Thanks & Best Regards,

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Hasan Andalib

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ANNALY®

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

Submitted electronically

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members,

Annaly Capital Management, Inc. (Annaly, the Company, we, our) welcomes the opportunity to provide comments to the Public Company Accounting Oversight Board (the Board) regarding the *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal)).

Annaly owns, manages, and finances a portfolio of real estate related investments and has elected to be taxed as a real estate investment trust (REIT) for federal income tax purposes. Annaly invests in residential mortgage-backed securities (RMBS) that are issued or guaranteed by a federally chartered corporation such as Fannie Mae or Freddie Mac, or an agency of the U.S. Government, such as Ginnie Mae as well as commercial real estate loans and commercial mortgage-backed securities. Our principal business objective is to generate net income for distribution to our shareholders from our investments.

While we appreciate the Board's efforts to improve audit quality and enhance the audit report, we do not support all aspects of the proposal as further discussed below.

**Critical Audit Matters (CAMs):**
We support the Board's decision to retain the current pass/fail model of auditor reporting however we have concerns about the Board's proposal to discuss Critical Audit Matters ("CAMs") in the audit report. Our financial reports filed with the SEC include disclosures about critical accounting policies, risk factors and significant estimates. Given that these disclosures already discuss the most judgmental, subjective and complex aspects of the financial statements, we believe the information

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in the auditor's report would be duplicative of information already provided by management. Given the increased risk as a result of not discussing a matter, we think the auditor will be motivated to include more rather than less CAMs in the audit report. We are also concerned that highlighting audit procedures around CAMs in the auditor's report may lead financial statement users to construe this as emphasis of a matter. Additionally, we are concerned that information that is not required to be disclosed in the financial statements will be included in the audit report. While the existing audit requirement to raise issues to the audit committee provides the opportunity for the auditor to discuss issues and provide context, we are concerned that disclosure in the audit report will present summarized information to the users without the same opportunity for discussion.

**Other Information:**

We are also concerned about the auditor's increased responsibility over other information outside of the financial statements and footnote disclosures. This information would include the Management Discussion and Analysis ("MD&A") section of the SEC filed financial reports. The MD&A section includes forward-looking information based upon management's analysis and insights into the business. Based on the highly-specialized, subjective, qualitative nature of this information, it may be extremely difficult for an auditor to objectively or adequately evaluate. We believe that the proposed change to "read and evaluate" from "read and consider" as to whether the other information in the financial statements is materially consistent with the audited financial statements, will result in a challenge for issuers to discuss the most relevant and useful information at the risk of this information being too difficult or costly for an auditor to evaluate. We further believe it will be unclear to users of financial statements the level of assurance provided by an "evaluation" of the MD&A or other information and therefore potentially subject both the preparers and auditors to increased liability risk. Additionally, we believe the increased level of assurance on the MD&A or other information blurs the line of responsibility between management and the auditor. We encourage the Board to retain the existing requirement to "read and consider" other information.

**Auditor Tenor:**

We don't believe that the disclosure of auditor tenor provides useful information as we don't think there is a direct correlation between audit tenor and audit quality, particularly given the mandate under Section 203 of the Sarbanes-Oxley Act which requires mandatory rotation of both the lead audit partner and the concurring partner after five years.

We appreciate your consideration of our comments. If you have any questions or require clarification, please contact Melanie Pinto at (646) 728-7673 or Jayne Stewart at (212) 696-0100.

Sincerely,

MPinto

Melanie Pinto
Director of Accounting Policy
Annaly Capital Management, Inc.

Jayne Stewart
Chief Accounting Officer
Annaly Capital Management, Inc.

**From:** Chuck Siegel
**To:** Comments
**Subject:** PCAOB Release # 2013-005 August 13, 2013; PCAOB Rulemaking Docket Matter # 034
**Date:** Wednesday, September 25, 2013 5:23:13 PM

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Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803 September
25. 2013
Sent via email to: comments@pcaobus.org

Re: PCAOB Release # 2013-005 August 13, 2013
PCAOB Rulemaking Docket Matter # 034

Ladies and Gentlemen:

Anworth Mortgage Asset Corporation is pleased to submit its views in response to the PCAOB's most recent request for comments on the two recent proposals – *The Auditor's Report on an Audit of Financial Statements, and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

While we commend the PCAOB for the solicitation of comments to address these issues and in its goal of trying to improve the auditors' report, we believe that the required disclosures have the potential to create misunderstanding by the investors; blur the roles between the auditors, management, and the audit committee; would be costly to implement; and may impede effective corporate governance.

In requiring disclosure of critical audit matters, we believe that this may cause misunderstanding by investors. A significant item at a company such as revenue may not be mentioned because it is relatively straight forward and does not require significant judgment, while a less significant matter may be disclosed because it requires some judgment. Investors may not understand the nature of why one item was disclosed while another item is not. Investors could become confused and draw unwarranted inferences. Auditors may feel pressure or be obligated to come up with critical audit matters in their audit report even if the audit is routine so that investors will feel they are doing a good job. Matters of significant judgment and material estimates are already disclosed in the financial statements and are discussed by the auditor with management and the audit committee.

In requiring the expansion of the auditor's report to include financial information outside of the financial statement such as the Management Discussion and Analysis, we believe that this may also confuse investors as to who is really responsible for the financial statements. It is our belief that Sarbanes-Oxley made it very clear to investors that management is responsible for the financial statements. While the auditor's role has been clearly limited to the attest function, they often do read and review the information outside of the financial statements as a service to their clients and in the preparation of comfort letters related to registration statements. Requiring an auditor to expand their audit report to evaluate and comment on such information will likely add substantially to the costs of audits. It will also place auditors in potential conflict with their clients as to what must be disclosed or reported in the information outside of the financial statements. While other governance entities (SEC, national exchanges) require that management be legally responsible for their filings, this will now make it more difficult for management of a company and its board of directors to fulfill this requirement if the auditors are now placed in the role of telling them what must be included in areas of reporting outside of the financial statements.

We would like to thank the PCAOB for the opportunity to comment on these recent proposals.

Sincerely,

Charles J. Siegel
Senior Vice President-Finance
Anworth Mortgage Asset Corporation
1299 Ocean Avenue, 2nd Floor
Santa Monica, CA 90401
Email: csiegel@anworth.com

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

December 10, 2013

Re: PCAOB Rulemaking Docket Matter No. 34

Board Members:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's proposed new auditing standards, "The Auditor's Report on the Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion" and "The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report" dated August 13, 2013 ("the proposed standards"). We previously commented on the concept release Matter No. 34 in our letter dated September 30, 2011.

Critical Accounting Matters

The proposed standards require the auditor to communicate in the auditor's report critical audit matters ("CAMs") that were addressed during the audit of the current period's financial statements. We do not support adding disclosure and discussion of CAMs in auditor reports because we do not believe they will enhance the auditor's reporting model as intended and thus will not provide any significant incremental information to financial statement users. This addition will significantly lengthen audit reports with information already provided by management in MD&A, financial statement footnotes, Section I on Form 10-K, or all three. No convincing evidence has been presented by the Board supporting the assertion that disclosure and discussion of CAMs in audit reports will benefit financial statement users or preparers. We believe including disclosure and discussion of CAMs in audit reports will unnecessarily delay financial reporting, weaken the primary objective of audit reports, and result in increased costs to companies without significant benefits to financial statement users.

Using the annual Form 10-K of Apple Inc. ("Apple" or "the Company") as way of example, MD&A in the Company's most recent annual filing, consistent with Securities and Exchange Commission rules and regulations for all public companies, includes three full pages describing critical accounting policies and facts and circumstances specific to Apple that make these accounting matters critical. As explained therein:

> *"Management considers these policies critical because they are both important to the portrayal of the Company's financial condition and operating results, and they require management to make judgments and estimates about inherently uncertain matters. The Company's senior management has reviewed these critical accounting policies and related disclosures with the Audit and Finance Committee of the Company's Board of Directors."*

The matters identified by the Company's management as critical accounting policies are described in detail in MD&A, both in a separate section dedicated to such matters and, as appropriate, in addressing the Company's results of operations and liquidity. In addition, critical accounting policies are addressed as appropriate throughout Section I of the Company's annual filing when describing its business and business risks and throughout the footnotes to its financial statements. These matters are described throughout the Company's annual filing in terms of their specific impact upon the Company's accounting, their level of materiality to Company's financial statements, and the extent to which they rely upon the judgment and estimates of management. Further, it is our experience that disclosure of critical accounting policies by other companies has generally been tailored to each company's specific facts and circumstances.

The proposed standard defines CAMs as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements." Based on this description, it seems likely that any accounting policies identified by management as critical that are not also identified as CAMs by the auditor will be subject to significant scrutiny after-the-fact by the PCAOB inspections staff. Therefore, we believe that in almost all cases those matters considered by a company to be critical accounting policies and those matters considered by its auditors to be CAMs will be the same. Accordingly, we believe providing disclosure of these matters by auditors in their audit reports will be redundant and of little incremental value to users of financial statements.

The FASB has been working on its Disclosure Framework project for some time with the primary aim of increasing disclosure effectiveness. At its meeting on February 13, 2012, the FASB presented a summary of the responses it received from users, auditors, and preparers to its *Invitation to Comment* on the project. Respondents believed that "disclosures had become burdensome, voluminous, and contain information that may not be relevant to users," and some respondents suggested the primary goal of the project should actually be to reduce the volume of disclosures. A central theme of the feedback received by the FASB was that unimportant or redundant disclosure damaged the actual effectiveness of the overall disclosures provided in an annual report. We concur with this general observation and believe the proposal to include disclosure of CAMs in auditor's reports is in direct conflict with some of the principal goals of the FASB's Disclosure Framework project, including reduction of disclosure redundancy and improvements to disclosure effectiveness and coordination. This is true given almost all of the information that would be contained in CAMs in the auditor's report is already included elsewhere in a company's annual report.

It is asserted multiple times in the release from the Board supporting the proposed standards ("the release") that the communication of CAMs by auditors would lead to three important benefits. First, it would provide financial statement users with previously unknown information about the audit. Second, it would reduce "information asymmetry" between company management and investors. Third, reducing information asymmetry "could result in in more efficient capital allocation" and "could lower the average cost of capital." We consider all of these assertions unproven. As described above, we believe that almost everything an auditor would include in an audit report regarding CAMs is already disclosed in annual reports. Therefore, with respect to critical accounting and auditing matters there is currently very little information asymmetry that would be addressed by implementation of this proposal.

There is no evidence provided in the release specifically supporting the notion that including CAMs in audit reports will reduce the cost of capital. The research cited in the Board's proposal supports the general notion that providing more extensive, broad and transparent disclosure and disseminating it appropriately can impact the cost of capital. The research cited however does not appear to support the argument that the cost of capital will be affected by disclosing any specific bits of information. It is our belief that implementation of this proposal would have no impact on our cost of capital.

We believe that further lengthening of annual reports by significantly expanding auditors reports with information addressing CAMs that should already be available to financial statements users in properly prepared annual reports will dilute the effectiveness of annual reports and will distract financial statement users from the primary purpose of the audit report, to provide a pass/fail evaluation that the subject financial statements are in compliance with generally accepted accounting principles.

As with most governmental regulation, the cost in time, dollars, quality, and other resources will ultimately be determined by the extent and depth government regulators influence implementation. We believe it is likely the PCAOB inspections staff will rigorously pursue implementation of this proposed standard and place significant focus on the judgment of auditor concerning disclosure of CAMs. This means the costs are unpredictable and that the full impact of implementation will be borne over multiple review cycles by the PCAOB inspections staff as they review how auditors address the proposed requirements.

There are two "cost" factors we are most concerned about. First, inclusion of CAMs in audit reports will displace the focus of auditors and management on key reporting and finance matters at a time when such matters require the most attention. The "cost" to audit and reporting quality this could have is a significant concern. Second, and most importantly, we believe if this proposal is adopted it is likely the issuance of many companies annual reports will be delayed. In Apple's case, we typically file our annual report on Form 10-K approximately 30 days after the end of our fiscal year or approximately 30 days before it is due per SEC regulations. We believe that providing our annual report as quickly as possible to be a great benefit to our investors. We currently have no way to judge how many more days will be added to our reporting cycle if this proposal is adopted. However, it seems likely significant additional time at the end of an audit will be required to accommodate our auditors identification of CAMs, their drafting of related audit report language, review of related audit documentation and report language by multiple levels of quality reviewers within the engagement team, interactions with the audit firm's national offices and in-house legal counsel to review customized report language, and review by our own management and Audit Committee of their draft audit report. Adopting the concept used by the Board in the release, any lengthening of the interval between the end of our fiscal year and the filing of our annual report negatively impacts the significant "*information asymmetry*" that exists between management and investors during that period. Adding to that interval so auditors can include customized and detailed language in their reports describing critical accounting areas disclosed elsewhere by management seems counterproductive.

Reporting in Auditor Tenure

The proposed standards include a requirement that audit reports include a statement indicating the year the auditor began serving consecutively as a company's auditor. It is indicated in the release there is no conclusive evidence as to how auditor tenure impacts audit quality or how such information would help investors. Further, it is currently not difficult for interested investors to determine if a particular firm has been auditing a company for a relatively short or relatively long period. We anticipate there will be no direct economic cost to include auditor tenure information in audit reports. However, because of the absence of an identifiable benefit, we do not support this proposal.

Reporting on Other Information

The proposed standards change the auditor's responsibility with respect to other information contained in an annual report from "read and consider" to "read and evaluate." It is not yet clear to us how this change will be interpreted by audit firms and the PCAOB inspection staff and how it would impact the procedures, costs and timing associated with an audit. Several of the major public accounting firms in their summaries of the proposed standards seem to have indicated this change could significantly add to the auditor's responsibility and possibly to the scope and cost of audit procedures. We encourage the Board to work closely with the major audit firms and the PCAOB inspection staff to ensure the full ramifications of this proposal are clear to all interested parties before a final decision is made regarding adoption.

* * *

Thank you for your time and consideration of our input. If you any questions regarding our letter, you may contact Luca Maestri at (408) 862-1401 or Joel Greenberg at (408) 974-1888.

Very truly yours

Luca Maestri
Vice President and Corporate Controller

Joel Greenberg
Senior Director and Assistant Controller

**From:** Sandra Powers
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 6:10:43 PM

To Whom It May Concern,

I support Lisa Roth's position on this matter and would appreciate your careful consideration of it. Thank you.

Sandra Powers
ARK Global LLC
Office: 1-800-676-2921
Mobile: 1-781-572-5288
Email: powers@arkglobalonline.com
2345 Washington Street Suite 303
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*a particular sector. Short positions may be considered speculative transactions and involve special risks, including greater reliance on the ability to accurately anticipate the future value of a security or instrument. Underlying investments within a Fund of Funds investment are subject to investment advisory and other expenses, which will be indirectly paid by the investment. As a result, the cost of investing in a fund of funds investment will be higher than the cost of investing directly in an underlying investment and may be higher than other mutual funds or non-mutual fund investments that invest directly in stocks and bonds. In addition to the normal risks associated with equity investing, international investments may involve risk of capital loss from unfavorable fluctuation in currency values, from differences in generally accepted accounting principles, or from economic or political instability in other nations. Narrowly focused investments and smaller companies typically exhibit higher volatility. Bonds and bond funds will decrease in value as interest rates rise. Index performance returns do not reflect any management fees, transaction costs or expenses. One cannot invest directly in an index. Past performance does not guarantee future results. Not FDIC Insured. No Bank Guarantee. May Lose Value.*

**From:** STEVEN RUBENSTEIN
**To:** Comments
**Subject:** Docket 034
**Date:** Thursday, December 12, 2013 9:58:31 AM

I support Lisa Roth's position

Steven Rubenstein
Arrow Investments, Inc.

# Proposed Auditing Standards –

# The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion;

# The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report;

# and Related Amendments to PCAOB Standards

Proposals issued for comment by the Public Company Accounting Oversight Board (PCAOB Rulemaking Docket Matter No. 034)

Comments from ACCA
10 December 2013

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Further information about ACCA's comments may be obtained from:

**David York**
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ACCA welcomes the opportunity to comment on the proposed improvements in auditor reporting, which are concisely and clearly addressed in PCAOB Rulemaking Docket Matter No. 034. The ACCA Global Forum for Audit and Assurance[1] has considered the matters raised in the Rulemaking Docket and the views of its members are represented in the following.

Our comments draw upon our world-wide membership, which includes significant numbers of members working in all aspects of the financial reporting supply chain in a wide range of industries, the public sector and public practice.

# GENERAL COMMENTS

ACCA has carried out a body of work, in our Accountancy Futures research programme, on the value of audit and auditor reporting. This is explained on our website, which includes links to the research and reports. We would particularly draw attention to *A Framework for Extended Audit Reporting,* a report commissioned by ACCA from the Maastricht Accounting, Auditing and Information Management Research Center (MARC), Maastricht University, Netherlands.[2]

In our view, the value of the audit would be enhanced if its scope were to be extended beyond the financial statements. We support, nevertheless, the intention of the PCAOB to improve the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report within the existing context.

As the PCAOB is well aware, related auditing standards are under development by the International Auditing and Assurance Standards Board (IAASB). In November 2013, ACCA responded to an exposure draft issued by the IAASB and our comments herein are consistent with those in that response. Moreover, the agenda papers for the December 2013 meeting of the IAASB make it clear that, in relation to an update of International Standard on Auditing 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* (ISA 720), the project task force wishes to obtain an understanding of the responses to the current PCAOB proposals.[3]

[1] http://www.accaglobal.com/en/research-insights/global-forums/audit-assurance.html
[2] http://www.accaglobal.co.uk/content/dam/acca/global/PDF-technical/audit-publications/extended_audit_reporting.pdf
[3] http://www.ifac.org/sites/default/files/meetings/files/20131209-IAASB-Agenda_Item_2%20-ISA_720-Cover-Final.pdf



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Although the IAASB is addressing similar issues, there are differences in the order in which subject matters are being addressed and the structure into which the proposals must fit. For example, disclosure of the name of the engagement partner and reporting aspects of going concern are integral to the IAASB's auditor reporting proposals, whereas they are separate matters for the PCAOB.

Recognising that the IAASB standards have to be written so that they may be applied in many jurisdictions and that the PCAOB standards reflect the requirements of the U.S. federal securities laws and rules, we nevertheless continue to recommend that the PCAOB develops standards with a view towards long-term convergence with those of the IAASB.

Auditor reporting and indeed the transparency of the audit are important matters that can contribute directly and indirectly to increased investor confidence and, through that, the better functioning of capital markets. We believe that it is important, therefore, that sufficient time is taken, and effort is made, by standard setters to ensure that their proposals meet investor needs and achieve change that is synonymous with progress.

We are at an unusual juncture in standard-setting, whereby standards are leading practice rather than recognising the best practice that is currently in place. It is even more important, therefore, that such standards are evidence-based to the fullest possible extent. We believe that it would be helpful if the PCAOB were to encourage field testing of its proposals in the same way that the IAASB has instigated a field test.

In subsequent sections of this response we answer the specific questions for respondents in Appendix 5 (other than those relating to proposed amendments to PCAOB standards and the audit of brokers and dealers – question 33 to 40) and in Appendix 6 (other than questions 26 through 28). We do not comment in respect of Emerging Growth Companies (Appendix 7).



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# APPENDIX 5 RE PROPOSED AUDITOR REPORTING STANDARD

## QUESTION RELATED TO SECTION II

**Question 1 Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**

We are content with the objectives as drafted; they are clear and consistent with the type of presentation in other recent PCAOB auditing standards. They encapsulate the requirements and should assist the auditor in developing an understanding.

## QUESTIONS RELATED TO SECTION IV

**Question 2 The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

The requirements deal with the common addressees and are flexible enough to accommodate others if necessary in individual circumstances. We do not believe that it is necessary to require the auditor's report to be addressed to other parties.

**Question 3 The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

The description of the nature of an audit should provide users with information but not overwhelm them with detail. We are reluctant, therefore, to suggest any further matters for inclusion.



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**Question 4 The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

A statement in the body of the report is inherently more powerful than just using the word 'independent' in its title, as it makes it clear that being independent is a requirement.

The mention of the specific laws, rules and regulations with which the public accounting firm is required to comply is informative for users. The references are necessarily at a high level, however, so users are not able to identify the precise requirements, nor perhaps to appreciate the precise role that independence plays in the audit.

Conceivably, more detailed information could be made available to users on a website maintained by an appropriate body. This would allow for the inclusion of educational material.

Users may also be interested in the other ethical obligations of public accounting firms that are relevant to the audit. For example, when dealing with other information, ethical requirements already drive professional accountants to ensure that they are not knowingly associated with misleading information.



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**Question 5 The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

a) **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**
b) **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**
c) **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

As the PCAOB is aware, there are current proposals within the European Union to instigate mandatory firm rotation. Guidance to put audit contracts out to tender (on a comply or explain basis) has been recently introduced in the UK by the Financial Reporting Council (FRC), and the UK Competition Commission's enquiry into the statutory audit services market has led to a recommendation to the Government that tendering become mandatory, at least every ten years. In its guidance the FRC chose not to include a requirement to disclose, in the auditor's report, the length of tenure.

There is undoubted current user interest in the length of tenure of the auditor. Even where the information is separately available, disclosure of the period of tenure seems to us to be something that it is difficult to oppose other than on the grounds that the usefulness of such a disclosure is not conclusively proven.

If and when it becomes a requirement to name the engagement partner, it would be consistent to disclose how long the particular engagement partner had served in that capacity.

**Question 6 The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

In broad terms we agree with the inclusion, within the auditor's responsibilities, of an extended responsibility in respect of other information. We believe that users will benefit from the disclosure of the results of the auditor's evaluation.



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**Question 7 Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

While there is a degree of merit in ensuring consistency between auditors' reports on different entities, the change in emphasis towards reports that are relevant to the individual entity, through the disclosure of critical audit matters, is best served through striving for innovation rather than consistency.

We feel that it is inevitable that there would need to be changes in order to accommodate different presentations depending on whether the report was, for example qualified or unqualified and depending on the number, relative importance and degree of exposition of critical audit matters.

**Question 8 What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

To the greatest extent possible, we suggest adopting the disclosures in the IAASB proposals. Although there are superficial differences between 'critical audit matters' and 'key audit matters' (IAASB), we would expect auditors to arrive at identical disclosures and descriptions under both standards.

We fear that users will put a negative interpretation on the disclosure of critical audit matters (or key audit matters) even though such transparency is intended to be neutral. This interpretation is likely to be intensified where the term is translated (as it often would be for companies with foreign listings, or when using IAASB standards). Neither term is easy to translate: 'key' does not have a direct translation, and 'critical' is close in meaning to 'criticism'. In such circumstances, translation is done by reference to the underlying meaning, which is 'matters that are of sufficient importance to justify disclosure'.

This leads us to the conclusion that, ideally, no new term should be created for the matters disclosed. If a term is thought necessary to allow the auditor to report succinctly that 'the auditor has determined that there are no [insert term]', the term chosen should be 'important audit matters' (or, if a more formal term is desired 'matters of audit importance'). These terms may be criticised because they do not communicate the degree of importance, apparently signified by the words 'critical or 'key'. That argument is, however, flawed as 'critical' is merely acting as a label for the matters of most importance that are disclosed. That introduces tautology, as once a matter is disclosed it is clear that it is of sufficient importance to be disclosed; labelling as 'critical' is unnecessary.



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**Question 9 What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

Inevitably, additional time will be spent determining and drafting the auditor's report. This work will involve management as well as the auditor and some of it will necessarily take place at the busy time of finalisation of the financial statements. The additional costs are unlikely to be substantial, however, as critical audit matters would already be discussed with management and the audit committee.

Such incremental costs that do occur may fall disproportionately on smaller audited entities, but it is for the market regulator to determine public policy concerning the balance between application of, and exemption from, the proposals.

QUESTIONS RELATED TO SECTION V

**Question 10 Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

Over the last five years, ACCA has participated in research and outreach events that have consistently confirmed the appetite of investors for additional disclosures from auditors about the audit. We support, therefore, the communication of critical audit matters.[4]

We do not suggest alternatives, as any such alternatives are likely to cross the boundary into the auditor communicating matters that should be disclosed by management.

[4] However, see our answer to question 8, in relation to the suitability of the term 'critical audit matters'.



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**Question 11 What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

Through having enhanced information, financial statement users should be better placed to make economic decisions. In addition, heightened scrutiny of critical audit matters should motivate management to ensure that its reporting of related matters is of a consistently high standard.

There need be no unintended consequences of such disclosure, as it should be possible to anticipate and mitigate potentially adverse consequences. For example, possible negative investor perception of expanded report wording should be addressed by the issue of educational material during the implementation phase.

**Question 12 Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

The definition of a critical audit matter is sufficient for its purposes, albeit that the definition, at paragraph A2 of Appendix A to the proposed auditor reporting standard is in the plural. It is important that the definition allows auditors sufficient scope to justify the inclusion of matters that they wish to bring to the attention of users.

The definition of a critical audit matter is sufficiently clear for determining what would be a critical audit matter, but a definition alone will not allow full determination; as candidates for inclusion will have to be balanced one against another to determine overall what should be reported. The definition provides links to where candidate matters would ordinarily be expected to be found and it is difficult to envisage matters that would not fit into this approach.

In the definition, the use of the word 'most' is understandable as a mechanism to reduce the disclosed matters to a reasonable number.



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**Question 13 Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

We believe that the additional time incurred will have a positive effect on audit quality. The increased transparency and focus on matters that were critical to the audit will also prompt management to ensure that any related disclosures in the financial statements are of a suitably high quality.

**Question 14 Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

The proposed requirements regarding the auditor's determination and communication of critical audit matters are sufficiently clear and understandable. As further explained in our answer to question 19 below, we feel that improvements can, nevertheless, be made.

**Question 15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

Users are unlikely to understand the audit procedures performed but could benefit from an explanation that a matter was resolved. It is important to distinguish a statement to that effect from a piecemeal opinion. The IAASB proposes introductory wording, which we support, to the effect that 'the auditor does not express an opinion on these individual matters'.

**Question 16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

While we agree that the factors in paragraph 9 are helpful, there is a risk that auditors will adopt a methodology that involves scoring a matter against each factor. This would give a false result, as the factors are simply listed without an indication of their relative importance.

Given that such general factors will have influenced whether a matter is treated in one of the three ways mentioned in paragraph 8, it should be possible to remove reference to such a list at this stage and merely refer to the relative importance of the matters in the specific audit.



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**Question 17 Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

It may be worth recognising that the existence of a similar disclosed matter in a prior year, or in disclosures made by auditors of companies in the same industry, are strong indicators that a matter is critical. In view of the risk we identify in our answer to question 16, we suggest that a discussion of factors is more suited to being presented as guidance material, for example in an Appendix to the proposed standard.

**Question 18 Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

The proposed requirement, referencing Auditing Standard No. 3, is clear; but we have reservations about it, as explained in our answer to question 19.



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**Question 19 Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

The requirement should not be 'hidden' in a documentation section but should be dealt with as a stage of the determination. We are, however, not in favour of this as a requirement or documentation requirement. It is not easy to operate as it implicitly requires the auditor to categorise matters into three types:

1. Critical audit matter (disclosed and documentation as to why critical)
2. Matters that would appear to an experienced auditor having no previous connection to the engagement to meet the definition of a critical audit matter (documentation if not disclosed as to why not disclosed)
3. Matters of such importance that they are included in the matters required to be documented in the engagement completion document; reviewed by the engagement quality reviewer; communicated to the audit committee; or any combination of the three but would not appear to an experienced auditor having no previous connection to the engagement to meet the definition of a critical audit matter (not documented further in relation to whether they are critical audit matters)

There seems little point in introducing a separate step in which the auditor has to decide whether an experienced auditor having no previous connection to the engagement would form a particular view, in order to decide what to document.

Auditors will be tempted to respond to a perceived risk of criticism by a regulatory body by increasing the number of matters in the first two categories and so increasing the amount of documentation of items that ought to be in category 3. This will not result in improved reporting or audit quality, will not benefit users but will be costly. It should be sufficient to document the decision as to which matters of importance are reported so as to expose the logic – which may be no more than a decision that, of the matters of importance, users would not derive significant benefit from the presentation of more than eight of the most important matters.



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**Question 20 Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**
The proposed documentation requirement is certainly sufficient and it is clear and understandable. We have, however, raised an objection to it (see our answer to question 19) and it is arguable whether there needs to be any specific documentation requirement at all; as the requirements of Auditing Standard No. 3 are sufficient to ensure that the documentation would meet the needs of an experienced auditor having no previous connection to the engagement.

**Question 21 What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

ACCA does not answer this question in full as it is aimed primarily at auditors. We believe that the increased costs will be justified because of the value to users of the increased transparency of the audit. As they are more of a fixed nature, such costs will fall disproportionately on smaller audits.

**Question 22 What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

ACCA does not answer this question in full as it is aimed primarily at audited companies. We believe that the increased costs will be justified because of the value to users of the increased transparency of the audit. As they are more of a fixed nature, such costs will fall disproportionately on smaller companies.

**Question 23 How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

ACCA does not answer this question because the determination of whether increased costs will be recoverable through increased audit fees is complex and depends on audit market conditions and specific auditor/client circumstances.



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**Question 24 Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

We believe that the focus of the communications should be on the needs of users of the current financial statements. There should not be separate requirements to report in the circumstances listed in question 24 but the auditor should consider whether critical audit matters ought to include matters arising in relation to such circumstances. Any reporting should not be in the manner that would have been appropriate in a prior year but should recognise current circumstances.

**Question 25 Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

The presentation in the Exhibit of hypothetical auditing scenarios that lead to the illustrative examples is very helpful.

In general, we believe that users will be interested in outcomes, not the detail of the process followed by the auditor in relation to a particular matter. As we noted in our answer to question 15, it is important to avoid piecemeal opinions but it should be possible to indicate that potential difficulties were adequately resolved.

If this is not done for each matter, it would help user understanding if there was additional wording in the standardised introductory text to the effect that: '*The critical audit matters communicated below were satisfactorily resolved and do not alter in any way our opinion on the financial statements, taken as a whole.*'

The description of the critical audit matter in scenario #1 may be too detailed for most users. We question whether users will understand, for example the significance of consultation with 'our national office'.



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**Question 26 What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

It is likely that users will look for comparability of reports in particular industries, or where circumstances giving rise to critical audit matters are pervasive (such as a financial crisis). In general, however, there is no need to strive for comparability as such reporting is intended to be specific to the particular audit.

**Question 27 What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

We consider that the possibility of the auditor disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards will be one factor influencing the communication. We can foresee management making disclosures so that the auditor is not the only party to communicate information but, if a matter is not material to the financial statements, disclosure by the auditor in compliance with an auditing standard should afford a degree of legal privilege to such wording.[5]

**Question 28 What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

ACCA does not comment on an auditor's potential liability in private litigation in the US environment. We assume that the PCAOB will take legal advice in this regard.

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[5] Following similar reasoning to that advanced in *Cucinotta v Deloitte & Touche LLP, 129 Nev. Adv. Op. 35 (30 May 2013).*



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QUESTIONS RELATED TO SECTION VI

**Question 29 Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

It is appropriate to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard as that enables the standard to act as a comprehensive signpost to readers.

**Question 30 Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

It is appropriate to retain the auditor's ability to emphasize a matter in the financial statements because such reporting satisfies a different objective to the reporting of critical audit matters.

**Question 31 Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

We are in favour of retaining the existing facility regarding matters to be emphasised, as the disclosure of critical audit matters is not, of itself, a reason for change.

**Question 32 Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

It is appropriate to keep the list of possible matters that might be emphasized under review in order to recognise changed circumstances over the years. However, as the examples are drafted in terms that are wide ranging, we have no additional examples to add at this time.

QUESTIONS RELATED TO SECTION VII AND QUESTIONS RELATED TO SECTION VIII

ACCA does not answer questions 33 through 40.



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QUESTIONS RELATED TO SECTION X

**Question 41 Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

We agree with the Board's proposed effective date for the proposed auditor reporting standard as it allows sufficient time for effective implementation.

**Question 42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

We believe that a two (or more) stage implementation is not necessary and could potentially confuse users.



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# APPENDIX 6 RE PROPOSED OTHER INFORMATION STANDARD

## QUESTIONS RELATED TO SECTION I

**Question 1 Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

The scope of the standard is clear and appropriate; users are properly informed about the scope in a particular audit by virtue of the requirement to identify the annual report.

**Question 2 Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

It is appropriate to apply the proposed other information standard to information incorporated by reference. Users would expect information to be within the scope of the standard where it is incorporated by reference. We see no particular issues attaching to the form in which the information is available.

**Question 3 Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?**

We agree with the approach justified on page A6-4 of Appendix 6, which makes a distinction between amendments according to whether or not they cause the auditor to consider the need to update or issue a new auditor's report.



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**Question 4 Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?**

It is right to exclude such financial statements because they are separately audited and users would derive little or no value from the primary auditor addressing them as 'other information'. There would, in such cases, be considerable practical difficulties in carrying out procedures were any to be considered necessary.

QUESTION RELATED TO SECTION II

**Question 5 Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?**

The objectives encapsulate the requirements and are clearly drafted. They should assist the auditor in developing an understanding and hence in performing the required procedures.

QUESTIONS RELATED TO SECTION III

**Question 6 Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

We support requiring the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact. This responds to calls from investors, in particular, for more informative reporting by auditors as annual reports are becoming more complex and increasingly include qualitative disclosures.

We do not support the use of the term 'misstatement of fact'. The term has been overtaken by events; increasingly it is not the factual basis of matters that is of importance but the manner of their presentation. As inappropriate presentation can be a material misstatement, the natural language meaning of 'misstatement of fact' no longer coincides with its use as a defined term. We have suggested to the IAASB that it is simpler to drop the words 'of fact' and that has been done in the proposed revised standard forming part of the agenda papers for the IAASB's December 2013 meeting.



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**Question 7 Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

It would be a matter for research to establish, but we expect that the procedures carried out by many auditors under a requirement to 'read and consider' would be extensive and a new requirement to 'evaluate' would not increase that effort but merely recognise that it was taking place. We nevertheless support the intention of the proposed standard as, whether it brings about improved practice or merely communicates better with users the effort employed, it should succeed in increasing confidence in other information and indeed in the financial statements themselves.

Any further procedures that might be considered by the PCAOB would likely extend assurance to the other information and this has not been called for by those commenting on earlier proposals.

**Question 8 Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?**

In our view the definition of materiality in the federal securities laws is an appropriate standard for the auditor's responsibility to evaluate the other information. As we have represented to the IAASB, it would introduce unwarranted complications to use a different approach, such as having regard to the financial statements and the other information taken as a whole as the reference point for materiality.

**Question 9 Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

The drafting of the procedures that the auditor would be required to undertake under paragraph 4 is clear. The wording is, however, repetitious, with the wording at the start of the paragraph ('based on relevant audit evidence obtained and conclusions reached during the audit') in effect repeated in subparagraphs a. to c.

We have concerns, however, about the structure of the proposed standard (beginning with paragraph 3). We discuss these in our answer to question 17 below.



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**Question 10 Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?**

Although procedures relating to consistency with the financial statements and relevant audit evidence are automatically constrained by considerations of materiality and risk, we are concerned that some auditors might interpret the recalculation requirement in paragraph 4.d.as one that extends to all calculations, irrespective of their significance.

**Question 11 Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?**

In our view the Appendix identifies all significant costs, including one-time costs of implementation.

**Question 12 Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?**

The responses are appropriate and are the same as currently proposed in the IAASB equivalent draft standard.

**Question 13 Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?**

In our view there are no significant additional costs to be identified.

QUESTIONS RELATED TO SECTION IV

**Question 14 Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

The proposed auditor's responses are appropriate, for the reasons set out in Appendix 6.



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**Question 15 Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?**

The issue of an auditor's report with a statement tailored to the actual circumstances encountered is valuable as it informs users of matters that may be material to them. Unless the auditor concludes that withdrawal from the engagement is necessary in the circumstances, such reporting should be done as a matter of course. In practice, the knowledge that the auditor will draw attention to the matter may motivate management or the audit committee to act to remedy the disclosure at issue.

**Question 16 Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

The proposed auditor's responses under paragraphs 10 and 11 are appropriate, for the reasons set out in Appendix 6.



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QUESTION RELATED TO SECTION V

**Question 17 Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?**

The proposed auditor's responses under paragraph 12 are appropriate, as they are references to requirements set out elsewhere.

We are not convinced, however, that the structure of the proposed standard is ideal. Paragraphs 6 to 11 deal with the position where, following the requirements in paragraph 5, the auditor has determined that a potential problem is really a material inconsistency, a material misstatement of fact, or both.

Paragraph 12 reverts back to a potential problem although the work under paragraph 5 could have determined that the potential problem is really a material misstatement in the audited financial statements. We understand that paragraphs 3 to 5 relate to other information, not financial statements, but the work on inconsistency is also capable of exposing deficiencies in the financial statements.

We find the structure adopted in the draft of ISA 720 to be considered in the December 2013 meeting of the IAASB to be preferable. Sections of that proposed standard deal with:

- 'Reading and [Evaluating/Considering] the Other Information'
- 'Responding to an Apparent Material Misstatement of the Other Information'
- 'Responding When There May Be a Material Misstatement in the Financial Statements'

This structure can be achieved through a small repositioning of paragraph 5 of the proposed PCAOB standard and changes to headings.

QUESTIONS RELATED TO SECTION VI

**Question 18 Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?**

The proposed reporting, including the illustrative language, is appropriate and clear. We address one concern, however, in our answer to question 21 below.



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**Question 19 Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

Information for which the auditor did not have relevant audit evidence, or (albeit not mentioned in the question) in relation to which the auditor had insufficient experience, knowledge or competence to evaluate, may be within scope because it is in a document that is within scope. There is a danger that users will assume that the auditor has done more work relating to it than is the case. The danger can be addressed by user education or a quasi-scoping out of information by identifying it in the report.

We are not in favour of requiring the identification of such material in the auditor's report because of the potential complexity of disclosures, the underlying extra work for auditors to determine and document the treatment of information potentially falling within this category and the need for brevity to avoid unbalancing the report by including matters on which the auditor not only does not provide assurance but warns specifically that that is the case.

We see some merit in permitting identification but would not want that to become the norm.

**Question 20 What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

ACCA does not answer this question in full as it is aimed primarily at auditors and audited companies. We agree with the general analysis of costs in Appendix 6. Additional costs will vary considerably depending on the individual circumstances. As they are more of a fixed nature, such costs will fall disproportionately on smaller audits.



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**Question 21 Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

The proposed reporting, including the illustrative language, is appropriate and clear. It is important that users appreciate the constraints on the evidence and that no separate assurance is being communicated.

The illustrative language concerning not identifying a material inconsistency or a material misstatement of fact in the other information is acceptable but there is potential for a statement of this nature to be mistaken for a negative conclusion conveying limited assurance. For this reason, we prefer the less direct approach in the draft of ISA 720 to be considered in the December 2013 meeting of the IAASB, where, having stated the responsibility (*'If we identify that the other information, to a material degree, is incorrectly stated, inappropriately presented or otherwise misleading, we are required to report that fact.'*) the auditor states that *'We have nothing to report in this regard.'*

**Question 22 Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?**

The auditor will have carried out procedures to establish that a material inconsistency or a material misstatement of fact in the other information exits. The procedures may have revealed why the problem arose and it is consideration of such circumstances that potentially affect the auditor's approach in the audit generally.

We do not believe that it is necessary to introduce any specific requirements relating to such circumstances.

QUESTION RELATED TO SECTION VII

**Question 23 Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?**

The proposed responsibilities of the predecessor auditor are appropriate and sufficiently clear to those informed by the relevant material in Appendix 6. The proposed standard includes only a short footnote relating to the matter and we do not think that is sufficient to properly communicate the responsibilities.



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QUESTIONS RELATED TO SECTION VIII

**Question 24 What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

ACCA does not comment on an auditor's potential liability in private litigation. We assume that the PCAOB will take legal advice in this regard.

**Question 25 Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?**

ACCA does not comment on an auditor's potential liability under the provisions of the federal securities laws or the Securities Act. We assume that the PCAOB will take legal advice in this regard.

QUESTIONS RELATED TO SECTION IX AND QUESTIONS RELATED TO SECTION X

ACCA does not answer questions 26 through 28.

QUESTIONS RELATED TO SECTION XI

**Question 29 Is the Board's effective date appropriate for the proposed other information standard? Why or why not?**

We agree with the Board's proposed effective date for the proposed standard as it allows sufficient time for effective implementation. It is appropriate for this date to be the same as that for the proposed auditor reporting standard.

**Question 30 Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

We believe that a two (or more) stage implementation is not necessary and could potentially confuse users. It is appropriate for the implementation to be done in the same way as for the proposed auditor reporting standard.



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QUESTIONS RELATED TO SECTION XII

ACCA does not answer questions 31 through 33 as we believe that it is for the market regulator to determine public policy concerning the application of the proposed other information standard to filings under the Securities Act.



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December 9, 2013

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

Re: *PCAOB Rulemaking Docket Matter No. 034*

Dear Ms. Brown:

On behalf of the Committee on Financial Reporting of the Association of the Bar of the City of New York, I respectfully submit this letter regarding the proposed auditing standard entitled "The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report" (PCAOB Release No. 2013-005 – August 13, 2013). This letter is also supported by the Bar Association's Committee on Securities Regulation.

By way of introduction, the Committee on Financial Reporting consists of attorneys representing different roles and perspectives within the financial reporting community, including preparers, users, and auditors. An important objective of the Committee is to enhance the integrity of financial reporting systems in order to foster the objectivity, understandability, and reliability of financial reports. The Committee seeks to improve financial reporting integrity through the enhancement of the rules and regulations of financial reporting as well as the culture in which those rules and regulations are called upon to function.

We very much share the Board's objective of improving the usefulness of financial reporting and appreciate the Board's efforts to that end. And we certainly share the Board's view that information reported in audited financial statements, and "other information" included in documents containing the audited financial statements, should not be inconsistent. However, we are concerned that the proposed audit standard may prove to be counterproductive. In summary, we are concerned that a consequence of the proposed standard, insofar as it would subject "other information" to explicit auditor reporting, may be that such "other information" becomes less useful.

The basis for our concern centers on the fact that auditor processes are more effectively directed to the evaluation of objective, rather than subjective, information. It is true, of course, that much "other information" is objectively verifiable and therefore susceptible to effective auditor evaluation. Much other information, however, is significantly less so. That is particularly the case as to aspects of information regarding trends, strategy, challenges, risks, and other more judgmental aspects of business activity.

We do not understand how an auditor's normal processes would allow it to effectively evaluate and report on such information. We are concerned that, instead, a requirement of auditor evaluation and reporting may result in an inclination by preparers to facilitate auditor approval through increased emphasis upon objectively verifiable information. From the perspective of users, such an inclination would be unfortunate insofar as a commonly expressed frustration with business disclosure today involves its presentation in the form of disaggregated numerical detail at the expense of broader discussion that explains how the data fits with the company's performance and prospects.

Our concerns are exacerbated by the logistics of the modern day audit environment. Today's audit takes place in an environment of increased expectations, increased demands for documentation, and accelerated deadlines. We can readily foresee scenarios in which the difficulties of auditor evaluation of subjective information would create a risk of delay ultimately resulting in, again, an inclination by preparers to favor data that can be more readily verified.

Nor are we familiar with an underlying problem that would justify these consequences. We understand the desire of the investment community for greater transparency into management decision-making and company prospects. But we do not believe this proposed standard addresses that. Rather, the standard seems directed to an entirely different issue: the potential for inconsistency between audited financial statements and other information. But that is an issue that, at least in our experience, rarely if ever comes up. In our experience, the much more frequent complaint involves the difficulties and tediousness of review of disaggregated detail.

In terms of cost-benefit analysis, therefore, our own judgment would suggest that the costs greatly outweigh the benefits. We see little if any benefit to the standard. The costs would include not only higher audit fees but higher internal costs associated with auditor involvement in the substance of information, which is already extensively reviewed by multiple departments within the reporting entity, beyond the scope of the auditor's normal systems for evaluation.

At root, we are of the view that transparency in "other information" is best served by giving management the opportunity to describe its business activity as management sees fit constrained by the obligations to tell the truth and otherwise to fulfill legal requirements. If management does not fulfill these obligations, legal means of redress and corrective mechanisms of corporate governance already exist. The installation of an additional layer of evaluation and reporting, and with it the risk of increased emphasis upon disaggregated detail at the expense of more subjective analysis and discussion, strikes us as counterproductive. We would therefore respectfully submit that this proposed standard should not be adopted.

We thank the Board for the opportunity to submit these comments and congratulate the Board on its continuing efforts to enhance the systems of financial reporting.

Very truly yours,

Michael R. Young

MRY/dt

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*The content of this letter does not necessarily reflect the views of any institution or organization with whom a member of the Committee on Financial Reporting is affiliated.*

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January 20, 2014

Office of the Secretary
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Re: PCAOB Rulemaking Docket Matter No. 34

Board Members:

Microsoft's Audit Committee appreciates the opportunity to provide comments on the PCAOB's Release No. 2013-005, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion" and "The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report". As members of Microsoft's Audit Committee, we have a critical role in the governance and oversight of the independent auditor and company management.

We share the PCAOB's objective that auditor reporting be relevant and useful to investors and other financial statement users. However, we do not believe the proposed requirements will meet that objective and are concerned with potential unintended consequences from the proposed requirements. In particular, we are opposed to the required disclosure of critical audit matters, changes to existing requirements with regard to the role of the auditor in reviewing other information outside the financial statements, and auditor tenure. We also believe the PCAOB needs to undertake detailed field testing in order to gain a better understanding of whether the proposed requirements will actually improve the relevance of the auditor's report while not unduly burdening the financial reporting process or undermining the role of the Audit Committee.

Disclosure of Critical Audit Matters

The proposed auditor reporting standard indicates that critical audit matters ordinarily are of such importance that they are included in the matters required to be (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three. Given this broad scope, we do not agree that auditors' reporting these matters will make the audit report more informative.

Rather, we believe it will lead to less useful and lengthy audit reports that include many audit matters that may not be of importance to financial statement users. The potential for disclosure overload is exacerbated by the fact that in addition to identifying these audit matters, the auditor's report will need to describe the considerations that led the auditor to determine that the matter is a critical audit matter as well as contain a reference to the relevant financial statement accounts and disclosures that relate to the matter. Furthermore, there are potential unintended consequences with requiring that auditors communicate these audit matters in the auditor's report. As indicated in the Release, the effort required to determine, prepare language for communication, and document such matters likely would occur during the final stages of the audit which might reduce the time available to the auditor for review and completion of the audit work.

We believe that for the most critical audit matters, management currently has the responsibility to disclose this information, for example in its discussion of critical accounting policies. Microsoft's critical accounting policies include revenue recognition, impairment of investment securities, goodwill, research and development costs, contingencies, income taxes, and inventories. The disclosure of these critical accounting policies comprises more than two pages of the Company's MD&A disclosures. In addition to these items, the accounting policy footnote to the financial statements discusses the principles of consolidation, estimates and assumptions, foreign currencies, cost of revenue, product warranty, sales and marketing, stock-based compensation, employee stock purchase plan, fair value measurements, allowance for doubtful accounts, property and equipment, and intangible assets. While we agree that not all of these items would rise to the level of critical audit matters as defined in the proposed rules, this extensive list of disclosures currently made by management illustrates our concern that the proposed rules will lead to less useful and lengthy audit reports that include many audit matters.

A requirement for the auditors to discuss these matters in an auditor's report could alter the fundamental roles and responsibilities of management, auditors and the Audit Committee. For example, the requirement to report matters discussed with the Audit Committee could have the unintended consequence of chilling the open and free flow of information from the auditor to the Audit Committee. Such an undesirable outcome would undermine the ability of the Audit Committee to fulfill its role and impair overall audit quality. The Audit Committee's role in overseeing financial reporting is intended to ensure that all material disclosures are included in a company's reports to shareholders based on input from management and communications with the independent auditors.

Finally, and perhaps most importantly, any lack of consistency between critical audit matters and management's disclosures will lead to confusion for financial statement users. Naturally, users will compare the critical accounting policies in the MD&A to the critical audit policies in the auditor's report. In any period we would expect differences based on changes in business, risks, and individual transactions. It is unclear how readers would reconcile two seemingly different descriptions of critical matters and whether it would be up to the company or the auditor to explain or answer questions about any apparent inconsistency.

Other Information Outside the Financial Statements

We agree with the proposal for clarification of the language in the auditor's report that would enhance users' understanding about the auditor's responsibility for other information outside the financial statements and support a statement in the auditor's report that clearly describes the auditor's role with respect to such information. However, such a requirement should not constitute a change from existing requirements with regard to the role of the auditor in reviewing such information or the level of assurance provided. PCAOB AU Section 550, "Other Information in Documents Containing Audited Financial Statements", indicates the following:

> Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should **read** the other information and **consider** whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. [Emphasis added.]

The proposed guidance would require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements. We are concerned that the change in terminology from "consider" to "evaluate" will lead to significantly more work for the auditor, with users assuming a greater degree of responsibility by the auditor for the other information in documents containing audited financial statements.

We also believe an unintended consequence of this proposed change could be a decrease in the amount and insight of the other information provided with the audited financial statements. Much of the other information provided with the audited financial statements is based on management's insight into the business and the drivers of value creation, which may be difficult for an auditor to evaluate based on audit evidence obtained and conclusions reached during the audit.

Auditor Tenure

We believe that any disclosure about auditor tenure would more appropriately be reported in the proxy statement, where the Audit Committee reports, among other things, its oversight activities with respect to the independent auditor, and many companies submit the appointment of the independent auditor for a shareholder vote.

Field Testing

Before taking any final action, it is incumbent upon the PCAOB to undertake detailed field testing of the proposed guidance in order to understand the implications and potential unintended consequences of the proposed guidance. We believe robust field testing, including obtaining user feedback as part of field testing, will provide insights into what effect the proposed guidance might have on the audit, whether it will produce more relevant and useful information to investors, and whether the benefits of the proposed guidance exceed the quantitative and qualitative costs that will be incurred.

Sincerely,

The Audit Committee of the Board of Directors of Microsoft Corporation

Charles H. Noski, Chairman

Dina Dublon

Stephen J. Luczo

Dr. Helmut Panke

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December 11, 2013

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

Dear Sir:

**PCAOB Rulemaking Docket No. 034: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.**

The Canadian Auditing and Assurance Standards Board (AASB) is pleased to provide its comments on the Public Company Accounting Oversight Board (PCAOB) *Proposed Rule on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, PCAOB Rulemaking Docket No. 034 (the proposed rule). We commend the PCAOB for soliciting public comment in connection with your proposed project to deal with possible revisions to the content and form of reports on audited financial statements and we appreciate the opportunity of responding to you.

By way of general background, the AASB's mission is to serve the public interest by setting high-quality standards and guidance that enable the Canadian public accounting profession to provide effective auditing, other assurance and related services. The AASB has the authority, as reflected in federal and provincial Business Corporations Acts, and other legislation and securities regulations, to set generally accepted auditing standards (GAAS) for financial statement audits in Canada. The activities of the AASB are overseen by the Auditing and Assurance Standards Oversight Council (AASOC), an independent body consisting of business leaders and regulators and having the oversight responsibility to ensure that the public interest is properly taken into account in the development of auditing and assurance standards in Canada by the AASB.

The AASB adopts International Standards on Auditing (ISAs) and International Standards on Quality Control (ISQCs) as Canadian Auditing Standards (CASs) and Canadian Standards on Quality Controls (CSQCs) respectively on the same timetable as the International Auditing and Assurance Standards Board (IAASB). CASs and CSQCs are Canadian GAAS for audits of financial statements. The AASB only makes amendments to ISAs and ISQCs that may affect how a practitioner performs an audit of financial statements in circumstances that meet specific criteria. These criteria allow the AASB to make very limited amendments, for example, to meet Canadian rules of professional conduct and to incorporate joint protocols for communicating with the Canadian legal and actuarial professions. When amendments are made, they are clearly identified in the standards. The AASB strongly believes in the consistent application of these standards and promotes their adoption globally.

Our response to Rulemaking Docket No. 034 addresses two key points:

- The need for global consistency in auditor reporting; and
- Specific concerns with the proposed rule relating to reporting on other information.

**The need for global consistency**
Canadian entities, like those in other countries, participate in today's global capital markets. However, Canada is also in a special position in that it has approximately 340 public companies registered and reporting with the Securities and Exchange Commission (SEC) as of December 31, 2012. This is well over twice the number from any other country and over a third of all foreign registrants.

Canadian securities regulators permit Canadian SEC registrants to have their audits conducted in accordance with PCAOB standards, recognizing the strong interrelationship between Canadian and US capital markets. Although there are differences between PCAOB reporting standards and Canadian GAAS, the auditors for some SEC foreign registrants are still able to prepare a single audit report that refers to both Canadian and PCAOB GAAS. This would not be possible if the reporting standards set by the PCAOB and IAASB were to diverge significantly.

While some flexibility between PCAOB reporting standards and those of the IAASB may be needed, we are concerned that significant differences in the form and content of reports resulting from the two sets of standards would create confusion for readers of auditor's reports on financial statements of Canadian SEC registrants, particularly as these comprise many of Canada's largest companies. We believe that significantly different auditor reporting models are not in the public interest. For example, while the PCAOB proposed "critical audit matters" requirements are similar to the IAASB "key audit matters" requirements, they are not identical. We do not believe it is in the public interest for the same auditor to report different matters for the same set of financial statements for entities listed in the US and in other jurisdictions where ISAs apply. Such differences will likely not be meaningful and may be confusing to users.

For this reason, we urge the PCAOB to work together with the IAASB and other bodies such as the European Commission, not only with respect to the auditor's report on financial statements but also in relation to the auditor's responsibilities relating to other information in certain documents containing audited financial statements.

For your information, we enclose a copy of our November 22, 2013 response to the IAASB on its exposure draft *Reporting on Audited Financial Statements.* This response outlines the significant concerns and other comments we had with the IAASB's auditor reporting proposals.

**Specific concerns with the PCAOB proposed rule relating to reporting on other information**

With respect to the PCAOB's proposed auditing standard on the auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report, we have specific concerns as set out in Appendix 1 to this letter.

We hope that our comments will be helpful to you in developing the possible revisions to the reporting standards. If you have any questions or require additional information, please contact Greg Shields at (416) 204-3287.

Yours very truly,

Mark Davies, FCPA, FCA, CIA
Chair, Auditing and Assurance Standards Board (Canada)

c.c. Canadian Auditing and Assurance Standards Board Members
Canadian Auditing and Assurance Standards Oversight Council Members

enc. AASB November 22, 2013 response letter to IAASB

**Appendix 1: The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report**

1. **Scope of the proposals**

   The definition of other information includes information incorporated by reference in the annual report if it is available to the auditor prior to the issuance of the auditor's report, or information from the proxy statement if the proxy statement is filed within 120 days after the end of the fiscal year. We believe that including within the scope of the standard certain information incorporated by reference depending on the timing of availability or timing of filing of a document will likely cause significant confusion in the market place.

   In particular, we are concerned that including within the scope of the standard other information available after the date of the auditor's report may create a misperception that the auditor is satisfied with such other information when the auditor's ability to communicate concerns relating to such other information to users of the financial statements and the auditor's report thereon is very limited after the auditor's report has been issued.

   **AASB recommendation**

   Therefore, the AASB recommends that the scope of the standard be limited to other information that is normally made available to the auditor prior to the issuance of the auditor's report.

2. **Auditor's responsibilities**

   Page 25 of the proposed rule indicates that "investors generally were not supportive of auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model because it would not be responsive to their information needs, and they saw little benefit with this type of assurance. Several commenters expressed concern that auditor assurance on information outside the financial statements would increase the time needed to perform these procedures and would not provide greater benefit than the auditor's current responsibilities related to other information outside the financial statements." The AASB is of the view that requiring the auditor to evaluate the other information and reporting on that evaluation would, in effect, imbed within the financial statement audit an unspecified type of assurance engagement related to other information. Therefore, the PCAOB's proposed approach appears to conflict with views of investors.

   Further, the AASB is concerned that the proposed approach would result in an increase in the expectations gap. The auditor may have very limited knowledge of certain aspects of the other information. For example, many companies in Canada are involved with mineral exploration. These companies may provide a great deal of technical information such as detailed geotechnical data in their annual reports. Auditors would not have addressed such technical information in the course of their audit of the financial statements. It would not be in the public interest to give users the perception that auditors have read, understood, and are in agreement with, this information as it is outside the scope of a financial statements audit engagement.

**AASB recommendations**

<u>If PCAOB intends for assurance to be provided on the other information</u>

If PCAOB intends for assurance to be provided on the other information, this should be the subject of a separate attestation standard. There is currently an attestation standard (AT) 701, *Management Discussion and Analysis*, which deals with assurance on the information in the MD&A. In the view of the AASB, assurance on the other information would be more appropriately dealt with in a separate attestation standard similar to AT 701. In the AASB's view, it would be inappropriate for a financial statements auditing standard to compel the auditor to also perform an assurance engagement on other information.

<u>If PCAOB does not intend for assurance to be provided on the other information</u>

If PCAOB does not intend for assurance to be provided on the other information, the standard should clarify the limitations of the auditor's involvement with that information. The AASB recommends that:

- The auditor be required to read the other information and consider whether there may be:
  - An inconsistency between the other information and the audited financial statements that may indicate the existence of a material misstatement in the financial statements; or
  - A material misstatement of fact in the other information.
- In specifying the auditor's responsibilities, and in reporting in the auditor's report, it should be made clear that, in reading the other information, the auditor is not required to obtain additional audit evidence beyond that required for the purposes of the audit.
- The auditor's report should be clear as to the auditor's limited knowledge of the other information (see below).

**3. Reporting**

For the reasons stated in the Auditor's Responsibilities section above, the AASB is concerned about unwarranted assurance by financial statements users arising from (a) the form of the required statement in proposed paragraph 13e that is similar to a review conclusion provided by the auditor and (b) the lack of transparency regarding the auditor's limited knowledge of the other information. The AASB believes that an appropriate description of the auditor's responsibilities relating to the other information that enhances the transparency of the auditor's limited knowledge and work effort would mitigate these concerns.

**AASB recommendations**
The AASB recommends that paragraph 13 of the proposed auditing standard be amended as follows:

1. Clarifying that the auditor did not review the other information

   The statement: "Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information" is very similar to a conclusion provided in a review engagement. This could result in confusion as to the level of work performed on the other information by the auditor. The AASB recommends that subparagraph 13(d) be expanded to state that the auditor did not perform an audit or a review engagement on the other information and therefore, does not express an opinion or a review conclusion on the other information.

2. Transparency regarding management's responsibilities

   The AASB believes that management's responsibilities for the other information must be clearly set out in the auditor's report to avoid confusion regarding management's and the auditor's respective responsibilities relating to the other information. Accordingly, the AASB suggests that the report include a statement that the completeness and adequacy of disclosures in the other information is the responsibility of management.

3. Transparency regarding the auditor's limited knowledge

   As discussed in Auditor's Responsibilities section above, the AASB recommends that the limitations of the auditor's knowledge be clearly described to enhance transparency. Accordingly, the AASB proposes that the auditor's report include a statement such as: "Our responsibilities do not require us to obtain additional audit evidence beyond that required for the purposes of the audit. Accordingly, our knowledge of certain matters in the annual report may be very limited." Paragraph 13c should be changed as follows:

   A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit, that the auditor's responsibilities do not require the auditor to obtain additional audit evidence beyond that required for the purposes of the audit, and that, accordingly, the auditor's knowledge of certain matters in the other information may be very limited.

November 22, 2013

Mr. James Gunn
Technical Director
International Auditing and Assurance Standards Board
International Federation of Accountants
529 Fifth Avenue – 6th Floor [confirm address]
New York, NY 10017
U.S.A.

Dear Mr. Gunn,

***<u>Re: Exposure Draft Reporting on Audited Financial Statements</u>***

The Canadian Auditing and Assurance Standards Board (AASB) is pleased to provide its comments on the Exposure Draft (ED) *Reporting on Audited Financial Statements.* In developing our response, we considered comments provided to us by our stakeholders who showed a strong interest in this topic. We held many face-to-face and conference call meetings with various user groups, including investors, analysts, management, audit committees, directors, regulators, auditors and others, as set out in Appendix 2 to this letter.

## General Comments

While our stakeholders have broadly expressed significant concerns about a number of aspects in the proposals, the AASB and many stakeholder support the objective of enhancing the value and relevance of auditor reporting including, as appropriate, enhancing the auditor's report on the financial statements. We also support the development of an auditor reporting model including consistent use of auditor's reports that users around the world can understand, that national standard setters would adopt and that auditors would apply.

In responding to the IAASB's Invitation to Comment *Improving the Auditor's Report*, (ITC) the AASB raised a number of significant concerns based on the input received from Canadian stakeholders. We recognize that in developing the ED the IAASB made improvements compared to the ITC. Accordingly, when consulting with Canadian stakeholders about the ED, the AASB informed Canadian stakeholders about the improvements, auditor reporting developments in other jurisdictions and the potential consequences of adopting or not adopting the proposed new and revised ISAs in Canada. While Canadian stakeholders are strongly supportive of the AASB continuing to adopt ISAs as Canadian Auditing Standards (CASs), they raised a number of broadly shared significant concerns about the proposals in the ED. The AASB is extremely troubled about adopting proposals that are still causing concerns to key elements of our stakeholder community solely to maintain our commitment to adopting ISAs as CASs. Therefore, we strongly encourage the IAASB to consider the recommendations noted below, and in our response to the questions in the ED set out in Appendix 1 to this letter, as they will, in our view, provide a basis to allow the final auditor reporting standards to be operational in the Canadian environment.

The following are significant points we would like to bring to your attention:

1. The applicability of the proposed Key Audit Matters (KAM) requirements
2. Achieving consistency in reporting of KAM
3. The approach to reporting on going concern
4. The need for consistency of reporting requirements of the IAASB and the United States Public Company Accounting Oversight Board (PCAOB)
5. The effective date of the final standards

**1. The applicability of the proposed KAM requirements**

The applicability of the proposed KAM requirements is a key concern for Canadian stakeholders. Comments focused on the proposed split between listed/other than listed entities and the appropriateness of this split in a Canadian context. Of concern to many Canadian stakeholders is the proposal that KAM be required for “listed entities”. Stakeholders support limiting the scope of the KAM requirements (as discussed in paragraph 54 of the Explanatory Memorandum). Reporting KAM is a new concept in most jurisdictions and allowing a period of experience will be important before considering whether it is necessary to expand the requirements to other entities or to address areas for improvement of the standards. However, stakeholders believe that the prescription that KAM be required for audits of financial statements of “listed entities” is problematic in a Canadian context.

1. On the one hand, we believe that requiring auditor’s reports on the financial statements of all listed entities to include KAM is too broad a requirement because of the nature of the Canadian listed entity marketplace. The Canadian market is segmented into the TSX (approximately 1,500 issuers of which nearly 10% have a market capitalization of less than $10 million), and the TSXV (approximately 2,000 issuers of which nearly 75% have a market capitalization of under $10 million, are in the resource sector and in start-up mode). Stakeholders highlight that there are a limited number of companies in Canada of a sufficient size that institutional investors and analysts are actively following them; and it is institutional investors and analysts who are expected to benefit most from the reporting of KAM.

There are significant differences between the needs of users of financial statements in the different market segments in Canada. Participants in the TSXV market indicated that given the nature of many of these entities and their often limited financial resources, requiring KAM may add cost with limited benefits for investors. In addition, investors and other users of the financial statements of many early stage resource and other companies listed on the TSXV place greater emphasis on reserve reports from experts and other reporting on future prospects of the commercial success of the company in making investment decisions. Accordingly, some questioned whether such a requirement would be in the public interest given what they see as the potential adverse consequences for economic development of imposing an additional burden on the auditors, preparers and audit committees of such entities.

2. On the other hand, we believe the requirement for auditors to include KAM in their reports on the financial statements of listed entities would exclude certain Canadian entities that would otherwise be treated similarly to listed entities in terms of regulatory and accounting requirements, such as financial institutions that are not listed entities.

There are a number of other terms in general usage in Canada, whether in securities and other legislation or regulation and accounting standards, such as "reporting issuer", "publicly accountable enterprise", and "market participant". There is no one term that we could recommend that appropriately addresses our concerns.

On the assumption that other jurisdictions may also have similar concerns to those identified in Canada, we believe the application of KAM to all listed entities needs to be reconsidered.

We recommend the IAASB change the scope of application of the KAM requirements to require KAM for audits of the financial statements of listed entities but also provide national standard setters with the flexibility to add to or subtract from the audits covered by the requirement. This might be accomplished by revising paragraph 30 of proposed ISA 700 as follows:

Key Audit Matters

30. For audits of complete sets of general purpose financial statements of a listed entity, other than those listed entities specifically excluded by the national standards setter in a jurisdiction, the auditor shall communicate key audit matters in the auditor's report in accordance with proposed ISA 701….

Application material to support this requirement could be provided along the following lines:

In some jurisdictions, the term "listed entity" may result in the inclusion of entities for which the disclosure of key audit mattes is of limited value to stakeholders. Alternately, there may also be entities that are not listed but for whom disclosure of key audit matters is of significant interest to stakeholders. In order to accommodate these jurisdictional differences, national standard setters are permitted to make specific inclusions or exclusions to the entities for which auditors are required to communicate key audit matters in the auditor's report on their general purpose financial statements without affecting the ability of auditors to state that the audit was conducted in accordance with International Standards on Auditing.

A conforming amendment to paragraph 4 of proposed ISA 701 would also be required.

We believe that this approach will allow national standard setters to define the entities where there will be benefit to having KAM requirements and therefore more consistent KAM reporting.

In the event that the IAASB does not agree with this approach, the AASB believes that another approach should be implemented – develop principles to explain the nature, type and size of entities that the IAASB believes should be included in the reporting requirements rather than using the term "listed entities". The AASB acknowledges that this approach is less desirable given the challenges the IAASB has already faced in developing a global definition of public interest entities.

**2. Achieving consistency in reporting KAM**

In discussing the illustrative examples of KAM included in the ED, comments and concerns from users included the following:

- The illustrative examples demonstrate different approaches that might be taken by the auditor in describing a KAM; users questioned what the implications are, if any, when an auditor uses a different approach for some matters than for others, for example including certain audit procedures and a conclusion in some cases but not in others.
- The level of detail provided in an auditor's report will depend on the judgment of each auditor so there is the prospect that two audit reports on two identical companies may look significantly different based on individual auditor perspectives. Users were of the view that lack of consistency could inappropriately affect conclusions they might reach from reading the report.
- There was concern that auditors will likely tend to report the same matters year after year, for example because (a) the auditing standards define the matter as a significant risk (such as revenue recognition), (b) other auditors in the same industry include the matters, or (c) out of fear of their judgments being questioned in the future.
- Some users were of the view that given the expected cost of the proposals and, in their view, the limited value of the information provided in the examples, perhaps a more effective approach would be for KAM to consist of a list of the matters the auditor considered to be of most significance with a reference to the related disclosures (rather than providing further information about audit procedures or conclusions from the auditor's procedures).

We conclude from this that more guidance is needed to help auditors report on a more consistent, meaningful basis. In acknowledging the views of users, we also note that auditors identified complementary concerns in terms of determining what matters to include as KAM and how to describe such matters in the auditor's report. The AASB also acknowledges the challenges that IAASB faces in addressing these concerns and, in particular, the difficulty in addressing such concerns in advance of practice evolving. We believe, however, that it is desirable to address potential issues in advance of issuing the final standards rather than wait until poor practices emerge and then trying to change behaviour. For this reason, we recommend that the IAASB consider developing new illustrative examples of KAM using the results of the field testing that took place during the exposure period with a view to assisting auditors better apply the proposed standards.

We believe that the results of field testing will assist the IAASB in considering whether the requirements and application material dealing with determining and communicating KAM need to be refined.

In addition, we believe that the IAASB should make changes to the application material in proposed ISA 701 to:

- emphasize that the number of matters to be disclosed is intended to be the matters of most significance in the audit that are ultimately useful to the users of the financial statements so as to limit the number of KAM that are included in the auditor's report;
- prohibit the auditor from providing conclusions or opinions on individual matters as users may take inappropriate assurance on the matters; and
- explain more clearly why one approach to describing a matter may be more relevant than another.

**3. The approach to reporting on going concern**

Although the IAASB has made improvements to the proposed wording of the going concern statements as compared with the ITC, Canadian stakeholders reiterated concerns they identified when responding to the ITC, namely:

- The statements are confusing and open to misinterpretation by less-informed users, particularly with respect to material uncertainties.
- Management is not currently required under IFRSs to make an explicit statement that it has prepared the financial statements on a going concern basis. Some auditors are concerned that this might confuse users as to the respective roles of management and the auditor with respect to going concern.
- Some auditors believe that the requirements will result in additional cost because making explicit statements in the auditor's report will necessitate greater involvement of senior audit staff and quality control reviewers. It is not clear that such additional work will increase audit quality.
- Public sector auditors are concerned that the proposed going concern wording may not be appropriate in a public sector context (for example, the references to "liquidation" or "ceasing trading", which generally do not apply in a public sector context).
- Users and others also questioned whether the proposals would address the underlying objective of the proposals – to address concerns coming out of the financial crisis.

- Most users and auditors commenting on the going concern proposals believe that the current exception reporting model is more effective in highlighting going concern issues for users than the proposed statements on going concern.

Based on the comments received from our stakeholders, we believe that the proposed statements on going concern will be of limited value to users and could also increase the expectation gap rather than reduce it. We also believe that the IAASB should continue to work with accounting standard setters as part of a holistic approach to reporting on going concern.

We recommend that, as outlined in paragraph 84 of the Explanatory Memorandum, the IAASB defer finalization of reporting on going concern as part of that holistic approach. We understand that such an approach would be consistent with the direction being taken by the PCAOB on this type of reporting.

**4. The need for consistency of reporting requirements of the IAASB and the PCAOB**

We believe it is important that auditor's reports on the financial statements of companies that operate in a global environment are consistent so that readers are not confused. In particular, because of the significant number of Canadian companies that are listed in the United States, we are supportive of the IAASB working with the PCAOB to reach solutions that will result in similar auditor's reports. For example, if the PCAOB "critical audit matters" requirements are significantly different from the IAASB KAM requirements it could result in auditors of two similar companies that operate in different markets having significantly different auditor's reports. For this reason, we support the IAASB continuing to work together with other bodies that are taking an interest in auditor reporting in their jurisdictions, such as the European Commission and the PCAOB.

**5. The effective date of the final standards**

We believe that it is preferable to have an effective date that creates a clear delineation between when auditors use the old and new form of report. Given the significance of the proposed changes in the auditor's report, we believe that having different forms of report during the same time period will be extremely confusing to users and serve to create questions about the relative quality of the respective audits which are not justified. An "early adoption is permitted" approach could exacerbate this concern for the same reasons.

We recommend an effective date of periods ending on or after December 14, 2016, with early adoption not permitted, for the following reasons:

- Using a "periods beginning" effective date is problematic because it would result in auditor's reports on financial statement periods shorter than one year (say, January 1,-March 31, 2016) containing auditor's reports under the new standards whereas auditor's reports on financial statements for years ending on the same date (say, the year ending March 31, 2016) would be under the extant ISAs. Using a "periods ending" approach does not affect the fact that auditor's reports for calendar 2016 would be under the new standards (as would be the case if the effective date were for periods beginning on or after December 15, 2015).

- We believe that audit firms will need time to develop their education and internal guidance, and national standard setters will likely need time to develop implementation guidance materials and increase awareness among the preparer and audit committee communities, in advance of the new reports being used. There would likely not be enough time with an earlier effective date.
- Making the new reporting standards effective for 2016 calendar year end audits would also be closely aligned with the timing of the proposed PCAOB reporting standards.

We hope that these comments will be useful to the IAASB in developing its proposed changes to auditor reporting standards. If you have any questions or require additional information, please contact Greg Shields, Director, Auditing and Assurance Standards at (416) 204-3287.

Yours very truly

Mark Davies, FCPA, FCA, CIA
Chair, Auditing and Assurance Standards Board (Canada)

c.c. Canadian Auditing and Assurance Standards Board members
Bruce Winter, FCPA, FCA
John Wiersema, FCPA, FCA

## Appendix 1: Responses to Questions in the Exposure Draft

### Key Audit Matters

1. **Do users of audited financial statements believe the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?**

   There were mixed views from users on this question. Most users of audited financial statements indicated that expanding the auditor's report to introduce a new section dealing with Key Audit Matters has the potential to be an improvement over the existing pass/fail model. However, users expressed different views as to how useful this information would likely be given the costs expected to be involved. Some users were concerned that the matters included in the report may be of a boilerplate nature and repetitive from year to year with little in the way of constructive insights that would aid their decision-making. Some users also were concerned that including such matters may be misunderstood, for example, if matters raised in the auditor's report are (a) perceived to constitute a warning to users even when the auditor may be satisfied that the financial statements are not misstated, or (b) perceived as providing additional assurance about the matter when none is intended.

   Many Canadian users, preparers and auditors are satisfied with the current auditor's report. They are not convinced that readers will take the time to read the longer reports, or read all of the report. There is therefore a risk that significant matters the auditor wishes to bring to users' attention will be lost sight of. Under the current reporting model, users are able to quickly detect if the auditor has added paragraphs to the auditor's report that contain additional information of which, in the auditor's judgment, the users need to be aware.

2. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?**

   Canadian stakeholders are concerned that the requirements and application material in proposed ISA 701 do not provide an appropriate framework to guide the determination of key audit matters on a consistent basis for the following reasons:

   - The matters that the auditor discusses with the audit committee and that the audit committee would consider to be significant to the audit are not necessarily the same as those that are relevant to users of the financial statements because of the audit committee's greater understanding of the entity and what is important in respect of its oversight responsibilities.
   - The matters auditors are required to take into account, as set out in paragraph 8 of ISA 701, are generally matters requiring significant auditor judgment. To the extent that there is variability in auditor judgments about such matters, there is likely to be variability of inclusion of such matters in the auditor's report. Different auditors may

have different thresholds in terms of determining whether a matter is a key audit matter.

- Circumstances that require significant modification of the auditor's approach often result from something that management has done or not done as expected in the audit plan, such as a significant deficiency in internal control. Describing in the auditor's report such a deficiency may constitute disclosing original information about the entity, which some stakeholders believe is not the auditor's role. Paragraph 8(c) of proposed ISA 701 may create an expectation that if the auditor does not include a significant deficiency in internal control as a KAM then there are no significant deficiencies in internal control when, in fact, there is a significant deficiency but it is not considered important enough to be a KAM.
- Paragraph A24 of proposed ISA 701 provides a list of other considerations in determining whether a matter is a key audit matter but is not helpful in explaining how these considerations affect this determination. For example, it is not clear whether the fact that a matter is common to all companies in an industry, increases or decreases the likelihood that it should be reported as a key audit matter. Similarly, it is not clear how the fact that the auditor has obtained a written representation from management about its plans and intentions would be a key audit matter.
- Paragraph 8 and the related application material do not address how the auditor is expected to deal with uncorrected misstatements accumulated during the audit (including the effect of uncorrected misstatements of prior periods on the financial statements). Such matters are, however, required to be communicated with those charged with governance and may require significant auditor attention.

For the above reasons, the AASB believes that there will not be reasonably consistent judgments about what matters are key audit matters. Because of this, we believe there will be a tendency for auditors to include a longer list of matters to address their concern that their judgments may be questioned in the future. Matters will be included in the auditor's report subject to the variable judgments of auditors. Accordingly, for two identical entities with two different auditors, the auditor's report may contain a significantly different list of key audit matters depending on the professional judgment of each auditor. This, in our view, detracts from the information value that could be provided by reporting on key audit matters, will inhibit users from appropriately assessing audit quality and prevent reasonable comparability of reporting.

We recognize that providing a numerical limit for KAM, or some kind of range, suffers from being arbitrary. However, we believe that the guidance in paragraph A7 of proposed ISA 701 should be enhanced to encourage more strongly that the number of matters reported as KAM should be small, for example by emphasizing that the number of matters to be disclosed is intended to be the matters of most significance in the audit that are ultimately useful to the users of the financial statements. We believe that if the number of KAM can be limited it may help to address to a certain extent our concerns about potential boilerplate disclosures and lack of comparability of auditor's reports.

We recommend that the IAASB evaluate the results of field testing that has taken place during the exposure period as they may shed light on the extent to which our concerns are borne out in practice and whether there is a need to specify a limit on the number of KAM in the auditor's report in the final standard.

3. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?**

No. From a user perspective, users who read the IAASB's illustrative report in the ED were struck by the diversity in the manner by which key audit matters might be reported. This led them to question (a) what the different approaches for describing key audit matters imply about the auditor's overall assessment of a key audit matter, (b) if two auditors describe the same key audit matter in different ways, whether this implies the auditors have applied a different work effort to the matter and (c) whether the different descriptions imply different levels of audit quality. They were therefore concerned that the underlying requirements and application material permit different possible approaches that will potentially result in inappropriately inconsistent descriptions of key audit matters.

From the auditor perspective, auditors also expressed concern about how they are expected to describe key audit matters. They recognize that there is significant flexibility provided on how this should be done which allows for innovation and professional judgment. However, many auditors feared that their judgments will be questioned in the future on why they described a matter in a particular way and why this description differed from the description used by the same auditor or other auditors in similar circumstances. This may drive practice towards less insightful, standardized wording.

The application material in paragraph A41 of proposed ISA 701 indicates that an auditor might provide a conclusion in relation to a matter. It also suggests that there is a need for the auditor to avoid giving the impression that the discussion about KAM in the auditor's report is intended to convey an opinion on individual matters. In our view, the auditor cannot control what assurance a user takes from a conclusion on a matter. In particular, we believe that the illustrative matters in the ED that include wording such as "we concluded the use of such a model was appropriate" and "based on the audit procedures performed, we did not find evidence of" could be misinterpreted as providing an opinion on the respective matters. Therefore, we believe that the IAASB should make it clear that the description of KAM should not include a conclusion on the matter as readers may take assurance from such conclusion that is not warranted.

Paragraph A37 of proposed ISA 701 provides guidance to the auditor with respect to providing original information about the entity. We recognize that there may be circumstances when the auditor may need to include such information in order to appropriately describe a KAM. Accordingly, we do not support a prohibition on the auditor providing original information about the entity if it is critical to the auditor's description of a KAM. However, paragraph A37 makes reference to the possibility that in some circumstances the disclosing of original information about the entity may be inappropriate. We note that paragraph A35 of proposed ISA 701 also refers to circumstances that may restrict the ability of the auditor to communicate KAM. It was not clear whether the circumstances in paragraph A35 are the ones considered in paragraph A37 where it would be inappropriate for the auditor to disclose original information about the entity or whether the IAASB is contemplating other circumstances not addressed in paragraph A35. We believe that this needs to be clarified.

4. **Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.**

Users did not find any of the illustrative examples particularly useful. They were viewed as being superficial and lacking in true insights. Many users questioned the value of including matters that, at the end of the day, did not appear to result in the identification of concerns or a misstatement of the financial statements. They believed that some matters may be misinterpreted as being a warning about potential problems when in fact that is not the case. The descriptions of audit procedures were generic in nature and likely not going to be understood by average users, whether in terms of their adequacy in addressing the related risk or the implications for quality of the audit. Users were confused as to why certain examples provide more detail (including conclusions on the matter) than others.

Specific comments from users included:

- Goodwill. This example provides factual information which is likely duplicative of disclosures in the financial statements but contains, in the view of users, no specific insights. It was considered to have limited informational value.
- Valuation of financial instruments. The discussion about valuation models is not in sufficient detail for sophisticated users who would want more information about how the model addressed specific accounting challenges of valuation of financial instruments. Preparers indicated that wording such as "We challenged management's rationale" casts negative aspersions about management which could be problematic.
- Revenue recognition. Users presume that because the fraud standard requires the auditor to assume that there is a significant risk relating to revenue recognition that revenue recognition will appear in most auditor's reports. They were not convinced that this would be useful. The example provides no indication of whether there was a problem. The fact that fraud is specifically mentioned in the matter even when none appears to have been detected may be misinterpreted as providing a warning to users in this respect.

- It was not clear whether, and to what extent, the illustrative examples included original information about the entity. It would have been helpful to know this when assessing the value of the information that the auditor is providing on a matter.

In our view, the IAASB should work to improve the illustrative examples by explaining more clearly why one approach to describing the matter may be more relevant than another. One approach to improving the examples may be by selecting from specific reports developed during the field testing phase by audit firms.

5. **Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor's ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?**

The applicability of the proposed KAM requirements is a key concern for Canadian stakeholders. Comments focused on the proposed split between listed/other than listed entities and the appropriateness of this split in a Canadian context. Of concern to many Canadian stakeholders is the proposal that KAM be required for "listed entities". Stakeholders support limiting the scope of the KAM requirements (as discussed in paragraph 54 of the Explanatory Memorandum). Reporting KAM is a new concept in most jurisdictions and allowing a period of experience will be important before considering whether it is necessary to expand the requirements to other entities or to address areas for improvement of the standards. However, stakeholders believe that the prescription that KAM be required for audits of financial statements of "listed entities" is problematic in a Canadian context.

(a) On the one hand, we believe that requiring all auditors' reports on the financial statements of listed entities to include KAM is too broad a requirement because of the nature of the Canadian marketplace. The Canadian market is segmented into the TSX (approximately 1,500 issuers of which nearly 10% have a market capitalization of less than $10 million), and the TSXV (approximately 2,000 issuers of which nearly 75% have a market capitalization of under $10 million, are in the resource sector and in start-up mode).

Stakeholders highlight that there are a limited number of companies in Canada of a sufficient size that institutional investors and analysts are actively following them; and it is institutional investors and analysts who are expected to benefit most from the reporting of KAM.

There are significant differences between the needs of users of financial statements in the different market segments in Canada. Participants in the TSXV market indicated that given the nature of many of these entities and their often limited financial resources, requiring KAM may add cost with limited benefits for investors. In addition, investors and other users of the financial statements of many early stage resource and other companies listed on the TSXV place greater emphasis on reserve reports from experts and other reporting on future prospects of the commercial success of the company in making investment decisions. Accordingly, some questioned whether such a requirement would be in the public interest given what they see as the potential adverse consequences for economic development of imposing an additional burden on the auditors, preparers and audit committees of such entities.

(b) On the other hand, we believe the requirement for auditors to include KAM in their reports on the financial statements of listed entities would exclude certain Canadian entities that would otherwise be treated similarly to listed entities in terms of regulatory and accounting requirements, such as financial institutions that are not listed entities.

There are a number of other terms in general usage in Canada, whether in securities and other legislation or regulation and accounting standards, such as “reporting issuer”, “publicly accountable enterprise”, and “market participant”. There is no one term that we could recommend that appropriately addresses our concerns.

On the assumption that other jurisdictions may also have similar concerns to those identified in Canada, we believe the application of KAM to all listed entities needs to be reconsidered.

We recommend the IAASB change the scope of application of the KAM requirements to require KAM for audits of the financial statements of listed entities but also include criteria under which national standard setters have the flexibility to add to or subtract from the entities covered by the requirement.  This might be accomplished by revising paragraph 30 of proposed ISA 700 as follows:

Key Audit Matters

31. For audits of complete sets of general purpose financial statements of a listed entity, other than those listed entities specifically excluded by the national standards setter in a jurisdiction, the auditor shall communicate key audit matters in the auditor’s report in accordance with proposed ISA 701….

Application material to support this requirement could be provided along the following lines:

In some jurisdictions, the term “listed entity” may result in the inclusion of entities for which the disclosure of key audit mattes is of limited value to stakeholders. Alternately, there may also be entities that are not listed but for whom disclosure of key audit matters is of significant interest to stakeholders. In order to accommodate these jurisdictional differences, national standard setters are permitted to make specific inclusions or exclusions to the entities for which auditors are required to communicate key audit matters in the auditor's report on their general purpose financial statements without affecting the ability of auditors to state that the audit was conducted in accordance with International Standards on Auditing.

A conforming amendment to paragraph 4 of proposed ISA 701 would also be required.

We believe that this approach will allow national standard setters to define the entities where there will be benefit to having KAM requirements and therefore more consistent KAM reporting. Further, if the definition of listed entities included in the final standard is more narrowly defined, for example by limiting the requirements only to larger listed entities, however defined, this would more likely result in national standard setters adding to the list of entities to which KAM requirements apply, rather than subtracting from this list.

In the event that the IAASB does not agree with this approach, the AASB believes that another approach should be implemented – develop principles to explain the nature, type and size of entities that the IAASB believes should be included in the reporting requirements rather than using any specific term such as "listed entities" The AASB acknowledges that this approach is less desirable given the challenges the IAASB has already faced in developing a global definition of public interest entities.

Further, some Canadian stakeholders expressed concern with the recognition in paragraph 30 of proposed ISA 700 (Revised) that law or regulation may impose requirements for auditors to communicate key audit matters. They acknowledge that law or regulation may impose requirements on auditors. However, stakeholders expressed the view that the incidences when this will be necessary will be greater if the IAASB does not clearly articulate when it is appropriate for KAM to be included in the auditor's report.

The AASB agrees that when an auditor decides to communicate key audit matters on a voluntary basis the auditor should follow proposed ISA 701 and indicate this intent in the engagement letter. We believe it is reasonable that management and those charged with governance are made aware when the auditor plans to report in accordance with proposed ISA 701. We are not aware of any practical considerations that need to be acknowledged in the proposed standards.

6. **Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?**

   **(a) If so, do respondents agree with the proposed requirements addressing such circumstances?**

   **(b) If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?**

Yes. The AASB agrees that it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate. However, there is a disconnect between this principle and the objective of the auditor to report matters of most significance. The proposed wording of the auditor's report in this circumstance ("this section of the auditor's report is intended to describe the matters…of most significance…and the auditor has determined that there are no matters to report") does not make sense.

We suggest the wording be changed to refer to "key audit matters" rather than matters of most significance. This would avoid the potential disconnect.

We do not believe that the requirements in paragraph 13(a) and (b) proposed ISA 701 are necessary. Paragraph 20(b) of ISA 220 already requires the engagement quality control reviewer to review the financial statements and the auditor's report. Further, a key discussion at the end of the audit with the audit committee is the form and content of the auditor's report. Adding these requirements in paragraph 13 is therefore duplicative and seems to imply that the auditor's initial discussion and communication would not be effective.

Paragraph A47 of proposed ISA 701 indicates that it will be "rare" that the auditor of a listed entity would not determine at least one KAM. Given the significant number of listed entities in the Canadian TSXV that are in the early stages of development, we do not believe that this will necessarily be a rare circumstance. We believe that reference to "rare" should be removed from this paragraph. Further, we believe it would also be helpful to expand the application material to provide more guidance as to other circumstances when no key audit matters may be identified.

We do not agree that auditors should be required to always communicate at least one key audit matter as this would result in perfunctory compliance in those situations where no key audit matters in fact exist.

7. **Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?**

Yes. We agree that the auditor's communication of key audit matters should be limited to the audit of the financial statements of the current period. However, for clarity, we believe that the application material in paragraph A8 of proposed ISA 701 should make it clear that a key audit matter in the audit of the financial statements of the current period may relate to the comparative information, for example determining whether the retroactive application of a change in accounting policy in the current period is appropriate.

8. **Do respondents agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?**

Yes. We agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters. We also agree with how such concepts have been differentiated in the proposed ISAs except that we believe that when a key audit matters section is presented in the auditor's report the heading for any Emphasis of Matter paragraphs should be required to include further context to clearly differentiate it from key audit matters.

We recommend that the second bullet in paragraph A15 of proposed ISA 706 (Revised) be added as a requirement in paragraph 9 of that ISA.

**Going Concern**

9. **Do respondents agree with the statements included in the illustrative auditor's reports relating to:**

   **(a) The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?**

   **(b) Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to continue as a going concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised))?**

   **In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.**

No. The AASB does not agree with the statements included in the illustrative auditor's reports relating to going concern.

Although the IAASB has made improvements to the proposed wording of the going concern statements as compared with the ITC, Canadian stakeholders reiterated concerns they identified when responding to the ITC, namely:

- The statements are confusing and open to misinterpretation by less-informed users, particularly with respect to material uncertainties.
- Management is not currently required under IFRSs to make an explicit statement that it has prepared the financial statements on a going concern basis. Some auditors are concerned that this might confuse users as to the respective roles of management and the auditor with respect to going concern.
- Some auditors believe that the requirements will result in additional cost because making explicit statements in the auditor's report will necessitate the involvement of senior audit staff and quality control reviewers. It is not clear that such additional work will increase audit quality.
- Public sector auditors are concerned that the proposed going concern wording may not be appropriate in a public sector context (for example, the references to "liquidation" or "ceasing trading", which do not generally arise in a public sector context).

- Users and others also questioned whether the proposals would address the underlying objective of the proposals – to address concerns coming out of the financial crisis.
- Most users and auditors commenting on the going concern proposals believe that the current exception reporting model is more effective in highlighting going concern issues for users than the proposed statements on going concern.

Based on the comments received from our stakeholders, we believe that the proposed statements on going concern will be of limited value to users and could also increase the expectation gap rather than reduce it. We also believe that the IAASB should continue to work with accounting standard setters as part of a holistic approach to reporting on going concern.

We recommend that, as outlined in paragraph 84 of the Explanatory Memorandum, the IAASB defer finalization of reporting on going concern as part of that holistic approach. We understand that such an approach would be consistent with the direction being taken by the PCAOB on this type of reporting.

10. **What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?**

We do not support the inclusion in the auditor's report of explicit statements about going concern. In the event that such statements are included in the auditor's report, we believe that when a material uncertainty has been identified the addition of the statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern is redundant and duplicative.

**Compliance with Independence and Other Relevant Ethical Requirements**

11. **What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?**

Users were of the view that this disclosure was marginally beneficial although most are satisfied with the extant requirement for the auditor's report to explain that the auditor is required to comply with relevant ethical requirements.

Auditors identified some practical implementation concerns. In Canada, for example, there are some differences in ethical requirements depending on the province in which the auditor is licensed. For Canadian audits of entities that involve auditors from different provinces, explaining the source of the ethical requirements maybe somewhat complex. Auditors also noted that this concern would be even greater for international audits. Nevertheless, we believe that these practical implementation concerns can be overcome.

**Disclosure of the Name of the Engagement Partner**

12. **What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?**

We are not convinced that disclosing the engagement partner name would have positive behavioral implications for auditors. We are concerned that users might reach inappropriate conclusions with respect to the performance and capabilities of engagement partners on larger audits.

Auditors of Canadian entities that are registered with the US Securities and Exchange Commission indicated that disclosure of the name of the engagement partner may increase the personal liability of Canadian engagement partners in the US when they are named in documents filed with the SEC. Because there may be different legal consequences in different jurisdictions, the AASB believes that national standard setters should be provided the flexibility to decide whether the requirement to disclose the name of the engagement partner should apply in its jurisdiction.

We support there being a harm's way exemption when disclosure is reasonably expected to lead to a significant security threat to the individual.

We do not see the need for application paragraph A45 of proposed ISA 700 (Revised), which indicates that law or regulation may require that the name of the engagement partner responsible for audits of financial statements other than listed entities be included in the auditor's report. While it is a true statement, we do not believe it adds any value.

In Canada and possibly in other jurisdictions, reference in the auditor's report to the engagement partner's licence number and the location of a public register identifying the engagement partner, is sufficient to enable those who wish to do so identify the name of the engagement partner.

We recommend that proposed paragraph 46(k) be deleted. In the event that this paragraph is retained in the final standard we suggest the following:

(a) the requirement be amended to require that the engagement partner be able to be identified in the auditor's report (rather than specifying that the engagement partner's name be included in the auditor's report);

(b) national standard setters be given the flexibility to decide whether this requirement should apply in its jurisdiction; and

(c) paragraph A45 be deleted.

**Other Improvements to Proposed ISA 700 (Revised)**

13. **What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?**

We support the improved description of the responsibilities of the auditor and key features of the audit in paragraphs 35-38 of proposed ISA 700 (Revised).

We agree with the requirement in paragraph 39 of proposed ISA 700 (Revised) that the description of the auditor's responsibilities shall be included within the body of the auditor's report or in an Appendix to the report. We do not agree with paragraph 40 which would permit location of such description outside the report because the description is, in our view, a key element of the auditor's report and users are less likely to read material that is located outside the auditor's report rather than within the report itself.

We recommend that paragraph 40 be deleted. In the event that paragraph 40 is retained, we believe that paragraph 39 needs to be revised. This is because paragraph 39 specifically requires the description of the auditor's responsibilities to be included in the auditor's report. As currently worded, if law or regulation permitted the auditor to refer to a website under paragraph 40, the auditor would still have to comply with paragraph 39. Accordingly, paragraph 39 needs to contain the caveat "Except in the circumstances described in paragraph 40…"

We support the requirement to describe the responsibilities of those responsible for overseeing the financial reporting process in paragraph 33 and the related application material in proposed ISA 700 (Revised).

We support the proposals dealing with other reporting responsibilities.

14. **What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?**

The AASB does not support the proposal not to mandate the ordering of sections of the auditor's report in any way, for the following reasons:

- We do not find the IAASB's reasons for not mandating the ordering of the auditor's report to be compelling:
  - Paragraph 104 of the Explanatory Memorandum refers to "cultural reasons". We do not believe that cultural reasons justify avoidance of presenting the auditor's report in a manner that enhances audit quality. In our view, this justification for not mandating the ordering of the report would set a dangerous precedent for future standard setting activities.
  - Paragraph 105 of the Explanatory Memorandum notes that the proposal to not mandate ordering of the report is largely consistent with extant ISAs 700, 705 and 706. This may well be the case, however under the extant ISAs the auditor's report is generally six paragraphs whereas under the proposed ISAs the auditor's report could be several pages in length. We believe that these significantly different circumstances justify serious consideration of the need to mandate ordering.

- We believe there are potentially negative consequences of not mandating the ordering of the report, which may include:
  - It will be more difficult for users to compare and contrast different auditor's reports;
  - It creates the potential for disagreements between management and the auditor about the placement in the report of important matters which may not be in the best interest of users of the report;
  - It may create confusion among users about the relative significance of matters that are presented in different locations in the report; and
  - It inevitably will increase inconsistency in global reporting.

We recommend that the ordering of the report be mandated in the final standard.

We support the level of prescription of the requirements in paragraphs 20-45 of proposed ISA 700 (Revised). We also support the requirements for specific headings in the auditor's report to ensure the required reporting elements can be recognized in all reports.

With respect to paragraphs 46-48 of proposed ISA 700 (Revised) we have the following comments, which we believe would enhance the consistency and comparability of auditor reporting in the public interest while permitting an appropriate degree of flexibility:

- The paragraphs should reflect the recommendations we have made in our other responses to questions in the ED to the extent that they are relevant. For example, consistent with our views with respect to ordering of sections in the auditor's report, we believe that ordering should also be mandated in paragraphs 46-48 (unless a specific ordering is required under law or regulation).
- Paragraph 46(a) should be identical to paragraph 21 to clearly indicate that the report is the report of an independent auditor. Permitting the use of other titles could result in titles that users find confusing and/or do not appropriately reflect the auditor's independence role.
- Paragraph 46(c) should be more specific as to the form of opinion expressed by the auditor by incorporating the requirements in paragraph 24. The auditor's opinion is probably the key piece of information that users refer to when reading the report. Consistency of the wording of the opinion is critical in clearly articulating to users the auditor's conclusion from the audit.
- Paragraph 46(f) should be identical to paragraph 29. We find the words "addresses the reporting requirements in" as being open to significant interpretation. We are not supportive of including statements on going concern in the auditor's report. However, if such statements are included, we believe that permitting different wording to be used would be confusing to users, particularly when the financial statements are prepared in accordance the same international financial reporting frameworks. If paragraph 46(f) is not revised as we suggest, we recommend that the words "and is not inconsistent with" be added after "requirements".
- Paragraph 46(h) should be identical to paragraph 31. Again, we believe that permitting different wording to be used would be confusing to users. If paragraph 46(h) is not

revised as we suggest, we recommend that the words “and is not inconsistent with” be added after “requirements”.

**Appendix 2: Summary of AASB Consultations with Canadian Stakeholders re IAASB Exposure Draft**

- Twelve written responses were received including from auditors of large, medium and small firms and public sector auditors, a prudential regulator and a bank.
- Roundtable discussions in various provinces throughout Canada (Nova Scotia, Quebec, Ontario, Manitoba, Alberta and British Columbia). These were organized by the local provincial institutes of chartered professional accountants. The institutes were asked to seek participants not just of auditors but also of preparers, management, directors/audit committees and users. There were over 100 participants.
- Roundtable discussions with various CPA Canada groups. These provided access to directors, preparers and investors, as well as auditors. There were approximately 40 participants in these groups.
- A conference call with the chief accountants committee of Canadian securities regulators.
- Staff also had a discussion with various members of the national professional practices groups of public sector auditor general staff across Canada.
- A webinar was held to inform participants about the ED. There were approximately 1,000 live participants and over 2,000 registrants who could assess the webcast either live or in archive.

AUTODESK.

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

December 10, 2013

**RE: Proposed Auditing Standards – Rulemaking Docket Matter No. 034**

Members of the Board:

Autodesk, Inc. ("Autodesk") appreciates the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (together the "Proposed Standards").

Autodesk is a world leading design software and services company, offering customers productive business solutions through powerful technology products and services. We serve customers in the architecture, engineering and construction; manufacturing; and digital media, consumer and entertainment industries. Our 7,300 employees work with customers in over 120 countries worldwide.

***The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

We support providing investors and other users of financial statements with timely, meaningful, and transparent information to better understand and assess the performance of the company. Similarly, we support the PCAOB's efforts to enhance auditor communications and information available to users of financial statements. However, we believe aspects of the Proposed Standards are duplicative of existing disclosure requirements, will unnecessarily confuse or detract the reader of an unqualified audit opinion, will be costly and time consuming for companies, and may not necessarily result in useful information to investors or other users of financial statements. We note the areas of particular concern below.

- Companies are already required to disclose areas of critical accounting based on management's assumptions, judgment and estimates within Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") as "critical accounting policies and estimates". These same critical accounting policies would likely be those considered for classification as critical audit matters ("CAM") under the Proposed Standards. We believe the disclosures regarding critical accounting policies, as required by the Securities and Exchange Commission ("SEC"), are more meaningful to investors than the auditor's assessment of the complexity of these areas or the degree of difficulty the auditor encountered in performing their audit procedures.

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- In addition to the critical accounting policies and estimates disclosure, the SEC MD&A disclosure standards require disclosure of known events, trends and uncertainties that are reasonably likely to have a material impact on a company's financial position and results of operations. The PCAOB should not require auditors to furnish original information that is not already required by the company. Requiring disclosure based on standards that would not meet SEC disclosure requirements for companies could be misleading to investors.

- Investors may misinterpret the identification of a CAM as indicative of an issue with respect to the quality of the financial statements or as a qualification of the auditor's report. Even though it is proposed such CAM disclosures be accompanied by an auditor's report that states that the opinion on the financial statements is not modified with respect to any of the described critical audit matters, we believe this approach may lead to more investor questions than answers.

- Inclusion of the audit procedures performed, including resolution of the critical audit matters, in the auditor's report will not enhance an investor's understanding of the financial statements. In order for the auditor to convey the context around such matters, it may be necessary to include expansive details that could overwhelm the auditor's report, again detracting from the auditor's overall opinion. Additionally, information about the results of audit procedures may lead investors to believe the auditor is expressing a "piecemeal" opinion on individual matters or accounts in the financial statements.

- Inclusion of the audit procedures performed, including resolution of the critical audit matters, in the auditor's report potentially would include disclosure of consultations with an auditor's national office or other third parties. This could lead to a chilling effect on issuers seeking additional clarification and guidance, which is an important practice for companies navigating complex accounting literature. Additionally, such disclosure could be given undue weight in the context of a matter that has been resolved to the satisfaction of a company and its auditors.

- In the past several years, the disclosure requirements have exponentially increased with the result actually being less transparency to the users of financial statements. Adding further disclosures that would be largely similar but with different terminology - critical accounting policy versus critical audit matter, would undermine the FASB's efforts to reduce the complexity in financial statements and associated disclosures.

We support including a statement affirming the auditor's independence. We do not believe the tenure of the auditor has a bearing on the quality of the independent auditor's work or the adequacy of their opinion and when presented in this manner, it may suggest otherwise. However, we would not oppose this requirement. Furthermore, while we do not believe it will have an impact on the quality of the independent auditor's work, we are not opposed to the addition of the auditor's signature.

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***The Auditor's Responsibilities Regarding Other Information In Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

We support including a description in the auditor's report that clarifies the auditor's responsibility for other information in documents containing financial statements. However, we do not support changing the auditor's responsibility to "evaluate" such information versus the current requirement to "read and consider" other information. We also do not support an expansion of audit procedures to include other information beyond MD&A and other schedules containing financial information that is derived from or that supports the financial statements. Finally, we do not support an extension of audit procedures to other information incorporated by reference. Such an extension would cause the auditor to review items not relevant to the financial statements, such as bylaws, proxy statements, and other documents where the costs associated with such additional procedures would not justify the benefit received.

In conclusion, we support improving communication to investors, while maintaining the scope and nature of an audit and the related responsibilities of auditors. We do not support making changes to the audit report that would require auditors to make subjective determinations or repeat information provided elsewhere in the financial statements and related disclosures. We believe the current roles and responsibilities of management, the audit committee and the auditors are the fundamental basis for the financial reporting infrastructure and certain of the proposed alternatives in the proposed auditing standards would negatively impact this structure.

We appreciate the opportunity to share our viewpoints on the Proposed Standards. If the Public Company Accounting Oversight Board has any questions regarding our comments, please contact me at (415) 507-5000.

Sincerely,

Mark J. Hawkins
Executive Vice President and Chief Financial Officer

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December 11, 2013

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

**Re: PCAOB Release No. 2013-005**
**PCAOB Rulemaking Docket Matter No. 034**

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("the Board") Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards.*

We have an interest in increasing the effectiveness and efficiency of the audit process and are supportive of the Board's efforts to improve the audit process and enhance transparency to users of financial statements. With respect to the proposed requirement for the communication of critical audit matters, however, we do not believe that the audit process will be improved if this proposed requirement is approved.

We believe it is management's responsibility to communicate key facts about the entity and its related financial statements, including the critical accounting policies and estimates used that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We believe it is the auditor's responsibility to separately opine on the facts as communicated by management. Accordingly, we believe an independent auditor commentary would be inconsistent with these fundamental principles.

Furthermore, instituting a requirement that auditors communicate critical audit matters could impede the work of both the auditors and management in the following ways:

- The effort and time that would be needed to determine, evaluate, and document critical audit matters could potentially significantly detract from the auditor's primary attestation responsibilities over the financial statements taken as a whole.

- Management and the Audit Committee would potentially need to devote a significant amount of time and resources to discuss and evaluate the critical audit matters as identified by the auditors, which could adversely impact the quality of the financial statements in the final stages of their completion.

We believe the roles of the auditor and management should not be intertwined. Management is responsible for its accounting policies, internal controls, and financial reporting and is responsible for providing transparent information and disclosure to the auditors so that they may opine on the financial statements taken as a whole. The auditor should not be the source of disclosed information that is not required to be disclosed by management. We believe a financial statement user could be confused by the need to interpret information presented by management as well as the critical audit matters presented by the auditor.

We believe a better approach to providing investors and other financial statement users with more meaningful information in forming an opinion on the financial statements taken as a whole would be to increase the auditors' attestation responsibilities surrounding critical accounting estimates. Management is responsible for the transparent disclosure of the company's critical accounting estimates in the MD&A section of its financial statements. The financial reporting process would be best served by having the auditor agree or disagree with management's determination of critical accounting estimates, the assumptions used in making those estimates, and the reasonableness of those assumptions.

We believe that this approach would result in maintaining the efficiency and effectiveness of both the audit process and management's financial reporting efforts.

We appreciate the opportunity to comment on the Board's proposal. If you have any questions, please contact me at 954-769-3145.

Sincerely,

Michael J. Stephan
Vice President – Corporate Controller

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Chris Barnard
Actuary

18 November 2013

- **Release No. 2013-005**
- **PCAOB Rulemaking Docket Matter No. 034**
- **Proposed Auditing Standards - The Auditor's Report on an Audit of Financial Statements When The Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor's Report; and Related Amendments to PCAOB Standards**

Dear Sir.

Thank you for giving us the opportunity to comment on your Proposed Auditing Standards - The Auditor's Report on an Audit of Financial Statements When The Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor's Report; and Related Amendments to PCAOB Standards. I will comment on your proposed auditor reporting standard that would require the auditor to communicate in the auditor's report "critical audit matters" that would be specific to each audit. I have already commented on similar issues at length;[1] for completeness I would suggest that you could also consider those comments in addition to these presented here.

I agree that critical audit matters are those that: 1) involved the most difficult, subjective or complex auditor judgments; 2) posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; or 3) posed the most difficulty to the auditor in forming an opinion on the financial statements. By requiring the auditor to communicate such critical audit matters, I believe that this proposed auditor reporting standard will enhance the usefulness of

[1] See Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB, June 2011, and Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs), IAASB, July 2013, and my comment letters thereon.

the auditor's report by improving audit transparency and increasing understanding of the audit process and its risks, reliances and limitations. However, it is important that the proposals should not mismanage expectations concerning the role of the auditor within the business and its financial reporting, and we must clearly delineate the auditor's role and responsibilities in this context.

I would also add that while I am happy with certain set language for introductory or explanatory purposes,[2] I would promote the use of specific language, tailored to the specific audit, which should be flexible enough to capture the complexities and circumstances, whilst nor becoming boilerplate over time.

Yours faithfully

C.R.B.

Chris Barnard

[2] For example, see paragraphs 12 and 13 of the Proposed Auditor Reporting Standard.

**From:** Jeanne Montague
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 7:01:13 PM

I wholeheartedly support Lisa Roth's position.

Best Regards,

**Jeanne Montague**
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**Theresa Barnett, CPA**
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September 2, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034; Proposed Rule Under Release# 2013-005; Release Date August 13, 2013

I appreciate the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its proposed new auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. I am choosing not to respond to the other proposed auditing standard contained within the same Release (Release # 2013-005), *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report,* in this comment letter, but may submit a separate comment letter focusing on this proposed new standard before the December 2013 deadline.

My comments on the Concept Release today address the following areas:

*I. Overall Comments*

*II. Recommendations for Changes to the Auditor's Report*

*III. The Most Important Needed Change to the Auditor's Report*

*IV. Conclusion Concerning the Current Proposed Standard*

## I. Overall Comments

As a CPA dedicated to the profession and committed to our responsibility to the public for over 10 years now, I have struggled with the mindset of many within the profession who do not truly apply the principals behind our accounting and auditing standards, especially transparency, due diligence, and professional skepticism; and their impact on the audit process, including risk assessment and the creation of the audit report. I have seen the work of Deloitte with "except for" unqualified opinions, qualified opinions, and explanatory paragraphs within unqualified opinion reports, and have a very positive perception, as a result of this and my research of this firm, of the overall leadership of this firm, and its dedication to the profession, including its understood responsibility to the public. Unfortunately, I cannot assert the same perception for another Big 4 firm, and other firms, currently registered with the PCAOB and conducting audits of SEC registrants, and it would also be impractical to assume **all** Deloitte partners have never, and will never, fall prey to our human nature to apply a biased perception and allow the current conflict of interest that exist between an audit firm and its audit client to affect their objectivity in any and all circumstances, especially when personal and/or business financial interest are at stake, that is, loss of the client to bankruptcy for instances, or another firm. It is because of these other firms that I am most excited to see the PCAOB work toward improving the value of the audit report, by requiring specific findings be included to assist public investors, and I truly hope the AICPA follows suit in promoting the adoption of a similar standard for audit firms of non-publicly held entities, and move away from the existing standardized audit reports to the benefit of the public, financial institutions, and venture capitalist, which our profession has a responsibility to protect in providing a quality audit and opinion on relied upon financial statements.

Although not directly related to the above referenced proposed standard, I would be remiss, if I did not also state that I hope the next steps of the PCAOB and the SEC, in its efforts to fully implement the provisions of the Sarbanes Oxley Act as Congress expressly meant for the Act to be applied, is to remove the current conflict of interest between the audit firm and the client SEC registrant, which is a true independence issue, and the main problem leading to the lack of transparency, lack of due diligence and prudence, and lack of professional skepticism, and other issues, resulting in low quality audits and an audit report of little value. Although audit firm rotation, and full engagement team rotation, may address some of these issues to some degree, until the conflict of interest is removed of the SEC registrants paying an audit firm directly to perform the audit and render an opinion on the SEC registrant's financial statements, the risk is still too high such conflict of interest will impact the engagement team and partner's perspective, resulting in lack of transparency, lack of due diligence, lack of professional skepticism, etc. and lead to public harm, possibly the equivalent of the Enron scandal or greater as some point in the future, given the number of registered firms with the PCAOB and my known personal experience with more than one of these firms, one of which is a Big 4 firm.

Although I have grown in my professional writing since I wrote the attached paper addressing this conflict of interest (i.e. it is raw and lacks diplomacy as it was written with emotion, demonstrating my frustration with certain ones within my profession, and with the government's, and governing bodies', past and present failures to promptly and directly address the conflict of interest and other objectivity issues), the attached paper is a truly honest assessment of the problems that existed, and still exist, within our profession from someone with first-hand knowledge of what goes on behind the scenes, for which the PCAOB inspectors most likely will not become aware of in their "after the fact" review of engagement work papers. The attached is not a full report, but only highlights certain problems.

Although prepared in 2007, I submitted the attached to the SEC in the early part of 2009 as an attachment to my comments on the IFRS timetable. In considering this attachment, I do commend the PCAOB for the subsequent recent steps to make the

Sarbanes Oxley Act more effective to the benefit of the public, including recent public meetings addressing audit firm rotation, engagement team rotation, and the conflict of interest of SEC registrants paying the audit firms directly for the audit and audit opinion of their annual financial statements, when independence is required and needed for the audit report to have any value. And even though most within my profession have not, and will not, agree with my recommendations in whole or in part, because it makes their business life more difficult, and could possibly negatively affect their income levels, and even though my personal and professional life has been negatively impacted for not accepting the status quo of how audit firms have in the past, and currently, audit and report, and for being outspoken about the deficiencies with the status quo of our audit profession, I believe the protection of public interest is more important and worth the difficulties that come with needed change to mitigate known risk. With the above stated, the purpose of the attachment and its mention herein, is to remind the Board of why the PCAOB originated, and to encourage the Board to stay strong in carrying out its original objectives to the benefit of the public at large versus folding to any degree to the voices of the influential and/or majority firms and SEC registrants who want to minimize change from the status quo, which includes encouraging the Board to stay strong in adopting an audit report standard that will be of true significant benefit to the investing public, that will force SEC registrants to be that much more on top of their internal controls and financial reporting than existing rules promote, and force audit firms to be that much more mindful of the need to apply appropriate risk assessment, professional skepticism, and to produce the type report that should be issued under the circumstances.

## II. Recommendation for Changes to the Auditor’s Report

I concur with the PCAOB’s proposal of requiring auditors to communicate critical audit matters which could help investors and other financial statement users focus on aspects of the company's financial statements, which they would not know to consider otherwise in reviewing the financial statements, especially if the required disclosure, by its content, promotes a true low audit risk that a material misstatement exist and has gone undetected during the course of a quality audit in line with our professional standards. In other words, I believe the value in adding certain disclosure requirement within the audit report is possibly not only in how the information will assist public investors in their investment decisions, but possibly also in how the required disclosures would force the engagement team and partner to reevaluate the sufficiency of their evidence obtained, how they addressed findings, and whether or not their audit risk is truly low that a material misstatement exist and has gone undetected in the course of the audit, and the effect of such reevaluation on their decision of the type audit report that needs to be produced (i.e. unqualified, qualified, adverse, or disclaimer) and the content within such report (i.e. explanatory paragraphs).

In looking at the cost/benefit of adopting a standard that requires additional useful information to the investing public, the benefit of protecting the investing public far outweighs any additional cost, which should be ultimately absorbed by the SEC registrant. In other words, expected costs to audit firms and SEC registrants should not deter the PCAOB from making changes that benefit the investing public in multiple ways, including changes that promote better performance of audit firms in carrying out the audit and better performance of SEC registrants in financial reporting. Under the current payment model, the audit firm would bill the SEC registrant directly for such additional time and money involved in preparing the audit report under any new reporting model that would come with the adoption of a new standard for such by the PCAOB. However, once the existing payment model is changed to remove the existing conflict of interest between the independent audit firm and the SEC registrant, the audit firm will bill the same additional costs to the PCAOB instead, who then bills and collects from the SEC registrant. This is how I perceive the existing payment model changing, but this concept is for a separate day under a separate concept release by the Board.

In reviewing the bullet points of additional information the Board has proposed in its earlier Concept Release, I believe the following, if not apparent on the face or notes of the financial statements, have the most merit, and would benefit the investing public the most with it disclosure in the audit report.

- Areas of high financial statement and audit risk;
- Areas of significant auditor judgment;
- The most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty;
- Significant changes in or events affecting the financial statements, including unusual transactions

If any of the above areas are covered in the footnotes to the financial statements, then I believe it would benefit the investing public to require the auditor point to the footnote instead of being redundant, which has the same affect in bringing the high risk areas to the investor's attention.

## III. The Most Important Needed Change to the Auditor's Report

I believe a required disclosure of the significant audit differences, for which were either not resolved or not accepted by the SEC registrant as a proposed audit adjustment must be added to the proposed standard, ***The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***, for such a standard to be highly effective in improving the value of the auditor's report to public investors, and ultimately improving the overall quality of audits produced by audit firms registered with the PCAOB. However, I further believe this change should be a required change for **Qualified Opinion Reports** as well. I actually believe the Board should consider adopting a standard that addresses **changing the reporting on both Unqualified and Qualified Opinion Reports versus only Unqualified Opinion Reports** for disclosure of unresolved or uncorrected significant audit differences as well as adopting some framework of reporting which addresses the bullet point items in section II above to some degree.

Review of the significant audit differences and their effect on risk assessment and the final report issued is a critical part of the audit process, and could therefore be considered a component of the “critical audit matter” part of the new standard the Board adopts. I do not believe certain matters should be left up to the auditor to decide as to whether or not it should be disclosed in the auditor’s report, or whether or not it qualifies as a critical matter. Significant audit differences is one of those matters the Board should mandate disclosure of in its upcoming new standard. My perception on its importance is due to what I have seen while working under the direction of others responsible for audit quality and opinion reports produced. I have seen significant audit differences go unaddressed or not sufficiently addressed when considering audit risk. One example includes identified premature revenue recognition the client did not want to correct, which was technically just below the SEC materiality thresholds for revenue, when considering quarterly segment revenue disclosure and trend analysis, but for which brought into question audit risk, and if I were a potential investor in this company, I would have wanted to know about this significant audit difference the SEC registrant refused to correct. Again, such a mandated disclosure would force audit firms to ensure they have reduced their audit risk to the required low and produced the right report, and possibly entice the SEC registrant to correct significant audit differences proposed as adjustments to keep their books cleaner.

In the name of transparency, maybe the same required auditor communications to management and the audit committee should be disclosed to the public as an attachment to the audit report. Although I have not read any of the comment letters from the 2011 release and this 2013 release, or yet fully read the Concept release or Proposed Standard release, for that matter, my focus is on potential investors versus existing investors in any particular SEC registrant, and believe the decisions of this Board should give more weight to the impact of its decision on potential investors (i.e. the public at large) versus the effect of the Board’s decision on any SEC registrant and its existing investors and its audit firm. With this stated, my questions is, “Why not require the required written communications to management and the audit committee, per existing and ongoing standards on such communications, be attached to the audit report and disclosed in the SEC form 10-K?”. Although I intend to read through the 2011 Concept release and the 2013 Proposed Standard release in its entirety as well as some of the comment letters for the 2011 Concept release and 2013 Proposed Standard release, and may provide an updated comment letter which excludes this proposal once read, my desire to contribute with available time, it being Labor Day, has me putting this thought, and this comment letter, to the Board now as I cannot predict my availability to contribute an updated comment letter before the December deadline as other matters currently have my priority.

## *IV.* Conclusion Concerning the Current Proposed Standard

Although I again commend the Board for its attempts to improve the audit profession and benefit the public with improvement to the audit profession’s unqualified opinion audit report, I am concerned it is mostly face value, as is, and will not benefit the public as the Board expressly desires. I do believe a standard needs to be developed by the Board to improve upon the existing reporting requirements to benefit the public and the quality of audits produced by PCAOB registered audit firms. However, the proposed standard is in need of some reconsideration and revision to accomplish the objectives of the Board, and truly add much needed value to the report in the interest of the investing public.

I apologize for just now making my comments directly known to the Board, versus bringing my comments to the Board in 2011, when the Board first brought it's concept of a change in the existing reporting model to the public for comment. However, I welcome an opportunity to participate in upcoming discussions on much needed changes to existing standards and Board rules to aid in rigorously implementing the Sarbanes Oxley Act for the best protection of investing public at large.

If you have any questions or would like to discuss these matters further, please contact me at (214) 772-5458. And I again thank you for this opportunity to comment and thank you for your consideration of these matters.

Very truly yours,

Theresa Barnett

cc: SEC Chairman
SEC Chief Accountant
Kenny Marchant, US Congressman

# What and When Will the Next Steps Be?

If one were to consider the face-value activity that has occurred since the Enron scandal; such as the congressional hearings, resulting legislation, and formation of the PCAOB, one may conclude that enough has been done to reduce the risk to an acceptable low level that a scandal similar to Enron happens again. But has enough really been done? The conflict of interest between the client and audit firm engaged to report on the internal controls and financial statement of the client still exist. We are fooling ourselves if we think enough has been done and is being done currently to prevent another Enron fiasco. The PCAOB has enhanced the independence rules to some degree to help reduce this risk, but it is not enough.

This conflict of interest is at the heart of what happened with Enron; and unfortunately, in today's society it is hard to find leadership in a firm willing to quit an account on principle and/or issue a modified opinion when required per standards for fear of losing the account. This is exactly why additional measures are warranted because we can't rely on the majority of leaders in today's society to do the right thing legally, ethically, and/or morally on their own accord. Is it going to take another scandal the magnitude of Enron to get Congress (or now, the PCAOB) to move on removing the conflict of interest between independent auditors and their clients?

As I read in various Wall Street Journal articles printed prior and just after the Enron scandal, individuals and governing bodies of authority warned the SEC years prior to the Enron scandal that changes were needed. One such article noted that Arthur Levitt, chairman of the SEC in the Clinton administration, had called for reform in the 90's before the accounting scandals broke out; and before these scandals, his suggested reforms seemed unreasonable; but after the Enron scandal, these suggested reforms seemed more than reasonable. A March 5, 1996 Wall Street Journal article titled, "Who is Going to Audit the Auditors?", talked about companies, including Enron, who were taking cost cutting measures by outsourcing their internal audit departments to their own auditors. According to the article, The Institutes of Internal Auditors wanted double duty stopped and warned the SEC that double duty can lead to major problems. Instead of listening to these expressed warnings by these individuals and governing bodies of authority and taking proactive measures to prevent such problems, the SEC apparently did nothing and it took the Enron scandal and a resulting act of Congress to make a move that was reactive in nature. Let's please learn from what is now history and be proactive going forward. By putting the PCAOB in-charge of assigning the audits of these publicly held corporations and paying the auditors versus allowing these publicly held companies to pay the auditors directly, the conflict of interest is removed and true independence is obtained, thus greatly reducing the risk of another scandal such as Enron from occurring. A step such as this is what the public needs to have the right amount of real (not false) assurance to invest in the capital market.

However, removing the existing conflict of interest isn't the only additional step needed to reduce the risk to an acceptable level that the fraudulent activity the size of Enron occurs again. Objectivity is a major component of independence. You can't be considered independent if you lack objectivity. There is a natural tendency for the professional skepticism that needs to be applied each year to ensure the investors receive the quality audits they deserve to dissolve over a period of years in serving the same clients as complacency sets in with these recurring clients and objectivity becomes lacking. I observed this exact lack of objectivity and thus lack of professional skepticism of engagement team management at both the Big 4 and regional accounting firm level where the client was a recurring client for numerous years. Section 203 Audit Partner Rotation of the SOX Act required amendment to Section 10A of the Securities Exchange Act of 1934 by adding the following: (j) Audit Partner Rotation – it shall be unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner (having primary responsibility for that audit) or the audit partner responsible for reviewing the audit has performed audit services for that issuer in each of the previous 5 fiscal years of that issuer. However, this amendment doesn't address the other members of the engagement team who have served the same client for 5 years or longer, but it should.

Third year seniors , managers and senior managers with Big 4 firms, especially those who start their audit career with the same Big 4 firm, more than likely have served the same clients since the beginning of their time with the Big 4 firm, thus they already have at least 5 years in these clients before they reach the partner level. Seniors, managers and senior managers handle the majority of the planning and supervise the fieldwork testing, in addition to performing their own testing on the more complex areas. These individuals work directly with client management as well as client accounting personnel and make the day-to-day decisions in fieldwork testing; and as such, must apply the right amount of professional skepticism to ensure a quality audit in –line with auditing standards, which the investing public deserves. It's not just the audit partner needing this professional skepticism, thus the mandatory 5 year rotation should apply to the entire engagement team and not just the audit partners.

Section 207 of the SOX Act required a study of mandatory rotation of registered public accounting firms by the Comptroller General of the United States to be completed and reported to Congress and the Senate before the end of 2003. The Comptroller General responsible for this study and resulting report was and still is David M. Walker. David became the seventh Comptroller General of the United States and began his 15-year term when he took his oath of office on November 9, 1998. However, between 1989 and 1998, Mr. Walker worked at Arthur Andersen LLP, where he was a partner and global managing director of the human capital services practice based in Atlanta, Georgia. So how does this former Anderson partner go about studying the potential effect of a mandatory audit firm rotation to help the House and Senate decide on the whether or not to make audit firm rotation mandatory? He polls the accounting firms and SEC registrant executives (i.e. CFOs and audit committees), the very same type professionals who caused the Enron downfall (& other scandals of the early decade) in the first place. How objective can their responses be? Per the GMO reported results, the majority of accounting firms and SEC registrants do not want mandatory rotation. Who would have thought such an outcome in this survey would result? Anyone who is a business person and understands the mindset of these industry executives and public accounting leaders would not be surprised by these results. Thus, one could say that a conflict of interest existed in asking these professionals for their opinion on the subject of mandatory firm rotation. Although no-one will come right out and say it, one of the main reasons the majority polled do not want this mandatory rotation is because it makes business and life more difficult for them and could hurt their own bottom line. They just do not want to make the sacrifices necessary to protect the investing public.

Two somewhat laughable responses reflected in the GMO reported survey results is the expressed concern that increased cost would result due to increased dominance by a few and the expressed concern that the first year with a new auditor would result in a lower quality audit, which could lead to missed material misstatements. First, the Big 4 already dominate the market of SEC registrants. A mandatory audit firm rotation should open up this market to fairer competition and reduce the dominance that currently exists, and thus benefit the SEC registrant in the long run. Having spent some time with smaller accounting firms which heavily compete for clients, I have first-hand knowledge that it appears to be common practice to expect additional fees from the client in the initial year of engagement to cover the warranted additional testing and considerations in the first year and the long term contracts (engagement letters) reflect this with lower estimated fees in the 2nd and subsequent years. Sure the first year with a new auditor might be a little more costly, but the long-term contracts should keep audit fees down with increased competition. Secondly, auditing standards for which all independent auditors in the United States are required to abide by dictate that auditors must have the knowledge of the industry and specific accounting issues or be able to obtain that knowledge during the course of the audit to competently complete the audit. Additionally, audit standards concerning risk (SAS 47and now SAS 107) requires the auditor to reduce to an acceptable low level the risk that material misstatements will go undetected in the course of their audit, thus the higher risk that comes with a new client is reduced with the additional time and testing required with an initial audit. With this in mind, a quality audit is as obtainable with the new successor auditor as it is with the predecessor auditor, who may lack the professional skepticism due to its possible lack of objectivity after serving the client for many years. These Big 4 firms have been serving the same audit clients for up to as many as 50+ years. As such, the PCAOB should consider a mandatory firm rotation from anywhere between 5 and 10 years after the initial audit for the protection of the investing public.

Approximately four years has past since the Comptroller General's release of its report on its study of mandatory audit firm rotation in which it stated that more time was needed to determine the effectiveness of existing implementation of the Sox Act to consider such a step in greater detail. How much more time is needed before the next steps are taking? In a March 4, 2003 Review of FASB Action Post Enron and WorldCom Hearings by the House of Reps. – It was stated, "Sarbanes Oxley represents a positive 1st step, but it will not make a real impact unless it is vigorously implemented." I believe it is time for the next steps in this continuous process to reduce the risk that another scandal the size of Enron happens again. Don't you?

CERTIFIED PUBLIC ACCOUNTANTS

December 9, 2013

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

**RE:** PCAOB Rulemaking Docket Matter No. 034

Board Members:

Thank you for the opportunity to comment upon the PCAOB's proposed two new auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.* We appreciate all the time and effort associated with the research, survey, compilation and drafting of these proposals.

The purpose of the new proposals is to make auditor's reports more informative as well as to increase the reports' relevance and usefulness to investors and other financial statement users. This purpose is well in line with the PCAOB's statutory mandate to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports. All of our comments that follow are to be viewed in this light. Whether we agree or not with certain aspects of the proposals is dependent upon whether or not we believe that an investor will be better served with the adoption of specific additional requirements.

We agree that the pass/fail model for the Auditor's Report, in which the auditor states whether or not the financial statements are fairly presented and which has been relatively unchanged for the past 70 years, should be retained. Other aspects of the proposed changes to the auditor's reporting model are discussed below.

**Addressees**

Most auditor reports are addressed to shareholders and the board of directors. Requiring that addressees include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body, is helpful in establishing consistency throughout the profession, and, more importantly, rightfully requires the identification of the appropriate parties for whom the report is written. Clearly the investor is better served by this requirement, and we support this change.

**Statement that the auditor is a public accounting firm registered with the PCAOB**

A requirement to make a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the audited company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB seems to us to create unnecessary redundancy. Since the title of the auditor's report is "Report of Independent Registered Public Accounting Firm," it seems excessive to repeat that point again in the body of the report.

While our objection is of a minor nature, we believe the auditor's report is not enhanced by this requirement. Users of the report are unlikely to gain additional comfort from this repetitive statement, and additional unnecessary language only serves to distract the reader from what is important, namely, the basis of the opinion and the opinion.

**Statement containing the year the auditor began serving consecutively as the company's auditor**

The audit committee is responsible for hiring, retaining and approving fees for the auditor. In fulfilling these responsibilities, the audit committee considers, among other things,

- The auditor's expertise in the industry
- Technical strength and experience of the audit team
- Turnover
- In an incumbent situation, the firm's relationship with the audit committee and the firm's added value in helping the audit committee fulfill their duties in overseeing the financial reporting process

The audit committee also may consider the auditor's tenure. However, in most instances, consideration of tenure is not as important as the other criteria mentioned above when the audit committee determines whether or not to retain an audit firm.

Requiring a statement of audit tenure would appear to undermine the duties of the audit committee to select the auditors based on the far more important criteria detailed above. Highlighting tenure in the auditor's report indicates to the reader that this one particular criterion retains more importance than other information about the auditor that the audit committee considers annually. In fact, numerous studies cited by the Board reach differing conclusions concerning the value of auditor tenure. As there is no consensus regarding the relationship between audit quality and auditor tenure, disclosing tenure in the auditor's report undermines the authority of the audit committee and possibly sets in motion regulation concerning audit firm rotation. Should such regulation transpire, the audit committee's authority would be undermined further. Such regulation would substitute the audit committee's sound judgment with regulatory time limits and rotation requirements. It is clear to us that investors would not be better served by this requirement.

**Statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud**

We agree that clarifying, in the Basis of Opinion section of the auditor's report, that the auditor plans and performs the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, does help the financial statement users more fully understand the responsibilities of the auditor. We are in support of this recommended change.

**Requirements for the auditor to communicate in the auditor's report "Critical Audit Matters"**

We understand that investors are requesting improved relevance of the auditor's report, and that the Board is proposing communication of critical audit matters with the objective of providing more insight about the most significant matters that the auditor addresses in the audit. The belief is that communicating critical audit matters likely would provide meaningful information to investors and other financial statement users about the auditor's work in performing the audit and in forming an opinion on the financial statements, taken as a whole. We have a number of issues related to this perception, and they are detailed on the following page.

- The definition of critical audit matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. This definition clearly connotes that the subject matter is complex. Certain accounting rules are equally complex, as are the audit procedures designed to obtain appropriate audit evidence with respect to financial statement assertions. It is our belief that a majority of investors and financial statement users may not fully appreciate or understand disclosure and discussion of critical audit matters. Anyone who has tried to explain the significance or lack thereof of "uncorrected financial statement misstatements" to non-accountants understands this argument.

- In order to ensure, if at all possible, that the reader is not misled or misunderstands the explanation of a single critical audit matter, and certainly multiple critical audit matters, a significant amount of printed space in the auditor's report may be required. This significant use of space in the report would only distract from the importance of the auditor's opinion.

- It is the role of management to disclose critical accounting policies and discuss the important financial statement metrics with its shareholders in a company's financial statements and annual report. Added information about the same from the auditors can only blur the line between management and the independent auditor in the eyes of the financial statement user.

- Audit costs will increase, most likely significantly, during the first year identification of critical audit matters is required. Drafting language addressing critical audit matters will be a difficult project to delegate to audit staff. Drafting of critical audit matters likely will be performed by higher level members of a firm, including partners, and may involve significant hours and, thus, increased cost.

- The auditor has always discussed critical audit matters with the audit committee. Drafting language regarding these critical audit matters for inclusion in the auditor's report will require additional time spent with the audit committee developing and approving the language. Management will most likely comment on this language, increasing the likelihood of friction between management, audit committee and auditors, that would not normally exist. This friction cannot be beneficial to anyone.

- The proverbial Pandora's Box – Will financial statement users view the disclosure of more critical audit matters as better or worse than the disclosure of less critical audit matters? Will companies in the same industry with the same issues but different auditors be viewed differently if one has more critical audit matters disclosed than the other? Will auditors with different clients in the same industry with the same issues need to take care to disclose the same critical audit matters for each client, less someone making a comparison would conclude something amiss?

- Auditors may conclude from a liability point of view that more critical audit matters are better. Additionally, the proposed requirement specifically states that the use of the word "most," as in "most difficult" or "most complex," is not intended to imply that only one matter qualifies as a critical audit matter. Management may conclude that more critical audit matters reflect poorly on their company's operations. This scenario places the auditors and management in unintended conflict.

- Will audit opinions issued under generally accepted auditing standards (i.e. not under PCAOB standards) be viewed as audit opinions of a lesser quality, thus forcing all non-public audits to adapt to the same standards?

**The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report**

We agree with the objectives of this proposed requirement and can readily understand the positive impact it can have on investors and financial statement users. However, as a firm that primarily audits registered investment companies (mutual funds), we see the potential for conflicts and problems resulting from this proposal. Registered funds file their annual reports with the SEC on form N-CSR. Fund annual reports typically contain (among other things) the following items of information that would qualify as "other information" under the proposed standard:

- A management discussion of fund performance
- Typically, a line graph of fund investment performance compared to the performance of a benchmark index or indices, accompanied by 3, 5 and 10-year or since inception average annual investment returns
- An expense example demonstrating the dollar amount of fund expenses incurred over the most recent six month period on an investment of $1,000
- A tabular or graphical representation of the fund's investment portfolio holdings
- A discussion of the factors the board of directors considered in approving the fund's investment advisory contract

While some of the information detailed above can be evaluated, recomputed and/or verified by the auditor of a fund's financial statements without obtaining additional audit evidence, much of it cannot. Further, some of the items that can be verified and some that cannot may be included in the same portion of the annual report. We feel that this may lead to investor confusion regarding which particular portions of the annual report the auditor is covering in the required statement that no material inconsistency with the financial statements or misstatement of facts were found in the other information. In particular, we see the following potential areas of conflict with respect to each of the above:

- The management discussion of fund performance will typically include items that the auditor can evaluate based upon the audit evidence already obtained, such as investment total returns for fund shares or portions of an investment portfolio invested in certain industries or specific securities. It may also contain a significant amount of information that cannot be so evaluated. This may include index performance, overweighting or underweighting in certain sectors relative to a benchmark index, general economic data such as inflation or unemployment and segmented investment performance for certain portions of a fund's portfolio, among potentially many others. Without clarifying which particular information in a management discussion of fund performance that the auditor has evaluated for inconsistency and misstatement of fact, investors could be misled.

- Similarly, the line graph will include a graphing of index performance. The auditor may or may not collect evidence on the performance of the index as part of audit procedures. Furthermore, if the auditor has only performed the audit for the most recent fiscal year or two of the fund, would he be required to obtain the investment performance for the years presented that were audited by the prior audit firm and recompute average annual returns and evaluate the line graph? In many situations, the auditor has this information included in his audit evidence, and in many he may not. This again creates inconsistency and may lead to investor confusion.

- The expense example would typically not pose any problems for an auditor to evaluate.

- The auditor may be able to evaluate the tabular or graphical display of the fund's investment portfolio if it is characterized in the same manner as it is in the fund's portfolio of investments included in the financial statements. However, in many instances this display may not be organized in the same fashion as the portfolio of investments. For example, a stock fund may categorize its portfolio by industry in the financial statements but by country or geographic region or by market cap or some other metric in the tabular or graphical presentation. Again, in certain cases, the auditor may not be able to evaluate this presentation based on the audit evidence obtained, resulting in inconsistency.

- The auditor typically has no role in the presentation of the factors the board of directors considered in approving the fund's investment advisory contract. While some information can be evaluated (fund total return, fund expense ratio), much of it cannot. This portion of the annual report is truly a disclosure for which fund counsel takes primary responsibility. Auditor evaluation of this discussion seems inappropriate.

We feel that the proposed standard on other information should be amended to either exempt the audits of registered investment companies altogether or to clarify which specific elements of the other information included in a fund's annual report the auditor will be responsible for evaluating.

We would like to thank the Board for the opportunity to respond to the proposals as addressed in PCAOB Release No. 2013-005, and we appreciate the work and effort of the Board to protect investors and further the public interest in the preparation of informative, accurate and independent audit reports.

**Sincerely,**

BBD,LLP

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December 11, 2013

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

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

Dear Board Members and Staff:

BDO USA, LLP is pleased to have the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposed Auditor Reporting Standard")*, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Proposed Other Information Standard")*, and Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting standard* (together, the "Proposed Standards").

We continue to support the PCAOB's efforts to explore ways to enhance the usefulness and informational value of the auditor's report and provide transparency about the audit. We support many of the enhancements to auditor reporting set out in the Proposed Standards, such as expanding the existing language in the auditor's report related to the auditor's responsibilities for fraud and notes to the financial statements and other information, and communication of audit related matters the auditor considered critical. While we recognize that certain aspects of the Proposed Standards will likely present challenges in implementation, we expect that over time such challenges will lessen as auditors gain experience in their application.

While we are supportive of the overall direction of the Proposed Standards, we have reservations about the approach taken in some important areas, such as the identification and communication of critical audit matters, including the extent of documentation required, and the expansion of performance obligations and auditor reporting with respect to other information. Our views on these matters are more fully described in the sections below and in our response to selected questions posed in the Release.

Identification of Critical Audit Matters

We believe the identification of critical audit matters should be focused on those matters identified during the audit that required special audit consideration, such as significant risks, or areas of significant difficulty in the audit, for example, with respect to obtaining sufficient appropriate evidence. Such an approach is similar to that included within the International Auditing and Assurance Standards Board's (IAASB) proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*. This contrasts with the PCAOB's identification of critical audit matters that has in large part focused on the difficulty of an auditor judgment or matter. While the identification of critical audit matters under the PCAOB Proposed Standard is likely to result in similar matters being identified under the IAASB's proposal, we believe that the use of a risk based approach, analogous to the approach used to focus the audit on the most important matters, better articulates those matters important to users of financial statements.

Furthermore, we believe that critical audit matters should be a subset of those matters communicated to the audit committee, and should not include matters from other sources, since we believe that the matters required to be communicated to audit committees under Auditing Standard No. 16, *Communications with Audit Committees*, encompass all matters that would be pertinent for a user to understand the matters arising from the audit that were of most significance to the financial reporting process. We understand that some concern has been expressed about the possibility of an auditor failing to communicate certain matters to the audit committee to avoid communication of that matter as a critical audit matter in the auditor's report. However, such a possibility could be avoided by ensuring that Auditing Standard No. 16 included the same criteria for identifying and communicating critical audit matters as the Proposed Standard. In this way, once a matter rose to the level of a critical audit matter, it would also have risen to the level of a required audit committee communication.

Communication of Critical Audit Matters

The requirement in paragraph 11 of the Proposed Auditor Reporting Standard explains that the communication of critical audit matters should identify the matter, describe the considerations that led the auditor to determine that the matter is a critical audit matter, and provide a reference to where that matter is described in the financial statements, if applicable. However, we note that all the illustrative examples provided in Appendix 5 of the Proposed Standard include a description of audit procedures performed, although such a description is not required. We believe that in some instances, a description of audit procedures performed may help to explain why a matter is considered a critical audit matter, and suggest including in the requirement that a description of a critical audit matter may include its effect on the audit, if considered necessary, taking care not to convey that a separate opinion or conclusion is provided on the critical audit matter. In this regard, we suggest providing examples of critical audit matter paragraphs that illustrate how to report in both circumstances.

We continue to believe that the auditor should not be the source of original information about the company and should not communicate matters that management is not required to communicate. As such, we do not support auditor communication of significant deficiencies, or other matters not already required to be reported on by management. Given that critical audit matters are intended to focus on those matters the auditor addressed during the audit that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, we would generally expect that such matters would also be the most difficult, subjective, or complex management judgments, and would accordingly also be reported by management within the notes to the financial statements, or elsewhere in documents containing the financial statements.

Extent of Documentation

The Proposed Auditor Reporting Standard requires the auditor to document the basis for determining that a reported matter was a critical audit matter, in addition to why a non-reported matter that would appear to meet the definition of a critical audit matter was not determined to be a critical audit matter. We believe that the requirement to document why something is not a critical audit matter has the potential to result in excessive documentation and increase the cost of implementing the Proposed Auditor Reporting Standard without a corresponding benefit.

Furthermore, if critical audit matters were a subset of those matters communicated to the audit committee, as we suggest, the auditor's judgments relating to why a matter was considered to be a critical audit matter would likely be supported by the documentation already included as part of the auditor's communication with the audit committee. Conversely, that documentation would likely provide an indication of why other matters discussed with the audit committee did not rise to the level of a critical audit matter.

Other Information

Overall, we support the elements in the Proposed Other Information Standard that enhance the user's understanding of the nature of the work performed by the auditor and the information to which the auditor devoted attention. However, we do not support providing a conclusion on the work performed with respect to other information. We are concerned that the requirement for the auditor to address whether, based on reading and evaluating the other information, they have identified material inconsistencies in the other information or material misstatements of fact may be perceived by users as providing some level of assurance, which is not supported by the extremely limited procedures performed.

Moreover, we believe the use of the term "evaluate" in the Proposed Other Information Standard, in contrast to the term "consider," which is the current performance requirement under AU 550, *Other Information in Documents Containing Audited Financial Statements,* could inadvertently cause auditors to expand their procedures relating to other information, particularly if the auditor is required to provide a conclusion on the other information. The term "evaluate" has heretofore been associated with the performance of procedures to obtain either limited or reasonable assurance, which is not contemplated in the Proposed Other Information Standard; to use the term "evaluate" to describe procedures outside that context has a strong potential to mislead users about the nature of the procedures performed and the degree of comfort that users should take from the performance of the limited procedures.

Applicability of the Proposed Standards

We do not believe the provision to communicate critical audit matters should be required for audits of brokers and dealers, investment companies, or employee benefit plans (for example, employee stock purchase, savings, or similar plans). These types of issuers differ from the typical SEC issuer, and we do not believe investors or other financial statement users are demanding additional information with respect to these companies.

With respect to the Proposed Other Information Standard, we do not believe that audits of brokers and dealers or employee benefit plans should be subject to this proposal. We believe that the compliance or exemption report required to be filed by brokers and dealers and required to be reported on by auditors under the proposed *Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission* provides users of their financial statements with sufficient information to make any additional reporting by the auditor unnecessary. Furthermore, employee benefit plans that file a Form 10-K contain limited other information that we do not believe is used by plan participants for investment decision making purposes, and for this reason we suggest the Proposed Other Information Standard should not apply to these audits.

As it relates to emerging growth companies, we believe that both the Proposed Auditor Reporting Standard and the Proposed Other Information Standard should be applicable to such companies, except as noted in our response to question 42 under the section, Considerations Related to Effective Date, to permit delayed compliance for smaller emerging growth companies.

Field Testing

We believe that field testing the provisions of the Proposed Standards, in particular the provisions relating to critical audit matters and the work effort relating to other information, both retrospectively and in live situations, has the potential to provide invaluable insights into the impact of these provisions on the audit, including cost benefit considerations. While we are currently engaged in performing some limited field testing of these provisions as a Firm and in conjunction with the Center for Audit Quality on a retrospective basis, we encourage the PCAOB to provide for sufficient time for the performance of both retrospective and live field testing and for the appropriate analysis of results before concluding on the matter.

Additional Commentary

We encourage the PCAOB to work with the IAASB to converge, to the greatest extent possible, the form and content of the auditor's report to increase comparability and ease of use by users so that any differences in reporting reflect genuine differences in approach. For example, the nature of the audit would seem to be largely similar between an audit performed in accordance with the International Standards on Auditing and an audit performed in accordance with the PCAOB Auditing Standards; thus we would expect that the description in the auditor's report would reflect that similarity. The greater the extent of differences, the greater the effort users will need to expend in understanding the significance of those differences when analyzing auditor reports between different jurisdictions.

Our responses to certain questions on select topics posed in the Release further expand upon our overall views expressed above, and are set out below.

**The Proposed Auditor Reporting Standard**

**<u>Basic Elements</u>**

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

We believe the auditor's report should be addressed to the investors in the company, such as the shareholders and the board of directors, or equivalent body, and not expanded to include other third parties such as bondholders. The auditor's report on an issuer's financial statements is a general use report and as such is available to all users of those financial statements, through the SEC website. For this reason, we do not see a reason for or benefit to expanding those to whom the audit report should be addressed. There is; however, likely significant litigation costs, and potentially significant legal liability, associated with adding addressees to the report. In particular, addressing the auditor's report to third parties will likely lead to an increase in in state law claims by such third parties. It can be expected that these third parties will claim that, under a particular state law, the fact that it was listed as an addressee creates a relationship that can lead to significant state law audit firm liability. It is unclear whether a particular court would agree under the applicable state law; but, given the general use nature of the report, BDO can see no reason to create this increase in audit firm litigation costs and potential liability.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**
   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**
   b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**
   c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

We understand that investors are interested in audit tenure and we support providing such transparency. However, we do not believe that including such information within the audit report provides the appropriate context for that communication. We are concerned that including such a disclosure in the audit report may infer a correlation between audit quality and audit tenure – a correlation which we believe has not been established. We believe such disclosure would be better placed on the PCAOB's Form 2.

6. **The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

We believe it would be appropriate to describe the auditor's responsibility for other information in a separate paragraph of the auditor's report to enhance the informational value of the report. However, while the auditor has an existing responsibility to describe any material inconsistency between the audited financial statements and other information and whether a material misstatement of fact exists, we do not believe it is appropriate to provide an explicit statement where there is nothing to report, given the limited nature of the auditor's procedures.

7. **Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

We do not believe the Board should require a specific order for the presentation of the basic elements required in the auditor's report. However, we would suggest the required use of section headings to assist users in understanding the auditor's report and making comparisons between audit reports of other issuers. Moreover, such an approach is consistent with the IAASB's exposure draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs),* and we believe it will be beneficial in circumstances where an entity is required to report under both the PCAOB Auditing Standards and the ISAs.

**Critical Audit Matters**

11. **What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

We understand that financial statement users believe that communication of critical audit matters will provide helpful insights into the audit of the financial statements and, as such, is responsive to their demands for more information about the audit. Moreover, including this information in the auditor's report would generally provide context to those areas in the financial statements that required significant auditor attention. However, in addition to these benefits, there are certain aspects of this communication, as proposed, that may result in unintended consequences, including:

- The disclosure of information that is the responsibility of management. For example, the severity of a control deficiency that is less severe than a material weakness may be considered a critical audit matter and result in the auditor providing information that was specifically exempted from disclosure by the SEC and PCAOB;

- The disclosure of consultations with others outside the engagement team may have a cooling effect on consultations, which would be contrary to enhancing audit quality;
- The chilling effect that disclosure of critical audit matters may have on communications with audit committees;
- Financial statement users may assume the auditor has provided a separate level of assurance on specific accounts or balances referenced in the critical audit matters, or conversely undermine the auditor's opinion on the financial statements taken as a whole.

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

The effect the additional time spent on identifying and communicating critical audit matters may have on audit quality is difficult to assess at this time, without the benefit of the results of field testing. However, a possible benefit could be increased attention by management and the auditor on the related financial statement disclosures. The more significant unintended consequences to audit quality include: an increased strain on resources at the end of the audit as a result of already tight filing deadlines; and a chilling effect on audit committee communications.

**16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

For the most part, we believe the factors in paragraph 9 of the Proposed Auditor Reporting Standard would be helpful in assisting the auditor in determining which matters should be considered in coming to a determination about whether a matter rose to the level of a critical audit matter. However, it is not clear whether once one factor is identified, on that basis alone, a matter would rise to the level of a critical audit matter. We do not believe that the intention of paragraph 9 is that the existence of one factor alone is the sole determination that a matter is a critical audit matter. If this is the case, we believe that additional guidance about how the factors are used in determining critical audit matters would be helpful. As such, we suggest moving the following guidance from page A5-29 of the Release into the proposed standard:

> Depending on the matter and its circumstances, the applicability and related degree or scope of just one factor might lead an auditor to conclude that a matter is a critical audit matter. In other cases, however, the auditor might take into consideration a combination of factors in determining that a matter is a critical audit matter.

Furthermore, while we agree that most of the factors are helpful, we do not believe that consultations outside the engagement team or use of auditor specialists should be considered factors in determining whether or not a matter rises to the level of a critical audit matter, as such consultations are often routinely performed during an engagement.

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

As noted earlier, we believe that a more informed response about costs will be available once the results from field testing are evaluated. However, some initial thoughts on costs relating to the characteristics of the entity under audit include:

- While the content of the communications in the auditor's report are the responsibility of the auditor, as the audit issues encountered during the audit increase in difficulty and the more extensive the discussions between the auditor and the audit committee, the greater the cost will be.

- Smaller entities with fewer resources to address reporting complexities may be impacted to a greater extent than larger entities with greater resources. For this reason, we suggest the PCAOB consider a staged implementation such that larger issuers implement the standard first to afford smaller entities the opportunity to learn from the experience of their larger counterparts.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

We support limiting critical audit matters to only the most recent financial statement period when the current period financial statements are presented on a comparative basis with those of one or more prior periods. Nevertheless, we believe the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

Additionally, to provide clarity about the need to include critical audit matters when a predecessor is asked to reissue a report, we recommend that the guidance from page A5-34 of the Proposed Auditor Reporting Standard be included within the body of the standard. It states:

> In situations in which a predecessor auditor has been asked to reissue his or her audit report on the financial statements of a prior period, existing standards require the auditor to consider whether the auditor's report on those statements is still appropriate after certain required procedures are performed. If the predecessor auditor determines that the auditor's report is still appropriate and is reissued, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for one year, the proposed auditor reporting standard would not require the communication of critical audit matters in the reissued report of the predecessor auditor for prior years.

**28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

The proposed requirements relating to critical audit matters would, in all likelihood, lead to increased litigation expense and risk of liability. In particular, plaintiffs will likely argue under the federal securities laws and/or state law that the auditor has made a "statement" that was somehow misleading (e.g., contains a material misstatement or material omission) and it relied on that statement to its detriment. The Proposed Auditor Reporting Standard's broad definitions regarding what constitutes a critical audit matter will require the auditor to engage in frequent, and significant, judgment calls. Because the auditor will exercise these judgments in determining what, if any, "statement" is made regarding a potential critical audit matter; these judgments have the potential to be the subject of persistent second guessing by plaintiffs. Proposed changes to the proposal aimed at making clearer what is, and is not, a critical audit matter will be important to defending against such second-guessing of auditor judgments. While such changes have the potential of mitigating liability, they will of course not eliminate the significant risk associated with the auditor's communication of critical audit matters under the Proposed Auditor Reporting Standard.

Furthermore, there is also the potential for claims by issuers (e.g., for disclosing client confidential information) to the extent the auditor discloses matters that go beyond what is required to be disclosed under corporate disclosure rules. As such, we believe it is extremely important to align the auditor's responsibilities to identify and communicate critical audit matters with the corporate disclosure rules. The auditor ought not to be put in the position of having to choose between potentially violating a PCAOB rule and facing a legitimate claim by an issuer for disclosing confidential and/or otherwise protected information.

**30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

We agree that retaining the auditor's ability to emphasize a matter in the financial statements is worthwhile to address those matters that do not fall within the scope of critical audit matters but the auditor nevertheless believes is worthwhile to emphasize. It may be helpful, however, to include application guidance that distinguishes how a critical audit matter differs from an emphasis of matter, to avoid confusion.

**Considerations Related to Effective Date:**

**41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

We believe the results from field testing will provide essential feedback to be considered in formulating a final standard. For this reason, until the results from field testing are evaluated, we believe it is premature to comment on a possible effective date. In this regard, it may be helpful to monitor the implementation of the UK's Financial Reporting Council's recently issued ISA (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statements.* This standard requires the auditor's report on entities that report on how they have applied the UK Corporate Governance Code to: (1) describe the risks of material misstatement that were identified by the auditor and which had the greatest effect on the overall strategy, the allocation of resources on the audit, and directing the effects of the engagement team, and (2) provide an overview of the scope of the audit, including an explanation of how such scope addressed the assessed risk of material misstatement. While the FRC standard differs in some respects from the PCAOB's Proposed Auditor Reporting Standard, there are sufficient similarities such that the UK and Ireland experience could inform the Board's deliberations on this matter.

**42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

Due to the significance of the changes in auditor reporting proposed in this Release, in particular as it relates to critical audit matters, we believe that a delayed compliance date for audits of smaller companies, such as non-accelerated filers, is appropriate.

**The Proposed Other Information Standard**

**Introduction and Objectives**:

**2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

When documents that are not yet available are incorporated by reference (e.g., the definitive proxy statement that is generally not available at the time of the issuance of the audit report), it is unclear how the auditor is to report at the audit report date and then subsequently when that document becomes available. We believe that it is inappropriate for the auditor to report on information that is not yet available, and suggest that additional guidance about how to report in such a circumstance be included within the Proposed Other Information Standard.

**Evaluating the Other Information**:

6. **Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

We believe the auditor's responsibility for other information directly related to the audited financial statements should be to read and perform certain limited procedures, and based on that work report whether a material inconsistency or a material misstatement of fact is identified. However, for other information not directly related to the audited financial statements, we believe the auditor's responsibility should be consistent with AU 550, *Other Information in Documents Containing Audited Financial Statements,* which requires the auditor to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, to discuss the matter with the client and request that misstatement to be corrected. Moreover, we believe the proposal should recognize that for information not directly related to the audited financial statements, the auditor may not have the expertise to assess its presentation and, accordingly, provide guidance for such circumstances.

9. **Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

Paragraph 4 of the Proposed Other Information Standard requires the auditor to read and evaluate the other information based on relevant audit evidence obtained and conclusions reached during the audit. We are concerned that the phrase, "relevant audit evidence obtained and conclusions reached during the audit," has the potential to be misinterpreted to require a search of the audit documentation to determine what particular items included within other information may be included within the working papers. To address this concern, we suggest aligning the auditor's performance responsibilities in this regard to the audited financial statements or accounting records that are the subject to the audit, or that have been derived from such accounting records by analysis or computation.

**Other Considerations:**

24. **What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

The Proposed Other Information Standard would likely lead to an unwarranted increase in private litigation against auditors under the federal securities laws and state laws. In particular, plaintiffs would likely argue that (i) the proposed auditor obligation to "read and evaluate" such other information requires the auditor to conclude on the accuracy and sufficiency of disclosures by management in areas beyond the financial statements and the associated footnotes; (ii) the auditor's written observations with regard to such other information (proposed by the PCAOB to be an affirmative statement that it has not identified a material inconsistency or misstatement of fact in the other information) constitutes a "statement" under the federal securities laws; and (iii) they relied upon such "statements" to their detriment. The litigation risk would be expansive, and equally unwarranted, given the auditors specific role in the public markets. We have therefore proposed, and support, changes to the proposal that are aimed at avoiding this unwarranted expansion of liability. These changes would certainly not eliminate all potential liability associated with other information; but rather would more closely align this potential liability with the auditor's legitimate role.

**25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?**

Please see response to question 24 above.

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We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Chris Smith, Audit and Accounting Professional Practice Leader, at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing, at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP

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December 10, 2013

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

Via email to comments@pcaobus.org

Subject: PCAOB Rulemaking Docket Matter No. 034

I appreciate the opportunity to comment on the proposed auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

As background, I am the chief accounting officer for a publicly held life sciences company and an individual retail investor. I am also a former audit partner with KPMG LLP, and previously served as the chief accounting officer of a mid-cap public company and as the audit committee chairman for a community bank. I am writing this letter in my capacity as an individual investor, since the PCAOB is seeking to provide information which would be useful to investors.

The proposed auditing standards document uses many words such as "could" and "might" in its description of potential benefits to investors. Although some investors have expressed the desire for more information when surveyed, investors do not usually ask the auditors any questions at shareholder meetings, which to me indicates that investors are not normally looking for additional information from auditors. Requiring a significant change to audit reports should be based upon more factual evidence of benefit than has been presented to justify the increase in costs, which may be significant.

<u>Auditor's Report</u>
As an investor, there is significant information available to analyze for public companies. One of the biggest challenges for investors is discerning what information is the most important and relevant for decision making purposes. The current pass/fail model of reporting in the auditor's opinion enables the investor to quickly understand the audit report. Although additional information could be provided in the audit report, it does not mean that the information would be helpful for decision making by investors. Instead, the additional information regarding critical audit matters could in fact be confusing to investors, as further discussed below.

If additional information were added to the audit report, it would be largely redundant with information provided by management within the financial statements or MD&A. As an investor, I don't want to spend time reading information which is redundant. Management is responsible for providing the information about its accounting policies, its financial condition and results of operations; this information should not be reported by the auditor as this may confuse investors as to what the auditor is responsible for.

Auditing Standard No. 16, *Communications with Audit Committees*, requires auditors to communicate with audit committees regarding critical accounting estimates, overall audit strategy, significant unusual transactions, difficult or contentious matters subject to consultation outside of the audit team, and other matters. It is the audit committee's responsibility to evaluate this information, and the audit committee has sufficient financial expertise and background to do so.

While information on critical audit matters is already provided by the auditor to the audit committee, more time would be required to ensure the description of critical audit matters are correct for publication. The audit committee has the ability to ask the auditors questions about the information reported and discuss the issues, whereas investors do not. Therefore additional time will be required to ensure the critical audit matters are described properly. This additional time will primarily need to be spent during the final phase of the audit engagement and will require significant information from senior members of the audit team and senior management to ensure that there is consistency in disclosures.

Timeliness of reporting is important. Requiring lengthy audit reports would only serve to extend the time required for the reporting process as the auditors would need to spend even more time ensuring that the documentation of critical audit matters is appropriate for public reporting. This additional time delay in reporting would not be in the best interest of investors.

There are other factors to consider:

- What basis or framework does an investor have to evaluate the critical audit matters described by an auditor for one company compared to that described for another? Differences in descriptions may be due to differences in auditors but not the underlying risks of the companies involved.
- Investors may misunderstand information presented. Investors may view the number of critical audit matters as a positive or a negative, which may not be the correct conclusion. Investors may view the critical audit matter discussion as a piecemeal opinion.
- How does knowledge of the audit process actually help the investor make investment decisions?
- The focus on critical audit matters may remove the focus on the financial statements taken as a whole, which is the basis for the auditor's opinion.
- Would the descriptions of critical audit matters become boilerplate in order to address the consistency and timeliness concerns? In that case the critical audit matters would become more noise that an investor needs to wade through to find information which is useful in assessing the future prospects for a company.

In many cases the information regarding critical audit matters may not be helpful in making investment decisions. For example, accounts receivable and inventory are often considered to be critical audit matters for manufacturing companies since the audits of those accounts requires significant effort and there is judgment in the valuation allowances. A description of the critical audit matters and the audit procedures would not likely enhance the user's ability to understand the financial statements of the company.

The description of the auditor's procedures for critical audit matters may give the reader the wrong conclusion. For example, if going concern is a critical audit matter and the auditor is satisfied that the opinion does not need to be modified for this matter, the description as a critical audit matter may have either the effect of a going concern opinion, or conversely, could subject the auditor to liability due to the statements made which indicate that the auditor has overcome significant doubt about the entity's ability to continue as a going concern, as noted on page A5-42. Valuation allowances are other areas where the additional information could amount to a piecemeal opinion and give the investor more or less assurance than warranted. Difficulty in auditing assets or liabilities which are impacted by management forecasts could give investors the wrong impression, either overly positive or negative.

In the example discussion of a critical audit matter on page A5-68, regarding sales returns, how does knowledge that the auditor consulted with their national office on the design and performance of the audit procedures and evaluation of the results aid in the investor's understanding of the financial statements and future risks, beyond what was disclosed by management? The auditor provided some additional information about the company's sales channel and process; if that information was significant to understanding the financial statements, it should have been provided by management.

In the example on A5-77, the description of the critical audit matter states that the audit of the securities required "an extensive amount of audit work, including significant involvement of senior members of the engagement team and the involvement of a third party valuation specialist." How would this information help the user of the financial statements make judgments, beyond the disclosures already provided? Would users take more comfort than they should, because they may believe that this provides more assurance on a particular account? How does the reader benefit by knowing that there was "extensive audit work" and "involvement of specialists" in particular areas of the audit? This could be viewed as a piecemeal opinion by some investors.

Auditors should not be reporting internal control deficiencies which are not a material weakness. Doing so creates an unnecessary concern about something which is not material. Where does an auditor draw the line between information to report or not report? Concerns about liability would likely influence an auditor to report more rather than less information, but that will not necessarily be helpful to investors.

The exposure draft indicated that additional disclosure would lower the cost of capital – which would mean investors would be willing to accept a lower return if they had more information about the audit. There are many factors which influence the price of stocks, particularly expectations for performance of the company in the future. I don't believe that additional information about the audit would lower the cost of capital; there is not a sufficient reduction in risk to warrant a lower expectation of return by investors.

Additional audit costs either reduce the return to shareholders or reduce investments that may be made in other areas of the company, such as in R&D or marketing, for example. Are investors really better served by this additional investment in audit fees? In my opinion, they are not.

Auditor's Responsibilities Regarding Other Information

The proposed standard for auditor's responsibilities regarding other information requires the auditor to "evaluate" the other information. While the proposed standard states that the auditor does not need to perform additional work other than that performed in conjunction with the audit, it is unclear how the auditor will "evaluate" other information which is disclosed, such as non-gaap reporting and forward looking information which is provided by management in an effort to help the reader of the annual report understand not only the financial statements (which have been audited) but the underlying trends and management's expectations for the business in the future. The auditor may not have the expertise to evaluate other information contained in the document. Under the existing standards, if the auditor believes that a disclosure is incorrect or misleading, the auditor would discuss that with management and if necessary, the audit committee, so that the disclosure was revised. This provides sufficient protection for investors. The auditing standards should not be changed to require additional audit procedures and disclosures for other information.

Other Comments

The fact that the auditor is independent is already in the title of the report and need not be repeated.

Auditor tenure is not relevant to the evaluation of the financial statements or the audit. Tenure should not be reported since there is no correlation between tenure and audit quality, and reporting on tenure implies that it is useful information. If considered necessary, disclosure in the proxy would be a more appropriate place to report that. Tenure should be defined as beginning with the earliest consecutive year audited, not the initial year of engagement as suggested.

In summary, the proposed standards appear to reach farther than necessary to expand the scope and responsibilities of auditors, beyond what is needed by investors. Timeliness and cost are also important factors to investors. I appreciate the opportunity to provide comments on the proposed standards affecting audit reporting. Thank you for your consideration.

Best regards,

Carolyn D. Beaver

Carolyn D. Beaver

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October 11, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Rulemaking Docket No. 34

Board Members:

This letter represents my views on the proposed auditing standards dealing with the auditor's report: PCAOB Release No. 2013-005 dated August 13, 2013. I previously commented on the concepts release on this same matter through my letter dated July 21, 2011. My comments are derived primarily from perspectives gained from serving as chairman of the audit committee for five large public companies over the past twelve years.

The views that follow address a number of the provisions in the exposure draft and include both support for and recommendations related to certain provisions. However, there are two proposals that I believe should be eliminated from any final standard:

- The required disclosure of critical audit matters (CAM), and
- The required disclosure of the tenure of the audit firm

Further, while I expressed support in my earlier letter for inclusion in the report of limited auditor assurance on "other information," I have major reservations about how that matter has been treated in the exposure draft and do not support the current position.

My reasoning for these beliefs is presented later in this letter. Before getting to that, I would like to express my agreement with and appreciation for the Board's decision not to move forward with the major changes suggested in the concepts release of (1) an auditor's discussion and analysis or (2) required and expanded emphasis paragraphs. For reasons noted in my earlier letter, I did not support those changes as was true for most other commentators. I did support limited improvements to the auditor's report that are included in the exposure draft:

> Clarifying that the auditor is required to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement <u>whether caused by error or fraud</u>.
>
> Addressing the auditor's report to both shareholders and the board of directors.

Additionally:

> In my earlier letter I indicated that I was ambivalent about having the auditor's report refer to the related footnotes as well as the basic financial statements and I can certainly support it as part of the current exposure draft.
>
> In my earlier letter I indicated that the title of the report (Report of Independent Registered Public Accounting Firm) seemed sufficient and there appeared to be no reason to require a statement in the body of the report that the audit firm is independent. However, this is a minor matter and I have no serious objection to the proposed inclusion of the language.

The remainder of this letter provides my comments on what I consider the major matters in the proposal.

<u>The Pass/Fail Model</u>

While the auditor's report has undergone certain revisions during my half century in the profession, the essential pass/fail model has stood the test of time and been retained. The proposal continues that model and the release notes that many commentators support it "… because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Additionally, commenters indicated support for the concise and useful message of the pass/fail model." I strongly agree with those sentiments.

However, I am concerned that the inclusion of several pages of critical audit matters as would be the case under the Board's proposal would make it more difficult for readers of the auditor's report to even locate the opinion on the financial statements and internal controls. This could be addressed in a number of ways should the Board retain the critical audit matters requirement. For example, the Board could require that the key opinion language be stated at the very outset of the report. It could be required to be presented in bold type or a subheading could be required, as the proposal suggests for the CAM section. At the extreme, the Board could require that all reports include a footnote on the first page calling attention to where the opinion can be found (e.g., "See page 11 for our opinion on the accompanying financial statements and internal control over financial reporting").

You may think I'm being a bit facetious in making these suggestions but I'm really not. I sincerely believe that most users of auditor's reports are mainly interested in whether the financial statements are fairly presented (a clean opinion), and they will look for guidance to work around lengthy auditor reports that contain information that they are not interested in. Journalists and others will provide that guidance to that vast majority of the public who simply want to find in the report whether the company has "passed." But if the PCAOB retains the critical audit matters requirement, it could make things a lot easier for users by adopting one of the ideas I just mentioned.

However, my strong preference is that the Board omits the CAM requirement from a final rule for a number of reasons mentioned in the following section.

Critical Audit Matters

As defined, critical audit matters are "Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements." "Most difficult" is a common theme although the proposal also makes clear that "most" doesn't limit disclosure to a single item in a category.

The language of the proposal indicates that the Board expects multiple CAMs in most cases. "Under the proposed auditor reporting standard, it is expected that, in most audits, the auditor would determine that there are critical audit matters (page A5-27)." "The proposal anticipates that in most audits the auditor would determine that there are critical audit matters and, depending on the circumstances of an audit, there may be several critical audit matters (Statement of Board Member Jeanette M. Franzel)." Further, I believe auditors would be highly motivated to err on the side of including more rather than fewer CAMs in their reports, else the PCAOB inspections staff will second guess their judgments after the fact. In the words of Board Member Lewis H. Ferguson, "It provides a standard that audit firms, regulators like the PCAOB, and others to measure compliance with the requirements of the standard." (His earlier comments supported the Board's approach because it allows auditors "substantial latitude to exercise professional judgment in determining what items to include as CAMs but constrains that judgment by an objective standard, the reasonable and experienced auditor looking at the same evidence.") Different auditors (or different inspectors, in the case of the PCAOB) will clearly reach different judgments so why would an auditor be motivated to determine that a particular matter is not a CAM when it is a close call?

In addition to the definition of CAMs as noted above, the proposal notes that "Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document, (2) reviewed by the engagement quality reviewer, (3) communicated to the audit committee, or (4) any combination of the three." Further, the proposal's documentation requirements include "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters."

The matters presently included in MD&A disclosures (see further discussion below) would almost certainly be judged as CAMs and most of them would probably fall under category (3). However, based on my experience in the auditing profession, I believe there will be many more matters included in categories (1) and (2) above and thus required to be considered as possible CAMs under the proposal. Given the need to document that matters in these categories are not CAMs, in too many cases auditors will be motivated to judge that they should be included in their reports to avoid a later challenge from the PCAOB inspections staff. Materiality considerations, of course, will come into play. But this is another issue where judgment is required and the motivation may well be to disclose more to avoid second guessing.

In a worst case scenario, auditors could even be motivated to not include matters in the engagement completion document or not communicate them to the audit committee in order to avoid the possibility of having them judged, after the fact by a PCAOB inspector, as a CAM. The PCAOB should be very careful about such possible unintended consequences that could decrease audit quality while intending to enhance communication.

I commend the Board for requesting examples of what auditors think they would include as CAMs under current circumstances. Having some realistic examples to ponder as the Board goes through its redeliberations should be very instructive. And it's equally important that the Board involve users in this exercise. Once you have a number of "real world" examples of what auditors would include in their reports, then it should be imperative to test how users would react to those disclosures and see if they would actually find them to be beneficial. The Board should be able to demonstrate some practical benefits to investors and creditors of adding these voluminous disclosures to the auditor's report <u>before the fact</u> rather than requiring all auditors and companies to incur substantial costs on the basis that they "might" be useful.

Board member Jay D. Hanson said it best in his remarks at the public meeting at which the proposal was adopted. "I would particularly like to encourage auditors to work with their client's audit committees and management to perform some voluntary mini 'field tests,' where the engagement partner, the engagement quality reviewer, management and the audit committee each independently consider what issues may constitute critical audit matters under the proposed standard. <u>Perhaps even share them with investors to obtain their views on the usefulness of the information."</u> I full agree with Mr. Hanson except for the "perhaps" language. For such field tests to be meaningful, they <u>must</u> include the reactions of the users of the auditor's report.

I have recently completed a number of years of service on large public company boards and reached the mandatory retirement age. So I'm not able to participate directly in a field test similar to that suggested by Mr. Hanson above. However, based on my experience and publicly available information, I can provide my own assumptions about what would be included in the CAMs for my two most recent board assignments, Legg Mason and Fannie Mae. Legg Mason is a Fortune 1000 asset management company and Fannie Mae is one of the largest financial services companies, guaranteeing home loans for a substantial percentage of the U.S.

For Legg Mason, the section of the most recent 10-K that reports on "Critical Accounting Policies and Estimates" includes six matters:

Consolidation (variable interest entities)

Revenue recognition

Valuation of financial instruments

Intangible assets and goodwill

Stock based compensation

Income taxes (recovery of deferred tax asset)

I think it's fair to assume that all of these would be strong candidates for consideration as CAMs by Legg Mason's auditors. And, without getting into confidential matters, it's possible that there would be others, particularly given the exposure draft's push for auditors to reach judgments on the side of disclosing more rather than less.

As noted, all of these matters are already disclosed – extensively – by the company in MD&A – as well as further in the footnotes to the financial statements. It's not clear to me what users will gain by further mention of them in the auditor's report other than perhaps confusion about the auditor's assessment thereof, as mentioned below. Depending on whether the auditor elects to include a description of the audit procedures applied, I would estimate that including the matters above as CAMs in the auditor's report for Legg Mason would add somewhere between 3-6 pages to that report.

For Fannie Mae, the section in MD&A on Critical Accounting Policies and Estimates includes only four matters:

Fair value measurement

Total loss reserves

Other-than-temporary impairment of investment securities

Deferred tax assets

However, that section is six pages long (in quite small type!) and makes reference to the financial statement footnotes as well. For a company as large and complex as Fannie Mae, it's probably reasonable to assume that the auditors would have additional judgment matters to consider as possible CAMs, although their materiality would have to be assessed. As noted, I'm concerned that the PCAOB's application of this kind of standard will be a sort of "gotcha" exercise through the inspection program so that for large, complex companies like Fannie Mae, there would be a number of potential CAMs for which the audit firm would err on the side of inclusion.

Page A5-36 of the proposal notes that, "... the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so." In reading the actual proposed standard, I found it curious that there is no mention of this – the proposal is simply silent on the matter. Having read the background section first, I had expected to find some wording (perhaps at least a footnote) that would state the Board's position on this matter. Then I found it doubly curious that the three Illustrative Examples of CAMs provided by the Board on pages A5-65-78 all included illustrative language of auditing procures preformed to deal with the CAM in question. This would seem to indicate an implicit preference for inclusion of such language in spite of the wording in the background section and in spite of not dealing with the matter in the basic standard.

Of more concern than the lack of clarity on this matter, the inclusion of audit procedures language may cause readers to infer that auditors are expressing reservations in their reports about the matters in question. That is because there is no opinion stated after the audit procedures language. I'm sure the PCAOB believes that the overall opinion on the financial statements is all that is needed. And it's certainly not appropriate under current standards for an auditor to add a separate opinion in its report on each of these individual matters. But by including them in the report and then listing audit procedures for each without a conclusion, the reader may well infer a form of qualification ("subject to") for each. An easy fix would be for a final standard to simply prohibit the inclusion of discussion of audit procedures. However, I believe this is just another reason why the inclusion of CAMs in the auditor's report is a bad idea and should be dropped.

Another concern relates to the current-year only requirement. While I appreciate the Board's effort to take a cost-sensitive approach, given that the report covers three years of financial reports, inclusion of CAMs for only the current year is apt to be confusing rather than helpful in at least some cases. Expecting users to review prior year filings in order to analyze CAMs over time seems to defeat the purpose of an auditor's report comprehensively reporting on the financial statements being included in the package currently delivered to those users.

Similar to my comments about the notion about an AD&A in the Concepts Release, I believe that including CAMs in auditor's reports would likely lead to an administrative nightmare in trying to wrap up the audit given that each report would be custom made and would likely have to be cleared with a firm's national office accounting and auditing technical experts and perhaps even legal staff. Further, given that the CAMs would include matters that the company is also reporting in most cases, such as significant accounting estimates, those matters would require extensive discussion and negotiation with company finance and legal staff at a time when meeting SEC deadlines is quite challenging. Rather than spending time on procedures that really add value to the audit, audit partners would find themselves haggling over wording issues that could serve as an unnecessary distraction. This factor alone should persuade the PCAOB not to advance the notion of CAMs as Board members should already know that too much partner time is involved in pinning down minor details of financial statement footnotes and other matters that take away from involvement in more important audit tasks.

As one final matter concerning CAMs, as the Board notes on pages A5-42-3 of the proposal, in certain cases (e.g., significant deficiencies in internal controls, certain going concern considerations), the auditor would be required to disclose information in the report that would not otherwise be required to be disclosed by management. This reverses the normal relationships of management and auditor and should be avoided.

In summary with respect to CAMs, I believe that adding multiple pages to the auditor's report of what would usually be duplicative of information reported elsewhere in the MD&A or financial statement footnotes would be of questionable value to the users of financial statements and may even obscure the principal purpose of highlighting an overall opinion on those statements. Further, I have provided certain other reasons that make such CAMs problematic and should cause the Board to conclude that such a fundamental change to the auditor's report is not justified at this time.

Reporting on "Other Information"

As noted earlier, in my comment letter on the concepts release I supported "limited auditor assurance" on other information outside of the audited financial statements. By that I meant that I believed the standard auditor's report would be enhanced by incorporating the substance of AU 550 so as to inform investors and other readers of the report of the extent of the auditor's responsibility for the other information in 10-K's, etc. The auditor presently reports this to the audit committee and I believed this was one matter that could be added to the external report that would aid communications with investors with little or no change in procedures.

Thus, I would have supported an exposure draft position that adopted a reporting requirement based on procedures that auditors are already performing. In my earlier comment letter I noted that reading the non-financial statement information and considering whether it is materially consistent with the audited financial statements seems sufficient to me.

At first reading, a proposed requirement to "read and evaluate" rather than "read and consider" doesn't sound like too substantive a difference. However, after reading summaries of the proposal issued by certain of the major accounting firms, I'm concerned that the change in wording will be more than a semantic one. For example, my former firm, Ernst & Young, reported that, "The proposal would require the auditor to <u>perform additional procedures</u> and to evaluate this information based on relevant audit evidence obtained and conclusions reached during the audit." Further, EY's analysis indicated that, "We believe additional audit effort and cost would be required to comply with the proposal." Likewise, Deloitte stated, "The proposal's auditor performance provisions <u>significantly add</u> to the auditor's responsibilities for other information by introducing required audit procedures to support the auditor's conclusion about the auditor's evaluation of other information. Specifically, under AU Section 550, the auditor is required to "**read**" and "**consider**" other information, whereas under the proposal, the auditor is required to "**read**" and "**evaluate**" the other information on the basis of relevant audit evidence obtained and conclusion reached during the audit."

As I have thought about this more, I am concerned not only that auditors will require more work to be done in order to meet the new standard, but the readers of the reports may assume a great degree of accountability that is warranted. For example, the subheading specified in the sample report in the proposal is "The Auditor's Responsibilities Regarding Other Information." The following wording notes that the "evaluation" of such "responsibilities" was based on "relevant audit evidence obtained and conclusions reached during the audit." A reader could reasonably infer from that wording that procedures were specifically designed and added to the audit work performed in order to support the "evaluation" so reached. This sounds like incremental audit testing work rather than the negative assurance from already performed auditing procedures that actually underlies this paragraph of the opinion. While that paragraph appropriately ends with a disclaimer of opinion on the other information, users may well read more into the overall message than intended.

This is another aspect of the proposal that calls for a form of field testing. The Board should work with accounting firms to determine what procedures they believe they would have to perform in order to meet the requirements of the exposure draft. This should be done with enough accounting different firms and with enough different sample clients within those firms to form a representative basis of what such a new requirement would actually entail. Neither the PCAOB nor the accounting profession should want a repeat of the situation that occurred after the issuance of PCAOB Auditing Standard 2 on internal control that had to be substantially modified when it was found that auditors performed far more work than intended by the Board.

In summary, I do not support this part of the proposal as written. The Board should reconsider the possibility of incorporating the substance of AU550 with a reporting requirement in the auditor's report. If that is not considered feasible, I believe this part of the proposal should be dropped.

Auditor Tenure

A major, new addition to the auditor's report would be, "A statement containing the year the auditor began serving consecutively as the company's auditor." The background information on this matter in Appendix 5 indicates that academic research is mixed as to whether short- or long-term audit relationships are more likely to adversely affect audit quality. Nevertheless, the Board indicates that "… investors and other financial statement users have indicated strong interest in this information." A footnote reference to a Council of Institutional Investors' policy statement is used to support this assertion.

Comments by individual Board members are somewhat less effusive in their support. For example, Lewis H. Ferguson stated, "Is this tenure information relevant or useful to financial statement users? Opinion varies on that question, but providing it in the audit report should not, in my view, involve additional cost either to the auditor or the issuer, and some financial statement users may find that information to be of interest."

Board member Jeanette M. Franzel expressed much doubt about this aspect of the proposal: "…the Board has not found evidence that would allow generalized conclusions about the impact of auditor tenure on audit quality." And, "I am concerned that by including auditor tenure in the auditor's report, there may be an implication that there is an analytical basis for interpreting such information."

Further, Board member Jay D. Hanson made comments similar to those of Ms. Franzel, "I question whether it is appropriate for the Board to require disclosure in the audit report of the auditor's tenure with the particular client." And, "Thus, we do not have, at this point, any data indicating that audit tenure has any correlation with audit quality."

Taken together, the very brief comments in the Board's basis for conclusions along with the statements of the individual Board members would seem to indicate a view that (1) some users have asked for this information, (2) we've looked at a lot of research and haven't found a persuasive basis for saying whether audit longevity affects audit quality one way or the other, (3) it wouldn't hurt (or cost) anything to add this to the standard auditor's report, (4) so let's put this in the exposure draft and see what reaction we get. This sounds like a classic case of running something up the flag pole to see what people think, even when there isn't much conviction among those charged to decide the issues.

Disclosure of auditor tenure is an issue that was actually faced on one of my former corporate board assignments – Legg Mason. However, there it was in the context of disclosure in the proxy statement of information about the relationship with our external auditor for purposes of the shareholder vote on ratification of the Audit Committee selection of the auditors for the coming year. After some discussion with an interested shareholder, the company decided to provide more information, including the year in which the current audit relationship had begun, about the Audit Committee's selection of the independent auditor, oversight thereof, engagement partner rotation, etc.

Audit firm tenure information may be useful when asking shareholders to vote on an Audit Committee action, in order to give them a full understanding of the situation. However, in an auditor's report a simple statement of when the audit relationship began won't have any context and, thus, will be of limited or no value to nearly all users. Thus, I do not support this aspect of the proposal and believe it should be eliminated. Rather, it should be left to the discretion of companies in providing appropriate information in proxy statements. Or, at some point the SEC may wish to consider further required disclosures about audit relationships in proxy statements.

Other Changes in the Description of an Audit

Paragraph 6m of the exposure draft specifies that the standard auditor's report would include a statement that an audit covers certain matters concerning audit procedures performed in assessing possible material misstatements, amounts and disclosures in the financial statements, and evaluation of accounting principles and significant estimates made. An illustration of the suggested wording for the new disclosures that would result from the part of this section of the proposal that is incrementally different from the present standard is in Appendix A of the exposure draft. While I don't believe that such changes will make a profound difference in users' understanding of the work of independent auditors, the proposals appear to be straight forward and they may be of marginal value in helping describe the nature of an audit.

Conclusion

As noted in my earlier letter on the Concepts Release, I believe some improvements to the current form of the auditor's report can be made. However, including critical audit matters would be a serious mistake for many reasons noted above. I also have reservations about the positions on "other information" and auditor tenure as noted. I trust you will give appropriate consideration to my comments and would be pleased to elaborate on them as you request.

Sincerely,

Dennis R. Beresford

Dennis R. Beresford
Executive in Residence

Biotechnology Industry Organization

December 9, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034, Release No. 2013-005

To whom it may concern:

The Biotechnology Industry Organization (BIO) is pleased to submit comments to the Public Company Accounting Oversight Board (PCAOB) on Release No. 2013-005, on proposed auditing standards.

BIO is a not-for-profit trade association that represents more than 1,100 biotechnology companies, academic institutions, state biotechnology centers, and related organizations in all 50 states. BIO members are working toward groundbreaking cures and treatments for devastating diseases, developing technologies for advanced biofuels and renewable chemicals, and researching novel gene traits for identifying food sources that could help combat global hunger.

BIO fully supports strong auditing standards, and believes that they can enhance investor protection and confidence. BIO applauds the PCAOB for its dedication to protecting investors and fostering confidence in the market. However, overly stringent regulatory requirements can have a detrimental effect on growing biotechs by causing a diversion of capital from science to compliance.

In the biotechnology industry, it can take more than a decade and over $1 billion to bring a single life-saving treatment from laboratory bench to hospital bedside. This entire process is undertaken without the benefit of product revenue – early-stage biotech companies do not have the luxury of using the sale of one product to finance the development of another. Rather, the entire cost of drug development is borne by external investors. As such, the efficient use of investment funds is of paramount importance to a growing biotech company. Spending valuable innovation capital on costly regulatory burdens can delay scientific progress and slow the growth of a promising company.

The recent surge in biotech IPOs since the passage of the Jumpstart Our Business Startups (JOBS) Act in April 2012 has brought the compliance requirements of emerging public companies into sharp focus. More than 45 biotech companies have gone public using provisions in the JOBS Act, and they are now subject to the regulatory regime of a public company. One of the key messages of the JOBS Act was that one-size-fits-all compliance burdens are not appropriate for all market participants and can harm growing companies. BIO believes that certain items in the auditing standards proposed by the PCAOB could hurt small innovators by subjecting them to burdensome and unnecessary regulatory requirements.

The true value of biotech companies is embedded in their groundbreaking research, pipeline of product candidates, and their progress in advancing those product candidates toward regulatory approval and product sales. Investors often make decisions based on these parameters rather than a biotech company's operating results and financial disclosures; therefore, higher costs to comply with the proposed standards would outweigh any potential benefits.

BIO appreciates the opportunity to comment on the following items in the proposed auditing standards.

**Proposed Auditor Reporting Standard**

Critical Audit Matters

*The proposed critical audit matters standard is substantially similar to requiring AD&A.*

In its 2011 concept release, the PCAOB proposed requiring auditor's discussion and analysis (AD&A) in company filings. At the time, BIO commented that an AD&A requirement would "make our companies' audits more expensive, duplicate management's discussion and analysis of its business, operations, and financial results (MD&A), and potentially confuse investors and analysts." BIO believes that the proposed critical audit matters standard is substantially similar to AD&A and that it would be extremely burdensome for pre-revenue biotech issuers.

The AD&A proposal would have required a supplemental report detailing the auditor's perspective about the audit and the company's financial statements. The proposed critical audit matters standard would instead include the auditor's discussion and analysis within the auditor's report itself. Though the new standard would somewhat narrow the scope of what the auditor is asked to identify and report to investors, it remains the case that the auditor is being asked to provide a subjective look into the auditing process that will likely create additional work and expenses.

The proposed critical audit matters approach is also similar to the emphasis paragraphs proposal from the 2011 concept release. BIO opposed this requirement, noting that "emphasis paragraphs would not be relevant or useful." It appears as though the PCAOB has combined AD&A with emphasis paragraphs and titled the result "critical audit matters" – without substantially decreasing the burdens that would be placed on growing companies if the proposal is adopted.

*A critical audit matters standard would increase audit costs, is duplicative, and could confuse investors.*

The PCAOB release states that the critical audit matters standard would be "cost-sensitive" because "the auditor's determination of critical audit matters is based on the audit already performed." Yet the release also notes that the PCAOB expects "that in most audits, the auditor would determine that there are critical audit matters." The virtual certainty that critical audit matters would be identified belies the PCAOB's assertion that the new standard would not increase audit costs. Additionally, the PCAOB's reassurance that most of the critical audit matters work will be done after the audit is completed is hardly comforting, as this will likely result in a time crunch as auditors and issuers struggle to meet the reporting deadline, increasing the chance for errors or a lower-quality audit. The additional requirement will create additional work, which will be translated into an increase in audit fees to public companies. For growing biotechs, the increased fees will come directly from investment dollars intended for groundbreaking R&D, a diversion of capital that could slow scientific progress.

The problem is further exacerbated by the fact that it is unlikely that the critical audit matters standard will provide any substantial benefits to investors. Currently, auditors review and provide comments and feedback to management and the audit committee on a company's financial statement disclosures and MD&A. During the course of this dialogue, management, the audit committee, and external auditors correspond in detail about identified risks, financial disclosures, management's judgments, estimates, and accounting policies and practices. Management and the audit committee address these auditor comments and feedback and, as required, engage in collaborative discussions regarding the appropriate depth and breadth of the company's disclosures. Auditors, whose opinion is included within a company's financial statements and incorporated into the company's Securities and Exchange Commission (SEC) filings, would not permit their audit opinion to be included with such financial statements if a company's disclosures and discussion of its operating results were inappropriate, inconsistent, or incomplete. Thus, the addition of critical audit matters reporting would appear to be duplicative, of no additional value, and potentially confusing.

The proposing release notes these "unintended consequences," but BIO believes that they should be more of a cause for consternation than the PCAOB seems to give them credit for. The release mentions that the critical audit matters standard "could result in additional effort involving both one-time costs and recurring costs." Investors "could misunderstand the meaning of a critical audit matter" because they are not accustomed to reviewing or analyzing financial statements in such a manner. Lower quality audits could be the result of the reduced time available to the auditor under the new standard. These concerns are not trivial, and should give the PCAOB pause before adopting this costly and unnecessary regulation.

Because biotechs do not generate product revenue during the R&D phase, capital spent on regulatory burdens comes directly from funds earmarked for innovation. Any proposed regulatory duties should be judged in this light, particularly those with the ostensible goal of protecting the very investors providing those funds. The critical audit matters standard would increase audit fees without providing much, if any, valuable information to investors, so its costs far outweigh any alleged benefits.

*BIO believes the JOBS Act precludes application of a critical audit matters standard to EGCs.*

The PCAOB release calls for further examination and discussion of whether the proposed standards and amendments should be applied to emerging growth companies (EGCs) as defined by the JOBS Act. It is BIO's belief that the proposed critical audit matters standard should not, and cannot, be applied to EGCs.

One of the goals of the JOBS Act was to avoid a one-size-fits-all regulatory regime. The law targets growing companies during the first five years after their IPO and provides certain exemptions and allowances to ease their transition to the public market and reduce some of the cost barriers of public reporting. Applying the proposed critical audit matters standard to all issuers, regardless of EGC status, would violate the spirit of the IPO On-Ramp by subjecting smaller issuers to this costly requirement. EGCs should not be required to comply.

Further, irrespective of the costs of the critical audit matters standard to EGCs, BIO believes that the JOBS Act specifically curtails the PCAOB's authority to enact such a requirement. The proposing release notes that Section 104 of the JOBS Act requires the SEC to determine whether any new rules adopted by the PCAOB should apply to EGCs. The release solicits comment on this issue, which BIO addresses in full on page 5 of this letter. However, the release fails to mention the sentence immediately preceding the highlighted one in Section

104, which forbids the PCAOB from requiring of EGCs "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer." The JOBS Act parenthetically identifies this potential supplement as AD&A, but it is clear that Congress was attempting to forestall any efforts by the PCAOB to require this type of additional information and analysis on the audit of an EGC.

Despite the name change from AD&A to critical audit matters, and the slightly narrower scope, BIO believes that these two provisions are substantially similar. The JOBS Act forbids the PCAOB from requiring additional information about an EGC's audit and financial statements, and the critical audit matters standard would do just that. As such, applying this proposed requirement to the audits of EGCs would be in direct violation of the JOBS Act. If the critical audit matters standard is adopted (and BIO's position is that it should not be), the PCAOB should provide for an exception for EGCs. This exemption is required by the JOBS Act, and following Congress's directive will prevent additional regulatory burdens from weighing down the progress of emerging biotech innovators.

**Proposed Other Information Standard**

Under current PCAOB standards, auditors must "read and consider" certain other information contained in Exchange Act annual reports and other documents to which the auditor devotes attention. The proposed other information standard would both increase the amount of information auditors are required to analyze and expand the procedures associated with reporting the other information.

A significant change in the proposal is in the amount and type of information for which auditors are responsible. The proposed standard would require auditors to review "Selected Financial Data, Management's Discussion & Analysis ("MD&A"), exhibits, and certain information incorporated by reference," among other items. Auditors are currently required to review information related to the audit in the annual report, but this expansion would substantially broaden the scope of the auditor's responsibilities. Issuers would see a corresponding increase in audit fees as auditors struggle with the new workload.

As previously noted, auditors currently review and provide comments and feedback to management and the audit committee on a company's MD&A. For other financial information included outside of an issuer's financial statements (such as an earnings release), the auditor will perform certain procedures to satisfy themselves that the information is accurate and not inconsistent with the company's financial statements. For other information included within an SEC filing that contains an audit opinion, auditors do not permit their audit opinion to be included if the other financial information is inappropriate, inconsistent, or incomplete. BIO believes that this process is sufficient, and that there is no added benefit or value to investors in having auditors expand the other information or processes for which they are responsible.

In addition to the broader definition of "other information," the proposed standard would also hold auditors accountable for a greater degree of analysis. The current "read and consider" standard is sufficient to garner relevant information and relay it to investors in a practical manner. The proposed "read and evaluate" standard increases auditor responsibility and liability – and audit fees. These new required audit procedures specified to support the auditor's conclusions with regard to the other information identified are complex and burdensome.

Under the proposed standard, the auditor must read and evaluate the other information for material inconsistencies and/or material misstatements of fact. Regardless of the auditor's findings, the auditor is required to identify the information evaluated, the auditor's responsibility regarding the other information, and the procedures used to evaluate the other information. The auditor must then communicate any conclusions in the auditor's report. This striking increase in auditor responsibility – extending so far that auditors are required to report even on information they do not believe is inconsistent or misstated – will create a new burden for auditors and issuers. The proposing release concedes that there will likely be an increase in cost and auditor effort because the proposed procedures go far beyond the current "read and consider" approach. The corresponding fees imposed on issuers could be damaging to company growth.

BIO believes that the existing other information standard is sufficient to protect investors. It balances disclosure standards with the needs of growing businesses – as directed by their investors – to efficiently use investment capital. The PCAOB should not adopt the costly, onerous other information standard described in the proposing release.

**Considerations Regarding Audits of Emerging Growth Companies**

As noted in the proposing release, Section 104 of the JOBS Act states that any new PCAOB rules "shall not apply to an audit of any emerging growth company, unless the [SEC] determines that the application of such additional requirements is necessary or appropriate in the public interest." According to the release, the PCAOB will make an initial determination as to whether it should recommend that the proposed standards and amendments be applicable to EGCs. If the PCAOB does recommend that the proposal apply to EGCs, the SEC will make a separate, binding determination on the issue. The PCAOB is soliciting comment to guide its initial determination. It is BIO's strong belief that the PCAOB should not recommend to the SEC that the proposed standards and amendments apply to the audits of EGCs.

The JOBS Act has been successful in spurring IPO activity amongst EGCs. The various provisions in the IPO On-Ramp have eased the IPO process and reduced the regulatory burden that newly-public companies face. The biotech industry has seen more than 50 IPOs since the law passed, a striking increase from the past two years when the market was essentially closed. It is clear that commonsense regulatory obligations play a part in the decision to go public. If growing companies face one-size-fits-all compliance burdens, they risk being dragged down by government red tape. These fears contribute to a reluctance to go through with an IPO and could harm a company's progress once it is public.

For EGCs in the biotech industry, an awareness of an issuer's potential regulatory burden is of paramount importance. As previously discussed, biotech companies face a decade-long, billion-dollar development timeline, and their research is supported by private investment capital rather than product revenue. Any funds spent complying with costly and complicated new audit regulations would be, by definition, lost to innovation.

Spending capital on regulatory burdens can slow the development process, increasing the time it takes to reach the important milestones that trigger new investments. Without product revenue, most biotech EGCs would be forced to ask investors to pay for the new audit requirements rather than scientific research. The cost burden of the proposed standards, and therefore the amount of capital diverted from R&D, could be significant.

These traits are shared by small businesses and growing innovators in all segments of the economy. Congress created the EGC definition as a means to protect these vital job creators and support their growth. The five year transition period onto the market, targeted specifically at small and emerging companies, circumvents the existing one-size-fits-all regulatory regime and instead implements commonsense, tailored regulations that are indicative of the unique nature of EGCs. The PCAOB should not undercut this important facet of the JOBS Act, and it should not recommend that the proposed audit standards apply to the audits of EGCs.

**Conclusion**

The proposed change to the audit report is presumably intended to inform, and therefore protect, investors, and BIO supports this goal. In the biotech industry, an informed investor is a good one. However, the information that these investors want and need does not always align with what would be disclosed under the proposed standards. The true value of a biotech company is found in scientific milestones and clinical trial advancement rather than financial disclosures.

The business model of biotechnology is simple – growing innovators take in millions of dollars to fund their research and often do not earn a single penny in product revenue for more than a decade. Their science is the complicated part of their business, and it is the most important aspect for investors to understand. Investors mainly make their decisions based on scientific results and development milestones, not financial disclosures: tracking cash and expenses is fairly straightforward. The proposed audit changes would not provide much insight for potential investors, meaning that the high cost of compliance would far outweigh its benefits.

From a scientific perspective, biotech companies are innovators expanding the world's understanding of human life. As corporations, they strive to stay as simple as possible so that the maximum amount of investment dollars can flow directly to R&D. Disrupting that flow by diverting research funds to the unnecessary and complicated proposed audit standards could slow research and hamper growth – all while failing to increase investor confidence or spur capital formation.

As such, BIO believes that the PCAOB should not adopt the proposed critical audit matters or other information standards. These onerous requirements would stall the progress of companies at all stages of scientific development. Further, BIO believes that the proposed rule in its entirety would have a unique and damaging effect on EGCs. These growing businesses, both in the biotech industry and elsewhere, have been identified by Congress for a tailored regulatory regime. The PCAOB should not revert to a one-size-fits-all approach by applying the proposed standards to EGCs.

BIO looks forward to working with the PCAOB to enhance investor protections through the audit report without impeding innovation and growth at research-intensive small businesses. If you have further questions or comments, please contact me or Charles Crain, Manager of Policy and Research, at (202) 962-9218.

Sincerely,

E. Cartier Esham
Executive Vice President, Emerging Companies
Biotechnology Industry Organization (BIO)

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October 30, 2013

Public Company Accounting Oversight Board

**RE: Proposed Auditing Standards –**

***The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

***The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

***Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard***

Members of the Board:

BlackRock, Inc. ("BlackRock") appreciates the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and *Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard* (together the "Proposed Standards"). BlackRock is a global investment manager, overseeing approximately $4.1 trillion of assets under management at September 30, 2013. BlackRock and its subsidiaries manage approximately 3,400 investment vehicles, including registered investment companies, hedge funds, private equity funds, exchange-traded funds and collective investment trusts, in addition to separate accounts. Certain of BlackRock's wholly-owned subsidiaries operate as U.S. registered broker/dealers, a U.K. registered life insurance company, a U.S. registered bank trust company and numerous investment advisory companies registered in jurisdictions throughout the world.

As an investment manager, BlackRock is in the position to provide commentary on the Proposed Standards from the perspectives of: a) a corporate preparer, b) an investment fund preparer and c) a user (i.e., BlackRock's research analysts). For purposes of this response, our comments primarily reflect those of our analysts as users of both financial statements and auditors' opinions.

**Overview**

We applaud the Public Company Accounting Oversight Board ("PCAOB" or the "Board") for undertaking this project, the goal of which is to enhance auditor communications and information useful to users of financial statements. Overall, we support the concept of communicating critical audit matters and believe that much of the framework proposed will result in useful information to users of financial statements. We wish to emphasize that certain entities, such as investment companies, have inherently less complex business models for which there may routinely be no critical audit matters. In order to avoid "boilerplate" language, we encourage the PCAOB to clarify that routine matters discussed

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with boards of directors or audit committees and comprehensively disclosed in the financial statements may not require identification as a critical audit matter because, while they may require substantial audit effort, they do not require significant auditor judgment or give rise to significant audit issues.

We are concerned that some investors may misinterpret the communication of a critical audit matter as indicative of an issue with respect to the quality of the financial statements or as a qualification in the auditor's report (even though the proposed auditor's report would state that the opinion on the financial statements is not modified with respect to any of the critical audit matters described). We suggest that additional language be added to the critical audit matter section of the auditor's report to explain that critical audit matters are not necessarily indicative of a financial statement deficiency.

From a preparer's perspective, we believe there will be additional time and expense associated with interacting with and providing information to the auditors in connection with their required assessment and reporting of critical audit matters and their documentation of matters that are critical audit matters. We do not believe that the auditor should be required to document why all other possible critical audit matters were not included as critical audit matters in the auditor's report.

We continue to recommend that the description of critical audit matters in the auditor's report exclude audit procedures performed or an indication of the outcome of the auditor's procedures and significant auditor judgments. Such information may lead a user to believe that the auditor is expressing a "piecemeal" opinion on individual matters or accounts in the financial statements, and any audit procedures enumerated may be taken out of context or misunderstood given their necessarily abbreviated descriptions.

We support including a description in the auditor's report that clarifies the auditor's responsibility for other information in documents containing financial statements. We do not support changing the auditor's responsibility for other information to "evaluate" such information versus the current requirement to "consider" the information, which might imply detailed comfort letter type documentation and procedures. We also do not support an expansion of audit procedures to include other information beyond Management Discussion and Analysis ("MD&A") and other schedules containing financial information that is derived from or that supports the financial statements. We do not support an extension of audit procedures to other information incorporated by reference.

We encourage the PCAOB and the IAASB to work together to standardize, to the extent possible, the form and content of the auditor's report in order to increase comparability and ease of use for users who may be readers of reports subject to both sets of standards.

*****

The following comments primarily reflect those of our analysts are in response to certain questions set forth in the Proposed Standards.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

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We rely on the auditor of the financial statements to determine their independence with professional standards, and the PCAOB to ensure that all auditors of public companies are registered with the PCAOB. We do not believe that the statement in the auditor's report relating to auditor independence provides any meaningful additional comfort.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Would information regarding tenure in the auditor's report be useful to investors and other financial statement users? Why or why not?**

   We do not object to inclusion in the auditor's report of the year in which the auditor began serving consecutively as the company's auditor, although it would be preferable to include such information in another public document, such as the proxy or elsewhere in a Form 10-K. It would be informative to know whether there has been a change in auditor. Such information may cause our analysts to inquire whether there were any disagreements with management as to accounting or financial statement disclosures, and may cause additional scrutiny, as new auditors may not have developed a comprehensive understanding of a new audit client, particularly when the client is complex and/or operates in multiple jurisdictions.

6. **The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

   We support inclusion of a statement clarifying the auditor's responsibility for other information; however, we are concerned that the Proposed Standards could result in a significant expansion of audit procedures. The Proposed Standards would include within the definition of other information documents incorporated by reference, some of which may have been partially superseded (such as loan or lease agreements), as well as other non-financial information. The Proposed Standards would require such information be read and evaluated as to consistency of amounts, manner of presentation and qualitative statements, as well as require an evaluation of other information not directly related to the financial statements as compared to relevant audit evidence obtained during the audit. Such procedures are not routinely performed on documents incorporated by reference, contrary to page 21 of the Proposed Standards, which states that "the Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard."

   We believe that the scope of procedures should be related solely to financial information included in the filing, such as MD&A and exhibits, and should not extend to documents incorporated by reference or other non-financial information. Furthermore, we recommend that the PCAOB clarify what audit procedures should be performed to identify information within the scope of other information, and the basis for concluding on the manner of presentation and qualitative statements.

7. **Should the Board require a specific order for the presentation of the basic elements required in the auditor's report?**

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We have no preference on the order of presentation. However, we encourage the PCAOB and the IAASB to work together to standardize, to the extent possible, the form and content of the auditor's report.

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

We believe the auditor's communication of critical audit matters will be relevant to investors and other financial statement users by focusing their attention on issues that would be pertinent to understanding the financial statements. As users of financial statements, we find value in identifying critical audit matters, particularly matters resulting from changes in principles or areas that involve significant judgment, which therefore may require further analysis and discussion with management in order to be properly understood and reflected in analyst models.

We are concerned, however, that such matters may become recurring disclosures of routine matters with "boilerplate" language, since companies in similar industries will presumably have the same critical audit matters (e.g., loan loss reserves for a bank). We suggest such routine matters be limited to a brief description of the critical audit matters, why the auditor considered them to be significant, and a reference to their location in the financial statements and/or footnotes.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

Inclusion of the audit procedures performed, including resolution of the critical audit matters, in the report would not provide information that would facilitate an understanding of the financial statements. In order for the auditor to convey the context around such matters, it may be necessary to include expansive details that could overwhelm the auditor's report. Additionally, inclusion of information about the results of audit procedures may lead a user to believe that the auditor is expressing a "piecemeal" opinion on individual matters or accounts in the financial statements. Furthermore, we are concerned that it may be difficult to succinctly convey the nature of audit procedures in a manner that provides the user with an understanding of the full scope of those procedures, and the quantitative and qualitative factors considered in reaching their decision.

We recommend that the Board clarify that highlighting audit procedures should be infrequent; however, if they are included, only the most significant procedures should be identified and then only when they are important to understanding why a matter was identified as a critical audit matter. Paragraph 11.b. does not seem to refer to disclosure of audit procedures, while the illustrative examples include such procedures. Additional guidance should be provided if the Board ultimately elects to retain the option for auditors to communicate the results of specific audit procedures.

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of**

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**critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

We do not believe that there would be material additional costs for communication of critical audit matters as these matters already should be reviewed by the engagement quality reviewer and communicated to the board or audit committee. However, we believe there will be additional time and expense associated with a comprehensive assessment of all matters (including internal control significant deficiencies), and the determination and documentation of whether those matters are critical audit matters based on the criteria in paragraph 9 of Appendix 1. For example, we would expect that significant (but not material) control deficiencies and changes in the auditor's risk assessments will entail more comprehensive assessment and documentation than currently performed as to why they were, or were not, a critical audit matter.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon?**

We are supportive of limiting critical audit matters to only the most recent financial statement period. Critical audit matters related to prior periods should be communicated in the auditor's report if they were not previously communicated in a public filing (e.g., an initial public offering containing audited financial statements for multiple periods) or if prior period financial statements have been re-audited because the previously issued auditor's report could no longer be relied upon.

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

In substantially all situations where an auditor would disclose information not contained in the financial statements, we believe it is likely that management would elect to disclose such information in the financial statements rather than having it summarized by the auditor in the auditor's opinion (in effect, resulting in an auditor disclosing management information). However, for those situations where management may elect to not make such disclosure, such as situations involving auditor judgments (e.g., disclosure of significant control weaknesses that did not rise to the level of a material weakness or auditor consideration of going concern status), we recommend that the PCAOB provide additional factors that should be considered by the auditor prior to making such disclosure. Those factors to be considered could include whether deficiencies and uncertainties were remediated prior to issuance of the auditor's report and whether the disclosure would result in making confidential information public or disclosing information that could result in a competitive disadvantage to the company. If such disclosure could result in making confidential information public or in a competitive disadvantage to the company, it would be

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appropriate to consider whether such disclosure is necessary in light of the overall financial statement presentation.

**38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?**

It is generally agreed that investment companies are inherently less complex than operating companies. Most registered investment companies file under the Investment Company Act of 1940 and the Securities Act of 1933, although a small number of closed-end funds file under the Securities Exchange Act of 1934 (to which the Proposed Standards, including the evaluation of other information, would be applicable). Investments generally comprise substantially all of an investment company's assets and net equity, and its income is derived from realized and unrealized gains on these investments. Expenses are primarily comprised of formulaic contractual obligations to third parties (e.g., the investment advisor, custodian, transfer agent and professional service providers). As a result, it is likely that only fair valuation of investments would be deemed a critical audit matter.

Investment companies include extensive disclosure in their offering memorandums/ prospectuses and footnotes as to the methodology of fair valuation and they disclose fair value information pursuant to ASC 820, *Fair Value Measurements and Disclosures*. Given these disclosures, we recommend clarifying that routine audit procedures, such as testing Level 1 or 2 fair valuation inputs or verifying the existence of investments, would not be deemed critical audit matters unless there were significant required estimates or judgments therewith. Accordingly, there should be a rebuttable presumption that the auditor's report on most investment companies would state that there are no critical audit matters to communicate.

**40. Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?**

We do not believe any companies otherwise covered by the Proposed Standards should be universally exempt from the requirement to communicate critical audit matters. Both the auditor and financial statement preparer would benefit by focusing the auditor on critical audit matters during the planning and execution phases of the audit. Exclusion of certain companies would negate this benefit.

**Additional Discussion Questions**

**1. Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

The scope of the proposed other information standard should be limited to MD&A and other exhibits containing financial information that is derived from or that supports the financial statements (e.g., ratio of earnings to fixed charges). The auditor's opinion should specifically identify the other information for which the

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auditor performed an evaluation for material inconsistencies or material misstatements.

2. **Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not?**

   The proposed other information standard should not be extended to information incorporated by reference. Performing additional procedures on this information would be of limited value, as the documents may include partially outdated or superseded agreements, documents containing minimal financial information, and lengthy documents for which the cost of having auditors perform, evaluate and document procedures would be prohibitive (e.g., stock award and incentive plans, share agreements, historical merger and acquisition agreements, loan and borrowing agreements, lease agreements).

6. **Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

   If the procedures to be performed are only with respect to MD&A and other exhibits containing financial information that is derived from or that supports the financial statements, then the “material inconsistency” and “material misstatement of fact” criteria are appropriate. However, if the procedures are applied to other non-financial information, these criteria may require significant judgment given the complexity of many corporate agreements. The costs associated with such procedures (including preparation of related audit documentation) would not justify the benefit received.

7. **Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

   Many analysts and users of financial statements already assume that MD&A and exhibits are read by the auditors for consistency with the financial statements. Accordingly, reporting on those procedures performed would clarify the auditor’s role and responsibility. We do not believe that additional procedures are necessary.

15. **Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?**

    It would be appropriate for the auditor to indicate in the audit report a material inconsistency or a material misstatement of fact in MD&A and/or exhibits containing financial information that is derived from or supports the financial statements. If the Proposed Standards are extended to other information incorporated by reference, the same standard should apply. However, as noted above, we do not support such an extension.

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19. **Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

    We do not support a further extension of the auditor's procedures to information not directly related to the financial statements.

20. **What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

    We would expect that the auditor and the company would both incur minimal additional costs related to the reporting of a material inconsistency or material misstatement of fact. Absent a disagreement of fact, such matters would be discussed and corrective action taken by management to correct the inconsistency or misstatement.

21. **Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

    As noted above in question 1, the auditor's report should specifically identify the other information for which the auditor performed an evaluation for material inconsistencies or material misstatements. If this identification is made, the proposed reporting would provide users with an appropriate understanding of the auditor's responsibilities for, and results of, their evaluation.

31. **Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?**

    We encourage the Board to defer extension of the application of the proposed other information standard to documents filed under the Securities Act until an evaluation can be made of the results from implementing the current Proposed Standards.

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We appreciate the opportunity to share our viewpoints on the Proposed Standards. If the Public Company Accounting Oversight Board has any questions regarding our comments, please contact Steven Buller at (212) 810-3501.

Sincerely,

Steven E. Buller
Managing Director

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December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Members and Staff of the Public Company Accounting Oversight Board:

Booz Allen Hamilton appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor's Report; and Related Amendments to PCAOB Standards (collectively the "Proposed Standards"). Booz Allen Hamilton is a leading provider of management consulting, technology, and engineering services to the U.S. government in defense, intelligence, and civil markets, and to major corporations, institutions, and not-for-profit organizations. Booz Allen is headquartered in McLean, Virginia, employs more than 23,000 people, and had revenue of $5.76 billion for the 12 months ended March 31, 2013. Our stock has traded on the New York Stock Exchange (NYSE: BAH) since November of 2010.

We commend the Board for undertaking this project to enhance the transparency and relevance of auditor communications provided to users of financial statements. We are supportive of any initiative that results in better information being provided to our investors and other stakeholders so that that they can make more informed decisions. We believe that improvements to financial reporting are achieved through a multi-faceted approach that include clarifying changes to the audit report by the PCAOB complimented by the continued efforts by the Financial Accounting Standards Board ("FASB") and the Securities and Exchange Commission ("SEC"). Both the FASB and the SEC have been responsive to investor and other stakeholder needs requiring additional disclosures focused on educating stakeholders, allowing them to make more informed investment decisions. The changes within the Proposed Standards could yield additional understanding but we do have concerns on how certain changes may be interpreted by the users of the financial statements.

We wish to emphasize that fundamental to any changes being contemplated by the Board, is that the financial statements and related disclosures are ultimately management's responsibility, with the auditor's role being to express an opinion on whether the financial statements are fairly presented, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Therefore it is critical that any changes to the auditor's opinion neither duplicate nor create confusion for the investing community, but rather focus on providing the investor with additional objective information. Any discussion of areas of judgment or critical accounting matters should, in our view, rest with management and the associated disclosures within the financial statements.

The preparation of our financial statements is a result of a rigorous process that involves a number of experienced executives and subject matter experts tasked with ensuring the financial statements are complete, accurate and provide a stakeholder with all necessary information upon which to make an informed investment decision. Additionally, these financial statements are prepared with the oversight of the Chief Financial Officer, Chief Executive Officer and the Audit Committee, ensuring that we address specific risks and meet all of the required FASB and SEC regulations.

We acknowledge that while our external auditors are not part of our oversight controls, the auditing of the financial statements are ultimately integral in the final product delivered to our stakeholders. We therefore generally support any changes to the auditor's opinion that further clarifies the auditor's responsibilities for the financial statement footnotes and the risk of material misstatement due to fraud. We believe investors would benefit from a deeper understanding of what the auditor does to further enhance the importance of the current "pass or fail" opinion. We do not believe any statement regarding the auditor's independence and tenure is warranted in the auditor's opinion to the financial statements. Such a statement does not add any value to our investors' decision making and much of this information is available in the proxy statement.

The proposal to identify and include in the auditor's opinion a discussion on critical audit matter(s) causes us a number of concerns:

- First, we encourage the Board to clarify the definition of what constitutes a critical audit matter. We believe this guidance is needed to ensure the appropriate balance between management's disclosures and those the auditors may be required to make. We believe matters routinely discussed with the board of directors and audit committee, or others in a governance role, and comprehensively disclosed in the financial statements should not require identification as a critical audit matter. While an area may require substantial audit effort or involvement of a subject matter expert, this may not give rise to a critical audit matter. We believe that clear guidance of what constitutes a critical audit matter will also avoid management and their auditors becoming overly excessive in their judgments in identifying critical audit matters, failure to include such guidance may cause inconsistencies with how management identifies its critical accounting policies. For example, we do not think the auditors should disclose a critical audit matter for each critical and significant accounting policy disclosed by the company.

- Second, the expanded disclosures may result in the auditor providing entity-specific piecemeal opinions on management's policies and the quality of those policies. For example, if the auditor were required to provide an opinion on management's specific policies, practices, and processes used to: account for significant unusual transactions; determine highly subjective significant assumptions applied in critical accounting estimates; and present financial statements and related disclosures, by communicating such information this could be interpreted as providing a piecemeal opinion on these specific areas.
- Third, we believe that some investors may misinterpret the communication of critical audit matters and the auditor's opinion on these matters as indicative of an issue with respect to the quality of the financial statements or as a qualification in the auditor's pass-fail opinion. For example, a Company may enter into a complex business acquisition that requires judgment on whether a portion of the purchase price is considered contingent consideration. Management makes a judgment based upon the facts and circumstances of the acquisition supported by in-depth research and interpretation of the relevant accounting literature. The auditors, consulting with their National Office, concur with management's judgment and as such issue an unqualified opinion on the financial statements, including the accounting for the business acquisition. Unless the disclosure within the auditor's opinion regarding the judgments reached by management and the auditor are specific and clearly note that no issues existed, this may lead an investor to interpret that an issue or problem existed when the Company completed the acquisition.
- Fourth, we believe there will be additional and, in some cases, duplicative time and expense associated with interacting with and providing information to the auditors in connection with their required assessment and reporting on critical auditing matters. Even further expense is likely to be incurred if the auditors have to document why certain matters are not critical audit matters to withstand inspection inquiries.
- Fifth, we believe that the Proposed Standard may have the unintended consequence of straining the relationship between management and the auditor. Clearly the difference in opinions on what may constitute a critical audit matter given the judgmental nature of such a determination and the extent of the disclosure will likely cause disagreements between the two parties. However, more importantly, we believe that cooperative management may be penalized for being open and transparent on the critical issues the company addresses on a quarterly and annual basis. The auditor may use this information to support a list of critical audit matters that they will in turn use to disclose in the financial statements. This may cause management to share less with the auditor at the risk of being less transparent in the financial statements so as to avoid a laundry list of critical audit matters being included in the auditor's opinion.

Likewise, we are concerned and do not support changing the auditor's responsibility for other information to "evaluate" such information versus the current requirement to "consider" the information, which may imply a detailed or higher level of comfort. We also do not support an expansion of audit procedures to include other information beyond the Management Discussion and Analysis ("MD&A") and other schedules containing financial information that is derived from or that supports the financial statements. We do not support an extension of audit procedures to other information incorporated by reference.

We encourage the PCAOB and the International Auditing and Assurance Standards Board to continue to work together to standardize, to the extent possible, the form and content of the auditor's opinion in order to increase comparability and ease of use for users who may be readers of reports subject to both sets of standards.

In summary, we are supportive of the Board's efforts to introduce alternatives to the audit reporting model that would meet the needs of the investors and be practical for management, audit committees and audit firms to adopt in a cost-effective manner. We believe that the focus should not be on providing more information to investors but improving the quality of information to investors. We believe that better information can be provided through a combination of clarifying changes to the audit report by the PCAOB coupled with targeted standard-setting by the FASB or SEC.

We appreciate the opportunity to present our views on this subject and welcome the opportunity to meet in person to review them with you. Thank you for your attention and consideration.

Best regards,

Kevin L. Cook

Kevin L. Cook
Senior Vice President
Corporate Controller

Roger Harrington
Vice President & Chief Accounting Officer

BP p.l.c.
1 St. James's Square
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SW1Y 4PD

3 December 2013

Public Company Accounting Oversight Board,
1666 K Street, N.W.,
Washington, D.C. 20006-2803
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Dear Sir or Madam,

**Invitation to Comment – PCAOB Rulemaking Docket Matter No. 034**

We welcome the opportunity to comment on the PCAOB's proposed new auditing standard "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion".

BP responded to the International Auditing and Assurance Standards Board's (IAASB) 2012 consultation "Improving the Auditor's Report". We believe that the points we made in response to that consultation are relevant to the PCAOB's proposals, and we include a copy of our response to the IAASB.

We recognize that investors are seeking further means to engage with management and auditors on the financial statements, but do not believe that "critical audit matters" are the best way of achieving that aim. Auditor reporting of critical audit matters would most likely either duplicate information presented as critical accounting policies or judgements, or would result in the auditor being the original provider of information about the company, which would violate the principles for auditor reporting that we set out in our response to the IAASB's consultation. We believe that the proposals effective in the United Kingdom this year – requiring the auditor to describe the main risks they identified and how they scoped their audit – strike a better balance.

If you would like to discuss any of the comments in this letter, we would be happy to do so. Please do not hesitate to contact me or Martin Perrie (martin.perrie@uk.bp.com).

Yours faithfully

**Roger Harrington**

Roger Harrington
Vice President & Chief Accounting Officer

BP p.l.c.
1 St. James's Square
London
SW1Y 4PD

7 September 2012

International Auditing and Assurance Standards Board (IAASB)
529 Fifth Avenue, 6th Floor
New York, NY 10017
United States of America

**Submitted through the IAASB website: www.iaasb.org**

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Dear Sir or Madam,

**Invitation to Comment – Improving the Auditor's Report**

We welcome the opportunity to comment on the IAASB's Invitation to Comment – Improving the Auditor's Report (the "ITC"). I am pleased to respond on behalf of BP p.l.c. to the invitation to comment

We support the objective of making the auditor's report more readable and more relevant to users of financial statements. We also agree that the scope of the audit and the role of the auditor is not particularly well understood and that efforts to educate those whose background is not auditing would be helpful.

However, we do not agree with the proposals in the ITC regarding Auditor Commentary. We question the assertion that this is something which a significant proportion of users of financial statements are requesting, and encourage the IAASB to conduct robust research into the demand for such a change.

**Increasing complexity of financial statements**

We recognize that large multinational companies' financial statements are becoming increasingly lengthy and complex, but we do not believe that a "roadmap" provided by the auditor is an appropriate means of addressing this development. There are a number of initiatives currently under way to improve the readability and understandability of financial statements and annual reports more broadly, such as the IASB's proposed forum on improving disclosures and prioritization of their Conceptual Framework, and in Europe EFRAG and the UK FRC's discussion paper on a disclosure framework and ESMA's consultation paper on materiality in financial statements. We welcome these efforts to streamline financial reporting so that significant matters, and only significant matters, are reported.

The IAASB has an important role to play in promoting the cultural change that will be necessary to achieve these improvements, but we are not convinced that the proposed changes to auditor reporting are either necessary or sufficient to meet these aims. A better outcome may be achieved by the IAASB working together with the IASB and securities regulators to promote better, clearer, more focussed reporting by issuers.

**Principles for auditor reporting**

There are two important principles that we believe should be applied to auditor reporting:

- The auditor should not be the "original provider" of information about the entity - that is management's role; and
- The auditor should not duplicate information already provided by management.

Clearly if both these principles are applied there is only a limited amount of information that the auditor will provide. This could include information related to the audit of the entity in question, such as how the audit was scoped, how materiality is applied, and a summary of work done on significant areas, although as stated above we do question whether there is a demand for this information from investors.

We do not agree with the proposals set out in the ITC. We believe that it is management's responsibility to set out the key judgements made in the preparation of the financial statements, and under the IAASB's proposals the auditor would end up duplicating information that management has already provided. If the objective is to ensure that the significant judgements are better disclosed, then there could perhaps be a requirement to include a specific statement in the audit report that the auditors have read the significant judgements disclosed and agree that it is complete and consistent with the audit work performed.

In addition, we are not convinced that the auditor is best placed to comment on what is most important to users of the financial statements – there are many different types of user, each with different interests and needs. Furthermore, in jurisdictions such as the United Kingdom the audit report is addressed to existing shareholders, and the audit report is consequently not addressed to other users of the financial statements.

We do agree that users would find it useful to understand the nature of the discussions between management, the audit committee and the auditor. We believe that the appropriate forum for this disclosure is in the report of the audit committee, not the audit report, and this will indeed be a requirement in the UK in the near future.

**Unintended consequences**

The proposals in the ITC could significantly alter the dynamics between management, those charged with governance and the auditor. At best we could foresee a significant drain on resources as the drafting of the auditor commentary is discussed between senior management, the audit committee and senior members of the audit team; at worst the discussions between management, the audit committee and the auditor may become constrained for fear of all significant discussions being required to be published in the audit report.

A longer list of significant matters set out in the auditor commentary would, we believe, detract from fundamentally important matters which currently require disclosure in the auditor's report.

We believe that the IAASB should perform a robust impact analysis to identify any other unintended consequences, either direct or indirect, that might result from its proposals before progressing with this project.

* * *

If you would like to discuss any of the comments in this letter, we would be happy to do so. Please do not hesitate to contact myself or Martin Perrie (martin.perrie@uk.bp.com).

Yours faithfully

**Roger Harrington**

**From:** Jon Curtis
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 6:46:11 PM

Hi,

I am Jonathan Curtis and Chief Compliance Officer for Bridge Street Securities, LLC (CRD# 152109). Bridge Street is a boutique M&A advisory firm – we maintain no customer accounts, do not receive funds on behalf of customers, and only deal with corporate clients. Yet we still have to endure costly compliance procedures and an annual audit with fees that are only going up! In my opinion, we are a "low risk" firm...but in many ways we are treated just the same as JPMorgan, Goldman Sachs, etc.

This email is to let you know that **I support Lisa Roth's position** to exempt non-custodial, non public BDs from the PCAOB constituency.

Regards,
Jon

**Jonathan Curtis**
Managing Director
Bridge Street Advisors

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415.710.6951

CalPERS

**California Public Employees' Retirement System**
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P.O. Box 2749
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May 2, 2014

Phoebe Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW, 8th Floor
Washington, DC 20006-2808

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

Dear Ms. Brown:

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on PCAOB Rulemaking Docket No. 34.

CalPERS is the largest public pension fund in the United States with over $291 billion in global assets and equity holdings in over 9,000 companies. CalPERS provides retirement benefits to more than 1.6 million public workers, retirees, and beneficiaries, and we rely on the quality and integrity of market information to allocate capital on behalf of our beneficiaries.

CalPERS strongly supports the PCAOB's mission to "[o]versee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." We are a strong advocate of reform that ensures the continual improvement and integrity of financial reporting. In our Global Principles of Accountable Corporate Governance, Principle 4 states, "[f]inancial reporting plays an integral role in the capital markets by providing transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards, as well as consistent application, rigorous independent audit and enforcement of those standards."

Although, the current pass/fail model provides some value, we previously shared at a March 2011 PCAOB Investor Advisory Group, an example where the current auditors' reporting model failed to provide meaningful insight. We noted that the auditor's report for 2008, 2009, and 2010, were virtually identical for a recipient of the Troubled Asset Relief Program (TARP) funds, with the 2008 report costing $119 million and the 2009 report costing $193 million. What additional work was necessary for the auditor to be able to once again provide a non-descript statement that the financial statements gave a fair presentation? We will never know.

We believe the Board's proposed auditor reporting standard, the proposed other information standard with regards to an auditor's discussion and analysis, along with required and expanded emphasis paragraphs and auditor assurance on information outside the financial statements would provide investors a better range of information about the audit.

From our perspective, users will then be able to better utilize and value the audit report, enhanced reporting, and the audit opinion. We believe the utility of the auditor's report will improve with the additions outlined in the proposed rule. These include:

- Requiring the auditor to communicate in the auditor's report critical audit matters;
- A statement regarding the auditor's existing requirements to be independent of the company and identification of the year the auditor began serving as the company's auditor (tenure);
- Identification of the auditor's responsibilities for other information and the results of the auditor's evaluation of the other information; and
- Enhanced certain standardized language which would allow the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement and an addition of the phrase "whether due to error or fraud.

**Critical Audit Matters (CAMs)**

The objective of CAMS is to provide disclosures that document the basis and determination for the auditor's opinion, along with identifying the relevant financial accounts which connect the critical audit matters. Who better positioned, than the auditor, to provide insights in how, and on what basis the auditor developed its opinion? The communication of CAMs does not fundamentally change the auditor's attestation of information prepared by management and does not blur lines of management's and audit committee's responsibilities. This three-legged communication is valued by investors to provide management's, the board of director's and the independent auditor's perspective in ensuring the overall stewardship of the company.

We believe the proposed rule changes will provide four important attributes - transparency, relevance, reliability and credibility. PCAOB Chairman James Doty said, "This is a watershed moment for auditing in the U.S." We back the PCAOB in making a bold move by initiating meaningful change in our audit reporting model. Auditors have the ability to enhance trust, to provide additional transparency, share the significance (relevance) of their service and rebuild the credibility in the integrity of financial reporting.

We have outlined more detailed information in the supplementary appendix on the importance of the role accounting and auditing play in our capital markets and our expectations for enhanced auditor reporting.

**Independence and Tenure of the Auditor**

Confidence in company's audited financial statements are key to the efficient functioning of the markets and exist because auditors bring integrity, independence, objectivity and professional competence to the financial reporting process.

We believe that the lack of auditor independence negatively impacts the auditor's objectivity. We are concerned where an audit firm receives significant fees for non-audit services. We agree that adding a statement by the auditor on their independence from the company and board of directors reinforces investors' understanding of the auditor's obligations to be independent and objective in expressing the audit opinion.

We also support the disclosure of the tenure of the auditor to advance the Audit Committee's fiduciary responsibility in determining the appropriate maximum length of tenure to ensure the independence of the auditor. We believe that auditor rotation will advance having a fresh perspective, improve the independence and objectivity of an auditor and provide additional confidence in the integrity of financial reporting.

**Auditor's Responsibilities Regarding Other Information**

Investors require reliable in-depth information on financial reporting as well as information on strategic risks and the major operational risks related to the company's business model. The company articulates those risks through other information such as management discussion and analysis (MD&A), selected financial data and exhibits included in annual reports but not included in the audit of the financial statements. Not only do institutional investors rely heavily on management's disclosures to make sound investments decisions and to be able to act as engaged shareowners; it is additionally important to investors to understand the nature and scope of the auditor's responsibilities with respect to other information as it related to consistency and factual interpretation in the audited financial statements.

We concur with the requirement that when issuing an auditor's report, the auditor will include in a separate section explaining the auditor's responsibilities regarding other information. The auditor should provide an explicit statement evaluating other information reviewed by the auditor for material misstatement of fact and material inconsistency. The statement should not only include the auditor's review of materials, but also how materials were utilized, requiring the auditor to document and share any material inconsistencies and disagreements within the enhanced audit report.

It is imperative to outline the use and responsibilities of the auditor on other information, to improve the clarity of how other information is used in the auditor's evaluation and conclusion in the audit opinion. This inclusion would be more in line with the global development towards integrated reporting.

**Enhanced Language**

We support the proposed revision to the auditor's report to recognize the auditor's existing responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

We applaud the work of the PCAOB, have addressed in the attachment certain questions in the proposal, and support the approach set out in the proposed rules. We refer you to the letter we submitted on the Board's concept release.

Thank you for your consideration. If you have any questions, please do not hesitate to contact me at (916) 795-9672 (Anne_Simpson@calpers.ca.gov) or James Andrus at (916) 795-9058 (James_Andrus@calpers.ca.gov).

Sincerely,

Anne Simpson

ANNE SIMPSON
Senior Portfolio Manager
Director of Global Governance

**Supplemental Responses of the California Public Employees Retirement System (CalPERS) regarding PCAOB Release No. 2013-05, PCAOB Rulemaking Docket No. 34**

Proposed Auditor Reporting Standard

*Questions related to Section II of Appendix 5*

1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?

**We believe that the objectives outlined in the proposed rule provide meaningful guidance to the auditors.**

*Questions related to Section IV of Appendix 5*

2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?

**As shareowners such as CalPERS are the providers of capital, we believe the audit report is best addressed to shareowners. Auditors need to view investors as their ultimate client. It is imperative that a change in perspective should occur. Investors' needs should be paramount as an auditor plans, performs, reports and provides an opinion on the audited financial statements. The audit report then would address the needs of investors, and as outlined in the proposed rules would provide the auditor's perspective for the client.**

**We believe it appropriate for the audit report to be addressed to boards given their fiduciary oversight role on behalf of shareowners.**

3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?

**We support the revised requirement, as outlined in Appendix 5, with the revision of better aligning the audit report with the requirements in the Board's existing standards and the eight standards (Auditing Standard Nos 8-15) that improve the description relating to an auditor's work performed in the Board's risk assessment standards.**

4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?

**Auditors play a unique role in our financial markets. The professional tension of skepticism is important to maintaining the balance of independence and ensuring open communication between the auditor, management and the Audit Committee. We believe**

**an affirmative statement concerning the auditor's independence could help demonstrate that the audit opinion is not simply a rubber stamp for management's financial reporting.**

5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.

a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?

**As supporters of periodic tendering and auditor rotation, we strongly support the disclosure of auditor tenure. As we have indicated previously, while we appreciate that professional skepticism is a component of auditor independence, we believe a fresh set of eyes would help enhance independence.**

b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?

**We would expect auditors would have no problems determining when it (or its predecessor firm) was first engaged as a company's auditor. Surely, each such firm maintains engagement records.**

c. Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?

**The easier it is for investors to locate such information, the more useful it will be. We believe the information should be included in the audit report, as well as other sources. We also believe the years of tenure may provide Audit Committees and investors a discussion topic in the annual assessment of auditor selection and ratification.**

6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?

**We believe there is a significant expectation gap between what information an auditor has examined and opined on and that which investors believe an auditor has examined and opined on. A description of the auditor's responsibilities for other information *would* be useful to investors if it provides a thoughtful, tailored description of the auditor's role. However, simply adding additional boilerplate language to the audit report would not be helpful. As the PCAOB considers substantial changes to the current reporting model, we would expect that PCAOB would require (through interpretative guidance and/or**

**inspections activities, as well as what is outlined in Appendix 5) descriptions relating to responsibility that are specifically tailored to a company's financial statements, other information and disclosures.**

7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?

**We believe auditors should have the flexibility to present the audit report in a manner they believe most effectively conveys their views on a company's financial statements and disclosures. However, we also believe the auditor should outline when certain Critical Audit Matters (CAMs), or in their assessment and planning did not find any critical audit issues that need to be explained in the audit report.**

8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?

**There is merit to include CAMs for all periods presented in the financial statements and providing updates on CAMs from the prior period, and the current effect on the reporting period. The CAMs from prior periods could be referenced in an appendix.**

9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.

**There will be those who argue that the cost of compliance outweigh the benefits. This is a convenient argument to make because costs can be predicted by financial models whereas the benefits to investors in the form of potential loss mitigation is impossible to predict. However, we would ask you and others to consider the benefits of a more meaningful audit reporting model with a view toward the past.**

**During the most recent financial crisis, CalPERS alone lost over $70 billion in assets.**

**Had there been greater transparency in the risks hidden in our financial system, perhaps different decisions would have been made with regard to asset allocation or corporate engagement. Perhaps this would have encouraged different decisions by companies. For example, given additional information about risks in the system, companies may have chosen not to invest in mortgage backed securities or credit default swaps. We will never know how behavior would have changed with stronger financial regulations. Moreover, we would be remiss if we did not emphasize that the audit fees and other compliance costs are ultimately paid by shareowners such as CalPERS. We would gladly support additional reasonable fees in exchange for greater assurance on a company's financial reporting.**

*Question related to Section V of Appendix 5*

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| 10. Would the auditor's communication of Critical Audit Matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider? |

**Yes, we believe the auditor's communication of Critical Audit Matters (CAMs) would be useful to investors and other financial statement users. We support the concept of enhanced auditor reporting or an auditor's discussion and analysis as outlined in our previous letter in 2011 as an acceptable means of communicating additional information regarding the audit findings and the audit process provided it was subject to professional accountability for quality. Our principal concern was that the information should be reported by the auditor in a way that it is not construed to be reported by management.**

**We believe communicating the Critical Audit Matters is an acceptable means of communicating additional information about the audit. And, we support PCAOB's proposed definition of Critical Audit Matters – matters that the auditor determines to be 1) the most difficult, subjective or complex audit judgments; 2) posed the most difficulty in obtaining sufficient appropriate evidence; or 3) posed the most difficulty in forming the opinion on the financial statements has the potential to inform the users of the areas of high audit risk.**

**CalPERS Global Principle 4.6 discusses our views on enhanced reporting to investors. It states:**

> **Auditors should provide a reasonable and balanced assurance on financial reporting matters to investors in narrative reports such as an Auditor's Discussion and Analysis (AD&A) or a Letter to the Shareowners. Enhanced reporting should include:**
>
> **a. Business, operational and risks believed to exist and considered;**
> **b. Assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low or high end of the range of possible outcomes;**
> **c. Appropriateness of the accounting policies adopted by the company;**
> **d. Changes to accounting policies that have a significant impact on the financial statements;**
> **e. Methods and judgments made in valuing assets and liabilities;**
> **f. Unusual transactions;**
> **g. Accounting applications and practices that are uncommon to the industry;**
> **h. Identification of any matters in the Annual Report that the auditors believe are incorrect or inconsistent, with the information contained in the financial statements or obtained in the course of their audit;**

**i. Audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee;**
**j. Quality and effectiveness of the governance structure and risk management; and**
**k. Completeness and reasonableness of the Audit Committee report.**

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|---|
| 11. What benefits or unintended consequences would be associated with the auditor's communication of Critical Audit Matters? |

**We have discussed the benefits of enhanced reporting above and we believe unintended consequences can be avoided by strong oversight by the PCAOB through inspection and enforcement.**

**We support the opinion proffered by others that insights on Critical Audit Matters could be relevant to analyzing and pricing risk. Greater transparency on Critical Audit Matters could help increase competition amongst firms. Investors could gain additional information that could enhance their ability to engage with corporate boards and/or management. And, additional insights on how a firm has addressed Critical Audit Matters could bear on investors' decisions on ratifying the auditor.**

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| 12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of Critical Audit Matters? |

**As mentioned above, we believe the definition could be expanded to include those items identified in CalPERS Global Principle 4.6.**

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| 13. Could the additional time incurred regarding Critical Audit Matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have? |

**We do not believe significant additional time should be incurred by the auditor to identify and/or report Critical Audit Matters. This is information that the auditor routinely identifies and should be routinely reporting to audit committees.**

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| 14. Are the proposed requirements regarding the auditor's determination and communication of Critical Audit Matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised? |

**We believe the objective of the proposal is quite clear, while providing auditors a good degree of flexibility on implementing this new reporting model. We trust the PCAOB will work to provide auditors additional guidance (through staff interpretations or inspection findings) as needed.**

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of Critical Audit Matters in the auditor's report be informative and useful? Why or why not?

**We believe procedures performed should not be included in the audit report as they could distract from the primary messages in the opinion. However, we would support the inclusion of a supplemental information document that provided such information.**

16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be Critical Audit Matters? Why or why not?

**We believe with deeper insights provided by the auditor through CAMs, we would expect the auditor to share:**

- **Where are the auditor's main concerns?**
- **Where does the auditor plan to spend it majority of time?**
- **What are the highest risks to the company?**
- **What keeps the auditor awake at night in concluding the audit opinion?**
- **What involved the most difficult, subjective or complex auditor judgments?**
- **What posed the most difficulty to the auditor in obtaining sufficient appropriate evidence?**
- **What posed the most difficulty to the auditor in forming the opinion on the financial statements?**

17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be Critical Audit Matters? Why or why not?

**See answers in number 16.**

18. Is the proposed requirement regarding the auditor's documentation of Critical Audit Matters sufficiently clear?

**We trust the PCAOB will work to provide auditors additional guidance (through staff interpretations or inspection findings) as needed.**

19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are Critical Audit Matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?

**Yes, we believe the proposed documentation provides how auditors should consider in a thoughtful and careful manner whether audit matters are Critical Audit Matters and how to utilize and disclose such in completing their audit.**

20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?

**From our perspective, the determination of CAMs, along with an explanation by the auditor what works was accomplished in formulating the audit opinion is necessary by the auditor. Also, the auditor may determine CAMs may provide the need to modify the audit plan and to obtain additional substantive audit evidence.**

21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of Critical Audit Matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?

**As noted above, we do not believe there should be significant additional costs for communicating Critical Audit Matters. This is work the auditor is already completing to substantiate and determine its audit opinion.**

22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to Critical Audit Matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?

**As noted above, we do not believe there should be significant additional costs for communicating Critical Audit Matters.**

23. How will audit fees be affected by the requirement to determine, communicate, and document Critical Audit Matters under the proposed auditor reporting standard?

**We would expect auditors to continue determining and documenting critical audit procedures as required by PCAOB standards and we do not believe there should be significant additional costs for communicating these matters to investors.**

24. Are there specific circumstances in which the auditor should be required to communicate Critical Audit Matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?

**We believe current securities laws and regulations sufficiently address such issues but also believe there may be value in expressing how CAMs from prior periods where mitigated or whether because of the type of industry that previous CAMs would always be critical in determining the work to be performed as well as substantiating evidence of the audit opinion.**

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of Critical Audit Matters and at an appropriate level of detail? Why or why not?

**We support the use of illustrative examples and reiterate our request that Critical Audit Matters include those items in CalPERS Global Principle 4.6.**

26. What challenges might be associated with the comparability of audit reports containing Critical Audit Matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.

**We believe the challenges associated with the comparability of audit reports containing Critical Audit Matters will be limited. If fact, we agree with other commenters that if the information contained in an auditor's reports is always consistent, the potential benefits to investors would be diminished. We believe the new reporting model is an opportunity for firms to distinguish themselves through thoughtful, creative discussions of Critical Audit Matters.**

27. What benefits or unintended consequences would be associated with requiring auditors to communicate Critical Audit Matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?

**Given the greater likelihood of exposure, we expect that management will be less likely to commit such acts in the first place. If they do, management will be more likely to explain rather than hide the issues. As such, investors will be better off. Under the current system, the described acts would not become known o the investors. We do not understand why that is a good thing. Greater transparency is a great thing in the long run.**

**We support the opinion proffered by others that insights on Critical Audit Matters could be relevant to analyzing and pricing risk. Greater transparency on Critical Audit Matters could help increase competition amongst firms. Investors could gain additional information that could enhance their ability to engage with corporate boards and/or management. And, additional insights on how a firm has addressed Critical Audit Matters could bear on investors' decisions on ratifying the auditor.**

28. What effect, if any, would the auditor's communication of Critical Audit Matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?

**We have no views on this item.**

*Questions Related to Section VI of Appendix 5*

29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?

**We would support the inclusion of a non-exclusive description or list of circumstances that would require and explanatory paragraph. We trust the PCAOB will work to provide auditors additional guidance (through staff interpretations or inspection findings) as needed.**

30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?

**We believe this option should be retained. It will provide auditors' additional flexibility to provide investors with information they believed is important.**

31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?

**Yes. For example, an auditor should be required to include an emphasis paragraph when there is a material uncertainty about a company's ability to continue as a going concern.**

32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?

**We recommend the PCAOB conduct research based on its inspection findings to identify items for which an emphasis paragraph is required.**

*Questions Related to Section VII of Appendix 5*

33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?

**Yes we believe the proposed amendments are appropriate.**

34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.

**Again, we do not believe there will be considerable costs.**

*Questions Related to Section VIII of Appendix 5*

35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?

**Yes, we believe this approach is applicable to the audits of brokers and dealers.**

36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report Critical Audit Matters appropriate for audits of brokers and dealers? If not, why not?

**Yes we believe the proposed auditor reporting standard is appropriate for audits of brokers and dealers.**

37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?

**We support using the same auditor reporting standard and amendments for audits of benefit plans and are not aware of other considerations that the Board should take into account with respect to audits of benefit plans.**

38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?

**From our perspective, the auditor reporting standard and amendments are appropriate for audits of investment companies.**

39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?

**We support using the same auditor reporting standard and amendments for audits of benefit plans and are not aware of other considerations that the Board should take into account with respect to audits of benefit plans.**

40. Should audits of (emerging growth) companies be exempted from being required to communicate Critical Audit Matters in the auditor's report? Why or why not?

**We believe all issuers, including emerging growth companies, should be subject to the same financial regulations.**

*Questions Related to Section IX of Appendix 5*

41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?

**We would defer to auditors regarding the time that might be needed to develop guides and perform training on the new rules, but based upon our understanding of the implementation schedule of PCAOB's AS2/5, we believe 12-18 months lead time should be sufficient.**

42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

**We believe all issuers, including emerging growth companies, should be subject to the same financial regulations.**

Proposed Other Information Standard

**As outlined in our cover letter, we generally believe the evaluation of the other information would improve the quality of information available to investors and could significantly contribute to greater confidence in the other information.**

**We believe investors will further benefit from management corrections and other improvement that may be derived from the practice of evaluating other information. By avoiding potentially inconsistent or competing information between the auditor and management, investors would benefit from the clarity and credibility of the audited financial statements.**

**Accordingly, we agree with the assertion in the release that:**

**As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information available to investors and other financial statement users.**

Emerging Growth Companies

**We believe all issuers, including emerging growth companies, should be subject to the same financial regulations.**

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November 25, 2013

Via e-mail: comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 034

Proposed Auditing Standards –

1. The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;
2. The Auditor's Responsibility Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.

The Accounting Principles and Auditing Standards Committee (the "Committee") of the California Society of Certified Public Accountants ("CalCPA") respectfully submits its comments on the referenced proposal. The AP&AS Committee is the senior technical committee of CalCPA. CalCPA has approximately 40,000 members. The Committee is comprised of 53 members, of whom 47 percent are from local or regional firms, 27 percent are from large multi-office firms, 12 percent are sole practitioners in public practice, 10 percent are in academia and 4 percent are in international firms. Members of the Committee are with firms which serve a large number of public and nonpublic business entities, as well as many non-business entities such as NFP's, pension plans and governmental organizations.

**The Committee's Overall Comments**

The Committee appreciates this opportunity to comment on the PCAOB's very significant auditor reporting proposals. While the Committee has provided its responses to the specific questions set forth in the proposed reporting standards, we also want to address a global concern. The two proposed auditing standards have as their goal the retention of the current "pass-fail" audit reporting model, with significant expansion of responsibilities for reporting on critical audit matters and on other information. The Committee believes this approach is seriously flawed for the following reasons:

First, requiring the auditor to report on critical audit matters results in a perceived difference in audit quality when none should exist. Each audit conducted in accordance with PCAOB Standards includes an assessment of the business in which the entity operates and the control risk within the entity, and addresses the audit risks that result from such assessments. In reporting critical audit matters, the users of the audit report do not learn whether such assessments were properly carried out or adequately addressed, nor do they learn any more about the business or control risks than is currently reported in other information filed with the Securities and Exchange Commission (the "Commission") and made public to users. Accordingly, an audit report that identifies many critical audit matters may be perceived to be of higher quality than a report with few such matters identified when the opposite may be true. In addition, an audit report that identified many critical audit matters may be perceived to reflect more difficulty in arriving at an opinion that the financial statements are fairly presented in accordance with accounting principles generally accepted in the United States of America ("US GAAP") which may also be untrue.

Second, identifying critical audit matters would duplicate disclosures already in annual reports under risk factors, management's discussion and analysis and summary of significant accounting policies, which are often currently duplicative. Since the auditor's report will only appear in annual reports containing all these disclosures, adding critical audit matters to the auditor's report would be duplicative and unnecessary.

Third, requiring the auditor to report on the other information associated with the filing of the annual report for material inconsistencies and/or a material misstatements of fact results in perceived assurance on such information that the auditor cannot provide. PCAOB Standards require the auditor to compare such information to the audited financial statements, but there are significant additional disclosures in other information, including forward-looking information and information requiring technological, marketing and other skills not possessed by most auditors, that prevent the auditor from being able to reasonably assess whether they meet the Commission's requirements. Accordingly, an audit report that fails to identify any material inconsistencies and/or material misstatements of fact provides no assurance to the user of that other information that it is, in fact, free of misstatements.

Fourth, the proposed requirements for the auditor to report on other information are unclear as to the scope of assurance the auditor might be providing, and the proposed requirements, to the extent they deal with misstatements of fact, are beyond the professional competence of auditors.

## Auditor's Report

**Question Related to Section II Objectives:**

**1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**

The objectives of the proposed auditor reporting standard are appropriately set forth. However, the Committee believes additional clarity is required in order to implement the Board's proposal to communicate critical audit matters, as the definition is inherently subjective, and unlikely to be consistently applied in practice.

**Questions Related to Section IV Basic Elements:**

**2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

No. The report should be addressed to the Company's Board of Directors (the Audit Committee having responsibility to contract with the auditors) and the shareholders. Since the report is a publicly available document, the report does not need to be addressed to other possible users.

3. **The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

   No. The Board's proposed revision regarding describing the nature of the audit is sufficient.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

   No. The Board's proposal is somewhat redundant, since the title of the report already includes the word "independent", and the report goes on to state the audit was performed in accordance with PCAOB audit standards, which sets forth independence requirements.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

      No. We do not believe the information on auditor tenure is particularly useful, and serves only to satisfy idle curiosity. It is not clear what inferences can be correctly drawn from the length of an auditor's tenure, so the information is not considered useful.

   b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

      No, but the requirement should make clear that if the auditor of an acquired entity becomes the auditor of the acquirer, its tenure be measured from when it became auditor of the acquirer.

   c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

      No. We do not believe the information on auditor tenure is useful.

6. **The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

The Committee, in responding to the Concept Release, stated its opposition to the auditor providing any required assurance on other information. The Committee was concerned that any form of assurance provided to general users of the financial statements, either directly or indirectly, that the other information is complete or complies with applicable rules and regulations was likely to be misunderstood. The Committee continues to hold that view, in spite of the PCAOB's more modest current proposal, and finds the proposal's requirement to have the auditor address "misstatements" objectionable.

The Committee believes the PCAOB's proposed reporting requirement is beyond the professional competence of the auditor. Currently, the auditor is accountable for determining if there is an inconsistency between the financial statements and the other information, and reconciling them (AU 551). If requested to provide a report on the other information, the report would state that the other information "is fairly stated in all material respects in relation to the basic financial statements taken as a whole" (AU 552). The current PCAOB proposal goes a step further by requiring the auditor to state that there is no material misstatement of fact in the other information. This is a significant expansion of the auditor's responsibility, and is a far broader conclusion than can be drawn based on performing the procedures set forth in paragraph 4 on page A-2. In addition, the determination of the accuracy of the factual content of the other information is a legal matter, generally beyond the professional competence of the auditor. Further, a misstatement of fact may exist because the other information presented is wrong, or because relevant information is not presented; the auditor currently is not required to search for information that may be missing, and may not be competent to know that it is missing. Therefore, we recommend the current proposal, at a minimum; remove the requirement for the auditor to address whether the other information contains a material misstatement of fact.

"Other Information" should be limited to historical information included in or amounts derived from historical information included in the financial statements. In no circumstances should the auditor have any association with any prospective financial data.

The scope of assurance given by the auditor when saying they "have not identified any material inconsistency with the financial statements" is very unclear. There is no basis for the auditor to say that any individual amounts in the financial statements are correct, since the materiality threshold is the financial statements taken as a whole, and no other materiality threshold for the other information is set forth. Further, it is unlikely that any individual amount will, by itself, be materially inconsistent with the financial statements, so is the auditor's assurance based on a lack of a pattern of inconsistency that is in the aggregate material? While clarification might be desirable, this may be the essential flaw in the PCAOB's proposal for reporting on other information.

For the foregoing reasons, the Committee is opposed to the proposed requirement to report on other information.

7. **Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

   No. The Committee believes the current proposal, which provides flexibility in the presentation of the basic elements required in the auditor's report, is appropriate.

8. **What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

   No additional changes need to be considered.

9. **What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

   The Committee believes that audit costs will likely increase by at least ten percent or as high as twenty five percent or more as a result of reporting on critical audit matters and by a substantially greater amount if reporting on other information which contains a material misstatement of fact.

**Questions Related to Section V Critical Audit Matters:**

10. **Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

    No. The proposed content of the critical audit matters section of the auditor's report can be expected to duplicate all or most of the topics already covered in the "risk factors" section of periodic financial statements filed with the SEC along with the content of management's discussion and analysis and summary of significant policies. The information in these topics is already available to users of financial statements, and it does not significantly enhance the understanding of the financial statements. So, it is questionable whether the auditor's reporting of specified critical audit matters will add anything to the information already considered by the users of the financial statements and raises the additional question of whether the additional work to add critical audit matters to the auditor's report is cost-beneficial.

    It is also unclear whether adding critical audit matters to the auditor's report will be useful since the matters to which they relate will have been resolved before publication of the financial statements or will be explained in an exception in the auditor's report. The coverage of critical audit matters in the auditor's report can be expected to be brief and even cryptic; questions about critical audit matters from users can be expected to be addressed to management, who may be able to respond, but responses, particularly as to the content of the auditor's report, may be incomplete since the auditor's report is not prepared by the respondent. The auditor cannot be expected to respond beyond what is in the audit report. So, while the discussion of critical audit matters might be interesting to some users, its usefulness seems marginal at best.

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

The Committee sees several consequences, the first unintended, the second foreseeable and undesirable.

First, questions and comments from regulators concerning the auditor's determination of critical audit matters can be expected, perhaps with the benefit of hindsight, and these can be extremely burdensome, both to those charged with governance and to the auditors, particularly if regulators do not agree with the auditors and demand restatement of the auditor's report. Differences of professional opinion between auditors and regulators are not unusual. Client reaction is often to try to respond and satisfy the regulators, but if that process bogs down, to acquiesce to the regulators even if the regulators position is not correct. The cost of this additional regulatory involvement could significantly offset any perceived benefits of the discussion of critical audit matters.

Second, the Committee believes that critical audit matters can be expected to become a focus of the plaintiff's bar in asserting claims against auditors. The fact that something is considered "key" by the auditors in a public document raises the bar higher than it is right now where such information is found only in the audit workpapers and communication to those charged with the entity's governance. It may cause each key matter to assume a materiality of its own, outside of the context of materiality associated with the audit of the financial statements. The Committee believes this is a potential undesirable result.

In addition, and notwithstanding the use of the word "most," there is a danger that the number of critical audit matters could expand substantially beyond that apparently intended by the PCAOB. One only needs to look to the discussion of "risk factors" which has grown over time to a multi-page exposition of almost any adverse event that an issuer may encounter.

**12. (a) Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? (b) Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? (c) Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

The Committee believes that paragraph 8 of the proposed auditor reporting standard creates certain boundaries regarding the identification of critical audit matters as a matter that ordinarily would be included in the engagement completion memo, reviewed by the engagement quality reviewer and communicated to audit committee (or a combination of the three).

The PCAOB definition of critical audit matters focuses on various "difficulties" encountered in an audit. The actual level of difficulty can vary substantially based on the issue itself and the knowledge and experience of the auditor or the audit team, with those with less knowledge and experience likely encountering more difficulty and those with more knowledge and experience encountering no difficulty at all. The Committee recommends the Board set forth discussion of an additional factor which focuses on audit risk and significant modifications to the audit approach (indicative of audit difficulties); these are less subjective and likely would elicit more consistency in designating a matter as a critical audit matter.

In addition, the Committee believes it would be useful to resolve the inconsistency between the IAASB proposal on "key audit matters" and the PCAOB's factors, set forth in Paragraph 9, to consider in determining critical audit matters. The IAASB refers to significant audit risks, significant difficulty encountered in the audit or significant modifications in the audit approach. The PCAOB refers to matters which (1) involved the most difficult, subjective, or complex auditor judgments (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. The definitions differ, and are reasonably likely to elicit the identification of different issues, which will complicate compliance by those auditors who are required to comply with both audit standards.

13. **Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

The Committee believes the proposed new requirements will impact the quality of the audit and not all of the impacts will be positive. Auditors will have to spend time evaluating what matters to discuss and then carefully draft the discussion in the auditor's report. This process will undoubtedly involve the most senior level personnel on the audit team, technical departments and possibly in-house counsel. The concern for the litigation exposure resulting from not discussing a matter, or not being sufficiently robust in the discussions of matters will add significant time to the audit process and could complicate the timeline required to file timely. To allow for sufficient time for the drafting and review of the critical audit matters, the audit work process related to these matters will have to be completed earlier and probably under considerable time pressure. In general, such conditions do not result in the best audit work.

14. **Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

The Committee believes the proposed requirements are clear enough to be operational even though inherently subjective language is used throughout.

15. **Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

No. The Committee believes this is a wholly unrealistic suggestion. Including the audit procedures related to the specific critical audit matters within the auditor's report could be deemed by a reader to be a separate opinion on the identified critical audit matters, which is contrary to current PCAOB audit standards.

16. **Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

Yes, but as noted previously, they are inherently subjective.

**17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

Please see the Committee's response to Question 12. Both the IAASB and PCAOB proposed requirements are reasonably clear, but it would be useful if they were the same.

**18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

Yes.

**19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to-consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

The PCAOB should not establish any specific documentation requirements beyond requiring that audit documentation be adequate in the circumstances. The exercise of the auditor's professional judgment should determine what is needed.

**20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

Please see the Committee's response to questions 18 and 19.

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

The Committee believes that incremental audit costs to be paid by clients will be proportionate and directly related to the complexity of the audit. As the Committee noted in its response to Question 9, there will be additional time incurred by the audit team and then by every layer of review from above, plus consultation time with technical reviewers, national office personnel, in-house counsel, and discussions with management, audit committees and others charged with governance. The Committee believes the nature of the costs will be the same for all audits.

The Committee would expect that audit firms will also incur substantial one-time implementation costs of developing firm internal guidance, templates and training. In addition, audit firms will likely develop outreach programs to discuss the significant changes arising from the two new reporting standards for those charged with governance. These costs would be expected to be passed on to audit clients over time.

**22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

The Committee believes that indirect costs can be considerable, but will likely fall more heavily in most cases on management, who must deal directly with the auditor on the content of the auditor's report before it is presented to the audit committee. There may not be nearly as much incremental time for the audit committee, since they likely would be informed of all or most critical audit matters under the existing PCAOB audit requirements to communicate details related to the audit plan.

**23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

Please refer to the Committee's responses to Questions 9, 21 and 22 above.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

The Committee believes it is appropriate to communicate critical audit matters for all periods presented only if the audited financial statements have never been publicly available, or if they are being reissued because previously issued financial statements were no longer reliable. Critical audit matters can normally be expected to be largely the same from year to year, except for critical audit matters related to non-recurring transactions and changes in the business. Therefore, there is no need to be repetitive.

**25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

The Committee believes the examples are generally appropriate, as they illustrate what the PCAOB has in mind. However, all three of these illustrative matters would have been discussed by the client under risk factors and significant accounting policies and also likely in the MD&A section, so the inclusion as a critical audit matter will likely add nothing to the information available to investors. The Committee believes that investors are more interested in information than in the audit process used to form the final conclusion on the individual matters.

However, the Committee believes the wording in the auditor's report examples is far too lengthy. It needs to be reduced substantially if anyone expects users to read it. Bear in mind that financial statements are already being criticized as being so long that few people actually read them.

In example C, the results of audit procedures should not be included. The inference is that there were no other errors, and that should not be something that a reader might be led to infer.

26. **What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

The Committee believes that audit reports containing critical audit matters ought to be reasonably comparable within a specific industry. Of course, the exercise of professional judgment by the auditor in evaluating the critical audit matters for significance would have to be communicated in the report. The Committee believes these challenges are similar across all industries.

27. **What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

Many issues not currently subject to disclosure could be considered critical audit matters. For example, potential litigation, a fraud investigation (resolved satisfactorily), or confidential inquiries from government agencies. To expand the "disclosure" requirements, by shifting the burden to the auditor to identify and then disclose such information as a critical audit matter in the audit report, is unreasonable. Under the circumstances, the Committee believes the entity has the disclosure obligation, or there should be no disclosure. And, if there is already a disclosure obligation, then the critical audit matters add little or nothing to the information already available.

28. **(a) What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? (b) Would this communication lead to an unwarranted increase in private liability? (c) Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? (d) Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

The Committee presents the following responses to the specific questions:

(a) The expansion of the auditor's report to include both critical audit matters and other information is highly likely to expand the risk of the auditor being drawn into private litigation if a plaintiff were to attempt to claim the auditor did not go far enough in dealing with a specific critical audit matter.
(b) Yes, consistent with our response to (a) above.
(c) The Board's proposed expansion of the audit report, under the assumption that such information will meet the investors' need for information, has limitless negative consequences to the auditor's potential liability. There is no end to what an investor can argue should have been discussed as a critical audit matter, and that the auditor is liable for either not discussing it and/or coming to the wrong conclusion.
(d) Any steps the Board, or the SEC (possible safe harbor?), could take in considering ways to mitigate the likelihood of increasing the auditor's potential liability ought to be considered.

**Questions Related to Section VI Explanatory Language:**

**29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

The Committee believes it is appropriate for the Board to include this guidance.

**30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

The Committee recommends the Board provide the auditors with the continuing ability to emphasize a particular matter, such as a material subsequent event.

**31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

The Committee believes the examples included in paragraph 16. a-f of the proposed auditor reporting standard provide sufficient guidance, and no specific matters should be required to be emphasized.

**32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

Additional examples are not required to convey the Board's intent with regard to the matters the auditor might choose to emphasize.

**Questions Related to Section VII Conforming Amendments:**

**33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? (b) Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?**

(a) Yes
(b) No

**34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.**

Please refer to the Committee's responses to Questions 9, 21 and 22 above with regard to the overall economic costs of adopting the proposed auditor reporting standard.

**Questions Related to Section VIII Specific Entities:**

35. **Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?**

    The Committee believes the proposed auditor reporting standard should only be applied to brokers and dealers who are considered issuers as such companies have a reporting responsibility to stockholders and prospective investors. The Committee understands that most brokers and dealers are closely or privately held, and subject to specific operating rules and regulations so the proposed reporting standard would be unnecessary.

36. **Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?**

    See the Committee's response to question 35 above.

37. **Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?**

    See the Committee's response to question 35 above.

38. **Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?**

    The Committee believes the proposed auditor reporting standard should only be applied to investment companies who are considered issuers as such companies have a reporting responsibility to stockholders and prospective investors. The Committee understands that many investment companies are closely or privately held, and subject to specific operating rules and regulations so the proposed reporting standard would be unnecessary.

39. **Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?**

    The Committee believes the proposed auditor reporting standard should only be applied to benefit plans that are considered issuers as such companies have a reporting responsibility to stockholders and prospective investors. The Committee understands that most pension plans are closely or privately held, and subject to specific operating rules and regulations so the proposed reporting standard would be unnecessary.

40. **Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?**

    As stated in our responses to questions 35-39 above, the proposed additional reporting requirements should only be applied to companies that are considered issuers.

**Questions Related to Section X Effective Date:**

41. **Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

    The Committee believes the Board has provided sufficient time to apply the new standard.

42. **Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

    The Committee recommends the Board consider a delayed effective date for non-accelerated filers, and also consider soliciting feedback from the auditors and users of the initial group of accelerated filers who would initially apply the new auditor reporting standard.

## Other Information

The Committee is opposed to the proposed requirement that auditors report on other information as set forth in our response to Question 6 to the PCAOB's Auditor's Report section above.

**Questions Related to Section I Introduction:**

1. **(a) Is the scope of the proposed other information standard clear and appropriate? Why or why not? (b) Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

    (a) The Committee believes the scope of the other information standard is unclear. Much data, including that filed with the SEC, are made available on company websites, in some cases directly, in other cases by a link to the EDGAR database; it appears the former is not covered by the proposed standard, but the latter is; we question whether this makes any sense. And if the "glossy" annual report is partially incorporated by reference, readers will have difficulty sorting out what is covered and what is not; this seems to make little sense.

    (b) The Committee believes the proposed other information standard should be limited to annual reports.

2. **(a) Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? (b) Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

    (a) The Committee believes the proposed other information standard should be restricted to information that is expressly included in the document which includes the audited financial statements.

(b) The Committee believes there are substantial incremental costs associated with requiring the auditor to include other information incorporated by reference within the scope of the proposed other information standard, along with the practical difficulties of identifying such information, which may have changed since the date the auditor's report was issued.

3. **Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?**

The Committee believes that unless the cause of the amendment requires the auditor to update their audit report for information that impacts the amended financial statements, it is not appropriate to apply the proposed other information standard to amended annual reports. To do so would require the auditor to continuously update their audit report which would be unduly expensive.

4. **Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?**

The Committee believes the proposed requirement is unclear. If it means that audited financial statements furnished pursuant to Article 3 are considered "other information," the Committee disagrees with the requirement; audited financial statements should not be considered "other information". Further, reporting on those financial statements is the responsibility of the other entity's auditor; the company's auditor should have no responsibility for them. To require some responsibility would be a waste of time and money.

In addition, if the "other information" concerning the other entity is interspersed in the document with that of the registrant, identifying which auditor has responsibility for what information could be extremely problematic.

**Question Related to Section II Objectives:**

5. **Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?**

The Committee believes the stated objectives are helpful, but we disagree with the auditor being held responsible for evaluating whether the other information has a material misstatement of fact. Please refer to the Committee's response to Question 6 under the proposed auditor reporting standard.

**Questions Related to Section III Evaluating Other Information:**

6. **Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

   The Committee agrees with the proposed requirement to evaluate the other information for a material inconsistency with the financial statements, but we do not agree with evaluating it for a material misstatement of fact. Please refer to the Committee's response to Questions 6 under the proposed auditor reporting standard, and the Committee's response to Question 5 above.

7. **Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

   The Committee agrees that providing an auditor evaluation may convey greater confidence in the other information. However, the Committee is doubtful the reporting requirement will have any impact on the content of the other information. No additional procedures are necessary or appropriate.

8. **Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?**

   The Committee believes the appropriate standard of materiality to apply in the proposed other information standard is that currently stated in AU sec. 550. Auditors already consider the implications of the SEC's definition of materiality in evaluating the impact of any variances.

9. **Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

   The Committee believes the proposed procedures are appropriate for evaluating inconsistency with the financial statements, but they are not appropriate for evaluating any material misstatement of fact. There may be no link between audit evidence obtained and conclusions reached during the audit with the facts included in the other information, so the auditor would have no basis for the negative assurance proposed by the PCAOB. Arguably, since the fact is not within the scope of the evaluation, there is no assurance given, but a reader would then have no way of knowing what facts are subject to assurance and what facts are not.

10. **Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?**

    The requirements set forth in paragraph 4.d. appear clear. However, to the extent recalculation is based on "other audit evidence" a user will not know whether it has been recalculated because the user will not know the content of the "audit evidence."

**11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?**

If the auditors are required to deal with misstatements of fact in the manner proposed, they may feel forced to investigate the validity of facts not subject to audit evidence obtained and conclusions reached during the audit, and the cost of this could be substantial.

**12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?**

The Committee believes the proposed auditor responses under paragraph are appropriate.

**13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?**

The Committee believes the increased cost of implementing the proposed other information standard would be substantial. Also refer to the Committee's response to Question 11. above.

**Questions Related to Section IV Responding to Inconsistencies and Misstatements in Other Information**

**14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

The Committee believes the proposed auditor responses are appropriate.

**15. (a) Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? (b) Under what circumstances would such a report be appropriate or not appropriate?**

(a) The Committee believes such reports are appropriate in the circumstances, but hope the client and auditor resolve the issues prior to the report's issuance.
(b) Such a report would always be appropriate.

**16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

The Committee believes the proposed responses are appropriate, but this situation creates a real problem. The auditor has no responsibility to investigate what occurs after its report is issued, and it is possible that a client may publish the other information without clearing it with the auditor; this is not unlikely if non-financial personnel are preparing the other information and controls over its release are not followed. As the time between the release of the auditor's report and the availability of the other information increase, the likelihood of inconsistencies increases.

**Question Related to Section V Responding if there is a Misstatement of the Financial Statements Based on Other Information**

**17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?**

The Committee believes the proposed responses are appropriate.

**Questions Related to Section VI Reporting in the Auditor's Report:**

**18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?**

As pointed out in the Committee's response under Auditor's Reports Question 6, the scope of assurance given by the auditor when saying they "have not identified any material inconsistency with the financial statements" is very unclear. The committee does not have a recommendation on how to fix this. For this, among other reasons discussed elsewhere in this letter, the committee is opposed to the proposed requirement that auditors report on other information.

**19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

The Committee believes that if the auditor does not have relevant audit evidence against which to evaluate certain other information (which may be relatively frequent under the PCAOB's proposal), the auditor will need to say so in its report. However, such a statement, which may run to multiple pieces of information, is bound to create confusion to the reader, which is undesirable. This potential for confusion is yet one more reason that the Committee is opposed to the proposed requirement that auditors report on other information.

**20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

The Committee does not believe these costs will significant, and only marginally greater than incurred under the current reporting standards.

21. **Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

    The Committee believes there is a real danger that financial statement users will consider any information that the auditor refers to in its report to be "verified," "certified," "approved" or similar terminology, regardless of what the auditor actually says in its report.

22. **Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?**

    No, the presumption is reasonable that management will resolve the material inconsistency or material misstatement in the other information.

**Question Related to Section VII Responsibilities of a Predecessor Auditor:**

23. **Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?**

    The Committee believes the proposed responsibilities are appropriate and sufficiently clear.

**Questions Related to Section VIII Other Considerations:**

24. **(a) What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? (b) Would this reporting lead to an unwarranted increase in private liability? (c) Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

    The Committee presents the following responses to the specific questions:

    (a) The expansion of the auditor's report to include other information is likely to expand the risk of the auditor being drawn into private litigation, although perhaps to a lesser degree than the proposed reporting of critical audit matters. Nevertheless, there is some increased risk.
    (b) It could, consistent with our response to (a) above.
    (c) Any steps the Board, or the SEC (possible safe harbor?), could take in considering ways to mitigate the likelihood of increasing the auditor's potential liability under the proposed other information standard ought to be considered.

**25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?**

The Other Information reporting requirements are stated to apply only to annual reports in Exchange Act filings. However, many of those filings are incorporated by reference into Securities Act filings. It is unclear how Section 11 liability can be avoided in this situation.

We suggest that the PCAOB, possibly with the assistance of the commission's staff, carefully examine the potential effect on auditor's liabilities under the securities acts and state laws.

**Questions Related to Section IX Conforming Amendments:**

**26. (a) Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? (b) Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?**

(a) Yes
(b) No

**27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?**

The Committee believes the Board should require such statements in order to remove a possible ambiguity.

**Question Related to Section X Broker Dealers:**

**28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?**

No, unless the broker/dealer is publicly held.

**Questions Related to Section XI Effective Date:**

**29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?**

The Committee recommends the Board establish a tiered effective date for accelerated and non-accelerated filers similar to our response in Question 42 related to the proposed auditor reporting standard.

**30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

See the Committee's response to Question 29 above.

**Questions Related to Section XII Securities Act Documents:**

**31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?**

The Committee does not believe the application of the proposed other information standard should be extended to other securities act filings containing audited financial statements. For example, in an underwritten offering, the other information external to the financial statements is usually thoroughly vetted by the underwriter and further reporting by the auditor would not add any value.

**32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?**

The Committee does not believe the application of the proposed other information standard should be extended to other Securities Acts filings that do NOT contain audited financial statements, as the basis for reviewing such other information is the financial statements.

Further, the Committee believes the proposal should be limited to Exchange Act filings and does not believe any part of the proposal should be extended to any Securities Act filings.

**33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?**

As we stated in our responses to several questions above, the Board should limit the required other information standard to securities filings that contain the annual report and should not be extended to Securities Act filings.

## Emerging Growth Companies

**Questions:**

1. **Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?**

   The proposed standards and amendments should not be applied to EGC's until they are fully effective for accelerated and non-accelerated filers and they have been evaluated for effectiveness. Imposing these complex new reporting requirements on EGCs could make the capital raising process more difficult for them.

2. **Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?**

   No.

3. **Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?**

   No.

4. **Would audits of EGCs be more, less, or equally likely to have critical audit matters?**

   EGC's in a particular industry are no more or less likely to have critical audit matters than established companies.

5. **Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?**

   No.

6. **What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?**

   The Committee cannot distinguish between the cost of implementing the proposed auditor reporting standard or the proposed other information standard between EGCs and established companies. However, it is likely the costs could be higher due to dealing with a newly formed company's need to establish its significant accounting policies and procedures, and may be disproportionately higher because of the relatively smaller size of EGCs.

7. **What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?**

   See the response to Question 6 above.

8. **Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?**

   See the response to Question 6 above.

9. **Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?**

   See the response to Question 6 above.

10. **For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?**

    This would not have a significant cost impact for audit firms, as PCAOB audit firms have been maintaining two audit methodologies since the formation of the PCAOB in 2003 (referring to PCAOB audit standards for publicly held clients and AICPA audit standards for non-public clients).

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The Committee would be glad to discuss its comments further should the Board have any questions or require additional information.

Very truly yours,

Michael D Feinstein

Michael D. Feinstein, Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

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February 11, 2014

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

**VIA EMAIL: comments@pcaobus.org**

**Re: PCAOB Rulemaking Docket Matter No. 034 – Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Members of PCAOB:

This letter is sent to you on behalf of the California State Teachers' Retirement System (CalSTRS). CalSTRS is a public pension fund that was established for the benefit of California's public school teachers over 100 years ago. CalSTRS serves the investment and retirement interests of approximately 865,000 plan participants. As of January 31, 2014, the CalSTRS portfolio was valued at approximately $180 billion with about $100 billion of the fund's assets being invested in the public equity markets, on both a domestic and an international basis. With such a large part of our investment portfolio exposed to the risks of the public equity markets, CalSTRS is supportive of the work done by the Public Company Accounting Oversight Board (PCAOB) that helps to promote investor protection.

The work performed by a corporation's external auditor is an extremely valuable means through which shareholders receive reasonable assurance that the company's financial statements are fairly presented. CalSTRS believes it is critical that the information provided by the external auditor enhances investor's confidence in the financial statements. It is for this reason that we are writing to you today concerning the PCAOB's efforts at improving auditor communications with shareholders. In particular, we would like to comment on the proposed revised auditing standards identified as *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards (Proposal).*

We generally believe that the Proposal requiring the auditor to communicate critical audit matters (CAM) in the auditor's report is an improvement compared to the current auditor's reporting model that merely states a pass or fail opinion. CalSTRS believes investors and other users of the financial statements will benefit from improved meaningful disclosure in the auditor's report. However, we have some concerns regarding what issues might constitute CAM. The Proposal defines CAM as a matter that involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty to the auditor in obtaining sufficient appropriate evidence or posed the most difficulty to the auditor in forming an opinion on the financial statements. It appears the definition of CAM provides the auditors with significant latitude in determining what audit matters to communicate in the auditor's report. Instead of relying on the auditor's professional judgment in determining which CAM to report, we would suggest that the PCAOB consider providing more clarity and/or guidance in regards to what CAM to report, and in doing so, making the audit reporting process less subjective.

We think an alternative approach might include having the PCAOB establish a list of specific issues or topics for consideration as CAM for inclusion in the auditor's report. The list of potential audit issues or topics may include the following: areas involving significant estimates and judgments, an assessment of the management's critical accounting judgments and estimates; significant unusual or one-time transactions; non-routine issues communicated to the audit committee; and/or accounting policies and practices. Such a list would serve the purposes of being useful for investors in analyzing companies as well as being helpful for auditors in doing their jobs. CalSTRS believes that investors would find the list useful because they would be getting information deemed as a high concern or as a high risk area related to the company, and would be getting consistent information that allows comparability between companies. The auditors may find the list helpful because it removes some of the guesswork in determining what audit matters are deemed CAM. Thus, they may also be less inclined to purposely underreport or overload information in the auditor's report as they determine what to communicate.

To reiterate, we support improved meaningful disclosure in the auditor's report but suggest that the PCAOB offer further clarification or guidance regarding what specific CAM to communicate in the auditor's report. Without additional clarification, we are concerned that the Proposal may potentially result in voluminous disclosure that investors may not find useful, defeating the intended purpose of having the enhanced communication.

CalSTRS appreciates the opportunity to comment on the Proposal. If you have any questions please do not hesitate to contact me.

Sincerely,

Anne E. Sheehan

Anne Sheehan
Director of Corporate Governance

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December 11, 2013

Office of the Secretary, PCAOB
1666 K Street, NW
Washington, DC 2006-2803

**Re: Proposed Auditing Standards - PCAOB Release No. 2013-005**
**Rulemaking Docket Matter No. 034**

The Canadian Bankers Association[1] ("CBA") appreciates the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB") proposal for two new auditing standards, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, issued on August 13, 2013.

The CBA is an industry association representing 57 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada, including 5 domestic bank members that are publically listed foreign private issuers registered with the Securities and Exchange Commission ("SEC") with a combined market capitalization over $350 billion. The CBA advocates for effective public policies that contribute to a sound and successful banking system that benefits Canadians and Canada's economy. Our members are keenly interested in maintaining and improving the efficiency and effectiveness of the capital markets both domestically in Canada and in foreign jurisdictions where our members operate. We believe that the auditor, including the format of their report, plays a key role in this regard.

We are pleased that the PCAOB is looking to improve upon the current pass/fail model. However, we believe the changes as currently proposed may not achieve these objectives and may result in unintended consequences. Specifically, we are concerned about the inclusion of critical audit matters ("CAM") within the audit report.

Audit committee members are uniquely qualified to oversee and assess the quality of the auditor and the adequacy of financial statements and related disclosures on behalf of an organization's shareholders. They have access to both management and auditors in assisting their assessment of whether CAMs are appropriately resolved, reported and disclosed.

To facilitate more efficient capital allocation, lower the average cost of capital and reduce the risk premium associated with securities, sufficient context would need to be provided in the auditor's report. Investors that do not have the same access to management and the auditors may misinterpret the new disclosures. We do not believe that the level of detail that would have to be provided to achieve this objective is practical, both from a competitive and a legal liability perspective. Instead, we expect standard disclosure templates to develop over time.

[1] The Canadian Bankers Association works on behalf of 57 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 275,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

In an attempt to pursue this amicable objective, we anticipate significant increases in audit fees in response to the increased disclosure and additional audit effort required to evaluate other information covered by the auditor's report. These increased costs are anticipated to outweigh investors' short term benefits from additional disclosures.

Our specific comments are covered in more detail within the remainder of this letter.

**Expand the current pass/fail nature of the auditor's opinion to include a discussion of critical audit matters that would be specific to each audit**

We are not supportive of PCAOB's proposal to include a discussion of CAMs in the Auditor's Report. In our view, audit committees, which are made up of qualified individuals are elected by shareholders to represent their best interests, and are in the best position to assess whether CAMs are appropriately resolved, reported, and disclosed. Audit committees have access to both management and the auditors which enables them to have open and interactive discussions to fully understand and evaluate CAMs, and how they are addressed within the audit process. This is critical as the audit process is subjective in nature allowing for individual items and items in aggregate to be evaluated within the context of the entity, its business, and its internal control environment. CAMs must be reviewed and assessed in their totality, which is currently facilitated through audit committees.

The audit committee's function is supported by the PCAOB and other audit regulators, including the Canadian Public Accountability Board ("CPAB") by regulating required minimum communication matters by auditors to audit committees. These communications are monitored by the PCAOB, CPAB and other jurisdictional audit regulators through both audit firm reviews and file inspections. These processes assist audit committees in ensuring significant matters are discussed and evaluated.

Furthermore, we believe the information regarding disclosure of CAMs is available within the Critical Accounting Matters section of the Management Discussion and Analysis (MD&A) and the financial statement notes, including key risks of the organization and areas of significant areas of judgment including, for example:

- Special purpose entities;
- Fair value of financial instruments;
- Allowance for credit losses;
- Employee benefits;
- Goodwill and other intangibles;
- Securities impairment;
- Derecognition of financial instruments;
- Income taxes; and
- Provisions.

As a result, including the information within the auditor's report will result in additional repetitive disclosures.

The current model, supported by the provision of enhanced information by the PCAOB on audit firm reviews and file inspection results would have a more beneficial impact than updating the auditor's report with CAMs.

The PCAOB indicated in the release that the recommendations will result in more efficient capital allocation and will lower the average cost of capital for most companies, effectively reducing the risk premium investors require to invest in equities. There will need to be a delicate balance of information sharing, so as to not include proprietary client information, yet provide enough information to drive capital flow to/from the auditors' clients. From a preparer's perspective, disclosure to an outside party about the resolution of critical audit matters could result in the possibility of misinterpreting this information as there is no mechanism to enable outside users to have the same level of interactive discussions as is currently had by audit committees with their banks' independent auditors. This could have a significant impact on a

Bank, if for example an auditor included going concern as a critical audit matter which was not included in the audit reports for competitor banks. This could lead to a run on a bank, effectively eroding capital, causing a bank's failure. Since audit firms are expected to have the propensity to reduce their audit risk through increased disclosure; they are in direct conflict with the needs of preparers in certain scenarios. We expect that this will eventually lead to consistent disclosure within industry groups that pose reduced risk to audit firms. Accordingly, as time progresses, we expect any differentiation from a capital allocation and cost of capital perspective among their clients that may arise in the short run to disappear in the long run.

Expanding the matters that the auditor is required to report on will also increase an issuer's and its director's and officer's potential liability driven by the potential misinterpretation of the incremental disclosure by investors, as they have a civil liability for material misrepresentation or omissions in an issuer's annual report, including in relation to the context of expert reports.

The PCAOB proposal is similar to the International Auditing and Assurance Standards Board ("IAASB") proposal; however, some of the terms and definitions differ. For instance, the PCAOB asks for "critical audit matters" be disclosed, compared with "key audit matters" as defined by the IAASB. This could result in two different reporting models and divergent views in some instances with respect to what key matters are disclosed. This creates unnecessary complexity for both users and preparers operating in the global market and reduces comparability of financial statements across geographic regions. The PCAOB and the IAASB should consider converging the guidance to achieve a valuable global standard that all investors and prepares can adhere to and more easily interpret.

Although the information regarding critical audit matters is currently available, we believe there will be substantial costs, especially in the first year of implementation, stemming from drafting the report, oversight and review of the new report, increased validation over completeness, and accuracy of CAMs that are now not only subject to governance structures, but also public disclosure.

For the reasons noted above, we do not see incremental value in disclosing CAMs within the auditor's report, and instead see more value in continued transparency by audit committees who are responsible for the oversight of their auditors on behalf of shareholders.

**Inclusion of an auditor's statement relating to auditor independence within the Auditor's Report**

We are indifferent to this proposal, although we believe it is redundant, as the current auditor's report is labeled "Report of Independent Public Accounting Firm." In our view, investors are currently relying on audit committees to perform their fiduciary duty in assessing the qualification and independence of the auditors and the PCAOB to monitor firm's compliance with SEC and other jurisdiction's independence regulations.

**Inclusion of auditor's tenure within the report**

We anticipate investors would derive value from having information regarding auditor tenure; for example, when a change in auditor has occurred. In those instances, they may inquire of management what prompted the change (e.g., disagreement with management regarding an accounting treatment). Our preference would be to include the information within another public document as it has no impact on the auditors' opinion on the financial statements, and in particular if a statement of independence is included in the auditor's report.

**Auditor's evaluation of other information outside of the audited financial statements**

Auditors are experts in financial information and controls over financial reporting. We are concerned that expanding the scope of their responsibilities beyond financial information included in the MD&A and other documents will go beyond their current training and area of professional expertise. Currently, auditors review the MD&A and other information incorporated by reference pertaining to registration statements and prospectus filings. The focus of this review is on the financial statements, related tables, exhibits and disclosures. Any inconsistency would be investigated and corrected or reported on where appropriate.

We are supportive of clarifying this role within the auditor’s report without expanding their current responsibilities.

The proposed standard changes the auditor’s responsibility for the information presented outside the financial statements from “read” and “consider” to “read” and “evaluate” whether the other information included in documents containing audited financial statements is materially inconsistent with information appearing in the financial statements, or includes a material misstatement of fact. This change will require the auditor to obtain evidence, and as a result this will substantially increase procedures and costs. Given the additional information provided in annual reports envisioned to be covered (financial data, MD&A, exhibits, and other regulatory filings), we anticipate the costs would be significant and outweigh the benefit of these procedures. For banks in particular, there is significant disclosure regarding capital, and risk-weighted assets in the MD&A, some of which are not currently audited and would significantly increase audit costs if required to be audited. As there is no objective set of standards to which the auditors can evaluate the disclosure against, this will lead to a significant area of audit judgment. If the amount of work required to audit information not currently audited in the MD&A becomes too high, it may reduce the motivation for management to report the information in the first place.

In addition to the audit costs, we anticipate additional costs as a result of the increased liability for experts (including auditors) who have civil liability for material misrepresentations or omissions in an issuer's annual report. Expansion of the matters the auditor is required to report on and potential misinterpretation of the disclosure will increase the auditor’s potential liability. Issuers' audit costs will increase to compensate for this increased liability and/or work effort required to sufficiently mitigate their increased audit risk.

The minimal additional level of comfort to investors is not anticipated to outweigh the additional costs discussed above. As a result, we are not supportive of the proposal. As noted above, we do support clarifying the auditor’s role under current standards within the auditor’s report.

We would be pleased to discuss any questions you may have on our comments.

Sincerely,

CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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December 18, 2013

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

Dear Sir:

**PCAOB Rulemaking Docket Matter No. 34: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain documents Containing Audited Financial Statements and the Related Auditor's Report**

The Canadian Public Accountability Board (CPAB) is pleased to comment on the Public Company Accounting Oversight Board (PCAOB) *Proposed Rule on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the proposed standards). Investors and other financial statement users (Users) are calling for more transparency from the audit process and we commend the PCAOB for proposing amendments to their auditing standards that will require auditors to share more information, related to the audit, directly with Users.

CPAB is Canada's independent audit regulator and is responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into the application of auditing standards and how they might be improved.

We believe the introduction of the critical audit matters section in the auditor's report will enhance the relevance and usefulness of auditor communications with Users. Augmenting the historic pass/fail model of the auditor's report to include a discussion of the most difficult, subjective or complex audit matters should help Users better understand the significant entity specific professional judgments the auditor made in performing the audit.

Canada has adopted the International Standards on Auditing (ISAs) as Canadian Auditing Standards. We are encouraged by the similarity between the concept of critical audit matters and the International Auditing and Assurance Standards Board (IAASB) concept of "key audit matters". While we appreciate that the PCAOB's mandate is to develop auditing standards that are relevant to the U.S. public securities market we commend the Board for considering the IAASB project on auditor reporting in developing the proposed standards. Canada has the largest number of foreign public companies registered with the Securities and Exchange Commission (SEC). As Canadian securities regulators permit SEC registrants to have their audits conducted in accordance with PCAOB standards we strongly support the Board's working together to minimize differences in global auditor reporting standards to mitigate investor confusion.

For your information, we have attached a copy of CPAB's November 22, 2013 response to the IAASB on its Exposure Draft Reporting on Audited Financial Statements. This response provides our views on the IAASB's auditor reporting proposals.

We appreciate the opportunity to respond to the proposed standards, and would be pleased to discuss our comments with you at your request.

Yours very truly,

Brian Hunt, FCPA, FCA
Chief Executive Officer

CPAB
CCRC

CANADIAN PUBLIC ACCOUNTABILITY BOARD
CONSEIL CANADIEN SUR LA REDDITION DE COMPTES

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Tel 416.913.8260 Fax 416.850.9235 www.cpab–ccrc.ca

November 22, 2013

Technical Director
International Auditing and Assurance Standards Board
545 Fifth Avenue, 14th Floor
New York, NY 10017
USA

Dear Sir:

**Re: Exposure Draft – Reporting on Audited Financial Statements**

The Canadian Public Accountability Board (CPAB) is pleased to respond to the International Auditing and Assurance Standards Board's (IAASB's) Exposure Draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)* (the "ED"). CPAB is Canada's independent audit regulator responsible for overseeing firms that audit Canadian reporting issuers. Our mandate is to promote high quality independent auditing that contributes to public confidence in the integrity of reporting issuers' financial reporting. We accomplish our mandate by inspecting audit firms and audit working paper files which provides us with insights into the application of auditing standards and how they might be improved.

We support the need for more transparency with respect to auditor reporting. Auditors need to provide greater value by sharing more information, related to the audit, directly with financial statement users ("Users"). The requirement to disclose key audit matters in the audit report will focus the attention of auditors, management and those charged with governance on the areas of most significant risk which should enhance audit quality and contribute to improving the quality of management's financial statement disclosures, however, we are concerned that disclosure of key audit matters will become boilerplate adding little value to Users. Key audit matters need to be informative, relevant and entity-specific to be useful to Users. We encourage the IAASB to appropriately field test the disclosure of key audit matters prior to finalizing the exposure draft to ensure that the requirements and related application guidance mitigate the risk of boilerplate disclosure.

We commend the IAASB for continuing to give the auditor reporting project such high priority in its work program. Consistent with our response to the IAASB's Invitation to Comment on *Improving the Auditor's Report* (the "ITC"), it is important for bodies such as the IAASB, European Commission and United States Public Company Accounting Oversight Board ("PCAOB") to work together to devise one global solution to the perceived deficiencies in auditor reporting. Since many audit reports are read globally; a more coordinated approach will improve consistency and mitigate investor confusion. Greater divergence in auditor reporting is not in the public interest. We are encouraged by the similarity between the IAASB concept of "key audit matters" and the PCAOB concept of "critical audit matters" in its auditor reporting exposure draft. We strongly support the Board's working together to minimize differences in global auditor reporting standards.

**Key Audit Matters**

We believe the introduction of the key audit matters section in the auditor's report will enhance the usefulness of the report to Users provided there is consistent identification of these matters in practice. The degree of usefulness will be impacted by how specific the auditor is in describing the matter and why the auditor considered the matter to be one of most significance in the audit.

We support a principles based approach for identifying key audit matters but anticipate implementation issues with the requirements as proposed in the ED. Through our inspections we have noted that auditors struggle with the identification of significant risks as we see inconsistencies in the nature and number of risks being identified. While we agree that significant risks should be considered for reporting as key audit matters, more consistent identification of significant risks would be necessary if this reporting is to be useful to Users. Conceptually we agree with the other two criteria for determining key audit matters: areas in which the auditor encountered significant difficulty during the audit; and circumstances that required significant modification of the auditor's planned approach to the audit, including as a result of the identification of a significant deficiency in internal control. However, more guidance is needed in evaluating what constitutes "significant", and therefore reportable, as auditors can expect push-back from management to what is effectively public criticism of them.

The illustrative examples of key audit matters in the ED are an improvement over the example auditor commentary included in the ITC, however, the examples need to be more entity-specific to provide value added insights to Users. We thought the "Goodwill" example would be particularly useful to Users although an auditor would likely encounter significant resistance from management to the auditor's level of detail if the disclosure by management was not at the same level of detail. Similarly, Users would probably appreciate the discussion of the risk of fraud from side agreements in the "Revenue Recognition Related to Long-Term Contracts" matter but we are not sure that management and those charged with governance would agree it was a key audit matter that required disclosure if the auditor was ultimately unable to find evidence of the existence of side agreements as a result of the procedures performed. The IAASB should consider developing guidance for auditors, audit committees and management with respect to interactions on key audit matters to reduce the risk of unintended consequences for audit quality.

**Going Concern**

We are concerned the proposed auditor statements regarding both the appropriateness of management's use of the going concern assumption and whether material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern have been identified will increase, rather than decrease, the Users' expectation gap. While we understand why the global financial crisis has resulted in greater focus on the assessment of going concern and related disclosures we do not believe statements by the auditor based on the work effort of ISA 570, *Going Concern* will meet the needs of Users in that context.

The long standing issue with going concern is whether the disclosure of certain matters becomes a self-fulfilling prophecy - a risk that may be significantly higher for particular entities such as financial institutions. To address the lessons of the global financial crisis there may need to be different solutions for Systemically Important Financial Institutions ("SIFI") versus other commercial entities. Given the significance of SIFIs to the broader economy, CPAB would again encourage consideration of alternative approaches, such as improved communication between auditors and prudential regulators, as a more effective method of achieving the desired objective.

In our response to the ITC we supported the development of additional guidance for auditors, under ISA 570, with respect to the identification and response to material uncertainties as it is a complex and judgmental exercise and our inspections have evidenced that auditors struggle to respond appropriately. In our view the International Accounting Standards Board needs to provide more guidance on management's responsibilities for evaluating and disclosing going concern uncertainties which the auditor would then evaluate and assess as part of the audit under ISA 570.

We believe that if auditors are required by Users to report on the appropriateness of the going concern assumption then there would need to be a commensurate increase in the work effort under ISA 570 to support that reporting. We understand there may be political pressure for the IAASB to incorporate additional going concern disclosures into the audit report, however, we encourage a more holistic approach to addressing this complex issue.

**Format and Structure of the Standard Auditor's Report**

We support the need to improve the format and structure of the existing standard audit report and to do so in a manner that enhances consistency of reporting at the global level. In responding to the ITC we agreed with the IAASB that there is merit in mandating the ordering of the elements within the auditors' reports across jurisdictions, unless otherwise required by law or regulation. While it is not clear why country specific "cultural" preferences for the placement of certain elements within the audit opinion should prevail over the benefits of global consistency, we support the IAASB's position to require specific headings in the auditor's report to ensure the required reporting elements can be recognized even if they are presented in a different order.

**Involvement of Other Auditors**

We are disappointed that the IAASB has chosen not to pursue a requirement to disclose the extent of involvement of other auditors in the audit. As stated in our response to the ITC, we believe such disclosure would provide greater transparency to Users with respect to who, other than the group auditor, was involved in the audit and the extent of that involvement. In its own inspections, CPAB continues to identify issues with both the extent the group auditor has used the work performed by component auditors and the extent of involvement of the group auditor in the work of the component auditor. This is particularly important when these other participants are not registered firms or when there are legal or other regulatory barriers to them being inspected by an audit regulator. Without impacting the group auditor's sole responsibility for the audit, disclosure of the other participants would enable Users to determine the extent of use of component auditors by the group auditor and the degree of oversight the participants are subject to, including publicly available disciplinary history.

In concluding we again commend the IAASB for engaging with stakeholders on this important topic. In a continually changing global business environment, with increasingly complex financial reporting requirements, it is critical that auditor reporting evolves in a way that better meets the needs of financial statement Users and enhances the relevance and value of the audit.

In addition to our comments above, our responses to the questions posed in the ED are included in the Appendix to this letter.

We would be pleased to discuss further any of the above comments.

Yours very truly,

Brian Hunt, FCPA, FCA
Chief Executive Officer

cc. Mr. Mark Davies, CIA, FCPA, FCA
Chair, Auditing and Assurance Standards Board (Canada)

Mr. Greg Shields, CPA, CA
Director, Auditing and Assurance Standards
Chartered Professional Accountants of Canada

**APPENDIX**
**Questions**

Since CPAB's mandate relates to listed entities in Canada our comments apply solely to listed entities.

**Key Audit Matters**

1. **Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?**

   We believe the introduction of the key audit matters section in the auditor's report will enhance the usefulness of the report to Users provided there is consistent identification of these matters in practice. The degree of usefulness will be impacted by how specific the auditor is in describing the matter and why the auditor considered the matter to be one of most significance in the audit.

2. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?**

   We support a principles based approach for identifying key audit matters but anticipate implementation issues with the requirements as proposed in the ED. Through our inspections we have noted that auditors struggle with the identification of significant risks as we see inconsistencies in the nature and number of risks being identified. While we agree that significant risks should be considered for reporting as key audit matters, more consistent identification of significant risks would be necessary if this reporting is to be useful to Users. Conceptually we agree with the other two criteria for determining key audit matters: areas in which the auditor encountered significant difficulty during the audit; and circumstances that required significant modification of the auditor's planned approach to the audit, including as a result of the identification of a significant deficiency in internal control. However, more guidance is needed in evaluating what constitutes "significant", and therefore reportable, as auditors can expect push-back from management to what is effectively public criticism of them.

3. **Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?**

   Key audit matters need to be informative, relevant and entity-specific to be useful to Users. We encourage the IAASB to appropriately field test the disclosure of key audit matters prior to finalizing the exposure draft to ensure that the requirements and related application guidance mitigate the risk of boilerplate disclosure. In performing the field testing, specific consideration should be given to whether there is sufficient guidance with respect to the circumstances where the auditor considers it necessary to indicate findings or a conclusion in relation to a matter as we do not believe that those circumstances are clear in the ED.

4. **Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why? Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.**

   The illustrative examples of key audit matters in the ED are an improvement over the example auditor commentary included in the ITC, however, the examples need to be more entity-specific to provide value added insights to Users. We thought the "Goodwill" example would be particularly useful to Users although an auditor would likely encounter significant resistance from management to the auditor's level of detail if the disclosure by management was not at the same level of detail. Similarly, Users would probably appreciate the discussion of the risk of fraud from side agreements in the "Revenue Recognition Related to Long-Term Contracts" matter but we are not sure that management and those charged with governance would agree it was a key audit matter that required disclosure if the auditor was ultimately unable to find evidence of the existence of side agreements as a result of the procedures performed. The IAASB should consider developing guidance for auditors, audit committees and management with respect to interactions on key audit matters to reduce the risk of unintended consequences for audit quality.

5. **Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why? Are there other practical considerations that may affect the auditor's ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?**

   CPAB's mandate relates to listed entities in Canada and so our comments are intended to apply solely to listed entities.

6. **Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?**

   a. **If so, do respondents agree with the proposed requirements addressing such circumstances?**

   b. **If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?**

   To avoid boilerplate reporting, it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate. However, the statement that these circumstances are limited and expected to be rare should be incorporated into the requirements not the application guidance.

   We agree that the proposed requirements to respond to the rare circumstance when no key audit matters have been identified are appropriate.

7. **Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?**

   We agree that the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges outlined in the ED.

8. **Do respondents agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?**

   We agree with the retention of the concepts of Emphasis of Matter and Other Matter paragraphs. However, in the context of Canadian listed entities, if the proposed changes to going concern disclosure in the audit report are made, we expect the use of an Emphasis of Matter paragraph to be rare and the use of Other Matter paragraphs to be limited to those situations where the prior period financial statements have been audited by a predecessor auditor.

**Going Concern**

9. **Do respondents agree with the statements included in the illustrative auditor's reports relating to:**

   a. **The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?**

   b. **Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised)? In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.**

   We are concerned that the proposed auditor statements regarding both the appropriateness of management's use of the going concern assumption and whether material uncertainties related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern have been identified will increase, rather than decrease, the Users' expectation gap. While we understand why the global financial crisis has resulted in greater focus on the assessment of going concern and related disclosures we do not believe statements by the auditor based on the work effort of ISA 570, Going Concern will meet the needs of Users in that context.

   The long standing issue with going concern is whether the disclosure of certain matters becomes a self-fulfilling prophecy - a risk that may be significantly higher for particular entities such as financial institutions. To address the lessons of the global financial crisis there may need to be different solutions for Systemically Important Financial Institutions ("SIFI") versus other commercial entities. Given the significance of SIFIs to the broader economy, CPAB would again encourage consideration of alternative approaches, such as improved communication between auditors and prudential regulators, as a more effective method of achieving the desired objective.

In our response to the ITC we supported the development of additional guidance for auditors, under ISA 570, with respect to the identification and response to material uncertainties as it is a complex and judgmental exercise and our inspections have evidenced that auditors struggle to respond appropriately. In our view the International Accounting Standards Board needs to provide more guidance on management's responsibilities for evaluating and disclosing going concern uncertainties which the auditor would then evaluate and assess as part of the audit under ISA 570.

We believe that if auditors are required by Users to report on the appropriateness of the going concern assumption then there would need to be a commensurate increase in the work effort under ISA 570 to support that reporting. We understand there may be political pressure for the IAASB to incorporate additional going concern disclosures into the audit report, however, we encourage a more holistic approach to addressing this complex issue.

10. **What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?**

As noted in the response to question 9, we are concerned that the proposed statements with respect to going concern will increase rather than decrease, the Users' expectation gap. It is unlikely that an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern will mitigate this risk.

**Compliance with Independence and Other Relevant Ethical Requirements**

11. **What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?**

We believe there would be limited value to Users in disclosing the source of independence and other relevant ethical requirements and could create confusion if that disclosure involved multiple sources.

**Disclosure of the Name of the Engagement Partner**

12. **What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?**

We understand the basis for the proposals to require disclosure of the name of the engagement partner in the audit report. However, we would encourage a more holistic approach to better understand the root causes of lapses in audit quality in developing solutions to improve accountability for the audit. Greater focus needs to be given to the organizational structure of audit firms and how this can be improved to build greater quality into the execution of the audit. Consideration needs to be given to how accountability can be strengthened for audit firms at the engagement level, office level and national level. A more holistic approach should also consider the role of the audit committee and explore ways in which audit committees can more effectively oversee and evaluate the quality of the audit.

**Other Improvements to Proposed ISA 700 (Revised)**

13. **What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?**

    We are generally supportive of the proposed changes to ISA 700 described in paragraph 102 of the ED. However with respect to the description of the auditor's responsibilities, this should be retained within the auditor's report to ensure completeness and accessibility regardless of the technology available to the user. Therefore, we do not support the proposed option to allow a cross reference to a website but to improve the readability of the audit report and to emphasize entity specific information it would be acceptable for this standardized material to be in an appendix to the auditor's report.

14. **What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?**

    We support the need to improve the format and structure of the existing standard audit report and to do so in a manner that enhances consistency of reporting at the global level. In responding to the ITC we agreed with the IAASB that there is merit in mandating the ordering of the elements within the auditors' reports across jurisdictions, unless otherwise required by law or regulation. While it is not clear why country specific "cultural" preferences for the placement of certain elements within the audit opinion should prevail over the benefits of global consistency, we support the IAASB's position to require specific headings in the auditor's report to ensure the required reporting elements can be recognized even if they are presented in a different order.

CAPITAL GROUP℠

**Capital Group**
6455 Irvine Center Drive
Irvine, California 92618

Phone (949) 975-5000

***VIA ELECTRONIC DELIVERY***

December 9, 2013

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

**Re: PCAOB Release No. 2013-005, Rulemaking Docket Matter No. 34**

Dear Office of the Secretary:

Capital Group Companies, Inc. (“Capital”) is one of the oldest and largest global investment management firms in the nation. We appreciate the opportunity to provide comments on the Proposed Auditing Standards, *The Auditor’s Report on an Audit of Financial Statements*, and *The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor’s Report (herein referred to as “Proposed Standards”)*. These comments are informed by our experiences as preparers of audited financial statements of Capital and its affiliated companies as well as the American Funds. These comments reflect our own views and not necessarily those of Capital or other Capital associates.

We support the Public Company Accounting Oversight Board’s (the “Board”) continued efforts to increase the informational value, relevance and usefulness of the auditor’s report to investors and financial statement users. However, we believe that certain key aspects of the Proposed Standards will not achieve this objective.

**Critical Audit Matters**

The objective of an audit is to provide an opinion on the financial statements. Consistent with this objective, we support the Board's endorsement of the existing "pass/fail" model for the auditor's report as it clearly and concisely conveys the auditor's opinion regarding whether the financial statements are fairly presented. However, we are concerned that the inclusion of one or more critical audit matters ("CAMs") would not be additive to the financial statement users' understanding and obscure the actual pass/fail conclusion.

The Proposed Standard indicates "it is expected that, in most audits, the auditor would determine that there are critical audit matters". With this statement, there is an expectation created that auditors would include more rather than fewer CAMs in their audit reports. We are concerned financial statement users may misinterpret the communication of multiple CAMs as indication of an issue with the quality of the financial statements, particularly for certain entities like investment companies, which may have few or even no CAMs due to their unique characteristics.

For example, investments generally make up substantially all of an investment company's assets; and an auditor is currently required to verify the existence (shares/par) and valuation of all investments. Income and realized/unrealized gain/loss are derived from these investments; and expenses, which generally represent a small percentage of assets, are primarily based on contractual obligations. In certain cases, management estimates related to fair valuation may be required, and thus, will likely be deemed a CAM. However, investment companies already include extensive disclosure in their offering memorandums/ prospectus and financial statement footnotes related to fair valuation (pursuant to ASC 820, *Fair Value Measurements and Disclosures*). These disclosures provide financial statement users with a high degree of insight and transparency to the entity's fair valuation methodology. The addition of a CAM related to fair valuation would be duplicative of the critical accounting policies already disclosed in the notes to the financial statement, and therefore not additive to the financial statement users' understanding. We also believe that there is a risk that such disclosure in the auditor's report would over time become "boiler plate" for similar issuers in the same industry and thus be of limited value to financial statement users. Accordingly, we believe there should be a presumption that the auditor's report for most investment companies would not include disclosure of CAMs.

Additionally, as noted in our September 30, 2011 comment letter on the Concept Release related to Reports on Audited Financial Statements (Release No. 2011-003), we believe there is value in the contextual discussion that takes place between the auditors, management and the audit committee that cannot be effectively disclosed in the auditor's report. Audit committee members have the opportunity to question and clarify their understanding through interaction and discussion with the auditor and management. Attempting to capture this discussion and provide the right context within the auditor's report, without providing the opportunity for the further clarification, reduces the value of the disclosure and may lead to erroneous conclusions on the part of the financial statement user.

Lastly, we are concerned that the time and effort devoted to fulfilling the Board's proposed requirements would divert and distract valuable resources of audit firms, management, and audit committees away from the core deliverables of the audit. The inclusion of CAMs in the auditor's report will introduce a high degree of judgment and subjectivity regarding which CAMs to disclose as well as the exact language used to describe the CAM. To provide the necessary level of context surrounding each CAM, the auditor's report would need to be customized for the specific circumstances of each audit and likely require expansive details and multiple pages of disclosure. As a result, significant resources would be spent reviewing and discussing the exact language of the CAM rather than focusing on procedures that truly add value to the audit, or in the case of management, substantive oversight of controls and financial reporting.

The proposal to include CAMs in the auditor's report is expected to benefit the end user and is not designed to have any impact on audit quality. Based on the above points, we do not expect users to experience this benefit, and as such do not support the inclusion of CAMs in the auditor's report.

**Reporting on Other Information**

Under existing PCAOB standards, the auditor has the responsibility to "read and consider" the other information for material inconsistency against the audited financial statements. Whereas, under the Proposed Standard, the auditor is required to "read and evaluate" the other information and communicate, in the auditor's report, the auditor's responsibilities and results of its evaluation of the other information. We are concerned the Proposed

Standard would significantly add to the auditor's responsibilities by introducing additional required audit procedures to support the auditor's evaluation and conclusion of the other information. These additional audit procedures will likely add to the cost of an audit. In summary, we are not opposed to including a description in the auditor's report that clarifies the auditor's responsibility for the other information. However, we do not support changing the auditor's responsibility regarding the other information and believe existing requirements in AU Section 550 to "read and consider" the other information are sufficient.

* * * * *

Thank you for considering these comments. Please feel free to contact any of us should you have any questions or wish to discuss our thoughts on the Proposed Standards.

Sincerely,

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December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Dear Ms. Brown:

I write to comment on PCAOB Release No. 2013-005 related to the auditor's report on financial statements when the auditor expresses an unqualified opinion. Although I am a member of the PCAOB's Investor Advisory Group (IAG), and although I will refer to the work of a sub-group of the IAG, I am writing this letter in my individual capacity as a professor of accounting, auditing, and corporate governance, and as a personal investor. I currently serve as the EY and Business Alumni professor of accounting at the University of Tennessee, where I also serve as the Executive Director of UT's Corporate Governance Center.

In evaluating the need for change to the standard audit report, I encourage the Board to evaluate the current audit report against the Board's mission – "... protect the interests of investors and further the public interest in the preparation of *informative, accurate and independent audit reports*" (emphasis added). Based on a number of surveys of investors and other financial statement users by the IAG, the Council of Institutional Investors, and the CFA Institute, among others, investors and other users clearly do not view the audit report as informative beyond simply indicating that in the auditor's opinion the financial statements are fairly presented in accordance with GAAP. Although opining on GAAP compliance is valuable, the PCAOB has a once in a generation opportunity to substantively reform the audit report so that meaningful, substantive communication occurs between the auditor and the auditor's ultimate client, investors and other users.

Before commenting on the strengths and areas needing improvement in the PCAOB's proposed auditor reporting standard, I refer the Board back to the comment letter of a sub-set of the IAG on PCAOB Release No. 2011-003 (letter dated 9-29-11). That letter describes the work of an IAG working group on the auditor's report, including reporting the results of a survey distributed to a number of institutional investors. As a result of our work, a majority of the IAG indicated that changes to the standard audit report should:

- Discuss the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment.
- Disclose areas of high financial statement and audit risk and how the auditor addressed these risk areas.
- Discuss unusual transactions, restatements, and other significant changes in the financial statements (including the notes).
- Discuss the quality, not just the acceptability, of the issuer's accounting practices and policies.

My evaluation of the PCAOB's proposed auditor reporting standard is tied to how closely the proposed standard is responsive to the above four recommendations.

In my view, the auditor's proposed auditor reporting standard is clearly an improvement over the existing report as originally promulgated in SAS No. 58. However, although the proposed standard represents an improvement, it fails to provide some of the most critical information needed by investors. Therefore, any weakening of the proposed standard in response to organized opposition by entrenched interests would likely result in a final standard that is so milquetoast that it would have been better for the PCAOB to not have pursued this project.

The heart of the PCAOB's proposed standard would require the communication of critical audit matters (CAM), with the expectation that these CAMs are customized to each audit – i.e., they should differ by company, and by year even for the same company. Avoiding boilerplate in reporting CAMs is imperative – this point simply cannot be overstated.

The proposed standard defines a CAM as a matter: (1) involving the auditor's most difficult, subjective, or complex judgments; (2) that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and (3) that posed the most difficulty to the auditor in forming an opinion on the financial statements. In my view, these areas almost certainly would involve areas of high financial statement and audit risk and, therefore, the inclusion of a CAM is responsive to the one of the four areas identified by the IAG for inclusion in the audit report. Although more subtle, I believe that the CAM criteria would generally require the audit report to discuss unusual transactions, restatements, and other significant changes to the financial statements. If the Board agrees with my evaluation, the inclusion of a CAM is responsive to a second of the four areas identified by the IAG for inclusion in the audit report.

Unfortunately, it is not clear to me that the proposed auditor reporting standard is responsive to the other two suggested changes made by the IAG. First, and most importantly, the proposed standard does not appear to require the auditor to discuss the estimates and judgments made by management. The auditor's evaluation of management's estimates and judgments was the most important piece of information desired by investors. If the Board believes that this information will be included in the audit report as a result of its proposed standard, it would be helpful for the Board to be more specific as to its expectation for the auditor to discuss management's estimates and judgments. Moreover, simply stating that a judgmental area (e.g., allowance for loan losses, fair value, impairments, etc.) represents a CAM is not what investors are seeking. In most instances, a knowledgeable financial statement reader would already know that these areas are critical to the audit. Investors need to know more about areas involving significant estimates and judgments. For example, investors would benefit from knowing:

- The auditor's evaluation of the process used by management in developing the estimate and, with the benefit of retrospective evaluation, the mapping of prior year estimates into subsequent year realizations.
- The auditor's evaluation of whether management's estimate is conservative, aggressive, or "down the fairway" with respect to its effect on current year income.
- The auditor's evaluation of whether a pattern exists across estimates and judgments – for example, are these estimates and judgments consistently conservative or aggressive (again with respect to current year income).

The Board can modify its proposed standard to provide the needed information relatively easily. The CAM for example #1 (the allowance for sales returns) in the proposed standard (p. A5-68) provides no information that would enable investors to assess the aggressiveness or conservatism of the allowance for sales returns, but the auditor would have a sense of how aggressive or conservative the Company's process is related to sales returns and could communicate such information to investors in the CAM. For example, the auditor could compare the allowance at 10-31 (end of the third quarter) to sales returns during the fourth quarter. Moreover, since the Company's credit terms are 120 days, any returns that relate to sales made before October 31$^{st}$ should have occurred before February 28$^{th}$ of the next year. Since the year-end date is January 31$^{st}$, the audit report would, in most cases, not have been issued by February 28$^{th}$. This type of information, through the eyes of the auditor, is what investors need, and the type of information that would spur capital formation and economic efficiency.

Finally, although investors are interested in the auditor's evaluation of the quality, and not just the acceptability, of the company's accounting policies and practices, it is not clear to me that the proposed standard would result in the auditor providing this information.

Although of less importance to the issues raised above, my other concerns with the proposed auditor reporting standard are as follows:

- The audit report should indicate, consistent with professional standards, that a reasonable level of assurance represents a high, although not absolute, level of assurance.
- The proposal would permit the auditor to state that there are no CAMs. This does not strike me as possible. It seems unlikely to me that an audit would involve no difficult, subjective, or complex auditor judgments, and that no such issues would be documented in the engagement completion document.
- As discussed by PCAOB member Steve Harris in his public comments at the Board's open meeting on August 13, 2013, the proposal appears to allow the auditor to not report a

CAM, even if the item meets the definition of a CAM, as long as the rationale for the auditor's decision is documented in the work papers. Although there may be valid reasons for not disclosing a CAM in some very limited situations (i.e., potentially due to litigation concerns or competitive business situations), the Board should more narrowly define the acceptable use of this exception.

- The proposed standard would modify paragraph #10 of AS #7 by indicating that the engagement quality reviewer (EQR) *should* (my emphasis) evaluate whether appropriate CAMs are communicated in the audit report. It seems to me that the EQR *must* or *shall* be required to do so.
- I agree that requiring the audit report to be addressed to investors is a small, but potentially significant, change, as the requirement has the potential to remind auditors who the ultimate beneficiary of the audit is intended to be.
- I agree with the Board that a significant benefit of requiring the disclosure of CAMs is that such a disclosure requirement is likely to both improve management's disclosures with respect to these items and lead to greater audit effort and focus there as well.

I close with the following observation. As of the date of my letter, there have been approximately 47 comment letters posted to the Board's web site. A number of these letters are from issuers or from audit committee members of issuers. Almost without exception, these letters oppose the inclusion of CAMs in the audit report. (As an aside, comment letters from two large institutions, BlackRock and Standard and Poor's largely support the Board's proposal, and the comment letters from individual investors also support the Board's proposal.) It is worth highlighting that issuers use shareholder monies to hire personnel who write comment letters opposing reforms that institutional investors, the majority owners of most of these companies, are seeking. Given that most investors have neither the time nor the resources to match the comment letters that will be forthcoming from the issuer community and its acolytes, I attach Exhibit A which captures the views of many institutional investors as to the need for a significantly revised audit report. Quotes appearing in Exhibit A are derived from the transcript of the PCAOB-sponsored roundtable on the auditor's reporting model held on September 8, 2011.

I compliment the Board and Marty Baumann and his staff for undertaking such a contentious, but vitally important, issue as the audit report. I believe that this topic is the single most important issue on the PCAOB's agenda. Thank you for giving me the opportunity to express my views.

Sincerely,

Joseph V. Carcello

Joseph V. Carcello
EY and Business Alumni Professor
Executive Director – Corporate Governance Center

**Exhibit A – Comments from Investors on Needed Changes to the Standard Auditor's Report**

PCAOB Roundtable – Auditor's Reporting Model – September 8, 2011

"I believe an AD&A should include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. Such disclosure was supported by 86 percent of the respondents to a 2011 CFA survey and 79 percent of the respondents to the IAG survey." (Ann Yerger, Executive Director, Council of Institutional Investors, p. 22)

"I strongly believe the additional information should come from the audit firms and not management or audit committees. Audit firms are objective, third-party experts that have unique insights into companies, and it is appropriate and beneficial for the investing public to receive more information directly from these unbiased experts." (Ann Yerger, Executive Director, Council of Institutional Investors, p. 24)

"When I think about coming back to the unqualified opinion, I think about accounting due diligence reports that I've seen where, let's say, an investor would hire an auditing or accounting firm to render some form of opinion on a company's financial profile. And those reports are generally rich in information, and they provide a lot of value, whereas the audit for public and private companies opinion does not." (Mark Newsome, Managing Director, ING Capital LLC, pp. 51, 52).

"We would not object to the identification in AD&A of those areas which were – where there is significant management or auditor judgment or significant uncertainty, given their complexity and, as part of that, the attendant disclosure of some of the key inputs upon which the auditor relied. And again, part of the thesis that we believe, which is based upon the need for management to make original disclosures, we believe that will in part force management to enhance their disclosure and their financial statements, as opposed to having the auditor talk about their key inputs." (Steven Buller, Managing Director, BlackRock, p. 58).

"And I promise you and the audit firms that are represented here that the additional information you will provide will not confuse me." (Flerida Rivera-Alsing, Chief Audit Executive, Florida State Board of Administration, p. 82).

"It's probably not a mandate or specific role of the PCAOB, but we think it's important, and that's strengthening the hand of the auditors. The mere fact that there's more to say than pass or fail, we think, would give – and there was broad consensus on this – we think would give the auditors a stronger hand. They would win more arguments, and we think that would be a good thing. And that could be a good thing even if they didn't say anything at all in the emphasis paragraphs. Simply the ability to say something there as an additional tool." (Paul Haaga, Jr., Chairman of the Board, Capital Research and Management Co., pp. 86, 87).

"When you were looking at second quarter numbers for several European banks recently, you saw wildly different outcomes for the numbers that were being reported related to losses on holdings in Greek sovereign paper, just wildly different. Having auditor insight into how those ranges of potential outcome were evaluated and where, to use a golf analogy, a firm was hitting the ball in that fairway of acceptable outcomes and how the conclusion was supported and was okay I think could be just incredibly valuable to investors as they look at the numbers and think about how we want to adjust or how we want to view the numbers differently in our analysis." (Mark LaMonte, Managing Director, Chief Credit Officer – Financial Institutions Group, Moody's Investor Service, pp. 101, 102).

"And it's very important to get a better understanding of some of the judgments and assumptions that are made and how the auditors basically – especially for some of the big issuers, how the auditors got themselves comfortable with that." (Stephen Kozeracki, Principal, Co-Head of the Corporate Bond Group, The Vanguard Group, pp. 115, 116).

"So we're talking about who should be giving more information, what the information should be, and where that information should reside. And overwhelmingly, we hear from our investor members that they want to hear it from the auditor, that it needs to be from the independent expert, that, that is important, that they want to have information that's informative." (Kurt Schact, Managing Director, CFA Institute, p. 232).

PCAOB Rulemaking Docket Matter No. 034, PCAOB Release No. 2013-005, August 13th, 2013_Comments Due Back Dec. 11th, 2013

Dear Folks:

Good morning and hope all is well within your respective time zones…

Please Note: We appreciate this opportunity to submit our comments in this critical area of the American Way of Conducting Business…

Also, any stupid errors, omissions and mistakes are not my fault….it's our DNA…..therefore, it's not my fault….

Respectfully yours,

Pw Carey

Page: 43......Define each of these terms...and what constitutes an example of same, serving as a baselne via a Best Practices Business Use Case....

Also, align this proposal with Docket No. 029...(aka: Auditors name and location of all those who actually conducted the audit (what percentage)...not just the name of the Final Report signing authority......

Page: 45 - Provide baseline best practices examples of same and/or Business Use Cases of each....

Page: 46 - Identify which accounting methodology/standard was used by the entity and include a brief three sentece descriptive definition of same....

Page: 47 - Specifically address whether there were or were not flags, triggers, outliers that would indicate to a reasonable individual that a potential and/or real-time fraud exists based upon the entities; people, processes, and technology in-place at this point-in-time of the finding....

Page: A3-16 - AU sec. 341, The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern....... Since the expectation placed upon the Auditor to forecast the future is a bit much, let's just provide them with the following template: "...To whom it may concern, at this point in time there are three forecasts available to me, although we are not qualified what so ever, by knowledge, background nor experience to conduct such a forecast, we offer up the following.....at this point in time they may have a chance, they may not have a chance or we don't known if they have a chance, based upon current and real-time Big Data analytics...extrapolated over multiple time lines and strategies..."

Page: 118 - Provide a Business Use Case to expand the interpretation and understanding of what a 'Critical Audit Matter' represents at this point in time....

Page:121 - Provide a Financial Statement checklist of outliers that indicate inconsistencies...or as Herbie the cockroach once said to his brother..."...You know Murphy, there's always more than one gestault in the kitchen...."

Page: 137 - Identify the entity being audited and their associated 3rd parties, the underlying systems and technology the Auditor is relying upon...including Cloud/Big Data Eco-systems and how their data is controlled for CIA (Confidentility, Integrity & Availability) and GRC (Governance, Risk & Compliance) issues and where their data is geo-located, identifying any and all 3rd parties involved with these controls by name, location and length of service....

Page: 149 - Define via Business Use Cases the tipping point(s) for either a 'pass' or a 'fail' grade...feel free to use percentages as you all see fit....

Page: 178 - Tenure can be used for good or not...however, the length of tenure often (actually quite often, as in always) drips down into the murky swamps of 'human nature'....where the longer the relationship...it becomes human nature to side with those you've worked with for a long period of time...and with and/or without conscious effort...make allowances for less than good behavior or even bad behavior..as in..."...they meant to do the right thing...they just didn't getter-done..." eg. the recent death of the oldest living animal ever discovered by scientists...as they opened it up to determine its age...a clam.....Also, who are the Auditors working for....; management, the company, the employees, or oh my guad....the real and/or perspective shareholders, pension funds for teachers, police, et al....and even hedge funds....? Editor comment provided by Pw Carey....Respectfully yours, Pw Carey

Page: 186 - Provide the auditors with the tools, guidelines and expected (baseline/minimum) best practices and follow along training via the Internet..that requires them to maintain their skills, improve their skills and thereby reduce the amount of time required to conduct an accurate, correct, independent and fair audit....Pw

Remove the most difficult, subjective, and/or complex open to interpretation topics...via Business Use Cases, guidelines, definitions and expected best practices and best strategies in the real world at this point in time.....Pw

Page: 197 - Do not delete...just reverse the order...emphasize the auditor's requirement to regularly (aka: monthly) communicate to the audit committee the on-going status of their audit and any speedbumps and/or roadblocks they've encountered in their daily efforts to conduct the audit...and identify the speedbumps by name, description and role/job title and functionality....

Page: 206 - C. Employee Stock Purchase, Savngs, and Similar Plans....should be viewed through the lens of 'Back Dating' schemes, insider trading activity and strategies, major sales and/or purchases by C-Suites...et al...Pw

Page: 208 - IX. Considerations Related to Effective....offer a pilot program for both parties at the table..and after six months of active participation, evaluate and modify the findings into a new and improved proposal...based upon the results of this pilot program...What a Great Idea Pw....yeah, but it wasn't mine alone, as are most great ideas....Respectfully yours, Pw

Page: 209 - Please See attached example of a Business Use Case here.....

Page: 210 - Note 1: Accounting Policies....Revenue Recognition...what a wonderful opportunity for fraud..eg., packing the pipe line....where product is shipped in one quarter...warehoused by the customer..then returned to the Mfg., but it's all counted as revenue...leading to a great quarter in sales and revenue...just to make the numbers look good for perspective buyer or a lazy Auditor....neat, eh?....

Page: 237 - Provide a Business Use Case example of what is at a minimum demonstrates an Auditor's Responsibility to Evaluate..otherwise human nature kicks in and less than diligent/determined-to-understand and communicate this understanding in a reasoned and understandable format will not occur...ever, well maybe not ever, but pretty more often than not....so, the Auditor should know the players, know the industry, know their competitors, markets, and what's going on in all aspects within an organization...including the good, the bad and the indifferent.....Pw

Page: A7-21......The answer to each of these questions are ..... Yes...to protect the shareholders......interests, first, last and always.....How much does a business model and/or strategy of Fraud cost...?Respectfully yours, Pw Carey

# Pw's_Current Draft, Ver. 0.1_Aug. 25Th, 2013: NBD (NIST Big Data) Finance Industries (FI) Taxonomy/Requirements WG Use Case

| | |
|---|---|
| **Use Case Title** | This use case represents one approach to implementing a BD (Big Data) strategy, within a Cloud Eco-System, for FI (Financial Industries) transacting business within the United States. |
| **Vertical (area)** | The following lines of business (LOB) include:<br>**Banking**, including: Commercial, Retail, Credit Cards, Consumer Finance, Corporate Banking, Transaction Banking, Trade Finance, and Global Payments.<br>**Securities & Investments**, such as; Retail Brokerage, Private Banking/Wealth Management, Institutional Brokerages, Investment Banking, Trust Banking, Asset Management, Custody & Clearing Services<br>**Insurance**, including; Personal and Group Life, Personal and Group Property/Casualty, Fixed & Variable Annuities, and Other Investments<br><br>**Please Note:** Any Public/Private entity, providing financial services within the regulatory and jurisdictional risk and compliance purview of the United States, are required to satisfy a complex multilayer number of regulatory GRC/CIA (Governance, Risk & Compliance/Confidentiality, Integrity & Availability) requirements, as overseen by various jurisdictions and agencies, including; Fed., State, Local and cross-border. |
| **Author/Company/Email** | Pw Carey, Compliance Partners, LLC, pwc.pwcarey@email.com |
| **Actors/Stakeholders and their roles and responsibilities** | Regulatory and advisory organizations and agencies including the; SEC (Securities & Exchange Commission), FDIC (Federal Deposit Insurance Corporation), CFTC (Commodity Futures Trading Commission), US Treasury, PCAOB (Public Corporation Accounting & Oversight Board), COSO, CobiT, reporting supply chains & stakeholders, investment community, share holders, pension funds, executive management, data custodians, and employees.<br><br>At each level of a financial services organization, an inter-related and inter-dependent mix of duties, obligations and responsibilities are in-place, which are directly responsible for the performance, preparation and transmittal of financial data, thereby satisfying both the regulatory GRC (Governance, Risk & Compliance) and CIA (Confidentiality, Integrity & Availability) of their organizations financial data. This same information is directly tied to the continuing reputation, trust and survivability of an organization's business. |
| **Goals** | The following represents one approach to developing a workable BD/FI strategy within the financial services industry. Prior to initiation and switch-over, an organization must perform the following baseline methodology for utilizing BD/FI within a Cloud Eco-system for both public and private financial entities offering financial services within the regulatory confines of the United States; Federal, State, Local and/or cross-border such as the UK, EU and China.<br><br>Each financial services organization must approach the following disciplines supporting their BD/FI initiative, with an understanding and appreciation for the impact each of the following four overlaying and inter-dependent forces will play in a workable implementation.<br><br>These four areas are:<br>1. People (resources),<br>2. Processes (time/cost/ROI),<br>3. Technology (various operating systems, platforms and footprints) |

| | |
|---|---|
| | and<br>4. Regulatory Governance (subject to various and multiple regulatory agencies).<br><br>In addition, these four areas must work through the process of being; identified, analyzed, evaluated, addressed, tested, and reviewed in preparation for attending to the following implementation phases:<br>1. Project Initiation and Management Buy-in<br>2. Risk Evaluations & Controls<br>3. Business Impact Analysis<br>4. Design, Development & Testing of the Business Continuity Strategies<br>5. Emergency Response & Operations (aka; Disaster Recovery)<br>6. Developing & Implementing Business Continuity Plans<br>7. Awareness & Training Programs<br>8. Maintaining & Exercising Business Continuity, (aka: Maintaining Regulatory Currency)<br><br>Please Note: Whenever appropriate, these eight areas should be tailored and modified to fit the requirements of each organizations unique and specific corporate culture and line of financial services. |
| **Use Case Description** | Big Data as developed by Google was intended to serve as an Internet Web site indexing tool to help them sort, shuffle, categorize and label the Internet. At the outset, it was not viewed as a replacement for legacy IT data infrastructures. With the spin-off development within OpenGroup and Hadoop, BigData has evolved into a robust data analysis and storage tool that is still undergoing development. However, in the end, BigData is still being developed as an adjunct to the current IT client/server/big iron data warehouse architectures which is better at somethings, than these same data warehouse environments, but not others.<br><br>Currently within FI, BD/Hadoop is used for fraud detection, risk analysis and assessments as well as improving the organizations knowledge and understanding of the customers via a strategy known as....'know your customer', pretty clever, eh?<br><br>However, this strategy still must following a well thought out taxonomy, that satisfies the entities unique, and individual requirements. One such strategy is the following formal methodology which address two fundamental yet paramount questions; “What are we doing”? and “Why are we doing it”?:<br><br>1). Policy Statement/Project Charter (Goal of the Plan, Reasons and Resources....define each),<br>2). Business Impact Analysis (how does effort improve our business services),<br>3). Identify System-wide Policies, Procedures and Requirements<br>4). Identify Best Practices for Implementation (including Change Management/Configuration Management) and/or Future Enhancements,<br>5). Plan B-Recovery Strategies (how and what will need to be recovered, if necessary),<br>6). Plan Development (Write the Plan and Implement the Plan Elements),<br>7). Plan buy-in and Testing (important everyone Knows the Plan, and Knows What to Do), and<br>8). Implement the Plan (then identify and fix gaps during first 3 months, 6 months, and annually after initial implementation) |

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| | | 9). Maintenance (Continuous monitoring and updates to reflect the current enterprise environment)<br>10). Lastly, System Retirement |
| **Current Solutions** | **Compute(System)** | Currently, Big Data/Hadoop within a Cloud Eco-system within the FI is operating as part of a hybrid system, with BD being utilized as a useful tool for conducting risk and fraud analysis, in addition to assisting in organizations in the process of ('know your customer'). These are three areas where BD has proven to be good at;<br>1. detecting fraud,<br>2. associated risks and a<br>3. 'know your customer' strategy.<br><br>At the same time, the traditional client/server/data warehouse/RDBM (Relational Database Management ) systems are use for the handling, processing, storage and archival of the entities financial data. Recently the SEC has approved the initiative for requiring the FI to submit financial statements via the XBRL (extensible Business Related Markup Language), as of May 13th, 2013. |
| | **Storage** | The same Federal, State, Local and cross-border legislative and regulatory requirements can impact any and all geographical locations, including; VMware, NetApps, Oracle, IBM, Brocade, et cetera.<br><br>**Please Note:** Based upon legislative and regulatory concerns, these storage solutions for FI data must ensure this same data conforms to US regulatory compliance for GRC/CIA, at this point in time.<br><br>For confirmation, please visit the following agencies web sites: SEC (Security and Exchange Commission), CFTC (Commodity Futures Trading Commission), FDIC (Federal Deposit Insurance Corporation), DOJ (Dept. of Justice), and my favorite the PCAOB (Public Company Accounting and Oversight Board). |
| | **Networking** | **Please Note:** The same Federal, State, Local and cross-border legislative and regulatory requirements can impact any and all geographical locations of HW/SW, including but not limited to; WANs, LANs, MANs WiFi, fiber optics, Internet Access, via Public, Private, Community and Hybrid Cloud environments, with or without VPNs.<br>Based upon legislative and regulatory concerns, these networking solutions for FI data must ensure this same data conforms to US regulatory compliance for GRC/CIA, such as the US Treasury Dept., at this point in time.<br>For confirmation, please visit the following agencies web sites: SEC (Security and Exchange Commission), CFTC (Commodity Futures Trading Commission), FDIC (Federal Deposit Insurance Corporation), US Treasury Dept., DOJ (Dept. of Justice), and my favorite the PCAOB (Public Company Accounting and Oversight Board). |
| | **Software** | **Please Note:** The same legislative and regulatory obligations impacting the geographical location of HW/SW, also restricts the location for; Hadoop, MapReduce, Open-source, and/or Vendor Proprietary such as AWS (Amazon Web Services), |

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| | | Google Cloud Services, and Microsoft<br><br>Based upon legislative and regulatory concerns, these software solutions incorporating both SOAP (Simple Object Access Protocol), for Web development and OLAP (Online Analytical Processing) software language for databases, specifically in this case for FI data, both must ensure this same data conforms to US regulatory compliance for GRC/CIA, at this point in time.<br><br>For confirmation, please visit the following agencies web sites: SEC (Security and Exchange Commission), CFTC (Commodity Futures Trading Commission), US Treasury, FDIC (Federal Deposit Insurance Corporation), DOJ (Dept. of Justice), and my favorite the PCAOB (Public Company Accounting and Oversight Board). |
| **Big Data Characteristics** | **Data Source (distributed/centralized)** | **Please Note:** The same legislative and regulatory obligations impacting the geographical location of HW/SW, also impacts the location for; both distributed/centralized data sources flowing into HA/DR Environment and HVSs (Hosted Virtual Servers), such as the following constructs: DC1---> VMWare/KVM (Clusters, w/Virtual Firewalls), Data link-Vmware Link-Vmotion Link-Network Link, Multiple PB of NAS (Network as A Service), DC2--->, VMWare/KVM (Clusters w/Virtual Firewalls), DataLink (Vmware Link, Vmotion Link, Network Link), Multiple PB of NAS (Network as A Service), (Requires Fail-Over Virtualization), among other considerations.<br><br>Based upon legislative and regulatory concerns, these data source solutions, either distributed and/or centralized for FI data, must ensure this same data conforms to US regulatory compliance for GRC/CIA, at this point in time.<br><br>For confirmation, please visit the following agencies web sites: SEC (Security and Exchange Commission), CFTC (Commodity Futures Trading Commission), US Treasury, FDIC (Federal Deposit Insurance Corporation), DOJ (Dept. of Justice), and my favorite the PCAOB (Public Company Accounting and Oversight Board). |
| | **Volume (size)** | Tera-bytes up to Peta-bytes**.**<br>**Please Note: This is a 'Floppy Free Zone'.** |
| | **Velocity (e.g. real time)** | Velocity is more important for fraud detection, risk assessments and the 'know your customer' initiative within the BD FI.<br><br>**Please Note:** However, based upon legislative and regulatory concerns, **velocity** is not at issue regarding BD solutions for FI data, except for fraud detection, risk analysis and customer analysis.<br><br>Based upon legislative and regulatory restrictions, **velocity** is not at issue, rather the primary concern for FI data, is that it must satisfy all US regulatory compliance obligations for GRC/CIA, at this point in time. |

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| | **Variety (multiple data sets, mash-up)** | Multiple virtual environments either operating within a batch processing architecture or a hot-swappable parallel architecture supporting fraud detection, risk assessments and customer service solutions.<br><br>**Please Note:** Based upon legislative and regulatory concerns, **variety** is not at issue regarding BD solutions for FI data within a Cloud Eco-system, except for fraud detection, risk analysis and customer analysis.<br><br>Based upon legislative and regulatory restrictions, **variety** is not at issue, rather the primary concern for FI data, is that it must satisfy all US regulatory compliance obligations for GRC/CIA, at this point in time. |
| | **Variability (rate of change)** | **Please Note:** Based upon legislative and regulatory concerns, **variability** is not at issue regarding BD solutions for FI data within a Cloud Eco-system, except for fraud detection, risk analysis and customer analysis.<br><br>Based upon legislative and regulatory restrictions, **variability** is not at issue, rather the primary concern for FI data, is that it must satisfy all US regulatory compliance obligations for GRC/CIA, at this point in time.<br><br>Variability with BD FI within a Cloud Eco-System will depending upon the strength and completeness of the SLA agreements, the costs associated with (CapEx), and depending upon the requirements of the business. |
| **Big Data Science (collection, curation, analysis, action)** | **Veracity (Robustness Issues)** | **Please Note:** Based upon legislative and regulatory concerns, **veracity** is not at issue regarding BD solutions for FI data within a Cloud Eco-system, except for fraud detection, risk analysis and customer analysis.<br><br>Based upon legislative and regulatory restrictions, **veracity** is not at issue, rather the primary concern for FI data, is that it must satisfy all US regulatory compliance obligations for GRC/CIA, at this point in time.<br><br>Within a Big Data Cloud Eco-System, data integrity is important over the entire life-cycle of the organization due to regulatory and compliance issues related to individual data privacy and security, in the areas of CIA (Confidentiality, Integrity & Availability) and GRC (Governance, Risk & Compliance) requirements. |
| | **Visualization** | **Please Note:** Based upon legislative and regulatory concerns, **visualization** is not at issue regarding BD solutions for FI data, except for fraud detection, risk analysis and customer analysis, FI data is handled by traditional client/server/data warehouse big iron servers.<br><br>Based upon legislative and regulatory restrictions, **visualization** is not at issue, rather the primary concern for FI data, is that it must satisfy all US regulatory compliance |

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| | | obligations for GRC/CIA, at this point in time.<br><br>Data integrity within BD is critical and essential over the entire life-cycle of the organization due to regulatory and compliance issues related to CIA (Confidentiality, Integrity & Availability) and GRC (Governance, Risk & Compliance) requirements. |
| | **Data Quality** | **Please Note:** Based upon legislative and regulatory concerns, **data quality** will always be an issue, regardless of the industry or platform.<br><br>Based upon legislative and regulatory restrictions, **data quality** is at the core of data integrity, and is the primary concern for FI data, in that it must satisfy all US regulatory compliance obligations for GRC/CIA, at this point in time.<br><br>For BD/FI data, data integrity is critical and essential over the entire life-cycle of the organization due to regulatory and compliance issues related to CIA (Confidentiality, Integrity & Availability) and GRC (Governance, Risk & Compliance) requirements. |
| | **Data Types** | **Please Note:** Based upon legislative and regulatory concerns, **data types** is important in that it must have a degree of consistency and especially survivability during audits and digital forensic investigations where the data format deterioration can negatively impact both an audit and a forensic investigation when passed through multiple cycles.<br><br>For BD/FI data, multiple data types and formats, include but is not limited to; flat files, .txt, .pdf, android application files, .wav, .jpg and VOIP (Voice over IP) |
| | **Data Analytic s** | **Please Note:** Based upon legislative and regulatory concerns, **data analytics** is an issue regarding BD solutions for FI data, especially in regards to fraud detection, risk analysis and customer analysis.<br><br>However, data analytics for FI data is currently handled by traditional client/server/data warehouse big iron servers which must ensure they comply with and satisfy all United States GRC/CIA requirements, at this point in time.<br><br>For BD/FI data analytics must be maintained in a format that is non-destructive during search and analysis processing and procedures. |
| **Big Data Specific Challenges (Gaps)** | | Currently, the areas of concern associated with BD/FI with a Cloud Eco-system, include the aggregating and storing of data (sensitive, toxic and otherwise) from multiple sources which can and does create administrative and management problems related to the following:<br>• Access control<br>• Management/Administration<br>• Data entitlement and<br>• Data ownership<br><br>However, based upon current analysis, these concerns and issues are widely known and are being addressed at this point in time, via the R&D |

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| | (Research & Development) SDLC/HDLC (Software Development Life Cycle/Hardware Development Life Cycle) sausage makers of technology. Please stay tuned for future developments in this regard |
| **Big Data Specific Challenges in Mobility** | Mobility is a continuously growing layer of technical complexity, however, not all Big Data mobility solutions are technical in nature. There are to interrelated and co-dependent parties who required to work together to find a workable and maintainable solution, the FI business side and IT. When both are in agreement sharing a, common lexicon, taxonomy and appreciation and understand for the requirements each is obligated to satisfy, these technical issues can be addressed.<br><br>Both sides in this collaborative effort will encounter the following current and on-going FI data considerations:<br>• Inconsistent category assignments<br>• Changes to classification systems over time<br>• Use of multiple overlapping or<br>• Different categorization schemes<br><br>In addition, each of these changing and evolving inconsistencies, are required to satisfy the following data characteristics associated with ACID:<br>• **Atomic-** All of the work in a transaction completes (commit) or none of it completes<br>• **Consistent-** A transmittal transforms the database from one consistent state to another consistent state. Consistency is defined in terms of constraints.<br>• **Isolated**- The results of any changes made during a transaction are not visible until the transaction has committed.<br>• **Durable**- The results of a committed transaction survive failures.<br>When each of these data categories are satisfied, well, it's a glorious thing. Unfortunately, sometimes glory is not in the room, however, that does not mean we give up the effort to resolve these issues. |
| **Security & Privacy Requirements** | No amount of security and privacy due diligence will make up for the innate deficiencies associated with human nature that creep into any program and/or strategy. Currently, the BD/FI must contend with a growing number of risk buckets, such as:<br>• AML-Anti-money Laundering<br>• CDD- Client Due Diligence<br>• Watch-lists<br>• FCPA – Foreign Corrupt Practices Act<br><br>to name a few.<br><br>For a reality check, please consider Mr. Harry M. Markopolos's nine year effort to get the SEC among other agencies to do their job and shut down Mr. Bernard Madoff's billion dollar ponzi scheme.<br><br>However, that aside, identifying and addressing the privacy/security requirements of the FI, providing services within a BD/Cloud Eco-system, via continuous improvements in:<br>• technology,<br>• processes,<br>• procedures,<br>• people and<br>• regulatory jurisdictions |

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| | is a far better choice for both the individual and the organization, especially when considering the alternative.<br><br>Utilizing a layered approach, this strategy can be broken down into the following sub categories:<br>1. Maintaining operational resilience<br>2. Protecting valuable assets<br>3. Controlling system accounts<br>4. Managing security services effectively, and<br>5. Maintaining operational resilience<br><br>For additional background security and privacy solutions addressing both security and privacy, we'll refer you to the two following organization's:<br>• ISACA (Information Systems Audit and Control Association)<br>• isc2 (International Information Systems Security Certification Consortium, Inc.) |
| **Highlight issues for generalizing this use case (e.g. for ref. architecture)** | Areas of concern include the aggregating and storing data from multiple sources can create problems related to the following:<br>• Access control<br>• Management/Administration<br>• Data entitlement and<br>• Data ownership<br><br>Each of these areas are being improved upon, yet they still must be considered and addressed , via access control solutions, and SIEM (Security Incident/Event Management) tools.<br><br>I don't believe we're there yet, based upon current security concerns mentioned whenever Big Data/Hadoop within a Cloud Eco-system is brought up in polite conversation.<br><br>Current and on-going challenges to implementing BD Finance within a Cloud Eco, as well as traditional client/server data warehouse architectures, include the following areas of Financial Accounting under both US GAAP (Generally Accepted Accounting Practices) or IFRS (…..):<br>XBRL (extensible Business Related Markup Language)<br>Consistency (terminology, formatting, technologies, regulatory gaps)<br><br>SEC mandated use of XBRL (extensible Business Related Markup Language) for regulatory financial reporting.<br><br>SEC, GAAP/IFRS and the yet to be fully resolved new financial legislation impacting reporting requirements are changing and point to trying to improve the implementation, testing, training, reporting and communication best practices required of an independent auditor, regarding:<br>Auditing, Auditor's reports, Control self-assessments, Financial audits, GAAS / ISAs, Internal audits, and the Sarbanes–Oxley Act of 2002 (SOX). |
| **re Information (URLs)** | 1. http://www.ey.com/US/en/Industries/Financial-Services/Insurance<br><br>2. http://www.treasury.gov/resource-center/fin-mkts/Pages/default.aspx<br><br>3. Cloud Security Alliance Big Data Working Group, "Top 10 |

Challenges in Big Data Security and Privacy", 2012.

4. The IFRS, Securities and Markets Working Group, www.xbrl-eu.org
5. IEEE Big Data conference http://www.ischool.drexel.edu/bigdata/bigdata2013/topics.htm
6. MapReduce http://www.mapreduce.org.
7. PCAOB http://www.pcaob.org
8. http://www.ey.com/GL/en/Industries/Financial-Services/Insurance
9. http://www.treasury.gov/resource-center/fin-mkts/Pages/default.aspx
10. CFTC http://www.cftc.org
11. SEC http://www.sec.gov
12. FDIC http://www.fdic.gov
13. COSO http://www.coso.org
14. isc2 International Information Systems Security Certification Consortium, Inc.: http://www.isc2.org
15. ISACA Information Systems Audit and Control Association: http://www.isca.org
16. IFARS http://www.ifars.org
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18. http://www.computerworld.com/s/article/print/9221652/IT_must_prepare_for_Hadoop_security_issues?tax ...
19. "No One Would Listen: A True Financial Thriller" (hard-cover book). Hoboken, NJ: John Wiley & Sons. March 2010. Retrieved April 30, 2010. ISBN 978-0-470-55373-2
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23. CobiT, Ver. 5.0, 2013, ISACA, Information Systems Audit and Control Association, (a framework for IT Governance and Controls), www.isaca.org.
24. TOGAF, Ver. 9.1, The Open Group Architecture Framework (a framework for IT architecture), www.opengroup.org.
25. ISO/IEC 27000:2012 Info. Security Mgt., International Organization for Standardization and the International Electrotechnical Commission, www.standards.iso.org/

**Note:** <additional comments> Please feel free to improve our **INITIAL DRAFT, Ver. 0.1, August 25th, 2013**....as we do not consider our efforts to be pearls, at this point in time......Respectfully yours, Pw Carey, Compliance Partners, LLC_pwc.pwcarey@gmail.com

**Note: No proprietary or confidential information should be included**

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| **From:** | Pw Carey |
| **To:** | Comments |
| **Cc:** | Pw Carey; Pw Carey |
| **Subject:** | Rulemaking Docket Matter No. 034 |
| **Date:** | Friday, May 02, 2014 3:37:17 PM |
| **Attachments:** | Pws_DRAFT COPY_PCAOB Docket No. 034 Comments_Submitted_May 2nd, 2014_Release_2013-005_ARM.pdf<br>Pw Carey"s snid thoughts SLASH Comments regarding PwC"s sillyness...May 2nd, 2014.doc<br>Pws COMMENT_Docket No. 034 Comments Regarding Claw Backs & Equity Receiverships in Cases of Fraud.doc |

Dear PCAOB:

Good afternoon and hope all is well way back East.

- Please Note: We appreciate the opportunity to submit our comments to you all regarding PCAOB Docket No. 034.
- We wish you the best in your efforts to improve a bruised and damaged system and continue your efforts as they are for all the right reasons....
- Lastly, we have attached our comments to your attention, in the hope that they will move the process forward...

In closing, our best wishes for a nice and relaxing weekend...

Respectfully yours,
Regards / Met vriendelijke groet

Pw Carey
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PROPOSED AUDITING STANDARDS –

THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;

THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;

AND RELATED AMENDMENTS TO PCAOB STANDARDS

PCAOB Release No. 2013-005
August 13, 2013

PCAOB Rulemaking
Docket Matter No. 034

Summary: The Public Company Accounting Oversight Board ("PCAOB" or the "Board") is proposing two new auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, which would supersede portions of AU sec. 508, *Reports on Audited Financial Statements,* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, which would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements.* The Board also is proposing related amendments to PCAOB standards.

Public Comment: Interested persons may submit written comments to the Board. Such comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 034 in the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on December 11, 2013.

Board Contacts: Martin F. Baumann, Chief Auditor (202/207-9192, baumannm@pcaobus.org), Jennifer Rand, Deputy Chief Auditor (202/207-9206, randj@pcaobus.org), Jessica Watts, Associate Chief Auditor (202/207-9376, wattsj@pcaobus.org), Lillian Ceynowa, Associate Chief

# Summary of Comments on Microsoft Word - ARM - Front of Release FINAL 8.12.13-Clean.doc

## Page: 1

Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 2:19:17 PM

**Dear Folks at PCAOB:**

**Good morning and hope all is well way back East....**

**Please Note: We thank you for this opportunity to add our thoughts to the conversation regarding the auditor's reporting responsibilities and due diligence in representing the Investment Community in their efforts.**

**Also, Comments are due Friday, May 2nd, 2014 by 5:00 PM EDT......**

**So, why not update the 'Public Comment:' paragraph.....no wait, cost savings......Thank you, thank....&.....Respectfully yours, Pw Carey, Senior IT Auditor, (GRC), CISSP, CISA**

Auditor (202/591-4236, ceynowal@pcaobus.org), Elena Bozhkova, Assistant Chief Auditor (202/207-9298, bozhkovae@pcaobus.org) and Ekaterina Dizna, Assistant Chief Auditor (202/591-4125, diznae@pcaobus.org).

*****

## I. Introduction

The auditor's report is the primary means by which the auditor communicates with investors and other financial statement users information regarding his or her audit of the financial statements. As it exists today, the auditor's report identifies the financial statements that were audited, describes the nature of an audit, and presents the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. This type of auditor's report has been commonly described as a pass/fail model because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).[1/]

The auditor's report in the United States has changed very little since the 1940s. The existing pass/fail model is thought by many to be useful because it provides a clear indication of whether the financial statements are presented fairly.[2/] However, while the existing auditor's report provides important information about an audit in general, it does not provide information that is specific to a particular audit.

Academic research suggests that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified

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1/ If the financial statements are not fairly presented, the standards of the PCAOB provide that an auditor may issue a qualified opinion, adverse opinion, or disclaimer of opinion.

2/ See paragraph (c) of U.S. Securities and Exchange Commission ("SEC") Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02. SEC rules require the accountant to clearly express an opinion on the audited financial statements that are required to be filed as part of registration statements under the Securities Act of 1933 ("Securities Act") and Section 12 of the Securities Exchange Act of 1934 ("Exchange Act"), annual or other reports under Sections 13 and 15(d) of the Exchange Act, proxy and information statements under Section 14 of the Exchange Act, and registration statements and shareholder reports under the Investment Company Act of 1940. See also paragraph (a) of SEC Rule 1-01 of Regulation S-X, 17 C.F.R. § 210.1-01.

because it does not provide any other informational value about the particular audit.[3/] During the Board's outreach activities over the last three years, many investors have expressed dissatisfaction that the content of the existing auditor's report provides little, if any, information specific to the audit of the company's financial statements to investors or other financial statement users. During a financial statement audit, auditors obtain and evaluate important information concerning the company, the company's environment, and the preparation of the company's financial statements. Many investors have indicated that they would benefit from additional auditor reporting because they do not have access to, or may not be aware of, much of this information. Additionally, many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the reports more relevant and useful.[4/]

Several commissions examined both the auditor's responsibilities and the form of the auditor's report in the 1970s and 1980s.[5/] These commissions made several recommendations to change the auditor's report; however, only a limited number of changes were made in response to these recommendations.[6/] In 2008, the U.S. Department of the Treasury's Advisory Committee on the Auditing Profession ("ACAP") recommended that the PCAOB undertake a standard-setting initiative to consider

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[3/] See, e.g., Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); and Theodore J. Mock, Jean Bedard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing 323, 323-351 (2013).

[4/] See survey, *Improving the Auditor's Report*, which was presented by the working group of the IAG on Auditor's Report and The Role of the Auditor, (March 16, 2011), available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

[5/] For example, in 1978, the Commission on the Auditors' Responsibilities (known as the "Cohen Commission") and in 1987, the National Commission on Fraudulent Financial Reporting (known as the "Treadway Commission") recommended changes to the auditor's report.

[6/] The changes expanded the discussion of attributes of an audit and management's responsibility. See Marshall A. Geiger, *Setting the Standard for the New Auditor's Report: An Analysis of Attempts to Influence the Auditing Standards Board*, 1 (1993), 38.

improvements to the auditor's standard reporting model.[7/] The ACAP report noted that "some believe…[that the] standardized wording does not adequately reflect the amount of auditor work and judgment."[8/] Similar sentiments were expressed more recently by members of the Board's Standing Advisory Group ("SAG")[9/] and IAG.[10/]

Additionally, ACAP noted that the auditor reporting model developed in the 1940s did not address the increasing complexity of global business operations that are compelling a growing use of judgments and estimates, including those related to fair value measurements, and also contributing to greater complexity in financial reporting.[11/] It was further noted that this complexity supports improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.[12/] ACAP concluded that an improved auditor's report likely would lead to more relevant information for users of financial statements and would clarify the role of the auditor in the financial statement audit.[13/]

During the Board's outreach activities, some investors noted that auditors gain knowledge about the company's financial statements during the audit that is not known to investors. These investors stated that they believe such knowledge would assist them when making their investment decisions. Academic research finds that the existing

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7/ U.S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP report"), at VII:13 (October 6, 2008), available at http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

8/ Id. at VII:13.

9/ See SAG meeting details and webcast for April 2010 available at http://pcaobus.org/News/Events/Pages/04072010_SAGMeeting.aspx.

10/ See IAG meeting details and webcast for May 2010 and March 2011 available at http://pcaobus.org/News/Events/Pages/05042010_IAGMeeting.aspx and http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

11/ See ACAP Report at VII:17.

12/ Id.

13/ Id.

auditor's report has symbolic value in that it represents the auditor's work but that it provides little communicative value.[14/]

Additionally, the auditor's report is undergoing change globally. Several international standard setters and regulators, such as the International Auditing and Assurance Standards Board ("IAASB"), the United Kingdom's Financial Reporting Council ("FRC"), and the European Commission ("EC") have been working on similar projects to change the auditor's report.[15/]

After extensive outreach conducted over the last three years, the Board is proposing two standards under its statutory mandate to "protect the interests of investors and further the public interest in the preparation of *informative*, accurate and independent audit reports"[16/] [emphasis added]. The proposed standards are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. At the same time, the Board sought a balanced approach that would not unduly burden the financial reporting process.

The two proposed standards are: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"). The Board also is proposing related amendments to other PCAOB auditing standards (the "proposed amendments"). This release collectively refers to the proposed auditor reporting standard, proposed other information standard, and proposed amendments as "the proposed standards and amendments."

Briefly, the Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that

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[14/] See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008).

[15/] See further discussion regarding the projects of these standard setters and regulators in Section II., *Board Outreach*.

[16/] Section 101(a) of the Sarbanes-Oxley Act of 2002 (the "Act").

would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

The auditor's report as currently designed, and as confirmed by academic research, conveys to investors and other financial statement users little of the information obtained and evaluated by the auditor.[17/] The proposed auditor reporting standard is intended to provide investors and other financial statement users with potentially valuable information that investors have expressed interest in receiving but have not had access to in the past.[18/]

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[19/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[20/] The Board is

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17/ See Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 70 (2008).

18/ See CFA Institute's surveys: *Usefulness of the Independent Auditor's Report* (May 4, 2011), *Independent Auditor's Report Survey Results* (February 26, 2010), and *Independent Auditor's Report Monthly Poll Results* (March 12, 2008), available at http://www.cfainstitute.org/about/research/surveys/pages/index.aspx.

19/ Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

20/ See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

seeking comment on whether the information communicated in critical audit matters would be valuable to investors and could reduce information asymmetry.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. In considering the nature and form of auditor reporting on other information, the Board evaluated the existing auditing standard related to the auditor's responsibilities with respect to other information and determined it was appropriate to update the other information standard to support a description in the auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. "Other information" in the proposed other information standard refers to information in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed enhancements to the required auditor's procedures in the proposed other information standard are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[21/] or intentional misreporting.[22/] As a result of the

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[21/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting*, Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[22/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[23/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.[24/] Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[25/] The Board is seeking comment on whether the proposed other information standard would increase the quality of information available to investors.

The Board anticipates that the proposed auditor reporting standard and proposed other information standard will have cost implications for both auditors and companies, including audit committees, as further discussed in this release and Appendices 5 and 6.

The remaining sections of this release describe the outreach conducted by the Board in considering possible changes to the auditor's report, the development and overview of the proposed standards and amendments, and alternatives considered. Additionally, this release includes a discussion of the applicability of the proposed standards and amendments to the audits of brokers and dealers and considerations regarding audits of emerging growth companies ("EGCs").

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23/ The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

24/ See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

25/ Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, refer to Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital*, 9 Review of Accounting Studies 233, 233-259 (2004).

## II. Board Outreach

Over the last three years, the Board has conducted extensive outreach with investors, auditors, financial statement preparers, and others to better understand the nature of improvements that could be made to make the auditor's report more informative. In developing its proposals, the Board also sought to better understand issues related to implementing improvements, including potential costs and other economic considerations involved.

From October 2010 through March 2011, the staff of the Board's Office of the Chief Auditor ("staff") met and held discussions with investors, financial statement preparers, auditors, audit committee members, other regulators and standard setters, and representatives of academia. During this outreach, some investors indicated that one of the primary reasons that they are looking to the auditor for more information, rather than management or the audit committee, is that the auditor is an independent third party. Some investors indicated that if they had a better understanding about the audit and how the audit was conducted relative to a particular company, then they would have a better perspective regarding the potential risks of material misstatement in a company's financial statements. The staff reported its findings to the Board at an open meeting on March 22, 2011.[26/] The Board concluded from its initial outreach that changing the auditor's report could improve the informational value of the auditor's report and enhance the relevance of the auditor's reporting model. During this same period at an IAG meeting, the recent financial crisis was mentioned as an example of a situation in which expanded auditor reporting in advance of, and during, the crisis might have been helpful in assessing a company's financial statements and providing early warning signals regarding potential issues.[27/]

Subsequently, on June 21, 2011, the Board issued *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release")[28/] to seek public

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[26/] See meeting details and webcast for PCAOB Board Meeting on March 22, 2011, available at http://pcaobus.org/News/Webcasts/Pages/03222011_OpenBoardMeeting.aspx.

[27/] See Investor Advisory Group ("IAG") meeting details and webcast for March 2011 available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx.

[28/] PCAOB Release No. 2011-003 (June 21, 2011) available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

comment on potential changes to the auditor's reporting model. The objective of the concept release was to seek comment on several alternatives for changing the auditor's reporting model in order to make auditor reporting more relevant and useful to investors and other financial statement users. The alternatives presented were:

- A supplemental narrative report, described as an auditor's discussion and analysis ("AD&A");
- Required and expanded use of emphasis paragraphs;
- Auditor assurance on other information outside the financial statements; and
- Clarification of the standard auditor's report.

The concept release indicated that each of the alternatives presented would retain the pass/fail opinion of the existing auditor's report and was not intended to alter the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. The concept release also indicated that the alternatives were not mutually exclusive and that other alternatives could be considered.

The Board received 155 comment letters on the concept release.[29/] Additionally, on September 15, 2011, the Board held a public roundtable ("roundtable") to obtain insight from a diverse group of investors and other financial statement users, preparers of financial statements, audit committee members, and auditors on the alternatives presented in the concept release.[30/] The topic was further discussed at the November 2011 and 2012 SAG meetings.[31/]

Commenters generally supported the Board updating and enhancing the auditor reporting standard and largely agreed that the existing auditor's report provided little informational value about a specific audit to investors and other financial statement

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[29/] See comment letters on the concept release available at http://pcaobus.org/Rules/Rulemaking/Pages/Docket034Comments.aspx.

[30/] See transcript of the roundtable available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[31/] See SAG meeting transcripts for November 2011 and 2012 available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

users beyond the pass/fail opinion. However, there were widely diverse views among different constituencies about the nature and extent of changes that should be made to the existing auditor's report and the potential costs associated with those changes.

Investors strongly supported the Board's initiative to enhance the existing auditor's report to provide more informative reporting about the audit, the financial statements, or both. This group of commenters generally expressed the view that the existing auditor's report was not sufficiently informative to meet the needs of investors who would benefit from further insights obtained by the auditor during the audit of the financial statements. Investors most frequently suggested additional auditor reporting on the following information:

- Areas of high financial statement and audit risk;
- Areas of significant auditor judgment;
- The most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty;
- The quality, not just the acceptability, of accounting policies and practices, for instance, management's application of accounting policies that are acceptable under the applicable financial reporting framework but are not the preferred practice;
- Significant changes in or events affecting the financial statements, including unusual transactions; and
- Identification of where significant matters are disclosed in the financial statements for investors' further information.

Some investors recognized that, if the auditor's report included this information, audit costs could increase due to the time required to draft and review such communications. However, these investors also expressed the belief that these costs, which are ultimately paid for by investors, likely would be modest since the communication would be based on the work already performed by the auditor. These commenters indicated that the benefits in terms of increased confidence in corporate reporting outweighed the costs.

Financial statement preparers, in general, did not object to the clarifications to the auditor's report described in the concept release if such clarifications would be useful to financial statement users and would increase the transparency into the audit process. The majority of these commenters, however, believed that there was little need for changes to the existing auditor's report and believed it was the responsibility of the company, not the auditors, to provide information about the company's financial statements to financial statement users. Audit committee members expressed similar views.

Auditors generally were supportive of changes to the existing auditor's report but believed that any additional auditor reporting should be objective and factual. This group of commenters also believed that certain changes to the auditor's report could provide benefits to users of the financial statements by providing additional clarification about the audit and audit process. Auditors noted that the alternatives presented in the concept release for changing the auditor's report would require additional effort, primarily related to drafting and reviewing the auditor's report, and as a result would increase audit costs and the potential for auditor liability.

Other commenters, including academics, other regulators, and other individuals and organizations, expressed a variety of views about changes to the existing auditor's report. For example, one commenter indicated that the existing auditor's report is not particularly informative and does not provide information regarding the nature and type of procedures, processes, and information used in forming the auditor's opinion. Other commenters indicated that the current pass/fail model is sufficient and that it is the responsibility of the company, and not the auditors, to provide additional disclosures about the company to investors.

One of the alternatives presented in the concept release was to require auditor assurance on other information outside the financial statements. Some commenters noted that they were uncertain as to the level of the auditor's responsibility for other information outside the financial statements. Some of those commenters supported changes to the auditor's report that describe the auditor's existing responsibilities related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information outside the financial statements.

In developing the proposed auditor reporting standard, the Board considered recent developments of (1) the IAASB's project on auditor reporting;[32/] (2) the EC's

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[32/] See IAASB project summary at http://www.ifac.org/auditing-assurance/projects/auditor-reporting. The IAASB issued an exposure draft, *Reporting* legislative proposal and subsequent European Parliamentary report that relate to audits of public interest entities;[33/] and (3) the FRC's recently adopted revision of its auditing standard on the auditor's report.[34/] The IAASB's project, the EC's proposal and subsequent amendments, and the FRC's revised auditing standard would require auditor reporting on certain additional matters.

In developing the proposed other information standard, the Board considered the IAASB's recent proposal, *The Auditor's Responsibilities Relating to Other Information in Documents Containing or Accompanying Audited Financial Statements and the Auditor's Report Thereon*.[35/]

## III. Development and Overview of the Proposals

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches (which are discussed in Section IV., *Alternatives Considered*); (5) current developments in similar projects by other standard setters; (6) relevant academic

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*on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*, for public comment in July 2013 available at https://www.ifac.org/publications-resources/reporting-audited-financial-statements-proposed-new-and-revised-international.

[33/] See proposal for a *Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities* (November 30, 2011) available at http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf. See amendments to the EC proposal that were approved on May 14, 2013, by the Parliamentary committee with principal jurisdiction over the proposal at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-%2f%2fEP%2f%2fTEXT%2bREPORT%2bA7-2013-0171%2b0%2bDOC%2bXML%2bV0%2f%2fEN&language=EN.

[34/] See FRC's revised auditor reporting standard at http://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/ISA-700-(UK-and-Ireland)-700-(Revised).aspx.

[35/] See IAASB project summary at http://www.ifac.org/auditing-assurance/projects/auditors-responsibilities-relating-other-information-documents-containin.

research; and (7) significant comments received by the Board from its outreach efforts, including comments received on the concept release. In considering the nature and extent of changes to the existing auditor's report, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding undue burden to the financial reporting process.

## A. Proposed Auditor Reporting Standard

The proposed auditor reporting standard, among other things, would make the following significant changes to the existing auditor's report:

- Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements. If the auditor determines that there are no critical audit matters, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.

- Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.

- Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.

The proposed auditor reporting standard would retain the pass/fail model of the existing auditor's report. The proposed auditor reporting standard would also retain explanatory paragraphs that are required in certain circumstances and the auditor's ability to emphasize a matter in the financial statements.

### *1. Auditor Reporting of Critical Audit Matters*

In developing the proposed requirements for the communication of critical audit matters, the Board considered many investors' requests for information regarding matters related to the audit and the most significant matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty. The concept release described as alternatives for providing additional information to financial statement users about the audit and the financial statements: (1) an AD&A and (2) required and expanded emphasis paragraphs. The

Board, however, is not proposing any of these alternatives, which are described further in Section IV., *Alternatives Considered*.

The Board, instead, is proposing requirements for the auditor to communicate in the auditor's report "critical audit matters." Critical audit matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Use of the word most is not intended to imply that only one matter under each criteria would qualify as a critical audit matter.

The Board is proposing communication of critical audit matters in response to the requests of many investors to improve the relevance of the auditor's report by providing more insight about the most significant matters that the auditor addressed in the audit. Communicating critical audit matters likely would provide meaningful information to investors and other financial statement users about the auditor's work in performing the audit and in forming an opinion on the financial statements, taken as a whole.

The auditor would determine which matters to communicate as critical audit matters. The proposed auditor reporting standard indicates that critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document,[36/] which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer;[37/] (3) communicated to the audit committee;[38/] or (4) any combination of the three. The Board would not expect that each matter included in any one or more of these sources would be a critical audit matter. Referring to these sources can provide a cost-effective and efficient means of determining critical audit matters. Additionally, the proposed auditor reporting standard provides a list of factors for the auditor to take into account in determining the critical audit matters. The factors are intended to help the auditor determine, from the results of the audit or evidence obtained, which matters are critical audit matters.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit. Thus, the proposed auditor reporting standard does not modify the

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[36/] Auditing Standard No. 3, *Audit Documentation*.

[37/] Auditing Standard No. 7, *Engagement Quality Review*.

[38/] Auditing Standard No. 16, *Communications with Audit Committees*, and other PCAOB standards.

objective of the audit of the financial statements or impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

The proposed auditor reporting standard would require the auditor to determine critical audit matters in the audit of the current period's financial statements, based on the results of the audit or evidence obtained. The proposed auditor reporting standard also provides that in situations in which the auditor determines there are no critical audit matters to communicate, the auditor would state that conclusion in the auditor's report. Critical audit matters would be determined based on the facts and circumstances of each audit. It is expected that in most audits the auditor would determine that there are critical audit matters.

The description of critical audit matters in the auditor's report would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[39/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Improving the auditor's report through the communication of critical audit matters also would address some commenters' concerns that it is the company's or the audit committee's responsibility, not the auditor's, to provide information, including any analysis, about the company's financial statements to financial statement users. The

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[39/] See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management. Rather, the auditor would be communicating information about the audit, based on audit procedures the auditor performed.

The Board intends for the proposed communication of critical audit matters to be responsive to cost issues raised by commenters. Because critical audit matters are based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that reporting of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees. In addition to the potential cost implications, there could be potential unintended consequences associated with requiring that auditors communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit which might reduce the time available to the auditor for review and completion of the audit work. The Board seeks comments on the nature and extent of those costs, as well as regarding any potential unintended consequences.

*2. Basic Elements of the Auditor's Report*

The existing auditor's report identifies the financial statements audited, describes the nature of an audit, and expresses the auditor's opinion using standardized language. The existing auditor reporting standard also provides a list of basic elements that are required to be in the auditor's report.[40/]

The concept release sought comment on whether the standardized language in the auditor's report required by the existing auditing standard is useful, whether any of the language could be clarified, and whether the auditor's report should describe the auditor's responsibilities for other information outside the financial statements. Several commenters indicated that clarifying language and certain other matters in the auditor's report could improve financial statement users' understanding of the nature of an audit, the auditor's responsibilities, and the purpose of the auditor's report. Some commenters, however, indicated that additional boilerplate language to clarify language already in the report would not be helpful. After considering the comments, the Board is proposing certain clarifications of the language in the report that the Board believes would enhance users' understanding about the audit and the auditor, including the auditor's responsibilities for other information outside the financial statements.

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[40/] See AU secs. 508.06-.08.

The proposed auditor reporting standard primarily retains the basic elements of the auditor's report contained in existing auditor reporting standards,[41/] incorporates certain elements from existing illustrative auditor's reports, and further describes some of the auditor's existing responsibilities, such as the auditor's responsibility for the notes to the financial statements and fraud.

Additionally, the proposed auditor reporting standard adds the following new elements to the auditor's report to provide investors and other financial statement users with information about the audit and the auditor:

- Auditor independence − a statement regarding the auditor's existing requirements to be independent of the company, intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations;

- Auditor tenure − the year the auditor began serving as the company's auditor, to provide investors and other financial statement users with information about the length of the relationship between the auditor and the company; and

- Other information – the auditor's responsibilities for, and the results of, the auditor's evaluation of other information in annual reports filed with the SEC containing the financial statements and the related auditor's report, to provide investors and other financial statement users with an understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board anticipates that these proposed changes to the auditor's report likely would have some cost-related implications for auditors and companies, including audit committees. The Board seeks comments on the nature and extent of those costs.

*3. Explanatory Language*

Under existing PCAOB standards, certain circumstances require that the auditor include explanatory language or paragraphs in the auditor's report, such as when there

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[41/] See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board*.

is substantial doubt about the company's ability to continue as a going concern[42/] or the correction of a material misstatement in previously issued financial statements. These circumstances are described in other PCAOB standards, which generally provide standardized language to be included in the auditor's report. Similar to the existing auditor reporting standard, the proposed auditor reporting standard describes those circumstances and provides references to the relevant PCAOB standards.

Additionally, the proposed auditor reporting standard retains from the existing standard the auditor's ability to include explanatory paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Currently, such explanatory paragraphs are not required and may be added solely at the auditor's discretion.[43/] As described in the proposed auditor reporting standard, these explanatory paragraphs would refer only to information presented or disclosed in the financial statements. The proposed auditor reporting standard provides several examples of when an auditor might include such explanatory paragraphs.

**B. Auditor's Responsibilities Regarding Other Information**

Other information outside the financial statements may be relevant to an audit of the financial statements or to the auditor's decision to be associated with the company's annual report. The proposed other information standard describes "other information" as information, other than the audited financial statements and the related auditor's report, included in a company's annual report that is filed with the SEC under the Exchange Act[44/] and contains that company's audited financial statements and the related auditor's report. For example, other information in an annual report filed by a company on Form 10-K would include, among other items, Selected Financial Data, Management's Discussion & Analysis ("MD&A"), exhibits, and certain information incorporated by reference.

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42/ The Board is considering a separate standard-setting project to enhance performance requirements and auditor reporting related to a company's ability to continue as a going concern.

43/ See AU sec. 508.19.

44/ Consistent with existing AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, the proposed other information standard would not apply to documents filed with the SEC under the Securities Act that contain audited financial statements and the related auditor's report. See further discussion regarding Securities Act documents in Appendix 6.

Under existing PCAOB standards, the auditor has a responsibility to "read and consider" other information in certain documents that also contain the audited financial statements and the related auditor's report; however, there is no related reporting requirement to describe the auditor's responsibility with respect to other information.

The Board began considering the existing other information standard, AU sec. 550, as part of an effort to better explain to investors and other financial statement users the auditor's responsibilities related to other information outside the financial statements. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

As a result of the link between the proposed auditor reporting standard and the proposed other information standard, the financial statement user would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description of the results of the auditor's evaluation of the other information.

Under the existing other information standard, the auditor considers whether the other information is materially inconsistent with information in the financial statements. If the auditor concludes there is a material inconsistency between the other information and the financial statements, the existing standard provides the auditor with certain procedures to respond to the material inconsistency. Additionally, the existing standard provides that, if while reading the other information for a material inconsistency, the auditor becomes aware of a material misstatement of fact in the other information, the auditor would discuss this with management and perform other procedures based on the auditor's judgment.

The proposed other information standard, among other things, would:

- Apply the auditor's responsibility for other information specifically to a company's annual reports filed with the SEC under the Exchange Act that contain that company's audited financial statements and the related auditor's report;

- Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;

- Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and

- Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The Board's existing standard has no requirements for the auditor beyond "read and consider" with respect to the other information. In contrast, the proposed other information standard includes procedures that auditors consistently would perform in evaluating the other information. The Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard.

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

In developing the proposed other information standard, the Board considered the additional effort and cost of implementing changes in the auditor's responsibilities regarding other information. The Board believes that the proposed approach represents a cost-sensitive approach that would be scalable to less complex companies based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees. The Board requests comments regarding the nature and extent of those costs.

## IV. Alternatives Considered

Before developing the proposed standards and amendments, the Board explored alternatives through extended outreach with investors, companies, auditors, audit committee members, and others. This outreach effort was followed by issuing the concept release in 2011, analyzing comment letters, holding a roundtable, and discussions with the SAG and IAG.

The concept release described alternatives for providing additional information to financial statement users about the audit and the financial statements, specifically: (1) an AD&A; (2) required and expanded emphasis paragraphs; (3) auditor assurance on other information outside the financial statements; and (4) clarification of the standard auditor's report. The following paragraphs explain the alternatives in the concept release. The Board, however, is not proposing any of these alternatives. The Board believes that its proposed approach, which includes communicating critical audit matters, provides many of the benefits described in the concept release while, at the same time, substantially reducing the challenges and costs mentioned by commenters, as explained in Section E., *Approach Proposed by the Board*, below.

The Board also considered retaining existing AU sec. 508 related to the unqualified report and issuing a staff practice alert or other guidance regarding the potential use of existing emphasis paragraphs. The Board believes, however, that proposing a new standard with changes to the auditor's report is appropriate in relation to its mandate under the Act to promote *informative*, accurate, and independent audit reports[45/] [emphasis added]. Additionally, the Board considered retaining AU sec. 550 and describing the auditor's responsibilities under AU sec. 550 in the auditor's report. The Board believes that issuing a new standard regarding the other information is appropriate because the proposed other information standard would provide a consistent basis for the auditor's evaluation of the other information and related auditor reporting.

## A. Auditor's Discussion and Analysis

As described in the concept release, an AD&A could provide investors with a view of the audit and the financial statements "through the auditor's eyes." The intent of the AD&A alternative was to provide the auditor with the ability to write a separate, supplemental narrative report that would follow the auditor's report on the financial statements and contain an open-ended discussion of the auditor's perspectives about the audit and the company's financial statements. The concept release describes the AD&A as being among the most expansive forms of auditor reporting.

According to the concept release, an AD&A could include information about the audit, such as audit risk identified in the audit, audit procedures and results, and auditor independence, and provide the auditor with the ability to communicate to investors and other users of the financial statements the auditor's significant judgments in forming the audit opinion. The AD&A, however, also could include the auditor's perspectives regarding the company's financial statements, such as management's judgments and

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45/ See Section 101(a) of the Act.

estimates, accounting policies and practices, and difficult or contentious issues. Also, as described in the concept release, an AD&A could provide further context to an investor's understanding of a company's financial statements and management's related discussion and analysis. In that regard, the concept release noted that the auditor's perspectives in an AD&A on certain matters could differ from those management might provide in its MD&A,[46/] possibly requiring additional time by management, the auditor, and the audit committee to resolve those differences before any views could be reflected in an AD&A or the MD&A.

Many investors indicated that additional information through an AD&A would provide more transparency into the audit and the financial statements. One commenter suggested that factors that would affect the way an auditor assesses risks of material misstatement in the financial statements might also affect how an investor views risks of investing in the company. Some commenters indicated that an AD&A would heighten the perceived value of the audit, increase competition among auditors based on audit quality, particularly with respect to auditor skepticism, and provide the firms more leverage to affect change and enhance management disclosure in the financial statements.

Other commenters, however, expressed reservations about an AD&A, as described in the concept release, primarily because they saw this form of supplemental narrative reporting as fundamentally changing the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information. These commenters were also concerned about possible undue reliance by financial statement users on an AD&A-type report to make investment decisions and the additional effort by auditors to write and review an AD&A in a compressed reporting timeframe. Some commenters were concerned that this type of auditor reporting could diminish the governance role of the audit committee over the company's disclosure of financial information by allowing auditors to make independent disclosures about the company's financial statements. Some commenters noted that an AD&A-type reporting would require auditors to draft customized language in a supplemental free-form report for public use. Additionally, commenters also noted that absent an extension from the SEC of filing and reporting deadlines, an AD&A would reduce the time available to the most senior members of the audit team for review and completion of audit work in order to identify matters to be included in an AD&A, draft customized language, and work with centralized review personnel to complete the review process.

[46/] See SEC Regulation S-K, Item 303; 17 CFR § 229.303.

## B. Required and Expanded Emphasis Paragraphs

Emphasis paragraphs are not currently required under existing PCAOB standards but may be added, solely at the auditor's discretion, to emphasize a matter regarding the financial statements.[47/] As described in the concept release, required and expanded emphasis paragraphs could highlight the most significant matters in the financial statements and identify where these matters are disclosed in the financial statements. The concept release indicated that emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation. The alternative in the concept release for required and expanded emphasis paragraphs was intended to provide investors with enhanced auditor reporting on much of the information investors indicated they want about the audit and the financial statements. As also explained in the concept release, for each matter of emphasis the auditor could be required to comment on the key audit procedures performed pertaining to the identified matters. The concept release indicated that this alternative was somewhat analogous to the French requirement that the auditor's report contain a "justification for the auditor's assessments."[48/]

Many commenters were supportive of using emphasis paragraphs to highlight significant matters to a reader, such as areas with significant management judgments and estimates or a high level of measurement uncertainty. Some commenters supported an emphasis paragraph approach that would inform financial statement users about important matters on which to focus in the financial statements for purposes of their investment decisions.

Many investors indicated that they did not support an auditor's report that only references the relevant financial statement disclosures because no incremental information would be provided in the emphasis paragraphs regarding the company's financial statements or the audit beyond what is already disclosed by management. Some other commenters noted that emphasis paragraphs raised concerns regarding the auditor's disclosure of original information that is not otherwise publicly known.

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[47/] See AU sec. 508.19.

[48/] On August 1, 2003, article L823-9 of the French Code of Commerce Financial security law was enacted, which requires that the statutory auditor include in the auditor's report a "justification of the auditor's assessments."

Additionally, at the November 2012 SAG meeting, SAG members discussed a potential approach to amending the auditor's reporting model that would include required emphasis paragraphs, based on the matters communicated to the audit committee under Auditing Standard No. 16.[49/] Some SAG members were supportive of linking auditor reporting in expanded emphasis paragraphs to matters communicated to the audit committee under Auditing Standard No. 16.[50/] Other SAG members did not support expanded emphasis paragraphs that would be specifically linked to communications with the audit committee because, in their view, it might affect the nature and extent of the communications between the auditor and the audit committee.[51/]

## C. Auditor Assurance on Other Information Outside the Financial Statements

The concept release indicated that an alternative for enhanced auditor reporting could be auditor examination of, and reporting on, information outside the financial statements, such as MD&A or other selected information (for example, non-GAAP information or earnings releases). Some commenters indicated that certain information outside the financial statements, especially the MD&A, is important to investors to provide context within which the financial results and financial position can be interpreted.

However, investors generally were not supportive of auditor assurance on other information outside the financial statements as an alternative for enhancing the auditor's reporting model because it would not be responsive to their information needs, and they saw little benefit with this type of auditor assurance. Several commenters expressed concern that auditor assurance on information outside the financial statements would increase the time needed to perform these procedures and would not provide greater benefit than the auditor's current responsibilities related to other information outside the financial statements.

Several commenters suggested that they would support changes to the auditor's report that described the auditor's existing responsibilities related to other information and the auditor's conclusions related to the other information.

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[49/] See Briefing Paper: Auditor's Reporting Model available at http://pcaobus.org/Rules/Rulemaking/Docket034/2012_11_15_SAG_BP_ARM.pdf.

[50/] See SAG meeting transcripts for November 2012 available at http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

[51/] Id.

## D. Clarification of Terms and Responsibilities in the Auditor's Report

### *1. Reasonable Assurance*

In the concept release, the Board sought comment on whether the term "reasonable assurance" should be further described in the auditor's report. Under existing AU sec. 508, the auditor's report explicitly asserts that the audit was conducted in accordance with the standards of the PCAOB and that "those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." An existing auditing standard describes reasonable assurance as being a "high level of assurance, but not absolute assurance."[52/]

Commenters generally did not support adding additional language to the auditor's report that would further explain the term "reasonable assurance." Commenters suggested that adding additional language would not significantly enhance financial statement users' understanding of the meaning of the term "reasonable assurance."

### *2. Management's Responsibility for the Preparation of the Financial Statements*

In the concept release, the Board sought comment on whether the auditor's report should state that management prepares the financial statements and has responsibility for the fair presentation of the financial statements.

Under existing auditing standards, the standard auditor's report includes a statement that the financial statements are the responsibility of the company's management and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit.[53/]

Some commenters supported clarification in the auditor's report with respect to management's responsibility for the preparation of the financial statements. These commenters indicated that some clarifying language could improve investors' and other financial statement users' understanding of management's responsibilities for the preparation of the financial statements. Conversely, other commenters were against such a clarification, stating that additional language is unnecessary because similar language is already included in the auditor's report and the SEC requires corporate officers' certification of the financial statements.

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[52/] See paragraph .10 of AU sec. 230, *Due Professional Care in the Performance of Work*.

[53/] See AU sec. 508.08.c.

Because the existing language in the auditor's report is generally understood to encompass management's responsibility for both the preparation and fair presentation of the financial statements, the Board is not proposing to modify the auditor's report in this regard.

### E. Approach Proposed by the Board

The Board believes the proposed auditor reporting standard and the proposed other information standard provide many of the benefits described in the concept release regarding an AD&A, required and expanded emphasis paragraphs, and auditor assurance on information outside the financial statements. The Board also believes that its proposed approach should eliminate or reduce some of the challenges mentioned by commenters in connection with the alternatives described in the concept release.

Unlike emphasis paragraphs as described in existing AU sec. 508 that generally just point to a disclosure in the company's financial statements, the proposed auditor reporting standard would require the auditor to communicate a wider range of information about the audit. Specifically, the proposed communication of critical audit matters would provide information regarding the reason the matter or matters were considered critical.

The proposed communication of critical audit matters would not fundamentally change the auditor's current role from attesting on information prepared by management to providing an analysis of financial statement information, which was one of the concerns expressed by commenters about an AD&A. Since the auditor would be communicating information regarding the audit, the communication of critical audit matters should not diminish the governance role of the audit committee over the company's disclosure of financial information. In addition, the proposed auditor reporting standard is intended to represent a cost-sensitive approach, because the auditor's determination of critical audit matters is based on the audit already performed.

The description in the auditor's report about the auditor's responsibilities for, and results of, the auditor's evaluation of other information is intended to provide greater clarity regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of other information. Finally, the proposed other information standard would provide a specific basis for the auditor describing in the auditor's report the auditor's responsibilities for, and results of, the auditor's evaluation of other information.

## V. Audits of Brokers and Dealers

Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act")[54/] expanded the authority of the Board to oversee the audits of brokers and dealers that are required under SEC rules. On July 30, 2013, the SEC amended SEC Rule 17a-5 under the Exchange Act, to require, among other things, that audits of brokers' and dealers' financial statements be performed in accordance with the standards of the PCAOB for fiscal years ending on or after June 1, 2014.[55/] At the publication date of this release, the final SEC rules have not been published in the Federal Register.

The Board will consider, and is soliciting comments on, whether the proposed standards and amendments are appropriate for audits of brokers and dealers. Appendices 5 and 6 include specific questions on the applicability of the proposed standards and amendments to the audits of brokers and dealers.

## VI. Economic Considerations

Economic considerations related to the proposed standards are noted in this release with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard. Appendix 7 provides further discussion of economic considerations specifically related to the audits of EGCs.

## VII. Audits of Emerging Growth Companies

Pursuant to Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act"), any rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs (as defined in Section 3(a)(80) of the Exchange Act) unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[56/]

In connection with its proposals, the Board solicits views of commenters on the application of the proposed standards and amendments to audits of EGCs. As part of

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54/ Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

55/ See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf.

56/ See Section 103(a)(3)(a) of the Act.

considering the potential application of the proposed standards to the audits of EGCs, the Board specifically requests comments, including information and data, to the extent available, relevant to issues relating to efficiency, competition, and capital formation, as well as the benefits and costs associated with its proposals.

## VIII. Effective Date

The proposed standards and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board seeks comment on the effective date related to each proposed standard in Appendices 5 and 6. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments.

## IX. Appendices

The Board's proposal includes this Release ("Release") and the following appendices:

- Appendix 1 contains the text of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

- Appendix 2 contains the text of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

- Appendix 3 contains amendments related to the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to other PCAOB standards.

- Appendix 4 contains amendments related to the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, to other PCAOB standards.

- Appendix 5 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the related amendments. Specific questions for commenters are included throughout this Appendix.

- Appendix 6 provides additional discussion of the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and the related amendments. Specific questions for commenters are included throughout this Appendix.

- Appendix 7 discusses certain other considerations related to audits of EGCs. Specific questions for commenters are included at the end of this Appendix.

Appendices 5 and 6 discuss significant comments received during the Board's outreach, provide additional background information regarding the requirements in the proposed standards and proposed amendments, and contain specific questions for commenters. Appendix 7 contains a discussion of certain considerations regarding the applicability of the proposed standards and the related amendments to the audits of EGCs and also includes specific questions for commenters.

## X. Opportunity for Public Comment

The Board is seeking comment on all aspects of the proposed standards and amendments as well as on the specific questions included in Appendices 5, 6, and 7. Among other things, the Board is seeking comment on economic considerations relating to the proposed standards and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters, regarding the proposed standards and amendments. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is also requesting that commenters prepare, and forward to the Board for its consideration, examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.[57/]

Written comments should be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington DC 20006-2803. Comments also may be submitted by email to comments@pcaobus.org or through the Board's website at: www.pcaobus.org. All comments should refer to the PCAOB Rulemaking Docket Matter No. 034 on the subject or reference line and should be received by the Board no later than 5:00 PM (EST) on December 11, 2013.

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57/ Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

The Board will consider all comments received. The Board is considering holding a public roundtable in 2014 to discuss the proposed standards and comments received. If the Board decides to hold a public roundtable, the Board will reopen the comment period related to the proposed standards and amendments.

Following the close of the comment period(s), the Board will determine whether to adopt final rules, with or without amendments. Any final rules adopted will be submitted to the SEC for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the SEC. Standards are rules of the Board under the Act.

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On the 13th day of August, in the year 2013, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown

Secretary

PCAOB
Public Company Accounting Oversight Board

## APPENDIX 1

## Proposed Auditing Standard

## *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

## *Introduction*

1. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements[1/] (the "auditor's unqualified report").[2/]

2. The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[3/] in conformity with the applicable financial reporting framework.[4/]

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[1/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; see, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

[2/] Paragraphs 85-98 and Appendix C, "Special Reporting Situations," of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

[3/] AU sec. 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*, describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

[4/] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

3. When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements. AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

## *Objectives*

4. The objectives of the auditor when the auditor concludes that an auditor's unqualified opinion is appropriate are to:

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters**[5/] relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

## *The Auditor's Unqualified Report*

5. The auditor's unqualified report includes:[6/]

a. The basic elements, as described in paragraph 6;

b. Communication of critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs 7-14; and

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs 15-16.

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5/ This term, as defined in Appendix A, "Definitions," is set in **boldface type** the first time it appears.

6/ Appendix B provides an illustrative auditor's unqualified report.

## Basic Elements

6. The auditor must include the following basic elements in the auditor's report:[7/]

   a. The title, "Report of Independent Registered Public Accounting Firm";

   b. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;[8/]

   *Introduction*

   c. The name of the company whose financial statements were audited;

   d. A statement identifying each financial statement and related schedule, if applicable, that has been audited;[9/]

   e. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

   f. A statement indicating that the financial statements, including the related notes and, if applicable, schedules, identified and collectively referred to in the report as the financial statements, were audited;

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[7/] Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. See, e.g., Investment Company Act § 30(g) and § 32(a)(4); SEC Rule 2-02 of Regulation S-X, 17 C.F.R. § 210.2-02; and Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 C.F.R. § 240.17a-5. Auditor reports on financial statements filed with the SEC are required to comply with all such applicable requirements.

[8/] For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

[9/] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. See, e.g., SEC Rules 5-04, 6-10, 6A-05, and 7-05 of Regulation S-X, 17 C.F.R. §§ 210.5-04, 210.6-10, 210.6A-05, 210.7-05. See generally, SEC Rule 12-01 of Regulation S-X, 17 C.F.R. § 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

g. A statement that the financial statements are the responsibility of the company's management;

h. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB;[10/]

i. A statement containing the year the auditor began serving consecutively as the company's auditor;

> Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

*Basis of Opinion*

j. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

k. A statement that the audit was conducted in accordance with the standards of the PCAOB;

l. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

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[10/] The term "United States federal securities laws" has the same meaning as "securities laws" as defined in PCAOB Rule 1001(s)(ii).

m. A statement that an audit includes:

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

(2) Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

(4) Evaluating the overall presentation of the financial statements;

n. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion;

*Opinion on the Financial Statements*

o. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.[11/] The opinion should also include an identification of the applicable financial reporting framework;

*The Auditor's Responsibilities Regarding Other Information*

p. When other information is included in an annual report filed with the SEC under the Exchange Act that contains both the audited financial statements and the related auditor's report, a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements of paragraphs 13 and 14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain*

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[11/] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. If the financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the Introduction section of the auditor's report. It need not be reported on separately in the opinion paragraph.

*Documents Containing Audited Financial Statements and the Related Auditor's Report*;[12/]

*Signature and Date*

q. The signature of the auditor's firm;[13/]

r. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[14/] and

s. The date of the auditor's report.[15/]

## Critical Audit Matters

*Determination of Critical Audit Matters*

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.[16/]

Note: It is expected that in most audits, the auditor would determine that there are critical audit matters.

8. Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion

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12/ The Auditor's Responsibilities Regarding Other Information section follows the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section.

13/ See SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

14/ Id.

15/ See AU sec. 530, *Dating of the Independent Auditor's Report*.

16/ Auditing Standard No. 15, *Audit Evidence*, describes what constitutes evidence obtained in the audit and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence.

document;[17] (2) reviewed by the engagement quality reviewer;[18] (3) communicated to the audit committee;[19] or (4) any combination of the three.

9. Certain factors might affect whether a matter addressed during the audit of the financial statements (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. In determining whether a matter is a critical audit matter, the auditor should take into account the following factors, as well as other factors specific to the audit:

a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

b. The nature and extent of audit effort required to address the matter;

c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;

d. The severity of control deficiencies identified relevant to the matter, if any;[20]

e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;

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[17] See Auditing Standard No. 3, *Audit Documentation*.

[18] See Auditing Standard No. 7, *Engagement Quality Review*.

[19] See Auditing Standard No. 16, *Communications with Audit Committees,* and other PCAOB standards.

[20] Other PCAOB standards provide auditing and reporting requirements related to the company's internal control over financial reporting. See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements.*

f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;

g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and

h. The nature of consultations outside the engagement team regarding the matter, if any.

*Communication of Critical Audit Matters*

10. The auditor must communicate in the auditor's report critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

11. For each critical audit matter communicated in the auditor's report the auditor must:[21/]

a. Identify the critical audit matter;

b. Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and

Note: For example, if the auditor identified the valuation of financial instruments with little, if any, market activity at the measurement date as a critical audit matter because the valuation involved the most difficult, subjective, or complex auditor judgments, then communication of that critical audit matter in the auditor's report must describe the considerations that led the auditor to determine that the

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[21/] The Critical Audit Matters section follows the Opinion on the Financial Statements section and any explanatory paragraphs.

matter is a critical audit matter, which might relate to the high degree of measurement uncertainty or the significant judgments and estimates involved.

c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Note: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used.

*Language Preceding Critical Audit Matters in the Auditor's Report*

12. The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

13. In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*

14. In accordance with Auditing Standard No. 3, the auditor must document the determination of critical audit matters. Auditing Standard No. 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached.[22/] To provide sufficient detail for a clear understanding of the conclusions reached[23/] regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters.

> Note: For example, if an audit matter was included in the engagement completion document, reviewed by the engagement quality reviewer, communicated to the audit committee and, after considering the factors in paragraph 9, otherwise would appear to an experienced auditor having no previous connection to the engagement to meet the definition of a critical audit matter, then the auditor would document the basis for the determination that the matter was not a critical audit matter.

## Explanatory Language Added to the Auditor's Report

15. Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report.[24/] These circumstances include when:

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[22/] See paragraph 4 of Auditing Standard No. 3.

[23/] Id.

[24/] An explanatory paragraph follows the Opinion on the Financial Statements section, unless otherwise required by other standards of the PCAOB.

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a. There is substantial doubt about the company's ability to continue as a going concern;[25/]

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[26/]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[27/]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[28/]

e. A material misstatement in previously issued financial statements has been corrected;[29/]

f. Certain circumstances relating to reports on comparative financial statements exist;[30/]

g. Selected quarterly financial data required by Item 302(a) of SEC Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[31/]

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[25/] See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

[26/] See paragraphs .06-.09 of AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

[27/] See paragraphs 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* (as proposed to be amended by this standard).

[28/] See paragraph 6 of Auditing Standard No. 6.

[29/] See paragraphs 9 and 16-17 of Auditing Standard No. 6 (as proposed to be amended by this standard).

[30/] See AU secs. 508.68-.69 and .72-.74.

[31/] See paragraph .50 of AU sec. 722, *Interim Financial Information*.

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h. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to the requirements of the applicable financial reporting framework;[32/]

i. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[33/] and

j. There has been a change in an investee year end that has a material effect on the company's financial statements.[34/]

16. The auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements.[35/] This explanatory paragraph refers only to information presented or disclosed in the financial statements. The following are examples of matters, among others, that might be emphasized in the auditor's report:[36/]

a. Significant transactions with related parties;

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[32/] See paragraphs .03 and .08 of AU sec. 558, *Required Supplementary Information*.

[33/] See paragraph 88 of Auditing Standard No. 5. Auditing Standard No. 5 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, Auditing Standard No. 5 notes that the auditor should consider those circumstances as well.

[34/] See paragraph .32 of AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35/] These explanatory paragraphs follow the Opinion on the Financial Statements section in the auditor's report.

[36/] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" when an explanatory paragraph to emphasize a matter regarding the financial statements is included in the auditor's report.

b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. Retroactive application of the prospective change in accounting principle that will result in the restatement of the current year's financial statements in the future, and the effects of the prospective change are expected to be unusually material;

e. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

f. That the entity is a component of a larger business enterprise.

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## *APPENDIX A – Definition*

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matters – Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

> Note: Use of the word "most" is not intended to imply that only one matter under each criteria would qualify as a critical audit matter. Depending on the facts and circumstances of the audit, there could be several critical audit matters. Also, an audit matter could meet one, two, or all three of the criteria in the definition.

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## *APPENDIX B – An Illustrative Auditor's Unqualified Report*

**[Changes from the current illustrative report are underlined]**

**Report of Independent Registered Public Accounting Firm**

To the shareholders and board of directors of X Company

[*Introduction*]

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [*year*].

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Critical Audit Matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[*Include critical audit matters*]

The Auditor's Responsibilities Regarding Other Information

In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[*Signature*]

[*City and State or Country*]

[*Date*]

## APPENDIX 2

## Proposed Auditing Standard

## *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*

### *Introduction*

1. This standard establishes requirements regarding the auditor's responsibilities with respect to information, other than the audited financial statements[1/] and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act")[2/] and contains that company's audited financial statements and the related auditor's report (hereafter "other information").[3/]

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[1/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

[2/] This standard does not apply to documents filed under the Securities Act of 1933 ("Securities Act"). When the audited financial statements and the related auditor's report are included in a registration statement under the Securities Act, the auditor has responsibilities under the federal securities laws and under AU sec. 711, *Filings Under Federal Securities Statutes*. This standard also does not modify the auditor's responsibilities under the federal securities laws or AU sec. 711. See, e.g., Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1.

[3/] This standard does not apply to supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*; required supplementary information addressed by AU sec. 558, *Required Supplementary Information*; and management's assertion on internal control over financial reporting in an integrated audit addressed by Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

Note: For purposes of this standard, other information in an annual report[4/] that is filed with the SEC under the Exchange Act includes information, other than the audited financial statements and the related auditor's report, contained in the annual report and also includes (1) information incorporated by reference in that annual report that is available to the auditor prior to the issuance of the auditor's report and (2) when the annual report is a Form 10-K, information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.[5/]

## *Objectives*

2. The objectives of the auditor are:

a. To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");[6/] (2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and

b. When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the

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4/ With respect to a company's amended annual report that contains the company's previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard. When the company's amended annual report contains (1) revisions to amounts or disclosures in the previously issued audited financial statements and (2) a related auditor's report, the auditor would apply all paragraphs of this standard.

5/ With respect to other information that is incorporated by reference into an annual report on Form 10-K from a proxy statement that is filed subsequent to the issuance of the auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of this standard.

6/ The requirements of this standard related to material inconsistency apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an annual report containing other information.

audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

## *Auditor's Responsibilities*

**Evaluating the Other Information**

3. The auditor must evaluate whether the other information contains (1) a material inconsistency; (2) a material misstatement of fact; or (3) both by performing the procedures in paragraph 4.

4. The auditor should read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the:

a. Consistency of amounts in the other information, and the manner of their presentation, that are intended to be the same as, or to provide greater detail about, the amounts in the financial statements, with the amounts in the financial statements and relevant audit evidence;

b. Consistency of any qualitative statement in the other information, and the manner of its presentation, that is intended to represent or provide greater detail about information in the financial statements, with the financial statements and relevant audit evidence;

c. Other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit; and

d. Amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence, by recalculating the amounts for mathematical accuracy.

Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula.

5. If, based on the evaluation in paragraph 4, the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, the auditor

should discuss the matter with management. The auditor also should perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both.

**Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both**

6. If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor should request management to revise the other information to address the material inconsistency, the material misstatement of fact, or both.

7. If management does not appropriately revise the other information and:

a. The other information is available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 8 and 9.

b. The other information is not available to the auditor prior to the issuance of the auditor's report, the auditor should perform the applicable procedures in paragraphs 10 and 11.[7/]

*Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*

8. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner and prior to the issuance of the auditor's report.

9. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

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[7/] Information incorporated by reference into a Form 10-K from the company's definitive proxy statement, filed within 120 days after the end of the fiscal year covered by the Form 10-K, might not be available to the auditor prior to the issuance of the auditor's report. Additionally, other information included in an amended annual report that contains previously issued audited financial statements and the related auditor's report, would not be available to the auditor prior to the issuance of the auditor's report.

a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; and AU sec. 317, *Illegal Acts by Clients*; and

b. Should determine whether to:

(1) Issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both; or

(2) Withdraw from the engagement.

Note: In addition, the auditor may withhold the use of the auditor's report for a prior reporting period.

*Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*

10. If management does not appropriately revise the other information, the auditor should communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner.

11. If the other information is not appropriately revised after the auditor has communicated the material inconsistency, the material misstatement of fact, or both to the audit committee, the auditor:

a. Must determine the auditor's responsibilities under Section 10A of the Exchange Act, 15 U.S.C. § 78j-1; and

b. Should apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.*

**Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements**

12. If, as a result of procedures performed under this standard, the auditor determines that there is a potential misstatement in the audited financial statements, the auditor should refer to the requirements of:

a. Auditing Standard No. 14, *Evaluating Audit Results,* and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, if the auditor's report on the financial statements has not been issued; or

b. AU sec. 561 if the auditor's report on the financial statements has been issued.

## *Reporting in the Auditor's Report*

13. When issuing an auditor's report, the auditor must include, in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information,"[8/] the following:

a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB"), the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;

c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;

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[8/] This reporting requirement applies to an auditor's report other than a report to disclaim an opinion. See AU sec. 508.61.

d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and

e. A statement that, based on the evaluation, the auditor:

(1) Has not identified a material inconsistency or a material misstatement of fact in the other information;[9/] or

(2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

14. The following is an example of "The Auditor's Responsibilities Regarding Other Information" section of the auditor's report:

a. Illustrative language for paragraphs 13.a.–d.:

*The Auditor's Responsibilities Regarding Other Information*

In addition to auditing the company's financial statements [and internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the [*period end date*] financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information.

b. Illustrative language for paragraph 13.e.(1) when the auditor has not identified a material inconsistency or a material misstatement of fact in the other information:

Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[9/] This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified a material inconsistency, a material misstatement of fact, or both that management has revised appropriately prior to the issuance of the auditor's report.

c. Illustrative language for paragraph 13.e.(2) when the auditor has identified a material inconsistency, a material misstatement of fact, or both in the other information:

Based on our evaluation, we identified [*a material inconsistency, a material misstatement of fact, or both*] in the other information that has not been appropriately revised. [*Describe the material inconsistency, the material misstatement of fact, or both.*] We have not identified [*a material inconsistency or material misstatement of fact* (this statement would indicate the situation that was not identified in the sentence above)] in the other information.[10/]

[10/] This sentence is appropriate only when the auditor has identified a material inconsistency or a material misstatement of fact, but not both. If the auditor identifies both a material inconsistency and a material misstatement of fact, the auditor's report should describe both the material inconsistency and the material misstatement of fact.

## APPENDIX 3

### *Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard*

In connection with the proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed auditor reporting standard.[1/]

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is <u>underlined</u>. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board's proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect changes to the auditor's unqualified report. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed auditor reporting standard would include:

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[1/] PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), PCAOB Release No. 2013-004, *Related Parties* (May 7, 2013), PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), and PCAOB Release No. 2011-007, *Improving Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2* (October 11, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed auditor reporting standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed auditor reporting standard.

- Changing the title of AU sec. 508 from "Reports on Audited Financial Statements" to [new proposed title] "Departures from Unqualified Opinions and Other Reporting Circumstances."

- Updating illustrative reports in AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* for the proposed basic elements of the proposed auditor reporting standard;

- Updating other reporting standards that result in the issuance of the auditor's report on the financial statement filed with the SEC for the proposed basic elements of the proposed auditor reporting standard;

- Updating references to "the auditor's standard report" and "introductory, scope, and opinion paragraphs" to reflect new terms referenced in the proposed auditor reporting standard;

- Updating Auditing Standards Nos. 7 and 16 and AU sec. 336 as a result of the new reporting requirement for critical audit matters in the auditor's report;

- Moving explanatory paragraph reporting examples from existing AU sec. 508 to the respective auditing standards that contain the related performance requirements for those circumstances; and

- Updating references to auditing standards that are being amended or superseded.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 5 of this release.

## Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board*

* * *

**~~APPENDIX~~**

**~~Illustrative Reports~~**

~~The following is an illustrative report on an audit of financial statements:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X3 and 20X2, and the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X3. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X3 and 20X2, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X3, in conformity with U.S. generally accepted accounting principles.~~

~~[ *Signature* ]~~

~~[ City and State or Country]~~

~~[ *Date* ]~~

~~The following is an illustrative report on a review of interim financial information:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have reviewed the accompanying [ *describe the interim financial information or statements reviewed* ] of X Company as of September 30, 20X3 and 20X2, and for the three-month and nine-month periods then ended. This (these) interim financial information (statements) is (are) the responsibility of the Company's management.~~

~~We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than~~

~~an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.~~

~~Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial (statements) for it (them) to be in conformity with U.S. generally accepted accounting principles.~~

~~[ *Signature* ]~~

~~[City and State or Country]~~

~~[ *Date* ]~~

## Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*

* * *

85. The auditor's report on the audit of internal control over financial reporting must include the following elements[18/]

a. ~~A~~ <u>The</u> title ~~that includes the word *independent*~~<u>, "Report of Independent Registered Public Accounting Firm";</u>

<u>a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;[18A/]</u>

<u>[18A/] For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.</u>

<u>a-2. The name of the company whose internal control over financial reporting was audited;</u>

<u>a-3. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;</u>

a-4. A statement containing the year the auditor began serving consecutively as the company's auditor;

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

f. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

* * *

87. The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and board of directors of W Company

[ ~~*Introductory paragraph*~~ *Introduction* ]

We have audited the accompanying balance sheets of W Company as of December 31, 20X8 and 20X7, and the related statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended December 31, 20X8, and the related notes (collectively referred to as the "financial statements"). We also have audited W Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*]. W Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [title of management's report].

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~[ *Scope paragraph* ]~~ [ *Basis of Opinion* ]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the company's internal control over financial reporting based on our audits. We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements.~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

[ *Definition* ~~*paragraph*~~ ]

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or

timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

[ *Inherent ~~limitations~~ Limitations ~~paragraph~~* ]

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

[ *Opinions on the Financial Statements and Internal Control Over Financial Reporting ~~paragraph~~* ]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of W Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, W Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [ *Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."* ].

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

[*Include critical audit matters*]

*The Auditor's Responsibilities Regarding Other Information*

In addition to auditing the financial statements and the Company's internal control over financial reporting, in accordance with the standards of the PCAOB, we evaluated whether the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X8 financial statements and our audit report on those financial statements, contains a material inconsistency with the financial statements, a material misstatement of fact, or both. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.

[ *Signature* ]

[ *City and State or Country* ]

[ *Date* ]

88. If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (following the Opinion on the Financial Statements section) to the auditor's report on the financial statements -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board ~~(United States)~~, W Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (following the opinion) to the report on internal control over financial reporting -

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the [ *identify financial statements* ] of W Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

* * *

B16. In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis of Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AU sec. 722, *Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

* * *

## Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*

* * *

8. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph 7 have been met, the auditor should add an explanatory paragraph to the auditor's report, as described in ~~AU sec. 508, *Reports on Audited Financial Statements*~~ proposed paragraphs 12-15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AU sec. 508~~.[8A/]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to the auditor's report, as described in ~~AU sec. 508~~paragraphs 12-15 of this standard.

[8A/] AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

9. The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, as described in ~~AU sec. 508~~paragraphs 16-17 of this standard.

10. The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph 31 of Auditing Standard No. 14, *Evaluating Audit Results,* and AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

**CHANGE IN CLASSIFICATION**

11. Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs 7,~~ and~~ 8, and ~~AU sec. 508~~12-15 of this standard. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs 9,~~ and~~ 10, and ~~AU sec. 508~~16-17 of this standard.

**REPORTING ON CONSISTENCY OF FINANCIAL STATEMENTS**

***Change in Accounting Principle***

12. A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the Opinion on the Financial Statements section. The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

13. The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

14. The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

15. The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

***Correction of a Material Misstatement in Previously Issued Financial Statements***

16. Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the Opinion on the Financial Statements section.[10/] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.

> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10/] AU secs. 508.68-69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

17. This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to

correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

## Auditing Standard No. 7, *Engagement Quality Review*

* * *

10. In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate whether appropriate critical audit matters are communicated in the auditor's report in accordance with Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

## Auditing Standard No. 14, *Evaluating Audit Results*

* * *

[7/] If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**APPENDIX B**

[1/] If the financial statements contain material misstatements, AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AU sec. 508.35 discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**APPENDIX C**

[2/] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances.*)

## Auditing Standard No. 16, *Communications with Audit Committees*

* * *

**~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

21. The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

[39/] See paragraphs .22-.32 of AU sec. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* for a discussion of scope limitations.

* * *

## AU sec. 315, *Communications Between Predecessor and Successor Auditors*

* * *

[fn 9] See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .70 through .74, for reporting guidance.

* * *

## AU sec. 317, *Illegal Acts by Clients*

* * *

fn 2 See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

## AU sec. 9326, *Evidential Matter: Auditing Interpretations of Section 326*

* * *

**.10** The third standard of field work requires the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph 35 of Auditing Standard No. 14, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .24, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, section 333 on *Management Representations* requires the auditor to obtain written representations from management. Section 333.06 states that specific representations should relate to the following matters, "availability of all financial records and related data," and section 333.08 states that a materiality limit does not apply to that representation. Section 333.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

* * *

## AU sec. 332, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

* * *

fn 15 See ~~section 508, *Reports on Audited Financial Statements*, paragraphs .16–.18.~~ Auditing Standard No. 6, *Evaluating Consistency of Financial Statements.*

* * *

## AU sec. 333, *Management Representations*

* * *

fn 15 See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .71. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999.]

* * *

## AU sec. 336, *Using the Work of a Specialist*

* * *

**.13** If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (See section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .22 and .23.)

* * *

**.15** Except as discussed in paragraphs .16 and .16A, the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a more thorough audit than an auditor not making such reference.

**.16** The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to ~~his or her standard~~ the auditor's unqualified report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.

**.16A** Reference to the use of a specialist also may be made in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter.[fn 7]

[fn 7] Critical audit matters are described in paragraphs 7-13 of the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

## AU sec. 9336, *Using the Work of a Specialist: Auditing Interpretations of Section 336*

* * *

**.21** *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer. [fn 14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with section 508.22–.26 and 508.61–.63.

* * *

## AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*

* * *

**.03** The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

c. After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

* * *

**.12** If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) to reflect that conclusion. [fn 4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13. [As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

**fn 4** The inclusion of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (see paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (see section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .61-.63).

**.13** An example follows of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time. [fn 5]

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

[As amended, effective for reports issued after December 31, 1990, by Statement on Auditing Standards No. 64.]

**.14** If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**.16** If substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time existed at the date of prior period financial statements that are presented on a comparative basis, and that doubt has been removed in the current period, the explanatory paragraph included in the auditor's report (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) on the financial statements of the prior period should not be repeated.

* * *

## AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*

* * *

**.03** *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an ~~emphasis-of-matter~~ explanatory paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (see paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

## AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410*

* * *

**.15** Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .41 states: "Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include related notes)." For financial statements that are prepared on the basis of accounting principles that are acceptable at the financial-statement date but that will not be acceptable in the future, the auditor should consider whether disclosure of the impending change in principle and the resulting restatement are essential data. If he decides that the matter should be disclosed and it is not, the auditor should express a qualified or adverse opinion as to conformity with GAAP, as required by section 508.41.

* * *

**.18** Even if the auditor decides that the disclosure of the forthcoming change and its effects are adequate and, consequently, decides not to qualify his opinion, he nevertheless may decide to include an explanatory paragraph in his report if the effects of the change are expected to be unusually material. The explanatory paragraph should not be construed as a qualification of the auditor's opinion; it is intended to highlight circumstances of particular importance and to aid in interpreting the financial statements (see ~~section 508.19~~paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

* * *

## AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*

**.01** An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the country of origin of those generally accepted accounting principles also is required (see ~~section 508.08h~~paragraph 6.o. of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

## AU sec. 504, *Association With Financial Statements*

* * *

**.04** An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and AU sec.~~tion~~ 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in section 722, *Interim Financial Information*.

* * *

## AU sec. 508, ~~Reports on Audited Financial Statements~~ ~~[fn *]~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*

~~[fn *] This section has been revised to reflect the conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.~~

**INTRODUCTION**

~~**.01** This section applies to auditors' reports issued in connection with audits [fn 1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs 85-98 of PCAOB Auditing Standard No. 5, *An Audit of*~~

~~*Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, for direction on reporting on internal control over financial reporting. In addition, see paragraphs 86-88 of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, which includes an illustrative combined audit report.~~

~~fn 1 An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with generally accepted auditing standards in effect at the time the audit is performed. Generally accepted auditing standards include the ten standards as well as the Statements on Auditing Standards that interpret those standards. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~**.02** This section does not apply to unaudited financial statements as described in section 504, *Association With Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in section 623, *Special Reports*.~~

~~**.03** Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with generally accepted auditing standards and on the findings. Generally accepted auditing standards include four standards of reporting. This section is concerned primarily with the relationship of the fourth reporting standard to the language of the auditor's report.~~

~~**.04** The fourth standard of reporting is as follows:~~

~~The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~**.05** The objective of the fourth standard is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in the fourth reporting standard to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the fourth standard of reporting as it applies to comparative financial statements.) The auditor may express an unqualified opinion on~~

~~one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~**.06** The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

~~**THE AUDITOR'S STANDARD REPORT**~~

~~**.07** The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards.~~

~~**.08** The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

~~*a.* A title that includes the word *independent*~~ ~~[fn 3]~~

~~*b.* A statement that the financial statements identified in the report were audited~~

~~*c.* A statement that the financial statements are the responsibility of the Company's management~~ ~~[fn 4]~~ ~~and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~*d.* A statement that the audit was conducted in accordance with generally accepted auditing standards and an identification of the United States of America as the country of origin of those standards (for example, auditing standards generally accepted in the United States of America or U.S. generally accepted auditing standards)~~

~~*e.* A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~f. A statement that an audit includes—~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~

~~(2) Assessing the accounting principles used and significant estimates made by management~~

~~(3) Evaluating the overall financial statement presentation~~ ~~[fn 5]~~

~~*g.* A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h.* An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles~~ ~~[fn 6]~~ ~~)~~

~~*i.* The manual or printed signature of the auditor's firm~~

~~j. The date~~ ~~[fn 7]~~ ~~of the audit report~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Independent Auditor's Report~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence~~

~~supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*Date*]~~

~~The form of the auditor's standard report on comparative financial statements [fn 8] is as follows:~~

~~Independent Auditor's Report~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*Date*]~~

~~*k.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~**fn 3** This section does not require a title for an auditor's report if the auditor is not independent. See section 504, *Association With Financial Statements*, for guidance on reporting when the auditor is not independent.~~

~~**fn 4** In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~**fn 5** Section 411, *The Meaning of* Present Fairly in Conformity With Generally Accepted Accounting Principles, paragraphs .03 and .04, discuss the auditor's evaluation of the overall presentation of the financial statements. [As amended, effective for reports issued or reissued on or after June 30, 2001, by Statement on Auditing Standards No. 93.]~~

~~**fn 6** A U.S. auditor also may be engaged to report on the financial statements of a U.S. entity that have been prepared in conformity with accounting principles generally accepted in another country. In those circumstances, the auditor should refer to the guidance in section 534, *Reporting on Financial Statements Prepared for Use in Other Countries.* [Footnote added, effective for reports issued or reissued on or after June 30, 2001 by Statement on Auditing Standards No. 93.]~~

~~**fn 7** For guidance on dating the auditor's report, see section 530, *Dating of the Independent Auditor's Report*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**fn 8** If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such~~

~~as "for each of the three years in the period ended [date of latest balance sheet]." [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**.09** The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

**.10** This section ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[fn8A] and provides reporting guidance in such circumstances. This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~

- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.

~~These opinions are discussed in greater detail throughout the remainder of this~~ This section also discusses other reporting circumstances such as reports on comparative financial statements.

[fn8A] The Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). Paragraphs 85-89 and Appendix C of Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

~~**EXPLANATORY LANGUAGE ADDED TO THE AUDITOR'S STANDARD REPORT**~~

~~**.11** Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory [fn 9] paragraph (or other explanatory language) to the standard report. [fn 10] These circumstances include:~~

~~a. The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~

~~*b.* There is substantial doubt about the entity's ability to continue as a going concern. [fn 11]~~

~~*c.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~

~~*d.* A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~

~~*e.* Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~

~~*f.* Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (See section 722, *Interim Financial Information*, paragraph .50.)~~

~~*g.* Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to complete prescribed procedures with respect~~

~~to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (See section 558, *Required Supplementary Information*, paragraph .02.)~~

~~*h.* Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (See section 550, *Other Information in Documents Containing Audited Financial Statements*, paragraph .04.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19). [As amended, effective for reports issued or reissued on or after February 29, 1996, by Statement on Auditing Standards No. 79. Revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]~~

~~**fn 9** Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**fn 10** See footnote 3. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

~~**fn 11** Section 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]~~

**~~Opinion Based in Part on Report of Another Auditor~~**

~~**.12** When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (See section 543, *Part of Audit Performed by Other Independent Auditors*.)~~

~~**.13** An example of a report indicating a division of responsibility follows:~~

~~Independent Auditor's Report~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~

~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

*** * ***

~~**Lack of Consistency**~~

~~**.16** The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

~~*a.* A change in accounting principle.~~

~~*b.* An adjustment to correct a misstatement in previously issued financial statements.~~

~~**Change in Accounting Principle**~~

~~**.17A** As discussed in PCAOB Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.[fn 12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~[fn 12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. See FASB Statement 154, paragraph 14.~~

~~**.17B** Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~**.17C** Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~**.17D** The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial~~

~~statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~**.17E**~~

~~If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

~~**Correction of a Material Misstatement in Previously Issued Financial Statements**~~

~~**.18A** Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph following the opinion paragraph.[fn 13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~[fn 13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

~~**.18B** This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~**.18C** The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

~~**Emphasis of a Matter**~~

~~**.19** In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing~~

~~[following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are—~~

- ~~That the entity is a component of a larger business enterprise.~~
- ~~That the entity has had significant transactions with related parties.~~
- ~~Unusually important subsequent events.~~
- ~~Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

**DEPARTURES FROM UNQUALIFIED OPINIONS**

**Qualified Opinions**

* * *

**.20A** When the auditor expresses a qualified opinion, the auditor's report must include the basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.[fn13A]

[fn13A] When the auditor expresses a qualified opinion, the section titled "The Auditor's Responsibilities Regarding Other Information"(described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has qualified the opinion.

**.21** When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph in the Opinion on the Financial Statements section of the auditor's report. The auditor should also include, in the Opinion on the Financial Statements section ~~opinion paragraph~~, the appropriate qualifying language and a reference to the ~~explanatory~~ "basis for departure from an unqualified opinion paragraph." A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

> Note: The auditor would refer to Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter.

**Scope Limitations**

**.22** The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with ~~generally accepted auditing~~ the standards of the Public Company Accounting Oversight Board ("PCAOB") and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

* * *

**.25** When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the auditor's report ~~situation~~ should ~~be~~ describe~~d~~ ~~in an explanatory~~ the basis for departure from an unqualified opinion in a paragraph preceding the opinion paragraph in the Opinion on the Financial Statements section and refer~~red~~ to in both the ~~scope~~ Basis of Opinion and the ~~opinion~~ Opinion on the Financial Statements ~~paragraphs~~ sections of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.26** When an auditor qualifies his or her opinion because of a scope limitation, the wording in the ~~opinion paragraph~~ Opinion on the Financial Statements section should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first paragraph as the standard report*~~ *Includes the same basic elements as the Introduction section of the auditor's unqualified report*]

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as discussed ~~in the following paragraph~~ below, we conducted our audits in accordance with ~~auditing~~ the standards of the PCAOB ~~generally accepted in the (United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, the financial statements referred to in the first paragraph above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.34** An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related notes (collectively referred to as the "financial statement"). This financial statement is the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on this financial statement based on our audit. We conducted our audit in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatements of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement. ~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

[*Opinion on the Financial Statement*]

In our opinion, the ~~balance sheet~~ financial statement referred to above presents fairly, in all material respects, the financial position of X Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**Departure from a Generally Accepted Accounting Principle**

**.35** When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, he or she should express a qualified (paragraphs .36 through .57) or an adverse (paragraphs .58 through .60) opinion. The basis for such opinion should be stated in the report.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.37** When the auditor expresses a qualified opinion, he or she should disclose in the Opinion on the Financial Statements section of the report, in a separate ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ preceding the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the ~~opinion paragraph~~ Opinion on the Financial Statements section of the report should include the appropriate qualifying language and a reference to the ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s).~~"~~ [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.38** The ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ that discloses the reasons for the qualified opinion should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable. [fn 15] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory "~~basis for departure from an unqualified opinion paragraph(s)~~"~~ in the auditor's report may be shortened by referring to it. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.39** An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America.

If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**.40** If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (preceding the opinion paragraph in the Opinion on the Financial Statements section) of the auditor's report in the circumstances illustrated in paragraph .39 might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.42** Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard report*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America. In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.44** ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income and retained earnings for the years then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audit.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as Company's auditor consecutively since [ *year* ].

[~~*Same second paragraph as the standard report*~~ *Includes the same basic elements as the Basis of Opinion section of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.51** ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph ~~.17A~~ 7 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* includes ~~states~~ the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

**.52** The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[fn 17]

In our opinion, except for the change in accounting principle discussed in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**fn17** Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ "basis for departure from an unqualified opinion paragraph" on consistency, a separate explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) as required by paragraphs ~~.17A thorough .17E of this section~~ 8 and 12-15 of Auditing Standard No. 6, *Evaluating Consistency of Financial Statements* is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

* * *

**.58A** When the auditor expresses an adverse opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the opinion as described in paragraph .58 and the basic elements included in the following sections of the auditor's unqualified report:[fn17A]

a. Introduction section;

b. Basis of Opinion section;

c. The Auditor's Responsibilities Regarding Other Information section;[fn17B] and

d. Signature and Date section.

> Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports with adverse opinions.

**fn17A** Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

**fn17B** When the auditor expresses an adverse opinion, the section titled "The Auditor's Responsibilities Regarding Other Information" (described in paragraphs 13-14 of Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*) also should include language that references the matter(s) for which the auditor has issued an adverse opinion.

**.59** When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ "basis for departure from an unqualified opinion paragraph(s)" preceding the opinion paragraph in the Opinion on the Financial Statements section of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[fn18] If the effects are not reasonably determinable, the report should so state. [fn19] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

**fn19** When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in paragraph ~~.11~~15~~,~~ ~~subsection (*b*), (*c*), (*d*), and (*e*)~~ of ~~this section~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

**.60** When an adverse opinion is expressed, the opinion paragraph in the Opinion on the Financial Statements section of the report should include a direct reference to a separate "basis for departure from an unqualified opinion paragraph" ~~that discloses the basis for the adverse opinion~~, as shown below:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~Same first and second paragraphs as the standard~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

In our opinion, because of the effects of the matters discussed in the preceding paragraphs, the financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.62** A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements. [fn 20] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (see paragraphs .35 through .57). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the ~~scope paragraph of the auditor's standard~~ Basis of Opinion section of the auditor's unqualified report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles. [Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]

**.62A** When the auditor disclaims an opinion, in addition to including the title, "Report of Independent Registered Public Accounting Firm," and the addressees, the auditor's report must include the basic elements included in the following sections of the auditor's unqualified report,[fn20A] modified appropriately as shown in an example report in paragraph .63:

a. Introduction section; and

b. Signature and Date section.

Note: Critical audit matters described in paragraphs 7-13 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, are not required in reports that disclaim an opinion.

[fn20A] Basic elements of the auditor's unqualified report are described in paragraph 6 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

**.63** An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We were engaged to audit the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. [fn 21]

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[~~*Second paragraph of standard report*~~ *Basic elements in the Basis of Opinion section of the auditor's unqualified report should be omitted*]

[*Opinion on the Financial Statements*]

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $_______ as of December 31, 20X2, and at $________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Since the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on these financial statements.

[*Signature*]

[*City and State or Country*]

[*Date*]

[fn21] The wording in the ~~first paragraph~~ Introduction section of the auditor's ~~standard~~ unqualified report is changed in a disclaimer of opinion because of a scope limitation.

The first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with ~~generally accepted auditing~~ the standards of the PCAOB. ~~In addition, the last sentence of the first paragraph is also deleted, because of the scope limitation, to eliminate the reference to the auditor's responsibility to express an opinion.~~ [Footnote renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 93, October 2000.]

* * *

**REPORTS ON COMPARATIVE FINANCIAL STATEMENTS**

**.65** The fourth standard of reporting[fn21A] requires that an auditor's report contain either an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference in the fourth reporting standard to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor [fn 22] should update [fn 23] the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period. [fn 24] Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (See section 530, *Dating of the Independent Auditor's Report*, paragraph .01.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

**fn21A** See paragraph .02 of AU sec. 150, *Generally Accepted Auditing Standards*.

* * *

**Different Reports on Comparative Financial Statements Presented**

**.67** Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the preceding paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first paragraph as the standard*~~ *Includes the same basic elements as the Introduction section of the auditor's unqualified report*]

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. Except as explained in the ~~following~~ first paragraph in the Opinion on the Financial Statements section, we conducted our audits in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[fn 25]

Because of the matter discussed in the preceding paragraph, the scope of our work was not sufficient to enable us to express, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

In our opinion, the balance sheets of ABC Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.69** If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate ~~explanatory~~ paragraph(s) preceding the opinion paragraph in the Opinion on the Financial Statements section of his or her report.[fn 29] The ~~explanatory~~ paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of a~~n~~ ~~explanatory~~ paragraph that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[~~*Same first and second paragraphs as the standard*~~ *Includes the same basic elements as the Introduction and the Basis of Opinion sections of the auditor's unqualified report*]

[*Opinion on the Financial Statements*]

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [fn 26]

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 79, December 1995.]

* * *

**.74** If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory paragraph~~ Basis of Opinion section of his or her report (a) that the financial statements of the prior period were audited by another auditor,[fn 29] (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor.[fn 30] An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

We have audited the accompanying balance sheet of ABC Company as of December 31, 20X2, and the related statements of income, retained earnings, and cash flows for the year then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on ~~these~~ the Company's financial statements based on our audit. The financial statements of ABC Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements. We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosure in the financial statements. Our audit also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

[~~*Same second paragraph as the standard report*~~ *Opinion on the Financial Statements*]

In our opinion, the 20X2 financial statements referred to above present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[City and State or Country]

[Date]

If the predecessor auditor's report was other than ~~a standard~~ an auditor's unqualified report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

> . . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Basis of Opinion section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

~~[Paragraph renumbered and amended, effective for reports issued or reissued on or after February 29, 1996, by the issuance of Statement on Auditing Standards No. 79.]~~

*** * ***

## AU sec. 9508, ~~Reports on Audited Financial Statements~~ [new proposed title] Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of Section 508

* * *

**.01** *Question*—Section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .24 states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

**.36** ~~Examples of~~ An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[fn 1A] ~~with such an explanatory paragraph follow.~~

~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~

[*Introduction*]

~~"~~We have audited the statement of net assets in liquidation of XYZ Company as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audit.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~"We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence~~

~~supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

[*Opinion on the Financial Statements*]

~~"~~As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

"In our opinion, the financial statements referred to above present fairly, in all material respects, the net assets in liquidation of XYZ Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph."

[fn1A] The auditor's report must include other basic elements of the auditor's unqualified report and critical audit matters described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard*, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~
An example of the Introduction and the Opinion on the Financial Statements sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows: [fn1B]

[*Introduction*]

~~"~~We have audited the balance sheet of XYZ Company as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes (collectively referred to as the "financial statements"). In addition, we have audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audits.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

~~"We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

[*Opinion on the Financial Statements*]

~~"~~As described in Note X to the financial statements, the stockholders of XYZ Company approved a plan of liquidation on April 25, 20X2, and the company commenced liquidation shortly thereafter. As a result, the company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

~~"~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of XYZ Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described in the preceding paragraph.~~"~~

[fn1B] *Id.*

* * *

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

**.51** *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

**.52** *Interpretation*—No. The statement about management's responsibilities for the financial statements required by ~~section 508, *Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

**14. Reporting on Audits Conducted in Accordance With the Standards of the PCAOB (United States) ~~Auditing Standards Generally Accepted in the United States of America~~ and in Accordance With International Standards on Auditing**

**.56** *Question*— ~~*Section 508, Reports on Audited Financial Statements*~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires ~~states that a basic element of the auditor's report is~~ a statement that the audit was conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB ~~generally accepted in the United States of America~~ and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor's report?

**.57** *Interpretation*—Yes. ~~Section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, requires that the auditor indicate in the auditor's report that the audit was conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~; however, ~~section 508~~ Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing. ~~fn 1~~

~~fn 1 Appendix B, *Analysis of International Standards on Auditing*, identifies sections and paragraphs, if applicable, within the International Standards on Auditing that may require procedures and documentation in addition to those required by U.S. auditing standards.~~

**.58** When reporting on an audit performed in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States of America~~ and International Standards on Auditing, the auditor should comply with the standards of the PCAOB ~~reporting standards generally accepted in the United States of America~~.

**.59** An example of reporting on an audit conducted in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States~~ and in accordance with International Standards on Auditing follows:

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB ~~auditing standards generally accepted in the United States of America~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

~~An~~ Our audits included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audits also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. We believe that our audits provide~~s~~ a reasonable basis for our opinion.

* * *

**.61** *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title]

*Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .74, the successor auditor should indicate in the ~~introductory paragraph~~ Introduction section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 29 of section 508 indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Basis of Opinion section of the successor auditor's report is presented as follows:

The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor’s report.

* * *

**.78** AU sec. ~~Section~~ 508.42 provides an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate). ~~as follows:~~

~~Independent Auditor's Report~~

~~[*Same first and second paragraphs as the standard report*]~~

~~The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.~~

~~In our opinion, except for the omission of the information discussed in the preceding paragraph, . . .~~

* * *

**.83** Following is an illustration of a ~~report that expresses a~~ qualified opinion because the Schedule of Investments fails to disclose investments constituting more than 5 percent of net assets, but in all other respects conforms to the requirements of the Guide:

~~Independent Auditor's Report~~

[~~*Same first and second paragraphs as the standard report*~~ *Opinion on the Financial Statements section*]

The Schedule of Investments included in the Partnership's financial statements does not disclose required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods)
- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

In our opinion, except for the omission of the information discussed in the preceding paragraph, the financial statements and financial highlights referred to above present fairly, …

**.84** An illustration of an adverse opinion relating to failure to present the entire Schedule of Investments and all of the related required information follows. [fn 6] This illustration assumes that the auditor has concluded that it is not practicable to present all of the required information. In such circumstances, the auditor presents in his or her report the missing information, where it is practicable to do so, and describes the nature of the missing information where it is not practicable to present the information in the report:

~~Independent Auditor's Report~~

[~~*Same first and second paragraphs as the standard report*~~ *Opinion on the Financial Statements section*]

The Partnership has declined to prepare and present a Schedule of Investments and the related information as of December 31, 20X2. Accounting principles generally accepted in the United States of America require presentation of this Schedule and the related information. Presentation of this Schedule would have disclosed required information about the following investments, each constituting more than 5 percent of the Partnership's total net assets, at December 31, 20X2:

- Amalgamated Buggy Whips, Inc., 10,000 shares of common stock—fair value $3,280,000 (Consumer nondurable goods) [fn 7]

- Paper Airplane Corp., 6.25% Cv. Deb. due 20XX, $4.5 million par value—fair value $4,875,000 (Aviation)

In addition, presentation of the Schedule of Investments would have disclosed [*describe the nature of the information that it is not practicable to present in the auditor's report*].

In our opinion, because the omission of a Schedule of Investments results in an incomplete presentation as explained in the preceding paragraph, the financial statements and financial highlights referred to above do not present fairly, …

## AU sec. 543*, Part of the Audit Performed by Other Independent Auditors*

* * *

**.07** When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Introduction, Basis of Opinion, and Opinion on Financial Statements sections the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor. [fn 3]

* * *

**.09** An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

~~Independent Auditor's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of X Company*

[*Introduction*]

We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20...., and the related consolidated statements of income and retained earnings and cash flows for the year then ended, and the related notes (collectively referred to as the "financial statements"). These financial statements are the responsibility of the Company's management. ~~Our responsibility is to express an opinion on these financial statements based on our audits.~~

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. We or our predecessor firms have served as the Company's auditor consecutively since [ *year* ].

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audit in accordance with the ~~auditing~~ standards of the PCAOB ~~generally accepted in the~~ ~~(United States) of America~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ include examining, on a test basis, appropriate evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

[*Opinion on the Financial Statements*]

In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

*Critical Audit Matters*

*The Auditor's Responsibilities Regarding Other Information*

[*Signature*]

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate. ~~[Revised, April 1998, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards Nos. 53 through 62. Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

**Procedures Applicable to Both Methods of Reporting**

**.10** Whether or not the principal auditor decides to make reference to the audit of the other auditor, he should make inquiries concerning the professional reputation and independence of the other auditor. He also should adopt appropriate measures to assure the coordination of his activities with those of the other auditor in order to achieve a proper review of matters affecting the consolidating or combining of accounts in the financial statements. These inquiries and other measures may include procedures such as the following:

* * *

c. Ascertain through communication with the other auditor:

* * *

(ii)That he or she is familiar with accounting principles generally accepted in the United States of America and with the ~~generally accepted auditing~~ standards of the Public Company Accounting Oversight Board ~~promulgated by the American Institute of Certified Public Accountants~~ and will conduct his or her audit and will report in accordance therewith.

* * *

* * *

**Other Auditor's Report Departs From ~~Standard~~ Auditor's Unqualified Report**

**.15** If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

* * *

## AU sec. 544, *Lack of Conformity with Generally Accepted Accounting Principles*

* * *

**.04** When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph),~~ ~~modified~~ modify the auditor's report as appropriate (see section 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .35 through .60 ~~.35-.60~~) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting. [As amended by Statement on Auditing Standards No. 62, effective for reports issued on or after July 1, 1989. As amended, effective for audits of financial statements for periods ended on or after December 31, 1996, by Statement on Auditing Standards No. 77.]

## AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*

* * *

**.02** The auditor's ~~standard~~ unqualified report covers the basic financial statements: balance sheet, statement of income, statement of retained earnings or changes in stockholders' equity, and statement of cash flows. The following presentations are considered part of the basic financial statements: descriptions of accounting policies, notes to financial statements, and schedules and explanatory material that are identified as being part of the basic financial statements. For purposes of this section, basic financial statements also include an individual basic financial statement, such as a balance sheet or statement of income and financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

* * *

**fn 4** See paragraph .10 for guidance when there is a modification of the auditor's ~~standard~~ unqualified report on the basic financial statements.

* * *

**.10** The auditor should consider the effect of a departure ~~any modifications in his standard~~ from the auditor's unqualified report when reporting on accompanying information. When the auditor expresses a qualified opinion on the basic financial statements, he should make clear the effects upon any accompanying information as well (see paragraph .14). When the auditor expresses an adverse opinion, or disclaims an opinion, on the basic financial statements, he should not express the opinion described in paragraph .06 on any accompanying information. [fn 5] An expression of such an opinion in these circumstances would be inappropriate because, like a piecemeal opinion, it may tend to overshadow or contradict the disclaimer of opinion or adverse opinion on the basic financial statements. (See section 508.64 and section 623.14.)

* * *

**.21** The auditor may be requested to describe the procedures applied to specific items in the financial statements. Additional comments of this nature should not contradict or detract from the description of the scope of his audit in the ~~standard~~ auditor's unqualified report. Also, they should be set forth separately rather than interspersed with the information accompanying the basic financial statements to maintain a clear distinction between management's representations and the auditor's representations. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 98, September 2002.]

* * *

## AU sec. 552, *Reporting on Condensed Financial Statement and Selected Financial Data*

* * *

**.02** In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .41 through .44, section 623, *Special Reports*, or other applicable Statements on Auditing Standards. [fn 2]

* * *

**.06** The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Independent Auditor's Report

We have audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements.

In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]

**.07** A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~fn 6~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate. [fn 7]

~~fn 6 If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (See section 508, *Reports on Audited Financial Statements*, paragraphs .41 through .44.) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Independent Auditor's Report. We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the~~

~~preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

**.10** The following is an example of an additional paragraph included after the opinion paragraph in the Opinion on the Financial Statements section of the ~~an~~ auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Independent Auditor's Report~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

Opinion on the Financial Statements

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the ABC Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~(United States) of America~~, the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of income, retained earnings, and cash flows for the years ended December 31, 20X2, and 20X1, and the related notes (collectively referred to as the "financial statements") (none of which are presented herein); and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

~~[Revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

## AU sec. 560, *Subsequent Events*

* * *

**.09** Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his or her report an explanatory paragraph directing the reader's attention to the event and its effects. (See ~~section 508.19~~paragraph 16 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.)

* * *

## AU sec. 623, *Special Reports*

**.01** This section applies to auditors' reports issued in connection with the following:

*** * ***

Note: If any of the auditor's reports described in this section are filed with the U.S. Securities and Exchange Commission, the auditor's report is required to include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-13, respectively, of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

fn 2 In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

**.06** Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (see section 508, *Reports on Audited Financial Statements*, paragraph .08) modified as appropriate~~ because of the departures from generally accepted accounting principles (see AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

**.14** The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (see section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraph .64). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**.15** When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

*** * ***

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

* * *

**.17** The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in ~~section 508, *Reports on Audited Financial Statements*,~~ paragraph ~~.11~~15 of Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

**.21** When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ following the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

**.31** Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

*a.* *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application, [fn 35] the auditor should add an explanatory paragraph to the report (following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon [fn 36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~section 508, *Reports on Audited Financial Statements*, paragraphs .16 through .18~~Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*. [fns 37–38]

b. * * *

*c.* *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in section ~~508~~543, ~~*Reports on Audited Financial Statements*~~ *Part of Audit Performed by Other Independent Auditors*, paragraphs .~~12 and .13~~06-.09.

*d.* *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).*If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph preceding the opinion paragraph of the report. Guidance on reporting in this situation is contained in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, paragraphs .68 and .69.

As in reports on financial statements prepared in conformity with generally accepted accounting principles, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (or specified elements, accounts, or items thereof). [Revised, February 1997, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 79.]

* * *

fn 22 When the auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the last two paragraphs of this report are examples of the paragraphs that should follow the ~~opinion paragraph~~ Opinion on the Financial Statements section of the auditor's report on the financial statements. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 77, November 1995.]

* * *

## AU sec. 9623, *Special Reports: Auditing Interpretations of Section 623*

* * *

**.45** *Interpretation*~~—Section 420.06~~ Auditing Standard No. 6, *Evaluating Consistency in Financial Statements* states that changes in accounting principles and methods of applying them affect consistency and require the addition of an explanatory paragraph (following the ~~opinion paragraph~~ Opinion on the Financial Statements section) in the auditor's unqualified report on the audited financial statements. Section 623.16 states that, if applicable, any departures from the auditor's ~~standard~~ unqualified report on the related financial statements should be indicated in the special report on an element, account, or item of a financial statement.

* * *

fn 10 Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AU sec~~tion~~. 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and the applicable industry audit guide.

* * *

**.83** *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in section 508, ~~*Reports on Audited Financial Statements*~~ [new proposed title] *Departures from Unqualified Opinions and*

Other Reporting Circumstances, paragraphs .35–.44 and .58–.60. [Paragraph renumbered by the issuance of Statement of Position 01-5, December 2001.]

* * *

## AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties*

* * *

**.27** When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report~~, the accountants should refer [fn 18] to that fact in the comfort letter and discuss the subject matter of the paragraph. [fn 19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (See also paragraph .35*f*.) [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

**.30** An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which section 722 pertains or (*b*) required supplementary information, to which section 558, *Required Supplementary Information*, pertains. Section 722 and section 558 provide that the accountants should expand the ~~standard~~ auditor's unqualified report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ auditor's unqualified report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (see also paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by sections 722 and 558, the accountants may do so and report their findings. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

**.35** Comments included in the letter will often concern (*a*) unaudited condensed interim financial information (see paragraphs .36 through .38), [fn 27] (*b*) capsule financial information (see paragraphs .36 and .39 through .41), (*c*) pro forma financial information (see paragraphs .42 and .43), (*d*) financial forecasts (see paragraphs .36 and .44), and (*e*) changes in capital stock, increases in long-term debt, and decreases in other specified financial statement items (see paragraphs .36 and .45 through .53). For commenting on these matters, the following guidance is important:

*** * ***

f. When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

[Paragraph renumbered by the issuance of Statement on Auditing Standards No. 76, September 1995.]

* * *

## AU sec. 722, *Interim Financial Information*

* * *

### Form of Accountant's Review Report

**.37** The accountant's review report accompanying interim financial information should consist of:

a. ~~A~~ The title ~~that includes the word *independent*~~, "Report of Independent Registered Public Accounting Firm".

a-1. Addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body.[fn24A]

a-2. The name of the company whose interim financial information was reviewed.

a-3. The date of, or period covered by, the interim financial information and each related schedule, if applicable, identified in the report.

*** * ***

d. A statement that the review of interim financial information was conducted in accordance with the standards ~~established by the AICPA~~ of the Public Company Accounting Oversight Board ("PCAOB") (United States).

e. * * *

f. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.

g. * * *

h. * * *

h-1. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.

* * *

In addition, each page of the interim financial information should be clearly marked as unaudited.

**fn24A** For example, addressees might include other appropriate parties depending on the legal and governance structure of the company.

**.38** The following is an example of a review report: [fn 26]

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") (United States) ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the ~~generally accepted auditing~~ standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*City and State or Country*]

[*Date*]

**.39** An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [fn 27]

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the condensed consolidated balance sheet of ABC Company and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0. These financial statements are the responsibility of the company's management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB")~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with ~~auditing~~ the standards ~~generally accepted in the~~ of the PCAOB ~~United States of America~~, the consolidated balance sheet of ABC Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended, and the related notes (collectively referred to as the "consolidated financial statements") (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived. [fn 28]

[*Signature*]

[*City and State or Country*]

[*Date*]

**.40** The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review. [fn 29] The following is an example of report including such a reference:

~~Independent Accountant's~~ Report of Independent Registered Public Accounting Firm

*To the shareholders and board of directors of ABC Company*

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended. This (These) interim financial information (statements) is (are) the responsibility of the company's management.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB") ~~established by the American Institute of Certified Public Accountants~~. A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with ~~generally accepted auditing~~ the standards of the PCAOB, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

[*Signature*]

[*City and State or Country*]

[*Date*]

**.41** The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles, ~~[fn 30]~~ which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. See paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~fn 30 If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in section 508, *Reports on Audited Financial Statements*, paragraph .15).~~

* * *

**.50** The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The following is an example of a paragraph that should be added to the auditor's report if the selected quarterly financial data required by item 302(a) has not been reviewed.

The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards ~~established by the American Institute of Certified Public Accountants~~ of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

## APPENDIX 4

## *Proposed Amendments to PCAOB Standards Related to the Proposed Other Information Standard*

In connection with its proposed auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), the Board is proposing amendments to several of its auditing standards to conform to the requirements of the proposed other information standard.[1/]

Language that would be deleted by the proposed amendments is ~~struck through~~. Language that would be added is underlined. The presentation of proposed amendments to PCAOB standards by showing deletions and additions to existing sentences and paragraphs is intended to assist readers in easily comprehending the Board's proposed changes to existing auditing standards and interpretations. The Board's proposed amendments consist of only the deletion or addition of the language that has been struck through or underlined. This presentation does not constitute or represent a reproposal of all or of any other part of a standard or interpretation that may be amended.

The proposed amendments would amend specific auditing standards to reflect requirements of the proposed other information standard. Some of these auditing standards may need further updating, which the Board may consider under separate standard-setting projects. The proposed amendments in connection with the proposed other information standard primarily include updating references to auditing standards that are being amended or superseded, changing references to AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* applied by analogy, and moving the reporting example from AU sec. 9550, *Other Information in Certain Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550,* to AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*, related to considerations in the auditor's report

[1/] PCAOB Release No. 2013-002, *Proposed Reorganization of PCAOB Auditing Standards* (March 26, 2013), and PCAOB Release No. 2011-005, *Auditing Supplemental Information Accompanying Audited Financial Statements* (July 12, 2011), include proposed amendments that would supersede, amend, or delete paragraphs for which amendments are included in this proposed other information standard. If, prior to the conclusion of this rulemaking, the Board has adopted amendments that affect the amendments proposed in this release, the Board may make conforming changes to this proposed other information standard.

regarding a report by management on an audit of internal control over financial reporting.

The following standard and interpretation would be superseded by this proposal:

- AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, and

- AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

The Board is requesting comments on all aspects of the proposed amendments. Significant proposed amendments are described in more detail in Appendix 6 of this release.

## Auditing Standard No. 7, *Engagement Quality Review*

* * *

[5/] See ~~paragraphs .04-.06 of AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; AU sec. 711, *Filings Under Federal Securities Statutes*.

* * *

## Auditing Standard No. 16, *Communications with Audit Committees*

* * *

[27/] *See, e.g.*, ~~AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* ("proposed other information standard"). In addition to ~~AU sec. 550~~ the proposed other information standard, discussion of the auditor's consideration of other information is included in AU sec. 558, *Required Supplementary Information,* and AU sec. 711, *Filings Under Federal Securities Statutes.*

* * *

**APPENDIX B**

This appendix identifies other PCAOB rules and standards related to the audit that require communication of specific matters between the auditor and the audit committee.

* * *

- ~~AU sec. 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, paragraphs ~~.04 and .06~~8 and 10.

* * *

## AU sec. 9324, *Service Organizations: Auditing Interpretations of Section 324*

* * *

**.37** If the service organization includes information about the design deficiencies in the section of the document titled "Other Information Provided by the Service Organization," the service auditor should read the information and ~~consider applying by analogy the guidance in section 550, *Other Information in Documents Containing Audited Financial Statements.*~~ ~~In addition, the service auditor should~~ include a paragraph in his or her report disclaiming an opinion on the information provided by the service organization. The following is an example of such a paragraph.

> The information in section 4 describing XYZ Service Organization's plans to modify its disaster recovery plan is presented by the Service Organization to provide additional information and is not a part of the Service Organization's description of controls that may be relevant to a user organization's internal control. Such information has not been subjected to the procedures applied in the examination of the description of the controls applicable to the processing of transactions for user organizations and, accordingly, we express no opinion on it.

A service auditor also may consider communicating information about the design deficiencies in the section of the service auditor's document titled "Other Information Provided by the Service Auditor."

* * *

## AU sec. 9342, *Auditing Accounting Estimates: Auditing Interpretations of Section 342*

* * *

**.09** When the unaudited voluntary disclosures are included in a client-prepared document and are located on the face of the financial statements, the footnotes, or in a supplemental schedule, the voluntary disclosures should be ~~labelled~~ labeled "unaudited." When such unaudited information is not presented on the face of the financial statements, the footnotes, or in a supplemental schedule, the auditor should consider the ~~guidance~~ auditor's responsibilities in ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

* * *

## AU sec. 508, *Reports on Audited Financial Statements*

* * *

**CONSIDERATIONS IN THE AUDITOR'S REPORT REGARDING REPORT BY MANAGEMENT ON AUDIT OF INTERNAL CONTROL OVER FINANCIAL REPORTING**

**.74A** In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in annual reports filed with the SEC under the Securities Exchange Act of 1934 that contain audited financial statements and the related auditor's report in Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

**.74B** If the auditor has not been engaged to examine and report on management's assertion about the effectiveness of the company's internal control over financial reporting, the auditor may include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;

- The audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis of Opinion section in the auditor's report that contains such statements:

[*Basis of Opinion*]

Our responsibility is to express an opinion on the Company's financial statements based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

*** * ***

## AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*

* * *

**.04** When an auditor submits a document containing audited financial statements to his client or to others, he has a responsibility to report on all the information included in the document. On the other hand, when the auditor's report is included in a client-prepared document [fn 2] and the auditor is not engaged to report on information accompanying the basic financial statements, his responsibility with respect to such information is described in (*a*) ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and (*b*) other sections covering particular types of information or circumstances, such as section 558, *Required Supplementary Information*.

* * *

## AU sec. 558, *Required Supplementary Information*

* * *

**fn2** This section is not applicable to entities that voluntarily present supplementary information not required by GAAP. For example, entities that voluntarily present supplementary information on the effects of inflation and changes in specific prices, formerly required by FASB Statement No. 33, *Financial Reporting and Changing Prices*, are guided by ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. [Footnote revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91. As amended, effective September 2002, by Statement on Auditing Standards No. 98.]

* * *

**.03** Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph in his report on the audited financial statements a disclaimer on the information. [fn3]The following is an example of a disclaimer an auditor might use in these circumstances:

> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

When the auditor does not apply the procedures described in this section to a voluntary presentation of required supplementary information required for other entities, the provisions of ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding* *Other Information in* *Certain* *Documents Containing Audited Financial Statements* *and the Related Auditor's Report*, apply, only if the annual report containing the financial statements and the related auditor's report is an annual report filed with the SEC under the Securities Exchange Act of 1934.

* * *

**.05** The auditor's responsibility for other information not required by the FASB, GASB, or FASAB but included in certain annual reports—which are client-prepared documents [fn4]—is specified in ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding* *Other Information in* *Certain* *Documents Containing Audited Financial Statements* *and the Related Auditor's Report*. The auditor's responsibility for information outside the basic financial statements in documents that the auditor submits to the client or to others is specified in section 551. The auditor's responsibility for supplementary information required by the FASB, GASB or FASAB (called *required supplementary information*) is discussed in the paragraphs that follow. [Revised, April 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 91.]

* * *

**.09** In conjunction with the audit of the financial statements, the auditor may subject the supplementary information to certain auditing procedures. If the procedures are sufficient to enable the auditor to express an opinion on whether the information is fairly stated in all material respects in relation to the financial statements taken as a whole, the auditor may expand the ~~audit~~ auditor's report to express such an opinion. ~~in accordance with section 550.07~~. ~~[Paragraph added, effective September 2002, by Statement on Auditing Standards No. 98.]~~In those circumstances, the auditor's report should describe clearly the character of the auditor's work and the degree of responsibility the auditor is taking regarding the supplementary information. The auditor may report on the supplementary information using the following examples:

a. Required supplementary information to which no qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The [*identify the required supplementary information*] is presented for purposes of additional analysis and is not a required part of the financial statements. Such information has been subjected to the auditing procedures applied in the audit of the financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

b. Required supplementary information to which a qualification in the auditor's report on the financial statements applies:

Our audit was conducted for the purpose of forming an opinion on the financial statements taken as a whole. The required supplementary information included in [*Schedules 1 and 2*] on page(s) [*XX and XX*] as of December 31, 19XX, is presented for purposes of additional analysis and is not a required part of the financial statements. The required supplementary information in such schedules has been subjected to the auditing procedures applied in the audit of the financial statements; and, in our opinion, except for [*describe reason for qualification*], such information is fairly stated in all material respects in relation to the financial statements taken as a whole.

* * *

## AU sec. 9634, *Letters for Underwriters and Certain Other Requesting Parties: Auditing Interpretations of Section 634*

* * *

**.04** The auditor may affirm to the board of directors that under generally accepted auditing standards, ~~the auditor is required to read the information~~ in addition to ~~audited~~ auditing the financial statements contained in the Form 10-K, the auditor is required to ~~for the purpose of considering~~ evaluate whether ~~such~~ the other information included in such annual reports filed with the SEC under the Securities Exchange Act of 1934 and contain audited financial statements and the related auditor's report contains (1) a material inconsistency, (2) a material misstatement of fact, (3) or both**,** and, if so, to respond appropriately, and to communicate in the auditor's report whether the other information contains a material inconsistency, a material misstatement of fact, or both (see Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*). ~~may be materially inconsistent with information appearing in the financial statements (see section 550)~~. ~~However, the report to the board of directors should state that the auditor has no obligation to perform any procedures to corroborate such information.~~

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## AU sec. 722, *Interim Financial Information*

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**.18** *Inquiries and other review procedures.* The following are inquiries the accountant should make and other review procedures the accountant should perform when conducting a review of interim financial information:

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f. Reading other information that accompanies the interim financial information and is contained in reports (1) to holders of securities or beneficial interests or (2) filed with regulatory authorities under the Securities Exchange Act of 1934 (such as Form 10-Q or 10-QSB), to consider ~~–~~whether such information or the manner of its presentation is materially inconsistent with the interim financial information or there is a material misstatement of fact in the other information.[fn 12] If the accountant concludes that there is a material inconsistency~~,~~ or ~~becomes aware of information that he or she believes is~~ a material misstatement of fact, ~~the action taken will depend on his or her judgment in the particular circumstances. In determining the appropriate course of action,~~ the accountant should consider the ~~guidance~~ requirements of ~~in~~ ~~section 550~~Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.* ~~paragraphs .04 through .06)~~

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## APPENDIX 5

### *Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release*

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"), presented in Appendix 1, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments"), presented in Appendix 3. This Appendix collectively refers to the proposed auditor reporting standard and proposed amendments as the "proposed auditor reporting standard and amendments."

Following the Board's initial outreach from October 2010 to March 2011,[1/] the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").[2/] Additionally, the Board held a public roundtable[3/] on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")[4/] and Standing Advisory Group ("SAG") meetings.[5/]

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[1/] See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

[2/] *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011-003 (June 21, 2011), is available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

[3/] A transcript of the public roundtable discussions is available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[4/] IAG meeting details and webcasts for March 2011 and 2012 are available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx and http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx.

[5/] See SAG meeting transcripts for November 2011 and 2012, available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

This Appendix discusses significant comments received during the Board's outreach regarding the auditor's reporting model and also provides additional background information regarding the requirements in the proposed auditor reporting standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, to assist the Board in evaluating the clarity of the Board's proposal relating to the communication of "critical audit matters,"[6/] the Board requests that commenters prepare and forward to the Board for its consideration examples of critical audit matters that could be communicated in the auditor's report under the proposed auditor reporting standard.[7/]

Further, the Board is seeking comment on economic considerations related to the proposed auditor reporting standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to specific entities, including the audits of brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans. Considerations related to the applicability of the proposed auditor reporting standard and amendments to audits of emerging growth companies ("EGCs") are discussed in Appendix 7.

The following sections describe the requirements in the proposed auditor reporting standard and amendments. The Exhibit to this Appendix provides three illustrative examples of communications of critical audit matters.

## I. Introduction (Paragraphs 1 – 3 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard establishes requirements for the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"). The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted

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6/ See Section V., *Critical Audit Matters*, of this Appendix for discussion of the proposed critical audit matters.

7/ Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

an audit in accordance with the standards of the PCAOB and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

The proposed auditor reporting standard would supersede portions of existing AU sec. 508, *Reports on Audited Financial Statements*, ("existing AU sec. 508") that primarily relate to an unqualified opinion.[8/] When the auditor is unable to express an unqualified opinion on the financial statements, resulting from, for example, a scope limitation or from the financial statements containing a material departure from the applicable financial reporting framework, the auditor would continue to refer to the requirements in existing AU sec. 508. Existing AU sec. 508 would be retitled to "Departures from Unqualified Opinions and Other Reporting Circumstances" and also would include proposed amendments resulting from issuance of the proposed auditor reporting standard.[9/]

## II. Objectives (Paragraph 4 of the Proposed Auditor Reporting Standard)

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed auditor reporting standard to highlight the overall context for the requirements of the standard. The proposed auditor reporting standard states that when the auditor concludes that an auditor's unqualified opinion is appropriate, the objectives of the auditor are to:

- Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

- Communicate in the auditor's unqualified report critical audit matters relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

The Board's existing AU sec. 508 does not include an objective for the auditor when expressing an opinion on the financial statements. However, existing AU sec. 508 states that the report shall contain either an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed, and, where an auditor's name is associated with financial

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8/ AU secs. 508.01-.09 and .11-.19 would be superseded.

9/ See Section VII., *Amendments to Other PCAOB Standards*, for a discussion of how the requirements of the proposed auditor reporting standard relate to a qualified opinion, adverse opinion, and disclaimer of opinion.

statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.[10] The objectives of the proposed auditor reporting standard include the auditor's expression of the opinion on the financial statements. Additionally, the basic elements that describe the nature of the audit and the auditor's responsibilities are similar to an indication of the character of the auditor's work.[11]

Question Related to Section II:

1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?

## III. The Auditor's Unqualified Report (Paragraph 5 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard provides the overall framework for the auditor's unqualified report. This framework would include:

- Basic elements;
- Communication of critical audit matters; and
- Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances.

Because of changes being proposed to the auditor's report, the proposed auditor reporting standard uses the term "auditor's unqualified report" to differentiate it from the "auditor's standard report" described in existing AU sec. 508. The auditor's unqualified report, as described in the proposed auditor reporting standard, not only would include certain standardized language but also would include tailored language related to the auditor's communication of critical audit matters specific to the individual audit.

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[10] See existing AU sec. 508.04.

[11] See Section IV., *Basic Elements*, of this Appendix for discussion of the proposed basic elements.

## IV. Basic Elements (Paragraph 6 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard retains the basic elements from existing auditor reporting standards[12/] and incorporates elements from existing illustrative reports that accompany the existing auditor reporting standards. Additionally, the proposed auditor reporting standard improves the language for certain elements in the existing auditor reporting standards. Finally, the proposed auditor reporting standard adds new elements that provide more information about the audit and the auditor, such as information regarding auditor tenure and the auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information.

The proposed auditor reporting standard retains the pass/fail model of the existing auditor's report. Many commenters supported retaining the pass/fail model because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented. Additionally, commenters indicated support for the concise and useful message of the pass/fail model.

The proposed basic elements are intended to improve investors' and other financial statement users' understanding about the auditor, the nature of an audit, and the auditor's responsibilities. Except for the new proposed requirement regarding the auditor's responsibilities for other information outside the financial statements, the proposed changes to the basic elements do not represent a significant departure from existing requirements and the Board does not anticipate that they would impose significant additional costs.[13/] The Board, however, would expect audit firms to incur minimal one-time costs that relate primarily to updating a firm's methodology regarding auditor reporting. These changes might not result in significant recurring costs because they involve standardized language that, once implemented, would be the same or very similar across different auditors' reports.

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12/ See AU sec. 508 and Auditing Standard No. 1, *References in Auditor's Reports to the Standards of the Public Company Accounting Oversight Board.*

13/ Costs related to reporting regarding the auditor's responsibilities for other information outside the financial statements and the results of the auditor's evaluation of the other information are discussed in Appendix 6.

## A. Basic Elements Retained from Existing Standards and Incorporated from Existing Illustrative Reports

### *1. Basic Elements Retained from Existing Standards*

The proposed auditor reporting standard retains the existing basic elements that are currently included in the auditor's report. Commenters indicated that these elements remain important for an understanding of the audit and the auditor's opinion and provide consistency and comparability among auditors' reports.

The basic elements retained from the existing auditor reporting standards include:

- A statement identifying each financial statement and related schedule, if applicable, that has been audited (paragraph 6.d. of the proposed auditor reporting standard);
- A statement that the financial statements are the responsibility of the company's management (paragraph 6.g. of the proposed auditor reporting standard);
- A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit (paragraph 6.j. of the proposed auditor reporting standard);
- A statement that the audit was conducted in accordance with the standards of the PCAOB (paragraph 6.k. of the proposed auditor reporting standard);
- A statement that an audit includes evaluating the overall presentation of the financial statements (paragraph 6.m.(4) of the proposed auditor reporting standard);
- A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion (paragraph 6.n. of the proposed auditor reporting standard);
- An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance sheet date and the results of its operations and its cash flows for the period then

ended in conformity with the applicable financial reporting framework.[14/] The opinion should also include an identification of the applicable financial reporting framework (paragraph 6.o. of the proposed auditor reporting standard);

- The signature of the auditor's firm[15/] (paragraph 6.q. of the proposed auditor reporting standard);

- The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[16/] (paragraph 6.r. of the proposed auditor reporting standard); and

- The date of the auditor's report (paragraph 6.s. of the proposed auditor reporting standard).[17/]

*2. Basic Elements Incorporated from Existing Illustrative Reports*

In addition to the basic elements retained from the existing auditor reporting standards, the proposed auditor reporting standard also incorporates basic elements from the illustrative reports accompanying the existing reporting standards.[18/] Although these elements were not specifically required by existing auditor reporting standards,

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14/ The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and required financial statements. For example, in an audit of an investment company, the auditor might use such terms as "the financial position," "the results of its operations," and "changes in its net assets" in the Opinion on the Financial Statements section of the auditor's report.

15/ See also U.S. Securities and Exchange Commission ("SEC") Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

16/ Id.

17/ See AU sec. 530, *Dating of the Independent Auditor's Report*.

18/ See illustrative reports on an audit of financial statements in existing AU sec. 508.08 and the Appendix of Auditing Standard No. 1.

the Board understands that, in practice, these elements generally are incorporated by auditors in the auditors' reports on financial statements filed with the SEC.[19/]

The proposed auditor reporting standard incorporates the following elements from the existing illustrative reports:

- The title, "Report of Independent Registered Public Accounting Firm" (paragraph 6.a. of the proposed auditor reporting standard);[20/]
- The name of the company whose financial statements were audited (paragraph 6.c. of the proposed auditor reporting standard); and
- The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report (paragraph 6.e. of the proposed auditor reporting standard).

The basic elements retained from the existing auditor reporting standards and incorporated from existing illustrative reports are generally understood by investors and other financial statement users and would continue to promote consistency among auditors' reports.

## B. Changes to Certain Language in the Existing Auditor's Report

The proposed auditor reporting standard would change the language for certain elements in the existing auditor's report. As further described below, the changes are being proposed in response to comments and to align the language with other PCAOB standards.

### *1. Addressees (Paragraph 6.b. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. The proposed auditor reporting standard indicates

[19/] Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, all auditors' reports incorporated these basic elements.

[20/] An auditor, whether registered or not, may be legally required to, or may agree voluntarily to, perform an engagement in accordance with PCAOB standards of a non-issuer. If the proposed auditor reporting standard is adopted, PCAOB staff may issue guidance regarding such situations.

that addressees might include other appropriate parties depending on, for example, the legal and governance structure of the company. Accordingly, the auditor's report also could be addressed to others, such as bondholders.

Under existing AU sec. 508, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[21/] Because the auditor is not required to address the auditor's report to a specific group, the auditor's report is not consistently addressed to the company's investors.[22/] In some instances, auditors address the auditor's report to the board of directors, or the company, rather than the company's investors.

Many commenters referred to investors as the "key customers" of the auditor's report, "the real client of the auditor," or "ultimately the ones paying for the auditor's opinions."[23/] Additionally, commenters suggested that the auditor's report should be addressed to the shareholders of the company in addition to the board of directors. In order to promote consistency in the addressees included in the auditor's report, the Board is proposing to require the auditor's report be addressed to investors in the company. The requirement for the auditor's report to be addressed to investors might serve as a reminder to the auditor that the auditor's ultimate customer is the investor.

*2. The Auditor's Responsibility for the Financial Statements, Including the Related Notes and, if Applicable, Schedules (Paragraph 6.f. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to identify the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.

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[21/] See existing AU sec. 508.09.

[22/] Based on the PCAOB staff's review of 125 Form 10-K filings for fiscal year 2011, there were approximately 5 percent of auditors' reports not addressed to investors.

[23/] See comments at the September 15, 2011 public roundtable on the alternatives presented in the concept release for changing the auditor's reporting model. See also United States v. Arthur Young, 465 U.S. 805, 819 note 15 (1984), which states, in part, "The SEC requires the filing of audited financial statements in order to obviate the fear of loss from reliance on inaccurate information, thereby encouraging public investment in the Nation's industries."

The proposed auditor reporting standard uses the term "financial statements" as used by the SEC, which includes all notes to the statements and all related schedules. The notes to the financial statements provide additional information about the financial statements, such as a summary of the significant accounting policies. The proposed auditor reporting standard also includes a sentence to clarify that the proposed auditor reporting standard and other PCAOB standards often refer to the notes as disclosures.[24/]

The schedules identified as part of the financial statements depend on the SEC's requirements for the type of issuer. For example, auditors of registered investment companies would refer to SEC Regulation S-X, 17 C.F.R. § 210.6-10, for the list of schedules required to be filed with the SEC, such as the summary schedule of investments in securities of unaffiliated issuers.

The proposed auditor reporting standard would not apply to supplemental schedules pursuant to AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*, because those schedules are not considered part of the financial statements.[25/] The auditor should continue to look to the requirements of AU sec. 551 for the auditor's reporting responsibilities regarding supplemental schedules accompanying audited financial statements.[26/]

Under existing AU sec. 508, each financial statement audited is specifically identified in the auditor's report. Existing AU sec. 508 also describes the basic financial statements as the balance sheet, statement of income, statement of stockholders' equity, and statement of cash flows.[27/] The notes to the financial statements and, if applicable, the related schedules, are not identified as part of the financial statements under existing AU sec. 508. The proposed auditor reporting standard would require specific references to the related notes and, if applicable, schedules because those are

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[24/] See, e.g., Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement.*

[25/] See AU sec. 551.03.

[26/] On July 12, 2011, the Board issued Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements,* PCAOB Release No. 2011-005 (July 12, 2011) available at http://pcaobus.org/Rules/Rulemaking/Docket036/PCAOB_Release_2011-005.pdf, which, if adopted, would supersede AU sec. 551.

[27/] Existing AU sec. 508.06 describes these as the basic financial statements.

identified as part of the financial statements pursuant to SEC Rule 1-01(b) of Regulation S-X.

Many commenters supported the addition of language in the auditor's report regarding the auditor's responsibilities for financial statement notes. Some commenters noted that this change would bring the auditor's report more in line with the actual responsibilities of auditors as set out in existing auditing standards and would give more prominence to the auditor's responsibility for such disclosures.

Since the related notes and, if applicable, schedules are an integral part of the audited financial statements, the Board is proposing to make clear in the auditor's report the auditor's responsibilities for the notes to the financial statements and related schedules.

The proposed auditor reporting standard also recognizes that not every company is required by the SEC to include related schedules as part of the financial statements. If, however, these schedules are required by the SEC to be included as part of the audited financial statements, the auditor's report also would identify these schedules.

*3. The Auditor's Responsibility for Fraud (Paragraph 6.l. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would revise the auditor's report to recognize the auditor's existing responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.[28/]

Existing AU sec. 508 does not require the auditor's report to describe the auditor's responsibility related to error or fraud in planning and performing the audit. This proposed change does not modify the auditor's existing responsibilities with respect to fraud in a financial statement audit.

Many commenters supported describing the auditor's responsibility for fraud in the auditor's report. Those commenters generally suggested modifying the language in the auditor's report to add the phrase "whether caused by error or fraud." Another commenter specifically noted that this description would help achieve the objective of enhancing communication between auditors and users of the auditors' reports.

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[28/] See paragraph .02 of AU sec. 110, *Responsibilities and Functions of the Independent Auditor*.

In the report by the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP"), ACAP requested the PCAOB to clarify in the auditor's report the auditor's role in detecting fraud under current auditing standards.[29/] Additionally, academic research suggests that some users might benefit from a specific statement in the auditor's report regarding fraud.[30/]

*4. Description of the Nature of an Audit (Paragraph 6.m. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit but revises that description to align it better with the requirements in the Board's existing standards.

Under existing standards, the nature of an audit is described in the auditor's report as follows:[31/]

- Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements;

- Assessing the accounting principles used and significant estimates made by management; and

- Evaluating the overall financial statement presentation.

In 2010, the Board adopted eight standards (Auditing Standard Nos. 8-15) that improve the effectiveness of the auditor's identification of, assessment of, and response to the risks of material misstatement in an audit ("risk assessment standards"). The proposed auditor reporting standard updates the description related to the nature of the

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29/ U. S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* ("ACAP report"), at VII:2 (October 6, 2008), available at http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf. See generally, ACAP report, at VII:13-VII:19.

30/ See Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011).

31/ See existing AU sec. 508.08.f.

audit to reflect the auditor's responsibilities in a risk-based audit and to align the description with the language in the Board's risk assessment standards.

The proposed auditor reporting standard includes the following description of an audit:

- Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
- Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
- Evaluating the accounting principles used and significant estimates made by management; and
- Evaluating the overall presentation of the financial statements.

## C. New Proposed Basic Elements Requirements

The proposed auditor reporting standard adds new basic elements to the auditor's unqualified report that would enhance investors' and other financial statement users' understanding about the auditor and an audit.

### *1. Auditor Independence (Paragraph 6.h. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws[32/] and the applicable rules and regulations of the SEC and the PCAOB.

Currently, the only indication of auditor independence in the auditor's report is in the title of the report "Report of Independent Registered Public Accounting Firm." Aside from the title, the auditor's report provides no further information regarding auditor

[32/] The term "United States federal securities laws" has the same meaning as "securities laws" in PCAOB Rule 1001(s)(ii), *General Provisions*. "United States federal" has been added to distinguish for investors the country and governmental level (federal, state or local) of the referenced laws.

independence. The statement regarding auditor independence is not intended to affect auditor independence requirements under the securities laws, SEC rules,[33/] or PCAOB rules.[34/]

In the concept release, the Board sought comments on whether to include a statement in the auditor's report, in addition to the title, regarding the auditor's responsibilities related to independence. In general, commenters were supportive of this change with one commenter specifically noting that a stronger statement regarding auditor independence would both be informative for investors and a reminder to auditors of their obligation to be independent of the company.

According to a January 2008 U.S. Government Accountability Office report, "investors and other users of financial statements expect auditors to bring integrity, independence, objectivity, and professional competence to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies' audited financial statements, which is key to the efficient functioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as independent and expert professionals who will conduct thorough audits."[35/] In the Board's view, adding a statement relating to auditor independence in the auditor's report could (1) enhance investors' and other financial statement users' understanding of the auditor's obligations to be independent and (2) serve as a reminder to auditors of these obligations.

*2. Auditor Tenure (Paragraph 6.i. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. Currently this information is not required to be communicated by the auditor (or by management or the audit committee) to investors and other financial statement users.

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33/ See SEC Rule 2-01 of Regulation S-X, 17 C.F.R. § 210.2-01.

34/ See PCAOB Rule 3520, *Auditor Independence, et seq*.

35/ See U.S. Government Accountability Office, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action*, 7 (Jan. 2008), available at http://www.gao.gov/new.items/d08163.pdf.

Auditor tenure has been the subject of discussion for decades[36/] and continues to be a topic of discussion today.[37/] Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[38/] Meanwhile, other academic research indicates that investors that participated in a study view long-term auditor-company relationships as adversely affecting audit quality.[39/] Other academic research suggests that both short and long tenure can have detrimental effects on audit quality.[40/]

Disclosure of auditor tenure also has been considered by other regulators and standard setters. For example, under rules adopted by the United Kingdom ("UK")

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[36/] See, e.g., Staff of Subcomm. on Reports, Accounting and Management of the S. Comm. on Government Operations, 95th Cong., *The Accounting Establishment iii* (Comm. Print 1977), at 21, available at http://archive.org/download/accstabl00unit/accstabl00unit.pdf; see also AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 108, available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

[37/] See, e.g., Richard Crump, *FTSE 100 Providing More Audit Tenure Information*, Accountancy Age, June 14, 2013, available at http://www.accountancyage.com/aa/news/2274992/ftse-100-providing-more-audit-tenure-information.

[38/] See, e.g., Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting,* 23 Auditing: A Journal of Practice and Theory 55, 55–69 (2004); and Bin Srinidhi, Sidney Leung, and Ferdinand A. Gul, *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge,* (2010), unpublished working paper available at http://dx.doi.org/10.2139/ssrn.1590811.

[39/] See, e.g., Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297-314 (2008).

[40/] See, e.g., Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517-548 (2009).

Financial Reporting Council, UK-listed companies are required to provide information on the length of auditor tenure in a separate section of the annual report.[41/]

Regardless of whether auditor tenure is viewed as a positive or negative influence on audit quality, investors and other financial statement users have indicated strong interest in this information.[42/] In developing the proposed requirement, the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure. The Board's inspection process has not been designed to determine a relationship between audit quality and auditor tenure. In light of the public interest in the subject of auditor tenure, the Board is proposing to include auditor tenure as a data point in the auditor's report.

In determining the year the auditor began serving consecutively as the company's auditor, the auditor would look to the year beginning when the firm signs an initial engagement letter to audit a company's financial statements or when the firm begins the audit, whichever is earlier. For example, if the auditor is appointed in January 2012 to audit a company's financial statements for the year ended December 31, 2012, and the auditor's report is dated February 28, 2013, the auditor would state 2012 as the year the auditor began serving consecutively as the company's auditor. In another example, if the auditor is appointed in January 2013 to audit a company's financial statements for the years ended December 31, 2010, 2011, and 2012, the auditor would state 2013 as the year the auditor began serving consecutively as the company's auditor.

The intent of the proposed requirement is to disclose the duration of the auditor's relationship with the company. For example, in a situation in which a company acquires another company, if the acquirer's current auditor continues serving subsequently as the company's auditor, the auditor tenure would continue. If the acquired company's auditor is selected to serve as the acquirer's auditor, the auditor tenure would begin anew.

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41/ See UK - Financial Reporting Council Corporate Governance Code and Auditing Standards at http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx.

42/ On April 19, 2013, the Council of Institutional Investors revised its corporate governance policies to state that "boards retaining an auditor beyond 10 years should be required to explain why doing so is in shareholders' interest." The revisions made to the Council of Institutional Investors' Policies on Corporate Governance are available at: http://www.cii.org/corp_gov_policies.

Additionally, the auditor's relationship with the company is not affected by the company's status as a public company. For instance, if a company went public but maintained its auditor, the auditor tenure would include the years the auditor served as the company's auditor both before and after the company became subject to the SEC financial reporting requirements.

The Board understands that, in some cases, the auditor may have difficulty determining the year the auditor began serving as the company's auditor, due to firm or company mergers, acquisitions, or changes in ownership structure. If the auditor is unaware of the year it became the company's auditor, the auditor could refer to publicly available information, such as the SEC's Electronic Data Gathering, Analysis and Retrieval ("EDGAR") for determining the year the auditor or the auditor's predecessor firm began serving as the company's auditor.[43/] EDGAR also may be used by investors to assess whether a company has filed a current report on Form 8-K to disclose a change in the company's auditor.[44/]

If the auditor is unable to obtain information regarding the year the auditor began serving consecutively as the company's auditor, the auditor would be required to state in the auditor's report that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge. As noted above, this might apply in situations in which other firms were acquired by the auditor's firm or were merged with the auditor's firm, or in situations in which the company's ownership structure changed. The following is an example of such a statement that could be included in the auditor's report:

> We are uncertain as to the year we [or our predecessor firms] began serving consecutively as the auditor of the Company's financial statements; however, we are aware that we [or our predecessor firms] have been Company X's auditor [or Company X's auditor subsequent to the Company's merger] consecutively since at least 19XX.

The auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor, but once the year has been determined the cost to include the disclosure about tenure should be minimal.

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[43/] Many company's filings are available via EDGAR starting in 1994.

[44/] See Form 8-K, 17 C.F.R. § 249.308, Item 4.01 Changes in Registrant’s Certifying Accountant.

*3. Other Information (Paragraph 6.p. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to refer to the reporting requirements contained in the Board's companion Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, (the "proposed other information standard") when the auditor's report is included in a company's annual report filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") that includes other information outside the company's audited financial statements as well as the audited financial statements and the related auditor's report.

When issuing an auditor's report, the reporting requirements of the proposed other information standard would require the auditor to include in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information" the following:

a. A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)], in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;

c. A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;

d. A statement that the auditor did not audit the other information and does not express an opinion on the other information; and

e. A statement that, based on the evaluation, the auditor:

(1) Has not identified a material inconsistency or a material misstatement of fact in the other information;[45/] or

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45/ This statement is appropriate in situations in which the auditor (1) has not identified a material inconsistency or a material misstatement of fact or (2) has identified

(2) Has identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

In the concept release, the Board requested comments on whether the auditor's report should describe the auditor's responsibility with respect to other information. Some commenters supported including a description of the auditor's responsibilities with respect to other information outside the financial statements in the auditor's report. Some of these commenters indicated that a description of the auditor's responsibilities would be helpful for investors' and other financial statement users' understanding of the auditor's responsibilities with respect to other information and would address any misperception that the other information is audited. A number of commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The proposed other information standard would strengthen the audit procedures the auditor would perform related to other information outside the financial statements when such information is included in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report. The proposed other information standard would provide a basis for enhancing the auditor's report regarding the auditor's responsibilities for other information and the results of the auditor's evaluation of the other information. These changes are intended to make the auditor's report more informative.[46/]

## D. Form of the Auditor's Unqualified Report

The basic elements of the proposed auditor's unqualified report are organized and categorized into introduction, basis of opinion, opinion on the financial statements, auditor's responsibilities regarding other information, and signature and date sections in the proposed auditor reporting standard. This categorization would replace previous references in PCAOB standards to introductory, scope, and opinion paragraphs. The purpose for this change is primarily to assist readers of the proposed auditor reporting

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a material inconsistency, a material misstatement of fact, or both, that management has revised appropriately prior to the issuance of the auditor's report.

46/ See Appendix 6 for proposed changes related to the auditor's responsibilities regarding other information.

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|---|---|---|---|
| Number: 1 | Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC | Subject: Highlight | Date: 5/2/2014 2:33:34 PM |

standard to understand the standard as well as to provide easy reference to specific sections within the auditor's report.

One proposed change in the form of the report involves the replacement of the "scope paragraph" in existing AU sec. 508, which describes the nature of an audit,[47/] with a "Basis of Opinion" section. The proposed change in terminology is based on the statement in the auditor's unqualified report that "we believe our audits provide a reasonable basis for our opinion."

The proposed auditor reporting standard does not require that the basic elements appear in a specific order in the auditor's report, nor does it require that section titles be included, except for the section titles regarding the auditor's responsibilities for other information and critical audit matters. The proposed auditor reporting standard does not preclude the auditor from including section titles for other sections in the auditor's report.

Questions Related to Section IV:

2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?

3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?

4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?

5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.

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47/ See existing AU sec. 508.08.

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 2:38:38 PM

**Yes.....the following two organizations:**

**PCAOB &**
**SEC**

**especially so when there is a suspicion**
**or suggestion of fraud.....**
**Respectfully yours,**

**Pw**

Number: 2 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 2:42:20 PM

**Provide an example of same, aka: demonstrating the auditor's adherence to their regulatory responsibilities and due diligence....just a simple 3-sentence paragraph describing their adherence & due diligence....Pw**

Number: 3 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 2:43:14 PM

**Yes...definitely....such as the following:Provide an example of same, aka: demonstrating the auditor's adherence to their regulatory responsibilities and due diligence....just a simple 3-sentence paragraph describing their adherence & due diligence....Pw**

Number: 4 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 2:45:46 PM

**Yes, definitely....because an auditor who has been serving consecutively for seven to ten years is becoming to familiar with the client, which will in-turn jaundice their opinions in favor of the client....Pw**

a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?

b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?

c. Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?

6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?

7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?

8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?

9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.

## V. <u>Critical Audit Matters (Paragraphs 7 – 14 of the Proposed Auditor Reporting Standard)</u>

The current version of the auditor's report includes the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail). Beyond the pass/fail nature of the report, the report provides little, if any, information specific to the audit of the company's financial statements. The proposed auditor reporting standard would require the auditor to communicate specific information through the auditor's

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:46:37 PM

**Yes, definitely....because an auditor who has been serving consecutively for seven to ten years is becoming to familiar with the client, which will in-turn jaundice their opinions in favor of the client....Pw**

Number: 2 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:48:03 PM

**Perhaps the client will come up with some.....then we question their motivation for raising such an issue.....Pw**

Number: 3 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:49:13 PM

**Yes....certainly for the Investment Community who is the silent partner sitting just to the right of the Auditor....Pw**

Number: 4 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:50:33 PM

**Yes...the more information provided to the Investment Community will allow them to make a more knowledgeable evaluation of the companies in question....before they place their bets....Pw**

Number: 5 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:51:49 PM

**Yes...a specific order will greatly enhance and speed up the review and understanding and interpretation process....as well as make the communication more clear for all parties....Pw**

Number: 6 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:53:33 PM

**Include a statement that says the Auditor will be turning over their audit report to both the SEC and the PCAOB for further review whenever there is a perception and/or suspicion and/or suggestion of fraud....within the data provided by the client....Pw**

report regarding "critical audit matters," which would result in information in auditors' reports tailored to the audit.[48/]

The Board developed its proposal for communicating critical audit matters in the auditor's report in a way that should provide greater insight regarding the audit, without unduly burdening the financial reporting process. The auditor is well positioned to communicate this type of information to investors and other financial statement users through the auditor's report. Under the proposed auditor reporting standard, the auditor would determine critical audit matters by leveraging audit work already required to be performed under existing standards. The proposed auditor reporting standard does not intend to change the auditor's traditional role of attesting to matters in the financial statements and will not require auditors to provide analysis of the matters in the financial statements when communicating critical audit matters. Notably, the auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements. Therefore, the communication of critical audit matters is not intended to, and should not, detract from, disclaim, or qualify the auditor's opinion.

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[49/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. A more informative auditor's report could benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown

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[48/] The communication of critical audit matters also would be required in an auditor's report with a qualified opinion. See further discussion in Section VII, F. *Amendments to Existing AU sec. 508*.

[49/] See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[50/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[51/]

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee to matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information[52/] in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[53/]

Communication of critical audit matters under the proposed auditor reporting standard, however, could result in additional effort involving both one-time costs and

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50/ Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

51/ See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

52/ The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

53/ See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

recurring costs in each individual audit relative to the determination, preparation of language for communication, and documentation of critical audit matters in the auditor's report. Companies, including audit committees will likely also incur additional costs in reviewing the critical audit matters in the auditor's report. Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix provides a more detailed discussion regarding costs and related questions associated with the requirements for critical audit matters.[54/]

There also could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand the meaning of a critical audit matter. Further, investors may not understand that information important to an investment decision may not be highlighted as a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

## A. Definition of Critical Audit Matters (Paragraph A2 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard defines critical audit matters as those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

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54/ In addition, the discussion regarding costs for auditors related to critical audit matters appears in two different areas as follows: (1) recurring costs are discussed under each proposed requirement for critical audit matters throughout this Section and (2) one-time costs are discussed in Section V.F., *Other Considerations for Critical Audit Matters*, of this Appendix.

The auditor might identify either one matter or a number of matters that meet the definition of a critical audit matter. It is expected that, in most audits, there could be several matters that would meet the definition of a critical audit matter. Use of the word "most" in the definition of a critical audit matter does not imply that only one matter under each criteria would qualify as a critical audit matter. The word most also is not intended to imply that there is only one matter that surpasses all other matters; but rather to refer to the matter or matters that would stand out from the other numerous matters addressed during an audit in terms of difficulty, subjectivity, or complexity, as stated in the critical audit matters definition. Additionally, an audit matter could meet one, two, or all three of the criteria in the definition.

*1. Involved the Most Difficult, Subjective, or Complex Auditor Judgments*

The auditor exercises judgment in a variety of ways throughout an audit of financial statements. For instance, auditor judgment is used in determining the nature, timing, and extent of audit procedures; evaluating sufficient appropriate audit evidence; and forming an opinion on the financial statements.

The proposed auditor reporting standard anticipates that the auditor would determine what matters addressed during the audit involved the most difficult, subjective, or complex auditor judgment for communication in the auditor's report. The degree of difficulty, subjectivity, or complexity of auditor judgments can vary depending on the matter. For instance, matters that are subjective in nature generally would require a greater degree of auditor judgment than matters that are objective. Similarly, matters that are difficult or complex might require a greater degree of auditor judgment than matters that are relatively straightforward. For example, the auditor might determine that auditing the allowance for loan losses of a bank represented one of the areas that involved the most difficult, subjective, or complex auditor judgments because of (1) the high degree of complexity and subjectivity associated with evaluating the determination of the allowance for loan losses; (2) the significance of the assumptions in the accounting estimate, including the possibility of reasonable alternative assumptions; and (3) the high degree of uncertainty associated with the assumptions.

*2. Posed the Most Difficulty to the Auditor in Obtaining Sufficient Appropriate Evidence*

Audit evidence may be obtained by the auditor from several different sources, for example, from management; third parties, such as through confirmation; or from the auditor's own procedures, such as observation. The sufficiency of audit evidence is the measure of its quantity, whereas the appropriateness is the measure of its quality, that is, its relevance and reliability.[55/]

The auditor might experience difficulty in obtaining sufficient appropriate evidence in several ways. For instance, difficulty might result from unexpected extensive effort required by the auditor to obtain evidence. Difficulty could also result when the auditor obtains information that conflicts with audit evidence previously obtained, thereby raising questions about the reliability of the audit evidence.

Those matters arising in the audit that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that auditing fair value measurements of certain financial instruments represented one of the areas that posed the most difficulty in obtaining sufficient appropriate evidence because the auditor encountered difficulties in obtaining relevant and reliable evidence regarding observable inputs in an inactive market. In situations where there is little market activity, the auditor may need to evaluate unobservable inputs to measure fair value, which requires the auditor's assessment of the assumptions that market participants would use to price an asset or liability.[56/]

*3. Posed the Most Difficulty to the Auditor in Forming the Opinion on the Financial Statements*

Matters that posed the most difficulty to the auditor in forming the opinion on the financial statements are those matters arising from the audit that commenters described

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[55/] See paragraphs 5 and 6 in Auditing Standard No. 15, *Audit Evidence*.

[56/] See Financial Accounting Standard Board's ("FASB") Accounting Standard Codification ("ASC") Topic 820, *Fair Value Measurements*, and International Accounting Standards Board's International Financial Reporting Standard No. 13, *Fair Value Measurement*, which define Level 3 inputs as unobservable inputs that are used to estimate the fair value of the asset or liability. Unobservable inputs should be used to measure fair value to the extent that relevant observable inputs are not available, thereby allowing a fair value measurement in situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs should reflect the assumptions (including assumptions about risk) that market participants would use when pricing the asset or liability.

as "close calls" or matters that "kept the auditor up at night."[57] The types of matters that would meet this criteria represent matters that concerned the auditor when the auditor was making the final assessment of whether the financial statements present fairly the company's financial position, results of operations, and cash flows in conformity with the applicable financial reporting framework.[58]

Those matters arising in the audit that posed the most difficulty to the auditor in forming the opinion on the financial statements would be communicated in the auditor's report under the proposed auditor reporting standard. For example, the auditor might determine that revenue recognition represented an area that posed the most difficulty to the auditor in forming the opinion on the financial statements because the authoritative revenue recognition guidance is not directly applicable to the company's product sales raising challenges for the auditor in determining if revenue recognition principles were properly applied.

## B. Determination of Critical Audit Matters (Paragraphs 7 – 9 of the Proposed Auditor Reporting Standard)

### *1. Requirement to Determine Critical Audit Matters (Paragraphs 7 and 8 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to determine the critical audit matters addressed in the audit of the current period's financial statements based on the results of the audit or evidence obtained.

Under the proposed auditor reporting standard, it is expected that, in most audits, the auditor would determine that there are critical audit matters. The proposed auditor reporting standard does not provide for an explicit exception from determining whether there are any critical audit matters for audits of certain types of entities. Since no two audits are alike, there may be critical audit matters even in an audit of a company with no operations or activities.

In determining the critical audit matters the auditor addressed during the audit, the auditor would leverage the work he or she already performed when conducting an

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[57] See, e.g., comments made during the PCAOB's Roundtable on the Auditor's Reporting Model. The transcript is located at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[58] See paragraph 1 of AU sec. 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.*

audit under the Board's existing standards. Those standards currently require the auditor to perform various procedures to provide a foundation for the auditor's significant judgments and conclusions on which the auditor's opinion on the financial statements is based. The audit procedures applied throughout the audit are based primarily upon an auditor's identification of, assessment of, and response to the risk of material misstatement. The proposed auditor reporting standard would result in the auditor reporting on the most difficult and challenging aspects of the audit. The proposed auditor reporting standard does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

Because critical audit matters ordinarily are matters of such importance, they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. The auditor's documentation and activities under these standards could provide the auditor with sources for identifying critical audit matters. However, the Board would not expect that each matter included in any one or more of these sources would be a critical audit matter.

The auditor's determination and communication of critical audit matters is not intended to take the place of the auditor's existing responsibilities under other audit performance and reporting standards. For example, the auditor's responsibilities associated with the auditor's consideration of an entity's ability to continue as a going concern and the related reporting requirements,[59/] and the auditor's communication of control deficiencies related to an audit of internal control over financial reporting that is integrated with an audit of financial statements or an audit of financial statements only,[60/] among other audit performance and/or reporting requirements, continue to exist unchanged. In addition, the communication of critical audit matters is not intended to function as an alternative to a departure from an unqualified opinion on the financial statements in difficult or challenging situations.

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[59/] See AU sec. 341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* and paragraph 15.a. of the proposed auditor reporting standard, which is being retained from the existing standard (AU sec. 508.11.b).

[60/] See Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and AU sec. 325, *Communications About Control Deficiencies in an Audit of Financial Statements.*

Although the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards, it could increase the auditor's focus on critical audit matters, which could result in enhancing the quality of the audit. Previous research has found that auditors increase audit hours and/or billing rates in response to audit risks.[61/] Although an increase in audit hours and/or billing rates likely would increase audit fees, an increase in focus on critical audit matters could also result in increased audit quality.[62/]

In determining critical audit matters under the proposed auditor reporting standard, auditors likely would incur recurring costs due to additional effort expended in individual audits. It is likely that senior members of the engagement teams, such as partners and senior managers, would be involved with determining the critical audit matters to be communicated in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office could also result in recurring costs.[63/]

*2. Factors (Paragraph 9 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard includes a list of factors intended to help the auditor determine, from the results of the audit or evidence obtained, which matters in the audit would meet the definition of critical audit matters. Depending on the matter and its circumstances, the applicability and related degree or scope of just one factor might lead an auditor to conclude that a matter is a critical audit matter. In other cases, however, the auditor might take into consideration a combination of factors in determining that a matter is a critical audit matter.

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[61/] See Jean C. Bedard and Karla M. Johnstone, *Earnings Manipulation Risk, Corporate Governance Risk, and Auditors' Planning and Pricing Decisions*, 79 The Accounting Review 277, 277-304 (2004). See also Mark F. Zimbleman, *The Effects of SAS No. 82 on Auditors' Attention to Fraud Risk Factors and Audit Planning Decisions*, 35 Journal of Accounting Research 75, 75-97 (1997).

[62/] See Gerald Lobo and Yuping Zhao, *Relation Between Audit Effort and Financial Report Misstatements: Evidence from Quarterly and Annual Restatements*, 88 The Accounting Review 1385,1385-1412 (2013).

[63/] See also Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.

In addition, the factors in the proposed auditor reporting standard are not intended to represent an all-inclusive list of factors pertaining to whether a matter meets the definition of a critical audit matter. There could be other factors that may be specific to the audit, which are not listed in the proposed auditor reporting standard, that affect whether a matter involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or posed the most difficulty to the auditor in forming an opinion on the financial statements.

The factors listed in the proposed auditor reporting standard are:

a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures (paragraph 9.a. of the proposed auditor reporting standard)

A high degree of subjectivity may be involved in auditing matters that are complex or unusual, or both. For example, the arrangements pursuant to which a company recognizes revenue might be complex and require significant judgments regarding the development of estimates, such as the fair value of certain deliverables pursuant to a multiple element sales contract. In this example, determining or applying the appropriate audit procedures to test management's fair value measurements, or to evaluate whether management's estimates are reasonable, might involve one of the most subjective auditor judgments during the audit.

b. The nature and extent of audit effort required to address the matter (paragraph 9.b. of the proposed auditor reporting standard)

The nature and extent of audit effort relates to the time spent by the engagement team members performing the audit procedures; the level of knowledge, skill, and ability of engagement team members necessary to audit the matter;[64/] the extent of supervision needed based on the assessed risks of material misstatements;[65/] and the extent of discussions with management or within the firm,[66/] such as the firm's national office, or consultations outside the firm.

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[64/] See paragraph 6.d. of Auditing Standard No. 10, *Supervision of the Audit Engagement*.

[65/] See paragraph 5.b. of Auditing Standard No. 13, *The Auditor's Responses to the Risks of Material Misstatement*.

[66/] See paragraph 19 of QC sec. 20, *System of Quality Control for a CPA Firm's Accounting and Auditing Practice*.

An area that requires extensive audit effort might be an indicator that the matter was among the most difficult during the audit or required a significant amount of judgment. Matters that required extensive audit effort could include the significant involvement of more experienced engagement team members or an increase in the amount of time incurred in (1) supervising the auditing of the matter; (2) discussing the matter with management and the audit committee; or (3) consulting with the firm's national office about the matter.

c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence (paragraph 9.c. of the proposed auditor reporting standard)

The sufficiency and appropriateness of the audit evidence obtained to support the matter, such as when the auditor identifies contrary evidence, might contribute to the degree of difficulty in applying audit procedures to address the matter.

Delays by management, the unavailability of company personnel, or unwillingness by management to provide information needed for the auditor to perform his or her audit procedures also could create challenges associated with obtaining relevant and reliable audit evidence.[67/]

d. The severity of control deficiencies identified relevant to the matter, if any (paragraph 9.d. of the proposed auditor reporting standard)

In both an audit of the financial statements and an audit of internal control over financial reporting that is integrated with an audit of financial statements, the auditor is required to obtain a sufficient understanding of internal control over financial reporting.[68/] In an integrated audit, the auditor would be required to audit the effectiveness of internal control over financial reporting.[69/] And in a financial statement audit, the auditor would be required to reach an understanding of the internal control over financial reporting and the company's control activities sufficient to assess the risk

67/ Difficulties encountered by the auditor during the audit could represent a scope limitation, which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement. See AU secs. 508.22-.32.

68/ See paragraphs 18-40 of Auditing Standard No. 12.

69/ See paragraph 1 of Auditing Standard No. 5.

of material misstatement in the financial statements and to design further audit procedures.[70/]

Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.

Although an auditor might determine a matter to be a critical audit matter because of the severity of an internal control deficiency, the communication of such a critical audit matter would not relieve the auditor from the auditor's existing auditing and reporting responsibilities under other PCAOB standards related to a company's internal control over financial reporting.[71/] This factor is intended to help the auditor determine which matters are critical audit matters and is not intended to supplement, replace, or create new audit requirements for matters related to internal control over financial reporting.

e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any (paragraph 9.e. of the proposed auditor reporting standard)

The Board's risk assessment standards require the auditor to modify, among other things, the audit strategy, materiality levels, and the assessment of the risks of material misstatement if circumstances change during the course of the audit. Such changes could result from the discovery of a previously unidentified risk of material misstatement or audit evidence that contradicts the auditor's initial risk assessment. Also, the number of misstatements found by the auditor might be indicative that other misstatements might exist.

Since a matter that resulted in changes to the planned audit strategy or to changes to the risks initially identified could involve significant auditor judgment, it might be a critical audit matter.

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70/ See paragraph 34 of Auditing Standard No. 12.

71/ See Auditing Standard No. 5, Auditing Standard No. 12, and AU sec. 325.

f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any (paragraph 9.f. of the proposed auditor reporting standard)

In forming an opinion on whether the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, the auditor's evaluation of audit results should include an evaluation of misstatements accumulated during the audit, including uncorrected misstatements.[72/] Misstatements can arise from error (that is, unintentional misstatement) or fraud.[73/]

A matter in which misstatements, either corrected or uncorrected, have been identified might lead the auditor to conclude that the matter is a critical audit matter.

g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any (paragraph 9.g. of the proposed auditor reporting standard)

In auditing matters that are complex or subjective, the auditor may determine that using the work of a specialist to obtain sufficient appropriate evidence is necessary. For example, specialized skill or knowledge might be needed by the auditor in areas such as the valuation of complex financial instruments, determination of mineral reserves, actuarial determinations, or interpretation of technical requirements.

An auditor's determination that a matter required specialized skill or knowledge to obtain sufficient appropriate evidence might be an indication that the matter involved difficult, subjective, or complex auditor judgments. In such situations, the matter might be a critical audit matter.

h. The nature of consultations outside the engagement team regarding the matter, if any (paragraph 9.h. of the proposed auditor reporting standard)

Issues that are complex or unusual can arise in various stages during the audit. In such situations, the auditor might consult with the firm's national office, industry specialists, or external parties. For example, matters related to the auditor's evaluation of management's judgments, estimates, or accounting policies might lead to

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[72/] See paragraphs 3-4 and 10-23 of Auditing Standard No. 14, *Evaluating Audit Results*.

[73/] See paragraph A2 of Auditing Standard No. 14.

consultation with others who might assist the auditor in arriving at the conclusions on which the auditor's opinion is based. Such matters might involve the most subjective or complex auditor judgments during the audit or might pose the most difficulty in forming an opinion on the financial statements. Consultation with others on a particular matter, therefore, might be an indication that the matter is a critical audit matter.

## C. Audit Period Covered by Critical Audit Matters (Paragraph 10 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard would require the auditor to communicate critical audit matters for the audit of the current period's financial statements. While most companies' financial statements are presented on a comparative basis, and thus most audit reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented in the financial statements, would provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users would be able to look at prior years' filings to analyze critical audit matters over time.

Because the communication of critical audit matters for prior periods also might be useful to investors and other financial statement users, the proposed auditor reporting standard states that, when the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

In situations in which a predecessor auditor has been asked to reissue his or her audit report on the financial statements of a prior period, existing standards require the auditor to consider whether the auditor's report on those statements is still appropriate after certain required procedures are performed.[74/] If the predecessor auditor determines that the auditor's report is still appropriate and is reissued, the communication of critical audit matters for the prior period need not be repeated. Since the communication of critical audit matters is only required for one year, the proposed auditor reporting standard would not require the communication of critical audit matters in the reissued report of the predecessor auditor for prior years.

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[74/] See AU secs. 508.70-.73, which discusses the report of a predecessor auditor.

## D. Communication in the Auditor's Report of Critical Audit Matters (Paragraphs 11 – 13 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard would require that, for each critical audit matter communicated in the auditor's report, the auditor (1) identify the critical audit matter; (2) describe the considerations that led the auditor to determine that the matter is a critical audit matter; and (3) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

The Board expects that the auditor's communication of critical audit matters in the auditor's report would be presented in language and in a format that is clear, concise, and understandable to a financial statement user. The Board also expects that the communication would be tailored to the audit and thus would avoid boilerplate language and reflect the specific circumstances of the matter in relation to the audit of the company's financial statements. While the same audit matter may be determined to be a critical audit matter from one year to the next or from one audit to another, the auditor would be expected to tailor the communication of the critical audit matter to the specific facts and circumstances that existed during that particular current period's audit.

As noted previously, the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements taken as a whole. Accordingly, the proposed auditor reporting standard indicates that the auditor should not use language in the auditor's report that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements. In issuing an unqualified opinion on the financial statements, the auditor has a responsibility to plan and perform the audit to obtain reasonable assurance that the financial statements, taken as a whole, are fairly presented in all material respects. Critical audit matters in the auditor's report are matters that have been addressed by the auditor and, therefore, should not be described to imply that a critical audit matter disclaims or qualifies the auditor's opinion on the financial statements.

The following discussion presents the proposed elements of the communication in the auditor's report relative to critical audit matters in more detail.

### *1. Identify the Critical Audit Matter (Paragraph 11.a. of the Proposed Auditor Reporting Standard)*

In communicating the critical audit matter, the auditor would identify each audit matter that the auditor determined met the definition of a critical audit matter. For example, the audit of the valuation of certain complex financial instruments could be identified as a critical audit matter in the auditor's report because the matter posed the most difficulty to the auditor in obtaining sufficient appropriate evidence.

*2. Describe the Considerations That Led the Auditor to Determine That the Matter is a Critical Audit Matter (Paragraph 11.b. of the Proposed Auditor Reporting Standard)*

To enhance investors' and other financial statement users' understanding of the audit, the proposed auditor reporting standard would require the auditor to describe the considerations that led the auditor to determine that the matter is a critical audit matter. The description of considerations that led the auditor to determine a matter is a critical audit matter may be derived from one or more of the factors; however, the auditor would not be limited to the factors listed in the proposed auditor reporting standard, which also could include other factors specific to the audit. Additionally, the auditor's description should be specific to the circumstances. For instance, using the same example from above regarding certain complex financial instruments that are identified as a critical audit matter, the communication in the auditor's report might describe the auditor's considerations related to the lack of observable inputs, a high degree of measurement uncertainty, and significant judgments needed to audit the fair value assumptions. Further, when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so.

*3. Refer to the Relevant Financial Statement Accounts and Disclosures That Relate to the Critical Audit Matter, When Applicable (Paragraph 11.c. of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard also would require the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable. Since the audit is of the company's financial statements, the auditor would be able to refer to the relevant financial statement accounts and disclosures in most cases. Following through on the example from above in which the critical audit matter was the valuation of certain complex financial instruments, the auditor would refer to the relevant financial statement account for financial instruments and the corresponding disclosure.

There also may be instances when a critical audit matter has a pervasive effect on the financial statements, such as an entity level control deficiency or circumstances in which there is no related financial statement account or disclosure. In such cases, the auditor would describe the matter and its effect on the audit of the financial statements, taken as a whole.

With regard to each of the proposed elements of the communication in the auditor's report, developing the language of critical audit matters to include in the auditor's report likely would result in additional recurring costs related to individual audits. These recurring costs likely would include additional time incurred by senior members of engagement teams, such as partners and senior managers. In addition, other recurring costs might relate to additional time incurred by others, such as the engagement quality reviewer and consultations with others, including national office. Further, additional time also might be incurred by the auditor as a result of discussions with management or the audit committee regarding the critical audit matters to be communicated in the auditor's report under the proposed auditor reporting standard.[75/]

*4. Illustrative Examples of Critical Audit Matters*

The Exhibit to this Appendix includes illustrative examples of communications of critical audit matters in the auditor's report. The Board has developed three different scenarios that contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.[76/]

The Board is interested in obtaining other illustrative examples of communications of critical audit matters under the proposed auditor reporting standard. Thus, the Board is requesting that commenters prepare examples of communications of critical audit matters that could appear in an auditor's report under the proposed auditor reporting standard and provide those examples to the Board.[77/]

*5. Language Preceding Critical Audit Matters (Paragraphs 12 and 13 of the Proposed Auditor Reporting Standard)*

The proposed auditor reporting standard would require the auditor to include a section titled "Critical Audit Matters" and include specific language in the auditor's report both when critical audit matters are being communicated and when the auditor has determined that there are no critical audit matters to communicate. In both situations,

[75/] See also Section V.F., *Other Considerations for Critical Audit Matters,* of this Appendix for a more detailed discussion regarding costs associated with the requirements for critical audit matters under the proposed auditor reporting standard.

[76/] The examples contained in the Exhibit to this Appendix are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

[77/] Any such examples would be posted to the PCAOB Rulemaking Docket Matter No. 034 without edits or redactions.

the language in the auditor's report is intended to inform investors and other financial statement users of the auditor's requirement to communicate critical audit matters and whether the auditor has determined there are any critical audit matters.

When the auditor determines that there are critical audit matters, the specific language for such situations notifies investors and other financial statement users that the auditor's communication of critical audit matters is not intended to affect the auditor's opinion on the financial statements and related disclosures, taken as a whole, and therefore, does not represent individual opinions for each critical audit matter.

In situations in which the auditor determines that there are no critical audit matters, the proposed specific language in the auditor's report would describe the auditor's responsibilities and indicate that the auditor determined that there are no critical audit matters.

## E. Documentation of Critical Audit Matters (Paragraph 14 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard requires the auditor to document the auditor's determination of critical audit matters and refers the auditor to the documentation requirements for audits conducted under PCAOB standards (that is, Auditing Standard No. 3). To provide sufficient detail for a clear understanding of the conclusions reached by the auditor, the auditor's documentation related to critical audit matters should contain sufficient information to enable an experienced auditor,[78/] having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

As noted previously, in determining critical audit matters, the proposed auditor reporting standard anticipates that auditors would leverage the audit work already performed under existing auditing standards. This includes the information documented in the engagement completion document, matters reviewed by the engagement quality reviewer, or matters communicated to the audit committee. The auditor's documentation and activities under existing standards could provide the auditor with sources for identifying critical audit matters.

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[78/] See note to paragraph 6 of Auditing Standard No. 3, which states that "[a]n *experienced auditor* has a reasonable understanding of audit activities and has studied the company's industry as well as the accounting and auditing issues relevant to the industry."

In fulfilling the documentation requirements under the proposed auditor reporting standard, the auditor would not be expected to provide an explanation for each matter documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee. The Board recognizes that documenting whether each such matter was a critical audit matter could result in an extensive amount of documentation that might be unnecessary. Accordingly, the auditor would be expected to document only those matters that were either communicated as critical audit matters or that would appear to meet the definition of a critical audit matter that were not communicated as such in the auditor's report.

*1. Audit Matters Reported as Critical Audit Matters*

As noted previously, the documentation of those matters the auditor communicated as critical audit matters would be required to meet the documentation requirements of Auditing Standard No. 3. That standard requires an auditor to prepare audit documentation that is in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached.[79/] In addition, Auditing Standard No. 3 requires that audit documentation contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the conclusions reached.[80/]

*2. Audit Matters Not Reported as Critical Audit Matters*

The Board is proposing a documentation requirement that is intended to encourage auditors to consider in a thoughtful and careful manner whether all matters that meet the definition of a critical audit matter are communicated in the auditor's report. The proposed auditor reporting standard would require the auditor to document why audit matters that would appear to meet the definition of a critical audit matter were not communicated as such by the auditor in the auditor's report.

Additionally, the Board is proposing this requirement to help the auditor and other reviewers, such as the engagement quality reviewer, have a better understanding of the basis for the auditor's determination of matters that would appear to meet the definition of a critical audit matter and were not communicated. Further, requiring documentation of the auditor's determination of such matters not communicated might have the indirect effect of preventing the omission of a critical audit matter due to potential management pressure to exclude the matter from the auditor's report.

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[79/] See paragraph 2 of Auditing Standard No. 3.

[80/] See paragraph 6 of Auditing Standard No. 3.

The proposed documentation requirement of why audit matters that would appear to meet the definition of a critical audit matter were not communicated by the auditor in the auditor's report would reflect the requirements of Auditing Standard No. 3. For instance, if a matter was included in the engagement completion document, reviewed by the engagement quality reviewer, and communicated to the audit committee, it could appear to an experienced auditor having no previous connection to the audit, after also considering the factors in paragraph 9 of the proposed auditor reporting standard, that the matter met the definition of a critical audit matter. If the auditor determined that such a matter was not a critical audit matter, then the auditor would document the basis for the determination in the auditor's working papers with sufficient detail to explain the basis of the conclusions reached.

The auditor's documentation of critical audit matters under the proposed auditor reporting standard likely would result in additional recurring costs to the firm due to efforts expended in individual audits. These recurring costs likely would include additional time incurred to prepare documentation in sufficient detail to address the proposed requirements. This also might include additional review time incurred by others, such as senior members of the engagement team or the engagement quality reviewer.

## F. Other Considerations for Critical Audit Matters

Enhancing auditor reporting requirements necessarily will involve changes in practice, related cost implications and other challenges. Discussed below are potential economic considerations that might be relevant to auditors and companies, including audit committees. Also, discussed below are potential effects of disclosing information through the communication of a critical audit matter that otherwise would not be required to be disclosed under existing auditor or financial reporting standards, and liability considerations for auditors.

### *1. Effects of Additional Effort by Auditors and Companies, Including Audit Committees*

Based on its outreach to date, the Board anticipates that the communication of critical audit matters likely would have potential cost implications for auditors and companies, including their audit committees. Such costs would include those related to additional time to prepare and review auditors' reports.

*Auditors*

For auditors, costs might represent both one-time costs and recurring costs. The recurring costs for auditors regarding critical audit matters under the proposed auditor reporting standard have been discussed previously.[81/] The one-time costs for auditors could be incurred as a result of (1) updating firm audit and quality control methodologies to reflect the new reporting requirements and (2) developing and conducting training of firm personnel on the new reporting requirements. When updating methodologies, some firms also likely would develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters in the draft auditor's report, which also would result in incremental one-time costs.

*Companies, Including Audit Committees*

Companies, including audit committees, could incur additional recurring costs as a result of the proposed auditor reporting standard. For instance, audit fees may increase due to the new reporting requirements in the Board's proposal. Additionally, companies might incur one-time costs in developing, and recurring costs in performing, internal processes for the review of critical audit matters in the draft auditor's report and the related interaction with auditors and others.

Audit committees might also incur additional time for the review of critical audit matters to be communicated in the auditor's report and related discussions with the auditor and management.

Companies, including audit committees, also could spend additional time comparing their auditor's report to the auditors' reports of similar companies. Even though comparability regarding the pass/fail model will continue to be maintained, the communication of critical audit matters in the auditor's report that is specific to the audit of the company's current period financial statements would make the auditor's report less comparable among companies.

The communication of critical audit matters would result in differences among auditors' reports. For instance, the communication of critical audit matters is intended to

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[81/] See Sections V.B., *Determination of Critical Audit Matters;* V.D., *Communication in the Auditor's Report of Critical Audit Matters;* and V.E., *Documentation of Critical Audit Matters,* of this Appendix for discussion of recurring costs.

be tailored to the audit of the company; therefore, auditors' reports are not expected to be comparable from one auditor's report to the next. Such differences would relate to the auditor's determination of the matters that involved difficult judgments and difficulty in obtaining evidence or forming the opinion for a company based on that audit's particular facts and circumstances.

Company management and the audit committee might be concerned with the differences in auditors' reports because of investors' and other users' perceptions of the potential differences between the company's current period critical audit matters and those of prior periods or those of the company's competitors. However, investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or Management's Discussion & Analysis ("MD&A") that is specific to a company or a reporting period.

*2. Potential Effects of Disclosing Information that Otherwise Would Not be Required to be Disclosed*

The proposed auditor reporting standard would require the auditor to describe in the auditor's report the considerations that led the auditor to determine that the matter is a critical audit matter, in addition to identifying the matter and referencing the matter to the relevant financial statement accounts and disclosures, when applicable. The description of the considerations regarding the critical audit matter could include information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework.

For example, under the proposed auditor reporting standard, the auditor could determine that a matter met the definition of a critical audit matter because it involved the most difficult, subjective, or complex auditor judgments, and, therefore, would be communicated as a critical audit matter in the auditor's report. However, under existing auditor reporting standards or requirements of the applicable financial reporting framework, such matter would not otherwise be required to be disclosed. Examples of such occurrences that might result in the communication of a critical audit matter could include situations involving (1) a deficiency in internal control over financial reporting that was not otherwise determined to be a material weakness and therefore, not required to be disclosed by management or the auditor; (2) a difficult decision by the auditor regarding a company's ability to continue as a going concern even though the auditor's ultimate decision was that substantial doubt did not exist, and therefore, did not require reporting by the auditor; or (3) a loss contingency, for which there was significant difficulty in obtaining audit evidence but that ultimately was decided by management and the auditor to not warrant disclosure by the company in the financial statements under existing financial reporting standards.

Although the Board is not seeking to constrain the information the auditor would communicate for critical audit matters under its proposal,[82/] it is seeking comments on whether there are potential issues raised by the auditor's reporting of information to investors as a result of communicating critical audit matters that otherwise would not have required disclosure under existing auditor and financial reporting standards.

*3. Liability Considerations*

Some commenters expressed concern that changes to the auditor's reporting model could result in increased liability for auditors and issuers. Liability may be imposed on auditors and issuers (as well as other securities market participants) under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, as well as various state law causes of action. In discussing their concerns regarding potential liability, a number of commenters raised particular aspects of the Board's concept release that they viewed as troublesome from a liability perspective. For example, some commenters were critical of the auditor providing a supplement to the auditor's report containing an open-ended analysis or a discussion that could result in the auditor providing new information regarding the company, independent of the company's own disclosures in its financial statements. Further, other commenters, while recognizing potential liability concerns, suggested that the Board take a balanced approach in its rulemaking related to changes to the auditor's report.

In developing its proposal for communication of critical audit matters, the Board has sought a balanced approach that would promote more informative reporting about the audit (1) in a focused way and (2) that would not fundamentally change the auditor's current role of attesting on information prepared by management. Under the proposed auditor reporting standard, the auditor would be communicating information about the audit, based on audit procedures the auditor performed. The proposed auditor reporting

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[82/] However, the proposed auditor reporting standard would provide that auditors should not use language that can be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for critical audit matters or the opinion on the financial statements. See further discussion regarding language in the auditor's communication of critical audit matters in Section V.D., *Communication in the Auditor's Report of Critical Audit Matters,* of this Appendix.

standard regarding critical audit matters would be guided by criteria and factors, rather than a separate free-form analysis. However, the determination of critical audit matters and the nature and extent of the communication in the auditor's report would be guided by the auditor's judgment, and the Board is not seeking to constrain the information the auditor would communicate for critical audit matters.[83/] The auditor's communication of critical audit matters would represent matters that have been addressed by the auditor in forming the opinion on the financial statements and is not intended to detract from, disclaim, or qualify the auditor's opinion.

The Board recognizes, however, that under its proposal, the auditor would be making new statements in the auditor's report that could raise potential liability concerns.

Questions Related to Section V:

10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?

11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?

12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?

13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?

14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?

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83/ Id.

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 3:14:19 PM

**Yes the Board should consider additional protections for the Investment Community.....since the current program hasn't worked for quite some time....Pw**

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?

16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?

17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?

18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?

19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?

20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?

21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?

22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?

23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?

24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an

auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?

26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.

27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?

28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?

## VI. Explanatory Language (Paragraphs 15 – 16 of the Proposed Auditor Reporting Standard)

Under existing PCAOB standards certain circumstances require that the auditor add explanatory language (or an explanatory paragraph) to the auditor's report. The proposed auditor reporting standard references those circumstances. Additionally, the auditor may add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements.[84/] This type of explanatory paragraph is not required by the

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[84/] AU sec. 508.19 describes these types of explanatory paragraphs as "emphasis of a matter paragraphs" or "emphasis paragraphs."

proposed auditor reporting standard or other PCAOB standards. Explanatory language is added to the auditor's report to provide information about the financial statements or the audit without affecting the auditor's opinion on the financial statements. This approach is retained from existing AU sec. 508.[85/]

## A. Explanatory Language Required by Other PCAOB Standards (Paragraph 15 of the Proposed Auditor Reporting Standard)

The proposed auditor reporting standard, similar to existing AU sec. 508,[86/] provides a list of circumstances in which the auditor is required to add explanatory language to the auditor's report and provides references to other PCAOB standards in which these circumstances and related reporting requirements are described. In certain circumstances, the auditor might communicate this information in a separate paragraph, called an explanatory paragraph.

The circumstances under which the auditor is required to add an explanatory language would occur, for example, when there is substantial doubt about the company's ability to continue as a going concern,[87/] when the auditor's opinion is based in part on the report of another auditor and the auditor decides to refer to that report,[88/] or when there has been a material change between periods in accounting principles or in the method of their application.[89/] The list of circumstances that require explanatory language can serve as a single reference source for auditors regarding when explanatory language is required in the auditor's report.

The proposed requirement to communicate critical audit matters does not alter the existing requirements to add explanatory language. However, a matter that requires explanatory language, such as a restatement, also might be a matter that involved the most difficult judgments or posed the most difficulty to the auditor in forming the opinion. Therefore, the same matter – the restatement in this case – would require an explanatory paragraph in the auditor's report in accordance with Auditing Standard No.

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85/ See existing AU secs. 508.11 and .19.

86/ See existing AU sec. 508.11.

87/ See AU sec. 341.

88/ See AU sec. 543, *Part of Audit Performed by Other Independent Auditors*.

89/ See Auditing Standard No. 6, *Evaluating Consistency of Financial Statements*.

6 and also would be communicated as a critical audit matter in accordance with the proposed auditor reporting standard. The auditor may include a cross-reference in the auditor's report as appropriate.

Further, recent academic literature finds that companies that receive unqualified audit reports containing explanatory language as described in AU sec. 508, such as a change between periods in accounting principles,[90/] are more likely to subsequently restate their financial statements.[91/] More specifically, the study states that audit reports with explanatory language could indicate a heightened risk of financial statement misstatement and that standard setters should be cautious to not require additional reporting without considering the potential of diluting information provided by currently required explanatory language in auditor reports.[92/] The proposed auditor reporting standard retains the provisions of AU sec. 508 with respect to explanatory language, such as a change between periods in accounting principles and stipulates that the communication of critical audit matters would be in addition to any explanatory language included in the auditor's report. Accordingly, the communication of critical audit matters is not intended to dilute the information that would be provided by the required explanatory language but would provide more information about the audit that might also be informative to investors and other financial statement users.

**B. Paragraphs to Emphasize a Matter Regarding the Financial Statements (Paragraph 16 of the Proposed Auditor Reporting Standard)**

The proposed auditor reporting standard retains from AU sec. 508 the ability for the auditor to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. Such explanatory paragraphs are currently used by auditors to emphasize (1) accounting matters, other than those involving a change in accounting principles, affecting the comparability of the financial statements and (2) other matters, such as the use of an accounting framework other than U.S. GAAP,

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[90/] Id.

[91/] See Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor 'Commentary' in Unqualified Audit Reports Reflect Financial Misstatement Risk?* Unpublished working paper (2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2245855.

[92/] Id.

litigation or regulatory matters, and certain fair value matters.[93/] Generally, an explanatory paragraph that emphasizes a matter in the financial statements points to a disclosure in the company's financial statements that discloses the matter without providing any further information.

Consistent with existing AU sec. 508, the proposed standard would not require the auditor to emphasize a matter but permits the auditor to add such explanatory paragraphs when the auditor determines that a matter presented or disclosed in the financial statements would be important to a user's understanding of the financial statements, such as a significant subsequent event.

The proposed requirement to communicate critical audit matters does not alter the auditor's ability to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. The auditor's communication of a critical audit matter may provide more information about the auditing aspect of the matter emphasized in the auditor's report.

Existing AU sec. 508 provides examples of matters the auditor may emphasize in the auditor's report.[94/] The proposed auditor reporting standard similarly provides a list of examples, which have been retained or enhanced from existing AU sec. 508, incorporates an additional example from the existing PCAOB standard,[95/] and adds new examples. While examples of potential matters that the auditor may emphasize in the auditor's report are provided in the proposed auditor reporting standard, the auditor also may decide to emphasize other matters in the financial statements if the auditor determines it is appropriate to do so.

Questions Related to Section VI:

29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?

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[93/] In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 4.5% of the filings.

[94/] See existing AU sec. 508.19.

[95/] See paragraph .18 of AU sec. 9410, *Adherence to Generally Accepted Accounting Principles: Auditing Interpretations of Section 410*.

30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?

31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?

32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?

## VII. Amendments to Other PCAOB Standards

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed auditor reporting standard. Appendix 3 contains the proposed amendments to existing PCAOB auditing standards related to the proposed auditor reporting standard. Significant amendments are described below.

### A. Amendments to Auditing Standard No. 5

Auditing Standard No. 5 establishes requirements and provides direction when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting that is integrated with an audit of the financial statements.

The Board is proposing to amend the auditor's report on internal control over financial reporting to include the following amendments to conform to the proposed auditor unqualified report:

- Conform certain required elements of the auditor's report on the audit of internal control over financial reporting[96/] to the auditor's report on the audit of the financial statements; and

- Amend the example combined report.[97/]

The proposed amendments to the required elements of the auditor's report on the audit of internal control over financial reporting, as well as to the example combined report, would require:

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96/ See paragraph 85 of Auditing Standard No. 5.

97/ See paragraph 87 of Auditing Standard No. 5.

- The title, "Report of Independent Registered Public Accounting Firm" (this title is included in the example combined report in Auditing Standard No. 5; however, the existing requirement in Auditing Standard No. 5 only specifies that the title include the word "independent");

- Addressees that include, but are not necessarily limited to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body;

- Name of the company whose internal control over financial reporting was audited;

- Statement that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB; and

- Statement containing the year the auditor began serving consecutively as the company's auditor.

Since the statements regarding the auditor's requirement to be independent and the auditor tenure are included as the proposed basic elements of the auditor's unqualified report, they also might be useful to the users of the auditor's report on the audit of internal control over financial reporting.

Additionally, the example combined report in Auditing Standard No. 5 would include a section titled "The Auditor's Responsibilities Regarding Other Information" that includes the reporting requirements related to auditor's responsibilities regarding other information outside the audited financial statements and the results of the auditor's evaluation of the other information. In addition, the proposed auditor reporting standard states that if the auditor performs an audit of internal control over financial reporting that is integrated with an audit of the financial statements and chooses to issue a combined report, the paragraph in the auditor's report describing the auditor's responsibilities regarding other information should be updated to indicate that the auditor audited both the financial statements and the company's internal control.

## B. Amendments to Auditing Standard No. 6

Auditing Standard No. 6 establishes requirements for the auditor's evaluation of the consistency of the financial statements, including changes to previously issued financial statements and the effect of that evaluation on the auditor's report. Auditing Standard No. 6 requires the auditor to include explanatory language in the auditor's report to recognize a change in accounting principle or a correction of a material misstatement in previously issued financial statements if the change has a material effect on the financial statements.[98/] The related reporting requirements and illustrative paragraphs, however, are currently included in existing AU sec. 508.[99/]

The proposed auditor reporting standard would amend Auditing Standard No. 6 to include the reporting requirements and illustrative paragraphs from existing AU sec. 508.[100/] This change was made because, except for a few circumstances, the reporting requirements for explanatory language are contained in the respective standards requiring such reporting.

## C. Amendments to Auditing Standard No. 7

The proposed amendments to Auditing Standard No. 7 would require the engagement quality reviewer to evaluate whether appropriate critical audit matters are communicated in the auditor's report. The engagement quality reviewer's evaluation could be facilitated by the documentation requirement of the proposed auditor reporting standard. The proposed auditor reporting standard requires the audit documentation to include the determination of critical audit matters in accordance with Auditing Standard No. 3, which would require the auditor's documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters that would appear to meet the definition of a critical audit matter were not critical audit matters.

Auditing Standard No. 7 currently requires the engagement quality reviewer in an audit engagement "to evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report."[101/] Therefore, the engagement

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98/ See paragraphs 5-10 of Auditing Standard No. 6.

99/ See existing AU secs. 508.17A through .18C.

100/ See existing AU secs. 508.17B-.17D and .18A-.18B and the proposed amendments to paragraphs 12 through 17 of Auditing Standard No. 6. In previous PCAOB standard-setting projects, the substance of current AU sec. 508.17A has been repeated in existing paragraphs 7 and 8 of Auditing Standard No. 6 and the substance of current AU sec. 508.18C has been placed in existing paragraph 10 of Auditing Standard No. 6. Therefore, the Board is proposing to supersede AU secs. 508.17A and .18C without corresponding changes to Auditing Standard No. 6.

101/ See paragraph 9 of Auditing Standard No. 7.

quality reviewer is likely to discuss the matters determined to be critical audit matters with the engagement team. The proposed amendment would require the engagement quality reviewer to evaluate the engagement team's compliance with the requirements of the proposed auditor reporting standard regarding the auditor's communication of the critical audit matters.

## D. Amendments to Auditing Standard No. 16

Auditing Standard No. 16 requires auditors to communicate certain significant audit and financial statement matters to the audit committee. Among other things, Auditing Standard No. 16 includes a requirement for the auditor to communicate to the audit committee matters related to departures from the auditor's unqualified report. Under the Board's existing standard, the auditor is required to communicate certain information when the auditor expects to (1) modify the opinion in the auditor's report and (2) include explanatory language or an explanatory paragraph in the auditor's report.[102/]

The proposed amendments to Auditing Standard No. 16 would delete the existing communication requirement regarding the auditor's report and would replace it with a requirement to provide to and discuss with the audit committee a draft of the auditor's report. Providing and discussing a draft of the report would inform the audit committee about the language in the audit report for tenure, critical audit matters, explanatory language (or explanatory paragraphs), and departures from an unqualified report. The proposed amendment to Auditing Standard No. 16, however, would not preclude the auditor from communicating with the audit committee any changes to the auditor's report prior to the preparation of the draft auditor's report.

## E. Amendment to AU sec. 336

The proposed amendment to AU sec. 336, *Using the Work of a Specialist*, would enable the auditor to reference the use of a specialist in the auditor's report in connection with the auditor's communication of critical audit matters, if the auditor believes such reference will facilitate an understanding of the audit matter or the considerations that led the auditor to determine that the audit matter is a critical audit matter. Currently, existing AU sec. 336 states that the auditor should not refer to the work or findings of a specialist, except for situations in which the auditor decides to add explanatory language to his or her report or depart from an unqualified opinion.[103/] The proposed amendment is intended to explain that the auditor is not precluded from

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[102/] See paragraph 21 of Auditing Standard No. 16.

[103/] AU secs 336.15-.16.

referencing the specialist if the reference is related to a critical audit matter. Because of the statement in the auditor's report that communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole, the auditor's reference to the use of specialists should not be misunderstood as a qualification of the auditor's opinion or a division of responsibility.

## F. Amendments to Existing AU sec. 508

The proposed auditor reporting standard would supersede portions of existing AU sec. 508 that primarily relate to an unqualified opinion.[104/] The remaining portions of existing AU sec. 508 primarily address departures from the auditor's unqualified report, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion. Accordingly, existing AU sec. 508 would be retitled from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances."

The proposed amendments to the remaining portions of AU sec. 508 are not intended to change the substance of the remaining provisions of AU sec. 508. The proposed amendments would primarily consist of (1) requiring the communication of critical audit matters in certain circumstances; (2) revising certain terminology to align with the proposed auditor reporting standard; and (3) amending the illustrative reports. Further updating and revision may be required to existing AU sec. 508, as amended by this proposal, which would be considered by the Board in a separate standard-setting project.

The proposed amendments to AU sec. 508 include:

### *1. Communication of Critical Audit Matters in Opinions Other Than Unqualified*

*Qualified Opinion*

A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with generally accepted accounting principles.[105/] Existing AU sec. 508 requires that when the auditor expresses a qualified opinion, he or she discloses all of the substantive reasons in a separate paragraph.

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[104/] AU secs. 508.01-.09 and .11-.19 would be superseded.

[105/] See AU sec. 508.20.

The proposed amendments would require that when the auditor expresses a qualified opinion, the auditor's report also include, among other things, communication of critical audit matters. The Board would expect in most circumstances that the reason for the qualification of the auditor's report would also give rise to a critical audit matter. In that case, the auditor may include a cross-reference in the auditor's report as appropriate. However, in such an audit, there may be other matters meeting the criteria of a critical audit matter; therefore, requiring the communication of critical audit matters would be considered appropriate.

*Adverse Opinion*

An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles.[106/] The existing requirements related to an adverse opinion were not amended to require the auditor to communicate critical audit matters. If the financial statements are not presented fairly, existing AU sec. 508 requires the auditor to explain the auditor's reason for the adverse opinion. Requiring the auditor to communicate additional critical audit matters was not considered necessary because the most important matter to investors and other financial statement users would be the reason for the adverse opinion.

*Disclaimer of Opinion*

A disclaimer of opinion states that the auditor does not express an opinion on the financial statements.[107/] The existing requirements related to a disclaimer of an opinion were not amended to require the auditor to communicate critical audit matters because the auditor is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements. Because the auditor is not able to complete the audit and form an opinion on the financial statements, the auditor would not be able to determine the matters that involved the most difficult, subjective, or complex auditor judgments, posed the most difficulty in obtaining sufficient appropriate audit evidence, or posed the most difficulty in forming the opinion on the financial statements.

*2. The Term "Explanatory Paragraph"*

Existing AU sec. 508 includes references to the term "explanatory paragraph" that describe the auditor's responsibility to provide the reason for a departure from an

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106/ See AU sec. 508.58.

107/ See AU sec. 508.61.

unqualified opinion. This term would be amended to "basis for departure from unqualified opinion paragraph" to differentiate this paragraph from an explanatory paragraph, as described in the proposed auditor reporting standard.

*3. Illustrative Reports*

Existing AU sec. 508 includes illustrative reports related to qualified opinions, adverse opinions, and disclaimers of an opinion. These reports would be amended to reflect the proposed basic elements of the auditor's unqualified report, as applicable in the particular reporting circumstances.

## G. Amendments to AU sec. 623

AU sec. 623, *Special Reports*, includes the reporting requirements for various types of special reports, such as reports on specified elements, accounts, or items of a financial statement. Since many of these reports are not required to be filed with the SEC, the Board did not amend the illustrative reports included in AU sec. 623. However, a note is proposed to be added to AU sec. 623 indicating that if any of the reports are to be filed with the SEC, the auditor would include the basic elements of the auditor's unqualified opinion and critical audit matters as described in paragraphs 6 and 7-14, respectively, of the proposed auditor reporting standard. For qualified, adverse, and disclaimer of opinion reports, AU sec. 623 also would be amended to include a reference to the requirements of AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances*.

## H. Other Amendments

The proposed amendments to other PCAOB standards primarily relate to:

- Updating references as a result of auditing standards that are being amended or superseded. For example, for references in the auditing standards to AU sec. 508, the proposed amendment would change the title from "Reports on Audited Financial Statements" to "Departures from Unqualified Opinions and Other Reporting Circumstances;"

- Updating illustrative reports for the basic elements of the proposed auditor reporting standard for the reports that are filed with the SEC. For example, updating the example report in AU sec. 543 that illustrates appropriate reporting by the principal auditor indicating the division of responsibility when the auditor makes reference to the audit of the other auditor; and

- Updating AU sec. 722, *Interim Financial Information*, for the basic elements of the proposed auditor reporting standard.

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 3:15:28 PM

Questions Related to Section VII:

33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?

34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.

## VIII. Considerations Related to Audits of Specific Entities

The Board is seeking comment on the applicability of the proposed auditor reporting standard and amendments to the audits of specific entities, including brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans.

### A. Brokers and Dealers

*1. Background Information*

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,[108/] the proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements.[109/] All of the statements contained in the annual audited financial statements of the broker or dealer are public, except that if the statement of financial condition is bound separately from the balance of the annual audited financial statements, the balance of the annual

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108/ See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

109/ See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

audited financial statements is deemed confidential and thus available for use only by the SEC and others to whom the SEC gives authorization.[110/] Therefore, in situations in which the broker or dealer binds separately the statement of financial condition from the balance of the annual audited financial statements, the auditor generally would issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete audited financial statements that, along with the audited financial statements, would be confidential and not available to the public.[111/]

There were approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012.[112/] Based on research conducted by the PCAOB's Office of Research and Analysis ("ORA"), approximately 45% of these brokers and dealers filed a statement of financial condition that was bound separately from the balance of the annual audited financial statements. For those brokers and dealers, only the statement of financial condition, with the related auditor's report, is publicly available, while the complete annual audited financial statements, with the related auditor's report, are confidential. For the remaining 55% of the population of brokers and dealers, the complete annual audited financial statements and the related auditor's report are publicly available.[113/]

ORA's research also indicates that there are no issuers among the approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 9% of the 4,230 brokers and dealers are subsidiaries of issuers. The remainder are not owned by issuers.

According to ORA's research, for the population of brokers and dealers that are not subsidiaries of issuers (1) approximately 90% are directly owned by an individual or an entity that owns more than 50% of the broker or dealer and (2) approximately 75% have five or fewer direct owners. A review of the title or status of the brokers' or dealers'

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110/ See SEC Rule 17a-5(e).

111/ See also SEC Rule 17a-5(c)(2) regarding audited statements required to be provided to customers.

112/ This information is based on the number of brokers and dealers that filed annual audited financial statements with the SEC through May 1, 2013 for fiscal periods ended during 2012.

113/ ORA obtained information from the SEC's EDGAR database on brokers and dealers that filed public and confidential annual audit reports with the SEC.

direct owners who are individuals suggests that these owners are generally part of the broker's or dealer's management.

In summary, ORA's research indicates that ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team.

*2. Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. Other commenters thought that certain changes, for example clarifications to language in the auditor's report, may be applicable to auditors' reports for brokers and dealers, but other changes to the auditor's report should not apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

## B. Investment Companies

*1. Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of investment companies. The Investment Company Act of 1940 ("Investment Company Act") generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[114/] Investment companies registered with the SEC under the Investment Company Act are required to file with the SEC, on Form N-CSR, annual reports containing audited financial statements.[115/]

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[114/] See Section 3(a)(1) of the Investment Company Act.

[115/] See SEC Rules under Section 30(e) of the Investment Company Act.

An investment company (1) is generally organized by an outside "sponsor" (also known as promoter[116/]), such as a bank or an insurance company and (2) has an investment adviser,[117/]which manages the investment company's portfolio securities for a fee. A sponsor might register many investment companies that generally would have the same or related investment advisers. Such investment companies are referred to as affiliated. Annual shareholder reports of affiliated investment companies that have the same fiscal year-end might be filed with the SEC in one Form N-CSR. This document generally contains a single auditor's report that refers to the financial statements of each audited investment company. The financial statements of the affiliated investment companies might contain some disclosures that would be similar across the affiliated investment companies, such as the management fee arrangements, because of the common investment adviser. Other disclosures might be different, such as disclosures related to the use of derivatives, because of the different investment strategies of each investment company.

Investment companies can also be part of master-feeder or fund of funds capital structures.[118/] In master-feeder structures, feeder investment companies invest all their assets in another investment company, known as the master fund, and own proportionate shares of the net assets of the master fund. Master-feeder accounting involves allocating the master's income, expenses, and realized and unrealized gains and losses among the feeder funds. Additionally, accounting policies of the master fund, such as valuation of investments of the master fund, may affect the feeder funds. A master and feeder fund may not be affiliated, may have different auditors, and different fiscal year ends. As described in SEC staff guidance, the annual report of each feeder fund generally contains the financial statements of both the master and the feeder fund.[119/]

Funds of funds are investment companies that invest in other investment companies. A fund of funds' structure is similar to that of a master-feeder, except that it

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[116/] See Section 2(a)(30) of the Investment Company Act.

[117/] See Section 2(a)(20) of the Investment Company Act.

[118/] See Section 12(d)(1) of the Investment Company Act, which describes investment companies involved in such structures as acquiring company and acquired company.

[119/] See SEC "Dear CFO" letters at http://www.sec.gov/divisions/investment/noaction/1997/cfo110797.pdf and http://www.sec.gov/divisions/investment/noaction/1995/accountingcomment110295.pdf.

generally invests its assets in more than one other fund. Because of certain limitations under the Investment Company Act,[120/] an issuer fund of funds and the investee funds are often affiliated, but may have different auditors and fiscal year ends.

In January 2009, the SEC adopted amendments to Form N-1A that require every open-end management investment company prospectus to include a summary section consisting of key information about the investment company.[121/] The SEC described these amendments as intended to help investors to access key information that is important to an informed investment decision.[122/] In describing the rationale for the adopted amendments, the SEC stated that there was consensus among roundtable participants and other commenters that the key information that investors need to make an investment decision about an investment company includes information about the investment company's investment objectives and strategies, risks, costs, and performance.[123/] The investment company's costs and performance calculations are subject to audit and are included in the financial highlights, which are referred to in the auditor's report.

*2. Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of investment companies. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of investment companies from a small number of commenters. Those commenters generally expressed the view that additional auditor reporting should not apply to audits of investment companies. These commenters viewed investment companies' financial

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120/ See Section 12(d)(1) of the Investment Company Act.

121/ See SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies,* Securities Act Release No. 8998 (Jan. 13, 2009), at 7.

122/ See SEC Release No. 8998, at 14-15.

123/ See SEC Release No. 8998, at 9-11. See also ICI, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006), at 2-3, available at http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf.

statements as inherently less complex than operating companies' financial statements and argued that the limited nature of an investment company's operations entails fewer estimates and judgments.

## C. Employee Stock Purchase, Savings, and Similar Plans

### *1. Background Information*

The proposed auditor reporting standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to the audits of employee stock purchase, savings, and similar plans ("benefit plans"). Benefits plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[124/] that includes the benefit plan's audited financial statements and the related auditor's report.[125/] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[126/]

In general, the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits. Defined-contribution benefit plan participants do not invest directly in a benefit plan; rather they select their investments outside of the benefit plan, with the plan holding the investments as its assets.

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124/ See Section 15(d) of 1934 Act.

125/ A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. See SEC Rule 15d-21, C.F.R §240.15d-21.

126/ See FASB ASC 960-10-05-6. Benefit plans subject to ERISA also file with the DOL an annual report on form 5500, including audited financial statements and an auditor's report. Pursuant to DOL requirements, the audit of the financial statements is performed under auditing standards generally accepted in the U.S., that is, not under PCAOB standards. ERISA-related information is available at the DOL website at http://www.dol.gov/compliance/laws/comp-erisa.htm#applicable_laws.

*2. Consideration of Comments on Concept Release*

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC. Many commenters who responded to this question of the concept release supported requiring the same reporting for all companies.

The Board received comments that were specific to audits of benefit plans from a small number of commenters. One commenter thought the Board should proceed with caution regarding employee benefit plans that file a Form 11-K. Another commenter said that users of pension plans' financial statements are not requesting or in need of an expanded auditor reporting model.

<u>Questions Related to Section VIII</u>:

35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?

36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?

37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?

38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?

39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?

40. Should audits of certain companies[127/] be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?

## IX. Considerations Related to Effective Date

The proposed auditor reporting standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposal as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed auditor reporting standard, such as for the audits of smaller companies.

Questions Related to Section X:

41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?

42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

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127/ See Appendix 7 for a discussion on costs and other considerations related to EGCs.

## Exhibit – Illustrative Examples of Critical Audit Matters

This Exhibit contains three illustrative examples of communications of critical audit matters in an auditor's report. Each of the three illustrative examples contain background information, the company's related notes to the financial statements, determination of the critical audit matter, and the communication of the critical audit matter as it would appear in the auditor's report.

All three examples are based on hypothetical situations and have been prepared for illustrative purposes only. They are not intended to provide guidance or any suggestions regarding the accounting or disclosure required, nor any implied audit procedures, in the circumstances presented.

### A. Hypothetical Auditing Scenario #1 – Allowance for Sales Returns

#### *1. Background*

In the year ended January 31, 2013 ("fiscal 2013"), an established brick-and-mortar retail company ABC Retailer ("ABC" or the "Company") implements a strategic decision to expand its product offerings concurrent with developing a significant on-line sales channel. Simultaneously, it lengthens its existing 30-day sales returns policy to 60 days. This change in returns policy, along with the expanded product offerings and new on-line presence, are announced in a fiscal 2013 advertising campaign.

ABC's management projects a significant increase in sales and an increase in returns in fiscal 2013 as a result of these changes. The Company designs and implements new or enhanced procedures, processes, and systems during fiscal 2013 to address the product expansion, the on-line distribution channel, and the expected increase in customer returns.

ABC has significant historical experience to estimate sales allowances based on its traditional products and sales channel. Because of the strategic changes and longer sales return period, management performs an in-depth analysis of how changes in product mix, customer demographics, and the use of on-line "stores" to sell merchandise are likely to affect historical experience in sales returns. Management uses industry data and other sources, including the results of its own market research, to perform this analysis. Management also implements new systems to improve the identification, processing, and tracking of sales returns and develops a statistical model to estimate future returns. The statistical model relies on a number of inputs and assumptions derived from the sales return tracking system. As a result, management believes its historical experience in combination with the new systems and statistical model allow management to make reasonable estimates of sales returns for fiscal 2013.

During fiscal 2013, ABC's management decides to significantly lengthen the 60-day returns policy without publicly announcing a change to the stated policy. In response to on-line customer complaints about the Company's returns policy in the past, full refunds are given "no questions asked" for returns within 90 days and in specific circumstances for returns within 120 days. To reflect the lengthened sales returns policy, management makes adjustments to the sales returns allowance determined by the statistical model. These adjustments are partly based on data generated by the sales returns tracking system and partly based on management's judgment about how recent sales activity and other factors such as seasonality, recent promotions, and the nature and frequency of customer complaints are affecting ABC's application of its stated sales returns policy. Disclosure of management's actions regarding its sales returns policy was made in the MD&A.

*2. Excerpts From the Company's Notes to the Financial Statements*[128/]

***Note 1: Accounting Policies***

***Revenue Recognition***

We recognize revenue when the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred; the selling price is fixed or determinable; and collectability is reasonably assured. For sales made at our retail stores, we generally recognize revenue at the time of a sale to a customer. For sales made through our website, we generally recognize revenue at the time the merchandise is shipped to a customer. As part of our customer service strategy, we offer customers the right to return undamaged merchandise for a full refund if they are not satisfied with their purchase. We record an allowance for estimated returns as a reduction of gross revenues and cost of goods sold, and as an accrued current liability based on historical experience and trends. If we are unable to make reasonable estimates of future returns, revenue is deferred until the return period expires. In fiscal 2011, 2012, and 2013, no revenues were deferred due to an inability to make reasonable estimates of future returns.

Beginning in fiscal 2013, we use a statistical model that utilizes our historical experience to estimate future returns. Inputs and assumptions to our model include, among other factors: historical experience based on sales of similar products; the

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[128/] Only financial statement information relating to the disclosure and determination of the revenue recognition relative to the allowance for sales returns is presented. Other required notes to the financial statements have been omitted from this example.

relative risk of returns based on the nature of the product, such as susceptibility to changes in technology or changes in demand due to new product introductions; historical data related to the effect that special promotions and/or seasonality has on returns; and the relative risk of returns based on the selling price of the merchandise and the sales channel that the customer used to make a purchase. We also incorporate expected changes, if any, in our returns policies and practices as well as changes in economic and buying trends that might impact customer demand and behavior. If actual returns are not consistent with our estimates, we factor the new information into our statistical model and adjust our previous estimate in the period new information becomes available.

*3. Determination of the Critical Audit Matter*

The auditor determined that the evaluation of the allowance for sales returns is a critical audit matter in the audit of ABC's fiscal 2013 financial statements.

Specific considerations, which led the auditor to determine that the auditor's evaluation of the allowance for sales returns is a critical audit matter, included:

- Extensive changes to the Company's business strategy, including changes to the Company's distribution channel through the use of on-line "stores" to sell merchandise;

- Significant lengthening of the Company's sales return policy (from 30 to 60 days) and flexible application of it (90 – 120 days);

- The development of a new statistical model to estimate future sales returns, which included management adjustments to the statistical model to reflect the flexible application of the sales return policy;

- Significant increase in the Company's expected sales returns;

- The extensive amount of consultation with the audit firm's national office regarding the design of appropriate audit procedures, evaluation of the results of those procedures, and assessment of compliance with U.S. GAAP relative to the audit of the allowance for sales returns;

- The significant difficulty in obtaining sufficient appropriate audit evidence to support management's subjective adjustments to the allowance computed by the statistical model; and

- The complexity and difficulty of evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

We determined that our evaluation of the Company's allowance for sales returns was a critical audit matter in the audit of the Company's financial statements as of and for the fiscal year ended January 31, 2013. The Company developed a new on-line sales channel. This new sales channel could have significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy. The Company developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, a key element in recording revenue. The lack of historical experience with the new assumptions resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns.

Because of these changes in the Company's distribution channel and sales return policy, our audit of the Company's allowance for sales returns (1) involved our difficult and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns and (2) posed difficulty to us in obtaining sufficient appropriate evidence to support management's adjustments to the allowance for sales returns. We consulted with our national office on (1) the design and performance of audit procedures to test the data underlying management's assumptions used to estimate future sales returns and (2) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments regarding the effect that changes in the Company's return policies and practices, as well as changes in economic and buying trends that affect customer behavior, have on the estimate of future sales returns. The Company's accounting policy for sales returns is discussed in Note 1 to the financial statements.

## B. Hypothetical Auditing Scenario #2 – Valuation Allowance for Deferred Tax Assets

### *1. Background*

As of the year ended June 30, 2013 ("fiscal 2013"), XYZ Technology Company ("XYZ" or the "Company") has been in business for 10 years. In its first three years, as its "first generation" products were being developed and commercialized, the Company incurred losses for both financial reporting and federal income tax purposes. For income tax purposes, the losses are carried forward and subsequently utilized to reduce federal income taxes that otherwise would have been payable. By its sixth year of operations, XYZ is profitable for tax purposes, has no remaining net operating loss carryforwards, and has repaid its borrowings. Cash flows from operations are strong.

By fiscal 2010 (its seventh year of operations), competition begins to erode the Company's market share. XYZ reports breakeven results for financial reporting purposes and a small loss for income tax purposes in fiscal 2010. The loss is carried back for income tax purposes. The Company returns to profitability in fiscal 2011 by carefully controlling costs and by offering some "add-ons" to its "first generation" products that boost revenues.

During fiscal 2012 (its ninth year of operations), XYZ raises equity capital to provide additional liquidity for its ongoing development of "next generation" products (targeted to be introduced in fiscal 2014-2015). Due to the significant increase in development costs combined with continuing pressure on sales prices and unexpected cost increases in a critical component, XYZ reports a loss for both financial reporting and federal income tax purposes in fiscal 2012. A portion of the loss in fiscal 2012 creates a net operating loss carryforward. The Company's cash position remains strong.

During the year ended June 30, 2013, XYZ recalls one of its products due to a defect in a component supplied by a third party. Although the supplier is contractually obligated to reimburse the Company for the costs to recall and repair the defective products, the supplier disputes the role its component played in the product failure that led to the recall. Product development and marketing costs increase in preparation for the targeted 2014-2015 introduction of the "next generation" products. Additionally, costs are incurred (1) to exit certain unprofitable, peripheral product lines that are no longer consistent with XYZ's strategy and (2) to relocate its corporate office. The Company is able to somewhat mitigate the fiscal 2012 cost increase in a critical component but does not expect the cost of the component to return to historic levels in the near term.

As a result of these various circumstances, the Company incurs a significant pre-tax loss in the year ended June 30, 2013, for both financial reporting and federal income tax purposes. In combination with other book-tax differences and the net operating loss carryforward from fiscal 2012, XYZ reports net deferred tax assets as of June 30, 2013.

As required by U.S. GAAP, management evaluates whether the recorded amount of deferred tax assets as of June 30, 2013 is realizable. In evaluating the need for a valuation allowance, management evaluates both negative and positive evidence to determine whether it is more likely than not that its deferred tax assets will be realized. From management's perspective, negative evidence includes losses in 2013 and 2012. However, management determined that it has not incurred cumulative losses in recent years[129/] when evaluated over a three-year time frame.[130/] Management's positive evidence includes the Company's historical ability to utilize operating loss carryforwards, a 15-year carryforward period, and a forecast of increased revenues and profits in the next three years. That forecast includes the following expectations: (1) favorable settlement with the supplier related to the recall; (2) elimination of certain unprofitable, peripheral product lines; (3) decline in the level of product development spending; and (4) commercialization of the "next generation" products.

Management also considers that some of the current year loss is the result of the product recall, the exiting of certain product lines, and the relocation of the corporate office, events that are not expected to recur in the future. Further, management considers XYZ's strong cash position. Lastly, management does not identify any qualifying tax-planning strategies. Based on the weight of all available evidence, both positive and negative, management concludes that no valuation allowance is required.

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129/ See FASB ASC paragraph 740-10-30-16 through 30-24, *Income Taxes – Overall – Initial Measurement – Establishment of a Valuation Allowance for Deferred Tax Assets*, for the accounting requirements of a valuation allowance for deferred income tax assets including discussion regarding "cumulative losses in recent years."

130/ ASC Topic 740-10-30-23 indicates that "[a]n entity shall use judgment in considering the relative impact of negative and positive evidence. The weight given to the potential effect of negative and positive evidence shall be commensurate with the extent to which it can be objectively verified. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome."

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Underline Date: 5/2/2014 2:29:21 PM

Number: 2 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014 Date: 5/2/2014 2:29:05 PM

**This is perfect fantasy on the part of the management of this company....If everything breaks in their favor....(aka: no floods, leaky LIBOR scandals, no sharknados, hurricanes or clients with bad dental hygene characteristics and/or criminal family connections....then we say....yes....this management group is spot on in forecasting a rosy future, for you, for me for everyone.....& God Bless America, too......Respectfully yours, Pw**

Number: 3 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Typewritten Text Date: 5/2/2014 3:14:31 PM

Number: 4 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Highlight Date: 5/2/2014 2:24:21 PM

Number: 5 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Typewritten Text Date: 5/2/2014 3:14:30 PM

2. *Excerpts From the Company's Notes to the Financial Statements*[131/]

***Note 2: Accounting Policies***

**Income Taxes**

We account for income taxes under the asset and liability method. Deferred taxes are determined based on the temporary differences between the financial statement and tax basis of existing assets and liabilities using tax rates that under current tax law would be in effect in the years in which the differences are expected to reverse. The effect of a change in tax rates on deferred taxes is recognized in the period that includes the enactment date.

We make judgments regarding the realizability of our deferred tax assets. We consider our deferred tax assets to be realizable when we believe it is more likely than not that we will generate sufficient future taxable income to realize our deferred tax assets after consideration of all available evidence. We record a valuation allowance to reduce our deferred tax assets to the amount that we believe more than 50 percent likely to be realized. In assessing the need for a valuation allowance, we consider all positive and negative evidence, including the expected timing of reversals of existing temporary differences, projected future taxable income, tax planning strategies, and recent financial performance. The more negative evidence that exists, the more positive evidence is necessary and the more difficult it is to support a conclusion that a valuation allowance is not needed for some portion or all of the deferred tax asset. A cumulative loss in recent years is generally a significant piece of negative evidence that is difficult to overcome in determining that a valuation allowance is not needed.

***Note 12: Income Taxes***

As of June 30, 2013, our deferred tax asset of $XXX million related to federal net operating loss carryforwards will expire in approximately 14 to 15 years if not utilized. The determination of whether it is more than 50 percent likely that we will realize the full benefit of all our deferred tax assets, including the deferred tax asset related to the net operating loss carryforwards, requires significant judgment. That judgment includes evaluation of negative evidence, such as recent losses, and positive evidence, including projections of future taxable income during the carryforward period. As required by the accounting literature, more weight is given to objective evidence. Negative objective

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131/ Only financial statement information relating to the disclosure and determination of deferred tax assets is presented. Other required notes to the financial statements have been omitted from this example.

evidence includes our losses in 2013 and 2012. However, we do not have cumulative losses in recent years when evaluated over a three-year time frame. Positive objective evidence that we considered in making our judgment included: (1) the effect of eliminating certain product lines and (2) the expectation that product recall costs and relocation costs will not recur in the future. Projections of future taxable income are subject to uncertainty due to various factors, including the general economic environment, industry and competitive conditions, timing of product enhancements and new product introductions, and the length of time of the projections included in the analyses. If our actual results are less favorable than current estimates and we revise our projections downward in future analyses, a valuation allowance may be required with a corresponding adjustment to earnings in the period in which such determination is made. As of June 30, 2013, based upon our estimates, we believe it is more likely than not that the Company will realize the full benefit of the existing deferred tax assets.

*3. Determination of the Critical Audit Matter*

The auditor determined that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter.

Specific considerations, which led the auditor to determine that its assessment of management's evaluation of the realizability of deferred taxes is a critical audit matter, included:

- The auditor's prior experience with management's forecasts of future revenues and costs, which indicated that actual revenues and income typically differed from forecasted amounts;

- The subjectivity involved in evaluating whether the weight of the Company's positive evidence is sufficient to overcome the negative evidence;

- The extensive amount of consultations with the firm's National Office regarding: (a) the design and evaluation of the results of its audit procedures related to management's forecasts of improved profitability; (b) the appropriate application of the criteria under U.S. GAAP for recording a valuation allowance; (c) the assessment of management's judgments regarding the identification and evaluation of negative and positive evidence; and (d) the adequacy of XYZ's disclosure regarding risks and uncertainties that could significantly affect deferred tax assets in the near term; and

- High degree of difficulty auditing management's forecast of future revenues and income due to significant difficulty in obtaining objective evidence to support management's key judgments about (1) the timing, demand and pricing of "next generation" products, (2) the ongoing demand for (and the life cycle of) existing products, (3) the level of future development spending, (4) the amount of marketing costs associated with the commercialization of new products, (5) the outcome of the supplier dispute regarding recall costs, and (6) future cost increases or decreases in the cost of critical components.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

We determined that our assessment of the Company's evaluation of the realizability of deferred tax assets was a critical audit matter in the audit of the Company's financial statements for the fiscal year ended June 30, 2013. Considerations that led to our determination, included the following:

- The Company exercised significant judgment in weighing positive and negative evidence regarding the realizability of the company's deferred tax assets, including in developing forecasts of projected future taxable income.

- The Company continues to experience increased competition with its "first generation" products which reduced revenue growth, sales prices and profitability. Further, the Company experienced an unexpected cost increase in a critical product component and does not anticipate that cost returning to historical levels;

- A return to profitability by the Company is dependent upon launching "next generation" products in the future; and

- The Company is experiencing increases in product development and marketing costs in preparation for its "next generation" products.

Because of these considerations, our assessment of the Company's evaluation of the realizability of deferred tax assets: (1) involved subjective auditor judgments in evaluating whether management's judgments regarding the weight given to positive and negative evidence is appropriate; (2) involved difficult auditor judgments in designing audit procedures to test the data underlying management's forecasts of its future taxable income; (3) posed difficulty in obtaining sufficient appropriate evidence to support management's forecasts of the timing and amount of future taxable income due to the lack of objective evidence; and (4) posed difficulty in forming an opinion on the financial statements because of the significance to the financial statements, taken as a whole, of the Company's determination regarding the recognition of a valuation allowance for its deferred tax assets.

We consulted with others outside the engagement team regarding: (1) compliance with U.S. GAAP; (2) the design and performance of audit procedures to test management's forecasts; and (3) our evaluation of the results of those procedures, including our assessment of the reasonableness of management's judgments and forecasts in light of independent assessments of future trends in the industry, analyst reports and publicly available information regarding relevant trends by key competitors. The Company's accounting policy for deferred taxes and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial statements.

## C. Hypothetical Auditing Scenario #3 – Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded

### *1. Background*

JLE Financial Institution ("JLE" or the "Company") holds fixed maturity securities in its investment portfolio. As of December 31, 2012 ("fiscal 2012"), the Company's investment portfolio includes U.S. corporate and state and local government securities. In addition, approximately 35% of the portfolio consists of private label mortgage-backed securities and collateralized loan obligations, which have very little or no trading activity. All of these securities are classified as "available for sale" and reported at fair value in the Company's statement of financial position under U.S. GAAP.

In measuring the fair value of available for sale securities, the Company utilizes third party pricing services for its U.S. corporate and state and local government securities. JLE's process requires that it obtain an understanding of the pricing service's valuation techniques, assumptions, and other inputs important to the fair value estimate. Further, JLE has controls over information received from third party pricing services.

The process to determine the fair value of the Company's private label mortgage-backed securities and collateralized loan obligations valued primarily using in-house valuation models involves a significant amount of judgment, in large part because of the inherent imprecision in measuring the fair value of securities for which observable market prices are not available and the subjective nature of some of the inputs to the valuation model. In testing JLE's controls related to fair value estimates determined by in-house valuation models the auditor noted a control deficiency less severe than a material weakness relating to the controls employed by the pricing and valuation committee. As a result of the control deficiency, the auditor expanded the planned audit procedures for securities for which the control applied. In performing additional audit procedures on the population of securities for which the control applied, the auditor identified several misstatements due to JLE's recorded amounts falling outside of the range of reasonable estimates developed by the auditor's specialist.

*2. Excerpts From the Company's Notes to the Financial Statements*[132/]

***Note 6: Fair Value***

**Recurring Fair Value Measurements**

When observable inputs are not available, JLE's valuation methodologies rely on inputs that are significant to the estimated fair value that are not observable in the market or cannot be derived principally from, or corroborated by, observable market data. These unobservable inputs can be based in large part on management's judgment or estimation and cannot be supported by reference to recent market activity. Even though these inputs are unobservable, management believes they are consistent with what other market participants would use when pricing such securities and are considered appropriate given the circumstances. Securities that are valued using significant unobservable inputs or assumptions are classified as Level 3 in the fair value hierarchy.

While JLE believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. During fiscal 2012, there were no changes to the valuation techniques that had a material impact on the Company's consolidated financial position or results of operations.

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[132/] Only financial statement information relating to the disclosure and determination of the fair value of Level 3 fixed maturity investment securities is presented. Other required notes to the financial statements have been omitted from this example.

*U.S. corporate securities*

Valuations are based primarily on matrix pricing or other similar techniques that utilize observable inputs that are derived from, or corroborated by, observable market data, including quoted prices for identical or similar securities. In other cases, valuation is based primarily on quoted prices for identical or similar securities.

*State and local government securities*

These securities are principally valued using the market approach. Valuation is based primarily on matrix pricing using market observable inputs, including benchmark U.S. Treasury yields or other yields, issuer ratings, broker-dealer quotes, credit spreads and reported trades of similar securities.

*Private label mortgage-backed securities and collateralized loan obligations*

Valuation is based on in-house valuation models, discounted cash flow methodologies, or other techniques that utilize inputs that cannot be derived from, or corroborated by, currently observable data, including credit spreads that reflect specific credit-related issues. The pricing and valuation committee review the inputs used for each security for which the fair value is determined based on in-house valuation models.

*3. Determination of the Critical Audit Matter*

The auditor determined that the evaluation of management's fair value estimates of private label mortgage-backed securities and collateralized loan obligations measured using valuation models, is a critical audit matter.

Specific considerations, which led the auditor to determine that evaluation of management's fair value estimates of these securities, measured using valuation models, is a critical audit matter, included:

- The materiality of the private label mortgage-backed securities and collateralized loan obligations;

- The valuation techniques used to estimate the fair value of these securities which were based primarily on in-house models to estimate fair value;

- The control deficiency relating to the review by the pricing and valuation committee;

- The highly subjective nature of the judgments involved regarding unobservable inputs to the fair value measurements for these securities;

- The extensive amount of audit work required to obtain sufficient appropriate evidence to form a conclusion, including significant involvement of senior members of the engagement team;

- The use by the auditor of the work of a third party specialist with expertise in the valuation of complex financial instruments to develop independent estimates of fair value for corroborative purposes;

- The auditor's expansion of the planned audit procedures relating to the valuation of the mortgage-backed securities and collateralized loan portfolio as a result of contradictory evidence obtained from those audit procedures; and

- The auditor's proposed adjustments to the valuation of the mortgage-backed securities and collateralized loan obligations.

*4. Communication of Critical Audit Matter in the Auditor's Report*

Critical Audit Matter

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficulty to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. Our audit of the Company's fair value of these securities in the audit of the Company's financial statements as of and for the fiscal year ended December 31, 2012 involved difficult and complex auditor judgments because these securities (1) trade less frequently and (2) were valued using in-house valuation models based on unobservable inputs, which are subject to a wide range of measurement uncertainty. Our audit of these securities required an extensive amount of audit work, including significant involvement of senior members of the engagement team and the involvement of a third party valuation specialist. Further, it was necessary to expand the planned audit procedures due to a control deficiency less severe than a material weakness noted in the Company's internal control system regarding fair value estimates, valued using in-house valuation models. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee. Our audit procedures resulted in our identification of several misstatements that were corrected by the Company. The Company's disclosures related to nature and fair values of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.

## APPENDIX 6

## *Additional Discussion of the Proposed Other Information Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release*

This Appendix discusses the Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"), presented in Appendix 2, and the related proposed amendments to certain PCAOB auditing standards (the "proposed amendments") presented in Appendix 4. This Appendix collectively refers to the proposed other information standard and proposed amendments as the "proposed other information standard and amendments." The proposed other information standard would supersede AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* and AU sec. 9550, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*.

Following the Board's initial outreach from October 2010 through March 2011,[1/] the Board issued on June 21, 2011 a concept release to seek public comment on potential changes to the auditor's reporting model (the "concept release").[2/] Additionally, the Board held a public roundtable[3/] on the concept release and changing the auditor's report was discussed at the Board's Investor Advisory Group ("IAG")[4/] and Standing

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[1/] See Section II., *Board Outreach*, of the Release for further discussion regarding the Board's outreach.

[2/] *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards,* PCAOB Release No. 2011-003 (June 21, 2011) is available at http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf.

[3/] A transcript of the public roundtable is available at http://pcaobus.org/Rules/Rulemaking/Docket034/09152011_Roundtable_Transcript.pdf.

[4/] IAG meeting details and webcasts for March 2011 and 2012 are available at http://pcaobus.org/News/Events/Pages/03162011_IAGMeeting.aspx and http://pcaobus.org/News/Webcasts/Pages/03282012_IAGMeeting.aspx.

Advisory Group ("SAG") meetings.[5/] Some commenters supported changes to the auditor's report that describe the auditor's existing responsibility related to information outside the financial statements to inform investors and other financial statement users of the extent of the auditor's responsibility for other information contained in a document that also contains the financial statements and the related auditor's report.

This Appendix discusses significant comments received during the Board's outreach regarding other information in documents containing audited financial statements and the auditor's report. It also provides additional background information regarding the requirements in the proposed other information standard and amendments.

The Board requests comments on specific questions included in this Appendix as well as on its proposal in general. Additionally, the Board is seeking comment on economic considerations related to the proposed other information standard and amendments, including potential costs. To assist the Board in evaluating such matters, the Board is requesting relevant information and empirical data, to the extent available to commenters. Commenters providing cost estimates are requested to provide the basis for any estimate provided. Finally, the Board is seeking comment on the applicability of the proposed other information standard and amendments to the audits of brokers and dealers. Considerations related to the applicability of the proposed other information standard and amendments to audits of emerging growth companies are discussed in Appendix 7.

The following sections describe the requirements in the proposed other information standard and amendments.

## I. Introduction (Paragraph 1 of the Proposed Other Information Standard)

The proposed other information standard establishes requirements regarding the auditor's responsibilities with respect to the other information in certain documents containing audited financial statements and the related auditor's report. As more fully described later in this section, the introduction to the proposed other information standard provides a description of "other information," as used in the proposed other

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[5/] SAG meeting transcripts for November 2011 and 2012 are available at http://pcaobus.org/Rules/Rulemaking/Docket034/11102011_SAG_Transcript.pdf, http://pcaobus.org/Rules/Rulemaking/Docket034/11162012_SAG_Transcript.pdf, and http://pcaobus.org/Rules/Rulemaking/Docket034/11152012_SAG_Transcript.pdf.

information standard, including (1) the documents to which the proposed other information standard would apply and (2) the information to which the proposed other information standard would not apply.

## A. Description of Other Information and Applicability of the Proposed Other Information Standard

### *1. Description of Other Information*

The proposed other information standard describes "other information" as information, other than the audited financial statements[6/] and the related auditor's report, in a company's annual report that is filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act") and contains that company's audited financial statements and the related auditor's report. The auditor's responsibilities with respect to other information outside the financial statements would thus focus on other information contained in annual reports filed with the SEC, such as Form 10-K. Annual reports filed with the SEC contain other information that is relevant and of interest to investors and other financial statement users.

Annual reports filed with the SEC under the Exchange Act may include information incorporated by reference from other SEC filings. Under the proposed other information standard, other information includes information contained in the annual report that is filed with the SEC under the Exchange Act as well as specific information that is incorporated by reference into the annual report.

Specifically, a note to the introduction of the proposed other information standard clarifies when information that is incorporated by reference would be included in the scope of the proposed other information standard. The note provides that other information includes information incorporated by reference into the Exchange Act annual report when the information is available to the auditor prior to the issuance of the auditor's report. Additionally, when the annual report is a Form 10-K, the other information in the annual report includes specific information incorporated by reference that is available to the auditor subsequent to the issuance of the auditor's report when that information is contained in the company's definitive proxy statement filed within 120

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[6/] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. See SEC Rule 1-01(b) of Regulation S-X, 17 C.F.R. § 210.1-01(b).

days after the end of the fiscal year covered by the Form 10-K. No other information incorporated by reference in the annual report that is not available to the auditor prior to the issuance of the auditor's report is included in the scope of the proposed other information standard.

Annual reports filed with the SEC under the Exchange Act may be amended from time to time, including when there are revisions to amounts or disclosures in the previously issued audited financial statements. Amended annual reports, such as the Form 10-K/A, that contain the company's audited financial statements and the related auditor's report, are included in the scope of the proposed other information standard.

When an amended annual report contains revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the amended annual report would be treated similar to an initial filing on Form 10-K. In this situation, because the auditor essentially is considering whether to update or issue a new auditor's report,[7/] the auditor would perform all the procedures under the proposed other information standard.

When an amended annual report does not contain revisions to amounts or disclosures in the previously issued financial statements that affect the auditor's report that was filed with the initial Form 10-K, then the auditor would treat the other information in the amended filing as not available prior to the issuance of the auditor's report.[8/]

The scope of the proposed other information standard contains some similarities to, and some differences from, the Board's existing auditing standard relating to other information, AU sec. 550.

AU sec. 550 currently applies to other information contained in (1) annual reports to holders of securities or beneficial interests, annual reports of organizations for charitable or philanthropic purposes distributed to the public, and annual reports filed with regulatory authorities under the Exchange Act or (2) other documents to which the

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7/ See AU sec. 530, *Dating of the Independent Auditor's Report*.

8/ See Section IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report*.

auditor, at the client's request, devotes attention.[9/] Existing AU sec. 550 does not specifically mention information incorporated by reference into an annual report.

Thus, consistent with existing AU sec. 550, the proposed other information standard would apply to annual reports filed under the Exchange Act. However, certain other annual reports included in the scope of the existing standard, such as a company's annual report to security holders that is provided to, but not filed with, the SEC (sometimes referred to as the "glossy" annual report because it may appear as a glossy publication) would not be within the scope of the proposed other information standard. As discussed further below, in some cases, a glossy annual report may be incorporated by reference, either in whole or in part, into a company's Form 10-K prior to the issuance of the auditor's report. In those circumstances, the portions of the glossy annual report, other than the financial statements, that are incorporated by reference would be considered other information under the proposed other information standard.

Additionally, unlike existing AU sec. 550, the proposed other information standard would not apply to other documents to which the auditor, at the company's request, devotes attention. The proposed other information standard does not preclude the auditor from applying the procedures in the standard to such other documents. Also, the proposed other information standard does not preclude the auditor from applying additional procedures not described in the proposed other information standard to the other information.

Finally, the proposed other information standard is consistent with existing AU sec. 550 in that it would not apply to documents filed with the SEC under the Securities Act of 1933 ("Securities Act").[10/] The proposed other information standard, like AU sec. 550, refers the auditor to AU sec. 711, *Filings Under Federal Securities Statutes*, and the auditor's responsibilities for Securities Act filings under the federal securities laws.[11/] The Board recognizes, however, that certain Securities Act filings may incorporate by reference annual reports containing audited financial statements and audit reports that are filed with the SEC under the Exchange Act. For a further discussion regarding the Board's considerations related to Securities Act documents, see Section XII, *Considerations Related to Securities Act Documents*.

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[9/] See AU sec. 550.02.

[10/] See AU sec. 550.03.

[11/] See, e.g., Section 11(a) of the Securities Act, 15 U.S.C. § 77k(a).

*2. Applicability to Annual Reports Filed with the SEC under the Exchange Act That Contain Other Information*

As noted above, the proposed other information standard would apply to annual reports that are filed with the SEC under the Exchange Act that contain audited financial statements and the related auditor's report.

The proposed other information standard would apply to the version of the annual report document filed with the SEC either electronically using the Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system[12/] or as a paper filing.[13/] Because the proposed other information standard is limited to annual reports that are filed with the SEC, the auditor's responsibilities would not extend to annual reports that are distributed by other means, such as corporate websites or social media. Information on websites, such as a company's own website, might contain audited financial statements, the related auditor's reports, or data derived from SEC filings. Consistent with existing AU sec. 9550,[14/] the proposed other information standard would not require auditors to evaluate information contained in electronic sites.

The annual reports covered by the proposed other information standard would include annual reports filed on Forms 10-K, 20-F, 40-F, and N-CSR, among others. The other information contained in these annual report filings can vary depending on the requirements of the SEC form on which the filing is made. For example, other information in a company's annual report filed on Form 10-K would include, among other items, Risk Factors; Selected Financial Data; Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"); Certain Relationships and Related Transactions, and Director Independence; and exhibits.[15/]

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[12/] See SEC Rule 301 of Regulation S-T, 17 C.F.R. § 232.301. EDGAR currently provides an electronic filing process for submitting documents under the Securities Act, the Exchange Act, the Trust Indenture Act of 1939, and the Investment Company Act of 1940.

[13/] See SEC Rule 101 of Regulation S-T, 17 C.F.R. § 232.101. For example, employee stock purchase, savings and similar plans may choose to file their annual reports with the SEC in electronic or paper format.

[14/] See AU secs. 9550.16-.18.

[15/] Any documents contained in the list of exhibits to the annual report would be considered other information in an annual report under the proposed other

Other information filed by an investment company issuer on Form N-CSR would include, among other items, Code of Ethics and Management's Discussion of Fund Performance ("MDFP").[16/]

Additionally, under the proposed other information standard, management's assertion on internal control over financial reporting would be considered other information when that assertion is included in an annual report filed with the SEC that contains audited financial statements and the related auditor's report, and management's assertion is not subject to an auditor's attestation under Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*. The auditor's responsibilities under the proposed other information standard regarding management's assertion on internal control over financial reporting generally would be consistent with existing AU sec. 9550.[17/] AU sec. 9550 states that, because an auditor is required to consider internal control in an audit of the financial statements, the auditor may be familiar with matters covered in management's assertion on internal control over financial reporting.

*3. Applicability to Information Incorporated by Reference in Annual Reports Filed with the SEC under the Exchange Act*

In many cases, the information incorporated by reference into an annual report filed with the SEC is available to the auditor prior to the issuance of the auditor's report. For example, as discussed above, the entire or portions of a company's glossy annual report may be incorporated by reference[18/] into a company's Form 10-K.[19/] Under the

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information standard. The proposed other information standard would not apply to information formatted in eXtensible Business Reporting Language ("XBRL") that is furnished with the SEC as an exhibit or otherwise. See SEC, *Interactive Data to Improve Financial Reporting*, Release No. 33-9002 (Jan. 30, 2009) at 94-95 and 101.

[16/] See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP. Form N-2, which sets reporting requirements for closed-end funds, does not require MDFP.

[17/] See AU sec. 9550.07-.11.

[18/] See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (2). See also SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23.

[19/] Glossy annual reports may also be included as part of a combined report filed on Form 10-K. In this case, information from glossy annual reports, other than the proposed other information standard, information incorporated by reference that is available to the auditor prior to the issuance of the auditor's report would be considered other information and covered by the proposed other information standard. The auditor's responsibilities for other information that is incorporated by reference and is available prior to the issuance of the auditor's report would be the same as the auditor's responsibilities for other information contained in the document filed with the SEC.

Under the proposed other information standard, with one exception, the auditor would not be responsible for information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report. Specifically, the proposed other information standard would apply to information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.[20/] Though this information may be filed subsequently, it is an essential part of the company's annual report on Form 10-K and is necessary to make the document complete.[21/]

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audited financial statements, would be considered other information under the proposed other information standard. See Form 10-K, 17 C.F.R. § 249.310, General Instructions H, "Integrated Reports to Security Holders."

[20/] The information required by Part III of Form 10-K (i.e., Item 10. Directors, Executive Officers and Corporate Governance; Item 11. Executive Compensation; Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters; Item 13. Certain Relationships and Related Transactions, and Director Independence; and Item 14. Principal Accountant Fees and Services) may be incorporated by reference from a proxy statement. See SEC Exchange Act Rule 12b-23, 17 C.F.R. § 240.12b-23. See also Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," Paragraph (3).

[21/] The standard also would apply to the other information that was to be incorporated by reference from the proxy statement but was instead filed as an amendment to the Form 10-K. If a proxy statement is not filed with the SEC within 120 days after the end of the fiscal year covered by the Form 10-K, the information that was to be incorporated by reference from the proxy statement is instead filed as an amendment to the Form 10-K. See Form 10-K, 17 C.F.R. § 249.310, General Instructions G, "Information to Be Incorporated by Reference," paragraph (3).

## B. Information Included in Annual Reports Containing Audited Financial Statements and the Related Auditor's Report to Which the Proposed Other Information Standard Would Not Apply

Consistent with AU sec. 550,[22/] the proposed other information standard would not apply to (1) supplemental information addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,[23/] and (2) required supplementary information addressed by AU sec. 558, *Required Supplementary Information*. The proposed other information standard also would not apply to management's assertion on internal control over financial reporting in an audit of internal control over financial reporting that is integrated with an audit of the financial statements.[24/] The information described in these circumstances would be subject to audit or other procedures under other PCAOB standards named above. Therefore, there is no need to impose the requirements of the proposed other information standard on that information because the auditor's responsibilities are already described in the other PCAOB standards.

The proposed other information standard would apply to the other information in the annual report of the company that is making the filing. Audited financial statements of an entity other than the company, such as a business acquired or to be acquired, may be required to be included in the company's annual report.[25/] The Board does not intend for the other entity's financial statements to be considered other information in the company's annual report, under the proposed other information standard, because they are not the company's financial statements and were already subject to a separate audit. Although the Board does not intend for the proposed other information standard to apply in such situations, the Board is seeking comment on whether the proposed other information standard should apply to audited financial statements of another entity that are required to be filed in a company's report under Article 3 of Regulation S-X and whether there are practical issues of doing so.

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[22/] See AU sec. 550.03.

[23/] See *Proposed Auditing Standard, Auditing Supplemental Information Accompanying Audited Financial Statements, and Related Amendments to PCAOB Standards*, PCAOB Release No. 2011-005 (July 12, 2011).

[24/] See Auditing Standard No. 5.

[25/] See Article 3 of Regulation S-X.

Questions Related to Section I:

1. Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?

2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?

3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?

4. Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?

## II. Objectives (Paragraph 2 of the Proposed Other Information Standard)

Consistent with other recently issued PCAOB auditing standards, the Board has included a section on the objectives of the auditor in the proposed other information standard to highlight the overall context for the requirements of the standard. Providing an overarching concept as audit objectives for the auditor to take into account can assist the auditor in performing the procedures required by the proposed other information standard and evaluating the results of those procedures.

The proposed other information standard states that the objectives of the auditor are:

- To evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ("material inconsistency");

(2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and

- When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency, a material misstatement of fact, or both.

The Board's existing standard, AU sec. 550 does not specifically identify an objective for the auditor regarding other information.

Question Related to Section II:

5. Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?

## III. Evaluating the Other Information (Paragraphs 3 – 5 of the Proposed Other Information Standard)

The proposed other information standard would require the auditor to evaluate whether the other information contains (1) a material inconsistency, (2) a material misstatement of fact, or (3) both. As more fully described later in this section, the auditor's evaluation would include reading the other information and performing specific procedures based on relevant audit evidence obtained and conclusions reached during the audit.

AU sec. 550 currently requires the auditor to read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[26/] Additionally, if, while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact, that is not a material inconsistency, the auditor is required to discuss the matter with management.[27/] Existing AU sec. 550 does not specify the procedures that the auditor should perform when considering the other information, but the standard describes the auditor's responsibilities for responding to identified material inconsistencies or material misstatements of fact.

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[26/] See AU sec. 550.04.

[27/] See AU sec. 550.05.

## A. Material Inconsistency (Paragraph 3 of the Proposed Other Information Standard)

The proposed other information standard generally retains the description of material inconsistency under existing AU sec. 550. A material inconsistency would exist under the proposed other information standard when the other information is materially inconsistent with amounts or information, or the manner of their presentation, in the audited financial statements. The other information often includes amounts or qualitative statements that are directly related to the financial statements because they are intended to be the same as, or to provide greater detail about, amounts or information in the financial statements.

A material inconsistency would involve an inconsistency between amounts in the financial statements and amounts in the other information that have a direct relationship to the company's financial statements, such as quantitative information in the Selected Financial Data or MD&A sections, among others, of an annual report on Form 10-K, but would not be limited to only quantitative information. Qualitative statements, such as the description of the company's critical accounting policies, estimates, and related assumptions in the other information of an annual report on Form 10-K, also would be directly related to accounts and disclosures in the financial statements and thus might involve a material inconsistency.

## B. Material Misstatement of Fact (Paragraph 3 of the Proposed Other Information Standard)

The proposed other information standard also retains the concept of material misstatement of fact in AU sec. 550. Similar to the existing standard, the proposed other information standard does not define material misstatements of fact, but describes the concept of material misstatements of fact in the context of the auditor's responsibilities.

Material misstatements of fact could relate to, among others, statements about the company's competitive environment, technological developments, or supplier relationships. Although such statements in the other information do not directly relate to the accounts and disclosures in the financial statements, the auditor might have knowledge of such information as part of obtaining audit evidence or reaching conclusions during the audit.[28/] Such statements also might be an important driver of the company's stock market value or be of particular importance to investors.

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[28/] For example, during the audit, the auditor may obtain such information as audit evidence in connection with obtaining an understanding of the company and its

For example, management might state in the other information that the company has the largest market share in the company's industry. This information could be material to an investor's decision about the company. The auditor might be aware, based on relevant audit evidence obtained during the audit, that the company does not have the largest share in the relevant industry. The proposed other information standard would require the auditor to evaluate whether management's statement represents a material misstatement of fact.

### C. Auditor's Responsibility to Evaluate (Paragraph 4 of the Proposed Other Information Standard)

The proposed other information standard would require the auditor to read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the other information. In order to strengthen the auditor's performance responsibilities to provide a basis for the auditor to evaluate the other information, the proposed other information standard provides specific procedures the auditor would perform related to the other information. The procedures set forth in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence.

In evaluating whether the other information contains a material inconsistency, a material misstatement of fact, or both, the auditor would refer to the definition of materiality under the federal securities laws. In interpreting those laws, the United States Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[29/] As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . .."[30/]

Since the purpose of evaluating the other information is to assess whether the other information contains a material inconsistency, a material misstatement of fact, or

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environment. See paragraph 9 of Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*.

29/ TSC Industries v. Northway, Inc., 426 U.S. 438, 449 (1976). See also, Basic, Inc. v. Levinson, 485 U.S. 224, 231 to 232 (1988).

30/ TSC Industries, 426 U.S. at 450.

both, the Board believes that it is appropriate for the auditor to use the established definition of materiality under the federal securities laws applicable to corporate reporting for this evaluation. Auditors should be familiar with this definition because, among other things, it is used to evaluate whether uncorrected misstatements detected during the audit are material.[31/] The Board understands that MD&A and other parts of the other information may contain information that does not reach the quantitative materiality level established for purposes of planning the audit[32/] and that the auditor accordingly may not have obtained audit evidence concerning those matters. As discussed above, the auditor's responsibility to evaluate such information would be based on relevant audit evidence obtained and conclusions reached during the audit. If, however, on that basis, the auditor identifies a potential inconsistency or misstatement of fact in the other information, the auditor should assess its materiality under the federal securities laws' definition of that term.

*1. Auditor's Responsibility to Read*

As noted above, the proposed other information standard retains the requirement of existing AU sec. 550 for the auditor to read the other information. The requirement "to read" in the proposed other information standard has the same meaning as in AU sec. 550 and other PCAOB standards, such as reading interim financial information,[33/] board minutes,[34/] prospectuses and registration statements,[35/] and other information by the engagement quality reviewer or during a review of interim financial information.[36/]

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[31/] See paragraph 17 of Auditing Standard No. 14, *Evaluating Audit Results.*

[32/] See Auditing Standard No. 11, *Consideration of Materiality in Planning and Performing an Audit.*

[33/] See, e.g., paragraphs .11 and .18.e. of AU sec. 722, *Interim Financial Information*.

[34/] See, e.g., AU secs. 722.18.a. and .19.

[35/] See, e.g., AU secs. 711.08-.11.

[36/] See, e.g., paragraphs 10.g. and 15.e. of Auditing Standard No. 7, *Engagement Quality Review,* and AU sec. 722.18.f.

### 2. *Auditor's Responsibility to Evaluate*

The proposed other information standard describes the auditor's responsibility as "should evaluate" the other information. Existing AU sec. 550 states that the auditor "should consider" whether the other information is materially inconsistent with the financial statements. AU sec. 550 further indicates that if the auditor concludes that there is a material inconsistency with the financial statements based on the auditor's reading and considering, then the auditor should perform certain procedures.[37/]

The proposed other information standard does not retain the term "should consider." PCAOB Rule 3101, *Certain Terms Used in Auditing and Related Professional Practice Standards,* indicates that if a Board standard provides that the auditor "should consider" an action or procedure, consideration of the action or procedure is presumptively mandatory while the action or procedure is not. As used in AU sec. 550, "should consider" is not followed by a specific action or procedure, but rather is described as a stand-alone requirement without further context regarding the action or procedure. "Should evaluate" is used in other PCAOB standards when the auditor is expected to come to a conclusion based on the performance of certain procedures.[38/]

The proposed other information standard differs from AU sec. 550 in that it requires the auditor to evaluate the other information for both a material inconsistency and a material misstatement of fact. Under existing AU sec. 550, the auditor's responsibility for a material misstatement of fact is conditioned on the auditor "becoming aware" of a material misstatement of fact while reading the other information for a material inconsistency. AU sec. 550 also currently states that, if the auditor becomes aware of information that he or she believes is a material misstatement of fact, that is not a material inconsistency, the auditor should consider that he or she may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion.[39/]

The proposed other information standard would require the auditor to evaluate the other information for a material inconsistency and for a material misstatement of fact

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[37/] See AU sec. 550.04.

[38/] See, e.g., Auditing Standard No. 7 and Auditing Standard No. 12.

[39/] See AU sec. 550.05.

based on relevant audit evidence obtained and conclusions reached during the audit. A consistent requirement to evaluate the other information for both material inconsistencies and for material misstatements of fact is appropriate because the auditor's evaluation would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit.

*3. Performing Procedures to Evaluate the Other Information*

In addition to reading the other information, the auditor's evaluation under the proposed other information standard would include performing procedures intended to help the auditor identify whether the other information contains material inconsistencies and material misstatements of fact. Existing AU sec. 550 does not specify any procedures for the auditor to perform in considering the other information.

The required procedures in the proposed other information standard set forth the nature and extent of the auditor's work to evaluate the other information. The procedures in paragraph 4 of the proposed other information standard involve using information and evidence already obtained by the auditor rather than procedures to obtain additional evidence. Specifically, the auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. Under other PCAOB standards, the auditor is required to obtain sufficient appropriate audit evidence[40/] and reach conclusions during the audit.[41/] These existing responsibilities provide the basis for the auditor's evaluation of the other information under the proposed other information standard.

Some commenters on the concept release indicated that they are aware that some auditors perform certain procedures related to the other information, such as comparing numbers in the other information to the audited financial statements, recalculating percentages, and providing input to management regarding the other information. Similarly, the Commission on the Auditors' Responsibilities established by the American Institute of Certified Public Accountants (known as the "Cohen Commission"), which examined the auditor's responsibilities and the form of the auditor's report, recommended in 1978 – prior to the establishment of the PCAOB – that the auditing standard for other information be revised to require the auditor to (1)

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[40/] See Auditing Standard No. 15, *Audit Evidence*.

[41/] See Auditing Standard No. 14 and paragraphs 62-73 of Auditing Standard No. 5.

compare the other information to the financial statements and the audit work papers for inconsistencies with the auditor's knowledge as a result of the audit and (2) recompute percentages or information presented in a manner different from that in the financial statements.[42/] These recommendations of the Cohen Commission have never been adopted as requirements for the auditor.

Because existing AU sec. 550 does not require procedures other than to "read and consider" the other information, the application of the auditor's responsibilities regarding other information among accounting firms may not be consistent. While the Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard, the Board's proposal is designed to promote a consistent basis for the auditor's evaluation of other information. The required procedures are discussed in Subsections a.–d. of this Section.

The proposed procedures are more specific than the "read and consider" approach in existing AU sec. 550 and thus likely would increase auditor effort and, therefore, costs for firms, particularly those firms that might not currently be performing similar procedures on the other information. Also, enhancing the auditor's responsibilities from "becoming aware" of a material misstatement of fact under existing AU sec. 550[43/] to performing specific procedures to evaluate whether the other information contains a material misstatement of fact might result in additional auditor effort. It is also anticipated that auditors would incur one-time costs related to the proposed other information standard, such as updating firm audit methodologies to reflect the new performance and reporting requirements and training firm personnel.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact, based on relevant audit evidence obtained and conclusions reached during the audit. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors

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[42/] See AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

[43/] See AU sec. 550.05.

and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[44/] or intentional misreporting.[45/] As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[46/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors also could facilitate more efficient capital allocation decisions.[47/] Academic research has shown that the increased quality of information could result in a reduction in the average cost of capital.[48/]

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[44/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting,* Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[45/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

[46/] The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[47/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

[48/] Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of*

a. Amounts in the Other Information Related to the Financial Statements (Paragraph 4.a. of the Proposed Other Information Standard)

For amounts in the other information that are intended to be the same as, or provide greater detail about, amounts in the financial statements, the auditor would be required to evaluate the consistency of the amounts and the manner of their presentation with the financial statements or relevant evidence obtained during the audit. If the amounts in the other information are at the same level of detail as those in the financial statements, for example, amounts in the Selected Financial Data section, among others, of an annual report on Form 10-K, the auditor would evaluate the consistency of the amounts with amounts in the financial statements.

The other information also might contain amounts that are more disaggregated than the amounts in the financial statements. For example, amounts related to Results of Operations in the MD&A section, among others, of Form 10-K might be presented in a way that provides greater detail on a geographic or product basis than the amounts presented in the financial statements. In those situations, the auditor would evaluate the consistency of the amounts in the other information and the manner of their presentation with relevant evidence obtained during the audit that includes disaggregated information.

b. Qualitative Statements in the Other Information Related to the Financial Statements (Paragraph 4.b. of the Proposed Other Information Standard)

For any qualitative statement in the other information that is intended to represent, or provide greater detail about, information in the financial statements, the auditor would evaluate the consistency of the information and the manner of its presentation with the financial statements, including the financial statement disclosures, and with relevant audit evidence. Such qualitative other information might appear in the MD&A section, among others, of Form 10-K and relate to, for example, critical accounting policies, practices, and estimates or the description of off-balance sheet arrangements.

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*Information Precision in Determining the Cost of Equity Capital,* 9 Review of Accounting Studies 233, 233-259 (2004).

c. Other Information That Is Not Directly Related to the Financial Statements (Paragraph 4.c. of the Proposed Other Information Standard)

With respect to other information that is not directly related to the financial statements, the auditor would compare the information to relevant audit evidence obtained and conclusions reached during the audit. Other information that is not directly related to the financial statements might appear in the Business, Risk Factors, or Quantitative and Qualitative Disclosures about Market Risk sections, among others, of an annual report on Form 10-K[49/] or the MDFP section of an annual report on Form N-CSR.[50/]

d. Recalculation of Amounts in the Other Information (Paragraph 4.d. of the Proposed Other Information Standard)

The proposed other information standard also would require the auditor to evaluate certain amounts in the other information by recalculating the amounts for mathematical accuracy. The amounts that would be subject to this procedure would be amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence.

For example, this requirement of the proposed other information standard would apply to amounts in the other information that the auditor can recalculate without the need to refer to a formula or when the formula is generally understood. The above-mentioned requirement would include amounts, such as totals or percentages, which are ordinarily calculated using simple mathematical operations that do not require a formula, as well as generally understood ratios, such as the current ratio. If the auditor needs to refer to a formula for the recalculation of an amount, such as for return on capital employed, the auditor would be required to recalculate the amount only when the formula is provided or described in the annual report. However, the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.

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[49/] See Instructions to Form 10-K available at http://www.sec.gov/about/forms/form10-k.pdf.

[50/] See Item 27(b)(7) of SEC Form N-1A for open-end investment companies. Money market investment companies are exempt from this requirement to provide MDFP.

## D. Responding When the Auditor Identifies a Potential Material Inconsistency, A Potential Material Misstatement of Fact, or Both (Paragraph 5 of the Proposed Other Information Standard)

As a result of performing the evaluation procedures under paragraph 4 of the proposed other information standard, the auditor might identify a potential material inconsistency, a potential material misstatement of fact, or both. If so, the proposed other information standard would require the auditor to discuss the matter with the company's management. The proposed other information standard also would require that the auditor perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both. Such additional procedures might include (1) requests for additional documentation and (2) consultations outside of the engagement team, such as a national office or other parties with appropriate expertise. The procedures would vary based on the auditor's evaluation of the relevant facts and circumstances.

It is anticipated that, in many situations, the auditor's discussion with management and the results of the additional procedures would provide the auditor with additional information that could be sufficient to enable the auditor to determine if there is a material inconsistency, a material misstatement of fact, or both. If the auditor determines that there is a material inconsistency between the other information and the audited financial statements, the auditor also would determine whether the financial statements or the other information would require revision. A material misstatement of fact generally would require revision of the other information, not the financial statements, because a material misstatement of fact in the other information is not directly related to the financial statements.

Existing AU sec. 550 does not specify the procedures to be performed when the auditor identifies a potential material inconsistency but has not reached a conclusion about the material inconsistency. AU sec. 550 describes the auditor's responsibilities once the auditor has reached a conclusion that a material inconsistency exists. However, when the auditor becomes aware of information that the auditor believes is a material misstatement of fact, and prior to reaching a conclusion about the material misstatement of fact, AU sec. 550 currently requires the auditor to discuss the matter with management.[51/] The requirement in the proposed other information standard to discuss the matter with management is similar to the requirement in AU sec. 550 regarding a material misstatement of fact.

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[51/] See AU sec. 550.05.

If the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, and the auditor performs additional procedures, as necessary, the additional procedures likely would result in additional auditor effort as compared to the existing requirements in AU sec. 550.

Questions Related to Section III:

6. Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?

7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?

8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?

9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?

10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?

11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?

12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?

13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?

## IV. Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both (Paragraphs 6-11 of the Proposed Other Information Standard)

### A. Communication with Management (Paragraph 6 of the Proposed Other Information Standard)

If the auditor determines that the other information contains a material inconsistency, a material misstatement of fact, or both, the proposed other information standard would require the auditor to request management to revise the other information. This requirement was retained from AU sec. 550 with respect to a material inconsistency.[52/] However, with respect to a material misstatement of fact, AU sec. 550 does not include an explicit requirement for the auditor to request that management revise the other information. Rather, AU sec. 550 includes a requirement for the auditor to propose that management consult with other parties, such as legal counsel.[53/]

### B. The Auditor's Response If Management Does Not Appropriately Revise the Other Information (Paragraph 7 of the Proposed Other Information Standard)

If management does not appropriately revise the other information, the auditor's response under the proposed other information standard would vary depending on whether the other information had been available to the auditor prior to the issuance of the auditor's report. When the other information is available to the auditor prior to the issuance of the auditor's report and management, in response to a request by the auditor, does not revise appropriately the other information to address a material inconsistency, a material misstatement of fact, or both, then the auditor would be required to perform certain procedures that are described in paragraphs 8 and 9 of the proposed other information standard and in Section IV.C., *Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report*, below. Additionally, when the other information is not available to the auditor prior to the issuance of the auditor's report and the other information is not appropriately revised by management, then the auditor would be required to perform other procedures described in paragraphs 10 and 11 of the proposed other information standard and in Section

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52/ See AU sec. 550.04.

53/ See AU sec. 550.05.

IV.D., *Responding When the Other Information Is Not Available Prior to the Issuance of the Auditor's Report* below.

## C. Responding When the Other Information Is Available Prior to the Issuance of the Auditor's Report (Paragraphs 8-9 of the Proposed Other Information Standard)

Paragraphs 8-9 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that the other information available to the auditor prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both and (2) the information is not appropriately revised by management. When the other information is available prior to the issuance of the auditor's report, the auditor's response would be the same whether the information is contained in the annual report or is incorporated by reference in it.

### *1. Communication with the Audit Committee (Paragraph 8 of the Proposed Other Information Standard)*

If management does not appropriately revise the other information after the auditor's request, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both, to the audit committee in a timely manner and prior to the issuance of the auditor's report.

Under existing AU sec. 550, if the other information is not revised to eliminate the material inconsistency, the auditor is required to communicate the material inconsistency to the audit committee.[54/] Additionally, if the auditor has concluded that a material misstatement of fact remains after communication to management, AU sec. 550 states that the auditor should communicate the material misstatement of fact to the audit committee, in writing.[55/]

The proposed other information standard would retain the requirements for the auditor to communicate to the audit committee, but would not require the communications regarding a material misstatement of fact to be in writing. This is consistent with the approach taken to communications to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees,* which allows the

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[54/] See AU sec. 550.04.

[55/] See AU sec. 550.06.

communication to be oral or written.[56] Auditing Standard No. 16, however, requires the auditor to document communications with the audit committee in the work papers, whether such communications took place orally or in writing.[57]

*2. Responding When the Other Information Is Not Appropriately Revised (Paragraph 9 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication with the audit committee, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A of the Exchange Act ("Section 10A");[58] AU sec. 316, *Consideration of Fraud in a Financial Statement Audit*; and AU sec. 317, *Illegal Acts by Clients*. This would direct the auditor to his or her responsibilities under federal securities laws and other PCAOB standards.

Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.[59] AU sec. 316 provides requirements regarding the auditor's responsibilities related to fraud in the audit of financial statements. AU sec. 317 provides the nature and extent of the auditor's consideration in the audit of financial statements of the possibility for an illegal act by the company.

Additionally, if the other information is not appropriately revised after the auditor's communication to the audit committee, the proposed other information standard would require the auditor to determine whether to (1) issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both or (2) withdraw from the engagement. In determining whether to issue an auditor's report when the other information is not appropriately revised after the auditor's communication to the audit committee, the auditor would consider, among other things, the implications of being associated with an annual report that contains a material inconsistency, a material

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[56] See paragraph 25 of Auditing Standard No. 16.

[57] Id.

[58] 15 U.S.C. § 78j-1.

[59] See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

misstatement of fact, or both. The Board is seeking comments regarding the appropriateness of issuing an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both.

The proposed other information standard requires the same response and reporting by the auditor for both a material inconsistency and a material misstatement of fact in the other information because the auditor's evaluation of other information would be based on the same factors – relevant audit evidence obtained and conclusions reached during the audit. Investors are likely to be interested in matters that the auditor determined are material inconsistencies or material misstatements of fact in the other information. Additionally, investors might consider the other information that is directly related to the financial statements, as well as the other information that is not directly related to the financial statements, important in their investment decision making.[60/] Therefore, the proposed other information standard aligns the reporting responsibilities for both a material inconsistency and a material misstatement of fact.

There may be circumstances in which the auditor determines that issuing an auditor's report is not appropriate. Similar to existing AU sec. 550,[61/] such circumstances may arise when the nature of the material inconsistency or material misstatement of fact is such that it may affect the auditor's decision to be associated with the annual report. Under the proposed other information standard, such circumstances would require the auditor to determine whether to withdraw from the

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[60/] See, e.g., IAG survey, *Role, Relevancy, and Value of the Audit.* The responses to survey question 13 indicate that investors often use other information, such as (1) MD&A, (2) Business Description, (3) Risk Factors, and (4) Proxy Information, to make investment decisions. The survey results were presented at the March 2012 IAG meeting and are available at http://pcaobus.org/News/Events/Documents/03282012_IAGMeeting/Audit_Firm_Practice_Survey_Summary.pdf.

[61/] See AU sec. 550.04, which states, in part, that "[o]ther information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report." It further states that if the other information is not revised to eliminate the material inconsistency "[t]he action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information."

engagement. Consideration of similar actions is currently required by AU sec. 550 with respect to material inconsistency,[62] but that standard does not specify the auditor's responses with respect to a material misstatement of fact.

The proposed other information standard notes that the auditor may withhold the use of the auditor's report for a prior reporting period. If the auditor determines that it is not appropriate to issue an auditor's report for the current reporting period, the auditor also may withhold the use of the auditor's report for a prior reporting period. This is similar to existing AU sec. 550, which states that the auditor should consider actions such as withholding the use of the auditor's report in the annual report, if the other information is not revised to eliminate the material inconsistency.[63] AU sec. 550, however, does not specify the period for which the report may be withheld.

## D. Responding When the Other Information is Not Available Prior to the Issuance of the Auditor's Report (Paragraphs 10-11 of the Proposed Other Information Standard)

Paragraphs 10-11 of the proposed other information standard set forth the auditor's response when (1) the auditor has determined that certain other information, that is not available to the auditor prior to the issuance of the auditor's report, contains a material inconsistency, a material misstatement of fact, or both and (2) the information has not been appropriately revised by management.[64]

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[62] See AU sec. 550.04.

[63] Id.

[64] With respect to other information in an amended annual report that contains previously issued audited financial statements and the related auditor's report, the auditor would apply paragraphs 2-7 and 10-11 of the proposed other information standard. Those paragraphs also would apply to (1) information incorporated by reference in a Form 10-K from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K and (2) other information that was to be incorporated by reference from the company's definitive proxy statement but was instead filed as an amendment to the Form 10-K.

1. *Communication with the Audit Committee (Paragraph 10 of the Proposed Other Information Standard)*

If, after the auditor's request, management does not appropriately revise the other information that was not available prior to the issuance of the auditor's report, the proposed other information standard would require the auditor to communicate the material inconsistency, the material misstatement of fact, or both to the audit committee in a timely manner. This requirement is similar to the requirement when the other information is available prior to the issuance of the auditor's report.

2. *Responding When the Other Information Is Not Appropriately Revised (Paragraph 11 of the Proposed Other Information Standard)*

If the other information is not appropriately revised after the auditor's communication of the material inconsistency, material misstatement of fact, or both to the audit committee, and the auditor's report has been issued, the proposed other information standard would require the auditor to determine his or her responsibilities under Section 10A.[65/] Section 10A includes requirements that apply when the auditor detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements) has or may have occurred.[66/]

Additionally, the proposed other information standard would require the auditor to apply the procedures in AU sec. 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report.* AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date which might have affected the auditor's report if the auditor had been aware of them.[67/]

The procedures in AU sec. 561 would apply in a situation in which the other information that was not available prior to the issuance of the auditor's report was not revised to eliminate a material inconsistency, a material misstatement of fact, or both.[68/]

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[65/] 15 U.S.C. § 78j-1.

[66/] See Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b).

[67/] See AU sec. 561.01.

[68/] See AU secs. 561.05 and .08-09.a.

For example, if the auditor identified a material inconsistency, a material misstatement of fact, or both in the related party information in a proxy statement covered by this standard, the auditor would:

- Determine the effect on the auditor's report if (1) the material inconsistency between the information about related parties in the other information and the audited financial statements, (2) the material misstatement of fact in the other information about related parties, (3) or both had been known to the auditor prior to the issuance of the auditor's report;[69/] and

- Notify each member of the company's board of directors of the material inconsistency, material misstatement of fact, or both, in the related party information and that if the other information is not appropriately revised, the auditor would take steps to prevent future reliance on the auditor's report.[70/]

If the other information is not appropriately revised after the auditor's notification to the board of directors, in this example the auditor would:

- Notify management and the audit committee that the auditor's report must no longer be associated with the financial statements;[71/] and

- Notify the SEC that the auditor's report should no longer be relied upon.[72/] This notification also would describe the effect the material inconsistency, material misstatement of fact, or both in the related party information would have had on "The Auditor's Responsibility Regarding Other Information" section in the auditor's report if it had been known to the

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[69/] See AU sec. 561.05.

[70/] See AU sec. 561.08. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.

[71/] See AU sec. 561.08a.

[72/] See AU sec. 561.08b. See also the auditor's communication requirements in Section 10A(b) of the Exchange Act, 15 U.S.C. § 78j-1(b), and AU sec. 317.

auditor prior to the issuance of the auditor's report and describe the material inconsistency, material misstatement of fact, or both.[73/]

The auditor's responsibilities under AU sec. 561 are not affected when the auditor has resigned or been discharged.[74/] The auditor's responsibilities under the proposed other information standard to apply the procedures in AU sec. 561 similarly would not be affected by the auditor's resignation or dismissal.

Questions Related to Section IV:

14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?

15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?

16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?

## V. Responding When the Auditor Determines That There Is a Potential Misstatement in the Audited Financial Statements (Paragraph 12 of the Proposed Other Information Standard)

The procedures in the proposed other information standard would require the auditor to evaluate the consistency of the other information to the audited financial

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73/ See AU sec. 561.09a.

74/ See AU sec. 9561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report: Auditing Interpretations of Section 561*.

statements. These procedures would provide an increased auditor focus on other information, which could improve the auditor's identification of potential misstatements in the financial statements. Academic research indicates that comparing non-financial measures commonly found in the other information, such as number of properties and employee headcount, among others, to audited financial statements can help the auditor identify red flags for fraudulent financial reporting.[75/] To the extent that discrepancies between non-financial measures and reported financial performance are red flags for possible financial reporting issues, including fraud, requiring auditors to evaluate other information could help them detect misstatements.

As a result of procedures performed under paragraphs 4 and 5 of the proposed other information standard, the auditor might determine that there is a potential misstatement in the audited financial statements. If the auditor's report on the financial statements has not been issued, the auditor would refer to the requirements of Auditing Standard No. 14 and amended AU sec. 508, [new proposed title] *Departures from Unqualified Opinions and Other Reporting Circumstances,* in this situation.

Auditing Standard No. 14 establishes requirements regarding the auditor's evaluation of audit results and the determination of whether the auditor has obtained sufficient appropriate audit evidence. The auditor's evaluation includes, among other things, an evaluation of misstatements accumulated during the audit.[76/] Proposed amendments to AU sec. 508, as reflected in Appendix 3, would describe the reporting requirements related to departures from an unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion.

If the auditor's report has already been issued, the proposed other information standard refers the auditor to the procedures in AU sec. 561. AU sec. 561 provides procedures for the auditor when, subsequent to the date of the auditor's report, the auditor becomes aware that facts may have existed at that date that might have affected the auditor's report if the auditor had been aware of them.[77/] Under AU sec. 561, the auditor is required to perform procedures to determine whether the information

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[75/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

[76/] See paragraph 4 of Auditing Standard No. 14.

[77/] See AU sec. 561.01.

is reliable and whether the facts existed at the date of the auditor's report, including discussing the matter with company management and the board of directors.[78] The auditor's further responsibilities under AU sec. 561 depend on several factors, including, among others, the effect on the audited financial statements and the auditor's report.[79]

Question Related to Section V:

17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?

## VI. Reporting in the Auditor's Report (Paragraphs 13-14 of the Proposed Other Information Standard)

The proposed other information standard provides a basis for the auditor to report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. Reporting on the results of the auditor's evaluation of the other information would provide potentially significant information to investors.

The proposed other information standard would require that, when issuing an auditor's report, the auditor include specific statements regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of other information. The auditor would be required to make these statements in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information."[80]

Regardless of whether the auditor identifies a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide in the report the following:

- A statement that, in addition to auditing the company's financial statements [and the internal control over financial reporting (if applicable)],

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[78] See AU sec. 561.05.

[79] See AU secs. 561.05-.08.

[80] The proposed auditor reporting standard refers the auditor to the reporting requirements of the proposed other information standard related to the auditor's responsibilities for and results of the auditor's evaluation of the other information.

in accordance with the standards of the PCAOB, the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;

- Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and period end date of the financial statements;

- A statement that the auditor's evaluation was based on relevant audit evidence obtained and conclusions reached during the audit of the financial statements; and

- A statement that the auditor did not audit the other information and does not express an opinion on it.

In addition, depending on whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, when issuing an auditor's report, the auditor would be required to provide a statement that:

- The auditor has not identified a material inconsistency or a material misstatement of fact in the other information; or

- The auditor has identified a material inconsistency, a material misstatement of fact, or both, in the other information that has not been appropriately revised and a description of the material inconsistency, the material misstatement of fact, or both.

A statement in the auditor's report that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information is appropriate in situations in which (1) the auditor has not identified a material inconsistency or a material misstatement of fact based on the auditor's evaluation of the other information and (2) the auditor has identified a material inconsistency, a material misstatement of fact, or both, that the auditor requested management to revise and management appropriately revised prior to the issuance of the auditor's report. In situations when management has revised the other information at the auditor's request because the auditor identified material inconsistencies or material misstatements of fact, and the auditor determines that appropriate revisions have been made, then the auditor's report would state that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information since the annual report that is ultimately filed with the SEC no longer contains such inconsistencies or misstatements.[81/]

The proposed other information standard also provides illustrative language for the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.

The reporting requirements under the proposed other information standard are generally new. Existing AU sec. 508 does not require any statement in the auditor's report regarding the auditor's responsibilities with respect to other information. However, the proposed reporting responsibility when the auditor identified a material inconsistency that was not appropriately revised is similar to existing AU sec. 550 regarding a material inconsistency.[82/] Under AU sec. 550, if the other information is not revised to eliminate a material inconsistency, then the auditor is required to consider actions such as revising the report to include an explanatory paragraph describing the material inconsistency.

AU sec. 550 does not include a reporting responsibility regarding explanatory language for a material misstatement of fact in the other information. However, as noted above, the auditor's evaluation of the other information that is not directly related to the financial statements also might be important to investors in their investment decision making. Therefore, the proposed other information standard proposes the same reporting responsibilities for both a material inconsistency and a material misstatement of fact.

Some commenters supported including in the auditor's report a description of the auditor's responsibilities for other information. They generally indicated that such a description in the auditor's report would help users understand the auditor's responsibilities with respect to other information and address the misperception that the other information is audited. Additionally, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's

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81/ In a situation in which the auditor identified a material inconsistency, a material misstatement of fact, or both that management subsequently revised, the auditor also has other responsibilities under other PCAOB standards, such as paragraphs 20-22 of Auditing Standard No. 14.

82/ See AU sec. 550.04. See also existing AU sec. 508.11.h.

conclusions on the work performed in addition to the description of the auditor's responsibilities regarding other information.

The report of the Cohen Commission states that "[t]he lack of explicit acknowledgement of the auditor's responsibility for other information in the annual report has the potential to create user confusion . . .."[83/] Similar to the Board's proposal, the Cohen Commission recommended auditor reporting that includes a description of the auditor's work performed over the other information and the auditor's conclusions.[84/]

The Board notes that some of the other information not directly related to the audited financial statements might be non-financial in nature or related to the company's operations and, as a result, the auditor might not have obtained evidence or reached any conclusion regarding such information during the audit. The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.

Requiring the auditor to state that he or she has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised would result in additional costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including the cost of conducting procedures to resolve and to report on such matters. Also, costs likely would arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing AU sec. 550 because the requirements of the two standards are similar in this respect. Currently, the Board is not aware of any specific instance of an auditor's report being issued under the existing auditing standards[85/] and filed with the SEC that contains

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83/ AICPA, *The Commission on the Auditors' Responsibilities: Report, Conclusions and Recommendations* (1978) at 69 available at http://www.sechistorical.org/collection/papers/1970/1978_0101_CohenAuditors.pdf.

84/ Id.

85/ See AU sec. 550.04. See also existing AU sec. 508.11.h.

explanatory language regarding a material inconsistency.[86/] This suggests that instances of material inconsistency generally are resolved between the auditor and the company. Therefore, the related reporting costs might be low.

Questions Related to Section VI:

18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?

19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.

20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?

21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?

22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?

## VII. Responsibilities of a Predecessor Auditor

Under existing auditing standards, before reissuing an auditor's report on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent

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[86/] In the audit reports of approximately 7,000 issuers with fiscal year 2011 filings, PCAOB staff did not identify any audit report containing explanatory language regarding a material inconsistency in the other information. PCAOB staff performed additional searches of SEC filings for other fiscal years and did not identify any audit report containing explanatory language regarding a material inconsistency in the other information.

period, a predecessor auditor should consider whether the auditor's report is still appropriate.[87/] Prior to reissuing the auditor's report the predecessor auditor is required to (1) read the current period financial statements; (2) compare the current period financial statements to the prior period financial statements being presented; and (3) obtain representation letters from management and the successor auditor.[88/]

In connection with the reissuance of a predecessor auditor's report, the proposed other information standard notes that the requirements of the standard related to a material inconsistency would apply to a predecessor auditor in situations in which the predecessor auditor's report is included in an Exchange Act annual report containing other information filed with the SEC.[89/] The proposed other information standard would apply to a predecessor auditor only with respect to a material inconsistency between the other information and the financial statements for the period audited by the predecessor auditor. The requirements in the proposed other information standard with respect to a predecessor auditor are similar to those of AU sec. 550.[90/]

As described in existing AU sec. 508.73, a predecessor auditor's knowledge of the current activities of the company would be limited in the absence of a continuing relationship. Additionally, the procedures required of the predecessor auditor prior to reissuing the auditor's report[91/] do not provide the predecessor auditor with additional audit evidence or new conclusions related to the previous audit. Therefore, the predecessor auditor would not be able to evaluate other information not directly related to the prior period financial statements that is contained in the current period Exchange Act annual report filed with the SEC. For this reason, the proposed other information standard, consistent with existing AU sec. 550,[92/] does not include a responsibility for the predecessor auditor with respect to a material misstatement of fact.

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87/ See AU sec. 508.71.

88/ Id.

89/ See footnote 6 of the proposed other information standard.

90/ See footnote 2 of AU sec. 550.

91/ See existing AU sec. 508.71.

92/ See footnote 2 of AU sec. 550.

The proposed other information standard would require the predecessor auditor to perform the procedures with respect to a material inconsistency based on relevant audit evidence obtained and conclusions reached during the predecessor auditor's previous audit. Therefore, the predecessor auditor's procedures would include reading and evaluating the other information in the current period annual report filed with the SEC for any material inconsistencies with the audited financial statements for the prior period. The predecessor auditor's procedures are not intended as an evaluation, with the benefit of hindsight, of the accuracy of the estimates and assumptions used in preparing the prior period's financial statements.

If the predecessor auditor concludes that there are no material inconsistencies, the predecessor auditor's report may be reissued. If, after communication with management and the audit committee, the predecessor auditor determines that the other information contains a material inconsistency, the predecessor auditor would be required to determine his or her responsibilities under federal securities laws and PCAOB standards. The predecessor auditor also may withhold the use of the auditor's report for the prior period.

Question Related to Section VII:

23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?

## VIII. Other Considerations

Liability may be imposed on auditors and issuers (as well as other securities market participants) under a number of different legal theories, depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act,[93/] Section 10(b) of the Exchange Act, as well as various state law causes of action. The Board is interested in the effect of such liability considerations and, accordingly, requests comments on the potential legal liabilities associated with the performance and reporting requirements under the proposed other information standard.

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93/ For example, the proposed reporting of the results of the auditor's evaluation of the other information may raise for auditors possible liability considerations under Section 11 of the Securities Act when the document filed under the Exchange Act that contains the proposed enhanced auditor's report is incorporated by reference into a registration statement filed under the Securities Act.

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report. The following discussion is intended to highlight some key Board considerations in developing each element.

The first element of the Board's proposal would require the auditor to describe, in the auditor's report, the auditor's responsibilities for other information in annual reports containing audited financial statements and the related auditor's report filed with the SEC under the Exchange Act. Many commenters suggested that including a description in the auditor's report would provide useful information to investors.

The second element of the Board's proposal involves specific procedures, based on relevant audit evidence and the auditor's conclusions, for (1) assessing the consistency of the other information with the amounts, information, and presentation of the financial statements and (2) identifying material misstatements of fact. Under the proposed other information standard, the auditor would evaluate the other information for consistency with the financial statements and for potential misstatements of fact because the auditor is knowledgeable about the company's financial statements and the audit evidence obtained during the audit.

In developing this aspect of its proposed approach, the Board took note of relevant comments on the concept release. Some commenters noted that auditors have responsibilities under existing PCAOB standards to read and consider information outside of the financial statements and that auditors have developed procedures and routinely review other information for consistency with the financial statements. Other commenters suggested that performing procedures over information prepared by the company is a traditional role for the auditor that maintains the appropriate line of accountability between the auditor and the company. The Board's proposal (1) incrementally strengthens the auditor's traditional role with respect to other information and (2) provides a specific basis for describing the auditor's responsibilities in the auditor's report.

Third, the Board is proposing specific responses and reporting based on the results of the auditor's evaluation. For example, when the auditor has not identified a material inconsistency or material misstatement of fact as a result of the evaluation of the other information, the auditor's report would describe the auditor's responsibilities and note that no material inconsistencies or material misstatements of fact were identified. However, when the auditor has identified a material inconsistency, a material misstatement of fact, or both that has not been appropriately revised by management, the auditor would be required to describe the material inconsistency, material misstatement of fact, or both in the auditor's report, if the auditor determined it was appropriate to issue the auditor's report. The proposed other information standard also would refer the auditor to existing PCAOB standards, such as AU secs. 316 and 317, and to federal securities law requirements that are already familiar to auditors. The proposed other information standard also includes other responses for the auditor.

While the Board did not specifically seek comment in the concept release related to reporting on other information in the auditor's report, the Board received some related comments during its outreach and considered them in developing the proposed other information standard. In connection with adding the description of the auditor's responsibilities in the auditor's report, some commenters suggested that the Board also consider requiring the auditor to include in the auditor's report the auditor's conclusions on the work performed, in addition to the description of the auditor's responsibilities regarding other information. A commenter on the auditor assurance alternative presented in the concept release noted that auditors today would not permit their audit opinion to be included in a filing if the other information was inappropriate or incomplete.

The Board received other comments suggesting that reporting relating to the auditor's involvement with other information should be in a separate section of the auditor's report and include an introduction that described the different nature of the auditor's work and that the auditor was not auditing the other information. Accordingly, the Board is proposing that the auditor's statements regarding other information be in a separate section of the auditor's report, and also is proposing language to make it clear that the auditor is not expressing an opinion on the other information.

The Board recognizes, however, that, under its proposal, the auditor would be making new statements in the auditor's report about the auditor's responsibilities for evaluating other information and the results of the evaluation of the other information, which could raise potential liability considerations.

Questions Related to Section VIII:

24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the

other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?

25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?

## IX. Proposed Amendments to PCAOB Standards

The Board is proposing amendments to several of its existing auditing standards to conform to the proposed other information standard. Appendix 4 provides the proposed amendments related to the proposed other information standard. Significant amendments are described below.

### A. Amendments to Existing AU sec. 508

In situations in which the company has determined that it is not required to obtain, nor did the company request the auditor to perform, an audit of internal control over financial reporting, AU sec. 9550 states that the auditor may consider adding statements to the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's assertion.[94/] Because AU sec. 9550 would be superseded by the proposed other information standard, existing AU sec. 508 would be amended to allow the auditor to continue including such statements in the auditor's report.[95/] Existing AU sec. 508 also would be expanded to include an example of the "Basis of Opinion" section in the auditor's report that contains such statements.

In order to make this information consistently available to investors, the Board is interested in commenters' views about requiring, rather than allowing, statements in the auditor's report that the auditor was not engaged to examine management's assertion

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[94/] See AU sec. 9550.10.

[95/] See proposed paragraphs .74A-B of AU sec. 508 in Appendix 4.

on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report.[96/]

**B. Amendments to AU sec. 558**

AU sec. 558 includes a reference to AU sec. 550, which permits the auditor to express an opinion on certain other information if that information has been subjected to auditing procedures. If the auditor decides to report on such information, AU sec. 558 references the reporting requirements of AU sec. 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*.

Since the proposed other information standard would supersede AU sec. 550 and the Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements*,[97/] would supersede AU sec. 551, the Board is proposing to add the relevant substantive requirements, which otherwise would be superseded, directly to AU sec. 558. Accordingly, the Board is proposing to amend paragraph .09 of AU sec. 558 to include the elements of paragraph .07 of AU sec. 550 and paragraphs .12 and .14 of AU sec. 551 related to expressing an opinion on other information that has been subjected to auditing procedures. Because AU sec. 550 would be superseded, the proposed amendment to AU sec. 558 would apply only to situations involving required supplementary information.

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96/ In July 2013, the U.S. Government Accountability Office ("GAO") issued a report in which it recommended that the SEC consider requiring public companies, where applicable, to explicitly disclose whether they obtained an auditor attestation of their internal controls. The GAO's report concluded that "explicit disclosure would increase transparency and investor protection by making investors readily aware of whether a company has obtained an auditor attestation on internal controls. The disclosure could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions." See GAO, *Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation* (GAO-13-582) (July 3, 2013) at 37, available at http://www.gao.gov/assets/660/655710.pdf.

97/ See PCAOB Release No. 2011-005 (July 12, 2011).

### C. Amendments to AU sec. 722

AU sec. 722 includes a list of interim review procedures the auditor should perform when conducting a review of interim financial information. AU sec. 722 requires the auditor to "read and consider" the other information that accompanies the interim financial information and directs the auditor to consider AU sec. 550, which would be superseded by the proposed other information standard. AU sec. 722 would be amended to direct the auditor to consider the requirements of the proposed other information standard, if the auditor concludes that there is a material inconsistency, a material misstatement of fact, or both.

Questions Related to Section IX:

26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?

27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?

## X. Considerations Related to Audits of Brokers and Dealers

As Exchange Act Rule 17a-5 ("Rule 17a-5") requires that audits of brokers and dealers be conducted in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014,[98] the proposed other information standard and amendments, if adopted by the Board and approved by the SEC, would be applicable to such audits. At the publication date of the Board's proposal, the final SEC rules have not been published in the Federal Register.

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[98] See SEC, *Broker-Dealer Reports*, Exchange Act Release No. 70073 (July 30, 2013), which includes the final rules available at http://www.sec.gov/rules/final/2013/34-70073.pdf. Citations in this Section are to SEC Rule 17a-5 under the Exchange Act, as revised in Exchange Act Release No. 70073.

Pursuant to Rule 17a-5, brokers and dealers are generally required to file with the SEC and other regulators annual audited financial statements on form X-17A-5.[99/] Form X-17A-5 includes, as part of the broker or dealer's filing, an oath or affirmation signed by an officer of the broker or dealer[100/] that the financial statements and supporting schedules[101/] are true and correct. Auditors of a broker's or a dealer's financial statements would read the oath or affirmation as part of the annual report filed with the SEC under the Exchange Act that contains audited financial statements and the related auditor's report, and evaluate the information in that oath or affirmation in accordance with the procedures in the proposed other information standard, as appropriate.

Rule 17a-5 also requires the broker or dealer to file a compliance report or an exemption report.[102/] The proposed other information standard would not apply to compliance or exemption reports by brokers or dealers as those reports and the related auditor reporting are addressed by *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*.[103/]

The Board's concept release included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of brokers and dealers. Many commenters who responded to this question in the concept release supported requiring the same reporting for all companies.

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99/ See SEC Rule 17a-5 of the Exchange Act, 17 C.F.R. § 240.17a-5.

100/ See SEC Rule 17a-5(e)(2) of the Exchange Act, 17 C.F.R. § 240.17a-5e2.

101/ The proposed other information standard would not apply to supporting schedules required by Rule 17a-5. These schedules are addressed by Proposed Auditing Standard, *Auditing Supplemental Information Accompanying Audited Financial Statements.* See PCAOB Release No. 2011-005 (July 12, 2011).

102/ See SEC Rule 17a-5(d)(1)(i)(A) and (B), 17 C.F.R. § 240.17a-5d1iA and B.

103/ See *Proposed Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission,* PCAOB Release No. 2011-004 (July 12, 2011).

The Board received additional comments that were specific to audits of brokers and dealers from a small number of commenters. Some of those commenters suggested that the Board take into account the special characteristics of brokers and dealers in considering whether the changes to the auditor's report should apply to audits of brokers and dealers. One commenter on the concept release noted that amendments to Rule 17a-5 proposed by the SEC would provide users of brokers' and dealers' financial statements with sufficient information that would make additional auditor reporting unnecessary.

Question Related to Section X:

28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?

## XI. Considerations Related to Effective Date

The proposed other information standard and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. The Board's final decision on the effective date would take into account the extent and nature of comments received on the proposals as well as the timing of Board adoption of any final standard and amendments. Additionally, some commenters suggested that, depending on the extent of changes to the auditor's report, the Board consider a delayed compliance date depending on the size of the company. The Board is seeking comment on whether any special consideration should be given to a delayed compliance date for the proposed other information standard, such as for the audits of smaller companies.

Questions Related to Section XI:

29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?

30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?

## XII. Considerations Related to Securities Act Documents

The Board's proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information contained in an annual report that includes audited financial statements and related auditor's report filed under the Exchange Act; (2) specifying procedures for the auditor to perform with respect to evaluating this other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report of the results of the auditor's evaluation. The proposed other information standard would supersede AU sec. 550 and AU sec. 9550. The proposed other information standard would not apply to documents containing audited financial statements and the related auditor's report that are filed with the SEC under the Securities Act, which is consistent with the approach in AU sec. 550.

Currently, AU sec. 550 refers the auditor to AU sec. 711 with respect to the auditor's responsibilities for filings under the Securities Act.[104/] AU sec. 711 refers the auditor to the provisions of Section 11 of the Securities Act.[105/] Section 11 imposes liability, subject to a due diligence defense, for material misstatements and omissions in a registration statement on "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement . . . which purports to have been prepared or certified by him."[106/] Separately, Section 7 of the Securities Act[107/] requires issuers to file the consent of any accountant who is named as having prepared or

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[104/] See AU sec. 550.03. This paragraph also refers the auditor to AU sec. 634, *Letters for Underwriters and Certain Other Requesting Parties,* which provides guidance to auditors for performing and reporting on the results of engagements to issue letters (commonly referred to as "comfort letters") regarding the other information contained in registration statements filed with the SEC.

[105/] See AU sec. 711.02. See also AU sec. 711.03 regarding the auditor's responsibilities as an expert and the burden of proof that the auditor must meet under Section 11(b) of the Securities Act when the auditor's report is included in a registration statement.

[106/] 15 U.S.C. § 77k(a)(4).

[107/] 15 U.S.C. § 77g.

certified any part of the registration statement or any valuation or report included in the registration statement.

Audit procedures contained in AU sec. 711 require the auditor to read relevant portions of the prospectus to make sure that (1) the auditor's name is not being used in a way that indicates greater responsibility than intended, and (2) the prospectus does not imply that the financial statements have been prepared by the auditor.[108/] Additionally, auditors perform certain procedures described under AU sec. 711 to identify any subsequent events that may impact the auditor's report included in the company's registration statement from the date of the auditor's report up to or shortly before the effective date of the registration statement as part of conducting a "reasonable investigation" pursuant to Section 11 of the Securities Act.[109/] When a company's annual report on Form 10-K is incorporated by reference into a shelf registration statement on Form S-3, AU sec. 711 requires that the auditor perform procedures with respect to subsequent events to a date as close to the date of the filing of the Form 10-K as is reasonable and practicable in the circumstances.[110/]

As previously described in this release, the proposed auditor reporting standard and the proposed other information standard are intended to increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report. Specifically, the proposed other information standard would respond to investor's interests in obtaining information regarding the auditor's responsibilities for other information that is contained in documents that include the audited financial statements and the related auditor's report. The Board began considering the existing auditing standard on other information in documents containing audited financial statements, specifically AU sec. 550, as part of its effort to develop a

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[108/] See AU sec. 711.08.

[109/] See AU secs. 711.10-.11. See also AU secs. 711.12-.13 regarding the auditor's responsibilities if the auditor discovers or becomes aware of facts upon performing procedures subsequent to the date of the auditor's report.

[110/] See AU secs. 711.10-.11 and paragraph .07 of AU sec. 9711, *Filings Under Federal Securities Statutes: Auditing Interpretations of Section 711*. See also AU sec. 9711.05 regarding the auditor's responsibility to perform the procedures in AU secs. 711.10 and .11 when (1) a post-effective amendment to the shelf registration statement is filed as allowed under SEC Rule 430B of Regulation C, 17 C.F.R. § 230.430B or (2) an Exchange Act filing that includes or amends audited financial statements is incorporated by reference into the shelf registration statement.

description in the auditor's report regarding the auditor's responsibilities for other information in certain documents filed with the SEC. Through that consideration, the Board determined that changes were appropriate to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of other information outside the financial statements.

The Board considered proposing to extend the applicability of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act. However, the Board has identified obstacles to applying the reporting requirements under the proposed other information standard to documents filed under the Securities Act. For example, a company will file a registration statement on Form S-1 with the SEC containing information required under the Securities Act and SEC rules and regulations as well as the company's audited financial statements and the related auditor's report. The SEC may require the company to file several amendments to the Form S-1 to update the information disclosed in the registration statement before it is declared effective by the SEC. Under current Securities Act rules, the auditor's report is not required to be updated for amendments to the registration statement, unless certain circumstances occur.[111/] Rather, the auditor consents to the continued use of the auditor's report in the registration statement.[112/] The filing of the auditor's consent with the company's registration statement does not change the date or content of the auditor's report filed with the original registration statement. Because an auditor is not required to update the auditor's report prior to the effective date of the company's registration statement, the auditor's report contained in the registration statement would reflect only the evaluation performed under the proposed other information standard of the other information as of the date of the auditor's report and not reflect the auditor's procedures under AU sec. 711 between the date of the auditor's report and the effective date of the registration statement.

The Board recognizes that a similar obstacle with the proposed other information standard would apply in the case when a company files a registration statement and incorporates by reference information from the company's annual report previously filed with the SEC. For example, under the proposed other information standard, an auditor

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111/ Under PCAOB standards, the auditor would be required to update the auditor's report under certain circumstances.

112/ See SEC Rules 436 and 439 of Regulation C, 17 C.F.R. §§ 230.436 and 230.439.

would evaluate the other information contained in a company's annual report filed on Form 10-K and include a separate section in the auditor's report that stated the auditor's responsibilities for, and the results of, the auditor's evaluation of other information contained in the company's annual report. When the company later files a shelf registration statement on Form S-3 and incorporates by reference the company's previously filed annual report into the registration statement, the auditor would perform procedures on the other information contained in the shelf registration statement, as required under AU sec. 711. Similar to the reporting framework described above, the auditor is not required to update the auditor's report on the financial statement contained in the company's previously filed annual report that is incorporated by reference into the company's registration statement, but rather, the auditor consents to the continued use of the auditor's report.[113/] Therefore, the auditor's report that is part of the company's registration statement would reflect only the results of the auditor's evaluation under the proposed other information standard of the other information contained in the company's previously filed annual report and not reflect the auditor's procedures under AU sec. 711 on the portions of the shelf registration statement other than the previously filed annual report. As such, it is difficult to propose a meaningful auditor reporting requirement for the results of the auditor's evaluation of other information under the existing SEC reporting framework for Securities Act filings.

The Board acknowledges that investors and other financial statement users may believe that the auditor's level of involvement with, and related reporting on, other information in a document filed under the Securities Act, such as a registration statement for an initial public offering, should be no different than the auditor's responsibilities regarding other information contained in an annual report filed under the Exchange Act. The Board continues to assess whether it is possible to propose applying some of the elements of the proposed other information standard regarding the auditor's responsibilities over other information contained in documents filed under the Securities Act. For example, the Board considered proposing only the performance aspects of the proposed other information standard to Securities Act filings. However, the enhancements proposed in the other information standard were driven largely to enable auditor reporting on other information in annual reports filed under the Exchange Act. Additionally, the auditor already has responsibilities to perform procedures under AU sec. 711 for Securities Act filings. As such, the Board is requesting comments and information on the application of the proposed other information standard to Securities Act filings, including possible approaches to applying the reporting aspects of the proposed other information standard or the possible need for additional procedures regarding the auditor's responsibility for other information. The Board is particularly

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[113/] Id.

interested in receiving comments on whether or not additional procedures under AU sec. 711 are necessary or appropriate.

Questions Related to Section XII:

31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?

32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?

33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?

# APPENDIX 7

## *Considerations Regarding Audits of Emerging Growth Companies*

### I. Introduction

The Board is proposing two new standards and related amendments[1/] pursuant to its mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. The proposed standards and amendments are intended to (1) increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report and (2) improve the auditor's procedures and enhance the auditor's responsibilities with respect to information outside the financial statements.

The Board's proposed auditor reporting standard would retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. Most significantly, the proposed auditor reporting standard would require the auditor to communicate in the auditor's report "critical audit matters" that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

Other proposed changes in the auditor's report would require a description of certain of the auditor's responsibilities, such as the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The proposed auditor reporting standard

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[1/] The Board's proposals include: (1) Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"); (2) Proposed Auditing Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"); and (3) related proposed amendments to PCAOB standards (the "proposed amendments"). The Board's proposals are also referred to collectively as the "proposed standards and amendments."

also would add to the auditor's report new information regarding the audit and the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements.

As more fully described in the Release and Appendix 5, the Board is proposing an approach that it believes would increase the relevance and informational value of the auditor's report, including by requiring the auditor to provide specific insight into the audit of the company's financial statements.[2/] The proposed approach would be aligned with the Board's mission and is intended to be implemented in a cost-effective way. For example, because critical audit matters are determined based on the relative complexity and difficulty of the audit, the Board anticipates that the proposed auditor reporting standard would be scalable based on the size, nature, and complexity of the audit of the company. The Board also anticipates, however, that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees.[3/]

The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to "other information," that is, information other than the audited financial statements and the auditor's report, in a company's annual report filed with the U.S. Securities and Exchange Commission ("SEC" or "Commission") under the Securities Exchange Act of 1934 ("Exchange Act"). The proposed enhancements to the required auditor's procedures are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. As a result of the linkage between the proposed auditor reporting standard and the proposed other information standard, investors and other financial statement users would obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description

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[2/] The Board's approach to increase the relevance and informational value of the auditor's report is discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*; V., *Critical Audit Matters*; and VI., *Explanatory Language*.

[3/] The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements*, and V.F., *Other Considerations for Critical Audit Matters*.

of the results of the auditor's evaluation based on the auditor's procedures on the other information.

As described in the Release and Appendix 6, the required procedures under the proposed other information standard are intended to provide consistency and improve the auditor's evaluation of other information, which could be of importance to investment decision making.[4/] The Board believes that the proposed approach to the auditor's responsibilities for other information would be scalable to less complex companies, based on the nature and extent of the information outside the financial statements for such companies as compared to companies with more extensive operations. The Board, however, also anticipates that the proposed other information standard would have cost implications for auditors and companies, including audit committees.[5/]

In developing the proposed standards and amendments, the Board considered (1) the information communicated in the current auditor's report; (2) the potential benefits that may result from auditors providing additional communications; (3) the potential costs related to the approach proposed by the Board; (4) alternative approaches; (5) current developments in similar projects by other standard setters;[6/] (6) relevant academic research; and (7) significant comments received by the Board from its outreach efforts. In considering the nature and extent of changes to the existing

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[4/] The Board's approach to improve the auditor's evaluation of other information is discussed more fully in Appendix 6, specifically Sections III., *Evaluating the Other Information*; and V., *Responding When the Auditor Determines That There is a Potential Misstatement in the Audited Financial Statements*.

[5/] The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate the Other Information*; VI., *Reporting in the Auditor's Report*; and VIII., *Other Considerations*.

[6/] The International Auditing and Assurance Standards Board ("IAASB") has similar projects related to changes to the auditor's report and the auditor's responsibilities regarding other information. In addition, there are a legislative proposal by the European Commission ("EC") and a subsequent European Parliamentary report that relate to audits of public interest entities. Most recently, the United Kingdom's Financial Reporting Council ("FRC") adopted revisions to its auditor reporting standard. The IAASB's projects, the EC's proposal and subsequent report, and the FRC's revised standard would require auditor reporting on certain additional matters.

auditor's report and the auditor's responsibilities for other information, the Board sought to respond to the needs of investors and other financial statement users by making the auditor's report more informative while not adding unnecessary burden to the financial reporting process.

## II. Statutory Background

The Board is considering the proposed standards and amendments pursuant to its authority under the Sarbanes-Oxley Act of 2002 ("Act").[7/] If ultimately approved by the Board, the proposed standards and amendments will be filed for approval by the Commission. Pursuant to Section 107(b)(3) of the Act, the Commission shall approve a proposed standard if it finds that the standard is "consistent with the requirements of [the] Act and the securities laws, or is necessary or appropriate in the public interest or for the protection of investors."

The Act was amended by Section 104 of the Jumpstart Our Business Startups Act ("JOBS Act")[8/] to provide that any additional rules adopted by the Board subsequent to April 5, 2012 do not apply to the audits of "emerging growth companies" ("EGCs")[9/] unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of

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7/ Pub. L. No. 107-204. Pursuant to Section 101 of the Act, the mission of the Board is to oversee the audits of companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Section 103 of the Act authorizes the Board to adopt auditing standards for use in public company audits "as required by this Act or the rules of the [Securities and Exchange] Commission, or as may be necessary or appropriate in the public interest or for the protection of investors." In addition, Section 982 of the Dodd-Frank Wall Street Reform and Consumer Protection Act expanded the authority of the PCAOB to oversee the audits of registered brokers and dealers, as defined in the Exchange Act. See Pub. L. No. 111-203. The term "registered broker or dealer" is defined in Section 3(a)(48) of the Exchange Act.

8/ Pub. L. No. 112-106 (April 5, 2012).

9/ Section 3(a)(80) of the Exchange Act defines the term "emerging growth company."

investors and whether the action will promote efficiency, competition, and capital formation."[10/]

In addition, the JOBS Act specified that "[a]ny rules of the Board requiring…a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company…".[11/] The proposed standards and amendments, if adopted, will be subject to a separate determination by the SEC regarding their applicability to audits of EGCs. Before adoption, the proposed standards and amendments will be subject to an evaluation as to whether the Board should recommend to the SEC that the proposed standards and amendments be applicable to the audits of EGCs and the SEC will make a separate determination regarding the applicability of the proposed standards and amendments to the audits of EGCs. At this time no determination has been made about the applicability of the proposed standards and amendments to the audits of EGCs.

This Appendix contains a discussion of considerations relating to EGCs and includes data on EGCs. This Appendix also includes specific questions and requests relevant information, including potential costs, and empirical data, to the extent available to commenters, regarding the potential application of the proposed standards and amendments to the audits of EGCs. Commenters providing cost estimates are requested to provide the basis for any estimate provided. The Board is requesting commenters' views on the applicability of the proposed standards and amendments to the audits of EGCs and responses to specific questions in order to provide information to enable the Board to assist the SEC in making its determination regarding the applicability of the proposed standards and amendments to the audits of EGCs.

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[10/] See Section 103(a)(3)(C) of the Act, as added by Section 104 of the JOBS Act.

[11/] Id. An auditor's discussion and analysis ("AD&A") currently does not exist in auditing standards but was described as one of several conceptual alternatives for changing the auditor's reporting model in the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the "concept release"), PCAOB Release No. 2011-003 (June 21, 2011). Section IV.A., *Auditor's Discussion and Analysis,* of this Release describes an AD&A and related comments received on the concept release.

The Board's Release, as well as Appendices 5 and 6, provide related information regarding the proposed standards and amendments, including discussions of the following areas (1) the background of and reasons for the proposed standards and amendments; (2) the Board's approach, including consideration of alternatives; (3) key changes and improvements from existing requirements; and (4) potential costs related to the proposed standards and amendments. Economic considerations related to the proposed standards and amendments are noted in the Release and this Appendix, with Appendices 5 and 6 providing further discussion regarding the economic considerations related to each proposed standard.

## III. Characteristics of Self-Identified EGCs

The PCAOB has begun to monitor implementation of the JOBS Act in order to better understand the characteristics of EGCs[12/] and inform the Board's considerations regarding whether it should request that the SEC apply the proposed standards and amendments to audits of EGCs. To assist commenters, the Board is providing the following information regarding EGCs that it has compiled from public sources.[13/]

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[12/] In general terms, an issuer qualifies as an EGC if it has total annual gross revenue of less than $1 billion during its most recently completed fiscal year (and its first sale of common equity securities pursuant to an effective registration statement under the Securities Act of 1933 ("Securities Act") did not occur on or before December 8, 2011). See JOBS Act Section 101(a), (b), and (d). Once an issuer is an EGC, the issuer retains its EGC status until the earliest of: (1) the first year after it has total annual gross revenue of $1 billion or more (as indexed for inflation every five years by the SEC); (2) the end of the fiscal year after the fifth anniversary of its first sale of common equity securities under an effective Securities Act registration statement; (3) the date on which the company issues more than $1 billion in non-convertible debt during the prior three-year period; or (4) the date on which it is deemed to be a "large accelerated filer" under the Exchange Act (generally, a company that has been public for at least one year and has an equity float of at least $700 million). See Section 3(a)(80) of the Exchange Act.

[13/] To obtain data regarding EGCs, the PCAOB's Office of Research and Analysis reviewed registration statements and Exchange Act reports filed with the SEC with filing dates between April 5, 2012, and May 15, 2013, for disclosures by companies related to their EGC status. Companies with filings indicating that they are no longer EGCs are not included in this analysis. Any filings subsequent to May 15, 2013 are not included in this analysis. The PCAOB has not validated these companies' self-identification as EGCs. The information presented also does not include data for

As of May 15, 2013, based on the PCAOB's research, 909 SEC registrants have identified themselves as EGCs in SEC filings.

These companies operate in diverse industries. The five most common Standard Industrial Classification ("SIC") codes applicable to these companies are: blank check companies; pharmaceutical preparations; real estate investment trusts; prepackaged software services; and computer processing/data preparation services.

The five SIC codes with the highest total assets as a percentage of the total assets of the population of EGCs are: federally chartered savings institutions; real estate investment trusts; national commercial banks; state commercial banks; and natural gas transmission. Total assets of EGCs in these five SIC codes represent approximately 42% of the total assets of the population of EGCs. EGCs in three of these five SIC codes represent financial institutions (that is, federally chartered savings institutions, national commercial banks, and state commercial banks) and the total assets for these three SIC codes represent approximately 28% of the total assets of the population of EGCs.

A majority of the companies that have identified themselves as EGCs have begun reporting information under the securities laws since 2012. Of these companies, approximately:

- 25% identified themselves in registration statements and were not reporting under the Exchange Act as of May 15, 2013.

- 55% of the companies that have identified themselves as EGCs began reporting under the Exchange Act in 2012 or later.

- 20% of the companies have been reporting under the Exchange Act since 2011 or earlier.

Approximately 20% of these companies have securities listed on a U.S. national securities exchange as of May 15, 2013.

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companies that have filed confidential registration statements and have not subsequently made a public filing.

Approximately 65% of the companies that have identified themselves as EGCs and filed an Exchange Act filing indicated that they were smaller reporting companies.[14/]

Audited financial statements were available for nearly all of the companies that have identified themselves as EGCs.[15/] For those companies for which audited financial statements were available and based on information included in the most recent audited financial statements filed as of May 15, 2013:

- The reported assets ranged from zero to approximately $18.2 billion. The average and median reported assets were approximately $183.7 million and approximately $0.3 million, respectively.[16/]
- The reported revenues ranged from zero to approximately $959.1 million. The average and median reported revenues were approximately $56.3 million and zero, respectively.

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[14/] The SEC adopted its smaller reporting company rules in *Smaller Reporting Company Regulatory Relief and Simplification*, Securities Act Release No. 8876 (Dec. 19, 2007). Generally, companies qualify to be smaller reporting companies and, therefore, have scaled disclosure requirements if they have less than $75 million in public equity float. Companies without a calculable public equity float will qualify if their revenues were below $50 million in the previous year.

[15/] Audited financial statements were available for 897 of the 909 self-identified EGCs. Audited financial statements were not available for some EGCs that have filed registration statements that have not been declared effective.

[16/] For purposes of comparison, the PCAOB compared the data compiled with respect to the population of companies that identified themselves as EGCs with companies listed in the Russell 3000 Index in order to compare the EGC population with the broader issuer population. The Russell 3000 was chosen for comparative purposes because it is intended to measure the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market (as marketed on the Russell website). The average and median reported assets of issuers in the Russell 3000 were approximately $12.1 billion and approximately $1.5 billion, respectively. The average and median reported revenues from the most recent audited financial statements filed as of May 15, 2013 of issuers in the Russell 3000 were approximately $4.6 billion and $717.2 million, respectively.

- The average and median reported assets among companies that reported revenues greater than zero were approximately $365.8 million and $59.9 million, respectively. The average and median reported revenues among companies that reported revenue greater than zero were approximately $113.5 million and $17.2 million, respectively.
- Approximately 48% identified themselves as "development stage entities" in their financial statements.[17/]
- Approximately 35% were audited by firms that are annually inspected by the PCAOB (that is, firms that have issued audit reports for more than 100 public company audit clients in a given year) or are affiliates of annually inspected firms. Approximately 65% were audited by triennially inspected firms (that is, firms that have issued audit reports for 100 or fewer public company audit clients in a given year) that are not affiliates of annually inspected firms.
- Approximately 55% had an explanatory paragraph included in the auditor's report on their most recent audited financial statements describing that there is substantial doubt about the company's ability to continue as a going concern.[18/]

Approximately 40% of the self-identified EGCs that provided a management report on internal control over financial reporting stated in the report that the company's internal control over financial reporting was not effective.[19/]

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17/ According to Financial Accounting Standards Board ("FASB") standards, development stage entities are entities devoting substantially all of their efforts to establishing a new business and for which either of the following conditions exists: (a) planned principal operations have not commenced or (b) planned principal operations have commenced, but there has been no significant revenue from operations. See FASB Accounting Standards Codification, Subtopic 915-10, Development Stage Entities – Overall.

18/ Approximately 1% of the population of companies in the Russell 3000 Index have an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern.

19/ Approximately 4% of the population of companies in the Russell 3000 Index provided a management report on internal control over financial reporting stating that the company's internal controls over financial reporting were not effective.

The JOBS Act includes a provision that allows Securities Act registration statements of EGCs to include two years of audited financial statements instead of three years for the initial public offering of common equity securities. Approximately 750 of the self-identified EGCs would not be required to present more than two years of financial statements regardless of the JOBS Act relief.[20/] Approximately 75% of the remaining portion of the EGC population have opted out of the provision by providing in their registration statements audited financial statements for three years instead of two. Some of the EGCs that opted out of this provision described in their filings risks related to taking advantage of some of the JOBS Act provisions. Risks described included the company's common stock becoming less attractive to investors and their financial statement disclosures not being comparable to those of similar companies.

## IV. Economic Considerations

The economic considerations summarized below are addressed in the Release, Appendix 5, and Appendix 6, and could apply to both small and large companies. A number of these considerations are relevant to efficiency, competition, and capital formation.

### A. Proposed Auditor Reporting Standard

The proposed auditor reporting standard would require the auditor to communicate in the auditor's report critical audit matters. Critical audit matters ordinarily are matters of such importance in the audit that they would be included in the matters required to be (1) documented in the engagement completion document under Auditing Standard No. 3, *Audit Documentation*; (2) reviewed by the engagement quality reviewer under Auditing Standard No. 7, *Engagement Quality Review*; (3) communicated to the audit committee under Auditing Standard No. 16, *Communications with Audit Committees* or other PCAOB standards; or (4) any combination of the three. Thus, the proposed auditor reporting standard is intended to leverage the work the auditor already performed when conducting an audit under the Board's existing standards and does not impose new audit performance requirements, other than the determination, communication, and documentation of critical audit matters.

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[20/] Some EGCs (1) are already afforded such relief as smaller reporting companies, (2) have existed for less than three years, (3) follow the reporting requirements of development stage entities which require an income statement since inception, or (4) have not filed a Securities Act registration statement yet, and thus have not availed themselves of this relief.

The Board believes that auditor reporting linked to matters identified during the audit that involved the most difficult judgments or the most difficulty in obtaining evidence or forming the opinion is responsive to the requests of many investors for information that should provide a greater degree of insight into the audit. Communication of critical audit matters is expected to result in information specific to each audit of a company's financial statements, and would highlight important aspects of the audit.

Additionally, the proposed auditor reporting standard would add to the auditor's report new information regarding the audit or the auditor, such as statements about the auditor's responsibility to be independent, the length of the auditor's tenure as the company's auditor, and the auditor's responsibilities for, and the results of, the auditor's evaluation of information outside the financial statements. This new information generally would be standardized language about the audit or the auditor and would be the same or very similar among different auditors' reports.

The proposed auditor reporting standard retains from the existing standard[21/] the use of explanatory paragraphs in the auditor's report, including the auditor's ability to emphasize a matter regarding the financial statements.

The Board also anticipates that some of the enhanced basic elements and communication of critical audit matters in the auditor's report would have cost-related implications for auditors and companies, including audit committees, such as:[22/]

- One-time costs that relate primarily to updating an audit firm's methodology and training regarding auditor reporting for basic elements and critical audit matters. Additionally, the auditor may incur some initial costs to determine the year the auditor began serving consecutively as the company's auditor;

- Recurring costs in each individual audit relative to the determination, communication in the auditor's report, and documentation of critical audit matters; and

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21/ AU sec. 508, *Reports on Audited Financial Statements*.

22/ The potential costs related to the proposed auditor reporting standard are discussed more fully in Appendix 5, specifically Sections IV., *Basic Elements,* and V.F, *Other Considerations for Critical Audit Matters*.

- Recurring costs for the company, including the audit committee, for reviewing the critical audit matters included in the draft auditor's report.

There could be potential unintended consequences associated with requiring auditors to communicate critical audit matters in the auditor's report. For example, the effort required to determine, prepare language for communication, and document critical audit matters likely would occur during the final stages of the audit, which might reduce the time available to the auditor to review and complete the audit work.

Requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. The communication of critical audit matters could help to alleviate the information asymmetry[23/] that exists between company management and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.[24/]

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the quality of the information[25] in the financial statements. Academic research has indicated that

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23/ Economists often describe information asymmetry as an imbalance, where one party has more or better information than another party.

24/ See David Easley and Maureen O'Hara, *Information and the Cost of Capital*, 59 The Journal of Finance 1553, 1553-1583 (2004).

25/ The term "quality of information" is formalized by the concept of precision. Information economics frequently treats information as consisting of two components: a increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[26/]

Auditor's reports that include critical audit matters would be specific to the audit of the company. Therefore, auditors' reports would be different between the company's current period critical audit matters and those of prior periods or those of the company's competitors. Some investors have commented that they are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditors' reports among companies and reporting periods. Critical audit matters, however, would not necessarily include all the information important to an investment decision.

Additionally, as critical audit matters in the auditor's report would not be something that investors and other financial statement users are accustomed to reviewing or analyzing, investors and other financial statement users could misunderstand a critical audit matter or the meaning of a critical audit matter. However, as financial statement disclosures have changed over time, investors and other financial statement users are accustomed to reviewing or analyzing new or different information. Therefore, such users should have the ability to interpret the meaning of critical audit matters communicated in an auditor's report.

Some comments regarding alternatives presented in the concept release indicated that more information about the audit in the auditor's report could lead to more efficient pricing of equity securities, either through changes in expected future earnings or changes in the discount rate used to value future earnings, or both.

As previously noted, the Board anticipates that the communication of critical audit matters would result in auditor's reports that could vary significantly – both among companies and reporting periods. Academics that conducted a study of financial

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signal that conveys information and noise which inhibits the interpretation of the signal. Precision is the inverse of noise so that decreased noise results in increased precision and a more readily interpretable signal. See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[26/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

analysts to assess how they use an auditor's report as part of a company evaluation found that the variability of information content would mean that the information would not be just confirming prior beliefs about financial statement quality but would be more likely to affect user decision making and increase the perceived quality of the audit.[27/]

Communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. Academic research suggests that the prominence with which information is disclosed can have implications for investment decision making.[28/] Communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making. Making the auditor's report more informative can benefit investors and other financial statement users by increasing the prominence of potentially valuable information, thus increasing the value of the auditor's report.

The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the amount or quality of the information in the financial statements. Academic research has indicated that increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[29/]

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[27/] See Paul J. Coram, Theodore J. Mock, Jerry L. Turner, and Glen L. Gray, *The Communicative Value of the Auditor's Report*, 58 Australian Accounting Review 235, 235-252 (2011).

[28/] See David Hirshleifer and Siew Hong Teoh, *Limited Attention, Information Disclosure, and Financial Reporting*, 36 Journal of Accounting and Economics 337, 337-386 (2003).

[29/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

## B. Proposed Other Information Standard

The proposed other information standard includes three key elements: (1) adding a description in the auditor's report of the auditor's responsibilities relating to other information; (2) including specific procedures for the auditor to perform with respect to evaluating the other information; and (3) providing for specific responses to the results of the auditor's evaluation of the other information, including reporting in the auditor's report.

The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. The proposed other information standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information, further protecting the interests of investors. The proposed other information standard includes specific procedures designed to improve the auditor's evaluation of the other information. These procedures are intended to provide consistency in practice among auditors when evaluating the other information or responding to material inconsistencies or material misstatements of fact identified in the other information. These proposed procedures also are intended to provide a specific basis for the auditor's description in the auditor's report of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. The Board, however, also anticipates that the proposed other information standard would have some cost implications for auditors and companies, including audit committees, such as:[30/]

- One-time costs, for example, updating audit firm methodologies to reflect the new performance and reporting requirements and training firm personnel;

- Recurring costs related to increased auditor effort to evaluate the other information, particularly for firms that might not currently be performing evaluation procedures on the other information similar to those in the proposed other information standard;

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[30/] The potential costs related to the proposed other information standard are discussed more fully in Appendix 6, specifically Sections III.C.3., *Performing Procedures to Evaluate*; VI., *Reporting in the Auditor's Report;* and VIII., *Other Considerations*.

- Costs for the auditor related to situations in which a material inconsistency or a material misstatement of fact is identified, including costs related to performing procedures to respond to, and report on, such material inconsistency, material misstatement of fact, or both;[31/] and

- Costs that might also arise for the company and its audit committee as a result of additional discussions with the auditor and others in connection with the description in the auditor's report.

The enhanced reporting requirements regarding other information are designed to provide investors and other users of financial information with an understanding of the auditor's responsibilities related to the other information as well as the results of the auditor's evaluation of the other information.

The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between the other information and the company's financial statements and on the identification of material misstatements of fact. When evaluating the other information, the auditor would be in a position to identify potential inconsistencies between the other information and the company's financial statements that could be difficult for investors and other financial statement users to identify when analyzing the company's financial performance. Such inconsistencies could occur for a number of reasons, including unintentional error, managerial biases,[32/] or intentional misreporting.[33/] As a result of the auditor's evaluation of other information and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the

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[31/] Costs related to reporting under the proposed other information standard regarding a material inconsistency should be similar to those incurred under the existing standard because the requirements of the two standards are similar in this respect.

[32/] See, e.g., Catherine M. Schrand and Sarah L.C. Zechman, *Executive Overconfidence and the Slippery Slope to Financial Misreporting*, 53 Journal of Accounting and Economics 311, 311-329 (2012) and Paul Hribar and Holly Yang, *CEO Overconfidence and Management Forecasting,* Unpublished working paper (2013) available at http://ssrn.com/abstract=929731.

[33/] See Joseph F. Brazel, Keith L. Jones, and Mark F. Zimbelman, *Using Nonfinancial Measures to Assess Fraud Risk*, 47 Journal of Accounting Research 1135, 1135-1166 (2009).

proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information[34/] available to investors and other financial statement users. In general, increasing the amount or quality of information available to investors could also facilitate more efficient capital allocation decisions.[35/] Academic research has shown that the increased quality of information could also result in a reduction in the average cost of capital.[36/]

## V. Request for Comment on the Applicability of the Proposed Standards and Amendments to Emerging Growth Companies

The Board is in the process of considering how the proposed standards and amendments might affect audits of EGCs.

Based on the data outlined in Section III, *Characteristics of Self-Identified EGCs*, above, EGCs generally appear to be smaller and newer public companies. Although it may be often assumed that such companies would have operations, and respectively audits, that are less complex, this may not be true for many EGCs.

As noted in Section III above, financial institutions represent approximately 28% of the total assets of EGCs. Given the nature of the operations of financial institutions, the audits of these EGCs might involve subjective or complex areas, such as the auditor's evaluation of the determination of the allowance for loan losses or the valuation of financial instruments with little market activity. Therefore, in the audits of these EGCs, the auditor might be addressing matters that meet the definition of critical audit matters because they involved difficult, subjective, or complex auditor judgments.

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[34/] See Robert E. Verrecchia, *The Use of Mathematical Models in Financial Accounting*, 20 Journal of Accounting Research 1, 1-42 (1982).

[35/] See Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2011).

[36/] Empirical research generally finds that increased public disclosure of information is associated with decreased cost of equity capital. For a review of the literature, see Christine A. Botosan, Marlene A. Plumlee, and Yuan Xie, *The Role of Information Precision in Determining the Cost of Equity Capital,* 9 Review of Accounting Studies 233, 233-259 (2004).

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Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 3:24:50 PM

**EGC's are a Safe Harbor for fraud....an inept and possibly fraud induced attempt for certain sectors of the country....(aka: Left Coast comes to mind....) Respectfully yours, Pw Carey......**

The data presented in Section III above also suggests that EGCs are 10 times more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective. As a result, in the audits of EGCs, the auditor might be presented with control deficiencies of high severity which likely would be a consideration in the auditor's determination of critical audit matters because the control deficiencies might, for example, pose difficulty to the auditor in obtaining sufficient appropriate audit evidence.

Further, the data presented in Section III above indicates that for 55% of the EGCs the auditor's report on the most recent audited financial statements includes an explanatory paragraph describing that there is substantial doubt about the company's ability to continue as a going concern, as compared to 1% for the population of companies in the Russell 3000 Index. This suggests that for the majority of EGCs the auditor is evaluating whether there is substantial doubt about the company's ability to continue as a going concern. Depending on the facts and circumstances, the auditor's evaluation might meet the definition of critical audit matters.

As described in Section III above, a review of SEC filings of EGCs indicates that three quarters of the EGCs that could have taken advantage of a JOBS Act provision to present two years of financial statements in their registration statements have chosen not to avail themselves of this provision and instead presented three years, which is generally required of non-EGC companies. Discussion included in EGC filings suggests that taking advantage of JOBS Act provisions that allow more limited disclosures in a company's filings is viewed by at least some EGCs as presenting risks that they are unwilling to take.

The application of the proposed auditor reporting standard, specifically the requirement to communicate critical audit matters, may be beneficial to EGCs because critical audit matters would provide more information about the company's audit to investors and other financial statement users. In general, there is less information available in the market about smaller and newer companies than there is about larger, more established companies. For example, smaller companies have very little, if any, analyst coverage which lessens the entire mix of information made available to investment bankers, fund managers, and individual investors which makes markets less efficient.[37/] The communication of critical audit matters would provide more information

37/ See SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission*, (April 23, 2006) at 73, available at http://www.sec.gov/info/smallbus/acspc.shtml.

to investors and provide insight about the most difficult, subjective, or complex matters that the auditor addressed in the audit. Providing meaningful information about the audit, such as the communication of critical audit matters in the auditor's report, could thus be particularly beneficial to smaller and newer companies. The availability of such information could contribute toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital.

As noted in Section III above, many EGCs have identified themselves as smaller reporting companies. Smaller reporting companies generally apply the SEC's scaled disclosure rules.[38/] Therefore, these companies have less other information for the auditor to evaluate under the proposed other information standard than larger companies. Thus, EGCs that are smaller reporting companies may incur less cost related to the evaluation of the other information than larger companies.

As the Board's considers whether it should request the SEC to apply the proposed standards and amendments to the audits of EGCs, the Board reviewed relevant comments received in response to the concept release and from the Board's Standing Advisory Group ("SAG"). The concept release, which was issued before the JOBS Act became law, included a question about whether the changes to the auditor's reporting model should apply to all audit reports filed with the SEC, including those filed in connection with the financial statements of public companies, investment companies, investment advisers, brokers and dealers, and others. Commenters diverged on whether certain types of companies should be excluded from the scope of changes to the auditor reporting model.

Some commenters that responded to this question in the concept release suggested that, depending on the nature and extent of changes to the auditor's report, the Board give different consideration to the auditors' reports of smaller companies, which would include many EGCs. Suggested examples of such considerations include a phased-in implementation depending on the size of the company; application of any new requirements only to larger companies followed by consideration of expanding the requirements to smaller companies; and total exemption for companies under certain market capitalization. The reasons for the suggested different considerations include

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[38/] The SEC adopted a new system of disclosure rules for smaller reporting companies. The new rules were effective February 4, 2008. They are scaled to reflect the characteristics and needs of smaller companies and their investors. See SEC, *Smaller Reporting Company Regulatory Relief and Simplification,* Securities Act Release No. 8876 (Dec. 19, 2007).

greater cost constraints typically experienced by smaller companies; differences in corporate structure, complexity, and the types of users of smaller companies' financial information; and statutory exemptions for certain smaller companies from the requirement for an auditor's report on internal control over financial reporting.

In contrast, other commenters that responded to this question in the concept release supported requiring the same reporting for all companies regardless of nature or size. The primary reason of these commenters' views was better consistency and comparability of auditors' reports across companies.

Likewise, some participants at the May 2012 SAG meeting commented that they do not support the development of separate auditing standards for EGC and non-EGC public companies because it would be very difficult for the auditor to apply an "on/off switch" with respect to the auditor's responsibilities.[39/] Those participants described a differential approach to EGCs as challenging and resulting in unnecessary complications for audits of EGCs. These participants did not clarify whether their comments relate to audit performance standards, reporting standards, or both. This concern of having different auditing standards for EGCs may be mitigated to the extent that reporting on critical audit matters is a discrete and separable task.

As noted previously, approximately 65% of EGCs were audited by triennially inspected firms that are not affiliated with annually inspected firms. Approximately 76% of triennially inspected firms audit 10 or fewer issuers[40/] which could indicate that these are small firms with more limited resources. Therefore, developing and maintaining different methodologies for audits of EGCs and non-EGCs, as well as the related staff training, could have a disproportionately negative effect on triennially inspected firms because of higher costs in relation to their income.

Exempting EGCs from the proposed standards and amendments might put them at an informational disadvantage compared to larger and more established companies that would be subject to the proposed standards and amendments. For example, if the

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39/ See May 2012 SAG meeting available at http://pcaobus.org/News/Webcasts/Pages/05172012_SAGMeeting.aspx.

40/ See Exhibit 1 of *Report on 2007-2010 Inspections of Domestic Firms That Audit 100 or Fewer Public Companies*, PCAOB Release No. 2013-001 (Feb. 25, 2013) available at http://pcaobus.org/Inspections/Documents/02252013_Release_2013_001.pdf.

standards do not apply to audits of EGCs, but are applicable to audits of larger and more established companies, the potential disparity between the two groups of companies in the amount and quality of public information available for investment decision making could increase. To the extent that market participants perceive adoption of the proposed standards and amendments as a step toward lowering information asymmetry between company management and investors, exempting EGCs from the proposed standards and amendments may also put them at a disadvantage. Exempting EGCs from the proposed standards and amendments could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a competitive disadvantage compared to non-EGCs in attracting available capital.

The Board is interested in commenters' views on the impact of the proposed standards and amendments on audits of EGCs. The Board is soliciting comments generally on issues it should consider relating to the applicability of the proposed standards and amendments to EGCs, as well as responses to the specific questions below.

Questions:

1. Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?

2. Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?

3. Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?

4. Would audits of EGCs be more, less, or equally likely to have critical audit matters?

5. Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?

6. What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?

7. What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?

8. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?

9. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?

10. For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?

# Page: 294

Number: 1 Author: Pw_Carey_Senior IT GRC Auditor, (CISA, CISSP), Compliance Partners, LLC Subject: Tuesday, March 25th, 2014
Date: 5/2/2014 3:27:34 PM

**Remove EGC's from the face of the earth would be a good first step.....other than that, please PCAOB folks continue trying to improve a very suspect soup of interconnected industries, interests and pressure groups......you all are fighting a good fight....because you're trying to do the right thing.....Respectfully yours,**

**Pw Carey, Senior IT Auditor, (GRC), CISSP, CISA....**

Pw Carey's snid thoughts SLASH Comments regarding PwC's sillyness...May 2nd, 2014

Re: PCAOB Docket No. 034 Comments

********PwC******************

We believe that certain

We are in the process of conducting field testing to evaluate the benefits and challenges of certain aspects of the proposals, including whether application of the framework to identify and communicate critical audit matters can be executed in a consistent manner; practical issues that may arise; unintended consequences that may occur; and the audit effort and costs required in executing the proposals. We hope to share any relevant information from our field testing as the Board continues to evaluate the feedback on the proposals.

Possible illegal acts: Section 10A of the Securities Exchange Act of 1934 establishes protocols for auditors to communicate potential illegal acts, including fraud, to the appropriate level of management and the audit committee and to escalate the matter when timely and appropriate remedial action is not taken. We believe including such matters in the auditor's report would undermine the proper functioning of these established processes.

Specific concerns related to fraud risk: As part of the auditor's annual risk assessment, the auditor is required to identify factors that may be indicative of a fraud risk and to plan and perform an appropriate audit response. Auditors may identify a fraud risk based upon limited information because they want to perform additional testing to evaluate whether a fraud is occurring. Due to the sensitivity of these risks, they are typically discussed only with senior level executives and/or the audit committee to avoid compromising the audit. Because fraud risks may involve the most difficult, subjective or complex auditor judgments, they would appear to meet the proposed definition of a critical audit matter regardless of whether a fraud actually occurred. We believe communicating such a matter in the auditor's report would have a negative impact on audit quality because it would reveal where the auditor is considering the risks of fraud, which will make the detection of fraud more difficult. Auditor reporting of fraud risks might also be misinterpreted by users to imply that a fraud has occurred and/or that the fraud materially impacts the entity's financial statements, when in fact there would be no basis for such a conclusion.

Obviously, the discovery, identification and reporting of fraud is way beyond the intelligence, deductive reasoning, acumen, experience and expertise of the Auditor for the following irrefutable reasons. To raise the investment communities Auditors expectations is a silly notion, since the Auditor is incapable of identifying fraud when they smell it, as opposed to the Chinese phrase..." A rotting fish begins at the head...". Opposed to this opinion we are faced with an Auditor's integrity and capability

during the enactment of an Audit Charter to recognize and report on a culture of fraud, acts of fraud and managed fraud for the following axioms written in stone by the Audit Industry
:

Fraud is way too challenging for the poor auditor to recognize...
Fraud is way too subjective and/or all together now....way too complex for the poor simple minded Auditor to identify and report (we apologize for the redundancy here....(aka: simple minded and Auditor)...

The PCAOB must put in place fines and penalties and the supporting maintenance mechanism via rules and regulations for the discovery, detection, identification and reporting of fraud...

Involved the most challenging, subjective, or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to the auditor in forming an opinion on the financial statements, and

We anticipate that our field testing will provide some insight to the potential costs and impact on audit quality, but we also recommend that the Board perform a robust cost/benefit analysis on these significant changes to the auditor's report.

******here's a cost benefit analysis....Madoff's/Enron's/WaMu's/Libor's/BoA's/JP Morgan's/Chase/Goldman Sachs/CitiBank's....et al....***** lets just clawback the fees each individual auditor received for the efforts, rather their lack of same....that should more than cover any and all ROIs....no?

***************

In addition, we agree with commenter's that the financial statements of investment companies are less complex than operating companies' financial statements and that the limited nature of an investment company's operations entails fewer estimates and judgments. Similarly, we agree that the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits, and we believe the plan financial statements meet this objective without the auditor reporting critical audit matters. For these reasons, we believe the aforementioned entities should be excluded from the scope of the requirement to communicate critical audit matters in the auditor's report.

Sincerely yours,

Pricewatershousecoopers, LLP

Appreciate the help P, help in identifying another couple of industries where fraud does not exist...thanks, man....

Respectfully yours,

Pw Carey, Senior IT Auditor (GRC)

Docket No. 034 or What one audit industry leader said, regarding the efforts of the PCAOB to make audits more useful and relevant to the investment community....

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Solution: Issue strengthened Claw Back and Equity Receiver Regulations and Rules, such as one rough hewn example:

Pw's 2014 Suspected And/Or Alleged Fraud Recovery Provision(s) via Individual Equity Clawback No. 666:

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No Politicians, No Lobbyists, No Special Interests will not be at the table during the design, development and construction of The Enhanced Claw Back Act….The accounting industry hand in hand with the PCAOB is more than capable of coming up with the best possible standards and regulations for protecting the investment community, without the intervention of politicians and special interest groups whose primary concern is not to find the right solution but to protect their power base and secure greater financial freedom to bend the rules in their favor, first last and always.

Bad examples of same: Graham-Leach Bailey....Clinton.....Regan, Enron, Clinton, Bush, (and repeal Dodd-Frank) and re-introduce.... Glass-Steagall....would be a good first step…..

*************

Individual Fraud Equity Trustee Recovery Act

1. There is No statute of limitations
2. The inperi delecto defense will be not be provided to escape responsibility for aiding and/or abetting fraud
3. Equity Trustee freezes individual assets by placing them into an Escrow Account whose sole purpose is for the recovery of assets gained from the fraud, plus triple-damages...
4. Individual's not corporate entities are governed by these provisions...
5. Originators of the fraud, those who participated in the fraud, and those who should have known of this fraud yet allowed the fraud to continue shall be governed by these provisions along the lines of the UFTA (Uniform Fraudulent Transfer Act)
6. Those individuals convicted of fraud under this recovery act must satisfy an incarceration formula of six years, six months and six days (666), with time off for aiding in the fraud recovery and/or good behavior, at a facility that will not place undue stress regarding family visits...

Equity Trustee Receivership.....Equity Receivership...Sue for Fraud en pari delecto defense....In Pari Delicto Law & Legal Definition

1Robert G. Wing and Katherine Norman, SEC Receivers: What Are They and What Do They Do?, Utah State Bar Journal (Nov. 2007), available at http://webster.utahbar.org/barjournal/2007/11/sec_receivers_what_are-_they_an.html.

Rick further publishes the "International Asset Recovery Blog", (www.internationalassetrecovery.com), where he writes about recovery claims/assets around the world.

The Idaho UFTA (Uniform Fraudulent Transfer Act) is identical to California's statute.

25 Official Comm. Of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PriceWaterhouseCoopers, LLP, 989 A.2d 313, 339 (Pa. 2010) ("This effectively forecloses an in pari delicto defense for scenarios involving secretive collusion between officers and auditors to misstate corporate finances to the corporation's ultimate detriment.").

26Thabault v. Chait, 541 F.3d at 529 (holding that the auditor was not a victim of the agent's fraud and that "allowing the auditor to invoke the in pari delicto doctrine would not serve the purpose of the doctrine—to protect the innocent."); Freeman v. BDO Seidman, LLP (In re E.S. Bankest, L.C.), 2010 Bankr. LEXIS 1288, at *31 (Bankr. S.D. Fla. Apr. 6, 2010) ("BDO's agreement to detect fraud as Bankest's auditor precludes BDO from using that fraud it failed to detect to assert the imputation/in pari delicto defense as a shield to Plaintiff's claims").

In pari delicto is a Latin term meaning "in equal fault". It's a legal doctrine that bars a plaintiff who has participated in wrongdoing from recovering damages for loss resulting from the wrongdoing.

In contract law, neither party can claim breach of contract by the other if the fault is more or less equal. In criminal law, a defendant who is found equally at fault with other defendants will have difficulty asserting that he/she was induced to commit the crime by another defendant. However, sometimes the defense is sometimes not applied in the interests of protecting the public, such as a suit by someone who sought to gain on trading stocks using inside information which is brought against the person who gave the inside tip.
When there is a Suspicion of Fraud...Immediately establish an Equity Receivership Trustee to pursue any and all assets gained through this Fraud.....
Chris Whalen at Tanget Capital www.bloomberg.law.com
Chris Whalen
www.bloomberglaw.com....

Equity Receivership Trustees

www.youtube.com/bloomberglaw.....
Sue for fraud....equity courts:
The Trustee Equity Receivership: could freeze assets, issue subpoenas...demand
Establish the Power of Trustee Equity Receivership....Suspicion of Fraud...suspect fraud....
YouTube

Inperi delecto defense....

Chris Whalen at Tanget Capital

| | |
|---|---|
| **From:** | Ron Lissak |
| **To:** | Comments |
| **Subject:** | PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor"s Report |
| **Date:** | Wednesday, December 11, 2013 8:15:37 PM |
| **Importance:** | High |

Dear Board Members:

Thank you for the opportunity to comment on the rulemaking referenced above.

I am the Managing Partner of a firm that has been regulated by the FINRA (and previously by the NASD) for over 12 years. Like many other firms, our business does not deal directly with the "public", does not maintain accounts, does not underwrite securities, does not commit capital—in short, we post ZERO risk to market integrity on a micro or macro level.

We are a small business. There are three partners and no employees. The additional work that the new rules would impose would be highly onerous for our business and would serve no public or private benefit. These rules should not apply to firms like ours. There should be a reasonable exemption for firms like ours.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best Regards,

Ron

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CENTER FOR AUDIT QUALITY
*Serving Investors, Public Company Auditors & the Markets*



December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034:** *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments*

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (proposed auditor reporting standard); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (proposed other information standard); and *Related Amendments to PCAOB Standards* (collectively, the proposal). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

The CAQ is supportive of the PCAOB's efforts to update and enhance the auditor's reporting model to provide additional information in an increasingly complex and global environment. This is an important project of great interest to many different stakeholders and one that will require careful deliberation and extensive outreach to develop an approach that can be practically applied. We commend the Board's consideration of international efforts, in particular those of the International Auditing and Assurance Standards Board (IAASB), in developing the proposal. We also commend the Board for considering the results of outreach conducted and the comment letters received from the CAQ and others, particularly in response to the PCAOB's June 2011 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (Concept Release).[1]

[1] See the PCAOB's Concept Release (link).

Over the past three years, the CAQ has shared its perspectives and views on the topic of auditor reporting through comment letters to both the PCAOB and the IAASB.[2] The CAQ recognizes that enhancing the information communicated by the auditor is a worthy and warranted objective. In response to the PCAOB's proposal, we have initiated a coordinated and collaborative effort with members of the public auditing profession to field-test the proposal in order to help inform our views and our comments to the PCAOB. It will take several months for those members to conclude the field-test and analyze the results, but we hope to share insights next year in advance of the PCAOB's expected Spring 2014 roundtable related to the auditor's reporting model.

We believe that changes of this magnitude present challenges that must be carefully considered. Our suggestions are aimed at addressing such considerations, while helping to achieve the objectives of the Board as articulated in the proposal. In developing our suggested changes, we were guided by a set of principles that we believe are most relevant to the proposal, including:

- Auditors should avoid providing information about the company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure.[3]
- Any changes to the auditor's reporting model should enhance, or at least maintain, audit quality.
- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
- Any changes to the reporting model should add value and not create investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.

Among our suggestions, we propose streamlining the auditor's process for determining critical audit matters (CAMs), in part, through leveraging the auditor's existing required communications with the audit committee, and focusing the auditor's determination of CAMs on the most important matters conveyed in such communications. With respect to other information, we suggest that the auditor's report be revised to articulate the auditor's responsibility for other information inclusive of the need to report unresolved material inconsistencies or material misstatements of fact, rather than requiring the auditor's report to contain a specific conclusion. Our suggested changes to the performance requirements related to other information comport with our understanding of the PCAOB's intent in revising the extant guidance, in a cost-effective way. We believe our suggested approach will provide users with a better understanding of the auditor's responsibilities with respect to other information, while creating less incremental litigation risk.

To further the Board's objectives, we also offer a number of suggestions related to the standard language in the auditor's report. We believe such changes will help clarify the report in a number of ways, including more clearly articulating the responsibilities of the auditor, management, and the audit committee, and providing context around important terms such as "reasonable assurance." Finally, as requested by the PCAOB, we discuss the liability risks associated with the proposal, and how our suggested changes to the proposal may help to mitigate these risks. We have organized our suggestions into the following sections:

I. Critical Audit Matters
II. Other Information
III. Auditor Tenure
IV. Auditor's Unqualified Report and Clarifying Language Changes
V. Applicability
VI. Cost-Benefit Considerations

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[2] See CAQ comment letters to the IAASB dated October 8, 2012 (link) and September 15, 2011 (link) and the PCAOB dated September 30, 2011 (link) and June 28, 2011 (link).
[3] Similar views were expressed by stakeholders who participated in the CAQ's "Role of the Auditor" roundtable discussions. See the CAQ's *Observations on the Evolving Role of the Auditor: A Summary of Stakeholder Discussions* (link).

VII. Appendices
   A. Illustration of Suggested Changes to the Proposed Auditor Reporting Standard and Examples
   B. Illustration of Suggested Changes to the Proposed Other Information Standard
   C. Illustration of an Unqualified Auditor's Report
   D. Legal Considerations

We draw your attention to Appendices A through C, which illustrate our suggested changes to the proposed auditor reporting and other information standards, and our suggested clarifying language changes related to the auditor's report. We stand ready to assist the Board in the coming months as it reviews comments on the proposal, conducts additional outreach, considers the results of field-testing efforts, and deliberates next steps.

## I. <u>Critical Audit Matters</u>

***Overall Comments***

We support the overall efforts of the PCAOB to improve the information communicated to financial statement users through the auditor's report, and we agree with the PCAOB that CAMs "…could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging" and "…could enable them to analyze more closely any related financial statement accounts and disclosures."[4] We believe that the PCAOB's proposal represents a constructive approach in this regard. However, there are areas that present important implementation issues that require further consideration. We discuss these areas below, and present suggestions for consideration that we believe could enhance the PCAOB's proposed approach.

*CAM Determination*

We note that the PCAOB's approach for the determination of CAMs includes consideration of matters in the engagement completion document, matters reviewed by the engagement quality reviewer, and matters communicated to the audit committee. We believe that these criteria are overly broad and largely duplicative and would potentially result in an excessive number of CAMs communicated in the auditor's report. Such an outcome would dilute the significance of the matters identified in the report and be contrary to the PCAOB's stated intent for the auditor's report to highlight the matters that were the most important to the audit. We believe matters that are important enough to merit communication with the audit committee represent the appropriate starting point for an auditor's consideration of CAMs, given the audit committee's oversight of the audit and role in representing the interests of shareholders. We have suggested additional changes to the proposed determination criteria which we believe will help provide for the identification of the most relevant of these matters.

*CAM Communication*

We note that paragraph 11 of the proposed auditor reporting standard requires the auditor to describe the considerations that led the auditor to determine that a particular matter is a CAM. The example CAM sections provided in the proposal appear to interpret this requirement to mean that the auditor's descriptions of each CAM are expected to address each of the specific factors included in paragraph 9 that were present. To the extent this reflects the PCAOB's intent, this raises several potential issues. First, having to describe each of the particular factors in paragraph 9, such as consultations with the national office or specialists, would obscure the more significant factors in the auditor's description of why the matter was critical to the audit and may contribute to user misunderstanding. In this regard, we note that events such as consultations with a firm's national office or engagement of firm specialists may be a response to a challenging audit issue, but are not a factor used in determining that the matter is challenging or critical. Second, the proposal as reflected in the example CAM reporting will likely lead to instances of an auditor providing original

[4] See the proposal pages A5-22 through A5-23.

information[5] that is currently not required to be disclosed by the company (e.g., control deficiencies less severe than a material weakness, and corrected and accumulated uncorrected misstatements). This would blur the roles of management and the auditor, and potentially widen the expectation gap.

*CAM Documentation*

We note that paragraph 14 of the proposed auditor reporting standard requires the auditor to document why "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." We do not believe that such a requirement is operational, as it is unclear how an auditor could effectively demonstrate that such matters *are not* CAMs. This documentation requirement may result in auditors communicating a significant number of matters in the auditor's report, in anticipation of potential second guessing that could occur subsequent to its issuance. We believe this outcome is contrary to the intent of the proposal. In addition, we believe this requirement would add significant costs to the audit process without a corresponding benefit.

***Suggested Changes to the Proposed Auditor Reporting Standard***

We have developed suggested changes to the proposed auditor reporting standard that we believe will provide for the auditor's determination and communication of CAMs while addressing the areas noted above. We provide our suggestions and rationale below. Appendix A reflects these suggested changes in paragraphs 7 through 14 of the proposed auditor reporting standard, along with related revisions to the three illustrative examples included in the proposal.

*CAM Determination*

When determining the matters that represent CAMs, we believe that the auditor should initially identify matters that were significant to the audit of the financial statements (significant audit matters). Such matters would be derived from (and would be a subset of) those matters communicated to the audit committee under PCAOB Auditing Standard No. 16, *Communications with Audit Committees* (AS 16). In the adopting release for AS 16, the Board noted (emphasis added):

> "Auditing Standard No. 16 is intended to improve the audit by fostering constructive dialogue between the auditor and the audit committee about *significant audit and financial statement matters*. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process."

Given the nature of these required communications, we believe that matters required to be communicated to the audit committee pursuant to AS 16 would be an appropriate starting point for the determination of any audit matter that would be important enough to the audit to be a CAM. Additionally, this approach would more closely align the PCAOB's CAM approach with the IAASB's *key audit matters* approach, which begins with matters communicated to those charged with governance, and would result in greater global consistency across auditors' reports.[6]

When determining which matters required to be communicated to the audit committee were significant audit matters, we believe that auditors should take into account the eight factors identified by the PCAOB in paragraph 9 of the proposed auditor reporting standard. The auditor would then need to determine which of the significant audit matters are CAMs, by identifying those matters that, in the auditor's judgment: a) were

[5] For the purpose of our response to the Board's proposed auditor reporting standard, original information is information about a company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure.

[6] See the IAASB's ED, Proposed ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (Proposed ISA 701), paragraph 8.

material to the financial statements; b) involved the most challenging, subjective, or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to the auditor in forming an opinion on the financial statements; and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our rationale for determining CAMs in this manner is as follows:

a) We agree with the PCAOB that CAMs could enable users to focus on certain aspects of the company's financial statements and analyze more closely the related financial statement accounts and disclosures. We believe this is the appropriate focus of CAMs and as such, we believe that matters that are not material[7] to a company's financial statements should not be CAMs.

b) We share the PCAOB's view that CAMs can be differentiated from other audit matters by their relative complexity and the challenges[8] they present to the audit.[9] As such, we suggest retaining much of what the PCAOB proposed in paragraph 9.

c) Given the audit committee's oversight role, we believe the auditor's determination of CAMs should consider the nature and extent of the interaction between the auditor and the audit committee. In our view, auditors and audit committees tend to spend the most time focusing on matters that have the characteristics, as generally contemplated in the proposal, of CAMs. As such, we believe the ultimate standard should be reflective of current practice, and the extent of the auditor's interaction with the audit committee on the various matters that arise during the execution of an audit should be an important factor in the determination of CAMs. This approach is responsive to investor requests for further insights into auditor-audit committee communications and is consistent with the audit committee's role representing the interests of shareholders.

Finally, we believe that care should be taken to provide that auditors communicate only the most important matters, as including too many matters would minimize the intended emphasis. Accordingly, we believe that the final step in the determination of CAMs should reflect an explicit provision that if an auditor has initially identified a large number of matters for potential communication in the auditor's report, the auditor may consider reassessing whether each of these matters meets the definition of a CAM.

*CAM Communication*

As noted above, we do not believe that the auditor's description of the CAM needs to include each of the factors that relate to a particular matter. We believe that requiring the auditor to describe the *principal* consideration(s) that led the auditor to conclude the matter was a CAM would allow the auditor to utilize his or her professional judgment to describe the factors that were most important to the determination that a matter was a CAM and tailor such communication to provide users with useful information about the identified matters relative to the audited financial statements.

We also note that while the proposed auditor reporting standard does not require the auditor to describe the CAM's effect on the audit, each of the PCAOB's three examples of CAM reporting[10] include such descriptions. We believe that in some cases describing the CAM's effect on the audit may help to explain why a matter was a CAM. While we acknowledge that the proposed auditor reporting standard does not prohibit the auditor from providing such descriptions,[11] we believe it would be improved by explicitly stating that the auditor may provide a description of the CAM's effect on the audit if the auditor considers it

[7] Although the concept of materiality is not mentioned in connection with the determination of critical audit matters in the proposal, we note that such a concept is listed in one of the examples regarding the auditor's determination of critical audit matters. See page A5-76 of the proposal.
[8] We suggest the word "challenging" instead of "difficult" as the latter can have a more negative connotation.
[9] See the proposal page A5-25.
[10] See the proposal pages A5-65 through A5-78.
[11] On page A5-36 of the proposal, the Board states that "…when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so."

necessary in describing why a matter is a CAM.[12] We believe such a provision would clarify the Board's intent with respect to this important area, and would provide auditors with the ability to describe the CAMs in a manner that best emphasizes why a matter is considered a CAM.

We also acknowledge the possibility that describing the CAM's effect on the audit could imply to financial statement users that the auditor is providing a separate opinion on specific accounts or balances referenced in the CAM (i.e., "piecemeal opinions") or, conversely, undermine the auditor's opinion on the financial statements taken as a whole. As such, we believe that the language preceding the communication of CAMs in the auditor's report must specify that while an audit includes the performance of procedures designed to address the risks of material misstatement associated with any identified CAMs, such procedures were designed in the context of the audit of the financial statements taken as a whole, and do not provide a separate opinion on individual accounts or disclosures. Moreover, the auditor's description of a specific CAM's effect on the audit (if included based on the auditor's judgment) should be a brief, high-level summary of the audit procedures performed to address the principal considerations that led the auditor to conclude that the matter is a CAM. We agree with the PCAOB that language that could be viewed as disclaiming or qualifying the auditor's opinion on the financial statements due to the existence of a CAM is not appropriate and must not be used. In addition, we suggest including an explicit requirement that the audit opinion must not convey that the auditor is providing a separate opinion or conclusion on the critical audit matters.

Consistent with the overarching principles articulated above, we believe that the auditor should not be the original source of information about the company. However, we acknowledge that there may be rare circumstances where, in the auditor's judgment, such information is necessary to the auditor's description of the CAM. In these situations, we believe that communication of such information would be appropriate, provided it is otherwise not prohibited by law or regulation.[13] In such circumstances, the auditor can encourage management to make relevant disclosures, rather than the auditor being the source of such information.

*CAM Documentation*

While we agree that the auditor should be required to document the determination of CAMs, we do not believe the documentation requirements included in the proposed auditor reporting standard are operational. It appears that much of the documentation focus in the proposal is centered on matters the auditor ultimately concludes are not CAMs. It is often very challenging to "prove a negative" in any setting and we believe this will be particularly difficult in this area. Leveraging the suggestions noted above, we believe a more practical approach would be to require documentation of the auditor's basis for (a) identifying those matters that were communicated to the audit committee that were determined to be significant audit matters, and (b) determining which significant audit matters were CAMs. We believe this approach will help address the practical challenges associated with documenting matters that "appear to be CAMs."

## II. <u>Other Information</u>

***Overall Comments***

As noted previously,[14] the CAQ supports enhancements to the auditor's report that provide transparency regarding the auditor's responsibility with respect to other information. However, we believe there are several provisions within the proposed other information standard that should be modified. Our observations and suggested changes to the proposed other information standard are discussed below.

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[12] This would further align the PCAOB's proposal with the IAASB's. See the IAASB's ED, Proposed ISA 701, paragraphs 10 and A38 through A41.
[13] This improves alignment with the IAASB's ED, see Proposed ISA 701, paragraph A37.
[14] See the CAQ's September 30, 2011 comment letter to the PCAOB (link).

*Performance Responsibilities*

The proposed other information standard expands the auditor's performance responsibilities from "read and consider" under AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AU 550), to "read … and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate"[15] the other information for a material inconsistency, a material misstatement of fact, or both. The term "evaluate" is extensively used within the PCAOB's auditing standards in relation to the auditor reaching an opinion (i.e., a reasonable assurance performance standard) or performing procedures to support the audit opinion.[16] We believe the use of "evaluate," in the context of the proposed other information standard, expands the auditor's performance responsibilities. In addition, an auditor may need to perform additional procedures, outside those described within the proposed other information standard, in order to support a conclusion based on an evaluation of the other information. Additionally, the ambiguity created by the use of "evaluate" would increase the risk of undue litigation against auditors, as discussed in Appendix D.

The proposed other information standard also requires the auditor to read and evaluate other information not directly related to the financial statements. Given that the auditor may not have accumulated any information from the audit that would provide a basis for evaluating other information not directly related to the financial statements, we believe it would be inappropriate for the auditor to be required to conclude on such information.

Further, the proposed other information standard states that the auditor's evaluation is based upon "relevant audit evidence obtained and conclusions reached during the audit."[17] This is also an expansion from AU 550 where the auditor's responsibility relates to the financial information that is identified in the auditor's report.[18] We believe "relevant audit evidence obtained and conclusions reached during the audit" could be interpreted as requiring an extensive search for documentation within the audit workpapers to determine if the other information had been addressed in the relevant audit evidence, and may imply the inclusion of all information gathered during the audit, not just the financial information subject to audit procedures.

*Reporting Responsibilities*

Requiring the auditor to communicate in the auditor's report that the auditor has evaluated the other information and conclude whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, would imply a level of assurance that is inconsistent with the proposed procedures. This may cause users of the financial statements to perceive the auditor's "conclusion" on the entirety of other information as a form of reasonable assurance on such information, despite the auditor making an explicit statement in the auditor's report that he or she did not audit the other information and does not express an opinion on the other information. We believe this will lead to a widening of the expectation gap. Further, requiring the auditor to state whether he or she has identified a material inconsistency, a material misstatement of fact, or both, would create significant incremental litigation risk for auditors, as discussed in Appendix D. Our suggested changes discussed below include reporting of the auditor's responsibilities with respect to other information and procedures performed and, where applicable, describing any unresolved material inconsistencies or material misstatements of fact. This approach makes more explicit an auditor's present responsibilities and we believe it will help address certain legal risks inherent in the proposed other information standard.

[15] See the proposed other information standard paragraph 4.
[16] For example, paragraph 6 of PCAOB Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (pending final SEC approval), "To form an opinion on the supplemental information, the auditor should evaluate…"; paragraph 9 of PCAOB Auditing Standard No. 7, *Engagement Quality Review*, "the engagement quality reviewer should evaluate the significant judgments made by the engagement team and the related conclusions reached in forming the overall conclusion on the engagement and in preparing the engagement report"; and paragraph 8 of PCAOB Auditing Standard No. 12, *Identifying and Assessing Risks of Material Misstatement*, "In obtaining an understanding of the company, the auditor should evaluate whether significant changes in the company from prior periods, including changes in its internal control over financial reporting, affect the risks of material misstatement."
[17] See the proposed other information standard paragraph 4.
[18] AU 550, paragraph 4.

***Suggested Changes to the Auditor's Performance Responsibilities***

As described below, we have developed suggested changes that we believe will help achieve the Board's objectives, while addressing the considerations described above. In articulating our suggested changes, we recognize the fundamental difference between other information that is directly, and not directly, related to the audited financial statements and the need for different procedures for each of these types of other information. Appendix B reflects our suggested changes to the Objectives and Auditor's Responsibilities sections of the proposed other information standard.

*"Evaluate" Other Information*

To more clearly define the auditor's performance responsibilities regarding other information, we suggest replacing "evaluate" with "perform certain limited procedures," and that the expected limited procedures be identified in the standard. These limited procedures (which include reading the other information) provide a "plain English" description of the performance expectations that more closely align the performance requirements with the extant standard and, as a result, will be more operational in practice and better understood by users. Further, to focus the auditor's performance responsibilities regarding financial statement-related information, we believe the limited procedures that extend beyond reading should only apply to other information directly related to the audited financial statements. In the context of our suggested changes, we are using a definition for other information directly related to the audited financial statements that focuses on other information derived either (1) from the financial statements or (2) from accounting records subject to the audit. We encourage the Board to consider incorporating the suggested definition within the standard.

Additionally, in identifying other information that falls within the scope of the auditor's performance responsibilities, it is critical to include the consideration of materiality. Therefore, we recommend that any procedures, beyond reading the other information, apply only to *material* other information that is directly related to the audited financial statements.

*Relevant Audit Evidence and Conclusions Reached During the Audit*

We believe the auditor's performance responsibilities regarding material other information directly related to the audited financial statements should be related to (1) the financial statements or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation. We believe this could also limit the auditor from having to perform extensive searches within the audit workpapers to determine if other information had been addressed in the audit.

*Certain Limited Procedures*

Based on our suggestions above, we have recommended modifications to the proposed other information standard to describe the certain limited procedures the auditor would perform. These limited procedures include reading all of the other information, and for material other information directly related to the audited financial statements, performing the following:

a) Comparing the amounts in the other information, and the consistency of the manner of their presentation, that are the same as, or provide greater detail about, the amounts in the financial statements, to (1) the amounts in the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;
b) Comparing qualitative statements that represent, or provide greater detail about, information in the financial statements, to (1) the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation; and
c) Recalculating the mathematical accuracy of the amounts in the other information that are calculated using amounts in (1) the other information, (2) the financial statements, or (3) accounting records that

are subject to the audit, or have been derived directly from such accounting records by analysis or computation.

*Other Information Not Directly Related to the Financial Statements*

We believe the auditor's performance responsibilities for other information not directly related to the audited financial statements should be consistent with AU 550, which requires the auditor to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, to respond appropriately.[19] Further, we believe the auditor's identification of potential material misstatements of fact should be based on knowledge gained in the course of conducting the audit, in order to link the auditor's performance responsibilities to the audited financial statements. Finally, since the auditor performs different procedures depending on whether the other information is directly, or not directly, related to the financial statements, we have separated these procedures within our suggested approach.

***Suggested Changes to the Auditor's Reporting Responsibilities***

As noted above, we support changes to the auditor's report that provide transparency about the auditor's responsibility with respect to other information. Specifically, we believe the auditor's reporting should describe the auditor's responsibilities to perform certain limited procedures on the other information, and emphasize that these limited procedures do not constitute an audit or review of the other information. The auditor's report should also include:

a) A statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the auditor's report; and

b) In situations where the auditor has become aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised, a description of the material inconsistency, the material misstatement of fact, or both.

We believe that this reporting would clearly communicate the auditor's responsibilities regarding other information, and whether the auditor was aware of an unresolved material inconsistency with the audited financial statements or a material misstatement of fact in the other information, while helping to mitigate certain of the litigation risks discussed in Appendix D. This reporting is illustrated in the context of an unqualified auditor's report in Appendix C, and is addressed by paragraphs 13 and 14 in Appendix B.

***Other Information Documentation Requirements***

The proposed other information standard does not provide guidance regarding the nature and extent of documentation that would be required with respect to the fulfillment of the auditor's performance responsibilities. The expansion to a "read and evaluate" performance responsibility could expand the auditor's efforts to document the procedures performed, including documenting the source of each qualitative or quantitative statement or number (irrespective of whether it relates to the financial statements). Our recommendations above will assist in focusing the auditor's documentation efforts, by more clearly articulating the auditor's performance requirements, outside reading the other information, to material other information directly related to the audited financial statements. However, to promote consistency in practice, we recommend that the PCAOB provide guidance within the other information standard on how the auditor should document the procedures performed addressing other information.

[19] AU 550, paragraph 5.

***Scope of Other Information***

The proposed other information standard defines other information broadly as information in the annual report, other than the audited financial statements and the related auditor's report, and includes documents contained in the list of exhibits to[20] – and information incorporated by reference in – the annual report.[21] We believe auditors would benefit from clarification regarding what exhibits would fall within the scope of the auditor's performance responsibilities. For instance, certain exhibits (e.g., plan(s) of acquisition or material contracts) may have been subject to audit procedures due to their relevance to the audit of the financial statements, and it may not be appropriate to subject these exhibits to the procedures within the proposed other information standard.

Further, the proposed other information standard would require the auditor to evaluate other information included in the proxy statement, which may not be filed until 120 days after year end.[22] It is unclear how this requirement can be applied in practice, as this information may not be prepared or available until after the respective Form 10-K is filed, and we do not believe it would be appropriate for the auditor to conclude in the auditor's report on information that is not available at the time the auditor's report is issued. Further, it is unclear from the proposed other information standard what impact the auditor's responsibility to perform certain procedures on this other information would have on the previously filed auditor's report. For example, when the proxy statement is filed subsequent to the Form 10-K, is the auditor required to provide a dual-dated audit opinion to reflect the performance of the required procedures on the other information in the proxy statement, subsequent to the issuance of the initial auditor's report?

We believe that describing the auditor's performance responsibilities in the auditor's report, rather than stating a conclusion, will help mitigate some of the scope matters discussed above. However, if the Board does not agree with the suggested changes, and requires a conclusion in the auditor's report, we believe the final other information standard should either exclude documents that do not exist at the date of the auditor's report (including the proxy statement) or clarify the auditor's reporting responsibilities for this information, including the impact on the previously issued auditor's report.

## III. Auditor Tenure

As noted in the proposal, the PCAOB has not found a correlation between audit quality and auditor tenure.[23] We believe that including auditor tenure in the auditor's report would create the false impression that such a correlation exists and would give undue prominence to this information. Accordingly, we do not believe that auditor tenure should be included in the auditor's report.

However, we do support other ways of making auditor tenure more transparent. For example, as noted in a recent study, a growing number of audit committees of Fortune 100 companies have decided to disclose the tenure of their auditors.[24] The CAQ, in collaboration with several governance organizations, encouraged all audit committees to consider such disclosures in a recent "Call to Action."[25]

Additionally, the PCAOB could require auditors to provide this information on the PCAOB's Form 2,[26] which would be a more appropriate place for this disclosure than the auditor's report given the lack of nexus between auditor tenure and audit quality.

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[20] See the proposal, footnote 15, appendix 6.
[21] See the proposed other information standard, "Note" in paragraph 1.
[22] Ibid.
[23] See the proposal page A5-16.
[24] *Audit Committee Reporting to Shareholders, 2013 Proxy Season,* EY (link).
[25] *Enhancing the Audit Committee Report: A Call to Action*, released by the "Audit Committee Collaboration" consisting of the following organizations: National Association of Corporate Directors; NYSE Governance Services, Corporate Board Member; Tapestry Networks; The Directors' Council; the Association of Audit Committee Members, Inc.; and the CAQ (link).
[26] Additional information regarding the PCAOB's rules and requirements for periodic filings by registered public accounting firms, including Form 2, can be found here (link).

## IV. Auditor's Unqualified Report and Clarifying Language Changes

The CAQ joins the Board in recognizing the value of the "pass/fail" opinion in the auditor's report. We also believe that standardized language in the auditor's report represents a significant benefit to financial statement users as it serves to narrow the expectation gap through an enhanced understanding of the auditor's role and responsibilities, the audit process, and responsibilities of others in the financial reporting supply chain. Standardized language also promotes consistency in practice across auditors' reports, because it serves to mitigate potential financial statement user misunderstanding that could occur through the use of inconsistent language.

***Basic Elements***

We appreciate the Board's consideration of input received on the Concept Release related to clarifying language and we support proposed changes to enhance the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding the notes to the financial statements and material misstatement, whether due to error or fraud. We also support proposed changes to better align the description of the nature of an audit with the Board's risk assessment standards.

We agree with the Board's decision not to require that the basic elements appear in a specific order in the auditor's report, other than the requirement that CAMs follow the opinion and any explanatory paragraphs. We do, however, recommend requiring the use of consistent paragraph captions regarding the basic elements of the auditor's report (e.g., the introduction, the basis of opinion, and the opinion on the financial statements), as such captions will assist financial statement users in better understanding the auditor's report.

We do not, however, support addressing the auditor's report to parties other than shareholders and the board of directors (or an equivalent body). As noted in Appendix D, we believe this would create additional litigation risk and would not improve the communicative value of the auditor's report.

***Addition of Clarifying Language to the Standard Auditor's Report***

The CAQ suggests that the PCAOB consider incorporating into its final auditor reporting standard five elements of clarifying language that are generally consistent with the IAASB's exposure draft[27] and with suggestions we provided in our 2011 letters to the PCAOB.[28] We continue to believe that these changes would enhance users' understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally. These additional elements take on added importance in the context of the contemplated changes to the auditor's report related to CAMs and other information.

1. *Management and Audit Committee Responsibilities* - Provide an expanded discussion covering management and the audit committee's responsibilities for the financial statements.
2. *Auditor's Responsibility for the Financial Statements* - Explicitly identify that the auditor is responsible for expressing an opinion on the financial statements "taken as a whole" when referring to those financial statements throughout the auditor's report.
3. *Reasonable Assurance* - Describe what is meant by the term "reasonable assurance."
4. *Professional Judgment and Professional Skepticism* - Highlight the necessity of using professional judgment in assessing audit risk, selecting audit procedures, and considering the issuer's internal control over financial reporting when responding to such risks. State that the auditor is responsible for maintaining professional skepticism throughout the planning and performance of the audit.
5. *Audit Evidence* - Refer to "the procedures performed and the audit evidence obtained" as providing the reasonable basis for an audit opinion.

[27] See IAASB ED, illustrative auditor's report on pages 13 through 16.
[28] See CAQ comment letters to the PCAOB dated September 30, 2011 (link) and June 28, 2011 (link).

Appendix C illustrates these proposed changes in the context of an auditor's unqualified report.

## V. Applicability

*Critical Audit Matters*

We believe that auditors of brokers and dealers, investments companies, and employee benefit plans (i.e., employee stock purchase, savings, and similar plans) should not be subject to the identification, communication, and documentation of critical audit matters under the proposed auditor reporting standard. Benefit plans and registered investment companies are typically designed for a specified purpose and, as a result, would likely have similar critical audit matters. For example, CAMs for these entities would likely include auditing hard-to-value investments. There are already extensive disclosure requirements regarding the fair value of investments pursuant to Accounting Standards Codification 820, *Fair Value Measurement*. We believe that financial statement users understand that financial instrument fair value issues are important to both the preparation and audit of such financial statements. We question whether the inclusion of CAMs in the audit reports for these entities would add much value.

In addition, as noted in the PCAOB Release, the ownership of brokers and dealers is primarily closely held (per the PCAOB's Office of Research and Analysis, approximately 75% of the brokers and dealers have five or fewer direct owners), and the direct owners are generally part of the entity's management. Accordingly, we believe that requiring the auditors of these entities to communicate critical audit matters would not provide investors or other financial statements users with additional relevant information to justify the incremental cost.

*Other Information*

In our view, brokers and dealers and employee benefit plans should be excluded from the scope of the proposed other information standard. We believe that the compliance or exemption report required to be filed by brokers and dealers under Exchange Act Rule 17a-5[29] and required to be reported on by auditors under the *Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*[30] provides users of their financial statements with sufficient information to make any additional reporting by the auditor for such entities under the proposed other information standard unnecessary.

Employee benefit plans that file a Form 11-K with the SEC are also required to file their financial statements and auditor's report with the U.S. Department of Labor, which requires an audit conducted in accordance with U.S. generally accepted auditing standards. Requiring employee benefit plan audits to be subject to the scope of the proposed other information standard could create the potential for two very different auditor's reports to be issued for the same plan. Moreover, employee benefit plans that file a Form 11-K contain a limited amount of other information, which is not the predominant source of information used by plan participants to make investment decisions.

*Emerging Growth Companies*

We believe that both the proposed auditor reporting standard and the proposed other information standard should be applicable to emerging growth companies (EGCs). As we have noted previously,[31] certain financial reporting risks can be more prevalent with EGCs than other public companies because of the size, nature, and complexity of their business model, capital structure, business processes and controls, and regulatory environment.

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[29] SEC Release No. 34-70073, Final Rule, Broker-Dealer Reports (link).
[30] PCAOB Release 2013-007 (link).
[31] See the CAQ's "*Related Parties*" comment letter dated July 3, 2013 (link).

## VI. Cost-Benefit Considerations

While there are clear benefits to the Board's proposal, there will be added costs and implementation challenges associated with a project of this magnitude. We have offered suggested changes to the proposal that we believe will retain or increase the benefits expected to be realized by the proposal, while helping to reduce the associated costs.

*Critical Audit Matters*

Our approach streamlines the auditor's process for determining CAMs and related documentation requirements by leveraging the auditor's required communications with the audit committee under AS 16. A key benefit of our approach is that it is designed around how audits are currently conducted, how matters are communicated to the audit committee, and how matters are documented in the audit workpapers, which will reduce the incremental effort and costs associated with application of the final auditor reporting standard.

As anticipated by the Board,[32] we believe that auditor reporting of CAMs will result in additional effort by the auditor, as well as by those who prepare and review a company's financial statements (e.g., management and the audit committee). Much of this work will occur at the end of the audit, when remaining issues are being resolved and final reviews are occurring. We anticipate that our field-testing effort will provide some insights into what effect this might have on the audit, but we also encourage the Board to conduct a robust analysis of the costs and benefits of the proposed auditor reporting standard that addresses the potential effect on key stakeholders including companies, audit committees, and investors.

*Other Information*

As discussed above, the proposed other information standard requires the auditor to evaluate other information based on relevant audit evidence obtained and conclusions reached during the audit. The proposed other information standard does not differentiate between information that is directly related to the financial statements and information that is not. Without making these distinctions, we believe the proposed other information standard would result in significant incremental effort and cost, particularly as it relates to non-financial information, which would far exceed the benefits. We believe our recommendations build upon the benefits that exist today with a lower impact on costs.

The proposed other information standard would require an auditor to conclude in each auditor's report whether the auditor identified a material inconsistency or a material misstatement of fact in the other information.[33] We believe that auditor reporting solely with respect to unresolved material inconsistencies with the financial statements or material misstatements of fact in the other information, coupled with a clear description of the auditor's responsibilities related to other information, will achieve the desired transparency without an unnecessary increase in litigation risks.

We believe it will be essential for investors and other financial statement users to have an understanding of the effect the proposed other information standard will have on the auditor's current responsibilities related to other information, audit costs, and the company's financial reporting process. Our field-testing effort is expected to help inform this discussion, but we encourage the PCAOB to carefully consider these factors in its analysis of the costs and benefits of the proposed other information standard.

*Legal Considerations*

The proposal requests comments on the liability risks associated with the proposal, noting in respect of both CAMs and other information that "the auditor would be making new statements in the auditor's report" which

[32] See the proposal page 17.
[33] See the proposed other information standard paragraph 14.

could raise potential liability concerns or considerations.[34] The risk of increased liability that accompanies the form of report contemplated by the proposal is real and substantial, as described further in Appendix D. We believe that our proposed changes to the PCAOB's approach would help to mitigate the potentially significant additional liability exposure inherent in the proposal, while at the same time providing more information to financial statement users and resulting in auditing standards that can be applied consistently.

****

We fully support the Board's efforts to enhance the information communicated by the auditor in the auditor's report and we embrace calls for change. We appreciate the opportunity to comment on the proposal and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:
PCAOB
James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
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Paul A. Beswick, Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Daniel Murdock, Deputy Chief Accountant

IAASB
Prof. Arnold Schilder, Chair
James Gunn, Technical Director

[34] See the proposal pages A5-44 and A6-40.

**Appendix A – Illustration of Suggested Changes to the Proposed Auditor Reporting Standard and Examples**

Note: *This appendix reflects our suggested changes to paragraphs 7 through 14 of the proposed auditor reporting standard, and example CAM reporting to illustrate these changes.*

**Critical Audit Matters**

*Determination of Critical Audit Matters*

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.

Note: It is expected that in most audits, the auditor would determine that there are critical audit matters.

8. As a first step in the determination of critical audit matters (see paragraph 9), the auditor identifies matters that are significant to the audit of the financial statements, and communicated to the audit committee pursuant to Auditing Standard No. 16 ("significant audit matters"). In identifying significant audit matters, the auditor should take into account the following general factors, as well as other factors specific to the audit:

a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;
b. The nature and extent of audit effort required to address the matter;
c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;
d. The severity of control deficiencies identified relevant to the matter, if any;[35]
e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any;
f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;
g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and
h. The nature of consultations outside the engagement team regarding the matter, if any.

9. Critical audit matters are those significant audit matters that, in the auditor's judgment, a) were material to the financial statements, b) involved the most challenging, subjective, or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to the auditor in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee.

In general, the greater the number of matters thought to represent critical audit matters, the less useful the auditor's communication of such matters may be. If an auditor has initially identified a large number of matters for potential communication in the auditor's report, the auditor may consider reassessing whether each of these matters meets the definition of a critical audit matter.

[35] Other PCAOB standards provide auditing and reporting requirements related to the company's internal control over financial reporting. See Auditing Standard No. 5, Auditing Standard No. 12, and AU section 325, *Communications About Control Deficiencies in an Audit of Financial Statements.*

*Communication of Critical Audit Matters*

10. The auditor must communicate in the auditor's report critical audit matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

> Note: When the current period financial statements are presented on a comparative basis with those of one or more prior periods, the auditor should consider communicating critical audit matters relating to the prior periods when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

11. For each critical audit matter to be communicated in the auditor's report, the auditor must:

a. Identify the critical audit matter;
b. Describe the principal consideration(s) that led the auditor to conclude that the matter was a critical audit matter and, if the auditor considers it necessary as part of the explanation, include a brief description of its effect on the audit; and
c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

Each description should be succinct, objective, and fact-based. Language that could be viewed as disclaiming or qualifying the auditor's opinion on the financial statements due to the existence of a critical audit matter is not appropriate and must not be used. Additionally, the audit opinion must not convey that the auditor is providing a separate opinion or conclusion on critical audit matters.

In describing the principal consideration(s) that led the auditor to conclude that the matter was a critical audit matter, the auditor should avoid providing information about the company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure unless, in the auditor's judgment, such information is necessary to the auditor's description and providing such information is not prohibited by law or regulation. In such circumstances, the auditor can encourage management to make relevant disclosures rather than the auditor being the source of such information.

*Language Preceding Critical Audit Matters in the Auditor's Report*

12. The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

> *Critical Audit Matters*
>
> The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide a separate opinion on individual accounts or disclosures. The

communication below is not intended to identify all matters we considered to be significant to our audit. Other matters, that we determined were not critical audit matters, were discussed with the audit committee during the course of our audit.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

13. In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title “Critical Audit Matters,” in the auditor’s report:

*Critical Audit Matters*

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period’s financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. We determined that there are no critical audit matters. Other matters, that we determined were not critical audit matters, were discussed with the audit committee during the course of our audit.

*Documentation of Critical Audit Matters*

14. In accordance with Auditing Standard No. 3, the auditor must document the determination of critical audit matters. Auditing Standard No. 3 requires audit documentation to be prepared in such detail to provide a clear understanding of its purpose, source, and the conclusions reached. To provide sufficient detail for a clear understanding of the conclusions reached regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor’s:

a. Identification of matters communicated to the audit committee that were significant audit matters; and
b. Determination of which significant audit matters were critical audit matters.

**<u>Illustrative Examples of CAM Reporting</u>**

The revised CAM examples below are based on the same facts provided by the PCAOB on pages A5-65 through A5-78 of the proposal. The reporting in these revised examples is consistent with the approach suggested above. In this regard, we believe the suggested communication is fulsome and informative. The circumstances in each example may not lend themselves to an auditor determining to provide a further description of the CAM’s effect on the audit. However, we offer, in the bracketed text, what such further disclosure might look like. Such illustrations may be helpful in developing language for situations where an auditor’s discussion of a CAM’s effect on the audit might, in the auditor’s judgment, be more relevant. As we review the results of the field-testing effort, we will consider developing one or more additional example CAMs to better illustrate when the auditor might describe the CAM’s effect on the audit in accordance with paragraph 11(b) above.

As required by paragraph 12 above, the text directly below would precede the critical audit matters communicated in the auditor's report:

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide a separate opinion on individual accounts or disclosures. The communication below is not intended to identify all matters we considered to be significant to our audit. Other matters, that we determined were not critical audit matters, were discussed with the audit committee during the course of our audit.

**Example 1 — Allowance for Sales Returns**

The Company developed a new on-line sales channel, which could have a significantly different return experience than sales through its more established retail stores. In addition, the Company simultaneously lengthened its return policy and developed new models with different assumptions to reflect these changes in its estimate of the allowance for sales returns, which is a key element in determining revenue.

We determined that our evaluation of the Company's allowance for sales returns was a critical audit matter in the audit of the Company's financial statements as of and for the fiscal year ended January 31, 2013. This was due to the changes in the Company's distribution channel and sales return policy and the Company's lack of historical experience with the new on-line sales channel, which resulted in a high degree of measurement uncertainty in estimating the allowance for sales returns. The Company's accounting policy for sales returns is discussed in Note 1 to the financial statements.

[Our audit involved challenging and subjective judgments in evaluating whether the Company had a sufficient basis to make a reasonable estimate of sales returns. We designed and performed procedures to test management's assumptions and the data underlying the Company's estimate of future sales returns related to the new on-line sales channel. Our procedures included, among others, assessing the reasonableness of management's judgments regarding the effect of changes in the Company's return policies and practices, as well as the changes in economic and buying trends that affect customer behavior.]

**Example 2 — Valuation Allowance for Deferred Tax Assets**

The Company recorded a deferred tax asset balance of $XXX million related to federal net operating loss carryforwards, as of June 30, 2013. In recognizing its deferred tax asset balance, the Company concluded that no valuation allowance was required. The Company exercised significant judgment in evaluating the realizability of its deferred tax assets, which included consideration of the losses in recent periods and an unexpected cost increase in a critical product component in 2013. The Company's analysis also considered other evidence, such as the expected timing of reversals of existing temporary differences, forecasts of future taxable income, and tax planning strategies.

We determined that our assessment of the Company's evaluation of the realizability of its deferred tax asset balance was a critical audit matter in the audit of the Company's financial statements as of and for the year ended June 30, 2013. This was due to the complexity and subjectivity involved in management's judgments regarding the reasonableness of the weight given to the positive and negative evidence, including the data underlying management's forecasts of its future taxable income. The Company's accounting policy and its evaluation of the realizability of deferred tax assets are discussed in Notes 2 and 12 to the financial statements.

[Our audit involved challenging management's estimate of the realizability of its deferred tax assets, including procedures to evaluate the reasonableness of the Company's forecasts of future taxable income. This included evaluating the sensitivity of the Company's forecasts based on the general economic environment, the Company's industry and competitive conditions, and the length of time associated with the Company's forecasts. This also included an evaluation of the timing and potential impact of product enhancements and new product introductions, the effect of eliminating certain product lines, and the expectation regarding the level of product recall and relocation costs.]

**Example 3 — Fair Value of Fixed Maturity Securities Held as Investments That are Not Actively Traded**

Approximately 35% of the Company's investment portfolio is comprised of private label mortgage-backed securities and collateralized loan obligations. The process to determine the fair value of these investments primarily utilizes in-house valuation models, discounted cash flow methodologies, or other techniques that utilize inputs that cannot be derived from, or corroborated by, currently observable data, including credit spreads that reflect specific credit-related issues.

We determined that the valuation of the Company's private label mortgage-backed securities and collateralized loan obligations was a critical audit matter in the audit of the Company's financial statements as of and for the year ended December 31, 2012. This was because of the high degree of estimation uncertainty due to the lack of observable inputs used in determining the fair value of these investments. The Company's disclosures related to the nature and fair value of these securities and the methods the Company used to determine those fair values are in Note 6 to the financial statements.

[Our audit involved evaluating the reasonableness of the Company's valuation methodologies and whether they were consistently applied. We performed tests of the Company's fair value determination by (a) testing management's significant assumptions, the Company's valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, and (c) considering subsequent events and transactions.]

**Appendix B – Illustration of Suggested Changes to the Proposed Other Information Standard**

Note: *This appendix reflects our suggested changes to the Objectives, Auditor's Responsibilities, and Reporting in the Auditor's Report sections of the proposed other information standard.*

**Objectives**

2. The objectives of the auditor are:

a. To perform certain limited procedures on other information, and determine whether he or she is aware of (1) a material inconsistency between amounts or information, or the manner of their presentation, and the audited financial statements ("material inconsistency with the audited financial statements"); (2) a material misstatement of fact in the other information; or (3) both, and if so, to respond appropriately; and

b. When issuing an auditor's report, to communicate in the auditor's report:

   i. The auditor's responsibilities to perform certain limited procedures on other information;
   ii. In the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement in the auditor's report; and
   iii. That the auditor has not audited or reviewed the other information.

**Auditor's Responsibilities**

3. The auditor should read the other information, and with respect to material other information directly related to the audited financial statements, perform the following additional procedures:

a. Compare the amounts in the other information, and the consistency of the manner of their presentation, that are the same as, or provide greater detail about, the amounts in the financial statements, to (1) the amounts in the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;

b. Compare qualitative statements that represent, or provide greater detail about, information in the financial statements (e.g., critical accounting estimates, or the description of off-balance sheet arrangements), to (1) the financial statements, or (2) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation;

c. Recalculate the mathematical accuracy of the amounts in the other information that are calculated using amounts in (1) the other information, (2) the financial statements, or (3) accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation.

   Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula. If the auditor needs to refer to a formula for the recalculation of an amount, such as for return on capital employed, the auditor would be required to recalculate the amount only when the formula is provided, or described in the annual report. However, the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.

4. In reading other information not directly related to the audited financial statements, if, based on knowledge gained in the course of conducting the audit, the auditor becomes aware of a potential material misstatement of fact in the other information, the auditor should perform the procedures in paragraph 5.[36]

5. If, based on the procedures performed in paragraphs 3 and 4, the auditor becomes aware of a potential material inconsistency with the audited financial statements, a potential material misstatement of fact in the other information, or both, the auditor should discuss the matter with management. The auditor also should perform additional procedures, as necessary, to determine whether there is a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both.

**Reporting in the Auditor's Report**

13. When issuing an auditor's report, the auditor must include, in a separate section of the auditor's report titled "The Auditor's Responsibilities Regarding Other Information," the following:

a. A statement that, in order to issue an audit report under the standards of the Public Company Accounting Oversight Board ("PCAOB"), the auditor is required to perform certain limited procedures on other information and determine whether he or she is aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised;
b. Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report, by referring to the SEC Exchange Act form type and the period end date of the financial statements;
c. A statement that the limited procedures included reading the other information, and with respect to material other information directly related to the audited financial statements, comparing the other information to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information;
d. A statement that these limited procedures do not constitute an audit or review of the other information;
e. A statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the auditor's report; and
f. In situations where the auditor has become aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised, the auditor should provide a description of the material inconsistency, the material misstatement of fact, or both.

14. The following is an example of "The Auditor's Responsibilities Regarding Other Information" section of the auditor's report:

a. Illustrative language for paragraphs 13.a.– e.:

*The Auditor's Responsibilities Regarding Other Information*

In order to issue an audit report on the Company's financial statements, in accordance with the standards of the PCAOB, we are required to perform certain limited procedures on other information, included in the annual report on [SEC Exchange Act form type] filed with the SEC that contains both the [period end date] financial statements and our audit report on those financial statements, and determine whether we are aware of a material inconsistency

[36] This represents paragraph 4(c) of the proposed other information standard, incorporated into a separate paragraph.

with the audited financial statements, a material misstatement of fact in the other information, or both. These limited procedures do not constitute an audit or review of the other information. Such procedures include reading the other information and, with respect to the material other information directly related to the audited financial statements, comparing it to (a) the financial statements or (b) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information. In the event we become aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact, or both, that has not been appropriately revised, we are required to describe the inconsistency, misstatement, or both, in our audit report.

b. Illustrative language for paragraph 13.f. when the auditor has become aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised:

Based on performing certain limited procedures, we became aware of [a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both] that has not been appropriately revised. [Describe the material inconsistency with the audited financial statements, the material misstatement of fact in the other information, or both.]

**Appendix C – Illustration of an Unqualified Auditor's Report**

*Note:* *This appendix illustrates our suggested changes to the Illustrative Auditor's Unqualified Report on pages A1-15 and A1-16 of the proposed auditor reporting standard. Suggested additions are underlined; suggested deletions are struck through.*

**Report of Independent Registered Public Accounting Firm**

To the shareholders and board of directors of X Company

Introduction

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 20X2, and the related notes (collectively referred to as the "financial statements"). ~~These financial statements are the responsibility of the Company's management.~~

We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB. ~~We or our predecessor firms have served as the Company's auditor since [year].~~

Management and Audit Committee Responsibilities for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with [applicable financial reporting framework], and for establishing and maintaining adequate internal control over financial reporting to enable the preparation of financial statements that are free of material misstatement, whether due to error or fraud.

The audit committee oversees the Company's financial reporting process and its internal control over financial reporting, areas for which management has the primary responsibility. Additionally, the audit committee is directly responsible for our appointment and compensation, and the oversight of our work (including resolution of any disagreements with management regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.

Basis of Opinion

Our responsibility is to express an opinion on the Company's financial statements, taken as a whole, based on our audits. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. In this context, reasonable assurance, although representing a high level of assurance, is not absolute and consequently an audit conducted in accordance with PCAOB standards may not always detect a material misstatement.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. In the course of completing our audits, the audit evidence we obtain is often persuasive rather than conclusive. The procedures selected for performance depend on our judgment, including our assessment of the risks of material misstatement of the financial statements, whether due to error or fraud. In making those risk assessments, we consider internal controls relevant to the Company's preparation and fair presentation of the financial statements in conformity with [applicable financial reporting framework] in order to design audit procedures that we believe are appropriate in the circumstances. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We maintain professional skepticism throughout the planning and performance of the audit. We believe that the procedures performed and the audit evidence obtained provide ~~our audits provide~~ a reasonable basis for our opinion.

Opinion on the Financial Statements

In our opinion, the financial statements, taken as a whole, referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [applicable financial reporting framework].

Critical Audit Matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are ~~those~~ matters ~~addressed during the audit~~ that, in our judgment, a) were material to the financial statements, ~~(1)~~b ) involved our most ~~difficult~~ challenging, subjective, or complex judgments,~~; (2)~~ posed the ~~most difficulty~~ greatest challenge to us in obtaining sufficient appropriate evidence,~~;~~ or ~~(3)~~ posed the ~~most difficulty~~ greatest challenge to us in forming ~~our~~ an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. ~~The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole.~~ Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide a separate opinion on individual accounts or disclosures. The communication below is not intended to identify all matters we considered to be significant to our audit. Other matters, that we determined were not critical audit matters, were discussed with the audit committee during the course of our audit.

[*Include critical audit matters*]

The Auditor's Responsibilities Regarding Other Information

In order to issue an audit report on the Company's financial statements in accordance with the standards of the PCAOB, we ~~evaluated whether the~~ are required to perform certain limited procedures on other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, ~~contains a~~ and determine whether we are aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both. ~~Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information.~~ These limited procedures do not constitute an audit or review of the other information. Such procedures include reading the other information and, with respect to the material other information directly related to the audited financial statements, comparing it to (a) the financial statements or (b) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information. In the event we become aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact, or both, that has not been appropriately revised, we are required to describe the inconsistency, misstatement, or both, in our audit report.

[*Signature*]
[*City and State or Country*]
[*Date*]

**Appendix D – Legal Considerations**

<u>Note:</u> *This appendix presents our response to the questions in the proposal regarding the liability risks associated with the proposed standards.*

The proposal notes in respect of both CAMs and other information that "the auditor would be making new statements in the auditor's report" which could raise potential liability concerns or considerations.[37] The risk of increased liability that accompanies the form of report contemplated by the proposal is real and substantial. As discussed below, any expansion of the auditor's report is almost certain to lead to additional liability exposure for the independent auditor. The proposal creates more statements that would be directly attributable to the auditor and which a financial statement user – for example, a shareholder that suffers a loss following a decline in an issuer's stock price – could claim were materially misleading or omitted required information. Accordingly, these changes are likely to lead to an increase in the number of cases being filed against issuers and their auditors generally, and an increase in the number of claims that may be asserted in any individual case.

Although it is not possible to quantify the magnitude of the incremental risk, we do believe it will be significant. We believe that our suggested changes would help to mitigate (at least, to some extent) the potentially significant additional liability exposure inherent in the PCAOB's proposal, while at the same time providing more information to financial statement users and resulting in auditing standards that can be applied consistently.

*Critical Audit Matters*

A requirement to identify and report on CAMs would increase an auditor's liability risk under both federal and state law. A user that suffers a loss in connection with his or her investment in an issuer's securities may claim that the auditor should bear some responsibility because the investor relied on statements made by the auditor about CAMs. Such a claim would most likely suggest that the auditor either (i) materially misstated a CAM or (ii) failed to include a CAM in the auditor's report. There is a risk that whatever the auditor says will be challenged after the fact – as communicating too little, or too much, or characterizing the information in the wrong way.

The liability risk presented by including a description of CAMs in the auditor's report is exacerbated by the scope of matters that would be considered in the auditor's determination of CAMs. The factors that may make an audit matter "critical" are broadly defined, and many judgments made during the course of an audit would touch on one or more of those factors. This lack of clarity will add further uncertainty to how a lawsuit will unfold, which will increase litigation costs by making early resolution difficult. The proposed requirement that auditors document matters that appear to be CAMs but are not, further adds to those risks. Our suggested changes to the proposed auditor reporting standard attempt to mitigate these risks by providing greater clarity regarding the auditor's process for determining CAMs.

This risk increases to the extent the proposed auditor reporting standard introduces novel concepts to the regulatory landscape. The concept of materiality currently underlies the liability regime under the federal securities laws, and is defined in respect of the "total mix" of information available to investors. The proposed auditor reporting standard introduces an additional concept: matters that were critical to the audit, but which (as is clear from the examples set out in the proposal) may not be "material" as that term is applied under the securities laws.[38] The changes we suggest attempt to mitigate this risk by incorporating the concept

[37] See the proposal pages A5-44 and A6-40.

[38] By way of example, the auditor in example 3 identifies a control deficiency, but not one significant enough to be a material weakness, or presumably require an adverse opinion under PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, so it does not separately require disclosure.

of materiality in the determination of CAMs, thereby aligning the auditor's reporting model with existing concepts governing liability under the federal securities laws.

Different risks are created by the fact that someone, after the fact, can claim that there was a material misstatement or omission with respect to an item which was identified as a CAM. An investor might allege that the auditor should have said more in its reporting of CAMs, claiming that some detail known to the auditor should have been communicated, or that it was not communicated with sufficient clarity. On the other hand, the company might object that these additional details disclose a client confidence or competitive information, or might raise confidentiality concerns under other regulatory regimes (e.g., bank regulatory requirements). By requiring the auditor to describe the *principal* consideration(s) that led the auditor to conclude that a matter was a CAM, and aligning the auditor's statements about a CAM with the existing rules governing corporate disclosure, our suggested changes to the proposed auditor reporting standard help mitigate the possibility that such situations will arise.

Although we support an express provision allowing the auditor to explain the CAM's effect on the audit, if the auditor considers it necessary, we should note that this by itself could expand liability risk. Plaintiffs in federal securities fraud lawsuits are required to plead fraud "with particularity" when bringing claims under Rule 10b-5, and an inability to do so requires the dismissal of the lawsuit at the outset. A description of audit steps taken by the auditor can enable plaintiffs to support meritless claims by including these details in their pleadings, which could cause courts to hesitate in dismissing such claims. Our suggested approach helps limit this risk, but does not eliminate it. For example, where the auditor does not describe audit procedures related to the CAM(s), plaintiffs may allege instead that the description of the CAM should have been more fulsome.

*Other Information*

Two aspects of the proposed other information standard are likely to significantly increase the risk of litigation for auditors. The first aspect is the proposed wording of the new performance responsibilities. The proposed other information standard would change the "read and consider" requirement under paragraph 4 of AU 550 to a "read and evaluate" requirement, which we believe could be read to impose a substantially greater set of obligations on the auditor. Indeed, the proposal states that the Board opted for the phrase "should evaluate" because, unlike "should consider," it requires the auditor to "*come to a conclusion* based on the performance of certain procedures (emphasis added)."[39] On this basis, plaintiffs will likely allege that the word "evaluate" makes the auditor responsible for what is and is not said by the issuer in MD&A and elsewhere. We are particularly concerned that this increased obligation makes the auditor responsible not only for what the issuer discloses but also for omissions.

The second aspect is the requirement that the auditor state in the auditor's report that the auditor has not identified a material inconsistency or a material misstatement of fact in the other information, when such is the case. This affirmative statement reads as if it is an opinion or conclusion that the other information is not misleading – even though under the proposed other information standard the auditor would also state that it is not, in fact, expressing an opinion.

The U.S. Supreme Court has issued several opinions addressing Rule 10b-5 secondary liability (which in the past was often applied to auditors). Beginning with *Central Bank*[40] in 1994 and extending more recently to *Janus Capital Group v. First Derivative Traders*,[41] the Court has made clear that persons cannot be held liable under Section 10(b) and Rule 10b-5 unless they actually "make" a statement. These decisions make clear that while an auditor may be liable for misstatements in its audit reports on financial statements or internal control, its liability is confined to such reports and cannot be extended to other documents or

[39] See the proposal page A6-15.
[40] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).
[41] *Janus Capital Group v. First Derivative Traders*, 131 S. Ct. 2296 (2011).

information as to which it has not opined. Under the PCAOB's proposed other information standard, however, the auditor would make affirmative statements about the other information, increasing the likelihood that allegations of liability would be made.

Even under our suggested approach, we note the auditor will still face increased risk for having made a statement about the other information. This is because the auditor's report would provide a description of the auditor's responsibilities for the other information (e.g., comparing the other information to the financial statements or the accounting records). Accordingly, the potential for increased litigation would remain. For example, a plaintiff might allege that the auditor knew the company misstated a material fact in MD&A; that the auditor failed to take adequate steps to correct that misstatement; and that, from the description of the auditor's responsibilities in the auditor's report, a reasonable investor would conclude that the auditor affirms that no such misstatement existed. Our suggested changes, in short, may reduce the additional liability risk, but would not eliminate it.

*Additional Addressees in the Auditor's Report*

The proposed auditor reporting standard would require addressees of the auditor's report to include "(1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body."[42] The proposal further suggests, however, that the report "could" be addressed to others, such as bondholders.[43] It is unclear whether the PCAOB is contemplating requiring the auditor to consider whether it must address the auditor's report to others (beyond shareholders and the board), or is merely suggesting that auditors consider doing so depending on the circumstances.

While many auditing firms currently address their auditor's reports to shareholders and the board, we do not see a basis for requiring – or even suggesting – that the report be addressed to additional parties. Any such addition to the addressees might permit such parties to assert that they are owed a duty of care by the auditor, which would expand the auditor's liability risk.

Under applicable state law, an audit firm and the client who engages it have a relationship of privity, which gives the client legal rights that others do not have. However, a particular third party may, under the law in some states, be able to establish the existence of a relationship with the auditor giving it the same rights as a client by demonstrating (1) that the audit firm knew the third party's identity and that it was relying on the auditor's report, and (2) conduct by the auditor linking it to the third party and its reliance. Even though the addressing of the auditor's report is not intended to create such a relationship, a court may find that one in fact existed based, at least in part, on including a third party as an addressee of the report, thereby creating undue incremental litigation risk without increasing the value of the report to users.[44] Adding addressees to the auditor's report will not affect those with access to it: the auditor's report is a general use report available to all capital market participants – shareholders, bondholders, rating agencies, analysts, and others – that the issuer can distribute without restriction, and to which third parties have ready access via the issuer's SEC filings.

[42] See the proposed auditor reporting standard, paragraph 6(b).
[43] See the proposal pages A5-8 through A5-9.
[44] See *Futureselect Portfolio Management, Inc. v. Tremont Group Holdings, Inc.*, 175 Wash.App. 840, 309 P.3d 555 (2013); *Anwar v. Fairfield Greenwich Limited*, 884 F.Supp.2d. 92 (S.D.N.Y. 2012).

CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets



January 30, 2014

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

**Re: PCAOB Rulemaking Docket Matter No. 034:** *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments*

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

As noted in the CAQ's December 11, 2013 comment letter[1] to the PCAOB regarding the auditor's reporting model and the auditor's responsibilities regarding other information (collectively, the proposal), we have initiated a coordinated and collaborative effort with members of the public auditing profession to field-test the proposal in order to help inform our views and our comments to the PCAOB. These field testing efforts were initiated during the fourth quarter of 2013 and are expected to conclude in the next two to three months. We plan to analyze the results and prepare a summary of findings near the end of May 2014.

[1] http://pcaobus.org/Rules/Rulemaking/Docket034/99b_CAQ.pdf

1155 F Street NW, Suite 450, Washington, DC 20004, (202) 609-8120 www.thecaq.org

We continue to hope that we will be able to share meaningful insights related to this effort in advance of, or in connection with, the PCAOB's expected spring 2014 roundtable on the auditor's reporting model. We respectfully request that the PCAOB consider the progress of these efforts in developing the timing of the planned roundtable, as we believe the roundtable discussions would be greatly informed by the field testing described above. If the timing of the roundtable does not accommodate the incorporation of the profession's field testing results, we would be happy to present these insights at the PCAOB's Standing Advisory Group meeting currently scheduled for June 24 and 25, or any other venue the Board would find helpful.

We continue to fully support the Board's efforts to enhance the information communicated by the auditor in the auditor's report and we would be pleased to answer any questions that the PCAOB staff or the Board may have regarding the profession's field testing efforts.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:
PCAOB
James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor

SEC
Paul A. Beswick, Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie Erhardt, Deputy Chief Accountant
Daniel Murdock, Deputy Chief Accountant

IAASB
Prof. Arnold Schilder, Chair
James Gunn, Technical Director

CENTER FOR AUDIT QUALITY

*Serving Investors, Public Company Auditors & the Markets*



June 19, 2014

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

**Re: PCAOB Rulemaking Docket Matter No. 034:** *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments*

Dear Office of the Secretary:

The Center for Audit Quality ("CAQ") is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ continues to support the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") efforts to update and enhance the auditor's reporting model. In our January 30, 2014 and December 11, 2013 comment letters submitted in response to the PCAOB's proposed auditor reporting standard and proposed other information standard (collectively, the "proposals"), we indicated that we would share with the PCAOB the results of a collaborative effort by members of the public accounting profession to field test certain aspects of the proposals. This field-testing initiative has been completed, and we have prepared the following summary of the observations and related recommendations for the PCAOB's consideration. We have organized our letter into the following sections:

I. Executive Summary
II. Objectives of Field Testing
III. Composition of Field Testing
IV. Critical Audit Matters Field Testing
V. Other Information Field Testing
VI. Conclusion
VII. Appendices
   A. Distribution of Market Capitalization for CAM Field Testing
   B. Primary Industry Classification for CAM Field Testing
   C. Potential CAMs by Market Capitalization Group

We believe the information in this letter may be helpful to the PCAOB as it continues to evaluate and develop the proposals.

## I. Executive Summary

The CAQ commends the PCAOB for considering the results of outreach conducted and the comment letters received from the CAQ and others in advancing the proposals. As described in greater detail below, results from the field-testing initiative identified areas within the proposals where there may be an opportunity for revision and refinement.

With respect to critical audit matters ("CAMs") field testing, certain enhancements could be made to the proposed auditor reporting standard that we believe would make it more operational in practice and more aligned with the PCAOB's stated objectives for this aspect of the proposals.

First, we believe the process of determining CAMs could be made more effective and efficient by refining the sources and factors to be considered when determining whether a matter is a CAM to focus only on matters communicated to the audit committee. In addition, an explicit requirement to include the concept of materiality, as a relevant consideration in CAM determination, would be constructive and help auditors finalize the list of potential CAMs to those matters ultimately determined to be a CAM.

Second, the field testing noted that some audit engagement teams believed they should document all items identified through application of paragraphs 8 or 9, while others only documented the matters that they determined to be actual CAMs. Additional clarification regarding how an auditor would effectively document why certain matters identified in the process were ultimately not determined to be CAMs would help mitigate the diversity in application that was observed in our field testing.

Finally, with respect to the communication of CAMs in the auditor's report, the field testing noted diversity in the length, detail and range or specific subject matters covered in CAM communications. Therefore, we believe the Board should consider clarifying how an auditor would effectively communicate those factors that were most important to the determination that a matter was a CAM.

With respect to the topic of other information ("OI"), feedback from the field testing indicated that the use of the term "evaluate" will likely give rise to additional work by auditors, compared to current practice, and that there is uncertainty and diversity of views as to what is required. If it is the Board's intent to capture what is currently being done in practice today, the Board might consider clarifying "evaluate" by providing a more specific identification of the nature and extent of procedures to be performed on the OI. Additionally, it may be helpful for the Board to consider the direction of the International Auditing and Assurance Standards Board ("IAASB") related to their re-proposal of International Standard on Auditing ("ISA") 720 (revised), *The Auditor's Responsibilities Relating to Other Information*,[1] which would require, among other matters, the auditor to perform only limited procedures to evaluate the consistency of the OI with the financial statements.

## II. Objectives of Field Testing

The objectives of our field-testing initiative were to:

1. Provide first-hand observations from accounting firms about the effects of the proposals. Secondarily, observations from management and audit committees were obtained; however our field-testing initiative was not able to solicit the perspectives of the investor community.
2. Develop perspectives on ways the proposals could be implemented and might be improved.

[1] See IAASB ISA 720 Re-Proposal (link)

Participants[2] in our field-testing initiative focused their efforts on testing the Board's proposals as drafted. We believe the results of the field testing could be helpful to the Board by providing additional insights regarding whether the proposals would be operational in practice and the incremental time and effort that may be involved in implementing the proposals.

## III. Composition of Field Testing

Nine registered public accounting firms ("accounting firms"), of various sizes, participated in the CAQ's CAM field testing and six accounting firms participated in the OI field testing. The national offices of these accounting firms were provided with suggested criteria or characteristics for selecting field-testing participants. The issuers selected to participate in the field testing initiative consisted primarily of fiscal year 2012 audits of domestic SEC issuers of various sizes and a broad range of industries. There were no Emerging Growth Companies in the field testing. See Appendices A and B for additional information related to issuers participating in the CAM field testing.

Field testing of the proposed auditor reporting standard as it relates to CAMs included 51 audit engagements. Field testing of the proposed other information standard included 15 audit engagements. Additional input related to the proposed other information standard was obtained from five audit partners.

When selecting participants for OI field testing, the accounting firms were asked to consider the degree of complexity associated with "other information" as a result of factors such as, but not limited to, the nature, extent or number of schedules, exhibits and other information included in the Form 10-K (including information incorporated by reference). In some cases, participants selected for OI field testing were different from those participants selected for CAM field testing.

Audit engagement teams were provided with instructions by their respective national offices on how to execute the field-testing initiative, as well as a standard template that was used to summarize their observations. The national offices were responsible for selection of issuers and oversight of the field-testing process, including analyzing and communicating observations from the field testing to the CAQ. In addition to the involvement of the audit engagement teams, the field-testing initiative involved interaction with the respective audit committees and management in order to obtain their perspectives on the CAMs identified and the related proposed CAM communications portion of the auditor's report.

## IV. Critical Audit Matters Field Testing

The CAQ observed a number of trends in the feedback received from the accounting firms regarding areas where the proposed auditor reporting standard could provide more clarity, make it more operational in practice, and help avoid unintended consequences. Based on the results of the CAM field testing, we have the following observations:

- CAM Determination:
  - Source of CAMs – Potential CAMs identified through the application of paragraph 8 of the proposed auditor reporting standard resulted in duplication and a broad population of matters. In many instances, the inventory of potential CAMs was substantial, and in some cases the same matters were identified through application of each of the three sources included in paragraph 8. Audit engagement teams observed that using matters communicated to the audit committee as the only source for identification of CAMs

[2] The term "participants" is used throughout this letter to reference those issuers who volunteered to participate in the field-testing initiative, their respective audit committees and management, and the respective audit engagement teams.

might be more effective and may result in the identification of those matters important to the audit in a more effective and efficient manner.

- Use of CAM Factors – The factors in paragraph 9 of the proposed auditor reporting standard were inconsistently applied due to the lack of clarity regarding how an auditor should refine the number of potential CAMs to those that are determined to be CAMs ("actual CAMs"), particularly when considering the broad initial population derived from the sources in paragraph 8.

- CAM Communication – There were inconsistencies in applying the proposed auditor reporting standard when communicating CAMs. For example, the length of the CAM descriptions ranged from one sentence to several paragraphs.

- CAM Documentation – There was confusion among audit engagement teams related to the requirements (including which matters would require documentation and how they should be articulated in the workpapers) for documenting those matters that were initially considered potential CAMs, but which ultimately were determined not to be actual CAMs.

- Additional Time and Effort – Feedback from audit engagement teams, as well as management and audit committees, was that the additional time and effort was likely to be incurred during the completion phase of the audit by senior members of the audit engagement teams. Additionally, while it is clear that incremental time will be required to implement this aspect of the proposals, it was challenging for audit engagement teams to estimate the specific level of additional time and effort required, as the field testing was performed on a retrospective basis and the effort will not be consistent with implementing in a live audit environment.

A. <u>CAM Determination</u>

One of the primary focus areas of our CAM field testing was to better understand how accounting firms would identify a potential CAM, and then refine the list of potential CAMs to those matters determined to be actual CAMs. Paragraph 9 of the proposed auditor reporting standard identifies CAMs as those matters that "(1) involved the most difficult, subjective or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements." Paragraph 9 also provides a list of eight specific factors that the auditor should take into account in determining whether a matter is a CAM, but it does not explicitly require consideration of materiality.

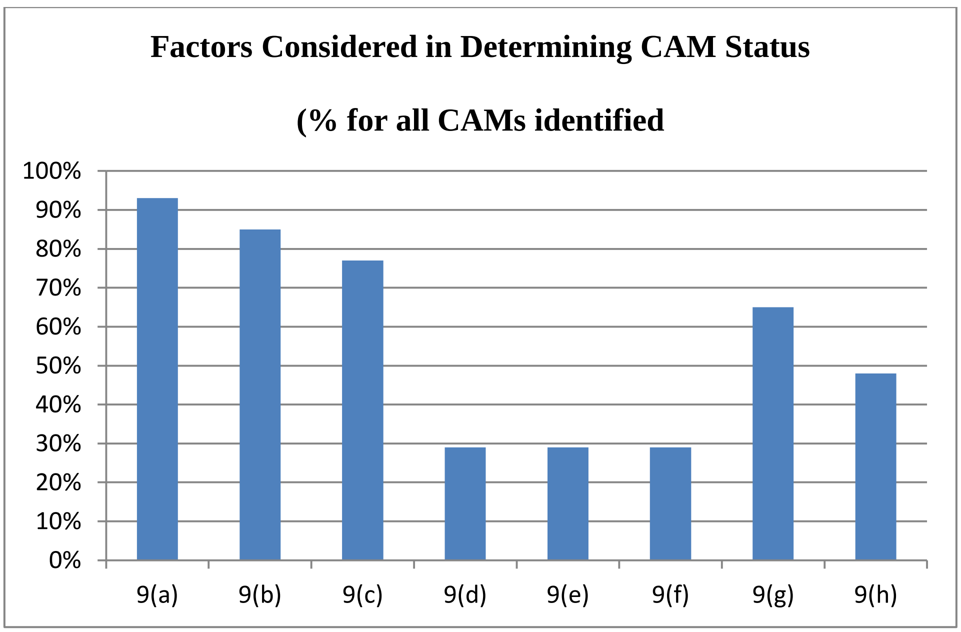
*i. Sources of CAMs*

The field testing observations suggest the paragraph 8 criteria for identifying CAMs should be revised to be aligned with communications and interactions on important matters with the audit committee and that this approach may provide a more effective and efficient method of determining CAMs. Audit engagement teams considered the population of matters included from all sources identified in paragraph 8 (i.e., engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee), and they indicated that 98% of the actual CAMs identified during the course of field testing were previously communicated to the audit committee.

*ii. Use of CAM Factors*

The factors in paragraph 9 of the proposed auditor reporting standard were also the subject of significant feedback from our field testing. In many cases, the accounting firms noted that the audit engagement teams considered materiality [3] (for example, whether a matter was itself material, or was likely to give rise to a material misstatement in relation to the financial statements taken as a whole) in determining whether a potential CAM should be an actual CAM. A number of accounting firms recommended that the process for determining a CAM should explicitly include the concept of materiality.

Observations from field testing also suggested that certain factors listed in paragraph 9 were more relevant in determining whether a matter was a CAM. In the event that multiple factors were used in the determination of a particular CAM, audit engagement teams were asked to report all factors that were used in the determination. As illustrated below, the three most common factors that led to the determination that a matter was a CAM were 9(a) (the degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures), 9(b) (the nature and extent of audit effort required to address the matter), and 9(c) (the nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence).[4] Additionally, for 100% of the CAMs where factors 9(d), 9(e), or 9(f) were identified, 9(a), 9(b), or 9(c) were also determining factors and for 98% of CAMs where 9(g) or (9h) were identified, 9(a), 9(b), or 9(c) were also determining factors.




Accounting firms also questioned whether there were some matters that should presumptively be considered a potential CAM (e.g., significant risk of material misstatement or matters addressed by an issuer's critical accounting estimates in MD&A). The proposed auditor reporting standard does not explicitly address such matters and we believe the Board should clarify that not all significant risks of material misstatement (e.g.,

[3] It appears the only time the concept of materiality is implied to be a factor in the proposed auditor reporting standard, is in one of the illustrative communications in appendix 5.

[4] Other factors listed in paragraph 9 of the proposed auditor reporting standard are: 9(d) – The severity of control deficiencies identified relevant to the matter, if any; 9(e) – The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any; 9(f) – The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any; 9(g) – The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and 9(h) – The nature of consultations outside the engagement team regarding the matter, if any.

management override and presumed risk of fraud in revenue recognition) or matters identified as critical accounting estimates should be presumed to be CAMs, as this determination should be based on the facts and circumstances specific to each issuer.

Another trend identified by the field testing was that, in many cases, the audit engagement teams initially identified a large number of potential CAMs, which were then narrowed to a much smaller number of actual CAMs. Additionally, some of the audit engagement teams noted that the criteria in paragraphs 8 and 9 made it difficult to document the rationale for matters that were potential CAMs, but not deemed to be actual CAMs. These numbers varied significantly from engagement to engagement, with the number of potential CAMs per issuer ranging from one to forty-five, while the number of actual CAMs per issuer ranged from zero to eight. See Appendix C for additional information on potential CAMs and actual CAMs by issuer and market capitalization. As noted above, we believe focusing the source for identifying CAMs only to matters communicated to the audit committee and incorporating the concept of materiality into the CAM determination could help to appropriately focus the auditors' attention on those matters that would be the most critical.

The field testing also identified a lack of clarity as to whether CAMs are only meant to be matters related to accounting and financial reporting, or if they would also include matters related to the conduct of the audit or the auditor. While these matters are related, some audit engagement teams expressed confusion as to how certain matters important to the planning of the audit should be considered in the determination of CAMs. For example, questions were raised as to whether matters such as audit scoping considerations or matters related to auditor independence should be considered "critical." Although these do not appear to meet the definition of a CAM, some audit engagement teams considered these matters to be CAMs. This suggests that additional clarification in this area may be useful in avoiding inconsistent application of the final auditor reporting standard.

*iii. Judgment*

Accounting firms observed that there could be different perspectives and viewpoints among the various audit engagement teams involved in the determination of CAMs. For example, some potential CAMs might not have been determined to be actual CAMs despite the presence of several of the paragraph 9 factors, while other potential CAMs were determined to be actual CAMs even though only one of the paragraph 9 factors was present. One of the key considerations noted by accounting firms in connection with addressing such situations was whether the matter related to a "material" item. For example, accounting firms noted that some matters appeared to meet the definition of a CAM, but were not included as a CAM based on relative materiality to the financial statements taken as a whole.

In addition, other considerations identified by the field testing (relative to the determination of CAMs) were the level of effort and judgment involved in the audit procedures and whether the item was already identified by management as a critical accounting estimate. Some audit engagement teams identified all areas that involved extensive audit effort as CAMs, while other teams considered not only the time spent auditing an area, but also the judgments involved when auditing those areas. Some audit engagement teams also considered those areas that management identified as critical accounting estimates as CAMs. Therefore, it may be possible to reach different conclusions as to whether or not a potential CAM is an actual CAM, given a similar set of facts and circumstances.

We applaud the Board's efforts to develop professional standards that allow for the use of professional judgment. However, as noted above, we believe that diversity in application of the proposed auditor reporting standard may arise and could lead users to draw inappropriate inferences about the issuer. Based on the results of the field testing, this is an area where further consideration from the Board could be helpful.

B. CAM Communication

The field-testing initiative highlighted two elements related to the communication of CAMs. The first is preparing the description of the CAM to be included in the auditor's report; the second is discussing that description with the issuer's management and audit committee.

*i. Description of CAMs*

Most of the audit engagement teams used the examples provided in the proposed auditor reporting standard as the starting point for drafting the communication of the CAM. Most accounting firms indicated that, in general, their CAM descriptions were similar to the PCAOB examples in format and approach. However, in a number of cases the length of the description of CAMs on similar topics varied significantly, not only between accounting firms, but also between participating audit engagement teams within the same firm. One accounting firm noted that a majority of the CAM descriptions included information that was duplicative of information included in management's disclosure of critical accounting estimates. Additionally, accounting firms indicated that some CAM descriptions included "original" information,[5] however due to the subjective nature of this determination, measuring the number of CAMs in the field-testing initiative that included "original" information proved challenging.

*ii. Discussions with Management and the Audit Committee*

The other element of communicating CAMs involved discussions with management and the audit committee regarding the determination of and language used to describe the CAMs. Most of the accounting firms indicated that management and the audit committee voiced concern about the potential need for management to revise disclosures to respond to CAM descriptions that include "original" information about the issuer and to involve disclosure committees and outside counsel in the CAM process to evaluate these potential changes to the issuer's financial statements.

C. CAM Documentation

While the objectives of the field testing did not include a detailed assessment of the relative time and effort of the documentation requirements regarding why a matter was not an actual CAM, field testing revealed that given the significant number (and range) of potential CAMs (compared to those determined to be actual CAMs),[6] there could be an unnecessary burden, in terms of effort and complexity. For example, some audit engagement teams interpreted the requirements of the proposed auditor reporting standard to be that if a matter was identified in any of the paragraph 8 sources, or met any of the paragraph 9 factors, documentation was required to justify why a matter was determined not to be a CAM.

Given the variation in the interpretation as to how audit engagement teams identified potential CAMs as well as the challenges inherent in making this determination, we recommend that the Board provide additional clarification regarding how an auditor should document why certain matters identified in the process were ultimately determined not to be CAMs. This clarification would also help mitigate the risk that the proposed auditor reporting standard is applied inconsistently.

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[5] Original information is information about an issuer's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the issuer's management to consider for disclosure (e.g., a new IT system implementation or control deficiencies that did not result in a material weakness).
[6] See Appendix C for additional information on potential CAMs and actual CAMs by issuer from the field testing.

D. Additional Time and Effort

On average, accounting firms, management, and audit committees believed that there is likely to be an increase in the audit effort, specifically as it relates to CAMs. For example, additional time incurred will most likely be related to initial implementation efforts, training, and ongoing monitoring. Expanded discussions with management and the audit committee may also require additional time and effort in a "live" audit environment versus the retrospective environment in which the field testing was conducted. Additionally, the time the accounting firms would incur to document the potential CAMs that were determined not to be actual CAMs may lead to on-going time and effort burdens (many audit engagement teams noted this would lead to additional time and effort, but did not actually complete the documentation during field testing).

Two additional observations related to the additional time and effort considerations are as follows:

- A majority of the additional time is likely to be incurred during the wrap-up phase of the audit, (i.e., once most of the audit work has been finalized, so that the auditor can determine what the actual CAMs are), despite efforts to start the process earlier in the audit. This could occur at a time when auditors, management and audit committees are focused on a number of other issues in connection with a particular filing, and the finalization of CAM communications may delay, or cause distractions in, the resolution of these issues.

- CAM related discussions with management and the audit committee are likely to involve senior members of the audit engagement team and may require national office consultations, thus requiring additional effort by key audit resources at the end of the audit.

Finally, many of the accounting firms expressed the view that the incremental time required may not decrease significantly in future years, given (1) that one of the stated objectives of the proposed auditor reporting standard is to avoid boilerplate descriptions and (2) the need to address new potential CAMs each year as a result of transactions or other changing business or financial reporting dynamics.

We continue to encourage the PCAOB to conduct a robust analysis of the costs and benefits of the proposed auditor reporting standard that addresses the potential effect on key stakeholders, including investors, issuers, audit committees, and accounting firms. In addition, we believe the changes suggested in the CAQ's previous comment letters on the proposed auditor reporting standard will retain or increase the benefits expected to be realized while helping to reduce the associated costs.

## V. Other Information Field Testing

OI field testing resulted in two primary areas of observation. First, the specific scope of responsibility of the auditor was not clear to the audit engagement teams. Many audit engagement teams stated that it is unclear whether the term "evaluate" is a higher threshold than the term "consider" as used in current guidance. Some audit engagement teams thought the scope of the proposed other information standard may require auditors to perform a number of additional procedures, while other audit engagement teams thought the scope was not substantially different from current practice under AU 550, *Other Information in Documents Containing Audited Financial Statements*. Consistent with our prior comment letters, we believe clarification of the procedures to be performed would help mitigate the confusion and potential diversity in the application of any final standard.

Second, several of the accounting firms participating in the OI field testing expressed concern about the ambiguity of the information that may be included in the scope of OI, the procedures to be performed related to this information, and the related documentation required. Accounting firms noted that it was not entirely clear whether the proposed other information standard required firms to evaluate the OI based on information they had already received in connection with the audit, or whether they would be required to gather additional information to support the OI. Most audit engagement teams, however, noted their belief that the level of effort necessary to document compliance with the proposed other information standard's performance requirements is an increase from what is required today.

We believe it would be helpful for the Board to clarify the procedures to be performed or consider the IAASB re-proposal that requires the auditor to read the OI and 1) consider whether there is a material inconsistency between the OI and the financial statements by performing limited procedures to "evaluate" the consistency between the OI and the financial statements, 2) consider whether there is a material consistency between the OI and the auditor's knowledge obtained during the course of the audit, and 3) remain alert for other indications that the OI appears to be materially misstated.

## VI. Conclusion

The CAQ supports the Board's ongoing initiatives to update and improve the auditor's reporting model and believes these field-testing observations provide insight into implementation of the proposals and identify some areas for the Board's continuing consideration. Although some of the observations from the field testing may not align with initial feedback from other initiatives to enhance auditor reporting around the globe, we believe it is important to consider the uniqueness of both the regulatory and oversight environments in the United States.

As it relates to CAMs, certain of the observations and suggestions noted above may mitigate some of the challenges identified. In particular, (1) focusing the source of CAMs only to those matters communicated to the audit committee may be more effective and efficient, (2) explicitly including materiality relative to the financial statements as a factor to be considered in the determination of CAMs may help with the consistent communication of CAMs that are considered "most difficult" and more consistent with the issuer's disclosure framework, (3) additional clarification appears to be needed regarding how an auditor would effectively document why certain matters identified in the process were not ultimately determined to be CAMs, and (4) clarification regarding how an auditor would effectively communicate those factors that were most important to the determination that a matter was a CAM would help to promote consistent application.

With respect to field testing of OI, there was uncertainty as to whether "evaluate" is a higher threshold than the extant standard, which may lead to challenges in the consistency of application by auditors and the interpretation of this term by users of the financial statements. We believe it may be helpful for the Board to consider the direction the IAASB is pursuing with the re-proposal of ISA 720 (revised), in defining the auditor's responsibilities in this area.

Finally, we encourage the PCAOB to consider a phased transition of the final standards based on the size of the issuer. Larger issuers and their auditors generally will have the resources necessary to more timely address the requirements of the new standards. While we ultimately support implementation by all issuers, we believe, a phased transition based on the size of the issuer will also allow smaller issuers and their auditors to benefit from the experiences of larger issuers. If the Board were to consider a phased transition, it could look to the experiences of the United Kingdom's Financial Reporting Council (FRC) as a starting point. When the FRC amended International Standard on Auditing (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statements* ("ISA (UK and Ireland) 700"), it required that audits of only a specified group of large issuers[7] adopt the amendments. Panelists at the PCAOB's roundtable[8] spoke favorably of the ISA (UK and Ireland) 700 adoption requirements.

[7] Only FTSE 350 companies and companies that voluntarily follow the UK Corporate Governance Code are currently required to apply the new provisions of ISA (UK and Ireland) 700.
[8] The PCAOB hosted a public roundtable on April 2-3, 2014 to obtain further input from constituents on the proposals.

****

We continue to appreciate the opportunity to provide additional input on the proposals, and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have regarding the information provided in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

cc:
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Prof. Arnold Schilder, Chair
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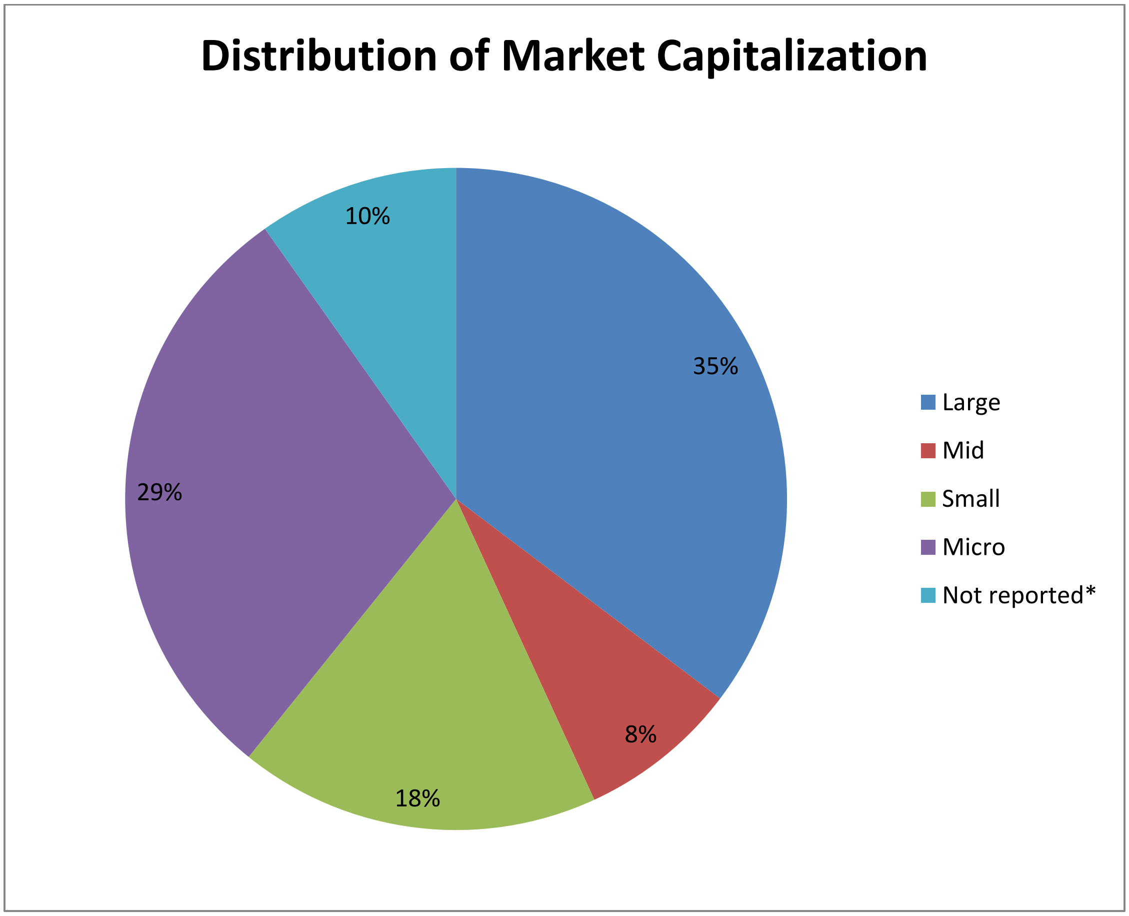
**Appendix A – Distribution of Market Capitalization for CAM Field Testing**[9]




*Some accounting firms opted not to provide this data as they believed it could lead to the issuer being identified.

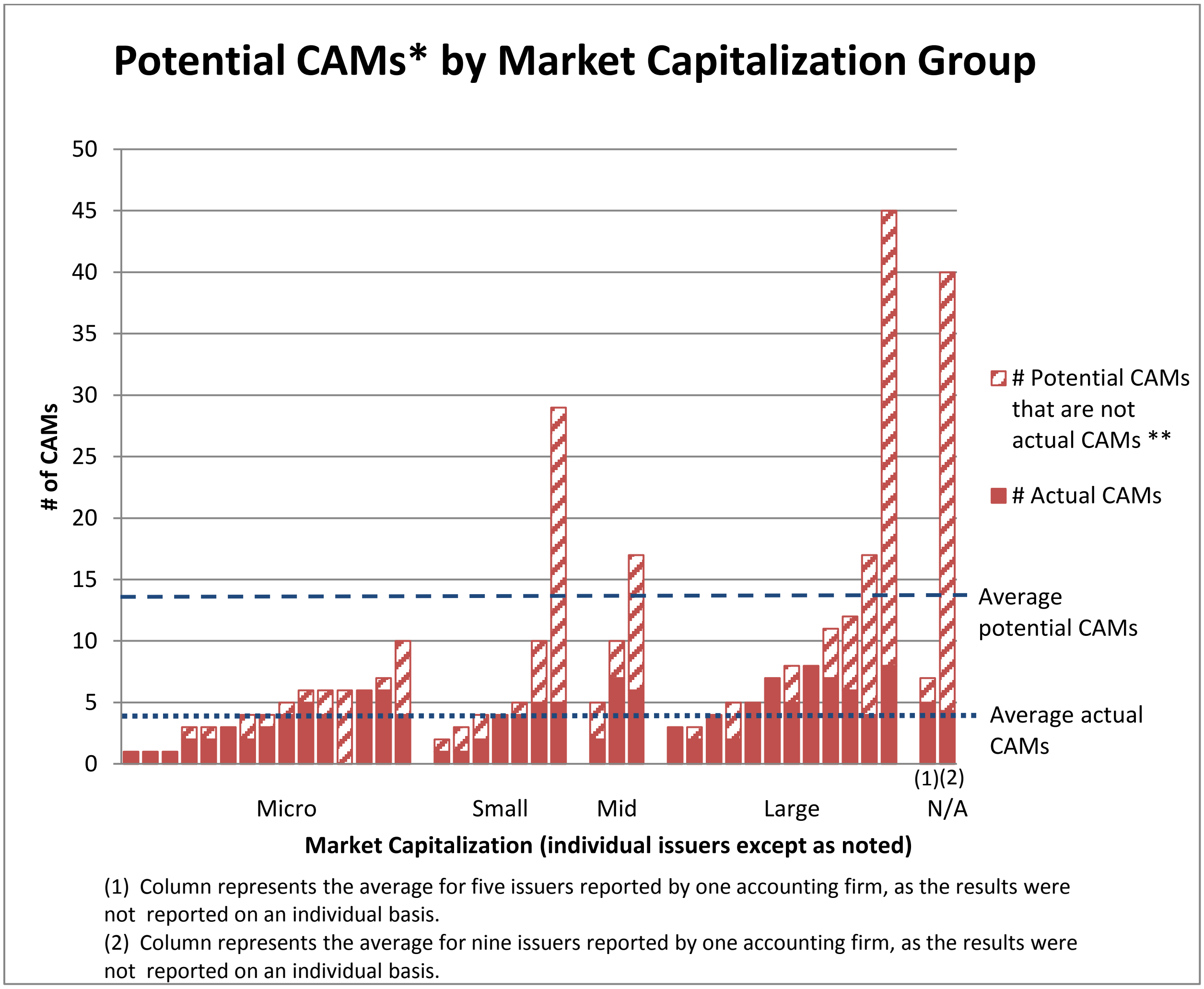
[9] Large-cap companies are those whose market capitalization value is more than $10 billion, mid-cap companies are those whose market capitalization value is between $2 billion and $10 billion, and small-cap companies are those whose market capitalization value is between $250 million and $2 billion. Micro-cap companies are those with a market capitalization value of less than $250 million.

**Appendix B – Primary Industry Classification for CAM Field Testing**

| Industry | Number of Issuers |
|---|---|
| Industrial & Consumer Goods | 8 |
| Financial Services | 8 |
| Pharmaceuticals & Biotech | 6 |
| Oil & Gas | 4 |
| Technology | 4 |
| Retail | 3 |
| Communications and Electronic Components | 2 |
| Professional Services | 2 |
| Real Estate Investment Trusts | 2 |
| Healthcare | 1 |
| Life Sciences | 1 |
| Publishing Services | 1 |
| Not Reported* | 9 |
| **Total** | **51** |

*Some accounting firms opted not to provide this data as they believed it could lead to the issuer being identified.

**Appendix C – Potential CAMs by Market Capitalization Group**




* "Potential CAMs" represents the entire population of matters considered in the process to determine CAMs, including those matters determined to be actual CAMs.

** "Potential CAMs that are not actual CAMs" represents the population of matters considered in the process to determine, CAMs but are determined not to be an actual CAM.

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December 30, 2013

PCAOB
Technical Director
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1666 K Street N.W.
Washington, D.C. 20006-2803

IAASB Chair
545 Fifth Avenue, 14th Floor
New York, New York 10017

**Re: Auditor's Reporting Model**

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC"),[2] appreciates the opportunity to comment on the Public Company Accounting Oversight's (PCAOB) and the International Auditing and Assurance Standards Board's (IAASB) (collectively referred to as "Boards") proposals to reform the auditor's reporting model.

CFA Institute is comprised of more than 100,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

## GENERAL COMMENTS

The IAASB and the PCAOB have issued separate proposals to improve the Standard Auditor's Report (SAR). CFA Institute is responding with a single letter to the Boards on these proposals since there are a number of overlapping issues and we believe that there should be a single globally relevant report to the extent possible. This would allow investors to compare audits of companies no matter in which region of the globe the auditor issues their report.

Our response is organized into discussions about what we see as the improvements needed to develop a single informative SAR. We observe that in many respects the individual proposals are similar but still contain some notable differences. For example, the PCAOB model does not contain provisions for going concern reporting and disclosure of engagement partner. The IAASB model anticipates future additional reporting for auditor responsibility and findings related to "other information", which is currently being considered in another project. The PCAOB model currently presents proposals for "other information" in their model. Although these matters are being addressed in separate standard setting initiatives, we

**1** With offices in Charlottesville, New York, Hong Kong, and London, CFA Institute is a global, not-for-profit professional association of more than 116,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 137 countries, of whom more than 108,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

**2** The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

believe that because they relate most directly to and are most consistent with a coordinated global approach.

Our response addresses the following areas:

- Investor/User support for enhancing the Standard Auditor's Report
- Retention of pass/fail model
- Key audit matters (IAASB)/Critical audit matters (PCAOB)
- Conclusions regarding going concern
- Auditor's statement regarding "other information"
- Identification of engagement partner

Responses to selected questions from each of the proposals are presented in Appendices A and B.

**Support for Enhancing the Standard Auditor's Report**

*CFA Institute Support for Changes to the Auditor's Reporting Model*

CFA Institute members have consistently supported efforts to enhance the quality, relevance and value of auditor reporting. As previously articulated in our letters to the IAASB and PCAOB we believe that improvements to the SAR are needed to advance a seriously outdated model for communication of important information to investors and other users regarding the auditor's professional examination of a company's financial statements. It is our belief that the SAR along with the financial statements and other narrative sections of an entity's financial report (i.e. management commentary, operating and financial review, etc.) should be considered part of a holistic communication of relevant information to investors to make informed capital allocation decisions. Significant efforts and investor-paid costs go into an audit, yet investors are provided very little information under the current SAR. Through increased transparency, a revised SAR will facilitate better analysis and heighten user confidence in the audited financial statements.

*CFA Institute Surveys Support Changes to the Auditor's Reporting Model*

CFA Institute has conducted multiple surveys[3] of our membership over several years on the importance of the SAR to investors and its information content. These surveys have consistently shown that the auditor's report is central to the analysis of financial statements, and should provide more information about the basis for the auditor's opinion.

The more significant survey findings regarding changes to the SAR are:

- Fifty-eight percent of respondents indicated that the auditor's report needs to provide more specific information about how the auditor reaches their opinion.
- Seventy-five percent of respondents believe that risk factors associated with measurement uncertainties in an entity's financial statements should be included in the independent auditor's report.
- A large majority of respondents indicated that more information regarding materiality, the auditor's independence, management's critical accounting judgments and estimates, and key areas of risk is important.

[3] CFA Institute, Usefulness of the Independent Auditor's Report, March 2011
http://www.cfainstitute.org/Survey/usefulness_of_independent_auditors_report_survey_results_march_2011.pdf
CFA Institute, Independent Auditor's Report Survey Results, March 2010
http://www.cfainstitute.org/Survey/independent_auditors_report_survey_results.pdf

These surveys consistently indicate that investors are not satisfied with the current "bare-bones" SAR and seek much more useful and qualitative information about the audit findings and process. Importantly, they also confirm that additional information from the professional auditor in the SAR is of much higher interest and value to an investor in addition to hearing more from the audit committee.

**CFA Institute Support for Retention of the Pass/Fail Reporting Model**
The current SAR has been commonly described as a pass/fail model since the auditor expresses an opinion on whether the financial statements are fairly presented (pass) or not (fail). This aspect of the SAR is beneficial because it is brief, clear, consistent and comparable. It benefits those investors who want to quickly scan the SAR for departures from the unqualified report. However, it has limited utility for those who desire a more thorough and complete understanding of the audit findings and the audit process. For this reason, we believe that the pass/fail element of the model should be augmented with substantive informative enhancements, explained below. Given the continued significance and relevance of departures from the pass/fail opinion, we believe that this should continue to be presented near the beginning of the audit report.

**Key Audit Matters (IAASB)/Critical Audit Matters (PCAOB)**
*Requirement to Report Critical Audit Matters*
Both of the Boards' proposals indicate that determining the audit matters to be reported is based on the auditor's professional judgment. The PCAOB model states that ordinarily these matters are of such importance that they are required to be (1) documented in the engagement completion document, (2) reviewed by the engagement quality reviewer, (3) communicated to the audit committee; or (4) any combination of the three. Specified audit guidance is provided for each of these items (i.e., AS No. 3 *Audit Documentation*, AS No. 7 *Engagement Quality Review* and AS No. 16 *Communications with Audit Committees*). The IAASB model specifies that the audit matters would be selected from a smaller number of matters, from the matters communicated with those charged with governance, based on the auditor's judgment about which matters were of most significance in the audit. This is also subject to specified audit guidance (i.e., ISA 260 (Revised) *Communication with Those Charged with Governance*).

Our principal concern is that the language used in the proposals prescribes a more subjective approach—what the auditor determines "key" or "critical" to be—rather than a more objective approach. The proposed subjective approach might easily allow an artful avoidance of providing any additional information whatsoever to investors. We fear the Lake Wobegone syndrome, where all issuers suddenly become above average and unremarkable from an audit perspective. Investors have been seeking specific information from the auditor for years, and giving more objective, prescriptive guidance is necessary to ensure that those specific matters are conveyed by the auditor.

The statements of PCAOB Member Steven Harris noted similar concerns:

> *Indeed, having the auditor concisely discuss a precise list of issues of interest to investors as suggested in the IAG survey and similar surveys by the CFA Institute, may well be preferable to a discussion of only issues that auditors, in their discretion, determine to be the most difficult, subjective or complex ones in an audit. Of course the two sets of issues may overlap, but they well may not. I believe we should be seriously considering a requirement that the auditors also report on "any matter that would otherwise be of greatest significance to a reasonable investor in understanding the import of the financial statements.*
>
> *Sir David Tweedie, the former Chairman of the International Accounting Standards Board and national technical partner of KPMG, suggested that investors should learn through the report: (i) what kept the auditor awake at night, (ii) what arguments the auditor had with the CFO, (iii)*

*what the big estimates are, (iv) what the contentious accounting policies are, and (v) what the going concern assumptions are?*

While these comments were made in the context of the release of the PCAOB proposal, we believe the concerns expressed equally apply to the IAASB proposal. We encourage the Boards to develop clear guidance that would not allow for important matters to go unreported.

*Comments on Content of Key Audit Matters (IAASB) and Critical Audit Matters (PCAOB)*
In previous proposals, the Boards considered a form of reporting on the audit by means of auditor commentary (IAASB) or auditor's discussion and analysis (PCAOB). We supported this in our previous letters as an acceptable means of communicating additional information regarding the audit findings and the audit process provided it was subject to professional accountability for quality. Our principal concern is that the information should be reported by the auditor, not the audit committee or otherwise construed to be reported by management.

Although we prefer an auditor commentary which we expect would draw in specific matters of importance in non-boilerplate language, we are supportive of the communication of key audit matters (IAASB) or critical audit matters (PCAOB) (herein, both are considered "audit matters") as an acceptable alternative means of communicating information about the audit.

In our previous letters, we indicated that investors would benefit from the information often contained in what is commonly referred to as the "audit completion document" wherein the auditor identifies all significant findings or issues and incorporates this upon completion of the audit. Our request was to have the auditor report the most relevant of these same matters, whether we refer to them as key or critical, in plain, non-boilerplate language. With this approach there would not be an increase in audit scope or additional procedures, rather the auditor would simply report what was done in the audit, using information already contained in the audit completion memo. As a cost/benefit matter, enhancing the SAR in this way, should not result in a materially significant increase in the cost of audit services. We would support the Boards' specific review and assessment of this issue.

Also as earlier expressed, CFA Institute believes that the following elements in addition to others as outlined in our previous letter should be considered key or critical and routinely reported:

- Audit Risk - Provide a discussion of significant risks identified by the auditor and include factors the auditor evaluated in determining which risks are significant and how they were audited and assessed. This risk assessment should include not only specific financial statement risks, but also the auditor's overall client risk assessment factors. Also discuss why the auditor views these risks as significant. We recommend the Boards present an objective list of audit risks, as a first step towards a type of risk-rating of audits that would be comparable across auditors and countries.
- Auditor Independence - Provide a discussion of any matters that were reported and discussed with the audit committee concerning independence of the audit partner or firm -presumably limited to negative issues.
- Auditor Materiality - Provide details about the quantitative and qualitative materiality levels and factors the auditor considered in establishing materiality levels.
- Assessment of Management's Critical Accounting Judgments and Estimates - Provide a discussion of the critical accounting estimates that were discussed with management or the audit committee, the assumptions underlying the critical accounting estimates, and the auditor's assessment of and findings associated with the evaluation of these critical estimates. This could also include a discussion of movements and ranges around critical estimates.

- Accounting Policies and Practices - Provide a discussion of:
  a. Discretionary changes in accounting principles or estimates affecting the consistency of reported amounts.
  b. Qualitative aspects of the company's accounting practices, financial statements and disclosures discussed with the audit committee or management.
  c. Material matters that, while in technical compliance with the financial reporting framework, could have enhanced disclosures to improve investor understanding of the matters.
  d. Significant unusual transactions in the current reporting period.
- Difficult or Contentious Issues, Including "Close Calls"- Discuss any difficult or contentious issues or "close calls" that arose during the audit and the final resolution of each issue.

*Comments on Instances Where There are No Critical/Key Audit Matters*
Both the IAASB and the PCAOB acknowledge that except in certain limited circumstances (expected to be rare), the auditor would not determine at least one audit matter to be reported. CFA Institute agrees that these conditions should be rare, however, each issuer should have at least one audit matter that would be deemed key or critical. Prescribing certain required communications as noted above may result in less transparent auditor reporting.

**Conclusions Regarding Going Concern**
CFA Institute agrees with the IAASB proposal that the auditor shall evaluate whether sufficient appropriate audit evidence has been obtained and conclude regarding the appropriateness of management's use of the going concern basis of accounting in the preparation of the financial statements. We agree that conclusions and observations regarding going concern should be separately and clearly identified in the audit report. A CFA Institute survey of the membership in March 2012 indicated that 92% of respondents supported this separate mention of going concern matters in the SAR. When the going concern basis is inappropriate or whether there is a material uncertainty has been identified that the auditor's report should qualitatively describe the uncertainties, conditions or events that have given rise to the doubt.

**Auditor's Statement Regarding "Other Information"**
CFA Institute supports additional reporting in the SAR for other information that would require the auditor to determine whether other information contains (1) a material inconsistency, (2) a material misstatement of fact, or (3) both. We believe that the auditor's determination should be limited to reading and considering other information and performing certain specific procedures based on relevant audit evidence obtained and conclusions reached during the audit. We understand that this is routine industry practice currently in the context of a standard integrated audit. We are not in favor of extending the auditor's responsibilities to providing separate assurance. If the auditor determines that there are material inconsistencies or misstatements of fact that are unresolved prior to issuance of the financial statements, these differences should be clearly communicated within the body of the auditor's report. We expect that there will be rare instances where differences will be unresolved.

We believe that clarifying the auditor's responsibilities and findings related to other information further enhances to usefulness of the auditor's report.

**Identification of Engagement Partner**
CFA Institute **is strongly in favor of mandating the disclosure of the engagement partner** (preferably by signature) in the auditor's report for audits of all entities. We agree with the IAASB's conclusion that disclosing the engagement partner's name improves transparency for users and perhaps more importantly, instills a greater sense of responsibility and accountability which ultimately translates to improved audit quality. This disclosure is already required in many jurisdictions throughout the world and standardizing this requirement will lead to further accountability.

CFA Institute has previously articulated our support for disclosing the engagement partner in our letter to the PCAOB in response to their Concept Release to require disclosure of the engagement partner. We refer you to that letter for a complete response and CFA Institute's rationale.

We urge both the IAASB and the PCAOB to require disclosure of the engagement partner. It is our preference that this disclosure be prominently displayed in the auditor's opinion, rather than through a link to the entity's website or included in some other regulatory filing. Investors and other users should have easy access to the information. We also believe that attaching it to the opinion, further accountability would be established.

**Improvements to the Auditor's Reporting Model Will Require a Cultural Shift**
In our previous letters to the Boards, we stressed that investor needs should be paramount when considering revisions to the auditor's reporting model. Requirements should be set with a view toward providing transparency and the most pertinent information possible for investors.

We believe that for meaningful changes to be effective, the reporting mindset of the audit committee, management, and independent auditors will need to undergo a cultural shift. The historical reporting relationship has tended to be viewed as the auditor reporting to the audit committee and to management, rather than as a communication to investors. Instead, the reporting considerations of the auditor should be directed to the user, since it is the users (i.e. investors) who foot the bill and approve the retention of the auditor, not management.

We appreciate the Boards' initiative in moving these proposals forward. They provide a vision and a workable path toward more useful and practical tools for finance professionals and investors around the globe. We acknowledge the transformational nature of these shifts and the inevitable industry resistance to change. Yet the markets and the world of finance have advanced so dramatically in terms of the complexity and speed of information in the past decade that all parts of the financial chain must improve and adapt. Auditing services should be no exception. We urge the Boards to be resolved in making these important improvements and stand ready to help as needed.

**Closing Remarks**

We thank the Boards for the opportunity to express our views on the Standard Auditor's Report. If the Boards have questions or seek further elaboration of our views, please contact Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

| | |
|---|---|
| */s/Kurt N. Schacht* | */s/ Ashwinpaul C. Sondhi* |
| Kurt N. Schacht, JD, CFA<br>Managing Director<br>Standards & Financial Markets Integrity Division | Ashwinpaul C. Sondhi<br>Chair<br>Corporate Disclosure Policy Council |

cc: CFA Institute Corporate Disclosure Policy Council

**PCAOB Questions** **Appendix A**

**Objectives**

1. ***Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?***
   We believe that objectives as stated should be sufficient to enable the auditor to understand the requirements for the audit report. However, we also believe that the objective should specifically identify that the investor is the main recipient of the report and that the report is intended to communicate entity-specific information. By highlighting an entity-specific approach boilerplate information will be reduced and/or eliminated.

**Basic Elements**

2. ***The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?***
   We believe that the auditor's report should be appropriately addressed to both the shareholders and the company board of directors.

3. ***The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?***
   We agree that any new standard on auditor reporting should retain the requirement for the report to contain a description of the audit. We agree with the PCAOB aligning this with the established risk assessment standards.

4. ***The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?***
   The proposal calls for the auditor to state that they are "required" to be independent with respect to the company in accordance with the United States federal securities laws and applicable rules and regulations of the PCAOB and SEC. We believe that a statement regarding independence is useful to investors and establishes a heightened sense of professional accountability.

   However, we note that stating that the auditor is "required" to be independent, rather than is "in fact" independent is a less than optimal positive statement. We believe a more definitive statement is preferable and adds further assurance that the auditor is independent.

5. ***The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.***

   a. ***Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?***
   We believe that auditor tenure is useful information to the investor, in that there could be instances where in the case of a newly appointed auditor, an investor may feel that the audit contains more risk. This may especially be the case where the new auditor may not have developed a complete understanding of the entity. Or in the case of a longstanding audit relationship, an investor may

question whether the auditor is as objective as possible. In other words, if the company has been a client for numerous years, the existing audit partner may not want to lose the client under his responsibility. This could render him less than objective when confronted with difficult or contentious issues.

b. ***Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?***
No comment.

c. ***Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?***
We are in favor of including the tenure information in the auditor's report in addition to EDGAR. This makes it less difficult for investors to access the information.

6. ***The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?***
We agree that the auditor's responsibilities for other information and the results of their evaluation should be clarified in the standard auditor's report. We emphasize that we are not in favor of expanding the auditor's responsibilities to provide assurance on the information, rather simply explain what they are presently required to do—and where there are material misstatements or inconsistencies, to explain them in appropriate detail. We believe that these instances will be rare since management is likely to correct the misstatements.

7. ***Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?***
We do not think that the ordering of the presentation of the basic elements required by the auditor's report is critical, provided that there are clear headings are used to indicate each section. We encourage the PCAOB and the IAASB to work together to arrive at a standard for both form and content.

8. ***What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?***
No comment.

9. ***What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.***
We are aware that some respondents may argue that the costs of implementing the proposed standards will result in an inordinate increase in costs. We agree with the following from the PCAOB proposal regarding costs:

*The Board would expect audit firms to incur minimal one-time costs that relate primarily to updating a firm's methodology regarding auditor reporting. These changes might not result in significant recurring costs because they involve standardized language that, once implemented, would be the same or very similar across different auditors' reports.*

We understand that initially the enhanced reporting could lead to an increase in costs as the auditor works through the language in the report with entity management and legal counsel. However, as noted in our previous letters, in accordance with the PCAOB Auditing Standard No. 3 paragraph 13, the auditor must identify all significant findings or issues in an engagement completion document. This document identifies and discusses the significant findings or issues and the basis for conclusions reached in connection with each engagement. We believe that the information in the completion memo should serve as the basis for identifying and reporting the information in the critical audit matters. Therefore, we are not suggesting any change in audit scope or additional procedures, rather that the auditor simply report what was done in conducting the audit, using information already largely contained in the audit completion memo. Increased costs in this regard ought to be minimal.

Finally with regard to costs, audit fees are paid for ultimately by the shareholders so to the extent that additional useful qualitative information can be supplied, investors would support reasonable additional fees.

**Critical Audit Matters**

10. ***Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?***
As noted in our opening remarks, we preferred reporting on the audit by means of an auditor's discussion and analysis. We supported this in our previous letter as an acceptable means of communicating additional information regarding the audit findings and the audit process provided it was subject to professional accountability for quality. Our principal concern was that the information should be reported by the auditor in a way that it is not construed to be reported by management.

We are supportive of the communicating the critical audit matters as an acceptable alternative means of communicating additional information about the audit. We believe that these key/critical matters that the auditor determines to be 1) the most difficult, subjective or complex audit judgments; 2) posed the most difficulty in obtaining sufficient appropriate evidence; or 3) posed the most difficulty in forming the opinion on the financial statements has the potential to inform the users of the areas of high audit risk. Discussing the critical audit matters in an entity specific, non-boilerplate manner will focus attention on issues that are essential to understanding the audit.

We question how the auditor will apply the guidance with respect to discussing the "most difficult" matters. For example, we think that the test should be those audit areas that were the most "significant". We are concerned that given the deep expertise most audit firms have, that "difficulty" could be too subjectively determined. However, "significant" could be a more reasonable threshold to apply. To this point, we believe that the IAASB proposal for "significant" matters appears to strike the right balance.

We are also concerned that the critical audit matters must not become routine boilerplate language. Industry similarities could result in similar or identical audit challenges, so that these should be limited to few matters.

11. ***What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?***
No comment.

12. ***Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what***

***would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?***

As mentioned above, we believe that using the word "difficult" could lead to a subjective application of the threshold. We believe that "significant" as defined by the IAASB would be a better determinant.

13. ***Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?***
    We believe that there should not be any significant additional time incurred by the auditor to identify and/or report critical audit matters. These matters should be identified as part of the normal course of conducting a high quality audit. One would expect that in today's environment that identifying these matters would not necessarily enhance audit quality given that they are a component of conducting the audit. However, by elevating these to specific reporting, overall quality should be enhanced.

14. ***Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?***
    Applying the requirements will require a significant amount of judgment. As mentioned we believe that there should be set requirements to report matters as noted in our General Comments. Users essentially want to hear directly from the auditor what is keeping them up at night written in an entity specific manner.

15. ***Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?***
    We are not in favor of the PCAOB prescribing that audit procedures be included as they relate to critical audit matters. The PCAOB should not necessarily exclude them; rather they should draft a standard which emphasizes that the auditor use their professional judgment on what should be included in the explanation of the critical audit matter. However, some brief explanation regarding how the critical audit matter was resolved could be beneficial to the users.

16. ***Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***
    No comment

17. ***Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***
    No comment.

18. ***Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?***
    No comment.

19. ***Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?***
    No comment.

20. ***Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?***
    No comment.

21. ***What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?***
    We do not believe that would be material additional costs for communicating critical audit matters. These matters should have already been elevated through the audit firm to the appropriate level of responsibility including the engagement quality reviewer. Furthermore, these matters should have been also communicated to those charged with governance (i.e., Board of Directors, Audit Committee, etc.).

22. ***What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?***
    No comment.

23. ***How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?***
    See previous comments.

24. ***Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?***
    We believe that there should be no differential reporting of critical audit matters in the cases of initial public offerings or for prior periods audited by other audit firms.

25. ***Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?***
    We believe that including realistic examples in the proposed standard should enable auditors to better apply the specific requirements. It is essential that the PCAOB test how users view the example disclosures as part of their re-deliberations. The examples shown in the Exhibit to Appendix 5of the Proposal on the surface appear reasonable and informative, but more extensive testing is essential with preparers, auditors and users.

26. ***What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.***
    No comment.

27. ***What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?***

No comment.

28. ***What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?***
    No comment.

**Explanatory Language**

29. ***Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?***
    No comment.

30. ***Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?***
    We believe that this option should be retained where matters should be highlighted that are not critical audit matters. Investors benefit from understanding an important matter deserving of emphasis and where it is disclosed in the financial statements.

31. ***Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?***
    Since the PCAOB has deferred a decision on communications regarding going concern, we believe that material uncertainties regarding going concern should be communicated.

32. ***Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?***
    No comment.

**Amendments to Other PCAOB Standards**

33. ***Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?***
    No comment.

34. ***What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.***
    No comment.

**Considerations Related to Audits of Specific Entities**

**Additional Discussion Related to the Proposed Other Information Standard**
CFA Institute supports additional reporting in the SAR for other information that would require the auditor to determine whether other information contains (1) a material inconsistency, (2) a material misstatement of fact, or (3) both. We believe that the auditor’s determination should be limited to reading and considering other information and performing certain specific procedures based on relevant audit evidence obtained and conclusions reached during the audit. We are not in favor of extending the

auditor's responsibilities to providing separate assurance. If the auditor determines that there are material inconsistencies or misstatements of fact that are unresolved prior to issuance of the financial statements, these differences should be clearly communicated within the body of the auditor's report. We expect that there will be rare instances where differences will be unresolved.

We believe that clarifying the auditor's responsibilities and findings related to other information further enhances to usefulness of the auditor's report.

**Considerations Related to Audits of Brokers and Dealers**
No Comments

**Considerations Related to Effective Date**
No Comments

**Considerations Related to Securities Act Documents**
No Comments

**Emerging Growth Companies**
No Comments.

**IAASB Questions** **Appendix B**

**Key Audit Matters**

1. ***Do users of the audited financial statements believe that the introduction of a new section in the auditor's report describing the matters the auditor determined to be of most significance in the audit will enhance the usefulness of the auditor's report? If not, why?***
As mentioned in our opening remarks that we prefer a more comprehensive auditor's commentary to provide entity-specific information regarding the audit. However, we believe that the identification of key audit matters selected from matters communicated with those charged with governance should provide users with more information about the most significant matters confronted by the auditor. We believe that this discussion will assist users in understanding the areas of significant management judgment, uncertainties, risks, etc.

   We do not believe that the standard should be overly prescriptive, but as mentioned in the opening remarks, we believe that certain matters should be discussed (e.g., audit risk, assessment of management's critical accounting judgments and estimates, auditor materiality, modifications of planned audit approach, etc.)

   Our principal concern is that the new standard is written in such a way so that the auditor would be required to disclose key audit matters.

2. ***Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide an appropriate framework to guide the auditor's judgment in determining the key audit matters? If not, why? Do respondents believe the application of proposed ISA 701 will result in reasonably consistent auditor judgments about what matters are determined to be the key audit matters? If not, why?***
No comment.

3. ***Do respondents believe the proposed requirements and related application material in proposed ISA 701 provide sufficient direction to enable the auditor to appropriately consider what should be included in the descriptions of individual key audit matters to be communicated in the auditor's report? If not, why?***
No comment.

4. ***Which of the illustrative examples of key audit matters, or features of them, did respondents find most useful or informative, and why? Which examples, or features of them, were seen as less useful or lacking in informational value, and why?***

   ***Respondents are invited to provide any additional feedback on the usefulness of the individual examples of key audit matters, including areas for improvement.***
We found that the examples of the key audit matters provided a reasonable explanation of the significant matters. We suggest that the IAASB field test the examples and solicit specific input from investors regarding the usefulness of the disclosure.

5. ***Do respondents agree with the approach the IAASB has taken in relation to key audit matters for entities for which the auditor is not required to provide such communication – that is, key audit matters may be communicated on a voluntary basis but, if so, proposed ISA 701 must be followed and the auditor must signal this intent in the audit engagement letter? If not, why?***

***Are there other practical considerations that may affect the auditor's ability to decide to communicate key audit matters when not otherwise required to do so that should be acknowledged by the IAASB in the proposed standards?***
We believe that key audit matters should be required for all entities, however, if the matters are voluntarily disclosed, we believe that they should be subject to the requirements.

6. ***Do respondents believe it is appropriate for proposed ISA 701 to allow for the possibility that the auditor may determine that there are no key audit matters to communicate?***
We believe that every audit should have at least one key audit matter to report. If an auditor determines that there are no key audit matters, this fact should be disclosed and the rationale. We also believe that these instances should be very rare.

***(a) If so, do respondents agree with the proposed requirements addressing such circumstances?***
We believe that by definition, each audit should have at least one key audit matter to communicate. However, should the IAASB determine that this will be permissible in very limited circumstances, then the auditor should expressly state that there were no such matters to report.

***(b) If not, do respondents believe that auditors would be required to always communicate at least one key audit matter, or are there other actions that could be taken to ensure users of the financial statements are aware of the auditor's responsibilities under proposed ISA 701 and the determination, in the auditor's professional judgment, that there are no key audit matters to communicate?***
We believe by definition, there should always be at least one key audit matter to report.

7. ***Do respondents agree that, when comparative financial information is presented, the auditor's communication of key audit matters should be limited to the audit of the most recent financial period in light of the practical challenges explained in paragraph 65? If not, how do respondents suggest these issues could be effectively addressed?***
Financial statement users are interested in comparability and as such, key audit matters should be discussed covering all periods presented. We believe updating the previous period key audit matters provide additional comfort to the user about the quality of the previous period presented.

8. ***Do respondents agree with the IAASB's decision to retain the concepts of Emphasis of Matter paragraphs and Other Matter paragraphs, even when the auditor is required to communicate key audit matters, and how such concepts have been differentiated in the Proposed ISAs? If not, why?***
We agree that the Emphasis of Matter paragraphs and Other Matter paragraphs should be retained to provide a mechanism to alert users to matters that would not otherwise be considered key audit matters. It is especially important that when these paragraphs are used, that they clearly clarify how they differentiate from the key audit matters. We agree that the most widespread use of this paragraph is normally associated with the material uncertainties associated with "going concern" assumptions which under the new proposal will be replaced by the going concern disclosure. However, we believe that Emphasis of Matter paragraphs are an appropriate means of highlighting where management discloses an important matter.

**Going Concern**

9. ***Do respondents agree with the statements included in the illustrative auditor's reports relating to:***

   ***(a) The appropriateness of management's use of the going concern basis of accounting in the preparation of the entity's financial statements?***

   ***(b) Whether the auditor has identified a material uncertainty that may cast significant doubt on the entity's ability to concern, including when such an uncertainty has been identified (see the Appendix of proposed ISA 570 (Revised))?***

   ***In this regard, the IAASB is particularly interested in views as to whether such reporting, and the potential implications thereof, will be misunderstood or misinterpreted by users of the financial statements.***

   CFA Institute is strongly in favor of expanded reporting by the auditor to include a specific section regarding going concern. In a survey conducted in March 2012, 81% of respondents said that the accounting concept of going concern is important in their analysis of a company. Also, 92% of respondents think that the independent auditor's report should identify the basis and reasons for their conclusion that the entity may not continue as a going concern. These disclosures are especially important in light of the global financial crisis.

   Disclosures in the auditor's report should include the following elements:

   - disclosures of risks that directly or indirectly affect the determination that there is a question as to whether the entity is a going concern.
   - disclosures on the expected courses of action that bear on the financial flexibility of the entity, and a reasonably detailed discussion of the entity's ability to generate sufficient cash to support its operations during at least the 12 months from the date of the financial statements.

10. ***What are respondents' views as to whether an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern should be required in the auditor's report whether or not a material uncertainty has been identified?***
    We are in favor of an explicit statement that neither management nor the auditor can guarantee the entity's ability to continue as a going concern. A statement such as this should narrow any expectations gap for users.

    We recognize that the accounting standard setters have active projects addressing going concern and that the active timelines for resolving these issues are still unclear. However, we believe that the IAASB and the PCAOB should continue to move forward with additional auditor reporting in this area and consider any accounting standards outcomes in the final decision for the auditor's report.

**Compliance with Independence and Other Relevant Ethical Requirements**

11. ***What are respondents' views as to the benefits and practical implications of the proposed requirement to disclose the source(s) of independence and other relevant ethical requirements in the auditor's report?***

We agree that the auditor's report be changed to include a statement that the auditor is independent of the entity within the meaning of the relevant ethical requirements or applicable law or regulation and has fulfilled their ethical responsibilities under those requirements.

**Disclosure of the Name of the Engagement Partner**

12. ***What are respondents' views as to the proposal to require disclosure of the name of the engagement partner for audits of financial statements of listed entities and include a "harm's way exemption"? What difficulties, if any, may arise at the national level as a result of this requirement?***
CFA Institute is strongly in favor of mandating the disclosure of the engagement partner (preferably in the form of signature) in the auditor's report for audits of all entities. We agree with the IAASB's conclusion that disclosing the engagement partner's name improves transparency for users and perhaps more importantly, instills a greater sense of responsibility and accountability which ultimately translates to improved audit quality. This disclosure is already required in many jurisdictions throughout the world, therefore standardizing this requirement leads to further accountability.

**Other Improvements to Proposed ISA 700 (Revised)**

13. ***What are respondents' views as to the appropriateness of the changes to ISA 700 described in paragraph 102 and how the proposed requirements have been articulated?***
CFA Institute agrees with the other improvements to the auditor's report which include:
- Improved description of the responsibilities of the auditor and key features of the audit.
- Reference to whom the entity is responsible for overseeing the entity's financial reporting process.
- Other reporting responsibilities to allow additional flexibility for national standard setters to determine how best to place the auditor's communication about the enhanced reporting requirements (i.e., key audit matters, going concern, other information, etc.).

We also agree that the IAASB should not mandate the ordering of the elements of the auditor's report, however each area should be specifically identified with headings.

14. ***What are respondents' views on the proposal not to mandate the ordering of sections of the auditor's report in any way, even when law, regulation or national auditing standards do not require a specific order? Do respondents believe the level of prescription within proposed ISA 700 (Revised) (both within the requirements in paragraphs 20–45 and the circumstances addressed in paragraphs 46–48 of the proposed ISA) reflects an appropriate balance between consistency in auditor reporting globally when reference is made to the ISAs in the auditor's report, and the need for flexibility to accommodate national reporting circumstances?***
We agree that the ordering of the sections of the auditor's report should not be mandated. We understand that this flexibility is needed in order to comply with the many different jurisdictions subject to the auditor's reporting model. We do not think that the ordering of the presentation of the basic elements required by the auditor's report is critical, provided that they are all contained in the auditor's report and clear headings are used to indicate each section.

We encourage the PCAOB and the IAASB to work together to arrive at a standard for both form and content.

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 34**
*THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION; THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT; AND RELATED AMENDMENTS TO PCAOB STANDARDS*

Dear Members and Staff of the Public Company Accounting Oversight Board:

Cherry Bekaert LLP welcomes the opportunity to comment on the Public Company Accounting Oversight Board’s (the PCAOB or Board) Release No. 2013-005, *The Auditor’s report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing audited Financial Statements and the Related Auditor’s Report; and Related Amendments to PCAOB Standards* (the Release). We recognize the desire of investors to receive additional information that might be useful to their decision making process and the unique roll and assurance that only the independent auditor can provide. We are committed to actively participating in efforts to improve audit quality that will enhance investor confidence in and their understanding of the audit process and the auditor’s responsibilities. However, we do not support all of the current proposals.

## A. Proposed Auditor Reporting Standard

### *1) Auditor Reporting of Critical Audit Matters (“CAMs”):*

We are concerned that the Board’s proposal to discuss critical audit matters (“CAMs”) in the auditor’s report will have an opposite effect on the Board’s desired objective to increase investor confidence through providing additional information. By highlighting those matters the auditor believes are most critical, it could be inferred by the user that the level of assurance for these matters is lower. However, the very purpose of the auditor’s risk assessment procedures including the analysis of significant management estimates and judgments is to develop audit procedures that will lower the risk to an acceptable level. The proposal does not require nor would we recommend that the auditor disclose what procedures the auditor performed to lower the risk. Rather the proposal only requires identification of the CAM, a description of why the auditor determined it was a CAM, and a reference to the accounts and disclosures in the financial statements. This is juxtaposed to the communication requirements of the recently effective PCAOB Auditing Standard 16 which requires communication to the audit committee among other things unusual transactions, significant estimates, and critical accounting policies which can raise a reader’s concern but also allows for a two-way iterative process whereby these concerns can be alleviated. Whereas the proposed changes to the auditor’s report could raise concern with no avenue for resolution. Thus the effect would only be to raise investor’s uncertainty while providing no additional assurance. In addition, we believe that in most circumstances, an informed investor should already be able to read the financial statements and reach their own judgment about the areas that an auditor would have considered more difficult to audit based on the degree of judgment necessary to develop the amount included in the financial statements or the complexity of the matter involved.

In addition, by highlighting only those matters that the auditor believes are critical the auditor is implying that other areas are not as critical which could be construed as stating that the other matters not explicitly noted do not have audit risk and are not important to an investor's decision. In the studies cited by the board (FN 39) the board acknowledges that the prominence of which information is displayed has investing implications. It is not the responsibility of the auditor nor should it be the responsibility of the auditor to inform investors as to what information is most important to their decision making. Providing or appearing to provide such information will likely lead to unanticipated reliance and potentially inappropriate litigation. Rather the auditor's responsibilities and the auditor's report has always been and should always be factual in nature. The purpose of the required disclosures in the codified accounting standards and those additional disclosures required by regulators is to provide useful information to investors. The purpose of the auditor is to attest to the material accuracy of that information and it is investor's responsibility to decide which information is most useful to their decision making. Moreover, under existing guidance those matters which are considered critical accounting policies and significant estimates are already required to be disclosed and audited.

The proposal also provides guidance on the source of CAMs including those matters documented in the engagement completion document, reviewed by the engagement quality reviewer, and those matters communicated to the audit committee. Yet the proposal also states that each matter noted in the aforementioned would not necessarily be considered a CAM. We believe that given the litigious nature of the U.S. operating environment and the risk adverse and conservative nature of our profession this requirement would lead auditors to conclude that all of the matters noted in the aforementioned audit documentation are critical thus increasing the length and complexity of the auditor's report thus decreasing the usefulness of the auditor's report or  potentially the reverse could happen and auditors would exclude such matters from quality review or communication to the audit committee so as to reduce risk of litigation. This correlation between risk adversity and excess disclosure is evidenced by the ever increasing risk factors included in many filers MD&A.

In addition the proposal would require auditors to document the rebuttable presumption that matters noted in the aforementioned audit documentation are not critical matters. Such increased documentation would be difficult and costly to create as it would require auditors to document why such matters were critical enough for quality review or communication to the audit committee yet not critical to enough to communicate the end users of the financial statements. A seemingly contradictory position especially considering the key purpose of this standard is to alleviate information asymmetry. The mostly likely result would be to include all such matters or incur significant costs in documenting such conclusions including multiple layers of review.

Lastly, the public disclosure and potentially negative perceptions of CAMs would likely lead management to prefer minimizing their inclusion in the auditor's report. This would likely lead to sharply contested discussions between management and the auditors regarding which CAMs to include in the auditor's report. The knowledge that these critical matters might potentially be disclosed will also likely impede the open dialog with management concerning problematic accounting issues which takes place during risk assessment and planning.

Given these concerns we cannot support the Board's proposal related to the inclusion of critical audit matters in the auditor's report.

### *2) Basic Elements of the Auditor's Report:*

We fully support improving the auditor's report by adding elements clarifying auditor independence requirements and the auditor's responsibilities regarding other information filed with the auditor's report and financial statements. We understand that some investors might not be aware of such requirements and responsibilities and an informative statement clarifying such would be helpful and inexpensive to implement. However, we disagree with the proposal to include information concerning auditor tenure. Such information is already available via review of historical filings including the required 8-K communications whenever a change in auditor occurs. In addition, such information can only serve to decrease investor confidence whether it be an investor that notes a short tenure thus potentially leading the investor to believe that the auditor lacks sufficient knowledge about the entity to conduct a thorough and quality audit or whether it be an investor that notes a long tenure thus potentially leading the investor to believe that the auditor lacks independence or professional skepticism. Moreover, it is the audit committee's responsibility to make judgments concerning the risk associated with auditor tenure. We believe that such a disclosure could potentially lead to an undue increase in auditor rotation. If more frequent rotation is a result of the inclusion of this information, we believe many firms that currently audit a small number of public entities may choose to exit this market due to the much higher costs imposed on them by more frequent rotation. This in turn will have the effect of reducing the level of competition and reduce the number of options available to Registrants when selecting their audit firm as well as increasing fees and ultimately the cost of capital.

## B. Auditor's Responsibilities Regarding Other Information

Our firm already performs many of the additional responsibilities noted in the proposal regarding other information contained in a document containing the auditor's report and financial statements. As part of the current requirement to "read and consider" we typically test the mathematical accuracy of computations and agree those amounts presented in such other information to the audited financial statements and footnotes when applicable. From this perspective the proposal would have little additional change or costs to our firm.

However, what is considered other information is disconcerting. Specifically, the inclusion of 1) All information incorporated by reference (exhibits); 2) All information incorporated by reference from the definitive proxy statement; and 3) Qualitative statements in the other information. We believe that inclusion of information incorporated by reference would create an undue burden on the auditor and increase the cost of providing audit services. Many times the information incorporated by reference is several years old, sometimes pertains to a period of time covered by the predecessor auditor, or relates to 8-Ks or other filings which currently auditors are not responsible to perform procedures over. The inclusion of qualitative statements is especially disconcerting because often times information contained in the MD&A and other information are more subjective or forward looking and not objectively verifiable. In addition, it is possible that this expansion of information to qualitative information may well lead to the auditor being held to a higher standard than management who actually authors the MD&A. Management has been provided a number of safe harbors with respect to certain types of information and, by expanding the auditor's role and responsibility to this information we perceive that there is a risk that the auditor may have some responsibility to information for which safe harbor rules with respect to management may apply.

Moreover, we expect that many firms and Registrants will find it costly and cumbersome to implement the proposed new requirement that other information not only be compared to the audited financial statements and footnotes but also that other information not directly related to the audited financial statements be compared to audit evidence obtained. During the course of an audit an enormous amount of information is obtained. Not all such information is useful to the audit of the financial statements. If the Board is proposing that all information outside of the financial statements and footnotes be tested for material misstatement of fact by comparing to any information obtained during the audit then this will likely lead to auditors testing all such information. Rather than risk that support for other information was indirectly obtained as part of normal audit procedures to test other balances and not used to test the other information because the auditor was unaware that it had such support auditors will instead audit all such other information in the document. For example, if a detailed general ledger was obtained as part of journal entry testing then would it be the auditor’s responsibility to test the material misstatement of fact for anything presented in the other information that can be agreed to the detailed general ledger or other support even if not presented in the financial statements or footnotes? This scenario would essentially require that all information presented be agreed to support. This will lead auditors to perform procedures similar to those employed in comfort letters for all amounts included in the MD&A and we believe this will increase audit costs.

We appreciate the opportunity to comment on the proposal. If you have any questions, please contact us at (704) 377-1678.

Sincerely,

Cherry Bekaert LLP

/s/ Raymond R. Quintin
Raymond R. Quintin, CPA
Technical Director of A&A Professional Practices, Cherry Bekaert LLP

Chevron

**Matthew J. Foehr**
Vice President and
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December 12, 2013

Via email to comments@pcaobus.org

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

**Re: PCAOB Rulemaking Docket Matter No. 34 – Release No. 2013-005**

Chevron Corporation (Chevron) appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board (PCAOB) on the two new proposed auditing standards and related amendments to current standards addressing the auditor's reports on audited financial statements – Rulemaking Docket Matter No. 34: *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Position; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; And Related Amendments to PCAOB Standards.*

Chevron is a global, integrated energy company based in San Ramon, California. The company explores for, produces and transports crude oil and natural gas; refines, markets and distributes transportation fuels and other energy products; manufactures and sells petrochemical products; generates power and produces geothermal energy; provides energy efficiency solutions; and develops the energy resources of the future, including biofuels. The company's activities are widely dispersed geographically with operations in North America, South America, Africa, Asia, Australia and Europe.

We support the PCAOB's efforts to develop audit standards that enhance the usefulness of corporate reporting to the investor. Re-iterating the core principle put forth in our September 21, 2011 comment letter on the concept release, while there may be some opportunity for improvement within the current auditor's report to clarify what an audit represents and what an independent auditor's responsibilities are, we strongly believe that it is management's responsibility to provide investors with information about the company and the financial statements. We believe that the proposal requiring the audit report to include Critical Audit Matters (CAMs) does not support that core principle and would not provide value-added information to the investor. We are also concerned that the proposed extension of the auditor's report to include the evaluation of information, such as the Management Discussion and Analysis (MD&A), in the annual report other than core financial statements would expand evaluation to strategies, forward looking statements, risks and litigation, which are difficult to audit.

**Critical Accounting Matters**

We support the PCAOB's decision to retain the "pass/fail model" and believe that the current requirements regarding the auditor's reporting of material items are functioning effectively. However, we do not believe the auditor's report should include CAMs, when the opinion overall is unqualified, for the following reasons:

The proposed structure for the CAMs would mean that the auditor's report would contain discussion on matters that were fully resolved through the established channels of internal control including internal and external audit, the Board Audit Committee, and management certification of the report. We do not believe that calling out key events and difficult judgments separately in the auditor's report would serve to clarify the technical and subjective matters to the investor or support the corporate reporting function. Highlighting only a few matters for discussion in the auditor's report would suggest to the investor those are areas where the results reviewed and approved by management are not as certain.

We also believe the company-specific factors proposed to be communicated via the CAMs are covered in both the Management's Discussion and Analysis portion and in the Notes to the Consolidated Financial Statement section of annual report, including discussions of Critical Accounting Estimates and Assumptions, Summary of Significant Accounting Policies, New Accounting Standards, and in the Results of Operations. We do not believe that this proposed format will provide new or meaningful information to the investor. In addition, including CAMs in the auditor's report conflicts with the expressed interest by both the FASB and SEC for companies to produce annual reports with more concise and meaningful content.

We are also concerned that the additional processes to determine and fully document which of the matters should be included as a CAM and why each was, or was not, included in the auditor's report would require significant additional effort by the audit staff, external reporting, management and the Board Audit Committee. This could not be accomplished within the window for filing without reducing the time available to assure the quality of the financial audit and the core reporting. We also expect these proposals would result in significant additional costs to the company given the extra time and resources required to meet the requirements from both external audit and corporate staffs.

**Reporting on Other Information**

The proposed standard addressing the expansion of auditor's responsibility from the "read and consider" if other information is materially consistent with the annual report to "read and evaluate" and further, to include a summary evaluation in the auditor's report, may pose more questions than answers. For example, an evaluation of the information in the MD&A section would cover many different types of data including strategies, forward-looking statements, risks and litigation. This type of data is not conducive to normal evaluation procedures as it is based on the best judgment of management and is often difficult to predict, unlike the audit of the financial statements and corresponding notes which reflect the actual transactions based on accounting standards. We believe it would be very difficult to communicate in the auditor's report precisely which data and statements were evaluated. In addition, following on the comment above, this would add steps to be accomplished during a limited window and we do not believe these steps would improve the overall quality of the results.

To summarize, we believe the core role of the independent auditor should continue to focus on completing the audit effectively and enhancing its communication with management and the Board Audit Committee, within existing standards, which we believe to be adequate.

* * *

If you have any questions on the content of this letter, please contact Al Ziarnik, Assistant Comptroller, at (925) 842-5031.

Very truly yours,

Matthew J. Foehr

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CIRRUS LOGIC®

December 11, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 34

Dear Board Members,

Cirrus Logic appreciates the opportunity to comment on the PCAOB Rulemaking Docket Matter No. 34 – *"Concept Release on Possible Revisions to PCAOB Standard Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards"* dated June 21, 2011.

We appreciate the Board's efforts to consider changing the audit reports for financial statements to enhance the usefulness for the investor community. We acknowledge the concerns addressed in the concept release and agree that investors should receive useful and relevant financial information on a timely basis. However, we do not support the Board's proposals in their current form.

We are concerned that the Board's proposal to discuss critical audit matters (CAM) in the auditor's report may be construed as an implicit qualification of the audit creating a perception that there may be weaknesses or deficiencies in management's judgment, financial statement estimates or internal control environment. The pass/fail model has served constituents well precisely because an opinion is expressed on the financial statements taken as a whole. While we strongly support the decision to retain the pass/fail model, the subjective nature of the definition, interpretation and ultimately the description in the auditor's report of CAM's increases the likelihood that users may perceive different levels of assurance on different areas of the financial statements. If the perception of the auditor opinion is compromised, all stakeholders will be ill-served as corporate governance, auditor independence and user investment decisions could be adversely impacted.

Intelligent users of financial statements understand that extensive information related to matters that may qualify CAMs is already available in existing disclosures. Quarterly and annual financial reports filed with the SEC already include extensive disclosures of critical accounting policies, significant estimates, business and operating trends, as well as financial operating risks. Given the litigious environment in the U.S., preparers are often reluctant to remove existing disclosures. Moreover, due to the nature and sheer volume of these disclosures, a meaningful portion may occur outside of the periodic SEC filings. While sophisticated users understand and know how to find these disclosures, all of this contributes to a complex patchwork of disclosures that may hinder the casual user's ability to fully comprehend the information that is readily available. Accordingly, we believe any user frustration regarding the audit process is symptomatic of a larger issue, disclosure overload, that the Board should address with the SEC and other standard setters and regulators to develop a more robust, transparent and user friendly disclosure framework.

Many entities operate in complex industries with unique challenges based on the prevailing business or economic climate. During the course of an audit, auditors naturally many encounter areas that involve difficult, subjective or complex judgments that require communication to the audit committee, consultation with experts or require extensive documentation. We are concerned that the practical application of the identification, documentation and justification of conclusions regarding inclusion of CAMs in the auditor's report will result in an overabundance of caution by the auditors. In other words, auditors will be motivated to include more rather than less CAMs in the auditor's report to avoid being second guessed during the PCAOB inspection process. Consequently, the auditor's report, at the expense of clarity of the auditor's opinion, will inappropriately become a mechanism to communicate matters of importance or significance related to an entity's financial reporting.

Financial statement users may confuse the roles of the auditor, management and the audit committee. Management is responsible for preparing and filing all financial reports. The financial reporting process is overseen by the audit committee, which oversees a reporting entity's accounting policies, internal controls, financial reports and the audit process. The auditor should never be the first source of information, provide disclosure of information that is not otherwise required to be disclosed by management or have the appearance that it is making financial reporting decisions on behalf of management. Any confusion of these roles could undermine both the reporting entity's corporate governance as well as the auditor independence.

It is also likely that reporting entities will incur incremental costs associate with the increased documentation requirements as auditors will now be compelled to justify in their work papers why certain items either qualify or do not qualify as CAMs. When coupled with the potential harm to investors, corporate governance and auditor independence, we do not see any incremental benefit to users from the Board's proposal. Notwithstanding the Board's stated objective, it appears that the practical purpose of the Board's proposal is to highlight significant disclosures and risks for users of financial statements. Given the level of disclosure information that is already available to users and the cost involved, we cannot support the Board's proposal.

A second point in the proposed audit standard relates to reporting on other information. We agree that users may benefit from a clearer articulation in the auditors' report of the auditors responsibility for the other information in annual reports filed with the SEC. However, we are concerned that the Board has proposed a more stringent standard of auditor involvement with other information. Rather than "read and consider," the auditor is required to "read and evaluate" whether other information is materially consistent with the audited financial statements. It is unclear to what extent the Board intended to substantively change the auditor's responsibilities relate to other information or if the Board simply intends to enhance users' understanding of auditors' existing responsibilities related to other information. If it is the Board's intent to substantively change the auditors existing responsibilities, we encourage the Board to consider whether it is necessary for users to expect auditors to provide incremental assurance on other information as rigorous and effective procedures already exist to ensure other information is materially consistent with the audited financial statements.

Current laws and regulations require CEO and CFO certification of disclosure required in the annual and quarterly reports, as well as the establishment of disclosure controls. Public companies are subject to independent audit committee oversight of annual and quarterly financial reporting. Moreover, many disclosures outside of the primary financial statements, such as in the MD&A, are more subjective or forward looking. These disclosures are based on management's analysis and insights and often may not be objectively verifiable. We believe it would be extremely difficult for the auditors to evaluate this information effectively. Given the inherent limitations associated with such an increase in the auditor's scope, and the difficulties this would pose to both auditors and management, it may be necessary to curtail the amount or type of information disclosed in the MD&A, ultimately reducing the overall insight and benefit to users. Lastly, questions regarding the auditor's independence may also surface as an increased level of assurance on subjective or forward looking information may be seen as advocating or challenging the decisions of management.

We do not believe the increase in audit fees, as they would invariably be raised due to these increased requirements by the auditors, as well as any indirect costs related to increased management time and focus, justify a change in scope. While we support clarification of the auditor's report to explain the auditor's responsibilities related to other information, we do not support the proposal as written. We encourage the Board to retain the existing requirement to "read and consider" and revised the proposed language in the auditor's report accordingly.

We appreciate the opportunity to comment on the proposal. If you have any questions, please contact me directly at 512-851-4547.

Regards,

Thurman K. Case
Chief Financial Officer
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December 11, 2013

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

Subject: *PCAOB Rulemaking Docket Matter No. 034*

Dear Board:

The Audit Committee of Cisco Systems, Inc. ("Cisco") appreciates the opportunity to comment on the PCAOB's proposed two new auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, and in addition, the related amendments to existing PCAOB standards (the "proposals").

As members of the audit committee of a large U.S. public company, we are responsible for ongoing oversight and independent appraisal of the financial reporting process and have a critical role in corporate governance. Therefore, we are very focused on ensuring that financial information is understandable, transparent, accurate and reliable. Similarly, we strongly support effective communication of financial information and understand that high-quality information is foundational to enhancing investor confidence.

The proposals are intended to "provide information that is specific to a particular audit" and "increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report". Outreach performed by the PCAOB has indicated that some investors are not satisfied with the content of the existing auditor's report, but believe the "auditors have unique and relevant insight" to provide "early warning signals regarding potential issues" and "knowledge that would assist them when making their investment decisions."

**Overview**

We support the PCAOB's decision to retain the existing pass/fail model on opinions on financial statements, which will continue to provide a clear and unambiguous message for investors and other users of financial information. While we also support the PCAOB's objectives to improve the informational value of the auditor's report and to include additional language that clarifies the nature and scope of the audit, we do not support proposals that would alter existing reporting responsibilities for disclosing information about the company. We are concerned that the proposals may have the unintended effect of reducing transparency and critical dialogue within the corporate governance framework. Similarly, while some of the proposals are not intended to require additional audit effort, we expect that these proposals will result in significant additional audit procedures in the aggregate, which would unnecessarily lead to a combination of increased costs, added pressure on reporting deadlines, and potential dilution of audit quality resulting from the auditor's broader scope.

**Critical Audit Matters**

The proposals would require the auditor to communicate in the auditor's report "critical audit matters" addressed during the audit. Critical audit matters include matters that (1) involved the most difficult, subjective or complex auditor judgments, (2) posed the most difficulty to the auditor to obtain sufficient audit evidence, or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. This communication is intended to provide investors and other financial statement users with "previously unknown information about the audit."

Within the existing corporate governance framework, the audit committee has a very active role in the financial reporting process. At Cisco, we have a robust process for reviewing financial information each quarter, which includes regular interaction with management and our auditors through ongoing, open communication. Each quarter, Cisco's disclosure committee meets three times to review the Form 10-Q/10-K prior to filing with the Securities and Exchange Commission (SEC). The disclosure committee is comprised of senior management from several functional areas, the Chief Accounting Officer, internal counsel, investor relations, and various finance and other functions of the company and includes reviews with the Chief Executive Officer and Chief Financial Officer. Additionally, both our external counsel and auditors attend the disclosure committee meetings. The audit committee also meets twice a quarter with management and our auditors to review the financial information prior to filing. This process ensures that all relevant information about material items is readily available and thoroughly discussed among key stakeholders.

In our view, requiring auditors to independently report critical audit matters may result in some unintended consequences such as limiting the information exchange and the level of involvement by both the audit committee and the auditors in disclosure committee meetings if management is concerned that information may be separately reported in a manner or format that does not appropriately convey the needed context or detail. Additionally, as judgment is required to identify critical audit matters, we are concerned that inconsistencies would exist in the nature or extent of topics discussed.

It is also important to consider that the disclosure of Critical Accounting Estimates is an existing component of Management's Discussion and Analysis (MD&A). It is highly likely that a disclosure of critical audit matters would include some or all of the areas involving critical accounting estimates. Repeating the same information in the auditor's report does not add significant value for users and may actually create confusion. As noted in the proposals, existing PCAOB standards provide for emphasis paragraphs that can be utilized today by auditors to highlight critical audit matters.

We would also like to emphasize that it is the responsibility of the company's management to provide information about the company. The role of the auditor is to attest to this information. To the extent investors and users of financial statements have information needs that are not currently met through established financial reporting requirements, those needs should be raised for consideration in future standard setting and policy-making initiatives through the appropriate regulatory bodies. It is key to understand that the independent audit firm is involved in the financial reporting process and their feedback and perspectives are integrated and reflected in the company's filings.

**Auditor Reporting on Other Information**

The proposals are intended to "improve the auditor's procedures and enhance the auditor's responsibilities" with respect to information outside the financial statements within an annual report filed with the SEC under the Exchange Act (including Selected Financial Data, MD&A, exhibits, and certain information incorporate by reference). This would be accomplished by focusing the auditor's attention on the identification of material misstatements of fact or material inconsistencies between the information outside the financial statements and the company's audited financial statements.

We do not support increased audit procedures or reporting beyond those currently required to "read and consider" other information in certain documents that also contain the audited financial statements and the related auditor's report. Beyond the increased costs that would result from any incremental audit procedures, we are concerned that investors and other users will not properly understand the limitations associated with the "evaluation" of other information, especially in the context of non-financial, qualitative and forward-looking information in the MD&A. Until there is clear evidence of demand among investors and other users for additional audit procedures on information outside the financial statements, we believe the auditor's report should not be modified to suggest additional audit procedures beyond those currently required under existing PCAOB standards. We do not believe that it is in the best interest of shareholders to burden them with increased costs without a clear understanding of the problem statement and benefits that will be attained.

## Elements of the Auditor's Report

The proposals would include "Auditor tenure" as a new element of the auditor's report and require disclosure of the year that the auditor began serving as the company's auditor. Consistent with our feedback on the PCAOB's Concept Release on *Auditor Independence and Audit Firm Rotation*, we are not aware of a clear linkage between the tenure of an audit firm and that firm's independence. Likewise, we do not believe that audit tenure is an indicator of audit quality and do not believe that this new element will bring added value to the auditor's report.

On the other hand, we do support clarifications to existing elements of the auditor's report that would improve users understanding of the nature of an audit, the auditor's responsibilities, and the purpose of the auditor's report. However, we suggest that the PCAOB not only improve the wording in the auditor's report, but also consider other mechanisms to raise public awareness of these important aspects.

## Concluding Remarks

We support the PCAOB's continued outreach activities and encourage additional public roundtables with stakeholders to further discuss the merits of the proposals. These discussions are of utmost importance not only from a cost/benefit perspective, but also to ensure that the role of the audit committee and auditors is neither compromised nor diminished inadvertently. It is equally important to clearly demonstrate to investors and other users of financial statements that it is management's responsibility to communicate information about the company.

We thank the PCAOB for the opportunity to provide our comments on the proposals. If you have any questions regarding our response or would like to discuss our views in further detail, please feel free to contact us.

Sincerely,

Steven M. West

On behalf of the Audit Committee of Cisco:
Steven M. West, Chair
Roderick C. McGeary
Arun Sarin, KBE
M. Michele Burns

CITRINCOOPERMAN
Attest & Assurance | Tax Compliance & Research | Specialty & Consulting

December 10, 2013

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

Reference: PCAOB Rulemaking Docket Matter No. 034

Ladies and Gentlemen:

Citrin Cooperman & Company, LLP ("Citrin Cooperman") is pleased to provide comments on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Proposed Auditing Standards (collectively the "Proposed Standards"): *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard").

Citrin Cooperman respects and supports the Board's mandate to protect the interests of investors and further public interest in the preparation of informative, accurate and independent reports.

Thank you for the opportunity to provide you with our viewpoints on the Proposed Standards. We would be pleased to discuss our comments with members of the Board or its staff.

Very truly yours,

Citrin Cooperman & Company, LLP

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**OVERVIEW**

We have summarized our views on three areas of the Proposed Standards. Our thoughts supporting these views are further discussed in the section entitled "Our answers to specific questions."

**1. Critical audit matters**

We find the Board's proposed auditor reporting standard to be thought-provoking. However, we are concerned that the outcome is likely to be additional paragraphs in an auditor's opinion that are lengthy and may become "boiler plate" over time. For the reasons discussed in the section of this response entitled "Our answers to specific questions," we believe that the proposed auditor reporting standard will unnecessarily focus investors' attention on specific areas of the audit without enabling investors to gauge the efficacy of the auditor's response to those "problematic" audit areas. Further, we believe that the added disclosures of critical audit matters may have the unintended consequence of diluting the value of the "pass/fail" opinion model. Finally, we are concerned that focusing investors on selected critical audit matters could expose the auditor to unintended litigation issues.

While we agree that enhanced communication of matters deemed significant to the financial reporting process is warranted, we would like to see the regulatory community, including the Securities and Exchange Commission ("SEC") and the PCAOB, develop a platform that would enable investors to communicate directly with issuer management in a forum that provides a reasonable framework for issuer management to respond to such direct inquiries in a questions and answers ("Q&A") format, and that this be made available on an issuer's website or a website sponsored by the issuer.

**2. The evaluation of other information by the auditor**

We do not support the Board's proposed other information standard. The proposed other information standard would, in our judgment, expand the auditor's role with respect to the evaluation of other information in the documents that accompany financial statements, and we don't believe that the Board's overall desire to help achieve a reduction in the information asymmetry between issuer management and the public or increasing the informational value of the auditor's report would be achieved by the proposed other information standard.

**3. Applying the Proposed Standards to other registered businesses**

The Board has asked for comments on three types of businesses that we feel well-suited to comment upon: registered brokers and dealers, registered investment advisors, and Emerging Growth Companies.

Registered brokers and dealers are unique because of the high level of interaction with regulators and the high level of disclosure to the public. We believe that it is appropriate to assume that investors can identify important facts and trends about brokers and dealers, including their track record of compliance and complaints. This information is useful in evaluating the management environment and serves to mitigate the need for additional disclosures in the auditor's report. We also believe that due to the unique nature of brokers and dealers, it is again appropriate to believe that financial statement users have been made aware of critical audit matters that are addressed through existing financial statement disclosure and presentation requirements.

Investment companies are unique because the nature of their business is focused on investments. As a result, many of the financial statement disclosures about investment companies emphasize the risks inherent in the investment portfolio of the investment company.

We feel that the PCAOB need not apply the Proposed Standards to brokers and dealers and/or investment companies for the reasons stated in our responses to questions 35 and 38, which are in addition to our comments described above concerning critical audit matters and other information.

Without altering our views expressed herein with respect to the Proposed Standards, we support the application of the Proposed Standards, in their final form, to Emerging Growth Companies. Investors in these companies deserve and need the same disclosures as are provided by other issuers.

## OUR ANSWERS TO SPECIFIC QUESTIONS

The following comments reflect our views in response to certain questions raised by the PCAOB.

### Questions and Responses Related to Section III

**Question 6:** Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?

**Response:** We believe that the PCAOB should not require the auditor to evaluate the other information for material inconsistency or material misstatement of fact.

We acknowledge the PCAOB's comment on page 20 of PCAOB Release No. 2013-005 (the "Release"):

> "Under existing PCAOB standards, the auditor has a responsibility to 'read and consider' other information in certain documents that also contain the audited financial statements and the related auditor's report; however, there is no related reporting requirement to describe the auditor's responsibility with respect to other information."

However, we believe that it would become necessary for the auditing profession to develop standards or best practices to perform procedures that would be appropriate to document the evaluation of additional information, including, but not limited to, its accuracy and completeness. This would, in our judgment, entail a very significant amount of additional work to be performed, and we do not see this additional work reducing the information asymmetry between issuer management and the public or increasing the informational value of the auditor's report.

In addition, it is not clear what the term "evaluate" is intended to convey to the reader of the auditor's report. We have read the illustrative language for the auditor's comments on other information on page A1-16 of the Release. We believe that the illustrative paragraph, as drafted by the Board, could be misunderstood by investors and other financial statement users by implying that the auditor did more work with respect to the other information than is intended to convey. The paragraph offers the reader a form of negative assurance, which is based on evidence and conclusions.

### Question and Responses related to Section V

**Question 10:** Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?

**Response**: We believe that the Proposed Standards, which have been written by the PCAOB after thoughtful discussion and consideration, include innovative ideas. The goal, which is to promote more efficient capital allocation and lower the average cost of capital, is a positive one. The method of achieving that goal, to reduce the level of information asymmetry between management and investors with the intent of increasing the relevance and usefulness of the auditor's report, is also positive.

However, we have the following concerns about the proposed requirement to disclose critical audit matters in the auditor's report:

1. We do not believe that the auditor should be disclosing information to financial statement readers about the registrant that hasn't previously been reported by management.

2. Readers of the auditor's comments about critical audit matters may begin to view the opinion as a "piecemeal opinion." This is because the auditor's report will begin to emphasize specific audit areas rather than the financial statements taken as a whole.

3. The public is likely to misunderstand critical audit matters. Critical audit matters may be interpreted as problems when in fact the auditor believes that the audit procedures have sufficiently addressed these risk areas. The public is likely to lose sight of the fact that if the auditor cannot perform sufficient procedures in order to obtain proper audit evidence, a modification to the auditor's report would be required.

4. The intention of communicating critical audit matters is to provide the reader with a focus on aspects of the registrant's financial statements that the auditor found to involve the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements. We refer the Board to the response by Mr. Beresford. We agree with Mr. Beresford's comments on this topic.

We believe that there are significant similarities between the requirements that management must disclose in their required management discussion and analysis ("MD&A") section and critical audit matters. Management is already required to disclose in the MD&A a separate section relating to accounting estimates and assumptions that may be material to accounting measurements. As a result, we believe critical audit matters would encompass all significant disclosures in the MD&A concerning accounting matters. This is likely to result in the disclosure of more critical audit matters than are needed out of concern that an auditor's judgment will be second guessed by regulators.

As a result of these concerns, we cannot support the disclosure of critical audit matters in the auditor's opinion.

**Question 11:** What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?

**Response**: Benefits: We agree that a reader of financial statements may learn facts about the issuer and its management that they might not otherwise have known.

Unintended consequences are difficult to know in advance. However, we believe that there is a likelihood that:

- Investors may be misdirected by comments in the "critical audit matters" narrative. It is likely that some investors may inappropriately perform less due diligence to understand an investment. An investor may focus on an audit risk detailed in the critical audit matters and fail to perform sufficient research to identify other business risks that are no less important.

- We believe that management, audit committees and auditors will face new challenges in terms of how much proprietary information should be disclosed. While management, audit committees and auditors are likely to agree upon reasonable disclosures for the investing public, there is a another group, the investors, who may demand more information than issuers and their auditors believe is appropriate to disclose. The boundaries for these disclosures are not known and could easily result in costly litigation to resolve.

**Question 15:** Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?

**Response**: Without altering our views expressed in question 10, we feel it would be helpful for us to respond to this question in the event that the disclosure of critical audit matters is required by the Board. The actual audit procedures that are performed are a matter of auditor judgment. We do not believe that a reader's understanding of a critical audit matter will be enhanced by the disclosure of the auditor's procedures. Also, we believe that it is unlikely that the goal of reducing the level of information asymmetry between issuer management and investors will be furthered by such a disclosure.

**Question 28:** What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation?

**Response**: Although liability in private litigation cannot be predicted, we feel that the potential for exposure to liability would increase significantly. We believe this is why commenters have already written that auditors will be inclined to write lengthy disclosures in a boiler plate fashion with the goal of reducing the risk of litigation.

### Questions and Responses Related to Section VIII

**Question 35:** Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?

**Response**: We do not feel it is appropriate for audits of brokers and dealers to be subject to the Proposed Standards. To the credit of the SEC and self-regulatory organizations such as Financial

Industry Regulatory Authority ("FINRA"), there are a number of regulatory activities that take place that are designed to protect the investing public.

1. Brokers and dealers are not issuers.

   As a practical matter, brokers and dealers are not issuers. As stated on pages A5-58 and A5-59 of the Release, the PCAOB's Office of Research and Analysis ("ORA") stated that their research indicated:

   > "There are no issuers among the approximately 4,230 brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012."
   >
   > "That ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team."

   These facts indicate that the users of financial statements are generally not making decisions to invest in brokers and dealers as issuers, but are often using the annual audited financial statements to be assured that it is safe to use the broker or dealer to conduct its investment transactions and in some cases that it is safe to permit the broker-dealer to have custody of their funds and securities. We respectfully believe that the Board should consider the broker dealers' interaction with and oversight from regulators, described below, as a safeguard that provides enhanced protection to the users of financial statements of brokers and dealers.

2. Interaction with and oversight from regulators.

   There is significant interaction with and oversight from regulators, such as the SEC and FINRA, surrounding brokers and dealers. In addition, there is a high level of public disclosure about businesses and individuals that deal with the public.

   Brokers and dealers file Financial and Operation Combined Uniform Single Report (FOCUS reports) at least quarterly; many file monthly if their minimum net capital is at a high level. The level of minimum net capital is a reflection of perceived operational risk. FOCUS reports include balance sheets, income statements and other operational measurements of financial condition. In addition, all brokers and dealers file quarterly Statements of Supplemental Income that include more details about results of operations. It is not unusual for responsible personnel at brokers and dealers to receive inquiries from regulators about the reasons for fluctuations and unusual amounts that are disclosed in these reports.

   We are not stating that the involvement of regulators is a substitute for audit procedures. But we do ask that the PCAOB consider these two items: 1) the requirement that financial statements of brokers and dealers be audited; plus 2) the benefits to the public arising from the regulatory interaction with brokers and dealers, which results in important disclosures to investors. We ask that the PCAOB consider that these two items be viewed as a combination of factors that mitigates the need for the Proposed Standards as they may relate to brokers and dealers.

For the above reasons, we do not agree that the Proposed Standards should apply to brokers and dealers. We would encourage the Board to consider these processes of interaction and disclosure. They are in place to protect the public.

While we do not agree that the Proposed Standards should apply to brokers and dealers, we do believe that if the PCAOB decides that the Proposed Standards should apply, they should only be applied to those brokers and dealers that have custody of customer funds or securities.

**Question 38:** Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?

**Response**: Investment companies are currently required to include as part of their financial statements a Condensed Schedule of Investments, as well as Financial Highlights particular to the funds. In addition, there are significant disclosures about the valuation of the assets pursuant to ASC 820 which are clearly important to the reader. We believe that it is reasonable for investors and the public to believe that these significant areas have been addressed by the auditors, and that restating these items as critical audit matters in the auditor's report is unlikely to provide additional benefits to the users of the financial statements.

Accordingly, we are not certain that the Proposed Standards' additional disclosures in the auditor's report would add value to the investor.

For purposes of the Proposed Standards, affiliated investment companies are defined on page A5-60 of the Release as other investment companies registered by a sponsor that generally would have the same or related investment advisers. The document containing annual shareholder reports of investment companies will have the same fiscal year-end and will generally contain a single auditor's report that refers to the financial statements of each audited investment company. We believe that the conclusions that we reached in the preceding paragraphs would be the same for affiliated investment companies, for the same reasons.

With respect to master-feeder funds or fund of funds capital structures, page A5-60 of the Release also notes that SEC Staff guidance requires that the annual report of each feeder fund generally contain financial statements of both the master and the feeder fund. Once again, our conclusion is that it is reasonable for investors and the public to believe that the significant areas related to the risks inherent in the investment portfolio of investment companies have been addressed by the auditors.

## Questions and Responses Related to Section XI

**Question 29:** Is the Board's effective date appropriate for the proposed other information standard? Why or why not?

**Response**: The Proposed Standards and amendments would be effective, subject to approval by the SEC, for audits of financial statements for fiscal years beginning on or after December 15, 2015. We believe that such timing should be sufficient for issuer managements and auditors to consider the implementation of the Proposed Standards once they are finalized, assuming a timely release of the final standard. We encourage the Board to consider establishing an effective date that allows at least eighteen months to implement. For example, if the final standard is published on June 15, 2015, we believe it would be appropriate for fiscal years beginning on or after December 15, 2015.

## Appendix 7 – Emerging Growth Companies ("EGCs")

**Question 1:** Should the Proposed Standards and amendments be applicable for audits of EGCs? Why or why not?

**Response**: We feel that investors in EGCs, as defined in the JOBS Act, are entitled to the same protections as afforded to investors in other registrants. The JOBS Act takes important steps to enable qualified new businesses to reach out to investors. These newly qualified investors will be taking investment risks. Therefore, we see no reason to provide less information to investors in EGCs than is available to investors in other issuers should the PCAOB implement all or parts of its Proposed Standards.

Peter Clapman
3 Valley Rd.
Scarsdale, NY 10583
Email: pclapman@verizon.net

December 5, 2013

Dear Board Members,
I am writing to express my support for the PCAOB proposed rules regarding enhanced disclosures to investors with respect to information provided in the independent audits of issuers. I believe that these rules, particularly those relating to critical audit issues, would enable investors to better understand the financial reports they receive.

I express these views from the perspectives gained from 32 years experience as former Chief Investment Counsel, with TIAA-CREF, the largest pension system in the world with over $500 Billion in assets. As former Chairman of the International Corporate Governance Network for a 3-year period, I was able to see how global investors look at the role of the auditor and the importance of their independence to investor protection. Over the past 20 years, there have been many instances of failure. Although there have been vast regulatory changes over this period, many investors still see the need for further improvements in the regulation of audit firms and how the audit is performed. The proposed rules are well crafted to achieve enhanced audits for the benefit of investors.

I do wish to comment more particularly on the new item being proposed, which would inform investors how long a period the audit firm has served. It is obvious that such a requirement imposes no additional cost to anyone in the audit chain. In assessing audit firm independence, many investors, including this investor, consider the tenure of the audit firms to be important information. So, why not provide it?

Some commentators who approach the issues from professional disciplines or experience other than the investment field argue that investors do not need this information, or worse yet, would be unable to properly understand the significance of the information. With due respect, I suggest that such views underestimate the ability of investors to decide what is relevant information to them and how to use such information in the investment process. To make the point more clearly: investors, not others, should decide which information is important and valuable to investors. Of course, on many issues, costs to provide certain information must be taken into account. On this issue, however, there are no costs.

In conclusion, I support the proposed additional disclosures to investors as advancing investor protection. I also believe auditor tenure is an important issue and see no countervailing consideration that should prevent such information from being disclosed.

Respectfully submitted,

Peter Clapman

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December 23, 2013

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

Re: PCAOB Release No. 2013-005; Rulemaking Docket Matter No. 034; *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

Ladies and Gentlemen:

The Public Company Accounting Oversight Board (the "Board" or "PCAOB") has solicited public comment on two proposed auditing standards and other matters discussed in PCAOB Release No. 2013-005 (the "Release") dated August 13, 2013. We appreciate the opportunity to comment on the Release and the important issues it raises.

## I. Introduction

We welcome the Board's continued efforts to make the financial statements and the related auditor's report more relevant to investors. As we discussed in our prior comment letter in respect of PCAOB Release No. 2011-003, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (June 21, 2011) (the "2011 Release"),[1] our perspective on these matters is informed by our role as legal advisers that represent issuers and others in connection with a wide variety of matters. These matters include advising issuers on their reporting obligations (including

[1] Comment letter of Cleary Gottlieb Steen & Hamilton (Oct. 14, 2011) (the "2011 Comment Letter"), available at http://pcaobus.org/Rules/Rulemaking/Docket034/149_Cleary_Gottlieb.pdf .

financial disclosures); advising issuers and underwriters in connection with a wide variety of capital markets transactions; and advising issuers, investors, acquirors, financial advisors and others in various corporate transactions. Financial reporting, including its reliability and relevance, is often a critical element of these matters, and our involvement requires us to be intimately familiar with (and, frequently, closely involved in) the financial reporting process.

The Board's two proposed auditing standards set out in the Release would significantly affect the role that auditors play in providing information about public companies to investors and other users of financial statements. The proposed standards are, first, a standard addressing the auditor's report on an audit of financial statements (the "proposed auditor reporting standard"), which would modify the content and format of the existing auditor's report and would, in particular, require the auditor to provide information with respect to both "critical audit matters" and its evaluation of "other information"; and second, a standard addressing the auditor's responsibilities regarding "other information" in certain documents that contain audited financial statements (the "proposed other information standard"), which sets out the responsibilities an auditor would have to review and evaluate such other information.

As we stated in the 2011 Comment Letter, in all of the contexts in which we consider financial reporting matters, we are dedicated to the full and fair disclosure – including, in particular, financial disclosure and reporting – called for by the federal securities laws, transparency to investors and markets, and the improvements in financial disclosure and reporting that are fostered by the application of robust auditing standards by independent external auditors. Like the 2011 Release before it, the Release identifies the investment community's concern that auditors may possess information that is useful to investors and other financial statement users that is not communicated in the existing auditor's report. And we believe that attempting to improve the relevance of the disclosures made by auditors continues to be a laudable objective.

As we separately noted in the 2011 Comment Letter, however, we also strongly believe the Board should keep in mind several important principles when considering any changes to the auditor's report and the processes and interactions that may result from those changes:

- First, any change to the auditor's role or report must have a significant probability of improving financial reporting or investors' understanding of an issuer's financial reporting;

- Second, if there is additional original information regarding an issuer that should be disclosed, that disclosure should be the responsibility of, and should come from, the issuer and not the auditor or any other third party;

- Third, any change to the auditor's reporting model should not adversely impact the relationship and the structure of interactions among management, the audit committee and auditors as they have developed since the enactment of the Sarbanes-Oxley Act of 2002 and the related implementation of regulations and standards adopted by the Securities and Exchange Commission (the "Commission") and the PCAOB;

- Fourth, while the Board is seeking to enhance the value of the auditor's report, the importance of the current pass/fail model should not be underestimated, and any changes to the auditor's report should not undermine the pass/fail model; and

- Fifth, the benefits of any path pursued by the PCAOB should outweigh the costs.

For various reasons, we are concerned the proposed auditor reporting standard, while in some ways representing an improvement from certain of the possible approaches discussed in the 2011 Release, continues in certain important respects to depart from these principles. The proposed other information standard – which goes significantly beyond the audit standard currently applicable to such information – raises particular concerns for a number of reasons, including an uncertain benefit to investors, ambiguous scope, increased costs and heightened litigation risk. We describe our concerns with both proposals in greater detail in Section II below. In Section III below, we propose an alternative to the proposals, which we request the PCAOB consider rather than adopting the standards as proposed. In particular, we believe revising the auditors' reporting model to encompass a review of what issuers disclose regarding critical accounting policies and estimates would, as discussed in Section III, be of far greater value to investors; preserve the primacy of issuer, rather than auditor, disclosures; avoid undermining the value of the pass/fail model; create fewer liability concerns; and be much less costly to implement.

## II. The Proposed Audit Standards Raise a Number of Significant Concerns

We are concerned the Board's two new auditing standards, as proposed, would have a number of serious, negative implications for auditors, issuers and, in some cases, even users of financial statements. These concerns relate to, among other things: the likelihood an auditor would be required to provide additional original information about the issuer, including immaterial or unnecessarily prejudicial disclosures, in responding to the proposed standards; undermining the existing pass/fail auditor's report model; chilling communications between an issuer's auditor and its management and audit committee; potential confusion among users of financial statements as to the scope and materiality of any new disclosures; heightened litigation exposure for both auditors and issuers; and the likelihood of significantly increased costs without commensurate benefits in terms of more meaningful financial reporting.

### *A. The Proposed Auditing Standards Would Represent a Significant Expansion of Existing Disclosure Regarding Issuers that Would Be the Auditor's, Rather than the Issuer's, Responsibility and, Worse Still, Would Require Disclosures that May Not Be Material to Investors or Are Unduly Prejudicial to the Issuer.*

One of our greatest concerns with the proposed standards is that, as proposed, they would require the auditor to disclose, and to be the source of, a significant amount of additional original information about an issuer. Indeed, this would appear to be an unavoidable consequence of the proposed requirement to include in the report information regarding critical audit matters. By contrast, under the existing auditor reporting model, original disclosures by an auditor (for example, a qualified opinion or an attestation that internal controls over financial reporting are not effective) generally occur only if an issuer has not complied with accounting principles or disclosure requirements.[2] Any change to the auditor reporting model should, we believe, otherwise keep the responsibility for disclosure about an issuer where it belongs, with the issuer.[3]

In addition, we are concerned that, as specifically contemplated by the Release, the additional disclosures an auditor would be making may be either not material to investors or unnecessarily prejudicial to issuers. In the Release, the Board stated that describing considerations around a critical audit matter could require the auditor to disclose "information about the audit or the financial statements that otherwise would not be required to be disclosed by either the auditor or the company under existing auditor reporting standards or requirements of the applicable financial reporting framework."[4] This result would be unfortunate. It would result in required disclosure by auditors (rather than issuers) not simply of information about issuers, but of information about issuers that may be neither material nor statutorily required, and that should not be required to be disclosed *by anyone* under *any* requirement, including a PCAOB standard.

*1. Information Disclosed Pursuant to the Proposed Auditor Reporting Standard May Not Be Material to Investors.*

Issues relating to "new" disclosures being made by the auditor will unavoidably arise insofar as the proposed auditor reporting standard requires the communication in the revised auditor's report of "critical audit matters."[5] As stated in the Release's proposed definition of critical audit matters, that disclosure would focus on the matters the auditor addressed during the relevant audit that involved the most difficult, subjective or complex auditor judgments, or posed the greatest difficulty to the auditor in obtaining sufficient appropriate evidence or in forming its opinion on the financial statements. Paragraph 9 of the proposed auditor reporting standard sets out a non-exclusive list of factors the auditor would need to take into account when determining whether a matter is a critical audit matter.

But the importance or materiality of an audit matter to what is reported in the issuer's financial statements is not specified as a factor in determining whether an audit matter is significant or critical. Indeed, most of the factors specified in proposed paragraph 9 relate to matters having to do with the audit process generally, rather than matters related to the significance of the impact of the audit matter on the financial statements.[6] As a result, under the

[2] We believe the "going concern" qualification, which can be original information in an auditor's report, is anomalous and in any event should not be viewed as the basis for wholesale inclusion of additional original information in an auditor's report.
[3] As we noted in the 2011 Comment Letter, the Treadway Commission's 1987 report squarely placed the primary responsibility for an issuer's financial statements on management, and made clear that independent public accountants play a secondary role.
[4] Appendix 5 of the Release, p. A5-42.
[5] For the reasons set out in Section II.D below, we think auditors will rarely if ever make "new" substantive disclosures about the issuer under the proposed other information standard.
[6] For example, the proposed factors include the degree of subjectivity involved in determining or applying audit procedures, the nature and extent of audit effort required and the nature and amount of available relevant and reliable evidence, as well as matters such as the extent of specialized skills needed to apply audit procedures and the nature of consultations outside the audit engagement team. Release, p. A1-7.

proposed definition, matters may be determined to be critical audit matters that are not material – and may not even be particularly meaningful – to the financial reporting or other financial disclosure of the issuer. It may not even be possible for an investor to distinguish whether a critical audit matter is, in fact, material from the issuer's standpoint.[7]

An appropriate "fix" for this consequence of the proposal would be to require explicitly in the process for identifying critical audit matters that the auditor consider the materiality of the impact of the audit matter on the issuer's financial statements and other financial disclosure, and conclude the audit matter relates to material elements of that disclosure, in order to be a critical audit matter. Such a change would not, however, address the broader point regarding auditor disclosure of original information about issuers.

*2. Information Not Otherwise Required to Be Disclosed or that May Be Unduly Prejudicial to Issuers Could Be Disclosed by Auditors Pursuant to the Proposed Auditor Reporting Standard.*

Regardless of whether a particular piece of information currently held by the auditors might in some way be probative, we believe disclosure of that information by the auditor should not be required if that disclosure would be more harmful or prejudicial to the issuer than its probative value. The Release states explicitly – and illustrates, via PCAOB-prepared sample disclosure – that an auditor may be required to make new disclosures beyond those mandated under the current financial reporting framework, including disclosures that apparently run contrary to current regulatory intent. We believe this would be an unfortunate and inappropriate result.

In Hypothetical Auditing Scenario #3,[8] the issuer has experienced a control deficiency less severe than a material weakness. The sample disclosure of the critical audit matter explicitly references that deficiency, stating that "…it was necessary [for the auditor] to expand the planned audit procedures due to a control deficiency less severe than a material weakness …. Specifically, a control deficiency was determined relating to the controls employed by the pricing and valuation committee."[9] The current rules of the Commission and those of the PCAOB, however, do not contemplate disclosure by an issuer (or an auditor) of a significant deficiency (or any other control deficiency not rising to the level of a material weakness). In fact, when proposing to define "significant deficiency," the Commission noted that "[t]he purpose of management's obligations with respect to significant deficiencies … is to disclose those matters relating to [internal control over financial reporting ("ICFR")] that are of sufficient importance that they should be reported to the external auditor and to the audit committee so that these parties can more effectively carry out their respective responsibilities with regard to the company's financial reporting, but which do not require disclosure to

[7] We believe it likely that, under the proposed standard, even if a critical audit matter addresses immaterial aspects of financial reporting, both issuers and auditors will prefer the auditor not be the sole source of the information disclosed in the auditor's report, which in many cases may lead issuers to revise their disclosures to include a discussion of any matter identified as a critical audit matter, regardless of materiality.
[8] Appendix 5 of the Release, p. A5-74 *et seq.*
[9] Appendix 5 of the Release, p. A5-78.

investors. (*Emphasis added.*)"[10] The Commission's expressed intent under the ICFR disclosure framework is that a control deficiency that rises only to the level of a significant deficiency is not required to be disclosed in a company's public filings. That conclusion is entirely consistent with the overall tenor of the discussions around ICFR disclosure, that public disclosures be limited to material weaknesses to avoid conflating material and immaterial disclosures to investors. The proposed auditor reporting standard would, however, apparently represent a "back door" requirement of the PCAOB for disclosure contrary to a settled disclosure policy. Further, there is no reason the same approach suggested in Scenario #3 would not be applied to a control deficiency that does not represent even a significant deficiency, the disclosure of which would be even less likely to be consistent with existing rules. By going beyond the approach reflected in the current requirements, this result would risk the same conflating of material and immaterial matters that has heretofore appropriately been avoided. And this auditor disclosure requirement about an issuer's ICFR would be imposed even if the issuer itself had determined the disclosure was unnecessary.

Another example where the proposed disclosure of a critical audit matter could add to the mix of information about an issuer that is publicly available, but in a way that is more prejudicial to the issuer than probative, is in the context of disclosures around potential loss contingencies. Under the current standard set forth in Financial Accounting Standards Board ("FASB") Accounting Standards Codification Topic 450 and related FASB interpretations, a company must accrue a liability for a loss contingency if available information indicates it is probable a loss has been incurred and the amount of the loss can be reasonably estimated. If the estimate is a probable range of loss, the best estimate within that range (or, in some cases, the minimum amount in the range) must be accrued. Recent proposals to update this standard were widely debated and roundly criticized for failing to adequately take into account the realities of today's litigation environment, because they required a company to disclose quantitative and qualitative information that could be highly prejudicial to its litigation posture.[11] The process of auditing loss contingencies often involves difficult, subjective or complex auditor judgments, and privilege and other concerns can pose challenges for issuers in providing evidence relating to determinations about loss contingencies made by issuers. At the same time, however, the very same issues that were raised by the recent FASB proposal would apply to the disclosures an auditor might be required to make in explaining in its auditor's report why this determination is a critical audit matter. Indeed, the proposed auditor reporting standard will likely raise additional concerns, because it might require (or be interpreted as requiring) an auditor to describe loss contingencies for which the issuer had determined neither an accrual nor disclosure of reasonably possible loss was required.

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[10] SEC Rel. No. 33-8811; 34-55930, p. 5 (June 20, 2007). In the related adopting release, the Commission stated that "[i]n proposing the definition, we believed that the focus of the term 'significant deficiency' should be on the communications required to take place among management, audit committees and independent auditors." SEC Rel. No. 33-8829; 34-56203, p. 9 (Sept. 10, 2007). The PCAOB's relevant Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, similarly requires the auditor to communicate any significant deficiencies identified only to the audit committee.

[11] *See, e.g.*, FASB, Exposure Draft, Proposed Accounting Standards Update, Contingencies (Tope 450), Disclosure of Certain Loss Contingencies, File Reference No. 1840-100 (July 20, 2010), and the summary of the 339 comment letters received on the proposal published by the FASB as of October 26, 2010, both available on the FASB's website at www.fasb.org.

The auditor reporting standard as proposed thus has the potential to (or, more accurately, is designed to) require an auditor to disclose original information about an issuer, even if that information may only be relevant to the audit process and not material to the financial statements or other financial reporting of the issuer or is otherwise too prejudicial to the issuer to justify incremental disclosure.

### *B. Disclosure of Critical Audit Matters Will Necessarily Undermine the Pass/Fail Nature of the Current Auditor's Report.*

The negative, though speculative, implications of the new critical audit matter disclosure will necessarily undermine the pass/fail nature of the current auditor's report. Although the Release makes clear that auditors are prohibited from including language in their reports that could be viewed as disclaiming, qualifying, restricting or minimizing the auditor's responsibility for matters deemed critical audit matters, or on the auditor's opinion regarding the financial statements, it is far from clear how that would work in practice or whether it would address our concern regarding preservation of the value of the pass/fail model. If, for example, a critical audit matter involves a valuation requiring an exceptional amount of professional judgment and few (or no) clearly identifiable data points, should that be viewed as an appropriate description of the circumstances surrounding the identification of a critical audit matter, or would it be viewed as a disclaimer?

In short, we are concerned the discussion of critical audit matters is likely implicitly to qualify the pass/fail nature of the current auditor's report, by calling into question the reliability of the information that is the subject of a company's critical audit matters. Notwithstanding the uncertainty as to what these disclosures would mean, they can be expected at least to convey that caution (whether warranted or not) should be applied regarding financial disclosures that were difficult to verify.

### *C. Disclosure of Critical Audit Matters May Weaken Comparability of Disclosures Among Issuers and Inappropriately Shift Investor Focus.*

The inherent variability in the number, subject matter and, most importantly, materiality of the critical audit matters disclosed by each issuer may cause investors to focus unduly on those matters and to inappropriately compare issuers on the basis of whether and the extent to which those matters have been identified. Because each critical audit matter would be determined based on unique facts and circumstances, disclosures may vary significantly between an issuer and its competitors, or from period to period with respect to the same issuer. Even when the same critical audit matter is identified across multiple issuers, there may still be no way to determine whether such a matter is material to some, none or all of them, or merely involves a similar set of difficult-to-determine factors driving the criticality determination. Again, notwithstanding the uncertainty as to the meaning of these disclosures, we are concerned about the provision to investors of information in the auditor's report that calls comparability into question, whether or not these distinctions are significant (and, indeed, the distinctions are in the last analysis necessarily insignificant in importance where the auditor provides an unqualified opinion).

***D. The Requirement to Disclose Critical Audit Matters May Chill Auditor/Board Communications.***

As described in greater detail above, the proposed auditor reporting standard would potentially require the auditor to disclose "new" information about an issuer that management has affirmatively chosen not to disclose and is not otherwise required to be disclosed under the securities laws or the Commission's regulations. Such information may be quite sensitive. Anything that risks interfering with the most open and robust communications among management, audit committees and auditors would be to the detriment of the relationship between issuers and auditors, and ultimately potentially to the detriment of investors. We strongly believe maximizing the openness of communications between management, audit committees and auditors is more likely to produce better financial reporting and disclosure than the questionable benefits of the additional disclosure provided by the proposed standard.

***E. The Proposed Other Information Standard Generally Will Not Give Rise to Additional Disclosure; Not Enable Financial Statement Users to Know What Information Has Been Evaluated; and Requires Auditors to Pass On Matters Outside the Scope of their Expertise.***

The proposed auditor reporting standard would require disclosure of the auditor's responsibility for, and evaluation of, certain other information,[12] pursuant to the proposed other information standard. This would represent a significant departure from the current auditor's report, which only requires the auditor to express an opinion as to whether the financial statements present fairly, in all material respects, the financial position of the company in conformity with generally accepted accounting principles. The proposed standards, by contrast, would require the auditor to expressly state both that it had evaluated the other information and whether or not it has identified any material inconsistency with the financial statements or material misstatement of fact.[13] But the likely result in almost every circumstance will be the same as under the current standard – if auditors have concerns about disclosure, they will discuss them with issuers; issuers, which can revise their disclosures at any time before the auditor issues its report, will make such changes, if any, as are appropriate; and the auditor's report will state that no such item has been identified, thus requiring no additional disclosure to be made by the auditor.

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[12] "Other information" is defined in the Release to include information (other than the audited financial statements and the related auditor's report, but including certain specified information that is incorporated by reference) included in a company's annual report filed with the Commission under the Securities Exchange Act of 1934 (the "Exchange Act") (*i.e.*, its Form 10-K, Form 20-F or similar form). The Release notes, however, that this evaluation is based on "relevant evidence obtained and conclusions reached during the audit." Release, p.7. Accordingly, if such "other information" is not directly related to the audited financial statements, is non-financial in nature or is related to the company's operations, the auditor may not have obtained evidence or reached any conclusion regarding that information during the audit – and, accordingly, would not be required to reach any conclusion with respect to it.

[13] Under the proposed standard, if the auditor has identified a material inconsistency with the financial statements or a material misstatement of fact, it must discuss the issue with management and may, depending on management's response and the circumstances of the statement or inconsistency, be required to advise the audit committee; consider any obligations it may have under Section 10A of the Exchange Act; withdraw from the audit engagement; or include appropriate disclosure in its auditor's report.

This change would, we believe, adversely impact the current auditor reporting model, with no likely benefit for the reasons stated above. Existing AU Section 550, *Other Information in Documents Containing Audited Financial Statements* ("AU 550"), already provides a sufficient check by the auditor on inaccurate disclosure and strikes an appropriate balance by requiring the auditor to read and consider the "other information" contained in issuer filings and, if it identifies concerns regarding that information, to report those concerns to management (and, if necessary, the audit committee, or, in particularly problematic cases, to consult with counsel or withdraw from the audit engagement). But AU 550 does not require the auditor to notify third parties of any concerns it may identify, nor does it place the auditor in the role of "evaluating" non-financial information. And since the auditor communicates its findings under AU 550 only to the issuer, the current standard has no need to define "other information" or to distinguish between financial and non-financial information (nor does it attempt to do so).

*1. As a Practical Matter, the Proposed Other Information Standard Will Rarely if Ever Give Rise to Additional Disclosure.*

The Release makes clear that an auditor may state it has not identified a material inconsistency with the financial statements or a material misstatement of fact in the other information in circumstances where the auditor identifies something in the course of the audit process and management subsequently makes what the auditor considers appropriate revisions before the auditor's report is issued.[14] In reality, therefore, in all but the most extreme cases the auditor will be in a position to state that no material inconsistency or material misstatement has been identified at the time the auditor's report is issued. Auditors and issuers will work together to rectify any errors that may be uncovered (as they do today in connection with inconsistencies or misstatements identified in connection with the procedures required under AU 550). As a result, in few if any cases will the proposed other information standard result in additional information for investors.

*2. Investors Will Have No Way to Determine What "Other Information" in an Issuer's Filings Has Been Evaluated by the Auditor.*

Because, as noted above, the proposed standard contains an unnecessary public disclosure requirement, it becomes necessary to define "other information," but the proposed definition of "other information" is broad, vague and non-specific.[15] The precise contours of the other information the auditor is actually evaluating will be, at best, extremely opaque to investors (apart from the obvious, *e.g.*, selected financial information, or recitals of GAAP financial data). The Release notes several less-obvious disclosures that could be covered in certain circumstances – such as statements about the company's competitive environment, technological developments, or supplier relationships – and describes a situation where the auditor might have knowledge, based on relevant audit evidence obtained during the audit, that contrary to a company's claims it does not have the largest market share in its industry. In each such case, however, the auditor's knowledge will necessarily derive from the facts and circumstances of a particular audit, which will of course vary from issuer to issuer, and may even vary from year to

[14] Release, Appendix 6, p. A6-33; paragraph 13.e of the proposed other information standard.
[15] *See* note 11 above.

year for the same issuer. Due to these variables, it will be impossible for investors to determine the extent to which "other information" in an annual report has actually been evaluated.

Take the market share example described in the Release.[16] For the sake of the following discussion, let us assume the issuer's market share disclosure is material. If a competitor of the issuer makes the same (incorrect) claim, but contrary information is not part of the audit evidence obtained by its auditor (and there is no reason, in our view, to expect that such information will necessarily be obtained by an auditor, unless the auditor would be expected, contrary to even the proposed standard and at even greater expense, to collect evidence related to "other information" as part of the audit), then, in that case, the statement is not subject to evaluation, even though the second auditor makes exactly the same recitation as the first auditor as to "other information" generally. Similarly, there could be different results of the evaluation of other information in different years, depending on information obtained. Another example might involve a comparison of a plant's actual production against its production capacity. An auditor might be able to determine, based on audit evidence, what goods a factory actually produced during a given year, but at the same time have no audit-evidence-based knowledge of the plant's capacity.

This concern as to whether a user of financial statements could determine whether particular statements are, or even could be, evaluated by the auditor – where the answers may vary significantly based on factors invisible to those users – is real and troublesome. Moreover, this concern is not necessarily isolated but could extend to every item of information included in the relevant filing.[17]

*3. Any Requirement to "Evaluate" Other Information Beyond Financial Information Would Exceed Auditors' Expertise.*

One of the significant issues auditors would face in applying the proposed other information standard with respect to information other than financial information is whether doing so is consistent with the auditor's role and core expertise. As we noted in our 2011 Comment Letter, auditor expertise centers on financial information, financial reporting, auditing and related matters, and generally does not extend to evaluating business strategy and trends, analyzing risk (other than risks regarding financial reporting) or predicting future performance. The Release does not go as far as the 2011 Release in suggesting as a possible approach that auditors affirmatively attest to the content of MD&A or information contained elsewhere in a company's annual report. We believe, however, that if auditors are required to do more than, at most, evaluate specified financial information disclosed in the annual report, that would increase audit costs while appearing to provide comfort regarding accuracy that is unjustified.

*4. The Proposed Standard Is Not Consistent with the Procedures Applied by Auditors in Connection with Comfort Letters.*

[16] Release, p. A6-13.

[17] One way the Board might try to narrow the proposed standard would be to limit "other information" to information contained in or derived from the issuer's financial records. This would allow auditors to focus their evaluation efforts, rather than taking a costly, scattershot approach, while benefitting investors by enabling them to determine what information the auditor had (and, more importantly, had not) evaluated. This, however, would not by itself address our concerns with the proposed standard.

The proposed standard would also represent a significant departure from procedures an auditor would perform under AU Section 634, *Letters for Underwriters and Certain Other Requesting Parties* ("AU 634"), in connection with a comfort letter provided to an underwriter in connection with an offering of securities. In that context, with respect to information that would be "other information" under the proposed standard, the auditor performs limited procedures only on information identified specifically by the underwriter, rather than performing procedures generally on all such information. And the content of each comfort letter, and the procedures performed on particular disclosure items, is frequently the subject of significant negotiations between the underwriter and the auditor, and in all events is limited to information derived from the company's books and records that are subject to an ICFR framework.

### *F. The Proposed Auditing Standards Are Likely to Heighten Litigation Exposure for Both Auditors and Issuers*

Another significant concern raised by both proposed standards is the cost imposed on both auditors and issuers in terms of heightened litigation exposure under the securities laws. The proposed other information standard, in particular, will significantly increase litigation exposure by requiring auditors to make an affirmative statement as to their findings, even in cases where nothing has been found. We emphasize that we are not merely raising the generalized concerns regarding auditor liability, or increases therein, that are often raised in discussions of the role of the auditor in public company financial reporting and audits. Rather, the proposed new standards, because of the combination of additional affirmative statements by auditors, the possible applicability of the *Janus* decision discussed below, and the possible implications of the proposal in respect of liability under the Securities Act of 1933 (the "Securities Act"), raise specific and serious issues we discuss more fully below.

#### *1. There Is a Significant Likelihood the Potential for Auditor Liability Would Increase Due to the Proposed Audit Standards.*

Under the federal securities laws, auditors face potential liability under various statutes, including in particular Sections 10 and 18 of the Exchange Act and Section 11 of the Securities Act. One of the claims most frequently made against auditors is under Section 10(b) of the Exchange Act and Rule 10b-5 thereunder. Under those provisions, an auditor can be liable if it makes a statement in its auditor's report that is misleading when made and the requisite scienter standard is met. The proposed audit standards require auditors to make several new statements in connection with their auditors' reports, including a statement as to whether or not the auditor has identified any material inconsistencies with the financial statements or material misstatements of fact in the other information included or incorporated by reference in the relevant annual report, as well as statements identifying critical audit matters.

The requirement under the proposed other information standard that the auditor make a public statement it has affirmatively evaluated the other information but did not discover any such inconsistencies or misstatements seems particularly problematic, both because the required evaluation procedures have the potential to involve a significant volume of evidence – including evidence that may or may not be related to financial statements or financial reporting –

and because the scope of "other information" is inherently broad and uncertain.[18] As a result, any qualitative statement relating to information as to which an auditor might have developed evidence during the course of the audit process has at least the potential to become the subject of a lawsuit. And because the auditor is making an affirmative statement, under the Supreme Court's decision in *Janus Capital Group, Inc. v. First Derivative Traders*,[19] the auditor could be subject to a private right of action under Rule 10b-5 predicated on the material inaccuracy of its statement, to which it would not have been subject had the statement, as under AU 550, been made only to the issuer. While it might be possible to attempt to distinguish the inclusion of this statement in the auditor's report on several grounds (including that the report would indicate the other information was not audited and the auditor was not expressing an opinion on it), there is no certainty that would be the case and even less likelihood that the auditor would entirely avoid litigation as a result.

Under the proposed auditor reporting standard, the auditor would similarly be required to make a number of publicly available additional statements in its auditor's report. In particular, the auditor would be required to identify the critical audit matters associated with the audit.[20] The disclosure (or non-disclosure) of these matters could create significant opportunities for a plaintiff to bring suit against an auditor following the revelation of a misstatement or omission that, particularly in hindsight, can be alleged to have been material. If the underlying issue relates to a critical audit matter, but was not discovered, the plaintiff may assert the auditor was reckless in not discovering the issue. If the underlying issue relates to a matter that was not considered as having the potential to be a critical audit matter, the plaintiff may assert the auditor was reckless in failing to identify the critical audit matter in question. Or, finally, if the underlying issue relates to a matter the auditor considered as a possible critical audit matter, but where it affirmatively determined the matter was not critical, the plaintiff may assert that determination was itself reckless.

In light of the heighted risk of litigation, another aspect of the proposed auditor reporting standard that should be reconsidered is the requirement for the auditor to retain audit documentation with sufficient information to enable an experienced auditor who has no previous connection with the engagement to understand the basis for the auditor's determination that each <u>non-reported</u> audit matter that would appear to meet the definition of a critical audit matter was, in fact, not a critical audit matter. While the Board notes several reasons why this would be important to the process of determining critical audit matters (including enabling the PCAOB inspection staff to determine whether this aspect of the proposed new standard is being properly implemented), it also creates (and requires an auditor to retain) a detailed documentary record of the auditor's determination that a matter was <u>not</u> "critical." If this would require an auditor to retain work papers or materials beyond those that would have been separately required to document the auditor's audit determinations, this requirement would seem to accomplish little of

[18] *See* note 11 above.

[19] 131 S. Ct. 2296 (June 13, 2011).

[20] We note the proposed auditor reporting standard would also require auditors to make affirmative statements regarding a number of other matters, including that it is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company, and the year that it began serving as the company's auditor. Because these are more focused, factual statements about matters with which the auditor is readily familiar, they do not raise a liability concern.

benefit to investors while giving rise to increased litigation risk with respect to any "identified but not determined to be critical" matter.

*2. As Proposed, the Standards Appear to Create at Least Some Potential for Liability under the Securities Act.*

Both the proposed auditor reporting standard and the proposed other information standard appear to have the potential to increase auditors' liability exposure with respect to offerings conducted under the Securities Act. The more difficult analysis of this question, however, involves the proposed other information standard. The Release explicitly notes that, consistent with existing AU 550, the proposed standard would not apply to documents that are filed with the Commission under the Securities Act, and that an auditor's responsibilities with respect to Securities Act filings are governed by its responsibilities under Section 11 of the Securities Act and AU Section 711, *Filings Under Federal Securities Statutes*.

But while the Release discusses in some detail various obstacles to applying the reporting requirements under the proposed other information standard to documents filed under the Securities Act, in our view the Release does not squarely address the implications for incremental auditor liability that arise from including the additional information required by the proposed audit standards, particularly with regard to other information, in auditors' reports incorporated by reference from annual reports into registration statements (including, but not limited to, liability for that information as an "expert" under Section 11 of the Securities Act, if that additional information is viewed as having been expertized). This is currently not of concern under AU 550 because, as noted in Section II.E above, that standard does not require the auditor to communicate the results of its work to any person other than the issuer. While the PCAOB may not intend to impose expert liability on the auditor with respect to the auditor's statement regarding other information, and also may not intend to impose such liability on the descriptions of critical audit matters under the proposed auditor reporting standard, that will not necessarily be the uniform outcome if the issue is widely litigated, as could be the case.

*3. Any Expansion of Required Addressees of the Auditor's Report Is Inappropriate Given the Increased Litigation Exposure.*

The Board also asked, in connection with the proposed auditor reporting standard, whether (and the extent to which) the list of persons to whom an auditor's report is addressed should be expanded. In the Release, the PCAOB noted that many auditors currently address their reports to an issuer's shareholders (as *permitted* under the existing audit standard). The proposed standard, however, would require the report be addressed, at a minimum, to "investors in the company, such as shareholders" and would require auditors to determine whether any non-equity investors are appropriate addressees.[21]

Under various circumstances, an auditor currently may be liable to a third party with whom it does not have a contractual relationship in respect of the statements it makes in its auditor's report, although in at least some cases that determination may require the third party to demonstrate the auditor knew, or should have known, the third party was relying on its report or

[21] Release, p. A5-9.

on the related financial statements.[22] There are, however, currently at least some situations where an auditor is less likely be liable to others, including in the case of mere negligence.[23] Expanding the pool of addressees to include non-equity investors would have the effect of increasing the potential liability of auditors by expanding the number of persons able to demonstrate they were entitled to rely on the report in those contexts. Moreover, while the existing reporting standard *permits* auditor reports to be addressed to shareholders, in light of the increased risk of auditor liability if the proposals are adopted, we anticipate auditors would likely wish to address their report solely to the issuer and its board of directors.

## III. An Alternative Approach for Consideration – Auditor Evaluation of Critical Accounting Policies and Estimates

In Section II, we have highlighted our concerns regarding the proposed standards, including in particular that an auditor will unavoidably be required to disclose original additional information about an issuer, including immaterial or unnecessarily prejudicial information; the revised auditor's report would undermine the existing pass/fail model; the procedures required by the proposals could chill communications between auditors, management and audit committees; the proposed other information standard would generally give rise to no new disclosure while simultaneously giving rise to uncertainty among investors; and heightened litigation exposure. We believe these concerns can largely be eliminated if, instead of the current proposals, the PCAOB modified its approach and auditors were asked to provide a supplemental statement regarding an issuer's disclosures relating to critical accounting policies and estimates.

Disclosure by issuers of critical accounting policies and estimates in their MD&A is now almost universal. Nonetheless, as referenced in the 2011 Comment Letter, we believe enhancing disclosure <u>by issuers</u> of the impact of accounting estimates and judgments on their financial statements and reporting may be desirable. Each issuer's financial reporting framework includes a significant number of estimates that could cause results to vary significantly; rarely if ever are these matters discussed in detail in an issuer's financial statements or other reporting.[24]

In the 2001 Guidance, the Commission suggested issuers should disclose in the MD&A the "accounting policies that management believes are most 'critical' – that is, they are

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[22] *See, e.g.*, *Credit Alliance Corp. v. Arthur Anderson & Co.*, 483 N.E.2d 110 (N.Y. 1985); *Utramares Corp. v. Touche*, 174 N.E. 441 (N.Y. 1931). Under these and other, similar cases, an auditor typically has a duty to a non-client if (i) the auditor was aware the report was to be used for a particular purpose; (ii) a known third party was intended to rely on the report to further that purpose; and (iii) some conduct by the auditor links it to the third party.

[23] *See, e.g.*, Restatement (Second) of Torts: § 552, Information Negligently Supplied for the Guidance of Others, comment h (1977) ("The rule stated in this Section subjects the negligent supplier of misinformation to liability only to those persons for whose benefit and guidance it is supplied. In this particular his liability is somewhat more narrowly restricted than that of the maker of a fraudulent representation, which extends to any person whom the maker of the representation has reason to expect to act in reliance upon it.").

[24] The Commission's guidance to date in this area includes the following: two releases discussing critical accounting policies in December 2001 (SEC Rel. No. 33-8040; 34-45149 (Dec. 2001)) (the "<u>2001 Guidance</u>") and January 2002 (SEC Rel. No. 33-8056; 34-45321 (Jan. 2002)) and guidance on critical accounting policy disclosure in its December 2003 interpretive release on MD&A (SEC Rel. No. 33-8350; 34-48960 (Dec. 2003)) (the "<u>2003 Guidance</u>"). The Commission also proposed rules on critical accounting policies in May 2002, but has not adopted them. SEC Rel. No. 33-8098; 34-45907 (May 2002) (the "<u>2002 Rule Proposal</u>").

both most important to the portrayal of the company's financial condition and results, and they require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain."[25] The Commission noted that both the issuer's management and its auditor should "bring particular focus" to evaluating the critical accounting policies. Subsequently in the 2003 Guidance, the Commission also focused on materiality, noting issuers should disclose in their MD&A "accounting estimates or assumptions where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material."[26] The Commission went on to say issuers "should provide quantitative as well as qualitative disclosure when quantitative information is reasonably available and will provide material information for investors. (*Emphasis added.*)" In addition, as the Commission separately noted in its 2002 Rule Proposal, an issuer's auditor is already responsible for evaluating the reasonableness of the accounting estimates made by management in the context of the financial statements taken as a whole.[27]

We believe the adoption of a narrowly focused auditor review standard in this context could improve issuer disclosure and thus provide greater insight to investors. The auditor could, for example, be asked to provide negative assurance that, based on its work on and evidence compiled during the audit, nothing has come to its attention that causes it to believe (a) the disclosure included in the document that contains financial statements that were subject to the audit fails to address all critical accounting estimates or policies that are required to be disclosed, or (b) the disclosure regarding the critical accounting estimates or policies included in the document is not accurate in all material respects.

This approach would, in our view, represent a significant improvement over the proposed standards. In particular, it would have the benefit of addressing matters that are material to an issuer's financial reporting generally, not to the audit specifically. In addition, it avoids any requirement that the auditor be a source of original disclosure about the issuer, as the auditor would be commenting on issuer disclosure and would not be making additional disclosure (assuming that, if the auditor identifies modifications necessary for the issuer to make in order to meet the requirements, the issuer makes those modifications). It also does not call

[25] 2001 Guidance, p. 2.

[26] 2003 Release, p. 18. The Commission went on in the 2003 Guidance to suggest that factors issuers might choose to address in this disclosure could include how management arrived at the estimate, how accurate the estimate/assumption had been in the past, how much the estimate/assumption has changed in the past, and whether the estimate/assumption is reasonably likely to change in the future, but noted that these factors should analyzed "to the extent material." Id.

[27] See 2002 Rule Proposal, pp. 26-27. See also AU Section 342, *Auditing Accounting Estimates*, paragraph 4 ("AU 342"). In making that evaluation, the auditor must obtain evidence sufficient to provide reasonable assurance that all accounting estimates that could be material to the financial statements have been developed, that those estimates are reasonable in the circumstances and that those estimate are presented in conformity with applicable accounting principles and are properly disclosed. AU 342, paragraph 7.

In the 2002 Rule Proposal, the Commission also indicated it was considering whether to adopt a requirement that an independent auditor must examine, in accordance with attestation standards, the MD&A disclosure relating to critical accounting estimates. The Commission has not adopted the 2002 Rule Proposal, and we do not believe there is a need for it to do so at this time.

into question the pass/fail model, as it does not raise any concern about audit judgments, nor does it implicitly raise questions about the reliability of the financial statements. Finally, it requires the auditor to evaluate only accounting matters, rather than other matters that may be beyond the scope of the auditor's expertise, which means it should both be meaningful and more cost-effective to implement.

We strongly believe the problems surrounding both the proposed auditor reporting standard and the proposed other information standard, as discussed in Section II above, effectively mean the risks, costs and uncertainties associated with the proposals outweigh their benefits to investors, and that the new standards should not be adopted as proposed. As an alternative, we strongly encourage the PCAOB to consider our proposal relating to existing critical accounting policies and estimates disclosure, as set out above. In any event, we strongly encourage the Board to address the serious concerns we and other commenters have raised regarding the proposed audit standards to help ameliorate their potentially significant negative consequences before adopting any final standards.

## IV. Phase-In Period

The Board has raised, in the Release, the issue of whether and to what extent it would be appropriate to implement a delayed compliance period for either or both of the proposed audit standards (including, for example, whether there should be a delay in the implementation of the proposal for smaller companies). In light of the significant changes the Board is proposing and the various concerns expressed by commenters, we believe a staged or delayed implementation of any adopted proposals would be beneficial, in part because that would permit the PCAOB to adjust the process were issues to arise while new standards were being implemented. The Board might also consider whether a voluntary pilot program covering a relatively small number of larger issuers might be useful in assisting the Board in determining whether there are benefits to the proposed new standards and identifying either general or specific issues during the process.

* * * * *

We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Leslie N. Silverman, Alan L. Beller, Nicolas Grabar or James D. Small (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: Public Company Accounting Oversight Board
Hon. James R. Doty, Chairman
Hon. Lewis H. Ferguson, Member
Hon. Jeanette M. Franzel, Member
Hon. Jay D. Hanson, Member
Hon. Steven B. Harris, Member

CMS ENERGY

An Integrated Energy Company

December 10, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 034

We appreciate the opportunity to comment on Public Company Accounting Oversight Board (PCAOB) Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report On an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the Proposed Standards). This letter contains the comments of both CMS Energy Corporation and Consumers Energy Company.

CMS Energy Corporation, whose common stock is traded on the New York Stock Exchange, is a domestic energy company engaged in electric and natural gas utility services and independent power production, operating through subsidiaries in the U.S., primarily in Michigan. CMS Energy Corporation's consolidated assets are $17 billion and annual operating revenues are over $6 billion. Consumers Energy Company, the principal subsidiary of CMS Energy Corporation, provides electricity and/or natural gas to more than 6 million of Michigan's 10 million residents and serves customers in all 68 counties of Michigan's Lower Peninsula.

We recognize that some investors have suggested that the auditor's report would be more useful and relevant if it contained more information. In response, the PCAOB previously issued Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release), and has now issued the Proposed Standards. While we are pleased with the PCAOB's decision to move away from the major provisions of the Concept Release (i.e., proposed requirements for an Auditor's Discussion and Analysis and/or the expanded use of emphasis paragraphs in audit opinions), we do not believe that auditor reporting of critical audit matters will achieve the PCAOB's stated objective of increasing the informational value of the auditor's report. Rather, we believe that auditor reporting of critical audit matters could:

1. Decrease comparability among audit reports;
2. Confuse investors;
3. Lead the auditor to disclose non-public information about the company's business; and
4. Cast a shadow of doubt over the auditor's unqualified opinion as well as over the company's financial statements.

*Decreased Comparability:* The Proposed Standards would require the auditor to communicate in the auditor's report "critical audit matters", which are those matters addressed during the audit of the financial statements that:

1. Involved the most difficult, subjective, or complex auditor judgments;
2. Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
3. Posed the most difficulty to the auditor in forming an opinion on the financial statements.

Determining which audit matters are "critical audit matters" would be a highly subjective exercise for the auditor and would result in markedly decreased comparability among audit reports. Different auditors could reach very different conclusions on which audit matters are critical as well as how many such matters to communicate in the auditor's report. In many cases, whether an audit matter is considered critical will depend **not** on the quality or reasonableness of the company's accounting policies and practices, but rather on the expertise and experience of the auditor. Depending on experience level, what is complex to one auditor may not be complex to another. For example, a newly engaged auditor might need to devote a substantial amount of time and effort to developing audit procedures and gaining comfort with an industry- or company-specific accounting matter, while a tenured auditor would not. Given the difficulty involved in assessing the accounting matter, the newly engaged auditor might communicate this matter as a critical audit matter, while the tenured auditor might not. As a result, an investor reading the newly engaged auditor's report could reach a different (and perhaps inappropriate) conclusion regarding the quality of the company's accounting policies and practices compared with an investor reading the tenured auditor's report. As illustrated in this example, the subjectivity in determining critical audit matters will lead to decreased comparability among audit reports. In our view, this could diminish the usefulness and relevance of the auditor's report.

*Investor Confusion:* Our second concern with the proposal is that it could lead to duplicative discussion of certain accounting matters – once by company management and again by the auditor. Accounting matters deemed to be critical audit matters by the auditor are likely to be discussed in the "Critical Accounting Policies and Estimates" section of the Management's Discussion & Analysis, as well as in the notes to the financial statements. As we stated in our comment letter on the Concept Release, we believe that commentary on a company's financial statements should come from a single source, rather than from both management and the auditor. Providing two perspectives on a single set of financial statements has the potential to confuse users and to reduce confidence in reported information. Furthermore, we believe that management is the best source of commentary on a company's business and financial statements. Though an auditor's understanding of a company's financial statements is more extensive than that of other third parties, it is still less complete than that of management. The degree to which the auditor must gain an understanding of the company's business, industry, transactions, and financial statements in order to render an audit opinion is substantially less than the depth of understanding required of the company's management. Correspondingly, the time the auditor devotes to gaining an understanding of these matters is a small fraction of the time invested by management. For these reasons we believe that, in order to provide users with clear and reliable information, management should be the sole source of commentary on a company's business and financial statements.

*Disclosure of Non-Public Information:* Another concern is the possibility that the auditor will disclose non-public information about the company's business when explaining its determination of a critical audit matter. In reading the *Illustrative Examples of Critical Audit Matters* provided in Appendix 5 of the Proposed Standards, we noted several examples within the communications of critical audit matters in the auditor's report where the auditor may have been disclosing information not previously made public by management and not required to be disclosed in the company's audited financial statements. Again, as discussed above, we believe that any information about the company's business and financial statements should come from management, not the auditor.

*Shadow of Doubt:* Our final concern with the proposal is that investors could perceive the auditor's discussion of critical audit matters as "qualifying an unqualified opinion". While we understand the PCAOB does not intend that the auditor's communication of critical audit matters be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's opinion on the financial statements, that does not change how investors may perceive the communication. We noted that the *Illustrative Examples of Critical Audit Matters* included extensive discussion of why the auditor deemed the audit matter to be a critical audit matter as well as the additional audit procedures the auditor performed as a result. Following this extensive discussion, however, there is no clear statement of the auditor's final conclusion on the critical audit matter. The reader may be left with the basic question: Did the auditor become comfortable with the critical audit matter? We realize that, by virtue of providing an overall unqualified opinion, the auditor has reached satisfactory conclusions regarding all the critical audit matters communicated. We believe, however, that the context of the discussion could cause an investor to infer that the auditor has reservations about a particular matter or, in other words, that the auditor is, in essence, qualifying its unqualified opinion. For an investor, this could cast a shadow of doubt over the auditor's unqualified opinion as well as over a company's financial statements.

It may be suggested that, to overcome this perception, the auditor's communication of critical audit matters could simply include a statement that it did indeed gain comfort with the critical audit matter. In doing so, however, the auditor would be stepping into the realm of providing a piecemeal audit opinion, placing more emphasis on certain accounting matters when it should be providing an opinion on the overall financial statements. In addition, as more and more discussion is added to the auditor's opinion, the auditor's report begins to depart from the simple pass/fail model, which many commenters have lauded as providing a "concise and useful message."

In conclusion, we believe that the proposal to require auditor reporting of critical audit matters would not achieve the PCAOB's stated objective of increasing the informational value of the auditor's report, but would in fact have the opposite effect.

Thank you for the opportunity to comment on the Proposed Standards.

Sincerely,

Glenn P. Barba

Glenn P. Barba
Vice President, Controller and Chief Accounting Officer
CMS Energy Corporation and Consumers Energy Company

Coca-Cola Enterprises, Inc.

2500 Windy Ridge Parkway
Atlanta GA 30339

December 11, 2013

Via email to: **comments@pcaobus.org**

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

**RE:** PCAOB Rulemaking Docket Matter No. 34 – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Proposed Amendments to PCAOB Standards Related to the Proposed Audit Reporting Standard.*

Coca-Cola Enterprises, Inc. (CCE, the Company, we, our, or us) appreciates the opportunity to respond to the Public Company Accounting Oversight Board (PCAOB) regarding the August 13, 2013 proposed changes to the Auditor's Reporting Model and Responsibilities for Other Information.

With over $8 billion in revenues in 2012, CCE is the leading Western European marketer, distributor, and producer of bottle and can nonalcoholic beverages and one of the largest independent Coca-Cola bottlers. CCE is the sole licensed bottler for products of The Coca-Cola Company in Belgium, continental France, Great Britain, Luxembourg, Monaco, the Netherlands, Norway, and Sweden. CCE is a public company and is registered with the New York Stock Exchange.

While we support the PCAOB's efforts to increase the value of the auditor's report to analysts, investors, and other financial statement users, we do not support the Board's proposal in its current form. Our viewpoints of the primary changes to the Auditor's Reporting Model, which are consistent with comments previously provided by the majority of respondents to this proposed rule, are as follows:

*Critical Audit Matters ("CAMs"):*
The proposed standard would require auditors to include in their report a discussion of matters they consider to be "critical" to the audit. As a multinational reporting company, we frequently enter into complex business transactions which require judgment in interpreting and implementing appropriate accounting guidance. These transactions are often discussed with our auditors and our Audit Committee. Many of these transactions are neither individually material to the overall financial statements, nor core to our day-to-day business operations. Our concerns fall into three broad areas. First, mandatory disclosure of these accounting matters could cause misunderstanding as to the magnitude and/or importance of these transactions in reference to the company's overall financial performance. Sophisticated users of financial statements likely already understand where to find information within existing disclosures. For the casual users, the addition of disclosures of potentially complex matters would negatively impact their ability to interpret the core financial information. Second, the use of CAMs also has potential to become an area of undue caution for auditors. This could lead to an abundance of matters designated as CAMs, which could place unnecessary importance on these items and result in significant variation

in the selection, interpretation and explanation of these items across their registrant clients. Third, we strongly support maintaining the pass/fail model as it focuses on the presentation of the financial statements as a whole. This pass/fail model is both effective and well understood by financial statement users. The disclosure of CAMs, however, undermines the value of the pass/ fail model by highlighting specific areas of the financial statements rather than only evaluating the financial statements as a whole. We believe the proposed changes to the auditor's report, if implemented, could be interpreted to provide different levels of assurance on different areas of the financial statements.

We also believe, in some circumstances, the possibility exists that the CAMs disclosure represent the sole discussion of certain accounting matters, and we do not support the use of the auditor's report as the primary source of accounting disclosure. An original or sole disclosure in the auditor's report blurs the responsibility of financial information communication between the corporation and the auditors. Management is responsible for all aspects of the preparation of disclosures. We caution the Board to consider the potential for CAMs to represent an original source of disclosure.

In the current regulatory environment it is likely that auditors will perform additional procedures documenting their justification for whether or not matters classify as CAMs which will, in turn, result in increased audit costs. Given the level of disclosures already available to financial statement users we do not believe this incremental cost would be justified.

*Reporting on Other Information:*
We support enhancements to the auditor's report which clarify the responsibility of the auditor in regards to the notes to the financial statements, fraud, and independence to the extent the enhancements provide improved information to the users of financial statements as to the meaning and relevance of the auditor's opinion. However, we are concerned the Board's current proposal increases auditor responsibility for information beyond the financial statements. Our company's information outside of the financial statements is often the result of subjective, forward-looking internal analysis. The use of the auditor to evaluate this information would prove difficult without further insight into the detailed and subjective decision-making of management. It is also our understanding that some accounting firms believe significant incremental procedures would be necessary to "evaluate" information within management's discussion and analysis, selected financial data, and other information incorporated by reference, such as proxy statements. Compliance with this proposal could result in a substantial increase in audit costs. We believe the current requirement to "read and consider" other information for consistency and material misstatement of facts is sufficient and the potential benefits of this proposal do not outweigh the additional costs.

*Auditor Tenure Disclosures:*
We believe that the quality of our audit increases over time with the use of an experienced auditor as the auditor is able to learn our business in more depth, and is therefore able to perform a more thorough audit. Disclosure of auditor tenure in the audit report could be interpreted by the reader as having a bearing on the independence of the auditor or the audit quality. We believe the auditor tenure is best disclosed elsewhere in annual Securities and Exchange Commission filings, such as the proxy statement, and we currently express this information therein.

In Summary, while we support the PCAOB's efforts to increase the value of the auditor's report to analysts, investors and other financial statement users, we do not support the Board's proposal in its current form due to the considerations detailed above.

Thank you for your consideration of our comments on these matters. If you have any questions, comments, or would like further information regarding this submission, please contact Janelle Tzanetakos at 678-260-3000.

Sincerely,

**Janelle Tzanetakos**
Director, Financial Reporting and Technical Accounting
Coca-Cola Enterprises, Inc.

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December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034, Proposed Auditing Standards

Dear Ms. Brown:

CohnReznick LLP ("CohnReznick") appreciates the opportunity to comment on the proposed auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (The Reporting Standard), and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (The Other Information Standard).

CohnReznick is the 11th largest accounting firm in the U.S., with its origins dating back to 1919. We are committed to serving clients that access the capital markets, and we recognize the significant role we have in facilitating efficient capital formation. We support the Board's intent to increase the informational value of the auditor's report in order to promote the usefulness and relevance of the audit and the related auditor's report. We support making changes to the auditor report that preserve and enhance the important role auditors have in serving the users of financial statements. While our domestic and international capabilities (through our Nexia International membership) allow us to serve a broad array of clients, we are a significant provider of services to the smaller and middle market. Our desire is that our response to the exposure draft will give you perspective into the unique impact these changes might have on small and medium size entities and their ability to attract capital.

Our comments in this letter are consistent with the messages we delivered to the IAASB in our letter dated November 22, 2013, responding to the Exposure Draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*.

The observations and recommendations we are providing in the attachment to this letter are intended to help the Board arrive at changes to the auditor reporting model that achieve the objectives of the proposal, without impairing the understandability of the auditor's report or changing the distinction between the roles of management and the auditor.

The Board proposed the performance of field studies of the proposed standard, and we recognize the importance of the results that would come out of such a study. We believe these efforts will generate useful insights about the how the proposed changes would impact companies that access capital markets, as well as alert us to any previously undiscovered benefits or consequences of the changes.

Our responses to specific questions on which the Board is seeking comment are included in the attachment to this letter.

If you have any questions concerning our comments or would like to discuss any of our responses or recommendations in more detail, please feel free to contact Kurtis Wolff at 770-330-1167.

Yours truly,

CohnReznick LLP

CohnReznick LLP

## BASIC ELEMENTS AND OTHER CHANGES

We commend the Board on undertaking the effort to update the audit report to improve the informational value the report provides, and we recognize that the proposed changes to the basic elements and the format of the report are intended to further such improvements. We have the following comments and observations about the proposed changes to the basic elements of the audit report:

- We find the objectives of the proposed Reporting Standard to be clear, and agree that, as written, they would assist the auditor in understanding what would be communicated in the audit report under the standard.
- We believe it would not be appropriate to address the audit report to others than the shareholders and board of directors of the company or their equivalents.
- We support the alignment of the description of the nature of an audit with the Board's risk assessment standards, and there are no additional auditor responsibilities that we believe should be included to further describe the nature of an audit.
- We believe that the statement relating to the auditor's responsibility to be independent will clarify the meaning of independence for the understanding of users of the financial statements, and is a beneficial addition to the auditor's report.
- We believe that the emphasis of a matter paragraph has a different purpose than the intended objectives of critical audit matters, and the retention of the emphasis of a matter paragraph is valuable.

We believe that changes to the basic elements of the audit report do not have material incremental cost considerations. However, we are commenting on what we believe to be some of the more significant cost considerations pertaining to critical audit matters and other information where appropriate in this letter.

Evidence has not demonstrated that auditor tenure impacts audit quality, as acknowledged in the Board's proposal. In fact, as was commented on by Marty Bauman at the AICPA SEC and PCAOB conference in Washington D.C. on December 10, 2013, some believe there is a greater risk to audit quality in the initial years of a new client/auditor relationship as opposed to a long term relationship. Without empirical evidence regarding tenure (near term or long term), we believe that adding information about auditor tenure to the audit report would inevitably lead a user to draw a conclusion about audit quality, and such a conclusion would ultimately be based on the undemonstrated premise that tenure and audit quality are related. As such, we believe that including the proposed statement on the year the auditor began serving the entity would not be useful to the reader, and might in fact be contrary to the intent of the proposed standard. Similarly, we believe that auditor tenure could not be useful to investors or other financial statement users if included in EDGAR or other sources, and would lead to frivolous litigation based on tenure or the lack thereof, increasing the cost of the proposed standard and hindering the efficiency of capital formation.

We believe the Board should not consider a delayed compliance for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies. Our viewpoint is informed by the history of the implementation of the requirements of the Sarbanes Oxley Act for SEC registrants, and the confusion that was created for all financial reporting stakeholders, as well as the costs and other unintended consequences during the period when compliance was deferred.

## CRITICAL AUDIT MATTERS

We understand and agree with the benefits of critical audit matters. In particular, we believe the user having knowledge and comprehension of the significant risks and areas where auditor judgment must be applied will make the user more knowledgeable of the entity's business, and allow the user to make more informed decisions. Furthermore, we see this transition as a positive development in the effort to communicate the value that the audit provides to the public. We support efforts that will improve the perception by the public that the public company audit process is transparent. Ultimately, we agree that all of these benefits will be conveyed to capital markets.

### COMMUNICATIONS WITH THE AUDIT COMMITTEE

Our perspective is that the objectives and requirements for identification and communication of critical audit matters should align with the type of information that has demonstrable value to the users, should be material to the financial statements, and should avoid adding information to the report that either would be of no interest or that might lead to confusion for non auditors. We would particularly like to emphasize the point that excessive or unnecessary information provided through the critical audit matters section of the audit report would be contrary to the Board's intent in creating the standard. We refer you to comments made on October 15, 2013, by Mary Jo White, Chairwoman of the Securities and Exchange Commission:

> *"When disclosure gets to be "too much" or strays from its core purpose, it could lead to what some have called "information overload" – a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant."*

Having the observation above in mind, we believe that additional information provided through the reporting of critical audit matters is appropriate. However, our preferred approach to addressing the marketplace desire for more relevant and useful information from the audit would be to have the Audit Committee provide in their own disclosure more insight stemming from their communications with the auditor. Such an approach would preserve the distinction between the roles and maintain that the primary responsibility for reporting of original information regarding significant audit considerations rests with the company, not the auditor. We are concerned that there is the potential for the auditor to report original information about the company, which management has not shared, and that this will cause readers to increasingly look to the auditors for incremental information. The practice would further blur the roles between those charged with governance and the auditor. We believe that would be counter to the underlying premise of the objectivity of the independent auditor.

Recently, a group of nationally recognized U.S. corporate governance and policy organizations known as the Audit Committee Collaboration, released "Enhancing the Audit Committee Report, A Call to Action." The document emphasizes the opportunity that audit committees have in reporting on significant matters discussed with the auditor as part of the audit, indicating:

> "*The audit committee should also consider whether additional disclosure about its general oversight of the external auditor – either through descriptions of processes or specific activities – would provide shareholders and potential investors with useful context. These might include discussions of the degree of the audit committee's interaction with the external auditor (including the nature or number of meetings outside the presence of management), the types of issues discussed at those meetings, and other activities that are central to the audit committee's oversight.*"

Under this approach that preserves the entity's responsibility for disclosure of original information, the auditor might then acknowledge in the audit report the communications described in the audit committee's disclosure, treated similarly to the auditor's response in the proposed other information standard.

We believe that matters described in a critical audit matters section in the audit report should expand on matters discussed with the Audit Committee. Such disclosure should not introduce additional matters, which could call into question the completeness of the these communications. Making matters discussed with the audit committee the starting point for identification of critical audit matters aligns the proposed standard with the guidance provided through Auditing Standard No. 16. The definition of critical audit matters in paragraph 8 of the proposed Reporting Standard, i.e., *matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three*, is clear as the source for the selection of matters that might be considered critical audit matters. However, our view is that all critical audit matters should be those matters the auditor has communicated (or plans to communicate) to the audit committee. This is consistent with the proposal from the IAASB, which indicates key audit matters are from those matters communicated with those charged with governance. We would like to see congruence between what the SEC will require of audit committees in public company filings, and what the auditing standards require of the auditor. More transparency about communication between the audit committee and the auditor, we believe, will produce the best flow of relevant information to the capital markets.

DEFINING CRITICAL AUDIT MATTERS AND CRITERIA

We believe that the inclusion of the illustrative examples provides substantial insight into the expectations of the Board, and helps the auditor interpret the requirements of the proposed standard. However, we noted that the illustrative examples make use of descriptions of the auditing procedures performed. Our view is that describing the audit procedures performed may in fact confuse users who are not familiar with the selection and application of audit procedures. For example, describing audit procedures performed specifically to address an increased risk of fraud for an account balance has the potential to cause a reader without an audit background to conclude fraud is likely occurring. For a small or medium size entity, auditing a particular area may require proportionally greater effort by the auditor through the selection of specific substantive procedures. However, we question whether such information is relevant or useful to a user. Some of the consideration factors described in paragraph 9 of the proposed standard, as depicted in the illustrative critical audit matters, would be problematic for an auditor to describe in the audit report without confusing a user who does not possess an audit background, especially corrected and accumulated uncorrected misstatements, the use of specialists, and consultations made outside the engagement team.

We are also concerned that communication of specific auditing procedures or responses to significant risks will lead to inconsistencies in reporting, which would likely lead to more user confusion. For example, auditors can respond to significant risks in various ways. Such responses can be influenced by matters that users may not understand, such as auditor or firm policies and preferences. Ultimately, the auditor is charged with responding to significant audit risks as necessary to reduce the risk of material misstatement to an appropriately low level; how the auditor accomplishes that objective varies. Communicating such information does not enhance the user's understanding of the entity being audited. Additionally, firms that focus on a given industry likely have developed proprietary approaches to auditing critical risk areas. Describing those procedures outside the context of the audit as a whole could be confusing even to those within the profession. A desire to protect such proprietary approaches would likely lead to “boiler plate” responses adding length, but no value, to the auditor’s report.

Further, requiring disclosures related to increased audit difficulties resulting from other issues, such as internal control, mistakes, talent or competency levels of management, or the quality of oversight provided by those charged with governance could result in smaller entities suffering a market perception that they were riskier or more difficult to audit. While such a perception might be warranted, it would increase the risk profile of such entities when, in fact, such risk is an audit risk, not a company or operational risk. We believe that this is a probable outcome, that is audit risk and even financial reporting risk will be assumed to be indicators of operational risk for the entity. Even so, we continue to support the concept of disclosing critical audit matters in the audit report.

We are also concerned that reporting by auditors of areas where the application of extended auditing procedures was required as a result of deficiencies in internal controls over financial reporting could cause smaller entities to feel increased pressure to eliminate such deficiencies. Many smaller entities may not be able to afford more robust internal control systems, and such systems would not necessarily be warranted to accomplish reliable and transparent financial reporting, but rather would only be implemented in order to avoid emphasis of an area in the auditor’s report. Such would be a costly unintended consequence of these proposed requirements. Likewise, requiring smaller entities to adopt and report on the effectiveness of their internal control systems was hotly debated in connection with implementation of section 404b of Sarbanes-Oxley. Ultimately, the requirement that the auditor’s report on the effectiveness of the internal control systems of smaller entities under section 404b of Sarbanes-Oxley was not implemented. Such issues should not be reopened through the auditor’s communication of audit difficulties arising from deficiencies in internal controls. We believe that companies should benefit from the lessons learned in placing such non-scalable reporting requirements on smaller and medium size entities, and the negative consequences and confusion that was created for all financial reporting stakeholders as a result.

The definition of a critical audit matter, as further explained in paragraph 9 of the proposed standard, is sufficiently clear. However, we have additional observations about the definition that we would like the Board to consider. The Board sought comment as to whether the use of the word “most” is understood as it pertains to the concept of judgments, and we believe that it is understood with respect to the use of auditor judgment. However, because “most difficult” is in our view a much more subjective concept, we are concerned the definition could lead to inconsistency about what matters are determined to be the critical audit matters. Furthermore, communication of matters that posed the most difficulty for the auditor to obtain sufficient appropriate evidence or that posed the most difficulty in forming an opinion may be inferred by the users of the financial statements as a separation of the audit opinion into matters in which the auditor is more and less confident. The information communicated in the auditor's report should be reported in a manner which does not cast doubt on whether the audit was performed satisfactorily. The current auditor reporting model has always reflected a high standard of not implying piecemeal opinions (in fact such opinions are prohibited). Disclosing information regarding how difficult it was to achieve that standard could be viewed by users incorrectly as a qualification of whether that standard was achieved. Consequently, users could perceive an audit with reported difficulties as being indicative of a lower quality audit than an audit without reported difficulties. Such a perception would be misleading and could actually damage the entity being audited if a communicated audit difficulty is viewed by users as a perceived risk regarding the entity.

We believe that the factors described in paragraph 9 of the proposed Reporting Standard are helpful in leading the auditor to consider what matters might be included in those matters communicated as critical audit matters. However, we are concerned these factors might be applied in such a way that could lead the auditor to communicate matters as critical that are not useful to the users of the financial statements Put another way, the factors described in paragraph 9 make a good starting point for *identification*, but not good criteria for *determination*. Without clear guidance regarding which identified matters should rise to the level of being reported, we believe there will be an excessive number of critical audit matters identified, and the objective of the standard will not be achieved. We believe the determination of what will be communicated as critical audit matters should not alter the fundamental responsibility of the company's management to determine what should be disclosed about the entity, and the factors should be applied through that requirement. Users are ill-equipped to conclude on the impact any identified audit matters may have had in forming the basis for the auditor's opinion. Without correlation to the information reported by the audit committee, such users may infer incorrectly that auditor communications are an extension of entity communications, or somehow reflect operational insights.

With the above in mind, we believe the following criteria should also be a part of the determination of what matters are communicated as critical in the audit report:

1) Matters that would be clearly relevant for the users to have a clear understanding
2) Matters that are material to the audited financial statements
3) Matters that will not cause unintended confusion, especially where communication of such matters might harm the entity

We believe that the proposed requirement regarding documentation of critical audit matters is sufficiently clear, and is consistent with the requirements of Auditing Standard No. 3. We believe that the proposed requirement regarding documentation of critical audit matters is sufficiently broad, and that it can be adhered to in a scalable manner, appropriate to the circumstances of the engagement. However, we believe any documentation requirement for non-reported audit matters should be limited to matters discussed with the audit committee, but ultimately not included in the reported matters. We believe documentation of other matters not included in the critical audit matters would create a costly additional layer of effort that may potentially drive auditors to make inappropriate additions to what is included in the critical audit matters out of concern over their ability to defend why matters were not reported.

COSTS

We have several considerations to present to the Board with respect to costs of the proposed standards. We view the considerations presented herein as ongoing and recurring cost matters, as opposed to one-time items. It was acknowledged in the proposal that significant audit matters will be handled by the most experienced members of the audit firm and the more senior members of those charged with governance, and they will therefore generally consume the time of the most costly resources. There is a clear opportunity cost in time spent discussing the wording of critical audit matters communication that would otherwise be spent addressing audit and financial reporting risks, especially during the final time period of the audit and reporting period. This is one of the most compelling reasons to ensure that critical audit matters are defined in such a way to allow the auditor to avoid communicating information through the audit report that management would otherwise not discuss with outside parties, such as contingencies or internal control deficiencies less severe than a material weakness.

In a smaller engagement team and smaller company environment, those higher level resources are less likely to be able to leverage their time to other members of either of those parties. Therefore, the smaller environment will disproportionately bear a greater burden of the costs of this additional reporting. Also, because we expect a higher number of critical audit matters for small and medium sized entities, the exposure risk to public accounting firms of accepting and issuing opinions for those companies may turn cost-prohibitive, making audit partners less willing to perform audits, reducing those companies' access to auditing firms and result in higher fee models for such companies.

We believe the communication of critical audit matters in the audit report will significantly increase the frequency of involvement of the audit firm's legal counsel prior to audit issuance. Because we expect small and medium size entities will have a greater number of identified critical audit matters to be reported by the auditor, the costs of audit reports for those entities will therefore be disproportionately impacted by such additional reporting costs.

At the conclusion of our field testing process, we believe we will have a more complete evaluation of the significance of these cost considerations.

LEGAL LIABILITY

We also have considerations for the Board with respect to the legal liability impact of the proposed standard regarding to the disclosure of critical audit matters. The proposed standard will require more information to be presented in the audit report than is currently required. This will inevitably serve to increase potential liability (and its corresponding costs), as there will be additional information in the audit report for private litigants to challenge. We believe that the auditor would be required to apply subjective judgments to determine what is useful to users of the financial statements in determining what should be communicated as critical audit matters. The communication about why matters were included in critical audit matters will raise questions about matters that were not included. We believe that there will be an increase in private litigation resulting from an auditor's decision to not include a matter in critical audit matters. In an effort to avoid potential litigation, the auditor could also decide that the proposed standard requires disclosure of additional non-essential information. The auditor may conclude that it is preferable to err on the side of excess in determining critical audit matters in order to meet the perceived level of risk tolerance. As such, a risk-averse auditor may choose to broadly interpret the definition of critical audit matters, resulting in an excessively detailed report. As previously indicated, the resulting audit report would effectively defeat one of the stated rationales behind the proposed standard by disclosing so much information as to be of minimal usefulness to all but the most sophisticated users of the financial statements.

OTHER CONSEQUENCES

In its letter dated March 21, 2013 to the Chairman of the SEC, the Advisory Committee on Small and Emerging Companies wrote:

> *"The Committee believes that current U.S. equity markets often fail to offer a satisfactory trading venue for the securities of small and emerging companies because they fail to provide sufficient liquidity for such securities and because the listing requirements are too onerous for such companies".*
>
> *"The frequent failure of U.S. equity markets to offer a satisfactory trading venue for small and emerging companies has discouraged initial public offerings of the securities of such companies, undermines entrepreneurship, and weakens the broader U.S. economy"*

We believe particular care should be taken to ensure that reporting of critical audit matters does not create an environment where discussions between management and the auditor are inhibited because of concerns about how such information might be communicated in the audit report.

More specifically, we believe that the introduction of the critical audit matters section to the report may make audit committees and management reluctant to discuss broader matters with the auditor, such as contingent liabilities, or activity within the entity's fraud monitoring. Entities may be reluctant to work with the auditor's internal specialists. We furthermore envision pushback when it becomes known that the auditor is consulting its national office on a matter. All of these potential consequences we believe should be addressed by carefully defining what is determined to be critical audit matters, striking a balance between improving the value of information provided through the audit with preserving the role of the auditor and the relationship of the auditor to the financial reporting stakeholders.

Comparability, a necessary part of making the audit report useful, ordinarily requires that audit reports should contain similar information for similar entities, especially for entities in the same industries. We believe small and medium size entities more likely lack the robust infrastructure for financial reporting we see in place at larger companies. Such a circumstance will undoubtedly impact the nature and frequency of the critical audit matters identified for small and medium size entities, especially in areas that would otherwise be considered significant risk areas in a company of any size. Therefore, we perceive an inverse relationship between the size of the entity and the frequency with which critical audit matters will be described under the proposed requirements. We note this relationship could put such smaller entities at a competitive disadvantage in attracting capital.

We believe that small and medium sized entities have a greater frequency of going concern matters, audit adjustments, and internal control deficiencies. Therefore, our expectation is that small to medium sized public entities will also have a greater frequency of critical audit matters. The result will be critical audit matters between two different sized entities in the same industry could be significantly different, without the reader necessarily having the appropriate context to understand why they are different. Furthermore, we believe there are critical audit matters that would likely be consistently identified and communicated by the same auditor for any company within specific industries. It would be difficult to prevent the auditor reporting of such critical audit matters from becoming boilerplate for the industry, which could lead to a potentially erroneous conclusion by users that the audit was substandard or failed to address "expected" matters.

## OTHER INFORMATION

We support the Other Information Standard, but we have recommendations that we believe will help the proposed standard better achieve what we understand to be the Board's intent. The recommendations are:

- Replace the term "evaluate" in the audit report with a description of the procedures required by the proposed standard
- Require a statement in the audit report that the auditor has not audited or reviewed the other information, and that the aforementioned described procedures do not provide the assurance of an audit
- Include an unambiguous description in the report of the other information on which the aforementioned described procedures were performed

Additional considerations about our recommendations and responses to specific questions asked by the Board are provided below.

Our overall view on the Other Information Standard is that it accomplishes the Board's desire to increase the perceived transparency of the auditor's responsibility with respect to other information. We see the intent of the proposed standard as more fully describing the auditor's responsibility under the existing AU sec. 550, and reasonably specify and strengthen the auditor's performance responsibilities, without extending a level of assurance to the other information. Continuing from that perspective, we believe that the audit report should not conclude on the other information, but should only state the auditor's responsibilities, including the responsibility the auditor would have if a material inconsistency, a material misstatement of fact, or both were identified. However, if the Board has the view that a greater level of assurance over information included with the audited financial statements is needed, we would suggest exploring the use of procedures under the attestation standards on such other information.

We believe that a description of the auditor's responsibility for other information would be most helpful to the user of the audit report when such a description is unambiguous about what defines other information, and clearly indicates what other information is not addressed by the limited procedures prescribed by the proposed standard. We believe the other information for which the auditor has responsibility should be discretely identified within the standard. We note that any ambiguity has the potential to increase the cost volatility associated with adopting the standard.

The Board sought comment as to whether it is appropriate to apply the standard to information incorporated by reference. We understand that the proposed requirement includes a note to the introduction of the standard which indicates information that does not become available to the auditor until after the issuance of the audit report when such information is included in the company's definitive proxy statement filed within 120 days of the end of its fiscal year is in the scope of the proposed standard. We do not believe that it is appropriate to apply the proposed other information standard to information incorporated by reference in such circumstances, because we believe such a practice would devalue the public's confidence in the auditor if the auditor were to comment on information on which he has not been able to apply the procedures described in the standard. Re-issuances of the auditor's report may become necessary after the information becomes available, and we believe such re-issuances would clearly undermine the public's trust in the audit profession.

We believe that the word "evaluate" does not correctly describe the objectives of the standard, because that term implies a level of assurance achieved similar to that when forming an opinion. A statement should be included in the text of the report that makes it clear these procedures are not the same as, nor do they provide the same level of assurance as an audit. The Board sought comment on whether the objectives assist the auditor in understanding the requirements of what would be communicated in an unqualified auditor's report. Our view is the objectives should be closely aligned with the specific procedures required by the proposed standard. We believe the proposed wording in the audit report should replace the concept of "evaluate" with a definition of the procedures performed with respect to other information, and that doing so will provide an appropriate understanding of the auditor's responsibilities.

However, we believe the objectives should also include providing a statement that the auditor has not audited or reviewed the other information. We further believe the objectives should clarify that the auditor's considerations are based upon audit evidence pertaining to the audited financial statements, and not on audit evidence gathered about the other information.

We believe the auditor should read and apply specific limited procedures to other information to identify a material inconsistency or a material misstatement of fact, or both. The proposed procedures are clear, appropriate, and sufficient. It is understood which amounts in the other information the auditor would be required to recalculate based on the proposed standard. For the reasons previously indicated, we do not believe the proposed standard should use the word "evaluate" in the description of the auditor's responsibilities.

We agree with the Board's assessment of the additional costs associated with the proposed required procedures. Beyond those described in the appendix, we do not believe there would be additional costs, provided the definition of what other information is clear and unambiguous. Also, beyond those described in the appendix, we believe there would not be additional costs when the auditor identifies a material inconsistency, a misstatement of fact or both. We believe there would be potentially recurring additional costs if it were left in doubt what information the auditor is required to perform the prescribed procedures on, or if the word "evaluate" is used to describe the auditor's responsibility with respect to the other information.

We believe the proposed auditor responses are appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both, in the scenarios described in the proposed standard. We do not believe there are circumstances where it would be appropriate for an auditor to issue a report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both. While we believe it would be appropriate for the auditor to address uncorrected matters in other information, we cannot imagine such a situation remaining unresolved.

## EMERGING GROWTH COMPANIES

We believe that the Board should recommend to the SEC that the standards, as ultimately issued, should apply to Emerging Growth Companies (EGCs) without delayed implementation. We believe the changes will be unlikely to impact an EGC's financial position or results of operations, and will add to the transparency of their financial reporting. We believe EGCs will, by their nature, have a higher frequency of matters of the sort that users of the financial statements would seek a better understanding of from the perspective of the independent auditor. Likewise, we believe the audit of an EGC would benefit from the performance of the procedures described in the Other Information Standard, because of the maturity stage of the EGC's financial reporting processes. It is important to note that our recommendation in this matter is not severable from the other recommendations we have made in our letter. We believe that without a narrower definition of critical audit matters focused on significant inherent risks and areas of auditor judgment, the proposed reporting standard would have the potential to make listing requirements onerous, hindering capital formation, and this is especially true for EGCs, as echoed in the aforementioned comments by the Advisory Committee on Small and Emerging Companies to the SEC.

## BROKER DEALERS, INVESTMENT COMPANIES and BENEFIT PLANS

We believe that the requirements in the proposed standards related to critical audit matters should not be required for audits of brokers and dealers, investment companies, or benefit plans. We believe the significant inherent risks and areas of auditor judgment for these entities would likely be the same. As a result, critical audit matters described for these types of entities would not meet the criteria of being useful and relevant to the users of the financial statements, and thus the costs of applying the proposed requirements would not be justified.

**From:** Chet Hebert
**To:** Comments
**Subject:** PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor"s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and
**Date:** Wednesday, December 11, 2013 12:15:49 PM

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Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective as an owner and operator of a small nonpublic, non-custodial broker-dealers.

My Firm is one of approximately 4000 firms that are not public companies. I own 100% of my firm and am fully responsible for its success or failure. I have seven home office employees and 68 registered representatives providing investment services.

The proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of my company. I am the sole investor in my firm.

I believe it is appropriate and consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers, such as my firm, from its oversight. It is important that regulation for small firms remain relevant to the business model and investing public; we encourage the Board to seriously consider the matter of small firm exemption.

Thank you for your consideration

*Chet Hebert*
Chairman & CEO
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February 27, 2014

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

Dear PCAOB:

We are submitting the following comments for the PCAOB's consideration in response to a request for comments on the proposed Auditor's Reporting Model (PCAOB Release No, 2013-005). These comments represent my perspective as an institutional investor for a large public pension plan representing more than 500,000 current and retired members and over $43 billion in assets.

I am pleased to see the PCAOB move forward with a proposal. Recognizing that there was no proposal that would completely satisfy all stakeholders, I believe the PCAOB has structured a well-balanced proposal that will ultimately benefit all stakeholders.

Of the many important efforts the PCAOB has made to improve the audit process for shareholders, I believe the proposed addition of critical audit matters to the auditor's report will be one of the most significant. I see parallels between the critical audit matters requirements in the auditor's report with the management discussion and analysis (MD&A) requirements in the annual report. The MD&A has not only become a powerful resource for investors, but I believe its introduction has helped to foster a stronger relationship between management and their investors. The MD&A helped to foster a culture where management was more welcoming of investor communication and disclosure with numerous benefits.

The MD&A was revised over time and it would be helpful if this proposal contains the essence of what the PCAOB would like to accomplish and need little revision over time. While the overall proposal is excellent, we would like to see a stronger requirement for auditors to disclose their evaluation on management's estimates and judgments, an issue of meaningful uncertainty for investors. Management's estimates can be the cause of inaccurate financial reporting, and a greater level of disclosure and discourse between management, auditors, and investors about estimates and judgments, will strengthen financial reporting and improve our capital markets.

We appreciate the PCAOB for giving us the opportunity to comment on potential changes of the auditor's reporting model, and would welcome additional opportunities to provide input to the PCAOB as this process continues.

Sincerely,

Jennifer Paquette

Jennifer Paquette
Chief Investment Officer

Comcast Corporation
One Comcast Center
Philadelphia, PA 19103-2838

December 18, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034**

Submitted via comments@pcaobus.org

Comcast Corporation appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board" or "PCAOB") *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposed Auditor Reporting Standard"); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Other Information Standard")*; and Related Amendments to PCAOB Standards* (collectively, the "Proposal").

Comcast is a global media and technology company with two primary businesses, Comcast Cable Communications and NBCUniversal. During 2012, we generated approximately $63 billion of revenue and approximately $12 billion of operating income.

While we support the Board's underlying objective in proposing changes to enhance the informational value, usefulness and relevance of the auditor's report and agree with including clarifying language in the existing standard auditor's report that enhances investors' and users' understanding of the scope of the audit, the work performed, and the inherent limitations of the audit process, we have significant concerns about the Proposal as noted below.

* * * * *

**Critical Audit Matters**

We believe the Proposal is fundamentally flawed as it relates to the processes and procedures surrounding the identification and public reporting of Critical Audit Matters ("CAMS"), which we believe may have the unintended consequence of altering the roles and responsibilities of management, auditors and the audit committee. Our specific concerns with the CAMS include: (i) the potential for putting auditors in the position of communicating original information that has not been separately disclosed, or is not otherwise required to be disclosed, by the company (e.g., significant deficiencies); (ii) the potential for a perception that auditors are providing piecemeal opinions on those matters; (iii) the potential adverse effect on the clarity of responsibility for preparation of the financial statements; (iv) the potential undermining of the existing corporate governance structure among the audit committee, the auditors and management; (v) the potential for confidential discussions between the auditor and audit committee to be publically disclosed; (vi) increased time and associated audit fees resulting from the process of identifying, evaluating and documenting (both within the audit firm and with the company and audit committee) the CAMS, especially those ultimately determined to be audit matters not considered critical; and (vii) the timing of such procedures occurring at the most hectic or critical time in the annual reporting process. We believe the costs of the additional procedures to comply, as currently proposed; will greatly exceed any potential benefits.

Accordingly, for the reasons set forth above, we do not agree with the Board's Proposal for auditor's to identify and publicly report CAMS. If, after considering the costs and benefits, the Board nonetheless decides to retain the concept of CAMS, we believe the identification of CAMS should be limited to those items required to be communicated to the audit committee under AS 16, *Communications with Audit Committees* ("AS 16"). Under AS 16, auditors are currently required, among other things, to communicate the following (i) audit strategy, including the identification of significant audit risks and audit procedures to address fraud risk; (ii) significant accounting policies and practices; (iii) critical accounting policies and practices; (iv) critical accounting estimates; and (v) significant unusual transactions. We propose that these items should form the "population" of potential CAMS, but the independent auditors should not be required to finalize the CAMS until following a timely discussion with the audit committee. We believe the identification, reporting and discussions of CAMS by auditors should stop with timely communications to the audit committee, where they can be discussed by experienced financial professionals.

With that said, if the Board can conclude that any potential benefit to investors outweighs the burdens and requires that CAMS be publically reported, we believe it would be more appropriate to require such disclosure in the audit committee report of a company's proxy statement and that such disclosure be limited to the fact that the audit committee has discussed CAMs with the auditors. We believe this approach would provide investors with the assurance that the auditors and audit committees are discussing CAMS, while maintaining the existing corporate governance framework among the audit committee, the auditors and management. As such, we would encourage the Board to solicit the feedback of the SEC on the feasibility of amending the requirements of Reg. S-X Rule 2-07 related to this potential alternative.

**Other Information**

Although we support the underlying objective of adding clarifying language around the auditor's responsibilities with regard to information outside of the financial statements, we believe that, as proposed, the standard would lead to significant additional audit work, and therefore issuer costs, by requiring that the auditor "evaluate" the information and expand the scope of their work to other information beyond their area of professional expertise. We would, however, support a standard that conformed the auditor's responsibility to the current requirement of a "read and consider" level of performance and limited the auditor's responsibility to read and consider other information directly related to the financial statements.

**Auditor Tenure**

Finally, we believe that disclosures regarding auditor tenure would be more suitably placed in the proxy statement, where many companies submit to a vote of their shareholders ratification of the reappointment of the independent auditor.

We have reviewed this letter with our audit committee and they agree with our comments and recommendations.

We appreciate the opportunity to express our views on this proposed auditing standard.

Sincerely,

Lawrence J. Salva

Lawrence J. Salva
Senior Vice President, Chief
Accounting Officer and Controller

Leonard J. Gatti

Leonard J. Gatti
Vice President, Financial Reporting

Comcast Corporation
One Comcast Center
Philadelphia, PA 19103-2838

December 18, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034**

Submitted via comments@pcaobus.org

I am Chairman of the Audit Committee of Comcast Corporation. I have read Comcast's submission of comments on this proposal (copy attached) and I am in full agreement with the views expressed therein concerning critical audit matters, other information and auditor tenure.

* * * * *

In support of the Comcast recommendation that critical audit matters be communicated to the audit committee rather than directly to investors, I believe the following considerations are most important:

Timeliness

Communicating critical matters in the auditor's report on annual financial statements will be too late to be of real value and relevance. If it is important for someone to know "what kept the auditors up at night," that can only be meaningful if that information is communicated on a timely basis, as such matters are identified, not two or three months after the year is over and the audit is completed.

Critical audit matters known at the time of preparation of the annual audit plan should be communicated to the audit committee in that plan. Critical audit matters identified thereafter should be communicated to the audit committee in a timely manner as they arise.

Communication to the Audit Committee

It is important that critical audit matters be communicated to the right people (the audit committee) at the right time (on a timely basis) so that appropriate questions can be asked, concerns expressed and discussed, and, if appropriate, action taken in response to the CAMs identified. The audit committee is knowledgeable about the Company's financial reporting and internal controls and about the audit process; they are, obviously, the group to receive this information and to act on it in cooperation with the auditors and company management.

* * * * *

Cost and Benefit

In my opinion, the proposal will impose significant costs, quantitative and qualitative, with little or no meaningful benefits.

Costs of implementing the proposed standard would include:

1. Significant monetary costs to be borne by auditors, registrants and, ultimately, investors.
2. A distraction of the time and attention of senior audit management at a critical stage of the audit process.
3. The likelihood that the presentation of numerous CAMs will dilute and perhaps obscure the critical audit conclusion – the result of the so-called "pass-fail test" that is the essential result of the audit.
4. Other concerns frequently mentioned – auditor communication in lieu of management which has primary responsibility for financial reporting; inference of piecemeal opinions; disclosure of other information not otherwise required to be disclosed by present standards - - to cite a few of the most significant.

Benefits

The objective of the standard is enhanced value of information communicated to investors. As indicated above, I believe that if such communications are not timely and not actionable, they are of limited relevance and questionable value.

In addition, while not objectively determinable at this stage, I strongly believe that this information will to be, perhaps from the outset, standardized "boiler plate," of little substantive value to anyone.

I appreciate the opportunity to express my views on this important matter.

Sincerely,

J. Michael Cook

J. Michael Cook
Chairman of the Audit Committee

Comcast Corporation
One Comcast Center
Philadelphia, PA 19103-2838

December 18, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034**

Submitted via comments@pcaobus.org

Comcast Corporation appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board" or "PCAOB") *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposed Auditor Reporting Standard"); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Other Information Standard")*; and Related Amendments to PCAOB Standards* (collectively, the "Proposal").

Comcast is a global media and technology company with two primary businesses, Comcast Cable Communications and NBCUniversal. During 2012, we generated approximately $63 billion of revenue and approximately $12 billion of operating income.

While we support the Board's underlying objective in proposing changes to enhance the informational value, usefulness and relevance of the auditor's report and agree with including clarifying language in the existing standard auditor's report that enhances investors' and users' understanding of the scope of the audit, the work performed, and the inherent limitations of the audit process, we have significant concerns about the Proposal as noted below.

* * * * *

**Critical Audit Matters**

We believe the Proposal is fundamentally flawed as it relates to the processes and procedures surrounding the identification and public reporting of Critical Audit Matters ("CAMS"), which we believe may have the unintended consequence of altering the roles and responsibilities of management, auditors and the audit committee. Our specific concerns with the CAMS include: (i) the potential for putting auditors in the position of communicating original information that has not been separately disclosed, or is not otherwise required to be disclosed, by the company (e.g., significant deficiencies); (ii) the potential for a perception that auditors are providing piecemeal opinions on those matters; (iii) the potential adverse effect on the clarity of responsibility for preparation of the financial statements; (iv) the potential undermining of the existing corporate governance structure among the audit committee, the auditors and management; (v) the potential for confidential discussions between the auditor and audit committee to be publically disclosed; (vi) increased time and associated audit fees resulting from the process of identifying, evaluating and documenting (both within the audit firm and with the company and audit committee) the CAMS, especially those ultimately determined to be audit matters not considered critical; and (vii) the timing of such procedures occurring at the most hectic or critical time in the annual reporting process. We believe the costs of the additional procedures to comply, as currently proposed; will greatly exceed any potential benefits.

Accordingly, for the reasons set forth above, we do not agree with the Board's Proposal for auditor's to identify and publicly report CAMS. If, after considering the costs and benefits, the Board nonetheless decides to retain the concept of CAMS, we believe the identification of CAMS should be limited to those items required to be communicated to the audit committee under AS 16, *Communications with Audit Committees* ("AS 16"). Under AS 16, auditors are currently required, among other things, to communicate the following (i) audit strategy, including the identification of significant audit risks and audit procedures to address fraud risk; (ii) significant accounting policies and practices; (iii) critical accounting policies and practices; (iv) critical accounting estimates; and (v) significant unusual transactions. We propose that these items should form the "population" of potential CAMS, but the independent auditors should not be required to finalize the CAMS until following a timely discussion with the audit committee. We believe the identification, reporting and discussions of CAMS by auditors should stop with timely communications to the audit committee, where they can be discussed by experienced financial professionals.

With that said, if the Board can conclude that any potential benefit to investors outweighs the burdens and requires that CAMS be publically reported, we believe it would be more appropriate to require such disclosure in the audit committee report of a company's proxy statement and that such disclosure be limited to the fact that the audit committee has discussed CAMs with the auditors. We believe this approach would provide investors with the assurance that the auditors and audit committees are discussing CAMS, while maintaining the existing corporate governance framework among the audit committee, the auditors and management. As such, we would encourage the Board to solicit the feedback of the SEC on the feasibility of amending the requirements of Reg. S-X Rule 2-07 related to this potential alternative.

**Other Information**

Although we support the underlying objective of adding clarifying language around the auditor's responsibilities with regard to information outside of the financial statements, we believe that, as proposed, the standard would lead to significant additional audit work, and therefore issuer costs, by requiring that the auditor "evaluate" the information and expand the scope of their work to other information beyond their area of professional expertise. We would, however, support a standard that conformed the auditor's responsibility to the current requirement of a "read and consider" level of performance and limited the auditor's responsibility to read and consider other information directly related to the financial statements.

**Auditor Tenure**

Finally, we believe that disclosures regarding auditor tenure would be more suitably placed in the proxy statement, where many companies submit to a vote of their shareholders ratification of the reappointment of the independent auditor.

We have reviewed this letter with our audit committee and they agree with our comments and recommendations.

We appreciate the opportunity to express our views on this proposed auditing standard.

Sincerely,

Lawrence J. Salva

Lawrence J. Salva
Senior Vice President, Chief
Accounting Officer and Controller

Leal J. Gatti

Leonard J. Gatti
Vice President, Financial Reporting

December 11, 2013

Phoebe W. Brown, Secretary
Attention: PCAOB Rulemaking Docket No. 034
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

VIA ELECTRONIC MAIL: comments@pcaobus.org

Re: PCAOB Release No. 2013-005, Rulemaking Docket Matter No. 034

Dear Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the recently proposed standards issued by the Public Company Accounting Oversight Board (the "**PCAOB**"), including *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "**Proposed Auditor Reporting Standard**") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "**Proposed Other Information Standard,**" and together with the Proposed Auditor Reporting Standard, the "**Proposed Standards**").

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-two leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Proposed Standards follow an initial concept release issued by the PCAOB in June of 2011, and broadly seek to improve the form of the auditor's report, which has changed little in the United States since the 1940's. Specifically, the Proposed Standards aim to address concerns that the current form of auditor's report provides little specific information about a particular company to financial statement end users.[1] The Committee applauds the PCAOB's goal of enhancing auditor communications and making financial statements more useful for end users. However, we believe several of the proposed changes may not serve this goal and, in fact, may lead to confusion by investors and unnecessary effort and expense on the part of both auditors and companies in producing financial statements, without recognizable benefit.

[1] Proposed Auditing Standards: The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards, PCAOB Release No. 2013-005, Rulemaking Docket Matter No. 034 (proposed August 13, 2013), p. 5.

First, we believe the discussion of "critical audit matters" should not be included in a final rulemaking. The Proposed Auditor Reporting Standard provides for disclosure of such matters, including "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements."[2] Critical audit matters include subjects that under current PCAOB requirements would be documented and/or communicated to the audit committee, although not all such matters would rise to the level of "critical audit matters." The proposal provides a list of factors auditors should take into account when determining critical audit matters.

Disclosing all "critical audit matters" is problematic for several reasons. Certain investors may misinterpret discussion of these issues as an indication of a problem, even if the audit results in a clean audit opinion – the additional disclosure has the potential to make mountains out of molehills. Inclusion of critical audit matters may be viewed by end users as an implicit qualification of the audit, and could lead users to perceive different levels of assurance on different areas of the financial statements. The mere fact that auditors and a board have spent significant time on an issue does not suggest it should be of particular interest to investors, and conversely, not all issues of interest should be considered "critical audit matters." What is of concern to investors is what the accounting policies and treatment are, not how they have been devised through discussion between auditors and issuers. The proposed additional information will not permit a more insightful evaluation of the fairness of the accounting reflected in the financials.

In addition, drafting disclosure of critical audit matters will likely require significant additional time and effort on the part of the auditors. Disclosure is likely to be voluminous, in particular as auditors seek to convey "critical audit matters" to investors not familiar with topics that, while complex and difficult to address, may routinely arise during public company audits. Auditors will likely take longer in producing their reports to address items that are not of clear informational value. Finally, and most importantly, a requirement to disclose "critical audit matters" would likely result in less open discussion between auditors and issuers and auditors and boards, as issuers and directors constantly will be mindful that any issue they discuss could be subject to disclosure.

Secondly, we believe the Proposed Other Information Standard is too broad and, at the least, should be limited to cover information derived from accounting records and subject to an internal control framework. The Proposed Other Information Standard would require that auditors perform specific procedures in evaluating "other information" taken from a company's public reporting, and that auditors provide an affirmative statement in their reports that they have not identified material inconsistencies or material misstatements of facts in the other information. "Other information" includes all company information, not just financial-related disclosures. The PCAOB says these inconsistencies could be the result of "unintentional error, managerial biases, or intentional misreporting."[3] Under existing standards, auditors already have an obligation to read and consider such other information, but there is no obligation to report their findings.[4]

[2] Proposed Standards, p. 15.
[3] Proposed Standards, p. 7.
[4] Proposed Standards, p. 20.

Requiring an affirmative attestation by auditors will result in auditors taking significant additional time and effort to review "other information" in public company filings, as they seek to protect themselves against potential 10b-5 liability. Particularly where this "other information" is unrelated to financial statements, we do not believe this is an efficient use of auditors' time and expertise. Much of the disclosure provided outside the financial statements and related notes is subjective and forward-looking, and accordingly, it will be difficult for auditors to evaluate this information or objectively to verify it. To avoid these concerns, registrants may curtail the amount or nature of information in their disclosures.

Furthermore, current law, including the Sarbanes-Oxley Act, requires the CEO and CFO of a public company to make certifications in their annual and quarterly reports, and stock exchange listing rules also require independent audit committee supervision of these reports. Management and the company audit committee are certainly better equipped to certify non-financial information than auditors. The Proposed Other Information Standard will result in significant expense with no clear benefit to investors.

Finally, we encourage the PCAOB to clarify how auditor tenure should be disclosed for registered investment companies. Mutual funds are often legally structured as a series of individual funds under a single legal entity (the "umbrella fund"), and their financial statements are issued at the umbrella fund level. Disclosure of the auditor's tenure for each individual fund may be voluminous, confusing and less relevant to end users than the auditor's tenure for the entire family of funds. We hope the PCAOB will consider the unique structure of registered investment companies and clarify an approach that provides maximum benefit to end users.

* * *

Thank you very much for your consideration of the Committee's opinion. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu), or its Executive Director of Research, C. Wallace DeWitt (cwdewitt@capmktsreg.org), at your convenience.

Respectfully submitted,

| | | |
|---|---|---|
| Robert Glenn Hubbard | John L. Thornton | Hal S. Scott |
| R. Glenn Hubbard | John L. Thornton | Hal S. Scott |
| CO-CHAIR | CO-CHAIR | DIRECTOR |

CNCC
COMPAGNIE NATIONALE DES COMMISSAIRES AUX COMPTES

ORDRE DES EXPERTS-COMPTABLES
Conseil Supérieur

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803
USA

13 December 2013

Référence : YN.JZ.CG.CB 20131009

**Re : Comments on PCAOB Rulemaking Docket Matter No. 034 – Proposed Auditing Standards Regarding the Auditor's Report and the Auditor's Responsibilities Regarding Other Information**

Dear Sir or Madam,

The Compagnie Nationale des Commissaires aux Comptes (CNCC) and the Conseil Supérieur de l'Ordre des Experts-Comptables (CSOEC) welcome the opportunity to comment on the proposed auditing standards regarding the auditor's report and the auditor's responsibilities regarding other information. Because of the economic links between France and the USA (and more generally between the European Union and the USA) and because of the very active involvement of the French Institutes in the IAASB, we are of course very interested in the PCAOB's initiative. Some French statutory auditors are registered with the PCAOB and carry audits and issue reports under PCAOB GAAS for French Issuers on the American market and this is another reason why we want to provide comments on the PCAOB's exposure draft.

Indeed, the reform of the auditor reporting that is currently being addressed by the PACOB is also being discussed on the other side of the Atlantic by the European Union[1] and at international level by the IAASB.

The auditor's report is the primary means by which the auditor communicates to investors and other users of financial statements information regarding his audit of the financial statements. This is why these projects are of the utmost importance and convergence among major constituencies is vital.

[1] Proposal of the European Commission available at:
http://ec.europa.eu/internal_market/auditing/reform/index_en.htm#maincontentSec1

COMPAGNIE NATIONALE DES COMMISSAIRES AUX COMPTES

ORDRE DES EXPERTS-COMPTABLES
Conseil Supérieur

We are pleased to provide you hereafter with our general comments on these two proposed auditing standards, respectively *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

If you have any further questions about our views on these matters, please do not hesitate to contact us.

Yours faithfully,

Yves NICOLAS
President of CNCC

Joseph ZORGNIOTTI
President of CSOEC

## 1. General comments on the Proposed Auditing Standard - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

We strongly support the proposed communication in the auditor's report of critical audit matters ("CAM") describing the matters the auditor determined to be of most significance and we believe that it will enhance the value and usefulness of the auditor's report.

We already have in France a very similar mechanism, called "justification of assessments" which was introduced in the auditor's report by the Financial Security Act (Loi de sécurité financière, LSF) of August 1, 2003 to "enable the user of the report to obtain a better understanding of the reasons behind the statutory auditors' opinion on the financial statements". We have been able to operationalize such system and that has proved to be useful[2]. We note that the PCAOB has made reference in its earlier papers to the French "justification of assessments" as a mechanism that was worth exploring and we are glad to see that the PCAOB proposal is, in substance, similar to the French "justification of assessments".

Convergence of auditor's report between the PCAOB, the IAASB and the European Union will enhance the communicative value of such report across various jurisdictions. As some entities require audit reports under both PCAOB and IAASB standards (and in the future may also need to comply with European requirements regarding auditor's report), it is important that there is consistency in the structure, content and format of the auditor's reports even of auditing standards applied differ to some extent.

We welcome the PCAOB convergence efforts with the IAASB proposed auditing standard on the auditor's report. However, we note some remaining differences:

– Different terminology to label the matters that were of most significance in the audit

The PCAOB proposes to use the words "Critical Audit Matters" ("CAM") versus "Key Audit Matters" ("KAM") in the IAASB proposed Auditing Standard. Different words to address a similar concept may be confusing for the users of the auditor's report, especially in the cases of entities that require audit reports under both PCAOB and IAASB standards, and may therefore limit the communicative value of the auditor's reports.

We consider that the term "Critical", which could be perceived as "negative" (it means "crucial" but also could mean "containing or making negative judgments" or even "involving a criticism"), may provoke anxiety for users of auditor's report. It may also generate potential translation issue, for entities which have to translate the PCAOB report into another language.

– Different content of the "CAM" / "KAM" section

We consider that the absence of information on the audit procedures performed by the auditor and the conclusion reached may also create anxiety for users of the auditor's report who may not understand whether the matter has been resolved to the auditor's satisfaction or not. In line with our comment letter to the IAASB Exposure Draft on *"Reporting on Audited Financial Statements: Proposed New and revised International Standards on Auditing"*[3], we suggest that the PCAOB should mandate a developed content and structure of the "CAM", i.e. specify that the description of each "CAM" should include the following information:

- the reason of the selection of a matter as a CAM,
- a brief overview of procedures performed or the auditor's approach to the matter, and
- an indication of the outcome of the auditor's procedures with respect to the matter,

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[2] Study independently conducted by FootprintConsultant (P. Manière) with a view to examine the perception of the statutory auditor's "justification of assessments" by users of the auditor's report : http://www.cncc.fr/download/footprintconsultant_reportstudy_va_cncc_fev2011.pdf

[3] Our comment letter is accessible at : https://www.ifac.org/sites/default/files/publications/exposure-drafts/comments/CNCCCSOEC_0.pdf

- a clear reference to the related disclosure in the financial statements (the auditor should not be the original source of information about the entity).

- We also note that the PCAOB has not provided any illustrative examples for the "CAM" section in the proposed PCAOB auditing standard

On the contrary, in its proposed auditing standard on *"Reporting on Audited Financial Statements"*, the IAASB provides 4 examples to illustrate the KAM section. We encourage the PCAOB to also provide examples of CAM in support of its proposal, at least for educational purposes.

- Going concern issue

We note that the PCAOB has not addressed the going concern issue, when this issue is indeed addressed in the proposed IAASB auditing standard on *"Reporting on Audited Financial Statements"* and in the currently discussed reform of the auditor-related EU legislation[4]. We encourage the PCAOB to tackle this issue. A lack of convergence on that precise issue would be detrimental to the communicative value of the auditor's report across both sides of the Atlantic.

## 2. <u>General comments on the Proposed Auditing Standard – *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Relatde Auditor's Report*</u>

We support the enhanced work effort with respect to other information and the communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation/consideration of the other information. Here again, we believe that convergence between the PCAOB, the IAASB and the EU[5] is essential.

We support the concept developed in paragraph 4 of the appendix A2, i.e. "read the other information based on relevant audit evidence obtained and conclusions reached during the audit". However we believe that the work effort developed in bullet points (a) to (b) is not "principle based" enough. It does not entail any concept of materiality. In addition, it is also difficult to understand the note to bullet point (d).

We wonder whether the terminology "read and evaluate" in the proposed PCAOB auditing standard is actually appropriate in light of the work effort required which does not seem to lead to an "evaluation" and we question the difference with the concept of "read and consider" in the proposed IAASB auditing standard[6]. We therefore encourage the PCAOB to provide additional guidance to illustrate this "evaluation" requirement.

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[4] Directive of the European parliament and of the council on statutory audits of annual accounts and consolidated accounts, Regulation of the European parliament and of the council on specific requirements regarding the statutory audit of public-interest entities

[5] For information, a new European requirement has recently been voted in the recast of the Accounting Directive. As stated in Article 34:

"[In addition to statutory audits on the basis of Directive 2006/43/EC], the statutory auditor(s) or audit firm(s) shall also:

(a) express an opinion on:

(i) whether the management report [which is often used as a proxy for other information] is consistent with the financial statements for the same financial year, and

(ii) whether the management report has been prepared in accordance with the applicable legal requirements;

(b) state whether, in the light of the knowledge and understanding of the undertaking and its environment obtained in the course of the audit, he, she or it has identified material misstatements in the management report, and shall give an indication of the nature of any such misstatements."

The approved Directive is accessible at:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF

[6] ISA 720 - *The auditor's reponsibilities relating to other information*

We do not support the distinction made by the PCAOB between the two following concepts, i.e. "material misstatements of fact" and "material inconsistency". We believe that this distinction is not useful for the users of the auditor's report who are rather interested to understand whether there is "something wrong" with the other information, irrespective of whether this "something wrong" comes from an inconsistency with the financial statements or with the audit evidence obtained and conclusion reached during the audit. Using a generic term such as "material misstatement of the other information" would certainly simplify the reporting on the other information. We also find it difficult to have in the standard the concept of "material misstatement of fact" without defining it. Does it include omissions for example?

**Glenda M. Schwarz**
Vice President and Controller

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2028 McLean
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ConocoPhillips

December 10, 2013

Mr. James R. Doty, Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Sent by email to comments@pcaobus.org

**Re: Rulemaking Docket Matter No. 034, Proposed Auditing Standards – *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; and Related Amendments to PCAOB Standards.**

Dear Mr. Doty,

ConocoPhillips appreciates the opportunity to comment on the Public Company Accounting Oversight Board (PCAOB) Proposed Auditing Standards - *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; and Related Amendments to PCAOB Standards (the Proposed Auditing Standards). ConocoPhillips is the world's largest independent exploration and production company, based on proved reserves and production of liquids and natural gas. Headquartered in Houston, Texas, our global operations involve the exploration, production, transportation, and marketing of crude oil, bitumen, natural gas, liquefied natural gas, and natural gas liquids in 29 countries. As of September 30, 2013, ConocoPhillips had $55 billion in annualized revenue, $120 billion of total assets, and approximately 18,000 employees worldwide. Our success as a large accelerated filer fundamentally depends on the integrity, accuracy and timeliness of the information presented in our financial reports, as well as the working relationship among our management, board of directors and external audit firm. Accordingly, the Proposed Auditing Standards are of critical importance to the Company.

We commend the PCAOB's efforts to make the auditor's report more informative, thus promoting its relevance and usefulness to investors and other financial statement users. With respect to proposed enhancements to the auditor's report regarding the auditor's responsibilities for fraud and notes to the financial statements, as well as auditor independence and clarification of the *current* auditor responsibilities to read and consider other information – to the extent these matters advance this objective, we are supportive. However, we are troubled by the provisions in the Proposed Auditing Standards requiring additional disclosures concerning critical audit matters as determined by the auditor, disclosure of audit firm tenure, and enhancing the auditor's responsibility with respect to other information outside the audited financial statements. We believe these provisions have the potential to improperly shift the responsibilities of management and the audit committee to the auditor; create substantial confusion among investors and other users of the financial statements; and impose significant implementation and recurring costs which will considerably surpass any benefits.

Our key concerns are further elaborated below.

## Shift of Responsibility from Management and the Audit Committee to the Auditor

Financial reporting standards and Securities and Exchange Commission (SEC) rules provide a clear framework that preparation and reporting of financial statements are the responsibility of the company's management. A requirement for the communication of critical audit matters by the auditor would be entirely inconsistent with this framework. Management bears responsibility for and certifies to the completeness and accuracy of the financial statements. Existing authoritative literature, including the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) as well as SEC rules and interpretive guidance, requires management to discuss its critical accounting estimates and general accounting policies in pronounced detail. If any additional information regarding matters of significant judgment is deemed necessary for users of the financial statements, this additional information should be provided by management. Similarly, it should be addressed by new or enhanced enforcement of existing financial reporting standards and SEC rules, rather than new auditing standards.

### *Responsibilities of Management*

The FASB guidelines in *ASC 235 – Notes to Financial Statements* require management to describe all significant accounting policies of the reporting entity. These policies identify and describe the accounting principles followed by the reporting entity and the methods of applying those principles that materially affect the determination of financial position, cash flows or results of operations. In general, the disclosures encompass important judgments as to the appropriateness of principles, encompassing a selection from existing acceptable alternatives, principles and methods peculiar to the industry in which the reporting entity operates, and the application of generally accepted accounting principles to unusual or innovative situations.

The SEC's interpretive guidance (Release Nos. 33-8350; 34-48960; FR-72) regarding Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A), which is required by Item 303 of Regulation S-K, requires management to disclose information concerning Critical Accounting Estimates. These are estimates and assumptions that are both a) material by nature due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and b) material based on their impact to a company's financial condition or operating performance.

As the SEC notes in its releases, such disclosures are made with the intent of presenting a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time. Companies are required to address questions that arise once the critical accounting estimate has been identified by analyzing such factors as how they arrived at the estimate, how accurate the estimate has been in the past, how much the estimate has changed in the past, and whether the estimate is reasonably likely to change in the future. Further, companies are required to analyze specific sensitivity to change for critical accounting estimates, providing quantitative analysis and qualitative disclosure.

The SEC further notes that management's discussion of critical accounting estimates supplements the description of accounting policies required by the FASB. Accounting policy notes in the financial statements describe the method used to apply an accounting principle, whereas the discussion in MD&A presents a company's analysis of the uncertainties involved in applying a principle at a given time or the variability that is reasonably likely to result from its application over time.

Considering management's standing requirements to discuss accounting policies and critical accounting estimates in comprehensive detail, we believe financial statement users will not benefit from additional discussion of complex accounting and auditing matters by the auditor. Management has deeper knowledge, closer involvement with the business, and more complete information about the company than the auditor. The responsibility of management to prepare and disclose information regarding critical matters should be maintained. We do not believe an auditor's discussion of critical audit matters would add value to the discussion provided by management regarding critical accounting estimates and accounting policies. We are disappointed PCAOB Release 2013-005 (PCAOB Release) on Proposed Auditing Standards fails to provide a meaningful analysis regarding the manner in which an auditor's discussion of critical audit matters would supplement existing FASB and SEC requirements.

*Responsibilities of the Auditor*

While the financial statements are explicitly the responsibility of management, the responsibility of the auditor is to attest and verify the information prepared and presented by management. The provisions of the Proposed Auditing Standards will inappropriately expand the role of the auditor into financial reporting related to a company's accounting policies and estimates in addition to attesting on the company's financial statements. This is inconsistent with the expectation the auditor should not be the original source of disclosures about an entity.

*Responsibility of the Audit Committee*

The audit committee plays a significant role in the oversight of a company's internal controls, the integrity of its financial reporting processes, and the approval and independence of the external auditor. SEC rules require management to annually disclose whether its board of directors has at least one audit committee financial expert who is independent of management. The expert must have a thorough understanding of the audit committee's oversight role, expertise in accounting matters, understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate. This requirement places notable importance on the governance role provided by the audit committee.

Auditors communicate significant audit risks to a company's audit committee. These may include critical accounting policies and practices and critical accounting estimates, among other items which may be considered critical auditing matters. Requiring the auditor to further clarify and provide public discussion regarding these matters autonomously in its audit report unavoidably reduces the importance of the governance role performed by the audit committee, as greater oversight responsibility is undertaken by the auditor instead. We believe the information included in the auditor's working papers regarding significant judgments involved in the audit should appropriately be communicated to the members of the audit committee, who have the opportunity for robust dialogue with the auditor. The audit committee can then analyze this information in the appropriate context and ensure the company's financial statement disclosures appropriately present these matters in a manner that is not confusing to investors. This is another area we do not believe a requirement for an auditor to discuss critical audit matters adds value beyond the existing regulatory framework.

*Relationship of Management, the Audit Committee and the Auditor*

In the current regulatory environment, the relationship between management, the audit committee, and the auditor typically has a healthy level of tension, which leads to disclosure of constructive financial information that benefits financial statement users. The appropriate level of tension in these relationships has a very delicate balance which should be maintained. We have serious concerns the expansion of the auditor's role will place a significant strain on these relationships. Placing a requirement on the auditor to disclose critical accounting and auditing matters independently of management and the audit committee raises concerns about confidentiality. It also may discourage certain management teams and audit committees from discussing various matters with the auditor due to apprehension about additional public disclosure. This may lead to an unproductive level of confrontation, as each party disputes the types of critical matters which should or should not be included in the auditor's report and the language with which these should be conveyed. We do not believe there is a need for dissemination of complex, judgmental audit information to extend beyond the audit committee and management.

**Potential Confusion among Financial Statement Users**

We are concerned that additional disclosures made by the auditor regarding critical audit matters will likely create confusion among financial statement users. The result will be overlapping, conflicting, inconsistent and onerous information added by both management and the auditor. Many financial statement users do not have the appropriate context to properly interpret the matters requiring the most complex auditor judgments that the audit committee has. This context includes live interaction with the auditor and deep background knowledge of the company's financial reporting processes integral to the audit committee's oversight role.

*Confusing, Lengthy Information within the Audit Report*

The Proposed Standards define critical auditing matters as those matters that involved the most difficult, subjective, or complex auditor judgments; posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and posed the most difficulty to the auditor in forming an opinion on the financial statements. Users who read an unqualified audit opinion followed by detailed discussion of critical auditing matters may misinterpret the language as demonstrating the auditor had reservations about the opinion provided, and consequently undermine the audit opinion. Far worse, they may incorrectly conclude they should not place reliance upon financial information in these areas. Even if the audit report is extended multiple pages, it is characteristically impossible for an auditor of a global company to accurately convey the audit effort related to all complex audit areas without leading to misconceptions by financial statement users who lack the perspective of the audit committee and also lack the opportunity for active dialogue with the auditor. We also believe auditors may include tedious legal disclaimers to avoid liability that could be associated with their expanded reports. We question whether this addition of lengthy and possibly confusing materials to the audit report adds value to investors who are already encumbered with voluminous financial disclosures.

We are also concerned that requiring the auditor to read and evaluate other information outside the audited financial statements, rather than read and consider this information as currently required under AU Section 550, will create further confusion about who is accountable for the financial statements and related information. Specifically, users may conclude that the auditor, rather than management, has responsibility for this other information, which includes forward looking statements, operating statistics, discussion of business performance, and analysis of the business outlook and environment "through the eyes of management" as required by SEC rules. Moreover, we question how an auditor could evaluate certain other information, such as material incorporated by reference from the Proxy Statement, when that content is not yet available at the time the audit report is issued.

Auditors currently read financial information in the MD&A, earnings releases, and other sources for inconsistencies with the audited financial statements. We understand investors may not fully realize these additional procedures currently being performed by the auditor. To the extent investors require additional clarification over the auditor's current responsibilities regarding other information outside the audited financial statements; we support the inclusion of a statement in the auditor's report clarifying this role.

*Disclosure of Duplicative, Conflicting and Confidential Information*

The expansion of the auditor's responsibilities also poses a significant risk for disclosure of duplicative, conflicting and confidential or competitively sensitive information. The matters currently included in the MD&A disclosures will almost certainly be judged as critical audit matters that are communicated to the audit committee. In addition, auditors may have numerous other matters included in the engagement completion documents or reviewed by the engagement quality reviewer that warrant consideration for disclosure as critical audit matters as defined in the Proposed Auditing Standards. Information underlying these complex auditing matters and conclusions reached should be clearly documented in the auditor's supporting working papers, which are currently subject to both PCAOB investigations and peer review. We are concerned that auditors, who anticipate inspection and peer review findings, may disclose more of these matters, as well as more information on the matters currently discussed by management, than investors would find useful. Accordingly, in addition to duplication, there may also be significant discrepancies between the critical auditing matters disclosed in the audit report and the critical accounting estimates and accounting policies disclosed by management. This could raise the level of confusion and lead to potential issues regarding confidentiality.

**Significant Costs Overshadowing Negligible Benefits**

When new regulations are considered, a thorough cost/benefit analysis should be performed to ensure financial statement users receive benefits which outweigh the costs of implementation and compliance. As the PCAOB notes in Appendix 5 V.F.1. of the PCAOB Release, companies and their audit committees will incur additional recurring costs due to audit fee increases, additional time for review of critical audit matters and discussion with the auditor, and time spent comparing the critical audit matters identified by auditors of industry peers.

We believe these costs will be significant and can easily be underestimated. Based on preliminary discussions, it appears likely our audit fees will increase by no less than 5% due to time spent on critical auditing matters and procedures performed evaluating other information outside the audited financial statements. While this percentage may not appear substantial, when it is applied to a consolidated audit fee of $14.4 million, as disclosed in our 2013 Proxy Statement, the dollar amount is not trivial. Further, we believe the extended length of the financial reports, the additional time incurred and resources involved reviewing and discussing critical audit matters, as well as the costs associated with disclosure risk of confidential information and investor confusion, warrant seriously challenging the appropriateness of the suggested changes.

The Chair of the SEC, Mary Jo White, in her October 2013 speech to the National Association of Corporate Directors, questioned whether investors are well-served by the existing burdensome disclosure, described as "information overload," in financial filings. In addition, the FASB has taken up a formal project to improve the effectiveness of disclosures by clearly communicating the information that is most important to users of each entity's financial statements. The implementation of auditing standards that further duplicate disclosures and add new disclosures will be burdensome to financial statement users. This fundamentally violates the principles underlying the SEC and FASB objectives for more resourceful and streamlined financial information.

Auditor evaluation and reporting on information outside of the audited financial statements will increase the scope of the auditor's assurance responsibilities, adding further procedures and increasing the amount of time spent in an already time-consuming process for both the auditor and management. We are concerned with the amount of time needed to complete these additional procedures within existing reporting deadlines. We are also apprehensive that increasing the scope of the auditor's assurance responsibilities will result in the development of still more auditing standards and additional regulatory efforts in an industry that is already burdened with abundant rules.

We are further perplexed by the PCAOB's intent to require disclosure of audit firm tenure in audit reports. As the PCAOB admits in the Release, "the Board has not reached a conclusion regarding the relationship between audit quality and audit firm tenure." The limited number of empirical studies, of which we are aware, addressing the relationship between audit firm tenure and audit quality indicate audit quality is positively correlated with audit firm tenure. The PCAOB states that financial statement users have indicated a strong interest in this information, yet the Release provides only narrow discussion regarding one shareholder activist group. We would expect the PCAOB to provide more comprehensive dialogue in this area, including results of its own empirical studies and cost/benefit analysis, rather than focusing the debate on a limited group of activists. After more vigorous due process, if the final conclusion is audit firm tenure should be disclosed, we strongly believe this additional information should be provided by management. Likewise, management should have the opportunity to provide related narrative so financial statement users do not reach an inappropriate conclusion regarding the correlation between audit quality and audit firm tenure.

Given the substantial and definitive costs of compliance with the Proposed Auditing Standards, the PCAOB Release, comprising nearly 300 pages of material, explained the potential benefits of these standards in merely a few short paragraphs. The discussion of benefits is largely conditional, using language such as "a more informative auditor's report could benefit investors," and the discussion wholly lacks any form of specificity. We do not believe additional disclosure of critical auditing matters by the auditor provides value to financial statement users as a whole, and we doubt whether a requirement for auditor evaluation of other information adds any value beyond that already provided by the requirements of AU Section 550. It certainly suggests the proposed standard would be challenged to withstand a rigorous cost/benefit analysis.

We respectfully disagree with the PCAOB's conclusions investors would benefit from further insights obtained by the auditor during the audit of the financial statements. We question whether purported benefits in terms of increased confidence in corporate reporting outweigh the costs. An extended audit report and the expanded role of the auditor into a preparer of financial information provides no perceived enhancement to corporate governance, no reduction of investor risk and no additional comparability of reports. We see no provisions to ensure consistency of application across audit reports, and this lack of comparability will cause further confusion. We question the unsubstantiated presumption that users of financial statements will find this greater volume of disclosure from the auditor helpful, in addition to the existing detailed disclosures from management already required by the present authoritative literature. The Proposed Auditing Standards appear to be a solution in search of a problem, and we request a much more comprehensive analysis of the specific benefits.

**Summary and Conclusion**

We commend the PCAOB's efforts to make the auditor's report more informative, thus promoting its relevance and usefulness to investors and other financial statement users. With respect to proposed enhancements to the auditor's report regarding the auditor's responsibilities for fraud and notes to the financial statements, as well as auditor independence and clarification of the *current* auditor responsibilities to read and consider other information – to the extent that these matters promote this objective, we are supportive. We believe the PCAOB needs to more strongly consider the negative impacts caused by the provisions in the Proposed Auditing Standards requiring additional disclosures concerning critical audit matters as determined by the auditor, disclosure of audit firm tenure, and enhancing the auditor's responsibility with respect to other information outside the audited financial statements. The negative consequences of shifting the responsibilities of management and the audit committee to the auditor; creating confusion among users of the financial statements; and imposing implementation and ongoing costs which significantly overshadow negligible benefits warrant heavier consideration. Considerable effort must be made to identify more specific benefits which outweigh these substantial, definitive costs. We strongly believe any additional information deemed necessary for users of the financial statements should be provided by management, and it should be addressed by financial reporting standards and SEC rules rather than new auditing standards.

We thank you for the opportunity to offer our comments on the Proposed Auditing Standards, and we hope that you find our comments helpful. Please contact Ken Seaman, Assistant Controller, by telephone at (281) 293-5628 or by e-mail at Ken.W.Seaman@conocophillips.com if you have any questions or wish to discuss our comments further.

Sincerely,

Glenda M. Schwarz

Glenda M. Schwarz
Vice President and Controller
ConocoPhillips

**James E. Copeland, Jr., CPA**
Chair, ConocoPhillips Audit & Finance Committee

ConocoPhillips Company
600 North Dairy Ashford
Houston, TX 77079-1175

December 5, 2013

Mr. James R. Doty, Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Sent by email to comments@pcaobus.org

**Re: Rulemaking Docket Matter No. 034 – Proposed Auditing Standards**

Dear Mr. Doty,

I appreciate the opportunity to comment on the Rulemaking Docket Matter No. 034 as discussed in PCAOB Release No. 2013-005 from August 13, 2013 (the Proposed Standards). Over the course of my 46-year career, I have served various industries in numerous leadership roles. I currently serve as a director of four companies, including Chair of the Audit & Finance Committee of ConocoPhillips, a Fortune 50 entity. I was a former director of Coca-Cola Enterprises, Inc. from 2003-2008, and also served as the former Chief Executive Officer of Deloitte, one of the largest international accounting firms, from 1999-2003. In addition, I previously served as Senior Fellow for Corporate Governance with the U.S. Chamber of Commerce and as a Global Scholar with the Robinson School of Business at Georgia State University.

I appreciate the PCAOB's efforts to increase the informational value of the auditor's report in order to promote its usefulness and relevance. To the extent that enhanced language on auditor independence, as well as the auditor's responsibility for fraud and the notes to the financial statements, promotes this objective, I am supportive. However, I have significant reservations regarding the provisions in the Proposed Standards requiring additional disclosures with respect to critical audit matters as determined by the auditor, enhancing the auditor's responsibility concerning other information outside the audited financial statements, and disclosure of audit firm tenure. I believe these provisions may blur the roles of the auditor with those of the audit committee and management; may cause considerable misunderstanding among financial statement users; and will impose substantial costs which will exceed minimal benefits. These provisions should be discarded or substantially revised to eliminate the potentially negative consequences.

The Importance of the Audit Committee's Oversight Role

I have seen the role of the audit committee evolve during the course of my experience. In the 1970s, the perceived role of the audit committee lacked significance. It was a role of narrow, functional supervision over management's compilation and presentation of accurate financial records. More recently, the audit committee has taken an extensive and critical position in securing the interests of investors through the broad oversight of each entity's financial reporting processes, internal controls, and the approval and independence of the external audit firm.

The importance of the governance role provided by the audit committee is highlighted by inclusion of at least one audit committee financial expert who is independent of management. The financial expert must have proficiency in accounting and financial matters, the aptitude to make appropriate inquiries to determine whether the company's financial statements are complete and accurate, and a deep understanding of the audit committee's oversight role. Currently, auditors communicate significant audit risks to a company's audit committee. These include critical accounting policies and practices and critical accounting estimates, among other items which may be considered critical auditing matters. As an audit committee financial expert, I have the opportunity for live discourse with the auditor, as well as deep background knowledge of the company's financial reporting processes, which is fundamental to my governance role. I, along with the rest of the audit committee, can analyze the auditor's communications in the appropriate context and ensure the company's financial statement disclosures present these matters in a manner that is not confusing to financial statement users.

Recently, I have noted a worrying trend of regulations that impose significant costs while providing questionable benefits. I believe the added prominence of the audit committee is one of the few benefits achieved by these regulations; however, whether other meaningful benefits have been obtained remains debatable, in light of the definitive costs of compliance. Not only do the additional costs imposed by the Proposed Standards expand upon this unfortunate trend, but the consequences of the critical audit matters provision contradict one of the few benefits achieved by these regulations. The governance responsibility of the audit committee and its financial expert may essentially be usurped by the auditor, who is required to further clarify and provide public discussion regarding critical matters autonomously in the audit report. This provision intentionally and improperly magnifies the role of the auditor. The responsibility of the auditor is to attest and corroborate the financial information prepared and presented by management. The Proposed Standards will inappropriately expand the role of the auditor into independently reporting on accounting policies and estimates, rather than purely attesting to the company's financial statements. This is inconsistent with the fundamental approach the auditor should not be an independent source of disclosures about an entity.

I am also concerned this additional responsibility assumed by the auditor will unproductively strain the dynamics of the relationships among the audit committee, management and the auditor. The well-balanced level of tension in these relationships, which currently benefits financial statement users, will be severely disturbed. I fear the shift of the auditor's role will lead to ineffective confrontation between the auditor and management and will allow the auditor an inappropriate level of oversight ability, which should remain the responsibility of the audit committee.

Misunderstanding among Financial Statement Users

I have concerns many financial statement users may lack the context, background and opportunity for live dialogue with the auditor to properly understand the matters requiring the most complex auditor judgments. Therefore, I believe a change this significant to our existing framework will lead to substantial misconception of critical audit matters. For instance, users who read an unqualified audit opinion, followed by detailed discussion of critical auditing matters, may misinterpret the language as demonstrating the auditor had reservations about the opinion provided or that less reliance should be placed on the financial information presented.

The rules defining critical audit matters also pose a noteworthy risk for disclosure of inconsistent and lengthy information. Most of the items meeting the definition of critical auditing matters are already communicated to the audit committee and currently disclosed in financial reports. However, auditors may have numerous other matters reviewed by the engagement quality reviewer or included in the engagement completion documents that must be deliberated as potential critical audit matters. By including these recommended guidelines in the Proposed Standards, there is a risk of significant discrepancies between the critical auditing matters disclosed in the audit report and those disclosed by management. Furthermore, I am concerned that auditors, who expect peer review and PCAOB inspection, may apply conservative judgment and disclose more of these matters, as well as more information on matters already discussed by management, than financial statement users would find valuable. In addition, auditors may include supplementary legal qualifications to mitigate liability, adding to the length of the audit report.

Costs

The substantial costs associated with the Proposed Standards demand a rigorous analysis of the benefits to be achieved. These costs include increased audit fees, the extended length of financial reports, additional resources involved and time spent deliberating and reviewing critical audit matters, and the risk of misunderstanding by financial statement users. I am disappointed the PCAOB has not provided as robust an examination of the benefits as I would expect.

I am confused by the PCAOB's inclusion of a requirement for disclosure of audit firm tenure. There is conflicting evidence of the correlation between audit firm tenure and audit quality – some academic studies show that longer audit firm tenure leads to higher audit quality, while some show the inverse. In the absence of any conclusive evidence regarding this relationship, it is unclear to me how disclosure of this information would benefit financial statement users. I also would challenge the PCAOB's statement that financial statement users have indicated a strong interest in this information. The Release makes reference to only one shareholder activist group in support of this claim. I would like to see a broader discussion on this topic, including a more representative selection of financial statement users as a whole. A final decision about disclosure of audit firm tenure should only be made after a more solid examination is performed. If such a conclusion is determined, management, rather than the auditor, should disclose this information and provide accompanying clarification to avoid any inappropriate conclusions regarding the correlation between audit firm tenure and audit quality.

Auditor evaluation and reporting on information outside of the audited financial statements will increase the scope of the auditor's assurance responsibilities and the amount of time spent in an already laborious process for the auditor, management and the audit committee. As a director serving on multiple audit committees, I am concerned with the amount of time needed to complete these additional procedures within existing reporting deadlines. I am also worried that this unnecessary increase in the scope of the auditor's assurance responsibilities will lead to the development of even more auditing standards and additional regulations.

An extended audit report and the expanded role of the auditor into a preparer of financial information on accounting policies and estimates provides no apparent improvements to corporate governance, no additional comparability of reports and no reduction of investor risk. I do not believe users of financial statements will find this greater volume of disclosure from the auditor helpful. Financial statement users may actually find these additional disclosures obstructive if they lead to misunderstanding.

I commend the PCAOB's efforts to increase the informational value of the auditor's report in order to promote its usefulness and relevance. To the extent that enhanced language on auditor independence, as well as the auditor's responsibility for fraud and the notes to the financial statements, promotes this objective, I am supportive. My concerns regarding the Proposed Standards require your consideration – specifically, the provisions requiring additional disclosures with respect to critical audit matters as determined by the auditor, enhancing the auditor's responsibility concerning other information outside the audited financial statements, and disclosure of audit firm tenure. These provisions may blur the roles of auditor and audit committee; may cause considerable misunderstanding among financial statement users; and will impose substantial costs which exceed minimal benefits. These provisions should be discarded or substantially revised to eliminate the potentially negative consequences.

Thank you for the opportunity to offer comments on the Proposed Standards, and I hope that you find my comments helpful.

Sincerely,

James E. Copeland, Jr., CPA

**Consumer Federation of America**

December 11, 2013

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

Re: Rulemaking Docket Matter No. 034

Dear Sir or Madam:

I am writing on behalf of the Consumer Federation of America (CFA)[1] to express our support for the proposal to revise and expand the auditor's report and to urge the Board to do more to make the auditor's report a useful document for investors. Investors have made clear their dissatisfaction with the current auditor reporting model, which provides no real information of value beyond an up or down opinion as to whether the audited financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. As currently designed, the report does nothing to distinguish between the audits of companies with straight-forward financial statements and those that present a number of auditing challenges, for example. Nor does it distinguish between those that take a relatively conservative approach to complex accounting issues and those that are more aggressive in their approach. This proposal represents a welcome step toward addressing critical shortcomings in the current auditor's reporting model which will, in turn, enable investors to better assess companies' financial reporting.

**Background**

More than two years ago, CFA joined with other members of the PCAOB's Investor Advisory Group in writing to the Board to urge more extensive revisions to the auditor's report.[2] While we appreciate that the current proposal reflects a partial response to that request, we are nonetheless disappointed that key aspects of our recommendations have not been included in the

[1] CFA is a non-profit association of nearly 300 national, state and local pro-consumer organizations. I was founded in 1968 to represent the consumer interest through research, advocacy and education.

[2] See, September 29, 2011 letter from twelve members of the PCAOB Investor Advisory Group to the PCAOB Office of the Secretary regarding PCAOB No. 2011-003, Rulemaking Docket No. 34, "Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards." We incorporate that letter by reference.

Board's proposal. As a result, the current proposal falls short, in our view, of what could and should be done to transform the auditor's report into a document that provides investors with valuable information to consider in evaluating their current and potential investments. We therefore urge the Board to reconsider those approaches recommended by investors but absent from this proposal. At a minimum, the Board must resist pressure from some issuers and auditors to further scale back the current welcome, but modest proposal.

The fact that investors want additional information from auditors and that it is both feasible and affordable for auditors to provide that information ought to ensure the proposal's adoption. After all, investors have said that receiving more information about the audit would allow them to make more informed investment decisions. More informed investment decisions lead to better and more efficient allocation of capital, and that benefits not only investors but also the health of the financial markets as a whole.

Revision of the auditor's report can help to address other important policy goals as well. For example, both Board members and leaders at the SEC have expressed concern in recent years over a lack of professional skepticism in the audits of public companies. At the same time, evidence has mounted that many audit committees do not effectively serve their audit oversight function.[3] And, past experience has shown that there will always be companies that will test the limits of acceptable financial reporting and auditors who will let them cross that line. While far from a silver bullet, a well-designed expanded auditor's report has the potential to help address each of these problems. At the simplest level, expanding the auditor's report can serve as a much needed reminder that it is the investors, and not management, who are the real audit clients and that it is their interests that the audit is intended to serve.

Consistent with the theory that sunlight is the best disinfectant, requiring a discussion of critical audit matters and how they were addressed in the audit can also have a salutary effect on the conduct of both issuers and auditors. Those issuers who are most aggressive in their approach to financial reporting may be reluctant to have that tendency highlighted in the audit report through a discussion of the audit challenges that resulted. Whereas the current audit report creates an incentive for such issuers to adopt the most aggressive reporting consistent with an unqualified opinion, an expanded discussion of critical audit matters may provide a counter incentive to adopt more conventional, widely accepted financial reporting approaches. At the same time, auditors who realize they will be required to report publicly on their handling of such issues may be more likely to demonstrate the professional skepticism necessary to promote a high quality of financial reporting. Thus, the required reporting may strengthen the auditor's hand in negotiating contentious issues with management. In each of these examples, the auditor's report would better serve this function if, as we have previously recommended, it also included a discussion of management's estimates and judgments and how the auditor arrived at its assessment of those estimates and judgments and an opinion on the quality, and not just the acceptability, of the company's accounting.

[3] See, for example, the discussion at the October 16, 2013 meeting of the PCAOB Investor Advisory Group, which suggested that, because of weaknesses in the board election process and in the definition of financial expert, many audit committees may lack both the independence and financial expertise necessary to provide effective oversight.

The following discusses key issues related to this proposal in greater detail. This comment is focused exclusively on the proposal to include a discussion of critical audit matters in the audit report.

1) Investors and other users of financial statements want more information from auditors than they currently receive.

Extensive evidence exists that investors and other users of the audit report want more information from auditors than the current audit report provides. Improving the content of the audit report has been identified as a priority by members of the PCAOB's Investor Advisory Group (IAG). As part of its consideration of the issue, the IAG weighed results of surveys conducted by the CFA Institute in 2008 and 2010 which indicated that a large majority of analysts want more information from the auditor's report.[4] To further its understanding of the issue, the IAG itself conducted a survey of investors in advance of its March 2011 meeting, the results of which were reported on at that meeting. The IAG survey sought input both on investors' perceptions of the value of the current audit report and on their views regarding needed changes. The IAG survey identified the following as the four most highly desired changes to the audit report:

- a discussion of the auditor's assessment of the estimates and judgments made by management in preparing the financial statements and how the auditor arrived at that assessment (desired by 79 percent of survey respondents);

- disclosure of areas of high financial statement and audit risk and how the auditor addressed these risk areas in planning and conducting the audit (desired by 77 percent of survey respondents);

- discussion of unusual transactions, restatements, and other significant changes in the financial statements (desired by 67 percent of survey respondents); and

- discussion of the quality, not just the acceptability, of the issuer's accounting practices and policies (desired by 65 percent of survey respondents).

The analysts and institutional investors surveyed by CFA Institute and the IAG respectively are among the primary users of financial statements and, by extension, the audit report. As such, their views should carry particular weight with the Board. They have made clear in this and other contexts that they believe that expanded communications from the auditor would help them to better evaluate the financial statements of the companies in which they invest.

2) The proposal delivers some, but not all of the information investors would like to receive from auditors.

The Board's proposal takes a related but somewhat different approach than investors have suggested by requiring disclosure of "critical audit matters" specific to the particular audit

[4] CFA Institute. 2008. February Monthly Question Results. Cited in *Final Report of the Advisory Committee on the Auditing Profession*. VII: 16; CFA Institute. 2010. *Independent Auditor's Report Survey Results*.

that is the subject of the report. As described in the proposing release, the auditor's required communication would focus on "those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements." The proposal further notes that these would generally be "matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three." Based on this description, there would appear to be significant overlap between the "critical audit matters" covered by the proposal and the information investors have previously indicated they want to receive. In particular, areas of financial statement and audit risk ought clearly to be covered under the Board proposal. Information about estimates and judgments and about unusual transactions could also be covered where they rise to the level of importance and posed the degree of audit challenge that would meet the standards for critical audit matters identified in the proposal.

Arguably the biggest divergence between the proposal and the information requested by investors is that the proposal focuses exclusively on information about the audit and avoids any discussion of the auditor's assessment of the financial statements, either with regard to estimates and judgments or more generally with regard to the overall quality of the financial reporting. This appears to reflect a conscious choice by the Board to avoid any changes that would put auditors in the position of providing "information, including any analysis, about the company's financial statements to financial statement users." We strongly object to this proposed limitation on auditor communications. There is no statutory reason that we are aware of why auditors should be precluded from discussing with investors their chief impressions of the quality of a company's financial reporting. Moreover, by failing to include this sort of assessment in its proposed revisions, the Board diminishes the proposal's most important potential benefit – its potential to improve the quality of financial reporting. The Board has not provided sufficient justification for the narrowed focus of this proposal (as we discuss further below).

Despite these significant limitations, the Board has in our view otherwise done a good job of designing the proposed additions to the audit report. Whenever new disclosures are proposed, a key consideration is whether the information will be communicated in a manner that truly promotes enhanced investor understanding. In this instance, the Board has proposed an approach to disclosing critical audit matters that, properly implemented, should provide valuable information to the users of financial statements. The specific sample disclosures provided by the Board make clear that the new disclosures can and should be presented in a way that provides genuine insights into the most challenging issues that arose in the course of the audit and how they were addressed. Despite the best intentions of the Board, however, there is an unavoidable risk that audit firms will implement the new requirement through the provision of boilerplate or cursory disclosures. There is a similar risk that auditors, who will have ultimate responsibility for determining what issues to disclose, will be too narrow in their approach.

In both these instances, the Board will need to provide effective supervision and enforcement of the proposed rule's implementation to ensure that it delivers the intended benefits. We nonetheless agree that the facts-and-circumstances based approach to determining what must be disclosed is the appropriate approach for the Board to adopt. Moreover, the guidance provided in the release, which suggests that most audits would be expected to involve critical audit matters, helps to send the right message about appropriate implementation.

3) It is both feasible and affordable for auditors to provide the information investors want in the audit report.

In determining whether to move forward with this proposal, the key questions the Board should address are: What information do investors want? And is it possible to provide the information investors want at a reasonable cost? As the Board notes in the proposing release, the proposed revisions to the auditor's report would not require auditors to gather much if any additional information. Furthermore, as the proposing release makes clear, critical audit matters are by definition matters that auditors are almost always already communicating in the engagement completion document, to the audit quality reviewer, and/or to audit committees. Thus any additional incremental cost of providing a brief summary of the information in the audit report should be minimal and far outweighed by the benefits to investors and to efficient capital allocation.

The same holds true for the information that investors have sought that is *not* included in the current proposal. This includes the auditor's assessment of key estimates and judgments in the financial statements, as well as the auditor's assessment of the quality, and not just the acceptability, of the company's financial reporting. An auditor could not complete a quality audit without reaching conclusions on these matters. Here again, auditors are already collecting this information and communicating it to audit committees. For example, AU ¶ 380.08 requires the auditor to ensure that the audit committee is informed "about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates." Similarly, AU ¶ 380.11 requires that, "In connection with each SEC engagement, the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting." Thus, a decision not to include the further information investors desire in the current proposal cannot be justified on cost grounds.

4) The proposal should be strengthened.

The Board proposal represents a positive step toward delivering the information investors desire, but it stops well short of providing the full range of information investors have indicated they would like to receive from auditors (as discussed further above). The limitations of the proposal in this regard appear to be driven by a desire on the part of the Board to address concerns raised by issuers and auditors over having auditors report on the quality of financial reporting rather than on an evaluation of the proposals on their own merits. The resulting narrow focus on issues directly related to the audit limits the potential effectiveness of the proposed changes.

The decision-making process reflected here also represents a fundamental misunderstanding of the Board's proper role. Specifically, the Board's responsibility is not to negotiate a compromise between issuers, auditors, and investors, but to serve the public interest.

The Board can best achieve that by adopting standards that make auditors more accountable to the investing public, enhance auditor independence and professional skepticism, and improve the quality of financial reporting. An expanded auditor's report has the potential to contribute to all three goals. Thus, in a case such as this where the potential benefits are significant and investors have made their preferences clear, the Board should see its obligation as delivering those changes viewed as beneficial by investors that can be accomplished at a reasonable cost and consistent with the relevant securities laws.

Such an analytical approach would clearly support not just the existing proposal, but also the broader reforms advocated by investors. For example, on what policy grounds has the Board concluded that it would be inappropriate for auditors to communicate to investors their assessment of management estimates and judgments? On what policy grounds has the Board concluded that it would be inappropriate to put auditors in the role of commenting on the quality of a company's financial reporting? The fact that some issuers and auditors are uncomfortable with that approach is not sufficient justification.

Another argument that has been put forward is that having auditors communicate such matters directly with investors would somehow weaken the role of audit committees. This is patently absurd. Good corporate boards and audit committees will continue to conduct their oversight functions effectively. At companies where board oversight has been less than effective, however, knowing that there will be greater public accountability could serve to reinvigorate audit committee oversight of the audit as well as broader board oversight of the financial reporting process. At a minimum, it would help to reduce the risk that investors will pay the price when boards fail to perform their governance functions effectively.

Similarly, some opponents of the proposed changes have argued that investors might be confused by the information provided. They offer no explanation, however, why this information would be any more confusing than the information provided in financial statements and other disclosure documents relied on by investors when making investment decisions. Moreover, this argument would seem to suggest that auditors and issuers believe they know better than investors what information they would find valuable. We reject that notion, and urge the Board to do so as well.

In short, given the strong preference among investors for expanded disclosures from auditors, the significant potential benefits of providing that information, the weak and self-serving arguments against expanded disclosures, and the feasibility of adopting the proposed changes at minimal cost, we believe the clear imperative for the Board is to move forward with the proposed changes.

**Conclusion**

The primary and laudable goal of this proposal is to transform the auditor's report into a document that provides investors with information that assists them in making informed investment decisions. That directly benefits investors, but it also improves the capital formation process and thus enhances the overall health of the markets. Thus the proposed changes – and the broader changes advocated by investors – can be justified on these grounds alone.

But changing the auditor's reporting model should also be seen as one part of a broader reform agenda designed to make auditors more accountable to the investing public, to enhance auditors' professional skepticism, and to strengthen their hand in negotiating contentious financial reporting issues with management. While the proposal to include a discussion of critical audit matters in the audit report provides modest additional benefits in these areas, these goals would be better served by a broader reform of the audit report to include the auditor's assessment of the company's financial reporting, including in the area of estimates and judgments. Investors have expressed a strong interest in receiving this information. Thus, while we support the current proposal to add a discussion of critical audit matters to the audit report, we urge the Board to go further and incorporate the additional disclosures sought by investors in its revisions to the auditor's reporting model.

Respectfully submitted,

Barbara Roper
Director of Investor Protection

**From:** Mari Buechner
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 6:09:40 PM
**Attachments:** PCAOB Docket 034 Comment.pdf

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I support Lisa Roth's position.

**Mari Buechner**
President & CEO

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1666 K Street, NSW
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Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

| | |
|---|---|
| **From:** | John Cornish |
| **To:** | Comments |
| **Subject:** | Docket 034 |
| **Date:** | Thursday, December 12, 2013 2:01:29 PM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |

I support Lisa Roth's Position.

Lisa Roth

630 First Avenue
San Diego, CA 92101
Phone: 619-283-3500

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

December 11, 2013

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

**RE: PCAOB Rulemaking Docket Matter No. 034**

Members of the Board:

Costco Wholesale Corporation (Costco) appreciates the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (together, the Proposed Standards).

Costco operates an international chain of membership warehouses that carry quality, brand-name and private-label merchandise at lower prices than are typically found at conventional wholesale or retail sources. Costco currently has approximately 71 million members, and we operate 648 warehouses in the United States and Puerto Rico, Canada, Mexico, the United Kingdom, Japan, Taiwan, Korea and Australia, employing approximately 185,000 full and part-time employees. In fiscal 2013, we reported total revenue of $105 billion and net income of $2 billion. Our stock trades on the NASDAQ Global Select Market under the symbol "COST."

A fundamental tenet of financial reporting and generally accepted accounting principles (GAAP) in the United States is that the financial statements and related disclosures are the responsibility of management; the auditor's role is to express an opinion on whether such financial statements are fairly presented, in all material respects, in conformity with GAAP. Costco strives to provide timely, relevant, thorough and transparent financial reporting to our investors. We, including the members of our Audit Committee, take this responsibility very seriously and continually seek to ensure that our investors have the appropriate insights into our business, the key metrics that measure the health of our operations, and the information necessary to make informed investing decisions. We believe that the Proposed Standards, specifically the reporting of "Critical Audit Matters" and the requirement of the auditor to "evaluate" other information contained in a company's annual filings, represent an undesirable change to existing principles. These elements of the Proposed Standards should not be adopted.

999 Lake Drive • Issaquah, WA 98027 • 425/313-8100 • www.costco.com

**Critical Audit Matters**

Our Audit Committee takes very seriously its role and responsibility of reviewing and understanding the critical accounting policies, judgments, and estimates. Our auditors review their audit plan with the Committee and, together with management, they assess risk, design appropriate audit procedures, and communicate final results. We believe that the responsibility and review of such matters and related conclusions lies with management and the Audit Committee.

We do not agree that requiring auditors publicly to communicate "Critical Audit Matters" (CAM) would help investors and other financial statement users. Items that would likely be considered CAMs are often complex in nature and can require extensive background information and context to evaluate. We believe that disclosure of CAMs will increase confusion, speculation and could result in investors drawing incorrect conclusions. Variability in the quantity and extent of CAMs in a registrant's audit opinion relative to other similar filers may cause investors to draw inappropriate conclusions regarding audit quality, earnings quality, and level of assurance provided by the audit opinion. An audit opinion containing a larger number of CAMs could result in the incorrect perception that the underlying audit was somehow more robust or that alternatively, although an unqualified opinion was reached, the auditor had concerns regarding the quality of the financial statements. In reality, a larger number of CAMs may have been driven by the views taken by a particular audit engagement team in the selection of matters to disclose as CAMs or the complexity surrounding certain audit areas. To the extent that the complex areas are material, the policy and judgments would already be disclosed by the registrant under current requirements. Should the drivers behind a particular CAM be attributable to a deficiency in combination with other factors, the discussion of such a deficiency or deficiencies, which did not reach the level of a material weakness, would not otherwise be required to be disclosed by existing SEC rules. Discussion of deficiencies may also confuse readers regarding the quality of the control environment, when an otherwise clean internal control audit opinion was issued by the audit firm. Furthermore, although the Proposed Standards maintain the current requirement for auditors to issue an opinion on the financial statements as a whole, discussion of such CAMs may give the illusion that other levels of assurance are being provided on those items.

We believe that the responsibility of reducing what the Proposed Standards refer to as "information asymmetry" is that of management through improved disclosure; not the responsibility of the auditors. We continuously review our critical accounting policy disclosures to ensure that we are providing the readers of our financial statements with the information helpful to understanding and evaluating our financial performance.

In our research and consideration of these Proposed Standards, we evaluated the items included in the final Audit Committee communication from our auditors as a sample of potential CAMs. We compared those items to disclosures contained in our critical accounting policies and footnotes. We believe that the information provided in these disclosures was complete and transparent in providing our readers the necessary information to understand these matters. In our opinion, the disclosure of CAMs in the audit opinion would be redundant with what we provided in our existing disclosures, which are already audited and covered by the audit report.

We are concerned that if auditors are required to disclose CAMs, they could be inclined to err on the conservative side and "over disclose" items, in an effort to avoid being second guessed. This will lead to additional burdensome disclosure overload, which preparers and investors are already facing, and which the FASB is currently working to address.

We believe that the additional disclosure requirements related to CAMs would significantly increase the time required at the final stages of the audit for the determination, drafting and review of CAMs, thereby reducing the timeliness of our reporting, while also increasing audit fees, with no countervailing benefit to shareholders.

**Auditor's Responsibility for Other Information**

We believe that the expertise of the auditor is related to the audit of the company's financial statements and related footnotes, and that is where their focus should remain. The current audit opinion states clearly that the audit covers the financial statements and the related footnotes. We do not believe that investors think that auditors have responsibilities for disclosures beyond the financial statements and the footnotes. Nor do we believe that modifying the PCAOB rules to require auditors to "evaluate," instead of the current "read and consider" requirement, will increase the quality of the other information reported by registrants.

The Proposed Standard increases the auditor's responsibility for other information in filings by requiring the auditor to "evaluate" the other information contained in the filing. We believe that the current "read and consider" expectation is clear and appropriate and any marginal additional work performed by the auditor as a result of the Proposed Standards would not materially alter the other information reported. We believe it is management's responsibility to ensure that information discussed in Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) and other sections is materially correct and consistent with the information contained in the financial statements and footnotes. We appreciate the current reading that our auditors perform on the other sections in our filings, such as MD&A, and thoughtfully consider and address all comments they provide us.

Increasing the requirement to "evaluate" the other information is unnecessary and any perceived benefit would not outweigh the additional time and costs incurred, which could be substantial.

In summary, we do not believe that the Proposed Standards regarding the disclosure of Critical Accounting Matters and the expansion of the auditors responsibility to information outside the financial statements and footnotes should be adopted.

**Auditor Independence**

While we do not disagree with the new elements proposed for the auditor's report related to independence, our belief is that the investor community is well versed with respect to the requirements and expectations regarding auditor independence. Furthermore, reinforcing or reminding the auditors of their responsibility by requiring these new elements, in our opinion, will not prevent or detect instances where an auditor misleads the public in this regard.

**Audit Tenure**

We do not oppose the disclosure of audit tenure, and in fact we already provide this information to our investors in our Proxy statement. We believe that this is a more appropriate location for such information. Including this information in the audit opinion itself would be a distraction from the purpose of the audit opinion.

Thank you for the opportunity to comment on this important topic. Please feel free to contact us to discuss our comments.

Respectfully,

Richard Galanti
Executive Vice President and
Chief Financial Officer

Cc: Charles T. Munger, Chair, Costco Wholesale Audit Committee

Council of Institutional Investors
The Voice of Corporate Governance

December 16, 2013

Phoebe Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Via electronic mail: comments@pcaobus.org

*Re: PCAOB Rulemaking Docket Matter No. 034*[1]

Dear Ms. Brown:

I am writing on behalf of the Council of Institutional Investors, ("CII") a non-profit association of pension funds, other employee benefit funds, endowments and foundations with combined assets that exceed $3 trillion. CII is the leading voice for effective corporate governance and strong shareowner rights.[2]

The Council appreciates the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Amendments to PCAOB Standards* ("Release").[3] We commend the Board for continuing to pursue one of the most important recommendations contained in the U.S. Department of Treasury's *Final Report of the Advisory Committee on the Auditing Profession* – "to consider improvements to the auditor's standard reporting model."[4] Our detailed responses to select questions contained in the Release are included as an Attachment to this letter.

Our views on the Release are generally consistent with the views we expressed in response to the Board's 2011 *Concept Release on Possible Revisions to the PCAOB Standards Relating to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards.*[5] These views are derived from our membership-approved policies.

Our policies have long reflected the principle that "investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy

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[1] PCAOB Release No. 2013-005 (Aug. 13, 2013), *available at* http://sddco.com/wp-content/uploads/5-PCAOB-Rulemaking-Docket-Matter-No.-034-Aug-13-20131.pdf.
[2] For more information about the Council of Institutional Investors ("CII"), please visit CII's website at http://www.cii.org/about_us.
[3] PCAOB Release No. 2013-005 at 1.
[4] U.S. Department of the Treasury, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* VII:13 (Oct. 6, 2008), *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.
[5] Letter from Jeff Mahoney, General Counsel, CII, to Office of Secretary, PCAOB (Sept. 19, 2011), *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/015_CII.pdf.

in a timely manner investors' information needs."[6] Last fall, our membership reaffirmed that principle when approving substantial revisions to our policies on *Auditor Independence.*[7] Those policies include the following provisions that we believe are relevant to issues raised by the Release:

> 2.13 Auditor Independence
>
> 2.13a Audit Committee Responsibilities Regarding Independent Auditors: The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company's independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality. Even in the absence of egregious reasons, the committee should consider the appropriateness of periodically changing the auditor, bearing in mind factors that include, but are not limited to:
>
> - the auditor's tenure as independent auditor of the company …
> - the incidence and circumstances surrounding the reporting of a material weakness in internal controls by the auditor
> - the clarity, utility and insights provided in the auditor's report …
>
> The audit committee report should provide meaningful information to investors about how the committee carries out its responsibilities…The report should include a fact specific explanation for not changing the company's auditor if the committee chooses to renew the engagement of an auditor with more than 10 consecutive years of service ….
>
> 2.13b Competitive Bids:
> The audit committee should seek competitive bids for the external audit engagement at least every five years.
>
> 2.13f Shareowner Votes on the Board's Choice of Outside Auditor: Audit Committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor.[8]

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[6] CII Statement on Independence of Accounting and Auditing Standard Setters (adopted Oct. 7, 2008), *available at* http://www.cii.org/policies_other_issues#indep_acct_audit_standards.
[7] CII, Policies on Corporate Governance § 2.13 Auditor Independence (updated Sept. 27, 2013), *available at* http://www.cii.org/corp_gov_policies#BOD ("Investors are the 'customers' and end users of financial statements and disclosures in the public capital markets.").
[8] *Id.*

In applying the above referenced policies, including the intent and basis thereof, to the issues raised by the Release, we have reached the following conclusions:

Proposed Auditor Reporting Model

We generally support the proposed auditor reporting model that requires the independent auditor to communicate in the auditor's report critical audit matters. However, we would revise the proposed model to provide that the auditor is required to communicate, at a minimum, an assessment of management's critical accounting judgments and estimates based on the audit procedures the auditor performed.[9] We generally believe that this modest revision to the proposed model would result in an auditor's report that provides the kind of insights that are more responsive to investor's information needs and, therefore, more likely to achieve the Board's worthy goal of "increasing [the auditor's report] relevance and usefulness to investors and other financial statement users."[10]

Proposed Other Information Standard

We also generally support the proposed other information standard. However, we generally believe that the proposed standard's greatest benefit to investors is not from the additions to the auditor's report relating to other information, but rather from the proposed specific procedures for the auditor to perform with respect to evaluating the other information. We generally agree with the Board that those procedures and the resulting communication of any potential material inconsistencies or misstatements of fact to the company's management "could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information available to investors and other financial statement users."[11]

Proposed Standards and Amendments to Emerging Growth Companies

We generally believe that the proposed standards and amendments, as improved by our comments, should be applicable to audits of all public companies, including emerging growth companies ("EGC"). We are currently unaware of any legitimate basis for excluding an EGC from the proposed standards and amendments. We generally agree with the Board that the application of the proposed standards and amendments to EGCs could provide useful information that "could contribute toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital."[12]

CII appreciates the opportunity to comment on the Release. We thank you for considering our views. We stand ready to continue to assist you in your efforts to improve the standard auditor's reporting model so that it is more responsive to the information needs of its key customer—investors.

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[9] Letter from Jeff Mahoney at 1-7 (Attachment) (providing a basis, with supporting citations, for the view that that investors believe the standard auditor's report should be improved to provide, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates).
[10] PCAOB Release No. 2013-005 at 16.
[11] *Id*. at 8.
[12] *Id.* at A7-19.

Respectfully yours,

Jeff Mahoney

Jeff Mahoney
General Counsel

Attachment

ATTACHMENT

Responses of the Council of Institutional Investors ("CII") to Select Questions Contained in the Proposed Auditing Standards
PCAOB Rulemaking Docket Matter No. 034[1]
December 16, 2013

**Proposed Auditor Reporting Model**

**<u>Questions Related to Section IV:</u>**

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?[2]**

CII generally believes that that the final auditor reporting standard should require that the auditor's report be addressed to investors in the company. We note that our membership approved corporate governance policies have long reflected the principle that "investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in timely manner investors' information needs." [3] Our membership reaffirmed that principle last April when approving substantial revisions to our membership-approved policy on "Auditor Independence*."*[4] That policy includes the following provision:

> Investors are the "customers" and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.[5]

Consistent with our policies, we generally agree with the Public Company Accounting Oversight Board ("PCAOB or "Board") that "the requirement for the auditor's report to be addressed to investors might serve as a [helpful] reminder to the auditor that the auditor's ultimate customer is the investor."[6]

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[1] PCAOB Release No. 2013-005 (Aug. 13, 2013), *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf.
[2] *Id.* at A5-20.
[3] CII Statement on Independence of Accounting and Auditing Standard Setters 2 (adopted Oct. 7, 2008), *available at* http://www.cii.org/policies_other_issues#indep_acct_audit_standards.
[4] CII, Corporate Governance Policies § 2.13 Auditor Independence (last updated Sept. 27, 2013), *available at* http://www.cii.org/files/committees/policies/2013/09_27_13%20CII%20Corp%20Gov%20Policies%20Full%20and%20Current%20%20FINAL.pdf.
[5] *Id.*
[6] PCAOB Release No. 2013-005 at A5-9.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?[7]**

CII generally believes that a statement in the auditor's report relating to auditor independence would provide useful information regarding the auditor's responsibility to be independent. As indicated in response to question 2, our membership-approved corporate governance policies relating to the audit are included under a single heading, entitled "Auditor Independence," a sign of the great weight that our members ascribe to the independence of the external auditor.[8] We, therefore, generally agree with "the Board's view [that] . . . adding a statement relating to auditor independence in the auditor's report could . . . serve as a reminder to auditors of these obligations."[9]

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

   b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

   c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?[10]**

CII generally believes that information regarding auditor tenure in the auditor's report would be useful to investors and other financial statement users. We note that our membership-approved corporate governance policies on "Auditor Independence" contain the following three explicit references to auditor tenure:

(1) In connection with the audit committee's consideration of the appropriateness of periodically changing the auditor;[11]

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[7] *Id.*
[8] § 2.13 Auditor Independence.
[9] PCAOB Release No. 2013-005 at A5-14.
[10] *Id.* at A5-20 to 21.
[11] § 2.13a Audit Committee Responsibilities Regarding Independent Auditors.

(2) In connection with the audit committee's consideration of what should be reported to shareowners as an explanation for not changing the company's auditor;[12] and
(3) In connection with the audit committee's consideration of when it should seek competitive bids for the external audit engagement.[13]

We generally agree with the Board that there is "strong interest in this information" from investors.[14]

The ability for shareowners to oversee and evaluate the audit committee's activities regarding the above referenced three best practices would likely be enhanced if information regarding the duration of the auditor's relationship with the company were disclosed. Moreover, disclosure of auditor tenure would also be useful to shareowners when seeking to develop a basis upon which to cast votes in connection with the ratification of the audit committee's selection of the external auditor. That vote, consistent with our membership approved policies,[15] is held annually at most public companies.[16]

Finally, since the auditor's report "is the primary means by which the auditor communicates with investors and other financial statement users,"[17] it seems entirely appropriate to us that certain information about the auditor that investors and other financial statement users find particularly useful, including information about auditor tenure, should be disclosed in the auditor's report.

**6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?[18]**

CII generally believes that the proposed auditor reporting standard requiring the auditor to describe the auditor's responsibilities for other information would not, with the exception of the reporting of the results of the evaluation, necessarily make the auditor's report more informative and useful to investors.[19] Disclosure of a largely boilerplate description of the auditor's responsibilities for other information is not, in our view, responsive to investors' information needs regarding improvements to the

[12] *Id.*
[13] *Id.* § 2.13b Competitive Bids.
[14] PCAOB Release No. 2013-005 at A5-16.
[15] § 2.13f Shareowner Votes on the Board's Choice of Outside Auditor.
[16] *See, e.g.*, ISS Link database: link.issgovernance.com (last viewed Dec. 13, 2013) (In 2013, 2,769 of the Russell 3000 companies held a shareowner vote to ratify the choice of independent external auditor).
[17] PCAOB Release No. 2013-005 at 2.
[18] *Id.* at A5-21.
[19] Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors, to Office of the Secretary, PCAOB 17-18 (Sept. 19, 2011) (Attachment), *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/015_CII.pdf [hereinafter 2011 Letter].

auditor's reporting model.[20] On this issue, we generally agree with noted analyst/investor Jack Ciesielski who recently commented:

> *[T]here's not a lot of new ground-breaking information provided to financial statement users in the report on other information. The only time it would really be of interest to financial statement users is when the auditor really has identified problems with the OFI and states so in the report. That's a situation that should be exceedingly rare; the ability of the auditor to contradict management in their own report is a powerful lever that should persuade managers to appreciate the auditor's point of view.*[21]

**<u>Questions Related to Section V:</u>**

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?[22]**

CII generally believes that the auditor's communication of critical audit matters would be more relevant and useful to investors and other financial statement users if the proposed communication were revised to require that the auditor communicate, at a minimum, an *assessment of management's critical accounting judgments and estimates* based on procedures the auditor performed. We generally believe that, as revised, the auditor's communication of critical accounting matters would be more responsive to investors' information needs.

Our membership-approved policies generally support the view that the auditor's report should be responsive to investor information needs and include insights from the independent external auditor.[23] Consistent with that view, the Board found that "many investors indicated that auditors have unique and relevant insight based on their audits and that auditors should provide information about their insights in the auditor's report to make the report more relevant and useful."[24]

The Board also acknowledged that one of the most frequently suggested areas for additional auditor reporting by investors is "matters in the financial statements, such as significant management judgments, estimates, and areas with significant measurement uncertainty."[25] We continue to believe that this area is the most common category of insights that investors consistently demand, and therefore,

[20] *Id*. at 18.
[21] Jack T. Ciesielski, 22 The Analyst's Accounting Observer 5 (Nov. 22, 2013) (on file with CII).
[22] PCAOB Release No. 2013-005 at A5-44.
[23] CII Statement on Independence of Accounting and Auditing Standard Setters 2; § 2.13b Competitive Bids.
[24] PCAOB Release No. 2013-005 at 3 (footnote omitted).
[25] *Id.* at 11.

should be required to be included in the auditor's communication of critical audit matters.[26]

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?[27]**

CII generally believes that there are many potential benefits that would be associated with the auditor's communication of critical audit matters, if the communication reflects the revision described in response to question 10. As indicated in our September 2011 Letter, in response to the Board's earlier *Concept Release on Possible Revisions to the PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("2011 Letter"), we generally believe that, consistent with our membership-approved policies, the benefits of the communication would:

> [First,] provid[e] investors with information relevant to analyzing and pricing risks and making informed investment decisions because (a) the auditor's extensive knowledge of the company and industry obtained through the audit process and the auditor's experiences with other companies in similar industries; (b) the auditor is an independent third party that could provide an unbiased view of the company's financial statements; and (c) the auditor could use the disclosure requirement to "'leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors."
>
> Second … increas[e] quality competition among audit firms, particularly in the area of professional skepticism, and, thereby, enhance the value of the audit to investors and the confidence in audited financial reports.
>
> Third … assist[investor/shareowners] … in their responsibilities for overseeing company directors and management. For example, information provided by the auditor providing insight into any disconnect between the company's and the auditor's assumptions would provide investor/shareowners a better sense of management, and perhaps management's willingness to engage in aggressive accounting.

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[26] *See* 2011 Letter, *supra* note 19, at 1-7 (providing a basis, with supporting citations, for the view that that investors believe the standard auditor's report should be improved to provide, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates).
[27] PCAOB Release No. 2013-005 at A5-44.

> Finally … assist[investor/shareowners] … in making an informed vote on the board's choice of the external independent auditor.[28]

We generally agree with the Board that the benefits that would be associated with the auditor's communication of critical audit matters could also include:

> [F]ocusing investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making….
>
> [H]elp[ing] investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. . . . [P]rovid[ing] investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures…. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.
>
> . . . [I]increasing the amount or quality of information in financial reporting could result in more efficient capital allocation decisions.[29]

**12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?[30]**

As indicated in response to question 10, CII generally believes that the definition of a critical audit matter would be sufficient for purposes of providing relevant and useful information to investors and other financial statement users in the auditor's report, if the definition were revised so that critical audit matters would be required to include, at a minimum, an assessment of management's critical accounting judgments and estimates based on procedures the auditor performed.

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[28] 2011 Letter, *supra* note 19, at 9-10 (Attachment) (footnotes omitted).
[29] PCAOB Release No. 2013-005 at A5-22 to 23 (footnotes omitted).
[30] *Id.* at A5-44.

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the financial statements? What kind of an effect on quality of the audit can it have?[31]**

As indicated in response to question 11, CII generally believes there are at least four reasons why the additional time incurred regarding critical audit matters could have a positive effect on audit quality. We also generally agree with the Board that "it could increase the auditor's focus on critical audit matters, which could result in enhancing the quality of the audit."[32]

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not? [33]**

CII generally believes that including the audit procedures performed in the communication of critical audit matters in the auditor's report would not, with the exception of the reporting of the resolution of the critical audit matter, necessarily make the auditor's report more informative and useful to investors. As indicated in response to question 10, our membership-approved policies generally support the view that the auditor's report should be responsive to investor information needs and include insights from the independent external auditor. Disclosure of audit procedures performed is not, in our view, the kind of insight that would be responsive to investors' information needs regarding improvements to the auditor's reporting model.

**17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?[34]**

CII generally believes that, consistent with our membership-approved policies, the Board should consider adding a factor that focuses the auditor on the key customer of audited financial reports – the investor. We note that a recent independent study commissioned by the Standards Working Group of the Global Public Policy Committee indicates that the appropriate application of professional skepticism could be enhanced if standard setters infuse standards with judgment frames requiring the auditor to consider issues from the perspective of other parties, including investors.[35] Consistent with the study's results and our policies, we believe the Board should consider adding a factor requiring the auditor to consider the most significant matters in the financial statements from the point of view of a reasonable investor.[36]

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[31] *Id*.
[32] *Id.* at A5-29.
[33] *Id*. at A5-45.
[34] *Id.*
[35] *See* Stephen M. Glover et al., *Enhancing Auditor Professional Skepticism* 22 (Nov. 2013), *available at* http://www.thecaq.org/docs/research/skepticismreport.pdf.
[36] *See* Steven B. Harris, Board Member, PCAOB Open Board Meeting 1-2 (Aug. 13, 2013), http://pcaobus.org/News/Speech/Pages/08132013_Harris.aspx ("I believe we should be seriously

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?[37]**

CII generally believes that one indirect cost that the Board should take into account relating to the auditor's determination, communication, and documentation of critical audit matters is that the communication would expand the length of the current auditor's report and, therefore, make it more difficult for investors to quickly and easily identify departures from the standard unqualified report.[38] We, however, believe this indirect cost would be far exceeded by the many benefits to investors of the auditor's communication, if the communication were viewed as responsive to the needs of investors for more relevant and useful information from the auditor. As indicated in response to question 10, we believe the auditor's communication of critical audit matters would be more responsive to the information needs of investors if it is required to include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates.

**25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?[39]**

As indicated in response to question 10, CII generally believes that the examples in the Exhibit would provide more useful and relevant information to investors if the examples provided more information about the independent auditor's insights, including their assessment of management's critical accounting judgments and estimates based on procedures the auditor performed. More specifically, we generally believe that the illustrative examples should include, for each critical audit matter, the auditor's assessment and insights about where on a continuum of aggressive to cautious management's key judgments and estimates fall, and whether the related reported amount is within a reasonable range according to the auditor's beliefs.[40]

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considering a requirement that auditors also report on 'any matter that would otherwise be of greatest significance to a reasonable investor in understanding the import of the financial statements.'").

[37] PCAOB Release No. 2013-005 at A5-45.

[38] *See* 2011 Letter, *supra* note 19, at 18 ("the clarifications, at least in combination, would likely diminish the value of the existing auditor's report by making it more difficult for investors to quickly discern whether the report departs from the standard unqualified report").

[39] PCAOB Release No. 2013-005 at A5-46.

[40] *See* 2011 Letter, *supra* note 19, at 6-7 (describing investor survey results and a Financial Reporting Council paper supportive of greater transparency surrounding estimates and judgments); *see also* Andrew Sawers, *Suddenly, Audit Reports Get Sexy*, CFO.com, June 27, 2012, at 1, *available at* http://ww2.cfo.com/auditing/2012/06/suddenly-audit-reports-get-sexy/ ("Instead of an audit firm approving a set of accounts, signing off on them through gritted teeth after wrangling over some edge-of –the-envelope valuations pushed hard by its fee paying client, the audit firm could have the ability—in fact, the requirement—to reveal that the assumptions underlying the financial statements are far from

We also continue to generally believe that the appropriate level of detail for the disclosure "should generally be consistent with the information currently required to be communicated to the audit committee, or the information required to be included in the summary memorandum prepared by the engagement partner for the audit work papers describing the major risks of the audit.''[41]

**26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.[42]**

CII generally believes the challenges that might be associated with the comparability of audit reports containing critical audit matters are limited. We generally agree with those investors who have commented to the Board "that they are interested in information that is specific to the audit of a company's financial statements, and, therefore, would expect differences in auditors' reports among companies and reporting periods."[43] As we indicated in our 2011 Letter, "if the information contained in the [auditor's] reports is always consistent, the potential benefits to investors would be diminished."[44]

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?[45]**

CII generally believes that the benefits that would be associated with requiring auditors to communicate critical audit matters are, at least in part, dependent upon the required disclosure of information that otherwise would not have been disclosed under existing auditor and financial reporting standards. As indicated in response to question 11, the potential benefits of such a disclosure are many.

**Proposed Other Information Standard**

**<u>Questions Related to Section III</u>:**

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conversative, though they may just fall within what the auditor regards as an acceptable range of valuations.").

[41] *See* 2011 Letter, *supra* note 19, at 12.

[42] PCAOB Release No. 2013-005 at A5-46.

[43] *Id.* at A5-42.

[44] 2011 Letter, *supra* note 19, at 13.

[45] PCAOB Release No. 2013-005 at A5-46.

7. **Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?[46]**

CII generally believes that the evaluation of the other information would increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information. In our view, if the evaluation of the other information results in management correcting or improving the other information "to avoid potentially inconsistent or competing information between the auditor and management, *investors would . . . benefit as a result of the 'enhanced management disclosure in the financial statements, thus increasing transparency….*''[47] We, therefore, generally agree with the Board that:

> As a result of the auditor's evaluation of other information, and communication of any potential material inconsistencies or material misstatements of fact to the company's management, the proposed other information standard could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information available to investors and other financial statement users.[48]

**Questions Related to Section VI:**

21. **Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?[49]**

CII generally believes that the proposed reporting, including the illustrative language, would provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. However, disclosure of a largely boilerplate description of the auditor's responsibilities for other information is not, in our view, responsive to investors' information needs regarding improvements to the auditor's reporting model.[50]

**Questions Related to Section IX:**

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[4646] *Id.* at A6-22.
[47] 2011 Letter, *supra* note 19, at 14 (emphasis added); *see* Jack T. Ciesielski at 5 ("the ability of the auditor to contradict management in their own report is a powerful lever that should persuade managers to appreciate the auditor's point of view").
[48] PCAOB Release No. 2013-005 at A6-18 (footnotes omitted).
[49] *Id.* at A6-36.
[50] 2011 Letter, *supra* note 19, at 18.

**27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?[51]**

CII generally believes that the Board should require the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting, and that the auditor does not express an opinion on management's report. We have been long-time proponents of requiring auditors of all public companies to examine and express an opinion on management's assertion of the effectiveness of internal control over financial reporting because we believe that, among other benefits, such assurance is an important and effective "driver of confidence in the integrity of financial reporting and in the fairness of the capital markets."[52] We generally agree with the U.S. Government Accountability Office's recommendation that the proposed disclosure "could serve as an important indicator of the reliability of a company's financial reporting, which may influence investors' decisions."[53]

**Emerging Growth Companies**

**<u>Questions:</u>**

**1. Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?[54]**

CII generally believes that the proposed standards and amendments, if revised in response to our comments, should be applicable for audits of EGC. We are currently unaware of any basis for excluding an EGC from the proposed standards and amendments.

We generally agree with the Board that the application of the proposed standards and amendments to EGCs would provide useful information that "could contribute

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[51] PCAOB Release No. 2013-005 at A6-43.
[52] *See, e.g.*, Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors et al., to The Honorable Scott Garrett, Chairman, House Capital Market Subcommittee et al. 2 (July 31, 2012), http://www.cii.org/files/issues_and_advocacy/correspondence/2012/07_31_12_joint_CAQ_CII_letter_opposing_HR_6161.pdf (referencing, among other benefits, the U.S. Securities and Exchange Commission staff study finding "that auditor involvement in [the company's internal control over financial reporting] ICFR is positively correlated with more accurate and reliable disclosure of all internal control deficiencies that conveys relevant information to investors about the company and how it is managed").
[53] GAO, Internal Controls: SEC Should Consider Requiring Companies to Disclose Whether They Obtained an Auditor Attestation, GAO-13-582 at 27 (July 3, 2013), http://www.gao.gov/assets/660/655710.pdf.
[54] PCAOB Release No. 2013-005 at A7-21.

toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital."[55] We also generally agree with the Board that "[e]xempting EGC's from the proposed standards and amendments could cause investors to perceive additional risk and uncertainty with EGCs, which could put EGCs at a [further] competitive disadvantage compared to non-EGCs in attracting available capital."[56] We believe the Board's views are likely bolstered by the underlying data indicating that "financial institutions represent approximately 28% of the total assets of EGCs,"[57] "EGCs are 10 times more likely . . . to have a management report . . . stating that the company's internal control over financial reporting was not effective,"[58] and for "55% of the EGCs . . . there is substantial doubt about the company's ability to continue as a going concern."[59]

[55] *Id.* at A7-19.
[56] *Id.* at A7-21.
[57] *Id*. at A7-17.
[58] *Id.* at A7-18.
[59] *Id.*

Council of Institutional Investors
The Voice of Corporate Governance

Via Email

April 10, 2014

Phoebe Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

*Re: PCAOB Rulemaking Docket Matter No. 034*[1]

Dear Ms. Brown:

The purpose of this letter is to follow-up on a question I was asked as a panelist at the Public Company Accounting Oversight Board's ("Board") April 2, 2014 meeting on the Auditor's Reporting Model ("Meeting"). The question sought more details on the Council of Institutional Investors' ("CII") proposed "modest revision"[2] to the Board's *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("Proposal").[3]

Attached to this letter is a marked version of paragraphs 7, 11b, and A2 of the Proposal.[4] The proposed revisions to those paragraphs illustrate the modest revision described in my opening statement at the Meeting,[5] and in CII's comment letter in response to the Proposal.[6]

Please feel free to contact me directly with any questions at 202.261.7081 or jeff@cii.org.

Sincerely yours,

Jeff Mahoney

Jeff Mahoney
General Counsel

Attachment

[1] PCAOB Release No. 2013-005 (Aug. 13, 2013), *available at* http://sddco.com/wp-content/uploads/5-PCAOB-Rulemaking-Docket-Matter-No.-034-Aug-13-20131.pdf.
[2] Jeff Mahoney, Opening Remarks at Public Company Accounting Oversight Board Public Meeting on the Auditor's Reporting Model 2 (Apr. 2, 2014), http://pcaobus.org/Rules/Rulemaking/Docket034/ps_Mahoney.pdf [hereinafter Remarks]; Letter from Jeff Mahoney, General Counsel, to Phoebe Brown, Office of the Secretary 3 (Dec. 16, 2013), http://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_16_13_CII_letter_PCAOB_docket_034_proposed_auditing_standards.pdf [hereinafter Letter].
[3] PCAOB Release No. 2013-005 at 1.
[4] *Id.* at A1-6, 8 & 14.
[5] Remarks, *supra* note 2, at 2; Letter, *supra* note 2, at 3.

# ATTACHMENT

## Critical Audit Matters

*Determination of Critical Audit Matters*

7. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements based on the results of the audit or evidence obtained.[16/]

> Note: It is expected that in most audits, the auditor would determine that there are critical audit matters~~.~~ and that those matters would include, at a minimum, management's significant accounting judgments and estimates.

. . . .

11. For each critical audit matter communicated in the auditor's report the auditor must:[21/]

   a. Identify the critical audit matter;

   b. Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and

      Note 1: For example, if the auditor identified the valuation of financial instruments with little, if any, market activity at the measurement date as a critical audit matter because the valuation involved the most difficult, subjective, or complex auditor judgments, then communication of that critical audit matter in the auditor's report must describe the considerations that led the auditor to determine that the matter is a critical audit matter, which might relate to the high degree of measurement uncertainty or the significant judgments and estimates involved.

      Note 2: For management's significant accounting judgments and estimates, communication of those critical audit matters in the auditor's report also must describe the auditor's insights on, and assessments of, management's significant accounting judgments and estimates, including the degree of aggressiveness or conservatism of those judgments and estimates, and whether the related reported amounts are, in the auditor's judgment, within a reasonable range.[22/]

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[22] See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees 15 (1999), http://www.chugachelectric.com/pdfs/agenda/fcagenda_051403_ixd.pdf (Recommending that "outside auditor discuss with the audit committee . . . such issues as . . . [the] degree of aggressiveness or conservatism of the company's . . . underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by outside auditors.").

c. Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

. . . .

## *APPENDIX A – Definition*

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matters – Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

Note 1: “Critical audit matters,” as defined, would include, at a minimum, management’s significant accounting judgments and estimates.

Note 2: Use of the word “most” is not intended to imply that only one matter under each criteria would quality as a critical audit matter. Depending on the facts and circumstances of the audit, there could be several critical audit matters. Also, an audit matter could meet one, two, or all three of the criteria in the definition.

Lauren Craft
3610 S Street N.W.
Washington, D.C. 20007

December 1, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Secretary of PCAOB:

As a member of the financial community and potential investor, I am writing to recommend the following revisions to improve the auditor's communication through the auditor report to better inform financial statement users through reporting on critical audit matters.

To do so, I will address the Critical Audit Matters Questions 10-28 specifically listed in Appendix 5, Section 5:

10. Yes, the auditor's communication of critical audit matters would be extremely relevant and useful to investors and other financial statement users who examine cash flows, assets and liabilities and overall financial health of companies. They are especially interested in errors and fraudulent issues in financial statements to which auditors may be privy.

11. The auditor's communication of critical audit matters would benefit investors and other financial statement users by shedding more light into potential areas of risk, the most significant matters found by auditors, the quality of accounting policies and practices, significant changes and events impacting the financial statements, and the areas where significant matters are disclosed in the financial statements. Furthermore, due to their regular interactions with management and by drawing more attention to critical audit matters, auditors may improve the quality of the audit.

On the other hand, unintended consequences include potentially higher audit fees and additional time needed for the auditor to determine and communicate critical audit matters. The Board should continue to ensure that the inclusion of critical audit matters does not compromise the quality of the audit report.

12. Yes, the definition of a critical audit matter is sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report. It also is sufficiently clear for determining what would be a critical

audit matter. Yes, the use of the word “most” is understood as it relates to the definition of critical audit matters.

13. Yes, providing that all current procedures are kept intact, the additional time incurred regarding critical audit matters is likely to improve the quality of the audit of the financial statements as auditors spend more time on these matters.

14. Yes, the proposed requirements regarding the auditor’s determination and communication of critical audit matters are sufficiently clear in the proposed standard. Determining and communicating critical audit matters will not expand beyond the scope of the auditing process and procedures, but rather be determined and communicated from the work already performed.

15. Yes, it would be informative and useful to include the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report. This would provide financial statement users with more background on the critical audit matter facing the company, which allows for deeper understanding of the business and risks associated.

16. Yes, the factors are helpful in assisting the auditor in determining which matters in the audit would be critical audit matters. Specifically, “the degree of subjectivity,” “the nature and extent of audit effort required”, “the nature and amount of available relevant and reliable evidence,” “the degree of difficulty in obtaining such evidence,” “the severity of control deficiencies,” resulting “changes in the auditor's risk assessments,” “the nature and significance of misstatements,” “the extent of specialized skill or knowledge” required, and “the nature of external consultations” all provide more background on the financial health of a company.(Appendix 5) I recommend all factors be included.

17. No, there are no other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters. Documenting and communicating critical audit matters will require incrementally greater financial and staffing resources, so I recommend limiting the factors included to those already addressed in the document.

18. Yes, the proposed requirement regarding the auditor's documentation of critical audit matters is sufficiently clear. It outlines the need for enough detail for the conclusions by the auditor to be clearly understood by any experienced auditor and differentiates critical audit matters reported and not reported as well as mentions potential management pressures and additional recurring costs that could arise.

19. Yes, the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter encourages auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters. This provides reasoning for omission and the basis for determination of seemingly critical audit matters by the auditor in the auditor's report. It also notifies auditors of potential management pressures to exclude such matters from the auditor's report.

20. Yes, the proposed documentation requirement is sufficient. The Board should consider broader documentation after the initial implementation of the critical audit matters in auditors' report.

21. & 22. The additional costs related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account revolve around time needed for preparation and review to include critical audit matters, both one-time costs and recurring costs, and vary given the types of audits being performed. As quality may improve in the auditor report, the Board should expect new quality control processes to arise as well as the need for additional training. These costs will affect auditors, companies and audit committees. The impact on companies will vary given size, as larger companies having more information available in the market than smaller companies. Thus, the inclusion of critical audit matters will reduce the market information asymmetry due to company size and potentially lower the cost of capital for smaller companies as lenders and investors gain more insight and confidence into financially sound small companies.

23. Audit fees will increase given the requirement to determine and communicate critical audit matters under the proposed auditor reporting standard. However, the quality of the auditors' reports is likely to increase.

24. Yes, special events encountered by a company should trigger the requirement of critical audit matters to be communicated by the auditor each period presented. The circumstances of the special events would need to directly impact the financial health of companies in order to trigger this requirement.

25. Yes, the illustrative examples provided offer useful and relevant information of critical audit matters and at an appropriate level of detail. Each of the three examples details the background, excerpts from company's notes to financial statements, determination and communication from the auditor. This provides a thorough way to understand how an auditor would determine and communicate the critical audit matter. I recommend that the examples be included.

26. The challenges associated with the comparability of audit reports containing critical audit matters include the type of audit performed, different auditors, varying levels of interactions with management of the auditors, and changes in accounting practices.

27. There are benefits and unintended consequences associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards. Users of financial statements and investors generally may benefit from understanding the critical audit matters faced by the auditor in greater detail and, in doing so, improve their financial analysis of companies and investment decisions. But, an unintended consequence may be that the market overemphasizes the significance of the critical audit matter. When companies encounter economic, business or profitability issues, there may be a flight of capital away from companies reporting critical audit matters that the market deems too risky. The Board should not make changes to overcome this unintended consequence, but rather allow the market to react to the information with a hands-off policy.

28. The auditor's communication of critical audit matters under the proposed auditor reporting standard may increase the auditor's potential liability in private litigation. This communication should not lead to an unwarranted increase in private liability provided that the auditor does not misuse the critical audit matters as a way to influence investors and users of financial statements. The proposed steps the Board has outlined to mitigate the likelihood of increasing an auditor's potential liability in private litigation, including a description of the auditor's responsibilities, specific procedures, and specific responses, should be implemented.

Thank you for the opportunity to provide comments on PCAOB Rulemaking Docket Matter No. 034.

Best regards,

Lauren Craft

Crowe Horwath.

**Crowe Horwath LLP**
Independent Member Crowe Horwath International

December 11, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 034,
Proposed Auditing Standards—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's Proposed Auditing Standards—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (Proposed Standards or Proposed Amendments, as applicable).

We support the Board's efforts to improve audit quality by enhancing existing auditing standards, and to provide additional information to investors for decision-making. Further, we agree with the Board's decision to retain the current "pass/fail" model for the auditor's report as the current report provides objective information with clarity. We also encourage the Board to ensure that the Proposed Standards do not increase the expectation gap between auditors and users of financial statements. We are pleased to provide our observations regarding areas where we believe the Proposed Standards and Proposed Amendments could be modified to provide more clarity for investors and other users, and to address other matters.

**Proposed Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

Alternative Approach

We are providing for the Board's consideration an alternative approach for reporting critical audit matters. We believe it is the role of management to provide information regarding the issuer's financial reporting to financial statement users, and it is the role of the audit committee to provide oversight of the financial reporting process. The auditor's role is to provide assurance on information provided by management. To alleviate the auditor from reporting original information, including critical audit matters that, under the Proposed Standard, might be included in the auditor's report, and to avoid a time-consuming process of determining the content of the auditor's report, generally occurring at a time of year that is critical to completion of audit engagements, we suggest that appropriate rulemaking require disclosure of critical audit matters by an issuer's audit committee, rather than the auditor. As part of the audit committee's role in corporate governance and oversight of the financial reporting process, and following discussions with the audit committee by the issuer's auditor under PCAOB Auditing Standard No. 16, *Communications with Audit Committees* (AS 16), the audit committee is in a position to understand and report on critical audit matters. The auditor would then be able to report on the critical accounting matters disclosed by the issuer's audit committee, and maintain the fundamental role of providing assurance on such information. If the audit committee is responsible for disclosing the critical audit matters, the auditor's report could indicate that the auditor read the critical audit matters disclosed by the audit committee, and report on whether there were any inconsistencies in the matters reported, as compared to the auditor's communications with the audit committee. Under this alternative approach, the audit committee's report of critical audit matters would best be included in the issuer's annual report. We acknowledge that this alternative approach would require rule-making by the Securities and Exchange Commission as it relates to audit committee reporting of critical audit matters.

The following comments represent our observations on the Proposed Standard without consideration of the alternative approach above.

**Critical Audit Matters**

Definitional Clarity and Unintended Consequences

Appendix A of the Proposed Standard defines critical audit matters as those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. Further, Paragraph 8 of the Proposed Standard states that critical audit matters ordinarily are matters of such importance that they are included in the matters required to be documented in the engagement completion document, reviewed by the engagement quality reviewer, communicated to the audit committee, or any combination of the three. We believe that the definition of critical audit matters is not sufficiently clear; given the three possible sources and that the matters to consider in the determination of critical audit matters in the Proposed Standard will lead to several unintended consequences:

- The subjectivity inherent in the Proposed Standard will result in inconsistencies in practice and the lack of comparability of auditors' reports. Based on auditor judgment, two different audit firms, or two separate engagement teams within the same audit firm, may identify and report different critical audit matters for a similar engagement. We believe that financial statement users prefer a clearly conveyed auditor's report with a concise and useful message. We also believe that introducing inconsistency and lack of comparability of auditors' reports could result in unintended assumptions by the users of the financial statements regarding the issuer's quality of accounting based on the number of critical audit matters in an issuer's auditor's report, or the inclusion or lack of specific critical audit matters in an issuer's audit report, compared to audit reports of other issuers. Users of the audit report may shift their focus from the auditor's conclusion that the financial statements are presented fairly, in all material respects, in conformity with the applicable financial reporting framework, a clear and concise conclusion, to inconsistencies in the number and type of critical audit matters within the auditors' reports.

- The lack of a clear definition of a critical audit matter increases auditor liability concerns. As a result, auditors' reports might include matters that do not meet the intent of the Proposed Standard in an effort to reduce auditor liability risk for the lack of sufficient disclosures. An auditor's report that provides other than important user information may not be understood by a user of the financial statements, and the relative importance of the information provided will be unclear.

- The lack of a clear definition of a critical audit matter will lead to a significant amount of documentation of matters that might appear to meet the definition of a critical audit matter but were ultimately determined to not be critical audit matters. Paragraph 14 of the Proposed Standard requires the auditor to document the basis for the determination that unreported audit matters that may appear to meet the definition of a critical audit matter were not critical audit matters. The matters and factors to consider in the determination of critical audit matters in paragraph 8 and paragraph 9 of the Proposed Standard are subjective judgments with no clear boundaries. As a result, we believe a significant number of audit matters will "appear to meet" the definition of a critical audit matter. It is not uncommon for a significant number of matters to be documented in the engagement completion form, reviewed by the engagement quality reviewer, or communicated to the audit committee. As a result, we believe the documentation of unreported audit matters will be of significant length and may likely exceed the documentation of critical audit matters that are disclosed in the auditor's report.

- Critical audit matters in the draft auditor's report will be reviewed by the issuer's audit committee, management, and their legal counsel. The additional time necessary to review the draft auditor's report will occur in a very critical and compressed period of time. Without clarity of the definition of a critical audit matter, we believe the additional time needed to review the draft disclosures in the auditor's report and resolve observations will be further magnified and create challenges for issuers to meet the current requirements for a timely filing. Further, documentation of items that were not deemed critical audit matters will not improve audit quality, but instead it will strain the auditors' ability to focus on other responsibilities during the critical wrap up stages of the audit.

To help avoid the unintended consequences noted above, we believe the definition of a critical audit matter in the Proposed Standard should be based on and limited to the existing communication requirements of AS 16. AS 16 includes materiality thresholds for required communications, which would also assist in determination of matters that are critical audit matters. We also recommend removing the requirement for the auditor to document the basis for the determination that unreported audit matters that may appear to meet the definition of a critical audit matter from the Proposed Standard.

Specific Critical Audit Matters and Examples

Paragraph 11 of the Proposed Standard requires the auditor's report to (1) identify the critical audit matter; (2) describe the considerations that led the auditor to determine that the matter is a critical audit matter; and (3) refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. The illustrative examples on pages A5-65 to A5-78 of the Proposed Standard include disclosures in excess of the requirements in the Proposed Standard. The additional disclosures in the illustrative examples, as noted below, raise several concerns.

- We do not believe that the auditor's report should contain commentary on the issuer's business and the anticipation of future events. We believe management is best suited to address their business and future plans, and to provide the most relevant information for investors; whereas the auditor's role is to provide independent assurance on the information that is disclosed by management.

- The examples include disclosures of audit procedures performed in response to a critical audit matter. Disclosure of audit procedures may not be clearly understood by a user, and put the user in the role of determining the sufficiency of the auditor's procedures in responding to critical audit matters. The disclosure of audit procedures will also result in increasing the length of the auditor's report, shifting the focus of the report from auditor conclusions on the issuer's financial statements to audit procedures that will be difficult for users to understand and determine their importance. The disclosure of audit procedures may also become boilerplate disclosures, further diminishing the value of the information to the users of the financial statements. In addition, we believe the disclosure of audit procedures could decrease audit quality by providing information on audit strategies and by reducing the element of unpredictability in the audit. As a result, we do not believe the auditor's report should discuss the audit procedures in response to critical audit matters.
- We do not believe that the auditor's report should disclose consultations with the auditor's national office or the use of specialists. Auditor interactions with the national office, audit firm specialists, or specialists engaged by the issuer, are routine considerations that occur during the audit process that are intended to provide assurance on the overall form and presentation of the financial statements, including any related audit affects. Specific reference to consultations or use of specialists in the auditor's report may appear to offer an inappropriate high level of assurance on these matters.

- We do not believe that the auditor's report should disclose internal control deficiencies that do not meet the definition of a material weakness. An internal control deficiency, or a combination of deficiencies, that is less severe than a material weakness, by definition, does not reach a threshold of a reasonable possibility that a material misstatement of the issuer's financial statements will not be prevented or detected on a timely basis. As a result, disclosure of internal control deficiencies that do not meet the definition of a material weakness is not of high importance to the user of the financial statements, and may result in confusion regarding the effectiveness of the issuer's overall system of internal controls. Further, disclosure of non-material weaknesses could result in disclosing original information about an issuer's processes or accounting systems. As previously noted, we believe the issuer should have the primary responsibility for disclosing original information.

- We do not believe that the auditor's report should disclose corrected and uncorrected financial statement misstatements. According to a January 2008 U.S. Government Accountability Office report, as referenced in an Appendix to the Proposed Standard, the sense of confidence in audited financial statements is key to the efficient functioning of markets. We believe the disclosure of corrected and uncorrected financial statement misstatements may add unfounded uncertainty that more misstatements may exist in the financial statements, or imply that the financial statements are not presented fairly, in all material respects, resulting in reduced confidence in the financial statements. Similar to the above observation, disclosure of these types of matters could also result in reporting original information in the auditors' report.

As a result of the above observations and to avoid the implication that such additional disclosures in the auditor's report are required, or become de facto required in practice, we recommend that the examples provided in the Appendices include only the disclosures required by the Proposed Standard.

Prior Period Critical Audit Matters

Paragraph 10 of the Proposed Standard requires the auditor to communicate the critical audit matters related to the audit of the current period's financial statements. Paragraph 10 further indicates that the auditor "should consider" communicating critical audit matters relating to prior periods when certain criteria are met. The additional discussion on page A5-34 states that when a predecessor auditor reissues an audit report, the communication of critical audit matters for the prior period need not be repeated. The language in the Proposed Standard and related discussion are not clear regarding the predecessor auditor's reporting responsibilities. We suggest modifying the Proposed Standard to clarify the requirement to communicate critical audit matters related to prior period's financial statements. Further, we suggest expanding the Proposed Standard to clarify a predecessor auditor's responsibilities when a predecessor auditor did not previously report an audit matter (since it did not meet the criteria) as a critical audit matter, however, based on subsequent events, the predecessor auditor's conclusion as to the need to report a matter as a critical audit matter may have changed. We believe guidance to explain the predecessor's reporting responsibilities in this situation would be helpful.

Basic Elements of the Auditor's Report

Paragraph 6b of the Proposed Standard specifies that the addressees in the auditor's report could include others besides shareholders and the board of directors. We recommend modifying the Proposed Standard to remove others from the entities to which the auditor's report may be addressed due to potential litigation risk.

Paragraph 6i of the Proposed Standard requires the auditor's report to include a statement containing the year the auditor began serving consecutively as the issuer's auditor. We believe an unintended consequence of including auditor tenure in the auditor's report is the implication of a correlation between auditor tenure and audit quality. The PCAOB's previous Concept Release on Auditor Independence and Audit Firm Rotation acknowledges that there is not a demonstrated relationship between an auditor's objectivity and professional skepticism and the tenure of the audit engagement. Further, the Proposed Standard does not suggest conclusive evidence of a relationship between audit quality and auditor tenure. Accordingly, we believe that auditor tenure should not be included in the auditor's report. We suggest it is more appropriate to disclose auditor tenure in the definitive proxy statement or in the registered public accounting firm's Annual Report Form 2 with the Public Company Accounting Oversight Board.

**Proposed Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

Definition of Other Information

Paragraph 1 of the Proposed Standard defines Other Information to include information in an annual report, other than the financial statements and auditor's report. Other Information is also defined to include information incorporated by reference, proxy statements filed within 120 days after the end of the fiscal year and, based on the circumstances, Other Information in amended annual reports. The suggested additions to the auditor's report regarding Other Information do not define the Other Information that is subject to the Proposed Standard. As a result, the scope of Other Information subject to the auditor's procedures may not be clear to users of the financial statements, resulting in an expectation gap between auditors and users. Further, unlike the requirements of AU 550, auditors would be required to evaluate Other Information to determine if a material misstatement of fact exists, even though such Other Information may be only tangentially related to the financial statements, resulting in significant additional time and cost by auditors. This tangential relationship between the financial statements and certain Other Information is particularly relevant to many documents incorporated into the annual report by reference. We suggest retaining the AU 550 requirement that the auditor consider Other Information only for the purpose of considering its consistency with the financial statements. This would allow users of the financial statements to understand that the Other Information that is subject to the auditor's procedures is limited to the Other Information that the auditor would consider when determining whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.

Regarding the applicability of the Proposed Standard to Other Information that is not available prior to the issuance of the auditor's report, we do not believe that it is appropriate for the auditor to conclude in the auditor's report on information that is not available at the time the auditor's report is issued. Providing assurance on information after the auditor's report is issued presents practical and logistical concerns that would make this aspect of the Proposed Standard inoperable. We believe the Proposed Standard should reflect limiting the auditor's procedures to information that is only available at the time the auditor's report is issued.

Further, Paragraph 11 of the Proposed Standard indicates that when Other Information is not available prior to the issuance of the auditor's report, and the Other Information is not appropriately revised after the auditor has communicated a material inconsistency, material misstatement of fact, or both, to the audit committee, the auditor should apply the procedures in AU 561. The audit procedures required by AU 561 are only required if the new information that may affect the auditor's report existed at the date of the auditor's report, therefore the Other Information in this situation would not be available at the date of the auditor's report. If information not available prior to the issuance of the auditor's report is not excluded from the Proposed Standard, as recommended above, we recommend clarifying in the Proposed Standard the audit procedures that are required.

Auditor's Responsibilities

Paragraph 3 indicates that the auditor must evaluate whether Other Information contains a material inconsistency, a material misstatement of fact, or both. The level of materiality to be applied for this requirement is not clear based on the Proposed Standard. For an audit of the financial statements and internal control over financial reporting, federal security laws interpret a misstatement to be material if there is "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." We believe that application of this interpretation of materiality to the wide variety of both financial and non-financial Other Information included in an annual report may be inconsistently applied and interpreted. Clarification in the Proposed

Standard of the auditor's application of materiality when evaluating whether Other Information contains a material inconsistency, a material misstatement of fact, or both, is suggested.

Paragraph 4 of the Proposed Standard includes the required procedures that an auditor should perform with respect to Other Information in an annual report. These procedures include evaluating Other Information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit. We suggest retaining the auditor's procedures in AU 550 with respect to Other Information for the following reasons:

- We believe an expectation gap with users of the auditor's report is possible due to introducing the term "evaluate", which is a previously unused term to express the level of assurance. We believe that users will interpret "evaluate" as a level of assurance that is beyond the "read and consider" language in current standard AU 550, and that significant additional procedures will be performed by auditors in response. Further, because users are not knowledgeable of the audit evidence obtained and conclusions reached during an audit, users' understanding of the extent of the auditor's procedures regarding Other Information may be inconsistent. Also, because the additional language that is proposed to be added to the auditor's report does not clarify the auditor's procedures, an expectation gap with users may result. Examples of Other Information that would be particularly susceptible to misunderstanding of the auditor's procedures include:
    - Forecasted information;
    - Assertions regarding the effectiveness of management's business plans;
    - Management's assertion regarding its internal controls when the auditor has not performed an audit of internal controls; and
    - Disclosed business risks, and the completeness of this information.

- Paragraph 4's requirement for auditors to read and evaluate Other Information based on relevant audit evidence obtained and conclusions reached during the audit will be difficult to implement. Consideration of every item of audit evidence in an audit file would often involve thousands of pages of audit file documentation, including copies of documents provided to the auditor by issuers. Also, many individual conclusions are reached in the conduct of an audit. To evaluate Other Information as compared to all relevant audit evidence obtained and conclusions reached could be viewed by auditors to involve detailed review and consideration of audit file documentation at the time of the auditor's evaluation of Other Information. Further, due to the significance of additional time and cost associated with auditors evaluating Other Information in this manner, issuers may consider this additional time and cost as they make judgments about the inclusion of Other Information in their annual reports, which could result in certain information that would be valuable to users not being disclosed.

- The following text from page A6-5 of the Appendix indicates that the auditor is not precluded from applying additional procedures beyond those described in the Proposed Standard:

  *"The proposed other information standard does not preclude the auditor from applying the procedures in the standard to such other documents. Also, the proposed other information standard does not preclude the auditor from applying additional procedures not described in the proposed other information standard to the other information."*

  This paragraph suggests to auditors that to "evaluate" Other Information in an annual report, additional procedures may be appropriate. Due to the lack of definition of the term "evaluate", as discussed above, the expectation gap between auditors and users regarding the scope of their procedures, and the additional risk of liability that auditors may incur as a result; significant additional effort by auditors is anticipated as compared to the work performed currently under AU 550. Further, we believe the text above provides an open ended obligation on auditors to consider whether to do more, which is in conflict with the introductory section on page 21, which does not require the auditor to perform other procedures or obtain additional information not directly related to the financial statement audit.

Paragraph 5 of the Proposed Standard indicates that if the auditor identifies a potential material inconsistency, a potential misstatement of fact, or both, the auditor should discuss the matter with management, and perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both. We believe this requirement to consider performing additional procedures, as necessary, may cause auditors to perform unnecessary and time-consuming procedures. For example, the auditor may read in Other Information that the issuer is the leading provider of a product. Based on issuer-provided documents regarding revenue streams included in the audit file, the issuer's market positioning is discussed, but it is unclear whether the disclosure that the issuer is the leading provider of a product is correct or not. Paragraph 5 could lead the auditor to both discuss this matter with management, as well as perform additional procedures to make a determination. We consider the additional procedures in this example to be unnecessary and costly. Similar to our above concern with paragraph 4, we note that Paragraph 5 is inconsistent with page 21 of the introductory section to the Proposed Standards, which reads:

> "*The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit.*"

While we agree with the concept outlined in the above paragraph, we believe it will not be clear to users what Other Information was subject to procedures and what information was not, since a user will not know whether the auditor obtained evidence during the course of the audit.

AU No. 3, *Audit Documentation,* requires audit documentation to be prepared in sufficient detail to provide a clear understanding of its purpose, source, and the conclusions reached. Also, the documentation is to be appropriately organized to provide a clear link to the significant findings or issues. Additional guidance within the Proposed Standard is suggested regarding the nature and extent of auditor documentation required, particularly considering the "evaluate" level of engagement involved, and the significance of Other Information, including information incorporated by reference, that would be subject to an auditor's evaluation procedures.

## Other Observations

### Scope

The Board has requested comment on the applicability of the Proposed Standards to Broker-Dealer, Investment Company and Benefit Plan audit engagements. Due to the unique characteristics of these companies, as indicated in Appendices A5 and A6 of the Proposed Standards (i.e. filing requirements; ownership structure; degree of complexity; user needs; sufficiency of other information available), we do not believe that application of the Proposed Standards to audits of these companies would provide investors or other financial statements users with sufficient additional relevant information to justify the additional cost of such information.. If broker-dealer, investment company and benefit plan audit engagements are not excluded from the scope of the Proposed Standards, we recommend providing additional guidance to assist auditors of these companies in applying the Proposed Standards, given their unique characteristics and differences from issuer entities.

### Reports of Subsidiaries

We observe that many subsidiaries of issuers also present separate only subsidiary financial statements for a variety of reasons, and those financial statements also require the independent auditor to issue a report on such financial statements. These financial statements are normally not included in any public filings; however, the audit report often reflects that the audit was conducted in accordance with PCAOB standards. We believe critical audit matters and other information would not apply in these situations and recommend providing reporting illustrations for these situations.

Reference to City and State in Auditor's Report

Paragraph 6r of the Proposed Auditor Reporting Standard includes a requirement to include the city and state or country from which the auditor's report has been issued. Due to the participation in many audit engagements of audit personnel from various cities and countries, we suggest providing guidance in the Proposed Standard on the determination of the city and state or country that should be included in the auditor's report.

Reference to Accounting Standard

Page A3-18 refers to FASB Statement No. 107. We suggest the use of FASB Codification references.

Reference to Financial Statements

We suggest updating the text on page A5-10 to include in the listing of financial statements the Statement of Other Comprehensive Income and to include such statement in the illustrative examples.

**Field Testing and Cost/Benefit Considerations**

We anticipate that substantial additional work by auditors, audit committees and management will be necessary to implement and comply with the Proposed Standards. As a result, we encourage the Board to perform field testing to fully understand the costs and other implications of the Proposed Standards. Further, we encourage the Board to perform a thorough cost/benefit analysis to determine that the benefits will meaningfully exceed the initial and annual costs to comply with the Proposed Standards.

**Effective Date of the Proposed Standards**

The proposed effective date of these standards is for audits of financial statements for fiscal years beginning on or after December 15, 2015. Based on the significance of the implementation effort required by issuer companies and their audit firms in response to these Proposed Standards, including developing appropriate methodologies and training, we suggest that the Board re-assess the proposed effective date at the time the proposals are approved by the SEC, and re-establish the effective date to be at least one year after approval. We also suggest a further delay in the effective date for audits of smaller reporting companies.

* * * * *

Crowe Horwath LLP supports the Board's efforts to improve its auditing standards for the benefit of investors and other stakeholders. We appreciate the opportunity to comment on the Proposed Standards and Proposed Amendments, and would be pleased to respond to any questions regarding the comments we have provided. Should you have any questions please contact Clarence Ebersole at (317)706-2636 or James Dolinar at (630)574-1649.

Sincerely,

Crowe Horwath LLP

Crowe Horwath LLP

| | |
|---|---|
| **From:** | Monica Daggs (mdaggs@cusonet.com) |
| **To:** | Comments |
| **Subject:** | Docket 034 |
| **Date:** | Wednesday, December 11, 2013 10:39:47 AM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |

Attention Board Members:

I support Lisa Roth's position attached.

Regards,

Monica Daggs
Vice President Compliance
CFS AML Compliance Officer
**CUSO Financial Services, LP**
**Sorrento Pacific Financial, LLC**
Members FINRA/SIPC

**Passion. Innovation. Success.**

Phone: 858-530-4431
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**We Grow Successful Investment Programs and Practices**

**Lisa Roth**

630 First Avenue
San Diego, CA 92101
Phone: 619-283-3500

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

**From:** Deborah Castiglioni
**To:** Comments
**Subject:** Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor''s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and
**Date:** Wednesday, December 11, 2013 1:45:05 PM

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To the members of the Board:

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of an owner of a small, independently owned, nonpublic, non-custodial broker-dealer.

Our firm, one of approximately 4000 SEC registered broker-dealers, is not a public company. We are a privately owned and operated small business with approximately 14 staff and about 45 independent financial advisors.
For small independent and privately owned businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is appropriate and consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight. It is important that regulation for small firms remain relevant to the business model and investing public; we encourage the Board to seriously consider the matter of an exemption for small, privately held firms.

Thank you for your consideration,

Deborah Castiglioni
CEO
Cutter & Company, Inc.
(636) 537-8770

Member FINRA, SIPC

December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Members of the Board:

Thank you for the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report,* and *Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard* (collectively the "proposed standards").

We agree that certain of the proposed changes would be beneficial to users of the financial statements. The proposed changes that we support cover the proposal to include in the auditor's report a statement regarding auditor independence and inclusion of information on the auditor's tenure. In addition, we support the addition of language to the auditor's report clarifying that the audit includes the footnotes to the financial statements and support adding language to the Auditor's report stating that the conclusion that the financial statements are free of material misstatement covers both potential material errors and potential material instances of fraud.

In addition, we support including in the auditor's opinion a description of the auditor's responsibilities regarding "other information" in documents containing financial statements. However we do not believe there would be significant benefits in increasing the auditor's responsibility regarding this information, or to expand the definition of other information to include information incorporated by reference. We believe the current requirement for auditors to consider "other information" and discuss with Audit committees that they have read the "other information", as currently defined, is a sufficient process to identify any material discrepancies between the audited financial statements and the "other information". Our Audit Committee, and we believe all audit committees, expect a standard of care from the Auditors when they consider "other information". We believe the proposed requirement to "evaluate" such information is not significantly different enough to provide a corresponding significant benefit to users of the financial statements and would not justify what would likely lead to increases in time and expense to complete an audit.

Finally, regarding communication of critical audit matters, we are concerned that the potential exists that such communication could be perceived by the users of financial statements as questioning the quality of the financial statements taken as a whole, even if the proposed auditor's report would state otherwise. We believe that the matters which would most likely be identified as critical audit matters are already discussed under Significant Accounting Estimates / Critical Accounting Policies and that any differences would be confusing to users of the financial statements. We are also concerned that a requirement for auditors to document why certain matters are not considered to be critical audit matters has the potential for significant increases in management's time and audit fees to complete the audit. Another issue to consider is the cautiousness and boilerplate disclosures by the auditors that cover every possibility which would bring inconsistencies and confusion for users of financial statements due in part to variability of such between accounting firms and partners.

We believe the supported changes noted above provide clearer insight into the Auditor's independence, role and process in regarding registrant's financial statements. We appreciate the Board's efforts to improve the quality of financial reporting, and would again like to thank you for the opportunity to comment on the proposed standards.

Sincerely,

David M. Drillock
Chief Financial Officer
Cytec Industries Inc.

| | |
|---|---|
| **From:** | Rick Dahl (rdahl@mybd.com) |
| **To:** | Comments |
| **Subject:** | PCAOB Docket 034 |
| **Date:** | Wednesday, December 11, 2013 7:52:17 PM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |

FYI, I support Lisa Roth's position for Rule Docket 034.

Sincerely,

Rick Dahl
EVP, **Sorrento Pacific Financial, LLC and**
**CUSO Financial Services, LP**
Chief Compliance Officer,
**Sorrento Pacific Financial, LLC**
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The Office of the Secretary Public Company
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1666 K Street, NSW
Washington, DC, 20006-2803 USA

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

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December 11, 2013

Re: **PCAOB Rulemaking Docket Matter No. 034**

*via email to comments@pcaobus.org*

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

Dear Ms. Brown:

We appreciate the opportunity to comment on two auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "**Auditor Reporting Standard**") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "**Other Information Standard**"), proposed by the Public Company Accounting Oversight Board on August 13, 2013 in PCAOB Release No. 2013-005 (the "**Proposing Release**").

The Board's goal is to "increase the informational value of the auditor's report."[1] This is not a controversial objective, but we believe that the costs of implementing these specific proposals, to be borne by public companies and their investors, would substantially outweigh their benefits to investors and the public. As a result we question whether the Securities and Exchange Commission would be able to approve the proposals were they adopted by the Board. As former Commissioner Paredes observed in 2012:

> "[T]he PCAOB . . . needs to engage in rigorous cost-benefit analysis of its rules, including its auditing standards. We need to be assured that the potential consequences – both for better and for worse – of a PCAOB rule have been thoroughly evaluated and considered in a balanced way. Otherwise, for example, how can we determine on a reasoned basis whether a PCAOB proposal advances the public interest? Whether a PCAOB rule advances the public interest depends on its practical impacts. Cost-benefit analysis allows us to better

[1] Proposing Release at 5.

anticipate and assess these impacts so that a well-reasoned judgment can be made."[2]

As discussed below, we believe that a thorough analysis would show the costs of the proposals difficult to justify compared to their anticipated benefits. More fundamentally, we believe that if additional information for investors is the goal, the company itself should be the source of that information, rather than a third party whose expertise lies not in communicating with the marketplace, but in assessing whether the company's financial statements are presented in accordance with generally accepted accounting principles.

**Auditor Reporting Standard**

The proposed Auditor Reporting Standard requires the auditor's report to include a discussion of "critical audit matters," defined as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements."[3] The disclosure would include identification of the critical audit matters, a description of the considerations that resulted in the determination that a critical audit matter existed, and reference to the relevant financial statement accounts and disclosures that relate to the critical audit matters.[4]

The Proposing Release indicates that critical audit matters could be derived from issues currently identified in the engagement completion document, issues reviewed by the engagement quality reviewer, issues communicated to the audit committee, or any combination of the three.[5] Although the Proposing Release does not mention it, critical audit matters would almost certainly include all of a company's "critical accounting policies," which Section 204 of the Sarbanes-Oxley Act of 2002 requires auditors to report to the audit committee and which U.S. public companies disclose as part of Management's Discussion and Analysis in the Annual Report on Form 10-K.[6]

The auditor's discussion of critical audit matters would not occur in a risk-free vacuum. Although the language in the proposed Auditor Reporting Standard focuses the need for disclosure on only the *most difficult* matters, auditors would be heavily incentivized to include *all* matters identified in the engagement completion document, *all* issues reviewed by the engagement quality reviewer, and *all* significant issues communicated to the audit committee regarding the audit, including the company's critical accounting policies. The Proposing Release states that "[t]he Board would not expect that each matter included in any one or more of these sources would be a critical audit matter,"[7] but this ignores the reality that auditors are at risk of being sued on the basis of their report, including the critical audit matters discussion, in the event of a subsequent financial restatement or other financial difficulties at the audit client. This fact alone virtually guarantees

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[2] Remarks of SEC Commissioner Troy A. Paredes at AICPA Council Spring Meeting, Washington, DC (May 17, 2012) (*available at* http://www.sec.gov/News/Speech/Detail/Speech/1365171490500).

[3] Proposing Release at 15.

[4] Proposing Release at 16.

[5] Proposing Release at 15.

[6] Critical accounting policies consist of accounting policies that "are both most important to the portrayal of the company's financial condition and results, and . . . require management's most difficult, subjective or complex judgments, often as a result of the need to make estimates about the effect of matters that are inherently uncertain." *Cautionary Advice Regarding Disclosure About Critical Accounting Policies*, SEC Rel. No. 33-8040 (Dec. 12, 2001).

[7] Proposing Release at 15.

that any discussion of critical audit matters will be a lengthy affair, because auditors will not want to be second-guessed in litigation about, for example, why some matters discussed with the audit committee were disclosed as critical audit matters while others were not. As a result we would expect the "critical audit matters" discussion to cover, for example, all matters that the engagement team discussed with their national office,[8] all matters on which the company may have consulted with the SEC or other regulatory agencies and all material weaknesses (and likely some significant deficiencies) in internal controls that were identified in the course of the audit, in addition to all critical accounting policies already discussed in the annual report. Because the discussion would appear in the company's own filings and express judgments about the company as well as provide a basis for liability against the company, we believe companies would insist on reviewing, potentially negotiating and approving all critical audit matters before finalizing the audit.

At the same time, because the engagement team will recognize that communications with the national office or with the audit committee will likely trigger a need for critical audit matter disclosure, we believe that a requirement to discuss critical audit matters in the audit report will invariably have a chilling effect on these discussions. It goes without saying that inhibiting communications between the auditor and the audit committee, or inhibiting the auditor's own internal discussions, will not have a healthy impact on the quality of public company financial reporting. Existing auditing standards promote an open dialogue between auditors and audit committees precisely because this communication results in better disclosure.[9]

The illustrative disclosure contained in the Proposing Release ranges from several paragraphs to more than a page of additional language for each critical audit matter.[10] This range multiplied by the number of critical audit matters a company is likely to have would dramatically lengthen the audit report. Because critical audit matters are expected to be subjective and variable among companies,[11] it will also be difficult or impossible for investors to compare one company's critical audit matters to another's. The sheer volume of critical audit matters, as well as the lack of comparability across companies even in the same industry, would undermine the benefits of the audit report's current pass/fail model, which the Proposing Release acknowledges enjoys investor support "because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented."[12]

Given the length and scope of a company's critical audit matters, the effort to analyze, draft and negotiate them would be substantial, would raise costs and would increase pressure on management, audit committees and auditors during already-hectic annual reporting periods. We therefore question the Proposing Release's assertion that developing critical audit matters

[8] Auditing Standard No. 16, *Communications with Audit Committees*, states that "the auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process."

[9] "The enhanced relevance, timeliness, and quality of communications should facilitate audit committees' financial reporting oversight, fostering improved financial reporting, thereby benefitting investors." PCAOB Rel. No. 2012-004 at 2-3 (Aug. 15, 2012).

[10] Proposing Release app. 5 at A5-65-78.

[11] "The communication of critical audit matters would result in differences among auditors' reports. For instance, the communication of critical audit matters is intended to be tailored to the audit of the company; therefore, auditors' reports are not expected to be comparable from one auditor's report to the next." Proposing Release app. 5 at A5-41-42.

[12] Proposing Release app. 5 at A5-5.

disclosure would not be unduly burdensome,[13] and find it at odds with its description of the process involved – which includes the attention of the senior members of engagement teams; the attention of the engagement quality reviewer; consultations with others, including the auditor's national office; and discussions with management or the audit committee.[14]

For all of the effort that the proposed requirement would entail, we wonder what the benefits to investors would be. To the extent critical audit matters merely echo the company's critical accounting policies already disclosed, the informational value would be minimal or non-existent. To the extent they summarize matters on which the engagement team needed to consult with their national office, they may be saying more about the experience of the individual auditors than the quality of the company's financial disclosures. To the extent they recap significant deficiencies or material weaknesses discussed with the audit committee, they would either be repeating information the company is already required to disclose, or information the SEC has already determined companies need not automatically disclose.[15]

We expect that the number of critical audit matters included in audit reports will only proliferate over time, exactly as experience has shown with respect to risk factor disclosure in public filings with the SEC. The inclusion of critical audit matters in audit reports will likely be seen to provide protection to auditors in the same manner risk factors are thought to provide protection to companies. It is hard to imagine that lawyers for auditors will not advise that the inclusion of more (rather than fewer) critical audit matters, together with a thorough and detailed discussion of each, would better serve to protect auditors from legal risk. If any auditor includes a critical audit matter with respect to a company in a particular industry, other auditors will be incentivized to include a comparable critical audit matter to avoid the litigation risk of having a less complete discussion.

The proposed Auditor Reporting Standard appears to be significantly driven by the belief that it could "alleviate the information asymmetry that exists between company management and investors"[16] and that investors want "more information." We do not believe these very general goals provide an adequate rationale for the dramatic expansion of the audit report with its increased costs, almost inevitable delays and potentially serious unintended consequences with respect to communication and consultation. If more disclosure is in fact necessary, it should be specifically identified and required to be provided by the company. The auditor's role as an independent third party should remain one of oversight.[17]

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[13] Proposing Release app. 5 at A5-22.

[14] Proposing Release app. 5 at A5-37.

[15] Although companies are required to disclose material weaknesses in internal controls, they are not generally required to disclose significant deficiencies. *See* SEC, *Frequently Asked Questions, Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, question 11 (Oct. 6, 2004) (*available at* http://www.sec.gov/info/accountants/controlfaq1004.htm).

[16] Proposing Release at 6.

[17] As Board member Jay D. Hanson noted at the Board's open meeting on June 21, 2011, "[A]uditors are not analysts or investment advisers. They are not trained to evaluate and communicate the overall business and strategic risks of the companies they audit." (a*vailable at* http://pcaobus.org/News/Speech/Pages/06212011_HansonStatement.aspx).

**Other Information Standard**

The proposed Other Information Standard requires the auditor to communicate its responsibilities for and conclusions with respect to "other information."[18] For a U.S. public company, this includes all information in its Annual Report on Form 10-K other than the audited financial statements and accompanying report.[19] Where the auditor does not identify a material inconsistency or material misstatement of fact in the "other information," the following language would appear in the auditor's report:

> "Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information."[20]

The proposed Other Information Standard differs from the existing standard, AU Section 550, *Other Information in Documents Containing Audited Financial Statements*, in both scope and substance [21] and would significantly expand the auditor's responsibilities with respect to "other information." The current standard provides that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements."[22] It also explicitly provides that the auditor's responsibility is limited to financial information identified in its report.[23]

By contrast, the proposed Other Information Standard requires the auditor to evaluate "other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit."[24] The auditor would need to perform "additional procedures, as necessary" to determine whether there is a material inconsistency or misstatement of fact in the "other information."[25] If the auditor identifies a material inconsistency or misstatement of fact, the auditor must request management to revise the "other information;" if management does not, the auditor may be required to contact the audit committee, consider resignation, withhold the audit report, or notify the appropriate regulator.[26]

Before proposal of the Other Information Standard, we believe it was generally agreed that auditors lack the necessary professional training, expertise and evidence to comment affirmatively on all "other information" in a company's annual report. In fact, the current standard

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[18] Proposing Release app. 2 at A2-2-3.

[19] Id.

[20] Proposing Release app. 1 at A1-16.

[21] The existing standard and the proposal each provide that "other information" includes information, other than the audited financial statements and the related auditor's report, contained in a public company's annual report. The proposed Other Information Standard also covers information about executive compensation and corporate governance, typically contained in the company's proxy statement, which is often filed with the SEC several weeks after the audit report is issued. Proposing Release app. 2 at A2-2.

[22] AU § 550.04.

[23] Id.

[24] Proposing Release app. 2 at A2-3.

[25] Proposing Release app. 2 at A2-4.

[26] Proposing Release app. 2 at A2-4-5.

instructs that when an auditor encounters a potential misstatement or inconsistency, "the auditor should consider that he may not have the expertise to assess the validity of the statement, that there may be no standards by which to assess its presentation, and that there may be valid differences of judgment or opinion."[27] Similarly, AU Section 337, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments*, cautions that in obtaining information regarding litigation, claims and assessments, the auditor "ordinarily does not possess legal skills and, therefore, cannot make legal judgments concerning information coming to his attention. Accordingly, the auditor should request the client's management to send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments."[28]

In preparing the "other information" in its annual report, the company is required to make numerous judgments, often of an explicitly "legal" character. One of the most frequent of these is to assess the "materiality" of information that may not be financial in nature. "Materiality," like the term "material," is not defined in the U.S. federal securities laws (or in authoritative accounting literature) but instead is expounded in numerous judicial decisions, including the U.S. Supreme Court's opinion in *TSC Indus., Inc.* v. *Northway, Inc.*, 426 U.S. 438, 449 (1976):

> "What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."

Given the complexity of the relevant legal standard, companies typically make materiality judgments in close consultation with their internal and external legal advisers. The proposed Other Information Standard would, however, expressly require the auditor to make these judgments relating to information that is wholly or partly non-financial in character.

For example, a company is required to describe in its annual report development-stage products that are "material" to it;[29] the company's competitive position in its markets, if "material;"[30] and the location and general character of its principal plants, mines and other "materially important" physical properties;[31] and to file as exhibits to the annual report its "material" contracts.[32] Audit evidence will frequently exist about a new product (research and development expenditures), the company's competitive position in a particular market (evidence of increasing or decreasing sales to a customer) or a particular physical asset (lease payments), but the company may choose not to discuss the particular product, competitive dynamic or physical asset in its annual report. Likewise the auditor may have access to volumes of contracts that are not filed as exhibits to the annual report. If any of these things were "material" to the company, the absence of disclosure would point to a "material inconsistency" between the audit evidence and the "other information." What professional training enables the auditor to satisfy himself that the undisclosed product,

[27] AU § 550.05.

[28] AU § 337.06.

[29] SEC Regulation S-K, Item 101(c)(1)(ii).

[30] SEC Regulation S-K, Item 101(c)(1)(x).

[31] SEC Regulation S-K, Item 102.

[32] SEC Regulation S-K, Item 601(b)(10).

competitive dynamic, physical asset or contract is not somehow material to the company? The proposed standard does not say that the auditor can defer to the judgment of company management or its counsel on questions like this – actually, it would run contrary to the principle of an independent audit if the auditor could substitute management's assertions for the auditor's professional judgment. Will the auditor need to engage its own counsel for advice? This seems likely given the expertise required, and this additional expertise will come at a cost.

At the same time auditors are tasked with passing on matters outside the scope of their professional expertise, they will face a broader scope of liability under the proposed Other Information Standard than they currently do. The auditor's statement about the accuracy of "other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit" would be included in the audit opinion and therefore would be relied upon by the investing public and available in investor litigation.[33]

Given the risk of litigation against auditors if a material inconsistency or misstatement subsequently arises, it is not realistic to expect that auditors would make the sweeping statement contemplated by the proposed Other Information Standard without substantially expanding the scope of the audit and enlisting the help of lawyers and other professional advisers with training and expertise that auditors lack. We therefore believe the Board underestimates the incentives auditors will have to augment their procedures in order to comply with the proposed Other Information Standard, thereby increasing both the cost and the lead time for audits under already-accelerated deadlines for annual filings.

We also do not believe that investors will have any appreciation as to which items of "other information" an auditor obtains relevant audit evidence and reaches conclusions during the audit, which is the stated basis of the auditor's evaluation. As a result, investors may be led to believe that the auditor's evaluation covers much more "other information" than it actually does, while at the same time leaving the auditor exposed to claims that it did or should have obtained such evidence or reached such conclusions.

We do not believe these additional costs in both money and time can be justified as being needed to ensure the absence of material misstatements and omissions in the annual report. We believe that the Board has not taken adequate account of the range of safeguards developed or strengthened since passage of the Sarbanes-Oxley Act of 2002 to achieve the same goal, including:

- Certifications required for each annual report and each Quarterly Report on Form 10-Q by Sections 302 and 906 of the Sarbanes-Oxley Act and SEC Rules 13a-14(a) and 15d-14(a), which among other things require a company's CEO and CFO to personally certify that the report "does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading." These certifications cover all "other information" in a company's annual report. Following promulgation of the Sarbanes-Oxley certification requirements, we believe most public companies significantly strengthened their internal processes in order to support the

[33] "In order to promote consistency in the addressees included in the auditor's report, the Board is proposing to require the auditor's report be addressed to investors in the company." Proposing Release app. 5 at A5-9.

required CEO and CFO certifications, by creating disclosure committees and by instituting “upward certification” procedures, for example.

- The requirement under SEC Rules 13a-15 and 15d-15 that each public company maintain and regularly evaluate the effectiveness of “disclosure controls and procedures” that are “designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Securities Exchange Act of 1934] is recorded, processed, summarized and reported, within the time periods specified in the Commission’s rules and forms.” A company’s disclosure controls and procedures cover all “other information” contained in its annual report. In combination with the Sarbanes-Oxley certification requirements, in our experience the requirement that public companies maintain and evaluate the effectiveness of their disclosure controls and procedures has significantly increased the amount of management and audit committee attention focused on companies’ annual reports and other SEC filings, minimizing the risk of error in “other information.”

- The requirement for auditors to evaluate the effectiveness of a company’s internal controls provides further assurance of the material accuracy of information contained in filings by companies subject to Sarbanes-Oxley Section 404(b).

- Disclosures in the annual report are also subject to review and oversight by a company’s audit committee and board of directors.

While there may be some incremental value in a third party’s evaluation of “other information,” the benefits would be marginal given the extensive procedures that are already in place to ensure the consistency and accuracy of this information. We do not believe these benefits would justify the costs of introducing new and additional procedures by the auditor at the tail end of an already time-compressed process.

* * *

For the reasons discussed above, we believe that the anticipated benefits of the proposals do not justify the related costs, and we urge the Board to reconsider its proposals in light of these concerns.

We appreciate the opportunity to comment and would be pleased to discuss any questions the Board or its Staff may have. You may contact Joseph A. Hall, Michael Kaplan, Richard J. Sandler, Richard D. Truesdell, Jr. or Sarah Ashfaq of Davis Polk at 212-450-4000.

Very truly yours,

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December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034.**

Deloitte & Touche LLP ("D&T") is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Proposed Auditing Standards — The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard"); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard"); and *Related Amendments to PCAOB Standards* (the "proposed amendments") (collectively, "the proposal"); PCAOB Release No. 2013-005; and PCAOB Rulemaking Docket Matter No. 034 (August 13, 2013).

## OVERALL COMMENTS

We support the Board's efforts to increase the informational value, usefulness, and relevance of the auditor's report. The more information of value that auditors are able to provide to the users of financial statements, the greater the value and relevance audits will have to the capital markets. Additional transparency regarding the audit also stands to enhance investor confidence in the rigor of the independent audit process.

The proposed changes to the auditor's report would represent the most significant expansion of tailored information provided about a financial statement audit by auditors to the user community in the profession's history. We are supportive of the objectives of the Board's proposal, and offer certain constructive suggestions in this letter geared toward ensuring that the final standards the Board adopts:

- Add value to users of financial statements;
- Narrow the expectation gap between what users of financial statements might expect from a financial statement audit and the actual objective of a financial statement audit, which is the expression of an opinion regarding the financial statements taken as a whole based on having obtained reasonable assurance about whether the financial statements are free of material misstatement; and
- Enhance clarity regarding the responsibilities of the auditor, management, and the audit committee.

Consistent with the above objectives, we are supportive of the following changes to the auditor's report:

- Identifying and commenting upon those matters that are critical to a user's understanding of the audited financial statements;
- Providing transparency regarding the auditor's responsibilities for other information included within the Form 10-K;
- Including a statement that the auditor is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the PCAOB and the U.S. Securities and Exchange Commission (SEC);
- Including additional standardized language regarding the auditor's responsibilities with respect to the detection of error or fraud and performing procedures to assess the risks of material misstatement; and
- Clarifying that an audit encompasses the financial statements and the related notes.

In addition to considering the changes included in the Board's proposal, we considered whether there are additional matters that could be addressed in the auditor's report to improve its value to investors. We believe a discussion about materiality would further enhance the utility of the report (see further discussion in the "Proposed Auditor Reporting Standard" section below).

We believe, however, that there are certain implementation and other issues that will need to be deliberated and resolved in order to ensure the objectives of the proposals are achieved. While some of these issues are complex and challenging, the potential benefits of the proposals are significant; accordingly, such issues should not stand in the way of moving forward. It is incumbent upon us, along with other interested stakeholders, to engage constructively with the Board and find reasonable solutions. A brief summary of the most significant issues we have identified is as follows (we offer further thoughts on each later in this letter):

**Critical Audit Matters (CAMs).** We agree that sharing information with investors and other financial statement users about the challenging aspects, from an audit perspective, of the company's financial statements would be useful. We recognize that application of the proposed standard could at times put auditors in the position of communicating original information that has not been disclosed by the company. Some constituents have expressed concerns that certain auditor disclosures may potentially be at odds with the long-standing, historical reporting model of management being responsible for the company's financial statements and disclosures and the auditor attesting to that information. We share these concerns. These perspectives raise the question as to whether additional companion disclosure requirements should be imposed upon companies in light of required CAM reporting, which would of course necessitate action by the SEC or accounting standard setters.

Given the broad implications of the issue of auditors communicating original information, we believe it is important that all stakeholders (e.g., audit committees, preparers, regulators, auditors and others, including those in non-U.S. jurisdictions who are affected by PCAOB standards), be actively involved in comprehensive discussions about such a significant change. We understand that the PCAOB plans to hold roundtable discussions during 2014 to solicit the views of stakeholders, and we look forward to participating constructively in a dialogue with the PCAOB, SEC, Financial Accounting Standards Board (FASB), and other interested parties.

We offer further observations on CAMs and suggest additional practical alternatives for consideration in the "Proposed Auditor Reporting Standard" section below.

**Auditor Responsibility with Respect to Other Information.** Investors would benefit from a transparent discussion of the auditor's involvement with certain financial information contained in the Form 10-K outside the basic financial statements and footnotes. In addition, when other information outside the financial statements is both within the competence of the auditor and closely associated with procedures performed by the auditor during the audit of the financial statements (and if applicable, audit of internal control), we believe this information may lend itself to additional auditor involvement, with an accompanying disclosure in the auditor's report outlining the procedures performed by the auditor. However, certain other information contained in the Form 10-K is not necessarily within the auditor's competence, and is not closely associated with procedures performed during the audit. We believe it is important to ensure that auditor performance requirements are clear, and that any statement made in the audit report about other information does not create an expectations gap as to the nature of the auditor's involvement with respect to such information, especially non-financial information and financial information not closely associated with procedures performed in connection with the audit. We discuss additional observations and potential alternatives in the "Proposed Other Information Standard" section below.

We commend the Board's outreach with the International Auditing and Assurance Standards Board (IAASB), which has also issued a proposal to modify the auditor's reporting model under the International Standards on Auditing. We believe it would be beneficial for the auditor's reporting model under PCAOB standards and IAASB standards to be aligned to the greatest extent possible, in order to provide a consistent basis for enhancing users' understanding of the audit process and the results of the audit and avoid unnecessary confusion. We encourage the PCAOB to continue to work with the IAASB as the two related proposals are finalized.

Some level of incremental costs will of course result from the application of the proposals. We believe the suggestions we offer in this letter will help manage costs for audits of companies of all sizes. In order to ensure that the benefits of the proposals outweigh the incremental costs, we encourage the PCAOB to carefully assess the costs associated with the various aspects of the proposals, particularly those aspects related to other information, by conducting appropriate research and outreach (including field testing where useful).

## PROPOSED AUDITOR REPORTING STANDARD

As articulated in the "Overall Comments" section of this letter, we support many of the PCAOB's proposed changes to the auditor's report. In order to provide meaningful feedback to the Board during the comment process and as requested by the Board, we conducted limited field testing (including interaction with financial management) of the proposed auditor reporting standard. The results of that field testing are summarized in Exhibit 1. In light of our field testing and our analysis of the proposal, we have identified several adjustments that could be made that would address certain implementation challenges we identified. We further describe our observations and recommendations to the proposed auditor reporting standard below.

*Determination of Critical Audit Matters.* In order to provide useful information to users of financial statements, we agree that CAMs should highlight the most significant, complex, subjective areas of the audit. Our field testing results demonstrated a wide range in the number of CAMs reported for individual audits, suggesting that applying the proposed definition of CAMs and the related factors to consider in identifying CAMs as stated in paragraph 9 of the proposed auditor reporting standard, could result in a large number of potential CAMs being identified and ultimately a large number being reported. Inclusion of a large number of CAMs in the auditor's report would potentially obscure the most relevant information (including possibly the overall pass/fail opinion still valued by investors), making the auditor's report less useful to investors. This would be contrary to the PCAOB's objectives in proposing this standard. Our field testing results also indicated that all CAMs identified were matters already communicated to the audit committee in accordance with extant PCAOB standards, including PCAOB Auditing Standard 16, *Communications with Audit Committees* (PCAOB AS 16). Our suggestions herein are intended to address these implementation issues and reduce the associated costs.

We recommend the PCAOB limit the population of *potential* CAMs to only those matters that were discussed with the audit committee under existing auditing standards. Current PCAOB standards addressing required communications with audit committees are thorough and result in the auditor discussing a variety of matters with the audit committee. Therefore, we believe starting with the population of matters communicated to the audit committee would improve the efficiency of the process of determining potential CAMs, and would still be an effective approach. Not all matters communicated to the audit committee during the course of an audit rise to the level of a CAM; however, in practical terms, auditors would not put themselves in the position of disclosing CAMs that had not already been discussed with the audit committee.

Further, the level of interaction, including the extent of discussion with the audit committee about a particular matter, could be highlighted as an additional consideration for the auditor when concluding which matters rise to the level of a CAM (i.e., in addition to the factors outlined in paragraph 9 of the proposed auditor reporting standard).

These suggested changes to the proposed auditor reporting standard will simplify the methodology for determining CAMs and should have the effect of appropriately limiting the number of CAMs so as to render the auditor's report more useful to users.

*Auditor Disclosure of Original Information.* Our field testing confirmed that CAM reporting under the proposal could result in (1) original information[1] about the company being communicated in the auditor's report, (2) disclosure of matters that, while requiring significant audit effort, were ultimately concluded to be immaterial to the company's financial statements and internal control, or (3) disclosure of information that the SEC or the FASB previously concluded need not be disclosed by a company. For example:

- **Going Concern:** If issues calling into question an entity's ability to continue as a going concern are overcome based on management's plans for dealing with the issues, and the auditor ultimately concurs with this conclusion after performing extensive auditing procedures and applying significant professional judgment, this matter may still be considered a CAM and thus require disclosure. This challenge would be substantially alleviated if the FASB moves forward with its proposal to require company disclosure of going concern uncertainties even when substantial doubt is not present.

- **Significant Deficiency:** If determining whether an identified control deficiency is a significant deficiency or a material weakness takes a significant amount of audit effort, results in modification of the planned substantive testing and is the subject of significant dialogue with the audit committee, and even if ultimately the company and the auditor conclude it is a significant deficiency and not a material weakness, this matter may still be considered a CAM under the proposed auditor reporting standard. This may result in disclosure by the auditor of the control issues, with no parallel disclosure obligation for the company under SEC rules.
- **Potential Illegal Act:** If the auditor encounters a potential illegal act, directs significant audit effort to the situation, and encounters challenges in gathering sufficient audit evidence but ultimately concludes, after extensive interaction with counsel, that an illegal act has not occurred, this matter may nonetheless be considered a CAM under the proposed auditor reporting standard; however, it is not clear that disclosure in the auditor's report of such a matter was intended by the proposed standard.

Some constituents have questioned whether additional information would be of value to users if matters determined to be CAMs relate to items determined not to rise to a level of required management disclosure under current regulatory requirements and accounting frameworks. We recommend stating (in the definition of CAM and in paragraph 9 of the proposed auditor reporting standard) that matters relating to amounts and disclosures that are ultimately determined not to be material to the financial statements (including footnote disclosures) or the company's internal control over financial reporting may not constitute CAMs, even if significant audit effort and professional judgment might have been required to reach such a conclusion. As supported by our field testing, it is important that the final standard explicitly state that the auditor uses both materiality and professional judgment in determining the CAMs to be communicated in the auditor's report.

*Describing CAMs in the Auditor's Report.* We support the requirements in paragraph 11 of the proposed auditor reporting standard for communication of CAMs in the auditor's report. We also agree with the Board that the auditor's communication of CAMs in the auditor's report should be presented using language and a format that is clear, concise, and understandable to users of financial statements.

We note that the release accompanying the Board's proposal states that "communicating critical audit matters in the auditor's report…would not require the auditor to describe the audit procedures related to critical audit matters"[2] but that the auditor would not be precluded from doing so. Further, paragraph 11 of the proposal does not address the auditor providing a description of the audit procedures related to each CAM. However, the illustrative examples of CAM reporting provided in Appendix 5 go beyond the stated requirements in the proposed auditor reporting standard and include a discussion of audit procedures performed (e.g., use of specialists, consultation with national office, among others). We believe it is important for the final standard to be clear as to whether the auditor is expected to describe the audit procedures performed, rather than relying upon examples and discussion in the accompanying release to set out this expectation. Further, we do not believe optionality would be appropriate as significant implementation challenges would result, including how the auditor would determine when to incorporate a discussion of audit procedures and to what extent they should be described.

If the Board intends for the auditor to include audit procedures performed in the CAM discussion in the auditor's report we offer the following observations:

- We recognize and support the objective that the Board is attempting to achieve, and believe users would in fact benefit from an appreciation of the rigor that underlies the audit of the identified CAMs. There are, however, significant challenges to accomplishing this objective—particularly on complex, large multinational audit engagements.
- Describing auditing procedures performed in the reporting of CAMs in complex audit engagements could make the auditor's report quite lengthy. In practice, written auditor communications to audit committees that include a description of some audit procedures in significant audit areas can be extensive, notwithstanding the opportunity the auditor has to supplement the written summary with dialogue at an audit committee meeting; no such opportunity for dialogue exists for a communication included in the auditor's report.
- In many cases, audit evidence with respect to material assertions is obtained through a combination of a large number of procedures. Because of the significant complex audit judgments and procedures that would be performed in connection with most (if not all) CAMs, it would be difficult to adequately describe even the significant procedures performed regarding a specific CAM in a concise manner. An overly brief description of two or three out of perhaps dozens of audit procedures would run the risk of decreasing confidence in the rigor of the audit, as it may imply that the auditor's procedures were much less in scope than was actually the case.

    - For example, our firm's practice aid for auditing goodwill, which is in excess of 80 pages, contains extensive auditing procedures for our practitioners to consider and apply. Auditing a discounted cash flow forecast prepared to support a goodwill impairment assessment involves significant procedures applied to a dozen or more unique variables. While incomplete, examples of the audit procedures applied would often include a review of external analyst reports, a retrospective review of the accuracy of the company's prior forecasts, in-depth analysis of future product portfolio and marketing plans, testing capital expenditure and working capital needs in relation to the future product portfolio, a review of the company's debt and equity structure, a review of the recent trends in the company's market capitalization, and consideration of competitor market multiples. During the course of performing these procedures, the auditor would often make use of internal specialists, external specialists, and other consultation resources of the firm. All of these procedures, in addition to several others, are essential in the aggregate to providing the auditor with the necessary level of evidence. An auditor could attempt to prepare such a summary for the report, but we believe it would often be quite lengthy.

If the intent of the Board is to require the auditor in all cases, to include a discussion of auditing procedures in the CAM discussion in the auditor's report, we suggest that the final auditor reporting standard include the following:

- A clear statement that for each CAM included in the auditor's report, the auditor should include a succinct description of the auditor's response to the financial statement risk associated with the CAM.
- An acknowledgement that the auditor applies professional judgment in determining which procedures to describe and how to describe them.

- A requirement for an explicit statement to be added to the auditor's report which states that the procedures described are not the totality of all procedures performed on any particular CAM.

*Documentation of Matters Not Concluded to Be CAMs.* Paragraph 14 of the proposed auditor reporting standard requires audit documentation to explain the basis of the auditor's determination that "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." While we support documenting those matters determined to be CAMs, we suggest that the Board modify the requirement in paragraph 14 to exclude the documentation of audit matters ultimately determined not to be CAMs.

As suggested previously, we believe the PCAOB should limit the population of *potential* CAMs to only those matters communicated to the audit committee under existing auditing standards. Under this approach, the auditor performance requirement would be directed towards identifying which of those matters (i.e., the potential CAMs) are to be included in the auditor's report as truly the most critical matters encountered during the audit. Accordingly, we believe it would be more appropriate for audit documentation to be focused on why matters are of such importance that they are included in the auditor's report (i.e., how the determination of actual CAMs was made from the population of matters communicated to the audit committee, as opposed to documenting why potential CAMs were determined not to be CAMs). Certain documentation would already be in place as a result of communicating matters to the audit committee, and as a result, extensive incremental documentation should not be required or necessary. Placing undue emphasis on documenting matters ultimately not concluded to be CAMs may have the unintended consequence of causing auditors to tend towards identifying too many CAMs, thereby reducing the usefulness of the CAM reporting. If the broad range of sources to be considered for identifying potential CAMs as proposed in paragraph 8 of the proposed auditor reporting standard is retained, for a complex audit engagement, this could lead to a very large population of potential CAMs; accordingly, the process to document why potential matters are not CAMs could become very lengthy and of limited value.

*CAMs and Continued Use of Emphasis of Matter Paragraphs.* The proposed auditor reporting standard does not address the interaction between an audit matter that is determined to be a CAM and where, under paragraph 16 of the proposed auditor reporting standard, the matter also requires an explanatory paragraph to emphasize the matter. We observe that the examples provided in paragraph 16 of the proposed auditor reporting standard would in many cases also likely qualify as CAMs. However, on page A5-49 in Appendix 5 of the proposal, it states "[t]he proposed requirement to communicate critical audit matters does not alter the auditor's ability to add an explanatory paragraph to the auditor's report to emphasize a matter in the financial statements. The auditor's communication of a critical audit matter may provide more information about the auditing aspect of the matter emphasized in the auditor's report."

We believe it would be confusing to have two disclosures included in the auditor's report addressing the same matter. Accordingly, we recommend that the Board clarify in the proposed auditor reporting standard that, if a matter would constitute a CAM and require an explanatory paragraph, the discussion in the auditor's report would be integrated so as to avoid duplication and repetitiveness.

*Additional Implementation Considerations.* As the Board finalizes its standards, it should consider various additional implementation matters, including:

- The real concern that CAM reporting over time may become boilerplate, which may result from marketplace pressure and auditing firms attempting to create standardization throughout their practices. If this were to happen, the Board's objective of providing unique information to investors would be compromised. In order to guard against this, we recommend clear language in the proposed auditor reporting standard indicating that CAM discussions in the auditor's report are intended to be tailored to the unique circumstances of each individual audit engagement.
- The likely increased pressure on senior audit resources (as well as on management and the audit committee) during the reporting phase of the audit as the identification of CAMs is finalized and related disclosures are drafted, and the implications on the timing of completing the audit and meeting SEC filing deadlines. In order to minimize the likelihood of problematic delays, the PCAOB should provide guidance in the proposed auditor reporting standard that it would be appropriate for auditors to communicate likely CAMs (along with draft report wording) to the audit committee when they are identified throughout the audit cycle, keeping in mind the requirements of PCAOB AS 16.26 to communicate matters to the audit committee on a timely basis.

*Reporting Period of CAMs.* We agree with the requirement in paragraph 10 of the proposed auditor reporting standard that CAM communications should pertain to the audit of the current period's financial statements. To provide further clarity for auditors, we also recommend that the Board include a statement in paragraph 10 of the proposed auditor reporting standard that each year the auditor is expected to take a fresh look at the CAMs and should not maintain a "rolling inventory" of CAMs that would need to be re-evaluated each year by the auditor with justification for why CAMs in prior periods may not be CAMs in the current period. We believe this is particularly important to avoid any tendency towards boilerplate disclosure.

*Implications of Proposed Standard on the Reissuance of Auditor's Report.* If the identification of CAMs is later questioned through a firm's internal inspection process or a regulatory review process and it is determined that a CAM was omitted from the auditor's report, the Board should consider how such a circumstance will affect the auditor's report and if revisions to the auditor's report will be required (including the presumed corresponding need for the company to amend its Form 10-K to include the revised report). If the auditor concludes that the omitted CAM is not significant in relation to the audit report taken as a whole, we do not believe there would be a need to revise and reissue audit reports and file amended Form 10-Ks. Rather, the auditor would consider any subsequently identified CAMs in connection with the next year's audit to the extent that the CAM remains applicable in the subsequent year. Therefore, we recommend that the PCAOB (1) specifically allow in the standard for auditor judgment to be exercised in applying PCAOB AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report,* (PCAOB AU 561) and determining whether reissuance of the auditor's report in question is necessary and (2) should further acknowledge that reissuances are not expected to occur frequently.

*Auditor Tenure.* As indicated in our comment letters to the PCAOB dated December 8, 2011 and April 20, 2012 in response to PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation*, we performed a comprehensive review of available evidence with respect to the effect of auditor tenure on audit quality, and respectfully believe no nexus exists. Many stakeholders have expressed similar observations. While auditor tenure is a matter of fact, we do have some concern that an auditing standard requiring its inclusion in the auditor's report suggests or implies that tenure has a direct effect on the conduct and quality of the audit, and may lead to ill-founded conclusions regarding auditor independence.

We recognize, however, that some constituents have expressed an interest in disclosure of auditor tenure. If the Board concludes that tenure should be disclosed, we believe there are opportunities to do so in a manner that may alleviate the unintended consequences described above. For example, the Board may consider requiring that tenure information for each company audit engagement be included in a registered firm's annual PCAOB Form 2, rather than in the auditor's report. Registered public accounting firms are currently required to provide to the PCAOB a list of entities audited in an annual PCAOB Form 2, which is publicly available on the PCAOB's website; adding firm tenure to Form 2 would represent another factual disclosure, providing information on a firm's entire audit portfolio in one location. Alternatively, as audit committees are responsible for oversight of external auditors, the audit committee report may also be an appropriate location for disclosure of auditor tenure, if it is determined to be relevant to its oversight. Based on a recent study, 32% of Fortune 100 companies already disclose auditor tenure in the audit committee report or elsewhere in the proxy statement.[3] Recognizing that the PCAOB does not have oversight authority with respect to audit committees and, therefore, does not have the ability to change the proxy or other rules governing required audit committee disclosures, the PCAOB may consider a rule such that if a registrant's audit committee has not disclosed auditor tenure in its most recently issued audit committee report or proxy statement, then the auditor would be required to disclose tenure information either in Form 2 or the auditor's report.

*Discussion of Materiality.* As discussed previously, we believe users of the auditor's report would benefit from a better understanding of the concept of materiality and how it is used by the auditor in the conduct of the audit engagement, including in the evaluation of overall financial statement presentation. We would, therefore, be supportive of including such a discussion in the auditor's report, proposed language for which is as follows:

> The concept of materiality is applied by the auditor in planning and performing the audit and in evaluating the effect of any misstatements on our audit and on the financial statements. The determination of materiality is a matter of professional judgment in light of the particular circumstances, and is affected by the auditor's assessment of what amounts would influence the judgment of a reasonable investor. The determination of materiality requires the consideration of both quantitative and qualitative considerations. As a result, there is not one specific quantitative threshold that is used in determining materiality; rather, a combination of quantitative and qualitative factors is considered. $[*XXX*] was the materiality used in conducting the audit of the consolidated financial statements as of December 31, 20xx and for the year then ended and, when combined with qualitative considerations, was used in concluding whether such financial statements were presented fairly, in all material respects, in conformity with the applicable financial reporting framework.

## PROPOSED OTHER INFORMATION STANDARD

As articulated in the "Overall Comments" section of this letter, we support enhanced auditor association with other information that accompanies the financial statements we have audited. In the proposed other information standard, however, we observe that the language in the auditor's report (which provides an overall conclusion and, therefore, implies assurance on the entirety of other information) does not appear to align with the performance requirement (i.e., to evaluate the information based upon the evidence obtained during the audit). We believe there are two alternatives that would address this issue, and we support the PCAOB pursuing either alternative. If the Board's desire is to add auditor reporting to today's performance requirement (thereby maintaining current auditor practices), the proposed wording of the report will need to be modified so as to not suggest a greater level of assurance than that which can be obtained based on the procedures that are performed. On the other hand, if the Board's desire is for the auditor to provide assurance on some or all of the other information, additional performance requirements would be necessary as some of the other information currently is not addressed by the procedures the auditor performs as part of the financial statement audit or, if applicable, the audit of internal control. Below we discuss additional observations regarding each approach.

**Maintaining Current Auditor Practices.** If the Board prefers to maintain current practices with respect to other information, we offer the following observations and suggestions.

*Definition of "Other Information."* The Board has proposed that the definition of "other information" specifically include exhibits to the financial statements and information incorporated by reference in the annual report, including the proxy statement which may be filed up to 120 days after the year-end encompassed by the Form10-K. For practical reasons, we recommend that the current definition[4] of "other information" be maintained (i.e., "other information" should be defined as the information included in documents containing audited financial statements and the auditor's report thereon). In addition, doing so will avoid the PCAOB having to amend PCAOB AU 561, which addresses a subsequently discovered issue relating to the financial statements that the auditor has reported on, but does not address issues in the other information (such as a subsequently filed proxy statement) included in a document accompanying the audited financial statements.

*Objective of the Auditor in the Context of Other Information.* Paragraph 2 of the proposed other information standard states that the objective of the auditor is to "evaluate whether the other information contains (1) a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements ('material inconsistency'); (2) a material misstatement of fact; or (3) both and, if so, to respond appropriately; and when issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for other information and whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency, a material misstatement of fact, or both." If the PCAOB intends to maintain current auditor practice, we recommend the proposed other information standard be revised to reflect that the auditor's objective is to read the other information and identify material inconsistencies with the financial statements based on knowledge gained during the audit of the financial statements (and, if applicable, audit of internal control). "Evaluate" is used throughout the PCAOB's auditing standards in the context of procedures that are performed to obtain reasonable assurance. Inclusion of the word "evaluate" in the proposed objective and in the auditor's report, therefore, implies a higher level of assurance than is present in existing practice and, as such, may cause confusion. In addition, extant PCAOB standards[5] incorporate an important distinction between the responsibilities of the auditor to identify a material inconsistency and a material misstatement of fact, highlighting that while reading the other information to identify material inconsistencies, the auditor may identify matters that may be material misstatements of fact. The extant standard acknowledges that the auditor may not have the expertise to assess the validity of a statement included in other information, that there may be no standard by which to assess its presentation, and that there may be valid differences of judgment or opinion. This distinction is important to preserve because, unlike identifying a material inconsistency with the financial statements, the auditor may have no basis (and may also lack the expertise) to identify a potential or actual material misstatement of fact in the other information.

*Reporting on Other Information in the Auditor's Report.* Under current practice, auditor reporting on other information occurs most frequently when providing a traditional "comfort letter" to underwriters. When an auditor provides a comfort letter, there is no ambiguity about the procedures that have been performed on individual amounts or disclosures. There is also no ambiguity regarding those amounts or disclosures for which the auditor has performed no procedures and, therefore, provides no "comfort" or level of assurance. Without some form of clarity in the auditor's report as to the nature and extent of the auditor's procedures and how those procedures might vary for the different types of other information, investors or users may assume the auditor has done more, which has the potential to exacerbate the expectations gap that currently exists regarding the auditor's association with other information. We believe providing clear language in the auditor's report regarding the auditor's responsibilities will mitigate this risk and suggest the following language for the auditor's report to describe what exists under current practice:

> In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we have a responsibility to read other information included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, and based on relevant audit evidence obtained and conclusions reached during the audit of the financial statements [and internal control over financial reporting], consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements. Our responsibility with respect to other information does not extend beyond the procedures we performed on the financial statements identified in our report. Therefore, certain elements of other information were not subject to any procedures beyond reading because the audit evidence obtained and conclusions reached during our audit of the financial statements [and internal control over financial reporting] were not relevant to such other information. We did not audit the other information and do not express an opinion on the other information. Based on our reading of the other information and our consideration of the other information in light of relevant audit evidence obtained and conclusions reached during the audit of the financial statements [and internal control over financial reporting], nothing came to our attention that caused us to believe that the other information included a material inconsistency with the financial statements.

**Expanding Auditor Involvement with Other Information.** Expanding the auditor's involvement to include the entirety of the other information (as currently defined in the proposed standard) is also an option. We believe expanded auditor involvement with many elements of other information would add value to investors and other users of companies' Form 10-K filings. Depending on the extent to which auditor involvement is expanded, significant additional costs could also result. If the intent of the Board is to expand the auditor's involvement with other information and to provide some form of assurance on it through expanded auditor reporting, we believe explicit performance requirements for the auditor will be necessary, particularly in the context of qualitative other information, and other information not directly related to the financial statements. As the proposed other information standard is currently drafted, the auditor is to use information already obtained in the conduct of the audit and not perform additional procedures to evaluate the other information. As a result, it is likely that the auditor will have limited or no basis for evaluating certain non-financial data or other qualitative statements included in the other information. There are numerous examples of such other information; some examples include certain backlog information, the number of patents owned by the company, market share data by country, square footage of company facilities, and qualitative assertions regarding the reliability of individual products. The explicit performance standards needed to address these and other types of other information should consider, among others:

- How to evaluate qualitative statements or assertions;
- How to assess the materiality of non-financial data;
- What procedures are necessary when a potential material misstatement of the other information exists;
- Reporting requirements to ensure that users understand the scope and nature of the auditor's procedures and the level of assurance being provided on the other information;
- Audit documentation requirements.

We would be pleased to work with the PCAOB staff to create a workable model for expanded auditor involvement with other information.

*Attestation on Management's Discussion and Analysis (MD&A).* Another option the PCAOB could pursue for expanding the auditor's involvement in other information would be to suggest that audit committees consider attestation engagements regarding MD&A, or a portion thereof (e.g., critical accounting policies). The Board may wish to consider outreach with audit committees and the investor community, and engaging in discussions with the SEC regarding such engagements. We observe that current PCAOB Attestation Standard 701, *Management's Discussion and Analysis*, (PCAOB AT 701) provides guidance for the auditor to attest to MD&A. The benefit of pursuing this alternative is that standards already exist for the auditor to perform such an engagement and the current standard permits either a review or an examination of MD&A (i.e., provides for an engagement based on varying levels of assurance). Further, the information contained within MD&A generally is both within the competence of the auditor and closely associated with procedures performed by the auditor during the audit of the financial statements. However, we note very few instances in which an auditor has been engaged to provide this level of assurance.

An examination report under PCAOB AT 701 would result in a report from the auditor on whether "the presentation includes, in all material respects, the required elements of the rules and regulations adopted by the SEC; the historical financial amounts included therein have been accurately derived, in all material respects, from the Company's financial statements; the underlying information, determinations, estimates, and assumptions of the Company provide reasonable basis for the disclosures contained therein." We believe such an examination report may also meet the objectives of the Board with respect to the auditor's involvement with other information.

## OTHER MATTERS

### Applicability to Audits of Brokers and Dealers.

*Identification and Communication of CAMs.* As discussed in Appendix 5 of the proposal, there are no issuers among the 4,230 brokers and dealers that filed annual audited financial statements with the SEC and only 9% are subsidiaries of issuers. Of the remaining brokers and dealers, approximately 90% are owned by an individual or an entity that owns more than 50%, and approximately 75% have five or fewer owners. Additionally, almost 45% of brokers and dealers file statements of financial condition separately from the balance of the financial statements to obtain confidential treatment of their filings, including the full set of financial statements. For these brokers and dealers, only the auditor's report on the statement of financial condition would be available to the public, and the auditor's report on the full set of financial statements would be confidential and not available to the public. While applying the CAM requirements to audits of financial statements of audits of brokers and dealers would be possible, given (1) the closely held nature of many broker dealers, (2) the fact that in 45% of cases, only limited financial information is available publicly, and (3) what appears in most cases to be a limited number of users of their financial statements, we do not believe that there would be corresponding value to investors of CAM reporting in the same way as for issuers. Accordingly, we do not believe that the requirements relating to identification and communication of CAMs should apply to audits of financial statements of brokers and dealers.

*Auditor Responsibilities for Other information.* We believe the SEC's amendments to Rule 17a-5 provide users of financial statements of brokers and dealers with sufficient information and already require reporting by the auditor on various aspects of other information, such that additional reporting would not be necessary. Auditor reporting includes, as pointed out in Footnote 101 in Appendix 6 of the proposal, reporting on supporting schedules required by Rule 17a-5 in accordance with Auditing Standard 17, *Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards* (which was issued subsequent to the PCAOB's other information proposal). Therefore, we do not believe the proposed other information standard should apply to audits of financial statements of brokers and dealers. In addition, the language that would be required by the proposed auditor reporting standard regarding responsibilities with respect to other information should also not be required in the context of brokers and dealers.

### Applicability to Investment Companies.

*Identification and Communication of CAMs.* Appendix 5, page A5-61 of the proposal discusses the Board's consideration of comments to their concept release by investment companies. These commenters expressed the view that additional auditor reporting requirements should not apply to investment companies and that "financial statements [are] inherently less complex than operating companies' financial statements and … that the limited nature of an investment company's operations entails fewer estimates and judgments." We agree with the views expressed by these commenters and believe that the requirements to identify and communicate CAMs in the auditor's report should not apply to audits of investment companies. Registered investment companies typically have an operating company or investment advisor, and sometimes hundreds of registered investment companies can exist under that operating company. Due to the similar nature of the financial statements of registered investment companies, if auditors of investment companies were required to identify and report on

CAMs in the auditor's report, the CAMs identified would become standardized across the numerous funds and from one complex to the next and likely from one year to the next as strategies of investment companies do not change significantly; thereby resulting in the disclosures providing little if any benefit to investors. As such, the Board's objectives in reporting CAMs (i.e., to provide unique insights regarding the audit and related financial statements) will not be achieved.

*Auditor Tenure.* If the Board does decide to require disclosure of auditor tenure in the auditor's report or in PCAOB Form 2, there are some unique implementation challenges that would arise when applying this requirement to auditor's reports on financial statements of investment companies. As such, if ultimately required to be included in either the auditor's report or in its Form 2, we believe auditor tenure should only relate to the relationship with the investment company complex as a whole and not to the relationship with each investment company. Investment companies are created frequently under an investment company complex, and typically the auditor is the auditor of multiple related investment companies within the same operating environment. Reporting auditor tenure at the investment company level would have little meaning, as these entities may be frequently formed and merged or liquidated. For example, as currently proposed, if a particular audit firm has been the auditor of an investment company complex for ten years and this investment company complex created five new investment companies in the current year, the firm would report only a one-year tenure at the investment company level for the five new funds. To report different tenure periods at the operating company and investment fund levels would be confusing and/or misleading to investors. Therefore, if the Board ultimately requires disclosure of auditor tenure, we suggest that it only be required for the relationship at the investment company complex level.

## Applicability to Emerging Growth Companies and Initial Public Offerings.

In the proposal, the Board is soliciting feedback on the applicability of the proposals to emerging growth companies (EGCs). We do not believe there is a basis for exempting audits of EGCs from the requirements of the final standards as we believe investors of these companies would benefit from the additional information communicated in the auditor's report in the same way that investors of larger companies would. While some level of incremental costs will of course result from the application of the proposals, we believe the suggestions we offer in this letter would help manage costs for audits of companies of all sizes. With respect to the requirement to communicate CAMs in the auditor's report, we believe the final auditor reporting standard should clarify whether CAMs are required to be reported in the context of IPOs.

## Increase in Auditor Liability.

The proposals represent an important step to ensure the auditor's report includes information that is responsive to the needs of users and remains relevant and valuable to the functioning of our capital markets. As a result, concerns over auditor liability should not stand in the way of moving forward. Rather, auditor liability concerns should be recognized and managed as the Board proceeds.

We believe that the proposed standards, if adopted, do present the potential for increased litigation. The PCAOB recognizes in the proposal that new statements will be made in the auditor's reports that could potentially raise new liability. The proposed new auditor statements — both with respect to CAMs and other information — could engender claims under Section 10(b) of the Exchange Act, Section 11 of the

Securities Act of 1933, and various state laws. For example, if the proposed auditor reporting standard is adopted, auditors will be subject to challenge based on the selection of matters considered to be CAMs and those that they do not consider to be CAMs. Plaintiffs will also invariably challenge the sufficiency of the auditor's evaluation of and disclosure about other information. Also of concern is the possible effect that disclosing CAMs may have on undermining efforts by Congress, which imposed the stringent pleading standards of the Private Securities Litigation Reform Act of 1995 (PSLRA), to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Plaintiffs will use descriptions of an auditor's procedures in its CAM disclosures to try to plead around the strict requirements of the PSLRA and federal jurisprudence that has interpreted it. The modifications suggested elsewhere in this comment letter may help mitigate some of the concerns relating to the effect of the proposed standards on an increase in litigation.

* * *

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential effects of the proposals. We encourage the PCAOB to engage in active and transparent dialogue with commenters as the proposed standards are evaluated and changes are considered. If you have any questions or would like to discuss these issues further, please contact Joseph Ucuzoglu at 202-879-3109, William Platt at 203-761-3755, or Megan Zietsman at 203-761-3142.

Very truly yours,

Deloitte + Touche LLP

Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member
Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards
Mary Jo White, SEC Chairman
Luis A. Aguilar, SEC Commissioner
Daniel M. Gallagher, SEC Commissioner
Kara M. Stein, SEC Commissioner
Michael S. Piwowar, SEC Commissioner
Paul A. Beswick, SEC Chief Accountant
Brian T. Croteau, SEC Deputy Chief Accountant
Russell G. Golden, FASB Chairman

## EXHIBIT 1 — Summary Results of Field Testing

In order to provide meaningful feedback to the Board during the comment process and as requested by the Board, we conducted limited field testing (including interaction with financial management) of aspects of identifying and communicating CAMs. We conducted field testing with nine engagement teams each of which was responsible for a separate audit; the applicable companies had revenues ranging from approximately $500 million to more than $50 billion. The field testing included, among other steps, identifying potential CAMs based on the guidance in paragraphs 7- 9 of the proposed auditor reporting standard. The determination of the final CAMs was made based on the consideration of the factors included in paragraph 9 along with additional factors we have recommended in the body of our letter. Summary results of our field testing are provided below:

| **Summary** | |
|---|---|
| **Identification of CAMs** | |
| Range of potential CAMs identified | 12 – 120 |
| Average # of potential CAMs identified | 40 |
| Range of final CAMs identified | 1 – 12 |
| Average # of final CAMs identified | 4 |
| **Characteristics of CAMs** | |
| % of final CAMs identified that were matters the engagement team had already discussed with the audit committee | 100% |
| % of final CAMs that are also included in at least one of the following: the discussion of risk factors in the 10-K, the discussion of critical accounting policies in the company's MD&A, and the footnotes to the financial statements | 82% |

[1] The PCAOB may need to consider whether providing original information regarding a company may implicate non-U.S. privacy and confidentiality laws and regulations, as well as accountants' professional obligations. For example, it appears that several countries impose strict confidentiality requirements on accountants not to reveal information about their work. In several countries, a violation of these confidentiality provisions also constitutes a criminal offense.
[2] See page A5-36 of the proposal.
[3] *Audit Committee Reporting to Shareholders: Going Beyond the Minimum*, Ernst & Young, February 2013, p. 2.
[4] See PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements*.
[5] Ibid, paragraphs 5 and 6.

**From:** Eleanor Sullivan
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 7:00:27 PM
**Attachments:** PCAOB Docket 034 Comment.pdf

I support Lisa Roth's position

All my best,
Ellie

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**Lisa Roth**

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

**From:** bohdickey@comcast.net
**To:** Comments
**Subject:** Docket 034: Proposed Auditing Standards on the Auditors" Report
**Date:** Friday, November 15, 2013 12:07:06 PM

I am a retired business executive. I am presently the chair of the audit committees of two public companies. My career in business includes being an audit partner with a big five accounting firm, a CFO of a major public company, and a board member of four public companies. In my role as CFO I supervised the Treasurer of my company and was very active in setting investment policy as well as the controls over the investment process. Also in that role as CFO I was the companies spokesperson to Wall Street analysts and investors and had extensive contact with that community.

I respectively suggest that the proposed changes in the Auditors' Report set forth in the Docket are not necessary and go against the rule "if it ain't broke don't fix it".

First of all, the proposed changes of having an Auditors' Discussion go against the long standing precept that the financial statement are the responsibility of management. The separation of the auditor from this primary responsibility should not be clouded. Sarbanes-Oxley has done much to reinforce this precept by requiring the CEO and CFO certifications. It is working. CEO's and CFO's are taking their responsibilities very seriously. Auditors should continue to opine of the financial statements and investors should not be confused about who has the primary responsibility.

Second, Sarbanes-Oxley has done much to reinforce the role and responsibilities of the audit committee in overseeing the production and communication of financial information to the investment community. We take our role very seriously. And the regulations contained in Sarbanes-Oxley are very effective. Audit committees are much more effective than before the SO rules and review and stay close to the "quality of earnings" of the companies they serve. Auditors are very candid with their audit committees about the financial statement they opine on both in general sessions and executive sessions with the audit committees.

And finally, I see little benefit to the investment community. With all of the disclosures required today by the SEC in our 10-Qs and 10-Ks there is more than sufficient information for the investor to make appropriate decisions.

These proposals will do little to improve the information available to investors and may indeed confuse the roles of the company and its auditor in the financial reporting process. More is not always better. These rules should not be adopted.

Respectfully,

Boh A. Dickey, CPA
Woodinville, Wa. 90872

DIRECTV

December 11, 2013

Via e-mail to: comments@pcaobus.org

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

File Reference: **PCAOB Rule Making Docket Matter No. 34- Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards**

Dear Office of the Secretary,

As the Chief Accounting Officer of DIRECTV, we appreciate having the opportunity to comment on the PCAOB's Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards ("Concept Release"). We also appreciate the PCAOB's concerns about the information and value of the auditor's report to promote the usefulness and informational value to users of financial statements. We understand the benefits the Board believes will ensue from an enhanced audit report and additional auditor responsibility for other information included in a Company's annual report filed with the Securities Exchange Commission ("SEC").

We agree with the Board that as the informational needs of users of financial statements and the amount of information available to them evolves, financial reporting by auditors, management of the company and the audit committee must change to meet those needs and such changes may include additional information. We agree that the auditor's report is an important communication of the audit work performed. We support the Board's proposal to include additional disclosure by the auditor to clarify that they are independent and to disclose their tenure with the company.

As part of our rigorous financial reporting process, we evaluate critical judgments and estimates and disclose these matters in our SEC filings based on generally accepted accounting principles in the United States, SEC requirements and if we as a company believe the information would be useful information to an investor. We review and discuss disclosure matters with both our disclosure committee and audit committee, as well as with our auditors. We believe we appropriately communicate critical accounting matters in our financial statement and footnotes. Under the proposal, our auditors could potentially be required to disclosure information that we as a company, along with our disclosure committee and audit committee have determined need not be disclosed.



2230 E. Imperial Hwy El Segundo, CA 90245

As a company, we work very closely with our auditors in the preparation of all of our SEC filings. They are active participants in the review process of the entire document and comply with the current auditing standard which requires them to read other information included in the filing and consider whether the other information is materially inconsistent with the financial statements. As part of our existing financial reporting process, we carefully consider and evaluate the input we receive from our auditors regarding other information included in our SEC filings. Because all information included in our SEC filings is the responsibility of our management, we do believe that the ultimate decision about what is communicated to our investors in other information should be made by the company and not by our auditors.

Thank you for this opportunity to comment on the PCAOB Concept Release No. 2013-005, Rulemaking Docket Matter No. 34.

Very Truly Yours,

John F. Murphy
Senior Vice President and Chief Accounting Officer

**From:** Thompson, Ray
**To:** Comments
**Cc:** "Paige Pierce"
**Subject:** Docket Matter No. 034
**Date:** Wednesday, December 11, 2013 12:16:46 PM
**Attachments:** Raymond A Thompson.vcf

**Re: PCAOB Rulemaking Docket Matter No. 034**

To the members of the Board:

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB, namely:

## Small, Independently-owned, Non-public, Non-custodial, "Introducing" Broker-Dealers and Investment Advisers.

Our firms, numbering approximately 4000, are **NOT** public companies. They are privately-owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. The majority of these small firms have fewer than 50 employees.

For these small independent and privately-owned businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is appropriate and consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and **exempt** the auditors of small, privately held, non-custodial "introducing" broker-dealers and investment advisers from its oversight.

It is important that regulation for **small firms** remain relevant to the business model and investing public.

We encourage the Board to seriously consider the matter of a **small firm exemption**.

Thank you for your consideration,

Ray Thompson

DORSEY & COMPANY INC.
WEALTH MANAGEMENT • INVESTMENTS

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DTE Energy

December 11, 2013

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

**Re: Request for Public Comment – Docket 034: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *Reports on Audited Financial Statements, and the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

Dear Office of the Secretary:

DTE Energy Company ("DTE," "we," "us," "our," or the "Company") values the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standards. We also appreciate the Board's extensive efforts to solicit feedback from stakeholders, and the careful consideration thereof.

DTE is a diversified energy company involved in the development and management of energy-related businesses and services nationwide. Our revenues for the year ended December 31, 2012 were approximately $8.8 billion, and we employ approximately 10,000 people. Our electric and gas utility businesses have each been in operation for over a century and together provide services to more than three million residential, business and industrial customers throughout Michigan. We have leveraged that wealth of experience and assets to develop a number of non-utility subsidiaries which provide energy-related services to business and industry nationwide. We prepare consolidated financial statements in accordance with accounting principles generally accepted in the United States of America that we file with the U.S. Securities and Exchange Commission. Our securities are listed and traded on the New York Stock Exchange.

We value the financial statement audit and the consequential benefits to maintaining strong financial markets. Accordingly, we are fully supportive of changes to the auditor's report that serve to narrow the gap between what is expected of the auditors by financial statement users and what is actually conveyed. However, we are not supportive of any changes to the auditor's report that i) do not enhance its usefulness and meet the needs of financial statement users; ii) could compromise the relationships between issuers, auditors, audit committees and financial statement users; iii) would require auditors to disclose information about issuers that is subjective, lacking appropriate context and not otherwise required by U.S. Securities and Exchange Commission ("SEC") rules and regulations; and iv) do not have apparent benefits that exceed costs. The following pages provide our thoughts and views on the key facets of the proposed standards.

*Enhancements to Certain Standardized Auditor Report Language*

We agree with the Board's proposal to retain the current pass/fail model of the existing auditor's report, as it is a concise indication that the financial statements are fairly presented and free of material misstatement. Further, the current pass/fail reporting model provides for consistency from period to period and comparability across audits, thereby eliminating the need for user interpretation of the auditor's conclusion.

We are not opposed to the proposed enhancements to the auditor report in the Board's illustrative example with respect to the addressees of the report, as well as the introduction, basis of opinion and opinion on the financial statements paragraphs with the following exception. We believe that inclusion of the tenure of consecutive years that an auditor has served as the registered independent public accounting firm for an issuer of financial statements should not be included within the auditor opinion. Audit committees are responsible for ensuring that auditors are independent and that their audits are completed in accordance with all applicable standards, regardless of auditor tenure. Additionally, as the Board noted in its proposal, information regarding changes in auditors is currently available to investors, as filers are required to publicly disclose this information on Form 8-K via the EDGAR system. The Board also acknowledged in its proposal that current empirical data is inconclusive at best in drawing a connection between auditor tenure and audit quality. We believe that inclusion of auditor tenure in the auditor report would imply that the Board and other standard setters believe that a correlation does exist, and that users of financial statements should therefore give weight to the auditor's tenure in connection with the other risk factors that they assess in forming decisions. Until such time that conclusive or highly compelling evidence that supports inclusion of this data point exists, we find that it would be an unnecessary modification as it could lead to unwarranted and speculative conclusions by users of financial statements regarding audit quality and perceived risk. If the standard setting community does find auditor tenure to be predictive of audit quality and a meaningful data point to investors, we believe that proxy filing requirements are a more appropriate target to make this revision than the auditor report.

*Auditor Reporting of Critical Audit Matters*

We agree with and thank the Board for tabling the auditor's discussion and analysis ("AD&A") alternative that was included in the concept release. The AD&A would have indeed represented a fundamental shift in the role of the auditor with the potential for unintended and undesirable consequences, the foremost of which would have been auditors disclosing original or conflicting information concerning an issuer. While the critical audit matter ("CAM") model represents a preferred alternative for us as compared to the AD&A model, we question whether or not inclusion of CAM in the auditor's report as currently proposed would effectively serve the needs of users of financial statements.

We believe that the reporting of any and all company information is, and should remain, the responsibility of management and those charged with governance. Any alteration thereto would undermine the role of the audit committee and its relationships with management and the auditors. The success of these relationships is based on periodic and dynamic communications between parties. Conversely, the proposed standard would result in confusion and misinterpretation as users of financial statements would not share the benefit of open dialogue and receive only one-dimensional CAM information from auditors. Further, requiring auditors to report matters that would have traditionally been discussed and settled with management and the audit committee may limit the candor and completeness of those discussions.

Based on the subjective nature of identifying CAM, auditors' reports could range from reporting zero CAM to an overwhelming and unfocused amount of CAM. Both of these alternatives would undercut the intent of the proposal, not be meaningful to users and create a lack of comparability between auditor reports. Due to the broadness of the proposed standard, the majority of auditor reports would presumably include an unmanageable number of CAM in an attempt to achieve complete coverage. In addition, highlighting a set of matters is inconsistent with the auditor forming the basis for its conclusion on the financial statements taken as a whole and not on a piecemeal basis. The examples of auditor reported CAM that were illustrated in the proposed standard provide objective facts and circumstances, but only insofar as describing how and why the auditor found a matter to be a CAM. The auditor need not provide any further information or conclude individually upon CAM. Without further context, users of financial statements could perceive CAM to have negative connotations or equate CAM to the existence of an issue. The CAM examples in the proposal are also largely redundant with information disclosed by management.

In addition, the proposed standard calls for auditors to identify and report CAM through the lens of the audit. This will no doubt result in CAM including matters of significance to the auditor that are more than likely inconsequential to users of financial statements. An example is the inclusion of a CAM for an audit area that is difficult to test or observe. Such a CAM may be in the ordinary course of business for a given issuer, without any unique risk and unrepresentative of an aggressive accounting practice or policy. The fact that a matter may have been difficult for the auditor to test is not by itself indicative of increased risk or relevance to users of the financial statements. CAM would therefore cloud the auditor report by adding information that has limited meaningfulness to users of financial statements and render the conclusion more difficult to decipher.

Following our previously mentioned concern regarding AD&A and the potential for auditors to become providers of original issuer information, CAM could also represent information disclosed by the auditor that would not otherwise be disclosed by the issuer (e.g. a significant deficiency in internal control over financial reporting). In our view, CAM should not change the traditional role of the auditor, or cause them to report information that is in conflict with or not required by existing standards. Any and all public disclosures regarding issuers should be governed by SEC rules and regulations, and PCAOB standards should not indirectly alter those rules and regulations.

*Auditor Responsibilities Regarding Other Information*

We are not opposed to the auditor’s report including clarifying language of the auditor’s existing responsibilities over information outside of the financial statements. However, we do not believe that the scope of the auditor’s responsibilities should be altered as the existing standard for auditors to “read and consider” the information outside of the financial statements and identify and communicate material inconsistencies and/or material misstatements of fact through the corporate governance process is appropriate and sufficient in our view.

An extension of auditors’ responsibilities to “read and evaluate” and report conclusions on information outside of the financial statements beyond the current scope of AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, would not be a meaningful step towards meeting the desires of users of financial statements for more informative auditor reporting and deeper insight into financial information. Under existing rules and regulations, management and those charged with governance are collectively responsible for ensuring the completeness and accuracy of information outside of the financial statements. This information is inherently predicated upon a multitude of factors regarding risk, uncertainties, opportunities, trends and industry knowledge and expertise. Accordingly, this information may not be easily verifiable or subject to clear standards of assessment. Without a robust and tested framework, and as they are not experts in general and non-financial matters, auditors could reach varying conclusions on information outside of the financial statements that create inconsistency between audit reports. Additionally, broad application of the proposed standard to other information that is included within a document, exhibits or information incorporated by reference would result in an onerous set of procedures to be performed by the auditor. The time and effort required for evaluation of such a volume of information would be extensive, result in significant increases in audit fees and delay the issuance of information relevant to users of financial statements.

The introduction of tiered levels of assurance (i.e. “audited” vs. “evaluated”) within the auditor report could leave users of financial statements with an unclear understanding of the scope and basis for auditor conclusions and further widen the expectation gap. The basis of opinion section of the auditor report in both the current and proposed standards defines the audit by leveraging the concept of evaluation (i.e. evaluating the accounting principles used, significant estimates made by management and the overall presentation of the financial statements) thereby implying a synonymous relationship between audit and evaluate. We acknowledge that the modifications to the auditor report in the proposed standard would specify that the other information is not audited. Nonetheless, we believe that users of financial statements would have an incomplete understanding of the different levels of assurance being communicated and difficulty determining the basis by which the auditor reached its conclusion over the unaudited information.

*Conclusion*

We understand the evolving needs of users of financial statements and appreciate the Board’s commitment to achieving progress in the auditor’s reporting model. We agree with enhancements to the auditor report that clarify the role and responsibilities of the auditor. However, we are not supportive of changes that do not provide meaningful value to users of financial statements or that alter the scope and nature of the audit. Enhancements to the auditor report may indeed be valuable to users of financial statements, but the financial community would experience a greater return from changes that facilitate explicit enhancements to the quality of the audit itself over deterrent-based modifications to the auditor report.

We thank the Board for the opportunity to share our thoughts on the proposed standards. If you would like to discuss our letter further, or if there are any questions from the Board or PCAOB staff that we can address, please contact Donna England (313-235-3510).

Sincerely,

/s/ Donna M. England

Donna M. England
Chief Accounting Officer

cc: PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Member
Jeanette M. Franzel, Member
Jay D. Hanson, Member
Steven B. Harris, Member

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Power by Association℠

Edison Electric Institute

December 11, 2013

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

**File Reference:** PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

The Edison Electric Institute ("EEI") respectfully submits our comments on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed audit standards included in Release No. 2013-005 addressing both *The auditor's report on an audit of the financial statements when the auditor expresses an unqualified opinion* (the "proposed auditor reporting standard") and *The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report* (the "proposed other information standard").

EEI is the association that represents all U.S. investor-owned electric companies. Our members provide electricity for 220 million Americans, operate in all 50 states, and directly employ more than a half-million workers. With more than $85 billion in annual capital expenditures, the electric power industry is responsible for millions of additional jobs. EEI has 70 international electric companies as Affiliate Members, and 250 industry suppliers and related organizations as Associate Members. Organized in 1933, EEI provides public policy leadership, strategic business intelligence, and essential conferences and forums.

**Overall concerns**

EEI appreciates the PCAOB's efforts to enhance the information provided to investors and financial statements users. We agree that financial statement users should have access to timely, accurate, objective and relevant information for purposes of making investment decisions. However, we strongly disagree with the proposed auditor reporting standard and proposed other information standard included in PCAOB Release No. 2013-005. We believe a company's financial information and the communication of that information is management's responsibility. We believe the SEC and the FASB should continue to serve as the standard setters for establishing the requirements for information to be provided to investors, and that management should be responsible for communicating such information.

The SEC has enacted various regulations over time (including designation of FASB as the organization responsible for promulgating US GAAP) on *what* information needs to be disclosed. Importantly, these rules designate management as the responsible party to determine *how* to communicate this information to most accurately reflect a company's financial results and position. The role of the external auditor is to verify that the information presented by management complies with the applicable SEC / FASB requirements and is presented fairly in all material respects. When such requirements are met, an auditor provides an unqualified audit opinion to investors. In the event that the financial statements do not meet these requirements, the external auditor is required under AU Section 508 to issue alternative audit opinions.

The audit committee is comprised of a subset of a company's shareholder-elected Board of Directors and is required to be independent[1] and either include at least one Financial Expert [2] or disclose why there is not one. This independent committee is charged with oversight of both the auditor and management's financial reporting. The SEC and PCAOB provide additional oversight of management, the audit committee and external auditors by reviewing the financial statements and the audits thereof to ensure these parties are performing their duties appropriately. If management, the audit committee, and the external auditors fulfill their respective responsibilities to communicate timely, accurate, objective and relevant information to financial statement users that is audited in accordance with existing professional standards, we believe the additional communications and requirements outlined in the proposed auditor reporting standard and the proposed other information standard are unnecessary.

In addition to these overall concerns, we provide the following specific observations regarding each proposal.

## The Auditor Reporting Standard

Of the various requirements proposed in the auditor reporting standard, we most strongly disagree with the requirement that the auditor disclose critical audit matters (CAMs) within the audit report. As such, we have limited our response on the auditor reporting standard to this matter. We believe the proposed standard would undermine the role of the audit committee and could be detrimental to the usefulness and relevance of the audit report. Further, we believe the proposed standard would result in lack of consistency and comparability of auditors' reports across companies while increasing the cost of regulatory compliance.

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[1] Sarbanes-Oxley Act Section 301
[2] SEC Release No. 33-8177

*The proposal would undermine the role of the audit committee and could be detrimental to the usefulness of the audit report*

The audit committee, as part of the shareholder-elected Board of Directors, has the authority to oversee the audit and ensure the financial statements contain appropriate disclosure on behalf of shareholders. With its access to auditors, management and the Board of Directors, the audit committee has the requisite knowledge, perspective and authority to ensure the various risks or issues of the reporting entity are disclosed in a manner commensurate to their materiality and relevance to investors. The Board's proposal would undermine this oversight role by effectively requiring the auditor to make disclosure notwithstanding the views of the audit committee. Furthermore, this requirement could potentially limit discussions of significant audit matters with the audit committee or put the auditor in the role of making disclosures in their audit report of *any* significant audit matter discussed with the audit committee in order to avoid being challenged by the PCAOB. We believe that these considerations could have an adverse impact on the role of the audit committee by reducing transparency between the independent auditor and the audit committee. We believe investors are best served by retaining the audit committee as the primary oversight of the audit process.

In addition to the above, in the preparation of the financial statements, management has the responsibility to develop disclosures with sufficient clarity to aide investors and analysts, while not providing information that could be used by competitors or litigators to the company's detriment. This fiduciary duty is entrusted to a company's management and Audit Committee by the shareholders and does not extend to the company's audit firm. Requiring audit firms to disclose critical audit matters may result in a conflict of interest between an audit firm's interests to reduce its own regulatory and litigation risk and an Audit Committee / management's fiduciary interests to not disclose proprietary or other competitively sensitive information.

The auditor is expected to conduct an audit to obtain reasonable assurance that the financial statements are materially correct when taken *as a whole*. The auditor's report does not include, nor do we believe it would be appropriate or practical to include, all of the factors considered by an auditor when forming the overall audit conclusion. Therefore, without the full context of a company's financial transactions, business environment and internal controls obtained by the auditor throughout the audit process, an investor may inappropriately over-emphasize the importance of a CAM when making an investment decision. Likewise, highlighting CAMs in the audit report may lead investors to over-emphasize certain risks because they are disclosed as a CAM and under-emphasize other important business risks that may not meet the proposed CAM disclosure criteria. Additionally, disclosure by the auditor of the most difficult aspects of the audit may be interpreted by some as the auditor expressing reservations in their report on those transactions or accounts affected by a CAM, or as the auditor providing a "piecemeal" opinion on the financial statements which would undermine the usefulness, authority, and credibility of the audit report.

*The proposal would undermine the relevance of the audit report/financial statement disclosures*

The matters that would be required to be disclosed as CAMs should already be provided in the financial statements or are not material to investors in making investment decisions. The proposal states that CAMs are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Many of those matters meeting the criteria above relate to subjective or complex accounting areas which are already disclosed within the financial statements as required by US GAAP or SEC rules. Examples include critical management judgments, risks and uncertainties, and accounting estimates and policies. Repeating these disclosures in the audit report would result in duplicative disclosure and would undermine the relevance of either the audit report or the financial statement disclosures. If any additional information or disclosure is deemed necessary, such disclosure should be addressed by the SEC and the FASB as part of the financial reporting standard setting process.

The proposed standard would also require that auditors disclose certain audit matters that we do not believe would be considered relevant to investors when making investment decisions. Examples include the level of audit effort applied to a particular account, immaterial or corrected misstatements, change in auditor risk assessment, and an auditor's use of a specialist. Such items may provide information on a business's accounting operations or an auditor's approach, but do not impact the underlying economics or accounting of the business and therefore may not be considered relevant by investors.

*Auditor reporting would no longer be comparable or consistent across entities*

Under the proposed standard, the auditor's determination of what is considered to be a CAM will involve a considerable amount of professional judgment and will decrease comparability of the auditor's report. There is a risk that auditors may take a conservative approach and include numerous CAMs in order to avoid potential PCAOB inspection findings or litigation, resulting in voluminous disclosure within the audit report and thereby obscuring the overall opinion. Further, investors may incorrectly interpret longer auditors' reports as an indicator of higher investment risk rather than as a matter of an auditor's professional judgment or reporting policy. There is also the risk that each audit firm's interpretation of what meets the definition of a CAM will differ, resulting in lack of comparability between audit reports for similar companies or industries. We therefore have concerns that the auditor's subjective determination of what is considered to be a CAM could be used erroneously as the basis for, or at least influence, differences in investor decisions among otherwise comparable entities.

*Potential implementation challenges and cost considerations*

We believe that the PCAOB should undertake a cost-benefit analysis to assess whether the increased costs of compliance with the proposal would outweigh any perceived benefit. A significant amount of additional time would be required by audit firms in order to develop, review and present CAMs, which would result in increased audit fees. Extensive discussion and consultation with Company management, legal and the audit committee would also be required, resulting in increased internal costs. Further, because some CAMs may not be identified until late in the audit process as the audit is performed, this additional work would be required during an already busy period within the audit and financial reporting cycle which would impact the timing of SEC filings, and would likely lead to filing delays. Consequently, the ability of investors to obtain financial information in a timely manner would be hindered. It is not clear to us that additional time and effort to comply with this standard would be cost beneficial to investors if management has complied with its responsibilities in preparation of financial statements.

While we do not support the inclusion of CAMs in the auditor's report, if the Board ultimately determines to implement the rule as proposed, we request that the effective date be delayed to allow companies and auditors to field test how the CAM provision would be applied in practice and provide an opportunity to mitigate the potential issues identified above.

**The Other Information Standard**

We support adding language to the auditor's report that will *clarify* the auditor's procedures and responsibility for other information contained in SEC filings (such as the MD&A). We do not support *expanding* the auditor's responsibilities regarding other information, or including language in the auditor's report that could be perceived as an expansion of the auditor's responsibilities. We believe the proposal would lead to higher costs with no commensurate benefit to investors. Further, we believe the proposal as written would result in several practice issues that would result in inconsistent application among audit firms.

Management should continue to prepare and present the other information contained in the annual reports of public companies, with over-sight from the Audit Committee, without the additional costs of such information being subject to additional procedures by the auditors. We support the retention of existing procedures contained in AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* which require auditors to "read and consider" other information to ensure the information is consistent with the audited financial statements. We believe AU 550 provides an appropriate level of assurance for the other information considering both the costs and benefits of such assurance.

We believe the "read and evaluate" language included in the proposed standard implies, and is likely to result in, a level of additional procedures that is substantively different from and greater than the requirements set forth in AU sec. 550. We do not agree with this change in the proposed language as it will have far reaching impacts on the procedures currently being applied to other information. We believe that, in carrying out their professional responsibilities, auditors presently are conducting a sufficient level of review commensurate with the nature and purpose of that information.

We believe the use of the term "evaluate" will prompt auditors to expand their procedures substantively beyond the existing requirements in AU sec. 550 resulting in unnecessary procedures and increased costs. Furthermore other information contained in annual reports is often subject to change late in the audit process. Similar to the timing of CAMs, the additional work over other information will be required during an already busy period within the audit and financial reporting cycle and would lengthen the timing of a company's SEC filings to the detriment of investors.

Alternatively, we recommend that the Board retain the existing procedures in AU sec. 550 but ensure that the language presented in the auditor's report clearly communicates what those existing procedures entail. If the Board believes further clarity is warranted to differentiate the level of assurance provided within the financial statements, we request the Board consider a more cost effective approach. For example, the Board could consider adding headers or other disclaimers on each page of the audited financial statements that indicate if the information is audited.

While we disagree with the proposal, we believe several practice issues need to be addressed within the standard if the Board determines to adopt the standard as proposed. These practice issues include determining what information would be subjected to the expanded procedures, what procedures to perform on forward-looking statements, and how an auditor should determine materiality of non-financial information.

**Conclusion**

As discussed above, we do not support the inclusion of CAMs in the auditor's report or expanded audit procedures on other information contained in the annual report. We urge the Board to reconsider the proposals. We believe that auditor reporting of CAMs would decrease the relevance of the audit report, the role of the audit committee, decrease audit report comparability and increase costs of compliance all to the detriment of investors. Further, we believe guidance currently contained in AU sec. 550 appropriately addresses the procedures to be performed by the external auditor over other information contained in SEC filings and it is unclear to us whether the benefits arising from any further audit scrutiny would justify the costs.

* * * * * *

EEI appreciates the opportunity to provide our input on the proposed audit standards included in the Release. We would be pleased to discuss our comments and to provide any additional information that you may find helpful.

Very truly yours,

/s/ Richard F. McMahon, Jr.

Richard F. McMahon, Jr.
Vice President

EDISON INTERNATIONAL℠

December 10, 2013

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

**Re: PCAOB Rulemaking Docket Matter Number 034**

Dear Madam Secretary:

We are pleased to submit our comments on the *Proposed Auditing Standards, PCAOB Release No. 2013-005 on Rulemaking Docket Matter #034 ("Proposal").* We serve as the Audit Committees ("Committee") for Edison International (NYSE:EIX) and Southern California Edison Company. Edison International ("Edison" or the "Company"), an integrated energy company, generates and distributes power, primarily through its wholly owned subsidiary, Southern California Edison Company, serving 14 million people across a 50,000 square mile area in Southern California. Our following comments are based not only on our experience serving Edison, but also from our experiences as senior leaders in business, academia and government.

We commend the Public Company Accounting Oversight Board ("PCAOB") for its decision to retain the current "pass/fail" model of the auditor's report and its efforts to consider improvements to the Auditor's Report and Responsibilities regarding Other Information.

**Auditor's Report**

Our corporate governance system consists of shareholders electing the Board of Directors ("Board"), as their representatives, to provide management oversight. Management is responsible for the financial statements and disclosures in accordance with the United States' Generally Accepted Accounting Principles ("GAAP") and Securities and Exchange Commission ("SEC") rules and regulations. The Board delegates the oversight of financial reporting, including the system of internal controls and risk management to the Audit Committee. In addition to financial reporting oversight, the Audit Committee has sole authority to retain the independent auditor and, therefore, primary responsibility for the assessment and approval of those services. The independent auditor opines on whether management's financial statements and disclosures are fairly presented, in all material respects, in conformity with GAAP and in the case of an integrated audit also provides an opinion on the effectiveness of internal controls over financial reporting. This division of responsibilities is the foundation of our current governance structure and clearly defines roles and responsibilities between and among management, the Audit Committee and independent auditor. We believe the audit committee has the requisite knowledge, perspective and authority to oversee that the reporting entity's management discloses the risks or issues in a manner commensurate with their materiality and relevance to investors. The Proposal would undermine our Committee's oversight role by effectively requiring the independent auditor to disclose matters that are management's responsibility, notwithstanding the views of the audit committee.

We strongly oppose the requirement that the independent auditors report Critical Audit Matters ("CAM") in the Auditor's Report. We believe that such disclosures:

- Would not provide meaningful discussion of the level of complexity or detail necessary to understand the full context and resolution of the audit issues—an audit committee responsibility and the proper forum within which to provide such oversight;
- May cause the reader to place inappropriate weight on the CAM from that provided by management in the financial statements and Management Discussion and Analysis of Financial Condition and Results of Operations (including critical accounting policies and estimates) or duplicate such disclosures;
- Could result in boilerplate language covering a number of generic audit topics relating to the issuer's industry (e.g. rate regulated matters);
- May result in financial statement users placing less reliance on the unqualified opinion on the fairness of the financial statements' presentation, taken as a whole—instead perceiving a series of piecemeal opinions.

The Proposal defines three conditions that could result in a CAM, one of which is a matter communicated to the audit committee. Currently, our Committee's discussions with the independent auditor are forthright and wide-ranging. Our Committee's agenda is the result of input from Committee members, management and the auditors. The topics range from routine, required matters, including significant events or transactions that impact financial reporting, to focused discussions on critical accounting and reporting matters, internal controls and risk management. Furthermore, in Executive sessions with the independent auditor, our Committee discusses management bias with respect to judgments, estimates, significant accounting policies and disclosures and whether any difficulties were encountered, such as obtaining appropriate audit evidence. These forthright and open discussions with the independent auditor provide our Committee with a perspective and understanding of audit issues, the business context of those issues, the auditor's professional skepticism and management's judgments.

We are concerned that the Proposal's condition for a CAM may inadvertently result in cautious and constrained discussions between the independent auditor and our Committee because the independent auditor might feel compelled to disclose any significant audit matter discussed with the audit committee or risk being criticized during PCAOB inspections. We believe that an open and transparent discussion between the audit committee and the independent auditors is essential to the effectiveness of our Committee in meeting our responsibilities.

**Other Information Responsibilities**

The auditor currently performs "read and consider" procedures on Other Information contained in SEC filings to assure there is no material inconsistency with the financial statements and disclosures. Currently, our independent auditor reports to us that they have performed these procedures on the quarterly and annual financial statements filed with the SEC and reports to us whether there are any material inconsistencies. The Proposal expands the independent auditor's responsibility by requiring that Other Information be "evaluated" if relevant audit evidence was obtained, regardless of whether that Other Information is directly related to the audited financial statements. As a result, the Proposal limits the scope of information to be evaluated to relevant audit evidence obtained.

We oppose the Proposal to change and expand the Auditor's Responsibility on Other Information because:

- The independent auditor may not have sufficient knowledge nor expertise to evaluate all of the Other Information; and
- Financial statement users will not know what relevant audit evidence was obtained and may conclude incorrectly that all Other Information was evaluated by the independent auditor, resulting in either confusion or unmet expectations.

Thank you for considering our views.

Yours truly,

Vanessa C.L. Chang

Respectfully submitted on behalf of the Audit Committees:

Vanessa C.L. Chang, Chair
Jagjeet S. Bindra, Member
France A. Cordova, Member
Luis G. Nogales, Member
Peter J. Taylor, Member

November 26, 2013

Ms. Phoebe W. Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006

**Re: Amendments to the PCAOB Standards (Rulemaking Docket Matter No. 034)**

Dear Ms. Brown and Members of the Board,

Thank you for the opportunity to comment on the proposed new auditing standards. As an investor, I agree with what seems to be PCAOB's main assertion: that the pass/fail model does not address the current complexities of global business. However, the expanded disclosure requirements put an unnecessary burden on the audit committee and auditors; specifically, listing the critical audit matters (CAMs), may cause confusion for investors and become a liability for auditors and companies. The goal of the PCAOB can be met with less drastic changes to the current accounting standards.

I believe that the goal of "protect[ing] the interests of investors and further[ing] the public interest in the preparation of informative, accurate and independent audit reports" can be met with modest changes to the current pass/fail model. Slight revisions to the current model will help ensure that the new standards can be enacted seamlessly and will help prevent future fraud, which is starting to seem inevitable. According to *Audit Analytics*, there has been a sharp rise in earning restatements at large companies over the past three years. The PCAOB inspection reports issued in 2012, showed that 36% audits from the Big Four (Deloitte, E&Y, PwC, and KPMG) the inspectors scrutinized were deemed deficient, up from 14% two years before that.[1]

Below are suggested key edits to the proposed PCAOB standards.

**<u>Recommended Edits:</u>**

1. As mentioned in PCAOB's proposal, auditors should report how long they have been auditing the company. However, companies should also have a limit on the number of consecutive years the company can employ the same public accounting firm.

   Currently, a company hires and pays an accounting firm, typically one of the big four, to review their financial statements. This intertwined relationship does not encourage objectivity.

[1] Rapoport, Michael. "New Rules Expected for Annual Audit Reports." *Wall Street Journal*. N.p., 12 Aug. 2013. Web.

According to Barbara Roper, head of investor protection for the Consumer Federation of America, "when you look at some of the big audit failures over the years, whether it's Enron or Waste Management, you find instances where they've had the same auditor for in some cases decades."[2]

2. In general, CAMs are subjective and should not be included in the auditor's report. The name itself, "Critical Audit Matters" and complexity of listing every difficult or subjective decision made by the auditor, can cause unnecessary investor concern. Instead of CAMs, the audit opinion should include less subjective measures to express a company's health. The auditors should include:

a. Divergence from industry norms. Auditors should possess knowledge of the company's industry; if items in the financial statements are incongruent with industry norms, the public accounting firm should disclose that in the audit report.

b. Opinion on whether the company can continue as a going concern. As mentioned in the PCAOB proposal, if there is doubt that a company can continue as a going concern it should be disclosed to investors.

3. Auditors should review Management Discussion & Analysis ("MD&A") along with the financial statements. The audit report should provide reasonable assurance that the MD&A is free from material error and covers material changes (increases or decreases) seen from the previous quarter and/or year.

To provide further insight, yet avoid redundancy, I answered select questions from sections IV and V.

**Answers to Select Questions Posed in Sections IV and V:**

**2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

The audit report should be addressed to the company's board of directors or the equivalent body and the entire investing public. The scope should not be limited to the company's current investors; future investors are also relying on the audit report and they should be addressed.

**5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

[2] Gao, Shirley. "Center for Public Integrity." *Center for Public Integrity*. N.p., 13 July 2011. Web.

The statement proposed would provide factual information to investors and potential investors about the relationship between the company and auditor. If there is not a limit placed on the number of years a public accounting firm can audit one company (I addressed this above), then this statement will allow shareholders to determine if the tenure of the auditor is a concern.

**b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

The PCAOB will need to create standards for mergers, acquisition, or other partnership agreements amongst public accounting firms.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

Including audit procedures performed and the resolution of CAMs would be an overwhelming amount of detail to include in the audit report for very little additional value. As it stands now, the auditor, as the expert, provides reasonable assurance that the financial statements are free from material misstatements. How the auditor arrived at that decision should not be important unless the expertise or judgment of the auditor is in question.

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

It is management's responsibility to prepare the company's financial statements and an auditor's responsibility to confirm accuracy; this proposal would shift that balance. The auditors should not disclose information that management is not required to reveal and has decided not to make public. Such information may be trade secrets that provide the company with a competitive advantage.

Again, I appreciate the opportunity to share my opinion. Thank you for your consideration on this matter.

Sincerely,

J. Edmunds

EideBailly®

CPAs & BUSINESS ADVISORS

December 11, 2013

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

**Re: Proposed Auditing Standards – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

Eide Bailly LLP commends the Board's ongoing commitment to the improvement of audit quality and appreciates the opportunity to provide our comments on these proposed auditing standards. Eide Bailly is a registered public accounting firm serving mid-sized and smaller issuer entities. We have provided general comments as noted below, followed by responses to certain of the detail questions for which the Board has sought specific comment.

**General Comments**

In our response to the Board's 2011 Concept Release on possible revisions to the auditor reporting model, we expressed our concerns related to requiring the auditor to provide information about the entity to the users of the entity's financial statements. We believe that the proposed standard achieves an appropriate balance between the responsibility of the auditor and the responsibility of management with respect to the nature of the information to be provided to users of financial statements, specifically in that auditor requirements will be focused on reporting related to the audit process and critical audit matters.

Acknowledging this, we are concerned about unintended consequences resulting from the implementation of the requirement for auditors to report on critical audit matters. As firms, and even individual engagement teams, perform assessments, arrive at conclusions, and prepare report language related to critical audit matters, invariably differences in reporting will result even when very similar circumstances exist for separate, but similar entities. A potential unintended consequence of these situations is that the same users of the separate entity financial statements arrive at different conclusions regarding the entities solely as a result of the differences in the respective auditor's reporting of critical audit matters, rather than as a result of any substantive difference in the respective entities. A possible response to this potential consequence is "boilerplate" language that will be developed and applied by auditors and used in the reporting on the financial statements for similar entities and/or similar audit matters, which will not achieve the desired result of this reporting requirement.

Lastly, we urge the Board to carefully consider and eliminate as many differences as possible between the Board's resulting standards on auditor reporting with those of the International Auditing and Assurance Standards Board (IAASB), even those appearing as simple as the difference in terminology of Critical Audit Matters versus Key Audit Matters. In consideration of this, we recommend that the Board specifically include as a part of its final adopted standards on Auditor Reporting and Other Information a summary of the differences between the Board's standards and the IAASB standards, and the reasons for those differences.

Following are our responses to certain of the specific questions for with the Board requested specific comment. We have not responded to all of the questions, rather only those for which we have comments for the Board to consider.

**Proposed Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion**

1. *Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?*

   Although this will not likely be a source of misunderstanding to auditors in applying the proposed standard, we question whether the communication of critical audit matters, or to state that the auditor determined that there were not critical audit matters, is a separate objective of the proposed standard. Alternatively, we believe the objective as stated in proposed paragraph 4(a) is sufficient.

4. *The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?*

   While we do not believe there will be negative consequences to the requirement to include such a statement, we question whether additional useful information will be provided as a result. We are not aware that this is an area that is currently misunderstood by users of the financial statements audited under the standards of the PCAOB.

5. *The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.*
   a. *Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?*

   b. *Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?*

   c. *Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?*

   We do not believe a requirement for the auditor to include a statement containing the year the auditor began serving consecutively as the company's auditor will result in significant challenges to the auditor in the reporting of this information.

However, we also believe that there is a potential unintended consequence related to the reporting of this information without additional context, as users may not consider other factors that are important to the consideration of auditor tenure. For example, the statement, as proposed, does not account for the existence and benefit of partner rotation, which is designed to allow for a "fresh look" in the audit of a company' s financial statements. Additionally, the statement, as proposed, would not provide any context with respect to changes in the company during the period of tenure being communicated. Accordingly, we believe that this information would be more appropriately communicated to users of the financial statements by the company's Audit Committee, accompanied by a discussion of other factors considered by the Audit Committee in their decision to engage the auditor.

6. *The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?*

   We agree that reporting of a description of the auditor's responsibilities with respect to other information is relevant to users when the other information is provided simultaneously with the financial statements and related auditor's report thereon. We agree that absent such a description, there is a risk of confusion related to what responsibility the auditor has with respect to this information.

7. *Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?*

   We do not believe it is necessary for the Board to specify a specific order for the presentation of the basic elements required in the auditor's report; however recommend that the Board be cognizant of the order of presentation included in illustrative examples, as the order of presentation in these examples will ultimately be what most auditors will follow in their implementation of the final standard.

9. *What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.*

   We believe that the only significant cost consideration related to the proposed basic elements of the auditor's report is related to time that auditors will incur with respect to reporting on Other Information.

   We do not believe that there will be significant cost considerations specifically related to the other proposed basic elements of the auditor's report, as we do not consider them to be fundamentally different than what is included in current auditor's reports, with the exception of the additional reporting related to the auditor's tenure, which we do not expect to result in a significant amount of additional cost and/or work effort by auditors.

10. *Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?*

    Generally speaking, we believe that investors and other financial statement users will find the auditor's communication of critical audit matters relevant and useful, as long as the reporting does not become boilerplate over time.

11. *What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?*

    As noted in our general comments above, we believe a potential unintended consequence may be that investors or other financial statement users arrive at varying, and potentially erroneous, conclusions about similar entities solely as a result of differences in the reporting of critical audit matters by different auditors in similar audit situations, rather than as a result of any substantive differences in the entities.

    We are also concerned about potential challenges resulting from the "negotiation" that will likely occur between auditors, Audit Committees, management, and potentially company legal counsel, related to the nature and language used in the auditor's communication of critical audit matters, particularly for audits of large, more complex entities. These discussions will likely often take place toward the end of the engagement, a time in which significant time pressures already exist.

12. *Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?*

    Although we believe the definition is sufficient for purposes of achieving the objectives of the proposed standard, we recommend that the final standard included examples of the communication of critical audit matters, as we believe this will assist in effective adoption of the final standard by auditors.

13. *Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?*

    We do not believe that the additional time incurred will necessarily have a negative effect on the quality of the audit, inasmuch as the effect of the timing of these additional considerations, much of which will be incurred during the later stages of the audit. See our related response to question number 11.

14. *Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?*

    We believe that the proposed requirements are sufficiently clear, with the exception of the requirement to communicate critical audit matters relating to the audit of the current period financial statements. We believe that the proposed requirements could be made clearer with respect to the fact that there is no requirement to communicate on critical audit matters related to the audits of prior periods that are also being reported on, and there is no requirement to communicate the reasons for differences in the identification of critical audit matters between periods.

15. *Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?*

    While investors and other users of the financial statements may find information on specific audit procedures performed useful, we do not believe the potential benefit of such reporting exceeds its costs. Not only would such reporting add additional time to the audit, the communication of specific audit procedures, particularly those related to the most significant areas in the audit, may result in a reduction of audit quality as the auditor's audit plan with respect to those risk areas will become "public information".

16. *Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?*

    We believe the factors included in the proposed standard are sufficient to assist the auditor in determining which matters would be considered to be critical audit matters.

18. *Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?*

    Yes.

19. *Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?*

    We believe that a specific documentation requirement related to non-reported audit matters is unnecessary and will place an undue burden on auditors. Appropriate documentation of those matters concluded to be critical audit matters, accompanied by other required engagement documentation, such as the engagement completion document, is sufficient to achieve the Board's objective of encouraging auditors to appropriately consider whether audit matters are critical audit matters.

21. *What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?*

    There will undoubtedly be additional costs related to the time incurred in the evaluation and determination of critical audit matters to be reported and the related documentation of those considerations and conclusions by the engagement team. Additional time will also be incurred by engagement quality reviewers to appropriately understand, question and concur with the conclusions of the engagement team. Also, there will likely be firms that will impose additional quality control requirements related to these considerations that will add additional time. These costs will be more significant for larger, more complex engagements.

22. *What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?*

    As noted above, we believe that additional costs will be incurred in the audits of companies of all sizes, as additional time will be incurred in considering and documenting the auditor's conclusions with respect to critical audit matters. In addition, we believe that the audits of the financial statements of larger, more complex entities will result in additional costs related to the likelihood of these types of companies also having their legal counsel consider the auditor's reporting of critical audit matters.

23. *How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?*

    Audit fees will undoubtedly increase as a result of these requirements for the reasons we have noted above.

24. *Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?*

    We do not believe that auditor should be required to communicate critical audit matters for each period presented unless the auditor is reporting on those financial statements for the first time; i.e. an initial public offering, or if the audit of the financial statements for the period being reported on is a "reaudit", that either being a reaudit of financial statements that is the initial audit of the respective financial statements by the current auditor, or a reaudit of the financial statements if an audit report was previously issued but subsequently determined that it could not be relied upon.

25. *Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?*

    Yes.

26. *What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.*

    Please see our comments above regarding concerns about the potential unintended consequences of the users of financial statements forming different conclusions in similar situations solely as a result of differences in the reporting of critical audit matters by different auditors.

33. *Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?*

    We believe the Board needs to consider the requirements for reporting of critical audit matters when the auditor chooses to issue a separate report on internal controls over financial reporting, specifically, is the auditor required to communicate critical audit matters in both reports, or only in the auditor's report on the financial statements?

35. *Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?*

    We believe that the proposed requirements, including the communication of critical audit matters, are appropriate for audits of large brokers and dealers. However, we also believe that additional consideration by the Board is warranted with respect to the cost benefit relationship of these requirements for small broker/dealers and/or non-carrying broker/dealers, and if differential reporting requirements are determined to be appropriate, how a "small" broker/dealer would be defined.

39. *Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?*

    We believe that the proposed standard is also appropriate for the audits of benefit plans, with the possible exception of the requirement to communicate critical audit matters for all audits of benefit plans. We believe that the communication of critical audit matters for the audits of benefit plans will likely be similar for virtually all plans, and thus will quickly evolve to boilerplate reporting that will be the same for every benefit plan audit.

40. *Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?*

    Despite our concerns about the cost benefit relationship of the requirement to communicate critical audit matters for smaller, less complex engagements, we do not believe that there should be an exemption for smaller public companies or Emerging Growth Companies. Such differential reporting will create a lack of consistency in reporting for public companies, thus creating possible confusion by the users of the financial statements, and/or a view that those audits are of lesser quality or relevance.

    As audits of non-issuer financial statements conducted under the standards of the PCAOB are not uncommon, we believe that the Board needs to address whether or not it is necessary for the auditor to communicate critical audit matters in such engagements, and for the final standard to clearly communicate whether or not these requirements are applicable for such engagements. We recommend that the final standard allow for, but not require the communication of critical audit matters for audits of non-issuer financial statements, consistent with the approach taken by the proposed IAASB auditor reporting standards.

41. *Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?*

    We believe the proposed effective date is appropriate and should allow auditors to effectively plan for the implementation of the standard.

42. *Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?*

    We do not support a delayed compliance date for audits of smaller companies. The reporting requirements will often be less burdensome to implement for the audits of smaller companies, and if they are not considered to be less burdensome as a result of the existence of critical audit matters, delaying these requirements in such situations is inconsistent with the objectives of the proposed standard.

**Proposed Standard - The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report**

We do not have specific concerns with respect to the proposed standard on Other Information; however do believe that it should be limited to information included in the company's annual report, as currently defined in paragraph 1 of the proposed standard.

In that regard, we do have the following questions and/or comments related to this proposed standard:

- The note following paragraph 1 of the proposed standard indicates that information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K is considered to be "other information" for purposes of this standard. Since in the proposed standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* the auditor is required to report on other information when reporting on the company's financial statements, it is unclear what the auditor's reporting responsibility is with respect to the information in a definitive proxy statement that will be subsequently filed. Accordingly, as this is a common situation, we believe that the standard needs to be more specific with respect to the auditor's reporting responsibilities in these situations.

- Paragraph 12(b) – it is unclear to us in what situations this provision would apply, as presumably the other information being reported on would have already been issued along with the financial statements as a part of the company's annual report filed with the SEC. We recommend that the final standard include an example of when such a situation would occur.

- As Other Information is defined with respect to a company's annual report filed with the SEC, it is unclear how this standard is to be applied in situations in which an audit of a non-issuer is conducted under the auditing standards of the PCAOB. For example, if such financial statements include supplementary information, is that information considered other information, or is the proposed standard essentially only applicable for audits of issuers that final an annual report with the SEC?

Once again, we appreciate the opportunity to comment on these proposed standards. We would be pleased to discuss our comments with the Board or its staff. Please direct any questions on our comments to Brian Bluhm, Director of Assurance Services, at 612.253.6590.

Sincerely,

Eide Bailly LLP

Eide Bailly LLP

Eli Lilly and Company
Lilly Corporate Center
Indianapolis, Indiana 46285
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www.lilly.com

December 11, 2013

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

Re: PCAOB Rulemaking docket matter No. 34

Dear Board Members:

Eli Lilly and Company ("Lilly") appreciates the opportunity to comment to the Public Company Accounting Oversight Board ("PCAOB") on the PCAOB Release No. 2013-005, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* . Lilly is a large, multinational pharmaceutical company, with presence in over 50 country jurisdictions, and creates and delivers innovative medicines that enable people to live longer, healthier, and more active lives.

Lilly understands the PCAOB's objective to revamp the existing Auditor's Reporting Model in an effort to "increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report". While we believe the current "pass/fail" model is effective, we do agree with the PCAOB that there are some potential enhancements that could make the auditor's report more transparent and relevant for the users. We believe that certain proposed amendments to the basic elements of the auditor's report could add value to the reporting model and enhance communication to users by improving the content of the auditor's report while retaining the current "pass/fail" model.

We believe that certain proposed changes, in particular the requirement for the auditor to report on Critical Audit Matters ("CAMs") and additional requirements around "other information" outside of the financial statements, could have a significant adverse impact to companies, auditors and financial statement users ("users"). We appreciate that the PCAOB has taken into consideration the comments raised by stakeholders through the 2011 Concept Release and has chosen not to pursue the implementation of the Auditor's Discussion and Analysis ("AD&A"). However, we are very concerned that requiring the auditor to report on CAMs, if adopted, could significantly increase the scope of the audit, blur the responsibility of auditors, audit committees, and management by changing the role of the auditor and lead to confusion of users among other concerns addressed throughout this response. We are concerned that imposing additional requirements around "other information" outside of the financial statements, if adopted, could also significantly increase the scope of the audit as well as substantially increase costs.

We address our thoughts and concerns in further detail below.

**Critical Audit Matters:**

We strongly oppose the proposal which would require the addition of a new section within the auditor's report in which critical audit matters specific to an audit would be communicated. The PCAOB defines CAMs as audit matters that involve the most difficult, subjective, or complex auditor judgments; pose the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; or pose the most difficulty to the auditor in forming the opinion on the financial statements. While we support the goal of increasing the relevance and usefulness to investors and other financial statement users, we have concerns about the application of the proposal, the unintended consequences and question if this proposal would help to accomplish the intended goal.

The current proposal leaves a lot of judgment for what the auditors may consider to be 'key' or 'critical' audit issues, which could lead to unintended consequences. We are most concerned about the potential for the auditor to disclose information in their report that the company has not yet reported or is not required to be disclosed by the SEC or FASB, making the auditor the original source of the information. The auditor could identify a CAM around a transaction that has not yet been recorded in the financial statements by management due to timing or facts and circumstances of the item (i.e. restructuring, litigation, impairment of intangibles, etc.). For example, as required by the FASB, we record restructuring charges when they are estimable and probable. Based on the facts and circumstances, the restructuring charge may get recorded in the following year, however, the auditor may elect to disclose this item as a CAM in the prior year audit if it meets the CAM criteria. Disclosing this as a CAM would make it public information before the company would have had a chance to go through the appropriate communication channels and timeline. Additional examples where the auditor could be the original source of information include disclosing the dollar amount of items that are currently not required to be disclosed or disclosing details used to describe the CAM that have not been disclosed in the financial statements. It seems counterintuitive that a company would need to disclose information not because of the accounting standards but because of the potential to appear as a CAM and not elsewhere in the financial statements or footnotes.

Another concern of the proposal is that a CAM may disclose sensitive, confidential or proprietary information such as tax matters including settlement with the IRS, legal matters, restructurings, etc. The auditor may also disclose a CAM that conflicts with current requirements or legislation, such as disclosing significant control deficiencies, whereas only material weaknesses are required to be disclosed today. While the items may have been discussed with the audit committee, it may not be public information. The auditor would be disclosing details of the CAM that are not disclosed elsewhere in the financial statements or footnotes.

If the proposal to require the auditor to identify CAMs is adopted, this would put the auditor in a position under numerous circumstances to be the original source of information to financial statement users and is contrary to the current roles and responsibilities of the auditor. This will blur the responsibility of auditors, audit committees, and management and could cause confusion to the user, lead to legal implications in terms of releasing confidential information and/or force management to include items within the financial statements that they otherwise would not have included and which are not required to be disclosed under current requirements. When the auditor believes it is required to disclose confidential, sensitive company information that the company is not required to disclose and such disclosure would damage the company, contentious legal and relationship issues could arise between the company and the auditor. Relationships between issuers and auditors that contain healthy tension are to be desired; dysfunctional, adversarial relationships are not.

In addition to our concerns noted above, we also believe that CAMs as defined in the proposal are too broad and may lead to the auditor disclosing many CAMs thereby producing lengthy audit reports. Auditors will likely compile a comprehensive list of potential CAMs that would include items (1) documented in the engagement completion document, (2) reviewed by the engagement quality reviewer, (3) communicated to the audit committee, or (4) any combination of the three. The auditor would then need to determine which ones meet the definition of a CAM and would be included in the auditor's report. As part of their internal documentation, the auditor would need to justify why the matter is not considered a CAM. In applying this current PCAOB guidance, we are concerned that most auditors would err on the side of including more rather than fewer CAMs in their reports due to the fact that CAMs will be subject to second guessing by PCAOB inspectors. This could lead to lengthy discussion in the auditor's report causing confusion to the readers of the financial statements and distract from the primary purpose of the auditor's report. The CAM disclosure requirements would add to the "information overload" that is already a real concern with SEC disclosure documents today, as acknowledged in October by Mary Jo White, chairwoman of the SEC:

> When disclosure gets to be 'too much' or strays from its core purpose, it could lead to what some have called 'information overload' — a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant.[1]

We are also concerned that if as part of the PCAOB inspection process the PCAOB felt that the auditor should have identified a matter as a CAM but did not, the auditor could be required to reissue their audit report, which would be concerning for the company impacted, the users and the auditor.

We believe that the costs associated with including CAMs in the auditor's report will be substantial due to the additional time required by the auditor to identify CAMs which would likely involve lengthy discussions with senior management on the audit team and could include consultation with the national office, in-house legal counsel, and others. In discussion with our auditors, they indicated that they expect that the process of identifying all potential CAMs will take a significant amount of time, which would translate to higher audit fees. In addition, significant indirect cost would likely be incurred by management in reviewing the CAMs and having discussions internally and with the auditor. We believe that the costs in terms of time and dollars to identify CAMs including the significant time the auditor would spend on justifying items that will ultimately not be reported to the public will add little, if any, value to the investors.

[1] Speech to National Association of Corporate Directors, October 15, 2013.

We also have concerns regarding the strong wording of the PCAOB's definition of a CAM which indicates that an audit matter is a CAM if it "posed the most difficulty to the auditor in forming the opinion on the financial statements". Auditors will likely use this same verbiage in their reports to indicate why an issue was selected as a CAM. When a user reads that an issue posed difficulty to the auditor in forming the opinion on the financial statements, this could be interpreted by the user that the auditor is not comfortable with the issue being referenced. In addition, if this statement is made for some CAMs but not others, it may not be apparent to the user of the differentiating factors in disclosing this statement. This could cause a lot of confusion and raise questions about the auditor's conclusion even though the auditor was able to get comfortable with the matter and issued an unqualified opinion.

We also believe that over time the language within the audit report may become boilerplate which would undermine the PCAOB's goal of increasing the informational value of the auditor's report. The audit issues identified as CAMs would be the same from year to year. In addition, audit firms will likely try and standardize the types of language used across various companies for similar issues in an effort to mitigate legal liability and to minimize PCAOB inspection findings.

Due to the various concerns identified above, Lilly strongly opposes the PCAOB's proposal to require auditors to identify critical audit matters within the auditor's report. We believe that any perceived shortcoming in the information presented to investors and other users should be communicated by management through the footnotes or MD&A and not through the auditor's report. If necessary, the FASB or SEC should address concerns through developing or further enhancing financial reporting disclosures. However, if the PCAOB does move forward with this requirement we would ask that the PCAOB strongly consider the following enhancements to the guidance/definition of a CAM:

a) An auditor must not be the original source of the information. The PCAOB should specifically clarify that if an issue is not required to be reported under current disclosure requirements then the matter should not be referenced by the auditor unless the company has elected to disclose this information.
b) CAMs must be material to the financial statements.
c) Highly sensitive (i.e. litigation, tax positions, etc.) and market or company confidential information should not be included as a CAM.
d) CAMs should not include information that is specifically excluded from disclosure by other legislation (i.e. significant deficiencies, etc.).
e) The audit report should not describe the audit procedures related to critical audit matters (we believe the examples in the Release are unclear and could lead audit firms to believe that such disclosures are required).
f) Auditors should not be required to separately document why audit matters are not considered to be CAMs.

**Proposed "Other Information" Standard**

The PCAOB "other information" proposal would require the auditor to 'read and evaluate' the other information as opposed to the current requirements under AU 550 which only require the auditor to 'read and consider' other information outside of the financial statements. The proposal specifically indicates that the auditor should evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements. In addition, the new proposal would expand the auditor's responsibility to include information incorporated by reference in the annual report including the proxy statement. Lilly generally supports the PCAOB proposal to clarify the auditor's current responsibilities under AU 550 and believe this information would be beneficial and help users to better understand the procedures being performed. However, we are concerned about the proposal to require the auditor to "evaluate" the other information which we believe could substantially increase the scope of the audit.

As stated above, the terminology change from "consider" to "evaluate" appears to represent a significant increase in the auditor responsibility for other information outside of the financial statements by introducing required audit procedures to support the auditor's conclusion about the auditor's evaluation of other information. We believe that this increase in scope would shift the auditor's focus away from the financial statements, negatively impacting audit quality and would lead to significant additional time and costs which would not be justified by the perceived benefits. The implementation of this proposal would lead companies to furnish periodic filings at an earlier stage of the process in order to allow the auditors to complete their procedures prior to the filing deadline. Doing so could put a severe strain on companies and auditors during the already tight reporting timelines and could delay of information being released to the public.

Due to the subjective nature of the information provided, it may be difficult for auditors to "evaluate" other information outside of the financial statements which includes non-financial data and information related to the company's operations. The MD&A provides historical and future business performance "through the eyes of management" and is intended to be qualitative and more forward-looking in nature. It could be very challenging for an auditor to "evaluate" qualitative statements for a "material misstatement of fact" and for consistency with the financial statements and relevant audit evidence. The guidance indicates that the auditor "would not be required to perform procedures to obtain additional audit evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit". However, we still have concerns that the auditor would need to expand their audit scope and procedures to fulfill their obligations to "evaluate" this type of information. The intent of this proposal is to further protect the interests of investors; however, this change could have the opposite effect as the information that management discusses in the MD&A may be influenced by the auditor or management may choose to limit the items they discuss in their MD&A to avoid issues with the auditor.

If this proposed requirement to evaluate the other information were implemented, the accounting firms would have to develop new methodology on their interpretation of the standard. This could lead to various discussions and questions as to how to interpret the standard and could lead to unintended consequences. For example, auditors would need to determine how differences in opinion or facts relating to other information would be compiled, evaluated and communicated to management and the audit committee. These differences could end up being reported in a manner that is similar to the summary of audit differences used in the financial statement audit which would give more weight to these items than what is necessary. Questions could also be raised as to whether management would need to develop controls around the MD&A and the other information and if a difference was identified, it could lead to discussions around whether the difference would constitute a control failure. While these consequences may not be the intent of the proposal, these are just a few examples of how the audit firms may interpret the guidance in a manner that extends beyond the intent of the PCAOB. We urge the PCAOB to strongly consider the impact of these changes and how they may be interpreted by auditors to avoid a situation similar to what occurred with the implementation of AS2 in which auditors performed substantially more work than was intended causing the standard to be subsequently modified.

We are also concerned about the implications of expanding the definition of “other information” to include “information incorporated by reference from the company’s definitive proxy statement”. The deadline for the filing the proxy is 120 days after year-end; therefore this information is often not available to the auditor until after the issuance of the audit report. The guidance is unclear as to how the auditor would issue their audit report without first reviewing the proxy if they are required to “evaluate” the proxy as part of their opinion. We are concerned that companies may be forced to move up the filing of the proxy to align with the company’s 10K filing date.

As stated above, we are supportive of clarifying the auditor’s current responsibility under AU550 for other information outside of the financial statements which we believe will increase transparency and relevance to users without increasing the scope of the audit. However, we oppose the PCAOB’s proposal to require the auditor to “evaluate” the other information for reasons discussed above. If the PCAOB elects to move forward with their proposal, we urge the PCAOB to field test the proposal first so that the implications of such a change can be properly assessed. In addition, we believe that the PCAOB should retain the section of AU 550 that specifically states that the auditor’s responsibility “does not extend beyond the financial information identified in [the audit] report” and we urge the PCAOB to specifically exclude the auditor from responsibility for prospective financial data. We also oppose the PCAOB’s proposal to expand the definition of “other information” to include information incorporated by reference from the proxy statement. We encourage the PCAOB to limit the auditor’s responsibility to information available prior to issuance of the audit report.

**Amendments to the Basic Elements of the Auditor’s Report**

The PCAOB release indicates that commenters on the PCAOB’s concept release noted that modifications to the language used in the auditor’s report could “improve financial statement users understanding of the nature of an audit, the auditor’s responsibilities, and the purpose of the auditor’s report.” The Board has therefore proposed certain clarifications to existing language in the report to include statements about (1) auditor independence; (2) auditor tenure; (3) the auditor’s responsibilities related to fraud and the financial statement footnotes; and (4) the auditor’s responsibilities for, and the results of the auditor’s evaluation of, other information. Below we discuss our view on each of the clarifications.

Lilly is generally supportive of the PCAOB’s proposed enhancement to the basic elements of the auditor’s report with the exception the proposal related to “Auditor Tenure”. We understand that there is some investor interest in having visibility of auditor tenure. However, we believe that including this type of information within the audit report could be misleading to investors as there is no substantiated evidence to support that audit tenure has an impact on the quality of the audit. The inclusion of this information could lead investors to infer that if the company has a new auditor or if a company and auditor have a longstanding relationship that the audit opinion is not as reliable. Auditor tenure is more appropriately considered a corporate governance matter and could easily be included in a company's proxy statement.

We are supportive of clarifying "Auditor Independence" within the auditor's report. We believe this could provide users with a better understanding of the auditor's role and provide more confidence in their judgments and process.

We are supportive of clarifying "Auditor's responsibility for fraud and the financial statement footnotes" within the auditor's report. We believe that including the auditor's responsibility for the detection of fraud within the standard auditor's report is more transparent to users. We are also supportive of revising the auditor's report to provide clarification on the auditor's responsibility for the financial statement footnotes that is consistent with the current auditing standard.

As discussed above within the "Proposed 'other information' Standard" section of this document, we are supportive of clarifying the auditor's current responsibilities under AU 550. We are supportive of the PCAOB's proposed language with the exception of the verbiage indicating that the auditor "read and evaluated" the other information. We believe that the PCAOB should retain the current requirements of AU 550 for the auditor to "read and consider" the other information. As such we would propose the following statement be included within the auditors report; "On the basis of relevant audit evidence obtained and conclusions reached during the audit we have read and considered the other information contained in this filing. We did not audit the other information and do not express an opinion on that information. Based on our review we have not identified a material inconsistency or material misstatement of fact in that information". We believe that the inclusion of this language would enhance the standard report by ensuring that the responsibility of the auditor related to the other information is clear to the financial statement users.

Clarifying auditor independence, auditor responsibility for fraud and footnotes and auditor responsibility for "other information", as outlined above, would not alter the scope of the audit nor impact the auditor's responsibilities; this would however provide additional information to users without changing the fundamental role of the auditor. We believe that these amendments to the basic elements of the auditor's report (with the exception of auditor tenure) most closely align with the PCAOB's goal of increasing transparency and relevance to users while not compromising audit quality. We also believe that this alternative is aligned with the principles of maintaining quality, adding value, providing objective communication and being cost effective. The more the users understand of the auditor's role, the better informed they can be when making decisions.

**Conclusion**

Again, Lilly supports the PCAOB's efforts to provide transparency and relevant information to users and believe that proposed changes to the basic elements of the auditor's report could add value to the reporting model and enhance communication to users by improving the content of the auditor's report while retaining the current "pass/fail" model. However, we are very concerned that requiring auditors to identify critical audit matters and expanding the auditor's responsibility for "other information" outside of the financial statements could result in a number of unintended consequences and negatively impact that audit process. We again urge the PCAOB to carefully consider and evaluate the impact that these proposals would have on the companies and the auditors who would be required to comply with any new standards issued and the related implications. We also urge the PCAOB to carefully consider the cost/benefit of all of the proposed alternatives prior to implementing any new standards.

We appreciate the opportunity to express our views and concerns regarding the concept release. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 651-2310.

Sincerely,

ELI LILLY AND COMPANY

/s/ Donald A. Zakrowski

Donald A. Zakrowski
Vice President, Finance and
Chief Accounting Officer

EMERSON

**Richard J. Schlueter**
Vice President, Controller
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December 17, 2013

Mr. Martin F. Baumann – Chief Auditor
Public Company Accounting Oversight Board (PCAOB)
1666 K Street NW
Washington, D.C. 20006-2803

Docket Matter No. 034 – Proposed Auditing Standards on "The Auditor's Report" and "The Auditor's Responsibilities Regarding Other Information"

Dear Mr. Baumann:

Emerson appreciates the opportunity to comment on the Revised Proposed Auditing Standards re: Reports on Audited Financial Statements. We agree with the Board's decision to withdraw the proposals regarding Auditor's Discussion and Analysis and mandatory use of Emphasis of Matter paragraphs. However, we also do not support the remaining proposals.

We continue to believe the pass/fail audit report functions properly in its current form. The proposed discussion of "Critical Audit Matters" is likely to be confusing to investors. If the audit is satisfactory, there is no benefit to describing the issues that presented the most challenge. Any perceived shortcomings of current reporting and disclosure requirements should be addressed through the SEC and the FASB. The auditor's role should remain one of oversight and should not be the original source of information for investors; that is the responsibility of management.

If all accounting and reporting matters are satisfactorily resolved, a discussion of what *might* have happened is unnecessary. Resolution of difficult matters is an everyday occurrence given the highly technical nature of accounting rules and complexity of issues in today's business environment. Auditor discussion of these items will be interpreted by investors as a disclosure of accounting *problems.* Investors do not have the benefit of deeply analyzing issues in the full context of the situation, nor do they have the benefit of interaction between auditors, management and the audit committee. A lengthy and highly technical discussion between management and auditors does not mean the matter is contentious, or even risky. Whether it is a new transaction, evolving business circumstances, adoption of a new accounting standard, or a complex matter elevated for SEC Staff consideration, once resolved, the background and process of resolution is not important. Investors cannot be expected to wade through highly technical matters and derive meaningful information from the type of report that is being proposed. An auditor rendering an unqualified opinion but then discussing transactions that *might have* resulted in a qualified opinion will likely confuse and potentially mislead investors.

On the other hand, unresolved material issues could lead to a qualified opinion, which should rightfully be accompanied by additional disclosure. We note there is already a requirement for management to report disagreements with auditors to the Audit Committee, as well as publicly disclose the nature of such disagreements under Rule S-X.

Our comments on the proposal follow:

- PCOAB efforts over the last several years have resulted in continued expansion of the audit scope and documentation requirements. We have not seen the benefit from the resulting increase in cost that has accompanied these efforts. We believe this proposal will lead to additional costs of compliance without improvement in audit quality. With the auditors' experience from the inspection process, we would expect they will exercise extreme caution to avoid second-guessing, resulting in an overabundance of Critical Audit Matters.

- It is not clear how this information will be of value to investors. In addition, the new report may distract from understanding the entities performance by giving undue prominence to elements of the financial statements that were difficult to audit. We do not see how investors would have behaved differently had this information been included in the auditor's report. Critical Audit Matters will only contain information that is already actionable from the MD&A or financial statements.

- We believe an expectation will be created that there must be Critical Audit Matters discussed in every audit report. This will quickly lead to boilerplate reciting of items such as critical accounting policies already disclosed in MD&A, as well as discussion of matters communicated to the audit committee (including, for example, significant deficiencies in internal control which is not required today), items included in the auditor's completion memorandums, consultations with auditor's quality review and national audit partners, and issues discussed by the company with the SEC. This may also result in audit firms developing *standard* Critical Audit Matters by industry that must be included in each report to avoid second-guessing and resulting in disclosure overload.

- As discussed with the original proposal, the requirement that every national office consultation or audit committee communication is potentially a Critical Audit Matter could have a significant "chilling effect" on the communications between auditors and the audit committee. The existing environment promotes an open dialogue.

- The illustrations contained in the proposal make it clear that compliance will require numerous pages of discussion. The proposed report will result in a lengthy technical summary that investors will not be able to understand or appreciate without direct and in-depth discussion of the matters with the company or auditor. The examination of these technical matters is why professional auditors are engaged in the first place, and what allows investors to rely on the financial statements.

- The proposed process will lead to significant effort on the part of the auditor to draft this information at a high level of quality required for external reporting to shareholders, and to undergo a rigorous internal review process. As the auditor's expanded report will appear in the company's filings, management will have a vested interest to review and provide input on all critical audit matters discussed. All this activity will occur in an already very compressed and stressful annual reporting cycle.

- The proposed change to the auditor's responsibility for Other Information is more substantive than it appears. Current requirements are to *read* the other information for inconsistency with the audited financial statements. The proposal requires an *evaluation* of all Other Information including that not directly related to the financial statements. This raises the auditor's responsibility and required standard of care which will result in increased procedures. Other Information includes statements which are not purely financial and are based on the knowledge, insight and experience of management which is not necessarily objectively verifiable. Auditors may not possess the expertise necessary to evaluate Other Information. This could lead to the auditor consulting with specialists, or conversely curtailed management commentary in MD&A. We believe there is only minor incremental value to be derived from this proposed requirement that will not justify the cost. We are not aware of problems in this area and believe the current approach is sufficient.

We appreciate the opportunity to respond to this proposal and trust that our comments will be seriously considered in future Board deliberations.

Sincerely,

Richard J. Schlueter

Richard J. Schlueter
Vice President, Controller and
Chief Accounting Officer

cc: Frank J. Dellaquila
Executive Vice President and Chief Financial Officer

December 11, 2013

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

**File Reference:** PCAOB Rulemaking Docket Matter No. 034

Dear Members of the Board:

I appreciate the opportunity to comment on the PCAOB's proposed audit standards included in Release No. 2013-005 addressing *The auditor's report on an audit of the financial statements when the auditor expresses an unqualified opinion* (the "proposed auditor reporting standard"). I currently serve as the audit committee chair on Entergy Corporation's Board of Directors and have served on the Entergy board since 2003. I have also served on audit and other committees on the boards of other organizations. I was an audit partner with Arthur Andersen for almost 25 years until my retirement in 1998, serving as director of the firm's North American utility practice. It is from this experience and perspective that I am providing my response to the PCAOB's request for comment on its release, and these comments are solely my own and should not be ascribed to any other entity.

As has been described in some industry and firm publications, I understand that

- this proposal has been issued in response to concerns expressed in feedback from U.S. and global audit standard-setting constituents, including investor groups, that the current auditor's report contains little or no information specific to a particular audit,

- investors have also indicated that they would benefit from the auditor's unique and relevant insights, and

- the proposed changes are intended to increase the informational value, usefulness, and relevance of the auditor's report.

As an Audit Committee chair, I consider the audit process to be critical in meeting a company's objective of presenting information that is accurate, compliant and meaningful to users of financial statements. I am supportive of endeavors by the PCAOB to advance the goals of audit firms providing high quality audits and companies producing relevant and reliable financial statements. I do not agree, however, with the current proposal primarily because: (i) it results in the independent auditor becoming a primary source of a company's financial information through the audit report and (ii) the investor concerns noted above are not addressed properly through audit report disclosures.

The SEC has enacted regulations, including designation of the FASB as the organization responsible for promulgating US GAAP, defining *what* financial information needs to be disclosed. These rules designate management as the responsible party to determine *how* to communicate this information to most accurately reflect a company's financial results and position. The role of the external auditor is to express an opinion indicating that reasonable assurance has been obtained that the financial statements prepared by management are free from material misstatement, whether due to fraud or error, and that they are fairly presented in compliance with the applicable SEC and FASB requirements in all material respects. The audit committee, comprised of a company's shareholder-elected Board of Directors, is charged with oversight of both management's financial reporting and the audit process. If management, the external auditors, and the audit committee fulfill their respective responsibilities, I believe the additional communications and requirements outlined in the proposed auditor reporting standard are unnecessary. In fact, the additional communications and requirements are likely to lead to disclosure overload and confusion regarding the roles of the various parties in the process.

Of the requirements proposed in the auditor reporting standard, I most strongly disagree with the requirement that the auditor disclose critical audit matters (CAMs) within the audit report. The proposal regarding CAMs would be detrimental to the usefulness and relevance of the audit report and, as noted above, would change the role of the auditor to one of primary responsibility for communicating a company's financial information. Further, the proposal would result in lack of consistency and comparability of auditors' reports across companies while increasing the cost of compliance. I appreciate the Board's efforts to understand and incorporate investor and user feedback related to disclosure into consideration of how to improve the audit process, but I believe that issues associated with sufficiency of disclosure are more appropriately addressed by SEC and FASB rulemaking rather than through an unprecedented expansion of the independent auditor's role and responsibilities.

For further discussion regarding objections to the proposed CAMs requirement, I refer the PCAOB to the comment letter submitted by the Edison Electric Institute ("EEI"). Entergy is a member of EEI, and its management participated in the drafting of EEI's comment letter. I concur with the views expressed therein regarding the proposed auditor reporting standard and the CAMs requirement.

I thank the Board for its effort on this important matter and for your consideration of this letter.

Sincerely,

/s/ Steven V. Wilkinson

Steven V. Wilkinson
Chair of the Audit Committee
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Building a better working world

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

18 December 2013

**Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments, PCAOB Rulemaking Docket Matter No. 034**

Dear Ms. Brown:

Ernst & Young LLP (Ernst & Young) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its Proposed Auditing Standards – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (Proposed Reporting Standard), The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (Proposed Other Information Standard), and the Related Amendments to PCAOB Standards* (collectively, the Proposal).

We support the PCAOB's efforts to examine the adequacy of the existing auditor's reporting model and believe that, in general, the types of changes contemplated in the Proposal will improve and increase the informational value of the audit report.

We also appreciate that the Board is considering the work of other standard setters such as the International Auditing and Assurance Standards Board (IAASB) and the United Kingdom's Financial Reporting Council on this important topic. We believe the effort by the Board to work closely with these standard setters to harmonize auditor reporting, where possible, and minimize potential complexity for users of financial statements is commendable.

While we are supportive of the Board's overall efforts relating to the auditor's reporting model, we also believe that certain elements of the Proposal present challenges that may give rise to significant application difficulties in practice. We propose changes to address these concerns in support of the Board's objective to enhance the auditor's reporting model. We refer the Board to the comment letter on the Proposal from the Center for Audit Quality (CAQ), which identifies a number of these challenges and provides suggestions of how to address them. The CAQ's letter addresses the following areas of the Proposal:

- Critical audit matters (CAMs)
- Other information accompanying audited financial statements

- Auditor tenure
- Auditor's unqualified report and clarifying language changes
- Other considerations
  - Applicability
  - Legal considerations

We share the CAQ's concerns and support the suggestions outlined to address them, as discussed and further supplemented below. We have also included, in Appendix B, comments on the conforming amendments included in the Proposal.

**Critical audit matters**

We agree, as noted in the Proposal, that including critical audit matters (CAMs) in the auditor's report "…could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging." We also agree that the CAMs should be "…presented in language and in a format that is clear, concise, and understandable to a financial statement user." We support these objectives and believe these enhancements to the report could be beneficial to users of financial statements.

However, we do have some significant operational concerns which are highlighted below, along with suggestions for improvement.

Determining CAMs

Paragraph 8 of the Proposal would require, when identifying a CAM, auditors to consider matters included in the engagement completion document, matters reviewed by the engagement quality reviewer and matters communicated to the audit committee. We are concerned that this very general approach will be too broad and could lead to practices that are inconsistent with the Board's objectives.

We note that auditors presently identify a wide range of matters in the engagement completion document, in discussions with the engagement quality reviewer and in communications with the audit committee. Without revisions to the proposal that could assist auditors with how to further filter these matters, auditors will find it difficult to select, from this universe of issues, those matters that are most important to the audit. In this regard, we are concerned that certain matters that an auditor appropriately determined not to be CAMs at the time the audit report was issued, may, with the benefit of hindsight, be unfairly subject to second guessing. This risk, combined with the requirement in paragraph 14 of the Proposal to document matters addressed in the audit that "would appear to meet the definition" of a CAM, but were not so reported, could prompt auditors to identify a large number of matters in the audit report, some of which might not meet the Board's expectation of a CAM. This would reduce the relevance of the CAMs, which would be contrary to the Board's stated objectives.

## Communicating CAMs

Paragraph 11 of the Proposal would require the auditor to describe the considerations that led the auditor to determine that a particular matter is a CAM. However, we note that the example CAMs in the Proposal appear to indicate that the description of *each* CAM should address *each* of the paragraph 9 considerations that were present. If this is the PCAOB's intent, we believe it raises the following concerns:

- *Checklist approach to the communication of CAMs* — Requiring a description of all of the factors that may be present could result in a "checklist" approach to CAM communication. This could result in a long list of all of the items that might have related, even tangentially, to the matter. Many of these matters would be of limited use to financial statement users and may obscure the most significant factors the auditor considered when determining the matter was a CAM. For example, paragraph 9 lists consultations outside the engagement team as a consideration. We believe that auditors typically consult with a firm's national office or engage firm specialists in response to a challenging audit issue, not as part of a determination that the matter is critical. Moreover, the decision to consult with others outside the engagement team may depend more on the expertise or prior experiences of the engagement team. Requiring a description of these consultations in the audit report may lead to inappropriate inferences about the quality of other audits in which similar issues arose but consultations were not performed. As such, as more fully described below, we believe requiring the *principal consideration* that led the auditor to determine a matter is a CAM communication would be a more effective way of accomplishing the Board's objective.

- *Potential inclusion in the auditor's report of original information* — The examples in the Proposal would appear to require the communication of certain specific matters, such as control deficiencies less severe than a material weakness and corrected and accumulated uncorrected misstatements related to the CAM. At present, public companies are not required to disclose these matters, and we are concerned that having the auditor serve as the source of this and other original information about the entity could blur the roles of management and the auditor. We believe a final standard should stress that the auditor should avoid conveying, through a CAM, information that the entity is not required to disclose.

- M*ateriality* — Certain matters addressed in the audit may present challenges, but may not relate to items disclosed in the financial statements. For example, an audit team may expend effort evaluating a company's accounting for a potential loss contingency and ultimately concur with the company's conclusion that no accrual or financial statement disclosure is necessary. The Proposal is unclear about whether a CAM communication would be required in this case. We do not believe it would be appropriate for the auditor to describe matters in the auditor's report if they do not relate to material matters disclosed in the financial statements.

- *Potential for user misunderstanding* — While we recognize that the Proposal would not require the auditor to describe specific audit procedures in the CAM communication, the examples in the Proposal suggest that such a discussion should be so included.[1] We note that it is difficult to

[1] See on page A5-36 of the proposal, the Board states that "…when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so."

explain, in a few sentences, the significant audit effort that may have gone into a particular area. We are also concerned that users of the financial statements might misunderstand the communication of audit procedures and may think it means the auditor has provided a specific level of assurance on the CAM (i.e., a piecemeal opinion). Further, if audit procedures are described in the audit report, we believe that preparers may also request that the results of such procedures be included in the description of the CAM to address users' questions or concerns about the outcome of the procedures. This would further exacerbate the potential for users to interpret the description of a CAM as providing a specific level of assurance on a particular matter.

### Documenting CAMs

As noted above, paragraph 14 of the Proposal would require the auditor to document why "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." We do not believe that such a requirement is operational because it is unclear how an auditor could easily demonstrate that such a matter *is not* a CAM. Consistent with the concern raised above, we fear that this requirement, if adopted, could result in auditors communicating a large volume of matters in order to avoid later challenges as to the completeness of the CAMs reported. Such an outcome would be contrary to the intent of the Proposal, and would likely add significant costs to the audit process without a corresponding benefit. In addition, inclusion of a significant number of matters in the audit report will likely result in significant time involved in developing their descriptions, which could put additional pressure on issuer's filing deadlines. As a result, we believe this aspect of the Proposal must be clarified.

## Suggestions to improve the PCAOB's CAM framework

Given the challenges noted above, we believe the changes we suggest below will result in:

- The identification of the matters in the audit of the financial statements that were most important
- A description of matters that should provide useful information to financial statement users, while minimizing potential unintended consequences
- A more efficient and effective process for identifying, describing and documenting the auditor's basis for his or her determination of CAMs

### Determining CAMs

As a starting point, we believe that the auditor should initially identify matters that were significant to the audit of the financial statements (significant audit matters). We believe all such matters should already be reflected in the required communications to the audit committee under PCAOB Auditing Standard (AS) No. 16. Such a CAM determination starting point is consistent with the Board's rationale for identifying the types of significant matters to be communicated to the audit committee.[2]

[2] We note, for example, in the adopting release for AS 16, the Board noted (emphasis added): "Auditing Standard No. 16 is intended to improve the audit by fostering constructive dialogue between the auditor and the audit committee about significant audit and financial statement matters. The standard requires the auditor to communicate certain matters regarding the audit and the financial statements to the audit committee, which should assist the audit committee in fulfilling its oversight responsibilities regarding the financial reporting process."

This approach would also have the benefit of more closely aligning the identification of CAMs with the IAASB's proposal.

From this initial population of significant audit matters, we believe the consideration of the factors included in paragraph 9 of the Proposal would help the auditor, using his or her judgment, to identify those matters most important to the audit of the financial statements. In our view, the determination of CAMs should represent those significant audit matters that (1) were material to the financial statements, (2) involved the most challenging, subjective or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence or posed the greatest challenge to the auditor in forming an opinion on the financial statements and (3) resulted in the most significant interaction with the audit committee. We note that this approach builds upon the PCAOB's criteria in the following manner:

- *Focuses on matters that are material to the financial statements* — The PCAOB's release notes that CAMs "could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging.... that could enable them to analyze more closely any related financial statement accounts and disclosures." (emphasis added) We believe this is the key benefit to users of the financial statements. As such, we believe the auditor's determination of CAMs should include consideration of only matters that are material[3] to a company's financial statements.

- *Facilitates identification of most challenging matters* — Consistent with the Proposal, we believe the factors included in paragraph 9, when considered in conjunction with our suggestions, help facilitate the identification of the most important matters.

- *Resulted in the most significant interaction with the audit committee* — Consideration of matters that resulted in the most significant interaction with the audit committee builds upon investor requests for further insights into auditor/audit committee communications and is consistent with the audit committee's role of representing the interests of shareholders. In addition, we believe that, in practice, auditors and audit committees tend to spend the most time focusing on matters that have the characteristics, as generally contemplated in the Proposal, of CAMs. Accordingly, we believe the ultimate standard should reflect what we see in practice, and the extent of the auditor's interaction with the audit committee on the various matters that arise during the execution of an audit is an important measure in CAM determination. We believe changes along these lines, particularly the need for the additional filter tied to the extent of audit committee interaction on a significant audit matter, will improve the operational and cost effectiveness of the requirements.

**Communicating CAMs**

As previously discussed, we do not believe that the description of a CAM needs to include all of the factors that may relate to the matter. In fact, we believe such an approach would lead to problems in practice and would likely confuse users of the audit report. Rather, we recommend that the Board revise the Proposal such that auditors should focus on the *principal* consideration (or, in some more

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[3] Although the concept of materiality is not mentioned in connection with the determination of critical audit matters in the Proposal, we note that such a concept is listed in one of the examples regarding the auditor's determination of critical audit matters. See Proposal page A5-76.

limited situations, the principal considerations) that led the auditor to determine that a matter was a CAM. We believe that in many cases, the principal consideration that led the auditor to determine that a matter was a CAM will also be apparent from a company's descriptions of such matters in the audited financial statements. Examples would include a high degree of complexity or subjectivity in determining the related amount or disclosure. We believe users of an audit report would benefit from the identification of the CAM and a short description of why the auditor concluded it was a CAM. The description should be concise and fact based, and we believe the example CAM communications in the CAQ letter illustrate this point. We also see significant challenges in practice, and the potential for user confusion, if the Board goes much beyond this approach, since a lengthy description of all of the factors may obscure the most significant issue the auditor considered when determining whether the matter was a CAM.

As noted above, we are especially concerned that a user might infer that a separate level of assurance is being provided on the matter described in a CAM, particularly if the description were to include a discussion of audit procedures performed. However, we also recognize that there may be some circumstances when a description of the CAM's effect on the audit may be necessary to explain why the matter was a CAM.[4] In our view, this may be the case when the principal consideration that led to the determination that a matter was a CAM was not apparent from the disclosures in the audited financial statements. For example, consider a situation in which a matter is identified as a CAM due to a material weakness in a company's internal control over financial reporting (ICFR) in an area that was integral to the determination of a material account or disclosure. While the company may describe the internal control matter in the filing that includes the audited financial statements, the audited financial statement may not, and a description of how the auditor considered the matter in the performance of the audit may be necessary to appropriately communicate to financial statement readers why the matter was a CAM. As a result, we recommend the Board revise the Proposal by stating explicitly that the auditor could provide a description of the CAM's effect on the audit if, and only if, the auditor considers it necessary to describe why a matter was determined to be a CAM. In this regard, while we observe that the examples in the CAQ letter include, in bracketed text, illustrations of potential descriptions of a CAM's effect on the audit, we believe this language is unnecessary given the facts and circumstances in those examples.

We have also included, in Appendix A, two examples of situations in which we believe an auditor may find it necessary to describe the effect that a CAM had on an audit.

**Documenting CAMs**

We believe it is important that the audit workpapers support the auditor's rationale for the determination of CAMs. As noted above, however, we do not believe the proposed documentation guidance is operational. Instead, we believe the PCAOB standard would be more practical if the auditor was required to document 1) those matters that were communicated to the audit committee that were determined to be significant audit matters and (2) which significant audit matters the auditor determined to be CAMs. Key to this determination is the auditor's assessment of the factors described in paragraph 9 of the Proposal and the consideration of those matters that involved the

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4 We note, however, that each of the PCAOB's examples appears to include such descriptions (see pages A5-65 through A5-78).

highest degree of interaction with the audit committee. We believe this is how practice is working presently where, in view of all of the issues required to be communicated, audit committees typically ask for the auditor to highlight those most critical to the audit. These are the matters that tend to receive the most attention and interaction.

**The importance of robust field testing**

Due to the Proposal's significance, we strongly believe that robust field testing should be conducted to help identify unintended consequences, ambiguities or the potential for inconsistencies in application. We believe a careful consideration of the results of field tests would improve the quality of any final standard. Field testing would also provide information about the likely additional audit effort required and the related cost. While we believe the PCAOB would benefit from conducting such an effort itself, we are currently field testing the Proposal on a number of engagements and intend to share our observations with the PCAOB in early 2014.

**Other information**

We support the auditor's performance responsibilities related to other information being better codified in the standards. We also support describing, in the audit report, the auditor's responsibilities for other information. We believe this would respond to requests from financial statement users to obtain a better understanding of the auditor's responsibilities in this area.

However, we do not support the Proposal's contemplated changes to current requirements and practices in the following three areas: (1) expanding the auditor performance requirements related to other information to "read and evaluate" from "read and consider," (2) the lack of certainty surrounding the scope of the "other information" covered by the Proposal and (3) requiring the auditor's affirmative statement about other information to be reflected in the audit report.

We believe these issues, if not addressed, will expand the auditor's other information performance responsibilities significantly beyond what the PCAOB believes is today's current practice, and the contemplated reporting requirements will result in increased liability risks for audit firms. Such outcomes will result in higher audit performance and reporting costs.

**Expanding auditor performance requirements to "evaluate" other information**

***Use of the term "evaluate"***

PCAOB interim standard AU 550, *Other Information in Documents Containing Audited Financial Statements*, (AU 550) requires the auditor to "read and consider" whether the other information, or the manner of its presentation, is materially inconsistent with information in the financial statements or the manner of its presentation.[5] If while reading the other information for a material inconsistency, the auditor becomes aware of information that the auditor believes is a material misstatement of fact, the auditor is required to discuss the matter with management and, if the matter is not resolved,

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[5] AU 550.04

consider other actions.[6] The Proposed Other Information Standard would require the auditor to "evaluate" the other information for a material inconsistency or a material misstatement of fact based on procedures performed, including reading the other information.

We understand that the PCAOB replaced "consider" with "evaluate" because AU 550 does not specify procedures to be performed by the auditor on other information. As more fully articulated in the CAQ's legal analysis, we believe the proposed use of the word "evaluate" implies a significantly higher expectation of performance on other information than what is required under the existing standard. For instance, we believe use of this term might result in an expanded responsibility for not only what the issuer has disclosed within its other information, but also for whether the issuer has identified all matters required to be disclosed (i.e., to assess completeness of all Regulation S-K requirements ). In other words, the auditor might be required to examine not only what the issuer has disclosed, but what it has not disclosed. Based on staff commentary on the Proposal provided at the 13 August 2013 open meeting, it is our understanding that the Board did not intend to significantly increase the performance standards in this area, so this issue needs to be clarified. In addition, as more fully described below, we believe the use of the term "evaluate" to describe the auditor's "conclusion" in the auditor's report could cause users to perceive that the auditor is providing a form of reasonable assurance on such information.

***Consideration of "relevant audit evidence obtained and conclusions reached during the audit"***

The Proposed Other Information Standard would require the auditor to base the evaluation on "relevant audit evidence obtained and conclusions reached during the audit."[7] We recognize that the auditor must use knowledge gained from the audit when considering whether a material inconsistency, or material misstatement of fact, exists in the other information. However, we are concerned that, as currently drafted, the requirement could be interpreted to mean that an auditor may need to perform a search for any and all documentation included in the audit workpapers related to each qualitative and quantitative statement in the other information. We believe that such an expectation would represent a significant expansion of auditor obligations relative to current practice.

***Other information not directly related to the financial statements***

The Proposed Other Information Standard would require the auditor to perform procedures on other information that are not directly related to the audited financial statements. In many instances, we believe the auditor may not have a basis (from the audit or otherwise) to "evaluate" such information based on information gained during the audit. However, from the proposed descriptions (and conclusion) included in the audit report, it would not be clear to users of the financial statements that the auditor may not have had a basis to "evaluate" such information. Such an outcome would appear to be contrary to the PCAOB's objectives of clarifying for users the auditor's responsibilities in this area.

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6 AU 550.05

7 Paragraph 4 of the proposed other information standard

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### Scope of "other information"

The Proposed Other Information Standard defines other information broadly as information in the annual report, other than the audited financial statements and the related auditor's report, and includes documents contained in the list of exhibits to[8] and information incorporated by reference in the annual report.[9] We believe auditors would benefit from the following clarifications:

- *Identification of the exhibits that fall within the scope of the auditor's performance responsibilities* — For instance, certain exhibits (e.g., acquisition plans, material contracts) may have been subject to audit procedures due to their relevance to the audit of the financial statements. It may not be appropriate to subject these exhibits to the performance procedures within the Proposed Other Information Standard, since we may have more than read and evaluated this information.

- *Performance obligations related to the proxy statement* — The Proposed Other Information Standard would require the auditor to evaluate other information included in the proxy statement. Because the proxy statement may not be filed until 120 days after year-end, which may be after the Form 10-K is filed, it is unclear how this requirement can be applied in practice. In addition, if such procedures are performed on the proxy statement after the auditor's report is filed, it is unclear whether the auditor would be required to reissue an audit report that is dual-dated.

### Requiring the auditor's conclusion about other information in the report

While we support describing, in the audit report, the auditor's responsibilities for other information, we do not support the proposed requirement for the auditor to assert, based on relevant audit evidence obtained and conclusions reached during the audit, whether the other information contains a material inconsistency, a material misstatement of fact, or both. We believe that providing this "conclusion" may be interpreted by investors and other financial statement users as providing an opinion on other information, even though the proposed other information standard requires a statement that the auditor did not audit the other information. To address this concern, we believe the Board should revise the Proposal to require a description of the auditor's responsibilities with respect to other information, including responsibilities related to material inconsistencies or misstatements of fact that are not addressed by the company. In addition, as more fully discussed in the CAQ letter, we believe that the requirement to make an affirmative statement with respect to the results of the procedures performed on the other information would result in significant increased liability risk to audit firms. Accordingly, we recommend that this statement be removed as a requirement.

## Suggestions on the Proposed Other Information Standard

We support the suggestions provided by the CAQ, which we believe would clarify the auditor's performance and reporting responsibilities related to other information, help address some of the increased liability risks resulting from the proposed changes and still enable the PCAOB to achieve its objectives in this area. We have summarized key elements of these suggestions below.

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[8] See the proposed other information standard, footnote 15, appendix 6.

[9] See the proposed other information standard, "Note" to paragraph 11.

*Replacing "evaluate" with "perform certain limited procedures"*

As indicated by the PCAOB, "evaluate" consists of reading the other information and performing specific procedures.[10] We do not support the use of this word to describe the results of the procedures required by the Proposal. As such, we believe the PCAOB should consider replacing "evaluate" with "perform certain limited procedures" in the audit report. As more fully discussed below, we also believe that the standard should articulate, in general terms, the limited procedures to be performed (on information that is directly related to the audited financial statements versus that not directly related to the audited financial statements), and that the auditor's report should also include a general description of these procedures.

*Performance requirements*

We believe the Board should revise the requirements to make a clearer distinction between the performance requirements related to information that is directly related to the audited financial statements and information that is not directly related to the financial statements.

We believe limited procedures (beyond reading) should apply only to "other information directly related to the audited financial statements," which would include information derived from either (1) the audited financial statements or (2) accounting records subject to the audit. This change would also make clear that the auditor does not have to perform an extensive search of the audit workpapers to determine whether other information was addressed in the audit. With respect to other information not directly related to the audited financial statements, we believe the Board should revise the requirements such that the auditor's performance responsibilities are to read the information and follow up accordingly if, based on knowledge gained during the course of the audit, any potential material misstatements of fact are identified.

In addition, we believe that it is important that the auditor consider the significance of the other information when performing the required procedures. We don't believe it is the Board's intention, nor would it be beneficial from a cost-benefit perspective, to have performance standards apply to other information that is not material. Accordingly, we recommend that the Board revise the requirement so that the auditor would only be required to perform procedures beyond reading with respect to *material* other information directly related to the audited financial statements.

We believe that these suggestions, combined with others in the CAQ's letter, would more closely align the Proposal's guidance on other information with what are often viewed as best practices under current standards.

**Communicating matters related to other information in the auditor's report**

We support additional transparency regarding the auditor's responsibilities related to other information in the audit report. Specifically, we believe the report should:

- Describe the auditor's responsibilities to perform certain limited procedures on other information

[10] Paragraphs 3-4 of the proposed other information standard

- Describe the limited procedures performed
- Emphasize that these limited procedures do not constitute an audit *or review* of the other information
- Include a statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised, the auditor is required to describe the inconsistency or misstatement, or both, in the audit report
- Include a description of the material inconsistency, the material misstatement of fact, or both in situations where the auditor has become aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both, that has not been appropriately revised

We believe that this reporting would clearly communicate the auditor's responsibilities regarding other information and, if and when applicable, identify an unresolved material inconsistency with the financial statements or a material misstatement of fact of which the auditor is aware. It would also help mitigate the risk that investors or other financial statement users would infer that the auditor has a greater responsibility for the other information than is required by the Proposed Other Information Standard. Finally, we believe this reporting would help address, at least to some extent, the significant liability concerns as described in the CAQ letter.

*Clarifying other information documentation requirements*

We noted that the Proposal does not provide guidance on the nature and extent of documentation that would be required with respect to fulfilling the auditor's other information responsibilities. The proposal to "evaluate" other information implies that auditors would have to document the source of information for every qualitative and quantitative statement in the other information, regardless of whether the other information is directly related to the audited financial statements. Such an effort would be significant and, in our view, would not have a commensurate benefit to audit quality. While we believe the recommendations above will assist in focusing the auditor's documentation efforts, by more clearly articulating the auditor's performance requirements that go beyond reading the other information, we recommend that the PCAOB provide guidance on how the auditor should document the procedures performed.

**Auditor tenure**

The Board has stated that to date, it has not found a link between audit quality and auditor tenure. As a result, we are concerned that requiring tenure information in the auditor's report, particularly at the end of the auditor's description of his/her independence responsibilities, would imply, incorrectly and without an evidentiary basis, the PCAOB has determined such a correlation exists. As such, we do not support the inclusion of auditor tenure information in the audit report.

We do support the consideration of other ways of making auditor tenure more transparent. We note that disclosure about the length of the auditor relationship is becoming more common in practice. For example, a recent EY survey found that a growing number of audit committees of Fortune 100 companies are disclosing the tenure of their auditors in the audit committee reports included in annual proxy statements.[11] In addition, we note that the CAQ, in collaboration with several governance organizations, recently encouraged all audit committees to consider making such disclosures in a recent publication, "Call to Action."[12]

While the Board could consider having auditors provide tenure information in the PCAOB's annual report on Form 2, we believe that tenure information may be most meaningful if provided by audit committees in the context of their evaluation of the auditor. As such, we believe the PCAOB should work with the SEC to explore the best possible means of providing auditor tenure information to users of public company financial statements.

**Other considerations**

Liability concerns

As more fully discussed in the CAQ's letter, we believe the proposed identification and disclosure of CAMs, as well as the proposals related to other information, pose risks of increased legal liability that are real and substantial. We strongly believe the PCAOB must weigh the potential benefits of the Proposal against the increase in auditor liability and costs that we believe would occur. While we believe that the improvements we suggest in this letter would help to mitigate (at least, to some extent) the additional liability exposure, such risks would, even then, remain a significant issue for the profession and one that requires much more thought and analysis than is currently evident.

Scope — broker dealer, investment companies, employee benefit plans and emerging growth companies

*Critical audit matters*

We do not believe that auditors of the financial statements of brokers and dealers, investments companies and employee benefit plans (i.e., employee stock purchase, savings and similar plans) should be subject to the identification, communication and documentation of CAMs under the Proposal.

Generally, benefit plans and registered investment companies are designed for a specified purpose and these entities tend to be heavily invested in financial assets. As a result, we suspect the CAMs for these entities would be very similar (i.e., matters related to valuing financial assets). These entities already follow extensive financial statement disclosure requirements for financial assets, and we believe users of these reports tend to understand that fair value issues are important to both the preparation and audit of these financial statements. Consequently, we question whether extending the requirements to describe CAMs to audit reports of investment companies and employee benefit plans would provide a significant benefit to users of financial statements of these entities.

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11 *Audit Committee Reporting to Shareholders, 2013 Proxy Season*, EY (link).

12 *Enhancing the Audit Committee Report: A Call to Action*, issued by the Audit Committee Collaboration consisting of the following organizations: National Association of Corporate Directors, New York Stock Exchange, Corporate Board Member, Tapestry Networks, Association of Audit Committee Members, Inc., and the CAQ (link).

As noted in the PCAOB Release, brokers and dealers are primarily closely held (the PCAOB's Office of Research and Analysis says approximately 75% of brokers and dealers have five or fewer direct owners), and the direct owners are generally part of the entity's management. In addition, many brokers and dealers are part of an issuer parent entity so the CAMs related to brokers and dealers would be considered in the parent's CAM communications. Accordingly, we believe that requiring the auditors of these entities to communicate CAMs would not provide financial statements users with additional relevant information to justify the additional cost.

***Other information***

In our view, audits of brokers and dealers and employee benefit plans should be excluded from the scope of the Proposed Other Information Standard. We believe that the compliance or exemption report required to be filed by brokers and dealers under Exchange Act Rule 17a-5[13] and required to be reported on by auditors under the *Standards for Attestation Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission*[14] provides users of their financial statements with sufficient information to make any additional reporting by the auditor for such entities under the Proposed Other Information Standard unnecessary. Moreover, Form 11-Ks filed by employee benefit plans contain a limited amount of other information.

***Emerging growth companies***

We do not think that emerging growth companies (EGCs) should be excluded from the auditor reporting and other information standards. We believe EGCs exhibit characteristics similar to other public companies and that users of financial statement will benefit from similar auditor reporting requirements. In addition, we believe that the recommendations provided above should help mitigate the costs (for audits of EGCs and all other public companies) of the expanded auditor performance and reporting requirements reflected in the Proposal.

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We would be pleased to discuss our comments with the Board or the PCAOB staff at your convenience

Yours sincerely,

Ernst + Young LLP

Appendix A — Example CAMs reflecting the "effect on the audit" description in the audit report
Appendix B — Comments on the conforming amendments

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13 SEC Release No. 34-70073, Final Rule, Broker-Dealer Reports (link).
14 PCAOB Release 2013-007 (link).

Copy to:

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James R. Doty, Chair
Lewis H. Ferguson, Board Member
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Paul A. Beswick, SEC Chief Accountant
Brian T. Croteau, SEC Deputy Chief Accountant

## Appendix A — Example CAM disclosures reflecting the "effect on the audit"

We have included the following two examples to demonstrate situations in which we believe an auditor may find it necessary to describe, in the audit report, the effect a CAM had on an audit.

### Example 1 — Implementation of new inventory system

*Background*

XYZ Company (the "Company") designs, manufactures, sells and services customized widgets. Revenues are recognized in accordance with the percentage-of-completion contract accounting method. During 2013, XYZ Company implemented a new inventory system, as its previous system was no longer supported by the vendor and was not suited to the Company's anticipated growth plans. The new system was also intended to better facilitate the gathering of production information and allow it to more efficiently plan, manage and track the production process. The system will include the following functionality, among others:

- Develop material requirements
- House bills of materials
- Collect production floor data
- Manage suppliers (ordering and receiving of materials)
- Manage the Company's inventory
- Track field service and warranties
- Track sales of parts and accessories

The new system caused the Company to redesign its internal controls in the inventory and revenue recognition areas. The Company worked with its software vendors to run the new and old systems on a parallel basis over a six-month period. As part of this process, it implemented controls to reconcile any differences in the cost information output from the two systems, as well as any differences in contract amounts. After the end of the 3rd quarter, the Company determined that the new system was operating effectively and ceased the parallel operations effective October 1, 2013.

*Company Disclosures*

<u>Significant Accounting Policies — Notes X and Y</u>

XYZ Company (the "Company") designs, manufactures, sells and services customized widgets. Revenues are recognized in accordance with contract accounting. The Company recognizes contract revenues under the percentage-of-completion method which is based on contract costs incurred to date compared with total estimated contract costs. Changes in estimates of total contract revenue (e.g., customer amendments to the agreed-upon design), total contract cost or the extent of progress towards completion are recognized in the period in which the changes in estimates are identified. Estimated losses on contracts are recognized in the period in which the loss is identified. If the final outcome of a contract cannot be reasonably estimated, but a loss on the contract is not expected, the Company recognizes revenues under the percentage-of-completion method based on a zero profit margin until more precise estimates can be made. If and when the Company can make more precise estimates, revenues and costs of revenues are adjusted in the same period.

Contracts accounted for in accordance with contract accounting are billable upon achievement of milestones specified in the contracts or upon customer acceptance. Costs incurred and revenues recognized under the percentage-of-completion method in excess of customer billings are included in "Accounts receivable" in the Consolidated Balance Sheets. Customer billings in excess of costs incurred and revenue recognized under the percentage-of-completion method, which typically reflect initial down payments, are included in "Advance payments from customers" in the Consolidated Balance Sheets.

Item 9A. Controls and Procedures: Changes in Internal Control Over Financial Reporting

During the 4th quarter, we implemented a new inventory system, which caused us to revise internal controls in the inventory and revenue areas.

The Company worked with its software vendors to run the new and old systems on a parallel basis over a six-month period. As part of this process, we also implemented controls to reconcile any differences in the cost information output from the two systems, as well as any differences in contract amounts. After the end of the 3rd quarter, the Company determined that the system was operating effectively and ceased the parallel operations effective October 1, 2013.

***Auditor's Considerations***

CAM Considerations

The external auditor determined this matter represented a CAM due to the following:

- Inventory, revenues and cost of goods sold are material financial statement accounts. The transition to the new system represented a significant area of risk to the accumulation of costs related to the Company's production of widgets, as well as the determination of revenue. The auditor made changes to the audit approach and planned procedures in this area in response to the changes in the Company's systems and underlying processes.

- Significant audit effort was expended evaluating the adequacy of the new controls related to the input of production cost and tracking information into the new system, including the reconciliation controls utilized during the 6-month period where both systems were operated in parallel.

- Significant effort was expended by the audit team, including significant involvement of the firm's IT personnel, to evaluate the effectiveness of the Company's IT controls related to the new system, including logical access, security and other application controls related to the accumulation of cost information related to production, inventory tracking/costing, supplier management, and revenue generation.

- The Company's audit committee was involved in tracking the progress the Company made in this area. For example, the audit committee (1) requested that management provide regular status updates related to the new system development and the related conversion, (2) inquired of management, internal audit and the external auditor about any challenges identified during the conversion, (3) requested the external auditor to specifically discuss the manner in which the audit approach would address the risks associated with the conversion and (4) directed the internal audit department to devote significant resources to evaluating the adequacy of the Company's controls in this area. As a result, this interaction represented some of the most significant with the audit committee during the course of the audit.

***Example CAM Disclosure***

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide assurance on individual accounts or disclosures. The communication below is not intended to identify all matters we considered to be significant to our audit. Other matters that we determined were not critical audit matters were discussed with the audit committee during the course of our audit.

Implementation of New Inventory System

The Company recognizes contract revenues under the percentage-of-completion method, which are based on contract costs incurred to date compared with total estimated contract costs. The amount of revenue recognized requires the company to estimate total contract costs at the outset of a contract and revise those estimates over the life of the contract as circumstances dictate.

During the 4th quarter, the Company implemented a new inventory accounting system. The system is integral to the accumulation of contract cost information which, in turn, is the key driver in the Company's determination of revenue to be recognized. Given the significance of the inventory system to the Company's ability to track and record production expenses, and in turn recognize revenue, we determined that the Company's implementation of the new inventory system was a critical audit matter in the audit of the financial statements as of and for the year ended December 31, 2013.

Our audit involved testing the company's conversion from its previous system to the new system, including evaluating the adequacy of the reconciliation controls used during a 6-month period where both systems were operated in parallel. Our audit procedures also included an evaluation of the revised internal control policies and procedures related to the new system. The Company's inventory and revenue recognition policies are discussed in Notes X and Y to the financial statements.

**Example 2 — Material Weakness in Internal Control Over Financial Reporting Identified During the Audit**

*Background*

XYZ Company (the "Company") is a leading manufacturer of widgets and is a non-accelerated filer with a non-integrated audit. During the preparation of the 2013 year-end financial statements, an error was identified in the current-year calculation of the valuation allowance recorded for deferred tax assets. The Company determined that the error was the result of a control deficiency regarding the preparation and review of the calculation of the valuation allowance by senior tax personnel. The review did not appropriately consider the reasonableness of the assumptions used in projecting taxable income and reversals of existing taxable temporary differences when developing the valuation allowance. Given the material amount of deferred tax assets recognized by the Company and the nature and extent of the control deficiency identified, the Company determined that a material weakness in its internal control over financial reporting existed as of December 31, 2013.

*Company Disclosures*

<u>Item 8 — Financial Statements and Supplementary Data in 10-K</u>

*Summary of Significant Accounting Policies — Income Taxes*
The Company recognizes deferred tax assets and liabilities for the expected future tax consequences or temporary differences between the financial statement carrying amounts and the tax bases of the assets and liabilities. Deferred tax balances are adjusted to reflect tax rates, based on current tax laws, which will be in effect in the years in which temporary differences are expected to reverse. Deferred tax assets are reduced by a valuation allowance when management determines that it is more likely than not that some portion or all of the deferred tax assets will not be realized (see Note Y)....

<u>Item 9A-Controls and Procedures in 10-K</u>

*Evaluation of Disclosure Controls and Procedures*
...Based on our evaluation, our CEO and CFO concluded that as of December 31, 2013, our disclosure controls and procedures are ineffective related to the preparation and review of the valuation allowance recorded for certain deferred tax assets...

*Management's Report on Internal Control Over Financial Reporting*
We assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2013 using the criteria set forth by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in *Internal Control — Integrated Framework*.... Based on our assessment, we have concluded that we did not maintain effective internal control over financial reporting as of December 31, 2013, due to the material weakness in our internal control over financial reporting described below.

We did not maintain effective controls over the preparation and review of the valuation allowance recorded for certain deferred tax assets. Specifically, the review of the valuation allowance did not consider all relevant facts and circumstances. This resulted in an adjustment during the 4th quarter to the Company's financial statements as of and for the year ended December 31, 2013. While the adjustment was not material to the prior year, management has concluded that this control deficiency, if not effectively remediated, could result in misstatements of the income tax accounts identified in Note X of the consolidated financial statements that would result in a material misstatement of the Company's annual or interim consolidated financial statements that would not be prevented or detected. Accordingly, we have determined that this control deficiency constitutes a material weakness.

In response to the identification of the material weakness, in early 2014, management plans to take actions to remediate its internal controls over the preparation and review of the calculation of valuation allowances recorded for deferred tax assets. The Company plans to implement more robust reviews over the determination of valuation allowances recognized, including more formal comparisons between deferred tax assets and all sources of future taxable income. In addition, the Company has added resources that will enable management review and oversight for those valuation allowances that involve a higher degree of inherent complexity and judgment required on the part of management.

***Auditor's Considerations***

CAM Considerations

The external auditor determined this matter represented a CAM due to the following:

- Deferred tax assets are material to the Company's financial statements.
- The estimate was complex and highly subjective, requiring projections of future taxable income and reversals of taxable temporary differences.
- The control deficiency identified was determined to be a material weakness by management and the external auditor, which resulted in changes to the auditor's risk assessments and the performance of additional control and substantive procedures in this area.
- An adjustment was identified as a result of the control deficiency related to the deferred tax valuation allowance.
- Due to the sensitivity of the area, the valuation allowance was typically the source of significant interaction with the audit committee. In addition, upon the identification of the error and related control deficiency, further interaction occurred related to the misstatement, the related control deficiency and management's remediation plans. This interaction represented some of the most significant with the audit committee during the course of the audit.

***Example CAM Disclosure***

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are matters that, in our judgment, a) were material to the financial statements, b) involved our most challenging, subjective, or complex judgments, posed the greatest challenge to us in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to us in forming an opinion on the financial statements, and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee. Our audit included performing procedures designed to address the risks of material misstatement associated with the matter(s) described below. Such procedures were designed in the context of our audit of the financial statements, taken as a whole, and do not provide assurance on individual accounts or disclosures. The communication below is not intended to identify all matters we considered to be significant to our audit. Other matters that we determined were not critical audit matters were discussed with the audit committee during the course of our audit.

Material Weakness Related to Deferred Tax Valuation Allowance

The Company determined that a material weakness in internal control over financial reporting existed as of December 31, 2013. Specifically, the Company determined it did not maintain effective controls over the preparation and review of the valuation allowance recorded for certain deferred tax assets. The determination of the valuation allowance is subject to significant estimation, including projections of future taxable income and reversals of taxable temporary differences.

Given the significance of the deferred tax assets recognized in the financial statements and the identification of the material weakness related to the determination of such amounts, we determined that our evaluation of the Company's valuation allowance for deferred tax assets represented a critical audit matter in the audit of the financial statements as of and for the year-ended December 31, 2013.

Our audit procedures included evaluating the reasonableness of the assumptions used in the projections of future taxable income and reversals of taxable temporary differences, as well as evaluating the controls over the preparation and review of the deferred tax asset valuation allowance. The Company's policy for accounting for income taxes and related income tax disclosures are discussed in Notes X and Y to the financial statements.

**Appendix B — Comments on the conforming amendments**

| Comment Number | Reference | Observation |
|---|---|---|
| 1 | Para. 1 | The auditor's report when the auditor expresses an unqualified opinion on the financial statements is defined as the "auditor's unqualified report." This term is used throughout the proposed standard. We believe that the terms "unqualified," "qualified," "adverse," and "disclaimer" should be reserved for describing the auditor's opinion, rather than the auditor's report.<br><br>On a related matter, the Amendments to PCAOB AU 508.10 refer to a departure from the "auditor's unqualified report," but the new title of this amended standard is "*Departures from Unqualified Opinions…*" |
| 2 | Para. 5 | We suggest that "The Auditor's Unqualified Report" requirements section should be presented after the "Basic Elements" section. |
| 3 | Para. 5.b. | The proposed OI standard indicates that the auditor's unqualified report includes communication of Critical Audit Matters as described in paragraphs 7-14. Paragraph 5 could be eliminated if the explanatory language/provision discussion were included in the Basic Elements section and if the Critical Audit Matters discussion were moved to paragraphs 7-14. Note that the Amendments to PCAOB AU 508.20A refer to paragraphs 7-13 rather than to paragraph 5. |
| 4 | Para. 5.c. | We suggest that "Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs 15-16" should be included in the Basic Elements section. |
| 5 | Para. 5.c. | Under the proposed auditor reporting standard, the auditor's report could have a matter discussed in both the Critical Audit Matters section of the report and in an explanatory paragraph. We suggest that the PCAOB consider addressing this situation in the new standard. One alternative would be that matters would not be required to be repeated in the explanatory paragraph if the same information is already addressed in the Critical Audit Matters section. |
| 7 | Auditor Reporting Standard Page A1-15 | The Introduction section includes the phrase "statements of operations." We suggest that this be updated for issuance of ASUs 2011-05 and 2011-12 for comprehensive income. For example, this could state "the statement of comprehensive income" or "the statement of comprehensive income and the statement of income." |

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|---|---|---|
| 8 | Auditor Reporting Standard<br>▸ Appendix B Page A1-15<br>▸ Appendix 3 Page A3-5 | We suggest that the defined term (PCAOB) be presented after (United States) rather than before that term since after this definition, only PCAOB is used. PCAOB should define the entire name of the PCAOB. Same comment for the Amendments to AU 722.38. Note that the amendments to AU 722.39 already have (PCAOB) after (United States). |
| 9 | Auditor Reporting Standard Appendix B Page A1-15 | We suggest that the phrase "appropriate evidence" be revised to say "appropriate audit evidence." |
| 10 | Auditor Reporting Standard Appendix 3 Page A3-5 | The updates to the report on internal control over financial reporting include the auditor tenure language. We challenge whether the auditor tenure language is needed in the ICFR report when separate reports are issued if it has already been included in the report on the financial statements. If it is retained, we suggest that guidance be provided on whether the tenure that is disclosed should be the same as that disclosed in the report on the financial statements, or whether this tenure disclosure would relate to the number of years that the auditor has been engaged to audit ICFR. |
| 12 | Auditor Reporting Standard Appendix 3 | Appendix 3 contains certain example reports from the Interim Standard AU 508 that have been updated for the new proposed auditor reporting standard. We suggest that the PCAOB review these examples to determine the applicability in an issuer environment and to reflect the SEC's reporting requirements. For example:<br>▸ AU 508.34 is for a balance sheet-only report<br>▸ AU 508.44 is for a situation when management declines to present a basic financial statement<br>▸ Various qualified, adverse and disclaimer opinion reports are presented (in the Appendix as well as in the Amendments to AU 9508)<br>▸ Examples refer to the Introductory paragraph of the new standard, which reflects a 3-year period for the results of operations and cash flows, but the examples provide an opinion paragraph that reflects a 2-year period for the results of operations and cash flows |

| | | |
|---|---|---|
| 13 | Auditor Reporting Standard Appendix 3 | Although the proposed auditor reporting standard does not require a certain order to the paragraphs of the auditor's report, we suggest that the PCAOB consider updating the examples to prominently present the opinion paragraph. The auditor's report length will significantly increase as a result of this new standard. Prominently presenting the opinion paragraph will help investors and other financial statement users readily determine the type of opinion issued. |
| 15 | Amendments to PCAOB AU 9508.36 | We suggest that the PCAOB determine that the example provided for a report on single-year financial statements in the year of adoption of the liquidation basis is in conformity with ASU 2013-07, *Presentation of Financial Statements* (Topic 205), or provides clarification on the portions of the report related to the stub-period that are not required by that ASU. |
| 16 | Amendments to PCAOB AU 9508.83 and .84 | These qualified and adverse opinion examples appear to relate to a non-registered investment partnership. We suggest that the PCAOB challenge the appropriateness of these examples. |

EXPRESS SCRIPTS®

December 10, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Dear Members of the Board:

Express Scripts Holding Company (the "Company") appreciates the opportunity to provide feedback on the Public Company Accounting Oversight Board ("PCAOB") Rulemaking Docket Matter No. 034 – Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments (the "Proposal"). We support the continued efforts of the PCAOB to examine alternatives for increasing the transparency of the auditor's report and to increase audit quality and provide protection to financial statement users.

However, we have significant concerns regarding the Proposal. Specifically, we are concerned with the focus on enhanced auditor's responsibilities regarding other information and reporting of critical audit matters ("CAM"). Under the Proposal, the auditor will serve as an original source of disclosures. In our opinion, the current roles and responsibilities of management, auditors and the audit committee effectively maintain audit quality, independence and transparency; and the incremental costs of the Proposal far outweigh the measureable benefits.

Central to our concern is that the auditor should not be an original source of disclosures about the Company. It is the role of management, with the oversight of the audit committee, to determine if financial disclosures are complete, accurate and provide users with appropriate insight into the Company. Our Management is in the best position to disclose relevant information in public reports which increases the reliability of information used by investors and provides greater insight into the unique health care industry in which our Company operates. Similarly, our audit committee is in the best position to provide oversight of the quality and integrity of information reported to the public, as well as the performance of our auditors with respect to significant matters affecting the Company. Finally, our auditors are in the best position to provide oversight and assurance with respect to the financial statements overall. Based on the current disclosure requirements, we believe our financial statement disclosures already provide users with the appropriate level of information regarding significant matters and material estimates in order to make informed decisions. The Proposal would make it difficult for management and the audit committee to fulfill their current roles and responsibilities because auditors would serve as an original source of information within the Company's financial reports. Moving the role of the auditor from providing oversight and assurance to serving as an original source of information could result in reduced investor confidence due to the disclosure and discussion of the auditor's subjective views on complex matters that are inherently and properly resolved through the audit process.

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We believe that the current roles and responsibilities of management, auditors and the audit committee foster an environment of open communication and should remain unchanged in order to maintain audit quality. The current process of live interaction between all parties enhances financial reporting as all subjective and complex matters and significant material estimates, assessments and conclusions are discussed in an open and transparent manner. If the auditor's role changes from providing oversight and assurance to reporting subjective viewpoints on complex accounting matters, meaningful open communication would be strained. Furthermore, the auditor's report would likely lack comparability between public reports due to the introduction of subjective information presented by the auditor which would likely differ greatly between auditors. Without consistent auditor reporting, comparability between the public reports of companies in similar industries would be reduced, causing further confusion on the part of financial statement users. Disclosing the subjective views of auditors could also limit open and honest discussion between management, auditors and the audit committee, effectively limiting the audit committee's ability to carry out oversight responsibilities. Currently, there is a clear distinction between the roles and responsibilities of management, auditors and the audit committee; if those lines are blurred we expect confusion on the part of financial statement users and a decrease in overall audit quality.

We also believe that the Proposal would prove a great distraction to management and the auditor and adding significant costs at the same time. The Proposal, specifically related to the expanded audit procedures to evaluate and publicly report on other information, would likely result in significantly increased audit effort and could distract the focus of auditors away from more important components of the audit. Under the current Proposal the auditor would be required to "evaluate and report" versus "read and consider" other information, which would significantly increase audit fees due to the change in scope and the level of effort the auditor would need to evaluate subjective and forward looking information. Furthermore, considering this substantial increase in scope, the auditor's ability to perform the additional work, in a quality manner, within the tight reporting timeframes in which we operate, would be greatly strained. We support the Board's effort to clarify the auditor's responsibility around other information, but would recommend the "read and consider" model be retained due to the undue cost that would be incurred by companies without commensurate benefit under the Proposal.

As mentioned above, we support the efforts of the PCAOB to provide transparency and audit quality to financial statement users. However, we believe that the financial disclosures in our public reports already provide meaningful and detailed analysis around key business, operating performance and strategic risks and accounting practices, and are discussed with and considered by the auditor. The information provided by the auditor under the Proposal would not provide additional or meaningful information to users. The current roles and responsibilities of management, auditors and the audit committee represent the right balance to promote transparency and meet the needs of users as defined by the PCAOB. In our opinion, the benefits of the Proposal are simply outweighed by the costs, which could include impairing communication among management, auditors and the audit committee, and the financial costs of the time and effort required in order to comply with the Proposal. We strongly encourage the Board to consider and evaluate the impact that the Proposal would have on providing investors with straightforward, reliable and useful information.

We appreciate the opportunity to express our views.

Sincerely,

/s/Chris Knibb
Chris Knibb
Vice President, Chief Accounting Officer and
Corporate Controller

**Exxon Mobil Corporation**
5959 Las Colinas Boulevard
Irving, Texas 75039
972 444 1202 Telephone
972 444 1221 Facsimile

**Patrick T. Mulva**
Vice President and Controller

ExxonMobil

December 11, 2013

Ms. Phoebe W. Brown, Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, D.C. 20006-2803
Sent by email to comments@pcaobus.org

**RE: PCAOB Rulemaking Docket Matter No. 034, The Auditor's Report and The Auditor's Responsibilities Regarding Other Information**

Dear Ms. Brown,

Exxon Mobil Corporation appreciates the opportunity to respond to the referenced Proposed Auditing Standards (the "Proposals"). We have concerns regarding disclosures of critical audit matters ("CAMs"), disclosures of the tenure of the audit firm, and the change in the level of assurance in the auditor's responsibilities regarding other information. We support similar observations expressed in the letter submitted by the Financial Executives International ("FEI") Committee on Corporate Reporting ("CCR"). Our most critical concerns are outlined below.

**Auditor's Reporting Model**

ExxonMobil agrees an opportunity exists for targeted improvements in the auditor's reporting model. We support the Proposal's enhancement to the language regarding the auditor's responsibilities for fraud and the notes to the financial statements. However, other elements of the auditor's report are working effectively and do not merit further change. Specifically, we support retaining the existing pass/fail model which both clearly and concisely conveys the auditor's opinion regarding whether the financial statements are fairly presented. As further explained below, we do not support the disclosure of CAMs or disclosure of audit tenure.

- *Critical Accounting Matters*

  The disclosure of CAMs will have an adverse effect on the clarity of management responsibilities for, and ownership of, the financial statements. Under the Proposals, the auditor's report would include information that duplicates items reported in Management's Discussion and Analysis or the financial statements. We therefore question its incremental value to users. We are also concerned that users may be confused regarding the opinion of the auditor and the relevance of the information found in this expanded auditor's report. The Board defines CAMs as those audit matters that involved the most difficult, subjective, or complex auditor judgments; posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and posed the most difficulty to the auditor in forming an opinion on the financial statements. Based on the Proposals, the auditors would identify all potential CAMs and presumably screen the list to determine what would be disclosed. If the auditor determines that certain items should be excluded from disclosure, the auditor would need to justify that decision in the work papers. These judgments, like others of similar importance made during the audit, would be subject to review and exception by PCAOB inspectors. Most auditors, we believe, would err on the side of including more rather than fewer CAMs in their reports. This additional degree of subjectivity, and the prominence the disclosure would be given in the auditor report under the Proposals, will cause confusion among users regarding the overall opinion on the financial statements. In addition, the Proposals potentially would lead to the disclosure of items of lesser significance that were ultimately deemed immaterial or resolved satisfactorily, and could in fact dilute focus on those issues of more importance.

- *Audit Tenure*

  Including a statement containing the year the auditor began serving consecutively as the company's auditor is not relevant or useful to users. The background information in Appendix 5 of the Proposals indicates that academic research is mixed as to whether short or long term audit relationships are more likely to adversely affect audit quality. To require inclusion of that data point lends unwarranted importance to it and could lead investors to draw erroneous conclusions.

**Other Information**

ExxonMobil supports language that clarifies the auditor's responsibility regarding information outside the financial statements. However, we do not support the change in the level of assurance to "read and evaluate" qualitative and quantitative information. This implicit increase in the level of assurance would require the auditor to perform additional procedures and would correspondingly result in higher costs to preparers. In addition to the added cost to preparers and increase in the volume of procedures auditors would perform during a critical audit period, users may misinterpret the extent of procedures performed by the auditors. The language should simply clarify that the auditor's level of assurance is "read and consider", consistent with existing requirements, but require no change in audit procedures.

**Conclusion**

ExxonMobil supports the comment letter submitted by the FEI CCR on the Proposals. As noted above, we do support certain clarifications in the auditor's report. However, we do not support the disclosure of CAMs, the disclosure of the audit tenure, or an increase in the level of auditor's assurance of other information. We strongly encourage the PCAOB to engage in outreach or field testing designed to determine if the Proposals are justified from a cost / benefit perspective. Unless the Proposals clearly meet that hurdle, implementing them will simply contribute to the ongoing dilemma of disclosure overload. We appreciate the Board's consideration of our input and welcome the opportunity to discuss it further.

Sincerely,

c: Martin Baumann, PCAOB Chief Auditor
Paul Beswick, SEC Chief Accountant
Brian Croteau, SEC Deputy Chief Accountant

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FBL Financial Group, Inc.

December 10, 2013

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Release No. 2013-005
Rulemaking Docket Matter No. 034 (Auditor's Report and Responsibility)

Dear Ms. Brown:

We appreciate the opportunity to comment on the PCAOB proposals for two new audit standards, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.*

FBL Financial Group, Inc. through its primary operating subsidiary, Farm Bureau Life Insurance Company, underwrites and markets a broad range of life insurance and annuity products in the Midwest and western United States. In addition, FBL Financial Group manages all aspects of two Farm Bureau affiliated property-casualty insurance companies. FBL Financial Group, headquartered in West Des Moines, Iowa, is traded on the New York Stock Exchange under the symbol FFG.

We support the proposal to further highlight the auditor's responsibilities with regard to the notes to the financial statements as well as "other financial information" accompanying the audited financial statements. It should be clear to the users of the financial statements what the audit opinion represents, and we agree that currently the audit opinion is vague with regard to those items.

We do not believe indicating the number of years the auditor has served in that capacity provides relevant information. A short tenure may indicate an auditor providing a "fresh look". A longer tenure may indicate an auditor who knows the company and is in a better position to assess risk. In any case the information is currently readily available to the public through the Security and Exchange Commission's EDGAR database. A better approach to convey auditor qualifications would be to require each auditing firm to maintain an internet site with such data as number of dedicated audit professionals, locations, total revenue, number of clients, an overview of their internal quality review process, their latest PCAOB examination report, summary of sanctions etc. Such information would be beneficial to both external parties relying on the audit opinion as well as audit committees monitoring and comparing qualifications of auditors.

We do not agree with the proposal for disclosure of critical accounting matters within the audit opinion as the result will likely be confusing to the readers, costly to prepare and delay the issuance of the financial statements. We believe the current pass/fail opinion with limited qualification paragraphs is a better approach. There are several areas of concern with the current proposal including:

- The financial statements are required to stand on their own, with or without the auditor opinion. Significant financial transactions are required to be disclosed in the footnotes to the financial statements, which this proposal will emphasis is within the scope of the auditor opinion. Risks and estimates are laid out in the 10K. If the normal disclosures are adequate, then the reader should have the information they need to evaluate the company and its risks. Inclusion of such detailed matters within the auditing opinion implies that the financial statements and disclosures are incomplete.

- While the engagement quality reviewer and audit committee review certain information provided by the audit team regarding areas of audit emphasis, they have the benefit of personal interaction with the audit team in order to understand the issues. They also have deeper insights into the overall audit approach and qualifications of the audit team. It will be virtually impossible to provide a similar level of comfort within a written document in an abbreviated and understandable fashion.

- The users of the financial statements should be able to rely on the auditor's opinion without being required to perform a quality review of the audit firm's auditing techniques. A more effective approach would be to leave the review to those with the access and authority to do so including the firms' internal quality review team, audit committees and the various regulatory bodies including the PCAOB and Securities and Exchange Commission.

- We agree that certain transactions are more complex to audit than others, however, the proposal suggests that only certain aspects of the audit are important which is misleading to those relying on the audit opinion.

- Highlighting the auditor's conclusions on specific portions of their audit gives the impression of the issuance of mini-audit opinions rather than an overall opinion on the accuracy of the financial statements, which feels confusing. In addition the auditor's level of precision will likely increase as their opinion will now be at a level much lower than that of the financial statements taken as a whole, accordingly the cost of the audit will increase.

- There will be the natural tendency for auditors to error in the direction of over disclosure in order to avoid criticism that something was missed. Regurgitating a list of audit procedures will be overkill for most readers and very expensive to prepare.

We do not agree that the auditors should expand their procedures around the other information provided with the audited financial statements beyond the consistency check performed today. We are concerned the increased procedures will result in a significant additional cost and delay along with confusing readers as to the level of work performed by the auditor.

Thank you for the opportunity to review and respond to these proposals.

Sincerely
FBL Financial Group, Inc.

Donald J. Seibel
Chief Financial Officer

Tony J. Aldridge
Accounting Vice President

**Federal Deposit Insurance Corporation**
**Board of Governors of the Federal Reserve System**
**National Credit Union Administration**
**Office of the Comptroller of the Currency**

February 6, 2014

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

RE: PCAOB Rulemaking Docket Matter No. 034 – *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

Dear Office of the Secretary:

The staffs of the four federal regulatory agencies (the agencies) responsible for supervising the safety and soundness of U.S. financial institutions appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standards on the Auditor's Report, the Auditor's Responsibilities Regarding Other Information, and Related Amendments (Proposed Auditing Standards). On November 7, 2011, we commented on the PCAOB's *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the Concept Release). The changes in the Proposed Auditing Standards on the Auditor's Report and Other Information strike a reasonable balance in addressing concerns raised by commenters on the Concept Release. We believe that the Proposed Auditing Standards will improve auditor reporting, provide additional useful information in the auditor's report, and enhance market discipline.

As we stated in our November 7, 2011, letter, the information provided in the auditor's report is relevant to the agencies given our requirements regarding independent audits and assessments of the effectiveness of internal control over financial reporting for financial institutions with total assets above certain thresholds.

The agencies support the PCAOB's decision to retain the pass/fail model for the auditor's report. The proposed changes to the auditor's reporting model should lessen the information and expectations gaps of investors and other users of audited financial statements. In this regard, we believe the communication of critical audit matters (CAMs) in the auditor's report will provide useful information that is based on audit procedures performed and may also aid in earlier identification of potential problems at individual public financial institutions. We also support the requirement for the auditor to document the determination of CAMs. Additionally, we believe investors and other users of audited financial statements will find the proposed disclosures regarding auditor independence and auditor tenure useful.

The Proposed Auditing Standard regarding Other Information is an improvement over the existing auditing standard on this subject. The Proposed Auditing Standard clearly articulates the objectives and responsibilities of the auditor regarding other information and may enhance the agencies' supervision of public financial institutions.

We offer the following specific comments and suggestions for your consideration as you evaluate possible changes to the Proposed Auditing Standards.

Deficiencies in Internal Control Over Financial Reporting (ICFR)

Paragraph 9 of the Proposed Auditing Standard on the Auditor's Report sets forth factors for determining whether a matter addressed during the audit of financial statements is a CAM. One such factor is the severity of any control deficiencies identified relevant to the matter. Section V of Appendix 5 to the Proposed Auditing Standard on the Auditor's Report provides additional discussion regarding the determination of CAMs, including the severity of control deficiencies. This section states that:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.

Thus, in some cases when a deficiency or deficiencies in ICFR have been identified, the auditor may determine that the aspect of the financial statements affected by the deficiencies is not a CAM. In these situations, the agencies recommend that the Proposed Auditing Standard require the auditor to evaluate whether the deficiency or a combination of deficiencies in ICFR not associated with a CAM is such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented or detected on a timely basis. If the auditor concludes that such a material misstatement is reasonably possible, the agencies believe that this information, by its nature, would be meaningful to users of the auditor's report. Thus, the agencies recommend that the PCAOB consider treating deficiencies that meet this condition as a CAM to be communicated in the auditor's report. Furthermore, the auditor's description of such deficiencies should explain the effect of their existence on the audit and the auditor's planned approach to the audit.

Disclosure of the Auditor's Responsibilities for Other Information

The Proposed Auditing Standard on Other Information articulates the objectives of the auditor in paragraph 2 and the procedures that the auditor should perform around the other information in paragraph 4. However, the proposed illustrative language in paragraph 14.a may cause confusion for users who are not familiar with the requirements of the Proposed Auditing Standard on Other Information. More specifically, the illustrative language seems to contain an implicit assertion regarding the accuracy of the other information although it also states that the other information was not audited and that the auditor does not express an opinion on the other information. We recommend that the disclosure in the auditor's report regarding other information be expanded to (1) more fully describe the other information evaluated by the auditor, and (2) disclose the procedures that the auditor performed regarding the other information to clarify the nature of the auditor's evaluation because the auditor is not opining on such other information. The procedures should be presented in a clear and concise manner similar to the second paragraph in the "Basis of Opinion" section presented in Appendix B of the Proposed Auditing Standard on the Auditor's Report – *An Illustrative Auditor's Unqualified Report*.

Scope of the Proposed Auditing Standard on Other Information

The scope of the Proposed Auditing Standard on Other Information, as set forth in paragraph 1, is limited to other information that is filed with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (Exchange Act). Certain banks and savings associations are required to file reports with the federal banking agencies, rather than the SEC, pursuant to Section 12(i) of the Exchange Act. The audits of such institutions are required to be performed in accordance with the PCAOB auditing standards. A literal reading of the scope paragraph of the Proposed Auditing Standard may suggest that other information filed with the federal banking agencies pursuant to Section 12(i) of the Exchange Act would be excluded from the requirements of the Proposed Auditing Standard. To clarify that the Proposed Auditing Standard is applicable to audits of banks and savings associations that are subject to Section 12(i), we recommend that the following footnote be added to paragraph 1: "This Auditing Standard is applicable to audits of banks and savings associations that file reports with the U.S. banking agencies, rather than the SEC, pursuant to Section 12(i) of the Securities Exchange Act of 1934."

Outreach Efforts

The agencies believe the PCAOB's outreach efforts to date on the auditor's reporting model have been beneficial. We encourage the PCAOB to continue to coordinate with other standard setters, particularly the American Institute of Certified Public Accountants' Auditing Standards Board and the International Auditing and Assurance Standards Board, in order to promote international consistency in the auditor's reporting model.

We appreciate your consideration of our comments and we would be pleased to discuss in more detail our views on the Proposed Auditing Standards.

Sincerely,

Robert F. Storch
Chief Accountant
Federal Deposit Insurance Corporation

Steven P. Merriett
Deputy Associate Director and
Chief Accountant – Supervision
Board of Governors of
the Federal Reserve System

Larry Fazio
Director
Office of Examination and Insurance
National Credit Union Administration

Kathy K. Murphy
Deputy Comptroller and Chief Accountant
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December 11, 2013

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

Dear Office of the Secretary:

The Federal Housing Finance Agency (FHFA or Agency) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) proposed auditing standards on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; *and Related Amendments to PCAOB Standards,* PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 34 (the proposed auditing standards).

FHFA commented on the Board's 2011 Concept Release on possible revisions to auditor's report (the 2011 Concept Release) in a letter dated September 30, 2011. In that letter, FHFA indicated support for (1) requiring an Auditor's Discussion and Analysis as a supplement to the standard auditor's report, (2) amending the format and content of the current standard auditor's report to improve clarity, and (3) requiring the auditor's assurance on other information outside of the financial statements, such as the Management's Discussion & Analysis (MD&A), earnings releases, and other non-generally accepted accounting principles (non-GAAP) information.

As the regulator of the Federal Home Loan Banks and the regulator and conservator of Fannie Mae and Freddie Mac, FHFA considers audited financial reports by its regulated entities an important input to the Agency's safety and soundness supervision process. The Agency therefore supports the proposed auditing standards' requirements that the auditor's report communicate:

(1) critical audit matters (CAMs);
(2) a statement relating to auditor independence;
(3) a statement relating to auditor tenure;
(4) the auditor's responsibilities to evaluate and report on other information; and
(5) more detailed information related to the auditor's responsibilities for fraud.

Further comments by FHFA are detailed on the following pages.

## I. CAMs

The Board has proposed, and FHFA concurs, that the auditor "communicating critical audit matters would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures." Having the external auditor provide such information would allow financial statement users to better understand the significant and complex areas of an audit.

FHFA is concerned, however, that the proposed auditing standard may result in auditors including a significant number of items as CAMs, rendering the auditor's report voluminous and possibly less useful to investors. Therefore, the Agency recommends that the PCAOB limit the CAMs included in the auditor's report to the most critical audit issues identified in the engagement, and set a limit to these CAMs, either a set number or range.

To foster consistency and utility in determining the scope of CAMs and the level of detail describing them in audit reports, FHFA also recommends that PCAOB publish more specific guidance as to what would constitute a CAM. FHFA believes that the Board's decision to collect and consider examples of CAMs from commentators will assist the PCAOB in identifying changes to its guidance that can provide sufficient clarity to external audit firms working to comply with the auditing standard.

## II. A statement relating to auditor independence

It is critical that auditors are independent and thus capable of exercising objective and impartial judgment. The PCAOB has proposed that the auditor's report include a statement that the auditor is "required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and PCAOB." While that statement is an important component of the auditor's report, it does not affirm whether or not an auditor is independent.

FHFA would like the standard to also include language requiring auditors to affirm that they are in fact independent and in compliance with applicable independence rules. In July 2013, the International Auditing and Assurance Standards Board (IAASB) issued the exposure draft, *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*, to enhance auditor reporting globally. IAASB's exposure draft proposes a positive and explicit statement that the auditor is independent.

## III. A statement relating to auditor tenure

The proposed auditing standards would require a statement containing the year the auditor began serving consecutively as the company's auditor. This would provide greater transparency for investors to use in assessing whether an auditor's tenure, whether short or long, could affect the auditing firm's audit quality or their objectivity in planning and conducting financial statement engagements.

The Board's release indicates that while academic research on the impact of auditor tenure on audit quality is divided, "investors and other financial statement users have indicated strong interest in this information." The Board's release also mentions that disclosure of tenure has been considered by other regulators and standard setters, and cites the example of rules adopted by the United Kingdom Financial Reporting Council that require UK-listed companies to disclose the length of auditor tenure in a separate section of the annual report. For purposes of transparency with financial statement users, FHFA agrees with the Board that auditor tenure information should be located in the auditor's report.

## IV. The auditor's responsibilities to evaluate and report on other information

The proposed standard for other information is designed (1) to improve an auditor's identification of material inconsistencies or material misstatements between the financial statements and other financial-related data in the Form 10-K annual report and (2) to improve auditor procedures to allow auditors to evaluate such other information. Under the Board's proposal, auditors would be required to read and evaluate information outside the financial statements, rather than just read and consider as is currently permitted by AU Section 550, *Other Information in Documents Containing Audited Financial Statements*.

While FHFA supports the Board's proposal for the evaluation of other information in the annual report, FHFA believes that it should also be extended to earnings releases as this information is relevant to the investor community. However, FHFA suggests the Board consider describing with more specificity as to what "evaluate" actually means in terms of procedures required to be performed by the auditor, so there would be consistency in how this is applied across audit engagements and firms. In addition, FHFA recommends that the Board establish enhanced guidance by field testing how audit firms would apply the guidance proposed.

## V. More detailed information related to the auditor's responsibilities for fraud

The Board's proposal adds the phrase "whether due to error or fraud" in the auditor's report to describe the auditor's responsibilities to obtain reasonable assurance about whether the financial statements are free of material misstatement. Also, in identifying the audited financial statements the auditor's report would be required to refer to "related notes." FHFA concurs with the Board's proposal to make these additions to the standardized language in the auditor's report.

With regard to the Board's reproposal related to *Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*, consistent with our comments provided on the 2011 Concept Release, FHFA recommends that the Board consider requiring the audit engagement partner's signature be included as part of the auditor's report.

Thank you for the opportunity to provide the Agency's views on the Board's proposals. FHFA hopes the Board and staff will find these comments and recommendations helpful. If the Board and staff have any questions or comments regarding this letter, please feel free to contact me at 202-649-3450.

Sincerely,

N. Satriano

Nicholas J. Satriano
Chief Accountant
Federal Housing Finance Agency

Federation of European Accountants
Fédération des Experts comptables Européens

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803
USA

11 December 2013

Ref: AUD/AKI/HBL/NRO/EBL

Dear Sir or Madam,

**Re: FEE Comments on PCAOB Rulemaking Docket Matter No. 034 – Proposed Auditing Standards Regarding the Auditor's Report and the Auditor's Responsibilities Regarding Other Information**

FEE[1] is pleased to provide you with its comments on the aforementioned matter.

## 1. International alignment with the IAASB

In our previous comment letters to the PCAOB, we have consistently expressed the view that the alignment of auditing standards globally to the maximum extent possible enhances both the quality of audits and also the acceptance of audit reports beyond home jurisdictions.

In this context, since some entities require audit reports under both PCAOB and IAASB standards, it is important that there is consistency in what needs to be included in the auditor's reports especially around the area of "critical audit matters" (CAM) and "key audit matters" (KAM). It would not assist users if the terminology, the definitions in the standards covering this area and the requirements as to the determination of and content of such

[1] FEE is the Fédération des Experts comptables Européens (Federation of European Accountants). It represents 45 professional institutes of accountants and auditors from 33 European countries, including all 28 EU member states. In representing the European accountancy profession, FEE recognises the public interest. It has a combined membership of more than 700,000 professional accountants working in different capacities in public practice, small and large firms, government and education – all of whom contribute to a more efficient, transparent and sustainable European economy.

reporting could result in the auditor reporting either more or even different “matters” under the different standards.

As you may be aware, in the European Union (EU), there is currently a discussion about the reform of the auditor-related EU legislation[2].The projects on auditor reporting that are currently being addressed by the PCAOB, the IAASB and other bodies are of the utmost importance as they will also inform and influence the European debate.

FEE supports the European Commission’s (EC’s) proposals to enhance the auditor’s public communication for public-interest entities (PIEs), especially on:

- Qualitative information on the individual audit;
- More reporting on going-concern assumptions based on information provided by management.

These proposals have, at the time of writing this letter, reached the final stage of the political discussion, the so-called Trilogue, where the European Commission, the European Parliament and the Council – representing the Member States – have to agree on a consensual text for final legislation. FEE believes that it is important that the PCAOB, IAASB and EC proposals converge together and are consistent.

## 2. General comments

FEE welcomes the proposed auditing standards and acknowledges that the PCAOB is aware of developments in the related projects at the IAASB and elsewhere. FEE has recently issued a comment letter to the IAASB in which we very much welcome the approach taken while suggesting some areas of improvement[3].

FEE notes the circumstances that underpin significant differences between the proposed IAASB approach and that of the PCAOB, which is specific to defined national circumstances (including e.g. the separate project on naming the engagement partner). Nevertheless, we would, once again, recommend convergence to the maximum extent possible with International Standards on Auditing (ISAs) issued by the IAASB in due course, in order to avoid unnecessary additional differences between the two sets of standards.

It is not just those auditors who may need to apply both sets of standards who would be confused by such differences, but also – and more importantly – investors familiar with capital markets outside the US. For example, considerable confusion may result from the fact that the PCAOB proposals do not mention significant risks in regard to determining CAM (risks only mentioned in the Paragraph 9 (e)), whereas the IAASB’s approach

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[2] Proposal of the European Commission available at:
http://ec.europa.eu/internal_market/auditing/reform/index_en.htm#maincontentSec1

[3] http://www.fee.be/images/publications/auditing/Gunn_131106_IAASB_EDs_comment_letter_auditor_reporting.pdf

essentially centers on these. Another example is the emphasis by the PCAOB on the relevance of “posed the most difficulty […] in the audit”, which is not a prominent feature of the IAASB’s proposals.

We do not comment on all the questions raised in the Rulemaking Docket. In particular, we have not responded to:

- Questions 33, 34 and 40 on Additional Discussion Related to the Proposed Auditor Reporting Standard;
- Questions 35 to 39, Appendix 5, Audits of Brokers and Dealers;
- Questions 41 and 42, Appendix 5, related to effective date;
- Questions on Emerging Growth Companies, Appendix 7.

We have included our general view on Other Information and the Responsibilities of the Auditor in relation thereto. However, given the uncertainty of the outcome of the IAASB work on other information (revision of ISA 720), we do not comment on the questions posed in Appendix 6, Additional Discussion Related to the Proposed Other Information Standard.

For further information on this FEE letter, please contact Hilde Blomme, Deputy Chief Executive at +32 2 285 40 77 or via email at hilde.blomme@fee.be or Noémi Robert, Project Manager at +32 2 285 40 80 or via email at noemi.robert@fee.be.

Yours sincerely,

André Kilesse
President

Olivier Boutellis-Taft
Chief Executive

## Appendix: Responses to Questions

### *Question Related to Section II*

**1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**

Subject to our comments in the accompanying letter relating to the desirability for consistency in terms of the definition and content of reporting certain entity specific matters within the auditor's report, we agree it is appropriate for the auditor to report critical audit matters and to this end the objectives, as set in the proposals, are clear.

### *Questions Related to Section IV*

**2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

From the European perspective, we agree that addressees should be limited to shareholders and those charged with governance (TCWG).

**3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

A section describing the nature of an audit may need to include a mention of going concern.

The linkage between critical audit matters and the going concern basis of accounting could be clarified. More specifically, in cases where there is a potential going-concern issue and where, following a considerable amount of audit work, the auditor concludes that there is no material uncertainty, the audit report should be clear on the difficulty of the audit work performed on the going concern issues as required in a critical audit matter. More extensive disclosures would then be required such as additional details about the work carried out by the auditor in this regard and the conclusion that "the auditor has not identified a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern"

Therefore, the work of the auditor on the going-concern basis of accounting and the reporting of the auditor's conclusions on the management statement thereon should be included in the proposed PCAOB standard. In that case, we would very much welcome a clear requirement that going concern issues should be included as a critical audit matter if the definition is met.

**4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

Yes, we think that a statement like the one included in paragraph 6h is necessary, as it provides more information than simply mentioning the independence of the auditor in the title of the audit report. The reference to specific laws, rules and regulations provides further transparency to inform users. Nevertheless, this paragraph should be kept concise to avoid ambiguity and boilerplate statements.

**5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

a) **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

b) **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

c) **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

In general, FEE believes that the auditor should not be the primary source of such information. It is up to the management or those charged with governance/the audit committee to disclose this type of information.

However, if not already disclosed in the management report or the annual financial statements for the same financial year, we agree that the auditor could indicate the date of the appointment of the audit firm and the period of total uninterrupted engagement including previous renewals and reappointments of the audit firm in the auditor’s report.

**6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

Yes, we consider that the proposed requirement would increase transparency in making the auditor’s involvement with other information clearer. FEE agrees it is necessary to revise the standards dealing with other information and the responsibilities of the auditor thereon. Therefore, we support the PCAOB proposal.

The objective of such revision should be to diminish confusion amongst stakeholders – including auditors - with regard to:

- What does, and what does not, constitute other information in the context of an audit of financial statements – in contrast to the IAASB's ED on ISA 720, this is far clearer in the US environment;
- The auditors' responsibilities in respect to this other information – we are concerned that the PCAOB term "evaluate" may be perceived to differ from the IAASB term "consider" (yet to be finalised) and would urge consistency if consistency is meant;
- The extent of the work effort – in this context, the last sentence in Paragraph 5 of the proposed Other Information Standard will need further clarification.

It is essential to be clear on the aforementioned "boundaries" as only then can there be clarity regarding the role of the auditor. FEE thinks that these boundaries are clear in the PCAOB proposals. More specifically:

- The PCAOB rightly uses the term "material inconsistency" with a clear definition of what is meant. We welcome the emphasis on materiality;
- The PCAOB proposal is more rule-based than the IAASB one[4], for instance in paragraph 3d of Appendix 6 with regard to calculations, the advantage of this proposal being that the auditor's involvement is more specific. The IAASB requires "considering whether there may be inconsistency […]", whereas the PCAOB concentrates the work of the auditor on the 'evaluation'. In addition, there might be a difference in approaches taken: the IAASB has included discussion with management in the first stage of the identification of the matters, whereas the PCAOB only refers to the evaluation of other information to be performed by the auditor without explicitly referring to discussion with management.

In the auditor's responsibilities for other information and the related reporting requirements, it is important that we concentrate on fostering international harmonisation as far as possible. We refer to our general comments included in the front letter on international alignment with the IAASB and the EU[5].

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[4] We acknowledge that the PCAOB is aware that the IAASB is currently revising its standard dealing with other information and the role of the auditor thereon. FEE commented on the IAASB exposure draft where we expressed our concerns to the proposals. This comment letter is available at: http://www.fee.be/images/publications/auditing/AUD_Gunn_130314_isa720_exposure_draft_final.pdf

[5] For information, a new European requirement has recently been voted in the recast of the Accounting Directive. As stated in Article 34:
"[In addition to statutory audits on the basis of Directive 2006/43/EC], the statutory auditor(s) or audit firm(s) shall also:
- (a) express an opinion on:
- (i) whether the management report [which is often used as a proxy for other information] is consistent with the financial statements for the same financial year, and
- (ii) whether the management report has been prepared in accordance with the applicable legal requirements;
- (b) state whether, in the light of the knowledge and understanding of the undertaking and its environment obtained in the course of the audit, he, she or it has identified material misstatements in the management report, and shall give an indication of the nature of any such misstatements."

**7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

FEE supports 'global standardisation' of the auditor's report, including the ordering of the paragraphs. This would help:

- Navigate users through the auditor's report; and
- Provide a comparison between auditor's reports.

However, we acknowledge that flexibility may be needed in some jurisdictions and/or in the circumstances of a particular engagement.

To this end, FEE welcomes the proposal of the IAASB to mitigate the risk of losing consistency at global level by requiring the report to include obligatory subheadings. Even if the paragraph order differs between jurisdictions, as a result of national laws or regulations, the reader can use those subheadings to navigate the report more easily. It would be most helpful if the PCAOB report uses the same headings, the comparison between auditor's reports will then be more straightforward.

**8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

Please refer to our response to Question 3.

**9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

The new requirements are expected to result in a cost increase for the additional time needed and potential delays in finalising the auditor's report concerning the following matters:

- Drafting the additional information (CAM) to be included in the auditor's report;
- Discussing these matters, as well as any matters ultimately not determined as CAM internally within the audit firm, including with the engagement quality control reviewer and possibly with others outside the firm (e.g. in some cases recourse to advisory services by a professional institute); and
- Discussions with both management and those charged with governance.

Management and TCWG are also likely to spend additional time reviewing and discussing wording and presentation with the auditor. Nevertheless, the European audit profession agrees that the benefits generally outweigh the costs, and is ready to enhance the

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The approved Directive is accessible at:
http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:182:0019:0076:EN:PDF

communication process. However, this step forward has to be done in an appropriate manner.

That is why responding to users' needs for more information should be proportionate to the nature, size and complexity of the entity, as foreign subsidiaries and smaller SEC issuers might have disproportionate costs attached to such disclosures.

***Questions Related to Section V***

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

Yes, we believe that enhanced auditor communication of critical audit matters or key audit matters would be relevant and useful to users of financial statements. There is evidence to support this as investors and shareholders have called for greater transparency about the audit outcome.

However, as noted in our accompanying letter, we consider it would be unhelpful to investors, auditors and regulators if the PCAOB and the IAASB were to use differing terminology, definitions and criteria in their respective final pronouncements. We have not been able to determine whether the differences in the proposals would lead to different reporting, and would encourage cooperation between the two Boards in this respect.

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

The auditor's communication of critical audit matters would be beneficial insofar as it would provide the public with more information on the audit and its outcome. However, there are cases that can be difficult to tackle. We refer to our response to Question 27.

It is worth noting that the critical audit matter proposals are an experiment, and that time will be needed to adapt and develop best practice. The definitions and requirements included in the proposals cannot currently respond to all possible questions which are bound to arise upon application of this new form of auditor reporting.

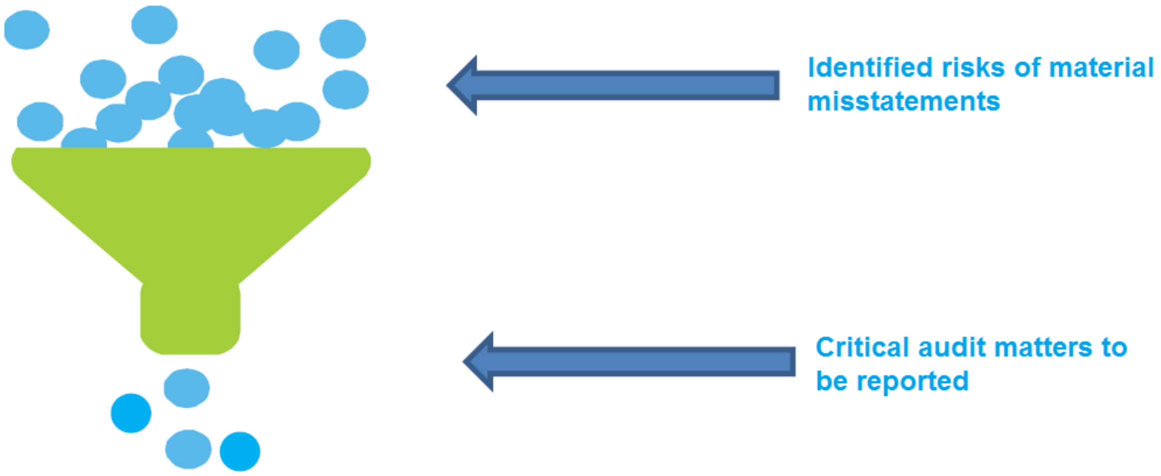
**12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

We refer to our response to Question 10 regarding the use of the PCAOB and IAASB' proposals use of different terms, definitions and criteria.

The definition of a critical matter or a key matter needs to be sufficient to determine the inclusion of matters that have to be brought to the attention of users. However, FEE wonders whether it is a good solution to focus on the level of difficulty of audit matters to select the ones to be reported.

We would advocate the use of the following principles-based approach, which can be viewed as a type of ‘funnel’ process:

- Identification of the potential critical audit matters in the identified significant risks of material misstatements;
- As a subset of the identified risks of material misstatements, the critical audit matters to be reported in the audit report should be the ones that would be relevant to users of financial statements and internal control report – in general, with the opportunity to clearly refer to the related disclosure of the financial statements.




Both the number of items and the length of descriptions would need to be limited in order to avoid lengthy paragraphs and/or boilerplate information.

FEE has carried out some work in this area and published a policy statement in July 2012 with regard to ‘improved auditor reporting’, which contains some examples of reporting of significant audit risks:

http://www.fee.be/images/publications/auditing/PS_120709_-_Policy_Statement_on_Improved_Auditor_Reporting_1372012371225.pdf

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

FEE would assume that the additional time incurred regarding critical audit matters would have an overall positive effect, but pose challenges to the timely completion of the audit.

Audit has become more complex over recent years with the increase in the complexity of entities’ business models and financial reporting. In this context, the auditor’s report cannot be viewed in a vacuum; rather there is a strong link to financial reporting. In addition, care needs to be taken to ensure that the so called “expectation gap” is not increased, i.e. that exactly what the auditor is reporting (and what the auditor is not reporting) is capable of being properly understood. This would ensure that the core service of the audit profession, the audit, continues to be valued by its users.

Improvements should only be made that really do meet user needs and enhance audit quality, i.e. by providing better information as opposed to merely providing more information.

In the broader context of the European debate on audit policy, it has become even more urgent to review at an international level whether improvements can be made as to how auditors should best communicate with all relevant stakeholders.

**14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

The requirements are clear and understandable. The content of paragraphs 8 and 9 provide sufficient criteria to be used by the auditor to determine critical audit matters. However, we also refer to our responses to Questions 10 and 12.

With regard to communication of critical audit matters, it should be emphasised that the PCAOB proposal requires “identification” in each critical audit matter paragraph, whereas the IAASB requires a ‘description’ of each key audit matter. Practical differences may arise as ‘description’ could be seen as more detailed than ‘identification’.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

Added-value from the auditor’s report will be provided by giving the following information for each critical audit matter reported:

- A clear reference to the related disclosure in the financial statements. This reference will help the users to link the point raised by the auditor to the disclosures, but not necessarily to navigate the users through the financial statements;
- The nature of the critical audit matter disclosed;
- The audit approach undertaken in response to this matter; and
- The key findings from that audit work.

FEE stresses that it is important to avoid piecemeal opinions. Accordingly, it is essential that the auditor states that the auditor’s opinion on the financial statements is not modified with respect to any of the matters reported, and the auditor does not express an opinion on these individual matters.

**16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

Yes. However, we also refer to our responses to Questions 10, 12 and 14.

**17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

We refer to our responses to Questions 10, 12 and 14.

**18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

Yes, the requirement as proposed is clear. The PCAOB's approach is more rule-based, as it requires documentation of the auditor's determination, including of matters not to be reported, whereas the IAASB does not require documentation of this step of the process in the proposed standard. However, we do not consider this a fundamental difference as the PCAOB 'explicitly' requires documentation in this standard while the IAASB includes an 'implicit' requirement, based on the objectives and requirements set out in ISA 230 'Audit Documentation'.

**19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

No addition to what is already proposed.

**20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

No addition to what is already proposed.

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

Please refer to our response to Question 9. Furthermore, auditors may also incur additional costs in conferring within the firm, and possibly with others, in respect of the documentation of matters determined not to be critical audit matters (see note to proposed paragraph 14 of the standard).

**22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

Please refer to our response to Question 9.

**23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

FEE is not commenting on this question.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

The auditor should first and foremost concentrate on those critical audit matters arising from the audit of the current period, even in the case of comparative financial statements, when the auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.

Nevertheless, due to the fact that a number of these critical audit matters are likely to recur in the risk assessment of the audit of financial statements and internal control report year on year, there might be a need to consider whether critical audit matters of the previous period have to be reassessed or not.

**25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

The examples are useful and will inform the implementation of the requirements, especially in the first year(s). With regard to relevance, we suspect that pointing out the "difficulties" as illustrated in the examples will be perceived as not sufficiently helpful, and that investors in particular will seek more information on the auditor's views.

However, as this could constitute piecemeal opinions, which should not be given, it is very important that the statement "The critical audit matters communicated below do not alter in any way our opinion on the financial statements taken as a whole" be read and properly understood in this context.

We consider these proposals as an experiment, and that time will be needed to adapt and develop best practice and acknowledge the difficulty to create examples in a vacuum.

**26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

It is likely that users will look for comparability of reports in particular industries or where circumstances giving rise to critical audit matters are pervasive. However, such reporting is intended to be non-boiler plate and specific to the audit on the financial statements and internal control report of a specific period, so comparability cannot be an overriding goal.

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

It must be recognised that there are cases that can be contentious and difficult to tackle.

For instance, the reference "to the relevant financial statement accounts or disclosures that relate to the critical audit matter, *where applicable*" (paragraph 11 (c)) allows the auditor – if identified as necessary – to disclose as a critical audit matter a matter that is not disclosed either in the financial statement accounts or disclosures. For example, the auditor may determine a weakness in the IT system is a critical audit matter having identified it as a significant risk of material misstatement during the audit. The auditor will have reported its internal control assessment to TCWG, and would like to write a critical audit matter paragraph on this matter. What if the company has not disclosed this risk in the financial statements or internal control assessment, which is highly likely for this type of risk?

In general, FEE considers it is important to have a clear linkage between the information already reported by the company and the critical audit matter. This linkage would:

- Enhance the dialogue between auditors and TCWG, including audit committees;
- Improve the financial reporting by companies; and most importantly;
- Help the auditors apply their professional judgement in reporting potential contentious cases – such as the one described above.

To help the auditor resolve contentious cases, it may be strategic to state that discussions with the entity will be needed as to why an entity has not disclosed the issue and that the auditor will take this into account when forming the audit opinion.

**28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

The legal framework and litigation culture in many EU member states often still differ from the situation in the USA and the extent of private litigation is not necessarily a phenomenon of the same magnitude as it is in the US and some other jurisdictions. However, there are EU member states where an increase of litigation can be observed or feared. At this stage, there is no clear sign that an auditor's potential liability would be a major impediment inhibiting the communication of critical audit matters.

We would recommend, however, that the Board take the following into account:

- The difficulty of determining whether the auditor has reported all relevant critical audit matters;

- Users' expectations regarding the critical audit matters to be reported; and
- The ways in which the reporting of critical audit matters might be influenced by their sensitivity.

***Questions Related to Section VI***

**29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

FEE agrees that it is appropriate to include these references to other PCAOB standards.

**30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

FEE agrees with the decision to retain the ability to emphasise a matter. Users of auditor reports are used to having such paragraphs which have a different objective to reporting of critical audit matters.

**31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

FEE is in favour of retaining the existing requirements as to matters to emphasise. The disclosure of critical audit matters should not change that situation.

**32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

FEE did not identify additional examples of matters to be added.

FedEx Corporation

December 11, 2013

VIA e-mail to: comments@pcaobus.org

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 034

FedEx Corporation has reviewed the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standards Release No. 2013-005 dated August 13, 2013, and we appreciate the opportunity to comment on the proposal.

FedEx Corporation is a global company that provides customers and businesses worldwide with a broad portfolio of transportation, e-commerce and business services. Our annual revenues total approximately $45 billion, we have more than 300,000 team members, and we serve customers in more than 220 countries and territories. Our financial statements are prepared under U.S. GAAP, filed with the Securities and Exchange Commission (SEC) and we are registered with the New York Stock Exchange. We present our views from the perspective of a financial statement preparer, and we support the PCAOB's mission to oversee the auditing profession and improve audit quality. However, we do not support the proposal made by the PCAOB with respect to the auditor's report and have set forth below our views on this issue.

**Proposed Auditor Reporting Standard**

The financial statements of a public company are the responsibility of its management and the oversight of that responsibility lies with the company's Board of Directors through its Audit Committee. This responsibility encompasses the completeness, accuracy and quality of the disclosures, including the disclosures about the financial statements embodied in the other sections of a company's SEC reports. This responsibility has been the cornerstone of the framework for financial reporting and for the audits of financial statements. This principle was further strengthened by the CEO and CFO financial statement certifications required for public companies under the Sarbanes-Oxley Act. In our view, the PCAOB's proposal seeks to supplant management's responsibility for disclosure of critical accounting matters with a company's auditor and publicize aspects of the audit process that may not be useful to investors and other users of financial statements. We strongly disagree with this concept and believe that auditors should not be disclosing editorial details about the audit process publicly and that their role is to opine on the fair presentation of the totality of the information provided by management and the internal control over financial reporting.

The broad nature of the proposal by the PCAOB seeks to unduly burden all financial statement preparers and the entire audit profession for a perceived lack of disclosure transparency. While some investors may desire improvements in disclosures, the proper source of this information is management and not the auditor. If the PCAOB believes that companies have overall deficiencies in their financial statement disclosures on critical accounting policies and estimates, then the proper venue for this issue is with the FASB and SEC.

We believe the issues that the PCAOB is seeking to address with this proposal can be addressed without the auditor's report including a discussion of critical audit matters. First, we encourage the PCAOB to take the lead on providing observations on disclosure failures noted in its audit reviews to the SEC, and have the SEC seek enhanced disclosures from companies, where necessary. Second, we believe that an acceptable alternative to the PCAOB's proposal would be for the auditor's report to simply acknowledge the auditor's concurrence with the critical accounting policies and estimates disclosed by the company. Finally, we believe that the audit process works, and that auditors should continue to leverage the well-defined process for required communications with audit committees for discussion of critical audit matters. The matters described in the proposal should be discussed in the boardroom, not the auditor's report. The auditor required communications to the audit committee provide ample opportunities for the auditor to engage in discussions on critical audit matters and the auditor's report could also include a statement that these candid discussions were held.

Beyond our fundamental disagreement with the basic principle of the PCAOB proposal, we believe a separate listing of critical audit matters in an auditor's report is redundant to the disclosure of a company's significant accounting policies and critical accounting estimates required in its Annual Report. The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make significant judgments and estimates to develop amounts reflected and disclosed in the financial statements. Like many companies, we maintain a thorough process to review the application of our accounting policies and to evaluate the appropriateness of the many estimates that are required to prepare the financial statements of a complex, global corporation. In our judgment, the sections of the financial statements and MD&A covering critical accounting policies and estimates are fully informative for most public companies. If a company falls short of the transparency required under the disclosure standards outlined by the FASB and the SEC in its audited financial statements, then the auditor has the duty to communicate that to the company's audit committee and if necessary, issue a qualified opinion on the financial statements, which will carry significantly more weight to investors than lengthy, duplicative statements on critical accounting matters.

Finally, with respect to the discussion of critical audit matters in the auditor's report, we believe that inherent in the PCAOB's proposal is a presumption that critical accounting matters have a bias towards being areas that are "questionable." However, in many cases these matters are simply complex accounting areas. As a result, a lengthy list provided by an auditor could be viewed externally as an indicator of a poorly run company or risky investment. The proposal has no balance in this regard and at a minimum, should this proposal move forward, the auditor should also be required to highlight areas of preferred accounting, strong internal controls and best practices. Further, the proposal could have the unintended, and in our view, unfortunate effect of discouraging the candid discussion of accounting matters between issuers and auditors due to concerns that such discussions would be referenced in the auditor's report.

**Auditor's Responsibilities Regarding Other Information**

Under current PCAOB standards, the auditor has a responsibility to read and "consider" other information in certain documents that also contain the audited financial statements and the related auditor's report. We believe that the language in the proposal to require "evaluation" rather than "consideration" of the other information is unclear and could be very difficult to effectively operationalize and objectively regulate. Including an evaluation requirement would likely increase the scope of the auditor's responsibility, require the development of new auditing standards and require additional regulatory efforts. The performance of additional procedures to meet an evaluation standard rather than the current standard (consideration of whether information is materially consistent with the audited financial statements) will result in audit costs increasing (potentially materially), which would need to be weighed against potential benefits to financial statement users. The PCAOB should be conducting outreach to various constituents to assess the cost/benefit of this aspect of the proposal. We do not feel a written evaluation in the auditor's report will add value to the consideration already given to the other information based on relevant audit evidence obtained and conclusions reached during the audit. At a minimum, the intent of the proposal needs to be clarified by the PCAOB. Should the evaluation criteria be retained, we believe that the PCAOB needs to provide the audit firms with objective standards to meet the evaluation standard.

The PCAOB's inspection activities in recent years have identified numerous findings with respect to issuer audits, particularly with respect to the audit of internal control over financial reporting. Audit firms respond to these inspection findings by increasing their procedures and audit effort which directly impacts public companies and their internal control processes. As a result, the PCAOB has made public companies part of its constituency. We strongly urge the PCAOB to formally bring the views of public companies fully into the deliberation process on how this proposal moves forward.

We appreciate the opportunity to comment on these proposed changes and thank you for your consideration of our comments. If you have any questions, please contact Bert Nappier at 901-818-7068.

Sincerely,

John L Merino

John L. Merino
Corporate Vice President
and Principal Accounting Officer

Herbert C. Nappier
Staff Vice President and
Corporate Controller

financial executives international

December 11, 2013

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

Subject: PCAOB Rulemaking Docket Matter No. 34

Submitted via comments@pcaobus.org

Members of the PCAOB:

The Committee on Corporate Reporting ("CCR") of Financial Executives International ("FEI") appreciates the opportunity to share its views on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2013-005, *The Auditor's Report on an Audit of Financial Statements when the Auditor expresses an unqualified opinion; The Auditor's Responsibilities regarding other information in certain document's containing audited financial statements and the related auditor's report* (collectively "the Release"). FEI is a leading international organization of senior-level financial executives. CCR is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. This document represents the views of CCR and not necessarily the views of FEI or its members individually.

Before discussing the current Release, CCR wishes to acknowledge the Board's decision not to pursue imposing a requirement for Auditor Discussion and Analysis (AD&A) contemplated in the 2011 Concept Release. For reasons outlined in our letter dated September 30, 2011, we believe that this was the appropriate action for the Board to take and sincerely appreciate the Board's consideration of the views expressed by CCR and others on this matter.

**CCR's Position on the Release**

CCR understands that the Board's underlying objective in proposing these changes is to enhance the informational value, usefulness and relevance of the auditor's report. CCR has significant concerns as to whether certain of the proposed requirements will accomplish that objective. We therefore believe it is imperative that the Board perform its own due diligence to examine the potential consequences of these requirements on the financial reporting process, auditor behavior, and communications amongst auditors, management and audit committees. We are concerned that the new procedures necessary to comply with the proposed requirements have the potential to be a significant distraction from the primary focus on the audit and consume valuable time and resources during the most critical phases. We believe that the Board needs to re-evaluate the scope and associated costs of the proposed rule, taking into consideration the effect on disclosure overload and other potential unintended consequences. Given these concerns, CCR is unable to support the requirements in the Release as proposed. In our comments below, we have made a number of recommendations which we believe would address these concerns.

CCR believes that the Board should ensure that the final standard will not alter or dilute the fundamental roles and responsibilities of management, auditors and the Audit Committee. We therefore concur with the Board's decision to retain the existing pass/fail model as we believe that this provides the clarity and accountability that investor's desire. We also believe that the current option for auditors to include an emphasis paragraph in the opinion, where appropriate, should be preserved.

**Field Testing by the PCAOB**

Before providing our views on the specific proposals, we wish to emphasize the value of robust and thorough due process in producing a high quality standard. We acknowledge and appreciate the steps the Board has already taken to solicit views from industry and the audit profession and welcome the opportunity to participate in the roundtables planned for the first half of 2014. However, we believe that with a proposal of this nature additional steps are essential to gain an understanding of the practical implications and effects on the audit processes prior to moving forward with these proposed requirements.

CCR believes that a comprehensive field test is the most effective way to address these questions and concerns. We believe it will be useful and insightful for the Board and Staff to determine whether the proposal will produce the information investors are seeking at an acceptable cost to preparers and auditors. We also believe that this work will provide the Board with the opportunity to study the impact that this proposal would have on the audit process to ensure the additional work does not unintentionally adversely affect audit quality.

It is the responsibility of the PCAOB to evaluate the benefits and costs of its proposals. CCR believes that, by playing a leading role in the conduct of a field test, the Board would gain valuable insights into the usefulness of the resulting disclosure and the likely costs (including those related to unintended consequences) of these requirements. It is possible that many of the issues that arose in the application of Auditing Standard (AS) 2 - *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* could have been avoided had there been some form of field testing performed prior to issuance of the final standard. While we are aware that the major audit firms have undertaken some informal work on their own to assess the effect of the proposal, we also understand the scope of this work is limited and unlikely to serve as an effective substitute for formal field testing conducted by the Board. CCR, therefore, believes that the Board should directly undertake this work as part of its due process.

**Critical Audit Matters**

We do not agree with the PCAOB's proposal for auditors to provide disclosures of Critical Audit Matters ("CAMs"). While CCR agrees that there is an opportunity to make targeted improvements in the auditor's reporting model, we do not believe reporting of CAMs will make the audit report more informative.

Based on our reading of the proposal, it appears that one of the desired outcomes of the proposed rule would be to provide investors with additional insights into how an auditor has dealt with the complex and difficult issues that normally arise during the process and are highlighted by management in the financial statements. To the extent the information provided by management is not sufficient to enable investors to adequately understand the underlying financial statements; we believe any perceived shortcomings are better addressed by improved footnote or management discussion and analysis. Accordingly, improvements in this area are better addressed by the FASB or the SEC. As it is implicit in an unqualified opinion that an auditor is satisfied with the reasonableness of such matters, we do not believe that the proposed information regarding steps the auditor took in reaching that conclusion, will provide information value in excess of the associated incremental costs.

The Board defines CAMs as the audit matters that involved the most difficult, subjective, or complex auditor judgments; posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and posed the most difficulty to the auditor in forming an opinion on the financial statements. The sources for CAMs include engagement completion documents, items reviewed by the engagement quality reviewer, and information communicated to the audit committee. In practice, we would expect the proposed documentation requirements for CAMs could draw upon any matters from these sources. If the auditor determines certain items should be excluded, he or she would need to document why these items were not CAMs. We expect that these judgments, like others of similar importance made during the audit, would be subject to close scrutiny by PCAOB inspectors. Accordingly, it is reasonable to assume that auditors will err on the side of being more inclusive, producing lengthy audit reports that include many CAMs.

CCR is concerned that such reports will give undue prominence to items of lesser importance that were ultimately deemed immaterial or resolved satisfactorily during the course of the audit. We also are concerned that these items may become “boilerplate” in nature due to their normal occurrence and the prevalence of accounting standards that require the use of judgment and/or significant estimates. We also believe that inclusion of CAMs could create the impression of a fragmented audit that provides differing levels of assurance on specific areas. Furthermore, if the information in the CAM disclosure is misinterpreted and leads to questions from the investment community, there is no obvious mechanism for the auditor to respond to them. This would put the issuer in the untenable position of feeling compelled to explain or speculate, after the fact, on what the auditor meant while adhering to the requirements in Regulation FD.

CCR observes that extensive information related to matters that may qualify as CAMs is already available in existing disclosures (e.g., critical accounting policies, significant estimates, business and operating trends, as well as financial and operating risks). Given the volume and complexity of the existing disclosure regime, and considering the concern investors have expressed regarding disclosure overload, we believe it is reasonable to expect that they may have difficulty in evaluating and assimilating this new information with other information provided by management.

CCR agrees with the Board that management should be the original source of information in external financial reports. In addition to the redundancy concerns expressed above, we observe that the Release provides examples which appear to suggest that disclosure will be compelled of certain additional information that is not currently being disclosed under existing requirements. For example, the implementation guidance appears to suggest that significant deficiencies and immaterial uncorrected errors meet the definition of a CAM. We ask the Board to more fully consider the implications and practical consequences of that conclusion. In addition to violating the principle that management should be the original source information, such a requirement would result in further complications related to the limited auditor involvement in interim filings. Specifically, the Board should consider the implications of occurrence of such items in interim filings and what management would be expected to do with them in annual financial statements. Given that such items are immaterial to the respective interim filings and absence of a requirement to report them, we would not expect management to change its practices regarding disclosure. However, the inclusion of these as CAMs would put management in the position of feeling compelled to make such disclosures. If they choose not to and such items are included in the Auditor's Report, the principle that the auditor should not be the original source of information about the company would be violated. This is just one example of the type of unintended consequence that could result from this proposal.

If after considering the results of its due process and field testing, the Board decides to retain the concept of CAMs, CCR believes that the final standard should adhere to the following principles:

- *Auditors must not be the original source of information.* The examples in the proposal provide extensive information well beyond the level of detail that management would normally be expected to provide in notes to financial statements or in MD&A. The examples are inconsistent with the principle of management being the original source of information.

- *CAMs must be material to the audit of the financial statements.* If the company is not otherwise required to include a particular disclosure in accordance with generally accepted accounting principles, regulation or legislation, the requirements for CAMs should not compel disclosure by the auditor.

- *CAMs should not be a source for highly sensitive, prejudicial information (e.g. litigation)*

- *CAMs identified should only include those communicated to the Audit Committee in accordance with PCAOB Standards (including AS 16) that provides additional investor insight into the audit.*

- *The audit report should not describe the audit procedures related to CAMs* (We believe the examples in the Release are unclear and could lead audit firms to believe that such disclosures are required).

- *Auditors should not be required to separately document why audit matters are not considered to be CAMs.*

**Other Information Outside the Financial Statements**

As part of the proposed disclosures in the auditor's report, CCR agrees that clarification of the auditor's association with other information included in the filing would be helpful and informative. CCR understands from speeches made by members of the Board that this was not intended to introduce a dramatic change from existing requirements with regard to role of the auditor in reviewing such information or the level of assurance provided. However, we believe that the change in terminology from *consider* to *evaluate* could, in practice, lead to significant additional work. We therefore believe that that the Board should not change the terminology and should not expand the scope of information to be considered as relevant other information.

CCR observes that the term *evaluate* is used in other parts of the auditing literature with a specific meaning that potentially broadens the obligations of the auditor beyond what is performed in practice today by audit firms at leading reporting companies. For example, the following excerpt from AS 17 appears to imply a more expansive scope and elevated responsibility for the term *evaluate*:

> The proposed standard included a requirement for the auditor to evaluate whether the supplemental information, including its form and content, is fairly stated, in all material respects, in relation to the financial statements as a whole, including whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria. The evaluation should encompass, among other things, whether the information: is complete and accurate, is consistent with the audited financial statements, and complies with relevant regulatory requirements, if applicable.

CCR believes that this level of assurance is different and higher than what is provided today under the requirement to read and consider. We are concerned this level of assurance will, of necessity, expand the scope of audit work performed and potentially lead to many challenging situations for the auditor, particularly with regard to qualitative statements and non-financial information. For example, we do not believe that auditors regularly collect data related to non-financial performance metrics and may, therefore, need to expand their audit scope and procedures to fulfill their obligations related to evaluating this information.

CCR observes that SEC regulations already require CEO and CFO certifications of disclosures that are required in the annual and quarterly reports, as well as the establishment of disclosure controls. Further the NYSE and NASDAQ listing rules require independent audit committee supervision of annual and quarterly reports. Those procedures are generally viewed as rigorous and effective. We, therefore, believe that investors can reasonably expect that non-financial information has been verified by the company, its disclosure committee, and audit committee and subjected to a certification process by management. Accordingly, we see little benefit to requiring the auditors to do more than what is already required to be performed under existing standards.

As stated above, CCR believes it would be helpful to investors to clarify the auditor's role related to "other information" in the audit report. We would therefore support a statement that clearly defines the types of information considered, a clear statement that the auditor has not audited and expresses no opinion on such information and a clearer explanation of actual procedures undertaken with respect to the information outside the audited financial statements. Such a statement might read as follows: "On the basis of relevant audit evidence obtained and conclusions reached during the audit, we have read and considered the other financial information contained in pages X to Y filed with the SEC. We did not audit the other information and do not express an opinion on the other information. Based on the work performed, we have not identified a material inconsistency or material misstatement of fact in that information."

CCR agrees with the Board's view that auditors should not be required to obtain additional audit evidence regarding other information that was not required to be obtained during the audit. With respect to the scope of the other information standard, CCR agrees that XBRL exhibits should be excluded but disagrees on the inclusion of information incorporated by reference contained within the Company's definitive proxy statement. Such information often is not available to the auditor until after the issuance of the audit report. We believe that the auditor's responsibility should be limited to information available prior to issuance of the audit report.

**Clarification of the Standard Auditor's Report**

The Release proposes to add new elements to the auditor's report related to auditor independence, auditor tenure, and enhancements to certain standardized language in the auditor's report (including the addition of the phrase "whether due to error or fraud").

CCR is generally in support of adding clarifying language to the existing standard auditor's report provided that it enhances investors' understanding of the scope, process and limitations of the audit process. We do not believe information related to the tenure of the auditor contributes to this understanding and is more suitably placed in the proxy statement, as it is more directly relevant to investor decisions on whether the independent auditor should be reappointed.

**Concluding Remarks**

CCR believes that the proposals in the Release have the potential to produce profound changes in the conduct and effectiveness of the audit. We believe that it is imperative for the Board to undertake its own due diligence to understand the implications of the requirements and to evaluate whether or not the proposal will yield the desired information at an acceptable cost and without adversely affecting audit quality. We are concerned that the Board will not be able to gather the necessary information solely from the planned elements of its existing due process steps. We therefore urge the Board to undertake a field test of this proposal and evaluate the results before proceeding to a final standard. Only then do we believe that there will be sufficient clarity regarding the efficacy of the resulting disclosures and the time, costs and resources that will be consumed by preparers, auditors and Audit Committees.

We appreciate the Board's consideration of these matters and welcome the opportunity to discuss any and all related matters. If you have questions, please contact Lorraine Malonza at (973) 765-1047 or lmalonza@financialexecutives.org.

Sincerely,

Stephen J. Cosgrove
Chairman, Committee on Corporate Reporting
Financial Executives International

cc: Martin Baumann, PCAOB Chief Auditor
Paul Beswick, SEC Chief Accountant
Brian Croteau, SEC Deputy Chief Accountant

| | |
|---|---|
| **From:** | Liz Collins |
| **To:** | Comments |
| **Subject:** | PCAOB Docket 034 |
| **Date:** | Wednesday, December 11, 2013 6:38:28 PM |
| **Attachments:** | image001.png |

I support Lisa Roth's position.

Liz Collins- V.P. Operations

Financial Telesis Inc.

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Financial Telesis

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***K Jon Taylor***
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*and Chief Accounting Officer*

*330-384-5296*
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December 11, 2013

Ms. Phoebe W. Brown, Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Sent via email: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

FirstEnergy Corp. appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board (PCAOB or the Board) on its proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (Proposal).

FirstEnergy is a diversified energy company in the United States with approximately $50 billion of assets, $15 billion in annual revenues, and $14 billion in market capitalization. Our subsidiaries and affiliates are involved in the generation, transmission and distribution of electricity, as well as energy management and other energy-related services. Our 10 electric utility operating companies comprise one of the nation's largest investor-owned electric systems, serving approximately 6 million customers within 65,000 square miles of Ohio, Pennsylvania, West Virginia, Maryland, New York and New Jersey. Our regulated and unregulated subsidiaries control approximately 18,500 megawatts of capacity.

We support the PCAOB's efforts to continue to explore avenues to increase the usefulness of the auditor's report and are pleased that the Board's proposal retains the pass/fail model. We believe this model clearly articulates the auditor's opinion on the fair presentation of the financial statements and is well understood by the investing community. However, we do not support the inclusion of critical audit matters (CAMs) in the auditor's report.

The Proposal defines CAMs as those matters the auditor addressed during the audit of the financial statements that:

(1) involved the most difficult, subjective, or complex auditor judgments;
(2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
(3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

Our primary concern is that CAMs contained in the auditor's report will alter the auditor's opinion in the eyes of investors. Although the Proposal states that "the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements taken as a whole", we are concerned that investors may question unqualified opinions nonetheless. Those of us who have been auditors understand that the responsibility in an audit engagement is to plan and perform the audit to obtain reasonable assurance that the financial statements, taken as a whole, are fairly presented in all material respects. Furthermore, we understand that the nature of an audit engagement often requires auditors to make judgments that are difficult, subjective or complex. For investors unfamiliar with the auditing profession, these challenges may be perceived as unique and unusual when in-fact, they are common and routine.

The Proposal discusses three elements that would be communicated in the auditor's report relative to issues identified as CAMs. These elements are:

(1) Identify the CAM
(2) Describe the considerations that led the auditor to determine that the matter is a CAM, and
(3) Refer to the relevant financial statement accounts and disclosures that relate to the CAM, when applicable.

Of the three, the second element is the most troubling. Page A5-36 of the Proposal describes the second element, in-part, as follows: "To enhance investors' and other financial statement users' understanding of the audit, the proposed auditor reporting standard would require the auditor to describe the considerations that led the auditor to determine that the matter is a critical audit matter. The description of considerations that led the auditor to determine a matter is a critical audit matter may be derived from one or more of the factors; however, the auditor would not be limited to the factors listed in the proposed auditor reporting standard, which also could include other factors specific to the audit. Additionally, the auditor's description should be specific to the circumstances. Further, when communicating critical audit matters in the auditor's report, the proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so." The description of the matter and the determination of the matter as a CAM are based on the training, expertise and experience of auditors. Investors would need to determine how the auditor's procedures (if provided) and the auditor's determination of the identified CAM affect their analysis and ultimately, their investment decision. For investors with little or no auditing background, this information will not provide additional, useful insight for making those investment decisions.

We also reviewed the illustrative examples of CAMs provided by the Board on pages A5-65-78. During the review, we noted that in all three examples, the auditor's report states "the critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole." In each of the examples, the auditor's report communicates the challenges the auditor encountered during the engagement including difficult and subjective judgments, difficulty in obtaining audit evidence, difficulty in designing audit procedures and the involvement of in-house and other third-party experts. What is absent from each of the example reports is an explanation of how the auditor resolved these challenges in order to issue an unqualified audit opinion. On the one hand, each report communicates that the CAM does not alter the opinion of the auditor, taken as a whole. On the other, the auditor is required to disclose challenges in issuing an unqualified opinion with no reconciliation between the challenges and the final opinion. We find it difficult to understand how investors with no real understanding of the auditing profession will glean useful information from such a contradictory report. Instead of providing useful information, we believe reporting CAMs in the auditor's report will likely lead to further confusion by investors around the quality of the financial statements, no matter the type of opinion issued by the auditor.

In addition, we are concerned about the number of matters that may be identified as CAMs and the additional time, effort and cost that will be borne by companies. The Proposal identifies the source of potential CAMs as being:

(1) items documented in the engagement completion document;
(2) items reviewed by the engagement quality reviewer
(3) items communicated to the audit committee or,
(4) any combination of the three.

The Proposal states that "the Board would not expect that each matter included in any one or more of these sources would be a critical audit matter." We believe auditors would deem many of the items identified during the audit and noted above as CAMs in order to protect themselves from the scrutiny of PCAOB inspections. This will result in additional effort by the auditors and increased costs for companies while providing no additional benefit to readers of financial statements. Furthermore, the number of CAMs identified and included in auditor reports under this proposal could increase for all companies when new accounting standards are initially adopted and implemented. New accounting standards inevitably challenge audit teams requiring communication to the audit committee, consultation with national office personnel and other experts. Will investors be well-served by auditor reports communicating the challenges experienced during the adoption and implementation of the proposed lease and revenue recognition standards by the significant number of companies that will be affected by these standards? In our opinion, the answer is no.

Furthermore, given the level of judgment and subjectivity involved in identifying a CAM, we acknowledge, consistent with the Board's acknowledgement, that companies in the same industry with a similar risk profile could result in differences in the type and number of CAMs reported in the auditor's report. We are concerned by this lack of comparability and believe that similar audit matters between two different companies and two different audit firms could, and will likely, result in different conclusions surrounding the identification and reporting of certain matters as CAM. This lack of comparability and consistent reporting of CAMs will most likely inadvertently bias the decision of an investor, when in fact, the differences in the CAM reported in the auditor's report is not representative of the different risk involved.

Again, we are pleased that the Board's proposed auditing standard retains the pass/fail model but do not support the inclusion of CAMs in the auditor's report. In our opinion, providing this information will increase the size of already voluminous financial reports while providing no additional useful information to investors.

Thank you for the opportunity to express our opinion on the Proposal. Please feel free to contact me if you have any questions or need further clarification regarding our response.

Sincerely,

**From:** Fitzgibbon, Brian
**To:** Comments
**Subject:** DOCKET 034
**Date:** Wednesday, December 11, 2013 1:25:35 PM

FITZGIBBON TOIGO & CO. LLC as a Broker/Dealer supports Lisa Roth's sensible position. Our Broker/Dealer is a placement agent, third party marketing firm that does not hold securities or handle customer money or accounts. We are not a public company and should be exempt from audits. These audits are expensive with no purpose. If the audits are to protect the interests of investors, they serve no intent other than as a auditor employment protection rule. I would hope that the PCAOB has a firm enough grasp of the placement business to see the folly of this rule.

FICPA
Florida Institute of Certified Public Accountants

October 18, 2013

Office of the Secretary
Public Company Accounting
Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, DC 20006-2803

Electronically submitted: comments@pcaobus.org

Re: PCAOB Release No. 2013-005 The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;
PCAOB Rulemaking Document No. 034 The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards

Dear Sirs:

The Accounting Principles and Auditing Standards Committee (the Committee) of the Florida Institute of Certified Public Accountants (FICPA) respectfully submits its comments on the referenced proposal. The Committee is a technical committee of the FICPA, which has approximately 18,500 members comprised primarily of CPAs in Public Practice and Industry. The Committee is comprised of 20 members, of whom 50% are from local or regional firms, 20% are from large multi-office firms, 10% are sole practitioners, 10% are in academia or private industry, and 10% are in international firms. Therefore we are addressing this exposure draft both from the viewpoint of preparers of financial statements as well as those performing attest services on them.

The Committee has reviewed and discussed the above referenced proposed auditing standards and the questions included in Appendix 5 of the proposed auditor reporting standard. The Committee concluded that it is in agreement with the reporting requirements as they relate to independence, with some clarification as noted in our response to question 4 below. However, there is a general disagreement with the auditor tenure reporting requirements and with the expanded disclosure requirements for critical audit matters. Our comments regarding these requirements are contained in our responses to questions 5 – 13 below. Questions 15 – 28 of Appendix 5 requested comments on more specific areas of the critical audit matters disclosure requirements. As the Committee strongly disagreed with inclusion of critical audit matters in the auditor's report, the Committee did not provide responses to those questions in this letter.

Finally, there was general agreement with the reporting requirements contained in the proposed other information standard, which we noted was in conformity with existing reporting standards for non-SEC reporting entities. Accordingly, the Committee has not provided responses to questions in Appendix 6.

1. The Committee believes the objectives in paragraph 4 of the proposed auditor reporting standard are clearly communicated in understanding the reporting requirements of an auditor's unqualified report.
2. The Committee is in agreement that the auditor's report should be addressed to at least (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body, and believes there should be others to whom the auditor's report is required to be addressed, depending upon the circumstances.
3. The Committee is in agreement and believes the auditor responsibilities outlined in paragraph 6 of the proposed auditor reporting standard are sufficient.
4. The Committee agrees that the proposed statement regarding independence as identified in Paragraph 6.h. of the proposed auditing standard will provide useful information, but believes that consideration should also be given to disclosing rules and regulations of other state regulatory bodies that have independence standards to which registered firms must comply. Absence of this reference might cause the audit firm to infer that the other rules and regulations would not apply in a PCAOB audit.
5. a) Although the information might be useful to users, the Committee finds it difficult to find what public interest is served through the inclusion of auditor tenure given the negative connotation of auditor tenure that the Board acknowledges in its commentary and footnote disclosures in the proposed auditor reporting standard. **Therefore, the Committee strongly disagrees with inclusion of auditor tenure in the auditor's report**, **as it believes that the tenure disclosure would dilute the independence disclosure already included in the auditor's report. The Committee believes this information is best reported in the other information accompanying the financial statements, such as the section on auditor fees in Series 10 SEC filings.**
   b) The proposed auditor reporting standard adequately addresses the reporting requirement regarding the year the auditor began serving as the company's auditor with the example paragraph provided in Appendix 5, Section IV.
   c) Inclusion of auditor tenure in the auditor's report as well as other information accompanying the financial statements would have only unintended negative consequences given the emphasis provided to the auditor's report in the SEC filing and the negative inferences on long-term auditor relationships.
6. The Committee agrees the proposed description regarding the auditor's responsibilities for other information would be informative and useful but believes that a specific description of the items covered is warranted. The Committee believes that some clarifying language should be added in the report and reporting guidance that there are no assurances as to the completeness and presentation of the exhibits and items incorporated by reference in an SEC filing.
7. The Committee believes a specific order for the presentation of basic elements in the auditor's report be required for consistency purposes. The ordering of the report implies order of importance. Allowing discretion here could cause inconsistency and allow the audit firm to "color" its opinion accordingly.
8. The Committee believes no other changes to the basic elements required in the auditor's report are necessary as it is consistent with existing reporting standards for non-SEC reporting companies.

9. The Committee believes outside of determination of tenure, which could cause some additional time and effort, the basic elements should not add more cost.
10. The Committee concurs that the communication of critical audit matters may be relevant and useful to users. However, there are negative factors that override the relevancy and usefulness of this information, such as potential liability issues regarding the content of the critical audit matters section of the auditor's report. **For these reasons, the Committee strongly disagrees with the inclusion of critical audit matters as other information to be included in the auditor's report.** The Committee considered one alternative to include the letter to those charged with governance required under AS 16 as an exhibit to the public filing, as an alternative to inclusion of critical audit matters in the auditor's report.
11. The Committee believes unintended consequences exist in the form of potential liability issues regarding the subjective analysis of inclusion or non-inclusion of content in the critical audit matters section of the auditor's report.
12. The Committee believes the definition of a critical audit matter is sufficient and clear as to what is considered a critical audit matter.
13. The Committee believes from a practical perspective, the additional time incurred regarding critical audit matters should improve the quality of the documentation supporting the disclosure. However in practice the Committee believes additional pressure would exist from management to dictate the content of the section.

The Committee appreciates this opportunity to respond to the proposed auditing standards. Members of the Committee are available to discuss any questions or concerns raised by this response.

Respectfully submitted,

Steven Morrison CPA, Chair
FICPA Accounting Principles and Auditing Standards Committee

Committee members coordinating this response:

Robert P. Bedwell, CPA
Donald K. Hulslander, CPA

FMR Co.
Office of the Fund Treasurer

Mail: 245 Summer Street V10F
Boston MA 02210
Phone: 617-563-7000

Fidelity INVESTMENTS

December 11, 2013

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

RE: **PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2013-005; Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards**

Ladies and Gentlemen:

FMR LLC, commonly known as Fidelity Investments ("Fidelity"),[1] appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board ("PCAOB") with respect to its Proposed Auditing Standards on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposed Auditor Reporting Standard"); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards* (the "Other Information Standard") collectively the "Proposed Standards".[2, 3, 4] Our comments reflect the views of a diversified financial services company and address the application of the Proposed Standards on open-end investment companies ("mutual funds") registered under the Investment Company Act of 1940 ("'40 Act"), clearing and introducing broker-dealers ("broker-dealers") registered with the U.S. Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934 ("'34 Act"), as well as insurance

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[1]Fidelity is one of the world's largest providers of financial services. Fidelity provides investment management, retirement planning, portfolio guidance, brokerage, benefits outsourcing and many other financial products and services to more than 20 million individuals and institutions, as well as through 5,000 financial intermediary firms.

[2]*See* The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor Report; and Related Amendments to PCAOB Standards. PCAOB Release No. 2013-005 (August 13, 2013). *Available at*: http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf

[3]Fidelity previously commented on the PCAOB's Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to the PCAOB Standards. PCAOB Release No. 2011-003 (June 21, 2011). *Available at*: http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf
Fidelity comment letter *available at*: http://pcaobus.org/Rules/Rulemaking/Docket034/109.pdf

[4]Fidelity generally agrees with the comments submitted by the Investment Company Institute and Independent Directors Council on the Proposed Standards and offers the following comments to supplement that letter on specific issues.

entities required to file financial information with the SEC under both the '40 Act and the Securities Exchange Act of 1933 ("'33 Act").

**Overview:**

Fidelity believes that any changes to the Independent Auditor's Report issued by a Registered Public Accounting Firm (Auditor's Report) associated with a public company's financial statements should be guided by the principle that the opinion must provide a clear, concise and unambiguous message regarding the scope of the audit, the responsibility of the auditor and their conclusion reached in order to ensure the continued confidence of investors. We support changes to the Auditor's Report that clarify the scope of the audit, will not create confusion about the opinion rendered by the auditor, and avoid redundancy of disclosures already included in the financial statements that are evaluated by the auditor, such as significant judgments, estimates and assumptions. Any changes should also balance the benefit of such changes with their potential costs including impacts to audit fees, time spent by management and the audit committee to consider auditor communications and also on the ability of companies to meet financial statement regulatory filing deadlines.

We offer the following suggestions that we believe will further enhance the Proposed Standards:

- Critical Audit Matters should not be included in the Auditor's Report. These disclosures may confuse investors and financial statements users with respect to the roles of the auditor, management and the audit committee, who has ultimate responsibility to oversee the audits and select the auditor for investment companies, broker-dealers and insurance separate accounts.

- Auditor Tenure should not be included in the Auditor's Report. While there is no clear link between tenure and audit quality, we believe users of financial statements may view this information as an indicator of audit quality, and place less confidence in the opinion rendered by the auditor; and

- The PCAOB should limit the scope of audit procedures around Other Information to items related to the financial statement audit and maintain the current requirement to "read and consider" such information.

Each of these items is discussed in detail below.

<u>Critical Audit Matters</u>

The Proposed Auditor Reporting Standard would retain the existing "pass/fail" model and other basic elements of the current Auditor's Report. To make the Auditor's Report "more informative, thus increasing its relevance and usefulness to investors and other financial statement users", the Proposed Auditor Reporting Standard would also require auditors to provide additional information, such as "Critical Audit Matters" to investors and other users of the financial statements in the Auditor's Report. Critical

Audit Matters include those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence for forming an opinion on the financial statements. In addition to identifying each Critical Audit Matter, the auditor must also describe the considerations that led the auditor to classify the matter as a Critical Audit Matter and when applicable, cross-reference the relevant financial statement accounts and disclosures in the notes to the financial statements that refer to the Critical Audit Matter.

*Disclosure of Critical Audit Matters will confuse investors and other of financial statements s and may erode their confidence to invest*

We recommend that the PCAOB not adopt the proposed disclosure of Critical Audit Matters because we are concerned that shareholders of registered investment companies, separate accounts and customers of broker-dealers would be unsure of how to incorporate this information into their investment decision making. Today, there is an existing regulatory infrastructure supporting shareholders' interests that charges audit committees of boards of directors to select the auditor of the companies for which they serve, oversee the audits and ensure that financial statement audit issues are appropriately resolved. This existing infrastructure provides investors and other users of the financial statements with confidence in the integrity of investment products offered in the United States. We believe that communication of Critical Audit Matters will confuse investors and other users of the financial statements about how to respond to these disclosures and may erode their confidence, given the reliance they place on audit committees and boards to look out for their best interests.

If investors and other users of the financial statements were left to interpret Critical Audit Matters disclosures on their own, we believe this information will likely create confusion and introduce ambiguity concerning the auditor's opinion on the financial statements. Investors and other users of the financial statements may likely misinterpret the communication of a Critical Audit Matter, including considerations made by the auditor to arrive at a Critical Audit Matter, as an indication of a qualification of the Auditor's Report, therefore weakening the unqualified opinion. To avoid ambiguity, this information would need to be accompanied by a description of the procedures performed by the auditor that enabled the auditor to gain comfort with, and ultimately arrive at an unqualified opinion. However, the shear volume of additional disclosure that may be needed to achieve this goal would conflict with our recommended guiding principle noted above.

*Critical Audit Matters communications will increase fund audit fees and place pressure on regulatory deadlines*

Communication between an auditor and an audit committee is an essential and required aspect of an effective and efficient audit. We do not anticipate additional costs to identify Critical Audit Matters, as this activity would occur during the normal course of audit procedures. However, we believe the auditors will incur additional cost to develop and review their opinion and communicate the details of their report to management and the audit committee. We believe that these incremental costs will be borne by the shareholders that are already benefitting from the ongoing governance and oversight of the audit committee, among other entities, in place to protect their interests.[5]

*Critical Audit Matters will duplicate management disclosures*

We are concerned that auditor communications of Critical Audit Matters would be duplicative of information already provided to investors and other users of the financial statements. Existing disclosures either within the financial statements or other documents required by the SEC or other regulatory bodies already provide sufficient information related to matters that may qualify as Critical Audit Matters. These matters include the disclosure of critical accounting policies, significant estimates, business and operating trends (such as is with the prospectus or Computation of Net Capital pursuant to Rule 15c3-1 and the Computation for Determination of Reserve Requirements, pursuant to Rule 15c3-3 under the '34 Act), as well as other financial and operating risks. Fidelity believes those targeted risks for investment companies, broker-dealers and insurance entities are extensively disclosed within an existing reporting framework. Providing Critical Audit Matters will likely be repetitive of information already provided by management and not provide incremental benefit to investors and other users of the financial statements.

Other Clarifying Language within the Auditor's Report

Fidelity supports the new information requirements in the Proposed Auditor Reporting Standard that help clarify for investors and other users of the financial statements what an audit represents, as well as an auditor's responsibilities. We believe that including information in the Auditor's Report such as the auditor's responsibility for the financial statements, including the related notes and schedules (if applicable) and the description of the nature of an audit, will help clarify which components of the financial statements have been audited by the independent registered public accounting firm. We also believe that it is important to highlight the auditor's responsibility for fraud resulting in material misstatements to the financial statements and the auditor's independence. All of these proposed changes should bring value to the Auditor's Reports at minimal cost.

Auditor Tenure Information

Fidelity objects to including a statement expressing auditor tenure in the Auditor's Report. We believe that users of financial statements may place undue emphasis on this data point as a positive or negative indicator of audit quality, despite the fact research studies draw contradictory conclusions on the impact of an auditor's tenure on audit quality. If the PCAOB ultimately concludes that a statement expressing auditor tenure should be included in the Auditor's Report, we are concerned that this information for mutual funds in a mutual fund complex may not provide an accurate representation of

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[5]Fidelity believes that disclosure of Critical Audit Matters may ultimately impact the frequency of currently established audit committee communications under CFR 210.2-07, facilitating quarterly communication between the auditors and audit committee of investment companies.

tenure. Mutual fund auditors are typically hired to audit all funds or a subset of funds advised by a particular manager. Under the current proposal, disclosing audit tenure for a newly commenced fund may not accurately address the auditors' overall tenure with the mutual fund complex, which may exceed the period listed within the Auditor's Report.

Operational Challenges

Fidelity urges the PCAOB to consider the significant operational challenges associated with adding Critical Audit Matters and auditor tenure information to the Auditor's Report. These challenges are particularly acute for mutual fund advisers who may have hundreds of mutual funds under management and dozens with the same period end reporting requirements. It is also common practice within the mutual fund industry, to present multiple mutual funds within a single financial statement book, to which the auditor's opine in a single Auditor's Report. If mutual funds are required to include different audit tenures and critical audit matters for each fund individually, the length of the Auditor's Report will expand superfluously. Moreover, we believe that investors and other users of the financial statements will be confused as to how to interpret multiple auditor tenure dates within the same fund family. If implemented, Fidelity asks the PCAOB to clarify the application of this proposal to specific mutual fund topics, including those noted above.

**Proposed Other Information Standard**

The PCAOB's Other Information Standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to other information contained in a reporting entities annual filing, other than the audited financial statements and the related auditor's opinion.

Fidelity recommends that the PCAOB further consider the scope of procedures to be performed under this standard and suggest, in the case of mutual funds, that this information be limited to Management's Discussion of Fund Performance ("MDFP"), Shareholder Expense Example and Performance reporting. This approach will limit the auditor's review to information that is governed by SEC guidance,[6] is derived from information included in the financial statements, and is objective, verifiable and absent subjective or forward-looking statements.

Fidelity further encourages the PCAOB to exclude from their final Other Information Standard any exhibits filed that contain non-financial information, which in the case of a mutual fund's N-CSR includes the fund adviser's Code of Ethics, advisory contracts, presentation of non-audit services, and trustees and directors information, including any applicable information incorporated by reference. These documents while contributing minimal financial information, may be lengthy or potentially superseded by information updated subsequent to the audit period and will require a substantial use of auditor resources to review. Fidelity does not believe that additional audit procedures

[6]Item 27(b)(7) of Form N-1A

performed on this information will be useful to investors and other users of the financial statements in their review of financial statements and this additional review and work will substantially increase audit costs to fund shareholders.

*Challenges to executing procedures within the Other Information Standard*

Fidelity does not support the requirement to use the term "should evaluate" when defining procedures auditors are required to perform on "other information". This term replaces the existing terms codified in AU sec. 550 of "should consider". The PCAOB explains, within its discussion of the Other Information Standard, that the words "should evaluate" are used in PCAOB standards when the auditor is expected to come to a conclusion based on the performance of certain procedures. The proposal is also clear in its requirement that auditors identify material inconsistencies and material misstatements of fact based on relevant evidence obtained and conclusions reached during the audit. We are concerned with the auditor's ability to effectively meet the requirement to "conclude through evaluation" while adhering to language within the same PCAOB proposal that requires the auditors to use only information and evidence 'already obtained' rather than perform procedures 'to obtain' additional evidence. Fidelity believes that as a result of this change, any auditor's attempts to achieve the goal of this proposal by either increasing auditing procedures or to draw conclusions from audit procedures already performed may prove to be burdensome to financial statement preparers when working with their auditors. Fidelity believes the PCAOB's is effectively creating a requirement for auditors to conclude, but not allowing auditors an efficient mechanism to achieve this conclusion.

* * * * * * * * *

Fidelity thanks the PCAOB for considering our comments. We would be pleased to provide any further information or respond to any questions that you may have.

Sincerely,

Kenneth B. Robins
Treasurer
Fidelity Equity and High Income Funds

Adrien Deberghes
Treasurer
Fidelity Sector Portfolios

Stephanie J Dorsey

Stephanie Dorsey
Treasurer
Fidelity Fixed Income and Asset Allocation Funds

Jeffrey Jarczyk
Executive Vice President, Chief Accounting Officer
FMR LLC

**From:** Allan Siposs
**To:** Comments
**Subject:** Docket 034
**Date:** Tuesday, December 10, 2013 9:22:06 PM

With regard to Docket 034, as an officer and Compliance Officer of a small BD, I support Lisa Roth's position. Please exempt non-custodial, non-public BDs from the PCAOB annual audit requirement.

Thank You;

**Allan A. Siposs**

Managing Director

**FMV Capital Markets, Inc.**

Mergers & Acquisitions / Valuation & Financial Advisory Services

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December 3, 2013

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

**RE: Rulemaking Docket Matter No. 34**
**Proposed Auditing Standards – Auditor's Report on an Audit of Financial Statements, Auditor's Responsibilities Regarding Other Information in Certain Documents, and Amendments to PCAOB Standards**

Members of the Board,

I appreciate the opportunity to submit my comments to the Board with respect to the *Proposed Auditing Standards – Auditor's Report on an Audit of Financial Statements and Auditor's Responsibilities Regarding Other Information in Certain Documents*. I retired from public accounting in 2007 after 27 years at Deloitte & Touche LLP and am currently a full-time faculty member at the University of Notre Dame teaching undergraduate and graduate courses in accounting and auditing.

Introduction:

My impression is that this project has been driven largely by user comments most of which appear to me to reflect perceived inadequacies in the GAAP reporting model. Users appear to be asking the auditors to tell them more about what is going on inside the company because management will not. I continue to believe that the appropriate course of action here is for the Board to coordinate its efforts with the Securities & Exchange Commission (Commission). The Board is in a unique position; it has access to information about registrants that the Commission only has in the course of litigation.

The Board's inspectors see the difference between what management discloses and what it could disclose as well as what audit committees do and don't do. Rather than pushing for a surrogate for difficult financial reporting matters as testifying users want, work with the Commission to improve the quality of management's reporting and the audit committee's oversight. For example:

- Work with the Commission to have management expand its disclosures of critical accounting policies to include comments on controls over those areas.

- Suggest to the Commission that it require management's certificates to address errors identified by the auditors, both corrected and uncorrected, and require they be addressed in audit committee reports as well.
- Request the Commission to require management and the audit committee to report on Significant Deficiencies that have gone un-remediated for more than one year.

It seems likely that the Board and the Commission are not jointly working on this project. For example, historically the Commission has not asked auditors to report on matters not governed by Regulation S-X yet the Board is forcing that on the Commission by virtue of this reporting model.

As I noted in my letter of July 21, 2012, commenting on the concept release related to this topic,

> "…the Board would better spend its time setting standards for the conduct of the audit rather than on reporting. I believe users, particularly those managing large investment portfolios, are intelligent business people who have the ability to fully understand what auditors do without an expanded auditors' report. PCAOB Standards are a matter of public record and available to any who want to understand the meaning of specific terminology or what auditors do in evaluating managements' assertions in the financial statements. The level of detail that should be added to the auditors' report would likely expand it to four or five pages, and yet the expanded report would be less comprehensive than the Center for Audit Quality's recently published "In-Depth Guide to Public Company Auditing: The Financial Statement Audit" (CAQ Guide). Any user who does not have the time or inclination to read the PCAOB standards but who reads the CAQ Guide once will have the information necessary to understand the auditors' report. Those who participated in the Board's outreach process would have invested much less time reading the introductory chapters to an undergraduate auditing textbook than they invested preparing to meet with the Board were they truly interested in understanding what auditors do…"

I believe the Board has exceeded its mission by focusing on perceived inadequacies in registrants' financial reporting and seeking to remedy this through the proposed changes to the independent auditors' report. I again suggest the Board work with the Commission to address users' concerns.

My specific comments are as follows:

Appendix 5 – Additional Discussion Related to the Proposed Auditor Reporting Standard

*1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?*

The second objective is inappropriate. By focusing on the communication of Critical Audit Matters as an objective of auditor reporting, the Board is shifting the emphasis away from the overall fairness of the financial statements taken as a whole and toward these Critical Audit Matters as the primary aspects of the registrant's statements on which users should focus. As I noted in my previous comment letter in response to question 14:

> "…this will cause investors and other users to rely on the auditors' report as a source to limit the extent to which they read financial statements and notes. This would also facilitate the development of software that would read the auditors' report, extract the related notes to the financial statements, and effectively eliminate the user's incentive to read the financial statements in their entirety. This implicitly places the auditor in the position of having to guess which areas are important to which users. The auditors' determination of what matters to emphasize would likely differ from those areas that would be emphasized by users and likely different from those areas the Board's inspectors would emphasize subjecting the auditors to additional litigation exposure from the former and criticism from the latter."

*2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?*

In comments I have made to the FASB on the Conceptual Framework I have expressed concern that the reporting model is too focused on capital providers – debt and equity holders – to the exclusion of other stakeholders. The Board is continuing that trend by having auditors address their reports to existing shareholders and debt holders. There are many other users of financial statements including prospective equity and debt holders, employees, vendors, customers, regulators, as well as state and local governments. The appropriate addressee is the Board of Directors which has a fiduciary duty to the Company and by extension to the various stakeholders existing and potential.

*3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?*

I suggest the following:

- Auditors have responsibilities to communicate with those charged with governance of the entity
- Auditors perform quarterly reviews which place them in contact with the entity throughout the year not just at the end

Auditors' responsibilities for internal control are noted in the current report, however for those with an integrated audit the standard should move to a combined report as this is all one, integrated audit not two separate audits with competing objectives

*4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?*

Given that the title of the report includes the statement that the firm is independent, adding the expanded language in the body of the report adds no additional information. Excess wording in any written communication should be minimized so as not to detract from other, important information. A report that is excessively long will likely not be read by unsophisticated investors; sophisticated investors already understand the concept of auditor independence. It would certainly not remind the auditors that they must be independent; if that's necessary, they should not be performing audits.

*5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.*

a. *Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?*

Audit partners rotate every five to seven years; audit staff turnover in public accounting firms is such that most of the individuals working on any public company audit are not the same individuals who were working on that audit ten years ago. Does it really make a difference that PricewaterhouseCoopers and its predecessor have been serving IBM for over 60 years given that fact? However, there may be some individuals who do serve the registrant as non-partners for decades.

The impetus behind this aspect of the proposed change to the reporting model appears to me to be an attempt to push audit committees to rotate auditors more frequently. These concerns could be alleviated if the Board took a more direct approach to the real problem of familiarity – that at the lower levels of the audit team. If the Board extended the maximum tenure of seven years to all individual auditors serving the registrant, much of the familiarity concern could be alleviated.

*b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?*

The Board must define who the 'Company" is. If Company B is acquired by a larger Company A but B's management is the surviving management of the combined entity, does the service clock start over if B's auditors are appointed to serve the new, combined entity? If A's auditors are the surviving firm are they still auditors of "the same company" given the changeover to B's management team? When companies go public by means of a reverse merger into a shell company, does the auditor service clock start over? Should consecutive years of service focus on continuity of the reporting entity and the audit firm or of the people involved? If an audit firm has been serving a registrant since 2002 and absorbed certain key Andersen professionals who previously served that entity has there truly been a change in auditors?

c. *Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?*

I do not see how the information is useful to investors. The firm is not the significant bit of data here. When Andersen collapsed, WorldCom changed auditors – and the successor firm hired the former personnel from Andersen who continued to serve that entity. As noted above, the underlying concerns related to auditor tenure would be significantly addressed if the Board would adopt a rotation requirement that applied to all personnel on the audit not just the partners on the audit.

*6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?*

As noted above, it seems highly likely that most users don't invest the time to understand the responsibilities the auditors already have with respect to that other information; so while auditors already know they have responsibilities for all information in a document that contains an auditors' report, no one other than the most sophisticated user has that knowledge. Accordingly, specifying an auditor's responsibilities for that other information would be valuable only to those actually reading that other information and reading the auditors' report. I do continue to express my concern that the users who testified before the Board won't read the expanded auditors' reports that will arise from this standard any more than they have read the CAQ Guide.

*7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?*

The flow should mirror the sequence of the audit – from engagement acceptance to issuance of the report. The current flow of the report generally does that.

*8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?*

None; as noted above, the Board could require the complete CAQ Guide be reprinted in every set of financial statements, but I doubt any user would actually read that. The Board could require the auditors to include a link to a particular part of the Board's own website containing detailed descriptions of what auditors do and what standards they must follow, but again I do not believe users would actually follow that link to the Board's standards or read any other information describing what auditors do.

*9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.*

Audit costs are correlated with the amount of effort the auditors must expend. This effort is dependent upon the complexity of the registrant's business, the competency of its management, and the skills of the auditors. As those combinations are unique for individual registrants, the costs should not be expected to be the same. I don't see how the inventory of basic elements in an auditors' report would impact those costs.

*10. Would the auditor's communication of Critical Audit Matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?*

I believe the users who testified before the Board want information about what is happening inside the registrant; not about what is happening inside the audit firm's conduct of the audit. To the extent users want additional information about areas that are critical for the registrant or difficult for management, they should request the Commission mandate that the Audit Committee make this communication as it has knowledge of what really is important from a risk standpoint. The auditors will report from the standpoint of what is critical to them – that which gets them sued or that which gets them criticized in PCAOB inspection reports – much of which is not critical to users. Investors do not want to know what the auditors find difficult; they want to know what management finds difficult. For example, the auditors have numerous specialists to help them evaluate Level 3 financial instruments; users would rather know whether the registrant has them. While the answer to this question will surface in a Critical Audit Matter, that answer should come from management, not the auditor.

If the Board ultimately adds these communications to the auditors' report, it must work with the Commission to mandate that management add its own comments in Item 9 on the registrant's controls over these areas and that the Audit Committee addresses in its report to shareholders in the annual proxy statement its oversight of the registrant's handling of these areas.

*11. What benefits or unintended consequences would be associated with the auditor's communication of Critical Audit Matters?*

I believe it will increase litigation exposure for auditors for anything that should have been a critical area and was not. The growth of critical areas will mirror the growth of risk factors in a registrant's filings. The report will be huge and no one will read it. A large corporation will likely have at least half a dozen Critical Audit Matters and commenting on those adequately should take three pages. Adding comments on controls over those areas will likely take more pages. Users will use key-word search software to focus only on those parts of the financial statements highlighted as Critical Audit Matters. They will ignore other parts which may not be critical for the auditors but would be critical for them.

*12. Is the definition of a Critical Audit Matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a Critical Audit Matter sufficiently clear for determining what would be a Critical Audit Matter? Is the use of the word "most" understood as it relates to the definition of Critical Audit Matters?*

Critical audit matters should comprise all those matters communicated to the Audit Committee. Additionally, all items listed in management's critical accounting policies should be candidates for Critical Audit Matters; these are supposed to be the drivers of the financial statements.

The Board must also include significant deficiencies in internal control as a possible Critical Audit Matter. For example if the auditor has determined the existence of a continuing significant deficiency, then testing any area affected by that significant deficiency should also be evaluated as a potential Critical Audit Matter. This does not apply only to those registrants subject to reporting or being audited pursuant to Section 404; it would apply to all registrants.

*13. Could the additional time incurred regarding Critical Audit Matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?*

The reporting deadlines are already short. Auditor time will increase to document not only those matters that are critical but those that could be. Auditors will spend as much time documenting what they did not do as documenting what they did do so as to minimize second guessing. The additional time spent in quality control to manage exposure to second guessing will cause increased calls for extension of time to file. It is not clear that more time spent preparing documentation necessarily equates to a higher quality audit and therefore higher quality financial reporting.

*14. Are the proposed requirements regarding the auditor's determination and communication of Critical Audit Matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?*

All of the indicators and examples for the determination of Critical Audit Matters are clear; more importantly they are all related to management's relative ability to handle difficult areas. Again, I suggest the Board work with the Commission to expand management's disclosures in the 10-K about controls over difficult areas and the audit committee's disclosures in the annual proxy statement as to how it exercises oversight of these areas. As I stated previously, users are looking for information about what goes on inside the registrant not what goes on inside the audit firm.

*15. Would including the audit procedures performed, including resolution of the Critical Audit Matter, in the communication of Critical Audit Matters in the auditor's report be informative and useful? Why or why not*?

As noted above, if users truly were interested, they would do their homework. Accordingly these changes to the report will not be useful other than for second guessing the auditors in the course of subsequent litigation. I do not believe users are sincerely interested in knowing about the procedures the auditors performed as much as they are interested in knowing about the procedures management performed or failed to perform.

*16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be Critical Audit Matters? Why or why not?*

The factors listed are appropriate for determining what matters are Critical Audit Matters.

*17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be Critical Audit Matters? Why or why not?*

- Matters identified by the PCAOB as Critical Audit Matters by virtue of its inspection focus.
- All areas identified as potential fraud risk – revenue, management override of controls, large transactions at the ends of reporting periods, and so on.
- Any matters identified as Critical Audit Matters in the course of discussion with the audit committee.
- All items listed by management as Critical Accounting Policies in the notes to the financial statements or in MD & A and all matters listed as Risk Factors in Item 1A in the form 10-K.

The above are among the drivers of financial reporting, and should be a focal point for the audit of internal control as well.

*18. Is the proposed requirement regarding the auditor's documentation of Critical Audit Matters sufficiently clear?*

Yes and the consequence will be that the inventory of critical matters increases. Inspectors will by nature look for other matters not included as Critical Audit Matters. Auditors by nature will want to avoid criticism so any matters that are close calls will end up being included so that nothing is left as a potential Critical Audit Matter.

*19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a Critical Audit Matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are Critical Audit Matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?*

As stated above, the auditors will want to avoid being second guessed so that list of non-reported matters will likely be empty or populated with Straw Men to placate inspectors.

*20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?*

The Board's goal should be to improve the quality of the audit; it is not clear to me that more documentation automatically achieves that objective. What is clear is that the auditors will spend more time documenting matters for the purpose of passing inspections and that does not automatically lead to improved quality.

*21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of Critical Audit Matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?*

The indirect costs include those that will arise as users focus on the auditors' lists of critical matters rather than on the financial statements taken as a whole and those matters that would be critical to them as users. The Board will incur increased inspection costs as inspectors search for unreported possible Critical Audit Matters. Litigation costs should also increase if for no other reason than that they can.

*22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to Critical Audit Matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?*

Critical Audit Matters will drive financial reporting as management and the audit committee move to match the level of financial statement disclosure with auditors' report disclosure. Management knows more about what's critical in financial reporting than do the auditors. Accordingly, areas not identified by the auditors as critical will not receive prominent disclosure even if management is aware of particular critical matters that it should disclose. I believe this will be most pronounced in small companies. Again, as stated above, the Board should work closely with the Commission to expand management's and the audit committee's reporting on critical accounting and reporting matters.

*23. How will audit fees be affected by the requirement to determine, communicate, and document Critical Audit Matters under the proposed auditor reporting standard?*

This is not only a matter of increased time spent but increased risk. Users will focus on what has been reported to the exclusion of what should be important to them; when things go badly they will find fault with the auditors because matters critical to them were not listed. This exposure to increased risk will likely drive some increase in fees. However there should also be an increase fees due to the increase in time related to documentation.

*24. Are there specific circumstances in which the auditor should be required to communicate Critical Audit Matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?*

If the Board goes forward with this proposed standard, it should require this expanded reporting for the most recent audit in all '34 Act and in '33 Act filings which include or incorporate by reference audited financial statements. The conditions at the registrant during the most current period under audit are the relevant conditions on which users would focus; those conditions are what will impact the registrant in the immediate future. As stated above, I do not believe users are concerned about what the auditors find difficult, but what management finds difficult. Accordingly, they will be even less concerned about what the auditors found difficult in the last reporting period.

*25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of Critical Audit Matters and at an appropriate level of detail? Why or why not?*

I don’t believe it provides useful and relevant information about the entity which is what the Board’s users are asking for. It provides information about the auditors and their audits. For all these critical matters the reporting examples address how the auditors obtained competent audit evidence which really speaks to how the auditors assessed controls in these areas and management’s competence. As stated above, the Board should work with the Commission to augment management and audit committee disclosures about tough areas and the controls over those areas.

If the Board continues with this project, the amendments need to extend to internal control reporting. Critical Audit Matters all appear to be control related; this should impact the conduct of the 404 audit and the content of that report.

*26. What challenges might be associated with the comparability of audit reports containing Critical Audit Matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.*

These reports may not be comparable because management strengths and weaknesses will not necessarily be comparable; however, some situations will be. For example, all Level 3 fair value applications must be Critical Audit Matters. Just as Risk Factors and Critical Accounting Policies have become somewhat standardized over time, Critical Audit Matters will as well. Revenue, fair value disclosures, de-recognition of transferred assets, consolidation of variable interest entities, uncertain tax positions, litigation, environmental and other contingencies are areas common to most large companies so these will all be listed as Critical Audit Matters; the auditors’ report language will become standardized in response to PCAOB inspection comments initially, and litigation experience later.

*27. What benefits or unintended consequences would be associated with requiring auditors to communicate Critical Audit Matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?*

The items identified in Appendix 5 are already good examples of potential consequences of this process. We will end up with an “intermediate going concern opinion” – one in which the auditors discuss their struggle to issue an unmodified opinion but which none the less puts the user on notice that this was a close call. We’ll have “intermediate scope exceptions” wherein auditors will discuss the difficulty of obtaining sufficient competent evidential matter but which doesn’t really address the difficulty management had in documenting its position – the matter that is of most concern to users. Perhaps this tension will lead to improved disclosures by management and the audit committee, but I would prefer to see the Board and the Commission work on this together rather than hope for a satisfactory though unintended outcome.

For non-404 reporting companies the auditors must of necessity end up reporting on the existence of material weaknesses in internal control as those must certainly be associated with Critical Audit Matters.

*28. What effect, if any, would the auditor's communication of Critical Audit Matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting* *standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?*

I'm not an attorney but in my experience the issue is not just about what is communicated but what is not communicated. Accordingly, Critical Audit Matters will likely put auditors in the same position as management is with Risk Factors – they grow and expand to include every possible risk that one could think of at the insistence of counsel who's trying to protect everyone from potential litigation. The same may happen here – Critical Audit Matters will expand to include things that are not critical to investors but are critical to the auditors' defense in litigation matters and in the face of PCAOB inspections. No published PCAOB inspection report will cite a firm for including too many Critical Audit Matters just as no published inspection report will ever cite an auditor for spending too much time in an area.

*29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?*

It seems clear that every matter that could end up in an explanatory paragraph will be a Critical Audit Matter; it would also appear that we are destined for redundancy if the Board goes down this path. If the matter is discussed in Critical Audit Matters, no additional information will be provided by an explanatory paragraph.

*30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?*

If the Board insists on auditors reporting on Critical Audit Matters these emphasis of a matter paragraphs will no longer be necessary since each example would be a Critical Audit Matter. Even a change in accounting principle is not an easy matter as one would have to take a fresh look at any unrecorded adjustments in those prior financial statements and conclude that not correcting them was still appropriate; if the change/restatement merits an explanatory paragraph under current standards, it is likely a Critical Audit Matter.

*31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?*

Those required now include Going Concern Uncertainty, Change in Accounting Principle, and Restatement for Correction of an Error. Each of these would likely result in the inclusion of a Critical Audit Matter discussion; I fail to see what the additional paragraph would accomplish. There is no scenario where an auditor would consider adding an explanatory paragraph but not a corresponding Critical Audit Matter. An auditor who does add an explanatory paragraph would certainly include a corresponding Critical Audit Matter so as to not be subject to second guessing.

*32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?*

Any matter the Board comes up with will be a Critical Audit Matter; significant contingent liabilities, difficulty in obtaining evidence for fair value pricing, and so on are all Critical Audit Matters.

*33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?*

The time the Board spends working on Qualified Opinions, Disclaimers and Adverse Opinions is necessary because of the regulation model the Board has adopted. As the Board is aware, the Commission will not accept an opinion modified in that fashion – hence those types of reports cannot be issued as they cannot be filed. Spending time on that aspect of the project is not productive.

*34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.*

The Board is shifting disclosure determination to the auditor rather than to the Commission, the Audit Committee and Management which is where it belongs. Critical Audit Matters should lead to significant disclosure in the financials however, those matters not critical to the auditor but critical to users will get less disclosure than they merit. Any area that's a Critical Audit Matter is necessarily a key area for internal control testing and that is not adequately addressed in the Board's example reports. The example management disclosures do not go beyond what the auditors include in their report; what is critical from an audit perspective is not necessarily what's critical from management's perspective or the investors' perspective. For example, consider Hypothetical Scenario #3; this is the type of situation where management should provide disclosure not only in MD&A and in Critical Accounting Policies but in Item 9 as well. The hypothetical note disclosure appears to follow from the auditors' Critical Audit Matter but there is no disclosure by management of the control deficiency likely because it is not considered a material weakness. Again, there are matters that are not critical to the conduct of the audit itself but that are critical to the business and those will get pushed aside or buried if they are disclosed at all. This project will naturally cause readers and perhaps the audit committee as well to focus on Critical Audit Matters to the exclusion of other items.

*35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?*

Critical Matters for Broker Dealers likely revolve around maintenance of minimum capital requirements and controls over customer accounts and assets. The Critical Audit Matters as structured will address the former but may not address the latter unless the Board incorporates those internal control matters into the standard.

*36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report Critical Audit Matters appropriate for audits of brokers and dealers? If not, why not?*

If the Board continues with this standard, it should be applied to all registrants regardless of size or industry. I believe information on controls over customer funds or the computation of capital for example may be more important for users of Broker Dealers' financial statements than the actual statements themselves. Accordingly, the consideration of Critical Audit Matters should contemplate those computations and controls.

*37. Since a broker or dealer may elect to file with the Commission a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?*

If the Board goes this route, then all Critical Audit Matters need to be included in the report on the Balance Sheet; any that would impact the income statement will impact equity and therefore required minimum capital. The Board needs to address Critical Audit Matters related to controls over customer funds, execution of orders and any other matters that could impact a customer's account even though they would not directly impact financial statement reporting.

*38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?*

Unless the investment company is invested solely in Level 1 instruments, there would be a Critical Audit Matter related to fair value. That being said, the Board needs to address controls here too – over timing, use of derivative instruments between reporting dates, etc.

*39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?*

Same comment on investments other than Level 1 instruments. Issues of diversification or control over employee funds, deposits and withdrawals, and so on, are all control items and those should be addressed as Critical Audit Matters even though the plan is not required to be audited for controls.

*40. Should audits of certain companies be exempted from being required to communicate Critical Audit Matters in the auditor's report? Why or why not?*

No. If the Board determines to go forward with this proposed standard, it must do it for all registrants. There is no reason why investors in one type of company should receive expanded auditor reporting and another not as that would suggest the Board had determined that certain users or potential users are more worthy.

*41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?*

I believe the effective date needs to be at least one year – one full audit cycle – following issuance of the standard.

That being said, I strongly encourage the Board to field test this with some public accounting firms if it has not already done so, and also share the results of that field test with the Commission if it has not already done so. The Commission may determine that it is preferable to change the requirements of Regulations S-K and S-X instead.

*42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?*

No; if the Board decides to do this, get it done and started for all registrants.

Appendix 6 – Other Information

1. *Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?*

First, the Board should consult with the Commission to determine whether there are other types of filings the Commission believes warrant increased auditor involvement. That being said, any Exchange Act filing that incorporates previously filed financial statements requires an auditors' consent. Auditors currently evaluate the information in those filings for consistency with the financial statements just as they do other information within a Form 10-K. Accordingly, if the Board goes forward with this proposed standard, auditors should report on other information in any Exchange Act filing that incorporates audited financial statements by reference by the inclusion of one or more additional paragraphs in their consent.

2. *Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?*

See my comment on the preceding question.

3. *Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?*

Yes it must apply to amended annual reports, especially if the other information is also amended. If the basic financial statements have changed, their relationship to the other information will also have changed. If the Board believes it appropriate to require the auditors in their reports to inform users of their association with the other information in a document, then the Board should require them to inform users that they are still willing to be associated with the other information in the amended document.

4. *Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?*

Again, this is an area in which the Board must work with the Commission on the latter's filing requirements. The Commission requires financial statements to be filed in these situations as it believes it is important for users of the registrant's financial statements to receive that information. Any financial statements filed that include the report of a registered public accounting firm should be audited in accordance with the Board's standards and, accordingly, be reported on in accordance with those standards. If the Board moves forward with this standard, it should apply to all reports of registered public accounting firms filed with the Commission and provided to users under the requirements of the '34 Act. The other auditors will have to agree/consent to the inclusion of their report and, accordingly, are associated with the other information in the document being filed.

5. *Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?*

The objectives are incomplete; auditors should also address controls over other information in their audit of internal accounting controls over financial reporting.

6. *Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?*

Yes, as auditors already do that as part of the audit; the only question is the extent to which that association gets reported in the auditors' opinion. Without some clear identification in the report as to the extent of the auditors' involvement, users will begin to expect that everything in the document has been "subjected to audit". I believe there needs to be some limit as to the extent of the auditors' reporting on other information and I believe that limit should be set by the Commission. It seems logical to include MD&A for example and the Management Compensation disclosures; reporting could be limited to that information by reference to page numbers. Blanket reference to other information is neither useful nor appropriate.

*7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?*

I do not believe there would be any increase in the quality of other information as a result of this standard. As stated in my letter to the Board on the Concept Release on this matter:

> "I do not believe reporting on MD&A would change either the form or content of those disclosures. Since it is included in the 10-K and auditors are therefore "associated" with that information, they already test those disclosures for consistency with the financial statements and underlying records; for 10-Ks incorporated by reference into registration statements, they are "comforted" in letters to underwriters. I have no expectation that the quality of MD&A would improve as a result of its inclusion in the financial statements and direct coverage by the auditors' report. The SEC has spent decades working to increase the quality of MD&A and the SEC certainly has all the leverage it needs in this area."

Again, I do not believe it would improve quality; it would however increase the visibility of the auditors' roles.

*8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?*

The Commission's Staff Accounting Bulletin No. 99 is the appropriate source for materiality determination by auditors of registrants.

*9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?*

They are not clear and in some cases are not appropriate. The Board should refer to AU634 *Letters for Underwriters*. Much "other information" in '33 Act filings, for example, is not comforted by auditors as it is not taken from the systems subject to the system of internal control that is the subject of the audit. Accordingly, the Board should not require auditors to report on anything they could not include in a letter to underwriters. As it says in that standard, auditors should not comment on matters just because they are present and can read or do arithmetic.

*10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?*

Yes, but in a comfort letter process auditors report on those items individually so that it's clear what items they are comforting and which they are not. Under the proposed standard, users will not know which items are covered and which are not. Additionally, users should be advised as to what information is covered by controls; they will likely believe it all is covered by control testing if it is covered by the auditors' report. Auditors should not just being doing "simple math" as the proposed standard would imply.

*11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?*

The significant costs for the auditors relate to quality assurance and documentation. This process will require even more documentation than a comfort letter. So look at the typical additional costs for comfort letters and just add these to the annual audit fee every year; that should be a starting point to estimate what this could cost.

*12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?*

Yes; auditors currently have the same response to errors in other information identified in the process of issuing a comfort letter or any report for a registrant: get management to fix it or don't issue the report.

*13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?*

The Commission won't accept the reports so the costs are related to the increased time associated with a delayed filing if management does not immediately make the necessary corrections and the auditors are unwilling to sign off. In these situations there are always additional meetings with the Audit Committee and additional consultations.

*14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?*

Yes, except for the listed response option pertaining to the issuance of a report noting the presence of a material inconsistency. The Board knows the Commission will not accept a qualified auditors' opinion. Accordingly, an auditors' report as described cannot exist.

*15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?*

This appears to be an inappropriate question. Again, the Board knows the Commission will not accept a filed document that is materially misstated nor will it accept a qualified auditors' opinion. Accordingly, an auditors' report as described cannot exist.

*16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?*

Reporting to the audit committee appears to be the appropriate response. It is difficult to contemplate that auditors would withdraw their report on filed financial statements if, for example, overly aggressive marketing information is included in a documents subsequently incorporated by reference into the previously filed form. The issue will, however, surface in the event the auditors are called upon to provide a consent to incorporate filed financial statements into a current filing and the inappropriate information is now incorporated into the financial statements that are the subject of the current consent. It would seem that the auditors should be unwilling to provide that consent absent the correction of the offending information.

*17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?*

Regardless of how the auditors learn of a material misstatement in the financial statements they need to require management to make the appropriate changes. The process is no different whether the error is detected looking at the President's Letter to Shareholders or in the audit of subsequent cash disbursements.

*18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?*

I believe it is not sufficiently clear because there's no distinction between the information covered by the system of internal control and information not so covered. As noted in AU 634 *Letters to Underwriters*, auditors have no business commenting on matters outside the financial reporting process. Just because auditors are capable of re-computing formulae does not mean they should do so and report as such.

*19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.*

The question relates not only to information not directly related to the financial statements but also to information for which there is no accounting standard. For example, Tenneco regularly discloses "non-recurring" items in an MD&A analysis of its earnings each quarter and many companies disclose comparisons of net income or operating cash flows to EBITDA. The former is a management judgment as to what constitutes "non-recurring" and the latter is a function of how EBITDA is defined in a particular entity's loan agreements.

Other examples include anything the auditors do not include in letters for underwriters such as backlog or the square footage of property owned and leased as well as any "forward looking information" included in the 10-K. The proposed standard will raise expectations that all this information is covered by the auditors' report. Any listing of items that are not covered by the auditors' report will be voluminous and will not be read by users.

*20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?*

I don't see a difference in costs from those they have now. When auditors identify a material inconsistency they would incur time costs for meetings, consultation, documentation, and so on related to the decisions of how to proceed. However, all involved, including the Commission, will likely lose any discretion to correct these things prospectively.

*21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?*

No as I believe this will generate an expectations gap with respect to the auditors' involvement with <u>everything</u> in the document. I think many users will come to believe that just about everything in the document has been audited regardless of how the opinion is worded. Users may not currently have expectations that auditors are reading the other information because they don't know that professional standards require that; going forward they will have expectations because they won't understand the practical limitations on what the auditors can do given the language in the opinion.

*22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?*

Yes; the Board has to address how this material inconsistency or material misstatement of fact is to be handled from the standpoint of reporting on internal control. The situation described is indicative of a material weakness in financial reporting of the other information. That weakness should be communicated no differently than any other material weakness.

*23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?*

If the registrant corrects other information in a current document and the Commission does not require restatement of that information for prior periods how will the successor report? Even if the Commission would prefer to have the information corrected prospectively, the predecessor auditor will know the older information was materially misstated and be unable to reissue an unqualified report. This appears to restrict the Commission's ability to exercise discretion; it may no longer be able to permit prospective correction.

*24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?*

All information in the document would be subject to testing by the auditor even that which is not related to the financial statements. For example, the Board can't say the auditor is not required to test or even understand a formula in order to prove that it is mathematically correct and expect the plaintiff's bar to accept that. Auditors will be exposed for the entire document even that which is clearly outside the auditors' expertise.

*25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?*

As I am not an attorney, I cannot comment on the question, however the fact that this question has been raised suggests the Board has not consulted with the Commission with respect to the enforcement of the federal securities laws.

*26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?*

Reference to work of specialists – This amendment raises questions as to the extent of the Board's consultation with the Commission. The Commission expects experts to be named; it also expects reports of "other auditors" to be included in filings when the registrant's auditor refers to such others in its report on the financial statements. If auditors refer to specialists in their reports the Commission may require those specialists to provide consents. This will add significant cost and complexity to the filing process every time a registrant files a document incorporating a 10-K by reference as it will need to obtain consents from any such specialists.

The Board must also amend Auditing Standard No. 5 to specifically include requirements that auditors evaluate controls over other information particularly MD&A. It would seem logical that reading that other information for consistency without evaluating the controls over the processes that generate that information results in a very incomplete reporting process. I submit that reporting on management's controls over that information process is more valuable to users than the auditors' reading of that information.

*27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?*

If the Board is changing the report, the auditors' responsibility for internal control should be addressed in the second paragraph of the opinion. Auditors should state what they have done with respect to internal control and by extension whether they have done an audit of controls or not. That reporting should also cover controls over other information.

That being said, any question about auditor reporting under AU Section 508 for registrants is an inappropriate question. As stated previously, the Commission will not accept a filing containing a Qualified, Adverse or Disclaimer of Opinion. Spending time with that reporting is not productive time.

*28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?*

If these entities file annual reports with the Commission that are available to users and contain such "other information" and if the Board determines it appropriate for auditors to report on such other information, there is no reason to exempt broker dealers or any other particular industry such as insurance companies, public utilities, government entities and so on.

*29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?*

All of this needs to go through the Commission so having an effective date be one full year audit cycle following approval by the Commission is the minimum. If the Board determines to expand the scope of controls understanding to include other information, then the effective date cannot be less than two year ends away – to allow for a full year of controls documentation and consideration at interim periods.

*30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?*

No; those who invest in small businesses have just as much right to protection as those who invest in very large registrants so there should be no size exemption when it comes to auditing standards, audit quality or financial statement quality. Auditors of smaller registrants are already reading the other information for consistency/inconsistency so the only additional need is for appropriate documentation and a means to assess information that would be covered by their reports. That situation will be true for all auditors not just those who audit smaller businesses.

*31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?*

If the Board expands reporting, it should extend that expanded reporting to Securities Act filings as well. Much of the other information is already "comforted" by auditors and reporting on that information would not require additional work other than preparation of additional documentation. Draft comfort letters are updated with each and every amendment; every time an auditor gives its consent it has read the document and considered whether there are inconsistencies in the information or the manner of its presentation. Accordingly, the procedures related to other information are in fact updated with each and every amendment to the registration statement. The auditors could easily add a paragraph on "other information" to their consents included in '33 Act filings.

However, the auditors are currently able to restrict their documentation and analysis to information that is rightly within the auditors' expertise and therefore able to restrict comfort letter procedures and related reporting to specific, appropriate items in the document being filed. The Board's standard is much more open-ended in its scope and would raise expectations on the part of users as to the breadth of the auditors' analysis.

*32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other* *information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?*

Again, the proposed standard would expand the auditors' responsibilities to include evaluation of information that is clearly outside the auditors' expertise. The amount of analysis and documentation implicit in the Board's standard would exceed that currently done in the comfort letter process. The auditors would be less exposed by having the comfort letter included as an exhibit to the filing than they would be by having that same information covered by the "other information" opinion paragraph proposed to by the Board. At least the comfort letter spells out specifically what the auditors have done to which information – and therefore which information in the filing is left to the reader of that letter.

Auditors' responsibilities for the information in current filings are quite significant; so are the responsibilities of the underwriters and private placement agents. Expanding the auditors' report to cover other information in this manner establishes expectations about the auditors' role and raises new expectations about the auditors' involvement with marketing information or forward looking information; these expectations would likely increase as users/securities purchasers assume auditors' are implicitly providing assurance on that information.

*33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?*

Requiring the auditors to report on the other information included in a '33 Act filing would not only convert a letter for the underwriter or private placement agent into a general use report, it would greatly expand the coverage of that letter to matters and information not currently subject to the comfort letter process. I submit that current fees for comfort letters would increase dramatically if that were to occur because, unlike the specific and detailed reporting in a comfort letter, the Board's proposed reporting on other information is broad if not all-encompassing; it would establish expectations in the minds of users that far exceed those of the underwriter or private placement agent.

Appendix 7 – Emerging Growth Companies - Comments on selected questions only:

1. *Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?*

Any changes the Board makes to auditors' reports should apply to EGCs as well. These entities are higher risk than existing registrants as evidenced by the Board's observations on going concern paragraphs for example. They should not be exempted from reporting standards.

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*3. Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of Critical Audit Matters?*

As the Board is aware, EGCs are more likely to have significant deficiencies/material weaknesses in internal control, are more likely to be candidates for "going concern opinions", and are in general more risky than their more established brethren. If there is any logic behind the Board's auditor reporting project, exempting EGCs flies in the face of that logic. The only reason to exempt them is that the analyst community does not care about

EGCs enough to want the additional disclosures it wants from the auditors of established companies. I would submit that such a stance is not beneficial to investors in EGCs who are exposed to more relative risk than those who invest in established registrants who are routinely covered by analysts.

*4. Would audits of EGCs be more, less, or equally likely to have Critical Audit Matters?*

As noted above, EGCs have fewer knowledgeable employees (e.g., those trained to handle areas such as financial instruments or fair value accounting), more control weaknesses, greater liquidity concerns, frequent going concern doubts, and largely uncertain futures. My expectation is that their auditors will report a proportionately greater number of critical matters than larger, more established entities.

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*6. What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of Critical Audit Matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?*

Again, I believe the costs are outside the audit. Investors will look to the auditors' report for a "road map" as to the parts of the financial statements on which they should focus and disregard other parts of those statements, or other aspects of that business that should be relevant to them as investors.

*7. What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?*

They will incur the incremental time difference between what they do now and what they would do to provide comfort on that information in a letter to underwriters, plus the time it takes to test other information not currently covered in a comfort letter but included in "other information" described in the Board's proposed standard. They will also incur time documenting their basis for reporting on the information that is not directly related to the financial statements but now affirmatively subject to auditor consideration by action of this proposed standard and the expectations it will raise among users. I suggest that EGCs should expect annual fees to increase by an amount comparable to the cost of a comfort letter.

I appreciate the opportunity to offer my comments.

Sincerely,

s/ James L. Fuehrmeyer, Jr.

James L. Fuehrmeyer, Jr. MBA, CPA
Associate Teaching Professor

**From:** Dan Veatch
**To:** Comments
**Subject:** I support Lisa Roth"s position
**Date:** Wednesday, December 11, 2013 7:43:22 PM

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**FROM:** Dr. Steven Glover (Accounting Professor at Brigham Young University)

Dr. Christopher Wolfe (Accounting Professor at Texas A&M University)

Brant Christensen (Accounting Ph.D. student at Texas A&M University)

**TO:** Office of the Secretary, PCAOB

**DATE:** December 2, 2013

**SUBJECT:** Comments on PCAOB Rulemaking Docket Matter No. 034

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We appreciate the opportunity to submit our comments with respect to the Proposed Auditing Standards on the Auditor's Report (the Proposal) released by the PCAOB. Our comments below are in response to questions outlined in Section V of Appendix 5 and are based on some of our recent research.[1]

*Question 10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?*
*Question 11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?*

In response to Questions 10 and 11, our research suggests that information communicated in critical audit matters would be relevant and useful to investors and other financial statement users. In our study, we examine how experienced and knowledgeable nonprofessional investors react to the inclusion of a critical audit matter paragraph in the audit report.[2] We find that investors are more likely to stop considering a company as an investment when a critical matter paragraph in the audit report highlights significant estimation uncertainty. This is true both when compared to investors who receive a *standard audit report* and when compared to investors who receive the same information about estimation uncertainty in *management's footnotes*. These results indicate that both the existence *and* the source of the information is important.

Further, we find that information in the critical audit matter paragraph influences investors' perception of risk as well as their confidence in the potential investment. These results indicate that the Proposal's suggestion to include critical audit matters in the auditor's report would provide both useful and relevant information to investors. Our study did not identify any unintended consequences of including a critical audit matter paragraph in the auditor's report.

We note that our study does not answer all potential questions about how investors would use the information suggested in the Proposal. For example, would this information retain

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[1] For additional information, see: Christensen, B. E., S. M. Glover, and C. J. Wolfe. 2013. "Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?" Available at http://ssrn.com/abstract=2318590.

[2] Study participants obtained at least a bachelor's degree in business; have on average 25 years of professional work experience; and have significant experience making personal investment decisions.

its usefulness in years subsequent to initial adoption, or would the disclosures lose their usefulness over time by becoming boilerplate? Additionally, we only test the inclusion of a single critical audit matter paragraph.

*Question 15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?*

In a second experiment, we include a paragraph following the critical audit matter that provides a brief description of the audit procedures performed on the account in question. This second paragraph also includes either positive or negative assurance specifically related to the critical audit matter. Our study finds that investors who receive both the critical audit matter and the second paragraph are less likely to stop investing than investors who receive the critical audit matter paragraph alone. As such, our findings would suggest that discussing the critical audit matter's resolution is informative and useful to investors.

*25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?*

Of the three hypothetical scenarios included in Appendix 5, our study can most explicitly speak to the third hypothetical scenario, which is similar in both content and length to the scenario in our experiment. Based on the results of our study, including information at this level of detail in critical audit matter paragraphs is viewed by investors as useful and relevant in making investment decisions.

We appreciate the opportunity to offer our comments.

Kind regards,

Dr. Steven Glover, Brigham Young University

Dr. Christopher Wolfe, Texas A&M University

Brant Christensen, Texas A&M University

| | |
|---|---|
| **From:** | Joe Lydon |
| **To:** | Comments |
| **Subject:** | PCAOB Rulemaking Docket Matter No. 034 |
| **Date:** | Wednesday, December 11, 2013 10:17:34 AM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |
| **Importance:** | High |

Dear Board Members:

I support the position of Lisa Roth (Monahan & Roth, LLC) which is described in the attachment.

Thank you for your consideration in this very important matter.

Sincerely,

Joseph M. Lydon

Managing Director, Founder

**GOAL Consulting LLC**

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M & R
MONAHAN & ROTH, LLC

**Lisa Roth**

630 First Avenue
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The Office of the Secretary Public Company
Accounting Oversight Board
1666 K Street, NSW
Washington, DC, 20006-2803 USA

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

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Via E-mail

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC
20006-2803

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 034**

Dear Sirs:

Goldcorp Inc. ("the Company") appreciates the opportunity to provide comments in response to the request for views on the proposed auditing standards: '*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*'; '*The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*'; and related amendments to PCAOB Standards as set out in PCAOB Release No. 2013-005, dated August 13, 2013.

The Company supports efforts to provide reporting enhancements and further clarity which would increase understanding of the audit report and the auditor's responsibilities to the reader of the financial statements. We do not however believe that the proposals set forth in the proposed auditing standards will address the concerns raised. The Company has provided the following comments on these proposals:

**Auditor Reporting of Critical Audit Matters**

In respect of the feedback received from investors during the Concept Release comment period requesting further information from the auditors, for example, on key areas of risk or those areas where critical judgment has been applied, the Company does not believe that the appropriate place for those disclosures is within the auditor's report. The preparation of financial statements is the responsibility of management and there are significant disclosure requirements contained within existing accounting standards which require management to disclose critical judgments and estimates, critical accounting policies and other areas of risk or key items within these statements. The Company believes the existing disclosure requirements are appropriate and retain the fundamental basis of preparation of financial statements, which is that these remain the responsibility of management. If the objective is to ensure that critical judgments are better disclosed, this would be better addressed through improvements to corporate reporting disclosure frameworks rather than through the auditor's report. An additional statement, incorporated into the auditor's report, referencing the completeness of the significant judgments disclosed and their consistency with the audit work performed would further augment the reporting and address the concerns raised.

Further, the Company believes that the existing auditor report pass/fail model provides a bright line for the reader as to whether the financial statements are represented fairly. To include critical audit matters within an unqualified report may lead to confusion over the reliability of the financial statement disclosures and the Company anticipates that any matters considered as critical audit matters would be included in the financial statement disclosures as required by the relevant accounting standards.

Depending on the process undertaken by the auditors to determine and report critical audit matters, this proposal may lead to unintended results whereby either excessive or insufficient areas of audit focus are reported to the audit committee. In either case, the Company foresees a significant drain on resources in the drafting of this commentary with little incremental benefit and believes that the financial statement disclosures as required by the relevant accounting standards are sufficiently transparent and comprehensive.

**Auditor Reporting on Other Information**

The Company supports a proposal to provide language clarifying the work performed by the auditors on other information included with the annual report or referenced therein. Current guidance within existing auditing standards requires the auditor to review and consider other information contained within the annual report, principally in the Management Discussion & Analysis. The current proposal, however, implies an increase to the scope of work being performed by the auditor with the proposed requirement to 'evaluate' the other information, and may result in audit procedures being performed on non-financial statement disclosures. Other information included in the annual report provides the platform for management to present other information outside of the financial statements which management considers useful to the reader in understanding its business and key operational trends. Inherently, some of this information is prepared on a forward-looking basis and a requirement for auditors to increase the scope of work on these disclosures may result in less disclosure provided by management, inevitably reducing the amount of information management considers useful to its stakeholders and raising the possibility of increased boilerplate language in non-financial statement disclosures.

**Additional Elements - Auditor Tenure/Independence**

The Company does not believe the changes proposed are warranted, specifically the proposal to include information on the auditors tenure may imply a reduction in audit quality based on length of tenure.

Overall, the Company is supportive of moves to improve reporting transparency to stakeholders; however the Company does not believe that the proposed changes provide the best avenue to address the concerns raised.

We appreciate the opportunity to provide the Company's views for your consideration.

Sincerely yours,

Wendy Louie

Ms Colette Rustad
Senior Vice President and Controller

Ms Wendy Louie
Vice President, Reporting

**Kevin Gomez**
1736 Hobart St NW
Washington, DC 20009

November 26, 2013

Public Accounting Oversight Board

**RE: PCAOB Rulemaking Docket Matter No. 034; Proposed Rule Under Release No. 2013-005; Release Date August 13, 2013**

***Comments Related to Critical Audit Matters (Paragraphs 7 – 14 of the Proposed Auditor Reporting Standard)***

Members of the Board:

I appreciate the opportunity to respond to the request for comments on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposed Standard"). I am electing to limit my comments to this Proposed Standard, and I specifically wish to address selected questions concerning Critical Audit Matters. I write as a member of the financial community and a potential investor.

**Overview**

In general, I agree with the spirit and intent of the Proposed Standard. While the current form of the auditor's report gives boilerplate language regarding the auditor's procedures, there is a general understanding that in the course of their procedures certain matters may have warranted significant effort in order to gain comfort. The auditor is in a unique position to provide further detail regarding areas of significant judgment or risk that their own procedures identified as requiring additional attention. The investing community would certainly benefit from having this insight, as the current pass/fail model of the auditor's report gives no specifics as to the particular issues of concern for a company. There are several examples of public companies that have experienced financial scandals and subsequent restatements while having previously received an unqualified opinion from their auditor. While I am sure that such auditors did indeed perform sufficient procedures as to obtain reasonable assurance regarding the presentation of the financial statements, I cannot help but wonder whether insight regarding risky areas might have given the investing community at the very least some indication to tread lightly where there may have been aggressive accounting treatment or management estimation.

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The following comments are in response to certain questions set forth in the Proposed Standards.

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

I believe that the communication of critical audit matters would unequivocally be useful to investors and other financial statement users. The purpose of financial statements is to give users pertinent information for decision-making, especially in the case of investors whether or not to invest. Identifying critical audit matters would only serve to assist a user focus on particular issues that would help complete their understanding of the financial statements.

For example, if during the year a company were to make several investments in entities with a less than majority-owned interest, they might have created multiple variable interest entities (VIEs) that would require careful analysis to determine whether the company was the primary beneficiary and thus would need to consolidate them. An auditor might dedicate a significant amount of time testing management's conclusions given the potentially significant balance sheet effects of consolidation, and given the high level of potentially complex judgments involved they might find it necessary to consult with their National office. Ultimately the auditor might obtain reasonable assurance that management's conclusions were accurate. However, given the high degree of judgment and complexity involved on both management and the auditor's parts, an investor might benefit from understanding that such transactions were a significant matter and might be given cause to perform their own due diligence such as performing sensitivity analyses around different scenarios if alternative conclusions could have been made.

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**; and

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

I agree with many of the unintended consequences cited in the Proposed Standard, including the strain on an auditor's work in the final stages of the audit and the potential misunderstanding of critical audit matters by an investing community that is unfamiliar with such disclosure. In the case of strain on an auditor's work, I believe that this risk is minimal given that an auditor's work would likely already contain significant documentation regarding critical matters given existing documentation standards, and in short course this extra step would easily be absorbed into the audit process. I expect the additional time required to address critical audit matters to have, if anything, a positive impact on the quality of the audit by focusing the auditor's attention on those matters which have a high degree of risk, subjectivity, and/or complexity.

In regards to the potential misunderstanding by the investing community, I believe that the risk of confusing the investing community is greater in the case of not having critical audit matters to guide their focus than in the case of having critical audit matters that an investor inappropriately interprets.

I believe that a far bigger unintended consequence would be the strain critical audit matters could impose on the auditor-client relationship. The auditor-client relationship is already an unusual one in that an auditor is meant to be an external party expressing an opinion on the fairness of a company's financial statements, and yet they are paid by said company, often on-site for extended periods of time, and are able to be fired. I can imagine that management would be incentivized to pressure an auditor into not divulging areas of significant complexity or judgment in a critical audit matter for fear that the investing community would take any such matters as indications of "softer" numbers or aggressive accounting. The auditor would thus be confronted by the pressures to uphold its own professionalism and its desire to maintain a client relationship. In some cases, this might lead to the critical audit matters section being reduced to merely boilerplate language and thus undoing the very spirit of the Proposed Standard to give the investing community additional guidance on how to focus their reading of the financial statements.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

The audit procedures performed related to a critical audit matter may vary in complexity depending on the matter involved, and in the cases in which audit procedures are exceptionally complex their description may unduly create confusion for the investing community rather than providing illumination on the underlying issue.

On the other hand, in some situations I can imagine that an investor might find the description of certain audit procedures helpful in determining what level of due diligence would be required of their own analysis. For example, if the critical audit matter concerned something like unusual inventory balances, knowing that the auditor performed extensive physical inventory counts might give them less cause to perform sensitivity analyses regarding inventory balances than they would if the auditor performed some form of analytic. Thus, I think the usefulness of disclosing audit procedures will vary case by case but should be guided by the principle that discussion of audit procedures should only occur if it can be done so succinctly *and* if a reasonable investor might draw different conclusions based upon the type of approach used by the auditor.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

In the spirit of the Proposed Standard, the investing community would be better served if the auditor was required to communicate critical audit matters for each period presented in the situations noted of an IPO or a previous auditor's report no longer being reliable, but *only if* these critical matters were not previously communicated in a public filing. Thus, especially in the case of an IPO where prior periods did not previously communicate critical audit matters, an investor can perform due diligence with full knowledge of where to focus attention in performing analyses for each given year. A company's critical audit matters could very well change from year to year, especially if the company undertook significant acquisitions or changed accounting policies in a given year but not in others. This might give an investor cause to focus their analyses on different aspects of the financial statements for each year in determining their full picture of a company's health.

**26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

Critical audit matters will inherently vary from company to company, and it is this very fact that allows an investor to glean company-specific focus. In some industries there will be more variance than others, as some might have a relatively comparable pool of critical audit matters that affect all of them while other industries consist of companies each with unique issues. Regardless, I think this challenge is minimal. Critical audit matters are not meant to radically alter the substance of a company's financial statements, but rather to grant the reader insight into specific areas that might warrant additional attention.

*****

I appreciate the opportunity to share my viewpoint on the Proposed Standard, and I thank you for your consideration of my comments.

Sincerely,

Kevin J. Gomez

| | |
|---|---|
| **From:** | Donald Bertucio |
| **To:** | Comments |
| **Subject:** | Docket 034 |
| **Date:** | Thursday, December 12, 2013 11:43:45 AM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |

I support Lisa Roth's position. Letter attached.

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

Grant Thornton

December 11, 2013

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**Re: PCAOB Rulemaking Docket Matter No. 034 – Proposed Auditing Standards on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards**

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed auditing standards and amendments, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report and Related Amendments to PCAOB Standards*, and we respectfully submit our comments and recommendations thereon.

Overall, we support the Board's efforts to enhance the relevancy and transparency of the auditor's report. We agree that retaining and also expanding beyond the "pass/fail" reporting model, will benefit investors and other users of financial statements and related financial information. As the PCAOB considers moving to a less-structured report in order to enhance relevancy and transparency, we believe global consistency is of critical importance. We strongly encourage the Board's collaboration with other standard-setters, such as the International Auditing and Assurance Standards Board ("IAASB") to align, to the extent practicable, the reporting requirements in order to minimize differences in definitions and application and, therefore, maximize the benefit to users of auditor's reports worldwide.

We are participating in the Center for Audit Quality's coordinated field-testing efforts of certain elements of the proposal. We believe this effort will provide important feedback on the operationality and cost elements of the proposal, and accordingly, we strongly encourage the PCAOB to consider the results of the field testing prior to finalizing the proposed new and revised standards. We also note that this analysis could be particularly important for smaller listed entities. We agree with the Board's expectation that the adoption of the proposals will increase the time necessary to complete an audit and the costs related thereto, predominantly related to critical audit matters and other information.

### Critical audit matters

We agree with the objectives of increasing the relevance and usefulness of the auditor's report. Providing more insight into critical audit matters ("CAMs"), the audit matters that were of most significance to the audit, should provide investors and other users of the financial statements with information that could be useful in evaluating the underlying financial statements.

We have identified suggestions for improvement with respect to the proposal's scope, filtering mechanisms, and form of communication. These suggestions are intended to address concerns we have as to how the proposal aligns with current audit processes and documentation protocols. For example, the proposal could better leverage the process and work performed under other auditing standards, such as Auditing Standard No. 16, *Audit Committee Communications* ("AS 16").

Additionally, we agree that tailoring CAMs to the specific facts and circumstances of each engagement is important in providing meaningful information to investors. However, we note that this may create challenges to investors who attempt to compare reports even within the same industry because risk assessment and audit issues are very unique to each issuer. To illustrate this point, consider two companies in the same industry where one auditor may report difficulties on one issuer while another auditor may not report anything on the other issuer. We understand the flip-side to this risk is that such disclosures will become boilerplate. We recommend that the Board continue to evaluate these potential challenges through further outreach and post-implementation review separate from the inspections process.

#### Scope and definition of a CAM

We believe that the proposed scope under which CAMs are determined (documented in the engagement completion document, reviewed by the engagement quality reviewer, and/or communicated to the audit committee) creates redundancy and inefficiencies when considering the current audit process. We believe that audit teams effectively identified matters that are most significant to the audit in developing their communications to the audit committee under AS 16. Our view is that the audit team will have already filtered through the engagement completion document and work reviewed by the engagement quality reviewer in order to develop those significant matters that will be communicated to the audit committee. Therefore, requiring reconsideration of the matters defined in the proposal would significantly increase time and costs with little benefit to CAM identification. Accordingly, we believe the more appropriate starting point for identification of CAMs is to consider the matters included in audit committee communications.

When comparative financial information is presented, we agree with limiting the CAMs to the most recent financial period. We believe the most recent financial period is likely the most relevant to users of the financial statements and may enhance understandability and transparency. Further, limiting the CAMs to the most recent financial period may avert unnecessary complexities in auditor reporting. Other than in the initial year of implementation, we believe that financial statement users may have access to the prior period's auditor's report should they wish to consider CAMs related to such period.

*Factors in determining a CAM*

We are supportive of the factors considered in determining CAMs listed in the proposed standard and believe these will assist the auditor in assessing matters, based on the audit procedures performed, to adequately identify CAMs. However, we believe that the current proposal would be improved by providing more direct linkage of the factors to significant matters disclosed in the financial statements. The examples provided and related discussions in the Release focus on those types of matters (for example, complex fair value measures). As currently drafted, situations where the auditor spent considerable effort in developing an audit plan over say a multi-location audit may appear to meet the CAM factors for consideration, but disclosing those efforts may not provide actionable information to the users of the financial statements as the auditor considerations would not be presented in the context of an impact on the financial statements. In relating matters directly to the financial statements, we would also encourage consideration as to materiality, which we believe is a significant factor when considering practical application of the standard, but is currently implicit in the requirements. Therefore, we strongly encourage the Board to revise paragraph nine of the proposed standard to include a more direct link to the financial statements – the auditor would consider matters that are material to the financial statements as well as those involving the most difficult, subjective or complex auditor judgments; posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; and/or posed the most difficulty to the auditor in forming an opinion on the financial statements.

Communication

We generally support the proposed language that would precede CAMs in the auditor's report, when considered with the relevant comments throughout this letter. However, we note that there is no reference to auditor judgment, and we believe it is important to specifically communicate that the determination of CAMs is based on the auditor's professional judgment. Adding language to this effect will better align the proposal with other standard setters as well as the Board's risk assessment standards.

Further, paragraph 11b requires that the auditor describe the considerations that led the auditor to determine that the matter is a CAM. We recommend the Board consider revising this requirement so the auditor considers the "primary" considerations that led to the determination of a CAM. As currently proposed, an auditor may repeat all of the factors in paragraph nine, which we do not believe is the Board's intention. If the requirement is revised to focus on the primary considerations, the auditor can better communicate what were the most relevant factors that led to the conclusion that a matter is a CAM.

We appreciate the Board providing various examples of CAMs and the opportunity to comment on those examples. We are generally supportive of the examples, however, we have significant concerns with respect to disclosing information about the company (internal control deficiencies and proposed adjustments) that should be the purview of management to consider for disclosure. Absent disclosure by the entity, we do not believe the auditor should be in the position of needing to or being expected to disclose such information.

We believe that the current proposal and related examples imply that certain information may be reported by the auditors and not disclosed by management. Such disclosures by the auditor would blur the auditor's responsibilities with those of management. We also believe that unintended consequences could arise if the auditor were to communicate matters that are not otherwise required to be disclosed, such as significant deficiencies in internal control, since this could create confusion and inconsistencies with current SEC reporting requirements. Such disclosure by the auditor could also result in negative consequences to the issuer given the context in which those disclosures might be made and the fact that the issuer did not make the disclosures themselves. Application guidance provided in paragraph A37 of the IAASB's Proposed International Standard on Auditing ("ISA") 701, *Communicating Key Audit Matters in the Independent Auditor's Report* states:

> "It is appropriate for the auditor to seek to avoid the description of key audit matters inappropriately providing original information about the entity that is the responsibility of the entity's management and those charged with governance unless, in the auditor's judgment, the additional information that the auditor may provide is critical to the auditor's description of the key audit matter and providing such information is not prohibited by law or regulation. In such circumstances, the auditor may encourage management or those charged with governance to make relevant disclosures in the financial statements that include such other information, so that reference can be made to those disclosures within the description of the key audit matters in the auditor's report, rather than the auditor providing original information."

We believe this is important application guidance that we recommend the Board consider adding to their proposed standard related to CAM. As noted above, we believe alignment in the auditor reporting standards is important for investors and other stakeholders. Adopting this guidance will better align the requirements with the proposed ISA and clarify that auditor reporting should be limited to only audit-related matters and should not include information that management is responsible for disclosing.

We also note that the examples include references to the procedures the auditor performed with respect to the CAM. As proposed, there is currently no guidance or framework for the auditor to consider how and what to describe with respect to the audit response to a CAM. While we recognize that CAMs are intended to make the auditor's report more informative and useful, it is essential for investors to better understand the concepts of auditing in order to fully benefit from this additional information regarding audit procedures performed and to be able to use the information as intended by the proposed standard. In recent years, investors have adapted to new and emerging accounting information, but accounting topics (and changes thereto) do not equate to auditing topics, and there would be a significant learning curve for many investors who do not understand audit fundamentals and objectives.

We do support providing the auditor the option to include audit procedures in the explanation of each CAM if, in the auditor's judgment, conveying those procedures provides a better understanding regarding the significance of the matter. However, we strongly recommend the Board continue to perform outreach in this area prior to concluding on whether to promote or require such disclosures.

Finally, we note that the reporting of CAMs will likely present additional auditor litigation risk surrounding what matters were selected, how they were described, and even the order in which they are presented in the auditor's report. Such risks may not be limited to the legal liability of the auditor but may also heighten the audited company's litigation risk. However, we believe revisions to the proposal based on certain of our recommendations may mitigate this risk.

Documentation

We support the effort to align the documentation requirement under the proposal with current auditing standards. However, as noted previously, we believe that it is important to clarify within the proposal that the determination of and response to CAMs are a matter of auditor judgment. Further, the current proposal requires the auditor to document why the auditor concluded that a matter potentially meeting the definition of a CAM was not ultimately communicated as a CAM. This type of documentation is inappropriate and will add unnecessary time and costs to the audit. We believe that this requirement is inconsistent with current auditing standards and auditor protocols regarding documenting the results of procedures performed and evidence obtained to support the auditor's opinion. Documenting what the auditor considered but did not act on is not operational, and we do not believe it improves audit quality.

Also, the proposed standard appears somewhat inconsistent with the additional discussion on this topic provided in Appendix 5, *Additional Discussion Related to the Proposed Auditor Reporting Standard* ("Appendix 5") of the proposal, which notes:

> "In fulfilling the documentation requirements under the proposed auditor reporting standard, the auditor would not be expected to provide an explanation for each matter documented in the engagement completion document, reviewed by the engagement quality reviewer or communicated to the audit committee."

We are concerned that, as currently drafted, the proposal will result in a significant amount of time and effort relating to fulfilling the documentation requirements, particularly at the end of the audit when available time is often minimal. Consequently, we are concerned with the potential impact on audit quality, as such requirements would strain resources and could potentially impact the communications between the auditor and engagement quality reviewer and/or the audit committee.

## Auditor's responsibility regarding other information

We support providing greater transparency into the auditor's responsibility and procedures related to other information, which we believe will be beneficial to users of the financial statements. We agree with the Board's view that investors and other users of the financial statements will benefit from understanding the auditor's responsibilities for information that accompanies the auditor's report and financial statements. We do note that some of the suggested changes in the proposal seem to indicate that the Board is remedying a deficiency in current practice, rather than bringing transparency to the existing process. We think this is most evident in the Board's discussion in Appendix 6, *Additional Discussion Related to the Proposed Other Information Standard* of the release as to the upgrading of the auditor's responsibility from "read" to "evaluate." We are not aware of previous concerns articulated by the Board or PCAOB staff with respect to the auditor's responsibilities and execution under current standards.

### Objectives and scope

We believe that certain clarifications to the objectives may enable the auditor to meet such objectives. We recommend clarifying the objectives to refer directly to the financial statements as well as adding language allowing for the auditor to consider the materiality of the other information, in order to focus the auditor's efforts in areas where potential misstatements of fact or material inconsistencies may be more likely to occur.

We have suggested certain revisions to the proposal related to clarifying the scope of the auditor's responsibilities and the auditor's ability to use judgment in determining the level of effort to expend on certain information. For example, we believe it would be appropriate to allow the auditor to determine the extent of work necessary on certain aspects of other information. Also, we are not clear as to the Board's intent with respect to the exhibits filed with the company's annual report and whether previously filed exhibits are also subject to the same approach with respect to evaluating the information and performing procedures. While such clarification is not currently included in AU 550, *Other Information in Documents Containing Audited Financial Statements,* we believe current practice would include a pragmatic approach to the need for or level of review of certain other information included in the exhibits, for example. Accordingly, we recommend the Board clarify the scope of other information that would be subject to this standard as well as provide for auditor judgment in determining the nature and extent of the procedures performed related to the other information.We are also concerned as to the implications of extending the auditor's responsibility to information filed subsequent to the issuance of the company's Form 10-K, specifically the definitive proxy statement or any subsequent amendments to the annual report. As currently written, the auditor is responsible for evaluating information that is not available as of the report date. We believe this requirement could result in significant operational issues. We recommend the Board reconsider the impact subsequent filings may have on auditors fulfilling their responsibilities under this standard and the interaction with other standards, such as those related to report dating, predecessor/successor auditor changes, etc.

We also believe the Board should clarify in the standard that it does not intend for another company's financial statements to be considered "other information" for purposes of this standard (for example, in cases where financial statements of an acquired entity are included in a registrant's Form 10-K). These financial statements should not be considered within the scope of the proposed standard given that they are not the company's information and were subjected to a separate audit.

### Evaluating the other information

As noted above, the proposed standard elevates the level of auditor responsibility, which we believe is unnecessary. The benefits of this change to investors will not be commensurate with the costs associated with expanding the auditor's responsibilities related to other information. By increasing the requirement from "read and consider" to "evaluate and conclude," the burden to identify misstatements of fact is now higher, but there is no reference in the second objective of the standard with respect to the evidence obtained. We strongly encourage the Board to consider retaining the current performance requirements in AU 550 .

We do have concerns regarding the proposed responsibilities for information not directly related to the financial statements. As currently written, we believe this may be interpreted inconsistently and potentially drive excessive work by audit teams attempting to compare audit evidence with aspects of such information. We believe that the evaluation of other information not directly related to the financial statements as described in paragraph 4c of the proposal should be separate from the responsibility for information directly related to the financial statements. Consistent with current practice, we believe the auditor's responsibility should be limited to reading and considering the other information not directly related to the financial statements based on the auditor's understanding gained during the audit.

We also note that the proposal does not specify that the auditor would communicate the date through which the other information subjected to the auditor's evaluation was available. We believe this should be included especially when considering potential issues related to report dating and subsequently filed other information.

Responding to material inconsistencies or misstatements

We support the proposed responses to potential material inconsistencies or material misstatements of fact as set forth in the proposal. We do note that it is unclear whether the Board's reference in the proposal to AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*, implies that the audit report should be amended or dual dated in instances where the auditor identifies a material inconsistency or misstatement of fact within a company's subsequent filing, such as a definitive proxy statement. Additionally, is the report on other information affected by subsequent matters? We believe further clarification of the intent of the Board with respect to such events is necessary.

Reporting in the auditor's report

We support flexibility with respect to the order of items to be reported within the auditor's report; however, we believe that reporting on other information should not be included prior to the description of management's (and the audit committee's) or the auditor's responsibilities, both of which refer to the audit of the financial statements. Reporting on other information should be clearly separated and included at the end of the auditor's report on the audited financial statements.

We believe it is important to consider the users' perception of the proposed paragraph to be added to the report and the conclusion provided in that paragraph. We believe that providing a conclusion on other information in the report would likely result in an increase in the expectation gap for investors and other users as to the level of work performed on the other information. We strongly recommend the Board consider revising the reporting requirements to focus on the materials the auditor was responsible for, and a general description of the performance requirements without providing a conclusion.

We suggest the Board consider clarifying scenarios as it relates to the auditor's reporting responsibilities. For example, if the auditor identifies a material misstatement of fact with respect to a matter that does not affect the financial statements and management will not revise the disclosure, would the auditor be expected to report this misstatement in the auditor's report? Would the auditor include it but specifically state that the material misstatement does not impact the financial statements? Since the scope of information currently encompasses all other information, all of the various scenarios that may arise should be considered by the Board prior to finalizing the proposal.

Finally, with respect to the impact on predecessor auditors, we do agree with the Board's proposed changes with respect to the predecessor's responsibilities. We note that AU 508.71 discusses representations from management and the successor auditor that the predecessor should obtain. We suggest the Board consider expanding the nature of the representations to include matters that come to the attention of the successor auditor that might have a material effect on the predecessor's conclusion with respect to previously reported other information, in addition to the financial statements reported on by the predecessor auditor.

## Basic elements of the auditor's report

### Addressees

We are supportive of the addressees of the auditor's report including both shareholders and the board of directors or its equivalent in order to gain more consistency in practice. We believe that addressing the report to the shareholders is supportive and consistent with the objective of the audit, which is to enhance public confidence. However, we do not believe the addressees should extend beyond the shareholders and the board of directors or equivalent. The primary users of the financial statements that are considered when planning and executing an audit are "reasonable investors" as described in Auditing Standard No. 11, *Considerations of Materiality in Planning and Performing an Audit.* Including other parties beyond these may misalign the addressees of the auditor's report and the primary users considered in an audit.

### Auditor's responsibilities and nature of an audit

We further support the clarifications and proposed additions to the report language surrounding the auditor's responsibilities as well as the nature of the audit. We believe such information may be helpful to investors and other users of the financial statements. We also recommend that the Board consider aligning those requirements, where appropriate, with the IAASB proposal, which we believe would be beneficial to financial statement users. In particular, we recommend adding the following:

- Definition of "reasonable assurance"
- The auditor's responsibility related to obtaining an understanding of internal control relevant to the audit (financial statement only audit)
- The auditor's responsibility to communicate with the audit committee

### Auditor tenure

We recognize that greater transparency regarding tenure may be important to some users of the financial statements, but we believe the auditor's report is not the appropriate place to convey this information. If included in the auditor's report, the information could be misinterpreted as having a correlation to audit quality, as highlighted in the PCAOB's release, where there is no definitive empirical evidence that such a correlation exists.

The Board refers to rules adopted by the United Kingdom ("UK") Financial Reporting Council in Appendix 5 that require UK-listed companies to provide information on the length of auditor tenure in a separate section of the annual report. In this case, the listed company provides this information, not the auditors. We believe it would be more appropriate if this information were reported by a company's audit committee through the proxy statement or other means. If the responsibility to disclose this information must lie with the auditor, we would be supportive of the Board requiring the tenure information to be included in audit firms' annual report on Form 2. Since an audit firm's Form 2 is available to the public, we believe this is a more reasonable method for conveying this information without risking it being misinterpreted.

### Form of the auditor's unqualified report

We believe retaining the pass/fail model is important, particularly with the introduction of CAMs. Maintaining the pass/fail model will make it clear that the auditor's opinion is on the financial statements taken as a whole and not on specific elements. As indicated above, we support not mandating the ordering of sections in the auditor's report in order to allow flexibility. However, we are concerned about the proposed standard's use of headings. Currently, headings are required for only certain sections of the auditor's report. The proposed use of headings may imply to users of the financial statements that certain sections are more important than others or should be weighed differently when evaluating the auditor's report taken as a whole. We recommend requiring headings for all sections, which is consistent with other standard setters. We believe this would better align the intended use of the auditor's report with how it is read and used by investors.

### Explanatory language within the auditor's report

We agree with retaining the concept of explanatory paragraphs to emphasize a matter regarding the financial statements. We note that the proposed definition of CAM is included in Appendix A to the proposed auditor reporting standard. We suggest the Board consider adding a definition of an "emphasis of matter paragraph" to clearly differentiate the expected use of those paragraphs from CAM. .

With respect to placement, we support the flexibility afforded by the proposal that permits auditor's to place emphasis of matter paragraphs within the auditor's report based on the nature of the information and the auditor's judgment as to its relative significance. This flexibility is consistent with not mandating the ordering of the various sections of the auditor's report.

## Other considerations

### Scope

We recommend that the two proposed standards be applicable to issuers, including emerging growth companies (thus entities filing Regulation 305 or 309 statements would not be subject to these provisions), with an  exception for Form 11-K filers. While we understand that certain industries, such as investment companies, include entities that are not complex and reporting and disclosures are straightforward (such as a mutual fund that invests in highly rated securities with little complexity or valuation uncertainty), we would find it difficult to “draw a line” as to when CAM would be required for an entity or type of entity based on those scoping characteristics.

We believe that employee benefits plans are designed for a specific purpose and as a result would likely have either no CAMs identified, or similar, potentially boiler-plate CAM descriptions. Employee benefit plans are inherently less complex and entail fewer estimates and judgments, and CAMs for these entities would likely include auditing hard-to-value investments, which require extensive fair value disclosures. Further, plans have a limited amount of other information that would be filed with the SEC. Since each plan also files an AICPA report with the Department of Labor, scoping plans out of the proposed standards would avoid different forms of the auditor’s report for the same entity.

With respect to broker-dealers, we believe the standards should apply to broker-dealers that are issuers, consistent with our views above. We are aware of situations where a broker-dealer can request confidentiality with respect to certain statements included in a filing. In those circumstances, the auditor’s responsibilities for reporting CAM may conflict with the reduced financial statement presentation. We recommend further discussion on this matter and consideration as to whether CAM, in those circumstances, would be limited for consideration to the matters related to the publicly available financial information.

### Consideration of other independent auditors

It is currently unclear how these proposed standards would interact with AU 543, *Part of Audit Performed by Other Independent Auditors.* We believe that further guidance is needed with respect to applying the proposed standards to audits where multiple auditors are involved, such as in scenarios where a principal auditor makes reference to another auditor’s report.

### Considerations related to securities act documents

We agree with the Board’s deliberate approach as it relates to expanding the scope of the proposed standard or incorporating elements of the performance and reporting of the proposed standard to AU 711 *Filings Under Federal Securities Statutes.* Current practice for most securities offerings that include capital-raising often include an underwriter who will require that the company’s auditor provide a comfort letter related to the financial statements and other financial information included in the filing. The interplay between the responsibilities and legal liability of the underwriter and that of the auditor under the federal securities laws is complex. Providing more transparency as to the auditor’s responsibilities for other information included in those filings without also including the responsibilities of the other parties (such as underwriters and attorneys) may be confusing and result in inappropriate conclusions by the readers of those filings.

## Cost considerations

As described above, we agree that initial costs will be incurred by firms in order to update firm policies and methodologies, and there will be ongoing costs in order to apply the requirements of the two proposed standards. We note that certain of our suggestions are intended to address efficiencies as well as maintain effectiveness of executing on the objectives set forth in the proposal.

Some of the additional cost considerations will include incurring additional time identifying and drafting CAMs, evaluating other information, documenting procedures and conclusions reached on CAMs and other information, and discussing these matters at length with the audit committee. Audit firm quality control procedures will likely include national office involvement. This increased time will also be incurred by the more expensive team members since the proposed standards provide minimal opportunity to leverage this work.

As noted above, we are in the process of performing field testing in conjunction with the Center for Audit Quality, which will help us determine an estimate of the increase in hours and costs. While we currently do not have empirical evidence to provide to the Board, we believe that the increase in cost and time will be due to considering the sensitivity of company information and interrelationship with company disclosures in the financial statements and other information, and the additional discussions that will need to take place with management, those charged with governance, and possibly the company's and auditor's legal counsel. We do expect that the increased time will impose pressure on meeting an issuer's filing deadline and also create pressures on audit quality. The costs to be incurred by the auditor will also pressure firms to raise the cost of the audit.

Lastly, we support and recognize the importance of a post-implementation review separate from the Board's inspection process that includes an evaluation of the direct and indirect effects on financial markets, regulatory scrutiny, and litigation matters. It is inevitable that auditor judgments across and within firms will differ with respect to determining and describing CAMs and, as a result, there will be variations in practice. In addition, we believe that users of financial statements would utilize and apply the additional information to be included in the auditor's report in diverse ways to suit their specific needs. Accordingly, monitoring the effects of the new auditor's reporting model and whether it is not only being applied appropriately by auditors but also has met user expectations will be essential to achieving the objectives of the proposed standards.

***************************

If you have any questions about our response, or wish to further discuss our comments, please contact Jeff Burgess, National Managing Partner of Professional Standards, at Jeff.Burgess@us.gt.com or at (704) 632-3940.

Sincerely,

Grant Thornton LLP

**From:** Andy Phillips
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 10:39:23 AM
**Attachments:** PCAOB Docket 034 Comment.pdf

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To Whom it May Concern,

As an owner of a non-custodial, non-public BD, I fully support Lisa Roth's position on this issue.

Regards,

Andrew Phillips

__________________________
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**Lisa Roth**

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Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

**From:** Stacy Havener
**To:** Comments
**Subject:** PCAOB Comments in support of Lisa Roth
**Date:** Thursday, December 12, 2013 9:05:41 AM

I endorse and support Lisa Roth's comments.
As a small independent business, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies many of which are closely held independently owned businesses.
Thank you for your interest in our opinion.
Stacy

**********************************************

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*Securities offered through Compass Securities Corporation, member FINRA SIPC*
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**From:** Jack Henry
**To:** Comments
**Subject:** Proposed Auditing Standards
**Date:** Monday, November 04, 2013 5:57:16 PM

Whenever I read proposed regulations I try to determine what problem exists that requires a new regulation. As to the proposal to "enhance" the auditor's report and to "enhance" the auditor's responsibility over other information outside the financial statements in annual reports, I do not find an existing problem that these proposals will solve.

Critical audit matters are akin to the critical accounting matters already disclosed, at least in duplicate, in the notes to the financial statements and the MD&A. Each of these began as an attempt to identify the critical matters but quickly expanded to an almost inclusive litany of all but the minor accounting matters affecting the financial statements. In practice registrants run a risk of omitting anything that litigants may subsequently deem critical. I see the same happening in this proposal so it will result in a third litany of matters already covered elsewhere in the financial statements and the annual report. The result will be additional bulk in an already bulky document. Recently, Chairman White commented on the unnecessary duplication and disclosure of information suggesting a need to streamline, not expand, data.

Asking the auditor to expand responsibility over information outside the financial statements is another solution seeking a problem to solve. Auditors already read the entire documents in which their reports are included and if they identify inconsistencies or other information with which they do not want to be associated, they can withhold their report. This proposal formalizes and expands their responsibilities which in turn will expand the scope, time and fees for their work plus increase their legal exposures.

The responsibility for complete and accurate financial statements and other information issued by issuers is that of management of the company. These proposals suggest a shift of responsibilities to the auditors. This trend leads to them, not the registrant, being responsible. At what point do they lose independence due to the expanded responsibilities?

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December 10, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 34

Board Members:

This comment letter is presented by the Audit Committee and management of Healthcare Realty Trust (NYSE:HR) in response to PCAOB Release No. 2013-05, PCAOB Rulemaking Docket Matter No. 034 dated August 13, 2013 (the "Release").

We are opposed to any significant expansion to the independent auditor's report and to the additional extensive disclosures by the independent auditors regarding the integrated audit that are outlined within the Release. We believe any specific expansion is not justified. This release, if adopted, would add more confusion and not clarity.

Our main objection is that it is not clear that there are any specific benefits to an expansion as contemplated by this Release. We do not believe this additional information from independent auditors would be useful to users of an Issuer's financial statements and periodic filings. The Release contains many references to academic research and highlights a major weakness to this type of academic research – the benefits are not definitive, only theoretical. Providing this information solely as a data source to be mined for further academic research is not in the best interests of the investing public, an Issuer, or an Issuer's independent auditor.

We believe this Release is an example of what SEC Commissioner Daniel Gallagher was referring to in his remarks on December 6, 2013 at the Second Annual Institute for Corporate Counsel. His outreach with investors reveals that currently "disclosure documents are lengthy, turgid, and internally repetitive" which results in disclosure documents that are "not efficient mechanisms for transmitting the most critically important information to investors – especially not to ordinary, individual investors. They are not the sort of documents most people are likely to read, even if doing so is in their financial self-interest." Given this overload of disclosure, the Board should be measured in its rulemaking to avoid expanding disclosures, such as those included in the Release, that are supported mainly by academic research that notes such rules "could" provide benefits that are elusory. The history of the accounting profession has been that rules, disclosures and related costs only increase. They very seldom are reduced.

Further, we have not been able to reconcile the inevitable expansion of an Issuer's regulatory filings as a result of the Release with the comments from SEC Chair Mary Jo White on October 15, 2013 to the National Association of Corporate Directors addressing information overload. She described this as "a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant." She also commented on the SEC's outreach activities in the mid-1970s:

> "the Commission... held public hearings on what topics should be required in corporate disclosures. In the course of those hearings, it received suggestions of over 100 topics – a 'bewildering array of special causes' – ranging from charitable contributions to 'good things a company has done.' Expressing the view that disclosure should generally be tethered to the concept of materiality, the Commission decided against requiring disclosure of the identified matters, noting that 'as a practical matter, it is impossible to provide every item of information that might be of interest to some investor in making investment and voting decisions.' "

In the Board's outreach it appears to have had a similar experience that Chair White references in her speech – "a bewildering array of special causes." The proliferation of ideas the Board has elected to explore and expose for comment has resulted in response fatigue. Issuers and independent auditors have responsibilities other than monitoring the Board's activities and responding to these activities in public letters. This creates the probability that ideas with little value will be promulgated since Issuers, who fund the PCAOB's operations, simply cannot keep up. Better discretion is needed by the Board in its rulemaking process and communications. As Commissioner Gallagher noted, "from an investor's standpoint, excessive illumination by too much disclosure can have the same effect as obfuscation – it becomes difficult or impossible to discern what *really* matters."

Another concern raised by Chair White in her speech is whether investors are "getting the information they need when they need it." The effects of this Release could constrain an Issuer's ability to meet the current regulatory filing deadlines. The Board needs to consider the current reporting requirements along with the expansion of disclosures in connection with this Release, and discuss this with the SEC, to determine what is in the best interests of the investing public.

In all of the Company's experiences and across all communications media with the public, the Company has never had any questions or discussions with investors on any matter involving the Company's audit. The Board does not appear to be communicating with the same investor groups as the Company. As an Issuer who is active in the public markets, the Company is in constant communication with existing and potential investors, both institutional and individual. An extensive and efficient infrastructure has been carefully created to allow investors to communicate easily with management. The Company's periodic filings are governed by the rules of the SEC and include not just the periodic reports on Form 10-Q and annual reports on Form 10K, but include all other 1934 Act and 1933 Act filings. This information is available instantaneously once filed and is designed to provide the investor with not just the GAAP-based financial statements and related notes, but management's commentary on historical results, forward-looking views on trends, risk factors and any other information deemed relevant to an investor or potential investor. In addition, the Company furnishes other information via a Form 8-K that is not required to be filed with the SEC, such as investor presentations and other supplemental information, all with the intention of assisting interested parties in developing as complete an understanding of the Company's business and industry as possible. Management holds a quarterly earnings call with analysts and investors where management makes itself available to answer questions regarding the Company's business. A shareholders' meeting is held annually that is open to all current investors to attend. At this meeting, representatives from the Company's management team, audit committee, and independent auditors are all available to interact with attendees and respond to inquiries of any kind. Further, the Company provides other telephonic and electronic means for all parties to access management. It should also be noted that the Company's independent auditors have never received any inquiries from the investing public regarding their audits or the Company's financial statements.

The Release would fundamentally alter the communications among independent auditors, Issuer's audit committees, Issuer's management, and the public. At its core, the nature of an attest engagement requires the independent auditor, through its audit report, to communicate its conclusion whether the Issuer's written assertions (i.e., the financial statements and related notes) are presented fairly, in all material respects, in conformity with accounting principles generally accepted in the United States of America. Requiring auditors to provide more information about what constitutes an audit will substantially increase the volume of information that will eventually be required under the Release. Alternatively, the Board could publish a description of what constitutes an audit on its website. Matters of judgment inherent in the execution of any audit of financial statements under PCAOB standards cannot and should not be relegated to boilerplate disclosures or "sound bites."

The Release injects information from outside the Issuer, but that pertains to the Issuer and its financial statements, that is beyond the control of an Issuer's management to substantiate or certify (as the CEO and CFO are personally required to do for every Form 10-K and Form 10-Q). We are fundamentally opposed to the independent auditors being such a source of original disclosure and believe this establishes a dangerous precedent. The primary focus of investors should be on the content of the financial statements included in the public filings, the sole reason for the filing. The source of this information is the Issuer. The requirements in this proposal are another step in shifting that focus away from the primary purpose of the filing in favor of the audit process, and the independent auditors. The purpose of the Annual Report on Form 10-K is not to give the independent auditors center stage. This document is the responsibility of the Issuer and is signed by members of the Issuer's management and Board of Directors. Embedding the type of third party information within these documents that the Board is proposing in this Release is a major change to the purpose of this 1934 Act filing.

We believe independent auditors under the Release would be encroaching on confidentiality and giving the appearance of assuming more responsibility for management's judgments and business decisions reflected in the financial statements that are the subject of the audit. This does not align with the Board's stated mission of preserving auditor independence.

This additional information that would result from this Release will become subject to review by the Board in the inspection process and could result in additional "failed audits." The Board already has unfettered access to a domestic Issuer's audit file that contains the raw materials for these proposed disclosures. The Board's inspections presumably already focus on the very items proposed to be disclosed publicly. However, the costs of complying with this Release will rise as further refinements, clarifications, interpretations, and expansions to the rules by the Board invariably occur in the future.

We believe the results of the Board's efforts in the last few years, intentional or not, are a re-defining of what constitutes an integrated audit without the clarity and transparency of purposefully and diligently communicating this objective to the public. This has created more confusion among auditors, Issuers' managements and audit committees, as well as within the investment community for whom these measures are purported to benefit.

We have concerns over the agenda of the PCAOB. It is difficult to understand who has established the agenda and what the ultimate objectives are. For example, the PCAOB has released concept statements or proposals on auditor rotation, auditor communications with management and the audit committee, this current Release, and signing the partner's name. In the midst of these piecemeal proposals, the Board released in December 2012 the results of its 2010 inspections that painted a dire picture of audit quality based on the number of "audit failures" it identified. We believe attention should be focused on these basics (i.e., eliminating "audit failures") and that the Board should strive to establish stronger bonds with audit committees, which was discussed in the response letter from the Company's audit committee in November 2011 on the auditor rotation project.

The multitude of regulations governing an Issuer requires that an audit committee satisfy certain criteria. These criteria, such as financial literacy and independence from the Issuer's management and the Issuer's independent auditor, are designed to make the audit committee relevant and credible in the execution of its responsibilities. One audit committee responsibility is to oversee the independent auditors and their work. In addition to focusing on auditor independence, objectivity and professional skepticism (as discussed in the Board's prior proposal on required auditor rotation), the audit committee is tasked with understanding how effectively the independent auditors executed their audit. This evaluation necessarily includes a discussion of the areas of significant auditor judgment, significant risks within the financial statements, etc. The Board has recognized the importance of these responsibilities and has mandated the formal communication of these and other matters in Auditing Standard No. 16, Communications with Audit Committees, many of which the Board is now proposing be disclosed directly to the public by the independent auditors. The audit committee is also responsible for overseeing management. This access to both parties involved in the audit – the auditor and the Issuer – makes the audit committee the resource through which the Board should operate.

The Board continues to incrementally marginalize the role of audit committees. The Release circumvents audit committees in favor of going directly to the public, unfiltered, with information they will not understand. Instead of further diminishing the role of audit committees, the Board should be seek to become an ally with audit committees in its efforts to promote "informative, accurate and independent audit reports."

Finally, the larger registered firms are a valuable voice in the rulemaking process. They must play a prominent role in the rulemaking process in order to ensure that the auditing standards of the Board are effective and the interests of the public are being served by the Board. We believe the Board should be aware of a growing point of view among Issuers and board members who serve on audit committees that the larger registered firms may not express candidly their perspectives with the Board formally in public in an effort to decrease the perceived tension that exists within that relationship. Those of your board members that have been directly involved in the audits of Issuers' financial statements and the expansion of the independent auditor's report understand the significant costs of expansion. Ultimately, the current shareholders of Issuers bear the costs of all these additional procedures. Whereas audits of internal controls over financial reporting have added benefits, they have significantly increased, in many instances more than doubled, the audit fee. What the Board is proposing in this Release will only increase fees without any actual benefits.

We are available to discuss this response letter with you at your convenience. We can be reached at (615) 269-8175.

Sincerely,

Bruce D. Sullivan

Bruce D. Sullivan
Chairman of the Audit Committee and
Retired EY Partner (retired in 2001)

Scott W. Holmes

Scott W. Holmes
Executive Vice President and Chief Financial Officer

David L. Travis

David L. Travis
Senior Vice President and Chief Accounting Officer

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

December 11th, 2013

**RE: PCAOB Rulemaking Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Board Members:

We welcome the opportunity to comment on the PCAOB's proposals in relation to the auditor's report.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from across the world, all of which invest in companies whose audits are subject to PCAOB oversight. In all, EOS advises clients with regard to assets worth more than $195 billion.

We are supportive of the proposed disclosure enhancements and of the intent behind them, and believe that if auditors report in ways that aspire to communicate effectively, real value can be added for shareholders. We make these concrete suggestions to enhance the proposals. These are italicised to ease identification.

Requiring disclosure of matters that are critical to the audit process is a welcome addition to corporate disclosure as it provides greater clarity on the robustness of the audit process and in turn on the quality of the audit report. We are supportive of the inclusion in the audit report of information clarifying the auditor's responsibility for the evaluation of other information which may influence their ultimate assessment of the company's financial statements.

Currently the audit is entirely invisible to the shareholders who pay for it and for whose benefit it is carried out. This is simply not a sustainable situation and it is no wonder that confidence in the value of the audit continues to fall and questions continue to be asked about whether there might be different and alternative models that would better serve shareholder interests. Making the audit more visible to those who pay for it and for whose benefit it is carried out is a small but vital step forwards. As well as providing necessary visibility, we believe that good disclosures will potentially rebuild confidence in audit quality.

We agree with the PCAOB's classification of "critical audit matters" and expect that by identifying these in the auditors report, users of financial statements will have a clearer indication of areas where further scrutiny is merited. As intended in the proposed reforms, it

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will be of particular value to enhance disclosure around areas of the audit process where the auditor has identified significant management judgements or where there is an indication of significant uncertainty. In addition, this would promote greater accountability as it would highlight areas in which the company has failed to provide sufficient information, or information of sufficient quality, for the auditor to perform a thorough assessment. We hope that, and will encourage, the audit firms to avoid this disclosure to descend into boilerplate. It is important that both *shareholders and regulators encourage audit firms to see competitive advantage in good quality audits* and the reporting of how they attempt to achieve them.

Another additional clear benefit of these proposals is that shareholders will have a foundation of information on which to hold dialogue with the company (whether the executive team or the audit committee) on matters related to the audit. We would also hope that over time mechanisms can be found for these disclosures also to form the basis for contact between shareholders and the auditor itself. Through these routes, both with the company and with the auditor, greater confidence in audit quality, and also in the quality of the company's reporting, can be built.

We believe that encouraging auditors to comment on matters that are unique to a company's audit process will be a welcome addition and a shift away from the largely boilerplate language currently disclosed by most companies in their reports. This should be more indicative of the quality of the disclosure that companies provide to auditors. We therefore also welcome the proposal to require auditors not only to consider other information disclosed by the company in preparation of its financial statements, but also to evaluate the materiality of such additional information and the impact it may have in the quality of the audit. *To encourage further the development of helpful audit reports, we believe that the auditors should identify any critical matters that had not been identified at the time of commencement of the audit.*

Overall, we view the proposed amendments as enhancements that should foster greater transparency and accountability by companies and auditors alike. We need to challenge audit committees to perform their role more fully and clearly on behalf of shareholders, and the changes proposed by the PCAOB will further empower us to do so. *However, to make engagement on these issues more effective, we believe that the audit committee should comment on what it believes the most important management judgments are in relation to the matters covered by the external audit together with a description of the main elements of its work programme during the year.*

We appreciate the opportunity to provide input into the consultation. I would be glad to discuss any of the points above with you further on +44 (0)20 7680 3758 or at m.isaza@hermes.co.uk.

Yours sincerely,

Manuel Isaza
Corporate Engagement Manager – North America

**From:** Deborah Higgins
**To:** Comments
**Cc:** Lizcollins@financialtelesisinc.com; "Lisa Roth"
**Subject:** Docket 034
**Date:** Thursday, December 12, 2013 12:59:17 PM
**Importance:** High

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I support Lisa Roth's position.

- Deb

Deborah M. Higgins
President
Higgins Capital Management, Inc.

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HOST
HOTELS & RESORTS®

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street NW
Washington, DC 20006-2803

*Delivered electronically to: comments@pcaobus.org*

**Subject: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards – *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* (the Proposal)**

Dear Board Members:

Host Hotels & Resorts, Inc. appreciates this opportunity to respond to the request for comments from the PCAOB (the Board) on the above referenced Proposal. We support the Board's objective to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports. While we agree with the Board's conclusion to preserve the pass/fail model, our main concern is that the proposed disclosures of critical audit matters in an unqualified report, as suggested by certain financial statement users, would not provide additional value.

Rather than expand the auditor's disclosures, we recommend that the Board and the accounting profession continuously: 1) uphold management's responsibility of the financial statements; 2) assert the current role of the auditor, audit process and auditor reporting framework; and, 3) emphasize the value of viewing the Form 10-K as a comprehensive financial reporting package. Further, we believe that investors are best served by the prevention of audit deficiencies through the improvement of standards and procedures that result in high-quality audits.

**About Host Hotels & Resorts, Inc.**

Host Hotels & Resorts, Inc. is an S&P 500 and Fortune 500 company and is the largest U.S. lodging real estate investment trust (REIT) and one of the largest owners of luxury and upper-upscale hotels. We are also a member of the National Association of Real Estate Investment Trusts® (NAREIT). The Company currently owns 102 properties in the U.S. and 15 properties internationally totaling approximately 62,200 rooms. We also hold non-controlling interests in a joint venture in Europe that owns 19 hotels with approximately 6,400 rooms and a joint venture in Asia that owns one hotel in Australia and a minority interest in two hotels in India. Guided by a disciplined approach to capital allocation and aggressive asset management, the Company partners with premium brands such as Marriott®, Ritz-Carlton®, Westin®, Sheraton®, W®, St. Regis®, Le Meridien®, The Luxury Collection®, Hyatt®, Fairmont®, Four Seasons®, Hilton®, Swissotel®, ibis®, Pullman®, and Novotel® in the operation of properties in over 50 major markets worldwide. For additional information, please visit our website at www.hosthotels.com.

**Host Hotels & Resorts, Inc.'s Comments and Recommendations**

As previously stated, rather than increase the auditor's disclosures, we recommend that the Board and the accounting profession: 1) uphold management's responsibility of the financial statements; 2) assert the current role of the auditor, audit process and the auditor reporting framework; and, 3) emphasize the value of viewing the Form 10-K as a comprehensive financial reporting package. These communications should be made to the user community on a continuous basis.

***Uphold Management's Responsibility of the Financial Statements***

We believe that the financial statements should unequivocally remain the full responsibility of management. Based on certain users' views, it appears that they would be inclined to use the auditor's disclosures as the primary source of disclosure about our company. We recognize that certain users believe that they would find value in critical audit matters, especially those matters resulting from changes in principles or areas that involve significant judgment, which may require discussion with management to clearly understand and correctly apply to their models. We suggest that the Board stress in its communications to users that management is responsible for the financial statements and that, in addition to evaluating the overall financial statement presentation, the auditor assesses the accounting principles used and significant estimates made by management.

Similar to financial statement users, we believe that the disclosures of these matters are relevant to issues that are significant toward understanding the financial statements. Therefore, we suggest that the Board inform users about companies' control requirements and refer users to the disclosures in Management's Discussion and Analysis (MD&A) and the notes to the financial statements. In this regard, we believe that the disclosures in the MD&A section are critical to an investor's understanding of the financial statements.

Accordingly, our most recent Form 10-K included five pages of discussion regarding these issues that when read in conjunction with the audited footnotes provides clear and important guidance to investors. Like many companies, our financial reporting objective is to provide a complete and accurate understanding of the financial statements. We perform extensive reviews to ensure appropriate disclosures, as well as establish effective controls and procedures surrounding these disclosures.

***Assert the Current Role of the Auditor, Audit Process and the Auditor Reporting Framework***

We recommend that the Board and the accounting profession increase user awareness of the current responsibilities of the auditor, the audit process and auditor reporting framework and make these communications outside of the auditor's report. Based on the Proposal, it seems as if there is a need to clarify the auditor's role and the work involved in an audit of the financial statements resulting in the need for change of the auditor's report. We understand the value of the current unqualified report because we are aware of the work involved in an audit. Therefore, we recommend that the accounting profession assert to the user community the standards and procedures applied to perform audits in accordance with the PCAOB. We believe that this information would be more beneficial and provide comfort to users.

Further, we suggest that the PCAOB retain the same level of materiality for disclosures of critical audit information as provided in the current auditor reporting framework. As such, if there is a material departure from U.S. generally accepted accounting principles (GAAP), material weakness or insufficient scope, the auditor issues a departure from an unqualified report (qualified, adverse or disclaimer based on the circumstances). As a result, the auditor discloses the basis for a departure because of its significance to users.

In an unqualified report, the auditor would deem critical audit matters as insignificant toward changing the outcome of the opinion; therefore, we believe that this information would not provide incremental value to users. Instead, these matters would complicate the user's understanding of the auditor's opinion. Based on the Proposal's examples, we believe that adding disclosures of critical audit matters would create confusion within the investor community that the judgments used by management may not be in accordance with GAAP or that the auditor disagreed with those judgments, which could ultimately raise doubt over the auditor's judgment used to form the opinion. Therefore, to avoid confusion, we support maintaining the current defined responsibilities of management and the auditor. We believe that investors are best served by the prevention of audit deficiencies through the improvement of audit standards and procedures.

***Emphasize the Value of Viewing the Form 10-K as a Comprehensive Financial Reporting Package***

Rather than providing supplemental disclosures in the auditor's report, we recommend that the PCAOB and the accounting profession emphasize the importance of looking at the Form 10-K as a comprehensive financial reporting package. This package includes but is not limited to: 1) the auditor's report on the financial statements; 2) the auditor's report on the company's internal control over financial reporting; 3) the financial statements and the notes to the financial statements; 4) MD&A; 5) certifications of the Chief Executive Officer and the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002; and, 6) management's representations of the effectiveness of disclosure controls and procedures and internal controls over financial reporting. When these integral parts are viewed together, we believe that users would receive greater value from this package than the proposed critical audit matters.

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Again, thank you for allowing us to participate in the Board's considerations toward the development of PCAOB standards. If you would like to discuss our comments, please contact Brian Macnamara, Senior Vice President and Corporate Controller, at (240) 744-5423 or brian.macnamara@hosthotels.com.

Respectfully submitted,

/s/ Brian Macnamara

Brian Macnamara
Senior Vice President and Corporate Controller
Host Hotels & Resorts, Inc.

Husky Energy

December 11, 2013

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

Via "Open to Comment" page, www.pcaobus.org

**RE: PCAOB Rulemaking Docket Matter No. 034; Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Sir or Madam:

Husky Energy is responding to the Public Company Accounting Oversight Board's (PCAOB or the Board) Proposed Rule; Docket 034 (the Proposal). We appreciate the opportunity to provide comments on the proposed ruling, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, specifically appendix 6.

Husky Energy is one of Canada's largest integrated energy companies headquartered in Calgary, Alberta, and is publicly traded on the Toronto Stock Exchange under the symbols HSE and HSE.PR.A. The Company operates worldwide with Upstream and Downstream business segments. As a Canadian incorporated entity and a filer with the SEC, the company is required to comply with both Canadian generally accepted auditing standards and the standards of the PCAOB.

We agree with the Board's overall objective to apply the auditor's responsibility for other information, which is consistent with existing US and Canadian standards. We have no specific concerns with the auditors communicating this objective within the auditor's report.

We are however concerned with the Board's objective to enhance this responsibility by adding procedures, and whether these procedures will provide more valuable information to users. Other information, such as the Management Discussion and Analysis (MD&A) is a supplemental narrative through the eyes of management of how an entity has performed, its financial condition and future prospects. Most of the information contained within these supplemental reports is forward looking, operational, non-financial or if financial, contains the use of non-GAAP measures or information indirectly related to the audited financial statements. The scope of these additional procedures should only relate to information drawn directly from the audited financial statements congruent with existing requirements. We recommend to the Board that the additional processes do not extend beyond the existing roles and responsibilities of the auditors by positioning them as evaluators of a company's operations and suggest clarification of scope to be included within the auditor's report. Without clarification there is a risk that users will be mislead to believe that forward looking, operational, non-financial and indirect financial information is being evaluated and concluded on.

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*www.huskyenergy.ca*

Husky Energy

Lastly, we would like to address our concern as to whether the additional disclosures would have an incremental benefit over current practice. We do not believe that including disclosure within the auditor's report on the evaluation of other information will significantly, if at all, impact the users' interpretation of the financial statements. We believe that additional procedures will result in significant costs. In order for entities' to provide a formal cost-benefit analysis as requested by the Board, detailed documentation outlining these additional procedures would have to be provided. We recommend that the Board not proceed with this proposal until specific procedures have been established in order for entities to appropriately assess the cost-benefit.

We would like to thank the PCAOB for the opportunity to allow us to respond to the proposal.

Regards,

Angela Butler
Vice President, Finance and Controller
Husky Energy Inc.

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IDACORP

December 11, 2013

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

Subject: **PCAOB Rulemaking Docket No. 034**

Dear Secretary,

As chairman of the audit committee for IDACORP, Inc. and Idaho Power Company, I am pleased to provide comments on behalf of the Audit Committee on the two proposed audit standards under the above referenced Docket.

IDACORP is an investor-owned utility holding company, with approximately $5.5 billion in assets, $1.1 billion in annual revenues, and serving 500,000 electric customers in Idaho and Oregon. IDACORP's principal subsidiary, Idaho Power, has a 98-year history as a hydro-based electric utility with significant facilities along the Snake River.

Below are my comments based on audit committee experience at IDACORP since 2008, but also as a board member for several other public companies, including International Rectifiers Corp. and DineEquity, Inc.

**Auditor Reporting Standard (Critical Audit Matters, or CAMs)**

Docket 34's Introduction lays out underlying rationale for the proposal to enhance the standard audit report with disclosures of key areas that the auditor found "the most difficult, subjective or complex" and "found to be challenging". The docket assumes that this type of disclosure "could help to alleviate the information asymmetry that exists between company management and investors." (Page 6, first and third paragraphs).

My first and primary concern with the proposal is that it undermines the foundation upon which the current rules (SEC, FASB) and the current roles of auditor and Audit Committee combine to effectively protect the integrity of financial reporting to the investing public. To increase auditor reporting by requiring our auditors to provide supplementary information that led them to their unqualified opinion, is tantamount to having investors read the auditor's required communications to the Audit Committee. Additionally, when the Audit Committee reviews such currently required written communications, we also get to hear and ask questions about the context which gives rise to any difficult to audit areas, or significant management estimates. Without the context discussion, the auditor report would be confusing and require additional language to provide adequate context for investors. Asking auditors to reduce this

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robust and engaging governing process down to a written subset for investors will become difficult and problematic in my opinion. I envision that in an absence of bright lines or clear definitions in matters of auditor judgment, reporting will tend toward over-kill and lead to marginal value CAM disclosures. I also believe that investors who may be frustrated that the current level of audit report language is uninformative, will soon grow frustrated with the expanded version as well. The current governance process - well defined under the charter of a public company Audit Committee - serves the investing public well, and should not become the domain of the auditor to communicate.

My second concern is the price tag. Each and every disclosure that our company makes to our auditors (for example, through the quarterly representation letter) and vice versa, that they make to the company (for example, a comfort letter for bank loan reporting) goes through a vetting process that includes senior management, audit partners, Audit Committee members, and internal and sometimes external legal counsel for these parties. A single word change at the last moment may ripple through another lap through senior level management, Audit partners and legal reviews. I anticipate that unscripted CAM language will trigger senior management process reviews that will become a regular part of the quarterly reporting cycle – driving up fees and slowing down the reporting cycle at precisely the time when issuers were poised to file with the SEC. The untimely delay and additional costs will not justify the value of the incremental information provided. Over time, I believe that the CAM language in the auditor's report will tend to mirror the company's language in disclosures of critical accounting estimates, policies, fair value measurements and risk factors.

Third, the current law governing the content and clarity of financial reporting is well established and comprehensive, and is the domain of the SEC and the FASB. If investors seek additional disclosures, these would be best addressed through the financial reporting model, its rulemaking bodies, and implemented by management. Management should remain fully responsible for disclosures to investors, and auditors should remain fully responsible to attest on such disclosures. It is my view that the current rules governing the various roles of management, Audit Committee, and auditors, working together, provide for a full and complete disclosure to serve the information needs of investors.

Lastly, I couldn't help but comment on the idea of information asymmetry between management and investors. Is this really a substantive issue that requires a remedy? The company must at all times maintain custody of the detailed information that runs the business, and investors will always need a summarized view of key details. It seems to me that there is a natural asymmetry here. Using this rationale to seek additional auditor disclosure is vague and frankly, a black hole that cannot possibly be filled with virtually any amount of additional information. Again, if more detailed disclosures are needed, they should remain the sole responsibility of management and be imposed through the well-understood and accountable rulemaking processes of the FASB and SEC.

**Other Information Standard**

"The proposed other information standard would respond to investors' interests in obtaining information regarding the auditor's responsibilities for other information outside the financial statements" (page 7, first full paragraph).

The current standard requiring our auditors to read and consider other information for consistency has been effective in my experience to raise areas of concern prior to issuing a report. The Audit Committee has been the proper venue for discussing and remediating any inconsistencies that have historically occurred. In no situations, have we allowed any concerns that were raised by our auditors to remain unaddressed in a final report. While I would not object to adding language into the audit report to describe and clarify this scope undertaken by the auditor, I would object to adding language to this requirement that might be construed as increasing the scope of review procedures. Increasing a system of internal controls over narrative information becomes problematic. The difficulty to define and make a bright line test over adequacy of narrative disclosures, will drive over-reporting and over-controlled reporting processes – driving up costs. Historically, we have remedied any discovered inconsistencies prior to issuing any report, and thus there is no need to report the process and issues to investors – they are gone by the time investors receive such disclosures. I do not see any justification here to increase compliance costs, or to delay reporting cycle time, both of which would ultimately be negative for investors.

I would like to thank the PCAOB for the opportunity to comment and invite your board or staff to further discuss these matters. I would be pleased to also discuss these comments if the need arises.

Sincerely,

Richard J. Dahl
Chairman, Audit Committee, IDACORP Inc. and Idaho Power Company

cc: Robert A. Tinstman, Chairman of the Board, IDACORP Inc. & Idaho Power Company
Joan H. Smith, Audit Committee board member
Thomas J. Wilford, Audit Committee board member
C. Stephen Allred, Audit Committee board member

J. LaMont Keen, President and CEO, IDACORP Inc., CEO, Idaho Power Company
Darrel T. Anderson, President and CFO, Idaho Power Company

December 11, 2013

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

Subject: **PCAOB Rulemaking Docket No. 034**

Dear Office of the Secretary,

The management of IDACORP, Inc. and Idaho Power Company (the Companies) submits its comments on selected components of the two proposed audit standards in Docket 34.

IDACORP has operated as an electric utility holding company since 1998 and its principal subsidiary, Idaho Power Company has operated as an integrated electric utility since 1915. The electric operations cover a 24,000 square mile service territory and serve 500,000 customers in southern Idaho and eastern Oregon. Idaho Power Company has been a publicly-traded issuer for most of its nearly 100-year history. Our auditors, Deloitte & Touche, and our Audit Committee, comprised of independent directors, half of whom are also considered financial experts, provide the Companies primary governance oversight for financial reporting to investors. We are proud of the quality and transparency that our public reporting to investors consistently achieves through the oversight processes currently in place.

Our comments will pertain to each of the proposed standards under Docket 34: first, the auditor's report on an audit of the financial statements when the auditor expresses an unqualified opinion (the Auditor Reporting Standard); and second, the auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report (the Other Information Standard).

Auditor Reporting Standard

There are a number of elements to the changes proposed for the auditor's report, but we will focus in on requiring auditors to disclose critical audit matters (CAM's) to investors. This proposal would erode the role and responsibility currently tasked to management, and transfers a key disclosure role to our auditors. A new requirement like this would usher in processes and controls to fully review all public language, involving senior management at both the Companies and at Deloitte, including each party's legal teams. This new and untimely process of circulating new auditor report language will increase costs to our Companies and delay filings.

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Will the proposed reporting requirement serve investors well? We don't think so. First, investors seek updated reports as soon as management will comfortably stand behind the underlying disclosures and is ready to file. The timing of reports would be slowed and likely migrate toward the last day allowed by the SEC. Historically, our reports have been issued several days in advance of the deadline. Second, investor groups with whom we have direct experience, primarily ask for information that would allow them to better forecast future impacts to financial results. Would the CAM proposal provide any forecasting value? We don't see much or any forecasting value to the CAM disclosures. Third, investors ultimately pay for the cost of compliance through the market prices of stocks, and naturally would expect reasonably useful information to come at a reasonable cost. Would this result under the proposal? We don't see either reasonably useful information, or reasonable costs associated with this proposal.

What might a new CAM requirement turn into? Inconsistent reporting across industry issuers; unnecessary shifting of reporting responsibility from management to auditors; erosion of oversight currently tasked to the audit committee; high cost reviews by external parties (audit firm and outside legal counsel); delays to issuing dates; CAM language standardization; duplication between auditor and management disclosures; increased pressure on audit fees – to name some possibilities. We don't see investors ultimately wanting this. Our experience indicates that investor's primary information gap is forward-looking insight to better predict the financial future. Unfortunately, disclosures surrounding an issuer's CAMs will not aid financial modeling.

An alternative approach might be to work through the SEC and the FASB to enhance management disclosures that would aid investor's understanding of the auditor's role and process. This approach would maintain the key responsibility of investor disclosure with management, not the auditors.

Other Information Standard

The current requirement that auditors read and "consider" the consistency between other information in a report and the underlying financial statements has been the rule long enough to build well-established processes that occur near the end of the audit cycle and just prior to the issue date. The practice of "consider" the consistency has generally led to discussions with management about how to tighten language for key events and issues. Inconsistencies, when they are noted by the auditor's reading of the document, become a discussion item that the Audit Committee and management work out and resolve, before any final report is issued.

The new proposal would now require auditors to read and "evaluate" the consistency. The breadth of "evaluate" is something yet to be defined, but connotes something more extensive than "consider". This subjectivity will lead our auditors to interpret such requirements protectively, instituting increased processes and controls, and resulting in higher costs. All of this activity would occur behind the scenes prior to issuing a report, and would increase timing pressure at precisely the time issuers are preparing to submit their report to the SEC. The end result of the new requirement will be the same as what we currently have – inconsistencies identified continue to be remedied prior to issue.

An alternative approach to aid investors wanting to know the steps and detail behind the auditors "read and consider" requirement, would be to add clarifying language to the existing auditor report to describe the current requirement.

IDACORP appreciates the opportunity to add its views to this Docket and acknowledges the PCAOB Board for being responsive to comment letters previously submitted under this Docket. We are particularly appreciative that the Auditor's Discussion and Analysis proposal was reconsidered by the Board in light to the many comment letters submitted in September 2011.

Additional information or discussion on this matter can be addressed to me at (208) 388-2650.

Sincerely,

Darrel T. Anderson

Darrel T. Anderson
Executive Vice President, Administrative Services and Chief Financial Officer, IDACORP, Inc.
President and Chief Financial Officer, Idaho Power Company

Cc: J. LaMont Keen, President and Chief Executive Officer, IDACORP, Inc.
Richard J. Dahl, Chairman, Audit Committee of IDACORP, Inc. & Idaho Power Company

ILLINOIS CPA SOCIETY

December 11, 2013

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

Dear Board Members:

The Audit and Assurance Services Committee of the Illinois CPA Society ("Committee") is pleased to comment on the PCAOB's Proposed Auditing Standards on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (Docket Matter No. 34) dated August 13, 2013. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter. These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

**Executive Summary**

The stated purpose of the release, as illustrated through the "proposed auditing standard," "proposed other information standard," and related "proposed amendments," is to increase the relevancy and usefulness of auditor reports, by adding "clarity" and "informational value," for investors. As indicated in our response to the Concept Release dated September 30, 2011, our Committee is in favor of adding clarity to the auditor's report so that the responsibilities of the auditor, management, and the audit committee are better understood by the financial statement users. We greatly appreciate the Board's efforts on this undertaking and the opportunity to comment on the proposal. Our comment letter divides the whole proposal into three sections: Critical Audit Matters, Other Information Reporting, and Other Matters.

The Critical Audit Matters section includes the Committee's views on adding such a section to the auditor's report. Our Committee agrees that the requirements for the critical audit matters, as drafted, will not necessarily provide meaningful information to the users and that the additional information will be costly to provide. We suggest the Board align certain portions with the IAASB proposal, including revising the scope of items to be considered a critical audit matter to just those items communicated to those charged with governance and those issuers where the auditor should report on such information limited to just accelerated and large accelerated filers.

The Other Information Reporting section indicates our agreement with the Board regarding the wide disparity in practice over other information. We support an effort to standardize practice amongst auditors. However, we have concerns that the scope of the Board's proposal includes items for which the auditor will be unable to make a determination based on the audit procedures performed. The proposal includes evaluations that the auditor cannot make based on normal audit procedures.

The Other Matters section includes the Committee's thoughts on the remaining items in the proposal including independence and tenure disclosures. While we support the Board's goal to increase investor knowledge and reduce information asymmetry, we do not believe much of the information included in this section will meet this goal. Rather, it appears neutral.

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## Critical Audit Matters

**Definition and Determination of Critical Audit Matters:**

Our Committee generally believes that the definition of critical audit matters is sufficient to capture information that *could* be relevant and useful to investors and other financial statement users. However, we believe that the definition, if applied too literally, may also capture information that is not likely to be particularly relevant or useful to those users. For example, the auditor may determine that the following matters could meet one or more of the three characteristics of a critical audit matter:

a. The partners and staff to include on the audit engagement.
b. The component auditors to reference in their report.
c. The auditor specialists, among several choices of such specialists in the same field, to select.
d. The auditor's need to be able to read and interpret audit evidence in a foreign language when the audit firm has limited resources that can read and understand that foreign language.

While the above examples, and others, might represent significant difficulties that the auditor needed to overcome to complete an audit, they generally would not be relevant or useful to financial statement users. That lack of usefulness might be obvious and lead auditors not to consider these types of matters as being critical audit matters worthy of communicating to financial statement users, but they nonetheless could literally be considered to meet the proposed definition of a critical audit matter. We note that some of these types of matters could conceivably be included amongst matters that are documented in an engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee. To reduce the potential for auditor's identifying these types of matters as critical audit matters, the definition of critical audit matters might refer to "Those matters having a material impact on the financial statements, including disclosures, that the auditor addressed during the audit of the financial statements …" or other clarifying language.

In any case, we further note that even if critical audit matters are disclosed that fully meet the probable intention of the definition of critical audit matters, our Committee was not convinced that the additional information would be useful to investors. As defined, critical audit matters are a reflection of audit risk. Investors would presumably be more interested in identification and understanding of business risks (environmental, legal, regulatory, etc.) facing the issuer. Such information should be provided by management, not auditors, and is, at least in part, already required to be disclosed pursuant to non-financial reporting regulations.

We also note that the proposed definition could result in the identification of reportable critical audit matters that otherwise would have been exempted from disclosure by other rules and regulations. As Jay Hanson, PCAOB Board Member, observed in his Statement on the Proposed Standard, matters such as significant deficiencies and going concern doubts that were overcome may represent critical audit matters under the proposed definition and thereby be disclosed when such matters are specifically otherwise exempt, or perhaps even prohibited, from disclosure by other rules and regulations. For example, if a "close call' regarding the level of probable loss contingency accruals and/or disclosure of reasonably possible contingent losses in excess of amounts accrued are described as a critical audit matter, the user may question whether the proper accruals and disclosures were made.

For some of the reasons described above, our Committee believes that the population of matters an auditor should consider as potential critical audit matters should be limited to those matters required to be communicated to the audit committee. Such a requirement would be consistent with the current proposal by the International Auditing and Assurance Standards Board. A broader requirement also to consider matters included in engagement completion

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documentation and reviewed by the engagement quality reviewer is likely to result in matters of significantly lesser importance being eligible for disclosure as critical audit matters. At a minimum, the proposed standard should indicate that matters communicated to the audit committee are the primary population of matters to be considered for disclosure as critical audit matters.

While the use of the word 'most' in the definition of critical audit matters in paragraph A2 is generally adequately explained, it is not clear whether 'most' should be considered solely in the context of the particular audit being reported on or whether it should be considered in the context of audits in general. For example, an auditor will likely encounter appreciable difficulties in auditing the valuation of intangible assets in many of its audits. For a particular audit, perhaps these difficulties – while less appreciable than in the 'average' audit – might nonetheless have posed the most appreciable difficulty for this particular audit. Presumably, the Staff's intention is to consider 'most' solely in the context of the audit being reported on; however, that intention is not clear in the proposed definition or guidance.

**Undue Consequences:**

An auditor's unqualified opinion on the financial statements indicates that the auditor was sufficiently able to overcome the difficulties associated with the disclosed critical audit matter(s) in order to provide the unqualified opinion that the audited financial statements are fairly stated in accordance with the applicable financial reporting framework. As such, the reporting of critical audit matters may unduly raise investors' and other financial statement users' concerns over the quality of the audited financial statements. If the critical audit matter describes a significant deficiency, that disclosure may not only prompt a user, who generally is not a trained auditor, to suspect the veracity of the financial statement opinion, but also of the internal control opinion if one is provided (and/or of management's report on internal controls). Such undue concerns will potentially result in a) excessive communications between management and stakeholders in earnings conference calls and other modes as stakeholders try to better understand the issues underlying the disclosed critical audit matters and how management nonetheless determined that the issuer's financial statements were reliable, and b) inappropriate conclusions regarding investing decisions.

While the auditor's report will indicate that no critical audit matters alter the auditor's opinion on the financial statements, users may nonetheless consider the disclosed critical audit matters as somehow qualifying that financial statement opinion. Also, as indicated above, investors that mistakenly over rely on critical audit matter disclosures to highlight areas of concern, may not be properly informed or consider items that were not included as a critical audit matter, in particular business risks. In an effort to potentially minimize these concerns, we suggest expanding the final sentence of the standard language preceding critical audit matters in the auditor's report as follows:

> "The determination of critical audit matters is highly subjective. The critical audit matters communicated below may not represent all or even the most important elements of the accompanying financial statements and should not be considered as such. Furthermore, the critical audit matters communicated below were adequately addressed by our audit procedures and therefore do not alter, in any way, our opinion on the financial statements, taken as a whole."

Due to the subjective nature of critical audit matters, different auditors, both within and amongst the audit firms, will select different places along the 'difficulty' continuum where a matter becomes a reportable critical audit matter. Comparability between auditor reports will decrease, in both the number and content of the specific matters that are disclosed, as well as the in the degree auditors consider matters to be critical audit matters. Additionally, companies may - over time and likely with the aid of media or other reports that will evolve to track such things - start to consider which audit firms disclose more or fewer critical audit matters and how those disclosures are made when those companies choose which audit firm to engage.

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**Audit Period Covered:**

We agree with the Board's assessment that it will usually be sufficient to include critical audit matters only for the current year audit as investors and other users will likely be most focused on the current year and could easily access prior year disclosures in any case. We believe inclusion of prior period critical audit matters may distract from the potential usefulness of the communication, since the matters disclosed are likely to be the same or similar from year to year. We suspect that auditors might tend to not want to vary the critical audit matter disclosures from year to year (other than for nonrecurring transactions that might result in critical audit matter disclosures) to reduce potential legal exposure with identifying critical audit matters in one year when they were not called out, but were present, in other years.

The Note on paragraph 10 requires the auditor to consider disclosing critical audit matters for prior years' audits in certain circumstances, but provides no guidance as to what those considerations might be relevant to such an assessment. Additionally, we would recommend that the guidance regarding a predecessor auditor not being required to include previously-disclosed critical audit matters when that predecessor's report is included in filings on comparative statements (as indicated on page A5-34) be added directly into the proposed standard.

**Communication of Critical Audit Matters:**

We strongly support not requiring, or even permitting, disclosure of any specific audit procedures, including resolution of critical audit matter. Doing so could a) undermine the audit process by informing management of the auditor's plans and b) lead to more investor confusion and uncertainty as such disclosures would be almost impossible to completely convey the range of relevant procedures performed, and why they were selected, as well as confusion over audit concepts such as sampling and materiality.

The examples of critical audit matters in Appendix 5 are helpful in that they provide a lot of detail that could be useful in drafting critical audit matter language on unrelated topics. However, we believe the repeated use of such phrases as "involved difficult and subjective judgments," "posed difficulty in obtaining sufficient appropriate evidence," "posed difficulty in forming an opinion on the financial statement," and "we consulted with others outside the engagement team," may result in similar, "boilerplate" language being used by firms in communicating these issues for similar reasons to those noted above. We also note that the amount of details included in the example disclosures add to their length and complexity and will potentially result in longer drafting and discussion time and cost. As such, we recommend more succinct example disclosures while leaving the comprehensive background and footnote disclosure elements.

**Documentation of Critical Audit Matters:**

In documenting the auditor's determination that each reported matter was a critical audit matter, it would appear that the considerations for such a determination would be the same as the considerations required to be disclosed pursuant to paragraph 11b of the Proposed Standard. As such, it is possible for the auditor to conclude that the auditor's report itself provides the documentation required by the Proposed Standard for matters that are reported. We recommend that the Proposed Standard indicate this concept in order to reduce the burden of such documentation.

In regards to the proposed documentation requirements for non-reported audit matters, we note that many auditors might consider that every matter included in an engagement completion document, reviewed by the engagement quality reviewer or communicated to the audit committee, is 'eligible' to be reported as a "critical audit matter". We note in the proposal's guidance on pages A5-39 and A5-40 that not every such matter would be expected to require explanatory documentation and that only such matters that an experienced auditor having no previous connection to the audit might, after also considering the factors in paragraph 9 of the Proposed Standard, believe to be reportable critical audit matters require explanatory documentation. However, many auditors will use similar criteria to that outlined in Paragraph 9 in determining which items to include in the engagement completion document, have been reviewed by the engagement quality reviewer or communicate to the audit committee. Therefore, an auditor may conclude that every one of these items would require explanatory documentation if it was not reported. We believe such a documentation requirement would be unduly burdensome and would likely result in auditors ultimately reducing the number or type of such items reviewed or communicated, resulting in lower quality reporting. We note again our preference that the population of possible matters to be considered as critical audit matters be limited to those matters required to be communicated to the audit committee.

Otherwise, we believe that the proposed documentation requirements are sufficiently clear.

**Other Considerations for Critical Audit Matters:**

An additional effort and cost, for both auditors and companies, which may not be adequately described, is the discussions between auditors and management and audit committees that will undoubtedly ensue regarding which matters the auditor determines to include in its report and how such matters are described. Even though the auditor’s opinion will be unqualified, management and audit committees will encourage fewer and shorter critical audit matter disclosures, whereas auditors may tend to want to include more matters and fuller descriptions to lessen perceived liability concerns, likely after internal legal consultation. As an additional detriment, these discussions will take place near the filing deadline, thereby adding increased pressure to achieve that deadline.

A similar situation occurred a several years ago when SEC reporting first required auditors to report identified material weaknesses in internal control. Such reporting also prompted discussions that took place at the back end of the audit process and, as such, perhaps there is some historical evidence to help assess more specifically what impacts critical audit matter discussions might have. However, since management was also required to identify material weaknesses but will not be required to identify critical audit matters, it may be difficult to use the experience with material weaknesses as a benchmark for assessing the effect of critical audit matter disclosures.

Another additional effort and cost for companies that may not be adequately described in the proposal material is the incremental communications management will likely need to make to its stakeholders as to the reliability of the issuer’s financial statements in light of the identified critical audit matters.

Our Committee believes that audit firms will incur fairly substantial costs - both one-time to adjust internal quality assurance mechanisms and recurring to determine the exact disclosures on each audit - in order to help manage perceived litigation and regulatory oversight concerns and to reduce potential confrontations with management and audit committees. This increased effort, primarily by partners, and increased perception of litigation and regulatory oversight concerns will translate into higher audit costs for issuers.

We would expect that such efforts and costs, for both auditors and companies, would generally be proportionate to the complexity of the audit, with more complex audits requiring more efforts and higher costs. Audit complexity might be driven by company size, company industry, the accounting standards applicable to the company, company SEC filing status, or other factors. However, even relatively non-complex audits would incur incremental efforts and costs, while the more complex audits will likely have diminishing incremental efforts and costs. For example, even the relatively non-complex audits will likely have one or a few critical audit matter(s) disclosed, while audits with, say, more than three times the complexity, will not necessarily have more than three times the number of disclosed critical audit matters. Investors may not understand this difference in critical audit matters related to the engagements.

To help contain incremental audit costs, our Committee would be in favor of limiting the requirement to disclose critical audit matters to reports on financial statements of accelerated and large accelerated filers.

While the Committee believes that incremental auditor liability concerns are less prevalent in these proposed critical audit matter reporting requirements compared to some of the approaches described in the related Concept Release, the proposed requirements do raise some incremental auditor litigation risk – if for no other reason than the requirements force an auditor to make incremental decisions (about what are and how to describe critical audit matters) and to disclose those decisions to the public who may not understand the meaning of the disclosures or the process an auditor might go through to make the related decisions. However, our Committee believes that this incremental risk is not substantial compared to the litigation risk that the auditor already assumes in being associated with the financial statements and issuing an unqualified opinion thereon. However, and importantly, we note that no one on our Committee is an attorney and, as such, our comments in this area are not supported with appropriate specialized knowledge.

## Other Information Reporting

The Committee agrees with the Board in that a more uniform process is necessary to minimize differences in an auditor's approach to other information included with audited financial statements in a company's annual report, as there is wide variety in what auditors are actually performing in practice. We support aligning the procedures performed by audit teams; however, we offer some suggestions to the current proposal, which are included below:

**Auditor's Responsibility to Evaluate:**

In paragraph 4, the proposal states the auditor will be required to read the other information and, based on relevant audit procedures and conclusions during the audit, "evaluate" the other information. The term "evaluate" is not specific to the procedures the auditor should actually perform. Each bullet should include the specific procedure language. For example, bullet a. could read "Trace and agree amounts from other information to the financial statements or relevant audit evidence for consistency." The release notes include greater discussion about the meaning of "evaluate." We request the Board to include the specifics (as discussed starting on A6-19 of the proposal documentation) within the standard itself. As written, the proposal can be broadly interpreted by auditors, which does not help to standardize the procedures between auditors.

Paragraph 4b of the proposed standard includes, "evaluate the consistency of any qualitative statement in other information…" Auditors are qualified to opine on the financial statements. They are not experts in all things like the qualitative statements (paragraph 4b of the proposal) often found in annual reports. Phrases like "industry leader," "top performer", etc. are common. These types of qualitative assertions are not the auditor's specialty to monitor. The SEC should be monitoring these types of claims through its inspection and comment letter process, rather than the auditor. If auditors question management's qualitative assertions, they may include less information in annual reports, instead of more – an unintended consequence of the proposal.

Paragraph 4c includes other information not directly related to the financial statements. This scope can include items that auditors are not qualified to evaluate. We disagree with this bullet for two reasons. With the advent of the risk assessment standards, the information that could potentially impact the audit have expanded greatly to include qualitative items, like company strategy, human resources involvement, and possible actions by competitors. As a result, the scope is unclear. Also, we are concerned this includes items that auditors do not have knowledge about and that does not related to any audit evidence. For example, the beneficial ownership table does not impact the financial statements and is not something auditors have expertise to evaluate. We request the Board to remove paragraph 4c in its entirety.

**Auditor's Report Language:**

We are concerned about the language in the example at paragraph 14b that reads, "based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information." It reads as if the auditor has performed involved audit procedures (equivalent to those performed on the financial statement balances as part of the audit) over the other information. This can confuse and mislead financial statement users into thinking that the auditor has performed audit procedures over the entire annual report, not just the financial statements. This sentence conflicts with the language found in paragraph 14a that reads, "our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information." Clearly stating that a material inconsistency or material misstatement was not identified can be interpreted similar to an official opinion.

**Economic considerations in applying the proposed standard:**

Additional time and staffing resources will be needed to comply with the proposal, which will add costs to audit engagements, particularly late in the engagement. Our Committee estimates that for simple, smaller reporting companies, the additional time could be as few as 20 hours. However, for large, multi-national companies with extensive other information, we estimate that the additional time incurred could exceed 50 hours. Public accounting firms will not be able to simply add a new member to the team to complete the proposed procedures because the proposal suggests that teams use their existing audit knowledge to complete the procedures. The core audit team will need to complete these procedures. Without adding more time to filing deadlines, this could potentially compromise audit procedures and time spent on other audit areas.

In addition, applying the standard to amended annual reports will cause a significant economic burden, due to scheduling challenges and audit team member rotation and tenure. In addition, this situation will lead to uncertainty surrounding the date of the auditor's report and the responsibility the auditor is taking after the original audit report date. There is not clear guidance in the proposed standard to address these concerns.

**Applicability of Standard to Audited Financials Statements of Another Entity Pursuant to Article 3 of Regulation S-X:**

The Board is seeking comment on whether or not the proposed other information standard should apply to audited financial statements of another entity that are required to be filed in the company's report under Article 3 of Regulation S-X (such as a business that is acquired or to be acquired) and whether there are practical issues in doing so. The Committee does not believe that the auditor should include these other entities in the evaluation because the financial statements of the other entity have been subject to an audit independent from the company and the auditor. So, the auditor would not have the audit support to evaluate the items included. We recommend that the proposed other information standard not apply to such information. If the audit of the other entity was performed in accordance with PCAOB standards, then the other auditor would have already performed an evaluation of the other information associated with the other entity's financial statements.

**<u>Other Matters</u>**

**Auditor Report Addressees:**

The proposed requirement to address the auditor's report to at least (1) investors/shareholders of the company, and (2) the board of directors or equivalent governing body could be perceived by users of the financial statement to be of

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relevance only for the explicitly addressed user groups and potentially limiting the scope and responsibilities of the auditor to those addressed user groups only.

We believe an audit should address the needs of all potential users of the financial statements, rather than being limited to the needs of specific users. Furthermore, the auditor stands between management and the investment community and must be viewed as independent of each. The auditor should not be viewed as an advocate of either party. While the auditor's role includes consideration of both management and investors as potential users of the financial statements, we believe addressing the auditor's report solely to these two groups may exclude other potential users of the financial statements is not realistically feasible, even if management helped identify potential users. As such, we believe that the required inclusion of addressees in the auditor's report will become standardized language to include only the two (2) proposed required user groups.

The Committee does not believe adding required addressees is significant to the financial statements, will appreciably serve the purpose of better informing readers of the financial statements, or will significantly impact the scope of the audit or the responsibilities of the auditor. We do not believe further consideration or amendment of this proposed requirement is worth the effort by any involved party, and we recommend that the requirement be excluded from any finalized standard.

**Auditor Tenure:**

Our Committee has no objection to the underlying principle of disclosing auditor tenure as long as it is not done in the auditor's report. The proposed requirement to disclose auditor tenure in the auditor's report tends to imply that there is an actionable basis for the financial statement user in interpreting such information. As noted in Board member statements and academic studies referenced within the proposal, there is not a definitive linkage between auditor tenure and audit quality. As such, adding an auditor tenure disclosure to the auditor's report infers that some definitive linkage must exist between auditor tenure and audit quality, which should be considered by the user.

The determination of the number of consecutive years that an auditor served is sometimes difficult to make. There are infinite grey areas regarding calculating auditor tenure and such determination may require legal involvement and, as a result, more effort and cost than might otherwise be expected. As such, we would recommend that any requirement to disclose auditor tenure allow the auditor to explain, if necessary, how such disclosure was determined. Additionally, the disclosure of just auditor tenure, without disclosure of auditing standards that likely have greater impact on audit quality (such as required quality control standards and even mandatory partner rotation requirements), may result in an unbalanced presentation of the relevant facts. We further note that if such expanded reporting was required or permitted (including information for balance), putting it in an auditor's report would risk overwhelming the users of the financial statements with information that may not be considered incrementally helpful to them.

We also note that auditor tenure information is already publically available to interested parties via historical filings, if desired. For example, if an individual investor decided that he/she would only invest in companies that have an auditor with tenure of less than 10 years, the investor could reference previous filings to determine whether or not the company met the individual investor's standards. Therefore, the additional effort for a potentially small segment of financial statement users that might be influenced by this disclosure is not worth the additional tangible and intangible costs to provide it.

**Auditor Independence:**

The proposed requirement to include a statement in the auditor's report regarding the auditor's independence is provided in the example as follows:

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> "We are a public accounting firm registered with the Public Company Accounting Oversight Board ("PCAOB") (United States) and are required to be independent with respect to the Company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB..."

The required title of the auditor's report is "Report of Independent Registered Public Accounting Firm." The Committee believes that even less sophisticated users of the financial statements could infer from the title of the report alone that the auditor is (1) registered as a public company auditor under the applicable governance body (the PCAOB in this case) and (2) independent. As even fairly sophisticated users will not be familiar with the nuances involved in the definition of "independent" in accordance with the "United States federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission ("SEC") and the PCAOB" referring to those laws and regulations has little significance. Accordingly, while we do not strongly object to the proposed independence disclosure, we do not believe it will add any appreciable incremental value to financial statement users. We further note that the use of unnecessary and overly technical references may diminish the trust between financial statement users and auditors.

**Explicit Reference to Opining on "Fraud":**

The existence of fraud is a valid concern of both auditors and users of the auditor's reports. Preventing and detecting fraud is the responsibility of management. Assessing the risk of fraud, and planning and performing audit procedures in relation to those risks, is a role of the auditor. Detection of all fraud, regardless of materiality, is not the responsibility of the auditor. The inclusion of the phrase "whether due to error or fraud" in the first paragraph of the Basis of Opinion section of the auditor's report when describing an auditor's reasonable assurance about whether the financial statements are free of material misstatement alone implies that the auditor is responsible to reasonably assure the users of the financial statements that they are free of even immaterial fraud. This implication could provide for a false sense of security and perceived transfer of responsibility in preventing and detecting fraud away from management, exposing companies to greater risk of fraud, and unintentionally increasing auditor liability. We believe that the required inclusion of the phrase inaccurately increases an auditor's assurance beyond auditor responsibilities and should be excluded from any finalized guidance, without adequate disclosure of the auditor's responsibility for fraud.

We strongly object to the sole addition of the phrase "whether due to error or fraud." As a solution to provide clarity, in addition to a supplemental alternative described in the "Other Report Wording Changes" subsection below, is to require the following sentence in the introduction paragraph describing management's various responsibilities:

> "Company's management is also responsible for designing and implementing controls to prevent and detect fraud, and to inform us about all known or suspected fraudulent activity that could have a material effect on the Company's financial statements."

**Other Report Wording Changes:**

The Committee recognizes the auditor's report has become "boilerplate" in nature and that financial statement users have become accustomed to the format and reference it solely to understand whether or not the Company passed or failed the audit. Although the current model has been effective, the Committee agrees that clarification and amendment of the standard auditor's report is appropriate if the information enhances a financial statement user's understanding of the audit process and auditor's, management's and the audit committee's roles in regards to the audited financial statements. Unless otherwise described in this letter, we do not object to the proposed wording

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changes in the auditor's report nor, however, do we believe that they necessarily add meaningful informational value or clarity.

The Committee believes that, irrespective of the significant proposed expansion of the auditor's report, the added section titles will aid the financial statement user in identifying relevant sections of the auditor's report.

The proposal acknowledges the need for greater clarification in the role and responsibilities of auditors, management and audit committees. However, the proposed auditor's report provides little improvement in adding clarity, transparency, or informational value in aiding the users of the financial statements in understanding those roles and responsibilities. We believe the current proposal is instead more focused on the disclosure of Critical Audit Matters and Reporting on Other information. The Committee recognizes that the auditor's report, as proposed, is approaching a potentially unreadable length and that a thorough description of everyone's roles and responsibilities with respect to the related financial statements and disclosures would further add to repetitive "boilerplate" verbiage across each auditor report for infinite periods, which is inefficient, and contrary to the principles of this proposal.

We do not believe the current reporting framework is broken; however, we do believe that the more financial statement users understand about the public company auditor and its responsibilities in regards to the audited financial statements, the more informed they will be as to the level of assurance the auditor provides in its report as to the fair presentation of the financial statements. While this incremental understanding does not necessarily translate into a better understanding of what risks might reside in those financial statements, it nonetheless allows the user to better appreciate how the auditor may have addressed such risk as part of its audit. However, we recognize that a lengthy description of the responsibilities of the various parties in regards to audited financial statements inside of the standard auditor's report would unduly increase its length and comprehensiveness. Accordingly, we remind the Board of a supplemental alternative we provided as a part of our response to the Concept Release to this proposal, for the auditor's report to provide a cross reference to a more complete description of what a public company auditor's roles and responsibilities are, and a general discussion on risk assessment, professional judgment, materiality, and sampling concepts a compliant audit might provide. The referenced materials would be described in "plain English" and could be available to the general public on a free basis from a named web-site. We believe that the cost of creating this singularly referenced guidance statement would significantly outweigh the repetitive and truncated statements of responsibility in each audit report, and would potentially be perceived as adding more value from an independent governing body providing outreach as compared to audit firm disclaiming responsibility.

**Relevance to Audits of Specific Entities:**

As further described throughout this letter, the additional required procedures, disclosures, and cost to comply with the standards, as proposed, are going to be overly burdensome to certain registrants. There are many entities required to register with the SEC and/or have their audits conducted in accordance with PCAOB standards due to various federal laws. However, the SEC has issued exceptions to many of their filing requirements to many of these entities due to the nature of their operations, users, and usefulness of their financial information and the cost/burden of providing much of the information as described in this proposal. Without analyzing each individual industry, we recommend as a general rule of thumb, the Board consider limiting the required final reporting requirements on Critical Audit Matters and Other Information to those entities considered a public reporting company under Sections 12 or 15(d) of the Securities Exchange Act of 1934.

**Overall comment:**

ILLINOIS CPA SOCIETY

Under the proposed standards, we believe that the potential liability in private litigation would increase. Based on the changes in the proposal, it would appear the auditor is taking on a significant amount of responsibility over the financial statements and other information, which is the responsibility of management and not the auditors.

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

**James J. Gerace, CPA**
Chair, Audit and Assurance Services Committee

**Elizabeth J. Sloan, CPA**
Vice Chair, Audit and Assurance Services Committee

ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE
ORGANIZATION AND OPERATING PROCEDURES
2013 – 2014

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

**Public Accounting Firms:**

**National:**

| | |
|---|---|
| Scott Cosentine, CPA | Ashland Partners & Company LLP |
| Eileen M. Felson, CPA | PricewaterhouseCoopers LLP |
| Angela Francisco, CPA | McGladrey LLP |
| Robert D. Fulton, CPA | Baker Tilly Virchow Krause, LLP |
| James J. Gerace, CPA | BDO USA, LLP |
| Jon R. Hoffmeister, CPA | CliftonLarsonAllen LLP |
| James R. Javorcic, CPA | Mayer Hoffman McCann P.C. |
| Matthew G. Mitzen, CPA | Plante & Moran, PLLC |
| Elizabeth J. Sloan, CPA | Grant Thornton LLP |
| Kevin V. Wydra, CPA | Crowe Horwath LLP |

**Regional:**

| | |
|---|---|
| Jennifer E. Deloy, CPA | Frost, Ruttenberg & Rothblatt, P.C. |
| Barbara F. Dennison, CPA | Selden Fox, Ltd. |
| Andrea L. Krueger, CPA | Corbett, Duncan & Hubly, P.C. |
| Stephen R. Panfil, CPA | Bansley & Kiener LLP |

**Local:**

| | |
|---|---|
| Scott P. Bailey, CPA | Bronner Group LLC |
| Matthew D. Cekander, CPA | Doehring, Winders & Co. LLP |
| Lorena C. Johnson, CPA | CJBS LLC |
| Loren B. Kramer, CPA | Kramer Consulting Services, Inc. |
| Carmen F. Mugnolo, CPA | Mugnolo & Associates, Ltd. |
| Geoff P. Newman, CPA | Weiss & Company LLP |
| Steven C. Roiland, CPA | FGMK, LLC |
| Jodi Seelye, CPA | Jodi Seelye, CPA |
| Richard D. Spiegel, CPA | Steinberg Advisors, Ltd. |
| Timothy S. Watson, CPA | Benford Brown & Associates, LLC |

**Industry:**

| | |
|---|---|
| George B. Ptacin, CPA | The John D & Catherine T MacArthur Foundation |

**Educators:**

| | |
|---|---|
| David H. Sinason, CPA | Northern Illinois University |

**Staff Representative:**

| | |
|---|---|
| Ryan S. Murnick, CPA | Illinois CPA Society |

INDEPENDENT COMMUNITY BANKERS of AMERICA®



December 11, 2013

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

Re: *Proposed Auditing Standards: The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* & *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; PCAOB Rulemaking Docket Matter No. 034

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) proposed auditing standards *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (proposed auditing standards). The objective of the proposed auditing standards is to make improvements to the current auditor reporting model by expanding the communication by the auditor of specific facts about the audit and the responsibilities of the auditor. The audit report would also be expanded to include discussion of identified critical audit matters.

ICBA objects to the PCAOB's desire to expand the independent auditor's reporting model without first considering the impact on the nation's community banks. Community banks are highly regulated financial institutions that operate today under tremendous regulatory burdens that limit the ability of these institutions to adequately serve their communities and the associated economies. Any increase in the auditor reporting beyond the current pass/fail model that increases auditor costs will in turn raise the cost of the audit and further strain vital community bank resources.

[1] The Independent Community Bankers of America®, the nation's voice for more than 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.

With nearly 5,000 members, representing more than 24,000 locations nationwide and employing more than 300,000 Americans, ICBA members hold more than $1.2 trillion in assets, $1 trillion in deposits, and $750 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

**Background**

The proposed changes to the auditor reporting model are designed to increase the usefulness of the auditor's report to the readers of the financial statements and footnotes as well as tackle the challenges of reporting on critical audit matters. These critical audit matters would be indentified in a specific section of the auditor's report. The auditor's report would also more thoroughly cover the auditor's independence, tenure, and his or her review of items that cover information beyond the financial statements.

Critical audit matters would be identified by the auditor as those items that prove most difficult to provide attestation, bring difficulty to the auditor's ability to form an opinion on the financial statements, and are the most subjective and complex. These items are generally those that are communicated to the audit committee. If the auditor concludes that no critical audit matters exist, that conclusion should also be communicated in the audit report.

In addition to the changing reporting model, the proposed auditing standards include the requirement for the auditor to review and evaluate information outside of the audited financial statements including information in the annual report filed with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 containing both the audited financial statements and the auditor's report. The evaluation procedures related to the other information include the search for inconsistencies and misstatements of fact.

**Impact on Community Banks**

ICBA believes that the proposed changes to the auditor reporting model that require the identification of critical audit matters represent a duplication of the disclosures already presented within the footnotes to the financial statements. Because the critical audit matters would require thorough documentation including determination with significant support for conclusions reached, the auditor would incur additional costs to properly complete the engagement that would most certainly be passed on to the engagement client.

Additionally, the expanded scope of the engagement that includes scrutiny of other information would require more time and effort on the part of the engagement team to complete applicable audit procedures leading to even more increased costs to the engagement client. The end result of this expansion of auditor responsibilities is an increased reliance on the part of financial statement users of the work performed by the auditor that could reasonably lead that user to obtain a false sense of assurance in the work performed by the auditor. The indirect impact of the proposed auditing standards include an almost certain increase in disclosures required to be made by the audit client and the level of work required by the auditor to mitigate the exposure to the engagement partner.

INDEPENDENT COMMUNITY BANKERS of AMERICA *The Nation's Voice for Community Banks.®*
*1615 L Street NW, Suite 900, Washington, DC 20036-5623 ■ 800-422-8439 ■ FAX: 202-659-1413 ■ Email: info@icba.org ■ Website: www.icba.org*

ICBA appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 659-8111 or james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
Vice President, Accounting & Capital Policy

IDC
INDEPENDENT DIRECTORS COUNCIL

INVESTMENT COMPANY INSTITUTE

December 11, 2013

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments; Docket Matter No. 034

Dear Ms. Brown:

The Independent Directors Council and the Investment Company Institute[1] appreciate the opportunity to comment on the Public Company Accounting Oversight Board's proposed changes to the auditor's reporting model.[2] The Proposed Auditor Reporting Standard would, among other things, require communication in the auditor's report of "critical audit matters" (CAMs). Communication of CAMs is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. The Proposed Auditor Reporting Standard would also enhance existing language related to the auditor's responsibilities for fraud, and add new language related to auditor independence and auditor tenure. In addition, the Proposed Auditor

[1] IDC serves the fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of Investment Company Institute member funds. ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.1 trillion and serve more than 90 million shareholders, and there are approximately 1,900 independent directors of ICI-member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] *See The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; and *Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (August 13, 2013) (the "Release"). We refer to these proposed standards as the "Proposed Auditor Reporting Standard" and the "Proposed Other Information Standard."

Reporting Standard would add new language regarding the auditor's responsibilities for other information outside the financial statements and the results of the auditor's evaluation of that information. The Proposed Other Information Standard is intended to improve the auditor's procedures and enhance the auditor's responsibilities with respect to the information, other than the audited financial statements and the related auditor's report, contained in a company's annual report filing.

Our comments focus on the application of the proposal to audits of investment company financial statements and the issues that may arise as a result.[3] Both IDC and ICI have demonstrated longstanding and strong support for meaningful disclosure that helps mutual fund investors make informed investment decisions.[4] But, as we discuss in greater detail below, we oppose the proposed CAM disclosure as it relates to investment companies because it would not provide useful information to fund investors and could inappropriately influence investment decisions, while certainly increasing audit fees. Investment company assets consist almost entirely of investment securities and, as a result, their financial reporting is less complex than other types of companies. Consequently, funds routinely may not have any critical audit issues, but the proposal, as currently structured, would pressure auditors to disclose CAMs in their reports.

We do, though, support the proposed enhancement to the existing opinion language regarding the auditor's responsibility for fraud, as well as the proposed new language regarding auditor independence. In addition, while we do not oppose the proposed auditor tenure disclosure, we question its value to fund investors. Finally, we are concerned that the Proposed Other Information Standard as currently drafted is overly broad in the investment company context and, thus, would unnecessarily increase audit costs. We therefore urge the PCAOB to limit a fund auditor's responsibility under the standard to those items that relate directly to the fund's financial statements.

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[3] In its proposal, the PCAOB indicates that, if adopted by the Board and approved by the SEC, the Proposed Auditor Reporting Standard would apply to the audits of investment companies. The proposal specifically seeks comment on whether the proposed changes are appropriate for audits of investment companies, and if so, whether there are any specific considerations that the PCAOB should take into account.

[4] *See e.g.,* Letter from Dorothy A. Berry, IDC Governing Council Chair, to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, re Comment Request for Study Regarding Financial Literacy Among Investors; File No. 4-645 (March 23, 2012); Letter from Robert W. Uek, IDC Governing Council Chair, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; File No. S7-28-07 (Feb. 15, 2008); Letter from Karrie McMillan, ICI General Counsel, to Nancy M. Morris, Secretary, U.S. Securities and Exchange Commission, re Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies; File No. S7-28-07 (Feb. 15, 2008); and Letter from Craig S. Tyle, ICI General Counsel, to Jonathon G. Katz, Secretary, U.S. Securities and Exchange Commission, re Shareholder Reports and Quarterly Portfolio Disclosure of Registered Management Investment Companies; File No. S7-51-02 (February 14, 2003).

**Proposed Auditor Reporting Standard**

*Critical Audit Matters*

The Proposed Auditor Reporting Standard would require auditors to communicate CAMs, which are described as those matters addressed during the audit that (a) involved the most difficult, subjective, or complex auditor judgments; (b) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (c) posed the most difficulty to the auditor in forming an opinion on the financial statements. CAMs ordinarily are matters of such importance that they are included in the items required to be documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee.

Under the proposal, the auditor must communicate in its report the CAMs relating to the audit of the current period's financial statements or state that there are no CAMs. For each CAM the auditor must identify the matter, describe the considerations that led the auditor to conclude the matter is a CAM, and refer to the relevant financial statement accounts and disclosures that relate to the CAM.

CAM Disclosure Would Not Provide Useful Information to Fund Investors. A fund's activities are limited to issuing and redeeming its capital shares and investing in securities. The principal objectives in auditing investment company financial statements are to provide reasonable assurance that: 1) the investment company has ownership of and accounting control over all of its portfolio investments; 2) all transactions are authorized and recorded in the accounting records in the proper account, amount, and period; 3) portfolio investments are valued properly, and their costs are recorded properly; 4) income from investments and realized gains and losses from securities transactions are accounted for properly; and 5) investments are free of liens, pledges, or other security interests or, if not, that such matters are identified properly and disclosed in the financial statements.[5]

In the investment company context, the audit matters most likely to be deemed "critical" under the proposal would involve the auditing of security values. Generally accepted accounting principles currently require extensive disclosure regarding valuation of investments, with particular emphasis on securities for which observable transaction prices are not available. For example, investment company financial statements are required, among other things, to disclose the following:

- The level within the fair value hierarchy in which the fair value measurements are characterized in their entirety (e.g., level 1, 2, or 3);

[5] *See* paragraph 2.189, *AICPA Audit and Accounting Guide, Investment Companies* (May 1, 2013).

- Any transfers between levels, the reasons for the transfers, and the policy for determining transfers;
- A description of the valuation technique(s) and the inputs used in the fair value measurement;
- For fair value measurements categorized within level 3, a quantitative description about the significant unobservable inputs used in the fair value measurement;
- For fair value measurements categorized within level 3, a reconciliation from the opening to the closing balances, disclosing separately gains or losses for the period, purchases and sales, and the amount of any transfers into or out of level 3 and the reasons for those transfers;
- For fair value measurements categorized within level 3, a description of the valuation processes used, including how the fund decides its valuation policies and procedures and analyzes changes in fair value from period to period; and
- For fair value measurements categorized within level 3, a narrative description of the sensitivity of the fair value measurement to changes in unobservable inputs to a different amount that might result in a significantly higher or lower fair value measurement.[6]

Given the extensive disclosure requirements relating to level 2 and level 3 securities, investors are well informed about the extent of the fund's investments in securities that present difficult or subjective fair value measurements. We believe that requiring the auditor to describe the difficulty associated with auditing these fair value measurements would not add anything to the mix of information already provided to investors. Indeed, CAM disclosure indicating that certain securities trade less frequently and were valued through reference to unobservable inputs would be repetitive of information already provided by management in the notes to the financials.

<u>CAM Disclosure May Inappropriately Influence Investment Decisions.</u> Identification of CAMs would involve a significant amount of judgment. We have concerns that two different auditors could reach different conclusions after reviewing the same set of facts and that the identification of CAMs would be inconsistent across different audit firms and even different audit partners within the same firm. This inconsistent identification of CAMs by audit firms may impair the comparability of funds. For example, an investor looking for a particular type of fund (*e.g.*, an intermediate-term bond fund) may compare funds of this type from multiple sponsors and interpret CAM disclosure relating to a particular fund as an indication that an investment in that fund carries a higher risk than investment in a comparable fund with no CAM disclosure. This scenario may apply as well in the context of existing shareholders, who may decide to redeem their fund shares after reading the auditor report. The influence of inconsistent CAM disclosure on investment decisions could be heightened if third-party rating services use the presence of

[6] *See* Financial Accounting Standards Board Accounting Standards Codification Topic 820-10-50.

CAM disclosure in auditor opinions as a factor in their fund ratings. As a result, CAM disclosure may inappropriately influence investment decisions.

CAM Disclosure Could Become Boilerplate. Auditors to funds that invest primarily in difficult to value securities may provide the same CAM disclosure year after year. For example, auditors to funds that invest primarily in mortgage-backed securities or bonds ranked below investment grade would likely provide the same CAM disclosure annually in each audit opinion. If the same or similar CAM disclosures are provided year after year, the disclosure will likely become "boilerplate" and, consequently, lose its effectiveness.

CAMs Should Not Be Expected in Most Fund Audits. We urge the PCAOB to clarify that it may not be unusual for an audit, particularly a mutual fund audit, to not involve any CAMs. Fund financial statements are relatively less complex than those of operating companies[7] and, consequently, it may be unlikely that there will be an audit matter that rises to the level where it should be disclosed to investors.

The Proposed Auditor Reporting Standard describes CAMs in relative terms as those matters that involved the *most* difficult auditor judgments, posed the *most* difficulty in obtaining sufficient appropriate audit evidence, or posed the *most* difficulty in forming an opinion on the financial statements. We submit that every audit would necessarily involve a judgment that is the *most* difficult relative to all the judgments made in the context of that audit, or posed the *most* difficulty in obtaining sufficient appropriate audit evidence. The fact that a particular judgment or audit procedure was the most difficult in relation to others, however, does not mean that the judgment or audit procedure gives rise to an audit risk about which investors should be informed.

We note that the Proposed Auditor Reporting Standard states "it is expected that in most audits, the auditor would determine that there are critical audit matters."[8] We are concerned that this statement, combined with the definition of CAMs as a relative concept, would pressure auditors to communicate CAMs in virtually all audits, notwithstanding the absence of a matter that is truly critical. For example, in order to ensure that the fund has ownership and accounting control over all of its portfolio securities, the auditor will seek confirmation of ownership from the fund's custodian, agent banks, and brokers. In certain instances these banks or brokers may not respond to the auditor's confirmation request. In such instances the auditor may perform alternate procedures to confirm ownership and the standard auditor report on an investment company makes reference to the auditor's use of such alternate procedures.

[7] The PCAOB previously recognized the relatively less complex nature of investment company audits in its decision to assess them accounting support fees at ten percent of the amount paid by operating companies. *See* Establishment of Accounting Support Fee, PCAOB Release No. 2003-003 (April 18, 2003). Investment company financial reporting does not include difficult or subjective matters relating to, for example, deferred tax assets, impairments, goodwill, or allowances for sales returns.

[8] *See* the Release, *supra* note 2, at Appendix 1 – Proposed Auditor Reporting Standard, Paragraph 7.

Obtaining this audit evidence may be the most difficult part of the audit. That does not mean, however, that the auditor could not obtain sufficient appropriate audit evidence, or that ensuring ownership and accounting control was subjective or judgmental in nature. Circumstances such as these could lead to disclosure that investors mistakenly believe describes a truly critical matter and they could attach much greater significance to it than is warranted.

The Proposed Auditor Reporting Standard Undermines the Role of Audit Committees. If a critical issue arises during the course of an audit, it is the audit committee's role to discuss and evaluate the matter with the auditor.[9] The audit committee is better equipped to ask questions and probe technical and complex matters in a one-on-one setting than investors are by just reading disclosure. This dialogue allows for a more nuanced conversation of any critical issues that arise during an audit. The audit committee can then determine what, if any, action is appropriate to take to follow up on the matter. For example, the audit committee may decide to modify the fund's valuation policies and procedures if the auditor disagrees with a fair valuation estimate.

CAM Disclosure Would Unnecessarily Increase Fund Audit Fees. As the PCAOB acknowledges, the proposal is not without costs. Auditors would incur one-time set-up costs relating to updating their methodology regarding auditor reporting. In addition, audit firms would incur ongoing annual costs associated with documenting their decisions as to why particular matters are or are not CAMs. Further, there would be costs associated with developing the disclosure to be included in the auditor's report. We anticipate additional costs associated with review by the audit firm's national office of the CAM disclosure to be included in the auditor's report. We are concerned that auditors would pass these costs on to their fund clients. Importantly, fund audit fees are paid by the fund – not the fund manager. Thus, for the reasons discussed above, these costs would reduce returns to shareholders without providing any discernable benefit.

The PCAOB Should Perform Outreach with Fund Investors. In its Release, the PCAOB notes that "extensive outreach conducted over the last three years" led it to issue the Release. Further, the Release indicates that "many investors have expressed dissatisfaction that the content of the existing auditor's report provides little, if any, information specific to the audit of the company's financial statements" and "that investors indicated they would benefit from additional auditor reporting" on this information. The PCAOB does not indicate, however, whether any of this outreach included retail mutual fund investors. Given the unique nature of investment company financial reporting, fund investors may value the proposed disclosure differently than investors in operating companies when making investment decisions. Because the PCAOB has not demonstrated a compelling need or desire from fund investors for this disclosure, we urge it to perform outreach to retail mutual fund investors to verify the perceived benefits.

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[9] AS 16, *Communications with Audit Committees*, ensures that the audit committee is well informed about difficult or contentious issues that arise during the course of the audit.

Fund-Specific Issues Should Be Addressed. Fund sponsors typically offer many different funds, each with their own financial statements. Where funds share a common fiscal year end, their financial statements may be combined into one shareholder report "book." That book contains financial statements and other SEC-required disclosures (*e.g.*, management's discussion of fund performance, the fund expense example, the graphic presentation of the fund's investment portfolio) separately for each of the funds included in the shareholder report book. The auditor's report, however, is typically prepared on a joint basis and covers all of the funds included in the shareholder report book. Currently, there are no fund-specific disclosures required to be included in a joint auditor report. The proposed CAM disclosure, however, would require fund-specific disclosures and therefore calls into question the ability of an auditor to provide a joint report covering several funds. We urge the PCAOB to confirm the ability of fund auditors to provide these joint reports.

*Basic Elements of the Auditor's Report*

The Proposed Auditor Reporting Standard primarily retains the basic elements of the auditor's report. There are, though, three basic elements of the auditor's report that the PCAOB seeks to refine: additional disclosure about the auditor's independence, clarification about the auditor's responsibility regarding fraud, and new disclosure about auditor tenure. Our comments are below.

First, the proposal would require additional disclosure regarding an auditor's independence. This statement, regarding the auditor's existing requirements to be independent, is intended to enhance investor understanding about an auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. We support adding this disclosure to the auditor's report.

Second, the Proposed Auditor Reporting Standard would revise the auditor's report to recognize the auditor's existing responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud. In particular, the phrase "whether due to error or fraud," would be added to the report when describing the auditor's responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement. The PCAOB has proposed this change to clarify the auditor's role in detecting fraud as the current auditor's report makes no explicit reference to fraud. We believe the proposed disclosure better informs investors of the auditor's responsibility and we support adding it to the auditor's report.

Third, the proposal would require the auditor's report to indicate the year in which the auditor began its service. The Release indicates that the PCAOB has not reached a conclusion regarding the relationship between audit quality and auditor tenure. The mere fact that the PCAOB proposes to require disclosure about auditor tenure, however, suggests that the PCAOB believes the information to be meaningful and that investors should consider the length of the auditor's tenure in assessing audit quality or auditor independence. As explained in the Release, the topic of auditor tenure has been the subject of discussion for quite some time, and IDC and ICI have been actively involved in the dialogue.[10] We do not object to disclosure of auditor tenure in the auditor's report, but we question its relevance to investors.

In the event the PCAOB determines to adopt the proposed disclosure, its application needs clarification in the investment company context. Typically, a fund complex organizes a corporation or a business or statutory trust under state law, which issues a number of separate series of shares, each of which represents a separate fund. Each fund will prepare its own financial statements and those financial statements must be audited annually. From time to time the corporation or trust may issue an additional series of shares representing a new fund. As proposed, it is unclear whether the auditor tenure disclosure requirement would apply at the fund complex level, the trust level, or the fund level. For example, assume an investment adviser first engages in the mutual fund business in 2000 by forming a business trust that offers one series of shares (*e.g.*, a growth fund). Assume that the adviser forms a separate business trust in 2005 and that trust offers one series of shares (*e.g.*, a value fund). In addition, assume the business trust formed in 2005 issues an additional series of shares (*e.g.*, a bond fund) in 2010. If the same auditor has audited each of these funds since their respective inception dates, the auditor tenure disclosure might be measured from 2000 for the complex, 2005 for the trust, or 2010 for the bond fund.

If the PCAOB requires auditor tenure disclosure, we believe it would be appropriate to measure the auditor's tenure from when it first audited any fund in the complex. This approach is logical because all of the funds within a complex are on the same accounting system and are subject to the same system of internal controls over financial reporting. Furthermore, many fund complexes have one board of directors that oversees all the funds in the complex and it is the board's responsibility, by statute, to select a fund's auditor.[11] This approach is consistent with the application of the SEC's audit partner rotation requirements to investment companies. In particular, an audit partner is required to rotate off all the SEC registered investment companies in the complex after serving any fund for five years, and that partner cannot serve any of the funds in the complex during the ensuing five years.[12]

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[10] *See* Letter From Dorothy A. Berry, IDC Governing Council Chair, to J. Gordon Seymour, Secretary, Public Company Accounting Oversight Board, re Concept Release on Auditor Independence and Audit Firm Rotation; Rulemaking Docket Matter No. 37 (Dec 14, 2011) and Letter From Gregory M. Smith, Director – Fund Accounting, Investment Company Institute, to J. Gordon Seymour, Secretary, Public Company Accounting Oversight Board, re Concept Release on Auditor Independence and Audit Firm Rotation; Rulemaking Docket Matter No. 37 (Dec 14, 2011).

[11] *See* Section 32 of the Investment Company Act of 1940 (the 1940 Act).

[12] *See* Rule 2-01(c)(6)(iii) of Regulation S-X. We recommend not using the definition of "investment company complex" included in rule 2-01of Regulation S-X to measure auditor tenure. That definition includes the investment adviser, any entity controlled by or controlling the investment adviser, and entities under common control with the investment adviser that provide services to the fund. These entities would be on a different accounting system and have a different board of directors than the funds.

**Proposed Other Information Standard**

Existing PCAOB standards require that the auditor "read and consider" whether other information in the annual report filing is materially inconsistent with information in the financial statements. In the context of mutual funds, this information is that which is contained in the fund's shareholder report and the fund's Form N-CSR filing. The Proposed Other Information Standard would enhance the auditor's responsibility for the information by requiring that the auditor "read and evaluate" it. That is, the auditor would need to perform specific procedures based on information obtained during the audit and then disclose in the auditor's report its responsibility for, and the results of, its evaluation of the information. For the reasons discussed below, we urge the PCAOB to modify the proposed standard to limit a fund auditor's responsibility to read and evaluate other information to those items that relate directly to the fund's financial statements.

<u>The Scope of the Proposed Other Information Standard is Overly Broad in the Investment Company Context and Would Unnecessarily Increase Fund Audit Costs.</u> We are concerned that the evaluation and reporting required by the proposal would unnecessarily increase fund audit costs. Much of the information the Proposed Other Information Standard would require the auditor to evaluate is beyond the scope of an auditor's expertise and does not relate to the fund's financial statements. Specifically, some of the information in a fund's annual shareholder report cannot be evaluated through reference to data obtained during the course of the audit of the financial statements. For example, the statement regarding the basis for board approval of the investment advisory contract[13] is not related to the fund's financial statements, note disclosures, or internal controls over financial reporting. Rather, the disclosure describes the factors and conclusions that led the fund's board of directors to approve the investment advisory contract, including the nature of the services provided to the fund by the adviser and the fee charged for those services. An evaluation of this information is well beyond the scope of the auditor's expertise and no procedures performed or evidence obtained as part of the financial statement audit will enable the auditor to provide a meaningful evaluation.

Similarly, certain of the information contained in a fund's Form N-CSR filing[14] beyond the shareholder report does not relate to the fund's financial statements and cannot be evaluated through

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[13] The statement regarding a board's basis for approval of the investment advisory contract appears in the annual shareholder report if the board approved the contract during the second half of the fund's fiscal year. Otherwise, the statement appears in the semi-annual report covering the first half of the fund's fiscal year.

[14] A fund's Form N-CSR filing includes the fund's shareholder report and the following other information: (i) the fund's code of ethics; (ii) identification of the fund's audit committee financial expert; (iii) audit fees, audit-related fees, tax fees, and all other fees paid to the fund's principal accountant; (iv) the principal executive's and principal financial officer's conclusions regarding the effectiveness of the fund's disclosure controls and procedures based on an evaluation of those controls and procedures performed within 90 days of the filing date; (v) any changes in the fund's internal controls over financial reporting; (vi) the principal executive's and principal financial officer's certifications; and (vii) certain other information for closed-end funds.

reference to data obtained during the course of the audit. Furthermore, unlike SEC Form 10-K, we believe it would be highly unlikely that a fund shareholder would rely upon Form N-CSR in evaluating the fund or to make investment decisions. Accordingly, we see little benefit in including it within the scope of the auditor's responsibility for other information.

The Proposed Other Information Standard Fails to Take into Consideration the Timing of a Fund's Form N-CSR Preparation. The proposal does not take into account the fact that the Form N-CSR filing likely is not available to the auditor in time for effective evaluation. This is because investment companies must send their annual shareholder report to investors not more than 60 days after the fund's fiscal year end,[15] and the shareholder report must be filed with the SEC on Form N-CSR not more than 10 days after the shareholder report is sent to shareholders.[16] We understand that the shareholder report, including the signed auditor's report, must be delivered to the printer several days prior to the 60th day to enable typeset, proofing, production and mailing no later than the 60th day. The Form N-CSR is generally prepared only after the shareholder report has been finalized and delivered to the printer and is typically filed with the SEC after the 60th day. As a result, a fund auditor would not be able to effectively evaluate the Form N-CSR prior to signing off on the fund's financial statements.

We understand this sequence is different than that in an operating company context, where the Form 10-K filing, including the audited financial statements, is first filed with the SEC and the glossy annual report or Form 10-K filing is later mailed to shareholders. Indeed, while many operating companies send the entire Form 10-K to shareholders, we are not aware of any investment company that sends Form N-CSR to its shareholders.

A Fund Auditor's Responsibility For Other Information Should Be Limited to Items Relating Directly to the Fund's Financials. We see no benefit associated with requiring the auditor to evaluate disclosures that have no relationship to the financial statements. Recognizing that investment companies must include information in the shareholder report on the fund's performance, the factors that affected performance, the fund's expenses, and the fund's portfolio, and that shareholders may consider this information in evaluating fund performance, we recommend limiting the auditor's responsibility for other information in the context of an investment company audit to those items that relate directly to the fund's financial statements. In particular, if the PCAOB adopts the Proposed Other Information Standard, the auditor's responsibility for other information should be limited to total return information included in management's discussion of fund performance,[17] the expense example, and the graphical presentation of

[15] 1940 Act Rule 30e-1.

[16] 1940 Act Rule 30b2-1.

[17] Much of the information in management's discussion of fund performance cannot be evaluated through reference to information obtained during the course of the audit of the financial statements, and should be outside the scope of the auditor's evaluation. In particular, information relating to how the fund over- or under-weighted certain sectors or securities relative to

the fund's holdings.[18] All of this information is included in the shareholder report that is sent to investors, and is available to the auditor in time for effective evaluation. Moreover, narrowing the scope of the proposal for funds in this way would limit the costs associated with the proposal. If the Board does not limit a fund auditor's responsibility for other information to those items that relate directly to the fund's financial statements, then we oppose the Proposed Other Information Standard.

* * * * *

If you have any questions, please contact the undersigned, Amy Lancellotta, at (202) 326–5824 or amy@ici.org, or Gregory Smith, at (202) 326-5851 or smith@ici.org.

Amy Lancellotta

Amy B.R. Lancellotta
IDC Managing Director

Gregory M. Smith

Gregory M. Smith
ICI Senior Director – Fund Accounting

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member

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its benchmark index would only be found in portfolio management or investment database systems outside the scope of the fund's accounting records.

[18] We recommend, though, that the PCAOB clarify that an auditor need not, as part of its evaluation of other information, evaluate or mathematically recalculate investment attributes relating to particular holdings or the fund's portfolio. This is because certain attributes of a fund's holdings, such as average market capitalization, average price to earnings ratio, and average price to book ratio, are based on information outside the scope of the fund's accounting records.

informatica

December 6, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034
Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Dear Board Members and Staff of the PCAOB,

Informatica Corporation and its Audit Committee of the Board of Directors ("Informatica") are pleased to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed revisions to the auditor's reporting model.

We are supportive of the Board's efforts to address the financial reporting concerns of investors and other users of financial statements. This letter provides our views on the proposed standards.

1. **The communication of Critical Audit Matters in the auditor's report would not provide meaningful new information to investors and other users of financial statements, would be costly for audit firms and management, and may impact comparability of financial statements.** Critical Audit Matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Informatica believes that any critical audit matters identified by our auditor would be duplicative to the "risk factors," "management's discussion and analysis," and "critical accounting policies and estimates" sections already disclosed in our financial statements. It is unlikely that critical audit matters identified would not already be disclosed elsewhere, and therefore, minimal new information would be provided to investors and other users of financial statements.

   Informatica believes that audit costs will likely increase as a result of communicating critical audit matters. While the Board's proposal includes reference to various sources to assist in determining critical audit matters, auditors must still incur additional time in order to identify critical audit matters, discuss and review the matters internally and with management, audit committees, and others charged with governance, and draft communications to be included in the auditor's report. The indirect costs include time taken away from auditors during the completion stage of the audit, and incremental investment of time by the audit committee to review critical audit matters.

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In addition, due to the subjective and judgmental nature of the determination of critical audit matters by the auditor, there may be inconsistencies of critical audit matters included in auditor reports of various companies, therefore impacting comparability of our financial statements to other companies.

2. **The proposed new element to the auditor's report related to auditor independence does not provide meaningful information to investors and other users of financial statements.** A statement regarding the auditor's existing requirements to be independent of the company is considered redundant as the title of the report includes the word "independent," and the report states that the audit was performed in accordance with PCAOB audit standards, which sets forth independence requirements.

3. **The proposed new element to the auditor's report related to auditor tenure may be informative to investors and other users of financial statements.** We do not object to inclusion in the auditor's report of the year in which the auditor began serving consecutively as the company's auditor, although we believe it would be preferable to include such information in the proxy. While disclosure of a change in auditor to the SEC is already required in a Form 8-K, inclusion of auditor tenure in the auditor report or proxy would provide another way to disclose whether there has been a change in auditor. Such information may cause investors to inquire whether there were any disagreements with management as to accounting or financial statement disclosures, and may cause additional scrutiny, as new auditors may not have developed a comprehensive understanding of a new audit client, particularly when the company is complex and/or operates in multiple jurisdictions.

4. **The proposed standard related to auditor's responsibilities regarding other information would significantly increase the scope of auditors and would be costly for audit firms and management.** Auditor reporting on information outside the financial statements would increase the scope of the auditor's responsibilities, would require the development of new auditing standards, and would potentially require additional regulatory efforts. Informatica would suggest that the Board perform a more extensive analysis of the demand for auditor's reporting on information outside the financial statements, and costs to issuing such a standard.

5. **Enhanced standardized language in the auditor's report would facilitate continued consistency, comparability, and clarity in auditor's reporting.** The enhancements to standardized language will result in enhanced understanding of what an audit represents and the related auditor responsibilities, thus narrowing the expectations gap. In addition, there would be very little cost to implementing enhanced standardized language.

6. **The inclusion of guidance on explanatory language or explanatory paragraphs is appropriate.** Additional guidance on circumstances that would require explanatory language and examples of when an auditor might include explanatory paragraphs provide enhanced clarity to the auditor.

In summary, we are supportive of various aspects of the proposals; however, we encourage the Board to continue to assess the demand and cost implications of communication of critical audit matters and auditor's responsibilities regarding other information outside the financial statements.

Thank you for the opportunity to comment on the proposal.

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Sincerely,

A. Brooke Seawell,
Chairman of the Audit Committee

Earl Fry,
Chief Financial Officer, Chief Administration Officer,
Executive Vice President of Global Customer Support and Services

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December 11, 2013

Mr. Martin F. Baumann
Chief Auditor and Director
Professional Standards
Public Company Accounting Oversight Board
c/o Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

by electronic submission

Dear Mr. Baumann,

**Re.: PCAOB Release No. 2013-005, August 13, 2013**

**PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards –**

**The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion**

**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report**

**And Related Amendments to PCAOB Standards**

We would like to thank you for the opportunity to provide the Public Company Accounting Oversight Board (PCAOB) with our comments on PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, And Related Amendments to PCAOB Standards (hereinafter referred to as "the draft").

Since the auditor's report is often the only product of the audit that external users see, auditor reporting is closely linked by users to the value of audits. If

GESCHÄFTSFÜHRENDER VORSTAND:
Prof. Dr. Klaus-Peter Naumann,
WP StB, Sprecher des Vorstands;
Dr. Klaus-Peter Feld, WP StB CPA;
Manfred Hamannt, RA

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the value of an audit and perceptions thereof can be increased within the context of the related costs and risks by including more information in auditors' reports, then this should be attempted. For this reason, and the discussions about the content of the auditor's report in the EU and at the IAASB, we consider this exposure draft to be both necessary and timely.

We would like to emphasize that we believe that the draft ought to be restricted to matters that relate to improving auditor reporting only, without consideration of matters in connection with the modernization of the audit or expansions of audit scope, such as those proposed in relation to other information. These latter issues are important too, but may need to be considered by the PCAOB in future in a separate project. Having the audit of the financial statements cover information other than the financial statements, whether by means of an attest opinion or by reporting on audit procedures, is a matter that can only be determined by legislators, securities regulators and terms of engagement – not by auditing standards setters. For this reason, we are convinced that changes to the auditor's responsibilities for other information that go beyond reporting on what is currently required in PCAOB standards is not a matter for the auditor reporting project, but is in fact a broader issue relating to the scope of the audit that needs separate treatment. It is also unclear to us whether the PCAOB has a statutory mandate to expand auditor responsibilities for other information in this way.

We are also aware that the discussions of the European Commission, the European Parliament and the Council of Ministers on matters of audit policy, including on the content of the auditor's report, are due to be finalized soon, and indeed, may have been completed by early next year. We therefore encourage the PCAOB to maintain an intense dialogue with the European Commission, the European Parliament, and the Presidency of the Council of Ministers so as to help minimize the risk that the final European legislation is at variance with the PCAOB's proposals beyond those necessary under U.S. securities laws and existing PCAOB standards.

We also note that the PCAOB issued proposed auditing standards are in many ways similar to those of the IAASB, but that also contain differences. We encourage the PCAOB to engage with the IAASB to seek to minimize differences for audits of financial statements of listed entities.

We have responded in the Appendix to this letter to some of the questions posed by the PCAOB in the draft. However, not all issues are relevant to our members and therefore we have not chosen to respond to all question posed. In addition, we have focussed on what appear to us to be major issues and the

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fact that we have not addressed every issue or relevant question is not indicative that we agree or disagree with the approach taken by the PCAOB for the issues that we have not addressed.

We hope that our views will be helpful to the PCAOB in its deliberations on auditor reporting. If you have any questions relating to our comments in this letter, we would be pleased to be of further assistance.

Yours truly,

Klaus-Peter Feld
Executive Director

Wolfgang P. Böhm
Director Assurance Standards,
International Affairs

494/584

# APPENDIX:

## Responses to Some of the Questions Posed

## Appendix 5 of the Draft

**Question Related to Section II:**

1. **Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**
   Subject to our responses to other questions posed in the draft relating to the meaning or definition of critical audit matters (CAM), we agree that the objectives assist the auditor in understanding the requirements and what would be communicated in an auditor's unqualified report.

**Questions Related to Section IV:**

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**
   To whom an auditor's report ought to be addressed is, in our view, a matter of U.S. securities and contract law. It seems reasonable to us, given what we know about that law, that the report be addressed to the owners of the company (the shareholders, or in a master limited partnership, the partners) and to those engaging the auditor (the board of directors or equivalent body). It does not appear to be appropriate to address the auditor's report beyond these parties.

3. **The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

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We believe it to be crucial that, with the exception of the description of the audit of internal control, the description of the audit of the financial statements in the auditor's report for both audits performed in accordance with International Standards on Auditing (ISAs) and PCAOB standards to be equivalent to the extent that the other underlying standards are equivalent. We therefore encourage the PCAOB to liaise with the IAASB to harmonize the content of the auditor's report with respect to auditor responsibilities.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

   With respect to auditors' reports for audits of financial statements under PCAOB auditing standards, we believe that a statement relating to independence would be useful. The inclusion of the source of independence requirements (PCAOB independence requirements) is also acceptable in an audit performed under PCAOB requirements because there is only one source of such requirements. In audits performed under the ISAs, for example, we are not convinced that reference to sources would be useful, since there may be multiple, and in part overlapping, sources, which may confuse users. This is an instance in which we believe that there may be a justifiable difference between PCAOB standards and the ISAs.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

      We believe that information regarding audit tenure might be useful to investors, but we do not believe that enough research has been done to determine whether this is so. Even if after such research it were to be determined that such information were to be useful to investors, we are not convinced that this information is relevant to an audit report that relates to conveying an opinion on the financial statements (and on internal control) and to describing the audit – such a disclosure would misuse the auditor's report for purposes for which it is not designed. In this case, we would prefer that the SEC require that management or those charged with governance provide information about audit tenure in documents that are filed by registrants with the SEC.

b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

We are not aware of particular challenges in this matter.

c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

As noted in our response to a., we believe that such information is more likely to be useful if included in filings by SEC registrants to the SEC, such as EDGAR.

6. **The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

We would agree that having the proposed auditor reporting standard require the auditor to describe the auditor's ***current*** responsibilities under ***extant*** PCAOB standards for other information would make the auditor's report more informative and useful. However, we believe that actually expanding the responsibility of the auditor to additional procedures or other form of evaluation is not just an auditor reporting matter and therefore requires deliberation in a project that is entirely separate from a project on auditor reporting. This is also the view we take with respect to the IAASB's proposals on these matters.

We would like to emphasize that we are, in principle, in favor of enriching the audit of financial statements by having the audit extend procedures or attest opinions or conclusions to beyond the financial statements. However, we are not convinced that a proper cost-benefit analysis of this issue has been done. We believe that investors will understand the procedures as providing some form of attest opinion or conclusion on the other information, when in fact it is not. Furthermore, we believe that this is a matter that needs consideration at statutory (i.e., Congressional) level, if not at least at SEC level that should not be dealt with by auditing standards setting alone.

For this reason, we would also request that the PCAOB consider whether expanding the scope of the audit beyond the financial statements is within its statutory mandate. We note that Section 101 (c) (2) of the Sarbanes-Oxley Act (hereinafter referred to as the "Act") empowers the PCAOB to "establish or adopt, or both, by rule, auditing ... and other standards relating to the preparation of audit reports for issuers in accordance with Section 103." Section 103 (a) (1) in turn empowers the PCAOB to "by rule, establish...such auditing and related attestation standards ... to be used by registered public accounting firms in the preparation and issuance of audit reports, as required by this Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors."

In this respect we note that, with the exception of the blanket phrase "as may be necessary or appropriate in the public interest or the protection of investors" both Sections 101 (c) (2) and 103 (a) (1) limit the powers of the PCAOB to establishing auditing and other (including attestation) standards to the preparation of audit reports as required by the Act or the rules of the Commission. An "audit report" is defined in Section 2 (a) (4) of the Act as "a document or other record (A) prepared following an *audit* [*underlined italics added*] performed for the purposes of compliance by an issuer with the requirements of securities laws; and (B) in which a public accounting firm either (i) sets forth the opinion of that firm regarding a financial statement, report or other document...". Section 2 (a) (2) in turn defines an "audit" as "an examination of the financial statements...for the purpose of expressing an opinion on such statements." Neither rules of the Commission nor both the Securities Act of 1933 and the Securities Exchange Act of 1934 appear to mandate anything other than an *audit of the financial statements* (and as required by Sections 103 (a) (2) (A)(iii) and 404 (b) of the Act, an audit of internal control over financial reporting). Furthermore, the "blanket phrase" noted above seems to us not to represent a "blank check", but rather should be interpreted narrowly given the clear intentions of both Congress and the SEC to limit attestation or assurance opinions or conclusions to the financial statements (and internal control over financial reporting) – that is, the

PCAOB is being given the power necessary to improve the *quality* of audits of *financial statements* (and internal control) as needed in the public interest and to protect investors – not to unilaterally expand the scope of the audit. Hence, there is a question as to whether there is a statutory mandate to expand the scope of the audit beyond the financial statements and internal control over financial reporting, even if such an audit could be extended by the terms of engagement (which appear covered in the interim standards AU 551, AU 623, AU 634 and AU 711). The interim standard AU 550 is limited to "reading", unless the auditor becomes aware of a potential material inconsistency or material misstatement of fact because the objective is to identify material inconsistencies between the financial statements and the other information that are obvious to users and that thereby undermine the credibility of the audited financial statements, and hence the audit. It is not the objective of an audit as currently defined in securities legislation to provide an attestation or assurance opinion or conclusion on the other information. We believe that the current proposal with its reporting of an "evaluation" and its required procedures will intimate to users that in fact such an opinion or conclusion is being provided. It also seems to us that the procedures being required in proposed paragraphs 4 a. to d. on page A2-3 would in fact lead to the auditor being able to provide an opinion on the consistency of the other information with the financial statements AND the audit evidence obtained during the audit, and would lead to the basis for an opinion on the other information in line with paragraph 12 of extant AU 551. We therefore believe that this represents a clear extension of audit scope "through the back door" that may exceed the PCAOB's statutory authority. We also expect that the work effort required to perform the procedures proposed on page A2-3 is much greater than the PCAOB probably anticipates.

7. **Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**
Based on our discussions with users and preparers on a similar question posed by the Invitation to Comment from the IAASB, it appears to us that users and preparers would welcome some comparability among auditors' reports worldwide. Changing the order for individual reports could also involve signaling effects for users. Hence, to increase the comparability of audit reports under PCAOB standards worldwide and to avoid unintended signaling effects, we suggest that the PCAOB require a specific order to the auditor's report. We recommend that the PCAOB liaise with the IAASB on this matter so that the structure of the two reports remains similar.

**8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

Other than the additional elements or content that might arise due to our suggestions in our response to Question 3 above, we do not believe that there should be any additional elements to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor.

**9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

Other than for critical audit matters (CAM) and for increasing the work effort for other information, no cost increases other than the one-off change in the form and content of the auditor's report are expected. The new requirements with respect to CAM are expected to result in a cost increase for the additional time needed and potential delays in finalizing the auditor's report with regard to the following areas:

- Drafting the additional information (CAM) to be included in the auditor's report;
- Discussing these matters as well as any matters ultimately not determined as CAM internally within the audit firm, including with the engagement quality control reviewer, perhaps the firm's legal counsel, and possibly with others outside the firm (e.g., in some cases recourse may be had to advisory services by a professional institute); and
- Discussions with both management and those charged with governance.

Management and those charged with governance (TCWG) are also likely to spend additional time reviewing and discussing wording and presentation with the auditor. Nevertheless, we regard the added benefit to users in increasing the usefulness of audit reports to outweigh the costs.

We note our concerns about the likely underestimation of the costs involved in expanding the work effort on other information in our response to Question 6.

**Questions Related to Section V:**

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

As a matter of principle, we welcome the idea that the auditor's report provide more relevant information to users (note: when we speak of users in our comment letter, we mean "intended users", which may be narrower than "users", and are referring to "external users" – that is, neither management nor those charged with governance, who have additional access to information about the audit) of financial statements because it would increase the value of audits to users. However, it seems to us that based on our roundtable of users, regulators, and preparers and from our consultation with members of our profession, not enough research has been done to determine which information is really of interest to users and what they would do with that information if it were available through the auditor's report.

For this reason, we do not believe that we are able to conclude as to whether the introduction of CAM into the auditor's report will in fact enhance the usefulness of the auditor's report. In particular, we expect a continuing danger of boilerplate and user misunderstanding of the nature of CAM (with the resulting increase in the expectations gap) in this respect to remain. On the other hand, we note that the inclusion of CAM may provide users with additional information about matters in the financial statements involving auditor judgment and that therefore the expectations gap may also be reduced with respect to the nature of the audit opinion. For these reasons, overall we believe that the arguments for including some form of CAM in such auditors' reports outweigh the arguments against. It is therefore important that the PCAOB monitor the implementation of CAM to review the application of CAM in practice after a few years of experience in practice.

We welcome the fact that CAM is focused on having the auditor report on matters that are important to the audit, and that therefore CAM no longer serves the purpose of having the auditor help users "navigate" through the financial statements, which we believe is the role of management – not the auditor.

However, in this context, we believe that the PCAOB has not emphasized the purpose of CAM in relation to user needs enough. Ultimately, like the content of the financial statements depends on the financial information needs of users, the contents of auditors' reports must be driven by the information needs of users with respect to the audit. It is inconsistent to claim, on the one hand, that auditors must use their judgment to determine materiality for the financial statements and consider materiality for the fair presentation of the financial statements based on the financial information needs of users, but at the same time claim that auditors are not able to determine what the contents of CAM ought to be based upon the auditor's judgment of the information needs of users with respect to the audit.

It is the lack of a connection to user information needs with respect to the audit that we believe causes some weaknesses in the proposed draft for the determination of when audit matters ought to be CAM. On the whole, we do not perceive a reasonable alternative to some form of CAM, properly defined and with clear criteria for its determination.

However, we do not believe it would be at all helpful to investors, auditors and regulators if the PCAOB and the IAASB were to use differing terminology, definitions and criteria in their respective final pronouncements. We have not been able to determine whether the differences in the proposals would lead to different reporting, and would encourage cooperation between the two Boards in this respect.

**12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

In line with our views in our response to Question 11, we believe that the definition of CAM ought to be as follows:

> "Those matters critical to the audit that the auditor judges are reasonably expected to influence decisions of intended users."

We believe that a definition should serve to identify the distinguishing characteristic of CAM – not serve as a set of criteria based on the definition to determine which matters are CAM. In our response to

Question 14 below we explain our views on the appropriate criteria for CAM that would clarify the determination of CAM.

We also believe that the use of a relative test ("most"), rather than an absolute test (e.g., the "critical" in the "critical audit matters"), suggests that number of matters identified as CAM must always be similar across all audits and that consequently, there can never be no CAM. It would be confusing to users as to why a matter that is critical for two registrants is not included in both audit reports because one of the registrants has more matters that are critical. It may also lead matters that are not critical to be included in CAM simply because they were "most" significant. We therefore suggest dispensing with the term "most".

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

We assume that additional time incurred regarding critical audit matters would have an overall positive effect on audit quality, but could pose challenges to the timely completion of the audit.

**14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

We believe that there is room for further improvement in the requirements regarding the determination of CAM. We have been informed that field tests undertaken in the firms in relation to KAM as defined by the IAASB appear to suggest that auditors intuitively identify those matters that they believe ought to be KAM or CAM. However, we do have some concerns that the criteria as currently conceived may not lead to reasonably consistent auditor judgments about which matters ought to be CAM across firms, and therefore may be difficult to enforce because the PCAOB may have a different view as to what is CAM: therefore the intuitive process applied by auditors needs to be reflected in a clear "filter".

As we note in our response to Question 12 above, basis for the determination of CAM must be user information needs with respect to the audit: the objective of CAM ought to be to increase the value to users of the auditor's report. Consequently, the filter gleaning matters of interest to users of the auditor's report that ought to be CAM needs to be based on the decision-usefulness of the information about the audit to users, which in turn depends upon the use to which auditors expect users to put that information.

We believe that unless the matter in question relates to a significant risk of material misstatement, the matter is not likely to be a matter that ought to be CAM because it is unlikely to be of interest to users. This means that the starting point for the determination of CAM ought to be whether a matter has been identified as a significant risk (or perhaps a high risk of material misstatement for which substantive procedures alone do not provide sufficient appropriate evidence and for which a significant deficiency in internal control is relevant). We note that the concept of significant risks of material misstatement is more than just an audit planning or risk assessment concept because an auditor is required to evaluate before the conclusion of the audit whether the risks of material misstatement at the assertion level remain appropriate (which implies determining whether the identification of significant risks remains appropriate).

However, this does not imply that all such significant risks of material misstatement ought to be CAM. In particular, those risks that are always significant risks or are presumed to be significant risks under the PCAOB standards (e.g., fraud risk, revenue recognition, management override of controls) need not be CAM unless the nature of such risks of material misstatement are of critical importance to the audit of the financial statements due to their being peculiar to the entity, the information about which would therefore also be decision-useful to users. This means that only those significant risks ought to be regarded as CAM that involve significant auditor judgment in relation to significant matters. Such auditor judgment would occur when the matter relates to significant management judgment as to the appropriateness of accounting treatment of recognition, measurement, presentation or disclosure issues, the use of grooming transactions, or in relation to auditor judgment that sufficient appropriate evidence has been obtained.

This approach would provide a clear set of criteria, directly related to items in the financial statements, to which auditors can apply professional judgment to filter out those matters that ought to be CAM.

In relation to the criteria for the determination of CAM, we suggest that the criteria be worded as follows:

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"The auditor shall determine those matters that are critical audit matters by:

(a) Identifying those matters that have been identified as significant risks of material misstatement or a high risk of material misstatement for which substantive procedures alone do not provide sufficient appropriate evidence and for which a severe significant deficiency in internal control is relevant;
(b) Excluding those risks of material misstatement that are always required to be treated as significant risks of material misstatement in an audit (the risk of material misstatement due to fraud, including the risk of management override of controls) or are always presumed to be a significant risks of material misstatement due to fraud (revenue recognition), unless the nature of such risks of material misstatement are of critical importance to the audit of the financial statements due to their being peculiar to the entity, the information about which would therefore also be decision-useful to users.
(c) Excluding those significant risks of material misstatement not relating to significant management judgments about recognition, measurement, presentation or disclosure issues in the financial statements or grooming transactions, or not relating to significant auditor judgment that sufficient appropriate audit evidence has been obtained."

This approach would help clarify the filtering process that auditors intuitively use to identify CAM and would aid documentation and enforceability.

With respect to the communication of critical audit matters, we believe that communication of the following matters is essential:

- A description of the matter
- An explanation as to why the matter is CAM
- A reference to where the matter is disclosed in the financial statements

We would not support including audit procedures performed in the communication of CAM because such inclusion is likely to raise more questions than answers for users. Furthermore, we believe that including a conclusion about the resolution of CAM would be regarded as a piecemeal opinion by users, and therefore such conclusions should not be included.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

As noted in our response to Question 14, we do not believe that including the audit procedures performed would be useful due to the fact that users will not understand that the description of the procedures would never be complete (and therefore this would raise more questions than answers to users). In addition, addressing the resolution of CAM would be construed by users as a piecemeal audit opinion, which we believe ought to be avoided.

**16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

**17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

We regard the factors not to be particularly useful; as long as the criteria for identifying CAM are clear as noted in our response to Question 14, we believe that such factors are not necessary. In particular, we note the following:

- The factor listed in a. on page A5-30 (degree of subjectivity) is already covered by the criteria we note in (a) and (c) in our response to Question 14, but in a manner linked to significant risks of material misstatements and management and auditor judgment.
- The factor listed in b. on page A5-30 (the audit effort required) may not be indicative that a matter has been resolved conclusively; users are not interested in matters that have been conclusively resolved, even if they required considerable audit effort.
- The factor listed in c. on page A5-31 (difficulty in obtaining sufficient appropriate audit evidence) is already covered by the criteria we note in (c) in our response to Question 14.
- The factor listed in d. on page A5-31 (severity of control deficiencies) is covered by the criteria we note in (a) in our response to Question 14.
- The factor listed in e. on page A5-32 (change in risk assessment and procedures) does not imply that this is necessarily of interest to users – particularly if the evidence obtained as a result is conclusive and therefore not critical.

- The factor listed in f. on page A5-33 (nature and significance of corrected misstatements) is not of interest to users once conclusively corrected,
- The factor listed in g. on page A5-33 (extent of specialized skill or knowledge) would not be relevant to users when that skill or knowledge led to the conclusive resolution of the matter.
- The factor listed in h. on page A5-33 ( nature of consultations outside engagement team) would not be of interest to users when the results of such consultations are conclusive.

Overall, we have come to the conclusion that it is more important to get the criteria for the determination of CAM "right" than to list factors.

Hence, we do not believe that additional factors are necessary either.

**18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

**19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

**20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

We believe that the proposed requirement is sufficiently clear, but we do not support the notion that auditors should be documenting matters considered for inclusion in CAM that were subsequently rejected. This list could be very long and would lead to the PCAOB second-guessing the list with hindsight. We believe that the documentation requirement is otherwise sufficient and that a broader requirement is not needed.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

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We believe that the auditor should first and foremost concentrate on those critical audit matters arising from the audit of the current period, even in the case of comparative financial statements, when the auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.

Nevertheless, due to the fact that these critical audit matters are likely to recur in the risk assessment of the audit of financial statements and internal control report year on year, there might be a need to consider whether critical audit matters of the previous period remain crucial audit matters in the current period.

26. **What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**
It is likely that users will look for comparability of reports in particular industries or where circumstances giving rise to critical audit matters are pervasive. However, such reporting is intended to be non-boiler plate and specific to the audit on the financial statements and internal control report of a specific period, so comparability cannot be an overriding goal – rather information useful to users about the audit should be the overriding goal.

27. **What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**
There may be circumstances when law or regulation effectively prohibits the dissemination of information by the auditor. In these cases, the draft needs to recognize that there may be legitimate limitations on what can be included in CAM. For example, law or regulation may effectively preclude the reporting of identified or suspected fraud or non-compliance with law or regulation.

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**Questions Related to Section VI:**

29. **Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**
30. **Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**
    We believe that it would be appropriate to retain the concept of emphasis of matter paragraphs and to introduce the concept of other matter paragraphs in line with ISA 706 as issued by the IAASB, even when the auditor is required to communicate CAM. In this respect it is important for the PCAOB to clearly differentiate these from CAM. The reason is that the definition (whether that proposed in the draft or our proposed definition) of CAM will not cover all of the circumstances for which emphasis of matter and other matter paragraphs can be used. It is therefore entirely appropriate that the former be retained and the latter introduced.

31. **Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**
32. **Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**
    The only matter that ought to require emphasis is the identification of substantial doubt with respect to whether the entity will continue to operate as a going concern. However, given the IAASB's direction on this matter, once FASB has completed its relevant accounting standards on this matter, the PCAOB may wish to consider whether going concern reporting requires a separate section rather than an emphasis of matter.

    We do not believe that more matters should be added to the list of possible matters that might be emphasized.

## Appendix 6 of the Draft

We note our response to Question 6 of Appendix 5 of the draft, which summarizes our views with respect to the requirements for auditor responsibility for other information.

Institute of
Chartered Accountants
Australia

02 December 2013

The Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NSW
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**Email:** comments@pcaobus.org

Dear Sir/Madam

**PCAOB Rulemaking Docket Matter No. 034**
**Proposed Auditing Standards *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

The Institute of Chartered Accountants Australia is pleased to respond to the above Rulemaking Docket.

The Institute has always been a strong supporter of enhancing auditor reporting as we believe that clear and informative auditor reporting is of value to the users of financial statements. Maintaining user confidence in the audit process is key to maintaining strong capital markets and auditor reporting that demonstrates the value of the audit to the users is key to achieving that aim.

We have consulted widely on the International Auditing and Assurance Standards Board (IAASB) proposals for changes to the auditor report and believe many of the matters raised by our members, who represent all participants in the financial reporting supply chain, are relevant to the PCAOB's proposals. We are restricting our comments to matters that were raised by our members during those consultations and not all the matters covered in the Rulemaking Docket.

**Global Consistency**

We note that the PCAOB and IAASB have consistent aims to enhance the value of the audit report through increasing transparency in relation to the judgments inherent in the audit process. This has led to many consistencies in the proposals. However we strongly urge more direct liaison as you contemplate responses and finalise recommendations.

The global nature of markets and investment, and the sizable number of companies reporting in multiple jurisdictions, mean even slight variations in wording or content can cause great expense to manage different compliance obligations, and great confusion for users. For example, understanding whether the difference between a "critical audit matter" and a "key audit matter" is merely wording or a more fundamental difference, is an unnecessary complication for users and can inhibit understanding and confidence in the audit process.

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**Critical Audit Matters**

Our recent consultations with members in relation to similar proposals from the IAASB revealed mixed views among stakeholders. While many, including investor bodies, saw advantages in an explanation of the important judgments made by the auditor, there were widespread concerns about the actual and potential costs associated with implementation. These include the:

- costs, time and resource to manage the expanded reporting requirements
- increased liability
- number of additional pages to the audit report, potentially losing the impact of the opinion and adding further to the length of annual reports
- amount of additional documentation in audit files to manage potential subsequent regulator review and challenge

The benefits to users of additional commentary by the auditor do not seem to outweigh these costs.

There were strong preferences expressed for a model where the company provides additional information to the users and the auditor provides assurance over that information. This was particularly evident when understanding that users were actually interested in the company's risks and judgments rather than audit procedures.

However on the basis that the proposals are pursued, we recommend that critical audit matters:

- be identified through principle-led judgment (rather than prescription), with clear and concise guidance around the framework for application of the principles
- focus on why the matter is of interest to users of the financial statements and not on what audit procedures were performed.

**Tenure of auditors**

Although not part of the consultation for the IAASB proposals, we would like to comment on the proposal to disclose the tenure of the auditor. We do not support including this information in the audit report. The date of appointment is available elsewhere in most jurisdictional regimes (and through the 10K process in the US). Including the information in the audit report:

- implies this is a defining matter or a key point of reference for users when in fact there is no evidence about the impact of tenure on audit quality
- merely adds to the length of the report and the amount of information users need to sort through.

**The Institute of Chartered Accountants Australia**

The Institute is the professional body for Chartered Accountants in Australia and members operating throughout the world.

Representing more than 73,000 current and future professionals and business leaders, the Institute has a pivotal role in upholding financial integrity in society. Members strive to uphold the profession's commitment to ethics and quality in everything they do, alongside an unwavering dedication to act in the public interest.

Chartered Accountants hold diverse positions across the business community, as well as in professional services, government, not-for-profit, education and academia. The leadership and business acumen of members underpin the Institute's deep knowledge base in a broad range of policy areas impacting the Australian economy and domestic and international capital markets.

The Institute of Chartered Accountants Australia was established by Royal Charter in 1928 and today has more than 61,000 members and 12,000 talented graduates working and undertaking the Chartered Accountants Program.

The Institute is a founding member of both the Global Accounting Alliance (GAA), which is an international coalition of accounting bodies and an 800,000-strong network of professionals and leaders worldwide; and Chartered Accountants Worldwide, which brings together leading Institutes of Chartered Accountants in Australia, England and Wales, Ireland, New Zealand, Scotland and South Africa to support, develop and promote over 320,000 Chartered Accountants in more than 180 countries around the world.

**Further information**

We trust you find our comments of value. Should you require further information or clarification on any of our views, please contact Liz Stamford, Head of Audit Policy via email at liz.stamford@charteredaccountants.com.au.

Yours sincerely

**Lee White**
Chief Executive Officer

The Association of Accountants and Financial Professionals in Business

November 12, 2013

Office of the Secretary
PCAOB
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Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 034

Dear Board Members:

The Financial Reporting Committee (FRC) and Small Business Financial and Regulatory Affairs Committee (SBFRC) of the Institute of Management Accountants (IMA) are writing to provide their views on the proposed auditing standards dealing with the auditor's report, PCAOB Release No. 2013-005 dated August 13, 2013 (Exposure Draft). We certainly understand the desire of the Board to "make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users." However, while we are pleased that certain major modifications to the auditor's report suggested in the earlier concepts release are not proposed in this Exposure Draft, we believe that key aspects of the current draft will not achieve the objective quoted above. Further, we are concerned that significant audit time will be added to most engagements without commensurate benefit and the timing of some of this work will be problematic with respect to Security Exchange Commission (SEC) filing deadlines.

The IMA is a global association representing more than 65,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. The SBFRC addresses issues that impact small and medium-sized organizations. On behalf of IMA's members, the SBFRC engages and suggests solutions to standard-setters and regulatory agencies such as the Financial Accounting Foundation, SEC, International Accounting Standards Board, Small Business Administration, American Bankers Association, Internal Revenue Service and others. Information on both committees can be found at www.imanet.org under the Advocacy section.

**Overview**

As noted in our September 22, 2011 letter commenting on the Concepts Release on this same subject, we believe that the overall framework for the auditor reporting model should be consistent with the following principles.

1. The objective of an audit should remain as we know it today. It should provide an opinion on the financial statements, not management's discussion and analysis (MD&A) or other areas of financial reporting.
2. Auditors should not be disclosing information for which they are not the original source. Rather they should opine on information provided by management.
3. The auditor's report should provide transparency for investors as to what the audit provides in terms of assurance (what it is), as well as, what it does not address (what it is not).
4. Auditor involvement and attestation should be limited to areas for which they have the appropriate expertise.

Consistent with this framework, we fully support the existing "pass/fail" model that has stood the test of time and is endorsed by the Board in the current proposal. Notwithstanding efforts of the PCAOB or others to improve the usefulness of the auditor's report, we believe most users will continue to look only to see if a company has received an unqualified ("clean") opinion. Our strong support for the pass/fail model is one reason we are concerned about critical audit matters (CAMs), as discussed below, as lengthy lists of CAMs may tend to obscure the actual pass/fail conclusion.

Also consistent with our framework, we strongly support the Board's decision not to include a proposal for an auditor's discussion and analysis (AD&A) in the exposure draft. In particular, an AD&A would have required auditors to report information that in many cases was not already being reported by the company itself. Financial statements and other information in SEC filings are representations of management. While investors may always desire improvements in financial reporting and other disclosures in filings, the proper source of this information is management and not the auditor. We also believed that a requirement for an AD&A would have diverted resources from the audit process and have similar concerns about the proposal for CAMs as discussed below.

Our earlier letter also suggested that a requirement for emphasis paragraphs to be added to auditor's reports in most cases was not warranted. Thus, we support the position in the Exposure Draft to continue current practice to allow such paragraphs in unusual circumstances but not burden all reports with numerous emphasis paragraphs. Some companies have experimented with "road maps" to their annual reports or similar ways to highlight matters that they believe will help readers better understand those reports. We encourage those efforts by companies but again believe it should be management's responsibility to take the lead on such disclosure matters rather than assigning such reporting to the auditor.

## Critical Audit Matters

Without question the most significant proposed change to the auditor's report is the inclusion of critical audit matters. The Board defines CAMs as the audit matters that:

- involved the most difficult, subjective, or complex auditor judgments;
- posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and

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- posed the most difficulty to the auditor in forming an opinion on the financial statements.

The source of such matters is identified as being:

- included in engagement completion documents;
- reviewed by the engagement quality reviewer; and
- communicated to the audit committee.

Proposed documentation requirements are such that any matters in the above source list are likely to be judged as CAMs under the proposal as the auditor would be required to otherwise justify in the working papers why such treatment was not appropriate. And that judgment, of course, would be subject to second guessing by PCAOB inspectors. Thus, we assume that the practical application of this guidance would be for most auditors to err on the side of including more rather than fewer CAMs in their reports. This, of course, would lead to several CAMs being included in an auditor's report in typical circumstances and resulting multi-page reports.

While we are concerned about whether multi-page auditor reports would be truly useful to the readers of those reports, our real concern about the proposed addition of CAMs to the auditor's report is not just with the issue of size. Rather, we return to the fundamental issue of the roles of the auditor and management. While the notion of CAMs purports to provide users with information about the audit, for all practical purposes the definition is simply an indirect way of identifying important matters in the company's financial reporting (where significant estimates were made, etc.). The Exposure Draft requires a description of the CAM and why it is one but is silent on whether the auditor should include a description of audit procedures applied (although the examples provided do include such procedures). This indicates that the information being provided is intended more as a way of helping the reader understand the financial reporting rather than understand the auditing performed.

As noted earlier, we understand the desire to "make the auditor's report more informative," which is the PCAOB's objective in this project. But we strongly believe that the report should be limited to describing the auditing procedures performed and related matters and not be extended to serve as guidance for readers of the financial statements and other information in annual reports, etc. to better understand that information. The latter responsibility clearly lies with management. Frankly, we believe the sections of MD&A covering critical accounting policies and use of estimates are quite informative at present for most companies. However, to the extent this and other financial reporting needs improvement, we stand ready to work with the FASB, SEC, and other parties as appropriate.

We also are concerned that the time and effort devoted to fulfilling these particular requirements could distract attention from what we consider the core deliverables of the audit and divert valuable resources of audit firms, management, and audit committees. At present, companies present their financial statements and other information for final review and signoff by the audit engagement partner, concurring partner, and often, national office SEC reviewing partner – all of this under very tight SEC filing deadlines. With a CAM requirement, the process would become more like a "simultaneous equation" as the company would have its information and the auditors would have their own version and each party would then have to enter into negotiations on which version of the description of certain significant estimates, etc. is in the CAM vs. the MD&A, footnotes, etc. This would require discussions among financial management, audit committees, internal and external legal advisors, local and possibly regional and national office audit personnel, and so on. It's hard to understand how this can possibly be a productive use of senior audit executive time at the critical audit closing juncture.

We are pleased that the Board has encouraged companies and auditors to field test how the CAM provision would be applied in practice and submit the results to the PCAOB. As noted, this exercise will be most effective if the auditor/company information is reviewed with users of the information (investors, creditors, etc.) and the investors' views are also shared with the Board. We believe that field testing is likely to demonstrate operational difficulties with the proposal and other negatives rather than positive reinforcement for the CAM notion. If nothing else, however, it will be useful to have some real examples of five to ten page reports that mainly repeat what is already in MD&A, footnotes, etc. and then to ask investors what they find useful about such reports.

In summary, we do not support the inclusion of CAMs in auditor's reports and urge that this part of the proposal be dropped.

**Reporting on Other Information**

In our earlier letter we indicated, "While the Committees do not support extending the auditor's opinion to cover other areas of filed reports (e.g., MD&A, other 10-K information) or earnings releases, we would agree that there may be some benefit to providing investors and other readers of the financial statements a clearer articulation of the auditor's responsibility for the other information in filed financial reports. This information is currently provided to the audit committee and could be added to the auditor's external report in a manner that would not be disruptive or otherwise detrimental to the audit and closing processes." Thus, we end that section of our letter with the following, "… we would not object if the PCAOB required that a brief description be added to the auditor's report to assist investors in understanding the nature and extent of auditor involvement in reviewing other areas of the reporting entity's filed information."

However, in the Exposure Draft, the Board has proposed a different standard of auditor involvement with other information. Rather than read the other information and "consider" whether it is materially consistent with the audited financial statements, the auditor would now be required to read and "evaluate" the consistency of the information. Further, paragraph 4 of the Exposure Draft states in part, "The auditor should read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the …"

The change from "consider" to "evaluate," and the phrase "based on relevant audit evidence obtained and conclusions reached during the audit" has resulted in some accounting firms indicating that they believe substantial additional auditing procedures would be necessary to satisfy the Board's intent. It apparently is unclear whether the quoted phrase was intended by the PCAOB to mean only what had already been performed or whether at least some additional procedures are needed to meet an "evaluate" standard. And if some additional procedures are needed, what are they? We assume this concern is based in part with the firms' experience with the PCAOB inspection program in second guessing the application of many audit judgments. And we are particularly interested in making sure that we learn from our past experience with auditing of internal controls, wherein the accounting firms went well beyond what seemed reasonable in the initial application of Auditing Standard No. 2, which ultimately resulted in the need to issue a revised auditing standard a few years later.

Rather than bringing forward the current auditing guidance in Section AU550 with an added reporting responsibility (to which we had not objected in our earlier letter), the Board seems to have carefully chosen words in its proposal to significantly expand the auditor's responsibility and risk. For example, the Board could have required that the auditor disclaim an opinion – e.g., "Because we were not able to apply sufficient auditing procedures, the scope of our work was not sufficient to enable to us to express an opinion, and we do not express an opinion." Or the relevant paragraph could be titled differently, such as "The Auditor's Disclaimer Regarding Other Information." In other words, there are several means available to make clear that no audit of the other information was performed and to not create report language that may well be misunderstood by even a sophisticated investor. It's no wonder that accounting firms' first reaction to the proposal is to suggest that they would have to perform substantially more auditing procedures.

As a final point on this issue, we urge the Board to study (field test) how accounting firms would apply the proposed guidance on the auditor's responsibility for other information. It is important to determine, before the fact, whether such procedures would be unduly costly. It is our belief that substantially expanding auditing procedures in exchange for some form of negative assurance on the other information would not meet any sort of reasonable cost-benefit evaluation. A robust field test of how the proposed guidance would be applied should help demonstrate that to the Board.

**Auditor Tenure**

We understand that there is some (limited?) investor interest in auditor tenure. However, given the lack of evidence of association with audit quality, we do not support inclusion in the auditor's report. Rather, we believe this is more appropriately considered a corporate governance matter and considered for disclosure in proxy statements as part of audit committee reports or in connection with shareholders' ratification of auditor reappointment.

**Other Matters**

The remaining matters in the Exposure Draft are modest wording changes that we support or at least do not object to as follows:

- addressing the report to shareholders and the board;

The Association of Accountants and Financial Professionals in Business

- adding wording to clarify that a material misstatement means whether due to unintentional error or intentional fraud;
- adding footnotes to the language of "financial statements" covered by the auditor's report; and
- adding wording to the report indicating that the auditor is independent (as defined by the SEC).

**Conclusion**

We appreciate the opportunity to express our views on the exposure draft. We would be pleased to further explain these views or provide additional information at your request.

Sincerely,

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December 10, 2013

Office of the Secretary
PCAOB
1666 K Street N.W.
Washington, DC 20006-2803

Submitted via electronic mail to comments@pcaobus.org.

Subject: PCAOB Rulemaking Docket Matter No. 034. Release No. 2013-005.

Dear Board Members of the PCAOB:

Intel appreciates the opportunity to respond to the Public Company Accounting and Oversight Board's (PCAOB) proposed auditing standards relating to the auditor's report and the auditor's responsibilities regarding other information. We support the PCAOB's objective of increasing the transparency and relevance of the auditor's report to financial statement users. However, as issued, we have significant reservations that the key elements of the proposed standards will achieve their objectives.

**Critical Audit Matters (CAMs)**

As stated in our letter to the PCAOB relating to their concept release on the auditor's reporting model on September 30, 2011, we firmly believe that any standard setting initiative should not change the responsibilities of management, the audit committee or the auditors. Our concern is that the current proposals may blur the lines of responsibility between management and the auditor by creating the context for the auditor to be the first point of disclosure and giving the appearance of playing the role of management.

We support maintaining the pass/fail model and the decisive clarity it brings to the auditor's opinion. We are concerned that through the expectation of CAMs existing for most audits and the likelihood the auditors will need to defend their judgments through the PCAOB inspection process, the number of CAMs will naturally increase. The subjective nature of CAMs will cause the auditor's report to become a highly interpretive document leading to user misunderstanding of the report's conclusion.

We are also concerned that this proposal is adding to an already comprehensive framework of disclosure with transparency over critical accounting estimates, risk factors and business trends. We expect that layering additional disclosures may have the unintended effect of creating more complexity and less clarity for users of the financial statements.

We believe that any changes to the auditor's report ought to require field testing with the user community to validate there is significant value from adding CAMs to the auditor's report. Other alternatives should also be explored, such as enhancing the transparency of the PCAOB inspection process and the timeliness of the inspection results, or a reexamination of the disclosure framework, so that the best solution can be developed for users.

**Auditor's responsibility regarding other information**

We support providing further clarity in the auditor's report regarding their responsibilities over other information. However, the proposal expands the scope of the auditor's responsibilities in areas that are more forward looking and subjective in nature. We note that comments from some audit firms indicate the current proposals will require additional audit procedures to be performed. It is unclear what level of assurance would result from these additional procedures. We therefore do not see significant user value in moving from a model of "read and consider" to one of "read and evaluate". Furthermore, we are unaware of significant issues associated with auditor's existing responsibilities over other information in the financial statements.

We recommend that the PCAOB carefully consider the procedures expected of auditors regarding other information and complete a cost/benefit study to determine if expected incremental costs are significantly outweighed by the value to users.

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Thank you for your consideration of the points outlined in this letter. If you have any questions regarding our comments, please contact me at (971) 215-6270.

Sincerely,

James Campbell
Finance Vice President and Corporate Controller

Invesco

**Sheri M. Morris**
Senior Director and Head of U.S.
Fund Administration

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December 11, 2013

**Submitted via electronic mail**
**comments@pcaobus.com**

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments; Docket Matter 034

Dear Ms. Brown:

Invesco Advisers, Inc. ("Invesco" or "we") is a registered investment adviser that, along with its affiliates, provides a comprehensive range of investment strategies and investment vehicles to retail, institutional and high-net-worth clients. As of October 31, 2013, Invesco had approximately $233.8 billion in assets under management in Invesco Funds registered investment companies ("RICs") and, along with our affiliates, had over $763.9 billion in total assets under management. Invesco appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposed changes to *The Auditor's Report on the Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements, and the Related Auditor's Report, and Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard* (the "Proposal").

Invesco supports efforts to improve audit quality in order to enhance investor confidence of the audit process and the auditor's responsibilities related to other information. However, Invesco does not support the PCAOB's proposals in their current form.

By this letter, we wish to communicate our support for the comments of the Investment Company Institute ("ICI") in their comment letter dated December 11, 2013, with respect to the Proposal. However, we are submitting this separate letter in order to emphasize the burden that the Proposal would place on investment companies and their auditors and the increase in audit costs, with no demonstrated benefit to mutual fund investors. Therefore, we to note the following specific points from the ICI's letter that we believe are of heightened importance to investment companies (mutual funds) and their investors:

- <u>No Additional Useful Information</u>. Critical Audit Matter ("CAM") disclosure requirements are not likely to add useful information to the existing disclosures in a mutual fund's shareholder report. Because mutual funds' assets are primarily invested in investment securities, the financial reporting is less complex than a traditional corporation and is significantly related to such investments. A CAM reported by the auditor regarding difficult or subjective audit matters is likely to be repetitive of similar disclosure already included in the financial statements (e.g., fair value measurements). The nature of the investments in certain mutual funds may mean that the auditor will make the same CAM disclosure every year and consequently lose its effectiveness. Conversely, some mutual funds may not have any significant audit risks but the proposed definition of CAMs as a relative concept may induce the auditor to communicate non-critical items as CAMs anyway.

- <u>Investor Confusion</u>. CAM disclosure requirements may inappropriately influence and/or confuse investors in their decision-making process regarding which mutual funds to invest in. By their nature, CAM disclosures can be subjective, from one auditor to the next and from one fact pattern to the next. Different auditors can see the same set of facts and make different determinations on whether a CAM is necessary. This inconsistent use and application of CAM disclosures could lead an investor to misunderstand the impact of a CAM on a mutual fund, placing emphasis on CAMs when reviewing similar types of mutual funds, and incorrectly using a CAM as a deciding factor on investing in a mutual fund, when other factors such as the mutual funds' investment objectives, strategies, risks and fees would be more appropriate tools to use for mutual fund comparison purposes. CAM disclosures may also unnecessarily impact brokers who sell mutual funds and/or third-party consultants reviewing mutual funds and recommending them for investment purposes. This influence and impact does not appear to be outweighed by the benefits, if any, of CAM disclosure in mutual fund financial reports, which are not typically the documents used by investors when making a mutual fund investment selection.

- <u>Increased Investor Expenses</u>. CAM disclosure requirements may lead to an increase in audit costs due to the one-time setup necessary to update auditing methodologies and the ongoing annual costs associated with making determinations on whether a CAM exists or not. These additional audit costs will be borne by the mutual funds being audited, not the investment adviser of the mutual funds. These additional mutual fund costs will have direct impact on mutual fund net asset values, in turn, reducing shareholder returns. Again, any benefits to be realized by potential CAM disclosures do not outweigh the negative impact of higher audit costs on mutual funds and the impact these higher audit costs will have on investor returns.

- <u>Outreach to Retail Mutual Fund Investors</u>. We do not believe that any substantive outreach was conducted toward mutual fund investors who own shares of investment companies that are being audited. There does not appear to be any evidence of a need or desire by mutual fund investors for CAM disclosures. Rather, as noted above, mutual fund investors base their investment selection on mutual fund strategies, performance and fees, among other things, not financial statement disclosures.

- Enhanced Auditor Review of Other Information. Unlike annual reports of traditional corporations, mutual fund reports contain a number of items that do not directly relate to the mutual fund's financial statements (e.g., fund performance and management's discussion thereof, growth of $10,000 chart, graphical representation of portfolio holdings and the board's basis for approval of the fund's investment advisory contract, among other things). We do not believe it is beneficial for mutual fund investors to incur additional audit costs for auditors to thoroughly review and evaluate this non-financial statement information when it does not relate to the mutual fund's financial statements—the subject of the audit. Nevertheless, the Proposal requires that auditors place more emphasis on these non-financial disclosures. Again, we do not believe these additional efforts are offset by any real tangible or potential mutual fund investor benefits. Moreover, if the Proposal does go forward, we believe that any "Other" information should be limited to the management discussion and other information included in the report itself, and not go outside the report. Expanding the reporting requirement to information included outside of the information in the report would create inconsistencies in the timing of required mutual fund reporting and would increase the costs to mutual fund investors without demonstrated incremental benefits. Narrowing the scope of the Proposal for mutual funds by limiting review to items included in the mutual fund report would limit the costs of the Proposal.

We appreciate the opportunity to comment on the Proposal. We support the ICI's comment letter to the PCAOB relating to the Proposal. And we would like to emphasize again our concerns that the Proposal will have a negative impact on mutual funds and their investors, without any real tangible benefits. The lack of benefits, the potential investor confusion and the potential for increased costs lead us to the conclusion that as written, the Proposal is inappropriate and unnecessary for investment companies. If you have any questions, please contact me at 713-214-4354.

Sincerely,

/S/ SHERI M. MORRIS

Sheri M. Morris
Senior Director and Head of U.S.
Fund Administration
Invesco Advisers, Inc.

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member

INVESTMENT COMPANY INSTITUTE

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February 27, 2014

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit; Docket Matter No. 034

Dear Ms. Brown:

The Investment Company Institute[1] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's proposed amendments that would require disclosure in the auditor's report of the name of the engagement partner.[2] The Proposal indicates that the Board believes that disclosure of the engagement partner would provide investors with important information about audits conducted for their benefit.[3] We are concerned that the Proposal as currently structured could impair the ability of investment companies and other issuers to access capital markets on a timely basis. In particular, if the engagement partner is unwilling or unable to consent to being named in the auditor's report, then the issuer would be unable to incorporate its audited financial statements into its registration statement and would be unable to conduct the planned offering. If the Board requires identification of the engagement partner, we recommend disclosure outside the auditor's report.

Section 7 of the Securities Act of 1933 (1933 Act) requires issuers to file with the Securities and Exchange Commission the consent of any accountant who is named as having prepared or certified any part of a registration statement filed with the Commission. Registration statement forms prescribed by

[1] ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $16.1 trillion and serve more than 90 million shareholders, and there are approximately 1,900 independent directors of ICI-member funds.

[2] *See Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards to Provide Disclosure in the Auditor's Report of Certain Participants in the Audit*, PCAOB Release No. 2013-009 (December 4, 2013) (the "Proposal").

[3] The Board cites investor comment, empirical research, and its oversight experience as basis for its belief that the proposed disclosure would benefit investors.

the Commission require audited financial statements to be included or incorporated by reference into the registration statement.[4] Accordingly, we believe an issuer would be required to file a consent of any engagement partner named in the auditor's report included in a registration statement in order for the Commission to declare that registration statement effective.

Mutual funds offer their shares daily and maintain an "evergreen" registration statement. A mutual fund with a December 31 fiscal year end would deliver its annual shareholder report including audited financial statements to its shareholders no later than March 1.[5] That fund would update its registration statement by filing a post-effective amendment that includes or incorporates by reference the annual shareholder report including audited financial statements no later than May 1.[6]

If the engagement partner has resigned or retired from the audit firm after March 1 and prior to May 1, the partner may be unwilling to provide the required consent. The engagement partner may be unable to provide the required consent due to death or disability. In order to avoid this outcome, if the Board determines to require identification of the engagement partner, we recommend disclosure outside the auditor's report.

* * * * *

If you have any questions, please contact the undersigned at (202) 326-5851 or smith@ici.org.

Sincerely,

Gregory M. Smith

Gregory M. Smith
Senior Director – Fund Accounting

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[4] For example, Item 27 of SEC Form N-1A, the registration statement form for open-end investment companies under the 1933 Act and the Investment Company Act of 1940 (1940 Act) requires the fund to include audited financial statements as prescribed by Regulation S-X. Item 28(j) of Form N-1A requires the fund to file any opinion, appraisal, or ruling, and related consents relied on in preparing the registration statement and required by section 7 of the 1933 Act.

[5] *See* Rule 30e-1 under the 1940 Act.

[6] *See* Rule 8b-16 under the 1940 Act.

October 14, 2013

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

Dear Secretary,

**Re: PCAOB Rulemaking Docket Matter No. 034**

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

Sincerely,

Karim Jamal
CA Chair Professor
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James L. Frank Professor
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## Overview

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

1) Current audit reports are based on a binary (pass/fail) model, and

2) The current "boilerplate" format of reports provides little company specific information.

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

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

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

## Analysis

**The Proposed New Audit Report**

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

The call for additional reporting of "critical audit matters" is an improvement in the sense that it takes us back to the past when auditors issued a long-form audit report including extensive commentary on the key audit procedures and key risk areas in the audit. However, by its failure to even identify the key areas of risk, the proposed revision appears to be a poor cousin of the long form audit report of the 1920's. All regulations, no matter how well-meaning, are vulnerable to be reduced to boilerplate meaninglessness jargon depending on how much room for judgment is allowed in their implementation and enforcement. Mechanical enforcement of such regulations will achieve little more than creating a longer report full of defensive legal verbiage. How many people believe (or believed at the time the law was written) that SOX provisions have (or would) transfer more responsibility for misstatements to the C-suite executives? The addition of proposed commentaries on independence, and its standardized language, also unfortunately belongs in this boilerplate category.

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

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

Audit reporting could be more informative if the auditors could convey their expert opinion (preferably via a letter grade) on the quality of the accounting policies and estimates made by management, quality of internal control, quality of governance and quality of disclosure. An alternative would be to publicly disclose the issues that the auditor reports to the audit committee. This would be more informative to users and would be specific to each entity, rather than boilerplate reports.

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

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

**Conclusion**

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

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14 March 2014

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

Dear Sirs,

**PCAOB Rulemaking Docket Matter No 29**
**PCAOB Rulemaking Docket Matter No 34**

As a recently appointed member of the PCAOB Standing Advisory Group I am writing in support of the PCAOB in their proposal to improve audit quality and transparency by requiring registered public accounting firms to disclose the name of the partner responsible for signing the audit report (Docket No 29) and the proposal to revise the auditing standard regarding the Auditor's Report and the Auditor's responsibilities regarding other information.

In 2011, I delivered the annual Aileen Beattie memorial lecture for the Institute of Chartered Accountants of Scotland (ICAS), an honour also bestowed on your chairman, James Doty, in 2013. My lecture contained a number of matters which I felt needed to be considered if our profession is to deliver a service to publically quoted companies that is relevant in today's (and future) global and local market places. I indicated that the "stool" of corporate reporting needed three strong legs in order to stand the weight of expectation from the investor community. It needs a robust financial reporting framework, quality auditing and reporting and effective, transparent, corporate governance, this latter part being partly delivered through the report of the audit committee. Without these three legs there is always scope for deficiencies in the information provided within financial statements all of which is relied upon by the investor community. It is also true that there is a need for all three legs to make their own contribution and one leg should not take on the task of rectifying any deficiencies in the other two. The audited financial statements underpin all other corporate reporting, whether it is quarterly and half yearly trading updates, preliminary announcements or analyst briefings, so it is essential that they contain sufficient, balanced and relevant information for the investor and the wider stakeholder community to understand the risks within the company.

My lecture notes contained a number of messages, all of which were designed to facilitate change in the auditor, company and stakeholder relationship and to ensure the information reported in the financial statements is helpful in commenting on the risks within the business. Only in this way will we ensure that we were continually developing the relevance of the work we do and be recognised as working in the public interest.. The audit model and auditor reporting has not changed very much in the 150 years that ICAS (the oldest accounting institute in the world) has been in existence. Techniques have changed and the scope has, to a degree, changed but the fundamentals of auditor engagement and reporting have not. As a result of more focus being put on company and auditor reporting following the financial crisis it has become evident that now is the right time to change.

The conclusions I drew in 2011, and therefore the basis for my support for the PCAOB proposals, were contained in the following extract from the lecture:

*"So how can we or should we be delivering on the mission to always undertake our work in the public interest? As I have said throughout this lecture, there is a need for the profession to do more in order to meet the ever increasing needs of the various stakeholders.*

- ***Firstly, let us get company reporting right.*** *The need for the corporate report to tell the story of the business in a much more concise manner, focusing on the business model, the strategy, the key business risks and the rationale for believing the company is a going concern, both in the short and medium to long term, is an absolute necessity. The responsibility for this lies, primarily, with the preparer but the auditor also has a role.*

- ***Let us deepen our role of the auditor.*** *There is potentially a need for auditors to do more in relation to going concern but how far should this go? As stated earlier, the auditor should opine on information provided but if the company does not disclose matters ….. then the auditor is likely to be asked to provide that information.*

- ***Let us expand the role of the auditor beyond the numbers and the statutory disclosures.*** *The desire of users for some form of assurance over the front half of the Annual Report is evident - auditors will need to adapt to meet that demand.*

- ***Let us expand the auditor's reporting.*** *The need for greater insight to be given publicly as to what happens behind closed doors in the audit process. The auditors' engagement with the audit committee and with management is crucial. The big debate is how should this information be conveyed externally – should it be through the audit report or through the report of the audit committee. This is fundamentally important to the whole question of auditor communication not only to users but also to supervisors and regulators. In my view, the audit committee report is the right vehicle.*

- ***Let us accept the need for more professional scepticism*** *and ensure that we build this into our day to day activities,*

- ***Let us contribute to better Company Stewardship.*** *There is a need for greater engagement with the investor community but as yet it is undecided how this could be best achieved. This is very important but if we get our mission 'right' by dealing with the points I have just made then perhaps this would, in essence, already have been taken care of.*

*And, during this whole debate we must ensure that the auditors' independence and integrity is not impaired or compromised."*

When I look back on these conclusions it is evident that we have come a long way in many jurisdictions around the world to plug what I call "the information gap"; a better description than the "expectation gap" which is a term so often used when considering what the investor community wants and the company and the auditor provides. We cannot provide all the information the various stakeholders seek but the current reporting model does need improvement and there is still a long way to go in most jurisdictions, including the United States.

We do need more work on corporate reporting as in some areas it is too complicated and does not always identify the key risks being, or likely to be, experienced by the company. This applies to all national and international accounting standard setters. The financial crisis has shown that there are areas where more is required from the financial reporting framework and this should be addressed by the accounting standard setters and not leave it to the audit standard setters to "plug the holes".

There is more to do on going concern by the company, and this is where the financial reporting framework could again help by having more requirements put onto company management to report formally within the financial statements. Additional requirements under auditing standards will help change the work the auditors do and how they report on this crucial area. In the UK this is now required and has been a positive move forward.

I think that the information in the front half of financial statements is extremely important both in relation to the present condition and the future prospects of the business and therefore there is more that the company and the auditor can do in relation to this information. It is appreciated that opining on future events is both difficult and dangerous for the auditor. Having said that, there are other judgements that need to be made throughout the audit of the financial statements so, as long as the auditor ensures that the reporting by the company is consistent with their knowledge of the company which is obtained during the course of the audit, why not say so in the audit opinion?

Expanding auditor reporting in my view is an essential part of the move to better quality auditing and more meaningful financial reporting. As I stated in one of my bullet points above, the information on the risks within the business should be provided by the company through its business review and through the audit committee report, however, the work undertaken by the auditor to mitigate the impact of those risks to ensure that there is no material error within the financial statements is also extremely important and useful to external stakeholders. This information forms the basis of audit committee / auditor discussion so should be pertinent to the investor community. Clearly, some matters are commercially sensitive but this should not be used as an excuse to withhold information that it critical to understanding the company's financial position.

During 2010, 2011 and 2012, I was very active in Europe on matters relating to the audit market, corporate governance and financial reporting as President of the Federation of European Accountants (FEE). In addition I was a member of the International Auditing and Assurance Standards Board (IAASB) Consultative Advisory Group (CAG). Consequently, I was heavily involved with the proposals put forward by the European Commission and the European Parliament primarily relating to changes within the audit profession. It became clear very early in 2010 that change was required and demanded. It was at this point I requested that auditor reporting should be much higher up on the agenda of the IAASB whose standards were being used throughout almost all of Europe in one form or other. The IAASB did take this, and other input, into account when formulating there future work plan and fast tracked the revision of the auditing standard on audit reports (ISA 700). At the same time there were discussions taking place in the UK where they too were moving in the same direction. Both these were positive moves in my eyes and the proposals being put forward by the PCAOB by the release of these two rulemaking dockets are equally seen as a positive move for the global economy.

Turning to the two areas currently being debated in the US in relation to these matters.

**Rulemaking Docket 29**

In my view the inclusion of the name of the partner responsible for the audit engagement and for signing the audit opinion on behalf of audit firm improves accountability and transparency. I do not, however, believe that other firms or individuals should also be disclosed. The auditor who signs the report is the one responsible for the whole engagement and the inclusion of other names has the potential to dilute the perception as to who is ultimately responsible. If a large amount of the work undertaken is performed by firms or individuals not under the direct control of the audit engagement partner then additional procedures are required to enable the engagement partner to sign the opinion as he/she has this ultimate responsibility. As is the practice in Europe, I suggest that the name is disclosed at the end of the report where the opinion is signed and that the signature is that of the person responsible not the name of the firm.

There are numerous reasons why the naming of the engagement partner enhances transparency and quality, many of which are included in other comment letters received by the PCAOB. Consequently, I do not intend to recite them here. One important effect, however, is to more easily identify and evaluate the engagement audit partner’s experience within the sector in which the client operates and the extent of his/her workload on publicly quoted companies within the audit firm. These are particularly important when assessing the quality of the work being undertaken and the time availability of the individual auditor.

**Rulemaking Docket 34**

The work undertaken by IAASB, the European Commission and the Financial Reporting Council (FRC) in the UK is moving the reporting framework for auditors in one direction and that is towards providing more detail of what an audit is, enhancing the information provided on audit performance and moving away from just a pass / fail model. The pass / fail model will still exist but the reasons behind the pass or fail will be more transparent.

Given the global nature of business it is therefore important that the US keeps itself aligned with the rest of the world. The PCAOB proposals go a long way towards closing this gap and should be encouraged but alignment would be preferable. Convergence in auditor reporting across the globe will improve understanding and enable comparison to be made from one jurisdiction to another. The opinion should use the same terminology, definitions and criteria if confusion is to be avoided.

The answer to most of the questions raised in the first public consultation on Rulemaking Docket 34 is “yes” but I consider one omission which should be included is specific reference in the audit report to the going concern basis of accounting adopted by the company and the auditor's conclusion on this issue. The comments on this aspect could be included as a critical audit matter as in the majority of cases it is relevant to many of the judgements being made. Much of this information should already be contained in the MD&A so it is not a significant move to link all the disclosures.

Regarding critical audit matters, these should be kept to a few rather than many. Depending on the complexity of the company / group I would expect these to be between five and ten each year. They are not the identified risks of material misstatement contained in the initial audit plan but those which required most consideration by the company and the auditor and which were critical in the understanding of the company's financial position and its internal control assessment. The proposed "Auditors Discussion and Analysis" will in my view lead to too much information being included and could detract from the important areas of judgement being made. In this regard the enhanced audit opinion should provide better information to the reader and not focus on just providing more information.

Disclosure of critical audit matters has many benefits. Comparison of critical audit matters reported from one year to the next provides the reader with useful information on whether there is a changing profile to the risks within the business. This is an important element in order to understand the shifting nature of corporate risk and is, once again, an important indicator to stakeholders.

As I mentioned during the Aileen Beattie lecture, I believe that the reporting by the audit committee should also be enhanced as it is here that information on the company should be addressed and not provided by the auditor. This is addressed in the second public consultation document and the answer here is "yes". The role of the auditor is to opine on the information provided by the company and only supply the information if there are shortcomings in the company's reporting. This is a clear dividing line and one that should continue. It is primarily management's responsibility to provide company specific information not the auditor's.

**Personal experience of changes to audit committee and auditor reporting**

In the UK, September 2013 saw a change in the FRC requirements on reporting to shareholders by both the audit committee and the auditor. As the chair of one audit committee and a member of another, the reporting in the 2013 financial statements saw a significant change in this regard. Reflecting on the positives coming out of this experience there was certainly greater engagement between the audit committee and the auditor. The audit committee focussed heavily on the key matters within the financial statements and were far more engaged with management and the auditor to ensure appropriate judgements were being made and that the reporting of these judgements was appropriate. There was also more detail provided by the auditor to the audit committee as to how they had addressed key matters and how they had satisfied themselves as to the key judgements. Altogether it was a positive experience with few, if any, negative comments from audit committee members or auditor. At the end of the process I believe that both parties benefitted from the new reporting model. There was robust debate but no differences of opinion as to what should be reported in the financial statements. The requirement in the UK to ensure that the financial statements, as a whole, must be fair, balanced and understandable also helped when drafting the disclosures.

From an auditor perspective, it was reported that the new requirements had increased the awareness of the whole audit team regarding the importance of the work being undertaken and also increased the level of scepticism being exercised. They felt that their work was having a more direct impact on the audit opinion itself. They also felt that they were providing useful information to the wider stakeholder community that required a higher degree of evidence to be obtained in order for it to be included in the auditor's report. Consequently, more engagement by the audit team in the audit and more evidence collected during the course of the audit.

Overall there was certainly better reporting by the audit committee and, I am sure, an improvement in audit quality as a consequence of the changes made.

I trust that my observations will be of use to the Board when it deliberates over the next steps to be taken in relation to this very important subject.

Yours sincerely

Philip Johnson

Kentucky Society
Certified Public Accountants

December 11, 2013

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

Re: PCAOB Release No. 2013-005, Rulemaking Docket Matter No. 34

Proposed Auditing Standards - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (collectively referred to as "proposed standards")

We are writing on behalf of the Emerging Standards Committee (ESC) of the Kentucky Society of Certified Public Accountants (KyCPA). The KyCPA is the sole professional organization representing CPAs in the Commonwealth of Kentucky. Its 5,100 members are engaged in business communities throughout the Commonwealth and have a comprehensive grassroots view of the needs of businesses, ranging from large public companies to small owner-managed businesses. KyCPA's ESC consists of a group of KyCPA members organized to monitor the activities of accounting and auditing standard setters, as well as government authorities, with the objective of participating in the standards-setting process by providing thoughtful comment on developing issues.

We appreciate the opportunity to comment on the PCAOB's proposed standards on auditor reporting. Our comments for your consideration are as follows:

**<u>Overall Comments</u>**

We are supportive of the PCAOB's efforts to improve audit quality that will increase investor confidence and understanding of the audit process including the responsibilities of the auditor. However, we have serious concerns regarding the effectiveness, excessive cost and operability of the current proposal as discussed in our comments below. We believe it would be in the best interest of the Board to perform extensive real world field testing of the key elements in this proposal. Such an action would help identify the more costly and less beneficial elements within the proposal. Accordingly, we suggest this proposal be tabled or deferred until further research is completed. Further, the SEC should be involved during this research and study phase because some of the information being proposed relates to the Company and may not be otherwise disclosed. Accordingly, the SEC's involvement is important and they may wish to have Company management address certain Company matters mentioned by the auditors. Investor confusion would not represent an improvement in current practice.

**<u>The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion</u>**

The proposed standards implement significant changes with respect to the existing auditor's report in three main areas: a) addition of a critical audit matters section, b) addition of new elements to the auditor's report, and c) enhancement of certain standardized language in the auditor's report. We highlight our concerns regarding each of these areas below.

*Critical Audit Matters (CAMs)*

We believe CAMs, as currently defined, will create confusion with respect to audit quality. Acknowledging there are varying levels of sophistication among financial statement users, the additional information provided may inappropriately skew investors' perceptions of audit quality and assurance provided, as well as create additional risk for auditors as a result of this confusion. For example, if more CAMs are disclosed, an investor may incorrectly assume a lesser quality audit was performed (e.g. more issues) when in fact the opposite could be true. In another example, one audit team may disclose they consulted their national office on a CAM, but another audit team of another company in a similar industry with the same CAM may not. Given there could be valid reasons that one team did and another did not consult, an investor may inappropriately conclude a different level of audit quality among the audit teams. Further, there would be no process for investors to have their questions addressed or clarification provided. However, we believe that certain improvements, clarifications and illustrations can assist in establishing a standard that is more operational. We believe the following comments highlight the most important issues that must be addressed.

- Determination of CAMs – We believe the current definition of a CAM in the proposed standards is flawed. Specifically, we believe the sources of a CAM (completion document, engagement quality review matters, and audit committee communications) and factors as noted in paragraph 9 of the proposed standards are too broad. We believe the starting point to determine a CAM should be the required communications pursuant to AS 16. The ultimate CAMs determined should represent only material items that involved significant interaction with the Audit Committee. If the current "catch all" approach is implemented, we fear this will significantly impair the robust two-way communication with the Audit Committee, which is critical to an effective audit.

  Further, we believe the requirement in paragraph 14 to document why a matter is not a CAM is not operational and subjects the auditor to unreasonable second guessing. A more practical approach would be to document the determination of which matters communicated pursuant to AS 16 were CAMs.

- Communication of CAMs – We have serious concerns regarding the communication requirements of CAMs. If the expectation is to communicate any items noted in paragraph 9, this would put the auditor in a precarious position as he/she may be communicating information not previously disclosed by the company. Examples of this would include deficiencies that are not material weaknesses, consultations outside the engagement team, and quantitative or qualitative information regarding corrected or uncorrected misstatements.

This issue must be addressed; auditors should not be allowed to serve as the original communicator of company information except in extraordinary circumstances. This is a matter that should be appropriately addressed by the SEC and not the PCAOB only.

The proposed standards provide the auditor the option, but not the requirement, to describe audit procedures related to CAMs. This will create diversity in practice and potential expectation gaps with investors. We suggest the description of audit procedures related to a CAM either be required or precluded. If it is required, we believe that further clarification and illustrations should be provided. We recommend a framework that is concise and focused on the financial statement assertions and factors that resulted in the determination of the CAM.

- Perceived assurance – Auditing standards require an audit be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to fraud or error (based on the financial statements as a whole). The audit report should clarify that the auditor is not reporting on individual accounts or assertions related to each CAM, but on the financial statements taken as a whole. Without clarification, an investor may inappropriately assume the auditor is providing assurance on individual accounts or assertions related to each CAM.

- Conformity with the IAASB Proposal – We strongly suggest that the PCAOB work with the IAASB to conform their effective dates and their proposals from a content perspective. The proposals regarding CAM (PCAOB) and Key Audit Matters (IAASB) are similar but not identical. This could result in different reporting depending on which standard is applicable, creating confusion with investors when evaluating U.S. vs. non-U.S. registered companies in similar industries that are under different standards.

- Litigation risk – We believe the proposed standards will absolutely result in additional auditor litigation risk. We understand this is not the Board's top priority, but the cause should not be flawed standards that cause investor confusion and increase the expectation gap.

*New Elements*

We agree with the proposed standards regarding new elements to the auditor's report with one exception. We believe that the auditor's tenure disclosure requirement should be removed. This does not appear to be relevant to the audit report and could result in inappropriate correlations between audit quality and auditor tenure. Acknowledging this is information certain investors have requested, we suggest this information be included in Form 2 reporting to the PCAOB or in the audit committee report of a company's annual proxy statement.

*Standardized Language*

We agree with the proposed standards regarding standardized language in the auditor's report.

**The Auditor's Responsibility Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report**

While there needs to be additional clarity and disclosure of the auditor's responsibility regarding other information, we do not believe the proposed standards as currently written are operational and we believe they will create significant incremental effort and costs. Further, the proposed standards as currently written may create significant gaps between the assurance investors will believe they are receiving versus what the assurance auditors will actually provide. The following comments highlight the most important issues that must be addressed and will help minimize confusion, cost and undue risk.

*Auditor's Responsibilities/Scope*

- The change in wording from "read and consider" under AU 550 to "read and evaluate" under the proposed standards appears to significantly increase the responsibility of the auditor. The term "evaluate" appears to infer a higher level of assurance. This will also create an expectation gap with investors who may assume auditors are providing a level of assurance similar to the audited financial statements. We recommend the wording and expectation be more consistent with AU 550. We also recommend adding clarification and examples of what procedures are expected to be performed by the auditor on other information.

- The proposed standards extend the auditors responsibility to include relevant audit evidence obtained during the audit, which is an expansion beyond the audited financial statements as currently described in AU 550. This appears to be unreasonably broad and cost-prohibitive. Specifically, it is unrealistic to expect the person performing the review of other information to know and remember all information that may reside in the audit work papers, especially if it is a multi-location or group audit.

- The proposed standard appears to increase auditor responsibility with respect to information not directly related to the financial statements. AU 550 only requires the performance of additional procedures if the auditor becomes aware of a potential material misstatement of fact. The increase in responsibility does not appear to be operational and we recommend reverting to the AU 550 requirement.

- The requirement to extend the other information procedures to information incorporated by reference and the proxy statement is cost prohibitive and not operational. We find it difficult to reconcile the cost/benefit regarding information incorporated by reference. Either this information would have already been considered as part of the audit or it is unlikely to be highly correlated to information in the financial statements. Further, it is impossible to perform these procedures on most proxy statements as they are not typically filed until after the auditor has issued their opinion.

*Reporting in the Auditor's Report*

We recommend that the audit report be revised to clearly state what procedures are performed on the other information and clearly state that the other information has not been audited.

**Other Matters**

*Cost and Resources*

We believe the implementation of the proposed standards, even if revised as we have suggested, will result in significant additional audit effort and costs (including ultimate costs to the investors). Further, the requirements in the currently proposed standards will likely cause significant resource constraints. Specifically, the effort required regarding CAMs will likely absorb critical capacity from the most senior members of the audit team in the late stages of the audit. We strongly suggest the PCAOB consider performing real world case studies to obtain better insights as to the actual effort and costs that will be required to implement the proposed standards.

*Scope of the Proposed Standards*

We believe that the proposed standards regarding CAMs are unnecessary for audits of benefit plans and we recommend these entities be exempted from CAM requirements. The potential CAMs for benefit plans would be very similar and these entities are inherently less complex. The effort and cost required would outweigh the benefit.

Similar to our comment on benefit plans as noted above, we believe the Board should justify why auditors of smaller reporting companies and non-accelerated filers should be required to comply with these proposed standards from a cost/benefit perspective. Specifically, the U.S. Congress and many others have grown increasingly concerned with administrative costs and related issues for smaller and emerging public companies. The JOBS Act is an example of addressing these issues. We believe this proposed standard is very costly and contrary to these initiatives.

Thank you very much for considering our thoughts.

Sincerely,

Glenn Bradley

Glenn Bradley, CPA, Chair
On behalf of the Emerging Standards Committee
Kentucky Society of CPAs

**From:** Tae Kim
**To:** Comments
**Subject:** comments of PCAOB change. _Georgetown MBA 2nd year student_Tae Kim
**Date:** Tuesday, November 26, 2013 7:17:03 PM

## INTRO

I spent more than 6 years in accounting field as an auditor in Big 4 accounting firm. So I have experienced limitation and difficulty of financial audit. I observed many companies receive an “Unqualified” opinion go bankrupt or become distressed within a couple of years of the judgment. The result was investors, who relied on the opinion, losing money. Why did this happened? The auditor didn’t do their work properly and therefore did not identify the problem. Still many investors and financial information users think auditors have better and unique insights based on their audits. In this regard, some believe auditors should provide information about their methods in the auditor’s report to make the reports more relevant and useful. On August 13, 2013, the Public Company Accounting Oversight Board (PCAOB) proposed two new auditing standards to enhance the reporting model.

Before we identify any potential problem or effect of new changes, we should understand the nature of audits**; auditors do not take responsibility for the financial statements on which they form an opinion and the responsibility for financial statement presentation lies directly in the hands of the company being audited.** As long as responsibility of financial statements does not fully fall on to auditors, a new initiative which PCAOB propose**, I believe there is higher chance that effect of new judgment call for auditors would be minimal.**

## Critical Audit Matters (CAMs)

First, the proposed standards would require the audit report to disclose and describe CAMs that were specifically examined during the audit. The PCAOB proposal define CAMs as matter involving the most difficult, subjective or complex auditor judgments, including areas that posed the most difficulty to the auditor in obtaining evidence or forming and opinion on the financial statements.

I experienced many difficulties during the audit when I was a low-experience staff auditor. I took care of “contingent liability”, I had contact with lawyers and experts in other fields regardless of level of complexity. In retrospect, personally I want to say those three cases were the extremely difficult for me. If this is the case, guideline of CAMs asks us to include those three cases within CAMs.

**However, I do not support this assertion.** Based upon CAMs guideline, many auditors will need to spend their time compiling and organizing facts for the CAMs rather than focusing on their traditional auditing. Regardless of industry, the auditor spends many hours to verify numbers on the financial statements such as account receivable and allowance for account receivable or verifying the number for impairment. Do those need to be included within the CAMs? In that case, all audit reports would require trivial information such as all the depreciation recalculation information and aging schedule. **I strongly believe that CAMs will not enhance the quality of audit information but it will just increase the load of the auditor's work. Requiring subjective standard would be hard justify in an objective manner.**

Other Information (OI)

The proposed standard would require the auditor to perform an evaluation of, and report on, information outside of the audited financial statements that is included in a company's annual report filed with SEC. This OI would include management's discussion and analysis of financial condition (MD&A), results of operations, exhibits, etc. Auditor should perform additional procedure to determine whether the OI contains a material misstatement of fact in the audited financial statements.

Auditors are not industry experts. They cannot judge management's future projection within MD&A for their business and are also not capable of verifying the reference data included within financial statements made by management. Based on Big 4 experience, having an interview for Discounted Cash Flow projection and having an interview for reconciling accounts are totally different. **As a whole, it is not feasible and adopting this procedure will require huge costs and generate little benefit to investors and financial users.**

Additional Changes

The proposed standard would require the audit report to contain a statement regarding the auditor's existing requirements to be independent from the issuer, and a statement disclosing the year that the audit firm began serving continuously as the company's auditor. In addition, the proposal would require auditors to address their responsibilities related to the notes to the financial statements, fraud and independence.

I do not think auditors' tenure information give some useful insights. Already, financial information users can find this data easily by checking the auditor's report. **This is obviously unnecessary suggestion. Also, addressing the responsibility for the fraud can bring side-effects. Auditor's job is not finding fraud**; maybe responsibility has to fall on the internal auditors or board members and financial executives. **Again, PCAOB has to understand that detecting financial statement fraud is not auditor's work.**

Conclusion

"Substance over form" and "Materiality" are the most important devices auditors use for their work. I truly understand the motive for this proposal, which increases the informational value and expands the auditor's responsibilities by improving current auditor reporting model. This proposal implies that current model do not work well and auditor should have more responsibility. This new initiative reminds me Sarbanes-Oxley Act of 2002

(SOX 404). I participated many SOX 404 engagements for US listed companies and even at that time, I had many doubts of effects if SOX 404 implementation; it was not only me who had doubts. By walking through this PCAOB's proposal, I sensed that there is strong similarity between SOX and the PCAOB's new initiative. This proposal would add value and not create misunderstanding if it designed and processed extremely well.

However, based on my observation, I believe it can be the next SOX 404 which has many controversial issues as an example, its failure to prevent the situations that led to the financial crisis of 2008. Many companies still tell me that it was expensive and useless. Lastly, I want to tell PCAOB who is taking care of this initiative; please focus the substance over form. Having a newly designed form does not enhance the value and quality of audit reports.

Reference


1. Deloitte_Heads Up_ Volume 20, Issue 30 (Sep 5, 2013)
2. Article from Perkins Coie (Aug 22, 2013)
3. Ersnt & Young_To the Point_(Sep 26, 2013)
4. Journal of Accountancy_by Ken Tysiac (Aug 23, 2013)
5. Article from The NY State Society of CPA_Vol 16_No 9 (Sep 23, 2013)


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Regards, Tae Kim

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December 11, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
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**PCAOB Rulemaking Docket Matter No. 034**
***Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards***

Dear Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the PCAOB Release or the Proposed Standards).

The Board has requested public comment on the PCAOB Release for changing the auditor's reporting model. The objective of the Proposed Standards is to improve the auditor's reporting model and to increase the informational value and promote the usefulness and relevance of the audit and the related auditor's report, while not placing undue burden on the financial reporting process. We are supportive of the Board's objective.

The Board has proposed two auditing standards, and related amendments, to meet this broad objective. The first proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the Proposed Auditor Reporting Standard), which retains the current pass/fail model, is intended to provide more information to investors and other financial statement users about the audit and the auditor through various proposed changes to the auditor's report, including the communication of critical audit matters. The second proposed auditing standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the Proposed Other Information Standard), is intended to be responsive to investors' desire to better understand the auditor's responsibility for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report.

**Overview**

As noted in the PCAOB Release, the communication of critical audit matters "could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor … found to be challenging," and would also "provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures." We believe that this is consistent with what the Board heard in its prior outreach activities, where investors identified certain information that they would recommend be included in the auditor's report, including (1) communication of areas with the most significant financial statement and audit risk and the work performed in those areas, (2) discussion of significant estimates and judgments made by management, the auditor's assessment of their accuracy and how the auditor arrived at that assessment, and (3) communication of results of sensitivity analyses in significant areas of judgment.

As originally noted in our comment letter dated September 30, 2011 on PCAOB Rulemaking Docket Matter No. 034, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (the Concept Release), we support the Board's objectives to improve the auditor's reporting model and increase its relevance to financial statement users, in a way that both serves the interests of investors and provides benefits that outweigh their costs. We also noted in our comment letter on the Concept Release that current SEC rules and regulations require disclosures that substantially overlap with many of the items that investors have requested to be included in the auditor's report. For example, with respect to material estimates or assumptions with significant levels of subjectivity and judgment (i.e., critical accounting estimates), management is directed to provide within Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) greater insight into the quality and variability of information regarding financial condition and operating performance, and the analysis should include, to the extent material, such factors as to how management arrived at the estimate, how accurate the estimate or assumption has been in the past, how much the estimate or assumption has changed in the past, and whether the estimate or assumption is reasonably likely to change in the future. Furthermore, the disclosures require analysis of the critical accounting estimate's sensitivity to change, based on other outcomes that are reasonably likely to occur and could have a material effect.[1]

Given that there continues to be a significant overlap between investors' request for additional information relative to the most significant financial statement and audit risks and the incremental disclosures required within MD&A compared to what is required by generally accepted accounting principles, we remain of the mindset that the most effective way to achieve the above objective would be to require auditor association with a critical accounting estimates section within MD&A. We acknowledge that the SEC would likely need to amend Regulation S-X to

[1] Refer to Section 501.14 of Financial Reporting Codification, *Critical Accounting Estimates*, for a complete description of the MD&A disclosure requirements for critical accounting estimates.

require the critical accounting estimates section to be subject to attestation. Additional action on the part of the SEC and PCAOB might be required to implement this recommendation, including:

- The SEC requiring that the critical accounting estimates section be clearly identified within MD&A;
- The SEC reviewing existing interpretive guidance relative to critical accounting estimates to determine the adequacy of such guidance, and whether it should be formally adopted as part of Regulation S-K; and
- The PCAOB reviewing existing PCAOB attestation standards (i.e., AT section 101, *Attest Engagements*, and AT section 701, *Management's Discussion and Analysis*) to determine whether such standards would be suitable to be used by registered public accounting firms for purposes of attesting to the critical accounting estimates section of MD&A.

While we believe that auditor attestation of the critical accounting estimates section of MD&A would be the most effective way to meet the Board's overall objectives, as stated above, we would also support an approach that requires the communication of critical audit matters, with certain specific enhancements as described further below. Our comment letter with respect to the Concept Release described several overarching principles for consideration when developing possible areas of the auditor's reporting model for further evaluation. Those principles, which we believe are also relevant to the Proposed Standards, are as follows:

- Auditors should not be the original source of information about the entity; management's responsibility should be preserved in this regard. A fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.
- Any changes to the auditor's reporting model should enhance, or at least maintain, audit quality.
- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
- Any changes to the auditor's reporting model should add value and not lead to investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and the independent auditors.
- Auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective; however it is important that auditor communications provide objective information about these matters.

The remainder of this letter provides our specific comments on the Proposed Auditor Reporting Standard, the Proposed Other Information Standard, and other matters.

***I) The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

As noted in the PCAOB Release, the Proposed Auditor Reporting Standard would make the following significant changes to the existing auditor's report:

- Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements. If the auditor determines there are no critical audit matters, the auditor would state such in the auditor's report.
- Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.
- Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements.

**Auditor Reporting of Critical Audit Matters**

The Proposed Auditor Reporting Standard would require the auditor to determine whether there are critical audit matters in the audit of the current period's financial statements, based on the results of the audit or evidence obtained. The auditor would then be required to communicate these critical audit matters in the auditor's report. The auditor's report would be required to include a description of the critical audit matters and would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to determine that the matter is a critical audit matter; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable.

As noted above, we are supportive of the Board's objective to provide investors additional information relative to the most significant financial statement and audit risks. We agree that the Proposed Auditor Reporting Standard may provide additional and more meaningful information to financial statement users. However, we believe that certain significant enhancements, clarifications, and illustrative guidance are required in order to ensure the Proposed Auditor Reporting Standard is operational, as further described below.

*Definition of a Critical Audit Matter*

An important element of the implementation and adoption of the Proposed Auditor Reporting Standard by auditors is ensuring that it includes an appropriate definition of a critical audit matter and an appropriate framework and application guidance to ensure the consistent identification and reporting of critical audit matters in a manner that meets the expectations of users. We believe that the definition of a critical audit matter, and the process used to determine critical audit matters, should be refined. We also believe that the population of potential critical audit matters is too broad, as currently written. We acknowledge that critical audit matters ordinarily would be documented in the engagement completion document and reviewed by the engagement quality reviewer. However, we believe that a critical audit matter would always be communicated to the audit committee pursuant to Auditing Standard No. 16, *Communications with Audit Committees* (AS 16). Therefore, the inclusion of the first two items noted in paragraph 8 of the Proposed Auditor Reporting Standard (i.e., documented in the engagement completion document or reviewed by the engagement quality reviewer) appears to be redundant and unnecessary. In determining whether a matter is a critical audit matter, we believe that the auditor should utilize a two-step process to first identify "significant audit matters," which would be those matters that are significant to the audit of the financial statements and required to be communicated to the audit committee pursuant to AS 16. The auditor also would take into consideration the factors noted in paragraph 9 of the Proposed Auditor Reporting Standard when identifying those matters deemed to be a significant audit matter. Critical audit matters would be a subset of significant audit matters, using the definition of a critical audit matter in the Proposed Auditor Reporting Standard, as further refined by adding two additional criteria. The first additional criterion is that a matter must be material to the financial statements in order for it to be a critical audit matter. The other criterion that we would recommend be added to the definition of a critical audit matter is one that is based on the level of auditor interaction (in terms of nature or extent) with the audit committee.

We also believe that certain wording related to identifying a critical audit matter should be refined and clarified in order to drive consistency in application. We agree with the Proposed Auditor Reporting Standard's intention to report those matters that are the most challenging, subjective, or complex. The word "most" implies that the number of critical audit matters should be limited, and we agree with the general premise that the greater the number of critical audit matters, the less useful the auditor's communication of critical audit matters may be. Therefore, we believe that the Proposed Auditor Reporting Standard should make this explicit, by indicating that the auditor should consider reassessing whether each of the matters meets the definition of a critical audit matter, if the auditor has initially identified a large number of matters for potential communication in the auditor's report.

*Reporting of Original Information*

As noted above, one of the overarching principles that we believe should be adhered to when developing the framework and basis for reporting is that auditors should not be the original source of information about the entity (referred to herein as original information); management's responsibility should be preserved in this regard. The Proposed Auditor Reporting Standard could require the auditor to convey original information, based on the definition of a critical audit matter and the manner in which the illustrative examples interpret the requirement in paragraph 11b.

We believe the illustrative examples included in the PCAOB Release, without any further application guidance, reflect an implicit requirement to communicate all of the paragraph 9 factors that are present, which would not be instructive, and may lead to less tailoring of the critical audit matter communication. As a result, we believe there are a number of items that may require communication by the auditor under the Proposed Auditor Reporting Standard that could have unintended consequences to the company and/or the users of the financial statements. These include (1) matters that may relate to confidential or privileged information; (2) information that would be harmful or detrimental to the company's operations; and (3) information that is not required by current securities laws to be communicated by the company.

The definition of a critical audit matter does not include any restrictions or any provisions related to this type of information. As an example, current securities laws do not require companies to disclose certain items, such as significant deficiencies in internal control and corrected or accumulated uncorrected misstatements, either in their financial statements or otherwise. However, based on the Proposed Auditor Reporting Standard, these items, if present in connection with a critical audit matter, would appear to be required to be communicated by the auditor, based on how paragraph 11b has been interpreted through the illustrative examples included in the PCAOB Release. As discussed in more detail below (see *Litigation Risks Raised by the Proposed Auditor Reporting Standard That Could Impact Auditors*), there also are potential legal issues that could arise if the auditor is the conveyor of original information.

In order to rectify this potential problem in the PCAOB's framework, we believe the auditor should describe the principal considerations that led the auditor to conclude that the matter was a critical audit matter. This would allow an auditor to exercise judgment in highlighting which particular factor, or factors, was most important to the auditor's determination that the matter was a critical audit matter, which would provide additional context as to why the critical audit matter is important to the financial statements. In addition, we believe the Proposed Auditor Reporting Standard should include a provision to preclude the auditor from communicating any original information, except in those rare situations where, in the auditor's judgment, the communication of such original information is necessary to the auditor's description of the critical audit matter.

We also noted that the illustrative examples included in the PCAOB Release contain a discussion of specific audit procedures performed by the auditor (e.g., consultations with the national office or the involvement of specialists). We do not support the communication in the auditor's report of consultations with the national office. Consultations with the national office can occur for a variety of reasons. Without any context regarding the experience of the engagement team, specific nature of the consultation, or details of discussions between the auditor and management and/or the audit committee, the inclusion of information about consultations with the national office, in the context of a communication about a critical audit matter, could have a number of adverse consequences, including widening the expectation gap (i.e., the user of the financial statements might improperly infer a higher level of assurance in those situations where consultation with the national office is communicated in the description of a critical audit matter).

*Description of Audit Procedures*

The PCAOB Release indicates that the "proposed auditor reporting standard would not require the auditor to describe the audit procedures related to critical audit matters. It would, however, not preclude an auditor from doing so." This is similar to the International Auditing and Assurance Standards Board's (the IAASB) proposal, which states that the auditor may communicate the effect on the audit, to the extent that the auditor considers it necessary for purposes of explaining why the auditor considered the matter to be one of most significance in the audit.[2] We note, however, that each of the illustrative examples in the PCAOB Release includes descriptions of audit procedures related to the critical audit matter. We believe that a description of the critical audit matter's effect on the audit would be of interest to users, and communicating it would be consistent with the objective of providing more transparency into the audit. In order to avoid inconsistent practice and interpretation of this provision, which would affect comparability, we believe the PCAOB's framework could be enhanced by explicitly requiring the auditor to provide a description of the critical audit matter's effect on the audit. If this enhancement to the framework is made, we believe it is essential that the PCAOB develop guidance on how the auditor should communicate the critical audit matter's effect on the audit. Such guidance should indicate that the description of the effect on the audit should be (1) a brief, high-level summary of the key audit procedures performed (e.g., the auditor's response to the risk of material misstatement identified in the critical audit matter) to address the principal considerations that led the auditor to conclude that a matter is a critical audit matter, (2) focused only on those assertions (e.g., completeness, valuation) that result in the matter being communicated as a critical audit matter, and (3) focused on the most significant assumptions or estimates, if applicable, affecting such assertions. While we believe this enhancement may provide more transparency into the audit, there are significant legal issues that the PCAOB should consider as it develops its guidance, which are discussed in more detail below (see *Litigation Risks Raised by the Proposed Auditor Reporting Standard That Could Impact Auditors*).

*No Piecemeal Opinion*

The auditor's report per the Proposed Auditor Reporting Standard would include an identification and description of critical audit matters and would make reference to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable. Auditing standards require that an audit be planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to fraud or error. The audit opinion is based on the financial statements taken as a whole. We believe that the Proposed Auditor Reporting Standard should include a statement that the audit report does not contain all significant matters identified and communicated to the audit committee and should clarify that the auditor is not reporting on the individual accounts or issues related to each critical audit matter, but on the financial statements taken as a whole.

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[2] See IAASB exposure draft entitled *Reporting on Audited Financial Statements: Proposed New and Revised Standards on Auditing (ISAs).*

*Documentation of Critical Audit Matters*

The Proposed Auditor Reporting Standard requires the auditor to document those items that would appear to meet the definition of a critical audit matter but were determined not to be a critical audit matter. This requirement is not operational, in our view, as there is no guidance in the Proposed Auditor Reporting Standard on how an auditor could demonstrate that such a matter is not a critical audit matter. Consistent with the enhancements noted above, we believe a more practical approach would be to require the auditor to document: (1) those matters communicated to the audit committee that were determined to be significant audit matters, and (2) the determination of which significant audit matters are critical audit matters. We believe this approach mitigates the practical challenges associated with documenting matters that "appear to be critical audit matters, but are not."

*IAASB Proposal*

In preparing our response to the PCAOB, we reviewed the criteria set out in the Proposed Auditor Reporting Standard to those in the IAASB's exposure draft. We note that the two proposals are similar, but not identical. This suggests that different items could be reported depending on which standard was applicable. We are concerned that auditors reporting under both PCAOB and IAASB requirements (e.g., for dual listed entities) may spend unnecessary time trying to understand and reconcile the differences. We strongly recommend that the PCAOB seek to work with the IAASB to ensure that the criteria for identifying and reporting critical or key audit matters are the same, because we do not believe that such differences are meaningful or helpful to users of the financial statements.

*Litigation Risks Raised by the Proposed Auditor Reporting Standard That Could Impact Auditors*

While any addition to the statements that an auditor is required to make increases the chance of civil litigation each time a company's performance differs from expectations, we believe the suggestions outlined in this letter will be helpful in limiting undue litigation risk.

The mere fact that the matter caused loss to an investor can make it appear critical. A significant litigation risk raised by the Proposed Auditor Reporting Standard is a claim that the cause of loss should have been identified as a critical audit matter. The factors listed in paragraph 9 of the Proposed Auditor Reporting Standard are very general, making it easy in hindsight for a third party to claim that an audit matter touches on one or more of them. The two-step process outlined above not only helps auditors identify and describe critical audit matters, it also will help courts and investors distinguish a truly critical audit matter from one that is merely claimed to be so after the fact.

With the benefit of hindsight, a third party also is in a position to second-guess what the auditor communicated about a critical audit matter. Requiring an auditor to communicate original information about the company magnifies the risk of such a claim. It would place sole responsibility on the auditor for information about the company beyond that which the company itself did not have to disclose to investors, allowing an investor to claim that the auditor should have provided more detail, or characterized the information differently. At the same time, more detail can put the auditor in conflict with other legal requirements. A company might object that the characterization is too negative, or that the added detail communicates a competitive confidence. A regulator (such as a bank examiner) might object that the auditor's communication of the information is prohibited by law. An employee (such as the subject of an investigation) might object that the details are personal.

In addition, the PCAOB Release notes that "the prominence with which information is disclosed can have implications for investment decision making." There is a risk that investors will give statements about critical audit matters a prominence that is undue, and such risk is increased when the auditor is communicating original information about the company since, by definition, such information was not considered of sufficient importance to investors to require disclosure by the company. The suggestions set out above can limit (although not eliminate) the harms caused by both misunderstanding and wasteful litigation.

Finally, statements about descriptions of audit procedures can appear to provide a level of line-item assurance not intended by an audit opinion. A plaintiff who believes that the communicated procedures were not performed adequately can claim that the auditor's description of such procedures is a misrepresentation, with the potential to turn every dispute over the auditor's communication of the critical audit matter's effect on the audit into an allegation of fraud. Just as the communication of a critical audit matter is not a separate opinion on that matter, the inclusion of the effect on the audit is not a separate opinion on those procedures. While such risks are an inherent risk of describing the critical audit matter's effect on the audit, we believe that undue risk can be limited if (1) the audit opinion contains a clear and explicit statement that the audit procedures that might be referenced in the auditor's communication of the critical audit matter's effect on the audit are directed toward the auditor's opinion on the financial statements taken as a whole, and (2) the Proposed Auditor Reporting Standard includes robust guidance on how the auditor should communicate the critical audit matter's effect on the audit.

As noted at the beginning of this section, an increase in litigation against auditors is a probable if not inevitable result of the expansion of the auditor's report contemplated by the Proposed Auditor Reporting Standard. Although the suggestions contained in this letter can help limit that risk, before proceeding with the recommendations included in our letter, it is essential that the Board review the scope of the litigation risk and its attendant costs, as well as the best means to avoid undue increase in litigation risk, in light of the field testing discussed in more detail below (see *Costs*).

**Addition of New Elements**

We agree with the addition of language on auditor independence explicitly stating that the auditor is independent. This is consistent with the requirement that the auditor's report be titled "Report of Independent Registered Public Accounting Firm" and provides clarification of this within the auditor's report.

We do not believe, however, that the inclusion of a sentence about the auditor's tenure within the auditor's report is appropriate. As noted in the PCAOB Release, no nexus has been established between an auditor's tenure and audit quality, and requiring such information in the auditor's report would give the false impression to the reader of the auditor's report that a correlation between the two does exist. We acknowledge that the communication of an auditor's tenure may be an item of interest to some stakeholders and support the communication and transparency that disclosing this information may provide. Therefore, we recommend that this information be required to be disclosed through different means (e.g., in the audit committee's report or by way of Form 2 reporting).

**Changes to Standardized Language**

We agree with the addition of the clarifying language proposed to be added to the current auditor's report, as it will enhance users' understanding about the audit and the auditor. However, we believe that the Board should re-consider adding the language noted by the Center for Audit Quality (CAQ) in their comment letter dated June 28, 2011, and re-iterated in their comment letter dated December 11, 2013 (see Appendix C in the CAQ's letter), as we continue to believe this language would provide added clarification for investors. This additional language also would more closely align the standardized language used by the PCAOB with the IAASB's proposed auditor's reporting model. The suggested additional language includes:

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

We support allowing flexibility in the ordering of paragraphs provided the auditor's report includes the key elements set out in the Proposed Auditor Reporting Standard. However, we recommend that section headings be required for all elements within the auditor's report.

*Litigation Risks Raised by the Ambiguity in Adding Additional Addressees That Could Impact Auditors*

The principal risk created by the Proposed Auditor Reporting Standard concerning addressees of the auditor's report is the possibility that it will be confused with concepts (such as privity) that govern the scope of an auditor's liability under state law. Different users of financial statements are very differently situated: the board that oversees management of the company is not in the same position as its shareholders; shareholders have different interests than bondholders and other creditors; etc. The Proposed Auditor Reporting Standard does not purport to alter any state's rules governing who may bring a lawsuit against the auditor, just as it does not purport to alter the state's rules governing when an auditor may be held liable. Appendix 5 in the PCAOB Release suggests that the auditor's report could be addressed to others, such as bondholders. The guidance in the PCAOB Release does not provide any circumstances where an auditor would be required to address its report to bondholders, and we are unaware of any example where such an addressee would be appropriate.

***II) The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

We acknowledge and agree that there is a shortcoming in the existing standard (AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AU 550)) with respect to the non-reporting of the auditor's responsibility related to other information. We support the Board's objective to provide a specific basis for the description in the auditor's report of the auditor's responsibilities for the other information outside the financial statements. We furthermore agree that the inclusion in the auditor's report of the auditor's responsibilities for other information in annual reports filed with the SEC containing the audited financial statements is the most effective manner of achieving the Board's objective.

However, the Proposed Other Information Standard goes beyond adding a reporting element to AU 550, and appears to have a number of flaws that would make the proposal difficult and costly to implement. The Proposed Other Information Standard expands the auditor's performance requirements, including raising the required level of assurance provided by the auditor on the other information to a level above what the extant standard currently requires, and to a level that could be construed as being consistent with the level of assurance being provided in the audit of the related financial statements. In addition, we believe that requiring the auditor to state in the auditor's report that the auditor has evaluated the other information and, based on that evaluation, has not identified a material inconsistency or material misstatement of fact would imply a level of assurance that is inconsistent with the proposed procedures.

We also believe that the Proposed Other Information Standard requires clarification with respect to certain other areas, including: (1) the scope of other information subject to the Proposed Other Information Standard; (2) the lack of a concept of risk assessment and materiality related to the other information; and (3) the documentation requirements under the proposal.

*Auditor Performance Requirements*

The Proposed Other Information Standard requires that an auditor "read and evaluate" the other information. The term "evaluate" appears to suggest a higher assurance and responsibility level than "read and consider," which is the performance requirement in AU 550. In existing auditing standards, the term "evaluate" is used in order to address auditor performance requirements. The context of the word "evaluate" in those standards is in connection with the auditor obtaining reasonable assurance on whether the financial statements are fairly stated in all material respects. We further note that proposed Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements*, includes a requirement for the auditor to evaluate whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria.

We believe the use of the word "evaluate" could be construed as providing reasonable assurance (or something akin to reasonable assurance, although not fully defined in the PCAOB Release) on the other information and this could have unintended consequences for investors or other users of the other information. We recommend that the requirement be changed from "evaluate" to "perform certain limited procedures" (such limited procedures would include reading the other information), which would more closely align the requirements to the extant standard and would be practicable from an operational perspective as well.

AU 550 states that the auditor's responsibility does not extend beyond the financial information that is identified in the auditor's report. The Proposed Other Information Standard extends this responsibility to include "relevant audit evidence obtained and conclusions reached during the audit." Relevant audit evidence is a broad concept and it could be interpreted to mean that the auditor who is fulfilling the performance requirement is required to be aware of each facet of each piece of audit evidence obtained during the course of the audit. This issue could be further exacerbated in a group audit situation, where the group auditor may only receive highlight memos from the component auditors, and may not have direct visibility into specific audit evidence that is present in the work papers of the component auditors. We believe that the interpretation described above is too broad and that the Proposed Other Information Standard should limit the responsibility of the auditor to compare the other information to the amounts in the financial statements and the accounting records that are subject to the audit, or have been derived directly from such accounting records by analysis or computation. This would clarify the auditor's responsibility and make the responsibility more consistent with current auditing standards and today's practice.

AU 550 also limits the auditor's responsibility to reading the other information not directly related to the financial statements, and requires additional procedures to be performed related to such information only if the auditor becomes aware of a potential material misstatement of fact. The Proposed Other Information Standard makes no distinction as it relates to requiring an evaluation to be performed with respect to other information directly related to the financial statements and other information not directly related to the financial statements. Given that the auditor's procedures are likely to be less in scope and generally may not entail any or a very limited amount of audit work with respect to other information not directly related to the financial statements, we believe that the Proposed Other Information Standard should be revised so that it requires the auditor to perform additional procedures with respect to other information not directly related to the financial statements only if the auditor becomes aware of a material misstatement of fact while reading such information.

*Auditor Reporting Requirements*

While we support the Board's proposal to include communication of the auditor's responsibility for other information, we believe that the format of the reporting should be amended to address several matters. Such changes include providing a description of the procedures that were performed and specifically stating that no audit or review has been performed on the other information. In addition, due to the heightened litigation risk that the Proposed Other Information Standard presents (see further description below), we believe that the reporting that should be required in situations where the auditor is not aware of a material inconsistency with the financial statements or a material misstatement of fact would be to indicate what the auditor's responsibilities are, without providing an explicit conclusion or statement about the results of that work. This could be accomplished by requiring the auditor to include a statement in the auditor's report that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency and/or a material misstatement of fact that has not been appropriately revised, the auditor is required to describe the inconsistency and/or misstatement of fact in the auditor's report.

*Scope of Other Information*

The Proposed Other Information Standard defines other information broadly as information in the annual report other than the audited financial statements and the related auditor's report, including (1) information incorporated by reference in the annual report that is available to the auditor prior to the issuance of the auditor's report and (2) when the annual report is a Form 10-K, information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K. We believe that clarification is required to further define and illustrate what exhibits would be within the scope of the auditor's responsibility. As an example, certain exhibits (e.g., a merger agreement in connection with a business combination transaction) may have already been considered by the auditor in connection with determining whether a transaction was properly accounted for within a company's financial statements. Since such documents were already considered by the auditor in carrying out the audit, we do not believe that they should be further subjected to the requirements of the Proposed Other Information Standard. In addition, there may be other documents that are included as exhibits to the Form 10-K that have minimal, if any, relationship to the financial statements (e.g., articles of incorporation). We recommend that the PCAOB clarify whether the Proposed Other Information Standard is intended to be applicable to all exhibits, or only to those exhibits that are specifically prepared for purposes of complying with SEC rules and regulations.

Furthermore, as noted above, the Proposed Other Information Standard indicates that the auditor's responsibility regarding other information extends to information that is incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K. It is unclear to us how this requirement would work in practice, since such information may not yet be prepared or available to the auditor and will not be filed until after the Form 10-K is filed. Since the auditor would be required to report on the other information (including the other information in the proxy statement not yet available) pursuant to the Proposed Other Information Standard, we believe it is inappropriate for an auditor to provide a "conclusion" on information that is not yet available or in final form. As such, it appears to us that the auditor would be required to reissue its report in connection with the filing of the proxy statement to convey that the other information in the proxy statement has been subjected to the auditor's performance requirements after the original issuance of the auditor's report. We are not sure how this would be applied in practice, since the auditor would presumably have to dual date its report, even if there was no change to the financial statements. We believe that the modifications we suggest above in the *Auditor Reporting Requirements* section appropriately address this timing issue, which is consistent with practice today under AU 550 (i.e., auditor reporting on the other information only on an exception basis).

*Materiality*

The Proposed Other Information Standard introduces specific procedures related to the auditor performance requirements. These procedures include comparing amounts in the other information to the financial statements and relevant audit evidence and re-calculating amounts presented in the other information. As currently written, there is no reference to materiality, as it relates to the requirement to perform the procedures in paragraph 4 of the Proposed Other Information Standard. We believe this is inconsistent with current auditing standards, whereby an auditor undertakes a risk assessment process to identify risks of material misstatement. We recommend that the Proposed Other Information Standard explicitly address or state that the performance requirements only apply to material other information.

*Documentation*

The Proposed Other Information Standard does not provide any guidance related to the nature or extent of the documentation that would be required with respect to the procedures performed on the other information, or the results of performing those limited procedures. With the change to a "read and evaluate" performance requirement, the level of effort that would be required to document the performance of the procedures described in paragraph 4 of the Proposed Other Information Standard (including having to perform procedures on other information that is not directly related to the financial statements) would increase. While some of our recommendations above may lessen the incremental impact related to documentation, we believe that further guidance would be helpful, in order to reduce any potential inconsistencies that could occur in practice. Therefore, we recommend that the PCAOB include specific guidance related to documentation within the Proposed Other Information Standard, in order to provide an auditor with a basis for documenting and retaining the results of its work.

*CAQ Comment Letter*

The CAQ's comment letter dated December 11, 2013 provides suggested changes to the auditor's performance and reporting requirements under the Proposed Other Information Standard, and the rationale for such changes. We believe those changes are consistent with our comments, and we are in agreement with those proposed changes.

*Litigation Risks Raised by the Proposed Other Information Standard That Could Impact Auditors*

Absent incorporating the changes suggested above, the Proposed Other Information Standard could create undue litigation risk to the extent it creates the impression that the auditor provides a level of assurance beyond the limited procedures contemplated. A court might construe the term "evaluate" to have the same meaning as it does in other auditing standards, and impose the requirements of those standards onto the consideration of other information. A court also might construe "relevant audit evidence" to hold an audit firm liable if anything in the company's filing does not comport with any part of the documentation in the work papers, or the understanding of any member of the engagement team. Where the other information in the filing is not directly related to the financial statements, its connection with the work of an auditor is that much less clear. That lack of clear connection leaves the auditor subject to more varied interpretations of its responsibilities, determined only after the fact in the context of civil litigation. The added clarity suggested above would help auditors know what to do, investors know what to expect, and courts know how to decide between the two.

Because an auditor can be held civilly liable under the federal securities laws only for the statements that it makes, requiring the auditor to make an affirmative statement that it has not identified a material inconsistency or material misstatement of fact creates a further, substantial expansion of the auditor's litigation risk. Even though the Proposed Other Information Standard cautions that the auditor is not expressing an opinion, and even though the actual procedures contemplated by such standard are limited, investors and courts may well find in this affirmative statement a conclusion that all of the other information set out by the company is accurate. Plaintiffs can argue that any error in the other information renders the auditor's statement false and actionable, greatly multiplying the chances of litigation. Meritless claims of this sort largely can be avoided if auditors are not required to conclude on a negative (i.e., the apparent absence of a material inconsistency or material misstatement of fact).

***III) Other Matters***

*Scope*

If adopted by the Board and approved by the SEC, the Proposed Standards would be applicable to the audits of employee stock purchase, savings and similar plans (benefit plans) that are required to file with the SEC an annual report on Form 11-K. The Proposed Standards would also apply to brokers and dealers that will be required to be audited in accordance with PCAOB standards for fiscal years ending on or after June 1, 2014, as well as registered investment companies.

With respect to the Proposed Auditor Reporting Standard, we recommend that the Board exempt all three types of entities (i.e., benefit plans, brokers and dealers, and registered investment companies) from the requirements to determine, communicate, and document critical audit matters pursuant to such standard. Benefit plans and registered investment companies are (1) designed for a specified purpose and, as a result, would likely have similar critical audit matters and (2) inherently less complex and entail fewer estimates and judgments. The typical critical audit matter that would be applicable to such entities would generally relate to auditing difficult to value investments, and there are extensive disclosure requirements regarding the fair value of investments pursuant to Accounting Standards Codification 820, *Fair Value Measurement.* In addition, as noted in the PCAOB Release, the ownership of brokers and dealers is primarily closely held (per the PCAOB's Office of Research and Analysis, approximately 75% of the brokers and dealers have five or fewer direct owners), and the direct owners are generally part of the entity's management. Therefore, the informational needs of these individuals would typically be different from those of an investor.

With respect to the Proposed Other Information Standard, we recommend that the Board exempt benefit plans and brokers and dealers from the requirements of such standard. We believe that the compliance or exemption report required to be filed by brokers and dealers under Rule 17a-5 and required to be reported on by auditors under Attestation Standard No. 1, *Examination Engagements Regarding Compliance Reports of Brokers and Dealers*, or Attestation Standard No. 2, *Review Engagements Regarding Exemption Reports of Brokers and Dealers*, provide users of broker and dealer financial statements with sufficient information to make any additional reporting by the auditor for such entities under the Proposed Other Information Standard unnecessary. In a similar fashion, there is limited other information that is included in a Form 11-K, and such document is not the predominant source of information that is used by plan participants when making their investment decisions.

We believe that the Proposed Auditor Reporting Standard and the Proposed Other Information Standard should be applicable to emerging growth companies, and therefore recommend that no exemption from the standards be provided to such companies.

*Costs*

We believe that the requirement of the auditor to determine and report on critical audit matters and the proposed increased requirements under the Proposed Other Information Standard will result in additional audit effort and increased audit cost. The enhancements put forth in this letter are intended to temper the incremental costs to implement the Proposed Standards, while still meeting the Board's stated objectives.

We are participating in a CAQ-led field test, and we believe that the results of that field test will provide some insights into the effect that the Proposed Standards will have on audit effort, audit costs, and a company's financial reporting process. We recommend that the Board also consider field testing the significant aspects of the Proposed Auditor Reporting Standard and the Proposed Other Information Standard to assist it in carrying out its cost benefit analysis of the Proposed Standards.

*Amendment to AU Section 722*

AU section 722, *Interim Financial Information*, is proposed to be amended to state that the auditor should consider the requirements of the Proposed Other Information Standard. We believe that the reference to "requirements" is too broad, as the reporting requirement of the

Proposed Other Information Standard would not be applicable in a review of interim financial information.

*Reporting When the Auditor Was Not Engaged to Examine Management's Assertion on the Effectiveness of Internal Control Over Financial Reporting*

SEC regulations do not currently require companies to disclose in their annual report, or for auditors to communicate in their auditor's report, that an attestation on internal control over financial reporting has not been performed. If a company is not required to obtain auditor attestation, then the auditor is permitted, but not required, to indicate in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report. We believe that this reporting should continue to be optional, given the fact that an investor can easily determine whether an attestation of internal control over financial reporting has been performed, based on currently available information.

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We appreciate the Board's careful consideration of our comments, and fully support the Board's efforts to enhance the auditor's reporting model and increase the value of the audit. If you have any questions regarding our comments included in this letter, please do not hesitate to contact George Herrmann ((212) 909-5779 or gherrmann@kpmg.com) or Rob Chevalier ((212) 909-5067 or rchevalier@kpmg.com).

Very truly yours,

KPMG LLP

cc:

**PCAOB**
James R. Doty, Chairman
Lewis H. Ferguson, Member
Jeanette M. Franzel, Member
Jay D. Hanson, Member
Steven B. Harris, Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards

**SEC**
Mary Jo White, Chair
Luis A. Aguilar, Commissioner
Daniel M. Gallagher, Commissioner
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
Paul A. Beswick, Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Daniel Murdock, Deputy Chief Accountant

Limitedbrands

December 11, 2013

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

Attn: Office of the Secretary

**Re: PCAOB Rulemaking Docket Matter No. 034**
**Proposed Auditing Standards –**
**The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion**
**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report**

Members of the Board:

We appreciate the opportunity to respond to you regarding the Board's *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (collectively, the "Proposed Standards"), issued by the Board on August 13, 2013.

By way of background, L Brands, Inc. (formerly Limited Brands, Inc.) (NYSE: LB) is an $11 billion global specialty retailer focused on intimate and other apparel, beauty and personal care products and accessories. We sell our merchandise through company-owned specialty retail stores in the United States, Canada and the United Kingdom and through our websites, catalogue and other channels. Our specialty retail brands include Victoria's Secret, Bath & Body Works, La Senza and Henri Bendel. We have been in business for over 50 years and employ approximately 100,000 associates.

Our management team and our stakeholders value accurate and informative financial statements and financial information. As a result, we understand and value a quality audit. We appreciate and support the PCAOB's objective to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports.

3 Limited Parkway Columbus, OH 43230 614/415-7201 f 614/415-7202

Based on our values and our experience, we commend the Board for examining how to improve audit firms and auditing standards. However, we believe that material changes to the auditing standards are not warranted. Changing the scope, content and form of the audit report is not an effective way to address concerns about the quality, quantity or nature of disclosures included in financial statements. We do not object to minor improvement in the language in the auditor's report, but we fundamentally believe that it is a company's responsibility to provide relevant information to investors and that it is the investor's responsibility to interpret and evaluate this information. These responsibilities should not be delegated to the auditors.

Additionally, we believe two of the most important areas for improvement with respect to financial information are 1) to improve its timeliness and 2) to reduce information overload. Many of the changes in the Proposed Standards are contrary to these; the proposed changes would increase the length of time necessary to complete an audit and, as a consequence, increase the length of time required to make audited financial information available to the public. Delaying the availability of information is contrary to the needs of investors and the financial markets. Our investors would prefer more timely disclosure as opposed to increased disclosure. Further, the proposed additions to the auditor's report only add to information overload.

Following is a detailed discussion of our specific comments with respect to the Proposed Standards.

<u>Critical Audit Matters</u>
As described in the Proposed Standards, a standardized form of the auditor's report has been utilized since the 1940's. Although changes to the audit report have been debated or proposed from time to time, the audit report has proved that it plays an important role in the financial markets and it is functioning effectively.

As defined in the Proposed Standards, critical audit matters represent those areas that the auditor deems to be the most challenging and complex. Inherently, these are subjective assessments that should remain in the domain of the auditor's relationship with the company's audit committee. Disclosure of these matters would not serve the best interests of investors or other users of financial statements as they would lack the context required to appropriately evaluate the matters. The investor community is inherently in the best position to understand the risks and rewards of investing in a business. This ownership should not be delegated to an audit firm.

According to the PCAOB release, "communication of critical audit matters in the auditor's report could focus investors' and other financial statement users' attention on challenges associated with the audit that may contribute to the information used in investment decision making." We believe that this premise is flawed as the scope of a financial statement audit is to determine whether the financial statements are free of material misstatement. It is not to provide the investor with investment perspectives for investment decision making. Most audits have subjective and critical auditor judgments. Many audits have areas that are difficult to audit. This does not equate to whether a company is a good investment or a bad investment. Evaluation of whether an investment is appropriate must be completed by the individual investor.

Our management team and our investors count on accurate financial information. The auditing standards are designed and audit firms are trained explicitly to obtain reasonable assurance that our financial statements are free of material misstatement and, therefore, accurate. Adding background information on the audit process does not provide enhanced information about the financial statements or their accuracy. We believe that adding this type of information about the discussions that occur in the audit committee meetings without context would likely lead to increased litigation costs for both audit firms and preparers, further increasing total audit costs.

Auditor's Responsibilities Regarding Other Information

Auditors are currently required to review information in documents containing the audited financial statements to consider whether such information, or the way that it is presented, is materially consistent with the financial statements or whether it constitutes a material misstatement of fact. We believe this scope is appropriate and well defined. We do not agree with the proposed expansion of the auditor's responsibilities to other information outside the financial statements as described in the Proposed Standards.

As we discuss above, auditors are trained in accounting and auditing and their attest scope should focus on financial statements. The expansion of the auditor's responsibility to the other information will increase audit costs and will add incremental time to complete the audit process, both without any incremental benefit. Although the Proposed Standard provides that the auditor's evaluation should be based solely on relevant audit evidence obtained during the audit, we believe this provision is problematic as auditors cannot evaluate all of the information included in "other information" based solely on their audit evidence. Disclosures typically included in "other information" expand well beyond the scope required to complete the audit of the financial statements.

Auditor Tenure Disclosure

As drafted, the Proposed Standards would require disclosure of the year the auditor began serving as the company's auditor. There is no evidence indicating that auditor tenure has any correlation to audit quality. Thus, we do not understand why the auditor's report should disclose this information. The audit report should report meaningful points, not data that is irrelevant to the quality of the audit or the accuracy of the financial statements.

Conclusion
We appreciate the efforts and the outreach of the Board to protect the interests of investors. We do not believe many of the changes in the Proposed Standards are necessary. In our opinion, these changes would not improve the quality of audits or financial statements and disclosures. However, many of the changes proposed would increase audit cost and the time necessary to complete an audit.

We thank you for the opportunity to respond to the Proposed Standards and to provide our comments on these important topics.

Sincerely,

Wendy C. Arlin
*Senior Vice President,*
*Controller*

D. Andy Meeting
*Vice President,*
*Financial Reporting*

December 9, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., 9TH Floor
Washington, DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 34, "Proposed Auditing Standards - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "Proposed Auditor Reporting Standard"), and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (the "Proposed Other Information Standard").

**FILED ELECTRONICALLY**
**(comments@pcaobus.org)**

Dear Board Members and Staff:

Thank you for the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board") "Proposed Auditing Standards Release on The Proposed Auditor Reporting Standard, and on The Proposed Other Information Standard" Release No. 2013-005 (the "Proposed Auditing Standards Release"), which was issued August 13, 2013.

I have been involved with financial reporting for many years in my current role as the Chairman of the Audit Committee of UTi Worldwide, Inc. and in my previous roles as Chairman of the Audit Committees for Levi Strauss & Co. and Allied Waste Industries, Inc. Further, for 17 years, from 1989 to 2006, I served as Chief Financial Officer and a Director of Computer Sciences Corporation. However, this letter reflects my opinions as an individual and my comments should not be taken to represent the views of any of these organizations.

The independent auditor's opinion is one of the cornerstones of our capital market system. It provides investors with assurance that the information they are using in their investment decision making is reliable; therefore, it allows them to concentrate on business performance rather than on evaluating the reliability of the information.

I believe there are two new requirements in these proposed standards which will have a significant and undesirable impact on investors, other users, preparers and auditors of financial statements and therefore should be reconsidered. These two new requirements are the requirement to disclose Critical Audit Matters (CAMs) and the requirement to perform additional procedures in evaluating other information.

**The Requirement to Disclose "Critical Audit Matters" and Related Drawbacks**

The requirement to disclose CAMs will have a significant negative impact because it will raise questions in the minds of investors and analysts regarding the quality of the accounting information provided by the reporting entity; it will raise questions regarding whether the auditor should have formed a different opinion on the financial statements; and, it will increase the effort and hours required by preparers and auditors and therefore the cost of audits to filers.

Causing investors and analysts to question whether the auditor should have reached a different conclusion is enormously undesirable. Attaching a list of CAMs to the unqualified opinion actually materially discounts the opinion. It is really no longer unqualified. This aspect of the proposal chips away at one of the cornerstones of the capital market system. Investors would be handed the added task of evaluating the reliability of the financial information. This effectively requires investors to become audit and accounting experts and defeats the purpose of having qualified accounting experts audit the financial statements.

While the term Critical Audit Matter is new, it is really just a way to classify an accounting issue. The existing standards already require that if an accounting issue results in a material deviation from Generally Accepted Accounting Principles this deviation must be disclosed in a qualified opinion. This current requirement meets the needs of investors and analysts in a straight forward and cost efficient manner.

The proposal indicates that investors and other financial statements users reference the existing auditor's report "solely" to determine whether the opinion is unqualified and the proposal implies that this simplicity is undesirable. Quite the contrary, this simplicity is highly desirable and, in fact, is the essence of the value provided by all the work that is performed in a financial statement audit.

The requirement to disclose CAMs will increase the effort and hours required by the auditor. The process of identification and disclosure of CAMs will require more time spent by audit teams, managers and partners of audit firms to determine that what makes it to the list of CAMs is adequate. This will increase the effort and hours required by the auditor which will then translate to yet an additional cost burden on SEC registrants.

In addition, the process of identification and disclosure of CAMs would be highly subjective. Two different auditors might reach different conclusions on whether or not a matter warrants disclosure as a CAM or not.

Also, taken out of the context of the auditor's work papers, the magnitude and effect of CAMs could easily be misinterpreted by users of the financial statements. Rather than providing additional helpful information, these disclosures will leave investors with many more unanswered questions.

**The Requirement to Perform Additional Procedures in Evaluating Other Information and Related Drawbacks**

The requirement to perform additional procedures in evaluating other information will have a significant impact because it will increase the effort and hours required by preparers and the auditor and; thereby, increase the cost of the audit to filers. The requirement to disclose the auditor's responsibility for evaluating other information will likely lead many investors to believe that the auditor has performed an audit of this information and that it is providing audit level assurance on this information.

Finance professionals who are familiar with the audit process recognize there will be significant costs associated with evaluating the details included in selected financial data disclosures, management's discussion and analysis and proxy statements. This effort will be considerable. The added hours will be significant and the additional costs to filers will be material. This will represent a further significant increase in the cost to be a public company filing on a US exchange.

Despite this significant level of added cost, this effort will not provide an opinion on the other information. However, by requiring the inclusion of reporting on the auditor's responsibility for other information as a component of the audit opinion, readers of the opinion will be confused about the level of responsibility the auditor is assuming. Many readers will assume that the auditor's assurance opinion extends to the other information.

**Drivers for the Proposal**

The proposal indicates on page three that "During the Board's outreach activities over the last three years, many investors have expressed dissatisfaction that the content of the existing auditor's report provides little, if any, information specific to the audit of the company's financial statements to investors or other financial statement users." The problem with this justification for the proposed changes is that it ignores the incredible volume of information that is specific to the company's financial statements which is already required to be disclosed in the notes to the financial statements, the 10-Q, 10-K and other filings.

The proposal further indicates on page four that "the auditor reporting model developed in the 1940s did not address the increasing complexity of global business operations that are compelling a growing use of judgments and estimates… contributing to greater complexity in financial reporting.. This complexity supports improving the content of the auditor's report beyond the current pass/fail model…" It is certainly a valid observation that there has been an increase in complexity in financial reporting. However, increasing the complexity in the auditor's report (which has changed over this period) hardly seems like a solution, on the contrary, this change would create additional complexities for analysts and investors which don't currently exist.

The fundamental flaw in the proposed requirements to disclose CAMs and perform additional procedures on other information is that the current approach in both areas is appropriate and cost effective. These proposals seek to fix things which simply are not broken. The additional costs and other drawbacks to these proposed changes are not justified by the minor perceived benefit to be gained by analysts who have indicated that the auditor could provide more information.

**Additional Concern**

There is one additional concern I would like to express regarding the nature of this proposal. It is the responsibility of the SEC to determine what disclosures companies should make regarding their financial information and accounting practices. The PCAOB was established to oversee the performance of financial statement auditors, not to direct the disclosure of additional information regarding filer's accounting practices. This division of responsibilities between the SEC and the PCAOB is appropriate and serves the investment community well. I think it is unnecessary, and potentially quite counterproductive, to add directing additional disclosures regarding company's accounting practices to the responsibilities of the PCAOB. Further, I suspect directing additional accounting practice disclosures exceeds the PCAOB's statutory authority.

**Summary**

In summary, I believe the existing layout and language of auditors' report meets the needs of investors and other users of the financial statements in an efficient and effective manner.  In addition, there are significant drawbacks and costs associated with the proposed requirements to disclose CAMs and to perform additional evaluation procedures on other information.

Thank you for the opportunity to comment on this Proposed Auditing Standards Release. I appreciate your consideration of my comments.

Sincerely,

Leon J. Level

Cc: Mr. James R. Doty, Chairman
Mr. Lewis H Ferguson, Board Member of the PCAOB
Ms. Jeanette M. Franzel, Board Member of the PCAOB
Mr. Jay D. Hanson, Board Member of the PCAOB
Mr. Steven B. Harris, Board Member of the PCAOB
Mr. Jeb Hensarling, Chairman of the House of Representatives' Committee on Financial Services
Mr. Tim Johnson, Chairman of the United States Senate Committee on Banking, Housing, and Urban Affairs
Ms. Mary Jo White, Chairman of the Securities and Exchange Commission

**Yoobin Liang**

901 South 15th Street

Arlington, VA 22202

November 26, 2013

Public Accounting Oversight Board

**RE: PCAOB Rulemaking Docket Matter No. 034; Proposed Rule Under Release No. 2013-005; Release Date August 13, 2013**

***Comments Related to Critical Audit Matters (Paragraphs 7 – 14 of the Proposed Auditor Reporting Standard)***

Members of the Board:

I am a member of the financial community and potential investor and am writing to comment on the recent proposal by PCAOB that requires auditors to discuss "Critical Audit Matters" ("CAM") in the auditor's report. I strongly support this meaningful and implementable change to enhance the usefulness of the Auditor's report to the investors and external financial statement users given the reasons below:

**1. Alignment with the fundamental purpose of Auditors' report**

The proposed auditor reporting CAM aligns with the fundamental purpose of Auditors' report, which is to provide financial statement users an assurance that will help them make decisions based on the results of the audit, and ultimately protect the interests of investors and further the public interest.

Auditor’s report has been the primary means by which the auditor communicates with investors and other financial statement users information regarding his or her audit of the financial statements. By reporting CAM in the Auditors’ report, investors and other financial statement users will potentially obtain valuable information that they have expressed interest in receiving but have not had access to in the past. As businesses become more and more complex and fast changing, auditors’ report are getting more and more challenging for investors and external users to understand. Many of the statements, descriptions, calculations on the financial statements are based on management’s subjective assumptions, which are highly susceptive to the rapid changing technology and economic environment today. Auditors who gain knowledge about the company's financial statements during the audit that is not known to the public can create added value to investors by sharing the CAM. As PCAOB indicated, “requiring auditors to communicate critical audit matters could help investors and other financial statement users focus on aspects of the company's financial statements that the auditor also found to be challenging. Ultimately, communicating CAM would improve the relevance of the auditor's report by providing more insight about the most significant matters that the auditor addressed in the audit and providing investors with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital.

## 2. Enhancing, or at least maintaining audit quality

First of all, the Board's proposed auditor reporting standard would still retain the pass/fail model, including the basic elements of the current auditor's report, and would provide more information to investors and other financial statement users regarding the audit and the auditor. The proposal is not intended to create more tasks, obscure auditors' work or expand the expectation gap, but rather to require that the auditor's communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements. If the auditor determines that there are no CAM, the auditor would state in the auditor's report that the auditor determined that there are no such matters to communicate.

Many people argue that reporting the CAM will have potential cost related implications to the auditor's report. While this may be true, the reporting standard could be scalable based on the size, nature, and complexity of the audit of the company. Moreover, the auditor's communication of CAM is actually based on information known to the auditor and procedures that the auditor has already performed as part of the audit. Thus, it does not modify the objective of the audit of the financial statements or impose new audit performance requirements, other than the determination, communication, and documentation of CAM. Nonetheless, PCAOB is still aware of the potential cost implications and unintended consequences. I believe any of these consequences could be addressed through field testing and future adjustments.

**3. Strengthening auditors' responsibility and independence**

Reporting CAM would not alter the original source of disclosure about an entity or compromise auditors' independence. Auditors will maintain their current role from attesting on information prepared by management. Rather, the auditor would be communicating information about the audit, based on audit procedures the auditor performed. Moreover, the proposed reporting standard adds new elements that provide more information about the audit and the auditor, such as information regarding auditor tenure and the auditor's responsibilities regarding other information outside the audited financial statements, which will protect auditors' independence.

**4. Implementable scope and standards**

The proposed reporting of CAM is highly implementable thanks to the clear scope and standard set by PCAOB. Firstly, the reporting is very specific to each audit. By PCAOB's guideline, critical audit matters are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. In addition, PCAOB also provide several sources for auditors to determine CAM, including those documented in the engagement completion document, reviewed by the engagement quality reviewer or communicated to the audit committee. These sources provide a cost-effective and efficient means for auditors to determine CAM.

**In conclusion**, I strongly support this meaningful and implementable change to the auditor's report, although it may require the auditors to provide original information about a company and could be perceived as providing a piecemeal opinion rather than in the context of the financial statements taken as a whole. Because this proposal is highly significant, I believe that robust field testing will be required. Such an effort would help identify unintended consequences, ambiguities or inconsistencies in application and improve the quality of any final standard.

*******

I appreciate the opportunity to share my viewpoint on the Proposed Standard, and I thank you for your time.

Sincerely,

Yoobin Liang

**Ivy Liao**
37th and O Street,
N.W. Washington D.C.

November 26, 2013

Public Accounting Oversight Board

**Re: PCAOB Rulemaking Docket Matter No.034; Proposed Rule under Release No.2013-005;**

***Proposed Auditor Reporting Standard – Critical Audit Matters (Paragraphs 7-14)***

Dear Members of the Board:

As a member of the financial community and potential investor, I would love to make some responses on the Public Company Accounting Oversight Board's (here after PCAOB) Release No. 2013-005, specifically on the Proposed Auditor Reporting Standard regarding the Critical Audit Matters (hereafter CAMs).

***General comment***

In general, I find the proposed auditor reporting standard regarding CAMs really helpful for financial community to focus on aspects of the company's financial statements that the auditor also found to be challenging and unknown information about the audit, for reducing the level of information asymmetry and resulting in more efficient capital allocation, and for potential improvement in the financial statement disclosures due to increased attention by the auditor, management, and the audit committee. However, there are certain anticipated challenges and concerns on the proposed standard. If it is possible, I would recommend that the PCAOB give out further detailed criteria on CAMs and promote unified procedures for different CPA firms on coordinating the CAMs disclosures with management and audit committee, which I believe would be critical to address the public concerns on the proposed standard.

***Benefits for the Financial Community and Potential Investors***

I. Provide focus and additional information on certain areas of financial statement

The proposed "communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. " As many investors believe that "auditors have unique and relevant insight based on their audits", the CAMs could provide some additional information for the community and support financial statement users to make better and more informed decisions.

For example in the analysis of Diamond Foods Inc., we had concerns on its correctness of cost and payment record, but we don't have enough information to get to a conclusion whether or not the company has cut-off issue. In that sense, the disclosure of CAMs from auditors would be great help. Through the audit process, auditor might already examine vouchers and ledger regarding the date of invoice and match that with the fiscal year end. Otherwise, it might suggest "posed the most difficulty to the auditor in obtaining sufficient appropriate evidence" which should be disclosed in CAMs and alert the investors.

II. Reduce information asymmetry and potentially lower the average cost of capital

"The communication of critical audit matters could help to alleviate the information asymmetry that exists between company managements and investors. More specifically, company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor as part of the audit, but this information is not usually known to investors. Reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital." This benefit for both the company side and investor community is stated in the appendix of PCAOB release No.2013-005.

With my experience of conducting financial analysis on different companies' 10-k, I find this statement very true. For example in the analysis on Diamond Foods Inc., I would be really interested to know the goodwill assessment related to the acquisition of Kettle Foods, since the result and assurance I got from auditor might significantly impact on my valuation of the investment opportunity on Diamond Foods Inc.. But unfortunately, very limited information was provided while I believe intensive communications between management and auditors had covered the topic. From investors' perspectives, if I can have more detailed information provided to address my concern, I could make a more informed decision. Thus, lower risk and higher level of assurance I have will allow me to require a lower rate of return on the investment.

III. Improve financial statement disclosures

PCAOB has specified the potential benefit of improvement on financial statement disclosures, "The auditor's focus on, and communication of, critical audit matters could lead to improved financial statement disclosures related to areas of the financial statements that gave rise to critical audit matters. Potential improvements to financial statement disclosures in such areas could occur because of increased attention by the auditor, management, and the audit committee of matters communicated by the auditor in the draft auditor's report regarding critical audit matters. The improvement in the related financial statement disclosures could incrementally increase the amount or quality of the information in the financial statements."

Throughout the audit process, regular interaction between auditors and managements should already cover a great amount of issues including financial statement adjustments and internal control deficiencies. The public disclosure of the most challenging issues could bring in incentive and pressure for the management to react and rectify in a timely manner. In long-term, this practice could lead to higher quality of the information disclosed in the financial statements and create a virtuous cycle for managements to focusing on shareholders' value creation.

***Potential Challenges***

I. New judgment to auditors to select the "key" or "critical" audit issues

In PCAOB release, CAMs are defined as "matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements." And PCAOB also listed factors specific to the audit to help auditors to determine whether a matter is a critical audit matter.

While the wordings and the description of CAMs make a great deal of sense, there is still huge room for auditors to make the judgment call. This might be the least wanted from the investors' standpoint, to propose a subjective judgment call on information disclosure selection. In the process of audit, a quantitative material level is applied to guide the work of auditors. I am wondering if a more detailed quantitative criteria coupled with a qualitative description on the CAMs could solve this potential challenge.

II. Extract cost and efforts for auditors and companies to be in compliance with the proposed standard

PCAOB has anticipated that some cost increases would be in line with the proposed standard, including "one-time costs that related primarily to updating an audit firm's methodology and training", "recurring costs in each individual audit relative to the determination, communication in the auditor's report and documentation of critical audit matters", and "recurring costs for the company, including the audit committee, for reviewing the critical audit matters included in the draft auditor's report". Besides, the standard setter also expressed its concern on reducing time available to the auditor to review and complete the audit work.

In my opinion, the annual audit cost comparably contributes a very small portion of SG&A cost of a public company each year. That said, even in the case of cost increase due to the new standard, the financial impact would be acceptable to most of the shareholders, as this would be critical to protect their own interest and value. Moreover, audit report nowadays which just gives a pass/fail grade for the company only reflects a small part of the audit effort. Auditors continually communicate with management and audit committee on adjustments on financial statements and deficiencies on internal controls, which suggests management and audit committee are already reviewing some non-disclosed "critical matters" with the auditors before the proposed standard. What we asked for now is just to disclose the most challenging matters already be discussed back door. Meanwhile, academic community has raised evidence that the reduce of information asymmetry between management and investors could help to lower the average cost of capital, which is beneficial to the company and might potentially wash out the increase costs related to the proposed standard. In addition, if PCAOB could provide more unified procedures for auditors on coordinating the CAMs disclosures with management and audit committee, it will even lower the incremental cost and establish a comparable environment for different companies' audit reports and continually improve the usefulness of audit report.

III. Change of auditors' current role criticism

Understand that most auditors are concerning about the alter of the role of being an auditor, as they believe the new disclosure requirement might lead them to inappropriately step into the roles of managements and audit committee. Auditors claim that it is managements' responsibility to prepare financial statement and increase the transparency. In addition, the profession is concerned that users of the financial statements may not have sufficient context to digest the information provided in CAMs.

In my opinion, this concern could be addressed by more promotion on the unified procedures for CAMs. First of all, most of the users of the financial statements are sophisticated investors and experienced with continually changes on accounting and auditing standards throughout years. The group of people should have the ability to adapt themselves with the new proposed standard and adjust their financial analysis with the newly provided information. Besides, PCAOB specified that "the proposed auditor reporting standard does not intend to change the auditor's traditional role of attesting to matters in the financial statements when communicating critical audit matters". And the new standard is actually requiring the auditors to "provide insights about the most difficult, subjective, or complex matters that the auditor addressed in the audit". That said, the CAMs in the auditor's report would not replace the efforts for investors and other financial statement users to analyze and review the financial statements. Through sufficient education and promotion, the investor community in my opinion will be able to adjust the expectation and better leverage the unique insights from auditors regarding the company's financial statements in their own usage.

*******************************************************************

In conclusion, as a member of the financial community and potential investor, I support the proposed audit standard regarding the critical audit matters and recommend that the PCAOB could give out further detailed criteria on CAMs and promote unified procedures for different CPA firms on coordinating the CAMs disclosures with management and audit committee to better facilitate the changes and address concerns from different stakeholders of the standard.

Sincerely,

Ivy Liao

2nd Year MBA student

McDonough School of Business, Georgetown University

**DECEMBER 11, 2013**

**Hunter College Graduate Program**
**Economics Department**
**695 Park Ave.**
**New York, NY 10065**

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

**Re: Invitation to comment PCAOB PROPOSED AUDITING STANDARDS:**

**THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;**

**THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;**

**AND RELATED AMENDMENTS TO PCAOB STANDARDS**

**To Whom It May Concern:**

**The Fall 2013 Advanced Auditing Class at Hunter College Graduate program in New York City appreciates the opportunity to comment on this important topic.**

**The class has discussed the above Invitation to Comment and offers the attached response to questions for respondents and feedback.**

**If you would like additional discussion with us on this topic, please contact Professor Joseph A. Maffia, at 212-792-0404.**

**Sincerely,**

**Joseph A. Maffia, CPA**

H U N T E R C O L L E G E – C I T Y U N I V E R S I T Y O F N E W Y O R K

**Hunter College Graduate Program**
**Economics Department**
**Advanced Auditing Class**
**Eco 775**

## Invitation to Comment
## PCAOB PROPOSED AUDITING STANDARDS –

## THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;

## THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;

## AND RELATED AMENDMENTS TO PCAOB STANDARDS

**PCAOB Release No.2013-005**
**August 13, 2013**

**Hunter College Advanced Auditing Class**

**Principal Drafters:**

Chuang,Tzu-yin
Hernandez, Eric
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## PCAOB PROPOSED AUDITING STANDARDS:

**The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (which would supersede portion of AU sec. 508, Reports on Audited Financial Statements).**

**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (which would supersede AU sec. 550, Other Information in Documents Containing Audited Financial Statements).**

**And the related amendments to PCAOB standards.**

The Advanced auditing Class has reviewed the above-referenced ITC and offers the following feedback for consideration by PCAOB.

Please note that our comments can be separated into two main categories: response to PCAOB questions and other suggestions.

For the sake of brevity we skipped those questions for which we had no substantive comments. Language that would be deleted by the proposed amendments is struck through. Language that would be changed is underlined.

**Responses to PCAOB Questions:**

**Discussion Related to the Proposed Auditing Standard - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

**Question 7.**
**Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

**In our opinion** the Board should require a specific order for the presentation of the basic elements required in the auditor's report. This allows the users of the auditor's report, including investors and stakeholders, to gain familiarity with the report and presents greater efficiency and effectiveness of the report if they are looking for specific information. A uniform presentation of the basic elements in the auditor's report will allow for a timelier manner to find the information needed for investors and the like.

**Question 12.**

**Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

**In our opinion** auditor's communication of critical audit matters will benefit investors and other financial statement users in their investment decision making process. It will make the auditor's report more informative – increase its relevance and usefulness. Also, we think that communicating of critical audit matters will lead to improvement of financial statement disclosures that could incrementally increase the quality of the information in the financial statements.

However, we do think that the definition of a critical audit matter is not very clear for determining what would be a critical audit matter.

The proposed auditor reporting standard defines critical audit matters as follows:

A2. **Critical** audit matters – Those matters the auditor addressed during the audit of the financial statements that (1) involved the ~~**most**~~ difficult, subjective, or complex auditor judgments; (2) posed ~~**the most**~~ difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed ~~**the most**~~ difficulty to the auditor in forming an opinion on the financial statements.

**In our opinion** the use of the word **critical** is misleading. Critical implies that the audit could not be completed without addressing the matter that the auditor would list as a critical audit matter. When, in fact, many items are critical in an audit, nothing can be left open in order for the audit to be complete and final. We think the word critical should be replaced with **challenging**. Using the word challenging explicitly defines that the matter was difficult for the auditor to complete. When listing an item as challenging, the auditor should also have to explain why the item was challenging.

In addition, we think that the use of the word **"most"** is not clearly understood as it relates to the definition of critical audit matter. In the proposed auditor reporting standard the word "most" refers to the matter that would stand out from the other numerous matters addressed during an audit in terms of difficulty, subjectivity, or complexity. It is also not intended to imply that there is only one matter that surpasses all other matters.

**In our opinion**, the word “most” indicates that the matter is more challenging than all others. However, “most” implies “one”, so there could not be more than one "most critical audit matter". As a result, we think the word “most” should not be used. Instead, the auditor should only list matters that were challenging.

**Appendix 6- Additional Discussion Related to the Proposed Other Information Standard, *The Auditor’s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor’s Report*, and the related amendments**

**Question 11**

Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?

The audit of the additional information would increase the fees and time associated with an audit. Auditors will be spending additional time understanding the format, and usage of different forms of additional information. This “consideration” of different types of additional information will add to the workload and training of auditors. The costs associated with the additional procedures would also include more time spent on the planning and review of the audit. The planning and review of the audit would now include preparation for and revision of the audit of other information to ensure that it is properly “considered”. Auditors would require more time to “read and consider” the other information and check for material inconsistencies and material misstatements of fact.

**Question 19**

**Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

**In our opinion,** the auditor’s procedures should not encompass evaluating information not directly related to the financial statements and for which the auditor has not obtained sufficient evidence. Requiring the auditor to identify other information not directly related to the financial statement takes responsibility away from management and the audit committee and places more on the auditor. Furthermore it expands the scope of the audit and would be more costly to the company than beneficial to users of financial statements.

**<u>Other Suggestions:</u>**

1. **Discussion Related to the Proposed Auditing Standard - *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (which would supersede AU sec. 550, Other Information in Documents Containing Audited Financial Statements).***

**In our opinion,** the word **"documents"** in the Introduction (Paragraph 1 of the Proposed Other Information Standard) should be changed to the word **"information".** In the paragraph these words being used in a similar contest which would be wrong. The word "document" would rather describe something that would serve as evidence or proof. The word "information" would mostly refer to knowledge. Using both words in a similar context is misleading.

**<u>Introduction (Paragraph 1 of the Proposed Other Information Standard)</u>**

The proposed other information standard establishes requirements regarding the auditor's responsibilities with respect to the other information in certain documents containing audited financial statements and the related auditor's report. As more fully described later in this section, the introduction to the proposed other information standard provides a description of "other information," as used in the proposed other information standard, including (1) the **~~documents~~** **<u>information</u>** to which the proposed other information standard would apply and (2) the information to which the proposed other information standard would not apply.

Moreover, the Proposed Other Information Standard uses the word "information": "The Auditor's Responsibilities Regarding Other **Information** in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (which would supersede AU sec. 550, Other **Information** in Documents Containing Audited Financial Statements)". In our opinion using the word "information" in both cases more appropriate and avoid misleading.

2. While increasing the consideration that auditors give to an annual report will assist investors, there should be an analysis of costs versus benefits. If auditors will be doing extra work to provide important information, there should be assurance that the investor will utilize the information.

3. The risk of litigation will be higher if the auditor is exercising more judgment and providing more information within the auditor's report. If companies believe that the auditor's report inappropriately conveys their financial position or negatively persuades investors, they may want to take legal action against the auditor. That being said, a disclaimer should be incorporated to address this issue. For instance,

“The following comments related to additional information in the annual report are based on assumptions and conclusions drawn during this company’s audit. These comments are subject to the judgment of the auditor, and should be analyzed with careful caution and consideration”

MAPI Stephen V. Gold
President and Chief Executive Officer

December 10, 2013

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

**Subject: Docket 034: Auditor's Reporting Model Proposal**

Dear Board Members and Staff of the PCAOB:

The Manufacturers Alliance for Productivity and Innovation ("MAPI") welcomes the opportunity to convey the views of its CFO and Financial Councils on the proposed Auditor's Reporting Model. The CFO Council is comprised of 107 corporate level CFOs with large publicly traded manufacturing companies while the Financial Council's has 86 members with publicly traded companies who are corporate level Controllers and Chief Accounting Officers. Together, there are 124 different publicly traded manufacturing companies represented on the two Councils.

The members of the CFO and Financial Councils were surveyed recently on their views regarding the PCAOB's proposed Auditor's Reporting Model. The results, based on responses from 63 companies, are briefly summarized in Part I and the detailed responses are presented in Part II. The companies that participated in the survey are very large manufacturers. Eighty-seven percent had annual revenues exceeding $1 billion in the latest fiscal year. The revenues of 45 percent of the companies exceeded $3 billion.

**Part I: Overview of Survey Results**

A majority of the respondents (97%) do not think expanded audit opinion letters will provide any value to investors or that any value would be nominal. At the same time, respondents believe that PCAOB's proposal will impose significant costs on companies. While the PCAOB's proposal is well intentioned, the association has three principle objections to the addition of critical accounting matters (CAM's) to the auditor opinion.

First, most respondents believe that the proposal will likely be interpreted as requiring auditors to disclose information not required to be disclosed by registrants. Generally, members believe that current FASB and SEC disclosure requirements, including those related to critical accounting policies, are sufficient to provide investors with necessary and appropriate information. However, if it is necessary to expand these disclosure requirements, members feel strongly that any new requirements should be required of registrants, not their auditors. Seventy-five percent of respondents said that the most important finding provided by the audit is that a firm's financial statements are presented fairly and that the stated financial position conforms to the financial reporting standards. Accordingly, members feel that the historical "pass / fail" basis for the audit opinion should remain intact, and auditors should opine on the accuracy of information provided by management, not provide original disclosure.

Secondly, 80 percent of the respondents indicated that the notion of "what keeps the auditor up at night" as a determinant of critical accounting matters is too subjective. In our existing litigious environment, this would result in auditors feeling compelled to identify a large number and broad array of critical accounting matters in order to protect themselves from later shareholder suits, similar to what has happened with the requirements regarding risk factors. In this event, members feel it is unlikely that investors will realize any additional useful information.

Last, the majority of members believe that in its current form, the proposal will significantly increase audit fees with no resultant investor benefit. One-third of respondents believe audit fees would rise by 6 to 10 percent or more and 32 percent said fees could rise by more than 10 percent. MAPI's most recent audit fee survey found that the median audit fee paid by its members companies in 2012 was $2.06 million.[1] A six percent increase in the median audit fee is equal to $124,000.

Members have additional concerns about the proposed requirement that auditors evaluate "other information" outside of the financial statements. The additional level of review expected under the proposal will increase audit fees and may result in auditors opining, in some cases, in areas for which they have no expertise. The majority of members believe that reading MD&A for consistency with the financial statements and footnotes, as required by auditors currently, is sufficient to meet the needs of investors.

Additional detailed comments from more than 30 respondents are reproduced in Part II.

* * *

Submitted by:

Stephen V. Gold
President and Chief Executive Officer
MAPI

Carlos Cardoso
Chairman, MAPI Board of Trustees
and
Chairman, President & CEO
Kennametal Inc.

Theodore D. Crandall
Chair, MAPI CFO Council
and
Senior Vice President & Chief Financial Officer
Rockwell Automation, Inc.

J. Ted Mihaila
Chair, MAPI Financial Council
and
Senior Vice President and Controller
The Timken Company

[1] Manufacturers Alliance for Productivity and Innovation, *Survey on Audit Fees, 2013*. S-148.

## Part II: Survey Results

1. Of what value would expanded audit opinion letters addressing critical audit matters be to investors?

| | Number | Percent |
|---|---|---|
| No value | 34 | 55% |
| Nominal value | 26 | 42% |
| Moderate to significant value | 2 | 3% |

2. If you do not believe information regarding critical audit matters would provide much if any value to investors, what are the main reasons? (Check all that apply)

| | Number | Frequency (Percent of 61 Responses) |
|---|---|---|
| The notion of “what keeps the auditor up at night” is too subjective. | 49 | 80% |
| The most important finding provided by the audit is that a firm’s financial statements are presented fairly and that the stated financial position conforms to the financial reporting standards. | 46 | 75% |
| Some of what the PCAOB proposal is asking for is already provided in MD&A critical accounting policies. Any problems with these would influence the auditor’s communications with the Audit Committee. | 37 | 61% |
| Investors would find little value in the additional information provided in expanded auditor letters. | 28 | 46% |
| The proposal gives the auditor too much discretion. | 26 | 43% |
| Much of the information provided by the audit is dated by the time it is published. | 17 | 28% |
| The financial audit is just one source of information regarding a company’s financial position; there are other sources of information that complement annual reports | 15 | 25% |
| Other | 17 | 28% |

Those who indicated “Other” elaborated:

- Investors rely mainly upon the Earnings release information, script and Q&A together with any other management presentations and sector comparisons. They rely upon the 10Q/10K filings for a little of the extra data such as Pension deficits, Debt details etc. and the Audit opinion is mainly a point of comfort that the financials they have been using are reliable. Very few investors read the 10Q/10K in full detail and those that do are the most junior analysts who simply do compare analysis, e.g., did management change a risk factor?

- I believe it will be confusing.

- What is the ultimate value of the information relative to the effort required, i.e., the company and the audit firm are going to spend enormous amounts of energy "word-smithing" the final product.

- The auditor will be forced into over communicating critical audit matters to manage their legal liability. Auditors often have 10 to 15 key audit matters that are offered summarized for their concurring and national office reviews. Therefore, auditors will naturally need to include these as "critical audit matters" further contributing to the information overload in financial statements today.

- It will significantly drive up the cost of an audit.
- Matters that are complex and subjective are things such as impairments that are non-cash. For investors focused on cash flows, subjectivity does not come into play.

- The proposal could potentially confuse investors and cause unnecessary double-guessing.

- Investors are already overwhelmed with financial statement disclosures. This just adds to it.

- Creates more audit fees and provides little value. What does the auditor have that investors can't get from asking questions - other than the financial statement detail?

- Companies are already required to discuss risk factors and "seeing the company through the eyes of management in the MD&A" and auditors have to "sign off" on those. Management has to agree to “clawbacks”, CEO's and CFO's have to personally sign off on controls, etc. We are being forced to jump through hoops for the black swan event and in the process becoming less competitive.

- The letter could become another "boilerplate" document that generally is carefully worded by lawyers and this could greatly reduce the significance to investors.

- Disclosures already exist.

- It is difficult to provide an objective standard of critical audit matters between companies and industries.

- There is potential to misinterpret the criticality of the issue.

- It is nearly impossible to succinctly state issues in document. Our litigious society will be addressed by more and more disclosures where the list will be long and ultimately un-useful. The "taken as a whole" should continue to be standard for investors.

- As I understand the proposal, the Auditor will have to come up with something, even if it's not substantive. I think the reader will be curious, but won't know how to process the data. What's the value to the investor in the end?

- There will be inconsistency between what different auditors might report for different companies and this may lead to inappropriate relative perceptions about companies.

- Because of the limitations of an audit, the auditor would be very measured in what he/she wrote. It would quickly become boilerplate.

3. What do you think is driving the PCAOB proposal?

| What do you think is driving the PCAOB proposal? | Number | Percent |
|---|---|---|
| The PCAOB's view that more oversight is needed | 52 | 83% |
| Academic accounting literature showing a need for information on critical audit matters | 7 | 11% |
| Investor complaints regarding the inadequacy of current financial reporting | 2 | 3% |
| Other | 2 | 3% |

Those who indicated "Other" elaborated:

- Probably a combination of all of the above.

- Government's view that they have to prevent any and all potential losses by investors, regardless of the cost. You can't govern and establish rules to catch the crooks that will always be crooks. There is enough governance in corporate America right now without increasing the workload and costs for companies to compete. Think about Conflict Minerals - this is just another example of over-reaching.

4. If the PCAOB proposal is adopted, to what extent do you think audit fees would increase?

| | Number | Percent |
|---|---|---|
| There would be little or no impact on the cost of the audit. | 1 | 2% |
| Audit fees would rise by 1% to 5% | 20 | 33% |
| Audit fees would rise by 6% to 10% | 20 | 33% |
| Audit fees would rise by more than 10% | 19 | 32% |

5. Briefly, what is your opinion of the PCAOB proposal?

Twenty respondents provided short statements to the effect that they do not like the PCAOB's proposal, that it is overreaching and unnecessary, that it will not provide investors with much in the way of additional or useful information, or that its costs exceed its benefits. The comments of the other respondents who elaborated their concerns follow.

- Continually looking for ways in which to provide additional useful information to investors is a commendable goal. However, the proposal appears to alter the basic fundamental model that has been in place for decades, a model that currently provides for disclosures of important information be made by registrants and not auditors, with the auditor communicating a simple, objective "pass / fail" opinion. As such, we believe much additional discussion and analysis should take place prior to any proposal such as this one takes effect and should be led by all parties responsible for financial reporting (such as but not limited to the SEC and FASB). In addition, the benefit related to the expansion of scope of work of an auditor to perform procedures on other documents (such as but not limited to the proxy statement) is not clear. The costs could be significant, and it is not clear what actual problems have occurred that would suggest such work would result in a meaningful benefit.

- The current yes/no status of an audit opinion letter has great value and is the main value that investors draw from the audit process - they want statements that they can rely upon that have had independent scrutiny. Adding shades of grey/emphasis of matter etc., will probably quickly become like the risk factors - an ever growing section that is driven by Attorneys and concerns over minimizing risk - in this case to the Auditors. The clarity of the current pass/fail audit opinion is profound and should be maintained. Furthermore, consider what would have happened back in 2008/2009 with all of the concerns over corporations' ability to get refinanced or achieve Bank Covenant amendments during that period - the Auditors expressing such concerns in public would have led to Vendor confidence collapse, removal of terms and the achievement of a self-fulfilling prophecy - expressing concern over financial stability would have engendered financial instability and much heightened risk of financial failure.

- Unfortunately, the PCAOB's sensitivity to cost is low, as the effort of the audit firms and their clients both will be magnified, significantly in many circumstances, and the cost of risk paid as part of audit fees will necessarily rise as more information and opinion which can spawn and support lawsuits is exposed to our litigious environment. They also ignore the impacts from disclosure of competitive information. Differences of opinion which can safely persist under current disclosures will become more problematic, ultimately resulting in audit firms dictating even more judgmental decisions than they do today. I do not feel that is wise or helpful. In all, I feel it is a gross overreaction to a simple question of whether the opinion letter should be updated.

- It will only add to investor confusion. Every investor looks at different aspects of the company. It will be impossible for the audit firm to cover every item that the investment community might want to know about. Even after an audit, the auditors know about 10% of your business (they think they know much more, but they don't) so their ability to span the scope of investor needs is limited. Our auditors sometimes have a difficult time explaining issues to our audit committee (who are familiar with our company and financial policies). I can't imagine the gyrations we will have to go through with the auditors to have them try to put issues in writing for the world to see. It will create a lot of extra work for me and my staff.

- The information proposed for the auditor's report should remain solely the responsibility of the audit committee and not be added to the auditor's report. The PCAOB's proposal would likely invite an increase in litigation as litigious parties use the information to the disadvantage of public companies and/or their auditors. Most of the proposed information should be apparent in the financial statements if preparers are following the current disclosure rules properly.

- This proposal will put audit firms in a very difficult position with regards to audit committee and management communications. It will also be difficult to implement in an objective manner - the same issue at one company may be considered critical while at another, it does not reach that level.

- It is the companies' responsibility to report on the company, not the auditors. This proposal could result in a contentious working relationship between the company and auditor. I don't think the audit world wants this either. It is too subjective and provides little value to the investing community.

- The PCAOB is trying to prevent the black swan and wasting investors' money in the form of lower business competitiveness and lower profits. There is little pragmatism.

- It has merit in theory but auditors already read the MD&A. It is hard to believe that if they read something different in MD&A than their understanding of what is contained in the financial statements they would not let Audit Committees know. They would also be putting their firm reputation at risk.

- Another layer of regulatory controls for accounting companies to address, giving them reason to expand their scope, increase the fee-based revenue and wanting more protection from perceived liabilities at the detriment of the client. This moves further away from the simple concept that the company is responsible to provide all the required information in prescribed formats and standards with the auditor to attest that it did so properly.

- I disagree with their premise. The auditors should just audit and express their opinion on the overall financial statements.

- The proposal is of little value. While some of the PCAOB oversight has been positive, much of what they have now evolved toward trying to require scientific conclusions and documentation around highly subjective matters.

- The proposal is not appropriate as it changes the role of auditor from solely opining to reporting on Company matters. Also, more attention than necessary could be placed on insignificant matters.

- It will not improve the quality of earnings, the quality of accurate financial records or of a quality audit.

- I disagree with the premise. Auditors cannot be all-knowing; expecting them to be will spiral out of control.

- Investors rely on the auditor to determine if the financial statements are presented fairly. They expect the auditor to adequately address the critical audit matters. Investors shouldn't have to make this determination on their own based on disclosures from the auditor.

- The proposal is a solution in search of a problem. I really doubt any sophisticated investors are reading much less relying on the auditor's opinion other than the financials have been subjected to audit. An audit can't prevent a business failure and that is what really concerns investors.

- I do not like the proposal at all. If it were implemented, I see too large an opportunity for adversarial relations to develop between client and audit firm. And, I see much more changing of audit firms due to these differences.

- The regulations that exist over financial reporting are adequate to address investor needs. This is another example of regulation overkill. Based on the PCOAB view, there will never be enough data to satisfy their needs. If would be interesting to see if investors would be willing to fund every new regulation from the PCOAB directly vs. corporation.

- An unneeded additional regulation. The audit already covered management estimates and management must disclose this. If the auditor had problems with them, you think they would sign the opinion?

- It is hard to get your hands around what they are concerned about. As we address critical accounting policies in the 10-K and the auditors opine on the filing, what isn't already covered? I believe it would add as much value as audit firm rotation would to the audit validity.

- It generates little or no value (comfort). It simply breaks out what the auditor should be doing anyway. Adding the additional disclosures will simply add exposure to the auditor and, consequently, fees to the audited.

- It is over-reaching PCAOB's authority. The SEC is accountable for this.

- I don't understand what's driving it. Who's pulling for this? There will be too much subjectivity in deciding what issues to discuss, and the Auditors will be compelled to have to report on something. I also worry about confidentiality of issues that would be disclosed.

- It is out of touch with reality. This is another compliance item that is being layered onto everything else that public companies are supposed to do that end of the day waters down the communications to shareholders. The more disclosures that are mandated the less meaningful the disclosures become.

- The proposal is not necessary and will result in higher audit fees and will add delays to the close process. Investors value information that is both timely and accurate. This proposal will not increase the accuracy of financial reporting. But it will delay the timing between 'closing the books' and publishing a set of audited financials.

- I believe that the PCAOB proposal, although well-intentioned, is misguided. The PCAOB proposal reflects an overestimate of the auditor's role in the financial reporting process and asks the auditor to comment on matters that are far better addressed by management.

- This seems like a solution looking for a problem. Plus, the audit firm is designed to opine on the financial statements and associated disclosures and whether they are in accordance with GAAP. The audit firm will be risk-averse, as any additional information they provide will only be a negative in the case of an issue with the company; therefore, the additional information will ALWAYS be biased to the negative. It is management's responsibility to fairly present all information that is relevant to an investor; the audit firms don't have expertise in this area and their views will likely only add confusion. Hard to see how this improves any information available for investors.

- The financial statements are either fairly stated or unfairly stated. Due to the more subjective nature of this request, I envision it leading to a more adverse relationship between audit firm and client.
- More regulation with minimal to no benefit. Don't believe this proposal would have avoided or provided headlights to the fraud at Enron, WorldCom, Global Crossing and Quest nor the financial meltdowns at Lehman Bros, Bear Stearns or Merrill Lynch.

- Not needed, would add little to no value and will result in nothing more than the regurgitation of what is already in MD&A.

- The PCAOB proposal would make U.S. companies more challenged to compete against other companies that are not subject to such rules.

6. If you think the PCAOB proposal does not provide benefits commensurate with the costs, is there an alternative that is more workable and less costly?

| | Number | Percent |
|---|---|---|
| Yes | 18 | 30% |
| No | 43 | 70% |

Those who indicated that there is alternative provided the following suggestions:

- Monitor and enforce the current audit standards.

- Put wrongdoers in jail for a long time.

- Expand discussions in the MD&A and footnotes.

- If a change is necessary, the opinion letter could list areas of greatest focus in the audit that were discussed with the company's Audit Committee (or a similar standard). (And, to be clear, that is just what I think.)

- If there are matters that aren't being adequately addressed then rules should be expanded for management to address them in the qualitative discussions in Forms Q and K with in MD&A or elsewhere. Greatly expanding the audit opinion only adds to information overload.

- Enhance information about critical accounting policies if that is not currently adequate.

- In my view, the board of directors should provide a letter annually to investors.

- Consider more disclosure in the footnotes on critical accounting policies.

- Require the auditor to review MD&A and raise concerns if inadequate (this is already part of the auditors' responsibility)

- Assuming the Auditors already read the MD&A have them say in their letter to the Board and Shareholders "that in conjunction with the audit they have read the MD&A and when considered in relation to the basic consolidated financial statements taken as a whole presents fairly, in all material respects the information set forth".

- Consider expanded disclosure on Significant Accounting Policies | Critical Accounting Estimates

- Manage audit firm expectations through the investigation process that is already in place.

- Rather than continuing to add more costs to US public companies there needs to be a risk based assessment of what is truly most important from an investor's point of view. Stop requiring anything that is not a priority and focus only on the priorities. Our costs continue to increase with every letter that the PCAOB issues to any of the accounting firms and yet I would argue that neither the investors nor the company are benefited by the resulting reactions/changes.

- Expand Critical Acct Policies section/MD&A Section.

- Limit the discussion of Critical Audit Matters to: (1) material items, (2) items required to be disclosed by registrants, (3) items discussed with a registrant's Audit Committee, (4) expand the scope of auditor responsibility to MD&A only, and within MD&A only to items that are generated by the registrant's accounting system.

7. What were your company's total worldwide revenues in its latest fiscal year?

| | Number | Percent |
|---|---|---|
| Less than $1 billion | 8 | 13% |
| $1 billion to $3 billion | 27 | 43% |
| $3.01 billion to $5 billion | 14 | 22% |
| $5.01 billion to $10 billion | 6 | 10% |
| Greater than $10 billion | 8 | 13% |

MARCUM
ACCOUNTANTS ▲ ADVISORS

December 9, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

**Proposed Auditing Standards**

1. The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;

2. The Auditor's Responsibility Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.

3. Marcum LLP ("Marcum", the "Firm") respectfully submits its comments on the referenced proposal. Marcum is a national, PCAOB registered CPA firm with offices in New York, Connecticut, Massachusetts, New Jersey, Pennsylvania, Florida and California. The Firm primarily serves microcap public and mid-sized nonpublic business entities, as well as many non-commercial entities.

**The Firm's Overall Comments**

We appreciate the opportunity to comment on the PCAOB's (the "Board") proposal. The proposal is a very significant change in the auditor's reporting on financial statements. Whereas we agree with the Board that the "pass-fail" model remains valid, we believe that certain of the proposals will degrade the reporting process:

- We believe that requiring the auditor to report on auditor tenure information in the auditor's report injects data that does not provide useful information and may imply problems or difference in quality where none exists.

- We believe that requiring the auditor to report on critical audit matters could result in a perceived difference in audit quality where none exists. In any audit conducted in accordance with PCAOB Standards, the auditor assesses the business in which the entity operates and the control risk within the entity, and addresses the audit risks that result from such assessments. We believe that the users of the audit report will not learn from the reporting of critical audit matters, whether such assessments were properly carried out or adequately addressed, nor will they learn any more about the company's business or control risks than is currently reported in other information filed with the Securities and Exchange Commission (the "Commission") and made public to users. Because the assessment of critical audit matters ("CAMs") is subject to wide interpretation, comparability is likely to be impaired. It is unclear to us whether a user would infer that set of financial statements, or the audit thereon, were of better or worse quality based on the number of critical audit matters disclosed under the proposed new auditor's report. Additionally, the number of such matters would vary between how individual auditors assess and categorize such matters.

- Requiring the auditor to report on CAMs could create the risk, especially with untrained readers that such reporting is read as a de facto piecemeal opinion on specific attributes of the financial statements.

- We believe that in regard to reporting CAMs, the Board may be attempting to address certain perceived problems through the audit reporting process that are better addressed through financial reporting standards through the appropriate standard setters.

- We believe that requiring the auditor to report on other information associated with the filing, including identifying material misstatements of fact, requires the auditor to express a conclusion the auditor is not trained or equipped to reach, and is beyond the auditor's competence. The auditor is considered to be expert in accounting and financial reporting, not in technology, marketing or the law.

- We also believe that the addition of excessive additional information can weaken the report's main message.

**<u>Auditor's Report</u>**

***Questions Related to Section II Objectives:***

1. **Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**

   No. The objectives are understandable, but the guidance to implement the requirements is inherently too subjective to be useful. For example, the objective that critical audit matters be communicated is clear, but the supporting definition of CAM is widely open to various interpretations.

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

   No. Addressing the report to the shareholders and the board of directors is sufficient as it is a publicly available document. Therefore, it is not necessary to require further addressees.

3. **The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

   No.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

   No. The title of the report, displayed prominently, is "Report of Independent Registered Public Accounting Firm". To add a redundancy in the body of the report just adds clutter that detracts from the reports main objective, which is rendering an opinion on the financial statements taken as a whole.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

   a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

      No. We do not believe that the length of the auditor's tenure has been shown to have any bearing on the quality of an audit and we are not aware of any body of reliable research that supports a correlation, much less causation between longevity of the audit firm and audit quality. We also believe that the board may be confusing data with information, or that more is always better no matter the relevance. Including this information could falsely give an impression that auditor's tenure in some way coincides positively or negatively with quality.

b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

No, however, the auditor's tenure should be explicitly defined to exclude predecessor firm tenure. When one firm acquires and merges with another firm, there may be inappropriate association of the pre-merged period with one of the pre-merged accounting firms or the combined accounting firm. By having the combined accounting firm associate with prior periods audited by one of the predecessor firms, it could increase the legal liability exposure of the combined accounting firm. Many transactions are structured as asset purchases, leaving the predecessor firm's legal existence intact, in order to mitigate exposure to historical liabilities of the predecessor. Additionally, there could be significant changes to the accounting firm's governance and quality control system subsequent to the merger, which would render the information useless, or worse, misleading.

Finally, should the Board decide to maintain the requirement to include the year the auditor began serving consecutively as the company's auditor, and should that requirement include firms that the auditor's firm has acquired or that have merged with the auditor's firm, some additional clarity is requested. For example, it is not uncommon for an individual audit partner of another firm to join a new accounting firm; that partner sometimes brings audit clients. Please provide guidance as to whether such a transaction would be considered a merger.

c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

No. This information is not important or of significant use (Please see our response in 5.a. & 5.b. above). Inclusion in the audit report implies importance. In addition, the information is publicly available elsewhere. Excess information in the report make the report a less readable, and therefore less useful to the reader.

6. **The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

No. A requirement that the auditor provides, or appears to provide, assurance on Other Information, particularly misstatements of fact that can cover facts outside of the auditor's competence, is problematical.

The proposed standard by, among other things, requiring the auditor to state that there is no material misstatement of fact in the other information, expands the responsibility of the auditor to areas that we believe is beyond the competence of auditors and requires a conclusion that cannot be reached based on the proposed procedures (Paragraph 4, page A2 – 3). In addition, the inclusion of Other Information is often a legal matter; auditors are neither trained to nor licensed to practice law.

The proposed standard expands the auditor's responsibility from addressing consistency between the financial statements and other information to state that we are "evaluating" whether there are material misstatements of facts in the other information. This expanded requirement involves addressing legal matters and completeness of other information in addition to its accuracy. In particular, the requirements of paragraph 4.c. of the Proposed Other Information Standard should be deleted. Additionally, it is introducing a new term in the assurance lexicon, an "evaluation". We do not believe that it is clear what level of service or procedures would be performed by the auditor to qualify as an evaluation. We strongly recommend that these requirements be deleted from the proposal. However, should the Board decide to maintain the requirement to report on Other Information, we would suggest opinion language that would be similar to the following:

> In addition to auditing the Company's financial statements in accordance with the standards of the PCAOB, we are required to read the other information, included in the annual report on [*SEC Exchange Act form type*] filed with the SEC that contains both the December 31, 20X2 financial statements and our audit report on those financial statements, to determine whether it contains a material inconsistency with the financial statements. Our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We did not audit the other information and do not express an opinion on the other information. Based on our evaluation, we have not identified a material inconsistency in the other information.

7. **Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

   Yes. This could be helpful to the reader by aiding comparability between auditor's reports for different companies.

8. **What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

   None.

9. **What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

The costs of a new requirement to report on a material misstatement of fact in Other Information that is not otherwise corrected by the reporting entity could be substantial, and would vary significantly between entities based on size and complexity. It is difficult to estimate such costs, but we estimate that it could be within 10% of total fees for small, non-complex engagements and as high as 25% for large complex engagements.

***Questions Related to Section V Critical Audit Matters:***

10. **Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

No. (1) Critical Audit Matters are too subjective. The inconsistency introduced in application by different accounting firms regarding what to disclose would make comparisons difficult between similar companies with similar issues, but different auditors. (2) The information would repeat much information that is already contained in the risk factors section of SEC filings; its inclusion would "crowd out" more relevant information and factors. (3) The additional factors would tend to either be short and formulaic, or excessively lengthy, and therefore unusable for the reader. (4) Disclosure of CAMs would likely be misunderstood by an inexperienced user that is not familiar with the audit process and does not have the context that both management and the company's audit committee possess.

Because the CAMs have been either resolved, or if not have been disclosed in a modification of the report or a scope restriction, it is uncertain what value is provided and to whom. We therefore believe it will not be useful. Although the information might be desired by a minority of users, and some investors would prefer as much additional data as possible, we do not believe such extra data would be relevant, or that the auditor's report would be the best place for it. It is not the auditor's responsibility to the reader to share the substance of the audit, especially if paired with responses and procedures, with the investor. We believe that management should be disclosing and discussing the critical aspects of a Company's business that would also be critical audit areas by nature and generally has more flexibility in doing so. The Board should not require the auditors to assume the responsibility of management.

We are not aware of other alternatives that should be considered.

11. **What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

This section of the auditors' report could become very lengthy and time consuming to prepare, adding to costs. It could also become too lengthy and needlessly technical and therefore become confusing. Complex audit engagements typically have various critical audit areas. To require a discussion of such matters in the auditors' report could transform the auditors' report into a version of the registrants' forepart. Any audit is subject to more than one valid approach; such approaches could result in different critical audit areas or different definitions of those areas. Reporting has been down this road before with the "long form" audit report, which has long been discredited and dropped from use. It would be undesirable return to the "long form" audit report.

As noted above, if the CAMs have already been addressed and resolved, then we believe the relevance of the additional disclosure in the auditor's report is doubtful. If the matter is resolved, it is unclear what inference a user should draw from the inclusion of resolved matters?

CAMs and their disclosures are the responsibility of the registrant. The auditors' responsibility is to conduct their audit, address the critical audit matters and render their opinion. Inherent in the auditor's opinion is the fact that their audit sufficiently addressed these matters. In addition, the presentation of the areas that the auditor determined to be critical is also subjective and would likely generate unwarranted criticism/second-guessing from others. The time required to complete an engagement would also be lengthened due to the proposed expanded content of the auditor's report within the existing very tight filing deadlines.

As noted above, there is a difference between data and facts. Piling everything that any interest group believes would be useful into the auditor's report makes the report longer, but not necessarily better.

The proposed requirement to disclose CAMs could be expected to result in a large increase in frivolous litigation.

The probability of such additional exposure could be expected to result in over-reporting of critical audit matters, which would make the report less user friendly and usable.

12. **(a) Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? (b) Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? (c) Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

(a) No. It is too subjective. The Board appears to have made a good faith effort to limit the disclosure to those CAMs that would be discussed with the audit committee, however, we believe that the additional exposure inherent in this proposal would lead to a much broader inclusion of matters. It is also unclear how inclusion of a critical audit matter in the audit opinion adds any relevant information that would not otherwise be provided by existing disclosure in the financial statements. (b) No. It is by nature subjective and subject to interpretation by the auditor and the user, which cannot easily be resolved through a standard, no matter how refined the definitions. For example, what poses the greatest difficulty will vary by individual and audit team. (c) No.

13. **Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

The time required in reviewing and drafting the additional disclosure, particularly if it needs to be addressed in a defensive manner (see comments on frivolous litigation above) will detract from time better spent addressing the procedures surrounding the audit. This additional time requirement would drain available resources, both of the auditor and the audited entity from the major focus of the audit.

14. **Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

Yes, although the CAMs themselves are highly subjective and subject to interpretation.

15. **Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

No. (a) We wish to remind the Board that audit reporting has been down this road before and the so-called "long-form report" was discontinued long ago. We do not believe this type of format would be considered to be any more useful today. (b) We can't see any benefit to the user; providing such detail could undermine the acceptance of the current "pass-fail" reporting model. (c) The audit procedures performed are proprietary information and do not belong in the auditor's report. Informing the reader of the auditors' procedures is circumventing the audit process. One area in particular that would be affected is the audit for fraud. We should not disclose to a company how we audit for fraud. (d) The individual consideration of specific elements of the audit process could also be construed as forming a de facto separate (or piecemeal) opinion on specific matters, which is prohibited.

16. **Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

Yes, but they are only helpful for internal purposes, in which governing boards have appropriate information and context. They are too subjective for meaningful disclosure to third parties.

17. **Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

No. These matters should be left to the professional judgment of the auditor, and attempts to codify them create more difficulty in allowing the auditor to apply such professional judgment.

18. **Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

    It is sufficiently clear in that an auditor can understand the criteria to be used. It is not sufficiently clear for the purposes of this proposal in that its high subjectivity cannot by nature be overly defined and attempts to do so should be resisted.

19. **Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

    It may contribute to additional consideration, although it would more likely contribute to defensive over-reporting. Excessive disclosure might be added in order to avoid second-guessing in what is by nature a subjective field. Such over-reporting may actually defeat the intent by resulting in the disclosure of information of lesser importance. We are not aware of any further changes the board should make because we believe that the board's intent is already appropriately met under current standards.

20. **Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

    Yes, it is sufficient.

21. **What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

    As previously noted, the additional costs are going to be incurred at the higher level of the engagement team in identifying how to communicate the critical audit matters including the firms' quality control review function. More consideration is going to be focused on auditor exposure. This will include additional time at every level of review, consultation with technical reviewers and possibly with in-house counsel that would not provide additional audit quality. Yes, considerations will be similar in nature for all types of audits, however, more complex audits will be more costly.

22. **What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

We believe additional time spent by management with the auditors regarding the reporting of CAMs could add to the company's cost, the amounts of which would vary depending on the size and complexity of the audit. Management will probably consider this a source of additional risk and unintended consequences.

23. **How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

    Based on the responses to the matters discussed above, we believe audit fees will increase.

24. **Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

    Yes, If CAMs exist and have never been communicated before then communication for all periods presented is appropriate. We believe, generally for recurring audits, that critical audit matters will not vary from period to period. In the case of material non-recurring transactions, there would be a possibility to probability that CAMs might vary between periods.

25. **Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

    The examples are useful to the extent that they describe what the Board has in mind, however we believe that they have two flaws: (1) the examples are too "textbook" and do not provide usable guidance as to what level of disclosure should be made; (2) the examples appear to be de facto piecemeal opinions on specific matters.

26. **What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

    The CAMs are going to differ as they are going to be judgmentally written by different audit firms. There are different, equally valid approaches to any problem, which would result in either different CAMs or different methods of describing them. Audit firms internal policies and standards may also result in different styles of presentation. This would likely make it more difficult for a user to determine what inferences to draw from the additional disclosure. A user could draw inaccurate conclusions that they may not have otherwise drawn. The additional requirements might produce more unintended consequences than benefits. For example, users may derive inappropriate inferences from a long list as opposed to a short list of CAMs. If the CAM has been resolved, it is not relevant, but may be given unwarranted relevance through the added audit report disclosure.

Differences will also exist depending on the type of entity, i.e. industry and complexities, however, this source of difference would not be considered a negative.

27. **What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

Although we believe it is beneficial to report resolved disagreements to those involved in governance, we do not believe it is beneficial to the outside user, who can't put it into the context of the Company's internal operations and controls. We do not believe, for example, that auditors are professionally trained to determine when a "possible" illegal act is "possible"? Many of the Board's examples in the Appendix come close to being piecemeal audit opinions, detract from the "financial statements as a whole" and introduce clutter rather than needed information. If the Board believes its current proposal for reporting CAMs will resolve some undefined problems with the current financial disclosure model, the appropriate remedy is to improve accounting and reporting standards through the appropriate standard setters.

As noted in our responses to several of the Board's previous questions, we believe that reporting CAMs is by nature highly subjective and would be expected to detract from the comparability between similar companies. Since there is no standard or context by which to analyze what is essentially not relevant since the CAMs have been resolved, the effects of reporting such matters may have unintended consequences.

As also noted above, this standard also appears to open the parties to endless frivolous litigation, increasing costs and perhaps resulting in significant defensive over-reporting, resulting in a less usable report.

28. **What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

We would expect expanding the auditor's report to include CAMs will result not only in significant excess litigation that would increase costs without providing any offsetting benefit or protection to the investing public. We are unaware under what authority the Board could mitigate the likelihood of this consequence.

*Questions Related to Section VI Explanatory Language:*

29. **Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

    Yes.

30. **Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

    Yes. No standard can foresee every circumstance. Some scope for judgment should be retained for those cases in which the auditor believes something should be brought to the attention of the user. This is, and should be, used in limited circumstances, not as a normal course of action.

31. **Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

    No. As noted above, this would be similar to discarding our successful common law tradition and trying to replace it with an inflexible legal code. No command and control solution can address a complex and changing landscape as well as allowing some scope for judgment.

32. **Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

    No.

*Questions Related to Section VII Conforming Amendments:*

33. **Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?**

    <u>Amendments to Auditing Standard No. 5</u>

    The "statement that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and PCAOB" is not in and of itself inaccurate or harmful, we believe it is unnecessary and redundant, does not contribute any value and adds only clutter that detracts from the central message of the auditor's report.

The "statement containing the year the auditor began serving consecutively as the company's auditor" does not contribute useful information given the lack of any apparent connection between longevity or lack thereof and quality of the audit.

Amendments to Auditing Standard No. 6

Appear appropriate

Amendments to Auditing Standard No. 7

Appear appropriate

Amendments to Auditing Standard No. 16

As noted above, we believe that these communications do not belong in the auditor's report.

34. **What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.**

Audit fees would increase due to the additional requirements of Auditing Standard 16 and exposure to abusive litigation would increase.

*Questions Related to Section VIII Specific Entities:*

35. **Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?**

No.

36. **Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?**

No. We do not believe that they are appropriate for any audit for the reasons described above.

In addition, the readers of an audit report on broker dealers are much more limited in number as they are generally privately held and therefore there would not be any extended benefits derived from such a requirement. Furthermore, it would be unduly burdensome on the time and cost perspective to the clients and their auditors of such entities.

37. **Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?**

    No. There doesn't appear to be any difficulty or lack of understanding for the affected users here. There is no risk that requires mitigation.

38. **Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?**

    No.

39. **Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?**

    No.

40. **Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?**

    Yes. Broker dealers that are not publicly held should be excluded. Otherwise, all public companies should be treated alike.

***Questions Related to Section X Effective Date:***

41. **Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

    Generally, yes. However, as with most new PCAOB standards, effective dates should be stated as fiscal year ending dates. Occasionally companies change year-ends, or for other reasons report on short periods. For example, the audit of a SPAC for an inception period dated March 1, 2016 to March 15, 2016, would require application of these new standards. As a result, an audit firm's implementation of a new standard could be at different times during the year. When implementing new standards, an audit firm needs to modify its policies and procedures and train its staff on the new requirements. It would be more practical to set effective dates based on a company's fiscal period end, so there is more uniformity with the timing of the implementation.

42. **Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

    Consideration should be given to an earlier date for accelerated filers to allow a lessons-learned year before the higher volume SRC audits come on line.

**<u>Other Information</u>**

The Firm is opposed to the proposed requirement that auditors report on other information as set forth in our response to Question 6 to the PCAOB's Auditor's Report section above.

***Questions Related to Section I Introduction:***

1. **(a) Is the scope of the proposed other information standard clear and appropriate? Why or why not? (b) Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

    (a) The Firm believes the scope of the other information standard is unclear. Much data, including that filed with the SEC, are made available on company websites, in some cases directly, in other cases by a link to the EDGAR database; it appears the former is not covered by the proposed standard, but the latter is; we question whether this makes any sense. And if the "glossy" annual report is partially incorporated by reference, readers will have difficulty sorting out what is covered and what is not; this seems to make little sense.

    (b) The Firm believes the proposed other information standard should be limited to annual reports.

2. **(a) Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? (b) Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

    (a) The Firm believes the proposed other information standard should be restricted to information that is expressly included in the document that includes the audited financial statements. In particular, there will be significant additional costs incorporating forward documents, such as a proxy, or an amended Form 10-K that includes the Part III information. It will be very difficult for auditors to control the process, as clients will not need their audit firm's opinion or consent to be included in the document. As such, it is possible that documents will get filed without the auditor's authorization. Such a requirement should only be implemented with a corresponding amendment to SEC rules to require a formal auditor consent, so that there is a definitive process for documenting and reporting that the auditor has completed its required procedures. Additionally, while there will be added cost and burden on auditors to comply, the users of the financial statements will not likely understand the auditor's involvement with the other information when it is incorporated by reference, so there will be no perceived benefit by the user community.

(b) The Firm believes there are substantial incremental costs associated with requiring the auditor to include other information incorporated by reference within the scope of the proposed other information standard, along with the practical difficulties of identifying such information, which may have changed since the date the auditor's report was issued.

3. **Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?**

The Firm believes that unless the cause of the amendment requires the auditor to update their audit report for information that impacts the amended financial statements, it is not appropriate to apply the proposed other information standard to amended annual reports. To do so would require the auditor to continuously update their audit report which would be unduly expensive.

4. **Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?**

The Firm believes the proposed requirement is unclear. If it means that audited financial statements furnished pursuant to Article 3 are considered "other information," the Firm disagrees with the requirement; audited financial statements should not be considered "other information". Further, reporting on those financial statements is the responsibility of the other entity's auditor; the company's auditor should have no responsibility for them.

In addition, if the "other information" concerning the other entity is interspersed in the document with that of the registrant, identifying which auditor has responsibility for what information could be impractical. Also, it would not be practical for the Article 3 auditor to give any level of assurance, even negative assurance, on information related to the company, and vice versa. Such information should be clearly and affirmatively scoped out of the proposed standards.

*Question Related to Section II Objectives:*

5. **Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?**

   The Firm believes the stated objectives are helpful, but we disagree with the auditor being held responsible for evaluating whether the other information has a material misstatement of fact. Please refer to the Firm's response to Question 6 under the proposed auditor reporting standard.

*Questions Related to Section III Evaluating Other Information:*

6. **Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

   The Firm agrees with the proposed requirement to evaluate the other information for a material inconsistency with the financial statements, but we do not agree with evaluating it for a material misstatement of fact. Please refer to the Firm's response to Questions 6 under the proposed auditor reporting standard, and the Firm's response to Question 5 above.

7. **Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

   The Firm agrees that providing an auditor evaluation may convey greater confidence in the other information. However, the Firm is doubtful the reporting requirement will have any impact on the content of the other information. No additional procedures are necessary or appropriate.

8. **Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?**

   The Firm believes the appropriate standard of materiality to apply in the proposed other information standard is that currently stated in AU sec. 550. Auditors already consider the implications of the SEC's definition of materiality in evaluating the impact of any variances.

9. **Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

The Firm believes the proposed procedures are appropriate for evaluating inconsistency with the financial statements, but they are not appropriate for evaluating any material misstatement of fact. There may be no link between audit evidence obtained and conclusions reached during the audit with the facts included in the other information, so the auditor would have no basis for the negative assurance proposed by the PCAOB. Arguably, since the fact is not within the scope of the evaluation, there is no assurance given, but a reader would then have no way of knowing what facts are subject to assurance and what facts are not.

10. **Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?**

    The requirements set forth in paragraph 4.d. appear clear. However, to the extent recalculation is based on "other audit evidence" a user will not know whether it has been recalculated because the user will not know the content of the "audit evidence."

11. **Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?**

    If the auditors are required to deal with misstatements of fact in the manner proposed, they may feel forced to investigate the validity of facts not subject to audit evidence obtained and conclusions reached during the audit, and the cost of this could be substantial.

12. **Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?**

    The Firm believes the proposed auditor responses under paragraph are appropriate.

13. **Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?**

    The Firm believes the increased cost of implementing the proposed other information standard will be substantial. Also refer to the Firm's response to Question 11. above.

*Questions Related to Section IV Responding to Inconsistencies and Misstatements in Other Information*

14. **Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

The Firm believes the proposed auditor responses are appropriate.

15. **(a) Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? (b) Under what circumstances would such a report be appropriate or not appropriate?**

    (a) No. A material inconsistency is a serious matter. If an auditor is unable to convince management and the audit committee that such inconsistent information be revised, then they should not be permitted to issue an audit report. By allowing the auditor the option of reporting the existence of a material inconsistency, it diminishes the seriousness of the issue. Auditors and management should be required to work out the issues, as is required with respect to an auditor's report (i.e. GAAP exceptions, disclaimers, adverse opinions are generally not acceptable in filings with the Commission).

    (b) It should never be appropriate.

16. **Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

    The Firm believes the proposed responses are appropriate, but this situation creates a real problem. The auditor has no responsibility to investigate what occurs after its report is issued, and it is possible that a client may publish the other information without clearing it with the auditor; this is not unlikely if non-financial personnel are preparing the other information and controls over its release are not followed. As the time between the release of the auditor's report and the availability of the other information increase, the likelihood of inconsistencies increases.

***Question Related to Section V Responding if there is a Misstatement of the Financial Statements Based on Other Information***

17. **Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?**

    The Firm believes the proposed responses are appropriate.

***Questions Related to Section VI Reporting in the Auditor's Report:***

18. **Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?**

As pointed out in the Firm's response under Auditor's Reports Question 6, the scope of assurance given by the auditor when saying they "have not identified any material inconsistency with the financial statements" is very unclear. Among other reasons discussed elsewhere in this letter, the Firm is opposed to the proposed requirement that auditors report on other information.

19. **Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

The Firm believes that if the auditor does not have relevant audit evidence against which to evaluate certain other information (which may be relatively frequent under the PCAOB's proposal), the auditor will need to say so in its report. However, such a statement, which may run to multiple pieces of information, is bound to create confusion to the reader, which is undesirable. This potential for confusion is yet one more reason that the Firm is opposed to the proposed requirement that auditors report on other information.

20. **What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

The Firm does not believe these costs will be significant, and only marginally greater than incurred under the current reporting standards.

21. **Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

The Firm believes there is a real danger that financial statement users will consider any information that the auditor refers to in its report to be "verified," "certified," "approved" or similar terminology, regardless of what the auditor actually says in its report.

22. **Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?**

No, the presumption is reasonable that management will resolve the material inconsistency or material misstatement in the other information.

***Question Related to Section VII Responsibilities of a Predecessor Auditor:***

23. **Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?**

    The Firm believes the proposed responsibilities are appropriate and sufficiently clear.

***Questions Related to Section VIII Other Considerations:***

24. **(a) What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? (b) Would this reporting lead to an unwarranted increase in private liability? (c) Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

    The Firm presents the following responses to the specific questions:

    (a) The expansion of the auditor's report to include other information is likely to expand the risk of the auditor being drawn into private litigation, although perhaps to a lesser degree than the proposed reporting of critical audit matters. Nevertheless, there is some increased risk.

    (b) It could, consistent with our response to (a) above.

    (c) Any steps the Board, or the SEC (possible safe harbor?), could take in considering ways to mitigate the likelihood of increasing the auditor's potential liability under the proposed other information standard ought to be considered.

25. **Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?**

    The Other Information reporting requirements are stated to apply only to annual reports in Exchange Act filings. However, many of those filings are incorporated by reference into Securities Act filings. It is unclear how Section 11 liability can be avoided in this situation.

    We suggest that the PCAOB, possibly with the assistance of the Commission's staff, carefully examine the potential effect on auditor's liabilities under the securities acts and state laws.

*Questions Related to Section IX Conforming Amendments:*

26. **(a) Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? (b) Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?**

    (a) Yes

    (b) No

27. **In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?**

    The Firm believes the Board should require such statements in order to remove a possible ambiguity.

*Question Related to Section X Broker Dealers:*

28. **Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?**

    No, unless the broker/dealer is publicly held.

*Questions Related to Section XI Effective Date:*

29. **Is the Board's effective date appropriate for the proposed other information standard? Why or why not?**

    The Firm recommends the Board establish a tiered effective date for accelerated and non-accelerated filers similar to our response in Question 42 related to the proposed auditor reporting standard. Also see our response to Question 41 regarding the use of fiscal years ending, instead of fiscal years beginning.

30. **Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

    See the Firm's response to Question 29 above.

***Questions Related to Section XII Securities Act Documents:***

31. **Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?**

    The Firm does not believe the application of the proposed other information standard should be extended to other securities act filings containing audited financial statements. For example, in an underwritten offering, the other information external to the financial statements is usually thoroughly vetted by the underwriter and further reporting by the auditor would not add any value.

32. **Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?**

    The Firm does not believe the application of the proposed other information standard should be extended to other Securities Acts filings that do NOT contain audited financial statements, as the basis for reviewing such other information is the financial statements.

    Further, the Firm does not believe any part of the proposal should be limited to Exchange Act filings and not extended to any Securities Act filings.

33. **What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?**

    As we stated in our responses to several questions above, the Board should limit the required other information standard to securities filings that contain the annual report.

<u>Emerging Growth Companies</u>

1. **Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?**

    The proposed standards and amendments should not be applied to EGC's until they are fully effective for accelerated and non-accelerated filers and they have been evaluated for effectiveness. Imposing these complex new reporting requirements on EGCs could make the capital raising process more difficult for them.

2. **Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?**

   No.

3. **Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?**

   No.

4. **Would audits of EGCs be more, less, or equally likely to have critical audit matters?**

   EGC's in a particular industry are no more or less likely to have critical audit matters than established companies.

5. **Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?**

   No.

6. **What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?**

   The Firm cannot distinguish between the cost of implementing the proposed auditor reporting standard or the proposed other information standard between EGCs and established companies. However, it is likely the costs could be higher due to dealing with a newly formed company's need to establish its significant accounting policies and procedures, and may be disproportionately higher because of the relatively smaller size of EGCs.

7. **What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?**

   See the response to Question 6 above.

8. **Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?**

See the response to Question 6 above.

9. **Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?**

   See the response to Question 6 above.

10. **For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?**

    This would not have a significant cost impact for audit firms, as PCAOB audit firms have been maintaining two audit methodologies since the formation of the PCAOB in 2003 (referring to PCAOB audit standards for publicly held clients and AICPA audit standards for non-public clients).

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The Firm would be glad to discuss its comments further should the Board have any questions or require additional information.

Very truly yours,

Marcum LLP

Gregory Giugliano, CPA
Partner-in-Charge of Assurance Services

**GG**/tm

Sent Via Email: comments@pcaobus.org

MasterCard

December 11, 2013

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

Docket Matter No. 034

Members of the Board:

MasterCard Incorporated appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Release No. 2013-005 dated August 13, 2013, "*Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*" (the "Proposed Standard"). We appreciate the Board's efforts to make improvements to the auditor's report by means of endorsing more valuable auditor reporting. However, we have significant concerns over the implications the Proposed Standard would have on the role of the auditor, the responsibility of management to be the source of company-specific information, and the flow of information between a company and its auditor.

**Critical Audit Matters**

The communication of critical audit matters, as determined by the auditor, poses several significant areas for concern. Appendix 5 of the Proposed Standard asserts that auditor communication of critical audit matters could lead to improved financial statement disclosures. We believe that the disclosures as required by the Financial Accounting Standards Board and the U.S. Securities and Exchange Commission ("SEC"), coupled with management's judgment, provide the adequate amount and level of information to investors for decision making purposes. Further, it is management's responsibility to ensure that disclosures are complete, accurate, balanced and in compliance with existing securities laws. We have concern that the Proposed Standard attempts to supplement current disclosure requirements and suggests that those requirements are not sufficient for investors. We do not believe that the auditor communicating critical audit matters, which may be based more in auditing matters, would lead to improved financial statement disclosures. To the contrary, these disclosures could result in investor confusion.

AU 110 *Responsibilities and Functions of the Independent Auditor* states that: "The entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's knowledge of these matters and internal control is limited to that acquired through the audit." The Proposed Standard would require auditors to be the source of information, which raises concern that a third-party is being asked to communicate information that is not within their direct knowledge and control. Further, a third-party may not possess the necessary depth of knowledge, unlike a company's management, to adequately comment on critical matters. Thus, we have serious concern that a third-party would be an originator of company information.

MasterCard

Critical matters are disclosed in management's discussion and analysis and in the notes to the financial statements. We expect that the discussion of critical audit matters would be aligned with that of critical accounting estimates, and therefore auditor disclosure will likely be repetitive in nature. However, the communication of critical audit matters creates the potential for inconsistent identification of matters as the determination of a critical audit matter could be influenced by the audit partner or audit firm. The Proposed Standard may also have the unintended consequence of shifting the ultimate decision of disclosure from a company to the auditor based on audit report communication. Further, it is also not evident how investors would utilize and benefit from the disclosure of critical audit matters. Therefore, the disclosures may lead to investor confusion, which would directly conflict with the objective of the Proposed Standard.

We also have concern that the Proposed Standard will have a negative impact on the current, open dialogue that exists between management, auditors and audit committees. Specifically, if certain discussions would trigger auditor external reporting requirements, it is logical to believe that such future discussions would exclude the auditor. This unintended behavioral consequence will likely negatively impact the quality of the audit, contradicting the intention of the PCAOB.

**Other Information**

We anticipate that there would be significant incremental audit procedures required by the audit firms in order to evaluate the other information and communicate on such under the Proposed Standard. These additional procedures will prove to be costly to companies given the comprehensive scope of other information, including forward-looking statements. Considering the audit firm is not required to audit or express an opinion on the other information, we do not believe the cost of adding to the current level of requirements exceeds any perceived benefit.

**The Auditor's Responsibility for Fraud**

We recognize that the additional language in the Proposed Standard, "whether due to error or fraud", is not intended to modify the auditor's existing responsibilities with respect to fraud. However, the inclusion of such language raises concern that investors will perceive auditors to provide more than a reasonable assurance against material fraud. This perception may result in an increased legal and financial risk to auditors. Further, auditors may choose to increase sample sizes beyond a statistical benefit in order to mitigate perception risk, impacting the cost of an audit.

We appreciate the opportunity to provide comments on the Proposed Standard. If you have any questions, please contact me at (914) 249-5222.

Sincerely,

Andrea Forster

Andrea Forster
Corporate Controller, Principal Accounting Officer
MasterCard Incorporated

cc: Steven J. Freiberg, Director, MasterCard Incorporated
Mark Schwartz, Director, MasterCard Incorporated
Paul Beswick, Securities and Exchange Commission

Maxim Integrated Products, Inc
160 Rio Robles
San Jose, CA. 95134
Sent via email to: comments@pcaobus.org

Re: PCAOB Release # 2013-005 dated August 13, 2013
PCAOB Rulemaking Docket Matter # 034

Maxim Integrated Products, Inc. is pleased to submit its views in response to the PCAOB's most recent request for comments on the two recent proposals – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "proposed auditor reporting standard") and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (the "proposed other information standard").*

While we appreciate the PCAOB for its solicitation of comments to address the issues discussed in PCAOB Release # 2013-005 and in its goal of trying to improve the auditors' report, we believe that the required disclosures have the potential to confuse investors by blurring the roles between the auditors, management, and the audit committee. Additionally, we believe that the proposed standard would significantly increase audit costs while providing little added context for investors. We, therefore, do not support the two new auditing standards proposed in PCAOB Release # 2013-005.

Specifically, we believe the requirement in the proposed auditor reporting standard that the auditor communicate in the auditor's report "critical audit matters" may cause confusion among investors. The company already discloses and comments on critical accounting policies and judgments in its Form 10K filings, which our auditors review and have the opportunity to provide comment. Under the proposed auditor reporting standard, a critical accounting policy item discussed by management in Management's Discussion and Analysis (MD&A) might be discussed within the auditor's report because it requires significant judgment while another critical accounting policy might not be discussed due to a lack of significant judgment. Investors may not understand the nature of why one item was disclosed while another item was not and might draw unwarranted inferences. Deciding what would be discussed and not discussed by the auditors in its audit report in the area of "critical audit matters" would in itself require judgment which in our opinion lessens the value of the auditor's report, as investors would have to read between the lines in trying to ascertain why certain audit policies were discussed in the auditor report and others were not.

In addition, we believe the requirement in the proposed other information standard to expand the auditor's report to include financial information outside of the financial statements, such as the MD&A, may also confuse investors and create questions as to who is ultimately responsible for the financial statements. We believe the Sarbanes-Oxley Act made it very clear to investors that management is ultimately responsible for the accuracy of the financial statements and that the auditor's role is clearly limited to the attestation function. To require an auditor to expand its audit report to evaluate and comment on such information will likely add substantially to the costs of audits as there would be significant time spent within the audit firm on what should be disclosed, and subsequent discussions with management to ensure that the company's disclosure and auditor's report contain consistent and substantially similar information.

We would like to thank the PCAOB for the opportunity to comment on the recent proposal and want to reiterate that we do not support the proposals contained in Release 2013-005.

Sincerely,
Joseph R. Bronson
Audit Committee Chairman
Maxim Integrated Products, Inc.

Mayer Hoffman McCann P.C.
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December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 34

Proposed Auditing Standards –

1. The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;

2. The Auditor's Responsibility Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.

Mayer Hoffman McCann P.C. ("MHM") is pleased to provide the PCAOB (or "the Board") its comments on the above referenced proposed auditing standards. The PCAOB's desire to evaluate the auditor's reporting model is certainly understandable given that the current reporting model has remained in place without significant change for several decades.

We agree with the Board's decision to retain the current "pass/fail" reporting model. Our comments are directed at the Board's decision to significantly expand the auditor's reporting responsibilities, specifically the requirement to disclose in the auditor's report certain "critical auditing matters" as determined by the auditor and the auditor's responsibility for other information.

**Disclosure of Critical Auditing Matters**

We believe that a significant reason the current auditor reporting model has stood the test of time is that it conveys to investors the auditor's opinion on the financial statements in a concise, straight forward manner. We are concerned that the proposed additions to the auditor's report (i.e., critical auditing matters) may produce unintended consequences that are not wholly desirable.

While we understand the desire to provide investors with additional "color" related to the current pass/fail model; it is entirely possible that such information will prompt investors to interpret the additional information disclosed by auditors in a manner inconsistent with the actual meaning of the auditor communication. For example, does the disclosure of a significant number of critical audit matters infer something "bad" is happening with an entity's financial reporting? There are many aspects of an entity's financial reporting process that while routine in nature retain a high degree of complexity and subjectivity. Will these be disclosed as critical auditing matters? If so, will investors understand that nothing out of the ordinary was identified by the auditor? Will investors try to compare audit reports across companies and industries and reach conclusions that cannot be supported based on the subjective nature of the proposed auditor communication, which are almost always dependent on a set of facts and circumstances unique to the company and audit engagement. Our observations are not intended to ignore the possibility that in many cases the additional proposed disclosures might be useful to investors. However, we want to voice our concern that in some cases the information disclosed by auditors will have the potential to be misunderstood by investors, thereby greatly diminishing the value of the communication or leading to unintended consequences. The subjective nature of critical auditing matters leads to other operational concerns within the existing regulatory environment. For example, how will the PCAOB evaluate decisions about what to include in the auditors' report? How will the PCAOB determine and describe its conclusion during the inspection process if it disagrees with the decisions of an engagement team? Additionally, how will the Board ensure that its interpretations are consistently applied given that each firm may address audit matters differently, even with the same set of circumstances (i.e., choose different things as critical audit matters or go into more or less detail about such issues, etc.)?

The matter of legal liability must also be considered when evaluating the Board's proposed auditing standards. Some commentators have suggested that the disclosure of critical audit matters will serve as a road map to the "plaintiff's bar" when an auditor's work is subject to regulatory and/or legal action. Auditors will have to carefully evaluate which matters to disclose and choose the appropriate wording that best reflects the facts and circumstances underlying the critical audit matter. Firms will by necessity involve their most senior and technically proficient audit and legal professionals in the drafting process. The amount of dialogue between the auditor, management and the audit committee will likely be significant. Some firms may resort to "boiler plate" disclosure while others may include everything "under the sun" in an attempt to deal with regulatory and legal risk. The combination of these factors leads us to believe that the cost related to the disclosure of critical audit matters is almost certain to be significant, while the actual benefit to investors may prove difficult to accurately determine. Additionally, we believe the proposed reporting requirements will likely place additional strain on both the auditor and management with respect to meeting existing reporting deadlines.

The proposed changes to the auditor's reporting model may imply that the auditor could, or even should, provide information to investors not previously made available to investors by management. The auditor's role has always been to verify information prepared by management as opposed to becoming a source of new information for investors. Is it possible that investors might try to use information coming from the auditor in a manner inconsistent with its intended use, thereby altering the role and function of the auditor? For example, determining the existence of critical audit matters requires the auditor to consider the severity of control deficiencies identified relevant to the matter, if any. This could imply the auditor discloses internal control deficiencies at a level below a material weakness, where management has no requirement to do so. We respectfully ask the Board to clarify that it does not intend for auditors to "grade and report" internal control deficiencies through the communication of critical audit matters, when existing auditing standards that apply to the audit engagement do not require the auditor to do so.

We note that in the examples provided by the Board to illustrate the determination of critical audit matters, the Board chose to describe certain auditing procedures related to the critical audit matter. It is not clear whether the Board intends the auditor to provide a description of the auditing procedures related to the critical audit matter. We believe the inclusion of detailed auditing procedures in the auditor's report will be operationally difficult, distracting to investors, and may add significant volume to the auditor's report that does not provide a significant benefit to most investors. If the PCAOB believes that auditors should describe the auditing procedures related to the underlying critical audit matter, we request that the PCAOB clarify their expectation related to describing audit procedures and provide a sufficient number of examples to help auditors understand the expectation.

**Other Information**

With respect to the Board's proposal on "other information" we are principally concerned with two major items. The first is the possibility that an "expectation gap" will exist whereby investors believe that they have some form of audit assurance related to other information simply because the auditor is required to make an assertion about it in the auditor report. The second is the increase in cost related to the audit engagement that is virtually certain to occur under the current proposal. While some firms may already perform procedures related to other information (as a form of best practice), the inclusion of an assertion related to such procedures in the auditor's report is likely to prompt more rigor in both the procedures themselves and the documentation of the procedures performed related to other information. We note that both an "expectation gap" and an increase in costs occurred when the CEO and CFO certifications were implemented several years ago, as part of the Sarbanes Oxley Act of 2002.

We are also concerned with the meaning of the term "evaluate" used in the proposed standard on other information to describe the procedures required of auditors. The term "evaluate" could infer that an auditor needs to do whatever is necessary to reach a conclusion about the other information, as opposed to performing a standard set of procedures. We ask the Board consider whether the term "evaluate" is precise enough in its meaning to appropriately describe the Board's expectation of auditors under the proposed auditing standard on other information.

There are other matters that may create operational difficulties for auditors, for example, what responsibility does an auditor have for other information not derived from the accounting systems and internal controls over financial reporting that are the subject of the audit? There are typically a number of statements made by management in the annual report that are highly subjective in nature. While we understand the Board expects auditors to work through such matters by engaging in conversation with management, such activities will certainly contribute to the overall cost of implementing the standard given that subjective judgments are often selected by regulators and plaintiff's attorneys as potential issues to challenge.

**Disclosure of Auditor Tenure**

We do not believe the disclosure of the auditor's tenure is particularly relevant and therefore we question its value to investors. We note that many commentators have noted the lack of empirical evidence that establishes a direct correlation between auditor tenure and audit quality. We are also concerned that disclosure of auditor tenure in the auditor's report may be interpreted by investors as implying a problem with auditor independence when none exists. We believe the appropriate place for the disclosure of the auditor's tenure is the Company's proxy statement.

In closing, we note that recently the PCAOB reproposed an amendment to its auditing standards that would provide greater transparency to audits of public companies and broker-dealers about the engagement partner and certain other participants in the audit. Because this proposed amendment also impacts the auditor's report, we respectfully recommend that the timing related to the issuance of a final auditing standard pertaining to the proposed standards noted in number one and two above be delayed until the PCAOB concludes the process related to its auditor transparency standard. This allows for a one-time change to the auditor's report that encompasses all of the PCAOB's identified changes as opposed to a multi-step process.

Finally, while we acknowledge and support the Board's desire to improve audit quality; we are concerned that ultimately the improvements that arise from the proposed auditing standards will be outweighed by the financial cost necessary to achieve the benefit. We encourage the Board to carefully study the cost/benefit relationship related to these proposed auditing standards before the issuance of the final standards.

Sincerely,

Mayer Hoffman McCann P.C.

Blythe J. McGarvie
3025 River Oaks Road
Williamsburg, VA 23185

December 4, 2013

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
Sent via email to: comments@pcaobus.org

Regarding: PCAOB Release No. 2013-005 August 13, 2013
PCAOB Rulemaking Docket Matter No. 034

Dear PCAOB Board Directors,

I attended the National Association of Corporate Directors annual conference in October 2013 and subsequently, at a private meeting, listened to Jeanette Franzel explain the work the PCAOB is doing. I thank you for your time and the desire to seek comments from members of board of directors. I would like to submit my views in response to your request for comments on your two recent proposals. I have served on corporate boards for 15 years and currently chair the audit committees for Viacom Inc. and LKQ Corporation. I was the audit committee chair for Accenture from 2001 to 2011 and currently serve as a committee member.

There are two parts of the proposal I find most troubling:

- The proposed requirement that an auditor report on "critical audit matters" that are specific to each audit. These matters are defined in the proposal as those that (1) involved the most difficult, subjective or complex auditor judgments; (2) posed the most difficulty for the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements.

- The proposal to enhance the auditor's responsibility with respect to other information outside the financial statements.

Critical Audit Matters ("CAMs")

As I understand the proposed standard, the auditor is being asked to report on many matters that are already extensively disclosed in Management's Discussion and Analysis (MD&A) and financial statement footnotes. Auditor reporting on CAMs would be expected to overlap with, but also could be different than, the critical accounting policies disclosed by management of the company in the MD&A.

Auditor disclosures would also include information on the execution of audit procedures. I do not believe that users of financial statements would benefit from this repetitive disclosure in the audit report, and the additional disclosures may create confusion or lead to a misinterpretation about what the auditor's assessment actually covers. As a result, this requirement will not improve the overall quality of available financial information included in annual reports.

In addition, I believe transparency and open communication between the auditors and an audit committee will be harmed if the auditors are required to report on CAMs (and to explain why they have not reported on potential CAMs). Audit committee members review critical accounting policies and procedures regularly. But, CAMs can be very different in that they relate to the execution of audit procedures, and should be addressed in an open and candid manner initially between the auditor and the company management, followed by a report to audit committee members. Inclusion of CAMs in the audit report suggests a usurping of the role of the audit committee, who are entrusted by shareholders of public companies with the fiduciary responsibility of overseeing the relationship with a company's external auditor. In order to be most effective, the participants in these discussions must not be distracted by or concerned with the possibility of public disclosure and the consequences of such disclosures. I think there is a danger that plaintiff attorneys, analysts and others would review CAMs and second guess complicated and nuanced decisions about how to explain financial results most clearly. As a result, I worry that in order to avoid being second-guessed in the future, auditors will either (1) not raise certain matters with management or the audit committee, or (2) begin to include more (rather than fewer) CAMs in their reports, leading reports to be too lengthy and complicated to be useful. Neither of these results is beneficial to stockholders.

The auditor can best serve the public by objectively verifying the information a company presents in its financial statements and working with the company management to craft disclosures that can be part of the MD&A as well as the extensive footnotes which are an integral part of the financial statements. As a senior lecturer at Harvard Business School, I teach the Financial Reporting and Control class to first year MBA students. This 30-session course covers many aspects of business, particularly using cases that may appear to have "gray" areas in accounting and management decisions. I teach my students to read financial statement footnotes to really understand what is occurring and may occur with a company's financial results. Having an auditor opine on, disclose and re-frame vaguely-defined issues such as CAMs may obfuscate the real purpose of a public company auditor: expressing an opinion as to whether the overall financial statements are fairly presented. Keep the responsibility of accurate disclosure with the CEO and CFO who have responsibility for public filings through their written certifications required by Sarbanes-Oxley, which are strong incentives already in place to discourage inappropriate behavior and give regulators the ability to hold individuals accountable for their actions.

Auditor's Responsibilities Regarding Other Information

The requirements of Sarbanes-Oxley, including Section 404, have served us well. However, auditors' costs have increased as they spend time evaluating and commenting on other information to more effectively comply with Sarbanes-Oxley. The auditor should continue to focus on the attest function, but we must conduct a realistic cost-benefit analysis of additional work being asked of auditors. I think expanding their role as suggested by the proposal will create extra costs without extra benefit to financial statement users. Auditors already have an obligation to read and consider other information included in a company's annual report. Creating additional procedures and reporting requirements around this information does not appear to be solving any identifiable problem that exists with the current standard and is not a cost-effective way of increasing the adequacy and transparency of information included in annual reports. The responsibility for financial reporting, including this other information, should continue to be the responsibility of management. Auditors should continue to have the obligation to review the information for any material inconsistency; the existing standard already provides the auditor with procedures to respond to any material inconsistency. The last thing we should do is shift responsibility for financial reporting away from management and to the auditors.

Sincerely,

Blythe J. McGarvie

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McGladrey

December 10, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

McGladrey LLP appreciates the opportunity to offer our comments on PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Auditing Standards*. McGladrey LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We strongly support retaining the existing pass/fail model of auditor reporting, and also support the PCAOB's objective of enhancing the auditor's report with more disclosure. The disclosure of critical audit matters would provide investors with more information than previously provided in the auditor's report. However, we have concerns whether the additional information would provide investment-decision-useful information. We are also concerned that the proposed standard has the potential to fundamentally alter the roles of management and the auditor. We believe management's role is to prepare the financial statements, and the auditor's role is to provide reasonable assurance that the financial statement information communicated by management is presented consistently with the applicable financial reporting framework. We believe the proposed requirements to communicate critical audit matters in the auditor's report need to be modified so as to not significantly alter these two roles.

We support transparency in the auditor's report with respect to the auditor's responsibilities related to other information but are concerned that, if adopted as proposed, the standard may lead to confusion as to the level of assurance provided by the auditor as it relates to other information. Further, we believe the proposed additional "evaluation" procedures beyond the current "read and consider" approach in PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements,* will simultaneously increase audit costs and further broaden the expectation gap between the users' understanding of the auditor's role and the auditor's actual performance when conducting an audit.

Our letter further explains enhancements that could be made to the proposed standards, and includes comments related to specific paragraphs of the proposal that we believe should be clarified or modified.

## Proposed Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

### Critical Audit Matters

*Determination of Critical Audit Matters*

Paragraph 8 of the proposed auditor reporting standard states that critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (a) documented in the engagement completion document; (b) reviewed by the engagement quality reviewer; (c) communicated to the audit committee; or (d) any combination of the three.

Due to the level of subjectivity and/or complexity involved with such matters, we are concerned that users of financial statements may not have sufficient context to understand a brief description of such matters. Further, providing all of this information to financial statement users who do not have sufficient context could diminish the governance role of the audit committee which does have sufficient context for evaluating critical audit matters. There also is a possibility that the communication between the auditor and the audit committee could diminish if every matter discussed with the audit committee was required to be included in the auditor's report.

We believe that any new standard should not diminish the role of the audit committee. Accordingly, the auditor should not communicate a matter in the auditor's report that was not required to be communicated to the audit committee. Therefore, we believe the only source of critical audit matters should be matters required to be communicated to the audit committee in accordance with PCAOB Auditing Standard (AS) No. 16, *Communications with Audit Committees*. We would not, however, expect all communications with the audit committee to necessarily be included as critical audit matters. Instead, the critical audit matters communicated in the auditor's report should be a subset of matters communicated to the audit committee.

Among other objectives, AS 16 is intended to provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process. The requirements of AS 16, including those results of the audit that are significant to the financial reporting process, were thoroughly scrutinized by the PCAOB, having initially been proposed and the subject of a roundtable in 2010 and then reproposed in 2011 prior to being issued in 2012. After this thorough vetting process, the PCAOB issued AS 16 in 2012 stating, "Communications between the auditor and the audit committee allow the audit committee to be well-informed about accounting and disclosure matters, including the auditor's evaluation of matters that are significant to the financial statements, and to be better able to carry out its oversight role."[1] The auditor's required communications with the audit committee, therefore, are the most logical starting point for the auditor to discern which matters are to be considered critical audit matters worthy of public disclosure in the auditor's report. Therefore, we believe paragraph 8 should be revised to read as follows (proposed deletions are struck through):

8. Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be ~~(1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3)~~ communicated to the audit committee~~; or (4) any combination of the three~~.

However, a requirement to communicate *all* matters communicated to the audit committee as critical audit matters would limit the auditor's ability to discern which of those matters are truly *critical* audit matters for purposes of communication in the auditor's report. Therefore, after reviewing the matters communicated to the audit committee, the auditor should then be required to determine which of those matters would be the critical audit matters to be communicated in the auditor's report. The auditor's decision-making process should be designed to select the critical audit matters, from the matters communicated with the audit committee, based on the auditor's judgment about which matters were of most significance to the audit. Therefore, we suggest the beginning portion of paragraph 9 be revised to read as follows (proposed deletions are struck through, and proposed additions are shown in bold font):

9. **The auditor's decision-making process should be designed to select the critical audit matters, from the matters communicated with the audit committee, based on the auditor's judgment about which matters were of most significance to the audit.** Certain factors might

[1] PCAOB Release No. 2012-004, page 2.

affect whether a matter ~~addressed during the audit of the financial statements~~ **communicated to the audit committee** (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. In determining…

*Communication of Critical Audit Matters*

Paragraph 11.b. of the proposed auditor reporting standard would require that for each critical audit matter communicated in the auditor's report the auditor must describe ***the considerations*** that led the auditor to determine that the matter is a critical audit matter (emphasis added). This required description of the considerations regarding a critical audit matter could require the auditor to disclose information about the audit or the financial statements that otherwise would not be required to be disclosed by the auditor under existing auditing standards or by the company under requirements of the applicable financial reporting framework or securities laws and regulations. Examples of such disclosures might include:

- Communication of a significant deficiency in internal control over financial reporting that was not determined to be a material weakness. Under applicable securities laws and SEC regulations, depending on the circumstances, a company may not have to disclose a significant deficiency, but the critical audit matter description in the audit report could cause that information to be disclosed.

- A difficult decision by the auditor regarding a company's ability to continue as a going concern even though the auditor's ultimate decision was that substantial doubt did not exist. Current standards expressly require the use of the phrase "substantial doubt about the entity's ability to continue as a going concern" whenever the auditor has reached that conclusion. The current standards also prohibit conditional language, such as, "If the company continues to suffer losses, there may be substantial doubt about its ability to continue as a going concern." Disclosure of a critical audit matter that describes considerations such as "possible future losses" would be inconsistent with current standards and could result in confusion for investors.

We do not believe it is appropriate for the auditor to be the source of original information about the entity. Both of the examples in the preceding two paragraphs would violate this principle. In addition, the auditor may need to obtain the client's permission to disclose confidential information to remain in compliance with the AICPA Code of Professional Conduct, which is included in the PCAOB's interim ethics standards.

Further, the requirement to disclose all considerations that led the auditor to determine that the matter is a critical audit matter could lead the auditor to disclose certain audit procedures, which, in turn, could compromise audit effectiveness. For example, one matter that could pose difficulty to the auditor in obtaining sufficient appropriate evidence is in the performance of auditing procedures related to revenue recognition that are responsive to the risks of fraud.

We believe the auditor should only be required to describe the *primary* considerations (*i.e.*, not all considerations) that led the auditor to determine that the matter is a critical audit matter so as to not require disclosure of audit procedures that could compromise audit effectiveness. Therefore, we believe paragraph 11.b. should be revised to read as follows (proposed addition is shown in bold font):

b. Describe the **primary** considerations that led the auditor to determine that the matter is a critical audit matter; and

*Documentation of Critical Audit Matters*

Paragraph 14 of the proposed auditor reporting standard requires audit documentation to contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis of the auditor's determination that non-reported audit matters addressed in the audit that *would appear to meet the definition of a critical audit matter* were not critical audit matters (emphasis added). We believe the "would appear to meet the definition of a critical audit matter" criterion is too ambiguous to apply in practice and could cause auditors to include more critical audit matters in their reports than they would without this requirement.

Including more critical audit matters in the auditor's report could dilute the importance of the critical audit matters that are communicated and may leave the user with more questions than answers. There also is a risk the financial statement user will infer that, by disclosing numerous critical audit matters, the auditor's report is providing more assurance on the critical audit matters than on the financial statements taken as a whole.

If the source for critical audit matters was those matters communicated to the audit committee as we suggest above, the second sentence of paragraph 14 could be revised as follows (proposed deletions are struck through, and proposed additions are shown in bold font):

> To provide sufficient detail for a clear understanding of the conclusions reached regarding the determination of critical audit matters, the audit documentation must contain sufficient information to enable an experienced auditor, having no previous connection with the engagement, to understand the basis for the auditor's determination that (1) each reported matter was a critical audit matter and (2) non-reported audit matters ~~addressed in the audit that would appear to meet the definition of a critical audit matter~~ **communicated to the audit committee** were not critical audit matters.

**Basic Elements**

*Source of Auditor's Independence Requirements*

Paragraph 6.h. of the proposed auditor reporting standard requires the auditor to include a statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB. We believe the quality of an audit that inspires investor confidence is built on the integrity, competence, objectivity and independence of our profession, so it is logical that the source of the auditor's independence requirements would be disclosed in the auditor's opinion.

*Auditor Tenure*

In 2011, the PCAOB issued Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation,* to seek comment on the advantages and disadvantages of mandatory audit firm rotation, among other matters. Because auditor tenure continues to be a topic of PCAOB discussion and the subject of academic research, we believe the concept of auditor tenure and mandatory audit firm rotation should be addressed in that context separately from any other proposed auditing standard.

Paragraph 6.i. of the proposed auditor reporting standard, however, requires the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. We are not supportive of including auditor tenure in the auditor's report for the reason discussed in the preceding paragraph and because it is unclear what a user should infer from such a disclosure. Disclosure of auditor tenure also has the potential of distracting the user from more relevant information in the auditor's report. Further, investors who are interested in information about auditor changes can obtain relevant information publicly.

If the PCAOB decides to retain the requirement for the auditor to disclose auditor tenure, we strongly believe the illustrative auditor's report on pages A1-15 and 16 should be revised to include the disclosure as the concluding sentence in the illustrative auditor's report. Including it in the same paragraph as the source of the auditor's independence requirements could cause investors and analysts to conclude that there is nexus between independence and auditor tenure when there is no empirical evidence to suggest that there is. Also, if the PCAOB decides to retain the requirement for the auditor to disclose auditor tenure, we suggest the following guidance from page A5-16 of PCAOB Release No. 2013-005 be included in paragraph 6.i. of the proposed auditor reporting standard:

> **In determining the year the auditor began serving consecutively as the company's auditor, the auditor would look to the year beginning when the firm signs an initial engagement letter to audit a company's financial statements or when the firm begins the audit, whichever is earlier.**

*Certain Auditor Responsibilities*

Paragraph 6.m. of the proposed auditor reporting standard requires the auditor to include the phrase "whether due to error or fraud" at the end of the statement describing the auditor's responsibilities to obtain reasonable assurance about whether the financial statements are free of material misstatement. Also, the proposed standard would require the auditor's report to include a statement that an audit includes performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. We support the proposed clarifying language to be added to the auditor's report regarding these auditor responsibilities.

**Order**

Footnote 35 to paragraph 16 requires the explanatory paragraphs follow the opinion on the financial statements. Footnote 21 to paragraph 11 requires the critical audit matters section follow the opinion on the financial statements section and any explanatory paragraphs. We believe these requirements should be included in the actual standard, rather than in the footnotes.

**Cost**

Paragraph 7 of the proposed auditor reporting standard requires the auditor to determine whether there are any critical audit matters in the audit of the current period's financial statements *based on the results of the audit or evidence obtained* (emphasis added). Although the auditor's determination of critical audit matters is to be based on the audit procedures already performed, substantial additional effort will be required to determine which matters are and are not critical audit matters, to document that determination, and to draft the communication of critical audit matters. The reporting of critical audit matters in the auditor's report will involve the exercise of seasoned professional judgment by the most senior professionals assigned to the engagement, such as the engagement partner and the engagement quality reviewer, and could involve others, such as national office consultants. The expenditure of additional time ultimately will be reflected in increased costs for the auditor and increased audit fees for the company.

Additional time also will be incurred by management and the audit committee in reviewing critical audit matters in the draft auditor's report and in the related discussion with auditors and others. Further, audit committees and management could spend additional time comparing their auditor's report to the auditors' reports of similar companies. Audit committees also may wish to disclose their own view of the critical audit matters in their report to investors together with the steps they took to mitigate the risks involved.

Even though comparability regarding the pass-fail model will continue to be maintained, the communication of critical audit matters in the auditor's report that is specific to the audit of the company's financial statements could make the auditor's report less comparable among companies. Management and the audit committee might be concerned about investors' and other financial statement users' perceptions when the disclosure of critical audit matters in their audit report is different in number and/or content than the disclosure of critical audit matters in the audit reports of their competitors. Also, the company might be concerned about investors' and other users' perceptions of the potential differences between the company's current-period critical audit matters and those of prior periods.

The requirements in the exposure draft could cause companies to incur another type of cost – reduced timeliness of financial statement issuance. Under the current auditor reporting model, little time is devoted to review of the auditor report to be included in the annual report. The introduction of the disclosure of critical audit matters will require more extensive review by the auditor, management, the audit committee, and the company's legal counsel. The effort required to determine, draft the communication of, and document critical audit matters likely would occur during the final stages of the audit, which places added pressure on completion and review of the audit to meet filing deadlines. The compression of work by both management and the auditor during the final stages of the audit may adversely impact the quality of financial reporting. This may be particularly burdensome for smaller reporting companies, most of which historically need all of the time available up to the reporting deadline for financial reporting.

We believe the PCAOB should discern whether investors, who have indicated they would benefit from additional auditor reporting, would deem such benefit to outweigh any impact on the timeliness of the information and the substantial additional costs, both in terms of dollars and time, that would be incurred to comply with the requirements as proposed. Our firm is one of several public accounting firms that are field testing the implementation of these proposed standards to directly assess the impact on various aspects of the audit, including, among others, the additional involvement of senior audit partners, the efforts that would occur during the final stages of the audit, and the cost to the client. We believe the results of the firms' field tests should be carefully evaluated before concluding that the benefits of the additional disclosures outweigh the costs and the impact on timeliness of information.

**Scalability**

We do not believe the proposed disclosure of critical audit matters would be scalable based on the size of the company. Smaller companies often do not have the same level of sophistication in terms of information technology systems or financial reporting professionals as larger companies are able to have. This lack of sophistication can cause the auditor to need to make more difficult, subjective, and complex auditor judgments and also can pose more difficulty to the auditor in obtaining sufficient appropriate evidence. All of these matters need to be discussed with the audit committee in accordance with AS 16 and therefore are the population from which critical audit matters will be determined. For these reasons, we believe auditors' reports on the financial statements of smaller reporting companies may be required to include a disproportionately higher number of potential critical audit matters than those of accelerated filers. Therefore, we recommend audits of the following entities be excluded from the requirement to communicate critical audit matters in the auditor's report:

- Smaller reporting companies
- Emerging growth companies
- Nonissuer broker dealers
- Futures commission merchants
- Employee benefit plans

We also believe it would be prudent to provide a two-year extension for the effective date of the proposed standard for audits of nonaccelerated filers. This would allow for more efficient implementation of the standard in audits of nonaccelerated filers because initial implementation issues could be resolved, and related costs would be absorbed, by issuers with the most sophistication and the largest economic footprint.

## Proposed Standard, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*

### Scope

The note to paragraph 1 of the proposed other information standard states that when the annual report is a Form 10-K, other information includes information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K. We believe that scoping in other information that is not available by the date of the auditor's report creates a responsibility for the auditor that extends beyond the date of the auditor's report, which contradicts existing guidance in paragraph 10 of PCAOB AU 560, *Subsequent Events*. Such a requirement also contradicts existing guidance in paragraph 15 of AS 3, *Audit Documentation,* which states, "Prior to the report release date, the auditor must have completed all necessary auditing procedures and obtained sufficient evidence to support the representations in the auditor's report." Further, scoping in other information that is not available by the date of the auditor's report could cause the auditor to be unable to assemble for retention a complete and final set of audit documentation as of a date not more than 45 days after the report release date as required by paragraph 15 of AS 3.

We believe other information issued after the date of the auditor's report should be excluded from the scope of the auditor's responsibilities for other information. We also believe documents filed as exhibits to an annual report should be excluded from the scope of the auditor's responsibilities for other information because those documents that are relevant to the financial statements and auditor's report would have already been subjected to audit procedures during the audit of the financial statements. Therefore, we suggest the note to paragraph 1 be included as the second sentence in the body of paragraph 1 after being revised to read as follows (proposed deletions are struck through and proposed additions are shown in bold font):

> For purposes of this standard, other information in an annual report that is filed with the SEC under the Exchange Act includes information, other than the audited financial statements and the related auditor's report, contained in the annual report and also includes ~~(1)~~ information**, other than exhibits,** incorporated by reference in that annual report that is available to the auditor prior to the issuance of

the auditor's report ~~and (2) when the annual report is a Form 10-K, information incorporated by reference from the company's definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K~~.

**Evaluating the Other Information**

Paragraph 4 of the proposed other information standard requires the auditor to read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate the:

a. Consistency of amounts in the other information, and the manner of their presentation, that are intended to be the same as, or to provide greater detail about, the amounts in the financial statements, with the amounts in the financial statements and relevant audit evidence;

b. Consistency of any qualitative statement in the other information, and the manner of its presentation, that is intended to represent or provide greater detail about information in the financial statements, with the financial statements and relevant audit evidence;

c. Other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit; and

d. Amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence, by recalculating the amounts for mathematical accuracy.

We believe that asking the auditor to evaluate the other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit per paragraph c would require, or at least cause, the auditor to document the evaluation by cross-referencing such information to the audit documentation or, failing to identify any relevant audit documentation, to document that fact. We believe the preparation and review of this cross-referencing and documentation will increase audit costs, which will be disproportionate to any benefit that could be received by financial statement users.

We believe this requirement would go beyond and contradict guidance in PCAOB AU 634, *Letters for Underwriters and Certain Other Requesting Parties,* for issuing comfort letters in connection with financial statements contained in registration statements filed with the SEC. Paragraph .55 of PCAOB AU 634 states, "Except as indicated in the next sentence [the accountants] should comment only with respect to information (*a*) that is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or (*b*) that has been derived directly from such accounting records by analysis or computation. The accountants may also comment on quantitative information that has been obtained from an accounting record if the information is subject to the same controls over financial reporting as the dollar amounts. The accountants should not comment on matters merely because they happen to be present and are capable of reading, counting, measuring, or performing other functions that might be applicable."

Also, although the auditor would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit, it is unclear exactly what level of assurance users would infer the auditor is providing on the other information. The concept of the auditor "evaluating" the other information also may have the potential to cause confusion for both the auditor and the user. The auditor's work to "evaluate" the information will not constitute what is normally understood to be an "audit," nor is it the same as a "review." We think this lack of clarity will widen the expectation gap between the users' understanding of the auditor's role and the auditor's actual performance when conducting an audit. The user may not understand the limited universe of information and documents to which the proposed standard would apply and potentially erroneously infer that the auditor is providing assurance on all of the information disclosed in the client's annual report.

For example, the SEC recently proposed amendments to Item 402 of Regulation S-K to implement Section 953(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. If finalized, the proposed amendments would require registrants to disclose the ratio of the median of the annual total compensation of all employees to the annual total compensation of the principal executive officer. We understand that registrants will have a fair amount of latitude to choose to identify the median using their full employee population or by using statistical sampling or another reasonable method. Also, registrants would be permitted to use reasonable estimates to determine the value of the various elements of total compensation for employees other than the chief executive officer. We believe investors will be confused about the degree to which the auditor evaluated this information when in fact the auditor may have obtained little, if any, relevant audit evidence related to this disclosure.

Therefore, we believe paragraph 4 should be revised to read as follows (proposed deletions are struck through, and proposed additions are shown in bold font):

4. The auditor should read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, ~~evaluate~~ **consider** the:

    a. Consistency of amounts in the other information, and the manner of their presentation, that are intended to be the same as, or to provide greater detail about, the amounts in the financial statements, with the amounts in the financial statements and relevant audit evidence;

    b. Consistency of any qualitative statement in the other information, and the manner of its presentation, that is intended to represent or provide greater detail about information in the financial statements, with the financial statements and relevant audit evidence; **and**

    c. ~~Other information not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit; and~~

    ~~d.~~ Amounts in the other information that are calculated using amounts in (1) the other information; (2) the financial statements; or (3) relevant audit evidence, by recalculating the amounts for mathematical accuracy.

    Note: For example, the auditor would recalculate the amounts when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula. Amounts, such as totals or percentages, that are calculated using simple mathematical operations, such as addition or division, ordinarily can be recalculated without referring to a formula.

**Reporting in the Auditor's Report**

Paragraph 13 of the proposed other information standard requires disclosures in the auditor's report about the auditor's responsibilities regarding other information. We believe there should be no disclosure in the auditor's report about the auditor's responsibilities regarding other information because the financial statement user does not know which other information in the company's annual report was considered by the auditor and which was not. We believe investors also will be confused about the degree to which the auditor considered this information.

**Costs**

The PCAOB's proposed other information standard would substantially expand the auditor's responsibilities related to other information contained in the annual report for public companies. The expenditure of additional time to meet these incremental responsibilities ultimately will be reflected in increased costs for the auditor and increased audit fees for the company.

The requirements in the exposure draft could cause companies to incur another type of cost – reduced timeliness of financial statement issuance. The introduction of the proposed requirements to evaluate other information and to include disclosures in the auditor's report about the auditor's responsibilities regarding other information will require more extensive procedures and review by the auditor. These efforts likely would occur during the final stages of the audit, which places added pressure on completion and review of the audit to meet filing deadlines. This may be particularly burdensome for smaller reporting companies, most of which historically need all of the time available up to the filing deadline.

We believe the requirements in existing PCAOB AU 550, *Other Information in Documents Containing Auditing Financial Statements,* adequately encompass the auditor's responsibilities for other information. If management believes investors desire additional procedures to be performed by the auditor on other information, there already is existing guidance for the performance of an attest engagement with respect to management's discussion and analysis presented in annual reports and in other documents in AT Section 701, *Management's Discussion and Analysis.* To the best of our knowledge, the performance of such an engagement has not been requested by any of our clients since the issuance of this guidance.

It is important to note that users can say they want information without considering the associated costs or the extent of its use or its investment-decision usefulness. We believe the PCAOB should be able to clearly demonstrate that the additional assurance to be provided by the auditor as a result of this requirement provides a benefit to users of the financial statements that would outweigh its costs, which will be significant.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to John Keyser, National Director of Assurance Services, at 614.456.2805.

Sincerely,

McGladrey LLP

McGladrey LLP

Medtronic

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December 11, 2013

**Via email: comments@pcaobus.org**

Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Subject: PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown,

Medtronic, Inc. ("Medtronic," "we," "our" or "us") appreciates the opportunity to provide the Public Company Accounting Oversight Board ("PCAOB" or "Board") with our comments on Release No. 2013-005, *The Auditor's Report on an Audit of Financial Statements when the Auditor expresses an unqualified opinion; The Auditor's Responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report* (collectively "the PCAOB Release"). Medtronic is the global leader in medical technology - alleviating pain, restoring health, and extending life for millions of people around the world.

## Summary

We support the Board's desire to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. We also appreciate and recognize the Board for evaluating the concerns raised from 155 comment letters and roundtable discussions related to the June 2011 Concept Release, and making changes to the original proposal such as the Board's decision not to pursue imposing a requirement for Auditor Discussion and Analysis (AD&D).

We understand that the Board's underlying objective in proposing changes to the auditor's report is to enhance investor confidence in the quality of audits by improving the informational content, usefulness, and relevance of the auditor's report. However, we have the following significant concerns with regards to the proposed PCAOB Release:

- We do not agree with the proposed change in terminology from "read and consider" to "read and evaluate" for other information outside the financial statements. We are concerned that auditors will perform significantly more work in order to meet the new standard, resulting in higher audit fees, and readers of the auditor's report may assume a greater degree of accountability than is warranted.

- Because root cause evidence does not exist that links audit firm tenure to audit failures or lack of auditor independence, objectivity, and professional skepticism, we disagree with the inclusion of auditor tenure in the auditor's report.

- We have grave concerns with the proposed auditor reporting standard requirement that the auditor communicate "critical audit matters" (CAM's) in the auditor's report.

- We are concerned that there is currently a lack of defined field testing in the PCAOB Release. We believe the Board needs to work closely with public accounting firms to determine the incremental procedures auditors believe they would need to perform in order to meet the requirements of the PCAOB Release in order to ensure the resulting benefits exceed the incremental costs.

**Change in Terminology from "Read and Consider" to "Read and Evaluate" for Other Information Outside the Financial Statements**

We appreciate investors' interest in obtaining more information regarding the auditor's responsibilities for other information outside the financial statements that is contained in documents that include the audited financial statements and the related auditor's report. We support additional disclosure regarding auditor's association with the other information in the filing, including a statement in the auditor's report that the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both. We would also support adding a statement in the auditor's report that clearly defines the scope of the data included or excluded from such a review of other information and an explanation of the depth of procedures undertaken and the level of comfort provided, including a statement that the auditor did not audit the other information and does not express an opinion on the other information. However, we do not support the proposed change in terminology from "read and consider" to "read and evaluate".

The following excerpt from Auditing Standard 17 "Auditing Supplemental Information Accompanying Audited Financial Statements" appears to provide context around the term evaluate:

> The proposed standard includes requirements that the auditor evaluate the supplemental information, which includes evaluating (1) whether the supplemental information, including its form and content, is fairly stated, in all material respects, in relation to the financial statements as a whole, and (2) whether the supplemental information is presented in conformity, in all material respects, with the relevant regulatory requirements or other applicable criteria. In addition, the evaluation should encompass, among other things, whether the

information is complete and accurate, is consistent with the audited financial statements, and complies with relevant regulatory requirements, if applicable.

We believe that a level of assurance to achieve "complete and accurate" is higher than what is currently provided today under the requirement to "read and consider". We believe that this will lead to significant expansion in the level of audit work being performed, resulting in higher audit fees, and potentially result in certain challenges for the auditor in gaining comfort with regards to certain non-financial information, performance metrics, and qualitative statements. We believe the auditor would need to expand their audit scope procedures considerably, to fulfill their obligations related to evaluating this other information. These metrics and supplemental information are frequently not derived from systems or processes which the auditor has previously audited, as such unwarranted scope expansion would surely occur.

In addition, we believe that current regulations and disclosure requirements, such as CEO and CFO certifications, and listing rules by the NYSE requiring independent audit committee supervision and review of quarterly and annual reports in conjunction with the establishment of effective disclosure controls, such as Disclosure Committees and quarterly certifications by key executive management, are an effective means to ensure that non-financial information has been verified by the company. Thus, we see no incremental benefit to requiring auditors to do more than what is already required under existing "read and consider" standards.

## Inclusion of Auditor Tenure in the Auditor's Report

The PCAOB Release proposes to add new elements to the auditor's report related to auditor independence, auditor tenure, and enhancements to certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud". While we are in general support of the inclusion of clarifying language to the existing standard auditor's report to enhance investors' and users' understanding of the scope, process, and limitations of the audit process, we do not support the PCAOB Release requirement that a statement be included in the auditor's report containing the year the auditor began serving consecutively as the company's auditor.

Because root cause evidence does not exist that links audit firm tenure to audit failures or lack of auditor independence, objectivity, and professional skepticism, we believe there could be unintended consequences resulting from investors believing that a shorter / longer auditor tenure is presumed to be good or bad. In addition, we believe inclusion of auditor tenure in the auditor's report could dilute the independence disclosure already included in the auditor's report. If the Board feels strongly about providing investors with further details as to the length of auditor tenure, then we recommend such information be considered more suitably placed in the proxy statement, as we believe such information is more directly relevant to investors' decisions regarding whether the independent auditor should be reappointed for another fiscal year.

**Auditor Communication of "Critical Audit Matters" (CAM's) in Auditor's Report**

The PCAOB Proposal would require the auditor to communicate in the auditor's report "critical audit matters" that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient audit evidence or forming an opinion on the financial statements. The sources for CAM's could include engagement completion documents, items reviewed by the engagement quality reviewer, and information communicated to the Audit Committee.

While we appreciate investors' interest in gaining a better understanding of what is reported in the financial statements, it remains unclear to us whether or not the reporting of CAM's in the auditor's report will facilitate an increased understanding. Based upon our regular interactions with our auditors as part of their audit, we believe a close relationship already exists between the auditor's most complex and challenging areas of the audit and the critical accounting estimates currently disclosed by the Company. Moveover, these topics are part of an ongoing dialogue between the auditor, Company management, and the Audit Committee and often require background and discussion between the parties to achieve an appropriate and meaningful communication. Thus, we believe the fundamental responsibilities of the Audit Committee, management, and the auditors should not be changed. We believe that the direction of the "PCAOB Release" may have unintended consequences on the clarity of responsibilities, the ownership of the financial statements, and undermine the existing corporate governance and audit oversight, including the communications between the Audit Committee, management, and the auditors. We strongly believe it is the responsibility of the Company, not the auditors, to provide useful information about the company's financial statements to financial statement users.

We also have doubts that the auditor's communication of CAM's would be based upon information known to the auditor and procedures that the auditor has already performed as part of current audit practices for a Company, resulting in incremental audit hours and significantly higher audit fees. For example, if the auditor determines that certain items should be excluded from CAM's, the auditor may assume it needs to justify in the audit work papers why such items were not CAM's. We expect that most auditors would error on the side of including more CAM's rather than fewer CAMs in their reports, given the increased risks an auditor would assume as a result of proposed requirement to include CAM's in their audit reports. In addition, we believe extensive information related to matters that may qualify as CAM's already exists in current disclosures such as critical and significant accounting policies, significant estimates, business trends, and operational and financial risks.

We are also concerned that the time and level of incremental effort required to fulfil these proposed requirements on CAM's could distract focus and attention from the primary deliverables of the audit and divert key time and resources from Audit Committees, Company management, and auditors, and result in incremental and time consuming discussions between Audit Committees, Company management, external legal advisors, and local and national office audit personnel. The level of effort required by the auditor to determine, prepare language for communication, and to document CAM's would most likely occur during the final stages of an audit, which may reduce the time available for the auditor to review and complete other key audit procedures. Thus, we do not believe the increased level of engagement required and resources consumed by this activity will significantly improve the quality of the audit.

We believe the roles and responsibilities of the Audit Committee, Company management, and the auditors should not be changed as a result of the proposed PCAOB Release. However, should the Board ultimately decide to retain the concept of CAM's in the Board's final standard, then we recommend development of a clearer definition with regards to CAM's, including, at a minimum:

1) CAM's identified should only include those requiring disclosure to the Audit Committee in accordance with existing audit standards
2) CAM's must be material to the consolidated financial statements of the Company
3) Prejudicial and/or highly sensitive information (such as loss contingencies or certain tax matters) should not be included in CAM's, except as previously disclosed by the Company in the consolidated financial statements
4) CAM's must not be included if specifically excluded from disclosure by existing other legislation
5) Outside of certain exceptions, (such as going-concern issues) auditors should not become the original source of information to investors and users of financial statements. The communication of CAM's by auditors should not diminish the current governance role of the Audit Committee over a company's disclosure of financial information.
6) Auditors should not be required to separately document why audit matters are not considered to be CAM's.

**Lack of Defined Field Testing in the PCAOB Release**

Given our concerns raised about significant incremental costs versus the assumed benefits of the proposed PCAOB Release, we are concern that the current PCAOB Proposal lacks a defined comprehensive field test.

We believe the Board needs to work closely with public accounting firms to determine what incremental procedures auditors believe they would need to perform in order to meet the requirements of the PCAOB Release in order to ensure the resulting benefits exceed the incremental costs. While we understand that the underlying intent is to raise audit quality, we are concerned that some of the proposed changes may have the opposite effect, as we have discussed above. Field testing has proven in the past to be an activity that leading standard setters use to better understand whether or not the proposed changes are operational and for purposes of identifying potential unintended consequences the proposed changes may have on the effectiveness of current practices.

* * * * * * * *

**Conclusion:**

In summary, we have certain concerns with the proposed PCAOB Release. In addition, we respectfully ask the Board to carefully review and evaluate all comment letters received, and specifically to consider and carefully review the issues and feedback identified in our comment letter.

Very truly yours,

Steve Howarth
Vice President Corporate Audit

Mary Wilcox
Vice President & Chief Accounting Officer

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New York, NY 10036

**Peter M. Carlson**
Executive Vice President and
Chief Accounting Officer
pcarlson@metlife.com

December 11, 2013

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

**Re: Request for Public Comment: *Proposed Auditing Standard – Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments:***

- ***The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;***
- ***The Auditor's Responsibilities regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report;***
- ***Related amendments to PCAOB Standards***

**PCAOB Rulemaking Docket No. 34, PCAOB Release 2013-005 (August 13, 2013)**

Dear Office of the Secretary:

MetLife, Inc. (MetLife) appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board's (PCAOB) Request for Public Comment regarding proposed auditing standards on (i) the auditor's report; (ii) the auditor's responsibilities regarding other information; and (iii) related amendments to PCAOB standards, (PCOAB Release 2013-005), which are updates to the PCAOB's Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards (issued June 2011).

MetLife is a leading global provider of insurance, annuities and employee benefit programs, serving 90 million customers in over 50 countries. Through its subsidiaries and affiliates, MetLife holds leading market positions in the United States, Japan, Latin America, Asia Pacific, Europe and the Middle East.

To reiterate our September 30, 2011 comment letter to the PCAOB regarding the June 2011 Concept Release, MetLife supports the PCAOB's overall effort to undertake standard-setting initiatives to consider certain enhancements to improve the quality and content of the current auditor reporting model.

However, consistent with our September 30, 2011 comment letter:

- Any changes must provide useful and objective information to investors and other financial statement users while continuing to acknowledge that the preparation of the financial statements and related disclosures are the responsibility of management and that the auditor's opinion is on the fair presentation of the financial statements "taken as a whole."

- In our view, it is management's role, and not that of the auditor, to disclose all financial information relevant to investors and other financial statement users to facilitate making informed decisions based on those financial statements. Management owns the financial information, is most familiar with it, and is in the best position to disclose it in the most complete and meaningful manner. The primary role of the auditor's report should remain in providing an opinion as to whether the financial statements present fairly, in all material respects, the financial condition, results of operations, and cash flows in accordance with the applicable financial reporting framework. The auditor's opinion on the financial statements, in our view, must remain, and, perhaps more importantly, be perceived by financial statement users to remain, on the financial statements "taken as a whole". The moment the auditor's report begins to discuss specific audit risks, audit procedures, management judgment calls, etc. the perception of the opinion covering the financial statements overall is compromised, which we believe will inevitably lead to a lack of clarity, consistency and comparability for financial statement users.

Upon review of PCAOB Release 2013-005, consistent with the recommendation in our comment letter on the June 2011 Concept Release, we are in agreement that the auditor's report be amended to contain clarifying language as to the auditor's current responsibility for information outside the financial statements. We are also in agreement that the standard auditor's report language be enhanced to (1) clarify the auditor's responsibilities for fraud and the notes to the financial statements and (2) include reference to audit tenure and applicable independence requirements. However, we are not in agreement with the PCAOB's proposed changes requiring auditors to include detailed descriptions of critical matters in the audit, including the auditor's criteria for what constitutes critical matters. Our reasons are as follows:

- It is counter to our position noted above, specifically that it is management's responsibility to disclose the relevant accounting treatment and risks with respect to critical accounting matters and estimates,

- Work performed by the auditors for addressing critical matters is part of their professional audit responsibilities in accordance with established audit guidance and audit standards and is, therefore, best left for discussion with a company's audit committee in their governance role, for reasons cited in our comment letter on the June 2011 Concept Release, and

- Additional language regarding critical matters could lead to the perception that the auditor's opinion is no longer covering the financial statements overall, which we believe will inevitably lead to a lack of clarity, consistency and comparability for financial statement users.

We suspect that critical matters identified by the auditor would directly align with areas currently identified and disclosed by management as involving critical accounting estimates, i.e., those areas involving the most subjective management judgment in preparing the financial statements and accompanying notes. To address our concerns, we would be supportive of the auditor's report containing the following with respect to critical audit matters:

  - A brief summary of the critical matters the auditor has evaluated to support their overall opinion,

- An overall statement that difficult, subjective, or complex auditor judgments were involved with respect to these critical matters, and

- Reference to the related financial statement accounts and disclosures made by management that highlight the related risks and uncertainties associated with these critical matters.

We also support clarification of the auditor's association with other information outside of the financial statements as part of the proposed disclosures in the auditor's report. Inclusion of such disclosure within auditor's reports would be informative to users of registration statements and periodic filings. It is our understanding that this proposed requirement was not intended to introduce a significant change from existing requirements with regard to role of the auditor in reviewing such information. Therefore, we recommend that the PCAOB not change the requirement from "consider" to "evaluate", nor expand the scope of information to be considered as "relevant other information." Such changes could lead to significant additional work by the auditor and cost to companies.

We once again thank you for the opportunity to respond to your proposal and for taking into consideration our previous observations and comments when preparing PCAOB Release 2013-005. If you have any questions regarding the contents of this letter or would like to further discuss our comments, please do not hesitate to contact me.

Sincerely,

Peter M. Carlson
Executive Vice President and
Chief Accounting Officer

cc: John C.R. Hele
Executive Vice President and
Chief Financial Officer

Karl Erhardt
Senior Vice President and
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MFS

December 10, 2013

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

File Reference: PCAOB Rulemaking Docket Matter No. 034

MFS Investment Management (MFS) and the MFS Funds Board Audit Committee appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or "the Board") Proposed Auditing Standards on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Proposed Standards"). Our comments relate to the Proposed Standards' application to Securities & Exchange Commission (SEC) registered investment companies as issuers of financial statements.

Background on MFS and the Industry[1]

MFS is a global asset management firm providing investment management services to clients including 140 registered investment products which in total represent approximately $170 billion in assets. MFS and its predecessor organizations have been registered as an investment adviser under the Investment Advisers Act of 1940 (the "Advisers Act") since 1969. MFS is a majority owned subsidiary of Sun Life Canada (U.S.) Financial Services Holdings, Inc., which in turn is an indirect majority owned subsidiary of Sun Life Financial, Inc. (a diversified financial services organization). MFS has been a subsidiary of Sun Life since 1982. As of June 30, 2013, MFS managed approximately $353 billion in assets.

From an industry perspective, U.S. investment companies are responsible for the investment of over $13.6 trillion; mutual funds, which are owned by an estimated 92 million shareholders, represent the lion's share of those assets. There are roughly 7,600 mutual funds, 600 closed-end funds and 1,200 exchange-traded funds, each of which is subject to an annual audit requirement and oversight by the PCAOB and SEC. As is the case with the registered funds managed by MFS, investment companies typically have no employees of their own, and the operations are carried out by various affiliated entities (e.g., the investment advisor, the administrator and the distributor) and unaffiliated service providers (e.g., the custodian and the transfer agent) under the oversight of the manager and a Board of Trustees.

Overview of the Proposed Standards

The Proposed Standards are a follow-up to the PCAOB's 2011 Concept Release No. 2011-003 entitled *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the "Concept Release") and the feedback received from related public roundtables. Based on the investor feedback received from those roundtables and on the Concept Release, the PCAOB's recommendations in the Proposed Standards seek to increase the relevance, usefulness and informational value of the auditor's report by (1) requiring the auditor to include more information in the form of "critical audit matters" on the most difficult, subjective or complex areas of the audit and (2) clarifying the auditor's responsibility with respect to fraud; independence; the notes to the financial statements; and other information outside the financial statements.

[1] Industry statistics as of December 31, 2012 per the *2013 Investment Company Institute Industry Fact Book.*

As discussed below, MFS Investment Management (MFS) and the MFS Funds Board Audit Committee understand and support the PCAOB's intent to increase the value of the auditor's report, and support some - but not all - of the changes to the auditor's report outlined in the Proposed Standards. We are in favor of the PCAOB's proposed clarifications to the auditor's report with respect to independence, fraud and the notes to the financial statements. We, however, express strong reservations with regard to the inclusion of Critical Audit Matters and tenure in the auditor's report and we also believe that further clarification is needed on the scope and relative costs-benefits of expanding the auditor's responsibility for other information outside of the financial statements.

Independence, Fraud and the Financial Statement Notes

Under the Proposed Standards, the auditor's report would be modified to include a statement that the auditor is registered with the PCAOB and is required to be independent. The language in the auditor's report also would be enhanced to better articulate the auditor's responsibility for fraud and the notes to the financial statements. We believe that these enhancements to the auditor's report will clarify existing auditor requirements and responsibilities in these areas for investors and, as such, we fully support the PCAOB's proposed changes to the auditor's report related to clarification of auditor independence as well as the auditor's responsibility for fraud and the notes to the financial statements.

Critical Audit Matters (CAM)

CAM as defined by the Proposed Standards would be matters that were deemed by the auditor to be the most subjective, involved complex auditor judgments or were the most difficult areas on which to obtain audit evidence or form an opinion. Under the Proposed Standards, the auditor would be required to communicate in a separate section of the auditor's report any CAM that it identified during the audit of the current period's financial statements.

We do not support the PCAOB's proposal with respect to the inclusion of CAM in the auditor's report as we believe that CAM compromise the current "pass/fail" model of an audit and introduce subjectivity into what should be an objective process. Based on the subjective decisions made by different audit teams or firms, the CAM identified in the auditor's report may differ among very similar entities with the unintended consequence of negatively impacting the comparability of the entities. CAM may also impact the appeal of an entity to an investor relative to its peers based solely on how the auditor's report is drafted. Investors will be directed to focus on particular accounts within the financial statements which have been identified as CAM, instead of on the financial statements taken as a whole. Also, inclusion of CAM may compel the auditor to report information that is not otherwise publicly available and is not required to be disclosed by management, which we do not feel is appropriate. In these ways, the inclusion of CAM alters the defined role of the financial statement auditor in a manner that is not consistent with the audit function.

*Red Flag*

CAM may be incorrectly interpreted by investors as a "red flag", a sign that there is something wrong with the audited entity. Indeed, even the use of the word "critical" to describe the audit matters has negative connotations. Requiring the auditor to call out as CAM each area in which a significant judgment is made or on which audit evidence is most difficult to obtain, may cause investors to incorrectly conclude that there are problems with the audited entity, when in reality judgments, estimates and assumptions are inherent in the financial statement process, a fact that is clearly disclosed in the financial statements in accordance with Financial Accounting Standards Board Accounting Standard Codification ("ASC") 275-10-50-4.

In the investment company industry, the use of judgments, estimates and assumptions is generally most prevalent with respect to investment valuation, especially with securities that are classified as Level 3 under ASC 820's fair value hierarchy. As such, investment valuation would presumably be called out by the fund auditor as a CAM. Although management makes significant judgments, estimates and assumptions in the valuation of Level 3 securities and the auditor may have to engage the help of a valuation specialist to evaluate those valuations, the auditor is able to obtain sufficient audit evidence to support those valuations in order to reach an unqualified opinion on the financial statements as a whole. Moreover, the financial statement disclosures with respect to investment valuation, especially with respect to the assumptions (i.e., methodologies and valuation inputs) used in valuing Level 3 securities, are very robust. In such circumstances, by calling out investment valuation as a CAM, the auditor is raising a "red flag" to investors where no problem exists and where significant disclosure is already available for the investor within the notes to the financial statements.

*Subjective Yardstick*
The PCAOB has expressed a view that they would not expect to see an auditor's report without a CAM. This may give the auditor an incentive to identify and disclose several items as CAM in order to demonstrate the comprehensive nature of its audit and its compliance with the PCAOB's directive. Given that CAM may be perceived as a "red flag" by investors, the requirement for auditors to disclose CAM may have further unintended negative consequences in that investors may use CAM as a "yardstick" with which to determine relative ratings on the investment worthiness of audited entities and even the quality of the related audits. The determination of CAM by an auditor is subjective and, as such, the number of CAM cited or the reason for citing a CAM in the auditor's report may differ among very similar entities based on subjective decisions made by the different audit teams or firms involved.

This issue of auditor subjectivity is particularly problematic for the investment company industry where, for most of the larger fund complexes, a portion of the funds in the complex are audited by one audit firm while the remainder are audited by a second firm (i.e., a "two audit provider model"). Under the two audit provider model, two substantially similar funds within the same fund complex could be subject to audit by two different audit firms - each with their own unique thoughts on what constitutes a CAM and the reasons why. Although the strategy, holdings and investment performance of those two funds may be almost identical, we believe that the fund that has more CAM (or more reasons for CAM) cited in its auditor's report may unjustly be at a relative disadvantage in the eyes of investors. This concern is magnified when looked at in the context of the auditor's reports for the industry's full universe of competing funds each of which is audited by different audit teams and firms.

*Auditor in the Role of Management*
In communicating their reasons for concluding something is a CAM, the auditor may be forced to include in the auditor's report information about the audited entity's operations or financial results that is not otherwise publicly available (e.g., control deficiencies or proposed auditor adjustments) and that is not required to be disclosed by management based on either management's judgment or the reporting requirements of the entity's regulators. Under such circumstances, the requirement to report CAM places the auditor in a position outside of the role of the auditor as defined by AU Section 110 *Responsibilities and Functions of the Independent Auditor* which states that "the financial statements are management's responsibility. The audited entity's transactions and the related assets, liabilities, and equity are within the direct knowledge and control of management. The auditor's responsibility for the financial statements he or she has audited is confined to the expression of his or her opinion on the fairness with which they present, in all material respects, financial position, results of operations and its cash flows in conformity with generally accepted accounting principles." The concept of CAM, which requires auditors to disclose information on the financial statements beyond what is required to be disclosed by management, is counter to the auditor's defined role and muddles the roles of management and the auditor. If the information that would be included in a CAM is considered truly important to an investor's investment decision making process, then management should be the party responsible for disclosing that information.

*Piecemeal Opinion*
The inclusion of CAM in the audit opinion will not only dramatically change the format and the length of the auditor's report, but also result in piecemeal CAM opinions which compromises the pass/fail model of the audit. Under AU Section 508 *Reports on Audited Financial Statements*, the auditor has a responsibility to express an opinion on the financial statements taken as a whole, or to state that an opinion cannot be expressed. Due to the prominence of presentation of the CAM, the auditor's conclusions on CAM audit areas may overshadow the auditor's opinion on the financial statements taken as a whole.

*Significant Costs*
Although the level of audit evidence and audit work required to reach a qualified or unqualified opinion should not change, a significant increase in hours would be necessary for the auditor to draft the CAM language in the auditor's report and to document their conclusions in the audit work papers on why or why not something was deemed a CAM. The opinion, which would now include language outside of the audit firm's standard template language, will undoubtedly require additional levels of review by others outside of the audit engagement team including, but not limited to, the management of the audited entity; national consulting partners for the audit firm; and the legal counsel of both parties. The additional hours incurred would have significant associated costs given the senior level of the parties involved in the drafting and review of the opinion. These costs likely will be tacked onto existing audit fees which, in the case of most investment funds, will translate into higher fund expenses borne by investors. It should also be noted that these additional hours most likely would be incurred at the conclusion of the audit when filing deadlines are looming and the stress level is at its highest for all parties involved. While the associated costs would be significant, we do not see an appropriate corresponding benefit derived from CAM. We actually feel that inclusion of CAM weakens the audit report as it is likely to draw investor attention away from the auditor's opinion on the financial statements taken as a whole and re-direct investor focus to a few specific financial statement areas. Further, we would note that there is already significant, required financial statement disclosure on areas that may be identified in CAM.

For the reasons enumerated above, we do not support the inclusion of CAM in the auditor's report. Fundamentally, we believe that the overall goal of requiring auditors to disclose CAM is unclear. If the information that the PCAOB intended to be conveyed in CAM is information about the audited entity, we believe that many of the areas which would be identified as CAM already are subject to significant disclosure requirements in the notes to financial statements. If additional disclosure related to these areas is warranted, we believe that management should be required to provide this disclosure (in the notes to financial statements or elsewhere) rather than requiring the auditor to make the disclosure in its audit opinion. Also, in addition to the very tangible increase in audit cost that will result from the drafting, documentation and review of CAM, we believe that the number of CAM (along with the reasons cited for those CAM) will have a significant indirect cost to the audited entity in that CAM will inevitably become a "yardstick" against which entities are rated by investors. In our industry, where there are any number of comparable fund offerings from which an investor can choose, we believe that the relative attractiveness of a fund to an investor should be based on its comparative financial performance and should not be unjustly disadvantaged by a benchmark that is so subject to variability based on the audit team.

<u>Auditor Tenure</u>
Under the Proposed Standards, the auditor's report would be modified to include a statement containing the years that the auditor has been serving consecutively as the entity's auditor. The requirement to disclose tenure in the auditor's report implies that tenure plays a role in the auditor rendering its opinion on the financial statements; however, despite extensive research on the subject, no conclusive link has been established between auditor tenure and the quality of the audit in terms of auditor independence, objectivity and professional skepticism. It should also be noted that in the context of an investment company complex in which new funds are often launched each year, the tenure disclosure may be confusing to investors as the auditor tenure dates may differ significantly fund to fund based on each fund's unique inception date. At MFS, for example, we have roughly 140 funds, substantially all of which have a different inception date and, therefore, a different auditor tenure date. We feel that there are other, more appropriate means of disclosing tenure, if information on tenure is indeed important to the investor. In fact, many public companies already disclose auditor tenure as part of their proxy statements.

Other Information

Under the Proposed Standards, the auditor would be required to state in the auditor's report that they neither audited nor expressed an opinion on the other information[2], but instead evaluated the information based on their audit work to conclude whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact or both. Based on that evaluation, the auditor also would be required to make a statement whether they have or have not identified a material inconsistency and/or a material misstatement of fact in the other information that has not been appropriately revised by management.

Based on our review of the Proposed Standards, it appears that the scope in terms of the specific elements of other information and the expected level of auditor effort and documentation has not been sufficiently defined. Without further definition, we believe that the elements to be evaluated as well as the level of auditor effort and documentation are subject to interpretation and, therefore, may differ greatly among audit teams. As such, the PCAOB's objective of clarifying the auditor's responsibility for other information would not be met. Additionally, we believe that requiring the auditor to perform procedures over other information for which the auditor has little or no expertise would add significant regulatory and litigation risk for the auditor, while providing little, if any, value to the investor.

In order to ensure that the benefits to investors exceed the costs in terms of additional hours that will be incurred by the auditor and management in evaluating other information, we believe that the scope of this requirement to evaluate other information should be well-defined and limited to other information that is directly related to the financial statement audit. There is little value in requiring the auditor to evaluate other information (e.g., Code of Ethics) in which the auditor has neither training nor expertise as the very real increase in costs related to additional auditor hours incurred would have little, if any, corresponding benefit in terms increased assurance for the investor. Whatever the scope, this requirement will undoubtedly result in additional work by management and the auditor which will translate into increases in costs. Whether borne by management or passed along directly to shareholders, those cost increases will negatively impact the return to shareholders.

The need for a scope clarification is especially important in the context of an investment company complex due to the number and year-round nature of the filings involved. In contrast to a corporate entity where there is generally one filing annually that would constitute other information, we prepare roughly 35 filings annually which include the audited financial statements and the auditor's report for one or more of our 140 funds. That number would be slightly larger for years in which fund mergers or other events occur. Even if the scope of the auditor's evaluation were limited solely to other information that is financial in nature (e.g., portfolio holdings; valuation, derivative and purchase and sales disclosures; fund expenses, expense ratios and returns), the additional work required by the auditor to complete their evaluation would be significant. The auditor's evaluation would be further complicated by the fact that filings deadlines are very tight and that these filings are made at the trust level (i.e., a trust generally includes multiple funds). Under the two audit provider model discussed above, a portion of the funds in a trust may be audited by one audit firm with the remainder audited by a second firm, with the result that not just one but two sets of auditors would be required to evaluate the other information in a trust's filing. With our fund year-ends staggered throughout the year for operational efficiency, our auditors' evaluation of other information would be practically non-stop.

Given the significant level of additional hours that would be involved and the perceived lack of clarity with respect to the scope of the auditor's responsibility for evaluating other information, we suggest that the PCAOB consider gathering more information before proceeding with this requirement. Public roundtables may help to determine the specific elements of other information that are most important to investors. Armed with that investor feedback, the PCAOB would then be able to determine which areas that auditors have the necessary expertise to evaluate. Once the types of other information have been sufficiently narrowed down, then auditor field testing of clients could provide a better understanding of the level of

[2] Other information in the Proposed Standards refers to information in an entity's annual report filed with the SEC under the Securities Exchange Act of 1934 that also contains the entity's audited financial statements and the related auditor's report.

effort required and the additional costs to be incurred. The overall objective of this fact gathering should be to define a scope for which the perceived benefit to investors exceeds the very real costs associated with the increase in auditor and management efforts.

Conclusion

MFS and the MFS Funds Board Audit Committee appreciate the opportunity to provide comments on the PCAOB's proposed changes to the auditor's report. We support the PCAOB's goals, and specifically support the proposed changes to the auditor's report related to clarification of auditor independence as well as the auditor's responsibility for fraud and the notes to the financial statements. We do, however, have significant concerns on certain other items outlined in the Proposed Standards. In response to those concerns, we encourage the PCAOB to:

- Reconsider the inclusion of CAM in the auditor's report because CAM would (i) introduce subjectivity into what should be an objective process; (ii) cause an investor to concentrate on piecemeal information and conclusions rather than the financial statements taken as a whole; (iii) considerably change the role of the auditor as defined in AU Section 110; and (iv) significantly increase audit cost with no corresponding benefit, only the potential downside of negatively impacting the comparability and investor appeal of a fund relative to its peers based on different audit teams' unique thoughts on what constitutes a CAM and the reasons why.

- Consider using public documents more appropriate than the auditor's report on financial statements for any required disclosure of audit firm tenure (e.g., proxy statements), as there is no evidence that tenure has a bearing on the auditor's ability to render an opinion.

- Gather information through mechanisms like public roundtables and field testing to understand (i) the types of other information on which investors are most interested in obtaining additional auditor assurance and which types of information that an auditor has the necessary expertise to evaluate as well as (ii) the relative costs-benefits of increasing the auditor's responsibility for each specific type of other information. With this level of detail, the proposed scope of the auditor's responsibility for other information then can be defined in a manner that provides an appropriate benefit in consideration of the additional costs that inevitably would be incurred by management and the auditor.

Should you have any questions about our comments regarding the Proposed Standards, please feel free to call Bob Uek or John Corcoran at 617-954-5637.

Sincerely,

John Corcoran
Fund President
Senior Vice President
MFS Investment Management

Robert W. Uek
Chairman
MFS Funds Board Audit Committee

# Comment letter to respond to the PCAOB invitation to comment on its Exposure Draft Concerning the Auditor's Report on an Audit of Financial Statements

Dec 10, 2013

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*Note: This comment letter is based partly on a synthesis of the literature on the audit reporting model (Mock, Bédard, Coram, Davis, Espahbodi and Warne 2013). This comment letter is written by a subset of the synthesis authors, it expresses the views of these authors and does not reflect an official position of the American Accounting Association, the Auditing Section of the AAA, or any other organization.

# Comment letter to respond to the PCAOB invitation to comment on its Exposure Draft Concerning the Auditor's Report on an Audit of Financial Statements

## I. INTRODUCTION AND COMMENT OBJECTIVES

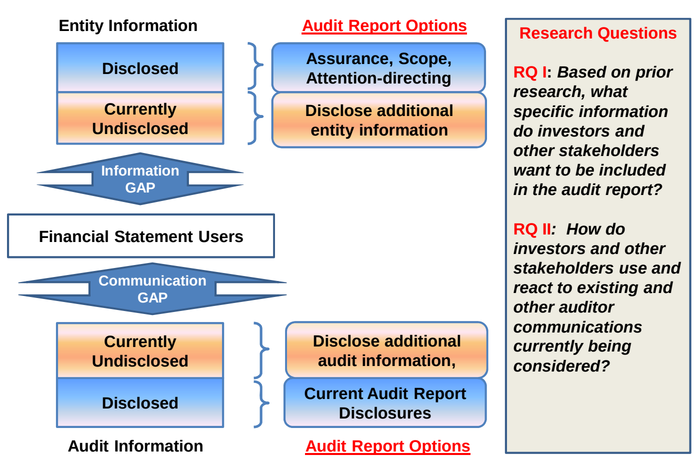
The PCAOB has invited comments concerning its Exposure Draft: *Proposed auditing standards – the auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion; the auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report; and related amendments to PCAOB standards* [PCAOB Release No. 2013-005].

The proposed standards include the disclosure of additional information highlighting matters important to users' understanding of audited financial statements or the audit, information which may help close the information and communication gaps depicted in Figure 1 below. In this comment letter, we augment a synthesis of academic research [Mock, Bédard, Coram, Davis, Espahbodi and Warne, 2013] by providing an updated synthesis of academic research; indicating to what extent we believe prior research suggests that the proposed additional information is likely to close the gaps; indicating the amount of prior research evidence that is available; and identifying research gaps, that is areas where little or no prior research evidence is available.

## II. FRAMEWORK, APPROACH AND COMMENT RESEARCH QUESTIONS (CRQs)

Mock et al. (2013) provide a framework based on communication theory to illustrate the basic options concerning the content of the audit report (see Figure 1). This framework separates the *expectation gap* into two components: the *information gap*, which relates to information about the entity, and the *communication gap*, which relates to information about the audit.

Figure 1: Information Gap, Communication Gap, Audit Report Options and Research Questions




In terms of research questions addressed, we focus on three Comment Research Questions (CRQs):

> CRQ1. *What additional research has been published and are there findings that either significantly support or weaken the synthesis findings in Mock et al. (2013)?*
>
> CRQ2. *To what extend is the PCAOB ED responsive to specific information investors and other stakeholders want to be included in the audit report? What information that research indicates stakeholders use and react to, is currently not provided? To what extent can the proposed disclosures be expected to close the 'gaps' identified in our prior Synthesis?*
>
> CRQ3: *To what extent is there a "Research Evidence Gap?"*

III. FINDINGS WITH RESPECT TO CRQ 1: *What additional research has been published and are there findings that either significantly support or weaken the synthesis findings in Mock et al. (2013)?*

Our prior synthesis built on a previous research review developed by Church, Davis, and McCracken (2008) and synthesized approximately 90 studies published between 2007 and 2011. To prepare this section, we considered an additional 30 research studies and reflect on whether the prior synthesis findings are supported (strengthened) or possibly weakened. As many of these studies relate to international settings or are not directly related to topics included in the PCAOB ED, they are not considered directly to prepare this comment.

*What Specific Information Do Investors and Other Stakeholders Want Included in the Audit report*?

There are two main recent studies that have examined the information desired by financial statement users. Carcello (2012) conducted a survey of over 300 diverse knowledgeable, financial statement users. The results indicate that 91% of participants did not read the standard audit report (SAR), and 18% reported that the auditor's report is useless. Participants also expressed a desire for more information from the auditor. For example, 79% of survey participants desired greater disclosures regarding management's significant judgments and estimates. Also, 77% wanted more auditor disclosures related to risk. Overall, the results indicate that a sizeable majority of experienced financial statement users desire more disclosures from the auditor.

Vanstraelen et al. (2012) conducted semi-structured interviews lasting 30-60 minutes each with a small number of auditors and professional financial statement users to assess the information gap associated with the auditor's report. Results indicate that neither auditors nor financial statement users want the auditor to release engagement statistics or information about the audit process. However, financial statement users state a desire for more information related to the entity's risk and internal controls. Furthermore, they express a desire for the auditor to provide an "evaluation of accounting policies and practices, critical accounting estimates, and accounting judgments" (p. 207). Based on the findings of their research, the authors propose an auditor reporting model that consists of the following elements:

1) Audit scope. Include a listing of items that are part of the audit. Additional educational material could be linked to a website.
2) Audit findings. Unequivocal conclusions on each part of the audit.
3) Auditor discussion and analysis. Discussion and analysis of the auditor's findings of each part of the audit.
4) Information about the auditor. To assist users to evaluated audit quality. This could be a reference to the firm's transparency report.

Mock et al. (2013) summarize prior research with respect to stakeholders' desired information in the audit report, which is based primarily on survey data and focus groups, as follows: "Stakeholders deem the audit report as important, but they desire more information about the auditor, the audit, and the financial statements including MD&A. Audit related information desired include auditor independence, audit process, materiality, level of assurance the auditor is providing, and entity-related information including accounting policies and risk-related information."[1]

In summary, the findings from the Carcello (2012) and Vanstraelen et al. (2012) studies are broadly consistent with Mock et al. (2013). That is, users want more information about the audit. However, one difference noted by Vanstraelen et al. was that more information about the audit process was not particularly important to either group they studied.

*How do investors and other stakeholders use and react to existing and other auditor communications currently being considered?*

Many prior studies have investigated the above research question using archival, survey, interview, focus group, and verbal protocol methods. In our prior synthesis, we categorized research into the following areas:

1) The impacts of information currently included in standard public company audit reports;
2) The impacts of information included in other types of assurance reports, such as sustainability reports;
3) The effects of auditor's association with MD&A or other information outside the financial statements;
4) Additional auditor report content explicitly contained in PCAOB Release No. 2011-003, mainly an Auditor's Discussion & Analysis, expanded use of the emphasis paragraph, and information which is intended to clarify audit terminology; and
5) The engagement partner signing the audit report or being individually identified otherwise.[2]

Recent research has examined issues related to four of the above five categories. We summarize these studies and discuss their impact on our prior findings below. In addition, we discuss the results of studies that have examined Mandatory Audit Firm Rotation/Audit Tenure and disclosure of "Critical Audit Matters," two categories not covered in our prior synthesis, but that are included in the proposed standard.

[1] Mock et al., 2013, p. 331
[2] Mock et al. 2013, p. 333

**The Impact of Information Currently Included in a Standard Public Company Audit Report: Information Concerning Going-Concern Opinions**.

A recent US research study by Kaplan and Williams (2013) shows that when auditors issue a going-concern opinion and they subsequently face litigation, legal settlements are lower than when the auditor did not issue a going-concern opinion. Mock et al. (2013) find that the value for financial statement users of audit reports modified for going concern to be somewhat mixed. The above recent research does seem to suggest that these reports have value for the auditors as they reduce their litigation risk.

**The Impacts of Information Currently Included in a Standard Public Company Audit Report: Information Concerning Internal Control over Financial Reporting**

Asare and Wright (2012a) conducted two experiments to determine whether an adverse opinion for the internal control over financial reporting (ICOFR) affects investors' and analysts' confidence in the standard audit report. They find that investors' and analysts' confidence in the standard audit report [SAR] is highest when it is accompanied by an unqualified ICOFR report, and lowest when an adverse IFCOR report contains an entity-wide material weakness. In a separate study, Asare and Wright (2012b) find that equity analysts view "reasonably possible" entity-wide material weaknesses as more predictive of a future material misstatement than an account-specific material weakness. Additionally, the authors find that analysts view reasonably possible account-specific material weakness as more predictive of a future material misstatement than an unqualified opinion. These two studies suggest that analysts and investors find value in the ICOFR opinion.

Chen et al. (2013) examined the association between ICOFR audits and earnings-return associations. They find that firms with first-time, clean ICOFR audit reports have higher earnings informativeness than in the year preceding these reports when they only received financial statement audit reports. This study also suggests there are some benefits from these ICOFR audit reports.

This recent research confirms the findings as reported in Mock et al. (2013) that investors value ICOFR audits.

**Additional auditor report content: Critical audit matters**

Mock et al. (2013) highlight a lack of research evidence on the communication of critical audit matters. A recent study by Bédard and Gonthier (2013) provides information on the nature of the disclosure of justifications of assessment by French auditors. For the 40 largest French companies, they find that auditors disclose an average of 3.2 critical matters per audit report, and that accounting estimates are the most frequent matters referred to followed by accounting methods. They also find that over the eight years studied, only 20 percent of the matters disclosed in the audit report were new matters. The other 80 percent were on same theme and most of the time were a simple "cut and paste" of the previous year's description of the critical audit matter.

**The engagement partner signing the audit report or being individually identified otherwise**

Mock et al. (2013) highlight a lack of audit evidence on this topic and referenced a commentary by King et al. (2012) that applied insights from three academic frameworks of source credibility, accountability, and the theory of affordances. From their analysis they note that there may be unintended consequences from the proposed changes in this area. While they find that the changes will increase perceived audit quality, they highlight that there is scarce empirical evidence on whether the changes will increase audit quality in actuality.

A recent study to address this question by Carcello and Li (2013) examined a number of consequences associated with the engagement partner signing the audit report in the United Kingdom. The results indicate higher audit fees as a result of the requirement, but also higher audit quality and earnings information. The authors also compared a sample of U.K. firms with a sample of similar U.S. firms, and the results suggest higher audit quality related to the audit partner signature. This study provides evidence of possible benefits of the audit partner signing their name. However, it does not address the question of whether the benefits exceed the costs. Of course, the other point to note that was highlighted by Mock et al. (2013) is that many countries around the world have had this requirement for years with no apparent adverse effects.

**Mandatory Audit Firm Rotation/Audit Tenure**

Prior academic research has documented possible advantages and disadvantages of mandatory audit firm rotation (e.g., Stefaniak et al. 2009). Possible advantages include auditors becoming more independent in fact and/or in appearance, and increased access of smaller audit firms into the audit market. Possible disadvantages include less questioning of management by auditors, a loss of client-specific audit information, which could lead to an audit failure, increased costs, and a greater concentration of large audit firms (Ewelt-Knauer et al. 2012).

Though prior research has investigated the topic of mandatory audit firm rotation, it is difficult to draw conclusive public-policy recommendations for at least three reasons. First, as noted by Li (2010), most research in this area contains an endogeneity problem, such as a self-selection bias of firms who voluntarily switch auditors. Also, the research findings are mixed, both between academic studies and often within specific studies. The research often examines samples, for example non-U.S. companies, that might have characteristics differing from U.S. companies.

Casterella and Johnston (2013) and Ewelt-Knauer et al. (2012) synthesize the academic literature regarding mandatory audit firm rotation. Casterlla and Johnston (2013) caution the use of academic research results that may not generalize into the setting of mandatory audit firm rotation in the U.S. However, they find that eight of the 11 studies conducted in a mandatory rotation setting provide evidence that lends support to a mandatory rotation policy. This contrasts with Eqelt-Knauer et al. (2012) who conclude, “Given the lack of evidence linking mandatory rotation with an improvement in audit quality, regulators need to carefully determine the long-term objectives of a mandatory rotation requirement before implementing a costly measure” (p. 9).

**Summary**

The results of the academic papers published recently largely support the findings of Mock et al. (2013). Recent research documents that investors continue to desire additional disclosures from the auditor specifically related to the financial statements, the audit, and the auditor. Questions persist regarding the value of the current standard audit report. Results of recent research regarding ICOFR opinions generally conclude that investors value these opinions, which is also consistent with Mock et al. (2013). With regards to the auditor’s going-concern opinion, Mock et al. (2013) note that earlier published archival papers question the value of the auditor’s going-concern opinion while later papers find such opinions useful to the market. The recent research discussed above provides more evidence that financial statement users find the auditor’s going-concern opinion useful. Mock et al. (2013) report little empirical evidence regarding the effects of an engagement partner’s signature on the audit report. However as noted above, Carcello and Li (2013) find that such a requirement is related to improved audit quality but also to increased fees. Finally, Mock et al. (2013) report that the provision of assurance on MD&A presentations—at least on the verifiable components such as financial information, key resources, and risks—is perceived to be value-relevant. No recent research has examined this issue.

IV. FINDINGS WITH RESPECT TO CRQ 2: *To what extend is the PCAOB ED responsive to specific information investors and other stakeholders want to be included in the audit report? What information that research indicates stakeholders use and react to, is currently not provided? To what extent can the proposed disclosures be expected to close the ‘gaps’ identified in our prior Synthesis?*

> *“The proposed auditor reporting standard is intended to provide investors and other financial statement users with potentially valuable information that investors have expressed interest in receiving but have not had access to in the past”* (PCAOB 2013, 6).

In this section, we address CRQ2. Our evaluation is based on research cited in Mock et al. (2013) updated to include additional published academic research since 2011. The evaluation is organized around the line items in Table 2 of our prior synthesis, but is somewhat rearranged so that they correspond more closely to the requirements of the PCAOB proposed standard.

Most importantly, the Board's proposed standard would require the auditor to communicate in the auditor's report "critical audit matters" (CAMs) that would be specific to each audit. The auditor's required communication would focus on those matters the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements.

The proposed standard also would enhance the auditor's responsibility with respect to “other information”[3] by adding procedures for the auditor to perform to evaluate the “other information.” The evaluation is intended to identify material misstatements of fact as well as material inconsistencies with amounts or information, or the manner of their presentation, in the audited financial statements, and would be based on relevant evidence obtained and conclusions reached during the audit. Finally, the proposed standards would (1) add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of “other information,” and (2)

[3] "Other information" in the proposed other information standard refers to information in a company's annual report filed with the SEC under the Exchange Act that also contains that company's audited financial statements and the related auditor's report.

enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility to obtain reasonable assurance.

Information gap items concerning the financial statements items stakeholders are interested in

Tables 1 and 2 summarize our evaluation of whether the PCAOB proposed standard responds to specific entity (client) information concerning the financial statements stakeholders want to be included in the audit report and possibly help close the information gap. The 19 entity information gap line items in Tables 1 and 2 are those in Panel A of Table 2 of Mock et al. (2013), somewhat rearranged so that they correspond to the requirements of the PCAOB proposed standard. Table 1 focuses on information concerning the client's financial statements, and Table 2 contains information concerning 'other' information in the annual reports or other client communications that relate to the client's financial statements such as management forecasts.

Each table contains three columns, with Column 1 listing in total 19 possible information gap items. Column 2 summarizes the requirements contained in the Exposure Draft (ED) and our belief as to whether the ED will be responsive to stakeholder needs and will possibly help close the information gap, using a three-level scale (Yes, Possibly, No). In some cases, such as additional communications regarding going concern, the item is indicated as being one on the PCAOB agenda to be considered separately.

Column 3 indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. We use a four-level scale (Ample, Moderate, Minimal, None) to signify the level of research on the information item, and a two-level scale (Moderate, Significant) to signify the extent of research opportunities. This column is discussed in Section V.

**Items 1 to 9:** As indicated in Table 1, the proposed requirement for communication of "critical audit matters" (CAMs) could potentially and significantly respond to stakeholders' demands for financial statements information items number 1 through 9 since the proposed standard requires that the description of critical matters identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures. This outcome assumes that the auditor would consider these items as potentially "critical audit matters" in every audit. This assumption would hold for some entity information items, but not all. For example, the auditor would almost always view difficult or contentious issues (item number 3) as "critical audit matters," but may not view many of management's judgments and estimates (item number 2) as such.

One potential issue relates to what stakeholders may infer if an item they consider important is not explicitly discussed in a CAM communication. The most likely inference is that the auditor did not consider that particular item to be "critical," indirectly inferring the item was deemed "not critical."

**Item 10:** The proposed standard does not require any new procedures or information relative to going-concern evaluation. This topic is on a separate PCAOB agenda. The gap in this area will largely remain, although CAM communications on critical audit matters may highlight risks related to the going-concern assumption.

Information gap items concerning other information included in financial statements or related to the financial statements that interest stakeholders

Table 2 summarizes our evaluation of nine information gap items. More specifically, it considers whether the PCAOB proposed standard responds to *other* information concerning the financial statements (or in some cases beyond the financial statements) that some stakeholders believe might benefit from auditor assurance.

**Items 11, 12, 13, and 14**: These entity information gap items are not addressed by the proposed standard. They may be addressed in the future. Thus, the existing gaps in these areas remain.

**Items 15, 16, and 17**: These entity (client) information gap items are addressed by other PCAOB standards. However, the proposed standard, if adopted, may change the language in these other reports. For example, AS 5 will be amended to assure consistency of the audit report on internal control effectiveness with an unqualified audit report on financial statements. Those changes can be expected to help narrow the information gap.

**Items 18 and 19**: Since non-GAAP information and MD&A are included in companies' annual reports, they would be considered "other information" in the proposed other information standard. As such, auditors will be responsible to look for material misstatements of fact and material inconsistencies with amounts or information in the audited financial statements. This information, however, will not be audited. Thus, while the exposure draft will narrow the information gap in these areas, it does not respond to the users' demand for assurance on them.

**Summary**

In summary, the proposed standard will likely close the information gap relative to some financial statement items of interest to various stakeholders. The proposed standard does not require any new procedures or information relative to going concern, which is on a separate agenda. The information gap on information other than financial statements is not generally addressed and thus will largely remain. The exceptions include non-GAAP information and information in the MD&A. The proposed auditor's responsibilities for these items likely will close the information gap.

Communication gap items concerning the auditor

Table 3, items numbered 1, 2 and 3 and column 2, summarizes how the PCAOB ED responds to the "communication gap" concerning the auditor and indicates our belief that the item will be responsive to stakeholder needs and will possibly help close the communication gap. Column 3 indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. This column is discussed in Section V.

**Item 1:** The proposed standard does not require signature or identification of the audit partner in the audit report. The existing gap in this area remains**.**

**Item 2:** Because it requires a new element in the auditor's report stating that the auditor is independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB, the proposed standard has the potential to reduce the communication gap by providing users information on which requirements the auditor followed. However, the reduction in information gap will be limited because users may lack knowledge of the requirements referenced, and the auditor may refer to multiple requirements. In addition, research studies show that users' perceptions of independence is affected by the level of non-audit services provided, their nature, and the length of the auditor relationship with the company. Although the proposed standard requires disclosure of audit tenure, and fees for non-audit services are disclosed in filing documents, the nature of non-audit services will not be known by users. Accordingly, the information gap may not be significantly reduced.

**Item 3:** The proposed standard adds a new element to the audit report to provide information on auditor tenure. Although this information has been available through the SEC filings, its appearance on the audit report might close the communication gap.

Communication gap items concerning the audit

Table 4, items numbered 4 through 13 and column 2, summarizes how the PCAOB ED responds to the "communication gap" concerning the audit and indicates our belief that the item will be responsive to stakeholder needs and will possibly help close the communication gap. Column 3 indicates our assessment of the level of academic research that bears on the information item and to what extent significant research opportunities exist. Again, this last column is discussed in Section V.

**Item 4:** The proposed standard does not address the role of other auditors involved in the audit; this item is on the PCAOB agenda as a separate project. Thus, unless use of other auditors constitutes a CAM, which may be the case in some audits, the existing communication gap in this area remains.

**Items 5-6:** The proposed standard does not address materiality and the level of assurance given that these matters are already addressed to some degree in other standards. Implicitly, this seems to imply that the PCAOB sees these items as expectation gaps, and not communication gaps. Nomenclature aside, the proposed standard will not close these gaps.

**Items 7-8:** The proposed standard will likely close the gaps related to these items by clarifying the auditor's responsibilities for fraud and financial statement disclosures. The auditor's responsibility for fraud is clarified by adding the phrase, "whether due to error or fraud," to the auditor report, and that for disclosures via enhancements to the auditor's report related to the auditor's responsibility for the notes to the financial statements.

**Items 9-10:** Non-GAAP information and MD&A are included in companies' annual reports, and thus would be considered "other information" in the proposed other information standard. As such, auditors will be responsible to look for material misstatements of fact and material inconsistencies with amounts or other information in the audited financial statements. This information, however, will not be audited. Thus, while the exposure draft may narrow the information gap in these areas, it does not respond to the users' demand for assurance on them.

**Items 11-12:** Significant audit risk, issues of significance related to the audit scope or strategy, difficult or contentious matters, and audit procedures responsive to these risks can be expected to be addressed as "CAMs." The ED requires auditors to "communicate critical audit matters" [CAMs] – matters that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty in obtaining sufficient appropriate evidence; or (3) posed the most difficulty in forming the opinion on the financial statements. The description of critical matters can be expected to identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures.

**Item 13:** The proposed standard enhances certain standardized language in the auditor's report, including the title of the report and audit clients. As such, the standard possibly may reduce communication gaps related to these two items.

**Summary**

In summary, the proposed standard will likely close the communication gap relative to many audit and auditor items of interest to various stakeholders. The proposed standard does not require any information or new procedures relative to audit partner signing the audit report or being individually identified otherwise, the role of other auditors, materiality, and level of assurance. Thus, the communication gap relative to these items will remain.

V. FINDINGS WITH RESPECT TO CRQ 3: *To what extent is there a "Research Evidence Gap?"*

Tables 1, 2, 3 and 4 also summarize in column 3 our evaluation of to what extent a "research evidence gap" exists. We indicate the level of evidence from reviewed published research supporting our conclusion on a four-level scale (Ample, Moderate, Minimal, None) and the extent of research opportunities on a two-level scale (Moderate, Significant). The research reviewed includes approximately 120 published academic research studies beginning in 2007.

<u>Information gap items concerning the financial statements items that interest stakeholders (Table 1)</u>

**Items 1 to 9:** As Table 1 indicates, there is minimal to no prior research on most of the listed items that may be communicated in the auditor's statement concerning critical audit matters. The onus will be on auditors to select the critical audit matters (CAM) to include. The newness of these disclosures creates significant research opportunities, for example to conduct studies to determine the frequency of items which are included in the CAM or to assess which included items affect the users' decisions. Also, the variability of disclosure will create opportunities for researchers to examine the decision making process of auditors in this task and their impacts on various audit variables such as litigation risk, audit delay, audit costs, and financial statements quality. Researchers could also examine the benefits of having the auditor provide this information rather than management or the audit committee as in the U.K.

**Item 10:** Recent research does seem to suggest value in going concern reports and the likelihood that the auditor's CAMs will include factors related to the going concern assumption and going concern risk. Thus, there exits significant opportunities to conduct studies to determine which items will be included in the CAM,  which items will stakeholders actually use and in what context, which items might be confusing or misleading, which items affect the users' decisions, and in what form the information should be disclosed. Research is clearly needed to ascertain what set of items will be investigated/considered by the auditor and whether the inference of factors not being communicated are indeed "not critical" factors.

<u>Information gap items concerning other information included in financial statements or related to the financial statements that interest stakeholders (Table 2)</u>

**Items 11, 12, 13, 14:** Table 2 indicates there has been some, but a minimal amount of, research on all four listed items, and thus significant research opportunities. Among other things, research can investigate the effect of assurance on the quality of information such as management forecasts.

**Items 15, 16, 17**: Prior archival research from the 1990s on quarterly financial statements for U.S. companies shows that auditors' reviews of these statements have value. Opportunities exit to examine whether their value has changed in a post-SOX environment. For example, a recent paper by Bédard and Courteau (2013) finds that for Canadian companies in the years 2004-2005, auditors' reviews are not associated with greater financial statements reliability. There is minimal prior research on earnings releases, and thus significant research opportunities. In contrast, many studied have investigated ICOFR, mostly relating to large audit clients. Similar research could yield value concerning ICOFR for small firms.

**Items 18 and 19:** Concerning MD&A, although sparse, the evidence from survey, focus group, and archival studies indicates that users demand the information in MD&A and find it useful. However, a significant research gap exists with respect to auditor identifications of material inconsistencies with the company's audited financial statements and material misstatements of fact. Thus, significant research opportunities exist, for example, to document identified inconsistencies and misstatements and to study market effects and effects on stakeholder decisions.

Communication gap items concerning the auditor (Table 3)

**Item1:** Archival and experimental studies on the impact of signature on audit quality offer mixed results as do some of the related studies. Carcello and Li (2013) find that such a requirement is related to improved audit quality but also to increased fees. Future research should address the research limitations identified in Blay et al. (2011), such as obtaining direct evidence on the effect of the signature on user decisions or judgments, and exploring other potential benefits of a mandatory partner-level signature requirement. It can also address the question of whether the benefits exceed the costs.

**Items 2 and 3:** The proposed disclosures related to auditor independence are somewhat novel and are disclosures in the U.S. related to auditor tenure. The mixed results of audit research concerning auditor rotation and tenure also suggest additional research. Thus significant research opportunities also exist related to these two items.

Communication gap items concerning the audit (Table 4)

**Item 4 - 10:** Although being addressed elsewhere, the role of other auditors in complex, multi-country audits presents significant research opportunities. Other proposed communications include disclosure of materiality and methods of determining its level, disclosure of circumstances or relationships that might affect the auditor's independence, disclosure of the identities and roles of other auditors, disclosure of the level of assurance, and potential changes in the auditor's responsibilities for detecting fraud. Experiments, surveys, and protocol analyses could help identify changes that would potentially affect users' decisions, or improve the communicative value of the audit report or the quality of the audit.

**Items 11-13:** Users request additional communications concerning significant audit risks and information related to the audit scope or strategy. Significant research opportunities exist is all of these areas. For example, experiments, surveys, or protocol studies can examine whether the disclosure of audit procedures designed to address identified risks affect and more importantly improve users' decisions.

**Conclusion concerning the research evidence gap**

In summary, Column 3 of the tables documents gaps in research evidence upon which to either assess the responsiveness of the ED or the likelihood of it reducing. In some cases the research is mixed, but many items have essentially no prior research that is directly relevant. Given that most of the research evidence is at best moderate, it is difficult for standard setters and regulators to base their standards on sufficient research results.

Several factors may explain this lack of evidence published in academic journals. The most critical seems to be insufficient access to evidence collected by audit firms themselves or by external inspection and quality control activities. Also, researchers face significant challenges in accessing appropriate participants in experimental, survey, interview, and process-tracing studies which could generate useful research evidence.

If one uses the publication process to filter out the most useful research, then another factor relates to timing as the time span from genesis of an academic research project to publication is usually quite lengthy. Also, some of the items being considered by the PCAOB proposals are relatively new. While researchers may be studying them, the output of these studies may still at the working paper stage. As noted above, we have not considered such working papers in this comment.

This research evidence "gap" suggests the need for the PCAOB to more closely work with the auditing research community and to provide or facilitate increased support to auditing researchers to study matters that will be subject to standard deliberations, including facilitating the study of the impact of both proposed and implemented standards.

Table 1: An analysis of how the PCAOB ED responds to the “information gap” concerning entity financial statement information. Items listed derived from Mock et al. (2013)

| | PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**] | Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3]**) |
|---|---|---|
| 1. Accounting policies and practices<br>2. Management’s judgments and estimates<br>3. Difficult or contentious issues, including “close calls.”<br>4. Material Matters<br>5. Component of a larger business enterprise.<br>6. Significant transactions with related parties<br>7. Unusually important subsequent events<br>8. Accounting matters affecting the comparability of the financial statements<br>9. Most significant matters in the financial statements | “Communicate critical audit matters” [CAMs] specific to each audit<br><br>**Yes** for all items included by the auditor in each client’s CAM communications.<br><br>Also, not being included implies items are not critical, thus the audit process did not uncover critical information that should be communicated. | **Minimal** or **No** prior research on all of the 9 listed items<br><br>**Significant opportunities**. For example, studies to determine the frequency of items which are included in the CAM and which included items affect the users’ decisions. Also, the variability of CAM disclosures will create opportunities for researchers to examine the decision making process of auditors and their impacts on various variables such as litigation risk. |
| 10. Going concern assumption | Will be addressed as a separate agenda item<br><br>**No** | **Ample.** Prior research on some aspects – earlier archival studies question the value of the auditor’s going-concern opinion while later papers found such opinions useful to the market. Recent research provides more evidence that financial statement users find the auditor’s going-concern opinion useful.<br><br>**Significant opportunities.** In some areas, for example, the value of positive assurance on the going concern assumption when there are no identified problems, or the impact of explicit auditor’s assessment of the appropriateness of management’s use of the going concern assumption on auditor behavior. |

Table 2: An analysis of how the PCAOB ED responds to the "information gap" concerning entity 'other' financial statement information

| | PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**] | Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3**] |
|---|---|---|
| 11. Management forecasts | Not addressed by the proposed standard and not on the PCAOB agenda<br><br>**No** | **Minima**l prior research on the value of assurance on most types of non-financial information. **Moderate** prior research on assurance of sustainability reports. **Significant opportunities** abound, e.g., investigating the impact of assurance on the quality of management forecasts. |
| 12. Key performance indicators | | |
| 13. Corporate governance arrangements | | |
| 14. Sustainability information | | |
| 15. Quarterly financial statements | Addressed in other standards; the proposed standard modifies the auditor report slightly by requiring the report to be addressed at least to investors in the company and the board of directors and changing the title of the report<br><br>**No** | **Ample** prior research, including a recent study.<br><br>**Moderate opportunities.** For example, investigating whether addressing the report to investors has an impact on the quality of quarterly financial statements. |
| 16. Internal controls over financial reporting | Addressed in other standards; the proposed standard modifies the auditor report slightly by adding new elements to the auditor's report on internal control related to auditor independence and auditor tenure<br><br>**No** | **Ample** prior research, including many recent studies.<br><br>**Moderate opportunities** focusing on the effects of additional communication requirements. |
| 17. Earnings releases | Addressed in other standards<br><br>**No** | **Minimal** prior research<br><br>**Significant opportunities**. For example, investigating current auditors' practices regarding earnings release and the impact of assurance of the quality of earnings releases. |
| 18. Non-GAAP information | "Identify material inconsistencies with the company's audited financial statements and material misstatements of fact"<br><br>**POSSIBLY** due to expanded auditor's responsibility for information outside financial statements | **Moderate** prior research<br><br>**Significant opportunities**, for example, to document identified inconsistencies, auditors' practices, market effects and effects on stakeholder decisions. |
| 19. MD&A | | |

Table 3: An analysis of how the PCAOB ED responds to the "communication gap" concerning the auditor

| | PCAOB ED requirements and whether the PCAOB proposals respond to the information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**] | Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3]** |
|---|---|---|
| 1. Audit partner name | Item not addressed in the proposed standard<br><br>**No** | **Moderate** prior research with mixed results. Recent research suggests higher audit fees, audit quality and earnings information quality. Overall, these imply signature requirement may be beneficial.<br><br>**Moderate opportunities**. For example, future research could further explore benefits, especially in relation to costs. |
| 2. Auditor independence | Explicit requirement that audit firm be independent with respect to the client in accordance with federal securities laws and the rules and regulations of the SEC and the PCAOB<br><br>**Yes**, explicitly required | **Moderate** prior research. Survey results indicate that stakeholders desire information on auditor independence.<br><br>**Significant opportunities.** For example, researchers could examine the impact of such disclosure about independence on users' perception of the independence. |
| 3. Other [items not listed in synthesis table] such as auditor tenure | Adds new element to the auditor's report related to auditor tenure<br><br>**Possibly** will close this gap, although information on auditor tenure has been available through SEC filings | **Moderate** prior research concerning mandatory rotation with mixed results.<br><br>**Moderate opportunities.** Researchers could examine the effect of this disclosure on users' perception of independence and firm rotation rate |

Table 4: An analysis of how the PCAOB ED responds to the "communication gap" concerning the audit.

| | PCAOB ED requirements and whether the PCAOB proposals respond to the audit information line items on a three-level scale (**Yes, Possibly, No**) [**CRQ2**] | Level of prior research (**Ample, Moderate, Minimal, None**) [**CRQ1**] and Research Evidence Gap opportunities (**Moderate, Significant**) [**CRQ3**] |
|---|---|---|
| 4. Role of other auditors involved in the audit | Will be addressed as a separate agenda item<br><br>**No** | **Minimal** prior research<br><br>**Significant opportunities** exist to expand this line of research to the use of other auditors |
| 5. Materiality | Not addressed in ED [addressed elsewhere]<br><br>**No** | **Moderate** level of prior research with mixed results.<br><br>**Significant opportunities**, for example to identify effects on users' decisions. |
| 6. Level of assurance | Not addressed in ED [addressed elsewhere]<br><br>**No** | |
| 7. Auditor's responsibility for fraud | Enhancements related to the auditor's responsibilities for fraud by adding the phrase, "whether due to error or fraud"<br><br>**Yes**, statement as to responsibility explicitly required | |
| 8. Auditor's responsibility for financial statement disclosures | Enhancements to the auditor's report related to the auditor's responsibilities for the notes to the financial statements<br><br>**Yes**, statements as to responsibility explicitly required | |
| 9. Management's responsibility for the preparation of the financial statements | | |
| 10. Auditor's responsibility for information outside the financial statements | Must identify material inconsistencies<br>Responsibility is limited<br><br>**Yes** | **No** prior research<br><br>**Significant opportunities.** For example, examining auditor work in this area and its association with the quality of the MD&A. |
| 11. Significant audit risks, audit procedures responsive to these risks, and results of these procedures | Required to "communicate critical audit matters" [CAMs] – matters that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty in obtaining sufficient appropriate evidence; or (3) posed the most difficulty in forming the opinion on the financial statements. The description of critical matters would identify, describe the considerations, and refer to the relevant financial statement accounts and disclosures<br><br>**Yes**, CAMs would likely involve these risks | **Moderate** Prior Research<br><br>**Significant opportunities.** For example, to conduct studies to determine the frequency of items included in the CAM and study which included items affect the users' decisions. |
| 12. Significant risks, issues of significance related to the audit scope or strategy, difficult or contentious matters noted during the audit | | |
| 13. Other information about the audit [not listed in synthesis table] | Enhance certain standardized language in the auditor's report, including the title of the report, and addressee<br><br>**Possibly**, by clarifying the language and specifying audit clients | |

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

***Cecil H. (C. H.) Moore, Jr., CPA***
*4444 Beverly Drive*
*Dallas, Texas 75205*

November 26, 2013

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

Subject: PCAOB Rulemaking Docket Matter No. 034

Board Members:

Thank you for the opportunity to comment on PCAOB's Proposed Auditing Standard and Proposed Other Information Standard (also referred to herein as "Proposed Standards").

***Background***

For the last 13 years, my occupation has been that of an Investor/Director. As an investor, I have invested in numerous public companies and private enterprises. I serve or have served on four public company boards listed on either the NYSE or NASDAQ generally as the Audit Committee Chairman and Audit Committee Financial Expert (ACFE). Prior to that time, I spent 37 years (29 years as a partner) with KPMG LLP. My primary experience at KPMG included serving many types of clients as an audit partner, managing and area partner, and international partner.

***Perspective of My Comments***

As a former KPMG partner, I am precluded from serving on boards of companies they audit. As a result, KPMG does not perform audits for any of the three boards I currently serve, but I have used and had exposure to all the "Big Four" CPA firms and several smaller CPA firms in various capacities. My comments in this letter are solely mine and not attributable to any public accounting firm or the boards that I serve. Having sat on both sides of the table and being a sophisticated investor provides me with a somewhat unique perspective to comment on the matters in the PCAOB's Proposed Standards.

***Position Overview***

As an experienced audit committee chairman and investor, I am not opposed to changing the annual external auditor's report and expanding the external auditor's scope of work if both can be accomplished in a meaningful manner and on a cost effective basis. Further, I appreciate and agree with the PCAOB's proposed retention of the standard pass/fail model in the external auditor's report and that other proposals were considered during its process. However, the PCAOB's Proposed Standards usurps the audit committee's responsibilities, generally serves to confuse and perhaps misleads stakeholders and users of financial statements, and adds unwarranted costs for public companies.

Further, while I appreciate reviewing the matters set forth in the Proposed Standards, I do not believe these are the major issues of the day. Some suggestions of areas where the PCOAB could spend its valuable time are set forth at the end of this letter.

***Position Major Reasons***

The major reasons for my position on the key aspects of the Proposed Standards are set forth in the following paragraphs.

***Proposed Auditor Reporting Standard:***

- Addressee of Auditor's Opinion – the PCAOB is proposing that the external auditor's (referred to herein as "auditor") report be addressed to the shareholders and board of directors of the company. While I have not performed a review of public company annual reports, my boards already follow this practice. Therefore, I do not foresee this as a major issue that requires a change to current reporting.

- Addition of Notes to Financial Statements in Auditor's Opinion – the PCAOB is also proposing to have the auditor's opinion include the notes to financial statements and refer to both as financial statements thereafter in the auditor's opinion. The notes are an integral part of financial statements and the basic financial statements generally contain a footnote indicating that they should be read in conjunction with the basic financial statements, but notes are not financial statements. What is the purpose of this change and why is it needed? Required disclosures are necessary in the notes to financial statements and are read along with the financial statements. Accordingly, I do not believe the notes need to be mentioned in the auditor's report; certainly not in the way it is currently proposed.

- Auditor Independence – requiring the auditor to state its independence requirement is repetitive during a time when we should be looking for ways to reduce and make additional disclosures more meaningful. Auditors already provide audit committees with letters stating their independence and appropriate disclosures are made public in the audit committee reports. Other key elements are an audit committee's oversights and management's determinations of independence. In addition, since an existing auditing standard requires that the title of the auditor's report is "Report of Independent Registered Public Accounting Firm," that is sufficient to communicate the auditor's independence and that the audit firm is registered with and meets all of the applicable legal and regulatory requirements of the PCAOB.

- Audit Tenure – Determining and disclosing the number of years that the auditor has audited a company should generally be an easy exercise. However, this is a backdoor attempt to addressing mandatory auditor rotation and would certainly be misleading and confusing to investors and users of financial statements. For example, if an audit firm had served a company for say 20 years, an investor might jump to the conclusion that something is wrong which could be far from the truth. Audit committees are required by law to evaluate, engage, and compensate the audit firm because they have all the facts to make such determinations, not investors and users. An audit firm serving a company is evaluated each year by the audit committee, and a determination is made whether to seek proposals from other qualified audit firms. In addition, there are substantial safe guards in this process. In my example of 20 years' service, there would have been four different audit lead partners and numerous staff serving on these audits. Restrictions on other prohibitive services to the audited company and non-selling of other services by the auditor also safeguard independence. Further, disclosing the audit tenure as XX number of years without disclosing any context around and reasons for such tenure (which context and reasons would not be practical to disclose, given the many factors that go into the audit committee's decision as to the selection of the audit firm that is engaged) would be an incomplete disclosure that at a minimum would not be meaningful, and likely would be misleading and confusing.

Accordingly, the proposal for disclosing audit tenure should be abandoned and removed from the Proposed Standard.

- Critical Audit Areas – the Proposed Standard would require that the auditor provide a description of the critical audit areas, describe the considerations that led to auditor to determine that the matter is a critical audit area, and refer to the relevant accounts and disclosures. Listing the critical audit areas is one thing, but providing additional discussion would be less relevant and less useful to investors, expanding the audit report in a nonsensical fashion where the key elements get lost, and adding significant and meaningless costs to enterprises. Of greater concern, is how does an investor or user of the financial statements bridge the gap between the critical audit areas disclosed by the auditor and the major risk factors disclosed by a company in its filings? Perhaps the only users of such information would be potential litigants, academic research, and the PCAOB in its inspection process. Further, one citing of academic research over 10 years old is very weak support for such a change.

  Requiring all of the Proposed Standard's disclosures also usurps an audit committee's oversight responsibilities during the audit process. Bear in mind that a company already discloses its major risk factors and critical accounting policies in various sections of public filing documents that provides ample information for investors and others.

  Accordingly, the proposal for critical audit areas requirement should be abandoned and removed from the Proposed Standard.

- Use of Explanatory Paragraph – the PCAOB is proposing that while it would not require the auditor to emphasize a matter (except for matters already proscribed in its existing standards), but it would permit the auditor to add such explanatory language paragraphs based upon the auditor's judgment and used a subsequent event disclosure as an example. Despite the PCAOB's intention, adding an explanatory paragraph further convolutes the auditor's opinion and serves only to confuse investors and other users. What if the auditor's judgment differs from a management's judgment? Further, explanatory paragraphs may draw undue attention to a particular matter as opposed to the overall financial statements where the reader should be focused. The PCAOB would be better served to limit explanatory paragraphs to specific areas set forth in its current standards.

- Fraud Language – the addition of the phrase, "whether due to error or fraud" is generally understood by investors and users of financial statements, and again could be viewed as repetitive which should be guarded against. Of equal importance, the PCAOB should be assured that by adding this phrase, no additional time would have to be spent by the auditor. If the PCAOB cannot be assured, then the phrase should be deleted from the Proposed Standard.

- "Evaluating" Accounting Principles and Financial Statement Presentation – the auditor performs an "assessment" of the accounting principles used and significant estimates made by management and evaluates the overall financial presentation during each audit. The PCAOB proposes to change from assessing to evaluating. What is the purpose of this change, and does this substitution of "evaluating" require more work by the auditor? If so, the PCAOB should rethink this proposed change.

***Proposed Other Information Standard:***

- "Evaluation" of Other Information - audit committees, preparers, investors, and users of financial statements understand that the auditor reads information outside the financial statements and notes thereto in filings for any inconsistency and misleading disclosure. Should an inconsistency or misleading disclosure occur, the auditor would discuss that matter with management, and if not satisfactorily resolved, it would bring the matter to the audit committee for resolution. The auditor also communicates to the audit committee that no inconsistency or misleading information was found. This process works very well in practice today and has done so for decades.

  Why then is it necessary for the auditor to add "evaluation" language on other information to its opinion? The fear here is that "evaluation" turns into increased auditing and documentation, which would be fueled by the PCAOB's future inspection efforts requiring additional work. As a result, the key issue becomes one of cost/benefit.

  Further, the addition of this requirement, if needed, should be undertaken by the Securities and Exchange Commission (SEC) as a part of its rulemaking process, not the PCAOB. The SEC could decide whether to proceed or not by addressing if this is the best way to protect investors and whether the benefit of such a requirement exceeds the costs to companies and their shareholders, or alternatively whether current practice is sufficient. Only after this process is complete, should the PCAOB address expanding the auditor's report.

In summary, I do not foresee the PCOAB's Proposed Standards adding value to the auditor's opinion. If adopted in their present form, some of the proposed requirements would impinge on an audit committee's responsibilities and incur unnecessary costs. Indeed, a few of the Proposed Standards would serve to confuse and perhaps mislead shareholders and other potential investors and users of financial statements. My suggestion is that the PCOAB end this project and move on to more worthwhile undertakings. At a minimum, the Proposed Standards should omit requirements relating to Audit Tenure, Critical Audit Areas, and Evaluation of Other Information for the reasons cited herein.

Before closing my comments on the Proposed Standards, let me take this opportunity to provide some constructive comments that are intended to be helpful to the PCOAB in other areas where the PCOAB could directly or indirectly be a catalyst for change.

- The PCOAB inspections are important to our public companies and audit firms. The auditor advises an audit committee when an inspection will be performed. However, it mystifies me that as part of the inspection process, the PCOAB does not undertake to discuss any improvements resulting from the inspections with the audit committee chair. I believe that both the PCOAB and the chair could benefit from the inspection process.

- As an investor, I believe a qualified ACFE should serve on each audit committee of every public company. SOX listed the proper requirements for a qualified ACFE when the Act was passed, but unfortunately this was changed due to public comments received by the SEC. Long before SOX was enacted, my audit experience with companies is they were far better served when a CPA sat on the audit committee. Much still needs to be done, and the PCOAB could work as a catalyst with the SEC to revisit this matter.

- The PCOAB could be proactive and assist in addressing disclosure overload and achieving fewer complexes in accounting and reporting.

- While I appreciate that the PCAOB's responsibility is to regulate the auditors of entities reporting to the SEC, my impression about the mindset used in the inspection process gives me concern. Too often, we hear about criticism of auditors and the audit firms or disagreements about judgmental matters. These comments are not recent but have existed since the formation of the PCAOB. I do not believe that was SOX's intent for the role of the PCAOB, and it is certainly not helpful to the profession or shareholders.

  Like the PCAOB, I believe in a zero tolerance for improper audits and that appropriate actions should be taken. However, as to subjective decisions where multiple answers are acceptable and handled through a proper audit process under the prevailing requirements at the time, I find it inappropriate for the PCOAB to insist that its determination is the only correct result in a given situation. Proactive work with the audit firms to enhance audit quality should be the goal. Revisiting these areas internally might be of value to the PCOAB and to the public companies its serves.

I appreciate the opportunity to provide my comments to the PCOAB and trust you will find them helpful in your pursuits for improving the audits of public companies.

Sincerely,

Cecil H. Moore Jr

Cecil H. Moore, Jr.

MFDF

MUTUAL FUND DIRECTORS FORUM
*The* FORUM *for* FUND INDEPENDENT DIRECTORS

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006

PCAOB Rulemaking Docket Matter No. 034

Dear PCAOB Board Members:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the proposed auditing standards dealing with the auditor's report, PCAOB Release No. 2013-005 dated August 13, 2013 ("Proposal").

The Forum, an independent, non-profit organization for investment company independent directors, is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through continuing education and other services, the Forum provides its members with opportunities to share ideas, experiences, and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern. As fiduciaries charged with protecting the interests of mutual fund shareholders, we are deeply interested in fund disclosure. Further, fund directors value and wish to preserve the benefits of the relationship with their independent auditors.

I. Introduction

We appreciate the PCAOB's goal to "increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report." We are concerned, however, that key provisions of Proposal will not achieve these goals with respect to investment companies that file under the Investment Company Act of 1940 and the Securities Act of 1933 ("Registered Investment Companies").

Specifically, we have two primary concerns with the Proposal. The first is that disclosure of "critical audit matters," as proposed, has the potential to disrupt the relationship between a Registered Investment Company's independent auditors and the board's audit committee, making the audit committee less effective. Audit committee members should have the freedom to discuss a wide variety of topics, issues and concerns, without consideration of how and whether such matters might be discussed in an audit report. Second, the additional disclosure that would be required under the Proposal would not be beneficial to shareholders and is unnecessary in light of currently required financial statement disclosure for Registered Investment Companies. We therefore do not believe the proposal should be applied to Registered Investment Companies.

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[1] The Forum's current membership includes over 775 independent directors, representing 105 independent director groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

II. Requiring Disclosure of Critical Audit Matters Will Result in Reduced Communication Between Audit Committee Members and Auditors

Audit committees play a central role in the protection of investors. Specifically, audit committee meetings, and particularly executive sessions, provide directors and their auditors opportunities to explore openly a wide variety of issues, no matter how large and no matter how seemingly immaterial. A free give-and-take between the audit committee members and the auditors regarding the fund's risk control environment, accounting processes, the quality and sufficiency of resources devoted to accounting and compliance functions and other matters is critical. Frank discussion of these and other issues can help directors gain a deeper understanding of the funds they oversee and the management companies that serve those funds.

These discussions are effective in part because the participants, and particularly the independent directors, do not need to worry whether the topics will be disclosed in any public fashion, and hence whether they will later be analyzed and second-guessed by regulators, plaintiffs' attorneys or others. Once a disclosure regime is imposed on top of these communications, the focus will inevitably shift to managing discussions in a way that insulates the parties by minimizing the necessary disclosure. The proposed requirement that critical audit matters be disclosed will thus likely chill this highly beneficial, free-flowing communication between auditors and directors.

Reducing the quantity and quality of communications in audit committee meetings as a by-product of regulatory reform will harm fund investors. Indeed, such a result runs counter to the express goal of PCAOB audit standards such as Auditing Standard No. 16, Communications with Audit Committees, which expressly sought to encourage effective two-way communication between the auditor and the audit committee. As regulators have long recognized, a healthy working relationship between a fund's audit committee and its independent auditors is critical to foster a good financial reporting environment.[2]

III. Disclosure of Critical Audit Matters in Audit Reports Should Not Apply to Registered Investment Companies

We do not believe the disclosure of critical audit matters should be applied to Registered Investment Companies. Unlike operating company investors, Registered Investment Company shareholders are primarily retail investors who need clear and concise information. We believe the proposed disclosure of "critical audit matters" in this context is both unnecessary and potentially misleading to fund shareholders.

A. Registered Investment Companies Are Transparent And Their Material Accounting Policies Are Fully Disclosed

With respect to auditing and accounting issues, Registered Investment Companies are transparent and inherently less complex than operating companies. Substantially all of an investment company's assets are investments, with income from returns on those investments. The financial statements contain a detailed schedule of investments. Expenses are in the form of contractual arrangements with third parties, which are approved and overseen by fund independent directors.

The Proposal seeks disclosure of critical audit matters in the audit opinion because "company management is typically aware of the auditor's most challenging areas in the audit because of regular interactions with the auditor

2 As the SEC has noted, "By effectively carrying out its functions and responsibilities, the audit committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practice." Release 33-8220, Standards Relating to Listed Company Audit Committees, effective date April 25, 2003.

as part of the audit, but this information is not usually known to investors."[3] While operating companies may have complex operations, off-balance sheet items and other accounting issues less visible to investors, such issues do not arise in the Registered Investment Company context. Registered Investment Company financial statement disclosures are comprehensive and already adequately identify areas of risk and complexity, including valuation of investments, as well as identification of all significant contractual relationships and related party transactions. As a result, fund shareholders now have information about the most challenging areas of the audit, and there is no clear benefit from additional discussion in the audit opinion.

For many Registered Investment Companies, the only potential "critical audit matter" is auditing the valuation of hard to value investments that do not have readily available market prices. While fair valuation matters may require a significant time commitment from the audit team regardless of materiality, prospectuses and financial statements currently include extensive disclosure about valuation policies and procedures, including a description of the inputs used in fair valuations. Thus, while the auditor's evaluation of fair values may, in fact, "involve the most difficult, subjective or complex auditor judgments" in the audit of a Registered Investment Company, we do not believe there is benefit to investors to re-stating what is currently fully disclosed elsewhere. Disclosure of fair valuation as a "critical audit matter" under these circumstances will wrongly imply that the already fulsome disclosure in the financial statements is incomplete or inadequate in some manner.

B. Uneven Disclosure Will Mislead Fund Shareholders

Many investment company complexes offer funds with strategies and investment portfolios that are similar to funds offered by other complexes. Indeed, fund investors often look to a "peer group" of funds in order to evaluate their own fund selection. However, should audit firms interpret and apply disclosure of "critical audit matters" differently, shareholders risk being affirmatively misled.

For example, in a peer group of funds with similar investments and strategies, one audit firm may identify fair valuation as a "critical audit matter" because it involved "the most difficult, subjective or complex auditor judgments." Two other audit firms may not identify any critical audit matters for funds in the same peer group because, although time consuming during the audit, the firms conclude that the issues did not rise to a level requiring additional discussion in the audit opinion.

As a result, shareholders will be presented with significantly different audit reports for a peer group of funds with similar investments and strategies, not because of real differences in the funds but because of the differing audit firm interpretations of the rule. Investors may attribute the substantial differences in the auditors' evaluations of how one of the funds in the peer group fair values its securities, to the amount of risk inherent in a particular fund's portfolio. This erroneous conclusion could lead to poor investment decisions, as investors shun funds within a peer grouping that appear to have issues connected with fair valuation of securities.

One potential solution to inconsistent application of the PCAOB standard to different fund audits could be to standardize disclosure so there are virtually no differences between audit reports on funds with similar investments and strategies. The resulting boilerplate, while adding additional disclosure, will not add useful information of value to investors.

C. Disclosure of Critical Audit Matters Will Reduce the Utility of Audit Reports for Fund Shareholders

Investment company complexes do not file a single set of quarter or year-end statements, as do other reporting entities. Different funds within a single complex may have different year-ends. Funds within the same investment company complex generally will share accounting and valuation functions and therefore will be included in a combined annual report. Accordingly, one audit opinion will generally cover numerous funds in a

[3] PCAOB Release No. 2013-005 (August 13, 2013) ("Release") at p. 6.

complex that share the same year-end. Disclosure of critical audit matters, however, would likely only involve some subset of the funds opined on, and thus would have to occur on a fund-by-fund basis. Shareholders, rather than having a crisp statement of audit conclusions for all funds in the complex sharing the same year-end, would have to wade through pages of audit reports seeking one that is applicable to their fund. This additional layer of complexity in fund disclosure does not seem to be in shareholders' best interest.

D. Disclosure of Audit Procedures Performed on Critical Audit Matters For Investment Companies Is Not Useful

The PCAOB asks if including the audit procedures performed, including resolution of the critical audit matter, in the audit report would be helpful to investors. We believe such disclosure would not be helpful in the Registered Investment Company context.

As noted above, Registered Investment Companies currently are required to disclose policies and procedures for significant accounting issues such as fair valuation of securities. Audit procedures for obtaining independent verification of individual fair values are simply not susceptible to a short explanation in the auditor's report. In order to provide context for the decisions made, the auditor would need to include a level of detail that would overwhelm the audit report.

Given the fact that the policies and procedures followed by the fund are fully disclosed in the financial statements, adding pages of additional information to the audit report about how values are tested will not add to shareholders' understanding of the accounting issues presented. Rather, such detail will likely make it less clear to fund investors whether the auditors are satisfied with the policies and procedures followed by the fund.

IV. Other Issues

A. The PCAOB Should Be Clear that Some Audit Entities Will Routinely Have No Critical Audit Matters

Should the Proposal be adopted and require Registered Investment Companies to comply with the new disclosure, the PCAOB should make clear that an audit may not generate any critical audit matters. This will occur when the issues that require the most audit effort (such as fair valuation of securities in the case of a Registered Investment Company) are fully disclosed in the financial statements. We see no additional value to fund shareholders of providing additional information as to how fully disclosed matters have been addressed in the audit. To the contrary, such a discussion may result in shareholder confusion as to whether the auditors are satisfied with the information disclosed in the financial statement footnotes.

B. The PCAOB Should Engage in Investor Testing Before Requiring Additional Information in the Audit Report

The Proposal includes two new auditing standards that would each increase substantially the volume of information conveyed to investors through the auditor's report. Registered Investment Companies, unlike operating companies, have a primarily retail shareholder base. As the SEC has realized, disclosure intended to inform retail shareholders should not be overwhelming. In 2009, for example, the SEC adopted a "summary prospectus" rule requiring all open-end funds to use a summary prospectus format in the first few pages of a fund prospectus. The rule requires presentation of a short list of critical items relevant to shareholders, including investment objectives, costs, principle investment strategies, risks and performance, and so on. The SEC's summary prospectus rule is a result of investor testing showing that short, crisp, clear disclosure improves fund shareholder comprehension.

Both of the proposed audit standards, the "critical audit matters" and the "other information," will result in more information in the auditor's report. The PCAOB should conduct investor testing, as the SEC did in adopting the short form prospectus, prior to adoption of these audit standards to assess whether in fact the additional information is useful to fund shareholders and whether any incremental benefits will outweigh the additional audit fees shareholders will bear.

C. Disclosure of Auditor Tenure

The Proposal also seeks comment as to whether information regarding the tenure of the audit firm would be so useful to investors and other financial statement users that it should be highlighted in the auditor's opinion. With respect to Registered Investment Companies, we believe the answer is "no" because the inclusion of this single fact in the audit opinion would wrongly imply that it is a factor of singular importance.

Auditor tenure is, in the context of Registered Investment Companies, simply not such an overwhelmingly critical factor in the selection of auditors by a fund's audit committee to deserve special focus in the auditor's report. To the extent that disclosing in the audit report the tenure of the audit firm will imply that auditor tenure outweighs any other considerations in the selection of auditors, we believe this requirement is not in the best interest of fund shareholders.

*****

We look forward to continuing to participate in this ongoing discussion, as independent directors have an important role to play in fostering healthy communications with fund shareholders. If you would like to discuss our comments further, please feel free to contact us at 202-507-4488.

Sincerely,

Susan J. Wyderko

Susan Ferris Wyderko
President, CEO

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
Steven B. Harris, PCAOB Member

PROPOSED AUDITING STANDARDS

THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;

THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;

AND RELATED AMENDMENTS TO PCAOB STANDARDS

PCAOB Rulemaking
Docket Matter No. 034

**ENCOURAGING LARGE CPA FIRMS TO FULFILL THEIR HIGHEST POTENTIAL IN THE CONTEXT OF NEW PROPOSED AUDITOR RESPONSIBILITIES**

**National Asian American Coalition**
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September 13, 2013

**ENCOURAGING LARGE CPA FIRMS TO FULFILL THEIR HIGHEST POTENTIAL IN THE CONTEXT OF NEW PROPOSED AUDITOR RESPONSIBILITIES**

The National Asian American Coalition has commented on a number of occasions on the PCAOB's laudable efforts to ensure public support for the highest auditing standards and ethics.

We believe that, in general, the vast majority of large CPA firms, including all of the Big Four, support the highest auditing and ethical standards. The PCAOB has now embarked upon, through this rulemaking, a once-in-a-lifetime effort to enhance the credibility of auditor reports and thereby enhance the reputation of the accounting profession.

As the Chairman of the PCAOB stated and many publications have noted, this could be the most major and significant change in the responsibility of auditors since the Second World War.

Because of the importance of the suggested new responsibilities of the Big Four and other audit firms, the African American AME churches join the National Asian American Coalition in this effort.

We support the changes suggested by PCAOB Chairman James Doty and the entire Board. Particularly, we support the changes requiring information on the auditor's independence from management, the duration of the CPA firm's work with the corporation, and on the need for CPA firms to offer independent and relevant observations on the potential for fraud.

As distinguished long time Board Member Steven Harris stated in his concurring remarks, "These are welcome changes, especially in light of the history of concerns about the impact on independence of the issuer-pay model, the potential for auditor capture in long-running engagements, and the need for clear understanding of the auditor's role. In addition, and most significantly, the proposals require an auditor to report on what he or she has identified as 'critical audit matters.'"

We would urge that the Board take seriously all of Board Member Harris' perceptive observations about the infirmities and weaknesses of the proposed changes.

As Board Member Harris states, these proposals are a step in the right direction, as we attempt to protect ratepayers and investors who depend on the accuracy of these reports.

In California, for example, three major utilities audited by Big Four firms have sought to have over $15 billion in additional costs be imposed on the ratepayers. These additional charges rely on the so-called independence and accuracy of CPA audit reports.

**PG&E as an Example**

To the great credit of Pacific Gas & Electric (PG&E) and its CEO, it has decided to reexamine one key aspect of the auditor relationship even before these proposed rules were issued. It has determined that its long time auditor, Deloitte & Touche, will be forced to compete in the marketplace if it is to be a future auditor for PG&E. That is, Deloitte & Touche must prove by a combination of the accuracy of its audit reports and the costs of its audit reports that it can compete in the marketplace with other large CPA firms.

This PG&E effort is a welcomed first step.

Our groups intend in all future California Public Utilities Commission ratepayer cases to raise this issue relating to Southern California Edison and Sempra (SoCal Gas and SDG&E) auditors.

**Need for PCAOB Independent Audit Fund**

Besides these reforms, we also strongly support other related reforms by the PCAOB. For example, we strongly urge an historic change from the past as to how auditors should be paid. Rather than being paid by the corporation they audit, all payments should come from a central PCAOB-controlled fund. This would enable the auditors to be totally free of corporate influence, at least as it affects the level of compensation for services. We estimate that this PCAOB central fund would be approximately $2.5 billion just for Fortune 500 corporations who would contribute to the fund based upon the complexity and size of the audit.

We believe that many large CPA firms would prefer this if the general level of compensation to them was fair and related to the size and complexity of the audit. Please note, we do not contend that present compensation is excessive. We are merely trying to maximize the independence of and perceptions of independence from management.

**Diversity Goals**

Further, as part of these historic changes, we would urge the PCAOB to once again examine the diversity and lack of diversity at most large CPA firms. In an increasingly complex and diverse world, particularly in the United States, where minorities will soon be the majority and the vast majority of college graduates are women, it might be appropriate for CPA firms, with guidance from the PCAOB, to set aspirational goals for diversity.

For example, within twenty years, 40 percent of senior partners should be women, including women of color, and 40 percent of senior partners should be minorities. We note with particular alarm, the present virtual absence of African American or Latino senior partners at the largest CPA firms and the surprisingly small number of Asian American senior partners even among Vietnamese Americans, Korean Americans and Filipino Americans (these are three of the five most populous Asian American sub-ethnic groups in the United States).

This type of diversity would also enable CPA firms to substantially increase the number of young people who turn to accounting as a profession. And, it would help fulfill Dr. King's dream on full economic and employment integration as articulated by President Obama in his August 28, 2013 speech. (We note that two of America's greatest failures regarding our youth are the absence of sufficient scientists and CPAs among minority youth.)

**Conclusion: Using the Bully Pulpit**

The Chairman and many Board Members have recognized not only the power of rules and regulations, but the power of the bully pulpit.

The bully pulpit can and should be used to encourage CPA firms to aspire to the goals of dedicated and objective independent service that motivated most CPAs when they entered the profession. That is, we believe that most CPAs share Dr. King's dream of equal opportunity and President Obama's desire to encourage upward mobility. We hope that this support will be reflected in the comments CPA firms file herein and the actions they subsequently take to fulfill Dr. King's dreams.

Respectfully submitted,

*/s/ Anthony Hughes*
Anthony Hughes
Senior Pastor
Bethel Memorial AME Church, San Diego

*/s/ Faith Bautista*
Faith Bautista
President and CEO
National Asian American Coalition

*/s/ Mia Martinez*
Mia Martinez
Chief Deputy
National Asian American Coalition

*/s/ Robert Gnaizda*
Robert Gnaizda
General Counsel

September 13, 2013

Dec. 11, 2013

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

Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments (PCAOB Rulemaking Docket Matter No. 34).

Dear Office of the Secretary:

On behalf of the board of directors of the National Association of Corporate Directors (NACD), we are pleased to submit our comments on the above-named Exposure Draft of the Public Company Accounting Oversight Board (PCAOB or Board). Founded in 1977, NACD is the only national membership organization created for and by directors. Given the close interaction between the auditor and the audit committee of a corporate board, and because many of our more than 13,500 members are audit committee members and chairs, NACD believes it is appropriate to provide our views on these issues. We commented earlier (Sept. 27, 2011) on the PCAOB's Concepts Release on the same subject.

**Primary Role of Management to Assert and Auditors to Attest**

As noted in our earlier letter, NACD believes any changes to the auditor's reporting model or expansion to the role of the auditor should preserve the established relationship between management and the auditors, namely, the role of management to *present* and *assert* information, and the role of the auditor to *attest* to that information. We believe that any change that would require or allow the auditor to disclose original information about the company would undermine management's responsibility for the financial statements (including the required certifications under the Sarbanes-Oxley Act. Further, such a change would significantly interfere with the well-established audit committee role in overseeing financial reporting, and could introduce the inappropriate situation of the auditor assuming principal responsibility for certain accounting and disclosures of the registrant. While NACD strongly supports effective independent auditing of financial statements, we would oppose any new standard that blurs the roles of asserting, attesting, and overseeing. These roles and their proper owners must be kept in mind when considering possible changes in reporting on such audits.

In our earlier letter, we expressed significant concerns about the possibility of requiring an auditor's discussion and analysis as part of the standard auditor's report. Thus, we are pleased that the Board has determined that this possibility is not being proposed for adoption.

We are also pleased to note that the Board has decided not to require "emphasis paragraphs." As we noted in our earlier letter, without a framework for defining what requires emphasis, this requirement could have resulted in overly broad disclosures intended to reduce litigation risk, rather than generating any disclosures of interest to investors.

**Critical Audit Matters**

The most significant change to the auditor's report proposed in the Exposure Draft would be the inclusion of critical audit matters (CAM). As described in the Exposure Draft, these could include matters already communicated to audit committees under the existing PCAOB auditing standard (No. 16, Communications with the Audit Committee, effective December 2012). In addition, CAMs could include matters that were already in the engagement review memo and/or discussed with the audit firm's executive office. Thus, in other than extremely simple businesses, multiple CAMs will be added to the standard auditor's report, lengthening it and literally burying the important "pass/fail" language that most readers key into.

Setting aside the issue of whether users will find much longer reports to be truly helpful, we return to our fundamental issue of management's vs. the auditor's role. While we have not performed a formal study, during our discussions in the development of this letter, we found that most of those who have served on audit committees believed that a very high percentage of the matters discussed with them by auditors and included in those required communications are already well disclosed in annual 10-Ks' management discussion and analysis (MD&A) and/or footnotes. Thus, requiring them to be included in the auditor's report is redundant, requiring a second or third level of highlighting for important matters in management's financial statements. Furthermore, it is not in the PCAOB's proper domain. Rather than have the PCAOB introduce such an arguably unnecessary additional financial reporting requirement, we believe it would be far more appropriate for the U.S. Securities and Exchange Commission (SEC) or the Financial Accounting Standards Board to consider whether such emphasized reporting is useful in the first place. Or, perhaps audit committee reports could be enhanced to serve such a purpose. In any event, we do not support having the auditor use its report to initiate what is essentially a management reporting function.

Furthermore, the Exposure Draft delves into the matters of significant deficiencies in internal control, certain going concern considerations, and even certain legal contingencies; all these too would have to be disclosed in the auditor's report as CAMs when present. This would be the case according to the new audit requirement even when there are other accounting rules that say the opposite and do not require management to make such disclosure.

We are also concerned about the impact of an expanded auditor's report on the preparation of year-end financial statements under tight SEC deadlines when management and auditors would be developing separate descriptions of similar matters. When financial management, legal counsel, audit committees, audit engagement partners, reviewing partners, and perhaps national office partners are all asked to provide their thoughts on identical company disclosures and auditor CAM descriptions of the same matters, a fair amount of contradiction could emerge, given the fact that these participants all have different roles and types of expertise. Having to reconcile these competing positions near the critical filing date for the annual report seems to be an unnecessary complication. It could also trigger meritless litigation focusing on discrepancies, even though these arose out of good-faith efforts to comply with this challenging new standard.

**Auditor's Responsibilities Regarding Other Information**

In our earlier letter we indicated that NACD is not opposed to having the auditor provide some level of assurance around management's assertions contained in the MD&A if—and only if—such information is *auditable* and within the *expertise* of the auditor. Nevertheless, we also noted that we believed cost and timeliness were important considerations as well, and that the benefit provided would need to outweigh the cost of the auditor performing such procedures.

According to the current Exposure Draft, the PCAOB has proposed a heightened standard of auditor responsibility for "other information." Previously, the auditor was charged with the responsibility to read the other information and "consider" whether it was consistent with the audited financial statements in material respects. The Exposure Draft changes the "consider" part of this procedure to require the auditor to "evaluate" the information, and specifies the procedures that should be followed in order to meet such a requirement. While those procedures appear on the surface to be very similar to what many auditors are doing under current practice, at least some of the major accounting firms believe that this change will trigger substantially more work in the future.

We hope that this will not become a déjà vu of the PCAOB's first attempt to mandate the auditing of internal controls. Auditing Standard No. 2 was applied in a way that required auditors to apply far too many procedures and incur far too much time than was necessary. While the Board ultimately addressed this through the issuance of Auditing Standard No. 5, many companies and audit committees continue to have a negative attitude toward their audit firm and the PCAOB because of that unfortunate experience. At a minimum, the Board should do careful testing of this aspect of the Exposure Draft to ensure that there is a clear understanding of how a final standard would actually be applied in practice.

**Auditor Tenure**

"A statement containing the year the auditor began serving consecutively as the company's auditor," would be another, major addition to the auditor's report. This matter was not in the original Concepts Release so we did not comment on it in our earlier letter. In the Exposure Draft and accompanying comments by Board members, the PCAOB explains that academic and other research is mixed as to whether audit quality is enhanced by shorter or longer auditor tenure. There apparently are also mixed views among users as to whether they would find such information to be meaningful in making investment decisions.

While disclosing this information would seem to be essentially costless, we question whether including it in the auditor's report is appropriate. We are concerned that without some additional context, simply including a year of commencing an audit relationship could be misconstrued by readers. For example, some financial press accounts could focus on a very long relationship (and imply too "cozy" a situation) without also reporting the many other factors to ensure auditor independence and objectivity such as:

- Continual change among key members of financial management of the company during the audit firm's tenure.
- Mandatory rotation of the audit firm's lead partner and other key partners, as well as other changes in the members of the audit team.

- Careful oversight of the relationship by the audit committee.
- Critical evaluation of audit quality by the audit committee (see the audit firm evaluation tool created by NACD as part of a broader initiative led by the Center for Audit Quality).

We are aware of certain companies that have provided auditor tenure information in proxy statements either in the audit committee report or in information provided in connection with a shareholder ratification vote on the selection of the independent auditors for the coming year. We recognize that these disclosures are presently voluntary and not required. If there is, however, truly sufficient investor interest in the auditor tenure information, we suggest the SEC should consider requiring it to be provided as part of proxy statement disclosures. We do not support including it in the auditor's report.

**Other Proposed Changes to the Auditor's Report**

In addition to those major changes, the Exposure Draft suggests a number of things that we consider to be "cosmetic" changes to the standard report including:

- A statement describing the audit (paragraph 6m).
- Clarifying that the statements are free of material misstatements *whether caused by error or fraud*.
- Addressing the report to both shareholders and the board.
- Referring to footnotes, as well as the financial statements.
- Stating in the report that the auditor is independent.

We have no objections to these changes.

**Summary**

As noted above, we have significant reservations about the three major changes proposed in the Exposure Draft: CAMs, Auditor's Responsibilities Regarding Other Information, and Auditor Tenure. As noted in our earlier letter, NACD urges the PCAOB to thoroughly consider how the changes proposed in this Exposure Draft could impact how the audit committee and management—equally important parties in the financial reporting process—carry out their responsibility to investors. We note, with full agreement, that the Board has urged companies and auditors to test the application of the CAM proposal using recent experience. We believe that such testing will demonstrate that the vast majority of CAMs in practice will repeat similar disclosures by management as noted in our comments above. We also urge testing of the "other information" provisions of the Exposure Draft as we believe it will demonstrate that such a proposal is not cost beneficial.

As also mentioned in our earlier letter, we urge the Board to make special efforts to reach out to the investment community to ascertain clearly how the proposed changes to the auditor's report would be used in their investment decisions.

NACD appreciates the opportunity to comment on this Exposure Draft, and would be pleased to respond to any questions regarding the views expressed in this letter.

Sincerely,

Ken Daly
President and CEO, NACD

Reatha Clark King
Chair, NACD

NATIONAL ASSOCIATION OF
REAL ESTATE INVESTMENT TRUSTS®

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
comments@pcaobus.org

**Delivered Electronically**

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements (PCAOB Release No. 2013-005, August 13, 2013, PCAOB Rulemaking Docket Matter No. 034)* (the Proposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 193 companies representing an

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equity market capitalization of $659.6 billion[1] at September 30, 2013. Of these companies, 154 were Equity REITs representing 90.7% of total U.S. listed REIT equity market capitalization (amounting to $598.5 billion). The remainder, as of September 30, 2013, was 39 publicly traded Mortgage REITs with a combined equity market capitalization of $61.1 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, Notice of Roundtable, (PCAOB Release No. 2011-003, June 21, 2011, PCAOB Rulemaking Docket Matter No. 34*[2]*)* (the Concept Release) that discussed alternatives for changing the auditor's reporting model. In particular, NAREIT supports the PCAOB's decisions to retain the current pass/fail model of auditor reporting and to reject the requirement for an auditor's discussion and analysis. However, NAREIT does not support a requirement for the auditor to report on "critical audit matters" (as that term is defined in the Proposal). In our view, such a requirement would not meet the PCAOB's objective of providing users of financial statements with additional meaningful information. As discussed further below, it is our view that the PCAOB's proposal for auditor reporting of critical audit matters would largely result in generic disclosures that are duplicative of information that is provided by management while simultaneously increasing audit cost.

**NAREIT Comments on Critical Audit Matters**

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand;

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information already disclosed by the issuer;

[1] http://returns.reit.com/reitwatch/rw1310.pdf at page 21
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/Concept_Release.pdf

- Increase audit fees for, among other things, the senior level time the auditor would incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee; and,

- Exacerbate existing time pressures to meet financial reporting deadlines.

Each of these concerns is further discussed below.

*Confuse and mislead users with a piecemeal discussion of audit procedures that readers of the financial statements have no context or basis to understand*

In reporting critical audit matters, auditors would likely feel compelled to describe the audit procedures they performed, consistent with the examples in the proposal. NAREIT questions whether the substantial majority of financial statement users are likely to understand a discussion of audit procedures. When the auditor discusses its audit process with the audit committee, the auditor has the opportunity to answer questions and provide additional information to the audit committee members, thus limiting the risk of confusion or misunderstanding about the nature and extent of audit procedures performed. Further, when the audit committee and auditor are discussing the audit work in discrete areas, they are doing so in the context of the audit taken as a whole. In this context, there is no potential for confusion about whether the auditor is, in some way, effectively providing a piecemeal opinion on an individual line item within the financial statements.

NAREIT believes that users would likely be confused by the discussion of audit procedures in an audit report not only because they lack an understanding of the audit process as a whole but because they lack the context for the discussion of discrete audit procedures on an individual financial statement line item. We are therefore concerned that the Proposal would widen the existing expectation gap regarding the nature and extent of audit work required by the PCAOB's auditing standards.

*Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer*;

One of the examples in the Proposal (Hypothetical Auditing Scenario #3) illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[3] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

[3] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77

The Proposal acknowledges a fact pattern whereby control deficiencies that are not material weaknesses would be disclosed by the auditor. For example, Appendix V of the Proposal states:

> Because a deficiency or deficiencies in the company's internal control over financial reporting could have a significant effect on the conduct of the audit and on the level of difficulty in gathering audit evidence or forming an opinion on the financial statements, an internal control deficiency might be an indicator of a critical audit matter.[4]

This would mean that the auditor would be disclosing sensitive information that is not otherwise required to be reported by the issuer. Furthermore, unlike the existing audit requirement to discuss such matters with the audit committee, the information is being presented to users of financial statements with limited context and no opportunity for the clarifying discussion that occurs during most audit committee meetings.

We strongly believe that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Proposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

*Duplicate information already disclosed by the issuer*

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the critical accounting policies and estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover critical accounting policies and estimates provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the Financial Accounting Standards Board (FASB) evaluate this aspect of financial reporting and provide additional guidance through the comment letter process. Another possibility would be to request that the FASB evaluate these disclosures as part of its Disclosure Framework Project.

*Increase audit fees for, among other things, the senior level time the auditor will incur describing the critical audit matters for purposes of drafting the proposed disclosure and incremental time discussing those matters and the related disclosure with management and the audit committee*

[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-32

NAREIT acknowledges that the current audit standards require the auditor to identify and communicate significant audit matters to the audit committee. However, NAREIT believes that requiring the auditor to report critical audit matters in the audit opinion would lead to increased audit fees. At a minimum, each and every audit engagement team would incur additional senior level time in order to determine the critical audit matters (CAMs) for purposes of drafting the proposed disclosure and discussing both the CAMs and the related disclosure with management and the audit committee.

Further, given the significant degree of subjectivity involved in determining which significant audit matters are "the most critical" and the inevitable second guessing of that determination by audit committees, management, PCAOB inspection teams, SEC staff and litigators, NAREIT anticipates that audit partners would need to consult others in the firm regarding both the selection of CAMs as well as the report language. The added time and related increased risk incurred by the audit firm would directly translate into an unnecessary and avoidable increase in annual audit fees. Further, we believe that there is a risk of inconsistent disclosure of CAMs both within and among the audit firms. We sense that the added disclosure in the audit report would open both audit firms and issuers to increased litigation risk, the cost of which will be passed on to issuers (and thus investors) in the form of increased audit fees.

*Exacerbate existing time pressures to meet reporting deadlines*

Given the nature of the audit process, auditors are unlikely to be able to conclude definitively on "the most" significant, judgmental or complex audit matters until substantially all the audit work has been completed. That necessarily places the decisions and discussions surrounding CAMs into the very final stages of the audit and just prior to the release of the audited financial statements on Form 10-K. If the Board moves forward with this Proposal, NAREIT foresees the addition of a very time consuming step into the late stages of what is already a tight deadline for many issuers.

In light of time pressures, liability concerns and fee issues, audit firms may feel compelled to develop standardized audit report language for common critical audit matters. Thus, stepping back and looking at the sum total of our concerns, we believe there is a significant risk that the PCAOB's proposal will result in boilerplate, duplicative disclosures that add to the cost of the audit without adding to the information available to users of financial statements.

**NAREIT Comments on Auditor Tenure**

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer's public filings. However, NAREIT does not support the Proposal that auditors report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that does not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only. A statement regarding auditor tenure placed in the audit report would provide no information about how the audit committee assesses the quality of the audit work and determines that a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report. If users of financial statements believe this information would provide significant value, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments.[5]

**NAREIT Comments on Other Information**

We do not understand the purpose of expanding the audit report to explicitly address information that is not audited and that is often outside the expertise of an auditor. More importantly, NAREIT believes the proposed language that would be included in the audit report regarding other information would mislead users into believing that the auditor has an authoritative basis to conclude on the sufficiency, accuracy or completeness of the other, unaudited information. This, in turn, would cause auditors to do additional work and invest additional resources into the reading of the unaudited information beyond what may be required by the standard because they would be perceived as being more closely associated with that information. Inevitably, this exercise would increase the cost of the audit as well as the cost of preparing the unaudited information. The result would be more cost to shareholders without additional assurance to those same shareholders.

In NAREIT's view, there is no need to change the existing audit standard related to other information contained in a report that includes audited financial statements. We are unaware of any evidence indicating that auditors are either not meeting their existing (albeit very limited) responsibilities for other information or that users are misinformed about which elements of an SEC filing are audited and which are not. In fact, in its Proposal, the PCAOB notes that "investors generally were not supportive of auditor assurance on other information outside the financial statements."[6] To the extent that the audit committee or external third parties (*e.g.,* underwriters, institutional investors, or analysts) believe it is appropriate to obtain additional assurance on other information included in SEC filings, the PCAOB's existing standards provide auditors with the tools to meet those requests. Accordingly, nothing more is needed.

[5] In its Proposal, the PCAOB notes that the UK-listed companies are "required to provide information about auditor tenure in a separate section of the annual report" (page A5-16.) The approach used by the UK is consistent with our view that information about auditor tenure, while potentially of interest to investors, is a matter of corporate governance.
[6] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 25

The PCAOB states that

> The required procedures under the proposed other information standard would focus the auditor's attention on the identification of material inconsistencies between other information and the company's audited financial statements and on the identification of material misstatements of fact, based on relevant evidence obtained and conclusions reached during the audit.[7]

NAREIT views these requirements as largely consistent with the existing audit standard which states that the auditor "should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation appearing in the financial statements."[8] However, the proposed changes to the standard, and the related proposed language in the audit report, suggest that the auditor's responsibility should extend beyond what has been historically required. Specifically, under the Proposal the auditor would be required to state that, "in addition to auditing the financial statements and the Company's internal controls over financial reporting," the auditor would also be required to "evaluate" the other information in the filing, an evaluation that was "based on relevant audit evidence obtained and conclusions reached during the audit." What level of assurance is provided by an "evaluation?" Absent clarification by the PCAOB, users of financial statements could mistakenly perceive the audit firm's work and the level of assurance provided surrounding other information as something substantial, with no meaningful understanding as to the distinction between an "evaluation" and an "audit." This perception gap could have severe ramifications on the investment community as well as the audit profession. Instead of adding more clarity to the audit report and narrowing the expectation gap, we view this Proposal as significantly obfuscating the nature and scope of an audit and dramatically widening the expectation gap.

In NAREIT's view, this aspect of the Proposal is fraught with many issues involving each financial statement users' perspectives, and would likely lead auditors by default to performing a far more significant amount of unnecessary work on other information than under current standards due to the lack of clarity regarding the nature and scope of the auditor's responsibility. This would cause increases in audit fees when there is absolutely no demand or requirement for any type of assurance on this information and could lead to less useful information being provided to investors.

**Summary**

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report, disclosure of auditor tenure, and the auditor's responsibility for other information are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of

[7] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page 7
[8] See AU 550.04

financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Proposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

In the event that the PCAOB decides to move forward with the Proposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community in order to fully assess both the costs and the benefits of the Proposal. This would provide the Board with evidential matter in evaluating whether the Proposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Proposal's objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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NASBA

National Association of State Boards of Accountancy

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December 9, 2013

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

Via e-mail to comments@pcaobus.org

Re: "Proposed Auditing Standards: The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards," PCAOB Rulemaking Docket No. 34.

Dear Members of the Public Company Accounting Oversight Board:

We appreciate the opportunity to provide comments on "Proposed Auditing Standards: The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards" (the Proposal) issued by the Public Company Accounting Oversight Board (PCAOB or the Board). The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness of the licensing authorities for public accounting firms and certified public accountants in the United States and its territories. Our comments on the Proposal are made in consideration of our ability as state regulators to adjudicate based on the proposed standards. In furtherance of that objective, we offer the following recommendations.

We support the Board's efforts to modify the auditor's report so that it is more useful to investors. The more information of value auditors are able to provide to the users of audited financial statements, the greater the value and relevance auditors can provide to the capital markets.

Specifically, we are supportive of the following changes to the auditor's report:

1. Providing clarity regarding the responsibilities for other information included within the 10-K.

2. Including a statement that the auditor is required to be independent under the applicable rules and regulations.

3. Additional standardized language regarding the auditor's responsibilities with respect to the detection of error or fraud and performing procedures to assess the risks of material misstatement.

4. Making it clear that the audit includes the notes to the financial statements.

## Critical Audit Matters

### General Support

With respect to the disclosure of Critical Audit Matters (CAMs), we support the underlying principle of providing meaningful and useful information to investors and other financial statement users. Certain disclosures, however, will potentially be at odds with the historical reporting model, which has management being responsible for the company's financial statements and disclosures and the auditor attesting to that information.

In responding to the Board's request for comments on the proposal, we also offer the following overall observations:

1. We have been following the International Auditing and Assurance Standards Board's (IAASB) proposal and applaud the Board's efforts in working with the IAASB on this proposal as it is important they be aligned.

2. With such significant changes being proposed, an important fiduciary duty exists to ensure that any changes adopted narrow the expectation gap between the understandings/perceptions by users regarding the audit and the reality of what an audit, which provides reasonable assurance, can achieve.

3. Changes that are market driven add value for users of financial statements, but they should be made with appropriate consideration of costs and benefits.

4. As the State Boards will be adjudicating based upon the PCAOB's rules, we would like to avoid requirements that would result in challenging implementation issues. Consequently, we ask the Board to give added consideration to including:

   a. Unique disclosures over time becoming boilerplate and, as a result, whether the Board's objectives of providing useful information to investors will be achieved.

b. The questioning of what is considered to be a CAM through the PCAOB inspection process and whether restatements of auditors' reports may be required as a result. We note that a failure to report a CAM does not mean that the financial statements were not fairly presented in accordance with generally accepted accounting principles, or that the audit procedures applied to determine whether or not the financial statements were determined in accordance with such principles were not in accordance with generally accepted auditing standards issued by the PCAOB.

We have concerns that the proposed requirements may result in matters being reported by the auditor that are not required to be reported by management which could lead to investor confusion.

We also have concerns that:

- Trying to describe the procedures related to CAMs in an extensive way that is understandable to readers will be challenging and may not add value.

- The sample reporting examples in Appendix 5 of the Proposal do not illustrate the reporting requirements as stated in the proposed standard (e.g., discussion of audit procedures, use of specialists, national consultation, etc.).

As state laws reference or adopt these requirements, we see potential practical implementation challenges, including:

- Suppose the auditor encounters a potentially illegal act. Arguably, this could meet the definition of a CAM; however, including discussion regarding an illegal act in the auditor's report may not be either sufficient or appropriate.

- The same matter may be considered a CAM in one year, but not another. Consequently, comparative disclosures may become very complicated.

- Continued use of emphasis of matter (EOM) paragraphs: As proposed, it is unclear how an overlap between CAM and EOM paragraphs would be addressed.

Based on the above, we offer the following suggestions:

1. Provide greater clarity regarding what should be considered a CAM.

   a. Narrow the starting population of potential CAMs to only those matters discussed with the Audit Committee - under AS 16 and other applicable PCAOB standards (the proposed IAASB standard has a similar requirement to this).

b. Provide additional guidance, beyond that included in paragraphs 9 and 10 of the proposed auditor reporting standard, that provides further clarity on how the auditor should filter potential CAMs to those that are ultimately reported in the auditor's report.

c. Recommend that the extent of communications with the audit committee about a potential CAM be an additional filter to apply in the final determination of what the CAMs are.

d. Limit CAMs to those matters already disclosed in the financial statements.

2. Provide greater clarity regarding the communication of CAMs in the auditor's report and guidance if the communication of CAMs should include a discussion of audit procedures performed. If it is the Board's intent for the auditor to include a discussion of procedures, suggest that an explicit statement be added to the auditor's report that states the CAM disclosure is not the totality of all procedures performed on a CAM and/or additional guidance for the procedures the auditor should include.

3. Provide additional guidance for the documentation requirements with respect to matters ultimately concluded not to be CAMs.

4. Include a statement in the standard that, in a situation where there is overlap between a CAM and an EOM, they should be integrated so as to avoid duplication/repetitiveness in the auditor's report.

5. Include the concept that each year the auditor takes a fresh look at CAMs and does not maintain a "rolling inventory" of CAMs.

## Matters Not Required to be Disclosed in the Financials but by Definition are CAM

The Proposal uses an example of a loss contingency that was a complex matter but which management and the auditor concluded did not have to be disclosed in the financial statements. The Proposal says that the matter should be disclosed in the audit report as CAM. If GAAP does not require disclosure of a matter, regardless of the complexity of the matter, from a regulatory standpoint, we question the appropriateness of the audit report requirement as CAM. In addition, such disclosure in the audit report would likely confuse readers because there would be no explanation of the matter in the financial statements.

## References to Relevant Financial Statement Accounts and Disclosures

The Proposal requires the auditor to: "Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable." The norm for references to financial statements in the auditor's report today is for the auditor to refer to a footnote disclosure in the financial statements, not financial statement accounts, as the footnote disclosures will typically reference to the amounts in the financial statement accounts. We suggest that references in the auditor's report to CAM be limited to reference to disclosures.

## Conformity with International Standards

The IAASB's recently issued an exposure draft, "Reporting on Audited Financial Statements Proposed New and Revised International Standards on Auditing (ISAs)" that uses the term "Key Audit Matters" in the same manner that the PCAOB uses the term "Critical Audit Matters." We suggest that the PCAOB, the IAASB and the Auditing Standards Board use similar terminology, definitions and requirements wherever possible.

## Communication of CAM in Writing by the Auditor to the Audit Committee

Under present standards, when an auditor communicates with the audit committee, the communication does not have to be in writing. The auditor only has to document the information that was communicated orally. The Board has recently issued an auditing standard that enhances communication of auditors with audit committees. We believe that the Board should revisit the issue of permitting only oral communication and require in the instance of CAM that, because of its significance, CAM be communicated in writing.

## Other Information

The Proposal updates the current PCAOB auditing standard for "Other Information" and adds a section in the auditor's report that addresses the auditor's responsibility for evaluating "Other Information." We support the addition of this section to the auditor's report.

The proposed new paragraph says that the auditor has evaluated whether the "Other Information" included in the annual report filed with the SEC contains a material inconsistency with the financial statements in the annual report, a material misstatement of fact, or both.

The proposed auditor's report does not include a definition of "Other Information." We suggest that the commonly understood Auditing Standards Board's definition of what constitutes "Other Information" (AU-C 720) be retained. Consider limiting auditor involvement to Management's Discussion and Analysis, including Critical Accounting policies.

We are suggesting this change, as there are several practical challenges with the proposed audit procedures, including:

1. The auditor does not have a basis or the knowledge to evaluate all qualitative statements in the 10-K. Examples include backlog, executive compensation, marketplace position, etc.

2. It is unclear what will be expected in terms of documenting the procedures with respect to other information.

3. The standard does not address the documentation aspect: How does an auditor document that he/she "read and evaluated"?

4. It is unclear if the auditor is obligated to aggregate immaterial inconsistencies with the financial statements or immaterial misstatements of fact and evaluate them on a collective basis.

## Retention of Pass/Fail Model

We agree that the Pass/Fail Model should be retained. As noted earlier with such significant changes being proposed, an important fiduciary duty exists to ensure that any changes adopted narrow the expectation gap between the understandings/perceptions by users regarding the audit and the reality of what an audit, which provides reasonable assurance, can achieve.

## Auditor Independence

We support the proposed addition of a paragraph addressing auditor independence. Stating in the auditor's report that the auditor is independent in accordance with federal laws and regulations and the rules of the Securities and Exchange Commission and the PCAOB will help financial statement users understand that the auditor must comply with these laws, regulations and rules, and not rules issued by other organizations.

## Tenure of Service

### Proposed Sentence Regarding Tenure of Service

The Proposal includes a sentence addressing tenure of service at the end the proposed new paragraph in the auditor's report addressing auditor independence. The sentence is: "We or our predecessor firms have served as the Company's auditor consecutively since [year]."

The Proposal also cites a rule adopted by the UK Financial Reporting Council that requires UK companies to provide information on the length of auditor tenure in a separate section of their annual report and not in the auditor's report.

**<u>Proposed Placement of Tenure of Service Sentence</u>**

We believe that the placement of the proposed sentence on auditor tenure as the last sentence in the paragraph on auditor independence clearly creates a link between auditor independence and tenure of service.

Yet, as the Proposal states, the PCAOB has not reached a conclusion regarding the relationship between audit quality and auditor tenure, and the PCAOB's inspection process has not been designed to determine such relationship.

Please consider the potential negative implication of the placement of the sentence on tenure in the last sentence in the auditor independence paragraph. We suggest that the sentence on tenure of service be placed in a paragraph immediately above the auditor's signature.

We appreciate the opportunity to respond to the Proposal referenced above.

Sincerely,

Carlos E Johnson

Carlos E Johnson, CPA
NASBA Chair

Ken L. Bishop

Ken L. Bishop
NASBA President and CEO

NATURAL ALTERNATIVES INTERNATIONAL
World Leader In Nutritional Science

December 9, 2013

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 2006-2803

Submitted via electronic mail: comments@pcaobus.org

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 034**

Natural Alternatives International, Inc (NAI) is a leading formulator, manufacturer and marketer of nutritional supplements. Our Company stock is traded under the symbol NAII on the NASDAQ Global Market Stock exchange.

Thank you for giving us the opportunity to share our thoughts and comments on *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion, the Auditor's Responsibilities regarding Other Information in Certain Documents containing Audited Financial Statements and the Related Auditor's Report, and Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard.*

While we support the PCAOB's efforts to improve financial reporting for investors and other financial statements users, we cannot support these Board proposals as currently outlined. In our opinion, these Board proposals will potentially create investor confusion that may lead to false conclusions on the quality of a Company's financial statement information and the audit work performed.

**Critical Audit Matters (CAM's)**

We believe the Board's proposal to require the auditing firm to determine and disclose CAM's will create unnecessary disclosures and generate increased reporting costs for all registered companies. In our opinion, the key CAM's are already required disclosure in public filings and are included under Part I, Item 1A – "Risk Factors", Part II, Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operation" and "Critical Accounting Policies and Estimates." We believe CAM's are inherent at some level for all companies and are the basis for the development of the independent

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auditor's auditing process. These auditing firms possess extensive industry experience and technical knowledge that allows them to identify CAM's surrounding financial reporting issues and design their audit plans and strategies to accommodate these risks. As such, the audit process and auditor's opinion on financial statements should remain a pass/fail model that is all inclusive rather than create a perception that the "taken as a whole perspective" does not apply to "X, Y and Z." We also believe that requiring the auditor to include CAM's in their audit opinions will result in increased and unnecessary disclosures and auditing fees as the auditing firms attempt to include any and all known audit risk items in their reports (after extensive negotiations with company management, audit committee board of directors and Regional/National Firm offices) in an effort to reduce their exposure to potential deficiencies identified during subsequent PCAOB audit reviews and increased premiums from their E&O insurance underwriters.

**Reporting on Other Information**

On the surface we agree with the Board's desire to create more clarity around the auditor's responsibilities for the "other information" included in financial statements filed with the Securities and Exchange Commission. However, we are concerned that this requirement will also unduly increase the costs associated with the auditing process and create confusion for the investing public related to the primary ownership and responsibility for this information. We believe the SEC rules and regulations surrounding the requirements for the content of "other information" included in public filings are well defined and properly fall under the responsibility of the company's management. Additionally, "other information" which is included in the MD&A discussion often includes forward looking statements and management's predictions of future events. These items will create difficulty for the auditing firm to reach definitive conclusions and may lead to investor confusion surrounding independence as the auditing firm purports to support or reach alternative conclusions on management's representations.

As an alternative to the Board's proposal, we would support a modification to the standard auditor's unqualified opinion to include a separate paragraph that clearly states that the auditor's opinion does not encompass the "other information" included in financial statements filed with the Securities and Exchange Commission.

Thank you for your consideration.

Respectfully,

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December 10, 2013

*Sent electronically to: comments@pcaobus.org*

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Reference: Request for Public Comment: *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards;* PCAOB Release No. 2013-005; PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Board:

The Accounting and Auditing Standards Interest Group of the New Jersey Society of Certified Public Accountants (NJSCPA) is pleased to provide its comments on the above referenced proposed standards. The NJSCPA represents over 15,000 certified public accountants and prospective CPAs. The comments herein represent those of some of the individuals of our Accounting and Auditing Standards Interest Group only and do not necessarily reflect the views of all members of the NJSCPA.

We commend the PCAOB's effort to make improvements to reports on audited financial statements, and appreciate the opportunity to provide the following comments on the questions contained in the Proposed Auditing Standards.

As a result of our review of the proposed standards we have summarized our overall views in additional to addressing the Board's specific questions below.

**Overarching Comments**

While we understand the difficulty facing the Board with balancing the need from investors for more information specific to the audit of the company's financial statements with the practical concern of what is appropriate for the auditors to share that provide relevant and useful information to the investors, we have the following concerns regarding the proposed standards:

- We agree with the retention of the pass/fail model since it gives the clearest message to investors. Our concern with the inclusion of critical audit matters in the auditor's report is the possible incorrect perception of investors that there are varying degrees of an unqualified opinion. An unqualified opinion that includes the disclosure of several critical audit matters may be viewed as less unqualified than an unqualified opinion where only one or no critical audit matters are identified.

- Since there is no conclusive correlation between auditor tenure and audit quality, auditor tenure should not be included in the auditor's report as it may encourage investors to make incorrect assumptions. If an investor needs to know about the tenure of the current auditor, the information is readily available in EDGAR.
- Since the proposed standard may require that the auditor disclose a critical audit matter that the client is not required to disclose under existing financial reporting standards, the auditor could be faced with the dilemma of complying with auditing standards and violating client confidentiality laws and regulations if the client does not give the auditor permission to disclose such matter.
- The example report language included in the proposed standard indicates that the auditor evaluated all other information for material inconsistencies and material misstatements of fact when the proposed standard does not require it and the auditor is often in the position of not being qualified to make that evaluation. In addition, we do not understand what level of assurance is given by the auditor "evaluating" the other information and neither will the investors.
- It is inconsistent with current standards to require auditors to evaluate other information that was not available as of the audit report date after their audit report date.

**APPENDIX 5 – Additional Discussion Related to the Proposed Auditor Reporting Standard**

***II. Objectives***

*1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?*

We do believe that the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report since it highlights the overall context for the requirements of the standard. However, as we will discuss in more detail later, our concern is with the subjective nature of the term "critical audit matters". Though the term is later defined in the standard, we believe the identification of critical audit matters is highly subjective. With any new standard, it is critical that the PCAOB ensures that auditors can apply this standard consistently. Though the objective is clear, due to the subjective nature of critical audit matters, we do not believe there can be consistent application.

***IV. Basic Elements***

*2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or* *equivalent body. Are there others to whom the auditor's report should be required to be addressed?*

No, we believe that it is appropriate to address the auditor's report to the investors/ shareholders and the board of directors of the company.

*3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?*

We believe it is appropriate to revise the description of the nature of an audit to better align it with the risk assessment standards and do not believe that any additional requirements are necessary.

*4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?*

We do not believe that the additional independence statement is necessary but do no object to its inclusion in the auditor's report.

5. *The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.*

a. *Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?*

   As discussed in the proposed standard, research related to the correlation between auditor tenure and audit quality has been inconclusive. Some research points to short-term tenure having an adverse impact on audit quality where other research indicates that long-term tenure has an adverse impact and other studies point to both as having detrimental effects on audit quality. In addition, the Board has not been able to reach a conclusion regarding the relationship between audit quality and auditor tenure after significant outreach. Considering that there are so many differing opinions on the topic and no conclusive evidence to support either opinion, we believe that the disclosure of auditor tenure will result in unintended consequences, such as users making inappropriate and inconsistent assumptions and/or conclusions based on the length of auditor tenure.

b. *Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?*

We are not aware of additional challenges.

c. *Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?*

Though we acknowledge that investors and other users can obtain auditor tenure information from EDGAR and other sources if that information is useful for them, we believe that by including that information in the auditor's report it is encouraging investors and other users to draw a conclusion on whether the tenure has a positive or negative impact on audit quality when there is inconclusive support for either opinion. As a result, we do not believe audit tenure should be included in the auditor's report.

*6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?*

We do believe that it would be helpful to investors and other users to describe the auditor's responsibilities for other information outside the financial statements in the auditor's report so as to make the auditor's responsibilities clear and dispel incorrect assumptions and misconceptions. However, as we discuss more fully below, we disagree with the proposed standard since we believe it may lead to investors' incorrect assumptions and misconceptions instead of reducing them and significantly expands auditor's responsibility.

*7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?*

We believe that the board should provide a specific order in order to facilitate comparability and consistency for users of financial statements. We also suggest that section titles be included in the standard auditor's report.

*8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?*

We do not have any suggestions for other changes to the basic elements of the auditor's report.

*9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.*

We do not believe that the proposed basic element changes related to auditor independence and auditor tenure will cause significant additional costs except for first year training and implementation costs that would not be material. However, due to the additional responsibilities created by the proposed changes to auditor's responsibilities regarding other information, we believe there will be significant incremental costs to comply with the new requirements.

### *V. Critical Audit Matters*

*10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?*

We do not believe that communication of critical audit matters in the auditor's report will be relevant or useful to the users of financial statements. Primarily this relates to the inability for such a standard to be appropriately applied on a consistent and comparable basis which is necessary for the information to be useful. The identification of critical audit matters is dependent on significant auditor judgment and the identification is not made in contemplation of the specific needs of individual investors. Investors are not familiar enough with auditing techniques, procedures and principles and the risk is that investors will only focus on the areas identified as critical audit matters and may overlook other important financial information that may be important to their investment decision. Finally, the proposal mentions that the communication of critical audit matters could lead to improved financial statement disclosures related to areas that give rise to critical audit matters because of increased attention to those areas by management and the audit committee after the communication in the draft auditor's report of the critical audit matters. However, these critical audit matters are already communicated as part of PCAOB Auditing Standard No. 16 so we don't agree that would be any incremental attention paid to these same areas just by their mention in the auditor's report. In addition, investors' need for additional disclosures should be addressed through changes to Generally Accepted Accounting Principles (GAAP) or SEC Regulation S-K and not through changes in the auditor's reporting model.

*11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?*

It is likely that auditors will broaden their critical audit areas if they will be communicated publically to avoid having their judgment questioned which could significantly increase audit time and fees to offset increased auditor's litigation liability. In addition it is likely that investors and users will form conclusions based on information that is not comparable or consistently applied and potentially incomplete if they only focus on the areas identified as critical audit areas and not all of the financial information available to them.

Another concern is that investors will only see the identification of the critical audit matter without the benefit of knowing how the auditor addressed that matter, the evidence they obtained, and how persuasive the evidence was. Therefore, it may appear to investors that an issuer that has several critical audit matters in the auditor's report is riskier when that might not be the case.

*12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?*

We believe that the definition of a critical audit matter is sufficiently clear to most experienced auditors to determine what would be a critical audit matter. Auditors currently determine critical audit areas in determining the nature, timing and extent of audit procedures, evaluating sufficient appropriate audit evidence and forming an opinion on the financial statements. However, what is not clear is if the definition is clear to investors that are not familiar with auditing standards and whether the identification of critical audit matters would provide relevant and useful information to investors and other users in making their investment decisions. In addition, we believe that the identification of critical audit matters is subject to substantial auditor judgment, therefore, the proposed standard would not be able to be applied consistently.

*13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?*

Auditors already focus their time on the critical audit areas during their audits so we do not believe that the additional time incurred to report on the critical audit matters will increase audit quality. However, we do believe there is the potential that the additional time needed to be spent on the reporting of the critical audit matters may take away from time spent on actual audit procedures which could decrease audit quality.

*14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?*

The proposed requirements regarding the auditor's determination and communication of critical audit matters is clear but what remains unclear is how this standard can be applied consistently when there is significant auditor judgment involved.

*15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?*

We do not believe that including the audit procedures performed on critical audit matters would be informative and useful to investors that are not sufficiently knowledgeable on auditing procedures and techniques. Independent auditors are professionals that are experts in accounting and auditing that are engaged to attest to information prepared by management. Investors should not need to know the specific audit procedures performed by the independent auditor to come to the conclusion that the financial statements present fairly, in all material respects, the financial position of the company. Plus, including resolution of the critical audit matters in the auditor's report could be seen as concluding on specific areas instead of the financial statements as a whole. We also believe that including the audit procedures performed would jeopardize audit quality by reducing the element of unpredictability in an audit and providing a roadmap for potential management manipulation of those procedures.

*16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?*

The factors are helpful but not sufficient to ensure consistent and comparable preparation and reporting of these items by auditors due to the professional judgment involved.

*17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?*

We do not believe any other factors are necessary.

*18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?*

The documentation requirement in the proposed standard is sufficiently clear.

*19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?*

The proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter is consistent with the requirements of PCAOB Auditing Standard No. 3.

*20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?*

The proposed documentation requirement is sufficient.

*21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?*

We agree with the proposal that the auditor's determination, communication and documentation of critical audit matters will increase costs and time expended by auditors, companies and audit committees. These costs will include one-time and recurring costs.

*22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?*

The development of the critical audit matters by the auditor and the drafting of the language to be included in the auditor's report will likely be completed towards the end of the audit engagement and will also need to be reviewed by management and the audit committee. This additional time incurred at the end of the engagement, which is already a busy time for all involved, may adversely impact the timeliness of filings.

*23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?*

We believe that audit fees will increase in order to compensate the auditing firms for expansion of their procedures, documentation and drafting of the language. In addition, there will be increased communication required with management and the audit committee.

*24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?*

Though we disagree with the communication of critical audit matters in the auditor's report, if communication is required, we agree that it should only be required for the current period. We also agree that communication of critical audit matters for all periods presented should be limited to initial public offerings and re-audits when the predecessor's opinion can no longer be relied upon.

*25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?*

The illustrative information is useful but we believe is insufficient to provide auditors with enough guidance to prepare this information on a consistent and comparable basis.

*26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.*

We do not believe this information can be applied on a consistent and comparable basis, nor will it be useable or reliable for users of the financial statements.

*27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise* *would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?*

The primary unintended consequence would be that any such disclosures may impair the auditor's independence and may violate existing client confidentiality laws and regulations of the PCAOB, SEC, AICPA, State Societies and State Boards of Accountancy. It is unclear how Certified Public Accountants can comply with these standards without changes to existing independence and ethics rules of these and other organizations.

*28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?*

We believe that by communicating critical audit matters in the audit report, it is changing the auditor's role of attesting on information prepared by management to the preparer of new information regarding the company that will ultimately be relied upon by investors and this will increase auditor's liability. It will open up additional avenues for investors to question the professional judgment of the auditor when they are looking to place blame for an incorrect investment decision.

***VI. Explanatory Language***

*29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?*

We believe it is appropriate for the Board to include a description of such circumstances.

*30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?*

Yes. We believe that retaining the auditor's ability to emphasize a matter in the financial statements is valuable to users of financial statements.

*31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?*

We agree that the proposed standard should retain the current list of circumstances in which the auditor is required to add explanatory language to the auditor's report required by other PCAOB standards related to going concern, reference to another auditor and consistency. The decision to emphasize any other matters should be left to the discretion of the auditor.

*32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?*

We would not object to the addition of additional examples of possible matters that might be emphasized in the auditor's report but do not have any suggestions.

***VII. Amendments to Other PCAOB Standards***

*33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?*

Overall, we do not have objections to the proposed changes to other PCAOB standards that relate to the proposed auditor reporting standard except for the following:

- Consistent with our comments above, we do not believe that auditor tenure should be included in the auditor's report on internal control over financial reporting
- We do not believe that an auditor should be able to reference the use of a specialist in the auditor's report in connection with the auditor's communication of critical audit matters. Even though the communication of critical audit matters is not supposed to alter the auditor's unqualified opinion, we believe the perception of the investors would be that the auditor is dividing their responsibility.

*34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.*

The potential costs related to the proposed amendments are consistent with what is discussed above.

***VIII. Considerations Related to Audits of Specific Entities***

We have no comments on the applicability of the proposed auditor reporting standard to the audits of specific entities, including brokers and dealers, investment companies, and employee stock purchase, savings, and similar plans.

***IX. Consideration Related to Effective Date***

*41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?*

We believe the effective date of any final proposal should provide a minimum of two years from the issuance date to allow auditors sufficient time to train staff, develop changes to quality control procedures, and educate clients and users of financial statements. We also believe sufficient time will be required for other regulatory bodies to potentially make changes to auditor independence and ethics rules and regulations which may need to be amended as a result of these standards in order for auditors to be permitted to comply.

*42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?*

Yes, we believe that a delayed compliance date of at least one year should be adopted for smaller reporting companies.

**APPENDIX 6 – Additional Discussion Related to the Proposed Other Information Standard**

### *I. Introduction*

1. *Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?*

The proposed scope is clear but as discussed more fully below, we have concerns about the significantly increased level of auditor responsibility proposed in the standard. There are no additional Exchange Act documents that the Board should consider including in the scope of the proposed other information standard.

2. *Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?*

We believe it is appropriate to apply the proposed other information standard to information incorporated by reference that is available to the auditor prior to the issuance of the auditor's report. However, we do not believe that the proposed other information standard should apply to information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report, such as information in the company's definitive proxy. Since neither the auditor's report nor a consent letter is required to be filed with the company's definitive proxy, the auditor may be unaware when the company files the proxy. In addition, there appears to be a conflict with performing the proposed procedures to the other information after the date of the auditor's report.

3. *Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?*

It is appropriate to apply the proposed other information standard to amended annual reports when the amended annual report contains revisions to the previously issued financial statements. When an amended annual report does not contain revisions to the previously issued financial statements, the proposed standard says that the auditor would treat the other information in the amended filing as not available prior to the issuance of the auditor's report. What is not clear is if that means that the auditor needs to perform the procedures under the proposed other information standard or if it is excluded.

4. *Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?*

We believe that if audited financial statements of another entity are required to be filed in a company's annual report, the other entity's auditor should have responsibilities under the proposed other information standard for the other information as it relates to the other entity.

## *II. Objectives*

5. *Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?*

The addition of the objectives to the proposed standard is helpful to auditors applying the procedures required. However, as discussed more fully below, we are concerned about the additional procedure that has been added to the standard that requires the auditor to evaluate the other information for a material misstatement of fact.

## *III. Evaluating the Other Information*

6. *Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?*

Overall, we agree with the addition in the proposed standard of performing procedures to help the auditor identify whether the other information contains material inconsistencies and material misstatements of fact. We believe in practice most auditors already perform specific procedures to the other information such as comparing numbers in the other information to the audited financial statements, recalculating amounts for mathematical accuracy and providing various input to management on the other information. Therefore, including these procedures in the proposed standard will increase consistency among auditors. However, it is not clear how auditors could evaluate if other information that is not directly related to the financial statements contains a material misstatement of fact. There are many disclosures in the company's annual report that are not directly related to the financial statements or the relevant audit evidence obtained so an auditor would have no basis to evaluate that information. In addition, how will it be clear to an investor which other information was evaluated by the auditor and which other information was not evaluated since the auditor had no basis to evaluate that information. We believe the proposed standard should retain the existing responsibility that is conditioned on the auditor "becoming aware" of a material misstatement of fact related to information that is not directly related to the financial statements instead of being responsible for evaluating information that is not directly related to the financial statements for a material misstatement of fact.

We also have a concern with the term "evaluate". The existing standard requires that the auditor read and "consider" whether the other information is materially inconsistent with the financial statements. The proposed standards now require that the auditor "evaluate" the other information and report on that evaluation. It appears to us that "evaluate" is a higher level of assurance than "consider", however, we believe more explanation is needed in the standard about what "evaluate" means in the context of professional standards. It is clear in the proposed auditor's report language that the auditor did not "audit" the other information but it does say that the auditor "evaluated" the other information. What does that mean to an investor? We don't believe it will be clear to an investor what level of assurance that entails.

7. *Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?*

We believe that the addition of the required procedures to the proposed standard would increase the quality of information available to investors to the extent that those procedures are not already being performed by certain auditors, however, as mentioned above, we believe most auditors already perform most if not all of the required procedures in the proposed standard. Since we don't think it is clear to investors what "evaluate" means, we are unsure if it will sufficiently contribute to greater confidence in the other information. We are concerned that since we don't believe it is clear to an investor what "evaluate" means, they will interpret it to mean a higher level of assurance than the procedures performed warrant and will create undue reliance upon such information which will remain unaudited.

8. *Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?*

It is unclear how any definition of materiality will be able to be applied to misstatements of fact in the same manner that it is applied to historical financial results.

9. *Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?*

The proposed procedures are clear and appropriate for evaluating consistency with the exception of paragraph 4.c. which says to evaluate other information that is not directly related to the financial statements by comparing it to relevant audit evidence obtained. Since it is highly likely that the auditor may not have any audit evidence with respect to other information that is not directly related to the financial statements, what does the auditor compare to be able to evaluate for consistency? We believe the standard should remain conditioned on the auditor "becoming aware" and not be required to "evaluate" other information that is not directly related to the financial statements since how can the auditor come to a conclusion on consistency based on the performance of the procedure when there may not be anything to compare.

We do not believe that the procedures are appropriate and sufficient in order for the auditor to evaluate whether there is a material misstatement of fact.

10. *Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?*

Per paragraph 4.d. in the proposed standard, the auditor would be required to recalculate amounts in the other information for mathematical accuracy using amounts that are in the other information, in the audited financial statements or in the auditor's audit evidence if the formula is described in the other information, there isn't a need to refer to a formula or if the formula is generally understood. We believe that it would be clear to the auditor, which amounts in the other information that they would be required to recalculate as they performed the procedure. Our assumption from the proposed standard is that the auditor would not be required to recalculate certain amounts that don't meet the requirements listed above, therefore, our conclusion is that some of the amounts may not be required to be recalculated. Since the language in the proposed auditor's report only refers to "other information" how will it be understood by an investor/user which amounts have been recalculated and which ones have not been recalculated?

11. *Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?*

We are not aware of any additional costs beyond those described in the Appendix.

12. *Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?*

Yes, it appears appropriate to discuss such matters with management and perform additional procedures, as necessary.

13. *Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?*

We are not aware of any additional costs beyond those described in the Appendix.

### ***IV. Responding When the Auditor Determines That the Other Information Contains a Material Inconsistency, a Material Misstatement of Fact, or Both***

14. *Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?*

Yes, we believe the proposed auditor’s responses are appropriate.

15. *Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?*

No, we believe all such material misstatements should be revised in the filing before an auditor’s report is issued.

16. *Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?*

    We believe the proposed auditor’s responses are appropriate except we need more clarification on why the auditor would be required to notify each member of the company’s board of directors after the auditor communicated to the audit committee and the other information was not appropriately revised before deciding that the auditor’s report must no longer be associated with the financial statements. We believe that communication with the audit committee should be sufficient. As discussed above, we do not believe it is appropriate for auditors to evaluate other information that was not available prior to the issuance of the auditor's report. Application of AU sec. 561 *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report* in this situation seems inconsistent with that standard since the material inconsistency or material misstatement of fact did not exist at the date of the auditor's report.

### V. ***Responding When the Auditor Determines That There is a Potential Misstatement in the Audited Financial Statements***

*17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?*

If as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements; the auditor should follow the same procedures they would follow if they identified the potential misstatement as a result of their audit procedures assuming the auditor's report has not been issued. If the auditor's report has already been issued, we agree that the auditor should refer to AU sec. 561, however, as stated above, we do not believe it is appropriate for auditors to evaluate other information that was not available prior to the issuance of the auditor's report.

### ***VI. Reporting in the Auditor's Report***

*18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?*

No, we do not believe that the proposed reporting is clear to investors since we don't believe investors understand what it means that the auditor "evaluated" the other information and the proposed reporting does not acknowledge that the auditor may not have obtained evidence or reached a conclusion regarding all of the other information.

*19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.*

One of the concerns that we have with the proposed auditor's reporting language is that it refers to all other information and does not acknowledge that there is likely other information for which the auditor did not have relevant audit evidence to evaluate against. However, we don't know how the auditor could practically identify such information in the auditor's report. As anyone who has ever prepared a comfort letter and has dealt with the "circle ups" and numerous tickmarks can attest to, it would be impossible to segregate the different procedures performed on the other information in a standard audit report paragraph.

*20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?*

There would be increased costs associated with the additional communication with various members of management and the audit committee as well as review of any revised other information.

*21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?*

We do not believe that the proposed reporting provides sufficient information to investors so that they have an appropriate understanding of the auditor's responsibilities. We like that the proposed reporting makes it clear to investors that the other information has not been audited, however, we do not believe that investors understand what it means that the auditor "evaluated" the other information and the proposed reporting does not acknowledge that the auditor may not have obtained evidence or reached a conclusion regarding all of the other information.

*22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?*

No.

***VII. Responsibilities of a Predecessor Auditor***

*23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?*

We believe the proposed responsibilities of the predecessor auditor are appropriate. Additional guidance on the auditor's reporting language is needed.

***VIII. Other Considerations***

*24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related* *to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?*

These regulations will increase an auditor's potential liability because users of financial statements may assume that the auditor has evaluated all other information which is not true.

*25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?*

Yes.

## *IX. Proposed Amendments to PCAOB Standards*

*26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?*

The proposed amendments to PCAOB standards are appropriate.

*27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?*

Yes, we believe that the Board should require the auditor to include a statement in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report.

## *X. Considerations Related to Audits of Broker Dealers*

*28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?*

We do not have a comment on this question.

## *XI. Considerations Related to Effective Date*

*29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?*

We believe the effective date of any final proposal should provide a minimum of two years from the issuance date to allow auditors sufficient time to train staff, develop changes to quality control procedures, and educate clients and users of financial statements. We also believe sufficient time will be required for other regulatory bodies to potentially make changes to auditor independence and ethics rules and regulations which may need to be amended as a result of these standards in order for auditors to be permitted to comply.

*30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?*

Yes, we believe that a delayed compliance date of at least one year should be adopted for smaller reporting companies.

***XII. Considerations Related to Securities Act Documents***

*31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?*

We do not believe that the Board should extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act.

*32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?*

No.

*33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?*

We do not believe that the Board should consider extending any elements of the proposed other information standard to documents filed under the Securities Act.

Thank you for the opportunity to comment. We are available to discuss our comments at your convenience if you require additional information.

Respectively submitted,

Renee Rampulla / ms

Renee Rampulla, CPA, Leader
Accounting and Auditing Standards Interest Group
New Jersey Society of Certified Public Accountants

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December 10, 2013

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

Via email: comments@pcaobus.org

**Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

**Release No. 2013-005, Docket No. 034**

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 29,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned proposed auditing standard.

The NYSSCPA's Auditing Standards, SEC and Stock Brokerage Committees deliberated the proposed standard and prepared the attached comments. If you would like additional discussion with us, please contact Julian Jacoby, Chair of the Auditing Standards Committee at (646) 644-4482, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

N Y S S C P A

J. Michael Kirkland
President

Attachment

**NEW YORK STATE SOCIETY OF**

**CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON**

# PROPOSED AUDITING STANDARDS – THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;

# THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;

# AND RELATED AMENDMENTS TO PCAOB STANDARDS

**(PCAOB Release No. 2013-005, Docket Matter No. 034)**

**December 10, 2013**

**Principal Drafters**

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**New York State Society of Certified Public Accountants**

**Comments on**

**Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion;**

**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report;**

**and Related Amendments to PCAOB Standards**

**(PCAOB Release No. 2013-005, Docket Matter No. 034)**

## General Comments

The New York State Society of Certified Public Accountants (NYSSCPA) is pleased to submit the following comments on the above-captioned release (the Release) issued by the Public Company Accounting Oversight Board (PCAOB or the Board). Our responses to the questions contained in Appendices 5, 6 and 7 of the release are presented below.

**Appendix 5** – **Additional Discussion Related to the Proposed Auditor Reporting Standard**

### Question Related to Section II

**1.** ***Do the objectives assist the auditor in*** **understanding** ***the requirements of what would be communicated in an auditor's unqualified report? Why or why not?***

We believe the first objective, as set forth in paragraph 4a of the proposed standard, has always been and continues to be implied and obvious and need not be expressly articulated. The second objective, as set forth in paragraph 4b of the proposed standard, refers to communicating critical audit matters, the benefits and advisability of which we have significant reservations that are expressed in our responses to Questions 10-28 of Section V of Appendix 5.

### Questions Related to Section IV

**2.** ***The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?***

The Board, in its discussion of the proposed standard, states that the shareholders are the auditor's "ultimate customer." It is our preference that the Board should specify shareholders or stockholders rather than "investors." We believe that in addition to the Board of Directors or equivalent body, the proposed standard should require the report be addressed to current shareholders. The basis for the "Board of Directors" inclusion is that the engagement letter is contractual and a legal obligation of the Board of Directors. The parties to the contract should be the parties issuing and receiving the report. We do not strongly oppose using "investors," because investors in short sales, option holders, debenture holders, holders of mutual funds who hold the company's securities, *etc*., are all investors.

**3.** ***The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?***

We believe that the proposed language in paragraphs 6(j) through 6(n) captures the spirit of the auditor's responsibility. We do not believe that every time the phrase "material misstatement" is used it needs to be followed by "whether due to error or fraud." Material misstatement can only occur intentionally or unintentionally. The inclusion of "whether due to error or fraud" is a redundant statement and is not necessary in the same section.

In addition, while paragraph 6(m) states that an audit includes among other things, examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. The word "appropriate" may be unclear to readers. Audit evidence is required to be sufficient and appropriate with the former relating to the quantity of evidence and the latter related to the quality of evidence. Because audit evidence by definition must include elements of both characteristics, the paragraph should read "Examining on a test basis, evidence regarding the amounts and disclosures in the financial statements."

Finally, the standard should include a reference to the auditor's responsibility to consider the company's internal controls when assessing risk and designing procedures to address identified risks. Whether the company is subject to Section 404 of the Sarbanes-Oxley Act, the auditor is required at a minimum to consider the design and implementation of the company's internal controls when designing an appropriate response to identified risks of material misstatement. This insert should be part of the auditor's responsibilities section of the auditor's report.

**4.** ***The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?***

Because independence is the prime tenet of auditing the fact that a separate statement that the auditor is public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities Exchange Commission (SEC) and PCAOB is additive. The general idea of this information is included in the title of the auditor's report. We appreciate the Board's overriding concern with independence but a boilerplate statement added to all reports will not affect or remedy concern for the quality of this matter.

**5.** ***The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.***

*a.* ***Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?***

*b.* ***Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?***

*c.* ***Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?***

As audit partners and engagement quality reviewers are required to rotate on each public company every five years (with limited exceptions for small audit firms), we do not believe that the length of time that firms have audited clients is relevant to the audit opinion on any given year's financial statements. This issue has surfaced and resurfaced from time to time. The PCAOB oversight regime and the firm's own quality controls would have more of an influence on poor audit quality than the premise that long- term tenure affects audit quality. Quality issues may be more influenced by personnel failure which we believe will always occur.

**6.** ***The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?***

Providing auditors with objectives links the procedures to what the auditor is trying to achieve; so we support this consideration.

Paragraph 2(b) should be revised as follows: When issuing an auditor's report on the other information and *when the other information includes* whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency or material misstatement of fact, *or both to describe these in the auditor's report.* We disagree with the requirement for the auditor to make a positive statement or conclusion about the absence of any inconsistencies, material misstatements or both discussed in paragraph 13(e). Also see our response in Question 18 of Appendix IV).

**7.** ***Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?***

We believe this is not a substantive matter. If left out of the standard, firms may have more flexibility in highlighting or emphasizing specific matters for users to consider.

**8.** ***What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?***

See our response in Question 3 above. The Board's discussion of the other elements of the report is satisfactory.

**9.** ***What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.***

We are uncertain if the drafters are categorizing critical audit matters as a basic element. That section will take the most time and effort relative to any other changes being proposed.

**Section V**

**General Comment**

We commend the Board for responding to the concerns expressed by many respondents to Release No. 2011-003 dated June 21, 2011, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release) by proposing a discussion of "critical audit matters" in audit reports in lieu of the "Auditor's Discussion and Analysis" (or AD & A) suggested in the earlier Concept Release. We responded to the Concept Release in a letter dated September 27, 2011, and understand those concerns to be rooted in a desire to preserve the purity of the attest function by not requiring auditors to speak about financial statement matters in a way that should be reserved for management. The critical audit matters discussion currently proposed is apparently intended to be limited to matters of auditor judgment which we believe (despite our reservations set forth in our responses to Questions 10-28 of Section V of Appendix 5 of the current Release) would be far more appropriate than the broader AD & A described in the Concept Release.

**Questions Related to Section V**

**10.** ***Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?***

No, the auditor's communication of critical audit matters would not be relevant and useful to investors and other financial statement users. Our view is that the expressions of demand for this kind of information by analysts and investor groups are largely exaggerated, lack credibility and are likely attributable to the "*if you build it, they will come*" syndrome. We believe that despite the perceived demand, there is little persuasive evidence that securities analysts and other investor groups will actually find such disclosures in audit reports useful or will rely on it for making or recommending investment decisions or that it will result in more informed and better investment decisions.

We do not believe it would be productive or appropriate for auditors to provide information in audit reports that is intended to help investors or other users to assess an audit. Auditing is a highly complex, professional discipline that requires years of education and training, experience, intimate knowledge of the issuer's business and seasoned professional judgment to enable appropriate audit scope (*i.e.*, the nature, timing and extent of auditing procedures) and related judgments (*e.g.*, those regarding risk assessment) as necessary to support an auditor's opinion. Moreover, as we have seen historically, there are numerous opportunities for legitimate disagreements on such judgmental matters between or among experienced and knowledgeable professionals (including, for example, regulators, expert witnesses and authors of non-authoritative professional guidance).

Accordingly, we believe that public disclosure of details of critical auditor judgments would not help users make investment or credit decisions or enhance transparency in any meaningful way or serve any other useful purpose but rather would negate or dilute the pass/fail message and, therefore, diminish the value of an audit report. Without the opportunity for two-way dialogue with auditors about such matters, (which is not practicable), such details would likely not contain enough information to help users to make meaningful assessments and useful judgments and quite probably would be misunderstood by many of them. We believe that financial statement users could never reasonably and meaningfully assess the effectiveness of such professional judgments, in relation to possible alternatives, without all the factual and technical knowledge that is available to the auditor.

Should the potential for misunderstanding be partially mitigated for institutional financial statement users by employing trained experienced audit advisors to assist in their analyses, we believe the inherent limitations on the extent of detailed information that could be communicated effectively in writing is likely to prevent the realization of any meaningful potential benefit, and the costs to such users would exceed the value thereof substantially.

Therefore, it is unreasonable to create expectations that any form of written report that is inherently limited, no matter how expanded it might be from the current model, would contain communications of sufficient factual and circumstantial details so as to help otherwise uninformed users, who do not have direct access to the auditors for two-way dialogue to make meaningful judgments as to such complex matters as risk assessments, audit scope and other auditor judgments.

Assessing audit quality is not the job of investors and other financial statement users; it is the job of the engagement quality reviewer, regulators such as the PCAOB (both its standard setters and inspectors) and licensing authorities (to a lesser extent). Additionally, and perhaps most significantly, audit committees upon whom investors should be able to place their reliance as to such matters. Although not the responsibility of the PCAOB, we see regulation of audit committees as the most relevant and, therefore, the best alternative way to assure that investor needs are served effectively.

**11.** ***What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?***

We see little, if any, opportunity for user benefit from this additional verbiage in audit reports. The obvious risk to auditors of providing regulators and others, (*e.g*., litigants and regulators such as the SEC or PCAOB inspectors) with additional opportunities for second-guessing critical auditor judgments is likely to lead to excessive self-protective, obtuse and unwieldy language in audit reports (see also our response to Question 28), as well as other unintended adverse consequences. These would include (1) increased audit fees, and (2) impairment of timely financial reporting due to delays in issuing audit reports (both resulting from cautious analysis to determine reportable critical audit matters) the documentation, communications, and additional layers of review, and of draft report language by audit firms and frequently by their attorneys.

In Appendix 5 of the Release (first paragraph, page A5-29), the Board suggests that the proposed requirement to report critical audit matters "could increase the auditor's focus on critical audit matters which could result in enhancing the quality of auditing." We firmly believe that other auditing and quality control standards already in place provide maximum assurance that such matters will be adequately addressed so that the achievement of any significant incremental assurance to be obtained from this proposal is highly unlikely. Accordingly, we see this statement as pure speculation, unsupportable, and potentially misleading to investors and other users.

Nevertheless, we do believe there is considerable probability that non-standardized reporting of critical audit matters under this proposal would serve to pressure auditors to report more rather than less. At first, variability among audit reports would likely reduce their comparability and their understandability, and the added language would tend to contradict an unqualified opinion, confusing users and diluting the value of the opinion. As time goes on (if this proposed requirement were adopted), we believe a tendency for the critical audit matters language in reports would evolve to look more similar, diluting their value (if there ever were any).

We also foresee that there may be pressure on auditors to skew their procedures based on how they would affect readers' perception of the description of the critical audit matter, rather than based on their own professional judgment as to what would minimize the risk of material misstatement.

**12.** ***Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?***

As noted in our responses to the foregoing Questions, we do not believe reporting critical audit matters would contribute in any meaningful way to achieving the objectives of providing relevant and useful information to investors and other financial statement users. However, in the event that the proposal for auditors to report critical audit matters is retained in a final standard (which we oppose), we believe the definition in paragraph A2 of Appendix A of the Proposed Auditor Reporting Standard (Appendix 1 of the Release), when considered in relation to the guidance contained in paragraphs 8 and 9 of the proposed standard (Exhibit 1 of the Release) is sufficiently clear for determining what would be reportable as a critical audit matter except for the implication of a one-directional limitation in the "Note" appended to such definition (*i.e.*, that it suggests that the definition contemplates that there could be more but not less than one reportable critical audit matter). According to the Note to paragraph 7 of Appendix 1 of the Release and the examples in paragraphs 12 and 13 of Appendix 1 of (and illustrated on pages A5-68, 73 and 77 of Appendix 5), the one-directional limitation appended to the definition is not the intent of the Board. Therefore, in the event that the proposal to report critical audit matters is retained in a final standard, the Note to paragraph A2 of Appendix A should be clarified.

**13. *Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?***

No, the additional time incurred regarding critical audit matters could not have an effect on the quality of the audit of the financial statements. We have seen no credible evidence or suggestion that audit quality would be affected, one way or the other, by adopting this proposed requirement. Conversely, as stated in our response to Question 11, we firmly believe the utility and the quality of the typical audit report would be substantially diminished if this requirement is adopted.

**14. *Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?***

Should the proposal for auditors to report critical audit matters be retained in a final standard (which we oppose), we would concur with the determination criteria set forth in paragraph 13 of Appendix 1.

**15. *Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?***

No. See our response to Question 10.

**16. *Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***

Should the proposal for auditors to report critical audit matters be retained in a final standard (which we oppose), we would concur with the determination criteria set forth in paragraphs 8 and 9 of Appendix 1 of the Release except that we believe the expression "nature and amount of available and reliable evidence" in paragraph 9c should be revised to read "nature, quality (*i.e.*, relevance and reliability) and amount of available evidence."

**17. *Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***

See our response to Question 14.

**18.** ***Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?***

The documentation requirement set forth in paragraph 14 of Appendix 1 of the Release clearly reflects the applicable portion of the general documentation standard (AS No. 3). Accordingly, should the proposal for auditors to report critical audit matters be retained in a final standard, we would be in favor of retaining paragraph 14 substantially as written, with one exception. That is, so as not to overburden auditors, we believe more guidance than that afforded by Appendix 5 of the Release (Part E2, pages A5-39 to 40) is necessary as to the nature and extent of documentation necessary for "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters."

**19.** ***Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?***

As indicated in our response to Question 18, we believe more guidance as to the nature and extent of documentation necessary for "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters" than that afforded by Appendix 5 of the Release (Part E2, pages A5-39 to 40) is necessary. Nevertheless, we find these documentation requirements unnecessary because we are opposed to the inclusion of critical matters in an audit report and, as indicated in our response to Question 11, we believe that other auditing and quality control standards already in place provide maximum assurance that critical matters is likely to be adequately addressed in the audit scope.

**20.** ***Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?***

See our response to Question 18.

**21.** ***What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?***

See our response to Question 11.

**22.** ***What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?***

We do not perceive any incremental costs for companies (other than audit costs, as discussed in our response to Question 11) or their audit committees that is likely to be incurred if this proposal were adopted. There could be costs associated with potential litigation.

**23.** ***How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?***

See our response to Question 11.

**24.** ***Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so under what circumstances?***

As indicated in our response to Question 10 and elsewhere, we are opposed to communicating critical audit matters in audit reports. However, should the proposal for auditors to report critical audit matters be retained in a final standard, we believe audit reports on comparative financial statements should be complete and should stand alone for all periods presented in all circumstances. Therefore, all critical audit matters included in the original audit report issued on prior period financial statements should be included when the statement is presented subsequently in comparative form. In the event prior period financial statements have been restated, we believe the subject matter of the restatement should be included in the discussion of critical audit matters for that period and should not be included in an emphasis paragraph as is the current practice.

**25.** ***Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?***

The examples presented in the Exhibit to Appendix 5 of the Release appear adequately responsive to the proposed requirements of Appendix 1 if adopted in a final standard. Nevertheless, we believe these brief examples serve to illustrate the inherent lack of utility of such limited discussions as to reinforce our views set forth in response to Question 10.

In addition, the first sentence of the illustrative introductory report language that would be mandated by paragraphs 12 and 13 of Appendix 1 (and also illustrated on pages A5-68, 73 and 77 of the Exhibit to Appendix 5) is unnecessary "boilerplate" and would only overburden the proposed standard report with excessive verbiage. Consequently, we believe this sentence should be removed from all examples presented in a final standard.

**26.** ***What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.***

As previously stated and in our response to Question 11, we are opposed to the communication of critical audit matters. But should the proposal for auditors to report critical audit matters be retained in a final standard, variability among audit reports is likely to reduce their comparability and their understandability at first, and the added language is likely to tend to appear contradictory to an unqualified opinion thus confusing users and diluting the value of the opinion. The reduction in comparability, in and of itself, might not inherently be dire except that users will likely be ill-equipped to make useful assessments of the significance (or lack thereof) of the differences. We see this challenge as equally applicable, more or less, without regard to the size or type of the reporting entity. In time, we believe a tendency for the critical audit matters language in reports would likely evolve to look more similar (especially for companies in similar industries or audited by the same firm) diluting their purported value.

**27. *What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?***

See our response to Question 11.

**28. *What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?***

The following paragraph expands our response in this regard to Question 11.

While we do not see the proposal as likely to lead to additional liability, *per se*, we do see the additional language in audit reports as likely to increase the number of incidents and the costs of litigation. This is because ultimately, audit quality will be attacked and defended largely on its performance merit rather than on the content of the report but for any material omissions or statements that are deemed to be knowingly false and/or misleading. In short, these disclosures are likely to inspire and provide new opportunities for assertions of omissions and inadequacies with respect to audit reports as well as affording additional avenues for plaintiffs to pursue in discovery that will add to an auditor’s defense costs.

**Questions Related to Section VI**

**29. *Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?***

Yes, it is appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard. It is helpful to bring the approximately ten requirements into one standard; especially for auditors who do not have significant experience in auditing issuers or investors who need a basic understanding of the purpose of such disclosures in auditor's reports.

**30.** ***Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?***

Emphasis disclosures could be valuable to users, but less so if the critical audit matters section is included in the audit report, because as noted in the Release, these types of issues would most likely qualify for inclusion in both sections. [Note: We are using critical audit matters as a default here irrespective of our comments in another section of this letter.] This duplication may not be all negative; however, because what we believe will occur is that the critical auditing matters will reference back (perhaps in a single reference) to the emphasis section without complete reiteration. The auditor should always have the ability to discuss matters that are deemed important. This standard retains that option.

**31.** ***Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?***

Certain matters should not necessarily be required to be emphasized in the auditor's report but rather left to the auditor's discretion. As to the ten matters that are now required to be included when they are evident, they should continued to be required as they are significant for the achievement of the basic objectives of reporting. Other matters to be included at the auditor's discretion should be evaluated on a client specific basis. This is a subtle but important difference, and these other issues could be included by the auditor after review and analysis as needed. The latter evaluation would include the client's presentation and disclosure of these matters (the auditor perhaps having a different perception).

Because the language in the Release is open-ended about including other matters at the auditor's discretion though an emphasis paragraph (or explanatory language in another report paragraph), we do not believe it is necessary to add any recommendations to the examples listed as matters that could be considered as well.

**32.** ***Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?***

No, see our discussion in Question 31.

**Questions Related to Section VII**

**33.** ***Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?***

See our comments with regard to inclusion of firm's registration, independence, audit tenure, and our responses on reporting on other information.

We are in agreement with changes to AS No.6 and No.7, (although we are opposed to the inclusion of critical audit matters) and the changes in AS No. 7 which presupposes this change.

We agree that it would be in the purview of the audit committee to discuss the draft auditor's report, but the auditor should be wary of changes that might dilute positions taken by the auditor.

We are not opposed to referring to the work of a specialist(s) in resolution of matters discussed in critical audit matters.

Our views on other proposed amendments would be consistent with our responses on the basic elements discussed in this comment letter.

**34.** ***What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.***

Implementation costs would likely include training and audit methodology changes on a firmwide basis; and preparation time, added review and supervision time, as well as additional time for those in corporate governance. Additional costs could also be incurred in related litigation defense.

Overall, the time and effort involved would be relatively insignificant when measured against total audit fees.

**Questions Related to Section VIII**

**35.** ***Are the proposed reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?***

We believe it is worthwhile to draw attention to the following facts as considerations (some of which have been mentioned in the pages of the Release that precede this question).

- Per the PCAOB's Office of Research and Analysis, there are no issuers among the brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 9% of the 4,230 brokers and dealers that file are subsidiaries of issuers. The remainder are not owned by issuers.
- Regulators such as the SEC and Financial Regulatory Authority (FINRA) have ongoing programs to monitor and examine the books and records of registered broker-dealers.
- Broker-dealers file Financial and Operation Combined Uniform Single (FOCUS) reports at least quarterly; many file monthly if their minimum net capital is at a high level. The level of minimum net capital is a reflection of perceived operational risk. FOCUS reports include balance sheets, income statements and other operational measurements of financial condition. In addition, all brokers and dealers have been filing quarterly Statements of Supplemental Income that include more details about results of operations. It is not unusual for responsible personnel at broker-dealers to receive inquiries from

regulators about the reasons for fluctuations and unusual amounts that are disclosed in these reports.

- There is public disclosure of the regulatory records of most brokers and dealers and of most individual registered representatives that deal with the public.
- The most recent amendment to SEC Rule 17a-5 requires that broker-dealers that are carrying brokers must provide permission to the SEC to see auditors' workpapers.

As a practical matter, the great majority of brokers and dealers are not issuers and have no public investors. Therefore, members of the public, when using the annual audited financial statements, are not making investment decisions, but rather are using the annual audited financial statements in considering whether to conduct transactions using the broker-dealer, and in some fewer cases, for the broker-dealer to have custody of its funds or securities.

In addition, there is a high level of interaction between brokers and dealers and the regulators and public disclosure about businesses and individuals that deal with the public.

Upon considering the above, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities.

**36.** ***Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for auditors of brokers and dealers? If not, why not.***

For the reasons explained in our response to Question 35, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards shall be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities.

**37.** ***Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?***

As we have discussed in our response to Question 35, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards shall be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities. If the proposed reporting standard is adopted for broker-dealers, any additional reporting obligations of the auditor should be limited to the contents of the complete set of financial statements (as opposed to the separately bound balance sheet). As most users of the financial statements of brokers and dealers are primarily interested in the financial well-being of the broker or dealer, an audited statement of financial condition and notes are typically all that should be required to be made available to them.

**38.** ***Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?***

We have no response to this question at this time.

**39.** ***Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?***

We have no response to this question at this time.

**40.** ***Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?***

As we previously stated, our position on this issue is that reporting of critical audit matters should not be required.

**Questions Related to Section IX**

**41.** ***Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?***

Although a concerted effort would be needed to make all changes that are proposed in the Release, we believe the effective date is appropriate, provided that the PCAOB's efforts and adoption (including the SEC's approval) will not be unduly delayed.

**42.** ***Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

If the Board decides to extend the proposed standards and amendments to brokers and dealers we believe a year delay from the effective date used for issuers be implemented because an acclimation period for auditors of these entities using PCAOB auditing standards, and basic changes in several filing forms is now underway (under recent regulation changes).

**<u>Appendix 6</u> – Additional Discussion Related to the Proposed Other Information Standard**

**Questions Related to Section I**

**1.** ***Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?***

The Board should, in consultation with the SEC, extend the reporting and procedure standard for other information to other Exchange Act forms such as Form 10. It should also extend these proposed requirements to Exchange Act filings where audited information is contained by reference, for example proxy filings under Regulation 14A.

**2.** ***Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?***

See response to Question 1 above.

**3.** ***Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?***

If the standard was applied to a filing for which an annual report was filed or incorporated by reference and was subsequently amended, but the amendment did not affect the financial statement information content, the auditor should nevertheless evaluate whether it should or should not have changed. If no changes were needed, the auditor should not reperform original procedures and update the audit report for the other information content.

**4.** ***Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?***

For a number of practical reasons, the proposed "other information standard" should not be required for entities filing financial statements or condensed financial statements under Article 3 of Regulation S-X.

- Auditors of acquired companies may not be the same as auditor of the acquirer. The acquiree's auditors may not be registered with the PCAOB. We believe in this circumstance the acquiree's auditor would not be able to satisfy the proposed reporting obligations.
- The purpose of several subsections of Article 3 are designed to provide information that is specific to a specific risk or concern—for example the guarantor financial statements requirements help investors determine if a guarantor is able to meet the guarantee obligation. In this scenario, there would be little or no added value based on the reporting objective stated.

**Question Related to Section II**

**5. *Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?***

We are in favor of providing an objective within the proposed standard that would assist auditors in understanding what needs to be achieved through the performance of the proposed required procedures. However, we believe paragraph 2.b. should be revised as follows:

> b. When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for the other information and *when the other information includes* a material inconsistency, a material misstatement of fact, or *both, to describe these in the auditor's report*.

Further, we disagree with proposed requirement for auditors to make positive statements or conclusions about the absence of any inconsistencies, material misstatements of fact or both, as contained in paragraph 13(e) (see our response to Question 18 of Section VI of this Appendix).

**Questions Related to Section III**

**6. *Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?***

We are concerned that the use of the term "evaluate" could imply a more in-depth level of analysis than should be required to enable a determination of whether other information contains a material inconsistency with amounts or information or the manner of their presentation or a material misstatement of fact exists. We believe that auditors' responsibility should be limited to reading the other information in the context of their understanding of the entity, its environment, activities and financial performance and condition, as acquired during the audit, and to consider whether there may be a material inconsistency, misstatement of fact, or both.

**7. *Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?***

Notwithstanding our response to Question 6 above, we believe it is likely that that the overall quality of information available to investors and other financial statement users might improve—including an understanding and appreciation for the limitations on the auditor's procedures and responsibilities. It is important for investors and other users to understand that while overall quality of the other information may improve; little or no assurance is provided on the other information because of the limited procedures performed and responsibility taken.

**8.** ***Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU Sec. 550?***

We agree that the appropriate standard for the auditor's responsibility to "evaluate" other information would be that afforded by the federal securities laws' definition of materiality and that this is consistent with current practice under AU Sec. 550 and Staff Accounting Bulletin 99.

**9.** ***Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?***

We agree that the procedures set forth in paragraph 4 of the proposed standard, *i.e*., to compare the amounts and qualitative statements in the other information to the financial statements and verify the mathematical accuracy of calculated amounts, are appropriate and consistent with the procedures many practitioners already perform. However, as stated in our response to Question 6 of Section III of this Appendix, we do not believe the use of the term "evaluate" is appropriate and suggest revising the requirement in paragraph 4 to delete that term and state instead that the "auditor should read the other information and perform the following procedures."

Additionally, we believe that paragraph 3 of the proposed standard, which sets out what would be the auditor's overall responsibilities, should be revised to delete the term "evaluate" so that the paragraph would state that "the auditor should read the other information and perform certain procedures to determine whether there appears to be a material inconsistency or misstatement of fact, or both."

We recommend that all references to "evaluate" be replaced with "to read" or "consider", in the standard due to all the possible interpretations of "evaluate."

**10.** ***Is it understood which amounts are in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?***

We believe that the guidance in paragraph 4.d. along with the related Note provides an appropriate explanation about which amounts in the other information the auditor would be required to recalculate.

**11.** ***Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?***

We believe the additional costs described in Appendix 6, including costs relating to (1) those incurred by some firms that might not currently be performing similar procedures as set out in paragraph 4, (2) strengthening the auditor's responsibilities from being "aware" to the performance of specific procedures relating to determining whether a material inconsistency or misstatement of fact appears to exist, and (3) one-time implementation costs that might be incurred by a few firms would, nevertheless, not likely be significant.

**12.** ***Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not why not?***

The proposed auditor responses described in paragraph 5, which consist of inquiry of management and the performance of additional procedures, are appropriate. However, we suggest recognizing that the nature and extent of the additional procedures should be sufficient to resolve the apparent discrepancy as determined based on the auditor's professional judgment.

**13.** ***Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?***

We believe the incurrence of such costs invariably would be warranted in the circumstances. See our response to Question 11 of Section III of this Appendix.

**Questions Related to Section IV**

**14.** ***Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?***

We believe that the proposed auditor's responses are appropriate and consistent with current practice in circumstances in which the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, misstatement of fact, or both.

**15.** ***Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?***

In certain circumstances, it may be appropriate for an auditor to issue an audit report that states the auditor identified a material inconsistency or a material misstatement of fact, or both, in the other information. However, we suggest providing additional guidance that explains that in determining the appropriate action, consideration should be given to the extent to which a material misstatement of fact in the other information could reasonably be expected to influence the economic decisions of the users for whom the auditor's report is prepared and the auditor's understanding of the rationale given by management and the audit committee for not making the correction.

**16.** ***Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of***

***the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?***

The proposed auditor's responses for those circumstances when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, misstatement of fact, or both, are appropriate.

We believe that in this circumstance consultation with counsel is a recommendation that should be added to paragraph 11 of the proposed statement.

**Question Related to Section V**

**17. *Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed information standard the auditor determines there is a potential misstatement in the financial statements? Why or why not?***

We agree with the auditor's responses set out in the proposed standard that would require reference to Auditing Standard (AS) No. 14, *Evaluating Audit Results* and AU 508 *Departures from Unqualified Opinions and Other Reporting Circumstances*, when the auditor discovers that there is a potential misstatement in the financial statements. However, we also believe that the standard should refer to AS No. 12, *Identifying and Assessing Risks of Material Misstatement,* since there may be implications related to the auditor's understanding of the entity and its environment, indicating a need to revise the auditor's initial risk assessment and audit scope.

**Questions Related to Section VI**

**18. *Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?***

We are in favor of expanding the standard audit report to include language in the discussion of auditor's responsibilities that would better inform investors and other users regarding auditor's limited responsibility for other information. However, we do not support requiring the auditor to make any positive statement or conclusion about the absence of any material inconsistencies or material misstatements of fact in the other information because we believe that such a statement is likely to mislead users to incorrectly believe that such information had been subjected to sufficient procedures to form a conclusion. We believe providing such a statement would have the undesired effect of widening the expectations gap.

**19. *Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.***

We do not believe that the auditor should identify in the auditor's report other information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against since such a statement would imply erroneously that the auditor had an obligation to examine supporting evidence for such other information beyond what would be necessary to express an opinion on the financial statements.

**20.** ***What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?***

While we do not believe that there would be significant direct additional costs incurred related to reporting under this proposed standard, we believe that additional indirect costs (such as defense costs in disputes or litigation) might be incurred because investors misunderstand the scope and nature of the work performed by the auditor on the other information and adversely affect investment decisions.

**21.** ***Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?***

See our responses to Questions 9 of Section III and 18 of Section VI of this Appendix.

**22.** ***Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?***

We are not aware of any practical considerations except for considering whether the detected inconsistency or misstatement, even though corrected, is indicative of a weakness in the issuer's internal controls over financial reporting or other disclosure controls that might also require revisions to management's statements made about such controls.

**Question Related to Section VII**

**23.** ***Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?***

The requirements in the proposed other information standard with respect to a predecessor auditor are similar to extant guidance, and we believe the proposed responsibilities are appropriate and sufficiently clear.

**Questions Related to Section VIII**

**24.** ***What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?***

We believe that if a contentious matter were to arise subsequent to report issuance which was not discussed in critical audit matters that the matter might be the subject of litigation, especially if there were other serious matters such as significant misstatements that were not identified, it is less likely that an issue that was not identified in other information or was misstated would become part of  a securities litigation, unless it was listed as a matter that was included in a compendium of issues.

**25.** ***Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?***

We have no response to this question at this time.

**Questions Related to Section IX**

**26.** ***Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?***

The proposed amendments appear appropriate.

**27.** ***In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?***

We believe that requiring the auditor to include a statement in the auditor’s report that the auditor was not engaged to examine management’s assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management’s report is appropriate. Such reporting would improve consistency between auditor reports and provide clarity to users with respect to the auditor’s responsibility.

**Question Related to Section X**

**28.** ***Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?***

Other information is not relevant to brokers and dealers that are not issuers.

**Questions Related to Section XI**

**29.** ***Is the Board's effective date appropriate for the proposed other information standard? Why or why not?***

We believe that the effective date for the proposed information standard, audits of financial statements for fiscal years beginning on or after December 15, 2015, is appropriate.

**30.** ***Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

We support delayed compliance dates for any proposed standard on other information to provide auditors of smaller companies with sufficient time to incorporate the guidance into their methodologies and educate their clients about the proposed standard and its impact on the nature and timing of procedures relating to other information.

**Questions Related to Section XII**

**31.** ***Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?***

Auditors have historically made a conscious attempt to have clients avoid cross-referencing content from "other information" (such as MD&A) directly into financial statements being filed. This was meant to avoid the implied direct responsibility which would attach to the integrated content. The risk increases under Securities Act filings as audited financial statements are "expertized" and the attendant liability concerns under Section 11 of this law.

One of the issues we discussed was that the report language dealing with required "supplemental" information and other language dealing with "other" information is much different in form and content. It is important that these terms be easily identified by making sure that each schedule or other supplementary information be listed, and that the same thing be done for other information.

The main issue we see is MD&A usually contains much forward looking information and does not lend itself to consistency with the underlying client financial statements on many levels. For instance, information may be based on cash flow management or budgeting analysis. Making a statement about not being inconsistent or that an omission of a material magnitude has occurred is problematical especially in a Securities Act filing.

**32.** ***Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?***

See our comment in Question 31, which suggests deletion of coverage for MD&A. We do not propose to add any other content.

**33.** ***What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?***

We believe there will be time costs but we do not have estimates at this time.

**<u>Appendix7</u> – Emerging Growth Companies**

**Questions**

**1.** ***Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?***

To the extent the proposed standards and amendments are retained in a final standard (which we oppose in many respects as noted above), we believe they should be applicable for audits of EGCs as a matter of consistency. As any standards, auditing standards should be consistently applied and comparable, in this case, for all audits. Although we do not believe the intended goals of the proposed standards and amendments will be achieved; excluding certain entities (other than non-issuers) from such requirements would be inconsistent and illogical.

**2.** ***Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?***

We do not believe special consideration should be given to EGCs related to competition, efficiency, and capital formation. As we have stated in Question 1 of this Appendix, despite our opposition to the proposed standards and amendments, application of auditing standards and amendments should be consistent and comparable for audits of all issuer entities.

**3.** ***Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?***

We do not believe special characteristics of EGCs should be considered in the applicability of such standards. As we have stated in our responses to various questions in Appendix 7 of the Release, despite our opposition to the proposed standards and amendments, application of auditing standards and amendments should be consistent and comparable for audits of all entities.

**4.** ***Would audits of EGCs be more, less, or equally likely to have critical audit matters?***

Based on the characteristics of EGCs, they are equally or more likely to have critical audit matters than non-EGCs. For example, as noted in Appendix 7 of the Release, data suggests that

"EGCs are 10 times more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective."

**5.** ***Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?***

No.

**6.** ***What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?***

Related costs to prepare the necessary communications will vary and such costs could be significant. Audit firms would incur initial costs in developing new audit methodologies to address the requirements of the proposed auditor reporting standard. Costs would also be incurred to train staff regarding the new methodologies and in changing the presentation of the auditor's report. With respect to communication of critical audit matters, implementation costs for audits of EGCs would not likely vary from that of larger and more established companies.

**7.** ***What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?***

Should the proposed standards and amendments be retained in a final standard (which we oppose), audit firms would incur additional and unnecessary costs in developing and maintaining separate audit methodologies for EGCs as opposed to other SEC registrants. In terms of costs specifically relating to implementing the proposed other information standards for audits of EGCs, it would be minimized as a result of the provisions in the Jumpstart Our Business Startups Act (the "JOBS Act") which allow for reduced disclosure requirements in IPO registration statements and the gradual phase-in of certain post-IPO disclosures and other requirements.

***8. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?***

See our response to Question 6

**9.** ***Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?***

See our response to Question 7

**10.** ***For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?***

We believe the proposed standards should be applicable for audits of EGCs as a matter of consistency. As consistency is always the most efficient approach, it would be more costly to have to maintain different audit methodologies for EGCs and other SEC registrants. Costs of maintaining different audit methodologies could be significant.

**VIA Email**

**December 10, 2013**

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

**RE: PCAOB Rulemaking Docket Matter No. 34**

Dear Members of the Board,

NextEra Energy, Inc. ("NextEra Energy") respectfully submits its comments on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed audit standards included in Release No. 2013-005 addressing both *The Auditor's Report on an Audit of the Financial Statements when the Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "proposed other information standard").

NextEra Energy is a public company with 2012 revenues of more than $14 billion. Its rate-regulated subsidiary, Florida Power & Light Company, serves approximately 4.6 million customer accounts in Florida. Additionally, NextEra Energy Resources, LLC, NextEra Energy's competitive energy business, is a leader in producing electricity from clean and renewable fuels in 24 states in the U.S. and 4 provinces in Canada.

At NextEra Energy we are committed to integrity and accountability in all aspects of our business. Providing accurate and complete information, and having the proper internal controls in place to ensure appropriate oversight, is a responsibility that we have always taken seriously. We believe that our shareholders, as well as investors and potential investors of every other publicly held company, are entitled to no less.

NextEra Energy is pleased to submit its views in response to the PCAOB's request for comments in connection with the above referenced proposals.

While we appreciate the PCAOB's efforts to enhance the auditor's reporting model and increase the relevance of financial statements for investors, the capital markets and the public, we do not support the Board's proposals as currently drafted. We believe the proposals have the potential to alter the roles and responsibilities of management, the audit committee, and the auditor, undermine the usefulness of the auditor's report and create investor misunderstanding. Furthermore, we believe that the proposals would be time consuming and costly to implement without providing any incremental benefit to financial statement users. Our rationale is presented below.

**Proposed auditor reporting standard**

The proposed standard requires the disclosure of critical audit matters ("CAMs") in the auditor's report. CAMs are defined as matters involving the most difficult, subjective or complex auditor judgments, including areas that posed the most difficulty to the auditor in obtaining audit evidence and/or forming an opinion on the financial statements. This area is of particular interest and concern to us and we have therefore limited our response on the proposed auditor reporting standard to this matter.

**The proposal would alter the roles of management, audit committee and the auditor**

We are concerned that this proposal would blur the roles and responsibilities of management, the audit committee, and the auditor. Management is responsible for preparing and filing all financial reports including determining the appropriate accounting for an entity's transactions, making the required judgments needed to calculate estimates, and providing meaningful disclosures in compliance with U.S. GAAP and SEC rules. The financial reporting process is overseen by the audit committee. However, the proposed standard significantly alters this paradigm by potentially requiring the auditor to disclose information, not otherwise required to be disclosed by management and notwithstanding the views of the audit committee, directly to financial statement users through the auditor's report. Auditors should not be the original source of disclosure about an entity. The role of the auditor should remain that of attesting to the fairness, in all material respects, of the financial statements presented by management. Management has the knowledge and business context for information most relevant to the financial statement users and they should retain the responsibility for communicating this information to the public through the financial statements and other investor communications.

**The proposal would undermine the usefulness of the auditor's report**

We have concerns that the inclusion of CAMs would undermine the confidence in and the usefulness of the auditor's report. Currently, the auditor's report expresses an opinion on the financial statements taken as a whole. However, the inclusion of CAMs may be interpreted by some financial statement users as the auditor expressing a different level of assurance on certain areas of the financial statements or as the auditor providing an implicit qualification of the financial statements. Furthermore, by focusing the attention of users on aspects of the company's financial statements that the auditor found to be challenging, there is the potential for investors to over-emphasize certain risks as a result of them being disclosed as a CAM and under-emphasize other important risks that may not meet the CAM criteria. A business that, by its nature, requires more judgment and/or the use of more estimates in its accounting may be inappropriately viewed by investors as more risky due to a higher number of CAMs in the auditor's report. Accordingly, this proposal could potentially mislead investors by inadvertently leading them to draw incorrect conclusions about the risk associated with an entity.

Another concern is that the auditor's determination of what is considered to be a CAM would involve a considerable amount of professional judgment which could have unintended consequences. We believe there is the potential for auditors to include more CAMs, rather than less, in order to avoid having their judgment on what is considered to represent a CAM challenged during a PCAOB inspection. This would result in voluminous disclosure within the auditor's report, potentially obscuring the overall opinion. We believe that the auditor's opinion will continue to be of primary importance to financial statement users and care should be taken to not let that opinion get "lost" among pages of information about which audit areas required the most time and judgment. Moreover, different audit firms would clearly have different judgments on what is considered to represent a CAM resulting in lack of comparability between auditor's reports for similar companies or industries.

**Potential for duplicate disclosure**

We are concerned that many matters that could be potentially disclosed as CAMs are already disclosed by management in the financial statement footnotes as required by U.S. GAAP and SEC rules (e.g., significant accounting and reporting policies). We therefore believe that an auditor's discussion of CAMs in the auditor's report would result in duplicative or irrelevant disclosure serving only to decrease the relevance of either the auditor's report or disclosures within the financial statements. This requirement would appear to contradict the Board's overall objective of making the auditor's report more informative for investors and other financial statement users.

**Potential implementation challenges and cost considerations**

Finally, the Board needs to consider the cost and additional time requirements for both auditors and companies in order to implement the proposed standard. A significant amount of additional time would be required by audit firms to develop, review and present CAMs resulting in increased audit fees. Extensive discussion and consultation with company management, legal and the audit committee would also be required, resulting in increased internal costs.

Furthermore, as CAMs may not be identified until late in the audit process, this additional work would be required during an already busy period within the audit and financial reporting cycle, which could potentially impact the ability of entities to file annual reports ahead of the SEC deadlines and, consequently, the ability of investors to obtain financial information in a timely manner.

In summary, the PCAOB has stated that the objective of the proposed auditor's reporting standard is to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users. We do not believe that the auditor's reporting of CAMs, as defined and required under the proposed standard, would meet this objective. Instead, we believe the proposed standard would fundamentally change the content of the auditor's report, alter the roles and responsibilities of management, the audit committee, and the auditor and may cause investors to draw incorrect conclusions about the risk associated with an entity. The proposal would also be time consuming and costly to implement while providing little incremental benefit to financial statement users.

We suggest that, if current financial reporting is not meeting the needs of financial statement users and additional disclosures are considered necessary, this matter should more appropriately be considered by the SEC and FASB as part of the financial reporting standard setting process.

**The proposed other information standard**

We agree that financial statement users would benefit from clearer articulation in the auditor's report about the auditor's current responsibility for other information included in the annual reports filed with the SEC. However, we have concerns that including the results of the auditor's evaluation of other information in the auditor's report could be perceived by some financial statement users as the auditor providing an *opinion* on this information. Furthermore, many of the disclosures outside of the primary financial statements contain subjective or forward-looking information which may not be objectively verifiable as many of these disclosures are based on management's analysis and insights. This would make it extremely difficult for the auditor to evaluate this information effectively.

We also believe that the requirements of the proposed standard would result in significant additional audit effort and cost. Currently, AU Section 550, *Other Information in Documents Containing Audited Financial Statements* ("AU Sec. 550") requires only that the auditor "read and *consider*" other information for inconsistencies with the financial statements. Under the proposed standard the auditor would be required to "read and *evaluate*". We believe the proposed requirement would prompt auditors to expand their audit procedures in this area, resulting in increased audit fees with no discernable benefit to financial statement users.

We therefore recommend that the Board retain its existing requirement to "read and consider" under AU Sec. 550 and ensure that the language in the auditor's report clearly articulates the auditor's responsibilities for other information contained within the annual report.

**Conclusion**

NextEra Energy, Inc. appreciates this opportunity to respond to the Board's proposals. As discussed above, we do not support the inclusion of CAMs in the auditor's report or expanded procedures on other information contained within the annual report. We urge the Board to reconsider these proposals.

We would be happy to respond to any questions or to participate in any discussions relating to these important issues.

Sincerely,

Chris N. Froggatt

Chris N. Froggatt
Vice President, Controller and Chief Accounting Officer

December 11, 2013

Office of the Secretary Public
Accounting Standards Board
1666 K Street N.W.
Washington, DC 20006-2803
Via email to comments@pcaobus.org

**Re: PCAOB Rulemaking Docket Matter No. 34**

NIKE, Inc. ("NIKE") appreciates the invitation to comment on the Proposed Auditing Standards regarding The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards (collectively, the "Proposed Standards") issued on August 13, 2013, by the Public Company Accounting Oversight Board ("PCAOB").

NIKE's principal business activity is the design, development, worldwide marketing and selling of high quality footwear, apparel, equipment, accessories and services. We are the largest seller of athletic footwear and athletic apparel in the world, employing over 48,000 people worldwide. Revenues for our fiscal year 2013 ended May 31, 2013, were over $25 billion. We sell our products to retail accounts, through NIKE-owned retail stores and internet websites, and through a mix of independent distributors and licensees, in virtually all countries around the world. NIKE prepares consolidated financial statements in accordance with accounting principles generally accepted in the United States ("U.S. GAAP") and files financial statements with the Securities and Exchange Commission ("SEC"). Our securities are listed and traded on the New York Stock Exchange.

We appreciate the PCAOB's continued efforts to improve audit quality and provide better reporting for investors and other users of the financial statements since the enactment of the Sarbanes-Oxley Act in 2002 ("the Act"). In particular, we believe making the independent audit committee directly responsible for appointing, compensating and overseeing our auditors has improved audit quality. Due to their experience and knowledge of NIKE and our business, our Audit Committee is in the best position to assess the quality of the audit we receive, the risks associated with the financial statements and the independence of our auditor. The ongoing relationship between our Audit Committee and our auditors allows for a frank evaluation of the quality of our financial statements and our system of internal controls, as well as the overall audit process, allowing the Audit Committee to act in the best interest of our shareholders. In short, we believe the current system has worked well and is effective.

We do not object to certain components of the Proposed Standards, such as including the auditor's statement of independence in the audit report. However, we do not agree with other proposed changes, such as the auditor's discussion of Critical Audit Matters ("CAMs"), the disclosure of the auditor's tenure in the audit report, and the auditor's evaluation of other information in annual reports containing the audited financial statements. In our view, these proposed changes would not provide material benefits to investors and in some cases would create confusion and increase costs. Our support for these conclusions is included below.

*Critical Audit Matters*

The Proposed Standards would require the auditor's report to include discussion of CAMs. CAMs are described as those areas that involve the most difficult, subjective or complex auditor judgments, posed the most difficulty in obtaining sufficient appropriate audit evidence, or posed the most difficulty to the auditor in forming an opinion on the financial statements. The Proposed Standards cite possible sources of CAMs as: i) items included in the auditor's engagement completion document, ii) items reviewed by the engagement quality reviewer ("EQR"), iii) items included in audit committee communications, or any combination of the three.

Our concerns regarding the proposed discussion of CAMs can be summarized as follows:

- The benefits to investors of these specific disclosures are unclear.
- Significant accounting matters already require disclosure in the financial statements, and in many cases management is required to disclose highly subjective accounting estimates or assumptions. Therefore, these new disclosures do not provide significant new information or insight for investors.
- Discussion of accounting and internal control matters that did not require disclosure under U.S. GAAP or affect the auditor's opinion may create investor confusion, undermine existing accounting and disclosure requirements and weaken investor confidence in the auditor's opinion on the financial statements and the effectiveness of internal controls.
- Determination of what matters are "critical" and should therefore be included in the auditor's report involves a high degree of subjectivity. As a result of this uncertainty, this proposal could result in significant additional disclosures, increasing investor confusion and requiring substantial additional work by the auditors and Company employees, increasing costs and time constraints. This proposal could also inhibit candid, open communications between the auditor, management and the audit committee as the parties consider in advance which matters might ultimately end up in the auditor's report.

The Proposed Standards cite certain academic studies that conclude that increased information provided to investors results in better capital allocation and a lower cost of capital. However, these studies do not link the proposed discussion of CAMs to the type of information that would result in such improvements. We do not believe the proposed disclosures would materially benefit investors.

Significant accounting matters already require disclosure in the financial statements. Furthermore, there are numerous examples in current U.S. GAAP where management is required to disclose highly subjective accounting estimates or assumptions. For example, the valuation of Level 3 investments requires a robust discussion of how fair value is determined, including the assumptions and subjective estimates. If an accounting matter includes one of these attributes for the reporting company, it is presumed to include the same challenges for auditors. A reiteration of the assumptions or subjectivity provides no additional insight to the investor beyond what is already required to be included in the financial statements.

The discussion of CAMs could also serve to undermine investor confidence in the auditor's opinion that the financial statements are free from material misstatement, as well as the auditor's opinion on the effectiveness of internal controls over financial reporting. The retained pass/fail form of the audit opinion should provide assurance to the reader of the financial statements that the financial statements are in accordance with U.S. GAAP and materially correct. A separate discussion from the auditor on accounting matters or potential control deficiencies that ultimately had no impact on the financial statement disclosures or the auditor's opinion, even if there are caveats that the discussion does not contradict the audit opinion, may undermine investor confidence in the financial statements by suggesting the disclosures are incomplete or inaccurate, or that internal controls are inadequate.

The discussion of CAMs could in some cases be inconsistent with existing accounting pronouncements, creating investor confusion. For example, current accounting rules require disclosure of material pending or threatened litigation, a judgment that often involves subjective evaluation. Such litigation matters, immaterial individually and in the aggregate, but involving substantial judgment or difficult estimates, might be considered by the auditor to be a CAM. In that event, the proposed auditor disclosure would introduce items not disclosed by management in its financial statements, creating investor confusion and potentially compromising the company's position on those matters. This would directly undermine the rationale behind the SEC's materiality threshold in financial statement disclosure.

More generally, we do not believe that it is appropriate for the audit report to be a source of new information about the reporting company's business provided by an outside party. Consistent with much of the commentary on the previously proposed Auditor Discussion and Analysis, we believe all information about our business should be provided by company management.

A similar issue could arise in the context of the auditor's opinion on the effectiveness of internal controls. The evaluation of control deficiencies can be complex and the final classification of a control weakness as a significant deficiency or material weakness requires discussion with the audit committee. The current description of CAMs in the proposed rule could result in including discussion of such a control deficiency in the auditor's report. Given that significant deficiencies are not required to be publicly disclosed, this would contradict the current reporting guidance.

As noted above, the Proposed Standards specify three possible sources of CAMs. While the Proposed Standards do not require all items included in these categories to be considered "critical," the list of topics included in this population can be extensive, driven by several factors. First, the increase in the quality of audit documentation has resulted in more exhaustive documentation of issues at varying levels of materiality, which has increased the number of items discussed with the EQR. Second, an open and productive relationship between the auditor and the audit committee has allowed for more frank discussion about a broader range of issues. This gives the audit committee valuable insights into the audit process and into the auditor's views on accounting principles, internal controls and quality of management, but also increases the number of issues discussed.

Because the determination of what items in this population are considered "critical" requires a high degree of subjectivity, there are several, possible unanticipated consequences of this requirement. First, because there is likely to be significant scrutiny of CAMs included in the audit opinion by both the public and the PCAOB, auditors may include unnecessary information in the auditor's report which would give undue prominence to such information and increase cost with no benefit. Another possible consequence is that the requirement for auditors to consider items discussed with the audit committee as possible CAMs could lead them to "edit" their communications with the audit committee, compromising the effective oversight function of the audit committee.

We are also concerned about the additional costs that would likely result from the proposed discussion of CAMs. At minimum, the auditors would need to document their judgments regarding which issues were considered CAMs and which were not. In addition, because statements made by the auditor regarding a position on individual elements of the financial statements would be perceived to increase risk, we believe auditors will increase audit procedures in these areas, increasing audit fees and costs for company personnel. This type of documentation would add little value to investors.

Furthermore, it is reasonable to assume that the majority of the auditor's work regarding the CAM report will come at the end of an audit, putting significant strains on already tight reporting deadlines for most public companies.

*Auditor Independence and Tenure*

The Proposed Standards would require that the auditor include in the audit opinion a statement of independence and a disclosure of the length of time their firm has audited the Company.

With respect to the proposed requirement that the auditor include a statement of independence in the auditor's report, we do not object to providing such a statement to the reader of the financial statements. Although the independence requirements for auditors are publicly available, a reiteration of the fact that the auditor must maintain a required level of independence may serve as a good reminder to the reader of those requirements.

However, we believe inclusion of the auditor's tenure seems unnecessary and may suggest to investors that the auditor is not independent based on the length of tenure. In response to the PCAOB's previous concept release regarding mandatory auditor rotation, most respondents expressed the view that mandatory auditor rotation would not reduce audit risk by improving auditor independence but on the contrary, would increase audit risk, and consequently, investor risk, due to a new auditor's unfamiliarity with the company. We agree with that position. Current auditor independence rules are robust and include mandatory partner rotation, limitation of non-audit services, regulatory review of a firm's audits and of a firm's independence procedures, and other effective rules that ensure that auditors remain independent.

*Auditor's Requirements Related to Other Information*

Lastly, the Proposed Standards include a requirement that the auditor include a discussion of the auditor's responsibilities for, and the results of the auditor's evaluation of other information included in annual filings that include the auditor financial statements. The auditor would not opine on the accuracy of the other information, but would only state that there are no material inconsistencies between the other information and the audited financial statements based on the audit of those statements. If material inconsistencies exist, and have not been corrected in the other information, a description of such inconsistencies would be included in the auditor's report.

Currently, the auditor is only required to "read and consider" the other information. It is our experience that with the current requirement, the auditor is already reviewing the other information for inconsistencies, which would be corrected prior to the issuance of the financial statements through discussions between the auditor and management and as a result of the auditor's (already) mandated communications to the Audit Committee. Therefore, we believe such inconsistencies would be rare. However, there are inherent difficulties associated with a reporting requirement that should be considered before such a change in the auditor's report is enacted.

The other information included in an annual report covers both financial and non-financial matters, as well as forward looking information. The PCAOB is not proposing that the auditor actually audit non-financial or forward looking information. Yet the statement that no material inconsistencies exist between the audited financial statements and the other information may cause confusion for readers of the annual report as to what other information is covered by such a statement and what procedures were applied by the auditor. In fact, no standards currently exist to guide auditors in making such a determination. As a result, the most likely outcome is that the auditor would significantly increase its procedures, increasing costs for the auditor and the Company as well as increasing the difficulty of meeting current filing deadlines.

*Summary*

We do not believe the Proposed Standards would improve the quality of our financial statements or deliver significant value for investors, but would result in increased cost and potential investor confusion.

Thank you for your consideration of the points outlined in this letter and we look forward to monitoring the project developments in the future. If you have questions or would like to discuss our responses further, please contact me at (503) 671-6453.

Sincerely,

Bernard F. Pliska

Bernard F. Pliska
Nike, Inc.
Vice President, Corporate Controller, Principal Accounting Officer

Bruce J. Nordstrom, CPA
Godfrey C. Loper, Jr., CPA
Marjorie T. McClanahan, CPA
Timothy D. Hansen, CPA

Nordstrom Associates P.C.
CERTIFIED PUBLIC ACCOUNTANTS

MEMBERS
American Institute of Certified Public Accountants
Arizona Society of Certified Public Accountants

December 10, 2013

Public Company Accounting Oversight Board
Office of the Secretary
1666 K Street, N.W.
Washington DC 2006-2803

Submitted by e-mail: comments@pcaobus.org

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 034**
I am Bruce Nordstrom, President and Certified Public Accountant with Nordstrom & Associates, P.C. and Chairman of the Audit Committee for Pinnacle West Capital Corporation ("Pinnacle West"). Pinnacle West is the NYSE-listed parent company of Arizona Public Service Company, the largest electric utility company in Arizona, serving more than a million customers. It is in my capacity as Audit Committee Chair for Pinnacle West that I respectfully submit comments on the PCAOB's Release No 2013-05; Proposed auditing standards on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* and *Related Amendments to PCAOB standards.*

I commend the PCAOB's efforts to improve information provided to investors and financial statement users. However, I do not support the PCAOB's proposals included in PCAOB Release No. 2013-005. I most strongly disagree with the proposals to include critical audit matters (CAMs) within the audit report and to expand the auditor's responsibilities regarding other information presented with audited financial statements. The proposed changes would unnecessarily alter the auditor's responsibilities from an attest function to a financial communication role, infringe upon the audit committee's oversight, and result in additional costs without commensurate benefits. Following is a detailed discussion of these specific concerns.

## Critical Audit Matters

The proposed guidance requires auditors to include a discussion in the audit report of CAMs that the auditor deems to have involved the most difficult, subjective or complex auditor judgments, posed the most difficulty to the auditor in obtaining sufficient audit evidence, and posed the most difficulty to the auditor in forming an opinion on the financial statements. The auditor will be responsible for identifying and disclosing information on these topics.

Financial statements and the communication of financial information is management's responsibility; with oversight provided by the audit committee. The auditor's role is to attest and opine on the financial information presented by management. The requirement for auditors to prepare and disclose CAMs within the audit report will distort these fundamental roles, resulting in auditors becoming a source of financial information.

This information may also be redundant, as existing SEC and US GAAP standards task management with disclosing many of the matters that would be CAMs; including: accounting estimates and policies, critical management judgments, risks and uncertainties. Topics that would be included in CAMs, if relevant to investors in making investment decisions, should already be disclosed by management as required by existing standards.

The audit committee is comprised of members of the shareholder-elected Board of Directors, and provides oversight of accounting policies, internal controls, financial reporting, and the audit process. This oversight role helps identify key audit matters and the communication of such matters to investors through management's financial disclosures. The inclusion of CAMs in the auditor report will usurp the audit committee's oversight role; as auditors will essentially have direct communications with investors. Ultimately, these disclosures will impede the audit committee's duties and diminish the oversight provided by the audit committee.

My primary concerns with the inclusion of CAMs in the audit report are the distortion of the auditor's function from an attestation role to a reporting role, and the undermining of the audit committee's oversight. Management should have the sole responsibility for reporting financial information, with oversight provided by the audit committee. Other issues with this proposed guidance include the subjective nature of determining CAMs, the risk of CAMs overshadowing the audit opinion, and the additional audit costs that will be incurred.

**The Other Information Standard**

I support adding language to the auditor's report to *clarify* the auditors' responsibilities and procedures regarding other information presented with the audited financial statements; however, I do not agree with expanding the auditor's responsibilities regarding other information. The existing standards require auditors to "read and consider" other information presented with audited financial statements to ensure the information is consistent with the audited financial statements. These existing procedures have proven to provide sufficient and reliable audit evidence for investors. The proposed guidance will require auditors to "read and evaluate" other information. The term "evaluate" is distinctly different from "consider" and will result in expanded audit procedures. Expanding auditor's responsibilities relating to other information will result in additional costs with no commensurate benefit to investors.

**Conclusion**

I appreciate the opportunity to comment on the PCAOB's proposals. I strongly urge the Board to reconsider their proposal to include CAMs in the audit report. Auditors should not be tasked with communicating financial information or information that can be perceived as financial information. Further, I urge the Board to re-evaluate the changes they have proposed regarding other information and consider retaining the existing audit requirements, but clarifying in the audit report the procedures that are performed on other information.

I would be pleased to discuss my comments in further detail or to provide any additional information you may find helpful in addressing these important issues.

**Sincerely,**

**Bruce J. Nordstrom**

NUCOR®
CORPORATE OFFICE

December 10, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

Nucor Corporation appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board (PCAOB) on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (together the "Proposed Standards")*.

Nucor is a large accelerated filer with approximately $15.1 billion of assets as of the end of our third quarter of 2013. Nucor is a manufacturer of steel and steel products. We also process and broker ferrous and nonferrous metals and manufacture Direct Reduced Iron. We are the largest recycler in North America, using scrap steel as the primary raw material in producing steel and steel products. Most of our operating facilities and customers are located in North America.

We have the following comments on the PCAOB's proposals outlined in the proposed standards:

<u>Critical Audit Matters (CAM)</u>

We are strongly opposed to the inclusion of CAMs in the auditor's report. We believe that management, with oversight provided by the audit committee, is best suited to provide information about the company's financial condition. Since management is responsible for making all judgments and estimates in a company's application of accounting policies and practices and resolving difficult accounting and disclosure issues, it should be exclusively responsible for communicating information about these matters to readers. Auditors should not be the original source of any disclosure about a company. Regardless of how extensive audit procedures are now or will be in the future, an auditor's knowledge about the company will never be as extensive as management's.

We are also concerned that the criteria for determining which matters should be designated as CAMs is too broad and could lead to the disclosure of classes of items that are not disclosed under the current reporting model. For example, some of the criteria that the proposed standards list for identifying CAMs are "the nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter" and "the severity of control deficiencies identified relevant to the matter." We are concerned that uncorrected misstatements or control deficiencies that are currently accumulated by the auditor solely for review by management and the audit committee, but that do not reach the level of materiality that would cause an auditor to issue an other than unqualified opinion, may now be incorporated into the auditor's report as CAMs. Additionally, even if the aforementioned items are not listed as CAMs in the auditor's report, we believe that significant effort will be required by auditors in documenting and defending why those matters are not CAMs. Although we believe that CAMs are not necessary, if they do become a requirement we believe that the criteria for identifying them should be narrowed and should focus more on significant transactions or events.

The broad criterion for identification of CAMs also leaves significant room for inconsistency amongst audit firms about which matters should be identified as CAMs. We can easily foresee situations in which two publicly traded companies operating in the same industry could face virtually identical risks and audit issues. However, due to the subjectivity and breadth of the CAM identification factors, one auditor could list CAMs in its report on one company while the other auditor does not list any CAMs for the similar peer company. The proposed standards state that one of the benefits of having additional information in the auditor's report is to provide additional information to investors which "could result in more efficient capital allocation." An investor comparing those two companies may infer that the company whose report contains the CAMs is a riskier investment and thus chose to allocate its capital to the company whose report does not contain CAMs even though the audit risks were virtually identical.

Another important consideration is the amount of time and cost involved in the documentation and approval of the CAMs and the resulting impact on audit quality. Because the CAMs will be about audit matters that are more complex or subjective, they will inherently require resolution by more experienced auditors and firm experts and by upper level company management and the audit committee. The involvement of more experienced auditors who command higher compensation will mean even greater costs associated with complying with the proposal. Also, the CAM documentation process will take a considerable amount of time during the critical final phases of an audit engagement so that all matters identified during the course of the audit may be considered together in a comprehensive matter. Given the rapid pace with which accounting guidance, required disclosures, and filing deadlines have accelerated over the past decade, it is already very difficult under current standards for auditors to complete their procedures and create adequate documentation by the filing deadline. This time scarcity would be even greater with the additional burden of crafting language around the CAMs and reviewing it with management and the audit committee.

We are also concerned that the inclusion of CAMs in the auditor's report would potentially obscure the pass/fail conclusion or appear to qualify the auditor's unqualified opinion.

Auditor Tenure

We do not support the proposed auditor reporting standard requiring the auditor to include in its report a statement containing the year it began serving consecutively as the company's auditor.  As the proposed standard points out, academic studies do not provide definitive conclusions about how the length of auditor tenure impacts audit quality.   Therefore, we believe that providing the tenure information will provide little proven benefit to the reader and will be evaluated subject to the readers' biases. Additionally, a company is already required to file a Form 8-K when there has been a change in its auditor, so the information is already available to readers.

Auditor's Responsibility Regarding Other Information

We do not support requiring additional auditor procedures on information outside the financial statements (e.g., MD&A, business overview, and documents incorporated by reference).  Under current auditing standards, the auditor is already required to read pertinent other information included in documents containing audited financial statements and consider whether such information is materially consistent with the audited financial statements.  We believe that including additional other information in that requirement would significantly increase the scope of auditor procedures and cause many unintended consequences.  There are many documents that are incorporated by reference that are non-financial in nature such as corporate governance documents that were previously not evaluated but may need to be evaluated in detail under the new proposed standards.  Performing additional procedures on these often very lengthy and sometimes partially outdated documents would provide limited value to readers.  The additional requirement may also cause timing issues.  For example, a company may incorporate its proxy disclosures by reference into its Form 10-K.  However, a company may finalize its proxy statement long after it files its Form 10-K, so it would be impossible for an auditor to include procedures over proxy disclosures prior to the filing of the 10-K.

We note that the proposed standards also state that the auditor must evaluate the "consistency of any qualitative statement in the other information" and "other information not directly related to the financial statements."  We are concerned that evaluating additional qualitative statements (e.g. company's share of the market, qualitative forward looking statements, etc.) will be extremely time consuming, very subjective, and go significantly beyond the scope of existing audit procedures. Requiring that the auditor provide any form of assurance on additional other information would be costly while providing little, if any, incremental benefit to readers. In addition, requiring that this other information be evaluated would further compound the timing issues noted in the CAM section above.

Other Matters and Conclusion

We believe that the main provisions of the proposed standards (inclusion of critical audit matters, auditor tenure, and responsibility for additional other information) will provide little additional information of value to readers while being very time consuming and costly for the auditor and the company. While it is difficult for us to quantify the costs associated with the additional effort, we understand that the Center for Audit Quality (CAQ) is currently conducting field testing on the proposed standards. We encourage the PCAOB to take the CAQ findings on additional cost and unintended consequences into consideration prior to making final determinations on the proposed standards.

Also, we believe that the auditor's report should remain concise and continue to follow the current "pass/fail" model. The language of the auditor's report should continue to use standardized language that provides consistency, comparability and clarity of auditor reporting. However, we do believe that readers would benefit from the following changes that are included in the proposed standards:

- Describe the auditor's responsibility to provide assurance whether due to error or fraud.
- Describe the auditor's responsibility with respect to other information in documents containing audited financial statements.
- Add additional information related to the auditor's independence.

Thank you for your consideration of these comments.

Very truly yours,

James D. Frias
Chief Financial Officer, Treasurer
and Executive Vice President

Mr. John Doty
1666K Street NW
Washington, D. C. 20006-2803

Dear Mr. Doty

I have just read today's WSJ article on *Audit Reports Changing.* I failed to verify what is reported with what was stated by you and your Board colleagues . I am however quite surprised about the comment "The Public Company Accounting Oversight Board. . . . . is pushing the accounting industry to disclose more about its views on a company, which some say will make the document attached to each public company's annual report more useful, albeit a little longer." This statement seems to imply that the auditor will be more than an auditor. The auditor will make judgments about what they obtain in evidence and what they believe is true.

I recall some years ago when the auditors were expected to make a forecast of the client's future success. We discussed that new rule in the auditing class I was teaching. The students and I were stunned at such a rule. It wasn't long until that rule was deleted.

Auditing has a clearly specified task: to *verify* what is presented through the use of clearly established criteria. The early auditors understood well the specificity of their responsibility. If the financial statements are not providing what is wanted by the investors, why aren't the accounting standards reviewed? The accounting standards must not be complete. To what extent has the FASB been involved in the current concern about the adequacy of the auditor's report and the extent to which what is needed is related to accounting and not to auditing?

The article, noted above, points out that AuditAnalytics.com commented on the increase in earnings restatements at larger companies in the past three years. Also noted were that your inspections of the Big Four in 2012 included 36 percent that were determined to be deficient, "which was up from 14 percent two years before that."

Why are audits deficient? When the first Board chairman announced that the inspection would have a supervisory context, I assumed that model would be used for a limited time. However, a decade after the functioning of the PCAOB, the gentle, supervisory inspection continues. There is a clear disclaimer that the public report is not to be used as a basis of evaluating the company. From time to time, there is a reference to the *rigorous* inspection process, but that seems totally different from the reality of an inspection. I wonder why the inspection doesn't now result in a clearly determined assessment of the quality of the firm's audits? (Any conclusion could be maintained confidential to the firm and not made public.)

I trust as you finalize your new reporting requirements there is clearly identified the role of the auditor.

Sincerely

Mary Ellen Oliverio

Mary Ellen Oliverio
moliverio@pace.edu

Dear Public Company Accounting Oversight Board,

I find that the proposal of Public Company Accounting Oversight Board to implement two new reporting standards in order to align the information held by the auditor with the information needed by an investor is a great initiative to make the auditor's statement not only indicative of the pass/fail status of a company's annual statement, but also more communicative.

The newly proposed standards imply that the auditor identifies critical issues, which he/she have been working at with a management of a company. In case when the auditor finds inconsistency or material misstatement of fact, the auditor is proposed to request management to revise the other information to address the issues. to make informed decision on a company's financial standing.

First, I particularly support the standard of highlighting the issues of auditor's main concern while working with a company's management. My five-year experience in financial statement analysis has taught me that sometimes the most important information is not contained in financial statements, which financial analysts use to conduct valuations and make investment decisions. While an auditor develops a close relationship with a company and a deep understanding of its operation processes, a financial analyst does not have such an advantage. Therefore, including highlights of the possible problematic issues of a company in the auditor's report will help an analyst to draw upon the profound expertise of an auditor and his/her knowledge of a specific company.

Second, many important issues of a company's operations and financial performance are hard to find in the statements themselves. They are often included in the notes to financial statements. Sometimes they do not even have a clear uniform structure for all public companies, which makes benchmarking and financial analysis difficult.

Third, there are several issues which could be used for manipulation of a company's results, and which are not included in financial statements at all. For example, transactions between a company and its franchisees could be recorded in several different ways, which will ultimately affect costs and net income from operations. While an auditor, who works with the management obtains information on the nature of the company's relationships with its franchisees, an analyst does not. The other example is an acquisition of a subsidiary and consolidated financial reporting. A financial analyst often does not have information on the nature of the acquired business, while the auditor has a chance to request it. The nature of contracts and the timing of payments is also not explained in the reports and could be used to manipulate the results.

Having mentioned these advantages of the new reporting standards proposed by the Public Company Accounting Oversight Board, I would like to also mention a concern with the incentives provided under the new reporting standard.

I believe that the proposed informative disclosure might lead to a disincentive for management to cooperate with an auditor in cases when the reporting is fair and transparent. In other words, cooperative management will be penalized under the proposed auditor reporting format. Under the new standard, the auditor lists all the areas, in which he/she cooperated with the management of a public company to make audit reporting more transparent. If the cooperation between the two parties was extensive, the shareholders will see a long list of issues, which might alarm them. Thus, management can be penalized by the shareholders' discontent for cooperating with an auditor and providing documents for more transparency.

In conclusion, I hope that the new initiative will quickly gain momentum, so that auditors' expertise could be drawn upon by the investor community.

Best Regards,
Svitlana Orekhova
Georgetown Investment Consulting

Pennsylvania Institute of Certified Public Accountants

December 10, 2013

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: PCAOB Release No. 2013-005 Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

The Accounting and Auditing Procedures Committee (the committee) of the Pennsylvania Institute of Certified Public Accountants (PICPA) appreciates the opportunity to comment on the proposed auditing standards revisions. The PICPA is a professional association of more than 20,000 members working to improve the profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. The committee is composed of practitioners from both regional and small public accounting firms, members serving in financial reporting positions, and accounting educators.

**Section I. Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements.**

The committee understands that financial statement users would like greater transparency from companies and are looking to the auditors for this additional information. However, the committee disagrees with the underlying concept and role being proposed for the auditor in this proposal. The committee believes that the proposed communications are fundamentally flawed, are in direct conflict with professional ethics standards, and would not result in meaningful communication to the financial statement user.

1. As the requirement to communicate critical audit matters would likely greatly increase the auditor’s practice management exposure, it is unclear which risk areas that an auditor would be willing to leave out. As a result, the audit report would likely become a lengthy document noting all risk areas material and immaterial. Standardization would likely result, as each firm looking to manage its practice risk would centralize and standardize the communication process. The value of the proposed communications is questionable, as the end result would be a lengthy document that would read like an audit textbook.

2. The auditor is not permitted by many state statues and the AICPA Code of Professional Conduct to release confidential client information without the client’s permission. The Code defines confidential client information as follows:

PICPA
Pennsylvania Institute of Certified Public Accountants

**"ET Section 92 – Definitions .05 Confidential client information.** Confidential client information is any information obtained from the client that is not available to the public. Information that is available to the public includes, but is not limited to, information

- in a book, periodical, newspaper, or similar publication;
- in a client document that has been released by the client to the public or that has otherwise become a matter of public knowledge;
- on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information;
- released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum;
- maintained by, or filed with, regulatory or governmental bodies that is available to the public; or
- obtained from other public sources.

Unless the particular client information is available to the public, such information should be considered confidential client information.

Members are advised that federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in the Code of Professional Conduct."

3. As the audit firm would be precluded from communicating any confidential client information, the client would have to approve the final wording of the audit report, including information about audit difficulties, negating the overall value of the communication. The auditors would likely involve their attorneys and the final audit opinion would result from a negotiation process involving the auditor, attorneys representing both parties, public relations specialists, and key members of a client's management. The process for issuing an audit opinion would not only be untenable, but if the process results in an adversarial situation, the auditor could lose independence and become unable to issue the opinion.

The auditor's role is to provide an opinion on the fairness of the financial statement presentation, not to provide communications regarding the overall health of the audited entity. If greater transparency is needed, the committee believes that financial statement users should look to the company's management for additional information (e.g., the "important information concerning the company, the company's environment, and the preparation of the company's financial statements" that is noted in the introduction to the proposal). If the financial statement users cannot ascertain this important information from the financial statements, then the communications included in the financial statements should be enhanced. The committee does not agree that the fundamental role of the auditor should change to correct a deficiency in financial reporting requirements.

Ultimately, the committee is supportive of proposed changes that would better communicate to the financial statement user the nature and limitations of an audit. The committee, for example, suggests that any proposed change to the audit report seek to minimize the gap between what financial statement users expect from the audit and what the audit is designed to accomplish. For example, improvements to the opinion could focus on further explaining the roles and responsibilities of the auditor and the audited entity's management, and that the audit is not designed to detect fraud due to the nature of fraud and the scope of the audit. The committee recommends that the PCAOB consider the findings included in the 103rd American Assembly Report, "The Future of the Accounting Profession," The American Assembly, Columbia University, which included tailoring the attestation level for the nature of the financial statement to remove the "illusion of exactitude." Two specific suggestions are as follows:

- More limited attestation on subjective judgments (e.g. accounting estimates and fair value determinations) instead verify reasonableness of process used.
- A new audit opinion to permit the external auditors to adhere to different attestation standards for different parts of the financial statements.

**Section II. Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.**

The question infers that the length of the auditor's tenure has a definite and measurable impact on the quality of the audit, with the longer the tenure the less the quality. The committee disagrees with this premise and believes that audit quality is lessened with mandatory firm rotation.

**Section III. Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.**

The committee supports the changes included in this area.

We appreciate your consideration of our comments, and members of the committee are available to discuss any of these with you at your convenience.

Sincerely,

Richard E. Wortmann, CPA
Chair, PICPA Accounting and Auditing Procedures Committee

Pfizer Inc.
235 East 42nd Street
New York, NY 10017-5755

**Loretta V. Cangialosi**
Senior Vice President and Controller

December 10, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

**Reference: Rulemaking Docket Matter No. 34**

Board Members:

At Pfizer, we apply science and our global resources to bring therapies to people that extend and significantly improve their lives. We strive to set the standard for quality, safety and value in the discovery, development and manufacturing of health care products. Our global portfolio includes medicines and vaccines as well as many of the world's best-known consumer health care products. Every day, Pfizer colleagues work across developed and emerging markets to advance wellness, prevention, treatments and cures that challenge the most feared diseases of our time. Consistent with our responsibility as one of the world's premier innovative biopharmaceutical companies, we collaborate with health care providers, governments and local communities to support and expand access to reliable, affordable health care around the world. For more than 150 years, Pfizer has worked to make a difference for all who rely on us. The Company's 2012 total revenues were $59.0 billion and its assets were $185.8 billion.

We appreciate the opportunity to present our comments on the Board's proposed auditing standards on the auditor's report (PCAOB Release No. 2013-005), and we recognize the Board's ongoing work in service to financial statement users. We acknowledge and commend the Board's efforts to reflect the advice and input of the many stakeholders in this process. In these proposals, the Board has addressed some of the most significant concerns expressed in our comment letter on the related concepts release. Several of the proposals in the release will likely improve the value of the auditor's report for financial statement users, but we also have reservations about some significant elements of these proposed standards.

We understand that it is sometimes difficult to strike the appropriate balance between investor "wants" and the concerns of preparers, but the Board also must recognize that the standards it promulgates have an impact not only on auditors, but also on auditee's resources, management time and audit committees. Below, we offer our comments and suggestions, which we hope will be helpful to the Board in moving forward with this project.

The proposed changes to the auditor's report which we considered to be most beneficial include:

- explaining that the audit is intended to provide reasonable assurance that the financial statements are free of material misstatement, whether caused by error or fraud;
- describing management's responsibility for the financial statements and related footnote disclosures;
- stating that the auditor is registered with the PCAOB and is required to be independent, although we would go further and have the auditor state explicitly that he complies with all SEC and PCAOB rules regarding independence;
- clarifying the nature of the auditor's responsibilities regarding information outside of the financial statements, if those responsibilities can be more clearly limited to information directly related to the financial statements and related disclosures, and supported by work the auditor would have performed to support his opinion (avoiding scope expansion and an expectations gap related to the meaning of "evaluate");
- disclosing the tenure of the auditor, only if the company has <u>not</u> already disclosed this information in the proxy (recognizing the increased value of providing this information earlier and in the appropriate context, we would expect most issuers to choose disclosure in the proxy).

We have several concerns and reservations about other aspects of the proposed standards. Broadly, we are concerned that these far-reaching changes are likely to present difficulties in application, costs and unintended adverse consequences, without producing actual substantive benefits to users of the financial statements. Although propelled by statements from investors indicating that they want these changes, they are not clearly supported by convincing evidence of the benefits that investors would receive from them. It is not clear to us that these changes will provide information beyond that which is already provided by management, or that additional, previously undisclosed information, can be provided without exposing the company and its shareholders to additional costs and other negative consequences. The costs, on the other hand, are real.

As expressed in our letter in response to the concept release, <u>we believe these uncertainties could best be addressed by a field-test designed to determine how these proposals could best be operationalized to balance costs and benefits, and to avoid unintended or undesired consequences</u>.

We see the added work and time related to the evaluation and documentation of critical audit matters (CAMs) and the evaluation of other information, as a diversion of time and attention of members of the audit committee, management, and the auditors during a critical phase of the audit, when everyone is already busy with essential tasks related to wrapping up the audit and meeting tight deadlines for reporting. The added time to appropriately document and discuss CAMs will not result in improved quality of the audit and in fact, may cause other quality checks done by auditors to receive less focus as they undertake this new work at a critical time.

As expressed in our previous letter in response to the concept release, we see potentially serious problems resulting from the shift of some reporting and disclosure roles to the auditors, and would much prefer to maintain the principle that management is the source of disclosures about the company's accounting. We question whether the net impact on audit cost and quality will be acceptable in view of the uncertain benefits. Again, in view of these uncertainties and potential consequences, the value of field-testing these proposals cannot be overstated.

We note that strong support has been expressed for retaining the pass/fail model for audit opinions, and that the proposed changes, taken together, will add significantly to the length of the report and will add language, particularly in connection with the discussion of critical audit matters, that could have the effect of communicating implicit qualifications to the auditor's opinion. Those who understand auditing will also understand that the auditor must have fully satisfied himself to have issued an unqualified opinion, but those who do not have an understanding of the process may misinterpret CAMs to be "trouble spots" or areas where the company was "aggressive" in its accounting. The potential for such confusion ought to be weighed carefully in framing the final version of these standards and we offer some suggestions in the Appendix to this letter.

In addition to these broad concerns, we have specific comments on the proposals for reporting critical audit matters and the evaluation of other information.

**Critical Audit Matters**

With respect to the inclusion of critical audit matters (CAM) in the auditor's report, we are particularly concerned about the potential for excessive disclosures that would be harmful to the company and its shareholders. The proposed standard should follow the IAASB example and make clear that the CAMs ought to be chosen from those matters discussed with the audit committee, and that only the most significant matters should be chosen to be included in the report (not all such matters). If a CAM does not rise to the level of an audit committee discussion, it should not be included in the auditor's report. Otherwise, it can reasonably be expected that auditors will "throw in the kitchen sink" to prevent any potential issues in later inspections by the PCAOB, or even litigation.

To demonstrate the reality of this behavior, we only have to look at the current "risk factors" section of SEC filings, where even obvious risk items are put in to guard against possible second guessing and to decrease the risk of potential litigation. The inspection process will drive behavior and therefore, we would recommend an ongoing monitoring mechanism be put into place that will help the PCAOB see if there is an increase in CAMs after the first inspection cycle and correlate whether investors are finding increased value from the increased listing of generic issues. As a large, global company, we are concerned with not only the increased effort and resources needed for this effort, but also whether investors will truly be getting relevant and more than tangentially useful information.

The standard should make clear that CAMs discussed in the auditor's report would not be expected to include specific disclosures of trade secrets or other proprietary information that would be harmful to the company's competitive position, a significant deficiency not required to be disclosed by the company under SOX, or sensitive information that would prejudice the company's position in respect of potential litigation. The auditors have access to confidential information that can harm a company's shareholders without providing any tangible benefit to other potential investors – there have to be some reasonable limits to avoid such unintended adverse effects and provide an acceptable balance. We continue to believe that management, not the auditors, should be responsible for providing the original source of such information.

It is also important that the presentation of CAMs in the auditor's report must make clear that CAMs are not indicators of "aggressive" accounting by management. If the auditor is commenting on an area of the company's accounting that is inherently challenging for both management and the auditor, because the rules for accounting in that area involve complex or subjective assessments, that should be made very clear. We suspect that as many readers will be confused by the addition of CAMs to the report as will find it enlightening, and that many will perceive the CAMs as equivalent to qualifications of the auditor's opinion.

We ran a quick field test to determine what issues we might surface in dealing with CAMs, but did not include input from other senior management or the Audit Committee members. What we determined was:

- the report grew to 6 pages in length;
- the report contained information that aligned with our critical accounting policies which did not add additional useful information;
- the report contained items that we were surprised were considered CAMs as they had never been a subject of significant discussion with the Audit Committee;
- the report contained some added useful information regarding additional steps the auditor undertook to audit the CAM; and
- context setting of the CAM was particularly important as otherwise a reader could easily misinterpret that the CAM was the result of a company-specific anomaly or accounting interpretation.

Given that we and our auditor were reading the same document and coming up with different views as to what a CAM was, I believe that the definition of a CAM is too far-reaching and will result in a large number of items considered CAMs without adding significant value. When coupled with the current proposal's requirement that the auditor document why audit matters that would appear to meet the definition of a critical audit matter were not communicated, the likelihood of an auditor putting in all matters is high. They will err on the side of putting too much in so as not to be criticized later. There is no "upside" for an auditor to use judgment and face an "audit failure". Because our current accounting model has evolved to be very complex and requires the use of estimates that inherently have uncertainty, and these estimates are throughout the financials, the number of CAMs will be very high for many companies, and not very meaningful for investors.

Some of our concerns are as follows:

- For example, the auditor relies on an actuarial expert for a pension plan, and, as we know, pension plan accounting is complex. It includes many assumptions, so the auditor reports that as a CAM. While this might appear to be a CAM on its face, the Board should recognize that it is likely that every company that has a pension plan will wind up with a CAM like this. We question the usefulness of such a CAM as it is not unusual or specific to the nature of the plan or the company, but is merely based on the complexity of required (there are no other alternatives) accounting. This will become a "boilerplate" disclosure.
- We can easily see CAMs covering all areas where level 3 fair values must be provided. These inputs are defined as unobservable or based on a hypothetical market participant; therefore, by their very nature they are difficult to determine, even for the preparers who must come up with a way to produce such values. Valuation specialists are very often used in these areas due to their inherent complexity. While investors might express usefulness in "knowing" that this is difficult to determine, we are surprised they don't already know that since they are the same people who drove this model with the FASB, and this information is in the company's financial statements and MD&A.
- Likewise, investors have played a role in making estimates a significant part of the process in areas like revenue recognition where future deductions must be determined at the time the sale is made. CAMs will show up in these areas as revenue is critical for every company and these will be boilerplate disclosures as well.
- Another example of a possible CAM that could lead an investor to misinterpret standard auditing practice for some anomaly that created additional scope changes has to do with the way many multinational companies are organized. Most global, multinational companies have instituted shared services organizations to streamline costs and standardize practices in financial accounting. Auditors must appropriately scope and determine the impact of such shared services on their audit procedures and the nature of work that will be performed in the shared service and that which will be performed in a local market. Such scoping requires judgment and can be difficult. We can foresee CAMs being created for such items which, in our view, do not add any additional value to an investor's view of the financial statements.

We are concerned that there could be unanticipated adverse impacts resulting from the auditors being required to discuss critical audit matters in the audit report. It seems very likely that the transformation of the auditor's report into a vehicle for separate disclosures about a broad range of sensitive and otherwise confidential matters will lead to less openness between management and the auditors. Rather than have a discussion with the auditor about a matter which we are struggling with which could then possibly trigger a CAM, we might delay that discussion until we have fully worked out a documented solution and final arguments to support the position, to avoid the audit team viewing it as "difficult". It must be well understood that, along with the perceived benefits, there will certainly be costs to the shredding of the confidentiality that currently exists in the auditor's role.

**Other Information**

It is sufficient that the auditors read this information and consider whether such information or its presentation is materially inconsistent with the financial statements they have audited. A statement to this effect, clarifying the extent of the auditor's responsibilities for such information, should be included in the audit report, to enhance the understanding of users. However, as the proposed standard is written, with the "read and evaluate" concept, we are concerned that auditors will have to perform substantial additional procedures that would be very costly relative to the benefit of added assurance thereby obtained, and would add significantly to the time required to issue annual reports.

We also are concerned with setting an expectation gap with investors about what "evaluate" means in this context. As you are aware, the definition of "evaluate" is "to judge the value or condition of (someone or something) in a careful and thoughtful way." We also note that the general layperson's definition of the term "audit" means "a complete and careful examination of the financial records of a business or person, or a careful check or review of something. These terms are very difficult to distinguish from a general meaning perspective and the term "evaluate" sets a much higher bar than the current "consider" language.

One example given has been for an auditor to evaluate the statement: "is the leading company...." We see this as being problematic for the auditor to have to correlate all data to understand whether it is leading in revenues, assets, manufacturing throughput or some other measure. Further, an investor will not understand what statements were or were not evaluated, thereby providing a false sense of comfort.

We believe the standard should only apply to other information directly related to the financial statements covered by the audit opinion; and it should be very clear that auditors should not be expected to perform additional procedures to verify other information. For example, in our own MD&A, there is an extensive discussion of non-financial information about research and development. As discussed in our earlier comment letter, significant time and effort would be spent verifying what phase a clinical trial is in, obtaining and documenting FDA approvals, etc.

There is a significant risk that this additional work would adversely affect the timeliness of reporting and put added pressure on management to not only answer inquiries, but also to formally document them for the auditors at a level sufficient for PCAOB inspectors. Our view is that this exercise would add significant audit time and cost as well as management time without resulting in any added benefit -- most companies already have extensive disclosure controls and procedures in place to review such information, incorporating a high level cross-functional team that will include senior management, finance, business leaders, legal, investor relations, internal audit and others.

As with critical audit matters, we believe that these proposals would benefit from field testing to better define what an investor will truly find useful around CAMs, the likely impacts on cost and timeliness of reporting, the potential unintended consequences, and the anticipated benefits of changes in this area.

* * * * *

In summary, as described above, we recommend a robust field test of the proposed standards to provide insight into the costs and benefits and to guide the clarification and enhancement of these proposals, prior to issuance of the final version of the proposed standards. We continue to be very concerned that the proposed approach to critical audit matters and the evaluation of other information would be very costly and would adversely affect the quality of the audit and timeliness of corporate reporting.

More importantly, they would also undermine the important principle that management is responsible for the company's financial reporting and blur the responsibilities between auditors and management. The unintended effects and practical and legal consequences of such a fundamental change and expansion of auditor responsibilities are a significant cause of concern.

Once again, we appreciate this opportunity to comment on these proposed standards and encourage the Board to continue to engage its constituents. We would be pleased to discuss our perspective on these issues with you at any time.

Very truly yours,

*Loretta V. Cangialosi*

Loretta V. Cangialosi
Senior Vice President and Controller

cc: Frank D'Amelio
Senior Vice President and Chief Financial Officer

Appendix: Specific suggestions on the proposal

The Auditor's Report:

- Paragraph 5i, change requested to delink the notion of independence from the tenure of the auditor: <u>If not disclosed in the proxy statement of the company,</u> a statement containing the year the auditor began serving consecutively as the company's auditor;

- Paragraph 8 change requested to ensure that any of these items are communicated to the audit committee and that an appropriate level of significance is obtained: Critical audit matters ordinarily are matters of such importance that they are included in the matters required to be ~~(1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer;~~ ~~(3)~~ communicated to the audit committee <u>as part of an audit planning document, interim update or as part of the year end-process</u>; ~~or (4) any combination of the three~~.

- Paragraph 9, changes requested as "the most difficult" seems to imply only one item and the context of the complexity of the accounting principles is an important consideration, severity of deficiencies should only be addressed in the case of a material weakness: Certain factors might affect whether a matter addressed during the audit of the financial statements (1) involved very ~~the most difficult~~ <u>significant</u>, subjective, or complex auditor judgments; (2) <u>had an very high level of</u> ~~posed the most~~ difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the ~~most~~ difficulty to the auditor in forming an opinion on the financial statements. In determining whether a matter is a critical audit matter, the auditor should:

    - <u>consider the complexity of the accounting principles that are required to be applied and whether there are any unusual circumstances that would make the audit of such an area more difficult for the specific entity being audited,</u>

    - <u>whether the matter is unusual in nature,</u>

    - <u>whether the matter has been the subject of a robust discussion with the audit committee</u>

    - <u>whether the matter is company-specific (in terms of accounting, obtaining of audit evidence, requiring of specialists, etc) or is it a matter that is generic in nature, that is, similar efforts and procedures would be undertaken in any company and such a matter is no unusual circumstances (for example, pension accounting might use estimates and a specialist, but may have no special circumstances, so there would be no incremental effort by any other auditor).</u>

    - <u>and take into account the following factors, as well as other factors specific to the audit:</u>

        a. The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

        b. The nature and extent of audit effort required to address the matter;

        c. The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence;

        ~~d. The severity of control deficiencies identified relevant to the matter, if any;~~

e. The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any

f. The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any;

g. The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and

h. The nature of consultations outside the engagement team regarding the matter, if any.

Auditor's Report – paragraph on critical audit matters

The standards of the PCAOB require that we communicate in our report critical audit matters relating to the audit of the current period's financial statements or state that we determined that there are no critical audit matters. Critical audit matters are those matters addressed during the audit that (1) involved our most difficult, subjective, or complex judgments; (2) posed the most difficultly to us in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to us in forming our opinion on the financial statements. The critical audit matters communicated below do not alter in any way our opinion on the financial statements, taken as a whole. <u>Critical audit matters are normal during the course of an audit and generally occur as a result of the inherent complexity in the required accounting standards and the uncertainties and assumptions surrounding estimates required to be made to comply with generally accepted accounting standards in the United States of America.</u>

| | |
|---|---|
| **From:** | Stewart Kim |
| **To:** | Comments |
| **Subject:** | PCAOB Rulemaking Docket Matter No. 034 |
| **Date:** | Thursday, December 12, 2013 6:24:38 PM |
| **Attachments:** | PCAOB Docket 034 Comment.pdf |

We are a small, independent broker-dealer and support Lisa Roth's position stated in the attached 100%.

Thank for you for your consideration.

Stewart M. Kim
Managing Partner
PGP Capital Advisors, LLC
11111 Santa Monica Blvd.
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Los Angeles, CA, 90025
Phone: (310) 268-0885 Ext. 18
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M & R
MONAHAN & ROTH, LLC

**Lisa Roth**

630 First Avenue
San Diego, CA 92101
Phone: 619-283-3500

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

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

**From:** John L. Pierschbacher
**To:** Comments
**Subject:** Proposed auditor reporting standard
**Date:** Thursday, November 14, 2013 3:45:51 PM

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November 8, 2013

Public Company Accounting Oversight Board

Re: Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard

Members of the Board:

I appreciate the opportunity to comment on The *Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. I am an investor in various stocks and have worked in public accounting. As an investor, I would like to provide my opinion on some of your proposed changes.

**Critical Accounting Matters:**

I am concerned that the proposed prominence given to the critical accounting matters will add confusion to the readers of the financial statements and distract from the primary purpose of the auditor's report. The auditor's opinion on the fair presentation of the financial statement should receive prominence and not be diluted.

**Independence:**

Including a statement as to the auditor's independence does not provide any meaningful information. If an auditor is unethical enough to give an opinion on an audit and that auditor is not independent, why would that same auditor have any qualms about stating they were independent as a part of their report.

**Auditor's Years of Service:**

I would not clutter up the auditor's report with information such as the years of service of an auditor. Such information could easily be included in the proxy statement of a public company, although there is no evidence that multiple years of service has any negative effects on the quality of the audit performed.

The PCAOB needs to focus on how to make opinions meaningful in instances like jurisdictions that do not allow inspections by the PCAOB and audits of certain industries that have typically had a lack audits of quality audits.

I appreciate the opportunity to share my viewpoint on the Proposed Standards.

Sincerely

**John Pierschbacher, Investor**

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December 6, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 2006

Re: Rulemaking Docket Matter No.34

Proposed Auditing Standards –

1. The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion;
2. The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

We write to comment on the proposed auditing standards included in PCAOB Release No. 2013-005, dated August 13, 2013. Our comments come from the perspective of management of a public registrant and are based on our experience, information included in the proposed standards and viewpoints expressed in the discussion to date.

**Critical Audit Matters**

We understand that the board believes that the proposed standard could provide financial statement users with potentially valuable information that investors have expressed an interest in receiving. While we are proponents of full and fair financial disclosure in financial statements and related communications by SEC registrants, we believe that there is an abundance of disclosure currently included in public filings. These existing disclosures include significant accounting policies, critical accounting estimates and overall risk factors to the business. We believe the sophistication of the investing community and the wealth of information publicly available regarding auditing standards cast doubt on the potential real benefit that will be gained in adding a significant amount of incremental, but similar disclosure to already lengthy 10-Ks.

Further we believe that the proposed standard is likely to result in either lengthy audit reports that are difficult to compare between registrants, or more likely, lengthy audit reports that are standardized and include boilerplate language that is the same for all companies across an industry. One of our most significant concerns is that the description of the considerations regarding critical audit matters could include information about the company that is not otherwise required to be disclosed by the registrant, which will result in the auditor becoming responsible for disclosure rather than auditing disclosures made by management. We believe that the proposed standard should be revised so that the role of the auditor is not changed in this way.

We also believe that adding discussion of audit procedures performed on critical accounting matters would create additional voluminous disclosure. Expansive details and a significant amount of discussion would be required to provide sufficient context to understand the audit procedures performed and we do not believe that this additional disclosure will facilitate a better understanding of the financial statements.

In addition, we believe there is a strong likelihood that the proposed standard will result in significant increased costs associated with the time invested by the audit engagement partner and manager, the audit firm's national office accounting and technical experts and senior accounting and finance management of the registrant. We are further concerned that the increased focus by all of these parties will occur in the critical final phase of the audit and the 10K preparation process, which could have a detrimental impact on the quality of audit work performed and an overall negative impact on the process.

In summary, we do not believe the proposed standard is cost beneficial – the benefit is at best questionable with a likely outcome an increase in "boiler plate" disclosure – what isn't questionable is the increased audit fees for all public registrants associated with preparing and "negotiating" the disclosure and the potential increased exposure to the auditors.

**Expansion of Auditor's Responsibilities Regarding Other Information**

We understand that under existing PCAOB standards, the auditor has a responsibility to read and consider whether other information in documents that also contain the audited financial statements and the related auditor's report is materially inconsistent between the other information and the financial statements. Based on the feedback that you have received regarding confusion or a lack of understanding of the auditor's responsibility for this other information, we are not opposed to adding clarification to the auditor's report that specifies the auditor's responsibility to "consider" such information. However, we do not support expansion of the auditor's responsibility to evaluate and report on the other information.

We have two primary concerns with this proposal. First, we believe that audit firms would need to perform a significant amount of additional procedures to support their conclusion about the auditor's evaluation of other information and believe over time that the auditors practice will evolve to be to "audit" the other information due to the perception of increased exposure associated with the requirements of the proposed standard. We do not agree that the benefits of expanding the auditors reporting outweigh the costs associated with such changes. Additionally, time spent "auditing" the other information in a 10-K, may reduce time spent auditing the financial statements and ultimately reduce audit quality. In addition, we believe that the additional procedures that the auditors will need to perform have the potential to delay filing timelines. The delay in disseminating information to the public runs contrary to the priority of timely access to information for investors. Second, we believe that the proposed expansion of the auditor's responsibility is beyond the professional competence of the auditor. As experts in accounting and auditing, the audit firms are appropriately situated to perform audits of financial statements. However, evaluating qualitative statements and non-financial data and determining the accuracy of the factual content of the various disclosure requirements throughout an SEC filing requires expertise above and beyond accounting and auditing expertise.

Thank you for the opportunity to comment on this concept release.

Sincerely,

Al Swanson
Executive Vice President and Chief Financial Officer

Chris Herbold
Vice President - Accounting and Chief Accounting Officer

December 17, 2013

Ms. Phoebe Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

File Reference: PCAOB Rulemaking Docket Matter No. 34

Dear Ms. Brown:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to comment on PCAOB Release No. 2013-005, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditors Responsibilities Regarding Other Information in Documents Containing Audited Financial Statements* (the "ED").

PNC is one of the largest diversified financial services companies in the United States. We take this opportunity to present the Public Company Accounting Oversight Board ("the PCAOB" or "the Board") with a large Securities and Exchange Commission ("SEC") filer's perspective on the Board's initiative intended to enhance the existing auditor's report and expand the auditor's responsibilities. The ED appears to be based upon an implied presumption that information needed by investors is not being disclosed, or that management is not willing to disclose it. Further, it appears that the PCAOB has not given an appropriate amount of credit to the positive results of the Sarbanes-Oxley Act. Specifically related to this, PNC management has developed strong internal controls over financial reporting to ensure adequate information is publicly disclosed. Accordingly, it is unclear to us, what is not working within the current financial reporting process, and what the PCAOB is trying to address/correct.

Additionally, our concerns regarding the proposal relate to weakening the boundaries between the roles of the auditor, the board of directors and management, increasing the possibility of disclosure of non-public information that may be detrimental to the investors of a company through an auditor's discussion of critical audit matters, and lengthening of the financial reporting time-frame in conjunction with incremental costs.

Further, the likely result of the ED will be an increase in disclosures of a lesser significance. When considering the factors an auditor should take into account when determining a critical audit matter, we note that certain factors related to the degree of subjectivity, the nature and extent of effort, and the amount of evidence regarding a specific item are already considered in management's determination of its key disclosures. These disclosures address risks and uncertainties to its operations, as well as the subjectivity of estimates. Ultimately, whatever marginal improvements are presumably gained will be outweighed by their costs.

In general, we support efforts to increase transparency and simplify financial statement disclosures; however, we believe that any additional disclosures resulting from the ED are management's responsibility and increasing the auditor's responsibility to add more disclosure to the annual report is counter to the auditor's role as attesters of the overall financial statement presentation. We also believe the Board's proposal will be a step back from the progress that has been made in making boards and audit committees more empowered. Today, matters related to the audit and financial information are discussed at length by management, audit committees and auditors in an open and constructive environment, which we feel would be at risk under the proposal.

*Recommendations*

PNC believes that the proposal will cause a fundamental change in the role of the auditors from a role of attesting management's information to a role of authoring information that management has not already disclosed and determining which issues are more critical for the company. Therefore, we respectfully disagree with the PCAOB's conclusion that its proposal would not change the auditor's role.[1] While critical audit matters will highlight areas of an audit that may have been challenging to the auditor, these matters do not necessarily provide any additional decision useful information to investors about the business and prospects of the company, particularly when the auditor agreed with management's judgment. Additionally, disclosure of critical audit matters by the auditor may even be detrimental to investors if prejudicial information is disclosed. Finally, an auditor's review of information outside the financial statements, including the MD&A, would increase the cost of the audit without a benefit that outweighs the cost and may result in a restriction of information that is deemed useful to investors by management. As such, we recommend that the Board reconsider and not move forward with the proposal to expand the auditor's report. Conversely, contrary to our view that adequate public information is disclosed, if an auditor has critical information that is not required to be disclosed by management, we recommend that changes be made to public disclosure requirements, which we respectfully submit falls within the SEC's and FASB's jurisdiction.

*Critical Audit Matters Section in Proposed Report*

Although we agree that the proposed requirements for auditors to identify critical audit matters, and to describe the considerations that led them to that designation, would provide more information about the audit, we question the ultimate value of that information to investors and users of financial statements. Critical audit matters would reflect matters that may have required more judgment by an auditor in reaching a conclusion, but from a management and investor perspective could be a standard business activity. In addition, an investor would also expect and rely upon the auditor to be sufficiently capable of resolving such matters to its satisfaction. Discussion of such matters would detract from more relevant disclosures that provide decision useful information. For example, PNC may issue debt instruments as part of our standard business activities, which may have embedded derivatives or other structured elements. As accounting for structured debt transactions can vary between debt, equity and fair value accounting, and impact our reported financial results, management would spend a significant amount of time in ensuring accurate accounting for these items, and consequently, the auditor would also be required to exercise judgment. However, in most cases, issuance of debt is generally a routine transaction which would be discussed by management in Management's Discussion and Analysis ("MD&A"). We do not believe that such transactions should be unduly emphasized as critical audit matters; however, the proposal could be construed as requiring the auditor to include discussion of such transactions in its audit report.

In addition to the distraction created in financial reporting, the proposal to require auditors to describe critical audit matters could potentially harm investor interests. For example, a company may have a pending lawsuit where the plaintiff is asking the company for an unreasonable amount in damages. Although the company may not believe that a legal liability exists and may conclude that, under accounting principles generally accepted in the United States of America ("GAAP"), an accrual is not required, the company's auditor would need to obtain evidential support for management's

[1] *Ibid.*, Summary page 27

position and may spend significant time and resources assessing the evidence collected[2]. Even if the auditor were to agree with the company's conclusion after the auditor's assessment, adoption of the critical audit matter reporting requirement could cause the auditor to make a determination that this issue, although resolved consistently with the company's viewpoint, was one of the most critical accounting matters that occurred during the reporting timeframe. Accordingly, the auditor would discuss this as a critical audit matter in compliance with the ED, thus providing more disclosure than what management would believe prudent or necessary. In this potential scenario, the company may not be required to provide any disclosure about the litigation under GAAP and may have strong and legitimate reasons for not wanting to explain its reasons for not accruing any amounts related to the litigation because such disclosure might result in information that would prejudice the litigation and adversely affect the company's ability to limit any adverse consequences of the litigation. The identification of this matter as a critical audit matter by the auditor would, accordingly, likely result in a prolonged process with additional costs incurred, as well as disclosures not required by GAAP.

The proposal would require auditors to explain variations in their audit approach surrounding critical audit matters that were caused in part by control deficiencies that would otherwise not arise to the level of a qualification in the Internal Controls over Financial Reporting ("ICFR") opinion, nor require such matters to be disclosed by management, therefore exceeding current SEC reporting requirements. In effect, the proposal would lower the bar for assessment and disclosure of internal control deficiencies that was set under the Sarbanes-Oxley Act.

As shown by examples above[3], the proposal would require disclosure in excess of GAAP and rules promulgated by the SEC under the Sarbanes-Oxley Act. The Board should consider that this proposal would override laws that establish reasonableness of disclosures and delineate responsibilities between management, the board of directors and the auditors. We do not believe that the Board should promulgate rules that allow for disclosures to be made that would otherwise not be required and as such provide a back-door to more disclosures at the discretion of the auditor. Further, in order for audit firms to limit their liability, or limit challenge from the PCAOB, it is inevitable they will insist on additional disclosures that are not required by the SEC.

Lastly, the ED requires the auditors to look to their engagement completion document, the work of engagement quality reviewers, and communications to the audit committee for the source of critical audit matters[4], and to document their determination of critical audit matters including why matters addressed in the audit that could meet the definition of critical audit matters were not reported as critical audit matters[5]. We believe this documentation requirement would result in the need for the auditors to document a large number of items, which would likely delay the completion of the audit. In addition, this requirement could lead to a significant demand on management's time and resources to 1) further document for its auditor why items are not critical audit matters and/or 2) assess the auditor's requests to include such items as critical audit matters and support the auditor's documentation efforts, while also increasing audit hours and overall costs of the audit. We believe these additional efforts and the associated costs will provide no value to the auditors, board of directors, management, analysts or investors. However, we believe the press agencies would value this information in order to create headline stories which would have little substance and could be taken out of context. In our case, extensive communications already exist between our auditor and PNC's Audit Committee. As we stated in our introduction, if a premise for this standard is that a company's process for disclosing higher risk or critical items is insufficient, a study of those practices

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[2] Based on the criteria in the proposed standard, an auditor might identify this matter as a critical audit matter. ED at §9(b), (c), (g) and (h) of Appendix 1, page A1-7 and A1-8.

[3] The Board also acknowledged possibility of additional disclosures. ED at Appendix 5, page A5-42-43.

[4] *Ibid.*, §8 of Appendix 1, page A1-6

[5] *Ibid.*, §14 Appendix 1, page A1-10

and recommendation for improvements should be conducted in order to improve financial reporting instead of this proposed standard.

*Other Information Section in Proposed Report*

The Board proposes to require that auditors also assess "consistency of any qualitative statement in other information, and the manner of its presentation"[6] based on relevant audit evidence obtained[7]. We believe this would result in the auditor imposing its views within MD&A. In our view, the purpose of the MD&A is for management to have complete authority and ability to determine the need and manner of presentation of qualitative information. The auditor should not be able to change management's qualitative analysis of information, as long as the information that is presented is reasonable and accurate. Therefore, we believe that the Board should not increase the auditor's responsibility to assess qualitative information presented within the MD&A. For example, management may discuss causes and effects of relationships between certain performance metrics and economic data in MD&A. The auditor may have noted an empirical relationship between economic data and the company's results as part of their substantive data analytics; however, the auditor may have developed a divergent opinion as to the likelihood of an outcome of an economic trend and therefore determine the qualitative statement to be inconsistent with audit evidence. Based on their interpretation, an auditor may ask the company to modify such statements. Because the proposed standard could potentially result in a modified audit report as it relates to other information, the company would not have any choice but to limit its discussion to what its auditor deems supportable and deprive investors of information that management considers relevant to the business.

*Incremental Costs*

We appreciate that the Board has already acknowledged that as a result of these proposals, the costs of performing the Audit will increase [8] and significant other costs will also be incurred by the company. We agree with auditors' views, described in the proposal document, that these costs would include costs to identify, draft, discuss and resolve issues around the critical audit matters and other information, as well as costs related to an increase in auditor's liability[9]. We recognize that the proposal document notes that investors have also acknowledged an increase in audit related costs. We believe, however, that the PCAOB, auditors and investors may not have fully realized the total impact of implementing the proposal.

Despite acknowledgement of additional costs, we believe there are other significant factors that need to be included in the analysis of this proposal. To the extent the auditor adds a comment on any critical audit matters not currently covered within the financial statements, it is unclear what management's responsibility would be to certify that information for SOX purposes[10]. We believe that a consequence of the proposal is that control processes that meet design and operating effectiveness criteria would need to exist related to any financial information being discussed as a critical matter. This would apply to information that is disclosed in MD&A today or information that is not discussed in the financial statements. Furthermore, it is unclear whether this information would then need to be included within the financial statements. In addition, typically, such matters would arise within the financial reporting time-frame (quarter end close through issuance of the Form 10-K/10-Q) and would

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[6] *Ibid.*, §4(b) Appendix 2, page A2- 3

[7] The ED would supersede current AU Sec 550, which does not include a specific requirement to review qualitative statements.

[8] *Ibid.*, Summary page 8, 12, 17 and 21

[9] *Ibid.*, Appendix 5, page A5-41 and Appendix 6, page A6-35

[10] i.e. under rules promulgated by the SEC under Section 404 of the Sarbanes-Oxley Act of 2002

not allow companies time to adequately establish, evaluate and document control processes appropriately for SOX purposes, leading to a further issue regarding internal control certifications.

Finally, we believe that the ED will place a significant burden on the time and resources of management and the audit committee to assist the auditor in completing the audit, which would lead to unnecessary added stress on the financial reporting time-frame. This process is already completed in a minimal amount of time (e.g., a large accelerated public company's Form 10-K is filed with the SEC within 60 days of quarter-end) given the voluminous amount of information provided in a filing. The additional documentation required by the proposal as well as discussions regarding the critical audit matters and any auditor observations about the information outside the financial statements will exacerbate the challenges in meeting current filing deadlines. We also believe that the proposed expansion of the audit report may increase the auditors' legal liability regarding information contained in the MD&A under the Securities Act of 1933,which imposes liability at a negligence level, given the incorporation by reference of the Form 10-K, including the MD&A, in registration statements for the public offer of securities.

In today's economic environment, where audit fees have already been significantly increasing because of additional audit work due to PCAOB inspections, some measure needs to be taken to directly link audit fees to value-added work by audit firms and limit annual fee increases to reasonable amounts. We believe the proposed additional costs are neither warranted nor necessary and that the additional costs will not support the benefits, if any.

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We appreciate the PCAOB's request for feedback on this matter and appreciate the opportunity to share our views with the PCAOB Board and staff. We welcome any questions or comments you may have. Please contact me with any questions about PNC's comments at 412-762-7546.

Sincerely,

Mr. Robert Reilly
Executive Vice President and Chief Financial Officer
The PNC Financial Services Group, Inc.

Mr. Gregory Kozich
Senior Vice President and Controller
The PNC Financial Services Group, Inc.

cc: John (JJ) Matthews
Director of Accounting Policy
The PNC Financial Services Group, Inc

PNM Resources

December 11, 3013

Via email to comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Office of the Secretary:

PNM Resources, Inc. appreciates the opportunity to respond to the Proposed Auditing Standards contained in PCAOB Rulemaking Docket Matter No. 34.

PNM Resources, Inc. is a diversified energy company in the United States with approximately \$5.4 billion of assets, \$1.6 billion in annual revenues, and a market capitalization in excess of \$1.8 billion. Our subsidiaries and affiliates are involved in the generation, transmission and distribution of electricity, as well as energy management and other energy-related services primarily in New Mexico and Texas.

We appreciate the PCAOB's efforts to enhance the current auditor's reporting model. Although we support certain aspects of the proposed standards, we do not believe that the proposed standards taken as a whole are an overall improvement in the reporting model. Therefore, we do not support the adoption of the proposed standards in their current form.

We commend the PCAOB for retaining the basic "pass/fail" model of the auditor's report. We believe that is the primary purpose of the audit process and what is of the most concern to users of audited financial statements. However, we believe the additional disclosures set forth in the proposed standards regarding critical audit matters will add many pages of language to the existing report model. These additional disclosures will detract from the basic intent of the auditor's report, which is to communicate the results of the audit under a "pass/fail" approach. These additional disclosures may have the unintended consequences of confusing the users of financial statements and implying that the additional language is qualifying the audit with respect to the items discussed. Additional comments regarding the disclosure of critical audit matters are provided below. We also believe that the PCAOB has underestimated the cost impacts of the proposals to disclose critical audit matters and to expand the auditor's responsibility with respect to other information in documents containing the audited financial statements. We believe there will be significant cost increases if the proposals are adopted while providing essentially no benefit for preparers and what will ultimately be of very little benefit to users of financial statements. Accordingly, we do not support the adoption of the proposed auditing standards.

We do support the proposed requirements to add "and the related notes" to the description of the financial statements being audited and "whether due to error or fraud" in the basis of opinion portion of the report. These are improvements in communication of the auditor's responsibility without adding to the auditor's responsibility or procedures and should not have impacts on the cost/benefit relationship. Also, we do not object to the additional discussion of independence although we do not think it adds information that will be meaningful to users of financial statements that is not already conveyed by having "independent' in the title of the report. Discussion of areas where we have concerns is presented below.

Critical Audit Matters

We do not support including a discussion of critical audit matters in the auditor's report. As mentioned above, we believe the additional discussion will be confusing and detract from the basic premise of the auditor's report, which is to communicate the "pass/fail" results of the audit.

The required description of critical audit matters will likely consist of many pages of lengthy disclosure for most entities. The audit firms will undoubtedly err on the side of more disclosure than less in order to protect their interests, which will exacerbate the extent of their reports. Auditors will not omit any matter that, in hindsight, might be considered critical in litigation or an investigation. Furthermore, over time, we believe the disclosures of critical audit matters will become somewhat standardized by industry and the language will evolve into boilerplate. For example, the reserve for loan losses for all banks and other lending institutions and the determination of mineral reserves for all oil and gas and mining entities will likely be critical audit matters. The descriptions of these matters will become relatively standard even though, in actuality, every entity and every audit is different.

The proposal allows for the discussion of the audit procedures applied to each critical matter and the PCAOB asks if such a description should be included in the audit report. We do not believe a description of the audit procedure should be allowed or required and suggest that it be prohibited if the requirement to disclose the critical audit matters is retained in a final auditing standard. We believe such description would only increase the length of the disclosures and add to the confusion of the audit report, while not adding any meaningful information.

While we do not support the inclusion of critical audit matters in the auditor's report, we find it curious that the proposal is to only include such a description for the most recent year. This seems inconsistent with the requirement for the audit report to cover all years presented and to the references to "audits" in the example wording of the auditor's report.

The PCAOB indicates that it believes there will only be a modest increase in cost to include a description of the critical audit matters in the auditor's report since it would just involve reporting on work already performed. We respectfully disagree with that premise. While additional detailed audit procedures would not be required, the time involved in the drafting and review of the auditor's report will significantly increase. That increased effort will primarily involve partners and managers of the audit firms and would be billed to their clients at much higher rates per hour than the overall rate for the entire audit. Furthermore, this effort will essentially all occur at the very end of the audit process, when the time of the partners and managers should be devoted to more substantive aspects of completing the audit.

The definition of critical audit matters contained in the proposals and the surrounding discussion indicates that most of the matters identified as critical will likely be very similar to matters management now identifies as involving critical accounting estimates, which are disclosed and discussed in the Management's Discussion and Analysis section of an entity's Form 10-K.

Therefore the discussion in the auditor's report will be somewhat duplicative of management's disclosures.

For the reasons set forth above, we do not support the requirement to include a discussion of critical audit manners in the auditor's report, and suggest this requirement be deleted from any final auditing standard.

Auditor's Responsibility Regarding Other Information

We do not object to clarifying the auditor's report with respect to their responsibility regarding other information in documents containing audited financial statements. However, we believe the requirements of the proposed auditing standards significantly increase the responsibility of the auditor's for such information. We do not support an increase in the auditor's responsibility since we do not think it will result in sufficient additional meaningful information to justify the costs involved with the additional responsibility of the auditor.

The current auditing standards require the auditor to "read" and "consider" the other information contained in documents including audited financial statements. The proposed auditing standard would require the auditor to "read" and "evaluate" such information. We believe there is a significant difference in those terms that will require auditors to perform fairly extensive additional audit procedures in order to meet the "evaluate" requirement. These procedures will increase the costs and such increases may be significant to some entities. For example, the proposals would seem to require the auditor to review and evaluate all of the information contained in the Compensation Discussion and Analysis section of an entity's proxy statement. The CD&A typically includes extensive tabulations of information related to compensation of the named executive officers of an entity. This information not only includes basic salary information, but also incentive compensation, perquisites, equity awards, retirement benefits, and termination benefits. Evaluating the CD&A information will require a substantial effort, which will increase the cost of an audit.

The proposals would require auditors to read and evaluate information that is not yet available, such as proxy information, when the audit is completed and the audit report is signed and dated. This requirement seems to place an unrealistic burden on auditors and the entities being audited. It is not appropriate to require an auditor to include something in the audit report that is not available at the completion of the audit. The proposals address how the auditor is to deal with such items, but we do not believe the proposals provide a practical framework. We would be surprised if the audit firms would be willing to accept such a proposal without at least identifying what they have not seen. Furthermore, the inclusion of information not yet available will likely confuse users of financial statements since they cannot make informed decisions, or place reliance on an auditor's involvement, regarding information that is not available.

In addition, the proposals cover all information incorporated by reference into the document not just information that is not available. We believe this would further expand the auditor's procedures for very little benefit to users and should not be required.

As mentioned above, we would not object to an addition to the auditor's report that simply explains the current auditing standard covering the responsibility of the auditor for information included in documents containing audited financial statements. However, we do not support the proposed auditing standards because they significantly expand the auditor's responsibilities, which would significantly increase audit costs without justified benefits.

Auditor Tenure

The proposed auditing standards would require the auditor to state the year the auditor began serving as auditor. We do not support this requirement as we do not think it adds meaningful information and could detract from the audit report or imply that a problem exists when one does not exist.

If there has been a change in auditors within the period covered by the financial statements, it will be obvious to users of financial statements since a report of the prior auditor would be included with the financial statements in almost all cases. In addition, a change in auditors requires the filing of a Form 8-K that discusses the change and whether there were any disagreements between the entity and the prior auditor. The audit relationship is also discussed in an entity's proxy statement. Many entities disclose how long the existing auditor has served the entity in their proxy statement, as well as factors relative to the retention and relationship of the auditors. The proxy statement provides a much better context for users to evaluate the tenure of the auditors rather than the mere inclusion in the audit report of the year the auditor began serving as auditor. Therefore, we suggest this requirement not be included in any final auditing standard.

Effective Date

The proposals indicate they would be effective for audits of financial statements for fiscal years beginning on or after December 15, 2015. We believe that the PCAOB may need to do extensive outreach efforts after responses to the proposals are received. We believe there will be substantial questions raised in the responses regarding the inclusion of critical audit matters in the auditor's report, the expansion of the responsibilities of the auditor regarding other information included in documents containing audited financial statements, and the cost of the proposals relative to the benefits obtained. For these reasons, we question whether the proposed effective date is realistic.

Presumably, the wording that the effective date would be would be "for audits of financial statements for fiscal years beginning on or after December 15, 2015" implies that a final standard would be applied only prospectively and that years prior to the year of implementation would not be included. This could have significant impact in situations where there has been a change in auditors. If the prior auditor has resigned, it might be virtually impossible to have the prior auditor involved in a manner that would increase the auditor's responsibility for other information. Even in situations where the change in auditors was not contentious, the need to involve the prior auditor beyond the re-issuance of the auditor's report on the prior financial statements would be less than desirable. We suggest the PCAOB add clarification that any final auditing standard would only apply prospectively.

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As set forth above, we do not support the proposals in their current form. We suggest that the requirements to disclose critical audit matters and the tenure of the auditor be removed from any final auditing standard. In addition, we suggest that the requirement to clarify the auditor's responsibility regarding other information contained in documents including audited financial statements be limited to a clarification of the auditor's responsibility under existing auditing standards and that the auditor's responsibility not be expanded. Furthermore, we believe that the requirements, as proposed, would significantly increase audit fees while providing essentially no benefit to the preparers and little benefit to users of financial statements.

Sincerely,

Henry A Ingalls

Henry A. Ingalls
Director, SEC Reporting and GAAP Analysis
PNM Resources, Inc.

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December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

PPL Corporation ("PPL") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed auditing standards included in PCAOB Release No. 2013-005 ("the Release"), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. PPL is an energy and utility holding company that, through its subsidiaries, owns or controls nearly 19,000 megawatts of generating capacity in the United States, sells energy in key U.S. markets, and delivers electricity and natural gas to about ten million end users in the United States and the United Kingdom.

PPL supports the PCAOB's initiative of developing standards that enhance audit quality and protect investors' interests. We also support the Board's intentions to increase the informational value, usefulness and relevance of the auditor's report. We do not support, however, auditing standards that require auditors to provide financial statement users with information that could be misinterpreted, is irrelevant or duplicative of information that is already contained in the financial statements, or whose benefits do not justify the additional costs of preparation. We, therefore, strongly disagree with aspects of both of the proposed auditing standards included in the Release. Specific observations related to each of the standards included in the Release are provided below.

## Proposed Changes to the Auditor's Reporting Model

### *Critical Audit Matters*

The proposal would require auditors to communicate "critical audit matters" ("CAMs") in the auditor's report to "help investors analyze any related financial statement accounts and disclosures more closely." CAMs are defined as those matters addressed during the audit of the financial statements that (1) involved the most difficult, subjective or complex auditor judgments, (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements.

*Relevance / Usefulness of Proposed Disclosure*
We do not believe that including a discussion of CAMs in the auditor's report would assist a financial statement user in making informed investment decisions. In fact, we believe such a discussion could potentially be misinterpreted by the reader as the auditor expressing reservations regarding the affected accounts or disclosures. In the example CAM disclosures included in Appendix B of the proposal, the auditor communicates the various challenges and complexities encountered while auditing certain accounts, but does not ultimately conclude on whether or not the amounts recorded and disclosures made related to those accounts were appropriate. We believe financial statement users would view this disclosure as a form of qualification of their opinion. If the auditor issues an unqualified opinion on the financial statements taken as a whole, we question the relevance and purpose of communicating in the auditor's report those matters that presented challenges to the auditor and the procedures that were performed to audit them.

The determination of what is considered a CAM is a matter of significant auditor judgment. We foresee a lack of consistency in the reporting of CAMs in auditor's reports for companies with similar accounts and transactions. This could lead to financial statement users believing one company contains more or less risk than another, simply due to different audit firms (or even different engagement teams from the same firm) making different determinations of what are CAMs.

In addition, most matters that would be considered a CAM because of subjective or complex accounting transactions would already be required to be disclosed within the financial statements due to standards established by the SEC and the FASB. We strongly support that such information should reside within the Company's disclosures and not the auditor's report, as described below.

*Sufficiency of Current Accounting Standards*
It is the responsibility of the SEC and the FASB to create standards to ensure transactions are appropriately recorded and disclosed by management in the financial statements in a manner that is most useful for financial statement users. If additional information is needed in order for financial statement users to analyze or understand financial statement accounts and disclosures, new accounting standards should be created, or existing standards amended, by the SEC and FASB.

We do not feel it is appropriate for the PCAOB to set audit standards that require auditors to communicate accounting related items that are the responsibility of management. As written, the proposal would likely result in auditors becoming an original source of disclosure about an entity. Independence rules prohibit the auditor from determining amounts and creating disclosures in the financial statements. We believe that if it is inappropriate for an auditor to be an original source of disclosure in the financial statements under the premise that they would be functioning in the capacity of management, it would be inappropriate for an auditor to be the original source of disclosure in any document, including the auditor's report.

*Sufficiency of Current Auditing Standards*
Audits of publicly traded companies typically involve complex accounts, transactions or disclosures that are difficult to audit. It is the responsibility of the auditor to opine on whether the financial statements, taken as a whole, are presented fairly, in all material respects, in conformity with the applicable accounting standards.

We believe the current auditing standards related to CAMs are sufficient to ensure that the amounts recorded and disclosures made in the financial statements related to those matters are appropriate. These matters are of such importance that they (1) are included in the audit engagement team's engagement completion document, which summarizes the significant issues and findings from the audit, (2) are reviewed by the audit team's engagement quality reviewer and, (3) most importantly, in our view, are communicated by the auditor to the company's audit committee. The audit committee has the requisite knowledge, perspective and authority to ensure that significant judgments made by management are appropriate and complex transactions are properly reflected in the financial statements. We believe that such matters are thoroughly vetted by management, the auditor and the audit committee to ensure they comply with the applicable accounting standards. Communication of CAMs by the auditor in the auditor's report is, therefore, not necessary and would seem to undermine the role of the audit committee and management.

*Cost / Benefit Concerns*
The increased costs of compliance with this aspect of the proposal will outweigh any perceived benefits. A significant amount of additional time will be required by audit firms in order to develop, review and present CAMs, which will result in increased audit fees. Extensive discussion and consultation with Company management, legal and the audit committee would also be required, resulting in increased internal costs. Further, because some CAMs may not be identified until late in the audit process, this additional work will be required during an already busy period within the audit and financial reporting cycle which could impact the timing of SEC filings and, consequently, the ability of investors to obtain financial information in a timely manner.

### *Amendments to the Basic Elements of the Auditor's Report*

We are not opposed to the Board's proposal to clarify the existing language in the auditor's report regarding auditor independence, audit tenure, the auditor's responsibilities related to fraud and the financial statement footnotes, and the auditor's responsibilities related to other information. The basis for requiring disclosure of an auditor's tenure, however, is unclear, as the Board has stated in the past that they have not reached a conclusion as to whether a relationship exists between audit tenure and audit quality.

**Proposed Standard on Other Information**

Currently, under AU sec. 550, *Other Information in Documents Containing Audited Financial Statements*, auditors are required to "read and consider" whether other information is consistent with the financial statements or contains a material misstatement of fact. The proposed standard would require the auditor "read and evaluate" other information on the basis of relevant audit evidence obtained and conclusions reached during the audit, and expands the definition of other information to include information incorporated by reference in the annual report that is available to the auditor before the issuance of the auditor's report. The proposed standard would also require a separate section in the auditor's report related to the auditor's evaluation of other information.

We do not support expanding the auditor's responsibilities regarding other information or including language in the auditor's report that could be perceived as an expansion of the auditor's responsibilities. The "read and evaluate" requirement in the standard will result in auditor's performing additional procedures beyond those that are performed currently under AU sec. 550. We believe the procedures currently being performed by auditors are commensurate with the nature and purpose of that information and, therefore, do not believe financial statement users will benefit from auditor's performing additional procedures on such information. Accordingly, we do not feel the additional costs and potential delays in the issuance of the financial statements, as a result of these additional procedures, would be justified.

As noted above, we do support clarifying in the auditor's report the auditor's responsibilities related to other information contained in audited financial statements.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Vincent Sorgi
Vice President & Controller

cc: Mr. P. A. Farr
Mr. M. A. Cunningham
Mr. M. D. Woods

November 25, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Board Members,

Thank you for the opportunity to comment on the significant proposed changes to the accounting and auditing profession through the introduction of two new auditing standards, *The Auditor's Report on an Audit of Financial Statements when the Auditor expresses an Unqualified Opinion* and *The Auditor's Responsibilities regarding Other Information in certain documents containing Audited Financial Statements and the Related Auditor's Report* as well as related amendments to PCAOB Standards.

I am analyzing these proposed changes primarily as a private investor in shares of publicly traded companies but also as a business professional who has had experience dealing with auditors, preparing annual reports and appraising the financial statements of companies in a professional capacity.

**Overview**

I understand that the impetus for these proposed new auditing standards and amendments is the Board's findings that at present the audit report provides little, if any, additional useful information for financial statement users on the conduct of a particular audit. As such, the majority of users only refer to the report to check that it is unqualified. These new auditing standards and amendments are designed to address these apparent shortfalls by increasing the informational value of the audit report and thus promote the usefulness and relevance of the audit conducted and the associated audit report.

However, I have some grave reservations about some of the methods being proposed to achieve the desired outcome and in particular the unintended consequences that may follow. Below I have addressed each of the main aspects of the proposed changes.

**Critical Audit Matters**

The biggest proposed change to the requirements of the auditor's report is the inclusion of critical audit matters ('CAMs'). According to the Board, inclusion of these matters in the audit report is expected to increase the relevancy of the auditor's report and communicate meaningful information to investors regarding the most significant issues encountered during the audit as well as the nature and extent of the auditor's work in forming an opinion on the financial statements of the company.

The Board defines CAMs as the audit matters that, (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence;

and (3) posed the most difficulty to the auditor in forming an opinion on the financial statements. These CAMs are typically of such importance that they are required to be: (1) included in engagement completion documents; (2) reviewed by the engagement quality reviewer; and/or (3) communicated to the audit committee.

By being very prescriptive as to the potential sources of CAMs, the Board has effectively mandated that all auditors must include any issues raised through those three mediums in their CAM disclosure on the audit report. No auditor would want to take the risk of subsequently having to justify failing to include a matter communicated to the audit committee as a CAM. An unintended consequence of this, is that auditors may now think twice before raising a matter in the engagement completion document or to the audit committee, if they do not think the matter is necessarily serious enough to warrant disclosure as a CAM. In my view, such second guessing can only be detrimental to overall audit quality and auditor/management relationships.

A more common malady to the new CAM requirement however, will be the inclusion of too many CAMs not too few, just to be conservative. I am very critical as to how creating multi page audit reports is going to enhance its relevancy or allow it to communicate more meaningful information to the financial statement user. As rightly pointed out, users still primarily focus on the opinion in the audit and burying it in pages of CAMs may obscure it. Another risk, is that users will interpret the CAMs as ‘except for’ clauses where the audit may have received an unqualified, clean opinion, except for the significant issues raised in the CAMs. This completely undermines the value of providing an unqualified opinion on the financial statements as a whole. At best the reader is confused as to the extent to which the financial statements represent fairly, and at worst, the auditor appears contradictory and thus undependable in their final report.

The reality is, extensive disclosure of critical accounting policies, areas which require management judgment and significant uncertainty are already being made in the pages and pages of notes to the financial statements and are specifically drawn to the attention of the user in the MD&A. Including these issues as CAMs is essentially a duplication in an already lengthy and unwieldy report. If the Board believes there can be more information disclosed to better inform readers, I am not inclined to disagree, however I think that should be enforced through changes to the accounting standards that govern the preparation of financial statements, not by requiring auditors to summarize once again issues already raised elsewhere.

If this proposed new standard on CAMs ever goes live, I think there is serious potential to compromise the independence between auditors and management as management will inevitably try and influence what the auditors include as CAMs. Management would not want an issue to be included as a CAM that is omitted from the MD&A. Thus management and auditors will find themselves working ever more closely on the preparation of the financial statements and associated disclosures. The other danger of course, is that lawyers will be so heavily involved in drafting these CAMs to be watertight legally, that their intended purpose as a specific comment on a particular audit disappears. Companies in the same industries may all end up with the same half a dozen CAMs resulting in the same situation as present, where the user just scans for the opinion on the audit report and ignores the rest.

There is likely to be extensive negotiations on CAMs at a senior level and this is going to be very costly and time consuming for all parties involved. Auditors will be much more focused on mitigating their potential liability should an issue ever arise with an audit client and so will likely devote an inordinate amount of time to drafting CAMs instead of actually focusing on performing quality, core audit procedures. As such, as with most other proposed changes, the Board should solicit the input of audit firms, financial statement users and senior management to gauge their reactions before proceeding with an overhaul of this nature.

Currently, the auditor has the latitude to issue an unqualified audit report with an emphasis of matter. If an issue was deemed critical enough to warrant an emphasis of matter than by all means it should be included in that section, but to require additional broad disclosures of CAMs seems to add little value to the user who is trying to determine how fairly statements present based on the auditor's report.

At the end of the day, as an investor, I want the auditors to focus on getting sufficient appropriate audit evidence to form their opinion. Additional information that is largely duplicative may be confusing and unnecessary and may detract from the quality of the audit procedures performed. Not to mention the real or perceived risks from increased management and auditor interaction in drafting their relevant disclosures consistently. However I do agree wholeheartedly with the need to make the auditor's report more meaningful, relevant and useful to financial statement users and will share my preliminary thoughts on a more effective way to go about achieving these goals at the end of this letter.

**Statement on Auditor Independence**

The Board proposes to add a statement to the Audit Report that clearly articulates the auditor's requirement to be independent so as to enhance users understanding of auditors' requirements to be independent and also function as a reminder to the auditors of their obligations.

I agree with the inclusion of statement regarding auditor independence as it more closely aligns US GAAP with a practice that has been occurring under IFRS for several years, to the best of my knowledge. In that way, I support any amendment that standardizes the reporting requirements across regulations and minimizes confusion to financial statement users. In addition, the marginal cost of requiring an additional statement pertaining to auditor independence is essentially nil.

Whether I think a statement regarding auditor independence will actually result in increased independence or additional comfort to users in the opinion expressed is a completely separate matter. This wording is likely to just form part of a standard template that auditors will now utilize and so it is highly unlikely to increase any critical thought on their part regarding their conduct throughout the audit. Without wanting to appear cynical, auditors who are willing to compromise their professional integrity and certification by breaching independence, are unlikely to baulk at signing an audit report that contains a statement of independence. Users of financial statements will quickly notice the use of standard 'legal' language regarding independence in all audit reports and so will soon begin to dismiss it as evidence suggests they dismiss the majority of the current audit report except for the opinion.

In Australia for example, auditors are required by the Corporations Act to submit an 'Auditor's Independence Declaration' to the directors of an audit client. It is a one page letter separate and distinct from the Audit Report and is required to be included in the financial statements and annual report of a company (sometimes it is included as part of the Director's Report). This declaration is in addition to the statement of independence already contained in the audit report in accordance with IAASB requirements. I respectfully suggest that the Board work with the SEC to make an independence declaration necessary for auditors as it is a more profound statement (with heavier penalties given it is a requirement of the Corporations Act) that is made to the client's board of directors (who are often mostly non-executive). It is likely to be more effective as a tool to enhance users' understanding of auditor requirements and also remind auditors of their obligations.

**Statement on Auditor Tenure**

The Board proposes to add a requirement that the auditor disclose the consecutive years they have served as auditor in the Audit Report. The Board acknowledges that there is mixed evidence as to the impact on audit quality of longer versus shorter tenures, but believes that this information is important to disclose as investors and other report users have indicated a keen interest in it.

At first glance, I was largely indifferent to this proposed inclusion. It seems like a very low cost measure to implement and it does provide additional factual data for users to interpret as they see fit, whether they view long tenure as a threat to independence or short tenure as a risk to auditor competence. So my initial view was that it does not do any harm to include additional information that provides a more complete picture of a company's auditor.

However, after more considered thought, I respectfully submit that the Board is perhaps being halfhearted in its approach in this instance. Why provide information that is completely open to interpretation and consequently diminished in any value it may have to a user? Including information on audit tenure will only cause users to call into question either the auditor's statement of independence or their competence. Neither of these consequences are particularly helpful, when they are completely uninformed. I believe the underlying rationale for inclusion of any data regarding tenure is to allow users to determine the competence and independence of a particular auditor and thus allow the following financial statements to be viewed with additional context. The Board could propose a number of changes that would do a significantly better job of achieving this policy objective than the un-contextualized disclosure of the number of consecutive years of audit tenure. These changes should perhaps include some or all of the following;

1) *Reasons as to why an audit firm has been changed*

Any time a public company changes its auditors, it is inevitably noted with interest by the investor and banking community. This usually results in increased scrutiny by stakeholders in the company as they try to ascertain the reasons for the change. There a multitude of reasons for a change in auditor, some practical or innocuous, other reasons are far more concerning, such as disagreements over accounting treatments or financial statement disclosures. At present a company need not provide any reason as to why a change in audit firms occurred except in special situations. In 2006, this meant that reasons were given for only 28.4% of auditor changes. As part of the overarching goal to increase the usability of the auditor report and financial statements generally to users, I think there is some value in requiring disclosure, most likely in the director's report of the reasons for a change in auditor. The reasons provided should be clear enough to be meaningful to users, as such, standard legal verbiage should be avoided.

2) *Credentials of first year auditor firm*

Related to the proposal above to provide details of why an audit firm has been changed, it would be useful to provide information to financial statement users as to the credentials of the incoming auditor. This would allow the user to form a subjective view of the level of reliance that can be placed on the opinion expressed in the financial statements. Obviously the auditor must exercise due care, be competent and satisfy the requirement of obtaining sufficient appropriate audit evidence, but the reality is that corporations are undertaking increasingly complex transactions and global operating models and it takes time for a new audit firm to become intimately familiar with the organization. It is pertinent for users to be aware of the audit firms' past experience with competitors in the same sector, organizations of similar scale and global reach and similar data.

3) *Forced auditor rotation after 5 number of years*

I realize this has been a contentious issue that the Board has proposed in the past and received huge congressional opposition, most recently in July 2013 where a Bill to prevent the PCAOB from forcing public companies to rotate orders was upheld in the House of Representatives by a huge margin. However, I do not think that indicates that the regulation is without merit. Forced auditor rotation could be structured to take place every five years and pertain to lead partners and review managers on a particular client. It does not necessarily have to require a completely new firm to be hired. In that way, it allows firm and partner specific knowledge on a particular client to be shared through appropriate succession planning and thus minimize any loss of audit quality due to lack of experience or familiarity with a particular client. Lead and review auditor rotation does substantially reduce the risk of compromised independence as it would require open collusion between incoming and outgoing partners and managers, a deliberate act that would force most to reconsider the consequences. Forced auditor rotation is consistent with practices in many Commonwealth countries and was ratified by the EU last month, albeit on different terms to what I am proposing. As previously mentioned, anything that aligns PCAOB standards with global best practices should be seriously considered.

**Reporting on 'Other Information'**

Currently the auditor is required to read and consider other information provided in documents that contain the audited financial statements, such as a company's annual report. The auditor is essentially trying to identify material inconsistencies with the audited financial statements and if found, will address them with management.

It appears that the proposed new standard on Other Information is far more onerous. It requires the auditor to read and <u>evaluate</u> other information provided in documents that contain the audited financial statements. The Board believes this will allow the financial statement user to obtain useful information such as: (1) the nature and scope of the auditor's responsibilities with respect to the other information; (2) clarification of what other information was evaluated by the auditor; and (3) a description of the results of the auditor's evaluation of the other information.

The Board's expectations in regard to this proposed new standard appear somewhat contradictory. On the one hand, "The Board believes that, in practice, some auditors currently perform procedures related to other information similar to the procedures in the proposed other information standard" and that "The auditor's evaluation would be based on relevant audit evidence obtained and conclusions reached during the audit. The auditor would <u>not</u> be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit." However, the Board also states that the proposed new standard would, "Enhance the auditor's <u>responsibility</u> with respect to other information by <u>adding procedures</u> for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit."

This is unclear to me. It appears that the Board is reticent to create extra work for auditors and is convinced the work is already being performed by many, but at the same time they acknowledge that the significantly higher standard of assurance and responsibility placed on the auditor for other information will likely require additional procedures to be performed. My view is that auditors are likely to adopt a conservative approach and expend significant time and resources 'evaluating' other information outside the financial statements seeing as they are going to be held responsible for it. Given the already limited time frame auditors have to meet all regulatory deadlines, my concern as an investor, is that the quality of their primary financial statement audit procedures will suffer.

There would need to be a significant favorable outcome from a cost/benefit analysis for me to support this proposed new standard as written. Indeed, as the Board suggests, there are likely to be cost implications of this new proposed standard and they should fully evaluate the nature and extent of those costs as submitted by a range of audit firms before deciding to proceed.

I think a more appropriate proposal is for an auditor to merely clarify for the financial statement user the level of work performed on other information outside of the audited financial statements. This shifts the onus back to management to take responsibility for the assertions and claims made in annual reports and other documentation that contains the audited financial statements. Financial statement users should be savvy in knowing that with the auditor clarifying the scope of work performed on the other information they need to analyze all management claims with an appropriate amount of skepticism.

**Additional standardized language in Auditor's Report**

I support the proposed improvements regarding the standardized language in audit reports. I believe the phrase "whether due to error or fraud" adds clarity that the intent of management is irrelevant when the auditors consider their responsibility to users of financial statements. However if I were to be cynical, I would suggest that additional standard legal jargon adds little real value to the users of financial statements.

**Other Matters**

1) *The relationship between IAASB and PCAOB*

I have mentioned it on a couple of occasions throughout this letter, but I think it is worth reiterating that wherever possible, it is of significant value to users of financial statements to be able to compare like with like. In an increasingly global world where investing and transacting across borders is becoming easier and cheaper, there is untold value in increasing comparability across jurisdictions. To the extent the Board can be mindful of this as the IAASB concurrently considers changes to its auditor reporting standards, I think financial statement users only stand to benefit.

An example would be the proposed IAASB disclosure requirements of key audit risks (their version of CAMs) along with key audit procedures performed in response to them. The PCAOB proposed standards appear silent on the requirement to state key audit procedures conducted, though the examples provided do contain them. While I may not necessarily agree with the concept of CAMs as proposed, I do think that the final design of the PCAOB standards should harmonize with the final version adopted by the IAASB for its key audit risks.

2) *The pass/fail model*

Given the rationale for the substantial changes proposed to audit reports, it was a surprise to see the perfunctory review given to the merits of the pass/fail model of auditing. While it has stood the test of time, I believe that it may be worthy of a more critical review. If we operate from the assumption that the vast majority of auditors are diligent and competent professionals I believe the PCAOB should be empowering them to exercise their professional judgment in awarding companies a specific rating when they receive an unqualified audit. Just as bonds are capable of having several ratings above junk bond status, not all unqualified audits are created equal.

Rather than taking the disciplinary approach of forcing an auditor to prove that they have done sufficient work through CAMs, and that they are competent and independent through the audit tenure requirement, would it not be preferable to empower auditors by giving them the latitude to exert their professional judgment. CAMs essentially shifts responsibility from the auditor to the end user as the auditor's primary role becomes one of disclosure and the end user is tasked with absorbing and interpreting increasingly voluminous amounts of complex language. However with a rating system, financial statement users will undoubtedly benefit from the increased information conveyed through each rating and perhaps even more importantly, the rating will be easy to identify and interpret.

Obviously a change like this would need to be thoroughly considered and extensively field tested, before it could even be drafted, but I believe that prima facie it may have some merit that warrants further exploration.

**Conclusion**

Thank you for the opportunity to comment on the proposed new standards in relation to audit reports and the related amendments. I have the utmost faith in the Board's ability to arrive at the most efficacious resolution on these matters for all stakeholders.

Sincerely,

S. Prabhakaran

PRAXAIR
Making our planet more productive

Praxair, Inc.
39 Old Ridgebury Road
Danbury, CT 06810-5113

December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 34**

We appreciate the opportunity to provide our comments on the PCAOBs Proposed Auditing Standards relating to (i) the Auditor's Report, and (ii) the Auditor's Responsibilities relating to Other Information. Praxair, Inc. is a Fortune 250 U.S. public company that produces, sells and distributes atmospheric, process and specialty gases, and high-performance surface coatings with 2012 sales of over $11 billion. About 62% of our sales are non-U.S. and we operate in over 40 countries.

***Praxair's Position on the Release***

We have reviewed and very much support the views expressed in the comment letter to the PCAOB issued by Financial Executives International (FEI). For the reasons stated, we do not support the requirements in the Release, as proposed. Please refer to the FEI letter for detailed comments.

Thank you for the opportunity to express our comments. We would be pleased to discuss our views with the PCAOB or with its staff. Please contact me at 203-837-2158 (chuck_jacobson@praxair.com) or Elizabeth Hirsch (VP & Controller 203-837-2354, liz_hirsch@praxair.com) if you have any questions.

Very truly yours,

Charles L. Jacobson
Assistant Controller and Chief Accountant

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

December 11, 2013

**RE: PCAOB Rulemaking Docket Matter No. 034, *Proposed Auditing Standards —The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards***

Dear Madam Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") proposed new auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("proposed auditor reporting standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* ("proposed other information standard"), and related amendments to PCAOB standards ("proposed amendments"), collectively "the proposals."

The proposals represent the culmination of several years' work by the Board that has taken place in the context of a global re-examination of the auditor's reporting model. While the Board affirms the value of the pass/fail model, the objective of the proposals is to increase the informational value of the auditor's report by including information specific to the particular audit.

We support changes to the auditor's report, and the auditor's responsibilities regarding other information, that will be responsive to the feedback provided by users while maintaining or improving audit quality. We believe there is much in the Board's proposals that has merit, and we commend the Board in making this significant step forward. At the same time, the fundamental changes included in the proposals pose significant challenges. We offer herein our suggestions to achieve the intended outcomes and help reduce any unintended consequences as the Board moves to the next phase of this project.

In that regard, we are pleased that the Board intends to hold a public roundtable in 2014 to discuss the proposals and the comments received from various stakeholders. We are in the process of conducting field testing to evaluate the benefits and challenges of certain aspects of the proposals, including whether application of the framework to identify and communicate critical audit matters can be executed in a consistent manner; practical issues that may arise; unintended consequences that may occur; and the audit effort and costs required in executing the proposals. We hope to share any relevant information from our field testing as the Board continues to evaluate the feedback on the proposals.

We believe that the determination and communication of critical audit matters and enhanced responsibilities related to other information will increase audit effort, and therefore costs. Perhaps more importantly, this audit effort will primarily occur late in the audit process when remaining open issues are being resolved and final reviews and analyses are occurring. This raises potential ramifications for the quality of audits and financial reporting, in addition to the monetary costs. We believe our field testing will

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help us to identify and better understand these issues. However, we recommend the Board conduct a robust cost/benefit analysis of the proposals, including both the potential impact on audit quality and whether there is sufficient demand for the proposed changes to justify the incremental costs. This is not to imply change should not occur, but rather that appropriate changes be made to help reduce the potential unintended consequences of the proposals.

We have evaluated the proposals by applying the overarching principles that we developed in responding to the PCAOB's 2011 *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* ("concept release") which are summarized below.

- Changes made to auditor reporting should:
  - maintain or improve audit quality
  - enhance the value of the audit to users
  - increase the reliability of information the entity provides in public reports
- Changes should maintain or enhance the effectiveness of the relationships and interactions of auditors, audit committees and management in the financial reporting process
- Auditor reporting should be sufficiently comparable
- Auditor reporting can provide greater insight based on the audit, but the auditor should not be the original source of factual data or information about the entity

We have organized our recommendations into the following topical areas:

- Critical audit matters
- Other information
- Auditor tenure
- Legal considerations related to the proposals

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

**Critical audit matters**

*Overview*

One of the most significant proposed changes is the introduction of a new section in the auditor's report describing critical audit matters. We commend the PCAOB for moving away from the Auditor's Discussion and Analysis alternative in the concept release and for instead developing the critical audit matter concept. We support including critical audit matters in the auditor's report and believe that they will enhance the report's informational value. Deciding which matters should be considered for inclusion as critical audit matters and the auditor's related reporting responsibilities are essential to getting this new model right. In accord with the principles outlined above, we believe that critical audit matters should be the most important matters that, in the auditor's judgment, would be relevant to users' understanding of the financial statements.

We are pleased that there is a high degree of consistency between the critical audit matter proposal and the International Auditing and Assurance Standards Board ("IAASB") proposal related to key audit matters included in its exposure draft, *Reporting on Audited Financial Statements* ("IAASB proposal"). In our view there is room for further convergence and we encourage the PCAOB to work with the IAASB in this regard, as different models would be confusing to users. We also believe there are other areas in which convergence would be beneficial, which we discuss throughout our response.

We believe that there are unintended consequences to implementing the requirements as currently proposed, most importantly for audit quality, but also in terms of unnecessary costs. As acknowledged in question 27 on page 46 of Appendix 5 of the release (Q27), the proposed auditor reporting standard would require auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards. This is in conflict with one of our fundamental principles that the auditor should not be the original source of factual data or information about the entity, a principle which has broad acceptance by various stakeholders. As explained further below, we believe that diverging from this principle is likely to have a negative impact on audit quality.

We believe our recommendations below, including requiring that critical audit matters be material to the financial statements, strike an appropriate balance and will result in the communication of critical audit matters that provide meaningful information while limiting the unintended consequences.

*Unintended consequences related to determining critical audit matters as proposed*

Critical audit matters are defined in paragraph A2 of the proposed auditor reporting standard as "those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements."

The proposed definition of critical audit matters is anchored to the audit, rather than the financial statements. As a result, this will likely require the auditor to communicate original information about the entity. This will blur the line between an entity's disclosure and auditor reporting, which is a fundamental distinction in our view, and has the potential to chill the dialogue between auditors and management. As discussed on pages 16 and 17 of the release, some commenters on the concept release were similarly concerned that it is the entity's or the audit committee's responsibility, not the auditor's, to provide information, including any analysis, about the entity's financial statements to financial statement users. We understand that the Board believes the proposed reporting of critical audit matters would address this concern because the auditor would be reporting information about the audit, based on audit procedures the auditor performed. However, anchoring the critical audit matters to the audit rather than to the financial statements will result in instances in which a matter addressed in the audit will meet the definition of a critical audit matter, but management will not have a related disclosure requirement. This will cause the auditor to have to cross the line from reporting to disclosure and communicate previously undisclosed information about the entity. As mentioned in Q27, examples of this could include a possible illegal act or resolved disagreements with management. Another example not discussed in the release is specific concerns related to fraud risk. The unintended consequences of each of these is discussed below.

- <u>Possible illegal acts</u>: Section 10A of the Securities Exchange Act of 1934 establishes protocols for auditors to communicate potential illegal acts, including fraud, to the appropriate level of management and the audit committee and to escalate the matter when timely and appropriate remedial action is not taken. We believe including such matters in the auditor's report would undermine the proper functioning of these established processes. It may also not be in the public interest for the auditor to publicly report it because the alleged illegal act may ultimately be found to be inconsequential or have no basis in fact; therefore, it was not disclosed. If, however, it is determined that disclosure by the entity is required under the federal securities laws or the applicable financial reporting framework, the matter would most likely meet the definition of a critical audit matter and reporting by the auditor would be appropriate.

- Resolved disagreements with management: An effective, quality audit depends upon open dialogue among management, the audit committee, and auditors. In the early years after adoption of Section 404 of the Sarbanes-Oxley Act, there were concerns that entities could no longer ask their auditors about accounting and internal control matters before they were resolved because such consultation might be viewed as making the auditor part of the entity's internal controls, or that the matter discussed might automatically be deemed to be a control deficiency that would need to be evaluated from that perspective. Requiring the auditor to report publicly on resolved disagreements with management has the potential to bring back these concerns and negatively impact open dialogue. If management is deterred from engaging in early discussions with the auditor due to concerns that a change in viewpoint might be interpreted as being a disagreement between auditors and management that lack of open and frank dialogue can diminish audit quality.[1] We believe that in many situations, the issue subject to discussion would likely be reported as a critical audit matter and provide meaningful information to users. However, characterizing the discussion as a resolved disagreement can have unintended consequences for audit quality.

- Specific concerns related to fraud risk: As part of the auditor's annual risk assessment, the auditor is required to identify factors that may be indicative of a fraud risk and to plan and perform an appropriate audit response. Auditors may identify a fraud risk based upon limited information because they want to perform additional testing to evaluate whether a fraud is occurring. Due to the sensitivity of these risks, they are typically discussed only with senior level executives and/or the audit committee to avoid compromising the audit. Because fraud risks may involve the most difficult, subjective or complex auditor judgments, they would appear to meet the proposed definition of a critical audit matter regardless of whether a fraud actually occurred. We believe communicating such a matter in the auditor's report would have a negative impact on audit quality because it would reveal where the auditor is considering the risks of fraud, which will make the detection of fraud more difficult. Auditor reporting of fraud risks might also be misinterpreted by users to imply that a fraud has occurred and/or that the fraud materially impacts the entity's financial statements, when in fact there would be no basis for such a conclusion.

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[1] Although there is currently a requirement for companies to publicly disclose disagreements with their auditors, it applies only in the limited context of changing auditors as opposed to an on-going auditor engagement. Separately, the auditor is also required to communicate disagreements with management to audit committees, but that circumstance is also different because it includes the opportunity for input by management and promotes the kind of open dialogue which leads to a quality audit.

*Recommendations to improve the framework for determining critical audit matters*

We believe the unintended consequences discussed above can largely be avoided if critical audit matters are required to be matters that are material to the financial statements.

Specifically, we recommend that critical audit matters be those "significant audit matters" (see below for further explanation) that, in the auditor's judgment,

(1) Were material to the financial statements,
(2) Involved the most challenging, subjective, or complex auditor judgments, posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence, or posed the greatest challenge to the auditor in forming an opinion on the financial statements, and
(3) Resulted in the most significant interaction (in terms of nature or extent) with the audit committee.

The factors described in (2) are consistent with the definition in paragraph A2 of the proposed auditor reporting standard, except that we propose changing "difficult" to "challenging" because we believe "difficult" has negative overtones that suggest critical audit matters are necessarily problematic. We are recommending that (3) be included because we believe that the matters involving the most significant interaction with the audit committee are those which would be most relevant to users' understanding of the financial statements.

Before the auditor determines the critical audit matters, we believe the auditor should first identify the significant audit matters. The significant audit matters could be defined as matters that are both significant to the audit of the financial statements and that were required to be communicated to the audit committee (we discuss this further below). We believe that the auditor's identification of significant audit matters in the first instance will assist the auditor in determining which are critical audit matters. In identifying significant audit matters, the auditor should take into account the factors identified in paragraph 9 of the proposed auditor reporting standard. The auditor would then apply the above framework to determine which of them meets the definition of critical audit matters. We discuss below the sources from which significant audit matters should be selected.

Determining critical audit matters in accordance with our recommendations will in most cases naturally overlap with the Board's proposed definition of critical audit matters and the illustrative examples in Appendix 5, all of which make reference to management's related disclosures in the financial statements. Explicitly requiring that critical audit matters be material to the financial statements will also promote consistency in their identification, thereby resulting in more comparable reporting across entities. Finally, we also believe this will result in reporting that is most useful to users' understanding of the financial statements. This is because critical audit matters will be providing information about the most important financial statement matters the auditor addressed in the current year, including, for example, the more subjective areas in the financial statements involving significant management judgments. Reporting the most important financial statement matters as critical audit matters is consistent with the preliminary views of engagement teams across our network when considering the criteria for the selection of key audit matters to form our response to the IAASB proposal.

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The "Recommendations for improving the reporting of critical audit matters" section below discusses what can be communicated in a critical audit matter, which goes beyond the emphasis of matter paragraph approach described in the concept release.

*Sources from which significant audit matters are selected*

Paragraph 8 of the proposed auditor reporting standard states that critical audit matters "ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three."

We believe that matters required to be communicated to the audit committee should be the sole source of potential significant audit matters (and therefore the source of all critical audit matters).

The auditor will have already considered matters in the engagement completion document or reviewed by the engagement quality reviewer in determining the matters to communicate to the audit committee. If a matter is not important enough to require communication to the audit committee, it seems very unlikely that it will be important enough to merit reporting as a critical audit matter. Furthermore, the possibility that the auditor may be required to include information in the audit report that is not required to be communicated to the audit committee appears to be taking a step backwards from the enhanced dialogue that has occurred with audit committees in recent years and that will continue under Auditing Standard No. 16, *Communications with Audit Committees*.

Therefore, we recommend deleting the references in the proposed auditor reporting standard to matters required to be documented in the engagement completion document or reviewed by the engagement quality reviewer as sources for potential critical audit matters, and limit the sources to matters required to be communicated to the audit committee.

*Recommendations for improving the reporting of critical audit matters*

Subparagraph 11(b) of the proposed auditor reporting standard requires the auditor to describe the considerations that led the auditor to determine that a matter is a critical audit matter.

First, we believe that the auditor's reporting of a critical audit matter can provide information into why the matter was important from an audit perspective by describing the principal considerations that led the auditor to conclude that the matter was a critical audit matter and a brief description of its effect on the audit. We recommend revising paragraph 11(b) to require that it is only the *principal* considerations that should be communicated in the auditor's report. As it relates to which considerations are communicated, we believe that requiring the auditor to communicate each factor identified from paragraph 9 that is relevant to the auditor's determination of the critical audit matter, as is done in the illustrative examples of critical audit matters in Appendix 5, would encourage a checklist approach that will lead to boilerplate language and diminish the communicative value of the critical audit matters. Furthermore, some of these factors require disclosure of original information about the entity, therefore raising the same concerns discussed above.

As it relates to the effect on the audit, we believe this would be a high level summary of how the auditor addressed the principal considerations that led the auditor to conclude that the matter was a critical audit matter. Similar to the Board's illustrative examples, the effects on the audit may include aspects of the financial statement line item which resulted in the most challenge to the auditor (*e.g.*, the significant assumptions in an estimate, and a brief description of how the auditor responded). However, we question whether statements about the extent of specialized skill or knowledge to address the matter, or the nature of consultations outside the engagement team regarding the matter, would be useful. These considerations in many instances are required by an audit firm's policies and methodologies rather than by existing standards and thus will lack comparability across audit reports.

Second, we recommend that paragraph 11 be clear that the auditor should not disclose information about the entity that is not required to be disclosed by management. As stated above, paragraph 9 of the proposed auditor reporting standard identifies eight factors that the auditor should take into account in determining whether a matter is a critical audit matter. Although we believe these factors are appropriate for assisting the auditor in identifying significant audit matters, certain of them, if communicated in the auditor's report when describing the considerations that led the auditor to determine that the matter is a critical audit matter, would result in the communication of original information about the entity, thus raising the same concerns about blurring the line between an entity's disclosure and auditor reporting. Severity of control deficiencies and corrected and accumulated uncorrected misstatements are examples of such information. For instance, the illustrative critical audit matter disclosure in the auditor's report pursuant to Hypothetical Auditing Scenario #3 on pages 77-78 of Appendix 5 shows the auditor reporting a control deficiency less severe than a material weakness. We do not believe it is appropriate to communicate in the auditor's report information about the entity that the entity itself is not required to disclose. This would give such information undue prominence and may serve to create confusion among users about the materiality of those matters. It may also inappropriately call into question the quality of management's disclosures, especially given that the auditor reports only on an annual basis. Communication by the auditor at the end of the period may call into question the adequacy of management's interim disclosures even though there is no requirement for management to disclose the information.

Third, we agree with the proposed auditor reporting standard in not requiring that individual conclusions about the critical audit matters be included in the auditor's report, as users may inappropriately infer from such a conclusion that a separate opinion is being expressed or additional assurance is being obtained with respect to the critical audit matter. For purposes of clarification, however, we recommend that paragraph 11 include an explicit requirement that the auditor's communication of a critical audit matter not convey that the auditor is providing a separate opinion or conclusion on a critical audit matter.

Finally, paragraph 12 of the proposed auditor reporting standard describes standardized language that should precede the discussion of the individual critical audit matters communicated in the auditor's report. Consistent with our recommendations above, we believe this should also include language:

- Conforming the reporting to the recommended definition of critical audit matters described above
- Stating that the audit included performing procedures designed to address the risks of material misstatement associated with the critical audit matters; such procedures were designed in the context of the audit of the consolidated financial statements, taken as a whole, and do not express an opinion on individual accounts or disclosures
- Stating that the communication of critical audit matters is not intended to identify all matters considered to be significant to the audit

- Stating that the auditor discussed other matters with the audit committee during the course of the audit that are not being reported as critical audit matters

*Documentation of critical audit matters*

Paragraph 14 of the proposed auditor reporting standard includes a requirement that the auditor document the basis for the auditor's determination that "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters." We believe this requirement should not be included in the proposed auditor reporting standard because it would present implementation challenges. If the auditor identifies a matter that "would appear to meet the definition of a critical audit matter," then the auditor should communicate it as a critical audit matter. If this requirement is retained, we believe the proposed auditor reporting standard should provide more guidance on how it is to be applied. We also believe our recommendation of first identifying significant audit matters and then critical audit matters will assist in meeting the documentation requirement for the auditor to document the basis for the auditor's determination of critical audit matters.

*Cost/benefit considerations*

Additional coordination among management, the audit committee, and the auditor will be required to address critical audit matters included in the auditor's report. Although critical audit matters will be identified from matters that are already required to be documented, there will be incremental costs in analyzing and documenting which matters should be reported as critical audit matters, drafting communications about critical audit matters, and consulting with the national office when questions arise about the wording of critical audit matter reporting. These costs should not be underestimated. Communicating with audit committees and management with regard to the selection and reporting of critical audit matters will involve their time as well as the auditor's time. In addition to these recurring costs, there will be significant initial costs in educating and training auditors to execute on the new standard. As noted above, much of this work will occur at the end of the audit when remaining open issues are being resolved and final reviews and analyses are occurring. This timing may also have a negative effect on audit quality. We anticipate that our field testing will provide some insight to the potential costs and impact on audit quality, but we also recommend that the Board perform a robust cost/benefit analysis on these significant changes to the auditor's report.

*Considerations related to audits of specific entities*

In response to question 40 on page 64 of Appendix 5, we believe that audits of brokers and dealers, investment companies, and employee stock purchases, savings, and similar plans ("benefit plans") should be exempted from being required to communicate critical audit matters in the auditor's report for the reasons discussed on pages 57-63 of Appendix 5. For example, research conducted by the Board's Office of Research and Analysis indicates that ownership of brokers and dealers is primarily private, with individual owners generally being part of the management team. In addition, we agree with commenters that the financial statements of investment companies are less complex than operating companies' financial statements and that the limited nature of an investment company's operations entails fewer estimates and judgments. Similarly, we agree that the primary objective of the financial statements of a benefit plan is to provide information about the plan's assets, liabilities, and ability to pay benefits, and we believe the plan financial statements meet this objective without the auditor reporting critical audit matters. For these reasons, we believe the aforementioned entities should be excluded from the scope of the requirement to communicate critical audit matters in the auditor's report.

**Other information**

*Overview*

We support the Board's intent to enhance the existing standard by requiring communication about the nature of the auditor's responsibility in the auditor's report. As currently drafted, however, we believe the proposed other information standard will increase rather than decrease the expectation gap by requiring language in the auditor's report that is ambiguous and susceptible to widely varying interpretation by users. In addition, we believe the proposed other information standard will result in a significant increase in audit effort, particularly with respect to information not directly related to the audited financial statements (i.e., "nonfinancial information"), with a corresponding significant increase in costs that in our view will exceed the benefits. Our recommendation above that the Board conduct a robust cost/benefit analysis of the proposals is of particular importance with respect to the proposed other information standard should the Board move forward with it as currently proposed.

We believe the changes we suggest below will (i) align the nature of the audit effort with the auditor's responsibilities, in particular by differentiating the work performed on material other information directly related to the audited financial statements from that performed on nonfinancial information, and (2) resolve significant issues with respect to the communication in the auditor's report of the auditor's responsibilities related to other information.

*Expectation gap*

In our comment letter on the concept release, we stated that "describing the procedures performed by the auditor on information outside of the financial statements would clarify the auditor's responsibility with respect to such information, and help reduce the expectation gap by addressing the misperception that the auditor's opinion covers such information."

We believe the reporting in the proposed other information standard, however, may serve to increase rather than decrease the expectation gap. Notwithstanding the disclaimer of opinion, we are concerned that the language "we evaluated" is ambiguous and could be read to mean that the auditor is expressing an opinion on the other information or performing audit-type procedures. The term "evaluate" is more commonly associated with the auditor's responsibility in an audit to determine whether the evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report. This is the context in which "evaluate" is used in Auditing Standard No. 14, *Evaluating Audit Results* and, more recently, in Auditing Standard No. 17, *Auditing Supplemental Information Accompanying Audited Financial Statements* (AS 17), which states on page 12 of Appendix 3 that "the evaluation should encompass, among other things, whether the information: is complete and accurate, is consistent with the audited financial statements, and complies with relevant regulatory requirements, if applicable." As a result, to evaluate typically includes consideration of completeness, which if applicable here would significantly change the auditor's responsibility and audit effort; this task is better placed with respect to other information as the responsibility of the entity and its securities counsel. If the Board retains "evaluate" either a separate examination engagement under the attestation standards should be considered or the proposed other information standard should explain specifically what is expected of the auditor in this context, including with respect to documentation.

We are also concerned that the statement in the report that "our evaluation was based on relevant audit evidence obtained and conclusions reached during the audit" is ambiguous and suggests that the audit effort with respect to other information is more extensive than the proposed procedures, particularly with respect to nonfinancial information. For instance, users may erroneously infer that the auditor obtained audit evidence and reached conclusions on all nonfinancial information. In addition, saying audit "evidence obtained" and "conclusions reached during the audit" seems to indicate that the nonfinancial information was subject to audit procedures. In reality the opposite is true, as the nonfinancial information is not in the scope of the audit. As indicated in the release and further discussed below, such information may coincidentally be gathered by the auditor during the course of risk assessment and other planning procedures, but this differs significantly from information subject to audit procedures. This may lead to an "over reliance" on the auditor's proposed statement that he or she has not identified a material inconsistency or material misstatement of fact. This issue may be exacerbated as companies expand the amount of nonfinancial information not directly related to the financial statements they disclose. For example, the Sustainability Accounting Standards Board has encouraged companies to consider disclosing sustainability topics within MD&A of the Form 10-K.

In order to mitigate the expectation gap, we believe the language in the auditor's report should clearly communicate the auditor's responsibilities by describing the nature of the procedures the auditor is required to perform, as further discussed below.

*Cost/benefit considerations*

We are concerned that the audit evidence obtained that is referred to in the proposed other information standard seems to include *all* information gathered during an audit, not just the information subject to audit procedures. Without making these distinctions, we believe the proposed other information standard typically would require the auditor to first search the audit file to determine whether information was gathered during the audit, and if so, to perform procedures in an effort to determine whether a material inconsistency or material misstatement of fact exists if the information in the audit file does not agree to management's disclosure, and finally, to document the findings from this exercise. We believe this will be a costly exercise that far exceeds the benefits.

For example, on page 13 of Appendix 6, the Board discusses how management might state in the other information that the entity has the largest market share in the entity's industry. In this example, the auditor may or may not have obtained information during the audit indicating whether management's statement is a material misstatement of fact. More importantly, the example suggests that the auditor would need to do a search of the audit file for nonfinancial information to determine whether there is something in the file about this issue regardless if it was subject to audit procedures. If the information is included in the audit file, then the auditor would need to consider whether it reconciles to the entity's filing. Searching for the information in the audit file and then determining whether there is a material misstatement of fact in the other information would involve significant audit effort with little obvious value to users as the information to which it is being compared was not subject to audit procedures. In addition, it will be difficult for the auditor to determine whether the other information truly contains a material misstatement of fact because the comparable information in the audit file (1) is not subject to audit procedures and (2) may have been gathered early in the audit and is no longer current.

Consistent with existing standards and with paragraph 5 of the proposed other information standard, we agree that if the auditor becomes aware of a potential material misstatement of fact in the other information, the auditor should discuss the matter with management and perform additional procedures, as necessary, to determine whether there is a material misstatement of fact. Our concern rather relates to the question of what audit effort should be required in searching for a potential material misstatement of fact in nonfinancial information. We believe our recommendations below with respect to nonfinancial information strike an appropriate balance from a cost/benefit perspective. If the Board believes there is value for the auditor to perform procedures on nonfinancial information, then a separate attestation engagement with separate reporting should be considered.

*Auditor's procedures*

Our recommendation is to replace the proposed "read and evaluate" proposal with one that is in our view more likely to result in consistent execution and more efficient in terms of the value provided for the audit effort involved. Specifically, we believe the proposed other information standard should include an overall requirement that the auditor read *all* of the other information (see below for comments related to scope), regardless of whether the other information is directly related to the audited financial statements. The auditor should then perform a prescriptive set of procedures, based in part on PCAOB AU 634, *Letters for Underwriters and Certain Other Requesting Parties*, with respect to material other information directly related to the audited financial statements, including qualitative statements.

The procedures to be performed on material other information directly related to the audited financial statements would compare the material other information to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information. In addition, we agree that the auditor could recalculate the amounts in the other information when the formula is described in the annual report, the formula is generally understood, or the recalculation can be performed without referring to a formula as described in paragraph 4(d) of the proposed other information standard. However, we believe these procedures should be performed only on "material" other information directly related to the audited financial statements, as some other information directly related to the financial statements is not material when considered in the context of other information compared to the materiality of the financial statements. We believe that limiting these procedures to material other information directly related to the audited financial statements will reduce costs but maintain the benefits.

For other information not directly related to the audited financial statements, we believe the auditor's responsibility should continue to be consistent with that in PCAOB AU 550, *Other Information in Documents Containing Audited Financial Statements*. That responsibility is to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, based on knowledge gained in the course of conducting the audit, to respond appropriately.

*Auditor's reporting*

We recommend replacing the report language in paragraphs 13 and 14 of the proposed other information standard with language that explicitly describes the limited procedures the auditor performed, as described below, and therefore will more clearly communicate the auditor's responsibility with respect to other information. In addition, we believe the statements in paragraph 13(e) of the proposed other information standard that the auditor has or has not identified a material inconsistency, a material misstatement of fact, or both should be replaced with a statement of our responsibility to report such matters in the audit report if they have not been appropriately revised. As discussed below, we believe that including a statement of fact describing our responsibility instead of stating a conclusion at a point in time will (1) help mitigate the practical challenges related to the timing of when information becomes available, (2) still provide relevant information about what would occur if the auditor becomes aware of a material inconsistency with the audited financial statements, a material misstatement of fact in the other information, or both that is not resolved; and (3) eliminate the ambiguity in the report language currently proposed. We would also note that the proposed changes would also help to mitigate some of the increased litigation risks associated with the proposed other information standard.

Specifically, we believe the report should include the following:

- A statement that the auditor is required to read the other information and, with respect to material other information directly related to the audited financial statements, perform limited procedures including comparing the material other information directly related to the audited financial statements to (1) the financial statements or (2) accounting records that are subject to the audit or have been derived directly from such accounting records by analysis or computation, and, where applicable, recalculating the mathematical accuracy of the other information
- A statement that these limited procedures do not constitute an audit or review of the other information
- A statement that in the event the auditor becomes aware, based on the limited procedures performed, that the other information contains a material inconsistency with the audited financial statements, a material misstatement of fact in the other information or both, that has not been appropriately revised, the auditor is required to describe the misstatement or inconsistency in the audit report

*Timing issues*

Under the proposed other information standard the auditor would not generally be responsible for information incorporated by reference that is not available to the auditor prior to the issuance of the auditor's report. However, the proposed other information standard would apply to information incorporated by reference in a Form 10-K from the entity’s definitive proxy statement filed within 120 days after the end of the fiscal year covered by the Form 10-K.

The information in the definitive proxy statement is not subject to the original reporting requirement, but the proposed other information standard would require the auditor to apply PCAOB AU 561, *Subsequent Discovery of Facts Existing at the Date of the Auditor’s Report* (AU 561). However, AU 561 is based on information the auditor has already reported on and was not meant to apply procedures to information that is planned to be received subsequent to issuance of the auditor’s report. Therefore, it appears the proposed other information standard arguably has in essence established “prospective” reporting on information that is not available at the time of report issuance, which is not feasible. At the very least this would likely create confusion as to what information is in or out of the scope of the auditor’s report. We believe that describing the auditor’s responsibilities instead of stating a conclusion at a point in time will help mitigate some of these concerns.

If the proposed other information standard continues to require a conclusion, we believe it should either exclude the proxy from scope or provide guidance on how the auditor should report with respect to the proxy when it is available to the auditor at a date later than when the 10-K is filed. We also believe the Board should provide guidance on how the auditor should report in situations in which the audited financial statements with the auditor's report thereon are issued prior to the 10-K filing, and therefore prior to the availability of most, if not all, of the other information that is within the scope of the standard. For example, some entities first complete an annual report to shareholders before the 10-K is filed and other companies file audited financial statements on a separate 8-K at the time of their earnings release. Also, for investment companies the Form N-CSR is not required to be filed until ten business days after the financial statements are transmitted to shareholders. In these circumstances, we believe this could be confusing to users because what is being reported on is dependent on when the entity issues its audited financial statements and, in the example of audited financial statements issued at the same time as the earnings release, there may be no other information, or very little other information, available to the auditor. The reporting on other information in this example would be inconsistent with most other entities purely as a result of the timing of issuance of the audited financial statements.

As stated above, we believe that describing the auditor's responsibilities instead of stating a conclusion will help mitigate these concerns. If the proposed other information standard continues to require a conclusion, we believe it should also address these practical considerations as part of a final standard.

*Scope*

The scope of the proposed other information standard includes all the exhibits listed in an entity's annual report except for XBRL. We believe the scope should be limited to exhibits that are directly related to the audited financial statements, that is, information from the accounting records subject to the audit, or which has been derived directly from such accounting records (e.g. ratio of earnings to fixed charges). Other exhibits, such as material contracts, would continue to be evaluated for purposes of the audit as deemed necessary. For example, the auditor would read a material contract during the audit to determine whether its terms were being accounted for appropriately in the financial statements. If the contract is included as an exhibit in the annual report, it would seem unnecessary for the auditor to further evaluate it for purposes of determining whether there is a material inconsistency or a material misstatement of fact as the proposed other information standard would require. We also question what would constitute a material misstatement of fact for the many exhibits that are executed contracts or final documents or what the material inconsistency with the financial statements might be when its terms were already considered in evaluating whether the accounting was appropriate. We believe our recommendation to limit the scope to exhibits that are directly related to the audited financial statements helps mitigate these concerns.

In addition, we agree with the Board's statement on page 9 of Appendix 6 that "Audited financial statements of an entity other than the company … may be required to be included in the company's annual report. The Board does not intend for the other entity's financial statements to be considered other information in the company's annual report, under the proposed other information standard, because they are not the company's financial statements and were already subject to a separate audit." We further believe that the company's annual report should not be considered other information from the perspective of the auditor of other entity, and that this is the Board's intent as page 9 of Appendix 6 also states, "The proposed other information standard would apply to the other information in the annual report of the company that is making the filing." We recommend that this point be clarified.

*Documentation*

We believe the proposed other information standard should provide guidance on the nature and extent of required documentation. Our recommendations above to limit the auditor's incremental procedures to material other information directly related to the audited financial statements should reduce the audit effort compared to what is currently proposed. Nonetheless, it still represents greater involvement by the auditor regarding other information than is required under existing standards, and we believe documentation guidance would be appropriate. If the proposed other information standard is finalized as it is currently proposed, we believe it is even more essential that documentation guidance be provided, as determining and documenting whether all other information is part of the audit file and then documenting consideration of each statement would be a significant increase in audit effort for what appears to be of limited value.

*Considerations related to audits of brokers and dealers*

In response to question 28 on page 45 of Appendix 6, we do not support the application of the proposed other information standard to audits of brokers and dealers because we believe the SEC's recently adopted amendments to Rule 17a-5 provide users of brokers' and dealers' financial statements with sufficient information that makes additional auditor reporting unnecessary. Furthermore, the PCAOB recently adopted attestation standards that address the auditor's examination of compliance reports and the auditor's review of exemption reports which, together with AS 17, provide sufficient auditor involvement in reporting of brokers and dealers.

**Auditor tenure**

Paragraph 6(i) of the proposed auditor reporting standard requires the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the entity's auditor. As noted on page 16 of Appendix 5, the Board has not reached a conclusion related to a relationship between audit quality and auditor tenure. We believe that including auditor tenure in the audit report would create the false impression that such a relationship exists and would give undue prominence to this information. Moreover, the responsibility for hiring and dismissing the auditor rests with the audit committee, not the auditor. Accordingly, we do not believe that auditor tenure should be included in the audit report. However, if audit committees and management believe it is useful information given their specific facts and circumstances, we would not object to disclosure by them of tenure elsewhere. This would allow for the disclosure to be provided in the proper context related to oversight of the auditor.

**Legal considerations related to the proposals**

The release asks what effect the proposals would have on an auditor's potential liability in private litigation. We believe there will be a significant increase in litigation risk for the profession.

First, the proposed auditor reporting standard greatly expands the number and variety of statements which will be attributed to the auditor and under applicable federal securities laws, an entity can only be subject to suit relating to statements that are made by and properly attributed to it. The additional statements will thus greatly expand the possibilities for plaintiffs' lawyers to allege auditor misconduct, irrespective of the merit of such allegations. Second, the proposed other information standard use of the word "evaluate" is problematic given how it is used in other auditing contexts as described above, and will encourage claims that the auditor should have identified omissions in the other information, regardless of the merits of those claims. This goes well beyond what we believe the Board intended and blurs significantly the line between the roles of the auditor and those of the issuer's securities counsel. Third, the additional statements regarding critical audit matters will allow plaintiffs to parrot and mischaracterize those statements to create an incorrect appearance of specificity as required to plead scienter and survive dismissal. Finally, if these cases are not dismissed at the outset, the enormous litigation and particularly discovery costs often drive a settlement regardless of merit. The proposals will likely mean more spurious claims will be brought, fewer meritless cases will be properly dismissed at an appropriate stage, and more unwarranted settlements will need to be reached.

The changes we have proposed help mitigate some of these risks, primarily by grounding the auditor's statement in a concept of materiality, by not blurring the lines of responsibility for reporting of original information about the entity related to critical audit matters, and by describing the auditor's responsibilities instead of providing a conclusion related to other information. However, even with these changes, the incremental liability risk to the auditing profession is expected to be significant.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Michael J. Gallagher (646-471-6331) or Marc Panucci (973-236-4885) regarding our submission.

Sincerely,

PricewaterhouseCoopers LLP

**APPENDIX**

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

**Basic report elements**

*Descriptions of the auditor's responsibilities and the nature of an audit*

Overall, we support proposed changes to enhance the description in the auditor's report of the auditor's responsibilities with respect to the notes to the financial statements; material misstatement, whether due to error or fraud; and independence. We also support proposed changes to better align the description of the nature of an audit with the Board's risk assessment standards.

In addition, we continue to encourage the PCAOB to work with other standard setters, in particular the IAASB, to eliminate unnecessary differences in describing the auditor's responsibilities and the nature of an audit in the auditor's report. The auditor's responsibilities and the nature of an audit are generally the same regardless of the auditing standards being followed; therefore, having different descriptions runs the risk of confusing rather than informing users of the financial statements.

*Addressees of the audit report*

Paragraph 6 of the proposed auditor reporting standard identifies the basic elements that must be included in the auditor's report. Subparagraph 6(b) states that the auditor's report must include "addressees that include, but are not necessarily limited to, (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body." Footnote 8 related to this subparagraph states that, "For example, addressees might include other appropriate parties depending on the legal and governance structure of the company," and page 9 of Appendix 5 identifies bondholders as an example of such "other appropriate parties."

The proposed auditor reporting standard does not provide sufficient guidance on what investor other than a shareholder should be an addressee and in which circumstances an auditor would be required to address its report to bondholders, and we cannot think of any.

There could also be legal risk in expanding the required addressees. As a practical matter auditors may already include "shareholders" as an addressee of the auditor's report. Indeed, we do this in recognition of the fact that shareholders are frequently users of financial statements, and so support the report being addressed to the shareholders and the Board of Directors or equivalent body. However, we do not do this out of any obligation and this practice does not reflect the auditor's legal duty of care which runs solely to the client. While the law differs from state-to-state, as a general matter where courts have found exceptions, it is because the plaintiff has been able to show that the auditor has exhibited its intent to accept an expanded duty of care through its conduct.

A standard which creates requirements in terms of the addressee of the auditor's opinion could cause courts incorrectly to hesitate in properly applying the privity rule and risk improperly expanding the auditor's duty of care based merely on the report's addressees.

*Opining on the schedules to the financial statements*

Subparagraph 6(d) requires that the auditor's report must include "a statement identifying each financial statement and related schedule, if applicable, that has been audited" and related footnote 9 states that "various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited." Pages 10-11 of Appendix 5 also state that "the proposed auditor reporting standard would require specific references to the related notes and, if applicable, schedules because those are identified as part of the financial statements pursuant to SEC Rule 1-01(b) of Regulation S-X."

We agree with the above requirements identifying SEC-required schedules as part of the financial statements covered by our opinion. However, paragraph A(4) in the General Instructions to Form 10-K provides that ". . . all schedules required by Article 12 of Regulation S-X may, at the option of the registrant, be filed as an amendment to the report not later than 30 days after the applicable due date of the report."

We ask that the proposed auditor reporting standard clarify that when a registrant files the schedules pursuant to the instructions above or other situations when the schedules are finalized separately from the financial statements, auditors may, consistent with current practice, issue a separate report.

*Basis of opinion*

Paragraphs 6(j)-6(n) identify the required statements that comprise the Basis of Opinion section of the auditor's report. We believe that subparagraphs (m)(1) and (m)(2) should be combined into a single subparagraph as shown below to be more consistent with the presentation in the illustrative report on pages 15-16 of Appendix 1 (proposed additions are in ***boldface italics***; deletions are in ~~strikethrough~~:

m. A statement that an audit includes:
   (1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks; ***such procedures include examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements***
   ~~(2) Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements~~

*Ordering of the basic elements of the auditor's report*

We support the statements in footnotes 12, 21 and 24 of the proposed auditor reporting standard that require explanatory paragraphs, if any, to follow the Opinion on the Financial Statements section of the auditor's report, unless otherwise required by other PCAOB standards; the Critical Audit Matters section to follow the Opinion on the Financial Statements section and any explanatory paragraphs; and the Auditor's Responsibilities Regarding Other Information section to follow the Opinion on the Financial Statements section, any explanatory paragraphs, and the Critical Audit Matters section. We also support the requirements in paragraphs 21 and 59 of the proposed amendments to PCAOB AU 508, retitled *Departures from Unqualified Opinions and Other Reporting Circumstances* (AU 508), that the paragraph(s) describing the reasons for a qualified or an adverse opinion, respectively, should precede the opinion paragraph in the Opinion on the Financial Statements section of the auditor's report. We do not believe any further specific order for the presentation of the auditor's report should be required.

We do, however, believe the proposed auditor reporting standard and related amendments should require the use of section titles throughout the report, not just for the Critical Audit Matters and Auditor's Responsibilities Regarding Other Information sections of the report, as we believe section titles will help users in reading the report and bring some consistency to the format of the audit report. The section titles in the illustrative report on pages 15-16 of Appendix 1 are a good start but could be another area where convergence with the IAASB may be helpful.

**Explanatory language in the auditor's report**

We support including in the proposed auditor reporting standard a description of the circumstances in the PCAOB's auditing standards that would require explanatory language or an explanatory paragraph along with references to the relevant PCAOB standards that establish such requirements. We believe that keeping this information in a single place facilitates consistency in execution.

We also support retaining the auditor's ability to add a discretionary explanatory paragraph (an "emphasis of a matter" paragraph in extant AU 508) to emphasize a matter regarding the financial statements in circumstances when the matter does not meet the definition of a critical audit matter. Paragraph 16 of the proposed auditor reporting standard identifies examples of matters, among others, that the auditor may choose to emphasize in the auditor's report. We believe that items (a) "significant transactions with related parties" and (e) "an uncertainty relating to the future outcome of significant litigation or regulatory actions" should be removed from the list because we believe these two items are more likely to be determined by the auditor to be critical audit matters.

We do not, however, support the discussion on pages 47 and 49 of Appendix 5 stating that a matter that is the subject of an explanatory paragraph, whether required or discretionary, might also be communicated as a critical audit matter. We believe discussing the same matter both in an explanatory paragraph and in the Critical Audit Matter section of the report could be confusing to users and, accordingly, we do not support that practice. We believe the auditor should determine whether the subject matter of the explanatory paragraph meets the definition of a critical audit matter and if so, limit the discussion to the Critical Audit Matter section of the auditor's report. If the matter does not meet the definition of a critical audit matter, then it should be included in an explanatory paragraph. See below for further details related to modified opinions.

**Amendments to other PCAOB standards**

We appreciate that the PCAOB has proposed amendments to its standards by marking its existing standards to show the additions and deletions. This facilitates reviewing the amendments and we encourage the Board to continue this practice going forward.

Proposed new paragraph 58A of AU 508 would require an auditor's report expressing an adverse opinion to include The Auditor's Responsibilities Regarding Other Information (other information) section of the auditor's report. If the proposed other information standard continues to require a conclusion statement related to other information, we do not believe this conclusion should be required when an adverse opinion is expressed. We agree with the statement on page 55 of Appendix 5 that "the most important matter to investors and other financial statement users would be the reason for the adverse opinion;" in such circumstances, we believe the other information section should be omitted because its inclusion may overshadow the importance of the matter(s) giving rise to the adverse opinion.

A proposed new note to paragraph 21 of AU 508 states, "The auditor would refer to Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter." We believe that a matter giving rise to a qualification of the opinion is a critical audit matter and the proposed note should be revised to be consistent with that position. Furthermore, we do not believe it is clear from the proposed amendments to AU 508 whether the Board would expect the reason for the qualification to be discussed both in the "basis for departure from an unqualified opinion" paragraph(s) which, along with the opinion paragraph, comprise the Opinion on the Financial Statements section of the report, and also in the Critical Audit Matters section of the report. We believe, as stated above, that discussing the same matter in two different sections of the auditor's report would be confusing and should not be required. We believe the discussion of a matter giving rise to a qualified opinion should be discussed in the "basis for departure from an unqualified opinion" paragraph(s) in the Opinion on the Financial Statements section of the report. A cross reference should also be made from the Critical Audit Matter section to the Opinion on the Financial Statements section of the report, such as the following example which is adapted from the IAASB's proposal: "In addition to the matter described in the Opinion on the Financial Statements section of our report, we have determined the matters described below to be critical audit matters."

From:
Tyler L. Prince
1320 N. Wayne St. #404
Arlington, VA 22201
(P): 401-440-7870
tyler.lee.prince@gmail.com

To:
Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Dated: November 26, 2013
RE: Comments on Proposed Auditor Reporting Standards

To Whom It May Concern:

I am writing today in support of *The Auditor's Report on an Audit of Financial Statements When Auditor Expresses an Unqualified Opinion* (the "proposed auditor reporting standard").[1] Auditors are granted a rare, unadulterated view of a company's financial position and the assumptions that go into creating the "estimated" values that are reported on the financials. Many minority shareholders, such as myself, will never have such an opportunity. A majority of this valuable knowledge is lost in the auditor's overly simplified binomial decision as to whether a company's financials are reflected fairly or not. The remainder of this letter is intended to add additional support to my position by addressing some of the PCAOB's proposed questions. Specifically, I will focus on questions regarding the critical audit matters section within the proposed auditor reporting standard.

Definitive Benefits:

One of the first questions proposed by the PCAOB is "[w]ould the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users?"[2] As expressed earlier, I obvious feel that the addition of a critical audit

[1] See, Proposed Auditor Reporting Standard, PCAOB Release No. 2013-005, August 13, 2013.
[2] Appendix 5 of Proposed Auditor Reporting Standard, PCAOB Release No. 2013-005, August 13, 2013, at A5-44.

matters section would add tremendous value to investors and users of financial statements. This conclusion stems from three lines of reasoning.

The first line of reasoning revolves around the notion of minimizing the effects of the principal/agent problem at play within public companies. Investors rely on executives and management of an organization to conduct business in a way that is profit maximizing for the shareholders, not for themselves. The financial statements are the primary way shareholders can evaluate an executive's performance. Audit firms are granted rare insight into the actual happenings within these public companies. As part-owners in these public companies, shareholders pay a significant amount of money to have audit firms verify that the information they are receiving in the financial statements is a fair assessment of the financial health of the company. Should an auditor have difficulty or concerns verifying certain aspects of the financial statement, why should the investors not be entitled to this information? I feel they should be, and doing so will help inform investors about the inner operations of their companies and reduce implications arising from the principal/agent problem.

The second line of reasoning for my option partly extends from my first. Should investors have a better understanding of the context around the difficulties encountered during an auditor's investigation, they will have a better idea of where to concentrate their efforts when evaluating a company's performance. This could save a tremendous amount of time and money for the typical investor.

The last line of reasoning for my option revolves around the notion that adding a critical audit matters section could provide more motivation for public companies to be as forthcoming and honest on their estimates and financials as possible. Certain accounting standards allow for some flexibility on how companies report certain line-items. By allowing auditors the ability to call into question the appropriateness of these subjective accounting decisions, management will be more likely to record these line-items in the most appropriate manner from an investor's view point.

Example of Potential Benefits:

To help provide context to the benefits, consider a recent company evaluation that I conducted regarding a publicly traded snack foods conglomerate. This snack foods company had been involved in a tremendous amount of M&A over the past several years. As a result, over 69 percent of their assets were within the goodwill and other intangible assets accounts.

Moving forward, management of the snack foods company will have a lot of influence over the assumptions that go into re-evaluating those assets for impairment. A critical audit matters section would have allowed an auditor to explain the subjectivity involved within these calculations and address the potential issues to shareholders. Thus, I would have been in a much better informed position regarding the financial state of the company moving forward.

Potential Obstacles to Implementation:

The PCAOB additionally raised many questions regarding the potential obstacles for the proposed auditor reporting standard. In particular, many of these questions revolved around the additional cost concerns for both the auditing firm and its client. Audit firms could face additional direct costs should they need to hire more personnel, increase the duration of the audit process with each client, or add training programs related to complying with the new standard. Client companies could incur additional direct costs relating to their audit committees reviewing the necessary matters included within the critical audit matters section.[3]

[3] PCAOB exposure draft lists this cost along with many other direct costs. See, Appendix 5 of Proposed Auditor Reporting Standard, PCAOB Release No. 2013-005, August 13, 2013, at A5-41.

Ultimately, I find little merit in arguments that these direct costs would outweigh the potential gains. First, as addressed in the PCAOB exposure draft, the changes made within the proposed auditor reporting standards are designed to ensure an "unduly burdening"[4] in the financial reporting process. Little to no additional time and resources will be used in complying with these reporting standards. The audit firm as already invested significant time and energy into verifying their client's financials. Any additional reporting within the critical audit matter section would not increase this initial sunk-cost imposed on the audit firm.

The second reason these direct costs will not outweigh the benefits to the proposal is that, ultimately, neither the audit firm nor its client will bear the full cost. Any additional direct costs that might be encountered by an auditing firm will most likely be passed along to the client. However, the proposed auditor reporting standards will instill more confidence in potential investors, thus lowering the overall cost the capital for the client. Any increase in direct costs for either the audit firm or its client would eventually be off-set.

Skeptics of the proposed auditor reporting standards also refer to the related indirect costs. These costs might not be initially tangible, but could cause major issues later on. For example, some argue that there could be a decrease in the quality of the audit of the financial statements due to the resource constraint imposed by the need to fulfill any new auditor obligations. However, I feel my previous comment regarding no additional "unduly burdening" adequately rebukes that concern.

Others argue that an additional indirect cost might include issues arising from auditors disclosing information that otherwise would not have required disclosure and could potentially be beneficial for the auditor's client's competitors. Understandably, some managers and senior

[4] See, Appendix 5 of Proposed Auditor Reporting Standard, PCAOB Release No. 2013-005, August 13, 2013, at A5-22.

executives will be hesitant to publicly disclose business sensitive information. However, any information discussed or potentially exposed in the critical audit matters section will not be of any particular advantage to a competitor. This section would not expose product secrets or covert corporate strategies, but merely discuss where the auditor had a difficult time verifying assumptions or receiving information. While this type of knowledge could be extremely beneficial to a potential investor, it should have no influence on the business practices of a competitor.

An additional challenge facing the proposed auditor reporting standard is that of standardization. In theory, standardization could help minimize many of the costs associated with the transition. From the view point of the auditor, standardization of the critical audit matters section could help to reduce any necessary training and help create more economies of scale within the process. From the financial statement users' prospective, standardization would allow for less time and energy to read and examine the difference and similarities between companies. However, over standardization of a critical audit matter section would completely nullify the purpose of the exercise. While it is a noble idea to provide a general outline and formatting instructions for the section (as is currently done within the PCAOB exposure draft), you must allow the auditor the necessary autonomy to disclose whatever matter he/she finds important. Thus the current proposed outline seems to be a good compromise.

All of the previous obstacles/implications to implementing the proposed auditor reporting standards are not valid or have an easily implemented solution. As an investor, however, there is one issue that is concerning regarding the roll out of the proposed auditor reporting standard. This proposed practice could reinforce the already high conflicts of interest existing in the auditing industry. The audit industry currently faces numerous conflicts of interests. Anytime an auditor is paid to verify the financial integrity of another organization, the auditor will feel pressure (if not an obligation) to sign-off on the related financials. Else, the auditor could feel they will be terminated and/or replaced. In a way, these proposed standards could reinforce those pressures. An auditor could feel pressure not to discuss any issues related to the audit. Given that no critical audit matters were disclosed in the new appropriate section, investors would feel more assured about the financially integrity of the company. Thus the results could be exponentially worse.

Many other potential issues still face the proposed auditor reporting standard (such as specific term definitions, documentation requirements, additional audit fees, or potential for liability in private litigation). However, these issues seem fairly minuscule and I would be unqualified to comment. As indicated earlier in this letter, I am a concerned personal investor, not an attorney or a classically trained accountant. Regardless, I strongly feel that the proposed auditor reporting standard and its critical audit matters section as it currently stands is a step in the right direction and will add significant value for the typical investor.

Thank you for considering these points.

Respectfully,

Tyler L. Prince

**From:** Bob Callaghan
**To:** Comments
**Subject:** PCAOB Rule Docket #034- I support Lisa Roth"s position
**Date:** Wednesday, December 11, 2013 11:06:51 AM

I would like to express my support for the position that Lisa Roth presents on behalf of small broker dealers concerning PCAOB Rule Docket #034

Thank you
Regards,

Bob Callaghan, Partner

Pursuit Capital Marketing, LLC
266 Main Street, Bldg 3, Suite 25
Medfield, MA 02052
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Fax: 508.242.5384
Cell: 617-513-3689
Email: bcallaghan@pursuitcap.com
Website: www.pursuitcap.com

Please note: effective 10/1/2011 we have moved to the new address above with new phone and fax numbers

**From:** Betsy Crane
**To:** Comments
**Cc:** Michael Quinn; Liz Collins
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 7:34:45 PM

I support Lisa Roth's position regarding the fact that non-custodial, non public BDs should be exempt from the PCAOB constituency, for many reasons that have been detailed by our community.

Betsy Crane

**Elizabeth L. Crane** | **Q Advisors**
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QUALCOMM Incorporated

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Submitted via email to comments@pcaobus.org
December 10, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034
Proposed Auditing Standards on the Auditor's Report and the Auditors Responsibilities Regarding Other Information and Related Amendments

Dear Sir/Madam:

QUALCOMM Incorporated (Nasdaq: QCOM), a large accelerated filer, develops, designs, manufactures and markets digital communications products and services. QUALCOMM is a leading developer and supplier of integrated circuits and system software based on CDMA ("Code Division Multiple Access"), OFDMA ("Orthogonal Frequency Division Multiple Access") and other technologies for use in voice and data communications, networking, application processing, multimedia and global positioning system products to device and infrastructure manufacturers. QUALCOMM also grants licenses to use portions of its intellectual property portfolio. At September 29, 2013, QUALCOMM employed approximately 31,000 full-time, part-time and temporary employees and occupied over 80 facilities in the United States and over 100 facilities internationally. QUALCOMM's revenues for the fiscal year ended September 29, 2013 were $24.9 billion, and net income attributable to QUALCOMM was $6.9 billion.

We respectfully submit this response to the request for comments from the PCAOB on its proposed auditing standards on *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* ("the Proposed Auditor's Reporting Standard") and *The Auditors Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (the "Proposed Other Information Standard") *and Related Amendments to PCAOB Standards* (together, the "Proposed Standards"), PCAOB Rulemaking Docket Matter No. 034, dated August 13, 2013.

While we recognize that some investors and other financial statement users have expressed an interest in changing the current pass/fail model of the auditor's report such that it provides more information, we do not believe that the Proposed Standards would increase the reliability of the information that is currently provided or that the Proposed Standards would enhance the value of the auditor's report.

QUALCOMM

*Proposed Auditor's Reporting Standard*

We believe it is already understood by investors and other financial statement users that certain financial statement accounts and disclosures may involve complex accounting issues and that auditing such accounts and related disclosures may pose difficulties for the auditor. We believe that requiring auditors to report on such difficulties as Critical Audit Matters ("CAM") provides little benefit to investors and other financial statement users when (i) the CAM have been appropriately addressed enabling the auditor to issue an unqualified opinion, and (ii) the Proposed Auditor's Reporting Standard retains the pass/fail model of the auditor's report, and thus, continues to require the auditor to conclude whether the financial statements as a whole are fairly presented or not. Including CAM in the auditor's report could be confusing to investors and other financial statement users and could lead them to believe that financial statements with an unqualified auditor's report that includes a certain number (and/or types) of CAM are somehow less reliable than financial statements with an auditor's report that includes fewer (or does not include such types) of CAM. Investors and other financial statement users might also place undue reliance on CAM that pertain to certain accounts and/or disclosures when considering the financial statements as a whole.

Furthermore, including CAM in the auditor's report introduces subjectivity into the auditor's report and decreases comparability between companies' auditors' reports, as auditors will apply varying judgments in deciding what CAM to include in their report. For example, the auditor of Company A may decide to include certain CAM in the audit report while the auditor of Company B decides not to include the same CAM, despite the facts and circumstances of the two companies being similar. This may be disadvantageous to Company A if investors and/or other financial statement users make certain decisions based on which CAM and/or the number of CAM included in its auditor's report. The decreased comparability that results from auditors applying such judgment is not in the interests of investors and/or other financial statement users.

We believe that it is likely that the inclusion and/or exclusion of CAM in an auditor's report will become the subject of legal actions against auditors. While we recognize that such actions will not arise as a result of including CAM in the audit reports of the vast majority of companies, even a relatively small number of legal actions (compared to the total number of audit reports issued) will increase the auditor's costs. To recuperate these costs, and/or to be compensated for the increased risk of litigation that auditors face as a result of this proposed standard, audit fees will likely increase across the board without any benefit to companies, investors and/or other financial statement users.

Lastly, auditors' inclusion of CAM may result in the auditor disclosing confidential information that is not included in the company's financial statements and notes. We believe that companies should prepare their own financial statements and notes, and that the auditor's role is to audit, not to provide additional disclosures based on their subjective determination of CAM.

For the reasons described above, we do not believe the PCAOB should require auditors to report on critical audit matters.

The following comments are in response to certain questions set forth in the Proposed Auditor's Reporting Standard.

QUALCOMM

*3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?*

*4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this requirement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?*

We do not believe these proposed changes provide investors or other financial statement users with any information that they do not already have available to them. In addition, such changes would likely result in standard or template information about the auditor and auditing requirements being provided and would unnecessarily lengthen the auditor's report.

*Proposed Other Information Standard*

Through performing an audit, the auditor obtains a general understanding of the other information the company discloses in certain documents containing audited financial statements and the related auditor's report ("Other Information"). However, auditors do not have the in-depth understanding that management has of matters that are disclosed in Other Information as auditors are not involved in the company's day-to-day operations. For example, Other Information includes risk factors and may include technical information regarding the technology used in the company's products. Auditors typically do not possess the legal, engineering and other expertise that management uses in preparing portions of Other Information. For these reasons, we do not believe that the auditor can properly evaluate everything that may be included in Other Information without performing significant additional work and adding expertise to their engagement teams.

We believe that we would need to allocate significant additional resources to support the incremental procedures that an auditor would perform under this proposed standard. Furthermore, audit fees will increase as a result of the auditor's responsibilities regarding Other Information.

For the reasons described above, we do not believe the PCAOB should require auditors to evaluate and report on Other Information as contemplated in this standard. We believe that the current PCAOB standard (AU 550) provides investors and other financial statement users with appropriate assurance that the Other Information is consistent with the financial statements.

Sincerely,

George S. Davis
Executive Vice President and Chief Financial Officer

**R.G. Associates, Inc.**
Investment Research/ Investment Management
201 N. Charles Street, Suite 806
Baltimore, MD 21201

Jack T. Ciesielski, CPA, CFA
President

Phone: (443)977-4370
Fax: (410)783-2955

December 4, 2013

Office of the Secretary PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Rulemaking Docket No. 34

To the Board:

This letter is issued to state my views on the above-referenced proposed auditing standard regarding the auditor's report. (PCAOB Release No. 2013-005, dated August 13, 2013.)

What has been proposed in the document is of lower strength than the proposals put forth in the 2011 auditor's report concept release, but in fact, I believe some of the most important ideas in that release have been refined and made their way into this proposal. I believe the most useful – and controversial - part of the 2011 release was its suggestion for the inclusion in the report of an "Auditor's Discussion & Analysis," (AD&A) as well as its suggestion for the required inclusion of emphasis of matter paragraphs. Both of these suggestions were roundly disliked by preparers and by auditors. The information they would have provided, however, would have added more information than the simple pass/fail information provided by the current auditor's report. Furthermore, the information would have been presented from a point of view that would be symmetrical with shareholders' interests.

Currently, investors only receive assurance that financial statements conform to generally accepted accounting principles. That assurance totaled $4.8 billion for the S&P 500 in 2012 – quite a price tag for letting investors know only that financial statements met the requirements expressed in thousands of pages of GAAP literature. Some investors believe they should get more value for their audit fees. Some investors might even be willing to see audit fees increase if they were getting more valuable information from the auditor; after all, the audit is supposed to be executed for the benefit of the investors, not for the benefit of the auditors or the managers. The proposed AD&A and required emphasis of matter paragraphs of the concept release would have presented better information to investors than the current standard report.

I consider the "Critical Audit Matters" (CAM) part of the current proposal to be a direct descendant of both the AD&A and required emphasis paragraphs proposals of the 2011 concept release. In fact, I think the CAM proposal is an improvement over either of the two prior proposals. It would be the combined essence of both the proposed AD&A and the inclusion of emphasis of matters paragraphs. It *should* be a concise summarization of the most critical issues encountered by the auditor – something that would capture the interest of investors.

In my view, the main problem with the CAM is that it's very much of a free form document; it is not based on a strict template like the current auditor's report. It might be omitted by auditors who claim there were no critical audit matters, and it could become a telephone book - full of facts, long in volume but containing little true information. This is where the PCAOB and its inspections process are necessary to provide enough tension in the process to keep it working honestly. It is not sufficient to simply put the CAM disclosure requirement on the backs of the auditors; the PCAOB must also be ready to make sure it is being applied properly. From outside of the PCAOB, it is not possible to judge whether the PCAOB will be able to provide that needed tension. The inspection process will be more involved if the PCAOB inspectors are looking for evidence of audit matters that perhaps, in their judgment, should have been addressed as critical, but were omitted. Conversely, PCAOB inspectors may have to spend more time considering why certain CAMs were considered to be "critical" in the first place.

I am not suggesting that CAM requirements be somehow forced into a template. I am only suggesting that for it to work as intended, auditors will have to learn to write differently than in the past, and the PCAOB will have to regulate differently than in the past. Change creates friction in processes, and friction in processes can increase costs. One argument that I suspect will be used by those who do not support the CAM proposal: it will raise audit fees. In my view, added cost that produces investor-usable information is not wasteful. As pointed out earlier, investors might be willing to pay more to get more information.

Investors might not even notice if costs rose. The most-watched measure in the investment world is probably earnings per share, and for 2012, there were 80 firms in the S&P 500 for which the after-tax audit fees did not matter even one penny per share. If audit fees were to increase for every firm in the S&P 500 to just under the point at which earnings per share would be rounded off by one penny, audit fees in the S&P 500 would increase by $2.4 billion – a 50% increase in revenues, and without affecting earnings per share. The point: there is room to increase audit fees and deliver a service to investors that they want.

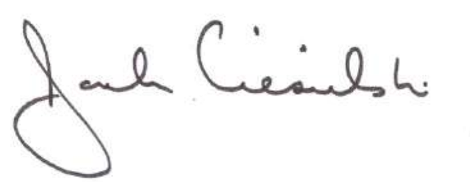
The other parts of the proposal seem far less important to investors, in my view. I support the changes to the auditor's responsibilities for other financial information included in the financial statements. The basic financial statement package, on its own, is not completely sufficient to convey financial information about the modern corporation; that is why other financial information has evolved over the years. Investors should have had at least minimal assurance that the auditor has considered it. The added reporting section on other financial information will finally provide that assurance. Though the added reporting section doesn't provide much in the way of investor-usable information, I hold that its importance lies in the fact that it will compel auditors to do sufficient work on the other financial information because their name will be attached to it.

I also support the inclusion of the auditor tenure information. I do not believe that such information will resolve the question of whether auditor tenure is a detriment to audit quality, but making the tenure information publicly and completely available will at least provide information to be used in developing objective analysis of such a hypothesis.

That concludes my comments. I have also attached a recent report my firm has published on the proposal, which includes some information about audit fees, and the "headroom" available for increase, that you may find interesting.

If you have any questions, do not hesitate to contact me. Best regards.

Sincerely,



Jack Ciesielski
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THE ANALYST'S
ACCOUNTING OBSERVER
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# Rewriting The Audit Report: The PCAOB Moves Closer

*In the summer of 2011, the Public Company Accounting Oversight Board issued a concept release intended to improve the way auditors communicate with investors. It wouldn't take much to improve it: the current audit report is the text equivalent of a light switch, which is either on or off. The current audit report is either a pass or fail grade: the financial statements conform to generally accepted accounting principles, or they don't conform. Investors, who foot the bill for the auditor's fees, have long wanted more benefits from the auditor's inside view of a firm's inside workings.*

*The 2011 concept release was ambitious enough. It proposed the inclusion of an Auditor's Discussion and Analysis; would have required and expanded the use of "emphasis paragraphs" in the report; proposed auditor assurance on other information outside the financial statements; and would have clarified language in the standard auditor's report, particularly with regard to auditor responsibilities.*

*Two years later, the PCAOB has issued a pair of proposed auditing standards – one on the auditor's report, the other on the auditor's responsibilities for other information in documents containing the auditor's report. Neither one completely embodies the concept release's proposed changes, but some of the 2011 proposal's DNA shows through in the proposed standards.*

*The PCAOB doesn't intend to change the actions of the auditor, only the way they tell investors how they did their work – and in theory, should not cause further cost increases to companies and their shareholders. In practice, auditors are likely to be very cautious about any "new and improved" information they provide to shareholders and will take care to insulate themselves from any additional liability; you can reasonably expect costs to increase. In this report, we take an educated guess at how much costs can increase before investors will notice.*

## I. What Do The Auditors Know?

If you're an investor, your greatest hope is that they know what they're doing. You'll receive assurance that the financial statements are presented in accordance with generally accepted accounting principles (GAAP), and apart from that you don't know much else. You won't be privy to any of the findings of the auditors that led them to conclude that indeed, the covered financial statements comport to tens of thousands of pages of text relating to accounting principles. That's not a lot of comfort to most investors. That's all that auditors are willing to provide under their government-granted monopoly, even though investors expect more. Those expectations can sometimes border on a wish for a guarantee, but almost universally, investors want more than just an on/off switch of an audit report. They'll always want information of a market-moving nature, something that auditors just aren't about to start providing separately from the company.

The 2011 concept release floated some ideas that might have been more market-moving than what we see in the current reports, but they were, as one would expect, wildly unpopular with an indignant audit profession. By comparison with the current reporting model, the suggestions in the concept release were downright edgy.

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## Executive Summary

- To investors, the auditor's report has long been a minor element of the financial statement package. It merely assures an investor that the financial statements comply with thousands of pages of accounting standards.
- That's not a lot of assurance, and in a post-financial crisis world, investors wonder why auditors cannot play more of an investor's advocate role in their reporting to them.
- In 2011, the PCAOB issued a Concept Release on modifying the auditor's report. It proposed several bold changes: for instance, the inclusion of an "Auditor's Discussion & Analysis," and requiring the inclusion of "emphasis of matters" paragraphs in the report. It also proposed numerous modifications that were less dramatic, but contributed to an overall stronger and clearer message from the auditor to investors.
- Two years later, the PCAOB has issued a proposal after much feedback on the Concept Release. The two changes above do not appear in the same form in the proposed rule, but in their place, perhaps, the PCAOB has proposed the auditor disclose "Critical Audit Matters" (CAMs). Essentially, the auditor would be required to report to investors the particular audit matters that keep them awake at night.
- This is the most contentious part of the proposal, for it will put the auditor in a difficult spot. Discuss matters too openly, and they may raise investor concerns about the veracity of client accounting; discuss too little, and they may provoke PCAOB inspections to investigate a lack of CAMs.
- The proposal is likely to be opposed on the grounds that it will "add to audit costs." In the S&P 500, however, the Big Four auditors could add another $2.4 billion to their annual fees without nicking EPS another penny.

A quick recap of what might have been, from the 2011 concept release[1]:

**1. Auditor's Discussion and Analysis (AD&A).** An AD&A would be a document that lets the auditor express views on the firm's overall preparation of the financial statements, and would give the auditor a forum to present investors with views on the audit process. This is a document that could provide leverage with the firm's management in contentious matters: clients would have an interest in not seeing an AD&A addressing, say, auditor concerns over management's estimates in particularly income-sensitive accounts.

**2. Required and expanded use of emphasis paragraphs.** While emphasis paragraphs already exist, they're not required – and they're rare. The concept release would have made their appearance mandatory, and put a spotlight on the most significant financial statement issues and their geography within the financial statements. They could have illuminated investors about the areas bearing significant management judgments and estimates, areas of measurement uncertainty, and any other areas the auditors felt needed clarification.

**3. Auditor assurance on other information outside the financial statements.** The concept release teed up the idea that auditors express assurance on information other than the basic financial statement package: things like the Management's Discussion & Analysis; non-GAAP information and earnings releases. Given that the audit happens only once a year, but investors act on information all through the year, there's merit to the idea.

**4. Clarification of language in the standard auditor's report.** While this part of the proposal wouldn't have expanded the audit report much, it would have cleaned up fuzzy concepts about what the auditor's job entails in the first place. This alternative would be less of an expansion of the auditor's report compared to the others, and provide more of an incremental description about the nature of an audit and the auditor's responsibilities. Clarifications pondered: the meaning of "reasonable assurance;" the auditor's responsibility for fraud; the meaning of auditor independence; and management's responsibility for financial statement preparation.

Two years later, the PCAOB has issued two proposed standards based on the 2011 concept release: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Reports on Audited Financial Statements*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report.* Neither will appear on the Amazon "most downloaded" list – the titles alone are almost a standard – but they do draw on some elements of the earlier proposal and they will provide investors with some new information to digest. A review of the basics of the two proposals is next.

[1] A concept release is a kind of trial balloon, or a testing of the water temperature, before a standard setter like the PCAOB publishes a proposal of something they intend to issue as a rule. See Volume 20, No.9, "A PCAOB Proposal: Not Your Father's Audit Opinion," for a full discussion of the concept release's provisions.

***Proposed Auditor Reporting Standard***

The proposed auditor reporting standard would continue the current pass/fail audit report model, yet it would add some very different information to it, in these three particular areas:

- Communication of critical audit matters.
- Basic elements of the audit report: added information about the auditor's independence, tenure, and responsibilities for other information in annual reports.
- Explanatory language: clarification of the auditor's responsibilities for fraud and financial statement footnotes.

**Communication of critical audit matters.** This is destined to be the most controversial element proposed. As described in the proposal, "critical audit matters" (CAMs) are those which involve the most difficult, subjective, or complex auditor judgments; pose the most difficulty to the auditor in obtaining sufficient appropriate evidence; or present the most difficulty to the auditor in forming the opinion on the financial statements. Critical audit matters are expected to be issues so important that they would ordinarily be included in the engagement completion document[2], or reviewed by the firm's engagement quality reviewer, or communicated to the audit committee, or any combination of these three. The auditor is not expected to perform new work to communicate CAMs; no new audit work is required by the proposed standard. The information about critical audit matters in the auditor's report would:

- Identify the critical audit matter;
- Describe the considerations that led the auditor to concluded that the issue is a critical audit matter; and
- Refer to the financial statement accounts and disclosures related to the critical audit matter, if applicable.

<u>If there are no critical audit matters, the audit report must give a statement to that effect as well.</u> It's not hard to see why auditors will resist modifying the audit report this way: the requirement puts them in a no-win situation. Presentation of CAMs could cast clients – who pay the auditor - in an unflattering light, and arouse short-selling activity as an unintended result of the auditor's actions. If they merely state there are no critical audit matters, or present safe, uninformative CAMs year after year, the auditor runs the risk of PCAOB admonishment. Take your pick: would you like a rock, or perhaps you prefer a hard place?

Other aspects of this provision may complicate the lives of auditors. Critical audit matters would best be captured and evaluated towards the *end* of the audit. That means there would be additional time pressure placed on the auditor when they are trying to wrap up the audit and deliver an opinion to the client, who is more concerned about filing their annual report with the SEC and releasing it to the public. It will complicate the audit firm's own work, and even though it won't require the performance of new audit tasks, it will certainly lead to more time spent on costly word-smithing with legal counsel. Expect "unintended consequences" to be a mainstay argument of the opponents of this proposal during the comment period, which ends December 11, 2013.

*Yet investors could benefit from the disclosures; at the very least, they'll be getting something more for the money they authorize to be forwarded to the auditors every year. If auditors discuss control deficiencies as critical audit matters - even if they are resolved to their satisfaction – they'll be adding some color to the internal control opinions. The audit report receives criticism for disclosing little to investors but a pass/fail grade; the internal control opinion is no more informative to investors than the audit report. The DNA from the 2011 concept release is evident in this proposed requirement: though there is no "audit discussion & analysis," or required and expanded emphasis paragraphs, this proposed addition captures precisely the kind of insider insight that auditors should possess, and brings it into the open for investors.*

**Basic Elements of the Auditor's Report.** The PCAOB's proposal would clarify the language in the auditor's report in order to improve the public's understanding about the audit and auditor's responsibilities, including the auditor's responsibilities for other information beyond the financial statements. While the existing report is retained, the proposal would require a description of some of the auditor's responsibilities, such as the auditor's responsibility for the notes to the financial statements and for finding fraud.

[2] This is a required PCAOB document summarizing the significant issues and findings resulting from the completion of the audit.

The PCAOB's proposed reporting standard would add several new elements to the auditor's report:

- Auditor independence - a statement about the auditor's current requirements to be independent of the company, to improve financial statement users' understanding about the auditor's independence obligations and to remind auditors of their obligations;
- Auditor tenure - the year the auditor began serving as the company's auditor, so as to provide financial statement users with information about the length of ties between the auditor and the company; and
- Other information - the auditor's responsibilities for, and the results of, the auditor's evaluation of other information in annual reports filed with the SEC containing the financial statements and the related auditor's report. Think of supplementary information, or most commonly, the Management's Discussion & Analysis. The auditor does not audit this information and will explicitly say so in the audit report.

In a way, the independence clarification is reminiscent of Sarbanes-Oxley's Section 302 requirement, which made CEOs and CFOs attest to the integrity of the financial statements filed with the SEC – something that probably caused sweaty brows and shaky hands for many officers. Here, the PCAOB is requiring the auditor to explain more about the legal concept of auditor independence and to declare that they are required to be independent as a firm registered with the PCAOB. Sweaty brows and shaky hands may spread to audit offices, too; in the current reporting model, the *only* mention of independence is in the phrase "Report of the Independent Auditor."

The auditor tenure disclosure will not likely have any discernible impact on the work of financial statement users. The PCAOB has been shouted down on its 2011 Concept Release suggesting mandatory auditor rotation, and this seems to be a way of dropping the subject and managing to declare some sort of victory. Having the tenure information available will give ammunition to those who want to pursue the rotation subject from either side of the debate; they will at least have tenure data for arguing their position, and it would doubtless make academic researchers happy as well.

*The auditor need not perform any additional steps to have grounds for making these statements in the audit report. Yet there will probably be "tighten up" costs made by auditors to make sure that any assertions they make – particularly any assertions about independence, whether explicit or implied – do not return to bite them. The PCAOB anticipates there may be cost-related implications for both auditors and companies.*

**Explanatory Language.** Currently, auditor reports are required to include explanatory language or paragraphs in the auditor's report, when necessary. For instance, such additional information is needed when there is substantial doubt about the ability of a company to function as a going concern, or when there has been a correction of material misstatements in previously issued financial statements. The proposed auditor reporting standard does not change this, nor does it expand the scope of the requirement. It does, however, include a clearer delineation of the auditor's responsibilities for material misstatements of the financial statements – including misstatements due to error or fraud, and including disclosures in the financial statements.

*Again, there's nothing here that directly improves the lot of financial statement users.*

***Proposed Auditing Standard on Other Information***

The audit report proposal doesn't stand alone; the PCAOB issued it simultaneously with a proposal on "other information (OFI) outside the financial statements." Examples of other information, beyond a company's financial statements and auditor's report, included in SEC 10-K filings are the "Selected Financial Data" tables and Management's Discussion & Analysis. Currently, auditors are charged with reading and considering the other information – but they don't have a reporting responsibility for what they may find.

That will change if this proposal passes. As proposed, the auditor will have increased responsibility for examining other information, and will have a reporting duty for the other information in a separate section of the audit report. The auditor will still need to read the other information, looking for material inconsistencies, material misstatements of fact or both. That determination will be made by comparing the other information to audit evidence already obtained. The auditor will need to evaluate 1) the consistency of amounts in other information and the manner of presentation; 2) consistency of any qualitative statements in the other information and its manner of presentation; 3) other information not directly related to financial statements, as compared to relevant audit evidence obtained and conclusions reached; and 4) amounts in other information calculated using amounts therein, or from the financial statements, or from relevant audit evidence.

The auditor's report will contain a brand new section entitled "The Auditor's Responsibilities Regarding Other Information," and it will contain:

- A statement that the auditor evaluated whether the other information contains a material inconsistency with the financial statements, a material misstatement of fact, or both;
- Identification of the annual report that contains the other information, and the audited financial statements and the auditor's report;
- A statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit;
- A statement that the auditor did not audit the other information and does not express an opinion on the other information; and
- A statement that, based on the evaluation, the auditor:
  - Has *not* identified a material inconsistency or a material misstatement of fact in the other information; or
  - *Has* identified a material inconsistency, a material misstatement of fact, or both in the other information that has not been revised, and a description of the inconsistency, misstatement of fact, or both.

*Is the proposed improvement for other financial information better that the current situation, where the auditor "reads and considers" OFI behind the scenes, and gives no assurance to financial statement users that they did anything? Yes. At the same time, though, there's not a lot of new or ground-breaking information provided to financial statement users in the report on other financial information. The only time it would really be of interest to financial statement users is when the auditor really has identified problems with the OFI and states so in the report. That's a situation that should be exceedingly rare; the ability of the auditor to contradict management in their own report is a powerful lever that should persuade managers to appreciate the auditor's point of view.*

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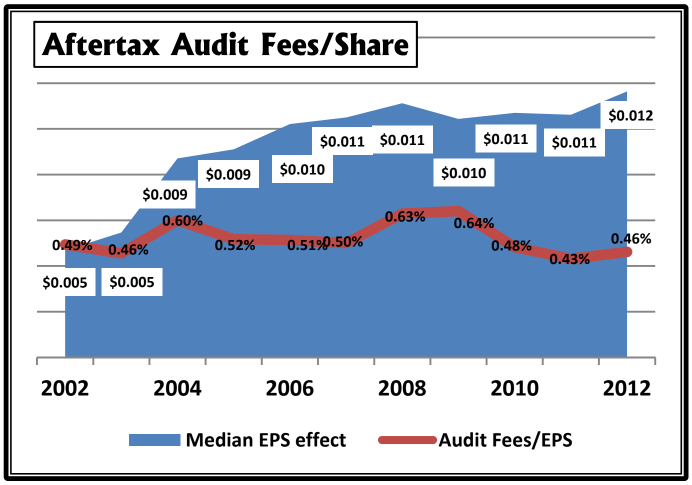
**Throughout the proposal, the PCAOB takes pains to point out that the changes do not require the auditor to perform new audit procedures. The changes are aimed at the reporting by the auditor, not the work done by the auditor. Theoretically, there should be no additional costs incurred by the auditor, but the PCAOB also admits in the document that costs will nevertheless be likely to increase. The auditor is expected to say more in the report, which means a foundation has to be built in order to support their statements – and that will lead to increased file-stuffing and memo-writing, at the very least. How much additional audit cost can be supported before investors even notice? This is explored in the next section.**

## II. If An Auditor Increases Fees…

Would an investor notice? It all depends on earnings per share, which gets investor attention like nothing else.




The graph at left tells an important story about the total audit fees for 450 companies[3] in the S&P 500 since 2002. The shaded plot shows the median total after-tax audit fees per share for the firms, carried out to three places to make the trend more visible. From less than a penny a share in 2002 – only $0.005 per share – the median total fees have tripled to $0.012 in 2012. In absolute dollar terms for the 450 firms, total pretax audit fees have grown at an annual clip of 8.4%. (See table below.) Auditing: a growth industry?

*There's less than meets the eye. The line plot in the graph shows the median after-tax audit fees divided by median diluted EPS. The 2012 percentage of audit fees to EPS is just less than 2002's level – 0.46% versus 0.49%.*

When looking at absolute dollars, be careful. Despite increased audit fees, it's no more onerous a piece of EPS than in the days before Sarbanes-Oxley. In 2002, the Act was passed; audit fees increased, as can be seen in the following table. Sarbanes-Oxley's burden increased the work done by auditors, and decreased the kind of services they could perform for their clients: no more consulting engagements. The total fees drawn down by auditing firms did not increase at nearly the same rate as the total audit fees – an annual rate of only 3.8% per year over the ten-year stretch, not much more than the 2.5% inflation rate over the same period.

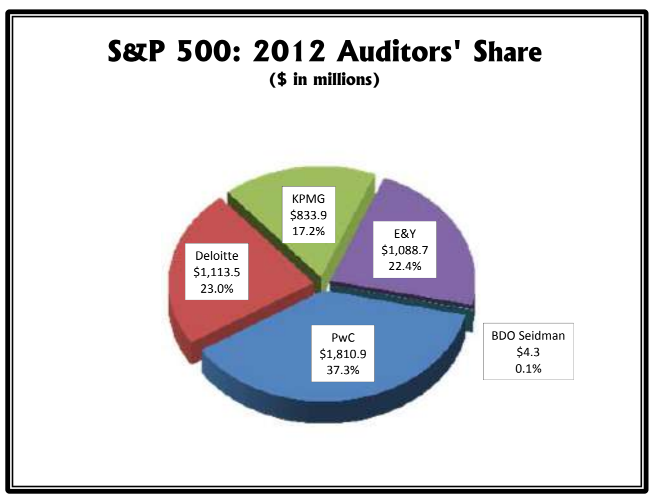
### Audit & Audit-Related, Tax & Other Fees For The S&P 500: 2012 - 2002

| *($ in millions)* | 10 Yr. CAGR | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Audit | *9.5%* | $3,909.2 | $3,769.0 | $3,662.5 | $3,650.1 | $3,647.1 | $3,594.3 | $3,519.1 | $3,282.5 | $3,082.3 | $1,909.4 | $1,581.5 |
| Audit-related | *3.3%* | 582.0 | 503.5 | 488.2 | 474.6 | 494.0 | 512.3 | 444.2 | 399.9 | 424.0 | 472.2 | 422.3 |
| Total audit fees | *8.4%* | $4,491.2 | $4,272.6 | $4,150.7 | $4,124.7 | $4,141.1 | $4,106.6 | $3,963.3 | $3,682.4 | $3,506.2 | $2,381.6 | $2,003.9 |
| Tax | *-3.7%* | 551.5 | 528.1 | 509.5 | 488.9 | 477.0 | 490.4 | 472.8 | 495.0 | 661.8 | 785.0 | 806.4 |
| Other | *-20.7%* | 71.4 | 70.1 | 64.7 | 37.1 | 28.7 | 21.6 | 28.6 | 50.6 | 66.0 | 117.6 | 721.9 |
| Total fees | *3.8%* | $5,114.1 | $4,870.7 | $4,724.8 | $4,650.6 | $4,646.8 | $4,618.5 | $4,464.7 | $4,227.9 | $4,234.1 | $3,284.2 | $3,532.2 |

*Source: Audit Analytics, company proxy filings.*
*Table is for 450 S&P 500 firms only, prepared on basis described in footnote 3 below.*

The chart at right shows how the 2012 audit-and audit-related fee pie was divided among the S&P 500's auditing firms. Total audit and audit-related fees were $4.85 billion for 496 firms; four of them were involved with spinoffs[4] and did not have separate audit fees in their proxy.

*All hail PwC! There's no contest: PwC is the clear leader with 37.3% of all the audit and audit-related fees for the S&P 500. Deloitte and E&Y are nearly tied for a distant second. PwC has the most clients in the S&P 500 (155) and the highest average total audit fees ($11.68 million). There's a huge gap between PwC and last place Big Four member KPMG: almost $1 billion. Oddly, that's even bigger than the $829 million gap between KPMG and diminutive BDO Seidman.*

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[3] Total audit fees are composed of audit and audit-related fees as stated in a firm's annual proxy statement. Audit-related fees are charges for services indirectly related to the annual audit. Examples would be reviews of interim financial statements, and due diligence on mergers and divestitures. There are 450 firms in the example because 50 firms did not have proxies as far back as 2002, and to include them for part of the time span would have distorted the trend. Firms did not always have proxies because they may have not been public as long ago as 2002. This was frequently the case with "spin-off" firms.

[4] AbbVie (an R.G. Associates, Inc. holding – see back page of report), ADT, Kraft Foods, and News Corp. did not report audit fees independently of the firms from which they were spun (AbbVie and News Corp.) or were spinning off (the other two).

# 2012: S&P 500 Auditors & Their Fees by Industry

| | PwC | | | E&Y | | | Deloitte | | | KPMG | | | BDO Seidman | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| ($ in millions) | Firms | Fees | % Fees | Firms | Fees | % Fees | Firms | Fees | % Fees | Firms | Fees | % Fees | Firms | Fees | % Fees | Grand Total | | |
| Automobiles & Components | 4 | $86 | 59% | 1 | $13 | 9% | 1 | $42 | 29% | 1 | $3 | 2% | | | | 7 | $144 | 3% |
| Banks | 3 | 35 | 27% | 6 | $43 | 34% | 2 | $7 | 6% | 3 | 42 | 33% | | | | 14 | 126 | 3% |
| Capital Goods | 13 | 213 | 35% | 11 | 111 | 18% | 11 | 127 | 21% | 5 | 153 | 25% | | | | 40 | 604 | 12% |
| Commercial & Professional Services | 4 | 20 | 22% | 6 | 22 | 25% | 2 | 48 | 53% | | | 0% | | | | 12 | 91 | 2% |
| Consumer Durables & Apparel | 5 | 29 | 36% | 6 | 31 | 40% | 3 | 9 | 12% | 2 | 10 | 12% | | | | 16 | 79 | 1% |
| Consumer Services | 2 | 9 | 14% | 5 | 28 | 45% | 3 | 17 | 27% | 2 | 9 | 14% | | | | 12 | 62 | 13% |
| Diversified Financials | 9 | 310 | 51% | 7 | 77 | 13% | 5 | 95 | 15% | 6 | 131 | 21% | | | | 27 | 614 | 7% |
| Energy | 14 | 126 | 40% | 15 | 98 | 31% | 5 | 32 | 10% | 9 | 62 | 19% | | | | 43 | 318 | 1% |
| Food & Staples Retailing | 1 | 4 | 8% | 4 | 33 | 61% | 2 | 11 | 20% | 1 | 5 | 10% | | | | 8 | 54 | 4% |
| Food Beverage & Tobacco | 9 | 75 | 37% | 6 | 63 | 31% | 4 | 10 | 5% | 6 | 55 | 27% | | | | 25 | 203 | 5% |
| Health Care Equipment & Services | 11 | 59 | 26% | 10 | 60 | 26% | 5 | 88 | 38% | 4 | 22 | 10% | | | | 30 | 229 | 2% |
| Household & Personal Products | 2 | 21 | 28% | 1 | 4 | 6% | 2 | 45 | 58% | 1 | 7 | 9% | | | | 6 | 78 | 9% |
| Insurance | 6 | 182 | 40% | 5 | 57 | 13% | 8 | 185 | 41% | 3 | 28 | 6% | | | | 22 | 451 | 5% |
| Materials | 13 | 111 | 46% | 4 | 24 | 10% | 6 | 74 | 30% | 7 | 35 | 14% | | | | 30 | 243 | 4% |
| Media | 6 | 85 | 44% | 4 | 59 | 30% | 3 | 22 | 11% | 2 | 28 | 15% | | | | 15 | 194 | 4% |
| Pharma, Biotech, Life Sciences | 9 | 122 | 50% | 7 | 35 | 15% | 4 | 27 | 11% | 3 | 57 | 23% | 1 | $2 | 1% | 24 | 244 | 5% |
| Real Estate | 2 | 3 | 5% | 8 | 21 | 33% | 3 | 16 | 24% | 5 | 25 | 38% | | | | 18 | 65 | 1% |
| Retailing | 4 | 12 | 12% | 12 | 44 | 43% | 8 | 23 | 22% | 7 | 21 | 21% | 1 | 3 | 2% | 32 | 102 | 2% |
| Semiconductors & Equipment | 7 | 24 | 31% | 7 | 42 | 55% | | | 0% | 2 | 11 | 14% | | | | 16 | 77 | 2% |
| Software & Services | 8 | 106 | 35% | 8 | 63 | 21% | 4 | 72 | 24% | 9 | 61 | 20% | | | | 29 | 302 | 6% |
| Technology Hardware & Equip. | 8 | 92 | 43% | 8 | 83 | 39% | 3 | 25 | 12% | 3 | 13 | 6% | | | | 22 | 212 | 4% |
| Telecom Services | 2 | 5 | 8% | 1 | 24 | 35% | | | 0% | 3 | 40 | 57% | | | | 6 | 70 | 1% |
| Transportation | 1 | 5 | 8% | 4 | 24 | 44% | 3 | 19 | 34% | 3 | 7 | 13% | | | | 11 | 55 | 1% |
| Utilities | 11 | 78 | 33% | 2 | 29 | 12% | 17 | 121 | 51% | 1 | 9 | 4% | | | | 31 | 237 | 5% |
| **Total** | **154** | **$1,811** | **37%** | **148** | **$1,089** | **22%** | **104** | **$1,113** | **23%** | **88** | **$834** | **17%** | **2** | **$4** | **0%** | **496** | **$4,851** | **100%** |
| **Average audit & audit-related fee** | | **$11.68** | | | **$7.31** | | | **$10.50** | | | **$9.48** | | | **$2.15** | | | | |

*Source: Audit Analytics, company proxy filings.*

*Above is a breakdown of the audit and auditing-related fees for the S&P 500 by industry, and by auditing firm. Auditing firms often seem indistinguishable from one another, due in no small measure to the monotony of the auditor's report under reconsideration. They've often tried to distinguish themselves from each other, however, by pursuing an industry specialization. The financial effects of that specialization are evident in the table above: there are quite a few firms that garnered 50% or more of all the audit/audit-related fees for a particular industry. (Highlighted figures above.) The greatest dominance occurred in the Food & Staples Retailing industry, where Ernst & Young took home 61% of all audit and audit-related fees; next was the Automobiles & Components industry where PwC accounted for 59% of such fees.*

Audit fees have risen, and they're certainly concentrated in the hands of a few powerful firms. Yet investors do not often complain about high audit fees. They're expecting that auditors are delivering something of value to them, even if they don't often fawn over the service they've received. (It's hard to get excited about an auditor's clean opinion on financial statements.) In addition, audit fees are a relative bargain in a couple of ways. First, they're fractionally over a penny a share – and they've only mattered a penny a share since 2003. (See the graph on the preceding page; though the median audit fees as a component of EPS is carried out to three places for clarity, it would be a penny per share for all of the last ten years on a two-place basis, just as it is reported.) Audit fees are a relative bargain in another way: total annual fees are usually less than the total annual pay packages for just the top five executives. In fact, at many firms, they're less than just the cash paid to the top five executives. [5]

# Audit Firm Fees For The S&P 500: 2012 - 2002

| ($ in millions) | 10 Yr. CAGR | 2012 | 2011 | 2010 | 2009 | 2008 | 2007 | 2006 | 2005 | 2004 | 2003 | 2002 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PwC | *8.4%* | $1,703.2 | $1,644.4 | $1,614.5 | $1,617.9 | $1,535.6 | $1,500.5 | $1,463.8 | $1,413.4 | $1,424.0 | $955 .3 | $763.6 |
| E&Y | *7.3%* | 1,002.4 | 987.6 | 940.3 | 920.2 | 941.0 | 909.8 | 867.0 | 766.4 | 725.9 | 529.8 | 495.4 |
| Deloitte | *8.9%* | 992.3 | 899.2 | 865.5 | 863.0 | 924.1 | 988.0 | 936.7 | 853.8 | 748.6 | 485.9 | 421.6 |
| KPMG | *9.6%* | 789.0 | 736.8 | 726.1 | 719.2 | 736.0 | 702.5 | 690.7 | 643.8 | 602.7 | 408.1 | 316.4 |
| BDO Seidman | *11.3%* | 4.3 | 4.6 | 4.2 | 4.3 | 4.4 | 5.7 | 5.1 | 5.0 | 4.0 | 1.7 | 1.5 |
| Grant Thornton | *NA* | -- | -- | -- | -- | -- | -- | -- | -- | 1 | .8 | 3.2 |
| Arthur Andersen | *NA* | -- | -- | -- | -- | -- | -- | -- | -- | -- | -- | 2.2 |
| | *8.4%* | $4,491.2 | $4,272.6 | $4,150.7 | $4,124.7 | $4,141.1 | $4,106.6 | $3,963.3 | $3,682.4 | $3,506.2 | $2,381.6 | $2,003.9 |
| **Annual % change:** | | *5.1%* | *2.9%* | *0.6%* | *-0.4%* | *0.8%* | *3.6%* | *7.6%* | *5.0%* | *47.2%* | *18.8%* | |

*Source: Audit Analytics, company proxy filings. Table is for 450 of the S&P 500 firms: only those with available data for all 11 years were used to keep the trend intact.*

*PricewaterhouseCoopers' growth is the most striking of the Big Four – almost a billion dollars of added revenues over 10 years of Sarbanes-Oxley Act repercussions – client consulting restrictions, increased oversight from PCAOB, internal control reporting – caused a near-doubling of audit and audit-related fees between 2002 and 2004. Yet from 2004 through 2012, fees have increased at a gradual annualized rate of 3.1% per year. In fact, during the financial crisis years of 2007-2009, the fees scarcely budged. It's hard for anyone to say auditor fees have run amuck.*

[5] See Volume 22, No. 9, "2012 S&P Executive Pay: "I'll Pour. You Say When." August, 2013. Page 8 discusses the comparison between executive pay in the S&P 500 and the auditors' fees.

At what point would investors sit up and notice audit fees? If they ever became a factor in missing earnings estimates, investors would probably rebel. These days, one does not usually hear of an earnings miss due to increasing audit fees. Though the PCAOB proposal doesn't require time-consuming new audit procedures – for instance, a requirement to physically inspect foreign-domiciled assets or to increase accounts receivable confirmation procedures to a specified minimum threshold – it will doubtless cause firms to engage in more prophylactic documentation of audit judgments and decisions. File cabinets will be more stuffed than ever if the "critical audit matters" reporting comes to fruition. Maybe as a result of increased auditor reporting, audit fees may take a bigger nick out of earnings than a penny a share, and auditors might start getting blame in earnings calls. (Of course, that might draw more attention to the new reporting done by the auditor, and managers might not want to go there, either.)

For now, assume that investors are calm about audit fees when they're at an average of a penny a share. Assume further that they won't stay calm if earnings per share are nicked by another cent per share, regardless of whatever the current level may be. For firms at the 2012 median of one cent per share, that may sound like there's room for auditors to double their fees, but it isn't so. If the audit fees increase beyond $0.0049 per share, their effect on EPS will actually be *one* whole cent.[6]

*For an individual firm, figuring out the EPS maximum effect is a minor exercise in reverse-engineering. Simply multiply $0.0049 by the diluted shares outstanding, and divide the result by an after-tax effect of 65%. The result is the audit firm's "room to cover." How much room to cover exists for auditors to raise their fees without impacting EPS by one more penny - in the whole S&P 500?*

| | Incremental Revenue Realization: | |
|---|---|---|
| *($ in millions)* | Increase by $0.0049/share | Increase Current Fee to $0.0049/share |
| PricewaterhouseCoopers | $798.1 | $61.1 |
| Ernst & Young | 618.5 | 96.6 |
| KPMG | 475.2 | 36.3 |
| Deloitte | 462.6 | 53.5 |
| BDO Seidman | 3.0 | 0.2 |
| | $2,357.3 | $247.9 |

*The answer is "quite a bit." The table at left shows how much additional revenue would be realized by each of the current auditing firms of the S&P 500 if their extra file-building can be billed to the client, up to the point where it won't affect EPS. There could be a potential $2.4 billion of additional revenues for the auditors to capture before EPS "rounding" forces budgetary control.*

The second column of numbers is interesting, in that it represents the portion of the total where the auditors aren't even currently realizing $0.0049 of audit fees per share. Surprisingly, there are 80 firms in this category. They're listed in the table on the next page.

* * * * * * * * * * * * * * * * * *

Take a moment to review the lessons of the above exercise. It's not intended to show how much auditors could grab for themselves before shareholders feel like they're pockets are being picked. Nor is it intended to imply that because audits are relatively cheap – and some might be *really* cheap – that auditors aren't doing a good job. The idea that "you get what you pay for" isn't always accurate. Bargains can be found in all walks of life! (Ask any active investment manager. It's their raison d'etre.)

*It would help investors if there were some uniform indicators of audit quality so there could be a better assessment of "getting what you pay for" than just being vaguely contented with a lack of audit failures. Developing a uniform set of audit quality indicators is one thing the PCAOB has not accomplished yet, and there's no telling if they ever will.*

The reason the above exercise is worth doing: in any financial standard-setting area, whether accounting standards or auditing standards, the "cost of a change" argument is always used as a justification by some parties for doing nothing. Without a doubt, that argument will be trotted out by opponents of this reporting proposal. The existing costs for auditors are fairly explicit, however. In this exercise, the cost information has been used to frame a level of tolerable (unnoticeable?) cost increase.

**That doesn't mean that the proposal is good or bad. It just means that when commenters start balking at a change – *any* change - because of "added costs," it's helpful to know how much additional cost might affect shareholders.**

[6] Prove it to yourself: open Excel and type .0049 into a cell with currency formatting set for two places. The result will be $.00. Change it .005, and the result will be $.01.

# Where 2012 Total Audit Fees Are Less Than $.01/Share

| *($ and shares in millions)* | Auditor | Diluted Shares | ($0.0049 x Shares)/65% | Current Total Fees | Incremental Potential | Incremental Potential % |
|---|---|---|---|---|---|---|
| Fastenal | KPMG | 297.2 | $2.24 | $0.69 | $1.55 | 226.4% |
| Lowe's | Deloitte | 1,152.0 | 8.68 | 2.99 | 5.69 | 190.0% |
| CSX | E&Y | 1,040.0 | 7.84 | 2.75 | 5.09 | 185.1% |
| Southwest Airlines | E&Y | 757.0 | 5.71 | 2.23 | 3.48 | 155.7% |
| Gilead Sciences | E&Y | 1,582.6 | 11.93 | 4.92 | 7.01 | 142.4% |
| Paychex | E&Y | 364.7 | 2.75 | 1.15 | 1.60 | 139.1% |
| Home Depot | KPMG | 1,511.0 | 11.39 | 4.84 | 6.55 | 135.5% |
| Altria Group | PwC | 2,024.0 | 15.26 | 6.50 | 8.76 | 134.7% |
| Progressive | PwC | 607.8 | 4.58 | 1.96 | 2.62 | 133.5% |
| Hudson City Bancorp | KPMG | 496.6 | 3.74 | 1.61 | 2.14 | 133.2% |
| Walgreen | Deloitte | 880.1 | 6.63 | 2.97 | 3.67 | 123.8% |
| Kimco Realty | PwC | 406.7 | 3.07 | 1.37 | 1.69 | 123.3% |
| Cisco Systems | PwC | 5,404.0 | 40.74 | 18.97 | 21.77 | 114.7% |
| Huntington Bancsh’s | Deloitte | 863.4 | 6.51 | 3.13 | 3.37 | 107.6% |
| Cabot Oil & Gas | PwC | 422.0 | 3.18 | 1.56 | 1.62 | 103.8% |
| Linear Technology | E&Y | 237.8 | 1.79 | 0.89 | 0.90 | 101.1% |
| Intel | E&Y | 5,160.0 | 38.90 | 19.58 | 19.32 | 98.7% |
| Frontier | KPMG | 991.8 | 7.48 | 3.94 | 3.54 | 90.0% |
| PulteGroup | E&Y | 384.6 | 2.90 | 1.54 | 1.36 | 88.7% |
| EMC | PwC | 2,205.6 | 16.63 | 8.82 | 7.81 | 88.5% |
| Cerner | KPMG | 351.4 | 2.65 | 1.44 | 1.20 | 83.3% |
| LSI Logic | PwC | 580.5 | 4.38 | 2.40 | 1.98 | 82.7% |
| AT&T | E&Y | 5,821.0 | 43.88 | 24.40 | 19.48 | 79.8% |
| Fifth Third Bancorp | Deloitte | 945.6 | 7.13 | 4.02 | 3.10 | 77.1% |
| Whole Foods Market | E&Y | 368.9 | 2.78 | 1.58 | 1.20 | 76.0% |
| D.R. Horton | PwC | 359.0 | 2.71 | 1.54 | 1.17 | 75.6% |
| Microsoft * | Deloitte | 8,470.0 | 63.85 | 36.86 | 26.99 | 73.2% |
| Dollar Tree | KPMG | 230.7 | 1.74 | 1.01 | 0.73 | 71.5% |
| Denbury Resources | PwC | 388.9 | 2.93 | 1.75 | 1.19 | 67.9% |
| Southwestern Energy | PwC | 348.6 | 2.63 | 1.61 | 1.02 | 63.3% |
| Oracle | E&Y | 4,844.0 | 36.52 | 22.54 | 13.98 | 62.0% |
| Kohl's | E&Y | 237.0 | 1.79 | 1.20 | 0.58 | 48.5% |
| Wal-Mart | E&Y | 3,389.0 | 25.55 | 17.52 | 8.03 | 45.8% |
| Corning | PwC | 1,506.0 | 11.35 | 7.85 | 3.50 | 44.6% |
| Nvidia Corporation | PwC | 625.0 | 4.71 | 3.27 | 1.44 | 43.9% |
| Regions Financial | E&Y | 1,387.0 | 10.46 | 7.34 | 3.11 | 42.4% |
| Comcast | Deloitte | 2,717.0 | 20.48 | 14.40 | 6.08 | 42.2% |
| Host Hotels & Resorts | KPMG | 719.6 | 5.42 | 3.85 | 1.58 | 40.9% |
| Applied Materials | KPMG | 1,277.0 | 9.63 | 6.96 | 2.66 | 38.3% |
| Delta Airlines | E&Y | 850.0 | 6.41 | 4.66 | 1.75 | 37.7% |

| | Auditor | Diluted Shares | ($0.0049 x Shares)/65% | Current Total Fees | Incremental Potential | Incremental Potential % |
|---|---|---|---|---|---|---|
| Boston Scientific | E&Y | 1,406.7 | $10.60 | $7.79 | $2.82 | 36.2% |
| Public Storage | E&Y | 171.7 | 1.29 | 0.96 | 0.34 | 35.5% |
| Hormel Foods | E&Y | 268.9 | 2.03 | 1.50 | 0.53 | 35.4% |
| Windstream | PwC | 584.5 | 4.41 | 3.26 | 1.14 | 35.1% |
| HCP | Deloitte | 428.3 | 3.23 | 2.42 | 0.81 | 33.6% |
| Republic Services | E&Y | 368.0 | 2.77 | 2.09 | 0.68 | 32.5% |
| Lorillard | Deloitte | 390.1 | 2.94 | 2.23 | 0.71 | 31.6% |
| Target | E&Y | 663.3 | 5.00 | 3.85 | 1.15 | 30.0% |
| ONEOK | PwC | 210.7 | 1.59 | 1.23 | 0.36 | 29.4% |
| Ross Stores | Deloitte | 222.8 | 1.68 | 1.31 | 0.37 | 28.5% |
| Equity Residential | E&Y | 319.8 | 2.41 | 1.89 | 0.52 | 27.3% |
| CarMax | KPMG | 231.8 | 1.75 | 1.37 | 0.37 | 27.1% |
| Altera | PwC | 324.5 | 2.45 | 1.94 | 0.51 | 26.2% |
| Noble Energy | KPMG | 360.0 | 2.71 | 2.16 | 0.56 | 25.9% |
| Pfizer | KPMG | 7,508.0 | 56.60 | 45.19 | 11.41 | 25.3% |
| Price, T. Rowe * | KPMG | 261.0 | 1.97 | 1.58 | 0.39 | 24.6% |
| QEP Resources | PwC | 178.7 | 1.35 | 1.11 | 0.24 | 21.3% |
| Dollar General | E&Y | 334.5 | 2.52 | 2.09 | 0.43 | 20.8% |
| Union Pacific | Deloitte | 476.5 | 3.59 | 3.02 | 0.58 | 19.1% |
| Broadcom | KPMG | 576.0 | 4.34 | 3.69 | 0.66 | 17.8% |
| Monster Beverage | Deloitte | 183.1 | 1.38 | 1.17 | 0.21 | 17.7% |
| Qualcomm | PwC | 1,741.0 | 13.12 | 11.17 | 1.96 | 17.6% |
| Bed Bath & Beyond | KPMG | 227.7 | 1.72 | 1.49 | 0.23 | 15.3% |
| U.S. Bancorp | E&Y | 1,896.0 | 14.29 | 12.40 | 1.89 | 15.3% |
| Starbucks | Deloitte | 773.0 | 5.83 | 5.10 | 0.73 | 14.3% |
| Forest Laboratories | BDO Seidman | 266.8 | 2.01 | 1.77 | 0.24 | 13.5% |
| Schwab, Charles | Deloitte | 1,275.0 | 9.61 | 8.50 | 1.11 | 13.1% |
| Urban Outfitters | Deloitte | 146.7 | 1.11 | 0.99 | 0.12 | 12.2% |
| Carnival | PwC | 779.0 | 5.87 | 5.30 | 0.57 | 10.8% |
| CVS Caremark | E&Y | 1,280.0 | 9.65 | 8.74 | 0.91 | 10.4% |
| Adobe Systems | KPMG | 502.7 | 3.79 | 3.44 | 0.35 | 10.2% |
| Wells Fargo | KPMG | 5,351.5 | 40.34 | 38.07 | 2.28 | 6.0% |
| People's United Fin’l. | KPMG | 338.4 | 2.55 | 2.41 | 0.14 | 5.7% |
| KeyCorp | E&Y | 943.3 | 7.11 | 6.76 | 0.35 | 5.2% |
| Yahoo! | PwC | 1,202.9 | 9.07 | 8.70 | 0.37 | 4.2% |
| Analog Devices | E&Y | 306.2 | 2.31 | 2.22 | 0.09 | 4.1% |
| Cintas | E&Y | 124.5 | 0.94 | 0.90 | 0.04 | 3.9% |
| Exxon Mobil * | PwC | 4,628.0 | 34.89 | 33.60 | 1.29 | 3.8% |
| TJX Companies | PwC | 747.6 | 5.64 | 5.50 | 0.13 | 2.4% |
| Crown Castle Intl | PwC | 291.3 | 2.20 | 2.19 | 0.00 | 0.1% |

***R.G. Associates, Inc. holding. See note on back page.** *Source, all tables this page: Fees - Audit Analytics, company proxy filings; shares – S&P Research Insight database.*

# Highest Dollar Potential Increases

| *($ and shares in millions)* | Auditor | Diluted Shares | (0.0049 x Shares)/65% | Current Total Fees | Incremental Potential % |
|---|---|---|---|---|---|
| Bank Of America | PwC | 10,840.9 | 81.7 | 104.4 | 78% |
| General Electric | KPMG | 10,564.0 | 79.6 | 92.5 | 86% |
| Coca-Cola | Deloitte | 4,584.0 | 34.6 | 35.2 | 98% |
| Ford | KPMG | 4,015.0 | 30.3 | 40.8 | 74% |
| JPMorgan Chase | E&Y | 3,822.2 | 28.8 | 83.6 | 34% |
| Merck | PwC | 3,076.0 | 23.2 | 33.4 | 69% |
| Citigroup | Deloitte | 3,015.5 | 22.7 | 84.3 | 27% |
| Procter & Gamble | E&Y | 2,930.6 | 22.1 | 33.5 | 66% |
| Verizon Communications | KPMG | 2,862.0 | 21.6 | 27.2 | 79% |
| Johnson & Johnson | PwC | 2,812.6 | 21.2 | 44.0 | 48% |

The table at left shows the firms with a potential increase of more than 20 million in total audit fees before affecting EPS by another penny. Obviously, these are some of the largest firms in the S&P 500 by any measurey – but their huge shares outstanding make large audit fee increases possible without affecting shareholders. Below: the 30 S&P 500 firms with the largest percentage difference from their current total audit fees, *if* the fees were raised by 0.0049 per share.

# Greatest Percentage Change From 2012 Total Fees

| *($ and shares in millions)* | Auditor | Diluted Shares | (0.0049 x Shares)/65% | Current Total Fees | Incremental Potential % |
|---|---|---|---|---|---|
| Vertex Pharmaceuticals | KPMG | 211.9 | 1.60 | 1.60 | 99.8% |
| Express Scripts | KPMG | 747.3 | 5.63 | 5.72 | 98.5% |
| Medtronic | PwC | 1,027.5 | 7.75 | 7.88 | 98.3% |
| Reynolds American | PwC | 567.9 | 4.28 | 4.36 | 98.3% |
| Coca-Cola | Deloitte | 4,584.0 | 34.56 | 35.23 | 98.1% |
| Bristol-Myers Squibb | PwC | 1,688.0 | 12.72 | 13.04 | 97.6% |
| Wisconsin Energy | E&Y | 232.8 | 1.75 | 1.80 | 97.4% |
| Micron Technology | E&Y | 991.2 | 7.47 | 7.70 | 97.0% |
| Brown-Forman | Deloitte | 215.0 | 1.62 | 1.67 | 96.8% |
| Red Hat | PwC | 195.8 | 1.48 | 1.53 | 96.5% |
| Norfolk Southern | Deloitte | 325.2 | 2.45 | 2.55 | 96.1% |
| Apple | E&Y | 945.4 | 7.13 | 7.46 | 95.5% |
| Amgen | E&Y | 787.0 | 5.93 | 6.27 | 94.7% |
| Texas Instruments | E&Y | 1,146.0 | 8.64 | 9.15 | 94.5% |
| CME Group | E&Y | 332.3 | 2.51 | 2.78 | 90.2% |

| | Auditor | Diluted Shares | (0.0049 x Shares)/65% | Current Total Fees | Incremental Potential % |
|---|---|---|---|---|---|
| Kroger | PwC | 536.6 | 4.05 | 4.49 | 90.2% |
| EOG Resources | Deloitte | 270.8 | 2.04 | 2.28 | 89.4% |
| Lilly, Eli & Co. | E&Y | 1,117.3 | 8.42 | 9.50 | 88.7% |
| Sysco | KPMG | 592.7 | 4.47 | 5.07 | 88.1% |
| TripAdvisor | KPMG | 141.3 | 1.07 | 1.22 | 87.5% |
| Ventas | PwC | 294.5 | 2.22 | 2.56 | 86.8% |
| General Electric | KPMG | 10,564.0 | 79.64 | 92.50 | 86.1% |
| Family Dollar Stores | PwC | 118.1 | 0.89 | 1.04 | 85.8% |
| DirecTV | Deloitte | 644.0 | 4.85 | 5.72 | 84.9% |
| Plum Creek Timber | PwC | 161.9 | 1.22 | 1.44 | 84.7% |
| eBay | E&Y | 1,313.0 | 9.90 | 11.72 | 84.5% |
| Regeneron Pharmaceuticals | PwC | 115.4 | 0.87 | 1.05 | 82.6% |
| Weyerhaeuser | E&Y | 542.3 | 4.09 | 5.03 | 81.3% |
| Health Care REIT | KPMG | 226.0 | 1.70 | 2.11 | 80.8% |
| Xilinx | PwC | 272.6 | 2.05 | 2.55 | 80.5% |

## III. What Next?

The comment period for the PCAOB's proposal closes on December 11, 2013. So far, there are few comments – but that's typical. The bulk of comments on proposals like this usually arrive in the last days of the comment period - and very often, in the week following the comment period's close.

Should investors care enough to peck out a response? The answer is a guarded "yes." What's actually proposed in the document is of much lower strength than the proposals put forth in the 2011 concept release, but that doesn't make them worthless. The most controversial part of that release was the call for an "Auditor's Discussion & Analysis," which was widely disliked, yet would have presented a point of view that should properly be symmetrical with that of the shareholders. So it is with the AD&A's direct descendant, the "Critical Audit Matters" part of this proposal. It won't be the auditors supporting this – if investors want it, they're going to have to provide the support for it. The Critical Audit Matters section is not going to happen by default.

One point of the AD&A critics was that it could all too easily become a "phonebook[7]" – full of facts, long in volume but holding little true information. That was a valid concern about the AD&A, and it's a valid concern about its direct descendant, the "Critical Audit Matters" section put forth in the current proposal. The "Critical Audit Matters" is the single most important change proposed: narrower in scope the AD&A, it should cut directly to the heart of matters. Maybe the auditor's interests are not always be aligned with the investor's interests – but the investor is always interested in the auditor's point of view.

*There's "phonebook potential" in the Critical Audit Matters presentation, for sure. Yet that doesn't hold up as a reason not to give it a try. Any financial reporting disclosure has the potential to be lame boilerplate when it's not executed conscientiously. It would be ridiculous to argue that no disclosures should ever be made just because they could be neutralized by semi-malicious intent. Besides, with the PCAOB conducting examinations of audits, investors would have to hope their presence might prevent firms from going down the path of seemingly safe, say-nothing reports on CAMs.*

Beyond the proposal to present critical audit matters, the remainder of the proposal doesn't bring much new information to investors. The auditor tenure data is new information, but it surely isn't information that will directly lead to investor action. The proposal can't be criticized for clarifying auditor independence, or criticized for more clearly stating the auditor's responsibility related to misstatements due to error or fraud. Nor can it be criticized for better stating the auditor's responsibility for other financial information. It's hard to get too worked up about these improvements, however. They seem to be minute changes that should have been done long ago; it's hard to call them ground-breaking.

**You might call the Critical Audit Matters ground-breaking, however – which is exactly why it will be stoutly opposed by the auditing community. We'll know how much they opposed it, in roughly another month.**

[7] "Phonebook" is a somewhat anachronistic term. In pre-internet days, telephone companies published thick, weighty books listing the phone numbers of people with telephones in a certain locale, including their legal names and addresses. Ripping them in half was a test of strength for body-builders, in fact. It is used here to denote a thick hard-to-read book, in much the same way the term "Sears catalogue" was once used.

# Appendix: 2012 Audit And Audit-Related Fees, By Industry & Auditor

| *( in millions)* | PwC | | Ernst & Young | | Deloitte & Touche | | KPMG | | BDO Seidman | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees |
| **Automobiles & Components** | | | | | | | | | | |
| BorgWarner | 5.4 | 0.1% | | | | | | | | |
| Delphi Automotive | | | 13.3 | 0.3% | | | | | | |
| Ford | 40.8 | 0.8% | | | | | | | | |
| General Motors | | | | | 42.0 | 0.9% | | | | |
| Goodyear Tire | 14.9 | 0.3% | | | | | | | | |
| Harley-Davidson | | | | | | | 3.0 | 0.1% | | |
| Johnson Controls | 24.5 | 0.5% | | | | | | | | |
| **Automobiles & Components Total** | **85.6** | **1.8%** | **13.3** | **0.3%** | **42.0** | **0.9%** | **3.0** | **0.1%** | | |
| **Banks** | | | | | | | | | | |
| BB&T | 9.1 | 0.2% | | | | | | | | |
| Comerica | | | 2.2 | 0.0% | | | | | | |
| Fifth Third Bancorp | | | | | 4.0 | 0.1% | | | | |
| Hudson City Bancorp | | | | | | | 1.6 | 0.0% | | |
| Huntington Bancshares | | | | | 3.1 | 0.1% | | | | |
| KeyCorp | | | 6.8 | 0.1% | | | | | | |
| M&T Bank * | 3.7 | 0.1% | | | | | | | | |
| People's United Financial Inc. | | | | | | | 2.4 | 0.0% | | |
| PNC Fin'l Services | 21.8 | 0.4% | | | | | | | | |
| Regions Financial | | | 7.3 | 0.2% | | | | | | |
| Suntrust Banks | | | 9.4 | 0.2% | | | | | | |
| U.S. Bancorp | | | 12.4 | 0.3% | | | | | | |
| Wells Fargo | | | | | | | 38.1 | 0.8% | | |
| Zions Bancorp | | | 4.5 | 0.1% | | | | | | |
| **Banks Total** | **34.6** | **0.7%** | **42.6** | **0.9%** | **7.2** | **0.1%** | **42.1** | **0.9%** | | |
| **Capital Goods** | | | | | | | | | | |
| 3M * | 14.4 | 0.3% | | | | | | | | |
| Ametek | | | 4.8 | 0.1% | | | | | | |
| Boeing | | | | | 26.4 | 0.5% | | | | |
| Caterpillar | 34.7 | 0.7% | | | | | | | | |
| Cummins | 10.0 | 0.2% | | | | | | | | |
| Danaher | | | 16.9 | 0.3% | | | | | | |
| Deere | | | | | 16.0 | 0.3% | | | | |
| Dover | 7.3 | 0.2% | | | | | | | | |
| Eaton | | | 24.4 | 0.5% | | | | | | |
| Emerson Electric | | | | | | | 30.9 | 0.6% | | |
| Fastenal | | | | | | | 0.7 | 0.0% | | |
| Flowserve | 8.8 | 0.2% | | | | | | | | |
| Fluor | | | 7.8 | 0.2% | | | | | | |
| General Dynamics | | | | | | | 21.0 | 0.4% | | |
| General Electric | | | | | | | 92.5 | 1.9% | | |
| Grainger W.W. | | | 3.0 | 0.1% | | | | | | |
| Honeywell | 21.8 | 0.4% | | | | | | | | |
| Illinois Tool Works | | | | | 17.6 | 0.4% | | | | |
| Ingersoll-Rand | 15.8 | 0.3% | | | | | | | | |
| Jacobs Engineering | | | 6.8 | 0.1% | | | | | | |
| Joy Global | | | 3.3 | 0.1% | | | | | | |
| L-3 Communications Holdings | 17.6 | 0.4% | | | | | | | | |
| Lockheed Martin | | | 16.5 | 0.3% | | | | | | |
| Masco | 8.9 | 0.2% | | | | | | | | |
| Northrop Grumman | | | | | 14.1 | 0.3% | | | | |
| Paccar | | | 6.6 | 0.1% | | | | | | |
| Pall | | | | | | | 7.8 | 0.2% | | |
| Parker Hannifin | | | | | 8.9 | 0.2% | | | | |
| Pentair | | | | | 13.5 | 0.3% | | | | |
| Precision Castparts | | | | | 8.4 | 0.2% | | | | |
| Quanta Services | 3.9 | 0.1% | | | | | | | | |
| Raytheon | 11.5 | 0.2% | | | | | | | | |
| Rockwell Automation | | | | | 5.6 | 0.1% | | | | |
| Rockwell Collins | | | | | 3.9 | 0.1% | | | | |
| Roper Industries | 4.7 | 0.1% | | | | | | | | |
| Snap-On | | | | | 3.6 | 0.1% | | | | |
| Stanley Black & Decker | | | 13.4 | 0.3% | | | | | | |
| Textron | | | 7.7 | 0.2% | | | | | | |
| United Technologies | 53.8 | 1.1% | | | | | | | | |
| Xylem | | | | | 8.8 | 0.2% | | | | |
| **Capital Goods Total** | **213.2** | **4.4%** | **111.2** | **2.3%** | **126.7** | **2.6%** | **152.9** | **3.2%** | | |
| **Commercial & Prof. Services** | | | | | | | | | | |

| ( in millions) | PwC Fees | PwC % Fees | Ernst & Young Fees | Ernst & Young % Fees | Deloitte & Touche Fees | Deloitte & Touche % Fees | KPMG Fees | KPMG % Fees | BDO Seidman Fees | BDO Seidman % Fees |
|---|---|---|---|---|---|---|---|---|---|---|
| Avery Dennison | 5.2 | 0.1% | | | | | | | | |
| Cintas | | | 0.9 | 0.0% | | | | | | |
| Dun & Bradstreet | 6.1 | 0.1% | | | | | | | | |
| Equifax | | | 3.8 | 0.1% | | | | | | |
| Iron Mountain Inc. | | | | | 6.6 | 0.1% | | | | |
| Nielsen Holdings | | | 7.0 | 0.1% | | | | | | |
| Pitney Bowes | 7.2 | 0.1% | | | | | | | | |
| Republic Services | | | 2.1 | 0.0% | | | | | | |
| Robert Half | 1.9 | 0.0% | | | | | | | | |
| Stericycle | | | 1.4 | 0.0% | | | | | | |
| Tyco International | | | | | 41.3 | 0.9% | | | | |
| Waste Management | | | 7.1 | 0.1% | | | | | | |
| **Commercial & Prof. Services Total** | **20.4** | **0.4%** | **22.3** | **0.5%** | **47.9** | **1.0%** | | | | |
| **Consumer Durables & Apparel** | | | | | | | | | | |
| Coach | | | | | 3.1 | 0.1% | | | | |
| D.R. Horton | 1.5 | 0.0% | | | | | | | | |
| Fossil | | | | | 2.8 | 0.1% | | | | |
| Garmin | | | 2.8 | 0.1% | | | | | | |
| Harman International | | | | | | | 5.2 | 0.1% | | |
| Hasbro | | | | | | | 4.4 | 0.1% | | |
| Leggett & Platt | 1.9 | 0.0% | | | | | | | | |
| Lennar | | | | | 3.4 | 0.1% | | | | |
| Mattel | 7.4 | 0.2% | | | | | | | | |
| Newell Rubbermaid * | | | 8.9 | 0.2% | | | | | | |
| Nike | 12.4 | 0.3% | | | | | | | | |
| PulteGroup | | | 1.5 | 0.0% | | | | | | |
| PVH | | | 4.0 | 0.1% | | | | | | |
| Ralph Lauren | | | 3.7 | 0.1% | | | | | | |
| VF Corp * | 5.4 | 0.1% | | | | | | | | |
| Whirlpool | | | 10.4 | 0.2% | | | | | | |
| **Consumer Durables & Apparel Total** | **28.7** | **0.6%** | **31.4** | **0.6%** | **9.3** | **0.2%** | **9.6** | **0.2%** | | |
| **Consumer Services** | | | | | | | | | | |
| Block, H&R | | | | | 3.2 | 0.1% | | | | |
| Carnival | 5.3 | 0.1% | | | | | | | | |
| Chipotle Mexican Grill | | | 0.6 | 0.0% | | | | | | |
| Darden Restaurants | | | | | | | 2.0 | 0.0% | | |
| Int'l Game Technology | 3.5 | 0.1% | | | | | | | | |
| Marriott | | | 6.3 | 0.1% | | | | | | |
| McDonald's * | | | 12.0 | 0.2% | | | | | | |
| Starbucks | | | | | 5.1 | 0.1% | | | | |
| Starwood | | | 7.1 | 0.1% | | | | | | |
| Wyndham Worldwide | | | | | 8.5 | 0.2% | | | | |
| Wynn Resorts | | | 1.8 | 0.0% | | | | | | |
| Yum! Brands | | | | | | | 6.8 | 0.1% | | |
| **Consumer Services Total** | **8.8** | **0.2%** | **27.8** | **0.6%** | **16.8** | **0.3%** | **8.9** | **0.2%** | | |
| **Diversified Financials** | | | | | | | | | | |
| American Express | 23.3 | 0.5% | | | | | | | | |
| Ameriprise Financial | 9.1 | 0.2% | | | | | | | | |
| Bank Of America | 104.4 | 2.2% | | | | | | | | |
| Bank Of New York Mellon | | | | | | | 31.5 | 0.7% | | |
| BlackRock | | | | | 20.3 | 0.4% | | | | |
| Capital One Financial | | | 12.5 | 0.3% | | | | | | |
| Citigroup | | | | | | | 84.3 | 1.7% | | |
| CME Group | | | 2.8 | 0.1% | | | | | | |
| Discover Financial Services | | | | | 6.7 | 0.1% | | | | |
| E*Trade Financial | | | | | 5.8 | 0.1% | | | | |
| Franklin Resources | 7.8 | 0.2% | | | | | | | | |
| Goldman Sachs Group | 63.7 | 1.3% | | | | | | | | |
| Intercontinental Exchange | | | 4.7 | 0.1% | | | | | | |
| Invesco | | | 6.6 | 0.1% | | | | | | |
| JPMorgan Chase | 83.6 | 1.7% | | | | | | | | |
| Legg Mason | 8.6 | 0.2% | | | | | | | | |
| Leucadia National Corp | 2.8 | 0.1% | | | | | | | | |
| McGraw-Hill Financial * | | | 10.1 | 0.2% | | | | | | |
| Moody's | | | | | | | 2.5 | 0.1% | | |
| Morgan Stanley | | | | | 53.7 | 1.1% | | | | |
| NASDAQ OMX | | | 6.8 | 0.1% | | | | | | |
| Northern Trust | | | | | | | 6.4 | 0.1% | | |
| NYSE Euronext | 6.9 | 0.1% | | | | | | | | |
| Price, T. Rowe * | | | | | | | 1.6 | 0.0% | | |

| ( in millions) | PwC | | Ernst & Young | | Deloitte & Touche | | KPMG | | BDO Seidman | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees |
| Schwab, Charles | | | | | 8.5 | 0.2% | | | | |
| SLM Corporation | | | | | | | 5.1 | 0.1% | | |
| State Street | | | 33.7 | 0.7% | | | | | | |
| **Diversified Financials Total** | **310.2** | **6.4%** | **77.3** | **1.6%** | **95.0** | **2.0%** | **131.5** | **2.7%** | | |
| **Energy** | | | | | | | | | | |
| Anadarko Petroleum | | | | | | | 6.9 | 0.1% | | |
| Apache | | | 6.5 | 0.1% | | | | | | |
| Baker Hughes | | | | | 19.0 | 0.4% | | | | |
| Cabot Oil & Gas Corp. | 1.6 | 0.0% | | | | | | | | |
| Cameron International | | | 4.7 | 0.1% | | | | | | |
| Chesapeake Energy | 7.2 | 0.1% | | | | | | | | |
| Chevron | 27.2 | 0.6% | | | | | | | | |
| Conoco Phillips | | | 17.7 | 0.4% | | | | | | |
| CONSOL Energy | | | 2.4 | 0.1% | | | | | | |
| Denbury Resources | 1.7 | 0.0% | | | | | | | | |
| Devon Energy | | | | | | | 4.1 | 0.1% | | |
| Diamond Offshore Drilling | | | | | 1.5 | 0.0% | | | | |
| Ensco | | | | | | | 3.6 | 0.1% | | |
| EOG Resources | | | | | 2.3 | 0.0% | | | | |
| EQT Corp | | | 2.3 | 0.0% | | | | | | |
| Exxon Mobil * | 33.6 | 0.7% | | | | | | | | |
| FMC Technologies | | | | | | | 5.9 | 0.1% | | |
| Halliburton | | | | | | | 13.3 | 0.3% | | |
| Helmerich & Payne | | | 1.5 | 0.0% | | | | | | |
| Hess Corporation | | | 12.0 | 0.2% | | | | | | |
| Kinder Morgan | 10.0 | 0.2% | | | | | | | | |
| Marathon Oil | 7.9 | 0.2% | | | | | | | | |
| Marathon Petroleum | 6.9 | 0.1% | | | | | | | | |
| Murphy Oil | | | | | | | 5.0 | 0.1% | | |
| Nabors Industries | 4.7 | 0.1% | | | | | | | | |
| National Oilwell Varco | | | 8.3 | 0.2% | | | | | | |
| Newfield Exploration | 2.1 | 0.0% | | | | | | | | |
| Noble | 5.3 | 0.1% | | | | | | | | |
| Noble Energy | | | | | | | 2.2 | 0.0% | | |
| Occidental | | | | | | | 10.4 | 0.2% | | |
| Peabody Energy | | | 5.9 | 0.1% | | | | | | |
| Phillips 66 | | | 11.8 | 0.2% | | | | | | |
| Pioneer Natual Resources | | | 3.3 | 0.1% | | | | | | |
| QEP Resources | 1.1 | 0.0% | | | | | | | | |
| Range Resources | | | 1.5 | 0.0% | | | | | | |
| Rowan | | | | | 1.8 | 0.0% | | | | |
| Schlumberger | 15.6 | 0.3% | | | | | | | | |
| Southwestern Energy | 1.6 | 0.0% | | | | | | | | |
| Spectra Energy | | | | | 7.1 | 0.1% | | | | |
| Tesoro Petroleum | | | 4.3 | 0.1% | | | | | | |
| Valero Energy | | | | | | | 10.3 | 0.2% | | |
| Williams Companies | | | 11.6 | 0.2% | | | | | | |
| WPX Energy | | | 4.7 | 0.1% | | | | | | |
| **Energy Total** | **126.5** | **2.6%** | **98.5** | **2.0%** | **31.7** | **0.7%** | **61.6** | **1.3%** | | |
| **Food & Staples Retailing** | | | | | | | | | | |
| Costco | | | | | | | 5.2 | 0.1% | | |
| CVS Caremark | | | 8.7 | 0.2% | | | | | | |
| Kroger | 4.5 | 0.1% | | | | | | | | |
| Safeway | | | | | 8.0 | 0.2% | | | | |
| Sysco | | | 5.1 | 0.1% | | | | | | |
| Wal Mart Stores | | | 17.5 | 0.4% | | | | | | |
| Walgreen | | | | | 3.0 | 0.1% | | | | |
| Whole Foods Market | | | 1.6 | 0.0% | | | | | | |
| **Food & Staples Retailing Total** | **4.5** | **0.1%** | **32.9** | **0.7%** | **11.0** | **0.2%** | **5.2** | **0.1%** | | |
| **Food Beverage & Tobacco** | | | | | | | | | | |
| Altria Group | 6.5 | 0.1% | | | | | | | | |
| Archer Daniels Midland | | | 15.0 | 0.3% | | | | | | |
| Beam | 3.7 | 0.1% | | | | | | | | |
| Brown-Forman | 1.7 | 0.0% | | | | | | | | |
| Campbell Soup | 4.2 | 0.1% | | | | | | | | |
| Coca-Cola | | | 35.2 | 0.7% | | | | | | |
| Coca-Cola Enterprises | | | 4.4 | 0.1% | | | | | | |
| ConAgra | | | | | | | 7.5 | 0.2% | | |
| Constellation Brands | | | | | | | 3.9 | 0.1% | | |
| Dr. Pepper | | | | | 3.4 | 0.1% | | | | |

| ( in millions) | PwC | | Ernst & Young | | Deloitte & Touche | | KPMG | | BDO Seidman | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees |
| General Mills | | | | | | | 7.8 | 0.2% | | |
| Hershey Foods | | | | | | | 5.2 | 0.1% | | |
| Hormel Foods | | | 1.5 | 0.0% | | | | | | |
| Kellogg | 9.1 | 0.2% | | | | | | | | |
| Lorillard | | | | | 2.2 | 0.0% | | | | |
| McCormick | | | 4.2 | 0.1% | | | | | | |
| Mead Johnson Nutrition | | | | | 3.5 | 0.1% | | | | |
| Molson Coors | 3.9 | 0.1% | | | | | | | | |
| Mondelez | 18.8 | 0.4% | | | | | | | | |
| Monster Beverage | | | | | 1.2 | 0.0% | | | | |
| Pepsico * | | | | | | | 26.1 | 0.5% | | |
| Philip Morris International | 23.3 | 0.5% | | | | | | | | |
| Reynolds American | | | | | | | 4.4 | 0.1% | | |
| Smucker, J.M. Company | | | 2.5 | 0.1% | | | | | | |
| Tyson | 4.0 | 0.1% | | | | | | | | |
| **Food Beverage & Tobacco Total** | **75.1** | **1.5%** | **62.9** | **1.3%** | **10.3** | **0.2%** | **54.8** | **1.1%** | | |
| **Health Care Equip. & Services** | | | | | | | | | | |
| Abbott Labs * | | | | | 27.1 | 0.6% | | | | |
| Aetna | | | | | | | 10.4 | 0.2% | | |
| AmeriSource Bergen | | | 4.3 | 0.1% | | | | | | |
| Bard, C.R. | | | | | | | 4.1 | 0.1% | | |
| Baxter Int'l | 10.0 | 0.2% | | | | | | | | |
| Becton Dickinson | | | 7.8 | 0.2% | | | | | | |
| Boston Scientific | | | 7.8 | 0.2% | | | | | | |
| Cardinal Health | | | 7.1 | 0.1% | | | | | | |
| Carefusion | | | 4.5 | 0.1% | | | | | | |
| Cerner | | | | | | | 1.4 | 0.0% | | |
| CIGNA | 10.0 | 0.2% | | | | | | | | |
| Covidien | | | | | 17.2 | 0.4% | | | | |
| DaVita | | | | | | | 6.4 | 0.1% | | |
| DENTSPLY International | 3.7 | 0.1% | | | | | | | | |
| Edwards Lifesciences | 2.3 | 0.0% | | | | | | | | |
| Express Scripts | 5.7 | 0.1% | | | | | | | | |
| Humana | 6.2 | 0.1% | | | | | | | | |
| Intuitive Sugical | | | 1.8 | 0.0% | | | | | | |
| Laboratory Corp of America | 1.5 | 0.0% | | | | | | | | |
| McKesson | | | | | 11.5 | 0.2% | | | | |
| Medtronic | 7.9 | 0.2% | | | | | | | | |
| Patterson Companies | | | 1.5 | 0.0% | | | | | | |
| Quest Diagnostics | 3.4 | 0.1% | | | | | | | | |
| St. Jude Medical | | | 6.6 | 0.1% | | | | | | |
| Stryker | | | 6.9 | 0.1% | | | | | | |
| Tenet Healthcare | | | | | 5.3 | 0.1% | | | | |
| United Health Group | | | | | 26.9 | 0.6% | | | | |
| Varian Medical Systems | 3.8 | 0.1% | | | | | | | | |
| Wellpoint | | | 11.4 | 0.2% | | | | | | |
| Zimmer Holdings | 4.2 | 0.1% | | | | | | | | |
| **Health Care Equip. & Services Total** | **58.7** | **1.2%** | **59.7** | **1.2%** | **88.0** | **1.8%** | **22.3** | **0.5%** | | |
| **Household & Personal Products** | | | | | | | | | | |
| Avon Products | 10.2 | 0.2% | | | | | | | | |
| Clorox | | | 4.4 | 0.1% | | | | | | |
| Colgate-Palmolive * | 11.2 | 0.2% | | | | | | | | |
| Kimberly Clark | | | | | 11.5 | 0.2% | | | | |
| Lauder Estee | | | | | | | 7.0 | 0.1% | | |
| Procter & Gamble | | | | | 33.5 | 0.7% | | | | |
| **Household & Pers. Products Total** | **21.4** | **0.4%** | **4.4** | **0.1%** | **45.0** | **0.9%** | **7.0** | **0.1%** | | |
| **Insurance** | | | | | | | | | | |
| ACE | 18.2 | 0.4% | | | | | | | | |
| AFLAC | | | | | | | 6.5 | 0.1% | | |
| Allstate | | | | | 10.4 | 0.2% | | | | |
| American Int'l Group | 88.5 | 1.8% | | | | | | | | |
| AON | | | 20.5 | 0.4% | | | | | | |
| Assurant | 12.1 | 0.2% | | | | | | | | |
| Berkshire Hathaway * | | | | | 28.0 | 0.6% | | | | |
| Chubb | | | 8.7 | 0.2% | | | | | | |
| Cincinnati Financial | | | | | 2.2 | 0.0% | | | | |
| Genworth Financial | | | | | | | 12.1 | 0.2% | | |
| Hartford Finl. | | | | | 19.1 | 0.4% | | | | |
| Lincoln National | | | 10.3 | 0.2% | | | | | | |
| Loews | | | | | 19.3 | 0.4% | | | | |

| ( in millions) | PwC Fees | PwC % Fees | Ernst & Young Fees | Ernst & Young % Fees | Deloitte & Touche Fees | Deloitte & Touche % Fees | KPMG Fees | KPMG % Fees | BDO Seidman Fees | BDO Seidman % Fees |
|---|---|---|---|---|---|---|---|---|---|---|
| Marsh & McLennan | | | | | 25.7 | 0.5% | | | | |
| MetLife | | | | | 77.0 | 1.6% | | | | |
| Principal Financial Group | | | 8.5 | 0.2% | | | | | | |
| Progressive | 2.0 | 0.0% | | | | | | | | |
| Prudential Financial | 47.0 | 1.0% | | | | | | | | |
| Torchmark | | | | | 3.2 | 0.1% | | | | |
| Travelers Companies | | | | | | | 9.0 | 0.2% | | |
| UNM Group | | | 8.6 | 0.2% | | | | | | |
| XL Capital | 13.8 | 0.3% | | | | | | | | |
| **Insurance Total** | **181.6** | **3.7%** | **56.6** | **1.2%** | **185.0** | **3.8%** | **27.5** | **0.6%** | | |
| **Materials** | | | | | | | | | | |
| Air Products & Chemicals | | | | | | | 6.7 | 0.1% | | |
| Airgas | | | | | | | 2.2 | 0.0% | | |
| Alcoa | 14.0 | 0.3% | | | | | | | | |
| Allegheny Technologies | | | 3.7 | 0.1% | | | | | | |
| Ball | 6.6 | 0.1% | | | | | | | | |
| Bemis * | 3.9 | 0.1% | | | | | | | | |
| CF Industries | | | | | | | 2.8 | 0.1% | | |
| Cliff Natural Resources | | | | | 3.9 | 0.1% | | | | |
| Dow Chemical | | | | | 27.0 | 0.6% | | | | |
| Du Pont | 20.7 | 0.4% | | | | | | | | |
| Eastman Chemical | 8.6 | 0.2% | | | | | | | | |
| Ecolab | 12.2 | 0.3% | | | | | | | | |
| FMC | | | | | | | 2.9 | 0.1% | | |
| Freeport McMoran | | | 9.3 | 0.2% | | | | | | |
| Int'l Flav. & Frag. | 5.2 | 0.1% | | | | | | | | |
| Int'l Paper | | | | | 20.7 | 0.4% | | | | |
| LyondellBasell | 10.3 | 0.2% | | | | | | | | |
| MeadWestVaco | 7.5 | 0.2% | | | | | | | | |
| Monsanto | | | | | 10.2 | 0.2% | | | | |
| Mosaic | | | | | | | 5.4 | 0.1% | | |
| Newmont Mining | 6.7 | 0.1% | | | | | | | | |
| Nucor | 3.4 | 0.1% | | | | | | | | |
| Owens-Illinois Inc. | | | 6.9 | 0.1% | | | | | | |
| PPG Industries | | | | | 8.7 | 0.2% | | | | |
| Praxair | 6.7 | 0.1% | | | | | | | | |
| Sealed Air | | | | | | | 11.5 | 0.2% | | |
| Sherwin-Williams | | | 3.6 | 0.1% | | | | | | |
| Sigma-Aldrich | | | | | | | 3.0 | 0.1% | | |
| U.S. Steel | 5.1 | 0.1% | | | | | | | | |
| Vulcan Materials | | | | | 3.3 | 0.1% | | | | |
| **Materials Total** | **110.8** | **2.3%** | **23.5** | **0.5%** | **73.8** | **1.5%** | **34.5** | **0.7%** | | |
| **Media** | | | | | | | | | | |
| Cablevision Systems | | | | | | | 4.7 | 0.1% | | |
| CBS | 9.6 | 0.2% | | | | | | | | |
| Comcast | | | | | 14.4 | 0.3% | | | | |
| DirecTV | | | | | 5.7 | 0.1% | | | | |
| Discovery Communications | 4.5 | 0.1% | | | | | | | | |
| Disney | 21.3 | 0.4% | | | | | | | | |
| Gannett | | | 3.8 | 0.1% | | | | | | |
| Interpublic | 31.9 | 0.7% | | | | | | | | |
| Omnicom Group | | | | | | | 23.6 | 0.5% | | |
| Scripps Networks Interactive | | | | | 1.9 | 0.0% | | | | |
| Time Warner | | | 17.3 | 0.4% | | | | | | |
| Time Warner Cable | | | 6.2 | 0.1% | | | | | | |
| Twenty-First Century Fox | | | 31.7 | 0.7% | | | | | | |
| Viacom | 13.0 | 0.3% | | | | | | | | |
| Washington Post | 4.2 | 0.1% | | | | | | | | |
| **Media Total** | **84.5** | **1.7%** | **58.9** | **1.2%** | **22.0** | **0.5%** | **28.4** | **0.6%** | | |
| **Pharma., Biotech. & Life Sciences** | | | | | | | | | | |
| Actavis | 13.4 | 0.3% | | | | | | | | |
| Agilent Technologies | 6.4 | 0.1% | | | | | | | | |
| Alexion Parma. | 2.2 | 0.0% | | | | | | | | |
| Allergan | | | 5.1 | 0.1% | | | | | | |
| Amgen | | | 6.3 | 0.1% | | | | | | |
| Biogen IDEC | 4.2 | 0.1% | | | | | | | | |
| Bristol-Myers Squibb | | | | | 13.0 | 0.3% | | | | |
| Celgene | | | | | | | 5.5 | 0.1% | | |
| Forest Laboratories | | | | | | | | | 1.8 | 0.0% |
| Gilead Sciences | | | 4.9 | 0.1% | | | | | | |

| ( in millions) | PwC | | Ernst & Young | | Deloitte & Touche | | KPMG | | BDO Seidman | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees | Fees | % Fees |
| Hospira | | | | | 4.1 | 0.1% | | | | |
| Johnson & Johnson | 44.0 | 0.9% | | | | | | | | |
| Life Technologies | | | 4.9 | 0.1% | | | | | | |
| Lilly, Eli & Co. | | | 9.5 | 0.2% | | | | | | |
| Merck | 33.4 | 0.7% | | | | | | | | |
| Mylan Laboratories | | | | | 5.8 | 0.1% | | | | |
| PerkinElmer | | | | | 4.1 | 0.1% | | | | |
| Perrigo | | | 3.1 | 0.1% | | | | | | |
| Pfizer | | | | | | | 45.2 | 0.9% | | |
| Regeneron Pharmaceuticals | 1.1 | 0.0% | | | | | | | | |
| Thermo Electron | 14.1 | 0.3% | | | | | | | | |
| Vertex Pharmaceuticals | | | 1.6 | 0.0% | | | | | | |
| Waters | 3.4 | 0.1% | | | | | | | | |
| Zoetis | | | | | | | 6.4 | 0.1% | | |
| **Pharma., Biotech. & Life Sciences Total** | **122.1** | **2.5%** | **35.4** | **0.7%** | **27.1** | **0.6%** | **57.1** | **1.2%** | **1.8** | **0.0%** |
| **Real Estate** | | | | | | | | | | |
| American Tower | | | | | 6.6 | 0.1% | | | | |
| Apartment Invt. & Mgmt. | | | 2.2 | 0.0% | | | | | | |
| AvalonBay | | | 1.8 | 0.0% | | | | | | |
| Boston Properties | 1.8 | 0.0% | | | | | | | | |
| CBRE Group | | | | | | | 8.5 | 0.2% | | |
| Equity Residential | | | 1.9 | 0.0% | | | | | | |
| HCP | | | | | 2.4 | 0.0% | | | | |
| Health Care REIT | | | 2.1 | 0.0% | | | | | | |
| Host Hotels & Resorts | | | | | | | 3.8 | 0.1% | | |
| Kimco Realty | 1.4 | 0.0% | | | | | | | | |
| Macerich | | | | | | | 3.1 | 0.1% | | |
| Plum Creek Timber | | | 1.4 | 0.0% | | | | | | |
| Prologis | | | | | | | 4.5 | 0.1% | | |
| Public Storage | | | 1.0 | 0.0% | | | | | | |
| Simon Property Group | | | 8.2 | 0.2% | | | | | | |
| Ventas | | | 2.6 | 0.1% | | | | | | |
| Vornado Realty Trust | | | | | 6.7 | 0.1% | | | | |
| Weyerhaeuser | | | | | | | 5.0 | 0.1% | | |
| **Real Estate Total** | **3.1** | **0.1%** | **21.2** | **0.4%** | **15.7** | **0.3%** | **25.0** | **0.5%** | | |
| **Retailing** | | | | | | | | | | |
| Abercrombie & Fitch | 2.6 | 0.1% | | | | | | | | |
| Amazon.com | | | 7.2 | 0.1% | | | | | | |
| AutoNation | | | | | | | 2.4 | 0.0% | | |
| AutoZone | | | 1.7 | 0.0% | | | | | | |
| Bed Bath & Beyond | | | | | | | 1.5 | 0.0% | | |
| Best Buy | | | | | 6.3 | 0.1% | | | | |
| CarMax | | | | | | | 1.4 | 0.0% | | |
| Dollar General | | | 2.1 | 0.0% | | | | | | |
| Dollar Tree | | | | | | | 1.0 | 0.0% | | |
| Expedia | | | 5.5 | 0.1% | | | | | | |
| Family Dollar Stores | 1.0 | 0.0% | | | | | | | | |
| GameStop | | | | | | | | | 2.5 | 0.1% |
| Gap | | | | | 4.9 | 0.1% | | | | |
| Genuine Parts | | | 4.5 | 0.1% | | | | | | |
| Home Depot | | | | | | | 4.8 | 0.1% | | |
| Kohl's | | | 1.2 | 0.0% | | | | | | |
| Limited Brands | | | 4.3 | 0.1% | | | | | | |
| Lowe's | | | | | 3.0 | 0.1% | | | | |
| Macy's | | | | | | | 5.9 | 0.1% | | |
| Netflix | | | 1.3 | 0.0% | | | | | | |
| Nordstrom | | | | | 2.4 | 0.0% | | | | |
| O'Reilly Automotive | | | 1.5 | 0.0% | | | | | | |
| Penney, J.C. | | | | | | | 4.3 | 0.1% | | |
| Petsmart | | | | | 1.6 | 0.0% | | | | |
| Priceline.com | | | | | 2.5 | 0.1% | | | | |
| Ross Stores | | | | | 1.3 | 0.0% | | | | |
| Staples | | | 9.3 | 0.2% | | | | | | |
| Target | | | 3.8 | 0.1% | | | | | | |
| Tiffany & Company | 2.9 | 0.1% | | | | | | | | |
| TJX Companies | 5.5 | 0.1% | | | | | | | | |
| TripAdvisor | | | 1.2 | 0.0% | | | | | | |
| Urban Outfitters | | | | | 1.0 | 0.0% | | | | |
| **Retailing Total** | **12.0** | **0.2%** | **43.8** | **0.9%** | **22.9** | **0.5%** | **21.3** | **0.4%** | **2.5** | **0.1%** |
| **Semiconductors & Semi. Equip.** | | | | | | | | | | |

| ( in millions) | PwC Fees | PwC % Fees | Ernst & Young Fees | Ernst & Young % Fees | Deloitte & Touche Fees | Deloitte & Touche % Fees | KPMG Fees | KPMG % Fees | BDO Seidman Fees | BDO Seidman % Fees |
|---|---|---|---|---|---|---|---|---|---|---|
| Altera | 1.9 | 0.0% | | | | | | | | |
| Analog Devices | | | 2.2 | 0.0% | | | | | | |
| Applied Materials | | | | | | | 7.0 | 0.1% | | |
| Broadcom | | | | | | | 3.7 | 0.1% | | |
| First Solar | 3.5 | 0.1% | | | | | | | | |
| Intel | | | 19.6 | 0.4% | | | | | | |
| KLA-Tencor | 2.9 | 0.1% | | | | | | | | |
| Lam Research | | | 5.2 | 0.1% | | | | | | |
| Linear Technology | | | 0.9 | 0.0% | | | | | | |
| LSI Logic | 2.4 | 0.0% | | | | | | | | |
| Microchip Technology | | | 2.3 | 0.0% | | | | | | |
| Micron Technology | 7.7 | 0.2% | | | | | | | | |
| Nvidia Corporation | 3.3 | 0.1% | | | | | | | | |
| Teradyne | 2.3 | 0.0% | | | | | | | | |
| Texas Instruments | | | 9.1 | 0.2% | | | | | | |
| Xilinx | | | 2.6 | 0.1% | | | | | | |
| **Semiconductors & Semi. Equip. Total** | **24.1** | **0.5%** | **41.9** | **0.9%** | | | **10.7** | **0.2%** | | |
| **Software & Services** | | | | | | | | | | |
| Accenture | | | | | | | 14.2 | 0.3% | | |
| Adobe Systems | | | | | | | 3.4 | 0.1% | | |
| Akamai Technologies | 2.7 | 0.1% | | | | | | | | |
| Autodesk | | | 3.4 | 0.1% | | | | | | |
| Automatic Data Processing | | | | | 9.9 | 0.2% | | | | |
| CA | | | | | | | 10.8 | 0.2% | | |
| Citrix Systems | | | 4.6 | 0.1% | | | | | | |
| Cognizant Technology Solutions | 3.1 | 0.1% | | | | | | | | |
| Computer Sciences | | | | | 19.8 | 0.4% | | | | |
| Ebay | 11.7 | 0.2% | | | | | | | | |
| Electronic Arts | | | | | | | 4.8 | 0.1% | | |
| Fidelity National Info. Services | | | | | | | 5.1 | 0.1% | | |
| FiServe | | | | | 4.9 | 0.1% | | | | |
| Google | | | 15.4 | 0.3% | | | | | | |
| IBM | 67.6 | 1.4% | | | | | | | | |
| Intuit | | | 4.2 | 0.1% | | | | | | |
| MasterCard Inc. | 8.0 | 0.2% | | | | | | | | |
| Microsoft * | | | | | 36.9 | 0.8% | | | | |
| Oracle | | | 22.5 | 0.5% | | | | | | |
| Paychex | | | 1.2 | 0.0% | | | | | | |
| Red Hat | 1.5 | 0.0% | | | | | | | | |
| Salesforce | | | 5.5 | 0.1% | | | | | | |
| Symantec | | | | | | | 9.7 | 0.2% | | |
| Teradata | 2.5 | 0.1% | | | | | | | | |
| Total System Services | | | | | | | 3.9 | 0.1% | | |
| VeriSign | | | | | | | 2.3 | 0.0% | | |
| Visa | | | | | | | 7.3 | 0.1% | | |
| Western Union | | | 5.8 | 0.1% | | | | | | |
| Yahoo! | 8.7 | 0.2% | | | | | | | | |
| **Software & Services Total** | **105.9** | **2.2%** | **62.6** | **1.3%** | **71.6** | **1.5%** | **61.5** | **1.3%** | | |
| **Technology Hardware & Equip.** | | | | | | | | | | |
| Amphenol | | | | | 4.1 | 0.1% | | | | |
| Apple | | | 7.5 | 0.2% | | | | | | |
| Cisco Systems | 19.0 | 0.4% | | | | | | | | |
| Corning | 7.9 | 0.2% | | | | | | | | |
| Dell | 17.9 | 0.4% | | | | | | | | |
| EMC | 8.8 | 0.2% | | | | | | | | |
| F5 Networks | 1.5 | 0.0% | | | | | | | | |
| FLIR Systems Inc | | | | | | | 2.5 | 0.1% | | |
| Harris | | | 6.5 | 0.1% | | | | | | |
| Hewlett-Packard | | | 45.4 | 0.9% | | | | | | |
| Jabil Circuit | | | 4.9 | 0.1% | | | | | | |
| JDS Uniphase | 4.4 | 0.1% | | | | | | | | |
| Juniper Networks Inc. | | | 5.0 | 0.1% | | | | | | |
| Molex | | | 4.7 | 0.1% | | | | | | |
| Motorola Solutions | | | | | | | 6.0 | 0.1% | | |
| NetApp | | | | | 4.5 | 0.1% | | | | |
| Qualcomm | 11.2 | 0.2% | | | | | | | | |
| SanDisk | | | 3.0 | 0.1% | | | | | | |
| Seagate Technology | | | 5.8 | 0.1% | | | | | | |
| TE Connectivity | | | | | 15.8 | 0.3% | | | | |
| Western Digital | | | | | | | 4.6 | 0.1% | | |

| ( in millions) | PwC Fees | PwC % Fees | Ernst & Young Fees | Ernst & Young % Fees | Deloitte & Touche Fees | Deloitte & Touche % Fees | KPMG Fees | KPMG % Fees | BDO Seidman Fees | BDO Seidman % Fees |
|---|---|---|---|---|---|---|---|---|---|---|
| Xerox | 21.0 | 0.4% | | | | | | | | |
| **Technology Hardware & Equip. Total** | **91.6** | **1.9%** | **82.8** | **1.7%** | **24.5** | **0.5%** | **13.1** | **0.3%** | | |
| **Telecom Services** | | | | | | | | | | |
| AT&T | | | 24.4 | 0.5% | | | | | | |
| Centurylink | | | | | | | 8.9 | 0.2% | | |
| Crown Castle Intl | 2.2 | 0.0% | | | | | | | | |
| Frontier Communications | | | | | | | 3.9 | 0.1% | | |
| Verizon Communications | | | | | | | 27.2 | 0.6% | | |
| Windstream | 3.3 | 0.1% | | | | | | | | |
| **Telecom Services Total** | **5.5** | **0.1%** | **24.4** | **0.5%** | | | **40.0** | **0.8%** | | |
| **Transportation** | | | | | | | | | | |
| CH Robinson Worldwide | | | | | 2.3 | 0.0% | | | | |
| CSX | | | 2.8 | 0.1% | | | | | | |
| Delta Airlines | | | 4.7 | 0.1% | | | | | | |
| Expeditors International | | | | | | | 2.5 | 0.1% | | |
| FedEx | | | 14.7 | 0.3% | | | | | | |
| Kansas City Southern | | | | | | | 2.1 | 0.0% | | |
| Norfolk Southern | | | | | | | 2.6 | 0.1% | | |
| Ryder | 4.5 | 0.1% | | | | | | | | |
| Southwest Airlines | | | 2.2 | 0.0% | | | | | | |
| Union Pacific | | | | | 3.0 | 0.1% | | | | |
| United Parcel Service | | | | | 13.4 | 0.3% | | | | |
| **Transportation Total** | **4.5** | **0.1%** | **24.3** | **0.5%** | **18.7** | **0.4%** | **7.2** | **0.1%** | | |
| **Utilities** | | | | | | | | | | |
| AES | | | 20.0 | 0.4% | | | | | | |
| AGL Resources | 3.3 | 0.1% | | | | | | | | |
| Ameren | 5.9 | 0.1% | | | | | | | | |
| American Electric Power | | | | | 12.1 | 0.2% | | | | |
| Center Point Energy | | | | | 5.8 | 0.1% | | | | |
| CMS Energy | 4.7 | 0.1% | | | | | | | | |
| Consolidated Edison | 5.5 | 0.1% | | | | | | | | |
| Dominion Resources | | | | | 5.6 | 0.1% | | | | |
| DTE Energy | 5.4 | 0.1% | | | | | | | | |
| Duke Energy | | | | | 14.7 | 0.3% | | | | |
| Edison Int'l | 10.1 | 0.2% | | | | | | | | |
| Entergy | | | | | 11.7 | 0.2% | | | | |
| Exelon | 25.2 | 0.5% | | | | | | | | |
| First Energy | 7.5 | 0.2% | | | | | | | | |
| Integrys Energy | | | | | 3.9 | 0.1% | | | | |
| NextEra Energy Resources | | | | | 9.8 | 0.2% | | | | |
| NiSource | | | | | 6.6 | 0.1% | | | | |
| Northeast Utilities | | | | | 4.4 | 0.1% | | | | |
| NRG Energy | | | | | | | 8.9 | 0.2% | | |
| ONEOK | 1.2 | 0.0% | | | | | | | | |
| Pepco Holdings | 6.2 | 0.1% | | | | | | | | |
| PG&E | | | | | 5.1 | 0.1% | | | | |
| Pinnacle West Capital | | | | | 2.2 | 0.0% | | | | |
| PPL | | | 9.1 | 0.2% | | | | | | |
| Public Service Ent. | | | | | 6.5 | 0.1% | | | | |
| SCANA Corp | | | | | 2.7 | 0.1% | | | | |
| Sempra Energy | | | | | 10.7 | 0.2% | | | | |
| Southern Co. | | | | | 12.2 | 0.3% | | | | |
| Teco Energy | 2.3 | 0.0% | | | | | | | | |
| Wisconsin Energy | | | | | 1.8 | 0.0% | | | | |
| Xcel Energy | | | | | 5.3 | 0.1% | | | | |
| **Utilities Total** | **77.5** | **1.6%** | **29.1** | **0.6%** | **121.3** | **2.5%** | **8.9** | **0.2%** | | |

*Source: Audit fee data from Audit Analytics and company proxy filings; Auditor from S&P's Research Insight database.*

***R.G. Associates, Inc. holding. See note on back page.**

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rg

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Response to Release No. 2013-005
Auditor's report on an audit of financial statement
when the auditor expresses an unqualified opinion
PCAOB Rulemaking Docket Matter No. 034

I am commenting on the above proposed standard ( the "Proposal"), which I believe it should not be adopted as it would add no information for users of financial statements and cost issuers money.

I am concerned by the increasing cost of disclosures required by the various legislative and regulatory bodies affecting financial reporting. A major issue facing the United States is operating efficiency and cost control so we maintain our international competitiveness. Congress has attempted to address some of this issue with the JOBS Act.

These issues have bothered me for some time. I have had the following articles published in the New York State Society of Certified Public Accountants monthly magazine The CPA Journal:

Have We Created Financial Statement Overload? – November 2007
PCAOB Proposal for Greater Disclosure from Auditors – January 2012
The Effects of Regulatory Overload – February 2013.

In line with my comments in my articles, I believe that the Proposal creates significant additional costs. In the description of the Proposal, the costs of the disclosure are not treated in detail and the benefits are not quantified or even justified in a material way. I believe that the Proposal should not be adopted as the benefits do not justify the costs.

I am not commenting on the proposal relating to "other information in certain documents containing…the audit report" as I do not believe that that proposed standard creates costs beyond those created by AU 550, although I am not sure that the proposed standard improves AU550.

**Costs**

First the costs. The Proposal refers to them in a few places with no specificity. I believe that the additional costs relating to this proposal include the following:

- Training maybe 100,000 auditors on the requirement and how to apply it;
- Training the same number of members of management in the same issues;
- Training possibly fewer attorneys in the requirements and their implication;
- Current auditing practice would entail requiring all Registered auditors to create a section in all audit programs with instructions for field auditors to complete and sign off;
- The time on each audit for the staff to complete the applicable portion of the audit program;
- Staff and partner time parsing the issues to determine which belong in and out of the auditor's report;
- Documenting the areas where the decision was not to include the item in the auditor's report;
- Discussions with management as to what issues, why the auditor included them in the report, negotiation with management of the inclusion or exclusion of items;
- Three-way discussion among management, and auditors and counsel as to the disclosures, including writing the disclosure and working details with management and counsel; and
- Cost of paper and postage.

I have left out the cost of having anyone closely reading the entire Form 10-K having to read additional pages and maybe wonder why an item is in the MD&A but not the auditors' report.

These costs are not insignificant. Assuming annually 12 hours of accountants' time, five hours of attorneys' time, one hour each for three members of the audit committee and ten hours of management time at an average of $200 per hour it is $6,000 per registrant per year. For the 10,000 public companies, that comes to $60,000,000 burden, per year, on the US economy for a proposal that there is no evidence that it will have a value. On page A5-41 the Proposal briefly differentiates between one time and ongoing costs. I suggest that one-time costs are a misnomer as manuals have to be continuously updated and employee turnover means new employees have to be continuously trained.

In response to your questions 21 through 23 of Appendix A5 I am unable to determine the relationship between costs and size of companies and I believe that audit fees will rise to cover the additional auditor time.

**Benefits**

Of the 78 pages in Appendix A, the benefits are glossed over in three paragraphs. I note that the benefits start based on academic research and are all, I believe, (1) modified with the words "should" or "could" and (2) unclearly defined as to a specific benefit. For example the sentence "the communication of critical audit matters could help to alleviate the information asymmetry that exists between company management and investors" on page A5-23, does not:

- Indicate why the reduction in the "information asymmetry" is good,
- Give an evaluation of the present "information asymmetry" and whether the extent it could be reduced is significant, or
- Any support that the proposal would in fact reduce the "information asymmetry".

There other examples of similar thinking. The three paragraphs describing the logic of the proposal on pages A5-22 and A5-23 use the words "should", "can" "may" and "could" twelve times. No sentence I read seems to say "the proposal does definitely help this issue". As none of the benefits, if existent, seem definite, are the changes worth the cost?

Three examples are given in the Proposal: Allowance for Sales Returns, Valuation of Deferred Tax Assets and Recurring Fair Value Measurements. They raise the following questions:

- Does the proposed addition say anything more than the proposed footnote and the required reference from MD&A as to critical accounting policies?
- Is a reader of the financial statements helped to know that I consulted with my national office, another partner in my office, or in my case another CPA who may have experience in the matter?
- Would these examples reduce the "information asymmetry"? If so, how?
- I am unconvinced that these are difficult matters, e.g. it appears to me that for example one it is clear that the registrant should not record sales until ultimate sale is known under 605-15-5.

**Duplicative disclosure of matters**

The issue of whether the information being proposed to be required in the Auditor's Report adds additional information to that which is already being disclosed is not addressed. The three examples in Appendix A start with a detailed footnote with the auditor add little, if anything, to the discussion in the footnotes. I agree that with the length of published reports on public companies (see Have we Created Financial Statement Overload? suppra.) it would be useful to have a place to go to find significant items. The SEC's approach is to add more and more disclosure, much of it repetitive. A far more useful approach is to determine what disclosures are significant and those of little or no use should be discarded.

**Disclosure of matters that would otherwise not be disclosed**

I have been unable to think of an example where an item would be disclosed by the auditors but is not otherwise required to be disclosed. It would be useful to have an example of such an item. If there is none, I believe that the lack of such an example is evidence that additional disclosure is not useful.

Question 27 refers to the issue of an item that would be in the auditors' report that would not otherwise be disclosed. I have racked my brain but been unable to think of one. Would the Proposal require the following disclosure:

> We, the auditors, determined that the difficulty of finding invoices to support inventory costs was a critical audit matter. The inventory clerk had quit just before the audit and the new staff had difficulty locating the invoices. As a result the completion of the audit was delayed a week and the auditor's fee was increased by $3,000. All invoices were ultimately located and the inventory found to be appropriately priced. We obtained the approval of audit committee for the additional fee involved.

For me to think that the Proposal will be an improvement over current reporting, it would need to indicate that both (a) additional matters would be disclosed and (b) such disclosure would be both useful and justify the additional costs.

**Does anybody read this stuff?**

As I wrote in my article, Have We Created Financial Statement Overload?, the length of financial statement and other annual reporting requirements turns off reasonable readers. While I have been told that some professional analysts read every word, I sincerely doubt it. Who can read every word of all 400 pages of one company's annual report and proxy statement?

My favorite example of over disclosure is the current rules on executive compensation in the proxy statements. The disclosure in a great reform went from a comprehensible page to many pages with tables and a description of the compensation committee's process. Do you know anyone, but attorneys, who have actually read the detailed disclosures; I do not.

The additional disclosures requested in your Proposal would make the matter of length worse.

**What is necessary**

In many areas of our society, the concept that "less is more" has produced improvements. We have made financial statements unreadable as the volume is just overwhelming. I have been told that security professionals actually read them all; the ones I have spoken to try to pick and choose so they do not waste a lot of time. My article in The CPA Journal "Have we Created Financial Statement Overload" (November 2007) lists a number of suggestions, none earth-shaking, to reduce disclosure. I believe that is the direction in which we should be going.

**Other changes to the Auditor's report**

Other than the inclusion of Critical Audit matters the proposal adds about 21 lines to audit reports for the approximately 10,000 reporting companies. I do not believe that the cost of adding the 210,000 lines of type annually justifies the improvement. I have always believed that a pass/fail model should be succinct. I recommend "We have performed an audit in accordance with professional auditing standards and believe that the accompanying financial statements are in accordance with prescribed standards." It could have made it shorter. I appreciate that courts might take an approach different from mine.

Very truly yours,

Arthur J. Radin

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December 3, 2013

Office of the Secretary, PCAOB
1666 K Street N.W.
Washington, DC 2006-2803

**PCAOB Rulemaking Docket Matter No. 034**

Dear PCAOB Board,

I am writing to communicate my perspective as an individual investor regarding the PCAOB's proposed auditing reporting standard. As articulated in the PCAOB Release No. 2013-005, the major purpose of these changes would be for the auditor to communicate critical audit matters addressed during the audit of a company's financial statements. Furthermore, these critical audit matters include mention of those topics the auditors found "most difficult, subjective or complex," as well as those which were the hardest for the auditor to obtain sufficient evidence for and proved the most challenging in providing an opinion on. While I recognize that the opinions and perspectives of all of the various stakeholders that are party to the auditing report must be considered and duly weighed, I felt compelled to express my perspective as one of the many individual investors who utilize the auditing report as a factor in making investment decisions.

The PCAOB Release No. 2013-005 articulates that one of the motivations behind the proposed rule changes is to make the auditor's report more relevant to investors looking to gain insights useful for potential financial decisions concerning the audited company. Since one of the main purposes of audited financials and the auditor's report is to alleviate the asymmetry of information between company management and investors, the PCAOB reasons that by increasing the relevance of the document to investors, the audits' mission is furthered. On the other hand, there is a counter-argument to making changes to the auditor's report which reasons that it is not the responsibility of the auditors to communicate clear information about a company's financial position, but rather that of management. However, I argue that because a company's management is not an independent third party, it is not capable of objectively mitigating the information asymmetry which exists for investors. Therefore, the auditors alone should be charged with addressing this. After all, there is a benefit to the entire financial system to providing investors with clear, objective information about companies' financial positions which can be used by them to better understand and to price risk. These include a lowering of the cost of capital and increased availability of financing.

There are several other reasons for increasing information regarding an auditor's unqualified opinion. First, there is little disagreement that the current auditing environment is quite different from the one in which the auditing system was developed in the 1940s. Globalization and increased financial and operational complexity have created greater ambiguity in accounting and led to increased utilization of estimates and judgment by management in the creation of financial statements. As a result, financial statements that received a passing grade could still have misrepresentations that significantly affect the economics of a company's current and future financial position. Secondly, the spate of accounting scandals over the past decade, many of which went unnoticed, or unexposed, by auditors have changed investors' attitudes towards auditors' opinions and reports. I believe these two factors are intertwined and ultimately serve to reduce the value that investors derive from the pass/fail rating system currently in use.

While I do not argue the pass/fail standardization should be reevaluated at this juncture, I do believe that these two factors give credence to the argument that the current environment dictates a need for pass or fail opinions to be supported by a broader discussion or recognition of challenges, such as is currently proposed by the PCAOB. Such a discussion of critical matters would serve to better inform investors who currently derive little to no comfort around risk levels based upon audited financial statements.

I agree with the auditors' opinions that any additional reporting which is required, such as around critical auditing matters, should be objective and factual. Page 10 of the PCAOB Release No. 2013-005 outlines alternatives for changing the auditor's report. I agree with the possible use of all of those listed except for the option which proscribes "auditor assurance on other information outside the financial statements." I believe that this option places auditors outside of their current, well understood role, and is a line that should not be crossed. As regards the other three options, as long as they do not place significant additional costs on auditors of time or resources, and if they adhere to objective and factual statements, each should be considered equally.

I believe that success or failure of PCAOB's recommendation to include a discussion on critical audit matters within the audit report will hinge upon how these changes are communicated to auditors and enforced. There are likely a large number of accounting matters which by definition may be quite subjective, complex, and difficult to obtain sufficient evidence around. Should all of these be termed critical auditing matters? If so, any discussion of critical auditing matters within the auditor report may risk becoming standardized and comprised of stock language, which would in turn take away from the effectiveness and relevance to investors which the PAOCB is hoping to achieve. Or, should the number of critical auditing matters addressed in the audit report be limited in order to really focus on the most pressing issues? If a limit is placed, how might this affect investors' understanding of a company's financial position if a significant issue is not included simply because it is the $4^{th}$ most important matter, for example? I believe more guidance and detail needs to be given to how the PAOCB's recommendations will be implemented in order to know whether this will ultimately prove beneficial to investors.

| | |
|---|---|
| **From:** | Joseph Hemphill |
| **To:** | Comments |
| **Subject:** | PCAOB RULEMAKING DOCKET MATTER NO. O34 |
| **Date:** | Wednesday, December 11, 2013 7:55:07 AM |

To the members of the Board,

I am writing to encourage a small firm exception from the Docket Matter No.034. As the President of a small Broker Dealer, I feel that this Rule will impose significant additional costs to my firm and the thousands of other Broker Dealers that have fewer than 50 employees. I believe it is appropriate for the PCAOB to exempt small firms from this Rule.

Thank you for your time,

Joseph A. Hemphill III
President/CEO
Regional Brokers Inc
1628 JKF Blvd
Suite 1901
Philadelphia PA, 19103
Cell:215-805-5168
Work:215-567-5400

December 11, 2013

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

Submitted via email: comments@pcaobus.org

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 034**

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") proposed rule, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard* (the "proposal"). Regions Financial Corporation ("Regions"), with nearly $120 billion in assets, is one of the nation's largest full-service providers of consumer and commercial banking, wealth management, mortgage and insurance product services. We serve customers in 16 states across the South, Midwest and Texas, and through our subsidiary, Regions Bank, operate approximately 1,700 banking offices and 2,000 ATMs.

We have significant concerns regarding both the proposal's requirement to discuss Critical Audit Matters ("CAM" or "CAMs") and the proposal's more stringent standard of auditor involvement in other information presented within the financial statements ("other information").

In an article published in their September 2013 issue of Heads Up, Deloitte and Touche noted that, "The proposal represents the most significant expansion of tailored information provided about a financial statement audit by auditors to the user community in the profession's history". In our opinion, these disclosures, along with the expanded responsibility for other information, will not promulgate decision useful information, will inappropriately infringe on management's disclosure responsibilities, will weaken and obscure the audit report, will create confusion among users, will impair an auditor's ability to meet filing deadlines, and will result in significant increases in audit fees. Consequently, we cannot support the Board's proposal as it currently exists.

**CAM**

The proposal would require auditors to disclose, in their report, matters that the auditor deems "critical" to the audit. As defined, CAMs are, "Those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements"[1]. For each CAM, auditors would describe the considerations that led them to identify the matter as a CAM and, when applicable, refer to the financial statement accounts and disclosures that relate to the CAM[2]. The proposal also seems to implicitly prefer the inclusion of language describing the audit procedures related to the CAMs[3].

When considering matters that may qualify as CAMs, we noted topics that were highly duplicative of issues extensively covered within existing company disclosures. The required disclosure of critical accounting policies, significant estimates, business and operating trends, financial and operating risk factors, and other required disclosures adequately address matters that may be considered CAMs. Considering this, it is unclear what would be gained by adding CAMs to the audit report.

Also, as noted by the Board on pages A2-42-3 of the proposal, in certain cases (e.g., significant deficiencies in internal controls, certain going concern considerations), the auditor would be required to disclose information in the report that would not otherwise be disclosed by management. This reverses the normal relationship of management and auditor. Management, not the auditor, is solely responsible for preparing and filing financial reports. The auditor should not be the first source of information, provide disclosure of information not disclosed by management or have the appearance that it is making financial reporting decisions on behalf of management.

Next, we are concerned that CAMs may lead users to construe implicit qualifications of the audit report creating a perception that there may be weakness or deficiencies in management's judgment, financial statement estimates or internal control environment, when none exists. The description of such complex matters would be necessarily abbreviated, given the forum; therefore, it is very likely that the enumeration of such matters will be taken out of context or simply misunderstood. Because the proposal would result in a large gap between private company audit reports and public company audit reports, we believe confusion would be particularly poignant among users of both report types.

[1] PCAOB Release No. 2013-005, Page A1 – 7, paragraph 9
[2] PCAOB Release No. 2013-005, Page A5-38, paragraph E – "[In addition to identified CAMs, auditors are also required to document] non-reported audit matters that would appear to meet the definition of a critical audit matter that were not critical audit matters".
[3] We say "implicitly" because, although the matter is discussed within the background section, the actual proposal is silent on the matter. However, the three illustrative examples on pages A5 – 67-78 all include illustrative language of auditing procedures performed to deal with the CAMs in question. This matter needs further clarification from the Board if CAMs are included in the final rule.

These misunderstandings or confusions could lead to several unintended conclusions. For example, users may equate the number of CAMs to inherent risk, users may conclude that auditors are expressing piecemeal opinions on individual accounts or matters, or users may conclude that auditors are expressing reservations about the matters in question. These conclusions would be understandable, yet inappropriate.

To further illustrate potential confusion among users, take, for example, the discussion of significant deficiencies in internal control within CAMs. Any such discussion necessarily challenges the current definition of significant control deficiencies, which is understood to have a less than material impact on the overall financial statements. Can a matter be both immaterial and "critical" to the auditor's report? This seems very confusing to us. We contend that if a matter is immaterial, then it is functionally irrelevant to the user. Thus, any discussion thereof only serves to weaken and obscure the auditor's opinion.

In light of the reasons outlined above, we believe CAMs should be omitted from the Board's final rule.

**Other Information**

The proposal's description of auditor responsibility for other information will significantly expand the scope of work by introducing required audit procedures to support the auditor's conclusion about the evaluation of other information. Specifically, under PCAOB AU Section 550, the auditor is required to "read" and "consider" other information, whereas under the proposal, the auditor is required to "read" and "evaluate" the other information on the basis of relevant audit evidence obtained and conclusions reached during the audit.

We don't believe most users of financial statements will be aware of the additional procedures required to meet this change. Where some users are aware, we are concerned that they might perceive the auditor's "conclusion" on the evaluation of other information as an opinion on this information. The proposed "negative assurance" report structure does not allow the user to know, exactly, what was independently verified and what was not. Some disclosures within other information involve forward looking financial information or insights that often are not objectively verifiable. The proposed "negative assurance" structure may, however, cause this information to appear subject to auditor procedures, when it was not. As such, we believe the proposed rules regarding other information will confuse users, thereby weakening and obscuring the auditor's opinion.

**Conclusion**

The purpose of the audit report is to definitively state whether the financial statements are fairly presented, in all material respects. The user community is best served when the audit report clearly and concisely communicates the auditor's singular, final conclusion. In other words, the user simply wants to know, "Are the financial statements fairly presented? Yes or no." We believe the current audit report effectively answers this question. Consequently, we do not believe the changes in the proposal are warranted.

Again, we appreciate the opportunity to comment on this proposal and we thank you for considering our views. If you have any questions about our comments or wish to discuss this matter further, please contact me at (205) 326-4972.

Sincerely,

Brad Kimbrough
Executive Vice President, Controller and
Chief Accounting Officer

**From:** Daniel Regis
**To:** Comments
**Subject:** FW: Docket 034: Proposed Auditing Standards on the Auditors" Report
**Date:** Tuesday, December 03, 2013 7:40:41 PM

I appreciate the opportunity to respond to the PCAOB's Release 2013-005 regarding proposed changes to the Auditors Report. I have several specific concerns about the proposal and they are enunciated below.

PERSPECTIVE

To put my comments into context, I am a former Audit Partner with one of the Big Four having served for over thirty years in various offices in both line and leadership positions. Following that, I was in the venture capital business for over ten years and financed a number of technology companies that became publicly listed during the mid to late 90's. Currently, I am the Chairman of the Audit Committee of Cray Inc. (CRAY), Chairman of the Enterprise Risk Committee of Columbia Banking System Inc. (COLB) where I also serve as a member of the Audit Committee and designated financial expert. I am the immediate past Chairman of the Board and member of the Audit Committee of ART Technology, Inc. (ARTG). I also sit and have Chaired several investment committees for endowed foundations and do so as General Partner of our private investment vehicle, Regis Investments, LP. I have, therefore, a broad background as both a provider and user of audit services.

CRITICAL AUDIT MATERS (CAM)

By far my greatest concern is with the expansion of the audit report to include commentary upon CAM's. The present Pass/Fail test of the auditor's report has served us well for many years and should not be degraded. CAM's profile and auditor involvement would undoubtedly become a very comprehensive list and will dominate the report by sheer volume because auditors will be very reluctant to omit anything that could later be used as a basis for oversight deficiency or litigation. And for what? Most of the commentary will likely concentrate on matters already full vetted either in the Footnotes to the Financial Statements under Significant Accounting Policies or in the MD&A (where such policies are repeated and further explained as to impact). I am also concerned that there will be an unintended consequence because there will be an understandable reluctance by auditors and management to routinely and openly discuss matters requiring a robust dose of judgment with Audit Committees for fear or raising matters to the level of CAM's that heretofore were considered of secondary or tertiary importance . I submit that the present results-oriented rather than process-oriented reporting process is superior and should be retained.

ADDITIONAL INFORMATION

Auditors have long considered other information contained in documents filed with the SEC and that practice is codified in AU 550 which states that the auditor shall “read” and “consider” whether such information is consistent with the audited financial statements on which an opinion is rendered. While the proposal appears, on the surface, not to change that responsibility significantly, the requirement to “read” and “evaluate” as well as develop a conclusion that there are no “material inconsistencies with the financial statements” and/or a “material misstatement of fact” proposes a significant new burden on auditors. Furthermore, the proposal extends that responsibility beyond the immediate-filed report (e.g. 10K) to anything to which it references (e.g. Proxy) and pertains not just to information that is contained or derived from the audited financial statements but to other data as well. While I have not canvassed all of the major accounting firms, at least two have suggested that this change will require significant additional audit work and extended procedures. I sincerely doubt the cost/benefit of this proposal and suggest that it be dropped. If the PCAOB were, in the alternative, to require language in the auditor’s report of the type that auditors now give under AU 550, I would not oppose that suggestion.

AUDITOR TENURE

The issue of auditor tenure should be left in the hands of the Audit Committee which is responsible for this matter under Sarbanes Oxley. The tenure of the auditor is already available to anyone who wishes to do some modest research and the facts are that it is not perceived by investors as an important data point. Furthermore, it is not the real issue that Audit Committees deal with when they are considering appointment or reappointment. It is far more important to know the tenure, skill set and industry-specific credentials of the specific engagement team than the duration of the business association. I am not satisfied that this provides any meaningful information and believe it should simply be dropped. In the alternate, I would suggest a more thorough discussion in the annual Audit Committee report as to the process by which auditor selection is accomplished.

Thank you for your consideration.

Daniel C. Regis

**From:** Gordon Rhodes
**To:** Comments
**Subject:** No. 034 Proposed Auditing Standards
**Date:** Wednesday, December 11, 2013 12:01:45 PM

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and

The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

To the members of the Board:

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, nonpublic, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. The majority of these small firms have fewer than 50 employees. Rhodes Securities, Inc has approximately 5 full time employees and less than $1mm in annual revenues. We also have about 15 1099 independent Financial Consultants.

For these small independent and privately owned businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is appropriate and consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight. It is important that regulation for small firms remain relevant to the business model and investing public; we encourage the Board to seriously consider the matter of small firm exemption.

Thank you for your consideration,

*"The dominant determinant of real-life, long-term investment outcomes is not investment performance; it's investor behavior." –Nick Murray*

*Follow us on Twitter @RhodesFW*

Sincerely,

J. Gordon Rhodes

*President; Financial Consultant*
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INCORPORATED

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306 W. 7th Street Ste 1000
Fort Worth, TX 76102

**From:** John R. Roberts
**To:** Comments
**Subject:** Fwd: PCAOB Release No. 2013-005; Rulemaking Docket Matter No. 034
**Date:** Friday, December 06, 2013 6:51:10 PM

Board Members and Staff of the PCAOB;

Thank you for providing me with an opportunity to share my views on the above referenced Release and Rulemaking Docket Matter. Over the last ten years I served at various times as the Audit Committee Chairman of three public companies listed on the New York Stock Exchange. I clearly recognize the importance of fairly presenting the financial position and results of operations of any enterprise and the auditors role in providing assurance. I do have some serious concerns with the proposed standards which would expand the standard audit report and add additional assurance on other information in documents containing audited financial statements. I must point out these are my personal views and not necessarily the views of the companies on whose Boards I serve. I will attempt to be brief.

The Responsibility for Full and Fair Disclosure Rests with Management

It has always been and will remain a registrant's responsibility for the accuracy of the financial statements and full and fair disclosure in accordance with FASB and SEC rules and regulations, which are voluminous and intended to be all encompassing. Significant risks and judgments must also be disclosed in order to properly inform a user of financial statements. As a result of a constantly growing set of requirements, financial statements and the notes thereto have become overly lengthy and complex. Further, the use of judgments and estimates pervades almost every element of the accounts in the statements. Since judgments and estimates are by their very nature imprecise, financial statements must be viewed in their totality, as has always been the case. To single out "critical audit matters" would, in my opinion, cause a focus on certain elements rather than the statements taken as a whole. Additionally, I am concerned that the proposal could be misinterpreted and could lead to unintended consequences such as restricting the critical open dialogue between the Audit Committee and the auditors over concern that such matters might become a matter of public record even if there was no impact on financial reporting.

The role and work of the PCAOB has significantly strengthened the audit process. These proposals do little, if anything, to further that process and it is difficult to see what real value is being added to the operation of the capital markets for the additional cost of this proposal. See below also.

What consideration has been given to a situation where a PCAOB examination results in a requirement that an auditor modify its report to add (or delete) a critical audit matter? Would the auditor be required to withdraw the existing report, thus invalidating the company's filings that include such statements. This could have a material impact on a company that might be in the midst of a transaction or registration even if there is no change to the financial statements or other information included in the filed documents.

Historical Financial Statements Play a Somewhat Limited Role in a Company's Market Valuation

While additional information about a company is provided in Management's Discussion and Analysis and other commentary in filed documents, the market (investors, analysts, etc.) values an enterprise based upon expectations for the future. Many, but not all, companies provide earnings guidance or other information, good and bad, that may impact future earnings. How would auditors be expected to give assurance on management's view of the future and what standards would be used?
While always being mindful of Regulation F-D, many companies follow earnings releases with earnings calls which are open to all interested parties. Many companies also hold investor days, speak at

industry conferences or participate in meetings sponsored by investment bankers. To what extent would auditors be required to give assurance on matters discussed at these meetings and what would be the basis for such assurance?
Investors and analysts use all of the above information as well as their knowledge of trends in the market (broadly and company specific), peer company performance, impact of existing and proposed regulations, geopolitical impacts, etc., in order to make decisions or recommendations regarding the value of a particular company. Historical and projected future earnings are then subjected to an estimated multiple in arriving at perceived value.
Thus a large variety of factors (only some of which I have attempted to outline above) enter into a valuation upon which investors may or may not act. In my opinion, it is highly doubtful that the proposed modifications to the standard auditors' report would have any meaningful impact on the market, thus any cost to implement would far outweigh its value.

I appreciate the opportunity to comment on these proposals and thank you for taking the time to consider my views.

Most sincerely,
John R. Roberts
jrrobertsstl@aol.com

**From:** Paige Pierce
**To:** Comments
**Subject:** PCAOB Rulemaking Docket Matter No. 034
**Date:** Tuesday, December 10, 2013 9:41:29 PM

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and

The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

To the members of the Board:

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, nonpublic, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. The majority of these small firms have fewer than 50 employees.

For these small independent and privately owned businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is appropriate and consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight. It is important that regulation for small firms remain relevant to the business model and investing public; we encourage the Board to seriously consider the matter of small firm exemption.

Thank you for your consideration,

Paige W. Pierce

**PAIGE W. PIERCE**
President & CEO

**RW SMITH**
**The Power of Wall Street. The Promise of Main Street.** TM
Seattle | Salt Lake City | Los Angeles | Scottsdale | Chicago | Tampa | New York

November 17, 2013

Faraz Saleem
1200 N Street NW, Apt 801
Washington, DC 20005
fs274@georgetown.edu

Office of the Secretary
PCAOB
1666 K Street NW
Washington, DC 20006

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Sir or Madam:

As a member of the financial community and investor, I am in agreement with the Board's proposal that the following auditing standards will likely be beneficial particularly in firm and financial statement analysis.

***1) The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion***

***2) The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report***

While I agree that these amendments will be advantageous to investors, they should be executed with a degree of caution so that auditor opinions maintain their level of objectivity and are not tainted by subjective rationale. Requiring auditors to provide more detail of their unqualified opinions can quite easily push the appearance of the report into the realm of subjectivity and consequently stray from the view as an unbiased opinion. Following is a discussion of my thoughts on both of these new auditing standards.

The existing auditor report is not useful for investors beyond the confirmation of whether the opinion is unqualified. The general 'boilerplate' type language is likely not even read by members of the financial community, so requiring auditor's to supplement the pass/fail recommendation with backup is a logical amendment. In particular I believe the 'Critical Audit Matters' section will help investors understand what actually went into the audit, which is a process that they are likely blind to at this point. Highlighting areas of difficulty can help investors pursue their own analysis of the areas of concern and potentially help them make better investment decisions. Additionally, and possibly more importantly, this may motivate companies to avoid confusing or irrational accounting practices which currently may be flying under the radar but would be exposed under this new reporting standard. For example, stock analysts currently have no insight into what auditors found difficult during an audit, or where there had to be subjective judgment. Increasing the level of transparency may potentially have an impact on stock analyst recommendations which ultimately finds its way back to the way the company is reporting its financials. Overall, having multiple eyes analyzing a firm's audit is more likely to unravel areas of concern as opposed to a single and secret auditor opinion.

Two specific aspects of this proposed amendment which I also feel will be valuable to investors and the financial community are the sections detailing the auditor's experience as well as the 'other information' portion. Accepting an auditor's opinion as valid could have a lot to do with that auditor's experience, given information about their experience is provided. At this point users of financial statements accept the auditor's opinion and have no idea how experienced or knowledgeable the auditor is. This amendment will require auditors to state their tenure so investors will be aware of how much experience the auditor has analyzing the specific company's financials. Similar to when selecting a doctor, individuals likely look at the doctor's experience (years in occupation, school, etc.). I believe the same process would be helpful in analyzing financials. The 'other information' section also seems helpful as it will bring to light any issues outside of the financial statements which may go overlooked otherwise. Things such as material misstatements in the manager discussion and analysis will be addressed by the auditors, which could be extremely helpful to investors who are not so experienced at reading the actual financial statements and focus more on other information.

While this is a logical step in financial reporting, I believe it comes with the risk of portraying auditors outside of their role as providers of unbiased opinions, and could potentially lead to backlash from the financial community. Currently these auditors experience issues during audits that require a degree of judgment or subjectivity. They are not required to disclose this information which, from the perspective of investors simply looking to see if the opinion is unqualified, maintains the auditor's reputation as a third party and independent analyst. With the proposed reporting amendment, investors will be able to see where these auditors applied subjective rationale which these investors may not necessarily agree with. In addition, companies may also disagree with the rationale which could lead to challenges from the financial community. Depending on how much power or influence these community members and firms have, there could be lobbying and regulatory action to amend the way audits are done which may or may not be beneficial to the community as a whole. Of course challenges and amendments to the subjectivity of auditors which enhance the integrity and usefulness of auditor reports would be considered improvements, but not all challenges are improvements when there are multiple special interest groups with varying degrees of power over regulation. Therefore while I feel this type of transparency is important, it could also lead to an array of new issues that the PCAOB and regulators should be prepared to deal with.

While I do understand the resistance from auditors in regards to this reporting amendment, I believe this may eventually make the jobs of auditors easier as well. Currently there is backlash from these professionals as they feel the explanation of financial statements is a job for the firm and its management, and not the auditors. However as an investor and member of the broader financial community, I am well aware that firms and their management often have an inclination to hide tricky items within their financial statements. Therefore there is a misalignment of interests between investors and firms, and auditors are ultimately the only intermediaries that can help to alleviate this issue of information asymmetry. Firm management typically has to work closely with auditors so they are typically aware of what items the auditor has significant issues with. However, there is no incentive on the firm's part to make life easier for the auditor if the process of working through these tricky issues will never be publicized to investors. With the rollout of this reporting amendment, management will know that their confusing or suspicious activity is likely going to end up in the auditor's report. This creates an incentive for the firms to keep their books clean, and eventually makes life easier for auditors.

Sincerely,

Faraz Saleem

December 9, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Via email to: comments@pcaobus.org

**RE: PCAOB Rulemaking Docket No. 034**
**Release No. 2013-005**
**(the "Proposed Auditing Standards" or the "Release")**

Members of the Board:

We appreciate the opportunity to respond to the Proposed Auditing Standards.

This letter represents a group response from several of the largest Engineering & Construction (E&C) companies, which are primarily SEC registrants, ("we", "us" or "Industry"), all of whom provide long-term construction related services to project owners around the world. Although each of the undersigned has its own individual perspective on the Release, we are unified in our view that there are aspects of the Proposed Auditing Standards that require revision for the reasons expressed herein.

**Summary:**

With respect to the proposed changes to the auditor's standard report:

- We *agree* that the current pass/fail model be retained as the foundation of the auditor's report on his or her audit of financial statements;
- We *agree* that the auditor's report be modified to include a statement that the auditor is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the standards of the PCAOB;
- We *agree* that the auditor's report be modified to include a statement that PCAOB standards require the auditor to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;
- We *disagree* with the proposed requirement that the auditor's report be modified to include a statement regarding the year the auditor began serving consecutively as the company's auditor;
- We *disagree* with the proposed change to the auditor's standard report to include a description and discussion of critical audit matters.

With respect to the proposed changes to the auditor's responsibilities regarding other information included in an annual report filed with the SEC under the Securities Exchange Act of 1934, as amended (the "Exchange Act") (the "Proposed Other Information Standard"):

- We *disagree* with the proposed requirements to expand the auditor's responsibilities regarding such "other information", and to modify the auditor's report to include a section discussing the results of the auditor's evaluation of such other information.

*****

For the remainder of this response, we focus on only those elements of the Proposed Auditing Standards with which we disagree.

**Proposed Changes to the Auditor's Standard Report:**

*Auditor Tenure*

We are unconvinced that disclosing the tenure of the independent auditor in the auditor's report provides useful information to the readers of our financial statements.

Consider the following excerpt from the Release (page A5-15):

> "Auditor tenure has been the subject of discussion for decades and continues to be a topic of discussion today. Some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry. Meanwhile, other academic research indicates that investors that participated in a study view long-term auditor-company relationships as adversely affecting audit quality. Other academic research suggests that both short and long tenure can have detrimental effects on audit quality."

And consider the following comment from PCAOB Board Member Jay D. Hanson at the Board's open meeting on August 13, 2013:

> "I also question whether it is appropriate for the Board to require disclosure in the audit report of the auditor's tenure with the particular client. We explained in the release that in developing the proposed requirement, the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure and that the Board's inspection process has not been designed to determine a relationship between audit quality and auditor tenure. Thus, we do not have, at this point, any data indicating that audit tenure has any correlation with audit quality. The mere fact that the Board requires a disclosure about auditor tenure, however, might suggest that the Board believes the information to be meaningful."

As specious as it is, the above excerpt from the Release lays the only foundation for the proposed change to the auditor's standard report to include auditor tenure. There is no evidence to support that auditor tenure has any relationship with audit quality. The "support" is in fact mere suspicion held by a small element within the investing community that the longer an auditor has been providing audit services to a client, the poorer the quality of the audits. The lack of any real data linking audit tenure to audit quality is confirmed by Member Hanson in his August 13 comments. In spite of this, the Board seems willing to throw-up its hands and proposes the modification to the auditor report to include tenure in a "What could it hurt?" approach. Disclosure of auditor tenure in the auditor's report conveys a linkage between auditor tenure and audit quality that simply does not exist.

We believe this proposed change to the auditor's standard report is unnecessary. The Board should only adopt those changes to auditing standards that have been properly vetted, are supported by empirical evidence, and are justified based on a cost/benefit analysis.

We also wish to point out that the SEC's rules regarding the preparation and content of proxy statements already require information regarding a company's independent auditors. Therefore, auditor tenure may be better disclosed in a company's proxy statement as part of the other auditor-related disclosures rather than as a random, disembodied statement in the auditor's opinion.

*Disclosure and Discussion of Critical Audit Matters ("CAMs")*

The Proposed Auditing Standards would create a new section in the auditor's report in which CAMs would be communicated. CAMs are defined as those matters addressed during the audit of the financial statements that:

- involve the most difficult, subjective, or complex auditor judgments;
- pose the most difficulty in obtaining sufficient appropriate audit evidence; or
- pose the most difficulty to the auditor in forming an opinion on the financial statements.

The Release suggests that CAMs would ordinarily consist of those matters of such importance that they are documented in the engagement completion document (pursuant to AS 3), or are reviewed by the concurring / quality review partner, or are communicated to the Audit Committee.

We disagree for the need of this new section, for the following reasons:

First, we do not believe our shareholders and users of our financial statements will view any discussion of CAMs as particularly meaningful. Although they will see CAMs as something interesting, and initially "novel", our shareholders and other stakeholders will invariably gloss over the discussion and place their reliance on the straight pass/fail opinion of the auditor, "because it clearly conveys the auditor's opinion regarding whether the financial statements are fairly presented" (page A5-5 of the Release). Including several pages in the auditor's opinion discussing CAMs will only detract from the auditor's opinion. We also believe there is a significant risk that the CAMs discussion will become rote over time as auditors realize that the readers of our financial statements value their *opinion* over any soon-to-become-boilerplate *discussion*.

Second, existing rules promulgated by the SEC require issuers to disclose and discuss critical accounting principles and estimates applied in the preparation of their financial statements. We find it hard to believe that the matters determined by the auditor to be CAMs would vary from the company's list of critical accounting principles and estimates. These disclosures are quite lengthy and often include, in the case of estimates, a sensitivity analysis based on changes in assumptions. Accordingly, the requirement to include in the auditor report a discussion of CAMs would be largely redundant and would not increase the reader's understanding of those matters nor their impact on the financial statements.

Third, and following the discussion in the preceding paragraph, we believe the proposed rule regarding CAMs *may in fact* lead to the auditor disclosing matters *not* covered by the issuers' disclosure of critical accounting principles and estimates. We believe that, in an abundance of caution and partially in response to concerns of being second-guessed by the PCAOB through the Board's inspection process, auditors may decide to over-disclose CAMs. To err on the side of caution may be viewed as prudent by our auditors and an easy way to avoid outside criticism of their audits and their reports. Disclosure overload has been the bane of issuers for years and is only getting worse. It is costly, often confusing, and reduces, rather than adds, value to the readers of our financial statements. To allow disclosure overload to creep into the area of auditing and reporting would be a profound mistake.

Fourth, we believe a discussion of CAMs will be confusing to the readers of our financial statements as users try to interpret how CAMs, which represent matters that are significant to the *audit process*, should be used or applied when evaluating a company's financial statements.

And last, we believe there is a significant risk through the CAMs discussion for the auditor to disclose company information not found elsewhere in the financial statements. We do not believe as a matter of principle that auditors should be the original source of information about an entity, its business, financial condition or results of operations.

**The Proposed Other Information Standard:**

The Release significantly changes the auditor's responsibilities related to other information contained in documents that include a company's audited financial statements.

First, the Release expands the definition of "other information" to include information that is incorporated by reference into a company's annual report. Second, the Release expands the responsibilities of the auditors vis-a-vis such other information to include an "evaluation" to determine whether such other information contains (i) a material inconsistency with data or information contained in the audited financial statements, or (ii) a material misstatement of fact.

We disagree with the proposed Other Information Standard.

PCAOB AU Sec. 550 already requires auditors to "read and consider" other information included in documents containing audited financial statements. AU Sec. 550 provides guidance to the auditor if he or she determines such other information is materially inconsistent with information contained in the financial statements or is an outright misstatement of fact. The guidance in AU Sec 550 is reasonable, practical, and focuses on communication between the auditor, management, and the company's audit committee to resolve the auditor's concerns.

Had the Release included a modest reporting requirement based on AU Sec 550, we may have supported it as we understand that many users of financial statements are not aware of the auditor's current responsibilities with respect to such other information. But as proposed, the Release is, frankly, over the top. If adopted, the Proposed Other Information Standard would greatly increase audit costs without providing any benefit to the readers of our financial statements. We believe auditors would need to increase their procedures to conduct their evaluation of other information included in, or incorporated by reference into, a company's annual report, not only due to the expansion of information to be considered by the proposed standard, but also due to a need to perform additional procedures necessary to "evaluate" such information for a material inconsistency or material misstatement of fact. These procedures will increase the costs of our audits.

Much like that section of the Release discussing CAMs, there is scant evidence supporting the need to expand the auditor's responsibilities over other information. We are sure the Board realizes that most changes affecting the auditor and his or her audit process invariably impacts the companies being audited, increasing audit costs and putting additional pressure on companies to meet their very tight filing deadlines.

Like the proposed requirement over CAMs, expanding the auditor's responsibilities over other information will require companies to institutionalize another layer of processes necessary to facilitate the additional procedures auditors will feel obligated to perform. Too much of the Release is devoted to addressing vague investor curiosity regarding insight into the audit process and the auditor's overall responsibilities without considering the additional audit costs. Such curiosities need to be vetted much more by the Board prior to making significant changes to current audit standards.

We'd be pleased to discuss our concerns with the Board. Please feel free to call Geoff Sanders of Jacobs Engineering Group at +1.626.578.6833, or by email to geoff.sanders@jacobs.com.

*****

Submitted on behalf of the E&C Industry and the industry leading organizations below.

*[Signatures appear on the following page.]*

Jacobs Engineering Group Inc.
John W. Prosser, Jr. - *Executive Vice President and Chief Financial Officer*
Joseph R. Bronson - *Chair, Audit Committee of the Board of Directors*

URS Corporation.
Reed N. Brimhall, *Vice President and Chief Accounting Officer*
H. Thomas Hicks, *Vice President and Chief Financial Officer*
Mickey P. Foret - *Chair, Audit Committee of the Board of Directors*

Fluor Corporation
Gary G. Smalley, *Senior Vice President and Controller*
Biggs C. Porter, *Senior Vice President and Chief Financial Officer*
James T. Hackett - *Chair, Audit Committee of the Board of Directors*

Chicago Bridge & Iron Company N.V.
Westley S. Stockton, *Vice President, Controller, and Chief Accounting Officer*
Ronald A. Ballschmiede, *Executive Vice President and Chief Financial Officer*
Michael L. Underwood - *Chair, Audit Committee of the Board of Directors*

McDermott International, Inc.
Hector Gonzalez, *Corporate Controller*
Perry L. Elders, *Senior Vice President and Chief Financial Officer*
David A. Trice - *Chair, Audit Committee of the Board of Directors*

Foster Wheeler AG
Lisa Z. Wood, *Vice President and Controller*
Franco Baseotto, *Executive Vice President, Chief Financial Officer and Treasurer*
Clayton C. Daley, Jr. - *Chair, Audit Committee of the Board of Directors*

Tetra Tech, Inc.
Steven M. Burdick, *Executive Vice President and Chief Financial Officer*
Hugh M. Grant - *Chair, Audit Committee of the Board of Directors*

Granite Construction Inc.
Bradley G. Graham, *Vice President, Corporate Controller*
Laurel J. Krzeminski, *Senior Vice President and Chief Financial Officer*

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December 10, 2013

Office of the Secretary, PCAOB
1666 K Street, N.W.,
Washington, DC 20006-2803
Subject: PCAOB Release No. 2013-005/ Rulemaking Docket Matter No. 034

Dear PCAOB Board:

Please find my commentaries below on the two proposed auditing standards "The auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion" and "The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report."

We understand from Page 2, your comment "that the auditor's report in the United States has changed very little since the 1940s and that the existing pass/fail model is thought by many to be useful, because it provides a clear indication of whether the financial statements are presented fairly." In my opinion and that of many highly qualified risk management practitioners and especially those from outside of the United States, the auditor's report has had serious deficiencies for a long time and as such, I reject the notion that the financial statements present fairly, as most of the major business risks that a company incurs, evolve from the strategic planning process and not the financial statements. The financial statements are one of the culminating documents from the strategic planning process.

As an example of the above, British Petroleum (BP) to date has paid out some $42.5 billion in penalties, fines and claims related to the Macondo oil spill in the Gulf of Mexico in April 2010. It is fair to say the external auditors focused on the financial statement audit prior to the spill but completely ignored the strategic plan/objectives and most of the critical risk management aspects of the company. The way that the external audit and Sarbanes Oxley in particular are conducted, is a "top down" risk assessment but top down in the context of the financial statements. This is consistent with the COSO Internal Control Framework and with AS5. A risk assessment following the guidelines of ISO 31000 and further the implementation guidelines of HB 436 from Australia as well as leading practices in Canada and the United Kingdom, commences from the strategic objectives.

The bottom line is to identify the uncertainties that could impact the business objectives of the company, upon giving consideration to the company's stakeholders. It is the analysis of such uncertainties for likelihood of occurrence and significance to the company's business objectives, which produces the risk. In the case of BP, it is unlikely that both management of the company and its external auditors, clearly identified the potential for a major spill as an uncertainty and thus a risk. The test of this is whether there would have been an accrual on the balance sheet for this pending disaster. We know that under existing generally accepted accounting principles, there was no such accrual and yet there was a major risk. This comprised a risk clearly not identified by the external auditors and as well by the company's risk management system and internal auditors.

For many years now, the external audit has been broken primarily evidenced with the Enron debacle and the subsequent roll out of Sarbanes Oxley. Use of the COSO framework as the backbone of Sarbanes Oxley was a huge mistake because this internal control model was constructed built on a flawed interpretation of the financial statement risks. It considers the "game" to be opining of the financial statements when the "game" is providing assurance to a wide variety of stakeholders. There were more suitable internal control/risk management frameworks available than COSO.

Unfortunately, in the United States unlike the United Kingdom, Canada and Australia/New Zealand, research in risk management was outsourced to the large accounting firms and their agents. So what exists in the United States is a product by the public accounting profession for the public accounting profession instead of a product produced by worldwide experts in internal audit, control, risk management and governance for use by all companies.

Just prior to the Enron disaster, there already existed in the marketplace leading internal control, risk management and governance frameworks from the countries of Canada (CoCo-1995; QSA 850-1997); United Kingdom (Turnbull, Cadbury, Combined Code ) and Australia/New Zealand (AS/NZS 4360:1999). Such guidance was ignored and instead, COSO was rolled out as the backbone to Sarbanes Oxley and then we witnessed introduction of COSO ERM in 2004 (also flawed). Simultaneously to COSO ERM, was the introduction world wide of the third edition of AS/NZS 4360(2004) from Australia/New Zealand, which served as the foundation for issuance of ISO 31000 in 2009. Enron was not a disaster on financial statement fraud. It was about corruption, tone at top issues and greed. A well constructed risk management program including an independent review of board performance, would have impeded significantly, issues resulting in the collapse of Enron. The internal control model represented by COSO is quite deficient and the COSO ERM framework is just a further representation of this deficiency.

The turbulence created as a result of such deficiencies in the framework being used and continued marketplace disasters, allowed for a variety of other non value services to be created such as GRC in 2003. When you analyze precisely what these materials contain, you will in the best possible scenario walk away with the impression that there is further distraction from the main issues that companies needed to be dealing with. In no other major English speaking country other than the United States, would this have been possible. In addition, the plethora of vendors hawking software which purportedly will manage risk, is staggering. None of these however, are founded on robust established principles of good risk management.

So when you state on page six of the release, that "the auditor's required communication would focus on those matters that the auditor addressed during the audit of the financial statements that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements", I think that you are missing the big picture. I thus concur with PCAOB Board Member Steve Harris's comment that "the proposal would not provide as much useful information for investors as he had hoped". The point is not about those matters that are addressed by the audit of the financial statements but about those issues that are not being addressed per my commentaries of above. In other words, you need to be thinking about all of the stakeholders in a company and not just the investors.

When Chairman James Doty's comments that "the proposed standards would make the audit report more relevant to investors by establishing criteria and a framework providing deeper insights from the audit, based on information the auditor already knows from the audit", I say, that this is quite miniscule and not worth the bother. Thinking about the range of miscues we have experienced over the past ten years and the modifications as represented by these proposed changes to the auditor's report, I believe these modifications would have made minimal difference to these previous events.

Below is a summary of some of the key deficiencies of both the COSO and COSO ERM frameworks.

In conclusion, your proposed releases will accomplish very little. While we recognize the good work being done by the PCAOB, we will continue to see disaster after disaster in the corporate world in the United States. What needs to change is the way the external auditors perform their audit. Instead of commencing from the financial statements, they need to work off of the risk management plan of the company including the strategic objectives and then filter this information down to the financial statements. This involves intensive coordination with several other groups in the company, including internal audit. This is a much different approach to risk assessment than that currently being deployed.

The approach I am describing is integrated in nature whereas the public accounting model is linear. Just as you made the switch from rules based thinking to principles based thinking, so too is the switch needed that I am describing.

I reference you as well to the Financial Reporting Council in the United Kingdom and their recently released draft at the following link http://frc.org.uk/Our-Work/Publications/FRC-Board/Consultation-Paper-Risk-Management,-Internal-Contr-File.pdf. You will note how they now wish to interpret the audit of the financial statements. I l also reference you to a case study just prepared with two other colleagues that is being published shortly by John Wiley & Sons, and this will provide useful information for you. This book will be part of a best in class book of case studies on enterprise risk management as a companion to the highly successful *Enterprise Risk Management: Today's Leading Research and Practices for Tomorrow's Executives* (Wiley: 2010). Finally, I reference you to HB 436 just released by Australia/New Zealand which is worthy of a gold medal in terms of how risk management should be implemented by a company and this encompasses the audit of the financial statements. This is a product of a working group under the Standards Australia and Standards New Zealand Joint Risk Management Committee. This is referenced at:

http://shop.standards.co.nz/catalog/436%3A2013%28SA%7CSNZ+HB%29/view or http://infostore.saiglobal.com/store/Details.aspx?productID=1694350

Thank you for consideration of my comments.

Sincerely yours,

Arnold Schanfield

**Appendix**

**Some of the Key Deficiencies in the COSO and COSO ERM frameworks**

- COSO was originally issued in 1992 and was a rule based document until the new release in May 2013. So for a 21 year period, implementation of internal controls followed rules based thinking
- The COSO framework just released in May 2013 as did the framework of 1992 and the COSO ERM framework, only defines risk in the "downside". But where does the upside of risk get reflected? For example, where does the risk get captured if we fail to properly monitor competition which does not allow our company to capture their customers in the event say that our major competitor goes out of business?
- There is almost no reflection in any of these documents on the role of the stakeholder in a company but plenty of attention focused on a company's investors. This is a very narrow interpretation of internal control and to my example above of British Petroleum, what about the fishermen that lost their livelihoods, the contractors that lost their lives, the environmentalists, the many local businesses that went bankrupt
- There is no reflection in any of these document of the slow demographic shifts from around the globe that create risk for a company
- The principle based approach of COSO ERM feels like a bolt on at the back instead of being woven into the material throughout the document. There is no mention of principles until you reach back of the book and then are confronted with 120 principles. The majority of these principles sound like more rules than principles and in any event, there is not attempt to tie these principles back to the literature.
- There is no distinction in any of these documents and especially that of COSO ERM, as to the difference between the risk management process and the risk management framework. In fact the COSO ERM cube completely ignores the risk management framework in a company and hence subjects such as stakeholders, communication process, commitment and mandate by the board, risk management policy, and context are completely ignored.
- No attempt is made to provide a completely integrated example either in the internal control framework or in the enterprise risk management framework. What appears are numerous disjointed examples

- No attempt is made to identify what constitutes effective risk management. See HB 436 which does a splendid job of this
- The authors  of these documents appear to comprise  a broad array of individuals but at end of the day, this initiative ignored the key risk management practitioners from around the globe and especially the material that such practitioners previously issued
- The subject of risk appetite to a company is not well understood and certainly not communicated in a way that can allow a practitioner to implement this effectively in a company. The leading professionals are now opting to use risk criteria and we encourage you to follow up HB 436 as I had indicated above

Sempra Energy®

101 Ash Street
San Diego, CA 92101

Tel: 619-696-2000

December 11, 2013

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

Submitted via email to comments@pcaobus.org

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

Ladies and Gentlemen,

Sempra Energy appreciates the opportunity to respond to the request for comment by the Public Company Accounting Oversight Board (the Board) regarding *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the Proposal).

**Sempra Energy** is a Fortune 500 energy services holding company whose subsidiaries provide electricity, natural gas, and energy products and services. Through our subsidiaries and joint ventures, we serve more than 31 million consumers worldwide. The Sempra Energy Utilities, indirectly owned subsidiaries of Sempra Energy, include Southern California Gas Company, a regulated natural gas utility that serves 21.1 million consumers through 5.7 million natural gas meters in central and southern California, and San Diego Gas & Electric Company, a regulated utility that provides service to 3.4 million consumers through 1.4 million electric meters in San Diego and southern Orange counties, and 840,000 natural gas meters in San Diego County.

Sempra Energy supports the Board's objective to improve the auditor's reporting model by increasing its usefulness and relevance to financial statement users and enhance the auditor's responsibilities with respect to other information to protect the interests of investors and further the public interest in preparation of informative, accurate and independent audit reports. However, overall, we do not support this standard-setting Proposal to modify current auditing standards resulting in an increase in scope or a significant expansion of the independent auditor's reports. We believe the historic relationship between management, the audit committee, and the auditors should be retained. Reported financial statements are management's responsibility, not the auditors, and management should continue to provide the original source for operating and financial information.

The auditor should be responsible for providing assurance surrounding the completeness and reliability of the financial information.

Sempra Energy has several concerns about the proposed rules as discussed further below. Our comments are organized in the following sections as set forth in the rulemaking release:

1. Reporting "Critical Audit Matters" (CAMs) as part of the Auditor's Report
2. Auditor's responsibilities regarding other information in an annual report
3. Other changes to the Auditor's Report, including information about fraud and auditor tenure

***Reporting "Critical Audit Matters" as Part of the Auditor's Report***

The proposed standard requires the auditor to report on audit specific "critical audit matters". CAMs are defined as those that (1) involved the most difficult, subjective or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements.

We are most concerned about the proposed requirement to discuss CAMs in the auditor's report. CAMs may be construed as an implicit qualification of the audit, creating a perception that there may be weakness and deficiencies in management's judgment, financial statement estimates or internal control environment. Auditor judgment may not be consistent among audit firms when reporting on audit specific CAMs as the identification of CAMs is subjective. Reporting on audit specific CAMs may not be sufficiently comparable and may be a detriment to market confidence in audited financial statements. The credibility of the audit process and perceptions of audit quality and consistency should be paramount. If the perception of the audit opinion is compromised, all stakeholders will be ill-served as corporate governance, auditor independence and user investment decisions could be adversely impacted. We believe that an unqualified opinion is just that, and there should not be varying degrees of "unqualified".

We believe an audit report is not the proper place for financial statement users to identify transactions that involve significant judgments and estimates. Reporting and disclosure of significant transactions, risks and uncertainties are addressed by the SEC, U.S. GAAP and other regulations. Among the disclosures required by U.S. GAAP, ASC 275-10-50-1 addresses disclosures about risk and uncertainties, including the use of estimates and certain significant estimates.

Users of the financial statements should be expected to read and understand disclosures provided by management. These users also understand that extensive information related to the matters that may qualify as CAMs is already available in existing disclosures and filings. We believe any user frustration or confusion regarding the audit process are issues the Board should address with the SEC and other standard setters and regulators to develop a more robust, transparent and user friendly disclosure framework. Investor or other financial statement user views about the reporting and disclosure of significant transactions, risks and uncertainties should be addressed by the standard setting process of the SEC and other standard setters and regulators and not through a modification of the auditor's report.

Financial statement users may confuse the roles of the auditor, management and the audit committee. Management is responsible for its internal control environment and preparation and filing all financial reports. The audit committee oversees a reporting entity's accounting policies, internal controls, financial reporting and audit process. The auditor plans and performs audit procedures to obtain sufficient appropriate audit evidence to provide a reasonable basis for their opinion. However, the auditor should never be the first source of information and provide disclosure of information that is not otherwise required to be disclosed by management or have the appearance that it is making financial reporting decisions on behalf of management. The expansion of the auditor's role to report on audit specific CAMs is inconsistent with expectation that the auditor should not be the original source of disclosure.

The reporting and disclosure of financial information is the responsibility of management, and disclosure about significant transactions, risks and uncertainties are most appropriately provided by management. CAMs may exclusively represent transactions with complex reporting issues (i.e., transactions with significant judgments and estimates, and measurement uncertainty). However, CAMs may also represent difficult audit processes that have no correlation with transaction risks and uncertainty. Such information may lead a user to believe that the auditor is expressing a "piecemeal" opinion on individual matters or accounts in the financial statements, and any audit procedures enumerated may be taken out of context or misunderstood given their necessarily abbreviated descriptions.

Further, the Proposal, by requiring the auditor to report on audit specific CAMs may bring to question the appropriateness of audit evidence and question audit quality, with potential negative impact on the relationship between the auditor, management and the audit committee.

***Auditor's Responsibilities Regarding Other Information in an Annual Report***

The Proposal requires the auditor to report on the auditor's responsibilities regarding other information, including a statement that the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit, and a statement that the auditor did not audit the other information and does not express an opinion on the other information.

The Proposal would increase the audit scope and substantially increase the cost and effort to complete the audit, which could result in jeopardizing the timely filing of the financial statements. Because the procedures necessary to provide such assurance can be extensive, such assurance should only be required on information that is most important to investors and where auditor assurance can provide increased confidence in such disclosures (i.e., the benefit to investors is greater than the cost).

Other information is based on management's perspective, which an auditor would not be able to reasonably attest. We believe that Sarbanes-Oxley made it very clear to investors that management is responsible for the financial statements. An expectation gap that other information has been subject to audit may result with investors or other financial statement users, increasing engagement risk to the auditor. It would be necessary for the auditor to manage this risk, and the cost of the audit would increase.

Requiring auditors to expand their audit report to evaluate and comment on such information would potentially place them in potential conflict with their clients as to what must be disclosed or reported in the information outside of the financial statements. While other governance entities (SEC, national exchanges) require that management be legally responsible for their filings, this will now make it more difficult for management of a company and its board of directors to fulfill this requirement if the auditors are now placed in the role of assessing and determining what's to be included in areas of reporting outside of the financial statements. Further, auditors' expertise is over financial and reporting matters and the requirement to comment on other information may be outside of their expertise. This may require auditors to supplement their engagement teams invariably leading to increased costs.

***Other Changes to the Auditor's Report, Including Information about Fraud and Auditor Tenure***

The Proposal changes the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud. We are not certain if this approach is helpful.

An auditor's responsibility is limited to performing the audit and to obtain a reasonable assurance about whether the financial statements are free of material misstatements. Reasonable assurance is a high level of assurance, but not absolute assurance.

An investor with a lack of knowledge of auditing standards and a misunderstanding of the essential role of external auditors may already have an expectation gap over the auditors' responsibilities. The addition to the phrase "whether due to error or fraud" would only widen this gap. Defining reasonable assurance, a high level of assurance, but not absolute assurance, within the standardized language in the auditor's report may better narrow the expectation gap.

The Proposal adds a statement to the auditor's report: the year the auditor began serving consecutively as the company's auditor. The basis to include a statement in the auditor's report containing the year the auditor began serving consecutively as the company's auditor is unclear. The statement implies auditor tenure has an impact on audit quality. There is no research that implies auditor tenure has an impact on audit quality. The Board has also expressly stated that it has not reached a conclusion that such a relationship exists.

**********

We appreciate the Board's careful consideration of our comments, and fully support the Board's effort to enhance the auditor's reporting model and increase the value of the audit. If you have any questions regarding our comments or other information included in this letter, please do not hesitate to contact me.

Thank you for your consideration.

Sincerely,

Trevor I. Mihalik
Senior Vice President, Controller
and Chief Accounting Officer
Sempra Energy

**From:** Joe Lawless
**To:** Comments
**Subject:** PCAOB Rulemaking Docket Matter No. 034
**Date:** Wednesday, December 11, 2013 12:40:20 PM

Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members:

I appreciate the chance to address the board in this matter. I am writing to you from a very small FINRA Broker-Dealer that is already weighed down by the many draconian rules imposed by the regulatory authorities that be. Although we are privately held, have fewer than 2 dozen employees, and are non- custodial, we have to jump through the same hoops as the biggest firms in the industry. In short, virtually no public entities review our financial information. The majority of firms fit this profile. I'm asking you to not inflict further impositions on our firms.

The change in rule for small firms to get a PCAOB audit caused my long time auditor to withdraw and my cost to increase approximately 5 figures. For our small, privately held entities, the proposed rules would inflict yet greater costs, with no relevance to the mission of the PCAOB or to the public investor. Indeed, the "investors" in these companies are the owners themselves, my company being owned solely by myself.

As members of the board, please take appropriate action and exercise your authority under the Dodd Frank Act to exempt the auditors of small privately held companies from its oversight. In the spirit of relevance, rationality and suitability, please consider heavily the matter of a small firm exemption.

Regards,

**Joseph M. Lawless**
**President**
**Sentinel Brokers Company, Inc.**
**516-541-9100**
***Noster populus facit discrepantiam***

sifma
Invested in America

December 10, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

**Re: PCAOB Release no. 2013-005, PCAOB Rulemaking Docket Matter No. 34**

Dear Members of the Board:

The Global Financial Institutions Accounting Committee of the Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to provide comments on the Public Company Accounting Oversight Board's ("PCAOB's" or the "Board's") proposed auditing standards; *The auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion; The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report; and Related amendments to PCAOB standards* ("Proposed Standards").

We support the PCAOB's objective to enhance auditor communications and to provide useful information to the users of financial statements, as these goals enhance the trust and confidence within the financial markets which rely upon these financial statements. However, we believe that the Proposed Standards will not achieve these objectives and, in fact may have a negative impact on audit quality.

As described below, we have significant concerns about the disclosure of critical audit matters and how they will be interpreted by users, and on the new responsibilities of auditors to evaluate other information presented outside of the audited financial statements.

We believe the Proposed Standards would cause significant changes in certain current roles. For example, Audit Committees would become involved in a level of detail that could be construed as management rather than oversight. Also, sections of the report that are currently used by Investor Relations to communicate messages (for example, the President's Letter) would become subject to negotiation with the auditor.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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The increased time and effort to prepare, review and obtain approval for audit report disclosures, required by the Proposed Standards, will either increase the current time lag between the period end date and the reporting date, or will take focus away from the quality of the audit and the audit conclusions reached, or on the adequacy of the company's financial disclosures – the more important responsibilities of the auditor.

The changes that would occur as a result of adoption the Proposed Standard are so significant that we suggest the Board view this current exposure draft more as a discussion paper. After considering these comments and the many similar comments we believe interested parties will submit, the Board should expose a new draft for comment, as we believe there are many details that merit comment.

In addition to the specific comments below, we are concerned that the Proposed Standards represent a potentially substantial increase in the scope of the PCAOB's mission to oversee the audits of public companies. Regulations as to what information must be audited are set forth in securities laws (for public companies), and are the domain of the SEC. We believe the proposed requirement to expand the auditor's responsibility to report on "other information" goes beyond the PCAOB's mandate of establishing audit standards, and is a first step on the path towards a requirement for an audit opinion on MD&A and other information prepared by companies. We believe this is inconsistent with the spirit, if not necessarily the letter, of the mandate of the PCAOB's mission. If the proposed requirement is to be put in place, it should originate with the appropriate regulatory institution, namely the SEC and not the PCAOB. Without doing so, a new proposed regulatory requirement would not be subject to the SEC's extensive due process requirements.

We have focused our current comments on the most significant concerns rather than provide a detailed response to questions or a paragraph-by-paragraph review.

**Critical Audit Matters**

We are concerned that significant judgment will be required to determine if an item should be disclosed as a critical audit matter ("CAM"), which could lead to inconsistent application and insufficient comparability of auditor reports among industry peers. We are also concerned with how the average user of the financial statements will interpret the meaning of CAMs disclosed in the audit opinion. The requirement for auditors to report on CAMs already exists, though the reporting is to the Board of Directors through the Audit Committee. These representatives have a clear responsibility to understand the results of the audit and oversee the decisions about disclosures and, in order to fulfill this responsibility, there is a requirement for at least one "financial expert" on an audit committee. We therefore believe that the interests of financial statement users are adequately represented and protected, and we question the utility of providing disclosure of CAMs more broadly, especially when there is (and can be) no such financial literacy requirement for users in general.

More specifically, the disclosure of CAMs in the audit opinion could inappropriately:

- cast doubt over the quality of the financial statements, the audit procedures, or both. If the auditor ultimately issues an unqualified (or "clean") opinion, it means the issues raised were appropriately resolved. We are concerned that this outcome will not be clearly understood by users of financial statements.
- dilute the meaning and power of a "pass/fail" audit opinion covering the entire financial statements by providing a series of different opinions on specific matters; highlighted items will be interpreted as deficiencies or weaknesses in financial reporting. We see this as a direct follow-on from the previous comment.
- provide information in the financial statements for the first time. Financial statements already include complex and detailed disclosures, often over hundreds of pages, to provide insight into management's view of critical accounting policies and estimates, business performance and trends and various financial and operating risks. We do not believe it is appropriate for auditors to disclose new information within the audit opinion that is not already provided elsewhere in the financial report. Additionally, if the information is already provided in the financial statements, we do not believe it needs to be repeated again in the audit opinion.
- increase the "expectations gap" between what an auditor is required to do and what an auditor is expected to do. We believe it will be exceedingly difficult for a reader to understand the decision-making process for including or omitting items from the list of CAMs, and that the comments could be construed by readers as opinions or disclaimers on specific elements of the financial statements, or as a qualified opinion regardless of the language of the actual opinion paragraphs. In addition, we believe the concerns auditors will have with the proposal will lead to the emergence of generic language used in all audit opinions (i.e., "boiler plate"), diminishing the usefulness of the additional disclosure. For example, within financial institutions, the valuation of level 3 assets will be a significant and highly judgemental aspect of any audit, and will be for all financial institutions. Including this in the audit report would not add any value to the audit report, particularly if the same disclosure is made by every financial institution.
- require additional audit procedures and effort. The Proposed Standards do not explicitly require additional procedures; however, it is highly likely that the enhanced audit opinion will require significant additional effort from auditors, preparers and audit committees, and during the busiest times of the year. As noted above, auditors already report this type of information to the Audit Committee, but including such comments in a publicly available report will inevitably cause an auditor to perform additional procedures and to increase the search for matters to report. For preparers, this additional cost will manifest itself both through increased audit fees as well as through increased internal resource requirements, calling into question whether the limited benefits will outweigh the added costs.

Given the concerns noted above, we cannot support the Board's proposal.

**Reporting on Other Information**

We agree that users would benefit from a clear and transparent disclosure of the auditor's responsibilities for the other information presented along with the audited financial statements. However, we are concerned that the Proposed Standards increase, rather than clarify, the auditor's responsibility and performance requirements for the other information, specifically the requirement to "evaluate" other information rather than "consider" other information. This is particularly troubling for forward-looking information included in the financial reports as we do not believe it is the role of the auditors, nor will they have the expertise, to evaluate management's forward-looking statements. Similar to the CAMs above, we believe this requirement will increase the "expectations gap" between what an auditor is required to do and what an auditor is expected to do, as users will not be able to distinguish between the information that the auditor has evaluated as being consistent with information obtained as part of the audit and information that is wholly outside of the audit scope.

The Proposed Standard requires a statement that, based on the evaluation of other information, the auditor (1) has not identified a material inconsistency or a material misstatement of fact in the other information, or (2) has identified a material inconsistency. The evaluation of "materiality" in regards to certain other information (especially that which is not directly related to the audited financial statements) may be difficult to apply in practice and cause inconsistencies in application.

Given this proposed increase in auditor responsibility and performance requirements, the cost of audits is likely to increase if auditors are now required to search the full audit file to evaluate every statement made by management outside of the audited financial statements. Although this cost cannot be definitively quantified, we do not believe this increased cost is worth the limited benefit provided by the Proposed Standards.

Given the above, we are concerned that the additional auditor responsibilities and performance requirements may lead to less disclosure, particularly as it relates to other information that cannot be sourced systematically and is not subject to the same level of controls and review as the data presented in the financial statements. For example, management may want to disclose the existence of cost savings programs along with anticipated cost savings and costs to achieve over time. Management could believe this type of information is relevant to investors, but if the estimates are subject to audit procedures or review, it might be easier to refrain from the extra disclosure. In fact, such items may be based on budgets and expectations and they are unlikely to be auditable at all. Additionally, this information is often provided as insight into management's analysis and expectations, and is not objectively verifiable, making it very difficult for the auditors to evaluate the information effectively. The accuracy and reasonableness of this information should remain the responsibility of management.

**Auditor Tenure**

We do not object to the requirement to disclose auditor tenure in the audit report, but we believe it is not necessary because we reject the assumption that auditor tenure and audit quality are related.

We hope you find our comments helpful. Should you have any questions or require further information concerning any of the matters discussed in this letter, please do not hesitate to contact me (mscucci@sifma.org; 212-313-1331).

Very truly yours,

Mary Kay

Mary Kay Scucci, PhD, CPA
Managing Director
SIFMA

cc:
PCAOB
James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
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SOCIETY
of Corporate Secretaries
& Governance Professionals

January 21, 2014

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

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

Ladies and Gentlemen:

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

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

**General Comment**

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

## Critical Audit Matters

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[5] See Appendix 5 of the Release.

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

**Auditor's responsibilities regarding other information in certain documents**

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

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

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

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

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

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

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

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

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

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

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

[6] See Release, at page 9.

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

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

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

**Auditor Tenure**

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

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

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

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

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

Respectfully submitted,

Darla C. Stuckey

Darla C. Stuckey, SVP, Policy & Advocacy

The Society of Corporate Secretaries and
Governance Professionals

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

**From:** Amy Beattie (abeattie@cusonet.com)
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 1:32:14 PM

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Re: PCAOB Rulemaking Docket Matter No. 034; Proposed Auditing Standards, The Auditor's Report on an Audit of Financial Statements, When the Auditor Expresses an Unqualified Opinion, and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;
Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, nonpublic, non-custodial broker-dealers. These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees. For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves. I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.
Best regards,
Amy Beattie

Amy Beattie, C.O.O.
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December 11, 2013

Mr. Martin F. Baumann, Chief Auditor
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006

Re: PCAOB Release No. 2013-005; Rulemaking Docket Matter No. 034; Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards

Dear Mr. Baumann:

In Release No. 2013-005 (the "Release"), the Public Company Accounting Oversight Board (the "Board" or "PCAOB") solicited public comment about a proposed standard-setting project on the content and form of reports on audited financial statements. Southwestern Energy Company ("Southwestern" or "We") appreciates the opportunity to comment on the Release. We have not previously participated in the PCAOB's rule promulgation process and believe the concepts set forth in the Release warrant the response of both Southwestern and other financial reporting participants and consumers.

Our perspective in considering the Rule is informed by our public company status (we are a well-known seasoned issuer, as defined by the Securities and Exchange Commission ("SEC"), with an equity capitalization of approximately $13 billion). We are dedicated to full and fair disclosure, transparency to financial statement users and capital markets, and responsible improvements in financial reporting and disclosure. Our comments on the Release are provided below.

## I. OVERALL COMMENTS

We believe that any new promulgation should not change the basic relationship and responsibilities of an issuer's management, audit committee, and auditors. Accordingly, we believe that (1) management should continue to be responsible for preparing the financial statements, adopting appropriate accounting policies, and establishing and maintaining internal controls that report transactions in accordance with Generally Accepted Accounting Principles ("GAAP") and applicable federal securities laws, (2) the audit committee should continue to have the responsibility to oversee management's financial reporting process, and (3) the auditor should continue to have the responsibility to express an opinion on whether the financial statements and disclosures (taken as a whole) are presented in conformity with GAAP (in all material respects). With strong emphasis, we continue to believe that the auditor may make suggestions around the form or content of the financial statements; however, the auditor's responsibility should remain confined to an expression of an opinion on them.

## II. CERTAIN RECOMMENDED AUDITOR REPORT CHANGES

We believe the single most important outcome produced by the audit is the auditor's report and have chosen to comment below on the three topics of most concern to us that relate to the contemplated auditor report changes. First, the current pass-fail model is succinct and clearly communicates that an audit of the company's financial statements and internal controls has taken place and that the issuer has presented financial statements in accordance with GAAP, unless disclosed otherwise. We believe that an audit expectation gap exists between what a financial statement user expects and the actual assurance provided by an audit. This expectation gap exists because auditors are not guarantors against fraud and their audit provides reasonable assurance, rather than absolute assurance, on the accuracy of an issuer's financial statements. Any responsible improvement to the auditor's report that appropriately resolves this expectation gap would be supported by Southwestern.

Secondly, the Release addresses the inclusion of an emphasis paragraph. Although rarely used, we believe that the current auditor's framework provides for the inclusion of an emphasis paragraph in AU Section 508.19. We believe that any new requirement to include an emphasis paragraph will most likely result in boilerplate verbiage and not improve financial reporting, absent improved guidance about its use. If the Board determines that it is appropriate to mandate the use of an emphasis paragraph, we encourage the Board to ensure that any added paragraph will improve the financial reporting process and the usefulness of the audit report for financial statement users, rather than add boilerplate language that provides little value to financial statement users.

Finally, the Release addresses the inclusion of an auditor's discussion about difficult or contentious audit issues. It is important to note that an auditor already discusses difficult or contentious audit issues with the audit committee, in addition to estimates, accounting policies and practices. We do not believe that a discussion of these topics necessarily improves a financial statement user's understanding of an issuer's financial statements. Rather, we believe additional disclosure may confuse the user because it may introduce one or more competing acceptable accounting treatments. If an accounting treatment adopted and disclosed by management conforms to GAAP, then, by definition, such treatment is acceptable accounting and, under the standard of the auditor's report, must fairly present the issuer's financial position. We firmly believe that issuers – not auditors – are responsible for accounting policy election and application and should therefore be responsible for explaining those choices. We believe this is consistent with the primary and secondary roles of the issuer and its auditor, respectively, in connection with financial reporting. Accordingly, we do not support the use of a discussion paragraph about management's judgments and estimates, accounting policies and practices, and difficult or contentious audit issues.

## III. AUDITOR DISCUSSION AND ANALYSIS AND OTHER INFORMATION

Included in the Release is a proposal to include an Auditor Discussion & Analysis ("AD&A") in the auditor's report in order to provide financial statement users with a view of the financial statements and audit "through the eyes of the auditor." We believe this proposal would most likely result in the communication of original information about the company by the auditor, rather than the issuer. In our opinion, management has the best insight and ability to provide written commentary about the financial statements and financial condition of a company. We firmly believe that management is best suited to make judgments about market conditions, risks and other factors that might be relevant to financial statement users. The role of the auditor is to provide assurance, not information about an entity. We do not support the use of an AD&A.

Furthermore, the Release addresses auditor assurance on other information outside the financial statements, in particular Management Discussion and Analysis ("MD&A"). With emphasis, we would like to highlight that the auditor already reviews other information in documents containing audited financial statements and considers whether such information, or the manner of its presentation, is materially inconsistent with the financial statements or represents a material misstatement of fact. Expanding the audit process to include assurance for MD&A would substantially increase audit fees. If financial statement users do not understand the roles and responsibilities of the auditor with respect to information outside the financial statements, we support additional discussion in the audit report about the auditor's role and responsibilities.

******

Thank you for the opportunity to comment on the Release. If you have any additional questions, please contact us at (281) 618-4700.

Sincerely,

R. Craig Owen
Senior Vice President
and Chief Financial Officer

Josh C. Anders
Vice President and Controller

STANDARD & POOR'S
RATINGS SERVICES
McGRAW HILL FINANCIAL

November 21, 2013

Public Company Accounting Oversight Board
1666 K Street
Washington, DC 20006

International Auditing and Assurance Standards Board
529 Fifth Avenue, 6th Floor
New York, NY 10017

Via upload to: www.pcaobus.org and www.iaasb.org

**Re:** **PCAOB Rulemaking, Docket Matter No. 034, "The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion" and "The Auditor's Responsibilities Regarding Other Information In Certain Documents Containing Audited Financial Statements And The Related Auditor's Report,"** the "Proposed Auditing Standards"

**IAASB Exposure Draft, "Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs),"** the "Exposure Draft"

Dear Sir/Madam:

Standard & Poor's Ratings Services appreciates the opportunity to provide the Public Company Accounting Oversight Board (PCAOB) and the International Auditing and Assurance Standards Board (IAASB) (together the "Boards") comments on their exposure drafts on changes to the auditor's reporting model.

The views expressed in this letter represent those of Standard & Poor's Ratings Services and do not address, nor do we intend them to address, the views of any other affiliate or division of Standard & Poor's Financial Services, LLC. We intend our comments to address the analytical needs and expectations of our credit analysts.[1]

[1] The opinions stated herein are intended to represent Standard & Poor's Ratings Services' views. Our current ratings criteria are not affected by our comments on the exposure drafts.

Standard & Poor's Ratings Services wholly supports the efforts of the Boards to increase the value of the audit and the auditor's report for analysts, investors, and other financial statement users. We believe the improvements the Boards propose will add value to the audit, the auditor's report, and the related financial statements by disclosing potentially useful information specific to each entity that will help inform our analysis on issues identified in the audit that were significant to the auditor. This improved communication about the audit will likely enhance audit credibility and quality beyond the current pass-fail opinion, increasing usefulness and transparency for credit analysts and other financial statement users.

Highlights of our letter include:

- We support the Boards' work to improve the auditor's report by providing additional information specific to each entity.
- We encourage the PCAOB and IAASB to develop standards consistent with each other.
- In addition to the proposals, we believe the auditor's report should evaluate and report on the appropriateness of accounting practices companies applied when alternatives were available.
- We also favor an improved format and structure of the auditor's report for more effective delivery of key messages. For example, the use of titles, headings, and subheadings is a good way to organize and identify sections of the auditor's report.

**An Enhanced Auditor's Reporting Model Is Favorable**

The auditor's report is how auditors communicate their work to financial statement users, and those financial statements are our primary source of information regarding an enterprise's current and past financial condition and performance. A company's financial statements are the starting point of our financial analysis. Our analysis of a company's financial statements begins with a review of the accounting features to determine whether the data in the statements accurately measure a company's performance and position relative to its peers and the larger universe of corporate entities. The analysis of footnote disclosures—e.g., detailed schedules, contingent liabilities, and assumptions used—can provide a better understanding of an enterprise's financial risks.

The auditor's work and report are clearly valuable in our analysis. We rely on the auditor's report, and are skeptical in its absence or qualification. As financial statement users, we believe we will benefit from information beyond the assurance currently provided by the pass-fail auditor's opinion. While the auditor's report will maintain its pass-fail element, we believe the expanded disclosures about critical or key audit matters will increase the usefulness of the auditor's report and enhance audit discipline. The PCAOB's critical audit matters (CAM) and the IAASB's key audit matters (KAM) should provide clear and concise entity-specific information; this is how the proposed auditor's report will likely provide significant value for users.

The CAMs and KAMs potentially will include important matters communicated to the audit committee or those charged with governance, respectively. We believe the CAMs and KAMs should include specific descriptions of how the auditor addressed each matter, and not be boilerplate language. For example, we emphasize the importance of the auditor addressing management's specific policies, practices, and processes used to: account for significant unusual transactions; determine highly subjective significant assumptions applied in critical accounting estimates; and present financial statements and related disclosures. In our view, by communicating such information in CAMs and KAMs, the auditor's report would make desirable strides towards increased usefulness and transparency for financial statement users.

With the information and understanding gained through the audit process, the auditor has the ability to provide entity-specific information and insight beyond the binary pass-fail opinion in areas of significant risks, judgments, estimates, and assumptions. This information would be especially meaningful to credit analysts and other financial statement users if it provides relevant information that helps to better understand financial risks, including future cash flows and prospects. Financial statements are increasingly complex, so we believe users will benefit from an independent and objective view of areas where preparers applied judgments and prepared estimates, and how auditors were able to obtain sufficient, appropriate audit evidence.

**Develop Consistent Standards For The Auditor's Report**

As a global rating agency, and users of financial statements across the globe, we ideally would like to see a fully converged auditor reporting model. We appreciate that the Boards are concurrently developing standards to improve the auditor's report and that they are monitoring each other's progress. We favor the many similarities between the PCAOB and IAASB projects, such as bringing transparency to judgmental areas and the rationale behind the considerations made. However, quite importantly, the Boards define the criteria to determine CAMs and KAMs differently. We believe this proposed addition to the auditor's report is most relevant to financial statement users, and believe the Boards should avoid the possibility of different standards that could generate different audit matters reported simply because of the definitional distinctions.

We urge the Boards to strive for greater consistency, not only in the definitions, but also in the disclosure requirements. In some areas, one proposal may be more developed than the other (e.g., the PCAOB's Proposed Auditing Standards has fully developed the auditor's responsibilities regarding "other information" included with the audited financial statements, whereas the IAASB included a placeholder with requirements to be developed). On the other hand, the IAASB's Exposure Draft robustly explains and discloses the auditor's responsibilities for the audit. We urge the Boards to use the best from each other's work and to develop consistent requirements for the auditor's report: we do not believe the lack of harmony in auditor's reports will aid global reporting and analysis, and it may lead to varying levels of regulatory enforcement.

**Evaluate Alternative Accounting Practices**

When accounting standards provide alternative accounting practices, we believe the enterprise's accounting choices should best reflect the underlying economics of its business transactions. An enterprise's accounting choices should depict information in the financial statements that is consistent with the intent and the economic drivers of significant transactions of the business, for example, the effect of its asset-liability management models, inventory methods, and construction contract accounting. We recommend the Boards consider auditing standards that would provide financial statement users with auditor views on the symmetries between the economic basis and accounting depiction of transactions when the enterprise has made accounting choices. Currently, as part of an audit, the auditor evaluates the appropriateness of the accounting policies the company used in the context of an established materiality. We believe the auditor's report should go further by concluding whether the accounting policies used are the most appropriate (not just in accordance with the accounting standard), in light of the entity's specific circumstances, and that they best reflect economic reality of the company. This disclosure should also include areas in which the accounting--while appropriate--did not fully meet the standard-setting intent or masked the economics (e.g., repo 105, synthetic leases, and other “unique” arrangements). We believe that evaluating and reporting on the quality of accounting practices would likely lead to entities selecting more relevant accounting policies and, consequently, to greater consistency in financial reporting.

**Format And Headings**

The audit report format is important to ensure that auditors can communicate key messages effectively. Because a well-defined format and structure for the auditor’s report will help users, we believe the Boards should define the format and structure. The use of titles, headings, and subheadings, as required by the IAASB’s Exposure Draft, is an excellent example of identifying the purpose of each section and paragraph within the auditor’s report.

**Reporting On “Other Information”**

We support potentially expanding auditors’ responsibilities to address evaluating any “other information” included with, but outside the financial statements, for material inconsistencies or misstatements. Further, we believe financial reporting is negatively affected if companies provide material to investors through other means (e.g., investor presentations) that is inconsistent with the audited financial statements.

**Going Concern Disclosures**

The going concern assumption is inherent in every audit and justifies valuing assets and liabilities using historical cost; otherwise, a liquidation (or fair value) perspective should be employed. Nevertheless, following the financial crisis, the going concern issue has become a greater worry, and accordingly, addressing it explicitly in the audit report may add accountability and comfort for this aspect of the audit.

**Private- Vs. Public-Entity Auditor’s Reports**

We believe financial statement users of public- and private-sector reports will better understand the financial statements and audit results if the auditor’s reports are more informative. In our credit analysis, we seek the same level of information from all entities, whether large or small, public or private, not-for-profits or governments. Because the PCAOB standards do not apply to private entities in the U.S., we encourage the American Institute of Certified Public Accountants to adopt auditor reporting model standards for private entities that are similar to the PCAOB and IAASB proposals.

* * * * * * *

We thank you for the opportunity to provide our comments, and we would be pleased to discuss our views with members of the Boards or your staffs. If you have any questions or require additional information, please contact the undersigned.

Very truly yours,

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February 26, 2014

Transmitted via Email: comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

The State Board of Administration (SBA) of Florida welcomes the occasion to provide comments to the Public Company Accounting Oversight Board's (PCAOB) Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Amendments to PCAOB Standards (Release). The SBA manages the assets of the Florida Retirement System (FRS), one of the largest public pension plans in the United States with 1.1 million beneficiaries and retirees. The SBA's governance philosophy encourages companies to adhere to responsible, transparent practices that correspond with increasing shareowner value.

The SBA's views on the Release are consistent with the opinions we expressed in response to the PCAOB's 2011 Concept Release on Proposed Auditing Standard Related to Communication with Audit Committees.[1] Our policies have long reflected the principle that the auditor's role in safeguarding investor interests is critical and that independent auditors have an important public trust, for it is the auditor's impartial and professional opinion that assures investors that a company's financial statements are accurate. Investors must be able to rely on the auditor's evaluation of a company's accounting policies and practices for, not only accuracy and acceptability, but also for quality. It is necessary that auditors report on the qualitative aspects of management's estimates, process, and judgment.

Proposed Auditor Reporting Model

SBA staff supports the proposed auditor reporting model that requires the independent auditor to communicate 'critical audit matters' in the auditor's report. SBA staff finds the requirement for the outside auditor to communicate significant unusual transactions to the audit committee to be an appropriate standard. Additionally, it is correct to require the auditor to communicate to the audit committee his or her views regarding significant accounting or auditing matters when the auditor is aware that management has consulted with other accountants about such matters and the auditor has identified a concern regarding these matters.

[1] Letter from Ashbel C. Williams, Executive Director and CIO, SBA, to Office of Secretary, PCAOB (February 29, 2012), available at http://pcaobus.org/Rules/Rulemaking/Docket030/033b_SBA_of_FL.pdf.

Also, if the auditor determines that there are no critical audit matters, the auditor should state in the auditor's report that the auditor determined that there are no such matters to communicate.

Proposed Other Information Standard
SBA staff supports the proposed 'other information' standard and the approach that the PCAOB has taken in specifying the types of communications that should occur between the outside auditors and the audit committee. We believe that the proposed specific procedures for the auditor to perform with respect to evaluating the other information will provide consistent disclosure for investors. We agree with the PCAOB that those procedures and the resulting communication of any potential material inconsistencies or misstatements of fact to the company's management "could promote consistency between the other information and the audited financial statements, which in turn could increase the amount and quality of information available to investors and other financial statement users."

Proposed Standards and Amendments to Emerging Growth Companies
SBA staff believes the proposed standards and amendments should be applicable to audits of all public companies regardless of their revenue base or market capitalization, including emerging growth companies (EGC). We agree with the PCAOB that the application of the proposed standards and amendments to EGCs could provide useful information that "could contribute toward investors making more informed decisions, resulting in more efficient capital allocation and lower average cost of capital."

As a member of the Council of Institutional Investors (CII), the SBA echoes their recommendations for the PCAOB to consider as it develops new auditing standards. The SBA looks forward to the potential benefits of additional auditor reporting. Thank you for your consideration and if you have any questions, please feel free to contact me at (850) 413-1252, or at governance@sbafla.com.

Sincerely,

Michael P. McCauley
Senior Officer, Investment Programs and Governance

cc: SBA Corporate Governance & Proxy Voting Oversight Group
Flerida Rivera-Alsing, Chief Audit Executive, SBA

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May 2, 2014

Office of the Secretary
Public Company Accounting Oversight Board
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Washington D.C. 20006-2803

Via email: comments@pcaobus.org

**Re: Invitation to Comment:** ***PCAOB Rulemaking Docket Matter No. 34: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments***

Dear Board Members:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Public Company Oversight Board's (PCAOB or Board) *Proposed Auditing Standards on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards (the Proposed Standards).* With $27.48 trillion in assets under custody and administration, and $2.38 trillion in assets under management as of March 31, 2014, State Street is a leading financial services provider serving some of the world's most sophisticated institutions. As a "Systemically Important Financial Institution" and a "Global Systemically Important Bank" as designated by the Financial Stability Board and the Basel Committee on Banking Supervision, State Street plays a key role in the global financial market infrastructure.

While we support the efforts to improve audit quality and auditor communication to enhance stakeholder confidence, we have a number of comments regarding the Proposed Standards that we believe should be addressed in order to achieve the proper balance of ensuring that additional information in the form of auditor communications is both reliable and relevant to the users of financial statements.

We are primarily concerned that the Board's proposal to add critical audit matters (CAMs) to the audit report may result in a perceived weakness in financial statement reporting process, including management's competence or effectiveness of the control environment. Requiring auditors to provide information on the company's financial reporting process may force independent auditors to consistently hold (or "assume") the most conservative view on matters of accounting judgment, resulting in more CAMs being included in the auditor's report. As this exercise of caution will vary between auditing firms, comparability will likely be adversely affected and will weaken the report's main message.

State Street believes that auditors should not be the original source of disclosure specifically related to management judgments and estimates, or accounting policies and practices, including areas of significant judgment. Providing information to investors with respect to our accounting policies and their application is the responsibility of State Street's management, not the independent auditor. Sophisticated stakeholders are aware that information that would be disclosed as CAMs by the auditor is already included in disclosures made by management. The auditor's role is to evaluate whether the financial statements taken as a whole are presented fairly in accordance with generally accepted accounting principles (GAAP). Requiring the auditors to disclose this information would unnecessarily convolute the financial statements, as they would need to sort through information provided by both management and the independent auditors. The auditor's responsibility to communicate such matters should be limited to situations in which the financial statements are not in conformity with GAAP in all material respects.

The Proposed Standards require the independent auditors to summarize to investors the same level of detail and context that is provided to a company's Board of Directors, the independent elected body representing stakeholders. In the absence of appropriate context and two-way communication, we believe that such information would be potentially misleading, incomplete, and would not enhance the overall understanding of the readers of the auditor's report and financial statements. Additionally, we note that requiring supplemental reporting such as the proposed CAMs likely will lengthen the time to complete the audit, as there may not be sufficient time for the auditor to complete the audit of the financial statements and provide assurance in additional areas and therefore adversely influence filing timelines for large accelerated filers.

We do not object to the concept of requiring auditors to provide assurance on certain information outside the financial statements, provided that the scope of such assurance is clearly defined. However, we are unclear on the incremental benefits to investors from the elevated level of assurance proposed to be provided by auditors over management's discussion and analysis (MD&A), including the critical accounting estimates currently discussed in MD&A, given the likely significant increase in audit procedures and audit-related costs that will ultimately be borne by our company's shareholders.

State Street believes that the current auditor's report ("pass/fail model") clearly communicates the nature of the audit and whether the financial statements are presented fairly, in all material respects, in accordance with GAAP. The concept of clarification of the standard auditor's report would further lengthen the auditor's report unnecessarily and create redundancies with management disclosures without achieving the objective of enhancing communication between auditors and the users of audit reports, thereby compromising the report's effectiveness. With respect to the proposed approach related to the required and expanded use of emphasis paragraphs, we note that existing standards allow auditors to add areas of emphasis at their discretion, based on circumstances. We believe that mandating the requirement for an emphasis paragraph would result in standardized language over time and would therefore not achieve the proposed objective.

We appreciate your consideration of these matters and welcome the opportunity to discuss them with you.

Sincerely,

Michael W. Bell
*Executive Vice President and Chief Financial Officer*

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December 11, 2013

Via E-mail: comments@pcaobus.org

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

Re: PCAOB Rulemaking Docket Matter No. 34 – Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Ladies and Gentlemen:

This letter is in response to the proposed auditing standards relating to auditor's reports on financial statements issued by the Public Company Accounting Oversight Board (the "Board") in PCAOB Release No. 2013-005 (August 13, 2013) (the "Release"). We appreciate the opportunity to submit these comments for the Board's consideration.

We previously commented to the Board's 2011 Concept Release on the audit report. Those comments, based on our perspective as lawyers regularly engaged advising issuers on disclosure and reporting matters, were animated by two key considerations:

- the issuer must be the original source of any disclosure about the issuer or its results of operations or financial position, and

- the best way to capture, for the issuer and its shareholders, the benefits of the auditor's insights and experience is for the auditor to have full and open interaction with the audit committee.

The proposed auditing standards do not reflect some of the more troubling potential changes considered in the Concept Release – such as the proposed "auditor's discussion and analysis" – but do include elements that in our view are likely to have unintended consequences that increase costs and are detrimental to the quality of issuers' disclosure and their governance processes.

The proposed requirement to include discussion of "critical audit matters" in the audit report significantly implicates these concerns. On a very basic level, in the context of an audit report that continues to state a "pass/fail" conclusion, we do not understand how a discussion of critical audit matters truly serves a useful disclosure purpose. The discussion appears to be pointing out areas of uncertainty, but we assume that it is not meant to convey uncertainty as to the basic "pass/fail" conclusion of the audit. Is it then intended to indicate uncertainty as to the information disclosed by the issuer? It seems to us that disclosure as to this sort of uncertainty is best left to the issuer itself. Indeed, issuers are required to disclose known trends and uncertainties in management's discussion and analysis of financial condition and results of operations (MD&A), and MD&A also includes a discussion of critical accounting estimates. Areas of uncertainty addressed in the audit process are at best a second-order indicator of the quality of the issuer's disclosed information. Someone engaged in direct discussions with the issuer – such as underwriters conducting due diligence discussions, or an audit committee overseeing the issuer's financial reporting – could follow-up on this sort of indicator and ask further, targeted questions as to the underlying state of affairs. But an investor reading financial statements does not have that opportunity to follow-up. For the investor, the significance of the critical audit matters disclosed seems uncertain and questionable, at best.

At the same time, any discussion of critical audit matters will, we think, necessarily expand disclosure about the issuer, and in particular about the issuer's internal control over financial reporting. For example, we would expect a critical audit matter requirement to lead to extensive disclosure and discussion of "significant deficiencies" in internal control. Indeed, the proposed standard provides that the "severity of control deficiencies identified" is a factor that the auditor should take into account in determining a critical audit matter. While some might view that as useful disclosure, for present purposes we think the key point is that any expansion (or effective expansion) of disclosure requirements in this area should be the result of Securities and Exchange Commission rule-making, with notice and comment, and not the by-product of new PCAOB auditing standards.

We are also concerned that a requirement to discuss critical audit matters may have, as an unintended consequence, a tendency to discourage free and open communication between the auditor and management and between the auditor and the audit committee and, to the extent issuers and audit committees may have an influence, between auditors and their respective national offices. As we read the proposed auditing standard, such communications could be taken as indicators of critical audit matter status. For any number of reasons, issuers and auditors may wish to limit, or otherwise influence, the number of critical audit matters that must be addressed, and seek to do so by limiting such communications. This would obviously be a most unfortunate effect, but we are quite concerned that it would be a real motivating factor for issuers and their auditors operating under the proposed standard. We are also concerned that discussion of critical audit matters in the audit report will lead issuers to feel compelled to make reactive disclosures, resulting in added costs and burdens to them. At the same time, it will have the effect of causing the auditor to be a source of disclosure about the issuer and its financial reporting rather than an independent auditor of the issuer's financial information, thus both changing and blurring the role of the auditor.

Our principal concern with the proposed "other information" standard also relates to unintended consequences. This standard would require addition to the audit report of a very simple, blanket confirmation. We expect most readers would understand that confirmation to provide additional "comfort" as to the other information covered or worse, that the other information is somehow being "expertised". Notwithstanding the contemplated disclaimers (as to the basis of the evaluation, and that no opinion is being expressed on the other information), we are therefore concerned that a requirement to provide such confirmations will provide auditors a powerful incentive to do more work to support the statement. On the other hand, if that is not the result, given the impression conveyed by the confirmation, we are concerned that the new requirement will have effectively widened the "expectations gap" between what investors believe the auditors are doing, and what they in fact do. As an example, the proposed standard would treat as "other information" any documents in the list of exhibits to the annual report on Form 10-K[1]. Putting aside the time and expense associated with having an auditor read and evaluate the information in those documents, we question whether the auditor has any particular expertise with respect to evaluating many of the documents so filed. Moreover, although the proposed standard would have the auditor state that her

1 Appendix 6 of the proposed standard, page A6-6.

evaluation of the other information was based on the relevant "audit evidence obtained and conclusions reached", we doubt the average investor will appreciate the limits that statement is intended to convey, thereby aggravating the "expectation gap".

We are also concerned that the new requirements, as to both "critical audit matters" and "other information", may expose the auditors to additional potential liability, unfairly in our view, since the auditor would be required to make comments on the basis of information acquired incidentally in the course of the audit, as opposed to as a result of procedures designed specifically to develop such disclosure. And we fear that auditor disclosures of the sort contemplated would likely enhance the issuer's liability profile, as well.

We continue to believe it is quite important that issuers (and derivatively, their shareholders) get the full benefit of the auditor's insights acquired through the course of the audit. But we feel strongly that requiring the auditor to make public substantive disclosures about "critical audit matters" and "other information" will not promote that objective, and may well inhibit the audit and governance processes now in place to oversee financial reporting. Auditors should be encouraged to have the fullest and frankest conversations possible within their firms and with the audit committee. The best way to promote that objective is to allow those conversations to be conducted on a confidential basis. We continue to be quite concerned that if the auditor's discussions within the firm and with the audit committee are conducted with the anticipation of subsequent public disclosures being made by the auditor, these internal and auditor/audit committee discussions may be seriously inhibited. Auditors may be more cautious in raising concerns, and audit committee members may be more circumspect in probing such concerns with the auditor.

* * *

We appreciate this opportunity to comment on the proposed auditing standard. You may direct any questions with respect to this letter to Robert E. Buckholz at (212) 558-3876, Robert W. Downes at (212) 558-4312 or William G. Farrar at (212) 558-4940.

Very truly yours,

Sullivan & Cromwell LLP

SULLIVAN & CROMWELL LLP

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December 10, 2013

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

VIA Email: comments@pcaobus.org

Re: PCAOB Rulemaking Docket # 034

I am writing to express my opinions regarding the above referenced Proposed Auditing Standard (Proposal) - *The Auditor' s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion;, The Auditor' s Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor' s Report; and Proposed Amendments to PCAOB Standards.* While I would be supportive of the Board's efforts to enhance investors understanding of the current audit process and the auditor's responsibilities as it relates to providing an attestation on management's assertions regarding its Company's financial statements and internal control over financial reporting, I do not support some of the requirements contained in the Proposal.

**Critical Audit Matters**

The Proposal would require the auditor to determine each critical audit matter (CAM), describe the considerations that led the auditor to make such determination and refer to the relevant financial statement accounts and disclosures to which each CAM relates. The Proposal includes a list of certain factors to be considered by the auditor in determining each CAM for an audit. The Proposal states that disclosure of the CAMs is not intended to change the auditor's traditional role of attesting to management's assertion regarding the conformity of its Company's financial statements being in accordance with GAAP, and will not require the auditor to provide an analysis of the matters in the financial statements when communicating CAMs. These assertions of the Board are not correct. The determination and description of CAMs has the auditor going beyond an attestation on management's financial statements, as a CAM ultimately provides disclosure regarding the nature and extent of the procedures performed by the auditor, and in many cases may result in the auditor's disclosure of information regarding the Company that is otherwise not required to be included in the Company's financial statements (including the footnotes) or in other areas of periodic SEC filings. The auditor should not be the source of any disclosure regarding a Company; if the auditor believes additional disclosures are required in the financial statements or other parts of a Company's periodic filings, existing auditing standards address the auditor's responsibilities in such an event, including communicating such concerns with the audit committee.

The disclosure and discussion of CAMs would also result in confusion on the part of investors as to the subject matter of the CAMs, and is inconsistent with the "pass/fail" model which the Board appropriately determined should be retained. The illustrative examples of hypothetical disclosures of CAMs in the Proposal essentially say "here is a CAM, here is why we determined it was a

CAM, we consulted with our national office on the nature, timing and extent of our audit procedures concerning the financial statement elements related to the CAM, and here is where such financial statement element is disclosed in the financial statements." The auditor's disclosure and discussion of each CAM would likely be viewed as a qualification to their overall opinion, despite the required disclosure that "the CAMs communicated do not alter in any way our opinion on the financial statements, taken as a whole."

It appears that the Board's objective in disclosing CAMs is to essentially highlight areas where a Company's management, in preparing its financial statements, has to apply significant judgment and/or make significant accounting estimates. Current SEC rules already require disclosure of such financial statement areas – the Critical Accounting Policies section of MD&A. This is the appropriate place for such financial statement areas to be disclosed, by MANAGEMENT.

The proposal for disclosure and discussion of CAMs should not be included in any final Standard.

**Reporting on Other Information**

I agree that there may be some benefit from a clearer articulation in the auditor's report of the auditor's responsibility for information outside of audited financial statements that are contained in SEC filings. However, the Proposal would enhance the auditor's responsibilities in this regard by changing the current requirement of "read and consider" to a new requirement of "read and evaluate" whether other information is materially consistent with the audited financial statements. The Board acknowledges that the enhanced requirement to "read and evaluate" is likely to increase the nature and extent of the auditor's procedures as it relates to such information, and therefore increase audit costs. I do not think the Board had adequately documented the cost/benefit analysis of the proposed "read and evaluate" responsibility.

I also do not believe the Board has adequately documented the need for such enhanced auditor responsibility in this regard. Management is already required to provide CEO and CFO certifications for a Company's periodic filings, as well as the establishment of disclosure controls and procedures. SEC registrants are also subject to audit committee oversight. In addition, certain disclosures outside the financial statements, such as forward looking information in MD&A, would be very difficult, if not impossible, for the auditor to objectively "evaluate." For the auditor to provide any level of attestation/assurance on such information, which a "read and evaluate" requirement would essentially encompass, would be totally inappropriate and call into question the independence of the auditor.

Other than having a disclosure of the auditor's CURRENT responsibility and requirement to "read and consider" information outside of the audited financial statements that are contained in SEC filings, the proposal in this regard should be dropped.

**Audit Tenure**

The Proposal would require disclosure of the auditor's tenure. The Board acknowledges that there is no agreement as to any correlation between the length of an auditor's tenure and audit quality. The Board admits that the Board itself has not reached a conclusion in this regard. This is a more than sufficient reason for this aspect of the Proposal to be abandoned.

Statutorily, the decision on which audit firm to engage is the sole responsibility of the audit committee. The audit committee is in the best position to make that decision, taking into consideration all factors the audit committee deems relevant. Some factors may generally be consistent from Company to Company, while other factors may be unique to a specific Company. Regardless, the audit committee ultimately makes the decision. Disclosure of audit tenure by the auditor in a vacuum without any additional disclosure regarding what factors went into the committee's determination on what firm to engage (and for whatever period of time the committee has determined to engage such firm) would be an incomplete disclosure, at a minimum, and potentially misleading. For these reasons, it is inappropriate for the auditor to disclose in its audit report the audit tenure as contained in the Proposal.

**"Assess" Versus "Evaluate" Accounting Principles Used and Significant Estimates Made**

The Proposal would change the current audit report from indicating that the auditor has "assessed" the accounting principles used and significant estimates made by management to "evaluated" the accounting principles used and significant estimates made by management. The Proposal contains no discussion of the reasons for or what the Board intended by such change. If the Board intends that the change from "assessed" to "evaluated" is solely to more effectively communicate the auditor's current requirements, then the Board should explicitly state such intention and expectation in any final Standard. However, if the Board intends that the change from "assessed" to "evaluated" is intended to impose additional requirements on the auditor, then the Board should explain its reasons behind such change, and justify the enhanced requirements with a cost/benefit analysis.

**Explanatory Paragraphs**

The Proposal notes that existing auditing standards provides examples of matters the auditor may decide to emphasize in an explanatory paragraph to their audit report. But rather than just incorporate the existing examples of such matters, the Proposal adds new examples of matters that may be called out in an explanatory paragraph. However, the Proposal contains no discussion of the Boards reasoning behind the inclusion of the new examples, and why such new examples would be appropriate. Any final Standard should just retain the existing examples of explanatory paragraph matters from the current auditing standards.

Thank you for your consideration of these comments and suggestions.

Sincerely,

Greg Swalwell

TARGA

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December 9, 2013

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

Re: Rulemaking Docket 034

Board Members:

We appreciate the opportunity to comment on two new proposed auditing standards in PCAOB Release No. 2013-005 (the "Release"):

- The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (the "proposed auditor reporting standard"), and

- The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report (the "proposed other information standard")

. . . and on other matters or questions raised in the Release.

Our comments are primarily from the perspective of an audited public company based on our experience with the traditional auditor reporting model, generally accepted auditing standards ("GAAS"), generally accepted accounting principles ("GAAP") as codified in the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") and public registrant reporting requirements of the Securities and Exchange Commission ("SEC").

In developing our comments, we have given consideration to the roles of the following entities and perspectives relative to the content of the Release to address the proposed reporting standard, proposed other information standard and other matters and questions.

- The SEC has oversight authority over the PCAOB and appoints the accounting standards setting body, the FASB, which establishes GAAP.

- The PCAOB has authority to regulate registered public accounting firms ("auditors" or "audit firms") and "oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports."[1]

- Registered public accounting firms audit entities that file reports and financial statements with the SEC.

[1] See PCAOB Mission, http://pcaobus.org/About/History/Pages/default.aspx

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- Audit Committees of public companies are required to be independent of management and are "directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee."[2] Further, audit committees have oversight over an audited entity's financial reporting and related activities.

- Investors (i.e., company share or unit holders and note holders), creditors and the investing public have an interest in the financial statements of a public company and the related audit reports issued by a registered public accounting firm.

The following sections address the proposed auditor reporting standard, proposed other information standard, and other matters or questions raised in response to the Release.

**Proposed Auditor Reporting Standard**

The proposed auditor reporting standard includes two major features: (a) retention of the historical pass/fail model incorporated in the standard auditor's report and (b) addition of auditor disclosure of any deemed critical audit matter(s) ("CAM").

Pass/Fail Model

The premise of the pass/fail model is the financial statements reported upon by the auditor are fairly presented, in all material respects, in conformity with GAAP ("pass" or unqualified opinion) or not ("fail").

The pass/fail model has been the basis of the auditor reporting standard with very little change for more than 70 years[3] and a historical focus of financial statement users. We believe that most financial statement issuers will continue to maintain their focus on whether a company received an unqualified opinion as it relates to the financial statements presented and support the decision of the PCAOB to retain the pass/fail model.

Critical Audit Matters

The PCAOB defines a CAM as those matters addressed during the audit that:

- Involved the most difficult, subjective, or complex auditor judgments;

- Posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or

- Posed the most difficulty to the auditor in forming the opinion on the financial statements.[4]

[2] See Sarbanes-Oxley Act of 2002, Sec 301. (2)
[3] See PCAOB Release 2013-005, page 2, Introduction, paragraph 2
[4] See PCAOB Release No. 2013-005, page 15

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The PCAOB's underlying presumption is that auditors would encounter multiple CAMs in most audits, and on a recurring basis, with the source of the CAMs identified as being:

- Documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
- Reviewed by the engagement quality reviewer;
- Communicated to the audit committee; or
- Any combination of the three.[5]

It is our belief that the proposed disclosure of CAMs will most likely become a corollary of management's existing disclosures of critical accounting policies ("CAP"), use of estimates or other significant events and matters in Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), which are required under the SEC Regulation S-K, Item 303 and related SEC interpretations and guidance, or in the notes to the financial statements.

Our concerns with the proposed inclusion of CAMs in the auditor's report include:

- The underlying PCAOB presumption that auditors will encounter multiple CAMs in most audits will most likely result in items being classified as CAMs that otherwise would not have previously been considered by auditors to be CAMs.
- Auditor judgments which could result in more CAMs in a report due to auditors erring to inclusion of items that may not otherwise rise to the level of a CAM to avoid a later challenge by PCAOB inspectors.
- Increased auditor workload and client billings to justify why CAM treatment is appropriate for certain items but not appropriate for other items.
- The potential for financial statement users to interpret a CAM as an issue indicative of an issue with the quality of the financial statements, conflicting with management's assessment of internal control over financial reporting, or as a qualification of the auditor's opinion.
- The potential for the use of CAMs over time to become repetitive "boilerplate" language included in the auditor's report.
- The potential for the use of CAMs over time to become an abbreviated version of the Auditor's Discussion and Analysis alternative which has been rejected by the PCAOB.
- The inclusion of CAMs in the auditor's report may result in situations where an auditor is required to disclose information in an audit report that is not required to be reported by management.

[5] See PCAOB Release No. 2013-005, page 15

- Management already discloses CAP, use of estimates or other significant events and matters extensively in MD&A as well as in the notes to the financial statements. There is no gain in clarity to financial statement users from a restatement of these items as CAMs in the auditor's report.

We do not support inclusion of CAMs in the auditor's report for the reasons noted above and believe that this item should not be implemented as part of a new proposed auditor reporting standard.

**Proposed Other Information Standard**

Other information is described as information other than the audited financial statements and related auditor's report in a company's audited financial statements filed with the SEC under the Securities Exchange Act of 1934 ("Exchange Act").[6] This information would include, among other items, business and property description and related statistics, selected financial data, MD&A and certain information incorporated by reference filed on SEC Form 10-K.[7]

In the existing standard, the auditor's responsibility is to "read and consider" other information in the SEC Form 10-K with no audit report requirement describing the auditor's responsibility with respect to other information. If the auditor concludes there is a material inconsistency between other information and the financial statements, the auditor performs certain procedures to respond to the material inconsistency. If the auditor becomes aware of a material misstatement of fact in the other information, the auditor would discuss with management and perform other procedures based on the auditor's judgment.

The proposed other information standard expands auditor responsibilities related to non- financial statement information included in SEC Form 10-K and would:

- Apply the auditor's responsibility for other information specifically to a company's annual reports filed with the SEC under the Exchange Act that contain that company's audited financial statements and the related auditor's report;

- Enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit;

- Require the auditor to evaluate the other information for a material misstatement of fact as well as for a material inconsistency with amounts or information, or the manner of their presentation, in the audited financial statements; and

- Require communication in the auditor's report regarding the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information.[8]

[6] See PCAOB Release No. 2013-005, page 19
[7] ibid
[8] See PCAOB Release No. 2013-005, pages 20 and 21

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The auditor's responsibilities for other information contained in a SEC Form 10-K are changed from "read and consider" to "read and evaluate" based on relevant evidence obtained and the conclusions reached during the audit.

Our concerns with the proposed change from "read and consider" to "read and evaluate" other information include:

- Increased auditor workload, which could include substantial audit procedures, and client billings to evaluate and report on other information.
- Assumption by users of financial statements that the auditors have a greater degree of accountability for other information than warranted under the particular circumstances.
- Presumption by users of financial statements that the auditors have a greater degree of understanding of the business or industry described in the other information than is required or warranted.
- Confusion on the part of users of financial statements due to inclusion of disclaimer language as it relates to other information within the auditor's report.

We do not support changing the auditor's other information responsibilities to "evaluate" from "consider" for the reasons noted above and believe that the proposed other information standard not be implemented as written. It would appear more appropriate to clarify auditor responsibility for other information in SEC Form 10-K within the auditor's report.

**Other Matters**

Auditor Tenure

While there may be some investor interest in auditor tenure, there is no evidence that associates audit tenure with audit quality. There are circumstances where disclosure of auditor tenure makes sense; for example, in a proxy statement related to an Audit Committee report or a ratification action that requires a shareholder vote. However, a statement of when the audit relationship began incorporated in the auditor's report with no context would appear to be of limited or no value; especially given the mandatory rotations of engagement and concurring audit partners on a five (5) year basis.

We do not support inclusion of auditor tenure in the auditor's report.

Materiality

In Appendix 6 of the Release, the PCOAB asks the question:

> "Is the federal securities law definition of materiality the appropriate standard for the auditor's responsibility to evaluate other information?"

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The federal securities law definition of materiality is incorporated within the SEC guidance[9] and operates in two dimensions – quantitative and qualitative. The application of materiality is based on the concept of assessments of the inferences a reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him.[10] Similarly, the FASB states "the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item."[11] Additionally, the FASB has made it clear that "[M]agnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, will not generally be a sufficient basis for a materiality judgment."[12]

Materiality as addressed by SEC relates directly to financial statements and, presumably, all other information filed in SEC Form 10-K that is derived from the financial statements. Thus, it would appear that the federal securities law definition of materiality would be directly applicable to certain other information (e.g., selected financial data and MD&A) and arguably to any other information a reasonable shareholder or person may rely upon in a SEC Form 10-K.

Although we do not support the change from "consider" to "evaluate", we believe that the federal securities law definition of materiality as incorporated in the SEC guidance is not only the appropriate standard for the auditor's responsibility to evaluate other information but equally is applicable to financial statements.

Auditing Standards

In the Release, the PCAOB shows proposed amendments to current audit standards based on the proposed auditing standards. We note in PCAOB Rulemaking Docket No. 40 that the PCAOB has proposed a framework for reorganizing the existing interim and PCAOB issued auditing standards into a topical structure with a single integrated numbering system as well as proposing (a) certain conforming amendments, (b) certain related amendments to the PCAOB auditing standards and (c) to rescind certain interim auditing standards that the Board believes are no longer necessary under the proposed reorganization.

While we applaud these administrative actions, we also believe the PCAOB should begin a review of all auditing standards to modernize audit practices and processes to recognize the significant changes in the business environment, business practices and technology since many of the auditing standards were developed. We also believe that the PCAOB should give due consideration to the differences in industry sectors when it revises auditing standards as the current one size fits all approach is not an effective or efficient approach to delivering high quality audit results.

**Conclusion**

We appreciate the opportunity to comment on the proposed auditor reporting standard, proposed other information standard, and other matters or questions raised in response to the Release. If the

[9] See SEC Staff Accounting Bulletins No. 99 which is codified as SAB Topic 1. M.
[10] ibid, footnote 27
[11] ibid, footnote 26
[12] ibid, footnote 35

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PCAOB has any questions regarding these comments, please contact Bob Sparger at 713-584-1021 / bobsparger@targaresources.com or John Klein at 713-584-1314 / johnklein@targaresources.com.

Sincerely,

Chris Tong
Chairman, Audit Committee
Targa Resources Corp.

Barry R. Pearl
Chairman, Audit Committee
Targa Resources Partners LP

John Robert (Bob) Sparger
Senior Vice President and
Chief Accounting Officer
Targa Resources Corp.
Targa Resources Partners LP

John R. Klein
Vice President and Controller
Targa Resources Corp.
Targa Resources Partners LP

| | |
|---|---|
| **From:** | rdferraro |
| **To:** | Comments |
| **Cc:** | lizcollins@financialtelesisinc.com |
| **Subject:** | Rule Docket 034 |
| **Date:** | Wednesday, December 11, 2013 6:52:14 PM |

To whom it may concern;
Please be advised that we support Lisa Roth's position on Rule Docket 034.
Sincerely,
Robert D. Ferraro
Vice-President
Teachers Financial Investment Corporation

December 11, 2013

**Via email to comments@pcaobus.org**

TESORO

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**Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Office of the Secretary:

Tesoro Corporation[1] is pleased to submit comments on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Rulemaking Docket Matter No. 034, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* (the "Proposed Standards"). Certain comments provided herein reference those outlined in our letter[2] dated September 30, 2011 (the "Initial Letter") on the proposed changes to the auditor reporting model as originally set forth in Concept Release No. 2011-003 ("Concept Release").

**Overall**

We commend the Board for their efforts to address concerns raised by constituents about the Concept Release. However, we continue to disagree with the manner in which the Board is attempting to enhance audit quality and transparency of information concerning entities' financial statements. As currently outlined, the Proposed Standards, while pared down from the Concept Release, will not achieve the Board's goals. Rather, the Proposed Standards will likely result in additional confusion for investors and other financial statement users as it may promote users' undue focus on certain areas of an entities' financial statements, result in subjectivity being incorporated into the audit opinion, and cause unnecessary uses of time and expense for preparers and auditors to comply with little or no added value.

**Critical Audit Matters ("CAMs")**

We do not support the requirement to communicate CAMs in the auditor's report as outlined in the Proposed Standards. We understand that the Board's intent with the CAM disclosure within the auditor's report is to remedy the information asymmetry that exists between a company's management and investors. Conceptually, this appears to provide financial statement users the same information available to the audit committee and

[1] Tesoro Corporation is one of the largest independent petroleum refiners and marketers in the United States. We primarily manufacture and sell transportation fuels. We own and operate six refineries in the western United States that refine crude oil and other feedstocks into transportation fuels, such as gasoline, gasoline blendstocks, jet fuel and diesel fuel, as well as other products, including heavy fuel oils, liquefied petroleum gas, petroleum coke and asphalt. Both Tesoro and our consolidated master limited partnership, Tesoro Logistics LP (together with Tesoro Corporation, "Tesoro"), are publicly traded companies requiring periodic reporting with the Securities and Exchange Commission ("SEC"). The commentary provided herein represents opinions expressed on behalf of both Tesoro Corporation and Tesoro Logistics LP.
[2] http://pcaobus.org/Rules/Rulemaking/Docket034/119.pdf

management. However, we believe the Board is not sufficiently considering the negative implications of including discussion of CAMs in the audit report.

Constituents view the current pass/fail audit opinion model as an objective tool by which they can understand if the financial statements as a whole are free of material misstatement. While we agree that users typically just look to the audit opinion to ensure an unqualified opinion was provided by the auditors, we do not believe adding elements of subjectivity will provide better transparency to users as sought by the Board. Rather, we believe that discussion of CAMs in the audit opinion would only further the problem referred to as disclosure overload. Similar to comments we made in a letter[3] submitted to the Financial Accounting Standards Board ("FASB"), we believe the current state of financial reporting requirements, whether issued by the FASB, SEC or through the Proposed Standards outlined by the Board, have caused a significant overload of information which users have trouble deciphering in order to make investment and credit decisions. The subjective discussion that will result from the inclusion of CAMs in the audit opinion will only add to the level of confusion inherent in current financial reporting requirements. Users may inappropriately focus attention on CAMs as being matters of greater importance than the financial statements a whole. Such focus should not be generated by the auditor, but rather management through its disclosures. Thus, the Proposed Standards would undermine the significant disclosures made by management throughout their financial statements about complex areas of the business.

Additionally, auditors typically encounter areas throughout the course of their audit for which complex or subjective audit procedures are necessary to evaluate the inherent judgments and representations made by management. Incorporating discussion of these matters into the audit report would likely never provide a complete picture of the procedures performed by the auditor. To discuss these matters with enough detail would require significant amounts of wording which could further confuse users. Auditors would also likely default to excess disclosure of matters that management and others may not consider CAMs due to the litigious nature of the U.S. financial reporting and audit environment and fear of repercussions from the Board during the inspection process.

As demonstrated by our points above, we do not believe the audit report is the venue for enhancing transparency of financial statements. Rather, we highly recommend that the Board not proceed with including CAMs discussion in the audit report and, instead, begin a collaborative effort between the Board, SEC, FASB and other regulatory bodies to perform a comprehensive review and revision of the current financial reporting and disclosure environment in which U.S. public companies operate. One-by-one revision to the current financial reporting and disclosure framework does little to address the evident issue of disclosure overload and limits improvement of financial statement transparency. Meaningful change in financial reporting will not occur unless all regulatory bodies view an entity's financial statement as a singular item and work to enhance all of the parts to arrive at one set of enhanced financial reporting and disclosure requirements to address the issues that the Board along with the other agencies currently have on their agendas.

[3] See our letter dated November 26, 2012 submitted to the FASB in response to their invitation to comment on the disclosure framework project.
http://www.fasb.org/cs/BlobServer?blobkey=id&blobnocache=true&blobwhere=1175825129506&blobheader=application%2Fpdf&blobheadername2=Content-Length&blobheadername1=Content-Disposition&blobheadervalue2=584378&blobheadervalue1=filename%3DDISFR.DP.0018.TESORO_CORPORATION_G._SCOTT_SPENDLOVE.pdf&blobcol=urldata&blobtable=MungoBlobs

**Other Information**

We do not concur with the expansion of the auditor's responsibilities from "read and consider" to "read and evaluate" with respect to other information in certain documents containing audited financial statements, including selected financial data, management's discussion and analysis ("MD&A") and other information incorporated by reference. It is our belief that such a requirement is not appropriate because the auditor's responsibilities to evaluate as used in this context implies the auditor is providing a certain level of assurance over the information. The degree of assurance perceived will differ due to the varied nature of information included. Additionally, forward-looking information is incorporated in these areas and would be difficult to audit thus resulting in increased costs to the preparers of financial statements. We believe audit firms would struggle significantly to determine the level of work to be performed on forward-looking information thus leading to comparability issues in reporting, which we believe contradicts the goal of enhanced financial reporting that the Board and other agencies are trying to address. Having audit procedures required over forward-looking information also would reduce the usefulness of such information as management would need to adjust its disclosures and estimates to ensure the amounts can be easily audited.

Consistent with our comments expressed in the Initial Letter, within the PCAOB attest standards, there is the option that few companies exercise for the auditor to be engaged to attest on MD&A. This indicates financial statement users have not requested auditor involvement to that extent. If it is believed that such information outside the financial statements and footnotes should be subject to an audit, review, or the focus of additional assurance procedures, then such requirements should be mandated by the SEC, and not indirectly by the Board. Likewise, if further assurance on this information were deemed necessary, then the FASB or SEC could require such information to be included within a company's audited financial statements and footnotes. We surmise the reason such requirements have not been mandated is due to the scope limitations inherent in forward-looking information contained within MD&A. It would be very difficult for an auditor to provide an objective evaluation of prospective information. In our opinion, an auditor providing any level of assurance on other information may be misleading and cause financial statement users to place undue reliance on certain information, assumptions, projections or other estimates included within MD&A. Current disclosures outlined by the SEC adequately address these limitations and advise users of the risks of relying on the other information.

While we object to any requirement which implies a level of assurance is being expressed by the auditor, we do not object to an auditor clarifying the objective procedures that they currently perform. Such an approach would bridge the expectations gap between the investing public and the audit report by facilitating an understanding of the extent of an auditor's involvement over other information while addressing the public's misperceptions that such information is subject to an audit. We believe this approach is reasonable as it is premised on our belief that increased auditor involvement over this area is not needed and should not be required for those companies who demonstrate adequate controls, due diligence and level of care performed in the financial reporting process.

**Additional Items**

We do not necessarily object to some of the other objective wording changes outlined in the Proposed Standards. However, we do struggle to understand how the Board hopes to address investor concerns by disclosing auditor tenure. With the significant changes in independence and audit requirements over the past decade, we do not believe that a strong enough correlation exists to demonstrate that audit quality is impacted by auditor tenure. We would recommend that the Board review this requirement and perform additional research to evidence its concerns before finalizing the Proposed Standards.

* * * * *

We appreciate the opportunity to comment on the Proposed Standards. While we understand the intent of the Board in developing the Proposed Standards, we do not believe the required changes, as currently outlined, would help enhance transparency for financial statement users. Rather, the primary components of the Proposed Standards will likely result in further disclosure overload and thus magnify the level of confusion currently experienced by users. We would be pleased to discuss our comments with the Board.

Sincerely,

G. Scott Spendlove
Senior Vice President and Chief Financial Officer

**From:** Donna Dimaria
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 10:04:34 AM
**Attachments:** PCAOB Letter.doc

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Dear Sirs – please see the attached letter. Furthermore, I am in complete support of Lisa Roth's position. Furthermore, as Chairman of the Third Party Marketer's Association (3PM), I am able to tell you that the Association is also fully behind Lisa Roth's position.

Regards,

Donna

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**Donna B. DiMaria**
**CEO / Principal**
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**Member FINRA / SIPC, Registered with the SEC and MSRB as a Municipal Advisor.**

3PM *Tessera is an active member of the Third Party Marketers Association (3PM)* *donna.dimaria@tesseracapital.com. Any complaints against the firm or the Representative should be submitted to Tessera's CCO at the phone number or email address given above. Tessera reserves and intends to exercise the right to review, monitor and retain the content of all e-mail communications*

TESSERA
Capital Partners

Member FINRA / SIPC, MA Registered with the SEC and MSRB

October 4, 2013

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

**Re:** PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of a small, independently owned, nonpublic, non-custodial broker-dealer.

My firm is one of the approximately 4,000 firms that are not public companies and is one of 1,800 firms that generate less than $1mm in annual revenues. Further my firm has only 4 employees. As a small independent business, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Regards,

Donna DiMaria
CEO / CCO

Texas Society of
Certified Public Accountants

December 10, 2013

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

RE: Proposed Auditing Standards—*The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The views expressed herein are written on behalf of the PSC, which has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

After a thorough review of the contents of the above referenced proposed auditing standards we decided to focus our attention on the issues therein that we consider most germane to our membership. The auditor's standard report represents the most critical communication link between the auditor and those third parties who use the auditor's report as a basis for their reliance on a client's published financial statements. We believe any proposed changes to the wording of the standard auditor's report should be viewed and evaluated in the context of this all-important communication link.

Thus, our response to this proposed auditing standard is focused solely on the recommended changes in the content and wording of the auditor's report. Our primary concern was directed to Appendices 1 and 5, and the following 12 questions posed in the Exposure Draft: 4, 5, 10, 12, 14, 15, 16, 25, 26, 27, and 28. We hope the Board understands our reasons for the focus of our efforts in responding to this Exposure Draft.

**4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

Based on the fact that the current auditing literature requires that the auditor's report have a title that includes the word "independent," we believe additional reference to the auditor's independence is

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redundant. This requirement has been in effect for a number of years, and most knowledgeable and competent financial statement users are keenly aware of the importance of auditor independence. Thus, we see no reason for multiple references to this issue.

**5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. (a) Would the information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report? (b) Are there any additional challenges the auditor may face in determining or reporting the year the auditor began serving consecutively as the company's auditor? (c) Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

The purpose of the auditor's report is to communicate the auditor's opinion on the client's financial statements. The auditing standards that apply to the performance of an audit engagement are basically the same for the auditor whether he or she has performed the audit for a number of years or only one or two. Thus, what important inferences does the Board see the user drawing from information regarding the tenure of an auditor? We believe the implementation of such a requirement could only lead to spurious inferences by a user resulting in irrelevant conclusions. Also, if such information is deemed to possess some relevance, wouldn't it be more appropriate to have it come from client management in the proxy statement or other related communication?

**6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

Yes, the proposed auditor reporting standard would be beneficial to users of the financial statements, provided that the statement is qualified and indicates (a) the auditor evaluated the information based on evidence obtained in the normal course of the audit, and (b) no opinion is expressed on the other information.

***Due to the fact that the following questions (10-16 and 25-28) focus exclusively on the "communication of critical audit matters," we have chosen to provide one combined response that addresses our opinion regarding the issues raised in these questions. The questions are listed below and our combined answer is provided after the listing of the questions.***

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

**12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

**14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

**16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

**25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

**26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

**28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

**COMBINED RESPONSE TO QUESTIONS 10—16 & 25—28**

We strongly believe, as have many others who have commented on the proposed guidance regarding "communication of critical audit matters," that the required disclosure of critical audit matters (CAMs) be eliminated from any final standard that may evolve from this proposal. Our reasons for this position are presented below.

**Summary**

Under the federal securities laws, including The Sarbanes-Oxley Act (Section 302 (a)), the responsibility that the financial statements fairly present, in all material respects, the financial condition and position of the company rests exclusively with company management. This fair presentation extends to the disclosures required to render the financial statement not misleading. In addition, the SEC has required certain other disclosures and relevant and useful information such as specific footnote disclosures and in Management's Discussion and Analysis (MD&A). The auditor is responsible for conducting the audit and issuing their opinion.

We believe that requiring the auditor to include in their report discussions of matters critical to the company and the audit supplants management's responsibility to make full and fair disclosures. We further believe the proposed disclosure of CAMs in the audit report blurs the bright line between auditor and management responsibilities. These disclosures may also impinge on the auditor's independence by putting them in the position of acting in the capacity of management in determining what information should be disclosed.

In addition, the communication of CAMs would put the auditor in a more adversarial rather than cooperative relationship with management. Such a situation would most likely confuse rather than educate financial statement users. The implementation issues associated with this proposal would surely add considerable cost to an audit engagement without a commensurate benefit to users. Thus, our conclusion regarding the issue of CAMs boils down to increased costs coupled with confusion and unintended consequences. The paragraphs below amplify on these conclusions.

**Management's Responsibilities vs. Auditor's Responsibilities**

The guidance in the proposed auditing standards is based on an attempt to alleviate the "information asymmetry" between company management and investors. The proposed auditing standard clearly states on page A5-23, "reducing the level of information asymmetry between company management and investors could result in more efficient capital allocation and, as academic research has shown, could lower the average cost of capital." While we both understand and appreciate the indicated goal, we believe that compromising the auditor and the audit process to accomplish this goal is totally inappropriate. Isn't management responsible for reducing the level of information asymmetry? We strongly question the Board's decision to place this burden on the auditor and basically weaken the credibility of the audit process.

It is a well-recognized fact that management is responsible for preparation of an entity's financial statements and related disclosures. In addition to the disclosures in the financial statements and related footnotes, management discloses other relevant and useful information to investors in the form of "business risks" and "management's discussion and analysis." The auditor's responsibility is to attest to management's assertions in the financial statements and related disclosures. Additionally, the auditor is required to identify any material inconsistencies between the financial statements and other information communicated by management outside the financial statements. To change the auditor's role to that of originating the disclosure of company information is a complete reversal of the auditor's responsibility, as well as the model that capital markets have relied upon for nearly a century. This doesn't even address the impact such a change would have on the auditor's appearance of independence.

Management is currently aware of these critical matters as was noted in the proposed auditing standard. Thus, if the Board and the SEC feel that these disclosures are important, it appears that company management should make the disclosures. In those cases where such disclosures are being made by management, we feel it would serve no useful purpose for the auditor to also make such disclosures.

**Alternatives**

We believe the Board could consider alternative measures to reduce or eliminate information asymmetry. One possible alternative would be to recommend to the SEC and/or FASB improvements in the Critical Accounting Policies and Estimates, or additional footnote disclosures regarding matters they consider beneficial to investors. Another alternative could involve increased disclosures or improvements to MD&A communications. While these recommendations involve actions by other organizations (SEC, FASB, etc.), we believe these organizations would be sympathetic to changes that benefit investors and their quest for relevant information.

While we are strongly in favor of enhancements in audit quality, we don't consider the disclosure of sensitive judgments made by an auditor or specific procedures performed by an auditor to represent such enhancements.

**Management vs. Auditor**

Company management and its legal counsel will always conduct a review of an audit report with the auditor prior to its issuance. Such a meeting to conduct this review is valuable in heading off any potential misunderstandings or misinterpretations that might have gone unnoticed. However, the inclusion of CAMs in an auditor's report would reduce this management/auditor meeting to a full-blown negotiation of the issues that should or should not be included.

Given the sensitive nature of such disclosures, it appears likely that the potential for an adversarial relationship between the parties involved is quite possible. There would obviously be concerns about confidentiality, relevance of an issue such as a CAM, and what constitutes "critical" in defining a critical audit matter. By its very nature, an audit engagement has the potential to be confrontational and contentious for many reasons. To propose an addition to the auditor's report which would most likely enhance this contentious relationship, without much benefit, seems to be an ill-advised decision.

**Cost vs. Benefit**

While most might contend that more is better than less, we are not willing to embrace that conclusion when it comes to the communication of critical audit matters. We believe the cost associated with providing this information far outweighs any benefits that may result. We anticipate the following should this proposed auditing standard gain acceptance.

We believe the proposal is not sufficiently clear as to what constitutes a CAM. In addition, we are troubled by references to "most," as the definition of this word is highly subjective and can be interpreted in a variety of ways. Auditors will naturally err on the side of disclosing more CAMs rather than fewer. This will, most likely, be done to head off circumstances where PCAOB inspectors and others ask why the auditor did not disclose what they feel (in their judgment) is a CAM when the auditor decided the issue did not rise to that level. As the auditor will document reasons why those issues were not CAMs, the inspectors will be able, with perfect hindsight, to argue the opposite conclusion. Thus, it would appear that the auditor is more likely to conclude that an item is a CAM rather than having to defend not identifying the item as a CAM.

A decrease in audit quality could be a possible unintended consequence as an auditor could also intentionally omit various issues from the engagement completion document, discussion with the engagement quality reviewer, or communicate with the audit committee to avoid having to document the decision regarding a CAM. As any matters subject to consultation may fall within CAM disclosure rules, auditors may be discouraged from consulting.

The required disclosure of CAMs will add many pages to the auditor's report. This added length has the potential to blur the intended message of the auditor's report, which is the auditor's opinion on the financial statements. CAMs may include items of discussion between management and the auditor that have been resolved. However, such disclosure may be interpreted as ongoing disagreements.

Matters identified as audit risks may not be significant investing risks. However, investors may interpret these issues as errors in the financial statements and consider them more significant than the unqualified opinion issued on the financial statements. Investors may question how an unqualified opinion could be issued with so many critical matters. Also, the more CAMs identified, the greater the potential for investors to question management reports citing no material weaknesses in internal controls.

Auditors will now be required to revisit all significant matters, first to determine risk and audit response, second to determine if disclosure in the audit report is required, and finally to document their conclusion as to required disclosure. This will add time to the audit process. Much of this time will occur during the critical wrap-up phase when an audit client is facing SEC filing deadlines.

**Disclosure of Audit Procedures Performed**

We believe the inclusion of audit procedures performed on any matters would not be beneficial to the users because knowing how the auditor tested certain accounts or assertions does not give the users any additional information regarding a registrant's financial position or results of operations. Adding information on the audit procedures performed would significantly increase the length of the auditor's report and decrease the clarity of its message. The negative impact on the reader's ability to understand the intended message of the report will be significant. Also, it is unlikely that the auditor will identify all the procedures performed or considerations of mitigating factors in the design of audit procedures, which will intensify the lack of understanding on the part of those to whom the audit report is intended. Further, we believe auditors will be prone to spend additional time performing procedures, not to assess the risks associated with the client but rather, to be compatible with audit procedures included in the audit reports issued by other auditors.

**Auditor Liability**

We believe the disclosure of CAMs could lead to increased litigation related to auditor judgment. Companies in similar industries could have significantly different CAMs. It is our belief that this would provide greater incentive to litigants to seek damages based on non-disclosed CAMs. Alternatively, if stock prices decline after disclosure of CAMs, litigants may look to the auditor for those potential damages.

Also, the existence of CAMs may result in the performance of an excessive amount of audit procedures that are not necessary under the risk assessment model. These procedures would be performed to avoid second guessing by investors who wonder why certain procedures performed by other auditors were not performed by the auditor in question. This kind of comparison could lead to unnecessary litigation.

We appreciate the opportunity to provide input into the standards-setting process.

Sincerely,

Sandra K Brown

Sandra K. Brown, CPA
Chair, Professional Standards Committee
Texas Society of Certified Public Accountants

The Clearing House
At the Center of Banking Since 1853

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: **PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 34, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the "Proposal")**

Members of the Board of the PCAOB:

The Clearing House Association L.L.C. ("The Clearing House"),[1] an association of major commercial banks, appreciates the opportunity to comment on the above-referenced Proposal. We support efforts to improve audit quality that will enhance investor confidence in and understanding of the audit process and the auditor's responsibilities. However, we believe that key aspects of the Proposal will not achieve the PCAOB's stated objective: "to make auditor reporting more relevant and useful to investors and other financial statement users."[2] Accordingly, we do not support the Proposal in its current form. In summary, our principal concerns are as follows:

- The proposal to add a discussion of critical audit matters ("CAM") to the auditor's report may result in investors assuming that auditors are effectively qualifying their audit opinion on selected areas of the financial statements as compared to the current "pass/fail" system; instead of providing investors with more useful information it may simply create confusion about the report. The onus to prepare and provide such information should continue to be on management rather than originating with auditors;

- requiring the auditor to evaluate other information will require additional audit procedures that are unnecessary in light of existing management certification disclosure requirements and it will

[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the U.S. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] Proposal, page 10.

be very challenging for auditors to develop and perform audit procedures on forward-looking information; and

- the Proposal will result in increased costs to both preparers and auditors and are not justified by the benefits of the Proposal.

**1. Including CAMs in the audit report is unnecessary, will reduce the clarity of the audit and internal control opinions, and may increase confusion regarding the auditor's responsibility.**

We are concerned that the proposal to add a discussion of CAMs to the auditor's report may actually increase investor confusion regarding the audit report. By definition, the audit report would be discussing issues that were satisfactorily resolved and deemed not material to the financial statements. We believe most investors will continue to look only to see whether a company has received an unqualified ("clean") opinion and has no material deficiencies in internal controls. The proposed discussion of CAMs in the audit report may serve to obscure those conclusions and may provide a less clear picture to investors about the financial statements taken as a whole and the overall effectiveness of the system of internal controls.

We fully support the existing "pass/fail" model as it provides consistency, clarity and comparability of reporting, and is well understood by investors and users of financial statements. An unqualified opinion means that all material matters have been resolved and that the auditors are in agreement with management that the financial statements do not contain any material misstatements. In contrast, disclosure of CAMs, which would describe those areas that posed the most difficulty to the auditor and why they were difficult, could create the impression that the auditor is uncomfortable with or "second-guessing" management's decisions; as a result, users may perceive that the auditor is effectively qualifying their opinion on different areas of the financial statements.

At the same time, disclosure of CAMs could increase the audit "expectation gap" by blurring the line between management and the auditor's responsibility. The fact that such disclosures originate with the auditor could suggest that the auditor, rather than the company, has the responsibility to prepare financial statements and disclosures in compliance with U.S. Generally Accepted Accounting Principles ("U.S. GAAP").

We strongly believe that the audit report should be limited to describing the auditing procedures performed and related matters. It should not be presumed that expanding the report to include CAMs would serve as guidance for investors and other users of financial statements and annual reports to better understand how the audit was performed or the effectiveness of the audit. We believe the example disclosures provided in the proposal that discuss the extent of national office consultations, highlight internal control deficiencies that were less severe than a material weakness, and errors that were corrected, could easily be interpreted in multiple ways and illustrate the confusion that may arise when users are presented with an unqualified opinion. Moreover, auditors should not be responsible for disclosing information for which they are not the original source, or even have the appearance of doing so; rather, the onus to prepare and provide financial reporting information should continue to be on management, and the auditor's role should be limited to opining on such information.

It appears that the primary purpose of the Proposal is to highlight significant accounting disclosures and risks for users of financial statements. We believe the sections of Management's Discussion and Analysis (MD&A) covering critical accounting policies and use of estimates are already quite informative. However, to the extent that this and other financial reporting needs improvement, we would be happy to work with the Financial Accounting Standards Board, Securities and Exchange Commission (the "SEC"), and other parties as appropriate.

2. **Requiring the auditor to evaluate other information will require additional audit procedures that are unnecessary in light of existing management certification requirements and it will also be challenging for auditors to develop and perform audit procedures on forward-looking information.**

We note that the PCAOB has proposed that, in place of the current requirement for the auditor to read the other information and "consider" whether it is materially consistent with the audited financial statements, the auditor would now be required to read and "evaluate" the consistency of the information. Further, paragraph 4 of the Exposure Draft states in part, "The auditor should read the other information and, **based on relevant audit evidence obtained** and conclusions reached during the audit, **evaluate** the ..." (emphasis added).

Thus, it appears that the PCAOB is proposing a different standard of auditor involvement with other information, and additional auditing procedures would be necessary to satisfy this new standard. It is unclear what additional procedures would be required, but we are concerned that they could rise to the level of detailed comfort letter-type documentation and procedures.

We do not support changing the auditor's responsibility for other information that is associated with the financial statements, as there are robust procedures already in place to ensure that other information is materially consistent with the audited financial statements, such as CEO and CFO certifications of disclosures in the annual and quarterly reports, requirements for disclosure control processes, and independent audit committee oversight of the financial reporting process.

In addition, MD&A often includes forward-looking information which by definition may not always be objectively verifiable. Accordingly, we believe it will be challenging for auditors to evaluate and conclude on such forward-looking information. However, eliminating this information from MD&A would substantially reduce the usefulness of the quarterly and annual reports to investors; and carving this information out from the auditor's evaluation would prove extremely cumbersome.

3. **The Proposal would be costly to implement with little incremental benefit.**

The proposed requirements to disclose CAMs and auditor evaluation of other information could increase – perhaps significantly – the time needed by management, the Audit Committee, and the audit firms to determine how best to present all of this additional information in a way that will be clear and unambiguous to financial statement users. In addition, the Proposal would likely result in an increase in the amount of time required to issue audited financial statements, putting further pressure on meeting SEC reporting deadlines, and would likely lead to a commensurate increase in audit fees as well.

Because we do not see any substantial incremental benefit to users from the PCAOB's Proposal, as described above, coupled with the likely increase in time and costs, we do not believe the benefits of the Proposal outweigh its costs, and, therefore, we do not support its issuance.

****************

Thank you for considering the comments provided in this letter. If you have any questions or are in need of any further information, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org) or Ryan Pozin at (212) 612-0135 (email: ryan.pozin@theclearinghouse.org)

Sincerely yours,

David Wagner
Executive Managing Director and
Head of Finance Affairs
*The Clearing House Association L.L.C*

cc:

Mr. Russell Golden
Chairman
*Financial Accounting Standards Board*

Mr. Paul Beswick
Chief Accountant
Office of Chief Accountant
*Securities and Exchange Commission*

Mr. Craig Olinger
Acting Chief Accountant
Division of Corporation Finance
*Securities and Exchange Commission*

Ms. Kathy Murphy
Chief Accountant

*Comptroller of the Currency*

Mr. Robert Storch
Chief Accountant
*Federal Deposit Insurance Corporation*

Mr. Steven Merriett
Deputy Associate Director and Chief Accountant
*Federal Reserve Board*

Mr. John (JJ) Matthews, PNC Financial Services Group Inc.
Chairperson – Financial Reporting Committee
*The Clearing House Association L.L.C.*

Ms. Esther Mills
President
*Accounting Policy Plus*

Mr. Ryan Pozin
Assistant Vice President
*The Clearing House Association L.L.C.*

# The Goodyear Tire & Rubber Company

Akron, Ohio 44316 – 0001

December 11, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 034

This letter is being submitted in response to the Public Company Accounting Oversight Board's (the "Board") request for comments related to the Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendment contained in PCAOB Release No. 2013-005. The Goodyear Tire & Rubber Company ("we", "us", "our") appreciates the opportunity to comment on this topic. We are one of the world's largest tire companies, employing about 69,000 people and manufacturing our products in 52 facilities in 22 countries around the world.

We support the Board's efforts to improve audit quality that will ultimately enhance investor confidence in the audit process and their reliance on financial statements. However, we do not fully support the Board's proposal in the current form. Although we do not object to the proposed additional elements of the auditor report related to independence and tenure and the standardized language "whether due to error or fraud," we do not perceive these changes to be a significant enhancement to the usefulness of the auditor's report. Overall, we do not support the remaining elements of the proposal, specifically, requiring the auditor's report to disclose "critical audit matters" and changing the auditor's responsibility for other information included in a company's Annual Report on Form 10-K ("10-K"), as 1) we do not believe the benefits to users of such changes outweigh the potential costs, 2) our external auditors may be required to disclose information that is not currently required to be disclosed by preparers of financial statements, and 3) with respect specifically to the changes to the auditor's responsibility for other information, we believe the changes will not serve to improve, and potentially detract from, users' understanding of information evaluated by the auditor. Our views are explained further below.

Critical Audit Matters (CAMs)

We do not support the proposal as it relates to CAMs as we believe management should be the source of a company's disclosure of financial information and the current proposal may put the auditor in a position of disclosing information that is not currently required to be reported by management under GAAP, SEC reporting rules or PCAOB guidance (with respect to management's report on internal control over financial reporting). Specifically, items concluded to be immaterial by management, the auditor and the audit committee, such as potential significant deficiencies in internal control over financial reporting and "passed" audit adjustments could be disclosed by auditors as CAMs under the current proposal. Further, even in the case of material items disclosed by management in the 10-K, we envision that the added requirements of the proposal may result in auditors disclosing additional details surrounding such matters that are not required to be reported by management, and such information could serve to be harmful to the company. For example, to the extent our auditors are required to provide additional details surrounding the audit process of certain legal contingencies, such disclosures could be detrimental to our legal position. For example, we disclose certain contingencies, including open legal proceedings, for which we have lengthy discussions with legal counsel to ensure compliant disclosure without disclosing privileged information or information that could jeopardize our legal position. Our auditor currently reviews such disclosures, as discussed above, and is required to challenge all factors, in order to reach a conclusion on the sufficiency of the disclosure; however, is currently not required to provide discussion of its audit approach or facts of any individual such matters in its opinion on the financial statements.

We also note that for material items that may be identified as CAMs by our auditors, existing financial statement disclosures provide a good source of information for financial statement users. We conducted preliminary due diligence on potential CAMs by reviewing our 10-K for the year ended December 31, 2012, management's report to the audit committee of significant accounting and reporting matters and internal controls, and our auditor's report to the audit committee. Based on this review, we expect there would be very strong alignment of material CAMs disclosed in the auditor's report with disclosures of critical accounting policies prepared by management in the Critical Accounting Policies section of Management's Discussion and Analysis ("M,D&A") and, to a lesser extent, matters disclosed in other sections of M,D&A and the Notes to the Consolidated Financial Statements. Although these disclosures are prepared by management and disclosures beyond the financial statement footnotes are not covered by the auditor's opinion, the auditors must review these disclosures and ensure there are no material inconsistencies with the audited financial statements. Given the expected alignment between material items required to be disclosed as CAMs in the auditor's report with information already disclosed by management (e.g. subjective areas of accounting with greater levels of management judgment and estimation), we do not see sufficient benefit to justify incremental auditor efforts and related costs. However, to the extent the Board proceeds with this element of the proposal, we recommend the reporting of CAMs be limited to items of a material nature.

Auditor's Responsibility for Other Information

We do not support the proposal as it relates to the auditor's responsibility for other information as we do not believe the benefits of the auditing standard will outweigh the potential related costs of making specific reference to other information in the audit report. We believe that our auditor's review of other information is sufficiently comprehensive under current guidelines given their obligation to review the disclosures for material inconsistency with information included in the financial statements covered by the audit opinion. As a practical matter, we believe auditors already perform a detail review of M,D&A. In addition, we believe that providing additional, somewhat vague, assurance on qualitative and quantitative information in the other information will likely result in unintended additional procedures being carried out by our auditors as our external audit firm will have additional perceived responsibility and risk pertaining to their opinion, especially as it relates to our projections for the future. We forsee these additional procedures, including additional substantive testing and the validation of information included in the auditors body of audit evidence obtained in the course of its audit will, in turn, increase audit fees. Further, we believe that this additional assurance will cause confusion to the users of our financial statements as it will be unclear as to which specific information has been evaluated by our auditors (as users have no knowledge of the audit evidence obtained by our auditors during the audit process) and, therefore, the level of reliance they should place on such other information. In summary, we do not see these extra procedures and auditor's disclosure providing benefit to our investors or users of our financial statements and, thus, do not justify the expected related costs.

To the extent the Board decides to proceed with this element of the proposed standard, we would suggest editing the auditor report to provide greater clarity on the scope and level of procedures performed by the auditor in conducting the evaluation, as well as the level of comfort provided to users.

Again, we thank the Board for the opportunity to comment on the proposed auditing standards. If you have any questions regarding the comments provided in this letter, please contact me at 330-796-2775.

Sincerely,

Richard J. Noechel

Richard J. Noechel
Vice President and Controller
The Goodyear Tire & Rubber Company

ICAEW

11 December 2013

Our ref: ICAEW Rep 172/13

Your ref: PCAOB Rulemaking Docket Matter No. 034

Office of the Secretary
PCAOB
1666K Street NW
Washington
DC20006-2803

Dear Sir

**PCAOB Release No 2015-005: The PCAOB's Auditor Reporting Proposals**

ICAEW is pleased to respond to your request for comments on:

*PCAOB Release No.2013-005:*

*The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;*

*The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and*

*Related Amendments to PCAOB Standards.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

Katharine E Bagshaw FCA
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ICAEW REP 172/13

ICAEW REPRESENTATION

**PCAOB RELEASE NO 2015-005: THE PCAOB'S AUDITOR REPORTING PROPOSALS**

**Memorandum of comment submitted in December 2013 by ICAEW, in response to the following PCAOB consultation published in August 2013:**

***PCAOB Release No 2015-005*:**

***The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;***

***The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and***

***Related Amendments to PCAOB Standards.***

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## INTRODUCTION

**1.** ICAEW welcomes the opportunity to comment on the following auditor reporting proposals published by the PCAOB in August 2013, a copy of which is available from this link:

*PCAOB Release No 2015-005:*

*The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion;*

*The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report;*

*Related Amendments to PCAOB Standards.*

## WHO WE ARE

**2.** ICAEW is a world-leading professional accountancy body. We operate under a Royal Charter, working in the public interest. ICAEW's regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the UK Financial Reporting Council. We provide leadership and practical support to over 140,000 member chartered accountants in more than 160 countries, working with governments, regulators and industry in order to ensure that the highest standards are maintained.

**3.** ICAEW members operate across a wide range of areas in business, practice and the public sector. They provide financial expertise and guidance based on the highest professional, technical and ethical standards. They are trained to provide clarity and apply rigour, and so help create long-term sustainable economic value.

**4.** The Audit and Assurance Faculty is a leading authority on external audit and other assurance activities and is recognised internationally as a source of expertise on audit issues. It is responsible for technical audit and assurance submissions on behalf of ICAEW as a whole. The faculty membership consists of nearly 8,000 members drawn from practising firms and organisations of all sizes from both the private and public sectors. Members receive a range of services including the monthly Audit & Beyond newsletter.

## MAJOR POINTS - A: AUDITOR REPORTING

### Investors would benefit from renewed efforts by standard-setters to converge auditing standards on auditor reporting

**5.** We are particularly grateful for this opportunity to comment on the PCAOB's auditor reporting proposals. The changes that will take place in auditor reporting over the next few years are unparalleled, and they constitute a rare, once in a generation opportunity to enhance the transparency of the audit process and investor confidence in the value of audit. We encourage the PCAOB, as we have encouraged other standard-setters, to seize this opportunity.

**6.** The PCAOB is an excellent position to exercise leadership in this area. We urge it and other standard-setters to take whatever steps are necessary to ensure that their auditor reporting requirements benefit investors, and are seen to do so, by streamlining those requirements globally. The growth in cross border capital flows over the last twenty years mean that the current, entrenched diversity in auditor reporting practices no longer reflects the needs of US and other global investors.

**7.** In our 30 September 2011 response to the PCAOB on its Concept Release on possible revisions to auditor reporting standards (Rep 91/11), we noted the effect of different corporate governance practices in different jurisdictions on convergence. We encouraged the PCAOB and IAASB to be diligent in their attention to each other's work in this area and urged them to co-operate as much as they could on their respective consultations. We remain hopeful that both bodies will seek further dialogue before finalising their proposals because we firmly believe that there is more scope for convergence.

**8.** Genuine convergence achieved through dialogue and understanding will help raise standards of auditing globally. Standard-setters such as the PCAOB can, if they chose to do so, drive this convergence in the interests of investors. If they do not, international standard-setters risk being ignored locally, and national standard-setters will simply impose additional costs on local investors without corresponding benefits, and may weaken their own position internationally.

**9.** The methodologies of firms required to report under UK, US and international standards are based on ISAs. We understand that a principal objective of their field testing in this area is to establish the extent to which the requirements and proposals under the different regimes can be accommodated either within one audit report or with a minimum of variation across different audit reports. We also understand that they are finding that in most cases, there are no significant reporting differences when different reporting regimes are applied to the same companies. Risk management dictates that firms will seek to align their reports across different regimes as far as possible.

**10.** In our recent response to IAASB on its auditor reporting proposals , we urged it to take a pragmatic approach by working directly with other major players, especially the PCAOB, in order to achieve as much global consistency as possible. We now also urge the PCAOB, as the standard-setter in the largest capital market in the world, to take positive steps to deepen its dialogue with IAASB.

**11.** Leadership amounts to a great deal more than acting unilaterally and if leading standard-setters do not work together on these radical changes, there is a real risk that history will judge their efforts to find the right answers, however well-intentioned, to have been a waste of resources by people who should have known better. Together, leading standard-setters have the opportunity to leave a lasting legacy of genuine improvements in auditor reporting standards that will help rebuild trust and confidence in the financial reporting supply chain. Both are sorely needed even in economies that are beginning to recover, and they remain in short supply globally.

## The PCAOB's consultation

**12.** We congratulate the PCAOB on its proposals. They are a substantial improvement on the preceding Concept Release not least because the basic principles, if not the detail, are aligned with the direction of travel internationally.

**13.** We have answered most of the PCAOB's questions regarding the proposed standard on auditor reporting. We have covered those issues that we believe to be important points of principle on other information. There is a total of 87 questions in the current consultation and with the best will in the world, developing a high quality response to all of them is a tall order, even for well-resourced respondents.

**14.** We encourage the PCAOB, going forward, to consider how best to obtain the widest range of input possible, especially on points of principle. Specifically, it might consider whether questions can be consolidated to make the overall task seem less daunting to those respondents with fewer resources, such as investors in smaller entities. We doubt that the PCAOB intends to over-burden its respondents with an excess of questions, but we fear that in this particular case, given the number of bodies that have recently published parallel and consecutive consultations and proposals, a certain amount of 'auditor-reporting-response-fatigue' is setting in. We therefore caution against taking silence in response to specific questions for assent to the proposals.

### Apparent differences between the proposed reporting regimes

**15.** We encourage the PCAOB to do what it can to ensure that the apparent areas of difference between the different proposed reporting regimes are minimised. US investors send large amounts of money abroad, and foreign investors spend large amounts of money in the US. Neither group, however different their needs and desires, is likely to have the time or inclination to distinguish between ‘key’ audit matters and ‘critical’ audit matters, whatever the purported virtues of either regime, particularly where dual listed entities include audit reports prepared under both local and PCAOB standards in their filings.

**16.** Investors are well aware that wording differences in audit reports will not, in the long run, result in any significant differences in what is communicated in audit reports. The depth and quality of auditor reporting will be driven less by detailed wording differences in auditing standards, and more by investor demands, the regulatory approach to monitoring auditors, the approach taken by reporting firms and common practices that develop within and across industry sectors in the next few years. We think it unlikely that it will become clear that reporting under the PCAOB’s regime is superior to reporting under other regimes, or vice versa, regardless of their respective virtues on paper.

**17.** In the UK, the FRC has chosen to introduce new reporting requirements before an international consensus has emerged. ICAEW is an international body and we have made our commitment to ISAs clear to the FRC. Our support for IAASB’s proposals is not unqualified though and we have made it clear to IAASB that we believe its proposals could be improved and that IAASB must consider the need to make pragmatic changes, if they are necessary to achieve global consistency. Auditors and companies are making these changes for the benefit of investors and it is incumbent on all concerned to do whatever they can to make sure that investors do in fact benefit.

### Auditor reporting is only the start

**18.** We note above the importance of the changes currently taking place in auditor reporting. This is the beginning of a journey whose outcome depends on the willingness of all of those with an interest in auditor reporting to co-operate constructively. Investors are a heterogeneous group with a range of information needs and we encourage them to lead the way by stepping up their level of engagement with audit committees and being clear about what they need to know. We encourage regulators to focus on fostering genuine innovation in communications as well as sanctioning non-compliance, and we encourage audit committees to seek better quality communications with both auditors and investors. Last, but not least, we encourage auditors to play their part by producing genuinely informative, high-quality audit reports and by resisting pressures to hide behind boilerplate.

## RESPONSES TO SPECIFIC QUESTIONS/POINTS

### Question Related to Section II:

### Q1. Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?

**19.** The objectives summarise the requirements of the proposed standard. To that extent they assist auditors in understanding the requirements. We have noted in past responses to the PCAOB and IAASB our belief that objectives should be more than mere summaries of the requirements, and that they should show the outcome that is to be achieved as a result of complying with the requirements. Real objectives, such as improving communications or enhancing transparency, are hard to measure, but they are a better measure than measuring whether auditors have complied with the requirements. At present, achievement of the objective is synonymous with having complied with the requirements.

**Questions Related to Section IV:**

**Q2. The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

**20.** There are no others to whom the auditors' report should be required to be addressed.

**Q3. The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

**21.** We do not believe that enhancing descriptions of auditor responsibilities will prove to be critical to enhancing transparency or improving communications with investors. There are no additional auditor responsibilities that should be included to further describe the nature of an audit.

**Q4. The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

**22.** We do not believe that requiring auditors to include a statement on their independence will result in any significant changes to their behaviour. Nevertheless, confidence in the independence of auditors is important and a statement in the auditors' report to this effect is unobjectionable, if superfluous.

**23.** The fact that the word 'independent' already appears in the audit report means that the bald statement to the effect that auditors are independent, a little further down in the report, manages to say very little and look repetitive at the same time. The statement does not add much to the word in the title and we have doubts as to whether it will in fact improve confidence in auditor independence. Merely stating that auditors are required to be independent does not make them so. The auditors' report should not be cluttered with poor quality information, particularly if it is repetitive.

**Q5. The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

**a. Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**

**24.** We have yet to be convinced that such evidence as is available regarding audit firm rotation clearly shows that there is any relationship between auditor tenure and audit quality, regardless of the proxies that are used to measure it. The evidence, such as it is, is mixed. Nevertheless, while we agree that information regarding auditor tenure is of *interest* to investors, we do not believe that the auditors' report is the right home for it. Decisions regarding when and whether to replace auditors are based on policies that are in turn based on the reporting entity's corporate governance strategy. A better home for this information might therefore be the MD&A, or its equivalent.

**b. Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**

**25.** The terms 'mergers, acquisitions and changes in ownership structure' do not cover all of the possible changes in firms either in substance or in form. We doubt any watertight form of words could be devised to cover every eventuality and without an explanation of the basis on which the calculation had been performed, misunderstandings and inconsistencies will be hard to avoid. There is certainly scope for genuine disagreement as well as abuse and we see little value in debates about whether a firm has been in place for thirty, fifty or eighty years, when the firm name, staff and offices as well as the audited entity itself have changed out of all recognition during the shortest of these periods.

**c. Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

**26.** We believe that the information about firms currently available outside the auditors' report is sufficiently widely available for investors to be able to make informed choices. We note above our belief that the auditors' report should not be cluttered with poor quality information, even if it is interesting.

**Q6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

**27.** The proposed description of the auditors' responsibilities for other information and the results of the evaluation of other information will make the report more informative and useful, but as we note in our major points on this issue below, we have serious reservations about the proposed requirements in this area.

**Q7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

**28.** Yes, there should be a requirement for a specific order for the presentation of the basic elements required in the audit report. Audit reports are likely to be significantly longer under the new regime and a specific order will make it easier for experienced readers to navigate reports. We urge the PCAOB to align this order with the order proposed by IAASB as far as possible. Without this, reports will be less comparable.

**Q8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

**29.** There are no other changes to the basic elements the Board should consider adding at this time.

**Q9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

**30.** It is important that the costs of these changes are recognised. The example reports produced by the PCAOB are far longer than those proposed by IAASB or implemented by the UK's FRC. While the length of the report and the cost of producing it are not directly related, it is inevitable that the sheer length of some of these reports will, of itself, result in additional cost, regardless of the substance of what is actually reported. The most important issue here is not the absolute quantum of costs, even though they will be far from negligible, but the benefits which need to be evaluated by standard-setters in due course, particularly in terms of enhanced investor satisfaction.

**Questions Related to Section V:**

**Q10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

**31.** The auditors' communication of CAM will be relevant and useful to investors and other financial statement users if:

- investors continue to engage with audit committees and auditors, and are clear about what they want to know;
- auditors avoid boilerplate where possible;
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

**Q11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

**32.** The main threat to enhanced transparency is that CAM disclosed will be irrelevant to investor needs, or will degenerate into boilerplate. We note in our main points above the behavioural changes needed among all stakeholders, and the fact that investors, audit committees and auditors need to step up their level of engagement with each other.

**Q12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter?**

**33.** We do not believe that CAM as defined by the PCAOB and KAM as defined by IAASB are significantly different. The range, depth and detail of reporting will be similar, whichever regime is applied. Firms, needing to be efficient, will seek to align the requirements even if standard-setters do not.

**34.** IAASB's definition of KAM starts with the population of items communicated to the audit committee. The PCAOB casts a much wider net as a starting point and includes matters reviewed by the engagement quality control reviewer and matters included in the engagement completion document, as well as matters communicated to the audit committee. This list of potential issues for disclosure is, nevertheless, very likely to be whittled down quickly by applying the PCAOB's other requirements.

**35.** We understand that field testing within some firms suggests that CAM identified under the PCAOB's requirements are all matters already communicated to the audit committee. The PCAOB states that its wider net is intended to safeguard against auditors not communicating matters to audit committees to avoid having to classify them as potential CAM, but we believe that this is very unlikely in practice. If the PCAOB believes that its existing standards would somehow permit such important matters not to be communicated to the audit committee, which we doubt, there is a deficiency in existing standards that needs to be remedied. We therefore believe that the PCAOB can afford to consider the benefits of further alignment of its requirements in this area with those of IAASB. PCAOB's net of potential CAM is currently cast unnecessarily wide.

**Q13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

**36.** The disclosure of CAM is intended to benefit investors. Benefits have costs, and costs have to be absorbed somewhere. The additional time incurred on CAM is likely to have a neutral or beneficial effect on audit quality provided that the costs can be passed on to the audited entity. Where this is not possible, there will be a risk of an adverse effect on audit quality overall, i.e. a risk that auditors will seek to cut costs elsewhere, in order to make up for the additional expenditure on CAM.

**Q14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

**37.** The proposed requirements regarding the auditors' determination and communication of CAM are reasonably clear.

**Q15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

**38.** We noted in ICAEW Rep 91/11 the need to cut clutter. While this is less of an issue in the US than it is elsewhere, the PCAOB would not wish to see US investors join the ranks of those jurisdictions in which investors have to navigate excessively lengthy and complex auditors' reports. It is clear, at least in Europe, that investors want better information, and not necessarily more information.

**39.** There is such a thing as too much information and we note below our belief that the example reports as they stand, are unwieldy. That said, auditors in the UK appear to be providing some high-level information of this nature voluntarily. If the PCAOB believes investors are calling for information about the procedures performed, it should consider whether to mandate it. If it chooses to do so, it should first make some effort to clear up some of the repetition in the existing examples and require auditors to report a summary of the principal procedures performed, rather than a full list.

**Q16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

**40.** IAASB's definition of KAM specifically refers to the use of auditor judgment. It is less prescriptive than the PCAOB's definition of CAM and includes more application material. The PCAOB's list of 8 factors to consider in paragraph 9 may encourage a checklist mentality and discourage the use of judgement. We understand that field testing in this area involves the use of spread-sheets with the factors across the top and 'high/medium/low' assessments in the respective columns for each potential CAM. We think the PCAOB could go further to allow for and encourage the use of judgement in this area.

**Q17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

**41.** Once again, we strongly urge the PCAOB to consider how it can align its requirements further with those of IAASB in this area.

**Q18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

**42.** IAASB's requirements for documentation focus on why KAM are KAM, with an option to describe why possible KAM were not considered to be KAM. PCAOB's requirements have more focus on documenting why possible CAM are not considered to be CAM, which seems to be more about preparing audit files for inspection than communicating information to investors. The requirements are tolerably clear, but they are not right.

**Q19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

**43.** We believe that auditors will invariably start with a very long list of potential CAM because of the subjective definition, and because of concerns regarding the approach taken by audit inspectors.

**44.** We understand that in field testing, the starting point under the PCAOB's requirements sometimes involves a very high number of potential CAM - over 100 in some cases. While these are very quickly whittled down, the need to document why something is not a CAM is a potentially onerous requirement. This is unlikely to make auditors more thoughtful or careful. Either the documentation requirement needs to be changed or the starting point for the determination of CAM needs to be narrowed, as suggested above.

**Q20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

**45.** The proposed documentation requirement is potentially excessive, as noted above.

**Q21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

**Q22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

**Q23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

**46.** We note above our belief that there are additional costs associated with these requirements and that in some cases it may have an adverse effect on audit quality.

**Q24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

**47.** We do not comment on this question.

**Q25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

**48.** The PCAOB's requirements for reporting CAM have resulted in some very unwieldy example audit reports that appear repetitive, pedantic and cumbersome. They are a hard read and as general communications, they do not score well. The PCAOB would do well to revisit the details of required disclosures in this area. They all include references to consultation with a 'national office' which may not be particularly meaningful to some investors: 'consultation with internal experts' might be more appropriate.

**49.** We note that the example reports in the UK proposals, which were useful in demonstrating the FRC's intentions, were dropped from the final standard to avoid boilerplate and artificially constraining the nature and style of reporting. We have suggested to IAASB that it follows suit.

**Q26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

**50.** There is a trade-off between boilerplate and consistency. Anything that does not use the same words is likely to be described as inconsistent and lacking in comparability and anything that does use the same words is likely to be described as boilerplate. The comparable and consistent reporting of critical audit matters within the same companies and across different companies is not therefore necessarily desirable. Evaluating comparability and consistency in the absence of boilerplate is likely to be difficult. Not all boilerplate is bad. Auditors should not change the description of a CAM if the substance has not changed simply to avoid writing boilerplate. New investors not having read it before will find value in reading what to others is boilerplate.

**Q27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

**51.** It is inappropriate to require auditors to disclose information about the company that is not already disclosed by management. We therefore encourage the PCAOB to work with other regulators to avoid such situations. The proposed requirements as they stand are very likely to result in auditors and companies working together, harder than they do now, to avoid the need to disclose illegal acts or similar matters in the audit report that are not disclosed elsewhere in the filing. This may be a good thing.

**28. What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor’s potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor’s potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor’s potential liability in private litigation?**

**52.** We do not comment on this question.

**Questions Related to Section VI:**

**Q29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

**53.** Yes, it is appropriate for the PCAOB to include the description of the circumstances that would require explanatory language or an explanatory paragraph.

**Q30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

**54.** Yes, retaining the auditor's ability to emphasise a matter in the financial statements is valuable not least because it allows for the use of judgement, for auditors to deal with unusual situations in an appropriate manner, and for alignment with IAASB’s requirements to be maintained.

**55.** We believe it would be helpful to provide guidance on situations in which a matter may both be a CAM and appropriate for inclusion as an emphasis of matter.

**Q31. Should certain matters be required to be emphasized in the auditor’s report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

**56.** Matters to be emphasised in the audit report should be left to the auditors’ discretion as far as possible.

**Q32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

**57.** Additional examples of matters that might be emphasised are not required, but the standard should emphasise the fact that an emphasis of matter is not a CAM.

**Questions Related to Section VII:**

**Q33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?**

**Q34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.**

**58.** We do not comment on these questions.

**Questions Related to Section VIII:**

**Q35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?**

**Q36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? If not, why not?**

**Q37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?**

**Q38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports unaffiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?**

**Q39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?**

**Q40. Should audits of certain companies127/ be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?**

**59.** We do not comment on these questions.

**Questions Related to Section X:**

**Q41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

**60.** We believe that the PCAOB's effective date for 2016 year-ends could be brought forward. While we would not expect discussions between companies and their auditors on the audit report to commence after the year-end, they would be addressed after planning has commenced. In the UK, the FRC provided a limited grace period which does not appear to have caused any significant difficulties, although the requirements are applicable to a much smaller population. There may be some merit in phasing in the requirements, firstly for large accelerated filers whose auditors have more resources to address the new requirements to help establish best practice, and then for all other issuers.

**Q42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer**

**status? Are there other criteria that the Board should consider for a delayed compliance date?**

**61.** We do not comment on this question.

## MAJOR POINTS - B: OTHER INFORMATION

**62.** The time is not yet right for auditing standard-setters to make significant changes to auditor responsibilities for other information.

**63.** Accounting standard-setters are currently grappling with several difficult and interrelated issues, all of which affect other information. Accounting standard-setters have specific projects on materiality and disclosures, including projects on materiality in the context of qualitative disclosures and on non-GAAP quantitative disclosures. Other information typically contains a large amount of both.

**64.** The projects undertaken by accounting standard-setters need to be progressed further before auditing standard-setters can address these difficult issues in earnest. Clarity regarding the materiality of qualitative disclosures and non-GAAP measures in other information is critical if auditors' responsibilities regarding other information are to be changed. These proposals, which would significantly extend auditor responsibilities, are quite simply a step too far at this time.

**65.** While IAASB may re-expose a revised ISA 720 in this area shortly, the proposed guidance is likely to be high level and auditors will be left to use their judgement in determining whether, for example, non-GAAP financial measures or qualitative disclosures are materially misstated or misleading. We did not support IAASB's proposals when they were first issued for public consultation for these and the other reasons, and are unable to support the PCAOB's proposals now for similar reasons.

### The scope of the proposed other information

**66.** The scope of the proposed other information standard is not clear. Information is now linked electronically and cross-referenced to an extent never before possible, and we do not believe that the boundaries proposed are sufficiently clear. Cross-referenced exhibits include thousands of pages of legal agreements relating to mergers and acquisitions, for example, and we do not believe that the PCAOB intends auditors to include these within the scope of the audit or even within the scope of the required 'evaluation'.

**67.** While we understand some of the problems caused by the SEC's integrated disclosure system, it seems difficult to justify requiring auditors to consider other information in an annual report but not in a registration statement in an IPO, when users arguably place greater reliance on the other information.

**68.** Is it not appropriate to apply the proposed other information standard to information incorporated by reference. Much of that information is likely to lie outside the auditors' competence, it may be unclear who has responsibility for it, and auditors may have no relationship with those who do have responsibility.

### Requiring auditors to evaluate other information for material misstatements of fact

**69.** We have serious reservations about the PCAOB's and IAASB's current proposals to require auditors to 'evaluate' other information for material misstatements of fact. We remain of the view that this is tantamount to requiring auditors to provide assurance on the other information. The proposed requirements would substantially increase the scope of the audit, its cost, and the expectation gap. The current requirements to 'read and consider' other information for material misstatements of fact represent a much lower hurdle. 'Evaluation' implies some benchmark against which auditors can perform the evaluation and no such benchmark exists.

Work on other information has always been a by-product of the audit of the financial statements and if standard-setters wish to change that, they must recognise the extent of work involved in providing a meaningful level of assurance on the front half of the annual report. We noted in Rep 9/11 our belief that there is merit in exploring the provision of assurance on the front half of the annual report, and we remain of that view.

**70.** If the PCAOB does not intend to require auditors to provide assurance on the front half of the annual report, and we do not believe that it does, it needs to find some other form of words to express what auditors do. In practice, many auditors do a great deal more than the current standards require: they 'tick' statements that can be 'tied' to the financial statements and they often 'check' statements that cannot be ticked and tied, to other supporting evidence. It is after all in their interests to ensure that the audited financial statements do not go out accompanied by misleading or erroneous other information. But requiring auditors to 'evaluate' all of the other material, including the enormous amount of material now routinely incorporated by reference, while maintaining that this is part of the audit rather than a substantial separate engagement, is another matter altogether, partly because of the sheer volume of information covered, and partly because there are some important figures and statements in other information that cannot be 'ticked and tied' or 'checked' to anything at all, such as the Pillar 3 disclosures for banks.

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December 11, 2013

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

Re: JICPA Comments on the PCAOB Rulemaking Docket Matter No. 034

The Japanese Institute of Certified Public Accountants ("we", "our" and "JICPA") is grateful for the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") Rulemaking Docket Matter No. 034: *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Related Amendments to PCAOB Standards* ("the Proposed Standards").

The discussion enhancing the information value of the auditor's report takes place around the world. In addition, due to globalization of the reporting entities' activities, consistency between the auditors' reports is becoming more critical. If the auditors' reports significantly differ in form or content according to the auditing standards with which auditors comply, auditors and users alike may be seriously confounded. The resulting confusion would surely not be in the public interest. We encourage the PCAOB to collaborate with the IAASB, a body engaged in a similar project focused on revisions for auditor reporting, and to align both standards by reducing unnecessary differences insofar as possible.

JICPA is responding to the Proposed Standards for two principal reasons. First, any JICPA members registered with the PCAOB would be directly affected by new standards. Second, we believe it is important to seek international solution as possible to maintain the consistency in the auditor's report globally, in order to protect the interests of investors and further the public interest. Below we provide comments to specific questions from Appendix 5 of the Proposed Standards: *Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release* that we consider especially relevant from Japanese or international perspective.

Sincerely yours,

Sayaka Sumida
Executive Board Member - Auditing Standards
The Japanese Institute of Certified Public Accountants

**Our Comments to Specific Questions in Appendix 5**
***Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release***

**Definition / Determination of Critical Audit Matter**

12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?

14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?

16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?

We understand that paragraphs 7 to 9 of the proposed Auditor Reporting Standard, in conjunction with the definition of a "critical audit matter", are designed to guide the decision-making process by which the auditor determines critical audit matters. Critical audit matters seem to be similar, conceptually, to the "key audit matters" that the IAASB proposed. Yet the two concepts do not appear to be identical, and it is not clear whether or not there are any substantial differences. Any unnecessary differences would confuse not only an investor who read and analyzes financial statements and auditors' reports, but also any auditor who audits a company listed on more than one market and accordingly needs to issue the auditor's report in accordance with both the PCAOB standards and the ISAs. We believe that unnecessary differences should be eliminated insofar as possible, and that any necessary differences should be explicitly clarified and explained.

**Audit Procedures, including Resolution of the Critical Audit matter**

15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?

We do not believe that it would be informative or useful to include the audit procedures performed, including resolution of the critical audit matters in the auditor's report. Following are our reasons for this opinion:

- It is difficult to avoid the impression that the auditor expresses an opinion on that individual matter, even if the language preceding the Critical Audit Matters section explains otherwise.
- It is difficult to summarize the procedures performed in succinct way, particularly in complex, judgmental areas of the audit. Information which summarized only parts of the procedures performed is likely to mislead the users about a complete picture of the auditor's response to the identified risks.
- If the auditor is allowed to include the audit procedures and the results of the procedures in the description of critical audit matters, it creates a situation where only some descriptions include the procedures and the results of the procedures, and as a result users may misinterpret that there are unresolved issues on the critical audit matter where the audit

procedures and the results of the procedures are not included in the description of the critical audit matter.

To avoid these unintended consequences, the PCAOB should clearly state that inclusion of the audit procedures, including the auditors' approaches and the result of the audit procedures should not be allowed. Likewise, the PCAOB should remove the descriptions of the audit procedures from the illustrative examples.

**Audit Documentations**

19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?

We do not believe the proposed documentation requirement for non-reported audit matters would produce the outcome that the PCAOB expects. The Note to paragraph 14 of the proposed Auditor Reporting Standard and Section V. E. of Appendix 5 state that the auditor would not be expected to provide an explanation for each matter documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated to the audit committee. They also state that the auditor would be expected to document only those matters that would "appear to meet the definition of a critical audit matter."

However, whether or not an audit matter "appears to meet the definition of a critical audit matter" depends on the auditor's professional judgment, which is inherently subjective. As such, we do not believe that this condition would work effectively. Given the possibility that the auditor's judgments are second-guessed, the auditor would, for example in a preventive manner prepare an extensive amount of unnecessary documentation, or increase the number of critical audit matters disclosed in the auditor's report, and this may result in a considerable burden.

Critical audit matters are those matters the auditor addressed during the audit of the financial statements, which are selected in light of relative significance in the particular period's audit. The auditor must identify all significant findings or issues in an engagement completion document in accordance with Auditing Standard No. 3, and the engagement quality reviewer should review the engagement completion document in accordance with Auditing Standard No. 7. Therefore, requiring documentation of the basis for the auditor's determination that each reported matter was a critical audit matter would be sufficient to achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters. We believe the proposed documentation requirement for non-reported audit matters is not necessary and accordingly, should be deleted.

**Illustrative Examples of Critical Audit Matters**

25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?

We have a comment on the status of the illustrative examples, which are included in the Exhibit to Appendix 5 but not in the proposed Auditor Reporting Standard. We believe that the illustrative examples play an important function in both informing the auditor's decision-making process and helping stakeholders' reach a common understanding. We also support the PCAOB's approach to include the illustrative examples with the information regarding the company's related notes to the financial statements. The examples give the auditors and other relevant stakeholders guidance on the level of description that can reasonably be expected, by showing the relationship between the individual critical audit matter and the related disclosure in the financial statements. We therefore recommend that the PCAOB update the illustrative examples and include them in the final standard together with the information on the company's related notes to the financial statements.

We comment on the contents of the illustrative examples in our responses to questions 15 and 27.

**Disclosing Information that Otherwise would not Have Required Disclosure under Existing Auditor and Financial Reporting Standards**

27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?

First, absent a requirement for the entity to disclose such information, we expect that the auditor would encounter considerable difficulty in disclosing the information in the auditor's report unless the company agreed to disclose the information voluntarily. Given that such matters are likely to be sensitive information for the company to disclose, the company would not be likely to agree to disclose the information in its financial statements.

Second, if information that would not otherwise have to be disclosed under the existing auditor and financial reporting standards would be disclosed as a critical audit matter, a contradiction would emerge between the requirements regarding the communication of critical audit matters and other disclosure mechanisms already in place in the financial reporting system. The example in the Appendix suggests that a deficiency in internal control over financial reporting could be disclosed in the description of critical audit matters in the auditor's report, even if it was not otherwise determined to be a material weakness in accordance with the SEC rule and PCAOB auditing standards under Section 404 of the Sarbanes-Oxley Act of 2002 (internal control reporting requirements). This means that the requirements for critical audit matters would effectively defeat both the purpose of and expected benefits from the internal control reporting requirements. Under internal control reporting requirements, for example, management is required to assess internal control over financial reporting as of the year-end rather than throughout the entire period. We understand that this provides an incentive for management to remedy identified deficiencies before the year-end. The description of critical audit matters, however, could include information about a material weakness that had been remedied before the year-end or a significant deficiency that had been identified during the year, even when the disclosure of the deficiency was not required by the internal control reporting requirements.

We do not believe that the auditor should provide original information about an entity that otherwise would not have required disclosure under financial reporting standards, through the communication of critical audit matters. However, if such disclosure is envisaged, the PCAOB should more clearly describe the cases when it would be necessary to disclose such information. Specifically, it should clarify the relationship between the requirements in the auditing standards regarding the communication of critical audit matters, and the ethical requirements regarding confidentiality. The PCAOB should also clarify, at minimum, it is inappropriate to disclose information in the description of critical audit matters that other existing reporting requirements have already dealt with. From this standpoint, we believe that the reference to the control deficiency in the illustrative examples should be deleted.

THE LACLEDE GROUP, INC.
720 OLIVE STREET
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RECEIVED
APR 29 2014

STEVEN P. RASCHE
CHIEF FINANCIAL OFFICER

April 23, 2014

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members and Staff:

The Laclede Group, ("Laclede") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed auditing standards and amendments, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("the proposed auditor reporting standard") and; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* ("the proposed other information standard") and we respectfully submit our comments and recommendations thereon.

On December 11, 2013 the American Gas Association ("AGA") responded to PCAOB Release NO. 2013-05 with regard to the Board's proposed auditor reporting standard and the proposed other information standard included. Laclede strongly supports the comments made by the AGA and disagrees with the Board's proposed changes. A copy of AGA's response is included for reference.

Specifically, we disagree with the following provisions:

- We believe that the proposed auditor reporting standard would decrease the usefulness of the audit report and the clear separation of duties between management and our auditors.

- We believe the proposals undermine the role of the Audit Committee.

- We believe critical audit matters ("CAM") should be discussed directly with the Audit Committee in their role of overseeing the audit and controls over financial reporting, and that the discussion of CAM's in the audit report could cause confusion to the readers of the financial statements.

- Finally, we believe that the costs associated with the proposals and the inefficiency caused by the added work on the part of the auditors and our staff far outweigh the benefits of the proposals.

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We appreciate the opportunity to weigh in on this matter and look forward to continuing discussion on this vital topic.

Respectfully submitted,

Steven P. Rasche
Chief Financial Officer

American Gas Association

December 11, 2013

Office of the Secretary
File Reference: Docket Matter No. 034
PCAOB
1666 K Street, N.W.
Washington DC 20006-2803

**File Reference:** PCAOB ~~Rulemaking Docket~~ Matter No. 034

Dear Ms. Brown:

The American Gas Association ("AGA") respectfully submits our comments on the Public Company Accounting Oversight Board's ("PCAOB" or "the Board") proposed audit standards included in Release No. 2013-005 addressing both *The auditor's report on an audit of the financial statements when the auditor expresses an unqualified opinion* (the "proposed auditor reporting standard") and; *The auditor's responsibilities regarding other information in certain documents containing audited financial statements and the related auditor's report* (the "proposed other information standard").

The American Gas Association, founded in 1918, represents 202 local energy companies that deliver clean natural gas throughout the United States. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which almost 93 percent – more than 65 million customers – receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the United States' energy needs.

**Overall concerns**

The AGA appreciates the PCAOB's efforts to enhance the information provided to investors and financial statements users. We agree that financial statement users should have access to timely, accurate, objective and relevant information for purposes of making investment decisions. However, we strongly disagree with the proposed auditor reporting standard and proposed other information standard included in PCAOB Release No. 2013-005. We believe a company's financial information and the communication of that information is management's responsibility. We believe the SEC and the FASB should continue to serve as the standard setters for establishing the requirements for information to be provided to investors, and that management should be the sole party responsible for communicating such information.

The SEC has enacted various regulations over time (including designation of FASB as the organization responsible for promulgating US GAAP) on *what* information needs to be disclosed. Importantly, these rules designate management as the responsible party to determine *how* to communicate this information to most accurately reflect a company's financial results and position. The role of the external auditor is to verify that the information presented by management complies with the applicable SEC / FASB requirements and is presented fairly in all material respects. The audit committee, comprised of a company's shareholder-elected Board of Directors, is charged with oversight of both the auditor and management's financial reporting.

The SEC and PCAOB provide additional oversight of management, the audit committee and external auditors by reviewing the financial statements and the audits thereof to ensure these parties are performing their duties appropriately. If management, the audit committee, and the external auditors fulfills their respective responsibilities to communicate timely, accurate, objective and relevant information to financial statement users that is audited in accordance with existing professional standards, we believe the additional communications and requirements outlined in the proposed auditor reporting standard and the proposed other information standard are unnecessary.

In addition to these overall concerns, we provide the following specific observations regarding each proposal.

**The proposed auditor reporting standard**

Of the various requirements proposed in the auditor reporting standard, we most strongly disagree with the requirement that the auditor disclose critical audit matters (CAMs) within the audit report. As such, we have limited our response on the auditor reporting standard to this matter. We believe the proposed standard would be detrimental to the usefulness and relevance of the audit report and would undermine the role of the audit committee. Further, we believe the proposed standard would result in lack of consistency and comparability of auditors' reports across companies while increasing the cost of regulatory compliance.

*The proposal would undermine the usefulness of the audit report and the role of the audit committee*

The auditor is expected to conduct an audit to obtain reasonable assurance that the financial statements are materially correct when taken *as a whole*. The auditor's report does not include, nor do we believe it would be appropriate or practical to include, all of the factors considered by an auditor when forming the overall audit conclusion. Therefore, without the full context of a company's financial transactions, business environment and internal controls obtained by the auditor throughout the audit process, an investor may inappropriately over-emphasize the importance of a CAM when making an investment decision. Likewise, highlighting CAMs in the audit report may lead investors to over-emphasize certain risks because they are disclosed as a CAM and under-emphasize other important business risks that may not meet the proposed CAM disclosure criteria. Additionally, disclosure by the auditor of the most difficult aspects of the audit may be interpreted by some as the auditor expressing reservations in their report on those transactions or accounts affected by a CAM, or as the auditor providing a "piecemeal" opinion on the financial statements which would undermine the usefulness, authority, and credibility of the audit report.

Currently the audit committee, as part of the shareholder-elected Board of Directors, has the authority to oversee the audit and ensure the financial statements contain appropriate disclosure on behalf of shareholders. Under current rules, the auditor already discusses difficult, judgmental, complex and other key aspects of the audit with the audit committee. With its access to auditors, management and the Board of Directors, the audit committee has the requisite knowledge, perspective and authority to ensure the various risks faced by the entity are disclosed in a manner commensurate to their materiality and relevance to investors. The Board's proposal would undermine this oversight role by requiring the auditor to effectively bypass the audit committee and disclose CAMs directly to shareholders in the audit report. We believe that the auditor's role should remain that of attesting on information prepared by management, and the Audit Committee should retain its function as providing primary oversight of the audit process.

*The proposal would undermine the relevance of the audit report/financial statement disclosures*

The matters that would be required to be disclosed as CAMs are already provided in the financial statements or are not relevant to investors in making investment decisions. The proposal states that CAMs are those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements. Many of those matters meeting the criteria above relate to subjective or complex accounting areas which are already disclosed within the financial statements as required by US GAAP or SEC rules. Examples include critical management judgments, risks and uncertainties, and accounting estimates and policies. Repeating these disclosures in the audit report would result in duplicative disclosure and would undermine the relevance of either the audit report or the financial statement disclosures. Further, if the auditor identifies a significant lack of internal control as part of the audit, the audit report on internal control already describes it as a material weakness. If any additional information or disclosure is deemed necessary, such disclosure should be addressed by the SEC and the FASB as part of the financial reporting standard setting process.

The proposed standard would also require that auditors disclose certain audit matters that we do not believe would be considered relevant to investors when making investment decisions. Examples include the level of audit effort applied to a particular account, immaterial or corrected misstatements, change in auditor risk assessment, and an auditor's use of a specialist. Such items may provide information on a business's accounting operations or an auditor's approach, but do not impact the underlying economics of the business and therefore may not be considered relevant by investors.

*Auditor reporting would no longer be comparable or consistent across entities*

Under the proposed standard, the auditor's determination of what is considered to be a CAM will involve a considerable amount of professional judgment and will decrease comparability of the auditor's report. There is a risk that auditors may take a conservative approach and include numerous CAMs in order to avoid potential PCAOB inspection findings or litigation, resulting in voluminous disclosure within the audit report and thereby obscuring the overall opinion. Further, investors may incorrectly interpret longer auditors' reports as an indicator of higher investment risk rather than as a matter of an auditor's professional judgment or reporting policy. There is also the risk that each audit firm's interpretation of what meets the definition of a CAM will differ, resulting in lack of comparability between audit reports for similar companies or industries. We therefore have concerns that the auditor's subjective determination of what is considered to be a CAM could be used erroneously as the basis for, or at least influence, differences in investor decisions among otherwise comparable entities.

*Potential implementation challenges and cost considerations*

The increased costs of compliance with the proposal will outweigh any perceived benefit. A significant amount of additional time will be required by audit firms in order to develop, review and present CAMs, which will result in increased audit fees. Extensive discussion and consultation with Company management, legal and the audit committee would also be required, resulting in increased internal costs. Further, because some CAMs may not be identified until late in the audit process as the audit is performed, this additional work will be required during an already busy period within the audit and financial reporting cycle which would impact the timing of SEC filings and, consequently, the ability of investors to obtain financial information in a timely manner.

While we do not support the inclusion of CAMs in the auditor's report, if the Board ultimately determines to implement the rule as proposed, we request that the effective date be delayed to allow companies and auditors to field test how the CAM provision would be applied in practice and provide an opportunity to mitigate the potential issues identified above.

**The Other Information Standard**

We support adding language to the auditor's report that will *clarify* the auditor's procedures and responsibility for other information contained in SEC filings (such as the MD&A). We do not support *expanding* the auditor's responsibilities regarding other information, or including language in the auditor's report that could be perceived as an expansion of the auditor's responsibilities. We believe the proposal would lead to higher costs with no commensurate benefit to investors. Further, we believe the proposal as written would result in several practice issues that would result in inconsistent application among audit firms.

Management should continue to prepare and present the other information contained in the annual reports of public companies, with over-sight from the Audit Committee, without the additional costs of such information being subject to additional procedures by the auditors. We support the retention of existing procedures contained in AU sec. 550, *Other Information in Documents Containing Audited Financial Statements,* which require auditors to "read and consider" other information to ensure the information is consistent with the audited financial statements. We believe AU 550 provides an appropriate level of assurance for the other information considering both the costs and benefits of such assurance.

We believe the "read and evaluate" language included in the proposed standard implies, and is likely to result in, a level of additional procedures that is substantively different from and greater than the requirements set forth in AU sec. 550. We do not agree with this change in the proposed language as it will have far reaching impacts on the procedures currently being applied to other information. We believe that, in carrying out their professional responsibilities, auditors presently are conducting a sufficient level of review commensurate with the nature and purpose of that information.

In our opinion, the use of the term "evaluate" will prompt auditors to expand their procedures substantively beyond the existing requirements in AU sec. 550 resulting in unnecessary procedures and increased costs. Similar to the timing of CAMs, the additional work over other information will be required during an already busy period within the audit and financial reporting cycle and would lengthen the timing of a company's SEC filings to the detriment of investors.

Alternatively, we recommend that the Board retain the existing procedures in AU sec. 550 but ensure that the language presented in the auditor's report clearly communicates what those existing procedures entail. If the Board believes further clarity is warranted to differentiate the level of assurance provided within the financial statements, we request the Board consider a more cost effective approach. For example, the Board could consider adding headers or other disclaimers on each page of the audited financial statements that indicate if the information is audited.

While we disagree with the proposal, we believe several practice issues that would need to be addressed within the standard if the Board determines to adopt the standard as proposed. These practice issues include determining what information would be subjected to the expanded procedures, what procedures to perform on forward-looking statements, and how an auditor should determine materiality of non-financial information.

**Conclusion**

We appreciate the opportunity to comment on the Board's proposals. As discussed above, we do not support the inclusion of CAMs in the auditor's report or expanded audit procedures on other information contained in the annual report. We urge the Board to reconsider the proposals. We believe that auditor reporting of CAMs would decrease the relevance of the audit report, the role of the audit committee, decrease audit report comparability and increase costs of compliance all to the detriment of investors. Further, we believe guidance currently contained in AU sec. 550

appropriately addresses the audit procedures to be performed over other information contained in the financial statements and the benefits arising from any further audit scrutiny would not justify the costs.

We would be pleased to discuss our comments in further detail and provide any additional information that you may find helpful in addressing these important issues.

Very truly yours,

Joseph L. Martin

Joseph L. Martin, Controller, American Gas Association

December 6, 2013

Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, N.W.
Washington, DC 20006-2803

PCAOB Rulemaking Docket Matter No. 034

Board Members,

The Accounting & Auditing Committee and the Public Companies Subcommittee of the Accounting & Auditing Committee of The Ohio Society of CPAs are pleased to provide comment on the proposed auditing standard dealing with the auditor's report (PCAOB Release 2013-005, dated August 13, 2003).

While we generally concur with the direction of this recent release and the proposed changes, including retention of the pass/fail model in the auditor's report, elimination of the supplemental narrative report (described as an auditor's discussion and analysis (ADA)), and the proposed enhancements to certain standardized language in the auditor's report, there are several areas where we would recommend alternatives be given further consideration by the Board, including:

- **Critical Audit Matters**--The proposal includes a requirement that Critical Audit Matters be delineated by the auditor in their report. We believe this proposed expansion of the auditor report will most likely mirror the detailed disclosures already included in the Critical Accounting Policies and Use of Significant Estimates area of the Form 10-K filed annually by publicly held companies with the Securities and Exchange Commission (SEC).

  Redundant inclusion of this type of information within the auditor's report will add to the length of that report without providing any truly unique information to the investor or other user of the financial statements. In an attempt to satisfy PCAOB expectations, we believe auditors will likely err on the side of including more, not less, of such identified Critical Accounting Matter disclosures and that such narrative in the end will therefore become watered down and boilerplate. Since the auditor already reviews similar disclosures prepared by management within the Form 10-K, we believe the onus should remain with the company within the existing Critical Accounting Policies disclosures in the Form 10-K. No further repeating of this information in the form of Critical Audit Matters in the auditor's report is beneficial. We also believe that this will add to the costs of the audits and for the negligible benefits to the users of the financial statements we do not believe these additional costs are warranted.

- **Auditor Independence**-- The proposal includes adding a statement regarding auditor independence. The auditor's report already includes the word "independent" and states that the audit was performed in accordance with PCAOB standards, which sets the independence standards. The proposed wording of "United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB" does not provide any further clarification.

- **Auditor Tenure**-- The proposal includes adding references to the year the auditor began serving as the company's auditor, to provide investor and other financial statement users with information about the length of the relationship between the auditor and the company. We do not believe this information is relevant within the auditor's report on annual financial statements, but would be more appropriate, within a company's proxy statement filed on Form 14-A (Proxy).

  With Proxy rule changes made on broker voting of shares, it is fairly common to have a proposal reconfirming the appointment of the external auditor included in the Proxy. In this context (as part of the Proxy), citing auditor tenure is relevant and useful to the investors in support of their vote on an external auditor. As a reference within the auditor's report, we believe this information is not relevant and could serve to inadvertently overshadow the pass/fail opinion being expressed by the auditor.

Beyond the areas of concern above, we would also express our support and suggestions for these particular aspects:

- **Field Testing**--We believe the Board should undertake field testing as a part of the process in finalizing any changes contemplated in the auditor's report and that such field testing should include participation from the auditor, investor and reporting company communities.

- **Other Information** --We also note changes are contemplated for dealing with other information in annual reports filed with the Securities and Exchange Commission. We understand those changes would include:

  1. Apply auditor responsibility to other information contained in a company's annual report as filed with the SEC, that contain the company's audited financial statements and related auditor report.
  2. Enhance auditor responsibility on that other information by added procedures for the auditor to perform in evaluating that information based on relevant audit evidence obtained and conclusions reached during the audit.
  3. Require auditor evaluation on other information for any material misstatement of fact or material inconsistency with amounts or information or in the manner of presentation in the audited financial statements.
  4. Require communication in the auditor's report on their responsibility for reviewing other information and the results of such auditor evaluation.

  We believe that auditors currently perform procedures on this other information and that the proposed change is only beneficial if the intent is to standardize practice in this area across audit firms and to clarify for users what the auditors' responsibility and results of their procedures are. The primary objective in evaluation of this information should be to ascertain that no material discrepancies or misstatement of fact exist with regards to the other information as presented versus related views as provided in the audited financial statements and related footnote disclosures.

This is a focused and cost-beneficial objective for the auditor as part of their review. Currently, the auditors have a responsibility to read and "consider" the other information. We do not believe it is clear as to what the difference between "consider" and "evaluate" would be. In addition, we question whether there would be a separate materiality for the other information. Financial statement materiality is based on the financial statements taken as a whole, including qualitative factors. Will this same materiality be used for the other information? Finally, some other information may not relate to the historical results reported in the audited financial statements, such as projections and proposed changes by the Company. How will the auditor "evaluate" this information?

If through interpretative application by the PCAOB, this process results in this other information becoming the end focus of audit work and part of the scope of the auditor's opinion on the fairness of the financial statement and footnotes, we believe the impact will be to add notable cost to the audit process and potential delays in filing. It is not clear such expanded audit process in this area would be cost beneficial; we would recommend any changes in this area be specifically defined by the PCAOB as to purpose. We believe this goal should be standardization of existing practice for reviewing other information outside the financial statements as opposed to significant expansion of the audit process to encompass other material as part of the overall audit process and audit opinion rendered by the auditor.

We would welcome any opportunity to further assist the PCAOB in its deliberations on this proposal and to answer any questions you may have on the above comments and recommendations.

Best Regards,

Gary Sandefur, CPA, Chair
OSCPA Accounting and Auditing Public Company Subcommittee
gsandefur@rgbarry.com

Scott Roush, CPA, Chair
OSCPA Accounting and Auditing Committee
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TRAVELERS

**D. Keith Bell**
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May 2, 2014

Office of the Secretary, PCAOB
1666 K Street, N.W.
Washington, D.C. 2006-2803
Sent via email to: comments@pcaobus.org

Re: PCAOB Rulemaking Docket Matter No. 034 (Release No. 2013-05)

Dear PCAOB Board Directors:

We would like to thank the Board for the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) two new proposed auditing standards, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*. While we agree with the Board's objective of providing more useful information to investors to assist them in making their investment decisions, we share the concerns of many of the respondents and participants in the public meetings that the proposals are too broad and could infringe on management and the audit committee's role in financial reporting. Our two specific concerns with the proposal are:

1. The proposed requirement to include "critical audit matters" in the audit report is not sufficiently clear and is overly broad, and

2. The proposed requirement to increase the auditor's responsibility over other information outside of the financial statements in certain filings with the Securities and Exchange Commission (SEC) is unnecessary and would be problematic as it would require skills other than accounting and auditing.

As discussed below, we have concerns with the proposals contained in Release No. 2013-05. However, if the Board concludes that new audit guidance is needed to address the concerns discussed in the release, we also offer some suggested changes to the audit standards that we believe would satisfy the intent of the proposals, without crossing the lines of responsibility of management and auditors.

**Critical Audit Matters**

We are concerned that the critical audit matters (CAM) proposal is not sufficiently clear and is overly broad and will lead to disclosure that may conflict with or duplicate disclosure that is the responsibility of and already provided by management. The conflicting or new disclosures would be due to the lack of clarity regarding what critical matters the auditor is required to disclose. As currently drafted, one could conclude that any matter that may be difficult for the auditor to audit or includes significant subjectivity in the estimate would be reported upon in the CAM even though the matter is not material to the financial statements. We are concerned that if a requirement for the CAM is created without squarely framing it in the context of materiality, the auditor's report will likely be viewed as conflicted and confusing rather than aiding investors' understanding of the company's financial position and results of operations.

Additionally, we believe that it is management's responsibility to disclose the most significant accounting and valuation estimates the in the Critical Accounting Estimates (CAE) section of Management's Discussion and Analysis (MD&A) and not that of the auditor. We do, however, believe that it may be helpful to have the auditors provide an assertion as to whether they agree that management has appropriately identified the areas that pose the greatest risk of material misstatement in CAE and adequately described the uncertainties associated with those estimates. We believe that the Board could leverage the requirements in Auditing Standard No. 16, *Communication with Audit Committees* (AU No. 16), which requires the auditors to communicate to the audit committee the critical accounting estimates and significant unusual transactions, or where management makes that communication to confirm whether management adequately communicated these matters. Including this information in the audit report would be a natural extension of the communications that auditors are required to make to the audit committee under AU No. 16.

**Auditor's Responsibility over Other Information**

While we completely agree that all information provided to investors should be consistent, we do not believe that it is necessary for auditors to perform enhanced audit procedures on the other information. As currently required by Interim Standard AU Section 550 (AU 550), auditors are required to read the information and consider whether the information is materially consistent with the information within the financial statements and related notes. We have observed that in practice auditors appropriately do more than just "read the information" but also compare and, where appropriate, determine whether such other information is in agreement with the company's financial statements and notes to financial statements. Additionally, there is a process in AU 550 that details considerations for the auditor if there is a material inconsistency or if the auditor becomes aware of a material misstatement of fact. This process includes notifying management and the audit committee of the issue, as well as consideration of withholding the audit report and withdrawing from the engagement if the company does not address the issue.

In addition to the auditor's review of the information, there are other mechanisms which provide penalties for companies that do not provide consistent information. The first is the discipline that comes with filing information with the SEC and responding to the SEC staff's comments during the review process. The second is the market itself, where investors will penalize companies for providing conflicting and incomplete information.

We also believe that it would be problematic for auditors to perform enhanced audit procedures on other information that falls outside of the accounting and auditing profession as such information may require skills from other technical professions, e.g., an electrical engineer may be required to review certain information provided by a micro-chip or computer manufacturer. With the mechanisms currently in place, we do not believe that the costs of requiring auditors to perform enhanced procedures would outweigh the marginal benefits, if any, that may be derived. It may be beneficial to inform investors as to the responsibility of auditors to review other information outside of the financial statements under current auditing standards. This can be done by including language in the audit report that describes the auditor's responsibility with regard to such information and a caution as to the limitations of that review.

**Recommendations**

If the Board concludes that new audit guidance is needed to address the concerns discussed in Release No. 2013-05, we recommend the Board:

- Revise the proposal on Critical Accounting Matters to require auditors to provide assurance in the audit report on whether they believe the company has appropriately identified the areas that pose the greatest risk of material misstatement in the Critical Accounting Estimates section of the MD&A, and whether the company has adequately described the uncertainties associated with the estimates; and

- Expand the audit report to include a description of the auditor's responsibility to review other information outside of the financial statements and the limitations of the auditor's review.

We would be pleased to discuss our views with the Board at your convenience. Please feel free to call me if you have any questions or would like to discuss our comments further.

Sincerely,

D. Keith Bell

D. Keith Bell

The Walt Disney Company

December 11, 2013

Ms. Phoebe W. Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Secretary:

The Walt Disney Company is pleased to have the opportunity to comment on two auditing standards recently proposed by the Public Company Accounting Oversight Board (the "Board"):

- *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

- *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*

While we are supportive of the Board's efforts to improve audit quality and increase the informational value of the auditor's report, we recommend the Board reconsider certain aspects of the proposed standards before they are finalized. We believe there are a number of undesirable collateral consequences flowing from certain aspects of what is proposed, particularly related to the disclosure of "critical audit matters[1]," that outweigh any benefits sought to be achieved.

**Critical Audit Matters or "CAMs"**

We do not believe that the proposed disclosure of CAMs will, in the end, make the audit report more useful. This is so for a number of related reasons:

- The breadth of the definition of a CAM and the requirement to document the rationale for non-disclosure of potential CAMs combine to create a dynamic that could well motivate auditors to disclose numerous CAMs to avoid the risk of being second guessed by third parties for non-disclosure. This would lead to a more voluminous auditor's report, which will both distract from the unqualified opinion and lead to doubt about the essential pass/fail objective of the audit. Such an outcome would be unfortunate as by definition the auditor would have resolved all CAMs to its satisfaction in order to render its opinion. In other words, the proposed disclosure may be read as creating doubt which, in the auditor's mind, does not fairly exist.

[1] The proposed standard defines CAMs as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements." In addition, the proposed standard places the responsibility with the auditor of determining which matters to communicate as CAMs and indicates that "critical audit matters ordinarily are matters of such importance that they are included in the matters required to be (1) documented in the engagement completion document, which summarizes the significant issues and findings from the audit; (2) reviewed by the engagement quality reviewer; (3) communicated to the audit committee; or (4) any combination of the three."

- CAMs may be misinterpreted by financial statement users as issues for concern rather than simply information about the conduct of the audit—a "piecemeal" audit report rather than a report on "the financial statements taken as a whole." Further, if the information in the auditor's CAM discussion is misinterpreted and/or leads to questions from the investment community, there is no disclosure venue for the auditor to respond. This would put the company in the position of explaining after the fact (in a Regulation FD compliant disclosure) what the auditor meant—potentially requiring management to "put words in the auditor's mouth."

- The definition of a CAM is sufficiently broad that there will be diversity in practice across audit firms in determining and describing CAMs. Such diversity will make it difficult for financial statements users to interpret the CAMs across companies, and users may make inappropriate inferences based on the number of CAMs reported for a company. For instance, numerous CAMs might be interpreted as an indication that there was contentiousness with the audit firm or extensive use of aggressive accounting practices when in fact, it was simply indicative of an audit that involved novel issues on which ultimately there was little or no dispute between the auditor and the company. Conversely, very few CAMs may be interpreted as an indication that the auditors were not thorough or are too comfortable in their relationship with management when in fact, it was simply indicative of an audit with few novel issues.

- Although the inclusion of CAMs in the auditor's report is intended to improve the mix of information available to investors and enhance their understanding of the financial statements, we believe that management's discussion and analysis (which is reviewed by the auditor) along with the footnotes to the financial statements (which are audited) is the most efficient way to highlight the most important factors investors should consider with respect to the evaluation of business performance. We don't believe investors are interested in understanding the audit process and requiring them to cross reference between management's disclosures and the auditor's disclosures to get a complete picture is not an efficient approach for increasing their understanding of the company's financial performance.

- In order to avoid incremental legal liability, there is a potential for auditors to make CAM disclosures boilerplate and redundant to standard accounting disclosures made by management, which will not aid investors in better understanding the financial statements of a company.

The CAM proposal also carries with it a number of undesirable collateral consequences that outweigh any perceived incremental value to the audit report.

***The requirement will result in a chilling of communication between the auditor, management and the audit committee.***

- We believe that open and candid dialogue between the three parties in the financial reporting process (i.e. the auditor, management and the audit committee) is integral to promoting the reliability and integrity of the audited financial statements and that the Board should avoid introducing any requirements that unduly interfere with that level of candor. We fear that the proposed CAM disclosure requirement would have precisely that effect. Management or the audit committee may hesitate to raise matters with the auditor on which they would otherwise seek input in order to minimize the risk of a matter unnecessarily becoming a CAM and triggering the disclosure of competitive or proprietary information, which would not be disclosed aside from the fact that it was discussed with the auditor. Auditors themselves may hesitate to discuss matters with management or the audit committee to minimize the risk that non-disclosure of a CAM would be second guessed or the risk that the auditor would be thrust into a position of having to disclose competitive or proprietary information that management would not otherwise be required to disclose. For these reasons, the proposed standard would inhibit the open, transparent and timely communications between auditors and audit committees that we believe the Board should strive to promote.

***The auditor will become a primary source of disclosure for companies and may disclose information, which would not otherwise be required for disclosure.***

- The communication of CAMs in the auditor's report may blur the roles of management and the auditor with respect to communication of information about the company. The auditor could be put in a situation of being required to disclose original information, including confidential information or information that management would otherwise have no obligation to disclose. For example, the auditor may disclose as a CAM, a weakness in internal control over financial reporting which was appropriately determined to be a significant deficiency rather than a material weakness. Or, the auditor may disclose a litigation contingency that was determined to be a remote probability rather than a reasonable possibility. In such cases, companies may feel compelled to preemptively disclose matters that otherwise would not be required (nor informative for investors) in order to avoid initial disclosure by auditors. This will lead to more voluminous management disclosures, which will obscure important disclosures, and lead to redundancy between management disclosure and the auditor disclosure.

***Disclosure of CAMs will increase audit cost without a clear benefit to financial statement users.***

- The inclusion of CAMs will place pressure on achieving tight filing deadlines while increasing the cost of the audit. Auditors will spend incremental resources on CAM identification, documentation, drafting and the related reviews. At the same time, companies will be required to devote resources to provide additional information to auditors in respect of potential CAMs, increase disclosures beyond that which is required, and debate and review auditor CAM disclosure language internally and with the auditor. Much of this effort will be concentrated at the time when both the auditor and the company are focused on the accuracy of the financial statements and meeting the financial statement filing deadlines.

**Reporting on "Other Information"**

We support clarification within the audit report of the auditor's existing responsibility for other information in documents which contain the audited financial statements. However, we do not support an increase in the auditor's current scope of responsibilities since we don't believe there have been significant issues with investor use of information outside the financial statements.

Current reporting requirements provide comfort that "other information" has been verified by the company through the Section 302 certifications. The Board's proposal to change the standard of auditor involvement to "evaluate" from the current standard (read and note inconsistencies) will require the auditor to perform substantial additional procedures, increasing audit costs without a clear benefit to financial statement users.

**Auditor Tenure**

We don't believe the PCAOB has identified any linkage between auditor tenure and audit quality. In the absence of such linkage, including tenure in the auditor's report will not provide financial statement users with helpful information about the audit conducted, nor the information presented in the financial statements. If auditor tenure should be disclosed, the most appropriate place for such disclosure would be in the proxy statement materials discussing auditor fees and/or auditor appointment.

Based on these factors, we do not believe that the disclosure of CAMs or the increase in the auditor's responsibility for other information is an effective or cost efficient solution to enhance the informational value of the auditor's report.

If the PCAOB continues to believe a change of this type is required to improve auditor reports, we recommend that the PCAOB explore whether increased use of "matters of emphasis" paragraphs in auditor reports would be a suitable alternative. With matter of emphasis paragraphs, the auditor could point to the management disclosures that the auditor believes would be of most interest to investors.

I would be pleased to respond to questions you have regarding this response.

Sincerely,

Brent A Woodford
Senior Vice President, Planning and Control
The Walt Disney Company
818-560-5054

TIAA CREF
Financial Services

December 11, 2013

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

Re: Docket Matter No. 034 - Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Ladies and Gentlemen:

TIAA-CREF appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") proposal for *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* ("the Proposal").

TIAA-CREF is the leading provider of retirement services in the academic, research, medical and cultural fields. We manage over $540 billion in retirement assets as of September 30, 2013 on behalf of approximately 3.8 million participants and serve more than 15,000 institutions.

In particular, Teachers Insurance and Annuity Association of America ("TIAA"), along with its two subsidiaries, TIAA-CREF Investment Management, LLC ("TCIM") and Teachers Advisors, Inc. ("TAI"), each registered investment advisers under the Investment Advisers Act of 1940, as amended, manage approximately 79 registered investment vehicles, which include investment companies registered under the Investment Company Act of 1940, as amended (the "Investment Company Act"), and a real estate life insurance separate account that is a registrant under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and makes a continuous offering of its securities registered under the Securities Act of 1933, as amended (the "Securities Act"). In particular, TIAA, TCIM and TAI manage investment vehicles registered with the U.S. Securities and Exchange Commission (the "Commission") under one or more of the Commission's reporting regimes above totaling approximately $297 billion in assets under management.

As a large investment manager, TIAA-CREF is in a position to provide commentary on certain aspects of the Proposal both from the perspective of a preparer and a user of financial statements. Overall, we support the PCAOB's efforts to provide additional transparency to financial statement users. However, we are concerned as to the precise manner in which the Proposal intends to accomplish this goal. Over the past few years, there has been a proliferation of disclosure requirements from regulators and standard setters seeking this exact objective. Generally, these enhanced standards, including the certification requirements, which have resulted from the Sarbanes-Oxley Act of 2002, have increased the investing public's confidence in the quality of registrants' financial statements and more generally, non-financial statement disclosures upon which informed investment decisions rely.

Given these positive developments over the past decade, we feel that investors currently have far more insight into the operating businesses and funds in which they invest, including increased confidence in the internal and disclosure control environment which underlies the preparation of filings with the Commission. While we support and seek to provide comprehensive and transparent information to investors, we believe that any new proposed standards that impact registrants and other key stakeholders, such as independent registered public accountants, should take into account the incremental additional clarity for, and confidence gained by, the investing public associated with the proposal, while at the same time assess the risk of investor confusion, disclosure overload and redundancy, and the application of resources in support of such efforts. In the case of the Proposal, we are concerned that certain of the proposed standards do not provide meaningful benefit, in particular as the Proposal seeks to further push existing disclosures into the hands of auditors, which further blurs the lines as to management's and the auditor's ultimate involvement and areas of responsibility.

## *I. Critical Audit Matters*

As users of financial statements, we support the concept of communicating critical audit matters. However, we believe the enhanced communication should be more targeted than the Proposal appears to contemplate. Such communication should manifest itself in the expansion of the auditor's "emphasis of a matter" in its report. The communication of certain matters related to one time transactions would be useful and is typically well disclosed in the notes to the financial statements, but would gain further prominence if included as an emphasis of a matter in the auditor's report.

TIAA CREF
Financial Services

As a practical matter, we are concerned that the Proposal's communication of critical audit matters will become "boilerplate" and not useful. It would seem for the most part a registrant's or fund's financial statements would remain relatively static, outside of specific nonrecurring transactions as discussed above (which may or may not result in a critical audit matter). It would therefore stand to reason most companies would have no critical audit matters or would substantially have the same critical audit matters after the initial year of adoption of the Proposal, withstanding nonrecurring transactions. If this would be the ultimate evolution of the Proposal, we believe this required communication would not be useful for investors.

In order to avoid boilerplate language, we encourage the PCAOB to clarify that routine matters discussed with boards of directors or audit committees and comprehensively disclosed in the financial statements may not be considered as a critical audit matter. While matters such as these may require substantial audit effort or significant auditor judgment they may not represent significant audit issues.

Further, we are concerned that some investors may misinterpret the communication of a critical audit matter as a de-facto qualification of the auditor's opinion even though the proposed auditor's report would state that the opinion on the financial statements is not modified with respect to any of the critical audit matters described, or an investor may take exception as to the overall quality of the financial statements or entity (company, institution or fund). In the case of registered investment companies with the same investment objective, we feel this could be most pronounced in situations in which an investor is reviewing two similar funds, ultimately making an investment decision based on one fund having a specific critical audit matter or critical audit matters versus another.

From a preparer's perspective, it is not unusual for fund complexes to file multiple funds in one joint filing or book (as discussed below) with a single auditor's report covering multiple funds within such book. Notwithstanding the discussion as to the boilerplate nature of critical audit matter disclosures, we would request the PCAOB provide additional consideration and guidance as to an auditor's report in such circumstances.

Finally, we believe there will be a substantial increase in time and effort associated with the auditor's gathering of and providing of information in connection with the auditor's required assessment, reporting of and documentation of critical audit matters. Even more so, the Proposal would require the auditor to document why other possible critical audit matters were not included as critical audit matters in the auditor's report. These efforts combined with the increased efforts associated with the auditor's evaluation of other information (as discussed below) will most certainly translate into increases in audit expense, ultimately borne by the investor. We would encourage the PCAOB to perform additional outreach, specific to the investing community in order to gain an understanding of their perceived benefits in light of the potential for boilerplate language and/or inconsistent disclosure and increased expenses.

### *II. The Auditor's Responsibilities Regarding Other Information*

As preparers of financial statements, we support including a description in the auditor's report that clarifies the auditor's responsibility for other information in documents containing financial statements. However, we do not support changing the auditor's responsibility to "evaluate" such information versus the current requirement to "consider" the information. This change seems to imply the same level of analysis be required as that in the audit of the financial statements. While the Proposal would require the auditor state they did not audit the other information, the auditor will also state their evaluation was based on relevant audit evidence obtained and conclusions reached during the audit. We believe these disclosures will inherently be confusing to the reader with the reader potentially placing the same level of reliance on the auditor's evaluation of other information as that placed on the audited financial statements.

Further we believe an auditor's required evaluation of other information will inevitably transform into the expansion of the auditor's scope. This is based on the Proposal's expansion to evaluate "other information not directly related to the financial statements" as well as additional audit procedures, as the emphasis of the term "evaluate" will press auditors to perform additional procedures to ensure compliance and to avoid unsatisfactory inspections. As an example, we do not understand how evidence obtained during the audit would provide the auditor with information to evaluate forward looking information, overall macro-economic analysis or market analysis. Inherently the evaluation of such information will force the auditor to opine on matters of management judgment of future events or economic conditions. Such additional required evaluation and the need for further procedures by auditors could have a chilling effect on registrants' disclosure of helpful information for the benefit of the investing community in, for example, the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of an Annual Report. For many years, the Commission has encouraged registrants to provide more detail regarding key trends impacting the registrant's business and while registrants will and must continue to

TIAA CREF Financial Services

disclose all material information relevant to such trends, additional helpful disclosure may be omitted as registrants and their auditors weigh the cost/benefit analysis of the expanded audit procedures on such disclosures.

### *III. Disclosure in Respect of Auditor Independence*

The Proposal would require the auditor to add additional language as to the auditor's independence, namely that it is registered with the PCAOB and is required to be independent in accordance with the federal securities laws and the rules and regulations of the Commission. As a user of financial statements, we understand and rely on the fact the auditor of the financial statements is in compliance with rules under current PCAOB standards which require an auditor registered with the PCAOB to be independent[1]. We believe that those standards are now well-established and understood in the investing community without specific reference to those standards. As the auditor's report is currently titled "Report of Independent Registered Public Accounting Firm" in accordance with standards of the PCAOB, we do not believe an additional statement in the auditor's report relating to auditor independence provides any additional comfort to the investing community.

### *IV. Additional Standardized Language*

The Proposal would require the auditor to include the phrase "whether due to error or fraud" in the auditor's opinion as part of the auditor's statement describing the auditor's responsibility under PCAOB standards. As a user of financial statements, we believe the proposed additional disclosure better informs the reader as to the scope of the auditor's responsibility or financial statement review and thus, we support the addition of this phrase in the auditor's opinion.

### *V. Disclosure in Respect of Auditor Tenure*

As a user of financial statements, we do not object to the inclusion in the auditor's report of the year in which the auditor began serving consecutively as the company's auditor and believe it may provide incremental benefit to the investing community. However, we believe that the disclosure would be better located if it were included in another regulatory filing made by a registrant, such as a fund's prospectus or, if the registrant files periodic reports under the Exchange Act, in the section of the Form 10-K (or equivalent) where audit and audit committee matters are required to be disclosed.

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[1] Rule 3520. Auditor Independence

TIAA CREF
Financial Services

As a preparer, we would ask the PCAOB to provide additional guidance specifically related to registered investment companies having one auditor over multiple funds for a given fund complex. Various mutual fund complexes will organize a business or trust having separate funds under the same business or trust. It is not unusual for these funds' audited financial statements to be organized and filed with the Commission in one combined filing or "book." As the business or trust adds new funds, these funds are added to the book. We would ask the PCAOB to better clarify how an auditor would treat its disclosure of tenure as it relates to these fund complexes. We believe the auditor's tenure would begin at such time the auditor first began auditing the fund complex, which is consistent with the application of the Commission's audit partner rotation requirements.

*******

We appreciate the opportunity provided by the PCAOB that allows TIAA-CREF to comment on the Proposal. Should you wish to discuss the contents of this letter, please contact Phillip Goff at 704-988-5244 or pgoff@tiaa-cref.org.

Very truly yours,

/s/ Phillip G. Goff

Phillip G. Goff
Senior Vice President,
Funds Treasurer

TIM HORTONS INC.
874 SINCLAIR ROAD, OAKVILLE, ONTARIO L6K 2Y1
TELEPHONE (905) 845-6511 • FACSIMILE (905) 845-1536

December 11, 2013

Via e-mail: comments@pcaobus.org

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

Re: Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Ladies and Gentlemen:

Tim Hortons Inc. ("Tim Hortons" or "we") appreciates the opportunity to provide comments to the Public Company Accounting Oversight Board (the "PCAOB") with respect to its Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments.

Tim Hortons is one of the largest quick service restaurant chains in North America by market capitalization and the largest in Canada based on system-wide sales and number of locations. Our common shares are listed on the Toronto Stock Exchange and the New York Stock Exchange. We file annual reports on Form 10-K, quarterly reports on Form 10-Q and periodic reports on Form 8-K with the U.S. Securities and Exchange Commission (the "SEC") as well as with Canadian securities regulators.

We share the PCAOB's goal of improving the quality and transparency of financial reporting, but we are concerned about certain aspects of the new proposals, as described below.

Critical Audit Matters

The proposed auditing standard entitled, *The Auditors Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion*, requires the auditor to disclose "critical audit matters" in the auditor's report. Critical audit matters are those that: involve the most difficult, subjective or complex audit judgments; pose the most difficulty to the auditor in obtaining sufficient appropriate evidence; or pose the most difficulty in forming an opinion on the financial statements. The description of critical audit matters in the auditor's report would require the auditor to: identify the critical audit matter; describe the considerations that led the auditor to determine that the matter is a critical audit matter; and refer to the relevant financial statement items and disclosures that relate to the critical audit matter, when applicable.

We are concerned that this:

(1) could require auditors to disclose information that is not required to be disclosed by the company and may be of a sensitive or confidential nature;

(2) could shift the role of the auditors from attesting information provided by the company to becoming an original source of disclosure, with negative effects for companies, auditors and investors; and

(3) could result in increased costs, from additional auditor procedures, that in our opinion would greatly outweigh any actual or perceived benefits to investors, companies or regulators.

*1. Auditor Disclosure of Information Not Required to Be Disclosed By the Company*

Critical audit matters would include, not surprisingly, those issues that involve the most sensitive judgments for the company, including items that are not required to be disclosed by the company under existing accounting and regulatory requirements. For example, critical audit matters could include the resolution of a significant deficiency in internal control over financial reporting, the existence or results of an internal investigation, alternate considerations for accounting treatment, materiality judgments, or similar matters that are not required to be disclosed by the company in reports filed with the SEC. In many cases, these are highly sensitive items that the company is not currently required to disclose. In the case of an internal investigation, for example, the effectiveness of the investigatory process may depend on the assurance of confidentiality for certain communications; in other cases, the information may be competitively sensitive.

Requiring disclosure of a critical audit matter that is not required to be disclosed by the company changes the disclosure regime for companies without giving due consideration to the policies permitting nondisclosure by the company. Knowing that the auditor may be required to disclose confidential information may cause company officials to limit their discussions with auditors, and may limit the willingness of audit committee members to hold frank and candid discussions regarding sensitive topics during their meetings. The chilling effect on communications between the company and its auditors and potentially during audit committee meetings, could impede the audit process and potentially result in lower quality audits.

*2. Shifting the Role of Auditors from Attestation to Original Source of Disclosure*

Requiring auditors to disclose critical audit matters could create confusion over the roles of auditors and the company and interfere with effective communication between the auditors, on the one hand, and the company and its audit committee, on the other hand.

An essential feature of the reporting system governing public companies is that the company is responsible for disclosure about the company and is responsible for its disclosure controls and procedures, just as it is responsible for preparing its own financial statements. The company's disclosures are made by management through specific policies and procedures, including a disclosure committee and a comprehensive disclosure policy, and under the oversight of the company's audit committee and full board of directors. The systems of internal control over financial reporting are the responsibility of management as well. The role of the auditor is to attest to certain information provided by management and to report separately to the audit committee. The current content of the auditor's report on the financial statements of the company, and management's assessment of the company's systems of internal control, reflect the fact that the auditor is not responsible for the reporting of specific information concerning the company. Rather, the auditor's role is to attest that overall financial results are free from material misstatements and whether effective internal controls over financial reporting are maintained in all material respects.

The proposals are not intended to change the role of the auditor from attestation to being an original source of disclosure concerning the company; they are intended to require the auditor to discuss matters pertaining to the audit process. We nonetheless believe that requiring the auditor to address critical audit matters in the audit report in the manner contemplated by the proposed standard will, in fact, require the auditor to make substantive disclosures concerning the company and will thus change the role of the auditor in ways that will not benefit companies, auditors or investors.

A frequent problem will be the development of two sets of disclosures of the same facts, one made by the company and the other made by the auditor. This poses the substantial risk of dueling narratives concerning the company on matters critical to it.

The fact that the auditor will become, in effect, a source for substantive disclosure concerning the company may increase the auditor's liability to investors, with the role of the auditor subtly shifting in the minds of investors. The auditor's need to protect itself from this liability is likely to affect the nature and substance of its disclosures. This could cause the auditor to, among other things, err on the side of over-inclusiveness and highlight issues involving subjective accounting and materiality judgments. In the alternative, auditors may fall back on standardized, boilerplate disclosures that vary little from company to company.

Whatever the nature of the auditor's disclosure, however, the fact that there will be two sets of disclosures about the same matters, driven by differing standards and interests, is likely to change the dynamics between the auditor and the company. This, in turn, is likely to have a chilling effect on communications between the company and the auditor, resulting in a more difficult audit process and potentially lower quality audits.

Determining what is a critical audit matter and how it should be disclosed will require the auditor to make significant subjective judgments that have not been part of the auditor's role in the past. The high degree of subjectivity could lead to a loss of investor confidence in the auditor's report.

*3. Cost/Benefit Analysis*

The additional responsibilities of the auditor with respect to critical audit matters will increase audit costs. Review and comment on the critical audit matter disclosure will also result in increased costs in terms of management time and legal costs, and will place increased time burdens on audit committee members.

The increased costs of critical audit matter disclosure, in our opinion, greatly outweigh any related benefits. While the volume of disclosure will increase, there is little indication that the quality of disclosure will improve. Instead, investors will face disclosure overload, with long boilerplate narratives and the confusion of largely duplicative disclosure. Much of the discussion of critical audit matters will repeat matters already disclosed in the MD&A or financial footnotes, and investors will find it burdensome and duplicative to review all three sets of disclosure. In addition, disclosure may be required of matters that, despite their complexity, are not material to the company, which may result in investor confusion.

Other Information

The proposed audit standard entitled, *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, requires the auditor to "review and evaluate" other information included in or incorporated by reference in the company's annual reports filed with the SEC, such as selected financial data, MD&A and exhibits to the annual report. The auditor is then required to explain its responsibilities with respect to such information in the audit report. Under the current standard (AU Section 550), the auditor has a responsibility to "read and consider" other information in documents that contain the audited financial statements and related auditor's report, but there is no related reporting requirement to describe the auditor's responsibility with respect to other information. In our view, the additional work that the auditor may need to do to be satisfied that it has fulfilled its obligations under the enhanced standard will add to the audit costs without improving the quality of disclosure and may require the auditor to make subjective judgments about company disclosure that have not been part of the auditor's role to date.

Conclusion

For all of the foregoing reasons, we have significant concerns about the proposed auditing standards. Tim Hortons thanks the PCAOB for this opportunity to share its views.

Very truly yours,

Jill Aebker

Jill E. Aebker
Executive Vice President, General Counsel
& Corporate Secretary

cc: Lisa J. Coulman, PWC

**From:** zzSteve Lucas
**To:** Comments
**Subject:** PCAOB Rulemaking Docket Matter Number 034
**Date:** Wednesday, December 11, 2013 6:30:19 AM

December 10, 2013

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

Re: PCAOB Rulemaking Docket Matter Number 034

Dear Madam Secretary,

I am a member of the Board of Directors of:

* – Transocean Ltd. (NYSE:RIG; SIX: RIGN), Chair of the Audit Committee and member

of the Finance Committee;

* – Tullow Oil (LON:TLW);

– African Barrick Gold plc; and

* – Essar Energy Limited.

I was the Group Finance Director for National Grid plc from 2002 to 2010 and also served in finance and treasury roles in various global, industrial and natural resource companies.

I am pleased to submit my comments on the Public Company Accounting Oversight Board's ("PCAOB") proposed audit standards included in Release No. 2013-005 on Rulemaking Docket Matter #034 ("Proposal") addressing both the auditor's report when expressing an unqualified opinion and the auditor's responsibilities regarding other information in certain documents containing audited financial statements and the auditor's report. I appreciate the PCAOB's efforts to consider these improvements.

Proposed Auditor Reporting Standard

I believe that management is responsible for a company's financial information and the communication thereof. The Securities and Exchange Commission ("SEC") and the Financial Accounting Standards Board ("FASB") are the standard setters for what financial information requires disclosure while management determines how that information is presented and disclosed.

The shareholder-elected Board of Directors delegates the Audit Committee with the oversight of both the auditor and management's financial reporting. I believe the additional communications and requirements proposed in both the Auditor's Report and Other Information Responsibilities are unnecessary if management, the Audit Committee and the auditors fulfill their respective responsibilities.

The proposed auditor reporting standard undermines the role of the Audit Committee and usefulness of the Auditor's Report because the Critical Audit Matters ("CAM") could:

* – Cause some investors to misinterpret the CAM disclosures as indicative of an issue undermining the quality of the audit and implying less assurance on the financial statements and disclosures, taken as a whole;

* – Result in over- or under-emphasis of certain audit and business risks;

* – Burden the audit report with recurring disclosure of certain critical but routine matters with standardised language since companies in similar industries are likely to have some of the same CAMs;

* – Duplicate the disclosure of Critical Accounting Policies and Estimates made by management, that is already included in the Form 10-K and therefore required to be considered by the auditor;

* – Override the value provided by the Audit Committee's requisite knowledge, experience and perspective in overseeing the various risks and financial reporting matters.

Proposed Auditor Responsibilities of Other Information

The PCAOB's proposal to report the Auditor's Responsibility with respect to Other Information is commendable if the responsibilities remain unchanged from the current standard of "read and consider" procedures. However, the Proposal requiring the auditor to "evaluate" other information contained in SEC filings will likely cause the auditor to expand significantly the documentation of the evaluation procedures resulting in increased costs and audit effort during the year end reporting at a time when there is significant pressure to meet reporting deadlines. Moreover, the auditor may not have the knowledge nor expertise to evaluate certain of the other information, especially if it is subjective, qualitative or forward-looking in nature.

Additional Changes

The Proposal requires that the Auditor address their independence and tenure. The Audit Committee's Report included in the Proxy Statement already comments on the independence of the registered public accounting firm. I suggest that the Audit Committee's report could be expanded to include the tenure of the firm.

Finally, I support the Board proposal to include clarifications in the auditor's report of the auditor's responsibilities related to the notes to the financial statements, independence and fraud.

Thank you for considering my views.

Yours sincerely,

Steve Lucas
Audit Committee Chair Transocean Ltd.

Sent from my iPad

12001 Tech Center Drive
Livonia, MI 48150

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

Re: PCAOB Release No. 2013-005, *The Auditor's Report On An Audit Of Financial Statements When The Auditor Expresses An Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements And The Related Auditor's Report; and Related Amendments to PCAOB Standards* (together "The Proposed Standard")

Dear Members and Staff of the Public Company Accounting Oversight Board:

TRW Automotive Holdings Corp. ("TRW") appreciates the opportunity to comment on the Proposed Standard. TRW is among the world's largest suppliers of automotive systems, modules, and components to global automotive manufacturers and related aftermarkets. TRW is also a large accelerated filer with the Securities and Exchange Commission ("SEC") and thus subject to audit under the standards issued by the PCAOB.

TRW supports the stated objectives of the Proposed Standard, and believes that enhanced auditor communications and augmented information would be useful to financial statement users and management. However, we do not support certain aspects of the Proposed Standard and have some significant concerns, many of which are the same concerns presented in our comment letter on the original 2011 Concept Release. Our primary concerns are summarized below, and detailed responses to select questions posed by the PCAOB are contained in Appendix A.

**Critical Matters**
First, while we support possible clarifications to the auditor's report, we do not support the communication of critical matters to financial statement users by the auditor. Such a change must be demonstrably meaningful to financial statement users and we do not believe there is any incremental benefit provided to users by auditors discussing critical matters. Critical accounting matters are already presented by issuers, and it does not appear likely that any such matters presented by auditors would differ from those already discussed by management.

As we previously noted in our 2011 response, management is responsible for the financial statements as stated in all applicable financial reporting frameworks and PCAOB auditing standards. As such, it does not appear beneficial, and is likely to cause confusion as to who is ultimately responsible for the financial statements, by requiring auditors to disclose the same information already disclosed by management.

We are concerned that any such discussions of critical matters will unnecessarily distract readers, who are arguably generally unfamiliar with audit theory and methodologies, such that misinterpretations of the critical matter discussion may skew their understanding of financial statements that are not deficient in any way.

**Other Information Changes**
Second, we do not support changing the auditor's responsibility for other information outside of the financial statements. We have significant concerns about the incremental cost that would be incurred related to the auditor's work around other information. Given the increased scope of audit procedures, audit fees would clearly increase, and incremental ancillary internal preparer costs could also result. Such costs borne by companies (as well as auditors and users) would significantly exceed any perceived benefit.

Furthermore, we believe users would likely perceive a level of assurance based on the auditor's responsibility for increased scope outside the financial statements, when in fact there is no such assurance. We believe the current requirement of auditors to review other information is sufficient and should remain unchanged.

**Summary**
As noted above and in our detailed responses to the questions in Appendix A to this letter, while TRW supports the stated objectives of the Proposed Standard, we nonetheless feel that the proposed changes will not adequately address such objectives in a cost efficient or effective manner.

We thank the PCAOB for its consideration of our comments, and would be pleased to discuss these issues with the PCAOB, or its staff.

Sincerely,

Tammy S. Mitchell

Tammy S. Mitchell
Vice President & Corporate Controller

Appendix A: Answers to Selected Questions for Respondents

**Appendix A: Answers to Selected Questions for Respondents**

__Critical Matter Questions__

**Question 5: The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any are associated with including such information in the auditor's report?**
b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**
c. **Is information regarding tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

**TRW Response:** This question seems to best illustrate some of our concerns with the Proposed Standard. We question why the Board would require information that the Board itself, on page A5-14 through page A5-16, recognizes as statistically inconclusive and therefore unhelpful to readers. We do not believe it is advantageous for any interested parties to require information for the sole purpose of having another data point in the report which, as the Board indicates on page A5-16, is the purpose of this information. In our view, this information has no substantiated meaning when it comes to understanding the financial statements. If no real relationship between auditor tenure and audit quality can be established, then we don't see how this would be helpful to an investor, but we do see how this information could unnecessarily, and subjectively, distract an investor from informative information contained elsewhere in the registrant's filing.

Any additional information included in the auditor's report should have an objective, substantive and conclusive meaning to financial statement users.

**Question 10: Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board Consider?**

**TRW Response:** We believe that the current "pass/fail" model of financial statement audits should be retained. A set of financial statements either conforms to the applicable financial reporting framework or it does not. Should the Board go forward with requiring the auditor's communication of critical audit matters and any related audit procedures performed, the usefulness of such information would be extremely limited to only a few users and audit reports would become so lengthy, that lack of clarity, conciseness and intended meaning would result. We acknowledge this communication could be useful in highlighting non-recurring transactions and/or changes in accounting policy, but this information would/should already be discussed in the footnotes to the financial statements.

Further, as noted previously, management already provides critical accounting matters. Inclusion of such information by auditors would be redundant and confusing to users, as it is likely that the critical matters discussed by auditors would be the same as those presented by management.

We are also uncertain how the discussion of critical audit matters or the related audit procedures would or should influence the decision-making process of a financial statement user. We see the audit report as an indication of whether the financial statements can be relied upon, and whether such financial statements are free of material misstatements. Thus, we believe the inclusion of such information would be misunderstood by the average investor who does not have a background in audit theory, practice or methodologies, thereby unnecessarily distracting the investor from more pertinent and useful information.

In addition, the inclusion (or exclusion) of a certain number of critical matters may cause users to perceive a difference in audit quality when there is none when comparing registrants, their financial statements and/or audit firms. Similarly, the inclusion of several critical matters could lead the average investor to believe the auditor had difficulty determining whether the financial statements were fairly stated in accordance with US GAAP, thus causing doubt when there should be none.

We see absolutely no benefit in providing audit procedures. Including audit procedures in the audit report inappropriately presumes every reader will be able to determine whether the procedures are sufficient. Further, presenting audit procedures will most certainly result in significantly increased risk of litigation to auditors. Thus, we are concerned that litigation costs, for both auditors and management, could significantly increase under the proposal.

We cannot contrive a situation where the discussion of a critical matter included in an unqualified audit report would provide any additional benefit to users above the required information already included in registrants' filings. We encourage the Board to provide examples of situations whereby including the suggested critical matter discussion would have been more informative and protective to the financial statement users.

**Questions 11 through 15: TRW Response:** See our response to Question 10 above.

**Question 21: What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

**TRW Response:** Since the auditor is already required to perform this work for discussion with registrants' audit committees, there should not be a significant increase in monetary costs to companies. However, in practice, we are concerned that costs could in fact increase given the now proposed public nature of such disclosures. We do believe there would be a significant indirect cost to users of the financial statements, who would need to filter through yet more information that is duplicative with other parts of registrants' filings.

**Question 25: Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

**TRW Response:** We are unsure how investors would use this information. Presumably, such issues are already addressed as key risk factors, critical accounting estimates or accounting policies in the registrant's filing.

Further, as noted in our response to Question 10, we believe the audit report is either an unqualified opinion or it is not. If unqualified, then the financial statement users should focus on the existing disclosures already required and contained in the financial statements and footnotes to evaluate their risks.

**Question 28: What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting Standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?**

**TRW Response:** TRW believes the new Standard, if adopted as is, will significantly increase the potential liability to auditors. Furthermore, this will likely cause the auditor to do more work than is normally necessary, thus increasing our costs.

**Other Information Questions**

**Question 1: Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

**And**

**Question 2: Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not?**

**TRW Response:** As we discussed in our response to the Concept Release, TRW does not support the PCAOB's proposals to extend auditor assurance on other information outside of the financial statements. While we do see some benefits associated with the Proposed Standard, TRW believes that the costs associated with the proposals would greatly exceed the benefits that users of financial statements would derive. In particular, TRW believes that extending auditor assurance would increase the workload on auditors, leading to higher audit fees, could create difficulties for the auditors in attempting to audit management opinions and forecasts, and could result in creating investor confusion about the suitability of the financial reporting framework under audit.

TRW does not support the change to the auditor's responsibility regarding other information outside of the financial statements. Again, we encourage the Board to provide examples of how such information would have proved useful in protecting financial statement users in advance of, and during, the financial crisis, which is cited by the Board as an impetus behind the Proposed Standard on page 9.

**Question 24: What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirement to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

**TRW Response:** While we are not in a position to opine on the legal liability this might pose for audit firms, similar to our response to Critical Matter question 28, we do believe there will be an increased liability exposure borne by audit firms which we believe would negatively impact our costs and those of other preparers.

**From:** Hoerrner, August
**To:** Comments
**Subject:** PCAOB Rulemaking Docket Matter No. 034
**Date:** Wednesday, December 11, 2013 9:35:14 AM

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Members of the Board,   I am in full support of the comment letter written by Paige W. Pierce President & CEO of R W Smith(dtd 12/10/13).   I spent over  thirty-five years with Chapdelaine and Co. a small, independently owned, nonpublic, non-custodial broker dealer.  I was the President from 1997-2012 prior to being acquired by Tullett Prebon a large Broker Dealer.  The proposed rule would definitely put an additional financial burden on small independently owned firms and would have very little impact on protecting the investing public.  I request most heartedly that the Board consider exempting small firm this additional requirement.  Your consideration is greatly appreciated.  Sincerely,  August J. Hoerrner SMD Tullett Prebon.

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December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members and Staff of the PCAOB:

On behalf of Tyco International Ltd. ("Tyco" or "Company"), I appreciate the opportunity to share its views on the Public Company Accounting Oversight Board's ("PCAOB" or "Board") Release No. 2013-005, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Document's Containing Audited Financial Statements and the Related Auditor's Report* (collectively "the Release"). Tyco is a diversified publicly traded company and a leading provider of fire protection and security products and services around the world. Tyco had more than $10 billion in revenue in Fiscal 2013, and employs more than 69,000 employees worldwide.

Tyco supports continued efforts by the PCAOB to increase the informational value, usefulness and relevance of the auditor's report. Tyco believes the new elements in the auditor's report related to auditor independence as well as the standardized language around auditor responsibility for fraud are aligned in achieving these goals. There are however concerns that certain proposed changes, specifically the requirement to include Critical Audit Matters ("CAMs") and the expansion and disclosure of auditors responsibilities for other information in the annual report, are not effective in meeting the aforementioned objectives.

**Critical Audit Matters**

The PCAOB defines CAMs as "those matters addressed during the audit that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or (3) posed the most difficulty to the auditor in forming the opinion on the financial statements." Tyco believes that many matters falling under the proposed criteria would already be disclosed under the Summary of Significant Accounting Policies and other footnotes that accompany the financial statements. Tyco does not support the proposed change to include CAMs, as adding redundant disclosures does not provide additional informational value or increase the usefulness of the auditor's report. Repetitive information may confuse investors as they try to comprehend the nature and sheer volume of the disclosures.

Tyco believes that the inclusion of CAMs in the auditor's report could potentially result in the auditor disclosing information that otherwise may not be required to be disclosed by management, such as internal control issues resulting in significant deficiencies, potential illegal acts, immaterial uncorrected errors, and going concern considerations. Citing the example of immaterial uncorrected errors, errors deemed immaterial based on a quantitative and qualitative assessment, as set forth in SAB Topic 1 (M) *Materiality,* are not required to be disclosed but could be reported as CAMs. As the financial statements are the responsibility of management, it is not appropriate that the auditor becomes the original source of this information or discloses information that is not required by accounting standards or other regulatory or authoritative bodies.

Tyco believes that the inclusion of CAMs prominently in an audit report could be perceived by investors as qualifications to the audit opinion. Adding to that perception is a description of audit procedures related to CAMs without a conclusion as to the results of testing. While the proposed standard does not require the auditor to describe the audit procedures performed related to CAMs, all illustrations in the proposed standard include examples of CAMs with a description of testing performed. This may imply a preference by the PCAOB that auditors include a description of testing. Additional information regarding the conclusion of testing performed is not required, however, it may be perceived as a piecemeal opinion which does not meet the objective of the auditor's report as an opinion on the financial statements taken as a whole.

The proposed standard does not require CAMs be included in the auditor's report for financial information of the prior period. Tyco believes that this is contrary to the objective of comprehensive financial reporting which includes disclosures for the prior period financial information. Investors should not have to refer back to prior year audit reports when analyzing comparative reports.

Tyco concurs with the Board's decision to retain the current pass/fail reporting model as we believe it effectively and clearly conveys the opinion that the financial statements are fairly presented. We believe that auditors should retain the current option to include an emphasis paragraph in the opinion, where appropriate. However, Tyco does not believe that disclosing CAMs in the auditor's report provides investors with a better understanding of the information contained with the financial statements. We acknowledge that there may be opportunities to enhance the auditor's reporting model and in lieu of including CAMs in the auditor's report, Tyco recommends adding instead information related to the audit areas of focus. The audit areas of focus are currently communicated to the Audit Committee as part of the requirements under AS 16.

If the PCAOB adopts the requirement to include CAMs in the auditor's report, Tyco recommends comprehensive field testing prior to implementing the proposed standard. The PCAOB should ensure that the time and effort to vet the CAMs by management and the Audit Committee does not have an adverse impact at critical points in the audit. Additionally, Tyco recommends that any proposal to include CAMs in the auditor's report require that only material issues that are required disclosures by management be identified as CAMs in the audit report.

**Auditor's Responsibilities Regarding Other Information**

While Tyco supports the opportunity to add clarifying language around the auditors responsibilities related to other information in the annual report, Tyco does not support the proposed change to expand the auditor's responsibilities related to other information contained in the annual report. Other information included in the financial statements is broader in scope than the traditional financial statements. The other information, such as Management's Discussion and Analysis section focuses on the business and includes non-financial performance metrics and contains prospective information. Auditors do not regularly collect documentation to support non-financial performance metrics during an audit, and to do so would require additional audit procedures.

Additionally, the auditor is required "to read the other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate" whether information is materially consistent with the financial statements. In order to "evaluate" the other information, additional audit procedures at additional cost to the Company would need to be performed to meet the "evaluation" standard. If it is not the intent of the PCAOB that auditors perform additional procedures in order to provide a higher level of assurance, the change in terminology may lead the reader to assume just that.

Tyco recommends that the proposed change define the auditor's role clearly with respect to the other information. We do not believe that an increase in the level of assurance is warranted and that the proposal be limited to adding clarifying language around the specifics of the auditor's role including the definition of "read and consider" and the procedures employed to obtain that level of assurance.

**Audit Tenure**

The proposal includes a requirement to disclose the year that the auditor began serving consecutively as the Company's auditor in the auditor's report. Tyco has concerns that the inclusion of the audit tenure could be perceived negatively, although there is no data that suggests a correlation between audit tenure and audit quality. As such, we believe any information regarding audit tenure should be relayed through the proxy statements where information regarding auditor reappointment is communicated.

Thank you for allowing us the opportunity to respond to this proposal.

Sincerely,

Sam Eldessouky
Senior Vice President, Controller and Chief Accounting Officer
Tyco International Ltd.

**Tyson Foods, Inc.**
Making Great Food. Making A Difference.™

December 11, 2013

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

Submitted via electronic mail

Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 034
PCAOB Board Members:

Tyson Foods, Inc. (Tyson), founded in 1935 with world headquarters in Springdale, Arkansas, is one of the world's largest meat protein companies and the second-largest food production company in the *Fortune* 500. We produce a wide variety of brand name protein-based and prepared food products marketed in the United States and approximately 130 countries around the world.

Tyson appreciates the opportunity to submit our comments on *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to Public Company Accounting Oversight Board (PCAOB) Standards*. We support the PCAOB's continued focus on enhancing investor confidence and understanding of the audit process. However, we do not support the PCAOB's proposal in its current form.

**Critical Audit Matters**

We have significant concern with respect to the PCAOB's proposal that the auditor's report include a discussion of Critical Audit Matters (CAMs). The Board defines CAMs as the audit matters that:

- involved the most difficult, subjective or complex auditor judgments;
- posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; and
- posed the most difficulty to the auditor in forming an opinion on the financial statements.

The source of such matters is identified as being:

- included in engagement completion documents:
- reviewed by the engagement quality reviewer; and
- communicated to the audit committee.

Tyson Foods, Inc.

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Our first objection is we do not believe it would be appropriate for the auditor to be the first source of information or to disclose information that is not otherwise required to be disclosed by management (or even exempt from disclosure). Board Member Jay D. Hanson illustrated an example in his Statement on Proposed Standards Regarding the Auditor's Report and the Auditor's Responsibility Regarding Other Information. The example he provided was a deficiency in internal controls that is classified as a significant deficiency, not a material weakness. If the auditor determined the evaluation of this deficiency was a CAM, then it would be disclosed by the auditor but not required (or exempt) from disclosure by management.

Secondly, the language of the proposal and Board member Jeanette M. Franzel's comments indicate the Board expects multiple CAMs in most cases. It seems likely auditors would err on the side of including more rather than less CAMs, and management would be compelled to address all CAMs within footnotes and/or Management's Discussion and Analysis. Like several other respondents have noted, we believe these reported CAMs would closely or exactly mirror management's existing disclosures, effectively diluting those areas of the financial statements. As a result, understanding of the information required to be presented in the financial statements would not be enhanced in any meaningful way, and the simple "pass/fail" opinion would be harder to find and interpret.

It is also quite possible the inclusion of specific audit procedures performed on these CAMs (as in all three of the Illustrative Examples of CAMs provided by the Board on pages A5-65-78), although not required, leads to the inference that the auditor has differing levels of opinions on these matters, since no conclusions are stated for the procedures performed. We do not believe a description of specific audit procedures performed is necessary nor would conclusions on those procedures be appropriate.

The potential "bright light" shined on CAMs by PCAOB inspectors and others would likely lead to additional review by the auditor's engagement leadership and national office and issuers' legal counsel, as well as requiring time for management's review of the auditor's disclosure. As a practical matter, this review would necessarily occur during the busiest few weeks prior to SEC filing, a period that is already pressured and that ought to be devoted to focused completion of the primary audit work.

Moreover, we believe that a likely consequence of adding superfluous (from the company's perspective) requirements is a potentially chilling effect on effective dialogue amongst auditors, audit committees and management. In the interest of arriving at the "best answer" when dealing with unusual, complex and/or infrequent financial reporting issues, it is not conducive to robust discussions (or discussions at all) among these groups if one of the results of such discussion is that the matter will be deemed a CAM. Ultimately, financial statement quality could become the main casualty.

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At a minimum, we agree that the proposal should be "field-tested" by accounting firms, their clients and representative investors.

**Reporting on Other Information**

We believe the proposed wording of the requirement to "read and evaluate" rather than "read and consider" will be interpreted as a higher standard by the auditors and a requirement to perform additional audit procedures, thus driving up the audit cost. Just as importantly, it leads to the inference that the auditors are undertaking a higher degree of accountability than warranted on information the auditor may not possess the expertise to perform. For example, reporting on forward-looking information that is complex or challenging for the auditor to evaluate involves complexities that could result in this standard requiring significant time and attention by auditors. At a minimum, we agree that the proposal should be "field-tested" by accounting firms, their clients and representative investors.

**Auditor Tenure**

Absent an objective correlation between audit tenure with audit independence or quality, and we are aware of none, we believe disclosing this information in the auditor's report, in which independence is already noted elsewhere, does not convey helpful information and potentially portrays an inaccurate implication to those readers. It is better suited to inclusion, if at all, in the proxy statement or other avenues.

**Conclusion**

Again, we thank the PCAOB for the opportunity to comment on these Proposed Auditing Standards. If you have any questions regarding the comments in this letter, please contact our Senior Vice President, Controller & Chief Accounting Officer, Curt Calaway at (479) 290-5576.

Sincerely,

/s/ Kevin M. McNamara
Kevin M. McNamara, Director and Audit Committee Chairman
Tyson Foods, Inc.

/s/ Dennis Leatherby
Dennis Leatherby, Executive Vice President and Chief Financial Officer
Tyson Foods, Inc.

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
VICE PRESIDENT

1615 H STREET, NW
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December 9, 2013

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

**Re: PCAOB *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (PCAOB Release No. 2013-005, August 13, 2013; PCAOB Rulemaking Docket Matter No. 034)**

Dear Ms. Brown:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. The CCMC supports efforts to improve audit effectiveness and appreciates the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") *Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* ("the Proposal").

Rather than informing investors and financial statement users, the Proposal may create a tower of Babel that can sow confusion in a marketplace that SEC Chair Mary Jo White has acknowledged already suffers from "disclosure overload."[1] The CCMC is concerned that the Proposal does not address investor needs, causes investor confusion by creating overlap and competition with other regulatory mandates, increases financial reporting complexity and blurs the lines of responsibilities between auditors and businesses. This will degrade audit quality and hamper the utility of financial reports for users and issuers thereby making the capital markets less efficient.

Accordingly, the CCMC believes that the Proposal does not meet minimum thresholds required to move forward. Instead, the CCMC respectfully requests the PCAOB should work with the Securities and Exchange Commission ("SEC") and Financial Accounting Standards Board ("FASB") to move forward on a broad agenda of financial reporting modernization as outlined in the CCMC's letter October 9, 2013 to SEC Chair Mary Jo White.

Our concerns are discussed in greater detail below.

**Discussion**

The PCAOB issued a Concept Release on possible revisions to the auditor's report in June 2011 and received 155 comment letters. The CCMC provided comments on the Concept Release expressing serious concerns in a comment letter filed with the PCAOB.[2] We continue to have the same concerns regarding the Proposal, and accordingly, have attached the September 14, 2011 letter. At the same time the PCAOB also issued a Concept Release on Auditor Independence, and the CCMC responded by filing a comment letter on October 20, 2011.[3] As we continue

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[1] *See* October 15, 2013 speech of SEC Chairman Mary Jo White, *The Path Forward on Disclosure*, before the National Association of Corporate Directors.

[2] *See* the September 14, 2011 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related amendments to PCAOB Standards* (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 034).

[3] *See* October 20, 2011 letter from the United States Chamber of Commerce Center for Capital Markets Competitivness on the PCAOB *Concept Request for Public Comment on Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable (PCAOB Release No. 2011-006, August 16, 2011, PCAOB Rulemaking Docket Matter No. 37)*

to have some of the same concerns on the Proposal's stance on auditor independence, we have also attached the October 20, 2011 comment letter. We respectfully request that these attachments be included as a part of the Proposal comment file.

## I. Investor Concerns

While we recognize that the PCAOB has engaged in outreach activities since the Concept Release, we are concerned that the PCAOB has not defined the investor need it is attempting to address, what investors it has consulted, and if the outreach has included a broad representative sample of the investor community. A failure to articulate specific investor needs and transparently identify the investor consultations undertaken to develop the Proposal undermines the fairness of the process, composition of the Proposal, and the need to move forward.

The CCMC believes that the articulation of investor needs and transparency of outreach in the development of the Proposal is a minimum necessary threshold for moving forward. This is particularly true since the Proposal fundamentally changes the Audit report and the role of the auditor.

The CCMC believes that these threshold requirements for moving forward with the Proposal have not been met.

## II. Alternatives to the Proposal

The Proposal would significantly change the role and responsibilities of the auditor and represent the most significant changes to auditor reporting in more than 70 years. In our September 14, 2011 comment letter, we emphasized the need to address the threshold question of whether the PCAOB should engage in such a sweeping standard-setting initiative. This threshold question still needs to be addressed with this Proposal. Simply put, why is the PCAOB proposing to fix an auditor reporting model that is not broken?

Addressing the threshold question is especially important given that the PCAOB has heard strong support from all stakeholders for retaining the current "pass-fail" model of auditor reporting. The Proposal appears to retain this model with additive reporting requirements. However, auditor reporting of CAMs essentially turns the auditor's report into a graded model.

Accordingly, the CCMC believes the PCAOB should work with the SEC and FASB to move forward on a broad agenda of financial reporting modernization as outlined in the CCMC's letter October 9, 2013 to SEC Chair Mary Jo White.[4] We would be happy to meet with the PCAOB board members to discuss these ideas further.

## III. Background of Proposal

The Proposal would require the following:

- A new section in the auditor's report describing critical audit matters ("CAMs");

- New auditor responsibilities for and reporting on other information ("OI") that include requirements to read and evaluate OI, describe the auditor's responsibilities for OI in the auditor's report and state whether the OI contains a material inconsistency, a material misstatement of fact, or both; and

- New language in the auditor's report regarding auditor tenure, auditor independence, and auditor responsibilities related to fraud and the notes to the financial statements.

The CCMC appreciates that the PCAOB has not proceeded with Auditor Discussion and Analysis ("AD&A") as articulated in the Concept Release. Unfortunately, CAMs appear substantively similar to AD&A, notwithstanding that CAMs are described as being grounded in auditing rather than financial reporting matters. Importantly, both CAMs and AD&A overturn the fundamental precepts of financial reporting, as explained below.

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[4] *See* October 5, 2012 letter from the CCMC to the PCAOB, *Information for Audit Committees about the PCAOB Inspection Process* (PCAOB Release No. 2012-003, August 1, 2012) and October 9, 2013 letter from the CCMC to SEC Chair Mary Jo White on financial reporting modernization

## IV. Auditor Reporting on Critical Audit Matters ("CAMs")

The Proposal defines CAMs as:

- Those matters that involved the most difficult, subjective, or complex auditor judgments;

- Those matters that posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or posed the most difficulty to the auditor in forming an opinion on the financial statements; and[5]

- Further, the Proposal would require that the auditor's report identify the specific CAMs, describe the considerations that led to each matter being considered a CAM, and refer to the related financial statement accounts and disclosures in the financial statements (if applicable).

As we discussed in our letter of September 14, 2011, financial statements and disclosures are the responsibility of management. This fundamental premise also extends to OI outside the financial statements such as Management's Discussion & Analysis ("MD&A") and proxy statements—both of which management prepares in accordance with SEC requirements. In turn, the board of directors, largely through the audit committee, exercises oversight of management's reporting and disclosures. The independent audit firm's responsibility is to express an opinion as to whether the company's annual financial statements, including the notes thereto, are presented fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP").

An essential element of the fundamental premise of financial reporting is that the auditor is not an original source of information about the company. In fact, the auditor is subject to both legal and ethical requirements on confidentiality that preclude this from occurring except in certain specific circumstances. Notwithstanding these core principles, the requirement in the Proposal for the auditor to report CAMs can put the auditor in the position of stepping into the shoes of

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[5] In addition, the Proposal lists a number of other factors that the auditor should take into accounting in determining whether a matter is a CAM (see paragraph 9 (pages A1-7 to A1-8) of the Proposal).

management, becoming an original source of information, and disclosing otherwise confidential information.

Furthermore, CAMs can require auditors to report on matters that management is not required to include or otherwise disclose in the GAAP financial statements, footnotes, or elsewhere, such as MD&A. If the Proposal is approved, management and auditors could be forced to make such disclosures, including disclosing information that would not be considered material by a reasonable and prudent investor. Thus, in multiple ways, the Proposal overturns the fundamental premise of financial reporting and corporate governance disclosures.

The PCAOB's proposed auditor reporting on CAMs also undermines the financial reporting and disclosure frameworks of the SEC and FASB. As the Proposal is currently drafted, CAMs can necessitate auditors disclosing matters that the SEC or FASB has specifically decided that companies are *not* required to disclose. If the SEC has decided that certain information is not useful for investors, thereby not meeting the threshold for disclosure, as a matter of public policy the PCAOB cannot override the SEC's decision.

Examples of this conflict include matters such as weaknesses in internal control over financial reporting ("ICFR") that were appropriately determined to be significant control deficiencies, considerations of going concern that were appropriately addressed by mitigating factors, contingent liabilities that were fully considered and appropriately found not to require disclosure, etc.

The potential to undermine the SEC and FASB reporting and disclosure requirements also occurs because the Proposal appears to preclude the auditor from referencing OI disclosed by management, including OI in MD&A. To illustrate, the Proposal states that "for each critical audit matter communicated in the auditor's report the auditor must … refer to the relevant *financial statement accounts and disclosures* that relate to the critical audit matter, *when applicable*" (emphasize added).[6] In other words, it appears that the Proposal limits the auditor's reference to information in the GAAP financial statements and footnotes covered by the auditor's opinion. Such a limitation would also exacerbate financial reporting complexity.

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[6] *See* paragraph 11 of the Proposal (pages A1-8 to A1-9).

The Proposal provides illustrative examples of CAMs and auditor reporting thereon.[7] These illustrations are instructive. For example, among other issues, the examples suggest that investors and other users may interpret the disclosure of CAMs consistent with the auditor providing differential (lesser) assurance on some aspects of the financial statements and notes or otherwise equivocating on providing assurance on the financial statements (including GAAP notes) as a whole. This consequence appears likely notwithstanding statements in the Proposal that it is not appropriate for the auditor to use language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for CAMs.[8]

Other problematic aspects of the Proposal in regards to CAMs include the following:

- CAMs would require the auditor to report on matters that were adequately and appropriately disclosed by management. In turn, this will likewise unnecessarily add to financial reporting complexity. It also raises the essential question of the usefulness of this information to investors and other financial statement users. The illustrative examples of CAMs included in the Proposal only reinforce this point.

- On the other hand, circumstances will arise when CAMs lack clarity and/or raise questions and there is no mechanism or venue for the auditor to respond. Again, confidentiality restrictions will likewise constrain the auditor. As a result, this puts the company and management in the position of having to explain (after the fact and in compliance with Reg FD) what the auditor meant.

- CAMs elevate for public disclosure matters that were fully addressed and resolved to the auditor's satisfaction before the audit report was issued.

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[7] *See* pages A5-65 through A5-78 of the Proposal.
[8] *See* the note following paragraph 11(c) (page A1-9) of the Proposal.

- CAMs are not limited to or grounded in matters communicated to or discussed with the audit committee.[9] On the one hand, it is difficult to fathom how a matter could be important enough to disclose to investors but not among those discussed with the audit committee—whether as part of required auditor communications or otherwise. On the other hand, it makes the list of potential CAMs vague, open-ended, and subject to second-guessing.

- It cannot be ruled out that mandating the disclosure of CAMs will have a chilling effect on the normal communication processes between the auditor and management and audit committees. For example, management and/or the audit committee may be more cautious and less open and/or timely in their discussions with auditors to avoid having a matter unnecessarily becoming elevated to a CAM.

- The potential for second-guessing of the auditor's determination of CAMs via PCAOB inspections, regulatory enforcement actions, and private securities actions is also exacerbated by other requirements in the Proposal. For example, the Proposal would require the auditor to document the basis for the determination that each reported matter was a CAM *and* to document the basis for determining that *non-reported* audit matters addressed in the audit, which would appear to meet the definition of a CAM, were not critical audit matters.[10]

- Auditor reporting on CAMs involves some practical considerations, including creating potential impediments to timely SEC filings by companies. Perhaps, on average, auditors will identify CAMs well in advance of SEC filing deadlines and resolve all necessary issues with the company in this regard. Nonetheless, circumstances will arise

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[9] In this regard, the PCAOB's Proposal is unlike the guidance on auditor reporting of key audit matters (KAMs) in the exposure draft of the International Auditing and Assurance Board ("IAASB") on *Reporting on Audited Financial Statements*. The Proposal states that CAMs *ordinarily* are matters required to be documented in the engagement completion document, reviewed by the engagement quality reviewer, communicated to the audit committee, or any combination thereof (see paragraph 8 (pages A1-6 to A1-7) of the Proposal.

[10] *See* paragraph 14 (page A1-10) of the Proposal.

when this is not the case; and so, the likelihood that the Proposal will result in situations where auditor reporting of CAMs delays the timely filing of information by companies cannot be ruled out.

- The audit committee represents investors and the audit committee has the responsibility under the Sarbanes-Oxley Act of 2002 ("SOX") for oversight and monitoring of the external audit. The implication of this SOX mandate is that actionable elements of issues involving CAMs would come under the purview of the audit committee. Furthermore, the Proposal fails to appreciate that the PCAOB has only recently issued new guidance on auditor communications with audit committees.[11] The Proposal does not give adequate time for this new guidance to be implemented and assessed through post-implementation review. The PCAOB should let the audit committee communication process work before considering any external communications by auditors.

- The reporting of CAMs is unlikely to be a "free-writing" exercise at the engagement level. A number of forces, including legal forces will necessitate consistency in the drafting of CAMs over time and across companies. Thus, the likelihood is very high that this initiative would result in auditor reporting that is simply boilerplate.

- The PCAOB expects that CAMs will be disclosed for most audits. Given the heterogeneity in the circumstances of an audit, this expectation may be misplaced. For example, some audits are less complex and more straight-forward.

- Furthermore, investors and other users may make inappropriate inferences about the quality of a company's financial reporting and the nature of the audit based on the number of CAMs disclosed. For example, a "large" number of CAMs may be interpreted as consistent with a contentious audit. On the other hand, very few, if any, CAMs

[11] *See* PCAOB Auditing Standard No. 16, *Communications with Audit Committees*, effective for audits of fiscal years beginning on or after December 15, 2012.

> may be interpreted as consistent with a less thorough audit and/or auditors that lack skepticism and otherwise fail to challenge management.

## V. Other Information ("OI")

It appears the PCAOB has determined that there is no meaningful support for auditor assurance on OI, including auditor assurance on MD&A. Therefore, the Proposal focuses on enhancing the auditor's responsibilities for and auditor reporting on OI. However, once again the threshold question comes to the fore as it seems that there is no meaningful demand to clarify or enhance the auditor's current responsibilities in regards to OI or to report thereon.

The Proposal includes new auditor responsibilities to read and evaluate OI for consistency of amounts with the financial statements; consistency of qualitative statements with the financial statements; comparability with relevant audit evidence obtained and conclusions reached; and mathematical accuracy. The Proposal also includes a new requirement for auditor reporting on OI. The Proposal would require that the auditor's report describe the auditor's responsibilities for other information and state whether the other information contains a material inconsistency, a material misstatement of fact, or both (based on the relevant audit evidence obtained and conclusions reached during the audit).

Unfortunately, the proposed reporting is likely to confuse rather than inform investors. First, the auditor is providing no assurance on OI. Yet the proposed auditor report implies there is some (new) level of service—called an "evaluation"—based on which the auditor is providing at least negative assurance with respect to OI. For example, illustrative language in the Proposal for the auditor's report includes: "Based on our evaluation, we have not identified a material inconsistency or a material misstatement of fact in the other information."[12] An oddity is that the Proposal would have auditors reporting on the results of what they do not do, as the OI is neither audited nor reviewed.

[12] *See* paragraph 14(b) (page A2-7) of the Proposal.

Discussions at the PCAOB's November 2013 Standing Advisory Group ("SAG") meeting revealed very different views on what the auditor should reasonably know with regard to OI based on the relevant audit evidence obtained and conclusions reached during the audit. The Proposal does not sufficiently tie the auditor's responsibilities for OI to the financial statements. This will be a source of great confusion and may force auditors into the position of having to do additional work.

The Proposal also has auditors intruding into areas such as MD&A that are intended to be where management discusses the state of the business. In doing so, MD&A uses qualitative, non-financial, and forward looking information. Again, it makes no sense to require the auditor "to read and evaluate" these MD&A disclosures (or OI generally) not derived from the financial statements. Current PCAOB standards are appropriate in regards to the role and responsibilities for OI.

OI also includes proxy statements, which raises the practical question of how the auditor reports on information not yet issued (or necessarily fully available to the auditor) at the date of the auditor's report.

These points illustrate another of our concerns with the Proposal—namely that the PCAOB is potentially undermining the disclosure requirements of others, including the SEC.

In addition, the Proposal creates confusion as to the new performance standards. Discussions at the PCAOB's November 2013 SAG meeting suggested that the PCAOB intends to formalize current practice with respect to OI. Yet, there was a good deal of ambiguity and uncertainty expressed at the SAG meeting as to what it means to "read and evaluate" (proposed guidance) versus "read and consider" (current guidance). This confusion occurs notwithstanding the guidance in the Proposal in regards to "evaluate."

Discussions at the November 2013 SAG meeting also revealed differences of views on what constitutes a "material misstatement of fact" that falls within the intended purview of the Proposal and whether OI can involve immaterial information. All things considered, it appears that the Proposal significantly extends the auditor's responsibilities for OI and will have significant legal liability implications for auditors that need to be understood and addressed. As it stands, the Proposal will only create an expectations gap with respect to auditor responsibilities for OI.

## VI. Auditor Tenure and Independence

The Proposal calls for several other changes in the auditor's report, including disclosing auditor tenure (that is the year the auditor began serving consecutively as the company's auditor), disclosing auditor independence (that is stating that the auditor is required to be independent in accordance with federal securities laws and applicable rules and regulations of the SEC and PCAOB), and including various statements regarding the auditor's responsibilities related to fraud and the notes to the financial statements.

First, is not obvious that more information in the auditor's report on either independence or auditor tenure is necessary. As to auditor independence, the auditor's report is typically headed "Report of the Independent Registered Public Accounting Firm." Furthermore, the audit committee reports in the company's annual proxy statement about its oversight and monitoring of auditor independence matters. So, on the one hand, the need for any additional information in regards to auditor independence is not obvious. And, on the other hand, if there is a need, it is better addressed by other regulators such as the SEC.

As to auditor tenure, it is not obvious how tenure connects to the nature of the auditor's work performed or the auditor's opinion and, therefore, why this information belongs in the auditor's report. As the audit committee has the responsibility to oversee and monitor the selection and retention of the audit firm, again the audit committee report in the annual proxy statement provides a more appropriate placement for such a disclosure. And, a number of audit committees already disclose this information in the proxy statement.

By including tenure information in the auditor's report, the Proposal implies some systematic connection between audit quality and tenure. However, as explained in the Proposal and emphasized by one Board member, the PCAOB "has not reached a conclusion regarding the relationship between audit quality and auditor tenure and the Board's inspection process has not been designed to determine a relationship between audit quality and auditor tenure." Thus, the PCAOB does not have "any data indicating that audit tenure has any correlation with audit quality." Yet, "the mere fact that the Board requires a disclosure about audit tenure, however, might suggest that the Board believes the information to be meaningful."[13] By that token, as an example, anecdotal musings, by the SEC, of ethical lapses by attorneys would not pass muster for regulatory action requiring disclosure of law firm tenure by companies.

Lastly, we would like to reiterate that the CCMC supports working to achieve one set of global high quality auditing standards through the convergence of PCAOB auditing standards with those of the AICPA's Auditing Standards Board ("ASB") and the IAASB. Particularly when it comes to auditor reporting, one global model for mandated auditor reporting seems not only desirable but essential. We encourage the PCAOB to work with the IAASB and ASB to develop an appropriate model.

## VII. Cost Benefit Analysis

The Proposal recognizes that the 2012 Jumpstart Our Business Startups ("JOBS Act") now makes economic analysis a necessary pre-condition for applying new PCAOB auditing standards to an audit of any emerging growth company (EGC). Specifically, JOBS Section 103(a) (3) requires that rules adopted by the Board after the date of enactment of the JOBS Act (in April 2012) shall not apply to an audit of any EGC, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation. Notwithstanding that JOBS Act exempted EGCs from any subsequent standard-setting on AD&A and, therefore, EGCs would likewise be exempted from CAMs, the need for subjecting this initiative to robust economic analysis remains.

The CCMC recognizes that the PCAOB is soliciting information on the estimated costs and burdens that will be placed upon businesses and auditors as a result of the Proposal, and to solicit other information on how the Proposal would contribute to investor protection and promote efficiency, competition, and capital

[13] *See Statement on Proposed Auditing Standards Regarding the Auditor's Report and the Auditor's Responsibilities Regarding Other Information"* by Jay D. Hanson, Board Member, PCAOB Open Board meeting on August 13, 2013.

formation. Further, the CCMC recognizes that the Proposal does not represent a final standard. Thus, additional evidence and analysis will occur and be reflected in any ensuing standard adopted by the Board and submitted for approval by the SEC.

Nonetheless, the CCMC suggests that the PCAOB needs an appropriate and transparent framework for economic analysis—one that will serve as a template for such analysis across all PCAOB rulemaking initiatives. One example of such a framework is the SEC staff memorandum, "Current Guidance on Economic Analysis in SEC Rulemakings" dated March 16, 2012.

Thus, the CCMC recommends that the PCAOB develop guidance on economic analysis for PCAOB rulemaking. Once developed, the PCAOB should expose the framework for public comment and the finalized framework should be publicly disclosed. As a starting point, the PCAOB could consider adapting the framework in the SEC staff memorandum to an audit context.

In addition, the framework should preclude reliance on generic economic arguments that could apply to almost any proposed auditing standard regardless of topic or substance. The framework should likewise discourage conjectures or speculative type arguments, including those related to reducing information asymmetries and cost of capital that are not grounded in credible evidence related to the specifics of the initiative at hand. The framework should also articulate an appropriate economic baseline against which to measure the proposed requirements likely economic impact.

Finally, in regards to this Proposal, if the PCAOB decides to proceed with this initiative in spite of all the concerns expressed about it, the PCAOB should recognized that auditor reporting of CAMs, in particular, is a giant experiment. As such, the CCMC recommends that any standard-setting that results from this initiative should include a sunset provision (of within three to five years of its effective date). Only after a robust post-implementation review of the costs and the benefits and a determination that the benefits exceed the costs should a similar or revised auditor reporting standard be allowed to be re-implemented.

## Conclusion

Once again, the CCMC appreciates the opportunity to comment on the Proposal.

The CCMC continues to have serious concerns regarding the Proposal – namely, that the Proposal blurs lines of corporate governance, may create duplicative disclosures and may raise liability for auditors and businesses which ultimately harms investors. We believe that these issues should be addressed before the Proposal moves forward.

In the alternative, the CCMC believes that the PCAOB should work with the SEC and FASB to move forward on a broad agenda of financial reporting modernization as outlined in the CCMC's letter October 9, 2013 to SEC Chair Mary Jo White.

Thank you for your consideration and the CCMC stands ready to assist in these efforts.

Sincerely,

Tom Quaadman

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

TOM QUAADMAN
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September 14, 2011

Office of the Secretary
Public Company Accounting Oversight Board
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**Re: Request for Public Comment *on Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards and Notice of Roundtable (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34)***

Dear Members and Staff of the Public Company Accounting Oversight Board:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC recognizes the vital role external audits play in capital formation and supports efforts to improve audit effectiveness. We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") *Concept Release on Possible*

*Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* ("Concept Release").

The CCMC has a number of concerns regarding the issues and concepts outlined in the Concept Release including those related to:

- The potential increase in financial reporting complexity;
- The apparent overturning of fundamental precepts of financial reporting;
- The conflict with other forms of mandated corporate disclosure;
- The fundamental shift in the role of the auditor and communications;
- The potential activities that may fall outside of the legal mandates of the PCAOB's powers and encroachment upon mandated powers of other regulators and standard setters;
- The potential increase in litigation harmful to investors and the capital markets; and
- The failure to weigh recommendations made by other entities to reduce financial reporting complexity.

In reviewing the intent and purpose behind the Concept Release, the CCMC believes that the PCAOB should work with the Securities and

Exchange Commission ("SEC") and Financial Accounting Standards Board ("FASB") to:

- Take a coordinated holistic approach to reducing financial reporting complexity;
- Create a Financial Reporting Forum allowing all stakeholders to work together to identify long-term financial reporting issues and solutions; and
- Follow transparency and disclosure standards, used by regulators, in the development of standards and concept releases.

**<u>Discussion</u>**

The stated objective of the Concept Release is to seek public comment on auditor reporting alternatives that could provide investors with more insight into the company's financial statements, or possibly other information outside the financial statements, and more transparency into the audit process.

The Concept Release presents four alternatives (auditor's discussion and analysis ("AD&A"), required and expanded use of emphasis paragraphs, auditor assurance on other information outside the financial statements, and clarification of the standard auditor's report). Nonetheless, the Concept Release makes clear that the PCAOB intends to retain the current ("pass/fail") approach of the standard auditor's report. Indeed, as recognized in the Concept Release, the PCAOB has heard overwhelming support from all stakeholder groups for retaining this long-standing approach to auditor reporting. Thus, the alternatives presented in the Concept Release would be additive to the current approach.

Before addressing any specifics in regards to the Concept Release, it is important to consider the threshold question of whether the PCAOB should undertake a standard-setting initiative. CCMC notes that standards related to auditor reporting are long-standing and have served the test of time. While this does not mean that improvements should not be considered by the PCAOB, it does suggest the need to exercise caution in doing so.

The CCMC has a number of concerns about the PCAOB's approach to this reporting project and the alternatives discussed in the Concept Release. These concerns are outlined in the remainder of this letter.

## I. Approach to Developing the Concept Release

An overarching concern is that, in developing the Concept Release, the PCAOB has not taken a comprehensive and holistic approach to considering the role of *both* auditors and audit regulators in achieving an optimal level of quality and clarity in public company financial reporting. The PCAOB has not clearly articulated the current structural audit weaknesses in public company financial reporting, which is a necessary predicate to address the threshold question of whether the PCAOB should undertake a standard-setting initiative on auditor reporting. In addition, the Concept Release does not appreciate that the PCAOB as the regulator of public company audits actually shares responsibility with auditors for audit quality. Instead, the Concept Release appears intent on transferring responsibilities to auditors when it comes to auditor reporting.

A more holistic approach to considering the interplay of audit and financial reporting regulation could likely have informed this PCAOB auditor reporting project in other ways, including by raising questions about some of the essential premises that underlie it. For example, in response to the 2008 economic crisis, FASB has promulgated new standards and the SEC has enacted new regulations. There is no indication that the PCAOB considered these FASB and SEC activities in developing the alternatives discussed in the Concept Release.

Furthermore, the project does not appear to have taken into account the insights and recommendations from prior blue-ribbon advisory committees, such as the SEC Advisory Committee on Improvements to Financial Reporting ("CIFiR"), the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP"), and the Panel on Audit Effectiveness.[1] For example, ACAP recommended that the PCAOB narrow the expectation gap and provided useful guidance to the PCAOB for exercising its responsibility to do so; whereas, the Concept Release seems intent on delegating this regulator responsibility to auditors, including through the assignment of new responsibilities.

Moreover, the reports and recommendations of previous advisory committees should have provided perspective on the feedback that the PCAOB received during its outreach activities. For example, it is financial reporting complexity, including disclosure overload, which is at the heart of some of what the PCAOB heard from its outreach activities. Calls by investors for "tell us what matters" and "give us a roadmap" should be less about asking auditors to weigh-in with their views (as the Concept Release suggests with alternatives such as AD&A and expanded and required use of emphasis of matter paragraphs), and more about the PCAOB working

[1] Recommendations of the Panel on Audit Effectiveness are discussed in a subsequent section of this letter on going concern reporting and disclosures.

with other regulators, including the SEC and FASB, to help fix the essential problem.

Disclosures for public companies and their investors are a triad that involves the SEC, FASB, and the PCAOB. It is imperative that this triad work in harmony to provide a rational coordinated system of disclosure for all public company stakeholders. A failure to do so will create competing disclosures and confusion, sowing uncertainty and doubt in the capital markets for investors and companies alike. The CCMC once again reiterates its call for a Financial Reporting Forum that will provide for coordination as well as the identification and resolution of problems that may drive complexity and obfuscation.[2]

Importantly, complexity challenges a premise for this project that expanded auditor reporting in advance of the 2008 economic crisis might have been helpful in assessing the quality of the financial statement and provided early warning signals regarding potential issues.

In its August 2008 Final Report, CIFiR recognized that over time "financial reporting has become a burdensome compliance exercise with decreasing relevance to investors" (p. 18). CIFiR identified financial reporting complexity as the key factor driving the disconnect between current financial reporting and the information necessary to make sound investment decisions. Thus, CIFiR made a number of recommendations to the SEC, FASB, and PCAOB to improve the usefulness and reduce the complexity in financial reporting. While some progress has been made, many of CIFiR's recommendations have yet to be taken up by the appropriate bodies – in particular the PCAOB.

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[2] See CCMC testimony provided to the U.S. Senate Subcommittee on Securities, Insurance and Investment's April 6, 2011 hearing: *The role of the accounting and auditing profession in preventing another financial crisis.*

One example of a CIFiR recommendation not yet addressed by the PCAOB relates to judgment. Whereas discussions in the Concept Release indicate that some participants in the PCAOB's outreach activities expect a single "right answer," CIFiR appreciated the role of judgment and understood that there is not necessarily one right answer in accounting and auditing matters. In turn, CIFiR recommended that the PCAOB develop and articulate guidance related to how the PCAOB, including in its inspections and enforcement divisions, would evaluate the reasonableness of judgments made based on PCAOB auditing standards. CIFiR also recommended that the PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC to the extent that the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.[3]

To summarize, CIFiR understood the need to take a comprehensive and holistic approach to overcoming the problem of financial reporting complexity. The CCMC recommends that the PCAOB adopt such an approach and redirect its efforts and resources from initiatives that will only exacerbate the disclosure overload problem. All financial reporting stakeholders would be better served if the PCAOB worked with other regulators and standard-setters, such as the SEC and FASB, to implement the CIFiR recommendations; to help update and improve existing disclosure requirements and eliminate redundant and unnecessary disclosures; to facilitate the ability of management (rather than lawyers) to drive discussions in MD&A, including those around critical accounting estimates; and to help address issues around the auditability of GAAP.

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[3] CIFiR recommended that the SEC issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments and include factors that it considers when making this evaluation. CIFiR then went on to suggest some components of an accounting policy statement related to the choice and application of accounting principles, as well as estimates and evidence related to the application of accounting principles. CIFiR's suggested components are consistent with advice on the SEC's website for consultations on accounting matters with the Office of the Chief Accountant and the Division of Corporation Finance. However, CIFiR made no such suggestions in regards to an audit judgment framework.

The CCMC also recommends that the PCAOB work with others such as the SEC and FASB to better understand the responsibilities of users when it comes to financial reporting. The Concept Release seems not to appreciate that users are heterogeneous and, therefore, their information needs vary. General purpose financial reporting, as represented by GAAP financial statements, is designed to meet the needs of the broad set of all users and not the demands of any particular special interest group.

## II. Overturning a Fundamental Premise of Financial Reporting

Another major CCMC concern is that the Concept Release overturns a fundamental premise of financial reporting—namely that the financial statements and disclosures are the responsibility of management. This premise likewise extends to other information that accompanies the financial statements, such as Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A"), which management prepares in accordance with SEC requirements, as well as other information outside the financial statements.

Management's financial reporting responsibility includes the selection and application of Generally Accepted Accounting Principles ("GAAP") and the determination of the many estimates and judgments required by GAAP and SEC financial reporting requirements, including MD&A disclosures. Management's responsibility for financial reporting extends beyond compliance with GAAP to determining the "quality" of the company's financial reporting within GAAP. In turn, the board of directors, largely through the audit committee, exercises oversight of management's financial reporting, including the company's annual (Form 10-K) and quarterly (Form 10-Q) filings with the SEC.

The independent audit firm's responsibility is to express an opinion as to whether the company's annual financial statements, including notes thereto, are presented fairly, in all material respects, in conformity with GAAP.[4] The auditor's report is the mechanism by which the audit firm communicates this opinion. The SEC does not accept filings that contain audited financial statements with qualified or adverse audit opinions.[5] Thus, for public companies, the auditor's unqualified audit opinion indicates that all material matters have been resolved.[6]

An essential element of the fundamental premise of financial reporting is that the auditor is not an original source of information about the company. Auditors' legal and ethical obligations recognize and reinforce this point by requiring that auditors treat all company-specific information as confidential.[7] Except in rare circumstances where management and the board of directors have failed to disclose certain information, as provided for under PCAOB auditing standards and SEC regulations,[8] auditors are *precluded* from disclosing any company-specific

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[4] Quarterly financials included in Form 10-Q filings with the SEC are reviewed by the auditor, rather than audited.

[5] The Concept Release does not explore the implications of this prohibition or suggest altering it.

[6] However, auditing standards provide that audit reports with unqualified opinions can contain additional explanatory or emphasis of matter language, including when there is substantial doubt about the entity's ability to continue as a going concern, there has been a material change between periods in accounting principles or their method of application, there are significant transactions with related parties, or unusually important subsequent events have occurred.

[7] Rule 301 of the American Institute of Certified Public Accountants ("AICPA") Code of Professional Conduct states that "a member in public practice shall not disclose any confidential client information without the specific consent of the client." The PCAOB did not adopt Rule 301 as part of its interim standards. Apparently the PCAOB's decision was based on a determination that incorporation of Rule 301 was not necessary to fulfill the Board's mandate under Section 103(a)(1) and (3) of The Sarbanes-Oxley Act of 2002 ("SOX"). The PCAOB has assured that this determination did not reflect a decision that auditor confidentiality requirements imposed by other authorities were inappropriate. In adopting conforming amendments in conjunction with Auditing Standard No. 6 ("AS No. 6"), *Evaluating Consistency of Financial Statements*, the PCAOB reaffirmed that it sought neither to modify nor detract from existing confidentiality requirements. Nonetheless, in approving AS No. 6 in September 2008, the SEC encouraged the PCAOB to develop and adopt a rule addressing the auditor's responsibility with respect to maintaining the confidentiality of client information. The PCAOB has yet to do so.

[8] Examples include information under certain circumstances in reports in connection with the termination of the audit engagement and reports that may be required pursuant to Section 10A(b)1 of the Securities Exchange Act of 1934 relating to an illegal act that has a material effect on the financial statements.

information to outside parties. Nonetheless, the Concept Release includes alternatives, in particular an AD&A, that represent a radical departure from the bedrock premise of financial reporting.

Further, at first blush it would appear that the proposed AD&A would be in direct conflict with the MD&A required by the SEC. Accordingly it would seem that such a system would provide competing disclosures that will increase complexity and create confusion for investors. Seemingly, that would appear to be a situation that the SEC could not allow to develop.

As described in the Concept Release, an AD&A would provide financial statement users with a view of the audit and financial statements "through the auditor's eyes" (p. 13). Importantly, the Concept Release recognizes that the auditor's perspectives about the company's financial statements could differ from those of management.

According to the Concept Release, AD&A would give the auditor the ability to discuss significant matters, which could include such things as the auditor's views regarding management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls." The Concept Release goes on to explain that:

> *Additionally, an AD&A could provide the auditor with discretion to comment on those material matters that might be in technical compliance with the applicable financial reporting framework, but in the auditor's view, the disclosure of such matters could be enhanced to provide the investor with an improved understanding of the matters and their impact on the financial statements. And, AD&A could also highlight those areas where the auditor believes management, in its preparation and presentation of the financial statements, could have applied different accounting or disclosures* (p. 13).

Needless to say, providing auditor views and perspectives would represent a profound shift in the role and responsibilities of the independent auditor vis-à-vis management and the board of directors/audit committee. AD&A would necessitate the auditor becoming an original and competing source of company-specific information.[9] While it is not clear that the PCAOB would have the authority to enact this sea change, on principle, the CCMC strongly disagrees with any move by the PCAOB in this direction.

Investors need factual information to make decisions with their goal being a return on investment. Those decisions are premised on the health, direction and management of a company. An auditor's opinion in AD&A may be considered Monday morning quarterbacking that may not even be welcomed by investors generally. For that matter why not create a disclosure on the opinions of top financial reporter's opinions on management decisions. While everyone may have an opinion, it may not provide relevant facts or substance for investment decisions.

Moreover, any such change in the fundamental premise of financial reporting would likewise have significant implications for auditors from the standpoint of legal liability. AD&A may even create new avenues for legal actions against auditors. For example, the U.S. Supreme Court recently reaffirmed its decision in Central Bank[10] that precludes private securities fraud actions against secondary actors such as auditors. As described in the Concept Release, it appears that an AD&A would move the auditor into the position of being an original maker of statements. The auditor would have ultimate authority and control over AD&A, including its content and

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[9] As subsequently discussed, a similar argument can be made for required and expanded use of emphasis of matter paragraphs in all audit reports as this alternative would necessitate that the *auditor* determine significant matters to highlight and reference where those matters are further disclosed by management in the financial statements.

[10] *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

whether and how to communicate it. As a consequence, Rule 10b-5 could then apply to auditors, as plaintiffs in private actions could allege the auditor directly or indirectly made an untrue statement of a material fact in connection with the purchase or sale of securities.

## III. Additional Practical Considerations

Setting aside disagreement on fundamentals, the Concept Release also does not appreciate the full range of practical implications from adding an AD&A requirement that go well beyond effects on the timing of the delivery of audit reports. For example, it seems unlikely that expressing auditor views on financial statement matters in an AD&A-type report could be the end of it. Investors and other third-parties would likely call for clarification, additional insights, and further explanations from auditors in order to understand the auditor's views and to help reconcile, as necessary, such views with those of management. Would auditors then need to issue press releases and hold conference calls to meet these demands for further information? Would SEC reviews by the Division of Corporation Finance come to involve reviewer comments addressed to auditors? Likewise, in putting the auditor in the position of being an original and competing source for financial information about the company, one can easily envision that an AD&A-type responsibility could create a material adverse interest with management and, therefore, raise questions about auditor independence under extant requirements.[11] And the list of problematic consequences goes on.

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[11] The Concept Release describes one rationale for an AD&A as being to "give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors" (p. 13). However, as previously discussed, this rationale involves transforming the role of the auditor vis-à-vis that of management and the board/audit committee. Additionally, the Concept Release fails to appreciate that under extant arrangements, the need for the financial statements to comply with GAAP to obtain an unqualified audit opinion provides auditors with powerful "leverage." Otherwise, extant auditing standards support the auditor's role in facilitating the operation of corporate governance mechanisms related to the quality of financial reporting, via requirements such as the one on auditor communications with audit committees about the "quality" of the company's accounting principles (within GAAP), in addition to their compliance with GAAP.

Other aspects of the AD&A alternative involve suggestions for an auditor narrative with information about the audit, including audit risks identified in the audit, audit procedures and results, and auditor independence. Regarding the latter, there is no indication in the Concept Release why current disclosures on auditor independence are inadequate, including proxy statement disclosures by audit committees. Indeed, it raises the question of whether investors participating in the PCAOB's outreach activities are even reading the information now available to them.

As to more information about the audit,[12] it is a difficult to envision how the auditor could condense all the work done on each engagement related to audit risks identified, audit procedures performed, and results obtained into a few sentences or even paragraphs. It is also a challenge to understand how any such condensation would be meaningful. PCAOB auditing standards, which are publicly available, provide the basis for performing audits. PCAOB inspections review the application of and adherence to such standards on individual engagements. The Concept Release does not make the case for why or how adding a reporting requirement for auditors to provide more details about their performance on each individual engagement would provide useful information to investors and other users.

Relatedly, the Concept Release is wanting when it comes to illustrating the alternatives. Illustrative examples that only contain placeholders for substantive information are unhelpful. The PCAOB should have developed substantive illustrations or even used field testing to assist in evaluating the usefulness and limitations of the various suggestions that emerged from their outreach activities *before* issuing a Concept Release.

[12] More information about the audit is also suggested under the alternative for required and expanded use of emphasis of matter paragraphs. For example, the Concept Release states that "under this alternative, the auditor also could be required to comment on key audit procedures performed pertaining the identified matters" (p. 20).

Otherwise, legal considerations and the need for audit firms to maintain consistency across engagements and over time preclude alternatives involving auditor narratives from being "free-writing" exercises. Before mandating AD&A or the expanded use of emphasis of matter paragraphs on all audits, criteria would need to be developed by the PCAOB (and audit firms would likely need to further refine such criteria). Even information currently part of internal communications among auditors, management, and boards/audit committees cannot be moved to the public arena without such criteria. For example, PCAOB auditing standards related to auditor communications with audit committees recognize that "objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting principles as applied in its financial statements" (AU 380.11).[13]

All things considered, rather than meaningful information, requirements for AD&A and the expanded use of emphasis of matter paragraphs on all audits appear more likely to add boilerplate to that already cluttering SEC filings. Boilerplate is the tip of the financial reporting complexity iceberg.

As we previously discussed, because of overly complex and detailed periodic reporting, CIFiR likewise heard that investors want to be told "what matters." However, after extensive deliberations, CIFiR did *not* recommend that auditors step-in to fill the breach; it did not recommend such things as an AD&A or required and expanded use of emphasis of matter paragraphs on all audits.[14] Rather, CIFiR recognized the importance

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[13] Moreover, altering the auditor's responsibilities to involve external disclosure of AD&A-type information would likely transform current relationships and interactions among auditors, management, and boards/audit committees to the detriment of audit quality.

[14] Members of CIFiR included investors and representatives of other financial statement users along with financial executives and board members, auditors, and securities lawyers. In addition, the chairman of the PCAOB was an official observer on CIFiR.

of the fundamental premise of financial reporting, as previously discussed. Thus, CIFiR recommended that *management* provide a short executive summary at the beginning of a company's annual report on Form 10-K (with material updates in quarterly reports on Form 10-Q). CIFiR suggested the summary describe concisely the most important themes or other significant matters with which management is primarily concerned, along with a page index showing where investors could find more detailed information on particular subjects (p. 3).

## IV. Additional Assurance Services

The Concept Release presents another alternative that would *require* auditors to provide assurance on information outside the financial statements such as MD&A (or portions thereof, such as critical accounting estimates), non-GAAP information, and/or earnings releases. Current PCAOB auditing standards describe the auditor's responsibilities regarding other information outside the financial statements in documents containing audited financial statements. These responsibilities include reading and considering whether such information or the manner of its presentation is materially inconsistent with the financial statements or represents a material misstatement of fact. The Concept Release fails to make the case for why this current arrangement is inadequate. Likewise, the Concept Release fails to identify the flaws in earnings releases that would be fixed with auditor assurances or how such assurances would otherwise be value-added in this context.

Moreover, extant PCAOB attest standards allow the auditor to be engaged to attest on MD&A and the standards provide requirements for such engagements. Yet, few if any public companies engage their auditors for this additional assurance service on MD&A. Further, CCMC is not aware of any instances where shareholders have requested a company to do so. The lack of any voluntary demand for additional assurance services is revealing and provides a basis for concluding that proposals to *mandate* such services fail cost/benefit considerations.

## V. Adding Clarifying Language to the Auditor's Report

The fourth alternative presented in the Concept Release would provide for adding clarifying language in the existing standard auditor's report. The Concept Release suggests that language around reasonable assurance, the auditor's responsibility for fraud, the auditor's responsibility for financial statement disclosures, management's responsibility for the preparation of the financial statements, the auditor's responsibility for information outside the financial statements, and auditor independence would be potential areas for clarification. These suggestions represent refinements to the current auditor's report and, overall, are not objectionable in concept, although it is hard to argue the need for all of them individually. For example, in regards to independence, currently the audit report is labeled as the "report of the independent registered public accounting firm" and, as previously noted, proxy statements provide disclosures on auditor independence. So, it is not clear why any further disclosures contemplated by the Concept Release would be useful information rather than added boilerplate.

## VI. Going Concern Reporting and Disclosures

At the PCAOB's open board meeting on June 21, 2011 to approve the Concept Release, one board member focused on going concern reporting by auditors. For example, the statement of Mr. Harris has an entire section on "Going Concern Opinions: A Rarely Used Tool." This is curious because the Concept Release is *silent* on this topic; and, it creates some confusion about the direction of this auditor reporting initiative.

Going concern is long recognized as an area in need of FASB attention. Although the financial statements are prepared on the assumption that the entity will continue as a going concern, auditing standards contain the only real guidance on going concern. More than a decade ago, the Final Report (August 31, 2000), of the Panel on Audit Effectiveness recommended that the FASB (1) define the going concern concept and clarify that management, not the auditor, has the primary responsibility to assess whether the entity has the ability to remain a going concern, (2) consider the appropriateness of the one-year time horizon in SAS No. 59 (i.e., the FASB should evaluate this time horizon and recognize its importance to auditors in framing their audit reports), and (3) promulgate explicit going concern disclosure requirements to fit various circumstances (pp. 61-62).

The FASB has had a going concern project on its agenda for a number of years now, but the FASB has yet to finalize any guidance in this area. If the PCAOB heard from its outreach activities in response to the 2008 economic crisis that this is an area of concern for investors, it would seem that this project should have provided a golden opportunity for the PCAOB board itself to become engaged in working with the FASB and SEC to overcome this perceived deficiency in GAAP and address other issues related to the auditability of GAAP.

## VII. Outreach, Transparency, and Cost/Benefit Considerations

Chairman Doty's statement at the PCAOB's open board meeting notes the "fluid" nature of feedback from the PCAOB's outreach activities on this project. However, this raises issues about the transparency of the PCAOB's outreach activities.

On one hand, the CCMC appreciates the extensive discussion of the feedback received by the PCAOB's staff from its outreach activities contained in the Concept Release, including Appendix C. On the other hand, the discussion is mostly confined to the alternatives pursued in the Concept Release rather than those considered but dropped along the way (e.g., going concern reporting).

In addition, it is difficult to interpret the information in the Concept Release because discussions with participants were private (no transcript is publicly available of the outreach discussions) and apparently informal (the PCAOB has provided no sample questionnaire or interview script).[15] Further, the Concept Release does not identify the number of participants in the PCAOB's outreach activities or list their names and organizations. And, while overall categories of participants are given, discussions of the various views, in particular those in Appendix C, mostly just combine all categories into "outreach participants," with only qualitative information on the degree of commonality in views noted by using terms such as "some" or "many" outreach participants.

The CCMC strongly agrees that the PCAOB should consult with and have access to a full range of perspectives among all users of financial statements. However, these activities need to have transparency. The CCMC appreciates that the PCAOB has included auditor reporting issues on the agendas at various public meetings of its advisory groups, including its Standing Advisory Group ("SAG") and IAG. Public roundtables are another mechanism for conducting public outreach with transparency and the PCAOB has announced plans to hold one or more roundtables in conjunction with this project. Nonetheless, as noted, the CCMC has

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[15] CCMC understands that the PCAOB includes the March 2011 Investor Advisory Group ("IAG") survey as part of its outreach activities and some details of participants in that survey are publicly available, including that IAG members themselves were among the survey participants.

concerns about the lack of transparency around many of the PCAOB's outreach activities that produced this Concept Release, which are consistent with concerns the CCMC has previously expressed about the transparency of the PCAOB's activities and due process generally.[16]

Finally, most of the reporting alternatives presented in the Concept Release would involve additional costs. Feedback from the PCAOB's investor outreach that informed the alternatives presented in the Concept Release appears to underplay the existence and significance of any additional costs. Indeed, in the main, it does not appear that cost/benefit considerations played a major role in the discussions with outreach participants.[17]

## Conclusion

In conclusion, the CCMC appreciates the opportunity to comment on the Concept Release. In closing, we would like to reiterate that the CCMC supports working to achieve one set of global high quality auditing standards through the convergence of PCAOB auditing standards with those of the AICPA's Auditing Standards Board ("ASB") and the International Auditing and Assurance Standards Board ("IAASB"). In this regard, CCMC notes that the Concept Release gives short shrift to activities by other audit standard-setters related to auditor reporting and fails to provide any comparison of relevant portions of PCAOB auditor reporting standards with those of the ASB and IAASB as part of considering improvements to PCAOB auditing standards. The CCMC

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[16] For example, see the October 7, 2009 letter from the U.S. Chamber of Commerce CCMC to the Honorable Daniel L. Goelzer, Acting Chairman of the PCAOB.

[17] For example, during discussions at the March 2011 IAG meeting, some IAG members dismissed cost concerns for AD&A with assertions that no additional audit work would be required as auditors would just be disclosing to investors information currently communicated with audit committees.

encourages the PCAOB to reconsider its "go it alone" approach to audit standard-setting.

Thank you for your consideration and the CCMC stands ready to assist in these efforts.

Sincerely,

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

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October 20, 2011

Mr. J. Gordon Seymour
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**Re: Request for Public Comment** ***on Concept Release on Auditor Independence and Audit Firm Rotation and Notice of Roundtable (PCAOB Release No. 2011-006, August 16, 2011, PCAOB Rulemaking Docket Matter No. 37)***

Dear Mr. Seymour:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.

The CCMC believes that businesses must have a strong system of internal controls, recognizes the vital role external audits play in capital formation, and appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB") *Concept Release on Auditor Independence and Audit Firm Rotation* ("Concept Release").

The CCMC has serious concerns about the Concept Release particularly the consideration of mandatory audit firm rotation. The premise for the Concept Release is not grounded in facts and therefore ill-conceived. Movement towards mandatory audit firm rotation will harm investors, endanger the competitive position of American public companies, degrade audit quality, and take a path that has, in the past, been explicitly rejected by Congress and the Securities and Exchange Commission ("SEC").

Additionally, the Concept Release is at odds with initiatives to reduce unnecessary and burdensome regulation as the economy struggles to recover from the recent recession and avoid another one.

Accordingly, the CCMC believes that the PCAOB should withdraw the Concept Release. The CCMC's concerns are outlined in more detail in the remainder of this letter.

## I. Discussion

The current form of audit practice and engagement is rooted in laws and regulations dating back to the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934 ("the 1933 and 1934 Securities Acts"). This structure has depended upon a private firm engagement with a public company to produce audited financial reports, under SEC supervision, to provide investors with decision useful information. An important feature of this structure has been the independence of auditors.

Since the passage of the 1933 and 1934 Securities Acts and the designation of the SEC as the arbiter of financial reporting in the United States, there have been periodic reviews of financial reporting structures with the implementation of reforms when needed.

In that context, mandatory audit firm rotation is in fact an old idea. More than three decades ago, mandatory rotation was considered and rejected by the Commission on Auditors' Responsibilities (the "Cohen Commission") as costly and with no net benefit to investors. The Cohen Commission stated that the lack of auditor familiarity with a client in the early years of engagement would cause more harm than benefit for investors.[1] The Cohen Commission concluded that the audit

[1] See *The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (1978), pp. 108-109. Curiously, in the end, the Concept Release acknowledges that mandatory audit firm rotation will end up lowing audit quality and then asks how to mitigate this effect (pp. 23-24).

committee is in the best position to evaluate audit effectiveness and decide if appropriate, to rotate audit firms. We believe that this conclusion remains true today.

In 1994, the SEC rejected the notion of mandatory firm rotation and stated that there was not a need for rules changes or legislation to further that goal.[2] Following significant financial reporting failures in the Enron and WorldCom incidents, Congress explicitly rejected mandated audit firm rotation instead choosing to mandate audit partner rotation and strengthening the role of audit committees in the debate and passage of the Sarbanes-Oxley Act of 2002 ("SOX").

So while Congress and the SEC have explicitly rejected audit firm rotation, in favor of other reforms, the threshold questions for the consideration of mandatory audit firm rotation are:

- What has changed to raise the issue again?
- What evidence exists to consider mandatory firm rotation?

The CCMC believes that the PCAOB has failed to provide answers to these questions and therefore also believes that the concept release should be withdrawn.

**a. Has Audit Regulation Failed?**

This is in fact the fundamental question that must be answered. To drastically change a structure that has been in place for 78 years would seemingly require pervasive financial reporting failures. Pervasive failures of this sort would require a close examination of the PCAOB's almost 10 year stewardship of audit regulation.

The Concept Release does not present any evidence of pervasive failures, and as will be discussed later, the failure to provide factual evidence is a fatal flaw in the consideration of the Concept Release.

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[2] SEC Office of the Chief Accountant, Staff Report on Auditor Independence (1994).

With this Concept Release, the PCAOB is advancing the proposition that the level of audit quality for public companies is somehow inadequate.[3] If the system is inadequate, the PCAOB must explain how the regulatory system failed. This alleged inadequacy is in spite of all the regulatory activities of the PCAOB and others, such as the SEC (including SEC rules on auditor independence), and the efforts of audit committees. Indeed facts are not presented to support the premise that the existing regulatory and governance structures fall short of the mark.

In establishing the PCAOB as regulator for audits of public companies, with oversight by the SEC, SOX gave the PCAOB multiple powers to maintain and improve audit quality through registration, inspection, standard-setting, and enforcement. An alleged inadequacy of audit systems, by inference, means that these powers have either not been used well or not used at all. Similarly, abdicating these powers in favor of the extreme move of mandating audit firm rotation is tantamount to the PCAOB throwing up its hands and stating that audit regulation cannot work.

This implication, embedded in the Concept Release, also extends to SOX mandated corporate governance structures. SOX gives audit committees the responsibility for the appointment, compensation, and oversight of the independent audit firm, along with responsibility for resolving any disagreements between management and the auditor regarding financial reporting.[4] While SOX gives the PCAOB jurisdiction over audit firms, it does not give the PCAOB authority over audit committees; instead, that responsibility rests with the SEC.

A reading of SOX demonstrates that a fundamental reordering of the audit committee responsibilities and actions would have to emanate from the SEC and not the PCAOB. Mandating a set period for changing audit firms— which would preclude both longer and shorter periods (at least without regulatory consent of some form)— deprives audit committees of discretion and judgment, contravenes SOX and

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[3] Advancing this proposition is curious considering that the Concept Release states that, based on its experience conducting inspections, the Board believes public company audit quality has improved post-SOX under the PCAOB (pp. 15).
[4] In addition, many public companies now require shareholder voting to ratify the retention of the audit firm recommended by the audit committee.

audit committee responsibilities for audit firm selection, and otherwise constrains and unduly complicates the work of audit committees.

It appears, therefore, that the PCAOB has failed to provide a case for moving forward and may have overstepped its authority in emasculating SOX governance mandates.

If the PCAOB is concerned about improving the level of audit quality, it would be better served to present evidence as to the nature of the problem and focus its efforts on improving its standard-setting and inspection activities in response to any such problem. For example, the CCMC notes that the PCAOB auditing and quality control standards have not been substantially changed from those applicable on public company audits pre-SOX. Concept Releases, such as this one, distract stakeholders and divert the PCAOB board and staffs focus from these other standard-setting activities that may benefit investors and the marketplace.

**b. Evidence Lacking to Support Mandatory Rotation**

The PCAOB has failed to provide evidence to issue this Concept Release or move forward with a roundtable. The PCAOB does not provide any evidence from its own activities, including from its inspection process, that audit firm tenure is an issue. Indeed, the PCAOB admits that it has no evidence from its inspection process that audit firm tenure has any systematic relationship with inspection deficiencies. To overcome this fatal flaw, the PCAOB attempts to equate Part I inspection deficiencies to audit failures, although the Concept Release acknowledges that the use of the term "audit failure" describes a situation of not obtaining (or not documenting the evidence to support) the reasonable assurance that a financial statement is free of material misstatement. It does not mean that a financial statement is in fact materially misstated.[5]

So an "audit failure" as used in the concept release is actually not a failure per se regarding the accuracy of financial reports, but rather the identification of what the PCAOB determines to be a deficiency in the process of an audit, which itself may

[5] Concept Release (pp. 5)

involve a difference of professional views as to what constitutes appropriate evidence to support reasonable assurance.

To overcome this Catch 22, the Concept Release argues that mandatory audit firm rotation will promote auditor objectivity and professional skepticism. The Concept Release only offers anecdotal evidence from PCAOB inspections that auditor skepticism is a problem. However, it is unclear that the anecdotes provided in the Concept Release even involve a lack of skepticism. It is also unclear that mandatory audit firm rotation would provide a solution to any such "skepticism problems."[6] Indeed, the PCAOB admits that the Concept Release is not based on any "root cause" analysis of its inspection findings. In fact the PCAOB readily admits that it needs to deepen its understanding of the "root causes".[7] Thus, the PCAOB offers no persuasive evidence, from its own activities, linking auditor tenure with a lack of professional skepticism that, in turn, would be mitigated by mandatory audit firm rotation.

The Concept Release is also flawed in failing to fully appreciate the nature of professional skepticism. Skepticism involves both a mindset and a critical evaluation of audit evidence with two critical components –objectivity and expertise. Distinguishing between these two components of skepticism is essential. The Concept Release admits that the instances offered from inspections as indicative of a lack of skepticism could, instead, involve issues related to technical competence or experience (i.e., expertise not objectivity). But, the Concept Release then fails to appreciate that expertise (not objectivity) as the essential issue in fact undermines any arguments presented for mandatory audit firm rotation. Mandatory audit firm rotation is widely recognized as creating expertise concerns, especially in the earlier years of auditor tenure. Thus, mandatory audit firm rotation would have the effect of exacerbating (not mitigating) the "skepticism problems" used by the PCAOB to motivate the Concept Release.

Additionally, the Concept Release posits that mandatory audit firm rotation would improve auditor skepticism because "an auditor that knows its work will be scrutinized at some point by a competitor may have an increased incentive to ensure

[6] Ibid (pp. 7).
[7] Ibid (pp. 6).

that the audit is done correctly."[8] However, this argument requires the assumption that scrutiny provided by audit committee interactions and oversight; by new lead and concurring audit partners under the SEC's rules implementing SOX for mandatory partner rotation; by audit firm quality control processes, programs, and procedures (such as the multiple formal reviews by other members of the engagement team, including reviews by the lead and quality review partners, an engagement team's consideration of prior year audit work during audits in subsequent periods, audit firm internal inspection programs, national office interactions etc.); and by PCAOB inspections (and the deterrence effects of regulatory enforcement and private litigation) somehow do not offer adequate incentives.

Inchoate potentialities of skepticism combined with a lack of understanding of root causes do not meet the minimal thresholds of issuing a Concept Release or moving forward in consideration of it. By that token, as an example, anecdotal musings by the SEC, of ethical lapses by attorneys would not pass muster for regulatory action requiring law firm rotation by companies.

From the standpoint of evidence on the implications of auditor tenure, it is also important to recognize that the weight of the evidence from academic research does ***not*** support the implementation of mandatory audit firm rotation. Indeed, a recent review of the research literature finds that the evidence suggests several attributes of audit quality improve as auditor tenure increases.[9] Further, research on fraud by a member of both the PCAOB's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG") finds that fraudulent financial reporting is more likely to occur in the first three years of the audit-client relationship and fails to find any evidence that fraudulent financial reporting is more likely given long auditor tenure. Similar to other studies, this study concludes that the results are consistent with the

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[8] Ibid (pp. 17).

[9] For a review of academic research on mandatory audit firm rotation see "The Causes and Consequences of Auditor Switching: A Review of the Literature" by C. Stefaniak, J. Robertson, and R. Houston in *Journal of Accounting Literature* (Gainesville: 2009) Vol. 28: 47-122. The study acknowledges some evidence indicates that mandatory auditor rotation might improve audit quality in certain situations, although not without costs. Thus, even this evidence does not suggest convincingly that the benefits of mandatory auditor rotation will exceed its overall costs.

argument that mandatory audit firm rotation could have adverse effects on audit quality.[10]

The Concept Release attempts to dismiss dissenting evidence from academic research, in part, by arguing that skepticism is "unobservable," and therefore not susceptible to empirical study. This argument is circular reasoning at best. The academic literature is quite robust and the relevant evidence is obtained using multiple approaches and measures. The weight of the evidence is consistent with a lack of familiarity in early years as a problem, not over familiarity in later years. The Concept Release fails to rebut established research.

In addition, the Concept Release attempts to broadly dismiss all research evidence, nonconforming to the notion of mandatory audit firm rotation, as irrelevant because most of it is not based on a regime of mandatory audit firm rotation. According to the Concept Release, a limitation of the academic studies is that they "tend to focus on environments where auditor rotation is voluntary rather than mandatory." And, "voluntary rotation may be associated with auditor-issuer disagreements, other financial reporting, or economic issues."[11]

This argument fails to acknowledge that voluntary auditor changes involve disclosures and communications that should reveal potential problems to successor auditors (and investors) reducing the likelihood of subsequent audit failures. For the PCAOB to broadly dismiss the evidence begs the question of why the required communications and disclosures were somehow inadequate and contributed to audit failures after changes in auditors. This problem, if it exists, is one that the PCAOB can and should do something about rather than focusing on mandatory audit firm rotation.

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[10] For example, see "Audit Firm Tenure and Fraudulent Financial Reporting" by J. Carcello and A. Nagy in *Auditing: A Journal of Practice & Theory* (Sarasota: September 2004) Vol. 23 (2): 55- 70. Also, see two monographs in 1999 and 2010 from the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") using SEC Accounting and Auditing Enforcement Actions during 1987-1999 and 1998-2007 as a proxy for fraudulent financial reporting. The latter, *Fraudulent Financial Reporting 1999-2007* by M. Beasley, J. Carcello, D. Hermanson, and T. Neal, reported that 26% of fraud companies switched auditors between the issuance of the last clean financial statements and the last set of fraudulently misstated financial statements, as compared to 12% of no-fraud firms during the same time period (p. 37).

[11] Concept Release (pp. 16).

Finally, the CCMC is concerned about another way the Concept Release overreaches for evidence to support mandatory audit firm rotation. As stated earlier, an "audit failure" as argued by the PCAOB is in fact not an audit failure.

The PCAOB's misleading use of the term is evidenced by its comparison to the definition employed by the GAO in its 2003 surveys ("GAO Report") and report to Congress on the mandatory audit firm rotation concept. The GAO report defined the term as follows:

> ***"audit failure"*** *refers to audits for which audited financial statements filed with the SEC contained material misstatements whether due to errors or fraud, and reasonable third parties with knowledge of the relevant facts and circumstances would have concluded that the audit was not conducted in accordance with GAAS, and, therefore, the auditor failed to appropriately detect and/or deal with known material misstatements by (1) ensuring that appropriate adjustments, related disclosures, and other changes were made to the financial statements to prevent them from being materially misstated, (2) modifying the auditor's opinion on the financial statements if appropriate adjustments and other changes were not made, or (3) if warranted, resigning as the public company's auditor of record and reporting the reason for the resignation to the SEC.*[12]

Contrary to such an accepted definition, the Concept Release mischaracterizes findings in Part I of the PCAOB's inspection reports as audit failures. In turn, the PCAOB uses these audit failures as a "call to action." Yet, as the PCAOB well knows, the vast majority of inspection findings are not audit failures. For example, very few PCAOB inspection findings have given rise to restatements.

Instead, many of the findings described in Part I of the PCAOB's inspection reports involve differences of opinion between PCAOB inspectors and auditors over judgments on documentation and evidence acquisition. Frankly, a number of Part I inspection findings can be characterized as PCAOB inspectors' judgments that differ from auditors' judgments on managements' judgments. They are not audit failures. It is both misleading and unworthy of an audit regulator to characterize them as such to buttress a Concept Release.

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[12] GAO 04-217 *Public Accounting Firms Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (2003) (pp. 6).

**c. CIFiR Recommendations**

Further, to improve audit quality related to auditor judgments, the CCMC has urged the PCAOB to adopt the recommendation of the SEC's Advisory Committee on Improvements to Financial Reporting (CIFiR).[13] In 2008, CIFiR recommended that the PCAOB develop and articulate guidance related to how the PCAOB inspections and enforcement divisions would evaluate the reasonableness of judgments made based on auditing standards. CIFiR also recommended that the PCAOB's statement of policy should acknowledge that the PCAOB would look to the SEC to the extent that the PCAOB would be evaluating the appropriateness of accounting judgments as part of an auditor's compliance with PCAOB auditing standards.

CIFiR also recommended that the concept of materiality be used as a determinative factor if mistakes in financial statements should trigger a restatement or simply further disclosure for investors. While the CIFiR recommendations were made in 2008, they still have not been acted upon.

**d. Mandatory Audit Firm Rotation Would Be Costly and Disruptive to the Markets**

As a supporter of effective audits, the CCMC believes a cost-benefit analysis is one effective approach to improving audit quality. In light of the weight of the academic research debunking mandatory audit firm rotation, it would seem that there is no net benefit for investors in moving forward in the consideration of the Concept Release.

As discussed earlier, mandatory audit firm rotation would be extremely costly and disruptive to the U.S. capital markets, harmful to investors and have far reaching negative consequences. The Concept Release acknowledges that mandatory audit firm rotation would disrupt markets and increase audit costs.[14] Likewise, the costs

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[13] For example, see letter to the PCAOB from the U.S. Chamber CCMC on *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 34).

[14] Concept Release (pp. 3).

and disruptions arise from many sources and are largely unexplored in the Concept Release. Disruptions would extend to capital formation activities including initial public offerings and mergers and acquisitions. Mandatory audit firm rotation makes auditor choice and change a much more complicated proposition for companies and audit firms with interdependencies beyond the control of any particular party. Indeed, it is possible that overlaying mandatory audit firm rotation on top of all the many existing restrictions on audit choice would leave some large global companies without any available, eligible, requisite audit firm.

That would be a disaster for investors, companies, and capital formation with direct negative consequences for economic growth and job creation.

The Concept Release does note that the GAO Report includes an estimate that initial year audit costs—which includes costs beyond the audit fee itself— would increase by more than 20 percent with mandatory audit firm rotation.[15] However, this estimate was made before integrated audits of both the financial statements and internal control over financial reporting. It is likely that those costs would be higher today, in light of the additional reporting requirements imposed by post SOX legislation and regulations including the Dodd-Frank Wall Street Reform and Consumer Protection Act. Also, as stated earlier, research shows that there is an increase in costs and fraud potential during the first three years of a new auditor engagement.

Increases in costs associated with the audit process and potential fraud are just the tip of iceberg. For example, mandatory audit firm rotation would require company personnel and board/audit committee members to devote significantly more time and effort to the external audit function and activities in order to obtain the same results as now.

The Concept Release argues for overlaying mandatory audit firm rotation on top of the existing audit regulatory and governance structures that are already far-reaching and complex. However, the Concept Release provides no analysis of how mandatory audit firm rotation would even work under and interact with the existing structures.

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[15] Ibid (pp. 14).

As just one example, the Concept Release provides no analysis of the implications of overlaying mandatory auditor rotation on top of a very rules-based system of auditor independence. The rules include the more visible ones that implement SOX provisions precluding certain non-audit services to audit clients and mandating audit partner rotation. Yet, there are many other less visible SEC and PCAOB independence rules that impact the hiring and retention of the audit firm and other accounting firms for non-audit services, as well as the hiring and retention of management, employees, and board members, too. As a result there are likely to be many companies, including those with large global operations, which will find themselves in the position of not being able to use any large audit firm as their external auditor.

An added complication is that audit firms are not fungible. As just one example, audit firms have differences in industry experience and expertise. Some firms have developed industry specializations. But, not even the larger audit firms specialize in all industries. It is not just a matter of severely altering and limiting audit firm choice from a company perspective. Mandatory rotation changes the ability of audit firms to develop and maintain expertise and complicates audit firm staff planning and allocation decisions, including geographically—all to the potential detriment of audit quality.

The Concept Release suggests that the PCAOB might consider precluding voluntary audit firm changes unless such changes are "for cause."[16] This is an untenable constraint on audit committees in their engagement of auditors and oversight of the audits. It naturally raises the question of what represents "for cause" and who decides. However, another problem is that preventing audit committees from dismissing an auditor at their discretion in this way actually reduces the amount of useful information available to investors. Voluntary auditor changes are informative to investors and other stakeholders in financial reporting. Eliminating this source of information by mandating audit firm rotation does not make investors better off.

Similarly, it should be noted that Congress, during the Dodd-Frank debates, considered and ultimately rejected a system whereby the SEC would assign credit

[16] Ibid (pp. 23-24)

rating agencies to review companies or products. It would seem incongruous for the PCAOB then to consider a mechanism whereby it could either assign or withdraw a firm from engagement, again depriving the audit committee of its discretion and judgment.

The Concept Release asks for feedback on the PCAOB imposing mandatory audit firm rotation on some subset of public companies. For example, the Concept Release suggests the possibility of the PCAOB requiring mandatory audit firm rotation for the largest issuer audits, or audits of companies in certain industries.[17] But, the largest issuers are those where the problems with mandatory audit firm rotation would be most pronounced. Focusing on large issuers and companies in certain industries seems pointed towards large systemic risk institutions.

Given all the problems with mandatory audit firm rotation, mandating it for this subset would be akin to heightening systemic risk into the capital markets for systemically risky institutions. If this is the case, the management of systemic risk is left to the prudential regulators and the Financial Stability Oversight Council ("FSOC").

It seems that the Concept release is totally devoid of any consideration of the need of a cost benefit analysis. PCAOB standards must go through the SEC rulemaking process to be approved. The SEC must perform a cost benefit analysis in order to pass the appropriate legal muster in promulgating a regulation, *Business Roundtable & U.S. Chamber of Commerce v. Securities and Exchange Commission*. The SEC has also that it will comply with the Presidential Executive Orders 13563 and 13579 on regulatory reform.[18] These Executive Orders require an agency to choose the least burdensome means of imposing a regulation.

Therefore, it would seem prudent for these cost benefit issues to be addressed early in the process.

**e. PCAOB Lacks Authority for Mandating Audit Firm Rotation**

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[17] Ibid (pp. 3 and 21).

[18] See October 6, 2011 letter from U.S. Chamber of Commerce to the Securities and Exchange Commission on the process enhancements needed to comply with the Executive Orders.

As was noted earlier, the CCMC believes that SOX provides the SEC and not the PCAOB with authority over the operation of the audit committee.

The CCMC is concerned that mandating audit firm rotation exceeds the authority of the PCAOB. The CCMC appreciates that the Concept Release frames mandatory audit firm rotation as related to auditor independence and that auditor independence rulemaking falls within the purview of the PCAOB. However, this appears to be more of a convenience of form. In substance, mandatory audit firm rotation, including proscriptions on voluntary auditor change, would contravene audit committee responsibilities under SOX. Mandatory audit firm rotation would directly affect issuers and the status of issuer filings, which are under the purview of the SEC. As such, any requirements in this regard would need to be addressed by the SEC through Commission rulemaking and the SEC's due process.[19]

Finally, the CCMC is concerned that the Concept Release discusses the benefits of mandatory audit firm rotation "as a catalyst to introduce more dynamism and capacity into the audit market" as argued by the European Commission "Green Paper."[20] [21] The Concept Release goes on to explain that "if the largest firms were periodically displaced from their positions auditing the largest companies, more firms might develop additional capacity and expertise in order to compete for those engagements. If so, auditor choice would be increased."[22] Not only is this speculative, but it does not recognize the long timeframe over which any such emergence might occur or appreciate the severe discontinuities that would be encountered during the emergence process. More importantly, promoting competition is *not* the mission of the PCAOB. The PCAOB's mission focuses on maintaining and improving audit quality. Needless to say, the Concept Release does not further this mission either.

## I. Conclusion

[19] It is inadequate to argue that the SEC must approve any rule adopted by the PCAOB before it can go into effect. The SEC rulemaking process is subject to requirements, including those related to transparency and cost-benefit analysis, which the PCAOB is not. Also, the Commission has delegated authority for approving certain PCAOB rules and standards to the Office of the Chief Accountant, where Commission action is required for SEC rulemaking.
[20] European Commission, *Audit Policy: Lessons from the Crisis* (October 2010).
[21] See also December 7, 2010 letter from the U.S. Chamber of Commerce to the European Commission with comments on the Green Paper.
[22] Concept Release (pp. 21).

The CCMC has serious concerns that the Concept Release will harm investors, adversely impact the competitiveness of American public companies and degrade audits in general. While we believe that improvements can be made to financial reporting, suggestions, ideas, and debates must be based upon hard facts, analysis and not on anecdotal information. The PCAOB is almost 10 years old and it is responsible for the system it has overseen, it is not a bystander that can simply opine pronouncements.

Public companies not only compete for capital internationally, but also against other conduits for investment return. The other competitors for capital include private equity, hedge funds, angel investing, venture capital, and debt instruments to name a few. Each of these venues of capital formation has its place and this variety is necessary for a fully functioning 21st century economy. However, the sharp amount of de-listings indicate that public companies are not able to compete for capital as they once did and there is an adverse economic consequence for us all as a result. The notion of mandatory audit firm rotation will not stem that tide, it will only exacerbate it.

The PCAOB has failed to answer questions or presented factual evidence that would justify the issuance of the Concept Release. As we should all work together to provide a sound basis for a strong capital market system that must create the 20 million jobs needed to recover economically and restore prosperity, this is the wrong idea at the wrong time and it should not only be rejected, it should be withdrawn.

Sincerely,

Tom Quaadman

UNION

December 9, 2013

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

RE: PCAOB Rulemaking Docket Matter No. 34, Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Union First Market Bankshares, Corporation (Union) appreciates the opportunity to comment on the exposure draft, Public Company Accounting Oversight Board (PCAOB) Rulemaking Docket Matter No. 34, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* (Docket Matter 34). Docket Matter 34 significantly expands the auditor's report, disclosing factual elements regarding the auditor as well as a discussion of critical audit matters (CAMs) specific to the audit. This exposure draft also addresses auditor responsibility and reporting over other information included with the audited financial statements.

We believe that level of detail required by Docket Matter 34 (assuming an unqualified opinion) adds specific information that may confuse a reader as to the nature of the opinion rendered.

The matters identified as CAMS are currently required to be addressed in the auditor's report, specifically regarding internal controls over financial reporting, Sarbanes-Oxley Act of 2002 (SOx). If a matter arose during the audit that reached the level of a material weakness (as defined by the Committee of Sponsoring Organizations – Treadway Commission), the auditor would be required to discuss any ramifications in detail, in an emphasis paragraph. If a matter does not rise to a level that impacts the audit, the inclusion required under Docket Matter 34 would add little to no value for the reader.

Information specific to the auditor should not be included as part of the report. These details: years of service, partner's name, independence under PCAOB and Securities and Exchange Commission (SEC) Rules, can be included in the issuer's proxy or Management Discussion and Analysis. The SEC could also expand the Audit Committee's report section of the proxy to include these facts, possibly as part of the consideration for the ratification of the auditor's election. Under Docket Matter 34, this other information would be included in the new report.

Financial statements remain the responsibility of the issuer. Since the financial statements, by definition, include the notes to the financial statements, expanding a reference to the notes within the report appears redundant. The notes, under the current system receive the identical scrutiny as the financial statements themselves.

References to fraud in the auditor's report, while basically the same as those included in the required communication to the audit committee, might unnecessarily alarm the reader. Inclusion serves no understandable benefit.



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The auditor's report may benefit from a disclosure regarding responsibility over "Other Information", as defined by Docket Matter 34, regardless of the proposed new standard. Docket Matter 34's proposed enhancement of the auditor's responsibility, with respect to other information, will necessarily compress already accelerated timelines for SEC filings and increase costs. The current standard seems to have few flaws and the correct level of scrutiny. It is unclear as to the value added in the requirement of an opinion audit of the other information.

The PCAOB has asked for a discussion of the prospective costs associated with the implementation of the new standard. This is very difficult to estimate, especially as it relates to the additional responsibilities added regarding other information. In discussions with our auditor we collectively estimated an approximate 15% to 20% increase in the audit fee, if Docket Matter 34 is implemented in its entirety. In the world of financial institutions, regulatory burden has become onerous. The weight of many compliance related costs, in concert with compressed margins, has already resulted in the resetting of investor expectations industry wide. The value does not appear to outweigh the cost.

SOx, in concert with other SEC Rules, have placed the oversight of the financial statements, and quality of financial reporting, squarely on the Chief Executive Officer, the Chief Financial Officer and the Audit Committee. We believe this responsibility is taken seriously. Accountability under SOx has proven effective. In today's complex regulatory environment, additional disclosures are simply unnecessary.

Union is a $4 billion single bank holding company, headquartered in Richmond, Virginia. Our 1,200 employees serve a wide variety of small to medium sized companies with an array of loan and treasury management products. In early 2014, Union will acquire StellarOne Corporation, becoming a $7 billion financial holding company.

Thank you very much for soliciting our comments.

Sincerely,

Patrick J. McCann
Chairman, Audit Committee

UNITED CONTINENTAL HOLDINGS, INC.

December 6, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034

Thank you for the opportunity to comment on the two new proposed auditing standards, *"The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion"* and *"The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report."*

As the Audit Committee Chairman of United Continental Holdings, Inc. ("UCH" or the "Company"), my views on the proposed audit standards are based on numerous meetings with audit committee members of other companies, representatives of the Securities and Exchange Commission, analysts from Wall Street investments banks, and some of the PCAOB Board members. I believe these interactions provide me with a comprehensive understanding of what is important to the users of UCH's financial statements.

**Critical Audit Matters**

In light of my experiences, I question the necessity of the Board's new proposed rules that would require the auditor to report on critical audit matters ("CAMs").

First, I strongly believe that the PCAOB Board needs to demonstrate (through field testing) how the communication of CAMs will benefit the users of UCH's financial statements. What is important to an auditor in conducting an audit may not align with what is important to investors. The main feedback the Company gets from investors and Wall Street analysts is to increase the disclosure of the type of information that will assist with modeling future financial results. Investors who make buy/sell decisions are uncertain about how CAMs would enhance their analysis without clear discussion. The belief that auditors will be able to adequately summarize extremely complex audit matters in a manner that is useful to a diverse set of constituents in a cost-beneficial basis is therefore dubious.

Second, proposed rules on critical audit matters would result in disclosures of information that are already disclosed by management to the extent there is close alignment to CAMs and management's critical accounting policies (which we believe there will be). There is a risk that the description of CAMs will be inconsistent with or perceived to be inconsistent with management's disclosures about similar issues. This lack of consistency between CAMs and management's disclosures will create confusion for readers of the financial statements.

Third, the proposed rule could potentially result in disclosure of information that is currently not required to be disclosed by management (for example, control deficiencies that are not material weaknesses and immaterial misstatements that are either unrecorded or recorded during the period). We believe it is inappropriate for the auditor to disclose information in management's financial statements that has not been disclosed by management, or for which no current disclosure requirements exist. We believe such a situation is contrary to maintaining the company's responsibility for the financial statements and the auditor's responsibility for providing an opinion on those financial statements.

Fourth, as a practical matter, a requirement to disclose critical audit matters has the potential to significantly alter the collaborative nature of the relationship between a public company and its independent auditor. As proposed by the Board, matters disclosed by the independent auditors and the audit committee are subject to consideration as to inclusion as a CAM. Company representatives will likely approach discussions with the auditors with the disclosure obligation in mind, which may impact the manner in which they share information about matters including critical audit matters and misstatements.

Finally, and perhaps most importantly, there is not enough objective criteria established around the definition and disclosure of CAMs to ensure consistency in their identification and disclosure, which will invite the inevitable comparison among peer companies. We believe there will be a tendency amongst users of the financial statements to compare the number and content of CAMs across companies in similar industries. Companies in the same industry could vary widely in their disclosure of CAMs simply by virtue of how their auditor interprets the proposed requirements. For example, if the nature and/or number of CAMs identified by our auditor differs from those of our peers, investors could come to several conclusions that may be neither true nor useful, such as a) we have additional complexity and/or risk in our financial statements compared to our peers or b) the audit of a peer that identified fewer CAMs than us may have been less diligent than our audit.

**Auditor's Responsibility for and the Evaluation of Other Information**

The proposal would require our auditors to read and evaluate other information in certain documents containing audited financial information. We believe that the proposed rule does adequately describe what is intended by the term "evaluate" with respect to the level of work required. In addition, we believe that the term "evaluate" may imply a higher level of effort regarding the other information than under current standards. Given the significant amount of other information that may accompany audited financial information, increasing the extent of audit effort on such information may increase the costs to companies significantly. The Company is also concerned about the potential time pressures and delays that could result from adding additional auditor time needed to review this information.

**Summary**

The Board decided not to pursue an Auditor's Discussion and Analysis ("AD&A") because it could (1) change the auditors role from that of providing attestation on financial statements to providing a qualitative analysis, (2) potentially expose investors to competing information from both the company and the auditor, which could complicate understanding of the financial statements , (3) diminish the governance role the audit committee has over the financial statements, and (4) add time pressures due

UNITED CONTINENTAL HOLDINGS, INC.

to the effort needed to develop a free-form AD&A report. I recommend the PCAOB Board not enact the proposed auditing standards for these same reasons and due to the lack of alignment between these rules and the objective outcome of better information for investors. I also do not believe changing the requirement for the auditor to read and evaluate other information is justified at this time. The cost-benefit of these rules is not evident and should be reconsidered if the Board continues to pursue the proposed standards.

Thank you for the opportunity to express my concerns. If you have any questions for me, I can be reached at (904) 359-1329.

Sincerely,

Oscar Munoz

Chairman of Audit Committee and board member
United Continental Holdings, Inc.

Cc: Jeff Smisek
Chairman of the Board, President and CEO
United Continental Holdings, Inc.

Carolyn Corvi
L.E. Simmons
David Vitale
John Walker
Audit Committee member
United Continental Holdings, Inc.

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

December 11, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
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Subject: *PCAOB Rulemaking Docket Matter No. 034: PCAOB Release No. 2013-005: Proposed Auditing Standard Related to the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

This letter provides the U.S. Government Accountability Office's (GAO) comments on the Public Company Accounting Oversight Board's (PCAOB) exposure draft.

We support efforts to improve the quality of financial reporting and increase the confidence users have in the audit of financial statements. However, we do not believe that certain of the proposed enhancements to the auditor's report, such as reporting critical audit matters, will enhance the perceived value of the financial statement audit or add value to the users of the financial statements. However, if the PCAOB nevertheless determines that it is appropriate to require reporting of critical audit matters, we encourage the PCAOB to work closely with other standard setters, such as the International Auditing and Assurance Standards Board (IAASB) and the Auditing Standards Board, to ensure a consistency of practice by harmonizing their standards on reporting critical audit matters, absent any compelling reasons that would require different practice. For example, the standard setters should determine thresholds or other guidance that facilitates the consistent reporting of critical audit matters.

**Requests for Specific Comments**

The PCAOB is seeking comments on a number of areas in the proposed standards. We have provided discussion on the areas listed in the exposure draft below. Our responses to specific questions in appendixes 5 and 6 of the exposure draft are included in the enclosure to this letter.

<u>Critical Audit Matters</u>

We do not support the requirement for a new section in the auditor's report describing matters the auditor determines to have posed the most difficulty during the audit (critical audit matters), and believe that this requirement will not enhance the usefulness of the auditor's report or add value to the users. We believe that, in practice, such requirements will result in entities reporting the substance of critical audit matters in the notes to the financial statements, to the extent they are not already included, and the inclusion of this information in the audit report would add little value to the users. We are also concerned that the incentives for consistent reporting of critical audit matters across entities would likely lead to "boilerplate" reporting language for each type of critical audit matter. Further, such a requirement may increase the risk of blurring the roles between entity management and the auditor, as it requires the auditor to comment on elements that are generally management's responsibility to discuss or disclose.

We are also concerned about the application of the requirement for reporting matters that posed the "most" difficulty to auditors as critical audit matters. Certain matters, while posing the most difficulty to the auditor, may be less significant to financial statement users and the requirement may lead to the reporting of an extensive discussion of matters unimportant to financial statement users.

In addition, the connotation of "critical" may lead users to believe that these matters necessarily could affect the entity's ability to be a going concern, instead of matters that the auditor determines should be disclosed to help the users focus on aspects of the company's financial statements that the auditor found to be challenging. The IAASB uses "Key Audit Matters", and we encourage the PCAOB, if moving forward with a requirement to report such matters, to harmonize its term with that of the IAASB unless there is a compelling reason for a different term.

Further, while we believe that the auditors should document significant audit matters in the audit documentation as required by current standards, we do not support the need for a separate documentation requirement solely based on critical audit matters. We also do not support a requirement for the auditor to disclose audit procedures performed in the critical audit matters section of the audit report as it will add little value to the users of the financial statements and may create unwieldy reports.

We believe that if a requirement is kept for statements from the auditor regarding critical audit matters, the auditor's communication of such matters should be limited to the audit of the most recent financial period when comparative financial information is presented. We also encourage the PCAOB to provide further guidance as to what should be considered a "critical audit matter". For example, this guidance could include information on the thresholds for determining whether a matter is a critical audit matter, as the proposed standard allows for the auditor to determine that there are no critical audit matters and could result in situation where the most difficult audit issues may nevertheless be unimportant with respect to the entity.

Finally, we do not support the proposed requirement to include a statement related to auditor independence in the auditor's report. We question whether such additional disclosures would benefit users; for example, the user may already be aware of auditor independence requirements or, if not, the user may have difficulty in understanding the concept of independence without extensive discussions in the auditor's report. We also do not agree with the inclusion of the tenure of the auditor on the engagement and question what value this information would provide to users of the financial statements. We are concerned that including this information could lead to incorrect interpretations about the entity, its current fiscal situation, and the auditor. Information about tenure may be relevant information to disclose in the proxy statement, as that document is more closely aligned with decisions concerning auditor selection.

<u>Auditor's Responsibility for Other Information</u>

While we agree that expanding the auditor's responsibility for other information has merit, we are concerned about the requirement in paragraph 3 of the proposed standard regarding material misstatements of fact. We believe that the identification of any material misstatements of fact should be based solely on the procedures in paragraph 4 of the proposed standard. However, we are concerned that the current proposed standard is unclear as to whether the auditor would be required to identify material misstatements of fact, beyond those that would be identified through performing the procedures described in paragraph 4 of the proposed standard. We believe it is important that this requirement be clearly stated to avoid confusion in its application

Further, we note that certain types of other information could be subsequently changed without the knowledge of the auditor, particularly those that are not incorporated into the same document as the financial statements. We also note that it will be challenging to convey to users of the auditor’s report that some of the other information reviewed by the auditor could be subject to change or revision, especially if presented in filings other than the annual report. However, we believe that auditors may be able to report that they evaluated other information as of a certain date, and that they would have no control over any subsequent changes to other information.

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We thank you for considering our comments on these important issues as the PCAOB continues its effort to enhance the value of auditor reporting.

James R. Dalkin
Director
Financial Management and Assurance

Enclosure

**Enclosure – Answers to Questions**

**Appendix 5**

1. **Do the objectives assist the auditor in understanding the requirements of what would be communicated in an auditor's unqualified report? Why or why not?**

We agree that the first objective assists the auditor in understanding the requirements of what would be communicated. Although the second objective may be clear as stated, we do not believe that the reporting of critical audit matters will add value for the users of the financial statements for the reasons stated in our letter.

2. **The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?**

The current standard is sufficient in this area.

3. **The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the PCAOB's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?**

We agree with the revisions to the description of the nature of an audit and do not suggest additional responsibilities be included.

4. **The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?**

We do not support the proposed requirement to include a statement related to auditor independence in the auditor's report, and we question whether such additional disclosures would benefit the users. For example, the user may be already aware of auditor independence requirements or, if not, the user may have difficulty understanding the concept of independence without extensive discussions in the auditor's report.

5. **The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.**

    a. **Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?**
    b. **Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?**
    c. **Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?**

We do not support the inclusion of the tenure of the auditor on the engagement and question what value this information would provide to the user of the financial statements. We are concerned that including this information could lead to incorrect interpretations about the entity, its current fiscal situation, and the auditor. Information about tenure may be relevant information to disclose in the proxy statement, as that document is more closely aligned with decisions concerning auditor selection.

**6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

We agree with the proposed description.

**7. Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?**

We believe the PCAOB should require a specific order for basic elements required in an auditor's report to promote consistency among auditors' reports.

**8. What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?**

We do not note any other necessary changes, unless additional changes would be required to enhance consistency with the standards of other standard setters.

**9. What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.**

The proposed changes to the basic elements would not appear to significantly affect audit costs.

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

We do not believe the introduction of a critical audit matters section would enhance the usefulness of the auditor's report and may make it more difficult for users to read and understand the audit report. We believe that in practice, such requirements will result in entities reporting the substance of critical audit matters in the notes to the financial statements, to the extent they are not already included, and the inclusion of this information in the audit report would add little value to the users. Also, we are concerned that incentives for consistent reporting of similar matters across entities would likely lead to "boilerplate" report language for each potential type of critical audit matter. Finally, we are concerned that the connotation of the word "critical" may lead users of the financial statements to misinterpret the purpose of the disclosure of such matters.

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

Please see our response to question 10.

**12. Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statements users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?**

The definition of critical audit matters should be clearer. As proposed, it could lead to an inconsistency in the practice of critical audit matter reporting.

**13. Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?**

We believe an audit under current PCAOB standards would address the critical audit matters and risks. Additional time would likely be required and such time would be focused on developing appropriate audit report language, coordinating with management on such language, and perhaps increasing legal counsel time and expense. In addition this time would likely be required near the end of the audit, and could compete or interfere with other critical audit steps performed to complete the audit.

**14. Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?**

We find the definition of critical audit matters unclear and do not agree that the reporting of critical audit matters will add value for the users of the financial statements.

**15. Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?**

We do not support the inclusion of audit procedures performed in an auditor's report, as we do not believe it would add value to the users of the financial statements and it could result in lengthy descriptions that are difficult to evaluate. The auditor's opinion should provide sufficient information about whether the auditor was able to perform adequate audit procedures related to the matter and obtain sufficient appropriate audit evidence

**16. Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

The factors are generally useful and informative; however, we encourage further development and expansion of examples to assist auditors in identifying critical audit matters, if the PCAOB requires disclosure of such matters.

**17. Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?**

We do not note any other necessary factors, unless additional factors would be required to enhance consistency with the standards of other standard setters.

**18. Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?**

The requirement is sufficiently clear and the illustrative examples are generally useful.

**19. Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?**

We encourage the PCAOB to consider how the documentation requirements for critical audit matters could be addressed under current auditing standards documentation requirements for auditor's audit documentation.

**20. Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?**

Please see our response to question 19.

**21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?**

In addition to the cost related to the additional time requirements discussed in our response to question 13 above, there would be additional costs associated with documenting the audit matters. These additional costs would likely be more significant to the audit costs related to smaller entities.

**22. What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?**

Please see our response to question 21.

**23. How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?**

We expect the audit fees to vary by audit.

**24. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?**

If reported, we believe that only critical audit matters related to the current fiscal period should be communicated, unless they were also relevant to the prior fiscal period.

**25. Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?**

The illustrative examples are generally useful and informative.

**26. What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.**

If the proposal is implemented, we are concerned about consistency between audit reports of critical audit matters and believe that the standard should be further developed to help auditors in their determination of the significance of audit matters. Tools such as threshold determinations would be useful, and we encourage further development and expansion of examples to assist auditors in their identification of critical audit matters and the consistent reporting of these matters.

**27. What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?**

We believe that in practice, such requirements will result in entities reporting the substance of critical audit matters in the notes to the financial statements, to the extent they are not already included, and the inclusion of this information in the audit report would add little value to the users. We are also concerned that the incentives for consistent reporting of critical audit matters across entities would likely lead to “boilerplate” reporting language for each type of critical audit matter. Further, we believe that such a requirement may increase the risk of blurring the roles between entity management and the auditor, as it requires the auditor to comment on elements that are currently management’s responsibility to discuss or disclose under current accounting standards.

**28. What effect, if any, would the auditor’s communication of critical audit matters under the proposed auditor reporting standard have on an auditor’s potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor’s potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor’s potential liability in private litigation?**

We do not offer a response to this question.

**29. Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?**

We believe that it would be appropriate for the PCAOB to include such a description.

**30. Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?**

We believe that the retention of the Emphasis of Matter paragraphs is valuable. These paragraphs provide additional information not included elsewhere in the auditor's report. This would also be consistent with the other standard setters' approaches.

**31. Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?**

We believe that the inclusion of Emphasis of Matter paragraphs should be left to the auditor's discretion.

**32. Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?**

The proposed examples are generally sufficient, unless additional examples would be required to enhance consistency with the standards of other standard setters.

**33. Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?**

Please see our responses to the previous questions.

**34. What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ?**

Please see our responses to questions 21, 22, and 23.

**35. Are the proposed auditor reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?**

We support consistency in auditor reports for all entities as variations would be confusing to the users of the financial statements.

**36. Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for audits of brokers and dealers? Why or why not?**

Please see our response to question 35.

**37. Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?**

Please see our response to question 35.

**38. Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditor's reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?**

Please see our response to question 35.

**39. Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?**

Please see our response to question 35.

**40. Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?**

Please see our response to question 35.

**41. Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?**

We ask the PCAOB to be consistent with the effective dates of other standard-setting bodies' new requirements regarding auditor reporting.

**42. Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

We do not support a delayed compliance date as we believe it would cause confusion for users of the financial statements.

**Appendix 6**

**1. Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

We encourage development of examples of quantitative and qualitative financial information that may be included in other information to assist auditors in their evaluation of other information.

**2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

We do not support the application of the proposed other information standard to information incorporated by reference. Such information may be difficult for users to locate and may be subsequently modified after the date of the auditor's report.

**3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?**

We agree that it is appropriate to apply the proposed standard to amended reports in relation to the other information previously reviewed.

**4. Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are these practical issues with applying the proposed other information standard to the other entity's audited financial statements?**

We do not offer a response to this question.

**5. Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?**

We believe that the requirements should be further developed to help the auditor determine the significance of its findings and the manner in which these findings should be presented in the report. Tools such as threshold determinations and a description of qualitative and quantitative factors would be useful.

**6. Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

While we agree that expanding the auditor's responsibility for other information has merit, we are concerned about the requirement in paragraph 3 of the proposed standard regarding material misstatements of fact. We believe that the identification of any material misstatements of fact should be based solely on the procedures in paragraph 4 of the proposed standard. However, we are concerned that the current proposed standard is unclear as to whether the auditor would be required to identify material misstatements of fact, beyond those that would be identified through performing the procedures described in paragraph 4 of the proposed standard. We believe it is important that this requirement be clearly stated to avoid confusion in its application

**7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

It is unclear whether the evaluation of the other information would increase the quality of information available, but it could provide users with greater clarity about the auditor's responsibilities with respect to such information and greater confidence in the quality of the information.

**8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying the definition represent a change to the materiality considerations auditors currently use under AU sec. 550?**

Please see our response to question 5.

**9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

We are concerned that the proposed procedures may not provide sufficient detail for auditors to be consistent in their evaluation of other information. We encourage the Board to develop examples of quantitative and qualitative information to aid the auditor's evaluation of the other information

**10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?**

Please see our response to question 1.

**11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?**

We do not offer a response to this question.

**12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor indentifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?**

We agree with the proposed responses.

**13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?**

The costs would likely vary by the nature of the potential material inconsistency or material misstatement of fact.

**14. Are the proposed auditor's responses under paragraph 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

We agree with the proposed responses.

**15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or**

**both? Under what circumstances would such a report be appropriate or not appropriate?**

Please see our response to question 14.

**16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

We agree with the proposed responses.

**17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?**

We agree with the proposed responses.

**18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?**

We believe that paragraphs 13 and 14 provide adequate illustrative language.

**19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples?**

We do not support a requirement for an auditor to identify information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against, as we question what value this would add for users of the financial statements.

**20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

The additional costs will likely vary depending on the nature of the material inconsistency or material misstatement.

**21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

We believe the proposed reporting is appropriate.

**22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?**

If management has revised the material inconsistency or material misstatement of fact in other information prior to the issuance of the auditor's report, a practical consideration may be evaluation of the cause of the material inconsistency or material misstatement of fact. If the inconsistency or misstatement was caused by a control deficiency, the auditor should consider following the same process of evaluation as used for those deficiencies that cause material misstatements in the financial statements. The auditor may also consider whether it was an intentional act and could reflect on the integrity of management.

**23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?**

The responsibilities are clear and follow logically from the requirements in the standards. However, from an implementation perspective, the role of ensuring that the predecessor auditor fulfills the responsibilities would most likely fall on the successor auditor.

**24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability?**

We do not offer a response to this question.

**25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11, of the Securities Act? Would it affect an auditor's potential liability under state law?**

We do not offer a response to this question.

**26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?**

We feel the proposed amendments are generally appropriate, unless additional amendments would be required to be consistent with the standards of other standard setters.

**27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?**

We believe the decision to include such statements should be left to the discretion of the auditor.

**28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?**

We support the proposed requirements being applied consistently.

**29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?**

We ask the PCAOB to be consistent with the effective dates of other standard-setting bodies' new requirements regarding auditor reporting.

**30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

We support a uniform date for compliance with the proposed other information standard and amendments to avoid confusion.

**31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?**

We do not support extending the application of the proposed standard.

**32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?**

Please see our response to question 31.

**33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?**

We do not offer a response to this question.

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December 6, 2013

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To Whom It May Concern:

UNS Energy Corporation is a utility services holding company engaged, through its primary subsidiaries, in the electric generation and energy delivery business primarily in the state of Arizona. Our largest operating subsidiary, Tucson Electric Power Company, which is a regulated public utility, represents more than 80% of our consolidated assets and 70% of our net income. Both UNS Energy and Tucson Electric Power are filers with the Securities and Exchange Commission ("SEC"). UNS Energy is a Large Accelerated Filer pursuant to Rule 12b-2 of the Exchange Act.

This letter is in response to the two proposed reporting standards issued for comment on August 13, 2013 in PCAOB Release No. 2013-005 (the "PCAOB Release"): *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses and Unqualified Opinion* ("Proposed Auditor Reporting Standard") and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* ("The Proposed Other Information Standard").

Respectfully, this letter provides general feedback of the proposed standards. An attachment to this letter responds specifically to certain questions asked by the PCAOB in Appendices 5 and 6 of the PCAOB Release.

We have several concerns with the Proposed Auditor Reporting Standard (as detailed in PCAOB Release Appendix 5). The SEC, in conjunction with the FASB, has historically developed rules and regulations regarding the required communications to be included in the financial statements for financial statement users to make investment decisions. The SEC has provided regulations on 'what' information needs to be disclosed. Importantly, these rules have allowed management to determine 'how' to communicate this information to best reflect the company's financial results and position. The auditor, with oversight by the Audit Committee, has ensured that the information complied with applicable disclosure rules and that the financial information was accurate. We believe the proposed standard would mark a significant shift in the regulatory framework by requiring an outside entity to communicate new information about a registrant's specific accounts, transactions and risks to financial statement users.

We believe the current framework, where a registrant's financial information is management's responsibility, continues to be valid. Communication of such information to financial statement users is likewise the responsibility of management. We believe the SEC, with the support of the FASB, should continue to serve as the sole regulator of the information provided to investors and that management should be the sole party responsible for communicating such information.

We believe the Proposed Auditor Reporting Standard and especially the provisions requiring Critical Audit Matters ("CAM") to be discussed within an auditor's report would:

i. Undermine the usefulness of the audit report and the Audit Committee's role of overseeing management and the auditor;

ii. Result in duplicative or irrelevant disclosure which would decrease the relevance of either the audit report or other disclosures within the financial statements;

iii. Decrease the comparability of audit reports between industries and among similar companies which may confuse users of the financial statements; and

iv. Significantly increase audit costs while providing little, if any, benefit to financial statement users.

The rationale for such beliefs is explained in our response to selected questions in the attachment.

We support clarifying the auditor's procedures and responsibility for other information contained in SEC filings within the audit report (as detailed in PCAOB Release Appendix 6). We do not support expanding the auditor's responsibility for testing or documenting the procedures over the other information as we don't believe the perceived benefits outweigh the costs. As described in the attached responses, we believe that the cost of compliance for this standard is expected to be high without comparable benefit to the financial statement users; that unintended consequences may result in delayed filings or may lead to registrants omitting informational content in the MD&A; and that implementation may be problematic as materiality cannot be easily applied to non-financial information such as customer counts or pipeline miles.

We appreciate this opportunity to provide comments on proposed standards and thank you in advance for your consideration of our comments in developing any final standards. If you would like to further discuss our comments, feel free to contact me directly.

Sincerely,

Frank P. Marino

**Attachment – UNS Energy responses to select questions from PCAOB Release No. 2013-005: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards.***

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**Additional Discussion Related to the Proposed Auditor Reporting Standard. (Appendix 5)**

***Question No. 5 - The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.***

Company Response - We believe this is neither necessary nor useful to be included in the auditor report because it has no bearing on the audit of the financial statements and could undermine the usefulness of other information included in the auditor's report. We believe that a registrant's Audit Committee should make a decision whether such information would be useful to its shareholders and to disclose such tenure information at its discretion in the annual Audit Committee report.

***Question No. 10 - Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?***

Company Response – We believe the auditor should not provide critical audit matters ("CAMs") in the audit report or elsewhere in the financial statements or annual report. We believe the role of the auditor is to attest that management's communication is correct in all material respects. We do not believe that communication of CAMs would be relevant or useful due to the following:

A. **It would undermine the usefulness of the audit report and the Audit Committee's role of overseeing management and the auditor.** Some users may interpret the auditor's communication of CAMs as limitations on the audit report or as the provision of a separate level of assurance. The auditor exercises judgment in determining whether the financial statements are fairly presented as a whole. Disclosure and discussion of CAMs may be interpreted as the auditor providing a piecemeal opinion and would not address all of the other factors the auditor considered relevant when forming the overall audit conclusion. As a result, the proposed audit report may provide investors with an incomplete or unbalanced picture of the audit. Critical aspects of the audit may be under emphasized as they do not meet the criteria of being a CAM. Likewise, CAMs may be over emphasized by users in making investment decisions.

Currently the Audit Committee, as part of the shareholder-elected Board of Directors, has the authority to oversee the audit and ensure the financial statements contain appropriate disclosure on behalf of shareholders. In its oversight role, the Audit Committee is already made aware of those items that would be considered CAMs under the proposed rule. We believe the Audit Committee is the appropriate body to evaluate these and other items of audit importance because the Audit Committee has in-depth knowledge of the Registrant's businesses, strategy and financial statements. The Audit Committee has the ability to ask questions and engage in dialogue with both management and the auditors regarding complex and judgmental audit areas that may be misinterpreted or inappropriately over or under emphasized without the appropriate context. **Bypassing the Audit Committee by disclosing CAMs directly to the shareholders will undermine the governance role of the Audit Committee.**

B. **It would result in duplicative or irrelevant disclosure which would decrease the relevance of either the audit report or other disclosures within the financial statements.** A description of significant accounting matters relevant for investing decisions, including critical management judgments, risks and uncertainties, accounting estimates and policies are already provided by management as required by US GAAP and SEC rulemaking. The form of these disclosures, including the level of detail and specificity is a matter of professional judgment. This judgment is best exercised by personnel most familiar with the risks and uncertainties of the business – management with oversight from the Audit Committee.

The auditor provides an attest service which includes the disclosures of management's estimates, judgments and accounting policies. We believe the disclosure of CAMs will provide new information to the investor that is not already contained in the financial statements including disclosure of additional forward looking information which may confuse users of the financial statements.

Matters for which the auditor has the most difficulty in obtaining sufficient appropriate evidence may not be relevant to users of the financial statements or may already be included in US GAAP or SEC disclosures. The proposed rule lists the following factors to take into account when determining whether an item would be considered a CAM:

a. *The degree of subjectivity involved in determining or applying audit procedures to address the matter or in evaluating the results of those procedures* – As further noted above, subjective and judgmental accounting areas are already provided elsewhere in the financial statements. Subjective or judgmental audit areas (i.e. sample size selection, methodology, audit coverage, etc) requires professional judgment and will likely vary between firms and individual audit partners. Investment decisions are based upon timely and accurate financial information; not the subjectivity of how that information was audited.

b. *The nature and extent of audit effort required to address the matter* - Audit effort does not always translate or signify relevance to users of the financial statements. For example if an IT application is found to have ineffective IT controls, it may require significant additional audit effort. However, risk to the financial statements can be mitigated by other audit procedures and discussion of such audit matters would not be relevant to users of the financial statements.

c. *The nature and amount of available relevant and reliable evidence regarding the matter or the degree of difficulty in obtaining such evidence* - Often this is disclosed as part of general GAAP requirements for estimates and uncertainties or in specific GAAP pronouncements (e.g., ASC 820 disclosures on fair value measurements with unobservable inputs). Investors expect auditors to conclude on their audit procedures based on relevant audit evidence. They are less likely to be concerned with the degree of difficulty in obtaining such information.

d. *The severity of control deficiencies identified relevant to the matter, if any* - Auditors currently disclose material weaknesses in internal control. Additional discussions of control failures, that may have been remediated, are not relevant to users and could serve to confuse users and over-emphasize their importance if disclosed.

e. *The degree to which the results of audit procedures to address the matter resulted in changes in the auditor's risk assessments, including risks that were not identified previously, or required changes to planned audit procedures, if any* – Any significant new financial statement risk or business risk should already be disclosed as part of SEC Rule Nos. 229.305 and 229.904. Whether these risks were identified by management, the Audit Committee or the auditor is not relevant to financial statement users.

f. *The nature and significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any* - Corrected errors are included in the financial statement balances presented to investors. The notes to the financial statements also explain to the user the nature of the corrections. For immaterial uncorrected errors there is not, by definition, "a substantial likelihood that the ...fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available" (Excerpt from PCAOB AS No. 14). More prominence of misstatements whether corrected or uncorrected could be misinterpreted by investors and given more importance by virtue of their mention in the auditor report. Such information may not be relevant to an investor's understanding of the registrant, its business or its financial statements.

g. *The extent of specialized skill or knowledge needed to apply audit procedures to address the matter or evaluate the results of those procedures, if any; and the nature of consultations outside the engagement team regarding the matter, if any* - The nature of external resources employed in an audit are often a function of audit staffing and the judgment of the audit partner. Many audit areas commonly use outside experts, including lawyers, actuaries and valuation specialists for common and frequently occurring transactions that may be over-emphasized as a CAM under the proposed rules and provide little, if any, additional benefit to users of financial statements.

C. **It would decrease the comparability of audit reports between industries and among similar companies which may confuse users of the financial statements.** As noted above, the auditor's determination of what is considered to be a CAM will involve a considerable amount of professional judgment. Therefore, the comparability between audit reports for similar companies or industries would likely vary greatly.

There is potential for audit firms to either:

a. Include more CAMs than was the PCAOB's intention in order to avoid potential inspection findings. This could result in auditors producing voluminous audit reports, which would diminish their usefulness and make comparability of audit reports challenging.

b. Alternatively, to ensure uniformity in practice and quality control, CAMs could simply be reduced to boilerplate language, resulting in additional communication of irrelevant information to the users of financial statements.

c. Additionally, investor decisions should not be driven by subjective judgments made by an auditor.

Moreover, the inclusion of CAMs for only the current year, while the financial statements present three years, would require the user to review the two previous sets of financial statements in order to obtain a full understanding of the CAMs.

***Question No. 11 - What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?***

Company Response - We believe that there could be several unintended consequences including:

*A.* **Undue emphasis** – Reported matters that may be necessary to ensure an audit addressed complex areas of accounting may not require emphasis to a reader because the existing accounting disclosures provide an adequate description of the accounting. Users of financial statements may believe that such emphasis was necessary because of lack of judgment by management, misapplication of policy or some other matter and give the reader an incorrect and perhaps negative impression of the company or its management.

*B.* **Misunderstanding** – There may be a misunderstanding on the part of users of the financial statements about the information reported by the audit firm and its relevance to a registrant's ongoing operations or financial condition.

*C.* **Information Overload** - Each identified CAM has the opportunity to add several paragraphs to the auditor's report while providing little, if any, additional value to the user of the financial statements. The reader would bear the risk of information overload and be distracted from reading the notes to the financial statements or other pertinent disclosures that the management of a company deems important.

D. **Auditor Judgment** – As discussed earlier, the auditor's determination of what is considered to be a CAM will involve a considerable amount of professional judgment. Therefore, there is the potential for audit firms to either:

   a. Include more CAMs rather than less, in order to avoid having their judgment on what is considered a CAM second guessed. This could result in auditors producing voluminous audit reports, which could potentially confuse users regarding the opinion being given and make comparability of audit reports challenging.

   b. Or, to ensure uniformity in practice and quality control, CAMs could simply be reduced to boilerplate language, resulting in the additional communication of irrelevant information to the user.

E. **Release of Competitive Information** – Depending on the nature of the CAM, competitively confidential information may be discussed. When dealing with critical accounting estimates, pertinent details leading to corroboration of the audit evidence may reveal information that is not a significant driver of the registrant's business but, if disclosed, may have pertinent "trade" implications that could be a detriment to the registrant.

***Question No. 12 - Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?***

Company Response - We believe the application of the definition to be highly subjective by an audit team and may not be consistently applied by another audit team or independent firm. As such, two companies in the same industry may have similar accounting issues in which one auditor highlights a

CAM which may not be highlighted within the industry competitor's audit report leading to confusion when comparing such companies to make an investment decision.

***Question No. 13 - Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?***

Company Response - We believe that the additional time incurred regarding CAMs will have an effect on the quality of the audits. For those areas identified as a CAM, we believe an extensive amount of additional time would be incurred to assist the auditor with their understanding in order for specific disclosures to be written by the auditor. As such, the audit over these matters should improve the quality. We believe however that the additional time to focus on particular CAMs could detract from the amount of time and effort applied to other audit areas which would be a detriment to the quality of the audit, especially if SEC current reporting deadlines are not extended to compensate for the increased reporting responsibilities.

***Question No. 15 - Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?***

Company Response – As described above, although the information may be informative, it is not clear how the information would be useful to the investor. The notes to the financial statements already include information describing a company's critical accounting policies and its complexities. Management's discussion and analysis likewise discusses critical accounting estimates, which we believe many of the CAMs will also address. The description of the CAM may specifically discuss audit procedures performed and how a matter was resolved to the auditor's satisfaction but the only benefit this provides the investor is comfort that the auditor performed the necessary procedures to corroborate the matter. Investors already expect this diligence under already prescribed auditing standards and as such would not benefit "hearing from the auditor" that the auditor "did its job" with respect to the complex accounting matter.

***Question No. 21. What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?***

Company Response – See response to Question No. 22 below.

***Question No. 22 - What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?***

Company Response – The additional costs that will be incurred and other considerations consist of:

A. Increase Audit Fees – Incremental time will be incurred by the audit firm to comply with the Proposed Auditor Reporting Standard. This incremental time could be significant depending on the identified CAMs. We would anticipate that partner and senior engagement personnel will be most used in this effort, causing incremental hours at the highest hourly rates.

B. Increased Audit Committee and Management Time – Incremental time will be incurred discussing CAMs with the auditor, evaluating the corroborative details gathered by the auditor and understanding the rationale for an auditor's CAM conclusion. This time could be extensive depending on the type and number of CAMs identified by the auditor.

C. Investor Queries and Potential Lawsuits – Depending on the nature of the CAM, investors may seek additional information from the registrant. If questions arise on the application of audit procedures, registrant personnel may be unable to satisfy the investor's question. The auditor also will not respond directly to investor inquiries about a particular audit engagement. In addition, unwarranted lawsuits could arise from the disclosure related to a CAM.

D. Delays in Reporting – Over the past several years Accelerated Filers and their auditors have been faced with new accounting pronouncements, XBRL reporting, and additional efforts associated with compliance of PCAOB standards resulting in extremely tight SEC reporting deadlines. The additional efforts required to comply with the Proposed Auditors Reporting Standard would create even further strain on both registrant and auditor resources potentially resulting in late filed documents, which could have a negative impact on the registrant.

***Question No. 23 - How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?***

Company Response – We believe audit fees will increase significantly and a registrant's ability to provide the auditor with assistance from the internal auditor will be reduced. We expect that documentation procedures will be expanded for all areas that the auditor believes a CAM may arise because the auditor will need to assess each potential CAM for disclosure in order to comply with the standard. Once a CAM is identified for disclosure, the auditor will continue to monitor in future years as long as such audit matters continue. In addition, we expect that the time required for concluding on CAMs and writing the disclosure will not come from junior level employees of the accounting firm but more experienced senior managers and partners at the highest level of the engagement team, at higher hourly rates.

***Comment No. 41 - Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?***

Company Response - The proposed standard is scheduled to be effective beginning January 1, 2016, a time during which registrants and their auditors will be busy preparing for the impending adoption of the new lease and revenue recognition guidance. The compounding effect of all of these new requirements could increase the likelihood of misstatements in the financial statements. We would request that any change to the audit opinion be delayed so as to not coincide with the adoption of these standards.

**Appendix 6 - Additional Discussion Related to the Proposed Other Information Standard**

***Question No. 2 - Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?***

Company Response – We believe the proposed requirement to apply the other information standard to information incorporated by reference that will be filed with the SEC following the filing of the Form 10-K would be overly burdensome and costly for registrants. Amending a Form 10-K and the auditor's opinion for information subsequently filed may require the auditor to update their report issuance procedures, subsequent event inquiries, independence and other aspects of their field work to address the new information incorporated by reference which would result in additional audit fees borne by the registrant. In addition, the length of time the auditor may require to complete such procedures may be extensive depending on the nature of the required procedures.

An amended Form 10-K could also cause undue investor concern and be negatively viewed by public markets and mistaken for a "restatement" if the investor does not properly consider the new information in the appropriate context.

***Question No. 3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?***

Company Response – If adopted, we believe it may be appropriate to apply the proposed other information standard to amended annual reports. If disclosure changes to an amended annual report would affect previous disclosures made by the auditor in their audit opinion, it may be appropriate for the auditor to reissue or update their opinion within the amended annual report. This decision should be made by the auditor and not required by the standard since auditor consent would be required in the amended Form 10-K.

In the event the auditor report were reissued or updated, we believe significant additional costs would be incurred by the registrant depending on the procedures that the auditor would be required to perform to reissue the report. The magnitude of such additional costs would be determined based on the nature of the changes to the annual report, the nature and extent of other information added, whether any new CAMs were identified or changes to previously reported information. Additional internal costs and time would also be incurred by the registrant and its audit committee to understand and facilitate the auditor's procedures and updated disclosures.

***Question No. 6 - Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?***

Company Response – We do not support expanding the auditor's responsibility for testing or documenting the procedures over the other information as we do not believe the perceived benefits would outweigh the costs, unintended consequences could arise and the proposed standard could be difficult to implement. There are several factors to consider:

A. Audit scope and resulting cost has expanded over the past 10 years due to SOX and incremental standard setting in US GAAP. The proposed audit standard will continue that expansion. It is not clear that the perceived benefits, if any, would outweigh the cost.

   a. Auditors already review information accompanying audited financial statements to ensure consistency with the statements. Expanded assurance would not provide additional useful information and may provide a distraction to procedures performed over information contained in the financial statements.

   b. In those circumstances in which additional assurance is desired (i.e. upon a new security or debt issuance) auditors provide comfort letters to underwriters to provide additional assurance over other information.

B. The cost of compliance is expected to be high.

   a. In order to timely test the other information contained in the financial statements, auditors may need to expand their testing of a company's internal controls to include the other information. This will result in additional audit cost to the registrant.

   b. The requirement to evaluate qualitative statements in the other information (for example, having the "largest market share in the company's industry" as discussed on p. 235 of the proposed standard) will lead to an increase in audit costs and time spent complying with audit requests as information required to evaluate qualitative statements may not be as readily available or as objective as financial information.

C. Unintended consequences

   a. Given the additional work that would be required for auditors to review the other information, and additional time preparers would need to prepare audit support, filing dates may be delayed and may be more susceptible to missing deadlines.

   b. More stringent requirements on the auditors around other information may deter preparers from disclosing non-required, but informational content in the MD&A so as to avoid the requirement to furnish supporting information that would be difficult / time-consuming to evaluate. This could diminish the value to the shareholder of the MD&A disclosures.

D. Implementation issues

   a. The proposed standard states that auditors "would not be required to perform procedures to obtain additional evidence regarding other information not directly related to the financial statements that was not required to be obtained during the audit." Determining what information is "not directly related to the financial statements" may be subjective. If approved, more clarity is needed to remove subjectivity.

   b. Materiality cannot easily be applied to non-financial information such as customer counts or pipeline miles.

***Question No. 7 - Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?***

Company Response – We do not believe the quality of information available to investors and other financial statement users would increase as a result of additional auditor evaluation. By virtue of its inclusion, management has already determined that the information is relevant to investor understanding and the context such information is unlikely to change solely as a result of auditor evaluation. Investors expect management to be best qualified to explain such information and its relevance and importance to the business. As we discussed above, auditor "involvement" with this disclosure could actually reduce quality if it now has to be written from an "auditor's perspective". There is greater risk that information would be omitted if a registrant believes it will be overly costly for an auditor to perform a more in-depth analysis of management's assertion. It may also prove difficult for the auditor to develop the appropriate procedures to validate the information or determine materiality in the case of non-financial information.

We do not believe that such auditor evaluation would sufficiently contribute to greater confidence in the other information. Investors already expect registrants to provide accurate and insightful information in the MD&A. Investors understand that it is a current PCAOB requirement for the auditor to read the other information contained in the Form 10-K for material inconsistencies and material misstatements of fact when their audit report is included in the public filing. Accordingly investors would expect the Form 10-K to be free of material inconsistencies or misstatement since they have provided consent for the registrant to include their report in the Form 10-K.

***Question No. 29 - Is the Board's effective date appropriate for the proposed other information standard? Why or why not?***

Company Response - If adopted, the proposed standard is scheduled to be effective beginning January 1, 2016, a time during which registrants and their auditors will be busy preparing for the impending adoption of the new lease and revenue recognition guidance. The compounding effect of all of these new requirements could increase the likelihood of misstatements in the financial statements. We would request that any change to the audit opinion be delayed so as to not coincide with the adoption of these standards.

Vanguard®

P.O. Box 2600
Valley Forge, PA 19482-2600

December 11, 2013

*Submitted Electronically*

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

**Re: PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2013-005 – Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Members of the Public Company Accounting Oversight Board:

Vanguard appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB") proposed auditing standards – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (together, the "Proposed Standards").

We appreciate the PCAOB's continued focus on the concerns of investors in relation to financial statements and the auditor's report, and we commend the PCAOB for seeking input from various stakeholders who participate in the audit and financial reporting process, including an issuer's management, independent auditors and investors. As discussed below, we support meaningful disclosures in an auditor's report that focus on matters of critical importance to investors and that the auditor is well-positioned to provide. Accordingly, we generally support those aspects of the Proposed Standards which would result in the meaningful disclosure of critical audit matters, the auditor's evaluation of financial information, and additional clarifying language in the auditor's report.

As both an *issuer* of hundreds of financial statements and as a *consumer* of financial information, we believe that Vanguard brings a special perspective to this area. Vanguard offers more than 180 U.S. mutual funds holding aggregate assets of approximately $2.4 trillion at October 31, 2013. Each of these mutual funds is registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940, and their shares are registered with the SEC under the Securities Act of 1933. Investment companies, as issuers of securities, are required to file audited financial statements with the SEC and mail annual and semi-annual reports to their shareholders within designated time frames under SEC rules. In addition, in their capacities as investors in the securities markets, investment companies review and analyze companies' financial statements that are filed with the SEC when making investment decisions on behalf of their investors.

Vanguard supports meaningful disclosure of critical audit matters in the auditor's report

We generally support the idea of auditors communicating information about critical audit matters in the auditor's report *but only if applicable*. For example, disclosure of critical audit matters could be useful to investors when reviewing complex financial statements, where the identification of critical matters would allow investors to focus their attention on these areas in the financial statements and the accompanying notes. However, to be useful to investors, disclosure of critical audit matters should only be used to emphasize areas of the audit that were objectively difficult, subjective, or complex, and not 'over-used' to call out non-critical matters. In that regard, we note that the Proposed Standards state that in most audits the auditors would determine that there are in fact critical audit matters. We strongly recommend that the PCAOB revise the Proposed Standards to avoid suggesting that auditors essentially be required to identify and disclose critical audit matters. We believe that any sort of *de facto* requirement to include critical audit matters in the auditor's report could lessen the impact of such disclosures, inevitably resulting in unnecessary boilerplate language that could detract from, rather than enhance, a better understanding of the financial statements and the audit process. More, rather than better, runs the risk of not serving the best interests of investors.

To this end, we agree with comments submitted by the Independent Directors' Council and the Investment Company Institute on December 11, 2013 (the "IDC/ICI Letter") to the effect that requiring disclosure of critical audit matters in every investment company audit report generally would not result in meaningful disclosure for investors and therefore should not be required. In this regard we encourage the PCAOB to acknowledge that financial reporting for mutual funds is inherently less complex than for operating companies, principally because a fund's activities are limited primarily to issuing and redeeming capital shares and investing in securities. Further, as acknowledged by the PCAOB, disclosures of critical audit matters would necessarily increase audit costs as auditors, particularly more senior members of the audit team, would be required to spend more time documenting and reviewing critical audit matters. For fund complexes like Vanguard, these increased costs would be multiplied by the number of funds and their corresponding audits, with the additional costs ultimately passed on to investors in the form of higher operating costs - *i.e.*, fund expense ratios. In our view, any change that would impose additional costs on investors without meaningful benefits for investors is not in investors' best interests.

Auditors should only be required to evaluate financial information

While management is responsible for preparing the financial statements and other financial information, the audit process provides auditors information about a company's overall financial condition. During the course of the audit process, auditors may gain unique and relevant insight into the financial condition of a company that auditors could use to review financial information about the company outside of the financial statements. Accordingly, we support requiring auditors to evaluate *financial* information contained in an issuer's annual report that could reasonably be expected to relate to the financial statements. However, due to an auditor's role and specialized expertise, we recommend that the PCAOB limit an auditor's evaluation of "other information" to other *financial* information that could reasonably be expected to relate to an issuer's financial statements. We also encourage the PCAOB to provide additional guidance and specificity to auditors with respect to the particular types of financial information they should be evaluating.

As accountants and auditors of financial statements, auditors have unique insight into a company's financial condition; however auditors do not necessarily have either unique insight or expertise in evaluating non-financial information about a company. An audit requires the auditor to express an opinion on an issuer's financial statements by examining supporting evidence, including the issuer's accounting records, and considering the issuer's internal control over financial reporting. Based on the nature of audit work, auditors are not well-positioned to evaluate non-financial information in an annual report, and requiring them to evaluate such non-financial information would be requiring something outside the scope of their expertise. We do not believe it would benefit investors to have auditors review non-financial information; in fact, such a review could be misleading in suggesting that an auditor agreed with information that it was not positioned to properly evaluate.

Additional clarifying information in the auditor's report

Lastly, we support adding language to the auditor's report relating to an auditor's independence. We believe that this information could enhance an investor's understanding of the auditor's role. With respect to tenure, we would not object to adding information about an auditor's tenure; however we agree with the IDC/ICI Letter and recommend that the PCAOB clarify that, for investment companies and for the reasons cited in the letter, this disclosure requirement applies at the fund complex level. We also support enhancing certain standardized language relating to the auditor's responsibility with respect to the audit. We recognize that some investors may not fully understand what an audit represents or the related auditor responsibilities and that adding clarifying language could meaningfully increase financial statement users' understanding and knowledge of the audit process and the auditor's report.

* * * * *

Vanguard appreciates the opportunity to provide these comments on the PCAOB's Proposed Standards. If you have any questions about Vanguard's comments or would like additional information, please contact Toai Chin, Director of Fund Accounting Policy, at 610-503-3043.

Sincerely,

/s/ Glenn W. Reed

Managing Director,
Strategy and Finance Group

Monty Garrett
Vice President Finance

December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Mr. Secretary:

Verizon Communications Inc. ("Verizon") appreciates the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") proposed auditing standard on The Auditor's Report on the Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to the PCAOB Standards (together the "proposal").

We support the Board's goal to provide investors with the information necessary to make informed decisions; however, we believe that management, not a company's auditors, should be the primary source for providing investors with information about the company's business and operational risks. While we understand that some modifications to the auditor's report may be desirable, we believe that the Board should carefully assess whether aspects of the current proposal will blur the line between the unique responsibilities of management and auditors. Moreover, we believe certain changes could negatively impact audit quality in ways that would be expensive, and could lead to investor confusion, disagreements between preparers and auditors, and inhibit open communication between management, the audit committee and auditors.

***Critical Audit Matters***

We believe the subjective nature of the proposal's criteria for identifying critical audit matters may lead to several potential issues in practice. Without a defined structure or precedent concerning the methods for determining critical audit matters, we foresee potential differences in opinion between auditors and preparers as to the number of critical audit matters, the wording used to describe them and their significance. We are concerned that the resulting discussions between these parties to indentify critical audit matters under this proposal may ultimately lead to a reduction in the quality of the overall audit process in order to complete the auditor's report given the filing time restrictions. We also foresee situations where companies with similar audit issues receive substantially different audit reports. This could include identifying different critical audit matters or identifying the same critical audit matters with different descriptions. While some investors have indicated that this situation is not problematic for them (as they are used to reviewing differing Management's Discussion & Analyses), other investors may wrongly conclude that significant differences exist between the companies and make invalid investment decisions.

In addition to the high level of subjectivity in the current proposal, we believe there is potential for duplication of information. We are concerned that critical audit matters focusing on the background of the matter rather than the audit procedures used to address the matter create the potential for duplication. For instance, we believe the examples provided in the proposal include redundancies with Item 303 of Regulation S-K, which requires management to identify and discuss critical estimates that are used in critical accounting estimates and policies. If critical audit matters are to be included in the auditor's report, the report should focus on audit procedures and reference to the background information within the financial statements, management's discussion and analyses, or other information.

Another unintended consequence of the proposal relates to the possibility for confusion by the investor or user of the audit report. The auditor will identify, describe and refer to the relevant financial statement accounts and disclosures for each critical audit matter; however, no conclusion or resolution is communicated for each matter. While we do agree that communication of a conclusion for each critical audit matter may lead to a piecemeal opinion, we anticipate that investors will have trouble connecting the critical audit matters to the "pass or fail" nature of the audit opinion. If critical audit matters are included in the auditor's report, the report should indicate these matters did or did not cause an audit finding or deficiency. In addition, we believe there is ambiguity in the current proposal concerning disclosures related to the audit matters not considered critical. If the auditor determines a matter not to be a critical audit matter in accordance with the proposal, then the additional disclosure should not be warranted. Eliminating this requirement will ultimately benefit investors as they will be relieved of the burden of sorting through extraneous levels of reporting. Finally, if investors have questions or request clarification on descriptions of critical audit matters, preparers will be put in the position of answering for the auditor which further blurs the role of preparer and auditor.

***Other Information Outside of the Financial Statements***

We recommend the Board limit the proposal as it relates to other information to identifying material inconsistencies with financial statement information that is included as part of a company's filing. Auditors currently have the responsibility to read non-financial statement information in public filings to ensure such information is materially consistent with the audited financial statements. The additional auditor requirements to provide attestation that other information falling outside the financial statements, such as management's discussion and analysis or other information incorporated by reference, is free from material misstatements of fact could be unreasonably burdensome. We are concerned that requiring these additional procedures will add significant cost with little countervailing benefits for investors, as the expertise of auditors may not extend to information beyond the financial statements. We believe an audit over areas that are not based on authoritative accounting requirements would create a costly, time intensive process for the auditors and preparers, and would ultimately make timely reporting more difficult. In addition, imposing this additional requirement may actually have the unintended effect of causing companies to reduce the financial information they include in their MD&A.

***Other Auditor Report Proposed Changes***

We do not oppose the proposed change to provide investors with information about the auditor's independence and tenure, although we do not necessarily believe communicating this information will enhance an investor's understanding of a company. The name of the current auditor's report includes the word "independent", which we believe is sufficient for investors to understand the auditor's obligations related to independence.

We commend the Board's efforts to enhance the communications to investors regarding audit information; however, we strongly believe there are significant unintended consequences and implementation concerns with the current proposal.

Thank you for the opportunity to comment on this proposal.

Sincerely,

Monty Garrett
Vice President - Finance

December 11, 2013

From:
**Gilbert F. Viets**
2105 North Meridian, Suite 400
Indianapolis, Indiana 46202
gilviets@aol.com
Phone: 317 513 5407

To:
**Office of the Secretary, PCAOB,**
**1666 K**
**Street, N.W., Washington, D.C. 20006-2803**

**Subject: Docket 034 : Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

Dear Mr. Chairman and Members of the Board:

Thank you for the opportunity to comment. Your retention of the "pass/fail" model is appropriate in my opinion. Attempting to install some sort of qualitative grading would only result in endless unwinnable arguments and little additional information, likely more confusion, for investors, energy better spent in other existing forums debating proper reporting.

The current proposal represents much work and energy for you and others. The proposal is a big step for which I commend you. You have no real choice. Your review results and the 2008 financial crisis are strong evidence problems exist in audits, probably more than can be cured by only this current proposal.

The results of PCAOB reviews of audits have been very helpful, but troubling. The database of your results is building. It is tending to show much effort is necessary to push private auditors to higher performance standards. You have now looked at thousands of audits with far too many conclusions saying "the work does not support the audit conclusions."

Regarding the 2008 financial crisis, mentioned above, I still shake my head in amazement that this situation was undetected and misreported under long existing requirements. It happened on the heels of many clean audit reports on financial statements and internal controls, issued up to immediately before the insolvencies, bailouts and forced mergers. The audit firms are likely not guilty of intentional complicity; other parties were responsible for creating the problems. However, the problems were auditor discoverable accounting and reporting problems long before they became one of history's largest financial crises. Auditors are supposed to discover problems like these.

You are constrained to some extent by coordination with your international counterparts; but you now have some temporary comfort from economic measures to restore confidence which hopefully dampens the pressure that historically has caused aggressive accounting and financial fraud. I hope it works and gives you the time you need.

In the end, probably after the next crisis, other major changes may be required. I have said before, seven things need to be fixed to provide the base of good audits. Among them are firm organization, capitalization and independence. I think I am right! Much smarter people have other ideas. The United States Treasury Advisory Committee offered a long report of suggestions, post Enron but pre 2008 financial crisis.

But, the next crisis will come. I do not think changes are yet made that make the audit firms effective warning systems for investor protection which they should be. Audit firm capital and management attention is more often, too often, spent building other service lines.

Let me then comment on components of your proposals with which I, respectfully, do not entirely agree: 1) the communication of critical audit matters; 2) a statement of the year the auditor began serving consecutively as the company's auditor; and 3) the city and state from which the auditor's report has been issued.

I know you are far down the road considering the proposals but you should recognize that misunderstandings may result.

All agree the new requirements will increase audit costs. If that is what it takes to get to the job done, it is unfortunate but necessary. The cost as usual is due to the few business managers and auditors who cause the problems, not the vast majority who consistently do a good job. Penalties for this misbehavior are far too light for the guilty, making the rest of the cost fall on the innocent.

**Communication of Critical Audit Matters**

This idea sounds better than reality, in my opinion.

The definition of "critical audit matters" is difficult so you must expect some evolutionary development, during which it may be premature to start listing things in the audit report. You attempt some definition using the words ***difficult***, ***subjective*** and ***complex***--- a big box to me, but not to some. You identify them as those that may have been discussed in certain audit documentation.

You have proposed a very good, robust documentation requirement for auditor consideration of Critical Audit Matters. If such documentation is not now taking place, your proposal for internal documentation is good and should be required.

Concurrently, I must also conclude that investors should accept some responsibility for their own knowledge and investigation of business risks relative to their own risk appetite, including that their auditors do not find everything. Investors will rightfully believe any list of critical matters is complete: "Nothing more is critical." They are wrong; but, it is a great argument in court.

The result of listing the critical audit matters will be, I think, an expansion of the infamous "expectation gap." This year I heard a high level management partner of a U. S. big 4 firm tell an audience that, "unlike Enron" the 2008 financial crisis was not an accounting problem. On the contrary, I think the accounting and controls in mortgage generation and for credit default swaps were awful, and had been for years. Assets were overstated; liabilities understated. There is a huge expectation gap as to what is a "critical audit matter" between the partner and me.

“Critical audit matters” go deeper than accounting matters. Other matters are often more difficult. For example, there are “tone at the top” issues and personal issues of key executives. These get much attention from auditors and audit committees and they should. But, I have to stop short of saying these matters should therefore be discussed in the audit report by anyone who has no legal right to subpoenas, sworn statements or protection from liability for public speculation.

**A Statement Containing the Year the Auditor Began Serving Consecutively**

Maybe auditor tenure would be appropriate information in the proxy statement, but not in the audit opinion. Keep the report confined to the central theme: the financial statements. Are they right or wrong?

Many big companies use the only audit firm they can use due to restrictive conflicts in a small group of suppliers, a fact more important for investors to know than “how long.”

If there is a concern with the auditor’s history, it should be with things that may compromise auditor objectivity. For example, if the auditor had previously served as a consultant to the company and is now subsequently the auditor, what was the nature of the prior relationship and how have they and the audit committee resolved the objectivity question? Further, for international companies or companies with significant, remote subsidiaries or divisions, to what extent is the auditor relying on the work on its own affiliated firms or other firms? But, even on these questions, if deemed important, the discussion should be in the proxy statement or annual report, not in the audit report.

I prefer not to clutter the important theme of financial statement trueness with other “clatter.”

**The City and State from which the Auditor's Report has been Issued**

Auditors’ reports disclose this now without your proposal. I would eliminate the disclosure. City and State of issuance is probably the least significant item in the auditors’ reports. Often, it is a little untrue, not a good way to append an audit opinion.

The effect of identifying a city or state for each audit report ranges from harmless to misleading. The range does not extend to “that’s good.”

There are many examples of audits performed by industry teams where the partner is from one city, the manager from another, staff from various locations, few of which are in the city or state of the audited company or the location of the issuing office. This dispersion of professional personnel, all transporting in for their work, can be an audit risk. It is the job of the audit committee and the audit firm to balance the risk with comfort of added expertise. If the PCAOB reviewers later disagree with the geographic staffing, they should say so.

In fact, there are other more important issues not disclosed that should be discussed somewhere, but not in an auditor’s report. What may be important to some investors is the disclosure of jurisdiction under which the audit contract must be interpreted. More often than not, that is not the state being identified in the audit report. It may also be important to know of any restrictions the audit contract places on where and how the company may pursue disputes and claims.

For smaller registered firms, I believe it is important for investors to consider remoteness of the auditor to the audited company. For large registered firms, I think it is important to consider which affiliated entity is taking responsibility for the work, regardless of who is doing the work and where. But, put this information in the proxy statement.

Otherwise, knowing the state of the issuing office, adds little to nothing. It would be better to eliminate the disclosure.

Thank you for your dedication.

Sincerely,

Gilbert F. Viets

December 11, 2013

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

Re: PCAOB Rulemaking Docket Matter No. 034; PCAOB Release No. 2013-005 dated August 13, 2013

Visa Inc. is a global payments technology company that connects consumers, businesses, financial institutions and governments around the world to fast, secure and reliable electronic payments. We provide our clients with payment processing platforms that encompass consumer credit, debit, prepaid and commercial payments.

We appreciate the opportunity to provide our comments to the Public Company Accounting Oversight Board on the two new auditing standards and other related amendments to PCAOB standards proposed in PCAOB Release No. 2013-005. We appreciate the Board's efforts and outreach in order to evaluate the effectiveness and relevance of the auditor's report for financial statement users. While we are amenable to certain proposed changes to the auditor's report, we respectfully request that the PCAOB strongly reconsider the proposals surrounding "Critical Audit Matters" and "Auditor's Responsibilities Regarding Other Information," for the reasons discussed below.

We strongly believe that management continues to be in the best position to communicate critical matters to investors given their intimate knowledge of and experience with the company and its business. We believe that the auditor's main responsibilities should remain focused on information grounded in authoritative accounting and reporting requirements. Proposed disclosures, such as those that may rise to the level of "Critical Audit Matters", should be addressed by existing GAAP or SOX accounting and disclosure requirements. Auditors are responsible for assessing the adequacy of these disclosures and should qualify their opinions if they believe such matters are not properly addressed. If current requirements are not providing an appropriate level of information for investors, then they should be revisited.

We do not believe that, in most cases, the proposed audit standards will improve the quality of information provided to financial statement users. We further believe that the standards will be inconsistently evaluated by different audit engagement teams and the resulting disclosure will be frequently misinterpreted by investors, potentially diminishing the content and quality of disclosures and the auditor's report.

The proposed standards are subject to differences in interpretation by individual audit engagement teams and investors. Given the diversity amongst audit engagement teams, divergences in the evaluation and application of the standards are inevitable. This likely will result in a fundamental lack of comparability between the auditor reports' discussion of "Critical Audit Matters", and confuse investors as they try to reconcile this discussion with the company's existing disclosures. The new disclosures can also misdirect investors to topics that are technically challenging for accountants and auditors, but are not as relevant to investors, while remaining silent on straight-forward matters, or topics deemed less critical, that are more material to the financial statements. The new disclosures may also be misleading without proper context and an understanding of the auditor's audit methodology. To manage these risks, the public accounting industry may adopt boilerplate language, which adds no further insight for the investor.

The scope of the "Auditor's Responsibilities Regarding Other Information" is also subject to differences in interpretation and application, and may provide false assurances for investors. For example, the forward-looking financial guidance disclosed in our Management's Discussion and Analysis is based on internal forecasts, only portions of which are shared with our auditor to inform current year valuation and other accrual decisions. This fact is not clear to a financial statement user, nor is the level of assurance an auditor is providing over this type of information.

Finally, we believe that both proposals surrounding "Critical Audit Matters" and "Auditor's Responsibilities Regarding Other Information" will significantly increase the cost and burden of audits and even prolong the audit process, all without yielding incremental value to investors. A prolonged audit process may also delay the availability of information to investors. We believe the risk of all these effects far outweigh the benefits that may result from implementing these changes.

We appreciate the opportunity to share our views with the Board. If you have any questions about our comments, please contact me at (650) 432-8165.

Sincerely,

/s/ James Hoffmeister

James Hoffmeister
Global Corporate Controller

cc: Byron H. Pollitt, Chief Financial Officer
cc: Tom M'Guinness, Senior Vice President – Corporate Legal

WRIT
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December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C.

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Board Members and Staff:

We appreciate the opportunity to comment on PCAOB Release No. 2013-005 ("Exposure Draft") related to the auditor's report and to the auditor's responsibilities regarding other information. Washington Real Estate Investment Trust ("WRIT") is a publicly traded real estate investment trust with a diverse portfolio of properties in the Washington metro region.

We appreciate the thorough process the Public Company Accounting Oversight Board ("Board") has undertaken to evaluate the auditor's report and the auditor's responsibilities to make the report more informative, useful and relevant to financial statement users. However, we believe that key provisions in the Exposure Draft would add significant time and expense to audits without commensurate benefits. We discuss our specific objections and propose alternatives in our responses to the following questions provided in the Exposure Draft:

**Auditor's Report**

**6. The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?**

The existing other information standard requires the auditor to consider whether the other information is materially inconsistent with information in the financial statements. The exposure draft would enhance the auditor's responsibility with respect to other information by adding procedures for the auditor to perform and would require communication of the procedures performed and their results in the auditor's report.

We do not object to adding to the audit report a description of the extent and nature of the existing standard for auditor's review of other information. We prefer that any modifications to the auditor's report be clear and objective. We believe that standardized language provides value for financial statement users by minimizing the potential for misunderstanding and facilitating comparisons across companies.

We are opposed to any expansion of the scope of the auditor's responsibilities on other information. We believe that such an expansion requires a significant increase to the scope of an audit. In particular, the management discussion and analysis ("MD&A") section of the Form 10-K contains extensive disclosures, many of which contain prospective financial information. A requirement for the auditor to perform additional procedures on these disclosures would inevitably entail a substantial increase in the time, effort and expense needed to complete an audit. In addition to this added expense, this increase in audit scope could cause financial statement preparers to adapt the nature and extent of their MD&A disclosures to be readily reviewable by the auditor and to meet SEC filing timelines. We believe that the potential costs and unintended consequences of changing the auditing standards for other information clearly outweigh the potential benefits to financial statement users, and that the Board should simply require a description of the existing other information standard in the auditor's report. In addition, such information is reviewed by management as part of the financial statement disclosure process.

**Critical Audit Matters**

**10. Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?**

**11. What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?**

The Board is proposing that communication of critical audit matters be included in the auditor's report. The Board defines critical audit matters as matters that:

1. involved the most difficult, subjective, or complex auditor judgments;
2. posed the most difficulty to the auditor in obtaining sufficient appropriate evidence; or
3. posed the most difficulty to the auditor in forming the opinion on the financial statements.

The Exposure Draft indicates that critical audit matters would ordinarily include matters of such importance that they are:

1. documented in the engagement completion document, which summarizes the significant issues and findings from the audit;
2. reviewed by the engagement quality reviewer; or
3. communicated to the audit committee.

While we are supportive of the Board's objective to make the auditor's report more informative for the investor, we have several concerns about the proposed communication of critical audit matters.

First, the proposed content of the critical audit matters is largely duplicative of items that should already be covered in the "critical accounting estimates" section of the MD&A. We therefore do not believe that the addition of critical audit matters to the auditor's report would add significant new information for the users of the financial statements. On the contrary, duplicating elements of the quarterly filings in the auditor's report would likely make the financial statements more confusing for the users.

Further, we believe that over time the volume of items considered to be critical audit matters will expand. In an effort to be thorough, the auditor may end up including extensive lists of critical audit matters in their audit reports. We question the usefulness of multi-page auditor's reports for financial statement users, as any useful information in the auditor's report would be obscured by the potential volume of disclosures.

Finally, we are concerned that critical audit matters could be used by the plaintiff's bar in asserting claims against public companies. Issues and findings from the audit or matters reviewed by the engagement quality reviewer could be improperly construed as potential areas of misstatement. We firmly believe that communications between the auditor and a company's audit committee should remain confidential for matters that do not rise to the level of material weakness.

We propose that the auditor should be required to provide in the auditor's report a more thorough description of auditing procedures performed, without disclosure of critical audit matters. If the Board believes that financial statement users need more information about subjective or complex items in the financial statements, then this would be better addressed through improved standards for MD&A disclosures.

Thank you for the opportunity to comment on this Exposure Draft. If you have any questions or would like to discuss our comments and concerns, please contact Robert Fisher, WRIT's Director of Financial Reporting, at (301) 255-0825 or bfisher@writ.com.

Sincerely,

Robert W. Fisher

Robert W. Fisher
Director of Financial Reporting

**ROBERT N. WAXMAN, CPA**
**866 UNITED NATIONS PLAZA, FL 4**
**NEW YORK, NY 10017**

December 11, 2013

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Rulemaking Docket No. 34 - PCAOB Release No. 2013-005:
Proposed Auditing Standard - The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and The Related Auditor's Report

Dear Secretary:

My General Comments on the above-mentioned proposal and my responses to the questions asked in Appendix 6 follow:

**<u>General Comments</u>**

**Auditor's Report**

I support replacing AU 550 with a stronger and more robust auditing standard; however, for the reasons stated in this letter, I recommend reissuing the proposal after deleting the auditor's external reporting requirements, making appropriate revisions as a result of the comment process, conferring with legal counsel concerning potential auditor liabilities, and field testing it.

Investors and other financial statement users believe that when auditors read and evaluate other information, they are in reality auditing such other information - despite the auditor's report asserting "we did not audit the other information and do not express an opinion on the other information." Considering that the auditor's evaluation is based on relevant audit evidence gathered during the audit, it is not credible that investors and other financial statement users will conclude that the auditor's "evaluation" is not an audit service; under this proposal, auditors are in appearance and fact auditing other information.

Since the auditor is not required to detail exactly which other information has been "evaluated" and which has not, investors and other financial statement users will believe that the auditors corroborated <u>all</u> the other information in the annual report and perhaps give such other information more credibility than is warranted.

Further, in that the audit report does not specify which other information has been evaluated, but nevertheless reports on it, it is expected that auditors will increase their litigation exposure to third parties for any material inconsistency or misstatement of fact either <u>not</u> (a) found and revised, or (b) disclosed in the audit report. In addition, given that the auditor's "evaluation" must comply with professional standards; any failure to meet these standards would also be the basis for accounting malpractice and other potential claims.

If a significant number of registrants and their audit committees believe the benefits to their investors will clearly outweigh the additional costs of the audit; the Board should at that time consider meeting this perceived need by formulating a separate report from the auditor (possibly using a form of "negative assurance") on other information.

**Audit Guidance**

Certain of the audit guidance in Appendix 6 is helpful in applying the proposed standard and should be incorporated into the final standard as a footnote, a Note to the applicable paragraph, or in a separate Appendix to the standard.

Other suggested revisions and comments are described below.

**Responses to the Questions in Appendix 6**

**I have answered the following questions as though the Board will proceed with this proposal substantially as written; however, these responses are subject to my overall disagreement with the auditor reporting required by paragraphs 13 and 14.**

**1. Is the scope of the proposed other information standard clear and appropriate? Why or why not?**

Yes, the proposal is clear regarding other information included in the scope; however, for increased clarity, I suggest the following additions:

a. That the 1934 Act annual reports listed on page A6-6 ("annual reports filed on Forms 10-K, 20-F, 40-F, and N-CSR, among others") be included as examples in the final standard.

b. That the Note to paragraph 1 (which states, "information incorporated by reference … that is available to the auditor prior to the issuance of the auditor's report") specifically mention the incorporation by reference of the annual report to security holders (the "glossy").

c. That the second sentence of footnote 4 be amended as follows:

   When the company's amended annual report contains ~~(1)~~ revisions to amounts or disclosures in the previously issued audited financial statements ~~and (2) a related auditor's report~~ that affect the auditor's report that was filed with the original Form 10-K, the auditor would apply all paragraphs of this standard.

d. The scope should state that the company's auditor does not have any responsibilities regarding (i) the audited financial statements of another entity, or (ii) any related other information required to be filed in a company's annual report under Article 3 of Regulation S-X – see Question 4.

e. The scope should be expanded to include the responsibilities of a predecessor auditor – see Question 23.

**Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?**

No other Exchange Act reports should be included in the scope.

**2. Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not?**

Yes. Information incorporated by reference, for example, under General Instruction G to Form 10-K (e.g., from the definitive proxy statement, or provided in an amended Form 10-K, or from the annual report to security holders (the "glossy")), is properly included in the scope of the proposal. As mentioned on page A6-8, this information "is an essential part of the company's annual report on Form 10-K and is necessary to make the document complete."

**Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?**

Practical Issues

Appendix 6 states (in footnote 15) that any documents contained in the list of exhibits to the annual report are considered to be other information. Thus, under the proposal, the exhibits incorporated by reference and listed under Item 15(a)(3) of Form 10-K would be required to be read for material inconsistencies, material misstatements of fact, or both. As is often the case, many of these exhibits and their various amendments have been filed with the SEC over many years. The other information included in the Item 15(a)(3) exhibits may or may not be compared with or traceable to any audit evidence obtained during the current audit and reading and "evaluating" all of these exhibits will be a significant enlargement of the audit scope, especially in the initial year of implementation of this proposal, and for large or complex registrants.

Consequently, I recommend that the final standard clarify the auditor's responsibilities regarding the exhibits filed under Item 601 of Regulation S-K.

Additional Audit Costs

AU 550 does not discuss incorporation by reference. Additional costs would be incurred to the extent auditors were not fully "reading and considering" the documents that are incorporated by reference (e.g., the exhibits, the definitive proxy statement, and amendments to other information in the annual report using Form 10-K/A).

Further, additional audit costs would include complying with AS 3 (Audit Documentation) which requires specific documentation of the information added to the audit working papers after "lock-down."

**3. Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not?**

Yes, other information included in an amended annual report is properly included in the scope of the proposal.

**Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?**

See Question 2.

**4. Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?**

The company's auditor should not have any responsibilities regarding audited financial statements of another entity, or any related other information required to be filed in a company's annual report under

Article 3 of Regulation S-X, since (as pointed out in Appendix 6) those financial statements were already subject to a separate audit.

I suggest this scope exception be clearly stated in the final standard – see Question 1.

There will be practical issues and related additional costs involved in coordinating and documenting the other auditor's evaluation of the other information that is related to the other entity's audited financial statements.

**5. Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?**

<u>Paragraph 2</u>

Concerning the overall Objectives, paragraph 12 addresses the auditor's responses to the potential misstatements in the financial statements. Page A6-31 explains that "[t]hese procedures would provide an increased auditor focus on other information, which could improve the auditor's identification of potential misstatements in the financial statements." I believe this is as important an objective as those mentioned in paragraph 2, and should be included in the Objectives paragraph in the final standard.

<u>Paragraph 2.a</u>

<u>Meaning of "evaluate"</u>

What does "evaluate" mean to investors and other financial statement users?

a. The other information (i) is not audited, (ii) is not unaudited, and (iii) is not reviewed; it has been evaluated!

b. What meaning will investors and financial statement users attach to the term "evaluate"? How will non-accountants understand this verb? The proposal tells us that since the other information being "evaluated" is based on "relevant audit evidence obtained and conclusions reached during the audit" the other information is in appearance and fact "audited."

I believe that investors and other financial statement users can come to no other conclusion – "evaluated = audited" – despite the auditor's report saying "we did not audit the other information and do not express an opinion on the other information" (required by paragraph 13.d).

This "evaluated = audited" conclusion is further supported by –

a. Appendix 6 (page A6-15) which explains that "should evaluate" is used in PCAOB standards when the auditor is expected to "come to a conclusion based on the performance of certain [audit] procedures (the footnote cites AS 7 and AS 12)."

b. Paragraph 12 which states that the potential misstatement in the audited financial statements uncovered by the procedures (outlined in paragraphs 4 and 5) must be evaluated using the audit procedures found in AS 14 (Evaluating Audit Results), AU 508 and AU 561.

c. The procedures undertaken (under paragraphs 9 and 11), when there is an uncorrected material inconsistency or misstatement of fact (or both), indicates that "evaluate" is equivalent to "audit."

<u>Other comments</u>

The word "fact" in paragraph 2.a should be footnoted and the audit guidance found on page A6-12 should be included in the final standard. This guidance suggests that the term fact "could relate to, among others, statements about the company's competitive environment, technological developments, or supplier relationships" and that "the auditor might have knowledge of such information as part of obtaining audit evidence or reaching conclusions during the audit."

<u>Paragraph 2.b</u>

To circumscribe any possible auditor liability –

a. The auditor should detail exactly the other information that has been "evaluated." This will also tell investors and other financial statement users that the auditor did not "evaluate" everything in the annual report (likely contrary to most investor and user expectations). In most cases, such a detailed listing would be impractical.

b. Require the specific identification of other information for which the auditor did not have relevant audit evidence (which other information may be considered to be "unevaluated/unaudited"). Such a listing would be substantially longer than that mentioned in a. above, overly cumbersome, and impractical to apply in practice.

   Under this proposal, the auditor does not specifically detail the other information evaluated and not evaluated. The auditor's report says nothing other than "we evaluated whether the other information … contains a material inconsistency with the financial statements, a material misstatement of fact, or both." Here the audit report is misleading those investors and other financial statement users who may believe and expect that the auditor has "audited" <u>all</u> the other information in the annual report, despite any statement to the contrary in the auditor's report – see paragraph 13 and Question 18.

c. Regarding the phrase "relevant audit evidence," AS 14 tells us that in forming an opinion on the financial statements, "the auditor should take into account all <u>relevant audit evidence</u>, regardless of whether it appears to <u>corroborate or to contradict</u> the assertions in the financial statements" (emphasis added). It would be helpful if the phrase "relevant audit evidence" be expanded to say that it should be used to corroborate or to contradict the assertions made by management in the annual report.

Paragraph 13.e.(1) requires the audit report to state that, based on the evaluation, the auditor has not identified a material inconsistency or a material misstatement of fact in the other information. This directive is contrary to the objective stated in paragraph 2.b.; accordingly, paragraph 2.b should be restated to insert the words "whether or not" and thus read –

> When issuing an auditor's report … and conclusions reached during the audit, <u>whether or not</u> the other information contains a material inconsistency, a material misstatement of fact, or both.

Unless registrants believe the benefits to financial statement users clearly outweigh the additional audit costs, and are willing to pay for the additional auditing procedures required by this proposal, auditors should not be required to report on their "evaluation." The additional costs would then pay for the procedures auditor's deem needed as a result of the their assessment of the potential exposure to the increased risk of litigation involved in the reading, evaluating and reporting on other information.

**6. Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?**

Yes, the objective regarding material inconsistencies of amounts or information, or the manner of their presentation, and material misstatements of facts (or both) is proper.

**7. Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?**

Quality of Information

I would anticipate that management would increase the accuracy and factual basis of other information in the annual report knowing that their auditors will be reading and "evaluating" such other information under an auditing standard.

Greater Confidence

As currently proposed, the auditor will evaluate the other information based on "relevant audit evidence" obtained during the audit. As discussed in Question 5, a detailed listing of the other information (both evaluated and not evaluated) is not required to be furnished by the auditor, nor in most circumstances is it practicable to do so. This lack of specificity generates the following questions –

a. How will investors determine what other information has been evaluated/audited vs. not evaluated/unaudited?

b. Will investors believe that the auditor read and "evaluated" all the other information in the annual report? Most or some of the other information? What percentage?

c. Should investors take any comfort in believing that some of the other information was evaluated even if a significant percentage of other information may not have been evaluated?

d. How can investors and users gain any confidence regarding such unevaluated other information?

As the proposal is now written, investors will believe that the auditors evaluated and corroborated all if not most of the other information and thus perhaps give such other information more credibility than is warranted.

While some may assume that investors and financial statement users will have greater confidence in other information, I have no information nor is there any direct evidence that the proposed auditor's report would "contribute to greater confidence." Assuming greater confidence posits the idea that investors confidence level would rise by some material and measureable degree – this is an entirely problematic inference and empirically unverified.

In sum, I do not believe that the proposed reporting will instill in investors and other financial statement users more confidence in the other information.

**8. Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information?**

Yes. I suggest that the term "material" be referenced to AS 14 (Evaluating Audit Results) and to TSC Industries, Inc. v Northway, Inc. in paragraph 2.

**Would applying this definition represent a change to the materiality considerations auditors currently use under AU sec. 550?**

Materiality under AU 550 is consistent with the requirements of SAB 99 (Materiality) and AS 14; both documents cite the Supreme Court's decision in TSC Industries.

**9. Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?**

Paragraph 4.b

The proposed procedures in paragraph 4.b mentions "[c]onsistency of any qualitative statement in the other information …."

I recommend that the meaning of "qualitative statement" in the context of this proposal be clarified by incorporating into the final standard the discussion found on pages A6-12 and A6-19. This guidance explains qualitative statements as "the description of the company's critical accounting policies, estimates, and related assumptions in the other information of an annual report … [that] would be directly related to accounts and disclosures in the financial statements …." This qualitative "other information might appear in the MD&A section … of Form 10-K and relate to, for example, accounting policies, practices, and estimates or the description of off-balance sheet arrangements."

Paragraph 4.c

Page A6-20 provides some additional guidance to paragraph 4.c observing that "[w]ith respect to other information that is not directly related to the financial statements … [this other information] might appear in the Business, Risk Factors, or Quantitative and Qualitative Disclosures about Market Risk sections … on Form 10-K or the MDFP section … on Form NCSR…."

This additional guidance continues saying that "management might state in the other information that the company has the largest market share in the company's industry. This information could be material to an investor's decision about the company. The auditor might be aware, based on relevant audit evidence obtained during the audit, that the company does not have the largest share in the relevant industry. The proposed other information standard would require the auditor to evaluate whether management's statement represents a material misstatement of fact."

I recommend that the above guidance regarding "other information not directly related to the financial statements" be incorporated into the final standard.

Paragraph 4.c should be reworded

So that it more closely relates to the objective in paragraph 2.a (which states, "To evaluate whether the other information contains … a material misstatement of fact …."), paragraph 4.c should be amended as follows:

> "Facts ~~Other information~~ not directly related to the financial statements as compared to relevant audit evidence obtained and conclusions reached during the audit …."

Paragraph 5

Paragraph 5 requires the auditor "perform additional procedures, as necessary, to determine whether there is a material inconsistency, a material misstatement of fact, or both." Page A6-21 says "[s]uch additional procedures might include (1) requests for additional documentation and (2) consultations outside of the engagement team, such as a national office or other parties with appropriate expertise. The procedures would vary based on the auditor's evaluation of the relevant facts and circumstances."

At a minimum, this guidance (regarding these additional audit procedures that either supplement, or are in addition to those undertaken during the audit to corroborate the amounts or disclosures in the financial statements and in other information) should be incorporated into the final standard.

**10. Is it understood which amounts in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?**

The amounts required to be recalculated are reasonably clear; however –

a. The audit guidance found on page A6-20 ("… the auditor would not be required to evaluate the appropriateness or sufficiency of the formula used in the calculation.") should be included in paragraph 4.d of the final statement.

b. The final standard should address those situations where the auditor believes (using professional judgment) a metric or formula used –

- Is not common (or standard) practice in the entity's industry, or
- Produces a misleading result (though potential management bias, error or otherwise).

c. In that the SEC encourages the use of tables, schedules charts and graphic illustrations in annual reports to security holders (1934 Act Rule 14a-3); the final standard should address financial and "factual" information presented in the form of charts or graphs. Among other things, this guidance should comment on the consistency of the other information with the financial statements, the completeness of the information, the manner of presentation and the possible misstatements that may enter into such chart or graph presentations.

**11. Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?**

Appendix 6 deals with the additional costs of complying with this proposal very broadly. More specifically additional costs incurred would include for example: keeping the audit working papers "open" past their "lockdown" date to comply with AS 3; the review of multiple drafts of documents; coordinating the "evaluation" of other information by other auditors and predecessor auditors; and coordinating with audit teams involved with subsidiaries of the registrant located outside the United States whose working papers contain the appropriate audit evidence.

**12. Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not, why not?**

Yes, the responses under paragraph 5 requiring a discussion with management and the performance of additional procedures are appropriate.

**13. Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?**

None beyond those broadly mentioned in Appendix 6

**14. Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

Yes, the responses under paragraphs 8 and 9 are appropriate.

**15. Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?**

Yes, it is appropriate to identify and disclose in the auditor's report (a) other information containing amounts or information that is materially inconsistent with the audited financial statements, (b) other information whose presentation is materially inconsistent with the audited financial statements, and (c) a material misstatement of fact, that is not corrected by management.

Since it is left unstated, the proposal implies that the auditor has no responsibility to correct the other information that does not agree with the "relevant audit evidence obtained." Nevertheless, to eliminate any uncertainty, the final standard should affirmatively state that the auditor has no duty to, nor should the auditor correct the other information in the audit report.

In addition to the auditor's "evaluation" of other information incorporated by reference after the issuance of the audit report, paragraph 7 outlines the audit procedures to be followed when management does not revise the other information and the other information is not available to the auditor prior to the issuance of the auditor's report. The final standard should address the impact, if any, of these procedures on the date of the audit report (AU 530, Dating of the Independent Auditor's Report).

**16. Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?**

Yes, the responses under paragraphs 10 and 11 are appropriate

**17. Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed other information standard, the auditor determines that there is a potential misstatement in the financial statements? Why or why not?**

Yes, they are appropriate. If the audit report has not been issued, I suggest that – in addition to AS 14 (to determine whether or not the auditor has obtained "sufficient appropriate audit evidence") – AS 12 (Identifying and Assessing Risks of Material Misstatement) should be referenced in the final statement so that auditors can determine that they had properly identified and appropriately assessed the risk of material misstatements, and had correctly considered the design and implementation of their responses to material misstatements.

**18. Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?**

Paragraph 13.d requires a "statement that the auditor did not audit the other information and does not express an opinion on the other information" be included in the auditor's report. This reporting contradicts the requirement that the auditor evaluate the other information based on relevant audit evidence obtained and conclusions reached during the audit, which procedure is viewed as tantamount to auditing the other information.

Concerning paragraph 13.e.(1), there is no logical reason for auditors to affirmatively report that they have has not identified a material inconsistency or a material misstatement of fact in the other information. This reporting is merely a form of negative assurance (e.g., "we have not identified a material inconsistency etc.", or "we are not aware of any material modifications that should be made to the other information etc.") submerged in the audit report of the registered public accounting firm.

**19. Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.**

The standard should neither require nor permit the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence.

**20. What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?**

After the audit report has been issued, additional costs would be incurred in discussions with management and the audit committee, and audit procedures to comply with Section 10A, AS 3, AS 12, AS 14, AU 508, AU 561, and other auditing standards and procedures as considered necessary in the circumstances.

**21. Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?**

No, see discussion under General Comments and Question 18.

**22. Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?**

No practical considerations come to mind.

**23. Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?**

I recommend that the final standard expand footnote 6 to paragraph 2 by including the discussion on page A6-38. This additional guidance requires "the predecessor auditor to perform the procedures with respect to a material inconsistency based on relevant audit evidence obtained and conclusions reached during the predecessor auditor's previous audit." Consequently, the "predecessor auditor's procedures would include reading and evaluating the other information in the current period annual report … for any material inconsistencies with the audited financial statements for the prior period."

This guidance continues "[i]f the predecessor auditor concludes that there are no material inconsistencies, the predecessor auditor's report may be reissued. If, after communication with management and the audit committee, the predecessor auditor determines that the other information contains a material inconsistency, the predecessor auditor would be required to determine his or her responsibilities under federal securities laws and PCAOB standards. The predecessor auditor also may withhold the use of the auditor's report for the prior period."

**24. What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability?**

Notwithstanding the auditor's report specifically states that "the auditor did not audit the other information and does not express an opinion on the other information," it is not plausible for investors and other financial statement users to believe that the "evaluation" is a non-audit service, since (a) the auditor expresses an opinion based on their "evaluation" (i.e., there are no material inconsistencies or misstatements of fact [a pass], or the contrary [a fail]), (b) the other information opinion is included in the basic auditor's report (under a separate section titled The Auditor's Responsibilities Regarding Other Information), and (c) that the evaluation was based on relevant audit evidence obtained and conclusions reached during the audit.

For these reasons, the auditor would increase their litigation exposure to third parties since they are in appearance and fact auditing such other information.

Further, the auditor's "evaluation" must comply with professional standards, i.e., due professional care, planning and supervision, sufficient relevant data, etc., and therefore a failure to meet these standards would be the basis for audit malpractice and other potential legal claims.

**Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?**

Yes, I recommend abandoning the reporting requirements in this proposal, but keeping the standard. A separate report on other information may then be formulated by the Board, possibly using a form of "negative assurance" saying, for example –

> Based on our work, described in Note X of this report, nothing has come to our attention that causes us to believe that other information (denoted with the symbol ** in the annual report on Form 10-K filed on xx) is materially inconsistent with the financial statements audited by us (referred to above), or contains a material misstatement of fact, or both.
>
> Note: The use of a symbol is one mechanism to let financial statement users know exactly what has been read and the procedures that were followed by the auditor. This method would be impractical in most cases.

This separate report assumes registrants believe the benefits and value added to their investors will clearly outweigh the additional costs of the auditor's procedures.

**25. Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?**

If the Board proceeds with this proposal substantially as written, I recommend that the Board seek legal advice from qualified counsel to determine the impact on the auditor's potential liability under the federal securities laws, as well as the laws in all jurisdictions.

**26. Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?**

The proposed amendment to AU 9634 (Auditing Interpretations of Section 634, page A4-8) is not appropriate for the reasons set forth under General Comments and the answers to the above Questions.

**27. In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?**

I support the Boards requiring a statement in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report.

**28. Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?**

This proposal should apply only to broker-dealers who either are issuers (as defined in the 1934 Act), or are a subsidiary of an issuer; thus all of the above comments and responses are applicable to other information disclosed by such broker-dealers.

**29. Is the Board's effective date appropriate for the proposed other information standard? Why or why not?**

Yes, the effective date of the standard (applicable to audits of financial statements for fiscal years beginning on or after December 15, 2015) is appropriate. See Question 30. ,

**30. Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?**

Notwithstanding the substantial expansion of the audit work and documentation, in that the obligation to read and consider is already required by AU 550, there is no reason why auditors of large accelerated filers, accelerated filers, non-accelerated filers or smaller reporting companies cannot read and "evaluate" the other information in annual reports by the effective date of the proposed standard.

**31. Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?**

The discussion in Appendix 6 of the difficulties involved and hurdles encountered in having the auditor report on other information in 1933 Act filings support a "no" answer to this question.

The perceived needs of investors are currently being met for certain 1933 Act filings since other identified information is read and reported on by the auditors in a letter addressed to the underwriter with a statutory due diligence defense under AU Section 634 (Letters for Underwriters and Certain Other Requesting Parties). In addition, 1933 Act filings are also subject to the requirements of AU 711.

**32. Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?**

At this time, no elements of the proposal should be extended to 1933 Act filings; however, a review of AU 711 and AU 9711 is warranted and should be added to the Board's standard-setting agenda.

**33. What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?**

See Question 32.

* * * * *

I appreciate your consideration of my comments, suggestions and responses to the Appendix 6 Questions and would be pleased to answer any questions the Board or the Staff may have concerning this letter.

Sincerely,

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MAZARS

WeiserMazars

December 9, 2013

**VIA E-MAIL comments@pcaobus.org**

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

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

Dear Members of the Board:

WeiserMazars LLP ("WeiserMazars") welcomes this opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Proposed Auditing Standards. WeiserMazars supports the PCAOB in its efforts to enhance audit quality for audits of issuers in order to provide investors and other financial statement users transparency in financial reporting so they can make appropriately informed investment decisions.

For this reason, we are joining the discussion about how best to address specific concerns raised by the Board regarding the demands of investors and other financial statement users that the current auditor's pass/fail reporting model does not provide sufficient information relating to a particular audit of an issuer. WeiserMazars is a firm with over 100 partners and 650 professionals in six offices across the United States ("U.S."), an independent member firm of the Mazars Group, an organization with 13,500 professionals in more than 70 countries around the world, and a member of Praxity, a global alliance of independent firms. We understand the increased complexity of global business operations and the use of judgments and estimates made by management of issuers as well as complex privately-held businesses. Because we are a U.S. registered public accounting firm, and a member of an international network, our perspectives may differ from our international counterparts due to variations in the client population and litigation environment.

We understand the PCAOB wants to enhance the current auditor's reporting model while at the same time does not want to create undue hardship to both independent registered public accounting firms and issuers, increase litigation, add further complexity in the capital markets or promulgate reporting requirements for which the costs outweigh the benefits.

Our responses to the Board's Proposed Auditing Standards are driven primarily by our position in the U.S. marketplace as a medium-sized public accounting firm servicing issuers with less than $.5 billion in market capitalization held by non-affiliates. Therefore, our focus is to address our concerns and challenges to companies with similar characteristics to our issuer client base as well as to similar accounting firms.

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WeiserMazars

**Overall Views**
We understand the Board's position with respect to the auditor's unique insights and knowledge developed during the audit process and that certain information should be shared with investors and other financial statements users. However, we do not believe it would be appropriate to mandate auditors to provide such information in the auditor's report. Auditing of an issuer is a highly complex professional discipline that requires many years of experience, training and education and knowledge of the issuer's business. An audit requires extensive use of the auditor's professional judgment. In our view, the disclosure of critical audit matters within the auditor's report would not incrementally help investors make informed decisions or enhance transparency and may confuse investors and dilute the value of an independent auditor's report.

We fully support improvement to the auditor's reporting model and also recognize investors' needs for meaningful information on which to base their investment decisions. But certain of the proposed changes will require significant judgments to be made by auditors, management, audit committees and other members of the Boards of Directors which may generate inconsistency between firms and issuers and could be widely misinterpreted by investors. We believe that investors and other users of financial statements may not reasonably and meaningfully assess the effectiveness of such judgments of critical audit matters without all the factual and technical data that is available to the auditor.

We believe the assessment of audit quality is the responsibility of practice and technical leaders of audit firms, regulators (such as the SEC and the PCAOB), state boards of accountancy and most importantly, audit committees of issuers upon whom investors should be able to place their reliance as to such matters. In our opinion, we view the regulation and strengthening of audit committee responsibility as "gatekeepers" as the most important aspect and viable alternative to assure that investor needs are served.

**Appendix 5 – Additional Discussion of the Proposed Auditor Reporting Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release**

**<u>Questions Related to Section IV:</u>**

2. ***The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?***

   We do not believe that there is a need to change the provisions of AU Section 508.09. The proposed standard indicates that the "requirement for the auditor's report to be addressed to investors might serve as a reminder to the auditor that the auditor's ultimate customer is the investor." We do not believe that the proposed requirement regarding the addressee will cause any change in an auditor's view of the importance of the investor. Therefore, the current provisions of AU Section 508.09 are adequate and appropriate. We also believe that because the current addressee model is appropriate, there are no others to whom the auditor's report should be addressed.

3. ***The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?***

   We believe that the revisions related to the description of the nature of an audit, as described in the proposed auditor reporting standard, are adequate and appropriate. We do not believe that there are any additional auditor responsibilities that need to be included to further describe the nature of an audit.

4. ***The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?***

We do not believe that a statement in the auditor's report relating to auditor independence is necessary. The title of the auditor's report states the auditor is independent, and we believe this is sufficient. Therefore, further disclosure regarding auditor independence is unnecessary.

5. ***The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.***

   *a.* ***Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?***

   Information regarding the tenure of the auditor does not fit into the context of the auditor's report and, therefore, would not be useful to investors or other financial statement users. Tenure of the auditor is not related to auditor responsibilities. There is no meaningful analysis that can be attributed to auditor tenure. The number of years an auditor serves an issuer may or may not impact audit quality.

   *b.* ***Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?***

   We believe auditor tenure is meaningless, and more so, if there have been a series of mergers among auditing firms.

   *c.* ***Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?***

   Auditor tenure is not a meaningful measure and should not be reported in the auditor's report or elsewhere.

**<u>Questions Related to Section V:</u>**

10. ***Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?***

We believe the inclusion of critical audit matters in the auditor's opinion will add further confusion to investors who do not fully understand the auditing process or how an engagement team reaches its conclusions regarding risk assessments. We would expect that the auditor and the issuer would incur additional costs related to the reporting of critical audit matters. We are also concerned, that such inclusion may become recurring disclosures of routine critical audit matters with "boilerplate" language, because issuers in similar industries will presumably have the same recurring critical audit matters (e.g., loan loss reserves for a bank). Use of the auditor's report to convey important information about the company is not a practical solution for providing critical information that should be authored by management, approved by members of the Board of Directors, particularly the audit committee, and included elsewhere in issuer filings.

11. ***What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?***

We do not believe there are any benefits derived from including critical audit matters in the auditor's report. Unintended consequences of such inclusion may include negative impacts on the relationship between the auditor, issuer's management and the audit committee regarding an ongoing and open dialogue, and forthright communication of significant audit matters. Another unintended consequence is that auditor judgment may be impacted whereby matters may be excluded from the Engagement Completion Document or not communicated to the audit committee.

12. ***Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?***

We believe the definition of a critical audit matter is clearly stated in the proposal. However, such matters would not necessarily be understood by financial statement users. We are concerned that some investors may misinterpret the communication of a critical audit matter to be indicative of an issue with respect to the quality of the financial statements or operations of a company, or that such communication may be seen as a qualified auditor's report.

We agree that the use of the word "most" as understood in the definition of critical audit matters in the Proposed Auditing Standard would be clear to a reasonable investor.

15. ***Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?***

We believe the inclusion of audit procedures performed, critical audit matters and other information subject to the auditor's judgment in the auditor's report will not be relevant or useful, and may even be further confusing to investors; this may result in more questions being raised than answers provided, which could impact the U.S. capital markets in a negative way. For instance, smaller sized filers may be significantly impacted by the inclusion of critical audit matters in the auditor's report because they may not have the same sophistication and resources as larger filers. Investors may not be able to understand critical audit matters or other information without the bases needed to put these matters in proper perspective.

21. ***What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?***

We believe additional recurring costs will be incurred by auditors, especially for smaller and medium sized accounting firms, caused by additional review time incurred by the lead engagement partner, engagement quality reviewer ("EQR"), Engagement Quality Control Reviewer ("EQCR"), and potential review by auditor's in-house or outside legal counsel. Auditors may also have increased liability insurance coverage.

For many non-accelerated filers, these activities will also require input from management, audit committees and others, including issuer's in-house or outside legal counsel. Also see our response to question #23 below.

23. ***How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?***

Substantial first-time through and recurring costs in these areas could be expected by auditors and their issuer clients. For auditors this could include training and manuals/template updates. For the issuers, there could also be additional training and increased professional fees. Consequently, we believe that additional time incurred and resources used by the engagement team and other firm personnel will cause audit fees to increase. Such fee increases may have an unintended consequence as issuers may consider changing auditors, which may compromise the quality of the audit in order to lower the cost of obtaining an audit opinion.

24. ***Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so, under what circumstances?***

We believe significant matters warranting inclusion in the auditor's report should be addressed through an emphasis of a matter paragraph in accordance with existing standards and based on auditor judgment; such matters should not be mandated by the Board.

26. ***What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.***

We believe that the time incurred for the inclusion of critical audit matters in auditor's reports would be quite lengthy and not particularly useful to investors, while simultaneously increasing costs and exposure to frivolous litigation for smaller to medium sized public accounting firms. Smaller to medium sized public accounting firms, as compared to the larger international public accounting firms, may not have the resources to protect their practices.

Critical audit matters for a smaller or non-accelerated filer may not be deemed as critical for a larger or accelerated filer. Therefore, the Board's single requirement for different sized filers may not be equally weighted in practice causing additional burden to non-accelerated filers. This also applies to complex verses simple accounting issues whereby a complex issue for a smaller or non-accelerated filer that would be deemed a critical audit matter by an auditor may not be deemed critical for a larger or accelerated filer.

Further, the comparability of auditor's reports that include critical audit matters would add confusion to investors, particularly if a critical audit matter existed in only one year. In addition, for critical audit matters to be truly comparative, a detailed history would need to be provided to the financial statement user. Provision of a detailed history would become a "form over substance" approach, whereby such long and technically detailed information would not be useful to investors. Additionally, we believe this information could be interpreted by the investing public potentially as "unresolved issues," which could lead to possible misinterpretation by analysts, investors and other financial statement users, leading to increased litigation against both the issuer and the auditor.

27. ***What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?***

We do not believe that overall users of the audited financial statements, particularly investors, would receive any additional benefit from this information, which would also prove to be more costly to the issuer. Such responsibility should be borne by management and not the independent auditor. Therefore, critical audit matters that have been satisfactorily resolved among management, the audit committee, other members of the Board of Directors and the auditor should not be included in the auditor's report.

28. ***What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?***

We believe the auditor's communication of critical audit matters would substantially expand the scope of auditor liability in private securities litigation without providing any corresponding benefit to investors. Any comment made (or omitted) would be scrutinized under the current "recklessness" *scienter* standard for liability under Section 10(b) of the Securities Exchange Act of 1934 for fraudulent or misleading statements made with respect to securities traded in the public markets. It would be extremely difficult to obtain dismissal of such claims on motion. This would revive the ability of class action securities counsel to present auditors with the choice of paying unreasonable settlements or enduring the very substantial costs of civil discovery on claims without legal merit. This, in turn, would increase the legal and insurance expenses of auditors and thus require material increases in fees to issuer clients.

The same considerations would inhere to any discussions of non-financial information required by the proposal. This problem would be exacerbated by the lack of auditor qualifications to understand and comment on non-financial, subjective company information and the inability to apply objective verification procedures to such matters.

A potential solution to these concerns might be the creation of a legislative "safe harbor" for such non-financial information comments (similar to that existing for projected financial statements). But it would be difficult to define that "safe harbor" to distinguish it from the current opinion on compliance with U.S. GAAP and it would require U.S. Congressional action.

The Board should consider proposing a related project to address the clarification of critical audit matters by considering the development of safe harbor language that auditors can insert in their auditor's reports in order to decrease the likelihood of financial statement users misunderstanding the nature, content and context of critical audit matters disclosed by auditors.

**Questions Related to Section VI:**

29. ***Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?***

We believe that the Board's description of circumstances that would require explanatory language is appropriate.

30. ***Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?***

We believe that it is valuable to retain the auditor's ability to emphasize a matter in the auditor's report. In general, the auditor should be able to exercise professional judgment regarding what matter(s) needs to be emphasized (taking into consideration materiality from a quantitative and qualitative perspective and other relevant facts and circumstances).

**Question Related to Section VII:**

34. ***What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.***

See our response to question #21 in Section V above. In addition, costs incurred by small to medium-sized accounting firms and smaller or non-accelerated filers, proportionately, will have a much greater impact on them than on larger or accelerated filers and larger international accounting firms.

**Questions Related to Section VIII:**

35. ***Are the proposed reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?***

Broker-dealers are not issuers. Although there are some broker-dealers that are subsidiaries of issuers, that is a small number and, we believe, to have the entire industry subjected to the proposed rule would be burdensome.

As the broker-dealer industry is heavily-regulated and subject to oversight by both FINRA, the SEC, and in some cases other exchanges, and with auditors of all broker-dealers being subjected to PCAOB standards in June 2014, existing layers of regulation pose significant costs already. Many broker-dealers are small in size. In fact, according to a recent presentation on October 31, 2013 at the PCAOB Forum on Auditing Smaller Broker-Dealers in Jersey City, of the approximately 4,200 broker-dealers, over 2,200 of the broker-dealers have minimum net capital of $5,000 and nearly 1,700 broker-dealers have revenues of less than $1 million.

Additionally, regulators receive monthly or quarterly regulatory reports (FOCUS Reports); broker-dealers are under constant scrutiny and maintain regular communication with regulatory bodies. Annual broker-dealer auditor's reports are filed with both the SEC and FINRA, and the SEC maintains a public library where investors can review the financial statements of broker-dealers. Regulators also review these filings. In addition, examinations of broker-dealers occur periodically by the regulators depending on the risk associated with that broker-dealer entity. If the Board decides that it would be appropriate to include all broker-dealers under the proposed reporting standards and amendments, consideration should be given to limit the rule change to broker-dealers that hold customer securities, only.

36. ***Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for auditors of brokers and dealers? If not, why not?***

As noted above, significant regulatory oversight already exists for auditors who audit broker-dealers. We believe that the inclusion of a requirement to communicate in the auditor's report critical audit matters for audit of brokers and dealers would provide no additional benefit. However, it is our understanding that those brokers who carry customer balances are the Board's focus. Therefore, if the Board requires critical audit matters to be included in the auditor's report, such requirement should be limited to audits of those broker-dealers who carry customer balances.

37. ***Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?***

We do believe that neither the balance sheet only auditor's report nor the full financial statement report should include critical audit matters or other information. This may cause confusion for investors as noted above for non-broker-dealer entities. However, the carrying broker-dealer should be the only broker-dealer entity considered for additional reporting as the risks of holding customer cash and securities rest with those firms.

38. ***Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of a master feeder fund or fund of fund structures?***

Investors in registered investment companies are required to meet the definitions of an accredited investor or qualified purchaser. Such investors are deemed sophisticated and the inclusion of a discussion of critical audit matters in the auditor's report would not add value for the investor.

**Question Related to Section X:**

42. ***Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

If the Board adopts the new reporting standards, we believe that there should be a time delayed phase-in of the proposed reporting requirements for auditors of smaller or non-accelerated filers or smaller reporting companies in order to provide the necessary training and guidance as well as to make appropriate revisions to their respective quality control policies and procedures. However, auditors of larger or accelerated filers should be the first to comply with the proposed auditing standards.

**Appendix 6 – Additional Discussion of the Proposed Other Information Standard, Proposed Amendments to PCAOB Standards, and Comments on the Concept Release**

**Questions Related to Section III:**

6. ***Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?***

We do not believe that the auditor should evaluate the other information for any material inconsistencies or material misstatement of facts. While the auditor gains an understanding of the other information, it would not be subjected to the same audit procedures and scrutiny as financial statement information and related footnotes, their source originating from the issuer's financial reporting system (general ledger). Therefore, much of the auditor's evaluation of other information would be conjecture, further subjecting the auditor to possible litigation and undue costs.

13. ***Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?***

As mentioned above, we believe there would be significant additional costs incurred in the instance when there is an identification of a potential material inconsistency and/or material misstatement of fact discovered. The concept of a "close call" leads to significant costs in ensuring that the documentation is accurate and not deemed to be misleading to the users of the audited financial statements. Further, there is an implicit risk that the mere reference to a potential material inconsistency and/or misstatement of fact could be interpreted by investors or other users of financial statements that there is a material inconsistency and/or misstatement of fact when in fact there is not. We also believe this would significantly increase the risk of litigation against both the registrant and the independent registered accounting firms by providing such information to the investing public.

**Question Related to Section IV:**

15. ***Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?***

We believe that it is appropriate for the auditor to appropriately address such circumstances prior to issuing the auditor's report. Specifically, the auditor should exhaust all reasonable means to understand the fact pattern causing the material inconsistency, material misstatement of fact, or both of such other information. In addition, the auditor should discuss with management and the audit committee why the issuer believes such material inconsistency, material misstatement of fact, or both, remains unresolved.

If, after performing the above procedures, the other information remains materially inconsistent, materially incorrect in fact, or both, then the auditor could consider including an emphasis of a matter paragraph in the auditor's report.

We also believe that the PCAOB may want to consider defining "material inconsistency" for purposes of evaluating circumstances to which this concept applies.

**Questions Related to Section VI:**

19. ***Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.***

We do not believe the Board should permit or require the auditor to identify in the auditor's report information not directly related to the financial statements and related footnotes. We do believe such decision should not be based upon whether the auditor had relevant audit evidence against which to evaluate because items outside the financial statements are outside of the scope of the auditor's engagement.

20. ***What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?***

We believe both the auditor and issuer would incur substantial time and resources when involving a material inconsistency, a material misstatement of fact, or both, when attempting to report such matters to the investing public. In accordance with current PCAOB requirements, such items should be documented in the Engagement Completion Document. Such documentation includes specific fact pattern identification with a basis for conclusion. In order to transfer this knowledge into a format that is appropriate, the following may be required:

- Additional time and resources in drafting the appropriate reporting presentation content. This may also require additional time and resources from management and perhaps even from in-house or outside legal counsel depending on the nature of the reported item.

- We expect that the presented content will require the application of significant professional judgment. Specifically, judgment will be required as to the nature of the information to disclose and the amount of information to disclose. To the extent auditor judgment in this area is required, additional auditor and issuer resources will be required to limit the auditor's and issuer's risk in disseminating information that is subject to misinterpretation by the investing public regardless of how careful and thorough the auditor and issuer may be in crafting this presentation.

- We also expect an increase in time to document such additional procedures required to follow up with management, audit committee and other designated parties of the issuer, in-house or outside legal counsel, and the national office (or quality control department) review including EQR.

To the extent the Board decides to invoke this provision, it should consider providing "safe harbor" provisions for the auditor.

21. ***Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?***

We believe the proposed reporting, including the illustrative language, may provide information only to a select group of investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information. It is highly unlikely that the majority of investors will derive benefit from these proposed standards regarding other information or would the related proposed reporting, including the illustrative language, provide clarity of the auditor's responsibilities. The group of investors and other financial statement users that may benefit consists of management, attorneys, audit committees, boards of directors, and sophisticated analysts and traders.

The typical investor or financial statement user is likely unable to distinguish between the audit procedures performed and assurance given on the financial statements and on other information. The proposed reporting includes a statement that *"the auditor's evaluation of the other information was based on relevant audit evidence obtained and conclusions reached during the audit"* and then goes on to say that *"the auditor did not audit the other information and does not express an opinion on the other information."* These two statements can be easily confused and along with the other proposed reporting language would create a more cumbersome and complex auditor's report.

**<u>Questions Related to Section VIII</u>:**

**24.** ***What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?***

The auditor's communication of other information would substantially expand the scope of auditor liability in private securities litigation without providing any corresponding benefit to investors. Any comment made (or omitted) would be scrutinized under the current "recklessness" *scienter* standard for liability under Section 10b of the Exchange Act for fraudulent or misleading statements made with respect to securities traded in the public markets. It would be extremely difficult to obtain dismissal of such claims on motion. This would revive the ability of class action securities counsel to present auditors with the choice of paying unreasonable settlements or enduring the very substantial costs of civil discovery on claims without legal merit. This, in turn, would increase the legal and insurance expenses of auditors and thus require material increases in fees to clients.

The same considerations would inhere to any discussions of non-financial information required by the proposal. This problem would be exacerbated by the lack of auditor qualifications to understand and comment on non-financial, subjective company information and the inability to apply objective verification procedures to such matters.

A potential solution to these concerns might be the creation of a legislative "safe harbor" for such non-financial information comments (similar to that existing for projected financial statements). But it would be difficult to define that "safe harbor" to distinguish it from the current opinion on compliance with U.S. GAAP and it would require congressional action.

**25.** ***Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?***

We believe while Section 11 liability is evaluated under a lower "negligence" standard, the same considerations apply, as would the lack of commonly agreed selection criteria for the matters discussed and terminology used in such discussions. As most securities related litigation is relegated to the federal courts by current law, the proposals would likely not have much impact on liability under state law.

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**Question Related to Section X:**

**28.** ***Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?***

We believe the proposed standard should not apply to broker-dealers because of the soon-to-be-effective (in 2014) compliance and exemption reports. As enacted, those reports will require significant detail in the identification of exceptions.

**Question Related to Section XI:**

**30.** ***Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

The Board should consider a delayed compliance date for the proposed other information standard and amendments for audits, particularly of smaller and non-accelerated filers.

**In Summary**

We applaud the Board's efforts in improving transparency in the audit of financial statements and related information, thereby beginning to close the expectation gap between investors and auditors. Our lack of support for certain aspects of the proposed auditing standards is mostly related to our conviction that we should not supplant the responsibilities of management or audit committees. We remain committed to participating in future discussions with the Board and its staff about how to best implement appropriate provisions of the proposed auditing standards that would further enhance audit quality with respect to issuers. Lastly, we fully support the mission of educating investors and other users of financial statements about the process of auditing issuers and the meaning behind the issuance of the independent auditor's report.

We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Wendy B. Stevens, Partner-in-Charge, Quality Assurance, at (212) 375-6699 (wendy.stevens@weisermazars.com), Salvatore A. Collemi, Director, Quality Assurance, at (212) 375-6552 (Salvatore.collemi@weisermazars.com) or David Bender, Director, Quality Assurance at (516) 620-8497 (david.bender@weisermazars.com).

Very truly yours,

WeiserMazars LLP

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WELLS FARGO

**Richard D. Levy**
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December 2, 2013

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Submitted via electronic mail

**Re: PCAOB Release No. 2013-005, PCAOB Rulemaking Docket Matter No. 34**

Wells Fargo & Company (Wells Fargo) is a diversified financial services company with over $1.5 trillion in assets providing banking, insurance, investments, mortgage and consumer finance services. We appreciate the opportunity to comment on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report, and Proposed Amendments to PCAOB Standards Related to the Proposed Auditor Reporting Standard*.

We support efforts to improve audit quality that will enhance investor confidence in and understanding of the audit process and the auditor's responsibilities related to other information. However, we do not support the Board's proposals in their current form.

**Critical Audit Matters ("CAMs"):**

We are most concerned that the Board's proposal to discuss critical audit matters ("CAMs") in the auditor's report may be construed as an implicit qualification of the audit creating a perception that there may be weaknesses or deficiencies in management's judgment, financial statement estimates or internal control environment. The pass/ fail model has served constituents well precisely because an opinion is expressed on the financial statements *taken as a whole*. While we strongly support the decision to retain the pass/ fail model, the subjective nature of the definition, interpretation and ultimately the description in the auditor's report of CAMs increases the likelihood that users may perceive different levels of assurance on different areas of the financial statements. If the perception of the audit opinion is compromised, all stakeholders will be ill-served as corporate governance, auditor independence and user investment decisions could be adversely impacted.

Sophisticated users understand that extensive information related to matters that may qualify as CAMs is already available in existing disclosures. Quarterly and annual financial reports filed with the SEC already include extensive disclosure of critical accounting policies, significant estimates, business and operating trends, as well as financial and operating risks. This is compounded by an ever-increasing disclosure burden as standard setters, regulators[1] and non-authoritative bodies[2] continue to promulgate additional disclosure requirements. Given the litigious environment in the U.S., preparers are often reluctant to remove existing disclosures. Moreover, due to the nature and sheer volume of these disclosures, a meaningful portion may occur outside of periodic SEC filings. While sophisticated users understand and know how to find these disclosures, all of this contributes to a complex patchwork of disclosures that may hinder the casual user's ability to fully comprehend the information that is readily available. Accordingly, we believe any user frustration or confusion regarding the audit process is symptomatic of a larger issue, disclosure overload, that the Board should address with the SEC and other standard setters and regulators to develop a more robust, transparent and user friendly disclosure framework.

Many entities, including financial institutions, operate in complex industries with unique challenges based on the prevailing business or economic climate. During the course of an audit, auditors naturally may encounter areas that involve difficult, subjective or complex judgments that require communication to the audit committee, consultation with experts or require extensive corroboration and documentation. We are concerned that the practical application of the identification, documentation and justification of conclusions regarding inclusion of CAMs in the auditor's report will result in an overabundance of caution by the auditors. In other words, auditors will be motivated to include more rather than less CAMs in the auditor's report to avoid being second guessed during the PCAOB inspection process. Consequently, the auditor's report, at the expense of clarity of the auditor's opinion, will inappropriately become a mechanism to communicate matters of importance or significance related to an entity's financial reporting.

Financial statement users may confuse the roles of the auditor, management and the audit committee. Management is responsible for preparing and filing all financial reports. The financial reporting process is overseen by the audit committee, which oversees a reporting entity's accounting policies, internal controls, financial reporting and the audit process. The auditor should never be the first source of information, provide disclosure of information that is not otherwise required to be disclosed by management or have the appearance that it is making financial reporting decisions on behalf of management. Any confusion of these roles could undermine both the reporting entity's corporate governance as well as the auditor's independence.

It is also likely that reporting entities will incur incremental costs associated with the increased documentation requirements as auditors will now be compelled to justify in their workpapers why certain items either qualify or do not qualify as CAMs. When coupled with the potential harm to investors, corporate governance and auditor independence, we do not see any incremental benefit to users from the Board's proposal. Notwithstanding the Board's stated objective, it appears that the practical purpose of the Board's proposal is to highlight significant disclosures and risks for users of financial statements. Given the level of disclosure information that is already available to users and the costs involved, we cannot support the Board's proposal.

[1] Financial institutions subject to Basel 3 will be required to provide extensive qualitative and quantitative disclosures of capital, liquidly and other risk information starting in 2014.

[2] In our industry, certain regulators are strongly encouraging compliance with extensive risk disclosure recommendations of the Enhanced Disclosure Task Force ("EDTF"). The EDTF is a task force created by the Financial Stability Board and comprised primarily of industry analysts.

**Reporting on Other Information:**

We agree that users may benefit from a clearer articulation in the auditor's report of the auditor's responsibility for the other information in annual reports filed with the SEC. However, we are concerned that the Board has proposed a more stringent standard of auditor involvement with other information. Rather than "read and consider" other information, the auditor will be required to "read and evaluate" whether other information is materially consistent with the audited financial statements. We understand that, as a result of this change, some accounting firms believe substantial incremental auditing procedures will be necessary to satisfy this new requirement. It is unclear to what extent the Board intended to substantively change the auditor's responsibilities related to other information or if the Board simply intends to enhance users' understanding of auditors' existing responsibilities related to other information. If it is the Board's intent to substantively change the auditor's existing responsibilities, we encourage the Board to consider whether it is necessary for users to expect auditors to provide incremental assurance on other information as rigorous and effective procedures already exist to ensure other information is materially consistent with the audited financial statements.

Current laws and regulations require CEO and CFO certifications of disclosure required in the annual and quarterly reports, as well as the establishment of disclosure controls. Public companies are subject to independent audit committee oversight of annual and quarterly financial reporting. Moreover, many disclosures outside of the primary financial statements, such as in the MD&A, are more subjective or forward looking. These disclosures are based on management's analysis and insights and often may not be objectively verifiable. We believe it would be extremely difficult for the auditors to evaluate this information effectively. Given the inherent limitations associated with such an increase in the auditor's scope, and the difficulties this would pose to both auditors and management, it may be necessary to curtail the amount or type of information disclosed in the MD&A, ultimately reducing the overall insight and benefit to users. Lastly, questions regarding the auditor's independence may also surface as an increased level of assurance on subjective or forward looking information may be seen as advocating or challenging the decisions of management.

We encourage the Board to field test how accounting firms will apply the proposed guidance to understand whether the proposal will be unduly costly to preparers. Given the expected increase in auditing procedures and level of auditor experience necessary to provide assurance on potentially subjective and forward looking information, we expect a meaningful increase in recurring audit fees. We do not believe the increase in audit fees, as well as any indirect costs related to increased management time and focus, justify a change in scope. While we support clarification of the auditor's report to explain the auditor's responsibilities related to other information, we do not support the proposal as written. We encourage the Board to retain the existing requirement to "read and consider" and revise the proposed language in the auditor's report accordingly.

**Auditor Tenure:**

While we do not object to the disclosure of auditor tenure in the auditor's report, we do not think it is necessary as there is not a correlation between auditor tenure and audit quality[3].

* * * * *

[3] Please refer to our comment letter on PCAOB Rulemaking Docket Matter No. 37, dated December 14, 2011.

We appreciate the opportunity to comment on the proposal. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controller

cc: Paul Beswick – Securities and Exchange Commission
Kathy Murphy – Office of the Comptroller of the Currency
Stephen Merriett – Federal Reserve Board
Robert Storch – Federal Deposit Insurance Corporation
Donna Fisher – American Bankers Association
David Wagner – The Clearing House Association

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

December 4, 2013

**RE: PCAOB Rulemaking Docket Matter No. 34**
Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

Williams (NYSE: WMB) is a leading energy infrastructure company focused on connecting North America's significant hydrocarbon resource plays to growing markets for natural gas, natural gas liquids and olefins.

Thank you for the opportunity to provide comments on the above referenced proposed auditing standard. While we find certain of the proposed changes acceptable, we believe most parts of the standard warrant further consideration.

Communication of critical audit matters: As a reporting entity, we believe that it is fundamentally the company's responsibility to communicate any critical information through the financial statements and notes or other disclosure requirements. A discussion of critical audit matters by the auditor would seem to significantly overlap certain existing requirements for public entities to discuss critical accounting estimates. If there is a perceived deficiency in the disclosure of critical information for investors, it should be within the domain of the Securities and Exchange Commission to address.

We are also concerned with the potential impact of disclosing information that would otherwise not be required to be disclosed. For example, as noted in the proposal, a critical audit matter may result in disclosure of an internal control deficiency that was determined not to be a material weakness. As such, this may result in a discussion of internal control over financial reporting that would otherwise not require disclosure in Item 9A of the Form 10-K. Additionally, it could raise the level of disclosure/discussion with an Audit Committee to include internal control deficiencies that are not considered a significant deficiency or a material weakness. We believe that the prominence and sensitivity of such a discussion in the audit opinion without the broader context could lead an investor to question the auditor's ultimate conclusion and assume their own worst-case interpretation. In the view of an investor, it is difficult to imagine any scenario where such disclosure would not reflect negatively on the reporting entity.

Finally, we would generally expect an increase in audit costs associated with this potential requirement. Given that this is only a hypothetical proposal at this point and that we do not have a similar point of reference, we are not currently able to provide a more precise estimate of the costs. However, realizing that such disclosures in the auditor's report would likely be highly sensitive for the issuing auditor, we would expect this to require additional work by the highest-level auditors on the engagement. This fact alone suggests that such incremental costs may be more than insignificant.

Responsibility for fraud: We believe that describing the auditor's responsibility related to fraud is acceptable as it does not modify any existing responsibilities. We do, however, question whether such an addition would actually enhance the communication to an investor when presented along with an unqualified opinion.

Independence: Similar to our comments regarding responsibility for fraud above, we believe this change is acceptable as well as it does not modify existing responsibilities. Again, though, we question whether this actually enhances communication to an investor.

Tenure: We do not believe that the audit opinion is the appropriate venue to address the client/auditor relationship, especially when there are other long-standing SEC requirements addressing that relationship (see Form 10-K, Part III, Item 14 regarding Principal Accountant Fees and Services and Item 9 of Schedule 14A (Proxy Statement) regarding Independent Public Accountants). These other two options would seem to be a much more appropriate location for a disclosure of auditor tenure if the SEC believed there was value in such a disclosure.

The lack of such a requirement by the SEC is perhaps reflective of the fact that there is not currently a generally accepted correlation between auditor tenure and audit quality. The prominence of the proposed disclosure of auditor tenure within the audit report would either imply such a correlation or impart a much greater significance on this information, well beyond that of a simple "data point" as characterized on page A5-16 of the proposal.

Additionally, page A5-17 of the proposal acknowledges the usefulness of the SEC's EDGAR system in researching auditor tenure. Thus, this information is already available to those users with a strong interest in it. It seems this would be a preferable alternative rather than requiring the auditor tenure in the audit report.

Evaluation of other information outside the financial statements: We are generally supportive of the scope of the proposed other information standard as it applies to information in annual reports filed with the SEC. However, we are opposed to the expansion of the auditor's role in evaluating such other information from the perspective of both cost and difficulty in communicating that responsibility in the audit report.

In general, we believe that an expansion of the auditor's role will directly translate into increased audit fees as it is reasonable to assume that the auditor's expanded role will drive significant additional documentation of their evaluation of the other information. The auditor's increased costs will likely be passed through to the reporting entity as additional fees, with no perceived additional value to the reporting entity. Similar to the discussion of increased costs related to critical audit matters, we do not have a similar point of reference from which to provide a more precise estimate of the costs.

We further question whether the auditor's expanded evaluation can be effectively communicated in an audit report. While the proposed standard would require an auditor to evaluate the other information based on audit evidence already obtained, would it ever be clear to an investor what exact information was or was not evaluated? It would not be practical to specifically identify every single disclosure that was or was not evaluated by the auditor. But absent this specificity, how would an investor know what information was evaluated?

It is also conceivable that an auditor could seek additional audit evidence to evaluate all other information. While not necessarily the intent or requirement of the proposed standard, this possible outcome could have a significant further impact on the associated increased costs.

As a final point on this topic, the proposal did not discuss any evidence that the current standard has been ineffective relative to the quality of information available to investors. As such, we believe that further consideration of the motive is warranted before imposing a standard that we believe will increase costs for little perceived benefit.

Again, thank you for the opportunity to provide these comments to the proposed rulemaking.

Sincerely,

/s/ Ted T. Timmermans

Ted T. Timmermans
Vice President, Controller and Chief Accounting Officer

WOLF & COMPANY, P.C.

December 11, 2013

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

**Re: PCAOB Rulemaking Docket Matter No. 034:** *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments*

Dear Office of the Secretary:

Wolf & Company, P.C. is a regional accounting Firm based in Boston, Massachusetts, with offices in Springfield, Massachusetts and Albany, New York. We are a PCAOB registered Firm providing audit and assurance services to public and private companies in diverse industries.

We welcome the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (proposed auditor reporting standard); *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report* (proposed other information standard); and *Related Amendments to PCAOB Standards* (collectively, the proposal).

We are supportive of the PCAOB's efforts to update and enhance the auditor's reporting model to provide additional information that is meaningful to stakeholders. We also recognize that any such efforts must balance many resultant issues related to, among others, (1) the clarity and source of information provided, (2) the qualitative and judgmental considerations involved, (3) litigation risk attributable to misinterpreted or inconsistent information, and (4) cost benefit analysis.

We recognize that change is needed to enhance the information communicated by the auditor. In commenting on the proposed standard, we focused on the following overarching principles that were included in the Center for Audit Quality's comment letters dated June 28, 2011 and September 30, 2011, and which we believe continue to be most relevant to the proposal:

- Auditors should not be an original source of disclosure about the entity; management's responsibility should be preserved with this regard.
- Any changes to the auditor's reporting model need to enhance, or at least maintain, audit quality.
- Any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.
- Any changes to the reporting model should add value and not create investor misunderstanding. Specifically, any revisions should not require investors to sort through "dueling information" provided by management, the audit committee, and independent auditors.

## I. Critical Audit Matters

We support the overall efforts of the PCAOB to improve the information communicated to financial statement users through the auditor's report. However, we believe the proposal presents important implementation issues that require further consideration, as follows:

*CAM Determination*

In the determination of matters that represent CAMs, we believe that the auditor should initially identify matters that were significant to the audit of the financial statements (significant audit matters). These matters should be derived from those matters communicated to the audit committee under PCAOB Auditing Standard No. 16, *Communications with Audit Committees* (AS 16).

We believe that the nature of the matters required to be communicated to the audit committee pursuant to AS 16 is the first step in the identification of any audit matter that would be significant enough to the audit to be a CAM.

We believe that the auditors consideration of the eight factors identified by the PCAOB in paragraph 9 of the proposed auditor reporting standard provides the criteria for the auditor to follow in determining which matters required to be communicated to the audit committee were significant audit matters. The auditor would then need to identify which of the significant audit matters are CAMs, by determining those matters that, in the auditor's judgment: a) were material to the financial statements; b) involved the most complex, subjective, or challenging auditor judgments or posed the greatest challenge to the auditor in obtaining sufficient appropriate audit evidence; and c) resulted in the most significant interaction (in terms of nature or extent) with the audit committee.

In addition, it is important that auditors communicate only the most important matters, as including too many areas would minimize the intended emphasis. We therefore recommend that the standard should provide an explicit requirement that if an auditor has initially identified a large number of CAMs for potential communication in the auditor's report, the auditor may consider reassessing whether each of these matters meets the definition of a CAM.

*CAM Communication*

The proposed auditor reporting standard requires the auditor to describe the considerations that led the auditor to determine that a particular matter is a CAM. The proposal's CAM examples lead one to believe that the auditor's descriptions of each CAM are expected to address each of the specific factors included in paragraph 9 that were present. If that is the PCAOB's intent, we believe several potential issues arise from this interpretation. First, having to describe each of the particular factors in paragraph 9 would obscure the more essential factors in the auditor's description of why the matter was critical to the audit and may contribute to user misunderstanding. Second, the example CAM reporting in the proposal could lead to an auditor providing original information that is currently not required to be disclosed by the company (e.g., control deficiencies less severe than a material weakness, or corrected and accumulated uncorrected misstatements). This would add confusion to the roles of management and the auditor, and potentially widen the expectation gap.

We believe that requiring the auditor to describe the *principal* consideration(s) that led the auditor to conclude the matter was a CAM would allow the auditor to utilize his or her professional judgment to describe the factors that were most important to the determination that a matter was a CAM, rather than each of the factors, in all cases relating to the specific matter.

We also note that while the proposed standard does not require the auditor to describe the CAM's effect on the audit, each of the PCAOB's three examples of CAM reporting include such descriptions. We believe that in some cases describing the CAM's effect on the audit may help to explain why a matter was a CAM. We believe the proposed auditor reporting standard should explicitly state that the auditor may provide a description of the CAM's effect on the audit if the auditor considers it necessary in describing why a matter is a CAM.

Because describing the CAM's effect on the audit could imply to financial statement users that the auditor is providing a separate level of assurance on specific accounts or balances referenced in the CAM (i.e., "piecemeal opinions") or, conversely, undermine the auditor's opinion on the financial statements taken as a whole, we recommend including an explicit requirement that the audit opinion must not convey that the auditor is providing a separate opinion or conclusion on the critical audit matters.

Consistent with the overarching principles articulated above, we believe that the auditor should not be the original source of information about the company. We do recognize, however, that in the auditor's judgment, there may be rare situations where such information is necessary to the auditor's description of the CAM. In these situations, we believe that communication of such information would be appropriate, if otherwise not prohibited by law or regulation. In such circumstances, the auditor should encourage management to make relevant disclosures, to avoid the auditor being the source of such information.

*CAM Documentation*

We believe the auditor should document the auditor's basis for (a) identifying those matters that were communicated to the audit committee that were determined to be significant audit matters, and (b) determining which significant audit matters were CAMs. We believe this approach avoids the practical challenges associated with the proposal's requirement that audit documentation contain sufficient information to understand the auditor's determination that matters that "appear to be CAMs" were not CAMs."

**II. Other Information**

We support enhancements to the auditor's report that provide transparency regarding the auditor's responsibility with respect to other information. We are also supportive of enhancing the auditor's performance responsibilities related to information that is both directly related to the audited financial statements and meaningful to the user of the financial statements. However, we caution against expansion of the auditor's responsibilities without meaningful cost/benefit analysis. In this increasingly complex accounting and auditing environment, the enhancement of audit quality is paramount. We believe that any diversion of the auditor's efforts to procedures that have not been determined to create value would not be in the best interests of the stakeholders as a whole.

*Performance Responsibilities*

The proposed other information standard expands the auditor's performance responsibilities from "read and consider" under AU section 550, *Other Information in Documents Containing Audited Financial Statements* (AU 550), to "read … and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate" the other information for a material inconsistency, a material misstatement of fact, or both. The concept of evaluation appears to expand the auditor's performance responsibilities. It is uncertain to us, the degree of procedures and the level of documentation that would be required to support the evaluation concept. Accordingly, we believe the auditor's performance responsibilities regarding other information should be based on defined limited procedures.

Reference is made to AU 634, *Letters for Underwriters and Certain Other Requesting Parties* and AT 701, *Management's Discussion and Analysis*. These standards illustrate the concept of defined limited procedures that are applied to specified financial information. For example, AU 634 indicates that procedures may be performed on information (*a*) that is expressed in dollars (or percentages derived from such dollar amounts) and that has been obtained from accounting records that are subject to the entity's controls over financial reporting or (*b*) that has been derived directly from such accounting records by analysis or computation. Under AU 634, the auditor may also comment on quantitative information that has been obtained from an accounting record if the information is subject to the same controls over financial reporting as the dollar amounts. AT 701 indicates that when the auditors have conducted an examination or a review of MD&A in accordance with AT 701, they may agree to trace nonfinancial data presented outside MD&A to similar data included within MD&A.

We believe that a definition for other information directly related to the audited financial statements should be developed and focused on other information derived either (1) from the financial statements or (2) from accounting records subject to the audit.

We believe the auditor's performance responsibilities should apply only to material other information that is directly related to the audited financial statements. For other information that is not directly related to the audited financial statements, we believe the auditor's responsibilities should be consistent with AU 550, which requires the auditor to read the other information and, if the auditor becomes aware of a potential material misstatement of fact in the other information, to respond appropriately.

We recommend the PCAOB provide guidance within the other information standard on what limited procedures should be performed and how the auditor should document the procedures performed, to provide consistency in practice.

*Reporting Responsibilities*

Requiring the auditor to communicate in the auditor's report that the auditor has evaluated the other information and conclude whether the auditor has identified a material inconsistency, a material misstatement of fact, or both, would imply a level of assurance that is inconsistent with the proposed procedures. Users of the financial statements may perceive the auditor's "conclusion" on the entirety of other information as a form of reasonable assurance on such information, despite the auditor making an explicit statement in the auditor's report that he or she did not audit the other information and does not express an opinion on the other information. We believe this would widen the expectation gap. In addition, the requirement of the auditor to state whether he or she has identified a material inconsistency, a material misstatement of fact, or both, would most certainly create significant incremental litigation risk for auditors. We suggest reporting of the auditor's responsibilities with respect to other information and procedures performed, and, where applicable, describing any unresolved material inconsistencies or material misstatements of fact. This approach makes more explicit an auditor's current responsibilities and we believe will mitigate certain legal risks inherent in the proposed other information standard.

*Scope of Other Information*

The proposed other information standard defines other information broadly as information in the annual report, other than the audited financial statements and the related auditor's report, and includes documents contained in the list of exhibits to, and information incorporated by reference in, the annual report. We believe that exhibits to the annual report should be scoped out of other information due to both the volume and content of the exhibits. Exhibits that are relevant and significant to the issuer's financial reporting would have been subject to audit procedures due to their relevance to the audit of the financial statements. Exhibits that are not relevant and significant to the audit of the financial statements should not be the subject of extended procedures, as the auditor will not be in a position to assume any level of responsibility for such exhibits.

The proposed other information standard would require the auditor to evaluate other information that is incorporated by reference in the annual report, such as information included in the proxy statement. Proxy statements may not be filed until 120 days after year end. It is unclear how this requirement can be applied in practice, as this information may not be prepared or available until after the respective Form 10-K is filed. Accordingly, an auditor would be unable to apply procedures to, or conclude on, information that is not available. Such information should not be included in the scope of other information.

**III. Auditor Tenure**

As noted in the proposal, the PCAOB has not found a correlation between audit quality and auditor tenure. Including auditor tenure in the auditor's report would imply that such a correlation exists and may result in false conclusions being drawn. Accordingly, we do not believe that auditor tenure should be included in the auditor's report. However, we do support the provision of this information in the PCAOB's periodic filings and the transparency that provides.

**IV. Auditor's Unqualified Report & Clarifying Language Changes**

We support the "pass/fail" opinion in the auditor's report, and the use of standardized language to enhance the user's understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting process.

We support proposed changes to enhance the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding the notes to the financial statements and material misstatement, whether due to error or fraud. We also support proposed changes to better align the description of the nature of an audit with the Board's risk assessment standards.

We do not support addressing the auditor's report to parties other than shareholders and the board of directors (or an equivalent body). We believe this would create additional litigation risk and would not improve the communicative value of the auditor's report.

****

We appreciate the opportunity to comment on the proposal, and appreciate the Board's efforts with regard to the proposed standards.

Sincerely,

/s/ Wolf & Company, P.C.

**From:** Michael Sladky
**To:** Comments
**Subject:** Docket 034
**Date:** Thursday, December 12, 2013 12:29:52 PM
**Attachments:** PCAOB Docket 034 Comment.pdf

Dear PCAOB,

I support Lisa Roth's position.

We are a small broker dealer, and these extra accounting fees will have a heavy negative impact on our firm.

Thank you.

Mike Sladky

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Account Executive
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*Please consider the environment before printing this e-mail.*

**Lisa Roth**

630 First Avenue
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The Office of the Secretary Public Company
Accounting Oversight Board
1666 K Street, NSW
Washington, DC, 20006-2803 USA

Re: PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standards The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditors' Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report

Dear Board Members;

Thank you for the opportunity to comment on the rulemaking referenced above. My comments are written from the perspective of specific constituents of the PCAOB: small, independently owned, non-public, non-custodial broker-dealers.

These firms, numbering approximately 4000, are not public companies. They are privately owned and operated small businesses. Approximately 1800 of these firms generate less than $1mm in annual revenues. Many of these firms have fewer than 50 employees.

For these small independent businesses, the proposed rules will inflict significant additional costs, with little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in these small businesses are the owners themselves.

I believe it is entirely consistent with the PCAOB mission for the Board to exercise its authority under the Dodd Frank Act, and exempt the auditors of small, privately held, non-custodial broker-dealers from its oversight.

Best regards,

//Lisa Roth//

**Lisa Roth**
President, Monahan & Roth, LLC
12.09.2013

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December 11, 2013

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

Dear Members of the Board:

We are writing to comment on your Docket Matter 034 concerning a proposed change in auditing standards. Wulff, Hansen & Co. is a small privately owned broker/dealer. As such, we are registered with the Securities and Exchange Commission, FINRA, and the Municipal Securities Rulemaking Board.

After more than 80 years as a carrying and clearing firm, we recently terminated our carrying and clearing operations and are now an introducing broker/dealer carrying no customer accounts, clearing no transactions, and having no customer funds or securities in our possession. We do not see any public benefit in requiring small firms such as ours to retain a PCAOB-registered auditor or to otherwise be subject to requirements designed for broker/dealers whose financial statements are available to, and used by, the public whose assets are held in their custody.

There are several thousand small closely held broker/dealers, many of which have no more than ten employees and many of which have but a single employee/owner. When we were carrying customer accounts the public had a right and a need to view our financial statement, and we gladly made it available to them on a continuing basis. A non-carrying and non-clearing firm, however, has no such obligation. The public has no access to its financial statements and has no need for such access since no publicly owned assets are held in custody by the firm.

Since the PCAOB's mission is to protect the public, we see no reason to require that such broker/dealers be audited by a PCAOB-registered firm. This requirement entails additional costs for the firm and for its auditors and since the resulting statements are not available to the public there is no demonstrable public benefit in requiring them to be produced by a registered firm. The public is not at risk with regard to the financial condition of such firms: Customer assets are held elsewhere and, should the firm disappear overnight, no customer assets would be endangered or unavailable.

The only persons who could conceivably receive the 'protection' ostensibly offered by a PCAOB-registered auditor are the owners of the firm themselves. Since the owners can always choose to select such an auditor that option would remain open to them if they so desired. If they did not wish to incur the additional costs involved, the result would affect no one but themselves.

Thank you for your consideration.

Very truly yours,

Chris Charles
President

**From:** Frank Minard
**To:** Comments
**Subject:** Docket 034
**Date:** Wednesday, December 11, 2013 9:59:03 AM

I totally endorse and support Lisa Roth's comments. As a small independent business, the proposed rules will inflict significant additional costs, with
little or no relevance to the mission of the PCAOB, which is to protect the interests of public investors and to promote investor protection. Public investors do not review the audits of these privately held companies. The investors in our small business are only ourselves.
Thank you for your interest in our opinion.
Regards,
Frank

Frank P. L. Minard
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Via e-mail: comments@pcaobus.org

Nov 26th, 2013

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 2006-2803

*Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standards on Auditor's Report and Auditor's Responsibilities Regarding Other information – The Required communication of Critical Audit Matters*

Dear Members and Staff of the Public Company Accounting Oversight Board:

I appreciate the opportunity to comment on PCAOB's Proposed Auditor Reporting . As a member of the financial community and a investor, I support the proposed standards because they are intended to increase the informational value of the auditor's report and thus to promote its usefulness and relevance to investors and other financial statement users. While, I also want to express my concerns regarding the use of the new information, such as "critical audit matters", and the economic considerations entailing the proposed standards, especially the potential cost.

Basically, the type of auditor's report in the United States has been commonly described as a pass/fail model. The existing model seems to be useful since it states a straightforward and clear position on whether the financial statements are fairly presented (pass) or not (fail). However, the existing Auditor's report provides little, if any, information specific to a particular audit. Admittedly, the existing Auditor's report provides discussion and analysis for each significant financial statement account with some degree of detailed breakdown and necessary disclosure. But it fails to communicate with investors the considerations on specific accounts in terms of auditor's subjective judgment and evidence gathering, or the influence and weights of matters in issuing Auditor's final opinion. Thus, the existing auditor's report is not informative enough for investors to make investment decision.

The proposed Auditor Reporting Standard would require the auditor to communicate in the auditor's report "critical audit matters", which could help to alleviate the information asymmetry that exists between company management and investors. Because company management is usually aware of the auditor's most challenging areas in the audit due to regular interactions with the auditor as part of the audit. However, investors do not usually know this information. When investors have a better grasp of the company's business, risk and material accounting issues, company would allocate the capital more efficiently and could lower the average cost of capital when investors have a better understanding of the company's business and risks.

The following are some examples of "critical audit matters" that could be communicated in the auditor's report under the proposed auditor reporting standard and that would be the additional information investor's are interested in obtaining.

- Areas of high financial statement and audit risk. For instance, a deficiency in internal control over financial reporting.
- Areas of significant auditor judgment. For instance, company's loss contingency, or going concern assumption
- Significant management judgments, estimates, and areas with significant measurement uncertainty, and application of accounting policy
- Significant changes or events affecting the financial statements, including unusual transactions; or incurrence of restatement.

To apply the proposed auditing standards regarding the "critical audit matters" to the practice of Auditor's report, I analyzed the Diamond Food's annual report as of and for the fiscal year ended July 31, 2010 and other relevant information concerning the company's financial reporting to prepare a "critical audit matters" section. The format complies with the Board's recommendations by including the identification of critical audit matters in the annual financial statement and related notes, considerations that led to determine the matter as critical, and relevant financial statement accounts and disclosure. There are two specific critical audit matters regarding Diamond Foods's financial statements and other significant information, which are: 1) Company's internal control over financial reporting, as of and for fiscal year ended on July 31, 2010 which was four month after its acquisition of Kettle Foods, and 2) Company's estimation of Cost of Goods Sold and Account Payable after its restatement of financial statement for fiscal year 2010 and 2011.

*****

The following comments primarily reflect my understanding and limited analysis are in response to certain questions set forth in the Proposed Auditing Standards.

10. *Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?*

    Yes. The proposed communication of "critical audit matters" section in the auditor's report would be tailor-made to be specific for each financial statement audit by the auditor. By focusing on the areas involving high financial statement and audit risk and significant management and auditor judgment, the communication of "critical audit matters" would serve as the bridge for the gap of information that company's management knows or auditor obtains during the audit while is unknown to investors. If these information is not sufficiently relevant and useful in terms of meeting investor's need, the

Auditor Discussion & Analysis, required and expanded emphasis paragraphs or auditor assurance on other information outside would provide with additional information.

11. *What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?*

Undoubtedly, investors would benefit from additional auditor reporting and further unique and relevant insight obtained by the auditor during the audit of financial statements. Communicating “critical audit matters” would provide investors and other financial statement users with previously unknown information about the audit that could enable them to analyze more closely any related financial statement accounts and disclosures. Essentially, the required communication of “critical audit matters” would have two direct positive impact on investors, one is that it could direct investors’ attention on challenges associated with the audit that may contribute to the information used in their investment decision making; another one is that it could let investors focus on aspects of the financial statement that the auditor also found to be challenging.

To meet the proposed auditing standards requirement, auditor may change or adjust how they plan the audit procedure, obtain reliable evidence, present and disclose information and express their opinion, which would have an indirect positive impact on investors and other financial statement users. Since the auditor's new focus on and communication of critical audit matters could lead to improved financial statement disclosures related to areas that gave rise to critical audit matters in the first place. The potential improvement in the related financial statement disclosures could incrementally increase the quality of the information in the financial statements, which assist the investors in investment decision-making and better evaluating the company’s financial position, results of operations, internal control environment and cash flow.

13. *Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?*

Yes. On one side, the quality of the audit of the financial statement could be improved because auditor would focus on areas where 'critical audit matters" gave rise to offer deeper insight. On the other side, due to the staffing constraint and tight deadline, auditor may compromise some of its work in areas less material. The tradeoff may lead to the ignorance of potential risk of omission or misstatement. I expect that the incremental cost in terms of time and effort for auditor would be modest since auditor could leverage the audit works that have already required to be performed under the existing standards. And the "critical audit matters" could have already been addressed by auditor in forming the opinion on the financial statements.

22. *What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?*

Responding to the requirement of communicating "critical audit matters" in the auditor's report, companies, including audit committee, would incur additional cost related to management review of and discussion with auditor about the "critical audit matters". Although it's auditor who determine, document and communicate the "critical audit matters" to the investors via auditor's report, it's actually the company's responsibility of addressing the potential issues and material concerns. These costs or other considerations could be different for audits of large and small companies. For instance, small company may not have audit committee and need to set up a special committee to work with auditor for the proposed standards. While, large companies have audit committee which already has resource and personnel.

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There are concerns about the use of the "critical audit matters" from investor's perspective. The proposed communication in the auditor's report could be something investors and other financial statement users not accustomed to review or analyze. The "critical audit matters" section could be misleading because it may deliver a wrong impression that all of the information important to investment decisions already highlighted as a critical audit matter, or investors may not understand the meaning of the critical audit matters correctly. Investors may seek guidance on the interpretation of a certain critical audit matter in the context of specific industry or company. It will be a good resource for investors to turn to if PCAOB could come up with a list of potential "critical audit matters" for reference.

In sum, the proposed communication of "critical audit matters" in the auditor's report is intended to make the auditor's report more informative and commutatively valuable to enhance its relevance and usefulness to investors and other financial statement users. The substantial benefits of the increased quality of corporate financial reporting and increased value of the auditor's report to investors would outweigh the potential cost increase for auditor and company related to the proposed auditing standards.

I appreciate the opportunity to share my viewpoints on the Proposed Standards. If the Public Company Accounting Oversight Board has any questions regarding my comments, please contact me at az318@georgetown.edu.

Sincerely,

Emily Zhang

Aberdeen

Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803
USA

August 10th 2016

Dear Madam Secretary

**Re: PCAOB Rulemaking Docket Matter No. 034**

We are writing, as a major institutional investor, to support the PCAOB's proposals for enhancing auditor reporting. By way of background, Aberdeen Asset Management is a UK-based global fund management house, with over $400 billion assets under management (as at the end of June 2016).

As a global investor, we have followed closely the debate on auditor reporting as it has developed around the world. In particular, we have welcomed the additional insights which the new reports have afforded to us as investors in UK companies as these reports have been enhanced over the last three years. The reports have helped build our confidence in the quality and effectiveness of the audit process, as well as giving us insight into the work that the auditors have done. They do indeed help to reduce information asymmetries and build trust between the parties to corporate reporting. By increasing transparency, we also believe that these reports tend to enhance the quality, both of the audit, and of company reports.

It has long been our view that the existing form of auditor reporting does the profession a profound disservice. It seemingly places greater emphasis on what the auditor has not done than what has actually has been delivered, and focuses on why investors should not rely on the auditor's work rather than providing confidence in the effectiveness of the audit process.

We regard the PCAOB's current proposals as an important opportunity to address these failings of the current auditor reporting model and we urge that they should be taken forwards into effect, applying to all public companies (including EGCs).

We are members of the Council of Institutional Investors and support their letter to you. In particular, we back their call that the definition of Critical Audit Matters should not be narrow, but should in fact be drawn broadly so as appropriately to encompass matters relevant to long-term shareholders. We support the formulation proposed by the CII, that Critical Audit Matters encompass issues involving significant accounting judgement or estimation by management. We also agree that the auditor should make some indication about its findings in relation to these Critical Audit Matters. These changes would be more congruent with the emerging international approach as well as adding to investor confidence.

It may be useful for us to outline the use we as an investor make of enhanced auditor reports in those markets where they are already available. Where they exist, these are now one of the earliest elements of the company's annual reporting that we read. The issues which are highlighted in the auditor report are typically the more judgemental elements of the accounting, and therefore the ones on which we wish to focus one of our key assessments when understanding a company as a long-term investor: the approach and mindset of management and their approach to communications with shareholders. This informs our trust and comfort in remaining invested for the long term. The auditor reports therefore do not provide new information, but they do offer new – and highly valuable – insight. The issues highlighted often form an element of our discussions with both management and non-executive directors, discussions which increase our understanding of the company and of its prospects. This specific use that we make of the reports as part of our investment and stewardship processes is in addition to our clear view that the greater transparency that the auditor reports is of itself a good thing. The simple fact of greater disclosure should encourage better performance by the auditor in their role, and so also enhance the quality of company reporting.

We also strongly support the disclosure of auditor tenure in the auditor's report. This is important data to inform investor perceptions of auditor independence, and its disclosure is unhelpfully inconsistent in the US at the moment. Our current position is that we cannot support the reappointment of auditors who have been in place at a company for more than 50 years (notwithstanding our recognition of the rotation of individual members of the audit team); our experience of tenders for the audit and changes of auditor in those markets where this is now required is that bringing in a new firm with a different approach and perspective has been positive for audit quality. Even where there is no regular requirement to change auditor, mandating disclosure of tenure would allow auditors the scope to explain to shareholders why they should not regard long tenure as a matter of concern.

Yours sincerely

Paul Lee
Head of Corporate Governance

American Bankers Association
Building Success. Together.

Michael L. Gullette
Vice President – Accounting and Financial Management
202-663-4986
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August 12, 2016

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

Via website submission: comments@pcaobus.org

Re: Rulemaking Docket Matter No. 034: Proposed Auditing Standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

To Whom It May Concern:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the Proposed Auditing Standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (Proposal). The major change proposed is the inclusion within the standard auditor's report of a description of "critical audit matters" (CAMs), intended to provide audit-specific information about especially challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures.

Representing both users and preparers of financial information, ABA recognizes the importance of effective auditing procedures as the underlying lynchpin of the securities markets. In short, investors rely on the reasonableness of reported financial performance. With that in mind, ABA has evaluated the Proposal in light of the current state of the auditing profession, new accounting standards recently issued, and the interface auditors have with both investors and preparers. We have also evaluated the Proposal in light of the fact that bank financial statements are normally full of matters that are especially challenging, subjective, or complex. In addition to those issues not unique to the financial services industries, valuation of financial instruments (including many equity and debt securities, derivatives, retained interests in variable interest entities, and other financial instruments) and goodwill, as well as estimating credit losses in a broad range of loan portfolios, will likely qualify as CAMs in a typical bank audit.

If the Proposal is approved, the new auditing standard could be the biggest change ever to the auditor's report. It also will largely converge with international standards. In the end, however, ABA sees little, if any, ongoing value provided to investors and analysts, while burdening both registrants and auditing firms with costly processes that will take the focus away from the registrant and onto the auditing firm – from the results of operations to the results of auditing procedures.

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

The PCAOB must carefully assess both the short- and long-term benefits and costs of reporting CAMs. Prudent investors already understand that auditors focus their efforts on those areas disclosed by registrants in various sections of their quarterly and yearly filings. The incremental value of a separate auditor's discussion will be minimal to these stakeholders, especially because descriptions of auditing procedures will inevitably become boilerplate and unnecessary scrutiny will accompany even the tiniest of CAM wording changes made by auditors. We believe investor focus should be on the registrant and not the auditor.

There is little doubt that the Proposal will generally result in increased auditing documentation requirements over issues identified as CAMs. In light of the continually increasing emphasis on auditing procedures over internal controls over financial reporting during the past several years, the Proposal could become the final blow to the PCAOB's common sense Auditing Standard No. 5 *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 5). If the Proposal is approved, check-the-box-like audit procedures that require overly-detailed documentation– those audit procedures that have increased dramatically over the past several years – will become a central part of registrant audits. This will provide value to no one.

As a result, ABA recommends that the PCAOB suspend this project and perform the steps described below.

**Provide Transparency to Audit Practice Expectations**

It appears that the disclosure of CAMs could undermine the importance of attestation reports of internal controls over financial reporting. Since Significant Deficiencies normally result in additional audit procedures, the Proposal appears to require, on a practical basis, the disclosure of Significant Deficiencies[2]. As per the SEC's guidance related to Sections 302 and 404 of the Sarbanes-Oxley Act of 2002 (SOX), Significant Deficiencies are currently reported by the auditor only to the Audit Committee and, therefore, should be excluded from the scope of the Proposal. Unless this contradiction is addressed prior to a final auditing standard, both investors and auditors will be confused on how to assess such internal control deficiencies. Significant deliberation had been conducted over these SOX internal control reporting requirements, and any auditing standard that changes those requirements should be subject to a similar extensive due process.

Although the above must be resolved, a much more urgent effort is needed from the PCAOB to help alleviate the confusion experienced by many companies (bank and non-bank) and their auditors about the appropriate level of documentation needed to support internal controls. It seems that auditors and PCAOB have constantly expanded requirements for detailed supporting documentation to the point of overkill.

[2] While the CAM may not explicitly name the Significant Deficiency, an investor will be able to review the internal control attestation report to identify Material Weaknesses and deduce the Significant Deficiencies through the CAMs.

Over the past several years, continuous changes to auditors' supporting documentation requests have transformed much of the "top-down" and "risk-based" approach of AS 5 to one that requires untenable levels of detail and precision that often do not reflect the company's internal control structure – work is performed merely to satisfy auditor demands that are apparently made in response to PCAOB inspection comments. This has particularly affected banks, which normally have very large balance sheet totals in comparison to net income statement results. Income statement materiality thresholds are often applied to balance sheet account testing, resulting in inordinately detailed documentation required to support items that are often clearly trivial to the balance sheet.

This situation needs to change, as the demand for detail grows with each passing audit. Since internal control testing, and the challenges thereof, will be fundamental aspects of any CAM, companies and their auditors must be able to anticipate what levels of detail and precision will be acceptable. Until these concerns are addressed, companies will not be able to adequately assess and structure their internal control systems. This is a high priority for not only auditors and SEC registrants, but also non-SEC registrants, in the likely event that similar auditing standards are adopted for all financial statement audits.

We recommend that comprehensive and ongoing outreach and education be performed by the Inspections Division of the PCAOB. The focus should be on the acceptable levels of audit evidence and other supporting documentation over internal controls. Roundtable and workshop sessions that include both auditing firms and SEC registrants should be a part of this effort. Without such discussions, the level of internal control testing and documentation will either remain at high levels or continue to skyrocket, and CAM challenges will unnecessarily turn the investor's attention from one of substance to one of compliance. That should not be the intent of the Proposal.

## Reevaluate Whether Actual CAM Disclosures will Add Value to Investor Decisions

If the PCAOB decides to issue a final auditing standard that contains CAMs, the issuance of FASB's Current Expected Credit Loss accounting standard (CECL) promises to open the floodgates to not only more internal control concerns as expressed above, but also to a continuous stream of CAMs to be listed in a typical bank's audit opinion. Given the high measurement uncertainty related to the highly subjective and judgmental process of estimating credit losses[3], the Proposal could result in requiring a separate CAM discussion on the allowance for credit losses related to virtually every lending product offered by a bank[4]. Such an expansion

[3] Such challenges related to measurement uncertainty will be significantly increased upon the adoption of FASB Accounting Standards Update 2016-13 *Measurement of Credit Losses on Financial Instruments*. Detail on the additional challenges can be found in the International Auditing and Assurance Standards Board's paper *The IAASB's Project to Revise ISA 540: An Update on the Project and Initial Thinking on the Auditing Challenges Arising from the Adoption of Expected Credit Loss Models*. (March 2016)

[4] While auditors will conceivably limit discussion to one CAM covering the entire loan portfolio, we believe auditors will feel a need to break out their discussions to align with how they will be discussed by registrants within their public filings.

of the auditor's report will result in pages of narrative of little worth, as general auditing procedures will likely be similar for each product. We question whether this is the intent of the PCAOB, as the focus should be on areas that are *especially* challenging, subjective and complex compared to the rest of the audit.

With this in mind, the Proposal attempts to rank some audit challenges as being higher than others (if *especially* challenging, it is deemed a CAM). Although we do not agree with identifying the entire ALLL estimation process as being a CAM (as described above), the ranking of audit challenges into CAMs versus non-CAMs could lead one to believe the standard ALLL estimation process is without significant risk. For instance, in the Illustrative Example on page 32 of the Proposal, a CAM is identified on a new loan product that represents 18% of one segment of a loan portfolio held by a company. Investors could be wrong to assume that accounting matters related to the other portions of this loan portfolio are not challenging, but that is what the disclosure implies. Worse, any possible subsequent financial statement restatements related to those challenges that did not rank high enough to be a CAM will unnecessarily increase audit liability to the point that nearly every challenge could eventually be considered a CAM. Thus, there is risk of identifying too few CAMs as well as the risk of watering down disclosures if there are too many CAMs.

Finally, we question how CAMs that are continuously disclosed will be handled in years subsequent to implementation. Will unnecessary attention be given to trivial language changes in the CAM disclosures? We believe this could be the case, which, along with the confusion just noted on the risks related to too-extensive CAM disclosure and non-CAMs, would divert investor focus from registrant performance to work by the auditors.

**Determine How Other Disclosures Can Address CAMs**

Analysts that are familiar with specific industries normally have a reasonable level of knowledge related to the most challenging audit areas. Banking analysts, for example, normally identify a critical auditing matter after reading sections in periodic registrant filings addressing key accounting policies, accounting estimates, fair value measurements, risks, and management's discussion and analysis. At the level of detail that can be expected during a bank audit, it is difficult to see significant incremental value provided to an investor derived from the information provided in a CAM, considering other existing reports (internal control attestations and the overall audit opinion, in combination with company disclosures) address the auditor's focus and the related results (including those for financial statement accounts, footnote disclosures, and internal controls).

As drafted, the Proposal will result in bank audit opinions that span pages with CAM disclosures of little difference between each other. Investors and analysts do not normally possess detailed knowledge of specific audit procedures and, therefore, will likely either ignore CAM disclosures or unnecessarily question them. In the event there are questions, it would appear that investors will need to speak directly with the auditors, and this seems to virtually eliminate the purpose of the audit committee. We do not believe this is a good result.

If the PCAOB wishes to consolidate information related to key accounting issues or otherwise educate the investing public on the nature and extent of auditing procedures, we believe such efforts can be done outside the audit opinion. In addition to other disclosures within a typical filing, the PCAOB can explore working with the SEC in appending such consideration to their project reviewing the recent SEC Concept Release *Possible Revisions to Audit Committee Disclosures.* The Concept Release currently addresses certain processes performed by audit committees, but mainly in regards to the audit committee's relationship to the external auditor. Overseeing the company's relationship to the external auditors is only one of the various purposes of the typical audit committee. The SEC should consider whether a discussion by the audit committee of key audit risks is appropriate within periodic filings.

In summary, ABA supports efforts to provide investors with relevant and decision-useful information. However, the Proposal will result in increasing the visibility of the audit report with noise that will not provide incremental decision-useful information for investors, and could create unwarranted and unnecessary confusion. Considering the evolving and ever-detailed audit demands that have resulted from PCAOB inspections, we believe the PCAOB should resolve those issues before ratifying a new audit opinion.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette

Michael L. Gullette

AFL-CIO

AMERICA'S UNIONS

**American Federation of Labor and Congress of Industrial Organizations**

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August 5, 2016

**Sent by email to comments@pcaobus.org**

Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

**Re: PCAOB Rulemaking Docket Matter No. 034 –
The Auditor's Report on an Audit of Financial Statements
when the Auditor Expresses an Unqualified Opinion**

Dear Ms. Brown:

On behalf of the American Federation of Labor and Congress of Industrial Organizations (the "AFL-CIO"), I am writing to express our strong support for the Public Company Accounting Oversight Board's (the "PCAOB") proposed auditing standard "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion." The AFL-CIO is the umbrella federation for U.S. labor unions, including 56 unions representing 12.5 million members. Union-sponsored and Taft-Hartley pension and employee benefit plans hold more than $646 billion in assets. Union members also participate directly in the capital markets as individual investors and as participants in single-employer and public pension plans.

Investors are the intended beneficiaries of public company audits, and yet today's auditor's reports on U.S. public company financial statements are almost entirely devoid of useful information. They contain nearly identical boilerplate and can be summarized as a single binary data point of whether the opinion was qualified or unqualified. Accordingly, auditor's reports are often skimmed or ignored by investors. In contrast to archaic nature of auditor's reports in the U.S., other jurisdictions outside the U.S. now require enhanced transparency. The International Auditing and Assurance Standards Board, the European Union, and the U.K. Financial Reporting Council have all adopted expanded auditor reporting requirements in recent years.

**Critical Audit Matters**

Overall, we support the PCAOB's proposed rule requiring auditors to disclose critical audit matters ("CAM") in the auditor's report. Mandatory CAM disclosure will help investors better understand audited financial statements. For example, CAM disclosure will provide new information that investors can evaluate to gage the possibility of an audit failure or the risk of an earnings restatement. Investors will be able to incorporate this information into their trading decisions, and thereby CAM disclosure will facilitate price discovery for securities and enhance overall efficiency of the capital markets. Moreover, we believe that investors should be entitled to receive information about CAMs in the auditor's report as a matter of good corporate governance.

In our view, mandatory CAM disclosure will also lead to more informed proxy voting by investors. Shareholders routinely vote to ratify the audit committee's selection of the auditor at company annual meetings. Yet today, shareholders are not provided with substantive information about the audit to take into consideration when voting. Accordingly, proxy voting decisions on auditors are based on limited information such as the ratio of audit fees to non-audit fees. Requiring auditor's reports to include a discussion of CAMs will help proxy voters to better evaluate the quality of the audit. Auditors rather than audit committees are best positioned to communicate CAMs to investors because they are the ones who are responsible for conducting the audit.

The PCAOB's proposed rule defines a CAM as a matter that was communicated or required to be communicated to the audit committee, relates to accounts or disclosures that are material to the financial statements, and involved especially challenging, subjective, or complex auditor judgment. While this definition encompasses audit issues that are of greatest relevance to investors, we are concerned that including a materiality threshold for the identification of CAMs may unduly limit the flow of useful information to investors. As a legal concept, materiality defines the floor for disclosure below which financial reporting becomes fraudulent. However, reasonable investors can differ in whether they consider information to be material to financial statements.

Instead of including a materiality threshold in the definition of CAMs, we urge the PCAOB to look to the IAASB's definition of key audit matters that requires auditors to select the most significant matters in the audit for discussion in the auditor's report. The IAASB's standard also avoids reliance on the auditor's determination of whether a matter involved especially challenging, subjective, or complex auditor judgment. Such a determination gives auditors too much discretion to decide whether a matter needs to be communicated to investors. In other words, investors deserve a discussion of the significant issues presented in the audit regardless of whether the auditor believes that they are material to investors or especially challenging to the auditor.

We also believe that auditors should be required to provide a gradated assessment of management's significant accounting estimates and judgements. For example, auditors could communicate whether management's accounting estimates and judgements are conservative, average, or aggressive rather than simply stating that they conform with GAAP. Such a differentiation would be useful to investors in making a determination as to the overall quality of a company's financial reporting. Moreover, a more gradated approach to the auditor's opinion would help investors better understand the nature of the audit and narrow the "expectations gap" between what investors expect from auditors and what auditors are actually responsible for.

**Additional Improvements**

We support the PCAOB's proposed additional improvements to the auditor's report. Regarding auditor independence, we support requiring auditors to state that they are required to be independent with respect to the audited company, and further believe that audit firms should be required to state if they are in fact independent and in compliance with the applicable independence rules. We also favor requiring that auditor's reports be addressed to investors in addition to company boards of directors. Investors are the intended third party beneficiaries of the audit, and therefore it makes sense that the auditor's report be addressed to them.

Finally, we strongly favor requiring disclosure of auditor tenure in auditor's reports. Many investors believe that an audit firm's independence can become compromised when a company employs the same audit firm for a substantial period of time. For example, the AFL-CIO's proxy voting guidelines recommend that voting fiduciaries consider voting against ratifying an auditor when a company has had the same audit firm for more than seven years. While long tenure is just one factor that can compromise objectivity, investors should be provided with this data point. Many companies have begun to voluntarily disclose their audit firm's length of tenure, but investors need to be able to access this information in a standardized location.

**Conclusion**

We commend the PCAOB for taking steps to make auditor's reports more meaningful to investors. The auditor's report is the primary means through which auditors communicate to investors regarding the audit of a company's financial statements. Updating the substantive content of the auditor's report is long overdue, and we hope the PCOAB will take into consideration our suggestions on how the proposed rulemaking may be further improved. If you need any additional information regarding our views, please contact me at (202) 637-5152 or brees@aflcio.org.

Sincerely,

Brandon J. Rees
Deputy Director
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***VIA ELECTRONIC DELIVERY***

August 15, 2016

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

Re: Request for Public Comment: Reproposed Rule on the Auditor's Report, PCAOB Rulemaking Docket Matter No. 034

Dear Office of the Secretary:

We are pleased to have the opportunity to provide comments on the Proposed Auditing Standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("Reproposed Rule"). The comments contained below are based upon our collective experiences as senior leaders in various business, governmental, legal and academic organizations, including our roles as audit committee chairpersons for the indicated American Funds (the "Funds"). The American Funds are one of the oldest and largest mutual fund families in the nation. Capital Research and Management Company is the investment adviser to these Funds; however, the views expressed here are our own and do not reflect those of Capital Research and Management Company.

As members of the audit committees, we applaud the Public Company Accounting Oversight Board's (the "Board") ongoing efforts to enhance the form and content of the auditor's report to make it more relevant and informative to investors and other financial statement users. We appreciate the Board's efforts to modify its previous proposal related to the auditor's report based upon comments received (including our own). As discussed in more detail below, we are supportive of both (1) the Reproposed Rule's exclusion of audits of investment companies from reporting critical audit matters, and (2) the inclusion of explanatory language in the auditor's report related to the auditor's responsibilities around internal controls over financial reporting, consistent with our original comment letter; however, we continue to question whether the disclosure of an auditor's tenure provides useful information in determining the quality of the audit.

Critical Audit Matters

As we previously commented in December 2013, an investment company's key accounting policies, such as fair valuation (as required by Accounting Standards Codification ("ASC") 820) and taxes (as required by ASC 740), are already extensively disclosed in the notes to the financial statements. Disclosure of these items as critical audit matters would be repetitive and could lead to boilerplate language in the auditor's report, resulting in increased audit costs while adding little value for investors. Furthermore, an investor's decision to invest in an investment company is primarily based on the investment company's investment objectives, risks, performance and fees, which are disclosed not only in the semi-annual and annual reports but also in the Fund's prospectus sent to each shareholder. We do not believe that the auditor reporting on valuations and tax as critical audit matters would provide meaningful, additional information or context. Accordingly, we support the Board's Reproposed Rule to exclude the audits of investment companies from reporting on critical audit matters.

Auditor Report Disclosure of its review of Internal Controls over Financial Reporting

Currently, an auditor of an investment company is not required to perform an audit of the company's internal controls over financial reporting ("ICFR"). However, the current auditor's report is inconsistent with the fact that the auditor has not expressed an opinion on the effectiveness of ICFR. We support the proposed additional language to the auditor's report which clarifies the auditor's responsibilities and promotes comparability across auditor's reports. We support the Board's inclusion in the Reproposed Rule to require language in the auditor's report describing the auditor's responsibilities over ICFR.

Auditor Tenure

The Reproposed Rule requires the auditor report to include a statement disclosing the year the auditor began serving the company. For an investment company, the rule states that the year to be disclosed should be the year the auditor began serving any investment company in the complex. As stated in our original comment letter, we do not believe auditor tenure provides meaningful information on audit quality or the independence of the audit firm issuing the opinion. Disclosure of the year the audit firm began serving the investment company complex ignores both personnel change (such as the mandatory rotation of audit partners, different audit committee members and management turnover at both the audit firms and the fund's investment adviser) and conformity to the evolving PCAOB guidance and best practices in this area. Many large investment company complexes engage two audit firms, each having audit responsibility for different funds within the complex, subjecting the fund's investment adviser to separate audits by two independent auditors. The Reproposed Rule defines auditor tenure to begin with the first year of service to the entire complex which might confuse or even mislead the reader of the auditor's report for a new fund, especially if the auditor has served the complex for several years. For the reasons above, we continue to believe that disclosing auditor tenure in the investment company's auditor's report could confuse or mislead the reader. As a result, we do not support the disclosure of auditor tenure in the Reproposed Rule.

* * * * *

Thank you for considering these comments, and please feel free to contact any of us should you have questions or wish to discuss our thoughts on the Reproposed Rule.

Sincerely,

Elisabeth Allison
Audit Committee Chairwoman –
New Perspective Fund, EuroPacific Growth Fund, New World Fund
Trustee, Co-Director, The Stanton Foundation

Ronald P. Badie
Audit Committee Chairman –
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August 14, 2016

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Sent by email to comments@pcaobus.org

Re: PCAOB Release No. 2016-003 Rulemaking Docket No. 034

Dear Board Members:

This letter reflects the comments of ArcBest Corporation ("ArcBest") on the May 11, 2016 Proposed Auditing Standard (Exposure Draft or ED), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards.*

We appreciate the Board's objective to improve the relevance and usefulness of the auditor's report. However, we are concerned by the provisions in the 2016 re-proposed standard regarding the inclusion of critical audit matters (CAMs) and the disclosure of the audit firm tenure in the audit report.

**Critical Audit Matters (CAMs)**

We understand that the Board has made a number of changes in what would be classified as CAMs and how these would be reported. However, we are concerned that the inclusion of CAMs in the audit report will fail to add relevant information for users of the audit report and related financial statements, while it is certain to add costs to the audit and impact the management and auditor relationship.

Page 74 of the Exposure Draft states, "Overall the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively, the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements." We agree with the view that including lengthy CAMs in the auditor's report will not provide additional value to investors or other users of financial statements, and recommend that the Board remove this requirement from any final standard.

We oppose the inclusion of CAMs because we also believe the provision improperly shifts the responsibilities of management and the audit committee to the auditor, inappropriately expanding the auditor's role and straining the relationship between management, the audit committee, and the auditor. In accordance with rules and regulations, management is responsible for disclosure of the financial information and risks, as well as the accounting policies that are critical to understanding the financial information and that require difficult or complex judgments. The auditor's report should not be the original source for company information, rather the auditor should opine on information provided by management. Including this type of information in the audit report could lead to duplicate or conflicting reports with management disclosures and lead to confusion among financial statement users. Drawing attention to certain CAMs may also cause investors to conclude there is a problem with the audit in spite of an unqualified opinion.

We also believe that there is a significant risk that third parties may conclude there is a correlation between the volume of CAMs included in the auditors' report and the quality of the audit, a completely erroneous conclusion. Such a development would create the potential for more and expanded CAMS as audit firms seek to improve the perceived quality, but not necessarily the actual quality, of their audits. Such an increase in CAM disclosures would result in additional audit costs to public companies and their investors disproportionate to any benefits.

The requirement to include CAMs in the auditor's report will also distract attention from the audit for both the auditor and the company at a very critical time for all those involved under tight filing deadlines. With two separate descriptions of certain critical accounting policies and estimates, discussions would be necessary to determine which version appears in the CAM vs. MD&A and the footnotes. Because the auditor's identification, evaluation and description of CAMs would require the attention of highly experienced audit executives, it is possible that the attention given to CAMS would result in less availability of those audit executives in the actual performance of the audit of the financial statements and of internal controls over financial reporting. That could have the effect of detracting, rather than adding to, the quality of the audit.

Finally, with respect to the concept of auditor reporting on CAMs, we believe that any action on this proposal should be deferred until after the finalization of amendments proposed by the Securities and Exchange Commission in July, 2016 regarding (quoting from the proposing release) "disclosure requirements that have become redundant, duplicative, overlapping, outdated, or superseded in light of other Commission disclosure requirements, U.S. Generally Accepted Accounting Principles ("U.S. GAAP"), International Financial Reporting Standards or changes in the information environment." The Commission in that release also solicited comment on certain Commission disclosure requirements that overlap with, but require information incremental to U.S. GAAP to determine whether to retain, modify, eliminate, or refer them to the Financial Accounting Standards Board (FASB) for potential incorporation into U.S. GAAP. The comments to that release will very likely include views of investors and others regarding currently required disclosures in financial statements and otherwise included in SEC filings. The SEC's analysis of those comments and its final conclusions and possible referrals to the FASB will provide relevant information regarding such items as critical accounting estimates and U.S.GAAP requirements which bear directly on the audit of registrants financial statements. No final rule on the inclusion of CAMs in the auditors' report should be finalized until after the SEC has completed its work.

If inclusion of CAMs is ultimately deemed necessary by the Board, then the CAMs should be selected from the critical accounting estimates as disclosed in detail by management, rather than from matters the auditor is required to communicate to the audit committee. This approach would eliminate the potential for the auditor to become the original source of information as well as the potential for duplicative or conflicting disclosures between the auditor and management. An alternative would be the inclusion of a statement that the audit included evaluation of the accounting policies and significant estimates. A single statement could be added to the auditor's report referencing the location of such policies in the document which the audit report is included.

For larger U.S. public companies, investors are also provided additional assurance in the auditor's report on internal control over financial reporting.

While the Board's changes to limit CAMs to those reported to the audit committee and introducing a materiality consideration help limit the number of items potentially reported, if including CAMs in the auditor's report is expected to remain in the final standard, we support the use of public roundtables to bring auditors, preparers, and users together to discuss CAMs and exactly how they would be developed and used in practice prior to the issuance of a final standard.

**Auditor Tenure**

In addition, we do not support the inclusion of auditor tenure in the auditor's report. We do not feel there is convincing evidence to support this information would provide value to investors or improve audit quality. Research outlined on page 91 of the Exposure Draft showed that views varied as to how short-term vs. long-term tenure is perceived among investors. With such mixed results, it does not appear that we can directly associate auditor tenure with audit quality and it is possible that investors could draw incorrect inferences about auditor tenure as it relates to audit quality. We also note the increased voluntary disclosure of this information in proxy statements, and we recently added auditor tenure in our proxy statement. Currently, the proxy disclosure format provides for additional discussion of auditor engagement in proper context. Therefore, we suggest that this item be removed from the proposal.

**Conclusion**

In conclusion, we oppose the inclusion of CAMs or auditor tenure information. We also believe that the magnitude of these proposed changes should be made in collaboration with the Securities and Exchange Commissions' related disclosure framework. We appreciate the opportunity to express our views on this exposure draft.

Traci Sowersby
Vice President – Controller and Chief Accounting Officer
ArcBest Corporation
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August 1, 2016

Office of the Secretary
Public Company Accounting Oversight Board
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Via email to comments@pcaobus.org

Dear Board Members:

The Auditing Standards Committee of the Auditing Section of the American Accounting Association is pleased to provide comments on the PCAOB Rulemaking Docket Matter No. 034; PCAOB Release No. 2016-003: Proposed Auditing Standard -- The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.

The views expressed in this letter are those of the members of the Auditing Standards Committee and do not reflect an official position of the American Accounting Association. In addition, the comments reflect the overall consensus view of the Committee, not necessarily the views of every individual member.

We hope that our attached comments and suggestions are helpful and will assist the Board. If the Board has any questions about our input, please feel free to contact our committee chair for any follow-up.

Respectfully submitted,

Auditing Standards Committee
Auditing Section – American Accounting Association

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**Responses to Selected Questions in the Reproposal**

**<u>Question 1a.</u>** *Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?*

We generally agree that requiring auditors to consider, for critical audit matter (CAM) treatment, all matters communicated or required to be communicated to the audit committee is appropriate, subject to the materiality requirement discussed in the reproposal. We believe that the requirements for auditor communication to the audit committee in PCAOB Auditing Standard No.16 (reorganized as AS 1301) align neatly with the intentions of the reproposal. We also believe that the reproposal requirement will help achieve a more uniform approach for auditors' consideration of which matters merit CAM treatment and provide a more orderly platform against which auditors, including quality review auditors, can perform and document their CAM-related procedures and decisions.

We do however acknowledge concerns raised by many respondents to the original proposal that the CAM reporting requirement may "chill" communications between management, auditors, and audit committees. Two recent studies provide insight into this issue. In one study, Gay and Ng (2015) find that auditors who face a more "reactive" audit committee are less likely to communicate with the audit committee about an uncertain accounting estimate in the presence of a CAM reporting requirement than when no such requirement exists. This effect is not observed with a more proactive audit committee, suggesting that the rigor of an audit committee's oversight of the external audit will be key to addressing this concern. In another study, Cade and Hodge (2014) find that managers exhibit less "communication openness" toward their auditors in the presence of a CAM reporting requirement. Participants acting in the role of management were less likely to share private information about a key accounting estimate with auditors if the auditors were required to report on the key estimate. Each of these studies suggest that CAM reporting requirements risk less candid communication regarding key matters of uncertainty in the financial statements. Such a risk could be exacerbated by requiring auditors to consider all matters communicated to the audit committee for treatment as CAMs.

**<u>Question 4.</u>** *Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a re-audit? Why or why not?*

We generally believe that the critical audit matter reporting requirements should extend to *all* financial reporting periods covered by the audit report, and should apply to all audits. While this "all periods" approach undoubtedly leads to increased length of the audit report, we think it is important for three primary reasons. First, the audit report itself usually covers multiple periods and we believe it should stand on its own in a manner similar to the financial statements and disclosures. Next, excluding critical audit matters related to prior periods increases the burden on users of information search. Prior research (Loibl and Hira 2009) suggests that investors with higher search costs (e.g., unsophisticated investors) decrease their information search relative to investors with lower search costs (e.g., financial analysts). We note that the Board highlights the burden of information search in other sections (e.g., audit tenure) of the reproposal and we appreciate this concern and believe it also applies in this context. Finally, prior year CAMs (e.g., uncertain reserve estimates), by construction, would frequently have multiple year implications.

**Question 6.** *Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:*

a. *The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit.*

We know of one recent study that might provide some insight on this concern. Fuller (2016) studies whether management disclosure decisions are impacted by the level of detailed discussion an auditor provides for a critical audit matter involving an uncertain accounting estimate (no CAM, brief CAM, or detailed CAM) and the vigor of audit committee oversight. Fuller (2016) found that when audit committee oversight was strong, auditors providing more detailed discussion of a CAM led to enhanced management disclosure of the uncertain accounting estimate including important *quantitative* information about the estimate such as the range and sensitivity analysis of the estimate. The study was done before the reproposal requirement that the auditor specifically discuss the audit procedures employed to address the CAM was added, which would merit further research.

Rather than two independent binary choices (disclose/not disclose) made by the auditor and management, we believe it is much more likely that disclosure of specific information regarding a CAM will be guided by an iterative "negotiation" between auditor and client management similar to how proposed audit adjustments are resolved (Fuller 2016). As many voices in the debate over CAMs have mentioned, the requirement of the auditor to report on CAMs is likely to give leverage to the auditor in seeking out necessary disclosure by management. Such a scenario would reduce the likelihood that the auditor would be the original source of information. Rather, the auditor will be including information within its CAM discussion that will likely overlap with greater management disclosure.

b. *Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?*

The literature speaks to two possible misinterpretations of the audit report: (1) CAM-related content causing users to confuse a CAM statement with an audit qualification and (2) users failing to ascribe the same level of assurance and auditor responsibility to CAM areas as other areas of the audit. Each is discussed in turn.

With respect to the first possibility, Brasel, Doxey, Grenier, and Reffett (2016) provide some direct evidence regarding unsophisticated users' interpretations of CAMs. Brasel et al. conducted an online experiment using U.S. citizens eligible for jury duty as subjects. The participant pool is, therefore, likely in the lower tail of financial sophistication, and thus, most likely to misinterpret aspects of the auditor's report. Despite this low level of financial sophistication, the results of manipulation checks included in Brasel et al. suggest such basic misinterpretation is unlikely. After reading an auditor's report with the CAM language proposed in PCAOB Release 2013-005, and a specific CAM paragraph similar to those in the current proposal (including the reasons the item was considered a CAM, the procedures applied, and the results of the procedures) participants were asked two true/false questions to assess their understanding of the unqualified audit report; 1) "[the auditor] issued an unqualified (clean) opinion for [the company]," and 2) "[the auditor] believes that [the company's] financial statements are materially misstated." Respondents answered these two questions correctly at a rate of 97.9 percent and 93.5 percent, respectively, indicating a low rate of misinterpretation caused by CAMs. It appears that this sample of unsophisticated users still largely understood the basic nature of the unqualified audit report and that the auditors were not indicating the presence of a misstatement. Consistent with these findings, Kachelmeier, Schmidt, and Valentine (2015) report that participants reviewing a CAM audit report expressed the same confidence in the financial statements "in general" as participants reviewing a control (current regime) report.

Five recent studies speak to the second possibility. These studies largely examine CAM disclosures in a legal liability setting and cases involving litigation over misstatements, so are reviewed in detail when we respond to questions 10 and 12, not here.[1] Though we provide the implication of those studies for the current question 6b here.[2]

In order to reduce the risk that users would misconstrue CAM paragraphs as modifying the audit report or that users would ascribe differing levels of assurance to CAM discussions and the remainder of the audit report, we propose modest changes to the Board's illustration of the Unqualified Report on pgs. A-17 to A-18 of the reproposal. Our suggested modifications are highlighted in blue in the draft auditor report in our Exhibit 1 below, the last two pages of our response.

First, to provide a stronger linkage between the *Opinion Paragraph* and the discussion of CAMs, we suggest the following words be included at the end of the Opinion Paragraph:

> "We are providing under "Critical Audit Matters" below, information on certain matters we communicated to the Audit Committee, which in no way alters our opinion on the financial statements taken as a whole. We do not provide separate opinions on the critical audit matters, or on the accounts or disclosures to which they relate."

[1] A sixth study by Christensen, Glover, and Wolfe (2014) also examines investor reactions to modifications to the auditor's report. However, we do not include the results in the main text because the study was conducted prior to the Board's 2013-005 release and uses a "CAM" approach and wording substantially different from those subsequently proposed and reproposed by the Board. To summarize, Christensen et al. found that including a paragraph in the auditor's report regarding difficult audit areas resulted in an increased likelihood that participants would "stop considering the firm as an investment" (2014, 72), but the effect was eliminated with the addition of a paragraph explaining the resolution of the matter (the procedures applied by the auditor) and specific assurance over the audit area.

[2] The studies reviewed in our response to questions 10 and 12 suggest CAM disclosure may act as partial disclaimers or public forewarnings of increased misstatement risk in a majority of settings, decreasing auditor liability (Brasel et al. 2016; Brown, Majors, and Peecher 2015; Kachelmeier et al. 2015). Whereas two studies suggest there might be settings in which CAM disclosure increases auditor responsibility / liability (Backof, Bowlin, and Goodson 2014; Gimbar, Hansen, and Ozlanski 2016b).

Second, the following similar language (as shown in Appendix – B illustration of the Unqualified Report on pgs. A-17 to A-18) would be removed from the *CAM section*:

> "Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate."

The introduction to the CAM section would then only contain the definition.

**Question 7.** *In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?*

We believe that it would not be appropriate for the auditor to reference other information outside of the audited financial statements for two main reasons. First, the audit report conveys the auditor's opinion on the financial statements, and, accordingly, all references to information in their report should be contained in the financial statements under audit. Second, referencing information not contained in the financial statements could confuse readers. Research has long shown (c.f. Libby 1979) that users of financial statements have a difficult time distinguishing between various levels of auditor association with information, and referencing unaudited information in the audit report would only serve to exacerbate their misperceptions. Report readers would need to accurately determine the reliability of the referenced information, and may ascribe a higher (or lower) level of reliability, or auditor level of assurance to the information. For example, if information in Management's Discussion and Analysis (MD&A) is referenced in the audit report, readers may readily assume that the MD&A has been audited, when it has not been. Thus, referring to disclosures outside the financial statements risks readers being confused as to the level of association the auditor has with the referenced information.

**Question 8.** *Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?*

We are aware of one study that directly addresses the explicit "No CAM" condition.[3] Brasel et al. (2016) manipulated CAM paragraphs such that participants either saw a CAM that matched the litigated misstatement, a CAM that did not match the litigated misstatement, a control (no mention of CAMs), or a "No CAM" statement in which CAMs were defined, but the auditors explicitly stated that they did not identify any CAMs. All conditions were run with two misstatement types (a liability and an asset). The "No CAM" condition exhibited the highest levels of auditor liability, significantly higher than the matched CAM conditions, marginally higher than the mismatched CAM conditions, and not statistically different than the control condition. This result suggests stating that there are no CAMs potentially increases auditor liability.

[3] The CAM research summary by Gimbar et al. (2016a) identifies the Kachelmeier et al. study as having a "No CAM" condition. However, a careful review of the most recent (December 2015) version of the paper available on SSRN found no such condition mentioned.

**<u>Question 9.</u>** *Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?*

We agree with the Board that the newly limited scope for CAM inclusion to only relate to amounts or disclosures that are material to the financial statements should make CAM identification and documentation requirements easier to comply with. As a practical expedient, some members of our committee believe the reproposed documentation requirement should include only items that the auditor considered for CAM inclusion be subject to the documentation requirement, even among those items communicated to the audit committee. Admittedly this may be a distinction without a difference if firms feel it is necessary to consider every item communicated to the audit committee for inclusion as a CAM. The reasoning is as follows: while prior academic research *suggests* that documenting issues considered, but ultimately rejected as CAMs could increase auditor liability in those areas (see Reffett 2010 and Backof 2015), failure to document why an area is or is not a CAM could be even more problematic. It would be a daunting task for the firms to protect themselves from second-guessing during Board inspections, internal quality control reviews, and litigation if there is no documentation of the auditor's conclusion as to why a "likely suspect" area considered for inclusion was *not* identified as a CAM. Tautologically, any given audit area/issue *not* identified as a CAM either was not considered for CAM inclusion, in which case, we believe it should not be covered by the documentation requirement. Or if it is considered for CAM inclusion and rejected, the auditor should have some justification for that conclusion. Assuming that an item was considered for CAM inclusion and rejected, this would seem to be an important audit judgment that ought to be documented for review by the engagement and quality control review partners.

Other members believe that another possible way to address the CAMs documentation requirement would be to limit §17a to matters that are required to be communicated to the audit committee (as in AS No. 16, reorganized as AS 1301), and exclude matters that were communicated to the audit committee, but were not required communications. For example, if an audit committee member of a manufacturing company, in a meeting with their auditors, asks a question regarding the reasonableness of the entity's depreciation calculation and related estimates, the documentation requirement in the reproposal would require auditors to document why the accounts and amounts related to depreciation expense and accumulated depreciation are not CAMs. More broadly, requiring auditors to filter though all issues discussed in audit committee meetings to determine whether the issues relate to accounts or disclosures that are material to the financial statements, in order to document that they did not involve especially challenging, subjective or complex auditor judgement would create unintended additional documentation. Limiting documentation of potential CAMS to items required to be communicated to audit committees would also be consistent with the discussion in the reproposal that suggests auditors "…could start with the communications to the audit committee, which are already documented, identify which matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether each matter involved especially challenging, subjective, or complex auditor judgment" (p. 39).

**<u>Question 10.</u>** *What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?*

<u>and</u>

**<u>Question 12.</u>** *Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?*

To date, the preponderance of evidence suggests that disclosure of a CAM may effectively act as a disclaimer (Kachelmeier et al. 2015) or a public forewarning (Brasel et al. 2016) and may reduce auditor liability for a misstatement, subject to the caveat that the CAM matches the misstated area. Brown, Majors, and Peecher (2015) also find that CAMs related to a misstatement reduce judgments of auditor negligence in litigation over the misstatement. These three studies taken together provide evidence that CAMs matching subsequently discovered misstatement areas reduce auditor legal liability. It is also important to note that these findings are robust to theory (each study employs a unique theory), participant pool (jury eligible individuals, law students, attorneys, financial analysts and MBA students), case facts, and the financial statement area of the CAM. However, the apparent liability reduction is somewhat sensitive to the comparison group in each study. For instance, in Brasel et al. (2016) the liability reduction was significant for matching CAMs compared to a control (current reporting regime) and compared to an explicit statement that there were no CAMs. However, there was no difference in legal liability compared to the case in which the CAM did not match the subsequently misstated area. This pattern of findings is similar to those of Kachelmeier et al. (2015).

The effect of CAMs on legal liability may also depend on the nature of the financial statement area associated with the CAM. Brasel et al. (2016) point out that the reduction in auditor liability occurred for a financial statement area (inventory) where the participants believed the plaintiff was less likely to expect financial reporting difficulties absent a CAM. Liability was not reduced when the CAM matched a financial statement area where participants believed users should already have a higher expectation of financial reporting difficulties (an estimated environmental restoration liability).

The findings of two additional papers appear to conflict with the findings of Brasel et al., Brown et al., and Kachelmeier et al. (2015). Specifically, Gimbar, Hansen, and Ozlanski (2016b) find that, relative to the current audit report, CAMs do not affect auditor liability under imprecise accounting standards, while both related and unrelated CAMs increase auditor liability under precise (bright-line) standards. Backof, Bowlin, and Goodson (2014) find that CAMs increase auditor liability only when audit procedures are included in the report (including audit procedures is also a feature in Brasel et al. (2016), where the opposite conclusion is reached), but that this effect is nullified when the meaning of reasonable assurance is also clarified. Thus, a simple, but potentially useful takeaway from the Backof et al. (2014) findings is that clarifying reasonable assurance in the auditor's report could potentially combat any increases in auditor liability associated with CAMs. Also, as noted by Kachelmeier et al., in both the Backof et al. (2014) and Gimbar et al. (2016b) studies, auditor liability was increased in cases where there was a violation of correct GAAP accounting (an inappropriate inventory valuation method and incorrect lease classification, respectively) indicating that the auditors accepted a GAAP violation in the accounting method. Thus, matching CAMs may only reduce auditor liability in "gray" areas of accounting, or as in the Brasel et al. (2016) study, in cases of management fraud in which the auditor did not know the accounting was incorrect.

Kachelmeier et al. (2015) go beyond jury decision making for auditor liability (proxied by MBA students) and also examine the effects of CAMs on the confidence MBA students, attorneys (plaintiff and defense perspectives), and financial analysts express in the financial statement areas associated with the CAM prior to any information about subsequent misstatements. They find that all groups expressed significantly lower confidence in the specific financial statement values associated with a CAM compared to values not associated with CAMs. Defense-perspective attorneys and MBA students also expressed lower confidence in CAM financial statement values compared to a control (current-practice) report. However, as previously noted, none of the groups expressed lower confidence in the financial statements "*in general*" (Kachelmeier et al. 2015, 3). Kachelmeier et al. (2015) conclude that CAM disclosures act as a partial disclaimer and that their findings are consistent with a piecemeal opinion. A more detailed and nuanced discussion of the results of all five of these studies can be found in the individual papers and in a summary by Gimbar et al. (2016a).

**Question 13.** *Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?*

The answer to the question, *"Is the reproposed requirement relating to auditor independence clear?"* is yes. However, the answer to *"whether or not this information improves investors' and other financial statement users' understanding of the auditor's independence responsibilities"* is more complicated. Considering that neither the PCAOB nor the SEC regulations provide a definition for auditor independence nor adequately discuss the inter-relationships between independence, objectivity and integrity, and conflicts of interest, this assumption lacks a strong foundation. Taylor, DeZoort, Munn and Wetterhall-Thomas (2003) state that definitional inconsistencies, or the use of varied and inconsistent definitions and conceptualizations, is a major source of confusion and controversy surrounding auditor independence. In 2008, the Advisory Committee on the Accounting Profession (ACAP) report to the U.S. Department of Treasury noted potential misunderstanding, at least with requirements about independence, among audit stakeholders and encouraged "improved understanding of … auditor independence requirements among auditors, investors, public companies, audit committees, and boards of directors to enhance investor confidence in the quality of the audit process and audits (ACAP 2008)."

Perhaps a more productive means of improving all parties understanding of auditor independence would be to clarify within the standards themselves the meaning and role of auditor independence to protect the virtues of integrity, objectivity and professional skepticism in situations involving conflicts of interest. Rather than defining the terms of objectivity, integrity or independence, Interpretations under Rule 102.02 provide a list for determining misrepresentations in the preparation of financial statements or records[4]. Gramling, Jenkins, and Taylor (2010) suggest independence rules such as these meet at least two public policy goals. First, is to protect "independence in fact" by attempting to reduce the influence of incentives provided by external factors that could undermine auditor objectivity and inappropriately influence auditor judgments and decisions. Second, is to maintain "independence in appearance" by promoting auditor reliability and audit quality to inspire investors' confidence in the audit opinion. We question whether the direction taken by the PCAOB to rely on proscriptions of relationships rather than providing guidance through definitions and frameworks demonstrating the interrelationship of these important concepts will sufficiently promote the intended benefits of an independence requirement. How realistic is the expectation that the independent auditor will *achieve a proper degree of independence* in the conduct of his work by administering his practice within the spirit of these *precepts* and *rules*?

In conclusion, while we believe that the reproposed requirement relating to auditor independence is clearly stated, we suggest that merely requiring the inclusion of the auditor independence requirement in the audit report does not provide the necessary information to improve investors' and other financial statement users' understanding of the auditor's independence responsibilities. We suggest that as standard setters, the PCAOB needs to incorporate within its standards clear definitions and a more specific discussion of interrelated concepts of independence, integrity, objectivity and conflicts of interests. This action will more appropriately provide the necessary information to improve investors' and other financial statement users' understanding of the auditor's independence responsibilities.

**Question 16.** *Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information in the auditor's report which the Board should consider? If so, what are they?*

The Committee does not believe that the case for requiring audit firm tenure information has been adequately made or supported in the reproposal. We largely agree with the sentiments of Board Members Franzel (2016) and Hanson (2016) that there is no clear documented link between auditor tenure and multiple measures of audit and financial reporting quality. For example, research on the association between audit firm tenure and audit reporting accuracy (Geiger and Raghunandan 2002), fraudulent financial reporting (Carcello and Nagy 2004), financial reporting quality (Johnson, Khurana, and Reynolds 2002) and meeting analyst expectations (Davis, Soo, and Trompeter 2009) either find no association or find that the early years of auditor tenure are more problematic for audit quality in the U.S. Yet, as noted by Franzel (2016), the mere inclusion of this data in the auditor's report presumes that there is some sort of overriding relationship between audit firm tenure and audit quality.

Further, as noted by Lennox (2014) in his review of this literature, if there is a relationship between audit firm tenure and audit quality, we do not even have a good grasp of the direction

[4] Both the SEC and the PCAOB sets of standards provide a generally consistent number of requirements and proscriptions related to the auditor's financial, business and employment relationships, the provision of non-audit services, contingent fees, partner rotation, and audit committee responsibilities around independence focused on financial and relationship-based independence.

of causality. That is, we do not know if longer audit firm tenure leads to higher audit and financial reporting quality, or if higher audit and financial reporting quality leads to longer audit firm tenure. Accordingly, supplying this information in the audit report may be data, but it is data that is very difficult for users of the auditor's report to interpret, and the implication is that longer tenure equates to lower audit quality.

In addition, in support of this disclosure, the reproposal mentions that the European Union (EU) includes information on audit firm tenure in their new audit report. However, the EU has recently instituted mandatory audit firm rotation rules which make information on audit firm tenure of more direct interest to report readers of EU companies. The U.S. does not have such a rule, eliminating the need for report readers in the U.S. to be concerned with monitoring audit firm tenure in order to determine when the company will be required to change audit firms.

***<u>Question 18.</u>*** *Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?*

While there is no extant research directly addressing this question, we believe that auditor tenure information is something that some investors may want, but that inclusion in the auditor's report is inappropriate. Providing the auditor tenure on Form AP would be a reasonable alternative solution. Information on the length of audit firm tenure is consistent with the intended provision of Form AP to increase the transparency and accountability for key participants in issuer audits and is consistent with the type of information on the current audit required on Form AP. In addition, inclusion of this information on Form AP would appear more of a "fact" than an implication of an association with audit quality. Alternatively, auditor tenure information could be included in the proxy statement in regards to shareholders' approval of the audit committee's selection of the independent auditor.

The reproposal states: "*The intent of the reproposed requirement, consistent with the 2013 proposal, is to require consistent reporting of the duration of the auditor's relationship with the company and have this information in a consistent location—the auditor's report (p. 48).*" We believe this is best accomplished by requiring disclose of auditor tenure on Form AP (or in the appropriate section of the company's proxy statement). Accordingly, we modified the draft auditors report eliminating the sentence "~~We have served as the Company's auditor since [year]~~"in our Exhibit 1 below, the last page of our response.

***<u>Question 19.</u>*** *Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?*

For those investors interested in such information, certainly inclusion on the face of the auditor's report would reduce search costs. However, most investors interested in this data likely already have access to data aggregators (e.g., Thomson Reuters, *FirstData*, *Audit Analytics*, etc.) that will include this as part of their database whether in the auditor's report, on Form AP, or in the appropriate section of the proxy statement.

If the Board votes to require this information in the auditor's report, requiring disclosure in a specific location would be beneficial both in terms of practitioner implementation of the requirement, as well as investors locating the information.

**Question 20.** *Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or Why not?*

We believe that the audit report should positively state the concept that an audit is intended to provide reasonable assurance that the financial statements are free of material misstatements whether due to error or fraud. Such communication is likely to (i) motivate auditors to effectively plan and execute the audit to achieve this purpose, and (ii) enable investors to use the information communicated by the audited financial statements without seeking too much additional information for making decisions.

A field experimental study by Gist, Shastri, Ward, and Wilson (2005) manipulated the audit report wording (using three versions of auditor's report formats) and examined 122 auditors (partners and managers) and 123 financial statement users (financial analysts and bank lending officers) and found that incorporating 'fraud wording' both in the scope (auditor's responsibility) and opinion paragraphs significantly enhanced the users' evaluation of the audit report compared to the audit report without the 'fraud wording.' Accordingly, we believe the opinion paragraph should incorporate "free of fraud" related wordings[5]. More specifically, in addition to stating that the "…financial statements are free of material misstatements due to error or fraud…" in the *Basis for Opinion* paragraph, we suggest that the *Opinion* paragraph incorporate fraud-related wordings, as follows: "In our opinion, the financial statements *are free of material misstatements due to error or fraud, and* present fairly, in all material respects … Our suggested modification is highlighted in blue in the draft auditor report in our Exhibit 1 below, the last page of our response.

**Question 22.** *Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?*

We agree with the reproposal requirement that inclusion of CAMs within explanatory paragraphs located elsewhere in the audit opinion should not serve as a *substitute* for their inclusion in the new *Critical Audit Matters* section of the report or vice versa for several reasons. First, allowing for such a substitution could lead to great diversity in practice and possible confusion of users as to where the discussion of CAMs and explanatory paragraph topics are located within each opinion.

Second, it is possible that if CAMs are distributed across multiple sections of the report, users might unconsciously assign to various CAMs differential importance not intended by the auditor. Kahneman and Frederick (2002) find that when people perform difficult judgment tasks (e.g., evaluating the importance of CAMs to the financial statements), they sometimes

[5] See Gist, Shastri, Ward and Wilson. (2005) regarding the effectiveness of the Auditing Standards Board in improving audit communication with the SAS 58 auditor's standard report.

resort to using heuristic cues as a substitution for the more effortful processing necessary for the judgment. Inclusion of a matter in a less prominent location in the report (e.g., within an explanatory paragraph) as opposed to including it within a prominently labeled *Critical Audit Matters* section of the report could provide such a cue leading the user to find the matter less important.

Finally, we believe that distribution of CAMs across multiple sections of the report unnecessarily increases the cost of information search to users. We agree with the Board's proposal allowing for cross-referencing of CAMs between the *Critical Audit Matters* section of the report and explanatory paragraphs elsewhere so long as each CAM is identified in the *Critical Audit Matters* section of the report and each explanatory paragraph required is included in the proper location within the report.

**Question 27**. *How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?*

and

**Question 29**. *Would critical audit matters be useful in assessing company financial performance? If so, how?*

Essentially, these two questions are directed toward identifying the benefits investors and other audit report users would hope to gain from disclosure of CAMs. We believe that investors will derive the following benefits from CAMs reporting:

1. A better understanding of the range of possible outcomes for the amounts and disclosures presenting the greatest uncertainty in the financial statements.[6]
2. A better sense of the overall quality of the company's financial reporting.
3. More informed models of a firm's current performance and future prospects.
4. Lower cost of information acquisition by the leveraging the auditor's clearer communication in the audit report.

Some recent research has addressed these issues. Sirois et al. (2015) find that investors do key in on CAMs and acquire information related to the CAMs elsewhere in the financial disclosures more efficiently. However, they also identify some negative aspects of reporting CAMs in that investors tend to neglect non-CAM issues in the financial statements. Further, Christensen et al. (2014) find that nonprofessional investors are more influenced by a CAM paragraph than when the identical information is provided by management in the financial disclosures. As discussed further in response to Question 35 below, a study by Elliott, Fanning, and Peecher (2016) addresses the information needs of investors and finds that investors will use CAMs as intended sources of additional information from the auditor regarding uncertainty surrounding specific financial statement amounts and disclosures. Elliott et al (2016) also find that a well-crafted CAM discussion can decrease "extraction costs" for investors seeking information on financial reporting quality.

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[6] This has been a common theme among investor stakeholders in much of the five years of debate.

The results reported in Foster and Shastri (2013) suggest that disclosure under CAM of non-trivial yet immaterial misstatements that affect income/earnings could none-the-less provide useful information to investors. As noted by the former SEC Chairman, Mr. Arthur Levitt, "missing an earnings projection by as little as a penny can result in a loss of millions of dollars in market capitalization (Levitt 1998)."

**Question 31.** *Would the communication of critical audit matters enhance attention by auditors, audit committees and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?*

One recent study provides evidence regarding the impact of CAM reporting on management disclosure behavior. Specifically, Fuller (2016) investigates how managers respond when auditors bring heightened attention to a critical accounting estimate in their CAM reporting. The study also investigates the influence of the audit committee on managers' disclosure behavior using an experiment with public company CFO participants.

Results suggest that managers are more likely to expand their accounting estimate disclosures when auditors provide more than a cursory CAM discussion of the estimate in the audit report. Further, managers are more likely to expand their accounting estimate disclosure when strong audit committee oversight of financial reporting exists (Fuller 2016). This finding highlights the continuing importance of the audit committee in its primary role of investor protection. Finally, managers are more likely to expand their accounting estimate disclosures in areas that are highly valued by investors such as disclosing *quantitative* uncertainty information. Quantitative uncertainty information may include items such as the estimate range, the key assumptions used in arriving at the estimate, and sensitivity of the estimate to changes in the underlying assumptions. Enhanced disclosure in these areas provides significant benefits to investors as they quantify the risk in a company's complex accounting estimates.

**Question 35.** *Are there additional academic studies or data the Board should consider? The Board is particularly interested in study or data that can be used to assess potential benefits and costs.*

We note that Elliot et al. (2016) examine whether investors are willing to pay higher prices for stock in companies where auditors use more expansive CAM reporting, particularly when the content is relevant to the assessment of clients' financial reporting quality. Elliot et al. (2016) theorize that more informative audit reporting lowers the "extraction costs" borne by users in the complex task of assessing financial reporting quality. In their experiment, they find that participants expressed a higher willingness to pay for shares of a mature company exhibiting higher quality financial reporting compared to a growth firm exhibiting lower quality financial reporting. Investors' willingness to pay only increased for the higher financial reporting quality firm when the auditor's report included commentary within the discussion of a CAM which helped investors assess the differing levels of financial reporting quality between the two firms. Elliot et al.'s findings suggest that more expansive auditor reporting benefits not only investors but also improves capital market efficiency, both in general and for individual firms, resulting in higher firm valuation and lower cost of capital for higher financial reporting quality firms.

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**Exhibit 1**

***Changes* (in blue-type) to Format as per PCAOB's Rel. 2016-003 (Appendix-B, p. A-17). Based on responses to Questions 6(b), 18, and 20.**

**To the shareholders and the board of directors of X Company**

| |
|---|
| Opinion on the Financial Statements<br>We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of operations, stockholders' equity, and cash flows, for each of the three years in the period ended December 31, 20X2, and the related notes [and schedules] (collectively referred to as the "financial statements"). In our opinion, the financial statements are free of material misstatements due to error or fraud, and present fairly, in all material respects, the financial position of the Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [the applicable financial reporting framework].<br><br>We are providing under "Critical Audit Matters" below, information on certain matters we communicated to the Audit Committee, which in no way alters our opinion on the financial statements taken as a whole. We do not provide separate opinions on the critical audit matters, or on the accounts or disclosures to which they relate. |
| Basis for Opinion<br>These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB. We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation |
| Critical Audit Matters [if applicable]<br><br>The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex judgments. ~~Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.~~ |

| |
|---|
| [*Include critical audit matters]* |
| [Signature]<br>~~We have served as the Company's auditor since [year].~~<br>[City and State or Country]<br>[Date] |

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August 12, 2016

Via E-mail: comments@pcaobus.org

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

**Re: PCAOB Release No. 2016-003, Rulemaking Docket Matter No. 034: Proposed Auditing Standard -** *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* **and Related Amendments to PCAOB Standards**

Dear Office of the Secretary:

BDO USA, LLP appreciates the opportunity to respond to the request for comments on the Public Company Accounting Oversight Board's (the PCAOB or the Board) reproposal of the auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and Related Amendments to PCAOB Standards (the 'Reproposal' or 'reproposed standard'). As previously expressed in our comment letter dated December 13, 2013 on PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report,* and Related Amendments to PCAOB Standards (the '2013 Proposal'), we support the PCAOB's efforts to modernize the auditor reporting model by enhancing the usefulness and informational value of the auditor's report, including: (1) expansion of the existing language in the auditor's report related to the auditor's responsibilities for error or fraud, (2) a description of the nature of the audit, and (3) the communication of audit related matters the auditor considered critical, among other enhancements. While we are supportive of the overall direction of the Reproposal, we have provided suggestions for areas of improvement and refinement of some of the concepts presented in the proposal that we believe will result in improved implementation of the standard, and where appropriate, alignment with the International Auditing and Assurance Standards Board's (IAASB) revised suite of auditor reporting standards[1].

As noted in the Reproposal, the form and content of the auditor's report is undergoing change globally. The IAASB, the European Union, and additional national bodies such as the Financial Reporting Council in the United Kingdom and the Authority for the Financial

[1] The International Auditing and Assurance Standards Board's (IAASB) new and revised suite of auditor reporting standards are effective for audits of financial statements for periods ending on or after December 15, 2016.

Markets in the Netherlands, have all adopted requirements for expanded auditor reporting. While the details of the standards established by these bodies differ, there is a common theme – to increase the informational value of the auditor's report for users of the financial statements. We recognize that that the regulatory environment in each jurisdiction differs, and we appreciate the Board's consideration of the initiatives and developments already undertaken by other regulators and standard setters in an effort to minimize differences where appropriate. Minimizing differences will strengthen comparability among reports, making it easier for investors to make comparisons between reports from different jurisdictions.

Our specific comments relate to the following topical areas:

- Critical Audit Matters (CAM)
- Additional Improvements to the Auditor's Report
- Audit Firm Tenure
- Exclusions to the Reproposed Standard and Considerations of Emerging Growth Companies
- Effective Date

**Determining and Communicating Critical Audit Matters**

Determination of Critical Audit Matters

The reproposed standard defines a critical audit matter as 'any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and involved especially challenging, subjective, or complex auditor judgment.' This definition reflects a change from the 2013 Proposal which was more prescriptive and included a larger population of matters that could potentially have been considered a critical audit matter. We support the revised CAM definition for a number of reasons, but most importantly because we believe that given the audit committee's oversight role in representing the interests of shareholders, communications to the audit committee is the appropriate starting point for considering potential critical audit matters. Furthermore, limiting the population of potential CAM to matters communicated or required to be communicated to the audit committee is consistent with the findings of the CAQ's field testing, in which BDO participated, that found that most matters determined to be CAM had been previously communicated to the audit committee.

As noted in our introductory remarks, we believe that alignment with the International Standards on Auditing (ISAs) is an important objective because of the interconnected nature of the global economy and the needs of investors for a consistent reporting framework in evaluating decision useful information such as CAM. While we recognize that there are differences in the actual definition between the IAASB's Key Audit Matters and the PCAOB's CAM, we believe that the approach in both are substantially similar and for all practical purposes would result in similar communications - which are the matters of interest to investors and other users of the auditor's report.

Communication of Critical Audit Matters

*Original Information Regarding the Company*

The note to requirement 14 on page A1-7 of the Reproposal states:

> When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Consistent with our views set out in our 2013 comment letter, we do not believe that the auditor should be required by this rule to provide information about the company that has not been made publicly available to the company, nor is it the auditor's responsibility to communicate matters within the auditor's report that are not already required to be reported on by management. Given that critical audit matters are intended to focus on those matters the auditor addressed during the audit that involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate evidence, we would expect that such matters would also be the most difficult, subjective, or complex management judgments, and would also be reported by management within the notes to the financial statements, or elsewhere in documents containing the financial statements. If this understanding is not correct, then we believe that changes to the rules and regulations that management is required to comply with would be the appropriate starting point for expanding disclosure. Accordingly, we suggest deleting the phrase 'unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit' from the note.

Furthermore, to explain why it would not be appropriate for the auditor to provide original information about an entity, we suggest looking to paragraph A34 of ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, which explains that 'the nature and extent of the information provided by the auditor is intended to be balanced in the context of the responsibilities of the respective parties (i.e., for the auditor to provide useful information in a concise and understandable form, while not inappropriately being the provider of original information about the entity).' We believe such guidance would be helpful to practitioners in applying the provisions of the reproposed standard.

*Description of How Each CAM is Addressed*

Paragraph 14, on page A1-9 of the reproposed standard, states that for each CAM communicated in the auditor's report, the auditor must describe, among other details, how the critical audit matter was addressed in the audit. However, the reproposed standard does not provide any guidance relating to the level of detail that might be expected. While we support a principals-based approach that allows for auditor judgment in how best to explain how a CAM was addressed in the audit, we also believe that it would be helpful to practitioners if the reproposed standard included guidance that outlined matters the auditor may consider describing.

We note that paragraph A46 of ISA 701 explains that the amount of detail to be provided is a matter of professional judgment, and that in exercising such judgment, the auditor may describe (1) aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement, (2) a brief overview of procedures performed, (3) an indication of the outcome of the procedures, and (4) key observations with respect to the matter. We believe such guidance would benefit practitioners in the consistent application of the requirement and, accordingly, should be included within the reproposed standard. We note that these factors are included in the introductory section of the Reproposal; however, to ensure that this supportive guidance is not lost in the process of codifying the reproposed standard and to reflect the high level of subjectivity that is inherent in how auditors can potentially describe their procedures, we recommend moving this content into the body of the reproposed standard.

Additionally, ISA 701, paragraph A48 explains that the language used in describing a CAM (or in ISA 701 terminology, a Key Audit Matter or KAM) should be carefully structured to ensure the description of a KAM (1) does not imply the matter has not been appropriately resolved by the auditor in forming the opinion, (2) relates the matter directly to the specific circumstances of the entity, while avoiding generic or standardized language, (3) takes into account how the matter is addressed in the related disclosure(s), and (4) does not contain or imply discrete opinions on separate elements of the financial statements. While Note 1 to paragraph 14 of the reproposed standard states that the language used to communicate a critical matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate, matters (1) – (3) are not included within the reproposed standard and we believe the inclusion of such guidance would be helpful to auditors in implementing the standard.

*Significant Deficiencies*

Auditing Standard 2201, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, requires the expression of an adverse opinion on internal control over financial reporting (ICFR) when a material weakness has been identified and also requires a description of the material weakness. Significant deficiencies, in and of themselves, do not result in an adverse opinion on ICFR and are not required to be described in management's assessment of ICFR nor in the auditor's report.

However, Note 2 to paragraph 14, on page A1-9 of the reproposed standard, states that while the auditor is not expected to provide original information about the company, it may be necessary to provide original information if it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit. We continue to believe that the auditor should avoid descriptions of CAM that inappropriately provide original information about the entity that is properly within the responsibility of management and Audit Committee, and therefore the communication of significant deficiencies would not be appropriate. Such an approach is consistent with ISA 701, and we encourage the PCAOB to look to the ISA guidance in this regard.

**Additional Improvements to the Auditor's Report**

Consistent with our comments on the 2013 proposal, we support including the opinion as the first section of the auditor's report followed by the basis for opinion. Such an approach aligns with ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements,* and is consistent with investor feedback to provide the most relevant information in a more prominent position. In addition, we support providing for flexibility in the placement of other components of the auditor's report and the inclusion of a statement regarding independence.

With respect to the addition of the phrase 'whether due to error or fraud' to the description of the auditor's responsibilities regarding obtaining reasonable assurance about whether the financial statements are free of material misstatement, we suggest including the phrase 'as a whole' to this statement to clarify that the objective of an audit is to provide an opinion on the financial statements as a whole and not on individual accounts, balances, or disclosures. As a result, paragraph .09 of the reproposed standard would be revised as follows: (additions in bold italics)

> .09 d. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements ***as a whole*** are free of material misstatement, whether due to error or fraud;

As noted in the introductory section of this letter, we believe it is important to eliminate unnecessary differences between the standards of the IAASB and the PCAOB to avoid any confusion in the market-place about whether differences between auditor's reports are the result of meaningful differences in the way an audit is conducted or simply a matter of format and presentation. For example, ISA 700 (Revised) includes expanded descriptions of the responsibilities of management, including those charged with governance, and the auditor, which is missing from the PCAOB standard. In addition to promoting consistency in reporting, we believe including these descriptions would be helpful to users in understanding more fully the separate responsibilities of each of the parties as it relates to the audited financial statements.

**Audit Firm Tenure**

While we understand that investors are calling for disclosure of auditor tenure, we do not believe such disclosure is appropriate within the auditor's report. The auditor's report is the communication mechanism audit firms use to convey the results of the audit and describe the responsibilities of each of the parties involved in the issuance of the audited financial statements. The disclosure of auditor tenure does not fit within this context. Moreover, we understand that some proponents of the disclosure of auditor tenure believe that it may be useful as an indicator of audit quality, and as such should be included within the auditor's report; however, as noted in the Reproposal, the academic research on this matter is inconclusive. For these reasons we do not support disclosure of auditor tenure within the auditor's report, nor do we believe there is support for a regulatory requirement for such disclosure.

We believe a more appropriate manner to disclose auditor tenure would be through audit committee disclosures as proposed by the SEC in Concept Release No. 33-9862, *Possible Revisions to Audit Committee Disclosures*. We note that some audit committees are already voluntarily disclosing auditor tenure as part of their responsibility for oversight of the auditor. In 2015, 54% of audit committees disclosed the tenure of their auditors, according to the 2015 *Audit Committee Transparency Barometer*.

**Exclusions to the Reproposed Standard and Considerations of Emerging Growth Companies**

We support the PCAOB's decision to exclude brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies that that are not business development companies, and benefit plans from the communication of CAM. As explained in the Reproposal, providing such information would not provide meaningful information for this group of entities.

While we support the limited exclusions noted above, we do not believe that emerging growth companies should be excluded from communicating CAM, as investors and other financial statement users would likely find the communication of these matters informative for this group of issuers.

**Effective Date**

The implementation of the Reproposal, in particular as it relates to the identification and communication of CAM, will require the development of training programs and quality control processes, to ensure the identification of CAM is done in a timely manner and there is appropriate oversight and review of the development of CAM by senior members of the engagement team. Additionally, it will be important to inform management and audit committees about the implication of changes to the expanded auditor's report (including additional areas of oversight and communication) to ensure successful implementation. For this reason, we believe that the effective date should be, at a minimum, a year after SEC approval, and no earlier than for audit reports issued on or after December 15, 2018.

Due to the significance of the proposed changes to the auditor's report, in particular as it relates to critical audit matters, we believe that a delayed compliance date for audits of smaller filers, such as non-accelerated filers, is appropriate. A delayed compliance date would provide auditors of smaller entities additional time to learn from the experience of audits of larger filers.

* * * *

We appreciate your consideration of our comments and suggestions and would be pleased to discuss them with you at your convenience. Please direct any questions to Chris Smith, National Accounting & Auditing Professional Practice Leader at 310-557-8549 (chsmith@bdo.com), Susan Lister, National Director of Auditing at 212-885-8375 (slister@bdo.com), or Jan Herringer, National Assurance Partner at 732-734-3010 (jherringer@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

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June 6, 2016

Office of the Secretary
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Rulemaking Docket No. 34

Dear Board Members:

This letter contains my comments on the May 11, 2016 Proposed Auditing Standard (Exposure Draft or "ED"), "The auditor's report on an audit of financial statements when the auditor expresses an unqualified opinion." I previously commented on the August 13, 2013 ED (my letter dated October 13, 2013) and earlier concepts release (my letter dated July 21, 2011) on the same subject. My comments are based primarily on having served as chairman of the audit committee of five large public companies from 2001 through 2013 as well as having earlier spent 26 years at one of the now Big 4 accounting firms.

Summary

First and foremost, I thank the Board for its very careful consideration of the important issues in this project. Given the earlier concepts release and ED, the Board may well have concluded that it should issue a final standard without further input from constituents. But it obviously has recognized the great public interest in this project and the need to thoroughly vet the significant modifications it has made to the last proposal.

This project has been under consideration for many years after being added to the PCAOB's formal standard-setting agenda in 2010. Its genesis perhaps derives mainly from the 2008 Treasury Advisory Committee report recommending improvements to the auditor's report. But over my fifty plus years in the accounting profession there have been several other calls for change to a report that is usually only a single page in length and provides little detail about the significant work involved in reaching a conclusion that a company's financial statements are fairly presented. Thus, it is easy to understand the calls from many to make such reports more informative.

At the same time, many of the suggestions for improvement considered over the years have been rejected after determination that they would provide few insights to investors and other users of auditor's reports and possibly create distractions from basic auditing procedures or have other unintended consequences. In that regard, I am pleased that during the current project the PCAOB has rejected the notion of an auditor's discussion and analysis and has deferred, for needed additional study, reporting on other financial information.

I am also pleased that in the latest ED the Board has adopted the recommendation in my 2013 letter that the opinion paragraph be presented first in the auditor's report in order to give it the greatest prominence and to avoid the possibility of its being "lost in the trees" of several pages of critical audit matters (CAMs) and other descriptions about the audit. Further, the required section subheadings are consistent with my suggestion in that same letter of having a table of contents so that readers of the report will be able to easily find what is most interesting to them (presumably, the opinion in most cases). And retaining the basic pass/fail measure of whether the audited company's financial statements are fairly presented is, of course, the most important aspect of the ED and I strongly endorse it.

I also agree with the proposed minor wording changes to the report such as standardizing the addressees and including the phrase "whether due to error or fraud." Consistent with my 2013 letter, however, I do not support two of the key features of the ED: required presentation of CAMs (or a statement that there were none) and required disclosure of auditor tenure. For the Board's CAMs proposal I suggest an alternative that I believe will accomplish the only meaningful aspect of this proposal. For the disclosure of auditor tenure I believe the topic should be removed from this project and left to the SEC to consider in the context of proxy statement disclosure rules. My reasoning for each of these issues is presented in the remainder of this letter.

Critical Audit Matters

A good portion of my 2013 letter was devoted to the reasons why I believed the Board should not require CAMs to be included in auditor's reports. To briefly summarize my reasoning from that letter, I believed:

Auditors would be motivated to over report CAMs in order to avoid later criticism from PCAOB inspectors or others, thus leading to unnecessarily lengthy auditor's reports

Not requiring descriptions of audit procedures related to CAMs may cause readers to infer that auditors are expressing reservations about those matters – a sort of qualification of the overall opinion

Determining the wording of CAMs would require extensive engagement partner/national office time and negotiation with company executives at the time of the audit when meeting SEC deadlines is quite challenging

Audit partners would spend time haggling over wording issues for CAMs rather than spending time on much more important substantive audit matters

In certain cases the auditor would be required to disclose information in CAMs that is not required to be disclosed by the company

Many of the comment letters on that earlier ED had similar or additional reservations about required disclosures about CAMs, particularly letters from company managers and audit committee members. To be fair, the PCAOB has extensively analyzed and addressed those comments in the new exposure draft and has made changes that it believes will mitigate many if not most of the concerns raised. However, of all of the matters listed above, I believe that only the second issue has been truly resolved in the new ED through the required descriptions of audit procedures (which raise other issues as discussed later) and required lead-in language to CAMs in auditor's reports. All of my earlier concerns remain as commented on further below and with reference to comments in my 2013 letter.

I will touch on these concerns in the paragraphs below but first will mention a very important issue that should have been covered in my 2013 letter.

Will CAMs actually present value-relevant information to investors and other users of financial statements? - A good deal of the ED is devoted to the Board's reasoning as to this matter in both the Discussion of the Reproposal and Economic Considerations sections. But all of the discussion seems to boil down to, in my words, "Several users have told us that they would like to have this information. They haven't told us how they would use it and we don't have any compelling evidence that it would help in investment decisions. But some other audit regulators have required this and it might help users analyze financial statements." It is particularly interesting that the first three questions in the Economic Considerations section about CAMs ask how investors would actually use them. And Board member Hanson said in his statement at the meeting at which the proposal was approved, "... it is important that we hear from investors about whether they believe CAM's will provide relevant, helpful information and how that information is likely to be used."

After six plus years of this project, I would have assumed that the Board should know the answer to those questions before proceeding further. It is possible that through this new exposure process the Board will obtain better information about whether and how disclosures about CAMs can assist users. At this point, however, the record would seem to indicate that the Board itself is not entirely convinced about the usefulness of this information.

More specifically, the ED summarizes the current state of play as follows on page 74: "Overall the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements."

On page 64 of the ED, the Board suggests a possible benefit of making these matters more prominent by going on to say this "... could facilitate (investors' and other financial statement users') analysis of the financial statements and other relevant disclosures." And page 70 states that "... the disclosure of previously unknown value-relevant information directly benefits the market because it allows market participants to make better-informed decisions." But in neither of those sections nor elsewhere that I found does the ED explain exactly how the Board thinks the description of audit procedures will provide value-relevant information (except, perhaps, in the case of disclosing some company information that the company hasn't previously provided – see next section).

I did note in the ED's Summary (page 2) that the Board suggests, "For instance, additional reporting by the auditor could facilitate analysis of the financial statements and help investors and analysts engage management with targeted questions about critical audit matters (emphasis added)." I agree that drawing more attention to critical accounting policies and estimates may be a good idea (see my modest proposal below). But questions the company responds to should be about its financial reporting and not the approach the independent auditor has taken to become satisfied with that reporting. Suggesting that investors and analysts will have targeted questions about critical audit matters seems to confuse the respective responsibilities of the reporting company and the independent auditor.

SEC proxy statement rules require that registrants must state whether representatives of their principal auditing firm are expected to attend the annual meeting and whether those representatives will have the opportunity to make a statement or respond to questions. Having attended a few dozen annual meetings as a board member, I have never heard a shareholder ask a question of the auditing firm representatives attending the meeting. And in informal discussions with other audit committee members they indicate similar experiences. (If this is considered relevant input for the current project I'm sure the PCAOB could quickly survey practice and find out whether my experience is common or not.) This causes me to conclude that while shareholders are very interested in the credibility added to financial statements through the annual audit, they aren't really interested in the details of what went into arriving at the auditor's opinion because they would derive no added value therefrom.

Auditor's opinions shouldn't initially report company information – As noted earlier, one of my comments on the earlier ED was that in certain cases the auditor would be required to disclose information in CAMs that is not required to be disclosed by the company. This was a concern shared by many commenters. The new ED addresses this in Note 2 to the draft standard: "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit[1] (emphasis added)." This is explained further in Board member Ferguson's statement as "... additional information is confined to what the auditor did in the audit and the principal reasoning behind key facets of the audit – all activities within the exclusive purview of the auditor."

While the position in the new ED is obviously an improvement, it is still objectionable. In short, it has the practical effect of mandating corporate disclosures in certain cases, which I believe is not within the PCAOB's purview.

The part of the Sarbanes-Oxley Act of 2002 that calls for the establishment of the PCAOB says this about its scope of activities: "There is established the Public Company Accounting Oversight Board, to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors." The Board essentially repeats this in its Mission by stating: "The PCAOB mission is to oversee the audits of public companies in order to protect the interest of investors and further the public interest in the preparation of informative, accurate, and independent audit reports."

Thus, both the law and its Mission make clear the Board's responsibility for the form and content of independent audit reports. And while it is clearly the Board's responsibility to continue efforts to improve the informative value of auditor's reports, it has long been established in the law that the Securities and Exchange Commission (with reliance on the Financial Accounting Standards Board for most aspects of Generally Accepted Accounting Principles) has the responsibility for the form and content of company financial and other information necessary to properly inform investors. Therefore, any changes to the auditor's report to make it more useful to investors in public company financial statements must be limited to matters relating to the audit and not provide additional information that wouldn't have otherwise been provided by the reporting company. The exception in Note 2 is, accordingly, inappropriate and should be deleted.

Further, the exception in Note 2 isn't really necessary based on other PCAOB auditing standards. That is, if a company should omit a disclosure that is material in relation to the presentation of the overall financial statements, the auditor would be required to issue a qualified opinion. In my experience, in the very rare cases where this might have happened in practice, the leverage that this requirement provided to the auditor always resulted in the company and the auditor

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[1] In this regard I note the analysis of the ED prepared by the Gibson Dunn law firm. In referring to this matter, Gibson Dunn states, "This note says that the auditor will not be expected to provide information about the company that has not been made publicly available by the company 'unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.' Companies and audit committees may wish to consider whether this exception in effect nearly swallows the rule, and if so, what disclosure considerations may be implicated, including whether it would put the auditor in a position of having to make disclosures in the first instance about any number of matters, such as loss contingency considerations or investigations."

reaching a meeting of the minds as to appropriate disclosure. Thus, in my opinion, the exception covered by Note 2 should be deleted from any final standard on the basis that (1) it is not within the PCAOB's jurisdiction to require company disclosures, and (2) the exception is unnecessary based on other, existing auditing standards.

Illustrating concerns by reference to examples – To help explain my continuing concerns about disclosure about CAMs, let me focus on the two illustrative examples that are included on pages 32-35 of the ED.

Company A's example is that of the allowance for loan losses for a loan product. While the first paragraph of the example does make reference to the company's financial statements, that paragraph also provides extensive information about the new loan product, including its percentage of the loan portfolio and how the company has developed an allowance for losses. While there is insufficient context for me to properly evaluate that description, it appears that the example provides information that would not normally be included in a note to the financial statements. More likely, the details about how much of the portfolio consists of this new category of loans would be included in MD&A. And any description of how the company has developed an allowance for losses would also be included in MD&A, assuming it was one of the critical accounting policies and estimates, which it may well not be.

It may be that the PCAOB intends this paragraph to illustrate the application of Note 2 to the draft standard as discussed earlier. If so, that explanation should be added because otherwise this example appears to go well beyond the guidance in the ED of "Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter."

There is also the issue of redundancy between what the company plans to say about this matter in the financial statement footnotes or elsewhere in the 10-K and what the auditor says in the CAM. At a minimum, having to coordinate any such language will lead to extensive discussions between company management, both financial and legal, and senior partners at the accounting firm, including national office representatives. In an ideal world, these discussions will take place well before year end so that the parties know what each plans to include in their report. But the pressures of completing an audit under tight SEC deadlines often result in matters that weren't fully planned at an earlier date. Haggling over wording issues could easily distract the engagement partner from attention to wrapping up more important, substantive auditing issues when facing these deadline pressures.

Moving beyond that opening paragraph for the Company A example, the next two paragraphs are more or less boilerplate simply describing why the new loan category is a critical audit matter and a lead in to the audit procedures.

The final two paragraphs cover the audit procedures performed per the draft standard requirement to "Describe how the critical audit matter was addressed in the audit." These sentences could be summarized as, "With the involvement of a specialist, we tested the reasonableness of the company's estimates and their computational accuracy." It's certainly possible that drawing readers' attention to these accounting estimates through mentioning them in the auditor's report will cause those readers to think more about these matters. However, I don't see how describing audit procedures will provide any further value-relevant information, particularly such summarized and generalized descriptions.

Further, while adding a description of audit procedures does address the concern I mentioned in my earlier letter about readers possibly inferring reservations about the matters listed, I now have the opposite concern. That is, notwithstanding the required lead-in caveat, I believe that readers will likely interpret the inclusion of audit procedures for CAMs as a form of implicit opinion that each one is fairly stated on its own and not just in the context of the overall financial statements.

Company B's example – begins with a brief reference to financial statement footnotes. However, the second paragraph then discloses certain information that arguably ought to be provided by the company or perhaps already was. Apparently, the inclusion of this information, which seems inconsistent with limiting CAMs to material within the purview of the auditor (see above), is needed in order to explain why this is a critical audit matter although that isn't clear. If the Board moves forward with the notion of CAMs in a final standard and includes examples along these lines it could help if it would explain why the various matters have been included, perhaps by cross references to the applicable sections of the standard.

The three paragraphs describing audit procedures go into a bit more detail than those for the first example. However, they are still general in nature and provide no quantitative or other information that could be used by an investor to "facilitate analysis of the financial statements" or otherwise do more than draw their attention to this being an important area of the company's accounting.

Possible chilling effect on communications – As a former audit committee chairman I would be concerned about any PCAOB action possibly having a chilling effect on communications between the committee and the independent auditors. The revised proposed documentation requirement is one that could have that effect. I'm confident that auditors would continue to communicate about the matters that truly belong in critical accounting policies and estimates, material unusual items, and the like. However, requiring that only those communicated need be documented could cause matters on the margin to be left out of communications so as to avoid even more documentation or PCAOB inspection second guessing of the documentation. On the other hand, the fact that all matters communicated to the audit committee have to be documented would seem to encourage auditors to err on the side of including all such items in their reports rather than leaving out some matters that qualify for communication but don't seem to require inclusion in the report.

This seems to lead to a sort of "damned if you do, damned if you don't" situation. It's hard to predict whether auditors will be like Goldilocks and get it "just right," but I suspect that in most cases we would find that the response is "too much" with at least some being "too little."

One other matter – While I do not favor even more additions to the auditor's report, I must comment on the Board's reasoning on page 52 in response to a couple of letters on the earlier ED that suggested an auditor's report should provide additional explanations about certain key elements of the report. The Board states, "Since it may not be practical to describe these elements concisely, adding these to the auditor's report would unnecessarily lengthen it without providing additional useful information to investors." I think that many (if not most) from the corporate world would apply that same reasoning to the whole notion of CAMs!

While I clearly do not support requiring the presentation of CAMs in the auditor's report, I believe that perhaps the most important aspect of the reasoning for requiring CAMs can be accomplished in a greatly simplified manner and I present that suggestion now.

A modest proposal – As noted, I believe the inclusion in the auditor's report of several, lengthy CAMs is not likely to provide value-relevant information to investors and other users of those reports. Further, there are costs and unintended consequences that are likely to ensue. But I believe that the major benefit of the proposal, focusing more user attention on the significant accounting policies and estimates section of the 10-K, can be accomplished with a simple solution that has essentially no costs or other consequences. That would be for auditor's reports to merely refer to the applicable section of the 10-K or, alternatively, list the policies and estimates included by the company.

For example, the next to last sentence in the Basis for Opinion section of the proposed auditor's report now states, "Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements." A sentence could be added along the lines of, "The most important of these principles and estimates are presented on pages __ to __ under Critical Accounting Policies and Estimates."

I would prefer the above approach as it is simple, straight-forward, and avoids any implication of separate auditor assurance on the individual critical accounting policies and estimates. However, those aspects of the company's reporting will always be among those to which the greatest attention is given during the audit. Therefore, even if readers would infer a degree of specific assurance about the individual items by their being listed separately in an approach similar to that in the next paragraph, I think this would be an acceptable alternative.

The alternative of listing the critical accounting policies and estimates individually would give these matters somewhat more emphasis and could be provided along the following lines using the examples from the March 31, 2013 Legg Mason 10-K as described in my 2013 comment letter:

> The most important of these principles and estimates are presented on pages __ to __ under Critical Accounting Policies and Estimates and are:

Consolidation (variable interest entities)
Revenue recognition
Valuation of financial instruments
Intangible assets and goodwill
Stock based compensation
Income taxes (recovery of deferred tax asset)

This suggested approach is somewhat similar to Auditor's Association with Portions of MD&A as discussed on page 93 of the ED as one of the policy choices considered but rejected by the Board. However, the important difference is that I am not suggesting the auditor provide separate assurance on the critical accounting policies and estimates. I am only recommending that they be highlighted in the auditor's report so that users of the report can appropriately go to the company's section of the 10-K where these matters are discussed by the party that has responsibility for them. As noted above, I believe this will accomplish what the Board suggests is one of the principal objectives of CAMs – drawing readers' attention to the most important accounting policies and estimates – without any related costs or unintended consequences.

I have long thought that the critical accounting policies and estimates section was one of the most important parts of the 10-K. For someone wishing to have a broad understanding of a company's reporting I would strongly suggest reading that part of the document before looking at the financial statements or other financial data. Enough attention probably hasn't been paid to this valuable section of the 10-K by investors, analysts, and other interested readers. So a requirement to highlight that section of the 10-K in the auditor's report could be quite useful without creating some of the other problems referred to above.

Auditor Tenure

As noted in my 2013 letter commenting on the earlier ED, "Audit firm tenure may be useful when asking shareholders to vote on an Audit Committee action, in order to give them a full understanding of the situation. However, in an auditor's report a simple statement of when the audit relationship began won't have any context and, thus, will be of limited or no value to nearly all users." That continues to be my position.

The current ED carries forward the earlier proposal but adds no convincing reasoning beyond what was stated in the earlier proposal. It seems to boil down again to (slightly rewording my earlier letter) (1) some users want this information and think it will be useful, (2) there is some research that this information may be relevant but the research doesn't give a conclusive answer, and (3) it would cost almost nothing for auditors to do this. In response to this line of thinking, two of the five Board members continue to have reservations and apparently share my view that the record developed to date does not support this portion of the ED.

The Board does offer the alternative of the tenure information being presented on Form AP. This strikes me as a "least bad" solution. As summarized above and in my earlier letter, if presented at all I think logic would call for its inclusion in the proxy statement in connection with shareholder votes on ratification of selection of the independent auditors by the audit committee. Putting it in Form AP at least avoids further muddying up the auditor's report with irrelevant information. But I would greatly prefer that the PCAOB leave it to the SEC to decide whether this is something that should be addressed in the context of annual meeting proxy statement disclosures.

Conclusion

While the PCAOB has spent many years on this project, I urge careful consideration of the comments received on this ED. Board member Harris hopes for a vote on a final standard by year end 2016. That might be possible if there are relatively few comment letters or most don't have significant concerns about the ED. However, the normal process of reading and analyzing the comment letters and then redeliberating any significant issues would seem to call for at least a bit more time. This is one of the Board's most important projects and it should make every effort to get it right.

Please let me know if you have any questions about the contents of this letter.

Sincerely,

Dennis R Beresford

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August 15, 2016

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Public Company Accounting Oversight Board
1666 K Street N.W.
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Re: PCAOB Rulemaking Docket Matter No. 034
*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

Dear Secretary:

The members of the audit committee of CA, Inc. (the "Company") appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") proposed auditing standard, Rulemaking Docket Matter No. 034 (the "Proposed Standard"), "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion".

We fully support the PCAOB's objective of improving the auditor's report to make it more informative and relevant to financial statement users and commend the Board on its thoughtful exploration of the important issues in this project. The Board's decision to repropose the standard for a second time after receiving over 400 comments in response to the initial proposed standard dated August 13, 2013 and the concept release dated June 21, 2011 shows how important and impactful this topic is to financial statement preparers, auditors and investors.

While we believe that there are certain aspects of the Proposed Standard which do further the PCAOB's objective, such as retaining the pass/fail model of the existing auditor's report, requiring the opinion to be the first section of the auditor's report and requiring section titles to guide the reader, we also firmly believe that there are other sections, mainly the requirement to communicate critical audit matters and disclose auditor tenure in the auditor's report, which will not further the Board's objective and should not be included in the final Proposed Standard.

CRITICAL AUDIT MATTERS

We acknowledge the Board's efforts to provide additional clarification on critical audit matters ("CAMs") but continue to believe that the inclusion of CAMs in the auditor's report will not provide the expected value to the users of the financial statements. We have the following specific concerns with the Board's CAM proposal:

- The primary responsibility for reporting on a company's financial matters has historically and appropriately resided with management in its duty to meet the disclosure requirements set forth in the Securities and Exchange Commission ("SEC") rules and regulations. Under existing SEC rules, companies are required to disclose areas of critical accounting, many of which involve complex situations and a high degree of judgment either in the application and interpretation of existing accounting literature or in the development of estimates that affect the financial statements, within Management's Discussion and Analysis of Financial Condition and Results of Operations ("MD&A") as "critical accounting policies and estimates". Since the SEC rules for determining what qualifies for disclosure as critical accounting policies and estimates differ from the Board's framework for determining CAMs, this will invariably lead to differences in identification of matters for disclosure. Moreover, the proposed disclosure requirements for CAMs differ from the SEC disclosure requirements. Together these fundamental differences will cause the auditor to become the original source of disclosure of company information. We believe that it is the responsibility of the SEC, not the PCAOB, to determine what disclosures a company must make to its investors. While it might be appropriate under certain circumstances for management and the auditor to work closely in determining the appropriate level of disclosures, we firmly believe that management, not auditors, should be the primary source for disclosure of critical accounting matters and be able to make final determination of what would be deemed critical information to the users of the financial statements and the auditor must determine if such disclosure, in the context of the financial statements taken as a whole, impacts their ability to issue an unqualified opinion.

- An unqualified audit opinion should, by definition, be free from qualifications. Since investors do not have direct access to the auditor and many may not have a thorough understanding of the audit process, CAMs will likely be misinterpreted as an indicator of an issue with any particular matter highlighted as a CAM and may also be perceived as an implicit qualifier to the audit opinion. This, in turn, could result in undue investor focus on the impact of CAMs on an unqualified opinion, unnecessary effort by management in answering questions on or providing explanations about CAMs and ultimately weaken the effectiveness and value of the auditor's unqualified opinion.

- The effort required to incorporate CAMs into the audit opinion will result in a diversion of time and attention of all parties involved in the financial reporting process that will lead to a chilling effect on communications between the auditor and the audit committee. The revision to the definition of CAMs to include "any matter that was communicated or required to be communicated to the audit committee…" may make some auditors include matters in audit committee communications that might not otherwise have been included out of concern the omission of the item from the CAM section of the auditor's report could lead to a PCAOB finding or legal exposure. On the other hand, some auditors may think twice about communicating border-line or judgment-based matters to the audit committee and may not do so knowing that this will need to be disclosed in the auditor's report and could perhaps be misconstrued or confusing to investors and/or regulators. Either way, it is reasonable to expect that CAMs that were not previously anticipated in the early phases of the audit will arise during the tight reporting deadline, and, as such, there will be a considerable investment of time and effort by the auditor in determining whether or not a matter "involved especially challenging, subjective or complex auditor judgment" and is therefore a CAM that should be included in the report and in formulating language describing a particular CAM that is acceptable to both management and the auditor. Furthermore, such assessment of what audit matters are "challenging, subjective and complex" requires the auditor to make a separate determination on each audit matter, which arguably is inconsistent with the objective of an integrated audit - the reasonableness of the financial statements taken as a whole and that the company maintained, in all material respects, effective internal controls over financial reporting as of the balance sheet date. In order to properly convey the context of a CAM to external financial statement users, disclosure will need to be expansive, and the likely battles over wording as well as the inclusion/exclusion of certain CAMs will cause other audit matters to receive less focus and could put pressure on communications between the auditor, management and the audit committee, thus undermining the overall quality of the audit while increasing the amount of time spent by the auditor on the engagement, ultimately leading to an increase in overall audit fees.

AUDITOR TENURE

The new Proposed Standard requires that the auditor's report include a statement regarding auditor tenure. As with the initial Proposed Standard, the new Proposed Standard once again indicates that there is no conclusive evidence as to how auditor tenure impacts audit quality or how the disclosure of auditor tenure would benefit investors. Likewise, there is no objective evidence on linkage between the auditor's tenure and audit firm independence. As such, we do not believe that this part of the Proposed Standard would add value to the auditor's report and should not be included in the final standard.

Just as important, requiring the auditor to disclose its tenure is inconsistent with the auditor/client relationship established by the Sarbanes-Oxley Act. The auditor is appointed by a company's audit committee and does not necessarily control its tenure. In response to the SEC's concept release seeking comment regarding an audit committee's reporting requirements, we noted that the Company, as well as other companies, have provided voluntary disclosures. Included among the Company's voluntary disclosures is the number of years our auditor has been the Company's auditor. We believe, in the Company's case, our auditor's tenure may be meaningful information. However, consistent with the auditor/client relationship framework such determination should be voluntarily made by the registrant.

CONCLUSION

We appreciate having the opportunity to comment on the Proposed Standard and commend the PCAOB's efforts to make the auditor's report more informative and relevant to financial statement users. With respect to the proposed enhancements to the auditor's report regarding retaining the pass/fail model of the existing auditor's report, requiring the opinion to be the first section of the auditor's report and requiring section titles to guide the reader - since these matters promote this objective, we believe that they should be included in the final standard. However, we believe that the PCAOB needs to more strongly consider the negative impacts caused by provisions in the Proposed Standard requiring disclosure of critical audit matters and disclosure of audit firm tenure.

We believe the proposed shift of responsibilities for original source of disclosure of company information from the company's management and audit committee to the auditors, as suggested in the Proposed Standard, inappropriately expands the role of the auditor and unavoidably takes away from the importance of management's responsibility to communicate important financial information and the governance role performed by the audit committee, thus essentially undermining the foundation of financial reporting. Therefore, we encourage the Board to take steps towards ensuring that the roles of management, the audit committee and the auditors are neither compromised nor diminished under the Proposed Standard, and that the objective of improving the auditor's report is achieved while maintaining the integrity of the current financial reporting infrastructure.

If it would be helpful to the Board, the chairman of our audit committee, Raymond J. Bromark, is available to discuss our comments with the Board or its staff. If you wish to arrange this meeting, please contact the Company's Executive Vice President, General Counsel and Corporate Secretary, Michael Bisignano, at 1-800-225-5224. Thank you for your consideration of our comments.

Very truly yours,

**The Audit Committee of CA, Inc.**

Raymond J. Bromark, Chair
Jens Alder
Rohit Kapoor
Jeffrey G. Katz

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August 15, 2016

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

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

Dear Madam Secretary

On behalf of the California Public Employees' Retirement System (CalPERS), thank you for the opportunity to provide our comments on the Public Company Accounting Oversight Board (PCAOB) Release No. 2016-003 proposed auditing standard titled "The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB standards" (Reproposal).

CalPERS is the largest public defined benefit pension fund in the United States with approximately $300 billion in global assets. CalPERS provides benefits to more than 1.8 million employees, retirees, and beneficiaries. CalPERS strives to achieve long-term, sustainable, risk-adjusted returns consistent with our fiduciary duty. To do so, we are guided by CalPERS Global Governance Principles[1] (Principles) which frame our approach to governance issues that impact the integrity and efficiency of capital markets. Embedded in our Principles is the expectation that shareowners are provided with fair, accurate and timely reporting on how companies manage and identify risks related to the three forms of capital: financial, physical, and human. We believe that PCAOB audit standards help protect these shareowner interests and strengthen investors' confidence in capital markets.

[1] See, CalPERS Global Governance Principles , dated March 14, 2016

As stated in our Principles, effective financial reporting depends on high quality accounting standards, consistent application, enforcement, and rigorous independent audits. Accordingly, it is critical that auditors bring integrity, independence, objectivity, and professional competence to the financial reporting process. As providers of capital, we have a strong interest in standards which strengthen the auditor's objective and unbiased audit of financial reports. Therefore, we support the efforts of the PCAOB to enhance the form and content of the auditor's report to make it more relevant and informative for investors. We believe that enhancing the audit report will help improve how we understand and use the information provided in financial statements thereby strengthening investor confidence in the use of financial statements to allocate capital and make informed investment decisions.

We commend the PCAOB for taking action on the comments received in the 2013 proposal about the proposed auditor reporting standard on an audit of financial statements when the auditor expresses an unqualified opinion, as well as the auditor's responsibilities regarding other information in certain documents containing audited financial statements and related amendments. In our response[2] to the 2013 proposal, we expressed support for the PCAOB's proposed auditor reporting standard that introduced the concept of critical audit matters (CAMs) and included new requirements for auditors to communicate CAMs as well as additional improvements to the auditor's report. Like the 2013 proposal, the Reproposal would retain the pass/fail model of the existing auditor's report. However, the Reproposal would also require auditors to include significantly more information in their reports including details on auditor tenure and independence. In particular, the Reproposal would require auditors to include CAMs that were communicated to the audit committee that related to material accounts or disclosures and involved especially challenging, subjective or complex auditor judgments.

Although some of the requirements in the Reproposal differ from the 2013 proposal, we understand that the requirements in the Reproposal have been narrowed to address the comments and concerns received, analysis of economic considerations, academic research, as well as international developments following the 2013 proposal. Specifically, the reproposed requirements have been narrowed by:

- Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee;
- Adding a materiality component to the definition of CAM;
- Narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgments; and
- Revising the related documentation requirement.

We are happy to see some of our concerns addressed in the Reproposal. For example, we appreciate the inclusion of expanded communications requiring the auditor to

[2] See, https://www.calpers.ca.gov/docs/2014-05-02-enhanced-auditor-reporting.pdf, dated May 2, 2014

describe how the critical audit matter was addressed in the audit. The expanded communications would give shareowners a better understanding of the auditor's opinion taken as a whole and how the auditor reached that opinion. We believe the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. As highlighted in an article[3] published by the Analyst's Accounting Observer, "if auditors are going to bring attention to a financial reporting area that caused them concern as auditors, and draw investor attention to a soft spot in the company's financial statements, the managers are going to have a hard time pushing back against the auditors who are arguing for proper accounting." Accordingly, whether a CAM is disclosed or not, there is still value in the fact that bad company behavior may be altered by virtue of the threat of CAM disclosure.

Additionally, we are pleased to see progress on the requirement to provide an auditor statement regarding independence and a disclosure of auditor tenure. From our perspective, a statement regarding auditor independence and the disclosure of auditor tenure provides necessary context for shareowners with respect to auditor objectivity, ratification, and rotation. However, we note that the Reproposal considers the inclusion of a materiality component in the definition of CAM. We believe that, if used, the materiality standard should be in line with the actual holding in TSC Industries, Inc. v. Northway, Inc. (1976).[4] In TSC Industries, Inc. v. Northway, Inc. (1976) the Supreme Court explicitly defined the standard of materiality in securities fraud cases, holding that:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[5]

The holding narrowed the focus of materiality to issues that impact shareowner judgment in making voting decisions. Our Principles set out the expectation that shareowners should annually ratify the selection of the independent external auditor. Therefore, the additional insights as to how a firm addressed a CAM will have a direct impact on how shareowners vote on ratifying the auditor.

We are delighted to see PCAOB make progress on this standard in light of the global efforts to enhance auditor reports that have already started to take shape. For example, the Financial Reporting Council (FRC) in the United Kingdom[6] already requires disclosure in the auditor's report of key audit matters (KAMs) that go beyond the binary pass/fail model similar to those found in the Reproposal. Additionally, new standards for enhanced auditor reports including discussion of KAMs and how the matter was

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[3] See, p. 3, Volume 25, No. 8, The Analyst's Accounting Observer, dated July 25, 2016

[4] See, TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976)

[5] See, *id*

[6] See, https://www.icas.com/technical-resources/international-standards-on-auditing-uk-and-ireland-the-frcs-key-proposed-changes

addressed in accordance with the International Standards on Auditing issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB)[7] which will become effective December 2016. Finally, in April 2014 the European Union (EU) adopted legislation[8] for newly expanded auditor reporting requirements for audits of public interest entities such as listed companies, credit institutions, and insurance companies. In April 2016, the FRC updated its auditor reporting requirements to incorporate the EU and IAASB requirements including adopting the IAASB's definition of KAM. Although the detailed requirements and processes may differ in each jurisdiction, the Reproposal notes[9] that all of these initiatives would result in expanding the auditor's report beyond the traditional pass/fail model to communicate information specific to the particular audit.

As the Reproposal builds on more than five years of PCAOB outreach and the consistent request by commenters to make the auditor's report more relevant and informative, we find comfort in the fact that PCAOBs Reproposal is analogous in many respects to auditor reporting requirements recently established in other jurisdictions. As the Reproposal notes, there are commonalities in the underlying criteria regarding CAMs to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches. Therefore, CalPERS' overall message in support of an auditor standard that includes requirements related to disclosure of CAMs in the auditor report is consistent with our May 2, 2014 letter[10] to the PCAOB. Consequently, in our responses to the Reproposal, we do not provide answers to the specific questions; instead we highlight certain points made in our responses to the PCAOB's 2013 proposal.

**Critical Audit Matters**

As stated in our prior response[11] to the PCAOB, we believe the PCAOB's proposed auditor reporting standard would provide four important attributes - transparency, relevance, reliability, and credibility. The reproposed standard revised the definition of a CAM to any matter arising from the audit of the financial statements that was

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[7] See, https://www.ifac.org/system/files/uploads/IAASB/Auditor-Reporting-Fact-Sheet.pdf, dated January 2015

[8] See, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014R0537, dated April 16, 2014

[9] See, p. 10, Public Company Accounting Oversight Board (PCAOB) Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards, Release No. 2016-003, Rulemaking Docket No. 034, dated May 11, 2016

[10] See, https://www.calpers.ca.gov/docs/2014-05-02-enhanced-auditor-reporting.pdf, dated May 2, 2014

[11] See, *ibid.*

communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment. We believe that auditors should provide independent assurance and attestation as to the quality of financial statements to investors in narrative reports including a statement demonstrating that the financial statements and disclosures are complete, materially accurate, and free of material misstatement, whether caused by error or fraud.[12] Since the purpose of CAMs is to provide disclosures that document the basis and determination for the auditor's opinion regarding financial accounts, we believe that requiring the auditor to communicate CAMs in the auditor's report provides investors with a better range of information about the audit thereby increasing the relevance and usefulness of the auditor's report. From our perspective, mandating CAMs and CAM-related communications will help users to better utilize and value the audit report, enhanced reporting, and the audit opinion.

Furthermore, our Investment Beliefs[13] includes an understanding that long-term value creation derives from the effective management of both risk and opportunities in the oversight of financial, physical, and human capital. As providers of financial capital, shareowners need a detailed explanation as to how a company employs, identifies and addresses CAMs to provide greater context for assessments of risk and return. Therefore, we continue to support the opinion proffered by others that insights on CAMs would be relevant in analyzing and pricing risk.

**Auditor Independence and Tenure**

As stated in our prior response to the PCAOB, we believe that confidence in a company's audited financial statements is key to the efficient functioning of capital markets. This relies on auditors bringing integrity, independence, objectivity and professional competence to the financial reporting process. Therefore, we agree that adding a statement by the auditor on their independence from the company and board of directors reinforces investors' understanding of the auditor's obligations to be independent and objective in expressing the audit opinion. Furthermore, including an affirmative statement concerning the auditor's independence could help demonstrate that the audit opinion is not simply a "rubber stamp" for information prepared by management. Additionally, as supporters of periodic tendering and auditor rotation we support the disclosure of the auditors' tenure. Tenure disclosures help advance the fiduciary responsibility of the audit committee in determining the appropriate length of tenure to ensure the independence of the auditor.

[12] See, p. 34, CalPERS Global Governance Principles, dated March 16, 2016

[13] See, https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf

We applaud the work of the PCAOB in its efforts to address investor concerns regarding the Reproposal thereby reinforcing your mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports. Accordingly, we will continue to support the PCAOB in initiating meaningful change to the audit reporting model. Thank you for your consideration of our responses. If you have any questions, please do not hesitate to contact me at (916) 795-9058 James.Andrus@calpers.ca.gov.

Sincerely,

JAMES ANDRUS
Investment Manager
CalPERS Global Governance

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August 8, 2016

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 200006-2803

comments@pcaobus.org

Subject: Comments on PCAOB Rulemaking Docket Matter No. 034
Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion And Related Amendments to PCAOB Standards

The California Society of CPA's ("CalCPA") Accounting Principles and Assurance Services Committee (the "Committee") is the senior technical committee of CalCPA. CalCPA has approximately 43,500 members. The Committee consists of 55 members, of whom 45 percent are from local or regional firms, 32 percent are from large multi-office CPA firms, 12 percent are sole practitioners in public practice, 6 percent are in academia and 5 percent are in international firms. Members of the Committee are with CPA firms serving a large number of public and nonpublic business entities, as well as many non-business entities such as not-for-profits, pension plans and governmental organizations.

The Committee is pleased to provide its responses to the questions raised by the PCAOB in the reproposed standard. However, a significant number of the Committee's members are opposed to the proposed requirement to include critical matters ('CAMs") in the auditors' report. As stated in the Committee's letter of November 23, 2013 on the original PCAOB Rulemaking Docket Matter No. 34, inclusion of CAMs in the auditors' report will lead to perceived differences in audit quality where such perception should not exist, and identifying CAMs would duplicate disclosure already included (or should have been included) in annual reports under risk factors, management's discussion and analysis and summary of significant accounting policies, which are often currently duplicative already. The Committee also has continuing concerns over the use of CAMs by the plaintiff's bar in asserting claims against auditors; this is a far more severe concern in the United States than it might be in certain foreign countries where a more expansive auditors' report has been adopted in practice. Please refer to our November 23, 2013 letter for more information.

**IV. Discussion of the Reproposal**

**A. Auditor Communications of Critical Audit Matters:**

1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? *Yes.* Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern. *The Committee believes the proposed definition is fine.*

    a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?

    *Yes, as the auditor currently has a responsibility to identify and discuss such matters with the audit committee. It is a natural extension of communications currently being made under AS 1301 – Communications with Audit Committees*

b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.

*Yes, but the proposed definition addresses this by its further qualifications.*

c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?

*The Committee believes that materiality is a matter of judgment, but the phrase is appropriate and clear.*

d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?

*The Committee believes this phrase is ambiguous and will be interpreted differently by different people. The Committee believes it might be better to expand the definition by including examples, e.g. items requiring consultation, items questioned by the EQR, etc. The Committee strongly recommends that sufficient interpretive materials be provided to supplement the new standard.*

2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

*Yes, factors such as those suggested in the Committee's response to Question 1.d. above, will be helpful but are items to be "taken into account" which is softer than saying something definitive.*

3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

*See the Committee's response to Question 1.d. above.*

4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?

*Yes, but not as contemplated by the question. The Committee believes the auditor should be required to communicate in the current period only matters of continuing relevance or if a matter previously reported as a CAM is resolved in the current period in a manner materially different than how it was handled in the period in which the CAM was originally reported.*

5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?

*The Committee believes the reproposed requirements are sufficiently clear.*

6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:

a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and

*The Committee does not believe it is the auditor's responsibility to disclose original or confidential information. If such information is considered necessary to be disclosed to understand a CAM, that information should be disclosed by the registrant in the financial statements or footnotes (see the Committee's response to Question 7 below).*

b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate? Are there other steps the Board could take to address these concerns? If so, what are they?

*The Committee does not believe the reproposed standard can fully mitigate a third party's misunderstanding regarding the communication of CAMs. The Committee also believes that all CAM disclosures will subject the auditor to being second-guessed with the benefit of 20/20 hindsight. Perhaps the PCAOB, in conjunction with the SEC, could devise a "safe harbor" to protect auditors from lawsuits related to the disclosure of CAMs.*

7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?

*No. The CAM definition is qualified as being related to matters with the potential for material misstatement of the financial statements. This suggests that all appropriate disclosure should be within the financial statements, including the footnotes.*

8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?

*Yes, but the Committee believes it is presumptuous to assume that every audit contains at least one CAM.*

9. Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?

*The Committee believes the reproposed documentation requirement is clear. However, documenting the negative would ultimately always come down to something like, "in our (i.e. "the auditors'") judgment ....*

10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?

*Given the potential for misunderstandings, the biggest risk associated with the PCAOB's proposal to expand the auditor's reporting model is increased litigation and the unwarranted increase in private liability arising from the disclosure of CAMs. As the Committee suggested in our response to Question 6.b. above, perhaps the*

*PCAOB, in conjunction with the SEC, could devise a "safe harbor" to protect auditors from unwarranted and frivolous lawsuits related to the disclosure of CAMs.*

11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?

*All of the "changes" addressing this issue are auditor judgment qualifiers, i.e. they are all subject to legal challenge. The reproposal may be a bit better, but it won't make much difference if there is litigation.*

12. Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?

*Yes. The Committee suggests having the audit committees indicate, as a matter of public record, its acceptance of the auditors' discussion of CAMs. Please refer to the Committee's ' response to Question 6(a).*

### B. Additional Improvements to the Auditor's Report

13. (a) Is the reproposed requirement relating to auditor independence clear? (b) Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?

- *(a) Yes*
- *(b) No. The auditors' report already uses the caption "independent auditors' report". Therefore, including similar wording within the body of the report is redundant and unnecessary.*

14. (a) Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? (b) Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?

- *(a) This is fine, however, please refer to the Committee's response to (b) below.*
- *(b) The auditors' report is intended for general use. Therefore, why address it to any one or two particular users?*

15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?

*See the Committee's response to Question 14.*

16. Are the reproposed requirements for information regarding auditor tenure (a) appropriate and (b) clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information in the auditor's report which the Board should consider? If so, what are they?

- *(a) The Committee believes this information should not be included in the auditors' report as it is included in the new Form AP.*
- *(b) See the Committee's response to (a) above. .*

17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?

*The Committee believes that disclosing audit tenure within the components of investment companies to be useful information. However, this information should be considered for* *disclosure in Form AP. By moving this disclosure out of the report and into Form AP, more detail can be provided when relevant, without cluttering up the auditors' report.*

18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?

*Yes. Please refer to the Committee's responses to Questions 16 and 17.*

19. (a) Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? (b) Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?

*(a) Not significantly*
*(b) Use Form AP, not the auditors' report*

20. Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?

*The Committee does not see any substantive changes in the form and content of the basic auditors' report that warrant any comment.*

**C. Explanatory Language and Emphasis of a Matter**

21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?

*Yes*

22. Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?

*EOMs are about matters handled appropriately in the financial statements to which the auditor wants to draw the reader's attention. They are not necessarily a CAM. The opposite is also true; every CAM does not require an EOM. Therefore, the Committee believes they should be separate, not integrated.*

23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?

*Yes.*

24. Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?

*Yes. However, please see the Committee's response to Question 22.*

**D. Information About Certain Audit Participants**

25. (a) Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? (b) Should the standard allow more or less flexibility in the presentation of the auditor's report?

> *(a) Yes*
> *(b) In this regard, the Committee believes that a standard order of presentation is desirable.*

**V. Amendments to Other PCAOB Standards**
**B. Other Amendments to PCAOB Standards**

26. Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?

> *The Committee has no input on the specific details of the proposed amendments aside from asking the PCAOB to reconsider the need to disclose CAMs, as suggested in the Committee's introduction to this letter.*

**VI. Economic Considerations**
**E Alternatives Considered, Including Policy Choices Under the Reproposal**

27. How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?

> *The Committee cannot comment on this question. It is for users to answer.*

28. How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?

> *See the Committee's response to Question 27.*

29. Would critical audit matters be useful in assessing company financial performance? If so, how?

> *Although really for users to answer, a possibility is that CAM disclosures would reveal something about management's appetite for risk.*

30. Would critical audit matters be useful in assessing audit quality? If so, how?

> *The Committee believes that audit quality is assessed with the benefit of 20/20 hindsight. The identification of CAMs and whether they were properly handled will also be evaluated with the benefit of 20/20 hindsight.*

31. (a) Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? (b) Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?

> *a) Maybe. Once a matter is identified as a CAM, it will undoubtedly receive extra attention.*
> *b) See the Committee's response to Question 30 regarding audit quality, and Question 6 (a) regarding management's disclosures. The Committee cannot respond on behalf of investors.*

32. Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?

*The Committee cannot comment on this question.*

33. Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?

*The Committee believes the number of CAMs reported will likely vary based on the size and complexity of the company as well as the size of the accounting firm. The Big 4 may be less likely to conclude that matters "involved especially challenging, subjective or complex auditor judgment" due to their deep technical resources, while smaller public companies who employ the services of smaller accounting firms could find more issues to be sufficiently challenging and complex requiring inclusion as a CAM.*

34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?

*See the Committee's response to Question 33. If the Committee's view is correct, the Big 4 could promote their vast resources of highly experienced personnel as a means of to reduce the number of matters being considered CAMs.*

35. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.

*The Committee is not in a position to comment.*

36. Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?

*None that the Committee is aware of, other than as stated in the introduction to this letter regarding substantially increased risk of litigation against auditors.*

***VII. Exclusions from Critical Audit Matter Requirements***

37. Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?

*Considering the definition of a CAM, the Committee believes it is applicable to every audit.*

38. For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?

*It is possible, since management's appetite for risk may perceived through the identified CAMs.*

39. While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?

*The Committee believes it should be required, not encouraged.*

40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? Why or why not?

*No, for the same reason the Committee stated in our response to Question 37.*

**VIII. Considerations for Audits of Emerging Growth Companies**

41. (a) Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? (b) Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? (c) Should the reproposed requirements be modified to make their application to EGCs more appropriate? (d) Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?

(a) *Yes*
(b) *Yes*
(c) *No*
(d) *If the concept of CAMs is valuable to any investors, it is valuable to all investors.*

42. If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?

*It would raise questions about why some are and some are not.. The Committee believes any final rules in this area should be applied consistently.*

43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?

*The Committee has no comment.*

44. (a) If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? (b) Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? (c) If so, what criterion should the Board use to classify companies, for example smaller reporting companies? (d) Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?

*(a) The Committee suggests at least twelve to eighteen months at a minimum.*
*(b) Yes*
*(c) Yes, something based on market capitalization*
*(d) No*

We thank you for the opportunity to comment on this matter. We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

A.J. Major III
Chair
Accounting principles and Assurance Services Committee
California Society of Certified Public Accountants

CALSTRS
HOW WILL YOU SPEND YOUR FUTURE?

California State Teachers'
Retirement System
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August 12, 2016

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

Re: **PCAOB Rulemaking Docket Matter No. 034 – Release 2016-003 Reproposed Rule - Auditor's Report -** ***Expanded –Auditor Reporting***

Dear Ms. Brown and PCAOB Board members:

I am writing on behalf of the members of the California State Teachers' Retirement System (CalSTRS) in response to the Public Company Accounting Oversight Board's (PCAOB, Board) request for written comments to the reproposed rule, release 2016-003, on the Auditor's Report. Thank you for the opportunity to provide a long-term investor's perspective on this reproposal on what is required in the auditor's report that would be useful to investors. We view this as a critical project and strongly support the PCAOB's finalizing what builds on more than five years of Board outreach, in which many investors such as CalSTRS reinforce the need for the Board to make the auditor's report more relevant and informative. We encourage the PCAOB to adopt a final standard on an expanded auditor's report expeditiously with an effective date that allows for audits of financial statements for periods ending on or after December 2017.

CalSTRS' mission is to secure the financial future and sustain the trust of California's educators. We serve the investment and retirement interests of more than 896,000 plan participants.[1] CalSTRS is the largest educator only pension fund in the world. We have a global investment portfolio valued at approximately $193.3 billion as of July 31, 2016, with approximately $108.9 billion of the fund's assets being invested in the public equity markets, on both a domestic and an international basis.[2] With such a large part of our investment portfolio exposed to the risks and rewards of the public equity markets, CalSTRS is grateful for the work done by the PCAOB that helps to promote investors' protection. We appreciate the Board's continued efforts to further the public interest in the preparation of informative, accurate and independent audit reports.

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[1] CalSTRS at a Glance, Fact Sheet: http://www.calstrs.com/sites/main/files/file-attachments/calstrsataglance.pdf

[2] CalSTRS Current Investment Portfolio for the period ending July 31, 2016. http://www.calstrs.com/current-investment-portfolio

Additionally, the long-term nature of CalSTRS' liabilities, the composition of its portfolio and the CalSTRS Board's fiduciary responsibility to its members makes the fund keenly interested in the rules and regulations that govern the securities market. We have a vested interest and rely on the quality and integrity of financial reporting and believe a robust auditor's report is integral to our capital allocation analysis done on behalf of our beneficiaries. We believe the proposed rule changes will provide four important attributes – *transparency, relevance, reliability and credibility*. Investors are the intended beneficiaries of public company audits, with shareholders' capital paying for the auditor's report.

Furthermore, CalSTRS reinforces the need for vigorous enforcement of auditing standards and appreciates the efforts of the enforcement actions by the Board. CalSTRS affirms the continued dialogue and work with the International Forum of Independent Audit Regulators (IFIAR) to stress enforcement.

CalSTRS emphasizes support for:

1. Additional improvements to the auditor's report regarding independence, auditor tenure, addressee and language.
2. The importance and criteria of Critical Audit Matters (CAMs), being entity-specific. CAM criteria should be determined as outlined in the proposal along with the auditor's consideration of a nonexclusive list of factors. Additionally, CAMS should include matters that involve especially challenging, subjective, or complex auditor judgment; such as the auditor's assessment of the risks of material misstatement, including assessed risks of material misstatement due to fraud and other significant risks specific to the issuer's industry.
3. The need for an enforcement mechanism to insure that CAMs do not degenerate into boilerplate. CalSTRS agrees with the requirement for a statement by the auditor in circumstances where there are no CAMs to report.
4. Alignment of the PCAOB's concept of CAMs to the International Auditing and Assurance Standards Board's (IAASB) concept of Key Audit Matters (KAMs), strengthening and improving consistent global audit standards.[3] Leverage the insights gained from the IAASB, the European Union (EU) and the Financial Reporting Council in the United Kingdom (FRC) from expanded auditor reports.
5. Inclusion of a going concern supplementary paragraph in the auditor's report and requirement, the minimum period considered to be at least, but not limited to, twelve months from the reporting date.

**Proposed Requirements in 2013 and this Release - Additional improvements to the Auditor's Report**

***Language***

1. In 2014, CalSTRS responded to Release No. 2013-005, Docket Matter No. 034 to support the proposal requiring the auditor to communicate critical audit matters (CAMs) in the auditor's report. We continue to believe the proposed changes would improve the current auditor's reporting model that merely states a pass or fail opinion. CalSTRS agrees the auditor's report should include "That the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement whether due to error or fraud."

[3] IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal,* May 2016. https://www.ifac.org/system/files/publications/files/IAASB-Auditor-Reporting-Comparison-between-IAASB-Standards-and-PCAOB-Reproposal_0.pdf

Adding the language requirement "due to error or fraud" articulates the already existing responsibility of the auditor under PCAOB standards. From our perspective, this is an essential clarification and should be included in the basis for opinion and description of procedures performed.

***Independence***

CalSTRS believes the lack of auditor independence negatively impacts the auditor's objectivity. We are concerned where an audit firm receives significant fees for non-audit services. We agree that adding a statement by the auditor on their independence from the company and board of directors reinforces investors' understanding of the auditor's obligations to be independent and objective in expressing the audit opinion. However, we feel it is important for the auditor to expand and explain the policies and processes the auditor completes to ensure their independence of the issuer. For example, in the HSBC Holding plc report of the independent auditor, the audit firm explained the steps they took to ensure their independence of the issuer and its worldwide subsidiaries.[4]

***Tenure***

We support the disclosure of the tenure of the auditor with a statement containing the year the auditor began serving consecutively as the company's auditor, not only for informational purposes but also to advance the Audit Committee's fiduciary responsibility in determining the appropriate maximum length of tenure to ensure the independence of the auditor. CalSTRS Corporate Governance Principles support companies clearly articulating their policy on audit firm rotation.

***Addressee***

As a shareholder and provider of capital, we agree the audit report should be addressed to the company's shareholders and board of directors, permitting additional addresses.

**Critical Audit Matters**

2. CalSTRS supports the PCAOB's proposed rule requiring auditors to disclose CAMs. Specifically, CalSTRS maintains the need for the auditor's report to contain consideration and articulation of:
    - critical financial statement and audit risks,
    - the auditor's assessment of management's estimates and judgments,
    - discussion of unusual transactions, restatements and other significant changes in the financial statements,
    - the auditor's assessment of the quality of the issuer's accounting policies and practices including those that are uncommon to the industry,
    - audit issues and their resolution which the audit partner documents in a final audit memo to the Audit Committee, and
    - the auditor's responsibilities regarding "Other Information."

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[4] HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015,* Report of the Independent Auditors, Page 323 Preparing to change auditors (steps taken to ensure the independence of the auditor), Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016. http://www.hsbc.com/investor-relations/financial-and-regulatory-reports?WT.ac=HGHQ_f3.5_On,

Further we would recommend clarifying, that when the auditor describes CAMs that involve significant accounting judgment or estimation by management, the auditor would be expected to include information about their assessment and insight providing whether these are conservative, average or aggressive rather than simply stating they conform to Generally Accepted Accounting Principles (GAAP). The Board should consider expanding the criteria of CAMs, ensuring the criteria is not narrowly defined by materiality within one given period, versus the cumulative effect and/or trends in issues, restatements and adjustments. We would support the auditor reporting prior period CAMs, along with steps taken toward resolution of these, to identify trends that may not be apparent with current listing of CAMs.

**Enforcement**

3. The auditing profession plays a critical role in ensuring the integrity and efficiency of the capital markets. The financial interests of CalSTRS beneficiaries are most effectively served where investors can justifiably expect reliable financial reporting to evaluate investment risks and returns. Only with rigorous independent audit and enforcement are these attributes possible in the capital markets.

   The PCAOB and other audit regulators around the world must collaborate to develop enforcement mechanisms to protect the interests of investors to increase efficiency, relevancy, reliability and transparency in accurate and reliable financial reporting. Only with consistent and broad regulation and enforcement will the enhanced auditor's report provide genuine and insightful information for investors. Moreover, it is essential that issuers and auditors preserve CAMs from weakening into boilerplate discussions that provide little value to investors and other users of financial reporting.

**Alignment of CAMs to Key Audit Matters (KAMs) – Global Standardization of the Auditor's Report**

4. CalSTRS reinforces the need for global standardization of the auditor's report, requiring ordering of paragraphs and obligator subheadings to mirror the auditor's reporting model under IAASB's ISAs.[5] Although the format would be structured, the content would be issuer-specific with flexibility to ensure the auditor is able to provide the "story" that is pertinent to the audit of that company. We advocate the use of the IAASB's definition of KAMs that requires auditors to select the most significant matters in the audit for discussion in the auditor's report.[6]

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[5] International Federation of Accountants (IFAC), IAASB, *International Standard on Auditing (ISA) 701, Communicating Key Audit Matters in the Independent Auditor's Report* *https://www.ifac.org/system/files/publications/files/ISA-701_2.pdf*

*The New Auditor's Report: Greater Transparency into the Financial Statement Audit,* January 2015. https://www.ifac.org/system/files/uploads/IAASB/Auditor-Reporting-Fact-Sheet.pdf

[6] IAASB, Determining and Communicating Key Audit Matters, prepared by the Auditor Reporting Implementation Working Group, July 6, 2016. http://www.ifac.org/system/files/publications/files/IAASB-KAM-Overview-Diagram.pdf

**Going Concern and Other Information**

5. Although the Board is addressing these topics under separate initiatives with a different timeline, CalSTRS agrees with the IAASB's requirements regarding the communication of going concern and other information in the auditor's report.[7]

**Benefits and Use by Investors**

CalSTRS see many benefits and improved usage of the expanded auditor's report. We agree with the intended benefits of the enhanced auditor's report which include:

- Enhanced communication between auditors and investors, as well as those charged with corporate governance, Audit Committees
- Increased user confidence in audit reports and financial statements
- Increased transparency, audit quality and enhanced information value
- Increased attention by management and financial statement preparers to disclosures referencing the auditor's report
- Renewed auditor focus on matters to be reported that could result in an increase in professional skepticism
- Enhanced financial reporting in the public interest

As a long-term shareholder and owner of more than 7,000 domestic and global companies, CalSTRS believes mandatory CAM disclosures through the enhanced auditor's report will lead to additional information and insight when we consider ratification of the auditor during proxy voting. Currently our voting policy is based on limited information provided by the auditor and the issuer using the ratio of audit fees to non-audit fees as a voting guideline. We believe the enhanced auditor's report will provide additional insight into the audit process, and improve our ability to evaluate the quality of an audit. This additional information may provide additional insight to gauge the possibility of an audit failure or the risk of an earnings restatement. Investors may be able to gain additional information that heightens their ability to engage with corporate boards to potentially enhance the long-term value of the company as well as possibly lower the cost of capital for the company. Additionally, we believe that insights on CAMs may be relevant in analyzing and pricing risks in our valuation and allocation of capital.

**Auditor's Responsibilities Regarding Other Information**

We concur with the requirement that when issuing an auditor's report, the auditor will include a separate section explaining the auditor's responsibilities and use of other information during the audit.[8]

**Broker Dealers and Emerging Growth Companies**

CalSTRS believes all issuers, including broker dealers, investment companies and emerging growth companies, should be subject to the same audit standards and requirements of an expanded auditor's report.

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[7] IAASB, *Auditor Reporting on Going Concern*, January 30, 2015.
http://www.ifac.org/system/files/publications/files/Auditor-Reporting-Toolkit-Going-Concern.pdf

[8] Reference example within HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015*, Report of the Independent Auditors, Other Reporting, pages 325-326, Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016

**Alternative Dispute Resolution Clauses – Auditor Liability**
CalSTRS principles outlines, "The external auditors should not receive indemnification from the company. Contracts with the external auditors should not require the company to use alternative dispute resolution."[9] We believe the auditor should disclose these types of clauses when this type of provision is included in the audit engagement agreement.

Lastly, we have included reference to a few audit reports that we believe capture the spirit of what an expanded auditor's reporting should include.[10]

We hope our summary perspective as a long-term investor provides insight to what we deem critical to the PCAOB's reproposal. We commend the PCAOB for taking steps to improve meaningful disclosures in the auditor's report for investors. If you would like to discuss this letter further, please feel free to contact me at my number above or Mary Hartman Morris at 916-414-7412, MMorris@CalSTRS.com.

Sincerely,

Anne Sheehan
Director of Corporate Governance
California State Teachers' Retirement System

[9] CalSTRS Corporate Governance Principles, Section B. Auditors and Audit-Related Issues, #2, April 3, 2015. http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf

[10] HSBC, *Value of the Network, HSBC Holdings plc Annual Report and Accounts 2015*, Report of the Independent Auditors, Page 323-335, Richard Oldfield (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers, LLP, 22 February 2016. http://www.hsbc.com/investor-relations/financial-and-regulatory-reports?WT.ac=HGHQ_f3.5_On, Downloads/hsbc-holdings-plc-annual-report-and accounts-2015%20Annual Report and Accounts 2015 (502-page PDF)

National Grid plc Annual Report and Accounts 2015/16 Interactive version , Independent Auditor's report, Page 85—93, Michael Timar (Senior Statutory Auditor) for and on behalf of PricewaterhouseCoopers LLP, London, 18 May 2016. http://investors.nationalgrid.com/~/media/Files/N/National-Grid-IR/reports/2016/NG_Interactive_16.pdf

Marks & Spencer Annual Report 2016, Page 78-85, Ian Waller (Senior statutory auditor) for and on behalf of Deloitte LLP, London, 24 May 2016. http://annualreport.marksandspencer.com/M&S_AnnualReport_2016.pdf

CAREER EDUCATION CORPORATION™

August 11, 2016

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

**RE: PCAOB Rulemaking Docket Matter No. 34; PCAOB Release No. 2016-03; Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards**

Dear Office of the Secretary:

Career Education ("CEC") is a for-profit provider of higher education. CEC's academic institutions offer a quality education to a diverse student population in a variety of disciplines through online, campus-based and hybrid learning programs. Career Education is committed to providing quality education that closes the gap between learners who seek to advance their careers and employers needing a qualified workforce. We appreciate the opportunity to provide comments on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* ("Proposal").

We support efforts to improve audit quality that will enhance investor confidence in and understanding of the audit process. We recognize and commend the Board's outreach to various stakeholders in order to receive feedback on the Proposal. However, we believe some of the types of changes outlined in the Proposal, in their current form, will have significant costs and negative unintended consequences which will far outweigh any potential benefits perceived.

**Critical Audit Matters ("CAMs"):**

We support retaining the existing pass/fail model of auditor reporting. Currently, the roles of auditors and management are clearly defined with management responsible for financial statement disclosures and auditors responsible for verifying management's disclosures and providing an opinion on those disclosures. We believe maintaining the current principle of all financial reporting disclosures stemming from management to be appropriate. Some specific concerns related to the Proposal are addressed in the following paragraphs.

*Evaluation of CAMs*

While the current Proposal has narrowed the scope of a CAM to 1) any matter that is communicated or required to be communicated to the audit committee, 2) relates to accounts or disclosures that are material to the financial statements and 3) involved especially challenging, subjective or complex auditor judgment, we believe that the range of matters that could meet the definition of a CAM remains quite broad and could lead to significant new disclosures in the audit report.

This broad definition raises the potential for auditors to err on the side of caution when identifying which items meet the definition of a CAM. The risk would be greater to the auditor to not include an item that may not meet the definition of a CAM in their opinion but could be questioned in hindsight as there is no risk to the auditor to include more. This creates a potential for excessive disclosure. Additionally, the criteria of a CAM which states it should "relate to accounts or disclosures that are material to the financial statements" could also influence the erroneous inclusion of a CAM as the matter itself may not be material but could impact accounts or disclosures that are material to the financial statements in total.

An unintended consequence of CAMs is that it may provide a disincentive for topics to be brought to audit committees' attention. A company's management team may be inclined to discuss fewer items with the audit committee in order to reduce the number of CAMs disclosed in the audit report. This may result in additional audit procedures required as the auditors may have to find alternative procedures to test areas where management may be less forthcoming to discuss or provide information for.

*Communication in the Auditor's Report*

Additionally, we question whether the inclusion of CAMs will provide an investor with any additional information that is not already provided for in the financial statement disclosures. In fact, we believe that users may not fully understand the concept of a critical audit matter. Furthermore, they may not understand the context surrounding audit procedures related to a CAM versus any other work performed related to the financial statement audit. They may question the reliability of the financial statements as a whole due to the auditor specifically identifying areas which were more challenging to audit.

It was noted in the Proposal that the auditor language must be specific as the common user may not understand the technical language used in describing audit procedures surrounding CAMs. This suggests that the common user does not have the technical expertise to understand how the auditor gained comfort over the CAM. The potential for misperception can influence investors' decision-making processes. CAM disclosures may also raise additional questions on the part of investors to management if CAM disclosures reference forward-looking information such as future projected cash flows. As not all companies disclose forward-looking information or disclose only pieces of this type of information this could lead to problematic and inconsistent disclosures.

Under the Proposal, the auditor would be required to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, describe how it was addressed in the audit and refer to the relevant financial statement accounts and disclosures. We do not believe that this objective can be accomplished in a concise and straightforward manner. Given that readers of the financial statements are not experts in audit technique and procedures, an abbreviated description would not be prudent as this may lead to increased misunderstanding or items taken out of context. Therefore, we believe that expanded disclosure will be required in order to effectively provide the information required under the Proposal for each CAM disclosed. As a result, we believe excessive and duplicative disclosure will occur and overshadow the relevant audit opinion.

The potential for boilerplate language also increases with the introduction of CAMs to the auditor report. Auditors of companies will compare CAMs to benchmark against others within the industry. This could create boilerplate language and lose the objective of the Proposal. Investors also would make comparisons to auditors' disclosure of CAMs across companies. This comparison could lead to conclusions regarding audit quality and effectiveness. As there is significant judgment regarding identification of a CAM, this conclusion could irreparably harm companies and shareholders.

A key concern with the Proposal is the potential for the auditor to provide information about a company's financial statements that would typically be management's responsibility to disclose. The Proposal does note that when describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company. Yet, the guidance provides an exception to this statement which allows new information to be presented if it is necessary information to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit. We believe that this exception negates the statement that an auditor would not be expected to provide new information. This blurs the role of auditor and management and shifts responsibility from management to the auditor. Irreparable harm could be made to the company and its shareholders if some of this information impacts its competitive advantage and discloses new information about a company's operations and strategy.

*Documentation of CAM determination*

The auditor would be required to document the basis for their conclusion for each audit matter presented to the audit committee. This documentation would take time away from the auditor during a critical period as these matters would be discussed towards the end of an audit when key items are typically coming to resolution. An auditor will likely expend significant additional effort to document its conclusion regarding each matter in order to limit any potential risk to the auditor if questioned. This additional effort would impact the timeliness of the audit.

As CAMs by definition relate to accounts or disclosures that are material to the financial statements, disclosure around these items would already be contained within the financial statement disclosure as well as within the Management's Discussion and Analysis section. Currently, readers of financial statements have expressed that duplicative disclosures exist within Form 10-Q and 10-K filings as companies typically provide similar disclosures within different items of quarterly and annual filings. Layering on another area to disclose material items to the financial statements will cause excessive and duplicative disclosures. As auditors review a company's filing to ensure that appropriate disclosures are made in relation to material items, this would indicate that the disclosures management has made would be sufficient for a reader of the financial statement to understand the matter absent additional disclosure of the same item in the auditor's report.

Overall, the additional effort related to identification of CAMs, determination of appropriate disclosures to communicate each CAM and the documentation necessary within audit work papers will significantly increase the time associated with each audit on the part of the auditor, audit committee and management as each play a role in these discussions. The significant effort will increase the costs of the audit which will be passed along to companies and their shareholders. The perceived benefit of the addition of CAMs in an audit report for which disclosures should already be contained within the financial statement disclosures do not outweigh the real costs that will be incurred.

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Another unintended consequence that must be considered related to the inclusion of CAMs in an audit report relates to the litigious environment within the United States. This litigious environment including with respect to securities class action lawsuits plays a role in corporate governance. The addition of CAMs within the auditor's report will create a new exposure by encouraging frivolous lawsuits that have no real merit but will be able to be used by the plaintiffs' trial bar to force companies into settlements they would not normally settle given the inclusion of CAMs in the audit report. We believe the CAM disclosure proposal has the potential to change the nature of securities class action and other types of litigation and will not be a positive development for corporate governance.

Specific characteristics of the U.S.-issuer audit market, specifically the legal environment, have the potential to significantly increase the liability for audit firms and companies. Investors may conclude that the type of audit procedures related to a CAM may not be considered appropriate. Auditors may be held liable for either 1) not identifying or disclosing CAMs in the audit report or 2) excessive disclosure of CAMs which negatively impact shareholder value. Overall, mandating disclosure of CAMs increases the likelihood of lawsuits and provides investors with an additional pathway to bring lawsuits forward as the auditor is identifying and disclosing higher risk areas in the audit and challenges in gaining assurance over these areas.

A suggestion to the auditor's report that would address the Proposal would be to add a statement in the auditor's report indicating that the auditor has reviewed the Company's critical accounting policies disclosed within Management's Discussion and Analysis and agrees with the Company's identification of critical accounting matters.

**<u>Additional Improvements to the Auditor's Report:</u>**

*Clarifications of Existing Auditor Responsibilities*

We are supportive of the clarifications and proposed additions to the report language that would enhance standardized language by clarifying the nature and scope of the auditor's existing responsibilities, including statements regarding auditor independence and the addition of the phrase "whether due to error or fraud" when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. We are in agreement with the Board's Proposal to limit the required addressees of the report to the shareholders and the board of directors, or equivalents for companies not organized as corporations and to allow auditors to retain the option to include additional addresses, consistent with today's guidance.

*Auditor Tenure*

We are supportive of disclosures surrounding the year in which the auditor began serving consecutively as the company's auditor. While we understand the desire for consistency in placement of this disclosure, we do not agree that the disclosure should be included in the auditor's report. We believe that the inclusion of this disclosure in the audit report would be misinterpreted as having a direct correlation to audit quality. We believe that this disclosure should be required in other required filings, such as the audit firms' annual report on Form 2 or in the company's proxy disclosures.

*Standardization Form of the Auditor's Report*

We are supportive of the proposed changes to the order of the auditor's report. We believe that the requirement to place the opinion first and to require section titles to guide the reader supports an overall objective to provide more concise and user friendly information to shareholders.

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In summary, as discussed above, we believe that the overall costs associated with the additional disclosure of CAMs in the audit report outweigh the potential benefit. We believe that this additional disclosure would be duplicative to managements' disclosures, blur the roles between auditor and management and imply piecemeal opinions while distorting the overall audit opinion. We are concerned that the addition of CAM disclosures to the audit report would adversely affect audit quality, timeliness of financial reporting, increase audit costs and have negative implications to practical and legal applications. We are supportive of the proposed improvement to the auditor's report but recommend that auditor tenure be a required disclosure outside of the auditor's report.

Once again, we appreciate the opportunity to comment on these proposed standards. If you have any questions, please contact me at (847) 851-7119.

Sincerely,

Michele

Michele A. Peppers, CPA
Vice President Accounting & Reporting, Chief Accounting Officer
Career Education Corporation
231 N Martingale Road
Schaumburg, IL 60173

August 15, 2016

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

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

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, DC, the CAQ is affiliated with the American Institute of CPAs.

The CAQ welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) reproposal of Proposed Auditing Standard - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Related Amendments to PCAOB Standards* (the Reproposal). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

Similar to views previously expressed on this topic, the CAQ applauds the PCAOB's efforts to consider ways to update and enhance the auditor's reporting model to provide additional information to stakeholders in an increasingly complex and global environment.[1] We recognize that the Board has been working diligently since the *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release) in June 2011 to develop an approach that is beneficial to all stakeholders. We appreciate the extensive outreach and commend the Board for its responsiveness to concerns raised and recommendations made by a variety of stakeholders throughout the process, including those of the CAQ.

[1] See comment letters from the CAQ on this topic dated June 28, 2011, September 30, 2011, December 11, 2013, January 30, 2014, and June 19, 2014.

We have organized our observations and suggestions on the Reproposal into the following categories:

- Critical Audit Matter(s) (CAM)
- Additional Improvements to the Auditor's Report
- Applicability
- Effective Date

We have also included an Appendix to help illustrate some of our recommendations with respect to the illustrations included in the Reproposal related to communication of CAM.

**Critical Audit Matter(s) (CAM)**

*Determination of CAM*

The CAQ supports narrowing the source of CAM to those matters communicated, or required to be communicated to the audit committee. As indicated in our previous CAQ comment letters, we believe that narrowing the source of potential CAM to those matters discussed with audit committees will assist auditors in identifying matters that involved especially challenging, subjective, or complex auditor judgment in the audit in an effective and efficient manner. We believe narrowing the sources of potential CAM in this way will also enhance the ability for auditors to communicate only the most important matters to users of the financial statements (i.e., including too many matters in the auditor's report would serve to minimize the intended emphasis on the matters of most significance). The CAQ's 2014 field testing initiative observed that 98 percent of matters determined to be CAM had been previously communicated to the audit committee. The field testing also indicated that potential CAM identified through the application of paragraph 8 of PCAOB Release 2013-005, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (the Original Proposal) resulted in a broad population of matters to consider.[2] In many instances, the inventory of potential CAM was substantial.

This change should reduce differences between the PCAOB's CAM approach and the International Auditing and Assurance Standards Board's (IAASB) approach to determining key audit matters (KAM), which are determined from those matters communicated with those charged with governance.[3] Stakeholder feedback gathered by the IAASB supported the approach as being "responsive to investor requests for further insights

[2] See CAQ comment letter from June 19, 2014 for full details on the field testing: https://pcaobus.org//Rulemaking/Docket034/247b_CAQ.pdf.

[3] Definition of *key audit matter* in ISA 701: Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance. https://www.ifac.org/system/files/publications/files/ISA-701_2.pdf. See also, IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal* (May 2016), available at https://www.ifac.org/system/files/publications/files/IAASB-Auditor-Reporting-Comparison-between-IAASB-Standards-and-PCAOB-Reproposal_0.pdf. The IAASB document observes that the framework for determining CAM under the PCAOB Reproprosal is substantially similar to determining Key Audit Matters (KAM) under the IAASB's Standards.

into auditor communications with the audit committee."[4] It was also viewed as consistent with the overarching role of the audit committee to represent the interests of shareholders.[5]

*Original Company Information*

As shared in our prior comment letters, the CAQ developed a set of guiding principles to frame our recommendations related to auditor reporting. One of the primary guiding principles was that the auditor should not be the original source of information about the company (i.e., should not provide information in the auditor's report about the company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure). Further, during the May 11, 2016 open meeting where the Board voted to release the Reproposal for public comment, statements were made by members of the Board that the intent of certain clarifications made in the Reproposal were to prevent the auditor from being the original source of information about a company through the identification of a CAM.[6] This intent appears to be a primary reason for the inclusion of materiality in the definition of a CAM. We therefore support including the concept of materiality in the definition of a CAM and appreciate the PCAOB's change in the Reproposal in this regard. As recommended in our previous comment letter on the Original Proposal, the addition of the concept of materiality for consideration when determining CAM will focus the auditor on those matters that are most critical to the financial statements and that, as a result, are most critical to the audit. However, we do not believe that the revised definition, when combined with the factors in paragraph .12 of the Reproposal, fully aligns with the Board's intent that the auditor not be the source of original information about the company in the determination of a CAM.

For example, a significant deficiency in internal control is a required communication to an audit committee that may relate to one or more accounts or disclosures that are material to the financial statements. If the significant deficiency involved especially challenging, subjective or complex auditor judgement, it could meet the definition of a CAM. As such, the matter could be identified in the auditor's report; however, management has no requirement to disclose a significant deficiency under the SEC rules.

We believe the suggested edit below to the definition of a CAM in paragraph .11 and .A2 of the Reproposal will still provide investors with the information they are looking for about the audit, while preventing certain types of original company information, such as a significant deficiency, from meeting the definition of a CAM. A significant deficiency may *relate to* a material account or disclosure; however, a significant deficiency by itself would not be a material matter to the financial statements. We believe the revised definition will most likely prevent other potential items that are not required to be disclosed by management, but relate to accounts or disclosures that are material to the financial statements from being a CAM.

> .11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee

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[4] Staff of the IAASB, *Basis for Conclusions: Reporting on Audited Financial Statements – New and Revised Auditor Reporting Standards and Related Conforming Amendments*, p.12 (Jan. 2015), available at https://www.ifac.org/system/files/publications/files/Basis%20for%20Conclusions%20-%20Auditor%20Reporting%20-%20final.pdf.
[5] Ibid.
[6] See statements by Lewis H. Ferguson https://pcaobus.org/News/Speech/Pages/Ferguson-statement-ARM-051116.aspx and Jay Hanson https://pcaobus.org/News/Speech/Pages/Hanson-statement-ARM-051116.aspx.

and that: (1) ~~**relates to accounts or disclosures**~~ ~~**matters that are**~~ **is** material to the financial statements **taken as a whole**[7] and (2) involved especially challenging, subjective or complex auditor judgment.

Further, we foresee a potential situation where auditors would, under the Reproposal, identify a CAM related to an account or disclosure that would not otherwise require especially challenging, subjective or complex auditor judgment, but could result in especially challenging, subjective, or complex auditor judgement regarding the audit approach to be employed to an account or disclosure due to a significant deficiency in the company's internal controls. In this case, even though the significant deficiency would not likely be a CAM in and of itself, judgments about the audit strategy could be principal considerations that led the auditor to determine the matter was a CAM based upon the factors in paragraph .12. As a result of it being a principal consideration, the significant deficiency could require disclosure in the communication of the CAM in the auditor's report. Such disclosure could result in the auditor being the original source of information about a company's system of internal control in an area where there was no similar disclosure requirement for the company.

To help further prevent auditors from being the original source of information for a company, we recommend the Board consider revising the factors to determine whether a matter involved especially challenging, subjective, or complex auditor judgment, in paragraph .12, as shown below. We believe that removing "determining" from the second factor will focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence, as opposed to an audit strategy decision. Additionally, the nature of audit evidence is a component of determining whether sufficient appropriate audit evidence has been obtained. To clarify how the auditor should consider one of the many factors involved in the evaluation of audit evidence, we are recommending that the last factor be removed, and the consideration for obtaining sufficient appropriate audit evidence be included in the third factor (c). These recommendations are illustrated below.

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a) The auditor's assessment of the risks of material misstatement, including significant risks;
b) The degree of auditor subjectivity in ~~**determining or**~~ applying audit procedures to address the matter or in evaluating the results of those procedures;
c) The nature and extent of audit effort required to **obtain sufficient appropriate audit evidence to** address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;
d) The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty; and
e) The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions.
~~**f) The nature of audit evidence obtained regarding the matter.**~~

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

[7] Please see below the *Introductory Language* section of the comment letter.

In addition, we suggest that the Board also consider revising note 2 of paragraph .14 to clarify that the auditor will not be the source of original company information:

> When describing critical audit matters in the auditor's report the auditor **should not** ~~**is not expected to**~~ provide information about the company that has not been made publicly available by the company ~~**unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit**~~.

These suggested revisions would also be consistent with the following statement in the Reproposal: "The Board believes that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; unusual transactions; and other significant changes in the financial statements."[8]

*Communication in the Auditor's Report*

We appreciate the inclusion in the Reproposal of the illustrations of example CAM communications. We expect that many auditors will utilize these illustrations as a resource to develop their own CAM communications, and therefore we want to ensure the content of the illustrations aligns with the principles of the Reproposal.

The Reproposal would require that each matter communicated in the auditor's report include a description of the principal considerations that led the auditor to determine the matter is a critical audit matter, as well as a description of how the matter was addressed in the audit. The illustrations included in the Reproposal seem to indicate that all aspects of how the matter was addressed in the audit be included in the description of the CAM. In the CAQ's previous comment letter on the Original Proposal, we recommended that the Board explicitly state that the auditor may provide a description of the CAM's effect on the audit if the auditor considers it necessary in describing why a matter is a CAM. Both examples in the Reproposal provide information on how the matter was addressed in the audit beyond what would appear to be key or critical audit procedures directly related to the principal considerations that resulted in the CAM, including detail about every phase of the audit. We believe that the PCAOB should consider revising the examples to make clear that they are intended to illustrate how an auditor may describe the *principal* considerations that led the auditor to determine that the matter is a CAM and the principal way in which the auditor addressed the CAM. We believe this would more clearly demonstrate the Board's intent on page 32 of the Reproposal. Otherwise, we are concerned that the examples could be interpreted by auditors to require additional detail, beyond the principal considerations and the principal way in which the CAM was addressed, which could result in boilerplate CAM communications.

Please see the Appendix, which illustrates suggested changes to the examples included in the Reproposal to demonstrate what we believe were the *principal* considerations that lead the auditor to determine the matter was a CAM, and the principal audit procedures related to those considerations.

*Legal Implications for Auditor Liability*

As before, the Board has inquired whether expanded auditor reporting as set forth in the Reproposal would increase legal liability. As communicated in previous CAQ comment letters,[9] an auditor can be liable under

[8] See p. 2 of the PCAOB Release 2016-003.
[9] See the CAQ's comment letter on the Original Proposal (link).

the federal securities laws for the statements it makes in the auditor's report, and enhanced auditor reporting inevitably increase the risk of litigation over liability.

Some of the changes in the Reproposal mitigate this risk, but the addition of the requirement to describe how the CAM were addressed in the audit could significantly increase it. The CAQ accepts that this is a necessary consequence of the communication requirement under the Reproposal. However, the Board should recognize the potential for adverse impact on auditors and on communication between auditors, companies and audit committees, and it should design the standard to avoid or reduce that impact where possible.

This idea underlies several of the modifications suggested in this comment letter. In particular, as discussed above under the "*Original Company Information*" section, the Reproposal should be modified so the auditor is not the required to include original company information in the auditor's report. Requiring the auditor to include information in its report, when the ultimate source should be the company, is unnecessary, and it creates a risk of liability that could have unintended consequences for the auditing process and the communication among the auditor, the company and the audit committee.[10]

Auditors may also be exposed to litigation from companies for exposing their original information under contract and state law duties of client confidentiality.

*Introductory Language*

We are supportive of introductory language preceding the description of the CAM in the auditor's report to make clear that the communication of CAM does not imply that the auditor is providing a separate opinion on the CAM or the accounts or disclosures to which it relates. However, we do have the following observations and recommendations for enhancements to the introductory language.

The language in the audit report introducing CAM, as proposed, refers to the auditor's opinion on the financial statements taken as a whole. That accurately reflects the requirements of paragraph .01 in the Reproposal. We believe that same language should also be included in the introductory language that defines a CAM. We would also recommend greater precision, as noted below, in the proposed language introducing the CAM that starts "Critical audit matters do not alter…"; we believe the subject of the sentence should be the auditor's communication of the CAM, not the CAM themselves.

The following markup of the CAM introductory language reflects the discussion above.

> The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that (1) **~~relate to accounts or disclosures that~~** are material to the financial statements **taken as a whole** and (2) involved our especially challenging, subjective, or complex judgments. **~~Critical~~ The discussion of critical** audit matters **~~do~~ does** not alter in any way our opinion on the financial statements taken as a whole, and we ~~do~~ **~~not provide~~ are not, by communicating the critical audit**

[10] One of the potential sources of auditor liability is Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder, and the Supreme Court has held that a person cannot be held liable for a false or misleading statements under these provisions unless the person actually makes the statement. *Janus Capital Group v. First Derivative Traders* 131 S. Ct. 2296 (2011). Another potential source of auditor liability is Section 11 of the Securities Act of 1933, and an auditor can be held liable under this provision for statement and omissions in its report.

**matters below or otherwise, providing** separate opinions on ~~the~~ critical audit matters **~~or on the accounts or disclosures to which they relate~~**.

**Additional Improvements to the Auditor's Report**

*Clarifications of Existing Auditor Responsibilities*

We continue to support the Board's proposed changes to enhance the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding financial statement notes and for obtaining reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Further, we also support moving the opinion paragraph, as the requirement to put the opinion paragraph first in the auditor's report more closely aligns the auditor's report with the IAASB standards.

In an effort to create further alignment with IAASB standards, we strongly encourage the Board to adopt the additional improvements to the auditor's report that are consistent with the IAASB standards. These additional changes are expanded descriptions of the responsibilities of management and those charged with governance, as well as the auditor's responsibilities, in separate sections of the report. We continue to believe that these changes would enhance users' understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally.

Also in line with IAASB standards and our recommended edits for the CAM introductory language, we encourage the PCAOB to consider revising paragraphs .08(e) and .09(b) to change the words "the financial statements" to "the financial statements, taken as a whole."

*Audit Firm Tenure*

Because we do not see a correlation between auditor tenure and audit quality, and consistent with our past views, the CAQ does not support including auditor tenure in the auditor's report. The PCAOB itself has acknowledged in the Original Proposal that it had not found a correlation between auditor tenure and audit quality,[11] and in the Reproposal stated that academic research is still divided on the relationship between auditor tenure and audit quality.[12] We believe that including auditor tenure in the auditor's report would create the false impression that a correlation exists between auditor tenure and audit quality and would give undue prominence to this information. Accordingly, we do not believe the auditor's report is the appropriate location to disclose auditor tenure. We do support other ways of making auditor tenure more transparent. For example, if the audit committee believes that the tenure of the auditor is important information for users of the financial statements to be aware of, the audit committee report in the proxy is an appropriate place for such disclosure. In fact, we are seeing an increasing number of audit committees of the S&P 500 disclosing the tenure of their auditors, from 47 percent in 2014 to 54 percent in 2015, according to the *2015 Audit Committee Transparency Barometer*.[13] Preliminary research by Audit Analytics for the *2016 Audit Committee Transparency Barometer* show that this trend continues with the percentage increasing from 54 percent in

[11] See Original Proposal, page A5-16.
[12] See page 49 of the PCAOB Release 2016-003.
[13]According to *2015 Audit Committee Transparency Barometer,* in 2015 approximately 54% of Audit Committees for S&P 500 Companies disclose the length of time the audit firm was engaged by the Company. http://www.thecaq.org/docs/default-source/reports-and-publications/2015-audit-committee-transparency-barometer.pdf?sfvrsn=2.

2015 to 59 percent in 2016. As audit committees are charged with responsibility for oversight of the auditor, including their appointment, we are encouraged by this increasing transparency being provided in proxy statements.

**Applicability**

The CAQ is supportive of the Reproposal's provision to not require the identification, communication, and documentation of critical audit matters in auditor reports for non-issuer brokers and dealers, investment companies (that are not business development companies), and employee benefit plans (i.e., employee stock purchase, savings, and similar plans). We are pleased to see the PCAOB's consideration of comments received and economic analysis to develop an informed decision for excluding these entities from CAM requirements.

Consistent with our comment letter on the Original Proposal, we believe that the Reproposal should be applicable to emerging growth companies (EGCs).[14] As we have noted previously, certain financial reporting risks can be more prevalent with EGCs than other public companies because of the size, nature, and complexity of their business model, capital structure, business processes and controls, and regulatory environment.

**Effective Date**

The preparation for and implementation of the Reproposal as it relates to expanded auditor reporting will take a considerable amount of time. In anticipation of implementation, audit firms will need to develop and implement training and effective quality control processes to support expanded communications that are (1) providing users with meaningful and useful information, (2) in compliance with applicable laws and regulations, and (3) not unnecessarily increasing potential legal liabilities. We also believe that the auditor's process of developing communications related to CAM will likely require extensive discussions with preparers and audit committees as they evaluate the potential effect of the additional auditor communications in the auditor's report.

We believe that the implementation of the Reproposal, particularly the effort to develop and deliver training and implement effective quality control processes, could place a significant and possibly disproportionate burden on smaller audit firms. As a result, we recommend that the Board allow for a two-phased adoption of the Reproposal. The first phase would be applicable to large accelerated filers with an effective date for audit periods ending two years after the SEC approves the final standard. The second phase would be applicable to all accelerated and non-accelerated filers one year after the phase one effective date in order to allow for firms to benefit from the experience of audits of large accelerated filers. Another benefit of a phased approach is that the PCAOB could leverage its inspection observations during inspections of audits performed during the first phase and provide insights to assist in phase two adoption.

We encourage the Board to take these matters into consideration when determining an effective date that will allow audit firms and preparers the necessary time to develop the appropriate processes, policies and procedures to implement the new standard.

****

[14] See the CAQ's comment letter on the Original Proposal (link).

The CAQ appreciates the opportunity to comment on the Reproposal and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have regarding the views expressed in this letter.

Sincerely,

Cynthia M. Fornelli

Cynthia M. Fornelli
Executive Director
Center for Audit Quality

CC:
PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor and Director of Professional Standards
Jennifer A. Rand, Deputy Division Director/Deputy Chief Auditor

SEC
Mary Jo White, Chair
Michael S. Piwowar, Commissioner
Kara M. Stein, Commissioner
James V. Schnurr, Chief Accountant
Wesley R. Bricker, Interim Chief Accountant
Brian T. Croteau, Deputy Chief Accountant
Julie A. Erhardt, Deputy Chief Accountant

IAASB
Arnold Schilder, Chairman

**Appendix – Suggested Modifications to the Illustrations**

**Company A**
**Critical Audit Matter**
The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

*Allowance for Loan Losses – New Loan Product*

As more fully described in Note 7 to the financial statements, during 2014, the Company [a mid-size regional bank] began actively marketing a nine-year auto loan in addition to the three- and five-year auto loans historically marketed. At December 31, 2015, the nine-year loans represented approximately 18% of the auto loan portfolio. ~~The Company estimates and records an allowance for loans that are impaired but are not yet specifically identified (collective impairment allowance) by developing a loss rate based on historical losses and other factors, including qualitative adjustments to historical loss rates based on relevant market factors.~~ Since management has limited historical loss data for the nine-year loans, it developed a new model to estimate this allowance using historical loss data from its auto loans of shorter terms and loss data from external sources for auto loans of longer terms to model a loss rate for the nine-year loans. In addition, management made qualitative adjustments to the historical loss rates to reflect lower borrower quality and higher risk of collateral impairment compared to its shorter term loans and for economic factors, primarily due to increasing unemployment in the markets served. There was a significant amount of judgment required by management when developing the model, which in turn involved our significant judgment.

The principal considerations for our determination that the allowance for loan losses for nine-year auto loans is a critical audit matter are that it is a new loan product with limited historical loss data and auditing the estimated allowance for losses on these loans involved our complex and subjective judgment.

Our audit procedures related to the collective impairment allowance for the nine-year loans included the following procedures, among others.

~~We tested the effectiveness of controls over the Company's new model, historical loss data, and the calculation of a loss rate.~~ We evaluated the qualitative adjustment to the historical loss rates, including assessing the basis for the adjustments and the reasonableness of the significant assumptions. ~~We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.~~

We used a specialist to assist us in evaluating the appropriateness of the new model and to review the loss data from external sources used by the Company to determine its relevance to the Company's nine-year loan portfolio and consistency with external data from other sources.
Finally, with the assistance of the specialist, we evaluated the incorporation of the applicable assumptions into the model ~~and tested the model's computational accuracy~~.

**Company B**
**Critical Audit Matter**

The critical audit matter communicated below is a matter arising from the current period audit that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

*Accounting for Acquisitions*
Refer to Notes 2 and 13 to the financial statements

~~The Company's strategy includes growth by acquisition. Acquisitions represent a significant component of the Company’s sales growth through the addition of new customers and new products~~ During 2015 the Company completed eight acquisitions for net consideration of $2.1 billion. The most significant of these were (1) the acquisition of all outstanding equity of ABC Inc. for net consideration of $1.1 billion and (2) the acquisition of all outstanding equity of XYZ Corp. for net consideration of $0.5 billion.

Auditing the accounting for the Company’s 2015 acquisitions involved a high degree of subjectivity in evaluating management's estimates, such as the recognition of the fair value of assets acquired and liabilities assumed. We planned and performed the following procedures in connection with forming our overall opinion on the financial statements. ~~We tested controls over the accounting for acquisitions, such as controls over the recognition and measurement of assets acquired, liabilities assumed, and consideration paid and payable, including contingent consideration.~~ For each of the acquisitions, we ~~read the purchase agreements,~~ evaluated the significant assumptions and methods used in developing the fair value estimates, and tested the recognition of (1) the assets acquired and liabilities assumed at fair value; (2) the identifiable acquired intangible assets at fair value; and (3) goodwill measured as a residual.

More specifically, for the acquisitions of ABC and XYZ, we assessed whether (1) intangible assets, such as acquired technology, customer lists, and noncompetition agreements, were properly identified, and (2) the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable. Specifically, when assessing the assumptions related to the revenue growth rate and projected profit margins, we evaluated whether the assumptions used were reasonable considering the past performance of ABC and XYZ and the Company’s history related to similar acquisitions and considered whether they were consistent with evidence obtained in other areas of the audit, such as assumptions used by the Company in its budget.

The purchase consideration for the acquisitions of ABC and XYZ also reflected, in part, the estimated fair value of significant contingent consideration arrangements based on attainment of product development milestones and patent approvals. In testing the valuation of contingent consideration, we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable. Finally, we evaluated management’s classification of contingent payments to continuing employees as either contingent consideration in the business combination or employee compensation.

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August 29, 2016

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

To the Members of the PCAOB;

**Reference:** *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (PCAOB Rulemaking Docket Matter No. 034)*

CFA Institute,[1] in consultation with its Corporate Disclosure Policy Council ("CDPC"),[2] appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*.

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that corporate financial reporting and disclosures provided to investors and other end users is of high quality.

***CFA Institute Position on Rationale for Changes Needed to the Independent Auditor's Report***
CFA Institute has consistently supported the efforts of the PCAOB to improve the independent auditor's reporting model. We have long expressed the need to improve the Standard Auditor's Report (SAR) as a means of communicating important information to investors and other users regarding the audit of a company's financial statements. It is our belief that the SAR along with the financial statements and management's discussion and analysis should be considered part of a holistic communication of valuable information to investors to make informed capital allocation decisions. Significant efforts and costs go into an audit, yet investors are provided very little information in the three paragraph report provided by the current SAR. Through increased transparency, a revised auditor's reporting model should heighten user confidence in the audited financial statements and better inform them about the auditor's role.

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[1] With offices in Charlottesville, New York, London, Brussels, Hong Kong, Mumbai, Beijing, CFA Institute is a global, not-for-profit professional association of more than 142,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 154 countries, of whom nearly 135,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 147 member societies in 69 countries and territories.

[2] The objective of the CDPC is to foster the integrity of financial markets through its efforts to address issues affecting the quality of financial reporting and disclosure worldwide. The CDPC is comprised of investment professionals with extensive expertise and experience in the global capital markets, some of whom are also CFA Institute member volunteers. In this capacity, the CDPC provides the practitioners' perspective in the promotion of high-quality financial reporting and disclosures that meet the needs of investors.

The current SAR contains largely "boilerplate" language which has contributed to an "expectations gap", commonly understood as the gap between the auditor's performance, the auditor's communication of what they did, and the users' expectations regarding the audit process and findings. It is our belief that enhancements to the SAR hold the greatest promise to narrow this expectations gap and to provide decision-useful information to investors.

We urge the PCAOB to act decisively and with the best interests of the investor in mind as it works to complete this project. Investors throughout the globe are already benefitting from new auditor's reports issued in accordance with the UK Financial Reporting Council Standards and will soon see new reports issued un the International Standards on Auditing as issued by the International Auditing and Assurance Standards Board. Those who invest in the US capital markets should be given the opportunity to benefit from a more informative auditor's report and the time has come for the PCAOB to thoughtfully conclude this project.

We refer you to our previous letters for more specific comments and reference to our survey's etc. We believe those comments apply in many respects to the current re-proposal.

The links to those letters appear below:

- PCAOB Release No. 2013-005 August 13, 2013 (Proposed Rule)
- PCAOB Release No. 2011-003 June 21, 2011 (Concept Release)

The links to CFAS Institute surveys appear below:

- CFA Institute, Usefulness of the Independent Auditor's Report, March 2011
- CFA Institute, Independent Auditor's Report Survey Results, March 2010

Our aim in this letter is to address certain key changes as shown below from the PCAOB 2013 proposal.

***CFA Institute Comments on Current Proposal***

Determination of Critical Audit Matters (CAM)

The re-proposal narrowed the source of potential CAMs to matters communicated or required to be communicated to the audit committee. The 2013 proposal would have required CAMs to be those matters required to be:

(1) documented in the engagement completion document;
(2) reviewed by the engagement quality reviewer;
(3) communicated to the audit committee; or
(4) any combination of the three.

While we also agree with the PCAOB that narrowing the source of CAMs may be technically correct in that they ordinarily would be communicated to the audit committee, thus would be captured in the revised definition. However, we think that this narrowing further provides a more subjective approach when a more objective approach would lead to a more thorough disclosure of CAMs. Our concern remains that the proposed subjectivity might easily allow for an artful avoidance of providing information to investors. Investors have been seeking specific information from the auditor for years, and giving more objective, prescriptive guidance is necessary to ensure that those specific matters are conveyed by the auditor.

Definition of CAM
We believe the definition of CAM has been weakened under the 2016 re-proposal by the addition of a materiality component to the definition. We agree with the Council of Institutional Investors comment letter to the PCAOB in response to materiality stated below:

> *First, the definition of CAMs as interpreted in the reproposal is too narrow and unnecessarily excludes relevant information from investors. More specifically, we would not limit CAMs to any matter that "relates to accounts or disclosures that are material to the financial statements" as that phrase is interpreted in the reproposal. We note that the reproposal provides an example indicating that the phrase would exclude from the definition of CAMs a "loss contingency that was communicated to the audit committee but that was determined by management to be remote." We believe that such a narrow interpretation of the phrase would unnecessarily exclude relevant information from investors.*

This sort of example demonstrates why narrowing the definition could omit information important to investors. We believe instead that the auditor should simply apply their judgement to reporting CAMs in accordance with the factors used to determine CAMs as approved by the PCAOB in the final standard.

Further, as previously mentioned in our 2013 letter, we believe that the auditor should provide details about the quantitative and qualitative materiality levels and factors the auditor considered in establishing materiality levels.

Factors Used to Determine CAMs
We disagree with the PCAOB eliminating the following two items from the list of factors that the auditor would need to take into account when determining CAMs:

1) The severity of control deficiencies identified relevant to the matter, if any
2) The nature significance, quantitatively or qualitatively, of corrected and accumulated uncorrected misstatements related to the matter, if any.

We believe that both of these items would be relevant information to investors as they assess the overall control environment and nature of any uncorrected misstatements. We believe that narrowing the list of factors could potentially further restrict information reported to investors.

Communication of CAMs
Adding a requirement for the auditor to describe how the CAM was addressed is an improvement to the 2013 proposal. The feedback from auditor's reports issued under the Financial Reporting Council's requirements has shown that this information is valuable to investors.

Interaction Between CAMs and Explanatory Paragraphs
We agree with the changes to clarify the communication of the CAMs and required explanatory paragraphs. It is important that the CAMs and explanatory paragraphs be appropriately cross-referenced in order for users to fully understand what is being communicated by the auditor.

The re-proposal calls for the auditor to communicate in the auditor's report critical matters relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters. This would imply that the auditor's report for any given audit on a comparative basis would not necessarily include critical audit matters that may have related to the prior period. Although the user could go back and review the auditor's report from the prior period, we believe that given the audit covers the prior period, that any critical audit matters relating to that period should also be in the report. By doing so, users will be able to understand the audit implications related to prior periods by reviewing only one report.

Auditor Independence
As mentioned in our 2013 letter; we believe that a statement regarding auditor independence is useful to investors and establishes a heightened sense of professional accountability. However, as we previously noted simply stating that the auditor is "required" to be independent, rather than is "in fact" independent is a less than optimal positive statement. A more definitive statement is preferable and adds further assurance that the auditor is independent. We do not believe that the PCAOB explanation for why it decided to retain the 2013 proposal language is sufficiently justified. The auditor is either independent or not, stating so should be simple.

Form of Auditor's Report
We agree that the "Opinion on the Financial Statements" should be the first section of the auditor's report followed by the "Basis for Opinion" section. We also agree that there should be titles for all other sections. These requirements improve the readability of the report.

Investor Use of the Auditor's Report
A key question being asked by the PCAOB is: how will investors use the information in the CAMs? To answer this question, the Board has to look no further than the letter of R.G. Associates, Inc. filed with the PCAOB in response to the re-proposal. The R.G. Associates, Inc. letter captures the essence of how investors will use the auditor's report and how over the many decades the auditor's report, beyond the pass/fail test (which is still very important) lacks any useful information.

## CLOSING REMARKS

CFA Institute commends the PCAOB and especially those Board members who have consistently supported investors and other users over the last several years to advance matters of audit quality, of which expanded more informative audit reports is an important element. We realize that brining the auditor's reporting project to a close has been challenging for the PCAOB, but we stress that is important for the PCAOB to deliver a new model. Other standard setters have completed their projects on this matter and it is now time for the PCAOB to deliver something for the benefit of investors.

We thank the PCAOB for the opportunity to express our views on this proposal. If the PCAOB has questions or seek furthers elaboration of our views, please contact Matthew M. Waldron by phone at +1.212.705.1733, or by e-mail at matthew.waldron@cfainstitute.org.

Sincerely,

*/s/ Sandra J. Peters*

Sandra J. Peters, CPA, CFA
Global Head Financial Reporting Policy
Standards & Advocacy Division
CFA Institute

*/s/ Ashwinpaul Sondhi*

Ashwinpaul Sondhi, Phd.
Chair
Corporate Disclosure Policy
Council

cc: CFA Institute Corporate Disclosure Policy Council

Cherry Bekaert LLP
CPAs & Advisors

August 15, 2016

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

RE: PCAOB Rulemaking Docket Matter No. 034

Dear Office of the Secretary:

We greatly appreciate the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2016-003, Proposed Auditing Standard–The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (Proposed Standard).

We support enhancing the form and content of information available to investors and make information more relevant and informative to investors and other financial statement users.

However, we disagree with the incorporation of critical accounting matters (CAMs) into the audit report. We believe that to do so would dilute the current pass/fail model and diminish the value of an audit report. We believe that due to the litigation environment in the United States most if not all auditors are likely to be overly cautious and conservative and include an overabundance of matters and in a standardized way "mirroring" audit reports of similar companies. The numerous CAMs added to the majority of audit reports will make auditor reports overly voluminous and confusing to the users of financial statements adding no substantial benefit but significantly adding to the cost to investors.

The foregoing notwithstanding, we appreciate the opportunity to comment and contribute and have answered certain questions which we feel are particularly relevant to consider:

Questions:

1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.

   a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?

      We do not believe that the source of CAMs should begin with those matters that are required to be communicated to the audit committee. We believe this because the audit committee's purpose is to oversee audit services, which includes both CAMs and non-CAMs. As highlighted in AS 16, the Audit Committee and the auditor should be working as a team, including timely two-way communications about matters critical to performing an effective audit such as risk assessment. In addition, the communication between auditor and audit committee is private.

      The above points create an environment between auditor and audit committee designed to foster open communications which best services the investing public.

      By starting the CAM decision with communications to the audit committee the Board would be creating an incentive counter to the goals of free and open, timely and two-way communications as prescribed in AS 16. This could result in matters which otherwise might be discussed and communicated from being communicated and thus counter-productive.

We recommend that if the Board is to follow through with introducing the concept of CAMs that the Board allow auditors to determine what are and are not CAMs. Auditor judgment has always been relied upon, whether in determining materiality, determining risks, designing audit procedures to address those risks or assessing the results of those procedures. Why would auditor judgment not be sufficient for determining what is and is not a CAM?

d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?

We do not disagree with the inclusion of this as a component in determining CAMs. However, we are unsure how this component would relate to critical accounting estimates and significant accounting estimates as disclosed in Management's Discussion and Analysis and the footnotes to the financial statements. Would all critical accounting estimates also be CAMs? If an account or disclosure involves critical accounting estimates would it not also involve challenging, subjective, or complex auditor judgment? If not considered a CAM, would the omission increase the risk of litigation and be perceived as an inconsistency?

2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?

We agree that there should be a list of factors to consider when making the CAM determinations.

3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?

We recommend that the board remove the phrase "extent of audit effort" from any factors. We agree that the use of specialized skills and judgment should be considered because they address the degree of uncertainty that investors seek to understand through the concept of CAM. However, certain audit procedures might be extensive but require little or no judgment or uncertainty while other audit procedures might not require as much work but involve significant judgment and uncertainty.

6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:

b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?

Given the definition of critical audit matters as "involving especially challenging, subjective or complex auditor judgment" it is impossible for a reader not to then interpret those balances and disclosures as being equal to balances and disclosure not deemed a CAM.

7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?

We believe that the auditor should not reference any information outside of the financial statements because the auditor's responsibility over other information is limited to review for consistency with the financial statement and footnotes. The auditor is not and should not be responsible to audit the other such information.

8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?

> We believe that many audits, especially those performed by mid-sized or smaller accounting firms, are often less complex than those performed by larger firms. While risks are always present, audit areas with "challenging, subjective or complex auditor judgment" are not always present.

10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?

> We believe that the inclusion of CAMs to highlighting difficult audit areas will inherently increase the risk of litigation despite the Board's efforts to minimize the likelihood. Those seeking to bring litigation would point to the absence of a CAM disclosure as support for either the auditor's negligence in identifying a CAM or in disclosing it. We believe that this increased risk will likely result in over disclosure of CAMs in a broad and ambiguous way using standardized wording thus increasing the length of the auditor's report but making it equal or less useful to investors.

12. Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?

> Yes, similar to the inclusion of limiting language regarding and audit of internal control, we believe that there should be standardized language that limits the reliance on the auditor's communication of CAMs.

18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?

> We believe that disclosure of auditor tenure would best be disclosed on Form AP because we believe that the auditor's pass/fail model is weakened whenever extraneous information is provided. For example, audit reports with differing auditor tenures could lead investors to weigh the opinions differently, whether it be because the auditor is inexperienced with auditing the client or has a long-standing relationship with the client. Having the information publicly available through the form AP but not presented along with the pass/fail opinion allows those investors who seek such information to obtain it.

29. Would critical audit matters be useful in assessing company financial performance? If so, how?

> Identifying which account balances or disclosures are "especially challenging, subjective, or [require] complex auditor judgment" would aid in making investment decisions across industries which might have different CAMs. However, we believe it is likely that most audit reports within an industry would include the same CAMs both due to the nature of the operations and the evidence available to auditors. In addition, the fear of litigation will likely result in auditors "mirroring" their CAMs to other audit reports of different companies in the same industry.

Thank you for the opportunity to comment and contribute.

Sincerely,

Cherry Bekaert LLP

**Jeanette L. Ourada**
Vice President and
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August 15, 2016

Via email to comments@pcaobus.org

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

**Re: PCAOB Rulemaking Docket Matter No. 34 – Release No. 2016-003**

Chevron Corporation (Chevron) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB) update to the proposed auditing standards (the "Update") and related amendments to current standards addressing the auditor's reports on audited financial statements – Rulemaking Docket Matter No. 34: *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Position; And Related Amendments to PCAOB Standards.*

Chevron is one of the world's leading integrated energy companies. Through its subsidiaries that conduct business worldwide, the company is involved in virtually every facet of the energy industry. Chevron explores for, produces and transports crude oil and natural gas; refines, markets and distributes transportation fuels and lubricants; manufactures and sells petrochemicals and additives; generates power and produces geothermal energy; and develops and deploys technologies that enhance business value in every aspect of the company's operations.

We support the PCAOB's efforts to develop audit standards that enhance the usefulness of corporate reporting to the investor. As communicated in our comment letters of September 21, 2011 and December 12, 2013 regarding the two previous releases on this matter, we continue to strongly believe in the core principle that it is management's, not the auditor's, responsibility to provide investors with financial and other company-specific information. We believe that the Update requiring the audit report to include Critical Audit Matters (CAMs) does not support that core principle and would not provide value-added information to the investor. We do, however, appreciate the PCAOB removing the proposal to include the evaluation of other information such as the Management Discussion & Analysis and hope it is not required in the future since evaluation of strategies, forward looking statements, and risks and litigation, are difficult and time consuming to audit and would add substantial audit costs that would be borne by the shareholder.

## Critical Accounting Matters

We believe that the current requirements regarding the auditor's reporting of material items are functioning effectively. While we acknowledge the Board's efforts to narrow the scope of the Update based on feedback received on the earlier proposals, we do not believe the auditor's report should be expanded to include CAMs, when the opinion overall is unqualified for the following reasons.

The proposed structure for the CAMs would mean that the auditor's report would contain discussion on matters that were fully resolved through the established channels of internal control including internal and external audit, disclosure committee discussions, management certifications, and the Board Audit Committee. We do not believe that calling out key events and difficult judgments separately in the auditor's report would serve to clarify the technical and subjective matters to the investor.

We also believe the company-specific factors proposed to be communicated via the CAMs are already adequately covered in both the Management's Discussion and Analysis portion and in the Notes to the Consolidated Financial Statement section of annual report, including discussions of Critical Accounting Estimates and Assumptions, Summary of Significant Accounting Policies, New Accounting Standards, and in the Results of Operations. We do not believe that this proposed format will provide new or meaningful information to the investor. In addition, we believe that including CAMs in the auditor's report will contribute to disclosure overload and conflict with the expressed opinion by both the FASB and SEC for companies to produce annual reports with more concise and meaningful content.

We are also concerned that the additional processes to determine and fully document which of the matters should be included as a CAM and why each was, or was not, included in the auditor's report would require significant additional effort by the external audit staff, the company's management and the Board Audit Committee. The Update calls for even more documentation by requiring the auditor to describe, in detail, how the CAM was addressed in the audit as well as refer to relevant financial statement accounts and disclosures. This could not be accomplished within the window for filing without reducing the time available to assure the quality of preparing the core financial report and performing the external financial audit. We also expect these proposals would result in significant additional costs to the company's shareholders given the extra time and resources required to meet the requirements from both external audit and corporate staffs.

While we do not believe CAMs should be introduced in the auditor's report, we appreciate that the Update introduces materiality to the scope of CAMs. However, the present wording in the Update suggests CAMs related to material accounts or disclosures should be included in the auditor's report. Rather, we believe the intent of the Update is to only disclose material CAMs.

Regarding any possible implementation of the Update, we feel the effective date should be no sooner than two years after final approval by the SEC.

If you have any questions on the content of this letter, please contact Al Ziarnik, Assistant Comptroller, at (925) 842-5031.

Sincerely,

Jeanette Ourada

CIRO E. ADAMS, CPA, LLC
*Client service, first and foremost.*
56 Rockford Rd. | Wilmington, DE 19806-1004

August 15, 2016

James R. Doty, Chairman
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006

Re: **Comments to PCAOB Release No. 2016-003, *The Auditor's Report***

Dear Chairman Doty and Distinguished Board Members:

Our firm appreciates this opportunity to comment on the proposed auditing standard. Our comments speak to the overall standard and its objective of changing the auditor's report. Our comments:

**The new Auditor's Report**

We agree that the auditor's report should continue to exist as a pass/fail model. To offer varying degrees of an opinion would input unneeded and confusing contrasts into the report.

We urge such pass/fail model continue.

Our agreement with the Board for a new audit report may end there. The reproposal, similar to the original proposal, endeavors to change the principal purpose of the auditor report: to give an opinion of financial statements presented by management. Since the audit report was conceived, its existence has always been to confirm (or not confirm by qualifying the report) management's presentation of the numbers. Simply stated, are the items fairly presented, yes or no? [Pass or fail.]

The Board's initiative is to now change that quest to offer a separate report to management's presentation in hope that an adversarial vetting of issues and matters may bring more clarity to the investor and financial statement user. This approach offers contrary views which never provides clarity in any matter presented. The reader is only left with, who's right? Could be the auditor, but then again, the Company is always more of an expert of its business than the auditor.

Along with such unresolved conflicts the reader may face, who is responsible to reconcile the differences? Again, the financial statement user can only be left more confused. Such a reconciliation has always been implied by what is presented in the financial statements. Management has presented the financial information and the auditor has opined on the presentation.

We also note, financial reporting is distinctly different from the audit process. The mixing of such apples and oranges indicates the same objective. The two outcomes, financial statements and an audit opinion, are quite different.

We fundamentally disagree with the approach to change the principal purpose of the auditor's report.

We do agree that the clarity the financial statement user may be missing is an understanding of what information the auditor is responsible to oversee. Our report speaks only to the financial statements, however, we all read the entire filing, agreeing the numbers, as well as, analyzing and substantiating many amounts presented throughout the document. We are also responsible for understanding the client's business, reading material documents, such as loan documents and purchase agreements, critiquing the MD&A and other Items. All these parts of the filing are within our purview. Auditors also review 8-Ks, proxies, and other filings, but no mention is ever made.

We suggest that the auditor report be tailored to better define auditor responsibilities, so that the financial statement user knows he can rely on other parts of the filing in addition to the financial statements.

Lastly, the disclosure of all items that were disclosed to the audit committee. The PCAOB has for years moved to have qualified, well-functioning, audit committees to oversee the audit process. Now that the investor is reaping the fruits of the PCAOB's commendable push for good audit committees, why the change in course to discount the audit committee's mission and go directly to the shareholders and investors?

We say stay the course with the current approach to audit committees in allowing the audit committee to fulfill the role of representative of the investor. The PCAOB's work has been validated in this area.

In closing our general comments about the audit report itself, we note that the PCAOB made reference to the use of such audit reports as reproposed outside the United States. The PCAOB has resisted placing full reliance on the work of independent audit regulators in other countries, requiring the PCAOB to inspect such firms. The SEC has also resisted converging or changing to IFRS because the SEC considers current GAAP and auditing standards supreme. We are humored that the PCAOB now points to such audit reports outside the United States to support its position. The PCAOB has always been the leader in setting auditing standards. No reason for the Board to now look elsewhere.

**Critical Audit Matters**

We have read the Board's argument for the disclosure of critical audit matters (CAMs) in the auditor's report. We reiterate the same above comments to address the need for CAMs.

August 15, 2016

Two critical points: 1) Management runs the Company, so management will emphasize its course of action to lead the Company. The auditor has no authority, nor plays any role in corporate governance, in order to effect any outcome of any action taken by Company management. Absent such authority to change the course of the Company, the auditor's assertion of what is important and what is not important is arbitrary. The Company leadership will give significance to important items. 2) The Board is reproposing that the auditor identify in their report the challenging, subjective, or complex matters affecting auditor judgments, and how the auditor responded to those matters. What is important is the information presented to the shareholders and investors, not the process of assessing such information. So if the auditor does opine to the Company's assertions to the information presented, then the investor only needs to read the information. The awareness of audit procedures performed does not add value to the investor. And CAMs will not assist investors and analysts engaging management with targeted questions about Company information.

In addition, to now have the auditor state each and every challenging, subjective, or complex judgment serves no purpose when the reader is only looking for one number. For example, did the issuer meet the financial covenant or not? [Pass or fail?] Audit procedures can vary in complexity, but still be very important. For example, cash and debt confirmations are routine audit procedures, but just as critical as assessment of fair value calculations which can be challenging, subjective and complex. By stating such audit procedures implies to the reader the importance of those procedures, thus, routine procedures which may not be mentioned, may not be considered critical to the process. The reader making such an inference would be misled and not fully understand the process or financial information.

Lastly, the comparison of audit procedures between companies in the same industry may be done, but also lead to a wrong conclusion. For example, if there are six different companies in an industry being auditing and five firms use sampling techniques, but one firm uses big data, is the audit procedure of that firm now in question and thus the financial statements less reliable? Of course not! But such a conclusion can be drawn by comparing disclosed procedures. [If the objective of the PCAOB is to have standard audit procedures performed only one way of companies in a particular industry, then publish an audit standard. Having a financial statement reader compare procedures amongst firms may detract to their understanding of the financial statements.] No incremental increase in the quality of financial information is gained by the user of the financial statement. And the auditor's report will certainly not be easier to read.

We disagree with the Board that the presentation of CAMs adds value to the investor in reading the financial information.

In each financial statement, significant accounting policies are disclosed. In an annual filing, the issuer also discloses in its MD&A trends, ratios, comparables, non-GAAP indicators, critical accounting estimates, capital resources and liquidity, and other presentations. The reading of the MD&A provides much information for the investor. And the SEC has issued excellent interpretative guidance to write MD&As.

The auditor is responsible to review the MD&A and other Items in filings to assure the consistency with other financial information. The auditor's report can be expanded to include such responsibility.

Defining such responsibility in the audit report will assure the investor that such areas are also covered by the auditor. Consideration can also be given to an auditor's report in quarterly and other filings that such information was reviewed.

We reiterate that the responsibilities of the auditor should be better defined in the auditor report.

In lieu of CAMs, renumbering footnotes in order of critical matters may accomplish a similar objective. Since the investor has to read the footnotes to glean information, having the footnotes in order of critical disclosures versus balance sheet and income statement order may provide the significance in matters that the investor is seeking.

In closing, we are not moved by the term "investor asymmetry". Regulation FD provides rules and procedures for disclosing information which assures the public information to all stakeholders is in the same time frame. For this reason, no additional regulation is needed to meet a wrongly perceived circumstance.

**Additional Improvements**

*Clarifications of existing auditor responsibilities:*

Independence – we note the title to the audit report already contains the word "Independent". We agree that independence and objectivity are critical to the audit process. Without belaboring the point, could independence be given any more prominence than being included in the title to the report?

Auditor tenure – we note the PCAOB now requires the disclosure of audit partners. This disclosure may be more important than the firm's tenure. We agree that the change in auditor, as well as a first-year auditor, may face challenges already overcome by an auditor retained for years. We agree that this disclosure does serve the financial statement reader. The PCAOB should require such disclosure on the same form as the audit partner.

Addressee – we understand that at times, firm individual offices may not all be the same. We agree that specific addresses identifying the office which performed the work should be disclosed. Again, the PCAOB should require such disclosure on the same form as the audit partner.

Enhancements to basic elements – as stated in our above comments, we agree wholeheartedly that auditor responsibilities should be better defined in the report. We do concede that the profession has danced around the phrase, "whether due to error or fraud" for decades. We agree that such wording will more exactly define the auditor's responsibilities. We also urge, as above noted, that the auditor's report better define the auditor's responsibilities.

Standardized form of auditor's report – we close our comments smiling that the Board is suggesting the opinion paragraph now be first and all parts subtitled to add clarity to the audit report since the reproposal has added cumbersome and confusing additions to the report. The reader of a reproposed audit report can no longer navigate his way to understanding like he could with the previous three-paragraph report.

**Other Notes**

Our last comment - we believe that there should be some consideration or exemption for smaller reporting companies. The documentation required, as well as, the increase in audit fees may be burdensome to such companies. Although the PCAOB may not want to have small-company auditing standards and big-company auditing standards, this reproposed standard begs for such a consideration.

We urge that if the standard is implemented, smaller reporting companies be given relief from some of the documentation and disclosure requirements of this standard.

We wish to thank the Chairman and Board Members for this opportunity to comment on the reproposed standard. Although we have taken different positions than the Board on some of the standard's provisions, we trust through dialog and the vetting of the standard within the profession will yield an even better standard to implement.

Very truly yours,

Ciro E. Adams, CPA, LLC

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August 15, 2016

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

Re: PCAOB Release No. 2016-003; Rulemaking Docket Matter No. 034; *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and the Related Auditor's Report; and Related Amendments to PCAOB Standards*

Ladies and Gentlemen:

The Public Company Accounting Oversight Board (the "Board" or "PCAOB") has solicited public comment on the reproposed auditing standard and other matters discussed in PCAOB Release No. 2016-003 (the "Reproposal") dated May 11, 2016. We appreciate the opportunity to comment on the Reproposal and the important issues it raises.

## I. Introduction

We continue to welcome the Board's efforts to make the financial statements and the related auditor's report more relevant to investors. As we discussed in our prior comment letters in respect of PCAOB Release No. 2011-003, *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (June 21, 2011) (the "2011 Release")[1] and PCAOB Release No. 2013-005, *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (August 13, 2013) (the 2013

[1] Comment letter of Cleary Gottlieb Steen & Hamilton (Oct. 14, 2011) (the "2011 Comment Letter"), available at http://pcaobus.org/Rules/Rulemaking/Docket034/149_Cleary_Gottlieb.pdf.

Release")[2], our perspective on these matters is informed by our role as legal advisers who are intimately familiar with both the fundamentals and the nuances of the federal securities laws, including how they apply to financial and other disclosures, and who represent issuers and others in connection with a wide variety of matters. These matters include advising issuers on their reporting obligations (including financial disclosures); advising audit committees on their responsibilities and best practices; and advising issuers and underwriters in connection with a wide variety of capital markets transactions to which the federal securities laws apply. Financial reporting, including its reliability and relevance, is often a critical element of these matters.

In drafting the Reproposal, the Board attempted to contour the reproposed auditing standard to the concerns raised by various constituencies in comment letters related to the 2013 Release. However, the Reproposal does not adequately respond to two main concerns raised by us and others. First, under the Reproposal, the auditor can be required to provide original disclosure about an issuer, a concern we raised in our 2011 Comment Letter and reiterated in our 2013 Comment Letter. Second, the auditor will be required to report critical audit matters in a manner that raises a significant likelihood, which neither the Board nor the Commission should find acceptable, that communications will be chilled between the audit committee and management, on the one hand, and the auditor, on the other.

As we stated in our 2011 Comment Letter and our 2013 Comment Letter, we are and remain dedicated to full and fair disclosure under federal securities laws, particularly when that disclosure relates to financial reporting and transparency to investors and markets, including improvements in financial reporting that are fostered by the application of robust auditing standards. However, we believe fair disclosure, transparency and the interests of investors must be considered against the backdrop of legitimate issuer concerns, including the commercial sensitivity of disclosing certain matters. We also believe disclosure requirements regarding issuer information, and the consideration of interests they entail, should remain the province of the Securities and Exchange Commission (the "Commission") in its application of the federal securities laws.

While we commend the Board for undertaking to refine the 2013 Release to address concerns raised through the comment letter process, including concerns contained in our 2013 Comment Letter, and recognize there are improvements when comparing the Reproposal to the 2013 Release and 2011 Release, we believe the Reproposal inadequately addresses some key concerns. We describe our concerns in greater detail in Section II below.[3]

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[2] Comment letter of Cleary Gottlieb Steen & Hamilton (Dec. 23, 2013) (the "2013 Comment Letter"), available at https://pcaobus.org/Rulemaking/Docket034/231b_CGSH.pdf.

[3] We also reiterate several important principles noted in our 2013 Comment Letter and our 2011 Comment Letter that the Board should keep in mind as it continues to refine the Reproposal and when considering any changes to the auditor's report and the processes and interactions that may result from those changes. These principles include: i) original disclosure about an issuer should be the responsibility of, and come from, the issuer and not any third party, including the auditor; ii) there should be no adverse impact on the relationship or structure of interactions between management, the audit committee and the auditors as a result of any changes to the auditor's report or role; iii) the pass/fail model should not be undermined; and iv) a cost/benefit analysis should be undertaken rigorously, in which the costs of any change, including the adverse impact on the foregoing principles, must be justified by the benefit of significantly improving financial reporting that would result from any change to the auditor's report or role.

## II. The Reproposed Auditing Standard Raises Two Significant Concerns

The Board's auditing standard, as reproposed, continues to be highly problematic in two significant respects: it will require auditors to provide additional original information about the issuer, even if such information is commercially sensitive and not required to be disclosed by the federal securities laws or the Commission's rules and regulations thereunder; and it will chill communication between the audit committee and management, on the one hand, and the auditors, on the other. Failing to address these concerns in a more meaningful way than reflected in the Reproposal will impose a cost on the disclosure process that in our view outweighs any benefit provided by the additional information proposed to be required in the auditor's report.

### *A. The Reproposed Auditing Standard Provides an Obligation that Auditors Expand the Scope of Existing Disclosure Regarding Issuers in a Manner that Supersedes Management's Responsibility for Disclosure, Ignores Valid Concerns Surrounding Commercial Sensitivity and Sidesteps the Commission's Authority to Determine Disclosure Requirements.*

One of our most significant concerns, dating back to the 2011 Release and the 2013 Release, and continuing in the Reproposal, is that the Reproposal, if adopted as proposed, would require the auditor to disclose, and to be the source of, additional original information about an issuer. The intention of the Reproposal is to "respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's experience or mandate,"[4] and the PCAOB believes it has "not change[d] the auditor's current role of attesting to information prepared by management."[5] However, the requirement for auditors to be the authors of original disclosure of issuer information still exists in important, explicitly specified respects, where "such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit."[6] It is counter-factual to believe disclosure in those specified circumstances will be limited to a description of audit-related matters that will not involve substantial disclosures of original issuer information. This will change the role of the auditor from its role as attester to management disclosure, and introduces a role that will influence the direction and content of disclosure, even though the Reproposal requires fewer instances in which auditors will be obligated to disclose original information about an issuer compared to the 2013 Release.

Any change to the auditor reporting model should keep the responsibility for disclosure about an issuer where it belongs, with the issuer.[7] The Commission agrees that

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[4] Reproposal, p. 2.
[5] Reproposal, p. 5.
[6] Reproposal, p. 35.
[7] As we noted in the 2011 Comment Letter and the 2013 Comment Letter, the Treadway Commission's 1987 report squarely placed the primary responsibility for an issuer's financial statements on management, and made clear that independent public accountants play a secondary role. In addition, it is clear from the Reproposal that other commenters felt similarly uncomfortable with the concept of auditor authored-original disclosure about an issuer, as the Reproposal notes that "[generally] preparers, audit committee members and auditors were not supportive of adding company-specific information to the auditor's report" and felt that management should be the primary source of disclosure. See Reproposal, p. 6.

oversight of issuer disclosure is a Commission responsibility and not the province of the PCAOB. In discussing PCAOB Release No. 2013-009, *Improving Transparency Through Disclosure of Engagement Partner and Certain Other Participants in Audits* (Dec. 4, 2013), the Commission opposed disclosure of auditor information anywhere other than the auditor's report, stating that "requiring any disclosure by the audit committee would require [Commission] action because the PCAOB does not have authority over issuer disclosures."[8] While the Reproposal does not purport to require an auditor to author disclosure anywhere outside the auditor's report, it is clear, as discussed below, that the Reproposal would require auditors to provide information about an issuer that the issuer had not previously made public, and whether that is part of or outside the auditor's report seems irrelevant to whether the Commission rather than the PCAOB has the authority to require it.

The Commission is the more appropriate body to consider and weigh the costs and benefits of requiring sensitive disclosure about an issuer and to judge the circumstances under which disclosure that may be contrary to an issuer's self-interest is required nonetheless. In the recent Commission release, "*Business and Financial Disclosure Required by Regulation S-K*,"[9] the Commission describes the costs and benefits of requiring disclosure, weighing the interests of investors and issuers. The benefits of additional disclosure, such as reducing information asymmetries between management and investors that results in more efficient investments and voting decisions and increases integrity of the securities markets, must be weighed carefully against the costs to issuers, including the incremental costs of producing the additional information, subject to appropriate controls, and the competitive harm that can result from such disclosure. The PCAOB has in many respects responded to the concerns raised by different constituencies throughout the comment process, but the Reproposal does not adequately consider the costs to issuers and the potential resulting harm as a result of requiring disclosure that issuers do not control and is not otherwise required by the Commission. Although the Reproposal undertook efforts to mitigate the extent of original disclosure of issuer information by auditors, the Reproposal does not address the key issues of superseding management control over the company's disclosure and the Commission's primary role in overseeing disclosure regulation.

The Reproposal argues that improvements it makes from the 2013 Release limit the amount of original disclosure of issuer information an auditor may be required to disclose; however, they by no means ensure that the auditor's responsibility ends where management's responsibility begins. While the Reproposal states that "the auditor is not expected to provide information about the company that has not been made publicly available by the company,"[10] the Reproposal countermands that statement by continuing, as noted above, "unless such information is necessary to describe the principal considerations that led an auditor to determine a matter is a critical audit matter or how the matter was addressed in the audit."[11] To illustrate the possibility, the Reproposal provides, "[f]or example, in describing the principal considerations that led the auditor to determine that revenue recognition is a critical audit matter, it is possible that the auditor could provide more information than is provided in management's disclosures."[12] The

[8] SEC Release No. 33-9862, File No. S7-13-15 (July 1, 2015), p. 24.
[9] SEC Release No. 33-10064, File No. S7-06-16 (Apr. 13, 2016).
[10] Reproposal, p. 35.
[11] *Id*.
[12] *Id*.

Reproposal makes clear that the auditors are bound by this obligation, stating, "management's decision about whether to disclose additional information does not affect the auditor's responsibility to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit."[13] As a result, auditors are potentially required to disclose original information about the issuer related to two elements of the critical audit matter process. The PCAOB justifies its decision to retain this disclosure requirement by concluding that the benefits of providing additional disclosure to investors are always greater than the issuer's interest in preserving confidentiality. The Reproposal thus ignores the potential harm to an issuer that may result from this original disclosure of issuer information by failing to consider the differing levels of commercial sensitivity against the relative importance of the additional information to investors (a determination, as we point out above, for the Commission and not the PCAOB to make).

In instances where an auditor would be required to provide original disclosure of issuer information, the Reproposal suggests management would have the opportunity to choose to address such disclosure[14] by authoring separate disclosure that would, presumably, permit management control over the tone and presentation of the matter. Providing an opportunity for management to author disclosure does not solve the issue of the auditor driving disclosure in the absence of any federal securities law or Commission requirement that the issuer provide such disclosure. If the audit committee or management chooses to disclose the information, it is doing so to restore control over disclosure, not because the audit committee or management believes the disclosure is required under existing securities laws or Commission regulations or otherwise is important as a matter of investor relations. That is no "choice" at all.

One of the rebuttals to criticism regarding undermining the audit committee or management is that "the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for a company's disclosure of financial information," noting that "communicating critical audit matters is not a substitute for [disclosure]."[15] However, this argument fails to acknowledge that when auditors drive the decision-making regarding the threshold decision about what is appropriate disclosure for an issuer, the auditor necessarily diminishes the governance role of both the audit committee and management in this respect.

### *B. The Requirement to Disclose Critical Audit Matters, as Reproposed, Will Chill Auditor Communications with the Audit Committee and Management.*

As described in greater detail above, the proposed auditor reporting standard potentially requires the auditor to disclose original information about an issuer that management has affirmatively chosen not to disclose and is not otherwise required to be disclosed under the federal securities laws or Commission regulations. Any requirement that risks interfering with open and robust communications between audit committees and management, on the one hand, and auditors, on the other, undermines the relationship between issuers and auditors and, ultimately, the safeguards to investors provided by the important gatekeeping role played by the

[13] Reproposal, p. 36.
[14] Reproposal, p. 35.
[15] Reproposal, p. 35.

auditor. Maximizing the openness of communications between audit committees and management, on the one hand, and auditors, on the other, is far more likely to produce better financial reporting than the questionable benefits of additional disclosure provided by the Reproposal.

The Reproposal acknowledged the risk in the 2013 Release that communications between the auditors and the audit committee could be chilled. As a result, in an attempt to mitigate the risk, the Reproposal limits potential critical audit matter topics to those matters that are the subject of "auditor communication requirements under [Auditing Standard] 1301, other PCAOB rules and standards, applicable law… and communications made to the audit committee that were not required."[16] Thus, the Reproposal states that "any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee" and argues that, because Auditing Standard 1301 is so broad, "there should be few communications affected by that possibility."[17]

However, this effort at mitigating the risk of chilled communications ignores the reality that a willingness to engage in candid discussion can be affected by the realization that it could form the basis for a conclusion regarding a critical audit matter and disclosed accordingly. Put another way, the concern we have about chilling communication is *not* so much about how often the audit committee and the auditors will engage but what will be said when they do.

We would also note that chilled communication is by no means entirely a speculative risk. The Reproposal acknowledges that, in a study of audit committee behavior, study participants assuming the role of management chose to be less forthcoming with information when they were aware that auditors could use the information as the basis for a critical audit matter.[18]

## III. Suggested Improvements to the Reproposal.

Despite our concerns, we reiterate that we welcome the PCAOB's commitment to improving the usefulness of the auditor's report to investors and believe in improving transparency between issuers and investors in a balanced fashion that considers the interests of both constituencies. We agree with the PCAOB that there is a salutary purpose in requiring auditors to identify critical audit matters to arm investors and analysts with information needed to "engage management with targeted questions about critical audit matters,"[19] which the PCAOB believes may "also lead to an incremental increase in audit quality of information presented in financial statements and related disclosures."[20]

That result can be accomplished, however, without requiring auditors to explain why they identified those matters as critical audit matters or how they addressed them in the audit. Limiting the incremental requirement to identifying critical audit matters will meaningfully address our two principal concerns – leaving disclosure judgments about issuer

[16] Reproposal, p. 18.
[17] Reproposal, p. 19.
[18] Reproposal, p. 87.
[19] Reproposal, p. 2.
[20] Reproposal, p. 3.

information to management and audit committees, consistent of course with Commission disclosure requirements, and preserving open communication between them and the auditors. Equally important, it will serve not only to highlight issues for investors and analysts to explore with management, but will also serve as an effective check by the auditors on management's response to the Commission's requirement that companies disclose in the management disclosure and analysis section of annual and quarterly reports critical accounting estimates and assumptions that "may be material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change, and that have a material impact on financial condition or operating performance,"[21] a standard that, in many ways, is similar to the standard for critical audit matter disclosure under the Reproposal.

In formulating our proposal, we considered eliminating the requirement to describe why auditors identified matters as critical audit matters but not how they addressed them in the audit. Although the risks of forcing disclosure not required by the Commission – for example, whether a matter was deemed a critical audit matter because of the control environment (short of a material weakness) or the uncertainty over a litigation matter not ultimately deemed to require disclosure under Regulation S-K 103 or ASC 450 – and the chilling of communication are more clearly present in the "why" requirement than the "how" requirement, we ultimately concluded that the latter should be dropped as well for a number of reasons. First, we expect this description of audit procedures to become boilerplate both to limit auditor liability and to reduce audit costs and management time in discussing the description with the auditors. Second, while the two principal concerns we have expressed regarding the Reproposal are more clearly eliminated or mitigated by striking the "why" requirement, there would remain uncertainty regarding the content of the description of audit procedures to address critical audit matters that may lead to unwanted disclosure and the concomitant chill on communication we fear. Finally, we believe the judgment regarding whether the incremental disclosures of audit steps to address critical audit matters provide sufficiently useful information for investors so as to outweigh the costs to issuers of forcing disclosure of issuer information not otherwise required by the Commission or the federal securities laws is, as we have noted, one for the Commission and not the PCAOB to make. Should the PCAOB continue to conclude that the disclosure of how auditors address critical audit matters is warranted, we urge the PCAOB to permit that requirement to be limited insofar as it would otherwise require disclosure of issuer information that has not been made publicly available by the issuer.

By implementing our proposed version of critical audit matter disclosure, the PCAOB can achieve the objective of reducing asymmetries in information between management, on the one hand, and analysts and investors, on the other, while deferring to the Commission's role as overseer of issuer disclosure and maintaining open and robust communication between the audit committee and management, on the one hand, and the auditors, on the other.

[21] SEC Release No. 33-8350 (Dec. 29, 2003).

***IV. Critical Audit Matter Disclosure and the Pass/Fail Nature of the Current Auditor's Report.***

Much has been said in the course of this standard-setting process about "undermining" the pass/fail nature of the current auditor's report and whether and how such undermining can be avoided. In fact, the negative implications of the reproposed new critical audit matters disclosure will necessarily and unavoidably weaken, or undermine, the standalone pass/fail nature of the current auditor's report. Indeed, we venture to say that, while in the Reproposal the Board has gone to considerable lengths to seek to ensure that the critical audit matter communications do not affect the standalone opinion on the financial statements taken as a whole, both the Board and the proponents of critical audit matters disclosure are willingly trading away the apparent certainty of the standalone existing formulation for the elaboration of the critical audit matter disclosure, with the expectation or at least hope that the elaboration of the critical audit matter disclosure will, when taken together with the pass-fail opinion, provide a more useful aggregate communication. We are also prepared to be hopeful, but we believe there is some risk that once the new reports begin to appear, the focus will be on superficial distinctions (five critical audit matters vs. three; four additional audit steps rather than two) that are not necessarily meaningful differences. We believe our suggestions above will have the salutary effect of focusing attention on what the critical audit matters are and possibly (if constrained as we have proposed) how they are addressed and therefore will lead to more focused and useful reports.

*     *     *     *     *

We thank you for the opportunity to submit this comment letter. Please do not hesitate to contact Leslie N. Silverman, Nicolas Grabar or Sandra L. Flow (212-225-2000) if you would like to discuss these matters further.

Very truly yours,

CLEARY GOTTLIEB STEEN & HAMILTON LLP

cc: <u>Public Company Accounting Oversight Board</u>
Hon. James R. Doty, Chairman
Hon. Lewis H. Ferguson, Member
Hon. Jeanette M. Franzel, Member
Hon. Jay D. Hanson, Member
Hon. Steven B. Harris, Member
<u>Securities and Exchange Commission</u>
Hon. Mary Jo White, Chair
Hon. Kara M. Stein, Commissioner
Hon. Michael S. Piwowar, Commissioner
Hon. Keith F. Higgins, Director, Division of Corporation Finance

CME Group

August 11, 2016

**TO:** Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

**RE:** PCAOB Rulemaking Docket Matter No. 034

***PCAOB Release No. 2016-03 "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion"***

We appreciate the opportunity to comment on PCAOB Release No. 2016-003 "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion" (the Proposal), issued by the Public Company Accounting Oversight Board (the PCAOB). We support the PCAOB's objective of addressing the asymmetry between information communicated by auditors to the audit committee as compared to the information communicated by auditors to investors.

Overall, we believe the Proposal would reduce the information asymmetry between investors and management. However, we recommend that the PCAOB consider certain modifications to the Proposal in order to mitigate the impact of unintended consequences and uncertainty in application associated with the scope of those items identified as critical audit matters, as discussed in the Appendix to this letter.

While we support the Proposal, we believe the PCAOB should continue to refine the definition of what it means to be deemed a critical audit matter. As the Proposal is currently written, auditors are being placed in the position to resolve the information gap between investors and management through more expansive disclosures within the audit report. We believe that these disclosures would have the following consequences:

- Draw undue attention to matters that are not material and potentially be a disservice to outside users of financial statements;
- Possibly lead to increased meritless litigation exposure;
- Place the auditor in the position of being the source of the disclosure; and
- Applied in an inconsistent manner.

Our position, however, is that management's financial statements and accompanying disclosures are the primary tool by which to effectively resolve information asymmetry, thereby keeping the onus on management for determining the sufficiency of disclosures to investors.

We would be happy to share our thoughts on possible next steps with the PCAOB staff. The Appendix to this letter contains our thoughts relative to certain aspects of the Proposal.

We would be pleased to discuss our comments with the PCAOB or its staff at your convenience.

Very truly yours,

John Pietrowicz
*Chief Financial Officer*

Jack Tobin
*Chief Accounting Officer*

## Appendix

The re-proposed standard would include the following significant changes to the existing auditor's report:

- *Critical audit matters (CAM)*—would require communication in the auditor's report of any critical audit matters arising from the audit of the current period's financial statements.

- *Definition of a critical audit matter*—any matter that was communicated or required to be communicated to the audit committee and that:

  - Relates to accounts or disclosures that are material to the financial statements, and

  - Involved especially challenging, subjective, or complex auditor judgment.

We believe that the scope of the revised CAM definition is still expansive and would more effectively accomplish the disclosure objective if it were more narrowly defined. Currently, CAMs must relate to an account or disclosure that is "material" to the financial statements. However, the proposed definition does not require the communication itself to involve a material issue. This can result in the disclosure of immaterial items in the audit report, thereby cluttering the audit report with items that do not have a significant impact to the readers of the financial statements. Disclosing immaterial items in the audit report could confuse and mislead readers to make investor decisions based on such information. Consider the following example:

- A material account on the balance sheet of a bank is Loan Receivables. In connection with the year-end audit, the audit team discovers that there was a change in the method used by management to value the Loan Receivables. The audit team determined that this change in approach was not unreasonable and did not result in a significant change to the valuation. This matter was communicated to the audit committee and is required under the Proposal to be included in the audit report.

We believe that, in this example, disclosure of the change in valuation approach draws undue attention to a matter that is not material to the overall financial statements. Further, additional disclosure within the audit report would cause the audit report to expand beyond just one concise page to multiple pages. This could be counterproductive to readers as they sift through potentially voluminous disclosures. This level of detail within the audit report shifts the auditor responsibility from providing a pass/fail rating on management's financial statements to effectively providing a grade on the financial statements on a relative basis. This grading system, as it is more complex than pass/fail, is less useful and could be a disservice to outside users of financial statements.

Also, inclusion of CAMs in public disclosures will possibly lead to increase meritless litigation exposure. Plaintiffs could use CAMs to allege error or wrongdoing. The identification of specific matters raised to the audit committee may be misconstrued by plaintiffs as acts of negligence or carelessness on the part of the company. Also, as litigation costs are one of the drivers of audit fees, audit fees are expected to increase due to the litigation exposure of audit firms as a result of the expanded disclosure requirements under the Proposal. We expect that, based on CAMs in the audit report, plaintiffs will seek to hold an audit firm liable for certain issues of the company, thereby increasing litigation costs.

We also believe that the Proposal has the potential to place the auditor in the position of being the source of the disclosure, rather than management, which has not previously been the intent of the audit report. The purpose of the audit report is to opine on the completeness and accuracy of the financial information as prepared by management. The financial statements and accompanying disclosures are management's responsibility. The onus is on management to prepare financial statements and disclosures that are not misleading to investors. The role of the auditor, on the other hand, is to opine on management's assertions. However, under the Proposal, the role of the auditor expands to become an actual source of disclosure. The auditor is not merely attesting to the sufficiency of management's financial information, but is also a mechanism for disclosure. The consequence of having the auditor bear responsibility to disclose CAMs is that such disclosure by the auditor would compel management to also disclose the item, which would not have been otherwise disclosed if it were not for the CAM requirement in the audit report. This reactionary circumstance undermines the spirit of our financial reporting model by compelling management to disclose items of an immaterial nature in the financial statements, which could be misleading to readers.

If a CAM is identified by the auditor and not disclosed by management, then readers of the financial statements might conclude that the CAM is a "finding" by the audit team. As a result, the Proposal will drive expanded disclosure both in the audit report and in management's financial statements thereby, diminishing the governance role of the audit committee as well as management's responsibility for the company's disclosure of financial information.

Our final point regarding the unintended consequences of the Proposal centers on the uncertainty in application of the requirements. Audit teams might limit their communications with the audit committee since CAMs include matters that have been voluntarily reported to the audit committee. At the risk of disclosing immaterial items in the audit report, auditors may become hesitant to raise matters to the audit committee, as it would then trigger potential CAM reporting. Alternatively, given the subjectivity in the proposed requirements, auditors may choose to over-disclose the existence of CAMs to avoid the consequences of being second-guessed regarding whether a CAM should have been disclosed.

In closing, while we agree that information asymmetry must be addressed, we believe that the current requirements under the Proposal would more effectively accomplish this objective if the scope of CAM were narrowed.

**_Glenn P. Barba_**
*Vice President, Controller*
*and Chief Accounting Officer*

August 5, 2016

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

RE: PCAOB Rulemaking Docket Matter No. 034

We appreciate the opportunity to comment on Public Company Accounting Oversight Board (PCAOB) Release No. 2016-003, *Proposed Auditing Standards – The Auditor's Report On an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; and Related Amendments to PCAOB Standards* (the "reproposed standard"). This letter contains the comments of both CMS Energy Corporation and Consumers Energy Company.

CMS Energy Corporation, whose common stock is traded on the New York Stock Exchange, is a domestic energy company engaged in electric and natural gas utility services and independent power production, operating through subsidiaries in the U.S., primarily in Michigan. CMS Energy Corporation's consolidated assets are over $20 billion and annual operating revenues are over $6 billion. Consumers Energy Company, the principal subsidiary of CMS Energy Corporation, provides electricity and/or natural gas to more than 6 million of Michigan's 10 million residents and serves customers in all 68 counties of Michigan's Lower Peninsula.

We recognize that some investors and academics have suggested that the auditor's report would be more useful and relevant if it contained more information. However, we do not believe that auditor reporting of critical audit matters will achieve the PCAOB's stated objective of increasing the informational value of the auditor's report. Rather, we believe that auditor reporting of critical audit matters could:

- decrease comparability among audit reports
- misdirect investors
- confuse investors
- create doubts about the auditor's unqualified opinion as well as the company's financial statements

*Decreased Comparability:* The reproposed standard would require the auditor to communicate in the auditor's report "critical audit matters," which the proposal defines as:

> *"Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment."*

We continue to believe that determining which audit matters are "critical audit matters" would result in markedly decreased comparability among audit reports. Different auditors could reach significantly different conclusions about which audit matters are critical as well as how many such matters to communicate in the auditor's report. In many cases, whether an audit matter is considered critical will depend not on the quality or reasonableness of the company's accounting policies and practices, but rather on the level of expertise and experience of the auditor. Differences in the judgment and communication style of auditors as well as in the number of critical audit matters and depth of discussion provided might lead investors to perceive differences in investment risk where they do not exist.

*Investor Misdirection:* Our second concern with the proposal is that it could cause investors to give undue emphasis to the critical audit matters, using them as a "roadmap" to the financial statements and thereby undermining other parts of the financial statements. The rules established by the Financial Accounting Standards Board (FASB) and the Securities and Exchange Commission (SEC) are meant to provide the appropriate level of information to allow investors and financial statement users to make investment decisions. The same rules are designed to minimize information asymmetry between investors and management. Under existing rules, it is expected that management's disclosures will clearly inform investors about which areas are complex and subjective, and thus might present investment risk. Additionally, the FASB and SEC both have initiatives underway to examine the effectiveness of and framework for disclosures in an effort to improve the usefulness of the financial statements and help eliminate "disclosure overload." It should not be the intention of the PCAOB to institute a "roadmap" to guide investors to areas that might pose investment risk; rather, guidance should be provided by the standard setters to ensure that companies direct investors' attention to areas of investment risk, not audit risk.

*Investor Confusion:* Our third concern with the proposal is that it could lead to duplicative discussion of certain topics, once by company management and again by the auditor. For example, accounting estimates and assumptions that may be material due to the level of subjectivity and judgment required to account for highly uncertain matters must be discussed in the "Critical Accounting Estimates" section of Management's Discussion & Analysis. As we stated in our comment letters on the Concept Release and the 2013 Proposed Standard, we believe that commentary on a company's financial statements should come from a single source, rather than from both management and the auditor. Providing two perspectives on a single set of financial statements has the potential to confuse users and to reduce confidence in reported information. Furthermore, we believe that management is the best source of commentary on a company's business and financial statements. Though an auditor's understanding of a company's financial statements is more extensive than that of other third parties, it is still less complete than that of management. The degree to which the auditor must gain an understanding of the company's business, industry, transactions, and financial statements in order to render an audit opinion is substantially less than the depth of understanding required of the company's management. Correspondingly, the time the auditor devotes to gaining an understanding of these matters is a small fraction of the time invested by management. For these reasons, we believe that in order to provide users with clear and reliable information, management should be the sole source of commentary on a company's business and financial statements.

*Creation of Doubts:* Our final concern with the proposal is that investors could perceive the auditor's discussion of critical audit matters as "qualifying an unqualified opinion." While we understand that the PCAOB does not intend that the auditor's communication of critical audit matters be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's opinion on the financial statements, investors might nevertheless perceive the communication in such a manner. We noted that the *Illustrative Examples of Critical Audit Matters* included extensive discussion of why the auditor deemed the audit matter to be a critical audit matter as well as the additional audit procedures the auditor performed as a result. Following this extensive discussion, however, there was no clear statement of the auditor's final conclusion on the critical audit matter. The reader might be left with the basic question: Did the auditor become comfortable with the critical audit matter? We realize that, by virtue of providing an overall unqualified opinion, the auditor has reached satisfactory conclusions regarding all the critical audit matters communicated. We believe, however, that the context of the discussion could cause an investor to infer that the auditor has reservations about a particular matter or, in other words, that the auditor is, in essence, qualifying its unqualified opinion. Differences in the type or extent of audit procedures disclosed by the auditor could add additional uncertainty as to whether appropriate audit procedures were performed during the audit. For an investor, this could cast doubt over the auditor's unqualified opinion as well as over a company's financial statements.

In conclusion, we believe that the proposal to require auditor reporting of critical audit matters would not achieve the PCAOB's stated objective of increasing the informational value of the auditor's report, but would in fact have the opposite effect.

Thank you for the opportunity to comment on the Proposed Standards.

Sincerely,

Glenn P. Barba

Glenn P. Barba
Vice President, Controller and Chief Accounting Officer
CMS Energy Corporation and Consumers Energy Company

COLORADO PERA®

August 12, 2016

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

RE: PCAOB Rulemaking Docket Matter No. 034: *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion (PCAOB Release No. 2016-003)*

Dear Madam Secretary:

We are submitting the following comments for the PCAOB's consideration in response to a request for comments on the proposed Auditor's Reporting Model (PCAOB Release No. 2016-003). These comments represent our perspective as institutional investors for a large public pension plan representing more than 500,000 current and retired members and over $45 billion in assets.

We believe the PCAOB's latest proposal on the Auditor's Reporting Model provides a good first step in increasing investor's transparency into the auditing process, while not overburdening corporations. We appreciate the opportunity for real communication between investors and auditors, even if it is a one way dialogue. We see the introduction of a modern auditor report as an opportunity to increase reciprocal dialogue between investors and management on accounting and auditing issues. This in turn, should provide auditors and audit committees more insight into investors' desired level of audit scrutiny. We look forward to increased insight into the audit process, giving us the ability to better evaluate the performance of auditors, management, and audit committees.

From our experience working alongside many buy-side and sell-side investors, there remains an expectation gap between how investors believe audits are conducted relative to what is actually being performed by auditors. The addition of "critical audit matters" to the auditor's report will be helpful in educating investors on the audit process. That said, we encourage the PCAOB to consider taking additional steps to help educate investors on the audit process and help investors understand the standards via a more user friendly format.

Below are a few potential projects that might be helpful to close the expectation gap:

- Create a framework for finance professors to help emerging financial professionals understand the role and responsibility of auditors
- Work with investor professional organizations to incorporate auditing topics into their educational programs/efforts
- Start a PCAOB education portal with video lessons on the audit process and overviews of auditing issues presented in a user friendly manner

While we are supportive of the changes and expansion of the Auditor's Reporting Model, we have reservations on the materiality standard set on the financial statements as a whole. As a user of financial statements, and the ultimate payor of auditing costs, we believe the value of increased transparency associated with a lower materiality threshold greatly outweighs the cost. In addition, materiality is an opaque topic for investors, and investors could benefit from a requirement for auditors to discuss their definition of materiality within the auditor's report.

We appreciate the PCAOB giving us the opportunity to comment on potential changes to the Auditor's Reporting Model, and would welcome additional opportunities to provide input to the PCAOB as this process continues.

Sincerely,

Jennifer Paquette
Chief Investment Officer
Colorado PERA

Amy C. McGarrity
Deputy Chief Investment Officer
Colorado PERA

Glenda M. Schwarz
Vice President and Controller

ConocoPhillips Company
2028 McLean
600 North Dairy Ashford
Houston, TX 77079-1175
phone 281.293.5293
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ConocoPhillips

July 12, 2016

Mr. James R. Doty, Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Sent by email to comments@pcaobus.org

**Re: PCAOB Release No. 2016-003, Rulemaking Docket Matter No. 034: Proposed Auditing Standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and Related Amendments to PCAOB Standards.**

Dear Mr. Doty,

ConocoPhillips appreciates the opportunity to comment on the Public Company Accounting Oversight Board (PCAOB) Release No. 2016-003 (2016 Release), which includes the Proposed Auditing Standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and Related Amendments to PCAOB Standards (the 2016 Re-Proposed Standard), a standard originally proposed by the PCAOB in August 2013 (2013 Proposed Standard). ConocoPhillips is the world's largest independent exploration and production company, based on proved reserves and production of liquids and natural gas. Headquartered in Houston, Texas, we had operations and activities in 21 countries, approximately 15,600 employees worldwide and total assets of $100 billion as of March 31, 2016.

We acknowledge the PCAOB's objective to improve the relevance and usefulness of the auditor's report without imposing requirements beyond the auditor's expertise or mandate. We agree with the 2016 Re-Proposed Standard's provisions to retain the pass/fail model of the existing auditor's report. Further, we are supportive of certain proposed enhancements to the auditor's report that may help achieve the PCAOB's objective, including 1) a statement regarding auditor independence, 2) expressly permitting additional report addressees, 3) enhancements to basic elements of the report, such as adding the phrase "whether due to error or fraud," and 4) standardizing the form of the report.

However, we are concerned by the provisions in the 2016 Re-Proposed Standard regarding 1) critical audit matters (CAMs) as determined by the auditor and 2) disclosure of audit firm tenure in the auditor's report. We expressed similar concerns in our letter dated December 10, 2013 regarding the 2013 Proposed Standard (2013 Comment Letter).

We continue to believe the CAM provision would improperly shift the responsibilities of management and the audit committee to the auditor, inappropriately expanding the auditor's role and straining the relationship between the auditor, management and the audit committee. Further, the additional disclosures required by the CAM provision would likely result in an onerous, lengthy auditor's report that duplicates or conflicts with existing management disclosure and confuses financial statement users, already overwhelmed by disclosure. At best, investors will have to dig through a lengthy auditor's report to distinguish the useful information, which may be hiding in plain sight. At worst, investors may conclude there is a problem with the audit in spite of an unqualified opinion. Accordingly, this provision does not increase the usefulness of the auditor's report, and it imposes requirements beyond the auditor's mandate. Consequently, it does not achieve the PCAOB's stated objective.

While we believe CAMs are characteristically inappropriate, if the PCAOB includes a CAM provision, CAMs should be selected from the critical accounting estimates as disclosed in comprehensive detail by management, rather than from matters the auditor communicates or is required to communicate to the audit committee. This approach is consistent with the intrinsic similarities between CAMs and critical accounting estimates. It also more effectively accomplishes the PCAOB's stated objective since it eliminates both the potential for the auditor to become an initial source of disclosure about a company and the potential for duplicative, overlapping or conflicting disclosure between the auditor and management.

Regarding auditor tenure, the PCAOB concedes in the 2016 Release it is possible that investors may draw incorrect inferences between auditor tenure and audit quality that could have an adverse impact on cost of capital and could lead to inefficient conversations that are a poor use of investor, management and audit committee time. We agree with this, and accordingly, we believe required disclosure is not necessary. However, if the final conclusion is it should be disclosed, this additional information should be provided by management or the audit committee in the proxy statement rather than by the auditor in the audit opinion.

The following discussion presents our views regarding the significant elements of the 2016 Proposed Standard in greater detail.

**Critical Audit Matters**

The 2016 Re-Proposed Standard includes a revised CAM definition which narrows the scope of potential CAMs to those matters involving especially challenging, subjective or complex auditor judgment that are both communicated or required to be communicated to the audit committee and related to material accounts or disclosures. While this is a slight improvement from the 2013 Proposed Standard, CAMs as determined by the auditor are conceptually inconsistent with the existing regulatory framework in the U.S., which clearly articulates the financial statements and related disclosures are the responsibility of management. Consistent with this framework, management should be the source of disclosure regarding all matters of challenging, subjective or complex judgment. The auditor's responsibility currently is, and should continue to be, limited to expression of a pass/fail opinion.

*Previous Concerns Not Adequately Addressed by the PCAOB*

Our 2013 Comment Letter presented three significant concerns regarding CAMs:

1. Communication of CAMs by the auditor would undermine the role of management as the primary source of disclosure.
2. Communication of CAMs would result in disclosure of duplicative, conflicting and confidential or competitively sensitive information.
3. Consequently, the CAM provision would lead to investor confusion and would strain the relationship between the auditor, management and the audit committee.

These concerns were similar to those raised by several preparers and other interested parties. While we appreciate the PCAOB's attempt to address these concerns in its additional considerations related to the CAM communication requirement, we do not believe they have been adequately mitigated.

Regarding our first above concern, the PCAOB states on page 35 of the 2016 Release, "Since the auditor would be communicating information regarding the audit rather than information directly about the company and its financial statements, the communication of critical audit matters should not diminish the governance role of the audit committee and management's responsibility for the company's disclosure of financial information."

The PCAOB's conclusion appears to be predicated upon an assumption that information regarding the audit is separate from information about the company and its financial statements to which the audit directly relates. Management is responsible for disclosure of the company's financial information, as well as the challenging, subjective or complex judgments incorporated into the assumptions and estimates upon which the financial information is based. An auditor makes especially challenging, subjective or complex judgments only as necessary to opine on the same judgments already made by management. In this context, we disagree with the PCAOB's unfounded presumption that the communication of information regarding an audit is separate from the communication of information about the company and its financial statements.

Regarding our second above concern, the 2016 Re-Proposed Standard revises the definition of a CAM to include a materiality component, and adds an explanatory note to address concerns about the auditor potentially becoming the source of original information. The explanatory note stipulates the auditor is not expected to provide information about the company that has not been made publicly available, unless such information is necessary to describe the principal considerations that led the auditor to determine a matter is a critical audit matter or how the matter was addressed in the audit. However, the scope of potential CAMs as currently defined – selected from a population of all matters communicated or required to be communicated to the audit committee – inherently permits the auditor to provide information about a company that has not been made publicly available, thereby expanding the auditor's authority beyond its mandate. Additionally, we expect auditors, conscious of potential liability, will err on the side of onerous disclosure resulting in duplicative, conflicting, and confusing information that does not add value.

Our third above concern follows logically from the first two. The amplified capability assumed by the auditor oversteps into the existing disclosure responsibilities of management and oversight responsibilities of the audit committee, which we expect will result in unproductive confrontation that ineffectively strains the relationships among these parties. Further, the additional drawn-out information included in the auditor's report may lead investors to conclude there was a problem with the audit in spite of an unqualified audit opinion, particularly if the auditor goes to great lengths to explain the audit approach to CAMs. Increasing the length of the auditor's report with overlapping and conflicting information will not achieve the PCAOB's stated objective to improve the usefulness of the auditor's report, and it also runs counter to the objective of the SEC's current disclosure effectiveness initiative to lessen disclosure overload and improve disclosure for the benefit of both companies and investors.

*Proposed Alternative – Select CAMs from Management's Critical Accounting Estimates*

We strongly oppose the 2016 Re-Proposed Standard's CAM provision. If the PCAOB retains a CAM provision, the scope should be further narrowed so CAMs are selected from the critical accounting estimates management discloses, rather than from matters the auditor communicates or is required to communicate to the audit committee. The PCAOB's CAM definition aligns closely with the SEC's existing critical accounting estimates definition, which requires management to disclose estimates or assumptions when 1) the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and 2) the impact of the estimates and assumptions on financial condition or operating performance is material. Under our approach, the auditor would not be required to identify every critical accounting estimate as a CAM, but only those involving especially challenging, subjective or complex auditor judgment.

With respect to auditor communication of CAMs in our proposed approach, the auditor could state "there are none except those disclosed by management," referring to management's critical accounting estimates rather than providing a long list of duplicative information. The auditor could then describe how each CAM was addressed in the audit. Certain judgmental matters for which classification as critical accounting estimates is unclear or borderline will require additional deliberation. Under our proposed approach, the auditor would still have the opportunity for robust dialogue and healthy debate with management and the audit committee regarding the final classification of these matters, as well as the determination of other critical accounting estimates from which critical audit matters would be selected.

Our proposed approach is more consistent with the existing U.S. regulatory framework, respecting management's role as the primary source of disclosure. It would also limit disclosure of duplicative, conflicting and confidential or competitively sensitive information, thus alleviating the potential for misunderstanding among investors and other financial statement users.

**Auditor Tenure**

The PCAOB explored required disclosure of audit firm tenure in the auditor's report in its 2013 Proposed Standard, and the SEC explored similar required disclosure in the proxy statement in its 2015 Concept Release – *Possible Revisions to Audit Committee Disclosures*. We have already presented our views regarding auditor tenure in our 2013 Comment Letter to the PCAOB, as well as in our comment letter dated September 8, 2015 regarding the SEC's 2015 Concept Release.

We reiterate our views here, namely that we are aware of only a limited number of empirical studies regarding the correlation between audit firm tenure and audit quality, and the evidence regarding a positive or negative correlation is inconclusive. We note the PCAOB also continues to admit both commenters and academic research are divided on the relationship of auditor tenure and audit quality. The PCAOB acknowledges on page 91 of the 2016 Release, "it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital and could also result in conversations that are an inefficient use of management and audit committee time." Accordingly, we do not believe required disclosure of audit firm tenure is necessary, and it may be misleading if not put in the proper context.

If the final conclusion is audit firm tenure should be disclosed, we believe this additional information should be provided by management or the audit committee in the proxy statement section discussing engagement of the audit firm, rather than by the auditor in the audit opinion. This approach would allow management or the audit committee to provide context so readers do not draw an inappropriate conclusion regarding a link between audit quality and audit firm tenure. Limiting this disclosure to a basic element in the auditor's report stating the year the auditor began consecutively serving the company, as the PCAOB has proposed, would lack this necessary perspective.

In the 2016 Release, the PCAOB notes a growing trend toward voluntary disclosure of auditor tenure to support its view that required disclosure is necessary. From our perspective, this voluntary disclosure appears to be occurring in response to the views of each registrant's investor group, which adds further evidence that a regulatory requirement is in fact not necessary. If investors find this information to be useful, they can and do communicate their concerns to senior management and the board of directors. We do not see a need for the PCAOB to propose rule-making for a problem for which various alternative remedies already exist.

**International Regulations**

Throughout the 2016 Release, the PCAOB highlights changes to the form and content of auditor's reports from other global standard setting agencies including the International Auditing and Assurance Standards Board (IAASB), the European Union (EU), and the Financial Reporting Council in the United Kingdom (FRC). On page 8 of the 2016 Release, the PCAOB claims that it considers the efforts taken in these other jurisdictions and their relevance to its own standard setting project, while at the same time recognizing the regulatory environments in other jurisdictions are different from the U.S.

We are disappointed in the lack of robust dialogue regarding specifically how the PCAOB considered the relevance of the standard setting efforts in other jurisdictions and how it incorporated the differences in the U.S. regulatory environment when drafting the 2016 Re-Proposed Standard. The result is a series of discussions throughout the 2016 Release of the ways in which the 2016 Re-Proposed Standard is analogous to standards from the IAASB, EU, and FRC, as if these similarities justify the provisions set forth in the 2016 Re-Proposed Standard. No conclusions can yet be drawn regarding whether the other jurisdictional changes have achieved the desired objectives, and at what cost or consequence.

**Summary and Conclusion**

We recognize the PCAOB's objective to improve the relevance and usefulness of the auditor's report without imposing requirements beyond the auditor's expertise or mandate. We believe the provisions regarding CAMs and auditor tenure do not achieve this objective.

While we decisively oppose CAMs, if the PCAOB retains a CAM provision, we believe CAMs should be selected from critical accounting estimates disclosed by management, rather than from matters the auditor communicates or is required to communicate to the audit committee. Further, while we believe required disclosure of auditor tenure is not necessary, if the final conclusion is it should be disclosed, this additional information should be provided by management or the audit committee in the proxy statement rather than by the auditor in the audit opinion.

We agree with the 2016 Re-Proposed Standard's provisions to retain the pass/fail model of the existing auditor's report. Further, we are supportive of certain proposed enhancements to the auditor's report that may help achieve the PCAOB's objective, including 1) a statement regarding auditor independence, 2) expressly permitting additional addressees, 3) enhancements to basic elements of the report, such as adding the phrase "whether due to error or fraud," and 4) standardizing the form of the report.

Thank you for the opportunity to offer our comments on the 2016 Re-Proposed Standard. We hope you find our comments helpful.

Sincerely,

Glenda M. Schwarz

Glenda M. Schwarz
Vice President and Controller
ConocoPhillips

ConocoPhillips

**John V. Faraci**
Chair, ConocoPhillips Audit &
Finance Committee

ConocoPhillips Company
600 North Dairy Ashford
Houston, TX 77079-1175

July 12, 2016

Mr. James R. Doty, Chairman
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Sent by email to comments@pcaobus.org

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

Dear Mr. Doty,

The Audit and Finance Committee of ConocoPhillips (Committee) appreciates the opportunity to comment on the Rulemaking Docket Matter No. 034 as discussed in PCAOB Release No. 2016-003 dated May 11, 2016 (2016 Proposed Standard). Our Committee is comprised of four distinguished members – Charles E. Bunch, James E. Copeland, Jr., Arjun N. Murti and myself. As a team, we have a unique depth of experience regarding business and financial reporting matters, including executive leadership roles and directorships at large, international companies in various industries. Our Committee plays a vital role in investor protection through oversight of ConocoPhillips' financial reporting function, as well as its internal and external audit processes. Accordingly, the 2016 Proposed Standard is of the utmost importance to us.

We recognize the PCAOB's efforts to increase the informational value of the auditor's report in order to promote its relevance and usefulness without imposing requirements beyond the auditor's expertise or mandate. To the extent that standardizing the form of the auditor's report, enhancing certain basic elements of the report, adding a statement regarding auditor independence, and permitting additional report addressees uphold this objective, we are supportive. We also agree with the PCAOB's decision to preserve the existing pass/fail auditor reporting model.

However, we have significant reservations regarding the provisions in the 2016 Proposed Standard requiring 1) additional disclosures with respect to critical audit matters as determined by the auditor (CAMs), and 2) disclosure of audit firm tenure. These provisions have been retained, although slightly modified, from the original standards as proposed by the PCAOB in 2013 (2013 Proposed Standard). We believe these provisions continue to have the potential to result in disclosure of lengthy and potentially inconsistent information, blur the roles of the auditor with those of the audit committee and management, and cause considerable misunderstanding among financial statement users already overloaded by disclosure. These provisions impose requirements beyond the auditor's mandate and do not achieve the PCAOB's objective as currently drafted.

The following paragraphs outline our views on certain key elements of the 2016 Proposed Standard in greater detail.

**Critical Audit Matters**

The 2016 Proposed Standard includes a revised definition of CAMs, referring to those matters involving especially challenging, subjective or complex auditor judgment that are both communicated or required to be communicated to the audit committee and related to material financial statement accounts or disclosures. This narrower scope is an improvement from the CAM scope contained in the 2013 Proposed Standard, which not only included matters communicated to the audit committee, but also matters reviewed by the audit team's engagement quality reviewer or included in the audit engagement completion documents. However, we do not believe this enhancement sufficiently alleviates the risk of blurring the role of the auditor with those of the audit committee and management or for disclosure of lengthy and potentially inconsistent information.

The regulatory framework in the U.S. contemplates an effective balance in the responsibilities of the audit committee, the auditor, and management. Management is responsible for the fair presentation and disclosure of financial information, including the complex assumptions and judgments underlying that information. The auditor is responsible for independent attestation and corroboration regarding the information presented by management. The audit committee is responsible for assisting the board of directors with its oversight responsibilities of both management and the auditor on behalf of a company's shareholders, and disclosing certain matters related to its role in the company's proxy statement.

Requiring the auditor to disclose CAMs, as determined by the auditor, autonomously in the auditor's report inappropriately magnifies the role of the auditor, expanding the auditor's responsibility into independently reporting on accounting policies, estimates, transactions and other matters, rather than purely attesting to a company's financial information through a pass/fail audit opinion. It inherently undermines the governance role of the audit committee and the disclosure role of management. It is also inconsistent with the principles underpinning our regulatory framework that an auditor should not be the source of disclosure about a company.

We question whether the PCAOB's inclusion of an explanatory note, that an auditor is not expected to provide information about a company that has not been made publicly available, is substantive. CAMs intrinsically allow the auditor to provide information about a company that has not been made publicly available, improperly increasing the auditor's role and influence, and providing the auditor an unsuitable level of oversight ability. This additional oversight capability assumed by the auditor infringes on the audit committee's responsibility, which will add ineffective tension to the relationship between the auditor, management and the audit committee.

We prefer the CAM provision be removed from the 2016 Proposed Standard in its entirety. At the very least, an additional improvement would be to further narrow the scope of potential CAMs to those critical accounting estimates already disclosed by management. This solution would better maintain the existing roles of the audit committee, management and the auditor, and preserve the delicate balance needed in these relationships. It is also more consistent with the principles of the U.S. regulatory framework.

**Auditor Tenure**

We question the value of a requirement for disclosure of audit firm tenure. The PCAOB has proposed disclosure in the auditor's report of the year in which the auditor began serving consecutively as the company's auditor. This approach provides no additional perspective. There is contradictory evidence regarding the correlation between audit quality and audit firm tenure. Some academic studies conclude that longer audit firm tenure leads to higher audit quality, while others conclude the opposite, and still others conclude no relationship exists. Further, any correlation may vary depending on specific facts and circumstances.

We do not believe a requirement to disclose audit firm tenure is needed. However, if audit firm tenure is disclosed, it should be disclosed by either management or the audit committee with the appropriate perspective included so readers do not draw improper conclusions regarding any link between audit quality and audit firm tenure.

**Conclusion**

We recognize the PCAOB's efforts to increase the informational value of the auditor's report in order to promote its relevance and usefulness. To the extent that standardizing the form of the auditor's report, enhancing certain basic elements of the report, adding a statement regarding auditor independence, and permitting additional report addressees uphold this objective, we are supportive. We also agree with the PCAOB's decision to preserve the existing pass/fail auditor reporting model.

We appreciate your consideration of our concerns regarding the provisions in the 2016 Proposed Standard requiring 1) additional disclosures with respect to CAMs as determined by the auditor, and 2) disclosure of audit firm tenure. We believe these provisions still have the potential to result in disclosure of lengthy and potentially inconsistent information, blur the roles of the auditor with those of the audit committee and management, and cause considerable misunderstanding among financial statement users. In our view, the PCAOB's proposed expansion of the auditor's role into a preparer of information regarding accounting policies, estimates, transactions and other matters provides no clear additional comparability of reports, no apparent improvements to corporate governance and no significant reduction of investor risk. Therefore, these provisions impose requirements beyond the auditor's mandate and do not achieve the PCAOB's objective as currently drafted.

Thank you for the opportunity to offer our comments on the 2016 Proposed Standard.

Sincerely,

John V. Faraci
Chair, ConocoPhillips Audit and Finance Committee

Council of Institutional Investors
The Voice of Corporate Governance

Via Email

July 27, 2016

Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

*Re: PCAOB Rulemaking Docket Matter No. 034*

Dear Madam Secretary:

The purpose of this letter is to provide you with the Council of Institutional Investors' ("CII" or "Council") comments in response to the Public Company Accounting Oversight Board's ("PCAOB" or "board") Proposed Auditing Standard entitled "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards" ("reproposal").[1]

The Council is a non-profit nonpartisan association of public, corporate, and union pension funds, and other employee benefit plans, foundations and endowments with combined assets that exceed $3 trillion. Our member funds are major, long-term investors committed to protecting the retirement savings of millions of American workers. CII also has associate members, including asset managers with more than $20 trillion in assets under management.[2]

We thank the board for continuing to pursue one of the most important recommendations contained in the U.S. Department of Treasury's 2008 *Final Report of the Advisory Committee on the Auditing Profession* – "to consider improvements to the auditor's standard reporting model."[3] We strongly support most of the key provisions of the reproposal and offer several suggested modifications for your consideration.

[1] PCAOB Release No. 2016-003 (May 11, 2016), *available at* https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf.
[2] For more information about the Council of Institutional Investors ("CII"), please visit CII's website at http://www.cii.org/about_us.
[3] U.S. Department of the Treasury, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury VII:13 (Oct. 6, 2008), *available at* http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf.

The views we express in this letter are generally consistent with those CII provided in letters to the PCAOB in 2011[4] and 2013.[5]

As the leading U.S. voice for effective corporate governance and strong shareholder rights, CII believes that accurate and reliable audited financial statements are critical to investors in making informed decisions, and vital to the overall well-being of our capital markets.[6] That strong belief is reflected in the following CII membership-approved policy on the "Independence of Accounting and Auditing Standard Setters":

> Audited financial statements including related disclosures are a critical source of information to institutional investors making investment decisions. The efficiency of global markets—and the well-being of the investors who entrust their financial present and future to those markets—depends, in significant part, on the quality, comparability and reliability of the information provided by audited financial statements and disclosures. The quality, comparability and reliability of that information, in turn, depends directly on the quality of the . . . standards that . . . auditors use in providing assurance that the preparers' recognition, measurement and disclosures are free of material misstatements or omissions.[7]

This policy establishes the principle that "investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in a timely manner investors' information needs."[8] Our membership reaffirmed that principle in 2013 when it approved substantial revisions to our existing policy on "auditor independence."[9] That policy, as revised, includes the following provisions that we believe are relevant to issues raised by the reproposal:

> **2.13a Audit Committee Responsibilities Regarding Independent Auditors:** The audit committee should fully exercise its authority to hire, compensate, oversee and, if necessary, terminate the company's independent auditor. In doing so, the committee should take proactive steps to promote auditor independence and audit quality. Even in the absence of egregious reasons, the committee should consider

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[4] Letter from Jeff Mahoney, General Counsel, CII, to Office of Secretary, PCAOB (Sept. 19, 2011) [hereafter 2011 Letter], *available at* http://pcaobus.org/Rules/Rulemaking/Docket034/015_CII.pdf.
[5] Letter from Jeff Mahoney, General Counsel, CII, to Phoebe Brown, Office of Secretary, PCAOB (Dec. 16, 2013) [hereinafter 2013 Letter], *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_16_13_CII_letter_PCAOB_docket_034_proposed_auditing_standards.pdf & http://www.cii.org/files/issues_and_advocacy/correspondence/2013/12_16_13_ATTACHMENT_CII_letter_PCAOB_docket_no_034_proposed_auditing_standards.pdf.
[6] CII, Policies on Other Issues, Independence of Accounting and Auditing Standard Setters (adopted Oct. 7, 2008), *available at* http://www.cii.org/policies_other_issues#indep_acct_audit_standards.
[7] *Id.*
[8] *Id.*
[9] CII, Policies on Corporate Governance § 2.13 Auditor Independence (last updated Apr. 1, 2015), *available at* http://www.cii.org/corp_gov_policies.

> the appropriateness of periodically changing the auditor, bearing in mind factors that include, but are not limited to:
>
> • the auditor's tenure as independent auditor of the company
>
> ….
>
> • the clarity, utility and insights provided in the auditor's report
>
> ….
>
> Investors are the "customers" and end users of financial statements and disclosures in the public capital markets. Both the audit committee and the auditor should recognize this principle.
>
> ….
>
> **2.13b Competitive Bids:** The audit committee should seek competitive bids for the external audit engagement at least every five years.
>
> ….
>
> **2.13f Shareowner Votes on the Board's Choice of Outside Auditor:** Audit Committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor.[10]

Summary of CII Views on Reproposal

*Critical Audit Matters (CAMs)*

We generally support the reproposed auditor reporting model that requires the independent auditor to communicate CAMs in the auditor's report. However, we would revise the reproposed model in several ways to better achieve the board's stated goal to making "the auditor's report more informative and relevant to investors and financial statement users."[11]

First, the definition of CAMs as interpreted in the reproposal is too narrow and unnecessarily excludes relevant information from investors. More specifically, we would not limit CAMs to any matter that "relates to accounts or disclosures that are *material* to the financial statements" as that phrase is interpreted in the reproposal.[12] We note that the reproposal provides an example indicating that the phrase would exclude from the definition of CAMs a "loss contingency that was communicated to the audit committee but that was determined by management to be remote."[13] We believe that such a narrow interpretation of the phrase would unnecessarily exclude relevant information from investors.

In addition, we would revise the reproposal's provisions on the determination of CAMs to clarify that in most audits, the auditor would determine that CAMs include those matters that involved significant accounting judgment or estimation by management. This revision would better ensure that CAMs include what we continue to believe is perhaps the most relevant information for investors.

[10] *Id.*

[11] PCAOB Release No. 2016-003 at 16.

[12] *Id*. at A1 – 7 (emphasis added).

[13] *Id.* at 20.

Finally, and for the same reasons, we would revise the reproposal's provisions on the communication of CAMs to clarify that in the auditor's report, when describing CAMs that involve significant accounting judgment or estimation by management, the auditor would be expected to include information about its findings. Such information should include the independent auditor's insights or assessments about whether management's significant accounting judgments or estimations were balanced, mildly optimistic, or mildly pessimistic, or equivalent language.

*Other Proposed Changes to the Auditor's Report*
We also generally support the reproposal's other improvements to the auditor's report. Specifically, we agree with the board that an "independence statement in the auditor's report could both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations."[14]

We also continue to believe that information on auditor tenure in the auditor's report would be useful to investors. We generally agree with the board that "requiring the disclosure of auditor tenure in the auditor's report would ensure that the disclosure is in a consistent location—the auditor's report—for all companies and would reduce search costs for investors . . . ."[15]

Finally, while we are generally supportive of promoting greater uniformity in the addressee of the auditor's report, we would revise the reproposed standard to limit the required addressees to the shareowners of corporations or equivalents for companies not organized as corporations. We believe this approach is more aligned with our policies and the underlying principle that investors are the key customers of the auditor's report.

A more detailed discussion of our views in response to select questions contained in the reproposal follows:

***Questions:***

1. **Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.**
   a. **Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?**
   b. **Are there any audit committee communications that should be specifically excluded from consideration as a source of potential**

[14] *Id.* at 43-44.
[15] *Id.* at 49.

**critical audit matters? If so, identify and explain the reason for the exclusion.**

c. **Is the "relates to accounts or disclosures that are material to the statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?**

d. **Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of the critical audit matter appropriate and clear? Why or why not?**[16]

CII generally believes that the reproposed definition of CAMs would be *more appropriate* for purposes of achieving the board's stated objective of providing relevant and useful information in the auditor's report if the definition were revised to: (1) eliminate the clause that narrows critical audit matters to accounts and disclosures that are *material* to the financial statements;[17] and (2) add clarifying language to the definition's existing "Note" indicating that it is expected that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment.[18]

We generally agree with the comments of Capital Strategy and Research Inc. that establishing a materiality requirement for CAMs creates "a serious deficiency in the proposal . . . [because] investors would only hear about critical audit matters after suffering large losses which is the current disclosure regime."[19] That concern is only heightened by the example contained in the reproposal indicating that "a loss contingency that was communicated to the audit committee, but that was determined to be remote and thus not to warrant disclosure under the applicable financial reporting framework, *would not* meet the definition of a critical audit matter even if it involved especially challenging auditor judgment."[20] In our view, if the remote determination by management involved significant judgment or estimation, the loss contingency should meet the definition of CAMs because the resulting account or disclosure (or lack thereof) would likely be viewed as material and relevant to investors.[21]

Finally, we note that the materiality consideration in the proposed definition of CAMs has not been adopted in the analogous Standards of the International Auditing and Assurance Standards Board or other jurisdictions that have adopted requirements for

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[16] *Id.* at 28 (emphasis added).
[17] *Id.* at A1 – 7.
[18] *Id.* at A1 – 8.
[19] Letter from Elizabeth F. Mooney et al., Accounting Analyst, Capital Strategy Research, Inc., to Office of the Secretary, PCAOB 2 (June 24, 2016), *available at* https://pcaobus.org/Rulemaking/Docket034/03c_Capital.pdf.
[20] PCAOB Release No, 2016-003 at 20 (emphasis added).
[21] *See, e.g.*, Roll-Royce Holdings PLC, Annual Report 170 (2015) (disclosure in the independent auditor's report of a United Kingdom firm containing findings relating to "contingent liabilities in respect of financing and asset value support provided to customers"), *available at* www.rolls-royce.com/~/media/Files/R/Rolls-Royce/documents/investors/annual-reports/2015-annual-report-v1.pdf.

expanded auditor reports.[22] We believe this is one area where those international standards may provide investors more useful information.

In addition, we generally continue to believe that from an investor perspective, perhaps the most relevant and useful expanded audit report disclosure would provide the auditor's assessments or insights on management's significant accounting estimates and judgments,[23] including the auditor's findings as to whether management's significant accounting estimates and judgments were balanced, mildly optimist, or mildly pessimistic, or equivalent language.[24] We, believe, therefore, the reproposal should include clarifying language to the definition's existing "Note" indicating that it is expected, that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment. In that regard, we share concerns raised by PCAOB Member Steven B. Harris that the "especially challenging, subjective, or complex auditor judgment" component of the definition of CAMs "grants [auditors] . . . too much discretion . . .''[25] We believe our proposed revision to the CAMs Note would assist in establishing a more objective floor for the determination of CAMs to better ensure that the information that is perhaps most relevant and useful to investors would be contained in the expanded auditor's report.

**6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:**

**a. The auditor providing original information in describing the principal considerations for the determination that the matter is a**

[22] *See* IAASB, The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal 2 (May 2016) ("Some might believe that the inclusion of a materiality consideration in the definition of CAM may result in a narrower population of matters that may be a CAM under the PCAOB reproposal than under the IAASB's Standards or approaches in other jurisdictions."), *available at* https://www.ifac.org/publications-resources/new-auditor-s-report-comparison-between-isas-and-pcaob-reproposal (registration required to view the publication).

[23] *See, e.g.,* 2013 Letter, *supra* note 5, at 3 ("we would revise the proposed model to provide that the auditor is required to communicate, at a minimum, an assessment of management's critical accounting judgments and estimates based on the audit procedures the auditor performed").

[24] *See* Letter from Jeff Mahoney, General Counsel, CII, to Phoebe Brown, Office of Secretary, PCAOB 1 (Apr. 10, 2014) (Attachment) ("For management's significant accounting judgments, communication of those critical audit matters in the auditor's report also must describe the auditor's insight's on, and assessments of, management's significant accounting judgments and estimates, including the degree of aggressiveness or conservatism of those judgments and estimates, and whether the related reported amounts are, in the auditor's judgment, within a reasonable range.") [hereinafter 2014 Letter], *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2014/04_10_14_PCAOB_letter_Rulemaking_Docket_Matter_34.pdf; *see also* FRC, Extended Auditor's Reports, A Further Review of Experience 22-23 (Jan. 2016) (describing those auditor reports of United Kingdom companies "which included commentary on findings against key audit matters . . ."), *available at* https://www.frc.org.uk/Our-Work/Publications/Audit-and-Assurance-Team/Report-on-the-Second-Year-Experience-of-Extended-A.pdf.

[25] Steven B. Harris, Board Member, Statement on Reproposed Auditing Standard on Auditor's Report 4 (May 11, 2016), *available at* https://pcaobus.org/News/Speech/Pages/Harris-statement-ARM-051116.aspx.

**critical audit matter or describing how the matter was addressed in the audit, and**

**b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?**

**Are there other steps the Board could take to address these concerns? If so, what are they?[26]**

CII generally believes that the reproposed communication requirements *inappropriately* respond to commenter concerns about the auditor providing "original information." As indicated, we believe that in order for the board to fully achieve its objective of providing relevant and useful information in the auditor's report for investors and other financial statement users, the communication should include the auditor's assessments or insights on management's significant accounting estimates and judgments, including the auditor's findings as to whether management's significant accounting estimates and judgments were balanced, mildly optimist, or mildly pessimistic, or equivalent language. That type of communication should not be limited by "original information;" a term that we understand is undefined in auditing literature.

Therefore, we would revise "Note 2" to the reproposal's provisions on communication of CAMs to clarify that among information "necessary to describe the principle considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit"[27] are the auditor's assessments or insights on management's significant accounting estimates and judgments.[28] We note that our view on this issue is generally consistent with recent findings of the United Kingdom ("UK") Financial Reporting Council that observed: "[i]nvestors feel that more could still be done to enhance [the expanded UK] auditor's reports, including . . . the auditor's view on the appropriateness of management estimates."[29]

We generally believe that the reproposed communication requirements does appropriately respond to commenter concerns about misinterpreting CAMs. We are unaware of any institutional investors that are likely to misinterpret CAMs. To the extent, however, that some preparers might be correct in their view that some other investors or other financial statement users might misinterpret CAMs, we generally support the reproposal's: (1) modification of the introductory language in the CAMs section of the

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[26] PCAOB Release No. 2016-003 at 38 (emphasis added).
[27] *Id.* at A1 – 9.
[28] *See* Michael Scanlon et al., Comment, Gibson Dunn Discusses PCAOB Issuance of Another Proposal to Change Audit Report, CLS Blue Sky Blog 3 (June 1, 2016) (indicating that the "exception" in Note 2 to the reproposed provisions on communication of critical audit matters could be interpreted broadly to "put the auditor in a position of having to make disclosures in the first instance"), *available at* http://clsbluesky.law.columbia.edu/2016/06/01/gibson-dunn-discusses-pcaob-issuance-of-another-proposal-to-change-audit-report/.
[29] FRC, Extended Auditor's Reports, A Further Review of Experience at 4.

auditor's report "to expressly state that the auditor is providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate;"[30] and (2) clarifying in a note "that the language used to communicate a CAM should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates."[31]

**13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?[32]**

Our members ascribe great weight to the independence of the external auditor, and CII agrees with the board that the reproposed "independence statement in the auditor's report could both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations."[33]

**14. Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?[34]**

CII generally believes it would be appropriate to limit the required addressees to the shareowners,' or equivalents for companies not organized as corporations. It is our understanding that our proposed approach is generally consistent with the approach taken in the UK auditor's reports which "are typically addressed to either the members or other shareholders of the company."[35]

As we explained in our comment letter in response to the 2013 proposal:

> CII generally believes that the final auditor reporting standard should require that the auditor's report be addressed to investors in the company. We note that our membership approved corporate governance policies have long reflected the principle that "investors are the key customer of audited financial reports and, therefore, the primary role of audited financial reports should be to satisfy in [a] timely manner investors' information needs."[36]

[30] PCAOB Release No. 2016-003 at 29.
[31] *Id*. at 29-30.
[32] *Id*. at 44 (emphasis added).
[33] *Id.* at 43-44.
[34] *Id.* at 46 (emphasis added).
[35] *Id.*
[36] 2013 Letter, *supra* note 5, at 1 (Attachment).
[36] *Id.*

**19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?[37]**

CII generally believes that requiring disclosure of auditor tenure in the auditor's report would reduce investor search costs. We generally agree with the board that "[r]equiring the disclosure of auditor tenure in the auditor's report would ensure the disclosure is in a consistent location—the auditor's report—for all companies and would reduce search costs for investors and other financial statement users who are interested in this piece of information."[38] As explained in our comment letter in response to the 2013 proposal, "[s]ince the auditor's report 'is the primary means by which the auditor communicates to investors and other financial statement users,' it seems entirely appropriate to us that certain information about the auditor that investors and other financial statement users find particularly useful, including information about auditor tenure, should be disclosed in the auditor's report."[39]

Finally, we would not object to disclosure of auditor tenure on Form AP rather than in the auditor's report if the timeliness, accessibility, search ability, and overall functionality of the information disclosed on Form AP is at least equivalent to having the information disclosed in the auditor's report.[40]

**27. How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?[41]**

CII agrees with the board that "having the auditor provide investors and other financial statement users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing a new perspective on the financial statements."[42]

We continue to believe that information asymmetry between investors and management, and investors and auditors, is more likely to be reduced if the information provides the independent auditor's assessments or insights on management's significant accounting

[37] PCAOB Release No. 2016-003 at 51 (emphasis added).
[38] *Id.* at 49.
[39] 2013 Letter, *supra* note 5, at 3 (Attachment) (footnote omitted).
[40] Letter from Jeff Mahoney, General Counsel, CII, to Phoebe Brown, Office of Secretary, PCAOB 5-6 (July 30, 2015) (comparing disclosure of auditor name in auditor's report versus disclosure in Form AP), *available at* http://www.cii.org/files/issues_and_advocacy/correspondence/2015/July%2030,%202015%20comment%20letter%20to%20PCAOB.pdf.
[41] PCAOB Release No. 2016-003 at 97 (emphasis added).
[42] *Id.* at 64.

estimates and judgments, including the auditor's findings as to whether management's significant accounting estimates and judgments were balanced, mildly optimist, or mildly pessimistic, or equivalent language.[43]

We also agree with the board that "[r]eporting critical audit matters would add to the mix of information that could be used in investor capital allocation decisions."[44] The board's conclusion is consistent with our long-standing view that many investors would use the information communicated in an improved auditor's report to "analyz[e] and pric[e] risks and mak[e] informed investment decisions because . . . the auditor is an independent third party that could provide an unbiased view of the company's financial statements . . . ."[45]

We also agree with the board that an improved auditor's report could be used by investors to "engage management with targeted questions and support investors' decisions on ratification of the auditor."[46] We note that our membership-approved policies explicitly reference "insights provided in the auditor's report" as a factor that an audit committee should consider when evaluating whether to retain an external auditor.[47] Moreover, the basis for that policy indicates that our members may use the information contained in an improved auditor's report as an additional data point in which to: (1) oversee the audit committee and management, and (2) cast a more informed shareowner vote on proposals to ratify the selection of the external auditor.[48]

The potential relevance of such information for those, and other purposes, is illustrated in a current print advertisement by one of the large U.S. audit firms.[49] The ad touts the firm's view that an important component of the value of an audit is the auditor's "insight into your organization's financial condition and performance."[50] As a key customer and end user of the audited financial statements and related disclosures, we continue to believe that at least some of that value should be shared with investors through the auditor's report.[51]

**31. Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such**

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[43] *See, e.g.*, 2014 Letter, *supra* note 24, at 1 (Attachment); *see also* FRC, Extended Auditor's Reports, A Further Review of Experience at 22-23.
[44] PCAOB Release No. 2016-003 at 65.
[45] 2011 Letter, *supra* 4, at 9 (Attachment).
[46] PCAOB Release No. 2016-003 at 71.
[47] 2.13a Audit Committee Responsibilities Regarding Independent Auditor's.
[48] 2011 Letter, *supra* note 4, at 10 (Attachment).
[49] J. Acct. 2 (July 2016) (on file with CII).
[50] *Id.*
[51] 2011 Letter, *supra* note 4, at 10 (citing multiple sources of support for the view that additional information from the auditor could "enhance the value of the audit to investors"); s*ee also* Office of the Investor Advocate, U.S. SEC, Report on Objectives, Fiscal Year 2017 at 13 (indicating that enhancements to the auditor's report "would be of major significance to investors"), *available at* https://www.sec.gov/advocate/reportspubs/annual-reports/sec-office-investor-advocate-report-on-objectives-fy2017.pdf.

**changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?[52]**

CII continues to believe that changes to enhance the auditor's report would improve both audit quality[53] and management disclosures to the benefit of investors.[54] On the latter point, we note that at least one prominent corporate law firm has opined that one implication of an anticipated final standard is that management should consider "revis[ing] or supplement[ing] its own disclosures, in light of the auditor's discussion, in order to ensure that the totality of the disclosure reflects an accurate and complete picture."[55]

**41. Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs [emerging growth companies]? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?[56]**

CII generally continues to believe that excluding audits of EGC's from enhancements to the auditor's report *would not* benefit investors.[57] More specifically, we generally agree with the comments of those accounting firms that have argued "EGCs exhibit characteristics similar to other public companies and that financial statement users would benefit from similar auditor reporting requirements."[58]

Finally, we also find compelling the recent academic research cited by the board indicating that enhanced audit reporting may produce "greater benefits" for investor's in EGC's relative to the broader population of issuers.[59]

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[52] PCAOB Release No. 2016-003 at 97 (emphasis added).
[53] 2011 Letter, *supra* note 4, at 10 (Attachment) (citing 2011 CFA survey indicating some users of financial statements believe "additional information from the auditor could increase quality competition among audit firms").
[54] *Id.* at 9 (citing PCAOB staff outreach to investors indicating that the auditor could use the disclosure "'to leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors.'").
[55] Sullivan & Cromwell LLP, Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard 3-4 (May 25, 2016), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Audit_Reports_05_25_2016.pdf.
[56] PCAOB Release No. 2016-003 at 109 (emphasis added).
[57] 2013 Letter, *supra* note 5, at 3 (Attachment) ("We generally believe that the proposed standards and amendments, as improved by our comments, should be applicable to audits of all public companies, including emerging growth companies . . . .").
[58] *See* PCAOB Release No. 2016-003 at 107.
[59] *Id.* 107-08.

We appreciate the opportunity to provide the Council's investor-focused perspective on this important project. Please let me know you have any questions about the contents of this letter.

Sincerely,

Jeff Mahoney

Jeffrey P. Mahoney
General Counsel

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August 15, 2016

Office of the Secretary
Public Company Accounting Oversight Board
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Re: PCAOB Rulemaking Docket Matter No. 034, Proposed Auditing Standard, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards"

Office of the Secretary:

Crowe Horwath LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) Proposed Auditing Standard, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards" (Proposed Standard or Proposed Amendments, as applicable).

As described in our letter to the Board, dated December 11, 2013, regarding the initial PCAOB Rulemaking Docket Matter No. 034, we support the Board's efforts to improve audit quality by enhancing existing auditing standards, and to provide additional information to investors for decision-making. We are pleased to provide our observations where the Proposed Standard could be modified to provide more clarity for investors and other users, and to address other matters.

**Proposed Standard**

*Critical Audit Matters Definition*

Appendix A of the Proposed Standard defines a critical audit matter as any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective or complex auditor judgment. We believe the definition of critical audit matters should be modified to avoid unintentional consequences.

The definition of critical audit matters continues to be broad and we recommend limiting it to only those matters which are material to the financial statements taken as a whole as opposed to **any** matter that relates to accounts or disclosures that are material. As defined, it is likely the auditor will be responsible for disclosing original information which is not required to be disclosed by management. For example, a schedule of uncorrected misstatements, which is other than clearly trivial but determined to be immaterial to the financial statements taken as a whole, is required to be communicated to the audit committee but are not required to be disclosed by management. Because the schedule of uncorrected misstatements can relate to accounts and disclosures which are material to the financial statements and can involve especially challenging, subjective, or complex auditor judgment, it would be considered a critical audit matter and would require disclosure. A second example relates to significant deficiencies. Significant deficiencies are required to be communicated to the audit committee but are not required to be disclosed by management.

Because significant deficiencies can relate to accounts and disclosures which are material to the financial statements and can involve especially challenging, subjective, or complex auditor judgment, it would also require disclosure. In both of these examples, the auditor would be required to report critical audit matters, but neither example would have been material to the financial statements taken as a whole.

To address the risk of the auditor disclosing original information or matters that are not thought to be critical audit matters, we recommend a two part solution. First, revise part one of the critical audit matter definition (noted below, new text in bold and deleted text in strikethrough), as follows:

> 11. The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was ~~communicated or~~ required to be communicated to the audit committee and that: (1) ~~relates to accounts or disclosures that are~~ **is** material to the financial statements **taken as a whole** and (2) involved especially challenging, subjective or complex auditor judgment.

The suggested edits above would reduce the risk of the auditor being required to disclose original information and align with management's requirement to disclose only matters that are material to the financial statements. We believe the revised definition will still capture those matters that are critical to the audit including those matters that require especially challenging, subjective, or complex auditor judgment.

Second, we recommend excluding the required auditor communication for uncorrected misstatements and significant deficiencies from evaluation as a critical audit matter. These exceptions would further mitigate the risk of the auditor disclosing original information. Limiting the critical audit matters to items required to be communicated, except for immaterial audit adjustments and significant deficiencies, will reduce inconsequential documentation in an audit file and is the basis for our suggestion to delete "communicated or" from paragraph 11.

It appears the Board's intent is to prevent the auditor from being required to provide original information about an entity. We strongly agree with this concept. It also appears it is the Board's intent to allow for the auditor to provide original information to be included in the description of the principle considerations that led the auditor to determine that a matter is a critical audit matter, if the situation arises. We agree, but this position should be an exception to the rule. To clarify the Board's intent, we propose the following revision (see deleted text in strikethrough) to Note 2 in paragraph 14 of the Proposed Standard:

> Note 2: When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company ~~unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit~~.

*Critical Audit Matters Documentation Requirements*

Paragraph 17 of the Proposed Standard requires "the auditor to document the basis for the auditor's determination whether each matter that both a) was communicated or required to be communicated to the audit committee and b) relates to accounts or disclosures that are material to the financial statements involved especially challenging, subjective, or complex auditor judgment." We believe comparable changes are needed to this paragraph should the Board agree with our previous recommendation to paragraph 11.

Notwithstanding our prior recommendation, the broad definition of critical audit matters will result in a significant increase in audit documentation to capture any audit committee communication that relates to accounts or disclosures that are material. That documentation requirement will lead to describing all matters discussed at the audit committee, without regard to the significance of the matter, that relate to accounts and disclosures that are material, in order to have an appropriate starting point for evaluation of potential critical audit matters. We believe this requirement will be more prevalent at smaller issuers resulting in disproportionate costs. In our experience, it is more common for audit committees of smaller issuers to request that the auditor provide information not currently required by PCAOB standards, for example: a list of all internal control deficiencies identified during the audit, regardless of the issuer's reporting requirements. These deficiencies, since communicated to the audit committee, will result in the auditor needing to evaluate each one as a potential critical audit matter since each deficiency might relate to an account or disclosure that is material to the financial statements. Additionally, in many smaller issuers, it is not uncommon for the auditor to discuss with the audit committee matters related to the audit of material accounts and disclosures. For example, a common matter discussed with the audit committee of a financial institution are the audit procedures performed on the growth of a loan portfolio. While loans are almost always considered to be an account that is material to the financial statements, audit procedures on a loan portfolio's existence generally does not involve especially challenging, subjective, or complex auditor judgment. These communications are not required nor are the specific matters required to be documented currently by PCAOB Auditing Standards, however, auditors would nevertheless be required to maintain a listing of these types of discussions and related matters and evaluate whether these matters involved especially challenging, subjective or complex auditor judgment.

We believe the cost of evaluating all matters discussed with the audit committee is an unintended consequences of paragraph 17 and can be significantly mitigated if corresponding changes are made to this paragraph consistent with our proposed change to paragraph 11.

With respect to the documentation requirements, limiting the identification of critical audit matters to only required communications, as well as our other proposed definitional changes, would:

- Likely remove the need to maintain a laundry list of any matter communicated to the audit committee that relates to a material account or disclosure, thus eliminating the documentation of inconsequential matters
- Better balance the effort and cost for smaller issuers
- Allow auditors to focus on other responsibilities during the critical wrap up stages of the audit
- Capture matters which required especially challenging, subjective, or complex auditor judgment.

*Communication of Critical Audit Matters*

Similar to the note in AS 1301, paragraph 9 that indicates "Note: This overview is intended to provide information about the audit, but not specific details that would compromise the effectiveness of the audit procedures." We suggest incorporating a note to paragraph 14c to indicate the purpose of the auditor describing audit responses to critical audit matters is intended to provide information about the audit but not specific details that would compromise the effectiveness of the audit procedures.

*Auditor Tenure*

As we have previously communicated, we continue to believe an unintended consequence of including auditor tenure in the auditor's report is incorrectly implying a correlation between auditor tenure and audit quality. The PCAOB's previous Concept Release on Auditor Independence and Audit Firm Rotation acknowledges that there is not a demonstrated relationship between the auditor's objectivity and professional skepticism and the tenure of the audit engagement. Further, the Proposed Standard acknowledges there continues to be a divided view on auditor tenure and audit quality. Accordingly, we believe that auditor tenure should not be included in the auditor's report. If deemed important by the audit committee, we suggest the audit committee to disclose auditor tenure.

Alternatively, if the Board continues to believe auditor tenure is a useful disclosure and the source of that disclosure should come from the auditor, Form AP, "Auditor Reporting of Certain Audit Participants," would be a more appropriate location.

The concept in paragraph 10 (page A1-6) provides data to the investor for which the relevance is unclear. The requirement is to report the year the auditor began serving consecutively as the company's auditor. The note below paragraph 10 requires the year to include situations in which a firm is acquired by another firm. We believe this confuses investors. If the Board believes there is a correlation between audit quality and a firm's tenure, then the tenure disclosure should be that of the firm currently signing the opinion. For example, Company A was audited by Firm 1 beginning in year 2000, and Firm 1 was acquired by Firm 2 in 2010 and Firm 2 was acquired by Firm 3 in 2015, therefore Firm 3 would report 15 consecutive years as the auditor for Company A. It is not clear how the investor should interpret the information as there is likely no correlation in audit quality or tenure by Firm 3. The auditor's relationship by Firms 1, 2 and 3 with Company A could be substantially different as each firm has its own audit methodology, quality control processes, etc. resulting in likely different audit quality. We believe the Board should reconsider this requirement on tenure.

*Cost*

The Board acknowledges a lack of specific quantitative data regarding costs. The Board also acknowledges recurring costs, such as drafting and documenting critical audit matters, and suggests senior members of engagements teams, such as partners and senior managers, would be involved in developing the language. In addition, other senior members, such as an engagement quality reviewer and national office partners, would be involved. We agree the aforementioned individuals would be involved in the reporting of the critical audit matters. We also envision these individuals will be reviewing the report multiple times, with costs increasing with each additional touch of the report. While the Board anticipates critical audit matters would be scalable based on the size, nature, and complexity of the audit, we believe there is limited scalability to the reporting requirement and the costs will be heavily disproportionate to smaller issuers. We expect the number of hours to report one critical audit matter will represent a larger percentage of the overall audit hours on a smaller issuer, as compared to the overall audit hours on a larger issuer. As such, we expect the costs would be disproportionate to smaller issuers. In addition to our recommendation in the effective date section below, we encourage the Board to study the disproportionate cost effect on smaller issuers and evaluate the cost benefit of reporting critical audit matters on smaller issuers.

*Effective Date*

The Proposed Standard does not include an effective date. Based on the need for audit firms to develop appropriate methodologies and training, we suggest the effective date should be a minimum of two years after a final Auditing Standard is adopted by the SEC. Also, in order to help manage the cost to smaller issuers, we encourage the PCAOB to delay the reporting requirement of critical audit matters for non-accelerated filers and smaller reporting companies until the SEC, PCAOB and industry can study the results of the initial implementation and evaluate whether the standard should apply more broadly.

* * * * *

Crowe Horwath LLP supports the Board's efforts to improve its audit standards for the benefit of investors and other stakeholders. We appreciate the opportunity to comment, and would be pleased to respond to any questions. Should you have any questions, please contact Michael G. Yates at (574) 236-7644.

Sincerely,

Crowe Horwath LLP

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August 12, 2016

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Public Company Accounting Oversight Board
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Washington, D.C. 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 034**

Deloitte & Touche LLP (D&T) is pleased to respond to the request for comments from the Public Company Accounting Oversight Board (the PCAOB or the Board) on its *Proposed Auditing Standard — The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the reproposed standard or AS 3101) and *Related Amendments to PCAOB Standards* (the proposed amendments) (collectively, the reproposal); PCAOB Release No. 2016-003; and PCAOB Rulemaking Docket Matter No. 034 (May 11, 2016).

**Overall Comments**

As stated in our prior comment letter to the Board,[1] we support the Board's efforts to increase the informational value, usefulness, and relevance of the auditor's report. We appreciate the substantive efforts of the PCAOB to address concerns and suggestions raised in previous comment letters related to auditor reporting, which we believe have led to substantial enhancements in the reproposed standard. In addition, we commend the PCAOB's consideration of similar auditor reporting efforts undertaken by several international and non-U.S. standard setters and regulators while also recognizing that the regulatory environments in other jurisdictions are different from the United States.

We are supportive of the revised requirements the Board has put forward in its reproposed standard. We believe the revised requirements result in achieving the overall objective of providing meaningful and useful information about the audit to investors and other financial statement users, while alleviating certain concerns of potentially being at odds with the long-standing, historical reporting model of management being responsible for the company's financial statements and disclosures and the auditor attesting to the information within financial statements. In particular, we are supportive of the following changes to the auditor's report:

- Including a statement that the auditor is required to be independent with respect to the company in accordance with U.S. federal securities laws and the applicable rules and regulations of the U.S. Securities and Exchange Commission (SEC) and the PCAOB.

- Including additional language regarding the auditor's responsibilities with respect to the detection of error or fraud and performing procedures to assess the risks of material misstatement.

- Clarifying that an audit encompasses the financial statements and the related notes.

Each of the above changes will help to clarify the role and resonsibilities of the auditor.

[1] See D&T's letter to the PCAOB in response to the PCAOB's *Proposed Auditing Standards — The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*; *The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*; and *Related Amendments to PCAOB Standards* filed with the PCAOB on December 12, 2013.

In addition, we are supportive of the revised requirements with respect to critical audit matters (CAMs) as discussed further below. Based on our review of the reproposal, we believe that there are certain limited implementation and other issues that should be further considered by the PCAOB as it moves to finalize the reproposal. We discuss our observations and additional items for consideration below and in Appendix A.

**Critical Audit Matters**

***Determination of CAMs***. We believe the revised requirements for determining CAMs will simplify the process while still resulting in the auditor identifying those matters that would be of most interest and importance to investors. In particular, we are supportive of the following:

- Narrowing the population of potential CAMs to those matters that were communicated or required to be communicated to the audit committee and to matters that relate to accounts or disclosures that are material to the financial statements. Also, further defining CAMs as those matters that involve especially challenging, subjective, or complex auditor judgment.

- Revising the factors to be used in determining whether a matter involved especially challenging, subjective, or complex auditor judgment.

- Retaining the requirement to communicate CAMs only for the current audit period, while providing the option for the auditor to include CAMs related to prior periods in cases of initial public offerings or reaudits.

***Describing the Principal Considerations.*** We agree with the clarification included in the reproposal that the auditor would be required to describe the principal considerations that led to the determination of a CAM. Describing all considerations that led the auditor to determine that each matter was a CAM could make the auditor's report quite lengthy, especially when there are multiple CAMs. Limiting the description of each CAM to the principal considerations that are specific to the circumstances of the matter and providing a clear description of why the matter involved especially challenging, subjective, or complex auditor judgment will be more efficient for auditors while still maintaining the usefulness of the information to investors and other users of the financial statements.

***Describing How CAMs Were Addressed in the Audit.*** While we do have some level of practical concern as to the ability of an auditor to succinctly summarize the myriad of audit procedures that are often performed with respect to complex matters, we understand the value to financial statement users and, therefore, support the proposed requirement to include a description of how each CAM was addressed in the audit. Users will benefit from an appreciation of the rigor that underlies the audit procedures performed related to CAMs. We also appreciate and recognize the objective that the Board is attempting to achieve in allowing the auditor flexibility to exercise professional judgement when describing particular procedures performed as discussed in the release.[2] We note that the release indicates that the auditor may describe "(1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements."[3] We agree with this guidance and believe that auditors will find it useful in making judgments when developing descriptions of how CAMs were addressed in the audit. We suggest that the Board include this guidance directly within the body of the final standard instead of in the release where it might be overlooked.

***Provision of Original Information About the Company.*** We support the PCAOB's acknowledgment that the auditor should generally not be expected to provide original information about the company in the auditor's report.[4] We appreciate the PCAOB's efforts to revise the definition of CAM as relating only to those accounts or disclosures that are material to the financial statements. We also support the

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[2] The release accompanying the reproposal states that "the reproposed standard does not prescribe the specific way to meet [the requirement for the auditor to describe how each CAM was addressed in the audit]." See page 31 of the release.
[3] See page 31 of the release.
[4] See page 35 of the release.

inclusion of Note 2, which has been added to paragraph 14 of the reproposed standard and indicates that "the auditor is not expected to be the source of original information about the company when describing CAMs in the auditor's report, unless such information is necessary to describe the principal considerations that led to the determination of a CAM or how the CAM was addressed in the audit." As this Note acknowledges that circumstances could arise in which the auditor is in the position of communicating original information about the company in the description of a CAM, we believe it would be helpful for the final standard to provide an illustrative example that can be looked to by auditors and preparers.

***Documentation Considerations.*** We believe it is appropriate for audit documentation related to determination of CAMs to be focused on why matters considered were determined of such importance that they are included in the auditor's report (i.e., auditors efforts should be focused on documenting how the determination of actual CAMs was made from the population of matters communicated or required to be communicated to the audit committee that related to accounts or disclosures that are material to the financial statements, as opposed to being overly focused on documenting why potential CAMs were determined not to be CAMs). To provide additional clarity to the documentation requirements, we suggest paragraph 17 be reworded as follows:

*For each matter that:*

*a. Was communicated or required to be communicated to the audit committee; and*

*b. Relates to accounts or disclosures that are material to the financial statements;*

*the auditor must document whether or not the matter was concluded to be a critical audit matter (i.e., document whether the matter involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.*

**Other Matters**

***Auditor Tenure.*** We understand the calls from investors and other financial statement users for auditor tenure information to be made available in the spirit of transparency. We are, however, concerned about the potential implications and practical challenges of providing auditor tenure information in the auditor's report. Below we discuss our concerns and suggest an alternative method of disclosure that we believe meets the Board's transparency objectives in a form that will be more meaningful to investors and others.

Our review of academic literature in connection with our previous letters to the PCAOB[5] and most recently in our letter to the SEC,[6] found evidence that, if audit quality problems do occur, they are less likely to occur later in the auditor's term; the literature, however, does not support a demonstrable link between auditor tenure and audit quality or independence.[7] We are concerned, therefore, that while auditor tenure is a matter of fact, requiring its inclusion in the auditor's report suggests or implies that tenure has a direct effect on the conduct and quality of the audit, and may lead to misperceptions regarding auditor independence. We are also concerned about including language in the auditor's report that "...the auditor is uncertain as to the year the auditor became the company's auditors..." in cases in which there might be uncertainty due to firm or company mergers, as we believe such language could be misinterpreted by investors and others.[8]

To address these concerns, we believe the most feasible alternative is for the PCAOB to require auditor tenure information be included in the PCAOB's new form, *Auditor Reporting of Certain Audit Participants*

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[5] See D&T letters to the PCAOB dated December 8, 2011 and April 20, 2012 in response to PCAOB Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation.*

[6] See our comment letter to the SEC dated September 2, 2015 in response to SEC Release No. 33-9862, *Concept Release on Possible Revisions to Audit Committee Disclosures.*

[7] As highlighted by Board member Hanson in his May 11, 2016 statement on the reproposed standard, "the evidence about the impact of auditor tenure on audit quality continues to be mixed, at best."

[8] See Release, pages A1-6 and A1-7.

(Form AP)[9] and that Form AP also provide for the ability to provide supplementary contextual information regarding auditor tenure, if needed. This approach would have the following benefits:

- Provides an opportunity for the auditor to explain or provide context in relation to any uncertainty as to the year the auditor became the company's auditor (e.g., in cases of firm or company restructurings).

- Would be similar in form to voluntary disclosures provided by audit committees regarding auditor tenure in company proxy statements, in which audit committees can and do provide additional commentary.[10]

- Would result in another factual disclosure being available for inclusion in the PCAOB's searchable Form AP database (i.e., along with the name of the engagement partner and information regarding the involvement of other accounting firms in the audit[11]).

***Addressee of the Accountant's Review Report.*** The reproposal includes a revision to paragraph 37 of Auditing Standard 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*) to require the accountant's review report be addressed to "the shareholders and the board of directors, or equivalents for companies not organized as corporations."[12] From our experience, review reports are not always issued, and when they are, they are often not included with the interim financial information filed with the SEC. Therefore, the reports are not readily available to the shareholders. We suggest the Board revise its proposed requirement to provide for the exclusion of shareholders from the required addressees of the interim review report if such report will not be included in a filing with the SEC.

***Amendments to Auditing Standard 3305,* Special Reports*.*** The reproposal does not include specific revisions to the auditor's reports in Auditing Standard 3305, *Special Reports* (AS 3305) (currently AU sec. 623, *Special Reports*) but instead provides direction to the auditor to include the basic elements of the reproposed standard in situations in which the auditor's report is filed with the SEC. We acknowledge that auditor's reports in connection with the circumstances described in AS 3305 are rarely filed with the SEC. However, we suggest the Board revise AS 3305 to reflect the concepts included in the reproposed standard for clarity and consistency (which would also be consistent with the approach taken by the IAASB in relation to its analogous standards.[13]) We note, however, that these changes may follow in a separate project once the reproposal has been finalized.

***Effective Date Considerations.*** We encourage the PCAOB to finalize the reproposed standard quickly. Internationally, new auditor reporting standards are already or will soon become effective.[14] Finalizing the PCAOB standard will provide necessary clarity to all stakeholders as to how the U.S. auditing standards compare to others being implemented elsewhere. However, we also believe that when deciding on the effective date of the auditor reporting standard other changes in the financial

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[9]Effective for audit reports issued on or after January 31, 2017, registered public accounting firms will be required to disclose the engagement partner name on Form AP, which will be publicly available on the PCAOB's website.
[10] Our analysis of the 2015 corporate proxy statements filed by the companies included in the S&P 100 index has found that 64 of the companies disclose either the tenure of the incumbent external audit firm, or otherwise gave an indication of how long the firm had been the company's auditor.
[11] Disclosures regarding certain other participants in the audit will be required for the auditor's reports issued on or after June 30, 2017.
[12] See page A2-70 of the release.
[13] Refer to International Standards on Auditing (ISA) 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks,* and ISA 805, *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement.*
[14] New and revised auditor reporting standards issued in January 2015 by the International Auditing and Assurance Standards Board (IAASB) will be effective for audits of financial statements for periods ending on or after December 15, 2016; European Union (EU) legislation related to audits of public interest entities, including expanded auditor reporting requirements was adopted in April 2014; and revised standards of the Financial Reporting Council (FRC) in the United Kingdom which enhance transparency of the auditor's report and communication to investors is effective for audits of financial statements for periods beginning on or after June 17, 2016.

reporting process such as the timing of the new requirements regarding revenue recognition,[15] leasing,[16] and expected credit losses[17] need to be acknowledged. In addition, we believe that some period of time will be necessary to develop guidance, train our professionals, create appropriate processes, and implement the related system of quality control to support reporting of CAMs in our auditor's reports.

Because of the significance of the effort that will be involved to effectively implement the revised reporting standard, we believe a phased implementation process should be considered by the PCAOB. Phasing in the changes would permit a targeted focus in the first year, and allow the lessons learned and experience gained in the first year to be applied in successive years. For example, the effective date could be phased such that new auditor reporting requirements would first be effective for audits of the largest companies (i.e., Phase 1 could require application to large accelerated filers only. Phase 2 could apply to accelerated filers and Phase 3 to non-acclerated filers.)

***Applicability.*** We agree that communication of CAMs should not be required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies, other than business development companies, and benefit plans while allowing for voluntary inclusion of CAMs in the auditor's report for such entities.

Consistent with our prior commentary, we do not believe there is a basis for exempting audits of emerging growth companies from the requirements of the final reporting standards. We believe investors of these companies will benefit from the additional information communicated in the auditor's report in the same way that investors of larger companies will.

***Auditor Liability.*** While some of the revised requirements discussed in the reproposal address certain concerns that have been raised about auditor liability, the reproposed standard does, of course, present some potential for increased litigation. However, we believe that concerns over auditor liability should not stand in the way of moving forward. Rather, auditor liability concerns should be recognized as the Board moves forward with finalizing the standard. As discussed in our previous comment letter, the reproposed new auditor statements — with respect to CAMs — could lead to new claims under Section 10(b) of the Exchange Act, Section 11 of the Securities Act of 1933, and various state laws. For example, if the reproposed standard is adopted, auditors will be subject to challenge based on the selection of matters considered to be CAMs and those that they do not consider to be CAMs. As also mentioned in our 2013 letter to the PCAOB, another area of concern is the possible effect that disclosing CAMs may have on undermining efforts by Congress, which imposed the stringent pleading standards of the Private Securities Litigation Reform Act of 1995 (PSLRA), to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Plaintiffs may use descriptions of an auditor's procedures in its CAM disclosures to try to plead around the strict requirements of the PSLRA and federal jurisprudence that has interpreted it.

* * *

[15] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers* (Topic 606) — unless early adoption is elected, public entities reporting under U.S. GAAP are required to implement the provisions of the new revenue standard for annual reporting periods beginning after December 15, 2017 and interim periods therein.
[16]FASB Accounting Standard Update No 2016-02, *Leases* (Topic 842) — public entities reporting under U.S. GAAP are required to implement the provisions of the new leasing standard for annual reporting periods beginning after December 15, 2018 and interim periods therein.
[17] FASB Accounting Standard Update No 2016-13, *Measurement of Credit Losses on Financial Instruments* (Topic 326) — unless early adoption is elected, public entities reporting under U.S. GAAP are required to implement the provisions of the expected credit losses standard for annual reporting periods beginning after December 15, 2019 and interim periods therein.

D&T appreciates the opportunity to provide our perspectives on these important topics. Our comments are intended to assist the PCAOB in analyzing the relevant issues and potential effects of the reproposal. We encourage the PCAOB to engage in active and transparent dialogue with commenters as the reproposed standard is evaluated and changes are considered. If you have any questions or would like to discuss these issues further, please contact Dave Sullivan at 714-436-7788 or Megan Zietsman at 203-761-3142.

Very truly yours,

Deloitte & Touche LLP

Deloitte & Touche LLP

cc: James R. Doty, PCAOB Chairman
Lewis H. Ferguson, PCAOB Member
Jeanette M. Franzel, PCAOB Member
Jay D. Hanson, PCAOB Member
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Martin F. Baumann, PCAOB Chief Auditor and Director of Professional Standards

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James V. Schnurr, SEC Chief Accountant
Wesley R. Bricker, SEC Interim Chief Accountant

## APPENDIX A — DETAILED OBSERVATIONS AND RECOMMENDATIONS

Based on our analysis of the reproposal, we have identified several technical modifications that could be made to improve or provide additional clarity in the requirements and which would address certain implementation challenges that would otherwise arise. We describe our recommendations below.

<table>
<tr><th>Reference</th><th>Recommendation</th></tr>
<tr><td colspan="2">Requirements and guidance in Appendix 1 and 2 of the reproposal:</td></tr>
<tr><td>Appendix 1, paragraph 05(b) of AS 3101</td><td>Clarify the note in paragraph 05(b) of AS 3101 such that it is clear that the requirements relating to the communication of CAMs would not apply to audits of nonissuers that are performed in accordance with the standards of the PCAOB.[18]</td></tr>
<tr><td>Appendix 1 and 2, paragraph 59 of AS 3105[19] and AS 3101</td><td>Move the requirement regarding how to modify the second paragraph under “Basis for Opinion” of the auditor’s report when the auditor is performing a nonintegrated audit from paragraph 59 of AS 3105 to AS 3101. We believe this guidance should be in the standard related to expressing an unqualified opinion, rather than in the standard regarding departures from unqualified opinions.</td></tr>
<tr><td>Appendix 2, paragraph 46 of AS 3105</td><td>Paragraph 46 should include specific requirements regarding how to modify the basic elements included in an unqualified auditor’s report when the auditor is disclaiming an opinion on the financial statements. For example:<br>• Modify the first section of the auditor’s report to include the title “Disclaimer of Opinion on the Financial Statements.”<br>• Modify the first sentence of the first paragraph under Disclaimer of Opinion on the Financial Statements to include a statement identifying each financial statement and any related schedule(s) that the auditor was engaged to audit.<br>• Modify the title of the second section to be “Basis for Disclaimer of Opinion.”<br>• Modify element b of paragraph 09 of AS 3101 to include a statement that the auditor’s responsibility is to express an opinion on the financial statements based on conducting the audit in accordance with the standards of the PCAOB.<br>• Add a statement that because of the matter described in the Disclaimer of Opinion on the Financial Statements section of the auditor’s report, the auditor was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements.<br>• Remove elements c-e of paragraph 09 of Section 310.<br>We also recommend that the Basis for Disclaimer of Opinion section read as follows:<br>These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on conducting our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.<br>Because of the matter described in the Disclaimer of Opinion on the Financial Statements section of our report, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.</td></tr>
</table>

[18] Although the PCAOB is only responsible for establishing auditing standards for issuers and brokers and dealers registered with the SEC, in certain situations the SEC requires audits of nonissuers to be performed in accordance with the standards of the PCAOB (e.g., a nonissuer subsidiary, division, branch, component or investment for which an audit report is filed under Rule 2-05 of Regulation S-X, a voluntary filer).
[19] AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances* (AS 3105).

| Reference | Recommendation |
|---|---|
| Appendix 2, paragraph 03 of AS 2705[20] and paragraph 04 of AS 2710[21] | Clarify placement of the explanatory paragraph in the auditor's report. |
| Appendix 2, paragraphs 44 and 45 of AS 4105[22] | Add requirement to include a section title and clarify placement of the explanatory paragraph in the review report. |
| ***Illustrative report examples in Appendix 1 and 2 of the reproposal:*** | |
| Appendix 1 and 2, AS 3101 | Provide an illustrative example of a nonintegrated auditor's report in AS 3101 and clarify whether each example provided is for an integrated or nonintegrated audit; add the explanatory paragraph required to follow the opinion paragraph when the auditor issues separate opinions on the financial statements and internal control over financial reporting in an integrated audit as required by paragraph 88 of AS 2201. |
| Appendix 1 AS 3101, paragraphs 15 | Revise to say (change indicated by underline): "*<u>Communication</u> of critical audit matters does not alter in any way our opinion on the financial statements taken as a whole…* " |
| Appendix 2, paragraphs 85D and 87 of AS 2201[23] | For consistency, create a section titled "Definition and Inherent Limitations of Internal Control over Financial Reporting" and place it above "[Definition Paragraph]." Revise paragraph 85D of AS 2201 accordingly. |
| Appendix 2, AS 2201 | Include a separate report on internal control over financial reporting in AS 2201. |
| Appendix 2 | Revise the requirements so that explanatory paragraphs, with the exception of those related to substantial doubt about a company's ability to continue as a going concern, immediately follow the "Basis for Opinion" section instead of immediately following the opinion paragraph. We believe it is more appropriate for this information to follow the "Basis of Opinion." |
| Appendix 1, paragraph 19 of AS 3101 | Clarify that an emphasis of a matter paragraph should go in the auditor's report following the section titled "Basis for Opinion" and any explanatory paragraphs included under "Basis for Opinion" (see previous comment). We believe it is more appropriate for this information to follow the "Basis of Opinion." |
| ***Terminology and related edits Appendix 1 and 2 of the reproposal:*** | |
| Appendix 1 and 2 | Replace references in the illustrative report examples to "operations, stockholders' equity, and cash flows" with "[*insert the financial statement titles as they appear in the financial statements, e.g.,* income, comprehensive income, stockholders' equity, and cash flows]." Currently, the illustrative report examples do not include reference to the statement of comprehensive income. |
| Appendix 1 and 2 | Modify second paragraph under "Basis for Opinion" in the illustrative report examples as follows (change indicated by underline): "*Such procedures include<u>d</u> examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.*" |
| Appendix 1, AS 3101, paragraph 09(b) | Add "taken as a whole" to make it consistent with paragraph 1. |
| Appendix 2, paragraph 25 of AS 3105 | Include full text of the first paragraph in the illustrative report example. |
| Appendix 2, paragraphs 38, 39, and 40 of AS 4105 | Add "Interim" in first section title (i.e., Results of Review of Interim [*Financial Information or Statements*]) and a reference to the related notes; define interim financial information or statements and related notes in first sentence of first paragraph (e.g., …for the three- |

[20] AS 2705 (currently AU sec. 558), *Required Supplementary Information* (AS 2705).
[21] AS 2710 (currently AU sec. 550), *Other Information in Documents Containing Audited Financial Statements* (AS 2710).
[22] AS 4105, *Reviews of Interim Financial Information* (currently AU sec. 722, *Interim Financial Information*) (AS 4105).
[23] AS 2201 (currently Auditing Standard No. 5), *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* (AS 2201).

| **Reference** | **Recommendation** |
|---|---|
| | month and nine-month periods then ended (collectively referred to as the "interim financial information [statements]"). |
| Appendix 2, paragraph 10 of AS 3315[24] | Revise the parenthetical that reads "collectively referred to as the financial statements" to "collectively referred to as the 20X3, 20X2, and 20X1 consolidated financial statements" in the illustrative report example because financial statements would have already been defined once in the auditor's report as it relates to the 20X5 and 20X4 financial statements. |
| Appendix 2, paragraph 09 of AS 1205[25] | Revise the parenthetical that reads "collectively referred to as the financial statements" to "collectively referred to as the consolidated financial statements" in the illustrative report example. |
| Appendix 2, AS 3105 | Relocate the illustrative report examples in AS 3105 to an Appendix to be consistent with AS 3101. |
| Appendix 2 | Modify the illustrative report examples, as appropriate, to include two years of balance sheets and three years of statements of income, comprehensive income, stockholder's equity, and cash flows to be consistent with AS 3101. |
| Appendix 2 | With the exception of the illustrative report examples, revise all references to "generally accepted accounting principles" to "applicable financial reporting framework" to be consistent with AS 3101 or at a minimum revise the references in AS 3105 given the pervasiveness of changes to this standard. |
| Appendix 2 | Replace outdated references to FASB accounting standards with the appropriate FASB Accounting Standards Codification reference. |
| Appendix 2, AS 3105 | Replace (1) "he or she," "he," "she," "him," and "her" with "the auditor" or other appropriate term and (2) "client" with "management," "the company," or other appropriate term, in AS 3105 given pervasiveness of changes to this section and to be consistent with the PCAOB's drafting conventions for newly issued standards. |
| Appendix 2, AS 3105 | Include sections titled "Introduction" and "Objectives" in AS 3105 given the pervasiveness of changes to this section and to be consistent with AS 3101. |
| Appendix 2 | Replace "evidential matter" with "audit evidence" or other appropriate term to be consistent with AS 1105. |
| Appendix 2, footnote 13 in paragraph 49 of AS 3105 | Remove footnote as it does not appear to be applicable as it references state and local governmental units. |
| Appendix 2, paragraphs 61 and 62 of AS 3105 | Remove these paragraphs as they are no longer applicable given new effective date of revisions to AS 3105. |
| Appendix 2, paragraph 37B(c) of AS 4105 | Revise the first sentence of item c to refer to "applicable financial reporting framework" instead of "generally accepted accounting principles" and the second sentence of item c to state "The statement should also include an identification of the applicable financial reporting framework." |
| Appendix 2, paragraph 37C(a) of AS 4105 | Replace "entity" with "company." |
| ***Other*** | |
| AS 4105 | Include a requirement similar to paragraph 09(g) of AS 3101. |
| Interpretation 14 of AI 23[26] | Consider whether this interpretation is appropriate in light of the revised reporting requirements in the ISAs or whether the interpretation should be modified to refer to auditing standards generally accepted in the United States of America and whether a new interpretation should be issued to address reporting on audits conducted in accordance with the standards of the PCAOB and the ISAs, taking into account the revised ISAs. |

[24] AS 3315 (currently AU sec. 552), *Reporting on Condensed Financial Statement and Selected Financial Data* (AS 3315).
[25] AS 1205, *Part of the Audit Performed by Other Independent Auditors* (currently AU sec. 543, *Part of Audit Performed by Other Independent Auditors*) (AS 1205).
[26] AI 23, Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 1051 (currently AU sec. 9508, *Reports on Audited Financial Statements: Auditing Interpretations of Section 508*) (AI 23).

# THE VALUE RELEVANCE OF MANAGERS' AND AUDITORS' DISCLOSURES ABOUT MATERIAL MEASUREMENT UNCERTAINTY

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# THE VALUE RELEVANCE OF MANAGERS' AND AUDITORS' DISCLOSURES ABOUT MATERIAL MEASUREMENT UNCERTAINTY


## ABSTRACT

Regulators seek to provide financial statement users with more information about how auditors evaluate complex estimates. Because users encounter auditor-provided information alongside management-provided information about these estimates, we jointly examine the value relevance of this information. We also examine whether visual cues in auditor disclosures influence the way nonprofessional investors use this information. While disclosures from managers and auditors provide *different* value-relevant information about the *same* underlying issue, we find that users do not weight information about the audit when it is presented in a fully-narrative format. Specifically, users weight management disclosures and fully-narrative auditor disclosures as substitutes in valuation judgments. However, visual cues facilitate their weighting of information about the audit, which also changes how they weight management disclosures. Consistent with market signaling theory, users reward robust supplemental management disclosures when audit reports provide visual cues. This suggests visual cues in auditor reports can promote increased transparency from managers.


**Keywords**: measurement uncertainty; fair value; audit reports; disclosure.

**Data availability**: *Contact the authors.*

# THE VALUE RELEVANCE OF MANAGERS' AND AUDITORS' DISCLOSURES ABOUT MATERIAL MEASUREMENT UNCERTAINTY

## I. INTRODUCTION

When accounting standards allow managers discretion in measuring complex financial statement estimates, reported amounts represent a point estimate among a range of reasonable values (e.g., Bratten, Gaynor, McDaniel, Montague, and Sierra 2013). The range of reasonable values for an estimate often includes amounts that, if recorded, would likely influence financial statement users' ("users") decisions (e.g., Christensen, Glover, and Wood 2012; Bell and Griffin 2012). Such instances result in material measurement uncertainty, which likely leads users to discount security prices (i.e., take price protection) (e.g., Diamond and Verrecchia 1991; Song, Thomas, and Yi 2010). However, users must rely on reported information to identify this uncertainty and impound it into security prices. Accounting regulators encourage managers to provide supplemental disclosures regarding material measurement uncertainty (SEC 2003; FASB 2010a). The PCAOB now also seeks to provide users with information about how auditors evaluate estimates that reflect material measurement uncertainty (e.g., PCAOB 2014, 2016). Because users encounter auditor-provided information alongside management-provided information about these estimates, we jointly examine the value relevance of management and auditor disclosures regarding material measurement uncertainty. We also examine whether visual cues in auditor disclosures influence the way nonprofessional investors use this information.

Issuers contend, and auditors agree, that only management should provide original information about an entity (e.g., PCAOB 2013a, 2013b, 2013c, 2013d). Under the current financial reporting model, management bears primary responsibility for providing users with original information about a company through assertions (i.e., about contracts and accounting measurement processes). On the other hand, auditors bear primary responsibility for providing users with information about the production of attestations (i.e., assurance). While assertions relate directly to contracts and the underlying economics, attestations relate only to assertions (and not underlying economics). Information about attestations therefore has a relatively weaker causal link to underlying economics than information in management's assertions. Material measurement uncertainty creates potential information asymmetry with respect to both *first-order* information in management's assertions and *second-order* information about auditors' attestations.[1] Notably, the existence of underlying material measurement uncertainty represents "bad news", which both management and auditors can communicate credibly (Skinner 1994).

Understanding users' valuation judgments related to material measurement uncertainty is important to standard setters as they consider approaches to reducing the information asymmetry this uncertainty creates. The current financial reporting environment provides issuers with significant discretion in determining specific disclosure practices (e.g., SEC 2003, 2008).[2] Understanding these judgments can help calibrate disclosure requirements around material measurement uncertainty. Additionally, the PCAOB proposes that auditors provide information about the production of assurance over high-uncertainty estimates using critical auditing matter disclosures in the audit report (PCAOB 2016). Our study can inform conversations among financial reporting stakeholders (e.g., regulators, auditors, management, and users) about potential upcoming implementation decisions related to format these disclosures.

We address two fundamental issues related to material measurement uncertainty and

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[1] *Second-order* refers to information about information, while *first-order* refers to information about an underlying phenomenon (see, e.g., Silverstein 2001). Gershon (2010, 18) notes "*Second-order information* refers to the information that can guide you into understanding how particular words and statements should be interpreted" (emphasis in original). While management assertions provide first-order information about underlying economics of contracts, auditor attestations provide only second-order information about this first-order information.

[2] SEC comment letters highlight significant and pervasive room for improvement in these disclosures in practice (e.g., Ernst & Young 2014). Additionally, research finds considerable variation in compliance with disclosure requirements, even for disclosures that do *not* involve complex judgments (Ettredge, Johnstone, Stone, and Wang 2011). This suggests that variation in the quality of supplemental disclosures about material measurement uncertainty will be particularly pronounced in practice.

information asymmetry. First, we jointly examine the value relevance of first-order and second-order information about material measurement uncertainty. Financial reporting stakeholders anticipate that many critical auditing matter disclosures will relate to issues about which management already provides robust supplemental disclosures (e.g., PCAOB 2013a, 2013b, 2013c, 2013d). Additionally, observations of expanded audit reports in the U.K. reveal instances where the auditor provides "key audit matter" disclosures with second-order information, but management *does not* provide supplemental disclosures with corresponding first-order information (e.g., Heineken 2015). Our study provides insights regarding the valuation implications of material measurement uncertainty under these different information scenarios.

Second, we examine whether visual cues in auditor reports influence the way nonprofessional investors use information about material measurement uncertainty. Research suggests that visual linkages between recognized amounts and disclosed information reduce information processing costs, as compared to narrative linkages (e.g., Einhorn and Hogarth 1981, 1986; Maines and McDaniel 2000; Clor-Proell, Proell, and Warfield 2014). Interestingly, while audit reports that reference specific amounts in financial statements do so *narratively*, reports in certain assurance settings do so *visually* (e.g., "comfort letters"; see Appendix A).[3] We examine whether users impound information about material measurement uncertainty differently when auditors identify amounts visually versus narratively in critical auditing matter disclosures.

Using a sample of 102 nonprofessional investors, we examine how supplemental management disclosures and auditor disclosures interactively affect users' valuation judgments. Participants in all conditions receive required, standardized ASC 820 disclosures that indicate Level 3 inputs reflect management's assumptions and learn that the auditors issued an

[3] AU 634, *Letters for Underwriters and Certain Other Requesting Parties* (PCAOB 2003), describes a presentation format whereby auditors place labels adjacent to amounts on financial reports to indicate the results of procedures applied to the respective amounts (par. 58). AU-C 920 (AICPA 2013) describes the same presentation format.

unqualified ("clean") opinion. First, we manipulate management disclosure through a series of statements about the material measurement uncertainty of a Level 3 fair value estimate and the related investment gain. Second, we manipulate auditor disclosure at three levels: absent, auditor narrative disclosure, and auditor visual disclosure. Participants receiving the auditor narrative disclosure manipulation view a fully-narrative critical auditing matter disclosure related to material measurement uncertainty in a Level 3 investment gain. Participants receiving the auditor visual disclosure manipulation view a critical auditing matter disclosure that visually identifies the Level 3 investment gain with a label on the face of the income statement. We measure participants' valuation judgments (our dependent variable) using assessed P/E multiples.

We predict and find that management disclosure and auditor narrative disclosure function as substitutes in reducing information asymmetry for nonprofessional investors (i.e., these users discount P/E multiples nearly equivalently in response to either or both). Auditor disclosures must incidentally indicate the existence of first-order information in order to communicate second-order information. While nonprofessional investors appear to weight the existence of this first-order information when auditor narrative disclosure is present, they do not incrementally weight the second-order information in their P/E multiple assessments.

We also predict and find that visual cues change the way nonprofessional investors use information about material measurement uncertainty in their valuation judgments. When management disclosure is absent, nonprofessional investors discount P/E multiples more in response to auditor visual disclosure than auditor narrative disclosure. Consistent with market signaling theory (e.g., Spence 1973; Healy and Palepu 1993), we also find that nonprofessional investors appear to reward management disclosure when auditor visual disclosure is present (i.e., assess *higher* P/E multiples when management disclosure is present than absent).

Our findings suggest that nonprofessional investors find both first-order and second-order information about material measurement uncertainty to be value-relevant. This is consistent with supplemental management disclosures and critical auditing matter disclosures providing *different* information about the *same* underlying measurement uncertainty. Our findings also demonstrate that nonprofessional investors use information about material measurement uncertainty differently when auditor reports provide visual, versus narrative disclosures. These users appear do not appear to weight second-order information when audit reports present it in a fully-narrative format. However, when audit reports visually identify the related amounts, nonprofessional investors appear to weight both first-order and second-order information in a manner consistent with market signaling theory (e.g., Spence 1973). Specifically, these users assess higher P/E multiples when management provides robust supplemental disclosures alongside auditor visual disclosures than when management fails to do so. This suggests that visual cues in auditor reports can promote increased transparency from managers.

Our study contributes to prior research on several dimensions. First, we draw the critical distinction between first-order information that GAAP requires managers to provide regarding material measurement uncertainty and second-order information about the related attestations. Our findings suggest that the valuation implications of auditor disclosures are conditional on whether management provides robust supplemental disclosures. Second, our findings demonstrate the importance of presentation format and visual cues in communicating second-order information about material measurement uncertainty. In doing so, we extend emerging research on implications of critical auditing matter disclosures (e.g., Brown, Majors, and Peecher 2015; Christensen, Glover, and Wolfe 2014; Kachelmeier, Schmidt, and Valentine 2014; Lennox, Schmidt, and Thompson 2015).

Third, we identify visual cues currently used by auditors in practice that appear to facilitate nonprofessional investors' weighting of disclosed information. Prior literature documents differences in the way users process recognized versus disclosed amounts (Davis-Friday, Folami, Liu, and Mittelstaedt 1999; Davis-Friday, Liu, and Mittelstaedt 2004). However, our findings suggest these visual cues can help bridge the documented gap in the decision usefulness of recognized versus disclosed accounting information. The remainder of this paper proceeds as follows. Section 2 presents background information, theory, and hypotheses. We discuss our experimental method in Section 3. Section 4 reports results and Section 5 concludes.

## II. BACKGROUND, THEORY, AND HYPOTHESES

### Standard Setting and Regulation

The SEC asserts that "management has a unique perspective on its business that only it can present" (SEC 2003). Accordingly, FASB standards and SEC interpretive guidance require managers to disclose information related to important accounting issues, including critical accounting policies and critical accounting estimates (SEC 2003; FASB 2010a, 2010b). We use the term "critical accounting matters" (hereafter, C*Acct*Ms) to describe these policies and estimates. C*Acct*Ms represent *first-order* information about amounts recognized and disclosed in financial reports (e.g., management disclosures around material measurement uncertainty).

FASB standards and SEC interpretive guidance provide managers with significant discretion in implementing disclosure practices (e.g., SEC 2003, 2008; FASB 2010a). ASC 235 *Notes to Financial Statements* provides flexibility in identifying significant accounting policies and provides only general guidance for developing the related disclosures (FASB 2010a). While the SEC requires issuers to discuss assumptions underlying critical accounting estimates, it encourages (but does not require) supplemental disclosure related to the sensitivity of estimates to changes in key inputs (SEC 2003, 2008). Correspondingly, SEC comment letters indicate significant variation in the quality of both required and supplemental C*Acct*M disclosures about material measurement uncertainty (e.g., Ernst & Young 2014). This is consistent with research that reports strategic variation in compliance with disclosure requirements (Ettredge et al. 2011).

The PCAOB currently proposes that auditors communicate *second-order* information from auditors about material measurement uncertainty as critical auditing matters (hereafter, C*Aud*Ms) in audit reports (PCAOB 2016). When material measurement uncertainty exists, auditors can only obtain assurance over a range of reasonable values (Christensen et al. 2012; Bell and Griffin 2012). The PCAOB's proposed standard requires auditors to identify such situations when they arise and provide information about the production of assurance over the related amounts in C*Aud*M disclosures (PCAOB 2016, A1-7 – A1-9). Importantly, the PCAOB does not propose that auditors provide any first-order information about material measurement uncertainty in C*Aud*Ms (e.g., assertions about the underlying contract or measurement process). Rather, the PCAOB proposes that auditors provide only factual second-order information about the assurance production process (e.g., audit procedures, audit effort, audit evidence, and risk assessments). Thus, although C*Aud*Ms and C*Acct*Ms can relate to the same amounts and/or disclosures (see, e.g., PCAOB 2013a, 2013b, 2013c), C*Aud*M information fundamentally differs C*Acct*M information. Only auditors can produce C*Aud*M information; relatedly, issuers contend that only management should provide C*Acct*M information (e.g., PCAOB 2013a, 2013b, 2013c).

Financial reporting stakeholders anticipate that many C*Aud*M disclosures will relate to issues about which management already provides robust C*Acct*M disclosures (e.g., PCAOB 2013a, 2013b, 2013c, 2013d). However, observations from recently expanded audit reports in the U.K. reveal instances where auditors identify "key audit matters" about underlying issues that management does not address through supplemental disclosure. For example, Deloitte's audit report on Heineken's 2015 financial statements identifies a key audit matter regarding the valuation of a deposit liability on returnable packaging (Heineken 2015, 143) (see Appendix C, Panel A). While Heineken reports a €606 million payable for "Returnable packaging deposits" in a table (Heineken 2014, 114), management provides no narrative explanation of this amount (see Appendix C, panel B). This suggests that robust supplemental C*Acct*M disclosures might not necessarily accompany proposed C*Aud*M disclosures in the U.S.

**Theory and Research on Users' Valuation Judgments**

Research reveals that first-order information about material measurement uncertainty is value relevant (e.g., Song et al. 2010, Clor-Proell et al. 2014). Research also shows that users understand and value information in auditor reports (for recent reviews, see Carson, Fargher, Geiger, Lennox, Raghunandan, and Willikens 2013; Mock, Bedard, Coram, Davis, Espahbodi, and Warne 2013). Specifically, users attend to negative signals in auditor reports (e.g., Libby 1979; Schneider and Church 2008; Shelton and Whittington 2008) and incorporate these signals in valuation decisions (e.g., Bamber and Stratton 1997; Taffler, Lu, and Kausar 2004; Citron, Taffler, and Uang 2008; Menon and Williams 2010). However, inferences from this research relate to first-order, rather than second-order, information. Namely, report modifications under the current auditor reporting model emphasize first-order information about a client's financial condition (i.e., going concern assumption) or accounting practices (e.g., changes in accounting principles). Second-order information about the production of assurance (e.g., as in PCAOB-proposed C*Aud*M disclosures) provides relatively weaker causal linkages to the underlying economic activity than this first-order information.

Individuals organize events in terms of cause and effect relations and therefore weight information to a greater extent when it is more causally linked to a judgment (e.g. Ajzen 1977; Einhorn and Hogarth 1986; Kim and Ahn 2002). This implies that users will experience more difficulty weighting second-order information in proposed C*Aud*M disclosures in their valuation judgments (as compared to first-order information in C*Acct*M disclosures) because that information is less causally linked to the economics that underlie the valuation. Consistent with this implication, emerging research reveals that assurance report users have difficulty processing information about the production of assurance (i.e., second-order information). In a sustainability reporting setting, Vera-Munoz, Gaynor, McDaniel, and Kinney (2015) find that non-expert users do not differentiate the level of assurance achieved based on descriptions of the verification procedures performed. Similarly, Kachelmeier et al. (2014) demonstrate that optional descriptions of audit procedures in C*Aud*M disclosures do not influence users' perceptions.

However, in communicating second-order information, C*Aud*M disclosures also incidentally indicate that first-order information about the underlying accounting issue exists.[4] Although Vera-Munoz et al. (2015) and Kachelmeier et al. (2014) show that users do not react to certain second-order information in C*Aud*M disclosures, other studies reveal that a variety of user groups do react to overall C*Aud*M disclosures. Using an instrument similar to our own and to that in Clor-Proell et al. (2014), Christensen et al. (2014) find that C*Aud*M disclosures reduce nonprofessional investors' willingness to invest in a company. Emerging research also reveals that C*Aud*M disclosures influence nonprofessional investors' confidence in financial statements, nonprofessional investors' and jurors' perceptions of auditor responsibility/ liability, and jurors' assessments of auditor negligence (e.g., Backof, Bowlin, and Goodson 2014; Kachelmeier et al. 2014; Brasel, Doxey, Grenier, and Reffett 2016; Gimbar, Hansen, and Ozlanski 2016).[5]

However, two studies that examine market reactions to expanded audit report disclosures in the U.K. provide mixed evidence regarding the joint informativeness of C*Acct*M disclosures

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[4] For example, auditors cannot provide C*Aud*M disclosures about the *auditing implications* of material measurement uncertainty in an estimate without also indicating that material measurement uncertainty *exists* in the estimate.
[5] Notably, these studies demonstrate that users view information in C*Aud*Ms as "bad news" about the underlying accounting issue, which both management and auditors can communicate credibly (Skinner 1994). Additionally, the operationalization of management disclosure and auditor disclosure in the current study (i.e., each treatment is presented on its own separate screen in Qualtrics) creates nearly equivalent salience between these two treatments. These features of our experimental design control for source credibility and salience across the management disclosure and auditor disclosure treatments.

(i.e., first-order information) and C*Aud*M disclosures (i.e., second-order information). Reid, Carcello, Li, and Neal (2015) find that the expanded disclosures in these reports incrementally reduce information asymmetry (i.e., increased abnormal trading volume, especially for companies with weaker information environments). Lennox et al. (2015) similarly find that information in expanded U.K. audit reports reliably reflects financial reporting risks (e.g., measurement uncertainty). However, they do not find these expanded audit report disclosures to be incrementally informative to the disclosures already contained in annual reports; they also report insignificant market reactions to these expanded disclosures. Collectively, these studies suggest that while users seem to understand information in proposed C*Aud*M disclosures, they experience difficulty weighting second-order information in their valuation judgments.

Based upon this discussion, we expect that both C*Acct*M disclosures and C*Aud*M disclosures will communicate first-order information about material measurement uncertainty (i.e., whereas C*Acct*M disclosures provide this information directly, C*Aud*M disclosures incidentally indicate this information exists). We further expect that users will weight first-order information in their valuation judgments similarly, regardless of whether they receive it through a C*Acct*M disclosure or fully-narrative C*Aud*M disclosure. We also expect that users will not weight second-order information when C*Aud*M disclosures present it in a fully-narrative format (i.e., the only information that users will weight from fully-narrative C*Aud*M disclosures is first-order information about the existence of the underlying issue). We therefore expect that, fully-narrative C*Aud*M disclosures will not incrementally influence users' valuation judgments when management provides supplemental C*Acct*M disclosures. Figure 1 illustrates these expectations.

INSERT FIGURE 1 HERE

In Figure 1, Point A represents the situation where management does not provide a supplemental C*Acct*M disclosure and the audit report does not provide a C*Aud*M disclosure. In this situation, we predict users will assess a P/E multiple of *n*, which reflects the perceived firm value in the absence of both first-order and second-order information about material measurement uncertainty. At Point B, management provides a supplemental C*Acct*M disclosure, but the auditor does not provide a C*Aud*M disclosure. Here, we predict users will assess a P/E multiple of $n - x$, where $x$ represents the discount attributable to first-order information about material measurement uncertainty. At Point C, the auditor provides a fully-narrative C*Aud*M disclosure, but management does not provide a supplemental C*Acct*M disclosure. Here, we predict users will also assess a P/E multiple of $n - x$, as they will weight the first-order information conveyed (incidentally) in the C*Aud*M disclosure, but not the second-order information. At Point D management provides a supplemental C*Acct*M disclosure and the auditor provides a fully-narrative C*Aud*M disclosure. Here, we predict that users will still only weight first-order information in their valuation judgments, resulting in a P/E assessment of $n - x$. This leads to our first hypothesis:

**H1: Nonprofessional investors will weight fully-narrative C*Aud*M disclosures and supplemental C*Acct*M disclosures as substitutes in their valuation judgments.**

Linking this theoretical discussion to the Heineken example in Appendix C, H1 predicts that users will treat the key audit matter disclosure in the Deloitte audit report as a substitute for robust supplemental C*Acct*M disclosures from Heineken management when making valuation judgments (Heineken management did not provide such disclosures in the annual report). The last sentence of the key audit matter in the Heineken audit report includes second-order information that proposed C*Aud*M disclosures would require (see PCAOB 2016): “As a response to this risk, we performed, amongst others, substantive procedures on the Company’s calculation of the returnable packaging liability, focusing on the valuation and completeness of the liability”

(Heineken 2015, 143). In communicating this second-order information, Deloitte's disclosure also incidentally reveals that first-order information about measurement uncertainty exists.

**Theory and Research on Presentation Format**

Research reveals that financial statement format affects users' judgments. For example, Maines and McDaniel (2000) find that users' weighting of the volatility of unrealized gains varies depending on the format of the financial statement where the gains are reported. Clor-Proell et al. (2014) find nonprofessional investors better decipher the reliability implications of measurement subjectivity when fair value gains appear in a separate column in the income statement. They further find that reliability judgments partially mediate the effect of this increased salience on valuation judgments. Research also reports that users place relatively greater weight on recognized versus disclosed amounts in their valuation judgments (e.g., Davis-Friday et al. 1999; Ahmed, Kilic, and Lobo 2006).[6] We extend this research by examining whether visual cues in auditor reports influence the way nonprofessional investors weight disclosed information about material measurement uncertainty in valuation judgments.

Research in psychology consistently demonstrates that visual cues orient attention to stimuli (see, e.g., Posner 1980; Posner and Cohen 1984). This suggests auditors can use visual cues to draw users' attention to financial statement amounts when the audit report contains second-order information about those amounts. In order to weight this second-order information, users must store the information in working memory while they analyze the related amounts and disclosures in the financial statements and footnotes. Research demonstrates limitations of working memory (see, e.g., Baddeley and Hitch 1974; Luck and Vogel 1997) and suggests that higher working memory loads interfere with information processing (e.g., de Fockert, Rees,

[6] Contemporaneous research also finds that visual representations help auditors themselves to understand complex estimates (Backof, Carpenter, and Thayer 2015) and accounting firms encourage the use of visualization to interpret data (e.g., Davenport 2013; KPMG 2015).

Frith, and Lavie 2001). Visual cues that identify specific financial statement amounts eliminate the need for users to remember which amounts relate to second-order information, thereby reducing the volume of information of users must hold in working memory when analyzing financial statements. Collectively, this suggests that visual cues will both orient users' attention to specific amounts and reduce the cognitive costs that users must incur to incorporate the related second-order information in their valuation judgments (see, e.g., Maines and McDaniel 2000).

AU 634, *Letters for Underwriters and Certain Other Requesting Parties*, describes visual cues available for auditors to use when reporting procedures and results in "comfort letters" (PCAOB 2003, par. 58). This standard specifically allows auditors to place labels adjacent to amounts on copies of financial reports (e.g., 10-Ks, 10-Qs, and prospectuses) that indicate second-order information about the respective amounts. Under this format, auditors use the body of the comfort letter to define "tick-marks" that indicate the results of procedures applied to reported amounts. Auditors then write or type these tick-marks directly on copies of financial reports (i.e., adjacent to the respective amounts) and attach these copies to the comfort letter (see an example in Appendix A).[7] We refer to this practice as auditor visual disclosure.

Tick marks on the face of the financial statements provide visual cues about second-order information in the auditor's report regarding the respective amounts (see, e.g., Lipe 1998). Following Maines and McDaniel (2000), we expect these visual cues to aggregate second-order information with the respective amounts and thereby facilitate users' weighting of this information in their valuation judgments. Additionally, research shows that users view first-order information about material measurement uncertainty as "bad news" for investors (e.g., Diamond and Verrecchia 1991; Song et al. 2010). Research also suggests that many user groups view second-order information in C*Aud*M disclosures as "bad news" for investors (e.g., Backof et al.

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[7] Copies of financial reports with tick-marks attached to comfort letters are referred to as "circle-ups" in practice.

2014; Christensen et al. 2014; Kachelmeier et al. 2014; Brasel et al. 2016). Following this, our second hypothesis predicts second-order information will have a stronger effect on users' valuation judgments in the presence of visual cues (i.e., auditor visual disclosure) than in the absence of these cues (i.e., auditor narrative disclosure):

**H2: Visual cues facilitate nonprofessional investors' use of second-order information about material measurement uncertainty in valuation judgments.**

In Figure 1, Point E represents the situation where the auditor's report provides a C*Aud*M disclosure with visual cues and management does not provide a supplemental C*Acct*M disclosure. In this situation, we predict that users will assess a P/E multiple of $n - x - y$, where $y$ represents the discount attributable to second-order information when management does not provide supplemental C*Acct*M disclosures. Linking this theoretical discussion to the Heineken example in Appendix C, the Deloitte report does not provide visual cues and Heineken management does not provide supplemental disclosures. H2 predicts that if Deloitte provides visual cues in the audit report, then nonprofessional investors will weight the second-order information in the key audit matter disclosure in their valuation judgments and incrementally reduce their assessments of firm value.

Our third hypothesis extends H2 and predicts that nonprofessional investors will weight first-order information differently in their valuation judgments when they also weight second-order information in these judgments. Consistent with market signaling theory (e.g., Spence 1973), Healy and Palepu (1993) suggest that management can mitigate threats to the credibility of financial reports by providing expanded disclosures. Thus, if auditor disclosures threaten the credibility of reported amounts, then managers can mitigate users' concerns by voluntarily providing robust supplemental disclosures. However, if auditor disclosures threaten the credibility of reported amounts and management provides only limited disclosures that do not mitigate users' concerns, then users will weight these credibility threats in their valuation judgments (e.g., Holthausen and Watts 2001). Following this, we expect that when users weight second-order information in their valuation decisions, they will take less (more) price protection in this second-order information when management voluntarily provides (does not provide) robust supplemental disclosures.

Research consistently demonstrates that users attend to negative information in audit reports (e.g., Libby 1979; Schneider and Church 2008; Shelton and Whittington 2008). This suggests that second-order information about material measurement uncertainty will threaten the credibility of the related amounts. In H2, we predict that visual cues will facilitate nonprofessional investors' use of second-order information about material measurement uncertainty. Following this discussion, our third hypothesis predicts the following:

**H3: Robust supplemental management disclosures will mitigate the predicted negative valuation effects of second-order information that is accompanied by visual cues.**

In Figure 1, Point F represents the situation where the auditor's report provides a C*Aud*M disclosure with visual cues and management provides a supplemental C*Acct*M disclosure. In this situation, we predict that users will assess a P/E multiple of $n - x - z$, where $z$ represents the discount attributable to second-order information when management provides robust supplemental C*Acct*M disclosures. That is, $z$ represents (1) the discount attributable to the second-order information about material measurement uncertainty (i.e., $k$) plus (2) the premium attributable to the signaling effect of robust supplemental C*Acct*M disclosures (i.e., $t$) (e.g., Spence 1973; Healy and Palepu 1993). Thus, $z = k + t$. Additionally, $y$ represents (1) the discount $k$ plus (2) the discount attributable to the lack of supplemental C*Acct*M disclosures (i.e., $s$). Thus, $y = k +$ s. H3 predicts that the premium, $t$, is numerically greater than the discount, $s$ (i.e., $z > y$).

H3 has hypothetical implications in the context of the Heineken example in Appendix C. Recall that the Deloitte report does not provide visual cues and Heineken management does not provide supplemental disclosures. H2 predicts that if Deloitte provides visual cues in the audit report, nonprofessional investors will weight the second-order information (i.e., as well as the first-order information) in their valuation judgments. H3 predicts that Heineken management can mitigate the predicted effect of this second-order information on these valuation judgments by providing robust supplemental disclosures.

## III. EXPERIMENTAL METHOD

### Participants

Participants are 102 Masters of Business Administration (MBA) students from a required financial accounting course at a large public university in the United States. Participants completed the experiment near the end of the course after covering standard financial statement analysis material.[8] All participants received course credit and cash compensation of $20 for completing the experiment. We present descriptive statistics for participants' education, work, and investing experience in Table 1. Participants have a mean of 5.86 years of work experience, have taken 1.84 accounting courses and 1.70 finance courses, and are 28.91 years old. Participants have a mean of 3.35 years of investing experience and a mean GMAT score of 643.02. Forty-seven percent of participants have made personal investments in the stock market. Sixty-five percent of participants had previously evaluated a company's performance using

[8] Participants had the requisite coursework necessary to qualify as proxies for nonprofessional investors (e.g., Clor-Proell et al. 2014; Elliott, Hodge, Kennedy, and Pronk 2007). We obtained institutional review approval for the study and gave all participants the option to complete an alternative task (two students chose this option). The faculty member that instructed this course had no other involvement with this study.

financial statements. Thirty percent of participants are female and 86 percent of participants speak English at home.[9]

INSERT TABLE 1 HERE

**Materials and Procedures**

The instrument has five parts: instructions (Part I), pre-experiment information (Part II), company information (Part III), experimental manipulations (Part IV), and manipulation/ attention checks and demographics (Part V). See Appendix D for experimental materials.[10] Figure 2 summarizes the information provided, manipulations introduced, and data collected in each part. Participants must complete these five parts in order and cannot return back to a completed part. However, participants can navigate between screens within each of five parts. Part II provides participants with a brief overview of the fair value hierarchy in ASC 820 and lists representative examples of measurement inputs for each level in the hierarchy. Part II also provides definitions and formulas for the financial statement ratios presented in the experiment.

INSERT FIGURE 2 HERE

Part III provides information from the Investor Relations department of Trans-Global, Ltd, a publicly-traded mid-sized specialty manufacturer of tools. This information includes a company description, a press release for its 2011 annual results, comparative industry information, the company's 2011 income statement, and fair value disclosures from the company's 2011 earnings release. The information indicates the company is generally performing well and compares favorably to industry averages. Additionally, the income statement indicates the company earned net income of approximately $182 million, which

[9] We use a series of *t*-tests for each of these descriptive variables to test the random assignment performed by Qualtrics. We find differences in some of these variables across cells (i.e., investing experience, personal investments in the stock market, evaluating a company's performance using financial statements, and full-time work experience). We discuss this further in the Methods section; our results are robust to controlling for these variables.
[10] We adapted the instrument used in Clor-Proell et al. (2014) and thank those authors for sharing the instrument.

includes an investment gain of $60.4 million. The fair value disclosures contain boilerplate descriptions of the input levels in the fair value hierarchy and specifically state: "The entire amount of the $60,400,000 investment gain relates to Level 3 investment securities".

Part III also presents a series of six questions. The first question solicits participants' assessments of Trans-Global's P/E multiple using a continuous scale from 10 to 20.[11] The next two questions ask participants to rate Trans-Global's potential for future earnings growth and the risk of an investment in Trans-Global's common stock, respectively, on a continuous scale from 1 to 10. The following three questions ask participants to rate the degrees of relevance, reliability, and faithful representation, respectively, of Trans-Global's financial statements, on a continuous scale from 1 to 10.[12] We use these pre-treatment measurements to control for idiosyncratic differences in post-treatment measurements of our dependent variables in Part IV.

Part IV contains all experimental manipulations.[13] In all cells, we provide information from the auditor's report that indicates the auditor issued an unqualified opinion (see Appendix D, Panels A and B). We also provide all participants with the company's fair value footnote, which contains required ASC 820 disclosures (Appendix D, Panel C, Section 1). Participants that receive the management disclosure treatment view information that describes the material measurement uncertainty inherent in the company's Level 3 Trading Securities and the related gain (Appendix D, Panel D).[14]

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[11] Following Clor-Proell et al. (2014) and Barton and Mercer (2005), the instrument conveys that (1) companies in this industry have historically had trailing P/E multiples ranging from 10 to 20, (2) a P/E multiple takes into account company and economy-wide factors, and (3) all else equal, higher P/E multiples result in higher stock prices.
[12] In these questions, we provide brief definitions of relevance and faithful representation derived from the joint FASB/International Accounting Standards Board (IASB) conceptual framework and a brief definition of reliability derived from the superseded FASB conceptual framework.
[13] We counter-balance manipulations to control for ordering effects.
[14] SEC guidance directs companies to "consider enhanced discussion and analysis of… critical accounting estimates and assumptions that… provides greater insight into the quality and variability of information regarding financial condition and operating performance" (SEC 2003). We adapted the wording for this manipulation from C*Acct*M discussions about Level 3 fair value measurements using annual reports for various public and private entities. Based on our own review of various C*Acct*M disclosures, the wording in these disclosures was particularly

We also administer the two auditor disclosure treatments in Part IV: auditor narrative disclosure and auditor visual disclosure. The information communicated in both of these treatments is identical. Both of these treatments indicate that the auditor's report contains a modification related to the reasonable assurance obtained over the company's "Investment gains" and "Level 3 trading securities". Both treatments indicate that the auditors audited these amounts by testing the processes that management used in developing the estimate. Both treatments also indicate that the auditors obtained reasonable assurance over a range of acceptable values and, although the reported amounts fall within a range of acceptable values, that range contains amounts that are materially different than the reported amount. Neither treatment mentions where the recorded point estimate falls within the acceptable range.

The auditor narrative disclosure and auditor visual disclosure treatments differ only in terms of presentation format. While auditor visual disclosure provides visual cues that identify the amounts in the financial statements to which this second-order information relates, auditor narrative disclosure does not. The auditor narrative disclosure treatment provides this second-order information and identifies the related amounts narratively in the body of the audit opinion (see Appendix D, Panel E). The auditor visual disclosure treatment includes a marked-up copy of the annual report as an attachment to the audit report (Appendix D, Panel F). In this marked-up copy, the auditor has labeled each amount with a letter (i.e., either an "A" or a "B"). The label "A" indicates the audit report does not contain specific second-order information about the respective amount. The label "B" indicates that the second-order information about material

transparent and forthcoming about (1) the judgment and uncertainty inherent in predicting future events, (2) the related measurement uncertainty and sensitivity of measurements to changes in assumptions, and (3) the possibility that estimates could change materially in the near-term. See Appendix B for examples of management disclosures about material measurement uncertainty.

measurement uncertainty in the body of the audit opinion relates to the respective amount. "B" appears next to the $60.4 million investment gain; "A" appears next to all other amounts.[15]

We designed both auditor disclosure treatments to operationalize a C*Aud*M disclosure in accordance with the PCAOB's proposed auditing standard for the auditor's reporting model (PCAOB 2016). Both treatments fulfill the proposed requirements that C*Aud*M disclosures: (1) identify the C*Aud*M, (2) describe the principal considerations that led the auditor to determine the matter is a C*Aud*M, (3) describe how the C*Aud*M was addressed in the audit, and (4) refer to the relevant financial statement accounts and disclosures that relate to the C*Aud*M (see PCAOB 2016, A1-9). The auditor narrative disclosure and auditor visual disclosure treatments differ only with respect to requirement (4).

Following the experimental manipulations in Part IV, participants complete the same six questions they responded to in Part III. Following Clor-Proell et al. (2014), we use participants' assessed P/E multiples from Part IV (i.e., post-treatment measures) as our dependent variable and control for participants' assessed P/E multiples from Part III (i.e., pre-treatment measures) in our models. Participants then complete an attention check question and a series of manipulation check questions in Part V. Following the experiment, we collect demographic information.

## IV. RESULTS

### Attention and Manipulation Checks

We include two questions to determine whether participants attended to the material measurement uncertainty inherent in the $60.4 million investment gain. Four of the 102 participants incorrectly answered a true/false question about whether the investment gain reflects

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[15] Providing participants with the marked-up income statement and marked-up summary of fair value disclosures in the auditor visual disclosure treatment re-exposed those participants to financial information. We therefore provided non-marked-up copies of both the income statement and the fair value disclosures to all participants that did not receive the auditor visual disclosure treatment to avoid a potential procedural confound.

significant management assumptions; we exclude these responses from the analyses. We also ask participants to rate the precision of the investment gain on a scale from one ("Not Precise at All") to seven ("Very Precise"). The mean response of 2.80 indicates that participants attended to the material measurement uncertainty construct.[16]

We also include closed-ended and open-ended manipulation check questions. In closed-ended questions, 18 of the remaining 98 did not correctly indicate the specific mechanism(s) used to communicate material measurement uncertainty.[17] We use open-ended questions to allow participants to demonstrate an understanding of how management and the auditor communicated material measurement uncertainty. Twelve of the 18 participants that missed a closed-ended question indicated a correct understanding of the respective disclosure mechanisms in the related open-ended question.[18] We exclude responses from the six participants who failed both the open- and closed- ended manipulation check questions, resulting in a final sample of 92.[19]

**Hypothesis Tests**

We present descriptive statistics on P/E judgments in Table 2. Table 3 presents results from our hypothesis-testing 2 X 3 ANCOVA model, which uses post-treatment P/E multiple assessments

[16] Measurement uncertainty is a component of estimation uncertainty, which is characterized by the distinct constructs of subjectivity and imprecision (e.g., Nelson, Smith, and Palmrose 2005; Bratten et al. 2013; Griffin 2014). Our attention check results show participants attended to both constructs.
[17] Four participants that did not receive either of the auditor disclosure treatments failed to indicate that the auditor's report contained no modifications to the standard wording. Four participants that received the management disclosure treatment failed to indicate that management communicated the material measurement uncertainty associated with the investment gain. Eight (two) participants that received the auditor narrative disclosure (auditor visual disclosure) treatment failed to indicate that the audit report communicated the material measurement uncertainty through an explanatory paragraph (labels in copies of financial statements).
[18] A second-year PhD student not associated with this project made these determinations. This individual was blind to the research questions and to experimental conditions. This individual has twelve years of public accounting experience and held the title of "Senior Manager" at a Big Four firm prior to entering a PhD program.
[19] Inferences are unchanged when we exclude all 18 participants that answered one or more closed-ended manipulation check questions incorrectly.

as the dependent variable and pre-treatment P/E multiple assessments as a covariate.[20] We present graphical illustrations of our results in Figure 3.

With respect to the random assignment performed by Qualtrics, we perform a series of *t*-tests to examine whether means of any descriptive variables differ between cells. Compared to participants in other conditions, participants that receive only the auditor visual disclosure treatment (i.e., Cell "E" in Table 2) less commonly made personal investments in the stock market and have less investing experience, less experience evaluating a company by analyzing its financial statements, and less full-time work experience. Similarly, participants that receive only the auditor narrative disclosure treatment (i.e., Cell "C") more commonly made personal investments in the stock market and have more investing experience and more experience evaluating a company by analyzing its financial statements. Our results are similar when we control for all possible combinations of these four variables and only full-time work experience approaches marginal significance when we include it in our 2 X 3 ANCOVA model ($F = 2.58$, $p = 0.11$, two-tailed). We therefore control full-time work experience in our hypothesis-tests.[21]

INSERT TABLES 2 AND 3 HERE

In our 2 X 3 hypothesis-testing ANCOVA model, we find a significant interaction between management disclosure and auditor communication ($F = 4.12$, $p < 0.01$, one-tailed). This is consistent with our predictions of conditional effects in H1, H2, and H3 and indicates that main effects in this model cannot be sensibly interpreted (Keppel and Wickens 2004, 197). We test H1 using the planned contrast in Table 3, Panel B (i.e., Cell A > [Cell B + Cell C + Cell D]/3). Consistent with H1, this contrast is significant ($F = 7.50$, $p < 0.01$). Additional pairwise

[20] This ANCOVA design enables us to use each participant as his/her own control when analyzing treatment effects (i.e., a pretest posttest design). Clor-Proell et al. (2014) note that controlling for pre-treatment measures is preferable to analyzing changes. We obtain similar results when analyzing changes in participants' P/E multiple assessments.
[21] Results are essentially the same, and inferences are unchanged, when we exclude this control from the model.

comparisons show that the effect of auditor narrative disclosure is negative when management disclosure is absent ($F = 4.05$, $p = 0.02$, one-tailed) and the effect of management disclosure is negative when auditor narrative disclosure is absent ($F = 6.07$, $p < 0.01$, one-tailed). Further consistent with H1, pairwise comparisons indicate that the effect of auditor narrative disclosure is insignificant when management disclosure is present ($F = 0.02$, $p = 0.89$, two-tailed) and that the effect of management disclosure is insignificant when auditor narrative disclosure is present ($F = 0.20$, $p = 0.65$, two-tailed).[22] This pattern of results suggests a substitution effect, whereby fully-narrative C*Aud*M disclosures do not influence nonprofessional investors' valuation judgments when management provides robust supplemental C*Acct*M disclosures.

H2 predicts that visual cues will facilitate nonprofessional investors' weighting of second-order information in valuation decisions. Research shows that several user groups consider second-order information in C*Aud*M disclosures to be "bad news" (e.g., Backof et al. 2014; Christensen et al. 2014; Kachelmeier et al. 2014; Brasel et al. 2016). Therefore, in conditions where management disclosure is absent, we expect participants who weight second-order information to assess lower P/E multiples than those who do not. We test this prediction using the planned pairwise comparisons in Table 3, Panel C. Consistent with H2, participants assess marginally lower P/E multiples when only auditor visual disclosure is present (Cell E) than when only auditor narrative disclosure is present (Cell C) ($F = 2.30$, $p = 0.07$, one-tailed). P/E multiple assessments in Cell E are also lower than those across Cell C and Cell D (i.e., both conditions with the auditor narrative disclosure treatment) ($F = 97.53$, $p < 0.01$). Collectively, our H1 and H2 results suggest that while second-order information is value-relevant,

[22] We also use the "two one-way significance tests" approach to test whether adjusted P/E multiple assessments in Cell D are statistically equivalent to those in Cell C and Cell B. Consistent with H1, mean adjusted P/E multiple assessment in Cell D are lower than the upper limit and higher than the lower limit of the 95% confidence interval of the adjusted mean for both Cell B ($F = 3.56$, $p = 0.03$ and $F = 2.38$, $p = 0.06$, respectively) and Cell C ($F = 6.44$, $p = 0.01$ and $F = 1.67$, $p = 0.10$, respectively) (see Table 3, Panel B; all $p$-values are one-tailed).

nonprofessional investors do not weight this information when it is presented in a fully-narrative format. Additionally, visual cues facilitate this weighting.

INSERT TABLE 3 HERE

Our third hypothesis predicts that participants will incorporate management disclosure in their valuation judgments differently under an auditor narrative disclosure regime versus an auditor visual disclosure regime. Following market signaling theory (e.g., Spence 1973; Healy and Palepu 1993), we predict that robust supplemental first-order information (i.e., in the management disclosure treatment) will mitigate potential negative effects of second-order information (i.e., in the auditor communication treatments) on P/E multiple assessments. Following H1 and H2, we further predict the mitigating effect of management disclosure will exist in an auditor visual disclosure regime, but not in an auditor narrative disclosure regime. We test H3 using the planned pairwise comparisons in Table 3, Panel D. Consistent with H3, participants assess P/E multiples higher in response to the management disclosure treatment when auditor visual disclosure is present (i.e., Cell F > Cell E; $F = 2.80$, $p < 0.05$), but not when auditor narrative disclosure is present (i.e., Cell C vs. Cell D; $F = 0.20$, $p = 0.65$). Further, the effect of management disclosure is different (i.e., less negative or more positive) in the auditor visual disclosure regime than in the auditor narrative disclosure regime (i.e., [Cell F - Cell E] > [Cell D - Cell C]; $F = 2.30$, $p = 0.07$). If managers attend to this signaling potential, these results suggest that visual cues in auditor reports may promote transparency around material measurement uncertainty through enhanced supplemental C*Acct*M disclosures.

INSERT FIGURE 3 HERE

**Additional Analyses**

While we ran our experiment using a fully factorial 2 X 2 X 2 design, we omit from our empirical analyses certain cells that reflect situations we would not expect to see in practice.

Including cells where auditor narrative disclosure and auditor visual disclosure interact introduces noise and reduces model power. However, results using a fully factorial 2 X 2 X 2 ANCOVA model (untabulated) yield inferences that are identical to those from our hypothesis-testing model. We further analyze our data using a two separate 2 X 2 ANCOVA models to test the respective auditor narrative disclosure and auditor visual disclosure regimes. Results from a 2 X 2 ANCOVA with management disclosure (absent versus present) and auditor narrative disclosure (absent versus present) yield the same inferences with respect to H1 as our hypothesis-testing model. Additionally, comparing results from this 2 X 2 ANCOVA model with results from a 2 X 2 ANCOVA model with management disclosure and auditor visual disclosure (absent versus present) yields the same inferences with respect to H3 as our hypothesis-testing model.

## V. CONCLUSION

We jointly examine the value relevance of first-order and second-order information about material measurement uncertainty. We also examine whether visual cues in auditor reports influence the way nonprofessional investors weight both first-order and second-order information about material measurement uncertainty in their valuation judgments. Our results reveal that robust supplemental management disclosures and fully-narrative auditor disclosures are substitutes in communicating information about underlying material measurement uncertainty to nonprofessional investors. This is consistent with research that does not find an effect of auditor disclosures on security prices (e.g., Lennox et al. 2015) and suggests that auditor disclosures become more important when management does not provide robust supplemental disclosures. Our results also reveal that nonprofessional investors react more strongly to second-order information when auditor disclosures provide visual cues. Collectively, these results suggest that nonprofessional investors weight second-order information when auditor disclosures include visual cues, but not when audit reports present disclosures in a fully-narrative format.

Our results also reveal that visual cues change the way nonprofessional investors weight both first-order and second-order information about material measurement uncertainty. Consistent with market signaling theory (e.g., Spence 1973), nonprofessional investors assess *higher* P/E multiples in response to robust supplemental management disclosures when audit reports communicate second-order information using visual cues. These results suggest that visual cues in auditor reports will incentivize managers to provide robust supplemental C*Acct*M disclosures. Future research might examine how managers respond to these incentives.

Our findings incrementally contribute to prior research on three dimensions. First, we jointly examine the value relevance of first-order and second-order information about material measurement uncertainty. We draw the critical distinction between first-order C*Acct*M information and second-order C*Aud*M information. We also clarify that both C*Acct*M disclosures and C*Aud*M disclosures provide *different* information about the *same* underlying issues. Second, we demonstrate the importance of presentation format and visual cues in communicating second-order information about material measurement uncertainty. Collectively, our findings suggest that the valuation implications of C*Aud*M disclosures are conditional on the presentation format of these disclosures and the quality of management's C*Acct*M disclosures.

Third, we identify visual cues currently used by auditors in practice that appear to facilitate users' weighting of disclosed information. In doing so, we contribute to research on recognition versus disclosure (e.g., Bernard and Schipper 1994; Davis-Friday et al. 1999; Hirshleifer and Teoh 2003; Davis-Friday et al. 2004; Ahmed et al. 2006; Müller, Reidl, and Sellhorn 2015). Namely, our findings suggest visual cues can help bridge the documented gap in the decision usefulness of recognized versus disclosed accounting information.

Our findings have interesting implications for regulation, practice, and future research. Visual cues can be readily used in the context of the proposed PCAOB requirement that C*Aud*M disclosures "identify the relevant financial statement accounts and disclosures that relate to critical auditing matters" (PCAOB 2016, A1-9). C*Aud*M disclosures can relate to many amounts in different places throughout an annual report. Our findings suggest that effective implementation of this requirement will directly influence whether users can process the second-order information in these disclosures. The PCAOB has not yet addressed the potential implementation of this proposed requirement; our findings can inform conversations among financial reporting stakeholders about potential upcoming implementation decisions.

Additionally, the FASB and SEC allow issuers significant discretion in implementing disclosure practices related to material measurement uncertainty (SEC 2003; FASB 2010a). Research, in turn, suggests significant (and sometimes strategic) variation exists in these disclosure practices (e.g., Ettredge et al. 2011; Ernst and Young 2014). Our findings highlight the importance of robust supplemental disclosures in reducing information asymmetry around material measurement uncertainty. Our findings also imply that managers can use robust supplemental disclosures to mitigate potentially detrimental valuation effects of C*Aud*M disclosures. If managers attend to this signaling potential, visual cues in auditor reports may promote transparency from management. Future research can continue to examine how changes to the auditors' reporting model might influence managers' discretionary disclosure practices. Future research might also examine management's use of visual cues to link recognized amounts to disclosed information.

Our experimental materials reflect two design choices that we made to maximize consistency with practice and facilitate valid theoretical inferences using our sample of MBA student participants. First, based on feedback during pilot testing, we used the following wording to introduce the auditor narrative disclosure and auditor visual disclosure treatments "The auditor's report contains the following **one modification** to the standard wording of a **clean**

**opinion**" (emphasis in instrument). It is possible that some participants incorrectly inferred that the auditor issued a qualified opinion. However, we would expect participants that draw such an inference to take incremental price protection and we do not observe this response to either treatment in our results. Second, due to the format in the auditor narrative disclosure and auditor visual disclosure treatments, the ordering of information differs, by necessity, between these treatments. To control for potential recency effects, we designed our instrument such that the last piece of information that we convey in both conditions is the amounts that relate (and do not relate) to the C*Aud*M. We communicate this information narratively (visually) in the auditor narrative disclosure (auditor visual disclosure) treatment. Additionally, it is difficult to predict whether and how primacy or recency effects would influence our results.

Our study is subject to certain limitations. We explore only specific types of management and auditor disclosures and only one level of material measurement uncertainty. Unexplored levels of each of these three independent variables could have a different effect on investor decision making than those we document in the present study. We focus on those possibilities that seem most feasible given the current state of financial accounting and auditor regulation. We also acknowledge that the effects of our treatments likely depend on the significance of the account in question. Future research can examine management and auditor disclosures related to ranges of acceptable values for estimates that reflect material measurement uncertainty. Future research can also examine whether the effects of auditor disclosures differ for aggressive versus conservative (or neutral) estimates. Further, this study measures investors' reaction to a novel new disclosure (C*Aud*Ms) and novel visual cues. It is possible that the effects we detect will change over repeated exposures that act to reduce this novelty.

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## APPENDIX A
## Excerpts from a Recent Letter to an Underwriter

Note: Below are excerpts from an actual recent Agreed Upon Procedures Letter issued by a large international accounting firm. These excerpts illustrate auditor visual disclosure. Omitted wording is indicated by an "..." and redacted identifying information has been replaced with a string of "X"s.

***Panel A: Wording in Body of Comfort Letter***

"...We have not audited any financial statements of XXXXX as of any date or for any period subsequent to XXX 3X, 20XX. Although we have conducted an audit for the year ended XXX 3X, 20XX, the purpose (and therefore the scope) of the audit was to enable us to express our opinion on the consolidated financial statements as of XXX 3X, 20XX and for the year then ended, but not on the consolidated financial statements for any interim period within that year. Therefore, we are unable to and do not express any opinion on the unaudited consolidated financial information as of and for the four-month periods ended XXX 3X, 20XX and 20XX, included in the Preliminary Official Statement, or on the financial position, results of operations, or cash flows as of any date or for any period subsequent to XXX 3X, 20XX...

At your request, we have read the items identified by you on the attached pages of the Preliminary Offering Statement and have performed the procedures indicated in Attachment A, which were applied as indicated with respect to the letters explained therein...

**Attachment A to the Letter Dated XXX XX, 20XX**
**XXXXX, Inc.**

*In all instances where we compared amounts, percentages or ratios and found such amounts, percentages or ratios to be in agreement, such agreement is after rounding or truncating as deemed appropriate by XXXXX, Inc. and Affiliates ("XXXXX"). In addition, we make no comment as to reasons for any increase or decrease, or as to the specific components of the amount or percentage or the definitions of certain terms.*

Letter key to certain procedures:

(A) Compared or agreed to amount or amount derived from the audited consolidated financial statements of XXXXX as of XXX 3X, 20XX and 20XX, and for the years then ended... and found them to be in agreement after giving effect to rounding, if applicable...

(B) Compared the amount to XXXXX's internally generated accounting records and related schedules and found it to be in agreement after giving effect to rounding, if applicable.

(C) Recalculated based on amounts in XXXXX's audited consolidated financial statements noted in (A) above and found the amounts to be in agreement after giving effect to rounding, if applicable. However, we make no comment with respect to any indicated causal relationship.

(D) Recalculated based on amounts from XXXXX's internally generated accounting records and related schedules and found them to be in agreement after giving effect to rounding, if applicable. However, we make no representation as to the completeness of these analyses or to any indicated causal relationships..."

**APPENDIX A**
**Excerpts from a Recent Letter to an Underwriter (continued)**

***Panel B: Excerpts from Preliminary Offering Statement referenced in letter in Panel A ("Circle-ups")***

Note: The Preliminary Offering Statement contains several sections. The excerpts below are from the "Selected Statistical and Financial Information" section and the "Management's Discussion and Analysis" section.

**SELECTED STATISTICAL AND FINANCIAL INFORMATION**
**XXX, INC. AND AFFILIATES**
**SUMMARY CONSOLIDATED STATEMENTS OF OPERATIONS** (1)

(000's Omitted)

A B

| | Fiscal Year Ended XX 3X, | | | Four Months Ended XX 3X, | |
|---|---|---|---|---|---|
| | 20XX | 20XX | 20XX | 20XX | 20XX |
| NET XXX XXX REVENUE | $1,060,811 | $1,080,368 | $1,114,102 | $372,783 | $381,259 |
| OTHER OPERATING REVENUE | 44,505 | 44,967 | 51,107 | 16,334 | 17,521 |
| TOTAL REVENUE | 1,105,316 | 1,125,335 | 1,165,209 | 389,117 | 398,780 |
| EXPENSES: | | | | | |
| XXX | 439,368 | 448,370 | 454,514 | 151,552 | 156,674 |
| XXX | 139,931 | 138,261 | 125,637 | 46,242 | 46,174 |
| XXX | 91,574 | 94,231 | 94,377 | 31,540 | 30,437 |
| XXX | 41,647 | 42,655 | 42,222 | 14,525 | 13,465 |
| XXX | 63,170 | 63,407 | 60,290 | 20,127 | 19,704 |
| XXX | 17,124 | 15,866 | 15,575 | 5,270 | 5,159 |
| XXX | 39,017 | 37,480 | 36,225 | 13,086 | 14,872 |
| Other Expenses | 228,142 | 222,750 | 244,393 | 84,462 | 89,564 |
| TOTAL EXPENSES | 1,059,973 | 1,063,020 | 1,073,233 | 366,804 | 376,049 |
| INCOME FROM OPERATIONS | 45,343 | 62,315 | 91,976 | 22,313 | 22,731 |
| NON-OPERATING GAINS (LOSS), NET | 13,211 | (6,260) | 7,694 | 10,859 | 4,337 |
| EXCESS OF REVENUE OVER EXPENSES | $58,554 | $56,055 | $99,670 | $33,172 | $27,068 |

(1) Refer to Appendix B for disclosure on the results of the financials had XXX been solely-sponsored on a historical basis for Fiscal 20XX and 20XX.

(2) Includes interest expense reflected in non-operating gains, net of $8,038 (20XX), $8,958 (20XX), $10,156 (20XX) and $3,459 and $4,052 for the four months ended XXX 3X, 20XX and 20XX, respectively.

A B B A

**APPENDIX A**
**Excerpts from a Recent Letter to an Underwriter (continued)**

***Panel B (continued): Excerpts from Preliminary Offering Statement referenced in letter in Panel A ("Circle-ups")***

Note: The Preliminary Offering Statement contains several sections. The excerpts below are from the "Selected Statistical and Financial Information" section and the "Management's Discussion and Analysis" section.

## MANAGEMENT'S DISCUSSION AND ANALYSIS

**Four Months Ended January 31, 2012** D

B

For the four months ended XXX 3X, 20XX ("*Fiscal Period 20XX*"), income from operations of $22.7 million was $0.4 million better than the prior fiscal year ("*Fiscal Period 20XX*"). Operating cash flow approximated Fiscal Period 20XX.

B D D

XXXXX at most XXXXX locations were down slightly and, in total, were 1.1% lower than Fiscal Period 20XX. Management had planned for flat XXXXX compared to the prior year. Gross XXXXXX and XXXXX revenue in Fiscal Period 20XX was $20.0 million higher than Fiscal Period 20XX as a result of increased XXXXX volumes and XXXXX intensity. The XXXXX and XXXXX mix was somewhat higher in Fiscal Period 20XX compared to Fiscal Period 20XX, resulting in an increased XXXXX ratio. This has been a continued trend. Other Operating Revenue was $1.2 million higher than Fiscal Period 20XX, which was primarily driven by $1.5 million of revenue recorded in relation to XXXXX payment from XXXXX.

## APPENDIX B
## Example management disclosures of material measurement uncertainty

Below are excerpts from recent audited annual reports and practitioner guidance that we used in developing the Management Disclosure treatment.

***Company A (privately held technology company): Goodwill Footnote***

"It is at least reasonably possible that management's estimate resulting in an impairment not being recorded will change in the near term and the effects of the change could be material to the financial statements."

***Company B (RDK 10/1/2013 10-K): Critical Accounting Policy disclosures in MD&A***

"The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions about future events that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosures of contingent assets and liabilities. Future events and their effects cannot be determined with absolute certainty. Therefore, management's determination of estimates and judgments about the carrying values of assets and liabilities requires the exercise of judgment in the selection and application of assumptions based on various factors including historical experience, current and expected economic conditions and other factors believed to be reasonable under the circumstances. Actual results could differ from those estimates. The Company constantly reviews the relevant, significant factors and makes adjustments where the facts and circumstances dictate.

Management has identified the following accounting policies as the most critical in the preparation of the Company's financial statements because they involve the most difficult, subjective or complex judgments about the effect of matters that are inherently uncertain."

***Guide to annual financial statements - Illustrative disclosures for banks (KPMG 2013): Fair Value Footnote***

"For more complex instruments, the Group uses proprietary valuation models, which are usually developed from recognized valuation models. Some or all of the significant inputs into these models may not be observable in the market, and are derived from market prices or rates or are estimated based on assumptions. Examples of instruments involving significant unobservable inputs include certain over-the-counter (OTC) structured derivatives, certain loans and securities for which there is no active market and retained interests in securitizations (as discussed below). Valuation models that employ significant unobservable inputs require a higher degree of management judgment and estimation in the determination of fair value. Management judgment and estimation are usually required for selection of the appropriate valuation model to be used, determination of expected future cash flows on the financial instrument being valued, determination of the probability of counterparty default and prepayments and selection of appropriate discount rates."

**Appendix C**
**Example of Auditor Disclosure of Material Measurement Uncertainty without Accompanying Supplemental Management Disclosure**

**Note**: Panel A and Panel B below contain excerpts from the 2015 Heineken N. V. Annual Report (Heineken 2015). Panel A includes all of the first-order information about returnable packaging deposits that management provided in the Annual Report (i.e., only the reported amount of the related liability). Panel B includes the excerpt from Deloitte's opinion that identifies a "key audit matter" around the valuation of the liability for returnable packaging deposits.

**Panel A: Management disclosure of liability (page 114)**

**31. Trade and other payables**

| In millions of EUR | Note | 2015 | 2014 |
|---|---|---|---|
| Trade payables | | 2,797 | 2,339 |
| Accruals and deferred income | | 1,270 | 1,211 |
| Taxation and social security contributions | | 806 | 802 |
| Returnable packaging deposits | | 606 | 580 |
| Interest | | 131 | 132 |
| Derivatives | | 89 | 104 |
| Dividends | | 46 | 45 |
| Other payables | | 268 | 320 |
| | 32 | 6,013 | 5,533 |

<u>**Note**</u>: Management does not provide a narrative explanation of these returnable packaging deposits anywhere in the annual report.

**Panel B: Auditor disclosure of material measurement uncertainty in liability (page 143)**

*Returnable packaging – valuation of deposit liability*
During the course of business the Company provides returnable packaging to its customers. In most instances the Company collects deposits for returnable packaging. A particular area of judgement is involved in assessing the value of the deposit liability. There is a risk that the assumptions used in the calculation of the liability for returnable packaging are unreasonable, which could result in an incorrect valuation of the liability for returnable packaging. As a response to this risk we performed, amongst others, substantive procedures on the Company's calculation of the returnable packaging liability, focusing on the valuation and completeness of the deposit liability.

**APPENDIX D**
**Experimental materials**

***Panel A: Default audit report information***

Note: Participants that did not receive either the Auditor Narrative Disclosure or Auditor Visual Disclosure Treatments (i.e., Cell A and Cell B) viewed the following information related to the company's audit report in Part IV.

**INFORMATION ON THE INDEPENDENT AUDITOR'S REPORT**

The company's auditors issued a **clean opinion**[1] on the 2011 and 2010 financial statements and footnotes. The auditor's report contains **no modification** to the standard wording of a **clean opinion**.

[1] A **clean opinion** is issued when the independent auditor believes that the company's financial statements are sound; that is, the statements are fairly and appropriately presented, and in accordance with GAAP. A **clean opinion** is the most common type of auditor's report and is referred to in auditor vernacular as an **"unqualified opinion."**

***Panel B: Audit report information when modifications are present***

Note: Participants that received either the Auditor Narrative Disclosure treatment (i.e., Cell C and Cell D) or the Auditor Visual Disclosure treatment (i.e., Cell E and Cell F) viewed a screen with the following information related to the company's audit report in Part IV.

**INFORMATION ON THE INDEPENDENT AUDITOR'S REPORT**

The company's auditors issued a **clean opinion**[1] on the 2011 and 2010 financial statements and footnotes. The auditor's report contains the following **one modification** to the standard wording of a **clean opinion (click ahead to view the modification)**:

[1] A **clean opinion** is issued when the independent auditor believes that the company's financial statements are sound; that is, the statements are fairly and appropriately presented, and in accordance with GAAP. A **clean opinion** is the most common type of auditor's report and is referred to in auditor vernacular as an **"unqualified opinion."**

**APPENDIX D**
**Experimental materials (continued)**

***Panel C: Default annual report information***

*Section 1: Baseline measurement uncertainty information*

Note: Participants that did not receive the Auditor Visual Disclosure treatment viewed this information, exactly as presented below, in Part IV (i.e., Cell A, Cell B, Cell C, and Cell D). Participants that received the Auditor Visual Disclosure treatment viewed this information, as presented in Panel F, Section 3 of this appendix, in Part IV (i.e., Cell E and Cell F). Because the Auditor Visual Disclosure treatment contains this information by design, we also provided this information to participants that did not receive the Auditor Visual Disclosure treatment to avoid an information confound.

The Fair Value Accounting Footnote from TransGlobal's 2011 annual report provides additional information on the "Investment gains" of $60,400,000 reported in its 2011 income statement. The footnote states the following:

> "The Company uses fair value accounting for its trading securities. Fair value is measured based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions. These two types of inputs create the following hierarchy:
>
> - Level 1 – Quoted prices for identical instruments in active markets
> - Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable
> - Level 3 – Model-derived valuations that reflect the Company's own assumptions and projections"

Additionally, the footnote contains standard disclosures that show the following:

- The entire amount of the $60,400,000 investment gain relates to "Level 3 investment securities."

**APPENDIX D**
**Experimental materials (continued)**

***Panel C: Default annual report information (continued)***

*Section 2: Income statement*

Note: Participants that did not receive the Auditor Visual Disclosure treatment viewed this information, exactly as presented below, in Part IV (i.e., Cell A, Cell B, Cell C, and Cell D). Participants that received the Auditor Visual Disclosure treatment viewed this information, as presented in Panel F, Section 3 of this appendix, in Part IV (i.e., Cell E and Cell F). Because the Auditor Visual Disclosure treatment contains this information by design, we also provided this information to participants that did not receive the Auditor Visual Disclosure treatment to avoid an information confound.

**SELECTED ANNUAL REPORT INFORMATION**

Below is a copy of the income statement included in the Annual Report
(**Note**: The amounts are identical to those in the Earnings Release in Part A.)

**Trans-Global Exports, Ltd.**
**Statement of Comprehensive Income**
**For the year ended December 31, 2011**
(Amounts in thousands except per share data)

| | **2011** |
|---|---|
| Net sales | $2,716,256 |
| Cost of goods sold | 1,831,250 |
| Gross profit | 885,006 |
| Selling, general & administrative expenses | 402,500 |
| Income from operations | 482,506 |
| Investment gains | 60,400 |
| | 542,906 |
| Interest expense | 252,378 |
| Income before income taxes | 290,528 |
| Income tax | 108,571 |
| Net income | 181,957 |
| Earnings Per Share | $1.82 |
| Shares Outstanding | 100,000 |

**APPENDIX D**
**Experimental materials (continued)**

***Panel D: Management Disclosure treatment***

**INFORMATION ON THE NOTES TO THE AUDITED FINANCIAL STATEMENTS AND MANAGEMENT'S DISCUSSION AND ANALYSIS**

The company has included disclosures in the notes to the audited financial statements (**"Footnotes"**) and management's discussion and analysis (**"MD&A"**) sections of its annual report that indicate the following:

- Management made assumptions about future events in estimating the fair value of the Level 3 Trading securities and the related gains on these investments. Future events and their effects cannot be determined with absolute certainty. Therefore, the measurement of these amounts required significant judgment.
- Management calculated the fair value of the Level 3 Trading securities and the related gains on these investments using a proprietary model, i.e., one that was developed "in-house" and by using company-specific assumptions.
- Management considered reasonable alternative assumptions in making these estimates, and these alternative assumptions yielded amounts that are materially different than the amounts ultimately reported in the financial statements.
- **It is at least reasonably possible that management's estimate resulting in an Investment Gain will change in the near term and the effects of the change could be material to the financial statements. (A change is material if it is important enough to influence decisions of financial statement users.)**

***Panel E: Auditor Narrative Disclosure treatment***

Note: Participants that received the Auditor Narrative Disclosure treatment viewed the information below (i.e., Cell C and Cell D).

**Modification # 1: The auditor's report includes an explanatory paragraph, which states that the amounts reported as "Investment gains" and "Level 3 trading securities" in the financial statements and footnotes are materially imprecise estimates**. This explanatory paragraph further indicates the following information:

- The auditors evaluated the reasonableness of these amounts by reviewing and testing the process used by management to develop the estimate.
- For these materially imprecise estimates, the auditors obtained reasonable assurance over a range of acceptable values. Although the amounts reported in the financial statements are each within a range of acceptable values, that range contains amounts that are materially different than the amount ultimately reported in the financial statements.
- For all amounts reported in the financial statements, other than the amounts reported as "Investment gains" and "Level 3 trading securities," the auditors obtained reasonable assurance that the reported amount is free from material misstatement.

**APPENDIX D**
**Experimental materials (continued)**

***Panel F: Auditor Visual Disclosure treatment***

Note: Participants that received the Auditor Visual Disclosure treatment viewed the information in Section 1, Section 2, and Section 3 of this panel (i.e., Cell E and Cell F). Participants that did not receive the Auditor Visual Disclosure treatment did not view this information.

*Section 1: Language in auditor's report*

**Modification # 1: The auditor's report contains language that describes the nature of the audit procedures performed over different amounts in the financial statements. The auditor has indicated the nature of the procedures performed for each amount in the financial statements by placing a letter (i.e., either "A" or "B") next to each reported amount.** The language in the auditor's report indicates the following:

A. For amounts labeled with an "A," the auditors obtained reasonable assurance that the reported amount is free from material misstatement.

B. The amounts labeled with a "B" are materially imprecise estimates. The auditors evaluated the reasonableness of these amounts by reviewing and testing the process used by management to develop the estimate, and the auditors obtained reasonable assurance over a range of acceptable values. Although the amounts reported in the financial statements are each within a range of acceptable values, that range contains amounts that are materially different than the amount ultimately reported in the financial statements.

**APPENDIX D**
**Experimental materials (continued)**

***Panel F: Auditor Visual Disclosure treatment (continued)***

*Section 2: Audit report attachments (Income Statement)*

Note: The following information appeared below the image in Appendix D, Panel F, Section 1. Participants that did not receive the Auditor Visual Disclosure treatment (i.e., Cell A, Call B, Cell C, and Cell D) viewed the information in Appendix D, Panel C, Section 1 in Part IV to avoid an information confound.

**SELECTED ANNUAL REPORT INFORMATION FROM AUDITOR'S REPORT**

Below is a copy of the income statement included in the auditor's report (**Note**: The amounts are identical to those in the Earnings Release in Part A.)

**Trans-Global Exports, Ltd.**
**Statement of Comprehensive Income**
**For the year ended December 31, 2011**
(Amounts in thousands except per share data)

| | 2011 | |
|---|---|---|
| Net sales | $2,716,256 | A |
| Cost of goods sold | 1,831,250 | A |
| Gross profit | 885,006 | |
| Selling, general & administrative expenses | 402,500 | A |
| Income from operations | 482,506 | |
| Investment gains | 60,400 | B |
| | 542,906 | |
| Interest expense | 252,378 | A |
| Income before income taxes | 290,528 | |
| Income tax | 108,571 | A |
| Net income | 181,957 | |
| Earnings Per Share | $1.82 | |
| Shares Outstanding | 100,000 | |

**APPENDIX D**
**Experimental materials (continued)**

***Panel F: Auditor Visual Disclosure treatment (continued)***

*Section 3: Audit report attachments (Fair Value Footnote)*

Note: The following information appeared below the image in Appendix D, Panel F, Section 2. Participants that did not receive the Auditor Visual Disclosure treatment (i.e., Cell A, Call B, Cell C, and Cell D) viewed the image in Appendix D, Panel C, Section 2 in Part IV to avoid an information confound.

**SELECTED ANNUAL REPORT INFORMATION FROM THE AUDITOR'S REPORT**

Below is a summary of the Fair Value Disclosures included in the Auditor's Report. (**Note**: The amounts are identical to those in the Earnings Release in Part A.)

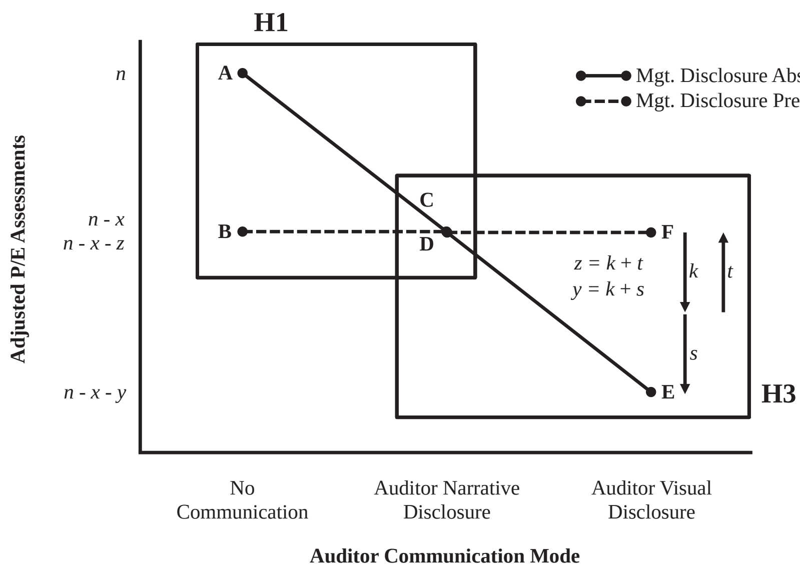
The Fair Value Accounting Footnote from TransGlobal's 2011 annual report provides additional information on the "Investment gains" of $60,400,000 B reported in its 2011 income statement. The footnote states the following:

> "The Company uses fair value accounting for its trading securities. Fair value is measured based upon observable and unobservable inputs. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions. These two types of inputs create the following hierarchy:
>
> - Level 1 – Quoted prices for identical instruments in active markets
> - Level 2 – Quoted prices for similar instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose inputs are observable
> - Level 3 – Model-derived valuations that reflect the Company's own assumptions and projections"

Additionally, the footnote contains standard disclosures that show the following:

- The entire amount of the $60,400,000 (B) investment gain relates to "Level 3 investment securities." This amount is labeled with a "B."

**FIGURE 1**
**Illustration of Hypotheses**




**<u>HYPOTHESES</u>**

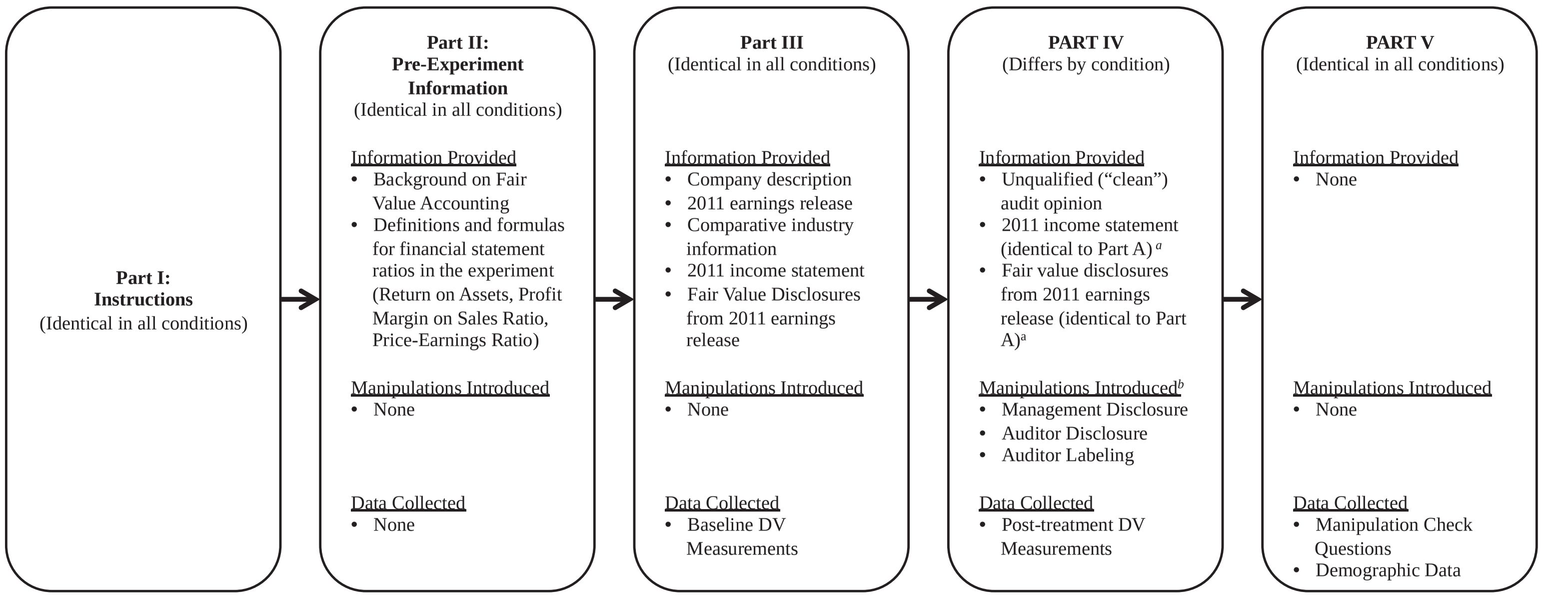
**H1:** D = B
D = C
A > (B + C + D) / 3

**H2:** E < C

**H3:** (F – E) > (D – C)

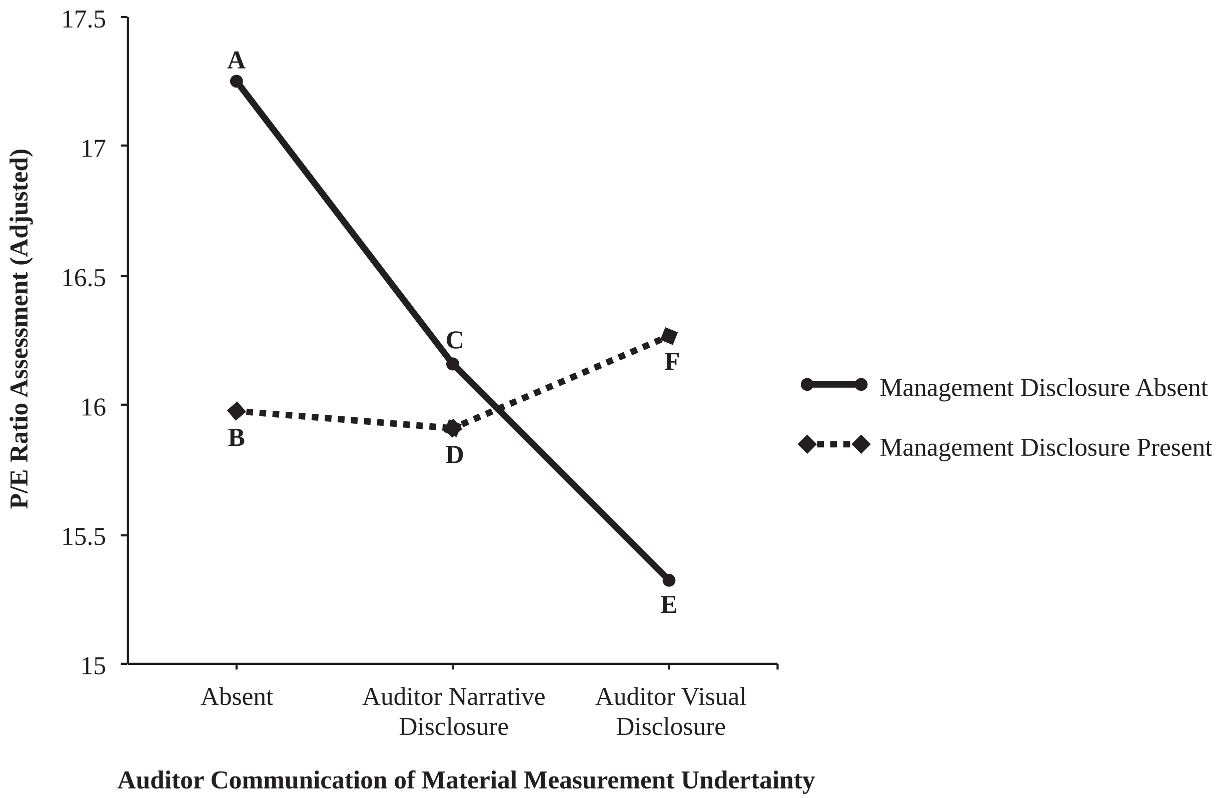
**Note:** The labels on this graph represent our operational dependent and independent variables, which differ slightly from the terms we use when developing theoretical predictions. Management disclosure corresponds to robust supplemental C*Acct*M disclosures from management. Auditor narrative disclosure corresponds to fully-narrative C*Aud*M disclosures. Auditor visual disclosure corresponds to C*Aud*M disclosures with visual cues. The mapping of cells A through F in this figure corresponds to the mapping in Table 2 (i.e., Management Disclosure is absent in Cell C and present in Cell D). With respect to H2 and H3, $y$ represents the valuation effect of second-order information when management does not provide supplemental C*Acct*M disclosures. This is comprised of 1) the discount attributable to the second-order information about material measurement uncertainty (i.e., $k$) plus 2) the discount attributable to the lack of supplemental C*Acct*M disclosures (i.e., $s$). Thus, $y = k +$ s. Additionally, $z$ represents the discount attributable to second-order information when management does provide supplemental C*Acct*M disclosures. This is comprised of 1) the discount attributable to the second-order information about material measurement uncertainty (i.e., $k$) plus 2) the premium attributable to the signaling effect of robust supplemental C*Acct*M disclosures (i.e., $t$). Thus, $z = k + t$.

**FIGURE 2**
**Overview of Experimental Instrument and Procedures**




Notes: Participants can navigate between screens within each of the five parts of the experiment. Participants must complete the experiment in order and must complete each part before navigating to the next part. Participants cannot navigate back to a completed part of the experiment. [a] We provide these items to participants in conditions where the Auditor Visual Disclosure treatment is absent only. The Auditor Visual Disclosure treatment includes versions of these materials that include auditor-defined labels and that are presented as part of the auditor's report. We include copies of both the 2011 income statement and the fair value disclosures from the 2011 earnings release in conditions where the Auditor Visual Disclosure treatment is absent to avoid a potential procedural confound. [b] We counter balance all manipulations to control for order effects. We utilize all potential treatment orderings, except for [Auditor Narrative Disclosure – Management Disclosure – Auditor Visual Disclosure] and [Auditor Visual Disclosure – Manager Disclosure – Auditor Narrative Disclosure], which interrupt the presentation of the auditor's report.

**FIGURE 3**
**Valuation Judgment Results**
**(2 X 3 ANOVA with Management Disclosure and Auditor Communication)**




**Notes**: The *dependent variable* is participants' P/E multiple assessments on a scale from 10 to 20 after viewing any experimental manipulations, adjusted for variation in participants' P/E multiple assessments prior to viewing manipulations. We manipulate *Management Disclosure* at two levels (present or absent), between participants. Participants that receive the *Management Disclosure* treatment view robust supplemental C*Acct*M disclosures related to measurement uncertainty inherent in a Level 3 investment. There is no reference to these C*Acct*M disclosures in conditions where *Management Disclosure* is absent. We manipulate *Auditor Communication* at three levels, between participants. Participants in all conditions learn that the auditor issued an unqualified opinion. Participants in the *Auditor Disclosure Absent* condition learn that there are no modifications to the standard wording of an unqualified opinion. Participants that receive the *Auditor Narrative Disclosure* treatment view information from a C*Aud*M disclosure in the audit report that narratively identifies the related amounts. Participants that receive the *Auditor Visual Disclosure* treatment view information from a C*Aud*M disclosure in the audit report that visually identifies the related amounts. The mapping of cells A through F in this figure corresponds to the mapping in Figure 1 and Table 2.

**TABLE 1**
**Descriptive Statistics for Participants' Education, Work, and Investing Experience**

| | | **Overall n = 127** |
|---|---|---|
| Full-time work experience (in years) | Median | 5.00 |
| | Mean | 5.86 |
| | SD | 3.16 |
| Number of accounting courses completed | Median | 1.00 |
| | Mean | 1.84 |
| | SD | 1.53 |
| Number of finance courses completed | Median | 1.00 |
| | Mean | 1.70 |
| | SD | 2.14 |
| Age (in years) | Median | 28.00 |
| | Mean | 28.91 |
| | SD | 3.54 |
| Investing experience (in years) | Median | 2.00 |
| | Mean | 3.35 |
| | SD | 4.39 |
| GMAT Score | Median | 650 |
| | Mean | 643.02 |
| | SD | 66.85 |
| Percent who have made personal investments in the stock market | | 47% |
| Percent who have previously evaluated a company's performance by evaluating financial statements | | 65% |
| Percent who are female | | 30% |
| Percent who speak English at home | | 86% |

**TABLE 2**
**P/E Multiple Assessment Descriptive Results**

***Panel B: Adjusted P/E Multiple Assessments from 2 X 3 ANOVA with Management Disclosure and Auditor Communication (absent vs. auditor narrative disclosure vs. auditor visual disclosure): Adjusted Mean (SE) [n] Cell***

| | | **Management Disclosure:** | |
|---|---|---|---|
| | | Absent | Present |
| **Auditor Communication:** | Absent | 17.25<br>(0.39)<br>[15]<br>A | 15.98<br>(0.34)<br>[19]<br>B |
| | Auditor Narrative Disclosure | 16.16<br>(0.38)<br>[15]<br>C | 15.91<br>(0.40)<br>[14]<br>D |
| | Auditor Visual Disclosure | 15.32<br>(0.39)<br>[15]<br>E | 16.27<br>(0.40)<br>[14]<br>F |

**Note**: This table presents *Adjusted P/E Multiple Assessment*, which represent participants' P/E multiple assessments after viewing any experimental manipulations, adjusted for variation in participants' P/E multiple assessments prior to viewing any experimental manipulations. A lower *Adjusted P/E Multiple Assessment* indicates a stronger effect of the manipulation(s) on participants' judgments. Participants assess P/E multiples on an 11-point scale anchored by 10 and 20.

**TABLE 3**
**Hypothesis Testing Models**

***Panel A: 2 X 3 ANOVA – Management Disclosure × Auditor Communication (Model 1)***

| Source | Sum of Squares | df | *F* | *p > F* |
|---|---|---|---|---|
| Management Disclosure | 0.85 | 1 | 0.38 | 0.27 |
| Auditor Communication | 11.23 | 2 | 2.53 | 0.04 |
| Management Disclosure × Auditor Communication **(Test of H1)** (one-tailed *p*-value) | 18.29 | 2 | 4.12 | 0.01 |
| Pre-treatment P/E assessment | 228.21 | 1 | 102.82 | 0.00 |
| Full-time work experience | 5.73 | 1 | 2.58 | 0.11 |
| Error | 186.44 | 84 | | |

***Panel B: Tests of H1***

| Test | *F* | *p > F* |
|---|---|---|
| **Planned Contrast** | | |
| Cell A > (Cell B + Cell C + Cell D)/3 (one-tailed *p*-value) | 7.50 | 0.00 |
| **Planned Pairwise Comparisons** | | |
| Cell A > Cell C (one-tailed *p*-value) | 4.05 | 0.02 |
| Cell A > Cell B (one-tailed *p*-value) | 6.07 | 0.01 |
| Cell B = Cell D | 0.02 | 0.89 |
| Cell C = Cell D | 0.20 | 0.65 |
| **Equivalence Tests (two one-way significance tests approach)**[a] | | |
| Cell $D_{MEAN}$ < Cell $B_{UL}$ (one-tailed *p*-value)[a] | 3.56 | 0.03 |
| Cell $D_{MEAN}$ > Cell $B_{LL}$ (one-tailed *p*-value)[a] | 2.38 | 0.06 |
| Cell $D_{MEAN}$ < Cell $C_{UL}$ (one-tailed *p*-value)[a] | 6.44 | 0.01 |
| Cell $D_{MEAN}$ > Cell $C_{LL}$ (one-tailed *p*-value)[a] | 1.67 | 0.10 |

***Panel C: Tests of H2***

| Planned Pairwise Comparisons | *F* | *p > F* |
|---|---|---|
| Cell E < Cell C (one-tailed *p*-value) | 2.30 | 0.07 |
| Cell E < (Cell C + Cell D) (one-tailed *p*-value) | 97.50 | 0.01 |

***Panel D: Tests of H3***

| Planned Pairwise Comparisons | *F* | *p > F* |
|---|---|---|
| Cell F > Cell E (one-tailed *p*-value) | 2.80 | 0.05 |
| (Cell F - Cell E) > (Cell D - Cell C) (one-tailed *p*-value) | 2.30 | 0.07 |

[a] Two one-way significance tests ("TOSTs") test the equivalence of two samples by testing the joint hypothesis that the mean of one sample is less than the upper bound and greater than the lower bound of a specified confidence interval around the mean of the other sample. Following Schuirmann (1987), we test the equivalence of Cell D to Cell B (Cell C) by testing whether the mean of Cell D is less than [greater than] the upper limit [lower limit] of the 95% confidence interval of the adjusted mean for Cell B (Cell C).

**Note: See notes on next page.**

**TABLE 3**
**Hypothesis Testing Models (continued)**

**Notes:** The *dependent variable* is participants' P/E multiple assessments on a scale from 10 to 20 after viewing any experimental manipulations, adjusted for variation in participants' P/E multiple assessments prior to viewing manipulations. We manipulate *Management Disclosure* at two levels (present or absent), between participants. Participants that receive the *Management Disclosure* treatment view robust supplemental C*Acct*M disclosures related to measurement uncertainty inherent in a Level 3 investment. There is no reference to these C*Acct*M disclosures in conditions where *Management Disclosure* is absent. We manipulate *Auditor Communication* at three levels, between participants. Participants in all conditions learn that the auditor issued an unqualified opinion. Participants in the *Auditor Disclosure Absent* condition (*Auditor Communication* = 0) learn that there are no modifications to the standard wording of an unqualified opinion. Participants that receive the *Auditor Narrative Disclosure* treatment (*Auditor Communication* = 1) view information from a C*Aud*M disclosure in the audit report that narratively identifies the related amounts. Participants that receive the *Auditor Visual Disclosure* treatment (*Auditor Communication* = 2) view information from a C*Aud*M disclosure in the audit report that visually identifies the related amounts. *Full-time work experience* is measured as the number of years of full-time work experience reported by the participant. *Pre-treatment P/E assessment* represents the P/E multiple assessed by the participant prior to viewing any manipulations. See a mapping of cell references in Table 2. *p*-values for tests of hypotheses with directional predictions are one-tailed, as noted; other *p*-values are two-tailed.

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August 15, 2016

VIA E-MAIL: comments@pcaobus.org

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

**RE: PCAOB Rulemaking Docket Matter No. 034**

Dear Members of the Board and Staff:

Dixon Hughes Goodman LLP (DHG) welcomes the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2016-003, *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (Proposed Standard). Headquartered in Charlotte, NC, DHG ranks among the top 20 public accounting firms in the nation, with more than 2,000 professionals and staff in 12 states, and is a member of Praxity, a global alliance of independent firms.

DHG is supportive of the PCAOB's efforts in modernizing the auditor's report to provide information that is of critical need to stakeholders, while maintaining the value of the 'pass-fail' opinion. We also commend the PCAOB for their significant outreach efforts in developing a balanced approach that considers the views of numerous stakeholders, as well as developments within the international markets. We believe the enhancements within the Proposed Standard generally align with those of the International Auditing and Assurance Standards Board (IAASB); in particular, the concept of Critical Audit Matters (CAM) with the IAASB's concept of Key Audit Matters.

This letter includes our views, observations, and recommendations on the Proposed Standard. Our responses are framed by our experiences serving middle-market public issuers and non-issuer brokers and dealers, and include our concerns regarding the potential implications the Proposed Standard could have for smaller to medium-sized accounting firms.

## Overview

Overall, DHG is supportive of enhancing the CAM definition towards material issues discussed with the audit committee. We also support the Board's non-prescriptive approach to the auditor describing how a CAM was addressed in the audit, including providing certain elements for the auditor's consideration[1] that generally align with similar elements included within International Standard on Auditing 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (ISA 701).[2] Further, we believe the language preceding the description of the CAM clearly articulates that the communication of CAMs should not be interpreted as altering the level of assurance on any aspect of the auditor's report, including

[1] Page 31, Proposed Standard.
[2] Paragraph A46, ISA 701.

the identified CAMs. In addition, given the level of professional judgment inherent in CAMs, we believe the profession will greatly benefit from the illustrative examples depicting CAM communications.

Outside of CAMs, we are supportive of enhancing the wording of the auditor's report in relation to independence and the auditor's responsibilities regarding financial statement notes and obtaining reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. We also support moving the opinion paragraph to the beginning of the auditor's report, which more closely aligns with the auditing standards of the IAASB.

Despite these numerous enhancements, we believe there are certain areas within the Proposed Standard that could negatively affect the profession; in particular the potential litigation risk of the audit firm being the source of original (and potentially confidential) information about a company.[3] As the auditor is responsible for opining on the information that comprises the financial statements, we believe any information communicated within the auditor's report should be limited to information opined upon, and not include information that is of original (or confidential) nature. Furthermore, appreciating the Board's interest, we continue to question the value of including auditor tenure in the auditor's report. Evidence about the impact of audit tenure on audit quality continues to be inconclusive, and there is a concern that disclosing tenure could imply there is negative correlation between auditor tenure and audit quality.

We have provided certain comments and recommendations below regarding these points as well as other matters detailed within the Proposed Standard.

## Source of Original Information

*Determination of Potential CAMs*

DHG supports limiting the source of potential CAMs to those matters communicated or required to be communicated to the audit committee, adding a materiality component that directly relates accounts and disclosures to the CAM definition, and focusing on matters that involve especially challenging, subjective, or complex auditor judgment in the audit. We believe, in totality, these enhancements would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of CAMs within the auditor's report that could deemphasize their importance. However, despite these advancements in narrowing the CAM definition, there is still risk, in certain situations, that the auditor could divulge original (and potentially confidential) information about the company, whether through the identified CAM or within the practical considerations in determining the CAM.

For instance, a significant deficiency within a company's system of internal control over financial reporting (ICFR) by itself is not a material matter to the financial statements. However, a significant deficiency is a required communication to the audit committee that typically relates to one or more accounts or disclosures that are material to the financial statements, and could meet the proposed CAM definition, if the matter involved especially challenging, subjective or complex auditor judgment. There also may be situations where accounts or disclosures, by themselves, would not likely be considered CAMs, but due to a related significant deficiency in the company's ICFR, could lead the auditor to identify these accounts

[3] For the purpose of our response, original information is information about a company's financial statements and other financial information or its system of internal control over financial reporting that is the responsibility of the company's management to consider for disclosure.

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or disclosures as CAMs, and therefore would require communication of the significant deficiency as a principal consideration that led to the CAM determination.

Under both scenarios, management has no similar requirement to disclose a significant deficiency under the SEC rules, and it is unclear, if such information is communicated in the auditor's report, whether this could result in a breach of client confidentiality and expose the auditor to related litigation or disciplinary action under contract and state law.[4] Regardless, we do not believe auditors should publicly communicate information, which is the responsibility of management, particularly in instances where the auditor could be at risk of potentially violating certain laws and regulation.

*Communication in the Auditor's Report*

In considering the potential risk of communicating original information about a company, the Proposed Standard includes a note that indicates that when describing a CAM, the auditor is not expected to provide information that has not been made publicly available. However, the same note also includes a statement that allows the auditor to provide such information if it was necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit.[5] Although we support the inclusion of a statement that explains the expectations of the auditor not providing original (and potentially confidential) information about a company, it is inappropriate to include a seemingly contradictive statement that allows for communication of such information in certain circumstances.

Allowing for the inclusion of original information (regardless of the situation) within the auditor's report could possibly expose the auditor to certain ethic codes and other regulatory violations, and effectively impose disclosure thresholds on management that go beyond the applicable financial reporting framework or SEC reporting requirements. Therefore, we strongly encourage the Board to consider removing this statement from Note 2 of the Proposed Standard.

Furthermore, the Board should specifically describe in the Proposed Standard that the auditor is not responsible for providing original information about the company in the auditor's report; and we recommend the Board revise Note 2 of the Proposed Standard as follows:

> "When describing critical audit matters in the auditor's report the auditor ~~is not expected to~~ **should not** provide information about the company that has not been made publically available by the company ~~unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit~~."

*CAM Communication Illustrations*

In considering potential challenges audit firms may face in implementing the Proposed Standard, we commend the Board for recognizing the need for application guidance by providing illustrative CAM communications examples.[6] We believe such illustrations could be a valuable resource to audit firms in guiding their expanded communications, and we strongly encourage the Board to include similar illustrations in the final standard.

---

[4] For instance, the Supreme Court has ruled in the past that persons cannot be held liable under Section 10(b) and Rule 10b-5 unless they actually "make" a statement (Janus Capital Group v. First Derivative Traders 131 S. Ct. 2296 - 2011).

[5] Note 2, paragraph 14, Proposed Standard.

[6] Pages 32 – 35, Proposed Standard.

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In providing such guidance, however, it is important to clearly articulate the purpose of the illustrations (e.g., illustrate how the auditor may describe the principal considerations that led the auditor to determine that the matter is a CAM), how they correlate with the minimum requirements of the standards, and not imply the need for additional disclosures outside those requirements. For instance, the illustrations within the Proposed Standard appear to include context associated with management's processes[7] and strategies,[8] and audit information[9] that are beyond the scope of the auditor's communication requirements.[10] We believe this is inconsistent with the Board's intention of providing a non-prescriptive approach to describing how a CAM was addressed in the audit,[11] and we encourage the PCAOB to revise the illustrations to correlate with, and limit any suggested disclosures outside of, the auditor's communication requirements.

*Legal Liability Implications*

The advancements made within the Proposed Standard, in particular narrowing CAMs to matters communicated to the audit committee and incorporating the concept of materiality, mitigates the increased legal liability associated with expanding auditor reporting, as compared to past proposals.[12] However, despite these advancements, there is still an increased level of litigation risk under both federal and state law, particularly in disclosing original (and potentially confidential) client information. We believe our recommendations above provide a basis for diminishing these concerns and strongly encourage the Board to consider these revisions within the final standard.

## Additional Considerations in Determining CAMs

Appreciating the Board's efforts to limit the potential number of CAMs as compared to prior proposals, we believe determining whether a matter is a CAM will still require significant auditor judgment. The Proposed Standard provides additional guidance in the form of factors auditors should take into account in determining whether a matter involves especially challenging, subjective, or complex auditor judgment.[13]

Although we support the inclusion of these factors, we believe there are opportunities to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures. For instance, in considering the degree of auditor subjectivity in paragraph 12b of the Proposed Standard, we believe the auditor should focus on procedures executed to obtain sufficient and appropriate audit evidence related to the matter under consideration, as opposed to focusing on overall audit strategy decisions in designing audit procedures to obtain sufficient appropriate evidence. Therefore, we recommend removing 'determining' from paragraph 12b of the Proposed Standard, and focus the auditor on procedures applied to address the matter under consideration or in evaluating the results of those procedures.

---

[7] For instance, details on management's processes in developing the loss rate within the *Allowance for Loan Losses* illustration (Pages 32 – 33, Proposed Standard).
[8] For instance, details related to management's strategies included within the *Accounting for Acquisition* illustration (Pages 33 – 35, Proposed Standard).
[9] For instance, details related to testing of the company's system of internal control over financial reporting within both illustrations (Pages 32 – 35, Proposed Standard).
[10] Paragraphs 13 and 14, Proposed Standard.
[11] Page 31, Proposed Standard.
[12] See PCAOB Rulemaking Docket Matter No. 34: Release No. 2011-003 – Concept Release, Release No. 2013-005 – Proposed Rule.
[13] Paragraph 12, Proposed Standard.

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Additionally, paragraph 12f of the Proposed Standard focuses on the 'nature of audit evidence,' which is a component in obtaining sufficient appropriate audit evidence. However, paragraph 12c of the Proposed Standard references to the 'nature and extent of audit effort required in addressing the matter,' which may also have a general correlation to sufficient appropriate audit evidence.

To limit any potential application concerns, we encourage the PCAOB to link the factors within paragraph 12 to PCAOB Auditing Standard No 15, *Audit Evidence*, which explains what constitutes audit evidence and establishes requirements regarding designing and performing audit procedures to obtain sufficient appropriate audit evidence. This could be accomplished by removing paragraph 12f and revising paragraph 12c, to provide enhanced linkage between the nature and extent of audit effort to sufficient appropriate audit evidence obtained.

## Auditor Tenure

Appreciating the Board's efforts in this area, DHG does not support inclusion in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor (i.e., audit firm tenure). There is no empirical evidence supporting a correlation between audit tenure and audit quality, and the inclusion of such information in the auditor's report could imply such a correlation exists. If the PCAOB continues to believe this information is of relevance, as audit committees are responsible for the oversight of external auditors, they may be in the best position to consider providing this information.

The Securities and Exchange Commission (SEC) issued a concept release[14] seeking stakeholder input on potential enhancements to disclosures for audit committees, specifically requesting comment on a number of possible changes to existing SEC disclosure requirements regarding the audit committee's oversight of the external auditor, including information about the length of the audit relationship in the audit committee's report. Therefore, we encourage the PCAOB, in considering a potential alternative location, to collaborate with the SEC to determine whether audit committees should consider disclosing this information within the proxy statement or the audit committee report.

## Effective Date Considerations

In considering an appropriate effective date, careful consideration should be given to the anticipated costs and efforts expected to be incurred by audit firms in ensuring appropriate processes are in place to comply with the Proposed Standard. For instance, audit firms would need to develop quality control processes and staff training programs to ensure auditors are appropriately identifying and documenting the consideration of CAMs. We would also anticipate substantially expanded communications between auditors, preparers and audit committees, particularly in evaluating the potential effect of the additional auditor communications in the auditor's report.

We believe that these extensive implementation efforts could place a significant and possibly disproportionate burden on smaller and medium-size accounting firms (and their clients). Therefore, in considering an effective date that provides an ample implementation period for audit firms of all sizes, while providing timely, reliable information to financial statement users, we strongly encourage the Board to consider a phased-in implementation approach, as follows:

- Phase 1 – Applicable to large accelerated filers for audit periods ending at least two years subsequent to the SEC's approval of the final rule.

[14] See Concept Release No. 33-9862, Possible Revisions to Audit Committee Disclosures.

DHG
DIXON HUGHES GOODMAN LLP

- Phase 2 – Applicable to accelerated and non-accelerated filers one year after the Phase 1 effective date.

We believe such an approach would also allow the Board, possibly through its Post-Implementation Review Process, to evaluate whether the Proposed Standard is accomplishing its intended purpose. As part of this evaluation, the PCAOB should solicit feedback from stakeholders (e.g., preparers, investors, audit committees) to identify, wherever possible, costs and benefits, and potential unanticipated consequences associated with the Proposed Standard.

## Applicability

DHG is supportive of not requiring the identification, communication, and documentation of CAMs in the auditor's report for non-issuer brokers and dealers, investment companies (that are not business development companies), and employee benefit plans (i.e., employee stock purchase, savings, and similar plans). However, we believe the requirements of the Proposed Standard, in its entirety, should apply to audits of emerging growth companies, as they exhibit characteristics similar to other public companies and financial statement users would benefit from similar reporting requirements.

* * * *

DHG is supportive of providing financial statement users additional transparency into the audit and believes the Proposed Standard provides a general basis for expanding auditor disclosure. We appreciate the opportunity to comment on the Proposed Standard and are pleased to discuss any questions the Board and its Staff may have concerning our comments. Please direct any questions to Dave Hinshaw, Managing Partner, Professional Standards Group (dave.hinshaw@dhgllp.com) and Jeffrey Rapaglia, Partner, Professional Standards Group (jeff.rapaglia@dhgllp.com).

Sincerely,

*Dixon Hughes Goodman LLP*

Dixon Hughes Goodman LLP

Edison Electric INSTITUTE

American Gas Association

August 12, 2016

Phoebe W. Brown, Secretary
Public Company Accounting Oversight Board
1666 K Street, NW
Washington, DC 20006-2803

**File Reference: PCAOB Rulemaking Docket Matter No. 034**

Dear Ms. Brown:

The Edison Electric Institute (EEI) and American Gas Association (AGA) respectfully submit our comments on the Public Company Accounting Oversight Board's (Board) reproposed auditing standard – *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* ("reproposed standard"), PCAOB Rulemaking Docket Matter No. 034.

EEI is the association that represents all U.S. investor-owned electric companies. EEI members provide electricity for 220 million Americans, operate in all 50 states and the District of Columbia, and directly and indirectly create jobs for more than one million Americans. With more than $100 billion in annual capital expenditures, the electric power industry is responsible for millions of additional jobs. EEI has dozens of international electric companies as International Members and hundreds of industry suppliers and related organizations as Associate Members. Organized in 1933, EEI provides public policy leadership, strategic business intelligence, and essential conferences and forums.

AGA, founded in 1918, represents 202 local energy companies that deliver clean natural gas throughout the U.S. There are more than 70 million residential, commercial and industrial natural gas customers in the U.S., of which almost 93 percent – more than 65 million customers – receive their gas from AGA members. AGA is an advocate for natural gas utility companies and their customers and provides a broad range of programs and services for member natural gas pipelines, marketers, gatherers, international gas companies and industry associates. Today, natural gas meets almost one-fourth of the energy needs in the U.S.

EEI and AGA appreciate the Board's efforts to enhance the form and content of the auditor's report to make it more relevant and informative to investors and other financial

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statement users. We agree that financial statement users should have access to timely, accurate, objective and relevant information for purposes of making investment decisions.

We understand the Board has taken into consideration the comments and additional feedback received from the original 2013 proposal and modified the definition of what would be included as critical audit matters ("CAMs"), including limiting the sources of potential CAMs, and adding a materiality component. However, we continue to have significant concerns with certain aspects of the reproposed standard, specifically, the disclosure of CAMs and auditor tenure in the auditor's report, as described in our response below.

We are aware that some regulators outside the U.S. are also considering or have made changes to the independent auditor's report. Should the PCAOB proceed with some version of this reproposal, we urge the Board to adopt a more principles-based approach to the definition of a CAM, similar to the IAASB. The IAASB defines Key Audit Matters "as those matters that, in the auditor's professional judgment, were of most significance to the audit of the financial statements in the current period. Key audit matters are selected from matters communicated with those charged with governance."

Notwithstanding these considerations, we continue to believe that it is inappropriate to include such a disclosure in the auditor's report for the reasons we describe in detail below.

**Critical Audit Matters**

The reproposed standard states that it is intended to respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's expertise or mandate. However, we believe that CAM disclosure would result in the imposition of requirements beyond the auditor's mandate as the independent auditor in that it would require the auditor to become a primary source of a company's financial information.

The reproposal asserts that the current form of the auditor's report does little to address the information asymmetry between investors and auditors brought on by the increased complexity of financial reporting. While we respect the Board's efforts to reduce this information asymmetry, we believe that it is inappropriate to address this concern through mandating disclosures by the auditor. Accordingly, as discussed further below, we do not believe that the disclosure of CAMs in the auditor's report provides investors with useful and relevant information on which to make investment decisions. In addition, we do not believe it is the role of the auditor to determine or highlight specific areas of the financial statements for increased investor focus.

*The Role of the Auditor*

The auditor's role is to express an opinion on the financial statements taken as a whole, which assists an investor's decision by stating whether the financial statements are in conformity with GAAP. The auditor's principal considerations that led to the determination that a matter is a CAM, and how the CAM was addressed in the audit, would only provide the reader insight into the *audit process*, not insight into the quality of the financial statements and, therefore, would provide little benefit to investors in making their decisions.

Regardless of the language included in the proposed auditor's report, inclusion of CAMs could be interpreted by some as the auditor expressing reservations in their report, or providing a "piecemeal" opinion. This could undermine the value of the auditor's opinion concerning whether the financial statements are presented in accordance with GAAP.

*The Role of the Audit Committee*

If CAMs are required to be disclosed in the auditor's report, the auditor may become the source of original and confidential information, which would diminish both the governance role of the audit committee as well as management's responsibility for the company's disclosure of financial information. We believe the audit committee is uniquely qualified to ensure that a company's various risks and issues have been adequately addressed during the audit and disclosed in a company's periodic filings, as considered necessary, because it has access to the full Board of Directors, company management and the auditors. The role of the auditor is to verify that the audit committee has adequately performed this responsibility.

*Purpose of the Financial Statements and the Auditor's Report*

GAAP and SEC rules have been designed to help companies determine what information should be provided to financial statement readers. These rules already require disclosure of critical accounting estimates, assumptions, risks and uncertainties, as well as an issuer's significant accounting policies. Given the volume of disclosures required for complex or subjective areas of accounting, we believe that financial statement users can already determine for themselves which areas are likely to be subject to a higher level of audit scrutiny.

In addition, we do not believe that directing a financial statement user's attention to specific areas of the financial statements and related note disclosures adds value. All disclosures in the financial statements and notes are included because they are material to the financial statements. It is the responsibility of the investor to review a company's periodic filing in its entirety. Providing a "roadmap" to direct financial statement users' attention to specific areas of the filing undermines the relevance of other areas that are not referred to in the auditor's report. Those areas may contain the same level of investment risk as a CAM but may not be required to be disclosed as such in the auditor's report.

*FASB and SEC Procedures Govern Financial Report Disclosures*

If stakeholders believe that better "roadmaps" are needed to guide investors to high risk areas in the financial statements, the most appropriate means for doing so is for the FASB and the SEC to provide guidance through their respective disclosure projects. The FASB and the SEC continue to update and refine disclosure requirements, and the issue of information asymmetry between a company and its investors should be addressed through those projects, which are intended to improve the effectiveness of information provided to investors.

The FASB's Disclosure Framework initiative is designed to assist investors in determining which financial statement items are significant to the company by allowing companies to provide disclosures that focus on those areas that are most relevant and important and eliminating those disclosures that are of less significance, thereby reducing "disclosure overload." The SEC's Disclosure Effectiveness initiative is seeking feedback on whether the current business and financial requirements in Regulation S-K provide useful information to readers and whether specific disclosure requirements in Regulation S-X could be changed or eliminated to avoid redundancy with GAAP and improve disclosure effectiveness.

Guidance provided through these FASB and SEC disclosure projects, rather than through an unprecedented expansion of the independent auditor's report, will ensure that users' attention is directed to areas of investment risk, *not audit risk*, as those risks by definition may not be the same.

*Supporting Research*

Section VI. C. 1. a. of the proposal notes that *"Overall, the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements."* Because the current research is inconclusive, we recommend that the Board obtain more thorough and conclusive evidence that CAMs provide investors with additional information that could influence investment decisions before including these additional auditor disclosure requirements in a final standard.

**Auditor Tenure**

We do not believe that the proposal adequately substantiates why auditor tenure information is important and useful to financial statement readers. Without a clear understanding of that importance and usefulness, we believe readers may misinterpret the information. Specifically, and as discussed further below, we believe that the inclusion of auditor tenure in the auditor's report could lead to incorrect and even erroneous inferences about possible correlations between auditor tenure, auditor independence, and audit quality. If the Board believes that information on auditor tenure is important and relevant to readers, we believe that the Board should provide additional, more conclusive research and information as to what readers should infer from a shorter or longer tenure, in order to avoid misinterpretation of the data.

For example, does longer auditor tenure indicate that the independence of the auditor or the quality of the audit performed might be compromised or of lower quality than those performed by an auditor with a shorter auditor tenure? Or might it indicate that the auditor has more experience with and insight into the complexities of the company it is auditing? Likewise, should investors consider not ratifying the appointment of an auditor if that auditor has a longer tenure? Or conversely, should investors be more likely to ratify an auditor with a longer tenure?

*Tenure and Audit Quality*

We believe that the disclosure of auditor tenure in the auditor's report could lead to readers making erroneous conclusions about the correlation between audit quality and auditor tenure. As stated in the reproposed standard, academic research on the relationship between auditor tenure and audit quality has produced inconsistent conclusions. Many readers of the auditor's report and financial statements are likely unaware of the range and potentially conflicting implications of these research conclusions.

Contrary to the presumption that long auditor tenure leads to reduced audit quality, some research shows that audit engagements with short-term auditor tenure are relatively *riskier* and that audit quality is *improved* when auditors have time to gain expertise in the company under audit and in the related industry. Therefore, we believe it is inappropriate to imply that there is a correlation between shorter tenure and improved audit quality, which could lead to incorrect inferences about that correlation. This, in turn, could result in investor inquiries or requests that are an inefficient use of management and audit committee time. It could also lead to faulty investor decisions based upon a presumed correlation that is not accurate.

*Tenure and Auditor Independence*

We also believe that the disclosure of auditor tenure in the auditor's report could incorrectly imply that there is a relevant relationship between auditor independence and auditor tenure. The feedback received on the Board's Release No. 2011-006 *Concept Release on Auditor Independence and Audit Firm Rotation* indicated that constituents did not agree that requiring audit firm rotation would lead to an increase in audit quality. We believe that required audit partner rotation sufficiently addresses any potential independence issues, and implying that there is a link between auditor independence and audit firm tenure is inconsistent with the feedback received on Release No. 2011-006.

In addition, we believe that there may actually be a higher risk that a new audit firm has not acquired the level of expertise and knowledge necessary in specialized industries to provide an audit of at least the same quality as a longer-tenured audit firm. Therefore, even if one assumes that a new audit firm may have a higher degree of independence, audit quality may be lower as a result of an auditor change.

*Cost-Benefit Analysis*

The release does not provide definitive research as to the benefit of this information to readers, other than to provide an example that information on auditor tenure could be used in "*understanding the audit committee's oversight of the auditor or in deciding whether to ratify the appointment of the auditor.*" The Board also indicates that one of the benefits of the proposal is reduced search costs related to readers searching for auditor tenure information.

However, the Board has not provided any information showing that significant costs are currently being incurred by users seeking this information. Our industry would be disadvantaged if readers began to correlate a longer audit tenure with reduced audit quality or reduced auditor independence because many of the audit committees of companies in our industry believe that the quality of our audits and audit firms are top-notch and, therefore, have not changed auditors in many years.

We believe that there are a limited number of audit firms with strong knowledge, experience and expertise in our specialized industry, and therefore changing auditors could result in ratification of a new auditor that would require significantly higher costs and effort to assure that it had the necessary expertise to provide a high-quality audit. As such, if our investors made incorrect assumptions about tenure and quality, and accordingly did not vote to ratify the appointment of the existing auditor simply because of a longer tenure, the risk of a lower-quality audit being performed would be higher, and significant additional costs of changing auditors would be incurred, thereby not justifying any perceived benefits.

If the Board decides to require disclosure of auditor tenure, we strongly believe such information should be included outside of the auditor's report to avoid misconceptions about the relationship between tenure and quality, and tenure and independence. For example, the Board could consider including this information in Form AP or in a consistent location within the proxy statement. The proxy statement may be more appropriate if research indicates that one of the main uses of this information would be to help investors decide whether to ratify the appointment of the auditor.

**Conclusion**

As discussed above, we do not support the inclusion of CAMs or auditor tenure in the auditor's report. We urge the Board to reconsider these proposals. We believe that auditor reporting of CAMs could decrease the relevance of the audit report and diminish the role of the audit committee. We also believe that disclosure of auditor tenure is unnecessary and, because of inconclusive and contradictory evidence about correlations with audit quality and independence, could result in misinterpretation by readers. If such disclosure is required, we believe it should be required elsewhere, such as within Form AP or the annual proxy statement.

* * * * * * *

EEI and AGA appreciate the opportunity to provide our input on the reproposed standard. We would be pleased to discuss our comments and to provide any additional information that you may find helpful.

Very truly yours,

/s/ Richard F. McMahon, Jr.
Richard F. McMahon, Jr.
Vice President

/s/ Patrick J. Migliaccio
Patrick J. Migliaccio
Senior Vice President & Chief Financial Officer
Chairman of the American Gas Association Accounting Advisory Council

August 12, 2016

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

**Re: PCAOB Rulemaking Docket Matter Number 034**

Dear Madam Secretary:

We are pleased to submit our comments on the *Proposed Auditing Standard, PCAOB Release No. 2016-003 on Rulemaking Docket Matter #034 ("Re-Proposal")*. We serve as the Audit Committees ("Committee") for Edison International (NYSE:EIX) and Southern California Edison Company. Edison International ("Edison" or the "Company"), an integrated energy company, generates and distributes power, primarily through its wholly owned subsidiary, Southern California Edison Company, serving 14 million people across a 50,000 square mile area in Southern California. Our following comments are based not only on our experience serving Edison, but also from our experiences as senior leaders in business, academia and government.

**Auditor's Report**

Our corporate governance system consists of shareholders electing the Board of Directors ("Board"), as their representatives, to provide management oversight. The Board, in turn, delegates to the Audit Committee oversight of financial reporting, including the system of internal controls and risk management. The Audit Committee has sole authority to retain the independent auditor ("Auditor") and, therefore, primary responsibility for the assessment and approval of those services. Management is responsible for the financial statements and disclosures in accordance with the United States' Generally Accepted Accounting Principles ("GAAP") and Securities and Exchange Commission ("SEC") rules and regulations.

The Public Company Accounting Oversight Board's ("PCAOB") states that the Re-Proposal is attempting to resolve the information asymmetry that exists between consumers of financial reports and preparers of those reports, including third parties such as the independent accountants. We have a fundamental belief that consumers of financial reports desire information about the subject of the report, the company itself. This includes the risks and issues facing the company, the company's financial results and the critical judgments and estimates that are made in preparing the financial results. Moreover, experienced and knowledgeable consumers read management's financial reports as a whole, including the Risk Factors and Management's Discussion and Analysis as required by the SEC. We believe the audit committee has the requisite knowledge, perspective and authority to oversee that the

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reporting entity's management discloses these matters in a manner commensurate with their materiality and relevance to investors. Any information asymmetry should be dealt with by revisions to GAAP and SEC disclosure rules and not through the PCAOB. Nevertheless, we recognize that some Independent Auditor Regulators outside the U.S. have or will be requiring changes to the Independent Auditor's Report. As a result, the remainder of our comments will focus on two aspects of the Re-Proposal—Critical Audit Matters and Auditor Tenure.

We commend the PCAOB efforts to consider comments made to the Proposal Release No. 2013-005 and make improvements in this Re-Proposal to the Auditor's Report, such as its decision to retain the current "pass/fail" model of the Auditor's report and the introduction of the concept of materiality.

The Re-Proposal defines a Critical Audit Matter ("CAM") as any matter that was communicated or required to be communicated to the Audit Committee that involves audit specific information which is determined to be either challenging, subjective or complex and is material to the financial statements and related disclosures. The SEC requires management to disclose matters for which information is incomplete and the financial impact is not known but which might develop into a significant or material matter. The Audit Committee and often, even the Board, are informed promptly of these matters. The Audit Committee oversees management's financial reporting and disclosure process and the Auditor provides an independent assessment of the disclosures. The timing of when a matter rises to the level of materiality varies. The introduction of materiality in deciding what constitutes a CAM could cause the Auditor to include a matter whose level of materiality has not yet been determined for fear of being second-guessed by a PCAOB inspector.

Materiality is both a quantitative and qualitative assessment. The Audit Committee approves the Auditor's audit plan which includes quantitative materiality levels. These quantitative materiality levels can increase or decrease as the financial year progresses due to different business conditions, and the Auditor informs the Audit Committee of such quantitative changes. A matter might meet the quantitative materiality level as presented in the audit plan but may not meet both the quantitative and qualitative materiality assessment relative to the business and the financial statements, taken as a whole.

The Auditor's Report reader could place inappropriate weight on the CAM instead of disclosures provided by management in the financial statements and Management Discussion and Analysis of Financial Condition and Results of Operations (including critical accounting policies and estimates.) CAMs could also duplicate Management's disclosures. Conversely, if a matter is excluded from the Auditor's Report and later develops into a material matter and a CAM, both the Auditor and the Audit Committee could be subject to criticism and litigation. Finally, the likely expansion of the Auditor's Report from the inclusion of CAMs could be very confusing to many of its readers.

We encourage the PCAOB to adopt a more principled-based approach to the definition of a CAM, similar to the IAASB. The IAASB defines Key Audit Matters "as those matters, that in the Auditor's professional judgment were of most significance to the audit of the financial statements in the current period. Key Audit Matters are selected from matters communicated with those charged with governance."

We have additional, significant concerns because the CAMs:

- May result in boilerplate language covering a number of generic audit topics relating to the issuer's industry (e.g. rate regulated matters);
- May result in a "first mover" disadvantage because CAMs reported by later filers in the same industry were omitted;
- May cause increased costs and filing deadline pressures because there would need to be close collaboration and communication between management, the Auditor and the Audit Committee as matters that might rise to the level of a CAM are not always known well in advance of the filing deadline;
- May cause the Auditor's Report to become a laundry list of matters over time because the Auditor may be reluctant to remove a CAM in subsequent reporting periods. The Re-Proposal provides no guidance for the removal of a CAM;
- Appear to contradict the SEC's disclosure effectiveness to be more meaningful to users of financial reporting. The Auditor might prefer to err on "more is better" concept in their Report detracting from the truly important matters with descriptions of the less important for fear of criticism and litigation.

The Re-Proposal requires the Auditor to disclose the firm's tenure with the company. We believe this disclosure is unnecessary. We believe that it is important that consumers of financial reports understand how the Audit Committee determines its recommended appointment of the audit firm. Required disclosures, such as what is being proposed, can detract from what the Audit Committee views as the most critical considerations. In the case of EIX, the Audit Committee discloses the tenure of the audit firm in our Proxy report to shareholders and describes pertinent factors considered when recommending appointment of the audit firm. Research has not concluded definitively that the tenure of the audit firm is correlated with audit quality and/or independence. Our appointment recommendation considers whether there is frequent and sufficient change in personnel who are responsible for preparation, attestation and oversight of the financial reporting process. The PCAOB requires mandatory rotation of the engagement audit partner every five years, the EIX Audit Committee Chair rotates every four years, Audit Committee members change, and Chief Executive Officers, Chief Financial Officers, Chief Accounting Officers, Controllers also regularly change as part of EIX's succession planning.

Thank you for considering our views.

Yours truly,

The Audit Committees of Edison International and Southern California Edison.

Peter J. Taylor, Chair

Vanessa C. L. Chang

Vanessa C. L. Chang, Member

James T. Morris

James T. Morris, Member

Ellen O. Tauscher

Ellen O. Tauscher, Member

Eli Lilly and Company

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August 15, 2016

Office of the Secretary
PCAOB
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Re: PCAOB Rulemaking Docket Matter No. 34

Dear Board Members:

Eli Lilly and Company ("Lilly") appreciates the opportunity to comment to the Public Company Accounting Oversight Board ("PCAOB") on the PCAOB Release No. 2016-003, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion; and Related Amendments to PCAOB Standards* (the Reproposal). Lilly is a multinational pharmaceutical and animal health company, with more than 200 legal entities in over 80 jurisdictions.

Lilly understands the PCAOB's objective is to revamp the existing Auditor's Reporting Model in an effort to "increase the informational value of the auditor's report to promote the usefulness and relevance of the audit and the related auditor's report." Lilly provided comments in 2013 for the original proposal. Lilly appreciates the PCAOB's consideration of comments provided on the original proposal and recognizes the Reproposal addresses some of the concerns shared. For example, we appreciate that the PCAOB has taken into consideration the comments raised by stakeholders and has limited the Critical Audit Matters ("CAMs") scope.

**Critical Audit Matters**

While the Reproposal limits the CAMs scope, we believe it remains inconsistent with the US regulatory reporting framework. According to the framework, management is responsible for financial statement and related disclosures. According to the Reproposal, CAMs should be selected from "any matter that was communicated or required to be communicated to the audit committee." This sets the auditor up to be responsible for disclosing information about the company that is not previously disclosed. Many companies, us included, are concerned that the auditor's report would disclose information not otherwise disclosed about the company. The explanatory note in the Reproposal articulates the auditor is "not expected to provide information about the company that has not been made publicly available". But, the significant caveat "unless such information is necessary to describe the principal considerations that led the auditor to determine a matter is a CAM" instructs the auditor to do exactly that.

We are most concerned about the potential for the auditor to disclose information in their report that the company is not required to disclose, by the SEC or FASB, making the auditor the original source of the information. The auditor could identify a CAM around a transaction that has not yet been recorded in the financial statements by management due to timing or facts and circumstances of the item (e.g., restructuring, product returns reserve, impairment, etc.). Based on the facts and circumstances, restructuring charges may not be required, under accounting standards, to be recorded until the following year; however, the auditor may disclose this item as a CAM in the prior year audit report if it meets the CAM criteria. Disclosing this as a CAM would make it public information before the company discloses the information to those affected and the public. Additionally, even though the company may disclose information about product returns reserves, for example, the auditor's report may disclose details that are currently not required to be disclosed like specific products and liability balances.

It seems counterintuitive that a company would need to disclose information not because of the accounting standards but because of the potential to appear as a CAM. The Reproposal could lead to tension from the auditor pushing the company to disclose information because the auditor will include it in the auditor's report. The company should not be burdened with de facto disclosure rules arising from the auditor's report. We suggest that SEC and FASB disclosure rules be used to determine specific information that should be shared about CAMs.

We believe CAMs should be limited to only matters already disclosed in the critical accounting policies section of the MD&A (Management's Discussion and Analysis). There is already a robust process that exists between management and the auditors as to the identification of, and reporting on critical accounting policies and estimates. CAMs by their definition should not differ from those items. This allows the majority of information disclosed to be provided by management.

If the PCAOB requires a broader scope for CAMs than matters already disclosed in the critical accounting policies, CAMs should be limited to matters that are material to the financial statements. We believe that certain proposed changes that have remained in the Reproposal, in particular the requirement that any matter that "relates to accounts or disclosures that are material to the financial statements" be included in the definition of CAMs, could have an adverse impact on companies, auditors and financial statement users. It is not sufficiently clear how an entity would make an assessment of whether a matter is included in this definition. The Reproposal attempts to clarify the meaning through explanation and example. In our opinion this attempt does not provide sufficient clarity. We suggest, at a minimum, simply limiting CAMs to matters that are material to the financial statements.

The addition of CAMs will significantly increase the length of the auditor's report. At our request, our auditor developed an example of the auditor's report including CAMs per the original proposal. Even though the Reproposal attempts to limit the scope of CAMs, the same CAMs would be included considering the Reproposal. In addition, the auditor report grew from one page to four pages and includes items already disclosed in the company report. It is difficult to see the value of having the auditor's report repeat information already disclosed. Duplication should be avoided. We suggest "refer to the relevant financial statement accounts" be removed. The auditor's report should reference relevant disclosures to avoid duplication. At a minimum, the auditor should be encouraged to coordinate descriptions of overlapping topics with management and to avoid duplication in reporting.

Auditors have no obligation to disclose significant deficiencies. They are reported to the audit committee, but not publicly disclosed. We believe current standards for communicating control deficiencies are clear and would like the Reproposal to avoid confusion. We appreciate there were modifications to the 2013 proposal to address this concern but think more clarity would be good. We suggest the following: "the auditors have no obligation to disclose significant deficiencies."

**<u>Auditor Tenure</u>**
We recognize the change to disclose the firm tenure rather than the engagement partner tenure is an improvement. However, we believe that including this type of information within the audit report could be misleading to investors as there is no substantiated evidence to support that audit tenure has an impact on the quality of the audit. The inclusion of this information could lead investors to infer that if the company has a new auditor or if a company and auditor have a longstanding relationship that the audit opinion is not as reliable. Auditor tenure is more appropriately considered a corporate governance matter.

**Conclusion**

Again, Lilly appreciates PCAOB's changes in the Reproposal that reflect consideration of comments provided. However, we still have significant concerns that the auditor is being asked to share with management the responsibility for disclosing company information.

We believe there is still a significant opportunity to clarify definitions which should lead to an efficient, consistent application. Additionally, the Reproposal's guidance remains unclear and will be confusing to implement. We again urge the PCAOB to carefully consider and evaluate the impact that these proposals would have on the companies and the auditors who would be required to comply with any new standards issued and the related implications. We also urge the PCAOB to carefully consider the cost/benefit of all of the proposed alternatives prior to implementing any new standards.

We appreciate the opportunity to express our views and concerns regarding the concept release.
If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 651-2310.

Sincerely,

ELI LILLY AND COMPANY

/s/ Donald A. Zakrowski

Donald A. Zakrowski
Vice President, Finance and
Chief Accounting Officer

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**Patrick J. Condon**
Audit Committee Chairman

August 15, 2016

Public Company Accounting Oversight Board
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**File Reference:** PCAOB Rulemaking Docket Matter No. 034

Dear Members of the Board:

I appreciate the opportunity to comment on the PCAOB's reproposed audit standards included in Release No. 2016-003, *The Auditor's Report on an Audit of the Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "reproposed auditor reporting standard"). I have served on the Board of Directors of Entergy Corporation since 2015 and currently chair its Audit Committee. I have also served on the audit and other committees of the boards of other public companies. Previously, I was an audit partner with Arthur Andersen LLP and Deloitte & Touche LLP.

My comments are limited to the reproposal as it relates to independent auditor reporting of critical audit matters (hereinafter, "CAMs") and the inclusion of the auditor's tenure within the auditor's report. These comments are solely mine and should not be ascribed to any other entity.

As has been described in the reproposal, I understand that

- the reproposed standard is intended to respond to investor requests for additional information about the financial statement audit by increasing the relevance and usefulness of the auditor's report, without imposing requirements beyond the auditor's expertise or mandate; and

- the Board has taken into consideration the comments and additional feedback received from the original 2013 proposal and modified the definition of what would be included as a CAM, including limiting the sources of potential CAMs and adding a materiality component.

I consider the independent audit process to be critical to assuring that companies present information that is accurate, compliant and meaningful to users of their financial statements. I am supportive of endeavors by the PCAOB to advance the goals of audit firms providing high quality audits and companies producing relevant and reliable financial statements. However, since I strongly believe that the primary source of a company's financial information should be the company itself, I find that the current reproposal (still) results in the imposition of requirements beyond the independent auditor's mandate as the independent auditor's report becomes a primary source of a company's financial information. A company's areas of high risk should be clear to investors from the disclosures included in its financial statements pursuant to FASB and SEC requirements. If the related standards are not deemed adequate in that (or any other) regard, the perceived inadequacies should be addressed through disclosure framework projects being undertaken by those regulatory bodies.

The SEC has enacted regulations, including designation of the FASB as the organization responsible for promulgating US GAAP, defining *what* financial information needs to be disclosed. These rules designate management as the responsible party to determine *how* to communicate this information to most accurately reflect a company's financial results and position. The role of the independent auditor is to express an opinion indicating that reasonable assurance has been obtained that the financial statements prepared by management are free from material misstatement, whether due to fraud or error, and that they are fairly presented in compliance with the applicable SEC and FASB requirements in all material respects. The audit committee of a company's board of directors is charged with oversight of both management's financial reporting and the independent external audit process. If management, the external auditors, and the audit committee fulfill their respective responsibilities, I believe the additional communications and requirements outlined in the PCAOB's reproposed auditor reporting standard are unnecessary. Furthermore, I believe the additional communications and requirements are likely to result in disclosure overload, confusion regarding the roles of the various parties in the process and perhaps even less perceived quality of company-prepared financial statements.

Additionally, all disclosures included in the financial statements are presumably included because they are material to the financial statements. I also believe the disclosure of CAMs has the potential to undermine the relevance of those areas that are not referred to in the auditor's report. Financial statement users should not look to the auditor's report to determine their areas of focus while making investment decisions. Given the volume of disclosures currently required by US GAAP and SEC rules for complex matters and/or areas that contain estimates and management judgment, it should be clear to a financial statement user which areas contain more inherent risk. If those rules are inadequate to serve investor needs, any such inadequacies should be addressed by the FASB and/or SEC.

In addition to CAMs, the reproposal includes other changes to the existing auditor's report including the addition of the independent auditor's tenure to the auditor's report. The reproposal states that the intent of disclosing auditor tenure is to require consistent reporting of the duration of the auditor's relationship with the company and have this information in a consistent location. The inclusion of the independent auditor's tenure is a fact based statement subject to verification and is not my primary concern. However, I am concerned that the basis behind the recommendation for the change in the auditor's report is an inference that long tenure equates to less objectivity in the audit process. I believe that an independent audit with a high level of objectivity and professional skepticism is a critical part of each company's overall risk management and governance structure around compliance with GAAP and reporting requirements, and I believe that experience with entities, particularly those which are complex and heavily regulated, such as Entergy, enhances the ability of the independent auditor to have a deeper understanding of risk and actually enhances the audit process and the ability to place sufficient focus on areas that require additional investigation.

I appreciate the Board's efforts to understand and incorporate investor and user feedback related to disclosure into consideration of how to improve the audit process and appreciate the opportunity to comment on the reproposal. I believe that issues associated with sufficiency of disclosure are more appropriately addressed by the current SEC and FASB disclosure projects rather than through an unprecedented expansion of the independent auditor's role and responsibilities.

I thank the Board for its effort on this important matter and for your consideration of this letter.

Sincerely,

/s/ Patrick J. Condon

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Building a better working world

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

15 August 2016

**Re: Reproposed Auditing Standard on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments, PCAOB Rulemaking Docket Matter No. 034**

Dear Ms. Brown:

Ernst & Young LLP (EY) is pleased to submit these comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its Reproposed Auditing Standard — *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* and the related amendments to other PCAOB standards (collectively, the Reproposal). We support the PCAOB's efforts to make the auditor's report more informative and relevant for investors and other users of the financial statements.

We appreciate the Board's efforts in considering the work in this area of other standard setters such as the International Auditing and Assurance Standards Board and the United Kingdom's Financial Reporting Council. We also support the Board's decision not to repropose, at this time, the auditor's responsibilities for other information in documents containing the audited financial statements, which was included in the 2013 proposal.

**Overall observations**

We recognize and appreciate the Board's efforts to address many of the comments and questions raised by stakeholders in response to its 2013 proposal to revise the auditor's reporting model, including concerns about the definition of a critical audit matter (CAM), what the auditor should communicate about CAMs and convergence with international standards. We believe the addition of certain clarifications and refinements will allow the standard to strike a balance between the needs and interests of investors and other users of the financial statements and the limitations under the securities laws and existing regulations around disclosure obligations of public companies and their independent auditors.

In the sections below, we recommend clarifications to the proposed definition of a CAM and the proposed communication requirements to reduce instances where the auditor will provide original information. We recommend that the PCAOB strengthen the language in the auditor's report to make clear to investors and other users of the financial statements that a discussion of a CAM is not a piecemeal audit opinion. We also discuss our concerns about increased liability for auditors and our perspective about associated legal issues.

We also refer the Board to the comment letter on the Reproposal from the Center for Audit Quality (CAQ), which identifies certain similar concerns and provides similar suggestions of how to address them.

**Critical audit matters**

Overview

We agree with the underlying objectives of the proposed requirements for determining, communicating and documenting CAMs. We also agree that the communication of CAMs would provide useful information to investors as focusing attention on CAMs could help investors better understand and analyze information available in a company's financial statements.

We support the objectives that the Reproposal is not intended to:

- Undermine management's role as the primary, if not the sole source of original information about the company
- Create a chilling effect on communications between the auditor and the audit committee
- Result in the auditor providing a separate opinion on the CAM or on the accounts or disclosures to which it relates

We believe that the Reproposal takes positive steps toward satisfying these objectives. To fully achieve these objectives, however, we suggest clarifying and refining the:

- Definition of a CAM
- Factors for determining whether a matter is a CAM
- CAM communication requirements

We discuss these suggestions and others in more detail below. We believe these changes, if adopted, would focus the discussion of CAMs on information that is most useful to investors.

Definition of a CAM

Paragraph 11 of the Reproposal defines a CAM as follows:

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

We recognize and appreciate that the Board's efforts to incorporate many of the suggestions raised by stakeholders about the CAM definition it proposed in 2013, including scoping in matters that were required to be communicated to the audit committee and also introducing the concept of materiality.

We have concerns that the Reproposal's definition of a CAM, when taken in conjunction with the factors listed in paragraph 12 of the Reproposal, could result in the auditor disclosing original information about a company, such as the existence of a significant deficiency. We continue to believe that the standard should not impose obligations that result in auditors serving as the original source of information about a company. We believe that any auditor reporting requirement that causes an auditor to report such original information would blur the roles of management and the auditor and may undermine the audit committee's role in governance of the company. We also note that any requirement that resulted in auditors being the original source of information about a company would be inconsistent with management's disclosure obligations under the Securities and Exchange Commission (SEC) rules and regulations, federal securities laws and applicable state laws to the extent they place strict limits on the ability of auditors to make disclosures of company-confidential information.

As an example of this concern, under the Reproposal, the auditor may be required to disclose original information if the auditor identifies a significant deficiency in information technology general controls (ITGC) supporting a material account. The following analysis illustrates how this situation could result in the auditor communicating original information:

- **Step 1** — Is the matter something that is communicated or required to be communicated to the audit committee?

  Yes. In accordance with Auditing Standard (AS) 1301, *Communications with Audit Committees*, a significant deficiency is a matter required to be communicated to the audit committee.

- **Step 2** — Does the matter relate to an account or disclosure that is material to the financial statements?

  This example assumes the significant deficiency relates to an account that is material because, based on our experience, most if not all significant deficiencies relate to material accounts.

- **Step 3** — Did the matter involve especially challenging, subjective or complex auditor judgment?

  In light of the importance of ITGCs to most internal control environments, it's likely these matters would involve the auditor's application of especially challenging, subjective or complex judgments, for example when determining a strategy to (1) test mitigating controls and (2) perform substantive audit procedures.

In this example, when describing the principal considerations that led the auditor to determine that the matter is a critical audit matter, the auditor would likely be required under the Reproposal to describe the existence of the significant deficiency. By contrast, Item 308(a)(3) of Regulation S-K does not include a requirement that registrants publicly disclose significant deficiencies.

As noted in our comment letter to the 2013 proposal, we believe the final standard should stress that the auditor should avoid identifying and describing a CAM that was principally due to a control deficiency because that would require the auditor to describe a matter that the company would not be required to disclose under SEC's rules and regulations.

Another example is in the context of the auditor's responsibilities when potential illegal acts come to the auditor's attention. Under Section 10A of the 1934 Act, the auditor has specific obligations to evaluate the matter and if the auditor detects or becomes aware of information indicating that an illegal act has or may have occurred and is not clearly inconsequential, the matter must be elevated within the company and ultimately must be reported to the company's audit committee or Board of Directors. If the company and the Board of Directors fail to take timely and appropriate to remediate a material matter, the auditor has obligations under Section 10A to notify the SEC about the matter. Notably, the auditor is neither required nor permitted to make a public disclosure of the nature of the auditor's findings. Also, as discussed further below, AS 2405 recognizes that "such disclosure [of an illegal act] would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements." By contrast, we believe many matters leading to an auditor carrying out its obligations under Section 10A would, under the Reproposal, trigger public reporting by the auditor as a CAM, irrespective of the company's disclosing the matter first.

The contrast between the absence of a disclosure obligation for the registrant (e.g., for significant deficiencies) or the auditor (e.g., under Section 10A) and the creation of disclosure obligations for the auditor under the Reproposal (even if the company has not made its own disclosures first) raises important policy and related considerations with respect to the respective roles of the auditor, the company, and the applicable legal and regulatory disclosure frameworks that we respectfully urge be further considered.

To address these concerns, we believe several matters should be addressed in the PCAOB's final rule in this area: (a) narrowing the definition of a CAM to those that are material and therefore would require the company's disclosure; (b) limiting the auditor's disclosure obligation to those matters that are required to be disclosed to the audit committee and (c) eliminating any requirement that the auditor make disclosures relating to CAMs that have not previously been disclosed by the company. We address those matters in additional detail below.

We urge the definition of a CAM be clarified to state clearly that a CAM is a *material* matter arising from the audit of the financial statements taken as a whole. We believe such a clarification would eliminate the possibility of the auditor disclosing a significant deficiency, which by definition is not material, and would reduce the likelihood that the auditor would be the source of original information. If the definition of a CAM required a matter to be material to the financial statements taken as a whole, then the possibility the auditor might have to disclose original information about matters other than significant deficiencies (e.g., critical accounting estimates and to a certain extent illegal acts) should be mitigated as well. We offer other suggestions to guard against the risk of an auditor being the source of original information about the company in the *Communicating CAMs* section below.

We believe that the proposed requirement to consider all matters communicated to the audit committee in determining CAMs is overly broad and could have unintended consequences related to the nature of the communications between the auditor and audit committee as well as overall audit effort. In the Reproposal, the Board expressed the view that "it seems likely that especially challenging, subjective, or complex auditor judgments would relate to areas that are required to be communicated to the audit committee, either under a specific requirement or more broadly as a matter that is significant to the audit committee oversight of the financial reporting process."

We agree with this statement. Consistent with this view, we believe that required communications to the audit committee communication under AS 1301 provide the appropriate source for potential CAMs. Required communications under AS 1301 are appropriately broad and include significant and critical accounting policies, practices and estimates, significant unusual transactions, and other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Without limiting the source of potential CAMs to the communication requirements in AS 1301, a standard risks creating a need for auditors to consider and document every communication with the audit committee, which we believe could result in less dialogue with the audit committee, which would not be in investors' interests.

We believe robust and open conversation between auditors and audit committees is critical to audit quality and protecting investors' interests and should not be curbed. As a result, we believe investor interests will be best served if the standard narrows the source of CAMs to matters that are required to be communicated to the audit committee, rather than including any matter communicated.

Recommendation

We recommend that the proposed definition of a CAM be refined as follows:

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

When incorporating "material" into the definition above, we recommend that it reference the Supreme Court's definition of materiality, consistent with the release to the Reproposal. Similarly, we believe it would be appropriate for an additional clarification that the matter be material to the financial statements "taken as a whole" given the nature of the materiality assessment articulated by the Supreme Court and the PCAOB's standards.

**Determining whether a matter involved especially challenging, subjective or complex auditor judgment**

Paragraph 12 of the proposed standard lists factors that the auditor should consider, in addition to other factors specific to the audit, in determining whether a matter involved especially challenging, subjective or complex auditor judgment. While we agree that most of these are appropriate factors auditors should consider when making this determination, we have some concerns with the following two factors:

- The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures [paragraph 12.b]

- The nature of audit evidence obtained regarding the matter [paragraph 12.f]

We believe that a discussion of CAMs would be most useful to investors if it helps them understand and derive value from a company's financial statements and disclosures. In our view, communicating matters that would rise to the level of a CAM because of the especially challenging, subjective or complex auditor judgment required in determining audit strategy or applying audit procedures would not necessarily accomplish this goal.

For example, in a multilocation engagement, the auditor often is required to use especially challenging, subjective or complex judgment in determining the locations or business units at which to perform audit procedures, as well as the nature, timing and extent of the procedures to be performed at individual locations or business units under AS 2101.11, *Audit Planning*. This complexity of judgment on the part of the auditor, however, may not be matched by a complex judgment made by management in the preparation of the financial statements and disclosures.

In general, we believe CAMs that focus on such matters (i.e., when the CAM definition is met due primarily to audit strategy considerations) would not provide investors with insights on matters that would be most relevant to their understanding of the financial statements. In addition, we believe auditors would be more likely to have to discuss original information in situations like this since in these situations, the underlying complexity related to the audit strategy judgments would be derived from underlying complexities in the company's system of internal control.

Similarly, in certain instances, an auditor might be required to comment on the company's process for making critical accounting estimates to the extent the auditor observed challenges in a company's method for making the estimate, but determined that the result of the method was reasonable based on the audit procedures employed to assess its reasonableness.

In contrast, we do agree that the degree of auditor subjectivity used in *evaluating* the results of audit procedures applied to address an accounting and reporting matter would be a factor to consider when evaluating whether a matter arising from the audit of the financial statements is a CAM.

Recommendation

We propose that the factor in paragraph 12.b of the proposed standard be modified as follows:

- The degree of auditor subjectivity in ~~determining or applying audit procedures to address the matter or in~~ evaluating the results of ~~those~~ **audit** procedures **applied to address the matter arising from the audit of the financial statements**

Paragraph 12.f indicates that the auditor should consider the nature of audit evidence obtained regarding a matter in determining whether a matter is a CAM. The auditor is required to consider the relevance and reliability of evidence when evaluating whether sufficient appropriate audit evidence has been obtained.

When evaluating the reliability of evidence, AS 1105, *Audit Evidence,* notes that the auditor must consider both its nature and source. Given the number of considerations the auditor must evaluate when deciding whether he or she has obtained sufficient appropriate evidence, it wasn't clear to us how this factor was intended to be used when evaluating whether potential matters should be CAMs. Additionally, potentially requiring the auditor to disclose the nature of audit evidence obtained (as part of describing how the matter was addressed in the audit) might require the auditor to disclose original information about the company under audit.

Recommendation

We believe these auditor considerations could be more effectively captured by eliminating paragraph 12.f and amending paragraph 12.c of the Reproposal as follows:

- The nature and extent of audit effort required to **obtain sufficient appropriate audit evidence to** address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter

When combined with the remaining factors, we believe these proposed revisions to paragraph 12.c provide an appropriate framework for evaluating CAMs and as a result, would obviate the need for paragraph 12.f.

**Communicating CAMs**

We agree with the proposed requirement to describe the principal considerations that led the auditor to determine that the matter is a CAM. However, we found the statement included in Note 2 to paragraph 14 regarding the auditor being the source of original information to be a bit circular. While the auditor is not expected to provide original information, the Reproposal indicates that the auditor may need to do so in order to describe the principal considerations that led it to determine the item was a critical audit matter. As previously discussed, we do not believe that the standard should create obligations whereby the auditor would be the source of original information about the company.

Recommendation

We recommend the language in paragraph 14 (Note 2) of the proposed standard be modified as follows:

- When describing critical audit matters in the auditor's report the auditor **should** ~~is~~ not ~~expected to~~ provide information about the company that has not **previously** been made publicly available by the company ~~unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit~~.

At a minimum, we believe any final standard should also include a statement that the auditor should not communicate original information about the company if law, regulation or applicable generally accepted accounting principles do not permit or otherwise require such disclosure. Auditors are required by their legal, ethical and contractual obligations to maintain client confidences. Some state confidentiality laws may not permit the auditor to breach confidentiality in order to comply with PCAOB standards. Additionally, some states recognize accountant-client privileges, which are held by the client. These privileges may preclude the auditor from disclosing privileged communications, in contradiction to what the Reproposal may require.

Some stakeholders, including the CAQ, have noted that the examples in the proposal appear to include communications of original information. If examples are included in the adopting release, we suggest that original information should not be included in the examples.

The Reproposal would also introduce a requirement to describe how the CAM was addressed in the audit. We agree that this information would be of interest to users and provide additional transparency about the audit. Similar to our concern about the auditor being the original source of information in describing the CAM, we also believe that the auditor should not be the original source of information in describing how the critical audit matter was discussed in the audit. We also respectfully request in its analysis of the costs and benefits of this information the Board consider that this additional information may increase the auditor's liability to investors.

**Piecemeal opinions and CAM introductory language in the auditor's report**

We agree with the Board that CAMs should not be considered piecemeal opinions. The Board's inclusion of the statement in paragraph 15 of the proposed standard is helpful in making the point more transparent to users of the financial statements, but we believe it could and should be strengthened.

Recommendation

The following modifications of the CAM introductory language reflect our recommendations that (1) the source of CAMs be limited to those matters that are required to be communicated to the audit committee and (2) a CAM should be a material matter arising from the audit of the financial statements. In addition, we believe these revisions further clarify the nature of CAM communications in relation to the auditor's opinion on the financial statements taken as a whole:

- The critical audit matters communicated below are matters arising from the current period audit that were ~~communicated or~~ required to be communicated to the audit committee and that (1) ~~relate to accounts or disclosures that~~ are material to the financial statements **taken as a whole** and (2) involved our especially challenging, subjective, or complex judgments. ~~Critical~~ **The discussion of critical** audit matters ~~do~~ **does** not alter in any way **the meaning of** our opinion on the financial statements taken as a whole, and we ~~do not provide~~ **are not, by communicating the critical audit matters below or otherwise, providing** separate opinions **or other audit conclusions beyond the information specifically communicated** on ~~the~~ critical audit matters ~~or on the accounts or disclosures to which they relate~~.

Recommendation

We also believe that the Board should reconsider the requirement to place the opinion paragraph first as well as the section headings in the auditor's report (i.e., Opinion on the Financial Statements, Basis for Opinion and Critical Audit Matters [if applicable]). While we agree that headings may help users navigate the expanded auditor report, the current ordering of the components of the opinion and the heading of the CAM section of the report may be misunderstood to imply that CAM communications are separate and distinct from the auditor's opinion, which could be misinterpreted as a piecemeal opinion.

**Documentation**

The Reproposal observes that the auditor's basis for the determination of a CAM may be so clear for some matters that a single sentence would be sufficient, while other matters may require more extensive documentation. Given this potential for a wide range of documentation, we believe that further clarity with respect to the Board's expectations regarding the application of the requirements of AS 1215, *Audit Documentation*, to the documentation of CAMs would be helpful.

Recommendation

We encourage the Board to consider providing additional guidance about when more extensive documentation would be necessary and provide some examples illustrating what this more extensive documentation might include. This additional guidance should help clarify the Board's requirements and hopefully lead to more consistent application of the standard by auditors.

**Auditor tenure**

The Reproposal observes that commenters' views and academic research are divided about whether there is a link between audit quality and auditor tenure. We have concerns that requiring the disclosure of auditor tenure in the auditor's report may inappropriately imply that such a correlation exists.

We believe that consideration of auditor tenure is most relevant and useful as one of multiple factors in the audit committee's assessment of the auditor's qualifications and retention considerations. We observe that companies increasingly voluntarily are disclosing information in their annual proxy statements about tenure and other factors impacting auditor retention considerations, indicating that boards are recognizing and responding to investor interest in this topic.[1]

We also note that the SEC has sought input on issue through its *Concept Release on Possible Revisions to Audit Committee Disclosures*, which asked questions about whether information about auditor tenure should be disclosed in the audit committee report. The SEC is currently monitoring such audit committee related disclosures, which we believe is the right approach at this time.

Recommendation

We believe the Board should not require audit tenure to be disclosed in the auditor's report. If the Board decides to require disclosure of auditor tenure, we believe it should be made in Form AP. Disclosure in Form AP would be a logical extension of the information already required within the form and would allow for explanatory discussion when necessary (for example, when the start date of tenure is not known). If the intent of the reproposed requirement is to require consistent reporting of auditor tenure in a consistent location, we believe that goal could still be achieved through disclosure in Form AP.

**Other considerations**

Liability concerns

We appreciate that the PCAOB has considered the potential costs of increased auditor liability in making the Reproposal and view the Reproposal as an improvement upon the 2013 proposal in this regard. However, auditor liability concerns will remain if the Reproposal is adopted as written.

First, we are concerned that an unintended consequence of the Reproposal could be to increase the auditor's exposure to non-meritorious claims under the federal securities laws, specifically claims alleging strict liability under Section 11 of the Securities Act of 1933. Current federal case law recognizes that an audit opinion contained in a registration statement — because it is an "opinion" — is not actionably false unless the auditor did not believe the opinion. Under the Reproposal, the audit opinion will include much more information than the current form of report. While we are generally

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[1] The CAQ's *2015 Audit Committee Transparency Barometer* showed that 54% of the S&P 500 companies disclosed information about auditor tenure in 2015, up from 47% in 2014. In addition, the EY Center for Board Matters has conducted an annual survey of audit-related proxy disclosures of Fortune 100 companies over the past five years and found that 62% of those companies now disclose tenure, up from 24% in 2012.

supportive of providing additional information, there needs to be a balance between what is provided and potential increased cost. Additional information may serve as fodder for plaintiffs seeking to misapply the securities laws and bring non-meritorious actions. Increased claims will lead to increased costs to firms because it may be more difficult to obtain early dismissal of these claims, which plaintiffs may try to present as based on facts imbedded in the descriptions of CAMs even though the auditor's opinion is not actionable. If this comes to pass, audit firms will be forced to choose between settling non-meritorious claims and costly litigation. These costs, and the cost of expanded audit procedures to comply with the standard, will in all likelihood inevitably be passed onto registrants.

Second, the Reproposal may also expose auditors to liability to their own clients, to the extent it requires auditors to disclose original information about the audit client. Auditors are required to comply with professional obligations of confidentiality, state confidentiality laws, accountant-client privileges, as well as the auditor's responsibilities under Section 10A. For example, Section 10A does not authorize the auditor to publicly disclose an illegal act. Indeed, AS 2405.23 recognizes that "such disclosure [of an illegal act] would be precluded by the auditor's ethical or legal obligation of confidentiality, unless the matter affects his opinion on the financial statements."[2] If the auditor discloses original client information in the course of describing a CAM, the auditor may be exposed to additional liability from its client for breaching these confidentiality obligations.

If the PCAOB were to adopt the recommendations set out in our letter we believe these liability concerns would be significantly ameliorated.

## Scope and exemptions from CAM communications

### *Communication of CAMs*

We agree with the Board's proposal to exempt non-issuer brokers and dealers, investment companies (that are not business development companies) and employee benefit plans (i.e., employee stock purchase and savings and similar plans) from the proposed requirement to identify and communicate CAMs. Based on the ownership and reporting characteristics of these entities, communication of CAMs would be less beneficial to the primary users of these financial statements and would not justify the additional costs associated with such requirements.

### *Auditor tenure*

The Reproposal observes that brokers and dealers are often controlled by an individual or entity that has direct access to the auditor. As a result, disclosure of auditor tenure arguably would not provide additional information to these users. Therefore, we believe that the Board should exclude non-issuer broker dealers from any such requirements for the same reasons they would be exempted from the proposed CAM communications.

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[2] Appendix B to AS 1301: Communications with Audit Committees recognizes that AS 2405, Illegal Acts by Clients, also requires communications with audit committees. Thus, communications of illegal acts to the audit committee would presumably be included in the definition of a CAM.

**Effective date**

As discussed in the CAQ letter, audit firms would need to develop and implement effective quality control processes and conduct training of their professionals. As such, we believe that any final standard should be effective for audits of financial statements of large accelerated filers with fiscal years beginning no earlier than 12 months after the date of final SEC approval. All other filers should have an additional 12 months before being required to adopt the new standard. This phased approach would make implementation more manageable for even the largest audit firms while allowing smaller firms to benefit from lessons learned during the initial phase of implementation.

**Conforming amendments**

We have also included in Appendix comments on the conforming amendments included in the Reproposal.

* * * * *

We would be pleased to discuss our comments with the Board or the PCAOB staff at your convenience.

Very truly yours,

Ernst & Young LLP

Copy to:

**PCAOB**

James R. Doty, Chair
Lewis H. Ferguson, Board Member
Jeanette M. Franzel, Board Member
Jay D. Hanson, Board Member
Steven B. Harris, Board Member
Martin F. Baumann, Chief Auditor

**Securities and Exchange Commission**

Mary Jo White, Chair
Kara M. Stein, Commissioner
Michael S. Piwowar, Commissioner
Wesley R. Bricker, Interim Chief Accountant
Brian T. Croteau, Deputy Chief Accountant

**Appendix — Comments on conforming amendments included in the Reproposal**

| Comment number | Reference | Observation |
|---|---|---|
| 1 | A1-8<br>AS 1301 12.d | The term *significant unusual transaction* is defined in paragraph 12.d of AS 1301. We recommend adding a footnote at the end of paragraph 12.e of the Reproposal that states:<br>The term *significant unusual transaction* in this paragraph has the same meaning as the term *significant unusual transaction* in paragraph 12.d of AS 1301. |
| 2 | A1-11<br>AS 3101 paragraph 18 | Existing AS 3101.10 specifies that the addition of an explanatory paragraph does not affect the auditor's unqualified opinion on the financial statements. We recommend that the Board include similar language in any final standard. |
| 3 | A1-17<br>AS 3101 Appendix B | Include the statement of comprehensive income in the example report. |
| 4 | A2-16<br>AS 3105 paragraph .9<br>A2-22<br>AS 3105 paragraph .22<br>A2-24<br>AS 3105 paragraph .25<br>A2-25<br>AS 3105 paragraph .27<br>A2-28<br>AS 3105 paragraph .34<br>A2-31<br>AS 3105 paragraph .43<br>A2-33<br>AS 3105 paragraph .47<br>A2-(36-37)<br>AS 3105 paragraph .51<br>A2-39<br>AS 3105 paragraph .53<br>A2-42<br>AS 3105 paragraph .58<br>A2-46<br>AS 1205 paragraph .09 | Include the statement of comprehensive income in the example report. |

| Comment number | Reference | Observation |
|---|---|---|
| | A2-75<br>AS 3315 paragraph .06<br>A2-78<br>AS 3315 paragraph .10<br>A2-82<br>AS 4105 paragraph .39<br>A2-92<br>AI 23 paragraph .36 | |
| 5 | A2-19<br>AS 3105 paragraph 16 | We recommend this paragraph be modified as follows:<br>***Limited reporting engagements.*** *The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income,* ***comprehensive income,*** *retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.* |
| 6 | A2-25<br>AS 3105 paragraph 26 | We recommend this paragraph be modified as follows:<br>*If a company issues financial statements that purport to present financial position and results of operations but omits the related statement****s*** *of* ***comprehensive income and*** *cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.* |
| 7 | A2-18<br>AS 3105 paragraph .12<br>A2-27<br>AS 3105 paragraph .31<br>A2-85<br>AS 4105 paragraph.43 | We recommend the Board update the references in these paragraphs to the current ASC guidance. |
| 8 | A2-35<br>AS 3105 footnote 13 (to .49) | The footnote references state and local governments and not-for-profit entities. As these entities are not issuers or broker-dealers required to comply with PCAOB standards, we recommend revising the examples provided in the footnote. |

| Comment number | Reference | Observation |
|---|---|---|
| 9 | A2-45<br>AS 3105 paragraph .62 | We suggest removing the reference to "explanatory" as uncertainties are not required to be disclosed in an explanatory paragraph. |
| 10 | A2-53<br>AS 2201 paragraph .85Eb | We recommend the Board remove the requirement to disclose auditor tenure in the auditor's report on ICFR for the reasons discussed above. If the PCAOB decides to require disclosure of auditor tenure either in the auditor's report or Form AP, we also recommend the Board remove the requirement to discuss tenure in the auditor's report on ICFR as it would be redundant with the disclosure to disclose it elsewhere. |
| 11 | A2-57<br>AS 2201 paragraph .B16 | We suggest the references to "explanatory" paragraphs be removed from this paragraph as these would not be explanatory paragraphs as required by AS 3101.18. |
| 12 | A2-62<br>AS 2705 paragraph .08 | The requirements in this paragraph for when an explanatory paragraph would be necessary are not consistent with the requirements in AS 3105.18j. |
| 13 | A2-73<br>AS 3305 paragraph .31d | It isn't clear why "explanatory" is deleted from this paragraph given it is an example of a matter that would require the use of explanatory language or an explanatory paragraph. |

Federation of European Accountants

Office of the Secretary
PCAOB

Sent by email:
comments@pcaobus.org

Brussels, 26 July 2016

**Subject: Reproposal of the standard ‘’The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion’’**

Dear Sir or Madam,

The Federation of European Accountants (the Federation) is pleased to provide you with its comments on the Public Company Accounting Oversight Board’s ("PCAOB") reproposal of the standard *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.*

(1) The Federation welcomes the reproposed auditing standard and fully supports an auditor’s report that is more informative, user friendly and easy to understand.

(2) It is encouraging that the IAASB and the PCAOB are engaged in a similar approach to improving the auditor’s report. This is particularly helpful for investors who are interested in an entity that is required to issue an auditor’s report both under IAASB and PCAOB standards. In particular, we note that the PCAOB’s concept of Critical Audit Matters (CAM) has now been more closely aligned to the IAASB’s concept of Key Audit Matters (KAM), as set out in ISA 701 *Communicating Key Audit Matters in the Independent Auditor’s Report* than originally proposed. We advocate for alignment of auditing standards globally to the maximum extent possible. In general, there should be no differences between CAM and KAM except where jurisdictional particulars dictate the necessity for specific clearly identifiable differences. This enhances both quality of audits and acceptance of audit reports beyond home jurisdictions, whereas differences between CAM and KAM reporting for a particular entity would likely impinge on users’ perceptions as to the decision usefulness of the new auditor reporting model.

(3) The constructive relationship between the PCAOB and the IAASB also provides further transparency to informed users about audit related matters and enhances the dialogue of users with those charged with governance (TCWG) (e.g. audit committee). As the PCAOB will be aware, the new European audit legislation comprises updated European Union (EU) provisions regarding the improvement of the quality of statutory audit across the EU. Key measures comprise strengthening the independence of statutory auditors and making the audit report more explanatory. Member States were required to adopt, publish and apply the measures necessary to comply with the Directive2014/56/EU[1] from 17 June 2016. Most provisions of the Regulation[2] also came into force from 17 June 2016. The main impact on auditor reporting in Europe will come from the Regulation and not the Directive. ISAs have not yet been adopted by the EU Commission and it currently seems unlikely that this will happen in the near future.

(4) Moreover, we support the reproposal in that it addresses the needs of users to receive information that is entity-specific. For the new auditor's report to bring the maximum added value to users, technical or standardised language needs to be avoided.

(5) The main threat to enhanced transparency is that CAM disclosed will be irrelevant to investor needs, or will degenerate into boilerplate. Extended auditor reporting should be seen as a journey; behavioural changes are needed among all stakeholders, and the PCAOB should not lose sight of the fact that to make CAM effective, investors, audit committees and auditors need to step up their level of engagement with each other.

(6) We do not comment on all the questions raised in the reproposal. In particular, we have not responded to:

- Questions 3, 12 and 14 to 20 on Section IV. Discussion of the Reproposal
- Question 26 on Section V. Other Amendments to PCAOB Standards;
- Questions 37 to 40 on section VII. Exclusions from Critical Audit Matter Requirements;
- Questions 41 to 43 on section VIII. Considerations for Audits of Emerging Growth Companies;
- Question 44 on section IX. Considerations Related to Effective Date.

[1] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN
[2] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN

Our detailed responses to the questions included in the Proposal are set out in the Annex below. For further information on the Federation's letter, please contact Hilde Blomme on +32 (0)2 893 33 77 or via email at hilde.blomme@fee.be or Eleni Ashioti on +32 (0)2 893 33 87 or via email at eleni.ashioti@fee.be from the Federation's team.

Kind regards,

On behalf of the Federation of European Accountants,

Petr Kriz
President

Olivier Boutellis-Taft
Chief Executive

## About the Federation of European Accountants

The Federation of European Accountants represents 50 professional institutes of accountants and auditors from 37 European countries, with a combined membership of over 875,000 professional accountants working in different capacities. As the voice of the European profession, the Federation recognises the public interest.

The Federation is in the EU Transparency Register (No 4713568401-18).

# Annex 1

## IV. Discussion of the Reproposal

**Auditor Communication of Critical Audit Matters - Questions 1-12**

1. *Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.*

   *a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?*

   *b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.*

   *c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?*

   *d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?*

(1) The reproposal to the definition of CAM is achieving the PCAOB's objective. Whilst it is also quite closely aligned to the IAASB'S terminology, we question the need to use different terminology without good reason and unless differences are genuine and significant.

(2) The auditor's communication of CAM will be relevant and useful to investors and other financial statement users if:

- investors continue to engage with the audit committees' and auditors' communities, and are clear about what they want as pieces of information;
- auditors avoid boilerplate where possible; and
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

(3) We agree that the matters communicated or required to be communicated to the audit committee are the appropriate source for CAMs.

(4) We have not identified any audit committee communications that should be specifically excluded from consideration as a source of potential CAMs.

(5) The component ''relates to accounts or disclosures that are material to the financial statements'' of the definition is appropriate and clear. The requirement is similar to the one included in ISA 701; despite the fact that this component is not included in the definition of KAM in ISA 701, the standard considers materiality in paragraph A29 as one of the relevant considerations to determine a KAM, i.e. ''The importance of the matter to intended users' understanding of the financial statements as a whole, in particular, its materiality to the financial statements.''

(6) We consider that the following component of the CAM definition "[…] involved especially challenging, subjective, or complex auditor judgment" is appropriate and clear.

> 2. *Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?*

(7) We welcome the reproposal listing a number of factors to determine CAMs, considering matters involved in areas which require judgement, or are challenging and subjective, such as the auditor's assessment of the risks of material misstatement, including significant risks.

(8) The fact that the PCAOB reproposal is, in general, now more aligned to the IAASB's approach than was the original proposal should limit the confusion to auditors who may need to apply both sets of standards and to investors receiving both auditor's reports under the IAASB standards and the PCAOB standards for the same entity.

(9) The PCAOB could go further to allow for and encourage the use of judgement in this area as well.

> 4. *Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?*

(10) The auditor should first and foremost concentrate on those CAMs arising from the audit of the current period, even in the case of comparative financial statements, when the auditor is required to report on both the current period financial statements and the prior period financial statements in connection with the current year's audit.

(11) We agree with the PCAOB's Reproposal indicating that the auditor might communicate CAM with regard to a prior period in particular situations. There may be circumstances, in the situation of an IPO for instance, where it might be relevant to include CAMs on other periods. The normal usage should be to report on the current year only. IPOs could be given as an example whereas re-audits are rare and should therefore not be used as an example.

> 5. *Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?*

(12) Notwithstanding our remarks as to the importance of global consistency, the reproposed requirements in relation to the description of CAMs in the auditor's report, including the principal considerations and how the matter was addressed in the audit are sufficiently clear for consistent implementation by auditors.

(13) The reproposal narrows the auditor to describe only the principal considerations. This should result in providing more useful information to investors and other users and avoid boilerplate language in this section of the auditor's report as well as potential overload with insignificant information.

(14) We welcome the fact that the PCAOB allows for flexibility on the level of detail in the description of each CAM. This should encourage the development of tailor-made reports. The guidance on page 31, which provides some examples that the auditor could use to describe how CAMs were addressed in the audit, will certainly benefit auditors in preparing the auditor's report and will help financial statement users better understand these matters.

> 6. *Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:*
>
> a) *The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and*
>
> b) *Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?*
>
> *Are there other steps the Board could take to address these concerns? If so, what are they?*

(15) Yes, the reproposed communication requirements appropriately address the above mentioned commenter concerns. It is beneficial that the proposed requirements are very likely to enhance the way in which auditors and audit committees work together.

(16) The reproposed standard specifies that the auditor's communication of CAMs does not change by any means the auditor's opinion on the financial statements, taken as a whole. We consider this reproposal to respond to commenter concerns on the misinterpretations indicated in the question 6 (b).

> 7. *In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?*

(17) No, we do not consider it appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating CAM. The CAM definition refers to information that is included in the financial statements.

(18) Also, our concern with referencing information outside of the financial statements is that the reader may infer that such information has been subject to audit, which will not be the case. This could lead to an expectation gap between what the reader thinks is done by the auditor and what the auditor has actually done.

> 8. *Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?*

(19) Yes, it would be appropriate to retain the possibility for the auditor to determine that there are no CAMs, and require a statement to that effect in the auditor's report.

(20) We agree with the PCAOB approach that while it is anticipated that at least one CAM will be communicated in the auditor's report, there are still cases where the auditor may identify a matter but not consider it so important as to merit disclosure in the auditor's report. Requiring such a statement is also consistent with the IAASB approach.

> 9. *Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?*

(21) We support the reproposal of narrowing the source of CAMs to matters communicated or required to be communicated to the audit committee and also in adding a materiality component.

(22) The IAASB's requirements for documentation focus on why a KAM is a KAM, with an option to describe why other potential KAMs were not reported as KAMs. The PCAOB's requirements have more focus on documenting why possible CAMs are not considered to be CAMs, which seems to be more about preparing audit files for inspection purposes than communicating useful information to investors. The requirements are clear, but do not go in the right direction.

*10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?*

(23) The legal framework and litigation culture in many EU member states often still differ from the situation in the USA and the extent of private litigation is not necessarily a phenomenon of the same magnitude as it is in the US and some other jurisdictions.

*11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?*

(24) We recognise the PCAOB's effort to address the concerns that have been raised from the 2013 proposal about private liability. This is evident from various aspects of the reproposal such as changing the source of CAMs, adding a materiality component, redefining the factors and modifying the communication requirement.

**Additional Improvements to the Auditor's Report – Questions 13-20**

*13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?*

(25) The fact that the word ''independent" already appears in the audit report means that the bold statement to the effect that auditors are independent, a little further down in the report, manages to say very little and looks repetitive at the same time. The statement does not add much to the word in the title and we have doubts as to whether it will in fact improve confidence in auditor independence. Merely stating that auditors are required to be independent does not make them so. The auditors' report should not be cluttered with poor quality information, particularly if it is repetitive. Requiring auditors to include a statement on their independence will not result in any significant changes to their behaviour. Confidence in the independence of auditors is important and a statement in the auditors' report to this effect is unobjectionable, if superfluous.

**Explanatory Language and Emphasis of a Matter – Questions 21-24**

*21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?*

(26) Yes, the interaction between the communication of CAMs and required explanatory paragraphs is clear and appropriate. Clarifying that a CAM is not a substitute for required explanatory paragraphs as well as considering that ''there could be situations in which a matter meets the definition of a critical matter and also requires an explanatory paragraph, such as going concern'' could be very useful in the preparation of the auditor's report, and ultimately may increase the confidence that investors and other users have in the audit and in the financial statements.

(27) Furthermore, we acknowledge that the PCAOB requires auditors in AS 2415 to include an explanatory paragraph in the auditor's report when there is substantial doubt about the company's ability to continue as going concern. Further clarification is needed to explain the linkage between CAMs and the going concern basis of accounting in the auditor reporting standard. We would very much welcome a clear requirement that going concern issues should be included as a CAM if the definition is met. A similar requirement is included in ISA 701.

(28) We very much welcome the fact that the next action under consideration in the PCAOB's agenda relates to a project on 'Going Concern'.

> 22. *Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?*

(29) Yes, the auditors should be permitted to include the CAM communications in the required explanatory paragraph. It would be helpful to investors since they will have access to additional information such as how the matter was addressed in the audit.

> 23. *Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?*

(30) We support transparency as to the scope of the audit. Such requirement should be included in all audit reports where an audit of ICFR was not performed to avoid any potential misunderstanding.

> 24. *Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?*

(31) Yes. The interaction between the communication of CAMs and emphasis paragraphs is clear and appropriate. We recognise the PCAOB's effort to do so by clarifying that emphasis paragraphs are not a substitute for required CAMs. We also find useful for the auditor the list of examples provided of matters that may be emphasized in relation to the financial statements.

(32) We agree that an emphasis paragraph would not be included in the auditor's report concerning a matter that meets the definition of a CAM, as in this case that matter should be communicated as CAM.

**Form of the Auditor's Report – Question 25**

> 25. *Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?*

(33) We support requiring the report to include obligatory subheadings and also to require the ordering of paragraphs to mirror the auditor's reporting model under ISAs. The 'global standardisation' of the auditor's report would help:

- Direct users to specific areas of interest such as CAM within the auditor's report; and
- Facilitate a comparison between auditor's reports.

(34) We note, however, that flexibility might be needed in some jurisdictions and/or in the circumstances of a particular engagement. To this end, even if the paragraph order differs between jurisdictions, as a result of national laws or regulations, the reader can use those subheadings to navigate the report more easily. It would be most helpful if the PCAOB report uses the same headings as the ISA equivalent, the comparison between auditor's reports will then be more straightforward.

## VI. Economic Considerations - Questions 27-36

(35) It is worth noting that the CAM proposals should initially be viewed as an experiment, and that time will be needed to adapt and develop best practice. The definitions and requirements included in the proposals cannot currently respond to all possible questions which are bound to arise upon application of this new form of auditor reporting.

FedEx Corporation

August 15, 2016

VIA e-mail to: comments@pcaobus.org

Office of the Secretary
PCAOB
1666 K Street, N.W. Washington
DC 20006-2803

RE: PCAOB Rulemaking Docket Matter No. 034

FedEx Corporation has reviewed the Public Company Accounting Oversight Board ("PCAOB") proposed auditing standards Release No. 2016-003 dated May 11, 2016, and we appreciate the opportunity to comment on the proposal. We previously commented on the August 13, 2013 auditing standard Release No. 2013-005 on the same subject.

FedEx Corporation is a global company that provides customers and businesses worldwide with a broad portfolio of transportation, e-commerce and business services. Our annual revenues total approximately $58 billion, we have more than 400,000 team members, and we serve customers in more than 220 countries and territories. Our financial statements are prepared under U.S. GAAP, filed with the Securities and Exchange Commission (SEC) and we are registered with the New York Stock Exchange. We present our views from the perspective of a financial statement preparer, and we support the PCAOB's mission to oversee the auditing profession and improve audit quality. We are pleased that the PCAOB revised the 2013 proposal to address matters raised by us and others; however, we still do not support the proposal with respect to the auditor's report and have set forth below our views on this issue.

**Summary**

Our December 2013 letter took issue with the proposals to include critical audit matters in the auditor's report and to extend the auditor's report to cover "other information" outside of the financial statements. Although the PCAOB revised and narrowed the scope of the critical audit matters that would be included within the auditor's report, we remain unconvinced that the inclusion of these matters will be useful to investors and other users of the financial statements. We are pleased that the Board has deferred consideration of the reporting on other information and has removed that topic from the new Release.

**Critical audit maters**

We remain skeptical that the inclusion of explicit discussion of critical audit matters within the auditor's report will add value to the investor/reader. We continue to believe that this will add costs and issues for a company as discussed further below.

As we stated in our prior letter, the financial statements of a public company are the responsibility of its management and the oversight of that responsibility lies with the company's Board of Directors through its Audit Committee. In our view, the PCAOB's original proposal and the current reproposal seek to supplant management's responsibility for disclosure of critical accounting matters with a company's auditor and publicize aspects of the audit process that may not be useful to investors and other users of financial statements. We strongly disagree with this concept and believe that auditors should not be disclosing editorial details of any nature about the audit process publicly and that their role is to opine on the fair presentation of the totality of the information provided by management and the internal control over financial reporting.

While some investors may desire improvements in disclosures, we continue to believe that the proper source of this information is a company's management and not the auditor. If the PCAOB believes that companies have overall deficiencies in their financial statement disclosures on critical accounting policies and estimates, then the proper venue for this issue is with the FASB and the SEC.

Beyond our fundamental disagreement with the basic principle of the PCAOB proposal, we believe a separate listing of critical audit matters in an auditor's report is redundant to the disclosure of a company's significant accounting policies and critical accounting estimates required in its Annual Report. If a company falls short of the transparency required under the disclosure standards outlined by the FASB and the SEC in its audited financial statements, then the auditor has the duty to communicate that to the company's audit committee and if necessary, issue a qualified opinion on the financial statements, which will carry significantly more weight to investors than lengthy, duplicative statements on critical accounting matters.

We believe that inherent in the PCAOB's proposal is a presumption that critical accounting matters have a bias towards being areas that are "questionable." However, in many cases these matters are simply complex accounting areas. As a result, a list provided by an auditor could be viewed externally as an indicator of a poorly run company or risky investment. Further, the proposal could have the unintended, and in our view, unfortunate effect of discouraging the candid discussion of accounting matters between issuers and auditors due to concerns that such discussions would be required to be referenced in the auditor's report. Finally, even with the revised definition of a critical audit matter, significant auditor judgment will need to be used in order to determine what qualifies as a critical audit matter. We expect judgment will be subject to second guessing, which will put pressure on auditors to report more critical audit matters, ultimately increasing audit costs.

We believe the issues that the PCAOB is seeking to address with this proposal can be addressed without the auditor's report including a discussion of critical audit matters. After reading the original proposal and the reproposal, we stand by our original comments and do not believe that narrowing the definition of a critical audit matter and adding a materiality component fully addresses or alleviates our concerns. First, we encourage the PCAOB to take the lead on providing observations on disclosure failures noted in its audit reviews to the SEC, and have the SEC seek enhanced disclosures from companies, where necessary. Second, we believe that an acceptable alternative to the PCAOB's proposal would be for the auditor's report to explicitly acknowledge the auditor's concurrence with the critical accounting policies and estimates disclosed by the company. Finally, we believe that the audit process is effective, and that auditors should continue to leverage the well-defined process for required communications with audit committees for discussion of critical audit matters. The matters described in the proposal should be discussed in the boardroom, not in the auditor's report. The auditor required communications to the audit committee provide ample opportunities for the auditor to engage in discussions on critical audit matters and the auditor's report could also include an explicit statement that these candid discussions were held.

**Tenure of the Auditor**

The proposed auditing standard in 2013 and the reproposal in 2016 require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. While we do not have a strong view on this proposal, we do not believe it adds any value to the report and think this statement may imply a correlation between the auditor's tenure and the audit quality, which is not the case. Longer tenure can develop an audit team with deep understanding of a company's complex accounting judgments and estimates. A decision of whether or not the auditor provides a quality audit should be left up to the audit committee of the board of directors since they are the most knowledgeable on the matter. Therefore, we do not believe this disclosure in the audit report is needed. Additionally, the mandatory partner rotation rules address any independence concerns that could be associated with the tenure of the auditor, and we believe that such rules are adequate and are operating as intended in practice.

**Form of the Auditor's Report**

The reproposed standard will require the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. This allows for consistency in the location of the opinion and the basis for opinion section across all auditors reports. We agree with this proposal as this is the main intent of the report and consistency in placement will allow ease of use for readers/investors.

We appreciate the opportunity to comment on these proposed changes and thank you for your consideration of our comments. If you have any questions, please contact Jennifer Johnson at 901-818-7828.

Sincerely,

John L. Merino
Corporate Vice President and
Principal Accounting Officer

Jennifer L. Johnson
Staff Vice President and
Corporate Controller

financial executives international

August 15, 2016

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

Subject: PCAOB Rulemaking Docket Matter No. 34

Submitted via comments@pcaobus.org

Dear Board Members:

Financial Executives International (FEI) is a leading international organization of more than 10,000 members, including Chief Financial Officers, Controllers, Treasurers, Tax Executives and other senior-level financial executives. The Committee on Corporate Reporting (CCR) is a technical committee of FEI, which reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. CCR member companies represent approximately $5 trillion in market capitalization and actively monitor standard setting activities of the Public Committee Accounting Oversight Board (PCAOB). This document represents the views of CCR and not necessarily the views of FEI or its members individually.

**CCR Response**

We appreciate the opportunity to respond to PCAOB's reproposal of the auditor reporting standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. Although the revised standard is responsive to certain of the concerns we raised in our December 2013 letter, we have significant concerns over the potential impact of the proposed standard as outlined further below.

As we have discussed with members of the PCAOB in other venues, regulation and inspection of audit firms can have direct and indirect implications for the issuers they audit. This has proven to be the case with the results of inspections of the firms in the area of Internal Control over Financial Reporting (ICFR). In this revised proposed standard we see the potential for reporting of information by the auditor for which management is the original source (original information) including potential disclosure of significant deficiencies, even though existing guidance would not require them to be disclosed. As this could affect public company reporting of matters related to ICFR and other areas, we believe changes in disclosure requirements are within the purview of the Securities and Exchange Commission (SEC) to promulgate.

As outlined further below, the concerns we have over the impact of this proposal are significant, as the standard, if approved, will have a lasting impact on the scope of the auditor's responsibility and the role of the PCAOB and SEC in addressing financial disclosure by registrants. In addition, this new standard could significantly increase the cost of the audit and/or delay or place additional pressure on the timing of key audit procedures. It is also unclear to us what identifiable benefits the additional information provides to investors. There is also potential, if these issues are not properly addressed through additional changes (e.g., introduction of safe harbors), that this proposal could create new avenues for baseless litigation to the detriment of the audit profession and/or issuers.

Original Information

While the revised proposed standard moves a step closer to acknowledging what we consider to be the appropriate roles of management and the auditors, we continue to have concerns around the scope and the definition of a critical audit matters (CAM). We believe that if a final standard is issued, it should make clear that:

> (a) Auditors should not be the original source of information about the registrant, and
>
> (b) Auditors have no obligation to disclose significant deficiencies in their audit report, consistent with the framework for ICFR, as such matters are required to be reported to the audit committee, but not publicly disclosed[1].

Note 2, paragraph 14, of the revised proposed standard states:

> "*When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company* ***unless such information*** [emphasis added] *is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.*"

We believe that the above language has potential to lead the auditor to disclose original information pertaining to the issuer that it has not disclosed and is not required to disclose. We disagree with this outcome and believe that auditors and management should directly resolve any such differences in views as to the adequacy and completeness of a registrant's disclosures. In today's reporting environment, there are substantial interactions between auditors and registrants related to disclosures contained in drafts of quarterly and annual SEC filings and differences are resolved in the normal course of this work. In unusual situations, where there is an unresolved difference on an important matter, the auditors may need to report such a difference to the audit committee for resolution. However, the revised proposed standard should make clear that it is not appropriate for the auditor to be the original source of information unless a matter continues to be unresolved with management and the audit committee. Communication to the audit committee of unresolved differences will be sufficient to drive appropriate resolution and adequately protect investors.

[1] Management is also not required to disclose such information.

A significant consequence of the proposal is that registrants may be compelled to add additional disclosures as a result of this proposal, which is inconsistent with the general disclosure framework for registrants who are governed by SEC guidance when determining what to disclose, rather than PCAOB standards.

Definition of a CAM

If the Board votes to move forward with the revised proposed standard, we recommend the Board consider revisions to the definition of a CAM. As drafted, the definition includes matters that were "*communicated or required to be communicated to the audit committee that: (1) relates to* ***accounts or disclosures*** [emphasis added] *that are material to the financial statements, and (2) involved especially challenging, subjective or complex auditor judgment.*" In order to address the issues discussed above, we believe that the Board should revise the above proposed guidance as follows:

> *"communicated or required to be communicated to the audit committee that: (1)* ***relates to any issue that is material*** [emphasis added] ~~*to accounts or disclosures that are material*~~ *to the financial statements, and (2) involved especially challenging, subjective or complex auditor judgment."*

In addition to concerns this proposed guidance raises discussed above (i.e., original information and disclosure of significant deficiencies), such language could cause other matters that are immaterial to the financial statements to be brought within scope even though such matters were adequately addressed and resolved by the auditor during its audit. We observe that the terminology used to define a CAM (i.e., "especially challenging, subjective or complex auditor judgment") is extremely broad and subjective, which has the potential to generate inconsistency in application, as it will inevitably depend upon individual judgments and/or biases regarding what matters qualify. For example, the same set of facts and circumstances are likely to be interpreted differently because even qualified and knowledgeable individuals applying reasonable professional judgment may reach different conclusions on the meaning and application of such a broad and subjective set of criteria. While we understand that the Board wishes this to be principles-based, we believe that there needs to be some objective components to the definition that are based on observable facts.

For context, we observe that an audit of a global entity is complex, involving a large number of individual audit and accounting issues. As currently drafted, and depending on the professional judgments applied, many issues that are considered in the normal course for a complex organization may nevertheless fall within the definition of a CAM (e.g., determining fair value measures based on hypothetical market participants, determining fair value of contingent consideration; and judgments and estimates for variable considerations). As such issues are regularly considered as part of the accounting issue resolution process of a global organization, we believe that the potential list of items meeting the overly broad definition of a CAM could indeed be voluminous.

In addition, we recommend that the Board consider, as an alternative, limiting the identification of a CAM to those matters already disclosed by management as critical accounting estimates, which we believe provides a more appropriate anchor for matters that the auditor should consider for inclusion in its audit report. Critical accounting estimates must be discussed with the audit committee, so this would also have a logical tie-in to the recommendation above.

Implementation Learning Period and Value Assessment

We have concerns that, as a natural consequence of the PCAOB's regulatory process, auditors will have a natural tendency to identify more CAMs than is necessary to meet the goals of the proposed standard. For example, auditors may choose to include disclosure of matters that are otherwise immaterial to users of the financial statements in order to avoid PCAOB audit findings from inspection teams. This concern is supported by recent findings from internal surveys conducted within our membership around how audits of ICFR are being conducted by auditors and the effects of PCAOB inspection findings on audits of our member companies. These concerns have also been raised and discussed recently in numerous meetings, conferences, and other discussions with preparers, investors, and regulators and are not unique to CCR member companies.

Application of the new standard will require significant auditor judgment, and therefore it is imperative the PCAOB have a robust plan that allows appropriate time to monitor and understand how auditors are interpreting and applying the new standard, recognizing that there may be differences in professional judgment or interpretation of the standard as written. As evidenced in other situations, auditor behavior is likely to be shaped by inspection findings over the long run which will have a lasting impact on the market overall.

Absent the benefits of adequate field testing on the revised proposed standard, we recommend that the PCAOB consider the first year of implementation as an opportunity for auditors to implement the new standard, and for the PCAOB to monitor implementation with the goal of learning how the standard is being interpreted and applied across audit firms, and to identify issues arising during implementation. This could include a type of "safe harbor" of at least one year, along with a robust post-implementation evaluation process to discuss findings and possible revisions that may need to be made to ensure the standard is achieving its objectives. This post-implementation review should include key stakeholder feedback including, for example, investor feedback to understand how the additional information is being utilized, as well as preparer and auditor feedback to understand the additional costs and time associated with implementation of the new standard. A robust post-implementation review and evaluation, and key stakeholder discussion, would not only allow auditors to develop and possibly make improvements in their process prior to formal PCAOB inspection findings, but would also allow appropriate time for the PCAOB to react to what it learns and to make revisions, where necessary, to improve the application of the new standard.

Filing Deadline Implications

In addition, we have operational concerns that audit procedures to address the new standard are likely to come at a critical time during the audit process, and may distract auditors and management from completing other critical parts of the financial statement preparation and audit process. This may involve partner and manager time, as well as national office resources, including input from the registrant's senior management team including inside and outside legal counsel, and audit committee members. In some cases, this could result in a delay in filing for certain companies and should be appropriately considered during implementation.

Cost / Benefit

We observe that as a general rule, certain investors are always willing to say yes to additional disclosure; however, as evidenced during the original and subsequent drafts of this proposal, investors have not explained how they would use this information to make better investment decisions and thereby improve the overall functioning of our capital markets. We observe that this type of information has potential to skew or mislead investors and, as noted in the revised proposed standard, inclusion of this type of information could result in a decrease in audit quality.[2] It is clear that investors understand and utilize the existing pass/fail model but unclear how the revised proposed standard enhances their understanding.

In addition to identification of a CAM in the audit report, the revised proposed standard will require auditors to "*describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, describe how it was addressed in the audit, and refer to the relevant financial statement accounts and disclosures.*" Given that we are not clear on how reporting of CAMs will realistically assist investors in understanding or analyzing a company's financial position and results, we do not see how a description of related audit procedures will benefit or provide additional value to investors and users of the financial statements. In addition, there is a risk that providing such information could, in some instances, cause an auditor to disclose original information about a registrant. We are also concerned that providing this level of detail could also result in boilerplate language over the long run, or auditors reporting a lengthy list of all procedures performed in order to avoid inspection findings.

As previously mentioned, we believe there will be a significant increase to cost overall as a result of this new standard and it doesn't appear that a compelling case has been made on how the benefits of this change exceed its costs.[3] If the PCAOB proceeds to a final standard based on this proposal, we recommend, as noted above, that a robust post-implementation review be conducted to identify the benefits and understand whether, and to what extent, investors and users of the financial statements are utilizing this additional information, along with an evaluation of the related costs.

As previously communicated to members of the Board, in areas where the work of the PCAOB directly or indirectly affects the reporting of issuers, we believe that all stakeholders (including preparers, investors, and auditors) would benefit from a more open dialogue on these issues or the creation of a mechanism for key stakeholders to come together and discuss proposals and practice issues with the goal of improving application of the standards.

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[2] Refer to section VI. Economic Considerations, section D. Costs and Potential Unintended Consequences, FN 178.
[3] Refer to section VI. Economic Considerations, sections C. Benefits and D. Costs and Potential Unintended Consequences.

Documentation

We do not believe that the documentation requirements by the auditor (which are significant and will add substantial cost to an audit) are likely to improve the quality of the audit, as we perceive the benefit to be limited to those involved in the PCAOB inspection. Specifically, this would require a process that enhances the ability of inspectors to determine that every item was considered and definitively adjudicated as a CAM or not. Having to document the "negative" of why something is not challenging, subjective or requires complex auditor judgment is cumbersome and is unlikely to be meaningful to investors. We believe that documenting only the reasons why something is a CAM is a more appropriate and efficient process. Given all that needs to be completed for the audit before meeting with the audit committee, we believe that having an auditor focus on creating contemporaneous documentation related to items that were deemed to be unimportant inevitably takes away time and resources during a critical phase of the audit. We fail to see how this resource intensive process will add to the quality of audits. On the other hand, we can certainly understand concerns that such diversions of resources raises the risk that audit quality will suffer as a result.

Litigation

The litigious nature of the US environment is well documented and requires little in the way of further explanation or support. It is not uncommon for lawsuits, brought by plaintiffs related to matters such as these, to be settled in order to avoid further litigation expenses even in the absence of any wrongdoing. It is important to remember that qualified knowledgeable professionals can disagree, particularly when it relates to assumptions or estimates which are not black and white, or when an issue relates to areas that are so complex that they require multiple discussions between the auditor, preparer and, sometimes, the auditor's national office in order to fully understand and evaluate the accounting requirements which may be applicable. We believe that the Board and the SEC need to be cognizant of this reality and take care to ensure that requirements of their standards do not inappropriately subject audit firms and issuers to litigation. As discussed above, introducing safe harbor rules during the implementation phase of this proposed standard may be a reasonable way to avoid such outcomes.

Auditor Tenure

We don't believe that there is any meaningful link between auditor tenure and audit quality (whether that is to say that longer tenure results in better or worse audit quality) and therefore, recommend that this disclosure should not be required in the auditor's opinion. Including this information in Form AP would be preferable to inclusion in the audit report.

Independence

We support inclusion of a statement that the auditor is required to be independent and the added language clarifying "whether due to error or fraud" when describing the auditor's responsibilities.

Opinion Paragraph

We support the PCAOB decision to move the opinion paragraph earlier in the auditor's report.

Concluding Remarks

As financial officers of public companies, we recognize the responsibility we have to the financial markets to produce accurate and reliable financial information, along with the importance of an independent audit as a signal to investors about their ability to rely on the information we provide.

While we are supportive of the efforts of the PCAOB to regulate the audit profession and to provide meaningful audit standards, we have significant concerns about the revised proposed standard and would object to a final standard that does not address the issues raised in this letter. If the Board votes to move forward after addressing these concerns, we recommend the PCAOB design a robust review process during implementation to adequately collect the information necessary to learn how the standard is being interpreted and applied in practice. We believe this process should be completed prior to any formal audit findings from PCAOB inspections.

We appreciate the Board's consideration of these matters and would be glad to answer any questions you may have.

Sincerely,

Richard Levy

Richard Levy
Chairman, Committee on Corporate Reporting
Financial Executives International

Florida Institute of Certified Public Accountants

Office of the Secretary
Public Company Accounting Oversight Board (PCAOB)
1666 K Street, N.W
Washington, DC 20006-2803

Electronically submitted to comments@pcaobus.org

Re: PCAOB Release No. 2016-003
*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, and Related Amendments to PCAOB Standards.*

Dear Board Members:

The Accounting Principles and Auditing Standards Committee (the Committee) of the Florida Institute of Certified Public Accountants (FICPA) respectfully submits its comments on the referenced proposal. The Committee is a technical committee of the FICPA and has reviewed and discussed the above referenced proposed auditing Standard, including the questions posed in the proposal. The FICPA has more than 20,000 members, with its membership comprised primarily of CPAs in public practice and industry. The Committee is comprised of 20 members, of whom about 65% are either sole practitioners, or are from local or regional firms, and about 35% are from large multi-office and international firms. We are addressing this proposed auditing standard both from the viewpoint of preparers of financial statements as well as those performing attest services on them. The Committee has the following comments related to the standard, and the questions posed, in its entirety.

The Committee discussed the above referenced proposed Auditing Standard, and the questions included therein. The Committee has a fundamental disagreement with the premise that incorporating Critical Audit Matters (CAMs) and auditor tenure in the audit report will provide useful information to investors or improve audit quality. On the contrary, there may be a net loss in useful information to the investors, and a compromise in audit quality. Therefore, we did not address individual questions, since many of them presume inclusion of the CAMs. Our general disagreement with the proposed standard is based on the following reasoning:

1. Inclusion of the CAMs in the audit report may necessitate revealing audit processes and procedures while discussing how the CAMs were eventually resolved. That would make the audit more predictable, and therefore compromise on the overall audit quality.

2. There is a wide diversity among auditors in making audit risk assessments, planning and procedures, even if the resulting conclusion may be the same. Much of this diversity is attributable to differences in the audit firm's knowledge and experience in a specific industry. Hence the CAMs would not be comparable across companies even in the same industry. Therefore, this will aggravate, rather than mitigate the information asymmetry among the investors that the proposed auditing standard hopes to accomplish.

3. The Committee continues to be concerned about liability issues, despite the narrowed definition of CAMs in the re-proposed standard. It may be difficult to avoid violating certain confidential matters, and still be in compliance with disclosure of CAMs. While the re-proposed standard does allow for excluding matters that violate confidential information, it nevertheless imposes the additional burden of making such a judgment upon the auditor.

4. The Committee was concerned that revealing the CAMs may influence investors' decisions in ways that were not intended by the proposed Standard. That is, especially in the case of the less informed investor, a discussion of the risk assessment might have a dilutive effect on the audit opinion as issued under the current "Pass/Fail" model.

5. In a similar vein, including the CAMs in the audit report may introduce a bias against certain types of companies, such as smaller companies, or those in a new industry. Such companies are inherently subject to more audit procedures and communications with the Audit Committees, even if that is not reflective of the final audit conclusion. This may create a higher perception of riskiness in the minds of the investors than is warranted by the actual audit conclusion.

6. The Committee also disagrees with the inclusion of information on auditor tenure in the report since tenure is not reflective of audit quality, and will not provide useful information to the investors.

The Committee appreciates the opportunity to respond to this proposed auditing standard. Members of the Committee are available to discuss any questions you may have regarding this communication.

Respectfully submitted,

Edward Cranford, CPA
Chair, FICPA Accounting Principles and Auditing Standards Committee

Committee members coordinating this response:
Poornima Srinivasan, CPA
Richard Edsall, CPA

| | |
|---|---|
| **From:** | Stephen Howard Fuller |
| **To:** | Comments |
| **Subject:** | Study on Critical Audit Matters |
| **Date:** | Monday, August 15, 2016 11:05:50 AM |
| **Attachments:** | Critical Audit Matter Study - August 2016.docx |

August 15, 2016

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

Dear Members of the Board:

Please find attached a study I hope you will find relevant to:

Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

For your convenience, following is an abstract of the study:

ABSTRACT:

Motivated by the current PCAOB proposed standard regarding expansion of the auditor's reporting model, this study investigates the effect of auditor reporting choice on management disclosure decisions. The proposed standard would require auditors to identify and provide information about the most significant audit and financial reporting issues encountered during the audit in a new section of the audit report on Critical Audit Matters (CAMs). I explore how auditor choices about reporting on CAMs might affect manager disclosure decisions. In addition, the study investigates whether this effect depends on a very important governance structure, the audit committee. I find that management reacts to the auditor shining a spotlight on a highly uncertain critical accounting estimate by increasing their own disclosure of the matter and that this effect varies directly with the strength of the audit committee's oversight. In addition, I find that as auditors increase the level of detail provided in their CAM reporting, management responds with increased disclosure. Finally, when the auditor provides a detailed CAM discussion, it appears that managers are likely to increase disclosure of quantitative information that would enhance the financial statement user's ability to quantify the risk in a critical accounting estimate. The study provides ex ante insights on how a mandated change in the auditor's reporting model might affect the level of information provided by management and received by investors.

Best Regards,

Stephen H. Fuller

# The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions

Stephen H. Fuller
Visiting Assistant Professor
Lehigh University

**August 2016**

This study is based on my dissertation and I express my deep gratitude to the members of my dissertation committee: Jennifer Joe (Chair), Kathryn Kadous, Lisa Lambert, Benjamin Luippold and Ivo Tafkov. My study benefited greatly from their patient guidance and commitment to excellence in research. In addition, I gratefully acknowledge the many parties who have provided assistance and feedback over the course of my dissertation including Christopher Agoglia, Ellen Best, Carol Bishop, Nerissa Brown, Dana Hermanson, Yoon Ju Kang, Siva Nathan, Usha Ramachandran, Kerri-Ann Sanderson, Galen Sevcik, Doug Stevens, Han Stice, Laura Swenson, Roger White, and all of the Georgia State University faculty, staff and doctoral students. I am especially grateful to the many professionals who kindly shared their valuable time and experience for my study.

# The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions

ABSTRACT:

Motivated by the current PCAOB proposed standard regarding expansion of the auditor's reporting model, this study investigates the effect of auditor reporting choice on management disclosure decisions. The proposed standard would require auditors to identify and provide information about the most significant audit and financial reporting issues encountered during the audit in a new section of the audit report on Critical Audit Matters (CAMs). I explore how auditor choices about reporting on CAMs might affect manager disclosure decisions. In addition, the study investigates whether this effect depends on a very important governance structure, the audit committee. I find that management reacts to the auditor shining a spotlight on a highly uncertain critical accounting estimate by increasing their own disclosure of the matter and that this effect varies directly with the strength of the audit committee's oversight. In addition, I find that as auditors increase the level of detail provided in their CAM reporting, management responds with increased disclosure. Finally, when the auditor provides a detailed CAM discussion, it appears that managers are likely to increase disclosure of quantitative information that would enhance the financial statement user's ability to quantify the risk in a critical accounting estimate. The study provides *ex ante* insights on how a mandated change in the auditor's reporting model might affect the level of information provided by management and received by investors.

**Keywords: Auditor Reporting, Critical Audit Matters, Audit Committee Oversight, management disclosure**

# I. INTRODUCTION

This study examines how managers' decisions to disclose information about critical accounting estimates might be sensitive to whether auditors bring attention to the estimates with their reporting choices. Investors and regulators contend that auditors have information about their clients' financial reporting that investors are demanding (PCAOB 2011b), but that management is choosing not to disclose (SEC 2003, PCAOB 2011b). The importance of this issue to investors was highlighted by the failure of financial sector companies to make adequate disclosure regarding the uncertainty surrounding fair value estimates, which some contend was a major contributing factor to the global financial crisis experienced in the late 2000s (PCAOB 2011a). To explore the issue, the Public Company Accounting Oversight Board (PCAOB) initiated a project in 2011 addressing how the current auditor's reporting model might be modified to provide information of greater value to investors (PCAOB 2011a). Highly debated changes to the auditor's reporting model have been proposed that would require auditors to bring heightened attention to key areas of uncertainty in the financial statements. It is important to shed light on how managers might respond to differing levels of attention brought by auditors to critical accounting estimates by adjusting their own voluntary disclosure decisions.

Effects of the proposed auditing standard are likely to be influenced by the corporate governance environment of the firm. Audit committees are a key element of corporate governance by virtue of their role in the monitoring of financial reporting (Blue Ribbon Committee 1999; Agoglia, Doupnik, and Tsakumis 2011). Prior research has consistently found that stronger audit committees are associated with higher quality financial reporting (Agoglia et al. 2011; Abbott, Parker and Peters 2004; Bédard et al. 2004). In the course of the debate over the PCAOB auditor's reporting model project, many audit committee members voiced concerns that expanding the auditor's reporting model might usurp the audit committee's responsibility for investor protection (PCAOB 2011b). However, audit committee oversight is likely to play a pivotal role in determining how changes to the auditor's report translate to changes in management's financial disclosure. Audit committees review financial statements and the auditor's report prior to their release (Beasley, Carcello, Hermanson, and Neal 2009), and management must consider the audit committee's reaction to the content of the auditor's report. Management's sensitivity to the auditor's reporting choices likely depends on the level of accountability felt by management to the audit committee. Therefore, I also examine whether the impact of the proposed standard on management disclosure choice is conditional on the strength of the audit committee's oversight.

The financial reporting and auditing of critical accounting estimates is an area that has received widespread attention in recent years due to the importance of these estimates to the financial statements and to the decisions of investors (Griffith, Hammersley, and Kadous 2015). The use of critical accounting estimates is pervasive in many financial reporting settings including fair value, asset impairment, product warranty and liability reserves and post-employment benefits (Griffith et al. 2015). Due to the uncertainty and subjectivity surrounding critical accounting estimates, there has been a consistent call by regulators and the markets for management to provide more extensive disclosure regarding the risk inherent in critical accounting estimates (e.g., SEC 2003, PCAOB 2011b). Unfortunately, such disclosure has not been broadly provided by issuers (SEC 2003; PCAOB 2011b).

The audit process represents an avenue for improving issuers' compliance with SEC regulations regarding disclosure of critical accounting estimates for several reasons. First, auditors interact with their clients on financial reporting issues as a matter of routine, allowing auditors to keep abreast of developments in the critical accounting areas of their clients. Next, some stakeholders feel that the proposed expansion of the audit report will provide auditors with greater leverage to compel clients to provide improved disclosure of critical accounting issues (PCAOB 2011b). Finally, the PCAOB, by virtue of their inspection powers over audit firms, can motivate audit firms to appropriately identify which client issues are most important to cover in the expanded audit report (Carcello, Hollingsworth, and Mastrolia 2011).

In August 2013, the PCAOB released a proposed auditing standard dealing with the auditor's reporting model which requires that auditors include in their audit report a section dealing with "Critical Audit Matters" (CAMs) which "involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements" (PCAOB 2013, 6). Under the proposed standard, the auditor would be required to disclose information about each CAM in a new section of the audit report or to state that there are no CAMs (PCAOB 2013). Importantly, auditors would still have broad discretion over the level of detailed information reported. In the course of the debate over expansion of the audit report, auditors have indicated they would only be supportive of providing factual and objective information in a CAM (PCAOB 2011b). Other constituencies in the debate argued that if auditors provide only limited information and mainly refer to management disclosure, the change would not provide investors with the information they are demanding (PCAOB 2011b). Therefore, I explore whether the level of detail provided in the auditor's reporting on the CAM impacts the manager's decision regarding how much information to disclose.

To address my research questions, I conducted an experiment with highly experienced public company financial executives, primarily chief financial officers. This high caliber group of participants was vital given the importance of obtaining reliable *ex ante* insights on the proposal from managers that will be directly impacted by the proposed standard. Participants rated the extent of disclosure they would choose to make related to a critical accounting estimate made by a hypothetical company as well as the importance of a variety of specific disclosure elements. I manipulated the auditor reporting choice regarding an accounting estimate made by the company at three levels: (i) No CAM (control); (ii) Short CAM with a brief description in the audit report; or (iii) Long CAM with a detailed description in the audit report. I also manipulated the strength of the audit committee's oversight at two levels, moderate and strong. Based on economic theory regarding the incentives surrounding disclosure as well as accountability theory, I predicted increases in the level of detail provided in the auditor's CAM reporting of an issue would lead to increased disclosure by managers, with the strongest effect coming in the presence of strong audit committee oversight.

Consistent with expectations, I found a joint effect of auditor CAM reporting choice and audit committee oversight strength on manager disclosure decisions. The increase in the manager's disclosure resulting from the auditor providing detailed discussion of a CAM was greatest in the presence of strong audit committee oversight, thus highlighting the continued importance of the audit committee to the quality of financial reporting. Further, I found that managers did not increase their disclosure when the auditor included only cursory discussion of the CAM in its audit report providing support for this concern voiced by some stakeholders in the debate. I also investigated the specific elements of disclosure a manager considers when making financial disclosure. I found that elements of disclosure that enhance the ability of financial statement users to quantify the level of risk in a critical accounting estimate (e.g., range of, key assumptions in, and sensitivity analysis of the estimate) are more likely to be disclosed when the auditor heightens the attention on a critical accounting estimate through its CAM reporting, and that this effect depends on the strength of the audit committee's oversight.

The study makes several contributions to regulators, practitioners and accounting researchers. First, the study provides timely feedback to regulators and stakeholders on the potential effects of the proposed standard that will inform regulator decision-making. Several important topics under debate are addressed in the study including the appropriate level of detail that should be required in the auditor's CAM reporting and the role of the audit committee. Next, the study answers the call for experimental research on how proposed policy changes might impact the nature and quality of financial reporting (Maines 1994; Beresford 1997). Archival information in the U.S. is not available to analyze the impact of the proposed change. Experimental research provides the advantage of seeing *ex ante* what might happen in a setting "as if" the change had been implemented (Maines 1994). While several concurrent experimental studies have begun to address the implications of the proposed standard, to my knowledge, this is the first experimental study dealing directly with the effect of auditor reporting choices on manager disclosure decisions. Finally, the study extends the accounting literature on the impact of audit committee oversight on the quality of financial reporting and disclosure.

The remainder of this paper is organized as follows. Section II provides theory and hypothesis development, Section III describes the research design, Section IV presents the results of the study, and Section V concludes.

## II. BACKGROUND AND THEORY

### PCAOB Project

In June 2011, the PCAOB initiated a project to explore how the current auditor's reporting model might be modified to provide information of greater value to investors (PCAOB

2011a). To many, the current auditor's reporting model is primarily seen as a "pass/fail" model that simply provides reasonable assurance as to whether or not the financial statements are presented free of material misstatement (PCAOB 2011b). Many investors have argued that auditors could provide much more useful reporting to investors if their reporting was expanded to provide additional information on a wide array of areas including critical accounting estimates and their impact on the financial statements (PCAOB 2011b, 2012).[1]

The PCAOB conducted extensive debate related to the auditor's reporting model project including all the major stakeholders – auditors, management, investors and audit committees. Auditors, management and the audit committee expressed many concerns about the project, chief among them that auditors should not be the source of "original information" about the company, which should remain the responsibility of management (PCAOB 2011b).[2] Additional concerns raised included the potential cost and administrative burdens (PCAOB 2011b). Investors, however, expressed significant support for the prospect of expanding the content provided by auditors in their reports. Eventually, the proposal to expand and mandate the use of emphasis of matter (EOM) paragraphs was the option that received the greatest support on both sides of the debate (PCAOB 2011b, 2012).

[1] The PCAOB issued a concept release on the project proposing three different methods by which expanded auditor reporting might be pursued: (i) the requirement of an "Auditor's Discussion and Analysis" (ADA) related to the audit; (ii) extension of the audit report to cover certain "information outside the financial statements"; or (iii) "required and expanded use of emphasis paragraphs" (PCAOB 2011a, 12).

[2] Current SEC regulations require firms to make supplemental disclosure in Management's Discussion and Analysis (MDA) regarding critical accounting estimates if they are material due to their subjectivity and impact on the financial statements (SEC 2003). However, despite these regulations, investors and regulators continue to assert that the appropriate level of disclosure is not being made (PCAOB 2011b). At present, auditors are not generally required to provide assurance regarding their clients' MDA and, accordingly, do not opine on the adequacy of the critical accounting estimates disclosure contained in MDA. Instead, they are merely required in the current model to read the client's MDA and resolve any inconsistencies between the MDA and the audited financial statements (PCAOB 2003).

In August 2013, the PCAOB released a proposed auditing standard dealing with the auditor's reporting model similar to the EOM paragraph approach in the concept release. Specifically, the proposed standard would require auditors to include in their audit report a section dealing with "Critical Audit Matters." Pursuant to the proposed standard, CAMs consist of matters which "involved the most difficult, subjective, or complex auditor judgments or posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence or forming an opinion on the financial statements" (PCAOB 2013, 6). The auditor is required to disclose certain information about each CAM in the audit report or to state that there were no CAMs. For each CAM, the auditor must (i) "identify the critical audit matter"; (ii) "describe the considerations that led the auditor to determine that the matter is a critical audit matter"; and (iii) "refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter, when applicable" (PCAOB 2013, 16).

In the debate surrounding the audit reporting model project, auditors generally took the position that any expansion of the auditor report should be limited to objective factual information for which auditors are <u>not</u> the original source and make reference to where the issue is discussed by management (PCAOB 2011b). They further argued that merely identifying an uncertain issue in the audit report would likely lead to disclosures by management that were among the most complete in the financial statements (PCAOB 2011b). Other stakeholders (e.g., investors) took the position that such a limited approach by the auditor provided little or no benefit and amounted to "roadmapping" for financial reporting (PCAOB 2011b). They called for greater information content such as discussion of *why* the auditor felt it was important to emphasize the matter and what uncertainties applied to the area (PCAOB 2011b). This study seeks to examine what impact reporting on CAMs might have at varying levels of detail.

Several concurrent studies explore the effect of the proposed auditing standard on various stakeholders in the financial reporting process. Several of these studies in a variety of specific contexts have found that auditor reporting of a CAM may alternatively lead to a reduced level of legal liability for auditors (Kachelmeier, Schmidt, and Valentine 2014 WP; Brasel, Doxey, Grenier, and Reffett 2016; Brown, Majors, and Peecher 2014 WP) or higher auditor liability assessments (Backof, Bowlin, and Goodson 2016 WP; Gimbar, Hansen, and Ozlanski 2016).

Other studies address the impact of auditor CAM reporting on investor decisions. Christensen, Glover, and Wolfe (2014) find that reporting of a CAM concerning fair value decreased the likelihood that non-professional investors would invest in the target firm. Sirois, Bedard, and Bera (2015 WP) found that discussion of a "key audit matter" in the audit report led to greater "information search" about the matter by non-professional investors. Interestingly, they also found that participants indicated "lower perceived audit quality" in the areas of the audit corresponding with the key audit matter (Sirois et al. 2015 WP). The relevance of these studies to my study lies in the many different factors that bear on the auditor's decision whether or not to report an audit issue as a CAM, suggesting that there might be significant variance in that decision.

One concurrent study addresses the influence of auditor key audit matter reporting requirements on auditor judgments. Gay and Ng (2015 WP) study whether a key audit matter reporting requirement influences the auditor's willingness to discuss an aggressive accounting estimate with the audit committee and/or accept the aggressive estimate, presumably to avoid discussion of the estimate with the audit committee. They also address whether the proactivity/reactivity of the audit committee plays a role in the decision. They find that when auditors face a reactive audit committee and a key audit matter reporting requirement, auditors are less likely to discuss the aggressive estimate with the audit committee and more likely to accept the estimate than if there is no key audit matter reporting requirement.

To my knowledge, there is no concurrent study that specifically addresses the effect of the proposed standard on management financial disclosure decisions. However, there is one study that addresses the "communication openness" of non-financial management toward auditors in the presence of a CAM reporting requirement (Cade and Hodge 2014 WP). The authors find that non-financial managers that have private information that the auditor is unaware of concerning "key accounting estimates" are less likely to openly communicate with their auditors when the auditor is required to report on the client's key accounting estimates than when they are not (Cade and Hodge 2014 WP). Their study is a valuable complement to this study in the sense that it addresses an important precursor to the auditor's CAM reporting decision – the ability of the auditor to obtain all the relevant knowledge of the issue needed to make an informed decision with regard to CAM reporting.

**Prior Research on Management Disclosure Choice**

Prior research has identified several factors affecting management's choice to make disclosure including a variety of offsetting incentives. On one hand, managers have a number of positive incentives to make greater disclosure. Managers might provide higher quality disclosure to establish a reputation for credibility with investors (Stocken 2000; Beyer, Cohen, Lys, and Walther 2010) for both themselves and the firm. Such a reputation can grant a number of economic benefits such as higher firm valuation and lower cost of capital (Beyer et al. 2010), and a reduction in litigation risk (Skinner 1997; Field, Lowry, and Shu 2005; Beyer et al. 2010).

On the other hand, managers also have incentives discouraging greater disclosure. First, since management compensation is frequently sensitive to stock price performance, managers might desire to avoid, or at least postpone, disclosure of bad news to avoid negative stock price impacts (Beyer et al. 2010). Second, greater disclosure has the potential for proprietary costs to the firm as competitors could derive information from disclosure that is detrimental to the firm's interests (Fischer and Verrecchia 2004; Arya, Frimor, and Mittendorf 2010; Beyer et al. 2010).

These offsetting incentives likely motivate management to seek a level of disclosure that secures the greatest net benefit after considering costs of the disclosure. Importantly, managers are influenced in this judgment by whether investors know that management has private information (Beyer et al. 2010). If investors are thought to know less about management's possession of private information, management would likely provide less voluntary disclosure of bad news (Dye 1985; Jung and Kwon 1988; Penno 1997; Pae 2002; Beyer et al. 2010).

An auditor's decision to report a matter as a CAM effectively shines a spotlight on the issue. As a result, managers are more likely to perceive a higher level of investor attention to and knowledge about the issue. Management would thus be more likely to increase the level of disclosure for the subject of the CAM due to a shift in its incentives. Management would derive less benefit from lack of disclosure because they would expect investors to "fill in the blanks."[3] In addition, if the matter was spotlighted by the auditor, management's concern would shift to its reputation and litigation risk, both of which call for increased disclosure. Furthermore, if the auditor's reporting on the CAM was more expansive and included a detailed discussion of *why* the auditor was emphasizing the matter, the perceived level of investor knowledge would be

[3] Prior accounting research (Hammersley 2006) has found that experts in a domain (e.g., industry expert auditors) are adept at elaborating full "cognitive representations" of a problem from partial information sets. In the context of this study, expert financial statement users such as industry analysts could be expected to assimilate information in an auditor's CAM reporting, even if it is incomplete, to identify areas of undisclosed risk in the financial statements.

even higher and should lead to even greater level of disclosure. Based on the foregoing discussion, primarily of economic incentives to disclose, I propose the following hypothesis:

> *H1: As the auditor increases the level of detailed reporting given a critical audit matter in its audit report, the manager will increase the level of disclosure made about the matter.*

**Audit Committee's Role in Financial Reporting**

Audit Committees provide a critical oversight role over financial reporting (Agoglia et al. 2011; Blue Ribbon Committee 1999; Beasley et al. 2009) which has only increased subsequent to the passage of the Sarbanes Oxley Act of 2002 (SOX). Among its provisions, SOX emphasized the importance of audit committee member independence and financial expertise (U.S. House of Representatives 2002; Agoglia et al. 2011). Prior research has characterized stronger audit committees as being more independent, having greater financial expertise, and meeting more frequently (Bédard et al. 2004; Agoglia et al. 2011). These audit committee characteristics have been found to lead to improvements in financial reporting quality (Agoglia et al. 2011; Abbot et al. 2004; Bedard, Chtourou, and Courteau 2004). Of particular significance to this study, Agoglia et al. (2011) found evidence that stronger audit committees constrain "opportuntistic reporting" by management via exploitation of "bright-line" rules-based accounting standards.

Prior research on audit committee oversight has also identified variance in audit committees' approach to their oversight responsibilities. For example, two different survey studies (Beasley et al. 2009; Cohen, Krishnamoorthy, and Wright 2010) addressed the audit committee process and explored how audit committees executed their oversight responsibilities. Beasley et al. (2009) surveyed 42 audit committee members and found evidence that some audit committee members felt that oversight of the financial reporting process by the audit committee was somewhat "ceremonial" while others felt that the audit committee was deeply involved. Cohen et al. (2010) surveyed 30 audit partners and managers about their perceptions of audit committee oversight. In their survey, only 52% of the respondents indicated that the audit committee impacted the "resolution of contentious" accounting and reporting matters between management and auditors.

The relationship between audit committee oversight strength and financial reporting quality can be explained by management's accountability to the audit committee. The psychology literature identifies accountability as an effective motivator of human behavior. According to Kang (2014 WP) under accountability theory (Tetlock, Skitka, and Boettger 1989), people adopt "social and cognitive strategies … to obtain acceptance from, or avoid conflict with" parties to whom they are accountable (Kang et al. 2014 WP; Tetlock et al. 1989). In the context of financial reporting, managers are accountable to many different parties, including investors, regulators, their own bosses, and audit committees (Cohen, Krishnamoorthy, and Wright 2004; U.S. House of Representatives 2002). Audit committees consist of a subset of the firm's board of directors, who oversee the firm's management and have the authority to terminate management. Accordingly, audit committees represent a high stakes source of accountability to management.

As part of their duties, audit committees communicate with both management and auditors and review the company's financial statements, disclosures and audit report (Beasley et al. 2009). Since management has incentives to avoid disclosure, one purpose for the audit committee's oversight of financial reporting is to constrain management's opportunistic disclosure decisions (Agoglia et al. 2011). I contend that such audit committee constraint on management opportunism is inconsistent with the preferences of management.

Prior research streams in psychology and accounting identify the concept of "motivated sensitivity" (Ditto, Scepansky, Munro, Apanovich, and Lockhart 1998; Hales, Kuang and Venkataraman et al. 2011; Hales 2007) and its impact on the processing of "preference-inconsistent information" (Ditto et al. 1998). In motivated sensitivity, people are expected to asymmetrically process information that is preference-consistent versus preference-inconsistent. Similar to motivated reasoning theory (Kunda 1990; Kadous, Kennedy and Peecher 2003; Hales 2007; Hales et al. 2011), information that is preference-consistent is expected to be shallowly processed and readily accepted. However, in motivated sensitivity, preference-inconsistent information is expected to be processed more deeply and have a greater influence on the final judgment (Ditto et al. 1998). Preference-inconsistent information is likely to signal some type of potential harm and so it is in the best interest of the individual to consider the information deeply (Ditto et al. 1998). In the context of this study, an auditor's reporting of a critical accounting estimate as a CAM is inconsistent with management's preference because it increases the audit committee's scrutiny of management's disclosure decision. Furthermore, the strength of the audit committee should impact the sensitivity of the manager to the information conveyed by the CAM reporting due to the differing level of accountability felt by the manager to the audit committee. Accordingly, managers facing stronger audit committee oversight should be expected to process more deeply and be more influenced in their disclosure by the content of CAM reporting than managers facing only moderate audit committee oversight.

Prior accounting research on accountability identifies various strategies accountable parties employ to avoid conflict with parties to whom they are accountable (Gibbins and Newton 1994; Peecher, Solomon, and Trotman 2013; Kang 2014 WP). For example, accountable parties may "shift their attitude toward" the attitudes of their evaluators, may become defensive and try to justify their contrary attitudes, or may "expend cognitive effort" to devise a strategy to avoid conflict with the evaluator (Gibbins and Newton 1994). One determining factor for the strategy used is whether the attitudes of the evaluator are known (Gibbins and Newton 1994; Peecher et al. 2013). When such attitudes are known, Gibbins and Newton (1994) identify "attitude shift" as a potentially effective strategy. Managers confronted with strong audit committee oversight are very likely to perceive that high quality financial reporting is a key mandate of the audit committee (Kang 2014 WP). Accordingly, they are likely to adopt strategies to provide higher quality financial reporting in order to avoid conflict with the audit committee. Agoglia et al. (2011) find evidence of this for managers who face strong audit committees. Managers in the study indicated that concern over "second-guessing" of their accounting decisions by the audit committee was greater when the audit committee was strong than when it was weak leading managers to make more conservative accounting treatment decisions (Agoglia et al. 2011).

Recall that H1 predicts that as the spotlight on a critical accounting estimate increases, managers will increase the level of disclosure made regarding the critical accounting estimate. Based on the foregoing discussion, I predict that this effect will be moderated by the strength of audit committee oversight and therefore propose the following hypothesis:

> *H2: Managers will increase the level of disclosure made regarding a critical audit matter <u>more</u> in response to increased level of detail given the matter in the audit report when the audit committee's oversight is strong than when it is moderate.*

The pattern of results predicted in H1 and H2 is presented in Figure 1.

[Insert Figure 1 here]

## III. METHOD

### Participants

Given the high degree of professional judgment required for the experimental task, it was important to ensure that participants had strong task-relevant experience (Trotman 2005). Accordingly, participants are seasoned public company financial executives, primarily CFOs, as they are the most likely to make the key financial disclosure decisions for their organizations. I identified potential participants in the Audit Analytics database of officer changes. I collected recent CFO appointments for public companies between 2007 and mid-2014 with positive revenues up to $2 billion.[4,5] Potential participants were invited to participate in the study via a recruitment cover letter which described the study and its importance. The mailing also included the experimental materials and a stamped return envelope. I mailed a total of 1,889 packages[6], 123 of which were returned as undeliverable, for a net total of 1,766. A total of 145 participants completed the experiment, for a response rate of 8.2%.[7]

Table 1 presents the demographics of participants in the study.[8] The participants' experience is a strong match for the demands of the experimental task. Participants had a mean

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[4] In the vast majority of cases, mailings were only sent to one CFO per company. In five cases, mailings were inadvertently sent to two different individuals who had been appointed to CFO for the same company at different times. In addition, in one case, two mailings were sent to one individual who was concurrently CFO of two different companies. In total, these mailings comprise less than 1% of the population to which mailings were sent.

[5] I followed the approach of Bishop, Hermanson, and DeZoort (2014) in choosing to recruit participants from companies with positive revenues up to $2 billion for several reasons. First, the positive revenue requirement was to focus on operational companies. Next, I reasoned that companies under $2 billion would be both more likely to respond and have CFOs more likely to be deeply involved in the financial reporting of their firms.

[6] The packages were sent out in a series of four mailings over a four-month period. The first mailing was sent in equal proportions to the six treatment conditions in the study. In order to achieve adequate sample size in each treatment condition, subsequent mailings were sent in proportions which emphasized cells which had previously received fewer responses from participants. To test for differences between mailings, I added MAILING as a covariate to all the ANOVAs in Tables 2-4. In all cases, MAILING was not significant (all p's > .29, two-tailed).

[7] The response rate of 8.2% falls within the range of response rates in recent studies involving accounting and finance professionals including Agoglia et al. 2011 (11.3%); Bennett, Hatfield, and Stefaniak 2015 (5.6%); and Bishop et al. 2014 WP (20%). To address whether non-response bias had any effect on my primary dependent variable, *Extent of Disclosure*, I added an early/late (EARLYLATE) response indicator as a covariate to all ANOVAs reported in Tables 2-4. In all cases, EARLYLATE was not significant in the analyses (all p's > .51, two-tailed).

[8] Demographic information excludes six participants that failed a key manipulation check and were excluded from results reported for this study. See note 20 for further discussion.

work experience of 29.2 years[9]. A total of 133 (95.7%) of the participants indicated their current title was CFO and all participants have had significant responsibility for their firm's financial reporting at some point. Approximately 73.4% of the participants were current or former CPAs, 71.2% had experience as an auditor, and 24.5% were current or former audit committee members. Mean age of the participants was 54.0 and 89.1% were male.[10,11]

[Insert Table 1 here]

**Design**

***Independent Variables***

I utilized a 2X3 full factorial between subjects design. My first independent variable, *Audit Committee Oversight Strength* (hereafter "*AC Strength*"), was varied at two levels, moderate and strong. My manipulation of *AC Strength* focused on the expertise of the audit committee members (Agoglia et al. 2011) as well as the audit committee's oversight of financial reporting. Prior research has found that while most audit committees have at least one financial expert as defined by SEC rules, a majority of all audit committee members do not have expertise in accounting (Cohen, Hoitash, Krishnamoorthy, and Wright et al. 2014; Badolato, Donelson and Ege 2014). Thus, in the strong *AC Strength* condition, all three members of the audit committee were described as accounting experts with direct accounting or financial reporting experience

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[9] Eleven of the 139 participants (7.9%) did not give precise years of work experience. Rather, they inserted a"+" after the given number (e.g., 30+). In the interest of conservatively estimating work experience, I coded these as the given number (e.g., 30 for "30+").

[10] One participant failed to indicate gender and two participants failed to indicate age. These participants are excluded from the reported demographic information for age and gender.

[11] I tested for systematic differences between experimental cells for all key demographic variables across all ANOVAs which I report as primary results. Only one variable, GENDER, yielded a significant difference between cells in any of the comparisons ($X^2_3$=8.481, p=.037, two-tailed when only No CAM and Short CAM conditions were analyzed). To determine whether GENDER had any effect on my primary dependent variable, *Extent of Disclosure*, I added GENDER as a covariate to an ANCOVA for the No CAM vs Short CAM comparison. GENDER was not significant in the ANCOVA ($F_{1,86}$=.173, p=.68, two-tailed). Accordingly, I did not include GENDER in the reported ANOVA results.

(Agoglia et al. 2011). In the moderate *AC Strength* condition, only 1 of the three audit committee members was described as a finance expert and none of the members had direct accounting or financial reporting expertise (Agoglia et al. 2011).[12] Prior research has also identified significant variance in the intensity of audit committees' approach to their oversight responsibilities (Beasley et al. 2009; Cohen et al. 2010). Therefore, in the strong *AC Strength* condition, the audit committee played an active role in resolution of challenging accounting and reporting issues including asking many questions about these issues. In the moderate *AC Strength* condition, the audit committee played a limited role in resolution of challenging accounting and reporting issues and occasionally asked questions about these issues. Excerpts of the *AC Strength* manipulations are presented in Appendix A.

My second independent variable, *Auditor Reporting Choice*, was varied at three levels in order to investigate whether the amount of detail provided in the auditor's CAM discussion had an effect on managers' disclosure decisions beyond the identification of the issue as a CAM. In the No CAM (control) condition, participants were told that the auditor had decided not to treat the critical accounting estimate as a CAM. The Short CAM and Long CAM conditions were designed to address the concern raised by some stakeholders that if auditors provided only minimal CAM reporting, the proposed standard would have limited impact (PCAOB 2011b). In the Short CAM condition, participants were provided with the auditor's brief discussion of the CAM in the audit report. The discussion was limited to the minimum information necessary to comply with the proposed standard -- identification of the matter and a brief discussion of why the matter was selected as a CAM. In the Long CAM condition, participants were provided with

[12] The manipulation of audit committee expertise within the *AC Strength* manipulation is borrowed with permission directly from Agoglia et al. 2011, for which I am grateful.

the auditor's detailed discussion of the CAM in the audit report. The Long CAM condition included the information in the Short CAM condition plus a richer qualitative description of the uncertainties encompassed in the matter and the potential future implications. [13]

***Experimental Materials and Task***

The experimental materials involved a financial reporting disclosure scenario. Participants were asked to assume the role of CFO for a hypothetical public company named Andarex Corp. which has traditionally manufactured high-end consumer products. Andarex has been public for 10 years and has consistently met its revenue and earnings growth targets. Andarex has a history of unqualified opinions on financial reporting and internal controls. Participants were informed that Andarex's auditors will be following a new PCAOB regulation that requires them to report on critical audit matters to highlight the audit and financial reporting issues of greatest significance. Participants were then told they would be asked to consider only one audit issue -- warranty exposure Andarex has for a newly launched product -- for which the auditor was considering treatment as a CAM.[14]

In the most recent year, Andarex launched a new product to a completely different, cost-conscious consumer segment. As a result, Andarex management was confronted with the difficult task of estimating its warranty exposure for the new product given its different warranty terms and customer base for the product. Participants received a detailed warranty calculation setting forth various assumptions including a significant element of uncertainty in the estimate related to what percentage of customers would likely file a claim in the event of a defective

[13] In order to hold information constant across all conditions, the qualitative information included in the Long CAM condition was included for all conditions within a discussion of the auditor's decision.
[14] I selected a warranty task as it is a fundamental accounting task that is widely understood by professionals with accounting experience and education (Perreault and Kida 2011).

product. The warranty estimate ranged from a minimum of $520,000 before taxes to a maximum of $1.56 million, the difference of which is material to Andarex's earnings. Andarex decided to record the minimum amount of the range until such time as it has more history with regard to the assumptions in the estimate.

After reviewing the case materials including a detailed discussion of the warranty estimate as well as the auditor's decision whether or not to treat the warranty issue as a CAM, participants rated the extent of disclosure they would choose to make about the warranty estimate as well as the likelihood that they would disclose different elements of information related to the warranty issue in Andarex's financial reporting. [15]

***Dependent Variables***

I collected one primary dependent variable and six secondary dependent variables from participants in the study. The primary dependent variable was a measurement of the *Extent of Disclosure* that the participant would provide for the warranty estimate on a 10-point Likert scale where 1 = minimal disclosure and 10 = extensive disclosure. I interpret increases in *Extent of Disclosure* as increases in the *amount* of information participants would communicate in their financial disclosure. I contend that increases in *Extent of Disclosure* correspond with increases in disclosure quality as users have more information on which to base their decisions. I treat *Extent of Disclosure* as my primary dependent variable as it is important to obtain an overall measure of participants' intention with regard to how much information will be disclosed.

[15] As part of instrument development, I met with three current or former chief financial officers to review all aspects of the case materials and post-experimental questionnaire. In each meeting, I had the professional read the instrument from beginning to end stopping between sections to discuss comprehensibility and realism of the materials, language used and questions. Prior to finalizing the instrument, I made revisions based on feedback received from the professionals to ensure the maximum comprehensibility and realism of the instrument.

Participants next considered six individual disclosure elements that could be included in the disclosure of Andarex's warranty exposure issue. I collect these ratings in order to perform further analysis of the different elements of information that managers might be more likely to include as *Extent of Disclosure* increases. Each disclosure element was rated on a 10-point Likert scale where 1 = Definitely Not Disclose and 10 = Definitely Disclose.[16] Certain of the disclosure elements represent quantitative information that could enhance the financial statement user's ability to quantify the risk in a critical accounting estimate. These elements include (i) the range of the warranty estimate (*RANGE*); a description of the key uncertain assumption in the estimate (*KEY ASSUMPTION*); and (iii) a sensitivity analysis of the warranty estimate (*SENSITIVITY*). While disclosures of this type are generally required by current SEC regulations, many stakeholders have pointed to a lack of compliance in this area (PCAOB 2011b). Other disclosure elements collected are more commonplace in current practice including (i) the amounts reported in the financial statements (*FS AMOUNT*); (ii) the rationale for the recorded amount (*RATIONALE*); and (iii) a description of uncertainty in the estimate (*UNCERTAINTY*). [17] A concrete example of each disclosure element (see Appendix C) was provided before the rating was elicited.

***Procedures***

[16] Since I contend that each of the disclosure elements I measure is necessary for a complete disclosure of the critical accounting estimate (see note 17), I interpret an increase in the likelihood of management disclosure of each element as an increase in the quality of the firm's overall disclosure of the critical accounting estimate.

[17] Taken together, I contend that disclosure of all six elements would result in a rich disclosure of the critical accounting estimate more in line with the SEC regulations (SEC 2003). It is likely that management has differing sensitivities to disclosure of these elements. For example, management is likely to be highly sensitive to the disclosure of the range of the warranty estimate, description of the key assumptions in the estimate and sensitivity analysis of the estimate. Disclosure of the amount of warranty expense and warranty accrual in the financial statements or the qualitative uncertainty surrounding the estimate is commonplace and managers are less likely to be sensitive to disclosure of these elements.

The experimental materials were divided into two packets. [18] Packet 1 included an introduction to the experiment and information regarding the company, its audit committee and the audit currently underway. Participants were then informed of the auditor's decision whether or not to report Andarex's warranty issue as a CAM. Finally, a detailed discussion of the warranty reserve issue was provided. Participants then provided their disclosure ratings, based on their knowledge of the case materials including the auditor's decision regarding the level of CAM reporting, if any, they intend to provide for the warranty reserve. Participants were instructed to complete Packet 1 before proceeding to Packet 2. Packet 2 was a post-experimental questionnaire which included manipulation checks, questions about the experiment and participant judgments, and demographic information. Participants were told not to refer back to Packet 1. The flow of the experiment is summarized in Figure 2.

[Insert Figure 2 here]

## IV. RESULTS

### Manipulation Checks

To test whether the *AC Strength* manipulation was effective, I collected participant ratings of the audit committee's accounting/financial expertise (Agoglia et al. 2011) and its involvement in financial reporting decisions. Participants rated each measure on a 7-point Likert scale where 1 = Low and 7 = High (Agoglia et al. 2011).[19] Participants in the strong *AC Strength* condition rated the audit committee's accounting/financial expertise as significantly higher than

[18] Approval of the experimental design and materials was received from the Institutional Review Board of my university prior to conducting the experiment.
[19] Two of the 139 participants failed to provide one or both of the *AC Strength* ratings and are excluded from the manipulation check tests.

participants in the moderate *AC Strength* condition (6.04 versus 2.97, $t_{136}$=15.06, p<.001, two-tailed). Participants in the strong *AC Strength* condition also rated the audit committee's involvement in financial reporting issues as significantly higher than participants in the moderate *AC Strength* condition (5.80 versus 3.15, $t_{135}$=10.89, p<.001, two-tailed). These ratings provide evidence of an effective manipulation of *AC Strength*.

To test the effectiveness of my *Auditor Reporting Choice* manipulation, I performed two tests. First, all participants were asked whether the auditor decided to report Andarex's warranty issue as a CAM. Of the 145 participants, 139 (95.9%) correctly recalled the auditor's choice regarding the CAM.[20] Next, I tested the effectiveness of the manipulation of *Auditor Reporting Choice* between the short CAM and Long CAM conditions by comparing how participants rated the informativeness of the CAM discussion provided by the auditor. Participants in the No CAM condition are excluded from this test since there was no CAM discussion provided by the auditor. Participants rated how informative the auditor's CAM reporting was on a 7-point Likert scale where 1 = Not at all Informative and 7 = Very Informative. Participants in the Long CAM condition rated the auditor's CAM reporting as significantly more informative[21] than in the Short CAM condition (4.67 versus 3.89, $t_{91}$=2.78, p<.01, two-tailed). Collectively, these results provide evidence of an effective manipulation of *Auditor Reporting Choice*.

**Primary Results**

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[20] Of the six remaining participants, four answered the question incorrectly and two failed to answer the question. Given the importance of the *Auditor Reporting Choice* manipulation, these six participants are excluded from the results reported in the remainder of this study. Including these participants in the results, in limited cases, would have minor impacts on the level of statistical significance of findings but would not qualitatively change the inferences drawn in the study.
[21] Of the 95 participants in the Short CAM and Long CAM conditions, 3 failed to answer the question and are excluded from the manipulation check tests.

In order to test my hypotheses, I conducted a series of ANOVAs of *AC Strength* and *Auditor Reporting Choice* on *Extent of Disclosure*. Each ANOVA is a comparison of two levels of *Auditor Reporting Choice* in order to determine specific effects of the various levels of detail in CAM reporting.[22] For each of the comparisons, I first test the interaction predicted in H2. Since the main effect of *Auditor Reporting Choice* predicted in H1 is dependent on *AC Strength*, I then test H1 using simple effects analysis. I first compared the No CAM control and Long CAM conditions. This is the starkest comparison which allows me to investigate the maximum effect of a Long CAM discussion by the auditor on management's disclosure decisions. The results for this comparison are presented in Figure 3 and Table 2. The ANOVA reveals a significant interaction of *Auditor Reporting Choice* and *AC Strength* ($F_{1, 88}$=2.829, p=.048, one-tailed).[23] The ANOVA also reveals a significant main effect of *AC Strength* on *Extent of Disclosure* ($F_{1,88}$=9.521, p=.002). Simple effects analysis reveals that when *AC Strength* is strong, the *Extent of Disclosure* provided by the manager is significantly greater ($F_{1, 46}$=5.279, p=.026) in the Long CAM condition ($\bar{x}$ =8.08) than in the No CAM condition ($\bar{x}$ =6.95). When *AC Strength* is only moderate, the *Extent of Disclosure* provided by the manager is no greater ($F_{1, 42}$=.078, p=.782) in the Long CAM condition ($\bar{x}$ =6.25) than in the No CAM condition ($\bar{x}$ =6.42). These results provide evidence that managers will respond to the auditor shining a spotlight on a highly uncertain critical accounting estimate by increasing their own disclosure of the matter and that this effect is strongest when audit committee oversight is strong.

[Insert Table 2 and Figure 3 here]

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[22] One of the 139 participants did not provide an *Extent of Disclosure* rating, the primary dependent variable. This participant is excluded from all results for *Extent of Disclosure*.

[23] To provide further evidence of the predicted interaction, I conducted a planned contrast of the effect of *Auditor Reporting Choice* and *AC Strength* on *Extent of Disclosure* (Buckless and Ravenscroft 1990). As expected, results of the planned contrast reported in Table 3, Panel C were significant ($t_{88}$=3.62, p<.001, one-tailed).

Next, I compared the Short CAM and long CAM conditions to investigate whether the *level of detail* in the discussion provided for the CAM affects the manager's *Extent of Disclosure* decision. Results of the comparison are presented in Figure 4 and Table 3. The interaction of *Auditor Reporting Choice* and *AC Strength* is significant ($F_{1, 88}$=11.771, p=.001, one-tailed).[24] Simple effects analysis reveals that when *AC Strength* is strong, the *Extent of Disclosure* provided by the manager is significantly greater ($F_{1, 47}$=8.005, p=.007) in the Long CAM condition ($\bar{x}$ =8.08) than in the Short CAM condition ($\bar{x}$ =6.70). When *AC Strength* is only moderate, the *Extent of Disclosure* provided by the manager in the Long CAM condition ($\bar{x}$ =6.25) is actually significantly lower ($F_{1, 41}$=4.311, p=.044) than in the Short CAM condition ($\bar{x}$ =7.48).[25] Collectively, these results suggest that the *level of detail* provided in the auditor's CAM discussion is an important determinant of the manager's disclosure choice regarding the matter and, when audit committee oversight is strong, greater detail in the auditor's CAM discussion is likely to lead to greater disclosure by management.

[Insert Table 3 and Figure 4 here]

Finally, I compared the No CAM control and Short CAM conditions to determine whether the auditor *merely identifying* the warranty estimate issue as a CAM and providing a brief discussion in the audit report would impact manager disclosure decisions. Results of the

[24] To provide further evidence of the predicted interaction, I conducted a planned contrast of the effect of *Auditor Reporting Choice* and *AC Strength* on *Extent of Disclosure*. As expected, results of the planned contrast reported in Table 3, Panel C were significant ($t_{88}$=2.00, p=.024, one-tailed).

[25] This result should be interpreted with caution as it may be an anomaly. Recall that along with this *Extent of Disclosure* rating, I also collected individual ratings for six disclosure elements. Comparison between the Short CAM and Long CAM conditions for these disclosure element ratings as well as the mean of all disclosure element ratings is presented in Table 5. The decrease in *Extent of Disclosure* between the Short CAM and Long CAM conditions when audit committee oversight is only moderate is not seen in the *likelihood to disclose* ratings for any of the disclosure elements or the mean of all ratings. So, it would seem that while participants in the Short CAM/ Moderate AC condition favored a higher *Extent of Disclosure* than participants in the Long CAM/Moderate AC condition, this did not translate to them being more likely to disclose any of the individual elements.

comparison are reported in Figure 5 and Table 4. The interaction of *Auditor Reporting Choice* and *AC Strength* was marginally significant ($F_{1, 88}$=3.321, p=.072, two-tailed) but not in the pattern predicted by theory.[26, 27] Simple effects analysis reveals that when *AC Strength* is strong, the *Extent of Disclosure* provided by the manager is no different ($F_{1, 43}$=.239, p=.628) in the Short CAM condition ($\bar{x}$ =6.79) from the No CAM condition ($\bar{x}$ =6.95). When *AC Strength* is only moderate, the *Extent of Disclosure* provided by the manager in the Short CAM condition ( $\bar{x}$ =7.48) is significantly greater ($F_{1, 45}$=4.597, p=.037) than in the No CAM condition ($\bar{x}$ =6.42).[28] Collectively, these results suggest that if the auditor only provides minimal detail in its CAM reporting, disclosure by the manager might not be affected.

[Insert Table 4 and Figure 5 here]

**Supplemental Analysis**

Management has to make a wide variety of decisions regarding what they feel is important to disclose. Recall that I identified six disclosure elements that collectively would make up a comprehensive disclosure of the critical accounting estimate. To gain further insight on management disclosure choices, I analyzed participant ratings of the likelihood that they would choose to disclose each item. Results of the disclosure element ratings are reported in

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[26] I used two-tailed tests for this ANOVA because the pattern of results was inconsistent with my theory.
[27] As an additional test of the predicted interaction, I conducted a planned contrast of the effect of *Auditor Reporting Choice* and *AC Strength* on *Extent of Disclosure*. Results of the planned contrast reported in Table 5, Panel C were not significant ($t_{88}$=-.238, p=.812, two-tailed).
[28] Once again, this result should be interpreted with caution as it may be an anomaly related to the same participant ratings of *Extent of Disclosure* for the Short CAM/Moderate AC condition discussed in footnote 25. As before, I compared the individual disclosure element ratings as well as the mean of all disclosure element ratings between the Short CAM and No CAM conditions presented in Table 5. The increase in *Extent of Disclosure* between the No CAM and Short CAM conditions when audit committee oversight is only moderate is not seen in the *likelihood to disclose* ratings for any of the disclosure elements or the mean of all ratings. So, it would seem that while participants in the Short CAM/ Moderate AC condition favored a higher *Extent of Disclosure* than participants in the No CAM/Moderate AC condition, this did not translate to them being more likely to disclose any of the individual elements.

Table 5[29]. For each disclosure element in each comparison (No CAM vs Long CAM, Short CAM vs Long CAM, and No CAM vs Short CAM), I conducted planned contrasts with weightings identical to the planned contrasts for *Extent of Disclosure* described in the primary analysis. In other words, I am testing whether participants increase the likelihood that they would disclose the element in response to an increase in the level of the auditor's CAM reporting and whether that increase in likelihood is greater in the presence of stronger audit committee oversight.

Several elements of disclosure stand out in the analysis. Most notable are three elements of disclosure, each of which provide quantitative information that would enhance the financial statement user's ability to quantify the risk in the warranty estimate. Specifically, participants' ratings of the likelihood that they would disclose the *RANGE* of the warranty estimate, the *KEY ASSUMPTION* used in the estimate, and a *SENSITIVITY* analysis of the warranty estimate each followed the general pattern of results predicted.[30]

In the comparison of the No CAM and Long CAM conditions, *RANGE*, *KEY ASSUMPTION*, and *SENSITIVITY* were all significant (all p's<.05, one-tailed). In the comparison of the Short CAM and Long CAM conditions, *KEY ASSUMPTION* and *SENSITIVITY* were significant (all p's<.05, one-tailed). In each of these CAM comparisons, the

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[29] As discussed in Note 11, despite random assignment of potential participants to treatment conditions, there were differences in gender by cell. To assess these differences, I analyzed the proportion of each gender by cell for each of the CAM comparisons used throughout the study. GENDER was only significantly different for the No CAM vs Short CAM comparison ($X^2_3$ = 8.481, p=.037). GENDER was not significantly different in the No CAM vs Long CAM comparison ($X^2_3$ = 5.079, p=.166) or the Short CAM vs Long CAM comparison ($X^2_3$ = 4.250, p=.236). To determine whether GENDER had an effect on the No CAM vs Short CAM disclosure element ratings reported in Table 5, I ran ANCOVAs of *Auditor Reporting Choice* and *AC Strength* on each of the disclosure element ratings with GENDER as a covariate. In all ANCOVAs, the GENDER term was not significant (all p's > .133).

[30] This is particularly noteworthy in light of the fact that even in the Long CAM condition, the auditor's discussion did not include any specific quantitative information regarding the warranty estimate. This was an intentional design choice to avoid the manager's decision to disclose being a foregone conclusion if the auditor provided such information in their own CAM discussion of the warranty estimate.

quantitative disclosure elements were rated as most likely to be disclosed in the Long CAM/Strong AC condition. This finding is of particular importance as these quantitative disclosure elements are the type of information frequently cited as lacking in management disclosure (PCAOB 2011b) and is consistent with participants increasing the *Extent of Disclosure* as discussed in the primary results.

In the comparison of the No CAM and Short CAM conditions, none of the planned contrasts for *RANGE*, *KEY ASSUMPTION*, or *SENSITIVITY* disclosure elements were found to be significant (all p's >.63, two-tailed.). A closer review of the results reveals that there is no discernible pattern wherein minimal auditor CAM reporting leads to greater manager disclosure than if the auditor chooses not to report the matter as a CAM, regardless of the audit committee oversight strength. Importantly, this finding provides support for investor and regulator concerns that minimal CAM reporting will not lead to meaningful improvement in manager disclosure.

In all of the comparisons, Elements of disclosure that do not reveal quantitative risk in the warranty estimate do not follow the pattern of results predicted in Hypothesis 2. Specifically, participant ratings of the likelihood that they would disclose (i) the *FS AMOUNT* of the warranty estimate actually recorded in the financial statements; and (ii) a qualitative description of UNCERTAINTY in the estimate each did not conform to the predicted pattern of results (all p's > .32, one-tailed except the comparison of No CAM and Short CAM which is two-tailed). This finding is not unexpected because disclosure of this type of information is already commonplace. There was also no significant result for *RATIONALE*, which might be due to the fact that it did not communicate much incremental information beyond that in the other disclosure elements.

[Insert Table 5 here]

## V. CONCLUSION

This study investigates whether the current changes proposed by the PCAOB to the auditor's reporting model are likely to spur management to provide enhanced disclosure that investors are demanding about areas of uncertainty in the financial statements. According to Martin Baumann, Chief Auditor of the PCAOB, the proposed standard is among initiatives that "would make very significant changes to the auditor's report for the first time in some 75 years" (PCAOB 2014). Thus, it is important to all stakeholders in the financial reporting process to develop an *ex ante* understanding of how proposed changes might affect financial reporting and disclosure quality (Maines 1994; Beresford 1997).

To study the effects of the proposed standard, I conducted an experiment involving highly experienced public company financial executives, primarily chief financial officers. The extensive experience of the participant group was critical given the importance of obtaining reliable insights on the proposal. Participants rated the extent of disclosure they would be likely to give for a highly uncertain critical accounting estimate. In addition, they rated the likelihood that they would disclose a variety of disclosure elements related to the critical accounting estimate. The experiment varied how the auditor treated the critical accounting estimate in their audit report as well as the strength of the audit committee's oversight over financial reporting.

Results of the experiment provide a number of important insights into the potential effect of the proposed change to the auditor's reporting model. I find that managers will react to detailed auditor reporting of a CAM by increasing their own disclosure of the matter including quantitative information which could enhance the financial statement user's ability to quantify the risk in a critical accounting estimate. In addition, I find that the level of detail provided by the auditor in its CAM reporting plays an important role in determining the extent of disclosure the manager chooses to make. Finally, despite concerns about the diminished role of the audit committee should the proposed standard be adopted, I find that the audit committee is likely to continue to be a key source of accountability playing a pivotal role in the effectiveness of the auditor's reporting model changes.

There are limitations to the study which represent opportunities for future research. In order to gain initial insights on the effect of the proposed standard on manager disclosure decisions, my experimental setting was an intentionally simple one in which the auditor makes an independent decision whether or not to report a CAM and what level of detail to provide. Furthermore, my design intentionally avoided the prospect of the auditor discussing specific quantitative information about the critical accounting estimate in its CAM reporting in order to allow managers to make unconstrained decisions whether or not to disclose the information themselves. In reality, the process is likely to follow a more iterative structure akin to the auditor-client negotiation process of resolving audit adjustments (Gibbins, Salterio, and Webb 2001, Sanchez, Agoglia, and Hatfield 2007). On one hand, auditors are likely to signal their preferences for disclosure to clients in the hopes that disclosure will meet their preferences. On the other hand, clients are likely to seek compromise with auditors on the minimum level of disclosure the auditor will accept without needing to disclose original information about the company in its CAM reporting. This auditor-client interaction represents a fruitful area for future research.

The study has important implications for the various stakeholders to the PCAOB project on the auditor's reporting model as well as academic research. First, in order to pursue their objective of providing greater information to the markets, it is critical for regulators to continue to emphasize the importance of auditors providing more than cursory discussion of CAMs in their audit report. The study confirms fears raised by many that minimal discussion of CAMs by auditors in their report is unlikely to lead managers to provide disclosure about uncertainty in the financial statements that investors are demanding. Next, the quality of audit committee oversight is likely to have an effect on how managers react to enhancements of the auditor report under the proposed standard. Strong audit committee oversight will be needed for the full benefits of the proposed standard to be reaped by investors. Finally, the study extends the accounting literature regarding the effect of regulatory changes on financial reporting quality. Most of the concurrent studies on the proposed standard focus on financial stakeholders other than management such as auditors and investors. Many of these studies, as a necessary part of their design, presume that the manager does not react to enhancements in the audit report. The results of this study suggest that if proposed regulatory change is implemented correctly and corporate governance is strong, higher quality financial reporting by management will more likely be forthcoming.

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## Appendix A – Audit Committee Description[31]

All conditions received the following general information regarding the Audit Committee:

> Andarex's audit committee is responsible for overseeing the financial reporting process, including a review of the company's financial statements and disclosures. The audit committee meets about eight times a year and is made up of three members, all of whom satisfy the independence criteria for audit committee members. In addition:

The following additional information about the audit committee and its oversight constitute the *AC Strength* manipulation:

*Moderate Audit Committee Oversight condition*

- **Only one of the members qualifies as an "audit committee financial expert,"** as prescribed by the SEC, and is viewed as a supervisory financial expert. That is, this is an individual with an understanding of financial reporting but no direct accounting or financial reporting experience. While this individual qualifies as an audit committee financial expert, **none of the members has any direct accounting or financial reporting experience.**
- The audit committee **is somewhat involved** in the resolution of key accounting and disclosure issues. Audit committee members **are reactive;** they **follow discussions of the issues** during meetings **but they do not ask too many questions** regarding these issues.

*Strong Audit Committee Oversight condition*

- **All of the members qualify as "audit committee financial experts,"** as prescribed by the SEC, and are viewed as accounting financial experts. That is, these are individuals with an understanding of financial reporting and direct accounting or financial reporting experience.
- The audit committee **is actively involved** in the resolution of key accounting and disclosure issues. Audit committee members **are proactive**; they **lead discussion of issues** during meetings, **often ask probing questions,** and **debate the appropriate accounting treatment** regarding key transactions/issues.

## Appendix B – Auditor Reporting Choice[32]

[31] Significant portions of the Audit Committee Description in my instrument, most importantly the description of the audit committee's expertise and part of the introduction, are borrowed with permission directly from Agoglia et al. 2011, for which I am grateful.

No CAM condition (received the following paragraph and no CAM excerpt of the audit report)

After careful consideration, in their best judgment, the auditors have decided **it is not necessary** to include a discussion of the warranty exposure related to its new product offering as a Critical Audit Matter in its audit report.

Short CAM and Long CAM Conditions (received the following paragraph plus the applicable excerpt of the audit report)

After careful consideration, in their best judgment**,** the auditors have decided **it is necessary** to include a discussion of the warranty exposure related to Andarex's new product offering as a Critical Audit Matter in its audit report. Following is the language that the auditor intends to use to address the warranty exposure issue in its audit report**:**

Excerpt of Audit Report

*Critical Audit Matter (Long CAM condition)*

> *The Company has potential warranty obligations associated with a new product launched during 2012. The Company is required to estimate the exposure and record a Warranty Liability and associated Warranty Expense in the Consolidated Balance Sheet and Income Statement as of and for the year ended December 31, 2012, respectively. Management's estimate of the warranty exposure incorporates subjective assumptions that have a high degree of uncertainty. In particular, the percentage of Andarex's customers with a defective unit that will actually file a warranty claim could be much higher than the Company estimated. The Company recorded the warranty liability at the lower end of the estimate range. Consequently, actual warranty expenses to be incurred could be significantly higher and earnings could be significantly lower than the amount recorded.*

*Critical Audit Matter (Short CAM condition)*

> *The Company has potential warranty obligations associated with a new product launched during 2012. The Company is required to estimate the exposure and record a Warranty Liability and associated Warranty Expense in the Consolidated Balance Sheet and Income Statement as of and for the year ended December 31, 2012, respectively. Management's estimate of the warranty exposure incorporates several subjective assumptions that have a high degree of uncertainty.*

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[32] In order to hold information constant across all conditions, the qualitative information included in the Long CAM audit report excerpt was included for all conditions within a discussion of the auditor's decision.

## Appendix C – Examples of Disclosure Elements

*FS AMOUNT*

*The Company has recorded a warranty accrual and related warranty expense of $520,000 for Product B in the Consolidated Balance Sheet and Statement of Income as of and for the year ended December 31, 2012, respectively.*

*RANGE*

*The Company calculated the potential warranty exposure associated with Product B and estimates that the exposure is between a minimum of $520,000 and a maximum of $1,560,000 as of December 31, 2012. The Company recorded warranty expense and reserve for the minimum amount of the potential exposure range ($520,000) as of December 31, 2012.*

*RATIONALE*

*The Company has decided to record warranty expense and reserve for the minimum amount of the potential exposure range ($520,000) as of December 31, 2012 until the Company has more experience with actual claims and costs.*

*KEY ASSUMPTION*

*The Company's estimate of warranty exposure is based on a key assumption. Specifically, the Company has estimated a range for the likelihood that a customer with a defective unit will actually file a warranty claim of between 20% and 60%.*

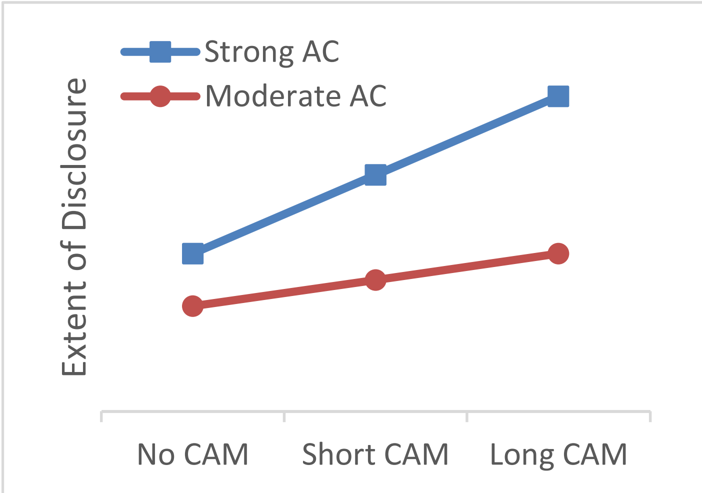
*UNCERTAINTY*

*The Company's estimate of warranty exposure for Product B incorporates a subjective assumption that has a high degree of uncertainty. Specifically, the customer segment for Product B is new to the Company and it is difficult to estimate the likelihood that a customer with a defective unit will actually file a warranty claim. Actual warranty expenses to be incurred could be significantly higher than the amount recorded in the financial statements.*

*SENSITIVITY*

*The estimate of warranty exposure depends on the Company's estimate of the likelihood that a customer with a defective unit will actually file a warranty claim, which ranges from 20% to 60%. The warranty accrual recorded by the Company is based on a 20% claims rate. Each increase of 10% in the claims rate would result in additional warranty expense of $260,000 before income taxes.*

**Figure 1 – Predicted Pattern of Results – Rating of Extent of Disclosure[a] by Audit Committee Oversight Strength[b] and Auditor Reporting Choice[c]**




[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[c]Auditor Reporting Choice was varied at three levels. The auditor provided either no CAM discussion (No CAM), a short CAM discussion (Short CAM), or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.

**Figure 2 – Flow of Experiment**

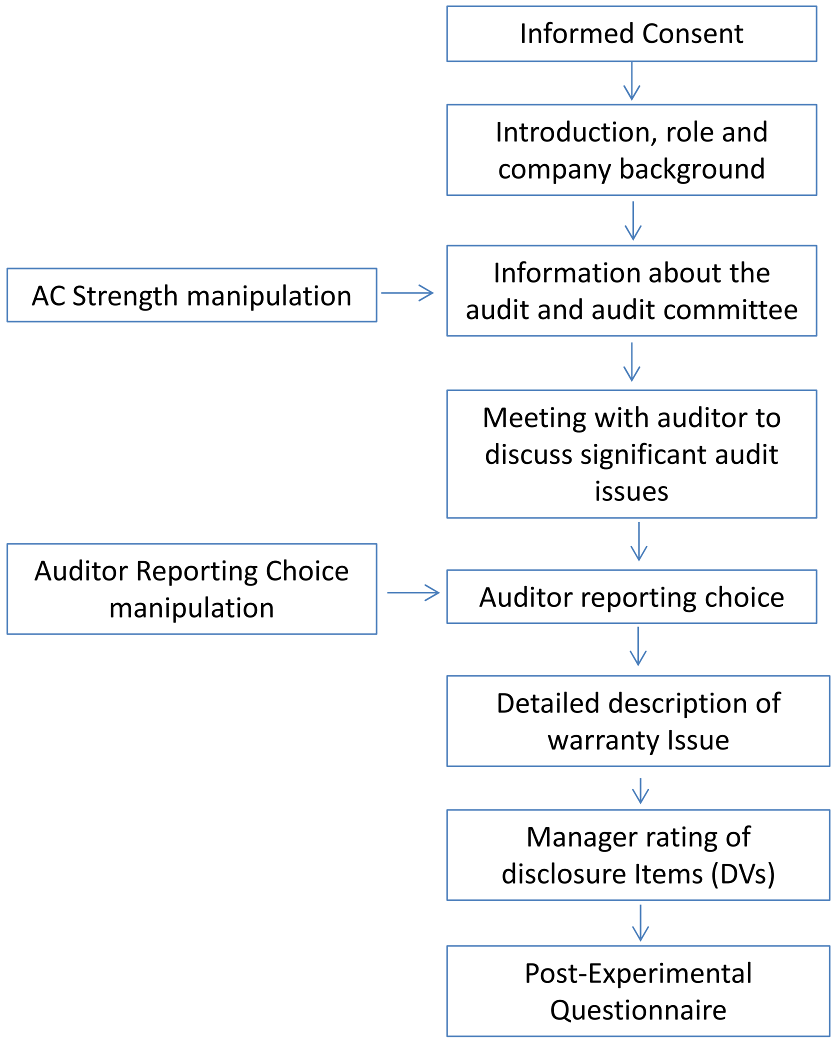
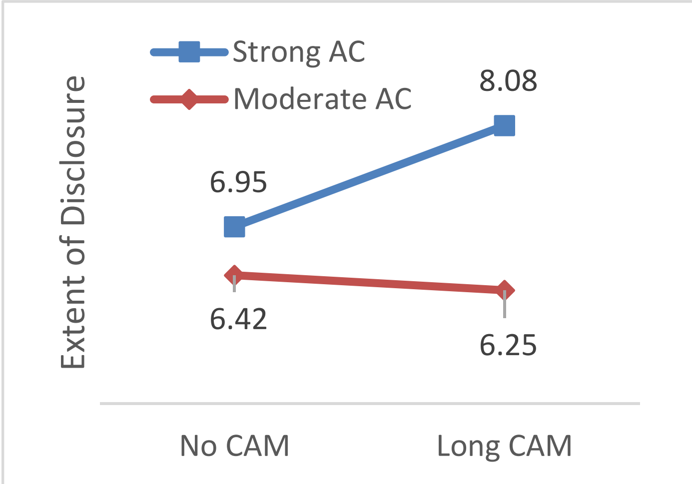
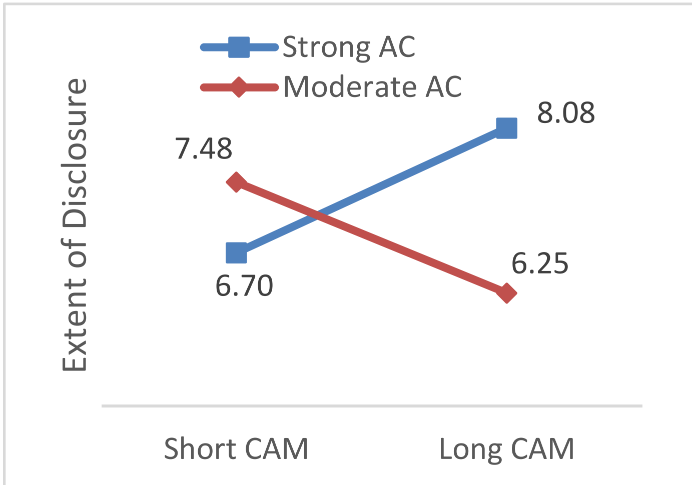


**Figure 3 – Rating of Extent of Disclosure[a] by Audit Committee Oversight Strength[b] and Auditor Reporting Choice[c] – Comparison of No CAM and Long CAM conditions**



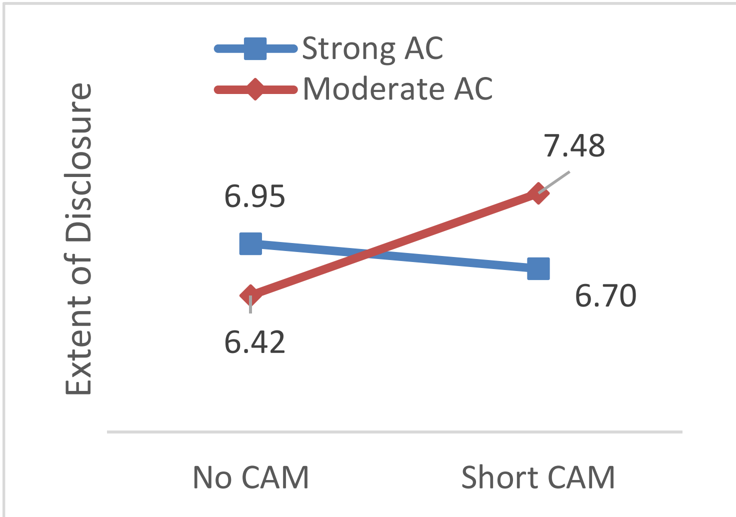

[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[c]Auditor Reporting Choice was either no CAM discussion (No CAM) or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.

**Figure 4 – Rating of Extent of Disclosure[a] by Audit Committee Oversight Strength[b] and Auditor Reporting Choice[c] – Compaison of Short CAM and Long CAM Conditions**




[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[c]Auditor Reporting Choice was either a short CAM discussion (Short CAM) or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.

**Figure 5 – Rating of Extent of Disclosure[a] by Audit Committee Oversight Strength[b] and Auditor Reporting Choice[c] – Comparison of No CAM and Short CAM conditions**




[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[c]Auditor Reporting Choice was either no CAM discussion (No CAM) or a short CAM discussion (Short CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.

**Table 1 – Demographic Information**

| | |
|---|---|
| Years of Work Experience | 29.2 years |
| Has Experience as Auditor | 71.2% |
| Current or Former Audit Committee Member | 24.5% |
| Current or Former CPA | 73.4% |
| Age | 54.0 years |
| Gender | 89.1% Male<br>10.9% Female |

**Table 2 – Rating of Extent of Disclosure – Comparison of No CAM and Long CAM conditions**

**Panel A: Mean (standard deviation) Ratings of Extent of Disclosure[a] by Audit Committee Oversight Strength and Auditor Reporting Choice**

| | | AUDITOR REPORTING CHOICE[b] | | Overall |
|---|---|---|---|---|
| | | No CAM | Long CAM | |
| **AUDIT COMMITTEE OVERSIGHT STRENGTH[c]** | STRONG | 6.95 (1.76) n = 22 | 8.08 (1.62) n = 26 | 7.56 (1.76) n = 48 |
| | MODERATE | 6.42 (1.74) n = 24 | 6.25 (2.22) n = 20 | 6.34 (1.95) n = 44 |
| Overall | | 6.67 (1.75) n = 46 | 7.28 (2.09) n = 46 | |

**Panel B: ANOVA results for Ratings of Extent of Disclosure**

| Source of Variation | df | SS | F-Value | p-value (1-tailed |
|---|---|---|---|---|
| Audit Committee Oversight Strength | 1 | 31.850 | 9.521 | ***.002*** |
| Auditor Reporting Choice | 1 | 5.202 | 1.555 | .108 |
| Audit Committee Oversight Strength X Auditor Reporting Choice | 1 | 9.464 | 2.829 | ***.048*** |

**Panel C: Planned Contrast for Test of Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Ratings of Extent of Disclosure**

| | t-statistic | p-value (1-tailed) |
|---|---|---|
| Model contrast[d] | 3.623 | ***.000*** |

[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Auditor Reporting Choice was either no CAM discussion (No CAM) or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.
[c]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[d]Contrast coefficients were -1 for Strong AC/No CAM, +5 for Strong AC/Long CAM, -3 for Moderate AC/No CAM, and -1 for Moderate AC/Long CAM.

**Table 3 – Rating of Extent of Disclosure – Comparison of Short CAM and Long CAM conditions**

**Panel A: Mean (standard deviation) Ratings of Extent of Disclosure[a] by Audit Committee Oversight Strength and Auditor Reporting Choice**

| | | AUDITOR REPORTING CHOICE[b] | | Overall |
|---|---|---|---|---|
| | | Short CAM | Long CAM | |
| AUDIT COMMITTEE OVERSIGHT STRENGTH[c] | STRONG | 6.70 (1.80) n = 23 | 8.08 (1.62) n = 26 | 7.43 (1.83) n = 49 |
| | MODERATE | 7.48 (1.65) n = 23 | 6.25 (2.22) n = 20 | 6.91 (2.01) n = 43 |
| Overall | | 7.09 (1.75) n = 46 | 7.28 (2.09) n = 46 | |

**Panel B: ANOVA results for Ratings of Extent of Disclosure**

| Source of Variation | df | SS | F-Value | p-value (1-tailed |
|---|---|---|---|---|
| Audit Committee Oversight Strength | 1 | 6.217 | 1.885 | ***.087*** |
| Auditor Reporting Choice | 1 | 0.133 | 0.040 | .421 |
| Audit Committee Oversight Strength X Auditor Reporting Choice | 1 | 38.820 | 11.771 | ***.001*** |

**Panel C: Planned Contrast for Test of Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Ratings of Extent of Disclosure**

| | t-statistic | p-value (1-tailed) |
|---|---|---|
| Model contrast[d] | 2.004 | ***.024*** |

[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Auditor Reporting Choice was either a short CAM discussion (Short CAM) or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition
[c]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[d]Contrast coefficients were +1 for Strong AC/Short CAM, +4 for Strong AC/Long CAM, -3 for Moderate AC/Short CAM, and -2 for Moderate AC/Long CAM.

**Table 4 – Rating of Extent of Disclosure – Comparison of No CAM and Short CAM conditions**

**Panel A: Mean (standard deviation) Ratings of Extent of Disclosure[a] by Audit Committee Oversight Strength and Auditor Reporting Choice**

| | | AUDITOR REPORTING CHOICE[b] | | Overall |
|---|---|---|---|---|
| | | No CAM | Short CAM | |
| AUDIT COMMITTEE OVERSIGHT STRENGTH[c] | STRONG | 6.95<br>(1.76)<br>n = 22 | 6.70<br>(1.80)<br>n = 23 | 6.82<br>(1.76)<br>n = 45 |
| | MODERATE | 6.42<br>(1.74)<br>n = 24 | 7.48<br>(1.65)<br>n = 23 | 6.94<br>(1.76)<br>n = 47 |
| Overall | | 6.67<br>(1.75)<br>n = 46 | 7.09<br>(1.75)<br>n = 46 | |

**Panel B: ANOVA results for Ratings of Extent of Disclosure**

| Source of Variation | df | SS | F-Value | p-value (2-tailed) |
|---|---|---|---|---|
| Audit Committee Oversight Strength | 1 | .344 | .114 | .736 |
| Auditor Reporting Choice | 1 | 3.701 | 1.227 | .271 |
| Audit Committee Oversight Strength X Auditor Reporting Choice | 1 | 10.017 | 3.321 | ***.072*** |

**Panel C: Planned Contrast for Test of Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Ratings of Extent of Disclosure**

| | t-statistic | p-value (2-tailed) |
|---|---|---|
| Model contrast[d] | -0.238 | .812 |

[a]Extent of Disclosure was rated on a 10-point scale where 1=minimal disclosure and 10=extensive disclosure.
[b]Auditor Reporting Choice was either no CAM discussion (No CAM) or a short CAM discussion (Short CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.
[c]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[d]Contrast coefficients were +1 for Strong AC/No CAM, +4 for Strong AC/Short CAM, -3 for Moderate AC/No CAM, and -2 for Moderate AC/Short CAM.

**Table 5 – Summary of Disclosure Element Ratings – Comparison of CAM conditions**

| Disclosure Element | AC Strength[a] | No CAM[b] | Short CAM[b] | Long CAM[b] | No CAM vs Short CAM contast p-value[j] (2-tailed) | No CAM vs Long CAM contrast p-value[k] (1-tailed) | Long CAM vs Short CAM contrast p-value[l] (1-tailed) |
|---|---|---|---|---|---|---|---|
| FS Amount[c] | Strong | 7.55 | 7.75 | 8.15 | .676 | .320 | .387 |
| | Moderate | 7.96 | 8.00 | 7.75 | | | |
| Range[d] | Strong | 4.27 | 4.29 | 6.00 | .629 | ***.040*** | .119 |
| | Moderate | 4.54 | 4.83 | 4.65 | | | |
| Rationale[e] | Strong | 4.32 | 3.92 | 5.69 | .317 | .144 | .225 |
| | Moderate | 4.88 | 4.52 | 5.15 | | | |
| Key Assumption[f] | Strong | 4.14 | 4.46 | 6.27 | .912 | ***.003*** | ***.020*** |
| | Moderate | 4.21 | 4.48 | 4.50 | | | |
| Uncertainty[g] | Strong | 8.23 | 7.71 | 8.08 | .753 | .362 | .372 |
| | Moderate | 7.75 | 8.35 | 7.90 | | | |
| Sensitivity[h] | Strong | 5.00 | 4.54 | 6.25 | .944 | ***.032*** | ***.001*** |
| | Moderate | 5.33 | 3.70 | 3.80 | | | |
| Mean of Elements[i] | Strong | 5.58 | 5.44 | 6.74 | .550 | ***.014*** | ***.026*** |
| | Moderate | 5.78 | 5.64 | 5.63 | | | |

Each of the six elements were rated by participants based on the likelihood they would choose to disclose the element. Ratings were given on a 10-point scale where 1 = Definitely Not Disclose and 10 = Definitely Disclose.

[a]Audit Committee Oversight Strength was varied at two levels, moderate and strong. See Appendix A for excerpts for each condition.
[b]Auditor Reporting Choice was varied at three levels. The auditor provided either no CAM discussion (No CAM), a short CAM discussion (Short CAM), or a long CAM discussion (Long CAM) of a critical accounting estimate with significant uncertainty. See Appendix B for excerpts for each condition.
[c]FS Amount - the amounts reported in the financial statements regarding the company's warranty estimate.
[d]Range - the range of the company's warranty estimate.
[e]Rationale - the rationale for the recorded amount.
[f]Key Assumption - a description of the key uncertain assumption in the warranty estimate.
[g]Uncertainty - a description of uncertainty in the estimate.
[h]Sensitivity - a sensitivity analysis of the warranty estimate based on movement in the key uncertain assumption.
[i]Mean of Elements – The mean of the preceding six disclosure elements.
[j]Contrast coefficients were +1 for Strong AC/No CAM, +4 for Strong AC/Short CAM, -3 for Moderate AC/No CAM, and -2 for Moderate AC/Short CAM.
[k]Contrast coefficients were -1 for Strong AC/No CAM, +5 for Strong AC/Long CAM, -3 for Moderate AC/No CAM, and -1 for Moderate AC/Long CAM.
[l]Contrast coefficients were +1 for Strong AC/Short CAM, +4 for Strong AC/Long CAM, -3 for Moderate AC/Short CAM, and -2 for Moderate AC/Long CAM.

**FROM:** Dr. Steven Glover, Associate Dean and K. Fred Skousen Professor at Brigham Young University
Dr. James Hansen, Associate Professor at Weber State University
Dr. Timothy Seidel, Assistant Professor at Brigham Young University

**TO:** Office of the Secretary, PCAOB

**DATE:** July 19, 2016

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

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We appreciate the opportunity to submit comments regarding the Board's Proposed Auditing Standard on the Auditor's Report (hereafter referred to as the Proposed Standard). We are pleased to see the Board's continued efforts to improve the transparency of the audit process. We applaud the Board's efforts to increase and enhance the information provided in the audit report to provide investors and others important information about the audit. Our comments below are in response to question 26 in the Proposed Standard and are based on our research.[1] We believe there is an effective and efficient way to include an important audit quality indicator in the auditor's report.

**Additional Improvements to the Auditor's Report**
*Question 26. Are the reproposed amendments to the PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?*

We believe there is an additional amendment that should be considered regarding the date when the auditor completed fieldwork to convey to users the level of deadline imposed time pressure the auditor may have faced. The listing requirements for publicly traded companies impose deadlines for the filing of audited financial statements with the Securities and Exchange Commission (SEC). In a 2014 speech, PCAOB board member, Jay Hanson, stated:

> "One of the biggest impediments to auditor skepticism…is the calendar. Public companies have filing deadlines to meet, and they are rarely missed. When they are missed, the consequences can be serious, including declining share prices and harm to investors. If potential issues are discovered late in the audit process, or an issue is not resolved in a timely manner, auditors may feel pressure to cut corners. We have seen it in inspections and enforcement matters: Auditors recognize that there may be a problem with management's estimates or conclusions but allow themselves to be talked out of doing anything about it. Staying organized and proactively dealing with problems far ahead of filing deadlines will

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[1] For additional information, see: Glover, S.M., J.C. Hansen,, & T.A. Seidel (2016), "*The Informational Value of the Audit Report Date and the Effect of SFAS No. 165.*" Working paper, Brigham Young University and Weber State University. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2561713.

help the auditor avoid running out of time as well as the pressure to accept insufficient audit evidence."[2]

Additionally, PCAOB Staff Audit Practice Alert No. 10, issued in December 2012, states that "scheduling and workload demands can put pressure on partners and other engagement team members to complete their assignments too quickly, which might lead auditors to seek audit evidence that is easier to obtain rather than evidence that is more relevant and reliable, to obtain less evidence than is necessary, or to give undue weight to confirming evidence."[3]

Recent research by Christensen, Glover, Omer and Shelley (2015) finds that the timeliness of completing audit fieldwork is an important attribute of audit quality.[4]

In 2009, the Financial Accounting Standards Board (FASB) issued SFAS No. 165, *Subsequent Events* (SFAS 165) (now codified in ASC 855). Although SFAS 165 contains no auditor related requirements, the standard, which requires public companies to evaluate subsequent events through the financial statement filing date, resulted in a change in practice regarding the dating of the audit report. Before the issuance of SFAS 165, auditors would date their report at the *end of audit fieldwork* when they had obtained sufficient audit evidence to support the audit opinion. As such, in many instances prior to SFAS 165, auditors dated the audit opinion well before the filing of the financial statements. In response to SFAS 165, auditors of public companies began dating their opinions on or very close to the date the financial statements are filed with the SEC.[5] In our research study (Glover, Hansen and Seidel, 2016) we examine companies with fiscal years ending between December 2003 and May 2014. Companies with fiscal years ending prior to June 2009 are considered pre-SFAS 165 observations. We find that the mean (median) number of days between the audit report date and the filing of the 10-K with the SEC has decreased significantly from 9.75 (3.00) days in the pre-SFAS 165 period to 1.00 (0.00) day following the passage of SFAS 165.

The histograms below present the difference in days between the audit report date and the filing date. The histograms reveal that although the distribution *of the days between dates* varies widely in the pre-SFAS 165 period, in the post-SFAS 165 period, the entire distribution is close to zero. The tight distribution in the post-SFAS 165 period provides support for the practice of dating the audit report close to or on the date of filing.

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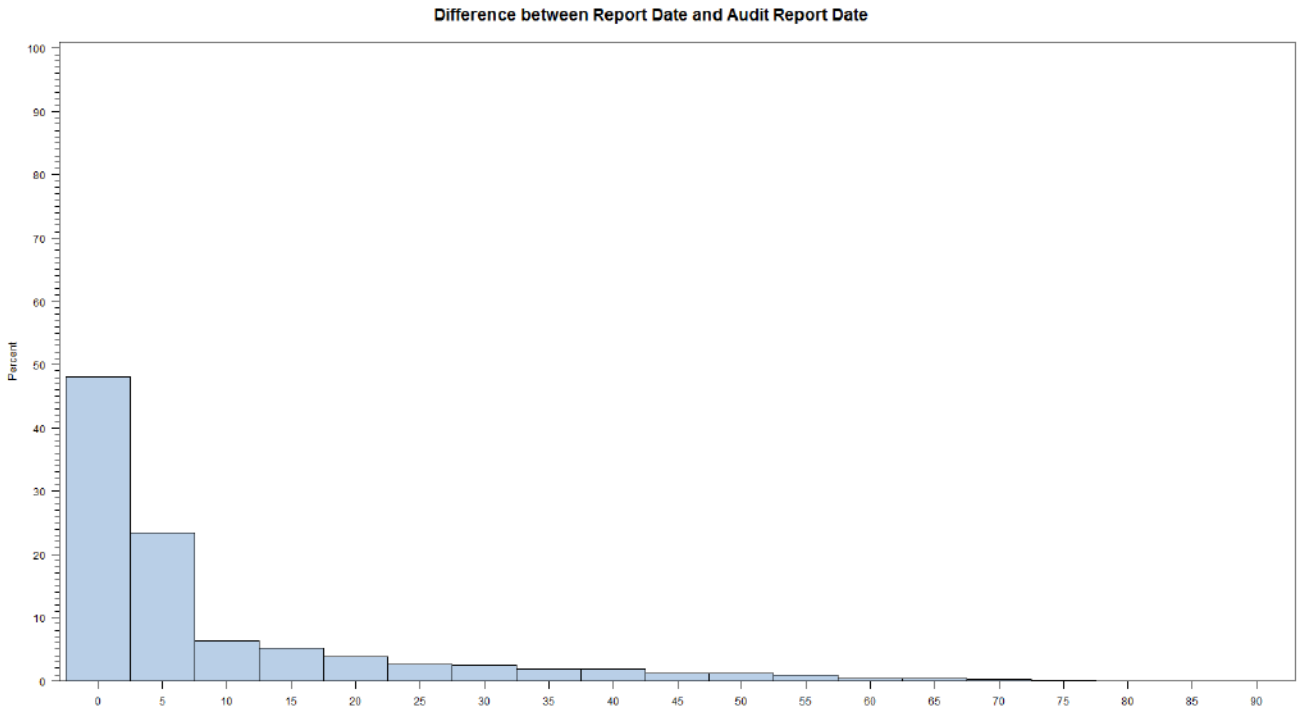
[2] See Hanson, J.D. '*A Call to Action for Future Auditors*,' Indianapolis, IN (March 28), 2014. Available at http://pcaobus.org/News/Speech/Pages/03282014_BAS.aspx.

[3] See PCAOB. *Staff Audit Practice Alert No. 10: Maintaining and Applying Professional Skepticism in Audits*. Washington, D.C.: PCAOB, 2012, p. 7.

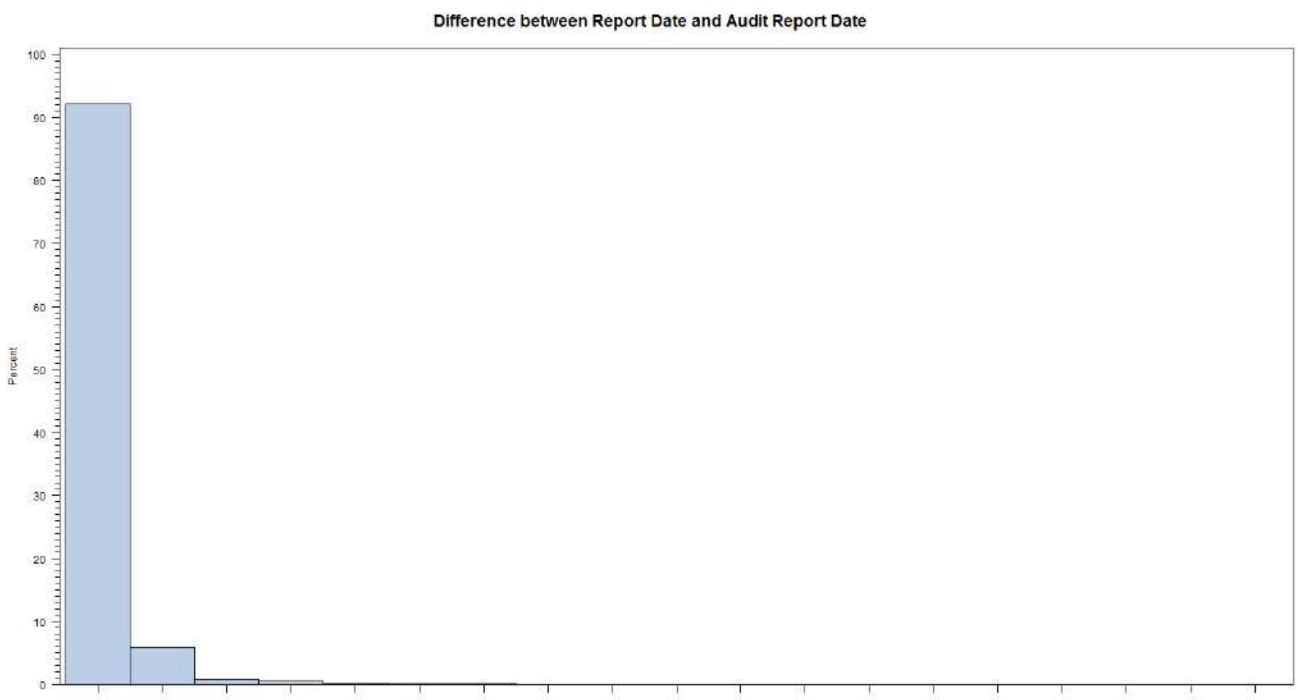
[4] See Christensen, B.E., S.M. Glover, T.C. Omer and M.K. Shelley (2015), "*Understanding Audit Quality; Insights from Audit Professionals and Investors*," forthcoming in Contemporary Accounting Research. Available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2358163.

[5] In Session 3 of the July 15, 2010, PCAOB SAG meeting it was noted that auditors began dating their opinions on the date the financial statements are filed with the SEC in response to SFAS 165.

Pre-SFAS 165:




Post-SFAS 165:




The majority of companies (~ 60 percent) file their annual report within one week of the required filing deadline. While the proportion of companies filing within the last week has remained stable pre- and post-SFAS 165, when we examine this set of companies we find that the proportion of companies with an *audit report dat*e within a week of or on the required filing deadline increased significantly from 64.5 percent in the pre-SFAS 165 period to 96.5 percent in the post-SFAS period.

The change in practice in dating the audit report limits the ability of financial statement users to identify auditors facing heightened deadline imposed time pressure. We find in our research that the ability of users to identify auditors under heightened deadline pressure provides a potentially important indicator of audit quality.

In our study we find that the nearness of the audit report date to the client's required filing deadline provided a useful signal of reduced audit quality (as measured by financial statement misstatements). However, after SFAS 165, there is no longer any observable association between an audit report date close to the required filing deadline and audit quality. In other words, the financial statement users lost a potentially important signal of audit quality due to the change in practice post SFAS 165.

The Board currently has audit quality indicators on its agenda.[6] We believe the findings in our study and Christensen et al. (2015) have important implications for auditor reporting and the ability of the audit report date to provide a signal of variation in audit quality. Although statements from the Board suggest a concern with the potential negative effect of deadline imposed time pressure, the Proposed Standard does not include a measure of the timeliness of the completion of audit fieldwork. We believe that an additional amendment to the Proposed Standard to help investors and users of the financial statements identify auditors under heightened deadline pressure would be the inclusion of the date the auditors completed fieldwork in the audit report. This could be accomplished in the form of dual-dating of the audit opinion to clearly convey the date of the end of audit fieldwork (first date) as well as the date through which subsequent events were considered (second date).

We appreciate the opportunity to provide the Board with our research findings and offer suggestions regarding the proposed Auditor's Reporting Standard.

Kind regards,

Steven M Glover

Dr. Steven Glover, K. Fred Skousen Professor and Associate Dean, Brigham Young University

James Hansen

Dr. James Hansen, Weber State University

Timothy A Seidel

Dr. Timothy Seidel, Brigham Young University

[6] See PCAOB. *Strategic Plan: Improving Relevance and Quality of the Audit for the Protection and Benefit of Investors*, 2012-2016, 2012; PCAOB. SAG meeting briefing paper, Audit Quality Indicators, May 15-16, 2013 (http://pcaobus.org/News/Events/Documents/05152013_SAGMeeting/Audit_Quality_Indicators.pdf); and PCAOB Session on Audit Quality Indicators, 2014 PCAOB/AAA Annual Meeting memo and meeting materials, April 17, 2014.

Grant Thornton

August 15, 2016

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

Dear Board Members and Staff:

Grant Thornton LLP appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or Board) reproposed auditing standard, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (Reproposal), and we respectfully submit our comments and recommendations thereon.

We continue to support the Board's efforts to enhance the relevancy and transparency of the auditor's report and commend the Board for their thoughtful consideration of comments received from various stakeholders on the original proposal in 2013. We are pleased to see many of the revisions contained in the Reproposal. We also note certain of the revisions tend to align with the model adopted by the International Auditing and Assurance Standards Board (IAASB), which we support from a global consistency perspective. However, we continue to have concerns with certain aspects of the Reproposal, which we discuss in greater detail below.

## Critical audit matters (CAM)

### Definition

We are supportive of limiting the population of potential CAM to matters communicated or required to be communicated to the audit committee. We believe this provides a better, narrower starting point for auditors in their determination of CAM and communication of matters that may be most meaningful to the users of the financial statements. We also agree with including matters required to be communicated as well as matters actually communicated to the audit committee.

We also appreciate the inclusion of the notion of materiality in the definition of CAM. We believe this will better enhance practical application of the reproposed standard. We also recognize the Board's intentions when using the phrase "relates to" as described on page 20 of the Reproposal.

However, we are concerned about unintended consequences in utilizing materiality in this specific fashion. We are concerned that specifically relating to "accounts or disclosures" could give the reader of the auditor's report the impression that piecemeal opinions are being provided despite the revisions made to the introductory language, as discussed further below. We are further concerned that, in retrospect, any audit matter relating to a material account or disclosure would have been expected to be considered a de facto CAM, in spite of the other considerations and factors. In order to minimize unintended consequences and better align the determination with the auditor's overall objective of expressing an opinion on the financial statements taken as a whole, we recommend the Board consider the following revisions (marked from the Reproposal) to paragraph 11 of Proposed AS 3101 to better integrate materiality into the definition.

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

We believe this language still sufficiently provides for the scenarios laid out on page 20 of the Reproposal, including goodwill impairment, evaluation of the company's ability to continue as a going concern or the risk of management's override of internal controls.

### Factors

We are supportive of the revisions made to the factors an auditor would consider in the determination of CAM. Most notably, we believe the direct linkage to the auditor's risk assessment provides a meaningful starting point on the path of determining those matters that involved especially challenging, subjective or complex auditor judgment. We further support that the reproposed standard does not include circumstances or matters that, if present, would always constitute critical audit matters. We commend the Board on recognizing that significant risks, including fraud risks, may not always involve especially challenging, subjective, or complex auditor judgment and appreciate the Board maintaining a principles-based approach in this area.

### Communication

We are supportive of the revisions made to the standard introductory language that would precede the specific CAM discussion. We believe clearly stating that the auditor is not providing a separate opinion on CAM could minimize users' potential misunderstanding of the CAM communications. However, we do recommend the Board revise the introductory language to align with our proposed revision to the CAM definition described above; the following provides suggested revisions (marked from the Reproposal) to better clarify the introductory language.

> The critical audit matters communicated below are matters arising from the current period audit that were communicated or required to be communicated to the audit committee and that: (1) ~~**relates to accounts or disclosures that**~~ are material to the financial statements **taken as a whole** and (2) involved our especially challenging, subjective, or complex auditor judgment. **The communication of critical** ~~**Critical**~~ audit matters ~~**do**~~ **does** not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide

separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

In our 2013 letter, we supported providing the auditor the option to include the audit procedures performed if, in the auditor's judgment, conveying those procedures provides a better understanding regarding the significance of the matter. We note in the Reproposal, however, that the Board has made it a requirement to describe how the CAM was addressed in the audit for each CAM communicated in the auditor's report. We continue to believe that this information should be optional in reporting CAM since circumstances will vary and information surrounding how the matter was addressed may not be relevant in all situations. However, we recognize the Board provided additional commentary on its intentions for this requirement on page 31 of the Reproposal. If the Board retains the requirement to describe how the CAM was addressed in the audit for each CAM communicated in the auditor's report, we ask the Board to consider including the language after "For example" in the third paragraph of page 31 as a "Note" in the final standard. This information more clearly conveys the Board's intention and will be valuable to auditors in operationalizing this requirement.

## Documentation

We appreciate that the scope of required documentation was revised due to the Board's proposed changes to the definition of CAM, but we continue to have concerns regarding the nature and extent of the documentation the reproposed requirement would seem to require. Our view of the requirement is that it leads the auditor to documenting why each matter communicated to the audit committee was or was not deemed to be a CAM. We are concerned that this approach is inconsistent with current audit documentation requirements as it requires documenting what the auditor considered but did not act on. We note that application material adopted by the IAASB in International Standards on Auditing 701, *Communicating Key Audit Matters in the Independent Auditor's Report* (paragraph .A39) also is helpful in providing guidance on documentation to the auditor with a focus on matters that were concluded to be key audit matters.

In order to address this anomaly, we considered the Board's related comments on pages 39-40 of the Reproposal and our previous comments related to the definition of CAM, and accordingly we submit the following edits to proposed paragraph .17 for the Board's consideration.

> The auditor must document the basis for the auditor's determination for each matter that both:
>
> a. Was communicated or required to be communicated to the audit committee; and
>
> b. ~~**Relates to accounts or disclosures that are**~~ **is** material to the financial statements **taken as a whole**
>
> involved especially challenging, subjective, or complex auditor judgment.
>
> **Note: This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation. The amount of**

> **documentation could vary with the circumstances. This standard does not require the documentation of why other matters communicated to the audit committee were not matters that involved especially challenging, subjective, or complex auditor judgment.**

We believe this "Note" is important guidance to clarify expectations for focusing documentation on those matters that were ultimately communicated as CAM.

### Proposed AS 3105

While we support reporting CAM in instances where the auditor expresses a qualified opinion, it is unclear how such qualification(s) interacts with the CAM reporting. While we understand the circumstances resulting in a qualified opinion for an issuer is limited (due to the fact that those opinions do not meet the general reporting requirements of the Securities and Exchange Commission) there may be other reporting circumstances where such interactions may occur. The IAASB approach, as described on page 61 of the Reproposal, is clear that the matter that gives rise to the qualified opinion is not described in the key audit matter section; rather, a reference to the basis for modified opinion section is made in the key audit matters section. We encourage the Board to clarify the interaction between CAM and matters resulting in report qualifications by including additional guidance. We submit the following language for the Board's consideration for inclusion in proposed AS 3105.

> If the auditor determines that the matter for which the auditor qualified his or her opinion is also a critical audit matter, (1) the matter should not be described in the critical audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the critical audit matter section to the basis for qualified opinion section where the matter is reported.

We believe this approach provides clarity to the readers of the financial statements and reduces potential redundancy in reporting a matter in two different sections of the auditor's report if/when the auditor determines the matter is also a CAM.

### Exclusions from CAM requirements

We support excluding non-issuer broker-dealers, investment companies other than business development companies, and benefit plans from the required CAM communications for the reasons enumerated by the staff in the Reproposal.

### Areas for further guidance

In light of the reproposed requirements, we have identified certain other areas where the profession may benefit from further guidance on how CAM reporting applies. These areas include:

- AS 3305, *Special Reports* – we note the proposed amendments to this standard included in Appendix 2 of the Reproposal and believe more guidance could be given around how or whether CAM determination may differ in instances where the auditor is reporting on the topics covered by this standard.

- AS 1205, *Part of the Audit Preformed by Other Independent Auditors* – recognizing the Board is currently in the proposal process to revise this standard, it is unclear whether the enhanced reporting in the Reproposal would change any requirements related to communications between the lead auditor and the referred-to auditor or the other auditor. It is also unclear whether the other auditor would be expected to communicate CAM to the lead auditor in the reporting requirement set forth in the Board's proposal. We encourage the Board to consider, in conjunction with moving forward on the Supervision of Other Auditors project, its intentions or current views as to the determination and communication of CAM in those circumstances.

## Additional improvements to the auditor's report

### Independence

We are supportive of the reproposed requirement to include a statement regarding the auditor's independence and status as a firm registered with the PCAOB. We believe this clarity will be beneficial to users of the financial statements. While we believe the requirement is sufficiently clear for those audits required to be performed under PCAOB standards, we encourage the Board to develop and provide robust guidance with regard to audits voluntarily performed under PCAOB standards, as acknowledged in footnote 68 on page 43 of the Reproposal. We believe guidance in this area is essential considering the potential confusion that may arise in this area.

### Auditor tenure

While we support greater transparency to users of the financial statements, we continue to have significant reservations regarding the requirement to disclose auditor tenure in the auditor's report. As noted in our comment letter to the original proposal dated December 11, 2013 (2013 letter), we believe the auditor's report is not the appropriate place to convey this information. It would be a data point without appropriate context and could lead to inappropriate inferences being made by users regarding the auditor. We further note that an audit firm has little to no control over its tenure with a client. The audit committee selects and retains the audit firm as part of executing its duties. Therefore, the most appropriate location for this information is in the audit committee's report in the company's proxy statement or other filing, where appropriate context can be provided by the decision-makers themselves.

### Addressees

We are pleased to see the reproposed requirement regarding report addressees. We believe limiting the addressees to shareholders and the board of directors or equivalents is appropriate and will create consistency in practice.

### Enhancements to basic elements

We continue to support the enhancements to the basic elements of the auditor's report regarding financial statement footnotes, error or fraud, and nature of the audit. However, as we noted in our 2013 letter, we recommend the Board consider aligning those requirements with the IAASB model to further enhance the benefits to financial statement users. Specifically, we recommend also including the following:

- Definition of "reasonable assurance"

- Auditor's responsibility related to obtaining an understanding of internal control relevant to the audit (for non-integrated audits)
- Auditor's responsibility to communicate with the audit committee

While we recognize the concern that adding these elements will unnecessarily lengthen the auditor's report, we believe they are important concepts for financial statement users to understand and would promote consistency in global reporting conventions.

### Standardized form of auditor's report

We also support the form of the auditor's report as reproposed. We believe requiring a specific order for the Opinion and Basis for Opinion sections as well as requiring section titles for all sections will make the auditor's report easier to use. We commend the Board on finding a reasonable "middle ground" that provides the appropriate level of flexibility to promote consistency and ease of use without being overly prescriptive.

## Considerations related to effective date

While we don't believe a significant amount of effort would be required for most of the other enhancements to the auditor's report, we believe a considerable amount of time will be necessary for firms to formulate firm policies and quality control procedures around the determination and communication of CAM. Recognizing that CAM reporting should not be or become boiler-plate, we believe it will be essential to audit quality for firm to establish the proper protocol around this new reporting requirement. Therefore, we encourage the Board to consider an effective date of fiscal years ending on or after December 15, 2018, assuming the Reproposal is adopted by the Board and approved by the SEC in late 2016 or early 2017. Since CAM will likely require incremental effort on the part of firms, we would not be opposed to an earlier effective date for the additional improvements to the auditor's report described in the Reproposal. We would also encourage the Board to consider whether early adoption would be permitted. Although this may create reporting differences among firms for a short period of time, it would provide an opportunity to begin reporting under the new standards for firms that wish to move forward on an accelerated schedule.

****************************

If you have any questions about our response, or wish to further discuss our comments, please contact Trent Gazzaway, National Managing Partner of Professional Standards, at (704) 632-6834 or Trent.Gazzaway@us.gt.com.

Sincerely,

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15 August 2016

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*Re: PCAOB Rulemaking Docket Matter No. 034*

**Proposed Auditing Standard – "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards" ("reproposal")**

Hermes EOS welcomes the opportunity to provide our comments on this consultation on PCAOB's reproposal of the auditor reporting standard.

By way of background, Hermes is an asset manager in the City of London, and is wholly owned by the BTPS, one of the UK's largest corporate pension schemes. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including PNO Media (the Netherlands), and VicSuper (Australia). In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over $252.5 billion (as at 30 June 2016).

We welcome the PCAOB's reproposal of the auditor reporting standard, which would retain the pass/fail opinion of the existing auditor's report but would make significant changes to the existing auditor's report, including the communication of critical audit matters arising from the audit and new elements related to auditor independence and tenure.

The auditor's report is the primary means by which the auditor communicates information regarding the audit of the financial statements to investors and other financial users. As currently designed, however, the auditor's report conveys almost no information obtained and evaluated by the auditor as part of the audit. The report features boilerplate language, that largely remains the same regardless of the risks a particular company might be dealing with or the specific problems that auditors encountered in performing the audit.

The reproposal will certainly enhance the form and content of the Auditor's Report, by making it more relevant and informative to investors and other financial statement users. In the UK[1], investors (like ourselves) have welcomed extended auditor reporting, and greatly value the enhanced information it provides.

[1] In June 2013, the Financial Reporting Council ('FRC') revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code. In April 2016, the FRC adopted a final rule updating its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, including the IAASB's definition of key audit matters.

In addition, the reproposed standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which would be based on work the auditor has already performed.

## Critical Audit Matters

Board of directors and audit committee oversight of the financial reporting process can further reduce the information asymmetry by enhancing the quality of the information disclosed. The communication of critical audit matters would inform investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgement, including the principal considerations for determining the matters and how the matters were addressed in the audit.

The communication of critical audit matters in the auditor's report would also help investors and analysts who were interested in doing so engage management with targeted questions about these issues. In the UK, we increasingly use the information provided in the expanded auditor's report to engage with audit committees.

In its latest report on this issue[2], the FRC notes that investors greatly value the information provided in expanded auditor reporting. It adds to the mix of information that can be used in investor's capital allocation and engagement decisions. We would endorse the following findings:

"In the second year of expanded auditor reporting in the UK, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's report provided discussion of significant risks that were more tailored to the company under audit, thus avoiding generic or standardized wording."

## Determination of Critical Audit Matters

*Definition of Critical Audit Matter*

*..any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that relates to accounts and disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgement.*

Under the reproposal, critical audit matters would be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). Investors are interested in matters of this nature that are resolved directly with management, without necessarily being communicated to the audit committee.

Therefore, we would prefer disclosure of matters communicated with management and non-executive directors, beyond the audit committee members. The IAASB's standard requires the auditor to communicate key audit matters selected from matters communicated with those charged with governance[3].

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[2] FRC - Extended auditor's reports – A further review of experience – January 2016

[3] Role of persons entrusted with the supervision, control and direction of an entity: highest level of management including the executive and non-executive directors and the audit committee.

*Factors*

A factor based on the extent of interaction with the audit committee can be a meaningful indicator and be useful information for the investor.

Because the determination of critical audit matters is principles-based, the standard does not contemplate circumstances or matters that, if present, would always constitute critical audit matters. To illustrate, revenue recognition is presumed to be a fraud risk and all fraud risks are significant risks; however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgement, it would not be a critical audit matter.

Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, the information provided is useful in evaluating financial performance and highlighting these differences is informative. Prior period critical audit matters are important information for investors, so we would prefer to keep the 'should consider' requirement in reproposed standard.

**Communication of Critical Audit Matters**

The communication of critical audit matters may help focus the audit committee's oversight efforts. By assessing what is critical and therefore required to be communicated there is likely to be a debate, allowing the audit committee to engage more effectively with the auditor and management about the matters identified as possibly critical audit matters and the adequacy of the company's related disclosures.

The introductory language is clear that the auditor is not providing a separate opinion on the critical audit matters or on the accounts or disclosures to which they relate.

Elsewhere, including audit procedures in the description of a critical audit matter would definitively make the auditor's report more informative and useful.

Given the experience in the UK, having no critical audit matters should be extremely rare.

**Liability Considerations Related to Critical Audit Matters**

The communication of critical audit matters is about disclosure of risks and challenges. We believe that non-communication of such matters would be more problematic from a litigation point of view.

We trust that our comments are useful and we are very happy to discuss any of the points that we have raised with the PCAOB further. Please contact roland.bosch@hermes-investment.com should you wish to do so.

Yours faithfully

Roland Bosh

**HESS CORPORATION**
1185 AVENUE OF THE AMERICAS
NEW YORK, NY 10036

JOHN P. RIELLY
Senior Vice President
and Chief Financial Officer
(212) 536-8230
(212) 536-8502 FAX

August 10, 2016

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

Re: PCAOB Rulemaking Docket No. 34 – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion

Dear Board Members:

Hess Corporation (Hess or the Corporation) appreciates the opportunity to respond to the request for comments from the Public Company Accounting Oversight Board (PCAOB) on the proposed auditing standard, *Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the Proposed Standard). Hess is a leading global independent energy company primarily engaged in the exploration and production of crude oil and natural gas. The Corporation is a registrant with the U.S. Securities and Exchange Commission and is classified as a large accelerated filer.

The primary issue addressed in the Proposed Standard is the requirement for auditors to disclose critical audit matters (CAMs) in an unqualified opinion. We believe the requirements as proposed are unnecessary, will reduce the effectiveness and relevance of other disclosures, and will undermine the reliability of an unqualified opinion despite whatever qualifying language to the contrary is added. The concerns raised by the PCAOB regarding CAMs are largely covered by disclosures already provided by registrants in their annual reports (e.g. critical accounting policies and related sensitivities, risk factors, fair value measurements, contingencies, material known trends in MD&A, and significant or unusual transactions). We believe investors understand the key risks of our business based on the totality of our disclosures and other information available. As a result, the addition of CAMs will unnecessarily increase cost and generate redundant disclosures. We also believe disclosure of audit procedures performed on CAMs is inappropriate as readers will not have enough information to understand the nature of the procedures performed or whether the extent of the procedures performed was adequate. As a result, a reader could make an incorrect conclusion regarding risk in relation to the unqualified opinion.

The Proposed Standard suggests the identification and disclosure of CAMs is meant to be guided on a principles-based framework, which by its nature requires judgment. We note in the proposal that if the auditor's report were determined to contain errors or misstatements, it is expected the registrant's SEC filing(s) would need to be amended. We are concerned the PCAOB, in applying its oversight authority, will assess the adequacy of CAM disclosures in an audit opinion and potentially trigger amendments to SEC filings due to differences in judgment regarding relevance of what needs to be disclosed by the auditor. If PCAOB imposed amendments to SEC filings resulting from changes in CAM disclosures is a potential outcome of adopting the Proposed Standard, we believe the confidence in the pass/fail model for unqualified opinions will be significantly undermined.

The Proposed Standard also suggests an indirect benefit will be "expanded auditor reporting may serve as a potential means of greater differentiation among accounting firms and engagement partners." This sentiment reinforces our concerns that disclosure of CAMs will undermine the reliability of an unqualified opinion, as well as potentially introduce a risk accounting firms and engagement partners view audit opinions as marketing documents via differentiating disclosures. This tone in the Proposed Standard is inconsistent with what you are trying to accomplish.

We believe the current regulatory framework sufficiently meets the needs of investors with the desired oversight protections in place for ensuring accurate, timely, and relevant information about financial performance, risks, and significant judgments. For the reasons cited above, we do not believe there is sufficient justification for the inclusion of CAMs in an audit opinion, nor do we believe there is clear evidence that this requirement would improve audit quality given the strength of the U.S. regulatory system over SEC registrants and independent registered public accounting firms. Instead, the Corporation believes continued evolution of auditing standards in response to changing market, business, technology, and other changes, as well as open dialogue between auditors, audit committees and management, is a better means to ensure ongoing high quality audits.

Our interpretation of the key objective the PCAOB is trying to achieve with the disclosure of CAMs is to address the information asymmetry between investors and auditors. While we do not agree with the proposal to disclose CAMs, if the PCAOB moves forward with this requirement, we recommend the disclosures be limited to simply identifying CAMs with a cross-reference to the related disclosure within a registrant's filed document, including sections outside the audited financial statements. We believe this recommendation will allow readers to understand the material transactions, disclosures, and judgements that were discussed between the auditor and the audit committee without the cost of developing repetitious disclosures. This more objective approach would also significantly reduce the potential for differences in judgment between auditors and the PCAOB on the adequacy of CAM disclosures.

In the attached appendix, we have provided responses to specific questions on topics other than CAMs included in the request for comments where we have a view. Thank you for the opportunity to provide feedback on this proposal. I would be pleased to discuss our views with you at your convenience.

Sincerely yours,

John P. Rielly

John P. Rielly
Senior Vice President and
Chief Financial Officer

Appendix

## Responses to Questions in the Proposed Standard

**Question 13:**

**Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?**

Response: We agree with the proposal to add language in the body of the auditor's report to clarify requirements with respect to independence to the company.

**Question 18:**

**Should disclosure of auditor tenure be made on Form AP rather than the auditor's report? Why or why not?**

Response: We do not believe auditor tenure is useful information in the auditor's report. We believe including such information in the auditor's report would be an indication the PCAOB views audit tenure as a distinctive factor in determining the quality of an audit. This can lead to baseless conclusions by readers as there is no definitive evidence of linkage between tenure and audit quality. The Proposed Standard states the disclosure of auditor tenure is intended to add to the mix of information that investors can use. Based on that desired objective, our view is auditor tenure, if provided, should be reported on Form AP.

**Question 25:**

**Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?**

Response: We agree with the proposal to require the "Opinion on the Financial Statements" section be the first section of the auditor's report immediately followed by the "Basis for Opinion" section, as well as, the requirement to use titles for all sections of the auditor's report.

August 15, 2016

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

Re: PCAOB Rulemaking Docket No. 034

Dear Board Members:

The Illinois CPA Society ("ICPAS") is a statewide membership organization, with over 23,000 professionals, dedicated to enhancing the value of the CPA profession. Founded in 1903, ICPAS is one of the largest state CPA societies in the nation. ICPAS represents Illinois CPAs in public accounting and consulting, corporate accounting and finance, not-for-profit, government and education organizations, as well as affiliate member groups for students, educators, international professionals and related non-CPA finance professionals. The organization and operating procedures of the Committee are reflected in the attached Appendix A to this letter.

The Audit and Assurance Services Committee of the Illinois CPA Society (the "Committee") is pleased to comment on the PCAOB's reproposal of the Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (Rulemaking Docket Matter No. 34) dated May 11, 2016 (the "Reproposal"). These comments and recommendations represent the position of the Illinois CPA Society rather than any members of the Committee or of the organizations with which such members are associated.

The stated purpose of the Reproposal is to increase the relevancy and usefulness of auditor reports (*i.e.*, to "address the information asymmetry between investors and auditors"). Consistent with our responses to the previous Releases dated September 30, 2011 and December 11, 2013, our Committee is in favor of adding clarity to the auditor's report so that the responsibilities of the auditor, management, and the audit committee are better understood by the users of the financial statements. We appreciate the Board's efforts on this undertaking and the opportunity to comment on the Reproposal. Our comment letter divides our response to the Reproposal into two sections: 1) *Critical Audit Matters*; and 2) *Additional Improvements to the Auditor's Report*.

## Critical Audit Matters

### Determination of Critical Audit Matters

We believe that the modifications to the definition of a critical audit matter provide additional clarity for auditors, and we agree that the incorporation of materiality judgements will aid in limiting over disclosure of matters not actionable by the financial statement users. However, our Committee is still not convinced that the additional information would necessarily be useful to investors. Investors would presumably be more interested in identification and understanding of business risks (e.g., environmental, legal, regulatory, etc.) facing the issuer. Such information should be provided by management, not auditors, and is, at least in part, already required to be disclosed pursuant to non-financial reporting regulations.

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**Communication of Critical Audit Matters**

We strongly support not permitting disclosure of even an indication of the outcome of the auditor's procedures, or any specific audit procedures, related to a specific critical audit matter. Permitting an indication of the outcome of auditor procedures related to a specific matter undermines the auditor's opinion on the financial statements taken as a whole.

Although the description of critical audit matters is not intended to provide a list of all audit procedures performed, permitting disclosure of specific audit procedures could lead to more investor confusion and uncertainty, as it would be almost impossible for such disclosures to completely convey the range of relevant procedures performed and why they were selected. Such disclosures could also add to confusion over audit concepts such as sampling and materiality. Commentary and recommendations, such as to refrain from use of highly technical accounting and auditing terms, suggests the Board is aware of the risk that the disclosure requirements provided in this Reproposal may cause additional misunderstanding by financial statement users.

An auditor's unqualified opinion on the financial statements indicates that the auditor was sufficiently able to overcome the challenges associated with the disclosed critical audit matter(s) in order to provide the unqualified opinion and that the audited financial statements are fairly stated in accordance with the applicable financial reporting framework. As such, the reporting of critical audit matters may unduly raise investors' and other financial statement users' concerns over the quality of the audited financial statements. Communication requirements of the Reproposal may not only prompt a user, who generally is not a trained auditor, to suspect the veracity of the financial statement opinion, and potentially question the internal control opinion if one is provided (and/or of management's report on internal controls).

While the auditor's report will indicate that no critical audit matters alter the auditor's opinion on the financial statements, users may nonetheless consider the disclosed critical audit matters as somehow qualifying that financial statement opinion. Also, as indicated above, investors that mistakenly over rely on critical audit matter disclosures to highlight areas of concern, may not be properly informed or consider items that were *not* included as a critical audit matter, such as business risks. In an effort to potentially minimize these concerns, we suggest expanding the final sentence of the standard language preceding critical audit matters in the auditor's report as follows:

> "The determination of critical audit matters is highly subjective. The critical audit matters communicated below may not represent all or even the most important elements of the accompanying financial statements and should not be considered as such. The critical audit matters communicated below were adequately addressed by our audit procedures. The disclosure of critical audit matters does not alter, in any way, our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate."

Initially, due to the subjective nature of critical audit matters, different auditors, both within and amongst audit firms, will select different places along the 'challenging' continuum where a matter becomes a reportable critical audit matter. Companies then may - over time and likely with the aid of media or other reports that will evolve to track such things - start to consider which audit firms disclose more or fewer critical audit matters and how those disclosures are made when those companies choose which audit firm to engage. As a result, several years after implementation, it is more likely than not that industry standard disclosures will be utilized and audit reports within certain industries will once again become uniform and diminish the value-added objective to the users of the financial statements that the Reproposal intends.

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**Documentation of Critical Audit Matters**

We believe the reproposed documentation requirements are sufficiently clear.

**Other Considerations for Critical Audit Matters**

We believe the Reproposal will have a material impact on the required additional effort, cost, and litigation risk, for both auditors and companies, to which we commented on in our December 11, 2013 response.

**Additional Improvements to the Auditor's Report**

**Auditor Independence**

We believe the reproposed requirement is clear. However, consistent with our December 11, 2013 response, we do not believe the reproposed requirement will improve financial statement users' understanding of auditors' independence responsibilities, but rather lengthen the report with unnecessary reference to technical standards. In addition, we do not believe that including the statement in the auditor's report is necessary to "serve as a reminder to auditors" of their independence obligations, as independence is a basic tenet of the audit profession.[1]

**Addressee**

While we agree that the reproposed standard will promote consistency in the addressing of the auditor's report, consistent with our December 11, 2013 response, the Committee does not believe that adding required addressees is significant to the financial statements or will appreciably serve the purpose of better informing financial statement users. We do not believe inclusion of the reproposed requirement in the final standard is worth the effort by any involved party.

Should the proposed standard be finalized, it would be helpful to include practical examples (similar to, and expanded upon, as provided in footnote 74 of the Reproposal and/or in illustrative auditor reports) to ensure clear guidance and consistent implementation.

**Auditor Tenure**

As noted in our December 11, 2013 response, the Committee does not object to the underlying principle of disclosing auditor tenure, but we do not believe it should be included in the auditor's report. The Committee believes that the disclosure would be more appropriate in the Form AP, *Auditor Reporting of Certain Audit Participants*. We believe disclosure in Form AP would sufficiently address the issue of consistent disclosure placement, provide a place for (likely) lengthy explanation of tenure calculations, reduce over reliance on inferences regarding the correlation and misunderstanding of audit tenure disclosed and audit quality, and would also limit investor search costs.

As mentioned in the Reproposal discussion and Board member comments, the calculation of tenure will often be complex and easily misleading (as in the cited case of group investment companies). We do not foresee any auditor disclosing their uncertainty as to their tenure in the audit report, nor do we believe the option should be permitted, as it discredits the perceived competence of the auditor to a user that is not familiar with the calculation requirements and complexities.

[1] Reproposal, §VI.C.2., p. 80.

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Should the proposed inclusion of auditor tenure in the auditor's report be finalized, we believe the most applicable location would be immediately following the reference to the applicable independence rules and regulations (end of the first paragraph in the Basis for Opinion section). In order to ensure consistency, we do not believe the auditor should have preferential options in terms of the disclosure's location. For the reasons mentioned and referenced above, we do not believe the disclosure merits its own section title.

**Enhancements to Basic Elements and Standardized Form of the Auditor's Report**

The Committee agrees that clarification and amendment of the standard auditor's report is appropriate if the information enhances financial statement users' understanding of the roles and responsibilities of the auditor, management, and the audit committee in regards to the audited financial statements. With the exception of adding section titles and providing limited flexibility in the positioning of the sections within the auditor's report, we do not believe the enhancements to the basic elements of the auditor's reports will improve upon the relevancy, usefulness, or information asymmetry between financial statement users and the auditor.

We strongly object to the addition of the phrase "whether due to error or fraud" without the addition of corresponding language regarding management's responsibilities with respect to fraud. We suggest language to be required in the *Basis for Opinion* section of the auditor's report describing management's various responsibilities beyond just the financial statements. An example disclosure is as follows:

> "Company's management is also responsible for designing and implementing controls to prevent and detect fraud, and to inform us about all known or suspected fraudulent activity that could have a material effect on the Company's financial statements."

As noted in our responses to the previous proposed standards, the Committee recognizes that the auditor's report, as reproposed, is approaching a potentially unreadable length and that a thorough description of everyone's roles and responsibilities with respect to the related financial statements and disclosures would further add to repetitive "boilerplate" verbiage across each auditor report for infinite periods, which is both inefficient and contrary to the principles of this Reproposal. Accordingly, we remind the Board of the supplemental alternative we provided as a part of our response to the Concept Release dated September 30, 2011, for the auditor's report to provide a cross reference to a more complete description of what a public company auditor's, management's, and audit committee's roles and responsibilities are, and a general discussion on the risk assessment, professional judgment, materiality, and sampling concepts that a compliant audit might provide. The referenced materials would be described in "plain English" and could be available to the general public on a free basis from a named website. We believe that the cost of creating this singularly referenced guidance statement would significantly outweigh repetitive and truncated statements of responsibility in each audit report and would potentially be perceived as adding more value from an independent governing body providing outreach as compared to an audit firm disclaiming responsibility.

**Considerations Related to Effective Date**

As indicated in our previous response, our Committee would be in favor of limiting the requirement to disclose critical audit matters to reports on financial statements of accelerated and large accelerated filers. If the requirement is to be retained as reproposed, we suggest delaying the compliance date related to critical audit matters for smaller reporting companies.

ILLINOIS CPA SOCIETY

The Illinois CPA Society appreciates the opportunity to express its opinion on this matter. We would be pleased to discuss our comments in greater detail if requested.

Sincerely,

**James R. Javorcic, CPA**

Chair, Audit and Assurance Services Committee

**Scott Cosentine**

Vice Chair, Audit and Assurance Services Committee

ILLINOIS CPA SOCIETY

APPENDIX A

AUDIT AND ASSURANCE SERVICES COMMITTEE

ORGANIZATION AND OPERATING PROCEDURES

2016 – 2017

The Audit and Assurance Services Committee of the Illinois CPA Society (Committee) is composed of the following technically qualified, experienced members. The Committee seeks representation from members within industry, education and public practice. These members have Committee service ranging from newly appointed to almost 20 years. The Committee is an appointed senior technical committee of the Society and has been delegated the authority to issue written positions representing the Society on matters regarding the setting of audit and attestation standards. The Committee's comments reflect solely the views of the Committee, and do not purport to represent the views of their business affiliations.

The Committee usually operates by assigning Subcommittees of its members to study and discuss fully exposure documents proposing additions to or revisions of audit and attestation standards. The Subcommittee develops a proposed response that is considered, discussed and voted on by the full Committee. Support by the full Committee then results in the issuance of a formal response, which at times includes a minority viewpoint. Current members of the Committee and their business affiliations are as follows:

**Public Accounting Firms:**

**National:**

| | |
|---|---|
| Timothy Bellazzini, CPA | Sikich LLP |
| Todd Briggs, CPA | RSM LLP |
| Scott Cosentine, CPA | Ashland Partners & Company LLP |
| Heidi DeVette, CPA | Johnson Lambert LLP |
| Eileen M. Felson, CPA | PricewaterhouseCoopers LLP |
| Michael R. Hartley, CPA | Crowe Horwath LLP |
| James R. Javorcic, CPA | Mayer Hoffman McCann P.C. |
| Timothy Jipping, CPA | Plante & Moran PLLC |
| John Offenbacher, CPA | Ernst & Young LLP |
| Elizabeth J. Sloan, CPA | Grant Thornton LLP |
| Richard D. Spiegel, CPA | Wipfli LLP |
| Kevin V. Wydra, CPA | Crowe Horwath LLP |

**Regional:**

| | |
|---|---|
| Jennifer E. Deloy, CPA | Marcum LLP |
| Barbara F. Dennison, CPA | Selden Fox, Ltd. |
| Genevra D. Knight, CPA | Porte Brown LLC |
| Andrea L. Krueger, CPA | CDH, P.C. |

**Local:**

| | |
|---|---|
| Matthew D. Cekander, CPA | Doehring, Winders & Co. LLP |
| Lorena C. Johnson, CPA | CJBS LLC |
| Mary Laidman, CPA | DiGiovine, Hnilo, Jordan & Johnson, Ltd. |
| Carmen F. Mugnolo, CPA | Trimarco Radencich, LLC |
| Jodi Seelye, CPA | Mueller & Company LLP |
| Joseph Skibinski, CPA | |

ILLINOIS CPA SOCIETY

**Industry:**

| | |
|---|---|
| Matthew King, CPA | Baxter International Inc. |

**Educators:**

| | |
|---|---|
| David H. Sinason, CPA | Northern Illinois University |

**Staff Representative:**

| | |
|---|---|
| Heather Lindquist, CPA | Illinois CPA Society |

August 15, 2016

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, DC 20006-2803

Re: Proposed Auditing Standard on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; Docket Matter No. 34

Dear Ms. Brown:

The Independent Directors Council and the Investment Company Institute[1] appreciate the opportunity to comment on the Public Company Accounting Oversight Board's proposed changes to the auditor's reporting model.[2] The Proposed Auditor Reporting Standard would make several changes to the auditor's report intended to make it more informative to investors. In particular the Proposal would, among other things: require communication of critical audit matters (CAMs), which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit; require disclosure of auditor tenure in the auditor's report; and clarify the auditor's existing responsibility to obtain reasonable assurance about whether the financial statements are free of material misstatement.

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[1] The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.9 trillion and serve more than 90 million U.S. shareholders. IDC serves the U.S.-registered fund independent director community by advancing the education, communication, and policy positions of fund independent directors, and promoting public understanding of their role. IDC's activities are led by a Governing Council of independent directors of ICI member funds. The views expressed by IDC in this letter do not purport to reflect the views of all fund independent directors.

[2] *See* The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, PCAOB Release No. 2016-003 (May 11, 2016) (Release). The Release includes a proposed audit standard, which we refer to as the "Proposed Auditor Reporting Standard" or the "Proposal" and proposes certain changes to other audit standards.

The Proposal is a reproposal of a 2013 proposal on which we commented.[3] We are pleased to see that the Board has made several changes to the 2013 proposal relating to audits of investment company financial statements that address comments raised by us and others. Specifically, the Proposed Auditor Reporting Standard indicates that communication of CAMs is not required for audits of investment companies registered under the Investment Company Act of 1940 (Investment Company Act). The Proposal would also specify how auditor tenure should be measured in the context of a group of investment companies.

We strongly support the Board's decision to exclude audits of registered investment companies from CAM reporting. We believe there would be little, if any, benefit of CAM reporting to fund shareholders in light of the purpose and structure of funds, and disclosures that they currently provide in their prospectus and shareholder report. We are concerned, however, that the disclosure of auditor tenure in the auditor's report may imply a relationship between auditor tenure and audit quality and recommend that tenure instead be disclosed in PCAOB Form AP. We elaborate on these and other comments below.

*CAM Reporting*

Investment companies are designed to provide investors with access to a professionally managed portfolio of investment securities. Funds can invest in a variety of stocks, bonds, and other securities, providing investors with pro-rata ownership of a diversified portfolio with a modest initial investment. The Investment Company Act includes specific requirements intended to reduce investors' risks in areas such as portfolio diversification, liquidity, leverage, and custody of securities. Funds provide extensive disclosure to investors that describes their investment objectives and policies, risks, fees, expenses, and performance. Unlike operating companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. Any material changes must be approved in advance by a vote of fund shareholders. Because of the purpose and structure of investment companies, we believe that CAM disclosure would provide little if any benefit to fund investors and would have the potential to become repetitive, making it uninformative.

For investment companies, the audit matters most likely to be deemed critical under the Proposal would involve the auditing of security values. Generally accepted accounting principles currently require extensive disclosure regarding valuation of investments, with particular emphasis on securities for which observable prices are not available (*i.e.*, Level 2 and Level 3 securities).[4] The SEC's

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[3] *See* Letter from Amy B.R. Lancellotta, IDC Managing Director, and Gregory M. Smith, ICI Senior Director, to Phoebe W. Brown, PCAOB Secretary, dated December 11, 2013.

[4] *See* FASB ASC 820-10-50.

investment company registration forms require disclosure of the fund's valuation policies, including the use of "fair value pricing" and the effects of fair value pricing.[5] Because of these disclosure requirements, we believe investors are well informed about the extent of the fund's investments in securities that present difficult or subjective fair value measurements. We believe that requiring the auditor to describe the difficulty associated with auditing these fair value measurements would not add meaningfully to the mix of information already provided to investors. Indeed, CAM disclosure indicating that certain securities trade less frequently and were valued through reference to unobservable inputs would be repetitive of information already provided by management.

Funds in an investment company complex that have the same fiscal year end often issue a combined shareholder report that covers several different funds. In these instances the auditor typically issues one auditor report that covers all of the funds included in the shareholder report. If the Board were to require investment company auditor reports to include CAMs, we believe it may be confusing to shareholders if an auditor report covering multiple funds included CAMs for some, but not all of the funds covered by the auditor report. Alternatively, if auditors were to prepare separate auditor reports for each fund in the shareholder report, then the shareholder report would include multiple auditor reports, likely increasing the fund's costs to print and mail the shareholder report. Such costs would be borne by the fund and its shareholders.

For the reasons described above, we support the Board's decision to exclude auditor reports for investment companies registered under the Investment Company Act from CAM reporting.

*Auditor Tenure*

We are concerned that disclosure of auditor tenure in the auditor's report may cause investors to infer a relationship between auditor tenure and audit quality. As the Release recognizes, academic research on the relationship between tenure and audit quality has varied conclusions.[6] Some research indicates that engagements with short-term tenure are relatively riskier or that quality improves when auditors have time to gain expertise in the company under audit and in the related industry. Other research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality. The Board's 2013 proposal on the auditor's reporting model indicates that the Board has not reached a conclusion regarding the relationship between audit quality and auditor tenure.[7]

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[5] *See e.g.,* Item 11 and Item 23 of SEC Form N-1A.

[6] *See* Release at 91.

[7] *See* PCAOB Release No. 2013-005 (August 13, 2013) at page A5-16.

In order to reduce the likelihood of any inappropriate conclusions being drawn from the relationship between auditor tenure and audit quality, we recommend that auditor tenure be disclosed in recently adopted PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*. Form AP, when implemented, will provide investors with the name of the engagement partner for each audit in a single searchable database. We believe disclosure in Form AP will provide investors with easy access to tenure information while reducing the likelihood of inappropriate conclusions being drawn from the relationship between auditor tenure and audit quality.

*Tenure Measurement for Investment Companies*

The Proposal specifies that for an investment company that is part of a group of investment companies, the auditor's tenure would be measured from the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. "Group of investment companies" for this purpose means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services, consistent with Section 12(d)(1)(G)(ii) of the Investment Company Act. This term would exclude other entities in the investment company complex, such as the investment adviser, any private funds, or entities that provide services to investment companies.

We support the Proposal's methodology for measuring tenure. The proposed methodology is appropriate given that all of the funds within a complex are on the same accounting system and are subject to the same system of internal control over financial reporting. Furthermore, many fund complexes have one board of directors that oversees all the funds in the complex and it is the board's responsibility, by statute, to select a fund's auditor.[8]

*Explanatory Language Regarding Audits of Internal Control Over Financial Reporting*

Unlike many operating companies, investment companies registered under the Investment Company Act are not required to engage an auditor to perform an audit of their internal control over financial reporting (ICFR).[9] Under current audit standards, auditors may, at their discretion, include a statement in the auditor's report indicating that they were not engaged to perform an audit of ICFR. For example, an investment company auditor's report may state:

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[8] *See* Section 32 of the Investment Company Act.

[9] *See* Section 405 of the Sarbanes-Oxley Act of 2002. Investment companies are, however, required to file with the SEC an auditor's report on the fund's internal control based on the results of procedures performed in obtaining an understanding of internal control over financial reporting and assessing control risk in connection with the audit of the fund's financial statements. This report must describe any material weaknesses identified. *See* Item 77B of SEC Form N-SAR.

> The Fund is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the fund's internal control over financial reporting. Accordingly, we express no such opinion.

The Release requests comment on whether auditor's reports for investment companies should be required to include an explanatory statement indicating that the auditor was not engaged to perform an audit of ICFR. We observe that certain audit firms routinely include such a statement in their auditor's reports for investment companies and that others do not. In order to better inform investors that rely on auditor's reports, and to increase consistency in auditor's reports, we recommend that the Board require an explanatory statement.

*Auditor's Responsibility to Obtain Reasonable Assurance*

The Proposed Auditor Reporting Standard would revise the auditor's report to better recognize the auditor's responsibility, under existing audit standards, to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud. Specifically, the phrase "whether due to error or fraud" would be added to the report when describing the auditor's responsibility to obtain reasonable assurance that the financial statements are free of material misstatement. The Board has proposed this change to clarify the auditor's role in detecting fraud, as the current report makes no explicit reference to fraud. We believe the proposed disclosure better informs investors of the auditor's responsibility and we support adding it to the auditor's report.

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If you have any question on our comments please contact Amy Lancellotta at (202) 326-5824 or amy@ici.org, or Gregory Smith at (202) 326-5851 or smith@ici.org.

Amy B.R. Lancellotta
IDC Managing Director

Gregory M. Smith
ICI Senior Director – Fund Accounting

IRBA
INDEPENDENT REGULATORY BOARD FOR AUDITORS

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12 August 2016

*Submitted electronically to*

Office of the Secretary

Deputy Chief Auditor

Public Company Accounting Oversight Board (PCAOB)

1666 K Street, NW

Washington D.C. 20006, USA

Dear Sir/Madam

**PCAOB RULEMAKING DOCKET MATTER NO. 034: COMMENTS ON THE PCAOB PROPOSED STANDARD – THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS**

The Independent Regulatory Board for Auditors (IRBA) is a statutory body of the South African government, and it is both the audit regulator and national auditing standard-setter in the country. The IRBA's statutory objectives include the protection of the public by regulating audits performed by registered auditors and the promotion of investment and employment in South Africa.

The IRBA has a keen interest in the scope, requirements and impact of the proposed standards specifically relating to disclosure of auditor tenure. We have recently issued a similar rule requiring the disclosure of auditor tenure. Thus, our comments below have been limited to the sections of the proposed standards dealing with auditor tenure. We appreciate this opportunity to comment on the draft *Proposed Auditing Standards*, developed by the Public Company Accounting Oversight Board (PCAOB), and remain available to discuss our comments with you. Our comments are presented under the following sections:

1. General Comments
2. Specific Comments
3. Disclosure of Auditor Tenure in South Africa
4. Annexures

Yours faithfully

***Signed electronically***

Bernard Peter Agulhas

**Chief Executive Officer**

## 1. GENERAL COMMENTS

1.1. We welcome the PCAOB's efforts in enhancing the transparency of the relationship between the audit firm and the audit client. The requirement to disclose auditor tenure is an important step towards having a robust conversation about audit firm independence. Our position is informed by our experience with implementing disclosure of auditor tenure in South Africa, which is discussed in further detail below.

1.2. We support steps designed to protect the public, and we commend the objective of the proposed standards to inform users of financial statements and to allow for educated decisions when appointing auditors.

1.3. The growing trend in USA to voluntarily disclose auditor tenure is indicative of investors' needs and the growing interest in the relationship between the audit firm and the audit client.

1.4. While we understand the concern to potentially misunderstand the correlation between auditor tenure and audit quality, the rewards for an informed reader would outweigh any potential temporary misunderstanding.

1.5. The key element to enhancing auditor independence is an evaluation of the oversight of the audit committee (body charged with appointing the auditor). Disclosure of auditor tenure will allow shareholders to ask the correct questions of the audit committees and make informed decisions when appointing auditors.

1.6. Disclosure of auditor tenure would be most appropriate in the auditor's report as it allows the user to locate information easily. Additionally, users of the financial statements who are unaware of this required disclosure will also have access to it.

1.7. The transparency about auditor tenure will generate a heightened interest in the audit process and attention to audit matters.

## 2. SPECIFIC COMMENTS

2.1. We have only responded to questions dealing with disclosure of auditor tenure.

*16. Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information in the auditor's report which the Board should consider? If so, what are they?*

2.2. The requirements in the proposed standard are appropriate and clear. However, practical questions may require further guidance. We have provided examples in the annexure under "Frequently Asked Questions on Disclosure of Audit Tenure"

*17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?*

2.3. It would depend on the significance and the role that the company plays in the group of investment companies. In South Africa we did not follow this approach as we did not want to overcomplicate the rule. The cost benefit of such an approach should be evaluated.

*18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?*

2.4. No. The Auditor's Report is the most commonly known output referred to by users. If the rule is intended to start a conversation on independence, then the auditor's report would be more appropriate.

*19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?*

2.5. Yes. If the reader requires this type of information, it would be reasonable to expect to find this disclosure in the auditor's report. In South Africa, we have specified a location for disclosure to ensure uniformity of auditor's reports. Further information is available in the annexure under the communiqué dated 4 December 2015.

## 3. DISCLOSURE OF AUDITOR TENURE IN SOUTH AFRICA

3.1. One of the IRBA's strategic pillars and priority is the "Strengthening of Auditor Independence". We are currently researching mandatory audit firm rotation, mandatory tendering and joint audits. We recently issued a rule similar to the proposed PCAOB rule, requiring disclosure of auditor tenure in auditor's reports.

3.2. Our rule requires the disclosure of the number of years of tenure on the auditor's report rather than the appointment date. We introduced an illustration of the wording of the disclosure which helped with keeping the format of the audit report consistent.

3.3. Practical questions were raised regarding the determination of auditor tenure and the scope of the disclosure. The IRBA issued Frequently Asked Questions (FAQs) on Auditor Tenure to facilitate the implementation of the new requirement and contribute to a consistent application of the rule across the country. The FAQs cover practical questions raised by professionals, the industry, investors, academics and other stakeholders on the implementation of the rule.

3.4. The IRBA Communiqués and FAQs relating to auditor tenure have been attached below for your consideration.

3.5. While it is too soon to assess the full impact of this requirement in South Africa, the initial response has been a heightened interest in the audit process and independence. We are starting to see changes of auditors who have been associated with clients over extensive periods. We look forward to sharing further information when it is available. The information gleaned has also played a part in our thinking as we consider measures to strengthen auditor independence.

3.6. The following links provide examples of disclosure of audit tenure in South Africa:

- http://www.metair.co.za/downloads/2015IntegratedAnnualReport.pdf
- http://www.aeci.co.za/reports/ar_2015/res-iaud.php
- http://www.aga-reports.com/15/
- http://www.mondigroup.com/PortalData/1/Resources/investor_relations/reports_presentations/2016/2015_Mondi_Limited_AFS.PDF
- http://www.basilread.co.za/downloads/reports/2016/Basil-Read-Financial-Report.pdf

## 4. ANNEXURES

**INDEPENDENT REGULATORY BOARD FOR AUDITORS**

### IRBA STRENGTHENS AUDITOR INDEPENDENCE BY MANDATING DISCLOSURE OF AUDIT TENURE

Johannesburg / 04 December 2015

The Regulatory Board, in terms of Section 9 and 10 read with sections 1, 2 and 3 of the Auditing Profession Act, Act 26 of 2005, published a Rule in the Government Gazette Nr 39475 of 04 December 2015 which makes it mandatory that all auditor's reports on Annual Financial Statements shall disclose the number of years which the audit firm / sole practitioner has been the auditor of the entity (audit tenure). A predecessor audit firm in this context refers to an audit firm where there has been mergers/de-mergers or other combinations in the audit firm and an audit firm shall therefore include a predecessor audit firm.

Audit tenure refers to the length of the auditor-client relationship. Thus tenure includes the period that the predecessor audit firms (where there has been mergers/de-mergers or other combinations in the audit firm) issued audit reports on the entity.

This rule applies to audit reports issued on the Annual Financial Statements of all public interest entities, as defined in the Companies Act of 2008 and prescribed by the Regulatory Board from time to time, for periods ending on or after 31 December 2015.

The Regulatory Board made the decision to require the mandatory disclosure of audit tenure in the context of strengthening auditor independence which is consistent with measures implemented in other jurisdictions. This disclosure of audit tenure will lead to transparency of association between audit firms and audit clients.

The IRBA will monitor compliance with the above rule for auditor's reports on all Annual Financial Statements of public interest entities for periods ending on or after 31 December 2015.

**Additional Guidance:**

- All audit firms and sole practitioners are required to comply with the new disclosure requirement.
- The audit tenure should reflect the number of years the audit firm/sole practitioner continuously served as auditor.
- In the case of audit firm mergers/ de-mergers or change in name, the longest length of tenure should be disclosed.
- Where the client is a company, information on the appointment and changes in auditors can be obtained from the Companies and Intellectual Property Commission (CIPC) or company secretarial records.
- In the case of companies, as the appointment and continuation of auditors is the responsibility of the audit committee, auditors are advised to bring the requirement of this rule to the attention of the audit committee.

An illustrative example of this requirement in terms of SAAPS 3 *Illustrative Reports*, (Revised November 2013), is provided below:

**Independent Auditor's Report**

*To the Shareholders of ABC Limited*

**Report on the Financial Statements**

We have audited the financial statements of ABC Limited set out on pages ...to ..., which comprise the statement of financial position as at 31 December 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and the notes, comprising a summary of significant accounting policies and other explanatory information.

*Directors' Responsibility for the Financial Statements*

The company's directors are responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards and the requirements of the Companies Act of South Africa, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

*Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the financial statements present fairly, in all material respects, the financial position of ABC Limited as at 31 December 20X1, and its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and the requirements of the Companies Act of South Africa.

*Other reports required by the Companies Act*

As part of our audit of the financial statements for the year ended 31 December 20X1, we have read the Directors' Report, the Audit Committee's Report and the Company Secretary's Certificate for the purpose of identifying whether there are material inconsistencies between these reports and the audited financial statements. These reports are the responsibility of the respective preparers. Based on reading these reports we have not identified material inconsistencies between these reports and the audited financial statements. However, we have not audited these reports and accordingly do not express an opinion on these reports.

**Report on Other Legal and Regulatory Requirements**

In terms of the IRBA Rule published in Government Gazette Number 39475 dated 04 December 2015, we report that XX firm/ sole practitioner has been the auditor of XX client for X years.

*Auditor's Signature*
Name of individual registered auditor
Capacity if not a sole practitioner: e.g. Director or Partner
Registered Auditor
Date of the auditor's report
Auditor's address

**Bernard Peter Agulhas**

**Chief Executive Officer**

***About the IRBA***

*The objective of the IRBA is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes.*

## Further Clarification: IRBA Strengthens Auditor Independence By Mandating Disclosure Of Audit Tenure

Johannesburg / 10 December 2015

Reference is made to the communiqué titled "*IRBA Strengthens Auditor Independence by Mandating Disclosure of Audit Tenure*" issued on 4 December 2015, regarding the publication of a Rule in the Government Gazette Nr 39475 of 4 December 2015.

We clarify that this rule applies to audit reports issued on the Annual Financial Statements of all public companies – as defined in the Companies Act of 2008 – that meet the definition of a public interest entity as per the IRBA Code of Professional Conduct for Registered Auditors.

**Bernard Peter Agulhas**
**Chief Executive Officer**

***About the IRBA***
*The objective of the IRBA is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes.*

# IMPORTANT NOTICE ON DISCLOSURE OF AUDIT TENURE AND FREQUENTLY ASKED QUESTIONS ON AUDIT TENURE

Johannesburg / 29 February 2016

Reference is made to the communiqué titled '*IRBA Strengthens Auditor Independence by Mandating Disclosure of Audit Tenure*' issued on 4 December 2015, regarding the publication of a Rule in the Government Gazette Nr 39475 of 4 December 2015, and the further clarification issued on 10 December 2015.

To further assist auditors with the application of the Rule, the IRBA developed a set of Frequently Asked Questions (FAQ), as attached. The communiqués referred to above have been attached to the FAQ for ease of reference.

Registered Auditors' attention are drawn to the following important matters:

1. The objective of the above Rule is to disclose the length of time which the audit firm had been involved with the client. It is therefore irrelevant whether the client had changed the format through which it traded, and the substance over form principle should be applied.
2. Auditors are strongly discouraged from disclosing any information which would detract from the reader's understanding of the length of time the firm had been involved with the client, for example by disclosing the details of the firm's partner rotation policy and current engagement partner's tenure on the engagement. The objective of the above Rule is to raise transparency regarding the firm's tenure and not that of the individual auditor.
3. The IRBA will monitor compliance with the above Rule through inspections, and will consider any disclosure which could mislead the public in a serious light.
4. Auditors should draw the Rule and the guidance issued by the IRBA to the attention of the chair of the audit committee.
5. Auditors are encouraged to disclose audit tenure in their reports even if the Rule does not apply to the client.

**Bernard Peter Agulhas**
**Chief Executive Officer**

***About the IRBA***

*The objective of the IRBA is to endeavour to protect the financial interests of the South African public and international investors in South Africa through the effective and appropriate regulation of audits conducted by registered auditors, in accordance with internationally recognised standards and processes.*

## Frequently Asked Questions on Disclosure of Audit Tenure

| **Relevant Definitions** | |
|---|---|
| **As per Section 1 of the South African Companies Act 2008 (Act 71 of 2008)** | |
| **Public Company** | means a profit company that is not a state-owned company, a private company or a personal liability company. |
| **State-owned Company** | means an enterprise that is registered in terms of this Act as a company, and either—<br>(a) falls within the meaning of ''state-owned enterprise'' in terms of the Public Finance Management Act, 1999 (Act No. 1 of 1999); or<br>(b) is owned by a municipality, as contemplated in the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000), and is otherwise similar to an enterprise referred to in paragraph (a)." |
| **Definitions per the IRBA Code of Professional Conduct for Registered Auditors** | |
| **Public Interest Entity (PIE)** | (a) A listed entity;<br>(b) An entity<br>(i) defined by regulation or legislation as a public interest entity; or<br>(ii) for which the audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to the audit of listed entities. Such regulation may be promulgated by any relevant regulator, including an audit regulator.<br>This definition should be read with Paragraph 290.26 of the IRBA Code of Professional Conduct.<br>Please note that a revised definition of public interest entity will be effective on or after 1 July 2016. |

| **Relevant IRBA Communiqués** | |
|---|---|
| **4 December 2015** | IRBA Strengthens Auditor Independence by Mandating Disclosure of Audit Tenure |
| **10 December 2015** | Further Clarification: IRBA Strengthens Auditor Independence by Mandating Disclosure of Audit Tenure |

| No. | Question | Suggested Answer |
|---|---|---|
| **1. Questions Regarding the Scope of the Tenure Rule** | | |
| 1.1. | For which entities are registered auditors required to disclose audit tenure in their audit reports? | The Rule applies to audit reports issued on the Annual Financial Statements of all public companies – as defined in Section 1 of the Companies Act of 2008 – which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors.<br><br>Hence, if an audit client is a public company, a registered auditor would have to consider if the client meets the definition of a public interest entity and if audit tenure disclosure is required. |
| 1.2 | Do the subsidiaries of these entities have to disclose audit tenure? | It depends.<br><br>If the subsidiary is a public company which also meets the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors, disclosure of audit tenure will be required. |
| 1.3 | Is disclosure of audit tenure required for a public interest entity that is not a public company, e.g. pension funds? | Only an audit client that is a public company that also meets the definition of a public interest entity will be required to disclose audit tenure. |
| 1.4 | Is disclosure of audit tenure required for state-owned companies (as defined below)?<br><br>''State-owned company'' means an enterprise that is registered in terms of this Act as a company, and either—<br><br>(a) falls within the meaning of ''state-owned enterprise'' in terms of the Public Finance Management Act, 1999 (Act No. 1 of 1999); or<br><br>(b) is owned by a municipality, as contemplated in the Local Government: Municipal Systems Act, 2000 (Act No. 32 of 2000), and is otherwise similar to an enterprise referred to in paragraph (a)." | As per the Companies Act 2008, public company means a profit company that is not a state-owned company, a private company or a personal liability company.<br><br>State-owned companies do not meet the definition of public companies in the Companies Act.<br><br>Disclosure is only for public companies, thus audit tenure disclosure will not be required. |
| 1.5 | Does disclosure of audit tenure only apply to JSE Inc. (Stock Exchange) listed entities? | Disclosure of audit tenure will be required for all public companies that meet the definition of public interest entity in the IRBA Code, and not only for listed entities. |

| No. | Question | Suggested Answer |
|---|---|---|
| 1.6 | Please advise where in the Companies Act of 2008 one would find the definition of public interest entities? | Please refer to the IRBA clarification communiqué issued on 10 December 2015, (attached for ease of reference) and the definitions above. |
| 1.7 | Will this mandatory disclosure apply to:<br>i. listed entity;<br>ii. Entities with a PI Score >350, requiring an audit in terms of the Act;<br>iii. Voluntary audits in terms of the MOI; and<br>iv. Voluntary audits in terms of shareholder resolution? | In line with the IRBA clarification communiqué issued on 10 December 2015:<br>i. Yes. A listed company is a public company and meets the definition of a PIE.<br>ii. It depends. See question 1.8 below.<br>iii. No<br>iv. No |
| 1.8 | Does the requirement to disclose audit tenure apply to entities that have a PI score above 350? | No, not automatically.<br>If the entity is a public company which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors, then disclosure of audit tenure will be required. |
| 1.9 | Is disclosure of audit tenure required only of audit clients that are companies? | Yes. All public companies – as defined in the Companies Act of 2008 – that meet the definition of a public interest entity as per the IRBA Code of Professional Conduct for Registered Auditors are required to disclose audit tenure.<br>Thus disclosure of audit tenure does not apply to partnerships, trusts or joint ventures, etc. |
| 1.10 | Does the domicile of the company have an impact on audit tenure disclosure? | No. The rule applies to audit reports issued on the annual financial statements of all public companies – as defined in Section 1 of the Companies Act of 2008 – which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors.<br>If the company meets the requirement above, audit tenure will be required. |
| 1.11 | Does audit tenure disclosure apply to debt issuers? | The rule applies to audit reports issued on the annual financial statements of all public companies – as defined in Section 1 of the Companies Act of 2008 – which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered |

| No. | Question | Suggested Answer |
|---|---|---|
| | | Auditors.<br>If the debt issuer meets the requirement above, audit tenure will be required. |
| 1.12 | Does the rule apply if the debt issuer is also an SOE/SOC? | No.<br>As per the Companies Act 2008, public company means a profit company that is not a state-owned company, a private company or a personal liability company.<br>State-owned companies do not meet the definition of public companies in the Companies Act.<br>The Rule applies to audit reports issued on the Annual Financial Statements of all public companies – as defined in Section 1 of the Companies Act of 2008 – which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors.<br>Auditors are encouraged to disclose audit tenure even if they do not meet the above criteria. |
| 1.13 | Does audit tenure apply to AGSA audits? | No.<br>As per the Companies Act 2008, public company means a profit company that is not a state-owned company, a private company or a personal liability company.<br>State-owned companies do not meet the definition of public companies in the Companies Act.<br>The Rule applies to audit reports issued on the Annual Financial Statements of all public companies – as defined in Section 1 of the Companies Act of 2008 – which also meet the definition of a public interest entity as per paragraphs 290.25 and 290.26 of the IRBA Code of Professional Conduct for Registered Auditors. |
| **2.** | **Questions Regarding Counting the Years of the Tenure Period** | |
| 2.1 | How would a change in the activities the audit client engages in affect the counting of the years relating to audit tenure? | The registered auditor should apply the application guidance provided in the IRBA communiqué issued on 4 December 2015 (attached for ease of reference), i.e. the longest length of tenure should be disclosed. The change of activities the audit client engages in will have no effect on the length of audit tenure |

| No. | Question | Suggested Answer |
|---|---|---|
| | | disclosed. |
| 2.2 | Would a change in the name of the entity have a bearing on the audit tenure? | No. The spirit of the guidance provided in the IRBA communiqué issued on 4 December 2015 should be considered, i.e. the longest length of tenure should be disclosed. |
| 2.3 | Would a change in the management of the audit client have a bearing on the audit tenure? | No. The spirit of the guidance provided in the IRBA communiqué issued on 4 December 2015 should be considered, i.e. the longest length of tenure should be disclosed. |
| 2.4 | How would a change in the format through which an entity trades affect the disclosure of the tenure? | According to the IRBA communiqué issued on 4 December 2015, the longest length of time of the tenure should be disclosed.<br><br>For example, the fact that the Co A was only incorporated 20 years ago but traded as a partnership previously does not mean that Audit Firm X was auditor firm for those 20 years, if it was also the auditors of the partnership.<br><br>The audit tenure counting will go back to when Audit Firm X was appointed to be the auditors. |
| 2.5 | It is listed under "Additional guidance" in the communication that "in the case of audit firm mergers/de-mergers or change in name, the longest length of tenure should be disclosed." How is the longest length determined?<br><br>The question can be illustrated by the following example: Client X has been audited by the audit firm for 20 years. However, the audit firm used to be firm ABC but merged five years ago with firm DEF and signs the audit report as DEF. So, does this imply that the disclosed longest tenure in the audit report should read that "DEF has been the auditor of client X for 20 years" or should it read that "ABC has been the auditor of client X for 15 years and DEF has been the auditor of client X for five years"? | According to the IRBA communiqué issued on 4 December 2015, the longest length of time of the tenure should be disclosed. Thus 20 years should be disclosed. It would not be permissible to disclose the year in which the audit firm was appointed, without also disclosing the number of years which the firm had been the auditor (audit tenure). |

| No. | Question | Suggested Answer |
|---|---|---|
| 2.6 | Can the registered auditor offer an explanation on the length of tenure in the audit report? | The registered auditor should disclose audit tenure in accordance with the wording in the IRBA communiqué issued on 4 December 2015 and in compliance with the rule.<br><br>Auditors should not dilute the impact of the disclosure by offering additional information that could confuse the reader. Therefore, auditors should not include details of the firm's partner rotation policy and current engagement partner's tenure on the engagement, as this will defeat the objective the rule is intended to achieve.<br><br>The objective of the Rule is to raise transparency regarding the firm's tenure and not that of the individual auditor. |
| 2.7 | What should an audit firm do if there is a difficulty in obtaining evidence of the accuracy of audit tenure? | The registered auditor will have to be diligent and use his/her professional judgment. Information on the appointment and changes in auditors can be obtained from the Companies and Intellectual Property Commission (CIPC) or company secretarial records.<br><br>It is not acceptable for "no disclosure" to be made. |
| 2.8 | How do short breaks of service (<1 year) affect the disclosure of audit tenure? | This will depend on the circumstances. According to the IRBA Communiqué issued on 4 December 2016, the audit tenure should reflect the number of years the audit firm/sole practitioner continuously served as the auditor.<br><br>However, if there were changes in statutory appointments of auditors during a period but the firm continued to sign off on the financial statements for consecutive years, then any break in service should be ignored, otherwise it would be misleading to the reader. |
| **3.** | **Questions on which Reports a Registered Auditor is Required to Disclose Audit Tenure** | |
| 3.1 | Can voluntary disclosure be made? | Yes. The registered auditor is encouraged to consider voluntary disclosure of audit tenure. |
| 3.2 | Is the disclosure of audit tenure required for ISA 800/805/810/ISRE 2410 (interim), provisional, preliminary/ proforma/abridged reports? | No. According to the IRBA communiqué issued on 4 December 2015, the rule applies to audit reports issued on the annual financial statements. |
| 3.3 | Is disclosure required in an integrated report <IR>, where the <IR> does not contain the statutory financial statements? | No. According to the IRBA communiqué issued on 4 December 2015, the rule applies to audit reports issued on the annual financial statements. |

| No. | Question | Suggested Answer |
|---|---|---|
| **4.** | **Monitoring of Compliance with the IRBA Rule** | |
| 4.1 | How will the IRBA be monitoring the disclosure of audit tenure? | The IRBA will monitor compliance with the disclosure of audit tenure rule in the same manner it monitors compliance to standards, the IRBA Code of Professional Conduct for Registered Auditors and compliance with Section 90(2) of the Companies Act.<br><br>It will also be alert to complaints received by its Investigations Department. |

INSTITUT DER WIRTSCHAFTSPRÜFER

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15 August 2016

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
USA

submitted via email to comments@pcaobus.org

**PCAOB Release No. 2016-003, PCAOB Rulemaking Docket Matter No. 034 Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements when the Auditor expresses an Unqualified Opinion and Related Amendments to PCAOB Standards**

Dear Sirs,

The IDW appreciates the opportunity to comment on the above mentioned Release, hereinafter referred to as "the Release".

The IDW also commented on the related Concept Release issued in 2011 and the draft standard proposed in 2013. We continue to support this initiative and refer to our two previous letters in this regard.

In this letter we include comments of a general nature before addressing specific issues or specific aspects of the proposals. We have not responded specifically to the 44 questions posed throughout the Release. However, certain of our comments may be directly relevant to one or more of these questions.

## General matters

### *Support for maximum alignment with the international standards*

As the Board will be aware, new audit policy legislation came into force throughout the European Union in June 2016. Amongst other things, this legislation will require enhanced auditor reporting for entities defined as Public Interest Entities (PIEs). The IAASB finalized the revision of its auditor reporting standards in January 2015, with the revised standards effective for audits of

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financial statements for periods ending on or after December 15, 2016. On the global stage, the PCAOB's proposal thus represents a third major initiative in this area.

The IDW is currently in the process of revising the equivalent IDW Auditing Standards so as to transpose the revised auditor reporting ISAs for application within the German legal environment. The first "new style" auditor's report has recently been issued in Germany on the basis of ISA 701.

In previous letters to the PCAOB, the IDW has consistently urged the Board to align its auditing standards to those issued by the IAASB to the maximum extent possible. Consequently, we are pleased to note the Board's acknowledgement that several commenters have urged the Board to work together with other regulators and standard setters to improve the auditor's report. As discussed below, we note significant improvement in this regard, and continue to believe that maximum possible global consistency in auditor reporting is highly desirable.

The IDW appreciates the current proposed standard is a significant improvement in comparison to the 2013 proposal. In particular, the Board has achieved far closer alignment of critical audit matters (CAM) with the IAASB's concept of key audit matters (KAM) than was previously the case. However, elsewhere in this letter, we express our concerns as to an apparent lack of conviction by the Board as to the importance of ensuring that auditor reporting, and reporting of CAM/KAM in particular, will be comparable internationally.

We trust that the Board will give careful consideration to our comments concerning the need for international comparability, and that in pursuing its stated intention to continue monitoring developments of expanded auditor reporting in other jurisdictions throughout the rulemaking process (page 11 of the Release) will seek to achieve maximum comparability going forward.

***Implied potential for differences in the matters reported***

Enhancing the "pass/fail" auditor reporting model by having auditors report on certain matters arising from an individual audit is the most significant change in auditor reporting in decades. The auditor's report is the main output of an audit that is available to external stakeholders, including investors. In the global environment of today it is increasingly in the interests of both the investor community and the audit profession for there to be as few differences as possible between the content of auditor's reports when different auditing standards are applicable. Consequently, in order to achieve maximum

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comparability standard setters need to consciously limit differences in auditor reporting requirements to those differences that result from jurisdictional particulars. In our view, this is especially important in respect of this "new" area.

The IDW's main concern relates to the PCAOB's implied stance in regard to the potential for there to be differences in the matters reported as CAM and KAM, respectively. Firstly, the paper "A Comparison between the ISAs and the US PCAOB Reproposal" prepared by the IAASB's Auditor Reporting Implementation Working Group points out many similarities, but also refers to the PCAOB's view that the processes for identifying these matters *would* vary across jurisdictions, and further that the commonalities in the underlying criteria *could* result in the communication of many of the same matters (see pages 10 and 11 of the Release). We believe it extremely unfortunate that this statement equally implies that the Board accepts that its proposals may result in the communication of different matters than would be reported under the ISAs. Secondly, as we discuss below in this letter, in ISA 701.15, the IAASB has determined specific matters that by nature would be KAM, but shall be reported upon differently from other KAMs, whereas the PCAOB proposes a different treatment in terms of their classification and placement of reporting.

We appreciate the Board's recognition of the potential for differences between the regulatory environment in the United States and other jurisdictions (page 8 of the Release). However, we have not identified discussions within the Release to justify any difference in regard to the nature or number of matters to be reported under CAM and KAM respectively.

In our view, the desire for comparability in terms of matters to be reported is a serious issue that deserves further consideration by all concerned.

### *Support for not reproposing a standard on "other information"*

The IDW agrees with the Board's decision not to repropose a standard on "other information" at this point in time.

We refer to the response to question 6 in the appendix to the IDW's letter dated December 11, 2013 in this regard, which detailed certain concerns, including the following:

"However, we believe that actually expanding the responsibility of the auditor to additional procedures or other form of evaluation is not just an auditor reporting matter and therefore requires deliberation in a project that is entirely separate from a project on auditor reporting." and "Furthermore, we believe that this is a matter that needs

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consideration at statutory (i.e., Congressional) level, if not at least at SEC level that should not be dealt with by auditing standards setting alone."

We appreciate that these concerns remain to be addressed in a future PCAOB project.

**Specific issues**

***Scope of matters that may be reported by the auditor (Question 7)***

We agree that the definition of CAM as well as the detail to be reported concerning CAM should not extend beyond matters in the financial statements. Any reference by the auditor to relevant disclosures outside the financial statements is likely to cause confusion, outweighing any potential benefit. Readers of the auditor's report would likely assume that a disclosure mentioned by the auditor had also been subject to audit procedures when, in fact, it may not have been subject to audit.

***Ability to communicate no critical audit matters (Question 8)***

We agree that, whilst probably rare, auditors may encounter audit circumstances in which they determine that no matters meet the definition of critical audit matter.

We also agree that in such cases it is appropriate for the auditor to report this fact.

***Clarification of auditor independence (Question 13)***

We agree with the proposals relating to the proposed title of the auditor's report as well as the proposed auditor's statement on auditor independence.

In our opinion the proposed statement is sufficiently succinct as to clarify to readers of the auditor's report which independence requirements were applicable to the audit.

***Basic elements of the auditor's report (Question 20)***

We note the discussions on page 53 of the Release concerning whether the disclosure of materiality and its application in the audit should be included in the auditor's report.

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As the following excerpt illustrates, the IDW expressed strong disagreement in its letter to the IAASB (November 29, 2013) when this issue was discussed during that Board's auditor reporting project:

"We ... strongly disagree with the inclusion of the example in paragraph A8 referring to "the application of materiality in the context of the audit". This would encourage auditors to consider the inclusion of a treatment of materiality in the auditor's report, and may in fact encourage the disclosure of quantitative materiality levels. Although we are aware that one jurisdiction has required this, we believe this to be ill-conceived because it ignores the qualitative aspects of materiality – both in terms of ISA 320 and especially in relation to ISA 450 – which cannot be described in any meaningful way in a short-form audit report."

We continue not to support this inclusion, for the reasons explained above.

### *Other amendments to PCAOB standards (Question 26)*

The PCAOB proposals differ from those of the IAASB in one further key respect.

In ISA 701.15, the IAASB determined that 1) a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern or 2) a matter giving rise to a qualified opinion or 3) an adverse opinion, would by their nature constitute key audit matters. However, ISA 701.15 also prescribes that these matters shall not be reported as KAM. The section on KAM shall instead include a reference to the appropriate section in the auditor's report that deals with the matter (i.e., sections entitled, or "Material uncertainty related to going concern", "Basis for qualified opinion" or "Basis for adverse opinion").

In contrast, when the auditor expresses a qualified opinion proposed AS 3105.02, would require the same communication of CAM as would be required in an unqualified auditor's report under AS 3101. The note following AS 3105.04 directs the auditor to refer to AS 3101 to determine if the matter for which the auditor qualified his or her opinion is also a critical audit matter. These requirements are in addition to the requirement for the auditor to disclose the substantive reasons for the qualified opinion.

In respect of adverse opinions, the PCAOB proposals stipulate that the requirements as to CAM do not apply (see Note following AS 3105.40). Thus there is no equivalent to the reference within the KAM section of the auditor's report as required under ISAs.

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We are concerned that these differences in placement of information and potential differences in classification impact comparability of auditor's reports, and may be particularly confusing for those readers who will read auditor's reports prepared under the ISAs and the PCAOB standards, especially where statistics e.g., on number of (CAM/ KAM) matters reported are collated.

If you have any questions relating to our comments in this letter, we should be pleased to discuss matters further with you.

Yours truly,

Klaus-Peter Feld
Executive Director

Gillian Waldbauer
Head of International Affairs

The Association of Accountants and Financial Professionals in Business

July18, 2016

Office of the Secretary
PCAOB
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Re: PCAOB Rulemaking Docket Matter No. 34

Dear Board Members:

This letter reflects the comments of the Financial Reporting Committee (FRC) of the Institute of Management Accountants (IMA) on the May 11, 2016 Proposed Auditing Standard (Exposure Draft or ED), *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. We previously commented on the August 13, 2013 ED (FRC letter dated November 12, 2013) and the earlier Concepts Release (FRC letter dated September 22, 2011) on the same subject. We continue to appreciate the Board's objective of seeking "to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users." We are pleased that the Board has made a number of changes to its 2013 proposal to address matters raised by us and many others. However, we are concerned that the most significant aspects of the new proposal will not meet the aforementioned objectives but will cause operational and other issues for companies and their auditors.

The IMA is a global association representing over 80,000 accountants and finance team professionals. Our members work inside organizations of various sizes, industries and types, including manufacturing and services, public and private enterprises, not-for-profit organizations, academic institutions, government entities and multinational corporations. The FRC is the financial reporting technical committee of the IMA. The committee includes preparers of financial statements for some of the largest companies in the world, representatives from the world's largest accounting firms, valuation experts, accounting consultants, academics and analysts. The FRC reviews and responds to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. Additional information on the FRC can be found at www.imanet.org (About IMA, Advocacy Activity, Areas of Advocacy, Financial Reporting Committee).

**Summary**

Our November 2013 letter principally took issue with the proposals to (1) include Critical Audit Matters (CAM) in the auditor's report, (2) extend the auditor's report to cover "other information" outside of the financial statements, and (3) require disclosure in the report of the auditor's tenure. We are pleased that the Board has deferred consideration of the reporting on other information and has removed that topic from the new ED. The Board has also made a number of changes in what would be classified as CAMs and how they would be reported. However, we remain unconvinced that inclusion of CAMs in auditor's reports will add value relevant information for readers of those reports while such inclusion will almost certainly add cost to the audit, create operational issues, and cause problems in the management/auditor relationship.

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The Board has suggested an alternative location (Form AP) as a possibility for auditor tenure information. We continue to believe this is a corporate governance matter that should be dealt with by the SEC. But including the information in Form AP would certainly be better than in the auditor's report.

In short, as spelled out in our following comments, we believe the principal components of the new ED – Critical Audit Matters and auditor tenure – would provide mainly irrelevant information to users, add unnecessary cost to the audit process, create operational issues, and create unnecessary tension in the preparation of the financial statements between management and auditors. We strongly recommend that the PCAOB convene a public roundtable with auditors, preparers and users before finalizing any auditing standard. This would provide an opportunity for a face-to-face discussion of exactly how CAMs might be used by investors as well as the identification of at least some of what we believe are apt to be numerous operational issues in application.

The remainder of this letter provides our reasoning for these positions.

**Critical Audit Matters**

As originally stated in our September 2011 letter responding to the Concepts Release on this subject, and as repeated in our November 2013 letter, we believe that the overall framework for the auditor reporting model should be consistent with the following principles (wording slightly revised from the original for clarity).

1. The objective of an audit should remain as we know it today. It should provide an opinion on the financial statements, not management's discussion and analysis (MD&A) or other areas of financial reporting
2. Auditors should not disclose information for which they are the original source. Rather they should opine on information provided by management.
3. The auditor's report should provide transparency for investors as to what the audit provides in terms of assurance (what it is) as well as what it does not address (what it is not).
4. Auditor involvement and attestation should be limited to areas for which they have the appropriate expertise.

The existing "pass/fail" model, carried forward in the new ED, is consistent with this framework and we continue to strongly support it. One aspect of the ED that we particularly support is the proposal to move the opinion paragraph to the beginning of the report. We believe that most readers of auditor's reports are mainly interested in whether a company has received an unqualified opinion from its auditor and putting that right up front makes sense to us.

Further, the decision to remove reporting on other information from this project, at least for now, is consistent with the first item in our suggested framework and removes concerns about some issues that would arise under the last item. And we appreciate that changes have been made that greatly reduce the incidence of disclosing information for which auditors are not the original source. However, the ED would still require the auditor to make such disclosure when necessary to describe a CAM or how it was addressed and that would violate our framework.

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Notwithstanding that the ED is somewhat more consistent with our suggested framework than the approach in the 2013 proposal, it is clear to us, through the discussions in the ED and otherwise that a compelling case for the inclusion of CAMs in auditor's reports has not been made. The PCAOB argues that certain users have requested this information and certain other audit regulators have required its presentation in other jurisdictions. However, the ED simply does not provide a convincing case that investors and other users would gain valuable information about company financial reporting as a result of including CAMs in auditor's reports.

CAMs will not help in the analysis of financial statements

We noted on page 2 of the ED, "… additional reporting by the auditor could[1] facilitate analysis of the financial statements..." This theme seems to be fundamental to the Board's support for the presentation of CAMs as indicated on page 64 under Economic Considerations, "The Board believes that the communication of critical audit matters should help focus investors' and other financial statement users' attention on these matters by making them more prominent, which could facilitate their analysis of the financial statements and other relevant disclosures (emphasis added)." Further, although the ED cites user interest in CAMs (e.g., footnote 119), nowhere in the document does the Board describe how CAMs would actually be used to help "analyze financial statements."

Our 2013 letter expressed support for the Board's encouragement for companies and auditors to field test how the CAM provision would be applied in practice. Based on our reading of the new ED, the only such test was the limited implementation trial performed under the auspices of the Center for Audit Quality (see footnote 36). We commend the CAQ field test as it led to changes in the approach to CAMs, particularly limiting them to those matters reported to audit committees and including a materiality consideration. However, it appears that no other field testing was performed by the Board itself. And, most importantly, the CAQ field test apparently did not include any discussions with investors as to how they might make use of the reported CAMs.

We note that in his statement at the meeting when the 2013 ED was approved by the PCAOB, Board member Hanson stated, "I would like to encourage a dialog among audit firms, management, audit committees and investors to discuss our proposals and to foster better understanding among everyone about potential benefits and costs (emphasis added)." And in encouraging auditors to work with companies to develop example CAMs based on the then proposal he added, "Perhaps even share them with investors to obtain their views on the usefulness of the information." That critical component of field testing was absent from the CAQ study and we are not aware of any other work the Board has done to determine what investors and other users of auditor's reports would actually do with reported CAMs. We note that the FASB has worked closely with users in recent years to test how new proposals would enable more decision useful information. Without some specific evidence of how CAMs could possibly be used to help analyze financial statements, similar to an FASB field test, we believe this proposal is problematic.

[1] While we did not count, we note that the ED is replete with the use of such conditional words as “could,” “might,” and “may.” This choice of words indicates a lack of solid evidence to support the usefulness of CAMs to investors and other readers of auditor’s reports.

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Based on statements made at the meeting approving the ED and otherwise, at least some Board members are anxious to complete the auditor's report project as soon as possible – perhaps as early as year-end 2016. We recognize that a great deal of research and public consideration has already gone into this project. But we believe that public roundtables at which auditors, preparers, and users (investors and analysts) would discuss exactly how CAMs would be developed and used in practice are necessary.

The Economic Considerations section of the ED does not, in our view, provide a true economic analysis of the pros and cons of mandating presentation of CAMs in auditor's reports. Rather, it consists largely of references to academic studies on the purported benefits of such presentation. And the most important point is captured well on page 74 in the following words, "Overall the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors <u>are limited</u>. <u>Collectively, the results are ambiguous</u> as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements (emphasis added)."

The two illustrative examples of communication of critical audit matters included on pages 32-35 of the ED demonstrate the lack of value relevant information that would be provided. These examples do include references to important accounting policies and/or estimates, which matters presumably have been thoroughly reported in the financial statements, footnotes, or MD&A. Those references may indeed "… help focus investors' and other financial statement users' attention on these matters by making them more prominent..." But the company already will have highlighted most, if not all, of these same matters by including them in the critical accounting policies and estimates section of MD&A. It is not clear to us that an additional notification in the auditor's report will cause investors to pay more attention to these matters.

More importantly, based on both the proposed auditing standard and the illustrative examples, we believe the remaining content of CAMs is likely to give only very generalized descriptions of auditing procedures. No information that would actually allow investors to analyze financial statements will be included. Further, we expect that the information would become boilerplate as it is overseen and managed by the accounting firms' national offices based on the respective risk areas – income taxes, fair value estimates, various accruals, etc.

For example, the following are some of the descriptions of audit procedures from the two illustrations included in the ED.

- "We tested the accuracy and evaluated the relevance of the historical loss data as an input to the new model.
- … we evaluated the incorporation of the applicable assumptions into the model and tested the model's computational accuracy.
- ...we assessed whether … the significant assumptions, including discount rates, estimated useful lives, revenue growth rates, projected profit margins, and the expected rate of return, used in valuing these intangibles were reasonable.
- … we assessed the terms of the arrangements and the conditions that must be met for the arrangements to become payable."

Those descriptions might lead a reader to conclude that the auditor has found the related accounting matter to be "fairly stated," although the Board warns against such piecemeal conclusions by way of the required introductory paragraph to the presentation of CAMs in the auditor's report. Beyond that, we cannot find anything in those and the other descriptions from the illustrative examples that could possibly help readers analyze financial statements.

In speeches and at open meetings, PCAOB representatives have cited some of the auditor's reports under relatively recent UK regulations as examples of how investors would be more informed with the inclusion of CAMs. In particular, the auditor's report for Rolls-Royce Holdings plc has been mentioned as an excellent example[2]. The 2015 report on Rolls-Royce by KPMG includes the following subjective assessments.

- We found the degree of caution/optimism adopted in estimates (re: revenue and profit guidance) to be slightly less cautious than in the previous year, but balanced overall.
- Overall the findings from across the whole audit are that the financial statements have been prepared on the basis of appropriate accounting policies, reflect balanced estimates compared to the mildly cautious estimates made last year resulting in slightly favourable current year profit recognition, and provide appropriate disclosure.

These assessments, which of course go well beyond what is called for in the ED, could conceivably help investors and other users analyze financial statements. But we understand that it is relatively rare for U.K. auditors to make these kinds of judgments. More importantly, in the heavily regulated and litigious environment in which the U.S. auditing profession operates, we expect that no firm would want to expose itself to challenges when such assessments are inevitably second guessed. In other words, what might seem like a good idea in other parts of the world is not operational in our culture and legal environment.

Rather than continuing to call for presentation of lengthy CAMs in auditor's report that have no demonstrated analytic value to investors or other users of the financial statements, the Board should take one of two steps. Our preference would be for this proposal to be eliminated from any final standard. An alternative would be to recognize one meritorious aspect of the CAMs proposal – to draw greater attention to the company's critical accounting policies and estimates. The proposed report now calls for a statement that the audit included evaluation of accounting policies and significant estimates. A single sentence could be added to state that such significant accounting policies and estimates are presented by the company on page so and so of the document in which the auditor's report is included.

We also note that investors in the larger U.S. public companies receive the benefit of an auditor’s report on internal control over financial reporting. This secondary reporting provides further comfort to investors about the quality of the application of the company’s accounting policies and estimates. As you know, this is not presently a common practice in many other parts of the world.

[2] In his remarks at a financial reporting conference sponsored by the University of Southern California on June 9, 2016, Board member Hanson stated something to the effect that the auditor's report for Rolls-Royce Holdings was the "Rolls-Royce" of auditor's reports, implying it was the best quality report he had seen.

Further, we question whether the PCAOB's concern for providing analytic information to investors exceeds the jurisdiction of the Board. We believe the PCAOB's role should be limited to oversight of auditors and should not directly involve the provision of company information or the analysis thereof to investors.

Auditor's reports should not be the original source for company information

As noted in the second point of our framework, auditors should not disclose information for which they are the original source. Rather they should opine on information provided by management. The Board has addressed this concern raised by us and others with respect to the earlier ED by proposing Note 2 to paragraph .14: "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit."

We are concerned, however, that the "unless such information" exception may lead to many cases of company information being initially reported by the auditor or at least disagreements between companies and auditors about how certain matters should be described in auditor's reports. For example, it is quite possible to read the two illustrative examples provided in the ED and conclude that much of the information about the accounting matters in question was initiated by the auditor and would not have been required to be disclosed except for the Note 2 exception mentioned above[3]. We, of course, do not have complete context for these illustrations but they do raise concerns among our preparer members about which party has the principal responsibility for financial reporting including disclosures.

As we have considered this issue we have concluded that the "unless such information" exception is not necessary and should be eliminated if CAMs are included in a final standard. In any situation where an auditor has major reservations about a company's disclosures for a critical accounting policy or estimate, the auditor can always threaten a qualified opinion if the company does not improve the disclosures. In the experience of our members as both auditors and preparers, such situations are fairly rare and are always resolved relatively amicably. Thus, we urge deletion of the exception language in that Note 2 to paragraph .14 if CAMs are included in a final audit standard.

Determining which items qualify as CAMs is likely to present many operational problems

As noted earlier, we applaud the Board for making a number of changes to the earlier proposal to address comments concerning the definition and application of CAMs. In particular, limiting such matters to those reported to the audit committee and introducing a materiality consideration should help limit the number of items potentially reported and provide reasonable guidelines for includable items. However, while we have only had preliminary discussions about how the ED would be applied in practice, we are already aware of certain issues. Consider the following example.

---

[3] A final auditing standard could address this concern by eliminating much of introductory language in the two examples and reducing it to a short reference to the company's financial statements where the matter is discussed. Or, if the PCAOB retains the Note 2 exception and wishes to include an example, it should explicitly describe such illustration as providing the information pursuant to the Note 2 exception.

> The auditor for Company A has reported a significant deficiency in internal control over inventory to the audit committee. However, a compensating control exists and there is no material weakness. Inventory is material to the company. Is this item required to be reported as a CAM? The PCAOB might clarify that a significant deficiency in and of itself should not result in a CAM.

A public roundtable as suggested earlier in this letter would be a good opportunity to surface these kinds of operational issues with the ED and determine whether the proposal can be applied effectively in practice.

<u>Requiring CAMs will distract attention of both the auditor and company during the important closing process</u>

We repeat the following paragraph that we believe is still relevant from our 2013 letter.

"We also are concerned that the time and effort devoted to fulfilling these particular requirements could distract attention from what we consider the core deliverables of the audit and divert valuable resources of audit firms, management, and audit committees. At present, companies present their financial statements and other information for final review and signoff by the audit engagement partner, concurring partner, and often, national office SEC reviewing partner – all of this under very tight SEC filing deadlines. With a CAM requirement, the process would become more like a "simultaneous equation" as the company would have its information and the auditors would have their own version and each party would then have to enter into negotiations on which version of the description of certain significant estimates, etc. is in the CAM vs. the MD&A, footnotes, etc. This would require discussions among financial management, audit committees, internal and external legal advisors, local and possibly regional and national office audit personnel, and so on. It's hard to understand how this can possibly be a productive use of senior audit executive time at the critical audit closing juncture."

This concern was proven to be valid during the CAQ field test. Included in the report on that work are the following statements.

> "Two additional observations related to the additional time and effort considerations are as follows:
>
> - A majority of the additional time is likely to be incurred during the wrap-up phase of the audit, (i.e., once most of the audit work has been finalized, so that the auditor can determine what the actual CAMs are), despite efforts to start the process earlier in the audit. This could occur at a time when auditors, management and audit committees are focused on a number of other issues in connection with a particular filing, and the finalization of CAM communications may delay, or cause distractions in, the resolution of these issues.
>
> - CAM related discussions with management and the audit committee are likely to involve senior members of the audit engagement team and may require national office consultations, thus requiring additional effort by key audit resources at the end of the audit.

> Finally, many of the accounting firms expressed the view that the incremental time required may not decrease significantly in future years, given (1) that one of the stated objectives of the proposed auditor reporting standard is to avoid boilerplate descriptions and (2) the need to address new potential CAMs each year as a result of transactions or other changing business or financial reporting dynamics."

We recognize that the CAQ study was based on the definition of a CAM and other CAM related guidance from the earlier ED. Nevertheless, we believe that the findings from the CAQ study reinforce our belief that CAM related discussions are likely to result in inefficiencies in both company and auditor time during the final stages of year end reporting. Requiring auditors and companies to report on the same items albeit in a different manner inevitably will lead to greater tension between the parties.

In summary, we do not believe that CAMs would provide value relevant information for investors and other readers of auditor's reports. We are concerned that requiring CAMs to be included in such reports would increase audit costs and create operational issues and unnecessary auditor/company conflict in many cases at a crucial time of the audit. Finally, we simply do not see any support in the ED for the statement on page 3 that the identification and communications of CAMs "… may also lead to an incremental increase in audit quality…" The mission of the PCAOB is to maintain and improve audit quality but simply asserting that something could occur is inappropriate without supporting evidence or rationale.

**Auditor Tenure**

Our 2013 letter did not support inclusion of tenure information in the auditor's report. We briefly noted at that time the lack of association of auditor tenure with audit quality. The new ED brings forward this proposal but with little evidence to support that it would provide valuable information to investors or somehow improve audit quality. Perhaps the most telling comments in the ED are the sentences on page 91, "Academic research on the relationship of audit tenure to audit quality has varied conclusions. Some academic research concludes that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry. Other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality."

We also note and concur with concerns expressed in another sentence on page 91, "… it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital and could also result in conversation that are an inefficient use of management and audit committee time."

FRC members' experience as preparers for or auditors of large, complex companies for the most part, leads us to believe that there is a significant learning process involved for those assigned as key audit personnel. So a reasonable amount of continuity is important for an audit firm to perform an effective audit. However, the mandatory partner rotation rules mean that not just one but several partners are bringing fresh looks to a major company's audit frequently. Even for the smallest public company, there

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is required rotation of both the engagement partner and concurring review partner. We think this provides an appropriate balance between continuity of audit firm understanding of company operations, etc. and independence of thought from new personnel.

Given the above, we continue to believe that auditor tenure information does not give investors any real insights about auditor quality. We do note from the ED the increased voluntary disclosure of this information in proxy statements and we expect this will continue as such disclosure becomes best practice. At some point the SEC may feel it is a matter that should be reviewed as a possible requirement for proxy statement disclosures.

In the meantime, the PCAOB should drop this part of its proposal. The suggested alternative of including the information in Form AP is certainly less objectionable than including it in the auditor's report. But even that alternative should not be adopted unless the Board can demonstrate that tenure has some audit-related value rather than being connected only to the governance/auditor ratification proxy process.

**In Conclusion**

We support the other wording changes to the auditor's report. However, we continue to believe that a case has not been made to require inclusion of CAMs or tenure information in the auditor's report and we do not support those matters. We appreciate the opportunity to express our views on the exposure draft. Please let me know if you would like us to further explain these views or provide added information.

Sincerely,

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ICGN
International Corporate Governance Network

12 August 2016

To: **Public Accounting Oversight Board**

Re: **Comment letter on PCAOB's The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion proposal**

Via email: comments@pcaobus.org

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on the PCAOB's The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion proposal.

ICGN was founded 20 years ago and is an investor-led membership organisation of more than 650 individuals based in 46 countries from around the world. Our mission is to inspire and promote effective standards of corporate governance and investor stewardship to support the sustainable value creation of companies and to advance efficient markets and economies world-wide. Our members represent institutional investors with global assets under management in excess of US$26 trillion. Accordingly, ICGN's members offer a source of practical knowledge and experience with regard to governance and investment issues. ICGN's Accounting and Auditing Practices Committee supports ICGN's policy positioning in matters relating to financial reporting, accounting matters and audit quality. For more information on the ICGN, please visit www.icgn.org.

ICGN fully supports the PCAOB's efforts to enhance the relevance and value of the audit for users and the public by stimulating greater transparency about the work carried out by auditors in the course of auditing financial statements. We believe extending auditor reporting is a key objective that will further strengthen investor protection when using financial statements in making informed investment decisions.

ICGN supports the retention of the current "pass/fail" model which provides investors valuable insight into the small percentage of companies with a qualified opinion. However, ICGN believes the current model can be improved upon for the vast majority of companies with an unqualified opinion by extending the auditor's report to include more audit-specific information for investors. The ICGN believes the new critical audit matters format will provide investors with relevant information related to the independent audit of a company's financial statements.

ICGN is encouraged by enhancements to the auditor's report globally. We would highlight in particular as a positive example the UK's independent auditor's report that requires auditors to provide an overview of "those risks of material misstatement that were identified by the auditor, and which had the greatest impact on the audit strategy, resources required and the work of the engagement team; the application of materiality; and the scope of the audit, including how it responded to the risks of material misstatement and the application of materiality". We believe this report has led to meaningful information disclosure, and has relevance to companies globally.

ICGN is supportive of the enhanced audit report, complemented by enhanced reporting by the audit committee - which is required to report on "the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed." Auditors are required to report by exception if the section in the annual report describing the work of the audit committee "does not appropriately address matters communicated by the

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auditor to the audit committee." We believe this mitigates the duplicate or dueling information that might arise in disclosures by the audit committee and the auditor's report and maintains important distinctions between their respective roles and responsibilities. In addition, we anticipate the IAASB's new requirement for the auditor to discuss Key Audit Matters will be a positive for investors and look forward to seeing how the new requirements are received in the marketplace.

**Critical Audit Matters**

ICGN supports the rationale for determining and communicating critical audit matters (CAMs).

The key to determining the right number of CAMs is the balance between too little and too much information. ICGN believes the definition of a CAM as a matter communicated or required to be communicated to the audit committee that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment is appropriate and aligns the scope and definition with the Key Audit Matters under the UK and IAASB models.

From ICGN's perspective the expanded UK auditor's report has found the right balance in the amount of information that the auditor provides. According to the PCAOB staff study cited in the PCAOB Proposal, "on average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight." In many UK auditors' reports, the new requirements generally have resulted in meaningful and targeted information for investors while avoiding information overload.

Given that the determination of the CAMs is based on a principles-based framework, we believe the "accounts or disclosures that are material to the financial statements" hurdle is appropriate. Given the US legal system, if the hurdle to determine what CAMs are communicated is too low, for example to include immaterial matters, then there is a high probability the auditor's report could result in too many topics communicated as non-critical audit matters. If that were to occur, the CAMs disclosed in the auditor's report could become a repeat of the excessive boilerplate risk factor disclosures that are included in some US company annual reports. Maintaining a principles-based framework that allows for auditor judgment for reporting CAMs also is important to avoid descriptions of CAMs from becoming boilerplate over time and avoids impeding innovative improvements in auditor reporting.

**Auditor Tenure**

The ICGN believes the reporting of auditor tenure could be beneficial for investors. Although the proposal notes some observers contend the information may lead to inaccurate assumptions that tenure is related to audit quality, we do not share that opinion. Consistently disclosed information on auditor tenure may be viewed as relevant by some investors in their analysis of a company.

The release also notes a growing trend towards voluntary disclosure of auditor tenure and cites a study by the Center for Audit Quality, together with Audit Analytics, that reviewed corporate proxies and which "identified that in 2015 and 2014 auditor tenure was disclosed in the annual proxy statements of 54% and 47% of the S&P 500 companies, respectively" (page 48-49). Moreover, the ICGN's Global Governance Principles (section 7.7) calls for companies to publish their policy on auditor rotation.

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**Auditor Independence**

ICGN questions whether the proposed statement on auditor independence will yield any incremental benefits or insight to investors. The proposal notes, "the proposed standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB."

As the proposal notes, the UK FRC "requires the auditor to state that the auditor is required to comply with the UK's ethical standards for auditors, which include requirements regarding auditor independence". An example of an independence statement from the auditor's report disclosed in Tesco's 2016 annual report is shown below:

*Independence. We are required to comply with the Financial Reporting Council's Ethical Standards for Auditors and we confirm that we are independent of the Group and we have fulfilled our other ethical responsibilities in accordance with those standards. We also confirm we have not provided any of the prohibited non-audit services referred to in those standards.*

In our opinion, there is little decision useful information in the Tesco independence attestation, though ICGN members see the benefits of the underlying process that supports this form of disclosure. We would recommend the PCAOB review UK company independence statements to determine how these statements may better include decision-useful information for investors. It is logical to assume that most if not all auditors will claim they abide by the FRC requirements; if that is the case then boilerplate disclosure of this nature may not be informative.

If the PCAOB decides to move forward with proposed changes to enhance the wording of the auditor's report in relation to independence, we encourage the PCAOB to consider aligning the required communication with IAASB standards. These would include expanded descriptions of the responsibilities of management and those charged with governance, as well as the auditor's responsibilities, in separate sections of the report. We believe these changes could enhance users' understanding of the auditor's role and responsibilities, the audit process, and the responsibilities of others in the financial reporting supply chain, and would promote consistency of auditor reporting globally.

We hope that these comments are useful in your deliberations and the ICGN Policy Director, George Dallas (george.dallas@icgn.org), would be happy to elaborate on any of the points raised in this letter. Thank you for your consideration.

Yours truly,

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# Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?

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# Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?

**Abstract**

This study examines the effect of investor sophistication on experienced audit committee (AC) members' propensity to ask challenging questions about management's significant accounting estimates. Findings indicate AC members are more challenging given a sophisticated vs. unsophisticated investor base. This difference, however, narrows in the presence of anticipated additional audit report disclosure regarding such estimates where AC members tend to *decrease* their overall questioning behavior. Further analysis indicates this pattern is driven by those who are designated financial experts and that the effects are likely below the level of AC members' conscious awareness. The finding that AC members ask fewer challenging questions given unsophisticated investors is potentially disconcerting given the SEC's traditional emphasis on protecting unsophisticated investors. Moreover, the finding that anticipation of mandated audit report disclosure decreases AC member's propensity to ask challenging questions has potential implications for both research and practice, especially given recent regulatory and standard-setting activities designed to increase audit report disclosure.

Keywords: Audit committee effectiveness, investor sophistication, mandatory audit report disclosure

## Introduction

As fiduciaries of shareholders, audit committee (AC) members form part of the "three-legged stool" who, along with management and auditors, are responsible for public company's financial reporting. AC members are charged with overseeing the external audit process (NYSE & NASD, 1999; AS 16). One of the most significant ways in which AC members can fulfill their duties and help protect shareholder interests is to ask challenging questions of the auditor or of management about significant accounting estimates (NACD, 2012; Beasley et al., 2009; Gendron & Bedard, 2006; Gendron et al., 2004). Prior research, however, provides little theory or empirical evidence on the factors that influence whether and the degree to which AC members actually ask such questions.[1] This study provides theory and empirical evidence of how two institutionally important factors jointly influence AC member's propensity to ask such questions. In particular, it examines the influence of *investor sophistication* (i.e., more versus less sophisticated investor base) and *anticipation of additional mandatory audit report disclosure* (i.e., presence versus absence of a new regulation requiring additional disclosure on management's significant accounting estimates in the audit report).

The protection of investors, especially those who are unsophisticated, has long been of interest to regulators and standard setters, as evident in various historic rules imposing fiduciary duties on accounting professionals and AC members to protect investors who are unable to sufficiently protect their own interests (e.g., SEC, 1969). Despite their fiduciary duty to protect shareholder interests, however, it is not clear whether and to what extent the characteristics of a firm's investor base affects AC members' oversight process. Melding institutional knowledge about the financial

[1] Some anecdotal evidence alleges that some AC members failed to ask challenging questions during the financial crisis and in the midst of corporate fraud (Deloitte, 2010; Ernst & Young, 2008). WorldCom board members, for example, were sanctioned up to 20% of their net worth for their passiveness in not asking critical questions, allowing for the fraud to sustain (Kaplan & Kiron, 2004).

reporting context with accountability theory from social psychology (Lerner & Tetlock, 1999), this study provides insight on this issue by examining how investor sophistication influences the extent to which AC members engage in questioning behavior.

Theory holds that individuals develop different social and cognitive strategies for coping with accountability to obtain acceptance from, or avoid conflict with, important interpersonal or institutional audiences (Tetlock, 1983; Tetlock et al., 1989). This implies that the extent to which differences in investor sophistication will influence AC members' questioning behaviors likely depends on whom AC members perceive greater accountability pressure from. Being fiduciaries, investor protection (especially of those that are more vulnerable and unsophisticated) may be the key motive underlying AC members' behavior, leading them to feel greater accountability pressure in the presence of unsophisticated investors. Simultaneously, however, AC members face significant reputational and liability risks. AC members are likely to be aware that sophisticated investors are more likely than unsophisticated investors to scrutinize discretionary accruals in financial statements (e.g., Balsam et al., 2002) and engage in aggressive actions such as shareholder activism if earnings disappoint (e.g., Ryan & Schneider, 2002). Hence, I expect AC members to perceive greater accountability pressure in the presence of sophisticated investors, leading their inclination towards pre-emptive criticism to be geared to protecting themselves from such negative consequences, instead of being geared to the fiduciary protection of unsophisticated investors. Therefore, I predict that AC members will be more questioning of significant accounting estimates in their oversight process given sophisticated as opposed to unsophisticated investors.

The study further investigates how and whether anticipation of additional mandatory audit report disclosure moderates the effect of investor sophistication on AC members' questioning behavior. Recently, regulators and standard setters have begun to contemplate requiring additional disclosure in the audit report as a way of providing more information to investors regarding the financial reporting and auditing process. Proponents of such change generally argue that greater disclosure will improve the frankness of communications among the AC, management, and auditors and thereby, help increase investor confidence (Ernst & Young, 2012; PCAOB, 2011, 2013; PwC, 2012).[2] These movements accentuate the importance of research questions related to whether and how additional mandatory audit report disclosure likely will affect AC members' oversight process.

Greater disclosure of significant accounting estimates in the audit report would subject these estimates to additional scrutiny by investors, especially those who are sophisticated. Proponents of increased audit report disclosure believe that greater disclosure requirements will make preparers (i.e., management) as well as overseers (auditors and ACs) of the financial statements exert greater effort (e.g., more questioning behavior from the AC) resulting in better financial reporting quality (Ernst & Young, 2012; PCAOB, 2013; PwC, 2012). However, the exposure to various reputational and litigation risks may cause AC members to choose a more defensive strategy when they anticipate greater disclosure in the audit report. One way AC members can reduce potential risk exposure is to strategically avoid asking challenging questions about the significant accounting estimate predicted to be disclosed in the forthcoming audit report. Such a tactic would enable AC members to create a portrayal that there was no reason for them to doubt the overall appropriateness of the estimate and hence, avoid being subject to additional scrutiny from sophisticated investors. Moreover, it may even cause the external auditors to believe less extensive disclosure about the estimate is necessary. Therefore, I predict AC members will

[2] Some of the changes that recently have been discussed by US standard setters and regulators, such as including more information about management's significant accounting estimates and communication of such matters to the AC, are already in new audit standards issued in some jurisdictions (e.g., ISA 700 in the UK and Ireland).

decrease their questioning behavior when they anticipate additional mandatory audit report disclosure. Further, given that sophisticated investors compared to unsophisticated investors are likely to be of greater concern, AC members' questioning behaviors will likely decrease more given sophisticated, as opposed to unsophisticated, investors in anticipation of additional mandatory audit report disclosure.

I test these predictions in an experiment using a 2 x 2 design, with investor sophistication and anticipation of additional mandatory audit report disclosure as between-subject factors. Participants are predominantly experienced AC members who first receive information about a significant accounting estimate related to potentially obsolete inventory that management has favorably revised late in the audit process. Participants who are in the anticipation of additional disclosure present conditions are then alerted of a new regulation that requires auditors to disclose additional information about significant accounting estimates in the audit report, while no such regulation is in the anticipation of additional disclosure absent conditions. The main task is to develop questions about the significant inventory obsolescence estimate after viewing the following: management's justifications for favorably revising it, the auditor's communication about the estimate to the AC, and a draft of the anticipated audit report under the regulatory regime where the requirement of additional audit report disclosure is either present (anticipation of additional disclosure present conditions) or absent (anticipation of additional disclosure absent conditions).

Overall, the findings support the hypothesized predictions. AC members ask a higher number of challenging questions given a sophisticated, as opposed to an unsophisticated, investor base. Moreover, AC members' questioning behavior drops to a significantly greater extent given sophisticated, as opposed to unsophisticated, investors when they anticipate additional mandatory audit report disclosure. Additional analysis shows that designated financial experts are more responsible than at-large AC members for driving this ordinal interaction pattern of findings. Because designated experts likely face greater accountability risk than those who are not so designated (Rupley et al., 2011; Vera-Munoz, 2005), the fact that they drive the results provides further support for the assumption that, on average, AC members are more concerned about avoiding potential scrutiny from sophisticated investors and protecting themselves than protecting the more vulnerable, unsophisticated investors.

Despite these main findings, analysis of post experimental questions shows that AC members believe that investor sophistication would *not* significantly affect their propensity to ask challenging questions and that they would ask *more* challenging questions when they anticipate additional mandatory audit report disclosure. Notably, neither belief is validated by actual AC questioning behaviors, and the latter belief runs exactly opposite to what actually occurs in my experiment. This indicates that the observed joint effects of investor sophistication and anticipation of additional mandatory audit report disclosure on AC members' questioning behavior likely is below the level of AC members' conscious awareness.

This study makes several contributions. One, it enhances our understanding of factors that influence AC members' questioning behaviors by identifying investor sophistication and anticipation of additional mandatory audit report disclosure as joint determinants of AC members' propensity to ask challenging questions. Two, the finding that AC members tend to ask significantly more probing questions given sophisticated as opposed to unsophisticated investors under the historic auditor's reporting model, is particularly interesting given the consistent historic and topical emphasis on investor protection by regulators and standard setters (SEC, 1969; PCAOB, 2012). Three, this study addresses the call for research on "unintended (behavioral) consequences" of attempts to regulate AC members (Turley & Zaman, 2004) by providing theory-consistent evidence on how mandating greater disclosure in the audit report can actually reduce AC members' oversight behavior. Four, this study suggests that AC members are unlikely aware of how investor sophistication and, especially, anticipated increase in mandatory audit report disclosure actually affect their propensity to ask challenging questions of management or auditors. Finally, the study adds to the expertise and corporate governance literatures by demonstrating that, despite having greater capacity to challenge management's estimates, designated financial experts do not act on this advantage when the investor base is predominantly unsophisticated, a potentially troubling outcome for these users' investment choices and for regulators and standard setters hoping to ensure adequate investor protection.

The remainder of this paper is organized as follows. Section II provides background and theoretical development. Section III outlines the experimental method and section IV provides the results. Section V presents supplemental analyses and section VI concludes.

## Background and Theoretical Development

### Background

The objective to protect investors is regaining attention from regulators and standard setters such as the PCAOB who recently announced investor protection as their new strategic mission (PCAOB, 2012). Given their fiduciary duty towards protecting investors, the AC members' role in the financial reporting process and the importance of enhancing their effectiveness are also being emphasized. The implementation of AS No. 16 *Communication with Audit Committees*, which encourages two-way communications between AC members and auditors, highlights the regulators' recognition of the vital role ACs play in ensuring the integrity of the financial reporting process.

Prior studies have examined AC effectiveness in terms of the extent to which AC members support auditors versus management given auditor-management disagreements (Knapp, 1987; DeZoort & Salterio, 2001; DeZoort et al., 2003a; DeZoort et al., 2003b; DeZoort et al., 2008). More recently, however, studies indicate ACs are rarely involved in resolving auditor-client negotiations (Gibbins et al., 2001; Cohen et al., 2002, 2010; Gibbins et al., 2007) and suggest measuring AC effectiveness in terms of the extent to which AC members ask probing questions related to negotiated accounting decisions (Kang et al., 2015; Pomeroy, 2010). This is consistent with the NACD's belief that "AC members should pay particular attention to the issues identified by management and … question assumptions that underlie critical accounting estimates" in fulfilling their oversight duty and protecting shareholder interests (NACD 2010, p. 8). However, little is known with respect to factors that actually influence AC's questioning behavior due to the paucity of empirical research in this area. This study sheds light on this important issue by melding institutional knowledge of the financial reporting and audit context with accountability theory from social psychology (Lerner & Tetlock, 1999) to predict and examine how two factors – investor sophistication and anticipation of additional mandatory audit report disclosure – jointly affect AC's propensity to challenge management's significant accounting estimates.

## Theoretical Development

### The Effect of Investor Sophistication

The social psychology theory of accountability concerns how individuals cope with different socio-economic pressures (Gibbins & Newton, 1994; Hoffman & Patton, 1997; Lerner & Tetlock, 1994, 1999; Peecher, 1996; Tetlock, 1983; Tetlock et al., 1989). Specifically, it predicts that individuals develop different social and cognitive strategies for coping with accountability to obtain acceptance from, or avoid conflict with, important interpersonal or institutional audiences.

This implies that AC members' questioning behavior in overseeing the financial reporting and audit process will be influenced by who they perceive greater accountability pressure from.

Within the financial reporting context, AC members are accountable for protecting shareholder interests and overseeing the external audit process (NYSE & NASD, 1999; AS 16). To the extent AC members take on this fiduciary duty, investor protection (especially those that are more vulnerable and unsophisticated) is likely to be a key motive underlying their behaviors. In addition, AC members arguably self-select into their fiduciary role because they desire to help protect others with integrity.

Along with their fiduciary duty to protect investors, however, AC members simultaneously face significant reputation and liability risks. These risks are more salient in contentious corporate governance environments, such as those subject to increased shareholder scrutiny and shareholder activism.[3] Relative to unsophisticated investors, sophisticated investors who hold greater analytical skills (Bartov et al., 2000; Walther, 1997) are more likely to question management's accounting (Balsam et al., 2002) as well as engage in shareholder activism, which often results in negative consequences such as a change in board composition (Carleton et al., 1998; Del Guercio & Hawkins, 1999; Karpoff et al., 1996; Ryan & Schneider, 2002; Smith, 1996).[4] These institutional aspects of the financial reporting context suggest that AC members will likely perceive greater accountability pressure in the presence of sophisticated, as opposed to unsophisticated, investors and act more as strategic agents to protect their self-interests, rather than as fiduciaries. Accordingly, I predict that AC members will ask more probing questions given a

[3] Shareholder activism refers to the use of power by an investor to bring about significant changes in the strategy or organizational structure of firms and include implementing confidential voting, creating shareholder advisory committees, and altering board composition.
[4] Change in board composition is one outcome of activist shareholders, who sometimes themselves join the board. For example, on August 30, 2013, Microsoft signed a pact with ValueAct Capital, an activist shareholder that gives the President of ValueAct Capital an option to join as a director (see http://wp.me/p3pFEk-2h1).

predominately sophisticated investor base to reduce their chance of being scrutinized by sophisticated investors and of facing negative consequences due to shareholder activism.

> **H1:** AC members' propensity to ask challenging questions about management's significant estimates is greater when the primary shareholders are sophisticated versus unsophisticated.

**The Moderating Effect of Anticipating Additional Mandatory Audit Report Disclosure**

Increasing information regarding the audit process by modifying the auditor's reporting model has been a longstanding issue which is gaining momentum with the project launched by the PCAOB Standing Advisory Group (SAG) on revising the current audit report to disclose additional information (PCAOB, 2010). Most recently, this project led to a proposed new standard from the PCAOB that would require auditors to disclose additional information about critical matters that have been communicated with AC members (PCAOB, 2013). Proponents of requiring additional audit report disclosure suggest that it will increase the effectiveness of the interaction between AC, management, and auditors NYSE & NASD, 1999; Ernst & Young, 2012; PCAOB, 2013; PwC, 2012). Notably, the PCAOB holds that new disclosures in the audit report should not diminish the governance role of the AC over public company's financial statement information but rather lead the AC to spend more time reviewing and discussing the critical audit matters (PCAOB, 2013, p. A5-41). Under this view, the hopeful expectation is that requiring greater audit report disclosure will lead AC members to not change or to ask even more probing questions of management or of auditors during their oversight process.

Greater audit report disclosure on the financial reporting and audit process, however, increases the possibility of sophisticated investors challenging the appropriateness of the firm's financial accounting or engaging in shareholder activism activities. Hence, when AC members are predicted to act more as strategic agents to protect their self-interests (e.g., trying to reduce facing reputational and liability risk), more than fiduciaries, AC members likely will choose a more defensive strategy that allows them to escape potential censure from such events. One way to achieve this objective is to ask fewer questions about management's estimates to create a portrayal that there are no unusual reasons for them to question the appropriateness of the financial reporting and auditing process.[5] The tactic would make it appear to the investor base that there are no unusual reasons for them to further question the appropriateness of the financial reporting and auditing process and protect the AC from any additional shareholder scrutiny that may result from greater disclosure regarding management's significant estimates in the audit report. Moreover, it may also lead to less extensive disclosure regarding the estimate deemed necessary by the auditors. Given that sophisticated investors compared to unsophisticated investors are likely to be of greater concern, AC members' questioning behaviors will likely decrease more given sophisticated, as opposed to, unsophisticated investors in anticipation of additional mandatory audit report disclosure. This prediction is hypothesized below and illustrated in Figure 1.

> **H2:** AC members' propensity to ask challenging questions about management's significant estimates is greatest when the primary shareholders are sophisticated and there is no anticipated additional mandatory audit report disclosure, lower when the primary shareholders are unsophisticated and there is no anticipated additional mandatory audit report disclosure, and lowest when additional mandatory audit report disclosure is anticipated.

[Insert Figure 1 Here]

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[5] Such a tactic is similar to what the accountability literature calls *defensive bolstering*, which is a self-serving strategy employed to cope with greater accountability pressure typically after a noncompliant action (Gibbins & Emby, 1984; Gibbins & Newton, 1994; Lerner & Tetlock, 1999; Messier & Quilliam, 1992). Prior auditing studies have found auditors that engage in defensive bolstering by "stylizing" documentation in audit working papers so as to create a desired portrayal of what happened such as the appropriateness of the work prepared and conclusions reached (Gibbins, 1984; Rich et al., 1997).

## Method

### Participants & Experimental Design

#### Participants

As AC members are high fidelity participants that are not easily accessed, I ensured complete anonymity and targeted individuals who either possess AC experience or are considered eligible to serve on an AC. [6] Individuals were invited via e-mail through the alumni association of the college of business at a Big 10 university and also through professional networks asking them to voluntarily participate in a study about the decision making process of ACs and were randomly assigned to experimental conditions.[7]

A total of 81 participants completed the online experiment, 73 (90.1%) of whom have some prior AC experience.[8] Specifically, they have 7.4 years of AC experience on average (st. dev. = 6.3; min = 0; max = 25), with no significant difference across the four different experimental conditions.[9] Approximately half (52.1%) of the participants with AC experience reported being designated financial experts. These participants also have significantly greater amount of AC experience (9.53 vs. 5.10 years, $t_{79} = 3.24$, $p < 0.01$, one-tailed) and have served on a significantly greater number of public company ACs (2.03 vs. 0.83, $t_{79} = 2.54$, $p < 0.01$, one-tailed) compared to those who are not so designated.

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[6] Eligibility is determined based on their year of earning their bachelor's degree in business and their current career standing. Specifically, their graduation year must be before 1996 (i.e., have at least 15 years of professional experience) and they must either be professors or hold or have held corporate positions in or near the C-suite.
[7] The survey software ensured complete anonymity (i.e., no IP addresses were collected). Hence, an analysis of the differences between the responses obtained from the two different recruitment methods could not be conducted.
[8] While I cannot calculate response rates because I do not know the number of participants recruited via professional networks, I can infer that a consistent response rate exists across experimental conditions given there was random assignment to experimental conditions and a similar number of observations manifested across conditions.
[9] Eight participants reported to have no AC experience but met qualifications to serve as AC members. The analysis result excluding these 8 participants are not significantly different from the results including all 81 participants. Hence, I include all 81 participants in my analysis.

As one would expect given random assignment, participants assigned to different experimental conditions are similar in terms of their prior propensity to ask questions at AC meetings and task-relevant knowledge. Specifically, the reported propensity to ask questions in AC meetings is moderately high with a mean of 1.33 on a scale of -3 (extremely low) to +3 (extremely high), with no significant difference across conditions (p = 0.157, two-tailed). Further, as Table 1 shows, the mean (median) values for participants' self-reported relative knowledge of financial accounting, financial statement analysis, auditing, AC best practices, and the industry used in the case materials are 80.8% (82.7%), 81.7% (85.0%), 79.2% (82.7%), 77.5% (81.3%), and 50.7% (50.0%), respectively, again with no significant difference across conditions (lowest p = 0.187, two-tailed).

[Insert Table 1 Here]

**Independent Variables**

I employ a full factorial 2 x 2 between-subjects online experiment, with investor sophistication and anticipation of additional mandatory audit report disclosure as manipulated independent variables. Investor sophistication is manipulated at two levels (lower vs. higher) using information regarding the firm's primary shareholders. Specifically, participants are informed either that 85% of the investor base consists of unsophisticated or sophisticated investors.

Anticipation of additional mandatory audit report disclosure is also manipulated at two levels (absent vs. present). In the present conditions, participants are informed of a new regulation that requires additional disclosure on management's significant accounting estimates in the audit report. They are also provided with a draft of an audit report, including a preliminary version of the likely additional disclosure regarding the significant accounting estimate described in the case. In the anticipation of additional disclosure absent conditions, there is no new regulation regarding audit report disclosure and the draft audit report is characterized as a standard unqualified audit report with no additional disclosures regarding the financial reporting and audit process.

**Dependent Variables**

The primary dependent variable, AC members' propensity to challenge management's significant estimates, is examined in terms of the level and nature of questions AC members ask. Specifically, I use the number of *probing* questions AC members ask after receiving information related to a significant accounting estimate as the primary measure of their questioning behavior. There is no generally accepted list of probing questions AC members should ask. Hence the coding scheme is developed based on AC best practices set out by the NACD, Center for Audit Quality (CAQ), and The Audit Committee Handbook. Specifically, probing questions are questions that are difficult to answer by challenging the respondent to justify the decision or questions that directly probe into the process of resolving the decision (Kang et al., 2015; Pomeroy, 2010). Therefore, if by answering the question, the question recipient would have to justify or provide important additional information about their decision or disclose how the accounting treatment was agreed upon, then the question is considered probing. The full coding scheme is shown in Appendix A.

The coding was performed independently by two manager-level auditors of two different Big 4 accounting firms who were blind to the experimental conditions and hypotheses. The coders were first provided with the previously described coding scheme that defines what probing questions are. The coders were then asked to evaluate the list of questions for every participant to determine whether or not each question was probing in nature (i.e., binary coding with 1 = probing, 0 = not probing). The coders initially obtained a high level agreement of 89.6%. Any disagreements were resolved through a conference call.

**Case Material and Procedures**

Participants who agreed to participate in the study clicked on a link to a website provided in the invitation e-mail that randomly directed them to one of the four experimental conditions. The experiment began by asking participants to assume they are a member of an AC of a manufacturing company and are preparing for an upcoming board meeting.

As illustrated in Figure 2, the participants first read background information about the firm, including a brief overview of its operations and information regarding its primary investor base (unsophisticated vs. sophisticated). Participants in the anticipation of additional disclosure present conditions were further alerted of a new regulation requiring additional commentary on significant accounting estimates in the audit report. After reading the background information about the firm, all participants read a document developed by the external auditor regarding a significant accounting issue related to obsolete inventory. The document included information about the nature of the accounting issue, management's initial and revised (more favorable) estimate, and the auditor's assessment of management's final estimate. The document was followed by an income statement and balance sheet that reflects the initial and revised estimate. Finally, participants in the anticipation of additional disclosure absent conditions previewed a preliminary draft of the anticipated standard audit report with no additional commentary. Participants in the anticipation of additional disclosure present conditions previewed a preliminary draft of the anticipated audit report under the new regulation that includes likely commentary about the accounting estimate.[10] Such operationalization of additional audit report disclosure is based on the

[10]It is important to note that the additional commentary provided in the additional disclosure present conditions does not include additional information regarding the significant accounting estimate that is not provided in the additional disclosure absent conditions. The additional commentary is simply a high-level summary of the information provided in the case materials to all participants. Hence, the information content regarding the significant accounting estimate is held constant across the different experimental conditions.

long-form reporting model, which is one of the possible forms of the modified audit report being considered by the PCAOB.

Although the eventually implemented, new form of the audit report may differ from the one used in the study, this is a realistic option and, more importantly, is well suited for testing my theory. In addition, the long-form reporting model is similar to how emphasis-of-matter is disclosed in current reports. Hence, the use of a long-form reporting model allows the study findings to have implications with respect to possible effects that emphasis-of-matter disclosures under the current reporting model may have. Appendix B presents the additional commentary provided in the additional disclosure conditions.

[Insert Figure 2 Here]

After previewing a preliminary form of the anticipated audit report, the participants were asked about their comfort level on the final estimate as well as the degree to which they would like to ask questions about the issue. I further asked them to develop questions they would like to ask the external auditors and/or management regarding the significant accounting issue. The experiment concluded by asking several debriefing and demographic questionnaires.

## Results

### Manipulation Checks

Analysis results indicate my manipulations of investor sophistication and anticipation of additional mandatory audit report disclosure were successful. Specifically, participants in the higher sophistication conditions perceive investor sophistication to be significantly higher than those in the lower sophistication conditions (1.79 vs. -1.43; $t_{79} = 14.60$, $p < 0.001$, one-tailed). Participants in the higher sophistication conditions also perceive the investor base to have a significantly higher level of expertise compared to the participants in the lower sophistication conditions (1.51 vs. -1.42; $t_{79} = 14.21$; $p < 0.001$, one-tailed). Moreover, participants in the higher sophistication conditions perceived the investor base to be significantly less vulnerable compared to the participants in the lower sophistication conditions (0.86 vs. 1.41; $t_{79} = -2.03$; $p = 0.023$, one-tailed).[11] Participants in the anticipation of additional disclosure present conditions also were found to believe the preliminary version of the anticipated audit report they saw would alert the financial users to a greater extent (0.09 vs. -1.5) than those in the additional disclosure absent conditions ($t_{79} = 4.45$, $p < 0.001$, one-tailed).[12]

To ensure that my manipulation of investor sophistication did not lead to a difference in AC members' risk assessment, I also conduct a post-test survey using a small panel of 13 participants.[13] Using a shorter version of the original experiment in which investor sophistication is manipulated within subjects, I ask the panel to indicate the level of risk of material misstatement and fraud.[14] Results suggest that my manipulation of investor sophistication does not lead to significantly different levels of assessed risk of fraud or material misstatement (lowest $p = 0.190$, two-tailed). Further, to examine the difference in accountability pressure activated by a more versus less sophisticated investor base, I ask the panel to indicate the likelihood they believe the investor base would 1) require them to justify their judgments and decisions, 2) evaluate the quality of their decision process, and 3) require them to explain the process they followed when making their judgments and decisions. Consistent with my predictions, I

[11] The responses regarding the extent to which they believe the investor base is vulnerable, sophisticated, as well as their perceived level of investor expertise were on a scale of -3 (extremely not vulnerable/unsophisticated/low) to +3 (extremely vulnerable/sophisticated/ high).

[12] The responses regarding the extent to which they believe the preliminary version of the anticipated audit report for the hypothetical firm would alert the financial statement users of the significant accounting issue were on a scale of -3 (extremely low) to +3 (extremely high).

[13] The panel members had an average of 7.88 years of experience serving on public company ACs. Six of them were designated as financial experts in the ACs they serve on while 7 of them were former audit partners who are eligible to serve as financial experts. It is important that the post-test panel consists of AC members who currently are designated financial experts or are eligible to serve as one given the significant effect of designated financial experts in my main findings (see Supplemental Analysis for details).

[14] The order of high vs. low investor sophistication was counter-balanced.

find that AC members feel greater accountability pressure given a more sophisticated, as opposed to a less sophisticated, investor base (highest $p < 0.001$, two-tailed).

**Test of Hypotheses**

AC members' propensity to question management's significant accounting estimates is examined using the number of probing questions asked by the participants. Panel A of Table 2 tabulates the average and standard deviation of the number of probing questions participants developed by experimental conditions, and Panel B of Table 2 presents the analysis of variance (ANOVA). Figure 3 also presents the observed pattern of results. Results show that AC members show greater questioning when the primary shareholders are sophisticated compared to unsophisticated ($3.74 > 2.11$; $F_{1, 77} = 4.66$; $p = 0.034$, two-tailed). Therefore, H1 is supported. Moreover, when AC members anticipate additional disclosure in the audit report, their level of questioning significantly decreases ($3.82 > 2.02$; $F_{1, 77} = 5.65$; $p = 0.020$, two-tailed). Results also show a significant interaction between investor sophistication and the anticipation of additional disclosure in the audit report on AC members' questioning behavior, in which the decrease in questioning behavior due to anticipation of additional disclosure is greater given a sophisticated, as opposed to, unsophisticated investor base ($F_{1, 77} = 4.40$; $p = 0.039$, two-tailed).[15]

As I predict an ordinal interaction (i.e., a non-symmetric pattern of cell means) of investor sophistication and anticipation of additional mandatory audit report disclosure on AC members' questioning behavior, I use contrast codes to test H2. Such analysis allows me to obtain greater statistical power in examining interactions compared to the conventional ANOVA tests (Buckless & Ravenscroft, 1990). Panel C of Table 2 presents the results of the planned contrast tests as well

[15] Analysis results of the participants' preference on questioning the accounting issue and their likelihood of questioning on behalf of investors are also directionally consistent with the findings based on the level and nature of questions developed by the participants.

as follow-up simple effect tests. Consistent with my prediction, I apply contrast weights as follows: +3 in the anticipation of additional disclosure absent/higher sophistication condition, +1 in the anticipation of additional disclosure absent/lower sophistication condition, and -2 in the anticipation of additional disclosure present conditions. Consistent with the predicted interaction in H2, results show that the planned contrast is statistically significant ($F_{1, 77} = 10.76$, $p = 0.001$, one-tailed).[16] These findings, combined with the post-test panel survey results where I find AC members perceive greater accountability pressure from sophisticated versus unsophisticated investors, suggest that AC members' concern in protecting themselves from potential scrutiny of sophisticated investors, rather than their fiduciary responsibility to protect unsophisticated investors has a greater influence on their oversight behavior.

[Insert Table 2 and Figure 3 Here]

Given the findings, some may argue that greater mandatory audit report disclosure levels the playing field between sophisticated and unsophisticated investors. However, the findings are potentially disconcerting as the "leveling of the playing field" is obtained by a *decrease* in questioning behavior given *sophisticated* investors, not an *increase* in questioning behavior given *unsophisticated* investors when there is anticipation of additional mandatory audit report disclosure. Moreover, the fact that the questioning behavior is lower for unsophisticated investors under the current regime where there is no additional disclosure in the audit report is also potentially troubling as unsophisticated investors are the ones who would most likely benefit from

[16] I examined the semi-omnibus F-test related to my planned contrast (see, e.g., Buckless & Ravescroft, 1990). The semi-omnibus F-test is statistically insignificant ($F_{2, 78} = 2.01$, $p = 0.142$), indicating that once the between-subject sum of squares accounted by the contrast is taken out, investor sophistication and anticipated additional mandatory audit report disclosure do not explain a significant amount of variation of the dependent variable (i.e., number of probing questions).

additional questioning from the AC, especially under financial reporting environments with less disclosure regarding the financial reporting and auditing process.

## Supplemental Analyses

### Effect of Designated Financial Experts

Being designated as an AC financial expert is likely to increase an AC member's perceived accountability risk (Paskell-Mede & Jackson, 1999; Rupley et al., 2011; Vera-Munoz, 2005; Zacharias, 2000). In fact, many of the comment letters to the SEC regarding the rule on financial experts proposed under Section 407 of SOX expressed concern that such rule would increase the perceived liability of AC members, decreasing their willingness to serve as financial experts or as AC members at all.[17] If this is true, the main findings of decreased questioning behavior when there is anticipated increase in mandatory audit report disclosure, especially given sophisticated investors, are likely to be stronger for participants who are designated financial experts. I conduct a supplemental analysis to test this prediction.

Table 3 summarizes the analysis based on the number of probing questions participants asked by groups. Panel A tabulates the descriptive statistics and Panel B presents the three-way analysis of variance (ANOVA), while Panel C primarily tests my prediction.[18] The observed pattern of the results by groups is shown in Figure 4.

[Insert Table 3 and Figure 4 Here]

Results suggest the findings documented in the previous section are mainly driven by participants who are designated as financial experts. Specifically, the +3, +1, -2, -2 planned

[17] See http://www.sec.gov/rules/proposed/s74002.shtml for the full list of comment letters.

[18] As participants were randomly assigned, I did not balance how many designated financial experts ended up in different experimental conditions. As it turns out, the four conditions have an unbalanced number of designated financial experts. Some statisticians recommend using Type II instead of Type III sums of squares in such situations (e.g., Maxwell & Delaney, 1990). Analysis results using the Type II sums of squares is not significantly different that that using the Type III sums of squares.

contrast is statistically significant ($F_{1, 34} = 14.85$, $p < 0.001$, one-tailed) for designated financial experts while it is not significant ($F_{1, 39} = 0.76$, $p = 0.194$, one-tailed) for non-financial experts.[19] In addition, the results of the follow-up simple effect tests for designated financial experts show that when the AC does not anticipate additional mandatory disclosure in the forthcoming audit report, there is a significant effect of investor sophistication ($F_{1, 34} = 13.93$, $p = 0.001$, one-tailed). The results also show that anticipated increase in mandatory audit report disclosure significantly influences the propensity to challenge management's estimates given sophisticated investors ($F_{1, 34} = 16.53$, $p < 0.001$, one-tailed), while having no significant effect given unsophisticated investors ($F_{1, 34} = 0.17$, $p = 0.343$, one-tailed). I also confirm that there is no statistically significant effect of investor sophistication given anticipated increase in mandatory audit report disclosure for designated financial experts ($F_{1, 34} = 0.02$, $p = 0.879$, two-tailed).

Such findings provide further evidence in support of the assumption that AC members are more concerned about reducing accountability risk than acting as fiduciaries for investors. The fact that the main findings were driven by AC members who are likely to be more concerned about liability or other forms of accountability risk (i.e., those designated as financial experts) also provides indirect evidence that anticipated increase in mandatory audit report disclosure leads AC members to behave more as strategic agents. Moreover, the findings suggest that despite their greater capacity to ask challenging questions, designated financial experts will challenge auditors and/or management to a greater extent only when they perceive a strong cognitive need to do so (e.g., when the primary shareholders are sophisticated and no additional mandatory disclosure is anticipated in the audit report).

[19] I also examined the semi-omnibus F-test for financial experts alone (e.g., Buckless & Ravenscroft, 1990). This test is once again statistically insignificant ($F_{2, 35} = 1.73$, $p = 0.192$), similar to my results for all participants (see footnote 15).

**AC's Self-Awareness of Their Decision Processes**

I conduct additional analysis to gain further insight on AC members' self-awareness regarding the effect of investor sophistication and additional mandatory audit report disclosure on their oversight processes. As part of my post-experimental questions, I asked AC members to assess how they think greater investor sophistication and anticipation of additional mandatory audit report disclosure would affect their questioning behavior on a scale that ranged from -3 (substantially decrease questioning) to +3 (substantially increase questioning).

The mean response for the effect of investor sophistication on their questioning behavior was 0.12 which is significantly greater than 0 "no effect" ($t_{80} = 2.16$; $p = 0.034$, two-tailed) but also significantly less than +1 "slightly increase questioning" ($t_{80} = -15.30$; $p < 0.001$, two-tailed). This suggests that AC members believe that investor sophistication has little qualitative effect on their questioning behaviors and that their propensity to ask challenging questions does not qualitatively drop when the investor base is unsophisticated. These results are inconsistent with the main findings where the predominance of unsophisticated investors caused a significant drop in their questioning behavior. This implies that the heightened questioning behavior observed in the presence of sophisticated investors is likely below the level of AC members' conscious awareness.

Moreover, participants believe they tend to increase their level of questioning when they anticipate additional mandatory audit report disclosure (mean = 1.24, $t_{80} = 9.15$, $p < 0.001$, two-tailed).[20] Only 8.64% said they would decrease their questioning behavior when they anticipate additional mandatory audit report disclosure. Recall, however, that the main results show that AC members' questioning behavior actually significantly *drops* when they anticipate additional

[20] Designated financial experts, compared to those who are not so designated, are not more aware of the effect of greater investor sophistication (mean = 0.12 vs. 0.13; $t_{79} = 0.13$ $p = 0.901$, two-tailed) and additional mandatory audit report disclosure (mean = 1.14 vs. 1.33; $t_{79} = 0.70$, $p = 0.486$, two-tailed) on their questioning behavior.

mandatory audit report disclosure. This provides evidence that the manner in which AC members react to anticipation of additional mandatory audit report disclosure is likely below their level of conscious awareness.

Together, the findings suggest that the motivational climate (i.e., incentive to avoid potential shareholder scrutiny or activism from sophisticated investors) triggers AC members to *subconsciously* increase their questioning behavior in the presence of sophisticated investors and when they do not anticipate additional mandatory audit report disclosure.

**Mediation Effects of Perceived Investor Vulnerability and Perceived Comfort Level**

To gain further understanding of the judgment processes underlying the effect of anticipating additional mandatory audit disclosure on AC members' questioning behavior, I examine the mediation effects of perceived investor vulnerability and perceived comfort level. If AC members are primarily concerned about reducing accountability risk and protecting their self-interests, an increase in anticipated additional mandatory audit report disclosure will likely lead AC members to rationalize not asking probing questions by convincing themselves that they already are comfortable with management's estimate. By contrast, if AC members' primary concern is to adhere to their fiduciary duty to protect investors (especially those who are more vulnerable and unsophisticated), an increase in anticipated mandatory audit report disclosure would likely lead to a perception of more information being available to investors. This would cause a decrease in perceived investor vulnerability, especially given unsophisticated investors.

Results show that anticipation of additional mandatory audit report disclosure does not significantly affect perceived investor vulnerability ($F_{1, 77} = 0.01$, $p = 0.933$, two-tailed) and there is no significant interaction between anticipation of additional disclosure and investor sophistication ($F_{1, 77} = 0.22$, $p = 0.637$, two-tailed). This implies that the observed decrease in AC members' questioning given the anticipation of additional mandatory audit report disclosure is not driven by a decrease in perceived investor vulnerability, as would have been expected if AC members were primarily concerned about adhering their duty as fiduciaries to protect investors.

If AC members were primarily concerned about reducing their accountability risk as predicted in my main hypotheses, AC members likely will respond to greater anticipated mandatory audit report disclosure by questioning less to rationalize that they are not directly responsible for management's estimate or that management's estimate is meritorious. One way to do this would be for the AC members to convince themselves that they are already relatively comfortable with management's estimate. To examine if this is the process in which anticipation of additional mandatory audit disclosure affects AC members' questioning behavior, I conduct a mediation analysis using the participants' comfort regarding the accounting decision.

I first develop a variable of AC's overall comfort regarding the accounting issue based on a factor analysis on the participants' perceived comfort regarding 1) management's change in estimate, 2) auditor's decision to allow management's updated, smaller write-down of inventory, and 3) the difference in the net income that results from the different write-down amounts. Using this new variable, I conduct a mediation analysis according to the four-step procedure specified by Baron & Kenny (1986). The analysis is only conducted on the responses provided by designated financial experts given sophisticated investors as these are the conditions that drive my overall findings. Figure 5 summarizes the results of the analysis.

Consistent with my main findings, step 1 indicates anticipation of additional mandatory audit report disclosure negatively affects participants' propensity to challenge management's estimates ($b = -6.10$, $p = 0.001$, one-tailed). Step 2 indicates that anticipation of additional mandatory audit report disclosure positively affects participants' perceived level of comfort regarding the accounting decision (b = 2.02, p = 0.041, one-tailed). Step 3 shows that the perceived comfort level about the accounting decision negatively impacts the participants' propensity to challenge management's estimate (b = -3.73, p = 0.003, one-tailed). Finally, step 4 indicates that participants' comfort with respect to the accounting decision fully mediates the influence of anticipating additional mandatory audit report disclosure on their propensity to challenge management's accounting estimate (b = -2.72, p = 0.166, two-tailed). Such results are consistent with the drop in AC members' questioning behavior with anticipation of additional mandatory audit report disclosure being rationalized by stating that they are more comfortable with, and thus, have less of a reason to question management's estimate.[21]

[Insert Figure 5 Here]

## Conclusion

This study provides theory and empirical evidence on how investor sophistication affects AC members' degree of questioning during their oversight process and how anticipation of additional mandatory audit report disclosure moderates such an effect. Overall, the findings suggest that when there is no anticipation of additional mandatory audit report disclosure, AC members challenge management's estimate at a significantly greater level given a primarily sophisticated, as opposed to unsophisticated, investor base. The evidence also indicates that AC members significantly decrease their level of questioning when additional mandatory audit report disclosure is anticipated,

[21] The increased comfort level found with anticipation of additional mandatory disclosure could be due to participants reasoning that auditors likely would provide more competent and impartial audits under such conditions, perhaps especially for sophisticated investors. While I did not design my case materials to test whether such reasoning occurred or mediated my hypothesized effects, analysis of two post-test questions on participants' assessment of auditor's competence and integrity are of some relevance. Specifically, participants were asked to assess the auditor's competence and integrity in light of the favorable revision in management's inventory obsolescence estimate. Neither anticipation of additional disclosure nor investor sophistication nor their interaction (lowest p=0.642) significantly affects participant's assessment of the auditor's competence or integrity. Future research can ask more pointed questions about whether perceived auditor effort on estimates separately disclosed and discussed in the audit report changes with investor sophistication and anticipation of additional disclosure in the audit report.

especially given a primarily sophisticated investor base. Overall these findings suggest AC members are more concerned about reducing their accountability risk and protecting their self-interests rather than acting as fiduciaries to protect investors (especially those who are more vulnerable and unsophisticated).

Supplemental analysis shows that my main findings are more pronounced for designated financial experts, whose incentives are more likely to depend on sophisticated investors' scrutiny of and reactions to management estimates that are described in an audit report. Further analysis also indicates that how AC members actually respond to investor sophistication and anticipation of additional mandatory audit report disclosure is quite different than how they think they behave. Thus, the joint influence of these two factors likely falls outside of the AC members' level of conscious awareness. Finally, I also find that a tendency to find more comfort in management's estimate fully mediates the effect of anticipating additional mandatory audit report disclosure on AC members' questioning behavior.

There are various ways future research can extend this study. One, this study identifies situations where the incentive to reduce accountability risk and protect self-interest outweighs the AC members' accountability towards protecting investors, especially those who are more vulnerable and unsophisticated. However, the two motivations are not mutually exclusive. Hence, identifying circumstances where the AC members' accountability towards investors outweighs their incentive to reduce accountability risk may be of interest for future research. Two, while this study's manipulation of anticipated additional mandatory audit report disclosure entails additional language describing one of management's key accounting estimates that is similar to the proposed standard in which auditors would identify critical audit matters, it does not use an approach that is identical to that currently being proposed by the PCAOB (e.g., no description of what a "critical audit matter" appears in the draft report). Although I am unaware of a theory that would predict it, it is possible that describing what critical audit matters are within a draft audit report could dampen or otherwise moderate the ordinal interaction I observe. Future research can examine this issue, which will help further our understanding of whether ACs react differently to otherwise identical descriptive information about significant accounting estimates in the audit report depending on whether or not it is also couched as being a "critical audit matter."

Overall, the theory and findings of the study provide some of the first theory-based empirical evidence regarding two factors that jointly determine AC members' propensity to ask challenging questions of management's key financial statement estimates. In doing so, it answers a call for research that provides ex ante evidence on how and why ACs could *decrease* their vigilance with greater audit report disclosure (Carcello et al., 2011). In short, my study shows that AC members' reaction to additional mandatory audit report disclosure can cause what Sterman (2002) calls 'policy resistance,' even though AC members themselves are unaware that their reaction is creating policy resistance. [22] Finally, the theory and findings herein also demonstrate that, while designated financial experts have greater capacity to challenge management's estimates, they are significantly less likely to draw upon this capacity to protect vulnerable unsophisticated investors than to protect themselves from scrutiny by sophisticated investors.

[22] Policy resistance is defined as "the tendency for interventions to be defeated by the response of the system to the intervention itself" and is used in the systems dynamics literature to refer to the occurrence of unintended consequences of well-intended efforts to solve pressing problems (Sterman, 2002).

## APPENDIX A

### Coding Scheme for Qualitative Analysis

Please code the questions in terms of 1) who the question was directed to and 2) whether the question is probing or not based on the coding scheme described below. *(Note: I do not make any predictions with respect to who the target of the questions will be. This is simply to obtain insight on the proportion of questions directed to management vs. auditors)*

1. Who is the question directed to?
   a. (0) none
   b. (1) management (CFO/COO/CEO)
   c. (2) auditor
   d. (3) both

2. Is the question probing?
   a. (0) No
   b. (1) Yes

- To be considered probing, questions must be directly related to the inventory valuation decision and must challenge the auditor and/or CFO to justify the decision.

  Specifically, probing questions are questions that are difficult to answer by challenging the respondent to justify the decision; or questions that directly probe into the process of resolving the decision. Therefore, if by answering the question, the question recipient would have to justify the inventory valuation decision, provide important additional information about the decision or disclose how the accounting treatment was agreed upon, then the question is considered probing.

  - Any question that asks about the *appropriateness of the accounting treatment* is considered challenging or probing.
    - Ex: Justify the difference between the two estimates.
    - Ex: How confident are the auditors about management's estimates?
    - Ex: What is the fair value of this inventory?
    - Ex: If given a choice, what method would you choose to value the inventory?
    - Ex: How would regulatory bodies view manipulation of this kind?

  - Any question that asks about the *internal or external influences or pressures* that could affect the estimate is considered challenging or probing.
    - Ex: Does the new estimate affect the company's ability to be in compliance with debt covenants?
    - Ex: What are the implications for going concern?
    - Ex: Does the new estimate affect management's compensation in any way?

- Any question that asks about *disagreements* between the management and auditors is considered challenging or probing.
  - Ex: Were there any disagreements with the management on the estimate, and if so, how did they respond to your disagreement?

- *Note: The list above is not conclusive. Any other question that challenges the respondent to justify the inventory valuation or provide important additional information about the decision or disclose how the accounting treatment was agreed upon is considered probing.*

- Non-probing questions: does not challenge the respondent to provide information or justification about how the issue was resolved with the other party.
  - Ex: How much additional investment does the company need to spend in order to make those products related to the old strategy to be sold?
  - Ex: What does the company plan to do with obsolete inventory? – Business strategy question that is not directly related to the accounting decision.
  - Are there any accounts receivables outstanding related to sales of the old strategy inventory?

## APPENDIX B

**Commentary Added in the Anticipation of Additional Disclosure Present Conditions**

**Justification of Assessments**
In accordance with the professional standards applicable in the Unites States, we bring to your attention the following matters:

SCA's management adjusted its inventory by writing it down to its estimated net realizable value. This write down was necessary when a portion of its inventory became unsalable after implementation of a new marketing strategy as described in note 3.2 to the consolidated financial statements. The portion of on-hand inventory that management estimated to be unsalable had a carrying value of $970,000, and so management took a write down of inventory in this amount, materially decreasing SCA's net income.

As part of our audit of significant accounting estimates, we assessed the assumptions made and the approach taken by management regarding this estimate for compliance, in all material respects, with U.S. GAAP. In addition, we communicated this issue to the AC in accordance with PCAOB Auditing Standards (AU 380). These procedures were performed in the context of our audit of the consolidated financial statements as a whole, and therefore contributed to the opinion expressed above.

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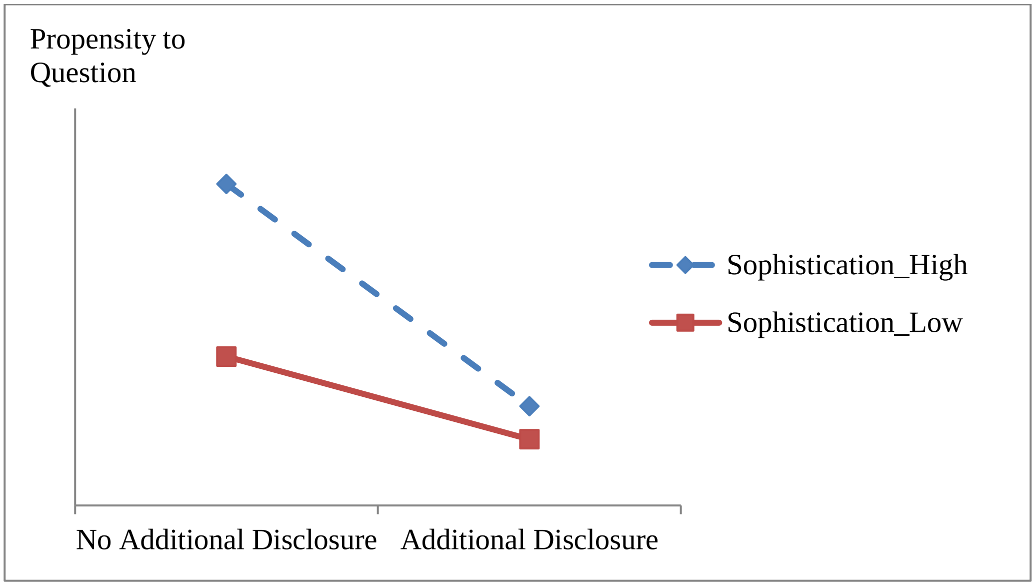
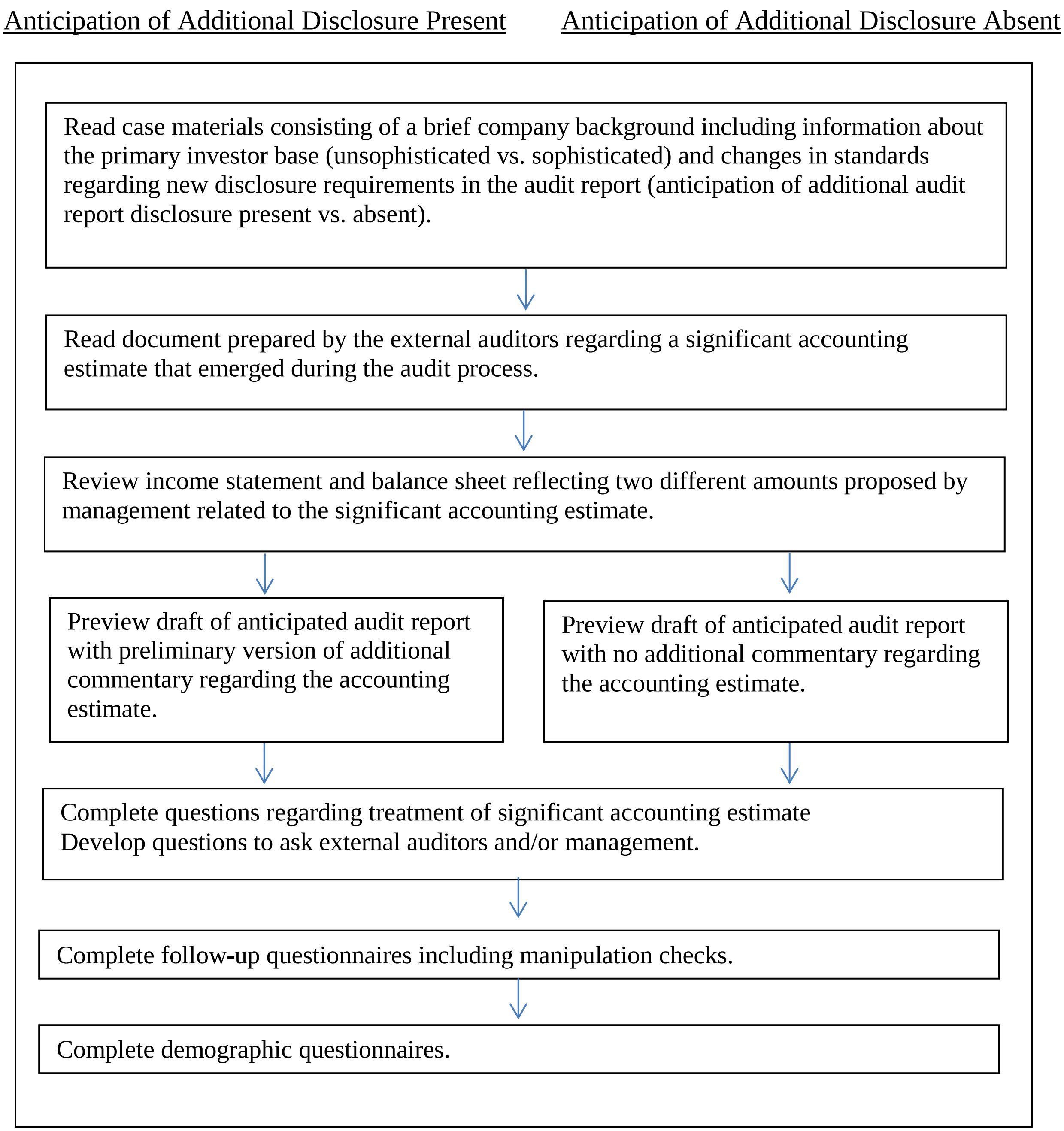
**Figure 1**
**Predicted Effect of Investor Sophistication & Anticipation of Additional Mandatory Audit Report Disclosure**



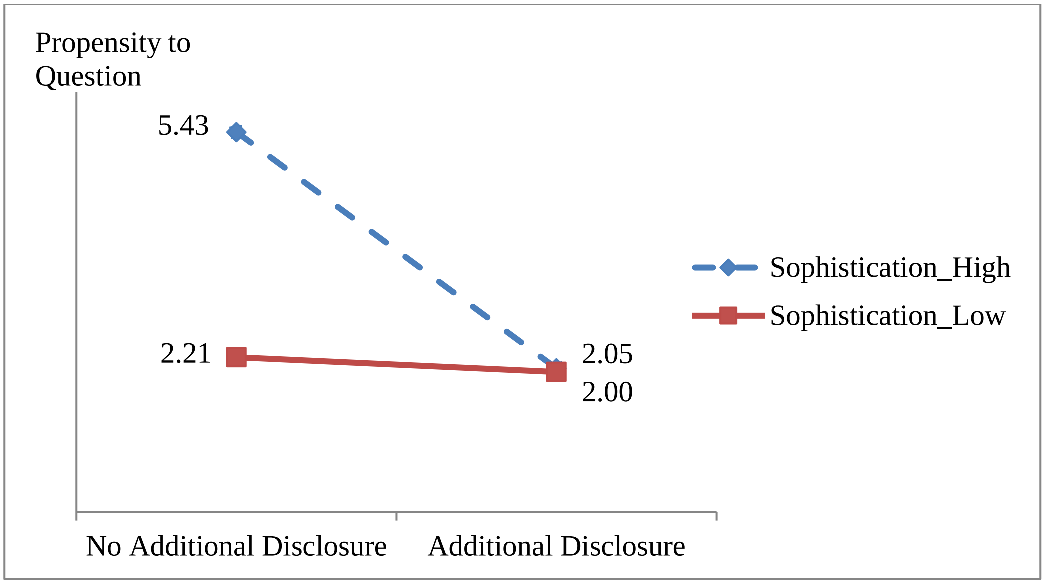

Note: This figure depicts the predicted joint effect of investor sophistication and anticipation of additional mandatory audit report disclosure on AC members' propensity to challenge management's significant accounting estimates. The propensity to question management's significant accounting estimates was measured by the number of probing questions developed by the experimental participants.

**Figure 2**
**Experimental Procedures**




Note: This figure depicts the experimental process for this study.

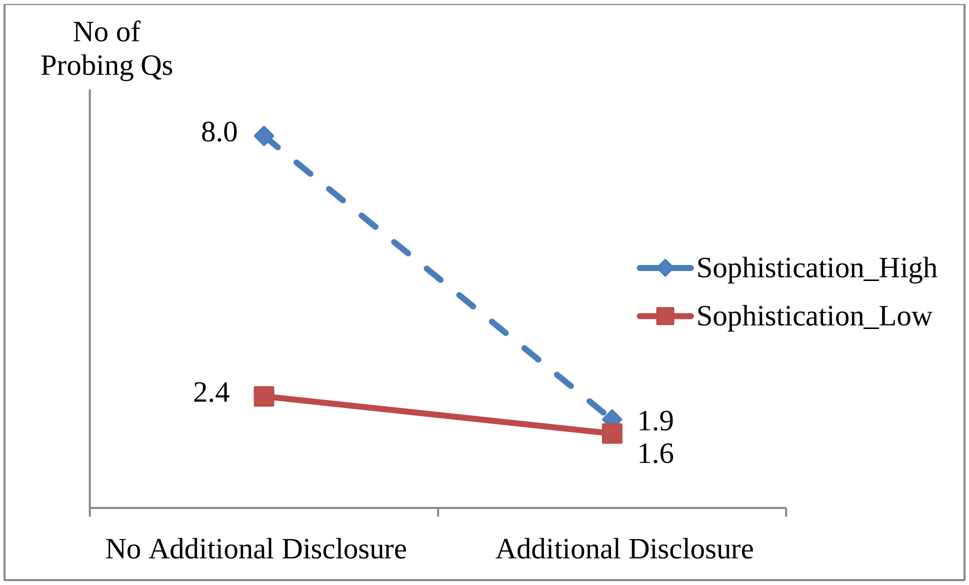
**Figure 3**
**Observed Pattern of Results**



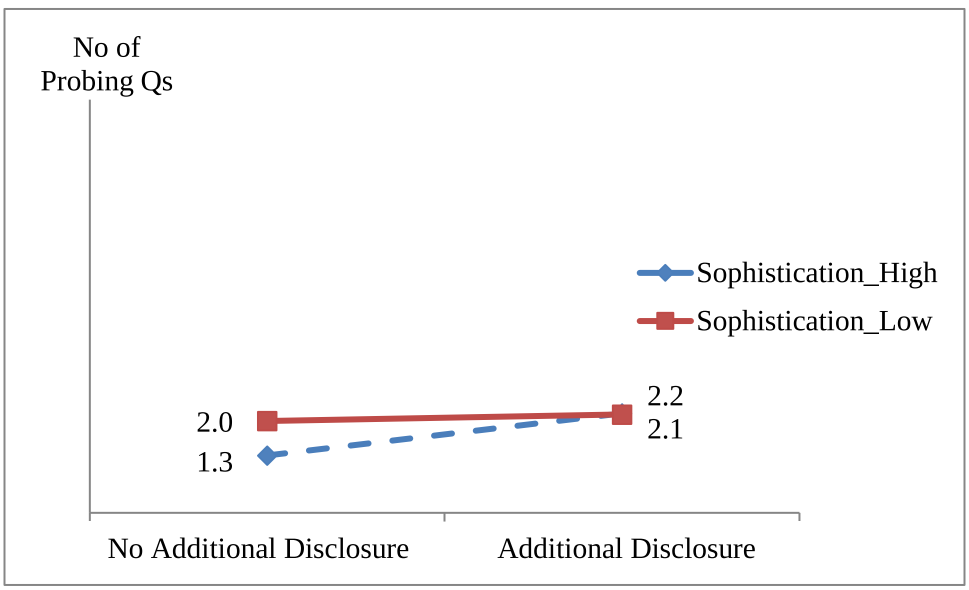

Note: This figure depicts the observed effect of investor sophistication and anticipation of additional mandatory audit report disclosure on the number of probing questions asked by the participants.

**Figure 4**
**Effect of Investor Sophistication & Anticipation of Additional Mandatory Audit Report Disclosure by Groups**

**Panel A: Designated Financial Experts**

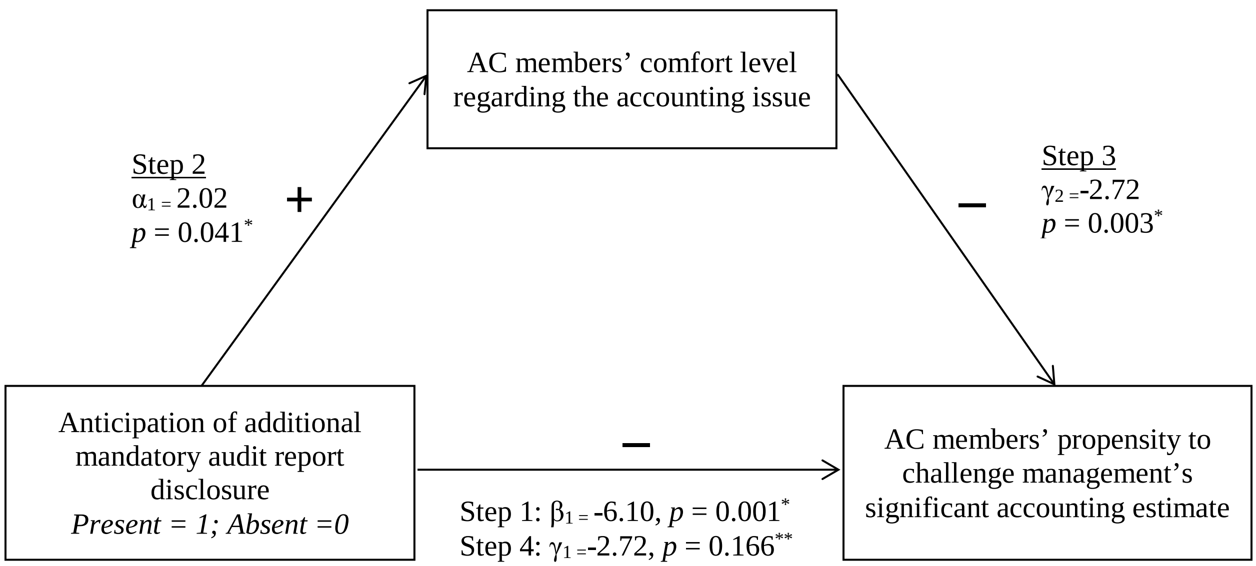



**Panel B: Non-Financial Experts**




Note: This figure depicts the Investor Sophistication * Anticipation of Additional Mandatory Audit Report Disclosure interaction plot based on whether the participants are designated as financial experts in the AC they serve on.

**Figure 5**
**Mediating Role of Perceived Comfort on how Anticipation of Additional Mandatory Audit Report Disclosure Affects AC Members' Questioning Behavior**




Note: This figure summarizes tests of the mediating role of perceived comfort in the causal relation between anticipation of additional mandatory audit report disclosure and the AC members' propensity to challenge management's significant accounting estimate.
*p-values are one-tailed, given directional predictions.
** two-tailed equivalent

**Table 1**
**Descriptive Statistics on Participants' Self-Reported Relative Knowledge Against Other AC Members on Specific Issues (Percentile)**

| | Issues | | | | |
|---|---|---|---|---|---|
| | Financial Accounting | F/S Analysis | Auditing | AC Best Practice | Case Industry |
| Mean | 81 | 82 | 79 | 78 | 51 |
| Std. Deviation | 17 | 17 | 19 | 20 | 26 |
| Minimum | 9 | 9 | 9 | 9 | 0 |
| 25th Percentile | 74 | 76 | 69 | 62 | 29 |
| Median | 83 | 85 | 83 | 81 | 50 |
| 75th Percentile | 91 | 92 | 95 | 95 | 72 |
| Maximum | 100 | 100 | 100 | 100 | 100 |
| *n* | 81 | 81 | 81 | 81 | 81 |

Note: This table presents descriptive statistics for the measure used in the experiment to capture the participants' self-reported extent of knowledge relative to other AC members on five different areas. A total of 81 participants provided responses on a 99-point percentile basis scale (1$^{st}$ percentile = few, if any, are less knowledgeable than me, 99$^{th}$ percentile = few, if any, are more knowledgeable than me).

**Table 2**
**Main Analyses Based on Number of Probing Questions: Descriptive Statistics and Two-Way ANOVA**

**Panel A: Mean [Standard Error] for number of probing questions**

| | | Investor Sophistication | | |
|---|---|---|---|---|
| | | Lower | Higher | Collapsed Across Sophistication |
| **Anticipation of Additional Mandatory Disclosure** | Absent | 2.21<br>[0.78]<br>*n* = 19 | 5.43<br>[0.74]<br>*n* = 21 | 3.82<br>[0.54]<br>*n* = 40 |
| | Present | 2.00<br>[0.78]<br>*n* = 19 | 2.05<br>[0.73]<br>*n* = 22 | 2.02<br>[0.53]<br>*n* = 41 |
| | Collapsed Across Disclosure | 2.11<br>[0.55]<br>*n* = 38 | 3.74<br>[0.52]<br>*n* = 43 | |

**Panel B: Basic ANOVA model**

| Source | Type III SS | *df* | Mean Square | *F*-Ratio | *p*-value |
|---|---|---|---|---|---|
| Investor | 53.70 | 1 | 53.70 | 4.66 | 0.034 |
| Disclosure | 65.11 | 1 | 65.11 | 5.65 | 0.020 |
| Investor * Disclosure | 50.75 | 1 | 50.75 | 4.40 | 0.039 |
| Error | 887.26 | 77 | 11.52 | | |

Note: All p-values are two-tailed.

**Table 2 (*continued*)**
**Panel C: Planned contrast coding and follow-up simple effect tests**

| Source | *df* | Mean Square | *F*-Ratio | *p*-value |
|---|---|---|---|---|
| <u>Overall test:</u> | | | | |
| AC members' propensity to ask challenging questions about management's significant estimates is greatest when the primary shareholders are sophisticated and there is no anticipated additional mandatory audit report disclosure, lower when the primary shareholders are unsophisticated and there is no anticipated additional mandatory audit report disclosure, and lowest when there is anticipated additional mandatory audit report disclosure. | 1 | 123.94 | 10.76 | 0.001 |
| <u>Follow-up simple effect tests:</u> | | | | |
| Effect of investor sophistication given no add. disclosure | 1 | 103.3 | 8.97 | 0.002 |
| Effect of investor sophistication given add. disclosure | 1 | 0.02 | 0.00 | 0.966 |
| Effect of disclosure given sophisticated investors | 1 | 122.97 | 10.67 | 0.001 |
| Effect of disclosure given unsophisticated investors | 1 | 0.42 | 0.04 | 0.425 |

Note: This table presents descriptive statistics, basic ANOVA, planned contrast coding, and follow-up simple effect test results for AC's propensity to challenge significant accounting estimates. The experiment manipulates (1) whether the primary investor base is sophisticated vs. unsophisticated and (2) whether the anticipated audit report is required to have additional disclosure on management's estimates. The cells of the experiment receive contrast weights as follows: sophisticated/additional disclosure absent = +3, unsophisticated/additional disclosure absent = +1, sophisticated/additional disclosure present = -2, unsophisticated/additional disclosure present = -2. Reported *p*-values are two-tailed for the simple effect of investor sophistication given anticipation of additional mandatory audit report disclosure, and one-tailed equivalent for all other tests given my directional predictions.

**Table 3**
**Supplemental Analyses: Descriptive Statistics and Three-Way ANOVA of Number of Probing Questions Asked**

**Panel A: Mean [Standard Deviation] for number of probing questions by groups**

| | | Financial Experts Investor Sophistication | | Non-Experts Investor Sophistication | |
|---|---|---|---|---|---|
| | | Lower | Higher | Lower | Higher |
| Anticipation of Additional Mandatory Disclosure | Absent | 2.40 [1.13] *n* = 10 | 8.00 [0.99] *n* = 13 | 2.00 [0.80] *n* = 9 | 1.25 [0.85] *n* = 8 |
| | Present | 1.60 [1.60] *n* = 5 | 1.90 [1.13] *n* = 10 | 2.14 [0.65] *n* = 14 | 2.17 [0.70] *n* = 12 |

**Panel B: Three-Way ANOVA model**

| Source | Type III SS | *df* | Mean Square | *F*-Ratio | *p*-value |
|---|---|---|---|---|---|
| Investor | 30.85 | 1 | 30.85 | 3.42 | 0.069 |
| Disclosure | 39.31 | 1 | 39.31 | 4.35 | 0.040 |
| Expert | 46.33 | 1 | 46.33 | 5.13 | 0.027 |
| Investor*Disclosure | 23.61 | 1 | 23.61 | 2.61 | 0.110 |
| Investor*Expert | 50.60 | 1 | 50.60 | 5.60 | 0.021 |
| Disclosure*Expert | 73.01 | 1 | 73.01 | 8.08 | 0.006 |
| Investor*Disclosure*Expert | 42.51 | 1 | 42.51 | 4.71 | 0.033 |
| Error | 659.38 | 73 | 9.03 | | |

**Table 3 *(continued)***

**Panel C: Planned contrast coding and follow-up simple effect tests**

| Source | *df* | Mean Square | *F*-Ratio | *p*-value |
|---|---|---|---|---|
| <u>Financial Experts</u> | | | | |
| *Overall test:* | | | | |
| AC members' propensity to ask challenging questions about management's significant estimates is greatest when the primary shareholders are sophisticated and there is no anticipated additional mandatory audit report disclosure, lower when the primary shareholders are unsophisticated and there is no anticipated additional mandatory audit report disclosure, and lowest when there is anticipated additional mandatory audit report disclosure. | 1 | 188.91 | 14.85 | <0.001 |
| [Contrast Weights (3, 1, -2, -2)] | | | | |
| *Follow-up simple effect tests:* | | | | |
| Effect of investor sophistication given no add. disclosure | 1 | 177.25 | 13.93 | 0.001 |
| Effect of investor sophistication given add. disclosure | 1 | 0.30 | 0.02 | 0.879 |
| Effect of disclosure given sophisticated investors | 1 | 210.32 | 16.53 | <0.001 |
| Effect of disclosure given unsophisticated investors | 1 | 2.13 | 0.17 | 0.343 |
| <u>Non-Experts</u> | | | | |
| *Overall test:* | | | | |
| AC members' propensity to ask challenging questions about management's significant estimates is greatest when the primary shareholders are sophisticated and there is no anticipated additional mandatory audit report disclosure, lower when the primary shareholders are unsophisticated and there is no anticipated additional mandatory audit report disclosure, and lowest when there is anticipated additional mandatory audit report disclosure. | 1 | 4.44 | 0.76 | 0.194 |
| [Contrast Weights (3, 1, -2, -2)] | | | | |

Note: Panel A and C present descriptive statistics and the planned contrast coding and follow-up simple effect test results based on whether the participants are designated financial experts in the ACs they serve on. Panel B presents the three-way ANOVA to examine whether financial expertise influence the joint effect of investor sophistication and anticipated additional mandatory audit report disclosure on the participants' propensity to ask probing questions. Reported *p*-values are two-tailed for the simple effect of investor sophistication given anticipation of additional mandatory audit report disclosure, and one-tailed equivalent for all other tests given my directional predictions.

# Does the reporting of key audit matters affect the auditor's report's communicative value? Experimental evidence from investment professionals


## ABSTRACT

This paper investigates the communication of key audit matters (KAM) in the auditor's report as required by the new International Standard on Auditing (ISA) 701. We conduct an experiment with investment professionals to test the communicative value of a KAM section relating to goodwill impairment. Our main results show that in the condition in which the KAM section suggests that *already small* changes in the key assumptions could eventually lead to a goodwill impairment (referred to as KAM negative), participants assess the economic situation of the company to be significantly better as compared to the condition in which the KAM section suggests that *only large* changes in the key assumptions could eventually lead to a goodwill impairment (referred to as KAM positive). We interpret our findings in light of a model of trust and conclude that the specific informational content of the KAM section triggers different factors in the model in different ways. Overall, our findings suggest that neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; rather, financial statement users value this information positively.




**JEL Classification:** M42

**Keywords:** improved auditor's report, key audit matters, communicative value, trust model

# I. INTRODUCTION

Since the 1970s, there have been numerous discussions about the need for improving the auditor's report as the auditor's primary means of communication with a company's stakeholders (see, for instance, regarding the history PCAOB 2011). The financial crisis has further spurred financial statement users (in the following referred to as users), but also regulators and national standard setters to address the auditor's role in early warning signaling and in the provision of additional insights into audited financial statements. Very recently, various institutions and regulators, such as the Center of Audit Quality (CAQ), the European Commission (EC), the International Auditing and Assurance Standards Board (IAASB), the Public Company Accounting Oversight Board (PCAOB), and the United Kingdom Financial Reporting Council (FRC), have started initiatives to improve the auditor's reporting model – also with respect to further insights into the auditor's work. Given the IAASB's position as a global standard setter whose auditing standards have been adopted in over 100 countries, the IAASB initiative is of particular interest. A promising way to provide users with more information about the auditor's work and, thus, to enhance the communicative value of the auditor's report, is a separate section in this report that communicates so-called key audit matters (KAM), i.e., "matters that, in the auditor's professional judgment, were of most significance in the audit […]" (IAASB 2015b, paragraph 11, a)). This concept is reflected by the new IAASB audit standard ISA 701 '*Communicating Key Audit Matters in the Independent Auditor's Report*', which was published in January 2015 and is effective for audits of financial statements ending on or after December 15, 2016.

There is scarce evidence on whether the inclusion of a separate KAM section in the auditor's report as required by ISA 701 will meet the IAASB's objective to enhance the communicative value of the auditor's report for users.[1] Prior auditor reporting research has primarily examined the effect of additional or amended content in the auditor's report on the expectation gap, i.e., "the difference between what users expect from the auditor and the financial statement audit, and the reality of what an audit is" (IAASB 2011, 7) and/or the potential narrowing thereof. One stream within this research uses revisions or draft revisions of relevant auditor reporting standards and their potential impact on the expectation gap (e.g., Bailey, Bylinski, and Shield 1983; Kelly and Moorweis 1989; Houghton and Messier 1991; Miller, Reed, and Strawser 1993; Monroe and Woodliff 1994; Kneer, Reckers, and Jennings 1996; Innes, Brown, and Hatherly 1997; Gold, Gronewold, and Pott 2012). Another stream examines different designs of auditor's reports (such as 'plain English' report format with the opinion at the end or at the beginning, e.g., Chong and Pflugrath 2008). A third stream examines additional – at least at the time of the respective study not required – information in the auditor's report such as materiality (e.g., Fisher 1990; Davis 2007) or corporate governance information (e.g., Manson and Zaman 2001).

The overarching purpose of the current IAASB initiative with respect to the communication of KAM is to provide information about the auditor's work and, therefore, to enhance the communicative value of the auditor's report for users (IAASB

[1] We are aware of one working paper (Sirois, Bédard, and Bera 2014) that uses eye-tracking technology to examine whether and how additional information on KAM affects how users navigate through and integrate the information presented in the related financial statements. However, Sirois et al. (2014) use post-graduate accounting students as surrogates for the users of financial statements, while we are able to capture users more directly by conducting our experiment with investment professionals. Sirois et al. (2014) find that the communication of additional information is associated with lower perceived audit quality and a perception that the level of assurance varies across components of the financial statements – a result that is contrary to the standard setters' expectation. Christensen, Glover, and Wolfe (2014) also do not use real investment professionals in their study about critical audit matter (CAM) paragraphs, but business school graduates. They find that participants who receive a CAM paragraph emphasizing the audit issue related to the audit of uncertain fair value estimates are more likely to stop investing in the company than participants who receive an auditor's report without a CAM paragraph or who receive the information from the CAM paragraph as part of management's footnotes. However, the effect of the CAM paragraph is mitigated when it is followed by a paragraph offering resolution of the CAM. There are few other working papers that examine the effect of CAM paragraphs on auditor liability (Backof, Bowlin, and Goodson 2014; Brasel, Doxey, Grenier, and Reffett 2015; Gimbar, Hansen, and Ozlanski 2015).

2013, paragraph 7). The objective of this study is to experimentally examine the potential effect of a separate KAM section in the auditor's report as required by ISA 701 on the auditor's report's communicative value for users.

Using a between-subjects experimental design among 89 investment professionals from Germany (82.28 percent), US, UK or Canada (10.12 percent), and other countries around the world (7.60 percent), we test whether the new KAM section in the auditor's report is associated with communicative value for investment professionals. In doing so, we capture the auditor's report's communicative value by two dimensions, the potential to change the user's assessment of the company's economic situation and the user's confidence in making that assessment. With these two dimensions, we capture the main assessments within investment professionals' analyses and/or investment decisions. We therefore assume that the communicative value of the auditor's report changes if user's assessments in either of these two dimensions change.

In our experiment, we manipulate the auditor's report by including a KAM section that relates to goodwill impairment, whereby we refer to the KAM goodwill example in the illustrative auditor's report outlined by the IAASB in its exposure draft '*Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*' (IAASB 2013). Assuming that the specific informational content of the KAM section triggers the different factors in a model of trust in different ways – which in turn has the potential to affect our results – we differentiate between two content-related[2] manipulations: (1) A KAM section suggesting that *already small changes* in the key assumptions could eventually lead to a goodwill impairment. We refer to this manipulation as a KAM section with a negative tendency regarding the

[2] Consequently, the focus of our research differs from other studies where presentation format is manipulated but information content stays the same (see literature review in section 3 for auditor reporting related studies and Libby and Emett (2014) for a recent review of the effects of earnings presentation attributes on manager and user behavior).

company's economic situation, or, in short, KAM negative. (2) A KAM section suggesting that *only large changes* in the key assumptions could eventually lead to a goodwill impairment. We refer to this manipulation as a KAM section with a positive tendency regarding the company's economic situation, or, in short, KAM positive.[3] The control group is provided with the former ISA 700 auditor's report (without separate KAM section).

Intuitively, it seems reasonable to expect the users' assessment of an entity's economic situation to be more negative if the auditor's report includes a KAM section with a rather negative tendency as compared to a KAM section with a rather positive tendency. Regarding our second dimension of communicative value, i.e., the user's confidence in the assessment of the company's economic situation, users should be more confident in their assessment of the company's economic situation if the auditor's report includes a KAM section at all – regardless of the specific KAM tendency. That is because the informational basis for users' assessment becomes larger by the provision of KAM and hence, information asymmetry is reduced in both conditions.

[3] Literally, if the auditor outlines that already small changes in the key assumptions could eventually lead to a goodwill impairment, he or she signals a high risk that an impairment will occur in the future which then would negatively affect net income and hence, the economic situation of the company. On the contrary, if the auditor outlines that only large changes in the key assumptions could eventually lead to a goodwill impairment, he or she signals a low risk that an impairment will occur in the future and hence, a low risk that net income/the economic situation of the company will be affected. Therefore, we refer to the former as KAM negative and to the latter as KAM positive. Furthermore, IASs are silent on specific tendencies of KAM sections. Hence, the communication of KAM does not necessarily imply a negative tendency. In the UK, the reporting of risks of material misstatement, which are considered to be conceptually equivalent to KAM, is required for auditor's reports with effect for periods commencing on or after 1 October 2012. A review of the experience with the new requirements reveals that "goodwill impairment" ranks on the third position among the most reported instances of risks (FRC 2015). Furthermore, an in-depth analysis reveals that the sections on goodwill impairment and other risks within the auditor's reports are not generally conveying negative tendencies (see for example section on risks due to capital restructuring in the auditor's report for New World Resources plc; New World Resources 2014), but also positive tendencies (see for example section on goodwill impairment risks in the auditor's reports for Pearson plc and Greggs plc; Pearson 2014; Greggs 2014). These findings do not only underline the relevance of the goodwill impairment setting we chose for our experiment, but also provide initial anecdotal evidence for the relevance of considering KAM sections with negative and positive tendencies.

However, based on the implications of trust literature and a model of trust, which we propose to applicate in our study in order to explain the potential effect of a new KAM section in the auditor's report on the communicative value for users, expectations change. In line with this theoretical framework, we find that in the KAM negative condition, participants assess the economic situation of the company to be significantly *better* as compared to the KAM positive condition. Correspondingly, the descriptive results indicate that participants' confidence in their assessment is higher in the KAM negative condition. Thus, based on a model of trust we conclude that the specific informational content of the KAM section triggers different factors in the model to different degrees, eventually leading to unequal levels of trust which the investment professionals associate with the auditor's report. This divergence in perceived trustworthiness of the auditor's report will then also alter the perceived trustworthiness of the financial statements and hence, the user's assessments of the company's economic situation and the user's confidence in making that decision. These results suggest that from a users' perspective the KAM section with a positive tendency is rather ill-perceived as a kind of appeasement given the challenges the auditor had faced during the audit, while the KAM section with a negative tendency is rather well-perceived as a helpful signal that draws the users' attention to issues that they had not been aware of before. Thus, neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; in contrast, users value this information positively.

This study contributes to the auditor reporting literature in at least three ways. First, it extends the very scarce literature on the potential effect of the KAM section in the auditor's report on the communicative value for users by using real investment professionals. The participants of our experiment are investment professionals from more than one country which has two main advantages. One, we do not have to refer to surrogates for users, such as graduate accounting students; we rather directly examine the assessment of one of the most important user groups. Two, given that our investment professionals are from more than one country, we believe that our findings are not restricted to a certain jurisdiction. Second, to the best of our knowledge, this is the first study that examines the potential effect of the additional information about KAM in the auditor's report by considering different tendencies of KAM on the communicative value for investment professionals. Our findings are useful for standard setters and auditors by highlighting the importance of carefully phrasing a KAM section, also considering how users' perceive the message conveyed with the KAM section. This aspect is highly relevant because the identification and communication of KAM are subject to the auditor's professional judgment. Third, by referring to a model of trust that theoretically explains why different tendencies of KAM potentially lead to different user's assessments of aspects related to the communicative value, we employ an innovative approach in the auditor reporting literature not used thus far.

The remainder of this study is structured as follows. Section 2 provides background information on the IAASB's initiative to improve the auditor reporting model. Section 3 reports prior research and in section 4, we develop the paper's hypotheses. Section 5 describes the experimental design as well as the participants. Section 6 reports the results as well as robustness checks, and section 7 concludes.

## II. BACKGROUND

Starting point for the IAASB's initiative to enhance the value of auditor reporting is the fact that the auditor's report per se is valued (e.g., Mock, Turner, Gray, and Coram 2009; MARC 2010), but that the message conveyed by the auditor's report beyond the 'pass-fail-conclusion' has been questioned by both regulators and researchers since decades (e.g., Commission on Auditor's Responsibilities 1978; Geiger

1993; Church, Davis, and McCracken 2008; Smieliauskas, Craig, and Amernic 2008; Mock, Bédard, Coram, Davis, Espahbodi, and Warne 2013). A major concern is the little communicative value of the auditor's report and related to that a call for more information primarily on insights into the auditor's work (IAASB 2013). The exposure draft '*Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing (ISAs)*' published by the IAASB in July 2013 is a culmination of IAASB's considerations regarding the auditor reporting topic, to which international research, public consultation, and stakeholder outreach undertaken by the IAASB contributed. Preceding projects in this process are the jointly commissioned international research on user perception of the standard auditor's report, the May 2011 Consultation Paper '*Enhancing the Value of Auditor Reporting: Exploring Options for Change*' (IAASB 2011), the June 2012 Invitation to Comment (ITC) '*Improving the Auditor's Report'* (IAASB 2012), global roundtables and additional outreach to solicit feedback on the indicative direction outlined in the June 2012 ITC, as well as continued monitoring of, and interaction with, policymakers and national standard setters with auditor reporting initiatives (IAASB 2013, 6). One of the key enhancements to auditor reporting suggested is the communication of KAM. After the issuance of an exposure draft in 2013, the final auditing standard ISA 701 '*Communicating Key Audit Matters in the Independent Auditor's Report*' was published in January 2015 and will be effective for audits of financial statements for periods ending on or after December 15, 2016. This standard includes requirements and guidance for the auditor's determination and communication of KAM. KAM have to be communicated in a separate section in the auditor's report for audits of full sets of general purpose financial statements of listed entities. Each KAM has to be described in the KAM section headed "Key Audit Matters" whereby appropriate subheadings have to be used for each individual KAM (IAASB 2015b, paragraph 11). Examples for KAM include for instance: Goodwill, valuation of financial instruments, and effects of new accounting standards (IAASB 2013, IAASB 2015b; see also IAASB 2015a).

In our experiment we use one of the IAASB (2013) KAM examples and refer to goodwill impairments. We only manipulate the KAM section and do not consider the other amendments of the auditor's report resulting from the new Auditor Reporting Model in order to isolate the effect the separate KAM section potentially has on the communicative value of the auditor's report for users. Following this approach, we do not consider any re-ordering of the individual auditor's report sections. Hence, the KAM section in the manipulated report is placed at the end of the auditor's report.

## III. PRIOR RESEARCH

Prior experimental/questionnaire auditor reporting research has primarily focused on the effect of amendments of the auditor's report on the expectation gap or the potential reduction thereof. One stream within this research uses revisions or draft revisions of relevant auditor reporting standards. Bailey et al. (1983) demonstrate that users perceive a shift of financial statement-related responsibilities from the auditor towards management in the desired way due to the suggested wording changes in the auditor's report as proposed by the American Institute of Certified Public Accountants (AICPA). They also find that more experienced and knowledgeable users are better aware of auditor's versus management's responsibilities. In line with the former Bailey et al. (1983) finding, the at that time new Statement on Auditing Standards (SAS) No. 58 '*Reports on Audited Financial Statements*' enhanced the understandability in terms of the audit objective and the responsibilities of management for financial statements (Kelly and Moorweis 1989; Miller et al. 1993). Houghton's and Messier's findings (1991) are also related to SAS No. 58 by showing that the exposure draft auditor's report under SAS No. 58 leads to a better alignment of CPAs' and bankers' assessment of the report. Kneer et al. (1996) support that changed wording in the auditor's report under SAS No. 58 can affect users' perceptions of auditor's responsibilities whereby SAS No. 58 has "achieved modest success" (p. 25). Australia followed the US example of SAS No. 58: The suggested changes to their standard on auditor's reports are content of Statement of Auditing Practice (AUP) No. 3 issued by the Australian Accounting Research Foundation (AARF). While the proposed new version of the auditor's report eliminated some differences between auditors' and various other users' perceptions, for instance in terms of auditors' responsibilities, the changed wording gave also room for new differences in areas not subject of the report, for instance fraud (Monroe and Woodliff 1994). The British analogue to SAS No. 58, Statement of Auditing Standards No. 600 '*Auditor's Reports on Audited Financial Statements*', led to a reduction of the expectation gap (Innes et al. 1997; Manson and Zaman 2001). Gold et al. (2012) use the revised ISA 700 at that time and test whether the related additional explanations in the revised auditor's report reduce the expectation gap. One of their main findings is that the revised ISA 700 does not lead to a reduced expectation gap. Based on that they conclude that the audit opinion alone "may signal sufficient relevant information to users" (p. 286).

Another stream of prior auditor reporting research examines auditor's report format changes on stakeholders' and auditors' perceptions. Chong and Pflugrath (2008) derive three different report formats from the Guidance Note Report to Australian Standard AUS702, namely, an expanded report, a 'plain language' expanded report with the opinion at the end, and a 'plain language' report with the opinion at the beginning. The questionnaire-based findings suggest that both more detailed explanation versions of auditor's reports, for instance regarding responsibilities for the audit, and 'plain language' versions appear unsuccessful attempts to narrow the expectation gap. However, re-ordering of report sections may be beneficial.

A third stream of more recent research examines additional – at the time of the respective study not required – information in the auditor's report. Manson and Zaman (2001) find in their questionnaire-based study that the communication of additional matters in the auditor's report, for instance corporate governance, is useful for users. They also recommend the disclosure of materiality. Consistent with this recommendation are the findings of the experimental economics studies by Fisher (1990) and Davis (2007). Fisher (1990) documents that materiality disclosure leads to greater market efficiency, with public disclosure being more beneficial than private disclosure. Davis (2007) findings show that the disclosure of materiality enhances investor perception accuracy and, thus, has a positive impact on market efficiency. However, market outcomes are not affected by materiality levels. An international survey of members of the CFA Institute (2010) underpins that materiality information would be useful. In addition, the vast majority of the participants want information on the method of determining materiality. The Houghton et al.'s (2011) findings regarding materiality disclosure are more restrained. They also examine the disclosure of materiality levels by conducting face-to-face office interviews with stakeholder groups. However, there are no conclusive findings whether the actual level of tolerable error, as one aspect of materiality, should be disclosed, because such a disclosure might be misleading. In contrast to the other studies, the CFA Institute (2010) survey also examines stakeholders' desires for additional information from the auditor. The participants agree that the audit report should contain more information, in particular on the audit process; auditor independence; and the actual level on assurance achieved in the audit. Another survey of the investor members of the Audit Quality Forum working group (2007) supports that additional auditor disclosures would be useful; areas identified in this survey are: more information about emphases of matter, and references to uncertainty and future risk; discussion of material issues identified in the audit and their resolution; tailored company reports rather than standardized reports; alternative accounting treatments considered and the reasons for adopting the treatment chosen, where material; and more information on material areas of judgment and difficult or sensitive issues. Mock et al. (2013) and Vanstraelen, Schelleman, Meuwissen, and Hofmann (2012) give an overview of the current audit reporting debate and provide insights on users' information needs. One very recent study by Christensen et al. (2014) examines nonprofessional investors' reactions – whereby business school graduates are surrogates for nonprofessional investors – to a CAM paragraph[4] related to the audit of fair value estimates. Their findings show that participants who receive a CAM paragraph are more likely to change their investment decision than participants who receive an auditor's report without a CAM paragraph or who receive the information from the CAM paragraph as part of management's footnote. Moreover, the effect of the KAM paragraph is mitigated when it is followed by a resolution paragraph containing auditor's assurance for the CAM.

Taken together there are only few studies that refer to additional – at the time of the respective study not required – disclosures in the auditor's report whereby the focus is on materiality (Fisher 1990; Manson and Zaman 2001; Davis 2007; CFA Institute 2010; Houghton et al. 2011). Only one very recent study explicitly examines the effect of a CAM paragraph (Christensen et al. 2014). Theoretical work in this area delivers an explanation for that: Previous changes in the auditor's report – may it be due to the provision of additional information or simply due to wording changes – put the main emphasis on providing more information on generalized audit responsibilities rather

[4] CAM are those matters addressed during the audit that (1) involve the most difficult, subjective, or complex auditor judgments; and/or (2) pose the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; and/or (3) pose the most difficulty to the auditor in forming an opinion on the financial statements (PCAOB 2013). CAM paragraphs reflect the Public Company Accounting Oversight Board's (PCAOB) implementation of enhancing the auditor's reporting model in terms of communicating auditor insights to investors about critical audit issues. CAM paragraphs are considered to be conceptually equivalent to KAM paragraphs.

than on audit-specific information, e.g., in terms of auditors' work and, therefore, on findings of the company which has been audited (Humphrey, Moizer, and Turley 1992; Humphrey, Loft, and Woods 2009). Hence, researchers have no basis for an examination of the potential effect of more information about the auditor's work on users' perception. However, researchers argue that additional disclosures in the auditor's report related to audit findings have the potential to enhance the communicative value of the auditor's report and, therefore, recommend such disclosures (Manson and Zaman 2001; Church et al. 2008). Surveys of users' information needs underpin that additional information in the auditor's report would be useful. The concept of communicating KAM in the auditor's report implements this thinking as under the new auditor reporting model matters of most significance in the audit have to be disclosed. The identification of the individual KAM and also the communication of KAM, however, are subject to auditor's professional judgment. Therefore, the disclosure of KAM relates to additional insights into matters that required in particular auditor's effort – information that is very relevant for users. Thus, the communication of KAM should also be linked to the communicative value of the auditor's report for the users.

## IV. HYPOTHESES DEVELOPMENT

To capture the communicative value of the auditor's report for users we refer to two dimensions which constitute our dependent variables: the potential to change the user's assessment of the company's economic situation, and the user's confidence in making that assessment. We consider these two dimensions as they directly reflect the main assessments within investment professionals' analyses and/or investment decisions. We therefore assume that the communicative value of the auditor's report changes if user's assessments in either of these two dimensions change. There is scarce evidence yet on whether the inclusion of a separate KAM section in the auditor's report is linked to the communicative value of the auditor's report for users. Beyond the effect that KAM per se potentially have on the communicative value, we believe that the specific tendency of the KAM section has to be addressed, in order to understand how users' perceive the message conveyed with the KAM section.

This is of particular interest for two reasons. First, the communication of KAM is not standardized, but subject to the circumstances of the audit and the auditor's professional judgment. This implies differences among KAM sections, e.g. in informational content. Second, as we outline in the following, differences in informational content are likely to trigger different factors in a model of trust in different ways which in turn has the potential to affect our results. Consequently, we differentiate between two manipulations of a KAM section relating to goodwill impairment (derived from an IAASB illustrative auditor's report). In a first manipulation, we generate a KAM section with a negative tendency regarding the company's economic situation by formulating the last sentence as follows: "*Already small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future*"; referred to as KAM negative. In a second manipulation, we generate a KAM section with a positive tendency regarding the company's economic situation by formulating the last sentence as follows: "*Only large changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future*"; referred to as KAM positive.[5]

[5] We stay as close as possible to the IAASB wording (IAASB 2013) in phrasing our manipulations (compare original wording in Appendix 1 to the wording of our manipulations in Appendix 2). As compared to the original, we only adjust the last sentence of the KAM section for our manipulations. In order to create a KAM section with a relatively strong negative tendency regarding the company's economic situation (KAM negative), we add the word "already" to the beginning of the original sentence. As outlined above, in comparison to the KAM negative condition we replace "already small" by "only large" in the KAM positive condition. In order to gain access to the investment professionals, we were compelled to keep the experimental materials as compact as possible, i.e., to minimize the time effort for

In many auditor reporting studies, hypotheses are derived from communications literature and communication models (e.g., Hasan, Roebuck, and Simnett 2003), or from a compilation of prior findings (e.g., Gold et al. 2012). Those studies often argue that changes in wording of a report affect the addressees' informational basis and thus alter the respective perceptions. Based on prior literature and in line with the IAASB's implicit objective, with respect to our first dimension of communicative value, we expect that users' assessment of the company's economic situation is affected by the specific informational content of the KAM section.

Intuitively, it seems reasonable to expect the users' assessment of an entity's economic situation to be more negative if the auditor's report includes a KAM section with a rather negative tendency as compared to a KAM section with a rather positive tendency.[6] Regarding the second dimension of communicative value, i.e. the user's confidence in the assessment of the company's economic situation, users should be more confident in their assessment of the company's economic situation if the auditor's report includes a KAM section at all – regardless of the specific KAM tendency. That is because the informational basis for users' assessment becomes larger by the provision of KAM and hence, information asymmetry is reduced in both conditions. However, the provision of directional predictions based on changes of wording is challenging, because the transformation of words into a message is an extremely complex cognitive process (see for example, Fiske 1990).

participants. We therefore could not include manipulation check questions in our main experiment. Instead, we validate our manipulations with individuals from Amazon Mechanical Turk as described in the robustness check section later.

[6] Even if the case of no communication of KAM in the auditor's reports of audits of complete sets of general purpose financial statements for listed entities in the new auditor reporting model should be extremely rare, we need that case as reference case for our analysis. In order to isolate the effect of the specific informational content of the KAM section in our experiment, we further include only one KAM in the auditor's report.

However, based on the implications of trust literature and a model of trust, which we propose to applicate in our study in order to explain the potential effect of a new KAM section in the auditor's report on the communicative value for users, expectations change. Lewicki, McAllister, and Bies (1998) outline that the understanding why people trust and how trust shapes (social) relations has been a major field of research for disciplines like psychology, sociology, political science, anthropology and economics (see also Worchel 1979; Gambetta 1988; Barber 1983; Ekeh 1974; Axelrod 1984). Furthermore, it is argued that trust is essential for a healthy personality (e. g., Shaver and Hazan 1994), provides a foundation for interpersonal relationships as well as for cooperation (e. g., Rempel, Holmes, and Zanna 1985), and constitutes the basis for stability in social institutions and markets (e. g. Williamson 1974). Definitions of trust are manifold. Earlier definitions focus on individuals' confidence in other person's intentions and motives (Mellinger 1956, Read 1962), while more recent research focuses on behavior (Hosmer 1995; Lewicki et al. 1998). Mayer, Davis, and Schoorman (1995, 712) define trust as the "willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party". Similarly, Currall and Judge (1995, 151) define trust as "an individual's behavioral reliance on another person under a condition of risk". Johnson-George and Swap (1982, 1306) suggest that "willingness to take risks may be one of the few characteristics common to all trust situations" and hence, that "there is something of importance to be lost" (Mayer et al. 1995, 712).

An own body of research focuses on understanding and measuring of trust (e. g., Currall and Judge 1995; Cummings and Bromiley 1996; Kramer 1999). Butler (1991) derives a conditions of trust inventory based on a compilation of factors utilized in prior studies (see also Mishra 1996, Sitkin and Roth 1993, who use very similar factors in their studies). Drawing from those studies, Mayer et al. (1995) propose a model of (organizational) trust which is outlined in Figure 1.

[Insert Figure 1 here]

Based on their model, the authors make three propositions all of which are of importance for our study. First, it is argued that trust for a trustee will be a function of the trustee's perceived ability, benevolence, and integrity (and also of the trustor's propensity to trust, which is of minor relevance for our approach). *Ability* captures the trustee's competence, *benevolence*, his or her loyalty, openness, receptivity and availability, and *integrity* aspects like his or her discreetness and fairness (see Figure 1). Thereby, each factor captures unique elements of trustworthiness. Second, it is proposed that the effect of integrity on trust will be most salient early in the relationship prior to the development of meaningful benevolence data. And third, the effect of perceived benevolence on trust will increase over time as the relationship between parties develops.

According to the model, the level of trust in the trustee will – in combination with the perceived risk of the situation – drive the trustor's attitude towards risk taking in the relationship with the trustee. Finally, the observation of outcomes in the specific situation of trust (was the trustor in fact trustworthy?) will influence the perceived trustworthiness and might alter the level of trust and consequently the trustor's attitude towards risk taking in the relationship with the trustee. Trustworthiness also affects, monitors, and guides individuals' actions and attitudes in their interactions (Kasper-Fuehrera and Ashkanasy 2001). Specifically, perceived trustworthiness reduces suspicion and increases openness toward the trustor (Shinners 2009; Szulanski, Cappetta, and Jensen 2004). Jones (1996, 5) argues, that "to trust someone is to have an attitude of optimism about" that person. Other studies find that trust has a positive effect on perceived accuracy of information provided (Benton, Gelber, Kelley, and Liebling 1969; Roberts and O'Reilly 1974) and a negative effect on the perceived probability of loss (Nooteboom, Berger, and Noorderhaven 1997). To summarize, "the effects of trust on attitudes and perceptions have been found to be fairly consistent and positive" (Langfred 2004, 385).

Drawing from the outlined conceptions of trust, we argue that the communication between auditor and user based on the auditor's report constitutes a situation of trust. The users base their investment decisions (in case of investors) or their analyses (in case of financial analysts/investment professionals) on financial statements and auditor's reports. Users rely on the trustworthiness of financial statement providers and auditors, with their money or reputation being at stake. Decisions and analyses will be driven by perceived assurance provided by the auditor and the (resulting) perceived credibility of the financial statement, or – in other words – by their trustworthiness. Consequently, differences in perceived trustworthiness related to the auditor's report will also alter the perceived trustworthiness of the financial statements.

In this study, we apply the outlined model of trust to our experimental setting. We argue that the two different KAM sections applied in this study (KAM positive vs. KAM negative) trigger different factors in the model to different degrees and hence lead to unequal levels of trust which the investment professionals associate with the auditor's report. Furthermore, we argue that this in turn leads to different levels of trust in, i.e., credibility of, the financial statements and, therefore, to a different user's assessment of the company's economic situation and different user's confidence in making that assessment.

Appendix 2 outlines the wording of the KAM section with positive and negative tendency. We expect that the specific differences in informational content mainly trigger the following drivers of perceived trustworthiness of the trustee (see Figure 1): competence, loyalty, openness, fairness and promise fulfillment. The other drivers being part of the model of trust (receptivity, availability, consistency and discreetness) rather imply direct and/or repetitive *interaction* between trustee and trustor and therefore do not match our setting very well. However, although we expect differences in the user's assessment of the company's economic situation, as well as in the user's confidence in making that assessment, due to different levels of trust, directional prediction based on theoretical deliberations seem ambitious, not least because the model of trust has not been used in auditor reporting literature.

Therefore, in order to validate our argumentation and the application of the model of trust in the context of our study, as well as to derive directional hypotheses, we conduct an online pioneer experiment with 81 participants (21 accounting students and 60 individuals from Amazon Mechanical Turk).[7] As we expect that the average participant can finish the pioneer experiment within about five minutes, we exclude those participants who worked on the experiment less than 120 seconds, as they clearly did not invest due effort, and end up with a final sample of 52 observations.[8] In this pioneer experiment, we instruct participants to assume that they work as an investment professionals and that their task is to assess the economic situation of a fictitious group – the Alpha Group. We provide participants with background information about the goodwill recognized by the group. The information is very similar to the information



[7] We were compelled to keep the experimental materials as compact as possible, i.e., to minimize the time effort for participants, in order to gain access to the investment professionals. Hence, validating the application of the model of trust with the participants of our main experiment, for example through an additional post experimental questionnaire, was not an option. Instead, we argue that the utilization of accounting students and individuals from Amazon Mechanical Turk was adequate for validation purposes, as the pioneer experiment does not necessarily rely on context-specific knowledge of the participants. The designs of all experiments in this paper meet the requirements for using human subjects in the experimental laboratory at the university where the lead author is located. The use of human subjects was also approved by the institutions where the main experiment with investment professionals was conducted, i.e. German Association of Financial Analysts and CFA Institute.

[8] Excluding more participants by setting higher duration thresholds does not change the results of the pioneer experiment substantially.

that we provide in our main experiment which we will describe in detail below (goodwill paragraph within the notes). In comparison to the main experiment, we include further basic explanations related to goodwill impairment in order to facilitate comprehension of the information provided. Participants are then instructed to read additional information which is made available by the auditor ("information provider") of the Alpha Group. Applying a between-subjects design, participants are thereby randomly either provided with the KAM section with negative or positive tendency (see Appendix 2). Finally, participants are asked to answer a set of 12 questions: 11 questions relate to different drivers of perceived trustworthiness within the model of trust (see Table 1 for details), while we capture the overall level of trust between the information provider and the participant with a final question. We utilize a structural equation model which mirrors the structure of the model of trust (see Figure 1) and analyze our data with smart PLS software (all constructs in the model are specified reflectively).

[Insert Table 1 here]

In a first step, we estimate the structural equation model for the full sample (KAM with negative *and* KAM with positive tendency) in order to show that the application of the model of trust in the context of KAM communication is adequate. In a second step, in order to carve out the moderating effect of the two different KAM sections on the overall level of trust, we apply a two-step approach. In a first step, we oppose model estimation results for the KAM section with negative (24 observations) and KAM section with positive (28 observations) tendency sample, respectively (group comparison approach in line with, for example, Rigdon, Schumacker, and Wothke 1998). In a second step, we explicitly include moderating effects as product terms into the (full sample) structural equation model (Henseler and Fassott 2010). Table 2 outlines the model estimation results. The explanatory power of the structural equation model is high for all estimations, as we yield an $R^2$ of 0.814/0.891/0.781/0.830/0.829 for the endogenous latent variable "trust" with the full sample/KAM with negative tendency sample/KAM with positive tendency sample/inclusion of moderator tendency of KAM*ability/inclusion of moderator tendency of KAM*integrity. The structural equation and measurement model quality criteria are generally met for all estimations (untabulated).

[Insert Table 2 here]

For the full sample, effects from the exogenous constructs "ability" and "integrity" on "trust" are positive and significant (path coefficients of 0.179 and 0.626, respectively). Furthermore, we yield higher positive path coefficients from "ability" and "integrity" on "trust" for the KAM with negative tendency sample as compared to the KAM with positive tendency sample. This suggests that the KAM section with negative tendency leads to a significantly higher level of trust in the trustee (auditor) as compared to the KAM section with positive tendency. The inclusion of moderating effects as product terms between a binary variable "tendency of KAM" (KAM with negative tendency = 0; KAM with positive tendency = 1) and the indicators associated with "ability" and "integrity" (the exogenous constructs with significant impact on "trust") confirms this conclusion, as we yield significantly negative path coefficients for both moderators. Overall, the results of our pioneer experiment confirm our assumption that potential effects of including KAM sections with different informational content into the auditor's report on the communicative value for users can be explained in light of implications of trust literature and a model of trust. In particular, we have shown that informational content of KAM is relevant. The KAM section indicating a negative tendency regarding the company's economic situation (KAM negative) leads to a significantly higher level of trust in the trustee (auditor) as compared to the KAM section indicating a positive tendency regarding the company's economic situation (KAM positive).

We argue that the KAM section with positive tendency might in fact be ill-perceived as a kind of appeasement given the challenges the auditor had faced during the audit. This would imply, inter alia, *lower* levels of perceived openness and fairness. On the contrary, a KAM section with negative tendency might be well-perceived as a helpful signal that draws the users' attention to issues that they had not been aware of before. This would imply, inter alia, *higher* levels of perceived openness and fairness (and possibly also competence). Consequently, a KAM section with negative tendency leads to a significantly higher level of trust in the trustee (auditor) as compared to a KAM section with positive tendency. Hence, in line with the implications of trust literature, the trustor (user) is less sensitive to risk, less suspicious and more open toward the auditor and associates higher levels of trust with the auditor's report (see for example, Kim, Ferrin, and Rao 2008; Klein and Shtudiner 2015; Guiso, Sapienza, and Zingales 2008). This leads (1) to a higher perceived trustworthiness of the financial statements and, consequently, (2) in line with the positive effect of trust on attitudes and perceptions of the trustor consistently found in the other mentioned studies, to a better assessment of the company's economic situation. In addition, it seems reasonable to assume that the user has more confidence in the assessment when he or she is less sensitive to risk, less suspicious, more open, and perceives the KAM section as an information sign that draws the attention to issues that he or she has not been aware of before.

Based on the outlined theoretical implications and the empirical validation of our argumentation, we formally state the following hypotheses:

*H1: Users assess the company's economic situation more positively if the auditor's report includes a KAM section with a negative tendency compared to a KAM section with a positive tendency.*

*H2: Users' confidence in their assessment of the company's economic situation is higher if the auditor's report includes a KAM section with a negative tendency compared to a KAM section with a positive tendency.*

## V. RESEARCH DESIGN

### Research Instrument

In order to make our experiment most accessible for participants and to increase the number of participations, we develop a web-based and a paper-and-pencil version of our research instrument. The web-based participants receive an invitation email with a link which opens a browser window with the first page of the experiment. On the first page, participants are instructed to carefully read the introduction on this page before working on the case study. Participants learn that they will be provided with information concerning the Alpha Group and that they will be asked for their assessments related to different economic issues and also for more general questions. Participants are also instructed to base their assessments only on information provided within the case study, that there is no possibility to receive further information concerning the Alpha Group, to work on the case study by themselves and in the given order, and to provide all required answers. Finally, we assure that responses will be analyzed on an aggregate basis and that individual answers and personal information will be treated confidentially and only used for research purposes. By clicking the button “Continue”, participants then access the case itself.

On the second page, all participants receive short background information about the Alpha Group and comprehensive excerpts of the group’s annual report which consist of a consolidated income statement, statement of cash flow, balance sheet, other financial data (for financial years 2011 and 2012, respectively) and notes according to International Financial Reporting Standards (IFRS). In addition, participants receive a full auditor’s report. All information elements are arranged one below the other and participants can scroll up and down to process the excerpts of the Alpha Group’s annual report.

While the Alpha Group itself is fictitious, we are guided by the financial statements of a real German medium-sized group within solar industry in setting up the experimental case. To avoid that our participants recognize the Alpha Group's real counterpart, we multiply all (balance sheet etc.) items with the same factor and change the industry in which the Alpha Group operates from solar to industrial machinery. In order to allow for meaningful variation in the assessment of the economic situation of the company and the confidence in that assessment, i.e., in order to avoid large proportions of answers on either end of the scales, we decided that the Alpha Group should neither be in financial distress nor economically booming. Therefore, the Alpha Group (as well as its real counterpart) is a financially stable group with a significant decline in profits from 2011 to 2012 (changes in operating income/profit for financial year -93.16 percent/-104.26 percent) driven by, among other things, declining sales revenue (-21.80 percent). We also believe that the decline in profits generally motivates participants to assess the provided information about the Alpha Group in more detail.

As we manipulate a goodwill-related KAM section in the auditor's report, the goodwill recognized by the Alpha Group as well as the related note is of particular interest for our study. By analyzing the respective balance sheet item and note, participants learn that the Alpha Group recognizes a goodwill with a carrying amount of 5,107 T Euro (26.01 percent of non-current assets/7.32 percent of total assets) and that the goodwill arose when the Beta AG (public limited company) and the Gamma GmbH (limited liability company) were purchased and merged with the Alpha Group. Furthermore, the note contains information about the impairment test procedure in general and states that the findings of the impairment test indicate no need for any impairment (in 2012).

Finally, the auditor's report is presented to the participants below the other information as part of the extracts of the Alpha Group's annual report. We apply a between-subjects experimental design in which we manipulate the informational content of a KAM section in the auditor's report. In the experimental groups we oppose two auditor's reports with different tendencies of the KAM section (as explained above) based on the goodwill-related KAM example provided in IAASB (2013) (see Appendix 1 for original wording and Appendix 2 for wording of our manipulations). In the control group, participants are presented with the former standard IAS 700 auditor's report (without KAM section).

At the end of the described second page of the web-based experiment (below the auditor's report), participants are instructed to click the "Continue" button and to answer the then following questions. They are also informed that they have the possibility to return to the excerpts of the annual report after reading the respective questions by using a "Back" button. The two questions on the third page of the experiment capture our dependent variables and constitute the experimental task. We ask participants to assess the Alpha Group's economic situation and the confidence in making that assessment on 11-points Likert scales (see Table 3 for questions and endpoints of the scales) – with these two dimensions we capture the communicative value of the auditor's report as they directly reflect the main assessments within investment professionals' analyses and/or investment decisions. We therefore assume that the communicative value of the auditor's report changes if user's assessments in either of these two dimensions change.

[Insert Table 3 here]

After answering the questions on the third page of the experiment, participants click on "Continue" and open the fourth page, where they are informed that it is not possible to return to the excerpts of the annual report anymore. Participants are then instructed to rate the relevance of each element of the provided excerpts of the Alpha Group's annual report (including auditor's report) for the assessment of the economic situation and to indicate how each of the elements changed their confidence in their assessment on five-points Likert scales (from "not relevant at all"/"high decrease in confidence" to "extremely relevant"/"high increase in confidence"). Finally, we gather demographic information on the fifth page and thank the participants for their participation on the sixth page.

Procedures, instructions and case materials for the paper-and-pencil version of the experiment are identical to the above described (analogously adapted where necessary). While we ensured technically that participants work on the experiment in the described sequence and that revisions of given answers are not possible in the web-based experiment, we split up the case material to two envelopes which have to be opened and sealed in a specific sequence for the paper-and-pencil experiment to implement similar controls.

**Participants**

We gained access to the CFA Institute (CFA – Certified Financial Analyst) with more than 123,000 members in 145 countries and to the DVFA (German Association of Financial Analysts) with more than 1,400 members in Germany. For the web-based experiment, the invitation email is sent out to a CFA Institute survey pool (with members from all over the world) and to all DVFA members. The paper-and-pencil experiment is conducted during several training sessions at the DVFA headquarters with investment professionals by one of the authors in turn.

We derive 14 participants from the CFA Institute (web-based) and 24/51 participants from the DVFA (web-based/paper-and-pencil) subjects pool (7 more web-based observations were deleted due to discontinuation of participation), yielding the final sample of 89 participants analyzed below (we do not identify further need to exclude individual observations from the analysis). As outlined in Table 4, the average age of our participants is 37.66 years. 79.75 percent of the participants are male, 82.28 percent of the participants come from Germany, 10.12 percent from the USA, UK or Canada (decreasing order) and 7.60 percent from other countries around the world. 81.40 percent of the participants work as investment professionals for on average 10.53 years. Of those participants working as investment professionals, 26.67 percent are bankers, 21.33 percent are (sell- or buy-side) financial analysts, 18.67 percent are asset managers, 5.33 percent are investment bankers, 5.33 percent are consultants, 4.00 percent are funds managers and 18.67 percent work in none of the outlined professions. Most participants mainly work with equity investments (35.92 percent), corporate bonds (21.36 percent) or sovereign bonds (12.62 percent). Our participants' experience with personal capital market investments is moderate to considerable (with an average of 3.45 on a 5-points Likert scale, see Table 4 for endpoints).

[Insert Table 4 here]

## VI. RESULTS

### Descriptive Analysis

Figure 2 outlines the results of our descriptive analysis for the two dependent variables. The excerpts of the annual report of the Alpha Group in combination with the former ISA 700 auditor's report (control group) lead to a mean user's assessment of the economic situation of 4.32 and to a mean user's confidence in this assessment of 6.20 (on 11-points Likert scales; see Table 3 for the respective endpoints of the scales). Hence, participants tend to assess the economic situation of the Alpha Group to be slightly negative and tend to be relatively confident in their assessment. In the KAM negative experimental group, participants' assessments of the economic situation are more positive with higher associated confidence in comparison to the control group, leading to means of 5.16 and 6.48, respectively. On the contrary, for the KAM positive experimental group, we find more negative assessments of the economic situation (4.03) with lower associated confidence (6.00) in comparison to the control group. Summarizing, the descriptive analysis suggests that there is a considerable difference in means for both dependent variables between the experimental groups. Furthermore, especially the KAM negative manipulation leads to considerable reactions to that information (see also Table 5).

[Insert Figure 2 and Table 5 here]

For all other variables outlined in Table 5 (relevance of individual elements of the annual report for the assessment of the economic situation and change in confidence due to individual elements) differences in means between groups are small and there is no obvious pattern. In general, the income statement seems to be the most relevant source of information for our participants, followed by the cash flow statement and the balance sheet (across-groups). The relevance of the auditor's report for the assessment of the economic situation is fairly low for all groups. Interestingly, although not statistically significant, mean assessments for the relevance of the auditor's report follow the pattern we observe for our dependent variables: the relevance is lowest for the KAM positive and highest for the KAM negative group. This makes sense in light of the theoretical framework we apply, because information can only be *relevant* if it is *trustworthy*.

**Analysis of Variance**

Table 6 outlines the results of the ANOVA applied to analyze the data for the assessment of the company's economic situation. First, group means for the former ISA

700/KAM positive/KAM negative condition differ significantly (p = 0.0529). A post-hoc mean comparison test reveals that the mean user's assessment of the economic situation of the Alpha Group is significantly more positive in the KAM section with a negative tendency as compared to the KAM section with a positive tendency condition (p = 0.057/0.063/0.056 based on Bonferroni/Scheffe/Sidak adjustment of confidence intervals). Hence, we can support our first hypothesis $H_1$. While the descriptive analysis revealed that the user's confidence in the assessment of the economic situation in the KAM section with a negative tendency as compared to the KAM section with a positive tendency condition is considerably higher – which is in line with our second hypothesis $H_2$ – the difference is non-significant in an ANOVA analysis (untabulated). Hence, the ANOVA does not support the descriptive result.

[Insert Table 6 here]

**Robustness Check**

To validate our findings, we utilize ANCOVA and regression techniques and include diverse covariates and control variables (relevance of/change in confidence due to individual items and demographic variables) for which theory or prior studies suggest an influence. While those analyses confirm the reported findings, we do not yield significant interactions or other results.

Furthermore, we validate our manipulations with 79 individuals from Amazon Mechanical Turk. All considered 79 individuals answered a simple accounting-related question correctly, with which we assure that the participants have a very basic knowledge of the matter.[9] We utilize the design of our pioneer experiment described

[9] We asked participants to choose the correct ending to the sentence "A company's equity is equivalent to…" out of three provided options: "…assets minus liabilities" (correct answer), "…current assets plus non-current assets" and "…profit before tax (EBT) minus operating income (EBIT)". Of originally 100 participants, 21 failed to indicate the correct answer.

above. Instead of the questions outlined there, we ask a set of questions in both KAM conditions (between subjects) which relate to the understanding/perception of the manipulation (random order of questions; see Table 7 for the questions). As can be seen in Table 7, participants' response pattern suggest that our manipulations were successful. In particular, as intended, the message conveyed with the last sentence of the KAM section (our manipulation) is perceived to be a significantly negative (positive) signal concerning the economic situation of the Alpha Group in the KAM negative (positive) condition. Furthermore, participants' assessment of the risk that a goodwill impairment will occur is high in the KAM negative and low in the KAM positive condition (means differ significantly from the midpoint "4" of the scale). The results for two other questions (see Table 7 for details) confirm that the manipulations were successful, but are less distinct. Overall, participants' reaction seems to be more intense in case of the KAM negative as compared to the KAM positive manipulation. This could provide an explanation for the dissimilar magnitude of effects described in the main experiment, but does not harm our findings in any way.

[Insert Table 7 here]

## VII. CONCLUSION

With the new auditing standard ISA 701, the IAASB has recently introduced a separate section in the auditor's report of audits of full sets of general purpose financial statements that communicates so-called key audit matters (KAM), i.e., matters that were of most significance in the audit. The intention thereby is to provide users with more information about the auditor's work and, thus, to enhance the communicative value of the auditor's report. In this study, we experimentally examine the potential effect of a separate KAM section in the auditor's report on its communicative value for users. In doing so, we capture the auditor's report's communicative value by two dimensions, the potential different user's assessment of the company's economic situation and the user's confidence in making that assessment as these two dimensions directly reflect the main assessments within investment professionals' analyses and/or investment decisions. We therefore assume that the communicative value of the auditor's report changes if user's assessments in either of these two dimensions change.

Assuming that the specific informational content of the KAM section triggers different factors in a model of trust in different ways – which in turn has the potential to affect our results – we differentiate between two content-related manipulations: (1) A KAM section suggesting that *already small* changes in the key assumptions could eventually lead to a goodwill impairment (KAM negative). (2) A KAM section suggesting that *only large* changes in the key assumptions could eventually lead to a goodwill impairment (KAM positive). The control group is provided with the former ISA 700 auditor's report (without separate KAM section).

We find that in the KAM negative condition, participants assess the economic situation of the company to be significantly better as compared to the KAM positive condition. Correspondingly, the descriptive results indicate that participants' confidence in their assessment is higher in the KAM negative condition. We interpret the results in the light of a model of trust and conclude that the specific informational content of the KAM section triggers different factors in the model to different degrees, eventually leading to unequal levels of trust which the investment professionals associate with the auditor's report. This divergence in perceived trustworthiness related to the auditor's report will then also alter the perceived trustworthiness of the financial statements and hence user's assessments of the company's economic situation and the user's confidence in making that decision. These results suggest that the KAM section with a positive tendency is rather ill-perceived by users as a kind of appeasement given the challenges the auditor had faced during the audit, while the KAM section with a negative tendency is rather well-perceived as a helpful signal that draws the users' attention to issues that they had not been aware of before. Thus, neither preparers nor audit committees or auditors need to fear that the disclosure of critical entity-related information leads to negative implications; in contrast, users value this information positively.

This study contributes to the auditor reporting literature in at least three ways. First, it extends the very scarce literature on the potential effect of the KAM section in the auditor's report on the communicative value for users by using real investment professionals. The participants of our experiment are investment professionals from more than one country which has two main advantages. One, we do not have to refer to surrogates for users, such as graduate accounting students; we rather directly examine the assessment of one of the most important user groups. Two, given that our investment professionals are from more than one country, we believe that our findings are not restricted to a certain jurisdiction. Second, to the best of our knowledge, this is the first study that examines the potential effect of the additional information about KAM in the auditor's report by considering different tendencies of KAM on the communicative value for investment professionals. Our findings are useful for standard setters and auditors by highlighting the importance of carefully phrasing a KAM section, also considering how users' perceive the message conveyed with the KAM section. This aspect is highly relevant because the identification and communication of KAM are subject to the auditor's professional judgment. Third, by referring to a model of trust that theoretically explains why different tendencies of KAM potentially lead to different user's assessments of aspects related to the communicative value, we employ an innovative approach in the auditor reporting literature not used thus far.

Our study is of course not without limitations. We employ an experimental approach in which we manipulate the informational content of one KAM example in a specific setting. Consequently, our findings mainly depend on our manipulations and the setting. However, it seems reasonable to assume that the KAM example in the IAASB illustrative auditor's report, from which we carefully derive our manipulations, is of significant practical relevance and may also be used by auditors as a general pattern. Furthermore, based on the implications of the model of trust, it seems reasonable to assume that *any* KAM section with a (strong) positive or negative tendency bears the risk of possibly unexpected users' perceptions. Also, unlike many other studies, our study relies on real investment professionals as participants. Accordingly, our findings reflect expert knowledge and experience applied in a relatively realistic scenario. The generalizability of our results might therefore be greater in comparison to many other experimental studies.

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**FIGURES**

Figure 1: Model of Trust

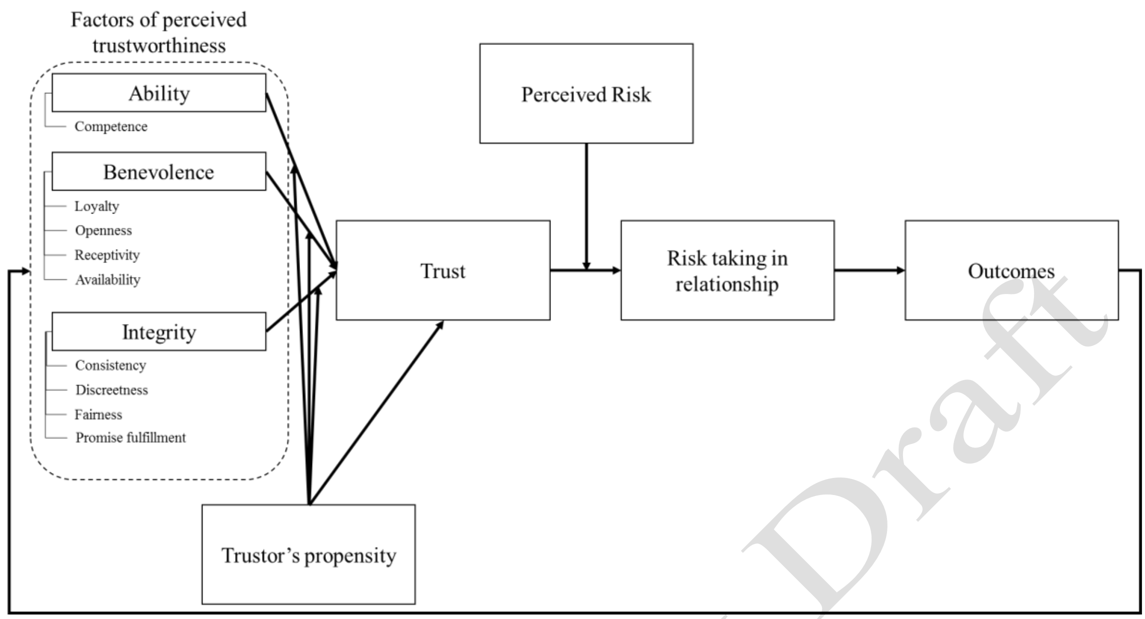
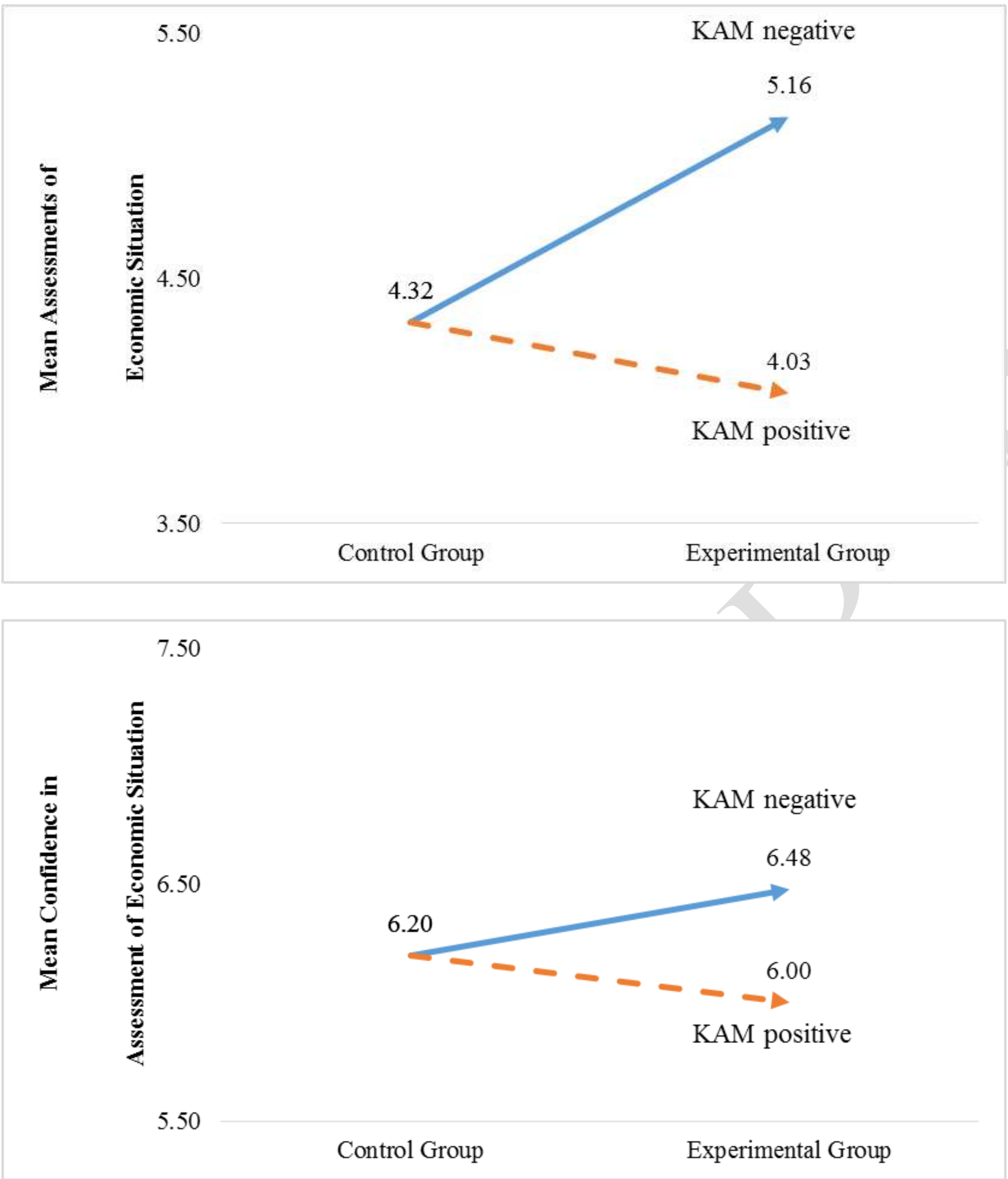


Figure 2: Descriptive Results for Dependent Variables



# TABLES

Table 1: Constructs, Factors, Indicators, and respective Questions in the Pioneer Experiment

| Construct | Factor | Indicator | Question |
|---|---|---|---|
| Ability | Competence | $x_{11}$ | My level of confidence that the information provider is technically competent at the critical elements of his or her job is… |
| | | $x_{12}$ | My level of confidence that the information provider has an acceptable level of understanding of his or her job is… |
| | | $x_{13}$ | My level of confidence that the information provider will be able to do his or her job in an acceptable manner is… |
| | | $x_{14}$ | My level of confidence that the information provider will make well thought out decisions about his or her job is… |
| Benevolence | Loyalty | $x_{21}$ | My level of confidence that the information provider is on my side is… |
| | | $x_{22}$ | My level of confidence that the information provider acts in my best interest is… |
| | Openness | $x_{23}$ | My level of confidence that the information provider shares all known and relevant information about important issues even if there is a possibility that the information might jeopardize my interest in the Alpha Group is… |
| | | $x_{24}$ | My level of confidence that the information provider openly addresses difficulties is… |
| | | $x_{25}$ | My level of confidence that the information provider provides me with precise information is… |
| Integrity | Fairness | $x_{31}$ | My level of confidence that the information provider will treat me fairly is… |
| | Promise Fulfillment | $x_{32}$ | My level of confidence that I can rely on what the information provider tells me is… |
| Trust | Trust | $y_{11}$ | The level of trust between the information provider and myself is… |
| | | | Scale: [nearly zero; very high] |

Table 2: Predictors and Path Coefficients in the Pioneer Experiment

| **Criterion** *Group* | **Predictors** | **$R^2$** | **Path coefficient** |
|---|---|---|---|
| **Trust** | Ability | 0.814 | **0.179 |
| *Full Sample* | Benevolence | | 0.159 |
| | Integrity | | ***0.626 |
| **Trust** | Ability | 0.891 | *0.264 |
| *KAM Negative* | Benevolence | | 0.098 |
| | Integrity | | ***0.645 |
| **Trust** | Ability | 0.781 | 0.140 |
| *KAM Positive* | Benevolence | | 0.228 |
| | Integrity | | **0.570 |
| **Trust** | Ability | 0.830/ 0.829 | ***0.238/ **0.213 |
| *Full Sample* | Benevolence | | 0.142/ 0.145 |
| *with Moderators* | Integrity | | ***0.609/***0.630 |
| | Moderator Ability | | *-0.135/ |
| | Moderator Integrity | | / *-0.127 |

*** significant at <0.01 level, ** significant at <0.05 level, * significant at <0.10 level (two-tailed tests)

Table 3: Dependent Variables and Questions in the Main Experiment

| **Variable** | **Question**<br>**[Endpoints of the Scale]** |
|---|---|
| Assessment of Economic Situation | How do you assess the economic situation of the Alpha Group based on the provided excerpts of the annual report including the auditor's report?<br>[extremely negative; extremely positive] |
| Confidence in Assessment of Economic Situation | How confident are you in your assessment of the economic situation of the Alpha Group based on the provided excerpts of the annual report including the auditor's report?<br>[not confident at all; absolutely confident] |

Table 4: Demographic Data of Participants in the Main Experiment

| Variables | Parameter | Category/Scale | Value |
|---|---|---|---|
| Observations | Count | Total | 89 |
| | | *web-based* | *38* |
| | | *paper-and-pencil* | *51* |
| Age | Mean | Years | 37.66 |
| Gender | Percentage | Male | 79.75 |
| | | Female | 20.25 |
| Country of Origin | Percentage | Germany | 82.28 |
| | | USA, UK, Canada | 10.12 |
| | | Other | 7.60 |
| Occupation | Percentage | Investment Professional | 81.40 |
| | | Other | 18.60 |
| Experience as Investment Professional | Mean | Work Years | 10.53 |
| Category of Investment Professional | Percentage | Banker | 26.67 |
| | | Financial Analyst (sell-/buy-side) | 21.33 |
| | | Asset Manager | 18.67 |
| | | Investment Banker | 5.33 |
| | | Consultant | 5.33 |
| | | Funds Manager | 4.00 |
| | | Other | 18.67 |
| Focus of Activity as Investment Professional | Percentage | Equity | 35.92 |
| | | Corporate Bonds | 21.36 |
| | | Sovereign Bonds | 12.62 |
| | | Real Estate | 4.85 |
| | | Money Markets | 2.91 |
| | | Other | 22.34 |
| Experience with Personal Capital Market Investments | Mean | [No experience = 1; Extensive Experience = 5] | 3.45 |

Table 5: Descriptive Results for the Main Experiment

| Variables | Coding [Endpoints of scale] | Group<br>Former ISA 700 | <br>KAM Negative | <br>KAM Positive |
|---|---|---|---|---|
| | | Mean / SD (Number of Observations) | | |
| Assessment of Economic Situation | 1 - 11 [extremely negative; extremely positive] | 4.32 / 1.80 (25) | 5.16 / 2.18 (31) | 4.03 / 1.60 (32) |
| Confidence in Assessment of Economic Situation | 1 - 11 [not confident at all; absolutely confident] | 6.20 / 2.65 (25) | 6.48 / 2.31 (31) | 6.00 / 2.16 (31) |
| Relevance Income Statement for Assessment of Economic Situation | 1 – 5 [not relevant at all; extremely relevant] | 3.73 / 1.12 (26) | 4.10 / 0.98 (31) | 4.19 / 0.82 (32) |
| Relevance Cash Flow Statement for Assessment of Economic Situation | | 3.88 / 1.11 (26) | 3.94 / 1.09 (31) | 3.97 / 0.97 (32) |
| Relevance Balance Sheet for Assessment of Economic Situation | | 3.62 / 1.13 (26) | 3.71 / 0.97 (31) | 3.84 / 0.81 (32) |
| Relevance Other Financial Data for Assessment of Economic Situation | | 2.96 / 1.22 (26) | 2.65 / 1.05 (31) | 2.72 / 0.77 (32) |
| Relevance Notes for Assessment of Economic Situation | | 2.84 / 1.03 (25) | 2.87 / 0.85 (31) | 2.66 / 0.94 (32) |
| Relevance Auditors' Report for Assessment of Economic Situation | | 2.38 / 0.94 (26) | 2.61 / 1.20 (31) | 2.25 / 0.80 (32) |
| Change Confidence due to Income Statement | 1 – 5 [high decrease in conf.; high increase in conf.] | 3.23 / 1.03 (26) | 3.16 / 1.34 (31) | 3.06 / 1.29 (32) |
| Change Confidence due to Cash Flow Statement | | 3.42 / 0.99 (26) | 3.39 / 1.17 (31) | 3.22 / 1.13 (32) |
| Change Confidence due to Balance Sheet | | 3.15 / 0.88 (26) | 3.61 / 1.02 (31) | 3.38 / 0.83 (32) |
| Change Confidence due to Other Financial Data | | 3.12 / 0.44 (25) | 2.97 / 0.75 (31) | 3.03 / 0.86 (32) |
| Change Confidence due to Notes | | 3.00 / 0.63 (26) | 2.80 / 0.89 (30) | 2.91 / 0.69 (32) |
| Change Confidence due to Auditors' Report | | 3.00 / 0.63 (26) | 2.74 / 0.96 (31) | 3.00 / 0.62 (32) |

Table 6: Results for the ANOVA (Main Experiment, Variable "Assessment of Economic Situation")

| **Source** | **SS** | **df** | **MS** | **F** | **Prob > F** |
|---|---|---|---|---|---|
| Between Groups | 21.386338 | 2 | 10.693169 | 3.04 | 0.0529 |
| Within Groups | 298.602298 | 85 | 3.51296822 | | |
| Total | 319.988636 | 87 | 3.6780303 | | |

| | | |
|---|---|---|
| Bartlett's Test for Equal Variances: | chi2(2) = 2.9704 | Prob > chi2 = 0.226 |

| **Mean Difference [Significance Bonferroni/Scheffe/Sidak]** | Former ISA 700 | KAM Negative |
|---|---|---|
| KAM Negative | 0.84129<br>[0.296 / 0.254 / 0.268] | - |
| KAM Positive | -0.28875<br>[1.00 / 0.847 / 0.918] | -1.13004<br>[0.057 / 0.063 / 0.056] |

Table 7: Results for the Manipulation Check Experiment

| *Question* **[Endpoints of a 7-points-Likert-Scale]** | **KAM negative (41 observations)** *Mean* | *SD* | *Median* | *Modus* | **KAM positive (38 observations)** *Mean* | *SD* | *Median* | *Modus* |
|---|---|---|---|---|---|---|---|---|
| *Is the message conveyed with the last sentence (in boldface) of the information above a positive or a negative signal concerning the economic situation of the Alpha Group?* **[Very positive; Very negative]** | 5.05*** | 1.38 | 5 | 6 | 3.34*** | 1.49 | 3.5 | 4 |
| *How do you assess the risk for the Alpha Group that a goodwill impairment will occur?* **[Very low; Very high]** | 4.66*** | 1.24 | 5 | 5 | 3.55** | 1.52 | 3 | 3 |
| *How robust is the calculation of the goodwill recognized by the Alpha Group against changes in the underlying assumptions used by management?* **[Very robust; Not very robust]** | 4.27 | 1.45 | 4 | 4 | 3.76 | 1.44 | 4 | 5 |
| *A goodwill impairment impacts the Alpha Group's income…* | …positively. 7 | | …negatively. 34 | | …positively. 17 | | …negatively. 21 | |

***: mean differs from midpoint of the scale at 1%-significance-level (one-tailed t-test)

**: mean differs from midpoint of the scale at 5%-significance-level (one-tailed t-test)

**Appendix 1: Illustrative Auditor's Report (IAASB 2013)**

## INDEPENDENT AUDITOR'S REPORT

**To the Shareholders of ABC Company [or Other Appropriate Addressee]**

**Report on the Audit of the Consolidated Financial Statements[3]**

**Opinion**

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, (*or give a true and fair view of*) the consolidated financial position of ABC Company and its subsidiaries (the Group) as at December 31, 20X1, and (*of*) their consolidated financial performance and their consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

We have audited the consolidated financial statements of the Group, which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

**Basis for Opinion**

We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group within the meaning of [*indicate relevant ethical requirements or applicable law or regulation*] and have fulfilled our other responsibilities under those ethical requirements. (see Question 11) We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

**Key Audit Matters** (see Questions 1-8)

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with [*those charged with governance*], but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.

*The four specific topics and content presented below are purely for illustrative purposes. This section would be tailored to the facts and circumstances of the individual audit engagement and the entity. Accordingly, the IAASB has intentionally drafted these examples in a manner that illustrates that Key Audit Matters will vary in terms of the number and selection of topics addressed and the nature in which they may be described, and are intended to be consistent with the disclosures in the entity's consolidated financial statements.*

*Goodwill*

Under IFRSs, the Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in [*Countries X and Y*]. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Group, in particular those relating to the

[3] The sub-title "Report on the Audit of the Consolidated Financial Statements" is unnecessary in circumstances when the second sub-title "Report on Other Legal and Regulatory Requirements" is not applicable.

forecasted revenue growth and profit margins for [*name of business lines*]. We also focused on the adequacy of the Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill. The Group's disclosures about goodwill are included in Note 3, which specifically explains that small changes in the key assumptions used could give rise to an impairment of the goodwill balance in the future.

*Valuation of Financial Instruments*

The Group's disclosures about its structured financial instruments are included in Note 5. The Group's investments in structured financial instruments represent [*x%*] of the total amount of its financial instruments. Because the valuation of the Group's structured financial instruments is not based on quoted prices in active markets, there is significant measurement uncertainty involved in this valuation. As a result, the valuation of these instruments was significant to our audit. The Group has determined it is necessary to use an entity-developed model to value these instruments, due to their unique structure and terms. We challenged management's rationale for using an entity-developed model, and discussed this with [*those charged with governance*], and we concluded the use of such a model was appropriate. Our audit procedures also included, among others, testing management's controls related to the development and calibration of the model and confirming that management had determined it was not necessary to make any adjustments to the output of the model to reflect the assumptions that marketplace participants would use in similar circumstances.

*Acquisition of XYZ Business*

As described in Note 2, in December 20X1, the Group completed the acquisition of XYZ Business. XYZ Business was a division of a large private company. As of December 31, 20X1, the Group has completed the initial acquisition accounting on a preliminary basis. The Group will finalize the initial acquisition accounting during 20X2, and the amounts recorded as of December 31, 20X1 could change. We focused on this transaction because it is material to the consolidated financial statements as a whole and the fact that values had not previously been assigned to the division as a standalone operation. In addition, determining the assumptions that underlie the initial acquisition accounting and the useful lives associated with the acquired intangible assets involves significant management judgment given the nature of the [*name of industry*].

*Revenue Recognition Relating to Long-Term Contracts*

The terms and conditions of the Group's long-term contracts in its [*name of segment*] affect the revenue that the Group recognizes in a period, and the revenue from such contracts represents a material amount of the Group's total revenue. The process to measure the amount of revenue to recognize in the [*name of industry*], including the determination of the appropriate timing of recognition, involves significant management judgment. We identified revenue recognition of long-term contracts as a significant risk requiring special audit consideration. This is because side agreements may exist that effectively amend the original contracts, and such side agreements may be inadvertently unrecorded or deliberately concealed and therefore present a risk of material misstatement due to fraud. In addition to testing the controls the Group has put in place over its process to enter into and record long-term contracts and other audit procedures, we considered it necessary to confirm the terms of these contracts directly with customers and testing journal entries made by management related to revenue recognition. Based on the audit procedures performed, we did not find evidence of the existence of side agreements. The Group's disclosures about revenue recognition are included in the summary of significant accounting policies in Note 1, as well as Note 4.

**Going Concern** (see Questions 9-10)

The consolidated financial statements of the Group have been prepared using the going concern basis of accounting. The use of this basis of accounting is appropriate unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so. As part of our audit of the consolidated financial statements, we have concluded that management's use of the going concern basis of accounting in the preparation of the Group's consolidated financial statements is appropriate.

Management has not identified a material uncertainty that may cast significant doubt on the Group's ability to continue as a going concern, and accordingly none is disclosed in the consolidated financial statements of the Group. Based on our audit of the consolidated financial statements of the Group, we also have not identified such a material uncertainty. However, neither management nor the auditor can guarantee the Group's ability to continue as a going concern.

**Other Information**

*[The illustrative wording for this section is subject to the IAASB's finalization of proposed ISA 720 (Revised). The content of this section may include, among other matters: (a) a description of the auditor's responsibilities with respect to other information; (b) identification of the document(s) available at the date of the auditor's report that contain the other information to which the auditor's responsibilities apply; (c) a statement addressing the outcome of the auditor's work on the other information; and (d) a statement that the auditor has not audited or reviewed the other information and, accordingly, does not express an audit opinion or a review conclusion on it.]*

**Responsibilities of [Management[4] and Those Charged with Governance or other appropriate terms] for the Consolidated Financial Statements**

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with IFRSs,[5] and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error. [*Those charged with governance*] are responsible for overseeing the Group's financial reporting process. (see Question 13)

**Auditor's Responsibilities for the Audit of the Consolidated Financial Statements** (see Question 13)

The objectives of our audit are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

*The remaining material in this section can be located in an Appendix to the auditor's report (see paragraph 39 of proposed ISA 700 (Revised)). When law, regulation or national auditing standards expressly permits, reference can be made to a website of an appropriate authority that contains the description of the auditor's responsibilities, rather than including this material in the auditor's report (see paragraph 40 of proposed ISA 700 (Revised)).*

[4] Throughout the illustrative auditor's reports in the Proposed ISAs, the term management may need to be replaced by another term that is appropriate in the context of the legal framework in the particular jurisdiction. For example, those charged with governance, rather than management, may have these responsibilities.

[5] Where management's responsibility is to prepare financial statements that give a true and fair view, this may read: "Management is responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with IFRSs, and for such ..."

As part of an audit in accordance with ISAs, we exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.[6]
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities and business activities within the group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We are required to communicate with [*those charged with governance*] regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We are also required to provide [*those charged with governance*] with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

**Report on Other Legal and Regulatory Requirements**

[*The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. Depending on the matters addressed by other law, regulation or national auditing standards, national standard setters may choose to combine reporting on these matters with reporting as required by the ISAs (shown in the Report on the Audit of the Consolidated Financial Statements section), with wording in the auditor's report that clearly distinguishes between reporting required by the ISAs and other reporting required by law or regulation.* (see Question 13)]

The engagement partner responsible for the audit resulting in this independent auditor's report is [*name*]. (see Question 12)

[*Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction*]

[*Auditor Address*]

[*Date*]

[6] This sentence would be modified, as appropriate, in circumstances when the auditor also has responsibility to issue an opinion on the effectiveness of internal control in conjunction with the audit of the consolidated financial statements.

**Appendix 2**

Wording of the auditor's report used for the ISA 700
[*KAM negative/KAM positive*] group
[Format differs from case material; accentuation for illustration purposes only]

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements
We have audited the accompanying financial statements of the Alpha Group, which comprise the statement of financial position as at December 31, 2012, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion
In our opinion, the financial statements present fairly, in all material respects, the financial position of Alpha Group as at December 31, 2012, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

*Key Audit Matters*
*Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements. Key audit matters are selected from the matters communicated with those charged with governance, but are not intended to represent all matters that were discussed with them. Our audit procedures relating to these matters were designed in the context of our audit of the consolidated financial statements as a whole. Our opinion on the consolidated financial statements is not modified with respect to any of the key audit matters described below, and we do not express an opinion on these individual matters.*

*Goodwill*
*Under IFRSs, the Alpha Group is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the assessment process is complex and highly judgmental and is based on assumptions that are affected by expected future market or economic conditions, particularly those in Europe. As a result, our audit procedures included, among others, using a valuation expert to assist us in evaluating the assumptions and methodologies used by the Alpha Group, in particular those relating to the forecasted revenue growth and profit margins for the cash generating units Beta AG and Gamma GmbH. We also focused on the adequacy of the Alpha Group's disclosures about those assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill.*

*[KAM negative]*
*Already small changes in the key assumptions used (see Alpha Group's disclosures about goodwill in Note 1) could give rise to an impairment of the goodwill balance in the future.*

*[KAM positive]*
*Only large changes in the key assumptions used (see Alpha Group's disclosures about goodwill in Note 1) could give rise to an impairment of the goodwill balance in the future.*

[Auditor's signature]
[Date of the auditor's report]
[Auditor's address]

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August 15, 2016

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

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

Dear Ms. Secretary:

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Release No. 2016-003, *Proposed Auditing Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (the "Proposed Standard" and "Proposed Amendments," respectively, and collectively the "Reproposal").

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

**Overview**

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

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

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

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

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

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

**Communication in the Auditor's Report**

***How the CAM was Addressed in the Audit***

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

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

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

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

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

***Clarifying Language in the Auditor's Report***

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

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

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

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

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

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

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

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

[4] *Id*. at 8.

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

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

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

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[5] *Id*. at 7.

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

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

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

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

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

***Original Information***

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

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

**Additional Guidance**

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

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

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

Further, we have some uncertainty about what the Board means by a matter that "relates to" accounts or disclosures that are material to the financial statements. In other contexts, such as civil litigation, the phrase "relates to" can be read broadly. For example, revenue presumably will be a material account in a financial statement. Any matter that is tangentially related to revenue therefore "relates to" a material account, no matter how small the individual matter. Indeed, it may prove difficult to identify anything that would not "relate to" a material account or disclosure. Our belief is that the matter itself should have significance. Therefore, to remove the potential for misinterpretation or misuse, particularly in the context of litigation, we propose the Board remove the phrase "relates to accounts or disclosure matters that" from paragraph 11 of the Proposed Standard.

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

**Tenure**

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

**Applicability and Effective Date**

***Applicability***

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

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

[10] *Id*. at 23.

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

***Effective Date***

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

**Editorial Comment**

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

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

Very truly yours,

KPMG LLP

KPMG LLP

cc:

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August 11, 2016

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
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File Reference: PCAOB Rulemaking Docket Matter No. 034

MFS Investment Management (MFS) and the Audit Committee of the MFS Funds Board appreciate the opportunity to comment on the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Proposed Auditing Standard entitled *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (the "Proposed Standard"). Our comments relate to the Proposed Standard's application to U.S. Securities & Exchange Commission (SEC) registered investment companies as issuers of financial statements and are consistent with our comments on PCAOB Release No. 2013-005[1] (the "2013 Comment Letter").

Background on MFS and the Industry[2]

MFS is a global asset management firm registered under the Investment Advisers Act of 1940, as amended, that provides investment management services to clients. MFS provides investment advisory and administrative services to 135 investment companies (the "MFS Funds") registered under the Investment Company Act of 1940, as amended (the “1940 Act”), and supervised by the MFS Funds Board, which in total represent approximately $207 billion in assets. MFS is a majority owned subsidiary of Sun Life Canada (U.S.) Financial Services Holdings, Inc., which in turn is an indirect majority owned subsidiary of Sun Life Financial, Inc. (a diversified financial services organization). MFS has been a subsidiary of Sun Life since 1982. As of June 30, 2016, MFS managed approximately $425 billion in assets.

From an industry perspective, U.S. investment companies are responsible for the investment of over $18.1 trillion; open-end investment companies ("mutual funds"), which are owned by an estimated 93 million shareholders, represent approximately 90% of those assets. There are roughly 9,500 mutual funds, 600 closed-end funds and 1,600 exchange-traded funds, each of which is subject to an annual audit requirement and oversight by the PCAOB and SEC. As is the case with most registered investment companies, the MFS Funds have no employees of their own and their operations are carried out by various affiliated entities (e.g., the investment advisor, the administrator, the transfer agent and the distributor) and unaffiliated service providers (e.g., the custodian and the fund accounting agent) under the oversight of the MFS Funds' Board of Trustees.

1 MFS and the Audit Committee of the MFS Funds Board filed a joint comment letter dated December 10, 2013 on the PCAOB Release No. 2013-005, *Proposed Auditing Standards on The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*.

2 Industry statistics as of December 31, 2015 per the *2016 Investment Company Institute Industry Fact Book*.

Overview of the Proposed Standard
A follow-up to PCAOB Release No. 2013-005 (the "2013 Proposal"), the Proposed Standard seeks to increase the relevance, usefulness and informational value of the auditor's report by:

- Standardizing the format and required elements of the auditor's report, including the reporting of audit firm tenure;
- Clarifying the auditor's responsibility with respect to fraud, independence, and the notes to the financial statements; and
- Requiring the auditor to include more information in the form of "critical audit matters" (CAM) on areas of the audit that were especially challenging, subjective or complex.

As discussed below, MFS and the MFS Funds Board Audit Committee understand and support the PCAOB's intent to increase the value of the auditor's report. We applaud the PCAOB's decision to exempt registered investment companies[3] (other than business development companies) from the requirement to report CAM and, with the notable exception of audit firm tenure reporting, we strongly support the proposed clarifications and changes to the auditor's report outlined in the Proposed Standard. Although we continue to express strong reservations with regard to the reporting of audit firm tenure in the auditor's report, we are encouraged by the PCAOB's willingness to consider other alternatives, such as disclosing tenure on PCAOB Form AP[4], if tenure reporting is ultimately required.

Format of the Auditor's Report
The Proposed Standard establishes a standard format for the auditor's report in an effort to more effectively communicate key messages and enhance comparability between entities. Under that standard format, the opinion paragraph would be the first paragraph of the report and standard headers would be required for each of the report's various sections. The Proposed Standard also would require the use of standard addressees, in that the auditor's report must be addressed to the entity's investors and its board of directors or equivalent body in addition to any additional, optional addressees. We believe that investors would benefit from these changes and we fully support these efforts to standardize the format of the auditor's report.

Independence, Fraud and the Financial Statement Notes
Under the Proposed Standard, the auditor's report would be modified to include a statement that the auditor is registered with the PCAOB and is required to be independent. The language in the auditor's report also would be enhanced to better articulate the auditor's responsibility for fraud and the notes to the financial statements. We believe that these enhancements to the auditor's report will clarify existing auditor requirements and responsibilities in these areas for investors and, as such, we fully support the PCAOB's proposed clarifications.

Critical Audit Matters (CAM)
CAM as defined by the Proposed Standard would be any matter arising from an audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Under the Proposed Standard, the auditor would be required to communicate in a separate section of the auditor's report any CAM that it identified during the audit of the current period's financial statements.

[3] Investment companies registered under the 1940 Act.
[4] PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*.

Based on the feedback received on the 2013 Proposal, the Proposed Standard would exempt certain industries, including registered investment companies (other than business development companies) from the requirement to report CAM in their auditor's report. We strongly support the proposed exemption of registered investment companies and, in response to question #37 of the Proposed Standard, we believe that this exemption is entirely appropriate. As discussed in the Proposed Standard and expanded upon below, there are a number of factors unique to registered investment companies in terms of their structure, their purpose, and their regulatory reporting requirements that render the concept of CAM disclosure unnecessary for the industry.

*Structure and Purpose*

Pursuant to Section 3(a)(1) of the 1940 Act, an investment company refers, in pertinent part, to any issue that “is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting or trading in securities”. Given that an investment company's primary business is investing, investment valuation would presumably meet the definition of a CAM in that it is an audit area for which the results are generally communicated to the audit committee and the related amounts are both material to the financial statements and likely to be subject to auditor judgment. Generally a registered investment company's investments represent almost 100% of its net assets, so in most circumstances it is likely that investment valuation would be the only CAM identified in a registered investment company audit. Given that a registered investment company's investment objective - and the types and the relative mix of investments held by the fund – generally would not change significantly from one reporting period to another, it is unlikely that the details of an investment valuation CAM would change much from audit to audit. As such, information conveyed in the valuation CAM would become boilerplate over time with the result that any investment decision-making relevance it might have to investors would be greatly diminished.

Additionally, we believe that by calling out investment valuation as a CAM, the auditor would be signaling to investors that there is a valuation issue with the fund, when in fact no problem exists and where significant disclosure is already available for the investor within the notes to the financial statements. Although an auditor in certain circumstances may need to engage the help of a valuation specialist, an auditor who is rendering an unqualified opinion is able to obtain sufficient audit evidence to support management's investment valuations. Furthermore, over the past decade the Financial Accounting Standards Board (FASB) has been very focused on standard setting around fair valuation, with the result that financial statement disclosures for registered investment companies with respect to investment valuation, especially with regard to the assumptions (i.e., valuation approaches, techniques and inputs) used in valuing Level 3 securities[5], are very robust[6]. In an industry where such robust disclosures already exist, we believe that the concept of a CAM is uninformative and unnecessary.

*Regulatory Reporting Requirements*

Conceptually, a CAM is intended to provide more information about the audit, thus making the auditor's report more informative and relevant to investors, presumably with the end result of those investors being able to make better-informed investment decisions. However, as noted by several commenters on the 2013 Proposal, an investor's decision on whether or not to invest in a registered investment company is likely based primarily on a fund's investment objectives, its principal investment strategies and risks, its past performance and its fees and expenses – none of which would normally meet the definition of a

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[5] One of three levels under the fair value hierarchy prescribed by the Topic 820 *Fair Value Measurement* of the Financial Accounting Standards Board's Accounting Standards Codification.

[6] In 2006 the FASB issued Statement on Financial Accounting Standard No. 157 (FAS 157), *Fair Value Measurement,* which defined “fair value”, established a framework for measuring fair value, and required the disclosure of information related to fair value determinations. A number of related FASB Staff Positions (FSP) were also issued to provide clarifications on FAS 157. Subsequently, the FASB issued Accounting Standards Update (ASU) 2010-06, *Fair Value Measurements and Disclosures (Topic 820)* provides more robust disclosures about (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in Level 3 fair value measurements, and (4) the transfers between Levels 1, 2, and 3. The FASB also issued ASU 2011-04, *Fair Value Measurement (Topic 820)* in which the FASB provided common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and IFRS. Most recently, the FASB has issued Proposed ASU 2015-350, *Fair Value Measurement (Topic 820) – Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement* which would clarify and improve existing fair value disclosure requirements.

CAM. Those data elements which are key to a fund investor's investment decision-making process are all required to be disclosed by a registered investment company in its prospectus, which is updated at least annually. In fact, the SEC advises an investor to request and read a fund's prospectus before investing in a fund[7] and requires funds to provide investors with a prospectus either prior to or upon their purchase of shares. As such, we believe that it is the information in a fund's prospectus, and not CAM, that is integral to a registered investment company investor's decision-making process.

In addition to the requirement of a prospectus that is updated annually, there are a number of other industry-specific regulations – existing and proposed - intended to provide investment company investors with the information necessary to make more informed investment decisions and to reduce the risks of investing in investment companies. The 1940 Act sets forth requirements with respect to an investment company's portfolio diversification, liquidity, leverage and custody of securities with the intent of reducing an investor's risk. We note that registered investment companies are required to file with the SEC their quarterly portfolio holdings. In addition, the SEC's Proposed Rule on *Investment Company Reporting Modernization* would enhance portfolio holding reporting and would require investment companies to report additional information, such as information about their use of securities lending and more information about their investments in derivatives and debt securities. The SEC has also issued another proposed rule to promote effective liquidity risk management and enhance fund liquidity disclosures for open-end registered investment companies[8]. In an industry where a wealth of information is already required to be reported under existing regulations with more inevitably to come from proposed rules, we believe the concept of a CAM is unnecessary for an investment company investor.

*Subjectivity and Costs*

In addition to the arguments expressed above, there are two other reasons why we support the PCAOB's proposal to exempt investment companies from the requirement to report CAM in their auditor's report; those reasons being subjectivity and costs.

As discussed more fully in our 2013 Comment Letter, we believe that the CAM identified in the auditor's report may differ among very similar entities based on the subjective decisions made by different audit teams or firms, with the unintended consequence of negatively impacting the comparability of the entities. This issue of auditor subjectivity is particularly problematic for the investment company industry where, for most of the larger fund complexes, a portion of the funds in the complex are audited by one audit firm while the remainder are audited by a second firm (i.e., a "two audit provider model"). Because each audit firm under the two audit provider model may have different interpretations as to what constitutes CAM, two funds with substantially similar investment objectives and investment strategies, portfolio holdings and investment performance may have differing disclosures regarding CAM. For example, one fund may report more CAM or more reasons for CAM. We believe that such a result may confuse investors in the funds. This concern is magnified when looked at in the context of the auditor's reports for the industry's full universe of competing funds, many of which are audited by different audit teams and firms.

In addition to the increase in audit cost that would inevitably result from the drafting, documentation and review of CAM, the Proposed Standard mentions that investment companies might bear additional costs of applying the CAM requirements as compared to other types of companies. Consistent with other investment company complexes (ICC)[9], the shareholder reports and financial statements for certain MFS Funds (e.g., the MFS target date funds-of-funds) are compiled in one document that contains a single auditor's report covering the audits for that group of MFS Funds. If investment companies were not exempted from the requirement to report CAM, our auditors would have to prepare separate auditor's reports for each of the MFS Funds, thus increasing the typesetting and printing costs borne by the funds' shareholders.

[7] *Mutual Funds, A Guide for Investors* which can be found at www.sec.gov.
[8] The SEC's proposed rule on *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*
[9] SEC Rule 2-01(f)(14)(i) of Regulation S-X defines an investment company complex.

Audit Firm Tenure
Under the Proposed Standard, the auditor's report would be modified to include a statement containing the year that the audit firm began serving consecutively as the entity's auditor. The Proposed Standard clarifies that tenure, with respect to an investment company within an ICC, would be the year that the auditor began serving consecutively as the auditor of any investment company in the ICC. While we appreciate this clarification, we continue to adamantly oppose the requirement to disclose audit firm tenure in the auditor's report.

We believe that disclosing tenure in the auditor's report implies that tenure plays a role in the auditor rendering its opinion on the financial statements. However, as discussed in the Proposed Standard, despite extensive research, no conclusive link has been established between auditor tenure and the quality of the audit in terms of auditor independence, objectivity and professional skepticism. More alarming is the suggestion made in the Proposed Standard that some investors may draw incorrect conclusions about tenure, resulting in negative impacts to a fund in terms of its cost of capital and the time spent by management and the audit committee to dispel these investor misperceptions. Our opposition to the PCAOB's required disclosure of tenure is bolstered by the fact that neither the International Auditing and Assurance Standards Board (IAASB) or the UK's Financial Reporting Council (FRC) has been concerned with establishing a link between audit firm tenure and auditor independence and that neither standard setter requires tenure to be disclosed in the auditor's report.

In the Proposed Standard, the PCAOB asks a number of questions around audit firm tenure including whether it would be more appropriate to disclose auditor tenure in Form AP than in the auditor's report[10]. The PCAOB's recently adopted Form AP is intended to provide investors and financial statement users with information about the partners serving on the audit engagement and about the other accounting firms, if any, involved in the audit. If the PCAOB believes that audit firm tenure must be consistently disclosed for all companies in one publicly-available document, then we would submit that tenure disclosure in Form AP would meet that objective.

Conclusion
MFS and the Audit Committee of the MFS Funds Board appreciate the opportunity to provide comments on the Proposed Standard. We support the PCAOB's overall objectives and its efforts to standardize the format of the auditor's report as well as its proposed clarifications with regard to auditor independence, fraud and the notes to the financial statements. As detailed above, the bulk of our comments are focused on (1) the proposed exemption of registered investment companies (other than business development companies) from the requirement to report CAM in the auditor's report and (2) the proposed requirement to disclose audit firm tenure in the auditor's report. In closing we would like to reiterate that:

- We strongly support the PCAOB's proposed exemption of registered investment companies from the requirement to report CAM in the auditor's report. In addition to our concerns around auditor subjectivity and industry-specific costs, we believe that there are a number of factors unique to registered investment companies in terms of their structure, their purpose, and their regulatory reporting requirements that render the concept of CAM uninformative and unnecessary for the industry.

- We adamantly oppose the PCAOB's proposed requirement to disclose audit firm tenure in the auditor's report and we encourage the PCAOB to consider using public documents (e.g., Form AP) other than the auditor's report for any required disclosure of audit firm tenure, as there is no evidence that tenure has a bearing on the auditor's ability to render an opinion.

Should you have any questions about our comments regarding the Proposed Standard, please feel free to call Bob Uek or Dave DiLorenzo at 617-954-5000.

[10] Question 18 of the Proposed Standard

Sincerely,

David DiLorenzo
Fund Treasurer
Senior Vice President
MFS Investment Management

Robert W. Uek
Chairman
MFS Funds Board Audit Committee

**From:** David
**To:** Comments
**Subject:** Comment on PCAOB Rulemaking Docket Matter No. 034
**Date:** Tuesday, August 02, 2016 8:00:28 AM

Many estimates require complex algorithms. Will the auditor have say what analytic approach the used in addressing a critical matter? Just saying "we used a machine learning approach to address..." or "we used a robust statistical approach to address..." is meaningless if we do not know exactly what the auditor did.

David Moskowitz

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Re: PCAOB Rulemaking Docket Matter No. 034

Dear Members and Staff of the PCAOB,

I welcome the opportunity to comment on the Board's Proposing Release No. 2016-003 regarding the standard form audit report (Docket Matter No. 034). The topic is vitally important to the quality of auditing and the utility of financial reporting. In my view, it is the most important standard setting initiative the Board has undertaken.

My views of the subject arise from a career of legal and executive responsibility for varied aspects of financial reporting and auditing, including 23 years as global Chief Legal Officer of major accounting networks and 15 years as Chairman or C-suite officer of the principal insurers of accountancy, legal practice and corporate directors. I was an active participant in the Cohen, Treadway and early COSO commissions, and in the counterpart initiatives conducted in Europe from 1990 to 2010. I was a member of ACAP and currently serve on the PCAOB Standing Advisory Group. The views I express are my own, free of constituency influence or known bias.

A brief look back is needed to see the importance of the Board's proposal in the context of capital market conditions and policy debates. The US capital markets, and financial reporting by US companies, were relatively calm and orderly following World War II, until storms of financial fraud and the emergence of class actions put legal liability into the forefront of driving factors. Those events of fifty years ago shook confidence in the capital markets, triggered the formation of what has become the FASB, launched SEC enforcement actions as the de facto audit regulator and introduced securities liability litigation as a strategic force in investment management and regulatory policy.

The turmoil of the time was addressed collegially (as measured by current conditions) through the public-private collaborations of the Cohen and Treadway Commissions of the 1970s and 1980s. The Cohen Commission Report was admirably comprehensive and perceptive, articulating the fact that liability litigation was the new elephant in the marketplace and endorsing auditing as the principle resource for taming it. The report identified fraud as the central regulatory challenge and anointed "the expectations gap" as the most difficult reporting and auditing challenge. Under the heading REGULATING THE PROFESSION TO MAINTAIN THE QUALITY OF AUDIT PRACTICE the Cohen report framed the issues, identified the challenges and outlined the regulatory options that have guided securities law and regulation since 1977.

We are forty years on, however, and still seeking the fix for the expectations gap and the keys to sustainable market stability. Fraud is still the driver of trouble, and audit is still the best tool in the kit. But, despite admirable efforts that have added disciplines to financial reporting and improved audit quality, the underlying challenges remain while the collegiality of the effort and the quality of discourse has deteriorated. Those were the realities that prompted Treasury Secretary Paulson to convene the Advisory Committee on the Audit Profession (ACAP) as the most ambitious and collaborative search for solutions yet undertaken.

ACAP's 2008 Final Report made many valuable contributions on important aspects of audit capabilities and regulatory objectives. But with regard to the vexing issues of the expectations gap and audit liability it was only partly successful. The Committee gathered the deepest resource of public and non-public information ever assembled about liability conditions and consequences. But its intense deliberations over the appropriate professional and regulatory responses produced a passionate division that could not be bridged within the Committee's mandate and timetable. Consequently, ACAP recommended by consensus that the PCAOB take over the effort. Its report provided a carefully detailed roadmap of the agreements and the conflicting conclusions it had reached.

Release No. 2016-003, and the PCAOB's initial proposal of 2013, is the first PCAOB initiative to date that deals with ACAP recommendations concerning audit capabilities and liability as a regulatory issue. It is thus an important step directly on the subject, and of broader consequence because several pending audit standard setting proposals take a position on the effect of litigation without having studied its properties.

The Release declares that the Board is responding to the ACAP Recommendation, and also to the Cohen and Treadway reports. It suggests that the Proposal is directly and fully responsive to ACAP, whose position the Board describes as follows:

> "ACAP recommended that the PCAOB consider improvements to the auditor's report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and also contributes to greater complexity in global financial reporting." (Release No. 2016-003, at page 6)

While that is the head note of Recommendation 5, the essence of the Recommendation and ACAP's reasoning are summarized at the conclusion of that section of the report:

> "The Committee therefore recommends that the PCAOB address these issues, both long-debated and increasingly important given the use of judgments and 2. estimates, by undertaking a standard setting initiative to consider improvements to the auditor's reporting model. With regards to this initiative, the PCAOB should consult with investors, other financial statement users, auditing firms, public companies, academics, other market participants, and other state, federal and foreign regulators. In view of the desirability of improving the quality of financial reporting and auditing on a global basis, the PCAOB should also consider the developments in foreign jurisdictions that improve the quality and content of the auditors report and should consult with international regulatory bodies as appropriate. **The PCAOB should also take cognizance of the proposal's potential legal ramifications, if any, to the auditors.**
>
> "Commentary has also suggested that the auditors must more effectively communicate their responsibility regarding fraud detection with investors and capital markets. The Committee agrees with this suggestion. Accordingly, the Committee believes that the auditor's role and limitations in detecting fraud. The Committee believes that expressly communicating to investors, other financial statement users, and the public the role of auditors in finding and reporting fraud would help narrow the "expectations gap."
>
> "In addition, the Committee recommends that the PCAOB and the SEC clarify in the auditor's report the auditor's role and limitations in detecting fraud under current auditing standards. **In addition, the Committee recommends, in light of the continuing "expectations gap," that the PCAOB review the auditing standards governing fraud detection and fraud reporting. Specifically, the Committee recommends that the PCAOB periodically review and update these standards."** (ACAP Final Report, at pp VII:17-18. Emphasis added)

I am dismayed by the narrow scope of the PCAOB's uptake of the ACAP recommendation. In 2011 the Board announced that it planned to initiate, in the near future, the collaborative fraud study recommended by ACAP. By 2013 that intention had been transformed into a plan to have the Board and staff perform the study without external participation. For the past three years there has been no sign of a continuing intention to do so. It appears that the Proposal for modification of the auditors reporting model is the extent of the Board's intended response to the ACAP Recommendation 5.

The need for attention to financial fraud, expectations gaps and liability consequences has not declined since the ACAP report. On the contrary, the data and analytic competencies that have emerged since 2008 have enabled a new landscape of audit initiatives that deserve more rather than less thoughtful regulatory attention.

Release 2016-003 proposes one fraud related change to the wording of the auditor's standard form report. Existing standard's require assurance that the examined financial statements are free of material misstatement. The Board proposes that this should be clarified by noting that the assurance applies whether material misrepresentation might have been "caused by error or fraud."

As a change of wording, but not of meaning, that must surely be appropriate. But it does not address the fundamental issues raised by Cohen and Treadway of the need to clarify what can be professionally and legally expected of auditors in relation to collusive financial fraud, nor does it attempt to deal with the expectations gap and liability consequences that were of central concern to ACAP.

Nevertheless, the proposal to add "error or fraud" generated considerable attention when it first appeared in 2013. Under the heading "Liability Considerations Related to Critical Audit Matters," Release 2016-003 provides a summary of the comments received that were concerned with the potential for adverse liability consequences of the proposed change, the five paragraphs of which begin as follows:

> "The potential for increased auditor liability was cited as a concern by a number of commentators…"
>
> "Some commenters raised more specific liability concerns about critical audit matters…"
>
> " Other commenters claimed that the fact-specific nature of critical audit matters or of certain potential elements of the description of critical audit matters, such as the audit procedures used, would make it difficult to obtain early dismissal of claims…"
>
> "Several commenters highlighted the proposed requirement to document the auditor's determination that a matter was not a critical audit matter as increasing litigation risk with respect to such matters…"
>
> "Some commenters argued that critical audit matters could also increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, and plaintiffs may attempt to use critical audit matters as a "road map" for litigation against the company." (Release, pages 40-42. The number of concerned commenters was not disclosed.)

By contrast, the entirety of opposing views is described this way:

> "On the other hand, one commenter asserted that communicating critical audit matters conceptually could decrease auditor and company legal exposure when the accounting in the areas of the critical audit matters is

> subsequently challenged, because the communication of critical audit matters is about disclosure of risks and challenges. The commenter further stated that the communication of such matters would be more problematic from a litigation point of view."

The meaning of that comment is less than self-evident. But it does seem clear that it was the sole voice of attempted comfort.

The Release concludes that the liability commentaries did not constitute a reason to reconsider "whether through error or fraud" was appropriate because the Board had modified the proposed CAM terms of implementation. The proposal does not explain how this conclusion was reached, nor does it attempt to address the core question of fraud and its impact on auditing.

ACAP developed a comprehensive platform of information and opinions on these issues, the most extensive and candid effort to date and one not easily recreated. It is a ready resource and starting point for the PCAOB to assess audit liability risks and their public interest consequences. Despite its deep divisions of opinion, the members of ACAP (with a single dissent) agreed on much of the factual underpinnings of the liability debate, specifically including the following:

- At the 2008 report date, the six largest US audit firms were defending a combined total of 90 malpractice suits seeking in excess of $100 million. Of those, 27 claims alleged shareholder losses of more than $1 billion and 7 claimed damages in excess of $10 billion. Those are not fantasy inflated numbers. They are actual market loss consequences of public company restatements. ACAP recognized that any one of the 90 suits, if successful, would dwarf the firm's capital.

- Annual liability costs (judgments, settlements and expenses net of insurance) was more than 15% of the six firm's annual audit revenues, a proportion of income that is vastly greater than that of any other industry or profession.

- State and federal regulations in the US require auditors to function as partnerships, prohibited from raising third party capital. While limited liability partnerships protect some assets, every partner's income, capital account and retirement benefit remain exposed to the unpredictable outcomes of liability litigation. No other form of US enterprise has such a hazardous balance of risks and rewards.

- The potential for a liability induced collapse of another major firm was a consensus worry, even to the extent that ACAP recommended that Congress enact a complex scheme for the rescue and rehabilitation of firms in jeopardy, not unlike the Dodd Frank model of bank resolutions. ACAP's co-chairs, Arthur Levitt and Donald Nicholaisen, went the further step of recommending federalization of the audit profession. Both proposed remedies are dramatic.

> These extraordinary remedies would not have been recommended without collective acceptance that audit liability risk is existential and real.

The ACAP report also articulates the differences that members could not overcome, with care to preserve the contrasting perspectives for future attention. These included:

- Whether it was likely that the unresolved issues of responsibility and liability would cause another firm to collapse, as Andersen just had.

- Whether another firm collapsed would be a stand alone event or the first leg of an implosion of the traditional large firm business model due to partner flight from within or insufficient competition to meet investor needs.

- Whether the extreme risks of audit liability inhibit advancements in audit quality, or constitute a motivator of optimal audit performance.

- What forms of liability law reform, or regulatory safe havens, would be most useful in the public interest.

- Whether expansions of the auditor's role can be responsibly contemplated without careful assessment of intended or unintended liability consequences.

Release No. 2016-003 proposes to do just that—extend auditor responsibilities—with exclusive focus on whether there might be benefits in doing so. The risks of doing so have barely been considered. The forty year search for a sound platform of how financial fraud and audit responsibility should intersect, and the parallel dilemma of how liability inducing expectation gaps can be mitigated, have been bypassed.

I urge that the proposal be withdrawn for further collective study, drawing upon the information and the strategic resources that have been prepared by ACAP and preceding studies. Only by enlarging the scope of attention can changes to the auditors reporting model emerge from core perspectives about the sustainable role of auditing in the world's most litigious society.

Respectfully submitted,

/S/

Richard H Murray

Cc: Chair Doty and Members of the Board
Chief Auditor and Director of Professional Staff

August 23, 2016

Office of the Secretary
PCAOB
1666 K Street NW
Washington DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Board:

This letter reflects the views of the Board of Directors of the National Association of Corporate Directors (NACD). NACD, a 501 (c) 3 nonprofit educational organization, helps more than 17,000 directors lead with confidence. As the recognized authority on leading boardroom practices, NACD aspires to a world where businesses are sustainable, profitable, and respected, and where stakeholders trust directors to develop strategies that create long-term value and provide effective oversight. World-class boards join NACD to elevate performance, gain foresight, and instill confidence. Fostering collaboration among directors, investors, and governance stakeholders, NACD has been shaping the future of board leadership for nearly 40 years.

As part of our role in society, we comment on matters of interest to U.S. corporations. We have commented on Docket Matter 34 in an earlier letter:

> NACD believes any changes to the auditor's reporting model or expansion to the role of the auditor ***should preserve the established relationship between management and the auditors, namely, the role of management to present and assert information, and the role of the auditor to attest to that information***. We believe that any change that would require or allow the auditor to disclose original information about the company would undermine management's responsibility for the financial statements. . . . Further, such a change would significantly interfere with the well-established audit committee role in overseeing financial reporting, and could introduce the inappropriate situation of the auditor assuming principal responsibility for certain accounting and disclosures of the registrant. While NACD strongly supports effective independent auditing of financial statements, we would oppose any new standard that blurs the roles of asserting, attesting, and overseeing. These roles and their proper owners must be kept in mind when considering possible changes in reporting on such audits. (NACD, letter dated Dec. 11, 2013, attached; emphasis added)

We believe that this reproposed standard continues to conflate the roles of auditor and management. Furthermore, we do not believe that investors need the disclosures of the "critical audit matters" enumerated in the reproposed standard, as these matters are already either disclosed in management's discussion and analysis (MD&A) or, if they are not material to investors, covered in discussions between the auditor and the audit committee. NACD will continue to explore this topic with our key stakeholders, including directors and investors. We support you in your important mission of assuring and guiding audit quality.

Sincerely,

Karen Horn

Dr. Karen Horn
Chair of the Board of Directors
National Association of Corporate Directors

Mr. Kenneth Daly
Chief Executive Officer
National Association of Corporate Directors

Attachment: NACD letter dated Dec. 11, 2013

Dec. 11, 2013

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

Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments (PCAOB Rulemaking Docket Matter No. 34).

Dear Office of the Secretary:

On behalf of the board of directors of the National Association of Corporate Directors (NACD), we are pleased to submit our comments on the above-named Exposure Draft of the Public Company Accounting Oversight Board (PCAOB or Board). Founded in 1977, NACD is the only national membership organization created for and by directors. Given the close interaction between the auditor and the audit committee of a corporate board, and because many of our more than 13,500 members are audit committee members and chairs, NACD believes it is appropriate to provide our views on these issues. We commented earlier (Sept. 27, 2011) on the PCAOB's Concepts Release on the same subject.

**Primary Role of Management to Assert and Auditors to Attest**

As noted in our earlier letter, NACD believes any changes to the auditor's reporting model or expansion to the role of the auditor should preserve the established relationship between management and the auditors, namely, the role of management to *present* and *assert* information, and the role of the auditor to *attest* to that information. We believe that any change that would require or allow the auditor to disclose original information about the company would undermine management's responsibility for the financial statements (including the required certifications under the Sarbanes-Oxley Act. Further, such a change would significantly interfere with the well-established audit committee role in overseeing financial reporting, and could introduce the inappropriate situation of the auditor assuming principal responsibility for certain accounting and disclosures of the registrant. While NACD strongly supports effective independent auditing of financial statements, we would oppose any new standard that blurs the roles of asserting, attesting, and overseeing. These roles and their proper owners must be kept in mind when considering possible changes in reporting on such audits.

In our earlier letter, we expressed significant concerns about the possibility of requiring an auditor's discussion and analysis as part of the standard auditor's report. Thus, we are pleased that the Board has determined that this possibility is not being proposed for adoption.

We are also pleased to note that the Board has decided not to require "emphasis paragraphs." As we noted in our earlier letter, without a framework for defining what requires emphasis, this requirement could have resulted in overly broad disclosures intended to reduce litigation risk, rather than generating any disclosures of interest to investors.

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**Critical Audit Matters**

The most significant change to the auditor's report proposed in the Exposure Draft would be the inclusion of critical audit matters (CAM). As described in the Exposure Draft, these could include matters already communicated to audit committees under the existing PCAOB auditing standard (No. 16, Communications with the Audit Committee, effective December 2012). In addition, CAMs could include matters that were already in the engagement review memo and/or discussed with the audit firm's executive office. Thus, in other than extremely simple businesses, multiple CAMs will be added to the standard auditor's report, lengthening it and literally burying the important "pass/fail" language that most readers key into.

Setting aside the issue of whether users will find much longer reports to be truly helpful, we return to our fundamental issue of management's vs. the auditor's role. While we have not performed a formal study, during our discussions in the development of this letter, we found that most of those who have served on audit committees believed that a very high percentage of the matters discussed with them by auditors and included in those required communications are already well disclosed in annual 10-Ks' management discussion and analysis (MD&A) and/or footnotes. Thus, requiring them to be included in the auditor's report is redundant, requiring a second or third level of highlighting for important matters in management's financial statements. Furthermore, it is not in the PCAOB's proper domain. Rather than have the PCAOB introduce such an arguably unnecessary additional financial reporting requirement, we believe it would be far more appropriate for the U.S. Securities and Exchange Commission (SEC) or the Financial Accounting Standards Board to consider whether such emphasized reporting is useful in the first place. Or, perhaps audit committee reports could be enhanced to serve such a purpose. In any event, we do not support having the auditor use its report to initiate what is essentially a management reporting function.

Furthermore, the Exposure Draft delves into the matters of significant deficiencies in internal control, certain going concern considerations, and even certain legal contingencies; all these too would have to be disclosed in the auditor's report as CAMs when present. This would be the case according to the new audit requirement even when there are other accounting rules that say the opposite and do not require management to make such disclosure.

We are also concerned about the impact of an expanded auditor's report on the preparation of year-end financial statements under tight SEC deadlines when management and auditors would be developing separate descriptions of similar matters. When financial management, legal counsel, audit committees, audit engagement partners, reviewing partners, and perhaps national office partners are all asked to provide their thoughts on identical company disclosures and auditor CAM descriptions of the same matters, a fair amount of contradiction could emerge, given the fact that these participants all have different roles and types of expertise. Having to reconcile these competing positions near the critical filing date for the annual report seems to be an unnecessary complication. It could also trigger meritless litigation focusing on discrepancies, even though these arose out of good-faith efforts to comply with this challenging new standard.

**Auditor's Responsibilities Regarding Other Information**

In our earlier letter we indicated that NACD is not opposed to having the auditor provide some level of assurance around management's assertions contained in the MD&A if—and only if—such information is *auditable* and within the *expertise* of the auditor. Nevertheless, we also noted that we believed cost and timeliness were important considerations as well, and that the benefit provided would need to outweigh the cost of the auditor performing such procedures.

According to the current Exposure Draft, the PCAOB has proposed a heightened standard of auditor responsibility for "other information." Previously, the auditor was charged with the responsibility to read the other information and "consider" whether it was consistent with the audited financial statements in material respects. The Exposure Draft changes the "consider" part of this procedure to require the auditor to "evaluate" the information, and specifies the procedures that should be followed in order to meet such a requirement. While those procedures appear on the surface to be very similar to what many auditors are doing under current practice, at least some of the major accounting firms believe that this change will trigger substantially more work in the future.

We hope that this will not become a déjà vu of the PCAOB's first attempt to mandate the auditing of internal controls. Auditing Standard No. 2 was applied in a way that required auditors to apply far too many procedures and incur far too much time than was necessary. While the Board ultimately addressed this through the issuance of Auditing Standard No. 5, many companies and audit committees continue to have a negative attitude toward their audit firm and the PCAOB because of that unfortunate experience. At a minimum, the Board should do careful testing of this aspect of the Exposure Draft to ensure that there is a clear understanding of how a final standard would actually be applied in practice.

**Auditor Tenure**

"A statement containing the year the auditor began serving consecutively as the company's auditor," would be another, major addition to the auditor's report. This matter was not in the original Concepts Release so we did not comment on it in our earlier letter. In the Exposure Draft and accompanying comments by Board members, the PCAOB explains that academic and other research is mixed as to whether audit quality is enhanced by shorter or longer auditor tenure. There apparently are also mixed views among users as to whether they would find such information to be meaningful in making investment decisions.

While disclosing this information would seem to be essentially costless, we question whether including it in the auditor's report is appropriate. We are concerned that without some additional context, simply including a year of commencing an audit relationship could be misconstrued by readers. For example, some financial press accounts could focus on a very long relationship (and imply too "cozy" a situation) without also reporting the many other factors to ensure auditor independence and objectivity such as:

- Continual change among key members of financial management of the company during the audit firm's tenure.
- Mandatory rotation of the audit firm's lead partner and other key partners, as well as other changes in the members of the audit team.

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- Careful oversight of the relationship by the audit committee.
- Critical evaluation of audit quality by the audit committee (see the audit firm evaluation tool created by NACD as part of a broader initiative led by the Center for Audit Quality).

We are aware of certain companies that have provided auditor tenure information in proxy statements either in the audit committee report or in information provided in connection with a shareholder ratification vote on the selection of the independent auditors for the coming year. We recognize that these disclosures are presently voluntary and not required. If there is, however, truly sufficient investor interest in the auditor tenure information, we suggest the SEC should consider requiring it to be provided as part of proxy statement disclosures. We do not support including it in the auditor’s report.

**Other Proposed Changes to the Auditor’s Report**

In addition to those major changes, the Exposure Draft suggests a number of things that we consider to be “cosmetic” changes to the standard report including:

- A statement describing the audit (paragraph 6m).
- Clarifying that the statements are free of material misstatements *whether caused by error or fraud*.
- Addressing the report to both shareholders and the board.
- Referring to footnotes, as well as the financial statements.
- Stating in the report that the auditor is independent.

We have no objections to these changes.

**Summary**

As noted above, we have significant reservations about the three major changes proposed in the Exposure Draft: CAMs, Auditor’s Responsibilities Regarding Other Information, and Auditor Tenure. As noted in our earlier letter, NACD urges the PCAOB to thoroughly consider how the changes proposed in this Exposure Draft could impact how the audit committee and management—equally important parties in the financial reporting process—carry out their responsibility to investors. We note, with full agreement, that the Board has urged companies and auditors to test the application of the CAM proposal using recent experience. We believe that such testing will demonstrate that the vast majority of CAMs in practice will repeat similar disclosures by management as noted in our comments above. We also urge testing of the “other information” provisions of the Exposure Draft as we believe it will demonstrate that such a proposal is not cost beneficial.

As also mentioned in our earlier letter, we urge the Board to make special efforts to reach out to the investment community to ascertain clearly how the proposed changes to the auditor’s report would be used in their investment decisions.

NACD appreciates the opportunity to comment on this Exposure Draft, and would be pleased to respond to any questions regarding the views expressed in this letter.

Sincerely,

Ken Daly
President and CEO, NACD

Reatha Clark King
Chair, NACD

NATIONAL ASSOCIATION OF REAL ESTATE INVESTMENT TRUSTS®

♦ ♦ ♦

REITs: BUILDING DIVIDENDS AND DIVERSIFICATION®

August 10, 2016

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

**Delivered Electronically**

**Re: PCAOB Rulemaking Docket Matter No. 034**

Dear Board Members:

This letter is submitted by the National Association of Real Estate Investment Trusts® (NAREIT) in response to the solicitation for public comment by the Public Company Accounting Oversight Board (PCAOB or Board) with respect to its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (PCAOB Release No. 2016-003, May 11, 2016, PCAOB Rulemaking Docket Matter No. 034)* (the Reproposal).

NAREIT is the worldwide representative voice for real estate investment trusts (REITs) and publicly traded real estate companies with an interest in U.S. real estate and capital markets. NAREIT's members are REITs and other businesses throughout the world that own, operate and finance income-producing real estate, as well as those firms and individuals who advise, study and service those businesses.

REITs are generally deemed to operate as either Equity REITs or Mortgage REITs. Our members that operate as Equity REITs acquire, develop, lease and operate income-producing real estate. Our members that operate as Mortgage REITs finance housing and commercial real estate, by originating mortgages or by purchasing whole loans or mortgage backed securities in the secondary market.

A useful way to look at the REIT industry is to consider an index of stock exchange-listed companies like the FTSE NAREIT All REITs Index, which covers both Equity REITs and Mortgage REITs. This Index contained 220 companies representing an equity market capitalization of $1.10 trillion at July 31, 2016. Of these companies, 179 were Equity REITs representing 94.5% of total U.S. listed REIT equity market capitalization (amounting to $1.04

trillion)[1]. The remainder, as of July 31, 2016, was 41 publicly traded Mortgage REITs with a combined equity market capitalization of $60.0 billion.

This letter has been developed by a task force of NAREIT members, including members of NAREIT's Best Financial Practices Council. Members of the task force include financial executives of both Equity and Mortgage REITs, representatives of major accounting firms, institutional investors and industry analysts.

NAREIT appreciates the PCAOB's efforts toward improving audit quality since its inception in 2002. NAREIT acknowledges the PCAOB's substantive consideration of the feedback it received on its *Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, (PCAOB Release No. 2013-003, August 13, 2013, PCAOB Rulemaking Docket Matter No. 34)* (the Proposal) that discussed proposed modifications to the auditor's reporting model and the auditor's responsibilities for other information in certain documents containing audited financial statements. In particular, NAREIT supports the PCAOB's decision to retain the current pass/fail model of auditor reporting. However, NAREIT fails to see where the PCAOB has made a compelling argument for why critical audit matters are needed in the auditor's report or how such a requirement would enhance the usefulness of the audit report for financial analysis purposes. Further, NAREIT does not see where there is convincing evidence for how the disclosure of audit tenure would translate into enhanced audit quality. Therefore, NAREIT does not believe that the PCAOB should proceed with issuing the Reproposal as a final audit standard.

**NAREIT Recommendation: Suspend further work on the Reproposal**

We understand that the PCAOB is trying to add value to the audit report and enhance its decision usefulness by requiring that the auditor identify and discuss critical audit matters as a part of the annual audit report. However, we believe that a requirement to disclose critical audit matters in the audit report would potentially:

- Confuse and potentially mislead users of financial statements by giving them a basis to question whether the opinion rendered by the audit firm is truly unqualified (*i.e.*, that the financial statements are presented fairly in accordance with U.S. GAAP);

- Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer;

- Duplicate information that is already required by the SEC of known risks and uncertainties and critical accounting estimates, and FASB requirements for disclosure of accounting policies;

- Dampen effective communication between the audit firm and the audit committee;

[1] https://www.reit.com/sites/default/files/returns/FNUSIC2016.pdf.

- Add tension between management and auditors for the topics addressed and wording utilized in critical audit matters; and,

- Result in boilerplate disclosure of critical audit matters and how these matters were addressed in the auditor's report.

Additionally, we find no evidence of a direct correlation between auditor tenure and audit quality.

Each of these concerns is further discussed below.

**NAREIT Discussion of Concerns with Disclosing Critical Audit Matters**

*Confuse and potentially mislead users of financial statements by giving them a basis to question whether the opinion rendered by the audit firm is truly unqualified (i.e., that the financial statements are presented fairly in accordance with U.S. GAAP);*

Consistent with our prior submission[2] on the Proposal, NAREIT does not support a requirement for auditors to report on "critical audit matters" (as that term is defined in the Reproposal). **In our view, a requirement to disclose critical audit matters would have the unintended consequence of audit firms effectively qualifying unqualified opinions.** Investors would be left to question the auditor's judgment that the financial statements are prepared fairly in accordance with U.S. GAAP given the list of risks that would be included in the auditor's report. This would detract from the investor's true purpose in utilizing the audited financial statements as a basis for their financial analysis. By giving auditors the opportunity to disclose the risks that "keep them up at night," analysts may be left with reduced confidence as to whether the financial information that serves as the basis for their capital allocation decisions is reliable.

Through our discussions with investors and buy-side and sell-side analysts that follow the REIT industry, investors and analysts are interested in whether the auditor has provided an unqualified opinion on the financial statements – period. When asked whether they would be interested in an auditor report like the often-cited Rolls-Royce[3] example, they questioned how they could read and interpret a six page auditor report for the 80 companies they follow regularly in the REIT industry in addition to their analysis of the audited financial statements. To reiterate, we have seen no evidence that including critical audit matters in the audit report would be useful to financial analysis. The Reproposal itself acknowledges that the results of research on this matter are "ambiguous".

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[2] https://pcaobus.org/Rulemaking/Docket034/125b_NAREIT.pdf.
[3] http://www.rolls-royce.com/~/media/Files/R/Rolls-Royce/documents/investors/annual-reports/2015-annual-report-v1.pdf at pages 167 - 174.

*Introduce situations when the auditor is disclosing sensitive information that is not otherwise required to be disclosed by the issuer*;

In our previous submission on the Proposal, we highlighted an issue with Hypothetical Auditing Scenario #3 that illustrates a fact pattern in which the auditor discloses a "control deficiency less severe than a material weakness noted in the Company's internal control system."[4] This information is part of the auditor's required communication to the issuer's audit committee, under current PCAOB standards, but there is nothing in securities law that requires public reporting of either significant deficiencies in internal controls or audit adjustments.

The Reproposal states that the PCAOB has addressed constituent concerns, but we continue to believe that this is an issue. The Reproposal

> …adds a note to address commenters' concerns about the auditor becoming the source of original (and potentially confidential) information about the company. The note indicates that when describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.[5]

NAREIT does not believe that the commenters' concern is addressed due to the words "unless such information is necessary." The Reproposal goes on to explain that the auditor's disclosure of a matter could trigger disclosure on the part of management. However, this would appear to have the auditors then act in the capacity of management in situations when management declines to disclose information that is not required by securities laws.

NAREIT strongly believes that an audit firm should not report sensitive information that is not required to be disclosed under existing securities laws and/or generally accepted accounting principles. We believe that existing U.S. securities laws and existing U.S. GAAP are sufficient to provide users with the appropriate amount of information to make investment decisions. Further, the expansion of existing disclosure requirements is the purview and responsibility of the SEC and the FASB. Accordingly, if the PCAOB were to go forward with this Reproposal, we believe the auditor should be prohibited from disclosing any information that is not otherwise required to be disclosed by the issuer.

*Dampen effective communication between the audit firm and the audit committee*

NAREIT believes that the Reproposal's requirement that auditors evaluate whether required communications to the audit committee represent critical audit matters, will have the unintended

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[4] http://pcaobus.org/Rules/Rulemaking/Docket034/Release_2013-005_ARM.pdf at page A5-77.
[5] https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf at page 37.

consequence of dampening open communication between the audit firm and the audit committee. We believe that standard setting that serves as an impediment to open and candid dialogue between the auditor and the audit committee should be avoided at all costs.

*Duplicate information that is already required by the SEC of known risks and uncertainties and critical accounting estimates, and FASB requirements for disclosure of accounting policies*

We believe that the most difficult, subjective and complex audit matters encountered by the auditor are highly likely to be the risks and uncertainties and critical accounting estimates that the issuer is already disclosing in its Management Discussion and Analysis (MD&A). Given that the sections of MD&A that cover risks and uncertainties and critical accounting estimates and the summary of accounting policies in the notes to the financial statements provide the reader with management's assessment of the most judgmental aspects of the financial statements, NAREIT questions why the Board would require auditors to duplicate this information. If the PCAOB believes that this existing information is not sufficiently robust or transparent, NAREIT recommends that SEC or the FASB evaluate this aspect of financial reporting and provide additional guidance through formal standard setting.

*Add tension between management and auditors for the topics addressed and wording utilized in critical audit matters*

Given the litigious business environment in the United States, we believe that the wording chosen for the critical audit matters would be highly scrutinized. Management may object to the risks included if, in their view, they do not mirror disclosures already made in MD&A. Additionally, management may take exception to the wording that the auditor uses in their audit report. NAREIT believes that the Reproposal will create unnecessary tension between management and the auditor over the auditor's report, and serve as a distraction from the auditor's role in auditing the financial statements and internal controls over financial reporting.

*Result in boilerplate disclosure of critical audit matters and how these matters were addressed in the auditor's report*

Similar to our previous comment on the legal framework in the United States, wording of critical audit matters will likely be streamlined by accounting firms to address potential litigation. Thus, the value that the PCAOB is seeking to achieve will not be realized when audit staff are left to utilize templates for standardized critical audit matters. NAREIT fails to see how requiring disclosure of critical audit matters will be an improvement in financial reporting, let alone audit quality.

**NAREIT Comments on Auditor Tenure**

NAREIT understands that there is some interest amongst financial statement users about auditor tenure. We observe that for many issuers, the tenure of an audit firm can be determined by a review of the issuer's public filings. However, NAREIT does not support the part of the Proposal that requires auditors to report on their tenure because that information, placed in the audit report, infers a direct relationship between auditor tenure and the quality of the audit or the content of the audit report that may not exist. NAREIT is unaware of evidence indicating that auditor tenure has a direct correlation to audit quality.

Perhaps more importantly, NAREIT considers auditor tenure to be a corporate governance matter under the direct purview of the issuer's audit committee only.

Further, a statement regarding auditor tenure placed in the audit report would be severely out of context. There would be no information about how the audit committee assesses the quality of the audit work and determines whether or not a change in auditor is appropriate. It also would provide no information regarding the most recent tendering of the audit. Some users might incorrectly infer that longer auditor tenure indicates that the audit has not been retendered when, in fact, the audit committee's decision to retain the incumbent audit firm was made after an extensive retendering process.

The Reproposal acknowledges that views on whether auditor tenure corresponds to improved audit quality are inconclusive amongst past commenters and academic research[6]. Therefore, NAREIT recommends that information regarding auditor tenure continue to be excluded from the audit report.

If academic evidence can prove that there is a direct relationship between auditor tenure and audit quality, the SEC should consider adding relevant disclosure requirements to proxy statements that are filed coincident with audit committee reports or in connection with company shareholder ratification of auditor appointments. In our view, the proxy statement would be the better place for disclosure of auditor tenure, where proper context could be given. Companies could include a summary of the process that the audit committee completed to vet the audit firm, including whether or not the audit was out for bid.

**Summary**

NAREIT does not believe that the changes recommended by the Proposal with respect to the audit report and disclosure of auditor tenure are warranted. These requirements would add costs without improving the quality of the audit. Furthermore, these proposals would be likely to confuse and in some cases even mislead users of financial statements. Therefore, NAREIT recommends that the PCAOB suspend its efforts on the Reproposal, and instead focus its time and resources on improving aspects of the audit procedures that would enhance audit quality so as to provide investors with more confidence that the audited financial statements are, indeed, free of material misstatement.

At a time when both the Financial Accounting Standards Board and the Securities and Exchange Commission are focused on disclosure effectiveness initiatives to improve disclosure and

[6] https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf at page 47.

eliminate redundancy, we find it odd that the PCAOB would be exacerbating the "disclosure overload" phenomenon by expanding the auditor report. In our view, an expansion of the unqualified audit opinion to include critical audit matters would prove to be misleading to investors and would largely result in generic disclosures that are duplicative of information that is provided by management. Moreover, we do not see a direct correlation between auditor tenure and audit quality, and believe that disclosing auditor tenure could be misleading to investors as well.

In the event that the PCAOB decides to move forward with the Reproposal, NAREIT recommends that the Board consider conducting robust field testing. In our view, field testing should involve not only the preparer and auditor community, but also representatives from the investment community and related regulatory bodies like the SEC in order to fully assess both the costs and the benefits of the Reproposal. This would provide the Board with evidential matter in evaluating whether the Reproposal is operational, whether additional guidance is needed, whether the implementation costs outweigh the perceived benefits, and if the Reproposal's objectives could actually be achieved.

* * *

We thank the PCAOB for the opportunity to comment on the Proposal. If you would like to discuss our views in greater detail, please contact George Yungmann, NAREIT's Senior Vice President, Financial Standards, at gyungmann@nareit.com or 1-202-739-9432, or Christopher T. Drula, NAREIT's Vice President, Financial Standards, at cdrula@nareit.com or 1-202-739-9442.

Respectfully submitted,

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NAREIT

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Vice President, Financial Standards
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August 12, 2016

Office of the Secretary
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Via e-mail: comments@pcaobus.org

Re: *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; PCAOB Rulemaking Docket Matter No. 034*

Dear Members of the Public Company Accounting Oversight Board:

We appreciate the opportunity to offer comments on the Proposed Auditing Standard referred to above. The National Association of State Boards of Accountancy's (NASBA) mission is to enhance the effectiveness and advance the common interests of the Boards of Accountancy that regulate all certified public accountants and their firms in the United States and its territories.

As stated in our December 9, 2013 response letter, we support the Board's efforts to modify the auditor's report so that it is more useful to investors. The more information of value auditors are able to provide to the users of audited financial statements, the greater the worth and relevance auditors can provide to the capital markets. We also believe the revisions that the PCAOB made, based on its requests for comments, better align the proposed standard with other international regulatory bodies' and provide a better framework for an independent auditor to serve the public interest.

**Definition of a Critical Audit Matter**

1. The Proposed Auditing Standard requires communication in the auditor's report of any critical audit matter (CAM) which "was communicated or required to be communicated" to the audit committee. We suggest deleting "communicated or" from the definition of a critical audit matter.

2. The Proposed Auditing Standard requires communication in the auditor's report of any CAM which relates to accounts or disclosures that are material to the financial statements.

We agree, but would add "and disclosed in" for the definition to require communication of CAMs which are related to accounts or disclosures that are material to as well as disclosed in the financial statements. We do have a concern that paragraph 11 of the proposed standard could require an auditor to provide information about the company that has not been made publicly available by the company.

3. We believe that illustrative examples of CAM included in the Proposed Auditing Standard should be clearer on whether a discussion of a CAM in the audit report should include the results of any findings related to the internal control over financial reporting (ICFR) that may have resulted in an adjustment to accounts or disclosures that are material to the financial statements. We suggest providing additional examples of CAM that include language describing such findings and their impact on the material accounts or disclosures.

4. The Proposed Auditing Standard currently does not outline the auditor's responsibility in respect to other information that is not currently included in the financial statements (e.g. MD&A disclosures). We understand that the PCAOB is considering additional projects in relation to such other information and we would support the PCAOB's efforts to further clarify the auditor's responsibility in respect to such other information.

**Independence**

The Proposed Auditing Standard requires that the auditor's report include the following statement:

"We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the…."

We believe that the auditor's report should state that the auditor "is independent," instead of "required to be independent."

**Auditor's Tenure**

1. The Proposed Auditing Standard requires the auditor's report to include a statement regarding the auditor's tenure. As noted in our December 9, 2013 response letter, State Boards have not found a relationship between the auditor's tenure and the auditor's independence. However if the PCAOB believes this is useful information, we would recommend that the information on the auditor's tenure be reported in Form AP, *Auditor Reporting of Certain Audit Participants*, rather than in the auditor's report.

2. There might be situations where, due to mergers, acquisitions or changes in ownership, there may be uncertainty as to the year the auditor began serving consecutively as the company's auditor. We believe that the proposed standard should provide more clarification for disclosure related to these cases.

**Additional Improvements to the Auditor's Report**

The proposed auditing standard allows the auditors to retain the option to include additional addressees in the auditor's report (page 45). The current proposal invites third parties to ask to be included as addressees. We do not believe the PCAOB should have language in the final rule that has the potential to inadvertently result in increased auditor liability and costs. The SEC requires audited financial statements be provided by public companies to protect investors, both those investors that have invested and those that may invest. We would suggest that the best solution would be to require no addressees. The title "Report of Independent Registered Public Accountant" speaks for itself without the need for an addressee.

**Explanatory Language and Emphasis of a Matter**

We understand there may be situations where an auditor may wish to combine a critical matter into an emphasis of matter paragraph based on the discussion in the proposed standard. Unfortunately this might lead to public confusion and we therefore believe that CAM and explanatory paragraphs in the auditor's report should not be integrated. However, we do believe it would be appropriate to make reference to the CAM in the explanatory paragraph.

**Conformity with International Standards**

We understand that in developing the Proposed Auditing Standard the PCAOB has considered similar auditor's reporting initiatives undertaken by international regulators. Although there are similarities between the PCAOB's and IAASB's auditor's reporting models, the use of different terms and concepts such as "Critical Audit Matter" by the PCAOB vs "Key Audit Matters" by the IAASB may create confusion and lack of consistency for users of financial statements in the international markets. Therefore we believe wherever possible, especially where the meaning is the same, consistent terminology should be used.

**Considerations Related to the Effective Date**

We think the implementation of the standard will take at least a year from the date of approval of the Final Audit Standard by the Securities and Exchange Commission. We do not believe that there should be any additional delay in the adoption of the standard related to audits of smaller companies.

* * *

Again, we appreciate the opportunity to comment on the Exposure Draft.

Very truly yours,

Donny H Burkett

Donald H. Burkett, CPA

Ken L. Bishop

Ken L. Bishop

July 28, 2016

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1666 K Street, NW
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Via email to: comments@pcaobus.org

Re: **Proposed Auditing Standard: PCAOB Release No. 2016-003, *The Auditor's Report***
**PCAOB Rulemaking Docket Matter No. 034**

Dear Chairman Doty, Distinguished Board Members, and others whom this may concern:

The Accounting and Auditing Standards Interest Group of the New Jersey Society of Certified Public Accountants (NJCPA) appreciates this opportunity to comment on the proposed auditing standard. The NJCPA represents over 15,000 certified public accountants and prospective CPAs. The comments herein represent those of some of the individuals of our Accounting and Auditing Standards Interest Group only and do not necessarily reflect the views of all members of the NJCPA.

Our comments speak to the overall proposed changes and their objective of changing the auditor's report. Those proposed changes may be summarized as: the addition of critical audit matters (CAMs) to the auditor's report; and other changes to the auditor's report, consisting of an independence statement, an auditor tenure statement, the addressee, and other enhancements to basic elements.

**<u>Critical Audit Matters</u>**

We have read the Board's argument for the disclosure of critical audit matters (CAMs) in the auditor's report. We fundamentally disagree with the reproposal to incorporate CAMs, as we believe this will change the principal purpose of the auditor's report. We disagree that the presentation of CAMs adds value to the user or investor in reading and understanding the financial information.

The Board is reproposing that the auditor identify a CAM as any defined critical matters arising from the current audit, or include a statement that no CAMs were identified. These will include challenging, subjective, or complex matters affecting auditor judgments, and how the auditor responded to those matters. We believe that what is critically important is the total package of information presented to the shareholders and investors, not insights into the process of auditing such information. The awareness of how certain audit procedures were performed does not add value to the user or investor. We do not believe that CAMs would assist investors and analysts in engaging management with targeted questions about company information. No incremental

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increase in the quality of financial information is gained by the user of the financial statement. If the intended consequence of incorporating CAMs is to drive improvements in audit quality, we believe that current measures, such as the PCAOB's inspection program and required communications with audit committees, are better ways of achieving that objective.

We do agree that the clarity the user may be missing is an improved understanding of what information the auditor is, and is not, responsible for. Our auditor's report speaks only to the financial statements; however, those are obviously contained in a filing with much additional information. The auditor's standard report as currently promulgated does not mention the footnotes. We agree that this should be added to the auditor's report. Further, the auditor has certain limited responsibilities with respect to the other accompanying information, for example, management's discussion and analysis, but no mention is made of what those responsibilities are, and are not.

We suggest that the auditor's report should better define auditor responsibilities for the additional information, so that the financial statement user has a clear understanding. The auditor's report can be expanded to include a brief statement about this responsibility. Disclosing this information in the audit report will enhance the investor's understanding of the auditor's role and responsibilities.

**Additional Improvements**

With respect to the proposed statement on independence, certain members of our group noted that the title to the auditor's report already contains the word "Independent". While they agreed that independence and objectivity are critical to the audit process, they believe that independence could not be given any more prominence than being included in the title to the report. Other members of our group were in agreement with adding this statement in the audit report.

With respect to the proposed statement on auditor tenure, we note the PCAOB now requires the disclosure of audit partners on Form AP, filed separately with the PCAOB. We agree with the proposed requirement to disclose the audit firm's tenure; however, we believe that it is better made as part of the Form AP rather than in the auditor's report. We agree that disclosure of auditor tenure should be available to present and prospective investors.

With respect to the proposal on the addressee, we agree that specifying the addressee in the audit report is appropriate.

With respect to the other proposed enhancements to basic elements, as stated in our above comments, we recommend that auditor responsibilities are better defined. However, certain members of our group do not support the addition of the phrase "whether due to error or fraud" because they believe that this will unintentionally confuse users regarding the auditor's responsibilities concerning fraud. Others in the group support the Board's proposed addition. They believe that the addition of "whether due to error or fraud" will improve the user's understanding of the auditor's responsibilities.

With respect to the other proposed enhancements regarding the standardized form of the auditor's report, we agree with the Board's proposal to position the opinion as the first paragraph, immediately followed by the subtitle "Basis for Opinion". This will add clarity and structure to the audit report. Further, we support this enhancement even though we do not support the addition of the Critical Audit Matters section. If the CAM reproposal becomes final, we believe this geography change is also important. The CAM reproposal, if approved, may significantly lengthen the audit report with potentially cumbersome and confusing additions. The reader of a reproposed audit report (including CAM), may no longer be able to easily navigate his or her way to clearly identifying the type of auditor's opinion rendered, as with the extant report. Positioning the opinion first addresses this.

Some members of our group believe that our above comments apply to Emerging Growth Companies, as defined. However, others believe that there should be some consideration or exemption for smaller reporting companies. The documentation required, as well as the increase in audit fees to comply with the proposals, may be burdensome to such companies. Therefore, some members suggest that the Board consider whether the proposed changes to the auditor's report should take into consideration the size of the entity being reported on. Those members would like the Board to consider providing smaller reporting companies relief from some of the documentation and disclosure requirements of this proposal.

We wish to thank the PCAOB for this opportunity to comment on the reproposed standard. Although we have taken different positions than the Board on some of the proposal's provisions, we trust that a high-quality dialog and the vetting of the proposal within the profession will yield an even better standard to implement.

Very truly yours,

Elizabeth B. Harper

Elizabeth Harper, CPA, Leader
Accounting and Auditing Standards Interest Group
New Jersey Society of Certified Public Accountants

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August 3, 2016

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By e-mail: comments@pcaobus.org

**Re: Proposed Auditing Standard—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards***

**(Release No. 2016-003; Docket Matter No. 034)**

Dear Mr. Secretary:

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 26,000 CPAs in public practice, business, government and education, welcomes the opportunity to comment on the above-captioned release.

The NYSSCPA's SEC and Auditing Standards Committees deliberated the proposed standard and prepared the attached comments. If you would like additional discussion with us, please contact Charles V. Abraham, Chair of the SEC Committee, at (516) 620-8526, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

F. Michael Zovistoski
President

Attachment

**NEW YORK STATE SOCIETY OF**

**CERTIFIED PUBLIC ACCOUNTANTS**

# COMMENTS ON

# PROPOSED AUDITING STANDARD—THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION

# AND RELATED AMENDMENTS TO PCAOB STANDARDS

**(Release No. 2016-003; Docket Matter No. 034)**

**August 3, 2016**

**<u>Principal Drafters</u>**

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# New York State Society of Certified Public Accountants

**Comments on**

**Proposed Auditing Standard—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards***

**(Release No. 2016-003; Docket Matter No. 034)**

## General Comments

The New York State Society of Certified Public Accountants (NYSSCPA) appreciates the opportunity to comment on the Public Company Accounting Oversight Board's (PCAOB or the Board) Release No. 2016-003, Proposed Auditing Standard—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (Proposed Standard).

We understand that the Proposed Standard "seeks to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users. In particular, the auditor's report would include a description of 'critical audit matters' (CAMs), which would provide audit-specific information about especially challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures."

We disagreed with the incorporation of CAMs into the audit report in our previous letter to the Board regarding Release No. 2013-005**,** Docket Matter No. 034, dated December 10, 2013 (attached). While we acknowledge the additional outreach and research conducted by the Board, and we recognize certain improvements in the Proposed Standard to address concerns, our views remain unchanged. We continue to believe that the inclusion of CAMs in public reports would not help users in making investment, voting, or credit decisions or enhance transparency in a meaningful way, but would dilute the pass/fail message and diminish the value of an audit report. We note that while other regulators and standards setters (such as the IAASB, the EU and the FRC) have enacted similar audit reporting requirements for CAMs, the litigation environment in the United States is different from these other foreign jurisdictions. For details supporting our opposition to reporting CAMs, we refer you to our response to Question 10 in our December 10, 2013, letter.

The foregoing notwithstanding, assuming the Board proceeds with its proposal relative to CAMs, we have answered questions 1–8 of the Proposed Standard. In addition to our responses, we also offer this general comment about the disclosure of auditor tenure within the audit report. Although we do not believe it is relevant or appropriate to disclose information about auditor tenure in the audit report, if the Board does require public disclosure of such information, we would suggest that it be incorporated into Form AP, or a similar reporting form, instead of the audit report. Inclusion of such information in audit reports would imply a relationship between the quality of the audit or independence and auditor tenure, which we believe does not and should not be presumed to exist.

**Responses to Specific Questions from the Proposed Standard**

Presented below are our responses to selected questions from the Proposed Standard.

**1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.**

The definition by itself is sufficiently clear; however, when used in the intended context, it is apparent it is subjective. As a result, the examples presented must be viewed as simply illustrative and the Board's objective of consistent application will not likely be served. The decision as to what matters in the audit are "challenging, subjective, or complex" and will necessarily depend on the judgment, knowledge and experience of the engagement team, especially the engagement partner. An engagement partner with extensive knowledge and experience will not view certain matters as reportable CAMs, while another individual (or team) with different judgment, knowledge or experience might characterize those matters as CAMs. Any standard should provide for differences in good faith—professional judgments, specifically—as to such reporting decisions, to mitigate the risk of inquiries by regulators and adversaries.

On another level, individual firm policies could be a significant factor in the decision about CAMs. For example, if a firm maintains a policy of mandating the review of a client's accounting for beneficial conversion features ("BCF"), we believe that the involvement of a national office or other central consultation might automatically trigger the characterization of the BCF as a CAM.

**1a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?**

The decision to start with communications made or required to be made to the audit committee is an appropriate source for the stated objectives. However, as a practical reality, the detailed dialogue between auditors and audit committees is not available to the investors or other users, who will, invariably want more information on matters reported as a CAM in the auditor's report.

We believe this reality will likely serve as a powerful incentive for auditors to include less detail, rather than more, when contemplating reporting a CAM. The ability to raise further questions on these matters is limited, and may affect a user's decisions. Investors and other stakeholders rely on audit committees to discuss critical accounting and audit matters with the auditor and come to appropriate conclusions regarding the registrant's financial statements. If the investment community does not have sufficient confidence in audit committees to place such reliance on them, then we believe the SEC should take appropriate action to further regulate the conduct and qualifications of the audit committee, rather than place additional public reporting burdens on auditors.

We do not believe there is a practical way to reduce the "information asymmetry," as suggested by the Board, nor do we believe that it is reasonable to expect information symmetry.

**1b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.**

Yes, we believe matters such as independence considerations, competency issues of management or other professionals involved in the engagement, discussions with component auditors (especially regarding audit scope), and delays encountered in the current audit, should generally not be reported as CAMs. We believe that such matters are among those sensitive topics that should be reserved for extensive dialogue between the audit committee and the auditor, as it may not be understood clearly if presented in an audit report as a CAM.

**1c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?**

We believe it is appropriate to include the above-quoted qualifier in the definition of CAMs, but we also believe that this question is more complicated, since its functional premise should be grounded in significant risk. Significant risks, such as going concern matters, may be mitigated by an entity that has adequately demonstrated its ability to meet liquidity requirements for at least a year. Notwithstanding how that circumstance plays out, the assumption here is that the disclosures would be adequate, the auditor would evaluate those disclosures, and the matter may be communicated in the audit report, such as in an emphasis-of-matter paragraph, thus making CAM disclosure unnecessary.

**1d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?**

See our response in Question 1.

**2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?**

We support the Board's reasoning in citing the underlying factors that should be considered for an auditor in determining whether to classify a matter as a CAM.

**3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?**

In general, we believe that the factors provided in the Proposed Standard are adequate to help auditors determine which matters qualify for treatment as CAMs.

**4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?**

The auditors' judgment should prevail as to the circumstances when CAMs should be reported, in addition to the overall requirement to provide CAMs in auditors' reports for the current year. The report on the financial statements of the entity's most current period provides the most relevant information for investors' or other users' decisions. We believe that auditors should be encouraged to use judgment as to whether to include CAMs for earlier periods when significant risks prevail in both the current and prior periods, but the final standard should be flexible in its requirements.

**5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?**

We are concerned about the addition to the bulleted list of communication requirements in the Proposed Standard. For example, when the Proposed Standard states, "describe how the critical audit matter was addressed in the audit," we ask at what level(s), overall, is it referring to? Should the description be at the account level? At the assertion(s) level? Should the disclosure describe how the matter affected the planning, audit staffing, timing and review? The point here is that there are many decision points in the audit, and it is a process not easily described or understood. The primary purpose of the audit report should be to inform investors and provide them with reasonable assurance regarding the fair presentation of the financial statements, not to provide a reader with an avenue to speculate about auditor judgment.

For example, let us assume that the CAM relates to an estimate. Would a sufficient description be that the auditor developed its own estimate, compared it to the client's estimate, evaluated the client's estimation process (including the information gathering process), and that the entity's internal controls over the assertions related to the estimate were audited? We do not believe that such a description would serve to strengthen investors' or other users' confidence in the audit and the auditors. There are inherent uncertainties embedded in an estimate that are assessed and addressed by the auditor, and these uncertainties may not be appropriately addressed within the context of the audit report to investors.

**6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:**

**a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit…**

Commenters on the original draft proposal were concerned about confidentiality issues in situations where the auditor disclosed new information that was not previously disclosed in the entity's filings or was disclosed from a perspective differing from that of the auditor.

The Proposed Standard, which would confine required CAM disclosures to matters discussed with the audit committee, mitigates this issue. However, we believe that if the auditor would like to make further disclosure of a CAM, it should not be precluded from doing so, and to overcome the confidentiality question, we suggest that client permission be obtained.

Descriptions of how auditors addressed the CAMs can become limiting and self-serving. Many procedures that auditors use to obtain comfort as to financial statement assertions are often called "primary" procedures. In situations where significant risks are high, several primary or corroborative procedures may be needed or used. Complex interrelationships of the many audit procedures and techniques (even in addressing one CAM) would be very difficult to explain to the users in a succinct and coherent manner, especially if what are commonly called "extended" procedures are employed.

We see the discussion of audit scope as part of the proposed CAM as a throwback to the old—and similarly nonstandardized—"long-form" audit report about which auditors were cautioned in 1957 (see SAP 27) that "comments or other data contained in the long-form report lend themselves to a contention that they constitute exceptions or reservations, as distinguished from mere explanations." Apparently, largely as a result of such cautionary language which we believe remains applicable today, the long-form report gradually disappeared from use. Accordingly, when explaining the underlying complexity of performing an audit, we believe that the level of detail provided would be a source of confusion to users.

**b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?**

We believe that in the first several years of use, a certain amount of misinterpretation of the content and purpose of CAMs by readers is probable. As users become acclimated to the new reporting, the risk of misinterpretation will diminish. If, in fact, CAMs become a required part of the audit report, illustrative non-authoritative examples or guidance, for example, through Staff Practice Alerts, would be helpful.

**7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?**

We view the discussion of matters outside financial statements by the auditor as problematic at best and, at worst, likely to be viewed as a form of attestation. If there were no audit assurance provided on such information, the role, responsibility and objectives of the auditor would likely be unstated and misunderstood. A level of assurance on such information (on a disclosure attributable solely to the auditor) would give rise to independence concerns. Liability concerns, especially under the Federal securities laws, would be an issue, unless future regulation provides a safe harbor, and there would have to be sufficient caveats, depending on the source and content, to be able to provide this information.

We note that there is an attestation standard (PCAOB Interim Standard AT 701) under which auditors can either review or examine the content of the Management Discussion and Analysis, which is of course client-generated information and the attestation report is issued only when the auditor is engaged by the registrant. AT 701 was issued in 2001, but we believe it has been used infrequently. We surmise that there has been little or no demand for this service because the cost/benefit relationship perceived is questionable.

**8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?**

We believe it is appropriate for the Proposed Standard to retain the possibility of the auditor determining that there are no CAMs. We believe that this is a better option than being pressured to insert one when it is not warranted, although we do not expect that there will be many reports devoid of CAMs. If, however, the auditor does come to the conclusion that there are no CAMs, it is inappropriate to require a negative statement to that effect in the auditor's report. The absence of a CAM in the auditor's report should be sufficient, without having to make a definitive statement. We would compare this to the current use of "emphasis-of-a-matter" paragraphs, the absence of which is not commented on by the reporting auditor.

NYS SOCIETY OF CPA's
NYSSCPA

December 10, 2013

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

Via email: comments@pcaobus.org

**Re: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

**Release No. 2013-005, Docket No. 034**

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 29,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned proposed auditing standard.

The NYSSCPA's Auditing Standards, SEC and Stock Brokerage Committees deliberated the proposed standard and prepared the attached comments. If you would like additional discussion with us, please contact Julian Jacoby, Chair of the Auditing Standards Committee at (646) 644-4482, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

NYSSCPA
NYSSCPA

J. Michael Kirkland
President

Attachment

NYS SOCIETY OF CPAs
NYSSCPA

**NEW YORK STATE SOCIETY OF**

**CERTIFIED PUBLIC ACCOUNTANTS**

# COMMENTS ON
# Article I.
# PROPOSED AUDITING STANDARDS – THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION;

# THE AUDITOR'S RESPONSIBILITIES REGARDING OTHER INFORMATION IN CERTAIN DOCUMENTS CONTAINING AUDITED FINANCIAL STATEMENTS AND THE RELATED AUDITOR'S REPORT;

# AND RELATED AMENDMENTS TO PCAOB STANDARDS

**(PCAOB Release No. 2013-005, Docket Matter No. 034)**

**December 10, 2013**

**Principal Drafters**

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**Julian Jacoby**
**Howard Levy**
**Melissa Telesca**
**Robert Waxman**

***From the SEC Committee:***

**Elliot L. Hendler**
**Mitchell Mertz**
**Arthur J. Radin**

***From the Stock Brokerage Committee:***

**David H. Grumer**
**Mark Levy**
**Gary Purwin**

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**New York State Society of Certified Public Accountants**

**Comments on**

**Proposed Auditing Standards – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion;**

**The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report;**

**and Related Amendments to PCAOB Standards**

**(PCAOB Release No. 2013-005, Docket Matter No. 034)**

## General Comments

The New York State Society of Certified Public Accountants (NYSSCPA) is pleased to submit the following comments on the above-captioned release (the Release) issued by the Public Company Accounting Oversight Board (PCAOB or the Board). Our responses to the questions contained in Appendices 5, 6 and 7 of the release are presented below.

## Appendix 5 – Additional Discussion Related to the Proposed Auditor Reporting Standard

### Question Related to Section II

**1.** ***Do the objectives assist the auditor in* understanding *the requirements of what would be communicated in an auditor's unqualified report? Why or why not?***

We believe the first objective, as set forth in paragraph 4a of the proposed standard, has always been and continues to be implied and obvious and need not be expressly articulated. The second objective, as set forth in paragraph 4b of the proposed standard, refers to communicating critical audit matters, the benefits and advisability of which we have significant reservations that are expressed in our responses to Questions 10-28 of Section V of Appendix 5.

### Questions Related to Section IV

**2.** ***The proposed auditor reporting standard would require the auditor's report to be addressed at least to (1) investors in the company, such as shareholders, and (2) the board of directors or equivalent body. Are there others to whom the auditor's report should be required to be addressed?***

The Board, in its discussion of the proposed standard, states that the shareholders are the auditor's "ultimate customer." It is our preference that the Board should specify shareholders or stockholders rather than "investors." We believe that in addition to the Board of Directors or equivalent body, the proposed standard should require the report be addressed to current shareholders. The basis for the "Board of Directors" inclusion is that the engagement letter is contractual and a legal obligation of the Board of Directors. The parties to the contract should be the parties issuing and receiving the report. We do not strongly oppose using "investors," because investors in short sales, option holders, debenture holders, holders of mutual funds who hold the company's securities, *etc*., are all investors.

**3. *The proposed auditor reporting standard retains the requirement for the auditor's report to contain a description of the nature of an audit, but revises that description to better align it with the requirements in the Board's risk assessment standards. Are there any additional auditor responsibilities that should be included to further describe the nature of an audit?***

We believe that the proposed language in paragraphs 6(j) through 6(n) captures the spirit of the auditor's responsibility. We do not believe that every time the phrase "material misstatement" is used it needs to be followed by "whether due to error or fraud." Material misstatement can only occur intentionally or unintentionally. The inclusion of "whether due to error or fraud" is a redundant statement and is not necessary in the same section.

In addition, while paragraph 6(m) states that an audit includes among other things, examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements. The word "appropriate" may be unclear to readers. Audit evidence is required to be sufficient and appropriate with the former relating to the quantity of evidence and the latter related to the quality of evidence. Because audit evidence by definition must include elements of both characteristics, the paragraph should read "Examining on a test basis, evidence regarding the amounts and disclosures in the financial statements."

Finally, the standard should include a reference to the auditor's responsibility to consider the company's internal controls when assessing risk and designing procedures to address identified risks. Whether the company is subject to Section 404 of the Sarbanes-Oxley Act, the auditor is required at a minimum to consider the design and implementation of the company's internal controls when designing an appropriate response to identified risks of material misstatement. This insert should be part of the auditor's responsibilities section of the auditor's report.

**4. *The proposed auditor reporting standard would require the auditor to include a statement in the auditor's report relating to auditor independence. Would this statement provide useful information regarding the auditor's responsibilities to be independent? Why or why not?***

Because independence is the prime tenet of auditing the fact that a separate statement that the auditor is public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the United States federal securities laws and the applicable rules and regulations of the Securities Exchange Commission (SEC) and PCAOB is additive. The general idea of this information is included in the title of the auditor's report. We appreciate the Board's overriding concern with independence but a boilerplate statement added to all reports will not affect or remedy concern for the quality of this matter.

**5.** ***The proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor.***

*a.* ***Would information regarding auditor tenure in the auditor's report be useful to investors and other financial statement users? Why or why not? What other benefits, disadvantages, or unintended consequences, if any, are associated with including such information in the auditor's report?***

*b.* ***Are there any additional challenges the auditor might face in determining or reporting the year the auditor began serving consecutively as the company's auditor?***

*c.* ***Is information regarding auditor tenure more likely to be useful to investors and other financial statement users if included in the auditor's report in addition to EDGAR and other sources? Why or why not?***

As audit partners and engagement quality reviewers are required to rotate on each public company every five years (with limited exceptions for small audit firms), we do not believe that the length of time that firms have audited clients is relevant to the audit opinion on any given year's financial statements. This issue has surfaced and resurfaced from time to time. The PCAOB oversight regime and the firm's own quality controls would have more of an influence on poor audit quality than the premise that long- term tenure affects audit quality. Quality issues may be more influenced by personnel failure which we believe will always occur.

**6.** ***The proposed auditor reporting standard would require the auditor to describe the auditor's responsibilities for other information and the results of the evaluation of other information. Would the proposed description make the auditor's report more informative and useful? Why or why not?***

Providing auditors with objectives links the procedures to what the auditor is trying to achieve; so we support this consideration.

Paragraph 2(b) should be revised as follows: When issuing an auditor's report on the other information and *when the other information includes* whether, based on relevant audit evidence obtained and conclusions reached during the audit, the other information contains a material inconsistency or material misstatement of fact, *or both to describe these in the auditor's report.* We disagree with the requirement for the auditor to make a positive statement or conclusion about the absence of any inconsistencies, material misstatements or both discussed in paragraph 13(e). Also see our response in Question 18 of Appendix IV).

**7.** ***Should the Board require a specific order for the presentation of the basic elements required in the auditor's report? Why or why not?***

We believe this is not a substantive matter. If left out of the standard, firms may have more flexibility in highlighting or emphasizing specific matters for users to consider.

**8.** ***What other changes to the basic elements should the Board consider adding to the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor?***

See our response in Question 3 above. The Board's discussion of the other elements of the report is satisfactory.

**9.** ***What are the potential costs or other considerations related to the proposed basic elements of the auditor's report? Are cost considerations the same for audits of all types of companies? If not, explain how they might differ.***

We are uncertain if the drafters are categorizing critical audit matters as a basic element. That section will take the most time and effort relative to any other changes being proposed.

**Section V**

**General Comment**

We commend the Board for responding to the concerns expressed by many respondents to Release No. 2011-003 dated June 21, 2011, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements* (the Concept Release) by proposing a discussion of "critical audit matters" in audit reports in lieu of the "Auditor's Discussion and Analysis" (or AD & A) suggested in the earlier Concept Release. We responded to the Concept Release in a letter dated September 27, 2011, and understand those concerns to be rooted in a desire to preserve the purity of the attest function by not requiring auditors to speak about financial statement matters in a way that should be reserved for management. The critical audit matters discussion currently proposed is apparently intended to be limited to matters of auditor judgment which we believe (despite our reservations set forth in our responses to Questions 10-28 of Section V of Appendix 5 of the current Release) would be far more appropriate than the broader AD & A described in the Concept Release.

**Questions Related to Section V**

**10.** ***Would the auditor's communication of critical audit matters be relevant and useful to investors and other financial statement users? If not, what other alternatives should the Board consider?***

No, the auditor's communication of critical audit matters would not be relevant and useful to investors and other financial statement users. Our view is that the expressions of demand for this kind of information by analysts and investor groups are largely exaggerated, lack credibility and are likely attributable to the "*if you build it, they will come*" syndrome. We believe that despite the perceived demand, there is little persuasive evidence that securities analysts and other investor groups will actually find such disclosures in audit reports useful or will rely on it for making or recommending investment decisions or that it will result in more informed and better investment decisions.

We do not believe it would be productive or appropriate for auditors to provide information in audit reports that is intended to help investors or other users to assess an audit. Auditing is a highly complex, professional discipline that requires years of education and training, experience, intimate knowledge of the issuer's business and seasoned professional judgment to enable appropriate audit scope (*i.e*., the nature, timing and extent of auditing procedures) and related judgments (*e.g*., those regarding risk assessment) as necessary to support an auditor's opinion. Moreover, as we have seen historically, there are numerous opportunities for legitimate disagreements on such judgmental matters between or among experienced and knowledgeable professionals (including, for example, regulators, expert witnesses and authors of non-authoritative professional guidance).

Accordingly, we believe that public disclosure of details of critical auditor judgments would not help users make investment or credit decisions or enhance transparency in any meaningful way or serve any other useful purpose but rather would negate or dilute the pass/fail message and, therefore, diminish the value of an audit report. Without the opportunity for two-way dialogue with auditors about such matters, (which is not practicable), such details would likely not contain enough information to help users to make meaningful assessments and useful judgments and quite probably would be misunderstood by many of them. We believe that financial statement users could never reasonably and meaningfully assess the effectiveness of such professional judgments, in relation to possible alternatives, without all the factual and technical knowledge that is available to the auditor.

Should the potential for misunderstanding be partially mitigated for institutional financial statement users by employing trained experienced audit advisors to assist in their analyses, we believe the inherent limitations on the extent of detailed information that could be communicated effectively in writing is likely to prevent the realization of any meaningful potential benefit, and the costs to such users would exceed the value thereof substantially.

Therefore, it is unreasonable to create expectations that any form of written report that is inherently limited, no matter how expanded it might be from the current model, would contain communications of sufficient factual and circumstantial details so as to help otherwise uninformed users, who do not have direct access to the auditors for two-way dialogue to make meaningful judgments as to such complex matters as risk assessments, audit scope and other auditor judgments.

Assessing audit quality is not the job of investors and other financial statement users; it is the job of the engagement quality reviewer, regulators such as the PCAOB (both its standard setters and inspectors) and licensing authorities (to a lesser extent). Additionally, and perhaps most significantly, audit committees upon whom investors should be able to place their reliance as to such matters. Although not the responsibility of the PCAOB, we see regulation of audit committees as the most relevant and, therefore, the best alternative way to assure that investor needs are served effectively.

**11.** ***What benefits or unintended consequences would be associated with the auditor's communication of critical audit matters?***

We see little, if any, opportunity for user benefit from this additional verbiage in audit reports. The obvious risk to auditors of providing regulators and others, (*e.g*., litigants and regulators such as the SEC or PCAOB inspectors) with additional opportunities for second-guessing critical auditor judgments is likely to lead to excessive self-protective, obtuse and unwieldy language in audit reports (see also our response to Question 28), as well as other unintended adverse consequences. These would include (1) increased audit fees, and (2) impairment of timely financial reporting due to delays in issuing audit reports (both resulting from cautious analysis to determine reportable critical audit matters) the documentation, communications, and additional layers of review, and of draft report language by audit firms and frequently by their attorneys.

In Appendix 5 of the Release (first paragraph, page A5-29), the Board suggests that the proposed requirement to report critical audit matters "could increase the auditor's focus on critical audit matters which could result in enhancing the quality of auditing." We firmly believe that other auditing and quality control standards already in place provide maximum assurance that such matters will be adequately addressed so that the achievement of any significant incremental assurance to be obtained from this proposal is highly unlikely. Accordingly, we see this statement as pure speculation, unsupportable, and potentially misleading to investors and other users.

Nevertheless, we do believe there is considerable probability that non-standardized reporting of critical audit matters under this proposal would serve to pressure auditors to report more rather than less. At first, variability among audit reports would likely reduce their comparability and their understandability, and the added language would tend to contradict an unqualified opinion, confusing users and diluting the value of the opinion. As time goes on (if this proposed requirement were adopted), we believe a tendency for the critical audit matters language in reports would evolve to look more similar, diluting their value (if there ever were any).

We also foresee that there may be pressure on auditors to skew their procedures based on how they would affect readers' perception of the description of the critical audit matter, rather than based on their own professional judgment as to what would minimize the risk of material misstatement.

**12.** ***Is the definition of a critical audit matter sufficient for purposes of achieving the objectives of providing relevant and useful information to investors and other financial statement users in the auditor's report? Is the definition of a critical audit matter sufficiently clear for determining what would be a critical audit matter? Is the use of the word "most" understood as it relates to the definition of critical audit matters?***

As noted in our responses to the foregoing Questions, we do not believe reporting critical audit matters would contribute in any meaningful way to achieving the objectives of providing relevant and useful information to investors and other financial statement users. However, in the event that the proposal for auditors to report critical audit matters is retained in a final standard (which we oppose), we believe the definition in paragraph A2 of Appendix A of the Proposed Auditor Reporting Standard (Appendix 1 of the Release), when considered in relation to the guidance contained in paragraphs 8 and 9 of the proposed standard (Exhibit 1 of the Release) is sufficiently clear for determining what would be reportable as a critical audit matter except for the implication of a one-directional limitation in the "Note" appended to such definition (*i.e.*, that it suggests that the definition contemplates that there could be more but not less than one reportable critical audit matter). According to the Note to paragraph 7 of Appendix 1 of the Release and the examples in paragraphs 12 and 13 of Appendix 1 of (and illustrated on pages A5-68, 73 and 77 of Appendix 5), the one-directional limitation appended to the definition is not the intent of the Board. Therefore, in the event that the proposal to report critical audit matters is retained in a final standard, the Note to paragraph A2 of Appendix A should be clarified.

**13.** ***Could the additional time incurred regarding critical audit matters have an effect on the quality of the audit of the financial statements? What kind of an effect on quality of the audit can it have?***

No, the additional time incurred regarding critical audit matters could not have an effect on the quality of the audit of the financial statements. We have seen no credible evidence or suggestion that audit quality would be affected, one way or the other, by adopting this proposed requirement. Conversely, as stated in our response to Question 11, we firmly believe the utility and the quality of the typical audit report would be substantially diminished if this requirement is adopted.

**14.** ***Are the proposed requirements regarding the auditor's determination and communication of critical audit matters sufficiently clear in the proposed standard? Why or why not? If not, how should the proposed requirements be revised?***

Should the proposal for auditors to report critical audit matters be retained in a final standard (which we oppose), we would concur with the determination criteria set forth in paragraph 13 of Appendix 1.

**15.** ***Would including the audit procedures performed, including resolution of the critical audit matter, in the communication of critical audit matters in the auditor's report be informative and useful? Why or why not?***

No. See our response to Question 10.

**16.** ***Are the factors helpful in assisting the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***

Should the proposal for auditors to report critical audit matters be retained in a final standard (which we oppose), we would concur with the determination criteria set forth in paragraphs 8 and 9 of Appendix 1 of the Release except that we believe the expression "nature and amount of available and reliable evidence" in paragraph 9c should be revised to read "nature, quality (*i.e.*, relevance and reliability) and amount of available evidence."

**17.** ***Are there other factors that the Board should consider adding to assist the auditor in determining which matters in the audit would be critical audit matters? Why or why not?***

See our response to Question 14.

**18.** ***Is the proposed requirement regarding the auditor's documentation of critical audit matters sufficiently clear?***

The documentation requirement set forth in paragraph 14 of Appendix 1 of the Release clearly reflects the applicable portion of the general documentation standard (AS No. 3). Accordingly, should the proposal for auditors to report critical audit matters be retained in a final standard, we would be in favor of retaining paragraph 14 substantially as written, with one exception. That is, so as not to overburden auditors, we believe more guidance than that afforded by Appendix 5 of the Release (Part E2, pages A5-39 to 40) is necessary as to the nature and extent of documentation necessary for "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters."

**19.** ***Does the proposed documentation requirement for non-reported audit matters that would appear to meet the definition of a critical audit matter achieve the Board's intent of encouraging auditors to consider in a thoughtful and careful manner whether audit matters are critical audit matters? If not, what changes should the Board make to the proposed documentation requirement to achieve the Board's intent?***

As indicated in our response to Question 18, we believe more guidance as to the nature and extent of documentation necessary for "non-reported audit matters addressed in the audit that would appear to meet the definition of a critical audit matter were not critical audit matters" than that afforded by Appendix 5 of the Release (Part E2, pages A5-39 to 40) is necessary. Nevertheless, we find these documentation requirements unnecessary because we are opposed to the inclusion of critical matters in an audit report and, as indicated in our response to Question 11, we believe that other auditing and quality control standards already in place provide maximum assurance that critical matters is likely to be adequately addressed in the audit scope.

**20.** ***Is the proposed documentation requirement sufficient or is a broader documentation requirement needed?***

See our response to Question 18.

**21.** ***What are the additional costs, including indirect costs, or other considerations related to the auditor's determination, communication, and documentation of critical audit matters that the Board should take into account? Are these costs or other considerations the same for all types of audits?***

See our response to Question 11.

**22.** ***What are the additional costs, including indirect costs, or other considerations for companies, including their audit committees, related to critical audit matters that the Board should take into account? Are these costs or other considerations the same for audits of both large and small companies?***

We do not perceive any incremental costs for companies (other than audit costs, as discussed in our response to Question 11) or their audit committees that is likely to be incurred if this proposal were adopted. There could be costs associated with potential litigation.

**23.** ***How will audit fees be affected by the requirement to determine, communicate, and document critical audit matters under the proposed auditor reporting standard?***

See our response to Question 11.

**24.** ***Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, such as in an initial public offering or in a situation involving the issuance of an auditor's report on a prior period financial statement because the previously issued auditor's report could no longer be relied upon? If so under what circumstances?***

As indicated in our response to Question 10 and elsewhere, we are opposed to communicating critical audit matters in audit reports. However, should the proposal for auditors to report critical audit matters be retained in a final standard, we believe audit reports on comparative financial statements should be complete and should stand alone for all periods presented in all circumstances. Therefore, all critical audit matters included in the original audit report issued on prior period financial statements should be included when the statement is presented subsequently in comparative form. In the event prior period financial statements have been restated, we believe the subject matter of the restatement should be included in the discussion of critical audit matters for that period and should not be included in an emphasis paragraph as is the current practice.

**25.** ***Do the illustrative examples in the Exhibit to this Appendix provide useful and relevant information of critical audit matters and at an appropriate level of detail? Why or why not?***

The examples presented in the Exhibit to Appendix 5 of the Release appear adequately responsive to the proposed requirements of Appendix 1 if adopted in a final standard. Nevertheless, we believe these brief examples serve to illustrate the inherent lack of utility of such limited discussions as to reinforce our views set forth in response to Question 10.

In addition, the first sentence of the illustrative introductory report language that would be mandated by paragraphs 12 and 13 of Appendix 1 (and also illustrated on pages A5-68, 73 and 77 of the Exhibit to Appendix 5) is unnecessary “boilerplate” and would only overburden the proposed standard report with excessive verbiage. Consequently, we believe this sentence should be removed from all examples presented in a final standard.

**26.** ***What challenges might be associated with the comparability of audit reports containing critical audit matters? Are these challenges the same for audits of all types of companies? If not, please explain how they might differ.***

As previously stated and in our response to Question 11, we are opposed to the communication of critical audit matters. But should the proposal for auditors to report critical audit matters be retained in a final standard, variability among audit reports is likely to reduce their comparability and their understandability at first, and the added language is likely to tend to appear contradictory to an unqualified opinion thus confusing users and diluting the value of the opinion. The reduction in comparability, in and of itself, might not inherently be dire except that users will likely be ill-equipped to make useful assessments of the significance (or lack thereof) of the differences. We see this challenge as equally applicable, more or less, without regard to the size or type of the reporting entity. In time, we believe a tendency for the critical audit matters language in reports would likely evolve to look more similar (especially for companies in similar industries or audited by the same firm) diluting their purported value.

**27.** ***What benefits or unintended consequences would be associated with requiring auditors to communicate critical audit matters that could result in disclosing information that otherwise would not have required disclosure under existing auditor and financial reporting standards, such as the examples in this Appendix, possible illegal acts, or resolved disagreements with management? Are there other examples of such matters? If there are unintended consequences, what changes could the Board make to overcome them?***

See our response to Question 11.

**28.** ***What effect, if any, would the auditor's communication of critical audit matters under the proposed auditor reporting standard have on an auditor's potential liability in private litigation? Would this communication lead to an unwarranted increase in private liability? Are there other aspects of the proposed auditor reporting standard that could affect an auditor's potential liability in private litigation? Are there steps the Board could or should take to mitigate the likelihood of increasing an auditor's potential liability in private litigation?***

The following paragraph expands our response in this regard to Question 11.

While we do not see the proposal as likely to lead to additional liability, *per se*, we do see the additional language in audit reports as likely to increase the number of incidents and the costs of litigation. This is because ultimately, audit quality will be attacked and defended largely on its performance merit rather than on the content of the report but for any material omissions or statements that are deemed to be knowingly false and/or misleading. In short, these disclosures are likely to inspire and provide new opportunities for assertions of omissions and inadequacies with respect to audit reports as well as affording additional avenues for plaintiffs to pursue in discovery that will add to an auditor's defense costs.

**Questions Related to Section VI**

**29.** ***Is it appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard?***

Yes, it is appropriate for the Board to include the description of the circumstances that would require explanatory language (or an explanatory paragraph) with references to other PCAOB standards in the proposed auditor reporting standard. It is helpful to bring the approximately ten requirements into one standard; especially for auditors who do not have significant experience in auditing issuers or investors who need a basic understanding of the purpose of such disclosures in auditor's reports.

**30.** ***Is retaining the auditor's ability to emphasize a matter in the financial statements valuable? Why or why not?***

Emphasis disclosures could be valuable to users, but less so if the critical audit matters section is included in the audit report, because as noted in the Release, these types of issues would most likely qualify for inclusion in both sections. [Note: We are using critical audit matters as a default here irrespective of our comments in another section of this letter.] This duplication may not be all negative; however, because what we believe will occur is that the critical auditing matters will reference back (perhaps in a single reference) to the emphasis section without complete reiteration. The auditor should always have the ability to discuss matters that are deemed important. This standard retains that option.

**31.** ***Should certain matters be required to be emphasized in the auditor's report rather than left to the auditor's discretion? If so, which matters? If not, why not?***

Certain matters should not necessarily be required to be emphasized in the auditor's report but rather left to the auditor's discretion. As to the ten matters that are now required to be included when they are evident, they should continued to be required as they are significant for the achievement of the basic objectives of reporting. Other matters to be included at the auditor's discretion should be evaluated on a client specific basis. This is a subtle but important difference, and these other issues could be included by the auditor after review and analysis as needed. The latter evaluation would include the client's presentation and disclosure of these matters (the auditor perhaps having a different perception).

Because the language in the Release is open-ended about including other matters at the auditor's discretion though an emphasis paragraph (or explanatory language in another report paragraph), we do not believe it is necessary to add any recommendations to the examples listed as matters that could be considered as well.

**32.** ***Should additional examples of matters be added to the list of possible matters that might be emphasized in the auditor's report? If so, what matters and why?***

No, see our discussion in Question 31.

**Questions Related to Section VII**

**33.** ***Are the proposed amendments to PCAOB standards, as related to the proposed auditor reporting standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed auditor reporting standard that the Board should consider?***

See our comments with regard to inclusion of firm's registration, independence, audit tenure, and our responses on reporting on other information.

We are in agreement with changes to AS No.6 and No.7, (although we are opposed to the inclusion of critical audit matters) and the changes in AS No. 7 which presupposes this change.

We agree that it would be in the purview of the audit committee to discuss the draft auditor's report, but the auditor should be wary of changes that might dilute positions taken by the auditor.

We are not opposed to referring to the work of a specialist(s) in resolution of matters discussed in critical audit matters.

Our views on other proposed amendments would be consistent with our responses on the basic elements discussed in this comment letter.

**34.** ***What are the potential costs or other considerations related to the proposed amendments? Are these cost considerations the same for all types of audits? If not, explain how they might differ.***

Implementation costs would likely include training and audit methodology changes on a firmwide basis; and preparation time, added review and supervision time, as well as additional time for those in corporate governance. Additional costs could also be incurred in related litigation defense.

Overall, the time and effort involved would be relatively insignificant when measured against total audit fees.

**Questions Related to Section VIII**

**35.** ***Are the proposed reporting standard and amendments appropriate for audits of brokers and dealers? If yes, are there any considerations that the Board should take into account with respect to audits of brokers and dealers?***

We believe it is worthwhile to draw attention to the following facts as considerations (some of which have been mentioned in the pages of the Release that precede this question).

- Per the PCAOB's Office of Research and Analysis, there are no issuers among the brokers and dealers that filed annual audited financial statements with the SEC for fiscal periods ended during 2012. Approximately 9% of the 4,230 brokers and dealers that file are subsidiaries of issuers. The remainder are not owned by issuers.
- Regulators such as the SEC and Financial Regulatory Authority (FINRA) have ongoing programs to monitor and examine the books and records of registered broker-dealers.
- Broker-dealers file Financial and Operation Combined Uniform Single (FOCUS) reports at least quarterly; many file monthly if their minimum net capital is at a high level. The level of minimum net capital is a reflection of perceived operational risk. FOCUS reports include balance sheets, income statements and other operational measurements of financial condition. In addition, all brokers and dealers have been filing quarterly Statements of Supplemental Income that include more details about results of operations. It is not unusual for responsible personnel at broker-dealers to receive inquiries from

regulators about the reasons for fluctuations and unusual amounts that are disclosed in these reports.

- There is public disclosure of the regulatory records of most brokers and dealers and of most individual registered representatives that deal with the public.
- The most recent amendment to SEC Rule 17a-5 requires that broker-dealers that are carrying brokers must provide permission to the SEC to see auditors' workpapers.

As a practical matter, the great majority of brokers and dealers are not issuers and have no public investors. Therefore, members of the public, when using the annual audited financial statements, are not making investment decisions, but rather are using the annual audited financial statements in considering whether to conduct transactions using the broker-dealer, and in some fewer cases, for the broker-dealer to have custody of its funds or securities.

In addition, there is a high level of interaction between brokers and dealers and the regulators and public disclosure about businesses and individuals that deal with the public.

Upon considering the above, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities.

**36.** ***Is the requirement of the proposed auditor reporting standard to communicate in the auditor's report critical audit matters appropriate for auditors of brokers and dealers? If not, why not.***

For the reasons explained in our response to Question 35, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards shall be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities.

**37.** ***Since a broker or dealer may elect to file with the SEC a balance sheet and related notes bound separately from the annual audited financial statements, should the Board address situations in which the auditor may issue two different reports for the same audit of a broker or dealer? Why or why not?***

As we have discussed in our response to Question 35, we believe that the additional costs involved do not justify the additional reporting requested of auditors in the Release. However we believe that if the PCAOB decides that these standards shall be applied to brokers and dealers, that they should only be applied to those brokers and dealers that have custody of customer funds or securities. If the proposed reporting standard is adopted for broker-dealers, any additional reporting obligations of the auditor should be limited to the contents of the complete set of financial statements (as opposed to the separately bound balance sheet). As most users of the financial statements of brokers and dealers are primarily interested in the financial well-being of the broker or dealer, an audited statement of financial condition and notes are typically all that should be required to be made available to them.

**38.** ***Are the proposed auditor reporting standard and amendments appropriate for audits of investment companies? If yes, are there any considerations that the Board should take into account with respect to auditors' reports on affiliated investment companies, as well as companies that are part of master-feeder or fund of funds structures?***

We have no response to this question at this time.

**39.** ***Are the proposed auditor reporting standard and amendments appropriate for audits of benefit plans? If yes, are there any considerations that the Board should take into account with respect to audits of benefit plans?***

We have no response to this question at this time.

**40.** ***Should audits of certain companies be exempted from being required to communicate critical audit matters in the auditor's report? Why or why not?***

As we previously stated, our position on this issue is that reporting of critical audit matters should not be required.

**Questions Related to Section IX**

**41.** ***Is the Board's effective date appropriate for the proposed auditor reporting standard? Why or why not?***

Although a concerted effort would be needed to make all changes that are proposed in the Release, we believe the effective date is appropriate, provided that the PCAOB's efforts and adoption (including the SEC's approval) will not be unduly delayed.

**42.** ***Should the Board consider a delayed compliance date for the proposed auditor reporting standard and amendments or delayed compliance date for certain parts of the proposed auditor reporting standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

If the Board decides to extend the proposed standards and amendments to brokers and dealers we believe a  year delay from the effective date used for issuers be implemented because an acclimation period for auditors of these entities using PCAOB auditing standards, and basic changes in several filing forms is now underway (under recent regulation changes).

**Appendix 6 – Additional Discussion Related to the Proposed Other Information Standard**

**Questions Related to Section I**

**1.** ***Is the scope of the proposed other information standard clear and appropriate? Why or why not? Are there Exchange Act documents, other than annual reports, that the Board should consider including in the scope of the proposed other information standard?***

The Board should, in consultation with the SEC, extend the reporting and procedure standard for other information to other Exchange Act forms such as Form 10. It should also extend these proposed requirements to Exchange Act filings where audited information is contained by reference, for example proxy filings under Regulation 14A.

**2.** ***Is it appropriate to apply the proposed other information standard to information incorporated by reference? Why or why not? Are there additional costs or practical issues with including information incorporated by reference in the scope of the proposed other information standard? If so, what are they?***

See response to Question 1 above.

**3.** ***Is it appropriate to apply the proposed other information standard to amended annual reports? Why or why not? Are there additional costs or practical issues with including amended annual reports in the scope of the proposed other information standard? If so, what are they?***

If the standard was applied to a filing for which an annual report was filed or incorporated by reference and was subsequently amended, but the amendment did not affect the financial statement information content, the auditor should nevertheless evaluate whether it should or should not have changed. If no changes were needed, the auditor should not reperform original procedures and update the audit report for the other information content.

**4.** ***Should the company's auditor, the other entity's auditor, or both have responsibilities under the proposed other information standard regarding audited financial statements of another entity that are required to be filed in a company's annual report under Article 3 of Regulation S-X? Why or why not? Are there practical issues with applying the proposed other information standard to the other entity's audited financial statements?***

For a number of practical reasons, the proposed “other information standard” should not be required for entities filing financial statements or condensed financial statements under Article 3 of Regulation S-X.

- Auditors of acquired companies may not be the same as auditor of the acquirer. The acquiree’s auditors may not be registered with the PCAOB. We believe in this circumstance the acquiree’s auditor would not be able to satisfy the proposed reporting obligations.
- The purpose of several subsections of Article 3 are designed to provide information that is specific to a specific risk or concern—for example the guarantor financial statements requirements help investors determine if a guarantor is able to meet the guarantee obligation. In this scenario, there would be little or no added value based on the reporting objective stated.

**Question Related to Section II**

**5.** ***Do the objectives assist the auditor in performing the procedures required by the proposed other information standard to evaluate the other information and report on the results of the evaluation?***

We are in favor of providing an objective within the proposed standard that would assist auditors in understanding what needs to be achieved through the performance of the proposed required procedures. However, we believe paragraph 2.b. should be revised as follows:

> b. When issuing an auditor's report, to communicate in the auditor's report the auditor's responsibilities for the other information and *when the other information includes* a material inconsistency, a material misstatement of fact, or *both, to describe these in the auditor's report*.

Further, we disagree with proposed requirement for auditors to make positive statements or conclusions about the absence of any inconsistencies, material misstatements of fact or both, as contained in paragraph 13(e) (see our response to Question 18 of Section VI of this Appendix).

**Questions Related to Section III**

**6.** ***Is it appropriate to require the auditor to evaluate the other information for both a material inconsistency and for a material misstatement of fact? If not, why not?***

We are concerned that the use of the term "evaluate" could imply a more in-depth level of analysis than should be required to enable a determination of whether other information contains a material inconsistency with amounts or information or the manner of their presentation or a material misstatement of fact exists. We believe that auditors' responsibility should be limited to reading the other information in the context of their understanding of the entity, its environment, activities and financial performance and condition, as acquired during the audit, and to consider whether there may be a material inconsistency, misstatement of fact, or both.

**7.** ***Would the evaluation of the other information increase the quality of information available to investors and other financial statement users and sufficiently contribute to greater confidence in the other information? If not, what additional procedures should the Board consider?***

Notwithstanding our response to Question 6 above, we believe it is likely that that the overall quality of information available to investors and other financial statement users might improve—including an understanding and appreciation for the limitations on the auditor's procedures and responsibilities. It is important for investors and other users to understand that while overall quality of the other information may improve; little or no assurance is provided on the other information because of the limited procedures performed and responsibility taken.

**8.** ***Is the federal securities laws' definition of materiality the appropriate standard for the auditor's responsibility to evaluate the other information? Would applying this definition represent a change to the materiality considerations auditors currently use under AU Sec. 550?***

We agree that the appropriate standard for the auditor's responsibility to "evaluate" other information would be that afforded by the federal securities laws' definition of materiality and that this is consistent with current practice under AU Sec. 550 and Staff Accounting Bulletin 99.

**9.** ***Are the proposed procedures with respect to evaluating the other information clear, appropriate, and sufficient? If not, why not?***

We agree that the procedures set forth in paragraph 4 of the proposed standard, *i.e*., to compare the amounts and qualitative statements in the other information to the financial statements and verify the mathematical accuracy of calculated amounts, are appropriate and consistent with the procedures many practitioners already perform. However, as stated in our response to Question 6 of Section III of this Appendix, we do not believe the use of the term "evaluate" is appropriate and suggest revising the requirement in paragraph 4 to delete that term and state instead that the "auditor should read the other information and perform the following procedures."

Additionally, we believe that paragraph 3 of the proposed standard, which sets out what would be the auditor's overall responsibilities, should be revised to delete the term "evaluate" so that the paragraph would state that "the auditor should read the other information and perform certain procedures to determine whether there appears to be a material inconsistency or misstatement of fact, or both."

We recommend that all references to "evaluate" be replaced with "to read" or "consider", in the standard due to all the possible interpretations of "evaluate."

**10.** ***Is it understood which amounts are in the other information the auditor would be required to recalculate under paragraph 4.d.? If not, why not?***

We believe that the guidance in paragraph 4.d. along with the related Note provides an appropriate explanation about which amounts in the other information the auditor would be required to recalculate.

**11.** ***Are there additional costs beyond those described in this Appendix related to the proposed required procedures for the evaluation of the other information? If so, what would these costs be?***

We believe the additional costs described in Appendix 6, including costs relating to (1) those incurred by some firms that might not currently be performing similar procedures as set out in paragraph 4, (2) strengthening the auditor's responsibilities from being "aware" to the performance of specific procedures relating to determining whether a material inconsistency or misstatement of fact appears to exist, and (3) one-time implementation costs that might be incurred by a few firms would, nevertheless, not likely be significant.

**12.** ***Are the proposed auditor responses under paragraph 5 appropriate when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If not why not?***

The proposed auditor responses described in paragraph 5, which consist of inquiry of management and the performance of additional procedures, are appropriate. However, we suggest recognizing that the nature and extent of the additional procedures should be sufficient to resolve the apparent discrepancy as determined based on the auditor's professional judgment.

**13.** ***Are there additional costs beyond those described in this Appendix related to responding when the auditor identifies a potential material inconsistency, a potential material misstatement of fact, or both? If so, what would these costs be?***

We believe the incurrence of such costs invariably would be warranted in the circumstances. See our response to Question 11 of Section III of this Appendix.

**Questions Related to Section IV**

**14.** ***Are the proposed auditor's responses under paragraphs 8 and 9 appropriate when the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?***

We believe that the proposed auditor's responses are appropriate and consistent with current practice in circumstances in which the auditor determines that the other information that was available prior to the issuance of the auditor's report contains a material inconsistency, misstatement of fact, or both.

**15.** ***Is it appropriate for the auditor to issue an auditor's report that states that the auditor has identified in the other information a material inconsistency, a material misstatement of fact, or both, that has not been appropriately revised and describes the material inconsistency, the material misstatement of fact, or both? Under what circumstances would such a report be appropriate or not appropriate?***

In certain circumstances, it may be appropriate for an auditor to issue an audit report that states the auditor identified a material inconsistency or a material misstatement of fact, or both, in the other information. However, we suggest providing additional guidance that explains that in determining the appropriate action, consideration should be given to the extent to which a material misstatement of fact in the other information could reasonably be expected to influence the economic decisions of the users for whom the auditor's report is prepared and the auditor's understanding of the rationale given by management and the audit committee for not making the correction.

**16.** ***Are the proposed auditor's responses under paragraphs 10 and 11 appropriate when the auditor determines that the other information that was not available prior to the issuance of***

***the auditor's report contains a material inconsistency, a material misstatement of fact, or both? Why or why not?***

The proposed auditor’s responses for those circumstances when the auditor determines that the other information that was not available prior to the issuance of the auditor’s report contains a material inconsistency, misstatement of fact, or both, are appropriate.

We believe that in this circumstance consultation with counsel is a recommendation that should be added to paragraph 11 of the proposed statement.

**Question Related to Section V**

**17.** ***Are the proposed auditor's responses appropriate when, as a result of the procedures performed under the proposed information standard the auditor determines there is a potential misstatement in the financial statements? Why or why not?***

We agree with the auditor’s responses set out in the proposed standard that would require reference to Auditing Standard (AS) No. 14, *Evaluating Audit Results* and AU 508 *Departures from Unqualified Opinions and Other Reporting Circumstances*, when the auditor discovers that there is a potential misstatement in the financial statements. However, we also believe that the standard should refer to AS No. 12, *Identifying and Assessing Risks of Material Misstatement*, since there may be implications related to the auditor’s understanding of the entity and its environment, indicating a need to revise the auditor’s initial risk assessment and audit scope.

**Questions Related to Section VI**

**18.** ***Is the proposed reporting, including the illustrative language, appropriate and sufficiently clear? If not, why not?***

We are in favor of expanding the standard audit report to include language in the discussion of auditor’s responsibilities that would better inform investors and other users regarding auditor’s limited responsibility for other information. However, we do not support requiring the auditor to make any positive statement or conclusion about the absence of any material inconsistencies or material misstatements of fact in the other information because we believe that such a statement is likely to mislead users to incorrectly believe that such information had been subjected to sufficient procedures to form a conclusion. We believe providing such a statement would have the undesired effect of widening the expectations gap.

**19.** ***Should the Board consider permitting or requiring the auditor to identify in the auditor's report information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against? If so, provide examples.***

We do not believe that the auditor should identify in the auditor’s report other information not directly related to the financial statements for which the auditor did not have relevant audit evidence to evaluate against since such a statement would imply erroneously that the auditor had an obligation to examine supporting evidence for such other information beyond what would be necessary to express an opinion on the financial statements.

**20.** ***What additional costs would the auditor or the company incur related to auditor reporting when the auditor identifies a material inconsistency, a material misstatement of fact, or both?***

While we do not believe that there would be significant direct additional costs incurred related to reporting under this proposed standard, we believe that additional indirect costs (such as defense costs in disputes or litigation) might be incurred because investors misunderstand the scope and nature of the work performed by the auditor on the other information and adversely affect investment decisions.

**21.** ***Would the proposed reporting, including the illustrative language, provide investors and other financial statement users with an appropriate understanding of the auditor's responsibilities for, and the results of, the auditor's evaluation of the other information? Why or why not?***

See our responses to Questions 9 of Section III and 18 of Section VI of this Appendix.

**22.** ***Are there any practical considerations that the Board should consider when an auditor identifies a material inconsistency or a material misstatement of fact in the other information that management has appropriately revised prior to the issuance of the auditor's report?***

We are not aware of any practical considerations except for considering whether the detected inconsistency or misstatement, even though corrected, is indicative of a weakness in the issuer's internal controls over financial reporting or other disclosure controls that might also require revisions to management's statements made about such controls.

**Question Related to Section VII**

**23.** ***Are the proposed responsibilities of the predecessor auditor appropriate and sufficiently clear? If not, why not?***

The requirements in the proposed other information standard with respect to a predecessor auditor are similar to extant guidance, and we believe the proposed responsibilities are appropriate and sufficiently clear.

**Questions Related to Section VIII**

**24.** ***What effect, if any, would the reporting under the proposed other information standard have on an auditor's potential liability in private litigation? Would this reporting lead to an unwarranted increase in private liability? Are there steps the Board could or should take related to the other information requirements to mitigate the likelihood of increasing an accounting firm's potential liability in private litigation?***

We believe that if a contentious matter were to arise subsequent to report issuance which was not discussed in critical audit matters that the matter might be the subject of litigation, especially if there were other serious matters such as significant misstatements that were not identified, it is less likely that an issue that was not identified in other information or was misstated would become part of  a securities litigation, unless it was listed as a matter that was included in a compendium of issues.

**25.** ***Would reporting under the proposed other information standard affect an auditor's potential liability under provisions of the federal securities laws other than Section 10(b) of the Exchange Act, such as Section 11 of the Securities Act? Would it affect an auditor's potential liability under state law?***

We have no response to this question at this time.

**Questions Related to Section IX**

**26.** ***Are the proposed amendments to PCAOB standards, as related to the proposed other information standard, appropriate? If not, why not? Are there additional amendments to PCAOB standards related to the proposed other information standard that the Board should consider?***

The proposed amendments appear appropriate.

**27.** ***In the situations described in the proposed amendments to existing AU sec. 508, should the Board require, rather than allow, the auditor to include statements in the auditor's report that the auditor was not engaged to examine management's assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management's report?***

We believe that requiring the auditor to include a statement in the auditor’s report that the auditor was not engaged to examine management’s assertion on the effectiveness of internal control over financial reporting and that the auditor does not express an opinion on management’s report is appropriate. Such reporting would improve consistency between auditor reports and provide clarity to users with respect to the auditor’s responsibility.

**Question Related to Section X**

**28.** ***Are the proposed other information standard and amendments appropriate for audits of brokers and dealers? If not, why not?***

Other information is not relevant to brokers and dealers that are not issuers.

**Questions Related to Section XI**

**29.** ***Is the Board's effective date appropriate for the proposed other information standard? Why or why not?***

We believe that the effective date for the proposed information standard, audits of financial statements for fiscal years beginning on or after December 15, 2015, is appropriate.

**30.** ***Should the Board consider a delayed compliance date for the proposed other information standard and amendments for audits of smaller companies? If so, what criteria should the Board use to classify companies, such as non-accelerated filer status? Are there other criteria that the Board should consider for a delayed compliance date?***

We support delayed compliance dates for any proposed standard on other information to provide auditors of smaller companies with sufficient time to incorporate the guidance into their methodologies and educate their clients about the proposed standard and its impact on the nature and timing of procedures relating to other information.

**Questions Related to Section XII**

**31.** ***Should the Board extend the application of the proposed other information standard to documents containing audited financial statements and the related auditor's report that are filed under the Securities Act? If so, are there obstacles other than those previously mentioned that the Board should consider before such a proposal is made? If not, why not?***

Auditors have historically made a conscious attempt to have clients avoid cross-referencing content from "other information" (such as MD&A) directly into financial statements being filed. This was meant to avoid the implied direct responsibility which would attach to the integrated content. The risk increases under Securities Act filings as audited financial statements are "expertized" and the attendant liability concerns under Section 11 of this law.

One of the issues we discussed was that the report language dealing with required "supplemental" information and other language dealing with "other" information is much different in form and content. It is important that these terms be easily identified by making sure that each schedule or other supplementary information be listed, and that the same thing be done for other information.

The main issue we see is MD&A usually contains much forward looking information and does not lend itself to consistency with the underlying client financial statements on many levels. For instance, information may be based on cash flow management or budgeting analysis. Making a statement about not being inconsistent or that an omission of a material magnitude has occurred is problematical especially in a Securities Act filing.

**32.** ***Are there some elements of the proposed other information standard that the Board should consider requiring the auditor to perform related to other information contained in filings under the Securities Act, such as the auditor's responsibility to evaluate the other information? If so, which elements of the proposed other information standard should the Board consider including in the procedures currently required for Securities Act documents under AU sec. 711? If not, why not?***

See our comment in Question 31, which suggests deletion of coverage for MD&A. We do not propose to add any other content.

**33.** ***What costs or other challenges should the Board consider when assessing whether to propose extending some elements of the proposed other information standard to other information contained in documents filed under the Securities Act?***

We believe there will be time costs but we do not have estimates at this time.

**Appendix7 – Emerging Growth Companies**

**Questions**

**1.** ***Should the proposed standards and amendments be applicable for audits of EGCs? Why or why not?***

To the extent the proposed standards and amendments are retained in a final standard (which we oppose in many respects as noted above), we believe they should be applicable for audits of EGCs as a matter of consistency. As any standards, auditing standards should be consistently applied and comparable, in this case, for all audits. Although we do not believe the intended goals of the proposed standards and amendments will be achieved; excluding certain entities (other than non-issuers) from such requirements would be inconsistent and illogical.

**2.** ***Are there any other considerations related to competition, efficiency, and capital formation that the Board should take into account with respect to applying the proposed standards and amendments to audits of EGCs?***

We do not believe special consideration should be given to EGCs related to competition, efficiency, and capital formation. As we have stated in Question 1 of this Appendix, despite our opposition to the proposed standards and amendments, application of auditing standards and amendments should be consistent and comparable for audits of all issuer entities.

**3.** ***Are there any special characteristics of EGCs that the Board should consider related to the proposed auditor reporting standard, including the communication of critical audit matters?***

We do not believe special characteristics of EGCs should be considered in the applicability of such standards. As we have stated in our responses to various questions in Appendix 7 of the Release, despite our opposition to the proposed standards and amendments, application of auditing standards and amendments should be consistent and comparable for audits of all entities.

**4.** ***Would audits of EGCs be more, less, or equally likely to have critical audit matters?***

Based on the characteristics of EGCs, they are equally or more likely to have critical audit matters than non-EGCs. For example, as noted in Appendix 7 of the Release, data suggests that

"EGCs are 10 times more likely than the population of companies in the Russell 3000 Index to have a management report on internal control over financial reporting stating that the company's internal control over financial reporting was not effective."

**5.** ***Are there any special characteristics of EGCs that the Board should consider related to the proposed other information standard and amendments?***

No.

**6.** ***What costs would audit firms incur when implementing the proposed auditor reporting standard, including the communication of critical audit matters, for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?***

Related costs to prepare the necessary communications will vary and such costs could be significant. Audit firms would incur initial costs in developing new audit methodologies to address the requirements of the proposed auditor reporting standard. Costs would also be incurred to train staff regarding the new methodologies and in changing the presentation of the auditor's report. With respect to communication of critical audit matters, implementation costs for audits of EGCs would not likely vary from that of larger and more established companies.

**7.** ***What costs would audit firms incur when implementing the proposed other information standard for audits of EGCs? How will those costs differ from the costs for audits of larger and more established companies?***

Should the proposed standards and amendments be retained in a final standard (which we oppose), audit firms would incur additional and unnecessary costs in developing and maintaining separate audit methodologies for EGCs as opposed to other SEC registrants. In terms of costs specifically relating to implementing the proposed other information standards for audits of EGCs, it would be minimized as a result of the provisions in the Jumpstart Our Business Startups Act (the "JOBS Act") which allow for reduced disclosure requirements in IPO registration statements and the gradual phase-in of certain post-IPO disclosures and other requirements.

***8. Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed auditor reporting standard and amendments to EGCs?***

See our response to Question 6

**9.** ***Are there particular costs or burdens applicable to EGCs that the Board should consider when determining what recommendation to provide the Commission regarding the application of the proposed other information standard and amendments to EGCs?***

See our response to Question 7

**10.** ***For auditors of both EGCs and other SEC registrants, would it be more costly not to apply the proposed standards and amendments to audits of EGCs because the firms would need to develop and maintain two audit methodologies?***

We believe the proposed standards should be applicable for audits of EGCs as a matter of consistency. As consistency is always the most efficient approach, it would be more costly to have to maintain different audit methodologies for EGCs and other SEC registrants. Costs of maintaining different audit methodologies could be significant.

Bruce J. Nordstrom, CPA

Marjorie T. McClanahan, CPA

Timothy D. Hansen, CPA

Nordstrom Associates P.C.
CERTIFIED PUBLIC ACCOUNTANTS

Member
American Institute of Certified Public Accountants

Arizona Society of Certified Public Accountants

August 9, 2016

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

**Re: PCAOB Release No. 2016-003, PCAOB Rulemaking Docket Matter No. 034**

I am Bruce Nordstrom, President and Certified Public Accountant with Nordstrom & Associates, P.C. and Chairman of the Audit Committee for Pinnacle West Capital Corporation ("Pinnacle West"). Pinnacle West is the NYSE-listed parent company of Arizona Public Service Company, the largest electric utility company in Arizona, serving more than a million customers. It is in my capacity as Audit Committee Chair for Pinnacle West that I respectfully submit comments on the Public Company Accounting Oversight Board's ("PCAOB") Release No 2016-003; *Proposed Auditing Standard - The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, and *Related Amendments to PCAOB Standards.*

I appreciate the PCAOB's efforts to address stakeholders' concerns regarding PCAOB Release No 2013-005 (the "2013 proposal") and the revisions the PCAOB has made to the 2013 proposal. Despite these revisions, I do not support Release No 2016-003. I strongly disagree with the PCAOB's proposal to include critical audit matters (CAMS) within the audit report as provided in Release No 2016-003. I believe including CAMS in the audit report undermines the role of the audit committee, will impede communications between the auditors and the audit committee, and inappropriately shifts the auditor function from that of an attest function to a management role. Furthermore, I do not support the PCAOB's proposal to disclose audit tenure within the audit report, as that information is irrelevant. The following is a detailed discussion of my concerns.

**Critical Audit Matters**

The proposed guidance requires auditors to include a discussion in the audit report of CAMS, with CAMS defined as certain matters communicated to the audit committee. The auditor will be responsible for identifying and disclosing the topics they believe qualify for CAM reporting. The PCAOB indicates the purpose of including CAMS in the audit report is to reduce information asymmetry between investors and auditors.

The audit committee is comprised of members of the shareholder-elected board of directors, and provides oversight of accounting policies, internal controls, financial reporting, and the audit process. The audit committee has access to auditors, management, and the board of directors. The audit committee has the knowledge, perspective, and authority to ensure relevant information is properly disclosed by management. This oversight role ensures key audit matters are properly addressed and communicated to investors through management's financial disclosures. The audit committee oversees the financial reporting process and audit process to ensure that matters that are material to shareholders are appropriately disclosed. The disclosure of CAMS undermines this audit committee oversight role, and effectively shifts the auditors from providing an attest function into serving in a management role. Reporting CAMS may lead to a decrease in audit quality as investors may place undue emphasis on CAMS instead of the audit opinion and related financial statements.

CAM reporting may also impede and significantly limit communications between the audit committee and auditors. Due to the proposed CAM requirement, auditors may be less inclined to discuss non-required topics with the audit committee, as discussion of any matters may require assessment for CAM reporting. Management may also attempt to limit non-necessary communications between the audit committee and the auditors. This could ultimately limit the effectiveness of the audit committee and information shared with the audit committee.

Auditors are privy to proprietary and critical company specific information. Access to this information is a necessary component of the attest function. Information asymmetry between the investor and the auditor is an inherent characteristic of an audit and the financial reporting process. The FASB and SEC are the organizations that should ensure financial statement disclosure rules provide investors with adequate information to make informed investment decisions.

**Auditor Tenure**

I do not support the PCAOB's proposal to require the disclosure of audit tenure within the audit report. In instances with long audit tenure this disclosure may imply a lack of auditor independence. Conversely, in instances with short audit tenure this disclosure may imply poor audit quality. I believe the PCAOB has taken great efforts to ensure the independence, quality, and effectiveness of all audits regardless of auditor tenure. Disclosing auditor tenure will diminish these efforts. Requiring disclosure of auditor tenure provides information that may be mistakenly misinterpreted by investors. The audit committee is in the best position to evaluate the auditor's independence, including auditor tenure and rotation.

**Conclusion**

I appreciate the opportunity to comment on the PCAOB's proposals. I strongly urge the PCAOB to eliminate the proposal to include CAMS and auditor tenor in the audit report.

I would be pleased to discuss my comments in further detail or to provide any additional information you may find helpful in addressing these important issues.

Very truly yours,

Bruce J. Nordstrom
BJN/nkg

NORTHROP GRUMMAN

**Northrop Grumman Corporation**
2980 Fairview Park Drive
Falls Church, Virginia 22042-4511

August 15, 2016

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

Subject: PCAOB Rulemaking Docket No. 034

Dear Board Members:

We are pleased to comment on the PCAOB's (the Board) reproposed rule, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "reproposed Standard"). Northrop Grumman is a leading global security company with annual sales of $24 billion and approximately 65,000 employees. We provide products, systems and solutions in unmanned systems; cyber; command, control, communications and computers, intelligence, surveillance, and reconnaissance; strike aircraft; and logistics and modernization to government and commercial customers worldwide.

We appreciate the Board's efforts to incorporate feedback received from preparers, accounting firms, and other constituents into the reproposed Standard. We share the Board's desire to provide timely and relevant information to investors in the auditor's report and support the Board's proposals to retain the requirements for auditors to communicate the nature of an audit, the auditor's responsibilities, and results of the audit in the auditor's report. We also support the Board's proposals to limit the addressees of the audit report to shareholders and boards of directors as well as to require specific ordering of certain sections in the auditor's report to improve readability.

However, we do not agree with the Board's proposal that auditors be required to disclose critical audit matters (CAMs) in the auditor's report, for the following reasons:

- Information material to investors is required to be disclosed by management and key judgments and accounting assumptions (along with the related financial sensitivities) are provided for investors in the critical accounting estimates section of MD&A. Adding a requirement for auditors to communicate CAMs would likely be duplicative to management's disclosure and could be confusing to investors. As evidenced by example disclosures in the reproposed Standard, CAM disclosures could extend well beyond a page and likely would contribute to disclosure overload rather than facilitate disclosure effectiveness.

- Audit committees and the PCAOB provide oversight to preparers and auditors, respectively, which is designed to improve the quality of financial reporting. This oversight enhances investor confidence regarding management's preparation of the financial statements and the auditor's performance of the audit. We believe these governance elements support investor reliance on the information presented in the audited financial statements without the need for further elaboration by the auditor on the matters they considered in reaching their audit opinion.

- CAM disclosure in the auditor's report may result in the unintended consequence of changing the quantity and nature of information communicated by auditors to audit committees. In contemplation of the required disclosure in the auditor's report, auditor communications with audit committees may lack the depth of current communications and become more general or boilerplate in nature.

- Requiring CAMs to be included in the auditor's report will likely result in increased audit costs for companies due to the additional preparation activities for auditors and corresponding reviews by management and audit committees. We routinely communicate with investors and none have inquired about audit matters, so we question whether the benefits of this proposal outweigh these added costs.

Please contact us if you have any questions or if you would like to discuss these comments.

Respectfully,

Michael Hardesty
Corporate Vice President, Controller and Chief Accounting Officer

August 15, 2016

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

**RE: PCAOB No. 2016-003, Rulemaking Docket No. 34 – Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Auditing Standards**

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

As members of the Auditor's Report Working Group (Working Group) for the 2016 annual meeting of the PCAOB's Investor Advisory Group (IAG), we are writing to provide comments on the PCAOB's May 11, 2016 Proposed Auditing Standard entitled *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Auditing Standards*. The undersigned members of the PCAOB's IAG Working Group have collaborated in drafting this comment letter to the Board.[1]

We believe that the Board's Proposed Auditing Standard (Proposal) represents a meaningful improvement from the current standard audit report. The requirement to discuss critical audit matters (CAMs), if devoid of boilerplate language, will be useful to the investment community. We encourage the Board to emphasize in any final standard, in subsequent outreach efforts and, especially through its inspection program, the need for CAMs to be highly bespoke. In our view, there will be a direct correlation between the extent of CAM company-specificity and the related value of the audit report to the investing public.

Notwithstanding our clear support for the Proposal, we ask the Board to do more. As currently drafted, the Proposal requires that the audit report: (1) identify the CAM, (2) describe why the auditor viewed the issue as a CAM, (3) indicate how the auditor addressed the CAM, and (4) refer to the financial statement line(s) and disclosure(s) that pertain to the CAM. We take no exception to these four requirements. But the Board stopped short of mandating the one item that we believe would provide the greatest value to investors – the discussion of what the auditor ***found*** when it addressed the CAM (i.e., what were the results of the auditor's procedures in these

[1] Hereafter when we refer to a position of the IAG, we are only referring to those IAG members who have chosen to sign this letter. Every member of the Auditor's Report Working Group of the PCAOB's IAG has chosen to sign this letter. Their individual views do not necessarily reflect the opinions of the companies or associations with which they are affiliated or any other officers, employees, or members thereof.

areas). We recognize that mandating the disclosure of findings at this late stage in the project may be problematic, particularly since the forthcoming IAASB standard does not mandate the disclosure of findings nor does the existing FRC standard. Given this reality, we ask the PCAOB to consider the more limited step of modifying the existing Proposal to simply add one sentence:

**"We view the inclusion of informative, company-specific findings related to each CAM as a best practice in auditor reporting, and although the inclusion of findings is not required in the Auditing Standard we strongly encourage auditors to include such findings in their audit reports."**

In the balance of this letter, we justify our position for the inclusion of informative, company-specific findings[2] related to each CAM in the auditor's report.[3] The PCAOB's Congressionally-mandated mission is "to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." We view including CAM-related findings as unambiguously making audit reports more informative. Therefore, our suggested modification to the Board's Proposal is clearly consonant with the Board's mission.

As the Board itself recognizes, accounts and disclosures involving significant management estimates and judgments may often be disclosed as CAMs (PCAOB 2016a, 2), and investors have previously indicated their high level of interest in significant management estimates and judgments (PCAOB 2016a, 2, 93). Moreover, the importance of estimates and judgments has become more pronounced over time as GAAP has evolved, serving to exacerbate the information asymmetry between investors and auditors (PCAOB 2016a, 1). We recognize that disclosing CAMs is useful, but believe that such disclosure will be incomplete without also revealing the related findings.

Most importantly, investors have a clear and strong interest in the disclosure of findings. Approximately 80 percent of investors believe that audit reports should include findings (KPMG 2015). Citi, in its analysis of the new audit reports being issued in the United Kingdom (UK), states, "We would like all auditors to disclose findings" (Deans 2015, 1). Finally, the FRC itself has stated, "Investors clearly valued the additional insight offered by extended auditor reporting, and have since encouraged the adoption of greater transparency, particularly in respect of auditor's judgments and their findings" (FRC 2016, 6).

[2] Just as the Proposal contemplates that CAMs will be determined "in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks" (PCAOB 2016a, 25), so too should findings provide audit-specific information.
[3] We realize that the Proposal already allows auditors to discuss the outcome of their procedures and/or to include key observations with respect to the CAM (PCAOB 2016a, 31). We fully support this language but simply encourage the Board to go further and more explicitly recognize and encourage, without necessarily mandating, the inclusion of findings.

But, in reporting findings, it is essential that the auditor provide informative and company-specific information, particularly with respect to estimates and judgments. A finding that states that an estimate is reasonable (FRC 2015, 59) or that an estimate falls within an acceptable range is already implied by the issuance of an unmodified audit report (Deans 2015, 16). Such findings lack granularity, and as a result fail to provide meaningful, incremental information. As Tony Cates, the head of audit at KPMG UK states, "Instead what is required is graduated findings that say whereabouts in a range matters sit" (FRC 2015, 25). We agree wholeheartedly with Mr. Cates.

The new audit reports in the UK have been so well received that the Investment Management Association (IMA) sponsors a yearly contest to select and recognize the best audit reports. While we admit that this competition is not quite as glamorous as the Academy Awards, it represents a giant leap from bygone years when investors only skimmed the report to see if any modification existed. In recognizing the Rolls Royce audit report, the IMA commends KPMG for including, "… what they found. The inclusion of findings was a step further than other auditors and *provided a real value add* (our emphasis), giving colour as to whether management's judgments were balanced, mildly optimistic or mildly pessimistic in the view of the auditor" (FRC 2015, 55).

In addition to the strong investor support for the inclusion of findings in the audit report, auditors in the UK are recognizing investor demand for this information and, at least in some cases, choosing to provide the information, particularly as it relates to the auditor providing his or her own commentary on management judgments (Touche 2014). We view this result as indicating that at least some audit firms view reports with findings as a superior market-responsive service. For example, PwC has committed to including findings in its reports across its entire UK portfolio (FRC 2016, 24). Moreover, to the extent that there are variations among issuers, audit firms, and even individual auditors within firms (Touche 2014), such variation creates a landscape where different parties to the financial reporting process can signal differential quality, or at least market responsiveness. Such differentiation, by definition, is what makes information useful (i.e., to the extent that all information provided is identical the usefulness of reports declines).

There is obviously some opposition to auditors disclosing findings. First, some may argue that disclosing findings would move the auditor toward providing original information and would exceed the auditor's mandate (PCAOB 2016a, 2). With all due respect, we view the extent of the auditor's mandate not as permanently engraved on tablets of stone but rather determined and defined by members of the PCAOB based on your collective judgment in fulfilling your investor protection mission.

Second, some critics, particularly in the audit committee community, have questioned what investors would do with the information in expanded auditor reports. Although we could offer many examples, we simply offer one based on TUI Travel plc's 2014 audit report. PwC, TUI's auditor, included the following in its audit report, "Management is forecasting high revenue and profit growth rates in the next five years resulting from the investment in Brazil and Asia. If these growth rates are not achieved, it could lead to impairment of the related goodwill and intangible assets" (PwC 2015, 5). If analysts do not believe that high growth rates are achievable they could quasi-impair now.

Finally, some might argue that including findings in the audit report might expose auditors to incremental legal liability (FRC 2015, 60). A decision to encourage, but not require, the reporting of findings allows each individual audit firm to weigh the benefits associated with issuing a more useful and market-responsive report against the costs of potentially increased legal liability. Notwithstanding that choice would be preserved under our recommendation, the signatories of this letter are supportive of efforts to provide auditors with a narrowly-tailored legal safe harbor. That is, we support a legal safe harbor related *only* to the inclusion of CAM-related findings in the audit report.

We close by highlighting the alignment between our recommendations for improving the Board's Proposal with recent statements by certain Board members. Lewis Ferguson has stated, "The reproposed standard is meant to better arm investors with *insight previously available to and considered by, the auditors, but not ultimately evident in the auditor's report*" (our emphasis) (PCAOB 2016b). Auditors clearly assess and consider the relative gradation in management estimates and judgments, but such knowledge and consideration is not evident in the audit report.

Jay Hanson has stated, "… proposed requirements will impose costs and burdens on auditors, preparers and audit committees …[o]ur goal, then, cannot be merely to reduce information asymmetry by requiring the disclosure of information, but *making sure that the information to be provided will be valuable to investors such that it justifies the imposition of the related costs*" (our emphasis) (PCAOB 2016b). Most of this comment letter details the investor demand for and value derived from informative, company-specific CAM-related findings.

Finally, with no disrespect intended, we pose a challenge to the Board. Board member Jeanette Franzel has stated, "Although this is *a significant step forward in auditor reporting, it is a small step*" (our emphasis) (PCAOB 2016b). We agree with Ms. Franzel, but in the spirit of vigorous debate on an important public policy matter we challenge what appears to be the implicit conclusion. Why would the Board take a small step when the preferences of the group that the Board was intended to serve, investors, are crystal clear?[4]

[4] This challenge is to the entire Board and not uniquely to Ms. Franzel. We simply use her quote to frame the issue.

In conclusion, we support the PCAOB's Proposal as a meaningful improvement in auditor reporting. We believe that the Proposal would be substantially strengthened if the Board simply encouraged, but did not require, the inclusion of informative, company-specific findings in the audit report.[5] Regardless of the Board's opinion regarding our recommendation, we encourage the Board to expeditiously adopt a final rule on auditor reporting, preferably no later than the end of 2016.

We, as members of the Auditor's Report Working Group of the PCAOB's Investor Advisory Group, jointly submit this comment letter.

Sincerely,

Mary M. Bersot, CFA
CEO and Chief Investment Officer
Bersot Capital Management LLC

Joseph V. Carcello, CPA, CGMA, CIA, CMA
EY and Business Alumni Professor
Department Head – Department of Accounting and Information Management
Executive Director – Neel Corporate Governance Center
University of Tennessee

[5] Our letter will serve as the foundation for our presentation at the IAG meeting on October 27, 2016. We will not introduce new ideas, proposals, or data at that meeting.

Sarah Deans
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Exane BNP Paribas

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Investment Director
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cc: PCAOB
James R. Doty, Chairman
Lewis H. Ferguson, Member
Jeanette M. Franzel, Member
Jay D. Hanson, Member
Steven B. Harris, Member

SEC
The Honorable Mary Jo White, Chairman
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Wesley R. Bricker, Interim Chief Accountant

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PICPA
Pennsylvania Institute of Certified Public Accountants

July 28, 2016

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: PCAOB Release No. 2016-003 Docket 034: Proposed Auditing Standards on the Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards

The Accounting and Auditing Procedures Committee (the committee) of the Pennsylvania Institute of Certified Public Accountants (PICPA) appreciates the opportunity to comment on the proposed auditing standards update. The PICPA is a professional association of more than 20,000 members working to improve the profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. The committee is composed of practitioners from both regional and small public accounting firms, members serving in financial reporting positions, and accounting educators. Our general comments are included below.

The committee believes that its Dec. 10, 2013, response to the PCAOB's previously issued exposure document remain valid to the re-exposed proposal. A copy of the committee's response to the original document is attached to this correspondence.

The committee appreciates that the PCAOB has restricted the definition of critical audit matters to matters communicated or required to be communicated to the audit committee and that relate to accounts or disclosures that are material to the financial statements. However, the committee remains concerned regarding the impact of the proposed requirements on the practitioner's ability to comply with legal obligations to maintain client confidentiality and independence, the risk of increased legal exposure, and the implementation costs.

1. Confidentiality – Most state CPA laws, as well as the AICPA Code of Conduct, require CPAs to maintain the confidentiality of their clients' information in the absence of specific permission to disclose. The definition of what is confidential is broad and generally encompasses all information that is not in the public domain. As further described below, the examples and wording included in the proposed standard seems to suggest a level of communication that goes beyond what a client normally disclosures. The committee is concerned that the proposed requirements would require CPAs to share nonpublic information with third parties, presenting threats to the practitioners' compliance with the confidentiality provisions within the Code.

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Pennsylvania Institute of Certified Public Accountants

- The definition of confidentiality extends to auditors' procedures. For example, without the client's consent, CPAs would be precluded from disclosing their audit methodology for a client's reserve process. However, the example for Company A provided within the release at pages 32-33 suggests that the auditor would describe the company's loan loss model in more detail than would normally be publicly available or included within the footnotes. The comment "since management has limited historical loss data for the nine-year loans…" might not be included in the footnotes or other publicly available information. To comply with confidentiality rules, the auditor would be precluded from communicating this kind of information in the absence of the client's permission.

- Some internal control or IT issues might be identified as critical audit issues, but may not have represented a condition required to be reported in the internal control report or otherwise disclosed publicly by management.

- Note 2 on page A1-9 specifically indicates that the auditor would not be required to provide information about the company that has not been made publicly available by the company "unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit." The committee believes that this requirement is in direct conflict with a CPA's legal confidentiality requirements.

2. Independence – The Committee believes that the proposed opinion increases the likelihood of adverse interest challenges, threatening practitioners' compliance with the independence rules included within the SEC rules, state CPA statutes, PCAOB guidance, and AICPA professional standards and Code of Professional Conduct.

   Requiring public disclosure of the type of information proposed by the PCAOB could result in adversarial type challenges by clients dissatisfied with certain disclosures. The client could disagree with an auditor's judgement on the materiality of a particular issue and challenge the release of specific information. The client could also challenge the auditor's wording, leading to significant wordsmithing. Concern over challenges such as these could lead to unwarranted auditor compromise solely to secure the client's permission to provide information to company stakeholders. The committee does not believe that the risk of such compromise is in the best interest of the client/auditor relationship, and does not think it would lead to greater transparency and enhanced value to financial statement users.

3. Misunderstanding and Legal Liability – The committee is concerned regarding the potential increased liability that could result from financial statement users' misunderstanding of and overreliance on the proposed critical audit matters.

   Comments such as the following from page 71 of the proposal clearly raise the concern that financial statement users may rely more on these matters than their actual nature and

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limitations warrant. "Some commenters stated that the communication of critical audit matters would focus the users' attention on issues that would be pertinent to understanding the financial statements for purposes of investment decisions or financial analysis." A critical audit matter may, or may not, represent an appropriate indicator upon which to make an investment decision, or predictor of the future health of the company.

Despite the revisions to the original proposal, the committee still believes that practitioners will use a lower threshold for reporting critical matters to deter the threat of litigation for failure to identify a specific matter as critical. Practitioners may also believe that adopting standardized language will provide safeguards against charges of inadequate disclosure.

4. Cost, Training, Communication – The committee questions the merit of the costs that will be incurred for outreach and communication to clients and financial statement users and for training of the staff of the public accounting firms that will result from adoption of the proposed audit reporting model. The committee does not perceive these as being value-added costs.

While the committee does not agree that the auditors should be required to publicly communicate confidential client information, there is nothing to preclude greater transparency by the audit committee. A separate communication of critical audit matters uncovered during the audit with a corresponding confirmation of these items from the external CPA is a reasonable approach. This approach would encourage improved audit committee/auditor communications and greater audit committee involvement, eliminate the threats to the CPA's compliance with the confidentiality and independence rules, reduce liability resulting from misunderstanding of the wording in the audit opinion, and reduce the overall cost of compliance over the proposed approach.

We appreciate your consideration of our comments, and members of the committee are available to discuss any of these with you at your convenience.

Sincerely,

Robert E. Williams, CPA
Chair, PICPA Accounting and Auditing Procedures Committee

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**ATTACHMENT - Committee's Response to the PCAOB Release No. 2013-005 Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments**

December 10, 2013

Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

Re: PCAOB Release No. 2013-005 Docket 034: Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments

The Accounting and Auditing Procedures Committee (the committee) of the Pennsylvania Institute of Certified Public Accountants (PICPA) appreciates the opportunity to comment on the proposed auditing standards revisions. The PICPA is a professional association of more than 20,000 members working to improve the profession and better serve the public interest. Founded in 1897, the PICPA is the second-oldest CPA organization in the United States. Membership includes practitioners in public accounting, education, government, and industry. The committee is composed of practitioners from both regional and small public accounting firms, members serving in financial reporting positions, and accounting educators.

**Section I. Require the auditor to communicate in the auditor's report critical audit matters that were addressed during the audit of the current period's financial statements.**

The committee understands that financial statement users would like greater transparency from companies and are looking to the auditors for this additional information. However, the committee disagrees with the underlying concept and role being proposed for the auditor in this proposal. The committee believes that the proposed communications are fundamentally flawed, are in direct conflict with professional ethics standards, and would not result in meaningful communication to the financial statement user.

1. As the requirement to communicate critical audit matters would likely greatly increase the auditor's practice management exposure, it is unclear which risk areas that an auditor would be willing to leave out. As a result, the audit report would likely become a lengthy document noting all risk areas material and immaterial. Standardization would likely result, as each firm looking to manage its practice risk would centralize and standardize the communication process. The value of the proposed communications is questionable, as the end result would be a lengthy document that would read like an audit textbook.

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2. The auditor is not permitted by many state statues and the AICPA Code of Professional Conduct to release confidential client information without the client's permission. The Code defines confidential client information as follows:

**"ET Section 92 – Definitions .05 Confidential client information.** Confidential client information is any information obtained from the client that is not available to the public. Information that is available to the public includes, but is not limited to, information

- in a book, periodical, newspaper, or similar publication;
- in a client document that has been released by the client to the public or that has otherwise become a matter of public knowledge;
- on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information;
- released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum;
- maintained by, or filed with, regulatory or governmental bodies that is available to the public; or
- obtained from other public sources.

Unless the particular client information is available to the public, such information should be considered confidential client information.

Members are advised that federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in the Code of Professional Conduct."

3. As the audit firm would be precluded from communicating any confidential client information, the client would have to approve the final wording of the audit report, including information about audit difficulties, negating the overall value of the communication. The auditors would likely involve their attorneys and the final audit opinion would result from a negotiation process involving the auditor, attorneys representing both parties, public relations specialists, and key members of a client's management. The process for issuing an audit opinion would not only be untenable, but if the process results in an adversarial situation, the auditor could lose independence and become unable to issue the opinion.

The auditor's role is to provide an opinion on the fairness of the financial statement presentation, not to provide communications regarding the overall health of the audited entity. If greater transparency is needed, the committee believes that financial statement users should look to the company's management for additional information (e.g., the "important information concerning the company, the company's environment, and the preparation of the company's financial statements" that is noted in the introduction to the proposal). If the financial statement users cannot ascertain this important information from the financial statements, then the communications included in the financial statements should be enhanced. The committee does not agree that the fundamental role of the auditor should change to correct a deficiency in financial reporting requirements.

Pennsylvania Institute of Certified Public Accountants

Ultimately, the committee is supportive of proposed changes that would better communicate to the financial statement user the nature and limitations of an audit. The committee, for example, suggests that any proposed change to the audit report seek to minimize the gap between what financial statement users expect from the audit and what the audit is designed to accomplish. For example, improvements to the opinion could focus on further explaining the roles and responsibilities of the auditor and the audited entity's management, and that the audit is not designed to detect fraud due to the nature of fraud and the scope of the audit. The committee recommends that the PCAOB consider the findings included in the 103rd American Assembly Report, "The Future of the Accounting Profession," The American Assembly, Columbia University, which included tailoring the attestation level for the nature of the financial statement to remove the "illusion of exactitude." Two specific suggestions are as follows:

- More limited attestation on subjective judgments (e.g. accounting estimates and fair value determinations) instead verify reasonableness of process used.
- A new audit opinion to permit the external auditors to adhere to different attestation standards for different parts of the financial statements.

**Section II. Add new elements to the auditor's report related to auditor independence, auditor tenure, and the auditor's responsibility for, and evaluation of, other information in annual reports containing the audited financial statements and the related auditor's report.**

The question infers that the length of the auditor's tenure has a definite and measurable impact on the quality of the audit, with the longer the tenure the less the quality. The committee disagrees with this premise and believes that audit quality is lessened with mandatory firm rotation.

**Section III. Enhance certain standardized language in the auditor's report, including the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether due to error or fraud.**

The committee supports the changes included in this area.

We appreciate your consideration of our comments, and members of the committee are available to discuss any of these with you at your convenience.

Sincerely,

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Pennsylvania Institute of Certified Public Accountants

Richard E. Wortmann, CPA
Chair, PICPA Accounting and Auditing Procedures Committee

Pfizer Inc.
235 East 42nd Street
New York, NY 10017-5755

**Loretta V. Cangialosi**
Senior Vice President and Controller

August 15, 2016

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, D.C. 20006-2803

**Reference: Rulemaking Docket Matter No. 34**

Board Members:

Pfizer Inc. is a research-based, global biopharmaceutical company headquartered in New York. We discover, develop, manufacture and market leading medicines and vaccines, as well as many of the world's best-known consumer healthcare products. In 2015, we reported revenues of $48.9 billion and total assets of $167.5 billion.

We appreciate the opportunity to present our comments on the Board's proposed auditing standard "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion." and we recognize the Board's efforts in service to financial statement users. We thank the Board for its consideration of comments received on the related concept release and note that the proposed standard has addressed some of the concerns raised previously by us by attempting to narrow the source of critical audit matters (CAMs). We also support the inclusion of a statement that the auditor is required to be independent, the added language clarifying "whether due to error or fraud" when describing the auditor's responsibilities and the PCAOB decision to move the opinion paragraph earlier in the auditor's report. While we agree with those aspects of the reproposal, we continue to have concerns around others as are outlined below.

## Critical Audit Matters

We believe that while using communications to audit committees as a source for CAMs appears to be a reasonable approach as those are generally the most important matters it is likely to have numerous unintended consequences including providing a potential disincentive to openness of interactions with the audit committee. As this is contrary to overall best practice and good corporate governance, we cannot support this proposed provision of the standard. Furthermore, there is a real and substantive cost to this proposal for which investors have not yet been able to articulate how they would use the information to make better investing decisions resulting in benefits which are intangible and amorphous. We are concerned that:

1. The language "involved especially challenging, subjective or complex auditor judgment" may, in fact, yield unintended consequences as described below.
    a. The language is dependent upon the audit partner's experience and biases and may result in inconsistent application and presentation of CAMs and communications to investors. For example, within the pharmaceutical industry, the rebate accrual process is complex as accruals are required at the time of sale for a rebate that is provided to an insurer who is neither the customer nor the patient. An audit firm or partner who is experienced in this, will likely not find this particularly challenging because he understands the process and the nuances involved. However, an audit firm or partner who is not experienced in this area may find this to be especially challenging and subjective. The experienced firm or partner will likely not have a CAM while the inexperienced firm or partner is likely to believe it is CAM. Another example which is more general is business combinations where the assets to be valued are intangibles that rely upon forecasted information and assumptions or where goodwill is being tested for impairment which requires forecasted information about the P&L as well as a segmented balance sheet which many companies produce manually. A firm or partner who has dealt with this subjective process may not see it as a CAM because he is comfortable with the process for validating assumptions utilized while another may find such valuations especially challenging and requiring complex auditor judgment. Investors may therefore be misled into thinking that the auditee's have significantly different issues when, in fact, they do not.
    b. The phrase "especially" challenging, subjective or complex auditor judgment" is still too broad and subjective that it will lead to inconsistent application by audit firms, PCAOB inspectors and audit partners. This is because the terms themselves are so highly subjective and dependent on the perspectives, experiences and biases of the individual applying them as to make application inoperable and subject to hindsight and second guessing by PCAOB inspectors, reviewing partners and plaintiff's attorneys. While the factors are helpful, the identification of CAMs, is fundamentally a subjective process which is prone to inconsistent application from the Board's intent. The same set of facts may be interpreted differently because even reasonable people may disagree on the application of a very subjective set of criteria. While we understand that the Board wishes this to be principles-based, we believe that there need to be some objective components to the definition that are based on specific facts, can be measured and are readily observable. We believe that the default when auditors are faced with this issue will be to include everything that is communicated to audit committees and thereby bury the important in the unimportant. An audit of a global entity is complex because a business is dynamic and ever-changing to meet current and future customer needs. Furthermore, based on the CAM definition, we can easily see that there would be many issues that would likely produce a CAM but are simply a part of the current complex accounting rules that preparers must apply, including contingent consideration must be fair valued even though the two parties in the transaction couldn't place a value on it today (hence the reason it is contingent), hypothetical market participants which are used to consider fair values in business combinations, making judgments and estimates for variable consideration in revenue is a regular part of the revenue recording process,

and litigation accruals which are inherently unpredictable and wherein the assessment process relies heavily upon estimates and assumptions that while reasonable, may prove to be incomplete or inaccurate and unanticipated events and circumstances may occur that might cause us to change those estimates and assumptions.

2. We do not believe that the proposed documentation requirements by the auditor, which are significant and will add substantial cost to an audit will improve the quality of the audit or CAMs as it seems to be mainly for the benefit of the PCAOB inspection process and the ability to determine that every item was considered, debated and reasons specifically documented as to why it is a CAM or not. Having to document the "negative" of why something is not challenging, subjective or requires complex auditor judgment is overly burdensome as it sets a presumption that everything is a CAM unless proven otherwise. We believe that documenting only the reasons why something is a CAM is a more appropriate and efficient process. Given all that needs to be completed for the audit before meeting with the audit committee, we believe that having an auditor focus on documenting unimportant items takes away from rather than adds to the audit quality.
3. Unfortunately, we live in a litigious society where lawsuits are brought by plaintiffs and often settled to avoid litigation costs even when there is no wrongdoing. Again, it is important to remember that reasonable people can disagree, particularly when it relates to assumptions or estimates which are not black and white areas, or when it relates to areas that are so complex as to need multiple discussions between the auditor, preparer and, sometimes, the auditor's professional practice group to understand and evaluate the accounting rules which may be applicable. We note that, at times, the Big 4 accounting firms offer differing interpretations or guidance of rules and that these interpretations and guidance have all been made in good faith. We believe the Board and the SEC needs to protect both audit firms and auditees from litigation brought solely in reliance on an audit report description of a CAM by introducing safe harbor rules. Otherwise, we believe that CAMs will be utilized as a source for potential litigation by enterprising plaintiff's bar as auditor workpapers are subject to discovery. We believe the situation will become analogous to securities lawsuits wherein plaintiff's bar begin actions based on negative news. We think that the Board and the SEC need to answer the question as to whether a CAM disclosure could ever result in a change in market price of the auditee's stock. If yes, then the advent of litigation is a virtual certainty.
4. Significant deficiencies are required to be reported to the audit committee; however, public disclosure is not required. The proposed statement still does not address this inconsistency and permits the auditor to disclose this as a CAM. A significant deficiency or deficiency lacks the potential to cause a material error, by definition. We cannot see how it will be helpful to investors to be presented with information about matters that have no potential to be material. As such, we recommend that the Board prohibit an auditor disclosure of significant deficiencies or other deficiencies.
5. Should the Board move forward with CAMs despite our objections, the Board should consider an implementation plan that will address the fact that no field test will be performed for this standard. Based on their experience with other PCAOB standards, auditees are very aware that PCAOB inspections will drive audit practices around the identification of CAMs. We are also aware that the PCAOB's influence on partner's compensation when there are audit failures has caused partners to be extremely cautious and conservative. In fact, we can envision that unless

a plan is enacted to understand both under and over disclosure of CAMs, the Board will not have achieved its purpose which is to provide important information to investors. Instead, taking a hard line immediately will drive auditors to be overly conservative and err on the side of caution by listing all items communicated to the audit committee as CAMs which undermines the purpose of the proposal. It is therefore important that the inspection process on this issue take into account that the evaluation of a CAM is highly subjective and influenced by the perspectives and set of experiences that the evaluator (including an inspector) has relative to an audit. Rather than issuing comments immediately, we suggest that the Board institute a "grace period" of at least two audit cycles during which practice can evolve and issues around the new standard can be better understood by all.

6. We note that the proposed standard allows for communications made to the audit committee that are not required to be a source of CAMs. We suggest that this language be eliminated so as to allow free communication between the auditor and the audit committee. Potential unintended consequences could include auditor's only communicating on required items to eliminate the risk that such an item could be considered a CAM. Because the current required items are quite extensive, we cannot see an event wherein the auditor would not be required to communicate an item which would qualify as a CAM unless process evolves in an inappropriately conservative manner.

**Other**

*Auditor Tenure:* We continue to view disclosure of auditor tenure as not meaningful as a link to audit quality has not been established. However, should the Board move forward with this proposal, we recommend that this disclosure be included in Form AP rather than required in the auditor's opinion.

*Boilerplate language:* With respect to the reporting of CAMs within the report, it is not clear to us that standardized language within firms and certainly within the Big 4 can be avoided, given the cost in both time and effort, and the risk of confusion and liability that attends the notion of "custom-tailored" report language. . PCAOB oversight will likely drive the firms to apply the broadest and most inclusive definition to these terms. Moreover, the firms themselves will quickly align with one another on that basis, leading to extensive and potentially confusing over-disclosure. We therefore believe that investors will likely find the first round of auditor's reports interesting, but not very useful in the following years as similar issues are noted by the auditor for each year and the audit report is treated like the financials whereby users will apply software to see what has changed from year to year.

* * * * *

In summary, as described above, while we support the efforts of the PCAOB to improve audit quality and provide the necessary standards, we continue to have concerns about aspects of the proposal and ask the Board to consider the recommendations provides in this letter

Once again, we appreciate this opportunity to comment on this concept release and encourage the Board to continue to engage its constituents. We would be pleased to discuss our perspective on these issues with you at any time.

Very truly yours,

Loretta V. Cangialosi

Loretta V. Cangialosi
Senior Vice President and Controller

cc: Frank D'Amelio
Executive Vice President and Chief Financial Officer

PHILLIPS EDISON & COMPANY

August 15, 2016

PCAOB
Attn: Office of the Secretary
1666 K Street NW
Washington, D.C. 20006-2803

Dear Board Members:

Regarding Rulemaking Docket Matter No. 034, first allow me to express my appreciation not only for the Board's willingness to reexamine one of the most critical components of a set of financial statements to ensure that its potential usefulness is maximized, but also for granting the public the opportunity to provide comments on the proposal. I believe there is great value in reexamining the most significant and enduring piece of communication between independent auditors and the governing bodies whom they serve.

In reading the proposed auditing standard, I see several individual proposals that I would consider to be useful and relevant to investors and other financial statement users, including the following:

- Independence statement: As independence between an external auditor and the company it audits is foundational to the provision of reasonable assurance over the material accuracy of the financial statements, I welcome the addition of this statement to the audit report. I think the addition of this language affirms for the readers of the financial statements that this critical aspect of the relationship between auditors and the preparers of the financial statements was and remains intact. Further, it may also serve as a meaningful reminder to both auditor and auditee the importance of maintaining this independence, which would be an added benefit.
- Report addressee: As the auditor by nature serves the company's shareholders and governing body, I think the addressee requirement is reasonable and appropriate, and a necessary addition to the requirements around the audit report. As with the independence statement, I also think it has use as a means of reminding auditors and the companies who employ them that the services provided by the auditor are ultimately acquired at the behest of the shareholders and those charged with governance.
- Enhancement to the basic elements - financial statement footnotes: Given how inseparable the notes to the financial statements are from the statements themselves in providing the reader with a complete and accurate portrait of the financial position and results of a company, I wholeheartedly support modifying the language of the audit report to make reference to the notes to the financial statements as being part of the financial statements upon which the auditor is

opining. I hope that it will also encourage and reinforce to the readers that they should spend time reviewing not only the financial statements but also the related footnotes and schedules, thereby enhancing the usefulness of the financial statements taken as a whole.

At the same time, in reading both the initial draft of the proposed rule published in 2013, as well as the reproposal published in May of this year, I concur with multiple other professionals and trade groups that have expressed tremendous concern with regards to the proposal that Critical Audit Matters ("CAMs") be disclosed within the audit report. My concerns stem from a variety of sources, notably the following:

- I definitively share the belief expressed by many professionals (in many cases via comments provided on the initial draft of the proposal) that the disclosure of such details will prompt an increase in litigation the merits of which prove to be questionable or unfounded. Speaking frankly, I strongly believe that the inclusion of CAMs in the audit report would provide a virtual roadmap for those who may be looking for underhanded ways to enrich themselves via baseless litigation at the expense of a company and/or its auditors.
- I consider it rather likely that the introduction of a new area of complexity requiring significant auditor judgment would result in measurable increases in audit fees, which would ultimately reduce amounts that may otherwise be distributed to shareholders. Additionally, these fees would be attributable not to improved audit quality driven by improvements or increases in audit testing and/or documentation, but rather to an increase in audit firm risk management procedures, involving lengthier reviews by expensive, senior-level individuals both inside and outside of the audit team.
- As the Board knows, the use of professional judgment in the preparation of financial statements—through both the accounting decisions of company personnel, as well as the auditing decisions of those independent accountants whose shareholders they serve—is, by nature, extensive. In addition to the obvious and critical role that researching the correct application of GAAP plays in making important accounting judgments, the ability to openly acknowledge these areas as being more challenging than others, as well as the ability to be transparent in related discussions and share methodology and conclusions with external auditors, is crucial to ensuring the best possible outcomes. I believe this proposal would ultimately inhibit communication with regards to these challenging areas, which in turn would decrease the quality of the accounting and reporting output on these critical issues.
- Simply put, I feel strongly that the inclusion of this highly subjective information in the audit report stands contrary to the factual and objective piece of communication that the audit report is intended to be. Further, to make such a radical change so suddenly (in the sense that the audit report would dramatically change all at once; I acknowledge with appreciation the significant amount of time that the Board has spent crafting this proposal) and without a strong sense of consensus from industry professionals and auditors seems overly ambitious. I appreciate the desire to be transformative in increasing the

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utility of the audit report and improving the quality of communications between auditors and shareholders, but I believe a more measured approach—which I think is reflected in many of the other proposals in Docket No. 034, some of which I highlighted earlier—is the correct approach. In addition to the two specific concerns on the CAMs proposal that I mentioned above, I think the potential for unintended consequences and a failure to maximize the effectiveness of the proposal due to a lack of consensus is significant.

Finally, the Board has specifically asked for commentary as to whether or not the disclosure of audit tenure would be more appropriately done through inclusion in the audit report or through submission of Form AP. I would suggest that Form AP would be the most appropriate method of disclosure. As I have detailed previously, the purpose of the audit report—to present an independent auditor's opinion with regards to the fairness and material accuracy of a specific set of financial statements—seems to indicate that facts about the auditors themselves (e.g. the identity of the signing partner, the tenure of the audit firm with respect to an individual engagement, etc.) are better documented separately from the audit report which appears in a particular set of financial statements. My concern with the inclusion in the audit report arises not from any fear of "overdisclosure", but rather from the very real possibility that inclusion of these facts in audit reports could (1) shift focus away from the intended subject of the audit report (the accuracy of the financial statements and, for integrated audits, the effectiveness of internal control) and (2) in the absence of context, imply that there is a direct relationship between audit quality and the length of an auditor's tenure, for which I do not believe there is any compelling evidence.

Thank you again for your consideration of this matter and the opportunity to provide commentary.

Sincerely,

Courtney C. Hathaway
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August 15, 2016

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

Via e-mail – **comments@pcaobus.org**

Re: PCAOB Rulemaking Docket Matter No. 034: Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and related amendments to PCAOB standards

Plante & Moran PLLC (Plante Moran) is the 13th largest public accounting firm in the United States and serves a wide range of public and non-public entities in multiple industries. Plante Moran supports the PCAOB's efforts in improving standards by seeking feedback and appreciates the opportunity to provide comments on the Proposed Auditing Standard referenced above.

Plante Moran Commentary on the Proposed Auditing Standard

***Definition of Critical Audit Matter (CAM).*** For the most part, we agree with the definition of CAM as proposed. We do believe, however, that it could be interpreted that a significant deficiency would qualify as a CAM in some circumstances. Given that we believe this is not the PCAOB's intent, we suggest adding some clarification that significant deficiencies, by themselves, would not be a CAM.

***Applicability***. We agree with the Proposed Standard's exclusion of CAMs in the auditor's reports for the audits of certain brokers and dealers, investment companies, and employee benefit plans. We also recommend that the requirement be excluded from the auditor's reports for the audits of emerging growth companies and smaller reporting companies, as we have not yet seen any research that indicates these audits would sufficiently benefit from the information provided by this requirement that would justify the cost of the effort.

***Effective date***. We recommend that the effective dates of the Proposed Standard be in the year or years following the respective effective date of FASB ASU No. 2014-09 *Revenue from Contracts with Customers,* assuming timely approvals from the PCAOB and SEC. We acknowledge, regretfully, that this would be a significant delay from the PCAOB's preferred time frame. However, issuers and accounting firms are entering some years of great change as a result of the multiple major accounting standards that are required to be implemented in upcoming years. We believe that implementation of the Proposed Auditing Standard subsequent to ASU 2014-09 will be of much higher quality than if required to be implemented before ASU 2014-09. In addition, we strongly recommend that the effective dates be phased in to allow the smaller accounting firms and issuers and their audit committees additional time to review and consider actual examples of CAMs from larger firms and issuers.

Thank you again for the opportunity to comment on this proposed auditing standard. We would be pleased to respond to any questions the PCAOB or its staff may have about these comments. Please direct any questions to Joan Waggoner at **joan.waggoner@plantemoran.com** or 312-980-2945.

Very truly yours,

**PLANTE & MORAN, PLLC**

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

August 15, 2016

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

Dear Madam Secretary:

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

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

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

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

[1] *See* https://pcaobus.org/Rulemaking/Docket034/Release_2013-005_ARM.pdf
[2] *See* reproposed standard paragraph .A2
[3] *See* Ibid
[4] *See* Ibid
[5] *See* reproposed standard paragraph .14b
[6] *See* reproposed standard paragraph .07

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

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

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

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

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

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

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

**Critical audit matters**

*Definition of critical audit matter*

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

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[7] *See* reproposed standard paragraphs .08, .09, and .15
[8] *See* reproposed standard paragraph .09
[9] *See* reproposed standard paragraph .15
[10] *See* page 52

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

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

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

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

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

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[11] *See* https://pcaobus.org/Rulemaking/Docket034/143b_PwC.pdf

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

[13] *See* https://pcaobus.org/Rulemaking/Docket034/143b_PwC.pdf

[14] *See* page 20

[15] *See* https://pcaobus.org/News/Speech/Pages/Ferguson-statement-ARM-051116.aspx

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

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

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

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

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

[17] *See* page 20

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

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

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

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

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

[18] *See* pages 32-35

[19] *See* reproposed standard paragraph .14b

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

**Auditor tenure**

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

**Effective date and costs**

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

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

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

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[20] *See* reproposed standard paragraph .10b

[21] *See* page 49

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

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

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

**Legal considerations related to the reproposal**

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

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

[22] *See* page 42

[23] *See* reproposed standard paragraph 14(b) and 12(f)

[24] *See* reproposed standard paragraph 14(c)

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

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

* * * * *

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

Sincerely,

PricewaterhouseCoopers LLP

**APPENDIX**

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

*Qualified opinions*

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

*Explanatory paragraphs*

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

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

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

[25] *See* page A2-15
[26] *See* page A2-30
[27] *See* page A2-32
[28] *See* page 55
[29] *See* page 55
[30] *See* page A2-44

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

*Financial statement schedules*

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

*AS 3305*

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

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

*Other periods presented*

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

*Referring to disclosures outside the financial statements*

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

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[31] *See* reproposed standard paragraph .8b

[32] *See* page 28

[33] *See* page 38

*Ability to determine there are no critical audit matters*

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

[34] *See* page 38

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July 25, 2016

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

Re: PCAOB Rulemaking Docket Matter No. 034

To the Members of the PCAOB,

I appreciate the opportunity to comment on the reproposed standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. It has been a long, slow road to improving the audit report since the Board shouldered this load in 2011. I applaud the Board for taking on this unpopular task - one where the status quo is considered good enough by the preparer and auditor community; understandably so, because they are the ones who have the most work ahead of them if this becomes an auditing standard. Their main concern is the critical audit matters – the CAMs. It is my main concern as well.

While I understand the anxiety surrounding CAM reporting, I believe it is misplaced: The Board has dramatically slimmed down its proposal from the last iteration. The requirement that reported CAMs relate to material reporting matters of which the audit committee should be aware and involving significant auditor judgment should cause only the most important issues to be reported; there should be no unreasonably lengthy audit reports resulting from this requirement. I believe that the specter of oversized, boilerplate audit reports is being invoked in order to arouse opposition to the proposal, as well as the possibility that auditors might disclose information that might not be required to be disclosed by accounting standards. I do not believe that this is what the Board intends in the proposal, nor do I believe that auditors would want to interpret the proposed standard in that fashion.

Some critics charge that investors do not need this information because it is already handled by the auditors in their dealings with the audit committee of the board of directors. Both auditors and audit committee members are agents of the shareholders, and are supposed to be championing the interests of their principals. That's true, but are the agents really putting the interests of the principals first if they can't share the most critical issues with those principals?

Keep in mind that both auditors and board members – including audit committee members – are elected by the shareholders and the cost of retaining both sets of agents is borne by the shareholders. What would happen to most of us if we refused to tell our employers what they wanted to know about the way we did our jobs for them?

The question has been raised, even at the Board level: how will investors use the information in the CAMs? The question seems to be posed as a reason for not improving the audit report. The thinking may be that if investors won't use the information to say, fashion their quarterly or annual earnings estimates, then the information must not be worth the effort to collect it.

Before answering the question "how will investors use CAM information," I have a question of my own: how do investors use the audit report *now*? In thirty-plus years of working in the investment research world, I've rarely encountered anyone who reads them – and when they do read them, it's not for the purpose of incorporating nuggets of information from them into an earnings model.

Also before answering the question, let us also be clear on just who the term "investors" addresses. If one presumes the kind of investors typically showing up at shareholder meetings – that is, usually individual investors, rarely professional or institutional investors – the answer is that they'll probably do nothing with the information, and they very likely don't ever do anything at all with the audit report or the financial statements. Does that make the PCAOB's proposal a bad idea because this particular class of investors won't use the information? No. Should standard setting efforts be aimed at pleasing this particular segment of investors? No. If they're not going to use financial statements anyway, it's wrong to make financial reporting standards tailored to suit people who don't use financial statements. It's a waste of resources.

If, by investors, one means professional investors, that's still not a monolithic class. Some professional investors can go through their whole career without looking at audit reports or financial statements, and still function viably. Consider stockbrokers: it's unusual to encounter ones that will spend time with an annual report, but nevertheless, they can be considered investors. They will, however, have their opinions shaped by the advice of their firm's research analysts – and those are investors who are very likely to read financial statements and audit reports (especially if they believe the audit reports aren't in the category of "seen one, seen them all.") Also likely to read financial statements and audit reports are the in-house analysts of buy-side institutions like mutual funds – and they often invest on behalf of the individual investors who will never read financial statements or audit reports.

That category of investors – the professional, institutional investor – is the one that's likely to use the information resulting from the PCAOB's proposal. So, back to the question – how will these investors use the information in the CAMs?

They'll use it like they use any other information about accounting standards. They'll read it and form opinions when they understand it. Nobody questions how investors use accounting policy footnotes or critical accounting estimates. Those disclosures help investors get an idea of a firm's reporting environment, and they also help an investor get an idea of their own limits: for example, if a company has an accounting policy related to revenue recognition tied to multiple-element arrangements, and the investor has no idea what that means, it will be incumbent upon the investor to learn about them. These disclosures in the audit report will augment and add another dimension to the story told by accounting policy footnotes in the financial statements and the critical accounting policies and estimates disclosed in the Management's Discussion & Analysis – and because it comes from the auditor, who is very directly the agent of the investor, it should be valued very highly by investors.

What preparers and auditors fail to take into account is the fact that the level of accounting knowledge within the investor community is not always deep, and certainly not consistent among investor factions. Information can always be ignored and sometimes, investors choose ignorance when it comes to existing information about accounting policies or critical accounting estimates. Standard setters have not chosen to penalize investors who make good use of such information because some investors choose ignorance.

Unlike investors, auditors are experts in accounting matters, and they should be. If a firm's auditors find that a material matter was particularly taxing of their own judgment, and they communicated that fact to the audit committee - the other agents of the investors – then including it in the audit report would amplify the investors' own understanding of the other information in the financial statements about accounting policies and estimates. Hopefully, an investor might think that if an expert considered this to be a tough matter, then maybe it would make sense for the investor to really understand the issue well.

Not every disclosure or number in the financial statement package is "used" by investors in, say, building earnings estimates. They don't "do" something with every figure in the package. That doesn't mean information of a qualitative nature, such as the CAMs, is without its uses. If investors get into the habit of understanding them, they may find that there are other parts of the financial statement package they've been neglecting. Critics of the proposal may say there isn't value to CAMs because investors won't "do" something with them, but if CAMs exist in the audit report and investors read about them, they will add a useful element to the current reporting package: an expert's link to the more vexing accounting issues embedded in the financial statement package. That will do more to highlight for investors the critical accounting issues of a company than any mere litany of accounting policies.

* * * * * * * * * * * * * *

If you have any questions about these thoughts, members of the Board or the staff are welcome to contact me to discuss further. Best regards.

Sincerely,

Jack Ciesielski

Jack Ciesielski

RETAIL INDUSTRY LEADERS ASSOCIATION
Educate.Collaborate.Advocate.

1700 North Moore Street, Suite 2250, Arlington, VA 22209

August 15, 2016

Public Company Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

ATTN: Office of the Secretary

Re: PCAOB Rulemaking Docket Matter No. 034

TRANSMITTED VIA EMAIL: comments@pcaobus.org

Members of the Board:

The Retail Industry Leaders Association ("RILA") and its Financial Leaders Council ("FLC") are pleased to submit the following comments on the Board's Proposed Auditing Standard for *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion* ("Re-proposed Standard"), issued by the Board on May 11, 2016. RILA is an organization of the world's most successful and innovative retailer and supplier companies – the leaders of the retail industry. RILA members represent more than $1.5 trillion in annual sales and operate more than 100,000 stores, manufacturing facilities, and distribution centers nationwide. Our member retailers and suppliers have facilities in all 50 states and the District of Columbia, as well as internationally, and employ millions of workers domestically and worldwide.

RILA and its FLC commend the Board for engaging in a thoughtful process and re-proposing its views following its initial, proposed standard to address the subject, issued by the Board on August 13, 2013, and its Concept Release on *Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements*, issued by the Board on June 21, 2011. Most of our members are public companies and all of our members recognize that the efficient operation of our markets mandates that financial statements present fairly the financial position of the company and provide sufficient transparency so that investors and other users of financial statements can make informed investment or other decisions.

We believe two of the most important areas for improvement with respect to financial information are 1) to improve the timeliness of the auditor's report and 2) to provide necessary information but not create information overload. Unfortunately, changes discussed in the Re-proposed Standard, relative to the communication of critical audit matters, are still contrary to both of these objectives. The additional disclosures increase the length of time necessary to complete an audit and, as a consequence, increase the length of time required to make audited financial information available to investors. Investors interested in our member companies would prefer more timely disclosure as opposed to increased disclosures in the auditor's report. In addition, disclosure of critical audit matters only adds to information overload, without contributing to assurances that the financial statements are free of material misstatement.

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Our specific comments follow:

1. The Re-proposed Standard has been revised to define a critical audit matter as any matter arising from the audit that was required to be *communicated to the audit committee* and that *relates to accounts or disclosures that are material to the financial statements* and *involved especially challenging, subjective, or complex auditor judgment.* SEC rules already provide for disclosure of audit related information that the SEC believes is relevant to investors in the Management Discussion and Analysis ("MD&A"). Disclosure of critical audit matters, as defined in the Re-proposed Standard would not serve the best interests of investors or other users of financial statements. Simply providing information on critical audit matters that are defined as challenging, subjective, or complex in the opinion of professionals whose job it is to perform the audit function would simply provide more information, but not "good" or "better" information. Instead, we believe such disclosures would only increase confusion, speculation and the drawing of incorrect conclusions, potentially increasing litigation costs for both audit firms and preparers. Audit committees are charged with evaluating this information, in the context of the business at issue, and the company is required to follow SEC rules and U.S. GAAP standards governing related MD&A disclosures including, but not limited to, accounting estimates and policies, critical management judgments, risks and uncertainties. Further, we believe that the proposal would usurp the audit committee's oversight role, and the role of a company's Board, as auditors would, in effect, be making communications directly to investors.

2. According to the PCAOB release, *"communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor and focusing their attention on issues that would be pertinent to understanding the financial statements."* We believe that the scope of a financial statement audit is to determine whether the financial statements are free of material misstatement. The issues that the auditor considered were obviously resolved to the auditor's satisfaction if the auditor is able to opine that the financial statements are free of material misstatement. What the auditor considered and discussed with the audit committee in order to reach the opinion that the financial statements are free of material misstatement will not provide investors with information that would allow a user of the financial statements to better understand those financial statements. The proposed inclusion of critical audit matters in the audit report distorts the auditor's function from an attestation role to a reporting role.

In sum, auditing standards are designed and audit firms are trained explicitly to obtain reasonable assurance that financial statements are free of material misstatement and therefore, are accurate. Frequently matters require communication to the audit committee. Most audits have subjective and significant auditor judgments related to accounts or disclosures that are material to the financial statements. Furthermore, many audits have areas that are challenging, subjective and complex to audit. This does not imply that a company is a good investment or a bad investment. The investor community is inherently in the best position to understand the risks and rewards of investing in a business; this ownership should not be delegated to an audit firm.

Although we appreciate the efforts and the outreach of the Board, we do not believe that the changes discussed in the Re-proposed Standard, relative to the inclusion of critical audit matters, is necessary. In our opinion, these disclosures would not improve the quality of audits or financial statements. Quite the contrary, the inclusion of critical audit matters in the audit report would increase audit costs, increase litigation costs resulting from confusion, speculation and drawing of incorrect conclusions, and protract

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the time necessary to complete an audit. We thank you for the opportunity to respond to the Re-proposed Standard and to provide our comments.

Respectfully submitted,

Susan M. Pifer

Susan M. Pifer, C.P.A., J.D.
Vice President, Compliance
Retail Industry Leaders Association

Cc: Kim Boylan, Esq., White & Case

**From:** John R. Roberts
**To:** Comments
**Subject:** PCAOB Release No. 2016-003
**Date:** Thursday, August 11, 2016 5:42:23 PM

Board Members and Staff of the PCAOB:

With regard to the above referenced Release I have several concerns that I would like to address. By way of background I spent 35 years with a large international public accounting firm 23 of which I was a partner and also served as managing partner of two different offices while also serving as lead audit partner on several large multinational clients. Beginning in 2001 I have served on the Board of Directors three NYSE registered firms (one retired and two current) and have served as chairman of the audit committee of each firm.

With that as a backdrop I can honestly say that I have attend in excess of one hundred shareholder meetings where the auditors were present and available to answer questions. To the best of my recollection I do not recall any investor ever asking any question of the auditors. Therefore I am having a very hard time understanding the need for the auditors to disclose “critical audit matters” when the opportunity already exists for interested investors to raise any questions they may have. This appears to be a solution in search of a problem.

I share the concerns of those other responders who believe such a standard will have a chilling effect on the open communications that presently exist between auditors and audit committees. Will auditors be reluctant to discuss sensitive matters or audit committees be reluctant to ask sensitive questions if PCAOB reviewers might subsequently conclude that such discussions could have been deemed “material”? I believe this issue alone might well diminish an audit committee’s ability to exercise its oversight responsibility of the audit on behalf of the shareholders.

If the PCAOB subsequently determines that an auditor’s report failed to include a certain “critical audit matter” will the auditor be required to recall the defective report and reissue a new one even if several years have passed? How might this effect a company in the midst of a transaction or registration? This might not not be a situation where the financial statements and notes, which are still the primary responsibility of management, were misstated but merely reflect a difference of opinion between the auditor and PCAOB. It seems such an occurrence could be highly detrimental to the shareholders.

I am not in favor of this release and appreciate the opportunity to share my comments.

Most sincerely,

John R. Roberts

Sent from Mail for Windows 10

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August 12, 2016

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street N.W.
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Re: PCAOB Rulemaking Docket Matter No. 034

Dear Office of the Secretary:

RSM US LLP appreciates the opportunity to offer our comments on the PCAOB's *Proposed Auditing Standard, "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion," and Related Amendments to PCAOB Standards.* RSM US LLP is a registered public accounting firm serving middle-market issuers, brokers and dealers.

We are pleased that the reproposal retains the existing pass/fail model of auditor reporting, which generally is acknowledged to be useful to investors and other users of audited financial statements. We continue to support the PCAOB's objective of enhancing the auditor's report with more disclosure and agree that the disclosure of critical audit matters would provide investors with more information than previously provided in the auditor's report. However, we are concerned that the material additional costs associated with critical audit matters will be disproportionate for nonaccelerated filers, smaller reporting companies, and emerging growth companies, and may outweigh the perceived benefits their investors gain from the information provided. As discussed below, we therefore suggest a phased-in approach with a period of evaluation after implementation by large accelerated filers and accelerated filers before the communication of critical audit matters would be required for audits of nonaccelerated filers, smaller reporting companies and emerging growth companies.

Our letter further explains other enhancements that could be made to the reproposed standard, and includes comments related to specific paragraphs of the reproposal that we believe should be clarified or modified.

**Critical audit matters**

***Determination of critical audit matters***

We support narrowing the source of potential critical audit matters to only those matters arising from the audit of the financial statements that were communicated, or required to be communicated, to the audit committee. We believe this is the most logical starting point for the auditor to discern which matters are to be considered worthy of public disclosure in the auditor's report because they involve especially challenging, subjective or complex auditor judgment.

We also support including the concept of materiality in the definition of a critical audit matter as we believe that will focus the auditor on those matters deemed to be most critical to the audit. However, the current materiality factor to be used in identifying a critical audit matter is "accounts or disclosures that are material to the financial statements." We believe this materiality threshold could result in the auditor being required to disclose a nonmaterial matter (related to a material account or disclosure) that would not otherwise be disclosed by the registrant, and therefore would inadvertently make the auditor the original source of information about a registrant. For example, it should not be necessary to disclose in the auditor's report a significant deficiency related to a material account when management is not required to disclose the significant deficiency under SEC rules.

We believe it would be more appropriate for the concept of materiality in identifying critical audit matters to relate to the financial statements taken as a whole so as to not require disclosure of nonmaterial matters related to material accounts or disclosures. We therefore suggest the following revisions to the definition of a critical audit matter in paragraphs .11 and A2 of the reproposed standard (deletions are struck through and additions are noted in bold font):

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

To further clarify that the auditor should not be the original source of information about a registrant, we recommend the Board consider revising Note 2 to paragraph .14 to read as follows (deletions are struck through):

> "When describing critical audit matters in the auditor's report the auditor is not expected to provide information about the company that has not been made publicly available by the company ~~unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit~~.

***Illustrative examples of the communication of critical audit matters***

We appreciate the Board providing illustrative examples of the communication of critical audit matters as we believe such examples will be helpful resources for auditors. We are concerned, however, that the illustrative examples go beyond the requirement in paragraph .14.b. to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter. The illustrative examples included in the reproposed standard seem to indicate that all aspects of the audit be included in the description of the critical audit matter. We suggest the Board consider revising the illustrative examples to clarify that they are intended to illustrate how an auditor may describe the *principal* considerations that led the auditor to determine that the matter is a critical audit matter.

***Cost Considerations***

Our firm was one of nine public accounting firms that field tested the implementation of the originally proposed standard to directly assess the impact on various aspects of the audit, including, among others, the additional involvement of senior audit partners, the efforts that would occur during the final stages of the audit and the cost to the client. As documented in the June 19, 2014 letter from the Center for Audit Quality to the PCAOB, feedback from audit engagement teams that participated in this field test, as well as from management and audit committees, was that the additional time and effort was likely to be incurred during the completion phase of the audit by senior members of the audit engagement teams and may require national office consultations and possibly legal review on behalf of the auditors and the registrant. This could occur at a time when auditors, management and audit committees are focused on a number of other issues in connection with a particular filing, and the finalization of critical audit matters may delay, or cause distraction in, the resolution of these issues. Further, many of the accounting firms expressed the view that the incremental time required may not decrease significantly in future years, given (a) that one of the stated objectives of the originally proposed auditor reporting standard is to avoid boilerplate descriptions and (b) the need to address new potential critical audit matters each year as a result of transactions or other changing business or financial reporting dynamics.

The expenditure of additional time ultimately will be reflected in increased costs for the auditor resulting in increased audit fees for the registrant. Additional legal counsel reviews also may result in increased costs for the registrant. Further, we believe the compression of work by both management and the auditor during the final stages of the audit may adversely impact the quality of financial reporting. This may be particularly burdensome for smaller reporting companies, most of which historically need all of the time available up to the reporting deadline for financial reporting.

Because nonaccelerated filers, smaller reporting companies and emerging growth companies have small market capitalization and typically less extensive investor and analysts' reviews of their financial statements, we are concerned the material additional costs associated with critical audit matters may outweigh the perceived benefits investors gain from the information provided.

*Applicability*

We agree that the following entities should be excluded from the requirement to communicate critical audit matters in the auditor's report:

- Nonissuer brokers and dealers
- Investment companies other than those regulated as business development companies
- Employee benefit plans

We continue to believe the reproposed disclosure of critical audit matters would not be scalable based on the size of the registrant. Smaller registrants often do not have the same level of sophistication in terms of information technology systems or financial reporting professionals as larger registrants are able to have. This lack of sophistication can cause the auditor to need to make more difficult, subjective and complex auditor judgments and also can pose more difficulty to the auditor in obtaining sufficient appropriate evidence. All of these matters are required to be communicated to the audit committee and therefore are the population from which critical audit matters will be determined. For these reasons, we believe auditors' reports on the financial statements of smaller registrants may be required to include a disproportionately higher number of potential critical audit matters than those of larger registrants. As discussed below, we believe a robust analysis of the costs and benefits of the reproposed auditing standard should be conducted prior to determining whether and when the standard should be implemented for nonaccelerated filers, smaller reporting companies and emerging growth companies.

**Effective Date**

If finalized, the auditor reporting of critical audit matters required by the reproposed standard will require audit firms a considerable amount of time to develop and implement effective quality control procedures and related training. Also, the new requirements likely will require extensive discussions with client management and audit committees as they evaluate the potential effect of the additional auditor communications in the auditor's report. Due to the extent of these efforts, we believe it would be prudent for the reproposed standard to first be effective for large accelerated filers for audit periods ending two years after the SEC approves the final standard. To allow firms to benefit from the experience of audits of large accelerated filers, we suggest the final standard be effective for accelerated filers one year after the effective date for large accelerated filers.

As to the effective date for nonaccelerated filers, smaller reporting companies and emerging growth companies, we continue to encourage the PCAOB to conduct a robust analysis of the costs and benefits of the reproposed audit reporting standard before concluding that the benefits of the additional disclosures outweigh the costs and the impact on timeliness of information. Therefore, subsequent to the implementation of the standard by large accelerated filers and accelerated filers, we encourage the PCAOB Center for Economic Analysis to perform a post-implementation review of the overall effect of the standard, similar to the approach used to assess Auditing Standard 7, *Engagement Quality Review*. This review could evaluate the costs and benefits associated with the standard, whether the adopted standard is accomplishing its intended purposes, and whether and when the standard should be implemented for nonaccelerated filers, smaller reporting companies and emerging growth companies. This review also should include evaluation of the unique needs of the investors for these filers as compared to large accelerated filers and accelerated filers.

We believe this phased-in approach would allow for more efficient implementation of the standard in audits of nonaccelerated filers, smaller reporting companies and emerging growth companies because initial implementation issues could be resolved, and related costs would be absorbed, by issuers with the most sophistication and the largest economic footprint. This approach also would align the with PCAOB's mission of protecting the interest of investors, without placing an undue burden on smaller players in the capital markets.

**Tenure**

In 2011, the PCAOB issued Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation,* to seek comment on the advantages and disadvantages of mandatory audit firm rotation, among other matters. Because auditor tenure continues to be a topic of PCAOB discussion and the subject of academic research, we continue to believe the concept of auditor tenure and mandatory audit firm rotation should be addressed in that context separately from any other proposed auditing standard.

Paragraph .10.b. of the reproposed auditor reporting standard, however, requires the auditor to include in the auditor's report a statement containing the year the auditor began serving consecutively as the company's auditor. We are not supportive of including auditor tenure in the auditor's report for the reason discussed in the preceding paragraph and because it is unclear what a user should infer from such a disclosure. Disclosure of auditor tenure also has the potential of distracting the user from more relevant information in the auditor's report. Further, investors who are interested in information about auditor changes can obtain relevant information publicly.

If the PCAOB wishes to consider disclosure of auditor tenure, we believe it would be more appropriate to make such disclosure in Form AP, *Auditor Reporting of Certain Audit Participants,* rather than in the auditor's report. Also, if the auditor is required to disclose auditor tenure either in Form AP or in the auditor's report, we believe guidance should be issued to address how tenure should be calculated so as to provide comparability across all firms. Such guidance should address the following issues, among others:

- The impact of the following on the calculation of auditor tenure:
  - Audit firm mergers and acquisitions
  - Registrant mergers, reverse mergers and acquisitions
- Whether periods audited before an initial public offering count toward auditor tenure or whether auditor tenure begins with the first effective registration statement

- Whether tenure for a new auditor begins when the firm signs an initial engagement letter to audit a registrant's financial statements or when the firm begins the audit

**Clarification of auditor responsibilities in the auditor's report**

We support the proposed change to move the auditor's opinion on the financial statements to be in the opening paragraph of the auditor's report. We also support the additional language clarifying the requirements related to auditor independence. Further, we agree with the expanded language regarding the auditor's responsibilities regarding financial statement material misstatement, whether due to error or fraud.

To promote consistency of auditor reporting globally, we strongly encourage the Board to consider additional auditor report language so as to further align it with the language used in auditor reports issued in accordance with the standards of the International Auditing and Assurance Standards Board. Such language would include expanded descriptions of the responsibilities of management and those charged with governance in a paragraph that is separate from the description of the auditor's responsibilities. Such additional disclosures would enhance financial statement users' understanding of the various responsibilities in the financial reporting and audit processes.

We would be pleased to respond to any questions the Board or its staff may have about our comments. Please direct any questions to Sara Lord, National Director of Assurance Services, at 612.376.9572.

Sincerely,

RSM US LLP

RSM US LLP

**From:** Joe Dugger
**To:** Comments
**Subject:** The Auditor"s Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion
**Date:** Wednesday, May 18, 2016 10:32:33 AM

The PCAOB needs to rein in the proliferation of new requirements that are driving the cost and complexity of audits with minimal or NO positive impacts to the benefits derived from the audit process and reporting. I've witnessed layer and layers of "additions" of processes, procedures and reporting as a result of the PCAOB's work and find it solely lacking in substance of better informing the reader of audited financial statements. In my opinion, the PCAOB needs to get members on the board and needs to incorporate a practical application understanding to what they implement.

I would NOT be in favor of the proposed additions PCAOB is proposing.

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August 15, 2016

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

**Re: PCAOB Release No. 2016-003,** Proposed auditing standard: *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards***.** PCAOB Rulemaking Docket Matter No. 34

Dear Members of the Board:

The Global Financial Institutions ("GFI") Accounting Committee and the Asset Management Accounting Policy Committee, both of the Securities Industry and Financial Markets Association ("SIFMA"), appreciate the opportunity to provide comments on the Public Company Accounting Oversight Board's ("PCAOB's" or the "Board's") revisions to the proposed auditing standard, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* ("The Re-proposal").

We support the PCAOB's objective to improve investor confidence and understanding of the audit process through enhanced auditor communications. We also applaud the Board's efforts to incorporate feedback on the original proposal by including the consideration of materiality in the identification of a critical audit matter ("CAM") and attempting to limit the auditor's ability to disclose original information. Additionally, we agree with the need to exclude extensively regulated entities such as broker-dealers and investment companies. However, we remain unconvinced that the changes in the Re-proposal fully address respondents' concerns to the previous proposal. We do not believe the disclosure of CAMs provides "value-relevant" information beyond what is already publicly available to users, and continue to have concerns that CAMs will almost certainly add significant cost to the audit, create operational challenges and potential legal issues, and could cause discord between management and the auditor. Therefore, in the penultimate paragraph of our comment letter we suggest an alternative approach.

We support the PCAOB's proposal to exclude broker-dealers for reasons regarding ownership and reporting characteristics, in addition to the recently updated reporting and auditing requirements for broker-dealers from both the SEC and the PCAOB. However, we disagree with the PCAOB's retention of the ability for auditors to "voluntarily" include CAM requirements for broker-dealers without justification. Retaining this unusual voluntary option for broker-dealers results in lack of

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regulatory clarity and will subject the broker-dealer industry to diverse audit practices. Further, the ambiguity could lead to auditors conservatively choosing to include CAMs in their reports to avoid the risk that their judgment would be challenged. As such, this may remove the voluntary nature of the option in practice, which would have the effect of overriding the PCAOB's original intent of the broker-dealer exclusion. Therefore, we strongly recommend that the PCAOB eliminate this voluntary option.

Additionally, to ensure that audit requirements across the industry are consistent (including the costs and operational efforts), we also believe that it would be more appropriate to exclude all broker-dealers, including those required to file audited financial statements under Section 13 or 15(d) of the Exchange Act ("issuer broker-dealers"). Further, given that the PCAOB notes that it is not currently aware of any issuer broker-dealers, we suggest that a conclusion on application of the proposed requirements for these entities be deferred until the PCAOB has a significant enough population to analyze the entities as thoughtfully as it has done for all other broker-dealers.

We agree with the PCAOB's exclusions for investment companies; however, we are concerned that investment companies, similar to broker-dealers, would also be subject to voluntary application of this auditing standard.

We support the proposal to move the opinion paragraph to the beginning of the report as we believe that most readers of auditor's reports are primarily interested in whether a company has received an unqualified opinion from its auditor.

Notwithstanding these points, we are also concerned that auditors might be economically and reputationally incentivized to exercise an overabundance of caution relative to the identification and disclosure of CAMs. Although the auditor is not expected to provide information about the company that has not already been made publicly available, such information may be provided by the auditor if it is necessary to describe the principal considerations used to determine that a matter is a CAM or how the CAM was addressed in the audit[1]. This exception language, along with the requirement to reference management's existing disclosures, provides auditors with significant leverage to compel disclosure in notes to financial statements of information that may not otherwise be required or considered necessary by management. This additional leverage by the audit firm may result in significant costs as management works with the auditors to identify, evaluate, debate and ultimately determine whether to disclose any CAMs.

While we agree with the requirement to apply a materiality threshold to the identification and disclosure of CAMs, it is likely to have little effect as long as existing audit firm materiality thresholds for balance sheet and income statement items remain the same. Moreover, given that matters that are material to the financial statements should already be disclosed by management in the notes to the financial statements, management's discussion and analysis (MD&A) or both, we question how

[1] Note 2 to paragraph .14 of Proposed AS 3101 included in Appendix 1 to the Re-proposal (page A1-9)

redundant disclosure in the auditor's report will provide decision useful information to users of the financial statement.

Given the feedback received by the Board on the original proposal and the limited empirical evidence to support expanded auditor reporting, we question whether there is sufficient basis to require CAMs. The Board noted in the Re-proposal that it is unsure of the value of CAMs to users, acknowledging that research on expanded auditor reporting is limited and that results are *ambiguous* as to whether expanded reporting would provide new information beyond what is already available in the financial statements. As such, we do not understand the Board's justification for the Re-proposal based on the hope that users will find information useful once they are provided with it. We strongly encourage the Board to study this matter further and gather more empirical evidence on the usefulness and the cost-benefit implications of expanded auditor reporting before concluding whether such expanded auditor reporting is warranted.

We are also concerned that the emphasis on the CAM disclosures may imply that the auditor is providing assurance on individual components of the financial statements, rather than the financial statements taken as a whole. Additionally, the Re-proposal's example disclosure related to the allowance for loan losses for a component of the loan portfolio appears to include information that would not normally be required in financial statement disclosures; rather it appears to contain information which, if material, would normally be disclosed in MD&A. Lastly, it is unclear what incremental value users will derive from the description of procedures performed by the auditors, which will be by necessity boiler plate, (e.g., read legal contracts, tested assumptions, and used specialists). It is unclear how this information will help users better analyze financial statements.

Instead of the disclosure of CAMs, we suggest the Board consider an alternative approach that will draw users' attention in the auditors' report to significant accounting policies and estimates in the financial statements and MD&A. This could be accomplished by referencing the disclosure of these items (i.e., location and page number), together with a statement indicating that the auditor's report should be read in conjunction with management's disclosures of significant accounting policies and estimates. This approach would avoid the inference that the auditor is providing assurance on separate components of the financial statements and would correspond with areas that receive the most attention from auditors during the audit.

SIFMA's GFI Accounting Committee and Asset Management Accounting Policy Committee would like to thank the PCAOB for the opportunity to provide feedback on this Re-proposal. We would be pleased to discuss our comments or answers to any questions that may arise. Feel free to contact either Tim Bridges at 212-902-7052 or tim.bridges@gs.com or Israel Snow at 212-357-5730 or israel.snow@gs.com.

Regards,

Tim Bridges

Chair
SIFMA, Global Financial Institutions Accounting Committee

Israel Snow

Chair
SIFMA, Asset Management Accounting Policy Committee

Cc:
**SIFMA**
Mary Kay Scucci, PhD, CPA, Managing Director

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Lewis H. Ferguson, Board Member
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Brian T. Croteau, Deputy Chief Accountant

**Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom**

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August 2016

This paper is based on my dissertation at Texas A&M University. I thank the members of my dissertation committee: Dechun Wang (Chair), Chris Wolfe, Sarah Rice, and Deidra Schleicher for their guidance, support, and helpful comments. I also thank participants at the British Accounting and Finance Association (BAFA) 26th Audit & Assurance Conference for their comments. This paper also benefited from the workshops at Texas A&M University, Louisiana State University, University of Tennessee, University of Arkansas, North Carolina State University, and Virginia Polytechnic Institute and State University.

# Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom


## Abstract

This study examines the effect of expanded audit disclosures required by ISA 700 (UK and Ireland), *The Independent Auditor's Report on Financial Statements*, on the communication value of the audit report. Using content analysis measures, readability and tone, as proxies for communication value, I find that in the post-ISA 700 period: 1) audit report readability improves and 2) audit report tone changes with a higher occurrence of negative and uncertain words. I also evaluate analyst behavior in response to the ISA 700 audit report. I find that analyst forecast dispersion decreases in the post-ISA 700 period. In additional analyses, I show that Big N and industry expert auditors write audit reports that are more readable. I also find that domain-specific word dictionaries, generated from Form-10Ks and earnings press releases, have a lower frequency in audit reports in both the pre and post ISA 700 period. With the heightened global interest in improving the historical pass/fail audit report, these results show that expanded audit disclosures can be communicated in a manner that is accessible and meaningful to the financial statement user.



**JEL classifications**: M42

**Keywords**: communication value, audit report, readability, tone, audit standards, United Kingdom

## I. INTRODUCTION

Communicating the results of financial statement audits has evolved from the two-paragraph report (AIA 1948; APC 1980) to the more recent multi-paragraph audit report (FRC 1993; AICPA 1988; PCAOB 2007). One mainstay in the evolution of the audit report is the standardized language that provides a uniform description of the audit process.[1] To address the criticism on the opaque audit reports that are dominated by boilerplate language, the United Kingdom (UK) Financial Reporting Council (FRC) issued International Standard on Auditing (UK and Ireland) 700, *The Independent Auditor's Report on Financial Statements ("ISA 700")* in June 2013 (FRC 2013a). ISA 700 requires audit reports, for issuers that comply with the UK Corporate Governance Code, to include a discussion of: 1) the risks of material misstatements with the greatest impact on engagement team effort; 2) the application of materiality in the audit; and 3) the scoping decisions made in the execution of the audit. The standard suggests that in order for the audit report to be useful to investors, the additional disclosures should be client-specific and not general or standardized (FRC 2013a).[2] The new ISA 700 audit report is the first attempt by a standard-setter to include expanded auditor disclosure in the audit report. The expanded disclosures significantly alter the pass/fail audit report model; however, it is not immediately clear that more audit report disclosures improve communication value. Using the

[1] In response to the Northern Rock bank failure, John Griffith-Jones, former UK KPMG Chief Executive Officer commented, "If you have a company that has leverage of 100 times and a company that has no leverage at all, the audit report is the same"(Osborne 2011). This view highlights the challenge of the historical pass/fail model of the standard audit report which prompted standard-setters to consult with constituents to determine the best path forward to enhance the communication value of the standard audit report (FRC 2007; IAASB 2011; PCAOB 2010; PCAOB 2013; PCAOB 2014; FRC 2013c).
[2] The UK Corporate Governance Code ("Code"), maintained by the FRC, provides principles and rules for boards of UK listed companies. The Code is located here: https://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx .

introduction of ISA 700 as a quasi-natural experiment, I examine whether the communication value of the audit report changes after the issuance of ISA 700.

Communication value in financial reporting is evident when the information provided by the source is received by the destination (Smith and Smith 1971). Coram, Mock, Turner, and Gray (2011) provide a similar definition when examining audit reports and note that communication value is shown when the message that is intended to be conveyed by the report is received by the intended user (Coram et al. 2011). I use two content measures, readability and tone, as proxies for communication value. Readability is a communication measure that captures whether the receiver can understand the message delivered by the sender. If the receiver understands the message, then the message is useful to the receiver thereby improving the communication value of the message. Tone is a measure that captures the "affect or feeling of a communication" (Henry 2008). If the audit report reflects the tone of the audit engagement, as expressed in the choice of words used in describing the audit, the receiver's understanding is improved thereby enhancing communication value. To assess the financial statement users' response to ISA 700, I investigate the change in analyst behavior under the new reporting regime. If the expanded audit report has increased in communication value, then analyst behavior should change, signaling an improvement in the information environment.

Evaluating the communication value of ISA 700 is important because it provides empirical evidence on whether the standard achieved its objective of enhancing communication between the auditor and the financial statement user. As the UK is the first jurisdiction to require client-specific audit disclosure, assessing the communication value of the expanded audit report will benefit other standard-setters considering or adopting similar proposals (PCAOB 2013; PCAOB 2016; IAASB 2015). Prior studies have shown the difficulty financial statement users have in understanding the information in audit reports (Church et al. 2008; Gray et al. 2011; Coram et al. 2011; Asare and Wright 2012; Manson and Zaman 2001; Hermanson et al. 1991). Academic research shows that the standard audit report did not convey financial risks during the financial crisis as the majority of the failed financial institutions received unqualified opinions prior to failing (Doogar et al. 2015; Sikka 2009). The introduction of ISA 700 provides a tailored approach for auditors to convey information that can enhance financial statement users' understanding of the audit process. The additional disclosures on risks of material misstatements, materiality, and audit scope give users insights into the auditor's decision process during the audit. Thus, consistent with the standard setters' objective, I predict that the communication value of audit reports under ISA 700 regime increases.

I address this important issue by examining audit report readability and audit report tone. First, I adopt the method proposed by Smith and Smith (1971) and Li (2008) in evaluating the communication effectiveness of financial reports by measuring readability. Readability measures have been used in evaluating disclosures and accounting narratives (Beattie 2014; Li 2010; Jones and Shoemaker 1994), however there is limited research on audit report readability (Barnett and Loeffler 1979; Pound 1981; Smith and Smith 1971). Previous studies on audit report readability performed in the late 1970's are prior to the issuance of Statement of Auditing Standard No. 58, *Reports on Audited Financial Statements* (AICPA 1988) and the audit market consolidation of early 1990s. I address this gap in the literature by comparing the readability of the newly introduced ISA 700 audit report to the pre-ISA 700 report using a sample of publicly traded firms from the UK and Ireland.

Second, I assess whether audit report tone changes in the post-ISA 700 period compared to the pre-ISA 700 period. Accounting and finance literatures have introduced evaluating tone as an approach to further understand the impact of the written word on investor behavior (Antweiler and Frank 2004; Tetlock 2007; Tetlock et al. 2008; Loughran and McDonald 2011). Historically, the audit report included legalistic and boilerplate language used in every audit report regardless of the underlying risks of the audit client. With the ISA 700 report, the language used is auditor-generated which can give additional insights into the nature of the communication to the user. I utilize financial word dictionaries developed by Loughran and McDonald (2011) to measure the tone of the expanded audit report. By comparing audit report tone in the pre-ISA 700 and post-ISA 700 periods, I assess whether the auditor issues reports consistent with the FRC's expectation to reduce general and boilerplate language.

Lastly, I investigate whether financial statement users respond to the expanded audit report. Focusing on a subset of financial statement users, I test the association between ISA 700 and a sell-side analyst behavior, analyst forecast dispersion. Evaluating analyst forecast dispersion determines whether the expanded audit report improves the information environment. When evaluating *annual* report readability, Lehavy, Li, and Merkley (2011) show that less readable Form 10-Ks are associated with greater forecast dispersion (Lehavy et al. 2011). However, it is an empirical question whether analysts respond similarly when the auditor is the source of the communication.

Using hand-collected audit report data from London and Irish Stock Exchange listed companies, I find that readability improves in the post-ISA 700 period. This finding supports that ISA 700 meets the objective of improving the value of the audit report to the financial statement user. I also find that the expanded audit report captures more client-specific audit risk with increases in negative and uncertain tone. This finding rebuts criticisms that the new audit report includes boilerplate language that is not useful to the reader (IAASB 2011; Mock et al. 2013;

Gray et al. 2011; Citi Research 2014a). Finally, I find that analyst behavior changes in the post-ISA 700 period as evidenced by lower analyst forecast dispersion. In addition, less readable audit reports are associated with higher analyst forecast dispersion in both the pre- and post-ISA 700 periods, consistent with Lehavy et al. (2011). In supplemental analyses, I find that audit report readability and audit report tone are associated with high quality auditor characteristics. I also find that domain-specific word dictionaries, generated from Form-10Ks and earnings press releases, have a lower frequency in audit reports in both the pre and post ISA 700 period suggesting that auditor disclosure is different from management disclosure.

My study makes several important contributions. First, I add to the readability literature by expanding the readability of annual reports to audit reports. Recent reviews on the auditor's reporting model and archival audit research (Mock et al. 2013; DeFond and Zhang 2014) and initial studies on the US expanded audit report proposal (Christensen et al. 2014; Kachelmeier et al. 2014) illustrate the need for more research on standard-setting related to the audit report. ISA 700 introduces several additional disclosures related to risk assessment, materiality, and audit scope designed to enhance the communication between the auditor and financial statement user. Using this setting, my paper is the first to examine audit report readability in the current environment. My results show that these additional disclosures are useful when the disclosures effectively transmit the information that the auditor intended.

Second, I provide insight that is useful to standard-setters and regulators. The International Auditing and Assurance Standards Board (IAASB) released guidance on expanded auditor reporting in January 2015 (IAASB 2015) and the Public Company Accounting Oversight Board (PCAOB) is currently deliberating expanding the audit report in the United States (PCAOB 2013; PCAOB 2016). This study informs standard-setters and regulators on how audit firms implemented ISA 700 in the United Kingdom and the response from financial statement users. These findings could influence future standard-setting in this area. I show that the audit report is more readable in the post-ISA 700 period, which improves the communication value. I also show that analysts respond to the ISA 700 audit report, which confirms earlier analysts' preferences for client-specific information in the report.

Finally, I expand the audit literature with the introduction of content measures to evaluate the effectiveness of the expanded audit report. More specifically, unlike concurrent studies (Gutierrez et al. 2016; Lennox et al. 2015; Reid et al. 2015) that use a year dichotomous variable to compare the audit report information content in the pre- versus post-ISA 700 era, I use readability to evaluate *how* well the ISA 700 report communicates its message to the user. In addition, I use audit report tone to assess *what* the auditor is communicating in the expanded report. I also examine domain-specific word lists in the context of auditor disclosure to investigate word choice differences in auditor disclosure versus management disclosure. Overall, my test results show the benefit of using content measures in the evaluation of the auditor communication.

The next section of the paper provides an overview of ISA 700, reviews prior literature, and develops my hypotheses. Section 3 discusses research methodology. Section 4 discusses results. Section 5 includes supplemental analyses. Section 6 summarizes and concludes.

## II. BACKGROUND AND HYPOTHESIS DEVELOPMENT

### The Auditor's Report on the Financial Statements (ISA 700)

The UK Financial Reporting Council issued ISA 700 (UK and Ireland), *The Auditor's Report on the Financial Statements* in June 2013. This standard requires audit report disclosures that describe: 1) the risks of material misstatement that required the greatest audit effort; 2) the application of materiality in the execution of the audit; and 3) the scope of the audit including how the engagement team addressed (1) and (2). The standard is applicable for entities subject to UK Corporate Governance Code and is effective for fiscal periods beginning on or after October 1, 2012 (FRC 2013a).[3] The introduction of ISA 700 (UK and Ireland) in June 2013 was the first major content change for the audit report in several decades. In the press release announcing the issuance of the standard, Nick Land, Chairman of the FRC's Audit and Assurance Council, commented, "*The provision of a fuller description of the work the auditor has undertaken will give far more insight to investors than the binary pass/fail model of the current audit report* (FRC 2013b)."

The introduction of ISA 700 provides a unique opportunity for auditors to discuss audit risk areas and audit scoping determinations. The standard addresses the critiques of the historical pass/fail model audit report by requiring client-specific audit risk information in the report. The standard provides suggestions for items to disclose such as the materiality type (overall, performance, and threshold for audit committee communication), audit coverage by area, locations visited by the auditor, and the audit group structure (centralized or multi-location). The standard also states the FRC's preference for client-specific language instead of "standardized language" when applying the provisions of ISA 700 (FRC 2013a).

[3] Entities subject to UK Corporate Governance Code reporting are companies with a Premium listing of equity shares on the London Stock Exchange and companies incorporated in Ireland with a primary or secondary equity listing on the Ireland Stock Exchange. The London Stock Exchange designates Premium listing for companies and investment entities that issue equity securities and comply with the UK super-equivalent governance requirements.

**Audit Report Readability**

*Communication Value, Communication Theory, and the Audit Report*

The audit report in its simplest form is a communication from the auditor to financial statement users about the results of the audit. Figure 1 shows the audit report communication model based on the linear communication model advanced by Shannon and Weaver (Shannon and Weaver 1949). Academic research on the communication value of the audit report has noted both an expectations gap and an information gap when assessing the communication value of the audit report. The expectations gap is the gap between what the auditor's responsibility is and what financial statement users believe the auditor's responsibility should be. The information gap is a different, but related concern, wherein there is a gap between information that is publicly available to the financial statement user and information that is not publicly available, that the financial statement user believes will be helpful in investment decision-making (IAASB 2011). An abundance of research on the expectations gap has resulted in mixed results on whether the changes to the audit report introduced by standard-setters have reduced the expectations gap (Mock et al. 2013; Church et al. 2008; Gray et al. 2011; Coram et al. 2011; Turner et al. 2010; Geiger 1994; Miller et al. 1990; Miller et al. 1993). Research on the information gap is limited, but survey evidence shows that financial statement users prefer more information in the audit report to assist with understanding their underlying investments (IAASB 2011; IOSCO 2009; CFA Institute 2010).

Smith and Smith (1971) advance the importance of communication theory when assessing how well financial reporting delivers its message to the financial statement users. In their study, they introduce readability as an approach to evaluate the effectiveness of financial reporting communication. Using a sample of fifty financial statements notes, they find that the notes are understandable to readers with at least a college education, highlighting the complexity of the documents. They contend that readability is an adequate measure to evaluate the performance of how well financial reporting communicates its message about the client (Smith and Smith 1971). Other studies show similar findings that financial statement communication is very complex when evaluating management reports (Lewis et al. 1986), footnote disclosure (Barnett and Loeffler 1979), corporate annual reports (Soper and Dolphin 1964; Jones and Shoemaker 1994; Clatworthy and Jones 2001; Courtis 1998; Courtis 1995; Li 2008) and analyst reports (De Franco et al. 2015).

Calculating readability is an approach to evaluate the performance of how well an audit report communicates its message about the audit process and the audited entity. There are limited studies that evaluate the readability of audit reports. Barnett and Loeffler (1979) find that the audit report readability is "very difficult." In addition, they found no statistically significant difference in readability between the external auditors issuing the audit report. Pound (1981) finds for a sample of Australian audit reports that the reading ease is "inhibitive" to effectively communicating audit results to financial statement users. Consistent with Barnett and Loeffler (1979), Pound (1981) did not find a difference in reading ease among the large public accounting firms. Taken together, these studies show that the audit report is inherently difficult to understand and that there is an opportunity to improve the communication value of the audit report.

*ISA 700, Communication Value, and Readability*

Leading to the issuance of ISA 700 (UK and Ireland), standard-setters discussed readability (FRC 2007; ICAEW 2007). However, most of the discussion centered on moving standardized audit scope language later in the report or to a separate website (FRC 2007). As noted in Smith and Smith (1971), "communication occurs in financial reporting only if the meanings intended by the information source are assigned to the financial statement messages by the destination." As previously established, readability is a measure that can assess how well information is communicated (Smith and Smith 1971; Courtis 1998; Courtis 1995; Li 2008; Beattie 2014). Therefore, it is an empirical question whether ISA 700, with its additional disclosure requirements, improves the readability of the audit report. Readability could improve as the auditor has the flexibility to comply with the provisions of ISA 700. If the auditor views the expanded audit report as a communication to the financial statement user and not a compliance exercise, the auditor may be more inclined to communicate in a way that is easier for the recipient to understand. As such, the readability of the audit report may improve with the implementation of ISA 700.

In informal discussions with UK audit practitioners from several international accounting firms, I noted a consistent theme of making the additional disclosures beneficial to the reader. Specifically, one senior practitioner commented that there was a focus to "make the [audit report] as readable as possible." Another practitioner commented that their firm "tried to stay away from jargon terms, [wanted to make the report] easy to follow." If the auditor acts with a communication focus versus a compliance focus when implementing ISA 700, the auditor will create an audit report that is more readable than the pre-ISA 700 audit report. As such, I state my first hypothesis in the alternative:

**H1a:** *Audit report readability improves in the post-ISA 700 audit report period compared to the pre-ISA 700 audit report period.*

**Audit Report Tone**

Critics of the expanded audit report raised concerns regarding the potential for boilerplate disclosures that provided limited information to the user (IAASB 2011; Mock et al. 2013; Gray et al. 2011; Citi Research 2014a). Readability measures *how* well a financial reporting message conveys its intended audience but it does not fully capture *what* the message contains. Recent accounting and finance literature has introduced content analysis to provide insights on whether the content of business texts is related to investor behavior (Antweiler and Frank 2004; Tetlock 2007; Tetlock et al. 2008; Loughran and McDonald 2011). One commonly used content analysis measure is tone, wherein tone captures the "affect" or "feeling" (Henry 2008) of Form 10-Ks, business press articles, and investor informal chat discussions[4].

Prior to the issuance of ISA 700, the need for an evaluation of audit report tone was non-existent as all audit reports contained the same boilerplate language. With ISA 700, there is an opportunity to examine the feeling communicated based on the words used as reflected in tone measures. I use Loughran & McDonald's (2011) *Negative*, *Positive*, and *Uncertainty* word dictionaries to capture the audit report tone. These three word dictionaries are more appropriate in the audit report setting as the negative and uncertainty word dictionaries approximate the level of negative or risk-related content discussed in the audit report. The positive word dictionary used in this setting captures the alternative word choice to negative or uncertain language. ISA 700 requires auditors to disclose risks of material misstatements that the engagement team

[4] Tone is commonly determined based on the word count frequency of words in psychology-developed word lists, such as the Harvard General Inquirer word list, found in the business texts (Loughran and McDonald 2011; Henry and Leone 2016). Loughran & McDonald (2011) provide an alternative to the psychology-based categorizations by creating six word dictionaries specific to financial statement disclosure (negative, positive, uncertainty, litigation, strong, and weak). I do not use the litigation word dictionary due to the significant overlap with the negative word dictionary. In addition, I do not use the strong and weak dictionaries due to low rates of occurrence. Several studies in accounting and finance have used these dictionaries when examining short-selling (Engelberg et al. 2012), local news and firm value (Gurun and Butler 2012), and disclosure tone and shareholder litigation (Rogers et al. 2011).

dedicated significant effort to and to disclose the material and scoping decisions related to those risk assessments. In informal discussion with audit partners on the implementation of ISA 700, they remarked that firms did not overly rely on standard audit report templates and allowed audit partners to tailor the audit report based on the underlying client-risks. One interviewee stated that the firm stressed that "this [audit report] is your communication; you need to be proud of what you have done." As auditors have the ability to expand their word usage in the post-ISA 700 environment, I expect the expanded audit report to include more word variety that captures risks than in the prior standard audit report. This leads me to my next hypothesis:

**H1b:** *The frequency of negative, positive, and uncertain words (i.e., audit report tone) will be higher in the post-ISA 700 period than in the pre-ISA 700 period.*

**ISA 700 Audit Report and Analyst Behavior**

*Financial Analysts and the Audit Report*

The aforementioned audit report communication model illustrates three components in the communication process: 1) the auditor, 2) the audit report, and 3) the financial statement user. To assess the communication value of the expanded audit report, it is necessary to determine if the financial statement user receives the audit report message. Financial statement users include a broad constituency including investors, financial analysts, banks, and regulators. Of these users, financial analysts are sophisticated consumers of financial information. The financial analyst performs an "information intermediary" role in the capital market by reducing the information asymmetry between management and the investor (Healy and Palepu 2001).

The audit report is a source of information for financial analysts when performing their information intermediary role. Prior research shows that analysts value the unqualified opinion included in the audit report (Coram et al. 2011; Mock et al. 2009). In an experiment with

Australian financial analysts, Coram et al. (2011) show that analysts focus on the opinion but not on the remaining audit report content. Mock et al. (2009) conducted focus groups with users, including financial analysts, to obtain user perceptions on the standard audit report. Their results show that financial analysts desire “more information and transparency” in the audit report (Mock et al. 2009). An analyst participating in the focus group commented that “in addition to the company’s disclosure of how they selected specific estimates and their judgments, analysts also would like a similar discussion from the auditor (Mock et al. 2009).” The CFA Institute, a professional association of investment professionals, issued a 2010 survey in which 94% of the respondents liked to see more information in the standard audit report (CFA Institute 2010). In addition, survey research on sell-side and buy-side analysts show that financial reports are an input to the forecasting process (Brown et al. 2015; Brown et al. 2014). In summary, prior research illustrates the analysts’ use of the audit report and preference for additional information in the audit report. Following prior studies, I examine analyst forecast dispersion, to capture changes in the information environment in the post-ISA 700 period.

*ISA 700 Audit Report and Analyst Forecast Dispersion*

Analyst forecast dispersion captures the variation in the views of analysts in their forecasts for a company. Analysts use private information along with publicly disclosed financial information to inform their earnings forecast. With each financial analyst having differing information sets and differing abilities to forecast, variation in the earnings forecasts occurs. Prior literature shows the less readable communication contributes to higher analyst forecast dispersion due to the high cost of processing and interpretation (Lehavy et al. 2011). ISA 700 audit reports include client-specific audit disclosures available to all financial analysts for use in forecasting earnings. The availability of these disclosures in terms of more readability and higher frequency of words representing audit risk (i.e. tone) could reduce the cost of processing the information, but the effect on the interpretation could differ. On one hand, audit reports in the post-ISA 700 period could result in analysts interpreting the client-risks in a consistent manner due to the ease of information processing. This results in more consistency with other analyst forecasts leading to reduced forecast dispersion. On the other hand, audit reports in the post-ISA 700 period could result in analysts generating divergent views due to the revelation of new information or due to differences in interpretations of the new disclosures. This leads to the same or increased forecast dispersion in the post-ISA 700 period compared to the pre-ISA 700 period. Due to these competing predictions, I state my next hypothesis in the null:

> **H2:** *Analyst forecast dispersion does not change in the post-ISA 700 period.*

## III. RESEARCH METHODOLOGY

### Content Measures

*Readability Measure*

Consistent with readability studies (Li 2008; De Franco et al. 2015; Smith and Smith 1971), I use *FOG* as the primary readability measure to compare the pre-ISA 700 audit reports to the post-ISA 700 audit reports.[5] The Fog Index *(FOG)* is a widely used readability statistic developed by Robert Gunning (Gunning 1952) that evaluates the number of words in a sentence and the percentage of complex words (words with three syllables or more) to estimate the

[5] Flesch-Kincaid (KINCAID) and Flesch (FLESCH) Reading Ease are additional readability measures. The Flesch-Kincaid (KINCAID) Index calculates readability based on syllables per word and words per sentence and rates the text based on the U.S. grade school level. The higher the measure the more education is required to read the text. It is calculated as: (11.8 x syllables per word) + (0.39 x words per sentence) – 15.59. Flesch (FLESCH) Reading Ease rates reading ease on a scale of 1 to 100 based on words per sentence and syllables per sentence. Contrary to FOG and KINCAID, the higher the number, the easier the text is to read. FLESCH is calculated as: 206.8 – (1.015 x words per sentence) – (84.6 x syllables per word). The empirical results and inferences using these measures are consistent with the FOG measures and are untabulated.

number of formal years of education an average person would need to read and comprehend the text.[6] The *higher the measure the more complex the text*.

*FOG = (words per sentence + percent of complex words) x 0.4.* *(1)*

To calculate *FOG* for each company-year observation, I obtain all annual reports for the companies, extract the audit report, and convert all documents to text files. I remove all header and pagination information from the text file to result in text-only opinion. Using Perl (Lingua::EN::Fathom package), I calculate *FOG* for each firm-year observation.[7]

*Tone Measures*

Tone is commonly determined based on a "bag of words" approach using the frequency of words in psychology-developed word lists, such as the Harvard General Inquirer word list, appearing in business texts (Loughran and McDonald 2011; Henry and Leone 2016). The word frequencies are utilized to quantify the tone exhibited in the written texts. Loughran & McDonald (2011) provide an alternative to the psychology-based lists by creating six word dictionaries specific to financial statement disclosure (*Negative*, *Positive*, *Uncertainty*, *Litigation*, *Strong*, and *Weak*).

I obtain the *Negative*, *Positive*, *Uncertainty* word lists from Bill McDonald's Word List Page maintained at http://www3.nd.edu/~mcdonald/Word_Lists.html. The latest Master Word List (Dictionary) is as of March 2015. There are 2,355 words included in the Negative word list, 354 words included in the Positive word list, and 297 words included in the Uncertainty

[6] I do not perform tests using other measures of readability such as file size (Loughran and McDonald 2014) and BOG (Bonsall et al. 2015) as these measures are focused on compliance with US Securities and Exchange Commission rules on Plain English usage and are not fully applicable in the UK reporting setting.

[7] In other readability studies (Li 2008; De Franco et al. 2015), length is used to capture another facet of readability and is calculated as the logarithmic transformation of the number of words in the text. In my setting, the audit report length mechanically increases due to the additional disclosures required by ISA 700. As such, length is not a readability measure in this study.

word list. I converted the word lists to column vectors that include word and dummy variables that correspond to the designated word list for each word. Due to the overlap in the Negative and Uncertain word lists, several words included more than one dummy variable. After the column vectors were completed, I imported the matrix into the Linguistic Inquiry and Word Count (LIWC) Software as a custom dictionary. Using the custom dictionary function, LIWC analyzed each audit report in the sample to generate the *NEGATIVE*, *POSITIVE*, and *UNCERTAIN* tone measures. The measures represent the word count frequency for the negative, positive, and uncertain word lists that appear in the sample audit reports.

**ISA 700 Implementation and Audit Report Readability (H1a)**

Prior readability models used by Li (2008) focus on client-specific variables when evaluating MD&A disclosure developed by client management. Audit reports are a product of both client characteristics and auditor characteristics. I expand the Li (2008) model to include auditor characteristics (Hronsky 1998) that may impact the level of auditor disclosure in the audit opinion. In addition, I control for the audit report structure. The following model tests the association between ISA 700 implementation and audit report readability. I use a differences approach where each firm serves as its own control using one observation from the pre-ISA 700 period and one observation from the post-ISA 700 period.

$$\begin{aligned} FOG \quad = {} & \beta_0 + \beta_1\, NEWOPINION_{it} + \beta_2\, SIZE_{it} + \beta_3\, MB_{it} \\ & + \beta_4\, AGE_{it} + \beta_5\, SI_{it} + \beta_6\, EARN\_VOL_{it} + \beta_7\, NBSEG_{it} \\ & + \beta_8\, ACQUISITION_{it} + \beta_9\, SEO_{it} + \beta_{10}\, BIGN_{it} \\ & + \beta_{11}\, COMBINED\_OP_{it} + Industry\ Fixed\ Effects + \varepsilon \qquad (2) \end{aligned}$$

*NEWOPINION*, the variable of interest, is an indicator variable equal to one if the audit opinion is issued in the first year of ISA 700 implementation and zero otherwise (the year immediately prior to ISA 700 implementation). I control for client characteristics and auditor characteristics that may alter the level of auditor disclosure in the auditor's opinion. Larger firms (*SIZE*), high market-to-book firms (*MB*), firms with special items (*SI*), firms with earnings volatility (*EARN_VOL*), firms with multiple business segments (*NBSEG*), firms that are acquisitive (*ACQUISITION*), firms that issue equity offerings (*SEO*), and firms with a combined audit opinion (*COMBINED_OP*) are more likely to have complicated audit opinions. Older firms (*AGE*) and Big N firms (*BIGN*) are less likely to have complicated audit opinions. Industry fixed effects are included to control for industry variation. Variable descriptions are included in Appendix A.

**ISA 700 Implementation and Audit Report Tone (H1b)**

To test the association between the implementation of ISA 700 and the tone of the audit report, I modify the readability model in Equation 2 to include tone measures (*NEGATIVE*, *POSITIVE*, and *UNCERTAIN*) as the dependent variables. I also include a composite tone measure, *COMBINED_TONE*, to capture the overall change in word usage by summing *NEGATIVE*, *POSITIVE*, and *UNCERTAIN* for each observation. I include the same control variables in the tone model as in the readability model as the same client and auditor specific characteristics that drive the complexity of an audit report also drive the tone of the audit report. The following model tests the association between ISA 700 implementation and audit report tone.

$$\begin{aligned} TONE = {} & \beta_0 + \beta_1\, NEWOPINION_{it} + \beta_2\, SIZE_{it} + \beta_3\, MB_{it} \\ & + \beta_4\, AGE_{it} + \beta_5\, SI_{it} + \beta_6\, EARN\_VOL_{it} + \beta_7\, NBSEG_{it} \\ & + \beta_8\, ACQUISITION_{it} + \beta_9\, SEO_{it} + \beta_{10}\, BIGN_{it} \\ & + \beta_{11}\, COMBINED\_OP_{it} + Industry\ Fixed\ Effects + \varepsilon \end{aligned} \tag{3}$$

*NEWOPINION*, the variable of interest, is an indicator variable equal to one if the audit opinion is issued in the first year of ISA 700 implementation and zero otherwise (the year immediately prior to ISA 700 implementation). Consistent with Equation 2, I include industry fixed effects to control for industry variation. All other variable descriptions are consistent with Equation 2 and are included in Appendix A.

**ISA 700 and Analyst Forecast Dispersion (H2)**

To test the association between the implementation of ISA 700 and analyst forecast dispersion, I follow Lehavy et al. (2011). Equation 4 tests the association between the implementation of ISA 700 and analyst forecast dispersion. Equation 5 tests the association between analyst forecast dispersion and audit report readability (tone) and the ISA 700 period. Equation 6 tests the interactive effect of ISA 700 implementation and audit report readability (tone) on analyst forecast dispersion.

$$\begin{aligned} DISPERSION = {} & \beta_0 + \beta_1\, NEWOPINION_{it} + \beta_2\, LOGSIZE_{it} + \beta_3\, MB_{it} \\ & + \beta_4\, NBSEG_{it} + \beta_5\, INST_{it} + \beta_6\, RD_{it} + \beta_7\, EARN\_VOL_{it} \\ & + \beta_8\, logFILESIZE_{it} + Industry\ Fixed\ Effects + \varepsilon \end{aligned} \tag{4}$$

$$\begin{aligned} DISPERSION = {} & \beta_0 + \beta_1\, FOG\ (TONE)_{it} + \beta_2\, LOGSIZE_{it} + \beta_3\, MB_{it} \\ & + \beta_4\, NBSEG_{it} + \beta_5\, INST_{it} + \beta_6\, RD_{it} + \beta_7\, EARN\_VOL_{it} \\ & + \beta_8\, logFILESIZE_{it} + Industry\ Fixed\ Effects + \varepsilon \end{aligned} \tag{5}$$

$$\begin{aligned} DISPERSION = {} & \beta_0 + \beta_1\, NEWOPINION_{it} + \beta_2\, FOG\ (TONE)_{it} \\ & + \beta_3\, NEWOP*FOG\ (NEWOP*TONE)_{it} \\ & + \beta_4\, LOGSIZE_{it} + \beta_5\, MB_{it} + \beta_6\, NBSEG_{it} + \beta_7\, INST_{it} \\ & + \beta_8\, RD_{it} + \beta_9\, EARN\_VOL_{it} + \beta_{10}\, logFILESIZE_{it} \\ & + Industry\ Fixed\ Effects + \varepsilon \end{aligned} \tag{6}$$

Consistent with Lehavy et al. (2011), *DISPERSION* is defined as the standard deviation of the individual analyst earnings per share forecasts in the first analyst consensus forecast (annual) after audit report issuance, scaled by the share price 90 days prior to the consensus forecast date. *NEWOPINION* is the variable of interest in Equation 4 and *FOG (TONE)* is the variable of interest in Equation 5. *NEWOP*FOG (NEWOP*TONE)* is the variable of interest in Equation 6. I control for client characteristics that are associated with analyst following found in prior literature. Lehavy et al. (2011), Bhushan (1989), O'Brien and Bhushan (1990), and Marston

(1997) find that larger firms (*LOGSIZE*) have greater analyst following. As a proxy for growth (Lehavy et al. 2011), I use the logarithm of book to market firms (*MB*). To control for firm complexity (Lehavy et al. 2011; Marston 1997) that may lead to higher analyst following, I include the natural logarithm of the firm's business segments (*NBSEG*). Institutional ownership is associated with high analyst following, therefore I control for institutional ownership (*INST*) (Bhushan 1989; Brennan and Subrahmanyam 1995; Frankel et al. 2006). I also control for high research and development expense (*RD*) (Barth et al. 2001), and volatile earnings (*EARN_VOL*) (Lehavy et al. 2011). Finally, I control for the content of the audit report using the logarithmic transformation of the electronic file size of the audit report (*logFILESIZE*). Industry fixed effects are included to control for industry variation. Variable descriptions are included in Appendix A.

**Sample Selection**

The study sample is comprised of companies listed on the London Stock Exchange (LSE) and Irish Stock Exchange (ISE) that are required to comply with the provisions of ISA 700. I start with all companies listed in the Compustat Global Fundamentals Annual Dataset listed on the London Stock Exchange or Irish Stock Exchange from 2012 – 2014. From those firms, I eliminate firm-year observations prior to the year immediately before ISA 700 implementation and firms that are not Premium listed based on the December 31, 2013 LSE Company Listing.[8] In addition, I eliminate financial institutions and investment funds based on the London Stock Exchange Securities Groups. I obtain financial information and securities identifying

[8] The listing of LSE companies and securities are located at http://www.londonstockexchange.com/statistics/companies-and-issuers/companies-and-issuers.htm .

information from the Compustat Global Fundamental Annual and Security Daily Datasets. This results in 458 companies eligible for the readability analysis.

I obtain audit reports for the pre-ISA 700 and post-ISA 700 periods for each company identified to generate readability statistics. I eliminate 30 companies in which readability statistics are not determinable due to language translation or file security issues. Subsequently, I match the Compustat Global and readability data to the Bureau van Dijk Amadeus (Financials) Dataset to obtain closing share price, market capitalization, and shares outstanding for each firm-year observation. I obtain institutional ownership information from Bloomberg and analyst information from the I/B/E/S International Summary Statistics File. Audit firm information is hand collected from company annual reports for each company in the sample. The resulting sample size is 350 companies and 700 company-year observations. Table 1 presents the sample size calculation for this study.

## IV. EMPIRICAL RESULTS

### Descriptive Statistics and Univariate Results

Table 2 presents descriptive statistics for the study sample. By design, fifty percent of the sample audit reports are subject to the provisions of ISA 700 (*NEWOPINION*). The mean *FOG* value of 27.35 indicates that the audit report remains a complicated text when compared to other business texts such as Form 10-Ks (FOG=19.39) and Wall Street Journal articles (FOG=15.20) (Li 2008). The tone measures for the sample show that 1.24% (*NEGATIVE*) of the words in the audit report are included in the negative word lists. Only 0.25% (*POSITIVE*) of the words in the audit reports are included in the positive word lists and 0.87% (*UNCERTAIN*) of the words in the audit reports are included in the uncertainty word lists. The *NEGATIVE* tone measure is consistent with Loughran and McDonald’s negative tone of 1.39% when assessing

Form 10-Ks (Loughran and McDonald 2011). However, the measures for *POSITIVE* and *UNCERTAIN* are lower for my audit report sample than for Form 10-K samples noted in the finance literature. The mean forecast dispersion (*DISPERSION*) is 0.30.

Audit firm related descriptive statistics show that the four largest international accounting firms (*BIGN*) audit 93% of the sample. Seventy-five percent (*BUSY*) of the audits occur during the months of December – March. Sixty-nine percent (*COMBINED_OP*) of the audit reports include the report for both the group and the parent company.[9] The natural logarithm of audit fees for the sample is 13.00 (*LOGFEES*). These audit firms descriptive statistics show that the companies subject to ISA 700 are primarily clients of the Big N firms and the audit work is concentrated in the traditional audit year-end work periods.[10] London audit firm offices issue fifty-five percent (*LONDON*) of the sample audit opinions. Client specific descriptive statistics show that 19% (*FTSE 100*) and 39% (*FTSE250*) of the company-year observations are for companies listed on the Financial Times Stock Exchange (FTSE) Index 100 and 250 for the entire sample period, respectively. The average size of the companies in the sample is 20.49 (*SIZE*) and the average age of the company is approximately 24 years. The market-to-book ratio is 2.41 (*MB*) and only 16% (*LOSS*) are loss firms. Two percent (*GOING CONCERN*) of the sample audit opinions have going concern report modifications. Approximately one-third (*EXP_DOMINANCE*) of the sample are audited by firms that are industry leaders. Overall, the client statistics show that the sample is comprised of mature companies that are fiscally healthy.

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[9] In the United Kingdom, the corporate structure includes the group and the parent company. In most cases, the operations of the company are recorded in the group accounts with the holding company operations in the parent company.

[10] I evaluate readability measures on an audit firm basis. In untabulated results, BDO and KPMG have the lowest average *FOG* measures at 26.22 and 26.56, respectively. PWC, which has the highest number of observations in our sample, has an average *FOG* of 27.55. OTHER, which represents the smallest firms in our sample, have an average *FOG* of 28.10. Overall, this provides support that there is variation in audit report content across firms.

All continuous variables have been winsorized at the 1st and 99th percentiles to account for outliers in the sample.

Table 3 includes the results of the univariate analysis that compares test variables in the pre-ISA 700 period to the post-ISA 700 period. The results show that readability (*FOG)* showed statistically significant improvement in the Post-ISA 700 period. *FOG* decreased 4.83 points ($p<0.01$). This result provides initial support that the expanded audit report improved in readability, which then enhances the usefulness of the report to the financial statement reader. Similarly, all tone measures increased in the Post-ISA 700 period with *NEGATIVE* showing the highest increase with an increase of 0.87. Untabulated results show that the majority of the client characteristics variables did not have a statistically significant change in the post-ISA 700 period from the pre-ISA 700 period. *MB* increased slightly and more firms had acquisition activity (*ACQUISITION*). In addition, more firms combined the parent company audit report with the group audit report in the post-ISA 700 period. Related to the audit report, the number of pages increased in the Post-ISA 700 period to 3.34 pages from 1.23 pages in the pre-ISA 700 period. On average, auditors included approximately four risks in the ISA 700 audit report. The analyst behavior variable, *DISPERSION*, decreased in the post-ISA 700 period, but the difference is not statistically significant. The multivariate analyses that follow further explore these univariate results.

**Multivariate Results**

*Hypothesis 1a*

Hypothesis 1a evaluates the association between readability and the implementation of ISA 700. Table 4 presents the ordinary least squares regression results of estimating Equation 2. The variable of interest, *NEWOPINION*, is negative and significant ($p<0.01$). The coefficient of

(-4.99) shows that an average person would need five *fewer* years of formal education to read and comprehend the audit report in the post-ISA 700 period. This indicates that in the post-ISA 700 report period audit report complexity decreased resulting in a more readable report. Said differently, the improvement in readability shows that the overall communication value has improved in the expanded audit report. The coefficients on the firm-specific control variables are not statistically different from zero except the positive coefficients on *BIGN* ($p<0.10$) and *COMBINED_OP* ($p<0.01$). This indicates that a change in client-level factors did not have an effect on how the auditors disclosed audit risks, materiality, and audit scope decisions. The change in readability is consistent with UK practitioners' views that the new standard was the impetus for generating reports that were easy to understand. These results support H1a and show strong evidence that audit reports under ISA 700 are more readable to users thereby achieving the intended purpose of ISA 700 of improving communication value of the report.

*Hypothesis 1b*

Hypothesis 1b tests the association between the implementation of ISA 700 and audit report tone. Table 5 presents the result of the ordinary least squares regression of Equation 3. Column 1 shows that the variable of interest, *NEWOPINION*, is positive and significant ($p<0.01$) when *NEGATIVE* is the dependent variable. This indicates that the tone of the post-ISA 700 report is more negative than in the prior period. This is consistent with auditors including risks of material misstatements and the impact of the risks on the scope of the audit. Large firms (*BIGN*) generated reports that had higher negative language evidenced by the positive and significant coefficient ($p<0.01$). Interestingly, clients with special items (*SI*), segments (*NBSEG*), and combined opinions (*COMBINED_OP*) have less negative language in their audit opinions. These areas would potentially generate additional disclosures but may have written in a manner that fewer negative terms were included.

Column 2 includes the results when *POSITIVE* is the dependent variable. Again, the variable of interest is positive and significant (p<0.01), however the magnitude of the coefficient *NEWOPINION* is much smaller than the coefficients when *NEGATIVE* and *UNCERTAIN* are the dependent variables. Larger clients (*SIZE*) have a statistically significant association with positive language in the audit report. Large firms (*BIGN*) have a higher occurrence of positive language in their audit report. Firms with volatile earnings (*EARN_VOL*) had fewer occurrences of positive language in their audit reports. The results from Column 2 indicate that in the post-ISA 700 period, auditors included positive language in the expanded audit report but at a lower frequency.

Column 3 provides results when *UNCERTAIN* is the dependent variable. Consistent with both Columns 1 and 2, the variable of interest, *NEWOPINION*, is positive and significant (p<0.01) when evaluating the presence of uncertain language. Large firms (*SIZE*) have a higher occurrence of uncertain language (p<0.01) while *SI*, *EARN_VOL*, and *COMBINED_OP* remain negative and significant (p<0.01). Evaluating the composite tone measure, *COMBINED_TONE*, the coefficient on *NEWOPINION* is positive and significant (p<0.01) indicating that in the post-ISA 700 period there is a higher rate of occurrence for tone-related words. Overall, the results provide evidence the audit report tone did increase in the post-ISA 700 period supporting H1b. The results refute the argument that the additional disclosures in ISA 700 would be boilerplate in nature and highlight the benefit of the auditor language choice in disclosure.

*Hypothesis 2*

Hypothesis 2 tests the association between analyst forecast dispersion and the implementation of ISA 700. Table 6 presents the results of the ordinary least squares regressions of Equations 4-6. Column 1 reports a negative and marginally significant coefficient on *NEWOPINION* ($p<0.10$), supporting H2b. These results indicate that the introduction of client-specific audit disclosures in the ISA 700 report assisted in reducing the variation between analysts when developing their forecasts. The public dissemination of audit risks and audit scoping decisions provides all analysts with similar information to use in their forecasts. The availability of previously private information has a leveling effect on the analyst forecasts resulting in reduced dispersion.

In Column 2, the coefficient on *FOG* is positive and significant ($p<0.05$). This indicates that less readable audit reports contribute to higher analyst dispersion. A less readable audit report is subject to more interpretation by the analyst covering the client and results in wider forecast dispersion. Consistent with prior literature, the number of segments, institutional ownership, and research and development expenditures are positive and significant ($p<0.10$). Overall, the results show that analyst behavior responded to the ISA 700 required disclosures. This validates the analysts' position that a more informative audit report is beneficial to their role as financial statement users. In the interaction model, *NEWOP*FOG* is negative and significant ($p<0.10$) indicating that *FOG* is less associated with analyst dispersion in the post-ISA 700 period.[11]

[11] To address collinearity in the interaction models, *FOG* (*TONE*) is mean-centered when the interaction term is included in Equation 6.

In Columns 4 and 5, the coefficients on *COMBINED_TONE* are negative but insignificant ($p>0.10$). The coefficient on *NEWOP*TONE* in Column 5 is positive and insignificant. These results indicate that the variation effect of tone is diminished in the post-ISA 700 period.

## V. SUPPLEMENTAL ANALYSES

### ISA 700 Audit Report Readability and Audit Quality

In November 2006, the FRC issued a discussion paper entitled “Promoting Audit Quality” that introduced an audit quality framework that included four main drivers of audit quality, which included the “reliability and usefulness of audit reporting (FRC 2006).” Linking communication theory to the FRC audit quality framework, more readable audit reports are more useful reports, which contributes to higher audit quality. This logic is consistent with practitioner feedback on the implementation of ISA 700, that the expanded audit report is a “positive driver of audit quality.”

Thus, auditor characteristics such as auditor size and office size that are associated with higher audit quality, may contribute to differential readability in audit reports. The auditing literature has shown that Big N firms exhibit higher audit quality than non-Big N firms due to their size and access to resources (Defond et al. 2014; Choi et al. 2010; DeAngelo 1981; Dopuch and Simunic 1982). Studies using office size show that larger offices perform higher quality audits than smaller offices when evaluating earnings quality (Francis and Yu 2009; Choi et al. 2010) and restatements (Francis et al. 2013) because larger offices possess a higher level of independence from their clients and expertise. As such, it is possible that the audit quality benefits embedded in large auditors and large practice offices shown in the financial reporting setting will extend to the audit report readability setting.

Auditor expertise is another auditor characteristic that may lead to differences in ISA 700 audit report readability. Prior literature shows that national-level and city-level industry experts provide higher quality audits (Reichelt and Wang 2010) and that there is an audit fee premium for industry experts (Ferguson et al. 2003; Francis et al. 2005). Balsam, Krishnan, and Yang (2003) also find that clients of audit industry specialists have better earnings quality than clients of non-audit industry specialists (Balsam et al. 2003). If the auditor is an industry expert, they may be well versed in the industry and can communicate their understanding of the client's business in an easy to read manner. Alternatively, the industry expert may resort to using industry jargon and terminology when discussing significant audit matters that may limit the readability of the audit report even when providing higher quality audits.

While ISA 700 is applicable for any auditors of premium listed companies on the London Stock Exchange or a listed company on the Ireland Stock Exchange (FRC 2013a), auditors are not equally equipped to apply this new standard. Barclays' Audit Committee Member Mike Ashley, stated that "the big four accountancies have fared well but [said] the next tier of firms had been slower to react (Pearce 2014)." This comment provides additional motivation for understanding implementation differences between Big N firms and non-Big N firms, between large and small practice offices, and between industry experts and non-experts.

The following model tests the association between auditor characteristics and audit report readability in the post-ISA 700 period.

$$\begin{aligned} FOG = {} & \beta_0 + \beta_1 \,(Auditor\ Characteristics) + \beta_2\, SIZE_{it} + \beta_3\, MB_{it} + \beta_4\, AGE_{it} \\ & + \beta_5\, SI_{it} + \beta_6\, EARN\_VOL_{it} + \beta_7\, NBSEG_{it} + \beta_8\, ACQUISITION_{it} \\ & + \beta_9\, SEO_{it} + \beta_{10}\, COMBINED\_OP_{it} + Industry\ Fixed\ Effects + \varepsilon \end{aligned} \tag{7}$$

I evaluate three auditor characteristics, Big N firm affiliation, industry expertise, and office size and their association with audit report readability. *BIGN* is an indicator variable equal to one if the auditor is one of the big four international accounting firms. Industry expertise is captured using two measures based on the number of clients audited by the firm in a specific SIC Code (one-digit). *EXP_NUMCLT* is equal to one if the company is audited by an audit firm with the most clients in that industry when compared to all other audit firms in the sample in year t and zero otherwise. *EXP_DOMINANCE* is equal to one if the company is audited by an audit firm that has 10% more audit clients in an industry than the firm's nearest competitor in year t and zero otherwise. *OFFICE_SIZE* equals the number of audit clients in each firm office for each firm-year in the sample. Industry fixed effects are included to control for industry variation. All other variable definitions are consistent with Equation 2.

Table 7 reports the ordinary least regression of Equation 7. This test uses observations in the post-ISA 700 period only because auditors have much less flexibility in audit reporting in the pre-ISA 700 period. Column 1 shows that readability improves when a Big N firm issues the audit report. The coefficient is negative and significant ($p<0.05$). This finding is consistent with untabulated univariate tests comparing readability statistics by firm.[12] Column 2 shows the coefficient on *OFFICE_SIZE* ($p < 0.05$) is negative and significant providing evidence that larger offices generate reports that are more readable.

Columns 3 and 4 include the results when evaluating industry expertise and the association with readability. Consistent with the results in Columns 1 and 2, the coefficient on *EXP_NUMCLT* and *EXP_DOMINANCE* are both negative and significant at the 1% level. Based on the results in Column 4, the effect is slightly stronger for the dominant industry leader. Columns 5 and 6 show the results of the full model including the Big N, office size, and industry expertise variables.

[12] The Big N firms had the largest average FOG change with a decrease of 4.96 points compared to the Non-Big N firms that had an average FOG change of 1.67 points.

When measuring industry expertise by the number of clients, Column 5 shows that *BIGN* and *EXP_NUMCLT* are significant at the 10% and 5% level, respectively. In Column 6, when industry expertise is measured by industry dominance, the coefficient on *EXP_DOMINANCE* is negative and significant ($p < 0.01$) with *BIGN* maintaining marginal significance ($p<0.10$). Taken together, the results from Columns 5 and 6 show that industry expertise is more strongly associated with improved readability. The results from Table 7 show that higher readability is associated with higher audit quality characteristics providing support that a more readable, hence a more usable report, contributes to audit quality.[13]

**ISA 700 Audit Report Readability and Audit Firms**

Recent analyst and regulatory reports on the implementation of ISA 700 have noted variation in the "quality of risk discussion" (Citi Research 2014a; Citi Research 2014b; FRC 2015; FRC 2016) among the auditors of FTSE 100 companies. ISA 700 reports generated by Ernst & Young (EY) are characterized as having less risk disclosures than the other Big 4 international accounting firms (Citi Research 2014b). To evaluate whether there is also variation in the readability of audit reports, I perform a firm analysis (untabulated) on readability in the year of implementation. First, I modify Equation 2 to include an indicator variable, *EY*, that equals one if the auditor is *EY* and zero otherwise. Second, I modify Equation 2 to include *EY*, *NEWOPINION*, and an interaction variable *NEWOP*EY*.

In the EY model, the coefficient on *EY* of 1.062 is positive and significant indicating that an average person would need one *additional* year of formal education to read and comprehend

[13] For brevity, I do not report the results of auditor characteristics and report tone. The inferences are similar. In sum, I find that high quality auditor characteristics are associated with changes in tone in the ISA 700 period. *BIGN* firms are associated with more negative words ($p<0.10$) in the ISA 700 audit reports, but industry experts (*EXP_CLIENT or EXP_DOMINANCE*) use fewer negative words ($p<0.01$). *BIGN* firms and industry experts are not associated with positive word use in the ISA 700 audit reports. Similar to the negative word finding, industry experts use fewer uncertain words ($p<0.01$).

audit reports generated by EY. In the full interaction model, the interaction coefficient on *NEWOP*EY* of 3.86 is significant at the 1% level indicating that approximately *four* more levels of education are necessary to read the audit reports generated by EY in the post-ISA 700 period compared to other firms. This shows that opportunity remains for audit firms to provide more readable and informative audit reports in future implementation periods.[14]

**Alternative Tone Measures Analysis**

With the advent of the expanded audit report in the UK, the words describing the audit reflect the linguistic choice of auditors. Prior accounting literature has evaluated the linguistic choice of managers when analyzing the tone of Form 10-Ks, conference calls, and press releases (Li 2010; Matsumoto et al. 2011; Henry 2008; Henry 2006). Henry and Leone (2016) evaluate tone measures used in the capital markets literature to provide evidence on the differences in general and domain-specific word lists when analyzing financial texts. In addition, the authors compare the dictionary approach to more complicated content analyses such as natural language processing and inverse document frequency (*idf*) weighting (Henry and Leone 2016). I extend their evaluation of tone measures into the audit report setting using the introduction of the ISA 700 report to: 1) further examine audit report tone; 2) assess differences in word dictionaries used in content analysis; and 3) determine if tone measures created in the management disclosure setting are also relevant in the new auditor disclosure setting.

In the test of Hypothesis 1a, I utilize the Loughran and McDonald (LM) (2011) *Negative*, *Positive*, and *Uncertai*n word dictionaries. To evaluate whether alternative tone measures also

[14] In untabulated analyses, I also evaluate each of the remaining Big N firms using the same model construction. The interaction coefficient on *PWC*NEWOP* of -2.67 is significant at the 1% level. The interaction coefficient on *KPMG*NEWOP* was also negative (-0.34) but not significant. *DT*NEWOP* was positive (0.22) but not significant. These results show the variation in ISA 700 implementation across the international firms and indicate areas for additional improvement.

show increased word choice and negative tone as shown in the Table 5 results, I construct *TONE_LM*, *TONE_FD Henry*, and *TONE_LIWC* following the variable construction in Henry and Leone (2016).[15]

The LM and FD Henry word lists are domain-specific based on financial texts such as Form 10-Ks and earnings press releases. The LIWC word list is a general list created to evaluate a wide variety of written and spoken texts. Following the tone interpretation in Henry and Leone (2016), an audit report with a maximum positive tone results in a tone score of one (1). An audit report with a maximum negative tone results in a tone score of negative one (-1). An audit report with a neutral tone results in a tone score of zero (0).

I modify the dependent variable, *TONE*, in Equation 3 to represent the alternative tone measures, *TONE_LM*, *TONE_FD Henry*, and *TONE_LIWC.* I expect that, consistent with the findings in Table 5, the post-ISA 700 audit report will have a more negative tone reflected in a negative coefficient on *NEWOPINION*. Additionally, I expect a higher usage of domain-specific words in the post-ISA 700 reports.

Table 8 reports the univariate and multivariate results evaluating the alternative tone measures. Panel A shows the univariate analysis of the tone measures and the audit report word frequency for each word list (LM, FD Henry, or LIWC). All tone measures show a statistically significant decrease in tone when comparing the post-ISA 700 reports to the pre-ISA 700 reports. The tone measures based on domain-specific word lists (LM and FD Henry) are both negative in

[15] As noted in Section III, the LM word lists include 2,355 negative words and 354 positive words. The FD Henry word lists are derived from Henry (2006, 2008) include 93 negative words and 117 positive words (Henry 2006; Henry 2008). The LIWC word lists, created by Pennebaker, Chung, Ireland, Gonzales, and Booth (2007) as a part of the LIWC text analysis software, provide an efficient method of analyzing the structural, emotional, and cognitive components of written language (Pennebaker et al. 2007). The LIWC word lists include 499 negative words and 408 positive words. See variable definition in Appendix A.

the post-ISA 700 period. However, the tone measure based on the general word list (LIWC) had a positive tone in both periods, but was less positive in the post-ISA 700 period. When examining the coverage of audit report words by the each of the three word lists, an interesting trend emerges. The domain-specific word lists, LM and FD Henry, only capture 3.8% and 1.5% of the post-ISA 700 audit report words, respectively. On the other hand, the LIWC word lists captures 79% of the audit report words in both the pre- and post-ISA 700 periods. This difference in word capture between domain-specific and general word lists provides some evidence that audit reports may include more common language than disclosures generated by management. This evidence is consistent with both anecdotal and regulatory views on the expanded audit report that indicate a less complicated discussion of audit matters in the report.

Panel B of Table 8 reports the ordinary least squares regression of Equation 3 using the alternative tone measures. Column 1 reports a negative and significant ($p<0.01$) coefficient on *NEWOPINION* when *TONE_LM* is the dependent variable. Columns 2 and 3 report similar results when *TONE_FD Henry* and *TONE_LIWC* are the dependent variables. These results further support the univariate analysis and the Table 4 results that the post-ISA 700 reports had a negative tone indicating the reports captured the underlying risks of the audit. Although the test results are consistent, the explanatory power of each model varies. The $R^2$ for Column 1 is 37.25% compared to 69.92% in Column 2 and 81.12% in Column 3. These differences in explanatory power shows the importance of word list selection when evaluating different types of financial texts. Appendix B summarizes the most frequent domain-specific words included in the pre- and post-ISA 700 audit reports.

**ISA 700 Implementation and Market Response**

Contemporaneous studies (Gutierrez et al. 2016; Reid et al. 2015; Lennox et al. 2015) evaluate the market reaction to the introduction of ISA 700 reporting. Although my study focuses on the auditor's response to ISA 700, I also examine market response using abnormal trading volume (*AVOL*) and abnormal returns (*ABRET*).[16] In untabulated analysis, I find a negative and insignificant (-0.03, p=0.54) association between *NEWOPINION* and *AVOL*. I also find a positive but insignificant association (0.01, p=0.31) between *FOG* and *AVOL*. Further, in assessing abnormal returns, I find a positive and insignificant association between *NEWOPINION* and *ABRET* (0.00, p=0.63). Consistent with the *AVOL* tests, I finds a negative and insignificant association between *FOG* and *ABRET* (-0.00, p=0.27). Taken together, this provides evidence that the market did not have an observable response to the introduction of the expanded audit report.

## VI. SUMMARY AND CONCLUSION

The introduction of ISA 700 presented a significant shift in auditor disclosure included in the audit report. The FRC designed the additional disclosures on risks of material misstatement and audit scoping decisions to make the standard audit report more informative to the audit report user. I examine whether introduction of ISA 700 changes the communication value of the audit report. Using readability and tone to measure communication value allows for a direct evaluation of the effectiveness of the expanded audit report. In addition, I address the financial statement users' response to the expanded audit report by evaluating analyst forecast dispersion.

[16] *AVOL* is calculated as the mean daily trading volume during the event period (-1, 0, 1) minus the mean daily trading volume during the non-filing period (-61, -21) deflated by the standard deviation of daily trading volume during the non-filing period (-61,-21). The estimation period is based on the earnings announcement date to avoid capturing trading volume related to the release of earnings. *ABRET* is calculated as company returns minus London Stock Exchange value weighted returns for the event period (-1, 0, 1).

Finally, I investigate the association of the expanded audit report with audit firm characteristics associated with high quality audits.

I find that audit reports in the post-ISA 700 period are more readable indicating improved communication value. I show that ISA 700 adoption resulted in more negative and uncertain audit report tone. This indicates that auditors capture the underlying risks of their clients by utilizing negative and uncertain words in the expanded audit report. The audit report tone results also provide indirect evidence that the auditor disclosures were not boilerplate but varied in language choice. In evaluating the financial statement users' response, I find that analyst forecast dispersion decreased lending support that the expanded audit report effected financial statement user behaviors.

My study contributes to the audit literature in three ways. First, my paper is the first to provide a content analysis of the expanded audit report to gain insight into *how* and *what* auditors communicate using the expanded audit report and adds significantly to readability and tone literatures. Second, my findings are useful to standard-setters and regulators. ISA 700 reports are easier to read and provide more information to assist investors and information intermediaries in making informed investment decisions. In addition, the ISA 700 reports are not boilerplate in nature and adequately capture the underlying client-specific audit risks through negative and uncertain word usage. I also contribute to the literature by showing that high-quality auditor characteristics are associated with producing more readable audit reports. Finally, I provide initial evidence in word choice differences in auditor disclosure compared to management disclosure. This study should be of interest to standard-setters, regulators, and academics as the study provides a content-based approach to evaluating the implementation of expanded auditor disclosure that can inform future standard setting.

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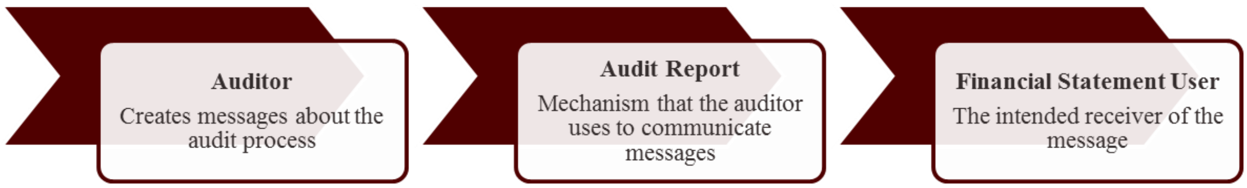
**Figure 1**
**Audit Report Communication Model**



# APPENDIX A

## VARIABLE DEFINITIONS

| | |
|---|---|
| **Dependent Variables – Main Analyses** | |
| *FOG* | Calculated as words per sentence + percent of complex words) x 0.4. |
| *NEGATIVE* | Represents the word count frequency in the audit report based on the Loughran and McDonald Negative Word List. |
| *POSITIVE* | Represents the word count frequency in the audit report based on the Loughran and McDonald Positive Word List. |
| *UNCERTAIN* | Represents the word count frequency in the audit report based on the Loughran and McDonald Uncertain Word List. |
| *COMBINED_TONE* | Calculated as the sum of *NEGATIVE*, *POSITIVE*, and *UNCERTAIN*. |
| *DISPERSION* | Calculated as the standard deviation of the individual analyst forecasts in the first analyst consensus forecast (annual) after audit report issuance, scaled by the share price 90 days prior to the consensus forecast date. |
| **Dependent Variables – Supplemental Analyses** | |
| *TONE_LM* | Calculated as *(POSITIVE-NEGATIVE)/(POSITIVE + NEGATIVE),* where *POSITIVE* and *NEGATIVE* refer to the word count frequency based on the positive and negative words in the Loughran and McDonald word lists, respectively. |
| *TONE_FD Henry* | Calculated as *(POSITIVE-NEGATIVE)/(POSITIVE + NEGATIVE),* where *POSITIVE* and *NEGATIVE* refer to the word count frequency based on the positive and negative words in the Loughran and McDonald word lists, respectively. |
| *TONE_LIWC* | Calculated as *(POSITIVE-NEGATIVE)/(POSITIVE + NEGATIVE),* where *POSITIVE* and *NEGATIVE* refer to the word count frequency based on the positive and negative words in the LIWC word lists, respectively. |
| **Test Variables** | |
| *NEWOPINION* | Is an indicator variable equal to one if the audit opinion is issued in the first year of ISA 700 implementation and zero otherwise (the year immediately prior to ISA 700 implementation). |
| *FOG* | Calculated as words per sentence + percent of complex words) x 0.4. |
| *BIGN* | Is an indicator variable equal to one if the auditor is one of the big four international accounting firms in year *t* and zero otherwise. |
| *EXP_NUMCLT* | Is equal to one, if the company is audited by an audit firm with the most clients in that industry when compared to all other audit firms in the sample, in year *t* and zero otherwise. |
| *EXP_DOMINANCE* | Is equal to one if the company is audited by an audit firm that has 10% more audit clients in an industry than the firm's nearest competitor in year *t* and zero otherwise. |
| *OFFICE_SIZE* | Equals the number of audit clients in each firm office for each firm-year in the sample. |
| *EY* | Is equal to one, if the company is audited by EY in year *t* and zero otherwise. |
| **Control Variables** | |
| *ACQUISITION* | Is an indicator variable equal to one if the company's acquisition expense is greater than zero in year *t* and zero otherwise. |
| *AGE* | Represents the number of years since the company's IPO at the end of year *t*. |
| *BIGN* | Is an indicator variable equal to one if the auditor is one of the big four international accounting firms in year *t* and zero otherwise. |
| *BUSY* | Is an indicator variable equal to one if the company's fiscal year end is from December to March and zero otherwise. |
| *COMBINED_OP* | Is an indicator variable equal to one if the audit report includes both the group audit report and the parent company audit report in year *t* and zero otherwise. |

| | |
|---|---|
| *EARN_VOL* | Represents the standard deviation of earnings over the prior five year period at the end of year *t*. |
| *Industry Fixed Effects* | Fama and French 12 Industry Classification |
| *INST* | Decile ranking of the number of the company's shares held by institutional investors divided by the number of the company's shares outstanding at the end of the fiscal year. |
| *LOGSIZE* | Represents the logarithmic transformation of market value at the end of year prior to the issuance of the audited financial report. |
| *logFILESIZE* | Represents the logarithmic transformation of the file size of the audit report. |
| *LOSS* | Is an indicator variable equal to one if the firms has net income of less than zero and zero otherwise. |
| *MB* | Represents the market value at the end of year t divided by the book value at the end of year *t*. |
| *NBSEG* | Represents the logarithmic transformation of the number of business segments included in the Bureau van Dijk dataset. |
| *RD* | Represents the ratio of research and development expenses to total operating expenses for the fiscal year. |
| *SEO* | Is an indicator variable equal to one if the company is listed in the Thomson One Equity Issuance Database as issuing an equity offering in year *t* and zero otherwise. |
| *SI* | Represent the amount of special items scaled by total assets at the end of year *t*. |
| *SIZE* | Represents the logarithmic transformation of total assets at the end of year *t*. |

## APPENDIX B

## TWENTY MOST FREQUENT WORDS OCCURRING IN THE PRE AND POST ISA 700 AUDIT REPORTS FROM THE LOUGHRAN AND MCDONALD NEGATIVE AND HENRY FINANCIAL DISCLOSURE WORD LISTS

**Panel A: Loughran and McDonald Negative Word List**

| Pre-ISA 700 Audit Reports | | | Post-ISA 700 Audit Reports | | |
|---|---|---|---|---|---|
| **Rank** | **Word** | **% of Fin-Neg Word Count** | **Rank** | **Word** | **% of Fin-Neg Word Count** |
| 1 | inconsistencies | 21.56% | 1 | misstatement | 10.96% |
| 2 | concern | 17.07% | 2 | concern | 10.15% |
| 3 | misstatement | 11.30% | 3 | misstatements | 7.15% |
| 4 | disclosed | 11.17% | 4 | impairment | 7.14% |
| 5 | error | 11.08% | 5 | inconsistent | 6.26% |
| 6 | fraud | 11.08% | 6 | inconsistencies | 5.95% |
| 7 | misstatements | 10.85% | 7 | fraud | 4.53% |
| 8 | loss | 2.09% | 8 | challenged | 4.14% |
| 9 | inconsistent | 0.54% | 9 | disclosed | 3.97% |
| 10 | incorrect | 0.45% | 10 | incorrect | 3.79% |
| 11 | unable | 0.45% | 11 | misleading | 3.26% |
| 12 | doubt | 0.36% | 12 | against | 3.21% |
| 13 | uncorrected | 0.18% | 13 | error | 2.21% |
| 14 | critical | 0.14% | 14 | uncorrected | 1.46% |
| 15 | redress | 0.14% | 15 | claims | 1.28% |
| 16 | undetected | 0.14% | 16 | loss | 1.27% |
| 17 | concerned | 0.09% | 17 | challenging | 1.13% |
| 18 | impairment | 0.09% | 18 | discloses | 1.07% |
| 19 | misleading | 0.09% | 19 | inappropriate | 0.96% |
| 20 | negligence | 0.09% | 20 | losses | 0.84% |

| Panel B: Henry Financial Disclosure (FD) Word List | | | | | |
|---|---|---|---|---|---|
| Pre-ISA 700 Audit Reports | | | Post-ISA 700 Audit Reports | | |
| **Rank** | **Word** | **% of Henry FD Word Count** | **Rank** | **Word** | **% of Henry FD Word Count** |
| 1 | under | 40.86% | 1 | risk | 18.22% |
| 2 | certain | 26.40% | 2 | under | 15.76% |
| 3 | more | 20.92% | 3 | risks | 12.54% |
| 4 | risk | 7.95% | 4 | certain | 6.83% |
| 5 | uncertainty | 0.81% | 5 | below | 5.81% |
| 6 | risks | 0.46% | 6 | above | 5.79% |
| 7 | below | 0.40% | 7 | challenged | 4.98% |
| 8 | uncertainties | 0.40% | 8 | more | 3.97% |
| 9 | low | 0.29% | 9 | growth | 3.36% |
| 10 | above | 0.23% | 10 | greatest | 2.29% |
| 11 | achieve | 0.23% | 11 | uncertain | 1.79% |
| 12 | successful | 0.23% | 12 | least | 1.56% |
| 13 | exceeds | 0.12% | 13 | uncertainty | 1.38% |
| 14 | greatest | 0.12% | 14 | most | 1.37% |
| 15 | uncertain | 0.12% | 15 | challenging | 1.36% |
| 16 | challenged | 0.06% | 16 | lower | 1.27% |
| 17 | challenging | 0.06% | 17 | uncertainties | 0.95% |
| 18 | exceed | 0.06% | 18 | challenge | 0.86% |
| 19 | exceeded | 0.06% | 19 | achieve | 0.70% |
| 20 | expansion | 0.06% | 20 | exceed | 0.57% |

**TABLE 1**
**Sample Size Calculation**

| | Companies | Observations *t* and *t-1* |
|---|---|---|
| **Sample Criteria** | | |
| Companies in Compustat Global listed on the London Stock Exchange (LSE) or Irish Stock Exchange with fiscal year ends from 2012 – 2014 | 1,680 | 3,360 |
| Less: Company fiscal year ends prior to the year immediately before ISA 700 implementation | (101) | (202) |
| Less: Non LSE Premium Companies | (871) | (1,742) |
| Less: Banks and Financial Institutions | (250) | (500) |
| | 458 | 916 |
| Less: Observations without readability data | (30) | (60) |
| Less: Companies without available stock data | (78) | (156) |
| **Full Sample** | 350 | 700 |

**TABLE 2**
**Descriptive Statistics**

| | N | Mean | Median | Standard Deviation | 25th Percentile | 75th Percentile |
|---|---|---|---|---|---|---|
| *NEWOPINION* | 700 | 0.50 | 0.50 | 0.50 | 0.00 | 1.00 |
| *FOG* | 700 | 27.35 | 27.24 | 3.16 | 24.30 | 29.90 |
| *DISPERSION* | 566 | 0.30 | 0.23 | 0.25 | 0.07 | 0.47 |
| *LOGFEES* | 700 | 13.00 | 12.90 | 1.05 | 12.21 | 13.71 |
| *RAW_FEES (millions)* | 700 | 0.77 | 0.40 | 0.85 | 0.20 | 0.90 |
| *BIGN* | 700 | 0.93 | 1.00 | 0.26 | 1.00 | 1.00 |
| *OP_PAGES* | 700 | 2.29 | 2.00 | 1.31 | 1.00 | 3.00 |
| *OP_RISKS* | 700 | 2.00 | 1.00 | 2.22 | 0.00 | 4.00 |
| *FTSE100* | 700 | 0.19 | 0.00 | 0.39 | 0.00 | 0.00 |
| *FTSE250* | 700 | 0.39 | 0.00 | 0.49 | 0.00 | 1.00 |
| *SIZE* | 700 | 20.49 | 20.50 | 1.50 | 19.26 | 21.80 |
| *SI* | 700 | -0.01 | -0.00 | 0.02 | -0.02 | 0.00 |
| *LOSS* | 700 | 0.16 | 0.00 | 0.37 | 0.00 | 0.00 |
| *BUSY* | 700 | 0.75 | 1.00 | 0.43 | 1.00 | 1.00 |
| *MB* | 700 | 2.41 | 1.84 | 1.78 | 1.03 | 3.43 |
| *ACQUISITION* | 700 | 0.52 | 1.00 | 0.50 | 0.00 | 1.00 |
| *AGE* | 700 | 23.91 | 18.00 | 17.09 | 10.00 | 37.50 |
| *NBSEG* | 700 | 3.98 | 4.03 | 1.17 | 3.09 | 4.77 |
| *SEO* | 700 | 0.08 | 0.00 | 0.27 | 0.00 | 0.00 |
| *EARN_VOL* | 700 | 0.05 | 0.02 | 0.06 | 0.01 | 0.06 |
| *COMBINED_OP* | 700 | 0.69 | 1.00 | 0.46 | 0.00 | 1.00 |
| *EXP_NUMCLT* | 700 | 0.36 | 0.00 | 0.48 | 0.00 | 1.00 |
| *EXP_DOMINANCE* | 700 | 0.33 | 0.00 | 0.47 | 0.00 | 1.00 |
| *LOGSIZE* | 700 | 6.45 | 6.61 | 1.58 | 5.16 | 7.72 |
| *INST* | 698 | 5.49 | 5.50 | 2.87 | 3.00 | 8.00 |
| *RD* | 700 | 0.02 | 0.00 | 0.03 | 0.00 | 0.02 |
| *NEGATIVE* | 700 | 1.24 | 1.21 | 0.58 | 0.97 | 1.70 |
| *POSITIVE* | 700 | 0.25 | 0.25 | 0.08 | 0.16 | 0.30 |
| *UNCERTAIN* | 700 | 0.87 | 0.80 | 0.44 | 0.44 | 1.29 |
| *LONDON* | 700 | 0.55 | 1.00 | 0.50 | 0.00 | 1.00 |
| *GOING_CONCERN* | 700 | 0.02 | 0.00 | 0.15 | 0.00 | 0.00 |

*Note: All continuous variables are winsorized at the 1st and 99th percentiles*

**TABLE 3**
**Univariate Statistics**
**(Mean Values)**

| | N | *Pre-ISA 700 (NEWOPINION= 0)* | N | *Post-ISA 700 (NEWOPINION= 1)* | Mean Difference |
|---|---|---|---|---|---|
| *FOG* | 350 | 29.76 | 350 | 24.93 | -4.83*** |
| *NEGATIVE* | 350 | 0.80 | 350 | 1.67 | 0.87*** |
| *POSITIVE* | 350 | 0.23 | 350 | 0.27 | 0.04*** |
| *UNCERTAIN* | 350 | 0.49 | 350 | 1.26 | 0.77*** |
| *FOLLOWING* | 310 | 10.84 | 310 | 10.57 | -0.27 |
| *DISPERSION* | 283 | 0.31 | 283 | 0.28 | -0.03 |
| *LOGFEES* | 350 | 12.99 | 350 | 13.01 | 0.02 |
| *RAW_FEES (millions)* | 350 | 0.76 | 350 | 0.78 | 0.02 |
| *BIGN* | 350 | 0.93 | 350 | 0.93 | 0.00 |
| *OP_PAGES* | 350 | 1.23 | 350 | 3.34 | 2.11*** |
| *OP_RISKS* | 350 | 0.03 | 350 | 3.97 | 3.94*** |
| *COMBINED_OP* | 350 | 0.61 | 350 | 0.77 | 0.16*** |

*** $p$<0.01, ** $p$<0.05, *p<0.10

**TABLE 4**
**ISA 700 Auditor Reporting Requirement and Audit Report Readability**

This table examines the association between the ISA 700 auditor reporting requirement and audit report readability. Variable definitions are located in Appendix A. T-values are in the parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.10$; represents one-tailed p-value significance for signed predictions and two-tailed p-value significance for unsigned predictions. Industry effects are included. Standard errors clustered by firm.

| | (1) |
|---|---|
| | DV=FOG |
| ***NEWOPINION*** | -4.99 |
| | (-30.55)*** |
| SIZE | -0.08 |
| | (-1.01) |
| MB | -0.03 |
| | (-0.58) |
| AGE | -0.00 |
| | (-1.05) |
| SI | -0.63 |
| | (-0.14) |
| EARN_VOL | -2.89 |
| | (-1.57) |
| NBSEG | 0.01 |
| | (0.14) |
| ACQUISITION | 0.03 |
| | (0.19) |
| SEO | -0.22 |
| | (-1.02) |
| BIGN | 0.76 |
| | (1.81)* |
| COMBINED_OP | 1.08 |
| | (6.40)*** |
| Constant | 29.79 |
| | (19.70)*** |
| *Industry FE?* | Yes |
| $R^2$ | 62.58% |
| *N* | 700 |

**TABLE 5**
**ISA 700 Auditor Reporting Requirement and Audit Report Tone Analysis**

This table examines the association between the ISA 700 auditor reporting requirement and audit report tone. Variable definitions are located in Appendix A. T-values are in parentheses. *** p<0.01, **p<0.05, *p<0.10; represents one-tailed p-value significance for signed predictions and two-tailed p-value significance for unsigned predictions. Industry effects are included. Standard errors clustered by firm.

| | (1) | (2) | (3) | (4) |
|---|---|---|---|---|
| | DV= NEGATIVE | DV= POSITIVE | DV= UNCERTAIN | DV= COMBINED TONE |
| ***NEWOPINION*** | 0.92 | 0.04 | 0.78 | 1.77 |
| | (36.50)*** | (7.12)*** | (51.68)*** | (46.16)*** |
| SIZE | -0.00 | 0.01 | 0.03 | 0.04 |
| | (-0.02) | (2.10)** | (3.47)*** | (1.93)* |
| MB | -0.00 | 0.00 | -0.00 | -0.00 |
| | (-0.39) | (1.08) | (-0.49) | (-0.31) |
| AGE | 0.00 | 0.00 | 0.00 | 0.00 |
| | (1.25) | (1.02) | (1.66)* | (1.56) |
| SI | -2.34 | 0.19 | -1.36 | -3.14 |
| | (-3.06)*** | (1.07) | (-2.70)*** | (-2.73)*** |
| EARN_VOL | 0.24 | -0.19 | -0.37 | -0.29 |
| | (0.70) | (-2.18)** | (-2.01)** | (-0.63) |
| NBSEG | -0.03 | -0.01 | -0.01 | -0.05 |
| | (-2.16)** | (-1.55) | (-0.96) | (-2.23)** |
| ACQUISITION | 0.00 | -0.00 | 0.02 | 0.02 |
| | (0.04) | (-0.16) | (1.17) | (0.37) |
| SEO | -0.01 | -0.00 | 0.01 | -0.01 |
| | (-0.21) | (-0.46) | (0.46) | (-0.11) |
| BIGN | 0.21 | 0.04 | 0.05 | 0.31 |
| | (2.89)*** | (3.40)*** | (1.35) | (3.16)*** |
| COMBINED_OP | -0.32 | -0.04 | -0.07 | -0.44 |
| | (-11.46)*** | (-6.52)*** | (-4.17)*** | (-10.85)*** |
| Constant | 0.86 | 0.09 | -0.12 | 0.78 |
| | (2.95)*** | (1.32) | (-0.72) | (1.97)** |
| *Industry FE?* | Yes | Yes | Yes | Yes |
| $R^2$ | 67.79% | 15.38% | 80.13% | 77.65% |
| *N* | 700 | 700 | 700 | 700 |

**TABLE 6**
**ISA 700, Audit Report Readability, and Analyst Forecast Dispersion**

This table examines the association between: 1) ISA 700 and analyst forecast dispersion; and 2) audit report readability and analyst forecast dispersion. Variable definitions are located in Appendix A. T-values are in parentheses. *** p<0.01, **p<0.05, *p<0.10; represents one-tailed p-value significance for signed predictions and two-tailed p-value significance for unsigned predictions. Industry effects are included. Standard errors clustered by firm.

| | (1) | (2) | (3) | (4) | (5) |
|---|---|---|---|---|---|
| | DV=DISPERSION | | | | |
| ***NEW OPINION*** | -0.02 | | 0.00 | | -0.03 |
| | (-1.66)* | | (0.16) | | (-0.78) |
| ***FOG*** | | 0.01 | 0.01 | | |
| | | (2.28)** | (2.26)** | | |
| ***NEWOP *FOG*** | | | -0.02 | | |
| | | | (-1.87)* | | |
| ***COMBINED _TONE*** | | | | -0.01 | -0.00 |
| | | | | (-1.18) | (-0.20) |
| ***NEWOP *TONE*** | | | | | 0.02 |
| | | | | | (0.47) |
| LOGSIZE | -0.02 | -0.02 | -0.02 | -0.02 | -0.02 |
| | (-1.60) | (-1.57) | (-1.55) | (-1.60) | (-1.59) |
| MB | -0.01 | -0.01 | -0.01 | -0.01 | -0.01 |
| | (-0.93) | (-0.91) | (-0.93) | (-0.96) | (-0.93) |
| NBSEG | 0.02 | 0.02 | 0.02 | 0.02 | 0.02 |
| | (1.67)* | (1.70)* | (1.76)* | (1.69)* | (1.65)* |
| INST | 0.01 | 0.01 | 0.01 | 0.01 | 0.01 |
| | (1.82)* | (1.81)* | (1.69)* | (1.83) | (1.80) |
| RD | 1.45 | 1.43 | 1.44 | 1.44 | 1.44 |
| | (2.12)** | (2.10)** | (2.13)** | (2.11)** | (2.10)** |
| EARN_VOL | -0.25 | -0.23 | -0.20 | -0.25 | -0.25 |
| | (-0.86) | (-0.80) | (-0.69) | (-0.84) | (-0.85) |
| logFILESIZE | 0.00 | 0.00 | -0.00 | 0.00 | 0.00 |
| | (0.12) | (0.12) | (-0.06) | (0.07) | (0.13) |
| Constant | 0.35 | 0.18 | 0.32 | 0.36 | 0.35 |
| | (2.95)*** | (1.26) | (2.78)*** | (3.14)*** | (2.78)*** |
| *Industry FE?* | Yes | Yes | Yes | Yes | Yes |
| $R^2$ | 12.70% | 12.99% | 13.50% | 12.63% | 12.73% |
| *N* | 566 | 566 | 566 | 566 | 566 |

**TABLE 7**
**Audit Report Readability and Auditor Characteristics**

This table examines the association between the ISA 700 auditor reporting requirement and auditor characteristics. Variable definitions are located in Appendix A. T-values are in the parentheses. *** p<0.01, **p<0.05, *p<0.10; represents one-tailed p-value significance for signed predictions and two-tailed p-value significance for unsigned predictions. Industry effects are included. Standard errors clustered by firm.

| | (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|---|
| | DV=FOG | | | | | |
| ***BIGN*** | -1.23 | | | | -0.96 | -0.89 |
| | (-2.54)** | | | | (-1.94)* | (-1.75)* |
| ***OFFICE_SIZE*** | | -0.01 | | | -0.01 | -0.01 |
| | | (-2.10)** | | | (-1.34) | (-1.36) |
| ***EXP_ NUMCLT*** | | | -0.61 | | -0.47 | |
| | | | (-3.17)*** | | (-2.42)** | |
| ***EXP_ DOMINANCE*** | | | | -0.89 | | -0.77 |
| | | | | (-4.55)*** | | (-3.83)*** |
| SIZE | -0.10 | -0.14 | -0.17 | -0.16 | -0.09 | -0.09 |
| | (-0.87) | (-1.23) | (-1.49) | (-1.41) | (-0.81) | (-0.78) |
| MB | -0.01 | -0.03 | -0.02 | -0.02 | -0.00 | 0.00 |
| | (-0.19) | (-0.54) | (-0.35) | (-0.31) | (-0.04) | (0.00) |
| AGE | -0.01 | -0.00 | -0.01 | -0.01 | -0.01 | -0.01 |
| | (-0.98) | (-0.82) | (-1.04) | (-1.24) | (-1.02) | (-1.21) |
| SI | 2.60 | 3.15 | 5.30 | 5.86 | 3.76 | 4.47 |
| | (0.44) | (0.54) | (0.89) | (0.99) | (0.64) | (0.76) |
| EARN_VOL | 2.45 | 3.60 | 3.80 | 3.78 | 3.13 | 3.21 |
| | (1.06) | (1.61) | (1.68)* | (1.68)* | (1.35) | (1.39) |
| NBSEG | 0.05 | 0.04 | 0.03 | 0.03 | 0.06 | 0.06 |
| | (0.48) | (0.35) | (0.30) | (0.28) | (0.59) | (0.56) |
| ACQUISITION | 0.07 | 0.10 | 0.08 | 0.09 | 0.10 | 0.11 |
| | (0.31) | (0.42) | (0.34) | (0.37) | (0.46) | (0.49) |
| SEO | -0.25 | -0.24 | -0.39 | -0.44 | -0.33 | -0.390 |
| | (-0.96) | (-0.94) | (-1.40) | (-1.60) | (-1.20) | (-1.44) |
| COMBINED _OP | 0.23 | 0.29 | 0.27 | 0.22 | 0.28 | 0.23 |
| | (0.82) | (1.06) | (1.02) | (0.83) | (1.06) | (0.91) |
| Constant | 27.66 | 27.56 | 28.30 | 28.29 | 27.48 | 27.51 |
| | (12.72)*** | (12.70)*** | (12.74)*** | (12.78)*** | (12.49)*** | (12.53)*** |
| *Industry FE?* | Yes | Yes | Yes | Yes | Yes | Yes |
| $R^2$ | 6.46% | 4.94% | 6.40% | 8.63% | 8.52% | 10.53% |
| *N* | 350 | 350 | 350 | 350 | 350 | 350 |

**TABLE 8**
**Alternative Tone Measures**

This table examines the association between the ISA 700 auditor reporting readability and alternative tone measures. Variable definitions are located in Appendix A. T-values are in the parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.10$; represents one-tailed p-value significance for signed predictions and two-tailed p-value significance for unsigned predictions. Industry effects are included. Standard errors clustered by firm.

**Panel A: Univariate Analysis (Mean Values)**

| | Pre-ISA 700 (NEWOPINION=0) | | Post-ISA 700 (NEWOPINION=1) | | Mean Difference |
|---|---|---|---|---|---|
| | N | | N | | *(Post – Pre)* |
| LM Dictionary | 350 | 2.504 | 350 | 3.834 | 1.330*** |
| LIWC Dictionary | 350 | 79.561 | 350 | 79.403 | 0.158 |
| FD Henry Dictionary | 350 | 0.724 | 350 | 1.459 | 0.735*** |
| TONE_LM | 350 | -0.437 | 350 | -0.715 | -0.278*** |
| TONE_LIWC | 350 | 0.901 | 350 | 0.372 | -0.529*** |
| TONE_FD Henry | 350 | 0.122 | 350 | -0.361 | -0.483*** |

**Panel B: Multivariate Analysis**

| | (1) | (2) | (3) |
|---|---|---|---|
| | DV=TONE_LM | DV=TONE_FD Henry | DV=TONE_LIWC |
| ***NEWOPINION*** | -0.30 | -0.48 | -0.53 |
| | (-17.02)*** | (-35.28)*** | (-53.66)*** |
| SIZE | 0.01 | -0.00 | 0.00 |
| | (0.56) | (-0.00) | (0.17) |
| MB | 0.00 | 0.00 | 0.00 |
| | (0.93) | (0.37) | (1.57) |
| AGE | -0.00 | -0.00 | -0.00 |
| | (-0.12) | (-1.06) | (-0.64) |
| SI | 0.81 | 0.84 | 1.66 |
| | (1.44) | (2.53)** | (5.08)*** |
| EARN_VOL | -0.38 | -0.26 | -0.05 |
| | (-1.66)* | (-1.73)* | (-0.38) |
| NBSEG | 0.01 | 0.00 | 0.00 |
| | (1.42) | (0.66) | (0.22) |
| ACQUISITION | 0.00 | -0.00 | 0.01 |
| | (0.17) | (-0.32) | (0.60) |
| SEO | -0.02 | 0.05 | -0.02 |
| | (-0.56) | (2.07)** | (-0.89) |
| BIGN | -0.12 | 0.03 | 0.09 |
| | (-2.74)*** | (1.24) | (2.89)*** |
| COMBINED_OP | 0.13 | 0.01 | -0.01 |
| | (7.68)*** | (0.50) | (-0.58) |
| Constant | -0.56 | 0.10 | 0.84 |
| | (-2.86)*** | (0.87) | (8.04)*** |
| *Industry FE?* | Yes | Yes | Yes |
| $R^2$ | 37.25% | 69.92% | 81.12% |
| *N* | 700 | 700 | 700 |

**From:** THOMAS SPITTERS
**To:** Comments
**Cc:** THOMAS SPITTERS
**Subject:** Comment Letter on PCAOB Release 2016 - 003. CONFIDENTIAL.
**Date:** Saturday, August 13, 2016 10:18:29 PM

August 13, 2016

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

Dear Public Accounting Oversight Board Secretary :

While it is a privilege to be able to comment on the PCAOB PROPOSED AUDITING STANDARD – "THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS", the present commenter has read through a number of the other comment letters and concerning these, the American Accounting Association letter is an outstanding memorandum on the subject at hand, especially in its summarizing of a number of items of considerable scope and supportive prose in considerable detail, the studies cited, and the supporting language at the end of the AAA paper. In the interest of utility of time and effort, therefore, and thereby in constructively commenting on PCAOB Release 2016 – 003, proposed AS 3105 and related documentation, present author will not attempt a writing in kind.

PCAOB Release 2016 – 003 in its request for comment has called not only for letters as to the various critical audit matters (CAM's) and the proposed requirements for disclosure given the CAM's, but for consideration and understanding of the uniqueness of the U.S. financial system and its accounting in addition to that as systemically strict and stringent. The additional language as proposed for the auditor's report for issuers appears to be an effort to allow the auditor to make some technical elaboration on the financial statements that would otherwise be somewhere within the statements documentation itself. There is a question as to whether this is actually good for investors and financial statement end – users, however, as the report itself might be used as a vetting tool, or as a proxy for one by these stakeholders. In addition, the purpose in including what might be interpreted as specific and technical business entity financial information on the face of the auditor reports might prove unfounded, especially given the necessity for investors and end – users to read the entire reports. These proposed changes and others represent a departure from the practice of balance sheet and the equity method of accounting that valuably characterizes the long – standing uniqueness and separateness of U.S. accounting. In this humble author's view, one need not depart from this simply because international investors and financial statement end – users, and other stakeholders, usually do not understand such things conceptually, nor the equity method of accounting overall. Systemically, one might be in a quandary about the way this dilemma is to be resolved, and in general this would not change the auditors' report itself as the cornerstone of financial reports, in fact due a tacit or inopportune, or even very rare plain willful ignorance of current U.S. accounting methods and practices. This interpretation of the dilemma that strict and detailed accounting rules present to stakeholders does not have to do with the principles or even rules approaches that one considers in auditing a business entity, but has more to do with what the common investor and financial statement end – user believe to be the purpose an intent of financial statements and how these are themselves evaluated and used. The proposed new framework for issuer audit reports also calls for additional communication between auditor and the business audit committee in enhancing a process that might propose additional risks to the audit while being only of ministerial or procedural importance and then of marginal benefit to stakeholders and to the value of the report form itself.

This reporting auditing standard as re - proposed allows for specific fraud language in the report, though after reading through the literature it does appear this is somewhat ambiguous as to purpose and intent in protecting who and what stakeholders involved in the production or use of specific entity financial statements, management and investors alike; and others including regulators and the public. The proposed standard also does not address the European practice of income – smoothing (or a proxy thereof) that goes hand – in – glove with European accounting methods and practices since some time ago. Further, due to an apparent departure from balance sheet accounting, any audit under this proposed accounting standard might inadvertently result in over – auditing business operations instead of attention to what are again in the U.S. more material and important line items on the balance sheet. Given again the enhancing of auditing questions around business operations, and other considerations including those of Emerging Growth Companies and the audit that influence this proposed standard, implementation of the new rules does possibly call for a financial tiering based upon assets and gross revenues of the business in deference to large issuers and their stakeholders who might more readily need the proposed disclosures and reports, and to alleviate a possibly undue compliance burden on small issuers. Also, and as mentioned in PCAOB Release 2016 – 003, there is indeed more information asymmetry with respect to details, public and private, about smaller public companies, though the economic impact of this is overshadowed by similar, yet less numerous, and much higher – impact large issuer questions. One needs consider as well whether or not the auditor is doing the equities research, benchmarking and financial scoring, and other homework of investors and financial statement end – users in integrating and implementing these proposed disclosures.

Very truly yours,

*Thomas H. Spitters, C.P.A.*

Thomas H. Spitters, C.P.A.
California 95051, U.S.A.

STATE STREET.

Sean Newth
Senior Vice President
Chief Accounting Officer & Controller

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August 15, 2016

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

Via email: comments@pcaobus.org

**Re: PCAOB Release No. 2016-003: Proposed auditing standard - *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards.*  PCAOB Rulemaking Docket Matter No. 34**

Dear Board Members:

State Street Corporation ("State Street") appreciates the opportunity to comment on the Public Company Oversight Board's ("PCAOB" or "Board") reproposal of the auditing standard, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards (the "Reproposed Standard")*. With $28 trillion in assets under custody and administration, and $2 trillion in assets under management as of June 30, 2016, State Street is a leader in providing financial services and products to meet the needs of institutional investors worldwide.

We support the efforts to improve audit quality and auditor communication to enhance stakeholder confidence and applaud the Board's attempt to incorporate feedback on the original proposal by including the consideration of materiality in the identification of a critical audit matter ("CAM") and attempting to limit the auditor's ability to disclose original information. However, we have a number of concerns regarding the Reproposed Standard that we believe should be addressed in order to achieve the proper balance of ensuring that additional information in the form of auditor communications is relevant to the users of financial statements and does not overshadow information provided by management.

State Street believes that the current auditor's report ("pass/fail model") clearly communicates the nature of the audit and whether the financial statements are presented fairly, in all material respects, in accordance with GAAP. The concept of clarification of the standard auditor's report would further lengthen the auditor's report unnecessarily and create redundancies with management disclosures without achieving the objective of enhancing communication between auditors and the users of audit reports, thereby compromising the report's effectiveness.

STATE STREET.

We are concerned that the Board's proposal to add CAMs to the audit report may inappropriately suggest a weakness in financial statement reporting process, including management's competence or the effectiveness of the control environment. Requiring auditors to provide information on the company's financial reporting process could compel independent auditors to consistently hold (or "assume") the most conservative view on matters of accounting judgment, resulting in excessive CAMs being included in the auditor's report. As this subjective exercise of caution will vary between auditing firms and audit teams, comparability of audit reports among different issuers likely will be adversely affected, potentially augmenting the risk of inappropriately perceived weakness in financial statement reporting process for some issuers and compromising the report's main message. Limiting the source of potential CAMs to matters communicated or required to be communicated to the audit committee does not address this concern.

State Street believes that auditors should not be the original source of disclosure specifically related to management judgments and estimates, or accounting policies and practices, including areas of significant judgment. The auditor's role is to evaluate whether the financial statements taken as a whole are presented fairly in accordance with generally accepted accounting principles (GAAP). Providing information to investors with respect to our accounting policies and their application is the responsibility of State Street's management, not the independent auditor. Sophisticated stakeholders are aware that information that would be disclosed as CAMs by the auditor is already included in disclosures made by management (e.g., "Significant Accounting Policies" and financial statement footnote disclosures). Requiring the auditors to disclose this information would unnecessarily convolute the financial statements, as stakeholders would need to sort through information provided by both management and the independent auditors. The auditor's responsibility to communicate such matters should be limited to situations in which the financial statements are not in conformity with GAAP in all material respects.

The Reproposed Standard requires the independent auditors to summarize to investors the same level of detail and context that is provided to a company's Board of Directors, the independent elected body representing stakeholders. Although the auditor is not expected to provide information about the company that has not been made publicly available by the company, such information may be provided by the auditor if necessary to describe the principal considerations used to determine that a matter is a CAM or how the CAM was addressed in the audit (e.g., information regarding information technology controls, or other information not currently required by GAAP or typically included in the financial statements). In the absence of appropriate context and two-way communication, we believe that such information potentially would be misleading, incomplete, and would not enhance the overall understanding of the readers of the auditor's report and financial statements. Additionally, we note that requiring supplemental reporting, such as the proposed CAMs, will likely lengthen the time to complete the audit, as there may not be sufficient time for the auditor to complete the audit of the financial statements while also providing assurance on the incremental areas identified in the Reproposed Standard, and therefore adversely influence filing timelines for large accelerated filers. Furthermore, while the introduction of a materiality component within the definition of CAM is an important improvement of the Reproposed Standard, it does not address our concerns above as it continues to require a dependency on auditor judgment, leaving the possibility for different materiality thresholds used by management for financial statement reporting and auditors for CAM reporting. Moreover, given that matters that are material to the financial statements should already be disclosed by management in the notes to the financial statements, management's discussion and analysis or both, we question how redundant disclosure in the auditor's report adds value.

STATE STREET.

State Street does not object to the requirement to disclose auditor tenure in the auditor's report, but we believe it is not necessary because we reject the assumption that auditor tenure and audit quality are related.

We appreciate your consideration of these matters and welcome the opportunity to discuss them with you.

Sincerely,

Sean P. Newth
*Senior Vice President*
*Chief Accounting Officer and Controller*

7915 Xavier Court
Dallas, Texas 75218-4513

August 11, 2016

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

VIA Email: comments@pcaobus.org

Re: PCAOB Rulemaking Docket # 034 (Reproposed Rule)

I am writing to express my opinions regarding the above referenced Reproposed Auditing Standard (Proposal) - *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.* I previously commented on the original proposal in my letter dated December 10, 2013. While I appreciate the Board's efforts to enhance investors understanding of the current audit process and the auditor's responsibilities as it relates to providing an attestation on management's assertions regarding its Company's financial statements and internal control over financial reporting, I do not support some of the requirements contained in the Proposal.

**Critical Audit Matters**

The Proposal would require the auditor to make certain disclosures in the audit report regarding each critical audit matter (CAM), as defined. While the definition of a CAM in the new Proposal is an improvement as compared to the CAM definition in the original proposal, my concern with the CAM requirements in the Proposal remain unchanged: the determination and description of CAMs would have the auditor going beyond an attestation on management's financial statements and internal control over financial reporting, as a CAM ultimately provides disclosure regarding the nature and extent of the procedures performed by the auditor, and in some cases may result in the auditor's disclosure of information regarding the Company that is otherwise not required to be included in the Company's financial statements (including the footnotes)[1]. The auditor should not be the source of any disclosure regarding a Company; if the auditor believes additional disclosures are required in the financial statements or other parts of a Company's periodic filings, existing auditing standards address the auditor's responsibilities in such an event, including communicating such concerns with the audit committee.

[1] See, for example, the illustrative disclosure regarding Company A beginning on page 32 of the Proposal. Much of the information in the first paragraph of the example does not represent disclosures that would normally be included in the footnotes to the Company's financial statements. The guidance in the Proposal that the auditor is normally not expected to provide information about the Company that has not been made publicly available by the Company is not responsive to this concern, as the guidance also indicates an exception to this expectation when such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a CAM or how the matter was addressed in the audit.

Of course the Board has statutory oversight authority in respect to auditors. But the Board has no oversight authority with respect to registrants or the form and content of a registrant's financial statements and other disclosures in their periodic filings with the SEC. Accordingly, I question whether the Board has the appropriate authority to adopt the Proposal as it relates to the CAM requirements, because as drafted the CAM requirements in the Proposal appear to go beyond disclosures regarding the auditor and the scope of the auditor's procedures in connection with their attestation engagements.

The disclosure and discussion of CAMs could also result in confusion on the part of investors as to the subject matter of the CAMs, and is inconsistent with the "pass/fail" model which the Board appropriately determined should be retained. The illustrative examples of hypothetical disclosures of CAMs in the Proposal essentially say "here is a CAM, here is why we determined it was a CAM, and here in general are the audit procedures we performed in connection with our audit of the relevant financial statement account(s) associated with the CAM." The auditor's disclosure and discussion of each CAM would likely be viewed as a piecemeal opinion and/or a qualification to their overall opinion, despite the required disclosure that "the CAMs communicated do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate."

As with the original proposal, it appears that the Board's objective in disclosing CAMs is to essentially highlight areas where a Company's management, in preparing its financial statements, has to apply significant judgment and/or make significant accounting estimates. Current SEC rules already require disclosure of such financial statement areas – the Critical Accounting Policies section of MD&A. This is the appropriate place for such financial statement areas to be disclosed, by management, and not by the auditor.

The proposal for disclosure and discussion of CAMs should not be included in any final Standard. However, if the Board believes that highlighting in the auditor's report the areas where a Company's management, in preparing its financial statements, has to apply significant judgment and/or make significant accounting estimates (on the basis that such areas would reasonably be expected to have an impact on the scope of the auditor's work), then this can be accomplished by the inclusion of the phrase to the standard auditor's report as contained in the Proposal, as indicated below.

> We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management (including those significant estimates made by management as described in the "Critical Accounting Policies and Estimates" section of this Annual Report), as well as evaluating the overall presentation

of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

**Audit Tenure**

My views regarding disclosure of auditor's tenure in the audit report remain unchanged from the original proposal. Statutorily, the decision on which audit firm to engage is the sole responsibility of the audit committee. The audit committee is in the best position to make that decision, taking into consideration all factors the audit committee deems relevant. Some factors may generally be consistent from Company to Company, while other factors may be unique to a specific Company. Regardless, the audit committee ultimately makes the decision. Disclosure of audit tenure by the auditor in a vacuum without any additional disclosure regarding what factors went into the committee's determination on what firm to engage (and for whatever period of time the committee has determined to engage such firm) would be an incomplete disclosure, at a minimum, and potentially misleading.

The Board notes that there is no agreement as to any correlation between the length of an auditor's tenure and audit quality. The Board has failed to provide any persuasive rationale for requiring such disclosure by the auditor in the audit report. For these reasons, it is inappropriate for the auditor to disclose in its audit report the audit tenure as contained in the Proposal. The Board notes that some registrants are voluntarily disclosing auditor tenure in their annual proxy statements. If such disclosure of auditor tenure is to be mandated, it should be left to the SEC to make that determination.

Thank you for your consideration of these comments and suggestions.

Sincerely,

Greg Swalwell

Texas Society of
CPA Certified Public Accountants

August 12, 2016

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

RE: ***Re-Issued*** Proposed Auditing Standards—*The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards.* PCAOB Release No. 2016-003 May 11, 2016.

To Whom It May Concern:

One of the expressed goals of the Texas Society of Certified Public Accountants (TSCPA) is to speak on behalf of its members when such action is in the best interest of its members and serves the cause of Certified Public Accountants in Texas, as well as the public interest. The TSCPA has established a Professional Standards Committee (PSC) to represent those interests on accounting and auditing matters. The views expressed herein are written on behalf of the PSC, which has been authorized by the TSCPA Board of Directors to submit comments on matters of interest to the committee membership. The views expressed in this letter have not been approved by the TSCPA Board of Directors or Executive Board and, therefore, should not be construed as representing the views or policy of the TSCPA.

After a thorough review of the contents of the original Exposure Draft (ED) which proposed radical changes to the auditor's report and the re-issued ED on the same subject, we decided to focus our attention on the issues therein that we consider most germane to our membership. The auditor's standard report represents the most critical communication link between the auditor and those third parties who use the auditor's report as a basis for the extent of their reliance on a client's published financial statements. We believe any proposed changes to the wording of the standard auditor's report should be viewed and evaluated in the context of this all-important communication link.

As we pointed out in our response to the original ED, we disagree with required disclosure of Critical Audit Matters (CAM) in the auditor's report. We firmly believe the inclusion of audit procedures performed on any matters would not be beneficial to the users because knowing how the auditor tested certain accounts or assertions does not give users any additional information regarding a registrant's financial position or results of operations. Adding information on the audit procedures performed would significantly increase the length of the auditor's report and decrease the clarity of the auditor's message. The negative impact on the reader's ability to understand the intended message of the report would be significant. Also, it is unlikely that the auditor will identify all the procedures performed or considerations of mitigating factors considered in the design of the audit procedures, which will serve to intensify the lack of understanding on the part of those for whom the audit report is intended. Further, we believe auditors will be prone to spend additional time performing procedures, not to assess the risks

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associated with the client's financial results, but rather to include procedures that are compatible with the audit procedures included in the audit reports issued by other auditors. Also, by requiring CAMs in the auditor's report the Board has implied an auditor cannot be trusted to determine the appropriate scope of an audit engagement. Thus, the user should be informed of the auditor's scope even though most users have little or no understanding of the purpose or relevance of the audit procedures being disclosed.

If the Board chooses to include disclosure of CAMs in the final Standard, we do not believe it is appropriate for auditors to refer to relevant disclosure outside the financial statements when communicating a CAM. The requirement that auditors refer to financial statement accounts and disclosures alone is burdensome for auditors. Requiring that they also cross reference other areas of the document would be overly burdensome and would further put them in the role of management. If the Board believes it important that other areas of the document be addressed then the Board should request that the SEC propose a change in disclosure requirements of the company requiring the company to cross reference each CAM to other parts of management's document.

We see no reason to include audit-tenure language in the auditor's report. Of what relevance is such a disclosure? What's better, longer tenure, shorter tenure or no knowledge of tenure? The auditing standards that apply to the performance of an audit engagement are basically the same for the auditor whether he/she has performed the audit for a number of years or only one or two. Thus, what important inferences does the Board see the user drawing from information regarding the tenure of an auditor? If such information is deemed to possess some relevance wouldn't it be more appropriate to have it come from client management in the proxy statement or other communication (i.e. Form AP)?

While we are opposed to the notion of CAMs for all entities, we find the concept to be totally without merit for small entities. If CAMs are a part of the final standard, we encourage the Board to exclude audits of emerging growth companies, smaller reporting companies, investment companies, broker-dealers, and employee benefit plans. To require CAMs in the audit of such entities would seem to fail the cost/benefit test.

We appreciate the opportunity to provide input into the standards setting process.

Sincerely,

Jerilyn K. Barthel

Jerilyn K. Barthel, CPA
Chair, Professional Standards Committee

CAPITAL GROUP®

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

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***<u>VIA ELECTRONIC DELIVERY</u>***

June 24, 2016

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

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

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

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

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

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

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

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

Recommendation 1 – Eliminate materiality requirement for CAMs

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

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

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

Recommendation 2 – Eliminate reference to subjectivity for CAMs

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

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

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

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

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

<u>Recommendation 3 – Require disclosure by auditors and management of materiality measures</u>

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

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

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

<u>Recommendation 4 – Address the problem of alternative dispute resolution clauses</u>

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

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

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

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

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

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

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

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

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

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

Sincerely,

*/s/ Elizabeth F. Mooney*

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

*/s/ Dane Mott*

Dane Mott
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The Capital Group Companies, Inc.

ICAEW REPRESENTATION
122/16

**PROPOSED AUDITING STANDARD—THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION AND RELATED AMENDMENTS TO PCAOB STANDARDS**

ICAEW welcomes the opportunity to comment on the *Proposed Auditing Standard —The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* published by the PCAOB on 11 May 2016, a copy of which is available from this link.

This response of 11 August 2016 has been prepared on behalf of ICAEW by the Audit and Assurance Faculty. Recognised internationally as a leading authority and source of expertise on audit and assurance issues, the Faculty is responsible for audit and assurance submissions on behalf of ICAEW. The Faculty has around 7,500 members drawn from practising firms and organisations of all sizes in the private and public sectors.

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For more information, please contact: representations@icaew.com

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## MAJOR POINTS

1. We congratulate the PCAOB on these revised proposals for auditor reporting. The further alignment with IAASB standards is particularly welcome and will benefit US investors. It will also benefit investors in Europe and elsewhere to the extent that the proposals are more closely aligned with the new EU audit legislation, effective 17 June 2016. The PCAOB is committed to research seeking to understand the outcome of enhanced auditor reporting. We applaud its support of rigorous and independent academic research not least because the data and information auditors will provide in the new audit report and Form AP will promote and facilitate innovative approaches to analysis and learning, particularly by academics. The information in UK audit reports already analysed, combined with the analysis of US audit reports and indeed reports from other jurisdictions should yield valuable insights into audit, auditors, companies and more. These insights will benefit US investors and investors worldwide, and should ultimately contribute, demonstrably, to the enhanced functioning of the US and global capital markets.

### Alignment with the IAASB and the wider purpose of enhanced reporting

2. We are particularly pleased that the PCAOB has decided not to prescribe how CAM are to be described, and have instead developed a list of matters to be covered that is very similar to the list used by the IAASB. We noted in our response to the PCAOB's original proposals dated 11 December 2013 (ICAEW Rep 172/13) our belief in the importance of the PCAOB doing what it can to ensure that the apparent areas of difference between the different proposed reporting regimes are minimised. We noted that US investors investing outside the US and foreign investors investing in the US are unlikely to have the time or inclination to distinguish between the purported virtues of the different regimes, particularly where dual listed entities include audit reports prepared under both local and PCAOB standards in their filings.

3. We also noted:

   - that investors are unlikely to be convinced that wording differences in auditing standards will, in the long run, result in any significant differences in what is communicated. The depth and quality of auditor reporting will be driven by investor demand, the regulatory approach to monitoring auditors, the approach taken by audit firms and common practices that develop within and across industry sectors in the next few years.
   - that we did not believe that CAM as defined by the PCAOB and KAM as defined by IAASB were significantly different, even as they stood, and that the range, depth and detail of reporting would be similar, whichever regime applied. The closer alignment of the two regimes means that this is even more true now. Firms reporting under UK, US and international standards base their methodologies on ISAs and firm efficiency and practice risk management dictate that they will seek to align their reports across different regimes as far as possible.
   - our belief that the main threat to enhanced transparency is that CAM disclosed will be irrelevant, or degenerate into boilerplate.

4. While we have some concerns that the new regime will come to be seen as an end in itself we are confident that the power of data analytics will, over time, enable academics, investors, regulators and others to mine the information provided in the audit report and Form AP to yield valuable insights. Enhanced auditor reporting is the start of a journey whose purpose is to open up the dialogue between auditors, audit committees, investors and boards by providing everyone involved with a starting point for a discussion. This requires changes to existing patterns and modes of thinking and communication. To make CAM *effective*, investors, audit committees and auditors need to step up their level of engagement with each other. CAM will be relevant and useful to investors and other financial statement users provided:

- investors continue to engage with audit committees and auditors, and are clear about what they want to know;
- auditors avoid boilerplate where possible;
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

### The UK experience

5. The enhanced reporting regime has, to date worked well in the UK. The UK has a strong and mature profession and deep and liquid capital markets, in which the threat of litigation involving auditors arises relatively infrequently. In jurisdictions where these conditions are not present, it may be harder to make the change to enhanced auditor reporting effectively and the easier the new regime is made for all concerned to operate, the better.

6. We noted in our previous response that IAASB's documentation requirements, and those in the UK, focus on why KAM are KAM, whereas the PCAOB's requirements focus on documenting why possible CAM are not considered CAM. This seems to be more about preparing audit files for inspection than communicating information to investors. Firms approach the documentation of CAM in different ways. Some do start with all matters reported to the audit committee and put them into 'in' or 'out' buckets in determining whether they are also CAM. But other firms start with a list of significant risks, put them into 'in' and 'out' buckets for reporting purposes, and then determine what to report to the audit committee. Other firms again approach each exercise separately. We urge the PCAOB to think again about this requirement, and about how it will be enforced. The documentation requirements as they stand re-inforce the sense that the disclosure of CAM is an end in itself. If the dialogue between investors, audit committees and auditors is not significantly improved as a result of the new regime, a great deal of effort will have been wasted and we urge the PCAOB to continue to think about how it will encourage these communications, and about how it will measure the *effectiveness* of the new regime.

### The nature and purpose of Form AP

7. We noted in our previous response that while we agree that information regarding auditor tenure is of *interest* to investors, we do not believe that the auditors' report is the right home for it. We are therefore pleased that the PCAOB is recommending inclusion of this information in Form AP. It would have been out of context in the audit report.

8. The evidence relating to the relationship between auditor tenure and audit quality is mixed and we note that two out of five of the PCAOB Board members are not wholly supportive of the proposals in this respect. We too have concerns. We remain of the view that the information provided will be fairly basic, that no form of words can cover every eventuality and that. misunderstandings and inconsistencies are therefore possible. Nevertheless, enhanced auditor reporting, as noted elsewhere in this response is the start of a journey and we expect that the PCAOB will monitor and finesse the nature and quality of the information in Form AP over time. The consistency provided by this reporting requirement will facilitate better quality academic work not least because academics currently have to construct their own data sets using their own assumptions regarding changes in firms and auditor tenure. The information will be publicly available and that of itself has value.

9. The PCAOB also needs to consider the nature and purpose of Form AP. Firms are currently making significant changes to their internal reporting mechanisms to fulfil the current requirements for the information required by Form AP. We encourage the PCAOB to

   - develop criteria for the inclusion of further information in this form;
   - consider its quality and its uses;
   - consider how information in this form and information in the audit report is to be distinguished.

There is a risk, otherwise, that unhelpful 'noise' will be created by Form AP, if it comes to house a large amount of basic data to which rudimentary analytical tools are applied by unskilled users. The PCAOB risks creating a rod for its own back if the only rationale for the inclusion of information in Form AP is that it is 'of interest' to some who strongly believe that there *is* a relationship between audit quality and audit tenure for example, and are determined to prove it, despite more rigorous academic evidence being inconclusive. Simply providing this information lends credence to the underlying but unproven assumptions about such relationships and the PCAOB is thereby, by implication, endorsing them. We are not convinced that the PCAOB is comfortable with this perception and we encourage the PCAOB to monitor the quality of the information in Form AP, and consider carefully how it is used and for what purposes.

10. We have not answered specific questions on issues that arise from PCAOB inspections or are specific to the US.

## RESPONSES TO SPECIFIC QUESTIONS

**Q1: Is the definition of 'critical audit matter' appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.**

11. There are no fundamental flaws in the definition and it is sufficiently clear to enable auditors to apply it consistently. However, we have concerns that regulatory, company and investor behaviour may encourage auditors to carry on including CAM, year after year, through *excessive emphasis on consistency* at the expense of applying the spirit of the requirements. It will always be easier to leave something in, rather than take it out, if auditors not only feel obliged to explain the change in the audit report, but then explain it again to investors and regulators.

12. We note elsewhere in this and previous responses our belief that there would be little if any difference in practice to what is reported if the PCAOB moved further in the direction of the IAASB's definition.[1] The only possible difference of emphasis is in the focus on materiality and while the IAASB standard focuses less on this, we believe it will be a rare set of circumstances indeed in which something is considered technically immaterial, but still relevant.

13. While terminology should be aligned between standard-setters wherever possible, we understand the limits to this. We therefore congratulate the PCAOB on using virtually the same words as the IAASB regarding the description of the matters to be covered by auditors. To have the confidence to do so is the mark of a mature regulator and we encourage the PCAOB going forward to continue to consider how it can best leverage the work of other standard-setters and, just as importantly, we will encourage other standard-setters going forward to consider how they can best leverage the work of the PCAOB.

14. Nevertheless, we remain uncertain about the rationale for the use of the term 'critical; rather than 'key'. While the IAASB and PCAOB definitions are different, as we indicate elsewhere in this response, we do not believe that combined effect of market pressure and audit firm desire for consistency will result in any significant differences in matters reported under the two regimes. While 'critical' can be read as a narrower category than 'key' in plain English - we are not sure how important that difference is to the PCAOB - if the PCAOB were to use the term 'key' rather than 'critical', we think there would little real danger that anyone would assume that the IAASB's regime had been applied.

[1] Matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements, as against matters that relate to material accounts or disclosures involving especially challenging, subjective, or complex auditor judgment

15. In achieving the Board's aim of providing relevant and useful information to investors and others the definition of CAM is probably less important than the behavioural drivers that will affect the quality of auditor disclosures. We note in our major points above our continued belief that auditor communication of CAM will be relevant and useful to investors and other financial statement users if:

- investors continue to engage with audit committees and auditors, and are clear about what they want to know;
- auditors avoid boilerplate where possible;
- regulators, companies and investors do not drive auditors into the defensive reporting of boilerplate with threats of sanctions and litigation.

16. We believe that the IMA awards in the UK which recognise excellence in auditor reporting are one way of encouraging stakeholders to engage with auditors, the audit process and auditor reporting, and that the PCAOB has a role in promoting this type of engagement with auditors to investors.

**a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?**

17. Matters communicated/required to be communicated to the audit committee is the appropriate source for CAM not least because it is aligned with IAASB's requirements.

**b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.**

18. There are no audit committee communications that should be specifically excluded from consideration as a source of potential CAM.

**c. Is the 'relates to accounts or disclosures that are material to the financial statements' component of the definition of a critical audit matter appropriate and clear? Why or why not?**

19. The 'relates to accounts or disclosures that are material to the financial statements' component of the definition of a critical audit matter is reasonably clear.

**d. Is the 'involved especially challenging, subjective, or complex auditor judgment' component of the definition of a critical audit matter appropriate and clear? Why or why not?**

20. The 'involved especially challenging, subjective, or complex auditor judgment' component of the definition of a critical audit matter is reasonably clear.

**Q2: Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?**

21. The factors listed are helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment although we are not clear as to why the factors refer to significant 'unusual' transactions in terms of the related work effort, rather than simply to 'significant' transactions.

22. The PCAOB should resist calls to add to this list. It is sufficient as it stands.

**Q3: Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?**

23. There are no factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment.

**Q4: Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a re-audit? Why or why not?**

24. We do not believe that there is any need for the PCAOB to prescribe specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented and we are pleased that the re-proposal regarding communication of prior period CAM does not mandate disclosure. Nevertheless, the PCAOB might wish to consider mandating auditor *consideration* of the disclosure of CAM for each period presented for any situation in which CAM in respect of prior periods have not been previously disclosed; for example, in the case of an IPO.

25. The PCAOB states that the change *allows auditors to include critical audit matters for prior periods when the auditor decides it is appropriate to do so*. On our reading of the proposals, the PCAOB appears to restrict communication of prior period CAM to those two circumstances. We believe that a more general permission is more appropriate.

**Q5: Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?**

26. We believe that the PCAOB should be clear that when it refers to consistent implementation, it is referring to the consistent identification of CAM, rather than consistent disclosure. The latter might encourage boilerplate by leading auditors in borderline cases to sticking to extant wording regarding a CAM identified in several consecutive periods, rather than changing it to reflect changes in circumstances, to avoid accusations of inconsistency and having to explain again to PCAOB inspectors why changes have been made.

27. We note in our major points that we are particularly pleased that the PCAOB has decided not to prescribe how CAM are to be described and have instead developed a list of matters to be covered that is very similar to the list used by the IAASB.

**Q6: Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:**

**a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and**

**b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate? Are there other steps the Board could take to address these concerns? If so, what are they?**

28. On rare occasions, auditors may have little choice about including original information about the entity in the audit report, particularly if management refuses, inappropriately, to disclose certain information in the financial statements and we believe that the manner in which the PCAOB deals with this is appropriate.

29. To the best of our knowledge, there have, to date, been no issues arising from investors or other financial statement users misinterpreting the UK equivalent of CAM as undermining the pass/fail opinion or providing separate opinions. Litigation aside, we see little reason why this should be an issue for US investors.

**Q7: In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?**

30. The PCAOB does not provide examples of situations in which auditors might refer to disclosures outside the financial statements and we cannot imagine any situations in which this might be appropriate. Such references would easily be misinterpreted as implying that auditors had audited or in some other way been more involved with the disclosure outside the financial statements beyond the requirements of existing PCAOB standards, which could lead to an expectation gap between investors and auditors.

**Q8: Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and to require a statement to that effect?**

31. It is appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, to require a statement to that effect in the auditor's report. The PCAOB may wish to consider adding to this situations in which the only CAM relate to certain modified audit reports, to bring it further into line with ISAs.

**Q9: Is the reproposed documentation requirement clear and appropriate? Why *or why not? If not, how should the documentation requirement be formulated?***

32. The re-proposed documentation requirements are clear, but they could be improved. We note in our major points above different firms approaches to documentation and our belief that flexibility will help ensure that the disclosure of CAM do not become a compliance exercise and an end in itself. Some firms start with all matters reported to the audit committee and put them into ‘in’ or ‘out’ buckets in determining whether they are also CAM. Other firms start with a list of significant risks, put them into ‘in’ and ‘out’ buckets for reporting purposes, and then determine what to report to the audit committee. Other firms again approach each exercise separately.

33. IAASB requires the documentation of the rationale for inclusion as KAM, rather than exclusion. We urge the PCAOB to consider the extent to which it could move further towards IAASB’s position, by, perhaps, deleting the first requirement regarding the documentation of everything communicated/required to be communicated and leaving it at matters that involved especially challenging, subjective, or complex auditor judgment.

**Q10: What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?**

34. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

**Q11: Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?**

35. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

**Q12: Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?**

36. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

**Q13: Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?**

37. Despite the fact that IAASB has a similar requirement, we remain of the view expressed in our previous response that the inclusion of the statement regarding auditor independence is unnecessary, although some readers might welcome the clarification for the specific independence standards that have been complied with. We do not believe that inclusion of such language in the audit report will have any significant impact on auditor behaviour.

**Q14: Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?**

38. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

**Q15: Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?**

39. We have not responded to this question as it arises from PCAOB inspections and/or is specific to the US.

**Q16: Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information they?**

**Q17: Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?**

**Q18: Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?**

40. We note in our major points above our belief that Form AP is a better home for the information regarding auditor tenure than the audit report, mainly because the audit report is the wrong place for it, and that we have yet to be convinced about the value of this information. It is likely to be fairly basic because no form of words can cover every eventuality. Misunderstandings and inconsistencies are therefore possible. Nevertheless, we expect that the PCAOB will monitor and finesse the nature and quality of the information in Form AP over time. The consistency provided by this reporting requirement will facilitate better quality academic work because academics currently have to construct their own data sets using their own assumptions regarding changes in firms and auditor tenure. The information will be publicly available and that of itself has value.

41. We also note in our major points above our belief that some further thought needs to be given to the nature and purpose of Form AP. Firms are currently making significant changes to their internal reporting mechanisms to fulfil the requirements for Form AP. The PCAOB needs to think about the purpose of Form AP, its uses and the quality of the information it houses and how decisions are to be made regarding the inclusion of information in the audit report or Form AP. We see no justification for information such as auditor tenure, being included in both Form AP and the audit report.

42. Form AP should not be permitted to become a repository for a large amount of basic data to which unsophisticated users apply rudimentary analytical tools. There is a risk that this will happen if the only rationale for the inclusion of information in Form AP is that it is 'of interest' to some who strongly believe that there *is* a relationship between audit quality and audit tenure, for example, and are determined to prove it, despite more rigorous academic evidence being inconclusive. Simply providing this information lends credence to the underlying but unproven assumptions about such relationships and the PCAOB is thereby, by implication, endorsing them. We are not convinced that this PCAOB is comfortable with this perception and we encourage the PCAOB to monitor the quality of the information in Form AP, and consider carefully how it is used and for what purposes.

**Q19: Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?**

43. We are puzzled by this question partly because it seems more likely that search costs will, if anything, be greater if the information is included in the audit report as they are not aggregated and appear in different locations within a company's filing. Moreover, we think that requiring disclosure of auditor tenure is unlikely to make *any* significant difference to investor search costs, regardless of where the information is housed. Investors and others concerned with such issues are likely to be making comparisons across companies and taking account of many other variables.

44. If the Board does require disclosure in the auditor's report, a specific location, clearly distinguished from the rest of the report is important to avoid confusion regarding the significance of the disclosure and its relationship to the better quality information in the rest of the report.

**Q20: Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?**

45. The changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor are broadly appropriate and clear.

**Q21: Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?**

46. The interaction between the communication of critical audit matters and required explanatory paragraphs is clear.

**Q22: Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?**

47. Auditors *should* be permitted to include the very limited number of matters meeting the definition of a CAM and requiring explanatory paragraphs such as certain going concern issues, in the required explanatory paragraph. It is unlikely that many such reports will be issued and this approach would avoid confusion and maintain the alignment of the PCAOB's requirements with those of the IAASB in this relatively rare but nevertheless important area.

**Q23: Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?**

48. The requirement to include an explanatory paragraph when the auditor did not perform an audit of ICFR should apply in all cases, because readers may not be aware of the specific requirements regarding when management is required to report on ICFR.

**Q24: Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?**

49. The interaction between the communication of critical audit matters and emphasis paragraphs is clear, appropriate and aligned with the IAASB's approach. Auditors are not expected to include an emphasis paragraph about a matter that meets the definition of a CAM.

**Q25: Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?**

50. The re-proposed requirements for a specific order of certain sections in the auditor's report and for section titles will make the report easier to use and is broadly aligned with the IAASB's requirements.

**Q26: Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?**

51. The re-proposed amendments relating to the interaction between CAM and qualified and adverse opinions are generally aligned with IAASB requirements except in respect of adverse opinions. However, the number of these issued is small.

**Q27: How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?**

52. We note in our major points above our belief in the importance of the new regime not being seen as an end in itself, and that it does in fact serve as the start of a journey, opening up a dialogue between auditors, audit committees, investors and boards by providing a starting point for a discussion. The formal evidence aside, anecdotal evidence tells us that:

- it takes time for the dialogue to open up;
- many investors are 'quietly satisfied' with the new regime, the information they had so long called for is now being provided.

53. The mischief that the new auditor reporting regime was intended to remedy, which is a lack of communication has, to some extent, melted away. Our overall impression is that the enhanced reporting regime has, to date, not just worked well in the UK, but better than expected. We hope that this success will be replicated elsewhere and we hope that it will be just as effective in the US, despite the more litigious environment.

54. We note in our answer to question 1,above belief that the IMA awards in the UK which recognise excellence in auditor reporting are one way of encouraging stakeholders to engage with auditors and auditor reporting, and that the PCAOB has a role in promoting this type of engagement to investors.

**Q28: How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?**

55. We believe that the auditor's response, findings and key observations are likely to be of most interest to investors. Investors are generally looking for more explanation of changes.

**Q29: Would critical audit matters be useful in assessing company financial performance? If so, how?**

56. This question is likely to be addressed in due course by academics, however, we believe that the PCAOB should exercise caution in blurring the boundaries between companies and their auditors. Poor quality financial statements are harder to audit than good quality financial statements but the relationship between audit quality and company financial performance is likely to be complex, and good quality evidence regarding that relationship is only likely to become available a decade or more of reporting under the new regime.

**Q30: Would critical audit matters be useful in assessing audit quality? If so, how?**

57. Assessing audit quality, as the PCAOB is aware, is a vexed issue as evidenced by the wide variety of approaches to audit quality indicators (AQIs) currently being proposed. Nevertheless,

the disclosure of CAM seems likely to result in more focus on CAM and to encourage more extensive dialogue and to that extent, it seems likely to promote audit quality. Poorly drafted CAM will clearly impact the indirect assessment of audit quality. In our response to the IAASB's recent ITC, we went further and suggested that enhanced auditor reporting can do more than just help to *assess* audit quality. It can also contribute to the *improvement* of audit quality through its indirect demonstration of professional scepticism and transparency.

**Q31: Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?**

**Q32: Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?**

**Q33: Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?**

58. It seems obvious to those outside the profession that communication of CAM cannot fail to enhance attention by auditors, audit committees, and management to the matters identified as CAM and that the idea that there will be no impact on the work performed, naive. It is to be hoped that such changes will enhance audit quality, improve management's disclosures, and thereby benefit investors, but this is not guaranteed. Improvements in audit quality require a belief in the value of transparency, and that companies and firms will be rewarded for it. There are fears in some jurisdictions that the financial markets might penalise companies whose auditors go the extra mile and regulators such as the PCAOB and the SEC have an important role to play in ensuring that the financial markets properly understand the purpose and value of the enhanced auditor reporting regime.

**Q34: Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?**

59. The PCAOB notes that communication of CAM is a way in which firms have sought to differentiate themselves in the UK. It is important to remember in that context though that mandatory auditor rotation was also introduced in the UK at the time the new reporting regime was implemented, which seems likely to have added impetus.

**Q35: Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.**

60. We are not aware of any such studies or data.

**Q36: Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?**

61. The PCAOB notes that the zero change in audit fees in the UK would not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms chose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting. This caveat is important. Underestimating the significance of the cost of regulatory reform, particularly for smaller companies and their auditors, is all too easy. The structures firm need in place to deal with these reporting requirements is such that enhanced reporting for just a few clients is likely to be particularly burdensome for smaller firms, some of which are likely to decide that it is too risky or expensive to operate in this market. This regrettable (but probably unavoidable) effect can be reduced if regulators inspect the new regime in a proportionate manner.

62. We have not responded to questions 37 - 43 as they arise from PCAOB inspections and/or is specific to the US.

**Q37: Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?**

**Q38: For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?**

**Q39: While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?**

**Q40: Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? Why or why not?**

**Q41: Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?**

**Q42: If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?**

**Q43: Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?**

**Q44: If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies? Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?**

63. We noted in our previous response that there may be some merit in phasing in the requirements, firstly for large accelerated filers whose auditors have more resources to address the new requirements to help establish best practice, and then for all other issuers.

THE MARCO CONSULTING GROUP

August 12, 2016

Pheobe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006

Re: PCAOB Rulemaking Docket Matter No. 034

Dear Ms. Brown:

The Marco Consulting Group ("MCG") is a registered investment advisor to more than 300 benefit plans with combined assets under advisement of $145 billion. The funds we represent provide retirement security to more than a million plan beneficiaries across the country. Investors rely on auditing standards to help them accurately assess the risks of their investment decisions.

MCG is writing to express its support for the proposed auditing standards outlined in "The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion." We applaud the Public Company Accounting Oversight Board's ("PCAOB") efforts to provide more transparency for investors.

In particular, we believe the proposed rule to require auditors to disclose critical audit matters ("CAM") in the audit report will allow investors to make better informed decisions when voting on auditor's reports, although we urge the PCAOB to broaden its definition of relevant information. Defining the threshold for reporting accounts or disclosures that are material to the financial statements is overly narrow and may lead to the exclusion of important information.

MCG also urges the PCAOB to require the disclosure of auditor tenure in the auditor's reports. Investors may have reason to question the independence of auditors given extensive tenures. Providing this data point to investors will enable them to assess whether tenure should be a factor to consider when approving company auditors.

We appreciate the PCAOB efforts and the opportunity to express our views. Should you require any further background, please contact me at 312-612-8446 or obrien@marcoconsulting.com.

Sincerely,

Maureen O'Brien
Director of Corporate Governance
The Marco Consulting Group



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CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

ANDRES GIL
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August 15, 2016

Ms. Phoebe W. Brown
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

**Re: PCAOB Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (PCAOB Release No. 2016-003, May 11, 2016) (PCAOB Rulemaking Docket Matter No. 034)**

Dear Ms. Brown:

The U.S. Chamber of Commerce (the "Chamber") is the world's largest federation of businesses and associations, representing the interests of more than three million U.S. businesses and professional organizations of every size and in every economic sector. These members are both users and preparers of financial information. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC believes that businesses must have a strong system of internal controls and recognizes the vital role external audits play in capital formation. We support efforts to improve audit effectiveness and appreciate the opportunity to comment on the Public Company Accounting Oversight Board ("PCAOB") Proposed Auditing Standard on *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "Proposal").

The CCMC is pleased that the PCAOB has dropped from the Proposal any new requirements on auditor responsibilities for other information outside the financial statements that were included in the prior proposal and is continuing research on these issues. The CCMC also appreciates the Proposal differs from the prior proposal in regards to critical audit matters ("CAMs") in that it reflects definitional refinements and narrows the scope and application of auditor reporting of CAMs. Nonetheless, many of the serious concerns we previously expressed about both the PCAOB's rationale for and approach to changing the auditor's report continue to apply. Specifically, our concerns include but are not limited to the following:

1. The need for the Proposal is not sufficiently addressed;
2. The required disclosure of CAMs is often duplicative and not decision-useful;
3. The treatment of original and confidential information and potential adverse consequences upon internal controls;
4. The increase of legal liability for business and auditors;
5. Additional concerns with CAMs and adverse consequences for business, auditors, and investors;
6. The Proposal should not apply to emerging growth companies; and
7. The PCAOB has not demonstrated why disclosure of audit firm tenure is necessary.

We discuss our concerns in more detail in corresponding sections below. This discussion reinforces a number of the concerns that we expressed in our prior comment letters, which should continue to be considered as part of the public record, and provides additional perspective incremental to those letters.

**Background**

Financial reporting is the responsibility of management and includes the GAAP financial statements and other disclosures, such as disclosures required by the Securities and Exchange Commission ("SEC") in Management's Discussion & Analysis ("MD&A"). In turn, the board of directors, largely through the audit committee, provides oversight of management's reporting and disclosures. The independent auditor's responsibility is to express an opinion on whether the company's annual financial statements, including the notes thereto, are presented fairly, in all material respects, in conformity with generally accepted accounting principles ("GAAP"). Determining GAAP for

U.S. companies is the responsibility of the Financial Accounting Standards Board ("FASB").

Another core principle of financial reporting is that the auditor is not an original source of information about the company. Accordingly, if there is material, decision-useful financial information for investors, it is not the auditor, but management that should provide it—based on guidance from FASB or the SEC.

This is the PCAOB's second proposal concerning revisions to the auditor's report. The CCMC commented on the prior proposal issued in August 2013, as well as a related Concept Release issued in June 2011.[3]

The Proposal would supersede or amend various existing PCAOB auditing standards on financial statement audit reports. The Proposal would require auditors to communicate in the auditor's report CAMs arising from the audit of the current period financial statements and certain information about each CAM. It would also add new language on auditor responsibilities regarding independence and obtaining reasonable assurance about whether the financial statements are free of material misstatements "whether due to error or fraud" and on audit firm tenure.[4]

These core principles provide a foundation for our discussion of the Proposal, including the threshold question of need.

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[3] *See* the December 9, 2013 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB Proposed Auditing Standards—*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; The Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards* (PCAOB Release No. 2013-005, August 13, 2013; PCAOB Rulemaking Docket Matter No. 034) and the September 14, 2011 letter from the United States Chamber of Commerce Center for Capital Markets Competitiveness on the PCAOB *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards* (PCAOB Release No. 2011-003, June 21, 2011, Rulemaking Docket Matter No. 034).
[4] *See* the Proposal, pages 3-4.

## Discussion

*Need for Proposal Not Sufficiently Addressed*

We continue to seriously question the need for this initiative. Our previous comment letters have emphasized the necessity of addressing this threshold question and whether the PCAOB should engage in such a sweeping standard-setting initiative that would substantially change the role and responsibilities of the auditor and represent the most significant changes to auditor reporting in more than 70 years. This question is especially important given the strong support from stakeholders for retaining the current "pass-fail" model of auditor reporting—a model that reflects the core principles of financial reporting just described.

According to the Proposal, the Board believes that the communication of CAMs should help focus investor attention on these matters and provide a new perspective on the financial statements.[5] We respectfully disagree with this premise as an appropriate rationale for PCAOB standard-setting to significantly change the auditor's report.[6]

As previously discussed, any perceived inadequacies in the financial information currently provided to investors should be addressed by the SEC and/or FASB, not the PCAOB. Furthermore, based on the Proposal itself, we strongly believe that CAMs would, for the most part, simply duplicate information already disclosed by management, while creating a number of other unintended consequences.

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[5] *See* the Proposal, page 2.

[6] We have long supported global convergence of auditing standards. However, the Proposal focuses on auditor reporting and would not change any auditor performance standards. Thus, while we appreciate that regulators and standard-setters in other jurisdictions, such as the International Auditing and Assurance Standards Board ("IAASB"), have changed auditor reporting to include "CAM-like" disclosures, we also recognize that financial reporting frameworks, regulatory requirements, legal settings and the like in other parts of the world differ from the U.S. For example, not all reporting frameworks in other jurisdictions have an equivalent of the SEC's MD&A requirements, including management's disclosures of critical accounting policies and practices ("CAPs"). Further, jurisdictions, such as the United Kingdom, that relatively recently changed auditor reporting requirements did so in conjunction with changes in management and audit committee reporting, while the PCAOB has no authority over management reporting or audit committees.

*Required Disclosure of CAMs Is Often Duplicative and Not Decision-Useful*

The Proposal would require auditors to report on matters that were adequately and appropriately disclosed by management. For example, in addition to management's disclosures in the GAAP footnotes, SEC requirements for MD&A include management disclosure of critical accounting policies and practices ("CAPs"). CAPs are those accounting policies and practices that require management's most difficult, complex, and/or subjective judgments. Yet, the Proposal defines CAMs as "accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment."[7] At times, matters that may require disclosure of CAPs by management may coincide with required disclosure of CAMs under the Proposal. In these instances, CAMs disclosed by auditors will only duplicate information already disclosed by management in MD&A and/or the GAAP footnotes.

The Proposal provides two examples of CAM disclosures that reinforce this point.[8] Although the Proposal provides no illustration of management's disclosures, we believe that by its very nature much of the information in the two CAM disclosure examples would clearly duplicate information disclosed by management in MD&A and/or the GAAP footnotes.

In many circumstances, auditor information identifying the CAM, describing the principal considerations that led the auditor to determine that the matter is a CAM, and referring to the relevant financial statement accounts and disclosures would all duplicate information disclosed by management.[9] Otherwise, the remaining required information in the illustrative examples, uniquely disclosed by the auditor, describes how each CAM was addressed in the audit. As subsequently discussed, in our view this information is problematic and not actionable by or decision-useful for investors.

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[7] *See* the Proposal, page 3.
[8] *See* the Proposal, pages 32-35.
[9] This reinforces a concern we expressed in our prior comment letter as to whether the auditor would be allowed to refer to information disclosed by management in MD&A not just the GAAP financial statements and footnotes covered by the auditor's opinion. Any such limitation would also exacerbate financial reporting complexity.

To summarize, the two examples of CAM disclosures in the Proposal illustrate that the proposed auditor information would be duplicative of management's disclosures or otherwise not decision-useful for investors.

*Treatment of Original and Confidential Information and Potential Adverse Consequences Upon Internal Controls*

A core principle of financial reporting is that the auditor is not an original source of information about the company. In fact, the auditor is subject to both legal and ethical requirements on confidentiality that preclude this from occurring except in certain specific circumstances. We discussed in our prior comment letters that requiring auditor disclosure of CAMs is inconsistent with this core principle. Further, auditor reporting of CAMs undermines the financial reporting and disclosure frameworks of the SEC and FASB, as they can necessitate auditors disclosing matters that the SEC and/or FASB have specifically decided that companies are not required to disclose.

We appreciate that the PCAOB recognizes these problems and the Proposal reflects revisions from the prior proposal in an attempt to address them. However, we do not believe the Proposal solves these problems.

For example, while the Proposal emphasizes that a note in the proposed auditor reporting standard indicates that "when describing [CAMs] in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company." But, the note goes on to say, "unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a [CAM] or how the matter was addressed in the audit."[10] Further, the Proposal adds:

[10] *See* the Proposal, pages 35 and A1-9.

> *[M]anagement may decide that additional management disclosures would be useful to financial statement users. However, management's decision about whether to disclose additional information does not affect the auditor's responsibility to describe the principal considerations that led the auditor to determine that a matter is a [CAM] or how the matter was addressed in the audit.*[11]

The Proposal provides another example related to deficiencies in internal control over financial reporting ("ICFR") that are not material weaknesses and, therefore, do not otherwise require any disclosure by management or auditors under SEC or PCAOB requirements, as follows:

> *However, matters that would not themselves constitute [CAMs] under the reproposed definition, such as information about the company's processes and controls, could be included, for example, in the description of the principal considerations that led the auditor to determine that a matter is a [CAM].*[12]

As we have stated in the past, the Chamber believes that spending a disproportionate amount of time on issues that are not material weaknesses, with respect to reporting on ICFR, do not promote investor protection or provide the basis for an effective and sustainable system of controls. This issue is particularly significant in the inspection context, where companies and auditors spend a significant amount of time documenting every judgment and decision. However, a natural consequence of the Proposal is that it could incentivize auditors to report potential deficiencies in ICFR in the auditor's report that are not material, adding more time and complexity to the ICFR process without any additional benefit to investor protection. The Proposal could also incentivize an expectation that controls need to be designed and tested to fit an audit, a concern that we have raised in the past.

To summarize, under the Proposal, auditors can still become an original source of information and/or disclose confidential company information in order to comply with PCAOB auditor reporting requirements, even though

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[11] *See* the Proposal, pages 35-36.
[12] *See* the Proposal, page 20.

doing so may violate codes of professional ethics and state laws. Consequently, the CCMC recommends the PCAOB include a statement in any final proposal that an auditor normally should not be an original source of information.

Also, we note that some of the quoted guidance appears in the release text of the Proposal, rather than in the proposed rule itself. The CCMC has previously expressed concerns about using release text in this manner.

*Increase of Legal Liability for Business and Auditors*

The CCMC remains very concerned about the legal liability implications of the Proposal. This encompasses potential liability for what auditors communicate and what they do not. The former includes liability for being an original source of statements, including disclosing confidential company information, as previously discussed, and the latter includes both private legal actions and regulatory activities (e.g., through PCAOB inspections and enforcement) based on second-guessing auditor judgments on matters that were deemed by the auditor not to meet the threshold of CAMs.

*Additional Concerns with CAMs and Adverse Consequences for Business, Auditors, and Investors*

The CCMC has additional concerns with the Proposal related to CAMs, some of which were expressed in our prior comment letters, as follows:

- Circumstances will arise when CAMs lack clarity and/or raise questions and there is no mechanism or venue for the auditor to respond. In addition, confidentiality restrictions will likewise constrain the auditor. As a result, the company and management are put in the position of having to explain, after the fact and in compliance with Reg FD, what the auditor meant.

- CAMs elevate for public disclosure matters that were fully addressed and resolved to the auditor's satisfaction before the audit report was issued.

- Auditor reporting on CAMs involves some practical considerations including creating potential impediments to timely SEC filings by companies. Perhaps, on average, auditors will identify CAMs well in advance of SEC filing deadlines and resolve all necessary issues with the company in this regard. Nonetheless, circumstances will arise when this is not the case, and so, the likelihood cannot be ruled out that the Proposal will result in situations where auditor reporting of CAMs delays the timely filing of information by companies.

- The reporting of CAMs is not likely to be a "free-writing" exercise at the engagement level. A number of forces, including legal forces will necessitate consistency in the drafting of CAMs over time and across companies. Thus, the likelihood is very high that this initiative would result in auditor reporting that is simply boilerplate.

- The Proposal adds a requirement to describe how the auditor addressed each CAM. It is unlikely that that an auditor's response to addressing "accounts and disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgment" can be reduced to a few sentences of meaningful or decision-useful information for investors and other users. Any such disclosure does not provide actionable information for investors and is particularly susceptible to becoming boilerplate.

- The PCAOB expects that CAMs will be disclosed for most audits. Given the heterogeneity in the circumstances of an audit, this expectation may be misplaced. For example, some audits are less complex and more straight-forward.

- Mandating the disclosure of CAMs related to any matter communicated to the audit committee rather than matters required to be reported to the audit committee will have a harmful chilling effect on the normal communication processes between the auditor and management and the audit committee. For example, management and/or the audit committee may be more cautious and less open and/or timely in their discussions with auditors to avoid having a matter unnecessarily becoming elevated to a CAM.

- While we support principles-based auditing standards and avoiding a "one-size-fits-all" or "checklist" approach, the CCMC has also emphasized the importance of respecting reasonable judgments by auditors and encouraged the PCAOB to develop an auditor judgment framework, which has not occurred.

Thus, given the definition of CAMs in the Proposal, the CCMC is concerned about the potential for second-guessing of auditor judgments on the determination of CAMs and the disclosures made in the auditor's report in regard to CAMs via PCAOB inspections, regulatory enforcement actions, and private securities actions.

Moreover, any determinations of audit reporting deficiencies, such as via PCAOB inspections, may cause inconsistencies for companies with regards to their SEC filings that include the auditor's report, even though there is no issue with respect to the information provided by management.

*Proposal Should Not Apply to EGCs*

The CCMC appreciates that the Proposal does not provide for auditor reporting of CAMs by brokers and dealers, investment companies (except business development companies), and benefit plans. However, the question remains as to whether the Proposal applies to emerging growth companies ("EGCs").

As background, the PCAOB has not proceeded with Auditor Discussion and Analysis ("AD&A") as articulated in the Concept Release of June 2011. Unfortunately, CAMs appear substantively similar to AD&A, notwithstanding that CAMs are described as being grounded in auditing rather than financial reporting matters. This is important because the 2012 Jumpstart Our Business Startups Act ("JOBS") provides that any PCAOB rules on audit reporting of AD&A shall not apply to audits of EGCs.

Accordingly, we believe the Proposal should not apply to EGCs.

*PCAOB Has Not Demonstrated Why Disclosure of Audit Firm Tenure is Necessary*

The Proposal calls for disclosing auditor tenure (that is the year the auditor began serving consecutively as the company's auditor). Consistent with statements by PCAOB Board members Franzel and Hanson,[13] the CCMC questions the inclusion of this information in the auditor's report.

It is not obvious how tenure connects to the nature of the auditor's work performed or the auditor's opinion and, therefore, why this information belongs in the auditor's report. As the audit committee has the responsibility to oversee and monitor the selection and retention of the audit firm, the audit committee report in the annual proxy statement provides a more appropriate placement for such a disclosure. And, a number of audit committees already disclose this information in the proxy statement.[14]

By including tenure information in the auditor's report, the Proposal implies some systematic connection between audit quality and tenure. However, as explained in the Proposal and emphasized by board members, the PCAOB has not reached a conclusion regarding the relationship between audit quality and auditor tenure and the PCAOB's inspection process has not been designed to determine any such relationship. Unfortunately, even though the PCAOB does not have data to support a relationship between audit quality and auditor tenure, the fact that the PCAOB would require disclosure of auditor tenure might suggest that the PCAOB believes the information is meaningful.

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[13] *See* Statements by Board members Hanson and Franzel on Reproposing an Auditing Standard on the Auditor's Report at the PCAOB Open Board Meeting on May 11, 2016.
[14] We also note that the SEC solicited public comment on this matter in the Concept Release on *Possible Revisions to Audit Committee Disclosures*; 17 CFR Part 240; Release Nos. 33-9862, 34-75344; File No. S7-13-15; RIN 3235-AL70.

The Proposal acknowledges that information to determine auditor tenure is already publicly available, but suggests that disclosing this information in the auditor's report will reduce investors' search costs.[15] Clearly any such costs incurred by investors are trivial.

To summarize, in our view any benefits of disclosing auditor tenure in the audit report are questionable and would be heavily outweighed by the costs imposed, as we have noted in our previous correspondence on this issue. Moreover, the Proposal has not demonstrated any linkage between auditor tenure and audit quality. Thus, the CCMC does not support disclosure of information on auditor tenure in the audit report.

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Once again, the CCMC appreciates the opportunity to comment on the Proposal.

The CCMC continues to have serious concerns regarding the Proposal, including that the Proposal

1. blurs and even weakens lines of corporate governance, especially in cases where open communication may been needed between the audit committee and an external auditor;
2. may create duplicative disclosures in many cases while risking auditors serving as original sources of information in others; and
3. may raise the liability for auditors and businesses which ultimately harms investors.

All things considered, the CCMC questions whether the costs of the Proposal outweigh the benefits. We believe that these issues should be addressed before any Proposal moves forward.

Finally, if the PCAOB decides to proceed with this initiative in spite of all the concerns expressed about it, the PCAOB should recognize that auditor

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[15] *See* the Proposal, page 68.

reporting of CAMs, in particular, is a giant experiment. As such, the CCMC recommends that any standard-setting that results from this initiative should include a sunset provision (of within three to five years of its effective date). Only after a robust post-implementation review of the costs and benefits and a determination that the benefits exceed the costs should a similar or revised auditor reporting standard be allowed to be re-implemented.

We stand ready to assist in this matter.

Thank you for your consideration.

Sincerely,

Andres Gil

cc: Wesley R. Bricker, Interim Chief Accountant, Office of the Chief Accountant, Securities and Exchange Commission

U.S. GOVERNMENT ACCOUNTABILITY OFFICE
**441 G St. N.W.**
**Washington, DC 20548**

August 15, 2016

Ms. Phoebe W. Brown
Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street NW
Washington, DC 20006-2803

**PCAOB Rulemaking Docket Matter No. 034: PCAOB Release Number 2016-003: *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (May 2016)**

Dear Ms. Brown:

This letter provides the U.S. Government Accountability Office's (GAO) responses to the Public Company Accounting Oversight Board's (PCAOB) Release Number 2016-003, *Proposed Auditing Standard – The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards* (hereafter Release No. 2016-003 or the Reproposal). GAO promulgates generally accepted government auditing standards, which provide professional standards for auditors of government entities in the United States.

We support efforts to improve the quality of financial reporting and increase the confidence users have in the audit of financial statements. Release No. 2016-003 is a reproposal of various changes to the audit report initially proposed in the PCAOB's Release No. 2013-005.

Consistent with our December 11, 2013, letter in response to the PCAOB's Release No. 2013-005, we continue to support the PCAOB's proposal to improve the format of the auditor's report, which should result in meaningful improvements for users. For the specific format, we encourage the PCAOB to consider using a format that more closely aligns with the International Auditing and Assurance Standards Board's (IAASB) International Standard on Auditing (ISA) 700 (Revised), including discrete sections that describe management's responsibilities and the auditor's responsibilities instead of including such information within the proposed Basis for Opinion section. We have consistently advocated for harmonized standards and consistent practice, absent any compelling reasons that would require different practice, to ensure audit quality. We acknowledge that ISA 700 (Revised) and ISA 701 call for including in the auditor's report (1) key audit matters and (2) a statement related to the auditor's independence. We believe that the PCAOB's Release No. 2016-003 represents an improvement to the original release and is better aligned with the standards adopted by the IAASB.

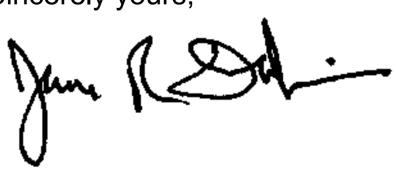
Also, we encourage the PCAOB to study early results from the changes implemented by the IAASB and perform periodic look-back analyses of the PCAOB implementation to determine whether the changes in the PCAOB reporting standards ultimately had the desired effects and whether the changes resulted in unanticipated or unintended consequences.

We are not persuaded that the Reproposal's addition of a requirement to disclose auditor tenure in the auditor's report represents an improvement to PCAOB standards. The information is already available by other means, and the PCAOB has not clearly indicated what it expects the users to infer from such information. Inclusion of the auditor tenure in the auditor's report may create user confusion about how to interpret the information with respect to the auditor's opinion. Further, the PCAOB seems to be adding information to the audit report that is beyond the report's primary purpose. While the additional information may be useful to users, we do not believe that the audit report is the appropriate place for it. Instead, we believe that the PCAOB should coordinate with the Securities and Exchange Commission (SEC) and jointly determine what type of additional information, if any, is critically important to users and determine the best communication method. We believe that if the PCAOB and SEC determine that additional auditor information is critical to users, the proxy statement would be the most appropriate place to communicate it, as investors consider the information in the proxy statement in determining whether to elect, approve, or ratify the principal auditor for the current year.

We believe that the Reproposal's interaction between the communication of critical audit matters, required explanatory paragraphs, and emphasis paragraphs may create unnecessary duplication and confusion for investors and financial statement users. For example, if descriptions of how a critical audit matter was addressed are provided in the required explanatory paragraph, a user may not be able to consistently locate the information when looking at multiple audit reports. Integrating critical audit matters and required explanatory paragraphs can also confuse the impact of some required explanatory paragraphs. For instances where a critical matter is also an explanatory paragraph or emphasis of matter, we suggest that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. The auditor would still have to follow the applicable standards related to reporting the required explanatory paragraph. The PCAOB is seeking comment on a number of questions related to the Reproposal. We have provided our responses to certain specific questions in the enclosure to this letter.

If you have any questions about this letter or wish to discuss any of our responses, please feel free to contact me at (202) 512-3133 or dalkinj@gao.gov.

Sincerely yours,



James R. Dalkin
Director
Financial Management and Assurance

## Enclosure: Answers to Questions

**1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users? Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.**

We have consistently advocated for robust standards that are in harmony among the various standard setters to ensure audit quality. While the proposed approach generally appears to be appropriate for achieving the Public Company Accounting Oversight Board's (PCAOB) stated objective, we believe that the PCAOB should harmonize the definition of critical audit matters with the International Auditing and Assurance Standards Board's (IAASB) definition of key audit matters to enhance overall consistency.

**2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?**

We have consistently advocated for robust standards that are in harmony among the various standard setters. While the proposed factors generally appear to be appropriate for determining which matters involved especially challenging, subjective, or complex auditor judgment, we believe that the factors should be harmonized with International Standard on Auditing (ISA) 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, paragraphs 9 and 10. In addition, additional application and explanatory guidance may help the auditor determine which matters involved especially challenging, subjective, or complex auditor judgment.

**3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?**

As noted in our response to question 2, we believe that the factors should be harmonized with ISA 701 paragraphs 9 and 10.

**4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?**

We believe that the PCAOB should consider requiring the auditor to report critical audit matters fully for the current year along with additional information sufficient to provide context on changes to critical audit matters from the prior year.

**5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?**

We believe that the reproposed requirement for describing the critical audit matters is sufficiently clear to facilitate consistent implementation. However, over time, we believe that the content may evolve into standard (boilerplate) language.

**6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as:**
**a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and**
**b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate?**

**Are there other steps the Board could take to address these concerns? If so, what are they?**

If the PCAOB requires auditors to include critical audit matters in auditor's reports, we suggest that the PCAOB perform periodic look-back analyses to determine whether the changes in PCAOB reporting standards had the desired effects and whether the changes resulted in unanticipated or unintended consequences.

**7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?**

Since an audit report relates to specific relevant financial statement accounts and disclosures, it would be appropriate for the auditor's reporting of critical audit matters to relate to those financial statement accounts and disclosures.

**8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?**

As some audits do not involve especially challenging, subjective, or complex auditor judgment, we believe that it is appropriate for the standard setter to allow for the auditor to determine that there are no critical audit matters. We concur that if the auditor deems that there are no critical audit matters, a statement to that effect in the auditor's report should be required to inform financial statement users of that conclusion.

**9. Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?**

We have consistently advocated for robust standards that are in harmony among the various standard setters. While the reproposed documentation requirement for critical audit matters generally appears to be clear and appropriate, the reproposed requirement differs from ISA 701 in that it does not address how to document the rationale for reporting no critical audit matters or instances where a critical audit matter would not be reported in an auditor's report because of circumstances such as a law or regulation precluding the disclosure of the information.

**10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?**

We are not providing comments responding to this question.

**11. Do the changes from the 2013 proposal address concerns that have been raised about private liability? If not, what additional changes would you suggest should be made?**

We are not providing comments responding to this question.

**12. Are there other steps the Board could or should take to address the likelihood of increasing an auditor's or company's potential liability in private litigation through the requirement to communicate critical audit matters in the auditor's report?**

We are not providing comments responding to this question.

**13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?**

We believe that the reproposed requirement relating to auditor independence is clear, and it is generally consistent with ISA 700 (Revised). We are not certain how this would meaningfully improve investors' and other financial statement users' understanding of the auditor's independence responsibilities.

**14. Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?**

We believe that the current auditor's report address format is appropriate and the PCAOB does not need to add additional addressees.

**15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?**

We are not providing comments responding to this question.

**16. Are the reproposed requirements for information regarding auditor tenure appropriate and clear? Why or why not? Are there any specific circumstances that could affect a firm's ability to include tenure information in the auditor's report which the Board should consider? If so, what are they?**

We believe that including auditor tenure in the audit opinion is unnecessary and may lead to user confusion and potentially inconsistent and inappropriate interpretation of the information. Also, the PCAOB has not clearly indicated what it expects the users to infer from such information. For example, are users expected to infer that an extended tenure diminishes independence or audit quality? Or should users infer that a long tenure is preferable, as presumably the auditor has a better understanding of the history of the issuer? This information is already available by other means, and the PCAOB seems to be adding information to the audit report that is beyond the report's primary purpose. While the additional information may be useful to users, we do not believe that the audit report is the appropriate place for it. Instead, we believe that the PCAOB should coordinate with the Securities and Exchange Commission (SEC) and jointly determine what type of additional information, if any, is critically important to users and determine the best communication method. We believe that if the PCAOB and SEC determine that additional auditor information is critical to users, the proxy statement would be the most appropriate place to communicate it, as investors consider the information in the proxy statement in determining whether to elect, approve, or ratify the principal auditor for the current year.

**17. Is it appropriate to disclose the earliest period the auditor began auditing any company in the group of investment companies even if the auditor has not audited all of the companies in the group for the same period of time? Why or why not?**

Please see our response to question 16.

**18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?**

As indicated above, if the PCAOB and SEC believe that auditor tenure should be disclosed, the more appropriate place would be in the proxy statement. However, if the PCAOB requires the disclosure of auditor tenure, making such disclosure on Form AP would be preferable to doing so in the auditor's report.

**19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?**

Please see our response to question 16.

**20. Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?**

The changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appear appropriate and clear. Consistent with AU-C 700 and ISA 700 (Revised), we suggest that the format include discrete sections for management's responsibilities and auditor's responsibilities, instead of including such information in the proposed Basis for Opinion section.

**21. Is the interaction between the communication of critical audit matters and required explanatory paragraphs clear and appropriate? Why or why not?**

We believe that the interaction between the communication of critical audit matters and required explanatory paragraphs may create unnecessary duplication and confusion for the investors and financial statement users. For example, if descriptions of how a critical audit matter was addressed are provided in the required explanatory paragraph, a user may not be able to consistently locate the information when looking at multiple audit reports. Integrating critical audit matters and required explanatory paragraphs can also confuse the impact of some required explanatory paragraphs. For instances where a critical audit matter is also a required explanatory paragraph, we suggest that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. The auditor would still have to follow the applicable standards related to reporting the required explanatory paragraph.

**22. Should auditors be permitted to include the critical audit matter communications in the required explanatory paragraph? Would integrating explanatory paragraphs and critical audit matters be helpful to investors? Alternatively, would it decrease the impact of the explanatory paragraph? Why or why not?**

Please see our response to question 21.

**23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?**

We are not providing comments responding to this question.

**24. Is the interaction between the communication of critical audit matters and emphasis paragraphs clear and appropriate? Why or why not?**

We believe the interaction between the communication of critical audit matters and emphasis paragraphs can create unnecessary duplication and confusion for the investors and financial statement users. Integrating critical audit matters and emphasis paragraphs can also confuse the impact of some emphasis paragraphs. Similar to our response to question 21, we believe that the PCAOB should include a reference in the critical audit matter section but waive the requirement to describe the critical audit matter in the emphasis paragraph.

**25. Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?**

The reproposed requirements for a specific order of certain sections in the auditor's report and for section titles will make the information in the auditor's report easier for users to locate. Also to ensure consistent presentation, the PCAOB should be consistent with other standard setters in the ordering and sections titles of the auditor's report.

**26. Are the reproposed amendments to PCAOB standards appropriate? If not, why not? Are there additional amendments related to the reproposed standard that the Board should consider? If so, what are they?**

As noted in our other responses, we do not believe that the reproposed language on auditor tenure and the statement of independence improve audit quality or meaningfully inform users about the audit.

**27. How would investors use the information communicated in critical audit matters? Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?**

We are not certain how investors would use information communicated in critical audit matters sections, and as noted earlier, we believe that such information may evolve into standard (boilerplate) language.

**28. How would each of the elements of the communication (i.e., identification, principal considerations, audit response, and financial statement reference) be used by investors?**

We are uncertain whether investors and other financial statement users will find the elements of the communication useful. Accordingly, we suggest that if the PCAOB adopts the changes proposed, it should perform periodic look-back analyses to determine whether the standard achieved its objective, including whether the information was ultimately useful to users.

**29. Would critical audit matters be useful in assessing company financial performance? If so, how?**

We are not certain that the audit report would be an appropriate source for information for assessing a company's financial performance. The company's performance data need to be presented in the financial statements and regulatory filings in accordance with the corresponding standards, laws, or regulations. The role of the audit report is to report whether the information in the financial statements is fairly presented in conformity with the accounting framework, in all material respects.

**30. Would critical audit matters be useful in assessing audit quality? If so, how?**

We are not persuaded that requiring auditors to report critical audit matters in the auditor's report will be useful for assessing audit quality. If the PCAOB requires auditors to report critical audit matters, we encourage the PCAOB to conduct periodic look-back analyses to assess whether the critical audit matters resulted in the desired effects and whether this reporting resulted in additional unexpected or unintended consequences.

**31. Would the communication of critical audit matters enhance attention by auditors, audit committees, and management to the matters identified as critical audit matters? If not, why not? Would such changes enhance audit quality, improve management's disclosures, or otherwise be beneficial to investors? Why or why not?**

We do not believe that under current auditing and regulatory standards there is insufficient communication among auditors, audit committees, and management to address matters critical to their audits. Accordingly, we are not persuaded that including critical audit matters would enhance communication among such parties. If the PCAOB adopts the proposal to require critical audit matters, we encourage the PCAOB to perform periodic look-back analyses to determine whether such reporting resulted in the desired effects and whether it resulted in unexpected or unintended consequences.

**32. Would the communication of critical audit matters trigger other changes in behavior? If so, what changes? Would such changes enhance audit quality or otherwise be beneficial to investors? Why or why not?**

As discussed in our December 11, 2013, letter, we believe that critical audit matters may evolve into standard (boilerplate) language. Thus, if the PCAOB requires critical audit matters reporting, we encourage the PCAOB to perform periodic look-back analyses to determine whether such reporting resulted in the desired effects and whether it resulted in unexpected or unintended consequences.

**33. Would the impact of critical audit matters vary depending on the size of the accounting firm? The size of the company? If so, what would the differences be?**

We believe the nature and complexity of the audit is more relevant to the impact of critical audit matters than the size of the accounting firm or the company.

**34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?**

We are not certain that the communication of critical audit matters would provide a basis on which auditors could differentiate themselves, but if the PCAOB adopts the proposal to require critical audit matters, the PCAOB should perform look-back analyses to assess the impact on auditors.

**35. Are there additional academic studies or data the Board should consider? The Board is particularly interested in studies or data that could be used to assess potential benefits and costs.**

We are not providing comments responding to this question.

**36. Are there additional benefits, costs or unintended consequences, or other economic considerations, such as competitive effects, associated with critical audit matters or the additional improvements to the auditor's report that the Board should consider? If so, what are they?**

We are not providing comments responding to this question.

**37. Is it appropriate for the communication of critical audit matters not to be required for the audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans? Why or why not?**

We are not providing comments responding to this question.

**38. For these specific types of entities, are there situations in which critical audit matters would be useful to investors? If so, what are these situations?**

We are not providing comments responding to this question.

**39. While not requiring communication of critical audit matters in the audits of these specific entities, should the Board encourage voluntary communication? Why or why not?**

We are not providing comments responding to this question.

**40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? Why or why not?**

We are not providing comments responding to this question.

**41. Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs? Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs? Should the reproposed requirements be modified to make their application to EGCs more appropriate? Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?**

We are not providing comments responding to this question.

**42. If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?**

We are not providing comments responding to this question.

**43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?**

We are not providing comments responding to this question.

**44. If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies? Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?**

We believe that the PCAOB should consider an implementation strategy that phases in companies by size. This approach may reduce implementation costs to companies and auditors, as lessons and accepted practices will emerge from the large company audits.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF THE
INVESTOR ADVOCATE

August 15, 2016

**Submitted Electronically**

Phoebe W. Brown
Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803

**RE: PCAOB Rulemaking Docket Matter No. 034**

Dear Madam Secretary:

The Office of the Investor Advocate[1] at the U.S. Securities and Exchange Commission ("Commission" or "SEC") monitors developments in accounting and auditing, and we strive to ensure that the interests of investors are appropriately considered as rules are modified. We appreciate this opportunity to provide comments in regard to the reproposed standard, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion.[2]

In summary, we support PCAOB's reproposed standard, which we believe advances the Board's statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[3] In particular, we strongly support the reproposed requirement for the audit report to include communication of critical audit matters ("CAMs") arising from the audit that required especially challenging, subjective, or complex auditor judgment, and of how the auditor responded to those matters. We also support the proposed additional improvements to the Auditor's Report, including a requirement for a statement regarding the auditor's tenure, and measures to improve the form of the auditor's report. We believe these improvements will enhance the usability of audit reports for investors and other users.

## Why Critical Audit Matters (CAMs) Are Needed

Investors and others have often argued that the current reporting model should be expanded to provide information specific to the audit of the company's financial statements. One investor organization has

[1] This letter expresses solely the views of the Investor Advocate. It does not necessarily reflect the views of the Commission, the Commissioners, or staff of the Commission, and the Commission disclaims responsibility for this letter and all analyses, findings, and conclusions contained herein.
[2] PCAOB Rulemaking Docket Matter No. 034, The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion, (May 11, 2016), https://pcaobus.org/Rulemaking/Docket034/Release-2016-003-ARM.pdf (hereinafter "Reproposal Release").
[3] Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley").

described the standard reporting model as "bare-bones" and "seriously outdated."[4] We agree, and we believe that the inclusion of critical audit matters (CAMs) in auditor reports will improve their communication value and make them more usable for investors.

Calls to enhance the auditor's report are not new. In 2008, the U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP") recommended improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.[5] ACAP noted that greater complexity in financial reporting, including the increasing complexity of global business operations and growing use of judgments and estimates, supported improvements to the auditor's report. Moreover, as far back as 1978, the Commission on Auditors' Responsibilities (Cohen Commission) made an observation that still rings true today:

> For the largest corporations in the country, an audit may involve scores of auditors and tens of thousands of hours of work for which the client may pay millions of dollars. Nevertheless, the auditor's standard report compresses that considerable expenditure of skilled effort into a relatively few words and paragraphs.[6]

The current pass-fail model has persisted for more than 70 years. The longevity of the standard reporting model, which arguably reflects the merits of the pass-fail model, nonetheless stands in contrast to the changes that have coursed through financial markets and financial reporting over the past decade and that continue to do so. These changes include the growing use of complex accounting estimates and fair value measurements, which we believe contributes to the information asymmetry between investors and management. Forthcoming fundamental accounting changes, including those involving the bedrock of revenue recognition, will make it even more imperative for investors to understand management's judgment. The due deliberation in which the PCAOB has been engaged for more than five years clearly makes the case for the proposed improvements, in particular in the communication of critical audit matters.

In this still-evolving environment of financial complexity, the disclosure of CAMs holds the promise of contributing to investors' understanding by communicating the most challenging, subjective, or complex auditor judgments on material issues that auditors face. We don't expect CAMs, in themselves, to provide investors with all the information they need in the face of growing financial complexity. We do, however, believe that the communication of critical audit matters will add to the total mix of information, contributing to the ability of investors and others to analyze companies, form a multifaceted understanding of them, and make informed investment decisions.

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[4] CFA Institute, Comment Letter on PCAOB's 2013 Proposal, (Dec. 30, 2013), https://pcaobus.org/Rulemaking/Docket034/232b_CFA_Institute.pdf.
[5] ACAP, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (Oct. 6, 2008), at VII:17.
[6] As quoted in ACAP, Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury (Oct. 6, 2008), at VII:15.

As the record assembled by the PCAOB makes clear, investors generally support the inclusion of CAMs to enhance auditor reports. The Reproposal Release (Part VI, Economic Considerations, in particular) lays out a compelling case as to why the proposed improvements will reduce informational asymmetries and add to the total mix of information available to investors.

Investors want to hear directly from the auditor. As the Reproposal Release observes, "Because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility."[7] Surveys of professional investors also confirm "that additional information from the professional auditor in the [Standard Auditor Report] is of much higher interest and value to an investor in addition to hearing more from the audit committee."[8] Certain academic research, as well as comment letters from knowledgeable investors, further reiterates this point.[9]

Investors can be expected to use CAMs in a wide variety of ways, reflecting the rich diversity of investors and their experience, resources, strategies and other attributes. Let me suggest three examples of how investors may use CAMs.

1. CAM disclosures can serve to focus users' attention on key financial reporting issues and identify areas that deserve more attention. For example, an investor may find that a set of CAMs confirms his or her analysis of key audit issues, or, alternatively, may surprise the investor and point the way for further analysis. In this way, CAMs can boost the efficiency of investors and others in the consumption of financial information.

2. The disclosures can facilitate a more focused and richer dialogue between investors and the company. Even without providing original information about the company, the communication of CAMs can highlight areas that investor may wish to emphasize in their engagement with a company. If a critical audit matter is important enough to merit a conversation between the auditor and the audit committee, investors may determine that it could also merit discussion in their conversations with management.

3. The disclosures offer important information that investors can use in making proxy voting decisions, including ratification of auditors.

We also believe that CAMs may have a salutary effect on the behavior of auditors, company management, corporate boards and their audit committees. By heightening the focus on critical audit matters, the communication of CAMs may provide incentives for preparers, corporate managers and audit committees to provide better disclosures, adopt more widely accepted financial reporting approaches, and enhance audit quality. That's a win-win for investors and companies alike – as well for our capital markets and economy at large. All will benefit if the communication of CAMs enhances the

[7] Rulemaking Docket Matter No. 034, Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments ("Docket 034").
[8] CFA Institute, *supra* note 4 at 3.
[9] *See generally*, Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest? 33 Auditing: A Journal of Practice & Theory 71, 71–93 (2014); Jack T. Ciesielski, Comment Letter on Reproposal Release (July 25, 2016), https://pcaobus.org/Rulemaking/Docket034/8c_JTCiesielski.pdf.

quality of audit information and thus ultimately helps to reduce the cost of capital and raise the efficiency of capital allocation.[10]

**Disclosure of Auditor Tenure: A Question of Where, not Whether**

In addition to the disclosure of CAMS, we strongly support requirements for public disclosure of auditor tenure. There are some differences of opinion about who is best positioned to make the disclosure (the auditor, company management, or the board audit committee) and where that disclosure should be made (in the auditor's report, on Form AP, in the audit committee's report, in the company's proxy statement, or elsewhere). However, we believe these questions are secondary, and that the more important and more immediate concern is the need for the disclosure *somewhere* that is easily accessible. In the absence of such a requirement by the SEC, the PCAOB should move forward with its proposal to require disclosure of auditor tenure.

In its Concept Release on Possible Revisions to Audit Committee Disclosures, the SEC asks whether information on auditor tenure should be required in the audit committee report.[11] At least one institutional investor has favored disclosure in the proxy or elsewhere in a Form 10-K.[12] The CFA Institute, meanwhile, has expressed support for including the tenure information in the auditor's report in addition to EDGAR.[13]

Ultimately, we believe that the Commission should decide these questions. We hasten to add, however, that the worst outcome would be for *neither* the PCAOB or the Commission to adopt a disclosure requirement. Therefore, we recommend that the PCAOB take a two-pronged approach. First, the PCAOB should adopt a requirement for auditor tenure disclosure (either in the audit report or on Form AP). Second, we suggest that the PCAOB consider including a contingent sunset clause, such that the required disclosure in the audit report or on Form AP would expire if and when the Commission adopted a requirement for audit tenure disclosure in the audit committee report, proxy statement, or other document.

**Enhancing Usability**

We commend the PCAOB for including several measures to enhance the usability of auditor reports. The reproposed standard would require the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The reproposed standard would also require titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report. These measures are relatively modest, but they would be a positive step for investors because they would enhance the clarity and comparability of disclosures.

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[10] Reproposal Release, *supra* note 2 at 76 ("Academic research has shown that increased quality of information could result in a reduction in the average cost of capital").
[11] See SEC, Possible Revisions to Audit Committee Disclosures, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015) ("SEC concept release").
[12] Blackrock Comment Letter on Reproposal Release, (Oct. 30, 2013) https://pcaobus.org/Rulemaking/Docket034/008b_Blackrock.pdf.
[13] CFA Institute, *supra* note 4 at 8.

**Materiality Component**

In response to earlier criticisms, the Board narrowed the scope of the CAMs disclosure in several ways, including adding a materiality component to the definition of critical audit matter.[14] Some investors have argued that the PCAOB pulled back too far in its adjustments. For example, the Council of Institutional Investors ("CII") argued in its comment letter that the modified definition "is too narrow and unnecessarily excludes relevant information from investors."[15] Another investor, in urging the Board to eliminate the materiality requirement for CAMs, argues: "Many cases of material accounting problems or fraud started as 'immaterial' to the financial statement and built over time.…It is a serious deficiency in the proposal if investors would only hear about critical audit matters after suffering large losses which is the current disclosure paradigm."[16]

These thoughtful investor criticisms of the Reproposal merit serious consideration. Despite this shortcoming, however, the reproposed standard represents a major improvement to the auditor model, and I encourage you to move forward swiftly to adopt these important reforms. And, if a materiality standard is ultimately adopted, the PCAOB should carefully monitor the implementation of the new standard to ensure that it does not create a significant disclosure gap.

**Audits of Emerging Growth Companies (EGCs)**

As the Reproposal makes clear, the question of whether to apply critical audit matter requirements to the audits of EGCs is necessarily two-pronged. First, this is a policy question, which the PCAOB should judge on the merits of the issue. Second, the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of the Jumpstart Our Business Startups ("JOBS") Act.[17]

From a policy perspective, we strongly believe that the proposed PCAOB standard should apply critical audit matter requirements to the audits of EGCs. The Reproposal Release itself makes a compelling argument:

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[14] Reproposal Release, *supra* note 2 at 3 ("The reproposal narrows the requirements in several ways: by limiting the source of potential critical audit matters to matters communicated or required to be communicated to the audit committee; adding a materiality component to the definition of critical audit matter; narrowing the definition to only those matters that involved especially challenging, subjective, or complex auditor judgment; and revising the related documentation requirement").
[15] Council of Institutional Investors, Comment letter on Reproposal Release (July 27, 2016), https://pcaobus.org/Rulemaking/Docket034/010c_CII.pdf.
[16] Elizabeth F. Mooney and Dane Mott, The Capital Group Companies, Inc., Comment Letter on Reproposal Release (June 24, 2016). https://pcaobus.org/Rulemaking/Docket034/03c_Capital.pdf.
[17] Reproposal Release, *supra* note 2 at 108 (As explained in the Release, Section 104 of the JOBS Act provides that "[a]ny rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company. Section 104 further provides that any other rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.")

> A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.[18]

This heightened asymmetry of information makes us wary of the various regulatory attempts to further reduce information by waiving disclosure requirements for small or emerging companies in the name of "scaling." Specifically with respect to CAMs, we believe that application of the communication requirements would result in even greater benefits for EGC investors than for investors in the broader population of operating companies. Moreover, these benefits would likely accrue not only to investors, but also to EGCs themselves. Both the companies and investors will benefit from such benefits as increased analyst coverage, higher trading volume, and lower cost of capital for EGCs.[19]

We recommend that the PCAOB adopt the proposed standard, and thereby advance the legal question to the SEC, which would then determine whether a CAMs requirement could be applied to audits of EGCs without running afoul of provisions in the JOBS Act. Moreover, to prepare for any outcome of that determination, we recommend that the PCAOB adopt language encouraging auditors, on a voluntary basis, to include CAM communications in the audit reports on EGCs.

**Adopt and Monitor**

We strongly support final adoption of the Reproposal standards, which will represent a major change for the auditor reporting model and hold the promise of important benefits for investors and capital markets. Given the scope of the changes to the auditor's reporting model, it will be especially important for the Board – along with the Commission, investors, analysts, preparers, company management and boards, and others – to monitor the implementation of the new rule. We offer three examples of the areas in which the proposed standard, once adopted, should be monitored.

First, some investors and other commenters have expressed concerns lest the new requirements merely result in a checklist approach and boilerplate, standardized language. Such an outcome would make it difficult for investors and other users to distinguish the critical audit matters involving one company from another's. The reproposed standard attempts to address this risk by clarifying that the auditor is required to describe only the principal considerations that led the auditor to determine critical audit matters, and by emphasizing that the communication should be tailored to the audit to reflect the specific circumstances of the matter.[20] However, the new standard, if adopted, should be monitored to make

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[18] Reproposal Release, *supra* note 2 at 108.
[19] Reproposal Release, *supra* note 2 at 73-74 (As the Release notes, one study found a significant increase in trading volume particularly for companies about which there is less information available to investors as measured by lower analyst coverage).
[20] Reproposal Release, *supra* note 2 at 31 ("In response to comments, the reproposed standard clarifies that the auditor is required to describe only the principal considerations that led the auditor to determine that the matter is a critical audit matter.

sure that the communication of CAMs does not devolve into mere boilerplate language, but instead provides the auditor's unique perspective on critical accounting matters.

Second, monitoring should assess the impact on investor understanding of the auditor's responsibilities and the audit report. Some have expressed concerns that investors and other users might mistakenly perceive an expanded auditor's report as providing a qualified or piecemeal opinion. The reproposed standard specifically addresses these concerns by proscribing certain language in the auditor's report,[21] but its effectiveness should be evaluated over time. The standard, if adopted and implemented, should be monitored to confirm that the expanded audit report does not cause investor confusion but, on the contrary, enhances their understanding of critical audit matters and the financial statements of issuers.

Third, and more broadly, the PCAOB and others should continue to monitor how investors actually use the audit report and other financial information. As noted above, finance and financial reporting continues to grow in complexity. At the same time, technological advances in the delivery of financial information have facilitated the use of data aggregation and data analytics by investors and other users of financial information. We should monitor how investors use financial reporting and how their usage may evolve in the face of technological change.

Thank you, again, for the opportunity to submit our comments regarding this important matter. Should you have any questions, please do not hesitate to contact me or Stephen Deane, who handles audit and accounting matters on my staff, at (202) 551-3302.

Sincerely,

Rick A. Fleming
Investor Advocate

---

The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially challenging, subjective, or complex auditor judgment. It is expected that the communication would be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter").

[21] Reproposal Release, *supra* note 2 at A1-9 ("Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate").

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August 29, 2016

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

Via email: comments@pcaobus.org

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

Dear Members of the Board:

This letter is submitted on behalf of UnitedHealth Group Incorporated ("UnitedHealth Group" or the "Company"), a diversified health and well-being company dedicated to helping people live healthier lives and making the health system work better for everyone. UnitedHealth Group employs more than 200,000 individuals, is a Fortune 10 company with annual revenues expected to exceed $180 billion in 2016 and a market capitalization in excess of $134 billion as of June 30, 2016. We report financial information under the generally accepted accounting principles in the United States ("U.S. GAAP"), and we file public financial statements in accordance with the regulations of the United States Securities and Exchange Commission (the "SEC").

We appreciate the opportunity to provide our comments in response to the Public Company Accounting Oversight Board's ("PCAOB" or the "Board") Rulemaking Docket Matter No. 034 as discussed in PCAOB Release No. 2016-03 dated May 11, 2016 (the "Proposed Standard"). The Company, together with the other four leading publicly-traded managed care companies in the United States (Aetna, Inc., CIGNA Corporation, Humana Inc., and Anthem, Inc.), commented on the PCAOB's concept release related to Rulemaking Docket No. 034 (the "Concept Release") in our letter dated September 28, 2011 ("2011 Joint Comment Letter").

We acknowledge the PCAOB's objective to improve the relevance and usefulness of the auditor's report, and do not object to certain proposed enhancements to the auditor's report that we would consider minor, such as standardizing the form of the report. However, many of the concerns expressed in our 2011 Joint Comment Letter continue to exist in the Proposed Standard with respect to critical audit matters ("CAMs") as determined by the auditor. Additionally, we do not agree auditor tenure should be added as a basic element of the auditor's report.

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**Critical Audit Matters**

In our 2011 Joint Comment Letter on the Concept Release, many concerns were raised related to an Auditor's Discussion and Analysis ("AD&A"). These concerns continue to exist in the Proposed Standard in the form of CAMs, which would require the auditor to provide audit-specific information about challenging, subjective, or complex aspects of the audit as they relate to the relevant financial statement accounts and disclosures.

Under the current distinct frameworks that govern financial reporting and auditing, the roles of all parties involved are clear. *Companies* are responsible for compiling and disclosing financial information in accordance with U.S. GAAP and SEC reporting requirements for the purpose of providing users of financial statements with relevant, useful information about our businesses. *Auditors* are responsible for forming independent, informed opinions about whether or not we have fulfilled that responsibility. Finally, *audit committees and boards of directors* are responsible for active and independent oversight of management regarding the adequacy of internal controls, integrity of the financial statements, compliance with legal and regulatory requirements, and risk management; and a significant component of this role involves dialog and discussion with the auditors regarding the results of their audit procedures.

With respect to CAMs, our primary concern is that the addition of these to an auditor's report could alter the balance of duties within this framework by partially shifting responsibilities for reporting to our auditors. Additionally, enacting the proposed changes could have the effect of implying, in a subtle way, that audit committees are not capable of, or effective in, carrying out the responsibilities traditionally reserved for them. We believe that the Board's intention is to find a way to *supplement* our existing financial reporting; but in practice we believe that the proposed changes would have the effect of *diluting*, and potentially *supplanting* our own reporting to varying degrees to the detriment of users of our financial statements.

We do not believe that implementation of CAMs is appropriate as contemplated in the Proposed Standard. CAMs could undermine the role of the audit committee, which is independent from management and already represents the shareholders in its oversight of and direct communications with the auditors. Though we recognize CAMs would focus on challenging, subjective or complex areas of the audit, we believe it would be rare in practice for those matters to differ from critical accounting estimates which are already required to be disclosed by management. Furthermore, we believe CAMs would ultimately provide little incremental value to users of financial statements since, over time, "boilerplate" language would be unavoidable and the information provided in such reports would likely gravitate towards the lowest level of acceptable disclosure for the purpose of minimizing legal exposure. At the same time, auditors would face significant risks by deviating in any meaningful way from the statements and commentary provided by management (or by choosing to highlight different areas), so their reporting would most likely mirror the

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company's reporting. The creation of duplicative disclosures does not add value or provide decision-useful information to our investors.

Though we believe duplication is most likely to occur, there is also risk of conflicting information being disclosed in the CAMs, or the CAMs disclosing competitively sensitive information. The Proposed Standard includes an explanatory note to address concerns about the auditor potentially becoming the source of original information, however, does not completely eliminate our concern. As previously stated, we believe financial statements, including disclosures of challenging, subjective, and complex estimates and areas are the responsibility of management. We believe it would be very rare for an auditor to deem something a CAM due to auditor judgment, which didn't first require management judgment. Auditors may not be consistent in identifying CAMs, and could identify inappropriate CAMs, for example based on industry benchmarking exercises. Exercising unbiased professional judgment may be difficult in practice, for legal exposure reasons, which could result in over reporting of CAMs, including CAMs related to areas not disclosed by management. Any unreconciled 'inconsistent or competing information' could be a source of great tension and disagreement between management, audit committees, and auditors and could lead to breakdowns in communication that would diminish the quality of financial reporting and auditing as a whole.

While certain investors may demand more transparent disclosure from public companies, we believe that reforms in that area should appropriately come from the standard-setters best positioned to enact them: the Financial Accounting Standards Board ("FASB") and the SEC.

Finally, the Proposed Standard requires auditors to describe how a CAM was addressed in an audit. We do not believe an auditor's procedures would be useful to users of the financial statements, and would also undermine the responsibilities of the audit committee. Publicly disclosing audit procedures would expose auditors to scrutiny from the public on whether their procedures were sufficient. A user of the financial statements does not necessarily have enough insight into a company or knowledge of auditing procedures to determine what procedures are appropriate given the facts and circumstances of a given company. The sufficiency of audit procedures should be determined through an auditor following generally accepted auditing standards, auditor judgment, an audit firm's quality control procedures, as well as through regulation by the PCAOB, among other things. The addition of these disclosures could result in increased audit procedures by the auditor to ensure that any and all possible procedures are performed, which could help mitigate auditor liability.

Audit risk is conceptually different than business risk, and not all of the risks businesses face impact the scope and conduct of an audit. More reporting on how and when specific audit procedures were conducted will not likely change how a strategic investor assesses the future prospects of our businesses, and will instead increase audit costs with little to no corresponding benefits to the investing community.

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**<u>Auditor Tenure</u>**

As further discussed in our comment letter to the SEC dated September 8, 2015 on SEC Release No. 33-9862 File No. S7-13-15, UnitedHealth Group does not believe disclosure about auditor tenure is necessary or effective. Requiring such disclosure implies there is a correlation between the length of an independent auditor's engagement and audit quality. However, as the Proposed Standard acknowledges, studies that have examined the role of auditor tenure on audit quality have reached mixed conclusions. We believe this to be particularly true in our complex and highly regulated industry. What matters most for companies such as ours is having a well-staffed and sufficient number of auditors with a deep understanding of the technical accounting principles applicable to our industry and our business.

UnitedHealth Group routinely chooses to disclose certain information in our proxy materials or other publicly available information that is not required under regulatory standards. Though we do not believe it should be a requirement within an auditor's report, UnitedHealth Group chooses to disclose auditor tenure within our audit committee disclosures in the proxy materials. We routinely engage with shareholders to determine which disclosures investors are interested in receiving, and take this feedback into consideration when preparing our disclosures. We believe auditor tenure should be a voluntary disclosure to be performed by the company and not the auditors, based on a company's unique facts and circumstances and investor base. We believe this information should be optionally included within other publicly available information, such as the proxy materials, where a company is able to further elaborate on auditor tenure such that inappropriate conclusions are not drawn by users.

**<u>Summary and Conclusion</u>**

We recognize the PCAOB's objective to improve the relevance and usefulness of the auditor's report, however, believe the provisions regarding CAMs and auditor tenure do not achieve this objective. As we and other commenters have already suggested, the proposed changes regarding CAMs could potentially undermine the responsibilities and credibility of management teams and audit committees; adversely affect relationships among auditors, audit committees, and our management teams; and increase auditor legal exposure (which therefore increases costs to companies and investors with little to no added benefits). These are all significant potential effects that we strongly urge the Board to avoid.

* * * * *

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We appreciate your consideration of our comments on the Proposed Standard. If we can provide further information or clarification of our comments, please call me.

Sincerely,

Thomas E. Roos
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UnitedHealth Group, Incorporated
(952) 936-1875

**ROBERT N. WAXMAN, CPA**
**866 UNITED NATIONS PLAZA, FL 3**
**NEW YORK, NY 10017**

August 15, 2016

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 20006-2803

Rulemaking Docket No. 34 - PCAOB Release No. 2016-003:
Proposed Auditing Standard—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards

Dear Secretary:

My comments and responses to certain of the questions asked in the above-mentioned proposed auditing standard (the "reproposal") are set out below. For convenience, this comment letter uses the term "investor" to include collectively every type of investor, shareholder, creditor, analyst, and other financial statement user including stakeholders.

## Critical Audit Matters ("CAMs")

General Comments

I am opposed to the inclusion of Critical Audit Matters in the auditor's report for the reasons outlined in this letter.

It will be argued by some respondents to the reproposal that any disclosure by the auditor would be informative and useful, add value, enhance audit quality, reduce asymmetrical information between management and investors, make the audit report more relevant and credible, and consequently help investors to incorporate whatever information the auditor deems appropriate to provide in the form of CAMs into their investment strategies, voting considerations and lending decisions.

Nevertheless, the reproposal does not support by compelling and reliable evidence that these objectives will be met. Based on the unpersuasive evidence in the reproposal, Critical Audit Matters will –

- not be "valuable" or "useful" to investors (as some respondents to the reproposal would hope),
- not provide investors with any real "insight into the extent and appropriateness of the auditor's work,"[1]
- increase (not decrease) information asymmetry between the auditors and investors,

[1] Page 79.

- run many pages and overwhelm other information in the audit report (for some industries), and
- be redundant, repeating information that has already been disclosed by management.

Investors always want more data and more information, especially when it is free. However, every public company will bear some portion of the cost of that information, which cost will be passed on to them by their auditors, and the auditors will in turn reap the monetary benefits of the reproposed CAM reporting. The reproposal says that the PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent.[2] For 2014, the average audit fees for 7,071 SEC filing companies were $1,533,438, totaling $10,842,940,098 of audit fees.[3] Using the 5 percent cited in the reproposal results in an increase in recurring total audit fees of approximately $542 million (aka a half billion dollars each year), an average of $76,672 for each of the 7,071 SEC filing companies.

The reproposal has not established that the benefits (as yet unknown and unproven) exceed the costs to be borne by every public company.

By definition, a CAM "is not expected to provide information about the company that has not been made publicly available by the company."[4] Nevertheless, the reproposal weakly argues that CAMs are important to investors because the auditors can "more effectively" convey company information than management.

> The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments should help investors and other financial statement users "consume" the information presented in management's financial statements more effectively.[5] (Emphasis added.)

In addition, the reproposal points out that there may be matters that are relevant or important to investors, but may not be reported as a CAM.

> With a materiality component, however, matters that are not material to accounts or disclosures in the financial statements but may be important to investors would not be included as critical audit matters in the auditor's report.[6]

Since auditors would not be required to present information about the company that has not been made publicly available,[7] it then follows that if investors really want useful and valuable information, they should read firsthand the registrant's entire Form 10-K, including MD&A and the financial statements, then they would immediately have the data, comparisons, trend

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[2] Page 83. The 5 percent pertains to the expanded auditor reporting in the United Kingdom.

[3] See the *2015 Audit Fee Report*, Financial Executives Research Foundation (issued October 2015).

[4] Paragraph 14, Note 2 of Proposed AS 3101. See discussion of the "unless" clause in answer to Question 6.

[5] Page 64.

[6] Page 95.

[7] See discussion of the "unless" clause in answer to Question 6.

information, business, operations, prospects, contingencies, the entity's "critical accounting policies" and "significant accounting policies," and much more.

The information contained in "critical accounting policies and estimates" and "significant accounting policies" includes the entire universe of accounts and disclosures required to be included in a CAM, and all the information investors need to understand the registrant's significant risks, management's judgments, operating trends and potential variability of a company's earnings, cash flow and more.

I do not believe that investors fully use the information they already have in the annual report on Form 10-K, interim reports on Form 10-Q, and other SEC filings – information much more usable and valuable than the limited amount of information that investors could glean from any CAM reported by the auditor.

Critical Accounting Policies

As mentioned, investors reading the SEC filings would be aware of the registrants "critical accounting policies." The SEC requires that registrants include in their MD&A a full explanation of their critical accounting policies, including "the judgments and uncertainties affecting the application of those policies, and the likelihood that materially different amounts would be reported under different conditions or using different assumptions."[8] The SEC advises that in the MD&A disclosure of critical accounting policies and estimates "companies should consider whether they have made accounting estimates or assumptions where:

> the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and
>
> the impact of the estimates and assumptions on financial condition or operating performance is material."[9]

The reproposal defines CAMs (in part) as [audit matters that] "involved especially challenging, subjective, or complex auditor judgment." The definitions of "critical accounting policies"[10] and CAMs are fundamentally the same, the only difference is that auditor's must report on those accounts or disclosures that were particularly "hard to audit" for any number subjective reasons and disclose some (but not all) of the audit procedures used to audit the CAM.

Significant Accounting Policies

As said, investors reading the SEC filings would be aware of the registrants "significant accounting policies." Hence, an investor reading the notes to the financial statements will learn, in great detail, the "significant accounting policies" followed by the registrant.

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8 See Cautionary Advice Regarding Disclosure About Critical Accounting Policies, SEC Release 33-8040 and Interpretation: Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, SEC Release 33-8350, FR 72.

9 SEC Release 33-8350, FR 72.

10 See paragraph .12, Item 2, and Appendix A to AS 1301 and Question 1.

FASB Topic 235, *Notes to Financial Statements*, requires the disclosure of all significant accounting policies. This ASC states "… a description of all significant accounting policies of the entity shall be included as an integral part of the financial statements.[11] ASC Topic 235 then defines accounting policies disclosure as –

> The accounting policies of an entity are the specific accounting principles and the methods of applying those principles that are judged by the management of the entity to be the most appropriate in the circumstances to present fairly financial position, cash flows, and results of operations in accordance with generally accepted accounting principles (GAAP) and that, accordingly, have been adopted for preparing the financial statements.[12]

IAASBs Key Audit Matters ("KAMs")

There are those who believe that convergence with the IAASBs KAM disclosure is a desirable goal. However, while somewhat similar, there are very significant differences between the IAASBs KAM disclosures and the reproposed CAM disclosures.

ISA 701 defines Key Audit Matters as "[t]hose matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance."[13]

The definitions of a KAM and a CAM do not align in many respects including the terminology used and the materiality (vs. significance) of the audit matter. Thus, audit reports using the ISAs KAM standard will contain significantly different information than the reproposed CAM standard.

Exhibit 2 contains a small sample from a number of audit reports of how the auditor addressed specific company KAMs. This is deadly reading, and confirmation of how useless these descriptions of the audit procedures undertaken by the auditor will be for investors.

Information Asymmetry

The reproposal states that "in economic terms, an expanded auditor's report should reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance."[14]

While at first this argument sounds appealing, the reproposal does not provide any evidence that the reporting of a CAM will in fact close the information gap between auditors and investors, and therefore in turn reduce asymmetric information between management and investors.

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[11] ASC 235-10-50-1.

[12] ASC 235-10-50-3.

[13] Paragraph .08 of ISA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

[14] Page 64.

The argument that CAM reporting will reduce the asymmetric information between the management and investors is wholly conjectural and there is no basis for the assertion. How does the reporting of audit procedures decrease the "information asymmetry" between the management and an investor? How can knowing that certain audit procedures were applied to an account or disclosure increase an investor's knowledge of a company's financial performance? The reproposal provides no answers to these "how" questions.

Useful Information?

The reproposal itself questions the usefulness of CAM reporting:

> Overall, the results from research analyzing whether the information provided in expanded auditor reporting is useful to investors are limited. Collectively the results are ambiguous as to whether the expanded auditors' reports have provided investors with new information beyond what is contained in the financial statements. The Board will continue to monitor academic research in this area during the rulemaking process.[15]

On the other hand, in making the case for the reporting CAMs, the reproposal observes:

> The Board believes that the communication of critical audit matters should help focus investors' and other financial statement users' attention on these matters by making them more prominent, which could facilitate their analysis of the financial statements and other relevant disclosures.[16]

Hence, it is possible that the reporting of CAMs could help investors, but the reproposal contains no concrete evidence that it would, or just how investors will use this information in their analysis of financial statements. The reproposal continues –

> The communication of critical audit matters in the auditor's report would also help investors and analysts who were interested in doing so engage management with targeted questions about these issues.

Auditors have not historically been engaged by management to act as a primary stimulus of investors to ask "targeted questions" of management regarding information in the auditor's report. In my view, these "targeted questions" inspired by CAM reporting will be a negative by-product of CAM reporting.

Still more from the reproposal (footnotes omitted):

> The communication of critical audit matters may also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality. For example, the audit matter may help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which may allow a more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have stated that having the auditor, a third party expert, rather than the company provide this type

[15] Page 74.

[16] Page 64.

> of information would be of added value to investment decision making. Because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility.[17] (Emphasis added.)

The basis for these claims is very weak and speculative: "may assist," "may help," "may allow," "may be viewed" tells the reader that there is also a possibility that CAMs may do none of these things and that the Board just does not know enough about the value and utility of CAM reporting.

**Question: 1. Is the definition of "critical audit matter" appropriate for purposes of achieving the Board's objective of providing relevant and useful information in the auditor's report for investors and other financial statement users?**

When first read the definition seems clear enough, but when examined more closely, the definition is not as clear as it could be. To eliminate any ambiguity, I believe that "involved especially challenging, subjective, or complex auditor judgment" should be read as "involved any combination of especially challenging, subjective or complex auditor judgment."

What Do the Words Really Mean?

Almost every word in the definition has an element of uncertainty and will mean different things to different auditors. The usual definitions of some of the words used in the definition follow:

- Especially: "to a great extent; very much." How much is very much?
- Challenging: "testing one's abilities; demanding." Obviously, the abilities and judgments of auditors differ.
- Subjective: "personal feelings, tastes, or opinions; existing in the mind; open to interpretation." What is the level and degree of objectivity? How much of auditor judgment is subjective?
- Complex: "consisting of many different and connected parts." This word only adds to the difficulty of having a uniform understanding of the definition.
- Judgment: "the ability to make considered decisions or come to sensible conclusion."
- Lastly, what is the meaning of the phrase "complex auditor judgment"? This is not a term of art, and as far as I could determine it appears nowhere in the PCAOB, AICPA, FASB or SEC literature.

AS 1301 (*Communications with Audit Committees*) defines "critical accounting policies and practices" as –

> … a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of

[17] Pages 64-65.

> the need to make estimates about the effects of matters that are inherently uncertain (emphasis added).[18]

AS 1301 also says

> Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.[19]

However, the similar usage in AS 1301 is not under discussion here.

**Question 1 (continued). Is the definition sufficiently clear to enable auditors to apply it consistently? If not, describe why the definition may not be clear, including examples demonstrating your concern.**

The definition cannot be applied consistently when auditors, be they in different firms or engagement teams, attempt to follow imprecise terms used in the reproposal and discussed immediately above, namely: "material," "especially," "challenging," "subjective," "complex," and "audit judgment."

**a. Are matters communicated or required to be communicated to the audit committee the appropriate source for critical audit matters? Why or why not?**

Yes. The source of CAMs should be limited to only those matters communicated to the audit committee.

**b. Are there any audit committee communications that should be specifically excluded from consideration as a source of potential critical audit matters? If so, identify and explain the reason for the exclusion.**

Yes, not all required communications should be the source of a CAM. For example, Item 2-07, *Communication with Audit Committees*, of Regulation S-X requires the auditor to report to the audit committee:

> (2) All alternative treatments within Generally Accepted Accounting Principles for policies and practices related to material items that have been discussed with management of the issuer or registered investment company, including:
>
> > (i) Ramifications of the use of such alternative disclosures and treatments; and
> >
> > (ii) The treatment preferred by the registered public accounting firm;
>
> (3) Other material written communications between the registered public accounting firm and the management of the issuer or registered investment company, such as any management letter or schedule of unadjusted differences;

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[18] Appendix A to AS 1301.

[19] Paragraph 12 of AS 3101.

Both of these requirements should not be the source of a CAM. In addition, the overall planned audit strategy,[20] the qualitative aspects of significant policies and practices,[21] uncorrected and corrected misstatements,[22] violations or possible violations of laws or regulations,[23] and disagreements with management,[24] should not be considered as a source of potential CAMs.

**c. Is the "relates to accounts or disclosures that are material to the financial statements" component of the definition of a critical audit matter appropriate and clear? Why or why not?**

As to the materiality component of the definition, the reproposal cites the US Supreme Court cases TSC Industries v. Northway, Inc. and Basic, Inc. v. Levinson.[25]

Obviously, any materiality definition cited in a final standard should reference the FASBs final standards (if issued) regarding (1) Conceptual Framework for Financial Reporting, Chapter 3 - Qualitative Characteristics of Useful Financial Information, and (2) Notes to Financial Statements – Assessing Whether Disclosures are Material.

Pending the issuance of these documents, the definition in FASB Concepts Statement 2, paragraph 132, should be referenced.

The proposal requires that the following language be included in the auditor's report: "The critical audit matters communicated below … (1) relate to accounts or disclosures that are material to the financial statements …." I suggest that the words "material to the financial statements" be followed by the words "taken as a whole" in order for the definition to be congruent with the other verbiage required by the reproposal in the audit report. Thus, the first sentence would read, "… (1) relate to accounts or disclosures that are material to the financial statements, taken as a whole, and …."

**d. Is the "involved especially challenging, subjective, or complex auditor judgment" component of the definition of a critical audit matter appropriate and clear? Why or why not?**

See above discussion.

**Question: 2. Are factors helpful in assisting the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? Why or why not?**

Yes, the nonexclusive listing of various factors[26] will be helpful in deciding in determining CAMs.

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[20] Required by paragraphs .10 and .11 of AS 1301.

[21] Detailed in paragraph .13(a) to (g) of AS 1301

[22] Paragraphs .18 to .20 of AS 1301.

[23] Paragraph .08 of AS 1301.

[24] Paragraph .22 of AS 1301.

[25] Footnote 40, page 20.

[26] Paragraph .12 of Proposed AS 3101.

**Question: 3. Are there any factors that the Board should consider adding or removing to better assist the auditor in determining which matters involved especially challenging, subjective, or complex auditor judgment? If so, what are those factors?**

Audit evidence must be appropriate and sufficient; therefore, the factor "[t]he nature of audit evidence obtained regarding the matter" should be expanded to say "nature, extent (i.e., sufficiency) and quality of the audit evidence."

Another factor entering into "matters involved especially challenging, subjective, or complex auditor judgment" would be the complexity, in the auditor's judgment, of the US GAAP accounting required to properly record transactions or an event. This factor would include among other considerations those FASB accounting standards that rely on "management's intent."

Still another factor would be the specific consultation protocols internal to the audit firm, such as when transactions involve complex or innovative accounting issues, or where there are differences of opinion regarding an accounting treatment or a financial reporting matter.

**Question: 4. Are there specific circumstances in which the auditor should be required to communicate critical audit matters for each period presented, rather than only the current period? For example, should communication be required in an IPO or in a reaudit? Why or why not?**

1. The reproposal[27] leaves investors in a twilight zone. An investor does not know why certain CAMs appear in one year <u>and</u> disappear the next year, or conversely.

What should an investor infer if a CAM regarding, for example, a loss allowance is reported for the prior year and is not reported as a CAM for the current year, notwithstanding that the current year's financial statement discloses a much larger loss allowance? Should an investor infer that the audit of the allowance is no longer "especially challenging"? That a different, smarter, more sophisticated audit term replace last year's team? That the company's internal controls strengthened? There is more evidence to support the allowance? That the auditors obtained a greater level of "reasonable assurance"?

Similarly, what should an investor conclude if a CAM is reported for the current year and was not reported for the prior year, notwithstanding the fact that similar accounts or disclosures were made in the financial statements for both years? Of course, any number of subjective factors go into the CAM decision, but what should an investor conclude when the audit report is silent as to the disappearance of last year's CAM? How should an investor interpret this mix of information?

2. One solution is to require CAM reporting for all periods reported on by the auditor. This solution would obviously expand the auditor's report to some as yet unknown size, and will overshadow in length and likely overwhelm the opinion and basis for the opinion paragraphs.

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[27] Paragraph .11 of Proposed AS 3101 requires, "The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements." Paragraph .13 of Proposed AS 3101 requires, "The auditor must communicate in the auditor's report critical audit matters (footnote omitted) relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters."

Where the prior year has CAMs 2, 4, 6 and 8, and this year has CAMs 2, 6 and 10, an investor would not understand why CAMs 4 and 8 disappeared and why 10 is now a CAM, when the account and disclosures for 10 also appeared in the prior year's financial statements.

The solution would be for the auditor to explain why there was no CAM last year but there is one this year, and conversely to explain why there is no CAM this year despite the fact there was one last year.

As said, this would enlarge the auditor's report, but an investor would learn why CAMs are moving in and out of the report. Auditors will need a creative writing course to explain cogently the reasons why CAMs appear and disappear during the three years covered in the auditor's report. This solution is odious and repugnant.

3. The reproposal leaves CAM reporting to the professional judgment of the auditor, thus each year stands on its own with no explanation as to why certain items disappear or reappear. Information asymmetry between the auditor and investors will increase under all of the above-outlined scenarios, and information asymmetry between the company and investors may also increase.

**Question: 5. Are the reproposed requirements regarding the description of critical audit matters in the auditor's report, including the principal considerations and how the matter was addressed in the audit, sufficiently clear for consistent implementation by auditors? Why or why not? If not, how could the requirements be clarified?**

While the definition of CAMs may be "sufficiently clear" to some auditors, because it uses highly subjective terms[28] it is very unlikely that the requirements would be consistently addressed and reported on.

Holding constant the financial statement accounting and disclosures, if three different audit firms (or engagement teams from the same firm) audited the same registrant for the same year, each using their professional judgment in interpreting the reproposal's highly subjective definition, they would not arrive at a consistent application of the standard. The odds would be low that the reported CAMs and the description of the audit procedures will be the same, or similar, for all three firms (or engagement teams).

<u>Identify Each CAM</u>

The reproposal says that "For each critical audit matter communicated in the auditor's report the auditor must: a. Identify the critical audit matter …."[29] Perhaps it would be clearer to say, "The auditor's report a. Must identify each critical audit matter…."

The reproposal cautions auditor's not to be the source of original (and potentially confidential) information about the company stating "When describing critical audit matters in the auditor's

[28] There is little question that all of the following terms used in the definition are subjective: "material to the financial statements," "especially," "challenging," "subjective," "complex," "judgment."

[29] Paragraph 14 of Proposed AS 3101.

report the auditor is not expected to provide information about the company that has not been made publicly available by the company…."[30]

Hence, in identifying each CAM, the auditor is duplicating information investors already have. For example, reading the examples given in the reproposal we see that they do not provide any new information that has not already been disclosed and that is readily available to the investor.

The example for Company A[31] says, "as more fully described in Note 7" regarding the Allowance for Loan Losses – New Loan Product. The auditor's report for Company A[32] then apparently repeats what has been disclosed in Note 7.

Similarly, the Company B example states, "Accounting for Acquisitions Refer to Notes 2 and 13 to the financial statements." The auditor's report for Company B[33] then restates information that is in Notes 2 and 13 to the financial statements, albeit using different words.

**Question: 6. Do the reproposed communication requirements appropriately address commenter concerns regarding auditor communication of critical audit matters, such as: a. The auditor providing original information in describing the principal considerations for the determination that the matter is a critical audit matter or describing how the matter was addressed in the audit, and b. Investors and other financial statement users misinterpreting critical audit matters as undermining the auditor's pass/fail opinion or providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate? Are there other steps the Board could take to address these concerns? If so, what are they?**

<u>Principal Reasons Why the Matter is a CAM</u>

The reproposal requires the auditor's report to "b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter …."

The reproposal illustrates this "principal reasons" disclosure as follows:

> The Company A example says "The principal considerations for our determination that the allowance for loan losses for nine-year auto loans is a critical audit matter are that it is a new loan product with limited historical loss data and auditing the estimated allowance for losses on these loans involved our complex and subjective judgment."
>
> The Company B example says "Auditing the accounting for the Company's 2015 acquisitions involved a high degree of subjectivity in evaluating management's estimates, such as the recognition of the fair value of assets acquired and liabilities assumed."

These two examples illustrate the disclosure of the principal considerations that led the auditor to identify a CAM, and they illustrate that the disclosures do not provide any information about the company that has not been already made publicly available management.

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[30] Note 2 to Paragraph 14 of Proposed AS 3101.

[31] Page 33.

[32] Page 32.

[33] Page 33.

Now that the auditor has repeated certain information that was already in the financial statements, how does the investor actually use this redundant information? See Question 27 below.

Audit Procedures

The reproposal then requires the auditor's report to "c. Describe how the critical audit matter was addressed in the audit …." [34]

Now the investor can read some (but likely not all) of the audit steps the auditor undertook to verify the CAM. See Exhibit 2 for a partial list of some procedures undertaken in response to the IAASBs KAM reporting. After a few minutes reading the audit procedures undertaken by the auditor, some investors will be in a deep sleep.

Investors reading the exposition of various audit procedures will and should believe that the account or disclosure reported by the auditor as a CAM has had much more scrutiny than is "normal" and is therefore is "certified"[35] by the auditor, notwithstanding the auditor has neither said or implied a separate opinion on the CAM, and notwithstanding the report does not contain any language that "could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion…."[36]

The "Unless" Clause

The reproposal states that a CAM "is not expected to provide information about the company that has not been made publicly available by the company **unless** such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit"(emphasis added).[37]

The reproposal provides the following example of the "unless" clause:

> [I]n describing the principal considerations that led the auditor to determine that revenue recognition is a critical audit matter, it is possible that the auditor could provide more information than is provided in management's disclosures.[38]

The reproposed audit report is required to include in the basis for the opinion the following sentence, "These financial statements are the responsibility of the Company's management." In addition, the first part of Note 2 says that that the auditor should not be the source of original information about the company, but when following the "unless" clause the auditor will now

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[34] Paragraph 14 of Proposed AS 3101.

[35] I use "certified" in the old-fashioned, circa 1915, sense, i.e., "WE HEREBY CERTIFY that in our opinion the described CAM correctly presents the account, amount and disclosure communicated in this audit report."

[36] Paragraph 14 of Proposed AS 3101.

[37] Note 2 to paragraph 14 of Proposed AS 3101.

[38] Page 35.

be responsible for financial statement information. Not a desirable consequence of CAM reporting, see Question 10 concerning litigation.

It is not clear from the example audit reports for Company A and Company B[39] whether the "unless" clause was followed; however, Example B discusses the auditors assessment of "revenue growth rates, projected profit margins, and the expected rate of return" of the 2015 acquisitions. This information (likely confidential information and not disclosed by management in any public filing) is viewed as an example of the "unless" clause and would inspire investors to ask for the rates and margins from management – an unintended consequence of this "unless" type of disclosure.

**Question: 7. In addition to referring to the relevant financial statement accounts and disclosures, would it be appropriate for the auditor to refer to relevant disclosures outside the financial statements when communicating a critical audit matter? Why or why not?**

Since I do not support the auditor reporting of CAMs, it follows that I cannot support CAM-type reporting of disclosures, even if relevant, that are outside the financial statements. Auditors should confine all CAM reporting to the audited financial statements, including notes to the statements and related schedules. Opening up disclosure to data or information outside of the audited financial statements is well beyond the scope of the usual audit engagement and the audit report.[40]

**Question: 8. Is it appropriate for the reproposed standard to retain the possibility of the auditor determining that there are no critical audit matters and, if so, require a statement to that effect in the auditor's report? Why or why not?**

There are many reasons for having no CAMs to report. For instance, this years financial statements contain no new transactions, there were no new GAAP requirements to implement, and an experienced audit team staffed the audit and in their professional judgment there were no unusually subjective or complex audit decisions – hence no reported CAM.

The PCAOBs expectation that "in most audits the auditor would determine that at least one matter involved"[41] a CAM, may "pressure" auditors to move at least one account or disclosure into a CAM category to meet the Boards presumption. How difficult would it be to move a subjective audit judgment to a very subjective audit judgment?

The absence of a CAM will be evidenced by the simple fact that there is no mention of one in the audit report. Said differently, the absence of the disclosure of a CAM should tell an investor that there was none.

There is no logical reason for auditors to state that "we did not audit intangible assets" if the audited entity does not in fact have such assets. It follows then that there is no reason for

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[39] Pages 32-35.

[40] If disclosures outside of the financial statements were referred to in a CAM, such disclosures should be considered as audited supplemental information and subject to the audit and reporting requirements of AS 2701 (*Auditing Supplemental Information Accompanying Audited Financial Statements*).

[41] Paragraph .12 of Proposed AS 3101.

auditors to state "that there were no matters that met the definition of a CAM during this year's audit."

Defining a CAM in the auditor's report,[42] and then saying that the matter did not exist is ludicrous. The sentence "We determined that there are no critical audit matters"[43] should be eliminated from any final standard.

**Question: 9. Is the reproposed documentation requirement clear and appropriate? Why or why not? If not, how should the documentation requirement be formulated?**

The documentation required in the reproposal is clear and appropriate.

However, the reproposal's discussion about documentation does not appear to agree with the requirements in the proposal. The reproposal says:[44]

> Thus, under the reproposed standard, auditors would be required to document the basis for the auditor's determination whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved <u>or did not involve especially challenging, subjective, or complex auditor judgment</u>. (Emphasis added.)

While Proposed AS 3101 states:[45]

> Documentation of Critical Audit Matters
>
> The auditor must document the basis for the auditor's determination whether each matter that both:
>
> a. Was communicated or required to be communicated to the audit committee; and
>
> b. Relates to accounts or disclosures that are material to the financial statements involved especially challenging, subjective, or complex auditor judgment. (Footnote omitted)

This proposed language does not require documentation of the basis for matters that did <u>not</u> meet the definition of a CAM. However, if matters that do not meet the definition of a CAM are to be documented, then the documentation requirements quoted above should be clarified.

**Question: 10. What effect, if any, could the auditor's communication of critical audit matters under the reproposed standard have on private litigation? Would this communication lead to an unwarranted increase in private liability?**

For the following reasons, I believe that litigation against auditors and registrants will increase.

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[42] Required by paragraph .16 of Proposed AS 3101.

[43] Paragraph .16 of Proposed AS 3101.

[44] Page 39.

[45] Paragraph .17 of Proposed AS 3101.

At this time, there is no direct evidence for an increase in litigation involving CAMs; however, auditors should never underestimate the resourcefulness of the securities class action bar.

CAMs are prominently set out in the audit report and put investors on notice that in the auditor's judgment the account, transaction or disclosure is material to the financial statements (by definition) and were especially challenging to audit. Therefore, class action lawyers will tag CAMs as potential "red flags" which may provide a road map to probable "smoking guns" and material risks and weaknesses, all required to be documented in the audit work papers.

Assuming a class action lawyer can make a plausible case that their client relied on the CAM disclosures in making investment decisions that resulted in provable damages, and the CAM accounts or disclosures were either misstated or omitted a material fact, the auditors and the registrant will likely then be defendants in litigation.

In addition, there is significant litigation risk when the auditor's description of the CAM does not accurately and completely describe the CAM, or the "principal considerations that led the auditor to determine that the matter is a" CAM, or fully describe exactly how the CAM was addressed in the audit, or does not properly (or inaccurately) refer to the financial statement accounts and disclosures that relate to the CAM.

The reproposal attempts to make the case that CAMs will reduce information asymmetry between the audit and the investors, which will in turn reduce information asymmetry between management and the investor. While this argument is baseless, it could open up another path for class action lawyers to maintain that auditors were somehow negligent (or worse) in fulfilling the desired outcome and goal of reducing the information gap between the company and the investor.

There is also a question concerning whether a CAM is an "opinion" on specific accounts or disclosures versus whether the auditor is making a factual statement in reporting a CAM and the audit procedures undertaken. I do not know whether the Supreme Court's decision in Omnicare[46] regarding audit "opinions" applies to CAM reporting. It is possible that CAMs may not be the expression of an opinion since some of the information comes directly from the auditor and may be viewed as specifically "carved out" of the audit report. The reproposal requires the report to say –

> Critical audit matters do not alter in any way our opinion on the financial statements, taken as a whole, and we do not provide separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.[47]

**Question: 27. How would investors use the information communicated in critical audit matters?**

Question 27 goes to the heart of another significant problem with CAMs. This is the key question, how would investors use CAMs?

Why is it important for an investor to know that the audit team believes the accounting for a specific transaction was particularly complicated and therefore "harder to audit," or the

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[46] Omnicare, Inc. v. Laborers Dist. Council Const. Indus. Pension Fund.

[47] Paragraph .15 of Proposed AS 3101.

valuation of a class of investments (for example, Level 3 fair values) required "complex" auditor judgment in verifying that valuation?

What really matters is that the auditor conducted the audit in accordance with the standards of the Public Company Accounting Oversight Board (United States) and that in the auditor's opinion, the financial statements are presented fairly, in all material respects.

Investors will be directed to read about critical audit matters and procedures that may in actually detract their attention from whatever the real operational issues and risks are. CAM disclosures will produce no (perhaps very little) signal and a great deal of noise, i.e., a low signal to noise ratio. See the discussion under Question 4.

Despite all the discussion and research, no one has yet made a believable case as to exactly how investors will factor the required CAM disclosures into any technical or fundamental analysis regarding how many dollars to invest in a company, how much of the investment to sell, when to buy or just to hold. The reproposal does not say exactly how investors can use these disclosures in their trading strategy or in deciding how to vote their shares.

The reproposal and the investment community have not demonstrated that CAMs would have some direct and objectively measurable influence on investment strategies.

In addition, assuming CAM reporting did have some small value to some segment of the investor universe; this value is diminished because it is historical, after the fact and stale information.

Some questions concerning the usefulness of CAMs –

- How can investors determine which CAM is important and which CAM is not?
- Is a reported CAM a negative or positive?
- Is the description of an account and the five audit steps followed by the auditor (of the seventeen actually undertaken) likely to be important and relevant to the decision to trade in a security?
- Will an investor have better and more useful information and really be motivated to trade a security if all seventeen audit steps were set out in the audit report?
- Which of the seventeen audit steps should the reader focus on?
- How do investors grade the audit procedures reported?
- Should investors feel more secure about the stated account or disclosure because the auditor highlighted that matter for inclusion in the audit report?
- Should investors reading the exposition of various audit procedures believe that the account or disclosure reported by the auditor as a CAM has had much more scrutiny than is "normal" and is therefore is "certified"?

The reproposal never does answer these questions other than to say investors want whatever the auditors see fit to say in the CAM disclosure.

As said earlier, investors will gather information that is more useful reading the Form 10-K and other SEC filings in their entirety, than they can from reading CAMs.

**Question 27 (continued). Would the communication of critical audit matters help reduce information asymmetry between investors and management? Investors and the auditor?**

Asymmetric information occurs when an investor has less knowledge than management about the financial condition, the results of operations, cash flows, liquidity, capital resources, trends, commitments, etc.

Investors must bridge this information gap by deriving information directly from management by reading SEC filings and the financial statements as are available. Investors cannot and should not rely on CAM reporting to reduce this gap.

**Question: 29. Would critical audit matters be useful in assessing company financial performance? If so, how?**

The reproposal does not persuasively present enough believable facts that support how

- most investors would actually use CAMs (Question 27),
- all or most CAMs can actually be used in assessing financial performance, and
- CAMs really reduce information asymmetry between management and investors.

**Question: 30. Would critical audit matters be useful in assessing audit quality? If so, how?**

The reproposal says the reporting of CAMs –

> may … lead to an incremental increase in audit quality[48];
>
> may lead to an incremental increase in the quality of information presented[49]; and
>
> may lead to an incremental increase in audit quality and financial reporting quality, which could increase investors' confidence in the reliability of the financial statements.[50]

However, the above-quoted possibilities are nothing more than conjecture, and it is entirely possible that CAMs will not lead to any increase in audit quality, or the quality of the information provided, or an increase in investor confidence in the reliability of financial statements.

The reproposal says –

> While these studies analyze potential effects of expanded auditor reporting on the perception of financial reporting quality, at least one study analyzes how the IAASBs expanded auditor's report influenced perceptions of audit quality. (Footnote omitted) The authors did not find evidence that key audit matters had an effect on the participants' perception of audit quality.[51] (Emphasis added.)

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[48] Page 3.

[49] Page 76.

[50] Id.

[51] Page 73.

> The second study concluded that additional reporting in the auditor's report can increase investors' attention to financial statement disclosures mentioned in the auditor's report, but that the communication of critical audit matters led to a decrease in the perceived level of audit quality and a perception that the level of assurance provided by the audit was not uniformly applicable across all aspects of the financial statements.[52] (Emphasis added.)

**Question 34. Would the communication of critical audit matters provide a basis on which auditors could differentiate themselves? Why or why not?**

Since the definition of CAMs is entirely subjective, it is possible (but not likely) that some auditors can distinguish themselves through a creative and innovative approach to the expression, or display of CAMs.

**Question: 40. Should the requirements related to critical audit matters not apply to the audits of other types of companies, such as shell companies? (Footnote omitted) Why or why not?**

Shell companies that qualify as an emerging growth company should not be subject to CAM reporting. See the response to Emerging Growth Companies, Question 41 et seq., below.

## Auditor Independence

**Question: 13. Is the reproposed requirement relating to auditor independence clear? Would this information improve investors' and other financial statement users' understanding of the auditor's independence responsibilities? Why or why not?**

Yes, the requirement is clear, but the additional language does little to improve an investors' understanding of the auditor's independence responsibilities.

The heading to the auditor's report says that the auditor is in fact independent when it states "Report of Independent Registered Public Accounting Firm."

The reproposal dictates the audit report to say we "are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB." Rather than communicate independence by inference, the report language would be more informative if it explicitly said "and we are ~~required to be~~ independent with respect to the Company in accordance with …."

The reproposed standard should allow, when appropriate, the report language be modified to include reference to other government agencies that license audit firms and CPAs. For instance,

[52] Page 73, footnote 142.

licensed New York State CPAs are required to comply with the independence requirements of the New York State Rules of the Board of Regents.[53]

## Addressee

**Question: 14. Is it appropriate to limit the required addressees to the shareholders and the board of directors, or equivalents for companies not organized as corporations? Are there other parties to whom the auditor's report should be required to be addressed, and if so, who are they?**

Yes, the addressee should be limited to include both the shareholders and the board of directors. I know of no other party to whom the audit report should be addressed.

**Question: 15. Is it clear how the auditor's report would be addressed for companies not organized as corporations? Why or why not?**

Yes.

## Auditor Tenure

**Question: 18. Should disclosure of auditor tenure be made on Form AP rather than in the auditor's report? Why or why not?**

No. This information has no discernible value to investors.

**Question: 19. Would requiring disclosure of auditor tenure in the auditor's report reduce investor search costs? Why or why not? Should the Board require a specific location for disclosure of auditor tenure in the auditor's report? If so, where and why?**

The reproposal includes many persuasive arguments against the inclusion of this information in the audit report, for example:[54]

- information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about correlations between auditor tenure and audit quality
- [a]cademic research on the relationship of tenure to audit quality has varied conclusions – for example
  - engagements with short-term tenure are relatively riskier
  - that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry

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[53] Specifically § 29.10 "Special provisions for the profession of public accountancy of" Part 29, "Unprofessional Conduct."

[54] Pages 90-91.

   - that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases … [suggesting] that investors view long-term auditor-company relationships as adversely affecting audit quality
   - that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit quality

- it is possible that some investors may draw incorrect inferences about auditor tenure that could have an unwarranted effect on cost of capital
- [it] could also result in conversations that are an inefficient use of management and audit committee time

The reproposal observes –

> While commenters' views and academic research (footnote omitted) continue to be divided on the relationship of auditor tenure and audit quality, the Board is proposing to include auditor tenure (footnote omitted) to make this data point readily available in the auditor's report. Requiring the disclosure of auditor tenure in the auditor's report would ensure that the disclosure is in a consistent location – the auditor's report – for all companies and would reduce search costs for investors and other financial statement users who are interested in this piece of information.[55] (Emphasis added.)

The reproposal does not (a) make a cogent argument as to why it is necessary to make this data point readily available, (b) support the argument that auditor tenure is in anyway useful to investors, (c) allude to the idea that audit tenure has an impact on independence or the "quality" of the audit.

The reproposal expresses the view that some investors may find audit tenure useful.[56] What is missing from the tenure discussion are answers to the questions:

> Exactly why are investors interested "in this piece of quantitative information"? How will investors use it? In what way?
>
> Does it make any difference to an investor whether Peggy Smith LLP has served as the Company's auditor since 2005? Since 1999?

The reproposal provides no answers to these questions and never definitively says exactly what this information about tenure implies.

There is no relationship of audit tenure and audit quality; there is no correlation between audit tenure and independence – so why add this information to the auditor's report when no one has any evidence regarding its significance.

It is also noted that PCAOB Release No. 2015-005 (*Concept Release on Audit Quality Indicators*), neither directly nor indirectly, mentions audit tenure as an indicator of audit quality.

[55] Page 49.

[56] Page 48.

SEC Initiative

I believe that many of the comments submitted to the SEC on its Release No. 33-9862 (*Possible Revisions to Audit Committee Disclosures, July 1, 2015*), which discusses auditor tenure, are relevant to this reproposal.

Exhibit 1 to this letter contains the questions asked in the Release and selected responses to the questions, which provide additional compelling arguments against the disclosure of, audit tenure.

To sum up, for all the above-mentioned reasons, auditor's tenure is neither relevant nor useful to investors, and the reproposal does not support the need for its disclosure.

## Clarifications of Existing Auditor Responsibilities

**Question: 20. Are the changes to the basic elements of the auditor's report to communicate the nature of an audit, the auditor's responsibilities, the results of the audit, or information about the auditor appropriate and clear? Why or why not?**

Related Notes

I agree with the reproposal to require the audit report identify the financial statements as including the related notes, and when applicable, schedules, as part of the audited financial statements.

Error or Fraud

As the release points out, this language tracks the language in AS 1001 (*Responsibilities and Functions of the Independent Auditor*); therefore, I agree with the inclusion of this language in the auditor's report.

## Standardized Form of the Auditor's Report

**Question: 25. Would the reproposed requirements for a specific order of certain sections in the auditor's report and for section titles make the auditor's report easier to use? Should the standard allow more or less flexibility in the presentation of the auditor's report?**

In General

The reproposal maintains –

> … the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report. The reproposed standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.[57]

While having a "uniform approach" initially sounds good, I favor a more flexible audit report. The proposed new headings will easily guide the reader through the audit report without the need for a rigid, inflexible format.

[57] Page 67.

The reproposal argues –

> These enhancements should increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports."[58]

The reproposal provide no evidence to support that premise that an investors understanding of the auditor's responsibility will measurably improve, or that search costs for information in the auditor's report were ever a factor in audit reporting.

Opinion Paragraph

For many years (decades), investors have read, understood and digested the auditor's report in its current form. Reading and understanding the current audit report (which ordinarily, and before CAM reporting) fit nicely to one page or less. Investors have had no difficulty reading the auditors opinion in its current location.

Obviously, if auditors are required to report CAMs, the report will grow to an indeterminate length and moving the opinion paragraph to the second sentence of the first paragraph will relieve investors from having to read further than the pass/fail words. The reproposal does not convincing make any case for exactly how investors will be better served by this move.

As said, I favor a more flexible, less rigid ordering of the audit report and suggest the Board express a preference about where the opinion should appear in the audit report and not mandate its location.

Overall, the PCAOB audit report is substantially different from the IAASBs audit report,[59] and there is no pressing need to have the PCAOB fall into lockstep with the IAASB as to the placement of the opinion language. There is nothing sacred about the IAASBs formulation of the report and there is little gained in having a uniform and inflexible report other than help lazy investors.

Headings

While the heading requirement is not a substantive issue, I support to use of headings in the audit report notwithstanding the following comments.

1. Today, the standard audit report normally 4 paragraphs and some 350 words long. The reproposal adds about another 100 words (without the description of specific CAMs and the procedures undertaken). No one really knows the length of future audit reports if this reproposal is adopted.

2. The reproposal would require section headings telling the reader that they are looking at the "opinion," then further down the page they will be reading the "basis for the opinion", then "critical audit matters" and lastly some other information, (i.e., the audit signature, the auditor's tenure, the location of the auditor and the date of the audit report).

3. The requirement for these headings is viewed by some accountants as a dumbing down of the audit report since it assumes investors and shareholders will not understand the report,

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[58] Page 96.

[59] See paragraph 37 of ISA 700.

have to be told what they are reading and then must be led through it. Again, the current audit report is quite short – do readers need to be told what they are reading? Is the idea here to allow readers of the report to skim it and land on only those parts of the report they may have an interest in? For example, an investor can read the "Opinion," then the "CAMs," and skip the mildly boring "Basis for Opinion."

4. The required headings differ from the AICPAs requirements.[60]

## Emerging Growth Companies

**Question: 41. Should the reproposed requirement regarding communication of critical audit matters be applicable for the audits of EGCs?**

In theory, and assuming the need for and utility of the disclosure of Critical Audit Matters, such CAM reporting should be of equal or greater importance to investors in EGCs vis-à-vis investors in non-EGCs.

As discussed in the reproposal,[61] the JOBS Act requires that rules adopted by the PCAOB do not apply to an audit of any EGC, unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation."

Unfortunately, the reproposal presents no persuasive evidence, empirical or otherwise, that the CAM disclosures are in the public interest, protects investors, and presents no economic analysis (other than mention the associated higher audit costs) as is required under the JOBS Act.

Information Asymmetry

The reproposal asserts[62] that EGCs "may have a higher degree of information asymmetry relative to the broader population of issuers." With regard to information asymmetry, the reproposal references to some stale "research" dated before the 2012 JOBS Act.[63]

One of the objectives of the JOBS Act was to simplify the registration process, reduce the costs and overall burden of financial reporting, and consequently the overall costs and burden of auditing the financial statements.

Like it or not, information asymmetry is exactly one of the objectives, and a by-product, of the JOBS Act. It is well understood that EGCs are eligible to take advantage of exemptions from various disclosure and reporting requirements that apply to non-EGCs including, but not limited to:

1. Not being required to comply with the auditor attestation of internal controls over financial reporting;[64]

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[60] AU-C 700, *Forming an Opinion and Reporting on Financial Statements*.

[61] Page 106.

[62] Page 107.

[63] Footnote 224, page 107. The four articles cited are dated 2000, 1995, 1988 and 1988.

2. being allowed to present only two years of audited financial statements and only two years of the related MD&A, instead of three years;
3. being permitted to present the same number of years of selected financial data as the years of audited financial statements presented (i.e., two years), instead of five years;
4. reduced disclosure obligations about executive compensation, including no Compensation Disclosure and Analysis;
5. not being required to comply with any requirement that may be adopted by the PCAOB regarding mandatory audit firm rotation, or a supplement to the auditor's report providing additional information about the audit and the financial statements (i.e., *Auditor's Discussion and Analysis*); and
6. exemptions from the requirements of holding a non-binding advisory vote on executive compensation and shareholder approval of any golden parachute payments not previously approved.

The reproposed audit report is not the proper vehicle to alter the JOBS Acts built in information gap (asymmetry) between management and investors. Until it has been firmly established that CAMs are truly useful to investors, and that the audit report is the logical and proper vehicle to fix asymmetrical information, EGCs should be exempt from the disclosure of CAMs.

As mentioned in Item 5 above, the JOBS Act[65] exempts EGCs from any future PCAOB rules calling for the expansion of the auditor's report to include a supplemental auditor's discussion and analysis (AD&A) of an EGC. The reproposed CAM reporting closely resembles the PCAOBs proposed supplemental AD&A reporting[66] and, therefore, will be considered an end run around the Section 104 prohibition regarding such reporting by the auditor.

**Should the other elements of the reproposed standard and amendments be applicable for the audits of EGCs?**

Language regarding auditor independence (see the suggested revision above), the addressee, and the clarifications of the existing auditor responsibilities, should apply to EGCs.

The requirement for disclosure of auditor tenure and CAMs should not be required for EGCs, or any public reporting entity.

As stated in this letter, I am opposed to the standardized and inflexible uniformity of the auditor's report imposed by this reproposal including the mandatory requirement that the opinion be in the first paragraph of the report.

I support the required headings to the report.

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[64] Required by Section 404(b) of the Sarbanes-Oxley Act of 2002.

[65] Section 104.

[66] PCAOB Release No. 2011-003, June 21, 2011.

**Should the reproposed requirements be modified to make their application to EGCs more appropriate?**

No.

**Would excluding audits of EGCs benefit or harm EGCs or their investors? Why or why not?**

I do not know of any research or evidence that demonstrates either benefit or harm if CAMs, or auditor tenure, where excluded from audit reports.

As discussed above, by law, EGCs provide much less information to investors than is required by non-EGCs, and auditors should not be assigned by the PCAOB to attempt to fix this information gap (asymmetry) in any way.

**Question: 42. If the Board determines not to apply all or part of the reproposed standard and amendments to the audits of EGCs, would there be any unintended consequences if auditors complied voluntarily? If so, what are they?**

When auditors of EGCs comply voluntarily with a standard that is not applicable EGCs, they run the risk of additional scrutiny and possible litigation. Auditors who make such voluntary disclosures should have answers to the following questions:

- Why were the standards not applicable to EGCs?
- What is the justification for the gratuitous disclosure?
- Does it present litigation or other risks?
- Could the voluntary disclosure be selective, that is, must the disclosures follow the exact requirements of the standard?
- If the disclosure is voluntary, must such disclosures be made every year?

**Question: 43. Are there any other benefits, costs or considerations related to promoting efficiency, competition, and capital formation that the Board should take into account with respect to applying the reproposed standard to audits of EGCs?**

Additional costs to auditors (which will be passed on to their clients) are discussed in the reproposal.[67] As to other benefits, I cannot think of any.

**Question: 44. If the reproposed standard is adopted by the Board and approved by the SEC, how much time would auditors need to implement it? Should the Board consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies? If so, what criterion should the Board use to classify companies, for example smaller reporting companies?**

[67] Pages 82 and 83.

In answer to the last question, not all EGCs qualify as smaller reporting companies ("SRCs"), and a full exposition of these differences is beyond the scope of these comments. However, SRCs are permitted to –

- provide simplified executive compensation disclosures in their filings,
- are exempt from the provisions of Section 404(b) of the 2002 Sarbanes-Oxley Act (requiring an attestation report on the effectiveness of internal control over financial reporting),
- limit the required description of the business, and
- have certain other decreased disclosure obligations in their SEC filings, including, among other things,
  - only being required to provide two years of audited financial statements in annual reports, rather than the three years required of other companies, and
  - are allowed to provide MD&A for these two years.

It is well known that EGCs and "smaller reporting companies" (SRCs) present unavoidable risks to investors and the reduced disclosure requirements may make investments in these entities less attractive to investors.

In sum, SRCs should be considered as EGCs for purposes of applying any final audit standard.

**Question: 44 (continued). Are there criteria other than the size of the company that the Board should consider for a delayed compliance date?**

If CAM disclosure is proven to have real value, then in theory CAM disclosures should be of equal or greater importance to investors in EGCs versus investors in non-EGCs. However, until the Board believably establishes that CAMs are truly useful and that there are in fact measureable benefits to investors by giving investors immediate and sufficient information needed to make informed investment, lending or voting decisions, the disclosure of CAMs should not apply to EGCs or SRCs.

## Internal Control over Financial Reporting

**Question: 23. Should the Board's requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies?**

There is no need to report matters that are not required. Conceivably, there is no limit as to this type of gratuitous disclosure in the future.

* * * * *

I appreciate your consideration of my comments, suggestions and responses to the reproposal and would be pleased to answer any questions the Board or the Staff may have.

Sincerely,

Robert N. Waxman, CPA

(212) 755-3400
rwaxman@mindspring.com

## EXHIBIT 1

This Exhibit sets forth the questions asked in the SECs Release No. 33-9862 *(Possible Revisions to Audit Committee Disclosures, July 1, 2015*), relating to audit tenure and some selected responses to the questions.

**Questions**

The SEC Release asked for comments on the following questions:

**45. Should the audit committee's report include information about the length of the audit relationship? What types of disclosures could the audit committee make in this regard? Should it be just the years of auditor tenure?**

**46. Should there also be disclosure as to whether and, if so, how auditor tenure was considered by the audit committee in retaining the auditor? Should there be disclosure of how tenure was considered in evaluating the auditor's independence and objectivity? Why or why not?**

**47. Would disclosure of auditor tenure be more appropriately disclosed in the auditor's report? Why or why not? Would it be better disclosed somewhere else (such as in a form filed with the PCAOB)? Why or why not?**

**Selected Responses –**

**Securities Industry and Financial Markets Association ("SIFMA")**

We do not believe that the audit committee should be required to provide any disclosures regarding auditor tenure. Such disclosure places an undue emphasis on one factor (i.e., audit firm tenure) and ignores information regarding partner rotation; differences in audit firms' industry expertise and other possibly more relevant information regarding the totality and the context of the audit committee's decision regarding the selection of the audit firm.

**Autoliv, Inc.**

In particular, companies should not be required to make specific disclosures related to audit firm tenure. Tenure is not necessarily an indicator of audit quality or audit firm qualifications since the relationship between auditor tenure and audit quality is necessarily fact and circumstance-specific to each issuer. Requiring disclosure related to audit firm tenure could lead investors to make arbitrary comparisons between companies without further information regarding the background of the relationship between a company and audit firm.

**New York State Society of Certified Public Accountants**

… auditor tenure should not be required to be disclosed as it might imply that there is a correlation between auditor tenure and audit quality or auditor independence. However, if the tenure of the external auditor is to be disclosed, it would be prudent for the audit committee report to discuss how the reappointment of the auditor was determined to be appropriate.

**BDO USA, LLP**

… while investors may find information about audit tenure to be interesting, we do not believe that including such information within the audit report provides the appropriate context for that communication. We are concerned that including such a disclosure in the audit report may infer a correlation between audit quality and audit tenure – a correlation which we believe has not been established.

**Mutual Fund Directors Forum**

Disclosure of Auditor Tenure Is Unhelpful With Respect to Funds. The Release raises the issue of whether disclosing the auditor's tenure might be "a relevant consideration to the audit committee's determination of whether or not to engage or retain the auditor." Whether or not that is true in the operating company context (and the Release concedes that neither short nor long auditor tenure is correlated with audit quality), it is not sufficiently significant for funds to justify highlighting it.

**Deloitte & Touche LLP**

… while auditor tenure is currently disclosed by almost two-thirds of the S&P 100, we have concerns that if the Commission were to require this disclosure, it would suggest that the Commission believes it has a relevance that is not supported by evidence.

## EXHIBIT 2

**IAASBs Standard re Key Audit Matters (KAM) requires disclosure regarding how the key KAM was addressed in the audit (see paragraph 13 of ISA 701). The following is a random listing of procedures found in audit reports reporting KAMs:**

- Our procedures included understanding and testing management's controls around the completeness and accuracy of
- We agreed the recorded amounts during the year to contractual evidence on a sample basis
- Amounts were either confirmed, recalculated or reconciled to
- We performed a retrospective review of subsequent collections
- We tested cut-offs
- We tested the identification and valuation
- We evaluated the competency and objectivity of the third party external appraiser
- We involved our tax experts
- We reviewed the work of the Company's predecessor auditor
- On a sample basis we
- We observed inventory counts
- We conducted additional audit procedures
- We evaluated the Company's policies and procedures
- We challenged management's assumptions
- We involved our valuation experts
- We assessed the legal advice
- We obtained confirmations
- We evaluated the actuarial and demographic assumptions and valuation methods
- We assessed whether the key actuarial assumptions are reasonable
- We validated that assumptions are consistently applied
- We involved our pension experts
- We tested management's controls
- We evaluated the adequacy of
- We verified the accuracy and completeness of (used several times to describe the audit procedures)
- We verified that the valuation of
- We verified the disclosure of
- We substantively tested the accuracy of
- We verified the additional costs incurred of
- We determined that the disclosure is complete and consistent with the financial statements
- Understanding and testing of the design and operating effectiveness of the key
- We assessed the eligibility of the development costs for capitalization
- We have reviewed the design of the key controls identified by management surrounding
- We tested such key controls and performed substantive test of details
- We tested on a sample basis testing underlying evidence
- We evaluated the assumptions and methods used by the company
- We assessed the adequacy of the company's disclosures

- With the assistance of tax specialists, we audited the available tax losses carried forward
- We obtained an understanding of the processes related to revenue recognition
- We evaluated the design and tested the effectiveness of controls in this area relevant to our audit
- We performed a combination of internal control and substantive audit procedures to address revenue recognition
- We performed extensive sales cut-off procedures
- We tested the calculation of the underlying data
- We obtained an understanding of the warranty process
- We evaluated the design of, and performed tests of controls in this area

WELLS FARGO

**Richard D. Levy**
Executive Vice President & Controller

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August 15, 2016

Office of the Secretary
PCAOB
1666 K Street, NW
Washington, DC 20006-2803
comments@pcaobus.org

**Re: PCAOB Release No. 2016-003, PCAOB Rulemaking Docket Matter No. 34**

Dear Members of the Board:

Wells Fargo & Company is a diversified financial services company with over $1.9 trillion in assets providing banking, insurance, investments, mortgage and consumer finance services. We appreciate the opportunity to comment on PCAOB Release No. 2016-003, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified opinion and Related Amendments to PCAOB Standards* (the "Re-proposal).

We continue to support the PCAOB's objective to improve investor confidence and understanding of the audit process through enhanced auditor communications[1]. We applaud the Board's attempt to incorporate feedback on the original proposal by incorporating the consideration of materiality in the identification of a critical audit matter ("CAM") and attempting to limit the auditor's ability to disclose original information. However, the changes in the Re-proposal do not fully address respondents' concerns nor do they provide compelling evidence that the disclosure of CAMs will provide "value-relevant" information beyond what is already publicly available to users. We strongly believe the identification and disclosure of CAMs will almost certainly add significant cost to the audit, create operational issues, and cause problems in the management/auditor relationship.

We question whether there is sufficient basis for the Board to re-issue the proposal given the feedback it received on the original proposal and the limited empirical evidence to support expanded auditor reporting, The Board acknowledged that research on expanded auditor reporting is limited and results are *ambiguous* as to whether expanded reporting has provided new information beyond what is already available in the financial statements. If the Board is unsure of the value of CAMs to users, we do not understand the Board's justification for the Re-proposal based on the hope that users will find information useful once they are provided with it.

[1] We previously commented on the original proposal in our letter dated December 2, 2013 (PCAOB Release No. 201-005, PCAOB Rulemaking Docket Matter No. 34).

We encourage the Board to study this matter further, gather more empirical evidence on the usefulness of the proposal and evaluate the cost benefit implications of expanded auditor reporting.

Although the auditor is not expected to provide information about the company that has not been made publicly available by the company, such information may be provided by the auditor if such information is necessary to describe the principal considerations used to determine that a matter is a CAM or how the CAM was addressed in the audit[2]. This exception language along with the requirement to reference management's existing disclosures provides auditors with undue leverage to compel disclosure of information that may not otherwise be required or necessary. We encourage the PCAOB to clarify in the Re-proposal that that it is not appropriate for the auditor to be the original source of information unless a matter continues to be unresolved with management and the audit committee. Communication to the audit committee of unresolved differences should be sufficient to drive appropriate resolution and adequately protect investors.

In addition, as a consequence of the PCAOB's inspection process, auditors will have a natural tendency to identify more rather than less CAMs. This concern is supported by the impact of PCAOB inspection findings on audits of internal controls over financial reporting, which we, along with other affected companies, have recently discussed with the PCAOB in numerous meetings and forums[3]. We fear the desire to avoid being second guessed by the PCAOB will provide further incentive for auditors to compel management to disclose non-public information, resulting in significant unnecessary cost, time and effort related for preparers. A significant consequence of the Re-proposal is that registrants may be compelled to provide significant incremental disclosures, which is inconsistent with the general disclosure framework for registrants who are governed by SEC guidance when determining what to disclose, rather than PCAOB standards.

Based on disclosures under the relatively recent and similar regulations implemented in the United Kingdom, we are also concerned that CAM disclosures may evolve over time to include subjective information that is not appropriate in the auditor's report. In particular, the 2015 auditor's report for Rolls-Royce Holdings plc has been mentioned as an excellent example by PCAOB representatives and includes subjective assessments such as:

- We found the degree of caution/optimism adopted in estimates…to be slightly less cautious than in the previous year, but balanced overall; and
- …the financial statements have been prepared on the basis of appropriate accounting policies, reflect balanced estimates compared to the mildly cautious estimates made last year…

[2] Note 2 to paragraph .14 of Proposed AS 3101 included in Appendix 1 to the Re-proposal (page A1-9)
[3] Meetings with the PCAOB were held with members of the Financial Executives International Committee on Corporate Reporting (CCR). CCR member companies represent approximately $5 trillion in market capitalization and actively monitor standard setting activities of the PCAOB. Wells Fargo is a member and current chair of CCR.

While these assessments far exceed what is required by the Re-proposal and such disclosures may be unlikely in the heavily regulated and litigious environment in the U.S., it is conceivable that such disclosures could eventually materialize.

We are supportive of the proposed inclusion of a materiality threshold for the identification and disclosure of CAMs. However, until the PCAOB addresses its guidance to the audit firms to eliminate clearly trivial matters from their examination findings it is unlikely to have much effect on balance sheet related matters as long as materiality thresholds for the balance sheet and income statement items remain the same. Moreover, given that matters which are material should already be disclosed in the notes to the financial statements and/or management's discussion and analysis (MD&A), we question how redundant disclosure in the auditor's report is value-relevant.

The example disclosures included in the Re-proposal do not provide compelling evidence that CAM disclosures provide users with value-relevant information. In fact, the example of the allowance for loan losses disclosure only perpetuates the concern that the auditor is providing assurance on a component of the financial statements rather than the financial statements as a whole. Also, the CAM disclosure seems to disclose information that is either not required or necessary. Management is already disclosing any relevant material information in either the notes to the financial statements, MD&A or both. Lastly, it is unclear what incremental value users will derive from the description of procedures performed by the auditors. Given the litigious environment in the U.S., such information will be boiler plate by necessity, i.e., reading legal contracts, tested accuracy of assumptions, and using specialists. It is unclear how this information will help users better analyze financial statements.

Moreover, an audit of a global entity is complex and involves a significant number of individual audit and accounting issues. Many issues that are considered in the normal course of an audit of a complex organization may nevertheless fall within the definition of a CAM given the professional judgments and estimates involved, (e.g., credit impairment, fair value measurements and hierarchy, derivatives and hedging activities, business combinations, etc.). These issues are regularly considered as part of the accounting issue resolution process of a global organization and the potential list of items that satisfy the overly broad definition of a CAM could be endless.

Instead of the disclosure of CAMs, we encourage the Board to consider an alternative that will draw users' attention in the auditors' report on the registrant of the significant accounting policies and estimates in the financial statements and MD&A. This can be accomplished by referencing the disclosure of these items, i.e., location and page number, and including a statement indicating that the auditor's report should be read in conjunction with management's disclosures of significant accounting policies and estimates. This approach avoids the inference that the auditor is providing assurance on separate components of the financial statements and would correspond with areas that receive most attention from auditors during the audit.

It is important to remember that qualified knowledgeable professionals can have reasonably different views, particularly related to assumptions or estimates that require significant judgment, or when an issue relates to complex matters that require multiple discussions between the auditor and preparer, including situations where it is necessary to consult with the auditor's national office. The PCAOB and SEC must acknowledge this reality and ensure that requirements of their standards do not inappropriately subject auditors and preparers to litigation. Introducing safe harbor rules may be a reasonable way to avoid such outcomes.

We also have concerns that audit procedures to address the new standard are likely to occur at a critical time during the audit process and may distract auditors and management from completing other critical parts of the financial statement preparation and audit process. This may involve partner and manager time, as well as national office resources, including input from the registrant's senior management team including internal and external legal counsel, and audit committee members. In some cases, this could result in a delay in filing for certain companies and should be appropriately considered during implementation.

We do not believe that there is any meaningful link between auditor tenure and audit quality and therefore, recommend that this disclosure should not be required in the auditor's opinion. Including this information in Form AP would be preferable to inclusion in the audit report.

We do support the proposal to move the opinion paragraph to the beginning of the report as it is our belief that most readers of auditor's reports are mainly interested in whether a company has received an unqualified opinion from its auditor. We also support inclusion of a statement that the auditor is required to be independent and the added language clarifying "whether due to error or fraud" when describing the auditor's responsibilities.

We appreciate the opportunity to comment on the proposal. If you have any questions, please contact me at (415) 222-3119.

Sincerely,

/s/ Richard D. Levy

Richard D. Levy
Executive Vice President & Controller

**NOTICE:** This is an unofficial transcript of the Public Company Accounting Oversight Board's Roundtable on the Auditor's Reporting Model held on September 15, 2011, that related to the Board's concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript. The transcript has not been edited and may contain typographical or other errors or omissions. An archive of the webcast of the entire Roundtable can be found on the Public Company Accounting Oversight Board's website at http://pcaobus.org/News/Webcasts/Pages/09152011_Roundtable.aspx.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

ROUNDTABLE ON THE AUDITOR'S REPORTING MODEL

Thursday, September 15, 2011

9:31 a.m.

1201 15th Street, N.W.

Washington, D.C.

# PARTICIPANTS

PCAOB Members:

| | |
|---|---|
| JAMES R. DOTY | MARTIN F. BAUMANN |
| DANIEL L. GOEZLER | LEWIS H. FERGUSON |
| JAY D. HANSON | STEVEN B. HARRIS |
| JENNIFER RAND | JESSICA WATTS |
| HASNAT AHMAD | ELENA BOZHKOVA |

Participants:

| | |
|---|---|
| ALAN L. BELLER | L. DOUGLAS BENNETT |
| STEVEN BULLER | JOSEPH V. CARCELLO |
| JACK CIESIELSKI | WILLIAM CLARK |
| J. MICHAEL COOK | JAMES D. COX |
| CHARLES ELSON | MIKE J. GALLAGHER |
| ROBERT L. GUIDO | PAUL G. HAAGA JR. |
| MARY HARTMAN MORRIS | GARY R. KABURECK |
| WAYNE A. KOLINS | STEPHEN KOZERACKI |
| ROBERT J. KUEPPERS | MARK LA MONTE |
| PETER H. NACHTWEY | MARK NEWSOME |
| SAM RANZILLA | KEVIN B. REILLY |
| FLERIDA RIVERA-ALSING | LAWRENCE J. SALVA |

PARTICIPANTS (CONTINUED)

| | |
|---|---|
| MICHAEL SANTAY | KURT N. SCHACHT |
| CHRIS SPAHR | MATT TORREY |
| LYNN E. TURNER | JOAN WAGGONER |
| GARY WALSH | ANN YERGER |

Observers:

| | |
|---|---|
| BRIAN CROTEAU | LAWRENCE W. SMITH |

P R O C E E D I N G S

[9:31 a.m.]

MR. BAUMANN: Well, good morning, everybody. I'm Marty Baumann, the PCAOB's chief auditor and director of professional standards.

I want to thank everybody for coming to this roundtable to discuss our concept release on the auditor's reporting model. This is an extremely important project. Efforts are going on not only here at the PCAOB, but in many other places globally discussing the auditor's report.

And our concept release asked for comments by September 30th. So we're looking forward for comment letters. We have received several and very valuable ones and looking for more. And we're very interested in everybody's comments today.

But with that, let me turn it over to our chairman, Jim Doty.

MR. DOTY: Thank you, Marty.

Today's open meeting roundtable of the Public Company Accounting Oversight Board will elicit the views of 32 experts that we have around the table this morning. You bring here such various backgrounds as investors, auditors, corporate board members, financial statement preparers, and academics.

In this, the third public meeting on today's subject, the PCAOB wants to hear how we can improve the relevance and usefulness of auditors' reporting on the results of their audits of public company financial statements.

I want to begin by thanking you, the distinguished group of participants who have agreed to spend the day with us to discuss the PCAOB's auditor's reporting model project. Your active, robust participation here constitutes the most meaningful public service our society asks.

Because you each have busy schedules and many other demands on your time, the PCAOB's chief auditor, Marty Baumann, who is chairing today's discussion, and his staff have worked very hard to ensure that your time is wisely and productively used here. We have a full day of discussion topics, and I expect it will be lively. I know it will be valuable to us and to the public.

I want to also thank the Securities and Exchange Commission, in particular Chairman Schapiro, Chief Accountant Jim Kroeker, Deputy Chief Accountants Mike Starr and Brian Croteau, for their support for the PCAOB and our inquiry into ways that we may be able to make the auditor's report more relevant for investors.

I also want to thank my fellow Board members for their support for and active participation in this project. And before I turn the floor back to Marty, who will invite fellow Board members to offer their thoughts, let me touch briefly on a couple of points about the concept release.

The PCAOB's consideration of the audit reporting model is intended to confront questions that recur in times of economic crisis. In the concept release, we attempt to identify meaningful opportunities to enhance the relevance of auditors' communications to investors.

Our alternatives aim to enhance relevance and to highlight a statement we made in the concept release -- the alternatives suggested do not aim to change the fundamental role of the auditor to perform an audit and to attest to management's assertions as embodied in management's financial statements.

To be clear, they are not intended to put the auditor in the position of creating and reporting financial information for management. So discussion about that may be very important today.

As the concept release states, the alternatives are not mutually exclusive. A revised auditor's report could include one or a combination of these alternatives, or elements of these alternatives. Discussants may also suggest other alternatives to consider.

We are at a very early stage in this project. The concept release format allows us to frame today's discussion and the broader debate that will play out through the public comment process. It is not intended to lead inexorably to proposed requirements in any of the areas we have suggested.

Proponents of ideas, whether embodied in the release or introduced today, should come forward with evidence and analysis explaining why the idea is worthwhile. Both supporters and opponents of changes to the auditor reporting model should present persuasive support for positions they advocate.

We are in the middle of a long public comment process. I am confident today will not be the last public discussion of the concept release, but I encourage participants and members of the public who are interested in the project to follow up on today's discussion with any additional analysis or evidence they have to inform and help shape this project.

Thank you again, all of you. Thank you for being here, for your interest in the project.

Thanks to Marty and the staff. Marty?

MR. BAUMANN: Thanks, Jim.

Let me now turn it over to Board member Dan Goelzer for some comments.

Thank you.

MR. GOELZER: Thank you very much.

First, I would like to join Chairman Doty in welcoming all of the roundtable panelists here this morning and thanking you for your willingness to provide the Board with your views on ways in which the auditor's reporting model could be improved.

Exploring whether to expand what auditors communicate to financial statement users raises fundamental issues about the purpose of the audit and about what it means to be an auditor. The Board has heard repeatedly that investors want more from auditors than the assurance that the traditional pass/fail report provides. Frustration over financial institution disclosures in the run-up to the economic crisis crystallized that dissatisfaction with the current reporting model.

As Chairman Doty indicated, to address these concerns, the Board's concept release floats a series of alternatives. At one end of the spectrum, auditors might be required to create an auditor's discussion and analysis commenting on such matters as management's judgments and estimates and its selection of accounting policies and principles. The auditor might also be asked to characterize particular accounting and auditing decisions as "close calls" and to describe the underlying issues and risks.

The AD&A proposal rests partly on the notion that auditors had insight into undisclosed risks and dubious judgments on which the pre-crisis reporting of major financial institutions rested and should have alerted investors.

In contrast, other concept release alternatives would expand auditors' reporting responsibilities by building on their traditional attestation role without requiring the auditor to compete with management as an information source. For example, emphasis paragraphs keyed to management's disclosures would be a way for the auditor to indicate the existing disclosures that, in his or her view, are the most significant to understanding the company's financial reporting.

Auditors could also be required to opine on the accuracy and completeness of information outside the financial statements that management already provides, such as in MD&A or in earnings releases.

I have serious doubts about whether financial reporting would benefit from requiring auditors to move from attesting to or emphasizing the importance of information that management presents and into creating their own information about the company's financial reporting. However, as the concept release discusses, even without requiring auditor-created commentary, there is still plenty of room to expand the scope and relevance of auditor communications.

In any event, this threshold issue is one that the Board will have to grapple with as the project moves ahead. I am looking forward to hearing the views of roundtable participants on that question and on the full range of possible ways of making auditor reporting more relevant to users.

Again, thank you very much to everyone for being here, and I'm certainly looking forward to the discussion.

MR. BAUMANN: Thanks, Dan.

Now comments from Board member Steve Harris.

MR. HARRIS: Thank you, Marty, and I will be very brief.

Let me say simply the law states that the purpose of the PCAOB is "to protect the interest of investors and further the public interest in the preparation of informative audit reports." And I stress the words "investors" and "informative."

Investors clearly do not believe the current three-paragraph, largely boilerplate, binary audit report is either sufficiently informative or serves their needs. This is apparent from comments made to regulators both in the United States and abroad in the context of the recent financial crisis.

So the issue before us today is how best to provide the information in a cost-effective and efficient way directly to investors. And by directly to investors, I mean not wholly funneled through management or audit committees.

I asked myself some basic questions. What keeps an auditor awake at night, and what information does an auditor learn from an audit that he or she would want to know as an investor?

Why shouldn't auditors disclose to investors that information and the same significant risks they disclose to audit committees? And since all that investors are asking for is what auditors already know, why can't this be done easily and cost effectively?

There was a time, going back to the days of Arthur Andersen and Leonard Spacek, that the profession embraced their obligation to safeguard investors' interests. I think we need to return to that mindset and provide investors with more of the information they are asking for.

I want to thank Kurt Schacht and Joe Carcello for the surveys they conducted for the Certified Financial Analysts and the Board's Investor Advisory Group, which forcefully demonstrate the desire amongst investors for modernizing today's antiquated audit report.

I look forward to hearing from our distinguished participants, and I thank you, Marty and Mr. Chairman.

MR. BAUMANN: Thank you, Steve.

Everybody should have a package in front of them which includes the concept release, the briefing paper we sent out, an agenda, and various other materials for the day.

I'm going to give a brief overview in a couple of minutes of how we expect this meeting to run and operate today. But before we do that, given the size of the crowd and the distinguished group that we've gathered, I'd like to go around the table and ask everybody to please just take a moment to say hello and introduce themselves.

So I've done that already, and I'll start to my left.

[Introductions.]

MR. BAUMANN: Thank you very much.

If you take a look at your agenda for the day, what we've planned is for each of the topics that are listed there, we at the PCAOB have asked a couple of people to kick off the topic with some opening remarks. After those opening remarks, the floor will be open to all for comments.

I will ask -- I will repeat what we indicated in the briefing paper, that we hope the comments that we get are as specific as possible about the proposals, about your view of the proposed change in the auditor's report, taking into account challenges, implementation issues, as well as what investors' needs are.

But the greater the specificity, the more valuable the input will be to us as we go ahead and think about this meeting and think about future possible changes to the auditor's report.

After the opening commenters speak on each section, anybody who wants to speak please just turn this tent card up on its edge. We'll then make sure we get around and call on each of you to comment and give your views on the specific topic we are discussing.

So, as the agenda indicates, we're starting with the suggested potential auditor's discussion and analysis, then later on moving towards emphasis paragraphs, and auditor assurance in other areas. To the best extent possible, we'd appreciate trying to stay on topic for each of these areas during the morning.

We also have a section later on to discuss other alternatives, but certainly, variations on the theme of the AD&A or variations on the theme of emphasis paragraphs would be welcome during those discussions.

Opening comments will be made by the following participants, just for your information. In the auditor's discussion and analysis, we've asked Ann Yerger to make opening comments. As you heard, Ann is with CII. Gary Kabureck from Xerox, and Bob Kueppers from Deloitte & Touche will all give opening comments on that subject. Again, after that, the floor will be open to all for comments.

In the required and expanded use of emphasis paragraphs, Joe Carcello from the University of Tennessee will kick that off and then followed by Kevin Reilly from Ernst & Young.

With respect to auditor assurance on other information outside of the financial statements, we've asked Mary Hartman Morris from CalPERS to lead the discussion initially, followed by Mike Cook, sometimes audit committee chairman, to follow thereafter.

And then, the final discussion of the day on the clarification of the language in the auditor's report and a further discussion, an open discussion of other alternatives that participants may have, Jennifer Rand from the Office of the Chief Auditor will lead that discussion.

For each topic, we've included questions to be considered. Your comments, when you make them, can be related to the questions or to any other aspect of the specific topic we are addressing. But again, we do ask that you focus your comments on specificity, as we requested in the briefing paper.

The outreach we performed, and many people here were parts of that outreach, greatly informed the concept release, and we appreciate the great participation of many people who were part of our outreach. Outreach gave us a lot of insights into what ways the audit report could potentially be changed, but it's this roundtable and comment letters that we're looking for to really help us get more granular in what those changes will be, as we think of changes going forward.

As a reminder, I just want to repeat one more time that comment letters are due by September 30th, the end of this month. As I said, we've received a number of valuable comment letters to date and hoping to receive many more between now and September 30th.

With that, let's begin starting discussing the auditor's discussion and analysis. The questions we'd like to address in the auditor's discussion and analysis -- and again, we can stay on topic with these questions, or you can think of others -- but include what types of information should an AD&A include about the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A -- audit risk, audit procedures and results, auditor independence?

What types of information should an AD&A include about the auditor's views of the company's financial statements based on the audit? What is the appropriate content and level of detail regarding these matters presented in an AD&A? That is, management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including close calls.

Next, what are your views regarding the potential for an AD&A to present any consistent or competing information between the auditor and management? What effect will this have on the financial statement presentation? And what are the potential benefits and any shortcomings for implementing the AD&A?

So, with that, I will keep these summary questions posted. With that, I would like to turn it over to Ann Yerger for your opening remarks in this area.

Thanks, Ann.

MS. YERGER: Thank you. Good morning, everyone.

Thank you, Chairman Doty, Board members, PCAOB staff, for hosting today's roundtable.

I'll speak on behalf of the Council of

Institutional Investors, that we greatly appreciate your leadership and, indeed, regulatory courage in exploring some issues that have long been debated and that remain very controversial even today.

As noted in the concept release, the quality of the auditor's report has been discussed and debated for decades now. And over the years, a variety of highly respected groups have recommended expanding the breadth and depth of the report.

Calls for reform actually haven't ebbed over the years. In fact, I think we could argue they have intensified in the wake of the financial crisis. Most recently, changes have been recommended by the U.S. Department of Treasury's Advisory Committee on the Auditing Profession; by surveys of members of the CFA Institute, which I am a proud member of; by a recent survey of investors by the PCAOB's own Investor Advisory Group; and by the PCAOB staff's own extensive outreach.

The bottom line is that investors want more information from the outside auditors. Today, an outside audit of a U.S. company may entail thousands of hours of work, involve reviews of financials produced around the globe, and cost more than $100 million. But all the investing public generally sees of this tremendously valuable labor is a few paragraphs of boilerplate language.

The current pass/fail model does have some benefits. It's brief, and it offers clarity, consistency, and comparability. However, today, it is clear that this report no longer adequately satisfies the information needs of investors, the key customer of this work.

An auditor's discussion and analysis section is an ideal approach for enhancing communications between auditors and investors. This supplemental report would maintain the benefits of the current report while satisfying the needs of investors for more relevant and useful information from the auditor.

This approach was supported by the IAG survey, which found that a majority of the surveyed investors believe there should be a separate AD&A section in the 10-K.

I believe an AD&A should include, at a minimum, the independent auditor's assessment of management's critical accounting judgments and estimates. Such disclosure was supported by 86 percent of the respondents to a 2011 CFA survey and 79 percent of the respondents to the IAG survey.

Respondents to the IAG survey also highly value discussions by the auditor of the following areas: first, high financial statement and audit risk; second, unusual transactions, restatements, and other significant changes to the financial statements; and third, discussions of the quality, not just the acceptability of accounting policies and practices.

And I'm not an auditor. I'm not a technician in this space. But I think the feedback from those surveys sort of suggest that investors want a little more color to what the auditors are seeing and what they view about what's being presented in the financials.

Certainly, there are risks to a supplemental report, and the biggest is that these reports would become boilerplate and of little value. Clearly, this is not a desired outcome.

To avoid this possibility, the PCAOB must write standards for this report. However, I also believe any standards must not be overly prescriptive and that all AD&As should be subject to robust enforcement by the PCAOB to ensure that auditors present reports tailored for each company's particular risks, facts, and circumstances.

The benefits of AD&As are many. They would provide investors valued information from an independent expert that is relevant for investors analyzing and pricing risks and making an investment and voting decisions. They would also heighten the perceived value of audit firm work and would give audit firms more leverage to effect change and enhance management disclosure in the financial statements.

The end result would be increased transparency to investors and heightened investor confidence in audited financial reports, and that's a good outcome.

I strongly believe the additional information should come from the audit firms and not management or audit committees. Audit firms are objective, third-party experts that have unique insights into companies, and it is appropriate and beneficial for the investing public to receive more information directly from these unbiased experts.

We would expect that these insights would result in complimentary and not dueling information to that provided by management. This is information that would inform and not confuse investors.

Regarding costs, the information of interest to investors is already being communicated by outside auditors to audit committees. So I do not believe the report should significantly increase audit costs. But regardless, I believe investors would say the benefits of this additional, highly valued information would far outweigh any incremental costs.

Thank you again for letting me participate today, and I look forward to learning from all of you during the afternoon and morning.

MR. BAUMANN: Thanks, Ann, for those very thoughtful opening comments.

I'll turn it now to Gary Kabureck for his opening comment.

MR. KABURECK: Good morning, everybody.

And let me begin by thanking Marty, you and Jessica and the Board, for inviting me to be here. I'm looking forward to it.

This clearly is a very important project and one certainly worthy of significant efforts by the Board and the staff. And I'd also like to actually compliment the authors of the concept release for a very readable, very professional document. It was very well done.

For today, I'll withhold judgment about how truly critical it is for the current standard order report to change. But that said, I do believe it's desirable and useful to do so.

In broad terms, I believe the preparer community will generally support a number of the changes in the concept release, provided the report expansion is reasonably concise and is limited to information about the audit, as opposed to the financial statements.

For example, I believe many preparers would support greater use of emphasis paragraphs, where you talk about critical accounting areas, critical audit areas, and likewise, I think you'd support a lot of potential clarifying enhancements in the release.

Regardless of where this project comes out, however, I think sooner rather than later I encourage the Board to decide what level of audit knowledge should be presumed to be known by the users of financial statements. While I personally believe it's a reasonable expectation that a user should be assumed to be a knowledgeable reader and can comprehend what is meant by phrases such as "reasonable assurance" and "free of material misstatements," the Board may conclude otherwise.

An early determination of what level of audit knowledge should be assumed I believe will greatly aid the Board and the staff in deciding what modifications need to be made to the standard report.

Today, I was asked to talk about a preparer's perspective of the concept of an AD&A. While it's certainly not impossible to do, to the extent any AD&A would provide commentary about a company's financial affairs, I submit that you'll find general opposition from the preparer community for a number of reasons -- some conceptual, some practical.

For instance, in my view, the auditor's report should not be the vehicle to communicate any new information about a company's finances, accounting policies, quality of earnings, significant judgments, conservatism on the account. If the Board or the SEC or the FASB believes additional information is needed, they should make this concern and address it through normal rulemaking processes applicable to preparers.

I think disclosures of a company's financial affairs are the roles of management and the company's board. To require the auditor to provide analysis of a company's financial statements I believe would create some independence and legal issues for the auditors and, let's be realistic, has an awful large number of practical limitations.

For example, auditors are experts in accounting and auditing, not operational and financial analysis, and I don't think we should lose sight of this. I think it's also wrong to assume that an auditor knows more about a client's financial affairs than management, but any rulemaking which requires the auditor to comment on a client's financial disclosures and affairs beyond management's disclosures could effectively put the auditor in that position.

And there is nothing an auditor could disclose that the client couldn't also disclose. Presumably, management has disclosed everything relevant or required. And if they haven't, the auditors have remedies are already available to the auditor.

Let's play this out and assume an AD&A, as envisioned by the concept release, becomes required. I think this creates some other problems you're going to need to deal with. For example, to the extent the auditor's disclosures are different or incremental to management's, how to reconcile and explain computing views.

I cannot envision a case where an adverse or more conservative or controversial disclosure by the auditor will go unresponded to by the client. I just don't see how investors and other users are better off in such situations to have competing disclosures.

We need to be mindful that in some types of AD&A, disclosures may be interpreted as close or contentious calls, when, in fact, this might not actually be the case. Then I would ask what controls and training will there be on the auditor to be balanced in his or her thinking? Will the Board or the SEC provide a set of boundaries and other rules that provide management some recourse?

Despite my reservations, should the Board decide to require an AD&A, I would strongly recommend the auditor be permitted to rely on similar and presumably new disclosures made by management, and it would only be the default answer if management does not provide that information.

I don't believe a goal of this project should be to increase a company's disclosures through new audit requirements. However, should this be the ultimate direction, everyone, in my opinion, is better off served by having expanded management disclosures rather than expanded auditor disclosures.

And my last point just on cost. An AD&A is not going to be free or even cheap. On the contrary, when dealing with external report drafting of this type, this tends to be very expensive time. I personally believe internal audit fees would be better spent diverting the value of this time into increased audit procedures in the high-risk audit areas rather than report writing.

So, in closing, I'll go back to the beginning of my remarks. As a preparer, I can see a number of beneficial changes in the standard audit report, provided a focus of the audit process. I want to reiterate that I believe it's inappropriate for the audit report to communicate any incremental information about a company's accounting or finances.

If such additional information is ultimately considered appropriate, then I think it should be addressed in FASB or SEC standard-setting processes.

So, again, thank you for the time, Marty. Appreciate it. Thank you.

MR. BAUMANN: And thank you for your willingness to make some opening comments, and we appreciate hearing them.

The third person to introduce this is from the audit profession, and that's Bob Kueppers.

MR. KUEPPERS: Thank you, Marty.

Let me take a few minutes to set out my thoughts on this topic of auditor's discussion and analysis, or AD&A. And I think my views are consistent with the views of my colleagues in the other firms here today. Of course, if they're not, they'll let me know that.

But the reason I say that is we've spent a lot of time -- actually, the better part of the last year -- collaborating, working together on the issues of what the auditor report might be, and I think there are a couple of important points to sort of set the stage for our part of this dialogue.

First, I think it's important to understand that the profession is in no way opposed to meaningful changes in the auditor's report. To the contrary, I think responsible changes to improve the relevance and information value of what we produce as auditors is a good thing. That should better serve investors and the other users of our reports as the end product of our work.

In fact, we provided the PCAOB with a fairly comprehensive set of examples in a preliminary comment letter just a week after the concept release was published, showing how reports might change under many of the proposals in that concept release. And now these examples are part of the public record, and I encourage you to take a look of so how might it look if certain of these changes were actually made? Hopefully, that will inform the standard-setting process.

I will tell you this, informing our views, we developed a short set of what we're calling overarching principles, and I think we'll come back to these throughout the day. And I'll be very brief, but I want to cover them right here.

First, we think that auditors should not be the original source of disclosure about the issuer. Management's responsibility should be preserved in this regard. One way to think about it is that we think management should remain the provider of information, and the auditor should be the provider of assurance on that information.

Second, changes should enhance or at least in no way diminish present-day audit quality, and I think changes should serve to narrow or at least not widen the expectation gap.

I also think it's important to avoid investor confusion. Any revisions requiring investors to sort through differences across information from management, the audit committee, and then the auditor I don't think will be an improvement. I think it will create misinterpretation on what it all means, and auditor reporting should focus largely on the objective rather than the subjective.

And finally, I think any changes should be market driven. In other words, they should be called for. What we do that might be different should add value, and I think we have to take note of appropriate cost-benefit considerations.

Now, having said that, while we do not support the changes to require an auditor's discussion and analysis as set forth in the concept release because I think it's contrary to the principles I just covered, I think it's very important to just give you a couple of reasons why we think that's the case.

Now if we become the original source of disclosure about the issuer rather than management, that is fundamentally changing our role, in my view, and I think it could do a disservice to investors and, in fact, create the confusion I mentioned earlier.

We talk about complicated areas like management estimates and the close calls. So, at the end of a robust discussion with the company, the audit committee, and the auditor, a decision is made, but it's in some nebulous category called a close call. Does that mean that that was not a good decision? Does the decision that was made that was not a close call, is that somehow qualitatively better than the one that received more attention?

The truth is that the -- when you talk about quality of accounting, variability of estimates, that is the subject of a two- or three-way dialogue with the audit committee, and I find that that process works very effectively. It is hard to capture in a report the essence of a dialogue that happens through the course of an entire financial reporting cycle, and I just don't think it lends itself to a meaningful reporting model that could ever capture the insight or the value of that.

So the audit committee, the knowledge of the management, the knowledge of the financial reporting process, and the oversight that they exhibit throughout an entire cycle is something that doesn't lend itself to a few paragraphs in a written report.

I think it also changes us, changes our role from being objective to subjective. Our work has a lot of subjectivity, a lot of judgment. When you take that and then have another layer of that in the reporting model, I think you will not find comparability across reports from the same firm. You will not find comparability across reports from different firms in the same industry, and I'm not sure that we, at the end of it all, would say that we have actually improved the system.

And I hate to mention it, because it sounds self-serving, but time is a problem. The current reporting deadlines that we face, I can only tell you, and I'll be sort of gentle with this, it is extremely difficult to get it all done, wrapped up, get our papers ready for inspection, everything that has to be done, all within a very compressed timeframe.

And with some of our new standards, including new standards for engagement quality review, the pressure just keeps building, and I think this kind of a model would add to that.

However, I think we should very carefully keep in mind the problem we're trying to solve. If disclosures are not adequate for the purpose of the users, the investors, the requirements for those disclosures should be changed. Whether it's the management's discussion and analysis, whether it's financial statements themselves, if we're not meeting the needs of investors, that issue must be addressed.

And I think there are some very good ways to do that that will give investors what they say they are lacking, and I think management is in the best position to provide those enhanced disclosures that we remain in the best position to provide assurance on those disclosures.

And I think some of the disclosures that are on the table today, including emphasis of a matter, some of the potential for assurance on other parts of the document, I think that will come out in the course of our dialogue today.

Let me just close by saying I've been around this process from the day that the doors of the PCAOB opened, and I must tell you, Marty Baumann and his staff have done an incredible job of outreach ahead of the concept release. It's sort of unprecedented. I mean, it went on for weeks, months, I'm not sure.

But having participated in that process, this is one of the healthiest, most informed concept releases you've ever done, and I encourage, as you go forward, to the extent you have the will or the time, to continue that process. I thought it was just excellent.

I look forward to the discussion, and I'm happy to answer questions.

Thank you, Marty.

MR. BAUMANN: Bob, thanks for your opening comments.

I will say during the outreach -- and please, I hope to start seeing tent cards turning up on their edge in the near term. Otherwise, I have to keep talking. Certainly, during the outreach, investors were very strong in their views and amongst a broad group that they needed to hear more from auditors than the standard report that Ann made reference to in her opening comments.

And different terms were used by different investors of what they wanted, but the essential issue was it was simply lacking during the financial crisis and over the years in terms of not understanding that there were certain issues that were borderline on the edge and, at the end of the day, could have caused -- would have informed them better had they known about that.

So those are strong views from investors, and we wound up calling it AD&A in the press release. That term "auditor's discussion and analysis" wound up being used a lot, but the concept was hear more from the auditor about the types of issues that are discussed with the audit committee. We did hear some concerns from the auditors, et cetera, about some of the problems with that, including timeframe.

So, with that, I'm glad to see cards. Jessica, you were up first. I think Mike Cook may have been up first. So we'll turn to Mike.

MR. COOK: Thank you, Marty.

And my sentiments to you and the staff as well, as have been expressed by others. Appreciation for a very thorough and open-minded approach to a subject that has been studied rather extensively for a rather long time.

And maybe I'd just offer one historical sort of perspective on that in that the auditor's report has changed some over the years. We've modified references to uncertainties. Where we used to have "subject to" opinions, the going concern has changed, the use of emphasis has changed. There have been some modifications, but the core of the report and the pass/fail characteristic is not substantially different than what it has been for a long time.

There is one thing, though, that I think has changed dramatically during that period of time that should be thought about when we analyze whether or not the auditor's report needs to be changed, and that is the emergency and growth of audit committees. Audit committees did not exist in many instances in the early stages of some of these studies that we're talking about.

I can remember being on the Auditing Standards Board 35 years ago when we took up this subject, and it's been lots of folks have had a go at it since then. So it's not an unfamiliar topic.

But the point being that audit committees are there for a reason, and one of the principal parts of the process that the audit committees are engaged in is a very robust dialogue and communication with auditors and with management, with others who participate in the process. And lots of what we're talking about here that we might be thinking about putting into an auditor's discussion and analysis doesn't end up in the same environment where there is an open discussion among people in person, live, free flowing.

Stating some of that same information is the notion that, "Well, if you say it to the audit committee, why not say it to the investors?" doesn't really comprehend, I don't think, the discussion and the give-and-take and all the effort that goes in to the close calls and things of that kind.

So one thing I would ask, I thought this would be better at a gathering of the American Medical Association. But nonetheless, I would say, as I think I've said once before, let's be sure we don't do any harm. Do no harm here to other communication processes that are emerging and growing and getting better all the time and are working quite well.

And when you get into some of the notions that are being expressed in different ways and what we have before us today, such as all communications from auditors to audit committees need to be in writing and communications from auditors to audit committees ought to be, in turn, communicated to the public. We start putting those pieces together, and we will drive communications between auditors and audit committees with management back, light-years back from where it is today and take out of the process what I think makes the process really work.

So I would make a plea on behalf of audit committee members and people who are working very hard at this to not be so quick to dismiss the effectiveness of that role in the process and leap from the auditor to the investor as if the audit committees were not actively engaged in the middle.

And I know you have a separate project on communications with audit committees, and perhaps a high degree of coordination between these two projects might produce a better end result for everybody than we might otherwise get.

I'd like to just make an observation about the auditor's discussion and analysis. I think we're all speculating as to what it might turn out to be.

And I, for one, if I was a betting person, I would put all my chips on the boilerplate number, whatever that might be, as opposed to betting that this will turn out to be a free-flowing, open, effective communication because I don't see how you can overcome the potentials from inconsistency from person to person, from company to company, from industry to industry, from firm to firm.

And to the extent we end up with something which is very different from company to company and firm to firm and so on, I think the inconsistency of that and the confusion that that will create, perhaps almost chaos that that will create, would detract so much more than any benefit that would be derived from it.

So if you end up with speculation A, boilerplate, probably not a great deal of harm, just cost with no benefit. If you end up with the alternative, I think you end up with a potential for substantial decline in the overall quality. so I would suggest we need to be very careful at what the standards are and agreeing with Ann saying they should not be prescriptive. But at the same time, this can't be a free-for-all.

And I would urge one thing, and that is if the inclination is to move forward with AD&A that, in addition to the great outreach you've done up to now, this needs some serious field testing because I think the issue of timing, which Bob points out is critical; the issue of how management will interact with what the auditor is saying in the discussion and analysis; the what the content is going to be, what is it going to look like, how is it going to be presented should not be done in a vacuum.

So I'm not a fan of this. I'm not enthusiastic about it because I still believe the boilerplate is going to win out in the end. But if we are going forward, I would say do so with great care.

MR. BAUMANN: Thanks, Mike.

And I can assure you that the staff and the Board will certainly encourage us to work with due care on this most important matter, and we'll continue to, hopefully, go about this with the thoughtful way in which many of you have complimented us for moving along so far. So thanks for those thoughtful comments.

I'd like to turn to Joe Carcello.

MR. CARCELLO: Thanks, Marty.

First of all, I think Ann did a wonderful job of laying out the case for AD&A. So I won't reiterate what she said, and I thought Gary and Bob and Mike's comments were very good, very thoughtful. I disagree with much of it, and I could try to rebut it, but I won't do that at this point.

I do want to point out -- since in this forum in the past at times I have been critical of the profession when I think their performance has fallen short, I do want to reiterate or second what Bob Kueppers said about the CAQ comment letter, and I've said this to Sam and others in other public forums, I think it's actually a very good comment letter.

The profession has gone further than I thought they would. Not as far as I'd like to see them go, but further than I thought they would. And in particular, Marty, I would point out to you in Exhibit A, Item Number 4 on page 4, I think is quite good. I think that's the kind of information that investors are really driving at. So I give the CAQ and their members credit for that.

But what I want to talk about very briefly is we're hearing a lot today, and I think this is really one of the essential issues -- maybe the most essential issue -- is that auditors shouldn't be --

MR. BAUMANN: Just as an aside, that Exhibit A is not something that everybody has in front of them. You're referring to the Exhibit A to the CAQ letter.

MR. CARCELLO: CAQ comment letter.

MR. BAUMANN: That's not in front -- it's on our Web site, but it's not in front of everybody today. I saw some people looking through their folders.

MR. CARCELLO: That's right. It's not in

front of everybody today.

The essential issue is whether the auditor's role in doing more direct reporting is appropriate or inappropriate, and I think that's probably the major source of tension. So I just want to do -- very briefly make a couple of comments not from Joe Carcello, but from the profession itself.

And so, I have a comment here. This is from testimony before ACAP by Dennis Nally -- Mike, your boss, I guess, or one of your bosses -- the chairman of PWC International, who stated, "It's not difficult to imagine a world where the trend to fair value measurement leads one to consider whether it is necessary to change the content of the auditor's report to be more relevant to the capital markets and its various stakeholders."

And in the white paper that the CEOs of the six largest firms produced in 2006, they stated, "The new reporting model should be driven by the wants of investors and other users of company information."

Also in that same white paper, they stated, "Given our independence and experience, we, the auditor, are in an ideal position to provide value to investors throughout the world." We agree with them. We agree with them.

The last thing, and this is from a book written by Sam DiPiazza, who is a former CEO of PWC and one of his colleagues, and I'm quoting now from this book, "Making the future better requires responding to the market's demand for audit opinions that say more about the information on the health of the business. Today, a great deal of this information is already reported by management and for certain purposes is considered in the course of the audit, including such issues as management estimates, the possibility of fraud, risks, liquidity, and future scenarios.

"The audit opinion" -- I'm still quoting. "The audit opinion could be expanded to address this information, as well as how all the pieces fit together as a whole."

So we're in agreement with everything I've just said there, and I guess my question to my friends in the profession is what's changed?

MR. BAUMANN: Joe, we appreciate those comments and all of the research that you've done on our behalf. And we'll look forward to your ongoing research to support our efforts.

I'll turn to Mark Newsome.

MR. NEWSOME: Thank you.

The first thing from my perspective over the years is the audit opinion generally has not provided much value. I typically look to see if it was unqualified or not and if there was something added after that, you know, some type of change in accounting policy.

And so, when I started to think about this invitation -- by the way, thank you for inviting me -- I started to think about what would be nice to see in an audit opinion and what I've seen through other channels in my investing career.

And so, the first thing is I think about what and auditor did review, right? An example might be, as an analogy, a legal opinion that I might see in a private investing transaction. There's a negotiation that takes place where the company's counsel will provide an opinion and explain what they reviewed and what they did to come to that opinion.

When I think about close calls, I think about not necessarily a contentious situation or, "Boy, that was a close call" type of conclusion. But I think about the range of possibilities that might have been discussed.

For example, if you're talking about a particular figure on a balance sheet, was the probability chosen equal among five possible outcomes, and they settled on one? So then, maybe the auditor should discuss the fact that there was a wide range of possibilities that were relatively equal and potential conclusion.

When I think about coming back to the unqualified opinion, I think about accounting due diligence reports that I've seen where, let's say, an investor would hire an auditing or accounting firm to render some form of opinion on a company's financial profile. And those reports are generally rich in information, and they provide a lot of value, whereas the audit for public and private companies opinion does not.

And then when I think about the boilerplate comments, my opinion of companies across my career is that each one is different, even within a small peer group where companies do generally the same thing. And I know that the management financials, not necessarily the audited financials, the management financials are generally different from company to company.

And so, if that's the case -- and I encourage management teams to use their own style because I believe the financial statements are a tool to help me understand how they run their company. And so, if management financials are different even within peer groups, then why should the audit opinion be identical for companies within a peer group?

And so, I have lots of other comments, but let me stop there and, again, thank you for the opportunity.

MR. BAUMANN: Thank you.

Steve Buller?

MR. BULLER: Thank you, Marty, and thank you for inviting us to speak this morning.

So I have a number of general observations and then a few specific observations with respect to the questions you've asked.

So, as part of BlackRock, we actually polled the analysts globally to get their input from our firm and also our preparers. So BlackRock preparers roughly -- it is subject to audits on roughly 3,500 sets of financial statements between the corporate entities we have and all the funds.

I was afraid for a while, as I was getting these very passionate views on both sides, that I would be issuing the reciprocal of the SEC disclaimer that the opinions were those of my company and not my own. But we've reached some agreement where they actually are my opinions also.

As part of our challenge in issuing all these statements, many of our statements that we have are SEC registrants, and particularly on the fund side, and those statements are included in the financial statements of other nonregistrants in the U.S., as well as local registrant and nonregistrant entities overseas.

So one of our general observations is that we really believe it's important that as part of this undertaking, which we believe is important and very useful, that there be a collaborative effort between the PCAOB, the AICPA, the SEC, the FASB, and certainly the IAASB in making sure there is some alignment to the extent possible in the audit opinion effort because we think it might be difficult for many of the users of our statements, who are global users, to see different sets of opinions that might have different levels of content. So, to the extent that those can be developed in a parallel fashion, that would certainly be useful.

So, in addition to that kind of global perspective, we also believe, and I think Bob made the comment from D&T, that it's important to have statements around objective as opposed to subjective information where possible. And we believe there are a number of objective criteria in the A&A which do benefit from comment.

And thirdly, again, a comment made by several people is it's important that management, where possible, be the original source of disclosure about the company. And again, we think there is value to having a review by the SEC and other entities in the materials that are contained in S-K to see if some of those should not, in fact, be moved to S-K because some of the disclosures that now are being made or should be made perhaps in MD&A could be subject to auditor oversight and, therefore, a higher level of assurance by the user.

So, with respect to some more specific comments, we do believe that the AD&A could be a useful tool, but there should be some parameters around the content of the AD&A. And among those are I think that it would be useful to have information on -- pointing on significant new accounting principles and whether they are preferable in the context of authoritative and regulatory guidance. So, again, something that is subject to a specific definitive benchmark, as opposed to a subjective determination.

We also think that our users in particular felt that there were a number of situations where they would have benefitted from additional information on going concern entities. So they thought that whether our issues involving uncertainties, that those -- the insight on those uncertainties, declining or concentrated cash flows, upcoming material financial obligations, changes in other characteristics of the operations of the company, that insight, if not communicated by management, would be very helpful to have in the AD&A.

There also are some areas related to auditor independence. And so, we think the AD&A could benefit from a couple of different segments to it. One is general observations on audit procedures, some on the company, and then on auditor independence because not all aspects of auditor independence are, in fact, disclosed in a proxy.

So we, of course, have our audit fees

disclosed in our proxy. We have a number of related party arrangements, including audits of our funds that we sponsor, that do not appear in the -- the fees don't appear in the proxy or other disclosures. And we think it's important for investors to have some perspective on the overall relationship that the auditor has with a registrant, which may be both direct through the fees paid by the registrant as well as indirect through those services provided to affiliates and related parties that can be audit and not audit services that could bear upon independence.

We also think it would be important to have information on the tenure of the audit relationship, again as part of that overall disclosure in the AD&A.

We think that there are some areas that, again, would be helpful to investors, and that would be disclosure of audit procedures and material errors. Now this is a catch-22 because we don't want the AD&A to be a 45-page document talking about every specific procedure performed.

But we do think that there are material errors where at least it would be helpful to allow the investor to have some insight into those significant judgments regarding uncertainty with respect to some of the sensitive areas like fair valuation, review of the impairment of intangible assets, loan loss reserves, tax uncertainties, all those things which have been the flashing red lights in the reports over the past several years.

We would not object to the identification in AD&A of those areas which were -- where there is significant management or auditor judgment or significant uncertainty, given their complexity and, as part of that, the attendant disclosure of some of the key inputs upon which the auditor relied.

And again, part of the thesis that we believe, which is based upon the need for management to make original disclosures, we believe that will in part force management to enhance their disclosure and their financial statements, as opposed to having the auditor talk about their key inputs. Because we believe that many of the key inputs that the auditor uses in performing their procedures also are the same key inputs that are used by management. Not in all cases, but we believe those would benefit from that.

Responding to the comment on close calls that was made, and I forget who made that, we really do not support disclosure of close calls because it almost has a pejorative nature to the assertion because it sounds like that there is a toggle point, and that toggle point is a close call when, in fact, the very nature of preparation of financial statements involves estimates and a level of uncertainty. And it would be perhaps misleading because it almost implies that there is a failure to adopt proper accounting principles or the failure to have an appropriate determination on the accounting issue.

So we believe there are other ways to communicate that. One of those is in the MD&A section, many firms are encouraged by the SEC literature to include ranges around estimates. We believe that that literature should be clarified to make it clear that information should be prepared by the registrant, included in financial statements to provide more insight on the nature of that uncertainty, as again opposed to a statement by the auditor that there was a close call may imply that something is wrong when, in fact, all there is, is a determination made around a range of possible outcomes.

Again, I think in the MD&A, it's important to the extent that there is also forward-looking information that that forward-looking information be made by management and that the auditor be restricted to objective comments and does not go beyond those points.

And I think those are probably the significant statements that we'd like to make.

Thank you.

MR. BAUMANN: Thanks, Steve.

Can I just follow up a little bit, just want to make sure I was clear on the point you were making on the insight with respect to judgments and estimates. Were you talking about the insight with respect to what audit procedures were performed by the auditor on those judgments and estimates, or about the auditor's insight as to the quality of those judgments and estimates made by management, or both?

MR. BULLER: So it would be based upon to the extent that there are audit procedures performed, it would be clarification around those procedures performed. So it, in fact, points the reader to understanding that there are areas of significant judgment.

That to the extent that there were inputs that were used in making those determinations by the auditor, potentially disclosure of those inputs so the reader would have some understanding of the basis upon which the auditor reached their conclusion.

MR. BAUMANN: Thank you.

Just so those whose cards are up, brief order I have right now is going to be Bob Guido, Jack Ciesielski, and then Mike Santay. And now I do see other cards up, but just knowing you're going to be called on.

MR. GUIDO: Thanks, Marty, and I appreciate the invite.

Many of the things that I'll mention have been addressed by a lot of you already. I'm all for changing the auditor's report in a very professional way. I've been dealing with the expectation gap for nearly 45 years, both from a public accounting standpoint and the last 5 1/2 years as an audit committee chair.

But again, I'll -- not quite as long as Mike Cook, by the way. But having said that, I do agree with what Mike said. And Steve, some of your comments just now, I do agree with.

I might start off by saying that in my mind, the auditor's report provides assurance that the financial statements are presented in accordance with GAAP. I really believe that provides a lot of value. So I personally take exception to anyone who doesn't believe that.

The audit is historical. There's no question the opinion is a point in time. It's not predicting the future. And if we need to focus more on the future, then we need to change a lot more.

I would say that in Mike's summation about audit committees and usefulness of audit committees and what they really have been doing -- and I've been a little bit spoiled in the profession because I had some great audit committees that I worked with. Then I had some not so great ones in the '70s and '80s.

But Sarbanes-Oxley really changed the game plan, and a lot of great things came out of Sarbanes-Oxley, in my mind. And the audit committee arena, which Mike mentioned and I fully agree, really needs to be studied more, where we are and where we're going, because there's a lot of great things happening, in my experience, with audit committee and audit committee institutes across the capital markets.

Today's markets, I would also say, are much more sophisticated, and the investors, institutional investors, the analysts that I deal with ask great questions. Their predictive models are wonderful.

However, as an audit committee chair, I really am concerned that many suggestions in the AD&A could make the committee's oversight of the audit and communications with the external auditors much more difficult without providing the promised benefits to the ordinary investors. Providing investors with the same information that is provided to audit committees without the context obtained from a two-way dialogue may be incomplete, generate, in my mind, greater confusion, and not enhance the overall understanding of the readers of such a report.

I've also great concern that the notion of an adoptable report that he or she could tailor to a company's specific risks, facts, and circumstances. This, in my mind, would lead likely to an administrative nightmare in trying to wrap up an audit, given that each report would be custom made and would likely have to be cleared with the national office, accounting and auditing experts, let alone legal.

The resulting report, in my mind, would be extremely long and complex. It would probably lack comparability with other companies and would likely not be in a format that easily can improve communications with users. And again, remember, that's what we're trying to do here.

And last, but not least, I have a real concern that at least in my boards, I want the audit partner to really focus on the risk and the complexity of what they're doing and prove audit quality and not worry about haggling over a lot of words. And I'm very concerned about that.

Thank you.

MR. BAUMANN: Thanks very much, Bob.

You've probably been observing the same thing, but I just want to maybe summarize a little bit because I'd be interested that as you are making your comments, those who think an AD&A is a good idea, those who seem to have expressed concern about it during this session have talked about timing and how it could impact 60-day reporting deadlines at year end.

The fact of a lack of context maybe that the two-way dialogue had between audit committee members, or three-way -- audit committee members, management, and the auditor. And some concerns that those who were expressing that about inconsistency, since individual partners would be writing the AD&A, inconsistency within a firm, I guess, with respect to various clients and then certainly between firms and industries. And those are some of the concerns being expressed, and we heard those in our outreach.

And I guess to the extent those who have their cards up who think AD&A is a good idea, how do they think that we could work around that as a concept? So please comment on whatever you want, but I just -- those are some consistent themes I hear, and I just am interested in those who have -- believe the AD&A is a good idea maybe to comment on those.

As I said, Jack Ciesielski was going to be the next commenter.

MR. CIESIELSKI: Thanks, Marty.

If I could just tack on to what you just said, obviously, I support the AD&A concept, but I don't think that it has to be a replacement for the audit opinion. It's a supplement. Therefore, I think you could expect to have variability from client to client and within a firm.

If you think about the MD&A as a model, the MD&A wasn't exactly, I think, welcomed by companies when it was first initiated. But it's evolved and developed, and it's not a bad framework for thinking about the AD&A. It's custom tailored to each individual company. There really isn't much comparability from one MD&A from one firm to another, and I don't think investors would expect one AD&A to be the same for two companies in the same industry, even if they're audited by the same firm.

The way I read the concept release and the understanding that I have of what an AD&A should be is a communication between the investor and the auditor. And I think when we start worrying about having competing disclosures with management's disclosures, I think we're muddying it up a little bit because it's really quite clear in the concept release that this is not intended to contradict or supplement the management disclosures. It really should be about the relationship between the investor and the auditor, which you don't get much of in three paragraphs right now.

I think, actually, if you're going back to the analogy of the MD&A, one place that auditors typically begin their audit is with an assessment of the risks within the company in the operating environment they participate in. So I think it would be very useful for an investor, just to throw away -- getting away from the close calls issue, but what would be good for an investor?

I think it would be good for an investor to understand how the auditor assessed the risks within the firm before they began the audit, how the economy, how their competitors might have effects on the assets and liabilities of that particular company.

There could be competition that's making their product obsolete. It might encourage the auditor to expand their testing of inventory or accounts receivable because maybe their products that they've already shipped are already obsolete, and they have problems with customers.

But understanding the environment that the company operates in is central to the audit, and sharing that assessment with the investor would be useful from a very broad, high-level kind of assessment, and that could be communicated and how that affected the way they performed the audit.

I don't think that the investor wants to have an audit program in an AD&A, but I think they want to know why the accounting principles employed by one company are sufficient. Not just because they're in GAAP, but what makes them preferable?

If I could give an example that's something happening right now? We've had pension accounting for about since 1988 that's a confluence of many deferred losses, deferred gains, all kinds of stuff amortized into pension costs.

Lately, in the past year, we've had companies, within the confines of GAAP, starting to use much more stringent accounting on pension by getting rid of deferred losses that they would otherwise amortize. You have some companies that you have the same audit opinion on both sets of pension accounting principles used.

One is preferable to the other. There is preferability letters for those companies that make the changes, but you don't see that in the audit opinion. It just says it's presented in conformity with GAAP.

I think investors would like to know more about the accounting principles being used, why they're preferable, why they're doing a good job of describing the economics of the firm. And I think that's the kind of thing they'd really like -- that investors would really like to see more of in an AD&A than just near death events, or close calls, whatever you want to call them.

So, that said, I just want to address one theme that was recurring in some of the earlier remarks about costs. Audits today are still a bargain. In the last 5 years for the S&P 500, the total change in the audit fee has been about 5 percent since 2006 through 2010. That's not much.

And in fact, there's in the S&P 500, there is 371 CEOs whose pay was greater than the entire audit fee. So you can think what you like about CEO pay, but it's making the audit fee look like a relative bargain in terms of the work that's done for the investor. I don't think I've ever heard investors complain about the size of audit fees.

And I think if you give them something more in the audit opinion with an AD&A or any of the other avenues that we're going to explore today, I don't think they'll complain about an increased fee either. So I know that that sits well some folks and not others, but the investors are the ones ultimately footing the bill, and I don't think they'd mind.

What else? That's all I've got for right now.

MR. BAUMANN: Thanks, Jack.

And let me turn to Mike Santay and then

Charles Elson and Kevin Reilly and then Flerida Rivera-Alsing.

MR. SANTAY: Thanks, Marty. And thanks, Jack, for your comments on audit fees. We appreciate that.

MR. CIESIELSKI: Thought you would.

MR. SANTAY: We understand investors are seeking more information, and the auditors need to bring more value, and we agree with that. We also agree with the earlier comments that the auditor should not be the original source of some of this information that might be contemplated for the AD&A. We don't think that's operational, as it's currently positioned.

Whether the auditor is the asserter or the attester, the end result should be the same. That is, the information that's presented should be accurate and useful in allowing the investor to make their decisions in evaluating the financial statements and the disclosures.

We believe that the auditor is in the best position to be the asserter in this model, and it's consistent with what their training has been and what their role has historically been. To provide subjective assumptions about the financial statements in an AD&A we believe has a high risk of calling into question the overall opinion that -- the GAAP opinion that they're providing.

We had analogized that to situations where the auditor is faced with a qualification of their opinion. You know, in those situations, the auditor does become the asserter. They need to -- they have a requirement to disclose what management has not in a qualified opinion. So, from that perspective, the AD&A could be construed as somewhat of a qualification of the auditor's opinion on the financial statements.

Now it strikes me that what the key disclosures are is what management -- what keeps management up all night and why? And that should be the basis for the financial statements and some of the subjective analysis that we've been talking about here.

And as it relates to opportunities for

improvement, I think we'll get into that in some of the other areas as we talk through the day, particularly auditor involvement in other information. We talked about critical accounting estimates. I think we'll talk a little bit about some of the auditor involvement in perhaps interim information and others, and I think that's going to be important.

But I think providing the auditor specific views as it relates to the subjective assessments we think would be problematic.

Thank you.

MR. BAUMANN: Okay. Thank you, Mike.

Charles Elson?

MR. ELSON: I take just a slightly different tact and look a little bit more at sort of the governance implications of -- general governance implications, I think, of the proposal. I mean, no one can be against increased information and transparency. That, in and of itself, is a good goal. But I think sometimes you also have to look at the side impacts of what you're attempting to do.

What you've seen in the last 10 years since Sarbanes-Oxley has been a tremendous change in the nature of the audit committee. I mean, 20 years ago, the audit committee was really the place you put people who you really didn't know what else to do with, and it was the worst place to end up. Perhaps it still is.

But you've seen a real professionalization of the committee itself, the idea of the financial expert on the committee, the idea of financial literacy on the committee. And it's really changed dramatically. I mean, the notion that you have retired auditors chairing committees is a new concept and I think have been a very helpful concept.

And the role of the committee itself has changed in that the committee today engages the auditor. Where 10, 15 years ago, it was management who, effectively, hired the auditor, today, it's the committee, and that was an important change in SOX. So the idea of the auditor is to effectively work for the committee, providing assurance to the committee and the shareholders, obviously, of the effectiveness of the financial reporting structure and information that's being reported.

The difficulty, I think, with creating a new auditor discussion and analysis section, which basically reports on what the auditor thinks and what the auditor has said or maybe hasn't said to the committee, is it changes the nature of the committee dramatically, if you think about.

Because what's happening now is the committee engages the auditor, and the auditor is now being asked to comment on all its relations to the committee.  It's like hiring a lawyer and having a lawyer, after the lawyer advises you on what to do and not to do, get up publicly and tell everyone what they said to you and what they didn't say to you, which effectively is substituting in a way the auditor for the committee itself.

And that's a bit problematic.  There's a difference between advising a committee and giving assurance to a committee and the shareholders and effectively becoming the committee itself. And from a governance perspective, I think if this goes through as proposed and it begins to weaken the committee -- it removes the committee as the middle person, if you will, between the company and the shareholders -- I think it ultimately may impact negatively the monitoring role obviously that the committee provides and the board itself.

Central to our system is the board within the organization, representing the investors, overseeing management for the benefit of the investors. It's a small group who reviews management for the benefit of the investors in the company itself. And if you diminish their authority and ability to monitor, I think you really create long-term problems with the entire board oversight model.

Substituting a third party, the auditor, for the board itself, elected by the shareholders, in this regard I think ultimately may lead to more problems than not. It's the old "careful with what you wish for, you may get your wish."

This is one of those because I think that while greater disclosure is welcomed, the greater disclosure here I think may lead ultimately to less effective monitoring, which ultimately is more harmful to the organization and the investors.

MR. BAUMANN: Thank you very much for those very thoughtful comments.

Kevin Reilly, Flerida Rivera-Alsing, and then Paul Haaga.

MR. REILLY: Yes, Marty. Just let me make a brief comment, and that is I just want to stress one of the points that I view to be the 800-pound gorilla in this debate. And that is -- and it's the one that speaking for the profession through the CAQ efforts is the one that has given us the greatest amount of indigestion.

And that is the calls for the auditor to provide subjective views and impressions surrounding a company's financial reporting matters is the one that we view to be really troubling in this regard. And that is, look, we have these conversations with audit committees. We provide these discussions in due diligence reports.

But those communications happen, as Mike Cook mentioned and as Bob Guido reiterated, in the context of an effective, two-way discussion and dialogue. And to blast this stuff out in a widely distributed public report is going to be a real problem and will create, in my view, significant confusion for investors.

So, to Joe Carcello's question to the profession, what's changed? I don't think anything has changed, Joe. We are for change. We think it has to happen, but it has to happen responsibly.

But to try to create a mechanism where we are providing subjective views and conversations and dialogues and impressions about a company's financial reporting matters without the ability of the audience to give and take with those impressions is really not going to be constructive.

MR. BAUMANN: Although, as Joe said, he was reading from a report of the GPPC, the partners of the major firms, who said that in the future, we'll be the ones to give insights and information because we have it. I'm not quoting you correctly, Joe, but it was something like that.

So I guess that's the question of it sounds like there are some in the profession who think it can be done and others are expressing this concern about because it isn't a two-way dialogue, it's going to be confusing, whereas the investors were speaking up saying, "I don't think I'll be confused. I want the information."

Any further thoughts on that or --

MR. REILLY: Well, Marty, I think, as was articulated in the letter that we sent back in June, I think there are ways that we can address some of the demands from the investors, and we are 100 percent behind that effort. It's just in the context of trying to convey and provide help and assistance or views via our subjective impressions is really not a healthy way to go in a format that involves a wide distribution report.

I can tell you, and I've had the experience of issuing a lot of due diligence reports throughout the years, and I've got to tell you that the report is issued. You then spend a day with the investor group or the users of that report going back in detail on "What do you mean by that?" "Provide some additional perspective or context on that finding." "What exactly am I supposed to do with that?"

And that type of interchange will not exist in the AD&A concept containing subjective views and impressions.

MR. BAUMANN: Thanks, Kevin.

Flerida?

MS. RIVERA-ALSING: Thank you.

First of all, thank you for the invite. And second of all, my opinion that I am going to express are my personal opinions and not of my employer.

I support the AD&A. I believe that the concern about having a boilerplate report moving forward is something that we should have asked ourselves like 20 years ago because in the past 40 to 50 years what we have been receiving is a boilerplate opinion page.

The disclosures I'm looking for from the auditors include what did you do to support the opinion you issued? We have investment in the private markets where the auditors will add an emphasis paragraph saying that 85 percent of the assets, the fair value of it is based on the estimate of management. But there's nothing there that tells me what did you do to be able to issue a clean opinion of that financial statement.

I would also want to see what the auditor -- or to know what the auditors did to assess the risk of fraud. That is not something that is disclosed or discussed in the financial statements. I would also want to see the corrected misstatements. What about the uncorrected misstatements?

These are just some of the things I would like to see. And I promise you and the audit firms that are represented here that the additional information you will provide to us will not confuse me.

Thank you.

MR. BAUMANN: That's what I am hearing the investors say. They won't be confused.

Paul Haaga, then I'm going to call on Sam Ranzilla, Pete Nachtwey, Mark LaMonte, and Lynn Turner.

MR. HAAGA: Okay. Thank you very much, Marty. And thank you particularly for reaching out to and including investors.

I think that if anybody has seen some of our comments on various accounting issues, we've often pointed out that investors are underrepresented, in our view, on the boards that set these -- the various groups that set these rules. And we're delighted to be included here.

I don't want to be redundant. So I'll just say that I agree with everything that's been said and everything that's going to be said.

[Laughter.]

MR. HAAGA: As I said, we are a buy-side firm that does deep research. We have many, hundreds of analysts who use financial statements, but we also issue hundreds of financial statements for our mutual funds, like the gentleman from BlackRock.

And by the way, Jack, if you're taking a survey, I would gladly trade my compensation for all our audit fees.

But anyway, when I did the survey, I got the information by survey, reaching out to both our accounting staffs and our -- many of whom were previously in private practice, and to our analysts. And there was a lot of passion on both sides, but the statement usually began, "This will be great," or "This will be a disaster." And everybody had a different "this" in mind. It was sort of blind man touching the elephant.

Really, this release just asks a lot of questions, and so I encouraged them not to focus on this, but to turn around and work the other way and say, "Okay, what can we do? What can we do better? What would you recommend?"

There was a very strong consensus from literally everyone, both sides, on the fact that we can do better by investors. So doing something would be our suggestion. I got a number of examples from the analysts, and it always centered around information that was uniquely known by the auditors. So nobody wants to replace anybody's role, substitute the auditors for management or interfere with the audit committee role, but there is some information known to auditors.

This should be modest, a modest cost for a modest amount of disclosure, which causes me to think that the emphasis paragraph is a better vehicle than an AD&A because an AD&A is a separate document, is likely to grow and be more comprehensive and not be modest. So we would prefer the emphasis paragraph.

I would suggest that the process here not be to sort of work forward from grand concepts of disclosure and matters that are to be commented upon, but just work backwards and take a couple examples. I don't want to fight the last war, but I think we can learn from previous examples of things that went wrong and say, okay, what would the auditors have known? What could the auditors have usefully pointed out without creating liability, cost, or interference with relationships?

And if we can identify that, then I think we can write rules around that. And some of the suggestions from my analyst colleagues about things they would have liked to have known included Chinese company structures and related party transactions, Citigroup's CDO assessments, Countrywide subprime loan securitizations, Lehman repos, Fannie Mae derivatives, Freddie Mac deferred tax assets, and AIG's credit default swap valuations, just to name a few, and I'm sure there are plenty more.

I also don't want to leave out something that's been mentioned here. It's probably not a mandate or specific role of the PCAOB, but we think it's important, and that's strengthening the hand of the auditors. The mere fact that there's more to say than pass or fail, we think, would give -- and there was broad consensus on this -- we think would give the auditors a stronger hand.

They would win more arguments, and we think that would be a good thing. And that could be a good thing even if they didn't say anything at all in the emphasis paragraphs. Simply the ability to say something there as an additional tool.

So thank you and, again, appreciate being here.

MR. BAUMANN. Good. And thank you for those very thoughtful comments.

Sam Ranzilla?

MR. RANZILLA: Thank you, Marty.

I guess where to begin? But I guess a day that I get a compliment from Joe Carcello, maybe I should just leave it at that.

[Laughter.]

MR. RANZILLA: But I'm not going to. As a profession, we have looked at this issue for over a year and read all the surveys. And I'm telling you, I think the basic issue that I have had the most difficulty in dealing with is, is that when you boil this all down, at least in my view, this comes as basically a situation where investors are basically saying we don't trust audit committees.

And as a result, they're looking for the same information that is provided to audit committees. And I don't know that simply looking at the auditor's report is going to deal with such a fundamental issue as a lack of trust of what audit committees are doing. So I'll leave that as sort of an overriding comment that I'm not certain that this Board can deal with this issue all on its own.

That said, when you get down to a different level of the issue, the common theme is, as an investor, I want to know more about those judgments and estimates that are critical to the financial statements and what is underlying them.

And you can slice that a number of different ways, and I think Ann had a list or somebody had a list of some things. And there might be some things on the periphery of that, but it comes down to most of what people are interested in financial reporting is where are the estimates, and what is the level of measurement uncertainty within those estimates? That's what drives the volatility and the ultimate reliability of a financial reporting.

So Marty tossed out for those that favor AD&A

how you overcome some of the downsides. I don't favor AD&A, for all the reasons that others have expressed that I won't go into today. But I would like to address, and getting a little bit ahead of myself, an alternative that simply does get to a potential root of the issue without an auditor's discussion and analysis.

And I refer you to the SEC financial reporting codification on critical accounting estimates. And I guess, Joe, this side of the room is going to do some reading today, based on a remedial reading class we had last night that you and I had to attend.

But if you look at existing literature today and what's required to be included in MD&A, the concept of a critical accounting estimate is any estimate or assumption is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of those matters to change, and the impact would be material.

If you fall into that category, this

particular reporting release asks the issuer to respond to a series of questions, such as what factors did you use in arriving at the estimate? How accurate has that estimate been in the past? How much has that estimate changed in the past? And whether the estimate is reasonably likely to change in the future and, if so, to provide some form of sensitivity analysis because of the highly uncertain nature.

Those are existing requirements. And as I've looked at surveys, quite frankly, if that's what you're asking the auditors, and I think that is a major piece of the proposed AD&A, that information is already required to be disclosed by issuers.

And one proposal would be for the auditors to attest to those disclosures, not all of MD&A, just a portion of MD&A to basically achieve two objectives. One, improve those disclosures and the compliance with those disclosures and, secondly, to provide investors with greater confidence around the disclosures around critical accounting estimates.

So my point is, is that I, too, support change. And I think there is a way to get to the root of the issue if you can overcome the basic lack of trust, which I don't think this Board can do on its own.

But as a means to try to improve that situation, there are superior alternatives, ones which will allow management to provide information and auditors to attest to it and allow us to provide objective assessments of otherwise very subjective information. And I think that that particular alternative is superior to an AD&A.

Thanks.

MR. BAUMANN: Thanks, Sam.

And we're going to have a thorough discussion later on, on the possibility of auditor reporting on MD&A or parts thereof, such as critical accounting estimates. Another way, Sam, of looking at the point you just raised of a lack of trust between investors and audit committees might be maybe a lack of compliance with existing MD&A requirements since they call for such information about estimates, including sensitivity analyses as to how these estimates were made and could change.

And I guess there's at least a question of compliance if investors are saying we don't have that information, and the rules are as specific as I have in front of me and you've read. So we'll explore that issue a little bit later.

Pete Nachtwey?

MR. NACHTWEY: Thanks, Marty.

And I'll just add my compliments to the group, the Board and the others who have done so much of what I think has been -- I know has been incredibly hard work and, I think, very thoughtful work. And it's clearly with the best interests of the investment community in mind.

I'm going to state at the beginning I agree with much of the direction that's being taken here and the fact that the audit report is several decades stale, if we want to refer to it that way. But I also have some concerns just in terms of unintended consequences and making sure that we're thinking this through. And I, again, would add to someone who said this earlier, compliment the process and just continue to encourage you to keep it open and very broad.

But I'd like to just state for the record, as others have, I don't speak for my organization, which currently is Legg Mason. But what I do speak with is kind of what I think is a bit of a unique perspective with wearing three hats. And while I've had the honor of serving on the Investor Advisory Group because I currently and have been working with several large investment firms for the last going on 5 years, I did spend 25 years in the profession as an audit partner and in other leadership roles.

Then the last 5 as an issuer and preparer of financial statements, including for public companies and, much like Steve mentioned, around the world under various regulatory regimes. And then, those CFO roles have kind of taken me into the investment territory with two large global investment firms that have about $800 billion under management of third-party money.

So, unlike my toughest critic is my wife, and she usually thinks my opinions aren't very well informed, I at least kind of feel I can bring a bit of a 360-degree view of the issues that we're talking about today.

So while I, again, agree with much of what's being talked about, I do have specific concerns, and they primarily relate to the first two topics. So, again, I'll stick to the topic here, Marty, of AD&A but stipulate that I have similar views around the emphasis paragraph.

And first is just the cost benefit of doing this. And as Mike said before, do no harm. We need to understand that the costs that certainly that I know we incur internally -- not just externally, which is disclosed, but internally as well -- to issue financial reports and comply with what, again, are appropriate regulations, but we need to recognize they're incredibly burdensome. And the cost to comply is enormous, and that ultimately is borne by our investors and our shareholders.

Second concern is just the practicality. You know, again, I think all of this is well meaning and well intentioned, but the practicality of it, I think we need to really be thoughtful about. And the questions that I ask myself, particularly on AD&A, are how would an auditor's AD&A differ from management's, first and foremost? And then if it doesn't differ, is the view worth the climb? I mean, why would we do it if it's not significantly different?

But then the catch-22 question, if it is different, then I think most of the folks around this table who are on audit committees or in audit firms or, like me, are CFOs are going to spend an enormous amount of time reconciling the differences, which I think just leads us, at the end of the day, to getting to boilerplate because we simply don't have the time to do a lot of creation of new work in the tight deadlines that we have to operate under.

And then also if they are different, the question is does that really help investors, or does it cause them more confusion? Because they then need to reconcile the differences, and they won't be able to sit down, as others have said, across from the auditors as the audit committee could or other users of financial statements. I also wonder how this again ends up being something that's new information at the end of the day and not just boilerplate.

So, lastly, just to provide a perspective, because I've been asked to do that, and I'll try to be very balanced. Hopefully, Joe recognizes that, and I've worked with Joe on this. And again, I compliment you and the rest of the committee that's been working on it.

So I've spoken with many of the senior investment people, not just the analysts, because we've got a horde of analysts inside of Legg Mason, a horde of deal people that are inside of Carlyle where I previously served. And yes, they will always say any additional piece of info -- you know, even if it's on a scrap of paper I pick up off the floor, it's like, you know, jeez, maybe that gives me the one edge that I'm looking for to look really smart to my boss.

But when I go talk to the guys that run our funds and run our affiliates, and these are very, very seasoned guys and gals who've been around for decades, they're not clamoring for a change in the auditor's report. It's, "Yes, it would be nice to have."

What they're clamoring for, they'd love to get more prospective financial information from management, and that's a whole different topic we won't explore today. And of course, the question of should auditors be involved in that? But that's what they like to have, what actually they would say they must have is that prospective information.

They're always looking for what's around the corner, not just what's historical. They do value the audit opinion. They value reputable firms being involved with issuer financial statements to know that's solid base on which to build the rest of the pyramid of how they're doing an analysis of companies they're invested in.

So, at the end of the day, when I press them on this issue, it's much more, "Well, okay, it would be nice to have if we can get it, but it's not a must have." And so, does that get over the cost-benefit hurdle?

So I'd just say in summary, we need to be very careful on how we're approaching this and be very thoughtful. I'm not saying that, again, I'd be against change, wearing any one of my three hats. But just making sure we don't do any harm.

Thanks again for inviting me.

MR. BAUMANN: Thank you for coming and for your comments, Pete.

Mark LaMonte?

MR. LAMONTE: Thank you. And thank you for the opportunity to be here today.

Let me start with some of Peter's comments because I found that very interesting in terms of the value and the "nice to have" versus the "need to have," and how investors and other users of financial statements think about auditor reports today and an audit.

I do think we find audits extremely valuable. When we get a 10-K, there is an expectation that those numbers have been audited, and we can place a level of reliance on the accuracy and completeness of the information that is very critical to the decisions we're making.

The audit opinion itself holds very little value to us in terms of what's written. This concept that the numbers are audited certainly is valuable. The opinion itself is essentially a commodity. It really doesn't matter which firm is auditing the numbers. As long as it's one of the large, reputable firms, we're just happy the numbers are audited.

So from the perspective of is the profession delivering the greatest value, it certainly is delivering a lot of value by providing us with numbers that are audited, but it's not providing us much insight above and beyond that. So I view this as a nice opportunity to provide more.

Going to Pete's comments, is it something that we're clamoring for? Not necessarily. Our analysts get a set of financial statements today, presume they're audited, and start doing their work. Could the auditor give us something that would be helpful to the work we're trying to do? Absolutely.

I think the audit discussion and analysis would be an opportunity to do that, would be an opportunity for the firms to decommoditize their product a bit and make it something that actually has differentiated value amongst the firms.

Sam raised a very interesting idea about the discussion of critical accounting policies. That was a terrific idea when that was introduced, I guess, what, 7, 8, 9 years ago now. It's become largely boilerplate and another disclosure that's largely ignored by investors today. It says the same thing every year. It really doesn't say much anymore.

Having an auditor provide that with their objective view or participate in the delivery of those three to five critical areas of judgment or uncertainty that the investor needs to understand to really make the best decisions with the financial statements would be extremely valuable.

Having auditor views on those very difficult decisions that come up or those areas where a decision management has made could have been very different would be valuable. Let me just use a real-time example that would not be a U.S. example, but might emphasize the importance of this should we continue down the path and start incorporating IFRS into our financial reporting.

When you were looking at second quarter numbers for several European banks recently, you saw wildly different outcomes for the numbers that were being reported related to losses on holdings in Greek sovereign paper, just wildly different. Having auditor insight into how those ranges of potential outcome were evaluated and where, to use a golf analogy, a firm was hitting the ball in that fairway of acceptable outcomes and how the conclusion was supported and was okay I think could be just incredibly valuable to investors as they look at the numbers and think about how we want to adjust or how we want to view the numbers differently in our analysis.

It's always critically important to realize that endless -- and investors are not just taking what's reported. They're taking what's reported and providing their own perspective on it. They're making adjustments. They're making projections. They're thinking about the numbers differently than what's presented.

And having more insight into those from the audit community, I think, with the objective view of the audit committee could be very helpful to us. And AD&A is one of those opportunities to do so.

Thank you.

MR. BAUMANN: So, Mark, as you spoke, you sounded like you were a lot more supportive of the AD&A because you talked about how valuable it would be to understand how the judgments were made around estimates that were so different from company to company and as opposed to I think early on, I thought you said it was a nice to have, but not necessary?

MR. LAMONTE: I'm very supportive of it. Could we live without it? Sure. If you want to make an audit valuable beyond just having a commoditized assurance over the numbers, then I think it would be a terrific thing to have.

MR. BAUMANN: Okay. Thanks.

I've got Lynn Turner next, and then we'll call on Steve Kozeracki, Alan Beller, and Wayne Kolins.

MR. TURNER: Thank you, Marty.

It's interesting to listen to this conversation around the table. I've heard the phrase "do no harm," "unintended consequences," and "let's not get overly high on the cost." I can't think of any other city in the country where I hear those three phrases said more and yet, at the end of the day, more damage is done to the investing American public than any other place.

So I think those are all synonymous with just saying "do nothing," which is pretty much what has happened in this profession with this report since this issue first really got a lot of attention back, as Mike said, when he was on the Auditing

Standards Board. Unfortunately, at that point in time, they pretty much did nothing and didn't do a whole lot with the report.

It didn't change much. There were some changes around the fringes, and so here we find ourselves three to four decades later with the same problem.

Rather than do no harm, I think, for once, the Board ought to look at doing something that's right, something that actually provides some value, some information to the investing public. I don't think the issue is raised because people don't trust the audit committees. I think the issue is raised because investors see reports like they've seen at Lehman, at AIG, the judgments on the Greek debt. And not only does the Greek debt look impaired, it looks like the judgment of the auditors has been impaired as much.

Adelphia, Xerox, you can go through it. That's why people are asking for this information. It isn't that they don't trust audit committees. There may be a lack of trust. People don't trust the auditors because they get that same clean report from everyone, and yet, all of a sudden, there is a blow-up and there was no red flags.

And when we get into the court cases, then all of a sudden, in the court cases, we actually find the auditors did know a lot. Some of it may have been conveyed to the audit committee, but in a lot of times, it isn't conveyed to the audit committee.

So that's what one court case after another shows. And I think Paul had some very astute comments in that the Board needs to go look at those cases and take a look at what it was that the auditor knew. What was their perspective on the numbers that they never told the investors about that would have been useful and helpful information?

We are not looking for original information from the companies. I agree with that. The company has obligation to turn around and disclose those. Those need to be improved. The CFA Institute, others told us at the Treasury Committee that those disclosures are deficit and need to be improved, especially with respect to significant judgments and estimates. That's the FASB's job.

But what we are looking for is the knowledge that the auditor has and their perspective on the information. That information that they have should come from them. It shouldn't come from the audit committee. It shouldn't come from management. They're the independent body, supposedly the independent body. Yet in so many of these cases, you just wonder if they were ever independent at all.

So that's what we're looking for is that independent, unbiased perspective on some of those significant things. I do think there is some value to the standard report, but when we keep having these blow-ups, you wonder if it's worth paying for.

You know, you look at a Sino-Forest, where someone, an individual outside could go look at just publicly available information and find the problem, but the auditors couldn't? And that with an audit committee with three chartered accountants on it, you know, it does raise a serious question.

So the auditors did have valuable information, the court documents show, at Adelphia, at Xerox, at Waste Management, at AIG, at Lehman, that I think, unquestionably, any auditor doing basic, fundamental research would have liked to have heard and would have liked to have heard it from the auditor.

I favor an AD&A. But at the end of the day, I really don't care whether you put it in an AD&A or an emphasis paragraph. I just want the information. So whether you print it on page 13 or print it on page 33 in the filing, I really don't care, as much as I care about getting the basic, fundamental information.

The concern with the use of an emphasis paragraph is it does tag on to the current paragraph, and it might be just easier if you just give me the yes or no, pass/fail, and then give me a separate report on what you think. I think that actually will be easier for investors to deal with and read and comprehend.

The other concern with the emphasis paragraph is if you make it optional at all, then I'll guarantee you, you will do harm because you will have not done anything. Because the profession has been able to use emphasis paragraphs for two, three decades now and just never use them. Just never use them. So this is not something that can be made optional.

In regards, as far as boilerplate, I think that's something certainly to be looked at. I think Paul's notion of maybe field testing a little bit here would be helpful in that respect. But we do have MD&As that are very specific to each company, and they are able to do MD&As. And what you're telling me here is the audit partners in these firms are so undertalented that they can't do what the company is doing.

The company seems to be able to write that MD&A. Gary and Larry and others turn around and work on that MD&A. Larry was an audit partner, but you're telling me, as an audit partner, he couldn't write that type of specific company information? I don't buy it. I think these are very talented partners. I think they're very up to it.

The difference is you've got to pull the attorneys out of it. The audit committee reports have become -- despite encouragement from the SEC not to do it, the audit committee reports have basically been turned over to the attorneys and, viola, of course, we're going to get something boilerplate out of the legal profession. It's what they do.

So I think you'd want to do something to make sure that you don't end up with that, that you do end up with something specific, like MD&A, which you can already do.

As far as timing, I think Mr. Kueppers raised the question about timing. In each of these audits, at the end of the audit before we sign off on the audit report, before the partner signs off, they have to write -- it's mandated by the PCAOB's own standards -- a completion memo. And if there is one thing that investors ever would want to see, it would be that completion memo because that completion memo is your own standards highlight, tells you you've got to discuss what the big ticket risks were, what the significant items were, and your perspective on those.

That is unequivocally, anyone that's written those, anyone that's seen those would know that's the one thing that investors would really like to -- all you have to do is take those on some of these audits and put it out there publicly and ask investors if they'd like to see it. I guarantee you, they would love to see those memos.

So by the time you get down to writing -- signing off and writing the report, you'd already have some of this drafted because you have to do it as part of the audit. To say that you couldn't write this is incredible because you already have to have written it before you signed off on the audit report. And so, now it's just taking and dropping that down into the right type of language and something that is plain English that the investors could understand, and I see no reason why these talented partners couldn't do that.

I think investors have been very succinct in what they've been asking for. In fact, in their 2006 white papers, the CEOs of these exact large firms turned around and said users of financial information may demand from public companies the ability to receive more finely nuanced opinions from auditors about the degree of a company's compliance with a given set of standards or the relative conservatism of judgments compared to peer groups, or more boldly, investors even may want an auditor's view about the overall health and future prospects of the company they audit.

The CEOs, as Joe aptly noted out before, the very CEOs of these firms, the guys running these firms, have said investors are looking for this type of information. And to the extent we can get information that will enhance the performance in our portfolio because we've done a better job of allocation, we're more than willing to pay that cost because we get tremendous benefit back from it. That's the real benefit.

I can guarantee anyone had had the information that the auditors did on Adelphia, on a Xerox, on an AIG, on a Lehman, would undoubtedly have significantly enhanced their performance, and the cost would be a drop in the bucket compared to what it did to the returns on those entities.

As far as the auditors reporting on critical accounting policies, I've recently had the chance to go back and look at some critical accounting policy disclosure by companies. And quite frankly, there is not a whole lot more in those than what you already get in the footnotes.

They probably, in a lot of cases, don't comply with what the SEC was looking for in terms of the robustness. So I understand the benefit of getting something that says they've got in there what they need. But I don't see that as a performance enhancer to me as an investor.

If you want to have the auditor's report on the entire MD&A, I can see that. But there is legitimate arguments that we ought to make sure the auditors get the entire audit done on the financials right first before we go on to MD&A, and

I would probably share that view.

I'd like to see MD&A, but I'd like to get the financials right first. But just expanding it to critical accounting policies, I see absolutely zero, no benefit to that in terms of enhancing the performance of our portfolios where we need it.

So, with that, I think that's it, Marty.

MR. BAUMANN: Thanks, Lynn.

On your comment regarding emphasis paragraphs, the concept that was in the release dealt with a required and expanded use of emphasis paragraphs. So I do acknowledge that they're used very infrequently today, but if it were an alternative or at least the one presented in the concept release is one in which there would be standards written by us, which would require emphasis paragraphs in certain cases.

So, hopefully, that would at least improve that scenario. And as you said, you don't care if you get it from that way or from an AD&A, you want to get pointed to where the critical information is in the financial statements.

MR. TURNER: What I want, actually, I want the critical information that the auditor knows about what the company has already disclosed. I agree with the statements that the basic information about the company should come from management. The audit report is already required to disclose if information isn't there that should be there, and hopefully, they would uphold that standard.

But I want to know the auditor's perspective about the things like what we saw with the valuations at AIG, the Repo 105 transactions. You know, the Greek debt thing was just an abomination, to say the least. The Xerox, the Adelphia. The auditors in each of those cases, the court cases have shown new, very significant information that was very vital to the investors, and they didn't say anything about it.

And when that occurs, that's when, and very rightfully so, investors lose trust and faith in the auditors. And that's what needs to be fixed. And you talk about the emphasis paragraph. I guess my real concern, Marty, is you'll do incremental change. You'll tweak with the regular opinion some, and then you'll do a tweak on the emphasis paragraph.

If all we do here is incremental change, people will be -- different people will be in this room three to four decades from now, just as we're here three to four decades after the Cohen Commission report, and we'll be having the same debate/discussion again. I know that's pretty common in this city, but that ain't how to fix problems.

And if you want to just say we'll do no harm, that's where you're going to be. If you want to say let's go do something that's right, then you aren't going to have incremental change.

MR. BAUMANN: Thanks, Lynn.

Stephen?

MR. KOZERACKI: Thanks very much for this forum, and I do echo a lot of Lynn's comments and do think that and Vanguard believes that an AD&A would be very useful. And it's very important to get a better understanding of some of the judgments and assumptions that are made and how the auditors basically -- especially for some of the big issues, how the auditors got themselves comfortable with that.

And there may be some issues, we're dealing now with some of the liability for mortgage putbacks on financial institutions, and maybe those would be very tough for them to get comfortable with. But maybe they need to -- it would be important for them to highlight those that would be very difficult, and what are the big issues and what judgments were made. And like I said, how they got comfortable with it.

So, as I said, we're very comfortable as a firm and think investors deserve more, and the AD&A would be very helpful and an emphasis paragraph would be helpful as well.

The rest are sort of my just personal comments, and some of this is from listening to people speak. I've never attended an audit committee meeting, but I've heard numerous times from some of the preparers and the auditors about a two-way dialogue and a three-way dialogue and how difficult that would be to capture in an AD&A.

And, but just listening to it, it sounds like it's being approached by the parties involved as more some sort of negotiation, as opposed to, you know, are they going in there saying, "The audit committee want a clean opinion, the auditors want a clean opinion, and the company wants a clean opinion. And what's it going to take? And what are we going to talk about, and who's going to give what, and how do we all get comfortable with it?"

And that just doesn't feel like that's the way to be approaching this, if that is what happens. If the approach is more of how are we going to get the most accurate financial statements and how are we going to get the most appropriate information to investors, it seems like the parties would be coming and the discussion would be very different. And it wouldn't be a negotiation. It would be more about getting it right.

Another comment that came up several times, this talk of close calls. Close calls sort of goes back to this idea that the audit committee meetings have turned into negotiations. If the AD&A is there and it's present, maybe close calls go away. Maybe then people say this could get brought up in the AD&A. The auditor may disagree on it. It may be disclosed.

So maybe we're going to take a more conservative approach now, and then now you don't have the close calls. And maybe those stop, and maybe those should be stopped.

We've heard a lot also about that it's the responsibility of management on disclosure. But certainly in the financial institution area, we find disclosure is especially inadequate. Going back to one of the large institutions that failed, you can read in their footnotes about owning $40 billion plus in mortgage-backed securities, the average credit quality of which was AAA. Well, I guess that was an accurate statement, but it clearly, you know, was not adequate and in hindsight clearly not appropriate.

I think we found a lot of times also with financial institutions, management only provides the disclosure and the insight and their thought process and judgment when their stock drops dramatically or their bond spreads widen. It's certainly not something that they've shown in history that it's something they do, that they're forthcoming about unless it's actually being reflected in the pricing of their securities in the capital markets.

Another comment was also made about the MD&A and the AD&A could be very different. Maybe they could be different, but maybe that would be just for a period of time of a year or two where some of these differences need to be worked through. And when people start seeing that there are differences, then it would raise some questions about what management is doing, how they're reporting things, what their estimates are, and why is there a big difference with the auditor assessment of those?

Like I said, there may be this transition period. There may be a period of time where it would be tough to work through. But once you got through that, you might actually get much better behavior and much more accurate reporting from the issuers.

Just finally mentioning again, we're dealing with it right now, people were mentioning the sovereign debt issues, what's going on in the mortgage markets. These are issues that are impacting investors. We have seen market values across markets dropping tens of billions, hundreds of billions, in some cases with major selloffs, trillions of dollars.

Investors, who are ultimately the ones paying for the auditor's opinions, I think would be well served with more disclosure certainly on the big issues. And I think having the AD&A there, I said, we might see better behavior from management and more conservative reporting in general.

MR. BAUMANN: Stephen, thanks for those very thoughtful comments.

I'm going to turn to Alan Beller.

MR. BELLER: Marty, thanks very much and thank you for allowing me to participate today.

A couple of basic principles. Just my perspective on this. I was at the SEC when some of those rules, which we all would like to work better, were put into place, and some of them should work better.

I'm currently a partner at a Wall Street law firm. I do sit on an audit committee of a Dow Jones company, and so that's where I'm coming from.

I'd like to avoid not only unintended consequences, but intended consequences that are unfortunate. I am in favor of changing the pass/fail model. Don't get me wrong. I think there's value in the pass/fail model. We're all prisoners of our past, and I don't want to sit through Enron again. I don't want to sit through WorldCom again, and I don't want to sit through Tyco again.

But there is no question but that the regulators in the profession and the preparers can do better by investors. And there is no question but that investors are demanding that they do better.

Having said that, AD&A is as -- AD&A, I think, probably means something different to everybody around this table. But at least the way I'm hearing it, which is a fairly broad-gauged attempt by auditors to describe in their own words what they see about the company as a result of the audit process, I do not favor.

Lynn should not underestimate the ability of my profession to turn that into boilerplate.

[Laughter.]

MR. BELLER: It will become boilerplate. It actually will be less productive than some of the more modest targeted suggestions that have been made around the table.

Paul Haaga said let's be modest. I absolutely agree with him about that. I think there are some meaningful improvements that can be made in terms of asking auditors to tell investors more about the things they really know about that could help the process.

Is that a mini AD&A? Is that required

emphasis paragraphs? I'm not really sure I know, and frankly, like Lynn, I'm not really sure I care. But let's take an example that's been talked about a lot and just focus it on critical accounting estimates. That's actually a two-part exercise.

Sam and Marty both have in front of them the accounting release that was issued January '02?

MR. RANZILLA: Close.

MR. BELLER: December '01? There's been a lot of work done at the SEC since then, and there hasn't been any further codification. You really want better disclosure rules around critical accounting estimates, and you want better auditing standards around critical estimates. And I think if you did those two things, you would really be doing investors a service if you then said let's have the auditors tell us what they did to provide better assurance around those numbers and the identification of those estimates than you're getting today would be a huge win.

And Lynn, we might be here 30 years from now debating what else to do. But if you could promise me that at the end of today, I would be very happy. And I think investors would at least think they've gotten something out of the bargain.

Same issue around uncertainties and accruals and actuarial information and reserves. Some of those, the standards are actually not too bad. But some of them the standards really aren't very good. In almost all cases, the auditing standards could be sharpened, and you could accompany that with better disclosure. And if you did those couple of things, I really think you'd be on the right track.

Asking auditors to kind of go through the other information that management discloses, you want auditors to second-guess what the company thinks the competition is going to do? I don't. Do you want the auditors to second-guess what inflation rates are going to be in 2012 and '13? I don't particularly. So I'd leave that on the cutting room floor and take what I could constructively get.

Close calls is, I think, a little tricky because what some think of as close calls -- close calls. If by close calls, you mean what do people on audit committees spend a lot of time thinking about, those are not necessarily the close calls in the sense that management wants to pull one way and the auditors want to pull the other way. Those are the really super important numbers in somebody's financial statements, and they are going to get more attention at a well-run audit committee. And they are going to get more attention in a well-run company-auditor relationship, but they are not necessarily close calls.

And if we start focusing disclosure on "close calls," the issues where auditors and companies push and pull the most, I think you may be shooting at the wrong targets. And so, I don't really think close calls is where you want to go.

Disagreements. A lot of what we've heard around the table, I think is, and somebody said it earlier on, but it's implicit in a lot of what we heard -- especially I think what we just heard -- some of these kinds of disclosure requirements will provide auditors more leverage over management. At the end of the day, company disclosure will change. And indeed, company disclosure might change for the better.

And indeed, that's one of the reasons I kind of like the idea of pushing auditor disclosure around estimates and uncertainties. I think your MD&A disclosure on those subjects will get better over time.

But the flip side of that is what has been going on since Sarbanes-Oxley really is, in the majority of cases, I think, certainly the majority of cases I've seen -- I've seen dysfunctional boards. I've seen functional boards. In the majority of cases I've seen, you've really got audit committees trying to do the right thing already, and giving the auditors the ability to push audit committees in a particular direction, the upside is the auditors may get what they want. And I'm assuming that would be good for investors.

The downside is that auditors might get less information than they're getting now. And I think you have to be -- you have to be careful about that. You have to be careful about that dynamic.

But there are some really constructive things that can be done within the four corners of this concept release, and I hope that the Board continues on its very thoughtful course and gets us there.

MR. BAUMANN: We're getting lots of thoughtful comments to help get us there. Not along the same track, but a lot of helpful, thoughtful comments to help get us there.

December 2003, the release.

MR. BELLER: Oh, that's my -- I wrote that release.

[Laughter.]

MR. BAUMANN: It is. It's brilliant. I agree with that.

We have Wayne Kolins, Larry Salva. Then we better go to Professor Cox before the rest of his table collapses over there. So I want to get you before something else happens.

MR. KOLINS: Yes, thank you, Marty.

I'll be brief because many of the comments I was going to make, almost all of them, were just made, just 3 minutes ago by Alan Beller.

It's clear that the reporting model has to change, and in my view, the changes have to be meaningful, and they have to be practical. And I think the better approach to go in that direction is through looking at the alternates of the critical accounting estimates and the mandated emphasis of a matter paragraph. And I think much of what is in there could go a long way to fulfilling the investor needs for information about the sensitive areas of the financial statements.

It was also mentioned earlier on as an example of the kind of information, the information in a due diligent report. But it was mentioned subsequent to that initial mention of it was that the due diligent reports are subject to a significant amount of two-way dialogue in a very granular fashion and not the type of negotiation that was earlier described as possibly a way to describe what happens in a discussion at an audit committee level.

Those kinds of discussions are very granular. They're really to get an understanding of what the issues are and not to negotiate the issue, but to make sure all of the facts are considered and the best decision is arrived at.

Thank you.

MR. BAUMANN: Thanks, Wayne. Larry?

By the way, we're running a little bit over the schedule that was on the agenda. But the AD&A I think is one of the most important subjects and, clearly, one of the most critical topics we want to get input on. So I am going to try to get each of these cards that are still up, and we'll just cut into a little bit of what we cover in the afternoon.

But I think this is clearly a critical aspect of the meeting. So bear with me, and lunch will be about probably just 30 minutes later than was on the schedule.

Larry and then Jim, Professor.

MR. SALVA: Yes, thanks, Marty.

And to try to achieve that or facilitate achieving that objective, I'll also be brief because I guess the benefit of being late in the lineup is many of the comments that I would have otherwise made have been made by other participants.

But I do want to at least anchor mine in some of those prior comments, and that was the observation that it's been 10 years or less that we've had the SRO mandate of audit committees including financial experts and people with financial literacy.

And the other comment, that the idea of the governance structure that we have of the audit committee actually operating on behalf of the shareholders and investors and users of the financial statements. And so, the financial literacy and financial experts, at least my experience, I think that it was geared more mostly toward accounting knowledge, financial knowledge of accounting matters. It does extend into audit matters when necessary.

But I question whether, as Gary said earlier, the ordinary investor, who is the ordinary investor? And I think a lot of the calls for increased information is coming from investors that do maintain a fair level of financial literacy and, in some cases, may actually run to audit literacy besides just accounting literacy and accounting expertise.

So my concern, especially with an AD&A, if it were to get into areas of specific audit procedures and specific findings, I believe will serve to confuse rather than inform the "ordinary investor." It may help sophisticated investors that have audit knowledge and detailed accounting knowledge. But I'm concerned that it may, in fact, widen the expectation gap rather than serve to close it.

So Sam made the point before about the fundamental concern here may be that there's a distrust of either management or maybe it's certainly management, because if you don't trust the audit committee to do what it's supposed to do, then there must be a distrust of management doing what it's supposed to do, which is prepare accurate and timely financial information for the market.

I'm in favor of more modest change. I do absolutely believe that change -- that improvements can be made, but I believe the changes ought to be more modest, as have been suggested by some other commentators, and that they should be focused more on what appear to be the areas that were the concerns in like the critical accounting judgments and estimates.

Some of the companies that have been mentioned clearly were either business failures and/or audit failures. But the majority of what goes on in public reporting are neither of those. And I'm kind of against writing rules to try to prevent that 1 or 2 percent of kind of the bad reporting that occurs or the audit failure that occurs. It's going to burden a system that is, I believe, already burdened significantly in terms of time and cost.

I absolutely believe that audits have value, and I might even believe that -- and this is where I shouldn't get quoted -- that maybe they are cheap in comparison to some other things that companies pay for, especially legal fees, which I don't see negotiated quite the same way that audit rate per hour fees are negotiated.

But they add tremendous value. But to the average investor, it's very valuable, I believe, to have a pass/fail opinion. It can be supplemented and should be supplemented, as is suggested in the financial reporting or the codification. But I also believe that if you read those specifics, they are rarely complied with by registrants in terms of getting into ranges of estimates or sensitivities or what-ifs in the critical accounting judgments and estimates.

That would be a major improvement, I think, if auditors were involved in looking at that and required to report on it potentially in an emphasis paragraph.

MR. BAUMANN: Thanks, Larry.

Professor Cox?

MR. COX: I'm going to hang on to my microphone because I'm not sure Mark isn't going to stretch his legs one more time here. So I'll grab it.

I want to just echo the point that was made by a couple others. One, whatever we do, we should probably identify just particular areas. And whether that's going to be in the AD&A or emphasis paragraph may depend on the item, but I don't think it really matters at the end of the day.

But one item I was going to emphasize was something that Jack and Paul had mentioned earlier, and that is I think there is a lot of information, at least on the audit committees I've been on, where -- that's imparted where the auditor comes in and says this is the normal area of reporting on the audit risk. But in this environment we're in, we have a new one.

You can think about relational transactions. You can think about acquisitions that were carried out. You can think about volatility, and I think that, in and of itself, has a good deal of information associated with if it's shared with investors. And I don't think you have to go the next step and identify to investors the procedures that are going to be used necessarily to go at that. But I defer to others on that, but I think that just identifying those risks are enough.

And then I wanted to relate that to something that Stephen had mentioned earlier, and that is how the impact of disclosure on managerial and oversight decision-making, and that's from some personal experience. And that is I had the great professional pleasure of overseeing the investigation, internal investigation of the largest financial fraud that was carried out in the 1990s.

And one thing that was going on there, much to my surprise, was known by the auditors and known by the audit committee, each of the members of whom I investigated, but never shared with the investing public. And that is the fact that they had carried out a number of acquisitions in which the reporting systems were not compatible, and it enabled this company in a very short period of time, which had a global network of over 30,000 employees, to make sure that one out of every four paychecks that were sent out -- not just once, but repeatedly -- were the wrong paychecks for the wrong amounts. Okay, that's how bad the accounting system was.

And I always wondered that if there had been disclosure of the risks, which were identified by what was then a "big five" accounting firm going forward, whether that would have changed a lot of the behavior in the organization. I don't know. That's a jump ball.

But I can certainly say that individuals buying this Fortune 100 firm would have thought about it a lot differently if the information that was within the audit committee and in the accounting suites of that firm was made public.

MR. BAUMANN: Thank you.

We have Chris Spahr.

MR. SPAHR: Hi. Thank you.

I've been covering U.S. financial companies for over 10 years with Mike Mayo. We've had many public battles on accounting issues with some of the largest global financial firms. Not once have we looked at an audit report. We don't find them very helpful. We do appreciate the audit process and the stamp of approval of pass/fail, but we don't find the audit report itself as a useful tool whatsoever.

So we endorse what Lynn recommends with the AD&A, and I have some more specific suggestions I'll have for later panels.

Thank you.

MR. BAUMANN: Thank you.

Mike Gallagher, Doug Bennett, Joan Waggoner, and Mary Hartman Morris gets the final word.

MR. GALLAGHER: Thanks, Marty.

I want to thank Joe Carcello first. Out of all the quotes he might have chosen, he chose two PWC chairmen. So, Joe, thanks for that.

[Laughter.]

MR. GALLAGHER: In all seriousness, I think the comments of Sam and Dennis really demonstrate the mindset of the profession in wanting to be constructive, and I think that we clearly have an interest in doing that, and it gets to the relevance of what we do in the capital markets. And so, I think that quote and that comment could have come from any of the firms because I think that's the spirit with which we got into this dialogue.

I also think it's the spirit with which we responded in the June 28th response to Marty and team, and I'll echo the compliments of a very thoughtful process. We, as a profession, have been thinking about this and working pretty hard over the last year.

And again, the spirit with which we provided those comments were we realized that change needed to happen. We need, in order to be relevant, to better accommodate the needs of our ultimate users. And at the same time, it's got to be with the appropriate balance, looking at the end game, not just good intentions in terms of what might be good and what people are asking for necessarily.

Without looking through the lens based on what we know about what happens on the ground in terms of practicality. You know, what are the issues, and how can we do it? How can we move the ball in a positive direction without potentially doing damage? All good intentions aside.

So that was the spirit with which we provided our comments. We are learning. We continue to learn. I think the dialogue we're having today will continue to inform our views as they evolve. I think it's been a good dialogue.

I won't reiterate all the reasons why I believe the alternatives that we put forward are better than auditor discussion and analysis. I think Sam hit a few of them. I think Bob Guido's point about diverting effort towards as opposed to spending the time on meaningful auditing I think are a couple that really resonate with me.

Speaking of audit committees, I guess I would challenge the notion that an audit committee is a negotiation. I've been involved in a lot of audit committee meetings over the years, and I never viewed any of them as a negotiation. It's a great dialogue. It's a great discussion.

The audit committees have the responsibility for overseeing financial reporting. I think the quality of audit committee performance over the last -- since Sarbanes-Oxley has improved dramatically. Now that we have independent directors, I think they take their roles very seriously.

And I also agree with the point that some are certainly better than others. But the quality has improved dramatically, and I think undermining audit committees is a danger here and is part of the ways that we might do damage if we're not careful.

And if you look at what we've discussed with audit committee, there are very substantive issues around the quality of financial reporting, recognizing that in many cases there are alternatives, not necessarily one being better than the other. Many cases, you have multiple alternatives that two people could have very different views around preferability. And those are good discussions with audit committees.

And the last part about audit committees is one of the most valuable pieces of the audit committee in my mind, audit committee meetings, is the private session, where an auditor can have that discussion with the audit committee without management and have a real candid dialogue around what we think and hopefully informing the audit committee's mindset in terms of carrying out their responsibilities for oversight.

So, again, I appreciate debate. I think this is a great -- for the profession, this is a great thing. The fact that we're talking about the value that we can bring to the market. I appreciate Ann's comments acknowledging the value that can come out of the audit.

We will continue to look for ways that we can better meet the needs of investors and do it in a way that, hopefully, is balanced and really does achieve the outcome.

So thanks, Marty.

MR. BAUMANN: Thanks. And we appreciated very much the receipt of the letter that you worked on so hard, and others in the profession, from the CAQ that not everybody in this room would agree with your position on the AD&A, but the thoughtfulness of the letter and the timeliness of putting that out there as a strawman was very helpful, I think, for us. So we appreciate your participation in that.

I think I said Doug and Joan.

MR. BENNETT: Thank you, Marty.

And I'll be brief because many, if not most of the comments that I would make have already been made by my colleagues previously.

But I wanted to emphasize one or two of the points that have been touched on earlier and put this in the context of what troubles me most about AD&A. And that is the notion that -- and I certainly appreciate the fact that investors are looking for additional information. Auditors have information, and is there a way that that can be communicated so that it's meaningful and helpful to investors?

I think that there are ways to do that, and as many have pointed out, I think we'll get to those this afternoon. But in the context of an AD&A, I've heard discussion and a desire to just tell us how you get comfortable with those difficult estimates or those numbers that are the riskiest elements of the audit.

And one notion was that, well, we as auditors have to compose and draft an end of engagement completion document, which we do. And just give us that information and put it in a form and context that the investor could understand.

And I would find that extremely difficult to try to communicate what my audit team, as skilled professionals, trained professionals with years of experience and training, and try to condense that and communicate that in a document to investors that don't have -- and the comment has been made that there is a two-way communication and opportunities with audit committees to have that communication.

But without that ability to have some back and forth discussion and explain what was done, what the auditor views were, I think, it would, in my view, be nearly impossible to condense that into a document that could be made a public document.

Thank you.

MR. BAUMANN: Thank you. Joan?

MS. WAGGONER: Well, again, thanks, Marty, for the invitation today.

My firm has a practice in smaller issuers. I have been listening with great interest to the comments today and again will try not to duplicate other comments that have been said that I agree with.

But one of the things that has occurred to me as I've listened today is I've heard how important to investors are the unbiased viewpoints of the auditors. And one of the things that I worry about, should we move to a model of reporting that allows auditors' views to be introduced such as AD&A, that we would be introducing perhaps an element of bias.

And it would seem to me that in the financial statement process, there needs to be someone or a party, such as the auditors, that remain purely objective and unbiased and are truly the attesters, rather than moving into the preparer role.

I've also heard various examples of places in the statements covering estimates where auditors' insights would be especially helpful in terms of some context around those estimates. And it strikes me that management is really in the best place to put forward the public description of how those estimates were derived and whatever context is included in the required disclosures.

And should they do so, the auditor can then or could, as the model changes or doesn't change, could attest to those and stay, again, pure to the attest role that the auditor is in.

I do agree with Mr. Elson's remarks that I worry about the undermining of the audit committee, but also, even more than that, I worry about undermining the responsibilities that the preparers themselves have for the financial statements.

Thank you.

MR. BAUMANN: Thanks, Joan.

Gary, is your card still up?

MR. KABURECK: It was, but --

MR. BAUMANN: Since you -- why don't you go ahead, and then we'll turn to Mary Hartman Morris?

MR. KABURECK: Okay. Thank you. I'll be quick.

But I've been reflecting all morning on what I thought was a great discussion about I keep going back to the concept of close calls here and began thinking about how would you actually write the guidelines when an audit standard or how would the firms operationalize it?

Just give some really quick perspectives of it is I think the most the Board could perhaps do is write indicators of when a close call would be required. I'm assuming you would be required to disclose close calls in the MD&A. That's the premise of where I'm starting from.

I don't necessarily accept that we should be there, but assuming we are. How would you write boundaries or guidelines for the auditing firms to apply? I still think it would come down to a series of judgments, to judgment with some perhaps indicators, indicating when you should or should not consider it.

So I think that's the first thing you need to come up with. What is the boundaries of when a close call would be deemed to be a disclosable event in some capacity?

And then I started going through. I've been involved with a lot of close calls over the years, both as an auditor, as an audit committee member, and in my own company. And a lot of times, I think close calls come down to it's not all that necessarily close in the way that perhaps really seasoned financial regulators might see it. But it comes down to the experience and the skills of either the audit partner or the audit firm or the management of the company.

I mean, I've seen it go both ways, where stuff we thought was a close call and the auditing firms did not, and the reverse is, of course, through stuff we thought was a no-brainer to do it this way, and the auditing firms thought it wasn't quite so clear. So I just wanted to sort of keep that in mind that some of this stuff will down to the experience and skill sets of the players that are doing it, as opposed to really and truly being a close call.

My third point is that if you're going to write guidelines on close calls, recognize close calls do not always necessarily indicate high risk. And I think high risk is perhaps the more prevalent or perhaps the more important issue to be concerned with. Because a close call doesn't mean it's a wrong call. It just means it's a close call. But I think just don't lose sight of close calls and high risk are not necessarily synonymous.

And then, lastly, I would say close calls, one size does not fit all. So let me sort of explain what I mean by that. I mean, there is estimates and there is judgments where there is recurring estimates, say, your bad debt reserve. And a close call in there may be a range of estimates -- I mean, in theory you've got the critical accounting policies disclosures to handle something like that.

And then there's what I'll call a transactions close call, where there's a structured transaction. And anybody that works in real estate knows that minimum lease payments are 89.9 percent of the deal. You do not have a capital lease.

Well, you understand the rules, but you move 5 basis points on your assumed interest rate, all of a sudden, you're at 90.1 percent. So is that a close call or not? Maybe it is. Maybe it's not. But it's an established type of structure.

Then there's new structures no one else has ever seen before, the first time an investment banker created it or whatever. And again, maybe it's a different set of close call disclosure guidelines criteria.

So I'm just using those as examples that, basically, the point is one size does not fit all. So as you're trying to write guidelines and your future standards, just to sort of be mindful of that.

MR. BAUMANN: We are very thoughtful of the fact of writing whatever standards we write here will be a challenging task. And certainly, the chief auditor will need the talents that we have in this division to the greatest extent possible.

Mary Hartman Morris, you have the final word on this subject. So we'll listen very carefully.

MS. HARTMAN MORRIS: Thank you, Marty. I really appreciate being the closer today.

A couple of things. Thank you, Chairman Doty. Thank you, all the Board members. Thank you, Ann, for your thoughtful comments as well, and Steve Harris. I think many of the comments today from all of you were very important to all of us, as an investor.

I know, Kevin, you mentioned that 800-pound gorilla, I thought you were talking about CalPERS, but from that perspective --

MR. REILLY: Not specifically.

MS. HARTMAN MORRIS: But from that perspective, I am here to present CalPERS viewpoints. I think the big point that was brought up earlier was we are capital providers, and I think the audit report is for the customer. So we are the customer.

And so, I think there's a couple of things, just a couple of things I wanted to go through, and there was just five areas. Some of the things about why it is our view from why we want an AD&A. Again, who is the customer?

A little bit, some of the questions that you brought up, Sam, about the confusion. And then -- or maybe that wasn't you, but someone else from investors. And then the fiduciary responsibilities of audit committees and whether or not we trust or mistrust them. And then, of course, the strengthening of the role of the auditor.

So just really quickly, I think it was brought up by Joe earlier, too, the Investors Advisory Group, Anne Simpson, our senior portfolio manager sits on that, and we were talking about the financial institutions, and she quoted we lost something in the order of $70 billion because of the crisis. And those companies at the heart of it had clean accounts and auditor's reports.

Every year, the audit report was the same with an unqualified opinion. The opinion was the same, but, well, Jack, maybe they didn't increase as much. But the fees increased each year.

For a fund like CalPERS, the loss affects ordinary people's lives and the pensions they receive. So I think that is the reason why we support an AD&A. We think that there is some value.

I think someone mentioned, too, that we were looking for forward future statements, looking for statements. And we're not. I think the four keys areas even mentioned through the ACAP -- key financial statement and audit risk the auditor has considered when conducting the audit and the extent of how the auditor addressed those risks; the auditor's assessment of the key estimates and judgments made by management and how the auditor arrived at that assessment. What keeps him awake at night.

The quality of the accounting policies and practices adopted by management. So you do have the expertise there. And accounting applications and practices that are uncommon to the industry.

You have that viewpoint. You go across industry. We'd like to understand that.

And then, of course, unusual transactions and significant changes to accounting policies. Many more. I think I agree with Lynn. There are some other areas, but I think those are the top four.

I think that we really believe that it's an important -- there is some things on a -- it's about governance. It's about transparency. So I think, Professor Cox, you mentioned it was a breakdown of governance. So I think that asking auditors to step up to the plate is asking for better governance.

I think that it is a communication tool, and I don't necessarily agree with Mark. I don't think we can live without it. I think we've gotten at this point in our review, in our investments, I think that it is important that we move to an AD&A. And I don't think the common investor, the initial investor, the institutional investor, I don't think, and I agree with Flerida, I don't think will be confused.

I don't think that -- there was some issues. I think there was some question about does CalPERS have any -- a question about the inconsistencies, if there were competing viewpoints. And I don't think that there would be having inconsistent or competing information between the auditor and management is necessarily an issue.

Shareowners, which we are, are the owners of the company. And obtaining both management and the board's perspective, along with the independent auditor, a third-party, independent person or group, would provide a better understanding from different perspectives for the stewardship of the company. I think that's the important point. The stewardship of the company.

And I think that, one last point, and no one has really talked about it. But I think it's whether or not the auditors work for their owners, the investors, and how they're paid. I think that's something that's held for a different point. I mean, I know you can't bite the hand that feeds you.

But I think it's really important to know that an AD&A would help, I think, strengthen the role of the auditor, be able to work with management a little bit closer. And I think that the audit committee, we do believe that they do have fiduciary responsibility to the investors.

But again, it's not asking and it's not that it's mistrust. We speak through our engagement process at CalPERS. We talk to many audit committee members, and we respect and understand their viewpoints. But it's also respecting and understanding the viewpoints of the external auditor as the independent party.

So I think it will strengthen the role, and I appreciate the opportunity.

Thank you.

MR. BAUMANN: Thanks, Mary, very much.

And thanks to all of you for a very energetic and informative morning. We've received a wealth of information from you on your views about the auditor's discussion and analysis, its benefits, and the views of some, its potential shortcomings.

We'll study the transcript thoroughly and dig into your comments and continue our research in this area. And again, appreciate tremendously the quality of the comments we received this morning.

We're going to break now. Our lunch for the participants is out in the foyer. And we should try to return promptly by 1:15 p.m.

Thank you very much.

[Break at 12:21 p.m.]

[Reconvened at 1:21 p.m.]

MR. BAUMANN: Okay. Thank you. We will begin the afternoon session. Thanks again, everybody, for the level of energy and involvement this morning. And hopefully, we can keep it up for the next couple of hours.

We're going to turn our attention right now to the -- another alternative for improving the auditor's reporting model, discussed in the concept release. And that is the required and expanded use of emphasis paragraphs.

It was mentioned a number of times this morning, that -- that is, another possible approach could require auditors to point investors to the most important aspects or greatest areas of judgment and uncertainty in the financial statements, and some have said maybe not as good as the AD&A, from the investor's side. But maybe it has the potential to do that.

Some of the questions, again, we'll -- we'll want to address, but when anybody wants to comment on this, please feel free to look at the questions or -- or not, but what specific information should the required and expanded emphasis paragraphs include regarding the audit of the company's financial statements, regarding the audit or the company's financial statements?

What is the appropriate content and level of detail regarding the matters presented in required emphasis paragraphs?

And again, what are the potential benefits and shortcomings of implementing required and expanded emphasis paragraphs?

As I mentioned earlier, we've asked a couple of participants to kick off this discussion, Joe

Carcello and Kevin Reilly. And I guess, from Joe's perspective -- and Joe you -- I'm sure you'll add whatever color you'd like.

But I was hoping you could touch on, as somebody who's a supporter, as you articulated this morning, a supporter of the AD&A as the tool to improve auditor reporting, could you see the emphasis paragraphs work? And -- and if so, how, or if not, why not?

Then, Kevin, in the letter that the CAQ sent to the PCAOB, in the comment letter, that did include some examples of emphasis paragraphs.

And I guess I'd wonder, from the profession's point of view, what your thoughts were in terms of how we could require those and what kind of boundaries we could put on those to -- so they wouldn't turn into a listing of boilerplate paragraphs, but -- but could actually work in a meaningful way, if you've given any thought to that.

But again, please feel free for your comments to go whichever direction you'd like them to, so let me kick it off with Joe Carcello.

MR. CARCELLO: Thanks, Marty. So Marty asked me to introduce this topic, so let me -- let me go ahead and do that.

One of the proposed changes to the standard audit report would require the use of emphasis paragraphs in all audit reports.

In addition, according to the Board's concept release, these emphasis paragraphs could be expanded to, one, highlight the most significant matters in the financial statements, including identifying where these matters are disclosed in the financial statements, two, discuss significant management judgments and estimates, areas with significant measurement uncertainty, and other areas that the auditor determines are important for a better understanding of the financial statement presentation, and three, with respect to those significant matters discussed in an emphasis paragraph, including judgment, and estimates, and areas with significant measurement uncertainty, the auditor could be required to comment on key audit procedures performed, pertaining to identified matters.

Before considering the potential merits of requiring an expanded version of emphasis paragraphs, let's take a brief look at how these emphasis paragraphs are being used today.

I examined the most recent audit report for every company in the S&P500, which represents a meaningful percentage of the total U.S. stock market capitalization. Only 5 of these 500 audit reports contained an emphasis of matter paragraph and 2 other companies had what I would consider an "other" paragraph, basically in -- explaining why they didn't audit equity-method investees.

More troubling than the base rate of inclusion of emphasis paragraphs, 1 to 1.5 percent, was the limited nature of these paragraphs, both in the substance of what was discussed and the lack of detail and transparency with -- with which these matters were discussed.

These five emphasis paragraphs discussed, which to give you something fun to do and that no good academic would come without, handouts, I've made copies of these five reports. And I've highlighted in yellow the emphasis paragraph, so you can kind of read along with me.

So these five emphasis paragraphs discussed, which are being distributed to you now, number one, the recapitalization of AIG by the Department of the Treasury, the Fed, and the AIG Credit Facility, this was one sentence, three lines.

Two, changes in Morgan Stanley's fiscal year-end, from November 30th to December 31st, this is one sentence, two lines.

Three, allocation of overhead costs from EW Scripps company to Scripps Networks may not be representative of actual costs that would have been incurred by Scripps Networks had it been operating as a standalone company. This was three sentences and seven lines.

Four, similar issue regarding the allocation of overhead costs for a former unit that has been spun off, two sentences, four lines.

It is interesting to note that the last two emphasis paragraphs were both issued by the same firm, and it is also worth noting that four of the five emphasis paragraphs were by one firm. And the report language, although similar, was not identical.

And the last emphasis paragraph was the announcement of a definitive agreement to acquire all of the outstanding shares of common stock of Marshall & Ilsley by the Bank of Montreal, one sentence, four lines.

If my friends at the PCAOB and at the firms view these as informative audit reports, we are using two radically different dictionaries. So to meet the needs of investors, emphasis paragraphs would have to be used very differently than they are now.

How might this be done? To meaningfully improve the audit report, emphasis paragraphs would have to provide the type of information needed by investors.

First, the emphasis paragraphs would need to discuss significant risks identified by the auditor and how the auditor's procedures and results of these procedures were responsive to the identified risks. AS number 12 provides the auditor a framework for identifying significant risks.

Second, at a minimum, the emphasis paragraphs would need to identify significant estimates and judgments in how the auditor evaluated the reasonableness of these estimates and judgments. SEC guidance exists to identify significant estimates and judgments.

Third, at a minimum, the emphasis paragraphs would need to discuss significant unusual transactions, how these transactions were audited, and the results of these procedures.

Notwithstanding what Sam said this morning about lack of compliments, here's my second compliment in one day. I was pleased to see that, in the CAQ's June 9th comment letter, on the second line of item two on page four, that unusual transactions would be discussed in a revised audit report with required emphasis of matter paragraphs.

Finally, the emphasis paragraphs would need to discuss alternative accounting treatments, discussed with management and the audit committee, the ramifications of selecting one alternative other -- over another and the treatment preferred by the auditor.

Again, there is SEC and PCAOB guidance on how the auditor currently discusses these matters internally.

From my perspective, although I prefer an AD&A, the key issue is providing investors with the additional information they need, whether that information -- whether that additional disclosure is in the form of an AD&A -- AD&A, required emphasis paragraphs, or in some other manner, because in my view, today's audit reports are clearly not informative, which is at odds with the PCAOB's mission statement, to provide informative audit reports to investors.

MR. BAUMANN: Thanks, Joe. Kevin?

MR. REILLY: Yeah. Thanks, thanks, Marty. And Joe, I do want to point out that, at lunch, I learned that today is Sam's 39th birthday, so I want to commend you for actually giving him two birthday gifts today, so happy birthday, Sam.

[Laughter.]

MR. REILLY: All right. Let me -- I just want to share a couple perspectives with you all on -- on the emphasis of matter approach and I am coming from the -- from the perspective of having been a member of the task force that the CAQ formed to take a look at this issue over the last 12 or 15 months.

But you know, in general, we believe the required -- key word there is required -- an expanded use of emphasis of matter paragraphs is a viable approach that will be helpful to investors and could be implemented by auditors on a practical and cost-effective basis.

As I mentioned, we -- we -- and as has been raised before, we suggested this type of approach back in June with our letter to the standards group, and we continue to support the approach articulated in that letter.

As outlined in the concept release, we think the approach could be used to highlight matters that, in the auditor's judgment, are the most significant matters in the financial statements, and identify where those matters appear in the financial statements and related disclosures.

In this way, the approach would draw attention to important items that may warrant further investigation by financial statement users and serve as a pointer to assist users in deciphering the often very lengthy and complicated financial statement packages.

We also think that audit report focus on these areas could also help preparers enhance the level of disclosures provided in those areas.

The approach is not perfect and I'm sure we'll hear a lot about that in a few minutes, but we think it could represent a meaningful improvement to the auditor's reporting model as it currently exists.

So let me just spend a couple minutes and go through the questions, Marty, that the concept released asks.  And question five is, what should be covered in the emphasis of matter paragraphs?

A couple thoughts here -- from a common sense perspective, we think the objective of the approach would be to have the auditor answer the following question. What, in your view, are the handful of most important matters impacting the financial statements this year? That was Steve Harris's thoughtful question that he raised first thing this morning.

Understand, developing a workable auditing standard that will answer that question is going to be a bit challenge -- challenging, but we think it can be done, and I know Marty and his team have been diligently kicking the tires on that front for some time.

But we suggest, perhaps, a two-part approach, and the first would be for the auditor to focus on the usual suspects, a significant accounting policy or practice, a subjective accounting estimate, an uncertainty, an unusual or infrequent transaction, or other event, but then give a highlight in the audit report to those types of usual suspects, only to the extent that the matter was a significant discussion with the audit committee, it involved some substantial audit challenges during the period, or underwent a significant change during the period.

Once again, there are other ways to slice the salami here, and I'm sure Marty and his group, with the help of others, could come up with other alternatives, but we thought that an approach like that would respond to what we heard from investors, as requiring additional focus in audit reports.

Question six relates to, what type of specific content should be reflected in the emphasis of matter paragraphs? And again, I'm going to sound like a broken record here, but I think the focus of our group is to have the auditor provide emphasis in the context of objective descriptions of the matter, as well as a direction to the reader, as to where those items are covered by the company, in the financial statements.

We don't think that having the auditor provide subjective user impressions on the matter in the audit report is really a constructive way forward.

We also don't think that the paragraphs need to give the discussion of the specific audit procedures that the auditor undertook relative to those matters. As you can appreciate, we find it really challenging to try to distill hundreds of hours of audit effort in a particular area into one, or two, or three sentences in a -- in a matter being emphasized in the audit report.

At the same time, if we went -- and I think, Jack, you raised this question -- whole hog and went through page and page of description of the various procedures undertaken by auditors in different areas, we don't really think that's going to be useful to investors.

So again, we don't think that the description of the specific procedures in each emphasis of matter paragraph makes sense.

However, as we suggested in our letter back in June, we do think that the auditor, at the conclusion of the emphasis of matter disclosure areas, could state and identify that including --

that the -- our audit work included performing specific procedures designed to address the risk of material misstatements associated with the individual emphasis matters, and that such procedures were designed in the context of the audit of the financial statements, taken as a whole, again, and try to connect the dots that way as opposed to a paragraph-by-paragraph description of the procedures performed.

So let me summarize. The net benefits of this approach -- we think -- we think it responds to some of the investor requests for more information and identification of the most significant matters by the auditors in the -- in the financial statements.

We think it may enhance, prepare as focus on these disclosure areas and improve them. We think it retains the established role of the auditor to attest to information provided by management. We think it will avoid some of the unintended consequences that we discussed this morning, relative to the AD&A approach. And we also think it could be likely implemented in a practical and cost-effective way.

Shortcomings and challenges -- as I mentioned, coming up with a framework that will be effective, that will help develop guidelines for an auditor in terms of what goes into the emphasis of matter paragraphs will be challenging. We recognize that.

But we want to make sure that the guidelines are sufficient so that it doesn't give rise to too many matters being emphasized, that really will not be helpful to investors.

I'll also tell you that, you know, we -- we spent some time looking at the French model, in which the concept released identifies has been out there since 2003. The French auditing body took a -- a review of that approach, and went out with some questionnaires, and -- and got some interesting feedback.

And the review was mixed. Some were very much in favor of it. Others raised issues with the approach. One of the key issues raised in the approach was, on the downside, was the excessive standardization of the disclosures, but we think that can be worked through, relative to the approach that is ultimately adopted if we move forward within this direction.

So again, long -- long story short, we think this is a constructive way forward. It's one of the -- one of the alternatives that the CAQ views as being viable.

And with that, Marty, I'll -- I'll turn it back to you.

MR. BAUMANN: Thanks, Kevin, and thanks, Joe, for your -- both of you for your very thoughtful comments to introduce this topic. Chairman Doty?

MR. DOTY: But, well, Kevin, first -- first, let me say that over -- over lunch, what I heard was a uniform compliment of the -- of the discussion that you all have given us here on all of these matters. The high quality of what you all have brought to the table is -- is not lost on any of us.

And this is -- this is really an informational point, Kevin. Is what -- as I listened to it, is this, what you have described -- is this really the French model? It -- if it is -- if it differs from the French model, which the firms have been following now for some time, in what respect does it differ? A pure informational point. It sounded to me as if it was largely the French model. Is it completely? What -- what's the difference?

MR. REILLY: Fair -- fair question, Jim, and it -- it does differ from the French model, which is a justification of assessments. And in that model, they will identify things that I have outlined, relative to significant estimates or uncertainties and the like.

The French model will also go into details relative to what the auditor has done to address the risk of material misstatement in those, in those matters, which as I said, is an area that we don't think, on a paragraph-by-paragraph basis, trying to distill the -- the level and effort of audit work on those areas into a crisp sentence or two really makes sense.

That's where it does, in fact, differ.

MR. BAUMANN: And in looking at the French model -- and I'd looked at a number of financial statements that -- that have -- that had disclosures under those justification of assessments. They typically were pretty much the same.

I could pick up every financial institution and it would say, "See the disclosure on fair values, see the allowance for loan losses," and see one or two other things, similar to off-balance sheet disclosures, which -- and we chatted with some people in our outreach who worked on these, some auditors in France.

And there was some concern that they were becoming rather boilerplate. How could we prevent that from happening, Kevin, or -- or Joe, or anybody?

MR. REILLY: Well, Marty, again -- again, if -- if what we've suggested, which is simply an identification of the -- in the auditor's judgment, the most important matters impacting the financial statements, I, for one, am less concerned about this boilerplate issue because it -- a judgment is involved in the actual identification on the matters, which we -- we think will be helpful in having investors sort through 200 pages of financial statement data. We're telling the investors -- and, Steve, to your point earlier this morning -- you know, what -- what keeps you up at night?

So I think the importance, Marty, of this approach is -- is in the actual identification of the matters and less so relative to what the auditor says about those matters, because most importantly, if it is a key, critical, important issue, then -- then we have a responsibility to make sure that the financial statements address the material disclosures relative to those matters.

MR. BAUMANN: And I think we could write requirements, as you indicated, or -- or Joe indicated as well, that would link the required emphasis paragraphs to what auditors are required to identify, significant risks in the audit. That's required under -- under our standards.

And to the extent there were significant risks that were identified in the audit, how were they addressed in the financial statements? That would be one way to -- to kind of get at that, and significant and unusual transactions have to be identified. That's another way Joe mentioned as well.

So it does seem to have the potential to -- to put some fences around it, as well as require certain areas. One area where you and Joe differed -- and I just keep this dialogue going just for one second longer. Joe did add that he thought that auditors should indicate, when they identify a significant risk, how they addressed that risk.

I'm just curious, because Joe is as aware as we all are, that the audit includes potentially hundreds of steps and thousands of hours in a particular complex area, like allowance for loan losses or fair value of financial instruments.

How might that be done in a meaningful way, rather than reducing it to some sentence, we tested fair values, which doesn't give investors much of anything.

So I don't know if you have a thought on that. Did Joe or --

MR. CARCELLO: Yeah, I -- I think it would be challenging, Marty. I'm actually working on something now with -- with another -- with a firm to try to do something like that.

And you know, I think it can be done, but it won't be easy. And, you know, at the end of the day, that would be something that, you know, the Board would have to decide. Could they?

If all you're going to end up with -- and I think Kevin's right -- is, in France, the language is so high level, and so general, and so common across different issuers that there's no real differentiation, no value.

And so unless you're going to get some specificity -- but it's going to obviously have to be summarized. It can't be 50 pages. Then it doesn't have value. But I think you probably could draft a standard that would require the auditor to summarize the key procedures they performed in different areas and, assuming it didn't devolve into boilerplate, you would find differences across firms and across clients.

Now, the firms would probably be uncomfortable with that because they don't really want that. But I think that level of transparency would be very useful to users.

MR. BAUMANN: Thanks. Bob Kueppers?

MR. KUEPPERS: Just before we get deeper into the question, I just -- you know, Joe, thank you for the examples. I'm proud to see that the market is thin, but we've got the major market share of -- of emphasis paragraphs.

I think one of the -- one of the -- one of the points you were making, though, is that this stuff is not all that meaningful. Now, it -- really, you can't tell that unless you see the footnote that's referred to because, if the footnote is fulsome, then you don't have to repeat the language in your -- in your opinion.

I will tell you one I can speak to. And that is, Morgan Stanley changed its year-end from

November to December, and we haven't had a single question about what that means. That one was pretty clear.

But I do think that what's important is, the EOM standard and the lack of, you know, deep practice, is not what we're talking about. We're talking about something where this would be customary. It would be necessary. It would be required, if you will, and you know, I think even using emphasis of matter as a term of -- piece of terminology is a little bit misleading because we all think of, you know, these kinds of examples.

But we're talking about, actually, moving things to the next level. And so we won't know what it really looks like until we begin to work with the Board on it, if -- if you go that way, how -- how it might actually be embodied in a standard.

MR. BAUMANN: Thanks. Sam Ranzilla?

MR. RANZILLA: To -- Marty, to try to address your question of the auditor response -- and over the last 15 months, we have tried to build some models out under an emphasis of matter paragraph or maybe even other approaches, where the -- where we would develop a framework where the auditor could describe its response to whatever the anchor is that causes you to have an emphasis of matter paragraph, whether that's significant risk, whether that's a critical accounting estimate.

Once you've determined what it is that the auditor is going to emphasize, we've -- we've tried to -- to develop models. And you know, I'll start off by first saying, I think when Kevin refers to the research note that was done out of France in the -- I think it was excessive boilerplate, I think that's pointed toward the auditor's response piece or the justification piece of -- of those paragraphs, because at least the ones I've looked at, generally, have -- have evolved to, we came, we saw, we conquered, and that's the auditor's response to the particular evaluation issue at hand.

But when -- when we tried to develop models, either the -- to try to get something succinct that didn't -- just didn't overcomment and take over the auditor's report, it didn't give justice to the level of work that -- that the auditor had done. And in fact, that will become boilerplate, no matter how hard we -- we try, or maybe -- maybe a better word, it will become more standardized over time.

We then took it and said, "Well, okay, if that's not fair to what the auditor did and it doesn't express the -- the absolute depth of what the auditor got into, let's write one that -- that goes into that."

And it was page, after page, after page of description of what the -- what the audit procedures were done, both from a control perspective as well as from a substantive perspective. At the end of the day, we just -- we concluded that neither one of those were -- were helpful.

Surely, though, the succinct model was not giving an appropriate impression. The longer the -- the longer model, people just aren't going to read it. And if you're not familiar and you haven't been down that journey on that audit, I'm not sure how meaningful it was.

So I understand, Joe, you're working with somebody. I -- you know, we're open to -- to continuing down that, but just to maybe give some background on what -- what we've been doing in trying to -- to develop that model, we've -- we've struggled with finding that, you know, the porridge that's -- that's just right.

MR. BAUMANN: There are some other cards up, but Joe, I assume, was responding back in this dialogue we've been having, so Joe, I'll give you the floor back.

MR. CARCELLO: Thanks. I would -- I would agree with Sam, that this is not easy. Just the little bit I've done so far, I would -- in working with the -- the -- one of the firms, it's -- it's not easy and I'm not sure we're going to be successful. So I'm not -- I'm not surprised that that's their -- the result you've had, Sam.

I think what would be, you know, useful -- and I've tried to encourage the firms to do this, but they -- they're going to obviously do what they think is in their best interests -- is if -- if when they have these projects on the way -- and they've clearly put a tremendous amount of effort into this in the last 15 months -- if they would pull into their little networks, you know, one or two investors, at a minimum, and then, Sam, when -- if you're reporting out and you're saying, "We did this and it's so high level, nobody can really get anything out of it," or, "We've did this and it's 75 pages, nobody will read it," I'm not saying I don't personally believe you, but it would more credibility, you know, if Mary was part of your group and Mary said that.

MR. RANZILLA: Well, it's always good to know where your credibility lies, but --

[Laughter.]

MR. CARCELLO: Yeah, yeah, well, just because it's a different perspective.

MR. RANZILLA: All right.

MR. CARCELLO: Yeah, it's -- you know, it's an investor perspective rather than an auditor perspective. Yeah, yeah.

MR. RANZILLA: I -- I think that that's good counsel. I will say that, before we got too far into the -- into the project, we did meet with a series of investors to try to get a better understanding of what -- what people were -- were concerned about, what were the -- the flashpoints, so that we could focus it.

But -- but you're right. We didn't take the results. We didn't take the 75 pages and three sentences and say, "What do you think? Could -- could you make this work?" And so --

MR. CARCELLO: And you could.

MR. RANZILLA: And -- and -- but Reilly will vouch for me that we actually did it.

MR. CARCELLO: Okay.

MR. REILLY: I -- I can guarantee that we did. And just -- also, just to add some additional color commentary, that the CAQ has also reached out to a number of investors via this future role of audit -- auditor project that they have underway. And I think the feedback that -- that we understand came out of those sessions was -- was that the investors were really not that fired up about hearing that much about what the auditor did.

They were really keyed into, what -- what's the risk, what's the area, and -- and what is it that, you know, keeps you up at night relative to the issues?

MR. CARCELLO: Kevin, I think, you know, if we go back to this morning -- and I, you know, did the best I could to take notes as people were talking, but obviously I don't have the transcript in front of me -- what I heard this morning was, clearly, some people, and some of the investors, clearly said exactly what you just said.

But I think, if I went back through my notes, there were other investors this morning who seemed to indicate they would find value in more granularity around what the auditor did.

So one of the problems is, you know, auditors are not homogenous and neither are investors, right?

MR. BAUMANN: So Joe and Kevin, I think, are least reasonably on common ground, as am -- as am I, that we could probably write some requirements that could require auditors to point investors to the most important aspects the -- of the financial statements, where there's the greatest judgment, the greatest uncertainty. And that might help investors as much as the AD&A that a lot of investors want, but it could go somewhere along the way.

And by the way, anytime I say anything like that, don't think that I'm espousing one -- one version or the other. I'm simply commenting that I agree that could possibly work, less -- les agreement on how you get the audit down to a couple of comments that are meaningful and -- versus a lengthy discussion.

So with that, a number of cards have been up and I look forward to your comments. We've got first three, Larry Salva, Bob Guido, and Lynn Turner.

MR. SALVA: Thanks, Marty, and just a -- just a brief comment, just to expand or clarify that the

-- the reference to the emphasis paragraph or whatever paragraph we end up calling it, directing people to where, in the financial statements, these items are discussed or disclosed, I think should be -- we should think broader than that and not limit it to the financial statements, because I think the MDNA is a much more effective communication tool in terms of management getting across certain points that you may not put into footnotes.

So that's the -- the only point is that it -- you know, the auditor does need to read the MDNA under other standards and look for material inconsistencies, etcetera. Management may choose to put a lot more information into the MDNA then into the -- into the footnotes.

And there is a, at least in some sections of the practice, a kind of a hesitancy to refer out of footnotes into MDNA, as opposed to the other way around. So if you just point to the footnotes, they may not get the whole picture.

MR. BAUMANN: Thanks. Bob Guido?

MR. GUIDO: You know, originally, when I read the information you all produced, I really wasn't warm to this idea. I lived through, 30 or 40 years ago, the boilerplate long form reports that we had in the profession and we blew those up.

But the more I read and the more I hear about this, I think there's a lot of possibilities here. One -- one word of caution, if you wait until you get this all right to get it out, you may never get it out.

So the only advice I'd have on that is that, whatever we produce here may not be 100 percent the right way to go, but it is something that we could do, and make changes, and modify as we go along.

I think the benefits of this approach -- we're really going back to what Alan Beller said before lunch. This could potentially increase the quality, I believe, of management's disclosures because of the specific references.

And when -- when I was an audit partner, a very famous investor, Warren Buffett, on the audit committee, used to ask me, "Bob, where's the road map? Where's the road map? Tell me the four, or five, or six items and this could be our road map."

So with that, there's going to be challenges. Identifying the most significant matters, I think, will be a challenge to some degree. There's going to be a lot of judgment and subjectivity in that. But I think the way the sample report was crafted probably would -- would take care of that.

I am a little concerned with some liability implications for the profession, but, you know, we could probably work through that, so thank you.

MR. BAUMANN: Thanks, Bob. One thing, you know, if I -- you -- we hopefully don't have to worry about is us not getting it out. I see Steve Harris every day, and can you imagine what would -- my life would be like if we didn't get something out on this?

[Laughter.]

MR. BAUMANN: So there's little risk of -- of that. And yeah, I think -- your other point you made, I'd like to comment on that, too. I think that is a valuable point to make. It's -- some people say, "Well, you're simply pointing to things in the financial statements."

But emphasizing that in the opinion, one does think that the auditors might do a better job of auditing, though, might do an improved job of auditing those high-risk areas if they're emphasizing that they're high-risk areas.

And one might think that the disclosure that management makes about those high-risk areas might be more robust if they're highlighted as well.

So there can be those other benefits in addition. I would -- I would like to -- sorry to -- to give -- to interrupt the -- the list of people with their cards up. But I wanted to go back with Kevin on one thing.

The -- the mock -- the model report that the CAQ sent in at least looks, to me, like it was more than just pointing somebody towards a particular footnote and not saying anything more about it.

You probably don't have it in front of you, but -- but tell me, Kevin. Am I right in how you approached this? And one example talks about goodwill of X dollars, and the company performed its impairment analysis, and -- and no impairment was recognized because they estimated the fair value exceeded the carrying value at that date.

However, the comparison was close. This -- that's a word like I heard investors say all day long like that. The comparison was close and a further decline in fair value of this reporting unit could give rise to an impairment of the goodwill balance in the future.

Boy, that sure sounds like stuff that people were talking about before they wanted. Were you expecting that, that was in the footnote, that? Or was that added by you in the mock report as additional color to the footnote?

MR. REILLY: No. The -- the -- I mean, that's a fair point, Marty. I think the take-away was that, that language would -- and that disclosure would -- would be in the footnotes of the financial statements.

So again, it is highlighting or giving emphasis to the goodwill and the related impairment evaluation as being a critical accounting estimate and an audit challenge. But the language in there was -- was essentially taken from what otherwise would be in the footnotes.

MR. BAUMANN: The company actually would -- said it was close.

MR. REILLY: Yeah, yeah.

MR. CARCELLO: Marty, can I ask Kevin a question? Because that's the one I -- I -- that was my first compliment this morning. And -- and Kevin, I think --

MR. REILLY: And now, you're going to take it away.

MR. CARCELLO: No, no, I'm not going to take it away.

[Laughter.]

MR. CARCELLO: I mean, yeah, I -- but I -- that's what I thought was really very, very strong in your letter, so let me understand, because I think Marty's question is an excellent question.

If a company didn't put that in the note, Kevin, and -- but you concluded, as the auditor, that it was close, you're going to stay silent? Because that's the problem. That's the essential problem.

MR. REILLY: Look, Joe, I don't -- please don't read too much into the -- to the examples that we -- we put into the letter. I think they were put -- put there for illustrative purposes. But I would tell you that, you know, as -- as we kicked around the issues as auditors, and -- and we were looking at a situation where a company was doing a goodwill impairment analysis, and they were on the rivet, relative to the comparison of book value and fair value, you know, we would scratch our heads saying, "Well, that -- that's something that we would expect that would find its way into the footnote disclosures.

MR. CARCELLO: Okay.

MR. BAUMANN: Thanks. Lynn Turner?

MR. TURNER: Thank you, Marty. I think you raised a good question with respect to the example. And again, I think it's the informational content here that is important, not whether it's in an emphasis or AD&A. What an investor needs, if we're going to pay for this, is additional information that will be useful and valuable to our bi-cell analysis as we try to actively manage a portfolio.

It's not so much important to the indexers, but for active managers, which I think is going to be a much more important role going forward in this economy, it's important that they get information that can actually add value and informational decision points in the active management.

What I heard Kevin say was, "The CAQ and the firms are proposing that they would give, in essence, investors a table of contents to what's in the financial statements and asterisk the points that they really want to make sure you read."

So we'll tell you, just as in the examples that Joe handed out, as described in note one to the consolidated financial statements, well, that doesn't add any informational content, to me, as I'm analyzing a company and financial statements.

And so the benefit of that would be zero. I don't need another table of content. I don't think the CAQ -- while they say they really want to make change, I think that's wordsmithing, because I really don't think they want to make change. I think they want more of the same with the current emphasis paragraphs.

I think we're looking for that additional informational content that you just highlighted with your question, Marty, with respect to what was in the example.

Not only do we want to know what were the -- the big ticket items, as Kevin said, Kevin said that when they met with investors, they wanted to know what keeps the auditors up at night. That's the informational content that can help us with investment decisions. That's what's in that completion memo.

That's not what's in a table of contents. A table of contents, the proposal that Kevin just described, would be of no value whatsoever. I can already just read the footnotes and get the information.

The only thing that he adds is an asterisk to a table of contents that says make sure you really read this footnote. So I see very little value, whatsoever, with respect to that proposal and see no value being added, in terms of information I need to make a better informed bi-cell decision.

MR. BAUMANN: Thanks, Lynn. We've got Mark LaMonte, Gary Kaburek, and Steve Buller.

MR. LAMONTE: Thanks. I'm going to agree with Lynn and disagree with Lynn in my remarks. I am enthused that the -- the firms seem to be getting behind this a little bit and I think this does have an opportunity to provide valuable value to the financial saving user.

I spoke earlier this week at the AICPA banking conference on loan loss disclosures. And one of the things I highlighted in my -- my slides was the proliferation of disclosures in recent years. If you look at the 10ks of the big four U.S. banks, they've gone from an -- on average, 141 pages in 2003 to 276 pages in 2010. And then you look at a firm like AIG, their 10k this year was 482 pages.

The only people actually reading these entire documents are some lawyers, some folks in the accounting policy shops at the companies themselves, and the auditors. Investors are getting out commentary on earnings or making decisions shortly after these annual reports come out and they have no ability to sift through all of this information.

We need that road map that Bob referred to. We need to know what the three or five key things that we need to read in those 300 or 400 pages are. And I think Larry's absolutely right. You can't stop at the footnotes. You also need to reference the MDNA.

I think you'd probably be referencing both the footnotes and the MDNA with an individual item. Where I think this could add value beyond just being an additional table of contents that Lynn was referring to is, you not only need to tell the investor what footnote to read, the auditor ought -- should also be saying why they think this is critically important to an investor's potential understanding of this entity, so not just pointing to where it is, but why you should read it, why this information is critical to your understanding.

To go to some of Joe's comments earlier, I don't think a lot of investors or financial saving users are going to be all that interested in audit procedures behind these critical areas. A lot of investors -- I mean, you have a lot of poets with MBAs and they're not all that interested in auditing procedures. You don't have a whole lot of former auditors or accountants out there in investing, so they're not kind of junkies of audit procedures or -- or what they mean.

There is one time where I think it would be very valuable to understand the audit procedures. And that is when there is a material weakness reported in the other reports that auditors are writing, and there's a reference to that material weakness in the audit opinion. I think it would be critically important for investors to understand what incremental audit procedures were performed for the auditor to get comfortable with that area where there was a breakdown in controls.

Beyond that, though, I wouldn't be all that excited about knowing about the audit procedures. Thanks.

MR. BAUMANN: Thanks, Mark. Thanks for those comments. Gary, if you don't mind, can I keep your card up for a second? I was going to ask, if you don't mind, if I defer to the SEC and let Brian Croteau -- Croteau put his card up.

MR. CROTEAU: Thanks -- thanks very much, Marty. I guess mine was really a -- a question. Again, without sort of passing judgment around any particular model, it -- it seems to me, from some of what I was hearing, perhaps the power in the emphasis of matter idea comes from the criteria that one would use in determining what to put in an emphasis of a matter.

So if it -- it were truly something that were just, you know, find the 10 largest numbers in the financial statements, anybody can do that and there's no magic to that. But I think what Kevin described in terms of the discussions with audit committees or the extent of procedures the auditor performed, if there's some amount of judgment in determining what to put in an emphasis of matter, which items to select, I -- I wonder if people find benefit in -- in that to some extent.

Certainly, there may still be limitations to the extent which -- which one finds that useful. But to me, sort of the question around what the right criteria would be to begin with in making the selection of the items to emphasize might be the important part of -- of this particular suggestion. So I guess --

MR. BAUMANN: I agree. The criteria, I think, is very essential. Thanks, Brian. Gary?

MR. KABUREK: Thanks, Marty. A couple of comments, just sort of listening to this dialogue, and I want to go back to one of the opening comments. I had made my remarks this morning, but I just listened to, you know, the relative merits of the French model versus one or two sentence saying, "We verified fair value," I think, was the example.

I think that just goes back to -- the point is, I think the Board needs to decide what level of what knowledge should be assumed by the -- the majority of the financial statement users, because if you assume they know very little, the French model looks pretty good. If you assume they're reasonably knowledgeable in accounting, and auditing, and the similar, well, maybe just saying, "We emphasized fair value testing," is sufficient. So I think -- I do think we need to wrestle that one to the ground.

I think, you know, a couple of corporate professional groups that I'm associated with, I think in general, are supporting the emphasis paragraph approach, you know, provided you keep it to, you know, objective stuff and focusing on accounting policies and the estimation process, you know, the important areas of audit focus. I think we can easily get our mind supportive of that.

I think I want to echo Larry and Mark's comments about -- that you should be -- MDNA should be available, you know, for reference in the auditor's report. If that's the direction you go, I'd probably take it further and go to the item one, you know, business description, or risk factors, or almost anything that's in the file document.

I will tell you, my experience trying to even have any footnote -- having a sentence say, "See the MDNA, this page, this paragraph for more details," has always been a problem with the audit firms I've been associated with. He said he got me auditing the MDNA. I says, "No, I think all your auditing is -- on that page in that paragraph, there's more information," you know.

So I think you need to wrestle, you know, linkage to the MDNA inside the audited statements. I think that's a narrow one that can be solved.

The -- I think -- and I don't know. Most of the time in these meetings, these usually -- I've usually -- when I've had a problem, I usually suggest an alternative. This one, I actually don't have one.

But when I think about the 10k process, I mean, it's -- you file your statements in, I don't know, say mid-February. Meanwhile, you're talking about events up to 14 months earlier. And to say, "Here's my audit processes in the critical areas," that's nice, but that's past news.

The question is, how do you keep that evergreen, you know, going forward? And just, when the audit emphasis areas change, I mean, should there be some sort of reporting mechanism to communicate that before 12 months later in the next MDNA or in the next 10k?

And I don't have a solution and I don't even know if it's a great idea. Well, of course, it is. I suggested it. But the -- but I think you should -- is there a way to, when audit emphasis changes significantly during the year for unobvious reasons -- it's one thing to make a big acquisition. I mean, I think the world understands you're doing something.

But how would you update that you're changing your emphasis? And again, maybe staff work, you'll conclude, is just not a good idea. But it's something that occurred to me.

And then so my last thought -- and I'm going to say it now; it's a little out of place, but I might not get a chance later -- is, I'm looking at the four areas of, you know, emphasis of matter, ATA, and so on. If I was project-managing this thing, I might almost break it into two projects, you know, or release, because

I think emphasis of a matter and clarification are going to be less contentious of issues. And you might be able to wrap them up quickly, get them out, make some improvements in the world recognizing the ATA and probably assurance outside of the financial statements will be more contentious, going to be more prolonged, and so on.

So you almost might want to consider doing a -- bifurcate the project. It's a thought, you know, and let the staff work however it goes.

MR. BAUMANN: Thanks, Gary. Steve?

MR. BULLER: Thank you. Well, we -- we do support the expanded use of the emphasis of matter paragraph, but think that the AD&A, the emphasis paragraph, and enhanced exposure all have their own responsibility, and actually, interconnectedness.

So I think that the AD&A is important to us because it does help define audit procedures on significant areas and provides some perspective on accounting principles. And I think, converse -- conversely to what Lynn said, our analysts believe that the emphasis of matter paragraph should point out the location of the financial statements of certain things that, in the accountant's opinion, are important for the reader to know.

And those are the, you know, the -- the new financial statement disclosures, significant transactions, and related-party transactions that are material, significant judgments and estimates with significant uncertainty, and also, significant information about acquisitions, or related financing, or -- and the reason they're important to our analysts is, they believe that -- that merely by having the auditor identify those in that paragraph points to them that they were important criteria in reaching the opinion.

So to the extent that they need additional information on the procedures that were performed, that should be in the AD&A. And the two we view as complimentary.

MR. BAUMANN: Good. Thank you. Next, we're going to Paul Haaga, Mike Santay, and Joan Waggoner.

MR. HAAGA: Thank you, Marty. Remarkably, I still agree with everything that's been said. My favorite -- as I was sitting here listening to this, I recall that my favorite movie title of all time is Snakes on a Plane. It tells you everything you need to know, nothing you don't need to know, and is unlikely to become boilerplate because it doesn't describe any other movie.

So following that, I do think shorter is better. I -- that's why I suggested that the emphasis paragraph is better than the AD&A approach. I think there are things that one can say, and we've gone back and forth on whether it's simply a road map to the largest numbers, or at the other extreme, it's the auditors giving their own financial statements and taking over the role of management.

I think you can strike a fine line between those two. I think it should focus on matters involving the audit and the audit process, but not be limited to that, and can actually comment on some numbers, and still be -- still be very useful to investors.

Just some of the areas -- these have been mentioned, but some of the areas that have been suggested is significant issues that arose in the audit, how they were addressed, areas of greatest risk, how those have changed over time, and where the audit emphasis was, significant estimates and judgments, uncertainties, unusual transactions, restatements, materiality standards.

Now, that sounds like an awful lot and I'm trying to get it down to Snakes on a Plane. But I think that, if you look back at the list of examples, including the examples we've given here, there are very few areas of concern that would have been extremely significant to investors. And I think pointing out those areas of concern and saying something in just a couple of sentences would have been very useful.

The challenge, of course, will be writing the rule that reflects what I think a lot of us understand or imagine a helpful emphasis paragraph would have looked like.

MR. BAUMANN: Thanks. And thanks for the colorful analogy. In particular, as actually, it works in another way because I think the things we want disclosed in emphasis paragraphs are the snakes on the plan. So I think we're right on target with that one. I wondered if Night of the Living Dead worked, but maybe that has more information than you need.

Mike Santay?

MR. SANTAY: Thanks, Marty. You know, as it relates to the -- to the emphasis paragraphs, we're supportive, along with others in the profession, for many of the reasons articulated.

One of the things, if the Board decides to move forward with this, is -- is going to be important to think about is transition. You know, as Joe pointed out, you know, well, there's -- then there's dearth of information. There's been nothing in -- in audit reports on emphasis, and all of a sudden, you know, there's going to be a new standard, which we wouldn't expect investors to read.

But you know, all of a sudden, there's going to be a lot of disclosures that are going to come popping in. And I think, you know, our view is, there -- there could be some -- you know, we want to make sure that there's a good understanding of what the -- what the framework for that's going to be, and what inspectors -- what investors should expect to see.

You know, that's not going to be operating risk. I mean, if -- if somebody's got a major contract with Wal-Mart that's disclosed, and you know, we're not going to make a judgment on operating risks or other types of risks. Those are, you know, supposed to be disclosed in the front part of the 10k, I think, in the risk factors.

So I think it's going to be important to frame what's being -- you know, we'll -- we, as auditors, will have a good understanding because we're going to, you know, beat the living daylights out of this, and train our people, and that. But I think it's -- it's going to be important for the readers to understand what's being presented.

One -- one comment on audit procedures. I think this one's difficult and I've heard discussions on both sides, as to whether or not it would be -- would be valuable. And you know, it's -- it strikes me that there's times when management does different things, depending on their view of, you know, what they need to do to -- to validate the assertion, you know.

Their -- if you've -- they've got a difficult fair value measure, they may go out and hire a valuation specialist. And that doesn't come through the financial statements, but we, as auditors, get comfort with that and we might think -- decide we need to get less audit evidence because we're vetting that specialist.

And so, you know, I don't know what the answer is here, but I think there's -- there's some aspects to what management's doing and -- and that might not be visible in the financial statements, and you know, the -- you know, all the work they're doing to support their assertion and -- and our response to that varies.

And so I think that's one of the challenges I see in trying to decide what procedures to talk about and what might be valuable, because if we just put our procedures in there, and somebody might look at it and say, "Well, they only did this, somebody else did all this," that could really be misconstrued. So --

MR. BAUMANN: Thanks. I was wondering if I could just ask you a question, since it was discussed by a couple of the other auditors. Getting to the concern that Lynn expressed before, that just pointing to the financial statements, the -- the riskiest areas may not be enough, the table of contents issue.

In the example that I read before, if the --

if the company had not disclosed that the calculation of impairment was close, and you concluded you could issue an unqualified opinion without that sentence, do you think that additional color is something that you could see auditors putting into the emphasis paragraphs?

MR. SANTAY: I think the devil's in the details on that one, Marty, I guess. And this kind of goes to what some people view -- might view as close, and versus not. And -- and so I think that, as it relates to why it's important, I think, you know, we -- one of my earlier comments today was, you know, the -- the need for management to discuss why it's important.

From an auditor perspective, I think I would have a hard time, you know, making -- you know, providing guidance to our folks as to what's close, what's not. But I think that -- you know, I think there should be sufficient disclosures in the footnotes for the -- for the reader to be able to determine that the -- you know, what methods were used, and what assumptions were used, and directionally, what -- you know, what -- why management was able to conclude on the veracity. So --

MR. BAUMANN: Jay, were you going to comment?

MR. HANSON: Yeah, Marty, I was just going to respond to you -- your question to Michael about -- about whether an auditor would actually put that language in -- they wish were in the footnote.

I'm suspecting that, if that threat was there, it's going to be in the footnote, which in and of itself, will improve reporting.

MR. BAUMANN: That, I think, is why some, such as Lynn, might say that additional color would be helpful. But I agree with your point, Jay. Joan?

MS. WAGGONER: Thank you, Marty. I would additionally agree with what Jay and Mr. Santay have said about this. It would be -- if it was important, sufficiently important, to be considered for EOM treatment, I think it would be one of those things that you can't disagree upon. I think management and the auditors would have to come to an agreement and you wouldn't be able to issue the financial statements without it being resolved, if it was of that nature.

I did want to make one other comment about the disclosure of audit procedures, building on what -- what Mike has said, that it might not be in the investor's best interests for audit procedures to -- to become too widely known.

Audit procedures are not supposed to be all that predictable, and if, as a matter of course, audit procedures are disclosed for these more interesting areas that will pop up in emphasis of matter paragraphs, it might be detrimental to the -- the interest of investors in the long term.

There is an element of surprise that is -- is supposed to be part of the whole audit plan that is put together. And I'm not saying that this is filled with mystical secrets or anything, but there -- there certainly is, perhaps, that factor to consider also, as we move forward.

MR. BAUMANN: Thanks, Joan. We have Flerida Rivera-Alsing, Wayne Kolins, and Alan Beller, and I think Kurt Schacht gets the final word.

MS. RIVERA-ALSING: Thank you. I just want to make sure that everybody understands that we value audit. And I am a firm believer that our -- the financial statements of our wholly owned entities and joint ventures are audited.

But how much time do we really spend in looking auditor's report, the opinion page itself? A few seconds. The first thing I tell my people is, "Are there three paragraphs?" "Yes." "Forget about it."

There's only one firm that, to this date, they still issue a one-paragraph audit report. We sampled 25 financial statements of the financial statements that we receive and only 1 firm issues an emphasis paragraph. And -- and that's to the firm represented to my left.

And in those instances, where paragraph -- emphasis paragraph is used, I felt like it is used to limit the auditor's liability. It is just my, you know, perception. I do not want to minimize what Kevin said earlier, advising the users of the financial statements for the significant matters are -- is a step forward.

But is it enough? I do not believe so. I look at the auditors to tell me why they believe those matters that they have identified are significant and how did they, the auditors, felt comfortable enough to have the name of their firm associated with those financial statements.

Do I have interesting reading for a 173-page report? Absolutely not. And that is the reason why we want you to cover only the significant matters.

My concern, however, if we go to the route of the emphasis paragraphs, how much information can you really give to the investors in a couple of paragraphs to make it meaningful?

Thank you.

MR. BAUMANN: And thank you. Jack, I hadn't seen your card up, so I will do Wayne, Alan Beller, Jack, and we'll still give Kurt his -- the last word, since I promised that before.

MR. KOLINS: Thanks, Marty. I'd like to focus on the audit procedures element and disclosures of it. And if -- if the objective of disclosure of audit procedures at the emphasis of matter paragraph is to provide a picture of the strength of the audit procedures around the particular area, I'm not sure even a 75-page description of what the audit procedures are is going to fulfill the objective because it won't say what procedure should have been done.

And audit's a very complex mechanism. There's a lot of interconnected parts here because you have to consider the risk of the area. You've got to consider the -- the validity of the evidence. You can describe a procedure that was performed, but if the evidence that the auditor is relying on shouldn't be relied on, that won't come across in terms of describing a procedure.

It also depends on what the controls are, and there could be one particular control that's missing, that would be a house of cards for the entire procedure to stunt.

So without knowing all of that, without entering into a dialogue between the auditor and --

and the investor, you really can't get a full understanding of what the procedures are in any event.

And one other element that seems to be missing, and hasn't been mentioned at all here, is the PCAOB inspections. Now, the financial statements at hand, that are just about to be issued, obviously haven't been inspected by the PCAOB. But it's possible that last year's engagement was inspected by the PCAOB. It's possible that, that particular engagement will be inspected in the subsequent year.

So I think the PCAOB inspection oversight provides an additional degree of comfort. I believe -- I should -- I believe it would be to the investors that the audit procedures are appropriate in the circumstances.

Thank you.

MR. BAUMANN: Good points. Thank you. Alan?

MR. BELLER: Sorry. Thanks, Marty. First of all, I guess I just want to, for purposes of the transcript, import what I said earlier about AD&A

into here, because I think, as I said, I don't much care. I'm not clever enough to know whether it's part one or part two. And I think, if you get what we were talking about, it's all the same.

I also think, though, that in thinking either about AD&A, which I am not a great fan of, or emphasis paragraphs, we all know investors want more information. We have heard, and I think we all know, that investors want more information from the auditors.

But I think there's a line, and it's somewhere -- it's -- sometimes, it's an easy line to draw, and sometimes, it's a harder line to draw, but I think, in continuing with this exercise, it's an important line to draw.

Where is it better to get information from the preparer and where is it better to get information from the auditor? And I want to go back to the goodwill example to kind of talk about that. The example in the -- in the CAQ emphasis paragraph is, they -- a segment was tested. No impairment was found. But it's close. And if value goes down further, there might be an impairment in the future.

I actually had it, the very same question, for Joe before lunch, that someone asked in this panel, which is, suppose the issuer, suppose the preparer, had said that in the financial statement footnote. And it wasn't an idle question, because I actually know of a preparer that said something like that.

And does it then go in the -- you still have an emphasis paragraph about the impairment because it's an important issue, but do you then go on? You got the information. I think that's the kind of information that's actually better from an issuer.

And the real value of the emphasis paragraph and the value of the process is, well, the auditor's going to put it in if the issuer does it. And I think the auditor has to put it in, in answer to that other question.

But the practical outcome here is, the issuer will put it in. And that's fine. And once the issuer puts it in, does the auditor also put it in?

I'm not sure I care and I'm not sure whether I care whether the standard says the auditor puts in or doesn't.

Let's take this -- let's take this issue one step further and let's stay with goodwill, even though we get a little bit into the weeds. Let's say that, if you do the kind of normal market value of the enterprise, and then you look at the market value of the segment as a portion of the market value of the enterprise, there's clear impairment, but the market just went down 67 percent in the last six months.

And we were there, guys, two years ago. This is not a -- this is not a hypothetical. And so you then do a discounted consent to search flow analysis to see whether, in fact, the market value of the segment supports or the -- or the discounted cash flow of the segment supports the market value, notwithstanding the fact that the market value of the enterprise is below what you get when you add all the segments up.

Do you put all -- does -- it seems to me that

that's important disclosure. It's in the footnote I'm thinking about. And it seems to me that, if it's not in the footnote that I'm thinking about, it goes in the emphasis paragraph.

That's getting pretty close to putting in audit procedures, right? So it's very hard. It's -- and again, if the issuer says it all in the footnote, do you need to do more than flag it in the emphasis paragraph?

Because the issue still is, it's close, and the answer is yes, you do. But do you put all that other stuff in? Don't much care. You want to get the disclosure.

But the second thing that comes out of this example is, sometimes you have to bounce a brush up against the audit procedures to get to the kind of disclosure that I think you're talking about.

The area where I think that actually -- that I'm familiar with, where it would be the most -- the most common is fair value accounting. It's very hard to talk about complicated fair value accounting questions without talking about auditing procedures in some -- in some cases, and so be it, which leads me to my penultimate point, which is, how do you, in a standard or in a set of disclosure rules, because -- again, I think this is a two-part exercise.

I think Brian's agency and this agency have got to go down this road together to talk about both issuer disclosure and auditing standards. I don't think either agency will be able to effectively write a black-letter rule around what's significant. What are those 10 things that have to be flagged in the emphasis paragraph?

I can almost promise you, you will not do that successfully. What you -- well, you're really in kind of a potter's story. You know it when you see it. You set out the principles. Where are the judgments hardest? Where is the estimation hardest? Where are the numbers biggest? And you put all three of those in a pot, and you stir it up, and out pop the five, or six, or 10 things that the investors care most about. And there really are no black-letter rules you can write that will produce that outcome.

The final point I would make, which has been talked about a couple of times here, who are the investors we're writing for? And what is their audit knowledge? It is one of the great myths of the U.S. disclosure system, that we are writing -- we are writing mutual fund disclosure for Aunt Martha. At least, we should be.

But we are not writing 10k, 20f, 10q, 8k disclosure for Aunt Martha and we haven't been for 25 years, at least. And you know, I'd love the answer to be different, but it's not. And -- and so what I think we really ought to be thinking about, if we're thinking about what's effective disclosure, think about fairly sophisticated institutional investors, who drive valuation in our market anyway, and Martha's a price taker. She's not a price maker.

Write for those institutions, and write rules for those institutions, and I think you're on the -- you're on the right track. Don't write them for me. I don't understand them.

MR. BAUMANN: Directors of corp fin give consistent advice, because John White, at our last discussion on the SAG on this similar topic, said, "If the auditor is going to put the calculation as close in the emphasis paragraph, it doesn't have to because the client will put it in the footnote." So we're getting consistent views, as -- as Jay just --

MR. BELLER: Now, you know what John and I do for a living.

MR. BAUMANN: Kurt -- Kurt, you're being delayed one further, I think. Matt Torrey?

MR. TORREY: Yes, thanks, first of all, to the PCAOB for the invitation to participate in this forum, but thank you also for including so many investors in the process. I think that's very, very, very healthy development.

I'd like to second the comments made by -- by Paul Haaga from -- from Capital earlier today, twice earlier today. I think we've got a very high level of consensus that -- that investors would benefit from improved disclosure on many issues, to ensure financial statements are as accurate as possible and as transparent as possible.

I furthermore believe the use of emphasis paragraphs would be an effective way to ensure that this happens, pointing areas -- investors to areas with the greatest financial statement risk, changes in reporting, and, perhaps, most importantly, most significant estimates and judgment.

So I think a lot of great points have already been made. I'll limit my comments to that.

MR. BAUMANN: Thanks. And there was concern that you were going to concur with Jack's comment that you agree with everything that was said today. And that was -- I've heard that twice. That was going to be troublesome.

Jack?

MR. CIESIELSKI: Thanks, Marty. Just two things, one thing to not worry about and maybe one thing to think about. I her a lot of auditors concerned that investors want to see audit procedures and worrying about putting out 75 pages of an emphasis paragraph that includes audit procedures.

And I really -- I have to second Mark's remarks earlier, that investors really don't want to see that. At least, that's my belief. That's what I've encountered in talking with lots of other investors.

They don't want to recalculate an audit. They don't want to re-audit something. They might want to recalculate a number that appears in greater detail in the footnotes, you know, details about assumptions about, I don't know, the black shoals option pricing model used in determining fair value of items, whether it be compensation or consideration.

They -- they might be interested in that, but I don't think they really want to take one audit report, and stack it up against another audit report, and see which audit firm was tougher, or something like that. That's just not within their ken and it's not within the time they have allotted to do their -- their jobs.

That said, I think that they don't care about, you know, the audit procedures as much as they care about the auditor's assessment of risks. What made an auditor decide to do more audit procedures in a particular area?

So I think, you know, the emphasis paragraphs should speak more to what is driving an auditor's decision in assessing risk in the audit of a misstatement.

Something to think about is that we have pages and pages of risk factors in the 10ks. And you know, somehow, I -- I don't see a link between that and the audit opinion. Those risk factors that have been identified by the client -- they should have some kind of an effect on the auditor's assessment of what kind of procedures need to be used in the audit.

So I think that it -- that might not be a bad starting place for trying to figure out how an auditor communicates the effective risks in an audit to the investor, because the auditor is supposed to be the eyes, ears, and nose of the investor within the company. And they should be doing some kind of risk assessment, and communicating that to the investor would give them a better idea of what kind of risks they take upon themselves by being an investor in that company.

So I hadn't heard anything about, you know, the risk factors section and trying to integrate that, maybe, with some of these emphasis paragraph issues that we're stumbling around on, so I just wanted to put that out there.

MR. BAUMANN: Thanks.

MR. CIESIELSKY: Sure.

MR. BAUMANN: While I conceptually agree with you on that, on the risk factors, Alan's profession has done a very good job on those risk factors in the 10ks that I read as well, that I don't think anything's omitted these days from those.

Kurt, you have the final word, and then we're going to take a break.

MR. SCHACHT: Thank you very much. Great job, Marty and staff. This is a very through consult and we appreciate the opportunity to -- to talk a little bit about it.

I just spent four days living like a pioneer up in New York because of Hurricane Irene. I think a lot of us in the New York area had the same experience. And I tried to get my kids to sort of see the romanticism in living like pioneers, and roughing it, and -- and they would have none of the -- none of the discussions. I heard words like, "I'm desperate," and, "Could you go out and get a small generator so we can at least run the Xbox?"

To show you how desperate I was, as I had a copy of the PCAOB handbook at home, and I had some -- some good reading time with -- with the handbook. And -- and I think we all sort of forget that a lot of people that are on the IAG and -- and on the SAG are not audit pros. They're not people with accounting backgrounds. And it's important for them to understand, really, how rigorous this auditing profession is, and all the rules, and the guidelines, and so forth that are there.

And I think the practice, generally speaking, has evolved, and it's adapted, and it's -- it's changed with the times, with the one notable exception of the communication between the auditor and the investor/shareholder. And that has not kept pace, in our view.

And you know, the interesting thing that we're hearing about some of these proposals in the comment letters is that this is a monumental change, if we were to do something, or that it changes the fundamental precepts of the auditor/investor relationship.

And the fact of the matter is that everything else in finance, in investment, and in markets has changed. And I'm not sure why this should be off limits, and why we shouldn't make some -- some pretty interesting and bold changes to how this -- this works.

Avoiding repetition, I -- I -- we agree with how Ann and Steve Harris have sort of outlined the investor concerns with respect to these issues. That's where a majority of our CFA institute respondents to surveys are, on three separate occasions.

I think we're sort of -- this -- so we're sort of at the point where this is a game of Clue. Do you remember that game, where you had to guess whether it was Colonel Mustard with the lead pipe in the -- in the living room?

So we're talking about how should be giving more information, what the information should be, and where that information should reside. And overwhelmingly, we hear from our investor members that they want to hear it from the auditor, that it needs to be from the independent expert, that, that is important, that they want to have information that's informative.

So if we're -- just again, I would agree with the other speakers, that if this is just a boilerplate description of the audit process, and what reasonable assurance means, and that -- and so forth, that that's really not what this discussion should be about.

It's about that informative, customized assessment of -- of the list. And I think we all sort of know what's on the list and what's been articulated in terms of risks, and judgments, and so forth.

Where it resides, again, I agree with the commentators that it's really less important about where it resides and it's more important about who and what is said. And I'm intrigued by this. Our view is that it should be more closely connected with the auditor's opinion, so there's no hunting and pecking around all of the documents associated with financial disclosure, so you see what the auditor thinks, and what the auditor views, and has judgments on in the opinion, either in these emphasis paragraphs, or with another appendix document, or however we might end up structuring it.

So those are -- are -- some of our basic comments. I'm intrigued by this -- this road map concept. I don't think that we have really focused on that as investors. I -- I do agree with Lynn Turner's concern that a simple highlighting by the auditor of where to look for more information and more discussion from management is not the -- is not enough.

But what Mark had -- what Mark LaMonte had suggested in terms of an iteration where you talk not just about where it is, but why you are specifically trying to emphasize investor's attention to that -- that location would be -- would be a step closer. Thank you.

MR. BAUMANN: Thank you, Kurt, and -- and thanks everyone for a lively, entertaining, and -- but most importantly, very informative discussion of the required and expanded use of emphasis paragraphs, as one of the alternatives to improving the auditor's reporting model. We'll -- we'll take a -- running a little bit behind schedule. Let's try to start again, if we can, at 2:55, and we'll be talking about auditor assurance on other information in the financial -- outside of the financial statements.

[Recessed at 2:43 p.m.]

[Reconvened at 2:55 p.m.]

MR. BAUMANN: The next session on our agenda, and I'm going to turn this over to Jessica in a minute to lead the discussion here, is "Auditor Assurance on Other Information Outside the

Financial Statements."

And that has come up a number of times today, and I think this is another important area for us to consider as to potential changes in the auditor's reporting model.

And again, I'm not indicating any preferences, because we don't have any at this point in time. But I do want to repeat what Sam Ranzilla said earlier today, that when you read what Alan Beller and team put out in 2003, and what's required by companies, even just the critical accounting estimates, so much of it sounds exactly like what I have been hearing throughout the day as to what investors want to hear: Companies should address material implications of uncertainties associated with the methods, assumptions, and estimates underlying the company's critical accounting measurements. Such disclosures should supplement, not duplicate, the description of accounting policies that are already disclosed in the notes to the financial statements. The disclosures should provide greater insight into the quality and variability of information regarding financial condition and operating performance. The companies should address specifically why its accounting estimates or assumptions bear the risk of change, so on and so forth, including a company should analyze their specific sensitivity to change for their significant estimates and assumptions.

One of the concerns I've heard is that this is turned into boilerplate today and the value of critical accounting estimates is not there. So at least one of the proposals would be auditor assurance on this, if we all believe audited financial statements are of a higher quality, because auditors audit them with the disclosure that we get on the MD&A, or critical accounting estimates, also achieve a higher level and the spirit of what is in here, which is pretty much what I've been hearing and what everybody wants is required already.

So in any event, our next topic, "Auditor Assurance on Other Information Outside the Financial Statements," and Jessica.

MS. WATTS: As Marty mentioned, one of the alternatives presented in the concept release is to require auditors to provide assurance on information outside the financial statements, such as the MD&A, portions of the MD&A, or other information; for example, non-GAAP information or earnings releases.

An auditor providing assurance on information outside the financial statements could improve the quality, completeness, and reliability of such information, providing users of financial statements with a higher level of confidence on information provided by management about the company.

This alternative would increase the scope of current auditor responsibilities, require the development of new auditing standards, and require coordination with the SEC.

So the questions for the concept release that we would like to focus on today are on what information should the auditor provide assurance: MD&A, earnings releases, non-GAAP information, or other matters? And then if the auditor were to provide assurance on a portion or portions of the MD&A, what portion or portions would be most appropriate and why? Would auditor reporting on a portion or portions of the MD&A affect the nature of MD&A disclosures? And then what are the potential benefits and shortcomings of implementing auditor assurance on other information outside the financial statements?

So I will leave up a summary of these questions.

And for this topic, we've asked Mary Hartman Morris and Mike Cook to help kick off this section.

Mary?

MS. HARTMAN MORRIS: Thank you, Jessica.

Chairman Doty; board members Ferguson, Goelzer, Hanson, Harris; panelists, and guests, my name is Mary Hartman Morris. I am an investment officer with CalPERS, and I thank you for the opportunity to discuss specifically auditor assurance.

I'm here to represent CalPERS, the largest pension fund in the United States with approximately $220 billion in global assets in more than 9,000 public companies worldwide with 47 markets. CalPERS invests these assets on behalf of more than 1.6 million public workers, retirees, and their families, and beneficiaries, in order to fund retirement and health benefits.

We continue our commitment to the concept of global best practices that contribute to the efficiency and effectiveness of capital markets, including credible, high-quality financial reports, which serve the needs of investors and other users of financial information.

CalPERS is fundamentally a long-term fiduciary investor with a vested interest in the stability of the markets and integrity of financial reporting. We believe financial reporting should provide users the information needed to make informed capital allocation resource decisions. The integrity and quality of financial reports is supported and strengthened by robust external independent audit carried out objectively and undertaken with a good dose of professional skepticism on the part of the auditor.

As an independent expert, auditors provide an independent opinion to the quality of financial statements to instill confidence to providers of capital, such as CalPERS. Currently, auditor assurance is critical to investors' confidence in the integrity of financial reporting and its consistency based on U.S. GAAP.

You heard the robust discussion this morning on AD&A, and we support the need for change in the standard audit report, as we had said earlier. We believe the PCAOB has the opportunity to make substantive, robust changes that will improve auditor reporting and provide real value to investors and other users. And we support the resources and efforts being focused on AD&A; however, I know you have asked us to talk about the MD&A.

It has been long recognized that financial statements alone are not sufficient to communicate overall performance of an entity. In particular, MD&A has become, in our opinion, a core element of the communication package for external reporting purposes.

As underscored by many different individuals and also by the principles for ongoing disclosure material development reporting by listed entities by IAASCO, an issuer should provide all information that would be material to an investor's investment decision, including disclosures in an MD&A.

So you know that the MD&A is meant to cover four principal objectives, enables investors to see the company through the eyes of management; improves financial disclosures overall and provides the context with which financial statements should be analyzed; provides information about different components of earnings and cash flow, and the extent to which they are recurring elements; and provides information about the risks to a company's earnings and cash flow.

MD&A provides a context within which the financial results and financial position can be interpreted. Currently, auditors as part of their engagement review the MD&A and consider whether such information or the manner of its presentation is materially inconsistent with the financial restatements or represents a material misstatement of fact. We believe the auditor could provide a statement made on their current responsibilities as it relates to MD&A within the AD&A.

Although the auditor would not be providing assurance on future performance, CalPERS believes auditors could through an AD&A provide a statement of whether the MD&A is reasonable, whether assumptions and conclusions are rational based on the current work of the auditor and its review of a company's financial performance.

CalPERS would support a full discussion of the MD&A, specifically as a framework for integrated reporting as further developed. Many of you know the International Integrated Reporting Committee released a request for comment on the integrated reporting framework this week. So I think this should also be considered as we think through the MD&A.

Clearly, from the discussions today, investors like CalPERS would recommend that PCAOB focus on the AD&A and provide clarity within the AD&A on the responsibilities of the auditor on MD&A.

We agree if assurance on other information such as the MD&A is recommended that we defer to the current attestation engagement procedures and have the option to engage the auditor to attest on an MD&A.

This is a great opportunity to determine which issuers, if any, currently request their external auditors to attest to their MD&A.  And if an issuer requests an attestation, then the benefits and challenges should have already been outlined to the audit committee and discussion of the benefits will be well-articulated.

I think one of the questions you asked is the greatest benefit, or if audited, what is the effect if the auditor does provide an attestation.  So I think the greatest benefit of assurance would be a driver or the impetus for management to do a better job, because I think earlier you heard that MD&A --

management does not necessarily cover everything MD&As is reflected to present.

So with that, I thank you, and I look forward to hearing other people's views. Thanks.

MS. WATTS: Thank you, Mary.

Mike Cook?

MR. COOK: Thank you, Jessica. And thank you to Marty and Jessica for the invitation and the opportunity to express some views, which will not be traditional with respect to this subject, but are heartfelt, I guess.

The notion of auditor's assurance on other information, I'd like to say that I don't get all that concerned about the issue of assurance.

If I could involve the auditors in other information and other financial communications, whether or not that resulted in the expression of assurance or a public communication might be secondary to that. And I would use as an example of that the current level of auditor involvement with quarterly releases, which are much more significant than the annual report that we have been spending all this time talking about in terms of the importance to the investor community, market-moving information.

We have auditors involved with that, as required, sometimes in greater depth than even as required. There are no reports on that, that I am aware of. It is very rare for those reports to be made public. Probably a handful. They are sometimes given to the audit committees and sometimes not.

But what is important is the auditor's engagement on behalf of the audit committee and the company with respect to the quarterly reporting process and the content of what I would put at the front of the financial reporting train.

And if you can just take this as an illustration, I view this financial reporting train, and what we have been spending all of our time talking about and spend lots and lots of money on, and attention on, is the caboose of the financial reporting train. The annual audited financial statements coming out next March are the caboose of the financial reporting train. And from now until then, the remainder of the financial reporting train, including the engine, will be very, very important, will be what matters in the marketplace, what matters for investors, not what they will get next March after the year-end process is complete.

I think things like this AD&A and EOM and all these other things, or MOE, or whatever, EOM, all of that is of great interest, but it is polishing the caboose instead of paying attention to what is going on in the most important part of financial reporting.

And unfortunately, today, the auditors, at least in terms of their relationship with the outside world and the investing community, only ride in the caboose. They don't ride in the engine. The engine is driven by the management of the company, and the management of the company, with oversight and guidance from the audit committee and auditors, to some extent, are responsible for their earnings release.

The earnings release has good, real segment information in it, vastly different and far more extensive than the segment information you get in a set of GAAP financial statements, what tells investors what they need to know and what they want to know about the company and about the company's current results, and then use that information to project the future results. The information is timely.

Imagine a financial reporting world where we said, "We'll get back to you next March, and we'll have some AD&As and some MOEs and all that kind of stuff for you. But in the meantime, we're not going to have current financial information for you to use in the marketplace." Not in this world. That is not where it is.

In addition, the earnings releases include lots of valuable information that is just not part of the financial reporting process: the business performance metrics of the company, lots of different things about what goes on in the company that never shows up in the traditional regulation-based annual audited financial statements done once a year.

And I would suggest that for -- and I realize the limitations of the scope of the PCAOB by legislative mandate, the scope of the auditing profession. But if we don't find a way to get out of the caboose and start moving up toward the engine, and get engaged with what really matters in financial reporting to the investor community, we will be left behind. We will be obsolete. Whether we're obsolete in 5 years or 10 years, maybe beyond my lifetime, I don't know.

But we are increasingly obsolete spending all of our time and all of this money and all of this effort on the caboose of the financial reporting system.

I'd welcome you to disagree with that point of view, and that's okay. But ask the audit committees where they're spending their time, how they allocate their time between quarterly work and confirming the 10-K when they finally get around to the 10-K sometime the following year.

Ask the investors, any of the investors that you in the corporate world have communications with, or the investor community, give up something. Give up the quarterly release or give up the traditional regulatory financial filings. I don't know anybody who would say that the earnings release is not the most significant driving factor in the marketplace that is absolutely essential to investors. If I am missing that, the people I talk to and the people that I hear from are not representative of the investment community.

But I recognize that I really need to talk to colleagues at the SEC about this, because that is where this authority for change would have to come from, if there were to be some higher level of -- I hate the word "regulation" -- but oversight, let's call it, and assurance with respect to quarterly information.

Having made that case, let me then suggest a little bit about then non-GAAP information, the MD&A, and the other items that we are talking about. I would urge that we do whatever is reasonable to engage the auditing profession in financial information that really is important on a timely basis going to the financial community.

I would suggest that MD&A is the obvious place to start, logically included in the discussion that we have here. And I would urge that the auditors at a minimum get involved in the elements of MD&A that are comprehended by financial statements and financial reporting -- estimates, judgments, so on and so on.

And somebody might say, gee, they already have that. Mary said that they're already engaged with that at a standard of not including a material error, being materially inconsistent. Not good enough. In my opinion, they need to get much more engage gauged with MD&A.

And to Lynn's point, what you said earlier, it wouldn't make any difference. I will tell you, it will make a difference. I have seen it make a difference, because I've seen companies, and I sat on the audit committees of one -- not currently -- where management was very clear that it was management's discussion and analysis. It wasn't the auditor's discussion and analysis. Butt out, that's mine.

And to the point where we got to the stage where the MD&A wasn't even complete. And the auditors, without resorting to the audit committee, didn't have any freestanding authority or responsibility for the completeness of MD&A.

So I would suggest it won't matter in 95 percent of the cases, but engaging the auditors with the direct responsibility for MD&A would be a good idea, in my opinion. I'd like to see them involved in all of what's in MD&A, with appropriate protections for forward-looking information and management opinions and things of that kind.

I just think engaging the profession in the entire content of MD&A, and liquidity analysis and things of that kind that are there, would be a good thing, because I think the engagement will be an improvement, will lead to improvement in the quality of the information. Non-GAAP financial information, stuff that can't go in the 10-Q, can't go to 10-K, but goes into the earnings releases, more often more meaningful information in the headlines of the earnings releases, or at least an equally prominent position, things of that kind that are being reported that auditors have no engagement with -- who would be more logical to be involved with non-GAAP information than the people who understand better than anybody else what GAAP information is.

And it seems to me such a natural extension to have auditors engaged. And again, I don't care about public reporting, but engaged and perhaps reporting to audit committees about the non-GAAP presentations that the company is making, which are very important to the investor communities.

So I would put MD&A as the car closest to the caboose and non-GAAP information a little further up in the train, not too far away from the engine, which is the earnings release, and the information that is going out on a quarterly basis and the quarterly regulatory filings being one notch below that.

So with that, I'd say we'd have to move cautiously, and we will move deliberately in this, if you agree with the premise that the world of financial reporting would be greatly enhanced by having the professionals of the auditing profession engage with all of what really matters in financial reporting, not just the stewardship confirmation 15 months after the beginning of the year, which tells everybody about how the audit went and what was important long after the financial statements for four periods of the year have been in the marketplace and been used for trading purposes.

So I think that each of these things should be taken individually, and the marketplace should be the driving force behind most of what we have here, because if the market doesn't want it, and the market says thanks very much but keep the auditors back where they are, I really don't want either the cost or the other considerations that go with having them involved with the timely information that is, in my judgment, driving the investment process. That's a market decision to make.

But I think I would take the steps, MD&A first; non-GAAP financial information next; quarterlies are already being done, but never being reported on; and then take the earnings release and the content of the earnings release.

I can tell you from the perspective of an audit committee chairman, we engage -- I don't mean in the formal engagement, dollars and cents use of that word -- we engage our auditors every quarter in the earnings release, in other communications are going forward from the company on a timely basis, and we spend substantive time on it. We don't just double-back at the end of the year and ask how the quarters came out.

And I think that's where the profession needs to go, and the PCAOB needs to help them get there.

So I think those are the points that I was hoping to make. I guess one I would address was overall the question about costs and benefit. Costs here can be considerable, depending on which portion of this financial reporting process you engage auditors in that they have not been engaged previously. The benefits, I think, would be far greater than the costs, if we could enhance the quality and credibility of all financial reporting, not just the annual audited financial statement process.

MS. WATTS: Thanks, Mike.

Mark Newsome?

Mr. Newsome: Thank you.

This topic touches on, I think, one of the more critical areas that we deal with time and time again with companies. Routinely, we look at audited information, and we look at management information, if I could use those two topics.

I think management financial information would include the MD&A and other information that the management teams provide to investors. And so, one of the things we do routinely is we will look at the management financials on a quarterly and annual basis, and then we will go to the audit, since that is a third-party verification. And we will try to bridge the gap or reconcile between the two.

And in most cases -- I'm trying to think of cases where we have done this on our own. You can do it on your own occasionally, but in most cases, you've got to call the CFO and ask how do we get to the audit from what you provided us. And we do this all the time. And so it's important to us.

So when you think about the information that an auditor could provide in this area, it would be helpful to get some type of assurance about the information that management is providing, other information or valuation reports that management is using, such as an actuarial report or some other type of valuation consultant, not necessarily to opine on that work specifically, but to acknowledge management is using other information to develop these figures.

And that gets back to the AD&A to a degree, I suppose, and maybe it fits somewhere there or somewhere else. I'm not too particular on where it fits, but it would be very helpful.

And then coming back to the role of the auditor, I have heard a couple of comments. From my perspective and I think from most investors' perspective, it's not about mistrust of management or the audit committee, it's about getting third-party verification. And that's very important in our role as an investor. And again, it's routine. It's something that we do every year and with every case.

MS. WATTS: Thank you.

Bob Kueppers?

MR. KUEPPERS: Thanks, Jessica.

In this area, terminology is important. So I'm trying to remember in the last 8 years whether I have ever been part of a conversation with PCAOB and the folks here about something other than an audit, and I don't remember that. So let me just put out a couple of thoughts.

There are three levels of service we can perform as auditors: attestations, reviews, and compilations. And compilations are sort of off the table for public companies.

It's fair to say that, and I can only speak for our firm in this, we are open to doing more. But if we declare that we are open to doing more, someone will suggest that we're just commercially motivated, and I find that offensive, but is just what it is.

And the point is that if there is a call for it, the chances are that we have the skills and the mechanisms to meet that call.

Let me give you an example. Mary Morris had some really good comments about MD&A, and made the comment that we review that and maybe at some point we should express a conclusion as to whether it's reasonable. Under current standards, the requirement is we don't review it; we read it. We literally read it. And we are, by our standards, required to observe and look for inconsistencies between MD&A disclosures and the financial statements that we do audit, and bring those inconsistencies to the attention of management and possibly the audit committee.

We could not conclude that MD&A is reasonable unless we did a higher level service than what existing -- I keep going to SAS 8. Maybe it's something else. Or it's AU-something. But the point is that those standards haven't changed in many, many years.

And one thing I'll mention, it's a little sensitive, but maybe it's time we did take another look at those standards, because we literally read the document, look for things that are inconsistent, and raise the flag.

There is another level of service we perform all the time, but it's not in the standards for us to report on, and that's what we call agreed-upon procedures. So it reminds me of what Mike was saying about a press release. Press releases in GAAP, it's called a document, but there are no standards on which you could audit a press release. But you can look at the numbers. You can tie those numbers back to other financial information, the company's records. You can tie it back to a lot of things. You can recalculate percentages. This is the kind of work we do all the time if we're underwriters.

But if we were to do that kind of work and there was a call for public reporting, there's no standard under which we could issue that report. Today's standards say you have to be part of the crowd who agreed upon the procedures in order to get a copy of the report.

I'm raising it for two reasons. I think those standards at some point need to be dealt with, because I think there are things we could offer that are a lesser level of service but could give some -- I'll use the word comfort, and I'll use the word assurance, some information to investors or others.

But in order to do that, we really would have to ask our regulator here to take another look at both of those standards, in my view.

So a fascinating topic. We could to do it a lot easier if we don't have to publicly report. But if that's wanted, we have to do some work on the mechanism.

MR. BAUMANN: Does that include, for instance, in a press release, for instance, beyond going to tie the numbers into the company's records and things like that, potentially concluding something like: Based on your knowledge of the company and its environment, that you're not aware of anything misleading in the press release?

MR. KUEPPERS: And that would be what we would we call a form of negative assurance. In other words, "nothing came to our attention that."

And I think that there is something very similar in the work we do in the quarter. So certainly, that's a possibility.

MS. WATTS: Gary Walsh?

MR. WALSH: Thank you.

I work with a buy-side firm, and so I guess I'm here representing investors, but I have spent a few good years in my early career as an auditor, so I have a lot of sympathy for some of the issues that are taking place.

It strikes me that there is still an enormous gulf between what auditors think that investors use statements for and what investors think that auditors do. And I think that as I went through the choice of the four options that we have here, I've been struggling for ways that we can bring the two groups together.

I think if you talk to an investor, unless he had some auditing experience, and asked him about materiality, I think he'd be blown away to think that auditors were passing on audit adjustments that were more than that penny a share that he is selling the stock based on, you know, the earnings miss that quarter. And by the same token, I don't think that auditors have much of an appreciation for what in the world investors are doing. That's too strong, but I do think that there needs to be more of a tight alignment.

When I thought about, if you were to give someone a financial statement, and say you've got 15 minutes to determine whether you're going to invest in this company or not, I don't think that the audit report would even be in consideration for something that someone would look at. I think they would quickly go to other areas. And I think that you want to make sure that the audit report is top of mind and certainly being closely considered, or the audit process becomes somewhat irrelevant.

So when I look through the approaches, the first, the AD&A, I really think that the management is the right person to do most of the AD&A. When I look at emphasis reports, I do worry about boilerplate. I think that that has some interest, and if you could make it so that you provided some type of safe harbor for issues that were brought up in an emphasis paragraph, then maybe you have some carrot to have more open disclosure.

Going down the list again, I guess I would've said that MD&A is really not that interesting. But from Michael's discussion about the train, I really think that that is the right place to focus attention on being relevant. Quarterly earnings, I think that's an area that it's still kind of the Wild West in terms of things that were reported one quarter and then are changed the next quarter. I still think that that is too loose, and investors would really benefit from having more consistency and having the oversight of auditors being involved.

And so the last part, the last option, I think we can beef up the audit report to provide more clarity into what is going on.

But those are just some random thoughts. I really do like the idea of having them involved in the quarterly report.

MR. BAUMANN: If I could just follow-up, Gary, with a question, just to make sure I understood the point?

If a company reported a $1.50 a share in the quarter -- or for the year, either way, because the auditors do quarterly reviews, too. And the auditors had an adjustment which really would've brought it to a $1.49, but they passed on that penny adjustment there, are you suggesting to investors that's important always, or that's important only if the announced earning target for the quarter was a $1.50?

MR. WALSH: No, I think going back, I think it's very important for auditing to have materiality thresholds. That's very important.

I don't think that investors understand that enough. And I think to have more appreciation there, it would give investors a better sense of where they should focus their attention, and not purely on that penny. We tend to be pretty long-term-oriented investors, but even saying that, I think the quarterly reports are full of great information.

MR. BAUMANN: Because auditing standards do require -- materiality standards do require auditors to consider not just quantitative misstatements, but qualitative. And that is if the market would think that that penny was important because of what the company had announced, that could be qualitative material, even if it was a relatively small percentage.

But you're right, maybe investors and auditors aren't on the exact same plane with respect to that entire subject.

MR. WALSH: And just for the record, that penny isn't important to anybody. It's the fact that your revenue growth, your operating margins assumption, your competitive advantage period, you realize that all on the same day that they show the penny disappointment, and that's why you have such a large adjustment to the value that people place on the stock, not because it's a penny.

MR. BAUMANN: Thank you.

MR. WALSH: You bet.

MS. WATTS: Lynn Turner?

MR. TURNER: Interesting to hear the analogy to the caboose. I've heard some say that they ride the caboose and then get out at the end and bayonet the dead.

But I actually think the auditors aren't that far behind. I think they're probably more up in the diner or the dome car. I don't think they're all the way back at the caboose.

And in fact, auditors do have to do a full review of the 10-Q now, underneath the standards. There's not a report required to be issued and filed. I was there when we did those rules. The reason we didn't require it was because at the same time we were doing the audit committee rules and there was enough pushback not only from the business community, but one of the Big 6 at the time also opposed having a report be filed. And we went about as far as we thought we could.

I think that, certainly, audit committees, if they aren't, they should be, the chair should be requiring a report. They're fools if they aren't, and they aren't doing their jobs, if they aren't.

But I would certainly think that getting those reports in the filings would be very beneficial. I agree with Mike that getting full assurance on the earnings release would be very beneficial and good, and I'd do the same thing on the full MD&A. I think just the critical accounting policies is a waste of time and money.

However, having said that, we've seen in recent days in this city where legislation is being introduced to exclude probably 80 percent, 85 percent all public companies from SOX 404. And the reality is with the political climate in this country at this point in time, there is absolutely zero chance -- none, nada -- that those type of things could be implemented by this board or the SEC.

And having lived through that, I think it would be a total waste of this board's time and money, and investors' money, because ultimately we're paying the fees, to go down that path and waste your time on it. Because just politically, it's not going to happen at this point in time in this city.

It's unfortunate. I couldn't agree more with Mike. I think he's absolutely right. But in this city, you can only take on so many fights at a time. The board is already taken on a couple of major fights here, and so I would turn around -- while I think those are all great, and I'd love to see them all, I think at this point in time, it would be a waste of time and resources, because at the end of the day, you try going down there, you're going to have legislation introduced so quick, your head will spin, that will cut you off at the pass, especially with the legislation we're already seeing in recent days pop up.

So I'd love to see it, but you have to deal with practical reality in the city, and it just can't happen at this point in time. But it's unfortunate. It would greatly benefit investors. I think it would be well worth the money. But it's not a reality.

MS. WATTS: Jack?

MR. CIESIELSKI: Thanks.

I have a few thoughts along those lines of Lynn's, but a little different maybe.

First of all, I'm not sure what kind of form the assurance on an MD&A would take. That's kind of a free-writing prospectus sort of thing that the managements do. And unless you are going to be writing a whole MD&A yourself and comparing it to what the management would come up with, I'm not sure what you would say in an opinion on the MD&A. And that really did not jump out at me in the concept release.

But going back to what Mike said in the beginning about the train, the caboose, et cetera, you're right, absolutely right, that earnings releases are important because they move the market. But they move the market because they're the first new information after the end of the quarter. So what you're proposing is to put some kind of assurance on the MD&A, which comes out much later in the quarter. And the time you're going to take to put assurance on the MD&A, whatever form that might be, is going to push that Q filing closer to the deadline, farther away from the time that the earnings release is made.

So I find that further cheapening, or maybe not cheapening is the right word, but making the Q somewhat less useful for the investor, because it's going to come out later. Maybe it's got assurance, and maybe that compensates for the fact that it's later, but if you're going to be putting some kind of audit procedures or assurance procedures on it, you're going to have to spend some more time, unless it's just what you're doing now, reading and reviewing and then putting the assurance opinion on it.

I think that if you're going to do anything along these lines, you have to do the whole package at one time. You have to put assurance on the earnings release, which is maybe in conflict with GAAP, and have the GAAP numbers out at the same time. And I think the solution is really to do the whole thing at once, and not have companies, and I'm not sure how you legislate this, but not have companies file an earnings release, issue an earnings release, without the Q.

The whole package all at once is going to give everybody all the information they need with all the assurance. And I think if you piecemeal it by doing assurance on the Q later, then you're actually going to give management a reason to go out and put the earnings release out sooner or increase the gap between the two, and I think that that's not a good thing for investors.

So for what it's worth.

And I think that would be an enormous amount of rules overhauling that goes far beyond changing the auditor's opinion. I'm not sure how you could get that synchronization of the earnings release with the Q in this kind of climate. For what it's worth.

MR. BAUMANN: I guess that would be something that the SEC would have to take up, in terms of an earnings release would have to accompany -- the Q would have to accompany the earnings release and the SEC would also have take up whether or not to report that Lynn said auditors have to, for procedures right now, in connection with the quarter, but they're not required to issue a report. And I think Lynn suggested he thinks that report should be accompanying the quarterly financial statements, I think -- right, Lynn? -- which would require SEC action.

And I think those are all good points, and worthy of discussion.

In theory, that one doesn't have any extra cost at all involved. If the review is already being done, putting a report attached to it has no cost.

With respect to your comment, I just want to make sure I have it correctly. There are existing attestation standards for reporting on MD&A. There was an example of that in the concept release and in the mock report that the CAQ put out. It talked about, we have examined the critical accounting estimates, and it talks about what that means. And it gives, ''in our opinion, the presentation of the critical accounting estimates," and it goes on and talks about what that opinion means.

MR. CIESIELSKI: I'll have to go back.

MR. BAUMANN: So it's worth looking at that. There are some existing criteria for that.

MR. CIESIELSKI: I was thinking of it in terms of an audit opinion, just, "We have examined the financial statements, and it's in accordance with GAAP." We don't have a body of -- well, we do have the PCAOB standards, so okay.

MR. BAUMANN: But whether we amend that or not would be another factor, but there are existing standards there.

MS. WATTS: Mark LaMonte?

MR. LAMONTE: Thanks. Very interesting discussion. I very much agree with what Mike led off with, the train analogy, where we're talking about the caboose being the driver of what we're thinking about here.

One of the issues that we're dealing with -- and this may be something we might not be able to really solve in this context; it might be a much bigger issue -- is we're dealing with a very archaic form of financial reporting that doesn't necessarily reflect how investors make decisions or the information they use to make decisions.

It's really about data with investors and the flow of data to investors. You don't have a lot of investors necessarily staring at balance sheets. It's about data that's getting into models. That may be getting into models by someone in India rekeying it at $10 an hour, or it may be a junior person putting it in.

But it's not really about financial statements. It's about the data that drives decisions and whether there is assurance over that data. Some of that data may be extracted from financial statements or earnings releases and be your traditional balance sheet metrics, which are subject to audit, or would be subject to audit after the fact.

Other pieces of information, which may be absolutely critical, might be more nontraditional information. If you're looking at Wal-Mart, a key driver might be same-store sales, which is never subjected to audit but is absolutely critical to making a decision on whether or not to invest, to buy or sell their securities.

So I think at some point we may need to really refocus on the flow of data rather than the preparation and auditing of the financial statements. And this may be in part why the financial statement presentation that the FASB and IASB has been working on has gotten bogged down. It's just recasting this old, archaic view of financial reporting and not focusing on data flow and then assurance over that key data.

So this might be a much big issue than can be addressed in this project, but I think it's something that the PCAOB and the industry really need to begin to think about.

MR. BAUMANN: In that context, would you be supporting auditor association with XBRL?

The data that is probably being sent over to India for use in --

MR. LAMONTE: If anybody was actually using XBRL, absolutely.

[Laughter.]

MR. KABURECK: Don't assume anyone is using it.

MR. BAUMANN: Thank you.

MS. WATTS: Peter Nachtwey.

MR. NACHTWEY: Thanks, Jessica.

Well, the first thing I have to share is both Mike and Lynn are taking me back early in my career when I was told what the definition of an auditor was, which was somebody who comes in after the battle was lost and bayonets the wounded. But I was also told that by an attorney -- so, Lou, don't kick me -- who defined lawyers as those who come in after the accountants and strip the bodies.

[Laughter.]

MR. NACHTWEY: So on that ghoulish note, on this proposal, as I said earlier, I definitely would be supportive, but with some caveats, because I do think it makes clear to investors, more clear what the scope of the auditor's involvement has been outside of the basic financial statements. And it more or less, frankly, acknowledges facts on the ground, as far as my experience shows.

I also think that probably this may be one of the most important things that we're talking about today as a relates to non-GAAP information, because I spent a lot of time on the road with analysts and investors, and, frankly, they spend very little time grilling me about the GAAP information. They spend a lot of time drilling me about the non-GAAP information.

So I think it's especially important that, as I think Mike said, that the auditors, well, you say, gee, they're trained in GAAP, well, they're trained in numbers, they're trained in financial analytics, a lot of things that lend themselves to being involved with that information. And I do think it would be helpful. And frankly, it might cut down on the number of questions that I need to answer, because people don't think the auditors are involved with that information today.

So I also think the quality and consistency within industries would be enhanced if auditors were involved with that information, and by derivation, this group, the PCAOB.

Conversely, on the earnings release front, I don't think auditor reporting on these really gets you over the cost-benefit hurdle from what happens today, because auditors are heavily involved in the Qs, as several have said, and they ultimately report on these anyway, in terms of the footnote that is in the financials at the end of the year.

So I think that management and auditors stay pretty close already on the numbers. And where they don't, you see embarrassing situations where, after preliminary earnings release, the numbers are revised when the ultimate filings go in, and I think that's already a sign of the involvement that auditors have there.

I just have a little trouble imagining how an auditor report on an earnings release, and particularly the tight timeframes that the market gives us to get earnings out, how that would work.

So those are my views.

MS. WATTS: Larry Salva?

MR. SALVA: Thanks, Jessica.

To follow up on something that Mark mentioned, data assurance, or I would put it more association with, and maybe that follows up on the last comment as well, in that I think it would be important for investors to know that auditors are somehow involved with, not necessarily providing assurance on, because somehow that gets more difficult to get into places.

And I note within the concept release that it notes that there is no requirement for an auditor to provide assurance on earnings releases or non-GAAP information. Well, I'd also note that there's actually no requirement for them to even read it for material inconsistencies, because it's not included in the document that includes audited financial statements. But it's absolutely part of the financial reporting process and integral to it.

To my knowledge, there's no requirement for a public company to actually publish an earnings press release prior to the filing of their 10-Q, although that is practice for most companies. And I could easily see a standard being written that said, in the case where a public registrant publishes a press release as part of its financial reporting process, that the auditor must read it at a minimum. The baby step would be read it for material inconsistency. If you want to go past the baby step, there's not a standard for the preparation of earnings press releases as there is with MD&A, where you can provide an attest report.

But as the concept release also points out on page 24, there are three things that an auditor opines on when they attest to MD&A. The one that I think would be lacking for press release would be that it's complying with certain published rules or specified rules. But they could easily, I think, get to the second two points, which is historical information has been accurately derived out of historical records of the company, and that maybe negative assurance, possibly, on nothing came to their attention that the underlying information, the termination estimates, assumptions, that the entity provided are not reasonably supported or that there's not a reasonable basis for the disclosures contained.

Auditors do have experience in being involved with statistical data when they issue comfort letters to underwriters. They have the ability to make reasonable determinations and reporting as to whether things are misleading, including statistical data being used that could be misleading. And we could pursue auditors being associated with, or at least involved with, maybe not providing assurance on, but if the standard required involvement with that data, and that the public was then made aware that the auditors do include some procedures on that data, I think it might run to Mark's objective of having, maybe not assurance, maybe not direct assurance to the investor, but at least knowledge that there was involvement with the data that was published by the company, and that that data is much more timely than what is coming either in the 10-Q with or without a limited review report, because I would also point out that limited review report is boilerplate. It's not tell you anything.

And we all know that the limited review has to be done, so to me it's not important to publish a limited review report. You just know that if you are a registrant, you have had that review done.

So I just think that there is opportunity here to pursue involvement with, but I'm hesitant to go as far as trying to define assurance on press releases.

Obviously, this also gets into cost and time constraints. You're in a very constrained, tight closing cycle. But I think it's possible to have the auditors have involvement with the press releases that should not be inconsistent with the subsequently filed Qs or Ks.

MS. WATTS: Jay Hanson?

MR. HANSON: I want to react to a couple things that the two Garys have said, and Alan Beller mentioned it as well, and maybe just pose a question, and a little bit of a surprise.

Gary Kabureck opened up the day with the question of who are the financial statement preparers writing the financial statements for, and who are the auditors reports directed at. And Alan said succinctly that it's not for Aunt Mabel; it's for the sophisticated investors. And so we have to assume some level of knowledge.

And, Gary, when you mentioned a little bit ago about that one cent differential in the earnings and how much the markets move on that, if they're missed by a penny. And I know that is reality. That happens a lot.

But unless you're looking at Joe's Barbershop's financial statements, which there is probably not a lot of subjectivity in the numbers in those financial statements, almost every sophisticated business today, as well as the larger financial institutions, there's a lot of squish in almost every number on those financial statements. And it would surprise me if a sophisticated analyst wouldn't appreciate that.

And I realize that Larry Smith is here as a representative of the FASB. And they have been working really hard on trying to get that more transparent in the financial statement for years with the leveling of the fair value measurements, as well as the disclosure proposals about the sensitivity and the measurement uncertainty. But even without specific discussion of this given number could vary by this many dollars, given the substantial improvement in disclosures over the last couple years, I would think that it shouldn't be any surprise to any sophisticated investor that there's just a lot of latitude in a lot of the numbers, the larger the financial institution becomes, and the more fair value measurements are in the financial statements.

MS. WATTS: Brian Croteau?

MR. CROTEAU: Thanks.

Actually, Larry, I'm glad you raised the point about there not being a requirement around earnings releases. Really, the question to pose relative to that point, I guess one is whether we see problems today where companies are re-issuing earnings releases on a regular basis, such that there needs to be some mandate for auditor involvement. And then secondly, I guess there'd be some requirement, presumably, that the auditor finish their work on the earnings release before the press release could be issued.

And I won't sort of get into the points around authority and whether the SEC would take up that kind of project, but I guess I just wanted to understand sort of the impetus and whether we're seeing a problem with the quality of earnings releases today that people are trying to address with this point.

MS. WATTS: Chris Spahr?

MR. SPAHR: As a sell-side analyst, timeliness always matters the most to me. And so I would think anything that would push out the earnings release is actually detrimental to the investment process.

Secondly, how I view the auditor work is I want accuracy and quality, and I don't know if looking at the sufficiency or the accuracy of an earnings release is actually going to give me greater confidence in the underlying marks or the accuracy of the low-loss provision. So I'm afraid that if you focus on the earnings release, you're going to get away from what we want the auditor to do, which is look at the quality of the financial statements. And that kind of goes back to the first two points, not to this third point.

MR. BAUMANN: I just want to understand your comment on accuracy, because that's not a word that goes particularly well with a set of financial statements, in my view anyway. And I think it was the point Jay was making.

Financial statements are nothing but a mass amount of estimates and judgments, allocations of cost for periods.

And they're anything but accurate. They are based upon the assumptions and estimates used by a company, hopefully prepared consistently, such that that the numbers present reasonably.

Is there any difference of view on that point?

MR. SPAHR: No, actually. I think accuracy would be the granularity of the quality of disclosures and what the exposures are.

I cover financial institutions, so to the extent that I know what the puts are for mortgage-backed CDOs in November 2007, some of that didn't come to light in July of 2007 earnings release, and it wasn't in the Qs following that.

And again, so it wasn't in the Qs, which was in theory reviewed by the auditors. It wasn't in the earnings release. So it was more of a qualitative point on that. Do we have the full amount of information that we need to make a good investment decision?

So again, it comes back to, is there sufficiency in the audit review process, and making sure that investors have all the information they have.

I'd rather judge management on the earnings releases, and then judge auditors on the quality of the Qs and Ks.

MS. WATTS: Sam Ranzilla?

MR. RANZILLA: I think it's fairly clear, based on my comments earlier this morning, that as it relates to the attestation of a portion of MD&A, I think that is a short-term solution to the issues. And I note that others in the room have stated they don't.

I vehemently disagree with that position. And I think if you look at what the CAQ has crafted out for a sliver of MD&A, I think it addresses the kinds of issues that have been raised.

I also agree with the context that today a full attestation of MD&A is not cost-justified. That's what we heard when we talked with investors. I think others have said that as well.

But I do think, from a short-term perspective, critical accounting estimates is a place where this board should look for -- at least pursue further a potential solution.

I would also suggest that the rest of this section dealing with other information outside of the financial statements is better left to a second, separate project, because -- taking earnings releases as an example. I mean, just think about what we just heard is all the challenges are to an auditor association with earnings releases beyond what it is today.

So when I say association that means some form of reporting to somebody who's going to rely upon it beyond either management or the Audit Committee. So the challenges around earnings releases -- one, there's no framework for which an auditor to assert to.

Bob Kuepper's point of he maybe agreed upon procedures as a place where we could provide some value but today we'd have to rewrite the rules because agreed-upon procedures reports can only be shared with, in essence, internal people or people that signed our engagement letter that says, do those procedures.

Somewhere that would have to be something like the SEC would designate the agreed-upon procedures and then the report could be issued as a standard form.

The third piece, and the piece that I have struggled with on whether it's a quarterly earnings release or an annual earnings release, is maybe absent agreed-upon procedures effectively what the auditor would be doing is reporting on work in process.

We're not done the audit -- we're not done the quarter -- the interim review at the time the press release goes out. I think how does an auditor report on work in process -- something, quite frankly, that we've struggled with a bit on comfort letters where we're in the middle of -- you know, a deal gets done after the press release goes out but before the 10-Q is issued, and that has always been a challenge for us and that's just an agreed-upon procedures report.

So I think the whole area of non-GAAP and earnings releases are things where maybe the profession can place some value.

I just think you ought to carve those out and look at that as a different element of this project because I think the amount of time it would take and maybe to Lynn's point the willingness of the marketplace to absorb that additional cost is a longer-term project than the more immediate issue of improving the reporting model for the auditor today. Thanks.

MS. WATTS: Steve Buller.

MR. BULLER: Just a few brief comments. I just struggle with whether we're proposing a solution in search of a problem here, especially with respect to interim reporting. I mean, the auditor for us is involved in reviewing our significant transactions on an interim basis and reading our 10-Q and reads the earnings releases.

But they really are focusing on pieces of the entire operation, and certainly they're in no position to make any assertion on the overall quality of information or on the fairness of presentation. So although people would hate to have it characterized as such, it reacts as a detect type control for management, and I think they'd feel comfortable reporting upon anything -- any association with the financial statements other than perhaps a type of agreed-upon procedure.

With respect to the year-end reporting on the activities they perform with respect to the MD & A and other information contained in reports containing financial statements, I think that perhaps can be clarified, as we'll probably discuss next in the auditor's report, as opposed to requiring a further set of procedures over their function.

MS. WATTS: Flerida Rivera-Alsing.

MS. RIVERA-ALSING: Thank you. One thing -- assurance on certain information is not a matter of whether we trust the management or we trust the Audit Committee of the company. I think, as former President Reagan said, trust and verify, and we look at the auditors to do the verification on behalf of the investors.

Saying that the auditors are involved in the process is enough, I think, is incorrect because that will give us a false sense of security on those numbers that are being released quarterly under earnings.

And then discussions about who are the users of the financial statements. Some says -- some say only the sophisticated investors. I totally disagree. I think it should be the reasonable investors. Thank you.

MS. WATTS: Okay. We'll take Bill Clark and then Charles Elson. Bill?

MR. CLARK: Yeah. Just -- I think I basically agree with what Steve from BlackRock said. I mean, just from talking to other pension managers and being in groups that represent funds, I think in the abstract most investors would say everything up on that screen is fantastic and is something we should strive for.

But practically, I can't say I've ever talked to anyone who would put that near the top of a list of things that they would want to see in terms of improved governance in financial reporting.

And maybe it's because of the cost

justification. Maybe because there are just other issues that are more important. I just -- I just don't see this burning need or desire on the part of investors to make this a priority item.

And then you kind of link it back to Lynn's comments to the extent political capital would have to be used to get something like this done, I think I would probably agree we'd rather it be used elsewhere.

The other point on the earnings releases, I would say more often than not the things that move the market the most are the forward-looking statements which wouldn't be subject to review anyway.

So I'm not -- and again, maybe that just gets to the point in terms of how much value -- is it relative to the cost and the impact on time in this because I agree with that as well.

When you get to the fifth business day and Alcoa is not out there with their earnings results, I think you'll see some reactions from investors.

MS. WATTS: Charles Elson.

MR. ELSON: I think there are certainly portions of the MD & A that the auditors could give an assurance on. The problem is once you move beyond the financials and you move way beyond the financials, there's a real slippery slope, I think, involved that once they are asked to provide assurance outside of the financials into other areas there's the danger that they'll be called upon to begin to offer expertise or insurance on all kinds of things, once you go through that -- you break through that line, if you will.

I mean, I've always, you know, wanted to be a fighter pilot but I can't see beyond my nose and, you know, there are certain things that I'm not good at. I can't repair plumbing and, you know, I can read a law text but that's where I need to stick to my business.

And I think that if you take them outside of the area which they have traditionally had expertise and knowledge, even if it looks a little bit like outside of that area they have some expertise, it's a real slippery slope.

Once you do that, then there will be pressure then to go beyond that and they effectively become this sort of uber monitor of the corporation, and that's not what they were set up to do.

MR. BAUMANN: Thanks, Charles. Sam, I'm going to ask a question -- if you can't answer it or if Bob or one of the others from the firms want to take a shot or don't want to answer it -- but Lynn made a point before of what's politically possible in this -- at this particular point in time and was talking about this area of providing expanding auditor responsibility to cover, for instance, critical accounting estimates.

They may not politically feasible and I guess mainly because he was talking about cost, I think.

From your perspective -- and if you don't have a view, fine -- would the AD & A be -- what's the relative costs of auditor reporting in an AD & A format versus auditor reporting on critical accounting estimates?

MR. RANZILLA: Well, let me -- let me reply on behalf of Bob Kueppers and Deloitte & Touche.

Marty, this is just my view and this is something that we have talked about. I believe it is -- it will be more costly to do an attestation of critical accounting estimates than it will be to do some form -- a form of AD & A that is very close to what's included in the concept release.

So I do think it is. Others might have a different view. But I will tell you I think the risk of affecting filing deadlines is more significant for an AD & A than it is for an attestation of critical accounting estimates because while MD & A is usually prepared later in the reporting cycle, it's also something that we can continue to do work on over -- first of all, it's objective in terms of you've seen the report, does it comply with SEC standards, where an AD & A is going to go through multiple reviews internally -- it's going to go through multiple reviews at the company, at the company's counsel, at the Audit Committee, at the Audit Committee's counsel.

And I think an AD & A has a higher risk of slowing down financial reporting even though it is marginally less costly than an attestation of MD & A. That is one man's view.

MR. BAUMANN: All right. Thanks, Bob. Lynn, is your card up on this topic? Okay.

MR. TURNER: Yeah. Also speaking for Bob Kueppers, I'd probably beg to differ with Sam on the -- the critical accounting policies, when I've gone through and I've done this here recently, looked at them and compared them to what their auditor is already reporting on in terms of the accounting policies back in the financial statements, there just isn't that much difference these days, quite frankly, and in fact in some cases you actually see more and more robust disclosures back in the actual footnotes.

So I would be shocked or surprised if it cost me more to get an audit report and assurance on the critical accounting policies than it would be to do a separate AD & A.

Having gone through and done MD & As and knowing the process that we've gone through to do that, I think there would be levels of review.

It'd take you more time -- not a lot more time because keep in mind you have to have that completion memo done by the time you sign off on the financials and get to the report date, and most of what you're going to write about would be at least in that completion memo anyway, which the partner -- concurring partner -- and if it has to go up the ladder that already has to be signed off on -- and so I think the AD & A would have additional cost.

Do I think it would slow things down that much? No, since I don't believe we're asking the auditors to do any more audit work.

What we're telling -- asking them is to tell us what they know from the audit work they've already done and they already have to capture that in that completion memo.

I don't think it should be significant additional cost, and if you do it on a fairly limited basis along the lines of what Alan Beller was suggesting I think there should be some additional cost and reimbursement but I don't think they'll be that significant. But that's just talking for myself.

MR. BAUMANN: Thanks, Lynn. All right. I think we have Bill Clark, Sam Ranzilla -- still up, Sam? Bob Kueppers to probably speak for himself, and Mike Gallagher.

MR. KUEPPERS: I don't -- I don't agree with Bob Kueppers.

[Laughter.]

MR. KUEPPERS: Either one of them.

MR. BAUMANN: Does that often happen to you?

[Laughter.]

MR. KUEPPERS: Here's the truth. Sam's right. We talked about it. But what he said that I -- I just want to point out I think the critical accounting estimates -- you know, attestation -- that's going to be about the work, less about the report.

It just -- AD & A is all about the report and I think -- I think there are additional costs but it's because of the iterative process you're going to end up going through -- certain amounts of reviews.

But we don't have any data that would suggest one versus the other. You know, Sam said marginal. There's a cost but we have done no studies to determine with any reliability the distinction between the two.

MR. BAUMANN: Mike.

MR. GALLAGHER: Yeah, Marty. That's kind of where I'm at. I mean, I honestly don't know. It was interesting. Sam went one way, Lynn went the other way. I'll say I don't know.

But don't underestimate the cost associated with the level of review, and it's not as simple as taking that completion memo and just publishing it. At the levels of review that would be extensive. And I'll just add to it, the other option -- the emphasis of matter paragraph -- I would say out of the three that's the least costly or and I would say most cost effective, perhaps.

You could argue between whether MD & A or whether that, but in terms of being able to do something quickly and relatively inexpensively that strikes me as something that would be the lower cost alternative and maybe greatest value.

MR. BAUMANN: Mike, you began. You were one of the two that began this discussion and Dan, is your card up too? Oh, Flerida. So Flerida, why don't I give you the floor and then Mike, I'll give you the last word on this one before we turn to our next topic.

MS. RIVERA-ALSING: Thank you. I just want to agree with Lynn. I will be very shocked that the assurance and critical accounting policies would cost more than the AD & A. Currently, the audit firms are already disclosing that and giving that assurance to the Audit Committee.

MR. BAUMANN: Mike.

MR. COOK: Marty, I share that same view. I guess if I were talking to a group -- a room full of Audit Committee chairmen I would say to them have a conversation with your auditing firm, your lead partner, and ask them what it would cost to report to you, perhaps -- might be the external reporting -- we could think of that separately --

on MD & A, and if it's going to cost a lot then I would be asking myself why is it that that isn't being done today because this is critical accounting policies, estimates, and judgments that go into the preparation of the financial statement. This is not new territory for the auditors.

Why would it take a great deal of effort to give us a report on something that is so integral to the financial statements? And if the answer is it's going to cost a lot, maybe we ought to start spending it because auditors aren't spending the time with critical accounting policies, estimates and judgments that they should be. I don't -- I just don't know.

I just personally don't think this is a big add-on, and the form of reporting that has been suggested seems pretty reasonable to me.

Just a final thought on the overall discussion. I think there -- you know, again, there are things here that are a bit controversial -- provocative, maybe, but also just thought stimulating. But I do think we ought to -- and not perhaps as a part of this specific project -- I thought the notion of keeping these separate is a pretty sensible thing because they're quite complex and quite different.

But looking at the total financial reporting process and who uses the results of financial reporting and when is it used and how is it used and where is the audit effort going, I'd like to hear from the investor community.

What do they use to make investment decisions? If their particular firm made a hundred investment decisions or recommendations in a year, how many of those are based on the annual financial statements that we're going to do a lot potentially to change in terms of the auditor's reporting on them?

How many of the decisions are made based on those statements? How many decisions are made based on quarterly earnings releases or Qs?

Take your pick. And ask yourself if we have the cost of assurance attestation reasonably aligned with the decision making that is resulting from that. I'd kind of like to know because if they make a hundred decisions a year and 94 of them are made for reasons other than what's in the annual financial statements, and Mike's point I agree with -- the data which is driving that -- then are we spending all of what we're spending on 6 percent of the decisions that are being made and is that a wise allocation of limited resources, and maybe those resources should be reallocated.

The thing I think that comes up here is this question about quarterlies and does it really make sense not to have some form of auditor engagement that reaches third parties.

If you stood back and asked the question would the emphasis of matters make a whole lot more sense if it was done on a timely basis instead of emphasizing things next March that are relevant in the second quarter of this year, and maybe that ought to be integrated into the quarterly reporting process, not into the annual financial statements.

Again, I realize the jurisdictional problems of PCAOB and others and I realize the real-world limitations that Lynn refers to, and I'm just saying let's think about what matters, when people get it and if we're going to fix things would it be better to invest some of our resources in fixing the things that matter the most instead of continuing to shine the caboose. So I'll leave it at that. Thank you, Marty.

MR. BAUMANN: Thanks, Mike. Sam, is your card up again?

MR. RANZILLA: It is, if I might indulge you one last time. First of all, I'd like to -- there's a difference between critical accounting estimates and critical accounting policies. We, at the CAQ's recommendation, is very specific to critical accounting estimates.

The second point that I'd like to make for your consideration is when you go back and read what is required under the critical accounting estimates for disclosure, I ask you to then try and find those disclosures in today's MD & A.

And while I agree the auditor is all over critical accounting estimates in determining whether or not the financial statements taken as a whole are fairly stated, I don't think there is a significant amount of original work.

But the disclosures that are required under that financial reporting release are fairly extensive and will require additional work on -- if not being done today on both behalf of issuers and with auditors.

So I just ask you to look at that very closely when you assess what all that would take and what is the cost benefit around that approach.

MR. BAUMANN: Thanks, Sam. Lynn, is your card up again or -- thanks.

MR. TURNER: Just one quick comment on the issue of who are you doing these for, Marty, and the reasonable or whoever the investor is -- Aunt Martha or Uncle Lyle.

But another thing to think about there's a -- there's a study been completed by IBM by a person who's now at State Street, and in that study it demonstrates and finds that 85 percent of the portfolio investment managers in this country underperform just industry benchmark averages, which leads you to believe that if you're indexing with Fidelity or Vanguard you're probably well ahead.

But 85 percent of the portfolio managers are underperforming, and I'd have to think that there's some group of those people who are underperforming just because they don't know what they should know and aren't doing their homework.

But I also think that a piece of that underperformance is they aren't getting the pieces of information that they need, which is to Mark and Michael's point about the reporting model. And as you go and look through this, this is another example of a situation where investors are saying, we do need this additional piece of information.

And so if we're going to try to get it to where these portfolios, which are so important to Americans retiring now and to this country in that respect, then we ought to really look at trying to get those investors the information that they need because the studies show that they aren't getting it and they are seriously underperforming.

And if you got 85 percent underperforming, that’s a really serious problem. Eighty-five percent of these people aren’t dumb and aren’t incompetent. So I’d suggest you may want to go get that study out of IBM and see if -- and/or talk to the lady who did the study who’s now at State Street and see if there’s some additional information that came out of there that might give you some tidbits on information that you could require that would help improve that for American investors.

MR. BAUMANN: I think I’d like to turn to the very last subject. But Stephen, do you have one more word on this?

MR. KOZERACKI: Yes. I just -- I was listening to what Mike Cook was saying about, you know, the timeliness and the importance of the quarterlies and, I mean, I think he is correct and that probably a lot more decisions get made based on the quarterly information.

But I think one of the differences is that, you know, most large public companies, after they release quarterly information, you know, the analyst community and investors have, you know, access to management for anywhere from, you know, 45 minutes to a -- maybe up to an hour and a half and, you know, you have sort of an entire group of educated investors and analysts who are sort of able to pepper them with questions and ask them, you know, a lot of detailed questions about, you know, perhaps how some things -- businesses perform during it and maybe even get some outlook on, you know, what's happening in the current quarter.

And so I think, you know, investors get some -- more comfort from that, and then also there's transcripts from those calls that allow the investors to review that as well. And I'm not sure they would want to give that up or the timeliness they get from the earnings release with the follow-up call with the -- with management just to get, you know, something that says, you know, we reviewed the earnings release and it, you know, appears to be accurate.

So I think there are more decisions from the quarterly information but I think it's as much based on the follow-up conversations with management and the investor calls rather than, you know, what's being attested to that the quarterly release is accurate.

MR. BAUMANN: Thank you very much. Well, turning to the last subject, Jennifer Rand does a lot of extraordinary work in the Office of the Chief Auditor and she will miraculously cover the last hourly topic in the next 30 minutes. Jennifer?

MS. RAND: Thanks, Marty. Okay. We're in the last section of talking about alternatives in the -- to the audit -- changing the auditor's report. This section will cover both clarifying language in the standard auditor's report as well as other alternatives that weren't described in the concept release or could also be a combination of the alternatives.

Going to the clarification, when we did -- when we did our outreach -- and a lot has been talked about the outreach we performed, which really helped inform our views on the concept release -- we did hear that while the current report is boilerplate, there would be some benefit to enhancing that quote, unquote, ''boilerplate language'' to better describe what an audit is and what an audit represents.

Many in our outreach said that would be a cost effective way to making some changes and there could be some benefits to doing so because there is some confusion about the auditor's responsibility over certain information like other information and other matters.

So certain other topics, and this list is not all inclusive, but it would be describing what's meant by reasonable assurance, and an auditor's report provides reasonable assurance that the financial statements are fairly presented.

So some have said it'd be helpful if the report described what reasonable assurance means. Another area is the auditor's responsibility for fraud.  The auditor's report today does not describe what that responsibility is and some said it would be helpful if it did.

Another is the auditor’s responsibility for financial statement disclosures. The financial statements include balance sheet, income statement, cash flow as well as the notes to the financial statements, and some have suggested perhaps it would be helpful if that was mentioned in the report.

Another is management’s responsibility for the preparation of the financial statements. There’s a sentence in the report today that says the financial statements are the responsibility of management but some have said it would help if it -- if there was better clarification that management is determining estimates and judgments and then the auditor’s responsibility is to issue an opinion on those financial statements. So what goes into the preparation of the financial statements.

Another is the auditor’s responsibility for information outside the financial statements, so MD & A. For example, we just talked about should there be greater assurance and we've talked about that auditors read MD & A for material inconsistency.

But the auditor opinion doesn't tell you that, and from what I heard from comments in the last section some think that auditors do a lot and they're all over it, as one person said, and others indicated well, they do a lot but it is limited to reading and so forth.

It doesn't go into all the things that's in the attestation report that exists but currently many auditors are not engaged to do those type of assurance reports.

And another possible area is auditor independence. The title says it's the independent auditor's report but some have said it'd be helpful to know more about auditors' independence -- if there's any potential issues discussed with the Audit Committee and have that brought forward in the auditor's report.

So the questions we're asking in that area include would these potential clarifications serve to enhance the auditor’s report and help readers understand the report, the auditor’s responsibilities, why or why not; what other clarifications or improvements could be made to better communicate the nature of an audit.

I said that the list I just went over was not all inclusive. There’s others. And then what are the potential benefits and shortcomings to providing clarifications in the report.

And then also in this section I want to cover other alternatives. So what alternatives or are there any other alternatives that the Board should consider as far as changing the auditor’s report. Would a combination of the alternatives that we’ve discussed today or presented in the concept release be more effective, so are you supportive of emphasis plus reporting on MD & A or something like that, and which alternative is the most appropriate and why.

So with that, I’m going to open up the discussion to both talking about clarification and other alternatives and we will effectively do that in now 25 minutes. So I open the floor up for your comments.

MR. BAUMANN: Things we are particularly interested in, as well as the commentary on clarification, are the things that we haven't thought about that we're not yet -- that weren't put in the concept release that somebody here thinks this is another good way to deal with clarifying or improving the auditor's reporting model, as Jennifer said.

MS. YERGER: Well, it's hard to say you oppose a clarification because by its very nature, I mean, everyone wants things clarified. I think -- when I see the long laundry list I get concerned that one of the primary benefits of that -- the current pass/fail report is its brevity and you add a lot of legalese, which I think a lot of this would be.

I don't know if that's a good thing. So let me just comment on two clarification/enhancements that were part of the Treasury Department's Advisory Committee on the Auditing Profession --

the ACAP, as we lovingly called it -- I was on that committee -- and I think they should be considered.

One has to do with the auditor's responsibilities regarding fraud, and we talked a lot in that committee about that expectation gap and our feeling was that the biggest expectation gap was about what's the auditor's responsibility when it comes to detecting fraud.

I think it's shocking, in a way, that the auditor's report doesn't even mention fraud, and the auditing standards do currently require the auditor to plan and perform the engagement to detect material misstatements whether caused by error or fraud, and I think that does need to be explicitly placed into the auditor's report.

The second item, which might be dubbed in the more provocative area and it's certainly an enhancement and not a clarification -- is -- and it was something that was discussed quite a bit at the ACAP was the addition of the name/signature of the audit engagement partner on these reports.

I don't think anything sharpens the mind more than placing a name on something and we think that would be a very important and valuable addition to the current report.

MS. RAND: Thank you. We do -- just on the second point regarding the name, we do have a separate project looking in that -- at that. So that's very active. I'm involved in that one as well.

This audit report is looking at the content -- what should be in the report. That other separate project, which is actively moving forward, goes into who providing transparency and to who. Is that Charles Elson or -- no, totally wrong. Sorry.

MR. SANTAY: Mike Santay.

MS. RAND: Michael. Sorry.

MR. SANTAY: Yeah. That's okay. Just a couple of brief comments. Generally, we support the changes that are outlined and some of these, you know, I think there could be some alignment with some of the proposed standards. For example, the International Standards on Auditing have addressed some of these matters and I think would be helpful to look at that as part of these considerations.

And then just, you know, operationally -- for example, if we were to add something around other information -- you know, reports get reissued, consents get used -- the other information might change. Just so from an operational perspective just be careful with how much detail we get into or specificity in some of these additions if the Board decides to move forward with some of these recommendations.

MS. RAND: Thank you. Mark Newsome.

MR. NEWSOME: Thank you. You know, the first thing is, you know, if you're going to expand the form in a boilerplate fashion I'm not sure that would be all that helpful.

I would encourage auditors to differentiate themselves with the letter -- make it more like an opinion that you might see in other situations. But with regard to the audit opinion itself, I would encourage you to include a negative assurance clause.

We often ask that of auditors in private investment transactions where the auditor will actually send us a letter, we're not aware of any defaults or other things that might cause you to be concerned or might cause a default in your own investment structure. I think that would be very, very helpful and something that people often want to see.

MS. RAND: The auditor's opinion is reasonable assurance (inaudible) higher than negative assurance unless you're looking for a particular negative assurance on particular items because the opinion goes as a whole -- the financial statements as a whole.

So are you looking for certain specific --

MR. NEWSOME: Right. I'm not looking for a lower level of assurance and so what I'm talking about specifically is a statement, we are not aware or have not become aware of any defaults or fraud or other matters, you know, in the opinion itself. That's something that we ask for from auditors separately from their opinion.

MS. RAND: It looks like I have the order down in a row. So Gary Kabureck and then Mark LaMonte.

MR. KABURECK: Thank you, Jennifer. Just a couple of quick comments in here. In terms of other alternatives, one thing you might consider is in the auditor's end report the role -- their involvement with unaudited statements, and you got a unaudited quarterly data footnote. I mean, it -- you've got some other unaudited, you know, subsequent events footnotes.

Maybe there's some other special industry disclosures that are unaudited. So what -- so these are annual financial statements. I mean, they're -- when they're filed they're covering stuff at least 14 months earlier.

So what's their involvement or responsibility for the unaudited data in their -- I'm thinking quarterly or subsequent events but maybe there are some other things -- again, just clarifying responsibilities that your work extends to the annual statements and not to the interim.

Now, maybe you got to clarify and say we've done reasonable procedures or something that goes back to the rest of the stuff about what else would you opine on. So there's that on the unaudited and the interim.

I think if you're going to pick one thing off this list I would say it's the responsibility for fraud whether -- either what the current responsibility is or what the (inaudible) may choose that should be in the future.

And then lastly, you know, Ann's point -- I absolutely personally agree with putting the auditor's -- signing engagement partner's name in the report, and I know we've discussed it several times at SAG and the PCAOB has done many times and you've heard me say more than once in this forum.

We've spent a lot of time on it. It's time to just give it a thumbs up or thumbs down vote, in my view. But since my own name is the releasing officer's in there I see no reason, you know, why the firm couldn't be there too.

I do appreciate you've hired the firm, not an individual. But nonetheless, these are Xerox's financial statements, in my case, but they are going out under my signature so --

MR. BAUMANN: You're endorsing the signature concept. Thank you.

MS. RAND: Okay. Mark LaMonte.

MR. LAMONTE: Thanks. Looking at your laundry list, I do see value in an investor knowing more about many of those things and the auditor's various responsibilities and the limitations thereof.

The concern I have about this or the thought I have about this is that you're just going to probably get very standardized language that will be the same from report to report depending on who the signing firm is.

So an easy way to address this or a way to address this more efficiently where you're not, you know, just increasing the forest for the trees problem we already have with very long annual reports is just include a Web link in audit opinions. It takes you to the firm's website where all of these things are described.

Beyond that, the one that could be unique for --from company to company is the discussion of auditor independence and issues affecting auditor independence.

Quite honestly, I would be surprised if investors are ever making investment decisions based on a view of whether or not they think an auditor is more or slightly less independent. So I'm not sure adding much on that in an opinion really would add value for investors.

MR. BAUMANN: On the point that Mark just made, Mike, or someone else, maybe you could help me. The U.K., I think, has that requirement today, don't they, where there's the opinion but there's a link to some of this other information about the audit. Do you know if that's accurate or not?

MR. GALLAGHER: Yeah, I think that is. I think that's -- you know, we'd certainly be, you know, very interested in looking -- certainly would have no objection to looking at that, Marty.

MS. RAND: Mark, just to follow up on your point about independence, in our outreach one of the -- I guess another reason that was cited that it might be helpful just to at least have a statement in the opinion for the auditors to reaffirm their independence. The title says independent auditor's report but if they sign off every year, yes, and we are independent there might be -- some perceive there might be some benefit to that.

MR. LAMONTE: I don't think a brief statement would hurt. I think that'd be fine. An extensive discussion, however, would not add value.

MR. BAUMANN: Well, the auditors are also required to report to the Audit Committee of matters that might be thought to bear on independence, such as if they had an independence violation during the year what that was and why they believe that doesn't affect their independence.

Do you think investors would benefit hearing about the things that might be thought to bear on independence -- that is, we found out that our manager owns some shares of stock and we replaced him or her and reaudited the area they were responsible for, and therefore we believe we can continue to express an opinion. Would that type of information be of value?

MR. LAMONTE: Of all the things we talked about today, I think that would be one of the least influential on an investor's actual decision making.

MR. BAUMANN: Thanks for that clear answer. We got clarity around something today.

[Laughter.]

MS. RAND: Okay. Flerida.

MS. RIVERA-ALSING: Thank you. Of all the list that you have, there are three things that I do support. The auditor's responsibility for fraud -- I would like to know what auditors do to assess the risk of fraud in the entities that they are auditing, and then the auditor's responsibility for financial statement disclosures.

On opinion page of the auditor's, they referred to the financial statements as only the balance sheet, the income statements and the statement cash flows. Nothing is being said about the notes to the financial statements, but really the devil is in the details. If you read the notes to the financial statements you will learn more about the financials.

The third one is the -- is the auditor independence. We hired a lot of auditors in our organization and they do an extensive check on whether indeed the entire audit firm is independent, but I noticed that it is more exhaustive when the entity that they are auditing is a public entity.

But if it is a private entity they don't really do a lot of -- I don't know, it's just my impression. They do affirm to the Audit Committee their independence and I do know that there are discussions about it.

Whether that is valuable to the individual investors or not, I think it is important for us to know if there is a conflict of interest as far as the auditors are concerned because we are relying on their words but if there is a conflict of interest should we rely on their words.

The fourth item that I do support is the name of the engagement partner. I would like to know who did sign the financial statements. Why should it be a secret? It is known in the entire audit firm. It is known in the company. Why should it not be made public? That's all.

MS. RAND: Thank you. Jack Ciesielski.

MR. CIESIELSKI: Thank you. First of all, I'd just like to point out, and maybe it's stating the obvious, but this is a little different than the other three areas that we discussed in the proposal in that it's not really so much amplifying information about the audit -- it's more or less redefining the audit report.

Maybe I'm envisioning it wrong from the concept release but I'm thinking that this would be a revised standard opinion and the language probably wouldn't change much from one company to another or from one auditor to another.

But I think what we have heard today is that there are different levels of knowledge of what goes on in an audit by investors and there's different levels of what investors -- knowledge of what investors do by auditors.

But, you know, by having something out there that more clearly delineates responsibility for fraud, for disclosures, management's responsibility, a statement of independence other than just, you know, the one reference to independence that we already have I think it would be good.

You know, maybe it would be a standard rubber stamp opinion but I think it would be a way of educating some investors about what an audit does or doesn't do, and I think if you have the possibility of having to state something embarrassing like what happened with our independence during the year I think investors indirectly benefit because I think firms would be very much more on their toes about whether their independence is impaired or the appearance of independence is impaired.

So, you know, I don't view the clarification of language section of the concept release as anything that's, you know, earth shaking but more or less, you know, clarifying what we've already implied in the existing audit report. So that's it.

MS. RAND: Okay. Thank you, Jack. Steven Buller.

MR. BULLER: Thank you. We sat down with our analysts and walked through these criteria, and it was interesting because as you go through them one by one you say, is it a good idea to put in clarification on reasonable assurance and the answer is oh yeah, it's a good idea.

And you go down to responsibility for fraud and they said oh, that's a good idea too. And you go through all of them and one by one they say, you know, those are good ideas.

Well, then you say okay, so here's what the opinion looks like, and they say oh, that's a lot of opinion. And so you almost -- we sat down and said let's talk about a Mazlovian hierarchy of needs and what you think would be most important to a user of financial statements -- what's least clear right now -- and they said that probably the auditor responsibility for information outside the financial statements for them would be the one thing which will be useful for clarification and also the responsibility for fraud would be good clarifications.

They thought that, consistent with our earlier comments, auditor independence should be in an AD & A section where it talks about auditor -- or an auditor inputs being used, the procedures they're performing -- belongs in that section.

They thought it was a good idea but not necessary to include auditor responsibility for financial statement disclosures and for preparation of financial statements. They thought those were pretty self-apparent.

But they would not -- we wouldn't object, certainly, with support and inclusion of all these in clarification somewhere. We just think that if it's -- if these are all part of the ultimate solution they probably belong in a separate and subsequent paragraph or a long footnote somewhere in the opinion so it doesn't overwhelm and obfuscate the ultimate communication you're trying to make about the auditor's conclusion on the fairness and presentation.

MS. RAND: Thank you. Regarding clarification, just a couple of thoughts. I see clarification as having a couple potential benefits. One, it really would add -- it would -- while it would add language to the standard auditor's report, it could serve to help educate investors -- better inform investors and other users of the financial statements about what an audit is and what it represents.

And another benefit I potentially see is, when the auditors are signing that opinion, having the auditor's responsibility stated in there for fraud helps reaffirms that responsibility when they're issuing the report that the auditor has done those things, potentially. So I see those two potential benefits.

I am very -- I don't see any other tent cards up but I am very -- we haven't gone over my 30 minutes for this session. So I am interested if others have any suggestions, thoughts for other alternatives that we have not explored today.

I guess we -- oh. Is that -- oh, Joe Carcello. Sorry.

MR. CARCELLO: This isn't really another alternative, Jennifer, but it looks like we're winding down and I wanted to get this in before. I didn't know when you were going to kind of call time here.

So it struck me that, really, this afternoon was very different than this morning. I think the last hour, although not unimportant, is -- clearly is lesser importance than the three things we talked about earlier today, and I think our discussion about the MD & A -- I agree with Sam on this -- it's a worthwhile discussion but it's probably down the road.

I think the real issue for the Board is going to be an AD & A and/or in emphasis paragraphs and how those are implemented. And so I went back and I looked at who we had here today and I -- if I counted right there's approximately 32 folks here today, not counting the Board and not counting observers.

Sixteen of those people could be classified as either direct investors or indirect investors or investor advocates, and the other 16 would be auditors, Audit Committee members and preparers.

And although those 16 auditors, Audit Committee members and preparers are very bright and very articulate and very well informed, the mandate of the Board is very clear in the language that Congress create -- used to create the Board and that is to protect the interests of investors.

There's really no ambiguity about that.

And so with apologies to George Orwell, all stakeholders are created equal but some stakeholders are more equal than others, and I would say investors are more equal than others than the people here today.

So I tabulated where people stood on the AD &

A and versus an emphasis paragraph -- and I encourage you and I'm sure you will go back through the transcript and audit my representation here. And so I'm going to go through this very quickly and if I'm miscategorizing anybody I would ask that they speak up, and this is in no particular order.

Steven Buller from BlackRock -- and this is a direct quote -- ''AD & A could be useful'' and then he kind of fleshed it out in a number of ways where he thought it could be useful. Flerida from the Florida Board in favor of an AD & A; Steven from Vanguard, AD & A would be helpful; Chris from Credit Agricole endorse AD & A.

Lynn Turner favors AD & A; I favor the AD & A. Ann Yerger favors the AD & A. Mary from CALPERS wants an AD & A. Jack favors the AD & A. Kurt wants the information from the auditor whereas less important so I'm not sure how you classify him. Paul from Capital Research, Matt from Fidelity and Gary Walsh prefer the emphasis paragraphs.

Mark Newsome from ING, I couldn't tell -- he never really explicitly stated it or if he did I missed it. But he talked about due diligence reports and how useful they were and it sounded a whole lot more to me like an AD & A than an emphasis paragraph.

MR. NEWSOME: AD & A.

MR. CARCELLO: I'm sorry -- AD & A. Mark LaMonte from Moody's -- give firms an opportunity to decommoditize their product. Again, I don't know if he said it explicitly but I think they probably have a better shot of doing that with an AD & A than an emphasis, but that's my judgment. And William Clark from the Federal Reserve, I couldn't -- I couldn't find where he really expressed an opinion on this.

So if I'm even close to right, there's 10 votes for the AD & A, three for the emphasis, two no opinions and one no statement at all. If you got that kind of vote on almost anything else in today's society you'd have an overwhelming mandate.

MR. BAUMANN: Thank you and -- well, I was just about to acknowledge you, Chairman Doty, but I wanted to first thank the group for a tremendous energy and participation today and throughout the entire day.

I know it was a long day and throughout the entire day everybody stayed committed to the discussions and gave us a lot of important information, and for that I thank you all very much. And I would like to turn it over to our chairman, Jim Doty, for final comments.

MR. DOTY: It struck me today how much this resembled a real deliberation and not a polarized debate. It is what regulatory administrative -- quasi-administrative bodies have to have.

When we started off this morning saying it wasn't the last such discussion we're going to have it certainly -- we may not have another roundtable before the end of the year on this concept release and on this issue but there are going to be other discussions of this kind.

And I think you should be very proud of the way in which you conducted the deliberation by linking all of the important things you had to say about the auditor reporting model concept release to the bigger issues that relate to the future of the audit profession, the welfare of shareholders, the vitality of corporate governance in our economy.

Listening to it, I think anyone who was thinking about whether a process is moving in the right direction would have been heartened and we are deeply grateful for that and cannot conceive of a better panel of expert opinion and enlightened thought.

Lawyers always talk about leaving your client's interest at the door. It never really is possible.

But in this case, we're speaking with the people who have the direct immediate interest in the financial reporting model and its issues from one vantage point or another, and you have managed to articulate your own interest in it in an enlightened self-interest way and in a way that helps all of us get to a better understanding of what each of us has to worry about.

We are deeply grateful to Martin Baumann and the standards group of the PCAOB. They have worked tirelessly and over the spring. This has been a most arduous period for them.

Like the long gray line of Douglas MacArthur's remarks, they have not failed us. They have never failed us and they never will, and we thank you all again for the support you've given them. You will hear from all of us again. Thank you.

MR. BAUMANN: Thank you, and safe travels.

[Whereupon, at 4:59 p.m., the meeting was adjourned.]

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on November 9-10, 2011 that relates to the Board's concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards. The other topics discussed during the November 9-10, 2011 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at: http://pcaobus.org/News/Webcasts/Pages/11092011_SAGMeeting.aspx.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

STANDING ADVISORY GROUP MEETING

Thursday, November 10, 2011

9:06 a.m.

1201 15th Street, N.W

Washington, D.C.

PARTICIPANTS

| | |
|---|---|
| MARTIN BAUMANN | KIKO HARVEY |
| ARCH ARCHAMBAULT | STEPHEN HOMZA |
| MICHAEL AUERBACH | ANTHONY KENDALL |
| DENNY BERESFORD | WAYNE KOLINS |
| NERI BUKSPAN | LISA LINDSLEY |
| ELENA BOZHKOVA | JEFF MAHONEY |
| JOE CARCELLO | BILL PLATT |
| BRIAN CROTEAU | STEVE RAFFERTY |
| BOB DACEY | JENNIFER RAND |
| LEW FERGUSON | SAM RANZILLA |
| MIKE GALLAGHER | BARBARA ROPER |
| LIZ GANTNIER | KURT SCHACHT |
| DAN GOELZER | ARNOLD SCHILDER |
| HARRISON GREENE | SCOTT SHOWALTER |
| MICHAEL GURBUTT | DAMON SILVERS |
| ARNOLD HANISH | BRIAN SIPES |
| GAYLEN HANSEN | DAN SLACK |
| GAIL HANSON | LARRY SMITH |
| STEVE HARRIS | LYNN TURNER |
| MARY HARTMAN MORRIS | BARBARA VANICH |

PARTICIPANTS (CONTINUED)

JOHN WHITE

DENISE WRAY

MEGAN ZIETSMAN

MR. BAUMANN: Our final session, as I mentioned, is a discussion about our comment letters and then further follow-up on the auditor's reporting model, and I'd like to ask Dan Goelzer to share with us some thoughts to kick this off.

MR. GOELZER: Thanks very much, Marty.

As Marty has just indicated, the last topic on the agenda for this meeting is the Board's review of the auditor's reporting model. I don't suppose that project requires much explanation for this group since it's been discussed here previously.

The objective is to determine whether the

Board should expand what the auditor's report to financial statement users conveys. That is, whether the end product of the audit should be something other than the traditional standardized pass/fail report.

We have saved this as the last item on the agenda, but I will say that at least in my view, this initiative is the most significant item on the Board's docket. I think that it raises fundamental questions about the purpose and value of the audit, and expanding the contours of what auditors communicate could have profound impact on investors, auditors, public company financial reporting, management, and directors.

Just a bit of background. Again, I know it's relatively familiar to this group. This is not a new project for the Board. It originates, I think, with the suggestion in the ACAP report. In any event, the Board has been looking for almost 2 years now at how it can increase the relevance of the information that auditors provide to financial statement users.

That effort on our side has included public discussion with both this advisory group and with our Investor Advisory Group. In addition, during 2010 and early 2011, we had a series of focus group sessions with investors, preparers, auditors, others.

And then, in June, we issued the concept release that we're going to be talking about this morning, which contains some alternatives for expanding the auditor's reporting responsibilities. We also held a public roundtable in September of this year at which those alternatives were debated.

We're now at the stage where the staff is analyzing the comment letters that we received on the concept release. And certainly, at least by PCAOB standards, the comment file is very voluminous. The last count we have was 151 letters submitted, and I believe, although the comment period ended some time ago, submissions are actually still coming in. So that number will increase.

We've heard from a very wide range of

participants in the financial reporting process or those influenced by the financial reporting process. And Jennifer Rand is going to summarize the comments in just a minute.

Before she does that, I thought I would just highlight some of the issues that I think the letters suggest the Board will have to grapple with as this project moves ahead. Of course, my views are solely my own.

First, if the comment file makes one thing clear, it's that investors deeply believe that they deserve more from auditors than they're currently receiving. There is very strong support for requiring the auditor to provide insight into things like financial statement risk, audit risk, significant judgments and estimates that management has made in preparing the financial statements, and the quality of the accounting choices that management has made.

Certainly, clearly, if we were to treat the comment process as solely an investor plebiscite, it's clear that a broad auditor's discussion and analysis requirement would be the winning choice. However, I think it has to be added that we've also received some views and other comments that raise some warning flags. A couple of examples.

A theme expressed in many of the comments is that management, not the auditor, should remain the primary source of information and insight regarding company financial reporting. Certainly many managements and directors see a risk of investor confusion if there are competing analytical presentations from the company and its auditor.

Also, some commenters have told us that the audit committee's governance role in overseeing financial reporting could be undermined by a broad auditor reporting requirement. In particular, we've heard from some audit committee members who believe that the quality and candor of the information that they receive could be compromised if the kind of information about financial reporting risk and accounting judgments that the auditor provides to them today routinely becomes public.

Further, questions have been raised about whether the training and standards that traditionally currently define the auditing professional equip auditors to create and communicate new information, as opposed to providing assurance on information created by others.  Some auditors fear that the effect of that kind of responsibility could be to widen rather than narrow the expectations gap that has traditionally bedeviled the profession and perhaps ultimately to decrease public confidence in auditing.

I won't go on with those examples, but I think maybe it's important to emphasize that our mission is to protect the interests of investors and further the public interest in the preparation of informative audit reports.  In light of that mission, we obviously need to give considerable weight, great weight to the investor views that we've received.

We also need to test potential changes in the reporting model against the goal of promoting full and fair disclosure. While I'm not speaking for the other members of the Board, I think I can confidently say that we're all committed to increasing the usefulness and the relevance of the information that the auditor reports.

But at least in my view, despite the volume and sophistication of the comments that we've received, the solution to the issues raised in the concept release is not self-evident, and creating a workable new reporting model will require the Board to make some very difficult judgments.

I'm looking forward to the discussion this morning and to hearing any additional thoughts that SAG members may have on how the Board should modernize the reporting model. And with that, Jennifer, let me turn the floor over to you so you can give a more detailed presentation about what we've heard in the comments.

MS. RAND: Well, thank you very much,

Dan. And thank you for your very thoughtful remarks.

What I plan to do this morning is provide you with a high-level overview of the comments we received, who provided comment letters and the types of themes we're seeing in those comment letters, as well as provide you with an overview of where we're headed in the next steps.

First, key milestones. Dan talked about the concept release that was issued on June 21. That concept release was informed by a lot of work that we did and outreach to many of you all, including investors, auditors, preparers, audit committee members, academics, attorneys, previous and current other regulators, et cetera. So we had very robust outreach, which helped inform our concept release.

The concept release was seeking input on changes to the auditor's reporting model, asking a basic question -- should the model be changed? And also asking, as far as options for supplemental or additional reporting, and the options we presented in the concept release included auditor's discussion and analysis, emphasis -- required and expanded emphasis paragraphs. Should there be additional reporting on other information, such as MD&A, earnings releases, et cetera? And also whether the report should be clarified?

We held a roundtable toward the end of our open comment period. That roundtable was held on September 15th. We had 32 participants and 2 observers, and those included the SEC and FASB.

The comment period ended September 30th, and Dan mentioned 151 letters, but we just received an additional letter yesterday. So now we're up to 152, which gives me great excitement because I am -- I do think we've received a very robust comment letter file and quite appreciative of all the comments, very thoughtful comments that we've received.

I feel like in each letter that I've gone through, there is gems in there that we need to pay careful consideration to. So I appreciate particularly those of you that took the time to write comments. They're very much appreciated.

The next slide gives you an overview of who we received the comment letters from. As I said, it was very robust, and we're considering each of these comments. As you can see up here, it's kind of listed somewhat and who provided the most comments to the least, and then we have a category for other.

Preparers provided the majority, sent us the majority of comment letters, followed by accounting firms, and then investors. As I said, we are giving considerable comment -- consideration to each of these letters. I'm going to provide a high-level overview of the different categories, the themes that we're hearing from the different categories.

Overall, we heard pretty consistently was a desire to retain the pass/fail model. So that's what auditor reports currently are today. Some of you call it pass/fail opinion. We've heard kind of resoundingly that that should be retained, but really also resounding need for change, particularly in the area of supplemental reporting.

In that area of supplemental reporting, whether it be an AD&A type report or an emphasis type report or reporting on other information, we saw quite a range of support on the type of change or the amount of change, depending on the commenter -- the person or group that provided comments to us -- and I'll go through that over the next few slides in more detail.

Starting with investors. In reviewing the investor letters, we saw kind of different themes coming from investors, and we kind of saw two different category of investors.

The first we saw coming from investor associations, pension managers, and analysts. In that, we saw clear support for auditors reporting on their assessment of areas of high financial statement risk; significant judgments; quality, not just acceptability, of accounting principles; and disclosure of significant changes or events impacting the financial statements.

Commenters in this group said that it

could be -- the form of reporting could be an AD&A type report or emphasis type report, kind of that form didn't matter as much, but the type of information mattered.  So they're looking for more expansive, the auditor's assessment, more than just identification.

Investors in this category supported other disclosures by auditors, including audit procedures, so the procedures performed on those significant financial statement areas or areas of high audit risk.  Also in this category, as far as information about the audit included materiality. So information about the audit, unrecorded differences was another area of interest about the audit.

And really, regarding other information or reporting on other information, commenters indicated that they're really interested in telling us more to having the auditor say more about what they're doing today on the financial statement audit rather than necessarily a desire to have the auditor report on other information.  So the view was clearly, "Just tell us more about what auditors are doing today."

The next category investor we categorized as large investment companies and advisers. Here, clearly, some desire for information, but it's less in the area of auditor assessment and more toward identification or pointing to those areas of significant areas in the financial statements.

So looking more for -- we saw some comments about tell us what the five largest areas of risk are, and where are those disclosed in the financial statements? So it was more of pointing to than a discussion of merit of discussion from the other category.

This group of investors indicated a preference that management be the primary source of financial information. So that's why not looking for an assessment or description of themes, but rather a pointing to where that information is disclosed by management in the financial statement.

There was some interest in information regarding audit procedures, but not as much as we saw from the other category of investors. And as far as other information, just again like the other group, preferring information about financial statements rather than assurance on other information.

Moving on to then preparers, clear view from preparers that management should be the primary source of information. Did not get support for AD&A or expanded and required emphasis type reporting.

As far as assurance on other information, concerns about that costs would exceed any benefits on that type of reporting, preparers don't object to clarification of the report, but didn't see a strong need that that would be necessary.

I saw some similar, but different views from Board members, including audit committee members, similar to preparers believe that management should be the primary source of information, not supportive of AD&A type reporting. But we had some mixed views regarding expanded and required emphasis reports. Some support some other, some less supportive, but not overall opposed.

There was some support for assurance on other information, not real strong support, though. And there was some support for clarification of the report, if that was considered to be useful to investors and other users of the financial report.

As far as accounting firms, saw some overall themes with some differences based on the type of accounting firm that provided a comment letter. Overall consistency, though, that management should be the primary source of information. Overall support or opposition to AD&A type reporting.

And here, we start getting into differences based on the type of accounting firm. Large and regional firms were supportive of emphasis type reporting, emphasis required, expanded emphasis reports. Also supportive of attestation on critical accounting estimates of MD&A.

Smaller accounting firms really were not supportive of either of those, didn't think it was that additional type of reporting, either through emphasis reports or reporting on other information, was necessary. So not supportive of that type of change. And then as far as clarification, that was supported by all types of firms.

Just have a slide up here to highlight comments we received from academics, other regulators and standard setters, and other individuals. We couldn't really see how we could group them because we got different types of comments within these categories.

So, academics, we saw some different views from certain academics that may have been longstanding academics versus other academics we saw that had been retired partners in an accounting firm and then an academic. So some different themes among there.

The other regulators and standard setters also had different views, depending on their own particular perspective. And other individuals and organizations include, in that bucket, we had actuaries. We have law firms. We have retired CPAs. So just a real mix kind of within each category.

So we didn't think it would be appropriate to summarize those like investors, preparers, et cetera. But we certainly are giving consideration to all comment letters that we have received. And we'll continue to receive if any should come in.

I wanted to point to some other comments that came through, the other I talked about kind of views from investors, preparers, auditors, others on the types of reporting, like AD&A and emphasis reports, other information, clarification. But there were some other themes that came through that we thought were worth highlighting.

Some themes came through, particularly from preparers, auditors, audit committee members, about working with other regulators and standard setters, particularly FASB and the SEC. So, as far as comments were coming through, that if there's need for additional information on financial information, that we should have a coordinated approach with the FASB and the SEC on what that might be to not duplicate disclosures that are already provided by management.

Also support for working with the IAASB and ASB and others as they're considering changes to the auditor's reporting model. There is also some support for additional reporting by or some reporting by audit committees. There was noted efforts in the UK, for example, on audit committee reporting and thought that might be an area of consideration, although recognizing that's not within the PCAOB's purview. And some comment support for considered field testing of any changes to the report.

There was also -- in addition to overall themes or considerations, there were some concerns that were noted. And again, these principally came from preparers, auditors, audit committee members, others rather than investors. But certain concerns about changes to the report, such as dueling information between the preparer and auditor, such that if the auditor were to have expanded report either through emphasis type reporting or AD&A, that how would that be in line or could be out of line or dueling with what management has said in the financial statements?

There were some concerns about this additional communication and the report impacting the audit committee's governance role for the oversight of financial statements to how would that play in? Where would that be if there's additional disclosure by auditor?

Some concerns about just impacting the overall three-way communication between the auditor, management, and audit committee. Some expressed concern about just with an expanded report there could be more boilerplate information, and that would not be desired. So concerns about that coming into play.

A number of concerns about maintaining confidentiality of company information. Some concerns that if the auditor had expanded disclosures in the report whether any of that company information that's otherwise confidential could be disclosed.

Concerns about increased costs, the increased costs were mostly described in terms of additional audit cost. But there was also concerns about costs being incurred, additional costs by preparers and also audit committees in having discussions or review or what's being said or what then might management say in the report in their financial statements.

Also concern about increase, potential increase in auditor liability, potential adverse effect on auditor independence. If auditors are saying here is the preferred view of accounting, then whether management feels they need to default to that. And then whether or not if that's the view that, in fact, it becomes more auditors' financial statements than management's financial statements. So concerns in that light regarding independence.

And then comments we're talking about all this additional disclosure, while it may improve communication, it's not doing -- there's little incremental effort or benefit on audit quality.

Our next step, what we've provided to have some discussion with you today is an overall high-level analysis. As I said, there's many different gems that we see in the comment letters. It's impossible to include all of the additional thoughts in these slides. So we will continue our analysis and our discussion with our Board in connection with next steps forward.

We cannot -- we're still in the process of digesting that information and discussing with the Board. So aren't in a position today to say what that will be as far as that it would come through in a proposal.

As we move toward a proposal, we will also be considering related projects of other standard setters, such as the IAASB. We'll also be having discussions, continued discussions with the SEC, as we have throughout, and also have discussions with FASB and what they're doing in terms of disclosures.

Our plan is to issue a proposal in the second quarter of 2012. I think, as Dan mentioned, our overall objective is to improve communication to investors, but certainly, we'll be considering thoughtful comments from others in determining our way forward.

So, with that, I see Barbara Roper has raised her tent card. But I'll open the discussion not just to Barbara, but to all others for any questions or comments on the auditor's reporting model project and comments we've received to date.

So, Barbara, I'll start with you.

MS. ROPER: Well, first, when I put my tent card up, it was specifically in response to that last slide, which went through and listed a number of other concerns with not necessarily any concrete backing behind them that have been raised. It could hurt independence. Well, it could improve independence.

It could, you know, do this. But it could have exactly the opposite effect. And I would just say I would hope that there would be --

as an investor advocate, we face this all the time, that industry raises concerns and they are given a credibility that advocates' expressions of hope about positive effects aren't given the same attention.

So I would hope that we don't -- I mean, I would like to see us go through the letters and find the same type of list of possible benefits to the rules. So that was sort of my initial emotional response to that slide.

But beyond that, I think the presentation is quite useful in separating out what sort of groups made what kind of comments. And the thing that comes through loud and clear from that is that investors think the system is broken. And if the document is designed to communicate to investors, the fact that investors are fundamentally dissatisfied with the document ought to carry a fair amount of weight.

And then I would add to that just we spent a lot of time talking yesterday about how can we promote greater professional skepticism among auditors? And it seems to me that one way you can do that is by forcing auditors to speak directly to their clients, the investors, about their views about the financial statements and that that has the potential to, one, make them focus on who it is that they actually work for, other than management, and it makes it more likely that they might be less willing to just go along to get along if they have to actually make an assertion of views.

So I think there's in an environment where investors have clearly indicated that they don't think a document that's designed to communicate to them communicates effectively to them, we should be looking at not just tinkering around the edges, but significant changes to the auditor's report.

MS. RAND: Thank you, Barbara.

I just wanted to comment on what you were -- one of your comments initially on the listing of considerations or concerns about changing the report. Certainly, we are giving consideration if there is a negative, could there be a positive, and trying to weigh and balance all of that. And recognizing what have investors said for a need for change and how can we effect such a change?

So we are taking those points into consideration.

MS. ROPER: And I realize that. I just think it's fairly typical, as an investor advocate, in this process that you look at a long list of statements from industry about their concerns for which they aren't really required to offer any backing except their expression of opinion that it could have this effect. It could chill communication here. It could do whatever.

And yet an investor advocate who makes a comparable set of assertions about what they think the benefits would be is asked to come up with a 100-page document of cost-benefit analysis to -- not by you, but as a general matter, as an investor, to justify that the regulation might somehow not end capital formation process as we know it.

So it's just a frustrating feature, but I recognize that you are balanced in your consideration. So --

MS. RAND: Thank you.

Arnold Schilder?

MR. SCHILDER: Thank you, Jennifer.

I would like to give a brief update of our similar project at the IAASB. First of all, many compliments for your presentation. I thought it was very interesting to see this overview of all your comment letters. And actually, we issued a consultation paper in May that had a lot of similarity, I think, between the concept release and our paper.

We also received many more comments than we usually do. We are currently at 82 comment letters, and usually there will be 40 to 50.

Many of the messages that you have shared with us came also across in our comment letters. I would say that particularly users seem to place most value on supplementing the information in the auditor's report with a discussion about auditor's insights on matters that include risks and views on the quality of management's financial statements, et cetera.

I'll never forget a quote that I once got from an investor representative. "We want more about the soft stuff." And that's basically about the judgments and the uncertainties and the ranges and the estimates, and that's what I see coming back both in your comment letters and ours.

Some striking points in letters that we have seen. One, of course, is, and you have mentioned it also, that a number of respondents urged us and the PCAOB to work together to develop a common global solution to audit reporting. And maybe it's a bit symbolic that my fellow Board member Arch is seated amidst CalPERS and the CFA Institute, two examples who are very vocal on this, and of course, we agree to that.

And another one was BlackRock, also familiar. Just quoting, "It's critical that the IAASB work with the Public Company Accounting Oversight Board to minimize the confusion and expectation gap that may be created if different auditor reporting models are adopted."

So that's the important message. I received similar messages from our CAG and regulators and others.

Also, and maybe a bit more than I learned from your presentation, there's a great deal of importance placed on other information that accompany financial statements. There was strong support for clarifying and enhancing the auditor's role and responsibilities with regards to that other information.

We have a project on that, revising our Standard 720. Hopefully, agreeing to an exposure draft in March, but that was an important item as well.

And thirdly, there was one difference, I think, between concept release and our consultation paper in that we asked more explicitly comments also about announced corporate governance reporting model, role of audit committees, et cetera, illustrating that, among others, we have the FRC proposals in the UK.

And we noted that respondents generally expressed support for exploring ways to help enhance management and corporate governance reporting and including that, of course, the role of audit committee reporting. I think the comment from CalPERS about cooperation between the two of us was also in that area.

And also many respondents urged that increased audit communication requirements would likely require additional auditor guidance to ensure consistent and appropriate application, but also let's say education of users and readers of that information, if it will be different from now.

And of course, one example would be where now the case will be that if an auditor expresses an emphasis of matter, usually there's a bit of a reaction. "Oh, gosh, there's a problem." And if you would like to change that into a direction that it would be more normal, that auditors would express more EOMs, other matters, AD&A, whatever you call it, then it should also be received in an appropriate way.

I will not -- I have a list here, but as I said, there are other similarities in many of the specific comments. And of course, also difference of views, as was clear from your presentation. We see it as well how far can you go?

Some specific challenges that were also identified in addition to yours. How one is maintaining global consistency in auditor's reporting while at the same time providing additional customized information? And then, of course, avoiding that it will be boilerplate in the end.

Also the issuing of dueling information, the risk of blurring responsibilities. On the one hand, those charged with governance providing the information. On the other hand, auditors attesting to that or doing more. That's a key issue for further consideration.

Understanding impact of changes not only in terms of cost, but how would it be understood and how would it be appreciated and how would it be done? And then also how to allow for developments in different jurisdictions. So should it be all the same, or could it be different depending on developments in, for example, UK, France, here, Australia, et cetera?

So, all in all, we will discuss in our board meeting in December -- 5 through 9 December in Los Angeles. For those that are near to LA, if you want to attend, I mentioned it already to Mary, our meetings are fully open. The agenda papers will soon be published, and we will discuss this.

And there will be a project proposal from our task force, and I figure just a draft version. But the project objectives are here described, and that may change, but the direction is clear.

First, to determine whether and how the IAASB reporting ISAs and their design can be modified to accommodate evolving national financial reporting regimes while at the same time ensuring that common and essential content is being communicated. And second, appropriately enhance the communicative value and relevance of the auditor's report through proposed revisions to the

ISA requirements that address its structure and content.

So, basically, there is a need for change, and that would be in particular regarding ISA 700. And I think this is a great momentum to move into that direction, and I would be fully supportive to those that have urged us to cooperate in particular on this line between the PCAOB and us, but also if standard setters and regulators and I'm sure that we will come somewhere, although I realize that it will not be an easy process.

That's my summary of where we are. Thank you.

MS. RAND: Thank you, Arnold.

Joe Carcello?

MR. CARCELLO: Jennifer, I'd like to ask a question first, and then I'd like to make a couple of comments. Can you go to your second or third slide? Can you go back to your second or third slide?

MS. RAND: I'm not in charge of the clicker after my yesterday challenge.

[Laughter.]

MS. RAND: Which slide in particular? Was it on the investor overview?

MR. CARCELLO: Well, you had the buckets of who responded. The number --

MS. RAND: Okay. The overall number?

MR. CARCELLO: Yes. Okay. That one right there.

MS. RAND: There you go.

MR. CARCELLO: Here's my question before I make comments. When you classified the third bucket there, investors, including investor associations, pension managers, analysts, and large investment companies, and advisers. So when you got a comment -- and let's say for hypothetically, we'll use Vanguard -- did you put them in that bucket, or did you put them in the preparer bucket?

MS. RAND: What we looked at, there were some we had to read the overall comment letter, and sometimes just overall classification was not easy. Sometimes very straightforward, but sometimes not easy.

There were certain things that I picked up a letter that seemed like it may have been an investor, but recognizing the organization was signing it from it was more the preparer house, the CFO or their accounting function. So, in that case, we would have put them in the preparer if they were essentially issuing it as a preparer.

MR. CARCELLO: Okay.

MS. RAND: But other letters like that, other letters came through, they would say we took a poll of our investors and the people doing the investing in the company. So, therefore, we put that in the investor category.

MR. CARCELLO: Okay. Just, and I'm saying some of this for the public record. I realize that the staff knows this. In the case of Vanguard, it's user and preparer. In the case of Capital Research and Management, it's user and preparer. In the case of BlackRock, it's user and preparer.

In the case of Fidelity, it's explicitly for the preparer. And in the case of State Street, it's explicitly preparer. So it sounds like you've made that adjustment. But I think it's important to understand that in terms of some of these asset managers, it's at best -- it's two perspectives. It's not purely an investor perspective.

I think it's also important to understand that the resources that the corporate community and the accounting firms can throw at this issue vis-a-vis the investor community, particularly pension plans and analysts and so forth, are so uneven. Talk about a lack of a level playing field. It makes the U.S. versus Russia in 1980 hockey look like a pick 'em hockey game, okay? That's about the scale that we're talking here.

I think it's also important to look at the assets under management in terms of the comments that you received not just from the asset managers, but from the pension funds. It's very, very significant assets under management.

Can you go to the slide that Barbara asked about? Can you click forward to the slide that Barbara asked about?

MS. RAND: That would be cost, I'm assuming, right? I mean concerns.

MR. CARCELLO: Yes, concerns.

MS. RAND: Which included cost as one of them, among others.

MR. CARCELLO: Yes, at the risk of repeating some of what Barbara said, as I was sitting here, I thought exactly the same thing. She just beat me to the punch.

I don't think this was intentional, but it's clearly asymmetric. It's presenting the downside, but not the upside. And there is a lot of potential upside.

So I think in fairness, in future presentations, if you're going to present potential downsides, you also need to present potential upsides. And I'm not saying you're not considering those. But when you present it, it would be more balanced.

When you look at these comments, though, expanding the auditor's role and the possibility of dueling information, if you look at the investor comments to the extent that they commented on this almost without exception, they said this is something they can manage. This is not something they're troubled by.

Adversely impacting the audit committee's governance role and the three-way communication, again there was investor arguments that, in fact, it may enhance the alignment between the audit committee and investors. The fact that the audit committee's perspective almost exactly mirrors corporate management's perspective bothers me. As an investor, that bothers me.

I view the audit committee as they ought to represent me. Corporate management doesn't need additional representation.

Risk of additional boilerplate language. That's why you have an inspection division, and that's why you have an enforcement division.

Increased costs. Let's not lose sight of the fact that although the company writes the check, they're writing the check with our money. At the end of the day, even Fidelity and Vanguard, that's just 401(k) and 403(b) money. And so, if investors want this information, they are paying for it.

Potential increase in legal liability of accounting firms. There may be validity there. I think that's something that you need to work with with the SEC. There are potential ways of dealing with that that I think would protect the accounting firms from additional legal liability.

Every investor I've spoken with, I have not heard one investor say to me we want this as another way of grabbing for the pockets, the wallets of the accounting firms.

Little incremental improvement in audit quality. Again, if you look at the CalPERS letter, Jennifer, the Vanguard letter, the Capital Research and Management letter, they all argued, in fact, that this additional communication will give the auditor additional leverage with management and, in fact, will increase audit quality rather than decreasing audit quality.

So that's what I mean about kind of

showing both sides, and it's the same point that Barbara made.

MS. RAND: It's clearly our goal here -- the comment period ended not that long ago, a little over a month ago, September 30th, with comment letters coming in like yesterday, literally yesterday. I take the point that it's impossible to say everything, as I said early on, to put everything in a slide.

There were a number of -- this slide is capturing the frequency, the ones that came through a lot. Not to say that the points you mentioned, and even Arnold raised a point that we didn't highlight in there, but that came through as well as far as consistency or a type of framework. How do you, when you say "significant risk," how are we capturing, getting auditors to think of those risks on a consistent basis that we would expect to see in an audit report?

So a lot of those themes came through. So it can't be perfect, and so I recognize that. And we take all of those points into consideration.

But our desire today was to share with you kind of some of the things we saw coming through frequently, the type of comments that came through, but recognize that there's other points.

Even like clarification, there was concerns about even doing something that I may think would be the easier thing to do, just clarify language in the report. Some comment letters would talk about fraud is really most important, and that was really the one that came through in ACAP, and all the other types of clarifying language could have the effect or certain comment letters didn't want the effect to be minimizing the auditor's role in any way.

So there's no change that would be easy and a lot of careful consideration, and we did get a lot of good thoughts and comment letters, as you point out and Arnold mentioned. But anyway, I just wanted to highlight we're aware of all those things. So we haven't lost sight of them at all.

Let's see, who's next? Denny Beresford?

MR. BERESFORD: As long as that slide is

up, I'd like to make sure that you add one more item to it, and that is --

MS. RAND: Once again, it's not intention to be everything. But --

MR. BERESFORD: I understand.

MS. RAND: I'm going to switch off this slide after this.

MR. BERESFORD: No, no. Don't -- leave it. Because I'd just like to make sure that the Board members do consider one more thing, and it ties into Sam's point earlier on that I wanted to make sure that the Board members consider the effect of slowing down the closing process.

MS. RAND: I was thinking with increased cost, our thought was it's in addition to money, it's time. That came through kind of cost of the time.

MR. BERESFORD: Well, and the focus really of the engagement partner and the senior officials, senior people on the team that depending on the content, depending on what other decisions, obviously, are made -- if it's an auditor's discussion, analysis, if it's several emphasis paragraphs -- depending on the complexity of the report, depending on the procedures that an accounting firm would need to put in place, for example, almost certain approval through the national office of the firm. Every report would be lengthy and custom made.

Outside counsel of both the accounting firm most likely. Outside counsel or at least inside counsel, if not outside counsel, of the individual company. And this is going to be a very intensive process that's going to add time near the end of the examination, when we don't have a lot of time when we're dealing with 60 days past year end.

And there's not a whole lot of slack in those schedules right now. So we're talking now about having to back up several days from the extremely tight deadlines that we have right now in order to accommodate that, which is just going to eat into our you might say substantive procedure performance time. And I think that has some danger of taking our eye off the ball on the really important things that the audit partners need to be spending time on.

MS. RAND: Okay. Thank you.

Wayne Kolins?

MR. KOLINS: Thanks, Jennifer.

I have a comment that's less -- that's more granular and less contentious than most of the other ones. Just in the discussion yesterday about going concern, now this one and one of the elements here is the emphasis of a matter paragraph that's being considered. It may be that we just put a placeholder in when we look at the going concern because of the substance of the discussion yesterday was is the on/off switch the right thing, or is it a sliding-scale approach in terms of what the disclosure needs to be?

And if there is to be a mandated expanded emphasis of a matter paragraph going to more of a sliding-scale, qualitative discussion of the factors that could lead to going concern uncertainty may fit better into that kind of a section of the auditor's report rather than just the one blinking light on/off switch of a going concern by itself.

MS. RAND: Thank you, Wayne.

I seem to have a cluster of open comment cards to go. There could be others. I see some others coming up, but I have Arnie Hanish next on my list.

MR. HANISH: Thanks, Jennifer.

First of all, let me echo what Denny said. I think those are really important points that really should be heeded as far as the timeline.

MS. RAND: Can you move closer to the mike? I'm just not hearing you as clearly as I had earlier.

MR. HANISH: Okay.

MS. RAND: Thank you.

MR. HANISH: Is this better? Okay. I've never been told that I was so quiet.

So I want to echo Denny's comments. I think, having lived through these timelines, the accelerated timelines, to get documents filed with the SEC, the challenges that we have today with XBRL and all of those issues that are out there, I think this obviously would put significant additional pressures upon us, as well as the audit staffs of our auditors.

So let me sort of raise a couple of points. It seems to me, and we're definitely -- I mean, I and our company are definitely not in favor of the AD&A. I think that it would be, in my view, a terrible mistake to include this in any documents.

I think it is, as I think you articulated, it's management's responsibility to communicate. I think that it would be in direct conflict if we choose to keep the pass/fail for the audit because why have a pass/fail if you're then going to ask somebody to come in later and try to articulate the -- what are perceived to be judgments with regard to accounting within the overall framework of our financial statements?

We all know that GAAP is not black and white. There are lots of judgments and ranges of estimates and outcomes in coming up with accruals. The SEC attempted to deal with that, with the initiation of disclosure of critical accounting policies and requiring us to provide quantitative explanations as to what would a change in various assumptions result in.

So I think if you look at our -- if you look at most companies' critical accounting policies, if they're articulated in an appropriate way in accordance with the SEC rules, then you would see that there are already in those documents and in those paragraphs quantifications of the change in estimate. Whether it's a 10 percent change in various significant accruals or a 10 percent change in pension assumptions or whatever the case may be, if the disclosures are appropriate, there should be quite a bit of information in there to provide the investors with some assumptions and analysis as to what would a change in those estimates result in with regard to our financial statements.

But again, we've concluded that -- at

least maybe we've concluded, I hope we've concluded that we're going to retain the overarching pass/fail. And therefore, the financial statements are prepared in accordance with GAAP.

I certainly would be in favor, as are a number of preparers that I've spoken with, they are in favor of an expansion of the report. I don't necessarily think you've captured that. I haven't read all the letters, obviously, that have come in. But I certainly have had discussions with a number of preparers, and they are in favor of an expansion of the current report.

They are in favor of including additional paragraphs of emphasis where the audit is. We don't think it's absolutely necessary because we think if you look at the critical accounting policies and some other things that you can glean from that where the auditors have spent most of their time.

But if investors believe that that's important, then we're certainly happy to have that included in the expansion of the auditor's report to make it clearer that areas of emphasis would generally include those areas that are identified as critical accounting policies. They would include probably major acquisitions, divestitures, areas of impairment of goodwill, areas of emphasis around the current economic conditions, as we talked earlier this morning.

I would be shocked if any auditing firm didn't focus their efforts on those areas of emphasis. And so, there is certainly nothing to hide from my perspective as to where our auditors have spent their time auditing.

But going beyond that I think is a terrible mistake. Again, I don't believe the system is broken, as Barbara might suggest. But she's entitled to her opinion. I'm entitled to mine.

I think that if we enhance the disclosures and the paragraphs, but stopping short of trying to have some sort of an opinion as to whether our financial statements are either conservative or liberal based upon the assumptions that are inherent in numerous estimates I think is where it ought to stop. And if you're going to do that, then you need to change the pass/fail and do something other than a pass/fail because I think trying to provide any expansion through an AD&A undermines the pass/fail that we're suggesting that I think should be retained.

Thank you.

MS. RAND: Thanks, Arnie.

I just wanted to, at the outset of your remarks, you made a comment that I articulated. You said, as I articulated, it's management's responsibility to communicate information about the financial statements. I haven't stated a view. All I've been trying to say is what others have said.

So we're seeing that view reflected in comment letters, but that's not my view, necessarily.

MR. HANISH: I didn't intend it to be your view, I intended -- I believe that it's management's responsibility. And if I said the otherwise -- it is our clear responsibility to maintain and communicate. They're our financial statements, and auditors can provide some insights, but not to the level that was suggested in this concept statement.

MS. RAND: Okay. Thank you.

Damon Silvers, you're next on my list.

MR. SILVERS: I mean, I found Wayne and Arnie's statements very interesting. Particularly Wayne said something that I was going to say, and I'll say it again, which is that I think there is a deep connection between this conversation and the conversation about going concern and the role of emphasis of matter in relation to going concern.

The more -- and I think there's also a deep connection between this conversation and the larger drift over the life of this Board of the financial reporting system toward more of a fair value approach. Then this is what I mean by this.

By the way, I don't think it's a particularly controversial notion that the preparer prepares the financial statements. The auditor audits them. I don't think anyone would disagree. So I don't feel like staff is stepping into any kind of dangerous terrain in asserting that.

But the nature of the audit as a binary exercise was an easier piece of terrain to defend when the financial statement that was being audited was substantially -- where the balance of the financial statement tilted more toward historical cost accounting. You were having an inquiry at that point that -- again, these are matters of degree. It's not absolute.

But the inquiry at that point was more an inquiry into whether things were being -- into whether the financial state of the firm was being, I suppose, accurately reflected in the financial statements in a kind of binary way. Were they or were they not lying? These were kind of like WorldCom questions, right? Did somebody erase one number and put another number in?

As you move toward a fair value system and particularly where you're fair valuing items for which there is not a liquid market, you're very quickly getting into a whole set of difficult to assess judgments, and it's harder and harder to answer the question about the accuracy of the financial statements in a binary fashion. And investors, when presented with financial statements of this kind, are increasingly asking of auditors something more than a binary opinion.

Similarly, on the -- in relation to the going concern matter, you have this same issue. If auditors and firms are unhappy with the prospect of potentially broadening scope of going concern anxieties, there's a natural push toward wanting to have something else to say rather than to have to express what is in reality, in the real business world, a very destructive statement that a firm is not -- that there's a going concern issue.

I think that's what makes -- those are the considerations, I think, that are at a more profound level driving the Board's inquiry into this area, and I think there are reasons for the Board to push in this direction that are only tangentially related to the question of whether or not the system is broken.

I think we get the system we ask for. And we've asked for a system that has the -- we, meaning all of us, have asked for a system that has the features that I was just reviewing. So then the question is what could the Board seek in terms of an audit letter that would be appropriate in relationship to what the role of the auditor is and would actually convey additional real information?

I've been around long enough sadly now to have seen a number of disclosure initiatives turn into mush. And it's not worth anybody's time doing more of that.

In the comment letter that we filed with the Board on this matter, we said basically anything that's going to be real in this area is going to have some aspect of the forced curve in it. And it seems to me that where these comments, where you might find some consensus in the varied comments you've heard today is in the notion that there ought to be more -- that it's sort of what the mutual fund said that they wanted, that there is a desire here for auditors to be much clearer and much more precise about where -- in their audit letter -- about where the areas of concern are, where the focus was.

I think if that's left free form, I think it's going to be mush. But I think there is some reason to hope that properly structured, such a requirement could actually provide information that was useful to investors and the public, and that was responsive to the actual nature of the way the financial statements and the role of the auditor have evolved.

So that's what I hear in the conversation, and I can tell you that I think your summary of investor interest in these areas certainly reflects what I know of investor opinion, that we don't really live in a binary world and that auditors know a lot of really important stuff about the quality of financial statements that would seem appropriate that investors have some access to.

MR. BAUMANN: Thanks, Damon.

I think all of these comments are very helpful, and we'll get to the other commenters. I did just want to share that, to some extent, what we are hearing, and I did hear it -- at least I thought I heard it -- recently at a meeting over at the SEC in the financial reporting series is that current accounting rules aren't adequately dealing with the measurement uncertainty that you talked about that's pervasive in financial statements.

And especially as there are greater movements to fair value accounting, but measurement uncertainty can also exist with complex allowance for loan losses and other things that are not of fair value. But accounting rules are not adequately dealing with that measurement uncertainty and could require disclosure of not just the point on the financial statements, but the ranges in the footnotes and inputs and assumptions that went into that measurement and give greater insight to investors about that uncertainty to help them sort out how they might model a different value of the company, et cetera.

So, to a large degree, we're hearing that. I heard it quite a bit at that meeting I was at recently. I think then I'm also hearing that since that's not being resolved, then PCAOB, we need to have the auditors communicate that because we're not getting it in any other fashion. And the auditors do have insight into those measurements and uncertainties and difficult issues. And so, resolve this through the auditor's report.

But yet others are saying work together with the accounting standard setters and try to solve this together because it is both a disclosure issue and a reporting issue.

So a lot of things on our plate here. We're committed to trying to get a proposal out to improve this reporting in 2012, but I think we're also committed to trying to work with these accounting standard setters to improve the total framework. And I think that's an important message that we've heard.

Thanks.

MS. RAND: Okay. Barbara Roper?

MS. ROPER: So I'll be quick because between you, Marty, and Damon, you've actually made the primary point that I wanted to make. So I won't belabor that point.

But beyond that, reacting to two things. One, I had exactly the same reaction Joe did on the responses from the audit committee. And there is sort of this sense that those who are already sort of in the tent think everything's fine and we really don't need to change anything. And those who are outside of the tent are saying it's not giving us what we need.

And I think investors might have more confidence about the role of the audit committees in overseeing this process if they didn't seem so frequently to speak with the voice of management.

But I also had a reaction to this point, this concern that was raised about dueling information because I thought, well, what's the implication of that? We're concerned that we would have dueling information coming from management and auditors.

Is the suggestion that auditors are routinely signing off on financial statements where they have views that are so significantly different that there would be some sort of conflict raised between what auditors might say in their assessment and what management would say?

And if that's the case -- I mean, because that's dueling information, right? Dueling information is information that's in conflict. Are investors better off not knowing that auditors and management have differences so significant that they would result in dueling information? Or if there's that kind of dueling information, are investors better off if they're informed of that?

And I would suggest that ideally that situation would not arise, but if the situation exists, investors should know about it, or maybe they ought to get their differences resolved. And if they have to publicly comment on it, maybe they would get their differences resolved.

MS. RAND: I think regarding dueling information, I think -- and auditors and others can speak for themselves. But in coming through the letters, kind of the sense I got on that point was certainly any significant differences would have to be resolved. Otherwise, the auditor couldn't issue the report today.

Talking about any nuances to some extent, in light of that point, if there's any significant differences, the auditors wouldn't be issuing their opinion. They'd have to -- those would have to be resolved. So then what more additive are they saying because it's points below that line. You know, they have gotten comfortable. There may be certain things that are more minor and then kind of to highlight that wouldn't be fair to their opinion, if that's coming across clear?

So --

MS. ROPER: Right. But that's a fundamentally different issue. If there are nuances, if the auditor is adding a nuanced understanding of the information, that is different from dueling information. And so, you can't sort of -- the people who are making this argument can't have it both ways. Either we're having dueling information that's going to come out there and investors are going to be somehow harmed by that, or the process of doing this reporting is going to eliminate the conflicts that result in dueling information. And what I get is some slightly different versions of the same truth.

So, I mean, you just have to sort of chose your argument and go with it, but the argument that's out there that this results in dueling information I just don't think works. I mean, I don't think it's valid.

MS. RAND: I accept that.

Mary Hartman Morris?

MS. HARTMAN MORRIS: Thank you, Jennifer.

I just want to say hear, hear to Barbara and Joe and Damon and what they said. I think auditors are in a unique position, and of course, we are shareowners. CalPERS is a shareowner, and we use that. We emphasize that we're the owner of a company.

And I think that only in this situation

that auditors are trying to appear adversarial because in any other industry a customer would help dictate what they would like. And I think that this is an important point. Investors are speaking out and saying that.

CalPERS signed onto two different, separate letters. I don't know if that was -- I wanted to emphasize that. We signed on as a member of IAG, the Investor Advisory Group. We also sent a letter from CalPERS. We also sent a letter to the IAASB.

And I think that it's really important that your numbers, and I think the points I want to make is that it only shows 16 investors. I'm not sure how you categorized the IAG letter, 70 preparers, 35 auditors. But I think identifying assets under management, I think that's probably an important point, asset owners.

I think that one other point -- a couple other points I'd like to make on what, Arnie, you mentioned about the pass/fail. I think investors still want that. I mean, it's a quick way to look at, and I think from your perspective, you're a preparer at this point. And the pass/fail is important to just show quickly what the auditor's opinion on. But I think it's really important that auditors then develop and explain to investors as a customer that perspective. You know, what is the important issue? What are the risks?

I think that CalPERS and other people in this room participate, excuse me, in the global auditor-investor dialogue, and we've been talking about the auditor reporting. But I think I'll mention Steve Mazlin, but he's, like, "Mary!" But I think that he, from his perspective, is trying to understand and provide a better perspective, a more balanced end from the auditors and receiving our opinions more from a customer's perspective. And I think that there is a role for auditors to provide more additional information.

On the point about the audit committees, we definitely respect the audit committees. They're a fiduciary to us in their responsibility to shareowners. But I don't think that there's a problem with the audit committee saying some things and the auditors providing additional information. I mean, that's the stewardship of the company. That's providing information to investors, to the owners.

So, with that, I'll leave it at that. Thank you.

MS. RAND: Thank you, Mary.

Jeff Mahoney?

MR. MAHONEY: Thank you.

My analysis may be a little bit too simplistic, but that's the way I look at things.

I would start off saying that investors are the primary customer of the auditor's report. I think everyone would agree with that. They ultimately pay for that report.

Evidence indicates that they are dissatisfied -- I think you said that in your summary -- clearly dissatisfied with the contents of the standard auditor's report. I think the evidence also shows that they want more information, and I believe the evidence shows they want more information directly from the auditor that they're paying for.

And I think the evidence also shows that, at a minimum, what they would like to see is they would like to see that auditor, as an independent expert, provide their assessment of management's critical accounting estimates and judgments, at a minimum. That information would provide investors with some useful data points to analyze and price risks and make investment decisions.

And as a shareowner, it would also assist them in making their voting decisions, both with respect to the audit committee members as well as with respect to their annual vote on the external auditor.

I think the bottom line is if you continue to ignore your primary customer, the risk is that the customer is going to continue to devalue your product. And I think we can all agree that that's probably not a good result for the auditing profession.

Thank you.

MS. RAND: Just as far as the auditor letters, we certainly saw recognition from many auditors with support for change to the report, too. So if they want to speak for themselves, they're welcome to do that.

Lynn Turner?

MR. TURNER: Let me just start out by saying I give tremendous kudos to the five members of the Board and Marty for taking up these issues we've discussed today and yesterday. These are tough, tough issues. They've been around for a long time.

And as I listen to the arguments, the issues have been around a long time. The arguments have been around a long time. Not a whole lot has changed in the meantime. So I think it took a lot of courage to put these up on the agenda, and I give you all kudos for that.

Having said that, I think what we've just heard from the last few commenters on the investor side is correct. It's a simple question. It is are you going to give the customer what numerous surveys now have shown that they wanted? Are you going to build that product or not?

And it is a tough decision, but it's a tough decision for anyone in business as to whether or not you're going to build what the customer wants and satisfy them or not?

It's very natural for members of management -- I've been there myself. It's very natural to be hesitant to have someone from the outside come in and publicly comment on what you're doing. But we'd have them come in and do surveys of the quality of our product. We'd have them come in, and we'd have customers come in and survey us as members of management.

I've seen other companies do it. GE does it under the Six Sigma type notion. It's always queasy. You really don't like it because you can't control what's going to happen with it. So I think there is a very, very natural hesitancy here to push back and say let's not go there because we want to stay in our comfort zone.

But staying in our comfort zone is what

has got us in the trouble that we're in today. And Marty, you talk about the uncertainties on derivatives and loans and fair values. I worked on Wall Street in the early '80s. We had derivatives then. We had fair values. We had loans. It's not new. Again, it's just one of those things that people discuss.

But the reason those things keep coming up in the papers is we've never got standards that delivered the information to investors that they wanted, including the standards about risk and uncertainty that you've aptly mentioned a number of times. It's the fact that every time we make incremental changes on these issues. And so, instead of fixing the problem, we go incremental.

And I think the real challenge for the Board here, for the five of you, is, are you going to go incremental, in which case what Jeff just said was absolutely true. You're going to continue to get criticism. You should expect to continue to get criticism, and there will be further degradation of the confidence in the product.

Or are you going to go big, make that tough decision, and deliver a product that people want? These are tough decisions. But that's why the five of you are in these roles. If they were easy decisions, we could have anyone in those five seats.

But we aren't. We've got great people who I think you've shown great courage. And I'd encourage you on this one to swing for the homerun, and I think what you've heard from Mary and Barb and Damon and Jeff is where that homerun is.

MS. RAND: Thank you, Lynn.

And I just see one other card up. So I'll turn it over to you, Arnie Hanish.

MR. HANISH: I'll try not to be redundant here. But this issue of dueling perspectives that was raised, it's hard for me to have a full perspective on that because we don't have dueling perspectives at our company. We have issues, we get them resolved, and -- but I would expect that -- and I would expect my auditors, if there were contentious issues that were dueling perspectives, that they would communicate those to my audit committee. I would expect that those be brought up. I would expect that a discussion would ensue.

And I know at our company, ultimately, I believe the audit committee would have final say as to whether or not they were going to side with the auditors or side with us, as far as management was concerned, over an issue that was a "dueling perspective" on accounting issues. But I know that not all companies are like our company, and I can't speak for all those other registrants that are out there, thousands of them.

But again, it's our responsibility. And I would believe -- I believe that there is enough in the current literature, whether it's the SEC literature around critical accounting policies, around MD&A disclosure, that if something is "broken," if there needs to be more disclosure for the investor -- because you are the customer, you own us -- then, to me, that's where it should come out.

And you should be pushing us to have

better disclosures with respect to our critical accounting policies, highlighting those areas of risk around the inputs and the outputs with regard to financial instruments or whatever the material aspects are that are of concern to us as well, because they're the same concerns that we have that we have to wrestle with all the time.

But I believe that the current mechanism is there. If something is broken, then it should be dealt with through those existing mechanisms. I believe, as I've stated earlier, we certainly are supportive of an expansion of emphasis in the report. That certainly is not troubling to most of the people that I've spoken with from the preparer community.

Other issues I think with regard to changes and estimates and what are the various inputs that go into those material aspects of our financial statements I think can be dealt with through existing disclosures that should be evident to all of us.

MS. RAND: Yes. Thanks, Arnie.

I see two more cards that went up. Neri Bukspan and then Mike Gallagher.

MR. BUKSPAN: Thank you, Jennifer.

And then, again, apologies if it looks like I missed an important part of the discussion. But what strikes me from the presentation and some of the discussion now that there are certain elements and there is certain desire for information for some reason investors are not getting.

From looking at your slides, there is some discussion stating, you know, not necessarily objecting to this information but suggesting it's not really my role, it's their role. And if it's not their role, it's the audit committee role.

So I think it may be useful to think about it almost as a package and as a matrix, right, because things are moving from one side to another. And think about whose role to deliver what that, ultimately, this information will be presented. And to Arnie's point, nothing falls between the chairs. Because in the current environment, maybe it's there, but there's a lot of things that falls between the chair in moving between the responsibilities.

And one element would be maybe you need to think about not only changing the auditor report, but suggesting to think about changing some other things. Maybe there should be an audit committee report suggesting how the audit committee executed its responsibility with respect to the audit and what's the dialogue with the auditor itself. So there is not necessarily one thing that you need to solve for, but a broader issue to solve for.

Yes, there will be a change to the auditor report. It will suggest some elements worth some consideration. Whether it's in the auditor report or an auditor MD&A type, that's a packaging issue in my mind.

Then perhaps there is another room for companies to suggest what their view is on these same particular issues and, in fact, also for audit committee. So maybe there is a role for each element here to be ramped up or notched up rather than suggesting you must -- there is one silver bullet that resides necessarily either with the auditor report or elsewhere.

So I would suggest thinking about it together as a package and delivering this information, and whose role. Maybe it's a matrix thinking, and maybe there's a role for the SEC to think about it. But I clearly see another element, which is the role of the audit committee and how the audit committee executed and its role vis-a-vis the dialogue with the auditor.

So if it has been mentioned before, I apologize.

MS. RAND: Thank you. No need for apologies.

Mike?

MR. GALLAGHER: Thanks, Jennifer.

Neri hit a couple of points that I was going to mention. I'll reiterate them. We do take the comments and the views of investors extremely seriously, and I think we have challenged ourselves as a profession to come up with some alternatives and not fight for the status quo. We'll continue to do that.

I think we need to continue to push ourselves, and what else can we do to meet the needs of our ultimate customers? And so, that is important, and we'll continue to do that.

I think Neri's point around other players in the system is really important, particularly audit committees. And if I look at the communication that occurs today in the audit committee report to shareholders, it's not very helpful. And I understand that maybe there isn't the best appreciation for what audit committees actually do, if that's the only data point that people have. So I think that is an opportunity.

But that said, as a profession, we first wanted to look at what we can do differently. I think we've done that, and we will continue to do that.

But I think Neri's point about as we do that, because there are so many interdependencies here of other players, I think those should be concurrent projects as well, whether it's the SEC or FASB or whatever. I think looking at it and making sure investors are getting the information they need, and I think we can debate somewhat, a big part of this debate is who provides it, and I get that. I think we just have reasonable people just disagree on that.

But I think it is critical. I think we can agree on what the information is and how we get that information to investors, including what audit committees do on behalf of investors. And I do think that there's room for improvement there. But we will -- as I said, we're going to focus on ourselves as well and continue to look for alternatives even beyond some of the things we've proposed.

MS. RAND: Thanks, Mike.

Gaylen Hansen?

MR. HANSEN: I want to make sure that it's clear that I believe or I hope that the Board comes down weighting these letters and the views of investors more heavily than anyone because, as has been said many times, they are the customers.

But following up on Neri's comment, occasionally, we do have disagreements with management. I think that maybe they don't rise to the level of dueling, as Arnie pointed out, but they are disagreements. Maybe that could be looked at in the context of SAS 61 disagreements. You don't see those very often. And when you do see them, the only time that they really surface is in an 8-K filing on disagreements when there's a change in auditors.

To what extent are those looked at during inspections, to what extent could it be explored as to whether or not that needs to be taken further, I think, is worth maybe talking about, and I think that speaks to what Neri was -- where he was going.

Thank you.

MS. RAND: Thanks, Gaylen.

Steve, you had your card up. Did you want to have some thoughts, comments?

MR. HARRIS: I was thinking about it,

then I put my card down. But I wanted to first associate myself with Mike's comments, to the extent that whose role is it to deliver what? I mean, I think that is a fundamental issue in what we're considering. Denny mentioned taking the eye off the ball and kind of wonder what the ball is.

But, Arnold, I appreciated your update in terms of what you're considering. Because in Sarbanes-Oxley, we provided -- the Congress provided in the law greater independence for the audit committee, but the audit committee was viewed as a gatekeeper. But it was not viewed as the gatekeeper.

And I think the conversation, both abroad and to a certain extent here, is that the independent audit committee is the gatekeeper with respect to protecting investors. The act says, the very first words of the act are, "An act to protect investors." And then the mission of the PCAOB and the establishment of the PCAOB was to protect investors.

And so, I think what we're wrestling with here is what's the direct role for the auditor to investors? And I know that in terms of the European community, they're focused very directly on the audit committee and management, and a whole host of the comments here are directly focused on the role of the audit committee as a funnel.

How do we get information directly from the auditors to investors, and what should that information be? To me, that is probably the fundamental point.

Scott, we were discussing it a little bit. You mentioned earlier on that the audit committees are backsliding and that there's backsliding on the part of the audit committees. If that's the case, I think we ought to get some empirical data, some academic research on that issue because if there's backsliding, that goes to the point that they're a watchdog which may not be performing part of their function directly to investors.

But I think the role of the auditor directly to investors is really what we're talking about, both with respect to the audit report and in other issues. So, Mike, I think you put your finger right on it. And I do appreciate from my vantage point the fact that the profession is focusing on it, and Arnold, that you're focusing on it. But we're coming at it from slightly different perspectives.

But I wanted to direct my remarks primarily to you because in terms of the audit committee and the role of the audit committee, the role of the audit committee in the United States and the role of the audit committee in various jurisdictions, I think, in the European community is also different, as I heard from Paul George very recently in the context of IFIAR.

So I would encourage you in your deliberations not to put all your eggs in the basket of the audit committee. And I know you're going through a very deliberative process, and now you've heard from a wide variety of constituencies here.

To the extent that everybody can work

together, I think that's extremely positive. But to the extent that we have an obligation on the part of the PCAOB to come up with the best standards we possibly can.

MR. SCHILDER: May I just briefly respond, Jennifer?

MS. RAND: Sure.

MR. SCHILDER: Steve, thank you very much for your comments.

We certainly are not putting eggs in one basket. Actually, we have five categories of possible options going forward, and this is just one of them. So we will explore all of those. And as I said, I hope in much dialogue with yourself and many others here.

Thanks.

MS. RAND: Okay. Thank you, everyone, for your very thoughtful comments.

Before I turn it over to Marty, I just also want to acknowledge and thank my colleagues working with me on this project, Elena Buzhkova, who's sitting next to me, and then Denise Wray, who's sitting next to her. Also recognize the significant efforts of Jessica Watts, who has a prior commitment and couldn't be here but has been very actively engaged in this project.

So we have much work ahead of us, considering all your very thoughtful comments and the comment letters and discussions. But we will be -- we're committed to doing that and very engaged in working through all these issues.

So thanks to them and thanks to all of you.

So, with that, I'll turn it over to Marty Baumann to close up the SAG discussion.

MR. BAUMANN: Thanks, Jennifer.

It's hard to close up this kind of a discussion over the last day and a half. I gave some thought to some summary comments, and it's really too difficult to summarize the varied comments and the quality of the comments in a few minutes, and therefore, I won't, except to say the following.

I think what we heard from you in many

ways, starting with the presentation yesterday of our standard-setting agenda overall, is that we have the right issues on our standard-setting agenda from your view, that we're tackling some very important and very tough issues, as was clearly evidenced by the quality and depth of the discussions throughout yesterday and today on the different standard-setting matters in front of us.

So I appreciate that support that we have the right issues on our agenda and that we're tackling the tough issues. And to a question that Steve Homza asked yesterday, do we have the resources to do that? I'll answer that again and say not only the quantity of resources, but based upon the quality of resources of people that you've seen here today like Jennifer and team, and yesterday Keith and team, and Greg Scates and team, and we have a very talented group of people to support the Board and me in getting through these very tough issues.

And we also have a great Standing Advisory Group here to give us valuable input.

So thanks for all of that. I appreciate all your effort through these day and a half of meetings and look forward to working with you more.

[Whereupon, at 12:02 p.m., the meeting was adjourned.]

# Auditor's Reporting Model – Preliminary Overview of Comments

Jennifer Rand

*Deputy Chief Auditor and Deputy Division Director*

# Key Milestones to Date

- Concept release issued June 21, 2011
- Roundtable held September 15, 2011
  - 32 participants and 2 observers (SEC and FASB)
- Comment period ended September 30, 2011
  - 152 comment letters to date

# Comment Letters Received

| | |
|---|---|
| Preparers, internal auditors and preparer associations | 70 |
| Accounting firms and associations of accountants | 35 |
| Investors, including investor associations, pension managers, analysts, and large investment companies and advisers | 16 |
| Academics | 7 |
| Other regulators and standard setters | 7 |
| Board members, including audit committee members, and their associations | 6 |
| Other individuals and organizations | 11 |
| **Total** | **152** |

PCAOB
Public Company Accounting Oversight Board

# Overall Themes from Commenters and Roundtable Participants

- Retain the pass/fail opinion
- General support for change to auditor's reporting model
  - Range of support depends on the type of commenter (e.g., investor, preparer, accounting firm, etc.)

PCAOB
Public Company Accounting Oversight Board

# Overall Themes - Investor Associations, Pension Managers, and Analysts

- Support auditors' reporting on their assessments of:
  - Areas of high financial statement and audit risk
  - Significant judgments and estimates used in the financial statements, including sensitivity analysis
  - Quality, not just acceptability, of accounting policies and practices
  - Significant changes in or events impacting the financial statements
- Support other disclosures by auditors, including audit procedures
- Prefer more information from auditors regarding the financial statements and the audit rather than assurance on information outside the financial statements or clarification

PCAOB
Public Company Accounting Oversight Board

# Overall Themes - Large Investment Companies and Advisers

- Support auditor's identification of significant areas in the financial statements:
  - A reasonable number of significant areas that would be most helpful for investors' understanding of the financial statements, such as:
    - Significant management judgments, estimates, and areas of measurement uncertainty in the financial statements
    - Significant changes in or events impacting the financial statements
  - Location of disclosure in the financial statements
- Management should be the primary source of financial information
- Some interest in information regarding audit procedures
- Prefer more information from auditors regarding the financial statements rather than assurance on information outside the financial statements or clarification

PCAOB
Public Company Accounting Oversight Board

# Overall Themes - Preparers, Internal Auditors and Preparer Associations

- Management should be the primary source of financial information
- Oppose “AD&A” and “required and expanded emphasis paragraph” type reporting
- Costs outweigh benefits for assurance on information outside the financial statements
- No objection to clarification of language, but do not believe it is necessary

PCAOB
Public Company Accounting Oversight Board

# Overall Themes - Board Members, Including Audit Committee Members, and Their Associations

- Management should be the primary source of financial information
- Oppose "AD&A" type reporting
- Mixed views regarding "required and expanded emphasis paragraph" type reporting
- Some support for assurance on information outside the financial statements
- Support for certain clarification of language

PCAOB
Public Company Accounting Oversight Board

# Overall Themes - Accounting Firms and Associations of Accountants

- Management should be the primary source of financial information
- Oppose “AD&A” type reporting
- Large and regional accounting firms generally support:
  - Objective and factual “required and expanded emphasis paragraph” type reporting
  - Attestation on the Critical Accounting Estimates section of Management’s Discussion and Analysis
- Small accounting firms generally do not support additional reporting
- Wide support for clarification of language

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# Other Commenters

- Academics
- Other regulators and standard setters
- Other individuals and organizations

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# Additional Themes from Commenters and Roundtable Participants

- Work with other regulators and standard setters towards a coordinated solution:
  - FASB/SEC
  - IAASB/ASB/Others
- Support for additional audit committee reporting
- Consider field testing of contemplated changes to the auditor's reporting model

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# Frequently Mentioned Concerns about Changing the Auditor's Reporting Model

- Expanding the auditor's role and the possibility of "dueling information" between preparer and auditor
- Adversely impacting the audit committee's governance role
- Impairing the three-way communication between auditor, audit committee and management
- Risk of additional boilerplate language
- Maintaining confidentiality of company information
- Increased costs
- Potential increase in legal liability of accounting firms
- Possible adverse effect on auditor independence
- Little incremental improvement in audit quality

# Next Steps

- Complete analysis of comment letters
- Consider related projects by other standard-setters
- Issue a proposal in the second quarter of 2012
  - Objective is to improve auditor communications to investors

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**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on November 15, 2012 that relates to the Board's concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards. The other topics discussed during the November 15, 2012 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at: http://pcaobus.org/News/Webcasts/Pages/11152012_SAG.aspx.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
STANDING ADVISORY GROUP
MEETING
THURSDAY
NOVEMBER 15, 2012

(9:01 a.m.)

MR. BAUMANN:

(…)

After that, we will introduce the two main topics to be addressed at this SAG meeting, the first being the auditor's reporting model and consideration of a possible approach to that auditor's report. And there is a briefing paper discussing that.

We have discussed the auditor's reporting model a number of times at this meeting. Obviously, we have had roundtables and concept release, but here we are talking about a specific possible approach, and we want to get views on that approach at that breakout session.

(…)

So there will be a report back from Group A on the audit reporting model, Group B on the reporting model, and other members of the SAG who participated in those discussions will be encouraged to comment on those reports with respect to, you know, how we characterize the comments made and emphasize any points that you think need further emphasis.

MR. DOTY:

(…)

As we have discussed, the audit reporting model several times, as has been focused on in these meetings, it will be focused on again. It is a significant part of the program here, and there will be a lot of good information and good opinion coming out of this meeting, I am confident.

(…)

MR. BAUMANN:

(…)

The third project on here for the first half of 2013, we are going to spend more time this afternoon talking about, is the auditor's reporting model. Obviously, we have spent a lot of time talking about this matter at prior sessions of the SAG, at roundtables.

Of course, our concept release discussed a couple of possibilities for enhancing auditor reporting, including something that we called an auditor's discussion and analysis, required emphasis of matter paragraphs, auditor responsibilities, maybe auditing other aspects of financial information such as MD&A, as well as potentially clarifying certain aspects of the auditor's report.

As you know, we have received a lot of comments back on this. At the same time, you are going to hear today about what other standard setters are doing, IAASB and others, on their projects in this regard as well. So I think everybody believes that changing the auditor's report is an important project, but changing it appropriately is equally important.

And so we have obviously spent a lot of time thinking about approaches, and today we want to talk about at least a possible approach, and that would be the required use of emphasis paragraphs. But we want to hear from the SAG members in the breakout sessions about, if that were the approach used, how could that work to provide all the interested parties with a reasonable amount of information that they want while not yet making it impossible to achieve auditor reporting.

Some commenters feel that certain of the other projects, such as auditor association with other documents like MD&A, is -- there is not a demand for it, plus it would increase audit costs substantially. Sometimes we hear that the auditor's discussion and analysis, more of a free-flowing document, would need significantly more rulemaking on our part to describe how an auditor would do some of the things that are described in ADNA.

The document -- the Board has not made a conclusion yet on how we are going to amend the auditor's report. We are still working on a variety of approaches to look at this, but this is certainly one approach that we are taking a careful look at.

The IAASB -- and Dan Montgomery is here from the IAASB -- had a document they put out, Invitation to Comment, where they included something called "auditor commentary" and will look at how that concept relates to matters of emphasis and how we could possibly look at all of these ideas and come up with something that everybody feels achieves the right balance.

So we are looking for valuable input during this breakout session this afternoon about this one possible approach and how it could possibly work for all of the interested parties.

(…)

MR. RANZILLA: Thank you, Marty. I will be quick. On the going concern project, I, like Bill, applaud you and the FASB for taking this on collaboratively. And my only recommendation is, as you look at the FASB's timing, which I understood from Larry is first half of 2013, with a proposal, you might also consider whether the going concern project ought to be folded into the broader auditor's reporting model, because, again -- and I think your timing fits well, because I think once you go down those two processes, you are going to find a fair amount of intersection regardless of which way you go with respect to enhancing the overall auditor's reporting model, and I think the going concern, especially the portion if we end up in a model like FASB's where the more-likely-than-not trigger is additional disclosure, I think that will also trigger something in the auditor's report beyond a substantial doubt paragraph.

So just something for you to consider as you look at those two particular projects, because I do think you will find intersection.

MR. BAUMANN: Thanks, Sam. We have given thought to that, and we will continue to. But that is certainly on the reporting end of the going concern standard. We also think that the audit procedures end, which doesn't deal as closely with the FASB aspect, is something we are working on separately that may not fit as well into the reporting project. But we agree with your comment generally to think about them together potentially.

(…)

MS. RAND:

(…)

This next session we'll be talking about the auditor's reporting model which is a very important project for us. We will be spending over the next two days a significant amount of time on the auditor's reporting model project which is as Jim Doty mentioned, a very significant and important project of the PCAOB.

This morning, I plan to provide you with brief background on the project, as well as to describe what we'll be covering in more detail this afternoon, as well as tomorrow.

Getting into the project, the auditor's reporting model is a subject we've been considering for a number of years. The main objective of the project is to enhance the value of the auditor's report. Many have said that the current pass/fail audit report is valuable, but it provides only limited information about the significant matters in the financial statements and the audit.

Last year, we issued a concept release on possible changes to the auditor's report. The alternatives presented for changing the report included auditor's discussion and analysis, required and expanded use of emphasis paragraphs, auditor assurance on other information outside the financial statements, and clarification of the auditor's report. The Board also held a roundtable to entertain further insight on the alternatives.

Since then, we have been considering the feedback received and developing a proposal for public comment. Your input to us over the next couple of days will inform us greatly with respect to next steps regarding the proposal.

We plan to issue the proposal in the first half of 2013, so that's coming up soon.

As part of working on the project, we've also been monitoring the activities of others. Several other regulators and standard setters have been working on similar projects as the PCAOB. Our briefing paper provides some information about their approaches to auditors' reporting and I'll just highlight on that briefly.

In the European Union last year in November 2011, the European Commission introduced proposed legislation that relates to audits of public interest entities and includes specific requirements for the auditor's report. There are a number of changes included in that proposal.

In September of this year, a counter proposal was issued containing amendments to that November proposal. It was introduced at the committee level of the European Parliament. The EC's proposal is advancing through their legislative process, but as of this point, we have no indication of when that process will be finalized.

The IAASB also has an active project on auditor reporting. A comment period on their most recent invitation to comment document ended about a month ago. Dan Montgomery, who is here a couple seats from me, is an IAASB board member, but he's also the chair of the IAASB's Auditor's Reporting Task Force. He is here today and will provide a brief overview of the current status of the IAASB's project, including highlights of feedback received today.

Rather than stopping and getting back into the rest, I thought I would continue talking about what we plan to cover and the objectives this afternoon and then provide an opportunity for Dan to provide you more information to reflect on and then we'll open it up for questions regarding anything that we've discussed.

The other regulators that we've been monitoring is the Financial Reporting Council. In September, so just a couple of months ago, the UK's Financial Reporting Council concluded their consultation on the Effective Company Stewardship project and issued revised auditing standards intended to enhance auditor reporting. Under the revised auditing standards, the auditor is required to report, by exception, if a required statement in the annual report issued by the board is inconsistent with knowledge acquired by the auditor. So in that instance, the auditor would be commenting if there's an inconsistency with what has been communicated by the company's board.

The auditor would also report if matters discussed in the annual report by the audit committee do not appropriately address matters communicated by the auditor to the committee.

Regarding our approach and the focus of our discussions this afternoon, our approach this afternoon is focused on emphasis paragraphs, but at this point I'd like to stress that the board has not eliminated any of the alternatives described in the concept release. Based on comments received to date though, the staff believes that there is more support for an emphasis of matters approach.

Today, we'll be exploring the potential approach that considers matters communicated to the audit committee as possible areas for emphasis regarding the financial statements.

In August of this year, also as Marty described, the board adopted Auditing Standard 16, Communications with Audit Committees. AS 16 is designed to enhance the relevant and quality of the communications between the auditor and the audit committee. It requires to communicate to the audit committee many of the same matters that investors have most frequently suggested for additional auditor reporting such as areas of high risk to the financial statements in the audit, the most significant matters in the financial statements such as significant management judgments and estimates, and areas with significant management uncertainty and quality of the company's accounting policies and practices. And finally, significant changes or events affecting the financial statements, including unusual transactions.

In the briefing paper, we provide a list of the areas that are required communications by the auditor to the audit committee. We will use that list to start our discussion this afternoon about matters that might be appropriate for the auditor to communicate in the auditor's report through emphasis paragraphs about the financial statements.

I'd like to clarify that an emphasis paragraph, as currently used in the PCAOB auditing standards, is not required. It is only added solely at the auditor's discretion. The auditor may use emphasis paragraphs to emphasize a matter regarding financial statements. And several investors have commented to us in the comment letter process that emphasis paragraphs today seem infrequently used.

Although we are using that same term in our project, we envision the new emphasis paragraphs could be used in a very different way. As described in the concept release, we are considering required and expanded emphasis paragraphs for the auditor's report. This means that we are considering mandated use and expanded content for the emphasis paragraphs.

I'd like to briefly go over the nature of the questions for which we'll be seeking your input and we'll be going over these in much detail this afternoon. I want to make sure we're all on the same page as far as the questions and the type of input for which we're seeking.

There are five questions in the briefing paper. The first three questions relate to whether emphasis paragraphs should be required for certain matters communicated to the audit committee under AS 16. As I mentioned, AS 16 requires a number of matters to be communicated related to the audit and financial statements.

Our consideration of AS 16 is that it might be a source for the auditor to consider areas for possible emphasis. Not that necessarily the communication in the emphasis paragraph would be the same as that communicated to the audit committee.

Let me give you an example. One requirement under AS 16 is for the auditor to communicate disagreements with management. An emphasis paragraph might highlight the matter in the financial statements for which there was a disagreement, perhaps financial instrument valuation, but not that it was a disagreement. Any disagreement with management that the auditor has would have had to have been resolved if the auditor was able to issue an unqualified report, therefore the disagreement would have gone away. But the auditor may feel it's appropriate to highlight the matter that caused significant discussion of the audit committee.

We're seeking your input on whether AS 16 would be an appropriate source for considering matters of emphasis. If so, should any of those matters in AS 16 be required to be reported. So just mandated to be included in emphasis paragraphs or should the auditor have discretion for some or all of them as far as which items to highlight in the emphasis report. If certain things were left -- should be permitted to left to the auditor's discretion, should there be any factors that the auditor should consider in determining which matters are most important to the financial statement users? For instance, factors could include subjectivity, the level of subjectivity, measurement uncertainty, degree of interaction with the audit committee, or something else. Could be some of the above that the auditor would consider or none of the above. So we're interested in your input on that.

And finally, regarding emphasis paragraphs, we're interested in what's the appropriate level of detail that should be provided in the emphasis paragraph? What information is important to be included and why? For instance, should it describe the area and provide reference to the information and the notes to the financial statements or provide other information? If so, what information would be appropriate?

Moving on to question 4, question 4 asks whether there should be any special reporting considerations for audits of smaller and less complex companies, brokers and dealers, and emerging growth companies. As you are aware, the PCAOB writes standards for audits of issuers including emerging growth companies as well as for audits of brokers and dealers. We are interested in your input on whether a standard requiring emphasis paragraph should have special considerations for certain types of entities.

Finally, we're interested in whether there are specific elements of the projects of other regulators or standard-setters such as the activities of those of the

IAASB, that the PCAOB should consider for its auditor's reporting model project.

When we get together this afternoon, we will have breakout group discussions on these questions which are included in your paper and we're very much looking forward to your input. We will have four breakout sessions this afternoon, so this group will be divided into a fourth. Each one of you should have in your folder a note indicating which session you will be joining. And each breakout sessions will be led by PCAOB staff, and as I said, will include approximately a quarter of the group.

Tomorrow morning, the PCAOB staff that are at the breakout session will present a summary of each one of the breakout sessions so even though you weren't in the other three, you will certainly hear what happened in those other groups. But when that summary is presented for the group in which you're participating, you will have an opportunity to add any commentary that perhaps may have been left out or to emphasize any particular area and then also have an opportunity to comment on themes, issues that came up in the other groups, so we are very much looking forward to a robust discussion tomorrow as well.

With that overview of what we hope to accomplish, I will turn it over to Dan Montgomery so that he can provide you with information, further information about the IAASB's activities and then after Dan is finished, we'll open it up for any discussions about anything that we plan to continue or the PCAOB's projects or if you have any questions for Dan.

So with that, Dan, I'll turn it over to you.

MR. MONTGOMERY: Okay, well, thank you very much, Jennifer, and good morning, everyone. It's indeed my pleasure to be here and appreciate the opportunity to update you on the IAASB's auditor reporting project. In my capacity as IAASB deputy chair, as well as -- as Jennifer said, as the chair of the Auditor Reporting Task Force, Professor Arnold Schilder, the chair of the IAASB, ordinarily would be here. He had a previous commitment this week. He is attending the IFAC council meeting in South Africa, so was unable to be here, but expresses his best wishes to all of you.

I'd like to give you a very brief overview and current status of the auditor reporting project. And Jessica, if you could go to the next slide, focusing in particular on the IAASB's most recent consultation document. It was an invitation to comment that was issued in June of this year. It was the second consultation for the IAASB. There was a previous consultation paper issued in May of 2011. And that first consultation focused on obtaining views and input about some of the concerns that had been raised about auditor reporting as well as some very broad suggestions for types of changes that could be made.

The invitation to comment was much more focused on specific types of improvements to the auditor's report. So the ITC, as indicated here, sets out the indicative direction for a future auditor's report and it really represents an amalgam, if you will, of many different suggestions for possible improvements that were received from global stakeholders, as well as presents the IAASB's views on relative value and impediments, including costs.

The ITC served as a basis for three public roundtables. You see them there. Several of you either attended or in fact participated in our roundtable in New York and in fact, in Paul's case, in Kuala Lumpur. And we appreciate that input.

The IAASB has to date received 164 responses. That number is relevant to us, to the IAASB because it really is about three to four times the number of comment letters that we normally would receive on a project and it is double the number, exactly double, the number of comment letters that were received on the original consultation paper. I might add that the IAASB continues to monitor and be informed by the efforts of the PCAOB, the European Commission, and others as well.

So on the next slide, what have we heard so far through these public roundtables and in the very preliminary analysis of the comment letters. And I might add here that these points are representative of a very early analysis. IAASB staff is continuing to go through and digest the comment letters, but overall, I can tell you that there's broad support for change in the auditor's report, broad support for making the auditor's report more informative.

With respect to the specific suggested improvements in the ITC, broad support across stakeholder groups for various of these suggested changes, but not all of them, but clearly some divergent views in terms of how best to proceed. And these divergent views are in some cases very strongly held and the challenge for the IAASB will be to reconcile these divergent views.

Some of the very overarching comments that came through that the IAASB will need to consider, one that came through very clearly from all stakeholder groups was to preserve the separation of responsibility between management, those charged with governance, and the auditor. So make sure the auditor is not providing original information about the entity or the financial statements.

The second one is reflect back on Marty's earlier comment which is change is important, but changing things appropriately also is important. So identify changes that indeed will move the ball forward, will be viewed as serving the public interest, but with a thorough consideration of the relative benefits and impediments.

From an international perspective, making sure that there's flexibility to incorporate different types of reporting regimes in different jurisdictions. And then finally, an acknowledgment that changing the auditor's report alone is probably not the whole answer here. That there may be changes needed also in financial reporting, in governance, and also in education. So consider all of these elements as well.

Next slide, please, Jessica.

In terms of this suggested improvement on auditor commentary and the invitation to comment describe it as a new separate section of the auditor's report that would provide information that was based on the auditor's judgment relating to matters that the auditor deemed to be of most importance to users' understanding of the financial statements or the audit. And in that regard, mixed views on that particular objective. There was support for some kind of commentary, if you will, support for the auditor to provide certain additional information, but certain mixed views again, on the best way to do that.

I would say in this regard that there were probably four things that came up. One, acknowledging that there already is a mechanism, emphasis of matter that could be used, perhaps could be clarified and used more frequently, that was point number one.

Secondly, some said if you have a concept of auditor commentary or expanded emphasis of matter, that it should be more than just a reference to management's disclosures.

That's the reference to additional audit context here. So some said at least provide an indication of why the auditor believed this matter was important.

A third point of view here was support for this type of an approach, commentary of some kind, but perhaps also retaining the current concept of emphasis of matter. Those holding that view said there's a certain value attached to those matters of emphasis today, so perhaps keep that and have another category that highlights additional important matters.

And then finally, there were some that said the auditor shouldn't be providing any information about the financial statements, that the auditor should be providing more information about the audit, how the audit was conducted. Just some preliminary views on the letters.

Clearly, a need for robust guidance criteria to help inform the auditor's judgment in this regard, concerns expressed about having the right language here to indicate that this is information in the context of the audit of the financial statements as a whole to avoid any concerns about piecemeal opinions, hidden qualifications or separate assurance.

And then lastly, the very strong support in terms of applicability for applying this notion to listed entities and in that regard, I might say there were also some that said even for listed entities, perhaps a consideration of how the concept might be scalable or applied proportionately to smaller listed entities.

On the next slide, certain of the other suggested improvements in the ITC, a going concern was a key aspect because there were some very strong calls globally for the auditor to include explicit statements in the auditor's report about going concern. But in this regard, the letters have indicated support for that, but also an acknowledgment of the importance of this area and therefore also support for enhanced reporting and hence disclosures by management with perhaps then the auditor making some reference to those disclosures. Also some concerns about the lack of understanding, common understanding of terminology and encouraging the IAASB to work collaboratively with the IASB in having a look at guidance for both preparers and for auditors.

Across the board, support for some kind of a statement in the auditor's report relating to the auditor's responsibility for other information that is included with the audited financial statements including identifying the information read and the auditor's conclusion, if you will, on that.

And just yesterday, the IAASB released an exposure draft on an updated standard that includes some reporting language in that regard. Other auditors, basically, the involvement of other auditors, much concern expressed about that, specifically pointing to running counter to the sole responsibility principle in the international auditing standard on group audits.

Finally then on naming the audit partner, basically, there's support in many jurisdictions because it's already done today, but on balance, I think the message was maybe something that's best left for national standard setters to decide.

And then finally, the last slide here just quickly to point to timing and that is the IAASB, this is the number one priority project. It's on a very accelerated time table and the goal still is to have an exposure draft of a revised auditor reporting standard by next June with final standards a year after that.

So with that, I will stop and Jennifer, turn it back to you.

(…)

MR. HIRTH: Yes, a question for Dan, kind of given what our charge this afternoon is, in the context of your proposal and thinking, is there any linking to any existing or potential international standard on communications between the auditor and the audit committee or a similar type of governance oversight mechanism?

MR. MONTGOMERY: I would say in that case, clearly yes. Where it has come up is in the criteria for determining the matters to include in auditor commentary and aligning that as best as possible with matters that had been discussed to a significant degree with audit committees. So not dissimilar to I think what has been outlined in the PCAOB paper here.

MS. RAND: Okay, Jeff Mahoney.

MR. MAHONEY: Thank you. I actually had, I think, the same question. If I look at paragraphs 43 to 47 of your document, Dan, would you view that as similar to what's in the PCAOB paper of their proposed approach?

And second, you mentioned this term original information was on your slide. And I'm just curious about the definition of that. Would that include the auditor's reports on the financial statements? Would that be viewed as original information under that definition? Thank you.

MR. MONTGOMERY: Let me take the second one first, because there has been considerable discussion, I will say, at the task force level and the IAASB about what is meant by original information. And it's in the context of whatever the auditor -- whatever words the auditor uses in the auditor's report, not conflicting with what management has disclosed in the financial statements. So if it's related to the financial statements or the entity, if there's language there that is new information, it could be perceived as the auditor stepping over the boundary, providing original information about the entity and/or confusing readers of the financial statements and the auditor's report about the information that management has presented.

Having said that, there's still some questions about well, if the auditor would summarize some of the information in a note disclosure and include that in a section on auditor commentary or an emphasis of matter paragraph, does that represent original information? So there's still more discussion that needs to happen, at least at the IAASB level about the nature and content of these paragraphs and how that relates to this concept of original information.

With respect to your other point on paragraphs 43 through 47 of the ITC, I will say this. I think there are some definite parallels between what is being considered here and what the PCAOB has outlined and will be discussed in more detail, but the global stakeholders of the IAASB, I think, had indicated a desire for perhaps more information, more and different information. So while there are some parallels, there are also at least in the ITC, there were some differences that need to be reconciled going forward.

We might ask Marty or Jennifer to comment on how their proposals or an outlined approach might align with what is here.

MR. BAUMANN: We'll look forward to this afternoon in that regard.

(…)

MR. MURRAY: Thank you very much, Jennifer. A quick follow up on Jeff's question to help us understand this afternoon's discussion and how we can contribute. It may be an obvious one, I don't know to you or Dan. Has there been any work done thus far that reconciles the IAASB's original information position or at least as that has emerged in your work with the emphasis of matter of suggestion that we are to consider, given that there isn't anything that couldn't be gathered by management and reported out in management's disclosures that might otherwise come from an emphasis of matter issued by the auditor?

Has that dichotomy between putting the emphasis in the auditor's words as contrasted with those who think original information should not arise from the auditor, has that issue been reconciled or is that part of what we will be addressing today?

MR. BAUMANN: I think that is what we are addressing today. And I think that both our project and the IAASB's project at least insofar as we're thinking of either commentary or matters of emphasis, starting with the financial statements and what should be brought out. But the question then goes to okay, how far should it be brought out? What should the auditor be saying about it? How much detail about the matter?

Additional information that's not in the financial statements about financial information, many have said that's original information and that should come from management. So how to bring out additional information, how to make these paragraphs valuable and not just a roadmap, I think is what was said by Dan. And I think we've heard similar things, too. So that's really a subject for this afternoon's breakout sessions with that point about how to make these kind of paragraphs, if this is a solution, make them valuable.

MS. RAND: Well, I have a number of cards up which is very encouraging as far as our discussions this afternoon. I expect it to be quite robust. And we also want to cover fraud. I'm just going to turn to Marty real quick as far as timing. To my count, I have six cards up and then the fraud discussion.

MR. BAUMANN: Let's try to take the cards that are up and then move to the next topic, but I think what we're finding here is many of these questions are the questions we want to address this afternoon in the breakout sessions.

If it's a matter you think we're going to discuss in the breakout session, you think we can leave it until then, and remember we're coming back again tomorrow to talk about it again, maybe you don't need to have that point addressed now. But if it's spot on to something that Dan said and you just want to get clarification, maybe that's better.

MS. RAND: Okay, Kurt Schacht, your card went down.

Okay, Bob Guido. I don't see Bob right now. Is his card still up? Okay, right in front of me.

MR. GUIDO: Well, thank you very much. I would encourage as much convergence as possiblerepresenting the audit committee community. I would like to see that.

I really put my card up because I wanted to address Roman's question, okay? As an audit committee chair, I really don't want four other financial experts on my audit committee. And the reason I don't, and let me tell you that we work hard in educating all of our audit committee members on current topics and high-risk issues, et cetera, et cetera. So there's a lot going on. There's a lot that's happened since Sarbanes-Oxley and I would not underestimate the power of the audit committee and their knowledge.

I would add that I believe, personally, that's me speaking, that divergence of views on audit committees are very important. I find some of the best questions of my fellow audit committee members are those who are not financial experts and I really wouldn't want to stifle that at all. So I just wanted to make that observation.

MS. RAND: Thanks, Bob. Next is Harrison Greene.

MR. GREENE: Hi, I have a question for Dan. And if you could help me understand when you had on your slide a thing about the sole responsibility where there's inclusion in the IAASB standards about naming other auditors. I know in the U.S. we can split that responsibility within the opinion. And I guess my question is how does naming other audit firms that participated in the audit violate the IAASB's principle of the sole responsibility?

MR. MONTGOMERY: In that regard, the views that were expressed by many commenters related to the fact that the standard explicitly indicates that the group auditor has sole responsibility for the opinion and that any reference to other auditors might confuse that sole responsibility and raise questions about which auditor, in fact, was taking responsibility for the group audit opinion. That's why respondents are pointing to that sole responsibility principle because there is no vehicle under the international standards for a group auditor to divide responsibility.

MS. RAND: Thank you, Dan. I would just like to point out Dan's project in auditor reporting covers disclosure, naming of the engagement partner in other firms. And as I think you're aware, but just to point out, that that's a separate project for us. We had issued a proposal last year and Marty talked about the timing of it for 2013 regarding the engagement partner and other firms. So we won't plan on covering that aspect this afternoon, but both of those areas are active projects for us.

MR. BAUMANN: I think I would only add that I think we heard a lot of demand and support for naming of other auditors. I think at least as we understood it, that there was still clarification that the view the people understood was that there was a signing auditor that had principal responsibility and they were assuming responsibility for the work of those other auditors. But there's still valuable informational content in knowing who else participated in that audit, especially in situations where you had another auditor who did maybe 80 percent of the work in an emerging market.

So in any event, it's a subject that we're thinking about still.  And I know the IAASB is still thinking about it.

MS. RAND:  Okay, I have two cards left.  So Steve Buller, you're next.

MR. BULLER:  Just two things.  First, from Roman's comment, I don't remember if it was in the European Parliament proposed regulations regarding the statutory audits of PIEs, but I think there it may have actually suggested that you have a requirement to have one person who is a financial expert and one person with auditing expertise specifically.  So I'm very sensitive to Bob's comment, but they at least suggested that they need not all the auditors, but at least they have that balance on the committee.

A question for Dan.  I was surprised by your comment, Dan, on the people who asked for information on how the audit was conducted.  Because when I look through the invitation to comment on the improving the auditor's report by the IAASB, they don't really focus on that issue. I'd be curious as to whether the tenor of those comments was more about the specific procedures performed or the criteria that they used in performing those such as materiality or if it was information being requested on the evaluation process and conclusions that were used in determining how the audit was performed.

MR. MONTGOMERY: Steve, there was no clear indication of the type of information that some would be looking for with respect to the audit. I mentioned it came up in two or three different contexts. One was if the auditor is commenting on matters disclosed in the financial statements that it would be useful to have at least some audit context to that in terms of at a minimum why the auditor believed that matter was important to the audit.

And then also some that just say it's not the auditor's responsibility to provide information about the financial statements. That's management's responsibility.

I would say that's a smaller number of respondents. And it seemed to be more focused, European focused, I might add in terms of those that said that the auditor should provide more information about how the audit was conducted. Hopefully, that responds.

MS. RAND: Okay, Gaylen Hansen, you have the last word on this subject.

MR. HANSEN: Thanks, Dan, for doing this. I was at your New York roundtable and thank you for that invitation. I do have a question on auditor commentary. And it seems that in New York a lot of the discussion about auditor commentary was how do we know what is likely to be important to users' understandings of financial statements. And so my question is sort of a benchmarking question.

Certainly, that 164 letters and the surveys that have been done already, but from a benchmarking standpoint are we talking about a sole investor or are we talking a sophisticated investor? Is there an intermediary step here? Is more academic research required on that particular point before you're able to go forward and be comfortable about what investor are we talking about here on auditor commentary?

MR. MONTGOMERY: I think, Gaylen, I would just say at this point that there's more discussion that needs to take place. There were several respondents to the ITC that pointed to that particular issue. How does the auditor determine what is, in fact, most important to a user?

Because you could have different users having different needs, different views of what's important to them.

So I think there will be more discussion needed about the objective of this particular section and the types of matters that might be highlighted, and I believe that the discussion that we'll have this afternoon could be highly informative in that regard in terms of the types, the criteria, to help identify matters and then help frame an objective for this particular section or the use of these paragraphs.

MS. RAND: Gaylen, I would just like to add, in our staff thinking, at least, regarding the PCAOB project as far as investors, goes to the reasonable investor concept, which already exists in terms of the audit. The auditors, when they look at materiality and overall disclosures, that goes to the reasonable investor. So we're looking to that test and there's case law, et cetera, that kind of routes that concept in the United States. So that's our perspective, our staff thinking at this point.

(…)

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on November 16, 2012 that relates to the Board's concept release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards. The other topics discussed during the November 16, 2012 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD
STANDING ADVISORY GROUP
MEETING
FRIDAY
NOVEMBER 16, 2012

MS. CEYNOWA: Good morning, everyone. I'd like to report that my group was very lively. We applied the street rules, as Marty had suggested yesterday, and I'm happy to report that there were no serious injuries after all the debates that we had. There were no fist fights, so everything turned out okay.

So, there was a considerable amount of discussion about the merits of the emphasis paragraph, or expanded auditor discussion in the report, and whether AS 16 should really be a starting point.

One issue that was mentioned was that starting with the auditor communications may cause a chilling effect between the auditor and the audit committee, and that was sort of cited as something to consider as an issue.

With regard to whether financial statement matters or auditing matters should be emphasized, the group generally favored financial statement matters, and did not favor auditing matters such as specific auditing procedures because describing this type of information could be extensive, may result in information overload, and may not appropriately reflect the amount of effort that went into an audit area.

And, of course, I just want to reiterate what Marty said. If anyone in our group, if I said anything wrong please, obviously, chime in, or if I left anything out, please chime in.

Participants generally believe that the emphasis of the audit process was not as important as the robustness of the disclosures in the financial statements.  With regard to financial statement matters to emphasize, it was recommended that the PCAOB look to what analysts look at in developing their models and their cash flows.

We heard that there was interest in knowing the following in emphasis paragraphs; that is, what has changed, areas subject to sensitivity, areas that are not apparent to users; for example, a disclosure that may be subtle, information that goes beyond what is required by GAAP to provide more valuable information to the user.

In terms of what should be communicated, there are certain matters communicated to the audit committee that are required to be included in the auditor's report. We had heard that investors want the following four things, which is insights on the quality and not just the acceptability of the accounting policies and practices, significant unusual transactions, high financial statement risk, the appropriateness of critical accounting estimates.

There was debate regarding the amount of insights with this regard -- the amount of insights that the auditor would provide to the audit committee that would be different information provided to users by management.

There were also factual matters, you know, in terms of what is not specifically required in AS 16 should be included in emphasis paragraphs. We heard that there are factual matters that should be emphasized. These include material fraud, violations of law, and instances where there's impaired independence.

A counter to that, there are also things that investors do not care about that is included in AS 16 and, therefore, should not be emphasized. Some examples of these are difficult or contentious matters, disagreements with management as these would be presumed that these would be resolved.

In terms of if things were left to the discretion of the auditor, what are the factors or the criteria that the auditor would use in determining those -- the things that they would highlight. It was suggested that auditors look at what investors demanded through the PCAOB's outreach, what we had heard, that the PCAOB should consider whether we use data points, such as audit effort or time spent discussing with the audit committee versus factors, such as impact on future cash flows.

If the PCAOB would provide specific topics that the auditor should emphasize and allow the auditor to use their judgment, we had heard some people, or one person say that this approach may result in firms competing via emphasis paragraphs by conveying the quality of their work.

In terms of what is the appropriate level of detail that should be provided in the emphasis paragraphs, we heard that it should include the description, it should include why it's important, and it should include the location.

We had a considerable amount of discussion in this area. The disclosures, we heard some believe that they should just point to disclosures in the financial statements serving as a roadmap for investor's attention to those areas. And as a consequence to that, we also heard that by emphasizing certain of these areas that these areas would most likely be the best written disclosures. Some did not think a roadmap was necessary. Instead, they prefer to receive specific detail from the auditor whether it was original or not. We also had heard communicated to us that investors will be disappointed if we only require a roadmap.

But others indicated that there would be concern about confusion between what management reports and what the auditor emphasizes, so the question was posed how are users supposed to reconcile the information when it's different. However, others believed again that this would not occur because management would probably not allow that and adjust their disclosures.

And to that point then the question was okay, so if management suggests their disclosures and we auditors have the emphasis paragraph, then there would be a repeat of information, the information would be shown twice.

We also heard are you driving GAAP through auditing, believes that the auditor should only attest to the information. Another challenge noted was that free writing would take negotiating the language in the emphasis paragraphs -- would cause negotiation of language in emphasis paragraphs, and that would add some more time causing constraints with trying to meet your reporting deadlines, your already tight reporting deadlines.

When asked whether there should be specific reasons to cite in the emphasis paragraphs as to why the auditor chose to emphasize a certain matter, we heard that the reasons should be self-evident because they would probably be related to matters that are volatile, material, subjective, and have an effect on the future.

With regard to the question on whether there should be special reporting considerations for auditors of smaller and less complex companies, brokers and dealers, and emerging growth companies we heard the following. We heard consider making it scalable, possibly consider a phase-in period starting with large accelerated filers. Investment companies should be excluded because they are simple and their infrastructures are outsourced, exclude wholly owned subsidiaries which brokers/dealers may fall into that. And in deciding what types of audits to exclude look to who the users of the financial statements are and the complexity of the organization.

And then a question was raised, what if you have a company that is not complex or doesn't really have anything significant to report, what should the auditor say in that situation?

With regard to the last question, are there specific elements of the project of other regulators that standard setters at the PCAOB should consider for its auditor's reporting model project? There were no specific elements noted. However, it was recommended that the PCAOB continue to monitor these activities of other regulators and standard setters.

There were also some other points that were made, and I'll go over those, as well, that were not specifically on point with the questions. We heard some want the auditor to indicate that the financial statements are presented fairly and not just that they are presented fairly in accordance with the accounting framework.

We heard that this project should not be viewed in a vacuum. When auditor partner identification becomes effective along with the required and expanded use emphasis paragraphs, the market or investors will start tracking disclosure of the emphasis paragraphs by partner to glean any trends associated with that partner.

We heard auditor liability concerns relative to emphasis paragraph, and then we heard some points regarding cost benefit, that the PCAOB should continue to issue standards that are in the best interest of investors and should not be fearful of cost benefit analysis, that auditors should do a better job articulating costs of what investors want in auditor's reports including impact on audit quality.

And then, lastly, we heard a recommendation or suggestion that we do a five-year Sunset provision for implementation of this with retrospective -- with a retrospective cost benefit analysis. Hopefully, I got that right.

MR. BAUMANN: I especially like the part about don't worry about a cost benefit analysis. Was that authoritative?

(Laughter.)

MS. CEYNOWA: I think Mike Gallagher has his card up.

MR. BAUMANN: Again, so thank you very much, Lillian. That group was led by Keith and Jeanette was in there, as well, and Lillian. Mike.

MR. GALLAGHER: Yes, thanks, Marty. Good summary, Lillian.

Marty, let me start by complimenting you on the format of yesterday. I think it was incredibly conducive to a substantive dialogue, and I would hope that we would take this forward to future discussions in having the break outs, because I think it really is conducive to a good back and forth where we can grab a lot of substance. I know we have to balance what we do in the public versus what we do privately, but I think that was a really good balance.

In terms of the subject, I think it was a really good session. I think it was a good dialogue. I think Lillian summarized it well. I do think it's important that the emphasis matters I think is the way to go. I think it's important, however, to stick with the principles. We laid out some principles both as a firm and as a CAQ particularly around the original information about the company and where that should come from, respecting roles, the different roles of management, audit committee, and the auditor, and at the same time making sure that investors and users get the information they need. And the role of the auditor is critical in making sure that that information is high quality. And we all know that the auditors play a significant role even in the financial statement footnotes that occur today in working side by side with management making sure they're as transparent and clear as they can be. And I think that this would move it even to a higher level. As you said, Lillian, anything that the auditor would emphasize, those are likely to be the best written footnotes in the document. I think there's definitely value there.

I just think the important part of sticking to the principles is to avoid the idea of moving to auditor discussion and analysis just by a different name, one paragraph at a time. And I think that those principles kind of stick to driving the value that you can get out of emphasis of matter. It's something that's practical, it's doable, and I think it provides significant value to investors.

So, thanks again. I thought it was a great session yesterday.

MR. BAUMANN: Thanks, Mike. Joe Carcello.

MR. CARCELLO: Let me start by saying I agree with

Mike that it was a great session yesterday. I think it was very productive. We may depart in terms of the second part of what we said.

I think if all you end up with, Marty, at the end of the day is the standard as currently written with some wording changes and reference to two, or three, or four paragraphs in the notes that the auditors emphasize and that's it, I think the Board really runs the risk of having this project viewed as an abject failure in the investor community.

I have rarely seen so much commonality in terms of feedback the Board has received both directly and indirectly in terms of multiple studies in terms of what investors want. Yesterday when we talked, and Steve Buller from Blackrock was very articulate, but if you go back and you look at the transcript of the roundtable on auditor reporting, Marty, I would say Blackrock, although supportive of changes among the investors who spoke at that meeting, were probably among the more cautious investors. The other investor groups and investor advocates wanted even more information than they seemed willing to accept. So, I think that's -- it's very important to keep in mind.

And the thing that keeps coming through to me in terms of three major areas, if at the end of the day investors don't know more about risks, if they don't know more about judgments and estimates, and if they don't know more about unusual transactions, there's going to be a significant percentage of the investor community that's going to say you have failed. I don't know how to be polite but more direct than that.

MR. BAUMANN: Jeff, your card was up. Are you -- did Joe speak for you?

MR. MAHONEY: Just to add  to what Joe just said. In developing the concept release that was issued last year, the PCAOB staff did extensive outreach to the investor community. And their conclusion was, and I'm quoting from the concept release, "There was consensus among investors that the auditor has significant insight into the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful."

So, if that view is correct, if that is the consensus of investors, and there seems to be some other surveys and studies that suggest that that is accurate, I think that raises the question, if you move forward and you're just pointing to other footnotes and you're not providing auditor insights, I think when you get to the cost benefit analysis that you have to perform, I think there's a question as what is the benefit if this change that you're making to the auditor's report is not responsive to the consensus from investor's, consensus view. Thank you.

MR. BAUMANN: Rick Murray's got his card up. I know, Rick, you weren't in that group, but did you want to --

MR. MURRAY: Marty, I think we need and deserve your guidance at this point for making the best use of this morning as to whether we're going to, in fact, run through the reporting cycle as you outlined, or take the deep dive into what's the right answer at this point of the discussion.

MR. BAUMANN: I think each group member here has had an opportunity in their group to make key points, as we heard an issue from Mike, and we've heard the other side of the equation from Joe and Jeff, and that group. So, I think we got a lot of benefit of hearing a summary from Lillian, but then maybe some emphasis from the others. So, I would like to keep with the path of going through the groups and letting people who were in that group comment on that.

We'll have more time after that to kind of delve into your point, which I think is get to a solution, but I think that would be -- if that's what you said, I think that would be a challenge in this room.

MR. MURRAY: I was hoping we weren't going to do that at this point.

MR. BAUMANN: I misunderstood your point, Rick.

MR. MURRAY: My concern was that we seem to be drifting quickly into searching for final summaries of position rather than going through the process you had outlined.

MR. BAUMANN: Okay. Well, we will try to go through the process I outlined, but as we said, after each team reports as to what they heard in their group, we did want to give people who were in that group an opportunity to say I think I have a little different color than maybe what you said in your summary. So, we'll try to stick with that and see how it works.

The second -- sorry, Steve, were you in that group?

MR. BULLER: Yes, thank you, Marty. So, I just wanted to clarify the one point you highlighted. I think that the group felt that the PCAOB should not feel constrained about cost when considering solutions initially so that they have the chance to come out with what they think is the best solution. But we agreed, I thought, that cost still is an important factor that needs to be considered at some step along the process. We just thought the initial process has to be free flowing, it has to be -- make sure all ideas are on the table.

And Lillian, by the way, did a wonderful job summarizing our group, and made us sound much better than we were, believe me.

MR. BAUMANN: Lillian has a way of doing that, so very good.

The next group is going to be summarized by Elena Bozhkova, which included Jennifer and Steve Harris. Thanks.

MS. BOZHKOVA: Good morning, everyone. The discussion in our group was a little bit different from that in Group A. It was a little bit more free flowing, so I will not necessarily be associating each one of the take aways from our group to a specific question. But the key take aways from the discussion in Group B are the following.

The majority of participants in Group B suggested staying away from the list of required communications in Auditing Standard 16, and instead focusing on a more narrow list of areas that could be considered for emphasis paragraphs in the auditor's report.

Some consensus seemed to emerge around a list of four items that would generally be of interest to investors, such as, one, how comparable are the financial statements to those of peer companies in the same industry? Is there any reason for them not to be comparable? Two, how different would the financial statements be if management used other reasonable estimates and judgments? Three, what are some of the unusual transactions and events? And, four, what is the auditor's view about whether there are any unusual risks related to the company?

It was recognized that there are a number of challenges with respect to this list, such as potential litigation. Upper discipline suggested a safe harbor for auditors in the case of expanded reporting. Another challenge that was discussed was the historical nature of the audited financial statements including the auditor's report versus the more current financial information such as earnings releases and quarterly reports that are often used in investment decision making. Another challenge that was mentioned was whether the auditor is motivated to make any of these disclosures.

A few SAG members in Group B thought that Auditing Standard 16 may be a source for determining the kinds of considerations and factors that would go into a framework for what should be disclosed in the auditor's report which should be based on the auditor's judgment, and not disclosing the actual communication with the audit committee.

It was further discussed that a reasonable investor might want to know those items that were contentious between the auditor and management. Many participants also thought it was very important not to chill the discussion with the audit committee as a result of any additional auditor reporting.

Some participants said that an argument can be made for management to provide information of interest to investors rather than the auditor. Other participants pointed out that there are reasons for auditors to be the source of that information, such as their independence.

A key point of discussion was whether any emphasis paragraphs should be focused on audit-related or accounting related matters, and many of the participants in our group supported a view that management should be providing any accounting-related information and the auditor should be focused just on audit-related matters.

While there was a general support that the auditor could provide audit-related information there was no consensus on what that information could actually be, but it was mentioned that it could be related to the four items described earlier.

The group discussed that the current reporting model does not give the auditor a voice. It was acknowledged that at the heart of this project is whether in order to serve investors better we should provide the auditor a voice and consider on which topics the auditor should provide information to benefit investors.

Auditor association with management discussion and analysis and with non-GAAP measures was deemed valuable by many participants as this type of information is typically used in investment decision making.

It was also noted that there will be some cost associated with anything of value that the auditor can provide, and there is also a time aspect to the auditor providing more information in the auditor's report.

A few participants believe that it would be worthwhile to combine the going concern project with this project due to the reporting of risk and uncertainty elements. And last but not least a participant thought that certain brokers and dealers should be exempted due to their ownership structure and nature of operations.

So with that, any comments from Group B? And I see Rick. No. Steve?

MR. BAUMANN: Wayne Kolins.

MS. BOZHKOVA: Oh, Wayne. I'm sorry.

MR. KOLINS: Yes, a good summary, Elena. One thing, in terms of the audit process and the focus being more on the audit rather than financial reporting was a view taken by some. But in terms of the audit process, I believe it was the results of the audit process, not the -- the results of the audit, not the process itself. In other words, no detailed listing of audit procedures that resulted in an auditor's view.

MS. BOZHKOVA: Thank you.

MR. BAUMANN: Bill Platt.

MR. PLATT: Thanks, Marty. First, I guess I would just compliment you also on the format of the meeting. I think it was very productive. I found both the breakouts I was in yesterday afternoon to be a very good dialogue that took I think each of the participants, evolved their thinking or views as a result of that dialogue. And I found it to be a more productive way to try to really tackle how do we best solve issues.

Also, Elena, I don't know how you took the chaos of our group and turned it into that nice organized summary, but congratulations. You made it sound like we were geniuses, but I would say that the point about focusing on -- and you mentioned four questions or four areas. And I would say in our group we didn't necessarily say that -- we didn't have a vision as to whether that was accomplishable or not, or how one might best accomplish best adding value in providing an auditor's voice on each of those items. They are aligned with what investors were asking for. If you look at page 3 of the summary, I think there's four bullets, and they're generally aligned with those four bullets. But we thought that rather than exploring hundreds of types of things that may be facetious by that comment but hundreds of types of things that might be considered, that maybe if we took a deeper dive on for and really tried to explore to say what's practicable, what's feasible, and what can add value at the same time and maybe value is a more important driver than I implied by the ordering of what I had that that would be a productive exercise to go through. But I think you did a great job summarizing what the group's discussion was.

MR. BAUMANN: Bill, I'm interested in -- or anybody else in your group in the context of the first group I thought I heard a lot of support for emphasis of matters paragraph, and then Joe made an editorial, emphasized that it needed to go further than just pointing to the footnotes. But the listing that Elena gave of matters that maybe would be discussed, and I don't know, Elena, if you could just summarize those one more time, it didn't sound necessarily like matters in the financial statements to be emphasized. It sounded -- it did sound more of I'll say AD&A like. Can you just say what those four or five items were that you thought there was some support around?

MS. BOZHKOVA: Sure. The first one is how comparable are the financial statements to those of peer companies in the same industry, and is there any reason for them not to be comparable? Second one is how different would the financial statements be if management used other reasonable estimates and judgments? Three, what are some of the unusual transactions and events? And, four, what is the auditor's view about whether there are any unusual risks related to the company?

MR. PLATT: Marty, I think that certainly some of those would be disclosures in the financial statements and are consistent with emphasizing that. One would think that the -- take estimates as an example, that the significant estimates and the ones that if estimates were different would have significant impact on financial statements should have robust disclosure in footnotes, and so the auditor's reporting I think would be complementary with the disclosure you would see in financial statements. I think significant unusual transactions would be the same aspect.

I think when you get to things like risk, and I think our discussion focused on financial statement risk, not risks to the entity, although some had some discussion about risks to the entity but I think there was a number of people in our group who felt that an auditor is not really the right person to talk about business risks, or environmental risks, but we are -- we do have a special area of expertise in some financial statement risk. That might be something that's not in the notes, that the companies aren't necessarily disclosing that. But I think part of looking at this would be to say what information is useful to investors, and then how best to convey that. And I think, ultimately, it probably is a combination of management reporting supplemented to some degree by auditor statements or auditor's views.

MR. BAUMANN: Thanks for that clarification. And the point you made about risks I think is a good one, too. That word is tossed out a lot, and you clarified that you thought that you were talking about risks are material in the statement of the financial statements.

Joe, you said before three things have to be included, otherwise we'll miss the boat. You said risks, significant usual transactions, and significant judgments and estimates. Is your context of risks the same thing, risks of material misstatement in the financial statement?

MR. MURRAY: Yes.

MR. BAUMANN: Thanks, Thanks a lot. Wayne.

MR. KOLINS: I just wanted to add one thing. In the context of the unusual items there was an idea thrown out about the auditor -- some kind of auditor association with non-GAAP information, with a non-GAAP earnings number which might then flesh out unusual items that are reported by management or unusual items that should be reported by management and called out by them.

MR. BAUMANN: Kevin Riley.

MR. RILEY: Yes, Marty.

MR. BAUMANN: You were in my group, Kevin. You forgot?

MR. RILEY: I have a question for Elena and maybe other members of the group. But one of -- and as Barb gives the debrief on our conversation, one of the thoughtful comments that was raised is we don't want to risk turning auditors into equity analysts. And when I hear the four issues that Elena raised as things that auditors might want to focus on, particularly things like what might the financial statements look like if management had used some other assumptions or issues, is that we're drifting away from auditor responsibility more into equity analyst land, and I just wanted to get some additional perspective or color commentary on that particular question.

MR. BAUMANN: I agree with your point. That's why I sort of went to that, as well. That sounded outside of the financial statements, including how does the accounting compare to a peer group. I think that was one of your points, too, so --

MS. BOZHKOVA: Well, I think the way this list was developed was really points that would be of interest to investors, and the discussion focused around that. And there were various points of view as to who may be in the best position to provide some of this information. And I wouldn't characterize the discussion as a consensus that all of this would come necessarily from the auditor, but there was general consensus that these types of matters would be of interest to investors, and so it's up to us to consider how to take that in consideration for purposes of this project.

MR. BAUMANN: Mike Cook.

MR. COOK: Marty, maybe just to add a little bit of flavor to that, as well. Our group was just wide ranging, very provocative kind of a discussion. I thought it was very good, and capturing it is an incredible task, and well done. But I think this discussion of the four items was not recommending that those four items are going to find their way into the auditor's report. I think it was in the context, and Greg should speak to this because he was the thought leader behind that particular discussion, was about the kinds of things that investors would be interested in and might, if practical, considerations could be or problems could be overcome, might be targets to be moving toward both by management and the auditor in reporting. And I thought there was very good discussion.

I don't think there was a consensus that we're ready to move to those items being included in the auditor's report other than in a transition basis. But I would like to just -- and Wayne picked up one of these items, follow a suggestion which again didn't necessarily garner great hordes of support, but it was suggested that there are existing disclosures and information outside the basic financial statements that you by auditing or by associating the auditor with them, MD&A, the risk factors that are disclosed and non-GAAP information could be dealing with and giving auditor assurance at some appropriate level to a number of the things that people tell us that they would be interested in. MD&A would take you to critical accounting policies, judgments and estimates, risk factors would deal obviously with that subject, and non-GAAP information would be particularly valuable because the message here is that GAAP isn't telling people what they need to know. And here's what you need to know to assess the results of this company. And the auditors are directly associated with what doesn't tell you enough, but are not associated with what you need to know. And that seemed to me, and perhaps others, to be a bit of anomaly when I think about how important the non-GAAP presentations are to investor communications, and audit committees. And the time that is spent on them, for the auditors to be detached from that seemed to be missing an opportunity. So, that was kind of where we were coming from, or at least my thought in those three items is instead of the almost impossible task of identifying all the things that people might emphasize in the future, or auditors might be reporting on in the future, that seems like almost a hopeless task. And I certainly, and I think our entire group almost to a person said AS 16 is not the right framework, and we should not be using AS 16 as a source for what auditors might report on. But I think if you can use existing frameworks that are there well understood, and all we need to do is wrap some part of the auditor around those disclosures, you could accomplish a high percentage of this without the, again, impossible task of trying to define what should be in and should be out.

So, I thought that was an important part of our discussion, but I don't think we should over-emphasize the four items. They were very thoughtful, but I don't think anybody was ready to sign on that we're going to have auditors doing those things in the near future, or maybe ever.

MR. BAUMANN: That's a good clarification, so thanks for sharing that. And I had a feeling it was an engine and caboose discussion coming down the path any moment, as well.

If there are no more cards up, the third group, Group C was Jessica, Greg Scates and Lou Ferguson from PCAOB.

MS. WATTS: I want to tell Lillian that I had a better group than she did, not as a general comparison, just better.

(Laughter.)

MS. WATTS: We did have some similar points to what Lillian pointed out, not as many similar to Elena's group. So, I felt like in our group we had some broad support for emphasis paragraphs, that I think everybody kind of thought that emphasis paragraphs was a good way to go for this project. And in discussing what should be included and what we should think about as a framework, we talked about AS 16, and there was really limited support for using AS 16 as a basis for what to communicate. However, maybe some of the items in AS 16 should be used as a consideration.

And we got into a little bit further about what types of things that are in AS 16 that might be used as a consideration. And, of course, it talks about critical accounting estimates and critical accounting policies and practices, as well as significant risks.

AS 16 also includes a lot of information about the audit. There was limited or no support really for including a lot of information about the audits, such as audit procedures or audit strategy. And partially the reason for that is because it would be very difficult to summarize the audit procedures into a concise paragraph that would be understandable to users of the financial statements.

We also talked about whether or not there should be certain matters that the PCAOB prescribes should be in an auditor's report, or if a lot of the matters should be up to the auditor's discretion. And there was really no support in our group for the PCAOB determining what should be in an emphasis paragraph; however, that maybe there are certain matters that we could point out in the standard that the auditor should really consider and think about these certain matters but maybe not make it a requirement.

So, we found in our group that there really was more consensus for the auditors to use  their discretion in determining what to emphasize using an established framework or some kind of framework, not one that's currently established. And so, we talked about what kind of things that the auditor should think about in determining what to emphasize.

And so, someone in our group suggested that the auditor should think about the greatest risk of the material misstatement to the financial statements, and about significant risks that the auditor identified in doing the risk assessment procedures. And then you have other matters such as the estimates, the critical accounting policies and practices, and the critical accounting estimates.

We also talked about what kind of details should be included in the auditor's report, and I think one of the things we talked about was, obviously, the matter should be identified, but really why the auditor is identifying it as opposed to just a roadmap that says go look at a certain financial statement disclosure, but why is the auditor identifying it? And one person gave an example in our group that presenting information to investors that might be calculable from the financial statements but maybe not readily apparent may aid investors in understanding why such matters are important from an audit perspective. In that instance, it was such as a percentage of Level 3 assets or the hard to value assets. And that would at least give information to the investors about why the auditor is highlighting it but without providing new information, because that information can come from the financial statements.

We also heard that the auditor should not be communicating matters that are not in the financial statements, so the auditor should be really pointing to things that are in the financial statements, and also maybe summarizing them in a manner that is easier for an investor to understand why the auditor is highlighting it.

There was a broad concern in our group. We think that these emphasis paragraphs could become boilerplate over time, and that the PCAOB needs to consider how to avoid boilerplate disclosures, the same disclosure every year, or the same disclosure for the different companies that have similar matters. It should be specific to the company and specific to the matter.

We also talked about whether there should be certain reporting considerations for different types of entities, smaller and less complex, brokers and dealers, and emerging growth companies, and what we got out of that is really we need to think about the standard as being scalable. As opposed to trying to eliminate or exempt certain companies, maybe we just need to consider that it should be scalable.

And then there are some other suggestions that came out of our group that the Board should perform field testing on the standard and that it should include the auditors, issuers, and investors in our field testing. And then we should also do a post implementation review after the standard has been implemented. So, we could do that through inspections or otherwise.

And then we did have one suggestion that perhaps we should make changes to the auditor's report gradually over time. We could start with a roadmap and then work towards maybe more disclosure in the emphasis paragraphs over a period of time. And then, ultimately, we had a suggestion that emphasis paragraphs or in changes to the auditor's report could increase the quality of the financial statement disclosures if you are pointing to it and could increase the audit quality. So, that was what we heard in Group C. Does anyone in Group C want to comment?

MR. SHOWALTER: Yes, good job of summarizing getting a diverse view. I had two points. I just want to emphasize, really not disagree but emphasize with your point. One was that, and it relates back to what, Lillian, you reported, as well; is we thought when auditors do include an emphasis paragraph it will clearly improve the disclosure in the financial statements. Particularly when we talked about adding the second piece to that disclosure, which, why the auditor thought it was important, would really focus the issue we're on making sure those disclosures are appropriate in that.

The other point you mentioned about liability, we were a little concerned that as this went forward, you could get over disclosure on behalf of the audit firms because they were trying to minimize their risk, as well. So, when we talked about that we were concerned about okay, if one firm has six risks and someone is talking about eight risks, then the next thing you the next firm next year will come out with eight risk because their attorneys have told them what happens if you don't get the risk disclosed in the emphasis matter, so we were concerned about driving those disclosures to the point where they don't become helpful because it's like the current risk disclosures in 10(k), not very helpful. Thank you.

MR. BAUMANN: Gary Kabureck.

MR. KABURECK: By the way, Jessica, very good summary of our meeting yesterday. Just one thing we did discuss, I don't know that we had a consensus on it but it was discussed in any event, not violently rejected, was should the audited financial statements and/or the auditor's report be amended to include critical accounting policies, that today is resonant in the MD&A. And I think a lot of the items that the investor community is asking for about auditor involvement with sensitivity, alternative accounting policy selections and stuff, that's what the critical accounting policy section is designed to do.

Now, there might be degrees of compliance with it out in the world, but I think what would happen is if the auditors were associated with it, I think the bar would be raised, perhaps better critical accounting policy disclosures more consistent with at least the spirit of which of the CAP rules were enacted, 10 years or so would help.

Again, there wasn't necessarily a consensus on it but by sweeping those inside the financial statements and underneath the audit report I think some of the concerns being addressed here about the criticality of accounting policy start to get to be addressed. Again, no consensus but I think something you could put in the work plan for consideration.

MR. BAUMANN: I assume it's recognized that that point, Gary, whether the opinion should be extended to cover critical accounting policies would be really probably outside the scope of -- I think outside the scope of what the PCAOB could do. What's in financial statements is based upon rules that are not ours so, therefore, auditors express an opinion on what's in the financial statements, so somebody else would have to make that determination to put that into the financial statements.

MR. KABURECK: Yes. No, we understand that, I mean, but as your organization, the SEC and the FASB work together. It's just part of the overall process.

MR. BAUMANN: Jerry De St. Paer.

MR. DE ST. PAER: Thank you, Marty. I'd agree also that the summary that you gave, Jessica, was right on the mark. And the one spin, and it was only that that I wanted to add, is that the idea that as we were looking -- going through this process with the auditor determine what was in and what was not in, it was going to be sort of a framework, that part of that framework would be something akin to, I'm not saying it would be the same as, but a SAD-99, what's important to the investor. So, the focus here is back on the user, and not just on the accounting and the numbers, because some numbers can move in material ways and not have a material impact on what investors are thinking. And others can move in less ways and have more impact, so the idea here was to try to get a focus on what would be important to the user.

MR. BAUMANN: Thanks, Jerry.

MS. PAQUETTE: Thank you. Jessica, very good summary. I just wanted to underscore one of the points from the group. We keep hearing comments about potential roadmaps, and I'm not sure all of us have the same idea of what a roadmap might look like. And I just wanted to highlight from a user's perspective that if an emphasis paragraph is included having some commentary on why it is important. Our group talked about whether we wanted a "War and Peace," or we wanted a third-grade reader in terms of the content of what was being added. And I take that point to heart, but I think from a user's perspective why the paragraph is being added is important. And I think the intention is to provide more information and more valuable information, and from my perspective if it becomes an indexing of information that's already provided in the financial statements, that will not be helpful.

MR. BAUMANN: Sam Ranzilla.

MR. RANZILLA: I just want to pick up on the point Gary made. And we had very limited discussion as a result of a very effective discussion leader on anything other than the five questions. But I do think, as I have for two and a half years now, that the answer here is somewhere embedded in the critical -- in an attestation by the auditor of critical accounting estimates, critical accounting policies. One very well could argue why do we need both of those terms and, Marty, I fully recognize that such an approach requires the Board to work with other organizations in order to effect such a change. But while I am a supporter of where you're headed, or where I think you're headed in terms of emphasize of matter paragraphs, I continue to believe that that is the second best option. And that an attestation of some limited portion around critical accounting estimates and using existing interpretations that the SEC has would really drive better disclosures and the auditor's association with those better disclosures I think hits the mark closer to what investors are asking for.

MR. BAUMANN: Sam, do you think there are sufficient rules around requirements and critical accounting estimates, and critical accounting policies that an auditor could attest to that today versus what I'll say is maybe interpretative guidance out of the SEC with respect to those areas?

MR. RANZILLA: I do. I mean, I think that if you look at the existing interpretation that the SEC has, especially -- I mean, my focus has been primarily around critical accounting estimates. And, again, I struggle a bit with why we need three different concepts around a company's accounting policies and estimates. Significant accounting policies, critical accounting policies, and critical accounting estimates, I mean, we ought to be able to come up with a definition of things that when you look at it you say what are the most important policies and practices of the company with respect to its financial reporting. And, as a result, we end up with I think complications that are unnecessary. But to your point, I think if others don't, I wouldn't object to additional interpretations, to additional frameworks that would help an auditor benchmark against that, but I think today an auditor could do that.

MR. BAUMANN: Thanks, Sam. I'm sorry. Dan Montgomery.

MR. MONTGOMERY: Thanks, Marty. And, first of all, I just wanted to express again my appreciation for allowing me to represent the IAASB at this meeting and in the breakout session yesterday. And, Jessica, great job, definitely a very good summary of the discussion of the group.

I did want to come back to one point, and that is it's been raised by a couple of the other folks on including in the emphasis paragraph at least something to indicate why the auditor believed the matter was of importantance to users. And this is something that the IAASB has heard from global stakeholders. And I think in part it speaks to some of the misperceptions about why this information is being asked for in the first place.

What we have heard, what the IAASB has heard internationally is that this is more related to the relevance and the value of the audit, and it's not about the accounting. So, while some believe that the auditor is being asked to provide information to fill gaps in terms of understanding the accounting or the complexity of the accounting, the global stakeholders that the IAASB has talked with have said that is not the case. They recognize that if there are issues with accounting that need to be fixed, that that is the role of the accounting standard setters. What's helpful, though, is to get a little more transparency into the audit, and by having the auditors identify those matters that were of the most importance or considered the most importance in the audit because they were matters of financial reporting complexity or matters of significant management judgment, or matters that had been discussed with those charged with governance, that that information is what is important to users to get a better understanding of where the auditors were focusing their effort. And then in turn by having at least a little bit of information about why that matter was considered important to the audit, that that provides at least a little bit of insight into the auditor's risk assessment process and the way the audit was approached.

MR. BAUMANN: Thanks, Dan. And I'm glad your sort of clarified I think further at the end about the audit, because on the other hand I do think we're hearing that people are not necessarily interested in some sort of brief summary of audit procedures. And I think you've acknowledged that's not the case here. It's about the audit, but why was this particular matter in the financial statements being emphasized because of its importance to the audit. And then why was it important to the audit as opposed to procedures. Thanks. Any cards up?

Okay. Then the final group Barbara Vanich is going to report on, and I was in that group with Jim Doty and Jay Harris, as well, from the PCAOB. I always mix up Steve Harris and Jay. I combine the two of you constantly.

MS. VANICH: Thanks, Marty, and good morning. At least I know I can't screw up worse than that.

(Laughter.)

MS. VANICH: It's always great going last once all the best jokes have been used, but honestly, Group D, take comfort in the fact that everyone knows we save the best for last.

(Laughter.)

MS. VANICH: Group D had a really constructive discussion. We didn't exactly stick to the discussion questions no matter how many times I kicked Marty under the table, but I believe at the end of the day we answered most of them. So, I tried to summarize the topics we discussed in that order, which I can just hope does justice to the thoughtful commentary that we had from our participants yesterday.

We also had some suggestions that were a little beyond the scope of the discussion paper but which, nonetheless, were very valuable so I'll try to add them on to the end. And in the interest of summarizing, I'm really going to take the first two discussion questions kind of at the same time because that's how we discussed them.

So, with respect to what matter is communicated to the audit committee under AS 16 should be in an emphasis paragraph and why, and what would not be appropriate and why, and whether financial statement in auditing matters should be emphasized or only should financial statement matters be emphasized. I think our group focused on what was important, and that it's important to have important matters included in an emphasis paragraph. And given the existing requirements for auditors to communicate important matters to the audit committee, there's likely going to be overlap. However, I didn't hear that we should use AS 16 as a checklist or as a kind of check the box on what should be included.

Our group was fairly supportive of including emphasis matters paragraphs, and focused I think more on financial reporting type matters such as significant accounting estimates and judgments, significant unusual transactions, transactions with related parties that are material, material uncertainties and other matters that affect the risk of material misstatements to the financial statements.

With respect to auditing matters, there wasn't as strong support. There wasn't a lot of dissent on perhaps some very high-level matters such as audit strategy or plan, but we didn't as a group seem to have a lot of value in communicating audit procedures at that level of detail.

Some participants thought that when you talked about what matters are important to an audit there would generally be overlap with significant accounting matters, so you might actually get to the same place.

With respect to what should not be included, I think our group was generally of the view not to include original material by the auditor, and that while the auditor should have judgment and discretion on what should be emphasized, they should not use judgment in the actual material that's being reported.

We spent quite a bit of time kind of starting with a model matter of emphasis paragraph that would include the matter, why the auditor chose to emphasize the matter, and where the matter is further discussed in the financial statements.

While our group suggested that we could go ahead and require the emphasis paragraph, they were definitely not as supportive of being prescriptive regarding the content. And we had a range I thought that was interesting of kind of at most having a rebuttable presumption that certain matters would be communicated while others at the other end of the range suggested it should be much more discretion based on the auditor's judgment.

With respect to if matters to emphasize were left to the auditor's discretion what factors should the auditor consider in determining what matters are most important to financial statement users. I think that we generally focused on items that were subject to measurement uncertainty, or that were otherwise significant to a user's understanding of the financial statements. You know, it all came down at the end of the day to where auditors spend their time, and what keeps the auditors up at night.

With respect to what the appropriate level of detail that should be provided in the emphasis paragraph, I think we spent quite a bit of time talking about the merits and the risks associated with various types of discussion that the auditor could have. And that generally, again, auditors would not include new information, but would rather reference where in the financial statement information is included. And while I think we did acknowledge that many investors might find more information valuable that the risks don't outweigh the rewards. And that you could potentially, if an auditor reported inaccurate or --inaccurate information or made the wrong judgment, you could have the auditor -- that paragraph changing the valuation of the company, and that would not be a good consequence to have.

When we talked about whether there would be any special reporting considerations for audit of smaller and less complex companies, broker/dealers, or emerging growth companies, I think we didn't hear that there would be any kind of carve-outs. And, in fact, several people mentioned that they thought it might be particularly important for emerging growth companies who because of a lack of a large accounting staff or focus might actually have more risk of material misstatements related to significant unusual accounting matters.

And with respect to whether there are specific elements of projects of other regulators or standard setters that we should consider, similar to Group A I believe, we didn't have any specific matters noted.

Some of the other things we heard that again our group, I think, was relatively supportive of matters of emphasis paragraphs, and that while it might seem like a small step, we thought that there would probably be a good change generated by having that small step, and whether it focused auditors more on what was most important, or if it improved the disclosures that are referenced to include more important information, that that would be, in general, a very good result, and a very good first step.

We did hear that it was important to strike the right balance of what was important without going overboard, so while there was the view that it shouldn't be limited to one paragraph, we also shouldn't encourage something that was so long that the important details got masked in the level of detail presented.

And another good comment was made regarding just the design and engineering of the opinion, in general, and that's something we could consider as we move forward with this project, that the auditor's opinion is still the most important opinion to investors, and to be careful that it didn't get clustered among other unnecessary information which could, in effect, diminish the value of the report.

With that, please, if there is anyone from Group D that would like to emphasize something they said that I didn't capture, please raise your tent card. Bob Herz.

MR. HERZ: Barb, you captured this, but it's a point that kind of building off of what Dan said about the international view. And I think some of that was in our discussion, too, as to really whether or not the auditor report, the emphasis should be based upon what the auditor viewed most significant to the conduct of the audit versus what the auditor thought was most significant to investors. And there might --hopefully, the two would overlap, but the issue of what was the point of departure in judging significance, whether it was the audit, or whether it was what the auditor thought investors might think most important, I think there were those little bit of back and forth, a little bit of -- in our group, you know, some people kind of I think framed it more from one point of view, and other people framed it from the other point of view. But listening to Dan, it seems to me that's something important to sort out.

MR. BAUMANN: Is that Kevin, Kevin Riley.

MR. RILEY: Yes, thanks, Marty, and great job, Barb.

The only other thing I just wanted to emphasize coming out of the group, it wasn't a total consensus but recognizing that this project will be a change, and we should perhaps focus on being more modest out of the gate with respect to the demands placed on the auditors to do things along these lines. See how things develop in practice, take a deep breath down the road and consistent with what I think came out of Jessica's group, then perhaps change on the fly after we've had a chance to take a look at how it's working. So, I thought that was an important concept.

MS. VANICH: Arnie.

MR. HANISH: Barbara, I thought you did a great job, also. I guess the only comment I would make is, I just want to make sure that we all understand that at least from the perspective I believe, and I think others believed in the room, I don't know if we had a total consensus, but that it would not necessarily be fully appropriate on the auditor's part to I'll call it opine or focus on the judgmental aspect of the accounting estimates. I think, you know, to try to stay focused on the emphasis of where the audit was being performed, the nature of the estimates, or the nature of the areas of most significance that would provide a reader with the understanding that these were the areas where there was significant time being spent.

This is where the areas of risk from a material financial statement misstatement existed, but to fall short of necessarily providing additional context around the nature of the judgments and accruals. Again, recognizing that the financial statements are made up of significant estimates with ranges, but it wouldn't necessarily be appropriate for the auditors to -- because they've already given an opinion on the financial statements, that they're in accordance with GAAP. And to go further to try to provide contextual aspects around the nature of those estimates, at least my view is that that would be one step too far.

MR. BAUMANN: Gaylen.

MR. HANSEN: Yes, just as a follow-up to -- and I don't know that we -- Barbara, I don't know that we necessarily discussed it in great detail yesterday in the breakout, but focus on what's important. And I raised that question yesterday, important to whom? And a reasonable investor, that -- and I appreciate your input on that, Jennifer, but we really need to think about who we're talking about here, because there's a wide range of investors. And I hope that wouldn't be overlooked.

MR. BAUMANN: It's very hard to summarize these comments, but I'm going to take a little bit of a shot. From what I heard, and maybe you all heard things differently, but the notes that I was taking down was there is a reasonable amount of support for an approach that used emphasis of matters paragraphs. There wasn't a lot of support for simply just pointing to those footnotes or those -- just saying what the matter was. There's a desire for some commentary as to why that matter is being emphasized, why it's a matter that was most important to the audit, maybe why it should be considered most important to investors, oftentimes maybe those two should overlap I think I've heard, but some commentary around that, the emphasis of matters not being tied to AS 16, specifically, but when I hear about the nature of the matters significant unusual transactions, related parties, matters with significant judgments and estimates, complex accounting, they're matters that are discussed with the audit committee. So, I think there's just some tonal aspect to that there about don't use the AS 16 necessarily as a checklist for this, but the types of things you would discuss with the audit committee are likely to be the types of things that you'd emphasize.

I guess in our group we did say could you imagine emphasizing something in the opinion that you had not discussed with the audit committee, and it was really hard to imagine that. You might do that. It's probably the last time you'd issue a report on that client, however.

Whether it's about matters in the financial statements or not in the financial statements, I think I heard more comments that it's emphasis of matters about matters that are in the financial statements versus matters that are not in the financial statements. And emphasizing matters about the financial statements, or about the audit, not about the audit procedures, but maybe why it's important to the audit, but really emphasizing the financial statements and what's in the financials, and not audit procedures.

Some other tangential benefits that seemed to be mentioned from a number of different groups were -- at least I heard it in a couple, that the emphasis of matters paragraphs will likely improve the audit of those critically important things that are being emphasized, and will likely improve the disclosures of those critically important things that are being emphasized. And those are benefits that are not necessarily directly related to meeting investor's needs with respect to some additional information, but I've heard a number of times that that probably is going to be an outcome of better auditing on the margin around these important matters, and on the margin maybe some better disclosures around these important items.

With respect to the point that Sam raised, and which I've heard a couple of times, that auditor -- and I think it came out of another group, as well, maybe it was the same group, but I know Mike was talking about it. Some type of auditor reporting on other matters outside the financial statements, or an attestation on critical accounting estimates or critical accounting policies. Don't think we've -- we haven't heard broad support for that certainly in the 150 or so letters, 155. There was not much support in the 155 letters for auditor reporting on other information outside the financial statements. And maybe, Jay Hanson, I'll give you the microphone. I do think I recall you attending a conference and coming back and saying you didn't hear that, as well.

MR. HANSON: A couple of us in the room here, Brian

Croteau and I attended a roundtable hosted by the Center for Audit Quality I think it was in January or so, early in 2012, and the point was to kind of tease out some of what investors wanted around the non-financial information, and there just wasn't a lot of support for it, which kind of surprised me because I came in with the paradigm they would want it. That was just one group that was pretty wide ranging group of investors, some preparers, some auditors.

MR. BAUMANN: So, hard to summarize. And, Joe, you made a very strong comment which I think you used the words "abject failure." I make note of words like that. But an emphasis of matter paragraph that described why it's being emphasized and the importance of it, and dealing with matters that are risks of material misstatement, significant unusual transactions, areas of particular judgment, is that directionally the types of things you think would be important to make this project successful?

MR. CARCELLO: It's hard to know, Marty, without seeing the detail of what the disclosures would have to be. I think the important thing is there needs to be meaningful new information around that either from management or from the auditor if all we get, as Jennifer said, is a roadmap. And as Jeff said, as well, I don't think the costs, I think the benefits are going to be less than the costs in that situation.

Let me briefly respond to what Jay said, because I think it's relevant. In this year's IAG meeting, Jay, we reached out to investors, as well, asking them about additional involvement for the auditors in some of these other spaces that you're talking about, and some of the feedback that came back, and the Board will remember this from the IAG meeting, was if auditors are not willing to communicate more to us now about what they know given the very significant amounts that are being paid in audit fees, we're not comfortable expanding their mandate. And, again, if I was an auditor I'd be really concerned about that. This is what customers are saying.

MR. BAUMANN: They were not necessarily saying, though, they wanted auditor association with other information. Right. Right. Can I just open the floor again for -- this is such an important topic to us, happy to at this point in time take additional comments from anybody on any subject on this auditor's reporting model. And I have, first of all, Denny Beresford.

MR. BERESFORD: Just a brief comment. Marty, in your summary you mentioned that emphasis paragraphs are likely to improve the auditing and disclosure of the items emphasized. And I think that's probably true, but keep in mind, too, that to the extent that there is going to be a lot of work that would go into the wording of emphasis paragraphs, and I think that that would involve both the senior level audit executives, senior lawyers on the side of both the company and the audit firms in many cases, that that is going to come at the cost of possibly taking away from some other aspects of the work and/or adding cost which, of course, is always a concern. So, there's always at least the possibility that these procedures are going to detract from other aspects of the engagement.

One of the concerns that I expressed in my comment letter on the invitation to comment was the fact that we already have engagement partners spending a great deal of their time on the wrapping up aspects of the engagement, and word-smithing and things of that nature, and to the extent that they have even more of this type of activity as opposed to the good old down and dirty auditing type aspects, that I think could be of great concern to a lot of people.

MR. BAUMANN: Thanks, Denny. Mike Cook.

MR. COOK: Marty, I'm just puzzled a bit. And I heard what Jay said, I heard what Joe said about investors don't want auditors necessarily to be involved with other information. But we've spent so much time talking about auditors should be addressing critical accounting policies, and estimates, and judgments, and that's what's in MD&A. It's not new. We don't need to reinvent the wheel. It's been there for, I don't know, 10 years, 15 years, John. I don't know how long it's been there. It can be improved, perhaps, but the same thing is true about risk factors. Well, we'd like auditors to be engaged with risk, and whether the disclosures of risk are appropriate. The disclosure of significant risk has been around for a long time, and it's part of the existing framework.

The one part that doesn't quite fit that, but I think is more telling, and I won't repeat what I said before, is non-GAAP information, because this is management saying notwithstanding this 70 pages of other stuff that we have given you to comply with one requirement or another, here are the things you really need to know about the operations of this company. So, take the stuff you got in the GAAP financial statements and add this, and subtract that, and add these other two things, and then you'll really know how we performed last year.

What would be more important to have the auditors associated with than information that takes what they live and die by, GAAP financial statements and translates it into what management believes investors need to know to assess the performance, the future cash flows and so on of the company. And if that is being done in a misleading way, or it's not being done fairly, the auditors are the best positioned to make judgments about that. So, we have these three things that are already there, and we're thrashing around trying to define new things that we ought to get people associated with. And AS 16 and all the stuff that's in there, and somebody said well, it's important enough to talk to the audit committee about, management is talking to the audit committee about those things, not the auditors. And the auditors are saying we agree, or if they don't agree they're standing up and saying so.

AS 16, again, perpetuates this myth of a two-way communication which is not the way the world works. And most of the communication is being done by the people who are supposed to do it, which is the management of the company. So, the auditors coming in at the end and saying we talked or didn't talk to the audit committee about something is almost irrelevant if management has done its job properly. And we hope they have.

But I'm just puzzled by this -- I don't -- do you know -- do all these people know what's in MD&A, and where it came from, and what it's intended to tell? And all you need to do is throw a saddle on that, put the auditor in the saddle, and you'll get them associated with management's having said notwithstanding 49 items in significant accounting policies in Note One, here are the four, or five, or six things you really need to know about to assess our financial reporting. What could be a better place to put the auditors?

MR. BAUMANN: Thanks, Mike. I think you're reacting to what I initially summarized, and I asked Jay because I knew Jay had attended a conference, but it was my summary. And it's just a matter of fact, in 155 comment letters we really didn't get any support for auditor association. We laid that out as an alternative so, therefore --

MR. COOK: Marty, if you don't ask the question in the right way and you don't know what you're asking about, you won't get the right answer. If you're asking the question of would investors like auditors to be associated with critical accounting policies judgments and estimates, and the answer is no, or they're not commenting I think you've asked the question in the wrong way, because that's exactly what people are saying they do want people to be associated with. And it's right there in MD&A and it has been for years.

MR. BAUMANN: Okay. Dan Slack, you had your card up for a while.

MR. SLACK: So, I just wanted to follow-up on what Jeff had said, Mahoney had said earlier. And I just think it's important that it should not be just a roadmap if emphasis of matter paragraphs is the path that the PCAOB goes down, that I think that it is important that there be some qualitative approach, some sort of why, into the process of why this matter is emphasized.

And I got a little distracted on my thoughts listening to Mike speak. It's sort of interesting about, you know, bringing the auditors into the non-GAAP pro forma estimates or whatever. And that is an interesting concept, maybe it's a little bit beyond this auditor's reporting model. I don't know, but I could see that that, in fact, could be useful to us as investors.

MR. BAUMANN: Thanks. No, it wasn't beyond the scope of this project. In our Concept Release we laid that out as one of the possibilities, auditor association with MD&A. And, in particular, we pointed out I think critical accounting estimates as being an aspect of that in the Concept Release. So, we did lay that out for investors. Jay, you want to --

MR. HANSON: Marty, I just want to make a clarifying comment on some of what I heard at this roundtable I attended a number of months ago, and that was there was acknowledgment of many of the people in the room talking about this auditor association with the press releases and the MD&A, that there already is involvement in most companies with the auditors actually reading the press release, and some of the context around the questions that were asked. And that setting was gee, since the press release often comes long before or at least weeks before the audit report is completed, the reporting that an auditor could do if there's actually a report being written wouldn't say a whole lot because it would say gee, we were engaged to do an audit. These numbers agree to the unaudited information. We're not done yet, and that would give limited value to investor as an additional report, but there is strong acknowledgment that there was already substantial auditor involvement in the process and additional reporting of what that involvement was wouldn't add a lot of value.

MR. BAUMANN: Thanks for that clarification. I think Mike pointed that out historically, too. And my experience is that's the case, as well, that there is auditor involvement in those things, but the question is reporting, as you point out. Let's hear from Brian Croteau from the SEC.

MR. CROTEAU: Thanks very much. I was actually just going to make a similar point in reporting back from what I recall hearing back in January, as well, at that meeting, and very similarly it wasn't -- what I wasn't hearing was that there was an interest in auditor involvement in that area of MD&A, but I think the starting point consideration was that auditors have a role relative to reading that information and considering material inconsistencies and material misstatement of fact today. So, the question was one more of the incremental.

Now, whether an audit of that information versus what's being done today would get better at completeness was a question that was put on the table, and I think that's a question people could continue to give consideration to. And I know that you all are giving consideration to whether any improvement or changes to the performance requirements would be appropriate relative to AU 550. But I don't think it was -- what I wasn't hearing was people saying we don't want any auditor involvement, or that we'd want to take away what auditors do today relative to that information, but there clearly at least in that particular group wasn't support for broadly expanding the auditor's role outside of auditing for financial statements and what they're required to do today under 550.

MR. BAUMANN: Yes, we didn't include this in the discussion materials and as part of yesterday's item but we are spending a lot of time on the existing standard on other information in audited documents, and maybe potentially clarifying in the auditor's report what that auditor's responsibility is, and maybe the auditor saying something about that if we can figure out the right tools and mechanism to do that. But we're definitely working on that aspect of other information accompanying the audited financial statements.

A lot of cards up here in the center of the room that I see, but let's start with John White, and then maybe over to Arnie, and Steve Rafferty. Arnie and Jerry De St. Paer.

MR. WHITE: I'm probably just repeating what Jay and Brian said. I was actually moderating that session, and we basically spent six hours with 30 investors in the room, and the real question we were asking was should there be expanded auditor association with MD&A and press releases. And I'll have to say very much to my surprise there was kind of a resounding no. Just to emphasize, I mean, it was just -- I was really quite -- I was very surprised.

I'll have to say just from my personal experience of being involved with MD&A and press releases and so on, and non-GAAP measures that when auditors are in the room and they're part of the dialogue, I think the disclosures get better, but they're just -- there was not -- I mean, there was certainly support for the existing association with those, with press releases and MD&A, but not that there should be an expanded association with them. I was very surprised.

MR. BAUMANN: We were equally surprised because we laid it out as one of the possibilities in the Concept Release, and were very surprised by the lack of support in the 155 comment letters. So, a resounding no is what we're hearing. Arnie, and then Steve, and then Jerry.

MR. HANISH: So, just a couple of comments maybe to build upon what Mike Cook was saying. I agree with Mike that -- and I know that document AS 16 talks about two-way communication, but I fully agree that it's really a three-way communication effort. And that I, as management, have that responsibility first and foremost to communicate with the audit committee as to the issues around my financial statements.

The auditors, they complement what I'm communicating, and certainly have every opportunity and every right to agree or disagree, provide additional color commentary, to expand upon my discussion and disclosures with the audit committee, but I don't think we need to -- we need to not lose sight of the fact that management has that responsibility first and foremost. And to infer that the auditor should be stepping into the shoes of management I think is -- and I know you're not saying that, but I --

MR. BAUMANN: Nobody is making that inference, and that's not what AS 16 says, Arnie.

MR. HANISH: I know you're not saying -- yes, I just think we need to keep that at the forefront. I think that the focus, again, should be on -- the focus should be on objective perspectives. I think if this is a matter of emphasis paragraph, which I do support the matter of emphasis paragraph, that it needs to be an emphasis on where the time is being spent, and areas within the audit. I think it needs to stay away from the qualitative assessments.

As I've said, I think that there are ways working with the SEC, if there are issues around the critical accounting policies, and people are not describing within their critical accounting policies the appropriate risks or the appropriate quantitative analysis for the reader to understand the changes in those estimates and what can cause those estimates to change based upon the risks assessment, the various assumptions that go into those, determination of the accounting accruals and other aspects of our financial statements, if we're not describing that appropriately with the required quantitative deviations that I believe are very clear and required within the scope of providing critical accounting policies, then I think the SEC has the responsibility to call us on the carpet, and provide and push us to have more appropriate disclosure within the critical accounting policies that I believe will make the investors, and provide the investors with reasonable and significant information around, again, the range of outcomes that can occur, and the impact that could occur if we've missed our estimates by 5 or 10 percent. At least sufficient analysis to determine what a different answer would be within our financial statements.

And I think a lot of it already exists, and to create something new other than maybe providing the reader with where is the auditor spending their time and the emphasis, and why they are spending their time there, and providing some context as to the framework for their scope and their audit plan, I think would be going too far. Thank you.

MR. BAUMANN: Thanks, Arnie. Steve.

MR. RAFFERTY: Yes, as I've listened to this discussion, I think we have to appreciate the fact that investors are telling us that they want and need additional information. And as I listened to all of the panels' report, there seemed to be something of a common theme on the kinds of information that they want, being identifying material estimates and why those estimates might change, to Arnie's point, other matters that might give rise to future volatility in financial statements, and what those uncertainties are, critical accounting estimates, material uncertainties, unusual transactions and events, perhaps even information about going concern. I would boil that down to investors wanting more information about the subjectivity and volatility in the financial statements potentially in the future.

So, I would -- it would be hard to disagree that there shouldn't be some kind of an emphasis of a matter paragraph around that kind of stuff, but if you -- I think one of the big struggles that we're going to have here if we stick to the principle that auditors shouldn't be providing original information is, that's going to be hard to do in an auditor's report. It's almost an emphasis of a matter paragraph or a footnote in the financial statement for that to be original information from management. And I think while you can argue that that information exists today, it's fragmented. Some of that information is in the financials, some of it's outside the financials, some of it's perhaps not required at all. But I think investors might be saying put that one place in the financial statements where I can read about the uncertainty and volatility of these financial statements. And I realize that maybe as a perfect world and requires standard setting beyond the scope of what the PCAOB can do, but I would encourage you to think about pursuing that if it is perhaps more of an ideal answer.

And then I appreciate the fact that investors might also want an auditor's evaluation of that, of those disclosures. And I wouldn't think there would perhaps be anything wrong with modifying the auditor's report to specify that the auditor has, in fact, evaluated the disclosures around uncertainty and volatility of financial statements and report that those disclosures are, in fact, adequate based upon the extent of the audit work performed.

MR. BAUMANN: Thanks, Steve. We have Jerry, and then Steve Homza, and Robyn Kravit, and I think after that we'll be due for a break.

MR. DE ST. PAER: Thank you, Marty. I just had two points that I think came out of our group, but one item was only mentioned by our group, and another that was mentioned in a couple that I think are worthy of your consideration for inclusion in your sort of summary, overall summary.

The first was the discussion that a couple of groups have talked to, and that is identifying the target of who we're trying to benefit with this. Who is the investor? And in our group -- and I think that's worthy of some consideration. Our group, I don't remember who it was. It may have been Gary who recommended using the FASB bar for that which is fairly high. It's a fairly sophisticated investor, but I do think it's useful for us in terms of trying to target where we're going to pitch this, to understand the audience that we're pitching it to. That's the first point.

The second point I thought really made a lot of sense was the idea of field testing. I have to say it was not my idea, so this isn't something I'm promoting, but it came up in our group, and I really think it's a good idea, to pick a few companies, go back, take a few years and see if you can kind of get a sense in a real way of what you would be looking at to inform the process, some field testing.

MR. BAUMANN: Great. Thanks, Jerry. Steve.

MR. HOMZA: Thanks, Marty. I just wanted to suggest that perhaps as I sit here and listen to this discussion there is a role for internal auditors to provide more assurance around information about risks in MD&A and so on and so forth. I hear a lot of gray through this discussion, so it may be appropriate, maybe kind of a compromise position between the investor world that is clamoring for more information and additional assurance, and auditors that may not be able to provide that, perhaps some responsibility could rest with internal auditors because they are inside the companies. They know the companies very well, and I think in the public company world, especially at that level, they're staffed with CPAs, Certified Internal Auditors, that have a deep background in business that come from major accounting firms, regulators, so on and so forth. So, I think that point is perhaps worthy of some consideration in this process.

MR. BAUMANN: How do you see that working, IIA coming up with a proposal, or companies voluntarily asking their auditors to do that, or what?

MR. HOMZA: That would be my suggestion for the PCAOB and the Institute of Internal Auditors to work together to come up with something around that. I understand that the IA, I have it in front of me, the comment letter to the Concept Release dated September 30th of last year, and it is one suggestion in that letter.

MR. BAUMANN: Thank you. Robyn, I think you get the last word.

MS. KRAVIT: Great. I know this is beyond -- I'm speaking to the PCAOB here, and this may be beyond scope, but in our breakout session I mentioned, and I think there was some support for the fact that really the audit committee's role -- I mean, I understand that investors are clamoring for more information, and I'm sympathetic to that, but maybe it's the audit committee's role to provide emphasis and additional information, because after all it's the audit committee that hears from an internal audit. It's the audit committee that has robust discussions with external auditors. And to decide where to point investors might be better placed in the audit committee scope working with the SEC, so I just throw that solution out as opposed to mandating certain information.

MR. BAUMANN: Thanks, Robyn. And, of course, as Jennifer commented yesterday, the FRC in the UK has gone down that route with expanded audit committee reporting. Their process and what they've done in the oversight of financial statements in the audit, and to make some commentary about financial statements and the audit, and then for the auditor to actually report on the fairness of the audit committee report. So, there is a model for that in the UK.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Investor Advisory Group meeting on October 16, 2013 that relates to the Board's proposals (1) Improving the Transparency of Audits: Proposed Amendments to PCAOB Auditing Standards and Form 2 and (2) Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the October 16, 2013 meeting are not included in this transcript excerpt.

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MEETING

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WEDNESDAY
OCTOBER 16, 2013

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CHAIRMAN HARRIS: In terms of this final general discussion session, I emailed all the Investor Advisory Group members, tasked them what topics they wanted us to discuss. And they indicated the auditors reporting model, audit transparency, the status of the PCAOB's work on the ACAP recommendations which is, I think everybody knows ACAP refers to the report of the Department of the Treasury's 2008 Advisory Committee on the Auditing Profession, the global agenda, which is something that

Anne Simpson raised, oversight of audit committees, and the possibility, although I think there was enough communication that we're probably not going to bring up a fair value accounting.

Since the first two topics are under consideration by the Board, we've made it clear that all comments will be transcribed as have the comments of this entire session. But those first two topics deal with the auditors reporting model and audit transparency.

And I should say that I anticipate that this last hour's discussion will be relatively free-flowing with members discussing issues as they see fit. And hopefully we'll have time before we break for everybody to bring to our attention what is most on his or her mind.

So having said that whether or not we want to start with audit transparency or the audit reporting model, whoever wants to start with that subject matter or either of those raise your tent card and we'll start, Ann, with you first, and then we'll just recognize people as they put up their tent cards. So Ann Yerger?

MEMBER YERGER: This is Ann Yerger, one of the two Anns named here. Well, yes, let me make one comment regarding just auditor report, and it sort of links on to our prior conversation.

I know we were talking a lot about audit committee disclosures to investors, but I do want to stress that certainly the council and personally I'm in favor of an enhanced auditor report to the public.

I appreciate the benefits of sort of that pass/fail model that's in place, but I think there's terrific, important information that the auditors have that I think should be disclosed to the public.

Second, let me comment on the issue of auditor transparency. I think that there is no simpler or less expensive reform that should and could be put in place than requiring the disclosure of the name of the partner on the engagement. I think nothing sharpens the mind more than a signature.

I know we all have to sign documents, public or not, and I pay a lot of attention to that. I think it's an incredibly important reform and I urge the Board to move forward with that. Thank you.

CHAIRMAN HARRIS: Anne Simpson?

MEMBER SIMPSON: Thank you. I'd like to fully support what Ann Yerger has just said. I think the question of transparency on the audit, it's hard to understand who would object to this. Who would not be willing to stand and be held accountable for their own work?

I recall us having similar discussions around boards of directors 20 years ago about knowing who the board were, what their background was and so forth. It seems to me just exactly as we were talking about, the accountability to shareholders which is in real need of being strengthened. That sense of personal accountability is extremely important. So we fully support this and we actually think it will sharpen the discussion in an extremely useful way.

On the auditors reporting model we'll be putting in comments. I think, you know, you will remember, I think it was the first meeting that I came to we looked at the auditor report, was one of the issues in the working group that I participated in.

And my party piece of the day was to illustrate the problem we had as shareholders by reading you the audit report from Bank of America before, during and immediately after the crisis. And there was not one dot or comma different.

So I think if we can't use the audit report to communicate on critical issues, and many of them are listed out in the consultation, then really this is becoming an exercise in pushing paper around. So accountability will be sharpened with transparency, and quality will most definitely be improved with this new scope to the audit.

DIRECTOR DOTY: With transparency there has been an issue raised in the comment process over the original proposal as to whether it was either useful or necessary or appropriate to have the engagement partner disclosed in the audit report, whether the same results could be achieved by having a separate form, a Form 2 filing or a special form that we would devise which would be filed either annually or within a certain period of time following the completion of the audit that would contain this information.

That raises also the question of whether you just stick with the auditor's name, the engagement partner's name, or whether you include more extensive information about his or her qualifications and the audit team. Are there any views you have on that?

MEMBER YERGER: I would strongly prefer that there not be a second or another filing. You know, the more you make folks hunt and peck for something, I think the less valuable it is. I don't know why you would add, you know, make something more complicated that really doesn't have to be.

I don't object, frankly, to having additional information disclosed regarding the background or expertise of the individual. I think that can be helpful as well. But I do think just having the name is a good data point. I think it sharpens the mind and I think it also can give the audit committee good information as well to compare.

MEMBER SIMPSON: Yes, I agree with that. I mean an auditor should be proud of the work they're doing. And in the same way that we know more now about the people who serve on the boards, it's entirely appropriate to have that sort of information about the auditor and the audit partner.

This is entirely complementary to the

improvements we'd like to see to the audit report itself. So if transparency is the watchword, you know, we hope the wind is in your sails. We certainly, as the users, the prime users of this information, fully support what the PCAOB's hoping to achieve.

MEMBER BUETTNER: And Steven, I would just say -- sorry, just to jump in on the back of that. I would say that if you are going to disclose additional information, the tenure, that particular engagement partner's tenure is actually relevant and important information and should be included.

CHAIRMAN HARRIS: Well, as I say, since this is the equivalent of a comment period as well, you're being transcribed, what are your views in terms of the identification of the engagement partner and the identification of other auditors involved in the engagement?

MEMBER BUETTNER: I would agree. I think the more information, frankly, the better, and I would think that to put that on a separate form probably complicates the issue as well. It should be relatively easy to find.

CHAIRMAN HARRIS: Norman?

MEMBER HARRISON: Very quickly on this question. First of all, I violently agree with everything that was just said on the other side of the room. But to take it a step further, as some may recall I was on the working group last year that dealt with the issues around the audit report, and of course we raised this issue at that time.

It's an important transparency issue, but it ties in as well to other things we've talked about today including this issue of whether there is or perhaps why there isn't competition for audit services that's based on quality.

I think that ownership and putting identities with work product, I think, moves us a step in that direction. And it may have some beneficial aspects for compensation issues as well. So I just wanted to point out, I think that it's an important issue for the reasons that both Anns provided but that it ties into a number of things we've talked about today.

CHAIRMAN HARRIS: It's extremely important that we get the temperature of investors on this issue because oftentimes the assertion is made that we only have comment letters from the profession.

I mean the profession's comment letters totally outnumber the comment letters that come from investors or representatives of investors or people who are associated with investors. So, you know, to the extent that you can flush out your arguments either pro or con on these issues, it's important to get it on the record.

Mike?

MEMBER HEAD: Mike Head. And as far as the additional auditors report, obviously I was on the similar subcommittee last time and still feel an auditor's discussion and analysis supplemental report would be very valuable.

And I guess based on what you just said I have no problem with a supplemental filing. I would just then require whoever the lead engagement partner is that is on the supplemental filing has to sign and be shown on the opinion in their name. I'd give them both instead of one or the other.

CHAIRMAN HARRIS: Lynn?

MEMBER TURNER: The getting the auditor's name, I think, would be very good. In fact, I'm shocked that this thing's been debated for 40 years and finally it looks like maybe someone will actually do something about it.

I agree, well, I mean put it this way, I don't think it matters whether you have a separate ADNA or you included in the filing the 10-k or whatever filing it is itself, what I'm concerned about is the information and getting the information that you need and I care less about, you know, which page it's printed on.

With respect to information that would be useful to and impact on someone voting on whether or not to retain the auditor, I think that stuff clearly ought to go into the proxy because that's when investors are most likely to be looking at it and where they're most likely to look at it when making that vote. So I think it probably ought to go in there. I wouldn't do a separate filing out beyond that.

As far as information like tenure and that as long as it's factual, I think that is good. I asked our CIO at Copara to survey all of her analysts and portfolio managers, and one concern that they came back and expressed was asking the auditor to provide information that would be perhaps turned into spin or hype. They were very concerned about that. They wanted it to be factual information and information that the PCAOB or someone at least periodically could test and see that it was actually accurate. So at least in that group they were very concerned about that at Copara.

So factual stuff like here's the tenure of the auditor, here's the experience the audit partner has in auditing that industry, that type of stuff is factual and it would be very helpful.

CHAIRMAN HARRIS: Damon Silvers?

MEMBER SILVERS: Yes, I again want to speak to this question of identifying the partner. Like Lynn, I mean I've been on many bodies that have advised doing this over a period of years and it just continues to surprise me it's not done, particularly against the context of, for example, the fact that individual attorneys sign SEC filings.

The fact that in general we demand a great deal of individual disclosure in disclosure systems generally. This is true with respect to boards of directors, to corporate executives. Corporate executives have to individually sign financial statements.

This is true in, to take a somewhat far-afield example but one which I'm somewhat familiar with, in the regulation of labor organizations. I mean a great deal of information is publicly available about me. I'm just an employee.

And so the idea of sort of some level of personal identification in relationship to important gatekeeper functions strikes me as just totally old hat, and I don't understand why this is controversial, and it's just long overdue.

And it ties to what we were discussing earlier. I mean throughout today in terms of the problem of commodification, the problem of audit committees not necessarily doing what they're supposed to do, the minimum that the PCAOB ought to be doing in this area is arming the various actors in this process so that if they choose to want to do their job seriously they have the basic information necessary to do it. And I would say the most basic information is knowing who's in charge of the audit.

Now I think there is, in addition, I think there is something that has not gotten a lot of attention here which is the question of who really is, whether we really have a consistent view of quote, who is in charge of the audit.

And the Big Four audit firms and now their global networks, is it truly meaningful, what does it mean to say that one of them is in charge of the audit without identifying specific human beings?

I think if we were talking about, you know, a Victorian partnership, you know, a handful of people sitting in an office together, you might be able to say, well, it's a meaningful thing to say that those five people or those ten people are in charge of an audit.

How many tens of thousands of people represent the institution of PwC or E&Y and is it meaningful to identify them as responsible collectively? I don't think it is.

And oddly enough, when we talk about auditor rotation currently we focus on partners. And the idea that we focus on partners there but then don't tell anyone who the partners are, it doesn't make any sense to me.

And so, you know, look, there's always going to be a certain amount of pushback here, but this seems sort of like a minimum thing for the PCAOB to move forward and adopt.

And then I'll make then a comment about the auditor reporting model for a moment and just a general piece which relates to what a number of people said about the danger of boilerplate in any revisions of the auditor reporting model.

Again, having seen a number or requirements for disclosure turn into meaningless mush, it seems to me that if you're going to try to get more information in a meaningful way out of the audit process that then again informs and potentially empowers a variety of actors that surround the, including the audit committee itself, but the actors surrounding the audit committee to try to improve audit quality, that those disclosures really have to either be specific, testable facts of the kind that I think people have discussed here already today, it was the subject, I think, of Ann's presentation, or they have to be kind of processes of requirements that for lack of a better word compel either the auditor or the audit committee to disclose sort of the things that essentially involve grading on a curve.

The example of, tell me the five hardest things you had to deal with in the audit process, the five toughest decisions, the five most marginal things, a process that doesn't allow you to say, oh, we don't have any. We're all fine here.

I can't help but just saying that, you know, the president of the AFL-CIO just came back from his first-ever trip to China. No president of the AFL-CIO has ever been to China since 1955 when the AFL-CIO was established. If you think about the dates involved you'll understand why.

And he had a great trip, but he was constantly in the process of asking people in various settings, so does anything ever go wrong here? Do you all ever have, you know, does the mine ever cave in? And the answer was always, oh no, no, no, no. Never, never, never.

Now we all understood that this was part of a ritual back and forth. We don't want to reproduce that kind of ritual back and forth in what we're doing here. And the way in which I think you avoid that is by not allowing, oh, there's no problem to be an answer.

MEMBER HANSON: Joe Carcello?

And let me ask the people who have commented to also respond to the liability issue associated with the partner identification.

MEMBER CARCELLO: Like the other people who've spoken, I also had a couple of comments about both of these. And in terms of the liability issue, I'm not an attorney so there's people in this room who are in a better position than I to talk about that.

But in terms of the audit report, let me just give you a very brief quote which I'm sure you've seen. "I believe the audit is at a tipping point. The audit report at present is hopeless."

Now that wasn't Damon, that wasn't Lynn, that wasn't either of the Anns. That wasn't me. That was Sir David Tweedie, okay, former Big Four audit partner, a former chairman of the IASB.

You know, this is as an establishment profession as you can get, and I could give you a bunch more quotes like that. So I think it's clear that there's a need.

I went back and I reviewed the transcript of the

September 2011 roundtable, and people who are opposed to your rules always pull out the bogeyman, right, Damon? Unintended consequences. If I've heard that once I've heard that dozens of times.

Here's a quote from Paul Haaga at the Capital Group. "The mere fact that there's more to say than pass or fail we think would give," and there was broad consensus on this within the Capital Group, "we think would give auditors a stronger hand. They would win more arguments and we think that would be a good thing." That's an unintended consequence. All unintended consequences aren't necessarily bad. In fact, that would be a good unintended consequence.

In terms of auditor transparency, there's a growing body of literature that finds that, in fact, identification or signature is helpful. Much of that literature the Board has seen.

As others have already said, CEOs, CFOs, chief accounting officers have certified Ks and other documents for years without huge problems. Most of the developed world require the partner to sign or be identified, virtually all of Europe, China, Australia. Has not been a problem.

And I'll close with another quote from a very bright person. "Common human experience suggests that when an individual is publicly identified with a particular activity that identification usually leads to a higher degree of care and focus." I agree.

CHAIRMAN HARRIS: Mercer Bullard?

MEMBER BULLARD: Sure, just a couple of comments on the, you know, on the liability issue. Often you hear liability risk used as if it is always a bad thing. The issue with liability risk is, is it a good liability risk, and then creating the liability is going to create net social benefits, but you always almost hear it as inherently negative.

I'm all for reducing liability risk that doesn't create net social benefits, but this is one I think you certainly would. And it also reflects a trend that you're probably aware of in that cohorts have been complaining about holding corporate entities liable and no individual's engaged in the contact for which they're being held liable.

Another problem has been true for quite some time. You have corporations in many cases paying damages. The corporation itself pays the damages to shareholders, who of course the shareholders of the corporation paying it, and no individuals are held liable.

You have the SEC now saying it's not going to take no-admit, no-deny settlements anymore and pointing out it's going to go after individuals. And this is precisely what we need to do.

We need to make individuals responsible, because in this sense corporations are not people. Corporations can't take action without an individual having taken that action. So I think that putting the name and the face on the action will have this behavioral modification effect, it also will be the kind of liability risk that you want.

And I think it also, to Anne's point, it really needs to be in the main source of information about the audit. You know, there's a general collective action problem that shareholders have in getting involved in anything. And a big part of the collective action is the information costs, and every time you increase the information costs you make it much less likely shareholders will engage and be active, because as a cost efficiency issue it's just not worth it.

And in talking to reporters this is constantly an issue. They will not write good stories if the information is not easily available.

And, you know, going further, this is an issue that I've been sort of arguing with the SEC about for more than a decade is, it's not clear to me why information is not provided in a way that when you go on useful websites it's provided where you can click a button and get all the combinations of information that you want that would be relevant.

And in the mutual fund world, for example, you should be able to compare ten funds and see their fees. In the context of issuers you should be able to compare the auditors. You should be able to compare who's been with what firm how long, who have been the auditors on different projects, what's the disclosure that is related to PCAOB inspections.

And you see the government using virtually none of that technology in order to make information really useful, and that is what would really make it actionable.

DIRECTOR DOTY: Mercer, you may have to write that to a legal argument on liability up in a comment letter. December the 4th, 60 days, it gives you until February. You'll have plenty of time to do this at the University of Mississippi. But we're going to need the comment, the legal argument on intended and unintended, good and bad litigation costs in the file.

CHAIRMAN HARRIS: That was not a set-up, Mercer.

Norman?

MEMBER HARRISON: Sorry to come back to it, but actually I had two things, one of which I think Mercer and Ann have eloquently described on the issue of liability.

I would second the notion that what the ideal and a probable outcome of engagement partner accountability for the content of an audit report and public visibility with respect to the conduct of the audit, I would think would be a risk mitigation tool not a risk aggravation tool.

Secondly, I'm not a litigator, but at the end of the day when an accounting firm is sued over an allegedly blown audit, I mean they're the deep pocket. I don't know that adding, the identity of the partner comes to life early in the litigation.

Any event through discovery, I don't get the whole thing, to be quite honest with you, about that adds anything of any material with respect to litigation risk or to risks of judgments or outcomes.

The other thing I wanted to mention briefly, and I was putting my board down when the thought popped into my head that when Damon gave so many good analogies I want to offer one more for everyone who's been or is a litigator.

I'm sorry the judge isn't here, but many of us in this room have at one point or another in our lives served as an expert witness in civil litigation. And it's not a perfect analogy but it's close, where we've been asked to examine a body of evidence and to apply judgment and experience to it and render an opinion on one or more issues.

And certainly under the Federal Rules of Evidence we sign the reports, we don't sign our firms' name to the reports. And then we are often challenged as to whether we possess the requisite expertise or not and a judge has to decide and we're deposed and there is sometimes an exhausting level of review and transparency disclosure on the contents of our report.

I'm not suggesting that same level of increase should apply here, but again it goes back to this notion of when someone holds themselves out as a professional it's hard to find many other examples where the individual's name isn't on it.

It really goes back to the issue we discussed earlier in our group's discussion of audit quality indicators where I made the point that we're in that context assessing or measuring or evaluating conduct. It's the same thing here.

The opinion was ultimately reached and rendered by a human being who had authority or responsibility for conducting an audit process. It was not reached and rendered by a limited liability partnership, a fictional legal entity.

Now I'll put my board down. Thank you.

CHAIRMAN HARRIS: Barbara Roper?

MEMBER ROPER: First of all, I agree with everything Mercer said and plan to cosign his letter when he writes it.

We were talking last night, we were kind of joking around about the fact that my sister and I have always said that fear of embarrassment has propelled us towards success. The fear of, you know, of embarrassment keeps us from ever having gone to class not prepared, you know, whatever.

I think it's sort of a frivolous example, but people behave differently when their name is on there. People speak differently when they're making an anonymous comment in the blogs or when their name is attached to a comment.

We know in a variety of context that this does affect people's conduct, and it affects people's conduct, I think, in this way precisely the way we want to affect it, which is to make them think more seriously about just exactly how comfortable they are with the opinion they're rendering.

And so I mean, I think the benefits of this proposal are self-evident. We've been talking about it for years, and I think, you know, I would strongly support the Board moving forward in that area.

CHAIRMAN HARRIS: Anne, I'm not going to recognize you now because I know that you want to talk about the global agenda, and we'll -- well, then if you don't we'll recognize you now and then you can talk about the global agenda. But that was one of the items in the email correspondence that you put on there. But talk about whatever and then we'll --

MEMBER SIMPSON: True enough, but I'm a nonresident alien so I'm honor bound to talk about other places. No, this was, you said, Steve, that you wanted people who had spoke in favor of transparency to address the question of liability, so I'm briefly going to do that.

I agree with what's been said that these corporate forms, be they joint stock companies or partnerships, the corporate forms have a lot of purposes. But these are not moral agents and cannot be held.

So whichever Lord Chief Justice, way back when, said, you know, corporations have neither a body to kick nor a soul to condemn to eternal damnation, at that point we're then back to people. And whatever has been said about political donations and political speech about corporations being persons is nonsense.

So if we want to change behavior, the corporation is not something that will behave differently. It's people that will behave differently, and behavior does change under observation.

If there are concerns about liability it is not to be addressed by drawing a veil over the people who are responsible. If there are issues around litigation and liability they need to be dealt with on their merit, but this would not be the channel I would suggest.

CHAIRMAN HARRIS: Okay, Lynn, then Damon.

MEMBER TURNER: Two points, one to your question of liability and then one back to the basic audit reporting model and your proposal that the staff have recently put out.

First, on the liability issue. In the state of Colorado, engineers and architects, you can add those to the list of people who have to sign in their own personal name, in addition to the CPAs who give expert reports, the boards and all those people.

In fact, when you come down it, the auditors signing these audit reports are about the only people that don't have to put their name down. Everyone else does. And they're the only ones, and there's no good reason why they should be given special privilege whatsoever.

And on liability, I chaired at the board of trustee committee at Copara that oversees our litigation. I can't fathom us deciding whether or not to sue a firm based upon who an individual partner is.

It's going to be based upon whether or not there was an audit report rendered when, in fact, the belief is that it was a failed audit and a clean opinion wasn't warranted.

And in every case I've ever seen go into litigation no one sued, first and foremost, the partner and left the firm off the thing. It's ridiculous to even propose that. It's always going to be the firm that gets sued.

You go into discovery and immediately upon discovery what's the first thing you find out? The partner's name. So the notion that there's audit risk associated here because of liability is a figment of someone's imagination and dreams. It just isn't supported by actual fact.

And in Colorado, and I've checked this with the state Board of Accountancy, you're liable as an individual whether you sign in the firm's name or your own name. So it doesn't affect liability in that respect in any way, fashion, shape or form. So there is no argument on liability on this that is factually based.

The second issue on the audit reporting model on the proposal that a comment, I guess, is due in December, and it's good that something's got out there that people can discuss and comment, I'd just say there has been an issue thrown up with respect to that proposal.

And depending upon how people look at it, and I've gotten different reads from different people, that proposal may or may not be fatally flawed. And the issue is whether or not that proposal as written would require disclosure of the items set forth, and there's some good items there that are set forth, but whether or not disclosure's required based upon the professional view of the auditor or is based upon what the auditing standards themselves would require to be identified as significant matters.

And when the ISB did the old ISB Standard Number 1, that standard was written and said you have to disclose to the audit committee, what, in the professional view of the auditor, is deemed to be something that the auditor would believe would impact on their independence wasn't required to be disclosed from an investor perspective or perspective of the standards.

And what we saw when the standard was written that way was the auditor's continued to violate black and white independence standards but didn't put it in the standards letter itself, and came back and always said, well, in our professional view.

So it became an unenforceable standard when it was written that way because auditors always came back and said, well, it doesn't matter what the standard said because it's what in our professional view was. And so the ISB Standard Number 1 turned out to be basically a fatally flawed and worthless standard.

Bill Allen is someone you might recall tried to fix it. He wrote a letter shortly after it was issued, after he and the other three members recognized the fatal flaw, but it never got it fixed and it's never worked.

There's been many, many instances of black and white violations that never were told to audit committees in that black and white letter.

So depending upon how you've written it, if you've written it to say in the professional view of the auditor this is what they would have to disclose, that document is fatally flawed and will never work. And we've got that experience behind us.

If it's written from the perspective of, here are the significant matters you would have to disclose if the auditing standards would deem those to be significant matters, then you're okay. And I've heard different interpretations of that standard.

DIRECTOR DOTY: This is a very valid point, and I think the limiting case you lay out, Lynn, is one that the proposal avoids. The proposal requires a discussion of what were the difficult auditor judgments, the difficult issues of supporting opinion, the complex issues.

It further goes forward to say if you decide there are none you must explain why. You must document how you got to the decision that there were none. And it goes further to say that it would be not expected that there would be many audits in which the auditor could conclude there were no critical accounting matters.

It directs the auditor to decide and to discuss what were the critical audit matters on the basis of, I think, a stated as well as implied assumption that almost any audit involves some critical audit matters.

And the documentation is required of the decision either way to exclude, if you exclude something that normally would have been reported to the audit committee you've got to explain why. You've got to document the reason why that would not be a critical audit matter in this case.

MEMBER TURNER: But are those critical audit matters determined in accordance with the standards, or critical audit matters determined in the professional view of the auditor? And that's the question.

MR. BAUMANN: Well, Lynn, you know, this is a lengthy discussion that we could have and it's probably beyond this room and we'll appreciate your comment letter when it comes in and we'll address it.

But clearly, as Jim just mentioned a moment ago, the critical audit matters we indicated would be things that the auditor documented under AS 3 requirements, for documentation requirements.

Would likely be things that the engagement quality review are under AS 7 had looked at as the most significant judgments in the audit. Would likely be things that the auditor communicated to the audit committee in connection with AS 16.

And went on to say as Jim indicated, if you have such matters that would appear to meet critical audit matters, and have those attributes of having been discussed with the engagement quality review and discussed with the audit committee, documented as a difficult matter, consulted on with the national office, and it's not disclosed as a critical audit matter, then the auditor has to document on the work papers what was the rationale why that was not a critical matter.

And that documentation, we believe, would be subject then to inspection to understand is that a reasonable rationale why that wasn't a critical audit matter. So I think it's somewhere in between where you're saying, is it directly driven by the audit standards or judgment?

There's definitely judgment involved, but that judgment is linked to existing auditing disclosure requirements in communications with audit committees, documentation requirements under AS 3 and things that are reviewed by the EQR under AS 7.

MEMBER TURNER: So are you saying, Marty, that if the auditing standards would deem whatever the matter was that it should have been a significant matter? For whatever reason the auditor decided not to make it a significant matter then that would be a deficiency in the report?

MR. BAUMANN: Yes. I am saying that once again if this is a matter that when somebody looks at it and sees the AS 3 required documentation of the most difficult matters, and there's a whole list of AS 3 of what has to be documented, the most difficult subjective matters in the audit, then looks at what was reviewed by the engagement quality reviewer, and the same matters that matter was a high priority for the engagement quality reviewer, what was discussed with the audit committee, the same matter was communicated and was a significant discussion matter with the audit committee, if that matter does not make it into a critical audit matter, I think it would be very difficult for an auditor to justify how they concluded that that was not a critical matter.

MEMBER TURNER: Yes, but I don't think that things will get to that point, Marty. We saw that with the ISB-1 thing. The bottom line was it didn't get to that point of being discussed with the audit committee and that was the problem.

MR. BAUMANN: Well, that would be a violation of AS 16 then, if things are missed and not discussed with the audit committee that should be, and I think that would be something we would inspect against as well.

So if people are omitting required disclosures to the audit committee, that itself is a problem and then we could have an inspection finding with respect to that also.

CHAIRMAN HARRIS: Lynn, let me jump in for a second. Two things. First, we do look forward to your comment letter. Second, I do think you raise a very valid question with respect to the objectivity of the standard and to the extent that there's judgment and whether or not there could be tightened.  You have five Board members with five different viewpoints on it, so I think you ought to reduce your comments to writing which I think we'll review very carefully.

Damon, you know, go ahead, and then Mercer.  And then I would like to, because, you know, we're going to be approaching the end of the session, I did raise other issues that were brought to the attention of the Board in terms of what other people might want to bring up.

But to the extent that anybody has an issue that they want to bring to our attention, I want to go right the way around the room and spend the last 15 minutes, you know, for you to tell us what you want us to hear, and to the SEC as well.

I'm sorry.  Brian, your card is up so we'll recognize you and then we'll go to Mercer.

MR. CROTEAU:  Well, thanks, and it does relate to the point we were just talking about, so I'll take the opportunity.  I think it's a great discussion we're having relative to what would be a critical matter, and certainly there's an open comment period.

I think one of the important questions to think about, really, is the criteria for what is a critical audit matter sufficiently objective or should it be any more objective than it is? And I think the PCAOB's asked some thoughtful questions in the release around that.

Certainly Marty's described the documentation and others have described the documentation requirements, you know, the question can be asked to whether documentation requirements are enough to overcome what some might view as a more subjective definition to begin with.

So very interested in comments as to whether there's improvement that can or should be made to the definition of a critical audit matter in the first instance, but I think the PCAOB's at least been very thoughtful in trying to put forth an initial proposal in that regard. But I think it's an area that could benefit from some focus and public comment.

MEMBER HANSON: Mercer?

MEMBER BULLARD: I'm just trying to figure out the dynamics here. So it sounds like there are scenarios in which the auditor will be exercising discretion, and whichever way they go is going to determine whether they have to disclose something as a significant issue.

And if that's true, why wouldn't the disclosure requirement give them a very strong incentive not to take those steps?  In other words, decide differently, not bring something to the committee precisely because that will trigger a different requirement where they don't want disclosure.

Or is it objections, there's no discretion for them to make those because it sounds like they're taking it up the chain was one thing you mentioned.  If I'm the auditor I'm not going to take it up the chain if it means I'm going to get public disclosure out of that.  So how does that dynamic work?

MR. BAUMANN:  Well, again I think it's rather than getting into a lengthy discussion about this item, I think it's important to read the proposal, read the standards and raise questions if you think that the way that it's crafted leaves the ability for an auditor to not disclose things and to not meet the spirit of what we're trying to get at here.

So I'll support what Brian said, and that is we worked really hard to get a standard that we think would improve disclosures to investors about what's critical in the audit. It's hard to mandate those things that were most difficult to the auditor because it's whatever was most difficult to the auditor in those particular circumstances. So you can't say what they'd be, it was what was difficult in that particular audit.

So as Damon said before, name the five things that were most difficult. Well, we could put a number five on it. We actually thought about that and we asked questions, should we have a minimum number? So that actually was a question in the release that would help.

Should there be any situations where you would not have critical audit matters? That's another situation, another question we asked. So there's lots of ways in which people can comment to us that listen, you can make this tighter in your final document by doing X, Y, or Z. And I think that's very valuable comment to get that.

But that's sort of the way it's structured. And we had a conversation way back when, Damon, you and I together and at the SAG also about, Marty, just have them disclose the five toughest matters. And that's sort of what this is.

But we are looking for valuable comment about how to make this crisp and tight so that this really does achieve the objectives and that matters aren't avoided by, well, I'm not going to communicate this to the audit committee because then it will look like it's too critical.

So you're right. We want to avoid those consequences, but we want to think about all those things. And if in the proposal, if there are ways in which people think that it can be fixed and made even better, we're looking forward to those comments and we'll move forward on that. We certainly want to have a strong standard here that greatly improves the audit report.

MEMBER HANSON: Damon, did your card go back up or --

MEMBER SILVERS: It was up before.

MEMBER HANSON: Oh, I'm sorry. Oh, I thought I heard you before. By all means, go ahead.

MEMBER SILVERS: Well, I had two things. Now after Marty spoke I've got three. Look, at first it was in response to your question about liability. I want to just even intensify what Lynn said.

I don't understand the argument about liability from the auditing firms. As Lynn pointed out it is a trivial matter in litigation to get the name of the partner. And the notion that somehow the lack of disclosure of the name in non-litigation situations is going to promote, that that's somehow protection against litigation, I think is not a serious argument.

And I would urge the PCAOB to the extent that auditors are making a litigation argument, and this doesn't even get into Mercer's point, I'm just saying I don't get what the argument is. And I think the PCAOB needs to sort of insist people who make this argument be specific as to what they think exactly is going to happen. But I think if you follow the thread of that logic through a little bit you get to a deeper issue.

So if litigation's not the point, what is the point? Why do investors want to see this name? And the reason is precisely because you want to be able to engage in types of accountability that don't rise to litigation, and you want to facilitate that on the part of investors who may not have the muscle to get it on their own.

Because I think, in addition to the fact that litigation can get that name, okay, if you hold three percent of a company's stock you can probably get that name. It's probably not that hard, in fact, to get that name.

What's absent though is in this regime, the existing regime we have, is the sense of a level playing field in the securities markets that is what, in fact, the audit report is all about in the first place.

I mean why, you know, we've had this conversation today and people have talked about what is an audit report for? Well, increasingly, I think, and I think Joe said this earlier that there's a real danger here of the diminishment of the value of the audit report in general.

And what's going on right now, and it's visible to me in terms of at least what is now, you know, ten years of this body's existence and going back to the period before this body was created, this body being the PCAOB, that what has increasingly happened, I think, is that the securities markets have become for a variety of different reasons, and a lot of people have talked about high-speed trading as part of this but that's not the only driver of this, the securities markets have become increasingly hostile to the involvement of investors who lack enormous scale and enormous resources.

If you have enormous scale and enormous resources, there's a sense in which maybe you don't need an audit report. You can send your own team of financial experts in to talk to a public company.

You've got a variety of ways, if you've got that kind of scale. You know, if you're at Black Rock you can have that conversation, closed doors, demand whatever metrics you want to get whatever you get and make your own conclusions.

Maybe for any given public company there are 20 investors who can do that. Everybody else is kind of left in the dark. As financial statements have become more complex, as the ability of firms to essentially play games with financial statements has grown, and in parallel, as trading processes have become less friendly to smaller investors, you have an overall drift away from a level playing field in the markets. Identifying auditors by name is by no means a solution to this problem broadly writ, but it pushes back on it a little bit.

DIRECTOR DOTY: I've got to ask you, is this about making small investors feel good about large, complex and impersonal markets or is it about having them think they have information that other people have and feel better about it that way, or is there something of use to them?

Of what utility is it for them to have the information given the situation they're in, which you and Ann have so articulated?

MEMBER SILVERS: I think it's a very fair question, and I think that there are two answers that go beyond feel-goodism here. I think the first is, is that it will be possible for a wide variety of actors, academic actors, providers of public, the press and other sort of providers of public analysis to look at the pay-driven individual partners across companies that is, and tell investors things that are meaningful.

The second thing I think is possible is, is that I think there is a landscape between, really, the small investor, the individual investor, there's a landscape between that party and the very largest players who have the resources and the market leverage to extract information sort of willy-nilly from companies.

And those, if you look at the history of corporate governance reform in the United States, it's often been those investors who have pushed the envelope on things and, you know, using publicly available data as opposed to what they can extract as a private party.

I think that was certainly true in the initial push for auditor independence, in the push around Board independence. A number of those funds are ones, this is certainly true of a lot of funds that are collectively bargained in one or another. I don't think this is a transformative move in relation to any of these dynamics, but I think it pushes it the right way. And I think it's not feel-goodism.

CHAIRMAN HARRIS: Well, I want to begin the wrap-up period here and just start, Brandon, with you and just go right the way around in terms of any final parting shots that you would like to leave the Board with in terms of what we should be doing to improve audit quality and protect investors.

MEMBER BECKER: Well, I do think that the signature makes a lot of sense, the same way we do it with mutual fund portfolio managers and the like where the SEC has been much more aggressive. I discount the liability issues for the various and other sundry reasons.

The context of the discussion today though, I think, really goes to the audit quality indicators in the morning, getting those built into the governance process. Because as Curt highlighted and as various have referred, basically the relevancy of the audit, getting more of that quality and ultimately going to the quality of earnings so that there is more value extracted rather than check the box from the audit would be valuable.

I should say, however, that while greater transparency to the audit is important, we would be worried if we lost the pass/fail. We think that we would not want to see the greater transparency degrade the pass/fail. I don't think it needs to, but I did want to at least highlight our concern along those lines.

CHAIRMAN HARRIS: Curt?

MEMBER BUSER: So I think the audit quality initiatives are key. I think that, you know, what I'd like to see happen is the PCAOB start to get in a position where it can comment on, you know, what we see in improvements in audit quality and what's the state of the profession and be able to answer a lot of the questions that are unknown about the quality of the people that are carrying this out. So I think we need to know, kind of, is the profession having the right people in place or not?

CHAIRMAN HARRIS: Grant?

MEMBER CALLERY: I think I'd like to see the Board take a further look into some of the issues, the governance issues that we talked about where you do have access to information. Because I think a lot of the sort of presumptive reactions that people have were based on very surface level knowledge and that you really ought to delve into it and see whether there's "there" there, and then move accordingly from there.

CHAIRMAN HARRIS: Grant, we certainly welcome you to the Investor Advisory Group.

MEMBER WALSH: Yes, I've been trying to think about how investors will react to a lot of what we've talked about today, and I think it's hard to imagine a situation where investors go in and short stocks of companies whose audit partners have shown mistakes in the past and buy really strong audit companies.

I don't know that that's going to happen, and before we get to that point we'll see trading cards with auditors on the face, and I think at that point you really do end the worry about commoditization.

But I really do have a sense that we need to get to more information, and I don't know how the market will use what we've talked about with audit quality indicators or how they're going to use identification of the partners responsible for the audit, perhaps the identification of the audit committee chairman.

I don't know how it will be used, but I think that there's an invisible hand that will ferret that information out and it's a process and we'll get better at this, and maybe we have 70 indicators that we disclose Round 1, it turns out that there 35 that are helpful. The market will figure that out and migrate towards those indicators.

And so I'm all in favor of more information rather than less, even if we don't know how it'll be used or which ones are going to be the most helpful. But I'm very encouraged by what we're talking about today.

CHAIRMAN HARRIS: Thank you.

Damon?

MEMBER SILVERS: Since the chairman caught me in my train of thought I left out my comment from Marty. I'm just going to make that. I think it's quite dangerous to have even with the caveat that you don't expect to see very many of them, I think, in the reporting model, it's very dangerous to have an option of saying no, we don't have any serious issues.

I think it raises this issue of then all of sudden auditors are, it becomes tricky to push issues in the internal process, I think, if you do that. I stand by what I said to you when however long ago that you were citing, which is put a number on it, one, two, three, five, whatever that number is and everyone has to disclose what that is. Every audit has an issue. It's not possible to have an audit without an issue.

CHAIRMAN HARRIS: Norman?

MEMBER HARRISON: Nothing new to add other than to thank you all for having us and for inviting us to be participants. And I'll say only we've covered a lot of ground today, not only in the panel-specific discussions but certainly here at the end.

And, you know, I think when you take a step back you realize that the issue of quality is the silver thread that connects it all and then the need to define it, to measure it, to report it and to use it as a tool for improving or providing safeguards around audit quality, I think there's further work to be done.

So by way of parting comment I'll say that rather than show up again next year, you know, see where we are, I'm happy to continue  being supportive in any way I can as the staff moves forward.

CHAIRMAN HARRIS: Thank you very much.

Tony? Tony Sondhi?

MEMBER SONDHI: Thank you. I'd like to simply emphasize what I thought was the two main things I said this morning. One is that as Norman just said, audit quality is the critical issue.

But if you develop indicators that are based on audit firm quality and audit process and not focus on audit quality, I think we're going to miss very significant opportunity. I think it's absolutely critical that we focus on audit quality.

The second point I want to make is that what the discussion today showed is that there are concerns. I understand that the sort of the nexus where the output based indicators meet, financial reporting quality and some of the other issues that Lynn and some other people have raised, and Joe, I think, I think that although that nexus is a difficult one, I think that should not get in the way of developing really good audit quality indicators. And being very firm, the complexity shouldn't get in the way.

CHAIRMAN HARRIS: Bob?

MEMBER BUETTNER: I hope this is not off-topic, but as you said you were hoping to get what was on our minds at this time. My question are something that I think at some point I'd like more explanation on was the issue around the Chinese reverse merger issues.

And most specifically, in fact, this might just go to harmonization of global accounting standards, but the differentials that existed between the Chinese accounts and the accounts that were ultimately reported here, I think the collapse that we saw and the investor losses that we saw across a wide range of those companies was really a black mark on the U.S. capital markets.

And so, really, my questions are more around, one, how was this allowed to happen? In other words, that these companies were able to, sort of, from an accounting and audit perspective slip under the radar? And then secondarily, are there processes that we can put in place to ensure that situations like that do not recur again?

DIRECTOR DOTY: Audits were ostensibly performed where we have reason to believe now there was no work done. In some cases by registered firms within China, in some cases by registered firms in the United States which were relying on firms in China.

That situation has received a lot of attention both in the area of enforcement, which will continue as an interest that we have, but also in our relations with the People's Republic we are continuing to press for a joint inspection regime.

I think that unless we could get to a position in which our division of inspections can go to China and can satisfy themselves about the quality of the audits that are being used to issue securities or trade securities in the secondary market here, we will have to move toward deregistration of firms and that will have, of course, implications for markets. It'll be something that we will have to work out with our colleagues at the SEC.

CHAIRMAN HARRIS: Anne Simpson?

MEMBER SIMPSON: Yes, I had two points, one of which I think Robert has referred to. So CalPERS invests in 47 markets worldwide and regulation is a global game. It's not just of account audits, it's accounting, securities law, capital adequacy for banks, you name it.

And what struck, although there are the multiplicity of regulators, the core of the regulatee is the Big Four, maybe plus two. So the work that you're doing to cooperate and coordinate is really important, but I hope it's also a weather eye to the fact that these public agencies are stumbling over themselves and each other dealing with four business networks.

And I don't know what the solution to that is, but that is something I would have talked about. So I really encourage that work that you're doing and thank you very much for it. If there's anything more we on the investor side can do to support you please let me know.

And the other thing, my closing comment is that with regard to audit, shareholders are weak and ill-informed. And you can do something about the ill-informed part and our friends at the SEC can do something about the weak part.

So I hope that we can make progress on this, because all this good work on quality and disclosure and all the rest of it, if we can't, you know, both speak softly but carry the big stick, if there's no stick, if we can't move in as the shareholders, it would be Teddy Roosevelt in style, it won't work.

But thank you for what you're doing. We greatly appreciate it. I think the PCAOB is doing tremendous work. We very much value what you do. Thank you.

CHAIRMAN HARRIS: Ann Yerger?

MEMBER YERGER: Well, let me echo the thank you. This is an energized Board and we really appreciate it. You've been bold, I think, recommending and proposing reforms, and I think on behalf of investors and the

Council we really appreciate it.

I would urge you to maybe get one easy or seemingly easy win and that's the auditor or the engagement partner transparency. I think it just seems like that's not a complicated reform and it would be great to push that across the finish line.

I think the second point is as everyone else has said, this is all about audit quality. I think the work that you're doing on audit quality indicators is profoundly important so I commend you to move forward with that, but also to not let the perfect be the enemy of the good.

I don't know that there's one perfect prescription for how to do this and this could get analyzed forever without a resolution. I think it's important to move along. I do believe public disclosure of audit quality indicators is very important.

I do think it's an interim step issuing some guidance, additional guidance to audit committees so they have a better arsenal of questions to be asking on audit quality, I think could be very helpful as well.

CHAIRMAN HARRIS: Mercer?

MEMBER BULLARD: I just would probably emphasize that the way I see the quality issue is really something bigger. It's more of a value-added issue. It's not so much quality to prevent fraud, it's to make the case for public companies. Because from the securities law perspective, you know, what I see is, 15 years ago there was twice as many companies on the New York Stock Exchange as there are now.

Over the last couple of years more money was raised in private markets in IPOs -- than in IPOs. You see Facebook trading on private markets millions of shares a day, so liquidity is not going out the window is a reason to an IPO.

You have the JOBS Act that's now eliminated, and this is the first meeting since the SEC adopted rules, eliminated the general solicitation in advertising which, I think, will have a geometric effect on the advantageousness of private offerings.

JOBS Act has also expanded the number of investors that require you to go public and also excluded certain investors from being counted, and the SEC takes a very liberal view as to how you count pass-through entities toward that and that will also another reason you'll have fewer public companies.

It's hard to know where this is all going to go. The trend is pretty clear, but I think the brand that is the public company, especially with steps that have essentially made what it means to be a public company be different things for different companies, 404 here, 404 not there, has really put the public company brand at risk.

And if you want to look at a specific threat to the importance of honest accounting, look at the filing of confidential registration statements, where I looked at about the last ten that have been done and you see three to eight confidential filings. And these were prompted, this rule was prompted by a company that you all recall went public and had repeatedly to go back to its registration and correct what were pretty blatant accounting abuses.

If you were to go into those confidential filings and you did a lot of work you'd probably find the same thing. And that is, you know, this is a market that is becoming more and more for retail investors only.

If you are going to go public now, it seems to me the biggest reason to do so is to sell to the least sophisticated group, because you will have gotten all the money you needed out of institutional investors and accredited investors before you go public. Because, you know, one of the key classes I teach is the pros and cons of an IPO, and most of the pros are disappearing.

CHAIRMAN HARRIS: Pete?

MEMBER NACHTWEY: Thanks Steve, and thanks to the Board for putting this group together and reaching out to us for input, and more importantly, maybe the staff for doing all the hard work to pull it off, so much appreciated.

Maybe three quick comments I'll canter through. One, I do agree audit quality indicators is a key thing coming out of the discussion today, but I think it has to be married up with heightened expectations for audit committees because there's got to be two levels of this.

One that I think the PCAOB is ideally suited for of looking at firm level quality, but where the rubber meets the road is individual audits and audit committees are going to be in the best position to really judge, are they getting quality, both people, the scope and the work plan that's put in place?

And then hat in hand with that has to come kind of heightened focus on what's a financial expert particularly for saying the auditors, the external auditors and the internal auditors are reporting to the audit committee, making sure we have somebody who is able to, on those audit committees, really manage that work.

Second topic, and I'm mindful of something. Curt will know the author of this statement, but everything's been said just not everybody's said it, but I'll jump in on the audit opinion, audit reporting model.

One, I do agree around the transparency on having audit partners. I don't why that would be any different than the professions that Lynn listed or responsibilities that people like I have to certify financial statements that we submit to the SEC.

On the other hand I think we've got to also be mindful of the dichotomy that we can't be aghast when we see marketing material with firms saying well, the individual signing partner has responsibility. So we've got to be careful a little bit of what we wish for, and

I think at the end of the day be mindful of the fact that we are, when we're buying an audit from a firm we're buying the firm and that's what we want. But I do agree it crystallizes the focus of that partner who ultimately has the signing pen.

But there were a couple other aspects of the reporting model. The critical accounting matters I do think can be an interesting expansion, but I think we've got to be practical about it. So how does that marry up with management's disclosure on critical accounting policies and estimates?

I would envision there would be a pretty parallel set of disclosures there, so if it's just duplicative do we get anything or do we just put more cost and time into the process of getting audits and financial statements prepared?

So, you know, whether we kind of road test that or find some way to say what's the practical aspects of it, then how do we make sure it doesn't end up being heavily lawyered, and no disservice to the legal profession but they're going to represent their clients, in this case the Big Four.

If we end up with 50 pages of boilerplate in their audit opinions and we can't find the pass/fail, which I think when I think I talk to our portfolio managers and analysts who are managing $650 billion of investor money, the thing they want to know at the end of the day, did they pass or did they fail? Because I don't have enough time to go through all the rest of the aspects.

And then last but not least, being the author of the fair value accounting, and I won't spend a lot of time on it, Steve, because I know it's an issue we could we spend eons on, but just to be clear on what I think the issue is there, which is the procyclicality of fair value accounting combined with the false precision that when you take numbers out to two decimal places and it's fair value and it's judgments and estimates on top of judgments and estimates it's important that, I think, somehow we have investors understand a), that level of imprecision, and b) the procyclicality that's just as bad in an environment that's being fueled by quantitative easing as it was in '09 and '10 when there was a dramatic cycle down. So enough said. Thank you.

CHAIRMAN HARRIS: Barbara Roper?

MEMBER ROPER: I think at some point in all of these meetings I say that the audit only has value to investors if it's conducted with an appropriate degree of professional skepticism. And we have seen a persistent problem with insufficient professional skepticism which, I think, is arguably the main driver of low audit quality.

So I would sort of review each of these issues we've talked about today through that lens of to what degree is there potential through whether it's audit quality indicators or whatever, to drive a higher degree of professional skepticism in the conduct of audits?

And toward that end, I actually think it's the issues that Grant's subcommittee was working on in terms of incentives and governance where there's rather a largely unexplored potential for further progress in terms of driving toward a more independent and skeptical audit.

CHAIRMAN HARRIS: Bob Tarola?

MEMBER TAROLA: Yes, thanks Steve. I guess I want to say I hope that you don't marginalize the audit committee. They're the primary body responsible to the shareholders. And I'm going to also be in favor of a pass/fail model, an auditor report for that very reason, is that if there are difficulties in auditing and enterprise let the audit committee explain those difficulties. The management of the enterprise has an obligation to do good accounting and disclose how they did it.

So if an auditor just comes behind them and says they did good accounting, we audited it and we're happy with it, I'm not sure what the benefit of that is. But if you have the audit committee explain how they monitored that audit with respect to those difficult issues, I think the investors, I think the system works better. Let me just say that.

I am in favor of transparency of the signer of the audit opinion. I think that there should be no difference between that signature and that of a CFO on the financial statements. And also I think if you're going to support the audit committee's role then you also have to look at the qualification question.

CHAIRMAN HARRIS: Thank you Bob.

Joe Carcello?

MEMBER CARCELLO: Yes. In the interest of time I think we're talking about the right things. I think the Board's looking at the right issues. I just would second what Ann Yerger said, let's get some things across the goal line.

CHAIRMAN HARRIS: Judge Sporkin, we've just gone around the table concluding and we've asked everybody for their final comment in terms of what they would most like the Board to address in terms of improving audit quality and investor protection.

I know you've mentioned 10A in the past but whatever you want to wrap this up with would be most appreciated, as long as you keep it under five minutes.

JUDGE SPORKIN: No, I've just got a few seconds. I agree with Chairman Doty's view on the signature on the audit. I think that the person who has done it has got to sign it. I think that should be a no-brainer.

The only other thing I think you, I didn't hear what whether there was much discussion, but 10A of the Securities Exchange Act is an extremely important provision, and I would like to see some emphasis on that provision. Because I do believe that it is not being followed the way the drafters of the provision want it to be followed. So I would hope that you would put that on your agenda. Thank you.

CHAIRMAN HARRIS: Judge, in terms of the transparency, since there are transcript, this is, you know, an open release, why do you support it?

JUDGE SPORKIN: Well, when I say it's a no-brainer is why shouldn't the person who has been involved sign it? I don't understand why there should be any question. It seems to me that if he knows he's got to sign it he knows it's got to be credible.

I'll tell you this as a lawyer that when I sign a pleading in court I want to make sure that it has what I wanted. There have been pleadings that I have, even though I've been co-counsel in cases, there have been pleadings that I have refused to sign because it didn't have what I thought it should have.

And it seems to me the accountant will have to make sure that he believes in it before he puts his signature. He's not going to put his signature on something that he has any question with. He's just not going to sign it.

CHAIRMAN HARRIS: Are there any final closing comments that Board members would like to make, then I'll just make a very brief one? No? Well, in that case I want to thank everybody for what I considered to be an excellent meeting.

We very much appreciate the leadership of the working group members, all the members on the working group, the entire membership of the Investor Advisory Group, and I personally especially want to thank Nina Mojiri-Azad and Tope Folarin.

Pete, you hit a home run. You mentioned that this is not possible without really extraordinary staff support. And I'm very lucky because I've had that support. And so Nina, wherever you are I want to thank you. And Tope, I want to thank you.

And Joann, you set the marker and I can think we're carrying the ball forward with respect to our Investor Advisory Group. So thank everybody for participating.

(Whereupon, the foregoing matter was concluded at 5:06 p.m.)

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on November 13, 2013 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the November 13, 2013 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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WEDNESDAY
NOVEMBER 13, 2013

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MR. BAUMANN: All good points also, Scott. So I want to thank SAG members for very good, valuable feedback from the comments made by the members of the PCAOB, the SEC and our distinguished academics. And thank you all on the panel for an excellent job done.

Well, this is the beginning of our discussion about our proposal on the auditor's reporting model. We'll continue this into tomorrow morning but there was a lot to cover and we wanted to discuss it starting this evening.

As I said, we'll probably go one hour on this and then our dinner reception begins at 6:30.

So joining me up here are Jennifer Rand to my left, Lillian Ceynowa to my left, Jessica Watts to my right and

Elena Bozhkova to my right. And who's kicking it off, Jennifer?

MS. RAND: I am. Good afternoon, everyone.

MR. BAUMANN: I'll let you get settled.

MS. RAND: Anything else? All right, we'd like to get into the auditor's reporting model.

The PCAOB issued a proposal a few months ago, August 13th. We've been working extremely hard on the auditor's reporting model, conducting a lot of outreach. Really this proposal leads up to three years of work, including a concept release that we had issued.

In front of you, you have the slides for this session and we had intended to provide background of how we got here, how we got to the board's proposals, what types of issues came into our thinking in developing the proposals as well as the summary.

Oh, pressing the wrong buttons. The disclaimer I think Marty's already covered this morning.

MR. BAUMANN: Right.

MS. RAND: As far as the slides in front of you, given that we have limited time in our remaining session today and given that we're very much interested in hearing from you rather than us speaking, we don't plan to cover the slides in any detail. We trust that you've read the proposals.

We had also provided you with a fact sheet, two/three-page summary of the key elements in the proposals as well as illustrative examples of the critical audit matters.

So you may want to refer to those in connection with the discussion, but we plan to just cover a few things in just very high level and then just open up the floor for discussion.

And our focus today will be on critical audit matters and tomorrow we'll talk about new elements in the report as well as other information.

So with that, I'm going to turn it over to Jessica so she'll provide a high-level overview.

MS. WATTS: All right, so I'm going to just in the interest of time talk about two slides.

The first slide is an overview of the auditor's reporting model standard. The proposed standard retains the pass/fail model of the current auditor's report. We heard from many commenters that they like this form of reporting and wanted us to retain it.

One of the major changes of the auditor's report relates to the communication of critical audit matters specific to each audit.

The communication of critical audit matters in the auditor's report is intended to make the auditor's report more informative, thus increasing its relevance and usefulness to investors and other financial statement users.

Additionally the proposal adds new elements to the auditor's report to provide investors and other financial statement users with information about the audit and the auditor. These include auditor independence and auditor tenure.

The proposed audit reporting standard further describes some of the auditor's existing responsibilities, such as the auditor responsibilities for financial statement notes and the risk of material misstatement due to fraud.

The proposed standard retains the existing requirements related to explanatory paragraphs and also retains the auditor's ability to emphasize a matter in the financial statement.

So the next slide I want to go over is the definition of critical audit matters.

As defined in the proposed standard, the critical audit matters are those matters addressed during the audit that involve the most difficult subjective or complex auditor judgments, pose the most difficulty to the auditor in obtaining sufficient appropriate evidence or pose the most difficulty to the auditor in forming an opinion on the financial statements.

The auditor's communication of critical audit matters would be based on information known to the auditor and procedures that the auditor has already performed as part of the audit.

Thus, the communication of critical audit matters does not modify the objective of the audit or impose new audit performance requirements, other than the determination, communication and documentation of the critical audit matters.

So with that, I'd like to turn it back to Jennifer to start the discussion.

MS. RAND: Critical audit matters is a significant

--

MS. WATTS: You need --

MS. RAND: Sorry. Turn the mic on. That might help. Critical audit matters is really a very significant aspect of the board's proposal. It's where the auditor would be communicating those matters that were the most significant, the most difficult to the auditor, the issues that kept the auditor up at night, communicate those in the report.

So for the rest of the day today we'd like to focus specifically on critical audit matters.

And I mentioned tomorrow we'll get into new elements so that's independence and tenure, other information and anything else that SAG members may have an interest in and want to discuss.

So with critical audit matters, we have this broken into four different areas where we're interested in your feedback.

First is on the definition and Jessica just covered that. And then next, usefulness of reporting, the determination, communication and the documentation requirements.

So I see some cards up ready to go. I appreciate that, so we'll get into it. So Denny Beresford.

MR. BERESFORD: Well, I've already written a comment letter but I'll summarize my views.

In fact, I also participated in the development of a comment letter by the Institute of Management Accountants and I think it was actually said a little bit better in that letter. My thinking evolved a little bit I guess.

My concern about the critical audit matters, in addition to just adding lots and lots of paragraphs possibly to the report and sort of losing the forest for the trees in some cases, obscuring the pass/fail key paragraph, is that the notion of reporting the critical audit matters, the things that involve the most difficult audit judgments, et cetera, the proposal itself doesn't actually call for the reporting of the auditing procedures.

So instead of actually reporting auditing matters, the proposal calls for a description of the company's reporting of key accounting objective estimates and things of that nature.

So for all practical -- I think they've cut me off on purpose here. For all practical purposes, this is really an indirect way of identifying important matters in the company's financial reporting, for example where significant estimates were made, et cetera, rather than the company, which they're already doing in their MD&A and so forth or a few companies have had road maps to their financial statements and things of that nature.

In fact, as I said, as I read the document, it's silent in the standards section with respect to reporting the procedures.

In the basis for conclusions, it said we're not going to actually require the auditors to report the procedures when they give the CAMs.

And then in the three or four examples that are given, they actually put in the procedures, which is kind of an interesting inconsistency I guess you might say about how those procedures are handled.

So it seems rather inconsistent that the approach that the PCAOB is using is to focus on auditing matters and yet not discuss any of the auditing, frankly, which I support.

I think that getting into discussing auditing on a piecemeal basis raises separate questions about what would be the opinion on each of those issues.

But as I said, it then becomes one of is this the auditor's responsibility to be listing all of these things or is it management's responsibility?

And in the letter that I wrote, I identified what I thought would have been the types of items that would have been reported by two of the boards on which I've previously, fairly recently served.

And those items are very well spelled out right now in both MD&A and financial statement footnotes so the reporting of those end CAMs would be a duplication.

In addition, of course, there would be the administrative, I hesitate to use this but I'll use it, nightmare of the auditors and the company having to negotiate what goes in the CAMs in the audit report versus what does the company put in its own disclosures and having to negotiate those among the auditors' legal counsel, auditors' national offices, et cetera, et cetera, et cetera.

And all things considered, I just don't see this as a major step forward. It seems like it's just repeating information that's in the financial statements already.

If there's a need to have these things better highlighted, I think that's management's responsibility and, as you can probably guess, I am not in favor.

MR. BAUMANN: Denny, I'll just make a very brief comment. There's a lot of cards up so we'll come back maybe to the comments later and I know Jennifer and others will want to react as well.

And she didn't go over, Jennifer did not go over the background but in the concept release we asked, many people talked about the auditor talking about the financial statements or the auditor talking about the audit.

And there was a lot more support for the auditor talking about the audit than about the financial statements, that the financial statements were the prerogative of management.

And so what we elected here was that option of the auditor talking about the audit and those matters that were most difficult and challenging to the auditor.

Now, whether they're similar matters that management's reported on in the financial statements, they might be.

On the other hand, it could be that there was a particular systems problem that forced the auditor to get a very difficult time getting audit evidence because of the breakdown in systems.

Whether management intended to talk about that or not, who knows. Maybe they will after the auditor says they're going to talk about it.

But in any event, we approached this from what were the most difficult things to the auditor, the most difficult judgments the auditor had to face?

And this is not information necessarily in the financials. This is what the auditor found to be difficult and challenging.

But we'll take your comments up further about should procedures be in there or not, but there's so many cards up, let's turn to Barbara Roper.

MS. ROPER: Thanks, Marty. And I appreciate your scheduling part of this discussion today because, my apologies in advance, I will not be able to join tomorrow's discussion.

I think there are a couple of things about this. You know, I have a son. I'm sure he would have loved over the years to tell me, you know, each grading semester, mom, I passed all my courses. I personally found it useful to get a little more information than that.

I think the same, and not to be flippant, but I think the same is true here. The current report with pass/fail does not adequately distinguish between the volume of companies, the vast majority of whom pass.

Investors have been saying for years that they want more information, you know, that the auditor is supposed to be working for them, reporting to them.

And they want more information from the auditor about issues related to the audit that would help them make more informed decisions about the companies in which they invest.

In an ideal world that would be enough. Investors want the information. It's reasonably cost-effective for auditors to provide the information. We should be talking just about how we do it and move on. Obviously it's more complicated than that.

I was talking at lunch today a little bit about the fact that I think in this new world of everything has to be economic analysis it's very important to think up front about the problems that you're trying to solve through a regulation.

And clearly one of the problems that you're trying to solve is that investors don't think they're getting enough information out of the current audit report.

But I would argue that this proposal is relevant to a number of other important issues that this board is addressing.

In the current system, pass/fail and no other information, you know, so what are the incentives in that system?

And for the companies that we're worried about, not the good, aboveboard, strong financial reporting companies but the companies we're worried about, the current incentive is to get as aggressive as possible in their accounting consistent with a clean opinion.

If you require the auditor to report about critical issues, some of that may surface in that context, that they may find a way to give a clean opinion.

But they may raise in the context of this reporting about critical issues elements that would point to certain aggressive practices.

That could change the incentives for issuers to get less aggressive. That would be an overall good thing that this could achieve.

You know, there's also a concern we talk about a lot, is that auditors are not sufficiently focused on the fact that they're working for investors and not management.

And requiring them to think more clearly in their auditor's report about what they think they should be communicating to investors about the key critical issues in the audit, what made this audit tough, might help to focus them a little more on their obligations to investors, you know, in a more concrete way.

You know, to the degree that they have to report out about these things and make a public record about what they thought were critical issues, they might be a little tougher in standing up to management in areas where they need, frankly, to be tougher in standing up to management.

And so I think when you look at this issue it's not just that investors would find this information useful, and I thought the examples that you provide were good. It proved to me that this can be done in a way that's not just boilerplate. This could provide interesting, valuable information to investors.

But beyond that, there are regulatory issues that you all struggle with, how do you improve professional skepticism, how do you improve auditor independence, that this proposal could help to address. It's not a silver bullet, but it could help to address.

One other point, I would just say procedurally when you think about economic analysis and you look at the court decision that has driven the SEC further in this direction, one of the key functions of that, one of the key issues that they focus on, is the need to assess reasonable regulatory alternatives that have been suggested.

And I know there are a number of suggestions that investors have made about information that they would like to see in the audit report that are not reflected in the board's proposal.

And I would encourage you as you analyze this issue and do the economic analysis that one of the things you do as part of that is analyze the various proposals that have been forward and have a good reason, have a good explanation, a reasonable basis for the decision not to adopt some of these other proposals because it shouldn't, frankly, be enough that some issuers don't want the auditor talking to investors or that some auditors are uncomfortable in that role. There ought to be a good regulatory analysis of why that is or isn't valuable information to have in this report. Thanks.

MS. RAND: Thank you, Barbara. Bob Herz.

MR. HERZ: Yes, I also thank you, like Barbara, for spending some time today because I also will not be here tomorrow and, because of that, I had actually sent Marty a couple much more technical-type questions I had.

I'm generally supportive of the approach you seem to be taking. I'm also glad that it seems to be, at least at this stage, pretty similar to the IAASB's approach. Of course, they call it key audit matters, also KAM, but, you know, got to be divided by the same language so to speak.

But my two questions were, one, it seemed like the requirement to communicate CAM was only in the context of an unqualified audit.

And I could think of circumstances like we have a qualification on a specific accounting matter and it would still be relevant to talk about CAM. That not right? That's just the way it reads to me.

MR. BAUMANN: In a qualified opinion, you'd also report critical audit matters. It is in the amendments.

MR. HERZ: Okay, then I must have read it wrong because the lead-in says in an unqualified audit the following requirements --

MR. BAUMANN: Not that there are many qualified opinions filed at the SEC, but it would apply.

MR. HERZ: Okay, good. And then secondly, just in reading some of the examples there, particularly the first two, the allowance for sales returns and the deferred tax assets, and maybe I'm too much of a nerd and an auditor but it kind of left me a little unsatisfied or it wasn't clear to me -- yes, I knew that clearly, because the auditor gave a clean opinion overall, that they must have concluded satisfactorily on this.

But it kind of says here's the issue, here's the problem, blah, blah, blah, and by the way the company's accounting's in Note 6. There needs some better overall contextual thing to lead into the whole CAM.

MS. RAND: Did you have anything specific in mind? We recognize it in the audit opinions and the financial statements as a whole. We didn't think it was appropriate to have piecemeal opinions on each thing.

MR. HERZ: I understood that problem so --

MS. RAND: So was there, kind of in that context --

MR. HERZ: I would just kind of, you know, a lead-in, something that, you know, the context of our overall audit which we above concluded, blah, blah, blah, the following critical matters arose.

So at least you alert the, I think an uneducated, average reader would kind of say, oh my God, this is the sales returns. They couldn't get happy with that.

MR. BAUMANN: We do say in the body of the opinion that the critical audit matters communicated below do not alter in any way our opinion of the financial statements taken as a whole.

But your point is well taken and it's somewhat similar to Denny's point, that should there be the procedures that were performed or something else, but then you do run into the problem of piecemeal opinions.

So both good comments that we'll figure out how to deal with, but thank you and thanks for the support on what we've done.

MS. RAND: Okay. Roman Weil.

MR. WEIL: Okay. Is it working? Can you hear me?

MS. RAND: Yes.

MR. WEIL: I sent you folks some comments. That's not what I'm going to talk about now. You have that.

I'm talking now as a member of an audit committee, sometimes audit committee, financial expert, sometimes not.

And I'm sitting there in an audit committee meeting and the auditor says to me, quote, "The PCAOB requires that I report to you," dot, dot, dot, and everybody's eyes glass over with boredom.

And the piece of paper he's got in front of me goes on for five or six pages of clear stuff they've taken from some template that they have at their audit firm and they reproduce and give it to us.

And absolutely nothing useful ever happens after "The PCAOB requires that we report to you" on X. Let's get through that. Let's get through that and get on to the discussion of what's important.

Now, what I hear here is we're going to have even more of that. "The PCAOB, in addition to what we've already told you about, has required that we tell you about these other things."

And I'm not saying these things aren't important, but you guys have got audit committee overload.

The audit committee does not get to schedule the length of its meetings in the board meetings I go to. The chairman of the board sets the overall agenda for two or three days and the audit committee gets some time and the auditor speaks.

And I do not believe that putting this on the plate is going to increase the amount of time available for real discussion.

So I'm urging you to think about what in other context people call regulatory overload. If you're going to put this one in, think about taking something else out.

Denny wants to get rid of it altogether and maybe that's the right way to go, but I'm just telling you that from being in an audit committee "The PCAOB requires us to report to you on" X is mind numbing.

MR. BAUMANN: Just a comment on that. When you said then they went on to talk about a lot of important stuff, I'm sure the PCAOB requires that the auditor talk about all those important things that you just referred to.

And maybe in some areas the requirements aren't as important at a particular company and, therefore, the auditor certainly has the flexibility, hopefully, to put the important things up front and then say, in addition, there are other communications and here they are and say but at your particular company this year these were not particularly important matters.

But that's another area. That's the audit committee report. This is about what investors are saying for years and commissions have been saying for years.

The single pass/fail audit report is not serving the needs and how can we improve the audit report, so that's our goal here.

You know, this certainly would have to be discussed with the audit committee but we believe these would be the important matters that were in that audit committee discussion that would wind up in this critical audit matter discussion. Who was next?

MS. RAND: Scott Showalter.

MR. SHOWALTER: Thank you. This semester I gave my graduate students assignment to compare your proposal to the IAASB, so I had to do a deep dive on both and read them.

And comments were made and, Bob, you mentioned about proposal. What concerned me was how similar they actually were but how different they were and the concern about a user understanding the difference when they're reading reports.

It's not just difference between key audit matters versus critical and it seems like you could come to agreement about that.

But the way you start, they start at governance, you start at lower border definitions, so several comments have been made about working with IAASB already today.

I would just encourage you to try to reconcile that because I think the user of these reports may lose out in the end because of the differences and not actually understand that they actually came from different things.

They may think because one is the key audit matter versus another one is critical they're the same thing. I don't think they are. I think they're developed differently and I'm not sure they would really understand that.

You said you're on the group, Marty. I would encourage you to do that. From a minor technical thing --

MR. BAUMANN: And Dan Montgomery, who's the chair of the IAASB's task force on their reporting model, is here today as well.

MR. SHOWALTER: So who should I talk to on this, you or Dan? Okay, so --

MR. BAUMANN: You're talking to both of us, so that's good.

MR. SHOWALTER: Okay. But I think it is important to the user. You talk about the user. We ought to probably not encourage that.

One technical thing is that if you go to Paragraph 7, and this is the difference between International and PCAOB version, International I think gives the impression that you could actually issue an opinion with no key audit matters.

Your Paragraph 7, you actually say in most you will. Well, I would suggest in Paragraph 9 the fact that it says you will always have to talk about the most difficult audit judgment, the most difficult evidence and the most difficult thing means you will always have a critical because it's the most difficult. So if I have ten things it's the most difficult in each one of those. So you've got an inconsistency between Paragraph 7 and 9.

MS. RAND: Okay, thank you. Steve Buller.

MR. BULLER: Thank you. So we also submitted letters to the IAASB and FASB and both are on the website, so. And as part of our letter submission, we generally talk to our analysts.

We have, you know, roughly 100 analysts throughout the organization and we try to talk to roughly 15 or so and get their thoughts on what their teams think about this proposal, and this one actually was a fairly spirited discussion.

But the analysts generally were supportive of the proposal. Their conclusion was that they think it's useful to have the critical audit matters disclosed. They did favor brevity.

I think that it was important to them that they understand what the matter was, why it was a critical audit matter, where it is in the financial statements so they at least are informed that there is an issue there where the auditor spent time and they then can have additional substantive discussions with management if they need to to understand why it was and how it was dealt with.

There are certain entities which have, I think, an inherently less business model, less complex business model, and, as a result, there will be routine matters that should not require identification, or if they do require identification, they're infrequent.

I think it's important people don't confuse the fact that someone spends a substantial amount of time with the fact that an issue is a complex issue or a critical issue.

In our case we have a lot of investment companies that are 34 registrants that would qualify.

I think that one thing we were concerned about, and this is as a preparer now, is we potentially have a lot of matters which could be considered critical audit matters and we're worried a bit about the fear auditors may have to over-document why a matter is not disclosed as a critical audit matter just because they spent audit time in the area.

So as a result, we thought there was some use in the IAASB model where they at least start determining which matters are critical audit matters or key audit matters by identifying those which were communicated with those charged with governance or basically the audit committee as a starting point for the matters which they would identify for potential disclosure.

We also did not support including the audit procedures in the opinion. We think that it's possible to take those out of context.

We already provide enough information for somebody to really understand what was done. It probably would overwhelm the audit report and we do worry a bit about people misinterpreting those and having it look a bit like a piecemeal opinion.

I think though, however, there are cases where an auditor may need to provide disclosure and I can't think of many examples but perhaps where there is a disclosure of a significant control weakness, it's not a material weakness, that somehow had an impact upon the determination of a financial result outcome.

The PCAOB probably should provide additional guidance on when the auditor should disclose information that is not in the financial statements if they're going to include it as part of the audit procedures performed.

But so, overall, we were in favor of the communication of critical audit matters and key audit matters also.

MS. RAND: Steve, just interested in, wanted to explore one of the -- You had a lot of good points. You make -- One of them was, kind of the source of the communications being limited eventually to the audit committees.

And in the PCAOB's proposal we don't limit it to that. But we say, likely the matters in the report we would expect would be discussed with the audit committee. Nonetheless, we also direct auditors to look at what was documented in their engagement completion memo, which would include summaries of significant issues and findings in the audit, as well as the matters that were reviewed by the engagement quality reviewer.

One question I personally have, so this is my own view, is if it was limited to just the audit committee, could that potentially, could there be an unintended consequence that auditors may be concerned about including something, or communicating something to the audit committee, for fear that that's now the target list of things that could potentially be in the report?

So, you know, it places greater emphasis on those communications. And could that have an effect? So, just interested in your reactions, since you did mention that suggestion.

MR. BULLER: Well, so our general impression is, and this is in part our experience and from our analysts, is that auditors tend to over communicate to audit committees matters.

And as a result, we find it hard to believe there would be something disclosed in an opinion that would not be disclosed to the audit committee. I think it's just hard to understand why they would ever do that.

First of all, if it's in the opinion, it's of such importance. And to not disclose that to the audit committee, I think would raise issues as to the intent and competency of the auditor.

MS. RAND: Okay. Thank you. Next on the list is Loretta Cangialosi.

MS. CANGIALOSI: Okay. Actually I'm going to talk about, I think I'm going to talk about three things on your list there. The first of which is definition.

And, you know, before I came into this meeting I had some concerns about how critical audit matters would be interpreted by investors and others.

And sitting here now, I've heard people talk about, you know, aggressive practices, and, you know, they're thinking about, well why was it critical? And they would discuss it with management, and how they dealt with it.

One of my real concerns here is, there's an awful lot of very subjective things that go on as a result of the accounting policies that we must follow. I'll take something that's, I'll say simple but complex, which is a Level 3 fair value measurement, okay.

And if I have to do a 20 year forecast, okay, you can be sure that that is going to be difficult. It's going to be difficult to audit. It's a 20 year forecast. So to the extent that these are like normal things. Are they hard to do? They're hard for me to do, let alone hard for the auditors to audit.

So I think my concern here is really that people come in with a mindset that there's something going on here when a critical audit matter is flagged. It means it's hard to do. It doesn't mean it's wrong or aggressive.

And so, I think there needs to be some education around some of these things, that investors should expect to see these. I mean, they are what they are. You've written out what you would determine, and the degree of subjectivity.

If you're doing a forecast, let me say it's subjective, right. We all agree that different people will come up with different forecasts, you know, the amount of audit effort to address the matter.

So a lot of these things, my concern is that if the definition is kind of being, people are interpreting it to mean something funny is going on, or something aggressive, or something that needs to be fixed. I don't if that's exactly what's written here. So that was my first thing on the definition.

My second is on the determination and the communication. And I do have some concerns with that of, in some cases, I'll say overload of critical matters being put in, with people rising to a level of looking at these, and deciding, you know what, I'm not taking any risks. I'll put everything in. In which case it becomes less and less valuable, I would think, to an investor.

Because they'll have to wade through a whole bunch of things that maybe aren't so big. But, you know, and we see this all the time with the SEC, when they come back and go, why did you disclose that? And people say, because I didn't want to get a comment.

I can see the similar thing happening here. And it will dilute the effectiveness of the communication if that occurs.

My other thing is, with respect to some of these factors, and it's not that I don't like the factors. It's really going to be within the implementation, and how this gets looked at within an inspection.

So, is an inspector going to be looking at every one of these factors, and expect a paper on what was considered, why was it considered, every single thing, you know? So you will actually drive how effective the communication is by how much they dig in and ask for in all of this documentation.

So, you know, I do have some concerns about litigation as well. We have a lot of very clever lawyers in the room. And, you know, I can easily see audit firms having more litigation as a result of this. And I'm not saying that's a reason not to do it.

But we should just be aware of the potential consequences with somebody saying, well, you know, didn't you think an investor would be, would want to know that? Well, I don't know. I'm not in the head of an investor, you know. I'm following the rules.

And you've set out rules. But I do think that this could potentially lead to a lot more litigation. I'm not sure what you do with that. Other than, probably it's in the implementation that I would caution and kind of take a measured approach.

MR. BAUMANN: Loretta, thanks for all those comments. I have a question, and maybe one or two comments. Barbara Roper talked before about, from an economic analysis perspective, we have to think about, what's the problem?

And the problem is that investors clearly have articulated, and a number of commission have articulated over the years, that the auditor's report just doesn't communicate enough about what the auditor did and found. And we're trying to solve that problem.

And some said, and wanted us to go really far, and say have the auditor really talk about the financial statements, and give some analysis of the financial statements. And from looking at alternatives, we looked at this and said, we think, really, the auditors should stay in the attest role and talk about, stay with their audit, and what they did in their audit. So that's how we selected that.

And one thing we did stay away from, though, you said maybe an investor would care about one thing versus the other. We didn't write this from the perspective of a report on those things in your audit that investors would care about, or a report on those things that were the most difficult things to you to try to avoid that problem.

Now, the lawyers may say, there's still an issue there. And so we're looking for solutions. But we didn't go to, what do you think a mind of the investor that would be the most important thing in the audit? But what was the most difficult issues for you, the most subjective and tough issues for you?

So we did try to think about a lot of those points that you're raising. I guess my question to you, and if you don't have an answer that's fine. But I hope preparers of financials, like you, Loretta, and thoughtful ones, also point out their concerns about this. But also maybe have other ideas for solutions.

Because this is a problem in need of a solution. And if you think there's some aspects of this that raise concerns, like being too many matters reported, et cetera. Are there ways in which we can improve this? And that's what we're looking for very much in your comment letters. So whether you have a comment now, or you want to think about that.

MS. CANGIALOSI: Yes, you know, and I -- One of the things that I know, there's a pilot that someone is going to run with the audit firms, I think. And to look at exactly how you would go about this, and what kinds of things would go in.

And I think it's really through that that we're going to learn kind of what those solutions might be. There's nothing like doing it to inform you of, you know, what the difficulties are.

MR. BAUMANN: Yes, we did, that was discussed at the open meeting when we proposed this with the Board. And some of the Board Members felt it would be a good idea. And I agree with that.

If auditors were working with their clients and audit committees today, and said, let's take a look at last year's financial statements, and last year's audit. What might we have reported as a critical audit matter? And try to see what different parties think about that. So, we do think that's a valuable idea. Wally Cooney. We have another preparer.

MR. COONEY: Yes. I think everyone here appreciates the balancing act that you all have had to go, in terms of formulating this proposal, and all the outreach you've done over the last few years. I guess, I had a few comments.

And, you know, to your point, Marty, I think as we work on comment letters, I think you hopefully will get a lot of practical suggestions.

As we were first going through this, I think people are focusing on some of the concerns that they have. And then, you know, and hopefully we'll have time, before we send letters, to step back and think about, you know, what alternatives we have.

Because if you just hear about concerns, without some resolutions, then, you know, it may not be that helpful. I think in general, you know, I supported some type of matter of emphasis proposal.

And in reading through the proposal, I think the overall framing and the objectives appear to be, you know, read fairly well. They appeared reasonable to me. But when I got to the examples I became a little bit concerned that perhaps there's just too much information that might be considered to be appropriate level of detail.

And two things I would mention. In the tax example there was a fair amount of information in there about lines of business that I'm not sure would necessarily be in an MD&A. Wouldn't really be necessarily anywhere in the, from a management standpoint.

And it just appeared that that could be new information that was being reported in the auditor opinion, that wasn't anywhere else in the financials.

The other example was what appeared to be a description of a significant deficiency, which as you know, is not required currently to be included in 10-K filings. And so the example appeared to be reporting a significant deficiency in the auditor opinion, which is at odds with what the current requirements are.

I guess, somebody made a point about perhaps limiting the audit matters to the audit committee, reported items. And I think, in general, I'd probably be in favor of that approach. Partly because, to simplify the job of figuring out what needs to potentially be considered.

And to limit it to becoming potentially a really onerous exercise, with the idea that anything that could potentially go in an audit opinion would almost surely have to have been communicated to an audit committee before.

I guess just another general comment. And it was that, you could be highlighting items that aren't particularly important. And Loretta got to this when she talked about things that are hard.

And there are some really important things that are in the financial statements that perhaps, you know, wouldn't be mentioned. And I guess a general concern that we've had is that people look at the audit opinion. And they look at it as a shortcut to identify the items that might be particularly important that an investor should look at.

And investors really need to look at the financial statements, the footnotes, the MD&A, the critical accounting policies, the entire Annual Report, not just a few bullet points that the auditor mentions.

And I think there's some danger that that could be a shortcut to people, to investors looking at the Annual Report and the financials.

MS. RAND: Thanks, Wally. Lisa Roth.

MR. BAUMANN: I just wanted to make a comment if I could, just with respect to one or two of those things. And, Wally, those are really good comments. You're a very good reader. We did point out in some of these examples that there could be things --

We structured them in a way that there could be something that wasn't otherwise in the financial statements. There could be a significant deficiency that was the most difficult matter, that required the auditor to really extend their audit procedures. And it was very difficult to get evidence because of that.

But only a material weakness has to be disclosed by management, and not a significant deficiency. So therefore, we wanted to point out that there could be things disclosed through these CAMs that may not otherwise be required to be disclosed.

So we intentionally did that to bring out that issue, and make sure people addressed it. And commented pro or con with respect to that. So thanks for pointing that out. But that was done intentionally to get feedback in that area. Lisa Roth.

MS. ROTH: Thanks. So I'm a regulatory compliance auditor, not a financial auditor. So when I look at the critical audit matters and those questions, I find them to be really thoughtful and meaningful. And I'm sure you work out the technical semantics, and so on, to make it a really great addition to the audit program.

But I also recognize that the incorporation of the reporting in that manner greatly expands the scope of the audit, if not the liability to the auditor. And I fear the next impact will be a heightened fee, higher fees.

I would imagine those of you who are financial auditors are going to charge more for that kind of audit. So I think it's important to recognize that about 3,000 broker-dealers that are subject to PCAOB audits are nonpublic, privately held, nonpublic, non-custodial firms. And they'll be subject to those audits.

And as Barbara mentioned, the auditor's working for the investors, meaning the shareholders, not the firm. But in those instances firms don't have investors. And 1,000 of those broker dealers are not only nonpublic, non custodial, but they have less than a million dollars in annual revenues, and two or fewer business lines in what are deemed to be generally low risk areas.

So for those firms in particular, the imposition of audit standards of this scope, I anticipate will be financially burdensome, with none of the impact that you've set out to accomplish. Because these firms don't have public investors. Their customers won't ever see the audits or the reports because they're privately held. And the impact is lost.

So I would encourage the Board to consider limiting the scope, or limiting the audience for this type of reporting, to those firms that will benefit, or those investors that will benefit from it the most.

MS. WATTS: Lisa, I'd like to address two points in your question. First, we don't plan on actually increasing the scope of the audit. This would be based on what the auditor has already done throughout the audit.

So we do recognize that liability or fees could increase. But it's based on what the auditor has already done. So the costs should be related to communication, determination and documentation. So that was one point.

And then the other one was, on brokers and dealers, we did recognize that in the release that brokers and dealers have a different ownership structure than issuers. And we put in some examples of how we understand that. And asked questions on whether or not this should apply to brokers and dealers.

MS. ROTH: Yes, thanks. And I will respond to that in a written comment letter. And I thought that the example that you used applies very well to a custodial broker dealer. And I'll comment in writing with respect to the rest of the community. Thanks.

MR. BAUMANN: Thanks, Lisa. And Gaylen Hansen.

MR. HANSEN: Yes, Marty, I think what this is all about is balance. And I think you've framed it very well, the responsibility management and the auditor.

But I can tell you, you know, over the years I've been to a lot of these audit committee meetings. And the auditor comes in and says, we didn't have any difficulties. And that's just nonsense. I've lost a lot of sleep over the years, laying awake at night worrying about things, as I'm sure many people here have. And those are the things, those few things is what has to be communicated.

But if I go to Paragraph 8, and we've had, I've heard a number of people talk about it. Critical audit matters ordinarily are those ordinarily required to be in the engagement completion document, the engagement quality review discussion, or in the discussions with the audit committee.

I don't like limiting it to even those. I think it's anything that has that auditor laying awake at night worrying about it. So while I'm in favor of this, and I think you've struck a good balance, and you're going to, with all the comments that are going to come back, I'm sure that you, I believe that you're on the right direction here.

I think, you know, to Jennifer's comment though, that you could get some unintended consequences if you start limiting things when it comes to critical audit matters. So that's basically how I feel about it.

MS. RAND: Thank you, Gaylen. Wayne Kolins.

MR. KOLINS: Thank you, Jennifer. A couple of comments, one narrow, one a little broader. A couple of times it was mentioned about the significant deficiencies, and one of the possible items that might lead you to a critical audit matter.

Aside from the question of whether that's other information, or additional information over and above what's in the financial statements, there's another potential consequence is that absence of any characterization of a critical audit matter attributable to a significant deficiency, and could imply that it's a positive opinion on the effectiveness of internal control. So it's one thing to consider.

And the other one is, the FRC in the UK has a standard that it's already been issued, it's already in implementation now. There's been a handful of reports issued under it. I think it was for years, beginning after October 1st, 2012. There'll be a lot more issued after the year end.

To what extent are you going to be reviewing the feedback from those, or any -- It would be great if a pilot test could be done on those. Because those would be reflective of live situations, versus a retrospective pilot done on engagements that were conducted in 2012.

MS. RAND: I think I heard one question regarding the FRC. And I wasn't sure if I missed a second question. Did you have a second question there?

MR. KOLINS: Well, the first question was about the significant deficiency. That wasn't a question. That was just a comment. And it was a question on the FRC, to what extent could you think about, you know, some kind of a pilot being developed to look at that, even though it is in a different environment?

It's in the UK environment. But the standard is relatively similar to that of the PCAOB. It's probably closer to the IAASB proposal. And they do have a requirement to indicate what the, how the audit approach has been reflective of the critical audit matter. So there are auditing procedures on a high level that could be in there.

MS. RAND: We have been actively monitoring the FRC's project, as well as certainly the IAASB developments in France, which happened several years ago. You're correct, the FRC --

And I'm not sure if everyone's aware of it. But in the UK the FRC issued a new audit report. Those are standards that are currently effective. And I think at the beginning of this year we'll be seeing a lot of those reports come out. I think, as you've rightly pointed out, there's just a handful right now.

But they are, they're a different approach. They talk about there are some differences. So I think it's useful to have different approaches, at least as we're in a development period.

Because to the extent commoners can review different approaches by the PCAOB and others, I think we can benefit in trying to develop an approach that would be suitable. So I think it's helpful to have other examples.

We'll certainly be looking at that, as well as monitoring comments that come in on the IAASB, and comments that come in to us, as far as our next steps. But we're certainly aware of that, and considering it.

MR. BAUMANN: Thanks. In the interest of making sure we don't keep you here all night, and we appreciate the amount of attention you've given to all of these matters today. I see, I think only four cards up. If I'm missing any, let me know

But I see Mike Gallagher's, Bob Guido, Barbara Roper, and Jeff Mahoney. If there's any others, please raise your hand. So maybe we can take those four, and then call it a day and get back to business tomorrow morning. So, Mike.

MR. GALLAGHER: So, Marty, your point about maybe being provocative in the examples, about showing a case where it's information not otherwise disclosed, I think is helpful.

And I think it will be mission accomplished in terms of your objective, in eliciting feedback. So that's definitely one of the areas that I hear a lot. And it's kind of connected also, you know, being the original source of information.

And Jennifer's point about potentially chilling the dialogue, you know, with audit committees. I know, Jennifer, that comment was in the context, if the audit committee information was the sole source, would that potentially make an auditor cautious about putting something on the agenda with an audit committee? That fear is there.

By the way, I am for narrowing it. Because I can't imagine a case where an auditor, based upon information not communicated to the audit committee, came up with something that he or she put in CAM. I think that auditor would have a major problem with the audit committee in that case. That, you know, you --

MR. BAUMANN: Just to comment on that one. It's really the opposite that we're concerned about. And that is, therefore, CAM doesn't get reported, because it was kept out of the audit committee report.

MR. GALLAGHER: Okay.

MR. BAUMANN: So that's the risk that we're concerned about. We also can't see a case where you wouldn't report a CAM that didn't get reported to the committee. But if you're limited to only things that were reported to the committee, then potentially there's something that would not be reported as a CAM. That was the thinking there, anyway.

MR. GALLAGHER: Fair enough. But, Marty, I guess what I would --

MR. BAUMANN: Again, just to be controversial, to provoke --

MR. GALLAGHER: What I would say is, that's operator error in my mind. You know, just because the auditor chose not to communicate something to an audit committee, doesn't mean he or she shouldn't have, okay.

And so, you know, the point being that, you know, there's an expectation that the most critical matters that, you know, come up during an audit must be reported to an audit committee. And I can't imagine a case where an auditor would say, okay, I've got to communicate something in CAM.

And that's outside the universe of things that I've communicated with an audit committee. And so, you know, having a more narrow focus in the spirit of not having CAMs go on forever, number one. And in the spirit of an auditor being comfortable of limiting, you know, the numbers to a manageable number.

You know, it seems to me narrowing that universe is helpful. But the two issues that I think you're going to need a lot of feedback on, the original source of information, you know.

And is this a back door way of requiring registrants to disclose things otherwise not required through the auditor's report? And then the chilling of the dialogue.

MS. RAND: Mike, I have a follow up question regarding the issue, which is an important issue, and one we did flag in our proposal, is something like significant deficiencies that might, would not be communicated.

But let's say it is a critical audit matter in auditing a particular area. And the auditor, you know, should the auditor then leave that out of the list of a critical audit matter, because it's not otherwise communicated?

You know, what would be the resolution for those type of things that otherwise are the types of things that kept the auditor up at night?

MR. GALLAGHER: Yes. And I think it's a fair point. And the two issues that I hear, that are of concern. One is, have we lowered the bar in terms of requirements for communicating things below material weakness to significant deficiency?

And I do take your point. How do you communicate that issue with respect to the audit, and how the auditor got comfortable, and what kept the auditor up at night?

The other thing is potential litigation, you know, where there's discussion at an audit committee around a matter of litigation. And whether or not it should be disclosed or not.

And if the answer was no, not required under the standards, could this be a back door way of requiring disclosure in the CAMs?

And obviously, to Marty's point earlier, if an auditor is going to disclose something in the CAMs, you better believe management's going to disclose it in the financial statements.

MR. BAUMANN: Thanks, Mike. Bob Guido.

MR. GUIDO: Mike just summarized a lot of my comments and observations. So thank you. I would like to just drop back for a second though. The last 12 years, I want to go on record as saying, that the audit firms report to the audit committees. So I want everyone to fully appreciate that that's happened in the capital markets.

Audit firms understand they report to audit committees. So with that in mind, I also say that good audit committees, and most audit committees that I'm familiar with, do talk about the qualitative aspects of management judgments, estimates and accounting policies.

And I'll tell you, if they get close to the line there's a lot of problems by the audit committees. So I just want everyone, you know, to know that there is pushback there. We're not just letting the audit firms or management do their thing.

There is a lot of checks and balances that are happening every day. And I can't overemphasize that. I like conservative accounting. I like conservative reporting. And the firms that work with me know that. And so does management, that I sit on Boards of Directors.

So there are a lot of checks and balances that have happened since Sarbanes. And there were probably a lot before Sarbanes. Having said that, I was -- if the critical audit matters live, I really like the idea of narrowing.

I'm one for a lot of communications. And I believe, very strongly, there ought to be a lot of communications at the audit committee level. And there ought to be a lot of things, probably in that closing document, or whatever we call it now, that don't go into a CAM. And I think that's fine.

If we say that there's indicators that they have to be, then I think that the CAMs, or excuse me, the closing documents and the communications with audit committees, you know, will be shortened. And that's an unintended consequence. I would encourage, if we do pilot testing, that, Marty, you mentioned, you know, the preparers, and the firms, and the audit committees.

I would get users involved. I think somehow users got to get involved in pilot testing too, to get feedback from users. And then last, but not least, I don't know what the issue is on this significant deficiency.

I would agree with you, if I were a registrant, and someone brought a significant deficiency in the CAM, I'd have a disclosure somehow. But again, that's backdooring what Sarbanes-Oxley requires on material weaknesses.

So, anyway, but I'm for more limiting if we go with -- If CAMs stand, I would rather see less, and really focus on those, and have users focus on those, are the more significant matters. Thank you.

MR. BAUMANN: Thanks, Bob. And again, thanks for the comments on the fact that we were transparent in this document about including certain things, so we could get input back on those kind of things. Barbara.

MS. ROPER: Right. One thing I want to clarify, and then I want to add one thing. First of all, when I was, in my initial comments it strikes me that there are two different things you need to do in your analysis.

One is, that there is this central point of what information investors want in the audit report, that's relevant to their investment decisions. The other is how this proposal relates to other priorities of the Board.

So when I talk about things like changing the incentives with regard to regressive accounting, that's not as the primary goal of this proposal. It's a way to think about the other positive impacts that it could have.

But in response to that, we get the issue about there are certain things that are hard, and there are certain things that are very subjective. And it is very different, as an investor, if you're looking at an audit report where you're talking about, well the financial statements were pretty straightforward.

There was very little subjectivity. The issues were pretty, you know, I mean, that's a different report than one that there's a lot of stuff here that's really hard. And there's a lot of stuff here that's really subjective.

And as an investor I would think you would look at those financial reports differently. And you should. And the audit report, by reporting critical matters, could help you do that.

You know, on this issue of the population of things that might be CAMs. I too find it virtually impossible to imagine that an auditor would communicate to investors something they wouldn't communicate to audit committees. And I would find that very troubling if they did.

But beyond that, I also think that there is, that we don't want -- If you look at different areas, you look at disclosures about risks in mutual funds. You get 20 boilerplate disclosures that tell you absolutely nothing about risks in mutual funds. And I think, you know, or anything that you would care about as an investor in choosing that fund over a different fund.

And I think in your examples you've done a good job of writing these in a way that are, you know, provide useful information. They're robust enough to be there. And they don't go on for 20 pages. We don't want, I don't think, I don't think most of us want 20 pages of boilerplate discussion.

So I don't necessarily disagree with the comments from people who say, you want to keep this focused on the really critical issues, and not just sort of go -- You don't want to create an incentive to report everything that might come up. I don't think you've done that.

But just the point being, I don't necessarily disagree with the comments of those who say, keep this focused on the really critical issues.

MR. BAUMANN: Yes, that's been good counsel for us. So thanks for pointing that out again. And, Jeff Mahoney, you get to have the final word. Or, you're the last person to keep us away from the reception.

MR. MAHONEY: Okay. In that case, I'll be very brief, extra brief.

MR. BAUMANN: No, that was not the point.

MR. MAHONEY: I just want to commend the Board and staff. And I personally believe that this was a very important recommendation of the Treasury Advisory Committee. So I just want to commend you for sticking with this, and getting to the point of issuing a proposal, and having a full due process around this important recommendation.

Just two brief points. One, I share the concern about having an overload of disclosure regarding critical audit matters. There's too many. We end up having a phone book that's not going to be helpful to investors, or anyone else.

But I'm also concerned on the other end that there would be a significant number of companies where the auditor, in their judgment, would decide that there should be no disclosure at all. If that ends up being the case, I think that's also going to be a real problem, in that it's going to undercut the basic objective of the project.

Second, my reading of the input from investors, and a lot of the surveys and studies, one of the common themes was that they wanted more insights from the auditor, focused on some of the key estimates and judgments. And so to the extent that through the auditor's judgment, they disclose critical audit matters, that are something other than some of the key estimates and judgments, and that ends up being a common practice.

I think many of the investors who were supportive of this project are going to be disappointed, since that's what many thought they were going to get out of this project. Thank you.

MR. BAUMANN: Okay. Thanks, Jeff. And thank you, all of the members of the SAG, and all observers here, for very valuable input on all of our discussions today, and particularly right now on the audit reporting model, one of our most important priorities.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on November 14, 2013 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the November 14, 2013 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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THURSDAY
NOVEMBER 14, 2013

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MS. RAND: Thank you, Marty. Good morning, everyone. As Marty said, we will continue our discussion on the auditor's reporting model.

Before we do that, though, I want to remind you of our disclaimer, which is the views expressed by each of the presenters are our own personal views and not necessarily those of the PCAOB, Members of the Board or other PCAOB staff.

So, getting into our discussion, yesterday we spent our time, and our time had been abbreviated, but we did discuss critical audit matters. Your feedback was very helpful. I think we may have time today if anybody has any further comments regarding that toward the end of this session.

But our focus, to start off with, is on the new elements of the report and the other information standard that is included in the PCAOB's proposals.

Since we are back on schedule and we have time, we thought that it would be helpful before we just open up the floor for discussion to provide an overview of the standards. And then we will get into the discussion. And then, of course, I expect we will have time at the end if there is anything else that wasn't covered that is of interest, certainly we would like to hear your views on that as well.

So, with that, I will turn it over to Jessica.

MS. WATTS: Thank you. As I mentioned yesterday, the proposed standard, in addition to critical audit matters, includes new elements. Specifically, independence and auditor tenure.

Related to independence, the proposed standard would require the auditor to include a statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company, in accordance with the United States federal securities laws and the applicable rules and regulations of the SEC and the PCAOB. Under PCAOB and SEC rules, the auditor is required to be independent of the company.

This statement in the auditor's report is intended to enhance investors' understanding about the auditors' obligations to be independent and to serve as a reminder to auditors of these obligations.

Related to tenure, the proposed auditor reporting standard would require the auditor to include in the auditor's report a statement containing the year that the auditor began serving as the company's auditor.

Currently, this information is not required to be communicated by the auditor, management, or the audit committee to investors or other financial statement users.

Auditor tenure has been the subject of discussion for decades and investors and others have indicated strong interest in this information. In light of the public interest, we've proposed auditor tenure as a data point in the auditor's report. The intent of the proposed requirement is to disclose the duration of the auditor's relationship with the company.

And then the next thing we will talk about is the other information standard. So, during the Board's outreach process, some commenters had indicated that they would support changes to the auditor's report that describe the auditor's responsibilities related to other information and the auditor's conclusions related to the other information.

And in order to provide a basis to better explain to investors the auditor's responsibilities related to that other information, and the auditor's conclusions, we determined that changes to the existing other information standard were appropriate to provide a specific basis for this description in the auditor's report.

As a result of this link between the proposed auditor reporting standard and the proposed other information standard, the financial statement user would obtain useful information, such as the nature and scope of the auditor's responsibilities with respect to other information, clarification of what other information was evaluated by the auditor, and a description of the results of the auditor's evaluation of the other information.

The other information standard specifically applies to a company's annual reports filed with the SEC under the Exchange Act that contain the company's audited financial statements and the related auditor's report.

The proposed other information standard would require the auditor to evaluate whether the other information contains a material inconsistency, a material misstatement of fact, or both, based on relevant audit evidence obtained and conclusions reached during the audit.

In addition to reading this other information, the auditor's evaluation of the proposed other information standard would include performing procedures intended to help the auditor identify whether the other information contains a material misstatement of fact or a material inconsistency. The proposed other information standard provides specific responses when the auditor identifies a material inconsistency, or a material misstatement of fact, or both, such as communication with management and further procedures as necessary.

So, now I will turn it back to Jennifer to start our discussion.

MS. RAND: Okay, thank you. So, to start off, we would like to talk about the new elements in the report, specifically the element regarding independence, a statement from the auditor about independence, and also on auditor tenure.

I see Loretta. Loretta, go ahead.

MS. CANGIALOSI: Good morning. On the independence, I don't have an issue. On the auditor tenure, I guess my question is, as I read this, it seems to be far reaching backwards, particularly with predecessor firms, because, as we know, audit firms have merged over the years. And one of the things I really would like to hear from investors is how relevant all of that is.

Because if you have been audited by the same firm for 15 years, 20 years, 30 years, I mean, when does that really strike them as a hot button? Because going all the way back, you have a different management, different partner, different firm. Having previously been with Main Hurdman and then KMG, I can tell you that when they merged with KPMG it was a different auditing set of processes.

So, I'm not sure how relevant the predecessor firm is. And also, you know, the fact is that if we are looking for independence, when you have different management teams and different auditors and audit firms, again, I don't think you have that independence issue as striking. But I am interested to know if there is a cutoff by which investors believe that it would be satisfactory to say they've been our auditors for over 25 years, rather than going all the way back.

MS. RAND: Okay, thank you. I think it would be helpful to get some other views on this topic and we can go back and respond. But, Gaylen Hansen.

MR. HANSEN: Yes, if I could comment on both of these. Auditor independence. So, certainly the audit report is titled, "Report of Independent Registered Public Accounting Firm." So, there is sort of an implied conclusion that the firm is independent.

It's interesting the way the paragraph is written. It says that the auditors are required to be independent. It doesn't actually say they are independent. And I understand the argument that there is violations, a lot of times very minor, that are resolved with the SEC, or with actions as taken, so that the firm can be independent during the course of the audit. But, for me, it's sort of a disconnect.

If the auditor can't say affirmatively that they are independent, I think there's an expectations gap problem with that in the report itself. So, I would like to see a stronger statement here. And I'm not sure exactly -- I don't know that I have the solution for that, but we have to make it clear that the auditor is independent in the way that it's communicated to users.

And then on tenure, I don't particularly have any problem at all with the disclosure of that. It seems to me that -- and the issue has been raised with me by others. It may be important as to any implications as to tenure on independence, and the placement of that in the report could be important. If it's next to the discussion of independence, maybe there is an implication that if there is some period of time that you have been the auditor that you are raising issues about independence. So I think we need to be careful about the placement and the manner in which it is disclosed. Thanks.

MS. RAND: Gaylen, did you have any thoughts about placement? It sounded like you thought an alternative might be preferable. I just didn't hear if you had made a suggestion or had any thoughts.

MR. HANSEN: The suggestion that has been made to me was that if it could be -- if the statement about tenure is not in the independence paragraph, it would be preferred. And maybe right near the end of the report, somewhere near the auditor's signature line.

MS. RAND: Thank you. Bob Hirth.

MR. HIRTH: Thanks, Jennifer. To pile on on the tenure comment, I had polled a number of CFOs and audit committee members and I got some consistent comments around tenure. And let me just kind of read you the sense of one. "I don't like the proposal to disclose audit tenure. It would be or is out of context being placed directly in the auditor's report, and for long-serving auditors, implies a taint on their independence, which I believe is unfair. We have independence rules. And either the auditor complies or not, irrespective of the tenure."

To add on to that, one option around placement would be to put it in the proxy, where there is discussion about the auditor and approval of the auditor. And you could put it there.

Now, Bob and I were talking about whether that is voluntary and suggested and companies just decide to do that or it's a requirement. So, that is a comment on tenure.

MS. RAND: Okay, thank you. Elizabeth Mooney.

MS. MOONEY: Thanks. I didn't get a chance to make some comments yesterday. So, I have a couple as well that might relate to yesterday's discussion, a couple comments.

Just on the tenure, from my discussions with analysts, they are interested in knowing how long the auditor has been in place on an engagement with the company, but I can't say there's a consensus around how many years. But they are very interested in that time frame.

And I wouldn't make a blanket statement that it's a taint. I just think it is helping to educate the investors. But it is something that they like to know.

And we have gone back and tried to piece it together with annual reports we can get our hands on. The analysts have asked me to do that.

So, I would just say it is relevant and I don't see why -- you know, it's a fact. It is a discernable fact, and where it is, I mean, I don't see why it would be a problem in the auditor's report.

Just another general comment. We talked a little bit about IAASB's proposal yesterday, and I just would encourage PCAOB not to wait. Convergence has been a slow process, and just be a leader and do what the Board thinks is the best thing. And, hopefully, convergence will happen naturally.

In terms of what information would be especially useful, you know, I think one important piece is the risk assessment and how it changed during this year, or this audit, from the prior period or periods. And, you know, the biggest risks and how the risk auditors responded to them, how much time is spent on them, how they got comfortable with them, any significant adjustments to the work they did. That is the kind of thing that would be really useful. And, again, it is about the audit.

And in terms of reporting the critical matters, I would just encourage you to make sure that the standards are strong enough. It should be really based on what's required, what is significant, according to the audit standards. I think this came up in your IAG meeting, but I think that's really important so that you can have some consistency and that it will be actually an enforceable standard.

And on the other information, you know, outside of the financial statements, I think if auditors know that investors are getting certain bad information, it's their responsibility to say something. So I think to fix it or do something, that makes a ton of sense.

Thanks.

MR. BAUMANN: So, before we take -- there is a lot of other cards up -- I thought we would pause just for a second because a lot of comments were made. Maybe I will add some color and see if it helps or not.

So, the thought on the tenure, because a lot of points have been made that it's not relevant and firms have merged and different partners change every so many years, and therefore to some it's not meaningful or some said it taints.

When we had hearings around the concept release on auditor independence, objectivity, and professional skepticism, including rotation, there were a lot of people who testified at those hearings and talked about concerns about long tenure. But at the same time, there were some people that testified and said they're concerned about rotation because they think the riskiest audits are in year one. So there was a lot of points that came out of those hearings about pro and con rotation with risks in both directions.

So the thought on putting in tenure was, well, for those investors who think it's very risky in year one of a new audit, of an audit, for an auditor that really isn't up to speed, potentially, on all the issues in the company, that's a valuable data point for that investor that has that concern.

And there are those others that have that concern that 120-year relationships, even though partners do change and firms merge, firms tend to value in a certain way their 100-year relationship clients or long-term clients. And there is probably some pressure on the audit partner, besides just doing a good audit, to not be the partner that loses that client that has been a client of the firm and a crown jewel of the firm for 100 years.

So, there is enough pressure doing the audit itself. But to be the partner who is going to make tough calls that might cause losing the client puts extra pressure on him. So maybe investors want to know about those relationships, because they feel those partners are under a unique kind of pressure.

So, tenure really is thought to be a data point of value, whether it's the first year of an audit or the hundredth year of the relationship or somewhere in between.

But the comments you're making, I think, are some of the comments we have heard across the board. Some people think it is not valuable and other investors have said we think it's a valuable data point.

So, I thought I would just add a little color. We're not just pointing out the lengthier tenure. It's whatever it is that could be potentially of value.

With respect to the comment on independence and the fact that we are "required to," as opposed to "we are independent," I think, Gaylen, you touched on the exact issue, and that is some firms have violations of independence rules during the audit. And if they have a violation, that might affect -- they violated the rules that year. So, the statement is written in a certain context.

I think we will continue to explore that, because I think your reaction is a fair one and I think others have that. But I think it's something we have to work through.

So, I thought I would just add those points as we take the rest of the comments.

Jennifer, did you have any other additional reactions?

MS. RAND: No.

MR. BAUMANN: Okay, thanks.

MS. RAND: Okay, next on my list is Steve Buller.

MR. BULLER: Thank you. Just thought, a couple thoughts, again as a user. So, we rely upon the audit firm to tell us if they are independent. It's hard for a user to understand if an audit firm is or is not independent. And additional disclosure is not really meaningful information which is actionable for us, as an investor, merely stating that they are independent.

I guess while we have the SEC in the room, the thing

I would encourage, actually which is probably of more benefit to us, is to have a full review of the auditor independence rules. Because between the investment company complex rules, the 21010 over-under rules, the former partner pension rules, they are difficult for the audit firms. They are difficult for users also. We have two full-time people who spend all their time, 100 percent, monitoring auditor independence with contracts and relationships and former personnel.

But, also, it's apparent to us, at least, that there is going to be a higher degree of auditor rotation. Now, whether that is one percent or 20 percent, I don't know. But unless someone goes back and just looks at the issue of former partner pension plans and unfunded pensions, you know, as we have more and more former partners who serve on boards, including our board, if there are rotations we're going to see more required changes because of partner pension plans and taints as they bring in new audit firms. So, I just encourage the SEC to look at that as part of this longer term project.

With respect to audit tenure, we don't object to disclosure of the number of years in which the firm as served as the auditor. Again, the question is what is actionable for us.

So, for us, we think it probably makes more sense to have that disclosure in a proxy in the auditor opinion and here is why. If we think that there is a problem with the auditor independence or the number of years they've served, the way we take action is by voting in a proxy to not reappoint the auditor.

It is hard for us to take action when we review financial statements to understand what it means and the impact upon financial statements if they have been an auditor for one year or 50 years. It's just not something that goes into our analysis of the integrity of those financial statements. It probably belongs in our decisionmaking of whether or not to retain the auditor.

So, those are a few comments.

MR. BAUMANN: Thanks for those comments, Steve. They're very helpful. I think actually a couple of them though are really for the SEC more than us.

And somebody else also had mentioned earlier that they had thought, maybe it was Bob Hirth who mentioned that he thought if tenure is going to be disclosed, it should be disclosed in the proxy, rather than in the audit report. So, that is outside the scope of our authority, again, but we take that point and appreciate that. So, the SEC has heard your views.

MS. RAND: Okay, Professor Cox.

MR. COX: So, it was my pleasure, although it interrupted a vacation, to testify, give some testimony at the Roundtable on Auditor Rotation in San Francisco a couple of years ago. And my actually eagerness to do that was informed by the fact that before I even had the opportunity to do that, I had started looking at the literature about what the implications were on the question of independence and tenure. And I was astounded. It was sort of like a Goldilocks situation. And that testimony is all a matter of record. People could look at the studies that have been done, which I think I tried to correctly summarize.

But really it's a Goldilocks moment because it's like the question about it's either too short or it's too long and how the empiricists have been able to document the problems that arose from this. And the studies all indicate the following, that it's very hard to figure out what is just right. Okay?

And we moved past the question of mandatory rotation of audit firms, at least at this moment in time. But it does make me think that what we would like to do is shine a light on this problem, because the problems are not only at too short a tenure, but the problems also exist, again, with some statistical significance, with too long a tenure.

And the whole function of what we are talking about starting yesterday afternoon and continuing this morning is where is an appropriate place to shine a light on this. And some things probably need to be centralized and located in one place. We all know that when you change an auditor, that's an 8-K filing that you have to make with the SEC. But there are some other things we may want to think as well, and that there is a central location of this very ever-growing set of financial statements where we would like to have some things just highlighted. And I think auditor tenure is one of those.

So, I think that just specifying what the length of the tenure is in the audit statement, in a very crisp statement, can at least shine a light on it and let investors do what they want with it. Some have staffs of two people who do nothing more than that. I'm going to suggest that a lot of investors don't fall into that category. But by being able to highlight it, maybe they can dig into the question more likely and figure out what to make of the question about too short or too long a tenure.

MS. RAND: Thank you. Rick Murray?

MR. MURRAY: Thank you, Jennifer. I think there is a terminological problem that requires some further attention. The concept of being independent really is two separate thoughts. One is the condition of being independent, which is, generally speaking, capable of objective identification and explanation. The other is the way of doing things, which is a process, a state of mind, and a far more subjective and nuanced issue.

I don't think it's clear in the materials whether one or both of those uses of the word are clearly intended. It seems to me there are places where you would imply one thought attaching to the way independence is used and other places where it seems more to be the other.

So, I would encourage a review of the drafting process, so that whichever of those the Board intends to be the purpose of independence for this purpose is clearly specified.

Second, and a briefer comment, there is a catch-22 here in that, for 40 years, there has been a debate about whether it is possible, at least theoretically, to be independent when being compensated by the client. And there are, clearly, many voices who continue to believe that it's not and that it is a misrepresentation, if you will, for an audit firm to declare itself to be independent in the current context of the way compensation is arranged.

For those voices, some in academia, some in a variety of other communities, the use of litigation as a tool to challenge that alleged misrepresentation, and to use this new element of the audit report to accuse the firm of overtly misrepresenting their status as independent, if that is the way that the Board elects to use the word, is an unintended consequence that I think needs some attention. It can be clarified by defining a little more closely what the standards are that are being used for that purpose.

But when you ask the auditor to make a self-declaration of that, it ought to be clear whether the declaration is one status or of process and how that can be recognized by the regulator as an accurate statement, in light of the compensation of auditors.

MR. BAUMANN: I would like to explore that a little bit, Rick, if we can. That's a very interesting comment.

I think the first thought is, by including a statement in the audit report that we are required to be independent, according to the rules of the SEC and the PCAOB, our intent in drafting that and putting it in the report was we thought that that had a chance of increasing the auditors' thinking about their decisions that they had to be independent of mind and had that objectivity in the decisions they were making as they were coming to their conclusion on the financial statements. It might have that intangible benefit of increasing that independent state of mind that you talked about that's one of the couple of aspects of independence. I think that is the main reason for putting that there.

We would also like to put in the statement "we are independent," to Gaylen's point, but there are some other technical issues with that.

But I would like to explore what you meant by this has a liability and litigation issue and overtly misrepresenting the auditor's position. So maybe you could share with me a little bit more your thoughts in that regard.

MR. MURRAY: First and most simply, Marty, if it is clearly the intent of the Board that the reference in the audit report is to the state of mind, the process, rather than the independence, that goes a long way. If that is clarified, that goes a long way to take both of my comments out of play.

MR. BAUMANN: Well, it didn't mean to say it ignores the fact that we had to comply with rules as well and that we are required to comply with rules. But, certainly, there are the two aspects. There is the rules and the state of mind.

MR. MURRAY: I may be wrong factually on this. But it is my impression that neither the SEC nor the PCAOB have ever overtly said we have examined the nature of the compensation of auditors in this system of financial reporting and we have concluded that that does not impair the auditor's ability to function independently.

If that were to be clarified and the declaration in the audit report were to fit into that model saying we have functioned independently, I think that reconciles the problem. It's the overhang of a historical and not formally resolved question about the effect of compensation, coupled with asking the auditor to make a self-declaration that, if claimed to be materially misleading, which is certainly within the reach of trial lawyers these days, that creates the concern.

MR. BAUMANN: Thanks. I would be interested in others' reactions to that, but I understand the point you are saying, that potentially the client pays model creates a conflict that inherently affects independence and therefore making that declaration raises the point that you are concerned about. I don't know if anybody has a reaction to that, but if they do, I hope to hear from them as part of the discussion.

MS. RAND: Okay, thank you. Jeff Mahoney.

MR. MAHONEY: Thank you. I just wanted to agree with the staff statement that there is strong investor interest in the tenure information. That's reflected in our corporate governance policies in at least two ways. First, with respect to shareowners' oversight of the audit committee, our policies related to audit committees indicate that tenure should be a factor that the audit committee looks at with respect to the retention issue.

MS. RAND: Jeff, I'm sorry. We were getting -- obviously, you are hearing that noise, but I was missing some of what you were saying. It was quite distracting. It seems like it has subsided. If you could just repeat that again. I apologize. I don't want to miss your point.

MR. MAHONEY: Sure. I wanted to express my agreement with the staff statement that there is a strong interest by investors in the tenure information. That's reflected in our corporate governance policies in two different areas. First, with respect to shareholders' oversight of the audit committee, in our policies related to the audit committee, we do say that the audit committee should look at auditor's tenure as one of many factors when considering auditor retention issues.

In addition, we ask for disclosure by the audit committee. When the auditor has been retained for ten consecutive years or more, that there be some additional disclosure by the committee about that decision to retain the same auditor beyond the tenure period.

It also has relevance with respect to our policies which many public companies have adopted with respect to the annual shareowner vote on the ratification of the external auditor, where we believe that the tenure of the auditor should be one factor. Again, not necessarily the most important factor, but one factor that shareowners should look at when making that retention vote, which, as I indicated, is a very common at a large number of public companies.

With respect to where the information is disclosed, we do not have a policy saying that the tenure information should be disclosed in the auditor's report or in the proxy statement. I can see the argument that it be disclosed in the proxy but I'm not aware of anyone in our membership who would be upset if that information was disclosed in the auditor's report, which is the main vehicle of communication between the external auditor and shareowners, rather than in the proxy statement.

In addition, I think if you asked them if it's disclosed in the auditor's report, you may get this information in a shorter period of time -- you may get this information in a few years. If it's disclosed in the proxy, it may be a long time before you ever get that information. If you add that to the conversation, I think a number of our members would agree or support the idea of having tenure disclosed in the auditor's report if they think they are more likely to get that information sooner rather than later.

Thank you.

MS. RAND: Thank you, Jeff. Bob Guido.

MR. GUIDO: Thank you. I just wanted to pick up on a couple of points, especially -- there goes the hammer.

But what Steve Buller said about independence, and not to dwell on this issue too much, but go back to the premise that we on the committee spend a lot of time in this area, and we do challenge. And I would like to just remind everyone that tenure, from an audit committee's perspective, is one year at a time, which means the firms have to prove themselves, not only in performance on an annual basis but in the independence, objectivity, et cetera. Fact and state of mind.

Therefore, if something -- and I really believe that disclosing this in the auditor's report is out of context. Put it in the proxy where, if we want to, make it voluntary. I will bet you if you do best practices, there will be a lot of registrants that will follow suit. But it could be couched within the audit committee's report, where we, in effect, challenge performance and reappointment.

However, if that doesn't fly, I have another suggestion. Ten years ago, we used to file with the PCAOB all of our registrant information. I don't know if that is still being done but I assume that it is. Why don't we just have the firms put in there how long they, in effect, have been a client? And that has access -- it used to be public information maybe it isn't anymore. But any investor that is interested could access that public information in a few seconds.

So anyway, just a thought.

MR. BAUMANN: Do you have a reaction to the comment that Jeff made that to the extent investors think that this is important, this is a proposal that we get this out to investors potentially in the near term. Whereas, if your argument is, maybe it belongs more in the proxy, there is no action taking place right now or no proposals on the plate to put that information in the proxy, other than voluntary. And there are some companies that are voluntarily disclosing that but there is no action underway, as far as I know, to put it required in the proxy.

MR. GUIDO: Well yes, I don't know of any action either. I do know that some registrants already put it in the proxy. And working with NACD and others, we could get this going, if that is so important to investors.

But again, I will go back to what I said before. For audit committees to opine on independence and performance, we do represent shareholders. And therefore, we have already concluded on that issue.

However, if we want to have it in the sunshine, put it in these reports and the firms file them annually, I believe. They still do, I hope.

MR. BAUMANN: They do. That is a form 2E you are referring to and that is available. Of course, an investor would have to do some searching to find not only the firm but then the issuer and so on and so forth. But it is an option, I am glad you pointed that possibility out.

MS. RAND: Okay, Jerry de St. Paer.

MR. DE ST. PAER: Thank you. I guess this is going to feel like piling on but I think my perception of it, while consistent with the views, for example, that Bob just expressed and others, it has a twist to it.

I chair one audit committee. I am on another audit committee. In every one of the audit committee meetings, we take pains to confirm with the auditors that they understand that they report to us, the audit committee. They don't report to management. We make that very clear. We make it very clear that they have access.

But the other thing that is very clear is that the responsibility for taking -- I thought the comment by Professor Cox was very interesting -- too short, too long. The audit committee is where the buck stops in deciding whether it is too short or too long or what the other factors are. It is not the auditor.

I mean with all due respect, the auditor can have their views of it but who actually decides whether you are going to recommend the appointment of that auditor for another year, as Bob says, one year at a time? It falls to the audit committee.

So, I hear the point about the issue about timing, that if you put it into the auditor's report you are going to get something sooner. But it absolutely is out of context because it doesn't include the judgment of the people who are actually making the decision whether the independence is adequate for reappointment or not. That is the audit committee.

So, I guess I would urge -- we have got Brian sitting here. We could all go beat up on Brian to try to get something moving at the SEC or to get the NACD or others.

I think that what I am focused on here is what is right and not what is expedient. I can understand why investors find this information meaningful. I completely get that. I completely also understand and sympathize with the view of the PCAOB to try to do something about that. I just think that we have got the ball in the wrong place.

I think to have an auditor to say they think they are independent is fine but I think it misses the fact.

The second thing that I wanted to express, and it has to do with this auditor independence when I read the proposal, and it goes to a little bit the concern I had yesterday. You can't get away from your roots. Having been CFO of an insurance company that does auditor liability insurance, the fact is here what will happen -- and then if you sit on the audit committee and lawyers come in and they say okay, we have got these new rules -- what will happen I am afraid, and this is the thing I would urge that -- and I don't know how you deal with this because I understand what you are trying to get on the CAM. I understand what you are trying to get on auditor independence but the pressure toward boilerplate is going to be so strong.

I mean can you imagine that this new thing comes out. We have got the new CAM. We have got this, and then there ends up being a problem. It is like a roadmap to litigation.

So what is going to happen, I predict, is that it will go overboard. There actually is no incentive for anybody to do anything other than to throw the kitchen sink in and call it material.

So, unfortunately, you should never make a suggestion. On the first instance, my suggestion is put it in the proxy. On this one, unfortunately, I don't have any helpful guidance, except that I could just see this thing blowing out the auditor's report significantly into a big document, which will be almost unfathomable for the average investor to be able to understand.

MR. BAUMANN: That is a risk certainly we are concerned about. We are concerned about boilerplate. So the things that you brought up are good points that could risk the value that we are trying to bring. So, we will carefully think about those issues.

Brian's card promptly went up when you talked about the SEC. So, we will give the floor to Brian Croteau.

MR. CROTEAU: Thanks, Marty, and good morning.

I guess first I just wanted to say I don't feel beat up upon at all. I think it is really important that we all hear these comments. And again, my disclaimer from yesterday still applies as well.

But certainly geography can be extremely important and we do appreciate the comments in that regard and particularly when we are talking about matters that may have to do with whether you are evaluating the engagement of the auditor, versus the report and the completion of the audit. We certainly can appreciate, or I can appreciate, the differences between the two. And so I don't think people should feel restrained in offering whatever feedback they think is appropriate about either the nature of the disclosure or the appropriateness of the location. And certainly me and my staff are here and others are listening to take good notes on that. So, I appreciate the feedback.

MS. RAND: Okay, thank you. Oh, sorry. A number of cards are up and then I would like to try to get to other information.

But next on my list is Walt Conn.

MR. CONN: This may also feel like piling on at this point, but I will take Brian's invitation.

In the interest of transparency, I fully support the disclosure of auditor tenure in a place that is easy for investors to find. I would argue, though, that including it in the auditor's report, just to echo some of the other comments that have been made, implies a correlation between tenure, a sweet spot for tenure from shortly after first year, second year, whatever that may be, to whatever a long tenure is, a sweet spot between that and audit quality that I don't think is known today. And therefore, I agree with the comments that have been made that it seems out of context to be in the auditor's report and it seems like to me the best place would be in the proxy or in the Form 2.

Thanks.

MS. RAND: Thank you. Bill Platt.

MR. PLATT: Thank you. The point has been made by several people that the consideration of tenure really is a question of reappointment of the auditor and the audit committee's responsibility and the audit committee's focus. And many people have observed that maybe it is better placed in a proxy, which discusses the audit committee's decision to reappoint the auditor. I would actually agree with that.

And then others have said then that well, but because the SEC doesn't have a project currently, therefore, it will take longer to get through proxy than possibly what the PCAOB can do through mandating through an auditor's report. It kind of reminds me if the only tool we have is a hammer, we are going to think that everything is a nail.

And I wonder, though, whether or not there might be a way to accomplish it through saying that if it has not already been disclosed in a proxy, then the auditor will include tenure in the report. But if the company and the audit committee has included auditor tenure in the proxy, then the auditor's report would be silent to that fact.

So, it might be a way for the PCAOB to take action, which sort of goes along the way of encouraging proxy disclosure and many companies then will probably jump on that, and therefore, one place or the other you would end up finding the disclosure of tenure information. So just a thought, in terms of saying, you know, can you use the hammer of the PCAOB to get disclosure either in proxies or in the report itself.

MS. RAND: So Bill, just to make sure I am thinking about it the say way as you are suggesting it, so you are suggesting -- because generally the proxy is filed after but you are talking the proxy that was filed before for the appointment of that year.

MR. PLATT: Yes, the proxy that was filed before. It would be a little different than now the incorporation by reference of compensation information, which is going to be in the next proxy, because you wouldn't necessarily know what was going to be in the next proxy.

But if it was in connection with the appointment for that year had been disclosed, then it wouldn't need to be repeated in the auditor's report.

MS. RAND: Okay, thank you. Dan Montgomery.

MR. MONTGOMERY: Thank you, Jennifer. And just a quick comment on independence to compare and contrast a bit with the IAASB proposal because I know that many in the room will be reviewing and commenting on both.

Like the PCAOB, the global stakeholders of the IAASB felt that there would be value in having a statement about independence in the auditor's report. However, the IAASB stakeholders, in particular global securities regulators, felt that there should be, along the point that Gaylen made earlier, an affirmative statement of independence. And so, the IAASB's proposal is to specifically indicate that we are independent of the company within the meaning of the relevant ethical requirements or applicable law or regulation and have fulfilled our other responsibilities under those ethical requirements. Also, it would be required to specifically identify the relevant ethical requirements.

And the IAASB, in formulating that language, also considered the notion of breaches. And maybe this is something that works in the international arena because there is a recent revision to the International Ethics Code that suggests that if there are any breaches of independence requirements, the auditor is required to communicate those with those charged with governance. And if the auditor believes that appropriate action can be taken and those charged with governance agree, then the auditor is able to affirm independence and issue an independent auditor's report. So the affirmative statement about independence, at least in the IAASB view, would work in that regard.

MS. RAND: Thank you, Dan. Roman Weil.

MR. WEIL: I have not necessarily been paying attention but I am confused about the auditor tenure and the disclosure that we have in mind here.

In the audit committees where I serve, we have got an audit partner. We have got an audit partner in waiting, the guy that is going to be the next audit partner. We have got the confirming partner. We have got the partner who resolves conflicts if something comes up. He is sort of in the background. And we have got the seniors and managers.

And in our audit committee reports, we have got a table where every one of these people, who they are, how long they have been serving, and when the audit company's, audit firm's rules will require that person to go off. Sometimes the audit company's rules are more stringent than the SEC rules or the regulator's rules. But they will tell us how long he has been there, when he has to go, and what the plan is for taking over.

Now, I can't tell from any of this discussion, when we are talking about auditor tenure, are we talking about one person or are we talking about the whole team? If it is the whole team, I think that is fine and we get it already. I just don't see what the big deal is.

MS. RAND: Tenure would be the firm relationship. So, there would be natural rotation of the partner, for example. But to Marty's example he used earlier, the firm may have been auditing a company for 100 years. There is rotation of the individual partners every five years, but the question is, some perceive that the 100-year relationship, even though there is the individual rotation, may have added pressure for those firms.

MR. WEIL: So that word "auditor" means the firm, not the person.

MS. RAND: Auditor means the firm, yes. Right, firm.

MR. WEIL: The firm, okay.

MS. RAND: Okay, I don't see any further cards up, so I am going to move on to other information. And thank you for your comments on both of those points. I think it was very valuable. Some good questions and suggestions came out of that.

For other information included in the PCAOB's proposal, as Jessica described, there was a proposed standard regarding the auditor's responsibilities for other information regarding the annual report that is filed with the SEC. So, that would be the 1934 Act filings, generally, the 10-K.

So, interested in your views on the usefulness, including a statement in the auditor's report about the auditor's responsibilities for other information. The proposed language in the report would state that the auditor has read and evaluated the other information.

The auditor's responsibilities include looking for both material inconsistencies with the audited financial statements, so looking at amounts and disclosures in the audited financial statements. If revenue is stated at $100 million, is it $1 billion in the 10-K? That would be a material inconsistency. So, they are looking for consistency with the financial statements.

And the auditor also would have a responsibility to look for material misstatement of fact. They have both these responsibilities today but a material misstatement of fact could be the auditor knows through their audit that the company is a manufacturer of widgets. They are not the leading manufacturers. Say they are number three. But in the 10-K they have disclosed that they are the leading manufacturer of widgets. The auditor may believe that would be market moving information if the public believed that they were the leading manufacturer. But based on the auditor's audit, obtaining understanding of the company, they know that is incorrect.

So under our proposed standard, the auditor would have a responsibility to discuss that with the audit committee to have that be removed, clarified.

And the proposed standard also includes procedures to evaluate the other information. Today, the auditor's procedures are read and consider. That's it. It is whatever the auditor does in connection with consideration.

We have read and evaluate. And evaluation means four different types of procedures, such as comparing the amounts with the financial statements for consistency, looking at the disclosures, taking into consideration the other information the auditor knows, is there any material misstatements of fact, and looking at calculations that are presented in the other information.

So, I will just open that up generally for views on other information and you can feel free to touch on any or all of those points.

Ian Dingwall.

MR. DINGWALL: Thank you. As I read this report on other information, it presumes the other information is in fact presented. In other words, it is a report on that which is presented. It is not necessarily a report on things that might be required but are not presented. In other words, we do require in 11-K filings or in plan filings, that a lot of other information be presented.

The problem usually is that it is not presented. It is not there. So, I would think that this report on other information could be more valuable if it talked about the completeness of the information, or it made some reference to the fact that none of the required information has been omitted, something along those lines.

Just to say what is presented is fairly stated in relation to the financial statements taken as a whole is fine but it would be, I would think, more valuable if it suggested that the information that is required to be there is in fact there.

So opining that nothing has been omitted, I think, would add to the value of this report.

MR. BAUMANN: So let me just comment on that, Ian, just to clarify a couple of things.

So, the other information, of course, we are talking about is in connection with the '34 Act filing. And what has to be there is in accordance with the SEC rules in connection with that particular '34 Act filing for either a corporation, or a mutual fund, or whatever it might be in that '34 Act filing.

We did ask in the concept release on auditor reporting, should auditors have some further responsibility to examine the other information? And generally there was not support for that. To the extent that there was support, I think there was support for the auditors' continuing responsibility to read other information and consider whether it has any material inconsistencies with the audited financial statements or material misstatement of fact.

So, there is not a requirement in existing standards, and we are not proposing one, for the auditor to extend his or her responsibilities to ensure that the company has fully complied with all of the various aspects of the SEC rules as to what has to be in MD&A, what has to be in risk factors, what has to be in the various aspects of the '34 Act filing. That would be a separate engagement. Legal interpretations would be involved in terms of what would have to be included in that information.

And so that is not the extent of our proposal at this point. We have heard your view that you think that would be valuable to the auditor to do that. We haven't proposed that and we really hadn't heard a lot of support for that, but I will be interested to see if others do that.

The comment that something is fairly presented in all material respects went to something I discussed yesterday on supplemental information that is related to the financial statements that is required by SEC rules to be part of the financials. But it is supplemental.

With respect to the other information that we are talking about here like MD&A and risk factors, there is no opinion being expressed on that information. It is a matter of we have read and evaluated it and we are not aware of any material inconsistencies or material misstatements of fact. Now, that is some type of assurance but it is not an expression of an opinion.

I don't know. Hopefully that clarified it, if anybody had any confusion as to what the requirements were.

MS. RAND: Thank you, Marty. Denny Beresford.

MR. BERESFORD: I think this part of the proposal could be one of the more useful additions to the auditor's report. And in the concepts release I, and I think a lot of other people, supported it with the sort of implicit understanding that at the time the idea was simply to have the auditor report explicitly on what was already being done.

But the proposal, and looking at one of the earlier slides, indicates that this would enhance the auditor's responsibility with respect to other information and, these are the key words, "by adding procedures for the auditor to perform in evaluating the other information based on relevant audit evidence obtained and conclusions reached during the audit." Adding procedures, I guess, would be the key words.

And in looking at the releases that came out shortly after the proposal by at least two of the major firms, and I suspect the others agree at this point, they characterize this as substantial additional work that would have to be performed. At this point, it isn't clear what that exactly means but it sounds like a very major undertaking that the firms see. Reading the document, it is not clear exactly what the PCAOB has in mind. And it is not clear, of course, to me what the firms have in mind that they would have to do.

One obvious concern is that without a lot more specificity, this could turn into another PCAOB auditing standard number two versus five kind of situation where something is put out along the lines of what you have right now. The firms think again lots and lots, and lots, and lots of additional work. And then we find out that is not really what was necessary. But in the meantime, we have added, pick a percent, 10 percent, 20 percent or whatever to our audit fees and so forth for minimal additional benefit, if any, to the users.

Again, I think going back to my beginning point, if we were simply asking the auditors to report on what they were already doing, in other words, that they had, as part of existing standards, reviewed the other information in connection with the procedures that were already part of the audit and found it not to be inconsistent, and simply stated that with appropriate caveats in the report and so forth and not putting subheadings in and other information that would lead the users to believe that this was subject to a lot of additional auditing and so forth, I think that could be a major step forward.

I guess my major concern again is would it really be worth it to add a lot of additional procedures to create something that would not be fully audited in any event.

I guess my major suggestion here would be that I think that this is something that would really -- I would urge you to be very careful. And I'm not sure exactly how you do it but I think you need to do some field testing. And I don't know how you can field test something in advance but I urge Marty that you work with the accounting firms and get an understanding of what do they mean, what do they have in mind in terms of all these additional procedures that would have to be performed and compare that to what you believe are the added procedures that would be necessary to meet the requirements of the proposed standard and try to have a meeting of the minds in advance, as opposed to putting out a standard that would then be, in effect, not operational or be subject to a lot of ambiguity, again, like the unfortunate situation we had before.

Given the existing situation, given the uncertainty about what is going to be performed, I don't believe that it is supportable in its present form but if it can be, you might say, rolled back to just reporting on I think it is AU 550 approach, then I think that would be a very good step forward.

MS. RAND: I just want to react to a couple of points you made. Kind of what you are suggesting at the end, your recommendation that we just stay with the standard that we have. Our challenge in using the standard we have today and having the auditor's report on that is the auditor's responsibility is read and consider.

And there are no procedures about what does consider mean. So, one auditor may do all these procedures and more. And we heard a lot in our outreach because we did ask, that was one of the alternatives in the release, if the auditor should perform additional assurance. We received a lot of feedback that auditors do a lot today in connection with consideration. But what is not clear to users is what is meant by consideration. One auditor could do a lot.

Another may read and not do much with it. So, we are looking for consistency in how auditors are reviewing that information. We do consider it important information, that there is no material inconsistencies, material misstatements of fact because the auditor's report is included in it. So, they are associated with that document.

The evaluation, the procedures in there, you compared a significant amount of work. Interested in reaction from the firms, our experience in developing the standard, we thought it was reasonable procedures. Again, it was consistent with outreach that we had conducted that auditors are generally performing a lot of work, a lot of these types of procedures, checking consistency of amounts. Checking to make sure that disclosures, what is in the financial statements, is not inconsistent with how it is being presented.

So, interested in other views on that, but just wanted to react to some of your points.

And Marty, do you want to add on?

MR. BAUMANN: Well, no, I don't want to add on but I want to concur with Denny that we don't want to create an AS 2-type environment. So, that is the reason why we put out a proposal and have SAG discussions around it. And hopefully, we will get comment letters that will -- if there are concerns around the nature of this, that it is not understandable or it is ambiguous or there is too many procedures, we will get those comments and certainly react to that.

There is at least some of us who have audited large companies at the PCAOB who, when we looked at this, said this is basically what we thought was pretty much existing practice in major corporations, at least, that basically the auditors felt this was part of what they did to read and consider. And certainly the audit committees and a lot of companies said we want you to read this information and make sure it is consistent with the financials. And if there is anything materially inconsistent, material misstatements of fact, certainly bring those to our attention.

So, I think our view is that a lot of this and these four procedures, so there aren't an extensive amount, there is four procedures, we felt was pretty much maybe a best practice that was already happening today in a lot of corporations, although we thought that there was probably varying practice among the 10,000 audits in the country.

But your points are all well-made and we look for comment if it is creating confusion, ambiguity or more work than is necessary. So I am sure we will hear that from firms or others.

Thanks, Denny.

MS. RAND: Brian Croteau.

MR. CROTEAU: Thanks very much. And it relates to these points, I think.

And Denny mentioned these words, and I hate to get overly technical but I just want to be sure that we are all thinking of an aspect of this that I think is embedded in the comments that were just made.

But paragraph 4 contains the words that Denny was reading from a performance perspective that get at the auditor should read the other information. And "based on relevant audit evidence obtained and conclusions reached during the audit" perform certain procedures. Paragraph 13(c), which has the report, contains those same words.

And it occurs to me that users of the report may not necessarily know what all of the evidence was that the auditor obtained. And so there is a limiting principle here relative to the auditor's work that has to do with what evidence the auditor gained in conducting their audit work. They are not expected, per the standard, although they may for other reasons but not for the standard, to go further and obtain more evidence in conducting this aspect of the work.

So, I think there is a limiting principle built in. Whether that is the appropriate limiting principle might be a question for people to comment on. And then how users will interpret the report, given that they won't know necessarily as a user what evidence the auditor obtained, I think is an interesting question that I would certainly be interested in feedback on either today or through the comment process.

But I thought I would just highlight that because I think that is an important element of what is being described here, relative to the limitations and what stops this from being a full audit, another element of what stops this from being a full audit, or something that is more like AS-2 if people think of it that way.

MR. BAUMANN: That is a good point, Brian. And we intentionally, of course, put that limiting factor in, that the auditor who performs these procedures read and evaluate in the context of information based on relevant audit evidence obtained during the audit.  And the point is that the auditor is not now intended to, supposed to -- not required by the standard to perform additional procedures to learn something about whether or not some product in R&D is going to be launched next year or not, if that is the statement being made in the other information, if that wasn't part of what the auditor obtained as part of their evidence.

And again, the procedures then are tied to, the four procedures are tied to what the auditor learned as part of the audit and then comparing that to what is in the other information.

But I fully accept your point, Denny, that we want to make sure that it is clearly understood.

And Brian's point goes to another issue, though, that there could be an expectation gap with this statement in here that we have read this other information and evaluated it, et cetera, that someone might think they did perform other procedures, even though it says in the report we did not audit this other information, did not express an opinion on it, and it was based upon what we learned during our audit but it has that expectation gap risk, potentially. So we wanted to get comments on all of that.

MS. RAND: Thank you. Richard Breeden.

MR. BREEDEN: Thank you. I think the objectives here are understandable and worthwhile. And certainly, the notion, as a member of an audit committee, that the auditor, in considering their work, has developed a conclusion that there is a material misstatement of fact, it doesn't seem radical that they should communicate that.

But the way this is drafted, material inconsistency and material misstatement of fact, to me that sounds awfully much like a violation of Rule 10b-5. That is fraud.

And so, asking the auditor to report on a formulation that sounds like a legal conclusion of fraud and if it is material and it is a misstatement of fact, it is unlikely to be accidental. There is almost certainly going to be an element of scienter in there.

Anyway, to me, I think you need to work carefully to make sure we are not creating something that becomes a rival legal review for the issues of fraud. And I am worried that this would trigger something. It could either be meaningless because the standard is such that if you are not -- if you haven't reached a conclusion, if all the element of a material misstatement are there, you wouldn't report it. And yet, the obligation to make that statement, if it is formulated in a way that is essentially a judgment of fraud -- if you want to say that auditors should report on any signs of potential fraud they have seen, that is one thing. But this is a legal conclusion that you may want to work on the formulation.

MS. RAND: Well, you raise a very good point. In the standard, we do point the auditor to our fraud standard when they identify material inconsistencies, material misstatements of fact. I think we recognize there could be a difference between the audited financial statements and the 10-K could be just an error. But we do point the auditor to consider the nature, you know, discuss it with management, go back to the fraud standards to consider if it is something more than that.

The current standard, under our current framework, the auditor reporting standard would allow the auditor to issue an unqualified report, even if there is a material misstatement of fact. They could include a paragraph and say we believe the audited financial statements are okay but we have identified this material misstatement of fact.

We are asking questions about the auditor's responsibility when something is identified and not corrected in their continued association. Kind of along, I think those same lines.

Did you -- you look like you were going to react to that.

MR. BREEDEN: Just the further observation that auditors are not experts in general matters of fact. And so when you go beyond the financial statements and into the realm of any misstatement of fact without qualification, that really can -- and without very carefully delineating, as Denny and others have said, what you have in mind, I think it would not be helpful to investors if you moved down the road toward competing 10-Ks. And the whole world of facts about a company's business that may be included in its reports get far afield from the financial information that the auditors are expert in reviewing.

So, that also is a slight concern of where this evolves to and making sure it is quite clear at the outset because that is a path that might lead other directions.

MR. BAUMANN: Richard, thank you. Those are all good points and we really have to consider those, especially the auditors are not in a position to reach a conclusion, necessarily about violations of 10b-5.

I just will point out, however, that under existing standard AU 500, which is the read and consider other information, so there is an existing standard today which requires the auditor to read and consider the other information to see if there is a material inconsistency with the audited financial statements. And it does go on to say if while reading that other information the auditor becomes aware of a material misstatement of fact, the auditor should discuss that with the audit committee and consider other actions.

So, there is existing auditing literature already that has this. So, we have built on that. So but nevertheless, even though we are building on that, we will take into account the concerns and considerations that you have expressed.

MR. BREEDEN: You might be better off having something where if the auditor is aware of an apparent inconsistency, they should discuss that, as opposed to keying it off a legal conclusion. And if the auditor is worried that what they have read is inconsistent with what they have seen, that is worthy of a discussion with the audit committee, and they shouldn't sit back and be having their own lawyers trying to evaluate has this crossed the line into an actual material misstatement of fact.

MR. BAUMANN: Thanks.

MS. RAND: Okay, Jerry de St. Paer.

MR. DE ST. PAER: Thank you. I seem to be in the piling-on mode today. But I hope from a little different perspective than the perspective that has been expressed, even though it supports that.

From the perspective of a CFO of a New York Stock Exchange company, with auditors who -- I couldn't tell you -- clearly, from their procedures, they were required to take a look at the other information, but we would never have issued it without them taking a look at it. So, I am not really sure what the chicken and the egg was there.

But I watched the way in which that procedure was done, and it goes to what Dennis said. There is a great deal of difference between making an affirmative statement of this kind and simply following the procedures.

Again, one of those companies that I was the CFO of happened to be one who wrote a lot of auditor liability insurance. And I can tell you that will cause the kind of reaction that Dennis was concerned about, where to be able to make that kind of a positive assessment, to go to the 10b-5 or the SAB-99 issue, you are asking the auditor to take an additional step. So, I would just also argue the caution.

But I want to also make a second point that I think is really important, is that we heard in the presentation yesterday about the volatility of earnings based on release of earnings. From the experience, at least, in the companies I have been CFO of -- and when I was CFO, I was pretty interested in what the stock price did relative to the release of earnings -- that volatility is almost all related to the press release.

What happens when the K or the Q comes out is very little additional movement. And so the whole issue -- we also, by the way, had the auditors review the press release to make sure that there was no material inconsistency or misstatement of fact, just to make sure that we were okay.

But there is a lot of non-GAAP measures.

The things that drive the market -- which is one of the things I thought was missing in yesterday's presentation -- the things that drive the market, with all due respect to the SEC and the design of all of the reports, isn't actually materially driven. It is at least equally driven by the non-GAAP information, in most cases, as it is by the GAAP information.

So, I just want to say while the concern about the risk you are creating by forcing this affirmative representation, to what Mr. Breeden said, is a big issue, and I am not sure it has got the elephant in the room. Because the thing that really is creating the biggest movement of share prices for the investors that are concerned about this information, actually it doesn't come out of the MD&A. What I found astounding in meetings with investors is that the questions almost always come -- they actually come before we ever issued the K or the Q. They came from the press release.

So, I would just like to caution to keep our eye on the ball here, that we are acting as if this other information is really the stuff that is driving investors.

And I guess maybe everybody here, all the investors, are going to say, oh, well, we look at all that stuff. I can say from my side, in talking with all my investors, that is not where the questions came from.

So, just in terms of priority, this will, I'm sure, involve additional scope and expense and I am not sure about the cost and the return.

MR. BAUMANN: Those comments we have heard from others. And I look to the left of the room over here to Mike. We have often heard about what really drives the stock price and what investors are really concerned about is probably in much earlier releases than the 10-K. So, we have heard, certainly, that comment before.

To some extent we are limited, in terms of the auditor's responsibility, that they have to audit financial statements and report on financial statements and what's associated with the financial statements, you know, their responsibilities can go to that, too.

At least right now, under our authority, I don't believe, speaking for myself only, that we could require an auditor to perform procedures on that press release. But we've heard that from Mike and from others that that would be very valuable if auditors were required to do that. But at least speaking for myself, and only for myself, I don't think we could require auditors to do that under existing authority that we have.

But one thing I will add, many, maybe not all, but many of the -- much of the information that gets in that press release that drives the market at that time, and the non-GAAP measures, are also in that 10-K and are discussed in that 10-K. It's usually the same type of information around a non-GAAP measure or the performance that was previously discussed in a release is in the business section of the 10-K.

Management, knowing that the auditor is going to read and evaluate that 10-K, which includes probably those same non-GAAP which the auditor would have to, under these standards, see how they are reconciled to the financial statements to be not misleading and create a material inconsistency with the financial statements, I think has a deterring effect on management's behavior when they come out with that release, knowing that the auditor will be performing procedures on that information later on.

So, I fully acknowledge what drives it. But knowing that that same information is likely to be in the 10-K, to be read and evaluated at a later date, I think has a deterring effect in addition.

So, I'm interested in your comments on that. I wish we could have the auditors do more up-front. And I know you want to comment even further. You're anxious to say something here.

MR. DE ST. PAER: I am. Because of the legal environment, at least in our case, we didn't release the press release until we had virtually a complete draft of the 10-K and the MD&A done because you could not possibly have a situation occur -- well, at least I don't think a responsible person could put out a press release where a few weeks' later you are going to put out a 10-K. You virtually have to be almost at the point where they auditors are pens down by the time you issue the press release, or you're taking huge liability.

And, actually, I was surprised Brian's card didn't go up because the truth is what happens if you don't put a reconciliation of the non-GAAP measures in the back of that press release or the supplement information that you put out which reconciles to the audited information, the next call comes from the SEC. I mean, I have had the opportunity to have that conversation with them.

And rightly. That is not a criticism. That is as it should be. But there is a reconciliation and the audit's not done. So, people don't put out press releases hoping that they get within the range of the 10-K. Most companies have this stuff all come together at the same time.

MR. BAUMANN: Thanks for that additional color and valuable input. Walt Conn is next.

MR. CONN: Yeah, in my firm, we are still developing our views on parts of the standard and particularly our comfort with the words in the report.

But let me just circle back to Denny's question on the procedures that are in here. I think, in general, in my experience, these procedures are consistent with what we do today. However, there are a couple of words or phrases that give us pause and we're formulating our questions or recommendations on those. But we want to be sure there is clarity about whether the scope of our work should expand beyond what it is today and whether our responsibility should expand.

One of the changes that gives us pause is the change from "consider" to "evaluate," because if evaluate means "do these procedures that are listed," period, then maybe that is okay. If evaluate means "do these procedures and whatever else you need to do to conclude that you have performed an evaluation," then that probably lacks some specificity that is needed.

The other change that gives us pause is that the reference to consistency with the financial statements, in the proposal now adds consistency with the relevant audit evidence. And that seems to be a subtle expansion beyond where we are today.

MS. RAND: Walt, to respond to that, you asked about what does evaluate mean. The way it's phrased in the standard, we have evaluation based on the procedures in paragraph four.

So I don't know -- and continuing your thinking on that, if you are just concerned about how that may be perceived in the report, but at least the way it is proposed in the standard, it's based on those four procedures in paragraph four.

MR. CONN: Yeah, and we realize that, and are just struggling with that choice of words, whether it will be clear to all stakeholders that evaluate means "just perform these procedures." Because we think of evaluate as not being limited to specific procedures but going beyond that.

MR. BAUMANN: Good points and we'll think of that as we consider where to go with this. But it was interesting to hear your comment that you think largely these are the nature of the things you do today, but with a careful looking at each of the words to make sure that they are the same as what you do today.

MS. RAND: Thank you. Damon Silvers.

MR. SILVERS: I just wanted to comment on the issue of whether or not material inconsistency and material misstatement of fact are necessarily a legal conclusion.

I mean, I think that the issue that has been raised is an important one to get right. But that without a statement about scienter here, it's not a legal conclusion, at least with respect to 10b-5. And I can't see how you could even -- I can't see, if an auditor were aware of a material misstatement of fact under the current reporting rules, that an auditor could sign the letter certifying the financial statement.

So, it's not clear to me this even, at least as stated on this slide, that it necessarily even represents an expansion of the auditor's current duties. And as long as you don't add a scienter component to it, I don't think it represents a legal conclusion.

MR. BAUMANN: Thanks, Damon. Wally Cooney.

MR. COONEY: Most of the concerns that I had have been covered one way or the other. So, I'll just comment that I share the concerns about the expectation gap. While it's helpful that the opinion drafted clearly says that they did not audit this other information, I think that's important, the word evaluate, even in the context of specific procedures, I think could really cause a problem with respect to expectation gap.

And just in practice, now that the auditors will be commenting, at least providing negative assurance, on the other information, I think sometimes that has the practical effect of just taking on a life of its own, including getting into non-financial information, and a lot of work, a lot of discussion, a lot of higher and more experienced people spending significant time on going through all that information. And I think there could be a significant cost effect.

The only other concern is that to the extent that MD&A is supposed to be through the eyes of management, it really is supposed to be management's report. I have some concern that companies may want to limit disclosure, maybe water down some of the commentary that they might have otherwise felt was more transparent and comfortable saying, but not having it subjected to the scrutiny of a long, drawn-out review process and discussion.

MS. RAND: Thank you. Professor Cox?

MR. COX: I think it would be helpful if you could separate these two issues out into two things. One is the process. Exactly what are the documents that are to be looked at and what the procedures are to be by the outside auditors, what they are supposed to look at, in which they are going to formulate some sort of opinion.

And then the other question I would say, separate from that, is how and to whom you communicate that. Richard Breeden made the observation, and never underestimate the power of a modifier: appropriate. And I think that that's something worth thinking about.

But the other idea I would put out there to take also some of the steam out of the process and some of the angst out of the process, is to work this a little bit through the existing legal framework and think that maybe investors are not the group. That a big full-blown evaluation or reporting on the evaluation to all the investor community is not where you want to go. You would say add to your standard that conversations have been had. That your duties are to see if there are any apparent inconsistencies, and part of your obligation is to communicate those to the audit committee. In which case I would think that that then triggers the existing format for what happens to auditors in certain situations under 10(A) of the Exchange Act.

And that could be a way of at least making this initial step. I'm not sure where we are going to be ten years from now in terms of this process, but maybe this would be a somewhat more palatable process to going through.

But I do think it is going to be useful to you to unpack, first of all, what you want the auditors to do from the question about how that then gets communicated and to whom.

MS. RAND: Thank you. We have talked, just reflecting on the comments so far on this subject, talked a lot about the procedures, what does read and evaluate mean, the work effort. I haven't heard that much, though, on the point regarding usefulness of reporting.

In our outreach we had heard, in one of the alternatives presented in the concept release on whether or not the auditors should provide additional assurance, was not to provide additional assurance, was really just describe the responsibilities that the auditor does with respect to the annual report. So, that was our intent. It initiated from a reporting element, thinking that might be useful.

So, I'm interested in feedback on that. We did feel that the current version of the report, just the read and consider with no procedures, wasn't robust enough to support a reporting statement in the auditor's report. So, we felt we needed to make some enhancement, have some minimum set of procedures regarding what the auditor does, their procedures over the other information.

But interested very much in is having the auditor report on, whether it's consideration, evaluation, is it used in the auditor's findings, is that useful to investors. So, hopefully, any other comments or if anyone that has their comment cards up now has any reaction, I am interested in thoughts on that.

Next, is Gaylen Hansen.

MR. HANSEN: Jennifer, I absolutely think that it would be helpful to clarify this aspect of what auditors do. And I agree with what has been said. A lot is done now, and I think that what you have done here is responsive in large part to addressing that issue.

I will try to bring out just a couple of other things really quickly, though. Who does this? And it's not the firm. It's people within the firm. And I think for it to be meaningful it needs to be senior individuals on the engagement team. And all too often I have seen this delegated to lower level staff people.

And that tends to be a focus on the numerical aspects, as opposed to the qualitative, the nuance, and the spin and the tone. You read the financial statements and they have one tone. And you read the forepart of the 10-K and it is almost a completely -- it seems like it's written from a completely different perspective. And particularly when it comes to minimization and exaggeration and the wording in which you couch certain things I think does impact the way investors might approach things and consider the company.

To your example, making widgets and characterizing yourself as the leading manufacturer of the widgets when you know you are the third, well, a lot of times what I see is someone saying we are a leading manufacturer of the widget. And you know perfectly well that's not the case. It's a misstatement but it's not numerical. And for a lower level staff person to be able to pick up on that, I think, is asking a lot of them.

So, I think that who does this and the tone and the spin and focusing on the qualitative is just as important as the numerical.

MS. RAND: Thanks, Gaylen.

Steve Buller.

MR. BULLER: Thank you. First of all, just a couple clarifying comments. One is I thought there was the inference earlier that a material misstatement may be fraud. And, certainly, there are conditions where you may have errors or typographical issues that of course, you know, occur. And as long as there is not intent or knowledge of the misstatement, I don't think, as a non-attorney, that would be something I would classify as fraud.

And secondly is with respect to just the timing of press releases and 10-Ks. There are some companies that do produce a 10-K and a press release concurrently, but quite often it is because they material information that they need. Quite often it is codependent upon a third party and they can't obtain that in time to provide an earlier press release. But most companies do a press release two to three weeks after quarter-end or period-end. And so that does proceed to 10-K in most situations.

But they do, of course, make sure the information that is in the press release is, in fact, accurate because most of it does, as you said, Marty, appear in the 10-K.

So, the main question is we do support clarifying the responsibility for other information. I think it's a good idea. I think, generally, I am concerned it could be an expansion of scope, especially if the other information includes documents that are incorporated by reference. I know when I go through our 10-K and through others, incorporated by reference documents often are two or three pages long of listings. And our concern, of course, is that it would take auditors just time to read that listing, let alone to read the documents that are included in there, just to see if there is information that may in fact be relevant to the audit.

Then, lastly, is I think that as part of the auditor performing their work, even though I know they are supposed to consider and evaluate information that's based upon evidence that has already been obtained.  If I were an auditor and I saw, for example, information that had a number of factors, one of which was information that was based upon audit information that I had obtained to do my core financial statements, but there was other information I had not obtained, or did not have, I would make sure my audit planning included getting that information as part of my audit.

So it may in fact be that there would be an expansion of the scope just to CYA, in part, to make sure that where there is information presented with information that would not otherwise -- would only be obtained as part of an audit that now becomes part of the audit planning process and therefore is obtained as part of the audit.

So, again, it's probably just the discussion of the expansion of scope.  Thank you.

MS. RAND: Okay, thank you, Steve. Elizabeth Mooney.

MS. MOONEY: Okay, thanks. I think it would be great if the earnings release and the 10-Qs would come out at the same time. That would be fantastic. And some companies do do that.

Obviously, investors do respond. Marty, just to echo your comments, I mean, they do respond to the most recent information, whatever that is, and the earnings release is significant.

But my experience, I had the great fortune of working with the best and brightest. I believe, investors, analysts, and for the long-term, fundamental research is all we do. And they do read the 10-Qs extensively and the 10-Ks.

So, I think, in terms of the other information, I said this earlier, but the goal, and we're getting a little sidetracked with a lot of this, but the goal is if the auditors are aware in their work of material misstatements otherwise, like Gaylen mentioned, that there is some responsibility to fix it.

I mean, I think that's the end goal and not just be silent. And I think that is the spirit of the project and just I would encourage you not to lose sight of that.

MS. RAND: Thank you. Rick Murray.

MR. MURRAY: Jennifer, a question, and a brief explanation of why I ask. The question is is it correct to understand that if the additional information that's at issue is itself not material, then it is impossible for that information to produce a material inconsistency or a material misstatement?

And the reason for the question has to do with the rapidly emerging movement now called integrated reporting, which really has two prongs. One of which is the view of many, that there should be more attention to sustainability-related information included in financial reporting as a voluntary, non-material election by reporting entities. And the second prong, best illustrated by the work of the Sustainability Accounting Standards Board, suggests that all sustainability-related information should in fact be recognized as material.

And it's that duality of position at the moment, and what will be, I think, a very rapid evolution to sustainability reporting issues arising in the next few years, that I direct the question. Because those issues would be a great deal easier to deal with if there were two points of clarity. One is the answer to my question and the other is what standard of materiality will be applied in making the determination of what falls within the scope.

MR. BAUMANN: I don't think I have an answer to your first question, whether or not one could conclude that if there is no other -- if the information by itself is not material, could you have a material misstatement or a material inconsistency.

There is requirements of what has to be included in a 10-K under the Securities Act. And I don't think we've thought through whether that information, or some of that, is by definition not material and therefore it wouldn't be subject to a consideration of a material inconsistency or material misstatement of fact, or whether a company decided to put in other sustainability information and how that might fit into this equation.

I think you've raised some things for us to think about with respect to that, but I don't think we have really explored that thought as part of this proposal. So, I will just say we will take your comment and note it and give it some thought.

MS. RAND: Okay, Wayne Kolins.

MR. KOLINS: Yeah, thank you. With respect to the reporting and the relationship of that to the limited nature of the procedures. And the procedures are more than read and consider and probably is similar to what is done currently in practice. But the conclusion is the negative assurance that was mentioned before is something that you see in a review engagement.

These are not review procedures. I think they are probably something less than review procedures. And I wonder if a way around that would be to specify that these are limited procedures, describe what the auditor's responsibility is to see that the information is revised, and if it's not, to refer to it in his or her report. And the absence of any such revision would be implicitly that they auditor did not have an issue with it. That the auditor did not become aware of anything.

Just an approach to take care of the very limited nature of the procedures and the ultimate reporting on it.

MR. BAUMANN: We understand that point and understand the careful line between the nature of the type of assurance being expressed and whether or not the procedures are the right procedures in connection with that type of assurance.

So, we gave a lot of thought to that in putting this out, but we'll continue to do that based upon those kind of comments. Thank you.

Who was next? Bill Platt.

MR. PLATT: Thanks, Marty. Just as I listened to the discussion, I sort of have two observations around this. And this is one area of the proposal that we spent a lot of time thinking about.

One is the performance of the work. And I think largely I would say that the procedures that are laid out in paragraph four may in fact be fairly consistent with what people are doing today in read and consider for a portion of the other information.

And when I say that, you really think about the other information. There is other information that is derived from the company's accounting records, was subject to the company's internal controls, and has been the subject matter of the audit. The audit tests have been performed around it. But then there is other information that is not related at all to the company's accounting systems or systems of internal accounting control.

And I do think that in 4(C), I think, would be this characterization of other information not directly related to the financial statements. I don't know that it is clear enough for me to know what I would do as an auditor to that information.

And right now you sort of would say, well, if an underwriter asked me for comfort and started circling a bunch of items for me to give comfort on, I would give comfort on the items that are derived from the accounting records or subject to the internal accounting control, but I would say that the other information is outside the scope of my audit, it's outside of the areas of my expertise and I wouldn't give comfort on it.

So, I guess I worry a little bit about this other information and what the expectations are and are we changing kind of the performance expectations or standards around that information. And if we are, I think we need to be clearer than this simple reference that's in 4(C) right now. So, that would be the performance side of it.

The other side that I had is in the reporting now of what's been done. And we are creating maybe a new byproduct level of service called an evaluation. We evaluate it. And, to me, I think evaluation implies something more than I considered in relation to the information that I had as an auditor. And I wonder whether or not the report is actually being set up in a way that will create an expectation gap, notwithstanding what the standard requires, which is consideration of consistency, but evaluation getting to a point that one would say, well, that to evaluate then you just have drawn a conclusion, which might then go beyond and actually start having piecemeal opinions on pieces of information that are in the other.

And this might go a little bit to Rick's question about immaterial information. Say you had a $10 billion company that had no real estate at all, 10,000 square feet of office, it just happens to be a very virtual company, and it was misstated by 2,000 square feet. It's material to the square footage of office space but is it material to an investor as you sort of look at that?

So I think some of those questions about materiality may actually come into play here if there's going to be an explicit statement that there wasn't an identification of a material misstatement.

So, I think that those would be my two places that I would suggest further thought around. One, is what do we need to do around information that's not from the either accounting records or subject to the system of internal controls over financial reporting? And, secondly, to make sure that we don't create a reporting format that is creating an expectations gap but truly is providing informative information to users of financials.

MS. RAND: Bill, do you have the paragraph 4(C) which you referenced, which is other information not directly related to the financial statements? That could be the example I gave about the leading manufacturer of widgets and the company purports to be that but you know that they are not. They are the third.

MR. PLATT: So, what if --

MS. RAND: Do you have a view as far as should the auditor ignore that or, you know, kind of what should the responsibility be?

MR. PLATT: But what if we have two auditors that one happens to know that and the other doesn't? Is the inference that you always should know that? And what happens if, for example, there is a lot of different ways to measure leading?

So, they manufacture more widgets than anyone else in the world from a unit perspective but they are the third in revenue because they manufacture cheap widgets and other people manufacture premium widgets. Is that something that is a material misstatement of fact or not? There are two leaders, depending on what metric you use, if you use total revenue or you use total units.

I think it introduces a lot of interesting concepts. And I also don't know -- I mean, I might think that I know that they're third, but I really don't know from my audit. I only know from other public information that's out there that everybody else can see, too.

So, I think even though you have a simple example, I'm not sure it as simple in the real world when you really try to apply it.

MS. RAND: So I'm assuming, and I'm not sure if it's a correct assumption, that you may be more supportive of the responsibility today, just if the auditor becomes aware of something. But I think what I'm hearing is you are concerned about the reporting on that aspect, the material misstatement fact.

MR. PLATT: Or the pieces that go -- for the pieces of information that are not derived from accounting records or subject to internal controls. I think I would say yes.

MR. BAUMANN: So, of course, we do say -- so, these are in context of you should read this other information and, based on relevant audit evidence obtained and conclusions reached during the audit, evaluate things.

So, it's not requiring you to evaluate that other information not directly related to the systems, based upon some new procedures. It's whether or not, when you were reading the minute, understanding the company and its environment, as part of those risk assessment procedures, you became aware of aspects of the company and their position in the marketplace, et cetera, or the growth opportunities or other things that when you finally read the other information, based only on procedures you performed during the audit, the risk assessment procedures and all of that, you became aware of it.

So, we do have that limiting factor. It may not ameliorate your concern but that was the intent of those words. You don't perform additional procedures. It's based on what you know.

So, the answer to your question would be one auditor might know with respect to a statement management makes that that is an inconsistency or a misstatement of fact, and another auditor might not know that because they didn't come upon that in their risk assessment procedures. So, that is a possibility, because it would be based upon what you learned as part of risk assessment. So, that is a possibility.

But the other point, I think, and you've made a lot of good points there, Bill, is there is different ways to understand leading. We just hope that that would trigger a conversation. If the auditor thought there was a misstatement, it doesn't mean the auditor is going to report that. We just hope that would trigger a discussion. And I would hope it would trigger a discussion between the auditor and management about let me understand the context in which you've said that. I thought I understood something different. And maybe it would trigger a conversation. If that wasn't satisfying with the audit committee, et cetera. But hopefully that would be resolved before somebody reported something.

MR. PLATT: Yeah, and I think those conversations largely take place today, Marty.

Just on the point of the other information, though, you know, and I think sometimes, in terms of a layman, and to say that there is other information that I don't have anything in my knowledge base to know anything about and therefore I say, well, I don't know whether it's true or not true but because I don't have any information from my audit to evaluate it, I'm going to be okay it. And then to characterize that as you have evaluated, it seems to me it may be setting up what I described before as that expectation gap. It's sort of odd to say that is an evaluation just because you didn't know anything.

MR. BAUMANN: I completely understand your point. Thanks.

MS. RAND: Okay, Dan Montgomery.

MR. MONTGOMERY: Thank you, Jennifer. And just getting back to your earlier point on just some input on the usefulness of reporting on other information, and just to give a little bit of international perspective on that. The IAASB did consider the alternative of simply acknowledging in the auditor's report the auditor's responsibility for reading the other information, reading and consider, reading and evaluate, whatever the terminology, and perhaps indicating a responsibility to discuss any issues identified with the audit committee.

But the IAASB heard very strongly through two public consultations, three public roundtables, and a significant amount of outreach that there is value to an affirmative statement by the auditor in the auditor's report on the auditor's responsibility for other information and the outcome of the auditor's work effort.

So, just the point in terms of usefulness, the IAASB is firmly committed to moving forward with an affirmative statement on other information in the auditor's report. This was something that was supported not only by investors, but there was strong support from regulators, from national standard setters and from other stakeholders globally to move forward because of the value of that statement in their view.

However, I also would point out that the IAASB will continue to look at the wording of the reporting language so as to not create any confusion or misunderstanding or certainly not further expand the expectation gap, and will be doing so in connection with its further work on finalizing the revision to the IAASB other's information standard, ISA-720.

MS. RAND: Thank you, Dan. That's helpful.

I see a couple of other cards up and I don't know if they're just up from previously: Steve Buller and Wally Cooney. Okay.

I have according to my watch that it's 10:30, which is break time. We've got a 30-minute break scheduled. I wanted to see if there was interest, anybody had any other topics -- I see one card up -- on other matters. So I see a couple. I would like to take those because I think, even if we have a little bit shorter break, we would still be okay. So Mike Cook?

MR. COOK: Thank you, Jennifer. I just have a sort of overall observation about a lot of the things that have been talked about, sort of the question you haven't asked. And I guess I think it's okay to answer it if you didn't ask it, but it's not a definitive answer. But one of the questions to me, an important question, is cost-benefit. What are the costs that we're going to impose by whatever we end up doing? And what are the benefits going to be? I know the economists get involved, and a lot of other people get involved in that. But that is a very important issue. So I'd like to take the opportunity to comment on that.

Many of the people who offer comments say, "I appreciate the opportunity to talk about this subject." I have talked about this subject, the auditor's report, for so long I don't know for sure that I appreciate the opportunity anymore, but that doesn't keep me from offering a few thoughts.

And then I would like to give you one suggestion from the perspective of an audit committee chairman that might really produce a benefit with whatever you ultimately decide to do. And I'll save that for the last.

As I look at the cost-benefit of this, like a lot of things, the costs are more obvious than the benefits. If you accept, this will make investors better informed as an overriding consideration that drowns out any cost issues. You can get to that answer pretty quickly. I don't think of it that way, and I don't get to that point. But for me, the cost, the dollar cost, of implementing what we have here or some modified version of that is going to be significant. So the benefit has to be significant, and I can't quantify either one of those for you.

We will divert audit attention from things that matter in terms of audit quality. We may do it depending on how this gets implemented at a time of the year after the end of the year when we need all of the attention we can get to the critical things that need to be done to complete an audit. And doing this, critical audit matters, writing them up, getting them reviewed, talking to 14 different people, I don't think is going to meet a standard of adding to audit quality.

I think there is a real risk of obscuring the key messages that do need to be delivered. I happen to like the pass/fail. I don't think we are abandoning that. But if you have a hard time finding it or when you find it, you are not sure that you did pass because you got so many other things in there that might indicate that you really didn't or you barely passed, I think that is a serious issue.

I am quite concerned about the issue of original reporting, auditors reporting things that are not being reported through management, through the financial statement process. I am very concerned about some of the discussion about disclosure and essentially creating new disclosure standards through a requirement here, such as with respect to material weaknesses and significant deficiencies. I don't think that it is in the prerogative or the parameters of the PCAOB to be writing disclosure standards indirectly.

So I would point all of those things out as being costs that are of concern to me. Then I get the benefit. And I'll make a prediction, which I can't substantiate, but I think a lot of people might see it the same way. And I have heard it described.

I will predict that this will become lawyerized boilerplate. And what we are trying to achieve, like a free hand where the auditor gets to sit down and write how they did the audit of company X and what bothered them in doing that, will be totally overtaken by the need for uniformity, legal considerations. And what we will see two or three or five years from now, when we look at it, is going to be boilerplate that is not particularly informative. I might be wrong. That is my opinion of the way this will play out.

And I then put all of those points together and say, does it meet the cost-benefit test for you? For me, it does not. And so I just offer that. It's not quantitative conclusion. But I think the need to step back and really ask what costs we're imposing, financial costs and diversion costs and unnecessary information costs, the kitchen sink that we're going to get, which I happen to agree with, when you start adding all of those up, the benefits have got to be very clear and very direct.

I also would observe, however, that I think this train has left the station, meaning I think I've heard it said often enough in the last day or so "We have to do something." I'm not compelled to conclude that we have to do something if we're not doing something that meets the cost-benefit test and is the right thing to do. But there apparently is a conclusion that we've got to do something here. So if you have to do something, then I would just say, you know, think carefully about the implications of what you're doing.

This last discussion about other information is very much on point, I think, with that issue. I didn't really want to get into it because it was being well-said by others. But the word "leading" is not a fact. And if you're leading people, using that word, into challenging that as a statement of fact, there are many accounting firms in the United States who claim to be the leading firm. That is not a statement of fact. Largest is a statement of fact. That is quantitative and could be challenged. It is just an indication of the areas that you can be leading people into that are going to be very problematic. And I like to know about these things as an audit committee chairman.

I would like to go to one other phrase that is used by members of the Board and others. I want to know what keeps the auditors up at night. And this is now my request to you. As an audit committee chairman, I want to know what keeps the auditors up at night, but I don't want to find it out next February or next March. This is my standard pitch. I'm not going to give you the big story about timeliness. And for the auditors to be writing next February or March about what kept them up at night in this year, when it's relevant to know that, from an audit committee standpoint is not satisfactory.

So I would urge you please if you are going to go forward with this, either in this standard or by rewriting or amending the standard on required communications with audit committees provide for this information to be given to the auditing committee on a timely basis. I want to know today what is keeping the auditors up at night. I hope they don't have anything like that, but I really am not interested in finding that out next March. And I represent the investors in our company. And I need to know that information now. And I don't see any reason why you can't build a requirement to that effect into whatever conclusions are reached about critical audit matters, but timeliness is very important.

Thanks for the opportunity.

MR. BAUMANN: Thanks, Mike.

Obviously we will clearly explore the economic rationale behind all of this. We have done that and discussed that to some degree in the proposal itself and certainly as we think about next steps, whether it's a group proposal or adoption, we'll clearly have to articulate the economic rationale of the need for this, various alternatives you may have considered to solve whatever the need is and, you know, what are the costs and related benefits. So that is something that's, without a doubt, things that will -- we will definitely do that. And whatever we ultimately issue and adopt will certainly reflect a very thoughtful economic rationale behind it. That's part of our mantra to do that.

I don't want to cover too many -- you made a lot of good points. And certainly we'll think about all of them. To your point about hopefully no auditors would keep this from the audit committee until the time of the annual report being issued and the opinion, AS 16 has in it already the communications with audit committees a statement that communications with the audit committee should be done on a timely basis. We can always think of reemphasizing that and making requirements in a different way to ensure that they are timely if that is not occurring, but that is certainly built into AS 16. So this in no way contemplates that the audit committees wouldn't hear about the issues that keep an auditor up at night on anything other than a timely basis.

But thanks for the comments. They are the valuable things for us to think about.

MS. RAND: Okay. I see three cards up. So I'll take those, and then we'll go to break. So Bob Hirth?

MR. HIRTH: Thanks, Jennifer.

I had one comment on critical audit matters from yesterday. In the draft standard on page A1-8, item 10, it talks about when financial statements are presented on a comparative basis and talks about where critical audit matters from the prior period might be restated. It talks about for the first time that information is presented publicly and also where there's a prior period where the auditor's report could no longer be relied upon.

I think what is missing there and I think you might add as a third point, where there are meaningful or significant differences in critical audit matters between reporting periods. What I mean by that is financial statements are generally presented in pairs.

And if you only have the critical audit matters of the most recent opinion, you're going to ask me to go back and find last year's opinion, which was the current year's opinion, and look at those critical audit matters. So if I had five critical audit matters that were exactly the same between both years, fine. What if I had five in one year and six in the previous year or five and some of them were different? So I think you need to ask the question, where you have that, should that be considered in the standard?

My second point was we've had a great discussion over the last two days. And this is a really, really important change. And, to Mike's point I think on the costs and benefits, I would really encourage the Board to think about how you monitor this with, you know, multiple parties but clearly the investors, the filers, and the audit committees, and get some feedback but also think about whether or not this is so important that we go back and report back to the SAG in a year or two on what the findings were from those studies on the costs and the benefits because this could be a standard that either continues or gets revised or when you really sit down and look at it and look at all of the benefits, you know, they weren't there and that becomes superseded in some way.

MS. RAND: Thank you, Bob.

Elizabeth? Oh, go ahead.

MR. BAUMANN: Just one comment to Bob's. And that is we have already announced that after the comment period is over, which is December 11th, we'll analyze those comments. And they certainly have a SAG meeting next May, but we also have already announced that we plan to hold a roundtable, some type of forum to discuss the comments that were received and a focused meeting just on the auditor reporting model as well as probably a SAG discussion in May. So we intend to get continued outreach and reaction beyond the many comment letters we get to make sure that we get all of that kind of input you're talking about.

So those are valuable points, Bob, and we plan to do that.

MR. HIRTH: And maybe just one step further. So would the idea be because we have these different parties that have, you know, different viewpoints? Would you even think about seeing that a third party does some kind of study or engaging some third party to really look at the costs and the benefits, you know, a year out or two years out or three years out?

MR. BAUMANN: Well, as Jim mentioned yesterday -- well, first of all, we have economists on board. And we'll be thinking, as I clearly stated, I hope, that nothing would go forward until we did a thorough economic analysis of why we're doing what we're doing, what's the problem we're trying to solve, and making sure that we're solving it in an economical way.

But we're also building the capability in the Center for Economic Analysis at the PCAOB to look at ways in which after we issue standards, the effectiveness of the standards and the benefits of the standard vis-à-vis the cost. So we want to continue to build that capability at the Board.

So thanks a lot.

MS. RAND: Elizabeth, I had you next on my list.

MS. MOONEY: Yes. Okay. Thanks. I just wanted to go back to the point I made earlier just about the critical accounting matters and encourage you to be clear in defining that and use the existing standard that is required. So auditors should report the matters that are significant in accordance with the accounting rule. So it's already defined in the documentation standard. And that should be -- you know, so going back over what work has already been done, what has already been identified as significant, and then talking about that. Rather than introducing a significant amount of additional unnecessary judgment, we have, you know, lots of different perspectives, even in just this room.

And I think, with all due respect to, you know, auditors having lots of different views, I think if you introduce that into this, then it is just going to be a huge loophole that is unnecessary.

MS. RAND: I am not sure I fully understand your point because you made reference to the documentation standards. So in my mind, I was thinking about the engagement completion document, which auditors document significant issues and findings --

MS. MOONEY: Right.

MS. RAND: And in developing the proposed auditing standard, it would have the auditor look to that engagement completion memo, the matters discussed with the audit committee, any matters communicated to or reviewed by the engagement quality reviewer. And then we have a definition of critical audit matters, which would be helping the auditor to identify not that entire population but those that are most significant to be communicated to investors in the report, rather than have a lengthy list of everything that might have otherwise been communicated.

So I wasn't clear on if you're thinking that our definition as proposed may be sufficient for purposes of communication or if you're --

MS. MOONEY: No. I think the proposed definition is insufficient because it doesn't -- it should say, I believe, that what should be reported is what is significant in accordance with the current standards, now, not everything but the completion engagement memo to the extent that that talks about what is most important.

MS. RAND: Okay. Thank you. I understand.

And Arch?

MR. BAUMANN: Final word.

MR. ARCHAMBAULT: Thanks, Jennifer. There was an item on the slides yesterday we didn't get a chance to talk about in detail. And that is the documentation. And there was an aspect of that. And, again, my firm is still in the process of developing our letter, but one thing I have raised in connection with this documentation is that it seems like an extremely onerous requirement to document not only those matters that you have identified and believe are critical audit matters but those, and I think the words are, that appear to be a critical audit matter but are not treated as one. So you're trying to document the negative. And the current documentation standard of the Board in my view is very robust.

I am not aware of anything where we have to document the negative. In other words, we will do a risk assessment.

We document those areas that we feel have a higher risk material misstatement. We have to document how we respond to those risks. We don't have to document those areas that we don't feel have a higher risk of material misstatement. And that's what this standard is directing us to do from the way I read it. And to me, that is going to lead to a situation where I think auditors are going to get extremely cautious to avoid any second guessing.

So I ask you to take a careful look at that and really decide whether that kind of a requirement is necessary here.

MS. RAND: I am glad you raised the documentation requirement. In developing that requirement, we considered whether it should just be only document those in your work papers, where the auditor did report a critical audit matter.

Our concern was the determination of critical audit matters is judgmental. It's those that were most difficult in forming the opinion, most difficult obtaining evidence, just had subjectivity and difficulty. So that determination is judgmental. And so if the auditor just determines, leaves something critical off, then what would be the safeguard to prevent a matter from appearing in the report?

We thought that if there is an issue that would appear to an engagement quality reviewer, that would otherwise appear, which is an experienced auditor, to have met their criteria, then that would be -- and was not communicated in the report, then that matter or matters should be documented so that the engagement quality reviewer would understand the rationale.

So we thought having that, kind of requiring the auditor to document it, it may have been something that was discussed significant with the audit committee that an experienced auditor would otherwise say. That should have been in the report. Why wasn't it? We felt that was a safeguard. We didn't think that the nature of the list would be extensive in our view.

And I know Marty is jumping up. So I don't know if you have anything further to add.

MR. BAUMANN: Well, I just want to -- you raised a very good point. And we expected to hear commentary on that. So we're glad you brought it up. And I'm sure it's going to be in the letters.

I think Elizabeth's point was require specific things to be reported and have what's reported as critical audit matters based upon specific things that are mandated in our standards that you have to report on all of these things in the audit report. And that's one way to go.

And so her comment was standards-based, write rules, pretty much like AS-16, communications with audit committees, take a subset of that, and say these have to be communicated in the audit report. Then that's one route to go.

The other route was the way we went, which was what was in the auditor's view the most difficult, subjective matters that he or she faced. But the problem with that was that there is a risk that Jennifer pointed out. What is the safeguard that the auditor will not under pressure or whatever, decide that I'm not going to put this matter in because management and the audit committee don't really want me to. What is the safeguard around that risk?

And so we had to think about that risk, that that could occur. And, therefore, maybe a documentation standard, something that might appear to an experienced auditor, to meet this, the standard, has to be documented.

So we understand your point, that it gets to whether or not we keep this as a judgmental based upon what the auditor believes are the most difficult matters to be reported or really change our threshold to say it is mandated that these items have to be reported and go to what Elizabeth said. Just put it in the standards, "This has to be reported in the audit report."

So that is a threshold decision for us. And the way we put it out in the proposal was one way, but based on comments, we'll reflect on maybe what some others have said. Do this according to standards and rules.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR'S REPORTING MODEL

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PUBLIC MEETING

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WEDNESDAY, APRIL 2, 2014

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The public meeting convened in the National Ballroom in the Westin Hotel, 1400 M Street, N.W., Washington, D.C. at 9:00 a.m., James R. Doty, PCAOB Chairman, presiding.

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JEANETTE M. FRANZEL, Board Member
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GAYLEN HANSEN, Immediate Past Chair, National Association of State Boards of Accountancy (NASBA); Audit Partner, EKS&H LLLP
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MARTIN F. BAUMANN, Chief Auditor and Director of Professional Standards
JENNIFER RAND
JESSICA WATTS
JENNIFER WILLIAMS

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P-R-O-C-E-E-D-I-N-G-S

9:03 a.m.

MR. DOTY: Good morning. This is an open meeting of the Public Company Accounting Oversight Board. We've assembled a distinguished set of participants to assist the Board over the next two days in an in-depth discussion of the PCAOB's proposed standard on the auditor's report and the auditor's responsibilities regarding other information in certain documents containing audited financial statements.

I want to begin by thanking the panelists for their contributions. All of us have many competing demands on time, they especially. And many of them have traveled a long way to be with us. I'm grateful for this extraordinary effort, and we want to assure all of these panelists over the next two days that their effort is appreciated and will be given very deep consideration.

I want to also thank the staff of the SEC for their counsel and support as we've advanced this standards setting project. In particular, Deputy Chief Accountant Brian Croteau is present as an observer, and, Brian, I want to invite you to participate any time as you see fit. Raise the flag, and you'll get the floor.

Former Chief Accountant Jim Kroeker is also here as an observer on behalf of the Financial Accounting Standards Board, FASB. It's always good to see Jim in these meetings. And I want to thank you for FASB's interest in this initiative and invite you to participate actively over the next two days.

Finally, I want to thank my fellow Board members and the PCAOB staff for being here today and for the immense preparation that I know they've all engaged in to analyze the issues before us.

The discussions we undertake during these two days will address important issues for our financial markets and the protection of investors. Eighty years ago, the Congress afforded a statutory franchise to the audit profession to protect the investing public's interest in accurate financial statements. The Congress' purpose in doing so was to regain and promote public confidence in the integrity of our capital markets.

The standard form audit report used to deliver on that mandate has not changed in any significant way in more than 70 years, although our capital markets, indisputably, have. This audit report continues to serve a critical purpose, but many call for it to be more relevant in our capital markets today and to better serve today's investors and other users.

As I said when the Board issued the proposed standards to enhance the auditor's reporting model, I believe this marks a watershed moment for auditing in the United States. But this is a global initiative. We've benefitted greatly from our cooperation and coordination with the International Auditing and Assurance Standards Board.

To arrive at an opinion as to whether the financial statements are fairly presented, the auditor amasses a great body of evidence and, based on that evidence, gains unique insights. Investors are calling for these insights to anear to their benefit: to make the auditor's report more relevant and useful.

Similar calls are coming from other important users. Earlier this week, the Basel Committee updated its supervisory guidance on bank audits. The Basel Committee calls for more robust communication channels between auditors and banking regulators and banking supervisors. The proposed standards are intended to make the audit report more relevant to investors by establishing criteria and a framework for the auditor to provide deeper insights from the audit based on information the auditor already knows from the audit.

The proposed standards emerged from an unanimous recommendation of the Treasury Department's Advisory Committee on the Audit Profession. They are also based on our own extensive outreach and public comment on both what would make the auditor's report more useful, as well as what auditors are in a position to deliver.

The hearings today and tomorrow are an important part and extension of that outreach. By requiring and providing a framework to report critical audit matters, the proposed standards would keep the auditor in its area of expertise: the audit. No one wants to return to the days before the pass/fail model was instituted when auditors' free writing could obscure disclaimer of assurance on misleading financial statements.

As many commenters have confirmed, there's real public interest in retaining the binary pass/fail model of opinion.

The proposed framework is intended to set forth concrete criteria to consider and apply in light of the specific audit at issue in order to limit both the discretion to avoid disclosure, as well as the opportunity to back into and fall back on boilerplate. The proposal would also require new elements in the auditor's report related to auditor independence, auditor tenure. It would include enhancements to existing language in the auditor's report related to the auditor's responsibility for fraud in notes in the financial statements.

The PCAOB's proposal would also require auditors to evaluate certain other information besides the financial statements, such as the company's annual report and management's discussion and analysis. And for the first time, the audit would describe this evaluation and its results.

Again, thank you for being here. I look forward to the discussion. And so we should commence with the first panel, and it's a distinguished panel. Let me point out a few of their qualifications.

Gaylen Hansen is the immediate past chair of the

National Association of State Boards of Accountancy, NASBA. He is an audit partner, EKS&H. He currently serves on the consultative advisory group to both the IAASB and the International Ethics Standards Board for Accountants. He serves on the International Auditing Standards Task Force for the AICPA. He's been a member of their Professional Ethics Executive Committee and on the PCAOB Standing Advisory Group. Gaylen, we appreciate your being here.

Richard Murray is the Chief Executive Officer of Liability Dynamics Consulting, a chairman emeritus of the Leadership Board of the Center for Capital Market Competitiveness. He serves on the board for the National Chamber Litigation Center. His current directorships include the Center for the Study of Financial Innovation and Oxford Analytica, both United Kingdom institutions. And he is a current member of the PCAOB Standing Advisory Group.

Lynn Turner is a managing director of LitiNomics, a firm that provides expert research, evaluation, analyses, and testimony in conflicts and commercial litigations. He served as the chief accountant in the

United States Securities and Exchange Commission from 1998 to 2001. He is a former member of the Technical Advisory Committee of the FASB, a former member of the PCAOB Standing Advisory Group, and a current member of the PCAOB's Investor Advisory Group.

Jeff Mahoney is the general counsel of the Council of Institutional Investors. He is responsible for developing and communicating the Council's public response to proposed regulations, rules, standards, and laws that may impact corporate governance practices of companies in which council members may invest. Prior to joining the Council, he was counsel to the chairman of FASB. He is currently chairman of the Investor Rights Committee of the Corporation Finance and Securities Law Section of the District of Columbia Bar Association and a member of the International Financial Reporting Standards Advisory Council. He serves on the NASDAQ Listing Qualifications Hearing Panel. He is also an adjunct professor at the Washington College of Law at American University and a current member of the PCAOB Standing Advisory Group.

The first panel takes us back to the Treasury's

Advisory Committee on the Audit Profession and its roots. And with that, I want to turn it over to Gaylen Hansen for your statement. Thank you.

MR. HANSEN: I'd like to thank the Board. Thank you, Chairman Doty, for the opportunity to express my views on your initiative today and to I guess go back in time to reflect on the ACAP recommendation that led to where we're at today.

I'm an audit partner and director of quality assurance with a Denver-based accounting practice. I've been an auditor for over, well, nearly 40 years and have signed many audit reports. I also have a regulatory background as a former chair and member of the Colorado State Board of Accountancy and the AICPA's Professional Executive Committee. I am the immediate past chair of NASBA, as you pointed out. I've been invited to share, as mentioned, some insight into ACAP's recommendation leading to this reporting initiative.

ACAP took place in the midst of the 2008 economic meltdown five years into the PCAOB. Among ACAP's many objectives was the opportunity to reflect upon the Sarbanes-Oxley Act and the PCAOB.

We met at the Treasury Building next door to the White House. I saw frenzied late night activity at Treasury and, as I walked the hallways, noticed an abundance of looseleaf binders curiously labeled "TARP." Later, we would all learn much more about TARP and the economic Armageddon that our country narrowly dodged.

So against that backdrop, the handpicked ACAP members, with very diverse backgrounds, hoped to wrestle with media issues, find common ground, and, in this city of grand bargains, come up with creative solutions designed to ensure the long-term sustainability of the auditing profession. We were dealing with matters that had been kicked around for decades, and this was a chance to do something meaningful, even historic.

While auditors were not being blamed for the economic meltdown, per se, there was a general sentiment that they could have done more and why didn't they. There was also serious concern about firm concentration and over-reliance on the remaining handful of firms auditing our largest companies.

At the same time, firms coveted civil litigation reform and were willing to consider some compromises.

On the table was greater firm transparency and governance, improvements in audit quality.

Our recommendations covered a broad range, from establishing a national center to combat fraud to enhancing independence. One led to the subject matter of this meeting, and I believe it to be among our most important.

ACAP wasn't interested in change for change's sake or just because the current audit report was 70 years old. We were interested in a substantive fix, increasing accountability and transparency with real teeth.

In retrospect, ACAP's recommendations remain as fitting today as it was in 2008. Investors continue to express dismay over reports offering limited, if any, value. Specifically, audit reports are noticeably silent about audit strategy and the overall audit approach, the extent of evidence obtained, and key audit judgments that are made.

During the crisis, there were numerous instances of clean opinions immediately followed by corporate collapse. Investors saw their capital vanishing overnight, while those in the know couldn't or wouldn't share untapped insight.

I don't believe that it's realistic that investors will begin expecting less of auditors any time soon. Consequently, raising the bar on the audit is inevitable. And for this reason, I support the PCAOB's proposal.

Generally, auditors don't take kindly to change, and some have objected to certain aspects of the audit reporting model, especially related to critical audit matters, or CAM, which I'll say a bit more about in a minute. Some objections are legitimate, but others simply because the ARM will take them out of their comfort zone, and that are understandable. What we are talking about won't necessarily be easy, so some convincing still needs to take place.

On the matter of that convincing, here's some ACAP testimony of Jules Muis, a former VP and controller of the World Bank, and I quote, (I have, on various occasions in the past, thrown out a less revolutionary teaser suggesting that we should ban clean audit opinions as an audit reporting instrument for at least ten years to come just to wean the audit profession off its addiction to clean opinions and to make it recognized a public interest in having the right opinion rather than a clean opinion.

I'm sure that Jules wasn't really serious about banning clean opinions, but his insight about the lack of communication and transparency resonates. And he goes on to say the problem is client confidentiality. Confidentiality has a long and important place in the profession. However, it doesn't serve investors when it prevents auditors from calling things as they see them.

The informational wants and needs of investors supersede all others in an efficient capital market. It doesn't escape notice that, of the 232 comment letters that PCAOB received, only nine percent came from investors. Hopefully, the weight of change will come down heavily on the side of that nine percent.

I'm going to sum up. There's a clarion call for many corridors today for greater auditor accountability and transparency. Other major players on the international scene are moving rapidly to require more informative audit reports, with or without the U.S. in tow.

The audit profession has a long and storied history of excessive secrecy. At times, this can even strain the imagination. My first four years in the profession were with a Big Eight firm in Los Angeles. The firm's office was a large standalone two-story red brick building without a single window. I was told this emphasized confidentiality. Outsiders would never know what was going on within those brick walls. On the other hand, we couldn't see out.

At the time, my first job, it seemed quite normal. I knew nothing better. In retrospect, it was just plain weird.

Today's reporting standard is akin to a windowless building. It just doesn't make sense. The world has changed, and we need to change the way we are doing things to stay relevant. We can do better, and doing it is long overdue. I look forward to it.

MR. MURRAY: Chairman Doty, Commissioners, I've had the fortunate opportunity to spend more than 40 years watching the process of audit firm performance in the public company sector, both from inside the firms and from critical positions outside the firms, critical in terms of having interests adverse to those of the profession.

I've also had the pleasure of participating in every assessment of audit performance, from Trueblood in 1973 to ACAP, and am very grateful for the opportunity to participate with you here today. And thank you, Chairman.

The judgments that have shaped my views from those experiences I think should be identified before I share them. I consider auditing to be the most challenging of the learned professions and callings of our era. I think it is a process that performs imperfectly at times, occasionally in an embarrassingly flawed way. But we live in an imperfect world of not uniformly perfect people, and I believe that the role and performance of audit generally equals or exceeds the performance standards of any of the comparable learned professions and callings that address our public sector interest.

I believe that the role of auditing in financial reporting, while not yet what it can be, is at the highest level of my period of experience, and much of the credit for that surely goes to the existence and the activities of the PCAOB and its commissioners, for which I thank you.

And, finally, I believe that the unfortunately litigious culture we enjoy here in America needs to be considered as one addresses all of the issues affecting auditing, not in terms of what's good for the welfare of the firms but in terms of what's good for the welfare of the American economy because litigation, a game that is played as a means of pursuing a variety of agendas in America, differs quite significantly from conditions in the US and the UK. It has impacts on audit quality, on the financial reporting environment. It impairs innovation and strains the ties of corporate governance.

I will deal with the issues that have been presented in the Board's proposal individually to save time. Regarding critical audit matters, I don't think there can be any question that the current form of the audit report is the longest-standing, least modified, most important, least informative, and most expensive and least understood form of commercial expression that man has ever created, or woman either.

The real question is is this like democracy, the worst choice, except for all others; or is there a better way? And it is clearly time to explore that better way, and I commend the Board for having done so in a very comprehensive and challenging proposal.

There were two ACAP recommendations addressed to what is called critical audit matters. The first was a strong call, as Gaylen has well expressed, to enhance the value of the audit report through narrative about the auditor's views, views that would enlighten on the understanding the public will have about the company, not the information that the public will have about the company, which is the company's privilege and obligation to disclose.

The critical audit matter proposal seems to me overly prescriptive and overly focused and not properly stimulative for the kind of narrative that ACAP had in mind, at least that is, in my personal impression, not an extension of the views of others on ACAP.

I think it also blurs objectives a bit. If the purpose is to gain insight about the company, there is an overlay of understanding that has grown around the CAM proposal that suggests that it also ought to enlighten about the quality of the audit performance, and I think that potential for confusion is unhelpful. And I would recommend that the CAM activity, as proposed, if it is to be pursued, be delivered through the audit committee rather than directly from auditor to the public. Nothing need be lost in content, but there would be a greater preservation of the growing and important role of audit committees as the nerve center of financial disclosure and corporate governance in all its aspects. I'm concerned that the proposal currently undermines much of the great work the Board has done in enlarging the responsibilities of the audit committee.

But ACAP had a second recommendation that there ought to be no harm done to the extreme value of the pass/fail model as the backbone of the capital markets. And we were concerned, not uniformly concerned but there was extensive concern about the extent of litigation risk to undermining the stability and clarity of the pass/fail model.

I do believe that that risk is a significant concern. I note just two respects. I believe the CAM proposal creates a new and more extensive risk of exposure to private rights of action. Its architecture is broader than Sections 10(b) and 11, and, as a process matter, it puts the auditor in a devilish position in the way the litigation process moves forward. The auditor can be questioned, if whatever went wrong happened to involve something you addressed in the CAM process, why didn't you carry through and recognize the consequences? If it did not involve something addressed in the CAM process, why did you address so many CAMs and not happen to find the right one? I think that's a dilemma that the profession and the companies they represent will find very difficult to deal with.

I'll address briefly fraud and independence together. I think they are aligned and embedded in the expectation gap, and I think neither is ripe for attention at this point.

ACAP recommended on fraud that the PCAOB establish a fraud center to study and facilitate collaboration in fraud detection and to study the subject in a way that for 50 years had never been fundamentally addressed as systemic risk. The PCAOB, I understand, does have a fraud project in planning. I am pleased and commend that. It may not be exactly what ACAP had in mind, but it surely must be a proper step forward. I suggest that the fraud proposals be deferred until that is completed.

The similarities of independence. ACAP had two recommendations here: That the PCAOB lead a compilation and rationalization of the requirements and standards for independence. There are multiple authority of guidelines on the subject that exist currently. They have conflicting interpretations. They don't even really agree upon whether independence is a noun, a condition to be independent, or is a verb, the way action is to be taken independently.

So long as we don't have a road map or even a common language to address the subject, there is concern, certainly in my view, that there is no way to get from here to there and it is time, after all these decades, to do the fundamental analyses of what qualities of judgment are really being sought here and what are the appropriate guidelines to measure those qualities?

We seem to have spent all those decades in rancorous debate based on non-concentric assumptions about what is the problem. Indeed, I wonder on both the fraud and the independent issues whether we've become so embracing of debate and controversy that we have forgotten that there is an opportunity to create understanding if we do a careful job of reassessing the fundamental assumptions on which we operate and put them at risk of being modified by listening to one another.

That is my recommendation as to both the fraud and independence studies. The acts of regulation follow on the acts of enlightenment that the Board is in the ideal position to bring to the profession and to the regulatory responsibilities. Thank you, Chairman, for the opportunity.

MR. DOTY: Thank you, Mr. Murray. Mr. Turner?

MR. TURNER: Thank you, Chairman Doty and all the Board members, for the invitation here today, as well as the staff. Thank you, Marty, as well. For the sake of time, I'll just ask that you include my written statement in the record, and I'll try to summarize it quickly before the red light goes on this time.

But I would echo everything that Gaylen had to say. I thought those were excellent comments. I would echo what Mr. Murray had to say about the profession being a very, very challenging job.

I would differ from Mr. Murray on the views of the subcommittee on the litigation issue. It was a fairly split committee as to whether there was an issue there on litigation or not. Those views were clearly set forth in the report. In fact, today, I think investors are very concerned about their ability to hold auditors accountable when, in fact, there have been failed audits, and they have suffered significant losses.

But the views I have today are based upon my experiences, almost four decades in this profession. It includes time as a preparer, as a CFO, audit partner. I've signed many, many audit reports, large, small, public, private companies. I've prepared, I can't fathom how many CAMs during that period of time and very well understand those. And I've served on the boards and chaired audit committees of public companies, as well.

And through all of that, I think it's clear that it's time to get something of value in the audit report.

The audit report today doesn't have value. That's something that I consistently hear from my fellow investors. In fact, in talking to a CIO where I sit on the board on one of the hundred largest investment funds in the world, the question was raised as to whether or not the portfolio managers even read the report because there's just nothing to be learned or gained from really reading it today.

So I would commend you all for taking on this project. It was a strong recommendation of ACAP. There are other recommendations which I wish you would also take up in short order, as well. But that's for another day.

As far as the approach, I think your approach is a good approach to tie it to the CAMs. I've sat at SAG meetings in the past that, if an investor ever saw those CAMs, if they were ever made transparent, they would understand that is what an investor really wants. It's what is critical, it's what significant to the auditor. That's why we prepared those CAMs. It lays out our strategy for dealing with them, how we dealt with them, how we resolved, and that's the type of information that investors are looking for today. That's what I hear time and time again that they want.

There are those that say, well, you should only disclose information management has. That's nonsensical. If management has already disclosed it, why does it need to be disclosed again by the auditor?

What the investors are looking for is what was the auditor's perspective on the audit? And one concern here is we've seen time and time again where the auditors were aware of very important information, information that, most typically, would have shown up in a CAM in a quality well-done audit report, and that information was hidden by the auditor from investors. And if investors had seen that information, it would have made them change, I think, their investment allocation decisions. It would have avoided costs and losses for investors and, I think, in many of those instances, would have avoided litigation and costs for the auditors, as well.

So I commend the CAM approach that you've come up with. I think, to Mr. Chairman Doty's point, I think boilerplate can be avoided. I've given some thoughts on that in my statement. I think you ought to lay out clearly your objectives, and I've given some other thoughts as to what I require in disclosure, and those are, in part, based upon what we do with similar type disclosures on related parties, which haven't worked all the time but have worked. So I think it's something to think about.

The one thing on the CAM approach that I would forewarn you about, and that is you can't leave it just to the discretion of the auditors. We did that when we did an independent standard in the past. It didn't work. It was fatally flawed, so leaving it solely to the discretion of the auditors would not be worth the time or money then because we'd get the same result. We've had that lesson once before. We shouldn't repeat it.

As far as some of your other recommendations, I think the recommendation on the auditor signing the report is very good. It's consistent with what ACAP recommended. There's no further liability to be had here. There is going to be the fact that, once you put your name out there as an audit partner, you're going to be concerned that have you got the job done right, and I think that's going to enhance, in the long run, audit quality. It's going to cause you to focus. I sign those reported, and when you're signing with your own name, you know if your name shows up in too many problematic audits, you're probably going to have a problem. And I think that's what the whole debate is about here as far as the audit partner signing the report, and so I think that goes without saying.

I think the points you make about tenure, disclosure of tenure and independence is good. I was there at the SEC when we went through the fight over the independence rules, and when those independence rules were adopted there was positive statements of support from five or six of the firms at the time in support of those standards. And the ACAP did not recommend any changes in those standards. It did suggest codification somewhat, which would be helpful.

Finally, if we've learned anything from China it's the fact that we really do need some transparency around who is doing the audit. And if a significant portion of this audit is not being done by the signing partner or is not subject to the typical examinations that you all do that have turned out to be beneficial, then certainly that needs to be disclosed, as well.

And I think, as Rich summarized about the audit report and his description of the current audit report being old and long in the tooth -- you know, it goes back now almost to the Model A, and we have had some things change in the country since the Model A came out, the assembly lines. So I suggest the time for change is now, and let's not let this get any longer in the tooth.

MR. DOTY: Thank you, Mr. Turner. Jeff Mahoney?

MR. MAHONEY: Good morning. Thank you, Chairman Doty and Board members and staff for hosting today's public meeting on the PCAOB's proposal to enhance the auditor's reporting model. The Council of Institutional Investors appreciate your leadership and willingness to pursue this important issue that has long been debated and remains controversial, particularly with some members of the auditing profession.

It was a real honor for me to have had the opportunity to serve on the Department of Treasury's Advisory Committee on the Auditing Profession on behalf of my executive director, Ann Yerger, and to participate on the Committee's Subcommittee on Firm Structure and

Finances with my three distinguished fellow panelists to my right.

As you may know the Subcommittee was ably chaired by Robert Glauber and, in addition to my fellow panelists, the Subcommittee included Timothy Flynn, the then chairman and CEO of KPMG; and William Travis, the director and former managing partner of McGladrey & Pullen. Others who devoted countless hours to the activities of the Subcommittee and, in my view, were instrumental in assisting in the development of the Subcommittee's findings and recommendations included Don Nicolaisen, who was co-chair of the Committee, along with Arthur Levitt; Alan Beller, the counselor to the co-chairs, who I understand will provide his perspectives this afternoon; and, last but not least, Kristen Jaconi, who was the senior policy advisor to the Undersecretary for Domestic Finance at the Department of Treasury at the time.

After reviewing extensive amounts of data provided from many sources, including from the audit firms, the Center for Audit Quality, and after receiving testimony and comment letters from a broad range of experts, the Subcommittee focused mainly on seven areas in need of improvement in the auditing profession and produced seven recommendations. In my opinion, perhaps the most compelling of the seven was recommendation number five, to urge the PCAOB to undertake a standard-setting initiative to consider improvements to the auditor's standard reporting model.

As the Committee final report indicated, the auditor's report is the primary means by which the auditor communicates to the users of financial statements regarding its audit of those statements. And despite the numerous instances over the years in which blue ribbon panels of experts recommended that the standard auditor's report be improved to provide more relevant information to users of financial statements, as we all know, material changes to the auditor's report were never implemented.

I believe it's also significant that the Committee's final report highlights the testimony of Richard Fleck, whose a global relationship partner for Herbert Smith. In that testimony, Mr. Fleck stated that institutional investors believe an expanded auditor's report would enhance investor confidence in financial reporting and recommended exploring a more narrative report in areas such as estimates and judgments, sufficiency of evidence, and uncertainties.

The substance of Mr. Fleck's testimony, in my view, has since been corroborated by multiple sources, including surveys at the CFA Institute and the PCAOB's Investor Advisory Group and the results of the PCAOB's own extensive outreach to investors and other users in connection with developing the proposed model.

Just a couple examples. Disclosure of the independent auditor's assessment of management's critical accounting judgments and estimates was supported by 79 percent of institutional investor respondents to a 2011 IEG survey and 86 percent of respondents to a 2011 CFA Institute survey. With respect to the latter survey, I understand Kurt Schacht will be on a panel this afternoon, and he can certainly provide more details and discuss other CFA Institute surveys and materials that may be relevant to the proposed model.

Based on those results, related findings and recommendation of ACAP, as well as the Council's own membership-approved corporate governance policies, we generally support the PCAOB's proposed audit reporting model. We would, however, revise the proposed model to provide that the auditor be required to communicate, at a minimum, an assessment of management's critical accounting judgments and estimates based on the audit procedures that have been performed.

In our view, this modest revision to the proposed model would result in an auditor's report that provides the kind of independent auditor insights that are reflected in our policies and, more importantly, are responsive to investors' information needs. In that regard, we would not support a proposed model that failed to provide independent auditor insights and simply repeated or referenced management disclosures that already are provided to investors.

We believe if our modest revision were adopted, the proposed model, as revised, would be far more likely to achieve the Board's worthy goal of increasing the relevance and the usefulness of the auditor's report to investors, who ultimately are the key customer of the auditor's report.

Thank you again for inviting me to participate in this important meeting. And I look forward to learning from my fellow panelists, the Board, and all of you here today. Thank you.

MR. DOTY: Thank you. The intention in these discussions is always to attempt to give everybody a chance and to have some structure but to preserve some spontaneity. And we now have about 15, a little more than 15 minutes to get in to that. My colleagues have permitted me to call on each of them for one question. If we have time, we'll go around again, and I want to be sure that both staff and observers have a chance to get on this.

But we'll begin. Mr. Harris, one question. Multiple parts not allowed.

MR. HARRIS: Well, you just took my multiple parts off the table. Under common guidance on economic analysis, when the Board undertakes a standard-setting project, it should identify the need and the problem. And while it may be self evident and obvious, because we're creating a record I'd like each of you to articulate the need and the problem with as much specificity as you can and why now?

MR. DOTY: Address to whom, Steve?

MR. HARRIS: The panel.

MR. DOTY: Gentlemen, should we just move down the line?

MR. HANSEN: That's fine. That's a great question. You know, I've heard over the course of my career every time there's a new standard that comes out, it layers on top of the others and that it's not going to take any significant additional time and nothing to worry about. I don't believe that. And I believe that, when it comes to the majority of the proposal, it will be pretty straightforward. It gets to the CAMs. You're talking about custom writing, custom thinking, and really thinking through the issues at the highest level of the talent within the audit organization, and I think it will take some additional time and it will involve some discussion with the audit committee. That shouldn't be overlooked.

Does that mean that it's going to be an overwhelming cost? No, because, as Lynn pointed out, I mean, those CAMs are part of the audit documentation already. It needs to be polished up. It needs to be articulated better, but I think the economic analysis is going to show that, while there's going to some increase in the cost, it's not going to be overwhelming.

MR. DOTY: Richard?

MR. MURRAY: The problem, to look at it from too high a height, is that we do not understand each other. We have continued to not understand each other on various aspects and perspectives on these issues for too many years. We've been focusing on sharpening the ability to dispute, rather than considering the possibility of agreement. And I believe why now is because we have the benefit and advantage of the established and growing importance of the PCAOB to take the leadership in exploring what can be accomplished by a search for agreement and a search conducted in a collaborative manner in which the regulator and the regulated operate in partnership, as well as in a regulatory relationship.

MR. DOTY: Lynn?

MR. TURNER: Chairman Doty, I think the crux of the issue is not one of understanding. I think the auditors understand it very well, and I think investors understand very well what they want. It's a difference over what product is going to be produced. Are you going to produce a product that the investors want, or are you going to produce a product that the auditors want?

As your own enforcement action on Medicis show and as I know full well from my time at the SEC in cases like Xerox, the auditors were fully informed about a fraud or a problem with the financial reporting, yet rolled out clean reports and remained silent and said nothing. And in those circumstances, silence is not golden. It's devastating.

And so that needs to change. The product needs to reflect what the customer wants. In this case, the customer is the consumer.

And to the question of why now, after 80 years that this report doesn't work, why not now?

MR. DOTY: Mr. Mahoney?

MR. MAHONEY: Similar to what Lynn said, we have a product that the major customers of that product are dissatisfied with it. And I think their dissatisfaction summarized in the PCAOB's staff's conclusions from their outreach, just reading from the concept release, the

PCAOB staff "observed that there was consensus among investors that the auditor has significant insight in the company and that the auditor's report should provide additional information based on that insight to make it more relevant and useful." I think that's where we need to head.

MR. DOTY: Mr. Ferguson?

MR. FERGUSON: Yes, I have a question for Jeff Mahoney on his suggestion that we have the auditor assess, that management's judgments on critical accounting estimates -- I can't exactly remember what you suggested. But if we were to do that, how would we do it? And would it be through a grading system, A to F, or like an honor's degree or magna cum laude or summa cum laude or, you know, they were conservative or they were aggressive? What would the criteria be, and how would we achieve comparability among audit reports so people looking at these judgments would be able to have a sense that there was a uniform standard being applied by the auditor?

MR. MAHONEY: With respect to the requirements, I think investors are not looking for anything new here.

The type of information, as Lynn has said earlier, is information that's already being provided to the audit committee. I think investors are just looking for some of that information to be provided in the main piece of communication with the auditor in the auditor's report.

As far as comparability, I don't think investors believe that this additional information needs to be comparable across all companies. I think, as I referenced earlier, what they're looking for is insights from the auditor. And if you look at the studies and surveys, a reoccurring theme is they want some insights with respect to significant estimates and judgments.

MR. DOTY: Mr. Hanson?

MR. HANSON: Thank you all for coming and your insightful comments. Just one question related to what investors think about our proposal that's on the table, and I'd ask you to each maybe comment about it to the extent you've had direct discussions with individuals responsible for making the investment decisions about what they think in the value of what we put on the table and any feedback you've gotten around that.

MR. DOTY: Is that a question for the panel or for --

MR. HANSON: A question for each of you on the panel.

MR. DOTY: Jeff, do you want to take it and then move left, right for you?

MR. MAHONEY: Sure. As I said in my prepared statement, it's very clear that investors are dissatisfied with the product and they want more information. And as I indicated, I believe and our policies reflect that what they want is some more insights from the auditor, so then it's a question of insights about what? And as I said earlier, if you look at the many studies and surveys, a common theme is that they want more insights about the key estimates and judgments.

MR. DOTY: Lynn?

MR. TURNER: Jay, as I was doing my remarks, drafting them, I did share them with a number of investors and I did get responses back I think from five investors, and these are people who are making investment decisions. And, universally, they came back, with one exception, and said they are exactly where those remarks were that I submitted in the written statement.

The one exception was one of the investors said he wanted further information, to Jeff's point, about changes in estimates, key estimates that the auditor had audited and changes in that estimate. So the feedback that I got from actual investors were my comments are exactly where they thought you should end up.

MR. DOTY: Mr. Murray, Mr. Murray, Richard?

MR. MURRAY: My perspective on the investment viewpoint comes primarily from involvement in the insurance industry, which is a major force. Insurers worldwide own 20 percent, 22 percent of global equities currently and remain a bastion of the investment stabilization of commerce.

To be overly quick and simplistic, my sense is the insurance industry is not opposed to things requested by groups of retail investors and some of the views that have made their way into active attention in the outreach reports of the PCAOB, but they don't consider them representative of their views and interests, as fixed long-term value-oriented investors. Their view, again simplistically put, is that there is a vast industry of intermediating advisors that can and do provide much of the insight and analysis that seems to be requested at the retail investor viewpoint. And the question that insurers would have is how can that value then be best aligned with anything that might additionally be done in the audit reporting process to produce a better net outcome?

MR. DOTY: Mr. Hansen?

MR. HANSEN: I must say that my interactions with actual investors is somewhat limited. I'm an investor myself. I don't see the critical audit matters as being a magic bullet. I don't see that it's going to solve all of the uncertainty that investors might like it to resolve. But I think it's going to contribute to them being able to make their own evaluations better.

That said, you know, there was a lot of discussion about who signs the audit report. Sometimes, I wonder whether we didn't spend enough time talking about who it's addressed to. You know, it's sort of legalistic, this addressing it to the board of directors and the stockholders. Maybe it should be addressed to the public interest or investors themselves. But those are just a couple of thoughts.

MR. DOTY: Ms. Franzel?

MS. FRANZEL: Thank you for being here today and sharing your insights. Going back to the recommendations of the ACAP and for expanding the information provided by auditors for the benefit of investors, in your view, does the CAM proposal meet those objectives based on the need that you all identified and the recommendation you made, along with everything we've learned since then? Does the current CAM proposal, as written, get us there? And if further refinements need to be made, in your view what would be the most important changes or revisions to the current proposal in order to meet the needs of investors?

MR. DOTY: To the panel, Jeanette?

MS. FRANZEL: It's to the whole panel, yes.

MR. DOTY: Gaylen, do you want to take it first?

MR. HANSEN: Sure. I believe they do meet the basic objectives of what we're trying to accomplish here. I think if the focus can be on, as it says, those few things that keep the auditor awake at night, those few things, not many things. That may be a different signal of a different problem, or, if there's no things that keep the auditor awake at night, maybe that's a completely different issue. But I think the objectives are met.

MR. MURRAY: I would go back to my brief and poorly-illustrated remarks earlier. I believe that, while Lynn and I may not have exactly the same recollections of the ACAP discussions, that the objectives we were identifying had to do with getting more insight about the company and not necessarily additional or different information about the company, and I think that is a distinction that isn't entirely well articulated in the current CAM proposal and creates some of the confusion of what is intended and how should it be performed.

And I also think that we had a focus on what can be learned through this process about the company, rather than a further standard and way to evaluate the performance of the audit. And I think that, too, could be clarified in the way this is articulated and presented.

MR. DOTY: Lynn?

MR. TURNER: The discussion at ACAP started out with the discussion, I think it might have even been Tim Flynn who brought up the issue with the pass/fail model and the shortcomings that some expressed with respect to the shortfalls in that model. And then it expanded to what about making sure that we tell investors exactly what the auditor is going to do to detect fraud and clarify that responsibility, which was an important part of the recommendation to be addressed.

And then, as we got into public hearings, then we started hearing from investors. Jeff has mentioned some. There was Tony Sondhi testifying on behalf of the CFA Institute and others. I'd urge you to go back and look through that testimony. There's binders of records of it -- I've still got them if you don't -- that lay out exactly what investors were looking for. And investors were looking not just for information about the company, if you look at that testimony, but, in fact, looking for an auditor's perspective of it.

When you look at the actual recommendation, the recommendation doesn't get to that detail. The recommendation says: Undertake a standard-setting process. This is your job, not our job at ACAP. It's your job to decide what should be done, so go through a thoughtful standard-setting process and go do it. And I think that's what was intended.

As far as does approach tied to disclosure of CAMs meet that? Based on my experience, having written many of those CAMs, done audits and, yet, been on the investment side, I actually think that's a good approach. It requires disclosure of all CAMs, though, and it requires that it not be discretionary. And there's been some question, as we've talked about at other meetings, about is there too much discretion or not and are the objectives around the CAMs clearly laid out?

But I think, in general, the CAM type approach is a good start and would respond, assuming you also deal with the fraud piece of that recommendation.

MR. DOTY: Mr. Mahoney?

MR. MAHONEY: Thank you. I, as well, agree the proposal can meet the objective. And as indicated in my comment letter and in my statement today, I believe it can be revised in such a way that it will get the auditor insights that our policies reflect and that investors have been asking for for many years.

And, again, we don't need to, we already have that information. We also already have rules related to that information in connection with communication. It's through the audit committee. So I think it's just a matter of refashioning those requirements to get that information into the auditor's report.

MR. DOTY: I want to ask a question back to Richard Murray because, as lawyers, we both share an interest in liability and litigation. And noting parenthetically that our re-proposal on transparency does not call for signature of the audit partner but naming of the audit partner, one of the issues that pervades all these discussions is a concern that, where we provide more disclosure, we think about the litigation and the liability issues.

And you made an arresting statement. You say that critical audit matters will lead to a new wave of litigation. If the disclosure of the CAMs appears in the context of the audit report and the audit report is good, it's a good audit, the auditor has his defenses even if the financial reporting is not good but the audit is good. That would seem to be not a problem for the CAMs in terms of what results from it.

But if the audit is not good or if there is, if there's frivolous litigation, I'm interested in getting to what you clearly see is a need for a constructive change. I'm wondering if, in fact, if we consider language both in the adopting release and in the standard to clarify the informational value of the CAMs, to clarify what I referred to in passing in my opening statement which is our intention that this be limited to what the auditor knows. Richard, you've also made a point as to communication of the audit committee and not the public, and I think that's a different issue. But do you think that by clarifying the value, the informational value of what the CAM is, that, at the same time, we diminish and really address the risk of litigation, of meritless litigation, frivolous litigation, with which we're all concerned?

MR. MURRAY: Chairman, first, I have to recognize that one of the things that's common to most lawyers is hyperbole, particularly in time pressure. My point was --

MR. DOTY: We've all done it.

MR. MURRAY: -- not to declare that this is clearly an unequivocally a problem to be accommodated but to urge the Board to pay more focused attention to explore whether the Board concludes that it is. Then at least it's apparent in the publically-disclosed materials.

In terms of what would help assist with the problem, if there is some degree of problem here, it seems to me there is a positive direction and it was explored by ACAP, not too agreement but it was explored, sometimes loudly. And that is whether or not there is some opportunity to create, by regulation or otherwise, a judgment privilege that surrounds the most sensitive and difficult judgment and expression forms.

We have a business judgment rule for the corporate sector that recognizes that you get into some gray zone issues that expose one to a double bind you're wrong if you do this, you're wrong if you do that. That doesn't exist in the audit environment in liability today. And with every more granular disclosure, whether it's the CAMs or any other formulation, that gray zone expands and deepens. And it seems to me the most promising solution would be to demand more of the auditors. But for the sake of the financial reporting process, not just the auditors, to allow that innovation to be addressed constructively and with enthusiasm, provide a degree, not full protection but a degree of accommodation to the judgment periphery on the edge of responsibility.

MR. DOTY: But do we at all, by speaking to the issue of what the CAM is and the value of it, do we, in any sense, ameliorate the risk of meritless litigation since the CAM is in the opinion and the opinion, as a whole, is what it is?

MR. MURRAY: You could, and you would, undoubtedly, have some influence. But if one considers the extent to which federal government agencies are having, generally speaking, are having their agendas rewritten and their interpretations ignored by judicial and private sector litigation, I think there's a real risk that your very best intentions, articulately expressed, would not survive the hassle of litigation.

MR. DOTY: You're not giving in on this point, and I respect it. One of the points of being chairman is I get to ask one more question before I go back to Jeanette Franzel, and it goes to Lynn Turner where you point out that neither the audit committee, nor management, knows what the auditor knows from the audit. How do you respond to Richard Murray's and others' comment that the appropriate place for what the auditor would otherwise say in a CAM is either in the proxy statement, as to which we have no real jurisdiction, or by more privileged communications directly with the audit committee, as Richard suggests.

Lynn, Jeff, do you all want to do a crisp one-minute? Isn't he right? Can't you do this by -- if the audit committee doesn't know this and this is such important information, don't you reduce the expectation gap by giving it to the audit committee and having rules expanding on the disclosures in the proxy statement and other documents?

MR. TURNER: The short answer is no. If you look at, again, the cases I mentioned, there's others that are out there, as well. In the WR Grace case that we have, the information didn't ever go from either the auditor to the audit committee.  Now, assuming it goes from the auditor to the audit committee, you still haven't delivered the product that the investor wants.  I've run a company, I've run a manufacturing company.  The key thing is to give a product to the customer that the customer wants, values, and pays for.  If you stop it at the audit committee, it doesn't go out to the investor.

This is simply a matter of are you going to give the customer what they're looking for, what they need to make sound capital allocations?  If that information doesn't get to the people making those investment decisions, and that's not the audit committee, it's not management, then you aren't giving them the information. And right now that information doesn't flow.

As to where you put it in the proxy or wherever, I really don't care, as I say in my statement, where the information is put out.  What I care about is the information investors want gets put in their hands in a timely and complete fashion and reflects the perspective of the auditors.

MR. DOTY:  Jeanette, you want to take one last shot?

MS. FRANZEL: Sure. I want to drill down a little bit on Mr. Mahoney's suggestion of a modest change to the proposal, and I think some might take issue with the characterization of that as modest. So I just want to drill down --

MR. MAHONEY: It is a little optimistic.

MS. FRANZEL: I just want to drill down a little bit. You are calling for an adjustment where a CAM would include an assessment of management's critical accounting judgments and estimates. What do you think that would look like and how would that be achieved under this current model? And then I'd be interested in the reaction of the other panel members, as well.

MR. MAHONEY: Here again, I'm looking at the communications that are currently being provided to the audit committee today. And looking at those communications related to significant estimates and judgments, I think those that the auditor thinks are most important in the CAM should be disclosed in the report.

Going back to the Chairman's last question, as Lynn said, the information is what's important. But right now the auditor's report is the main piece of communication between the auditor and investors. And investors want more communication from the independent expert. The audit report seems to be a logical place to put it since that's the only communication that we have between the two today.

MR. TURNER: Jeanette, I've served as chair of three public audit, chaired the audit committee of three public companies. In each of those three instances, each a different one of the Big Four, so three of the Big Four, came in and, consistent with the blue ribbon panel recommendations, had a discussion with us about not just the acceptability but the appropriateness of the judgments and estimates made by management. That's part of that report recommendation. It's not the first time it's come up. Jeff's recommendation is totally consistent with what's been recommended in the past.

In all three of those audit committees, the auditor would come in and, in part of their communication to us, they presented us a slide or two each time, giving us their estimate, their view, perspective on those estimates, and they would typically do it in a graph that had aggressive on one side and conservative on the other side, and they defined that in their graphs to us and said here's where we think it lays. So the information is there. It's being communicated. It's being communicated consistent with recommendations of very well known panels in the past. It's not new information.

MR. DOTY: Reluctant as I am, we're going to leave it at that. I'm going to make sure that we start with the next panel's question with Jeanette, run through Jay, and move up and end with Steve. And I will cede my time on the next question. So we're going to do justice.

I'm going to wait for flags to go up from the wings here. But when they go up, I'll call on them.

Thank you for taking us back to ACAP, for refreshing our recollection of what all this is about, and for some very meaty insights, trenchant insights on the current issues we face. Thank you all.

Well, where to begin? We next have one of the giants of the auditing profession with us, and Sir David Tweedie will be here until 10:40. He's making a special effort to do this.

He serves as the chairman of the International Evaluation Standards Council, which is looking into many of the key issues that come up in this audit reporting model question. From 2001 to '11, he was the first chairman of the International Accounting Standards Board, as well as the chief executive officer of the International Financial Reporting Standards Foundation.

It goes on. A fellow at the Judge Business School at the University of Cambridge; visiting professor of accounting in the University of Edinburgh Management School; honorary degrees from nine British universities; various honors and awards, in addition to knighthood, for his dedication and service to the accounting profession; president of the Institute for Chartered Accountants of Scotland from 2012 to 2013; chairs the Royal Household Audit Committee for the Sovereign Grant which funds the work of the British monarchy.

He's a current member of the PCAOB Standing Advisory Group. Mr. David, we're grateful for your presence. Please enlighten us.

MR. TWEEDIE: Well, thank you, Jim. And can I say what a pleasure it is to be here and see so many of my old friends. As several people in the room will know, as I've said before, it's always a privilege to come out here to the colonies and to continue my missionary work.

But this is a particularly interesting project. Everybody knows about a bad audit. It's splattered all over the press. Very good audits you actually don't hear anything about. They're hidden.

And audit, I think, is seen as a necessary commodity. It's what you have to pay for to get access to the capital markets, and the opinion, as we've discussed already, is an on/off switch. And when I first qualified as an accountant over 40 years ago, I could look at an audit report and know instantly if it was qualified because it was only three lines long. If it was more than that, it was something I ought to read. Otherwise, I just knew it was okay.

Since then, with the expectation gap, we've lost the crispness of the audit report in a whole lot of what now has become boilerplate language. And one of the things I'm slightly concerned about in the new proposals is a lot of that is still going to be in the audit report. Personally, I'd like to see that on a website or in an appendix. You might like to ask my UK colleagues about how they deal with it.

But the investor, quite clearly, as signaled from your own papers that they would like, is they would like additional audit reporting because they don't have access to or aware of many of the issues that the auditor has raised. And Lynn mentioned that a lot in the last session.

The audit report really, in my view, should be adding value. At the moment, it's more one of limitation. You know, how many auditors does it take to change a light bulb? None because they've formed a committee to say it's not their responsibility. And that's the sort of thing that we end up getting in the audit report.

But I think you've given the auditor a wonderful opportunity to start ending the notion of the audit being just a necessity and make it a vital part of investment analysis. Developments have already taken place elsewhere, notably the UK and Europe. And if you can get Europe to agree on these things, surely it can't be difficult to get the U.S. to agree on it.

But it would be a real help, too, I think, if PCAOB and the IAASB could get together and make sure the terminology was the same so audit reports throughout the world said the same sort of thing and we knew exactly what they all meant.

I would actually have liked the PCAOB to have gone further than it did. I would like to see the audit report based on the notion that investors want auditors to ask themselves what would they like to know if they were investing in the company and make sure that's what was in the report.

The critical audit matters I think is a real step forward. But that, again, I don't think goes far enough because it asks, you know, what are the matters and what did you do about it? What I feel it also has to do is and what were your findings?

I will draw your attention to the Rolls Royce audit report in the United Kingdom, which I'm sure my UK colleagues will talk about and certainly Tony Cates of KPMG because I found it quite excellent. It talks about the problems. The findings are that the company was slightly cautious in some areas, overly optimistic in others. But you get the picture that, on balance, this was actually a fair presentation, even though in certain areas there may be slight movements one way or the other.

And when you start looking at things such as valuations, Level 3 valuations, how do we know how far the auditor has gone in the range? Is this an aggressive company? It is it a pessimistic company? I think that's information that really should be out there in the public domain.

The genesis of this change, as we heard from the last panel, has been the financial crisis. And if anyone wants to argue that the audit report was fine in that crisis, they just have to look at some of the figures that you've got in your own papers about two or three years ago where it was pointed out that the 2008 and 2009 audits of a company receiving the TARP funding was actually, word-for-word, the same. And, yet, in 2008, the audit report costs $119 million, and in 2009 it cost $193 million. So what if you learned, as an investor, for your extra $74 million, nothing. It was still the switch was on, and that's all you heard.

And, yet, as we've seen when Enron and WorldCom blew up, if there's concern about the audit, then the markets start to tumble and confidence is lost. Going concern is always difficult for auditors. It can be a self-fulfilling prophecy if they give a growing concern qualification.

And when you look, though, at what happened, certainly in the UK -- let's take our biggest casualty or the first casualty, Northern Rock. It bought it from the wholesale markets in a very major way. Three months loans from the wholesale markets. It lent out 20 or 25 years, so it was all predicated, its business model, on that market staying open. Well, it didn't. It closed, and so did Northern Rock.

It was in the notes and, in a sense, you could see for yourself, looking at the liabilities, where they were coming from. But that was a key assumption. That company could only exist if the wholesale markets stayed open, and I think the auditor should draw attention to something like that.

What are the assumptions laying behind your view that this is a going concern? It may be that investors will look at that and think this is a bit risky and I want to get out, and that's the sort of thing I think they should do it.

And you can see from your own papers that eight of the top ten bankruptcies, there was no going concern qualification during the crisis. And the TARP, major TARP receivers also had no qualifications in there. I think giving some form of assumption why you've agreed that it is a going concern would be extremely helpful.

If you want to change the audit paradigm, I think what you've done at present is a necessary but not sufficient condition. I would like to see far more being done with the audit and making it far more helpful to users. And you can see the complaints and the pressures, certainly in Europe for mandatory rotation or at re-tendering. It's coming from the view that perhaps fresher eyes are needed, and that's the good reason. The bad reason is perhaps they're too cozy. And I think it is in the auditor's interest to make it far more obvious that he is reporting to the investor and not simply to the audit committee. So a repositioning I think would be very helpful for the audit and also for the investor.

I think there's things that can be done to assist the audit. I think the auditor is under too much pressure from companies these days. I would like to see the removal of the annual appointment and the company talk about re-tendering and then appoint the auditor until that re-tendering date and only allow them to be removed by a vote by the investors, if necessary.

And if tendering does take place, I would ban the companies, the audit firms, from putting a price in there. Let the audit committee choose on quality and then ask for a price. And if it shocks, let us tell the investors how much it saved by taking the second best audit and let's see if they agree that was a worthwhile investment.

And I think there's other things starting to happen in there that, after re-tendering, as your own figures have shown, audit fees are fallen. Well, there's limits to how far that can go. I think if audit committees think one of their major proposals or major jobs is to cut the audit fee, you're really starting to get into the question of are you starting seriously to damage the audit because, if the fees are driven down and if audit partners are not of the caliber of the people they're auditing, then we're going to have a major problem.

And how do the audit firms deal with that? You can probably ask some of them as they go through this, but are they taking part in a time out of the audit to try to make it pay? And I think that is a serious problem we're having. One disclosure I'd like to see in an audit report is how much partner time has been spent on it compared to those of managers and juniors.

As I've said before, I firmly believe the auditor should sign his own name on behalf of his firm. I think that concentrates the mind. In my own firm, when I was there as a national technical partner, I remember twice an audit partner getting away with something by signing the firm's name. We ended up in court. He was protected, and we weren't. I don't think he'd had had a second chance if his name had been on the first one.

It's not what you're dealing with at the moment, but I think there's also societal duty on the auditor to act as a whistleblower in certain situations. Lynn talked about various cases where the auditor knew things. I think it would have been very helpful if the securities regulator or the prudential regulator had been informed. So I would see the audit repositioning to be much more focused away from the company and onto the investor and also onto the regulator, where necessary.

Well, maybe that was a little bit like a sermon. I was in the church not so long ago listening to the minister banging on, and the old lady in front of me turned to her neighbor and said, (Is the minister not finished yet? and back in answer, (She just can't stop. Well, let me show you I can.

Advice. I'm always reluctant to give advice. When I moved into my present home near Edinburgh, there was a rather architecturally-unusual plant in the front garden, which looked like overgrown parsley. But the neighbors who didn't like the lifestyle of the previous occupants thought it was marijuana.

So I was a bit concerned, so I got a horticulturist in, and he gave me advice I never forgot. He said, (Look, if you're worried about this plant, he said, (pick it, dry it, and then smoke it. And if you're still worried about it, then it's parsley.

Well, the advice that I would like to give to the PCAOB is I would like to see audits in the U.S. the same as audits everywhere else. I'm delighted you've had the foresight and generosity to invite international observers to these panels, and I do hope it ends up with both the IAASB and the PCAOB putting out something extremely similar.

Audit, I think, is at a tipping point. Its worth to investors in society has been questioned, certainly by the crisis. Jay, in his recent speech, made it very clear that the auditor has a unique and indispensable position in the capital markets to help investor confidence, and I think that's something that you can really assist by the audit report.

And I'd like to see you go further. I remember when I left the IASB, the London Sunday Times talked about my time there and said, (When Tweedie came to the International Accounting Standards Board, financial reporting internationally stood at the age of a precipice looking into a chasm. Since he arrived, it's taken a big step forward. And I think you have taken a big step forward, so I'd like you to lengthen your stride a bit and do a bit more. Thank you.

MR. DOTY: Thank you. Jeanette?

MS. FRANZEL: Well, thanks for venturing out to the colonies for this important meeting. I appreciate your comments about not wanting large differences between the audit reports and the audit approaches between the U.S. and internationally. And I'm also intrigued by the UK approach in the audit report describing assessed risks of material misstatements that had the biggest impact on the audit. How far apart do you think our approaches are at this point, our proposal and the approach? And how do you think that they could come together?

MR. TWEEDIE: I think they're very similar. I would like to see a bit more about the findings. I don't necessarily think that is part of the UK approach, but I'm not an expert and you'd best ask Nick and his colleagues. But they are close. I think the Rolls Royce one went further and was an experiment, but I thought it was a highly successful experiment. I know you can ask about that later on.

But I think really we want to try and take the best. At the IASB, the idea was can we just take the best of whatever is out there? It doesn't have to be the international one. If the New Zealanders or even the Americans on rare occasions have the best accounting policy, we should have it. And that's what I think exactly PCAOB's line should be.

MR. DOTY: Jay Hanson?

MR. HANSON: I just wanted to thank you for being here and coming across the pond. Just a follow up to Jeanette's question relative to the IAASB proposal that's still on the table. If you think that a worthy goal is to have our ultimate standard align with their ultimate standard, if you think there are particular things in our proposal that theirs might be missing or particular things in their proposal that you think we should steer towards in our thinking, I'd appreciate to hear your thoughts on that.

One tongue-in-cheek follow on, have you concluded whether the plane you flew here on is on the balance sheet of the airline that you flew?

MR. TWEEDIE: Well, the one I was on yesterday has probably been written off by British Airways a long time ago, I think. But, certainly, on the issue of the IAASB, I think the main point is you move along with interaction, and it's really a question can we just get the terminology the same so that people know this is the same and it's not something that's got a variant on it.

There may be jurisdictional issues which you'd have to deal with in the U.S., and that is obviously up to yourselves. But I think the more you can get even the words the same, the happier people are going to be that this U.S. report is the same as a UK report and so on.

MR. FERGUSON: Yes, I just want to thank you for coming across the ocean to see us. But the question that I have and one of the things I've been very concerned about the CAM proposal we have is that it will deteriorate into boilerplate disclosures. I think that's happened in France where they already have certain kinds of disclosures like that, and they're not particularly meaningful.

And I'm particularly curious about your view of the KPMG opinion in the Rolls Royce matter because I read that, too, and it's really quite extraordinary. It appears to me, in many ways, to go further than the way I read what would be required under the British standards. And is this, in your view, is that simply an example of an auditor showing unusual courage, or do you think that's sort of a lamp into the future that, under these standards, that there will be auditors who actually feel comfortable in writing opinions like that?

MR. TWEEDIE: That's an interesting question, Lewis. I think, from what I gather, there was an arrangement with Rolls Royce that the firm would actually go further and experiment on that.

And I think the reaction from the investors in the UK has been highly positive, and I certainly would like to see that be made more mandatory because I think it does reflect, when you actually have to state that, okay, here's the problem, you've got a lot of Level 3 valuations, which wasn't the case in Rolls Royce, but you've got a lot of Level 3 valuations, how have they tackled it, we've tested it in the following manner, and, on balance, we feel that this is where they're positioned. And I think that is extremely helpful. It certainly gives the investor a view is this an aggressive management or it's within the bounds of acceptability but always at one end or are they somewhere down the middle? And Rolls Royce comes out I think pretty well down the middle. This little bit could be the liabilities perhaps understated. On the other hand, they're slightly overstated on balance. And I thought it was an excellent report. It taught me a lot more than I've ever learned from an audit report.

MR. HARRIS: How do you respond to those who would say that what you are recommending in your written statement would require the auditor to be the source of a significant amount of additional original information about an issuer and that is simply not the role of the auditor? We're going to hear that throughout the day.

MR. TWEEDIE: Well, you know, I was listening to the comments that this is the role of the audit committee. I really don't agree with that. I would like to see the auditor moving away from the company. He's representing the investor. He's going into the company. He's reporting to the investor in my book, and that's where he should be.

So the information that goes out there, that's what the auditor feels that the investor should know. And I feel very strongly that we should not have the audit committee giving that information and the auditor remaining quiet saying, yes, I agree. I would rather he did it, and I think that increases the value of the audit.

It's certainly interesting, listening to a few of the audit partners who have been involved in the audit report. I think it's energized the firms, and it's made those involved in the audit much more interested in it. They can see it's far more than just a tick. It's actually helping the markets. I think there's a lot more we can do. A lot more you can do. I'm out of this now.

MR. HARRIS: Well, I think that goes directly to the role and the future relevance of the profession, but you're cutting against the grain of significant amount of the testimony we're going to hear throughout today with respect to original information.

MR. TWEEDIE: Well, I'm quite used to doing that, I think. One beauty I found after 25 years of standard setting, I don't have to be polite anymore. I can just say what I think. You'll enjoy it, too.

MR. DOTY: Oh, the chief auditor.

MR. BAUMANN: Thanks very much. And, David, thanks very much for joining us today. I know you had a difficult trip over, so thanks again for doing that.

Similar to the question that Steve Harris asked, many of the objections that we've received in the comment letters are that, if additional information is needed by investors, then accounting standard setters should require new, different disclosures. If the information that investors are looking for is, well, what was, as Lynn Turner was talking about, where was the management on the range of reasonableness with respect to the estimates? Could accounting standard setters require management to disclose their ranges, their high and their low and where they came out on that?

So I guess the question is is this a, as an accounting standard setter in your great career, do you think this is something that can be solved through an accounting standard setting, as opposed to auditor reporting?

MR. TWEEDIE: You know, this is a great country, but I really despair of it at times. When you look at the quantum of accounting standards you have in the U.S., and this is no criticism of FASB who have been trying to cut it back, but it's almost you've got to get everything written down. Judgment disappears in that sense. And they're always worried. I heard at the last panel the concern about the lawyers. Well, if you had a panel of lawyers writing the Declaration of Independence, I'd suspect you'd still be paying homage to Her Majesty at the moment and trying to define liberty and happiness and things like that.

But I really would like just -- the auditor has actually got a range of experience, which, quite frankly, the company hasn't got. So if we want to find out, you know, where does this company stand, the auditor is in a much better position, having audited the industry or various companies in the industry, to be able to say, well, these guys are aggressive. I don't think the company itself could say or even would want to say that. So I suspect they might get boilerplate disclosure.

MR. HARRIS: If we've got five minutes to go --

MR. DOTY: We have five minutes, but Sir David has a 1:00 plane. So we do him a courtesy by springing him and by convincing our next panel on time. So, Sir David, with copious thanks from this board and from all of your many friends and associates here, God speed, safe travels, and we'll see you soon. Thank you.

We should commence the next panel as promptly as we can. If we could take a ten-minute break, ten minutes strict, that would get us started at 10:45, and it would be a good idea.

(Whereupon, the foregoing matter went off the record at 10:33 a.m. and went back on the record at 10:47 a.m.)

MR. DOTY: If we can resume. This of course, is the -- this is the international panel that will take us into the noon hour. This is truly a blue ribbon and distinguished panel of commenters from Europe. Sven Gentner is the counselor for Economic and Financial Affairs Section for the delegation of the European Union to the United States.

He's responsible for the coordination of the financial markets regulatory dialogue between the European Commission and the United States. Before joining the Commission, he has been working for Allianz Insurance, PLC, the Institute of Public Finance at the University of Muenster, Germany. He has a private sector and academic background, as well as his distinguished service in the EU.

Nick Land is the Chairman, Audit and Assurance Council of the UK Financial Reporting Council. He retired as chairman of Ernst & Young in 2006. He's a non-executive director and chairs the Audit and Risk Committees of Vodafone Group, Alliance Boots, BBA Aviation, and the Ashmore Group.

Nick is a director of the FRC. He's a member of the FRC's Codes and Standards Committee, and we're privileged to have him here for these proceedings.

Professor Arnold Schilder became chairman of the International Auditing and Assurance Standards Board, the IAASB in January 2009. Previously, he was a member of the managing board of the Dutch Central Bank, responsible in particular for banking regulation and supervision.

In addition, he served as the chair of the Basel Committee on Banking Supervision Accounting Task Force, and he's a member of the Public Interest Oversight Board. Arnold is also a frequent observer at meetings of the SAG, and we always benefit from his presence. Thank you all and please begin, Sven.

MR. GENTNER: Thank you. Good morning and thank you for inviting me to speak here on behalf of the

European Commission. I think this is another sign of the very good cooperation we've got between the PCAOB and the Commission, and we're very grateful for that, and we also fully support your process.

I've been invited to talk about audit reform in the European Union. I was actually looking forward to telling you that the European Parliament had just voted the reform in the EU, but unfortunately the vote has been postponed until tomorrow. It will nevertheless take place and I'm sure it will go well.

Let me just say a few words about the reform in the EU. As you know, our main objective, of course, was to increase the quality of statutory audit. The reform we are undertaking has got two pillars in EU law. We've got various legal instruments, one of which is a directive, which will be -- contain horizontal measures applicable to every audit unit and their regulation, which will contain stricter requirements for the audits of public interest entities, PIEs.

For example, credit institution, listed companies, insurance undertakings or other entities designated as such by member states, member states of the

European Union. Of course, the reasons behind that are that the consequences of misstatements for PIEs are much greater than for other types of companies.

Concerning the auditors' report, the new legal framework will only define a minimum. The EU member states have the right to impose further requirements, which is a tool for us to accommodate the specific needs of each concrete legal environment, which as you are aware, these environments differ across our 28 member states.

We don't impose a template or a model requirement in the new frameworks. It is up to the member states to define these models or templates.

Let me say a few words about what is new in our reform. All the initiatives we're taking are mostly motivated by the objective of achieving greater transparency. So we've introduced a requirement that the place of where the statutory auditor or audit firm is established be indicated.

We want a statement that indicates by whom or by which body the auditor was appointed. Typically, these are the shareholders at the annual meeting, but there are also other modalities possible in European law, as long as the independence is assured. But we want this to be made public.

We want a statement indicating the date of the appointment and the period of total uninterrupted engagement, including previous renewals and reappointments of the auditor. Again, this is to provide more information to the investors, and to allow investors to better assess the relationship between the auditor and the audited entity.

We also introduced an obligation to report on any material uncertainty related to events or conditions that may cause significant doubt about the entity's ability to continue as a going concern.

As you are aware and has been mentioned before, this is in particular a reaction to what happened during the financial crisis, where we've seen many cases where financial firms revealed huge losses just after they had received a clean audit report.

We think that the introduction of these requirements will help address these issues.

We are also introducing obligation to describe the most significant assessed risks of material misstatements, as well as a summary of the auditor's response to those risks, and finally and where relevant, key observations arising with respect to those risks. As you are aware, typical examples are the use of off balance sheet finance, changes in IT environment, et cetera.

Important is that there really is a description of the most significant risks of material misstatement in the new report, which again we hope will improve transparency in that respect.

Finally, we want that the audit report explains to what extent it was capable of detecting irregularities including fraud. This addresses the issue which has been there before, the expectation gap.

We're not proposing a model template. We're expecting the profession to develop a structure here, but we think this will be an important element to counterbalance the impression that auditors sometimes rely too heavily on management statements, and to make sure that auditors can show how they've checked the validity of these statements.

As you are probably aware, we are requiring in addition to the auditor's report, now also a more detailed additional report, which is to be made available to the audit committee of the audited entity. We expect that this additional report will enhance the flow of information between the auditor and the audit committee.

The report will not be public, but member states can allow the report to be made available to third parties when necessary, for example, courts.

Finally, we think that there is a lot of convergence and congruence between what has been proposed by the PCAOB and what is in the EU audit reform. I think we share the general principle of making the auditor's report more informative, and we share a concrete approach how to establish that.

In particular when it comes to including critical audit matters in the audit report, and also in relation to the reference to the year when the auditor began serving as the company's auditor, where you are aware that we've introduced mandatory rotation requirements.

Again, I would like to thank you for inviting me and the European Commission today, and we look forward to cooperating with the PCAOB. Thank you.

MR. DOTY: Thank you, and your work on this panel has just begun. Chairman Land, please proceed.

MR. LAND: Well good morning, and it really is a great pleasure to be here. It's actually a surprise to be here; it wasn't part of my career plan to find myself at a public hearing with such an august body. But it's a pleasure to be here.

Can I briefly start by describing the role of the UK's Financial Reporting Council, because I think it will help put into context some of the changes that have been made. The FRC is an independent regulation whose mission is to promote high quality corporate governance and reporting to foster investment, and in essence it has two legs.

The first is codes and standards. It sets the corporate governance code for publicly listed companies. It sets audit and ethical standards, and it sets accounting standards. It obviously sets those standards under the sort of general auspices of the international standard setters.

The second leg is conduct. It reviews companies' financial statements, inspects audits, oversees professional bodies and disciplines auditors and accountants. It's more or less a regulatory one-stop shop.

So what drove us to want to enhance the audit report in the UK? Well, a number of your speakers have already talked about the wider impact of the financial crisis in 2008, and of course we suffered from it very, very significantly. But just sort of narrow down one of the repercussions from that crisis.

We did see a significant increase in the intensity of focus on the effectiveness of company stewardship, and the adequacy of the communications to the market of both audit committees and auditors, and in that, I'm sure we weren't unique.

As part of this, we also detected that investors were becoming increasingly frustrated that the audit and auditors operated in a black box. They felt they had no visibility over the audit and no -- and very importantly, no hooks on which to ask questions about the audit.

As an aside, and as a number of your guests have said, it's always seemed strange to me that the audit report, which is the only truly independent voice in a set of accounts, is the one part of the financial statements that there's normally no point in reading, and you've referred to the fact that your audit report over here hasn't fundamentally changed for 80 years.

Well, you think you've got problems; it hasn't changed in the UK for about 150 years. So against this background, in the first half of 2013 the FRC, after very extensive consultations, made two significant interlinked changes.

First, it revised the UK corporate governance code to increase the disclosure in a company's annual report, about the work of the audit committee, including the significant issues that the committee considered in relation to financial statements, and how these issues were addressed.

It also required that the board should make a statement in the annual report that they consider the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

Second, the FRC revised the audit standards governing audit reports in a number of areas. First, the auditor is now required to report by exception, if the board's fair, balanced, and understandable statement is inconsistent with the auditors' knowledge, or if the matters disclosed by the audit committee describing its work do not appropriately communicate the matters that the auditor communicated to the audit committee.

Second, the audit report is now required to describe those assessed risks, material misstatement identified by the auditor, and which have the greatest effect on the overall audit strategy, the allocation of resources to the audit and in directing the efforts of the engagement team.

Third, the report should also provide an explanation of how the auditor applied the concept and materiality in planning and performing the audit. Last, the report should provide a summary of the audit scope, including an explanation of how the scope was responsive to the risks of material misstatement, and the auditor's application of the concept of materiality.

I think it's very important to emphasize that these requirements in our new standard are set at a very high level. We want to encourage different approaches, and to discourage standard paragraphs and boilerplate.

So what has the experience been in the UK so far? The new standard applies primarily to companies having a primary premium listing on the London Stock Exchange, and it was effective for periods commencing on or after the 1st of October 2012. So we now have -- we're now seeing a significant number of new style audit reports.

The reactions from the audit firms, essentially the Big Six, has been positive, constructive and very supportive. Many front line audit partners, as Sir David referred to, are genuinely enthusiastic about these changes, and have embraced the new concepts.

And indeed, it appears to be enhancing their position with management and the audit committee, and giving them a chance to demonstrate their depth of thinking and management challenge. We've not yet seen any signs of boilerplate or legalese. It is, of course, early days.

We're seeing experimentation and Sir David referred to the Rolls Royce report, but there are others.

We're seeing experimentation and real attempts by the auditor to be frank and open about their discussions of the risk they focused on, and how they satisfied themselves, the application of materiality and the scope of the audit.

Finally, initial reaction from investors has been very positive. It's given them some insight into the auditor's world, and disclosure around scope materiality has begun to generate discussions amongst stakeholders. This must be a healthy development in respect to both good stewardship and increasing stakeholders' understanding of what an audit can and cannot do, therefore potentially narrowing the expectation gap, and we hope increasing the confidence in audit, which I suspect in the UK at least, is at an all-time low.

Thank you very much for listening to me.

MR. DOTY: Thank you, Chairman Land. Chairman Schilder.

MR. SCHILDER: Thank you, Chairman Doty, and thank you very much for the opportunity to speak here about the work of the IAASB on auditor reporting. We are an independent global standard setter, and an important aim of our work is therefore to facilitate adoption and convergence of national and international auditing standards.

So I really commend the PCAOB for arranging this global panel, and I note that our collaboration with the PCAOB has been a critical part of our work to date. I also note many positive comments on how far we have come already.

Why is the IAASB seeking to change the auditor's report? This topic has been on our radar screen for some time already. In 2006, we commissioned academic research jointly with the Auditing Standards Board of the AICPA, and Professor Ted Mock, a panelist this afternoon, and others, provided us with global input about user's perceptions of the auditor's report.

And then of course the financial crisis has heightened the demand for more communication from auditors, and has highlighted over-arching concerns about the value of an audit and the relevance of the accounting profession.

Well that sparked the IAASB and our work to consider how best to respond to the needs of users, and audit reporting has been our top priority for the past two years. We issued two public consultations on the topic, and note the continued support for moving forward to enhance the communicative value of the auditor's report.

In our most recent consultation and exposure draft package in July 2013, unanimously agreed by the IAASB, focused on audit reporting, on key audit matters, other information and going concern. It also included other initiatives to increase transparency about the audit and the auditor's responsibilities.

Overall, as we learned, there's strong global support for the IAASB finalizing its proposals this year, and we have determined to do that.

Now the topic we refer to as key audit matters or KAM, similar to your critical audit methods, also CAM; it's just a K or C so far as we have come already. That topic is viewed by many as the most significant enhancement to audit reporting, and we propose to require auditors of listed entities to communicate KAM in the auditor's report, and others of course are encouraged to review that on a voluntary basis.

We define key audit matters as those methods that in the auditor's professional judgment they're of most significance in the audit of the financial statements of the current period. KAMs are selected from methods communicated with those charged with governance, the audit committee, and thereby providing transparency about communications that investors have said are important to audit quality.

Looking now at the common levels, investors, regulators and auditors largely support what we have proposed. But they've asked for more guidance and more specificity on how auditors should apply the decision framework, and they've also urged us to take steps to ensure that both the methods identified and how they are described in the auditor's report results in meaningful communication to investors.

Robust application guidance in our standards, as well as revised examples of key audit matters, will give an indication of how the IAASB expects the concept of key audit matters to be applied in practice. Preparers and others who do not support the concept of KAM often cite concerns with the auditor providing original information, that is, information that is not otherwise required to be disclosed in the financial statements.

Auditors have asked for more guidance on how to deal with circumstances that might result in the auditor communicating about sensitive matters. So our Board is exploring how to find an appropriate balance between auditors providing useful information about the most significant methods in the audit that was performed, while at the same time respecting the important concepts of client confidentiality.

We are very pleased to support. We have heard from global groups like the International Corporate Governance Network, IOSCO, IFIAR, the Basel Committee, World Bank - for our concept of KAM, and including KAM in the auditor's report will be a significant change in practice.

So the IAASB will do all it can to support effective implementation to achieve its intended aims. Now similar to the PCAOB, we have also substantively revised our standard addressing the auditor's responsibilities for other information.

Investors and others have emphasized the importance of information included in MD&A and other areas of a company's annual report. While this information is not audited, the auditor's attention to it helps to increase user's confidence in such information.

Our proposals included required auditor reporting on other information, including identification of which information has been read by the auditor. We will re-expose this proposal in mid-April for a 90-day comment period.

Our project also addresses the topic of auditor reporting on going concern. Feedback to our proposals has highlighted the need for a holistic approach, that is, that changes in auditing standards need to be considered in tandem with changes or clarifications to accounting standards.

We know the PCAOB's separate project in the area is closely tied to the FASB, and we have had similar liaison with the IASB to understand how they addressed this topic and are following their developments with interest, as we seek to finalize our proposals.

In relation to other improvements, the Board supports requiring disclosure of the name of the engagement partner in the auditor's report for listed entity audits, and we note, of course, the PCAOB has a similar proposal in process, and we look forward to hearing about the Board's plans for a way forward.

We also, of course, are taking into account relevant developments in Europe. I think, simply said, Europe is a done deal with regard to audit reporting. You heard from Nick about the UK FRC, and there are now more and more examples of this new style of audit reporting.

They are coming into the market, providing it can be done, and does result in helpful information for investors and others. I must say in my own country, where it's not in law but on a voluntary basis, already almost half of listed entities' auditor's reports also show this new model with great enthusiasm.

Stakeholders, including bodies such as the CFA Institute and the Center for Audit Quality, have encouraged us to take every opportunity to seek to minimize differences among the various approaches to auditor reporting, and we heard it this morning again.

We take that, and you do as well, very seriously, recognizing that we all have a duty in the public interest to respond to what we have heard through our multiple consultation processes.

So in conclusion, through its work on audit reporting, the IAASB believes it has a unique opportunity to increase the relevance of the audit, and to trust in the profession. Not only will the auditor's report become more informative, but we expect that this increased reporting could change the behaviors of not only auditors, but also management and those charged with governance.

A renewed focus by the auditor on matters to be addressed in the auditor's report, together with the increased attention by management and those charged with governance on financial statement disclosures, stands to benefit investors, and have a corresponding effect on audit quality and the credibility of financial statements. Thank you very much.

MR. DOTY: Thank you. We have ample time in this panel for all the questions, and I want to therefore begin with one for the panel.

Whenever one proposes a change in the audit model that involves additional disclosure, additional information, whether it's the name of the engagement partner, critical audit matters, there are objections in addition to different litigation regimes, which we'll talk about later and which will occur.

There are objections made which are difficult, and for which we must take account, we have to think about. Your experience bears on this. The objections are message-mixing. If you include information in the audit report, the message that this is the firm's report, the message that the binary opinion conveys will be somehow mixed and confused and obliterated or obscured. Investors won't understand it.

You run the risk, if you include information of the kind that your regimes are doing and that we are contemplating, of mixing message.

The second is one that is less of a problem for you, with your legal regime, but is a problem for us, and that is mission creep. Who are you as an audit regulator to tell audit committees what they need to know about or what they need to worry about, in terms of additional information that you're asking the auditor to comment on, such as the CAM?

That really leads -- that collapses into a very important argument, that by doing any of these things that we propose in these disclosure releases, we are compromising the authority, the independence, the effectiveness of the audit committee. This is a very big issue for us.

What have you found about this? Has -- you have all got the regime now. You're doing it or you're outreaching to find out about it.

To what extent are you concerned and to what extent should we be concerned about message-mixing, obscuring the message of the binary opinion, putting pressure on audit committees that properly is within their business judgment, and essentially getting over the line into compromising the effectiveness of the audit committee?

Is this something that should block us from -- should keep us from modernizing an audit reform model? What's happened, and what does your experience tell you? I'm sorry for the sermonette, but you'll hear some other sermonettes from my colleagues as we go forward.

MR. LAND: Shall I kick off, Chairman? Of course in the UK we do have an advantage, as you are well aware, because we set the corporate governance code, which covers the responsibilities of audit committees, and we set guidance for audit committees. So we were able to do these two things in parallel.

The truth was we were changing the rules of engagement for audit committees about the transparency of their work, and then it suddenly, as far as I'm concerned at least, I suddenly realized this would be a great time to change the audit report, so there was a little bit of serendipity in all this. So we don't -- we don't have that fundamental problem that you're dealing with.

Having said that, I mean there is no doubt, and I've seen it to a limited extent on one of my boards, that the new auditor reporting in the UK can create some additional tensions between the auditor and management. I personally think that's a good thing in principle. I think that, you know, increasing in the right way.

I don't think we should be worried about tensions being increased, as long as they're done in a mature and sensible way, and as I said, I think it's given the auditors in a sense, if I can put it like this, more authority.

I suppose the naive answer to your question vis-a-vis the USA, which I'm not really very qualified to comment on, is of course there's nothing to stop an audit committee or board inverted commas responding to what's in a new form audit report in the UK.

I mean the logic to me, if I was chairing an audit committee in the USA, and I say this with very little knowledge, so forgive me, and your proposal, as I hope they are, are enacted, my response I think, hopefully not defensively, would be to consider what more I needed to say in my audit committee report. So it seems to me that there's a remedy there.

MR. DOTY: Other panelists? Sven?

MR. GENTNER: Yeah. I can't yet talk about the implementation, of course, of our reform because it's just about to be decided.

But I think what has come out of the negotiations in Europe we feel is a good compromise between a realistic view on what the audit report can convey, but at the same time also taking into account more the needs of investors, who are an important audience for the report, and of course also the needs of the audit committee.

I don't think we're worried about message-mixing when it comes to our reform. The things that I've mentioned in terms of the tenure, the length of the period of the auditor is active there. The issues about addressing the expectation gap and other things, if anything, will make it clearer and better understandable what an audit report can do and cannot do, which I think are two important elements for investors to understand.

There is a risk that you do too much and there's a risk that you do too little, and I think it's very important that the investors know exactly what they can get out of such a report.

Finally, I don't think that there is a risk the audit committee will lose in terms of its importance will be bypassed or whatever, because both the audit committee and the investors play an important role in this respect, and I think these roles will be preserved.

MR. DOTY: Thank you.

MR. SCHILDER: When you talked about message-mixing, Jim, what struck me most is the quote "investors won't understand it." I find that -- it's not your quote, of course -- I found that almost offending to investors. Maybe that was true long, long time ago, but nowadays, I think that will be a completely unfair argument.

Because investors, as we learned from all the consultations and dialogues, are very interested, and they are really willing to do a lot of exercise and effort to really understand.

That's behind -- I mentioned the examples in the Netherlands, which is on a voluntary basis, so companies have chosen to invite their auditor to already report this new style, and just that public report from senior partner from one of the large firms, and I, as did my clients, in this case, made that choice.

So it's not so much about international compatibility, because these reports will be very unique per company. But it's also very important to fulfill and to accommodate outspoken wishes of investors, and investors have been much engaged in this dialogue.

Last year, we saw that in many examples where auditors spoke publicly in the AGM, and then they got feedback, of course, from investors.

So I think we have to take investors' wishes, as they now have expressed over so many years in so many ways, to take very seriously, and therefore it will be very interesting to see the analysis that of course will come, as so many reports come into the marketplace, how investors, analysts and others will comment about that, what is most helpful, what is less helpful.

On the other point, on the audit committees, well a similar observation, that actually these experiences reinforce the dynamics, the positive dynamics between management, audit committees and the auditors.

It's not only a challenge to the auditors; it's the other way around as well. It may result in better and more informative disclosures from management and audit committees, and certainly the UK is a very interesting example.

So rather than compromising, it's I think respecting regarding the independence of each of these stakeholders, and as we learned from our work on audit quality, as additional published in our framework for audit quality, these interactions between the various stakeholders are very important, and the more we can stimulate it, the better.

MR. DOTY: Steve Harris.

MR. HARRIS: Well Chairman Schilder, first of all I want to commend you for making the audit report the top priority over the past two years for the IAASB, and I commend you for all the work you've done on that. I also encourage you to finalize the audit report and what you're doing at the IAASB if possible in 2014.

I know it's been a very aggressive schedule, but I think you've outreached. I applaud you for all the work that you're doing and have done. Before I get to the questions, since time does run out, I just want to make a point somewhat separate, but a point that Rick Murray brought up on the last panel, which I'd like you to think about, because I think we ought to think about it.

It's not directly related to the audit report. I will get to the question on the audit report. But Rick Murray encouraged, as has the ACAP, that the SEC and the

PCAOB should compile independence requirements into a single document, and make this document website-accessible.

So on this issue of independence, I wish you internationally would consider doing the same thing.

Now with respect to the question, in your remarks, you mentioned the IAASB as exploring how to address concerns raised by some commenters, about the auditors providing original information. So would you please clarify what type of information the IAASB would consider to be original information, and then for instance, would the auditors, the disclosure of key audit matters be considered original information, since it's not disclosed by management as such?

Additionally, would you please expand on how the Board plans to address this matter. Finally, in encouraging you as aggressively as I have, to complete your project in 2014, that's with the caveat that it has support from users and investors.

MR. SCHILDER: Thank you, Steve. Thanks for the compliments. It was hard work. I can only refer to Dan Montgomery, my deputy chair and many on the Board and staff that have worked so hard, but inspired by the many comments that we received.

The independence requirements is something that we are discussing at the moment, and in our proposals, we also proposed a statement about the auditor being independent, but then also referring to let's say the sources of these independence requirements.

Now for a multinational group that can be quite a lot, and the same is true in the public sector. So we're discussing what is the best way forward there, and certainly the suggestion from Rick is an interesting one, whether it would help that you would have somewhere a combination of all the many requirements.

But again, if you take that from a global perspective, it's not easy, because it will basically point to the many ethical requirements, not just in, let's say, the ethics code of the ethics board, but many national requirements and very specific ones.

So there's probably a bit in between, an option that we will be discussing, whether it would make sense to focus on the group engagement partner and which requirements are applicable to him and his team, rather than all the component auditors.

So that's basically where we are. So we have not a final answer yet, but it on one hand needs to be practical and not result in a long list of many pages. On the other hand, it needs to be informative.

But as we are thinking about the concept of using that size also for let's say the kind of boilerplate, relevant boilerplate about responsibilities, this might be another interesting option.

Original information. Maybe the simplest answer will be what is -- what the company is required to disclose by the applicable accounting standards. That's the original information that has to come from management and the board, and it may not just be accounting standards.

It could be more, national requirements, et cetera. So that is management's and the board's responsibility. Therefore, the focus on key audit matters is what the auditor can comment upon that, from the auditor's work. And as I mentioned, we start with what the auditor has reported and will report to let's say the audit committee.

It's quite clear if the auditor would come to the audit committee and tell them information, where they immediately say well, we expect that to come from management or we have already received from management, that's not what is expected from the auditor.

What is expected from the auditor is sharing significant judgments that the auditor had to make, and that may include many comments, how that, of course, relates to specific items in financial statements or whatever.

The point, of course, is that there can be a bit of a gray line there. If the auditor wants to explain why certain audit conclusions or certain significant auditor work was done, you may want indeed to explain a bit more than already at that point has been in the draft financial statements or MD&A, whatever.

That, we think, would just reinforce the dynamics between management, the audit committee and the auditor, and that's why we also think that this should not be something that is only discussed at the very end of your reports.

It should already be part of the beginning, and focus on what might be key audit matters, and how then is management disclosing about that, and how the auditors would help in deciding about it.

But again, it's a bit of an area now of starting experimentation. So I think it's difficult to have a very black and white response. At least that's how we approach it.

MR. DOTY: Lewis.

MR. FERGUSON: Thank you, and thank you all for coming here from Europe. I just want to re-ask a question that I asked Sir David Tweedie again, which has to do with the potential for these additional disclosures to generate -- to degenerate into a form of meaningless boilerplate.

Clearly, that does not seem to have happened in the early days in the United Kingdom. I mean it's almost like a thousand flowers, let the thousand flowers bloom and that seems to be what happened. Do you see that as a continuing trend, and how in the IAASB proposal did you consider that issue, and what have you done to try to guard against it?

MR. LAND: With regard to the UK, well I mean it's a lovely expression. I think we are at this moment seeing a thousand flowers or at least a hundred flowers sort of blossoming, and they're all a bit different. So I think we are very, very encouraged so far.

We are seeing, which I think is good, I think we are beginning to see some healthy competition. It's obviously it's new. I think we are seeing a bit of competition between the firms, who can come up with the most appropriate audit report.

You've heard Sir David refer to Rolls Royce, which I think is a shining example at the moment. So I think, you know, I think we are going to see some competition there, which I think is healthy.

I mean, the other thing that we were very conscious of is our amendment to our audit report standard, which obviously is based on Arnold's standard, but our amendment to encompass these new requirements. It was very short indeed.

I mean we really did not, you know, it's no more than a page. I mean we kept it at a very high level, you know. We've refused in the consultation process to define too much, and we've made it very clear that we, you know, we expect them to use, you know, use their judgment and not to revert to boilerplate.

I think in terms of managing expectations, one thing that is inevitably going to happen is you're not necessarily going to see next year's --

I mean if I just take the board I'm on, which is Vodafone, its key financial risks and therefore the critical audit matters have basically remained the same, ever since I've been on the board for seven years, impairment because the mobile phone industry in Europe has spent a lot of money and gets impaired.

It's tax risk, because we have big fights with jurisdictions, particularly in India, audits, deferred tax assets, because we have huge amounts of losses.

So next year's audit report from Deloitte, and Deloitte was the very first to do, to produce a new style report, isn't likely to look that much different, I would judge, from last year's report. So we have to manage expectations there. There's not going to be a new Vodafone plan necessarily next year.

But we've genuinely seen the firms, effectively the Big Four so far, embrace this, want to -- want to comply with the spirit underpinning our standard, and to date, I think, should feel very proud at the way they've tackled this, quite frankly.

So I think all that bodes well for the future. I mean time will tell is the honest answer. But so far, it's way ahead of our expectations.

MR. DOTY: Jay Hanson.

MR. HANSON: Echo the thanks to the panelists for coming today, and I've got another question for Mr. Land, and the requirements or the -- I think you hesitate to call them requirements -- but the guidance for auditors for what to put in the report includes some of the details about the conduct of the audit.

What were the risks assessed, what was the materiality level applied, how was the scope responsive to the risk? We've chosen at this point to not go that direction, to have the details of the holistic conduct of the audit included, and we've gotten mixed feedback on some of the outreach about whether investors would find that useful. So for now we've chosen to not go there.

I'm curious if you, in all your considerations for adopting what you put in place, if you had feedback from investors about what they would find useful, and if -- obviously you chose to go this path, but maybe the decision points that you're weighing and whether to go this route about the details of the audit versus some other route, it would be helpful to hear some insight about that.

MR. LAND: I could certainly do that, and I mean first, it seemed to me -- I mean I was an auditor 20 years ago, but things have changed a great deal. But it seemed pretty obvious to me that if you are going to reform the audit report, and it badly needs reforming, that getting some idea of what the input into the audit is what is the output seems to me very logical, which is not just me; which was our starting off point.

But in some very extensive consultation, we had a lot of extensive consultation. We had an open hearing, such as yours. To the best of my knowledge, the investors, and you'll be hearing from investor reps from the UK tomorrow, were pretty unanimous in saying they thought this would be helpful.

Certainly in discussions that we've had post the adoption of this new audit report, investors have continued to tell us they found it very helpful. It's quite interesting that there is already a debate that's started, not that I'm aware at a company level.

But there's already a debate started in the UK amongst investors, amongst stakeholders about the whole concept of materiality. That's been driven, I'm sure, by the disclosures that we require and is a requirement, but also because the FRC has produced a sort of thematic review on materiality.

But it has begun to generate that debate, and I think the truth of the matter is, and I'm not in any way being rude about investors, but you know, I suspect that investors were somewhat surprised when they read in the Vodafone audit report that materiality right at the very top is 500 million pounds. I mean that's a lot of money, as it were.

So I think that they've welcomed it. We got very little pushback from the firms. A little bit of reservation from the firms, but very little pushback from the firms, and I think it's led to this sort of debate, and I think it's a civilized debate.

It's not the sort of pointing of finger at a company. It's really raising questions about the whole concept of materiality. In opening this black box, which frankly the audit is in, has always been in, I think it's very, very healthy.

I would also say, and this was not scientific, as part of our consultation, one of our senior staff members, McMarrick, who spends a lot of time working with Arnold and his team, we informally -- he informally rang 13 U.S. investors that he had contacts with, just to see what their reaction was.

You know, it was pretty unscientific and he's not here to report. But the report back that he gave to us was yes to materiality, yes to scope and yes to critical audit matters. Now I'm not suggesting that in any way is that significant, but when we put it to them in our language, those 13 were, I'm told, positive.

MR. DOTY: Jeanette Franzel.

MS. FRANZEL: Thanks for being here today.

I'd like to ask to what extent did each of your organizations analyze costs and benefits of the proposal before, you know, during the development of the proposals, and then in particular in the UK, what kind of post-implementation analysis is also being done on costs and benefits, and what were the results of your various analyses, and if there are any really important things that came out of there that we should be considering as we go through our own analysis of costs and benefits?

MR. LAND: We did consider cost, of course. We will be doing an analysis at the end of the reporting season. We haven't done it yet. Our own -- my own view, and that of my counsel and indeed I think the feedback from the firm, was that -- it's not scientific because we haven't done the appraisal, was that the cost implications are pretty low.

I mean at the end of the day, what are they reporting on? Well you know, in the audit plan, the audit strategy document, at the beginning of the audit, they set out the critical audit matters they're going to focus on.

At their closing report, they will report on those critical audit matters and if those critical matters have changed will tell the audit committee and report on it. I'm not sure where the other costs should be.

I mean essentially, put very crudely, I'm afraid in my language is the new-style UK audit report is not -- I mean the part that has to be written a bit more carefully is basically what the executive report in the audit plan says update that the audit committee get.

So I just don't see the argument why, apart from a bit of cost, of a bit more sort of checks and balance within the firm on this new-style audit report, I don't really see where the costs, where the new costs should be.

I mean if -- you know, they should be focusing on these things, whether or not they're reporting on them. So I just don't buy the cost argument, and I don't think -- it was certainly nothing -- certainly none of the firms put it forward as a major impediment.

MR. DOTY: The wings have been very quiet, both from the staff and the observers.

MR. SCHILDER: Just adding a bit to what Nick said, the consultations he mentioned were of course part of ours as well, and in a way the various consultations and research was all the time about pros and cons, because all the time the question is why are you doing this? Certainly in the beginning, there was more hesitation than now, I think.

To some extent, of course, there is intangible benefit, the failure to use is not something that you can easily quantify. You can't think about costs. We thought like mixed standard usually that should not be too much of extra cost.

But one thing to help this would be the starting point of what you have communicated with the audit committee, because there you have the issues as a gross collection, and also how you have communicated that to them.

So they're deriving something about of that for external users. It could be not that complicated, and actually we're pleased to hear feedback from partners who have done this in practice, and also the results from field testing that we got and said well, the audit partners almost intuitively knew what they had to report about it and how --

There can be, of course, special circumstances, where there are very sensitive issues, difficult issues, which certainly will take more time. But then the argument could be that it's worthwhile to spend that time, because it's just a matter of reality, and again, relevant to users.

MR. DOTY: The dilemma we face coming out of the concept release stage and going into our proposal was that where other information was concerned and the CAMs were being suggested, along with the auditor obligation to evaluate and to discuss the evaluation of other information.

What I actually heard in these meetings was a very strong investor endorsement of where you were, and a suggestion that we were really coming in with less than investors would want and could use, and that investors might want more from us.

On the other hand, we had equally strong voices suggesting that this was going to be a real departure. "A significant departure in practice" was the term that I think you used, Arnold, in terms of getting into evaluation of other information and discussing or revealing what our evaluation was.

To some sitting here, it might seem with these two polar opposites of where we were, that we might have gotten it just about right, that we might be just where we need to be in terms of coming forth with an augmentation of the audit report, and new information.

But given where you are and what you're hearing and what you have described to us today, how would you reply to people who say look, once you cross that line and once there is other information contained in what the auditor says about his evaluation or its evaluation of other information in the audit report, you have really crossed the Rubicon. You've made a change that has a slippery slope implication and you won't stop.

Is this something we have to worry about, in terms of any sip of the cup of other information, is fatal? Leading the witness is something that lawyers have a bad habit of doing, and chairmen are especially prone to it. But my colleagues are going to pay me back later with other panelists.

MR. SCHILDER: Thanks. In a way, I'm in an easy position. I've mentioned in my introduction that we very soon will re-expose our revision of ISA 720, which deals with the other information, and it's a difficult subject.

You can very much simplify it; that's how we start with a standard already, and you have that as well, and that deals with the auditor's responsibilities. There's to be a certain amount of work to be done, and the only thing we would like to add is to make the conclusion of that work explicit to users, whereas nowadays it's implicit. Nobody knows about it.

But we have published and exposed the draft to revise the standard, and we got a lot of critical feedback, in all fairness, because what exactly is the other information that you're talking about? What is the kind of work effort that you're expected to do?

That all has been part of our deliberations before re-exposing. In my now six years as chairman, it's the first time that we re-exposed something. So it just illustrates how complicated that is.

I hope that we now have struck a reasonable balance between on one hand the need for transparency that we see here as well, so making explicit the conclusion of the auditor's work here, without on the other hand making it a complete new assurance engagement or so.

So basically, the construct is the intelligent read by the auditor of the other information, and that's just a matter of reality. You cannot just have the French statement, but you see the whole context, and you have to do that with all your knowledge of the company, and what you have learned during your audit, and then you have to see where there are inconsistencies or maybe misstatements, an item that has to be addressed appropriately by management or you have to make a comment about it.

So that's what we soon will be re-proposing, this basic concept of this intelligent read. I hope that by that we have struck a reasonable middle position.

MR. DOTY: I didn't mean to goad the wings into action.

MR. BAUMANN: I was just waiting for all of you to finish your questions, and take my turn. In our proposal for changes to the audit report here in the United States, and in the responses to it, there's wide support from investors for change.

The audit profession, like in the UK I think generally is largely supportive of change. Maybe some differences on the details, but largely supportive of change to the audit report. Academic research, I think, largely supports the need for change.

The one objection really coming through us is from preparers, who are throwing a lot of reasons up as to why changing the audit report is a bad idea and will have bad consequences. I'm just wondering if any of you can respond to that, but certainly in the UK, since you've already had the experience.

Was there opposition from management about the changes to the audit report, or in the EU when your proposals went out, and in the UK then, what's the reaction been since you got a report from management? So both was there opposition and how is the reaction now?

MR. LAND: There was no opposition to this from preparers. Now let me then -- that sounds great. The truth of the matter is that the preparers, whether to their credit or not, didn't actually choose to take a lot of interest in this standard.

So from memory of the sort of hundreds of responses we got, we only got two from preparers. So I can look you in the eye and say it hasn't been a problem. But I do have to put an auditor's caveat on that.

But reaction, I mean I think post, I can just talk about my four boards, and I appreciate it might be a little -- a little not exactly fair to the preparers, because they probably know or some at least know that I'm, you know, I'm involved in this.

But it hasn't created, in my experience, any problems. That's obviously very limited. I haven't heard of the 30 or 40 reports out there. I wouldn't obviously necessarily hear. But I haven't heard of big issues.

I mean it has -- you know, you can well see it will create some tensions, and on one of my boards, you know, the CEO was a bit sort of uppity about when he saw the audit planning document, and saw that they were worried about a particular area of judgment, which -- you know which was about revenue recognition, which his first reaction, he wasn't crazy about it.

But I think -- I mean that's a good and healthy tension, I think, as long as it's amongst mature people. So no. The short answer is we haven't had any problems with preparers and no problems have come through, and indeed I think the Rolls Royce one, which everybody is instancing, I mean you know, that style audit report in the real world would not have been produced in the way it has without, in effect, the agreement of the company, because it was pretty pioneering. So they were happy to live with it.

MR. BAUMANN: I wonder in the proposals in the EU, in comments that you received, did preparers weigh in on that and what type of -- and the IAASB, what kind of reaction did they have?

MR. GENTNER: As far as I'm aware, and we've had an extensive public consultation, and you know, we've had long negotiations in the European process, where all sorts of parties also contributed, it was not a major issue that preparers came up with concerns.

Obviously, there were some concerns from the audit industry. But I think we found a good solution. So my feeling is that no, this is not -- this is not a key issue, and we believe that the reform will actually help companies by receiving more information, better targeted information, and also in their dealings with investors.

MR. DOTY: Mr. Kroeker, former chief accountant, current FASB member.

MR. KROEKER: Thank you, Chairman Doty. I know you've mentioned it's early days and the number of reports is dozens, not hundreds or thousands yet. But have there been examples where investors have come back and said this is important market-moving information, or information that surprises us?

The one example that's been cited, that's been more forward-leaning, also tends to at least possibly put the company in a favorable light, and whether or not there's been other examples, that might put a company in not such a favorable light, and whether those are the types of opinions you're seeing in the early days.

MR. LAND: I find it very hard to answer that question, and I think if I could suggest perhaps leave that question to the panel tomorrow from the UK. Liz, who is here from a very big investor association, may have a better view.

I honestly couldn't answer that question at this stage. Certainly I'm not aware that anybody's share price has sort of plummeted, but it really does raise the question of when should the audit report appear? I mean at the moment, it appears in the published financial statements annual report. Maybe it should appear when the premier announcement is announced.

MR. DOTY: Any Board members have any other questions?

MR. HANSON: Professor Schilder, I'd like to ask you another question on the other information proposal that you've yet to come out with, and I noted in your statement that you I think said something to the effect that you're trying to better identify what information the auditor essentially looked at, or had the ability to consider against the audit evidence.

I know that that's a concern that I personally have, is investors won't know the information that's in an annual report, what was subject to the auditor doing something to. It might be the most important information that they -- that an investor might consider the auditor might not have done anything with, because it was forward-looking information.

I know we're going to hear -- he stepped out of the room now -- from the esteemed Alan Beller this afternoon about sharp concerns about investors won't know what information was really subject to some procedures by the auditor and what wasn't.

So I was intrigued by your comment that you're trying to identify what it was, and I'm just curious as to where you're heading on how you would do that? I think about in the context of a comfort letter, and those of us who have been involved with it, it's a very extensive process, of actually circling individual sentences and numbers that the auditor did something to, and just kind of --

How cumbersome that is for somebody to actually read and understand, and how it's probably not possible in this context of the audit report? But just thoughts on where you're headed with this.

MR. SCHILDER: In the previous exposure draft, we had wider concept of what possibly could constitute other information, including press release, website information and what have you. What we learned from the consultation and the feedback is that we should narrow that down in a more manageable concept.

So we have brought that back basically to what we call the annual report, recognizing that not in every jurisdiction that is just one booklet or one publication, but it can be comprising more and several. So that's why at least it might be better doable to identify it by starting with the concept of the annual report, but nevertheless pointing to various publications that would be constituting that definition of annual report.

That certainly would include, if you just take the MD&A as an example, forward-looking information. That's why it's also important to explain the work effort, and there we make a distinction between on one hand, the inconsistencies between the financial statements and the other information that of course the auditor has clearly audited that, and has to perform some limited procedures to be sure about no material inconsistencies.

But on the other hand, the intelligent read is more important here. At least you can, as an auditor, read the other information, even with a forward-looking nature, with all your understanding of the company that you have acquired during your audit.

Then if you're dealing with restatement, you would say well, I really can't reconcile that with my understanding or my assessment of this company. At least it would take a further discussion. So it's not an explicit assurance or an additional work to let's say specifically assure all forward-looking information.

But at least you cannot ignore it, and that's why you have to apply this intelligent read.

MR. DOTY: Steve Harris.

MR. HARRIS: Chairman Schilder, could you summarize for us what the key differences are between your key audit matters and our critical audit matters, and why you think yours are better in terms of the investor or the user benefits?

MR. SCHILDER: Well at least we like more the term "key" than "critical." But it is kind of a just little joke. I think in essence, we do think that both of us are aiming at providing investors with the most relevant information coming from the audit, and the PCAOB in-depth concept has defined it in a bit more detail.

We focus on, as I've mentioned, starting with what has been communicated to those charged with governance. You can discuss whether that includes everything. But this is just an example of some detail about how you define it.

But we are currently discussing how we should adjust the language that we have proposed, the exposure that have to do better justice to the comments that we have received, and to make it even more clear. Also, on Lou's earlier point, avoiding to every extent possible boilerplate language, to really focusing on what is of relevance to users.

I think, Steve, that's exactly what you are aiming at as well. So we really look forward to our further mutual discussions on how we are moving forward, and certainly having had our Board meeting in March with on one hand a lot of support; on the other hand, a need to further redefine and going forward to do, I think, some in May or so.

That's a matter for some in-depth discussion. But very much starting from -- well, what many have said to us. There is a lot of similarity, and I'm not aware of a serious difference of opinion in this matter. But I'm always a bit of an optimist.

MR. FERGUSON: I have a question. This grows out of a just a position I made as I listened to the comments here. One was Nick Land's comment, that he thought that in the UK, one of the things that might be happening is that the various forms of reports could be leading to a potential kind of competition among the firms, which might be useful.

Then Jim, Kroeker's comment, that the one he did read, which involved a forward-looking one, appeared to be, you know, to give a very favorable picture of the company.

Is there a risk here that an auditor who begins to write a lot finds this a way of sending a quite favorable message that, you know, these people really did a great job? They were very thoughtful. We had to look at all these areas, but they did a very great job.

There's a way of sending this kind of subtle message to not so much users as other potential clients that, you know, if you hire us, you're really going to get -- we can say some really good things about your report. Is there a risk inherent in this approach, that that's what could happen, particularly if there variability among them?

The short question is discuss the negatives and positives of the variability argument and competition.

MR. LAND: That's a very good question. I don't want to -- I don't want to, as I said earlier today, I don't want to overstate that sort of firms are going to hire a tong who can produce the sort of -- either the most explicit or longest or most granular audit report.

But I mean I do think the firms are very conscious of what everybody -- what their competitors are doing, and they're no doubt weighing that up and balancing it. I suppose, I mean it is a very good question, because I think if you took it to the extreme in the way you've described, I mean I think there is a potential risk there if you took it to that extreme.

I mean my own view is that that won't happen, that the auditor will be -- continue to be responsive to its obligations. I'm readily confident about that, and it was -- we don't have, I mean we do have pending litigation against sources in the UK, but we don't have class actions, thank goodness.

I mean, you know, the back of -- the dagger or the sword of litigation, I mean, is hanging over them. So I don't think we've seen anything, based on one's knowledge, that I would consider to be a sort of reckless or over-optimistic statement.

I mean the Rolls Royce one, I know we keep referring to it, but it is, you know, it is a bit of a sort of mini-landmark in this short period. I mean as Sir David, it did talk about -- a lot of it was about revenue recognition, because it's in the aircraft engine business.

You know, on one it said well, on balance we thought the view the company had taken was sort of marginally optimistic, and on another key financial risk, they thought they were being marginally conservative. I mean it's very early days, but that struck all the readers as sort of a very balanced view of an audit report that was pretty granular.

I think it's something where you obviously have to guard against, but I personally don't see there's a big risk.

MR. DOTY: We're going to first thank Chairman Land, Chairman Schilder and Councilman Gentner for one of the more illuminating panel discussions that you can imagine, given the task at hand. We greatly appreciate -- we're in your debt for what you have brought to this by way of perspective, and I'm sure it's not the last time we will hear from you.

MS. FRANZEL: Do we have time for one last follow-up question?

MR. DOTY: It has to be a very quick hit. You have the last hit.

MS. FRANZEL: Great. I just wanted to follow up on Steve Harris' question, on the differences. We seem to be moving in the same direction, but there seem to be some pretty important differences between the CAMs, the KAMs, you know, and the other approach of the assessed risk of misstatement and disclosure of those.

How important is it, in your minds, for us to try to minimize differences now at this point in the process, or is this something that can be done several years down the road, after several years' worth of experience?

MR. SCHILDER: The answer to that is very straightforward. Everything that we can do to minimize differences now is a response to what many have said to us and I know about to you as well. As I said, I don't think there are important difference in concepts, but for example of course, there's differences in style. We have high level principles based in the application material. You have to have straightforward requirements.

But if you combine that with a detailed analysis, that gives rise to optimism. Nevertheless, we are not there yet, and therefore I think what we can do in the next couple of months to further bring that together, respecting of course your confidentiality requirements, that will be very helpful.

MR. DOTY: We will reconvene at one o'clock. With that encouraging -- that's an encouraging note on which to close. We should not let the perfect be the enemy of the good is what you hear you saying.

Thank you all. We'll reconvene promptly at one here. We have a panel coming on that has a very high yield rate. So please come back quickly.

(Whereupon, the above-entitled matter went off the record at 12:01 p.m. and resumed at 1:01 p.m.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

1:01 p.m.

MR. DOTY: Well, it is slightly after 1:00 p.m. PCAOB time. So it's with pleasure that I welcome a truly distinguished panel. We're moving now into academic opinion, legal advisory and firm policy matters.

Ted Mock is the Distinguished Professor of Audit and Assurance at the University of California-Riverside. Prior to joining the University of California-Riverside, Professor Mock served as a professor of Accounting at the University of Southern California, professor of Auditing Research at Maestricht University in the Netherlands, previously, the Arthur Andersen Alumni Professor at the University of Southern California.

In 1983, he helped found the University of Southern California Audit Judgment Symposium, now an international symposium on audit research. His interests lie primarily in the areas of audit judgment, assurance service, evidential reasoning.

Alan Beller, partner, Cleary, Gottlieb, Stein and Hamilton. He served as the Director of the Division of Corporate Finance at the United States Securities and Exchange Commission, and as senior counsel to the Commission, from January 2002 until February 2006.

But the years tell only half the story. Among the accomplishments of this extraordinary tenure and service were the implementation of corporate provisions of the Sarbanes-Oxley Act of 2002, the adoption of corporate governance standards for listed companies, the successful completion of comprehensive securities-altering reforms.

Alan is a frequent commenter and contributor to the PCAOB's thought process, and we are grateful for it.

Douglas Skinner is the Eric Gleacher Distinguished Service Professor of Accounting at the Booth School of Business, University of Chicago. Professor Skinner is a leading expert in corporate disclosure practices, corporate financial reporting, corporation finance with a focus on payout policy.

His research addresses topics such as the causes and capital market effects of managers' corporate disclosure choices; how the legal and regulatory environment affect managers' corporate disclosures; managers' incentives to use their discretion in the financial accounting and reporting process, to manage reported earnings.

Prior to his appointment at the University of Chicago, he was the KPMG Professor of Accounting at the Roth School of Business, University of Michigan, where he had been on the faculty since 1989.

Joseph Ucuzoglu, the national managing partner, Regulatory and Professional Matters at Deloitte in Washington, D.C. He's a member of the firm's Executive Committee. In his current role, Joseph Ucuzoglu participates actively in the management of the audit practice, serving on both the board of directors and executive committee of the firm's Audit and Enterprise Risk Services subsidiary, Deloitte and Touche.

Previously, he served as senior advisor to the chief accountant at the United States Securities and Exchange Commission. In that capacity, he advised the chief accountant on complex auditing and public policy matters, and interacted frequently with other government agencies and Congressional staff.

He serves on the executive committee of USC's SEC Financial Reporting Institute. So we have a group of truly heavy and thoughtful commentators, and with that, Professor Mock, welcome. Please continue. The floor is yours.

MR. MOCK: Okay. I thought I was third. Well Chairman Doty and the Board, thank you for the opportunity today, and you're welcome for bringing California sun to Washington yesterday when I came.

MR. DOTY: We'll grant you that. We'll give you that.

MR. MOCK: Okay. So my comments today are founded on research I conducted myself, and the citations are at the end of the formal comment. I have some PowerPoint here, if I get this to work and you can see my opening slide, with has my information.

My presentation is actually in four areas. There's five points listed there, but a little background, the objective of my comments today, some key findings in the research that I've tried to help synthesize, and then some limitations and conclusions of what I'm going to talk about today basically.

As far as background, and Arnold Schilder mentioned this, I've done research a long time, as you mentioned in your opening comments. But I started in this area most with a study that I helped do, that's sponsored by the AICPA and the IAASB, about ten years.

But more importantly, I've chaired a group, a team that the Triple A audit section put together, at the invitation of the PCAOB, to synthesize research. The team that has continued doing work on this project for a long time is listed there. So we have a team, originally six, but of five of us who put this together.

I'd like to, before I go into my discussion objectives, I'd like to commend and highlight the critical importance of the PCAOB in supporting the work of the academic community, by among other things, formally considering research and I think in most of your activities.

I think this actually is an example of divergence between what the IAASB is doing and you are doing. So that's one step forward, I suppose. Okay. As far as the next section is my primary objective and my comments.

My main goal today is to address today's main topic, which is to consider the need for change in the auditor's report. I was specifically asked to focus on the proposed changes to the auditor's report, based upon published or relevant economic research. So that's the focus of my research.

This objective has been addressed in the team, I'll say our basically, papers and comments that we have put together. Firstly, it is a synthesis report that was submitted to you and eventually published, and actually five other related instruments, including comments to the Board and also to the IAASB.

We organized our research in these three research areas, research questions that we tried to address, and everything we've done is kind of organized along those lines. What specific information do investors and other stakeholders want to be included in the auditor's report, based on research.

A second research question, how do investors and other stakeholders use proposed additional auditor communications in their decision-making, and third, to what extent can the proposed disclosure be expected to close the communication and information gaps.

The third research question was kind of a forecast, because research doesn't often lend much insight on that.

The research framework underlying our analysis is based on communication theory, and basically the expectation gap, looking at that, and particularly looking at it from the standpoint of an information gap and a communication gap. The end of my comment is our framework.

Over the time that we've reviewed research, we've looked at about 130 research studies. In addition to that, our synthesis built upon an earlier study that was done by Church, et al. So it's based upon a lot of research.

Key findings. These are findings based upon published research, and trying to abstract this is a challenge, but this is what I'd like to say. There are three overall findings I would like to highlight.

Number one, users of financial statements do not appear to carefully evaluate the current standard audit report, because it is such a standardized product. Of course, that's been said many times. The reports are basically viewed as being the same.

However, reports that augment the standard audit report with information, such as going concern, uncertainties or internal control weaknesses, do seem to contain additional relevant content.

Number two. Users do want -- do seem to want more information on risk materiality and other information surrounding the specific audit. In particular, information -- users are more interested in information about the audit, like risk and materiality, than information about the audit process. This is what research basically says.

Number three. While significant research exists in many areas, there are many areas where a research gap exists. That is, where there seems to be lack of sufficient research evidence. A lot of things talked about today are in that domain. For example, is there message-mixing? Well, you know, there's no direct research I've seen dealing with that issue.

Oh, okay. Before I go to limitations, I'll make a couple of comments. Well, limitations and conclusions. Similar to a financial statement, one should not draw solely from bottom line. I've given you kind of bottom line summaries here in this formal concept. But you have to consider the details provided in various research that we're looking at, and the comment letters.

The research synthesized has both research methods limitations and sampling limitations, and there's no generally accepted research synthesis methodology. Our group had a real challenge in doing this.

Lastly, as has been mentioned earlier, much of the research -- the topic's been mentioned -- does not explicitly account for litigation risk or cost versus benefits in general.

To conclude with perhaps the most important finding of our review, academic research is fairly consistent across different research methods, time periods and economic settings, and suggesting that an important way to improve the communicative value of the audit reporting model is if it is not boilerplate. Thank you for the time.

MR. DOTY: Thank you.

MR. BELLER: Chairman Doty and members of the Board, I'd like to thank you for -- the Board and the staff for the opportunity to participate in the Board's public hearing regarding the proposal to advance the Auditor's Reporting Model. I'd also like to thank the chairman for that kind introduction.

I would mention that in addition I did, as was I think mentioned this morning, also serve as a member and counsel to the co-chairs of the Treasury ACAP in 2007 and 2008, and I am a member of the board of directors and the audit committee of a public company.

Having said all of that, I'm going to of course speaking this afternoon only for myself, and not for any of my current or prior affiliations, and my remarks today are a distillation of a and summary of the views I presented in a paper for these hearings, that I think will be published on the PCAOB website after this session.

I'm a strong proponent of changes to the auditor reporting model, that will improve financial reporting or improve the understanding of financial disclosure by investors, other users and markets and, as was also mentioned this morning, the ACAP recommended that the Board undertake an initiative to address the auditor reporting model.

Preparers, auditors, advisors, users and regulators should all be striving for better disclosure and understanding, especially of the material aspects of financial reporting and financial disclosure. More information is not necessarily better. Indeed, where the more overly fact focuses on immaterial items or is confusing in nature, it is not only not an improvement, but it also distracts from the usefulness of the overall disclosure.

In my view, the Board's task was to achieve the better, and not just the more. Today's sessions focus primarily on the proposal that auditors report on critical audit matters or CAMs, and I'll concentrate my remarks on that subject.

I also included some observations on the other information standard in my written presentation, and will address questions on that subject if anyone is interested. I regret that in my view, the CAM standard as proposed would lead to uncertain improvement at best, in either financial reporting or investor understanding.

I have two principle concerns in reaching that conclusion. First, the audit is a means to an end. Procedures that in the case of unqualified opinion at least, provide reasonable assurances that will improve and increase investor confidence in financial statements, coupled with an audit report that improves investors' understanding and enhances that confidence.

But the CAM standard only gets at financial reporting indirectly, and targets material financial disclosure imperfectly. As proposed, the standard will require disclosure in the auditor's report regarding audit difficulties, but may not be material to financial reporting or its understanding.

Second, the proposed standard will necessarily lead to disclosure made, or at least dictated, not by the issuer but by the auditor. The standard is designed either to require auditors to disclose information about issuers, or effectively force issuers to disclose information that they do not consider material, and that need not be disclosed under the current securities law regulatory framework.

This hodgepodge approach runs a risk of confusing rather than informing. In one of the Board's own examples, an auditor reporting on a hypothetical CAM identifies and discusses an issuer's significant deficiency in internal control over financial reporting, that is not a material weakness.

Why is this helpful rather than potentially confusing to investors, where by definition it is less likely than reasonably likely, i.e. remote, that the significant deficiency will result in a material error in the financial statements.

Further, under the disclosure framework, significant deficiencies are not required to be disclosed to investors, but rather to auditors and audit committees, in order to avoid conflating the material and the immaterial.

The Cleary comment letters and my written presentation suggests an alternative approach, because I really would like to see an improvement in the reporting model. To summarize that approach, we recommend that the Board focus on the disclosure of critical accounting policies and estimates, which is directly applicable to and by definition material to the quality of financial reporting and investor understanding of that reporting.

Auditor attention could be applied through a standard regarding critical accounting policies and estimates, and a statement could be included in the audit report to the effect that (a), the correct critical accounting policies and estimates are disclosed and (b), the description of the critical accounting policies and estimates is accurate and complete in all material respects.

This approach directly addresses core material elements of financial reporting, rather than proceeding indirectly to address auditing matters that may or may not be material. It would leave disclosure to issuers, where it belongs, and have auditors report on issuer disclosures.

Auditors and issuers would in fact, I think under this proposal, discuss critical accounting matters and estimates, and there would be more attention and more robust disclosure about those items. Auditors would have to make disclosure if they disagreed with issuers about what the required disclosure was, but otherwise the disclosure would be issuer disclosure. Discussions between auditors and audit committees could be fostered around issuer disclosure, and unquestionably material matters.

On another point, I've also been asked to address the proposed new standards from a legal point of view. Both standards, CAM and other information, carry legal implications and impact legal costs. Legal costs and issues are not in themselves reasons not to adopt new standards.

Indeed, they are acceptable and often necessary consequence, where the resulting changes bring benefits. However, the Board should consider the proposed new standards do raise some significant legal issues that should be on the table.

First, under Section 10(b) of the Exchange Act, and Rule 10(b)(5) thereunder, an auditor can be liable if it makes a statement in its auditor's report included in an annual report of filing that is misleading, where the requisite scienter standard is met.

Both proposed standards would require those affirmative statements. The requirement of the proposed other information standard raises more novel issues here, because the auditor under the proposal must make affirmative statements about its evaluation of that information, where the scope of other information is extremely broad.

As I read the proposal, all information, other than audited financial statements and notes and some supplementary financial information, must be included or incorporated into the reports, and secondly, where the proposed quote-unquote "evaluation procedures" involve a significant volume of evidence obtained by the auditor during the course of its audit.

Under the Supreme Court's decision in Janus, the auditor's affirmative statements could be the subject of a private right of action under 10(b)(5), predicated on any material inaccuracy or incompleteness of those statements. The potential liability would be new, because it does not currently exist on AU 550, where statements by the auditor as to other information are made only to the issuer.

Under the proposed CAM standard, the auditor would similarly be required to make a number of additional affirmative statements, and those statements could similarly give rise to a private right of action.

I readily concede and agree that the affirmative statements made by an auditor under the proposal we have suggested, regarding critical accounting policies and estimates, would also give rise to that potential set of issues, and the real question is whether the current proposal or the other approach would provide greater benefits to evaluate against those legal issues.

A particular litigation concern is raised by the proposed requirements under the CAM standard, that the auditor retain audit documentation with respect to each non-reported matter that would appear to meet the definition of a CAM, but was not reported as a CAM.

While this may be useful to some, including the Board, it also creates and requires an auditor to retain an additional detailed documentary record. This may accomplish little benefit to investors, while providing a potentially discoverable road map in litigation, and should be considered in that light.

One last or a couple of last points or issues under the Securities Act. The proposing release explicitly notes that consistent with existing AU 550, the other information standard would not apply to documents filed with the Commission under the Securities Act, but rather existing standards would govern auditor responsibilities for those filings.

There are, of course, other provisions of the Commission's rules and the Board's standards that apply to Exchange Act filings and not Securities Act filings. Perhaps the most apposite example involves management's evaluation of and auditor's attestation of internal control over financial reporting, which is required in an annual report, but which is not required in a Securities Act registration statement.

But Section 11 of the Securities Act would apply to an Exchange Act filing incorporated by reference into a Securities Act registration statement. This anomaly does not seem to me to be one that should overly-concern the Board in its standard-setting exercise. There is precedent for it.

The proposing release does create and does not address certain implications for incremental auditor liability under Section 11 of the Securities Act. In particular, it's not clear whether the statements regarding CAMs would or should be viewed as statements of an expert under Section 11(e), which would make them subject to Section 11 liability.

It's even less clear whether statements regarding other information, based on a quote-unquote "evaluation" rather than quote-unquote "audit," would or should be viewed as statements of an expert.

In the absence of clear guidance by the Board and particularly by the Commission regarding these new statements about CAMs and particularly other information, Section 11 litigation uncertainty will persist upon the adoption of such standards, and settlement dynamics, which are absolutely key and particularly important in Section 11 cases, will be affected. That's another consideration that the Board should keep in mind.

MR. DOTY: Thank you. Professor Skinner.

MR. SKINNER: Thank you. First of all, I very much appreciate the invitation to contribute to the important discussion about the Board's proposal.

To begin, let me state that I think the Board is to be congratulated for investing significant resources to understand whether the current reporting model, which as the Board observes has been in place without significant modification since the 1940's, needs to be modified, given the extent to which our capital markets and economy have changed since that time.

Further, I think most will agree with the general proposition that expanding the amount of disclosure about the audit process is potentially beneficial to investors. My comparative advantage in these proceedings is perhaps to inform the Board and other interested parties about the academic literature on disclosure, and offer some words of caution about the general thrust of the current proposal, that significantly expands the disclosures required by, as well as the role of auditors.

By way of background, I'm a professor of Accounting at the University of Chicago, and have served as editor of the Journal of Accounting Research since 2006. Prior to that, I served as editor of the Journal of Accounting and Economics for seven years. JAR and JAE are generally considered, along with The Accounting Review to be the top academic accounting journals in the world.

So I mention this because I have extensive knowledge of the accounting literature. My research interests span financial accounting, auditing, disclosure and corporate finance, and I generally take a strong empirically-oriented economic space approach to problems in these areas.

I also have consulting experience in these areas, and have in the past provided input to policy deliberations at both the FASB and the SEC. I may also mention that I started my professional life as an auditor at Coopers and Lybrand in Sydney, so David mentioned this morning the Colonies. Australia, of course, was originally a penal colony, so I'm hoping that after my remarks this afternoon I'm not going to be sent back there.

There's a very large literature in economics, finance and accounting on disclosure, both mandated disclosure; that is required disclosures such as 10(k) filing requirements, and voluntary disclosures, such as managers' decisions to provide earnings guidance.

I'll focus my comments on what economists have to say about mandated disclosure, since that is what we're talking about here. As a general proposition, I think it's fair to say that economists agree that increasing disclosure has benefits.

As the proposal observes, there is much theoretical work that shows generally that increased disclosure of information, assuming that information is in some sense relevant and informative to investors, has benefits in terms of reducing information asymmetries in capital markets, and can result in improvements in market liquidity and pricing, including a lower cost of capital.

However, there are also costs of mandating additional disclosure, both direct costs, such as proprietary and litigation costs, and indirect costs, which we might refer collectively to as unintended consequences.

In the case of the current proposal, I think these costs, which are inherently hard to observe and quantify, could be very significant. Moreover, I have some skepticism about the potential benefits of these disclosures, which are perhaps even more difficult to quantify.

This makes it hard to assess the cost-benefit trade-off involved in making a decision about the proposals. Let me expand on these points, focusing on the benefits first. Professor Mock and his co-authors have prepared a very useful and thorough summary of a particular part of the auditing literature in accounting.

Given Professor Mock's participation here, I will not reiterate the conclusions of that research. However, I will observe that as the authors of these studies acknowledge, much of the evidence offered on the espoused benefits of the new disclosures is based on survey and experimental data, as opposed to empirical archival data.

There is not much we can do about this. It is exceedingly difficult to design studies using real world data, that is, non-experimental or archival data, to assess the costs and benefits of disclosure.

However, in my view, we should be very careful placing too much weight on survey evidence from investors, who say they want more disclosure. Given that there is no cost to them, what else would we expect them to say.

I'm not sure we learned very much about the benefits of disclosure from this type of evidence. The logical extension of this idea, that the world will be better with more disclosure, is sometimes known in economics as the nirvana fallacy.

I would also point out that there is perhaps reason why the audit report in its current form has survived largely unchanged for many decades, not only in the United States but essentially throughout the world. As the economics literature makes clear, auditing generally, including the traditional pass/fail model, plays a central role in validating the information in a firm's general purpose financials.

This role predates regulation that mandated the disclosure of audited financial statements. Audited financial statements have been used for hundreds of years, dating back to at least medieval times in England. This implies that the basic attestation role of auditors, which includes the pass/fail model, serves an important economic function as currently configured.

Thus while surveys may indicate that certain users claim not to use the audit report very much, we should take care in inferring from this that the report, in its current form, is not fulfilling an important economic role, given the very strong survival value of the current model.

I worry that tampering with a model that has survived for so long will have consequences that we cannot easily predict. Let me turn to some of the potential cost disclosures. First, it seems to me that the proposed requirement for auditors to report critical accounting matters or CAM could expand the set of information disclosed about firms beyond what is currently required under the securities laws.

This seems like a very significant change in the whole financial reporting model, because it means that the audit report would potentially become a disclosure mechanism in its own right, beyond what is currently disclosed by issuers in their financial statements and related disclosures.

Thus an important element of the current model that management takes responsibility for preparing financial statements and that auditors then attest to the reliability of that information would change, because now the auditors potentially would actually be disclosing information about the firm directly.

To the extent that the new auditor reporting model expands firm disclosures, it seems likely that proprietary costs come into play. These are the costs to firms of additional disclosures that provide information, that provide important competitive information about the firm's operations and strategies to competitors, suppliers, customers or other entities.

For example, a bank's risk management strategies and procedures are likely to be one source of its competitive advantage.

To the extent that the auditor now provides additional detailed and specific information about the financial instruments the bank uses to implement that strategy, other banks may be able to infer useful information about the bank's risk management program.

Auditor litigation costs are also a concern. There is an extensive academic auditing literature that examines the determinants of audit fees. It is clear from both the economic arguments and empirical data that expected litigation costs are a big driver of audit fees.

By expanding the auditor's role and disclosures in the manner envisioned in these proposals, I think we can confidently predict that the plaintiff's bar will not have to work very hard to expand both the extent to which auditors are held liable for client firm problems, and the magnitude of the associated damages claims.

These are the obvious costs. However, the more pernicious problems engendered by these proposals fall under the general label of what economists call the real effects of disclosure. The idea here is fairly straightforward.

By changing the mandated disclosure regime, the underlying actions of the affected economic agents are not held constant. That is, if agents know ex ante that the information they will have to disclose after the fact ex post has changed, it will change the way they play the game.

The implication here is also straightforward. Once auditors and client firm management and personnel know that the auditors will be reporting additional more detailed information about the auditors as CAMs, it will likely change their incentives going into the audit process, and may even change how managers make operating and financing decisions.

For example, if managers now know that auditors will be reporting detailed information about how they get comfort about certain of the entities' transactions, managers and their personnel may well be less open and forthcoming in providing information to the auditor about these transactions, and may even change the transactions themselves.

This in turn will change how auditors conduct their audits, as they find the need to find alternative audit approaches. Moreover, even if we assume that the actions of the firm and its personnel are held constant, it seems likely that auditors will extend additional effort to either avoid having to disclose a CAM, or to support the required CAM disclosures.

Without much doubt, the actions of firms and auditors will change under the new requirements in ways that are hard to predict, and that are likely to vary across firms. This leads me to a suggestion with which I will conclude.

As a reasonably sophisticated consumer of financial statements for a variety of purposes, one of the major improvements I have seen in financial reporting over the last decade has been the addition to the MD&A of the critical accounting policies discussion.

In the interest of minimizing the extent to which the new audit model expands disclosure, which as I have argued could have a number of potentially costly effects, I wonder if the CAM proposal could not be modified to require the auditors to comment just on the critical accounting policies discussed by management in the MD&A.

Presumably, the auditors are focusing attention and additional work on these already, so that the real effects problem, as well as the expanded disclosure problem I have identified above could be minimized. Thank you.

MR. DOTY: Thank you. Joe Ucuzoglu.

MR. UCUZOGLU: Thank you, Chairman Doty, members of the Board and the staff. You should be commended for the leadership role that you're playing in this important dialogue.

At Deloitte, we have been engaging with a variety of external parties, exploring the ways in which the auditor's report should evolve, to meet the information needs of the capital markets and we're of the perspective that there is a critical need for action.

The profession has been talking about the need to enhance the auditor's report for over a half century, yet every time the subject is raised, a myriad of challenges seem to stand in the way of progress. In the late 1960's, the AICPA's Committee on Auditing Procedures suggested that the prospect of revising the standard form audit report was much like Moses smashing the tablets containing the Lord's Commandments.

This is not an easy task, but we shouldn't need divine intervention to make modest changes to the auditor's report, in response to the information needs of investors. This can be done.

In fact, if one looks back far enough in time, there are examples of tailored audit reports to the stockholders of major U.S. corporations in the early 1900's that make specific reference to areas of the audit that were presumably important in the judgment of the auditor, one could say a primitive form of reporting CAMs.

Somehow during the past 100 years, we've managed to go backwards with respect to the information content in audit reports. Investors are now expressing concern that the standardized model currently in use is not meeting the information needs of the capital markets.

So in our perspective, the status quo is not an option. We need to combine the benefit of an unequivocal pass/fail opinion with the transparency associated with providing some additional color. Frankly, your project is a pivotal moment to reverse the trajectory of the past century away from boilerplate, and towards an era of informative, tailored, transparent communications from auditors to the capital markets.

Enhancing the auditor's report will play an instrumental role in ensuring a vibrant audit profession rooted in quality. We've heard several of the panelists this morning speak of the benefits of enhanced auditor communication, extending beyond the additional information content in the report. I would wholeheartedly echo that sentiment.

The very act of an auditor crafting a tailored communication to external constituencies stands to enhance the connection of the auditor to the user of the audit report, the investing public. Reinforcing the auditor's public interest responsibility and fostering the healthy exercise of independence, objectivity and skepticism, attributes that lie at the foundation of a high quality external audit.

As the proposal moves towards finalization, it is important to be sensitive to the concerns that have been raised by several stakeholders, as to the appropriate source of original information about a company. Management is and should remain the primary voice of a corporation's financial performance.

But the auditor must be the voice of the audit that was performed, and there is much that can and should be shared with investors about the performance of the audit, without infringing on the role of management and the audit committee in the financial reporting process.

Our field testing of the PCAOB's proposal to identify and report on CAMs indicated that with modest refinements, the exercise is relatively intuitive and capable of being exercised. The starting population for potential CAMs under the proposal is quite broad, and it could be narrowed to ensure the auditor is focused on the limited subset of items of greatest importance to investors.

We also did observe the possibility that some environmental forces could drive the reporting of CAMs in the direction of standardization. I would like to believe that the market forces that were discussed earlier would cause auditors to strive for informative crafted communications.

But I do believe it's also necessary for the PCAOB to make clear, in any final standard, that the information content is intended to be customized to the particular facts and circumstances of each engagement.

The focus today and tomorrow is appropriately on the currently proposed changes to the auditor's report. But I believe it's important to also begin exploring more fundamental changes that may be necessary to provide investors with the information they'll need in the future.

When one thinks of the changes in our capital markets in recent years, including technology, the way stocks are created, the size, complexity and geographical scale of corporations, and changes in the investor base itself, you can't help but think that more fundamental changes in the public company reporting model are on the horizon, along with corresponding changes in the performance and reporting of independent audits.

Perhaps auditor assurance on information will be demanded on closer to a real-time basis, and the focus of auditor reporting may shift away from a point in time opinion and towards the integrity of the processes and controls that govern the information that companies disclose.

The type of information that auditors are associated with will also likely need to expand, and the PCAOB's proposal has begun an important dialogue.

As other information outside the financial statements becomes increasingly important to investors, we need to explore the extent to which auditor assurance and related auditor reporting should be provided on market-moving information, such as earnings releases, key performance indicator, non-GAAP information and at some point even forward-looking information.

Now I recognize I've ventured into several areas well beyond the scope of the PCAOB's proposals, and this is not to imply that all of this can or should be accomplished in the context of the current auditor reporting project.

But if we can't get this project done, how are we possibly going to tackle some of the additional challenges that lie ahead? We need to make this successful, to set the profession on a positive trajectory towards an ever-expanding and valuable flow of information from auditors to the investing public. Thank you, Chairman Doty.

MR. DOTY: Well, question time. Mr. Harris?

MR. HARRIS: Well first of all, thank you for that extremely positive statement, in terms of moving this project ahead, and your enlightened vision of the future. I couldn't agree with you more, in terms of some of the other issues that you mentioned, which are not directly related to today's assignment. But I do think that those are issues that the profession's going to have to focus on as well.

You talk about a subset of items of greatest importance to investors, and I know you've done a lot of investor outreach. Could you talk a little about that investor outreach and what, in your opinion, are the subset of items of greatest importance to investors, and then getting back to a point that I think that all of us have raised in one context or another, how do you avoid creeping boilerplate?

MR. UCUZOGLU: With respect to the feedback from the investor community, I'd suggest that there are two broad themes, one of which is you the auditor shouldn't ever forget that we, the investing public, are the customer. You the auditor learn a great deal of information during the conduct of the audit.

Some of that information would likely be valuable, in terms of sort of what you thought was important, how you scoped your audit, what risks are most significant, where you spent your time, what you did in response to those risks.

We, the ultimate customer, ought to have access to some summary of that information, and it's a proposition that's sort of difficult to argue with.

The second major theme would be sort of a concern that the basic financial statements comprise a smaller proportion of the total mix of information that investors are using to make decisions, and I don't think we should lose sight of the fact that the basic financial statements and the auditors reporting on them still forms the building block for everything else.

If those are compromised and there's questions about their veracity, the foundation for everything else is impaired. But the basic financial statements and the reporting on them isn't enough, and that as a result, we need to explore the possibility of reporting on the broader set of information contained outside the financial statements, with the caveat and the concern from the investor community that having the auditors involved with that other set of information shouldn't lead to that disclosure for management becoming boilerplate, the concern that if the auditors are involved, it will drive management's disclosure towards standardization, which would be a bad outcome.

MR. FERGUSON: Yes. Thank you all for coming, and thank you for the very thoughtful papers you have presented to us. They were both interesting reading and very thought-provoking.

I want to ask the panel to -- you know, one of the things that makes this process interesting for us right now is we are doing this while other places in the world have actually moved beyond it and it's being tested. We are seeing how it works -- maybe not exactly the same proposals we have, but proposals that involve the auditor saying much, much more.

And I'd like to have your comments on how we should look at particularly the experience in the UK right now. I realize it's a different culture. I'm reminded of that a little bit in some of the objections that are made in this proposal of the French intellectual who was asked to assess an idea, and he said, (Well, you know, it may work in practice, but does it work in theory?

(Laughter.)

And, you know, the question here, you know, is the UK has an experience that appears to be positive. Investors do not appear to be confused by this individual, this extra information. What do we make of that? How should we take that into account? Anybody? I mean, all of you. All of you. Whoever.

MR. BELLER: I'll take a first crack at that. I guess I have two observations. One, and I have not read anywhere near all, but I have read a couple of the UK reports. I think the guidance that the standard provides is very high level, much more high level than the PCAOB proposal.

I think that gives scope for auditors who are trying to do what Joe suggested, to really write customized disclosure about the most important matters. I dare say those most important matters -- the couple of ones I have read, those most important matters do come down to, in many cases, critical accounting estimates and policies that we talk about in our somewhat different regulatory framework.

So I think the way they have gone at it is one of the explanations for why you've gotten what I think are pretty beneficial results.

The second thing I would say is more cautionary, which is I know how to run Compare Right. Every company in America knows how to run Compare Right. I dare say they know how to do it in the UK as well. And I do worry that Company A will see something that Companies B, C, D, and E and its industry have done, and they have disclosed a little less information or they have disclosed a little more information.

And my unfortunate -- I won't call it a prediction because I'm not -- I don't think it's fair, but my unfortunate concern is that over time -- and we've seen this with risk factors in the United States, and we've seen it with MD&A in the United States. The tendency is towards uniformity and boilerplate and away from customized and original disclosure.

You and I should have this conversation in three years, and we'll see how they did. That's my --

MR. SKINNER: Could I add a couple of things? This will -- I was very interested this morning to hear Mr. Land's comments, and one of the interesting things about what he said, based on the initial experience in the UK, including his own experience, he talked about what I had mentioned, you know, using this language of real effects. He actually mentioned that there was tension between management and the audit team as a result of the new disclosures.

And, you know, to follow on what Alan just said, I think looking at the first year's experience is actually not going to be representative of what we see going forward in the sense that I think going through this process once management will learn some things about what is going to be disclosed that they didn't think about the first time around. And it may be very interesting to see how this disclosure evolves in the next two or three years.

The other thing about the UK model that is different to the proposed model here, of course -- and Mr. Land also talked about that -- was that there was a corresponding change in the Audit Committee model of disclosure that was paired with the auditor model that is not going to occur here.

So in the U.S., under the current proposals, unless something happens at the SEC or the FASB in conjunction with this, there is going to be an expansion of disclosure by the auditors and through the audit report that we have not seen in the UK. And I think that's a pretty significant difference.

MR. DOTY: Ted Mock, you had a light on?

MR. MOCK: I think actually that school is out on many of these issues, and that is one of the difficulties, isn't it? In the synthesis we sent to the board, we identified research gaps basically, and there is lots of them. But we are slowly seeing some things happening, right? I mean, we have some experience in France as to what -- some commentary about auditors, what effects they may or may not have, basically.

As I learned this morning, what, half of the reports in Holland now have some sort of expanded disclosure. So we will slowly get evidence we need, but it takes time. And eventually we will see them published in JAR and JAE I think.

MR. DOTY: Jay Hanson?

MR. HANSON: Well, thank you all for coming, and I want to especially thank our two esteemed professors for all the hard work you do in shaping the young minds that will be sitting at this table years from now giving us their views on the projects or issues of the day, as well as the research that you do.

I think this is a unique opportunity to have two professors with very different views of what their research suggests about the need for additional information in an audit report. With Professor Mock's research and Professor Skinner's research and views -- kind of taking a little different view on that. And I realize that academics, when given the chance, will usually take up the opportunity to critique each other's views and positions.

And so since I've got the two of you sitting here, and you seem to be on kind of different pages, I'd like to hear your perspectives on each other's views and get a little discussion going about how we reconcile your two positions.

MR. MOCK: I should go first because Professor Skinner commented a bit on our study. I'm not sure we disagree so much. I think he said basically that required disclosure has positive effects potentially. I believe you said that basically, and so I think that's kind of confirming of the general results that we see in our research.

It is a tremendous challenge integrating mixed evidence over a bunch of studies. That's for sure. But I'm not sure -- I mean, I would agree with him that the data often we look at in terms of surveys, these kind of things, is not the strongest evidence you would like to have. You'd like to have stronger evidence in different ways.

But I think in general we have the same conclusion. Do you agree with that?

MR. SKINNER: Pretty much. So, I mean, I would make a couple of observations. One thing I think when you're looking at the benefits and costs of disclosure, and, you know, not just in the auditing context or even in the financial reporting context, but generally there is a huge literature in economics on disclosure and regulation.

You know, it's in the law literature, in the economics literature, and so, you know, I spoke to that literature as opposed to specifically the accounting literature. And I think one of the big problems is, it is very hard to get a -- to measure costs and benefits. It is basically impossible. And so, you know, one of the things we sort of know theoretically -- and, you know, it's pretty much got to be the case that if you put more disclosure out there and increase transparency, it can't be a bad thing. So there are clearly benefits. It is just very hard to actually quantify those benefits.

So to give you an example, there is a tremendous amount of research in the last 10áyears or so on the benefits of IFRS adoption. And if you look around the world -- and I couldn't tell you how many studies there has been on this and how much discussion there has been about it, cost of capital goes down with improved IFRS reporting. But the benefits are pretty small.

So, you know, there is going to be benefits in terms of cost of capital, how large are those benefits in the U.S. You know, that may be small. But the problem is, if you ask investors, you get the problem that I mentioned briefly which is you survey them, and, you know, what -- if you ask someone, "Do you want more information?" they are pretty much going to say, "Well, yeah, I'd like more information." So I'm not sure how much you learn about that.

And so then you've got to counterweight that against the cost. And like I said, the real effects' costs -- I don't know that we really understand those very well, and that's why I'm a little cautious about this proposal because, you know, I think we are even seeing a little bit of evidence from the UK about, you know, some of the dynamics between management and auditors changing. We don't really know much about that, so --

MR. DOTY: Jeanette Franzel?

MS. FRANZEL: Thanks to the panel for your insightful comments and views and research. I found this panel very helpful and interesting.

Alan, I want to go back to the principles that you set forth. I find them very intriguing, and I'd be interested in knowing more about how you developed these principles. And then I'd be interested in hearing the other panelists' views on these principles and where we might be out of line perhaps, or where you see a lot of additional work that we would need to do under some of these.

And then, finally, I'm thinking maybe we need an eighth principle to deal with the long-term view as we are looking at potential changes. So your comments on those principles would be appreciated from all the panel members. But, Alan, if you wouldn't mind starting off by letting us know, how did you develop these principles, or where did they come from?

MR. BELLER: Oh sorry. This is the audit as a means to an end principle or --

MS. FRANZEL: This is on page 5 of the written statement that I've gotten from you.

MR. BELLER: Ah, okay. Hang on. Let me -- I won't say they come -- I think -- I can't tell you that I've surveyed the academic literature and derived them. There are no sources for these. These are -- if you start with my kind of first principle, which is what we should be striving to do here, including with the changes to the auditor reporting model, is to enhance audit quality and to enhance investor understanding of what financial -- of what is being said in financial reporting.

These are for me the things that kind of fall out of that -- that fall out of that concept. And certainly the first five are -- or the first six are, but the second -- the seventh is really just cost -- benefits should exceed cost -- that's a truism, a difficult-to-apply truism, as Professor Skinner has pointed out, but a truism nonetheless.

I think the other six really are subsets of the -- we should be trying to improve financial reporting. We should be trying to enhance investor understanding. You know, to repeat myself, my concern about the CAM proposal is I think there is a more direct way to get to a better place. And I think -- I don't think that issuers should be the source of disclosure and auditors should be the source of attestation is a -- is something written on a stone tablet somewhere. I think if you depart from that principle, you risk confusion. And that is the reason I view that as a kind of guiding principle. I don't think it has any -- it doesn't have any value standing there by itself. It is because of the consequences of it that I am concerned about it.

MR. DOTY: One of the problems -- Jeanette, am I clear? One of the problems I have --

MS. FRANZEL: I wanted to see if any of the other panelists wanted to comment as well on the principles.

MR. DOTY: Joe, do you want to hit it first?

MR. UCUZOGLU: Sure. Many have observed that one of the overriding principles here ought to be that management is the source of original information. And often the conversation ends there, and we don't go the next layer down with respect to original information about what. If it's original information about the company's accounting policies, and original information about the company's controls, management ought to be the source of that original information.

But if it's the original information about the audit that was performed, the auditor may well appropriately be the source of that original information. And so the auditor shouldn't be introducing wholly new topics that don't fit within the various categories of what management has already disclosed.

But there is clearly an interest from investors to understand how the auditor went about approaching the task, scoping the audit, where they focused, what kept them up at night. And if that's the kind of original information we are talking about, it ought to come from the auditor.

The one other area that I would touch on -- and it has been hinted at throughout the morning -- is this subject of materiality. And it is not currently part of the proposal that was put out. But we're of the view that there would be a benefit along the lines of helping users understand how the auditor went about approaching the audit for the auditor to disclose materiality.

MR. DOTY: Brian, your flag is up.

MR. CROTEAU: Thank you very much. Joe, I think you might have just started to answer the question I was going to ask you, but I just wanted to be clear. When you described the CAMs maybe need relatively minor modification relative to the way they have been teed up in the proposal, I just wanted to be sure I understood, when you're talking about things like a going -- an ongoing concern or a material weakness or a disclosure that is otherwise not required, you would in some way scope those out or rewrite the definition of CAM to exclude those, is what I think I understand you to be saying. But I just wanted to be sure of that, because if that's the case I think some might think of that as more than a minor change, but I just want to be sure we're clear.

MR. UCUZOGLU: So if we took them one by one, with respect to the possibility of the auditor touching upon going concern, I actually think the likelihood of the auditor venturing into territory that management hasn't covered would be mitigated if the FASB -- when it moves forward with its work on going concern.

With respect to the possibility of the auditor touching upon a control weakness that was less severe than a material weakness, that would be the auditor venturing into an area of management's controls that the securities laws currently don't require management to disclose. And so one can have a debate about whether that is information that should or shouldn't be in the public domain, but that debate ought to take place in the confines of disclosure requirements imposed upon issuers. So I would scope out a requirement for the auditor to mention a controlled deficiency less severe than a material weakness.

MR. DOTY: Marty, your flag is up.

MR. BAUMANN: Thank you. I have a question for Professor Mock and Joe Ucuzoglu. Both Alan Beller and Professor Skinner have suggested a solution to improving the auditor reporting model via the auditor reporting on critical accounting estimates.

So there's a number of issues there potentially, aside from maybe suitable objective criteria upon which auditors could report on CAE.

I guess the question I have for you, Professor Mock, and for you, Joe, based upon your outreach and your research, which included that users want more information from the auditor on risk, materiality, and other information surrounding the audit, do you think that would meet investors' needs in any way, the additional reporting on critical accounting methods? And that is for Joe and Professor Mock.

MR. MOCK: I think the research would support that, but there is nothing -- there are very few specific studies that look at those particular issues. So the general conclusion was, yes, it would probably be viewed positively. Now whether it would be -- affect decisions, affect behavior, these kind of things are basically unanswered.

MR. UCUZOGLU: I think there are two broad objectives that the PCAOB proposals are trying to accomplish, one of which is, you know, captured in the form of reporting critical audit matters, giving users a better understanding of where the auditor assessed there to be risk; and, second, to have the auditor say something about what they did with respect to other information.

I would actually view the auditor making a statement about the propriety of management's disclosures in the area of critical accounting policies and estimates as being perhaps more responsive and relevant to the second of those objectives -- the auditor reporting on other information -- than the first.

And there is clearly some level of crossover. But as we work through how to come up with a subset of information outside the financial statements that is both within the competence of the auditor and has a close nexus to the audit that was performed, that critical accounting policy disclosure is a rich source that potentially lends itself to some direct targeted form of auditor reporting.

MR. DOTY: One of the problems which I have as an aging securities lawyer holding a job for which I am not qualified and get no -- is to try to get below, to get beneath the objections that we hear in these meetings to determine how serious do they go. I mean, we have heard the words pernicious and undermines and -- there have been a lot of the adjectival -- the usual adjectival advocacy that comes with strong opinions from strong minds.

So mindful of that, I am trying to be sure that I understand what people whom I consider to be my mentors mean. And I start with Alan Beller as one whom I consider to be my mentor.

And going back to your advice to the co-chairmen of ACAP, Alan, I do not understand your position to be that we can't have -- that we, at our peril, disclose anything new.

Going to Joe Ucuzoglu's comments, and picking up on your concern about risk factors and MD&A, there is nothing statutorily that keeps the auditor from saying more than they now say, transgressing this line of what is said by management and commented on by manager, and it makes me wonder, where would we be if we had not begun with risk factors and MD&A.

There has been some boilerplate that has vexed all of us, but I don't think you're saying that your proposal or your alternative formulation keeps the auditor out entirely of the area of saying something new.

MR. BELLER: I guess a couple of thoughts. One, I think if the auditor and the -- with respect to the specific proposal about critical accounting policies and estimates, I think if the auditor and the Audit Committee have the kind of conversation that I am used to having with an auditor as a member of an Audit Committee what you would ideally get is better critical accounting policy and estimate disclosure by preparers and some sort of affirmative statement by auditors as to the -- it's all there. They have identified all of them, and they have described them correctly.

Just to be clear with what Joe said, I don't think of this as just another -- as part of the other information standard. I think it is -- I think auditors do enough work around critical accounting policies and estimates that it is fair to ask auditors to -- I'm not the standard setter, but you can -- you can develop a standard that would support an affirmative statement. Maybe it's a statement of negative assurance, but some kind of affirmative statement around critical accounting policies and estimates.

So that would not lead to -- unless the issuer said, (No, I'm not going to do that, and the auditor says, (I have to do that, then it goes in the audit report.

With respect to CAMs, beyond that, I guess two thoughts for you. One, I really do think if you get the critical accounting policies and estimates right -- and I'm not sure they're right in the current disclosure regime. I don't think -- too much of it looks like Footnote 1 or Note 1 to the financial statements as opposed to what it should be.

But the answer to the question, what keeps the auditor awake at night ought to be in that list of critical accounting policies and estimates. It shouldn't be, "Oh, my goodness, I had to spend 60 more hours than I expected I would auditing the cash reconciliation of the intercompany accounts." And I'm honestly not sure that that is not a CAM under your current definition. So that's one thought.

Our comment letters have said this, my written presentation said it, the oral one did not -- if you're going to go the way of the auditor talking about the audit, one, Joe and I agree -- and I use the significant deficiency example just because it's so glaring to me, but it's not obviously the only issue. There shouldn't be auditor disclosure about issuer matters.

Secondly, there has to be -- in my view, there should be a much more powerful materiality filter than there is in the proposal to get to the stuff that really is important. And the final point I would make because, I'm sorry, but the UK idea of materiality is $500ámillion or 500 million pounds.

I understand that that is the way auditors begin their analysis, but I'll also tell you when I sat at Corpfin -- and I'm sure the SEC folks here today would agree -- the SEC is never and should never sign off on a quantitative materiality standard. You go down a very slippery slope if you start talking about, well, materiality for this company is $300ámillion, because SAB-99 tells us correctly that that's not the way to think about it.

MR. DOTY: Mr. Kroeker? Sir?

MR. KROEKER: Thank you. I had a followup, Alan, and Professor Skinner perhaps as well, on the critical accounting policies and estimates. It occurs to me that is certainly one area where there is a big -- a potential for overlap with what we do at the FASB.

And to be clear, the first piece of this -- I'm speaking only on my own behalf. I'm not representing the Board in this view. But it does intrigue me as to whether that means we ought to be thinking about perhaps folding critical accounting policies and estimates into a financial statement footnote requirement, which would then, by that very nature, require auditor direct association. They already have certainly association with those in the context of you need to know what those are in order to do your audit. But if you pulled that into direct obligations that we impose through GAAP standards, would that -- I guess what would be the pros and the cons of that? Would that address the auditor association?

And also perhaps might address, Alan, your issue of it looks today like Footnote 1, and maybe we could get rid of redundancy and focus those on what they are supposed to be focusing on.

MR. SKINNER: Yes. I mean, I would agree. I think that would be very helpful because my impression, similar to Alan's, is that that initial footnote, as it currently stands, is not very helpful. And I think the point I was generally trying to make was that having some form of consistency about what the issuer's disclosure requirements are, including the accounting standards and what the auditor was reporting on, having those things meshed together I think is pretty important. And, I mean, the UK example, we are seeing that in a different form, but we are seeing that same thing.

The thing that concerns me a little bit about the U.S. proposal right now is that the auditors, you know, in some situations I think would go beyond what the issuer is currently required to disclose, whether it's through the FASB or the SEC regulations. And that is -- we just don't know what that is going to do.

MR. DOTY: I have one more question, but I want to be sure my colleagues have a chance. Jay, do you have --

MR. HANSON: Yes, I've got one for Alan and one for Joe. So, Alan, you were heavily associated with ACAP, sat there during all of the discussions. And I thought it was interesting this morning on the panel, the opening panel, that most of the members here supported what we're doing relative to CAMs and the proposal, and, obviously, several wanted to go further than what we've done. And yet you're kind of in a different space than they are about this, and just your thoughts about not --

I know you can't speak for other ACAP members, but just your thoughts about maybe why you're in a different place than some of the others are.

And before you answer, I'll just give Joe a question to think about, which is if you can just talk a little bit more about the field testing that you've done and maybe some of the discussions you have had with management and audit committees about the proposal, because we have more than 200 comment letters from preparers saying we don't like this, and you've probably had discussions with about 25 percent of those people that sent us comment letters, and just your thoughts and discussions that you had with the preparers about your views versus their views being against it.

So I'll turn to Alan.

MR. BELLER: I heard the back end of that panel. So I think perhaps the principal reason I'm coming out at a -- and I'm not sure it's a hugely different place, because some of what Jeff Mahoney said sounds a little bit like what I was saying in terms of focusing on the critical stuff and the policies and estimates and not into the weeds of the audit.

I challenge the notion. I guess I have principally two answers for you. One, I challenge the notion that the details of the audit process are what -- and, look, I'm not going to say investors shouldn't have what they think they want, because they're the investors and -- but the details of the audit process just strike me as much less important in terms of both of my objectives of enhancing understanding and making the audit better than some of the things I have been talking about.

The second reason is I think just your experience -- my experiences formed me. I spent a lot of time with the preparer community. I spent a lot of time with audit committees. And I -- you know, I can't deny the fact that I come with a little bit of that perspective. And I think that probably somewhat shapes my views.

I honestly have not spoken to -- and I have talked to a fair number of preparers. I'd love to hear what Joe is going to say, because I haven't talked to a single preparer who is really enthusiastic about this. I am more enthusiastic about it than they are.

MR. DOTY: Lewis?

MR. UCUZOGLU: Well, you have found more preparers who are enthusiastic about this than I have. You had asked, Jay, about some of our experiences during the field testing process. I would say that the number one concern that has been articulated really relates to this possibility of the auditor disclosing original information about the company's financial accounting and controls.

And the subset of that broader set of concerns that is most often raised is this issue of the auditor disclosing a significant deficiency that management wasn't otherwise required to disclose. I suspect if the proposal were modified in such a way to alleviate that outcome that it would take a lot of noise out of the system. There have also been concerns raised about issues such as timing and the crunch to get the report out, concerns around or the effect on the dynamic in the board room with respect to auditor -- Audit Committee communications.

But, frankly, one can come up with a long list of the risks of doing something and moving forward. What I'm equally focused on is the risk of not doing something. And I was struck by sort of one particular piece of Professor Mock's research; 91 percent of users of audit reports don't read it.

So if you're sitting in my shoes, and 91 percent of your customers don't read your basic product, what is the risk to the viability and relevance of the profession of not evolving to meet the information needs of investors? And that ought to be every bit as much front in mind as the risks which I believe are manageable of crafting the proposal in such a way that it can be moved forward.

MR. DOTY: Lewis?

MR. FERGUSON: I guess the question I have grows out of some of the discussion here, and particularly the assumption that there seems to be that the proposal that Alan had and Professor Skinner had that instead of our proposal on CAMs that what the auditor do -- should do is really comment on whether the critical accounting policies are the right ones and whether the information about them is correctly stated.

It seems to me in many ways they are quite different approaches in certain cases. They wouldn't necessarily always be, and that's what I want to get to. But they are different approaches in the sense that we are asking the auditor to speak originally, but not about -- we are just asking the auditor to speak originally about what the auditor did, as Joe said. What did he do in the audit? And what were the critical matters?

And those may or may not intersect with the critical accounting policies. And it seems to me that we have at least come -- or at least I have come to believe, in listening to investors, that investors would like to hear about what the auditor did.

I mean, what I thought was interesting about the discussion about Footnote 1 is it strikes me that if the company is in fact adequately disclosing the critical accounting policies, in fact the auditor may do nothing but look at critical accounting policies. I mean, is that a fair statement? Does that reconcile things or not? Or are we in fact talking about two really quite different approaches here?

MR. BELLER: I think we are talking about two different approaches. I'm not sure they are completely different. I think they are related. And it goes back to the question that we sometimes use to frame what we are trying to get to here, which is, what keeps the auditor awake at night?

And as a lawyer who thinks about financial reporting and financial statements and financial disclosure, and talks a fair amount to auditors, I think what keeps auditors awake at night is principally, I blew the audit and the numbers are wrong.

And, you know, the individual items of that question really should be -- and if they're not, issuers and auditors are not doing their jobs currently -- should be what is listed in critical accounting policies and estimates. Those are the things that are the likely items that will lead to a blown audit.

And if I'm an investor, that is what I really want to know the most. I take the point that investors want to know how auditors conduct the audit and what they scoped out, and that is a different point. But it is not a completely unrelated point to my vision of what keeps auditors awake at night. And I think you've got to kind of think about the two of them together.

MR. DOTY: Joe? Steve? Is there another

comment? Sorry. Sorry, Doug.

MR. SKINNER: I just had one simple observation. Having read a number of the examples we now have from the UK, a lot of them actually do look quite similar to the critical accounting policies. I mean, if you look at the -- I've read the HSBC audit report that came out a few weeks ago, the Rolls Royce one. Some of the things are very similar, and the informative part is of course what the auditors did about this.

So I think there could be a fair bit of overlap between potential CAMs and what we are seeing in the UK.

MR. DOTY: Steve?

MR. HARRIS: I think I take the Sir Tweedie view that was expressed this morning about original information, I think, Alan, which is somewhat at odds with yours, and in terms of keeping the auditor awake at night, and more in lines of what, Joe, you were articulating. And nobody did more work on Sarbanes-Oxley and promoting the rules and regulations in a timely fashion or a more brilliant job than you did.

But I read Section 101 as giving the PCAOB considerable authority in this area and considerable liberal authority in terms of information provided by the auditor to the user, or in this case the investor. I mean, 101 says -- which defines the mission (to protect the interests of investors in the preparation of informative audit reports.

And so what informative audit reports? I think what I'm hearing from users or investors is it goes a little bit beyond enhancing investor understanding of financial reporting. So I think there is a disconnect, and I think that to the extent that we can either bridge that disconnect, I think that it's important that we continue to focus on it, because I think once again there is the expectation gap in terms of what is expected from the audit report.

And then I'd just ask the question, in terms of your analysis and your testimony, which once again I thought was typically excellent, you focus a lot on the Treadway Report. But I'm wondering, what is your original statutory authority with respect to supporting your view about the auditor not providing original information about the company, putting aside whether we should or we shouldn't? Is there any statutory authority along those lines, or is it just -- is it the --

MR. BELLER: I don't think -- I don't think this is -- let me be absolutely clear. I don't think this is a question of authority. I think 101 gives you the authority to make and adopt the proposal that you've made. I think the question is whether there is a better idea, but it's not -- do not misread me as saying you don't have the authority to do it. I don't think that's an issue. There may be others who disagree with me, but I don't think that's an issue.

MR. HARRIS: And then, how do you both -- we have asked this question of all the witnesses. How do you avoid the creeping boilerplate? And what do you put in the audit report? And what do you put in an appendix?

MR. UCUZOGLU: I will start, Steve. You know, this idea of an appendix has been raised at various times. And it is at least worthwhile to consider whether there is some important baseline information that doesn't change over time from year to year, and that folks ought to have access to sort of go back and refresh the basic confines of an audit, but that essentially clutters up the report and has the potential to obscure the really important stuff that does change from year to year.

And so I wouldn't necessarily be averse to at least exploring the idea of some basic information about sort of, what is an audit, in an easily retrievable form or linked to a report. It is worth exploring.

With respect to the issue of boilerplate, there are a host of reasons that we are all well aware of as to why pressures might exist to move in that direction. But I actually believe that the most powerful tool that you have within your disposal is to make clear in the standard that some form of standardized, you know, I pulled this off the shelf for this industry -- you know, while it might serve as a guidepost in terms of you ought to think about these particular matters, and here is some of the types of information that might be relevant, that at the end of the day it ought to be a tailored communication and that you mandate that through the standard, which would, again, sort of put the auditor in a position of meeting the professional standard that we are required to tailor something specific to the circumstances of the engagement.

MR. DOTY: Jeanette, you have a parting shot coming.

MS. FRANZEL: I'm struck a little bit by the hints of cynicism among the panel that the various players in the system will take this requirement and do the wrong thing with it. You know, they will quickly turn it into boilerplate. You know, auditors will stop communicating with audit committees, and management and auditor communications will be chilled.

And so I want to explore a little bit, because I think, Doug, you raised the issue about management and auditor communications and how that could deteriorate potentially with this type of a requirement. Alan, I think you raised the same concern. And, Joe, you thought that this is a manageable risk, so I'd like to hear all of your comments on that issue.

MR. SKINNER: Yes. I mean, I was just raising the general economic principle, which I think is pretty well established that whenever you change the disclosure regime, the mandated disclosure regime, whoever is subject to that disclosure are going to change their actions in some fashion. And I think, you know, it is likely this will happen.

Now, some people talked this morning about this happening in a positive way, that the auditors and the management had a more energetic discussion. So it may be a positive change rather than a negative change.

But, I mean, I don't think there is any doubt that, you know, some of -- the proposal, when you read it, says at some places things like, (Well, what the auditors are doing right now won't change. All we're doing is we are making that information available.

I think that is not the case. I think as soon as you disclose something you then are going to change economic behavior. And I think what I don't know and what is very hard to predict is how exactly that will change.

MR. DOTY: It has been a terrific panel. Ah, 50 seconds, Alan.

MR. BELLER: Sorry?

MR. DOTY: Fifty seconds.

MR. BELLER: Okay. Jeanette, the cynicism, to the extent you are detecting it, comes out of thirty-plus years of experience. And it's not unique to your proposal. The MD&A suffers from this problem. Note 1 suffers from this problem. Critical accounting policies and estimates suffer from this problem.

One thought I have is I think -- I mean, when I was at Corpfin, we -- comment letters, stop writing boilerplate. It's a long, slow struggle. One thing, aspirationally, I would suggest, not just what Joe was talking about but all three agencies take an initiative to try to encourage preparers, auditors, to do a better job of that kind of -- of that kind of disclosure.

On the cynicism about audit committees -- the red light is on, so I'm not going to say anything.

MR. DOTY: Eternal vigilance.

This has been an extraordinary panel. You all have made a great contribution to the dialogue. Thank you.

I am going to introduce the new panelists as you all vacate and as they come to the rostrum. We are on time and we are going to stay on time, but thank you all. This has been wonderful.

This panel -- we have -- we are now going to focus on -- this was a panel that showed the range of perspectives on this proposal. We are now going to talk about critical audit matters related to the audits of large companies, and we have an extraordinary panel.

Ann Cavanaugh has been a Managing Director and a global head of accounting policy at BlackRock since December 2011. She is a member of BlackRock's New Products Review Committee, which analyzes and approves new products offered to clients, and their Global Valuation Committee.

She is involved in the firm's project to assess IFRS implementation and is one of 35 women selected to participate in BlackRock's inaugural Global Women's Leadership Program. She served as the Director of Accounting Policy at BlackRock from July 2008 until December 2011. She previously served as the Director of Accounting Policy at Merrill Lynch from October '85 -- '95 until July 2008.

Wallace Cooney is Vice President of Finance and Chief Accounting Officer of Graham Holdings Company, where he is responsible for accounting, internal and external financial reporting, consolidated budgeting and forecasting and income taxes.

Previously, he was Director of Consolidation

Accounting and Financial Reporting at Gannet, where he directed internal and external financial reporting, and before joining Gannet he was an auditor at PriceWaterhouse.

He serves on the Committee on Corporate Reporting of Financial Executives International, a current member of our standing advisory group. And it is always good to see Wallace here.

Kevin Reilly, America's Vice Chair, Professional Practice and Risk Management, Ernst & Young. He is responsible for the national office accounting, auditing, and U.S. Securities and Exchange Commission reporting functions. He oversees the quality and the risk management activities of the firm's assurance practice. He has been with the firm for more than 30 years during which he served as a coordinating partner for major clients and the media and entertainment sector and for financial services, private equity industries.

He previously served on FASB's Financial Accounting Standards Advisory Council, a current member of the PCAOB's standing advisory group.

Aulana Peters, a former partner of the law firm of Gibson, Dunn & Crutcher from '84 to '88, a Commissioner of the SEC from 2001 to 2002. She was a member of the Public Oversight Board of the AICPA. She has also served as a member of the FASB's Steering Committee for its financial reporting project and is a member of the Public Oversight Board's Panel on Audit Effectiveness.

She serves also on the Comptroller General's Accountability Advisory Council and the Board of Trustees of the Mayo Clinic, a director of Northrop Grumman, 3M, and Deere & Company. And she also served on the board of Merrill Lynch during the past five years.

A panel extraordinarily well qualified to talk about this in terms of the impact on major companies.

Ann, would you please proceed? Thank you.

MS. CAVANAUGH: So thank you for the opportunity to be here today and share BlackRock's views regarding the proposed changes to the auditor's reporting model.

For most of you -- I'm going to assume they already know -- BlackRock is a global investment manager, overseeing approximately $4.3 trillion of assets under management at year-end 2013. BlackRock, together with its subsidiaries, manage approximately 3,400 investment vehicles, including registered investment companies, hedge funds, exchange traded funds, collective trusts, as well as separate accounts.

As an investment manager, we are in the unique position to provide commentary on the proposal from several different perspectives. One, that of a corporate preparer; two, that of an investment fund preparer; and, three, as a user. For purposes of my remarks today, my response primarily will reflect those of our research analysts as users of both financial statements and auditor opinions.

So overall we commend the PCAOB for undertaking a project to enhance auditor communications and provide information useful to users of financial statements. Overall, we support the concept of communicating critical audit matters and believe that much of the framework will provide useful information.

As users of financial statements, our analysts have expressed that they find value in identifying critical audit matters, particularly matters resulting from changes in principles or in areas that involve significant judgments, which therefore may require further analysis and discussion with management in order to be properly understood and reflected in their analyst models.

The additional information provided will be particularly useful to our analysts to the extent that it provides a better understanding of financial risks, including future cash flows of a company.

We are concerned, however, that some investors may misinterpret the communication of a critical audit matter as indicative of an issue with respect to the quality of financial statements. And, as a result, we would suggest additional language be added to the auditor's report to explain that critical audit matters are not necessarily indicative of a financial statement deficiency.

We wish to emphasize that certain entities, such as 1940 Act investment companies, have inherently less complex business models than traditional operating companies, and, therefore, may not warrant disclosure of critical audit matters.

Because mutual funds assets are primarily invested in securities, it is likely that the only fair valuation of investments would be deemed a critical audit matter. Given the extensive disclosures that are already required under the FASB's Accounting Standards Codification 820, we recommend clarifying that routine audit procedures, such as testing Levelá1 and Level 2 fair valuation inputs would not be deemed critical audit matters, absent significant judgments therewith.

Accordingly, we would suggest there should be a rebuttable presumption that the auditor's report on most investment companies state that there are no critical audit matters to communicate.

From a preparer's perspective, we do believe there will be additional time and expense associated with interacting with and providing information to auditors in connection with the required assessments and reporting of critical audit matters and their documentation of such matters.

We do not believe that the auditor should be required to document why all other possible critical audit matters were not included as critical audit matters in the auditor's report.

We continue to recommend that the description of critical audit matters in the auditor's report exclude audit procedures performed or an indication of the resolution. In order for the auditor to convey the context around such matters, it may be necessary to include expansive details that could overwhelm the auditor's report.

Additionally, inclusion of such information may lead a user to believe that the auditor is expressing a piecemeal opinion on individual matters, and any given -- and any audit procedures enumerated may be taken out of context or misunderstood, given their necessarily abbreviated descriptions.

Furthermore, we are concerned it may be difficult to succinctly convey the nature of an audit procedure in a manner that qualifies -- I'm sorry, in a manner that provides users with an understanding of the full scope of these procedures and the quantitative and qualitative factors that went into reaching their decision.

We recommend that the Board clarify that highlighting audit procedures should be infrequent. However, if included, only those most significant procedures should be identified and then only when it is important to understanding why the matter was identified as a critical audit matter.

With regard to the auditor's responsibilities for other information, BlackRock supports including a statement clarifying the auditor's responsibility for other information and documents containing financial statements. We do not, however, support changing the auditor's responsibility for other information to evaluate such information versus the current requirement to consider the information.

We believe that the scope of the audit procedures involved in evaluating the material inconsistency and material misstatement of fact criteria should be related solely to financial information included in the filing, such as MD&A and exhibits, and should not extend to documents incorporated by reference, some of which may have been superseded, and should not extend to other non-financial information.

Such procedures are not routinely performed today on documents incorporated by reference, contrary to the statements that were included in the proposal which states that the Board believes, in practice, some auditors currently perform procedures related to other information similar to procedures in the proposed other information standard.

However, if procedures are applied to other non-financial information, these criteria may require significant judgments given the complexity of many corporate agreements. We do not believe that the costs associated with such procedures, including preparation of related audit documentation, would justify the benefit received.

Many analysts and users of financial statements already assume that MD&A and exhibits are read by the auditors for consistency with the financial statements. And, therefore, we believe that reporting on those procedures performed would clarify the auditor's role and responsibility.

In closing, we support the Board's efforts for increased transparency and providing additional useful information to users of financial statements. As users of financial statements and auditors' reports, our analysts have stated that succinct disclosure of critical audit matters in the report is a step forward toward accomplishing that goal.

We encourage the PCAOB to work together with the IAASB to standardize, to the extent possible, the form and content of the auditor's reports in order to increase comparability and ease of use for users who may be readers of reports subject to both sets of standards.

Thank you for your time and attention to this matter.

MR. DOTY: Thank you.

Wallace Cooney?

MR. COONEY: Good afternoon. Thank you for hosting the public meeting and inviting me to participate on the panel. This project has been underway for many years now, and I commend the Board for all the outreach that has been undertaken during this time. The Board has shown great interest in hearing from all interested parties on this topic over a long period of time.

Management has a very distinct role, so I will offer my observations on the proposed reporting of CAMs from a financial statement preparer perspective. I believe that my observations are shared by many in the preparer community.

On several occasions, the Board has pointed out that the auditor's report has changed very little since the forties. Just from a personal standpoint, I don't really see it that way, since the opinion was expanded in 2004 to include a report on the internal control over financial reporting. And from a preparer's standpoint, that was a huge change, a major overhaul, that fundamentally expanded and changed the financial reporting process and the audit process. At many companies, audit fees doubled or tripled as a result of this new requirement.

My hope is that the Board will consider the implementation problems with ASá2 as they deliberate on the best approach for this project.

Another point I'd like to make is from a preparer perspective, receiving a clean opinion is a major accomplishment each and every year. A lot of effort is undertaken by management and auditors. It is substantial and costly from the more routine and material components to highly subjective, judgmental, and complex areas.

A clean opinion comes at the end of a very comprehensive and robust audit process and only once all important matters are resolved and many, many questions are answered and lots of dialogue and supporting documentation and discussion. And at the end of the day, the auditors need to be fully satisfied in terms of resolving all of those issues. So I believe a clean opinion should mean a lot to investors.

With respect to CAMs, overall, I have concerns about the proposal as drafted. The examples, quite frankly, are more troubling than some of the concepts. And so I believe it's imperative that the Board lead a comprehensive field test to assess whether the proposal will produce the information that investors are seeking at an acceptable cost.

With respect to the proposal, it does not include an AD&A, which was of great concern to the preparer community. The CAM approach, however, does have some elements that we have similar concerns with as follows. My primary concern relates to preserving and not confusing the distinct roles of management, auditors, and Audit Committee.

Management is responsible for financial statement preparation and the footnotes and ensuring full disclosure of important qualitative and quantitative financial information, including the MD&A. Open communication between auditors, management, and the Audit Committee is vital to this process.

The proposal, in certain cases, could require auditors to be the original source of new information as well as highlighting potentially items that aren't particularly important.

The audit report, in my view, should not be used as a vehicle to communicate new information. This will serve to inhibit a healthy and well-functioning financial reporting process. And if there are shortcomings in the financial reporting model currently, the FASB or the SEC should work to address these concerns. And management will take the lead on improving whatever shortcomings are of concern.

Written auditor communications, from my standpoint, are really the beginning part of a dialogue between auditors and audit committees. And the written reports have limited value without the important discussion that takes place between auditors and audit committees as well as management. Ideally, all important matters are discussed in detail, context is provided, there is an opportunity for a robust dialogue and followup on specific questions or concerns as necessary.

With CAMs included in audit report, there really would be no effective mechanism for any dialogue with investors. In certain cases, this could result in questions coming to issuers about an auditor's report, about what they might have meant in talking about a CAM, which would put issuers in a difficult position.

As I mentioned earlier, the CAM examples in the proposal are of significant concern. Disclosure by the auditor of a significant deficiency is not currently required, so this example is in direct conflict with existing rules. Discussion of an immaterial corrected error would not, in my view, seem appropriate for discussion as a critical audit matter. Since management isn't required to disclose these matters, I don't believe it is appropriate for the audit report to provide detail on them.

I am also concerned that auditors will err on the side of including too many CAMs, and they will spend too much time documenting why certain matters should not be included as CAMs. This could worsen the so-called disclosure overload problem that is subject -- by the SEC currently.

And from my personal experience, auditors, in my view, should spend more time performing audit work, less time documenting the work that they have done. Documentation requirements are overwhelming audits and could be an obstacle to auditors spending time on important issues.

Much of the work on CAMs is expected to be completed near the end of the audit -- another concern because it could be a distraction for auditors and management as they are wrapping up critical areas. The proposal is also unclear but seems to imply that a discussion of audit procedures with respect to critical audit matters is preferred. And, in my view, quite frankly, talking about audit procedures may be more appropriate than analysis of management's financial statements.

I am concerned about audit fees potentially rising and would encourage a robust cost-benefit analysis.

Lastly, there is no substitute for actually reading the financials, and I think there is some risk that an auditor's report that included CAMs could be used by a reader as a shortcut, a cheat sheet, that investors would rely on to dummy down the extensive and important disclosures that an investor gains from actually reading the entire financial statements and the 10-K.

MR. DOTY: Should we drop the project and forget about it?

(Laughter.)

You don't have to commend us if you think we should drop the project and forget about it. Is that --

MR. COONEY: I actually don't --

MR. DOTY: No change in the binary model?

MR. COONEY: I actually don't think you should drop the project. I had a few --

MR. DOTY: I'm waiting for the reason why.

MR. COONEY: I have a few other just overall general comments. I think that at the end of the day my personal opinion is the CAM approach has a lot of risks associated with it. The concept release talked about required emphasis of matter paragraphs. I think that approach would be preferred.

The other idea that has been discussed was some type of auditor association with critical accounting policies and estimates. And I think, again, that would be a preferred approach in general.

If the CAM approach is continued, I believe that the requirements should be tightened to avoid the unintended consequences and to make the process more efficient.

That concludes my remarks.

MR. DOTY: Kevin Reilly?

MR. REILLY: I thought the last panel solved all the CAM-related issues, so I'm a little uncertain as to what you want me to cover, Mr. Chairman. But I thank you and appreciate the opportunity to be with you today and talk about issues surrounding the projects, specifically as they may relate to critical audit matters or CAMs.

My firm, and the profession more broadly, has been supportive of exploring ways to improve the informational value of the auditor's report, and we commend the Board and the staff -- Marty tells me the staff does all the work around here -- for the many efforts on this project. And I certainly hope that the Board has found the many suggestions we have raised in our letters, our comment letters, including those from the Center for Audit Quality, to be constructive and helpful as you work through this challenging effort.

I also want to acknowledge and appreciate the work of Arnold Schilder and his team from the IAASB as they pursue and tackle the similar issues.

My firm, Ernst & Young, is supportive of the concept of CAM disclosure in the audit report, be it with a C or a K, and believe the concept, if it is properly developed, could help investors focus on aspects of the company's financial statements that were important or challenging in the audit.

But I think the real lightning rod on the CAM front doesn't so much involve the identification of the CAM; it really revolves around what the auditor should say about the CAM in the audit report.

The proposing release notes that the report should identify the CAM, describe the considerations that led the auditor to conclude that the matter is a CAM, and then reference where that matter is covered, where applicable, in the company's financial statements.

We understand these broad objectives, and we think this general framework makes sense. However, we do have some significant concerns with how the approach has been applied in crafting the specific examples that appear in the proposing release.

Wally touched on some of those concerns. You have heard them front and center relative to the many comment letters that we have seen, the original information issue that was covered in the last panel, the redundant, potentially lengthy repetitive disclosures that may appear in the audit report, a discussion about audit procedures and how that could lead some to conclude the auditor is issuing a piecemeal opinion.

And, last but not least, you know, the example language focused so much on the difficulties and challenges faced by the auditor in a particular area that it left me wondering whether we are serving to undermine the company's accounting and reporting for that very matter.

So, Mr. Chairman, you raised a good question at the last panel which is, okay, well, smart guy, what is really bothering you with respect to what is proposed? So let me give you some granularity with respect to that question.

So go to the deferred tax valuation allowance example that is contained in the proposing release. It has four paragraphs, runs for a page and a half, uses the term (difficult or (difficulty a half dozen times. And I get it; deferred taxes are challenging.

The example also highlights a number of very specific matters we thought would be company disclosure areas, such as the occurrence of an unexpected cost increase in an important component part that is expected to unfavorably impact future profitability.

The example also makes reference to various audit steps or actions, such as consultations with others outside the engagement team, that we don't really see as particularly relevant to the overall disclosure. We think the overall objective -- to inform financial statement users of those matters that were truly important or challenging in the audit -- can be met with a much more pragmatic approach.

This alternative would require a crisp, fact-based outline of the issue that does not compete with the company's disclosure or reflect original information about the entity, to an outline of the principal reason and not a checklist of any and all influences that may be in the mix, but the principal reason why the auditor believes the matter is a CAM. And, finally, a reference to where the matter is covered in the company's financial disclosures.

So let me boil that down to how this approach would differ from what is reflected in the proposing release. So we think this approach could distill the CAM in two or three sentences, and let me read the suggested format for you. "Our assessment of the company's evaluation of the realizability of deferred tax assets and the related determination of the valuation allowance required for such assets was a critical audit matter in the audit of the company's financial statements.

Deferred taxes are material to the financial statements. The company's realizability assessment involves many complex and subjective judgments, including those used to prepare forecasts of future taxable income, and this was a challenging audit area.

The company's accounting policy for deferred taxes and its valuation of the realizability of deferred tax assets are covered in Notes 2 and 12 to the financial statements."

We think this approach -- it's shorter and more to the point -- still accomplishes the objective -- telling investors what were the critical audit matters faced by the team in the execution of the audit.

I expect one reaction to the suggestion is that it will potentially drive some to have CAM disclosures take on a more standardized language format. It's clear boilerplate is now viewed as the new four-letter word in this discussion.

I fully appreciate that some are calling for this project to drive audit report disclosures of special insights, views, or impressions on a company's financial reporting. We think attempts to meet such objectives could lead to some harmful consequences.

In a more freeform writing world, two different auditors could have different views and perspectives on similar fact patterns. The resulting diversity in what might be said, and how matters might be characterized in the two instances, could lead to misinterpretations by financial statement users.

Do more details point to more problems with the company's account? Do more details or color commentary on the audit -- does it really point some towards a more thorough audit? I don't think so, and I think those are some of the harmful and unintended consequences that could be achieved if we head in this direction.

We think a concise articulation that is to the point, even if the description becomes somewhat standardized, would nonetheless be valuable to users of the financial statements. We also think that highlighting the CAM in the audit report will lead to improved financial reporting in those identified areas for the benefit of investors and other financial statement users.

So, to sum up, we support CAM. We have some significant indigestion relative to the examples in the proposing release. We are hopeful that the approach I have outlined could be considered by the Board and staff in terms of moving this ship forward. And I look forward to your questions on this area.

MR. DOTY: Thank you.

Aulana Peters?

MS. PETERS: Good afternoon, all. Thank you for this opportunity to share my views on the Board's Release Number 2013-005 on changes -- proposed changes to the auditor's report.

As you know from my written statement, I firmly believe that users of financial statements could benefit from an expanded audit report, and I support the PCAOB's efforts to improve the current form of auditor report.

The question is, of course -- and all of the panels today have tried to answer this question -- what should the auditor's report communicate? In my view, the contents of the report should relate directly to and illuminate the auditor's opinion. Therefore, it should include more information about the audit process, and also my friend Alan Beller is not going to be happy to hear me say that. Are you still here?

(Laughter.)

About the audit process and the approach, the audit approach, so that users of financial statements better understand the role and responsibilities of the auditor. In other words, I would focus on information designed to reduce the expectation gap, and that rather than to rebalance a lack of symmetry between information accessible and available to management and that available to investors.

I was going to -- but I am going to make a point now that I was going to save to the last, and that is about the investors about whom we should be concerned, that we are concerned about. These investors, I would like to emphasize, are institutions with -- and powerful institutions with considerable resources. I will only say that. And that the lack of symmetry I think is more perceived than real and actual.

That is not to say that they don't -- shouldn't get some of what they are asking for, but the Board should keep in mind that these are not uninformed and -- well, just uninformed individual investors.

The Board's proposed standards for audit reports that express an unqualified opinion would require the auditor to identify and address critical audit matters, CAMs, which are defined as -- and this is -- I paraphrase it, so you can pull me up short if I'm doing so inappropriately -- defined as (matters which the auditor found to be the most challenging and difficult to audit with respect to the complexity of the issue presented, the amount of effort required, and the ability of the auditor to obtain sufficient, appropriate evidence.

This definition, while it focuses most certainly on issues that auditors must and do address, does not seem, in my reading of the release and the standard, does not seem to take into account the notion of materiality or the fact that auditors apply a risk-based approach in performing their audits today, not only in planning them but in, also, executing them.

I would suggest that the factors that should be used to define CAM should be based on what the auditor determines presents the greatest audit risk and the greatest risk of material misstatements in the financials, whether due to error or fraud. In my view, such information would be much more useful to the user of financial statements and understanding the auditor's opinion on those statements.

Again, in my reading of the release and the language in the proposed standard, the focus on requiring the auditor to report problems and challenges encountered during the audit, rather than to outline the process through which the auditor reached his or her opinion in question. That is the focus. My concern about this approach is that matters which present the auditor with significant challenges and require a lot of effort to audit may not be material and may not present a risk of material misstatements in the financials, or they may be completely unrelated to management's financial condition.

As the Board knows, if auditors encounter difficulties, they are resolved during the course of the audit, thus requiring a detailed account of challenges and difficulties, all of which have been either eliminated or resolved before the unqualified opinion is issued, in my view is more likely to cloud the reader's view of a final audit result and might undermine the value of the auditor's pass-fail opinion.

For me -- this probably will reveal that I watch far too much television -- they are just sort of like asking the auditor to perform an autopsy on a living patient. If you've given a pass-fail, the patient is still alive. We should not be performing a post mortem in that respect.

I think that an audit report structured on a -- this is the lawyer coming out. If I didn't like the definition, I am going to suggest another one. So, but I think we get to the same place. I would recommend that the definition of "CAM" focus on identifying the most significant risks of misstatements and the specific financial misstatements, whether due to error or fraud, and the risk that the audit procedures selected and applied selectively might not uncover such misstatements. That approach would be, in my view, far more useful in understanding the auditor's opinion and the financial statements themselves.

Significantly, if the auditor's report focused on how the auditor planned and executed the audit with the greatest risks in mind, I believe that the most complex, the most subjective, and the most challenging matters should be revealed in any event in that process and discussed, albeit in a different context -- the context of what were the risks as opposed to what were the problems.

One final point, and I'm just going to say it because everybody else has pointed to significant deficiencies, which I believe the standard would require disclose, or at least that's what the panel seemed to indicate. And putting my Audit Committee hat on, I really do agree with the suggestions that that would not be beneficial necessarily to users of the financial statements.

In my experience as an audit committee, of course, these significant deficiencies are reported on an ongoing basis. But I can tell you that the two or three that might be reported in a quarter, most of the time there is something new in the second quarter and the third quarter and the fourth quarter. And frequently, of the significant deficiencies that are uncovered either internally by the Finance Department or the external auditor, they are resolved before they are even disclosed to the Audit Committee.

As I sit here -- and I am in favor of full disclosure -- I really do not see that it advances the goal of understanding the opinion on the financial statements to know that there were five or six significant deficiencies that were all resolved and that did not have a material effect on the final product.

Thank you very much.

MR. DOTY: Thank you.

Steve Harris, questions?

MR. HARRIS: Yes. I was struck on the last panel -- I'm not sure I remember who the panelist was. I think it may have been Joe Ucuzoglu who mentioned it, where he said that 91ápercent of the users do not read the product. I have heard that before; the percentage may differ.

But my feeling is that if we have a report, the report ought to be read and it ought to be informative. And so the question is, how do we get a report which is read and informative?

And then, Aulana, you know, getting back to you, you stressed, you know, by and large we are dealing with the BlackRocks of the world, although you mentioned BlackRock, but you used institutional investors -- no, no, you used the term (institutional investors. But I don't want to believe that the retail investor is dead and buried in this country. Hold on for a second. So what I want to do --

(Laughter.)

So what I want to do is I want to try and figure out, how do we get an audit report which is read and used not only by the institutional investor, who is plenty sophisticated, but the individual investor? And what do we do, and what's critically important?

But that was -- I wasn't addressing the comment. I was going to -- because you can all answer that. But I did have a question, and I --

MS. PETERS: I would defer to Kevin for your first question, and then I'm happy to address the second one if you'd like.

MR. HARRIS: The clock ticks. I wanted to ask Ms. Cavanaugh a question, because you indicate here that, (we recommend clarifying that routine audit procedures, such as Testing Level 1 or 2 fair valuation inputs would not be deemed critical audit matters, absent significant judgments therewith. I think everybody would agree with that.

MS. CAVANAUGH: Right.

MR. HARRIS: The question I have got is, what do we do about Level 3? And where should that be reported? And for all practical purposes, it can't be valued or it's very difficult to value. So does that have any place in the audit report, or where does that come up? And where should that be disclosed to the investor? So I know there are a lot of questions up there. Go for it.

MS. CAVANAUGH: We were -- I was intentionally silent when I put that paragraph together because I do think when it comes to Level 3 there may be, when you're talking about hard to -- difficult-to-value securities, that may be something that would warrant a CAM disclosure. And I think that's one of the reasons why -- there was a question in the proposal that said, (Should certain entities be completely scoped out, meaning investment companies, and we don't think they should be completely scoped out. We think you have to look at the nature of what the transactions are.

So for Level 3s, they may warrant CAM disclosure.

MR. REILLY: Steve, on your first question, the 91 percent, I would submit to you that I do think financial statement users do use the report. When you say, (Read the report, I think they focus in on one thing, which is the binary nature of pass-fail. And if it's a pass, move on. If it is not a pass, or there is an emphasis of matter paragraph being stressed in the report, I do think those reports get a lot of focus.

MS. PETERS: Steve, I can count on you for seizing the wrong end of my double-edged sword, in terms of the comment that I make. I did not -- I'm not going to back off my remarks that most -- 90 percent of the investors out there are institutional investors, but I also said they deserve the information that they need to make their investments.

However, my point is that there really -- I don't think there are any more investors like you and me. I don't rely on my own acumen, investment acumen in making investments. I turn to my financial planner to do that. Warren Buffet does that. So I really think that your focus needs to be on making a useful audit report that does not muddy the waters, that really gives information that illuminates and focuses on, what does this audit opinion mean?

And from my point of view, it would be requiring the auditor not to discuss problems and like -- and making his job seem more Sisyphus-like than it perhaps really is, but would discuss the actual audit and what the risks were and how they address those risks.

MR. COONEY: I would just make one comment.

MS. PETERS: And not many from Missoula will understand that.

MR. COONEY: With respect to level of knowledge, I think at the outset at least we had commented that it would seem reasonable that the Board would expect users to be reasonably well-educated. And I guess from my standpoint the audit report could certainly highlight areas, whether it's through a matter of emphasis or whether it's through some type of association with the critical accounting policies for users.

But, really, I think any reasonably well-educated investor should be able to look at an annual report, go through the MD&A and the financials, and there is a lot of information in there. And I'm not sure it's necessarily the auditor's job to go back and pull out all the pieces of information that someone might find important. That's really an investor's job to do that.

MR. DOTY: Jay? Oh, of course.

MS. CAVANAUGH: One other comment I wanted to add. I think, you know, from speaking to our analysts, their prime concern is they are interested in cash flows, companies, financial risks. And by at least highlighting the CAMs, without giving a lot of detail, it at least alerts them to discussions that they then may want to go back and discuss with management. It allows them -- pinpoints to them what particular areas are that they really need to get more information on.

So they don't expect everything to be in the auditor's report. I think that would be -- what we heard is disclosure overload. But what are those key points that they can then take back to management and drill deeper on?

MR. FERGUSON: Okay. I have a question that is directed I guess to the whole panel but primarily to Kevin as a preparer and to Ann as an investor, a user of financial statements. And it's a question I seem to keep asking and it may reflect --

MR. REILLY: I'm not a preparer. That would be a clear independent --

(Laughter.)

MR. FERGUSON: Whatever it is you are.

MR. REILLY: Let the record show --

(Laughter.)

MR. FERGUSON: I know you're relevant. I don't know what you are, but I know you're relevant to my question.

This question may reflect either my fixation or my lack of imagination. But, you know, we're doing this project in the midst of a lot of stuff that is happening in the world. And we are actually beginning to see some real examples of new models that are out there. The UK has one, the Netherlands is now doing it, Arnold Schilder has got a proposal that is very close to ours.

And as either a firm that has audited financial statements and has had to write audit opinions in the United Kingdom, or for you who I assume have investments in companies in the United Kingdom and in the Netherlands, where you have seen these new reports, do you find that what is coming out of there is confusing to you? Or is it useful?

And certainly in the UK I know the reports have not been standardized. They have been kind of all over the lot. Has that been a problem in auditing these things? Has it been a problem in preparing your report? So just -- I'd just like to get the panel's impression of what they have seen going on around the world.

MR. REILLY: Great question, and a fair question. I think, as Professor Skinner mentioned in the last panel, I think the UK experiment, which is now live and in color, we are still in the early days. As I said in my prepared remark, we think CAM, concept of CAM, is a good thing and will be helpful to users of financial statements, irrespective of geography.

The real issue is, how do you translate that into practice? And how is it made practical? And I'm hearing a whole lot of pie-in-the-sky concepts in the various interactions this morning and earlier this afternoon. And I'm just struggling with, how do we land the plane and bring this thing, you know, to fruition?

MR. FERGUSON: But it is happening in the UK. You're doing it. Are you able to do it? Is it impossible? What is the experience there?

MR. REILLY: It is most definitely not impossible. As you said, it is happening now. I will tell you, though, you know, we have seen it in other countries, and let me share with you a reaction that I found interesting relative to what has happened in France over the last 10-plus years.

So they adopted a justification of assessments approach for commentary in the audit report. They did that in I think 2003. They did a fairly comprehensive look-back in 2012 or '13 as to how is it going. They found a lot of movement towards standardization, not unexpected.

But one of the things in the report that I found fascinating is -- one of the observations, and that is things are moving towards standardization. But in an otherwise black and white audit report, the commentary is a helpful shade of gray.

So, again, I don't think we are going to be able to make this perfect. I think we need to make it practical. And I think by making it practical it will still be useful to investors.

MR. DOTY: Jay?

MR. HANSON: I've got a question primarily directed at Ms. Cavanaugh. I really appreciate that you, on this panel especially, and the one most directly connected to people that actually make investment decisions. And so I'm going to ask you to imagine what your analyst -- how your analyst would answer this question.

So Commissioner Peters suggested that instead of focusing on the most difficult matters at the end of the day that the auditors spent the most time on, kept them up at night, that the approach be a little bit more holistic around what were the risks that the auditor considered initially.

And that is very similar to this UK model that -- I don't think you were in the room this morning as we had the discussion about it, but it was their approach is focused on, what were the most important risks that were identified in the audit plan? What was the materiality level established? And then how did the scope of the audit address all the risks? And that's a very different model than, what were the most difficult areas of the audit, all things considered?

And I know we talked for a bit about the -- Steve's question about the Levelá1/Levelá2 securities, that routine procedures aren't necessary to include. And your comment letter also referenced that the audit procedures performed on a given CAM would not be helpful except would maybe tend towards a piecemeal opinion.

But what are your views on whether an approach more like what Commissioner Peters suggested, that holistically describing the most significant risks and what the plan was to address them as something -- an alternative to what we propose for CAMs, maybe how you think your analysts would react to that.

MS. CAVANAUGH: I mean, I think just based on the conversations that we have had with them, and based on what I'm hearing here, they would probably be more in line with that holistic financial risk type approach as opposed to what is currently in the document today, because I think financial risk and cash flows is what they are interested in. And what is going to give them that information is going to be most useful.

MS. FRANZEL: My comment is along the same line as Jay's. You know, all day here we have been listening to concerns about the CAM approach, but support for the concept and support for the notion of, you know, getting the right information to investors that they need.

And so I'm really struck by Aulana's suggestion here because it seems to just tie together a whole lot of what we have been hearing, you know, and that is really the suggestion that the CAM should be based on what the auditor determines to present the greatest audit risk and the greatest risk of material misstatements in the financials.

It is similar to the UK and EU approach, and we have been hearing that we need to somehow figure out how to bring our approaches closer together. We have heard concerns about materiality and the potential for disclosure of immaterial and irrelevant information, and I think that this type of a framework would help maybe mitigate some of that risk.

We have heard concerns about non-helpful information, you know, potentially irrelevant and confusing information. So I guess I would like each of the panelists to comment about your thoughts on, would this help mitigate some of your concerns? And would this be useful to investors if, in fact, the CAMs were based on a framework that really focused on those areas of the highest risk of misstatement in the financial statements?

And let's start with Ms. Cavanaugh.

MS. CAVANAUGH: I do. I do, because right now, the way the PCAOB proposal is written, it is -- as we mentioned, you could wind up with CAMs, which may not be very material to the company. In those instances, I don't think our analysts are going to find a lot of value from there.

Overall, their big picture view was, what are the risks to the company? You know, anything I can learn about that, I don't need it detailed within the auditor's report, but something that will pinpoint that and allow me to go back to management and further explore. That's what they are looking for. So I think what you are proposing is something that would likely be more amenable to them.

MR. COONEY: Yes. As I mentioned earlier, when management prepares the critical accounting policies and estimates, we focus on the significant items. They are generally material. They are generally going to be, in my view, similar at the end of the day. If we went through a CAM process, I would think there would be a fair amount of commonality.

So cutting to items that are material by definition, things that, you know, not including some of these other items that we have covered earlier, and focusing on critical accounting policies and estimates with potential changes as was discussed in the prior panel about ways to improve that and make that perhaps more of a collaborative process with the auditors I think would be the best approach in terms of getting to where -- getting to where you all are headed hopefully.

MR. REILLY: I think, as I understood your question, I think there is a lot of overlap in terms of the various buckets here. But in terms of what thoughts we have conveyed to the Board and the staff is, you know, we cover a lot of ground with the Audit Committee.

Under ASá16, we are required to raise the significant issues and cover a whole host of different matters with the Audit Committee, and we think what is missing, at least relative to the identification of CAMs, is, okay, you look at this big inventory of stuff, what were the most important things out of that inventory? And we think what would be helpful is building in an additional filter which covers, what were those things that you spent the most time with, the most interaction with, the Audit Committee in discussing.

And we found that that lines up with the way practice is running right now. You know, I remember an Audit Committee meeting on that. I'd go through the whole enchilada on ASá16, and the Audit Committee Chair looks at me and says, (Thanks for the warning, Kevin. But tell me, what were the handful of matters that really cause you some indigestion relative to the execution of the audit? We think it would be helpful to bring that practical approach into a final standard.

MS. FRANZEL: Aulana, did you want to comment on your own suggestion?

MS. PETERS: I'm not sure that you really needed to hear more from me, other than to say I don't disagree. In fact, I agree with the comments on my comments.

I would say that I intentionally did not focus on circumscribing the auditor's report solely within the parameters of auditing standard -- what is it now? I knew it when it was -- 16. 16. I think that that is important, but I think that the approach that I suggest gets you there anyway, and also makes sure that any new issues that crop up that change from quarter to quarter, from year to year, gets pulled into a more expanded auditor's approach as things change at the issuer themself.

So I agree, but I wouldn't leave it -- circumscribe it with audit -- communications between the auditor and the Audit Committee for that reason.

MR. DOTY: Marty?

MR. BAUMANN: Thanks. I have a question for Wally Cooney. Thanks for being here, Wally, and participating. And thanks for being in our SAG.

We have a long list of investors who have sent us comment letters, and we have surveys prepared for the Investor Advisory Group, all of which -- covering trillions of dollars of assets under management, and we have letters from BlackRock and Vanguard and the Council of Institutional Investors.

All of those letters indicate that investors are looking for much more from the audit report and from the auditor. The BlackRock letter says, What type of information? "The additional information provided will be particularly useful to our analysts to the extent it leads to a better understanding of financial risks, including future cash flows of the company."

Jeff Mahoney was here this morning and saying that our CAM is useful but only to the extent that it talked more about an assessment of the critical audit matter and, you know, management's estimates and subjective judgments, et cetera.

So many of these, I assume, are some of your owners in your company. So how do you respond to the owners of your company who say, (I want more information, and I want it from the auditors, about the critical aspects of the audit, about the difficult judgments in financial reporting, and about the information that will lead to better understanding of cash flows. And I want to hear that from the auditors. And how do you respond to your owners and say, (I don't think the auditor's report should include any of that?

MR. COONEY: Okay. Well, I mean, my experience may not be similar to everyone else's. But I've been to a lot of annual meetings and a lot of investor days at several companies I have worked for when I was an auditor. And in all those years, there has never been a single question, ever, in my career that has ever been directed to an auditor. Not once, at any annual meeting or investor day.

We are -- the company I work for is not widely traded. I'm not aware of a single question ever being posed by any investor about the audit or the auditor. Questions are directed to management.

I believe, you know, based on my experience that shareholders want -- generally want information from management, from the people who run the company and manage the business. Auditors certainly gain a lot of knowledge about the company, about the management team, et cetera, but, really, at the end of the day, the management really has far more knowledge and expertise about the company. They're in a much better position to answer questions effectively and provide information that I think is most useful to investors.

With respect to some of the surveys and the comment letters that I looked at from investors, I think someone mentioned earlier that they didn't find surveys particularly helpful because generally the question is, do you want more information and they say (yes. That's not necessarily a great barometer for what is actually valuable.

I didn't find many of the comment letters -- and I didn't read them all, so there may be some out there -- that were really that specific about specifically what they thought would be valuable. They just said, (We think discussion about CAMs would be valuable. We would like to know more information about the audit. But I didn't find anything in particular that I found compelling, this, you know, idea that there's a real desire or clamor for information.

And in my personal experience, I just haven't ever been asked a question or seen a question been asked at a meeting about the audit or the auditors.

MR. DOTY: You are drawing me out, Wally. Annual meetings have been structured often to discourage large attendance and questions from -- of the auditors. Aulana is nodding. I take that as a concurrence.

The knowledge about the audit has been limited. There is a proposal by the Basel Commission and the others that there be a vastly expanded discussion of the audit that go to the regulator, directly to the regulator.

I must say, speaking, again, as one unqualified for the job of judging auditors that it seems to me that that has been part of the problem that we have, that what you've got -- an MD&A is what you're going to get.

I think I hear Kevin as saying that in fact a more general -- if the proposal and the CAMs offered guidance at a more general level and avoided the detail, examples, stayed away from the more detailed examples, that that would be something that auditors might welcome, and that it might actually help management do a better job of communicating with its shareholders, such as BlackRock.

Doug Skinner, very important academician. I let him out of here without asking him whether we should simply wait to see if the market starts to price American equities at a disadvantage to European equities. I think this was involved in Lewis' comment. There is some Chicago research that suggests that is going to happen. So maybe 10 years from now we wake up and we find that, in fact, we are trading at a discount because we are conceived to be -- perceived to be a more retrograde disclosure regime.

I am leaning on you, but is it really in the interest of preparers to say, (We just don't want it when BlackRock wants it, when TIAA-CREF wants it, when people such as Aulana Peters say that there would have been -- the audit profession, which she advises would have been better off if there had been more interaction with shareholders at annual meetings.

When Kevin Reilly says that he thinks that in fact we can do it, are doing it in London, when Alan Beller says, you know, you might even go farther than just critical audit matters. You might even start having auditors make judgments about whether the companies -- and communicate whether they think the company's critical accounting policies are better. We seem to be coming in, as I said this morning, somewhere between what the most expansive view of what the auditors ought to say would be and what in fact others have done abroad.

How far -- this is Marty's -- this really is where Marty is going. How far are you willing to go in saying, (We just don't want anything anytime soon? And if you want something, if there is something more to do, if it's -- is it something that has to be -- that management influences, controls, and dictates? Is that the problem? You are concerned that you are losing control with the CAMs of something management has traditionally controlled? Because that's an independence issue.

MR. COONEY: I am not sure I have communicated my position well, because I am actually not opposed to this proposal. I have a lot of concerns that I think other people share.

In my comments, I talked about if you are going to go forward with a critical audit matter framework, which I don't have strong conceptual issues with, that I thought you should more tightly define the framework. And I had some ideas that I put in writing. They were also in the -- in some of the other prepared comment letters as well.

I personally think a matters of emphasis would be a better approach because I think it could a little bit more -- it could be a better framework to do that.

I actually think that Alan Beller's suggestion, and others -- one of the accounting firms talked about auditor association with critical accounting policies, which would be a significant change. So I think that all of these options should be looked at carefully.

I don't have strong opposition to critical audit matters in general. I just have some concerns about the way it would be applied, and it wouldn't be my first choice. But I believe that, based on all of the work that you've done, that this is an important project, and that you should go forward with some type of change. And what that is I think we are just here to talk about today, about what the best way would be to go forward. But I'm not personally opposed to that.

And as I said earlier -- I answered Marty's question directly -- my experiences at the companies I have worked for is just my experience. Just because I haven't heard a question ever about an audit or an auditor doesn't mean people from BlackRock and other companies who are in that profession, that maybe they hear it all the time, I just haven't personally.

He asked me, (How do I answer owners in our company? I have never had the opportunity to answer them because I have never gotten questioned.

MS. PETERS: May I address that? Because, Chairman Doty, I did nod when you described what the current situation is generally at annual shareholders' meeting, but I don't think, while I agree with that observation, that it really discounts Mr. Cooney's observation that rarely is there a question put to the auditor, who is at every annual meeting that I have attended in the past 23 years of serving on a total of seven different Fortune 500 boards -- I am not touting myself, but just sort of defining my experience.

Has there been a question put to the auditor about the balance sheet or the profit and loss statement, or anything that would go to understanding better that pass-fail opinion on the financial statements? And I have attended meetings where there have been 5,000 people, 5,000 shareholders there, down to currently people tend to try and winnow it down to 50 attendees and 15 minutes.

But that is not the universe. Sometimes these meetings last for three hours, and in those meetings the questions don't arise, and I won't bore you with the questions that do.

MR. HANSON: Aulana, I would like to just ask you a followup from your role as an Audit Committee Chair, Audit Committee member, and the large esteemed companies that you are associated with, and just a reflection that from the discussions I have had with some Audit Committee Chairs, their pushback or feedback comes very similar to what Wally has said, that they don't get questions from investors about what the auditor thinks. And their earnings calls or other direct interaction with investors, they don't see the swell from that side coming.

And just I wonder about what your experience has been relative to investors either directly talking to you, which I know is a challenge with a lot of committees, you know, the connection to investors, but on earnings calls or other situations where you have seen a manifestation of this demand that we -- we are talking about.

MS. PETERS: Well, first of all, for the record, I am currently not an Audit Chair. I have served in that capacity, but currently I am not. So, and because I am not and haven't been, say, for the past five or six years, I am usually not in the front line of communications with investors.

But I do know from my work on boards of directors and on audit committees and governance committees that most of the inquiries that come into us for more information are -- say over the past 10 years, are more related to governance issues rather than issues relating directly to the financial condition of the company or financial statements. Is that an answer? Is that -- did I get your question, Jay, or --

MR. HANSON: Yes. I think that's reasonable.

MS. PETERS: Okay.

MR. FERGUSON: I have a question.

MS. PETERS: We get a lot of them.

MR. FERGUSON: Given the fact that in this panel, and in the previous panel, when Alan Beller and Doug Skinner were on and talked about critical accounting policies and then approach on that, would it be a good idea for -- and given the fact that those two are related but not necessarily coextensive, would it be a good idea for us to require both of those? That the audit report include CAMs and include a statement that the critical audit policies are, in the auditor's opinion, in fact, the critical audit policies, and that what the company has said about them is complete information? That we do both, because they are not coextensive. What do you guys think about that?

MR. REILLY: Good question. But, you know, when we started talking about this issue in 2010, 2011, one of the suggestions the CAQ put forward was a separate attestation of the segment of MD&A that comprises the discussion of critical accounting policies.

MR. FERGUSON: I take it you were in favor of my suggestion.

MR. REILLY: We were. And we thought it -- there was a great deal of overlap. We heard from investors that these are the types of things that they have particular concerns about. Alan Beller mentioned in the last panel discussion that, you know, there is some degree of unevenness relative to the extent of the disclosure and discussions in this broader area. And we thought this would be one tool to employ that would help with providing information to investors.

MS. PETERS: I would like to be clear and at the same time respectful. Since I -- although CAMs are not coexistent with critical accounting policies, I have to reiterate the fact that since I don't like the way you have defined CAMs -- and I think you -- I would recommend and suggest that you take a different approach to your definition, you will get to where -- you will probably get to where the other panel was trying to lead you ultimately.

So I would say, no, I don't think it would be helpful to require both a discussion of critical accounting policies and CAMs, mainly because I don't think the way you defined (critical accounting -- audit matters that that will be particularly useful. With respect.

MS. FRANZEL: Let me take this one step further. And I want to address this question to Ms. Cavanaugh, since you are here representing investors. You know, today we have heard a lot about focusing on critical accounting policies, management estimates, and risk of material misstatements. And if we were to somehow mix all this up into the perfect solution, in the definition of a CAM or whatever we're going to call it, would those types of things be, you know, what your analysts look to when they're looking to make investment decisions?

Because in your statement, you know, you say that additional information would be particularly useful to the extent that analysts can use it to better understand financial risks and to -- including future cash flows, to have those conversations with the company.

So some of these things we have been talking about -- critical accounting policies, management estimates, material areas of risk. Are those the types of areas that would be helpful?

MS. CAVANAUGH: For the analysts --

MS. FRANZEL: Right.

MS. CAVANAUGH: -- you are asking? You know, I think it really varies. They didn't give us a lot of specifics, but I think, you know, for example, loss of a major customer relationship. That's something they may be interested in that may impact cash flows.

So items that might highlight, you know, issues with revenue recognition may lead them, then, to go back to management and say, (Well, why was that the case? Was it because of the loss of a customer relationship? And allow them to dig deeper, and that's not information I think you would normally obtain today in the financial statement.

So I think it varies, but some indication of where risks and changes have taken place ultimately will get them what they want, which is cash flows.

MR. DOTY: If there are no further questions, it may be that we have saved four and a half minutes for the next panel. But we shouldn't adjourn without telling you what a terrific job you have done in responding to the questions, to the dialogue, to the back and forth, and how valuable your written submissions are. This is a real contribution to the seriousness of what we have to do.

With that, I think we could move on to the next panel. Thank you.

We'll take a break now. We have 10 minutes -- 15. We have 15 minutes, so we're going to start -- we can start, instead of at 4:10, we can start at 4:05. We can start a little past 4:00. 4:05.

(Whereupon, the proceedings in the foregoing matter went off the record at 3:41 p.m. and went back on the record at 4:05 p.m.)

MR. DOTY: All right, the sixth panel, Critical Audit Matters Related to the Audits of Smaller Companies. Kurt Schacht, Managing Director of the Chartered Financial Analysts Institute, he heads the ethics and professional standards area there, leads advocacy and think tank functions. He is an attorney and the CFA charter holder. Previously, he spent 15 years in the investment management industry as a chief legal and compliance officer for a large public pension plan and later a hedge fund. He was Chief Operating Officer for a retail, mutual fund complex. He serves as a member of the SEC's Investor Advisory Committee. And he's also a member of the PCAOB's Standing Advisory Group.

Andy Bishop is the CFO and the Chief Accounting Officer of Hallador Energy Company. Previously, he was with PriceWaterhouse. He also served on the Audit Committee of SemGroup Energy, SemGroup Energy Partners, now Blueknight Energy Partners and we welcome Andy.

Dr. Cartier Esham serves as Executive Vice President for Emerging Companies at the Biotechnology

Industry Organization and in this role she manages and directs BIO's policy development, advocacy research, and educational activities, and initiatives for emerging companies which comprise approximately 90 percent of BIO's member. Prior to joining BIO, Dr. Esham was the Vice President and Director of Research at Dutko Worldwide, a private consulting firm based here in Washington. And she also has published papers in peer reviewed science journals.

Joan Waggoner, a partner in Professional Standards at Plante Moran, she specializes in accounting, auditing, ethics, professional liability and quality control issues. She has recently completed her service on the Professional Practice Executive Committee of the Center for Audit Quality. She has also served on various subcommittees and task forces of the CAQ and has participated in various roundtables of the U.S. Government Accountability Office, the SEC, and the PCAOB, so we welcome all of these panelists who have important views to share.

Kurt, you want to lead us?

MR. SCHACHT: Thank you, Chairman Doty and the rest of the PCAOB Commissioners and PCAOB staff. Thank you very much for including us in this discussion today.

I am Kurt Schacht. I'm from the CFA Institute. That's the Chartered Financial Analyst people. It's a global organization now of 120,000 professionally trained financial analysts around the world. We have another 250,000 or so people in our 3-year program. So it's growing tremendously and it's our next generation of financial analysts.

In that capacity and working for CFA as well as having the pleasure and the opportunity of being involved in the SAG for a number of years, our organization, I've been helping our organization and its members in talking about improved audit quality. For many months now, and as you know, some of these debates have been going on for decades, as a means to improve the audit process, its independence, its quality, particularly of things like outputs around the Auditor's Reporting Model.

We very much appreciate the PCAOB and its staff and the very interesting and challenging position that they find themselves in. Trying to change audit rules is a very slow process to begin with, but particularly when you're talking about anything that is a major regulatory change. And we've witnessed that time and again over the years as to how difficult it is, particularly when there's very deeply ingrained professional and commercial interest in not changing the practice. The road to reform is always very long. It's always more difficult. And it's always more acrimonious.

We certainly put the Auditor's Reporting Model change proposals in that category. We're very hopeful that we're getting closer to some changes there, but honestly I felt that in times past in a number of different settings, but I think now with the two proposals from the IAASB and from the PCAOB on the table around key and critical audit reporting matters, that maybe we're a little bit closer.

From an investor perspective, from the user of financial statements perspective, our very clear and consistent input from professional analysts and from investment manager members and you've heard reference today to several of our different surveys in this regard, is tell us more information. We like the pass/fail opinion, but tell us more information because the

Auditor's Reporting Model is now behind the times. It's been permitted to remain a bit of a remnant of the audit practice of decades gone by and it is no longer in keeping with the information demands of the marketplace in the 21st century. That's just sort of plain and simple how many of our investor members feel.

Having an auditor's signature is nice. Having a rotation of the firm is nice. Having more information, useful information from the Audit Committee or from the issuer, that's all fine and well, but in the view of many of our members, those are minor players in comparison to what would be a well-articulated discussion of the audit like we're proposing, like you're proposing with the critical audit matters discussion and coming from the auditor.

So that's our view. That's what we have communicated in this venue and other settings quite often. I certainly do understand the practitioner issue or concerns about this. The standard nature and the beauty of long-standing historical practice is important. I understand all of the opposition, the commercial issues associated with this issue and certainly appreciate the skill with which the practitioner and issuer community weigh in on this. But the fact of the matter is that everything else in the world of finance has changed dramatically in the last five years and over the last decade, rapidly changing around audit practice in terms of information, the speed, the quality, the transparency of it, and certainly the usefulness of information.

Let me address two real quick things that we come across in terms of this debate. We hear repeatedly that the financial analyst community is never satisfied. They never have enough information. It's never good enough. It is never of high enough quality. It's just another one of those requests from the financial analyst industry.

The other thing is that very few investors ever read the financial statements. A lot of our professionally-trained investors read financial statements, but very few investors read them, much less the footnotes, much less the audit opinion. So why on earth are we building up this very expensive rule book, regulatory rule book and the corresponding outputs that no one is apparently using?

I think you all know the answer to that. I think we've talked about it a number of different times. And the fact of the matter is that these practices and rules are so very fundamental to the integrity and quality of our markets. Investors know that they exist. They have to exist. They're required of those seeking public investment and if they violate those rules, there is some hell to pay in terms of having violated those. I think everybody gets that their existence is not a 100 percent guarantee on fraud or cheating or even 100 percent enforcement by PCAOB or SEC or that investors even understand or appreciate the complexity of the outputs.

What investors do know is that the rigorous nature of these is a condition to taking their investment money. It is a type of discipline and responsibility that is not optional in the U.S. publicly-traded markets.

That brings me very quickly to talk just a little bit about the smalls and mediums, whether the audit reporting model rules changes be waived for smaller issuers. We have never in our organization supported a variable system for publicly-traded companies based on market cap or size. If you want access to the public's money on the same terms as other public companies, we think the rules ought to be the same. We do get that being public is expensive. It's very complicated. It's complex. The regulations overlap sometimes and maybe they're even over broad. But if you understand that and you don't like that, then maybe you list on a lighter touch exchange or a lighter touch regulatory regime. That is your option. But if you want to access these markets and stand toe to toe with other seasoned issuers whose reputation and confidence level and standing in the marketplace are built on regulatory rigor, we don't expect there should be a free pass. We think that's the right approach from an investor protection standpoint. Thank you.

MR. DOTY: Andy Bishop. Thank you.

MR. BISHOP: I would like to extend my appreciation and thanks to the Board for including me in this panel discussion. Hallador is an underground and surface coal mining company serving Indiana and Florida electric utilities. Our mines are located in Indiana. We trade on the NASDAQ. It's HNRG. Get it, N-R-G. H for Hallador (R-G. We are a small reporting company as defined by the SEC rules and our public float June 30 was $75 million, although our market cap exceeds $240 million.

I started my career at PriceWaterhouse in 1975 in the Oklahoma City office after graduation from the University of Oklahoma, that's the team that trounced Alabama in the Sugar Bowl.

(Laughter.)

Thank you. In 1984, I transferred to the Denver office. Practically all my audit clients were SEC registrants. In 1990, I joined Hallador as the CFO, left in '93 and then came back again as CFO in 2009. From 1993 to March 2009 I was the Executive VP and CFO and a third owner of the SEC Institute. During those 16 years, I also assisted Hallador in preparing their SEC filings. In July of 2009, I sold my interest in the SEC Institute. I also served on the Audit Committee of SemGroup Energy Partners, now called Blueknight which is a NASDAQ company from July 2007 to July 2008.

Before I go further, I should tell you that the views I express today are my personal views and do not necessarily reflect the views of any of the officers and/or directors of Hallador.

So for the past 29 years, I've been intimately involved in this space and along with many others have noted that the auditor's report has not substantially changed. Now is the time for change. And nobody likes change but a wet baby.

I recall years ago in the self-regulation days when the Big Eight, now the Final Four, I picked the Gators, audited each other. I worked both sides of that fence. I firmly believe in less regulation than more, although I have to admit there were serious flaws in that system. We audited each other and I recall each firm received an A plus year after year. It's not unlike asking your mother if you're good looking.

The PCAOB system was a much-needed change. Other information in the auditor's report, I'm in favor of having the auditor's report on the other information disclosed in the 10-K. Also consider a mechanism where they also report on the earnings release. The earnings release moves the market more than the 10-K disclosures.

For smaller companies that don't have an audit of internal controls, I assume that other information includes management's representation that the internal and disclosure controls are effective. It is not clear to me how the auditors will report on the proxy statement that's incorporated by reference to the 10-K. The proposed standard states that this information is covered, but what will be the mechanism to make it clear to investors that the information was, in fact, read and evaluated by the auditor. Also, it's not clear to me that the XBRL data that is filed as an exhibit to the 10-K is covered by the proposed standard.

Critical audit matters. Rather than have the auditors include in their report the critical audit matters, I believe the Audit Committee Report should be expanded to include such matters. If the auditors are not in agreement with the report, they have the obligation to report such and include those critical audit matters that were excluded from the Audit Committee Report. Most likely, this would be a joint effort between the Audit Committee and the auditors. The CFO and/or the CAO have an intimate knowledge of these matters and such matters are included in management rep. letter to the auditors and also included in the auditor's communication to the Audit Committee.

This approach would also be more cost and time effective as we have strictly reporting deadlines and at times obtained the final wording from the auditor slows down the process. That being said, the rightful home for the Audit Committee Report is the 10-K, not the proxy statement.

Maybe this concept is a jurisdictional concern and we sure don't want Audit Committees regulated by the PCAOB. I'm sure the SEC and the PCAOB can come to an understanding if this approach was considered.

I would like to take advantage of this esteemed captive audience to touch on some other matters that I have observed over the years. Number one, referring to auditors as independent auditors could be misleading to the average investor. The issuer-pays model compromises objectivity and professional skepticism, always has, always will. For instance, GE, General Electric, pays KPMG over $100 million for their independent audit. Best I can tell, GE has been a client for over 100 years and probably will be for the next 100 years. For simplicity, let's just say the annual profit on the audit is $25 million. The present value of $25 million for the next 100 years approaches $500 million, depending on assumptions. Now that's an asset that would be safeguarded by any firm. What defies logic is if KPMG audit partners invest $25 to buy one share of GE stock, then KPMG is no longer independent. This might be heresy to some, but why not tweak the rules to allow some ownership by partners and staff. Certain partners and staff could be subject to Section 16 reporting, the same as D&Os and others.

Number two, another way to look at audit fees' independence is how significant the fees are to the firm as a whole or to that particular office. For instance, the KPMG Louisville, Kentucky office is the reporting office for the Yum! Brands engagement. The audit fees are about $7 million. Is $7 million significant to the firm? Doubtful, but how about that office? It could be. Now the point being that investors have no way of knowing. Maybe more transparency regarding these matters would assist investors in determining true independence.

I'm not picking on KPMG. The other firms have the same issues.

Number three. Being a smaller reporting company, we are exempt from the 404 audits of internal control, so are emerging growth companies. I thought the passage of SOX was great, especially the CEO and CFO certifications and creation of the PCAOB. That was good, common sense regulation. However, I think the cost of 404 internal controls audits far exceeds the benefits. I am not in the camp that if the regulation only saves one life is worth it. One would think other jurisdictions around the world would jump on the 404 audit bandwagon if it was such a good deal. But we might be the only country.

All CEOs and CFOs certify as to the effectiveness of the internal controls four times per year. That should be sufficient. As mentioned earlier, this management assertion would be subject to the auditor's obligation to report on other information in the 10-K.

Let the investors decide if they see value in the requirement. Make it an optional requirement subject to shareholder approval. Call it (Say on SOX. In the interim, the SEC could at least raise the public float from $75 million to $250 million or higher as recommended by the Advisory Committee on Small and Emerging Companies in their March 2013 letter.

Number four, another required cost that far outweighs the benefits is XBRL. At a minimum, small reporting companies and emerging growth companies should be exempt from this tedious and time-consuming project. For sure, the requirement to detail tag the footnotes of the financial statements is ludicrous. We are followed by three analysts. They seem to be oblivious to XBRL. I'm surprised Congress did not exempt the emerging growth companies from XBRL in the JOBS Act. Maybe they too were oblivious.

The only groups I know singing the praises of XBRL are the service providers. We have fewer public companies on the national exchanges than 17 years ago, 8,800 in 1997 compared to 5,000 or so today. XBRL might have made some sense years ago to assist the SEC in their mission to protect investors, but today it does not. EDGAR is a fabulous tool. XBRL is not.

Number five. In my opinion, either the CFO or the CAO, Chief Accounting Officer, or a member of the Audit Committee should be required to be a CPA.

Number six. I applaud the PCAOB for moving forward with the requirement to name the audit partner. For the last two years, we have named the audit partner and the concurring partner in our information statement filed with the SEC. We also include their ages and their tenure as auditors. We considered including biographical information for the partner not unlike that required for our own D&Os. I do believe that more than just the name of the partner is needed. Their age, years on engagement, industry experience, and any regulatory issues would also prove useful.

As has been said many times, a little something signed is the best disinfectant.

Number seven. We include the Auditor's Review Report in our firm 10-Q. Over 15 percent of the S&P 500 does the same. I'm surprised that the percentage is so low. Consider extending the other information standards of the quarterly review procedures and encourage or require the inclusion of the Review Report in the 10-Q.

Number eight. Final comment, kudos to the SEC for jumping off the IFRS bandwagon. Thank you for this opportunity to speak to you today.

MR. DOTY: Thank you. Cartier Esham.

MS. ESHAM: Good afternoon, Chairman Doty, members of the Board. My name is Cartier Esham and as stated I'm the Executive Vice President of Emerging Companies at BIO.

Roughly 90 percent of BIO's 1100 member companies are pre-revenue emerging businesses. Thus, product sales do not fund biotech research which can cost upwards of $1 billion. Instead, companies turn to external investors to finance their drug development programs. The capital markets play an important role in biotech capital formation and I want to thank you for the opportunity to speak with you today about ensuring that small public companies are given the opportunity to succeed on the market.

Because small biotechs do not have product revenue, burdensome regulations have an outsized effect on them. A one-size-fits all compliance requirements regime diverts funds from the lab and slows the development process. The JOBS Act has shown that a common sense regulatory approach helps biotech capital formation. In fact, nearly 80 biotechs have gone public in the last two years, a dramatic surge considering that two years prior the JOBS Act, we only saw 30 biotech IPOs. The reasoned regulatory approach prescribed by the JOBS Act has been a success. Bio is hopeful that the PCAOB will bear in mind the importance of right sized regulatory requirements as it considers changes to the Auditor's Reporting Model.

We agree with the GAO's finding that the proposed critical audit matters would for any science company not enhance the usefulness of the auditor's report or add value to the users.

As a representative of emerging growth companies, the proposal would only add significant cost burden on growing companies without providing a corresponding benefit to its investors. The PCAOB is proposing release notes that is virtually certain that an auditor would identify critical audit matter based on the proposed standard in any given audit report. Meaning, we can be similarly certain that the audit cost will go up. Quite simply, the new proposed standard would increase the scope of work necessary to complete an audit and these costs would be passed on to emerging growth companies and its investors which can ill afford such a substantial capital diversion.

Again, as stated by the GAO, these additional requirements they determined would not improve audit quality. Emerging growth companies in the biotech industry have few employees and a simple corporate structure, so it does not require an overly detailed analysis to understand the inner workings of their business. BIO fully supports strong investor protections, but the primary value of a biotech company is and will be based on its scientific disclosures and not additions such as proposed.

But I also believe that the provisions in the JOBS Act were designed to ensure that a one-size-fits all approach and increasing regulatory burdens on small companies should be actively discouraged, unless the SEC determines that any such additions are "necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation." We believe the proposed standard would increase the auditor's scope of work and the audit fees for the company would not provide -- would not meet that test to providing additional value to investors and would divert valuable time and resources away from these small companies' core missions.

In the case of small biotechs, this would mean a diversion away from funding scientists and their efforts to research and develop the next generation of medicines, a result Congress clearly sought to avoid.

Bio urges the PCAOB not to apply the standard to emerging growth companies which have thrived under a common sense regulatory regime rather than the one-size-fits all burden. And we thank you for your time and I look forward to answering any questions you may have.

MR. DOTY: Thank you. Joan Waggoner.

MS. WAGGONER: Chairman Doty, Board, Chief Auditor and staff, thanks for inviting me to participate in the meeting. I am a partner in the Professional Standards Group of Plante Moran which is a regional public accounting firm in the Midwest. My previous firm, Blackman Kallick, merged into Plante Moran almost two years ago.

I've been asked to discuss CAMs, the CAMs aspect of the proposed model from the viewpoint of the smaller auditing firms.

First of all, I would like to thank the Board for all the work it has done to reconsider the Auditor's Report Model. This project is, I think, one of the most difficult that the Board has undertaken since its inception, given all the diverging points of view and interests that are involved, and to focus the auditor's voice on only audit matters has been a very interesting concept to contemplate.

My partners and I discuss the typical CAMs that we would expect to see in our practice. We would expect to see predominantly valuation allowances or impairment issues on asset accounts as the most common theme, although there are certainly others. I have included a list in an exhibit at the end of my statement that is more specific and complete. I have also highlighted those that we think are especially relevant to emerging growth companies. We do recognize though that the determination of CAMs is very specific to a particular issuer and requires significant judgment on the part of an auditor.

From reviewing the comment letters of the smaller accounting firms, there seems to be a reluctance to total embrace the inclusion of CAMs in the auditor's report. From discussing the issues with my partners, we also have some worries about certain aspects of CAMs, although we are supportive of the Board's objective to make the auditor's report more meaningful to investors.

Now I should warn you there will certainly be some similarities in my following remarks about these concerns with what you have already heard today, but I will be looking at them from a different perspective which is from the smaller accounting firm and smaller issuer companies.

I believe the concerns emanate from a couple of things. First, some of the reluctance may come from accounting firms' lack of history in disclosing original information. I believe that many of the CAMs would correlate with other disclosures already present in the 10-K or that arguably should be in the 10-K. However, we may end up with some instances where we are faced with the potential disclosure of original information.

This disclosure of original information is not natural to auditors. And since the beginning of recorded time, we have been following the model of management asserts, we attest. This model has been reinforced over time as auditors' responsibilities have changed, most recently with the Sarbanes-Oxley internal control work where again management asserts and we attest.

The force is strong within us that original information should be authored by management. And I should clarify that what I mean by original information in this context would be control deficiencies and other things like corrected or uncorrected misstatements. And so that is what we are thinking of as being original information.

It is important though that the auditor's report be relevant to investors. And so the big questions with many of the small firms is will the inclusion of CAMs and auditor's report benefit the investors in small companies? As my partners and I were thinking through the possible CAMs we would expect to see in our practice of smaller issuers, we were not sure how information would be used or interpreted by investors who do not fully understand the complete auditing process.

I understand that the Center for Audit Quality has initiated a field test of the proposed Auditor's Reporting Model and I am very interested in reviewing the results of that testing once it is completed to help us see more clearly the value of CAMs to the investors in small companies.

In addition, in the comment letters I saw a lot of commentary indicating the concern that the CAM paragraphs might be construed to be piecemeal opinions within the financial statements or otherwise diminish the value of the pass-fail model.

At this point, we do not have clear information about how investors in small companies would use or perceive that information and so it is hard to conclude one way or the other as to whether or not the opinion would be enhanced or diminished by the inclusion of CAMs. But I believe that it is very important that investors understand that the audit is of the financial statements taken as a whole and that the CAMs be presented in a manner such that they enhance, rather than diminish the opinion.

Also, I expect that the volume and the cost of CAMs will be proportionately greater for smaller issuers and especially for emerging growth company audits. Many smaller issuers have excellent controls and processes, some including some emerging growth companies have not yet built the necessary financial infrastructure because of spending priorities. I expect that this lack of financial infrastructure would most often result in a lot of CAMs or at least some lengthy ones, disproportionate to the larger filers.

Lastly, many of us have concerns regarding the availability of firm resources during a very busy time. We expect that significant firm resources in terms of our most senior and experienced people will be necessary at the end of an engagement to determine the CAMs and also the content of the additional paragraphs in the report, especially for some of the smaller and emerging growth company issuers.

We worry that this additional responsibility at the end of the engagement may strain resources so that attention would be diverted from other value-added audit responsibilities. I believe these factors are the primary ones that worry smaller auditing firms with respect to CAMs. The big unanswered question though in my view though still to come is whether or not investors in smaller companies will find CAMs useful. Once that question on the information available from these surveys and to the Board's satisfaction, then it will perhaps easier for the Board to be confident in its direction regarding CAMs.

I do have a couple of suggestions for the Board's consideration to address some of these above concerns which are included in my written statement which can be looked at at another time.

Lastly, one of the questions in the proposed guidance was whether or not the guidance should be applicable to emerging growth companies. On one hand, as I mentioned previously, I would expect that for the typical emerging growth company that there would be CAMs, maybe many CAMs to be considered for inclusion in the auditor's report. On the other hand, I would expect that the market place's primary interest in these companies at this stage of their development is whether or not the issuers has the potential to be successful in its mission or its product. And if this is so, then the cost-benefit may not be there for CAMs.

Again, thank you for the invitation for me to participate on this panel and I look forward to our discussion.

MR. DOTY: Thank you. Jeanette.

MS. FRANZEL: Thank you for being here today and sharing your perspectives with us regarding smaller companies and smaller audit firms. I'd like to ask each one of the panel members in your experience what do you see in terms of how investors communicate with the company and with the boards in the smaller company environment that maybe we should be considering as we are considering this standard.

And Cartier, if you could also add comments about EGCs as well. So we can just work our way down the panel and anyone who would like to start.

MR. DOTY: They're all looking at you, Andy.

MR. BISHOP: We have three analysts that follow us. Each quarter when we report our numbers, they come up with an update of their reports and they have never asked any questions about the accounting. They ask questions on why maybe costs went up, why margins went down, but no questions on accounting.

Personally, I don't have a problem with this approach. I would like to see it done by the Audit Committee as opposed to the auditors though. If we are doing what is called a non-D&O road show, we go out and talk to investors. Again, no questions. They're more interested is the coal business going to be around for a while? That was their concern.

MR. DOTY: Any other points of view on the panel to address Jeanette?

Cartier?

MS. ESHAM: I am going to provide an answer and again, I hope it's the answer you're looking for in the sense of small companies and investors and I'm talking institutional investors actually have a very prolonged, often, relationship in determining whether or not a small company is going to go public. In regards to -- one of the things I wanted to comment in regards to some of the comments I've been hearing this afternoon in the sense of more information is better, I think that's true. But in the case of certainly the biotech community, we worked for years with the passage of the JOBS Act on that more information sort of mantra and that was really carried out in the provision of testing the waters such as provisions of testing the waters which has allowed and I think been perceived by both investors and the small companies as a huge success with the ability to communicate more information. But again, it's really been, the conversation has really been focused about educating about their ability, of the science, and the ability to carry that science forward.

We have not heard a lot of questions in regards to auditing report content, although we have had a history of working with this Board and providing numerous comments on a variety of the excellent work that you're doing in looking for improvements.

MS. FRANZEL: And do you see differences between the EGCs and the other small companies that you deal with in terms of that communication?

MS. ESHAM: Well, the other small companies we deal with are private companies, so that's in the venture capital world.

MR. DOTY: Jay?

MR. HANSON: I've got another question along the governance theme and I'll pick on Andy first, but I'm interested to hear all of your views on this.

Andy, your suggestion is having the Audit Committee report the critical audit matters and I appreciate many people have that same view that may be an appealing way to go and we're doing much more interaction now in the last year or so with Audit Committee chairs and Audit Committee members and getting good sense of what the larger company Audit Committees are doing.

We have fairly significant, albeit anecdotal feedback, and the smaller the company, the less robust the Audit Committee discharges their responsibilities and part of it is the ability to track Audit Committees that have the skills to do and part of it is maybe just not knowing what to do.

And I'm not going to ask you to comment on your Audit Committee because that will put you in a tough spot, I know you and I have been around a lot and talked to lots of companies and lots of preparers. And just your sense as to with regard to the operationality of your suggestion for the smaller companies having the Audit Committees do it, whether today you think there's the skill set and the capability across the universe of the smaller companies, just from your experience? And appreciate any of the rest of your comments about your observations about the effectiveness and the ability of the audit committees of smaller companies to do more than they're doing now.

MR. BISHOP: The way I see it playing out is that I would sit down with the Audit Committee chairman and together I'd put together the bullet points. I'd say here's what we're going to talk about. And he says I think that's right. And the auditors would have given their report, too. And he would say, Andy, you draft it. That's probably how it would shake out. He would agree with the points.

MR. HANSON: Any comments from the rest of you on this?

MR. SCHACHT: I'm not sure, Jay, I fully understand your question, but big company, small company, medium company, there's plenty and plenty of resources out there in terms of how you properly empanel and engage in the activities of an audit committee. So it's not for lack of resources. Whether small issuers can attract the same level of competence and capability that the larger issuers do on the Audit Committee is clearly, they're clearly at a deficit to do that. So I would say, generally speaking, there is not the same level of experience and expertise on the smaller company boards and on the Audit Committee. I think we're getting there. I think there's certainly a heck of a lot more attention being paid to it than ever before. And I think people are waking up to the fact that if there is one key important check and balance on corporate governance for investors it is the Audit Committee that, in fact, is probably the king of all the corporate governance bells and whistles and protections.

MS. WAGGONER: In addition having the Audit Committee prepare a report of some sort that timely goes out along with the auditor's report has a great appeal to it. As I was listening and hearing about the UK model where the FRC is in that enviable place where they can both set corporate governance regulations and also the auditing standards. You know, that's like a perfect way to bring it all together which is to say you get an auditor's report that's very much complemented or complements the report from the Audit Committee and everything just works much more as everyone is collaborating to get good information out to investors.

MR. FERGUSON: I have a question, initially directed to Andy, but the rest of you pop in if you want to. As I heard you, you said that you thought critical audit matters, if they were disclosed at all, should be done by the Audit Committee rather than the auditors. Those are two different kinds. They're not identical proposals, so the kind of disclosure would not be identical, let's assume you're correct about that. Given the fact that we have no jurisdiction over that and that would have to be done by the Securities and Exchange Commission and I would defer to my colleagues from the SEC here, but my understanding is that the SEC has a really, really full docket now. And I would suspect that this might be pretty low on their list of priorities. If that were the case, is having the auditor do it such a bad idea, in your view, that we should simply drop this project?

MR. BISHOP: No, I don't think you should drop the project. Maybe SEC could rearrange their priorities and move this up to the top.

MR. FERGUSON: Assume they don't rearrange and I'm not speaking for my friends from the Commission here. They do what they want to, but let's just assume for purposes of this argument, they're not going to rearrange their priorities for this.

MR. BISHOP: Then we'll go with what you have, let the auditors do it. But for the Audit Committee to do it, the Audit Committee Report needs to move to the 10-K. It doesn't make any sense to get the 10-K out and then two months later the Audit Committee Report comes out in the proxy statement needs to go out and the 10-K and again, that's probably their jurisdiction. But that's how I look at it.

MR. DOTY: Steve Harris.

MR. HARRIS: Mr. Schacht, you heard what Ms. Waggoner said about the disclosure of original information. And my question is why you think it is important that auditors provide additional information directly to investors?

MR. SCHACHT: I think there's been a -- just to maybe reiterate some of my opening remarks, we've been talking about this now for decades about the quality of the information that's coming from the professional firm that's actually being voted on by investors and being paid for by investors, and the quality of what -- the usefulness of that information. And I'm not an expert on the history of original information coming from the Audit Committee versus the company, but I think the fact of the matter is that everything else is changing in the world of finance and around the process of being a public company.

And I don't think there's any reason why the audit profession and the profession that they are providing, the service that they are providing for investors should somehow be exempt from those changes and from the very dramatic differences at how markets operate and how markets trade and how people invest.

And so it may be long-standing, commercial, historical practice. I get that, but does that mean we never change it? I don't think so.

MR. DOTY: Mr. Baumann, Chief Auditor.

MR. BAUMANN: Thanks, I have a question for Joan and Cartier. Both of your comments, you indicated an expectation of increased costs as a result of this and maybe disproportionate costs on smaller companies. CAMs, as we've talked about them in the proposal, are based upon what the auditor has done. It's fundamental to their work, critical audit matters are documented in their work papers, discussed with the engagement quality reviewer. That's probably the critical audit matters that's contemplated are probably the topics that are most discussed between the auditor and the Audit Committee. So there's nothing new about developing a CAM. It is the fundamental things that are being discussed with the top management of the firm and the audit firm, the engagement team, the engagement quality review, the Audit Committee, et cetera. So we're talking about here about putting in the audit report what's probably already written in the Audit Committee Report, except maybe more succinctly.

In addition to that, we heard today from several people, most notably from the UK experience where they're actually having these enhanced disclosures. And Nick Land from the FRC indicated he didn't see any reason for increased costs as a result of this for similar reasons. So given the fact that all of these matters are just matters that are already addressed with the Audit Committee and it's really adapting something that's already written to the Audit Committee for consumption by the investor and there's some experience overseas that it doesn't have any cost, where do you have the expectation of significant costs?

MS. WAGGONER: Certainly one of the big factors for the smaller companies is the cost associated with transition in the very first year because of what we would expect to be a heavier volume of CAMs that would exist for certain of the smaller companies and the emerging growth companies.

On a recurring basis, one of the things we were trying to think through is what would cause that cost to continue to be higher than we would expect. And I think it's because you know where those systems, the systems of the smaller companies aren't necessarily geared up in the early part of their lives to capture all the information needed for accounting purposes and so forth and so on, that things will just pop up a little bit more. We would expect a little bit more of a volatile environment.

So even though I would expect from year to year there would be recurring CAMs of which perhaps the cost to process the auditor's report would not be excessively high. There is an associated cost with the volatility at the end of an audit which will take up a lot of time from folks disproportionate to the engagement. So I think that would be the continuing factor that we would see.

MR. BAUMANN: Just an observation again, even though there could be more issues in a smaller company, again all of those issues should still have been discussed by the engagement team, evaluated by the engagement team, discussed with the Audit Committee if there are important issues so again, even if there's more, they've already been communicated to the Audit Committee and now it's a matter of communicating them in some lesser format or some -- to the investor.

MS. WAGGONER: Arguably, quite true, but the crafting of new ones for purposes of public dissemination would still be a significant cost because it's not just correcting the spelling and put it out there, you know. It does go through a few levels of review and consideration and so forth and that is going to be taking the time of the most senior people in the firm to get those handled properly.

MS. ESHAM: Just to agree with several of the points that Joan raised and I think as we read the proposal, I think a couple of the concerns that we have are again, they're almost -- there was an implication that essentially every auditor would have a critical audit matter outside of the context of the audit report process which includes the dialogue between management, the Audit Committee and the auditor. So I think there were a lot of mays and coulds of what that might entail that is concerning and so the presumption is that it inevitably will require more work and thus more fees by the emerging companies.

And the price tag of paying for extra auditing fees is not the only cost to an emerging growth company. Again, when you have a company that has 25 employees, and again, their core mission is in our case research and developing medicines, it is perhaps a hiring of extra staff. It is a longer runway of paying for auditing fees that are diverting funds away from again their core mission which is of concern as proposed.

MR. DOTY: I think Kurt wanted to comment on that.

MR. SCHACHT: I think the interesting thing that's going on is that everybody is still very gun shy about SOX 404 and sort of early experience with that and maybe the miscalculation of the cost benefits of that and I don't think anybody wants to make that mistake again. But I would tend to see this similar to as you just laid it out that it's not a lot of additional work. It's not the same dynamic as we were experiencing with a brand new Sarbanes-Oxley and that when you look at the audit completion document or the report of the Audit Committee that most of the work is done, it's just a matter of how you would price the step of actually having to make a professional disclosure about that and I really don't know how that would happen.

MS. WAGGONER: If I can make one more point.

MR. DOTY: Please.

MS. WAGGONER: Thank you. There is in a lot of the smaller company audits, it is a kind of a rush to the finish. The deadline looms and everybody is very focused on getting the audit done and management is working to get the financial statements done. There's still a lot of stuff happening at the last minute because a lot of these audits are not the most efficient audits in the world just because of the way the data is gathered and so forth and so on.

So there's also not just a cost, but the rush to the finish is a real thing that exists for many, many audits of small companies.

MR. BAUMANN: That environment sounds like it's even more important for the investors, therefore to understand, there's critical audit matters in those companies. So that's my view.

MS. WAGGONER: And indeed, you may be quite correct, Marty, on that. I think the proof is actually going to be as we see things roll out and how the information is used, I still haven't heard anything definitive on exactly how the investors in smaller companies actually would utilize the information. And I think that is arguably a very important thing to be resolved before we move forward on this, simply because it is so important to the smaller companies and the emerging companies because of the cost.

MS. ESHAM: I did just want to respond to that to make sure I didn't leave that just hanging out there, but again, I think from our point of view, the value of small companies, again, I can speak most assuredly about the biotech industry again. In our conversations with investors and what we hear from our CEOs is the value of the company rises and falls on the product -- their ability to advance their product, the science that they're working on. That's the value of a small business of an emerging growth company. So I do just want to emphasize that.

Again, going back to the discussions that were held in both the House and Senate during the JOBS Act debate, that is why you see provisions specifically laid out in the law that recognize one, the importance of allowing these emerging growth companies to transition into the public market. That's why there are exemptions to certain things. That's why there is not a one-size-fits-all framework in that. And again, it's pertinent to this argument, the one that specifically talks about the supplemental information in the form of the AD&A proposal and determine that that is not appropriate to apply to emerging growth companies.

MR. DOTY: I want to follow up on this with both of you because I want to talk about, get your reaction to what I'll call the bonding principle. The JOBS Act didn't wall off the PCAOB from the audit report and it certainly didn't suggest it was out of the question to add further information. It did go, as Cartier points out, to the question of an AD&A which we've taken some pains to distinguish from.

But is there any concern on the part of either you, Cartier Esham or Joan Waggoner, about the precedent we have with what I will call blue light districts that have been launched with the best intention of creating more rapid capital formation? And I'm thinking of the London AIM market and sort of the American Stock Exchange's ill-fated excursion into a midcap market. The Nuevo Mercado and certain other areas.

Are you concerned or should we be concerned or should we be concerned that if we have a rule that requires some kind of amplified audit discussion, if we modify the audit reporting model at all for big companies, for other companies, everybody else but EGCs, that if we don't fashion a rule that can be applied by EGCs, we have -- and it's required to be applied by EGCs, that we have created the beginnings of a kind of blue light district for some of the companies that we're most interested in growing.

I do understand that audits are cost. Kurt makes the point that none of the reforms in Europe have really delayed the completion of the audit cycle, but I hear Joan point out that it's harder for smaller companies. It's a messier situation, but the fact that the smaller companies will perhaps have less in the way of critical mass on controls, more of the critical audit matters, including perhaps more related party transactions and other issues that auditors have to look hard at and that, in fact, they are less likely to be free of any concern for the auditor. Isn't that a reason why we should be concerned that whatever we say about the actual disclosures that it should apply to everybody? That we don't want to have a situation in which we're creating a class of second class companies that can go on the exchange and are we really doing no favor to emerging growth companies if we create the lowest expectations for their auditors in terms of what we want them to tell the public?

Discuss among yourselves, please.

(Laughter.)

MS. WAGGONER: Well, you know, I am in actual total agreement with Kurt, that if you enter the public markets, you accept the level of responsibility and accountability. But when we are considering changes to the auditor's process and the auditor's report, I think we need to distinguish between two things. Is the change being designed to protect the markets, to protect the marketplace? Or is it to enhance the information available to the marketplace?

I would suggest that if the goal is to protect the marketplace, certainly I think rules should get applied across the board or with a much higher level of cost-benefit analysis or a lower threshold, if you will.

If the goal is to enhance the information available in the marketplace, that might be a lesser standard. And so the cost-benefit analysis would go -- the threshold would be higher. And it is then for us to contemplate are the proposed changes to the auditor's report to protect the marketplace or to enhance the information available to the marketplace?

MR. DOTY: A choice the logicians always struggle against that opting from one or the other.

Cartier, how about it? Isn't the biotech industry one that needs to be worried about having the emergence of a blue light?

MS. ESHAM: One, I do not think that we are a lower class small business on the market today.

I did have a question and I apologize for my own ignorance, but in the London example that has been brought up today, are there exceptions to emerging growth, small companies within that system that's being applied?

MR. BAUMANN: Right now, that applies to the largest companies, the FTSE 350. So it's not just emerging growth companies. They applied it initially to the FTSE 350.

MS. ESHAM: Just to clarify, we don't have --

there's not an example then in London of how this would or would not affect emerging growth companies as of yet. I just wanted to clarify that.

So again, I think Joan raises a great way to put it is protect and inform and on the informed side, again, I think the question and again, very specifically focused, my comments are very specifically focused on the proposed CAM and in that sense I don't think that we agree that the added regulatory burden would equate to again as prescribed by the JOBS Act necessary and appropriate to protect or benefit the public.

Secondly, I do also want to make clear that in the greater context of are there ways to improve the auditing process or the auditing report as to how that may inform. We've certainly been engaged with your work since 2010, 2011 and I think, in fact, have been supportive of certain proposals such as one made in our comments in 2011 around clarifying language within the auditor's report. So I want to distinguish between a very specific issue that my comments were directed at today, the proposed CAM. But again, we are willing and have been working with this Committee on looking for improvements, to ensure that that doesn't happen, any blue light districts sort of situations, it's not --

MR. DOTY: I was impressed with Joan's paper because I think you, in fact, have five very pragmatic suggestions for CAMs and for the reporting level change which are quite specific. You do not seem to be concerned that any expansion of the information in the audit reporting model conjures up concerns about excessive liability.

You don't believe that any attempt to reform the audit reporting model necessarily involves devaluing the binary report. I may be misreading you, but your concerned about that, but you have you have suggestions to avoid it.

I come away with the sense that you think that on the whole, while there's some work to do on this proposal that it's time to expand the reporting model and that your firm can do it.

And you can do it on a cost-efficient basis for mid cap and small cap issuers. Am I wrong?

MS. WAGGONER: Chairman Doty, I must say that nobody reads between the lines better than you. Well, yes, I would say we think that the CAMs model is a reasonable one to apply and that it's workable as a thought process. We would not be worried about our ability to write the CAM. We certainly have plenty of talent in-house to do that.

The cost I don't know, but we did not actually develop any sort of estimates about what the add-on costs would be associated with it, so I cannot speak to that. We've already spoken about it a little bit.

On the litigation front, we're not in the same world as the large firms and I knock on wood when I say that. So I can't really speak to the litigation side of things because it's not the world we live in at this point.

MR. DOTY: You may feel it's ungentlemanly of me to try to create these differences between you and Cartier, but that's the kind of ruthless, mean regulator that I am. At this point, I'm going to pass the -- pass it on to Jeanette, to my colleagues?

MS. FRANZEL: We heard earlier today concerns from a number of panelists about the lack of sort of a materiality threshold or filter in the current CAM proposal. And I'm wondering if we were to address that issue, would that alleviate to any degree some of the concerns that you have with the current CAM proposal?

Joan, and whomever else would like to address that question?

MS. WAGGONER: I think it would be helpful to add a materiality factor to it just to make it absolutely clear. I rather think it was kind of implicit in the way it was written and I wasn't concerned that it wasn't there. But as I've listened to the comments, it strikes me why not be perfectly clear.

MS. FRANZEL: Would that help with some of the messiness and the small companies that you -- when I was listening to you talk about sometimes it's just difficult to pull data together, I guess I was interpreting that as sort of maybe deficiencies in internal controls, but not ones that would rise to material weaknesses, but that was one of the examples we heard earlier that gee, if that's a CAM, all of a sudden that may not be material and that may be original information being disclosed by the auditor.

MS. WAGGONER: One of the things as I was thinking through the CAMs definition was was it workable? And at first I began to believe that if we were just auditing something very inefficiently, that that might be something that qualified as a CAM. But then I realized as I continued to look at it and think about it, that I believe it wouldn't necessarily be that it was an inefficient audit area as long as the test was based upon good quality evidential matter that was clear.

And so for instance, I was thinking of the area of customer contracts and revenue recognition. And maybe the system of the issuer doesn't capture all the information that it should in order for us to be able to figure out, should it be 2014 revenue? Should it be 2013 revenue or whatever. And so perhaps the testing that we do is extended. But if the customer contract is very clear as to what the terms of sale are, then we have good and sufficient evidence supporting the revenue cutoff procedures as we call them.

And so I don't think that would end up being a CAM because it just doesn't seem to hit on the definition. If, however, the customer contract isn't clear, if the customer contract was pulled off the internet and used by the company because it didn't want to pay some legal fees right off the bat, which I don't recommend by the way, you have a lack of clarity and then you just might be in CAM country. Did that address?

MR. HARRIS: I am just wondering Joan, how do you avoid boilerplate? We've discussed that all day, but in terms of the CAM, how you constrain it to what's most important to the user?

MS. WAGGONER: The big risk, I think, in writing CAMs is the ones that recur year after year, pretty much the same thing. And in a way, if you have a heightened level of detail, the detail might change from year to year and that might keep them kind of fresh. But I worry about the recurring items, but for any particular year, those recurring items may still be very relevant and helpful to investors. So I'm hoping that the world continues to evolve and that we understand the increased importance of a fresh look at things every year. And I think we can do it. I think we can do it.

MR. HARRIS: And how about the others of you. Do you have any ideas in terms of how we streamline this to avoid boilerplate and what's most important to the investor or to the user?

MR. BISHOP:  Sitting here thinking about what's been discussed, just going through my mind, Hallador has always been a trendsetter in disclosures.  I thought well, maybe I'll just file the Audit Committee Report as an exhibit to my 10-K and see what comes out of that. I have to get the okay from my auditor.  They may not like that idea, but that would give you what you want.

MR. HARRIS:  Do you have a problem with that?

MR. BISHOP:  I'm just thinking, I wouldn't have a problem, the rest of the Board, auditors might have a problem with that, but that gets the answers what you guys are looking for.

MR. HARRIS:  Would anyone else have a problem with that?

MR. FERGUSON: One of the things several of you have mentioned is the fact that for smaller auditors and smaller audit firms having to identify CAMs and write them up would be a squeeze at the time you have to issue your report.  I'm not an auditor, so but it would have occurred to me that given that there are critical audit matters that they should have been identified in the first risk assessment meeting for the auditor. And that they then should, in fact, inform the audit work that you do because they are, after all, critical to the audit. And if that's the case, why can't these things be written up during and early on in the process so the most that has to happen in the end is simply a review of what's already been written. Because it strikes me if you find a critical audit matter right before you're about to issue the opinion, something has gone wildly wrong with the audit. Am I wrong?

MS. WAGGONER: One of my recommendations was in my letter is that the planning and Audit Committee standards of the PCAOB be amended to include the preliminary spade work on CAMs in the planning process, and in the early communications with the Audit Committee because I think we can really help the workload issue at the end if we know and can expect which are the -- well, we try to identify risk of material misstatement early on and so that kind of goes hand in glove with determining the critical audit matters.

And I believe that on a recurring basis they can be identified early on. I'm just saying we have a more volatile situation sometimes with certain of the small and emerging companies such that issues, new issues will pop toward the end of the audit. Those are the ones I was referring to on a recurring basis.

MR. BAUMANN: A follow up if I can. Andy, a comment, discussion on cost was primarily focused on Cartier and Joan, but you indicated earlier that you didn't have a disagreement with CAMs, that primarily you'd like to see them in the Audit Committee Report. Secondarily, if that didn't happen then continue our project for the audit report. But did you agree with my assessment of they shouldn't necessarily cost a lot given the fact --

MR. BISHOP: I agree with that. Where the costs will come in is the wordsmithing of how this is going to deal with the words. I think we all know what the issues are. How is -- do you put a comma here, do you capitalize that? That's what's going to --

MR. BAUMANN: So in other words, the bulk of the work has already been done on the CAMs.

MR. BISHOP: Yes.

MR. BAUMANN: I had one other follow up with you,

you did talk about the disclosure of the engagement partner's name in your information statement filed with the SEC. Any reaction from the engagement partner about disclosing the name and/or any costs involved with that?

MR. BISHOP: No. At first, I think they thought why are you doing that? Well, I think it's the right thing to do. And at the end of the day they agreed.

MR. HARRIS: Just out of curiosity so many people don't think it's the right thing to do. Why do you think it's the right thing to do? I mean the entire profession disagrees with that.

(Laughter.)

MR. BISHOP: I look at it, I have to disclose my name, my age, my bio, my compensation, what I've been doing the last ten years. And I'm paying these guys a lot of money, so what's wrong with disclosing their name? I don't see anything wrong with it at all. It's done in other countries, too.

MR. HARRIS: Does anyone on the panel have a problem with that?

(Laughter.)

With the auditor disclosing their name on the audit report? I take that everybody's saying they don't have a problem. Okay.

MR. DOTY: Your good humor and your -- throughout all of this, your good humor and your willingness to indulge us is, of course, appreciated and it relieves a long afternoon. But mainly we appreciate the kind of insight you brought from small companies, the care that's gone into the preparation of your written work which is really very good and which will be an important part of this record.

And your interest in this whole project.

Oh, Brian, my regulator.

MR. CROTEAU: Sorry, thanks. Before you wrap up, I just wanted to add not that I think -- hopefully people would not be confused by this, but Lew's comments about the SEC's workload and any considerations relative to the Audit Committee Report. Certainly, since there is now an open public comment period, if people do believe that we ought to be doing something with the Audit Committee Report, they should still continue to make those recommendations. We certainly do consider all the feedback and we will continue to think about those type things. Lew's hypothetical applied to the panel discussion here, just in the event people are listening and might be writing comments, I just wanted to make that clear.

MR. DOTY: Fair enough. You have given us insight into an important part of this whole picture that we cannot go forward without. And to get where we need to go, and to do something meaningful with the audit report, we need to take account of the things you've raised and the kind of intelligence and wisdom you've brought to us. Thank you. We adjourn. We will convene again in the morning. See you all then.

(Whereupon, at 5:13 p.m., the meeting was adjourned, to reconvene the following day, Thursday, April 3, 2014.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor's Reporting Model

Before: Public Company Accounting Oversight Board

Date: 04-02-14

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

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Court Reporter

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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AUDITOR'S REPORTING MODEL

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PUBLIC MEETING

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THURSDAY, APRIL 3, 2014

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The public meeting convened in the National Ballroom in the Westin Hotel, 1400 M Street, N.W., Washington, D.C. at 9:00 a.m., James R. Doty, PCAOB Chairman, presiding.

PCAOB BOARD

JAMES R. DOTY, Chairman
LEWIS H. FERGUSON, Board Member
JEANETTE M. FRANZEL, Board Member
JAY D. HANSON, Board Member
STEVEN B. HARRIS, Board Member

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JOAN L. AMBLE, President, JCA Consulting; Member, Council of Audit Committee Chairs, NACD; Retired EVP and Principal Accounting Officer, American Express Company; public company board member
JEFFREY L. BURGESS, National Managing Partner of Professional Standards, Grant Thornton LLP
TONY CATES, UK Head of Audit, KPMG LLP (UK)
PETER CLAPMAN, Former Chief Investment Counsel, TIAA-CREF; public company board member

JOHN CORCORAN, Fund President, Senior Vice President, MFS Investment Management
E. MICHAEL FEHRMAN, Managing Director, Head of Accounting Policy and Advisory Group Americas, Deutsche Bank AG
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LIZ MURRALL, Director of Corporate Governance and Reporting, UK Investment Management Association
PETER H. NACHTWEY, Senior Executive Vice President, Chief Financial Officer, Legg Mason, Inc.
CHARLES J. PAGANO, Partner, WeiserMazars LLP
JEREMY PERLER, Director of Research, Schilit Forensics
WILLIAM TOUCHE, Partner, Deloitte LLP (UK)
MICHAEL R. YOUNG, Partner, Willkie Farr & Gallagher LLP; Chairman, Financial Reporting Committee, New York City Bar Association

OBSERVERS

BRIAN CROTEAU, Securities and Exchange Commission
JAMES KROEKER, Financial Accounting Standards Board

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MARTIN F. BAUMANN, Chief Auditor and Director of Professional Standards
JENNIFER RAND
JESSICA WATTS
JENNIFER WILLIAMS

C O N T E N T S

P-R-O-C-E-E-D-I-N-G-S

9:00 a.m.

MR. DOTY: Well, good morning. Good morning. We have a panel that is focused on the issues raised by the proposal of auditors responsibility for other information. And it's a highly qualified panel.

But before I introduce people, a bit of news from the front. We're advised by Natalie Berger of the EU that the European reform proposals, which were summarized so ably in Sven Gentner's materials yesterday in which he discussed in detail, were passed by the European Parliament this morning.

So they're now law in the EU with the overarching subject to the country and member state is for you to have a more restrictive, or a stronger policy.

The panel, as I said, has extraordinary qualifications. Jeremy Perler is the Director of Research at Schilit Forensics. And he's the co-author of Financial Shenanigans: How to Detect Accounting Gimmicks and Fraud in Financial Reports. It's gone through three editions in 2010.

Previously he served as the in-house forensic accounting analyst for Coatue Management, a long/short equity hedge fund. Director of Research for CFRA. Auditor of PricewaterhouseCoopers. He served on the FASB Financial Accounting Standards Advisory Council as a representative of the investor community.

Michael Young. Litigation partner at Willkie Farr & Gallagher. His practice concentrates on securities and financial reporting with a particular emphasis in accounting issues.

He's also chairman of the Financial Reporting Committee of the New York City Bar Association. He is chair of the firm's securities litigation and enforcement practice.

His trial work has included financial reporting matters in federal, state and bankruptcy courts throughout the United States. His experience includes the landmark jury verdict for the Defense in the first securities class action tried before a jury pursuant to the Private Securities Litigation Reform Act of 1996/1995.

He previously served as a member of the Financial Accounting Standards Advisory Counsel. He is the Chair of the Financial Reporting Committee of the New York City Bar. And he is counsel to the AICPA and the Center for Audit Quality.

Michael has a record -- a distinguished record in this area that is second to none. And he's going to have a lot to say.

Peter Nachtwey is Chief Financial Officer at Legg Mason. A member of the firm's Executive Committee. He's responsible for the areas of finance, investor relations, corporate communications, human resources, operations and technology.

Previously he was Managing Director and Chief Financial Officer of the Carlyle Group. Prior to joining Carlyle, he was a partner at Deloitte & Touche. Served as the Northeast Regional Managing Partner for the Investment Management Industry. He is a current member of our, the PCAOB's Investor Advisory Group.

Mike Gallagher. Manager Partner for Assurance Quality at PWC. He supervises national office efforts in the areas of accounting services, US Securities and Exchange Commission services, risk management, strategic fault leadership, auditing services, auditing methodology.

He's also responsible for PWC's audit transformation program, learning and development, regulatory relations and inspections groups. He currently serves as the Chair for the Center of Audit Qualities Professional Practice Executive Committee. He is a current member of the PCAOB standing advisory group.

Gentlemen, welcome. Jeremy, the floor is yours. Thank you.

MR. PERLER: Good morning. And thank you for having me on this distinguished panel. I am delighted to be here today.

It's a great honor to speak with you and share my perspectives on a topic as important as other information and the auditors role in financial reporting. Thank Chairman Doty for that nice introduction.

If I may, I'd like to add a little bit more context on my background as I believe it to be helpful in understanding how my perspectives as a financial statement user have been framed. I spent the last 17 years studying and analyzing companies who employ aggressive accounting and manipulative reporting tactics to embellish their financial performance.

My current role as an advisor to asset managers, is at a forensic accounting consultancy called Schilit Forensics. We advise well regarded investment firms that engage us to unravel complexities and uncover misrepresentations in the accounting and financial reporting of their portfolio companies.

Now over the years I've had the pleasure of working with and advising hundreds of asset managers on the accounting and reporting practices of their portfolio companies. So my perspectives today are based not just on being a power financial statement user myself, but on my daily conversations with these investors.

From these interactions, I gained a strong understanding of relevancy and how financial information is consumed and used in the investment decision making process. Now the topic of other information is an extremely important one. And I commend the Board of its efforts to increase auditor's scrutiny to areas beyond the financial statements.

It speaks to what is to me the biggest problem facing financial reporting today. The growing dissidence between audited financial results and the key performance metric showcased by management.

This is a weak spot in our financial reporting system that allows issuers to bypass the traditional audited financial statements and engage in an un-scrutinized parallel conversation with investors. By not participating in this conversation, the audit function is weakened and the investors are worse off.

Indeed the traditional audited financial statements are becoming less relevant as an investor communication tool. It has been commonplace for management to present self-made, non-GAAP metrics as more relevant proxies for earnings and cash flow performance.

These metrics are delivered to investors in earnings releases, PowerPoint presentations, as well as the MD&A and other places outside the financial statements. And it is usually the case that these metrics are the most important data points and disclosures to the investment community.

Often these metrics make sense and provide very helpful insight into a company's operations. For example same store sales for a retailer, organic growth for an acquirer or earnings excluding a large litigation settlement.

However in many cases they don't, like something called steady state free cash flow before special items. And the laughable adjusted cash EBITDA less one-time items.

However in all cases, regardless of their legitimacy, these metrics are unaudited and susceptible to the whims of management discretion and definition and disclosure. For example, when EBITDAs no longer flattering, it becomes adjusted EBITDA. And then adjusted cash EBITDA. And then finally adjusted cash EBITDA less one-time items.

And even in cases where the metrics seem commonplace and logical, they are easy to redefine as needed. For example determining which stores are included in same store sales is rife with discretion.

Relying on management to self-police these important metrics is insufficient just as it is insufficient for traditional GAAP measures. To be clear, the issue here is not whether a company is honest or disingenuous about these disclosures, rather it is that the supremely important disclosures and data points are not being scrutinized by auditors. A point which is generally lost on investors.

This is where I believe the Board's proposals on other information and helpful. The current financial reporting paradigm promotes this environment in which many of the most important metrics to investors are widely unchecked.

Enhancing auditor responsibility over this information by as the Board proposes, requiring evaluation of these disclosures with a focus on material inconsistencies and material in the statements is common sense and will no doubt strengthen and add robustness to our financial reporting system. And ultimately lead to fewer cases of willful or negligent misrepresentation.

I recognize that evaluated scrutiny likely means added procedures. However the benefits to investor protection and public disclosure far outweigh the costs.

The flow of information from companies to investors has changed. And so too should the auditor's responsibilities. Naturally I would like to see more steps taken to reign in the mass promotion and dissemination of un-scrutinized information. But I recognize that many of these efforts would be beyond this Board's jurisdiction.

However I believe this Board's proposal regarding other information shows leadership. And is a very positive step that will have a powerful impact with regard to protecting investors and promoting more reliable and representative financial disclosures.

Thank you for the opportunity to participate in this conversation. And I look forward to our discussion.

MR. DOTY: Thank you. Mr. Young.

MR. YOUNG: Well, I am exceedingly sympathetic to the desire of investors for better information. Like a lot of people in this room, I am reading 10Ks all the time and they have gotten to be as dry as dust.

And what is particularly frustrating as I think about it, is that it does not have to be like that. It is theoretically possible to write about things. To write about business things, even with all of the rules and the regulations and all of that, it is theoretically possible to write about things in a way that is understandable and informative and interesting.

And at the risk of sounding trite and saying the obvious, I would offer that perhaps the best illustration of that is the Annual Shareholder Letter of Warren Buffett. It is interesting, it is understandable. You get the sense of what's going on within his companies. The challenges, the triumphs, the failures.

And the question for me is how can we get people to write like Warren Buffett? Boiling it down.

My concern with the other information proposed standard is that it doesn't get us there. And in fact my concern is that it may take us in the opposite direction.

Now let me explain why. The Board has asked me to focus on how the standard will be interpreted and applied. And that is actually the root of my concern.

Under this standard, I would expect auditors to find themselves being held fully accountable for other information. They will be evaluating the information. They will be speaking to its truthfulness and if the information turns out to be false, they will have some explaining to do.

And even if they are able to point to the standard and to say, well we missed the false statement, but look at the standard, we complied with the standard. That to my way of thinking, does not satisfactorily mitigate the concern. Because historically where auditors have missed a false statement, insistence on in compliance with the applicable standard, has not sufficiently mitigated the appearance of professional failure.

So as I think through how this standard will work, my own reaction is that probably two things will happen. One is that the amount of work needed to be undertaken by the auditor will need to increase commensurate with the risk. Or the information will need to get easier to evaluate. Or both. And I would expect both.

So one consequence of the standard, as well intentioned as it is, is that it may create an incentive for management to draft other information in a way that is easier for the auditor to evaluate. That runs less of a risk of auditor recalcitrance.

And the concern is that we will end up building into financial reporting, still another incentive to favor objectively verifiable information of the sort that auditors are more comfortable with at the expense of the kind of subjective commentary that connects the dots and explains what the data means in very day words of the sort which may be harder for the auditor to evaluate.

And you know, to my way of thinking, that's the opposite of the direction in which we want to go. I mean when I think of it as an investor, I think about wanting management to connect the dots.

Don't just give me the data, but tell me what the data means. Tell me how you are looking at this data and what it's telling you management, as to what it means for your past performance, what it means for your future performance. What the data means for risk.

And I'm concerned that instead, under this standard, we would be headed more in the direction of disconnected, objectively verifiable data. And therefore the 10Ks, if this is possible, would even get less interesting.

And I would like the record to reflect that for the first time in the history of recorded civilization, an attorney has taken less than his allotted time.

MR. DOTY: We'll make up for it Mr. Young. We'll make up for it.

MR. GALLAGHER: Mr. Chairman I'd like to reserve that for my remarks.

MR. DOTY: But did you record the time? Mr. Nachtwey.

MR. NACHTWEY: Thank you Chairman Doty. And hopefully I won't you know, screw up the timing by using all the time he saved us. But first of all good morning to all of you. And thank you and the other members of the PCAOB for the opportunity to be here and speak with you today.

I think the proposed standard regarding auditors reporting on their involvement in other information is of great interest to me and to my organization. But this morning I'll speak from three very different perspectives.

So first as a former audit partner with Deloitte & Touche where I practiced for 25 years. Second as CFO of Legg Mason, an S&P 500 company and an issuer of public company financial statements. And then finally as a fiduciary for almost $700 billion of third-party assets under management by Legg Mason.

My remarks represent my own views and do not necessarily reflect those of Legg Mason or my colleagues. So with that bit of housekeeping out of the way, let me address the proposed reporting standard which I generally favor, but with some key caveats that I'll address in a moment.

I think it's important to recognize that with this proposal, we're talking about information auditors are already required to read and consider in auditing public company financials. So I believe it is a positive step to have auditors clarify what they are currently involved with, as users of financial information very often rely on numbers outside of the financial statements.

At a very high level, this proposal provides the audit profession with the opportunity to help investors and others understand what information outside of the financial statements the auditor has been involved with. And that is clearly a worthy objective.

But we should be careful to comprehend the real world implications of such changes and weigh the potential costs against benefits. In that regard we must be very clear-eyed in understanding the value of these benefits to investors, which easily could be overstated. And we need to be thoughtful about added costs, which are ultimately borne by investors and can easily be understated.

In my view, the public generally believes that auditors already verify information outside the audited financials. As a consequence, many investors have an imperfect understanding of what auditors actually do with that information.

They may believe auditors are involved with any and all numbers in a company's annual report or 10K, including numbers not derived from the books and records. And of course as all the auditors in this room will know, that is not true. But without a bit of a roadmap, how can investors be sure where the auditors have been involved?

So I'll give you an example of this from the asset management industry. For firms like Legg Mason, a key performance indicator is assets under management or AUM. AUM is generally a big number both quantitatively and qualitatively. And we often use it as shorthand to describe the size and scale of our firms as you may note that I just did in my intro about Legg Mason.

Consequently, AUM gets significant MD&A attention by asset managers. Yet the related numbers are not per se audited. However, our auditors do see our AUM numbers and perform significant work around them given their direct impact on our revenues. And I think investors would likely find value in knowing auditors have done work on these disclosures which would provide an important check on management.

The proposal also may provide the audit community at large with better leverage. Currently there is no recourse for audit firms if they disagree with management assertions outside the financials, other than the nuclear option of pulling their audit opinion and resigning from the client.

So I believe the proposal properly structured, could promote a more useful dialog between auditors and management. There could be other benefits as well.

In stock and debt offerings, underwrites require the company's auditors to review and report on information outside the financial statements, and provide them with comfort letters. If the other information is already reviewed and reported on, this could expedite and possibly lower the expense of public offerings.

While I like those aspects of the current proposal, it's critically important to determine now, in advance, whether the potential benefits truly justify making a change. Because history has shown that regulations are seldom, if ever, rolled back, owing to silly things like greater than anticipated costs.

I also believe other aspects of the proposal require further review and consideration. First and foremost, we must develop a common understanding of what the word evaluate means. Or eliminate it from the proposal. And this I refer to both in terms of how much work the audit firm should do and how much information they should provide in their reports.

If left in I feel evaluate will cause significant additional work by auditors. The resulting expense to issuers and investors would not add commensurate value in my view.

The PCAOB should make clear whether the proposal calls for auditors to do more work, or simply report on the work they have already done. And I strongly advocate the later.

Further it is unclear what other information is in scope. For example, annual reports often include a company's headcount. A disclosure of the auditor is generally not involved in.

Clarity around how auditors evaluate qualitative statements or assess materiality of non-financial data, is also very important. Examples of these include descriptors firms frequently use to reference their industry standings such as, we are one of the largest, or we are one of the fastest growing.

How can auditors validate those types of statements. Frankly, in my view, they can not and should not. To the extent that information outside the audited financials is deemed part of the auditor's scope, it becomes very important to clearly identify information not within an auditor's expertise, and thus not within their scope.

And then practically speaking, boilerplate language that would obviate the clarity of the PCAOB and the clarity that the PCAOB investors seek in this area. And I think it's important to recognize that we live in one of the most litigious societies on the plant. And like it or not, boilerplate will be part of the bargain in this proposal. We should acknowledge that up front and be careful to encourage as little of it as possible.

Finally, there's the cost of the reporting extension itself. Auditors will be doing more, even if it's just adding language and documentation based on existing requirements. Auditors will want to pass these costs onto their clients.

Clients will also have to deal with a higher level of questions and documentation auditors will needs for their files, which will require them to add headcount. Both of these are costs that our investors would ultimately bear.

The proposal however, need not become onerously expensive or another giant process creator. Thus I do not see any concerns -- any of my concerns here as fatal to its adoption. But I do believe the Board needs to exercise proper due diligence as it has with other initiatives to avoid the potential pitfalls I and others have noted.

I think this session is a great example of giving the regulatory community, the audit firms and their corporate clients, like Legg Mason, time and opportunity to work through these important issues together.

So I applaud the Board and the staff for making this event happen. And I think you for your kind attention.

MR. DOTY: Thank you. Mr. Gallagher.

MR. GALLAGHER: Thank you Chairman Doty and members of the Board and staff. I appreciate the opportunity to provide feedback today on the Board's proposed auditing standards related to the auditors reporting model and other information.

First let me recognize that these proposals represent the culmination of several years' work by the PCAOB what has taken place in a context of global reexamination of the auditor's reporting model with the objective of making the auditor's report more informative. I commend the PCAOB for this effort and applaud the continued outreach including this public meeting to seek feedback from all stakeholders.

As the Board has noted, the auditor's pass/fail model is still highly valued. Therefore it's extremely important for the Board to consider the feedback from all stakeholders to look for ways the audit report and the role of the auditor can continue to evolve to better meet the needs of stakeholders today and minimize unintended consequences.

Speaking on behalf of PWC, we support the changes to the auditor's report. Including reporting with respect to other information that will be responsive to the feedback, while maintaining or improving audit quality.

Avoiding the auditor becoming the original source of information about the company, I'll talk more about that in a second, insuring the benefits exceed the cost, and I believe these proposals represent a really strong step in how we can enhance the current auditor's reporting model.

In addition, we're challenging ourselves to continuously explore ways to enhance the role of the auditor, beyond what the profession does today in order to address the evolving needs and complexity of global capital markets. While we believe there is much in the Board's proposals that has merit, we also have concerns that some of the fundamental changes included in the proposals pose challenges.

Today I'll describe certain of these challenges and then offer suggestions that we believe will still achieve the intended outcomes of the proposals while mitigating unintended consequences. I'll briefly touch on critical audit matters and then focus my comments on other information.

With respect to critical audit matters, we understand that and support, including critical audit matters in the audit report, as a way of making it more valuable to investors. However we believe it should be limited to, or focuses on, matters that were material to the financial statements that resulted in the most significant interaction with the audit committee.

We believe these changes and others that we suggest in our common letter would add meaningful information to the audit report while not placing the auditor in the position of being the original source of information about the company. It will also minimize the potential that including critical audit matters in the audit report will chill the dialog between auditors and management, something which could have an adverse effect on quality.

Now in listening to the discussion yesterday, which I thought was outstanding, a couple of comments that I at least with respect to PWCs position on CAM, I think is worth some clarification.

There was the notion that if the auditor is not the original source of information about the company, then isn't the auditor just repeating what's in the financial statements. And at least our view of things is no.

That an example of what we would be concerned about is potentially a litigation matter that the auditor discusses with the audit committee. The culmination of that discussion was that no disclosure was required because it was remote.

Well theoretically under the proposal, there may be some pressure to record that or report it as a critical matter, thereby you know, driving disclosure that management is not required to make, through the audit report. And we would be against that.

However, that does not mean that the auditor can't and shouldn't say more about the matters that they are reporting on as CAM. And specifically, the issues that in the auditor's judgment, drove the CAM disclosure.

You know, whether it's the materiality of the matter, the judgment involved in coming up with the matter, the susceptibility to change. And talking about the audit response to why something was a CAM.

And you won't find that information in the financial statements. But that's information about the audit, and I think that that can be valuable to investors.

The other point I want to raise from the discussion yesterday was this notion of 91 percent. And that 91 percent of investors don't read the auditor's report as it exists today.

My own view is that's a very misleading statistic. We do substantial outreach to the investor community at PWC through our investor institute run by Kayla Gillan.

And the feedback we get from investors is, they may not read the reports word for word, it's a standard report, I wouldn't expect most to do that every time. But they look at every report. They look at every single one for who the auditor is, and was there something in the report that went beyond the standard.

So I go back to what Chairman Doty said when he opened up the meeting yesterday. The pass/fail report has value. I would say it has quite a bit of value. What we're talking about today is how do we enhance that value and make a good produce better?

So back to other information. We support the Board's intent to enhance the existing standard by requiring communication about the nature of the auditor's responsibility for other information to report. However, we believe the proposed standard as drafted, could potentially increase rather than decrease the expectation gap and risk increased execution -- or inconsistent execution by the use of language that's ambiguous and susceptible to varying interpretation.

In addition, we believe the proposed other information standard will result in a significant increase in audit effort. Particularly with respect to information not directly related to the audited financial statements, with a corresponding significant increase in costs that in our view could exceed the value or the benefit.

To be clear, we are not opposed to enhancing the performance standard beyond what it is today if there's a market demand for such an enhancement. However enhancing the performance standard will by definition require additional work, which will increase costs.

It's our understanding that the intent of the Board with this standard was to have the auditor report on the information generally based on the level of work performed under existing practice. If that's the objective, we believe certain changes should be made to the proposed standard which I'll describe.

As an example of language that's ambiguous and susceptible to vary interpretations, is the use of the term evaluate as the performance standard. We believe this term is more commonly associated with the auditor's responsibility in an audit to determine whether the evidence obtained is sufficient and appropriate to support the opinion to be expressed in the auditor's report.

We recommend replacing the proposed performance standard of read and evaluate with one that is more likely to result in consistent execution and more efficient in terms of the value provided for the effort involved. Specifically, we believe that proposed other information standard should include an overall requirement that the auditor read all other information regardless of whether that other information is directly related to the audited financial statements.

The auditor would then perform a prescriptive set of procedures similar to comfort letter procedures with respect to material other information directly related to the financial statements.

Finally, we recommend the language in the auditor report explicitly describe the limited procedures the auditor performed as opposed to a conclusion. Thereby decreasing the expectation gap and eliminating the practical challenges associated with a conclusion.

If the stakeholders would find value and demand exists for the auditor performed procedures on non-financial information, then perhaps a separate attestation engagement with separate reporting on other information could be considered. Good discussion yesterday about potentially an attestation standard with respect to MD&A or elements of MD&A. We would support that.

So in closing, I'd like to again thank you for the opportunity to provide the feedback on the proposals. The recommendations I've outlined today, and the others provided in our comment letter are intended for the proposals to meet their intended objectives while minimizing unintended consequences.

These proposals represent a strong step in how we can enhance the current auditor's reporting model. And I look forward to continuing the dialog as we evaluate how we can further enhance the role of the auditor in the capital markets beyond what we do today.

Thank you Mr. Chairman.

MR. DOTY: The panel has given us a lot to chew on. Mr. Harris.

MR. HARRIS: Well I think I agree with both Pete and Mike with respect to the term evaluation. And the need to develop a more common understanding of what the word evaluate means.

I'm not quite clear Mike in terms of what you're recommending other than described the procedures that were follows. So -- and Mike you're a lawyer, so between the three of you --

MR. YOUNG: I didn't come here to be insulted.

MR. HARRIS: It wasn't meant as an insult. Especially given your commentary, which is much appreciated.

But how would each of you -- what term would you use other than evaluate and other than describing the procedures that would presumably go to the word evaluate? Is there a term of art that you would prefer?

MR. GALLAGHER: Steve I guess my -- as I mentioned in my comments, I think the most plain way to communicate is just to share you know, in plain English, what we did.

And you know just to give you a flavor of what that would be, typically, as you're probably aware, in comfort letter situations, when companies are raising capital and the underwriters are doing due diligence, typically what the auditor does with information, an MD&A for example, where there's comparisons around revenue or other financial metrics, is the auditor would recalculate the numbers that are shown in MD&A.

They would compare it to information that's included in the audited financial statements to the extent that exists. To the extent that doesn't exist, you could tie things back to original books and records which are subject to a company's system of internal accounting control.

And so our view is the best way not to have an expectation gap, because I'm not sure there is a perfect term that would capture in a word or two, what we do is just -- let's lay it out. Let's explain you know, that if information is directly related to the financial statement and it's in there and it's potentially material, we do these you know, prescriptive -- this is what we do.

And with respect to the other information, you know, we do what we do today. We read it for consistency and look for material inconsistencies in the financial statements.

MR. HARRIS: And Mr. Young I think that you quoted Chair White in terms of the concern about information overload. And you talked very eloquently about being concise and understandable. So I think that I don't disagree with where Mike is coming from in terms of describing evaluation.

But you know, you could get into some pretty significant information overload just in the description. So how would you concisely deal with the term evaluate?

MR. YOUNG: I wish I had a good answer to that. And appearances notwithstanding, I really would like to be helpful. Let me tell you the challenge as I see it.

And that is I agree with the problem with the word evaluate. The challenge is not so much the verb, the challenge is the broader concept of the auditor speaking to the truthfulness of the information because users of the information are going to be inclined to boil it down very quickly.

And if they see the auditor speaking to the subject of the truthfulness of the information, they're not going to think about whether the word is evaluate or examine or inquire into or review. They are going to say to themselves, the auditor spoke to the truthfulness of the information. The information as we now know turned out to be false. And therefore, it sounds like the auditor didn't do its job.

And to illustrate, let me just -- let me describe a newspaper story that we have all seen many, many times. And that is the newspaper story says there was a fraud at XYZ Company. The auditor failed to detect the fraud. Where was the auditor?

How many times have we seen the newspaper story go on to say, however, under the applicable auditing standards, this fraud was conducted in such a way that the auditor would not be expected to detect it. I'm still waiting for that story after more than 30 years.

The challenge as I see it. Evaluate is a troublesome concept and a troublesome word. And I agree with that. And I wish I could say that that problem can be mitigated by choosing a different word. But I think the problems more deep rooted than that.

MR. DOTY: Mr. Ferguson.

MR. FERGUSON: Yes, I want to focus for a minute to see if I understand what was said correctly. And I want to focus particularly on the statements that Jeremy made and Mike Young, which seem to be in many ways polar opposites. And to present us with a binary choice here.

As I heard you Jeremy, you said that indications -- or that statements by management, things like key performance indicators, non-GAAP measures, are not subject to audit and are area because they're not looked, are potential areas for fraud or for manipulation or for management to tell a story that is not necessarily reflected in the audited financial statements.

You Mike on the other hand, seem to say that if we have the auditor start looking at these things, we will inevitably inhibit their use in such a way that they are effectively the only really clear communication management makes. That the audited financial statements are increasingly not relied on by investors. And that we will actually make disclosures by management less useful.

Those seem to me to pose a binary choice. You know, we're dammed if we do and we're dammed if we don't, under your two arguments together. Are they reconcilable? Am I mishearing?

MR. YOUNG: Lew, I actually think that they are. And let me try to reconcile them. Because first of all I'm a big fan of Jeremy and his firm. And I've got Howard Schilit's book on my selves. And he and I are in the same business, which are investigating problems.

I think they are reconcilable. And let me explain how. One is one of the things that Jeremy told was that these different ways of looking at things can be helpful. And that's true. They can be helpful.

Another thing is we did not hear from Jeremy that the information is not truthful. We just heard that it's not the best way of looking at it. And I give a lot of credit to the sophistication of investors.

I mean I think Jeremy's main point was that the information is being sliced and diced in a way that while it's truthful, creates an impression that you shouldn't have if you look at different ways.

Also, the information that Jeremy's talking about, I don't think would get included in other information. I mean the 10K isn't going to have that kind of non-GAAP information.

So the other information proposal wouldn't really reach it. You would have to even go further than other information. If in fact, well let me stop there.

So I don't think, I'm not hearing from Jeremy that this is misstated stuff. It's just looking at it in different ways, some of which is helpful, some of which may be less helpful.

That's not what I'm really speaking to. I'm really speaking to the concern that management will strip out sort of the dot connecting subjective information because of concern about auditor recalcitrance.

Is that helpful? I --

MR. FERGUSON: Yes, I mean that is sort of. I want to hear from Jeremy too though.

MR. PERLER: And what's most interesting to me, and I understand right now the scope of the proposal is very broad, all other information. But my comments are more focused on all detail and disclosures related to communicating the financial performance, or financial status of the company.

So anything like market share, or subjective comments like that I'm less concerned about. It's more here is our adjusted earnings. Or here is our non-GAAP revenue.

MR. FERGUSON: Statements that are based on the financials.

MR. PERLER: Based on the financials, arrived from or proxy for.

MR. FERGUSON: Just different from the connecting the dots information. Or can be different.

MR. YOUNG: Yes, but how would the auditor police that. I mean if it's true and if it's consistent with the financial statements, is the auditor going to say we don't think that's the best way of looking at it?

MR. PERLER: Well I do also want to say most of the time it is true, it's a way to communicate it. But many of the frauds and many of the you know, fraud with a lower case F if you will, ware rooted in these misstatements that are subjectively altered.

So I don't want to say there are not misstatements in there, but this is the area rife for discretion that I think is -- right now it's beyond the auditor's reach and stepping into that area will not just -- it's not just a matter of policing the metric, it's a matter of changing the overall behaviors.

Maybe auditors -- or maybe companies would not use some less relevant or manipulative metrics.

MR. DOTY: Mr. Hanson.

MR. HANSON: I've got a question and direct towards Pete, but I want everybody to weigh in.

In overall the feedback we've collective heard from you and others that the use of the word evaluate is problematic. The scope of what gets included is problematic, and that's what I want dig a little bit deeper on.

And also the fact that it's a game changer that the auditors actually report on the conclusions from that. And I'm kind of surprised that none of you touched on that one.

So I'll want overall reaction to the actual reporting of we did this stuff, evaluate or whatever the procedures are an didn't find anything. But on the scope.

And Pete you teed up that this is somewhat similar to what's accomplished in a comfort letter. And my experience with comfort letters, that underwriter's counsel starts with, they want every single number, including the page numbers, some sort of comfort given on it in this 200 page prospectus.

By the time you're all said and done, there's a lot on the cutting room floor that there's no comfort given on so that whatever's disclosed falls on the floor. And the hierarchy of what underwriter's counsel usually wants is, gee if you can trace it directly to the financial statements, that's the best.

The second best is to the general ledger. A third best is to a schedule which reconciles to the general ledger. And then fourth is to a management prepared schedule that doesn't tie to anything, which those sometimes fall on the cutting room floor.

But the exercise of doing the comfort letter is very precise in that the exact number that you're given comfort on is circled with the exact procedure identified as to what was done. And one of my concerns is an investor will never know what comfort was given on any given number within the other information because it's not distinguished.

In some numbers there will be some comfort given, so reconciled the financial statements are tied to the general ledger. In others, there's not a darn thing you can do about that number because the auditor doesn't have that information. And what we're doing in this proposal would not impose an obligation to go find the support for every number.

So Pete any ideas about how we could better identify to investors to make it more useful for them. And maybe your reaction how your team of analysts and investors would think about this with an unknown, we don't know what the auditor actually did. And whether they did anything to the numbers we find most important.

Is that even helpful if it's a well, I don't know what the auditors did, so I can't really take any comfort at all in it.

MR. DOTY: That's compelling testimony. Does Michael Gallagher agree that you're tending toward a comfort letter approach to this?

MR. GALLAGHER: Yes, I believe, yes. I think that we have to be careful not to have the perfect be the enemy of the improvement.

And I think regardless of what standard you put out there, whether it's evaluate or some other standard, because of the different nature of the information that's included in other information, you're going to have varying degrees of comfort if you will, for lack of a better word, in terms of what the auditor did and what the auditor was able to do.

Now I would hope that whether it's through technology or some way, that the numbers that can be traced back you know, to a system, something that ties to the general ledger or something that is covered by the system of internal control, perhaps that can be identified in some way. Okay, to give that reader better procession in terms of you know, at least some sense of what was done relative to that.

But in the meantime I think some if it will be intuitive. I would say maybe pick your percentage depending on the investor. You know clearly if it's a revenue number or something that's you know, directly related to the financial statements, it will be quite clear based on the articulation of the report, well that was something that was tied to the financial statements or ultimately something that came from the internal control system.

But in the spirit of making improvements and not having it be perfect before we make the improvement, is in the spirit of where we were going with our suggestion.

MR. NACHTWEY: And it's a great question. And I think first of all by referencing the comfort letter process, I think that's a somewhat imperfect process for the reasons you've mentioned. It's all about the investment banks throwing the risk football back and forth between the accounting firms.

And so the more they can get the accounting firms associated with every number including ridiculous things, you know the page number thing isn't too far off. Anything a monkey could do, and they could have their own staff, but they want to have the auditor on the hook.

So I don't think slavishly following the comfort letter approach is probably going to be workable here. I think something that's closer to read and consider, although I'm sure the lawyers in the room and at the table will say, well that's no less specific then evaluate. And I agree it's not.

But it is something that's exactly what the auditors do today. And I think we have to put some of the burden on this into how the standard is drafted itself. What does it mean when they say if we stuck with evaluate, which I hope we don't, but if we did, you know it's got to be very clear what that means.

If we say read and consider, what does that mean. Right now I think everyone in the accounting profession understands very clearly that means A, read it. B, consider whether it's inconsistent with anything that's in the financial statements you've audited. And C, make sure that if it comes out of the books and records, you've got even more certainty about it.

So I think there's a great understanding in the profession -- I don't think, you know fairly stated, and you know in current standard audit opinion, if we were subjecting that to the same level of scrutiny we're subjecting these words to, we'd have the same issues with fairly stated. But people have gotten used to that over many, many decades of reporting and again, what the standard says.

I also think we're in completely unbroken ground. When we're over many, many decades we're talking about a two paragraph opinion that we've sometimes some of the firms reverse the paragraphs, or the combine the paragraphs, but they pretty much all say the same thing.

And that's given investors and users a lot of comfort. Because they don't have to read a report and guess well, what's the auditor telling me? If it's pass/fail, I know if they've passed it, they've got a good understanding of what was done.

So I think a bunch of what's in scope comes from what are you going to ask the auditors to say. And then again, what should be in scope. I think non-GAAP financial measures, you know by in large virtually every number, I know certainly the ones that Legg Mason reports, of which we've got primarily three.

And frankly, I talk to investors that probably 40 percent of my life is spent either on earnings calls or in investors sessions with both sell side analysts, or buy side investors. And Legg Mason is a buy side, so our mutual funds are out investing in things every day. But they're relying on sell side analysts who mostly work for the Wall Street firms in terms of their diagnosis of our financials.

They're not only relying on that, but they heavily rely on it. And frankly 80 percent of the questions that I get, and I get all the numbers questions, my CEO gets all the fun ones to talk about strategy, et cetera, 80 percent of those questions are about the non-GAAP measures. Because GAAP unfortunately forces us to do some things in our financials that the analysts look and say that's not relevant.

I'll give you one example and then I'll pass the microphone on. But net revenues in our business. You know there's a lot of tension around wanting to make sure in accounting parlance we're reporting everything that's coming in. And then everything that's flowing out is an expense and what's left for the shareholders.

But in our business we have a huge amount of marketing costs that are referred to as 12b-1 fees that are highly regulated part of the mutual fund business. And 100 percent of those fees are passthroughs to the distribution partners that we have.

So nn one looks at that as revenue that comes to Legg Mason, because why in the world would you be in a business where you have 100 percent of your revenues going out as expense?

So the analysts want to understand in terms of are we running the business efficiently. What is the net revenue that's actually coming to you that you're managing. And what's the margin you have off of that.

So again, very few of the questions that I get go to the GAAP numbers. They go more to the non-GAAP.

MR. DOTY: Ms. Franzel.

MS. FRANZEL: Thanks for being here today. Assuming we get the verb right here, you know evaluate, consider, read. Or maybe we need more than one, you know sort of verb to apply to different categories of information. I'd be curious to hear your thoughts on that.

But what are the categories of information that you think would be most important to have some kind of explicit auditor involvement and conclusion on. Right now we've got a very broad you know, other information.

Are there certain categories where you would envision that we'd get most value from auditor involvement? And what level of auditor involvement would that be? And the question is for all the panelists who would like to respond. Start with Jeremy.

MR. PERLER: Yes, I think in my mind it's a no-brainer for there to be auditor involvement on anything used to communicate financial performance. Be it a number, be it a qualitative disclosure about why revenue grew ten percent this year.

I would say that area is the most important area. Everything else would be below it.

MR. YOUNG: I'm a listener on that one. So I'm going to defer.

MR. NACHTWEY: Ditto.

MR. GALLAGHER: Yes, I like the discussion that was held yesterday where we discussed and we supported the CAQ proposal of reporting the auditor involvment with critical accounting estimates. Because those are the things that if they're done right, are really the most important things that drive financial performance, or where financial performance could be effected most significantly.

And I think there is a real opportunity to up the game in terms of how well they are written. Right now there is not auditor involvement beyond the read and consider. I think if the auditor were to attest to that, I think the quality of compliance with SEC rules and the clarity with which it was written, I think would only improve.

So supportive there. And as I said, I do agree with Jeremy, I think things that are most significant and directly associated with the financial statements that really drive how a company's evaluated, is where the auditor involvement should be greatest.

MR. NACHTWEY: Again, it's a difficult issue. I think investors probably today assume anything has a dollar sign on it, or even if it's a number, that the auditors have done something with it.

You know frankly I think it's difficult for the audit profession to do much with things that don't come from -- directly from the books and records. And things that are subject to the internal control system, you know a lot of thought and theory that's been put into internal controls by a number of bodies including COSO.

But I think confining it to things that are you know, within the expertise of the auditor, mostly financial information, financial numbers. The things that are so often have been in these tense meetings with underwriters, that they want auditors to comfort.

And the same kind of things that I think Jeremy is talking about here. I agree they are important numbers. So things like square footage. So a firm that owns office buildings or regional malls, et cetera, is -- has square footage is a key, not so much performance indicator, but certainly a key statistic in their financial reporting.

Yet there's incredible amount of subjectivity as how you measure square footage. So I used to do some real estate work in a prior life. And in New York City, we always talked about the gross leasable area was how far you could throw your boss out the window. And then you've got to measure that distance onto the sidewalk.

And this was all a game of the real estate brokers and the owners and the tenants deciding how much they're going to pay in rent. And then what's leasable area? Do we count the restrooms? Do we count the elevator shafts, et cetera? Things that accountants clearly aren't capable of accessing.

The second one, proven reserves. Some of the resource, oil and gas, minerals business, et cetera.

Incredibly complex. Not something -- I can tell you, again I'm a CPA, I spent many, many years both in school studying for the exam. In practice and in no way shape -- I know what a proven reserve should be. But am I engineeringly capable of going out and verifying it? Absolutely not.

And then last but not least, in the valuation space. And there was a time in my prior life at Deloitte where I ran the valuation practice for the firm. Not because I was an NAI and knew really the first thing about the science of valuation, but the firm needed somebody back when FAS 141 and 142 came out, to connect the valuation folks to the auditing folks.

And it's a very different again, amount of rocket science that goes into valuing things. Whether it's hard assets or financial instruments.

So I know I haven't given you a clear answer to that. It's -- this is why I'm suggesting that we have to be very careful at constructing this thing. And making sure that we don't cause more confusion by people assuming once the auditors started reporting on information, if it's not clear exactly what they've done, on what numbers, we create some difficulty.

So the last point. In going back to this, we're breaking new ground on the reporting. Everybody's taking comfort in having this one page, two paragraph opinion. And then we may be in a land where you need an appendix to the opinion that describes exactly what's done.

You don't want to torture everybody to have to read that to get to the substance, but it might help with the litigation protection. And for the ones who really want to go deep on this, they'll have the information as an appendix to the report.

MR. DOTY: Brian Croteau.

MR. CROTEAU: I think Pete you started to actually answer the question I was going to ask. But I wanted to come back to the evidence point again.

I'm obviously again for the fairest amount. There will be a range of evidence that the auditor gathers and has in his files. And you know, some information will be covered -- would be covered under Jay's model and under the proposed standard.

And other -- for other information, there would be a range of relevance relative to the information in the auditor's file. And to the extent that we're talking about a report that is a paragraph or two versus describing for each specific element of the other information what was done.

My question was really is it more risky or more helpful to have that kind of report? And I'd be interested in other's thoughts on that. I think you just started to answer that question. I'd be interested to know what others think about that.

MR. YOUNG: Forgive me, I don't understand the question.

MR. CROTEAU: So in some cases, the auditor may not have any information from the financial statement audit in the file. And in other cases the information the auditor has may be relevant to some degree, or may be completely relevant to the other information that's being looked at. But yet the report we're talking about wouldn't necessarily identify what was done for each element.

And I guess my question is, is that kind of report that generally describes what the auditor has done, relative to the other information, the procedures performed, helpful? Or is that likely to be more confusing without what Peter was just sort of describing, sort of a tick mark legend if you will, of what was done for every element?

MR. YOUNG: Right. Here's the challenge. And that is let's say we want to take, I'll call it a comfort letter approach, because that really crystalizes it. You got a number, you circle it, the auditor looks at the number, very little ambiguity there.

The challenge is coming to that level of clarity, that level of crispness, that sort of line of demarcation when you're talking about other information more generally. Now sure if we could have the auditor circle numbers, well yes, okay, that would take care of it.

But in a sense, almost anything you say about the business, at some level ties to something in the financial statements. And let me give you an example which makes it perhaps a little bit more concrete.

And that is risk management, it's a big thing right now. Disclosure about risk management. And let's say that the company says, and speaking, you know speaking operational, we believe that we have effective risk management.

Well the auditor knows that the company has FAS 157 Level 3 assets. And let's say sure enough the value of those assets goes down. And then the contention is, auditor, how could you have allowed management to say they have effective risk management when you knew they had FAS 157 Level 3 assets, and look what's happened. The value has gone down. That's not effective risk management. How did you let them say that?

Now that's an example. You don't think of an operational statement about effective risk management as really tying to the financial information. But those dots are not difficult to connect.

How realistic is that hypothetical? Not only is it pretty realistic, it's not even very creative.

MR. DOTY: Mr. Baumann.

MR. HARRIS: What do you do in that situation where there's effective Level 3 assets?

MR. DOTY: Steve, let's hold it. Let's let Marty pursue the question and then we'll get back. You'll get another round.

MR. BAUMANN: Thanks. You've all made a great contribution to this important topic. And I really appreciate Mike's comment about don't let the perfect be the enemy of the good here.

I -- Jay asked a really good question. He talked about investors really don't know which level of assurance was given on different numbers because the auditor knows more or less about different number in the other information. And that's a good point, but still can't we still improve auditor reporting without getting perfect in this regard?

I'd be interested in Mike and Jeremy's reaction to a comment that was made by Pete in his remarks that, we are the fastest growing company in this industry, is something that he said cannot -- auditors cannot report on that type of information.

Now as part of the risk assessment standards, auditors are required to gain an understanding of the company and it's environment, which encompasses industry factors including a competitive environment. So auditors have to understand a company and it's environment as part of the risk assessment standards.

So if the auditor is doing that and is reading the company reports about its growth, its strategy, also minutes of the Board of Directors, and is aware of the fact that they believe that they have some problems in growth. And that they have competitors that are growing faster than them, and have better products than they do.

And the auditor reads that statement that says we are the fastest growing company in the industry, but the auditor knows that that's not what is reflected in management's own records in the board meetings that he attended, or audit committee meetings, is that not the type of information where the auditor could and should say to management, we think you have a material misstatement of fact here that we think has to be corrected.

So and isn't that the kind of information that otherwise could be very market moving in other information that might be at the heart of what we're trying to get at here?

MR. PERLER: Yes, I think that would be a material, and if the auditor saw that as a material misstatement of fact, that would be a great area for discussion and something that the auditor could speak about and communicate with management, absolutely.

I recognize the subjectivity of that particular statement, and what are you using to make that judgment? Growth in what measure? And you can pick any measure and say we're the fastest growing company. However I do think that would be a helpful area. Less important to me than actual financial reporting numbers, but helpful.

MR. GALLAGHER: So Marty, the way I think the auditor would approach it today, is ask management, hey you're making this statement, what is it based on. You know recognizing that it's a very ambiguous statement. There are so many ways you could measure you know, fastest growing.

So very ambiguous, and you'd want to get behind it in terms of what is your basis for making that claim. And if there wasn't a basis for making that claim, I think the auditor would likely raise it and say hey, this is problematic.

But it would be very difficult for the auditor to report on that because of the subjectivity of it. And there's probably some metric that they can find given the ambiguity of the measure that they might be able to support the claim. Whether you think that that measure was a reasonable measure would be another matter.

So those are -- that's the caution we would have as auditors in terms of reporting on information that's fundamentally not objective, it's subjective and potentially ambiguous.

MR. NACHTWEY: I was thinking Marty, I recognize as well that that's you know, an important area for investors to have a feel for. But it's a question of whether the auditor is the right place to get the information, or a standard that we can craft that everyone would agree objectively. First of all, how do you define industry.

And so there's many subsets and levels of SIC codes we could go through as to is it you know, a very finite example, Legg Mason, are we a financial services company? In which case you're going to compare us to insurance companies, banks, broker dealers, et cetera. Or are we an asset management company, and within that are we an active asset manager versus passive like a bank or et cetera.

And then getting into the unit of measure, is it, or what is fastest growing. Is it units of production? Right now most tech companies that are being sold for billions of dollars have you know, fast growing stuff, and they're not making any money.

So is it you know, growth and profitability, growth in units of sales, growth in revenues. I think is where the challenge is. But like Mike, my prior life, if I had a management that was consistently, you know it when you see it. And if they're consistently misstating things like that, those are the kind of clients you say, should we be associated with.

MR. BAUMANN: Or at a minimum, if they're making that kind of statement and you know it's factually wrong because in their minutes of the board meeting, they've asserted you know, we're the third fastest growing in our industry in every single category. You'd want them to, when you read and whatever the verb is, evaluate or consider, whatever, say maybe that's something I've just read, but I think either management has to correct, or my report would say we did read this and we found something to be materially inconsistent with our knowledge of the company, or a material misstatement of fact.

MR. DOTY: Steve Harris.

MR. HARRIS: Getting back to me.

MR. DOTY: Yes, go ahead Steve.

MR. HARRIS: The question on Level 3, what's the responsibility and role of the auditor to report on, in essence impossible to value assets?

MR. YOUNG: Well I mean I would think it is to come to a judgment as to whether management's judgment in trying to value the assets is fairly presented as of the date of the valuation. You know, it's -- I would not view the auditor as having a -- no, no, now I'm talking about auditing standards. Please correct me where I go astray.

But I would not view the auditor as having a responsibility for you know, thinking what the value's going to be next month. It's what is the value under Level 3 as of the date of the information.

MR. HARRIS: But there is no value. I mean Level 3 is from my understanding --

MR. YOUNG: Oh no, you -- no, there's a value, it's just hard to set the value.

MR. HARRIS: There's such a range. I mean from everything I gather, it's such a range that it's virtually impossible to value. So in essence what you do is to what is extent is the auditor responsible for reporting the difficulty in valuing the Level 3 asset. If at all.

MR. YOUNG: Well -- that actually is a very good point. Because it take us to what Mike Gallagher was talking about earlier about critical audit matters.

And that's one, if I may leave other information just for a moment. I mean that's actually something that would be useful for investors to see, that this is challenging number. You know, you've got a FAS 157 Level 3.

But you have to come to a value. I mean the FASB doesn't say, gee it's tough to value, so just leave it blank.

MR. DOTY: Lewis.

MR. FERGUSON: Yes. Alan Beller talked about this yesterday. And as I heard him, what he said was he had two concerns about it. One was the question that there did not appear to be any materiality standard in terms of what the auditor did. And number two, you didn't' really know what the auditor had done beyond evaluate this large body of other information.

Would it help for example if assuming we cure the problem with evaluate and come up with a definition of what the auditor, that is clear and understandable and people know what it means. Beyond that, that auditor has to say and in addition, we preformed procedures with respect to the following areas, so the reader knows more specifically in this body of other information, what areas the auditor thought were worthy of attention enough to do work on.

Does that help?

MR. GALLAGHER: So Lew I would break it down between other information and CAM. And I don't recall yesterday whether Alan's comments were focused on articulate -- potentially articulating procedures with respect to critical audit matters.

That I would be less enthusiastic about a litany of procedures that was performed, that may call into question whether you have a problem with that number or not. As opposed other information where again, if the purpose of the Board was to capture what practice does today with respect to other information. And we do things that go beyond what we're required to do in order to manager our risk.

So we're required to read and consider. Do we do more than that? Sure. We tie numbers out all the time. Whether it's in connection with a comfort letter, or just you know, just to get the 10K done. Every number in MD&A that's the key numbers for sure, are tied out.

So I think articulating procedures and what we do just being transparent about what we do today, recognizing the imperfections that from Jay's comment, which we recognize. And I think Brian's question is exactly the right one in terms of the consumer, would they find it to be more confusing, or would they find it to be helpful?

I think that would be a great thing to test in a field test.

MR. FERGUSON: Are you saying that you do think that would be helpful to do?

MR. GALLAGHER: I think in the context of other information, not CAM.

MR. FERGUSON: Yes, that's what I'm asking. I'm not asking about CAM. I meant other information.

MR. GALLAGHER: I do, but I would keep it limited to you know, a few categories. Not an endless articulation of individual procedures.

MR. DOTY: Jay.

MR. HANSON: A question mostly directly at Jeremy around the non-GAAP financial information. It seems to me that one of the problems is that there are no standards around how you present any particular non-GAAP measure. And I know that we can't solve that problem, the PCAOB.

And I'm looking at Mr. Kroeker, and I'm guessing that he would say gee, we're having enough problems with disclosures on GAAP matters, much less taking on non-GAAP measures. And Brian's colleagues in Corp Fin are the ones that tend to do some policing in the non-GAAP measures.

But it seems like there is a fundamental problem of there are no definitions behind it, nothing uniform. Even if something as on a simpler end of the scale as same store sales, that there are many ways to compute that.

But without solving that problem, which I don't know is even solvable, I think we're always going to have the problem of people saying whatever they want to say with whatever caveats being on it. And there will always be a schedule that describes how the number was computed.

But you made a -- I'm trying to figure out what my question is here. Because I -- do you have suggestions about getting at the core of that problem of it's a wild, wild west relative to non-GAAP measures. Or is it your message really that auditors paying more attention to that may curb just the use of some non-GAAP measures at all?

MR. PERLER: It's a great topic. And I think Pete illustrated it really well when he said that 80 percent of his investment community asks him about the non-GAAP metrics then the GAAP metrics.

And I'm not an advocate of banning non-GAAP metrics. Or turning them all to GAAP, or telling companies that you can't report this information, because I agree it would curb information flow.

And I recognize that this is a fundamental problem that the system has, that it could foster a wild west situation. But I think there are absolutely steps that could be taken. Particularly from the auditors perspective.

You know some easy ones include -- we all know for every company, what are their most important investor communication metrics? Pete just said at his company there were three non-GAAP metrics that they use. Every -- you go to open-ending earnings release, and you look in bold on page one, and you can see right there what they're communicating to investors.

For those metrics, at minimum, to not have any robust quality check or auditor scrutiny on them, I think is a problem that could be fixed with some procedures. I don't want to suggest everything and anything needs to come under the umbrella, but there is a way to pick off the most important investor communication metrics.

MR. HANSON: And just a commentary on that, which is -- which we've heard some feedback in different settings that auditor involvement in press releases. And actually Mike Cook, one of our standing advisor group members, talks a lot about the need for auditors to get on the train earlier than at the tail end when the audit report is issued.

But that in most companies, the auditors do have some involvement with the press release. But definitionally, since most major companies issue press releases long before the audit report is ready to be signed, it's an imperfect exercise. And the auditor is never going to be able to sign off because they're not done with their audit yet. So that is a real change.

MR. PERLER: I recognize that. I think many of these metrics do find their way through the MD&A. And just this overall scrutiny over what the most important metrics are will influence what metrics are used. And just to acknowledge, the audited financial reports are not the primary communication tool with investors. They're not secondary, they're not tertiary, they're what -- above that are the earnings releases, the conference calls, the PowerPoint presentations, the one on ones. This is how companies communicate with their investors.

And the audited financial statements are well below that. So I think it -- and I know it speaks to a grander change in the system, but I think some kind of involvement with the key measures reported in those other communication tools only makes sense from an auditor's perspective. That's where investor protection would be best served.

MR. GALLAGHER: If I could just add to that. I think that I agree with Jeremy. And I would certainly be supportive if the demand exists on the part of the stakeholders, investors and others, to have auditor involvement in press releases and others.

But I would also say that this notion that the audit is all the way at the back end, which from a time perspective it is, but I think when a press release comes out, there's the knowledge that an audit's being done. And God help the company that has numbers that are different in the audited financial statements from their press release.

Now you do have that. Sometimes you have a subsequent event which was beyond their control. And I think the market generally understands that. But if a company consistently, like more than once, has an issue that -- where there's a disconnect between those audited financial statements which come later, and those numbers are different than that press release, they're going to pay a pretty heavy price.

MR. DOTY: Jeanette.

MS. FRANZEL: I want to talk a little bit about the potential impact of whatever we do. Let's assume we can get it exactly right. The impact on perhaps increasing the expectations gap. Because to me that seems to be another factor that we need to worry about.

So if we define auditor's involvement and we define the scope of auditor's involvement, yet you do have some qualitative connecting of the dots and presentation matters that could potentially be misleading, even though the auditor has managed to get comfortable with the various numbers. What do you all see as potential risk here in terms of increasing expectation gap and what advice would you give for us to consider that?

Let's start with Jeremy. And I think Michael you touched on a lot of that.

MR. PERLER: I think the expectation gap is very large right now. I'm not too worried about increasing it. The question I get very frequently from investors when I point out some sort of misrepresentation, is why aren't the auditor's looking at this?

Whether it's in the press release, whether it's in the MD&A. I would say if you surveyed investors, the vast majority would think that the MD&A is audited. Maybe not the press release. But I think the expectation gap is so wide, I wouldn't fear implementing something just because it might increase.

MR. YOUNG: I think that in everyday language, this will be -- start to be referred to as auditing MD&A. Or auditing the 10K. And the distance between that articulation and the reality will be the expectation gap.

MR. NACHTWEY: And I actually agree with both what Jeremy and Mike have said here. And I think there is a huge expectation gap today. I do think that investors by and large believe that if auditors have signed off on an audited financial statement including in some other public filing, or in a public filing, that virtually all of the other information, particularly if it's a number, and if it's got a dollar sign even more. That the auditors have been involved with that.

And even the ones who have a better or more sophisticated knowledge, I think assume okay, I realize the auditor may not have subjected it to the same level of audit procedures, but it's a higher level than what auditors are capable of doing.

So I think this is a great opportunity to tighten that expectation gap. But depending on how we ultimately you know, articulate the proposal, it could cause -- it does have the risk of creating more confusion.

MR. GALLAGHER: I agree with Pete's comments. And I go back to Brian's question. I mean the true test here is if we can experiment. You know whether it's finding the perfect word or articulating the procedures, and get a reaction from those that use the financial statements. And look at the other information and get a reaction. Is this helpful, is this widening the expectation gap, or is it closing it.

MR. DOTY: I am concerned listening to Michael and to some extent the rest of the panel. With the notion that we have now auditors as a matter of practice, looking at other information. The concern that if the issuer knows they're going to have to say something where they find inconsistency, this will result in management leaning toward cooking the books. They will lean toward withholding information. They will lean toward trying to make it -- to neutralize the comment.

It seems to me that they do that at their peril. And the suggestion is what comes out of the suggestion is that the involvement -- some involvement as Jeremy is suggesting of the auditor and the audit process and other information and addressing inconsistencies, should correct, should produce management conduct that is better.

I understand the liability issue. But is the panel comfortable with the notion that we do not -- that we will not empower the auditor. We will not by virtue of directing the auditor to form judgments of some kind. That we've decided that what comes out of this panel discussion is there's a lack of uncertainty about evaluate.

But some -- requiring the auditor to form some judgment and communicate some judgment, is that consistent with best corporate practice and best disclosure? Do you really -- do you believe that that in facts leads us away from boilerplate?

So are you willing to say we're going to abandon the attempt to have the auditor perform some judgmental review. And then having done it, communicate that. Is that where you are? No involvement?

MR. YOUNG: Look, I know you guys have put a lot of work into this. But I'm afraid that's where I am. And let me -- and let me respond to.

Warren Buffet in his most recent shareholder letter says something about a write down. But the number is economically meaningless. If an auditor were reporting on that statement, that statement would not be in there.

And I remember an earlier shareholder letter -- but I do other things in life besides read his shareholder letters, just but -- an earlier shareholder letter I think we talked about a reserve. And he said the one thing we know about that number is it's wrong.

If an auditor had responsibility for reporting that sentence, it wouldn't be in there. And my concern -- I mean let me say it this way. The lawyers will take over. The lawyers will go over the disclosure and they will look at the risk, and they will say, fastest growing, maybe it's right, but there's evidence to the contrary, get that statement out of there. Economically meaningless, get that statement out of there.

And the thing -- I mean they have -- 10Ks have so little life now. I mean you know, maybe an argument is they're so unbearable now you can't make it any worse. But, you know, hope spring eternal.

And my concern is bluntly, the lawyers will take over.

MR. NACHTWEY: Chairman Doty, as I said in my comments, I generally favor the standard. And I think because going back to Jeanette's question, I think there's more risk and harm today in terms of the lack of understanding of what auditors are involved with and the other information, that we can close that expectation gap.

And I think to obviate the issue that Mike so wisely raises, you don't want to limit you know, what Warren Buffet could write. But those kind of subjective things, are not really the part, the purview of the audit firms. And we shouldn't be forcing the audit firms to get involved in that stuff.

Again I think it's much more about reporting and what they already do, to make it clear to investors where the auditor's been involved in other information. Or as Mike said, Mike Gallagher said before, and again from my experience of you know, 25 years at Deloitte, we were involved with a lot of the information. And we just have to come up with an appropriate way for them to report on what involvement they have. What the information is they're involved in and the level and scope of what they've done.

MR. DOTY: Well there's a real dichotomy that emerges. Because Jeremy began with a very profound statement that he says that he has an understanding in his career of how information is read and used, consumed. The whole panel I think fits that description.

You all have through your careers, a heightened understanding of how information is read and consumed. And I take it that along with Mike Gallagher's written materials, I thought there was not the same reluctance or the same concern about the critical audit matters, the CAMs.

That in fact in your view of some of the arguments made that the evidence concerned with involvement in other information, would in fact suggest that you think there is not a risk in having CAMs in the audit report. That's a different breed of cat. I know it's not your panel's subject.

And there are issues of naming the engagement partner and the tenure of the firms that were discussed yesterday and that are coming out of the European model, and that we are considering. I would like to know the panel's views as sua sponte as they are, on whether in fact we should proceed with CAMs, engagement partners, tenure.

Are these matters that are a different issue than the ambiguities and the dangers of other information? Jeremy?

MR. YOUNG: May I speak first to that?

MR. DOTY: Please, please.

MR. YOUNG: Let me speak to the CAM question. I actually think that at a -- I think there's a lot of benefit to the CAM disclosure if it's done right. I mean don't get me wrong. I think there's some issues.

But at a conceptual level, there are tough numbers. I mean Steve it goes to your point about FAS 157 Level 3 assets. You know the mere fact that FASB says you've got to come up with a number doesn't make it easy. And doesn't mean that there's not a range that takes you from A to Z.

And it's useful for investors to understand that. And that's good for investors. It's good for preparers. It's good for auditors. And by the way, in at a conceptual level, that helps you with regard to litigation risk. I mean you're talking about challenges, you're talking about risks. You're talking about problems.

The disclosure of problems doesn't get you into litigation trouble. It's the non-disclosure of problems that gets you into litigation trouble.

Now permit me to just insert here, I was in the room yesterday when Alan Beller was speaking, and I accept that when you get into the weeds, there are some real issues. But that's really on the implementation.

At a conceptual level, I would not suggest that you abandon the CAM project. Quite the contrary. I'm sort of cheering you on as a matter of concept.

MR. PERLER: I agree. There are benefits to the CAM, the auditor's name. I agree with all of that. I think all of those -- or I should say, the most important thing that can be done on the entire proposal is around these most important financial metrics I talk about. All of those are very helpful context as well.

But in my mind, strengthening the robustness of the system for communicating financial performance, is the most important thing that can be done.

MR. NACHTWEY: I appreciate having the opportunity to weigh in on those. Although again, having spent as much time studying them as we did this topic. But I have concerns about all three. Don't have to be fatal.

But in terms of the first, in terms of CAM, so management already does MD&A with massive disclosures and footnotes. If you go to some of the big banks, just critical accounting policy runs on for 20 pages.

So ours is a little less complex, but still runs to probably 10 pages just in the main footnotes. Get into MD&A, there's going to be even more.

So how do we make sure that we're not confusing investors by auditors saying one thing. Now presumably auditors would agree with our disclosures, or they wouldn't have signed off on the audit opinion. But now you get into words as opposed to numbers.

And so the time that it would take to make sure that we're consistent. And if we're not, the idea that either the company did something wrong, and therefore should have had a qualified opinion. Or the auditor's disclosing information that management should have been disclosing to begin with.

And I do have some tissue rejection about the idea that auditors should be the source of original disclosures from -- about the company. But again I think there could be workable things.

I do agree as Mike says, you know FASB, the Level 3 asset issue, and I've had clients -- audited clients and was the CFO for a firm that literally had 100 percent of their assets that were Level 3. And you know did -- the users of those financial statements really understand the challenges in valuing those.

And the risk, valuing them on any given day is tough enough. Trying to say what's going to happen between now and next quarter, virtually impossible.

On the engagement partner, that's a, it's a tough one. You know, from my view, I had audit clients, I had one of the largest audit clients in my former firm. I had 200 partners, audit partners around the world that worked on that client.

So, I mean, I can sign it, but, gee, I'm relying in large part on those other 200. Do we want a laundry list, but I accept the fact there were other professions that do, you know put the individual's name on it.

I just question whether -- does that have as much value as people might think? Or is it misleading that there's simply one, you know, one individual that's responsible for the audit.

And then on the tenure front, could be a good disclosure. We do it. We do it in response to a shareholder proposal. But quite frankly, my concern there is it's a data point that without some context to it, can be used by, you know, folks that want to make a point. Well we just should not have long tenured relationships.

Well I guarantee you, that audit whose name will remain nameless for the moment, but where I had 200 audit partners on it. Imagine trying to get 200 audit partners in the new firm up to speed, overnight, on an incredibly complex business.

So rotation is -- tenure in my mind is simply the camel's nose under the tent of forcing the rotation discussion, another step down the fairway. And I'm not sure it's the appropriate way to do that.

MR. GALLAGHER: So CAM, as the written comments suggest, and my oral comments, very supportive of CAM. As to tenure, very similar to what Pete just articulated. It's a data point. Certainly no issue about having it be somewhere, probably the proxy is the best place to put it to be able to provide that context.

The partner identification as we've communicated in our response letters to that proposal, we're supportive of transparency and letting everyone know who the partner is. Just logistical issues about whether it belongs in the report or if there's a way to do it and have that transparency without creating other issues.

MR. DOTY: Any last questions? Go.

MR. HARRIS: I had just one final question. And

Pete I wasn't exactly sure in your statement where you say a key performance indicator is assets under management. What's the auditor's role? What do you view as the auditor's role in that area?

MR. NACHTWEY: Again, it's not a number that actually comes out of the general ledger. But it's a number that general ledger numbers are derived from.

So assets under management, bottom line is, daily we calculate our revenues off the assets that we manage. So there's I don't know how many thousands of different fund products and separate accounts that all have different fee structures.

So every day we obviously have this in the system, but there's also some subjectivity to it, where my finance team has to effectively book revenues on a daily basis. So again the auditors can't ignore AUM, it's the first part of the equation. So asset times fee, equals revenue.

On the other hand, AUM isn't subject to the same kind of you know, double entry accounting system tension, or the same -- it's subject certainly to our internal control system, but in a different way.

But again, that's why I used it though as I think a good example, a little bit of what Jeremy's getting at is, you know that's a really important number. And it goes beyond the financials.

Every month the market waits with bated breath for all of -- for my firm and all of our peers, to announce what our AUM is. And it moves the stock immediately once it goes -- once that goes out.

So again, it's something that I think having the market understand clearly, what level of involvement the auditor has and doesn't have with that number is important.

MR. HARRIS: But what do you think the level of involvement of the auditor should be in that instance?

MR. NACHTWEY: Well I think it already is heavy. So I think you know, articulating what that involvement is, I think would be important.

MR. DOTY: We're at break. We're having a break. We have a great panel coming up.

Let's take 15 minutes. Let's be back here promptly at 10:45 if we can. Thank you all. And thanks to the panel. Extraordinary panel.

(Whereupon, the foregoing matter went off the record at 10:30 a.m. and resumed at 10:49 a.m.)

MR. DOTY: Good morning. The panel, whom we welcome, includes William Touche, the senior audit partner of Deloitte, in the London audit practice. He also leads Deloitte's UK Center for Corporate Governance.

And as a center leader, follows developments in the UK regulatory environment, the listing rules of the SSA, the FSA and the developments of the UK Financial Reporting Counsel.

William Touche is Deloitte's representative on the Audit and Assurance Faculty of the ICAEW and also serves on its corporate governance committee.

Philip Johnson, the Non-Executive Director of Yorkshire Building Society. Prior to joining that society, he was the head of Audit Quality and Risk Management at Deloitte, UK. During his 30 year tenure as a partner at Deloitte, he was a Board member, also served on the Structure and Risk Committee and Compensation Committee, and sat as the first Chairman of the Audit Committee.

Previously he was the President of the Federation of European Accountants, a member of the International Auditing and Assurance Standards Boards, and the International Ethics Standards Board Consultative Advisory Groups.

He serves on the scientific committee of the World Congress of Accountants of 2014. And he's a current member of the PCAOB Standing Advisory Group.

Tony Cates is head of audit for KPMG UK, and also for Europe, Middle East and Africa. He joined KPMG in 1987, qualified as a chartered accountant in 1990, was promoted to partner in 1998.

He spent a year on secondment to KPMG in Kuwait in the 1990s and has subsequently held a number of senior leadership roles in the firm, as well as serving a wide range of clients from owner managed businesses through to the FTSE listing across a number of sectors -- FTSE 100 clients across a number of sectors.

Liz Murrall. Director of Corporate Governance and Reporting at Investment Management Association, the trade body representing the UK asset management industry. She monitors the developments in corporate governance, companies' reporting requirements, assesses the implications for the industry, and where necessary, lobbies for change.

She represents the IMA on a number of committees including the Institutional Shareholders Committee, the CBI's Companies and Financial Reporting Committees, the Corporate Reporting Users Forum. She is the secretary to a cross industry group that liaises with the International Accounting Standards Board and the Main Accounting Practices on Reporting and Auditing.

Before IMA, Liz Murrall worked at a number of the main accounting practices providing consulting services to a variety of financial services consultants.

The experience and the expertise represented on this panel regarding changes in the auditor's report in the United Kingdom, have direct relevance for us and what we're trying to learn. And we appreciate your doing it.

Please begin Mr. Touche.

MR. TOUCHE: Well, thank you very much Chairman and members of the Board for inviting us here today.

And so I'm going to give you perspectives from the point of view of a practicing audit partner who issued one of the first audit reports under the new regime. And that was for British Sky Broadcasting and their satellite broadcaster.

I thought I'd touch on three areas. And first why I believe extended auditor reporting is so important for the future of the profession. Second I'll share some observations gained from signing last year in July, one of these first reports.

And third, based on that experience, just a few observations on what works in the UK and some perspectives on what I perceive the challenges will be for the second year of reporting. Because I think we're all very excited about the first. But actually the second is also - you need to have a view on.

So to start, I thought I'd mention that I wouldn't be here today unless I was a big fan of the new regime. However a lot of the success of the regime in the UK is because at the same time as introducing the new auditor reporting, the FRC also introduced new requirements for Boards and for audit committees.

For Boards, to make two statements, first of all that the annual report is fair, balanced and understandable. And second, that it contains sufficient information to explain the strategy, business model, and performance of the company.

So in addition to these, new requirements for the audit committee and its own reporting to shareholders, that they should examine the scope of the audit, and explain in their report to shareholders, the key issues that they considered and how they were resolved in respect to the financial statements.

So, and I know this is a hot topic here.  In my view, this quite properly puts the communication responsibility for financial statement judgments on the company rather than the auditor.

And it also highlights and reinforces the role of the audit committee in supervising on behalf of shareholders, the production of the financial statements, the supervision of the scope of the external audit, and the resolution of key issues raised by the auditors, and doing that on behalf of shareholders.

So second, just a few introductory contextual remarks about B Sky B.  It has a reputation as one of the most successful and innovative companies in the UK, well led by a management with a focus on its core mission.

And in common with many consumer-oriented companies, its focus and clarity is reflected already in its annual report.

So I was very pleased when the CFO and the CEO, Andrew Griffith and Martin Gilbert -- and Martin is a significant investor, he's the Chief Executive of Aberdeen Asset Management, a major institution investor -- agreed to take the lead in early adoption.

So first the importance of the new external audit report. So I've been a partner for about 18 years at Deloitte. We employ 15,000 people in the UK. And we recruit about 700 graduates into the audit practice. And all hugely talented people. And most of whom will use their training as a springboard for successful and fulfilling careers in finance and business.

Now for these people, the facts that the key matters we address in our audit work are now directly described in our public reporting, is actually rather inspiring for our new auditors. They're proud to see their work so directly described in an audit report. It underscores the public interest nature of our work at a time when the profession has had a pretty rough ride.

It invigorates their personal sense of responsibility and pride. And it underscores to them why quality is so important in everything that we do.

So from the perspective of Deloitte UK, we see the audit report as an opportunity to inform shareholders about the important work we do on their behalf. We're appointed by shareholders to form our view on the overall financial statements. The commenting now on the major areas of focus of our work actually seems quite natural in the public domain. Even just a few months of the new reporting regime.

So speaking as a member of the profession as a whole, thanks to the leadership of the FRC, and the good work of many others, I think we've been given an opportunity to reestablish the value of audit. And of course without being too sentimental, London's pretty proud that we've taken the lead out there.

And just as also we've taken a bit of the lead on our comply or explain governance model, which has helped the governance regimes' shape around the world, led by the FRC, the ICAEW and the EBRD as well. And that's an important part of the reporting structure.

So what were the experiences of the new extended auditor reporting? As I said Sky embraces it from the very first suggestion. The attitude of the company is very much if we can lead, then we will.

Now the new audit report drives auditors to describe the areas of focus that consume audit effort. And the matters that we chose to report on, record recognition, the recognition of programing costs when they're expensed, and the validity of capitalization of capital projects are those that do consume our audit effort. And are areas that are routinely discussed with the audit committee.

So the topics were already well aired. And there should really be no surprises for management or for the audit committee on any of the topics commented in audit reports. So from a communication perspective, there's a bit of a breakdown would have occurred if there are surprises at the 11th hour.

And the next question I thought would be of interest, if the topics are understood and well aired, were the words difficult to find to describe them. And that, in fact this proved to be uncontroversial as Sky's hugely respectful of the work of the external auditor and of the reporting that we have to make under the standards that we follow.

So we had very little discussion about the choice of words. But in some companies that perhaps may be less respectful of the audit, maybe the auditor's latitude that provides a much more potent voice now with the new form audit report, actually should engender greater respect for the role of the auditor and for the profession. And probably greater engagement with the auditor by management and the audit committee. And I expect this will be one of the positive outcomes from our new regime.

I thought one of the challenges would be to figure out how many issues to report and the level of detail. But again, this proved to be quite uncontroversial. We actually -- I have a keen focus on trying to keep comments succinct, and again with the focus on year two, I think succinctness will be a benefit.

I've had shareholder representatives comment to me that it would be very helpful to flag in year two what has changed. So following the less is more principle when describing the audit risks and responses would be a very good principle to adopt.

So to summarize, a few ingredients for success. Early discussion and communication. The company's robust governance that respects the role and work of the auditor. And remember that the audit report is about succinct communication with investors.

I think one challenge to be faced in the coming year is the proposed reporting on the internal controls. And you've obviously had internal control reporting here established for longer than we have. Under the proposed changes, it will be very interesting to see how our free form audit reporting develops.

So a few final lessons. One boilerplate disclosures are public enemy number one. Innovation and company specific tailoring could be stifled by requiring specific ordering or prescribing standardized language. And you can achieve comparability by achieving a limited number of defined headings, allowing freer form reporting under each.

And we're seeing in the UK a wide variety of practice emerging based between firms and between individual partners. I personally like our opinion, which is focused on the audit effort rather than -- and leaving the audit committee to explain the judgments. And our opinions on the statement as a whole whether they show a true and fair view, it's up to the audit committee to explain their scrutiny of management's judgments.

And I think there needs to be real care and attention in explaining audit procedures. I don't think we should be going into a long laundry list of audit procedures.

And finally, and perhaps the most important point, is we're very lucky to have the governance regime that we have. Where the audit committee itself and the Board has to make these statements, which if you like are auditor reporting regime compliments.

So I hope that's been a helpful commentary. And a scene-setter for the panel discussion.

MR. DOTY: Thank you. Mr. Johnson.

MR. JOHNSON: Thank you Chairman and thank you for -- sorry, technology. Thank you Chairman and thank you for your kind remarks. And also for inviting me to speak here today.

I am here in my capacity as an audit committee chair, thus representing a part of the non-executive director community. But I've also had great interest in seeing the audit profession move forward.

Having spent 30 years as an audit partner in a Big Four accounting firm, during which time I helped develop communication to audit committees. I had six years in Europe representing the accounting profession discussing changes to our profession and the auditor reporting model.

And now as a chair of one audit committee, and a member of another, at last I can say that we finally started to tackle the long standing information gap concerns, which so long has been described by stakeholders as an expectation gap.

You heard comments yesterday about how long it has been since there was a change in the auditor's report. 80 years was mentioned for the US and Nick Land commented about 150 years in the UK.

This 150 years goes back to the middle of the industrial revolution when trade expanded, companies got bigger and external capital was sought in ever increasing amounts. The owners were not the managers anymore. So the audit as we know it, was formulated to give assurance to the owners that the financial statements properly reflected the company's financial position.

So having said that, it is quite clear to me that the purpose of the audit is for the auditor to inform the investor. Thus the need to provide more than just a pass or fail. Recognize that the pass or fail model is fundamentally important to the investor.

I appreciate that the UK has a different legal system and a different litigation environment. We also have a set of principles based standards rather than the rules based approach. The new audit reporting standard is only 16 pages long including the application material.

And therefore the auditor can use his judgment as to how to report on the requirements in the standard. Quite different to what is normal here in the US.

We heard from Nick Land yesterday that the new auditor reporting model in the UK caused some tensions between auditors and management. When I was working in Brussels, it was stated at one point by the European commission, that they wanted to create some tension between the audit committee and management in order to create better corporate governance.

The question must be, is it tension or is it challenge? If it's the latter, then it can only be healthy. And for the audit, it can only result in a better quality audit.

So with this backdrop, let me focus a little bit on what happened in the UK. As we already mentioned, the FRC encouraged by Parliament and investor groups, first it looked at the corporate governance code for company reporting, focusing on the role of the audit committee and what it should cover in the audit committee report. And then as an audit standard center, look for changes to the audit report.

To give credit where credit is due, by looking at both audit committee reporting and auditor reporting, the FRC has addressed or moved a long way to addressing the shortcomings of two of the three legs of the corporate reporting stool. The third leg is the financial reporting framework, which also needs some changing. But two out of three is a good start.

This is why I think the SEC and FASB also have a role to play here in the US and not just leave change in this area in the hands of the PCAOB.

Turning to my personal experience of the changing environment in the UK, let me focus on the company where I chair the audit committee and what if any were the differences in reporting I've seen as a consequence of the changes.

By way of scene setting, we are a financial institution. The second largest building society in the UK with 55 billion dollars of assets. We are involved in savings and loans but also have a regulated financial advice business, have some complex financial instruments, undertook two significant mergers during the financial crisis and accounts under IFRS. As a consequence, we have a number of significant judgments to make each year, and also carry some significant risks.

So at December 31, what did our auditors report on? Well let me start by saying that their comments were merely on the risks, which could result in material misstatements in the financial statements relating to critical accounting policies and estimates and the judgments made by management.

Firstly, let it be said that the audit opinion, i.e. the pass or fail opinion, came right up front in the first paragraph. So no confusion there. Which was a concern expressed yesterday by some presenters.

They made specific comments about going concern and the work that they had undertaken. But also had to comment whether they had identified any material uncertainties that cast significant doubt on the group's ability to continue as a going concern.

They helped to define materiality and the level of audit differences that would be reported to the audit committee. That was covered yesterday, so no need to say more now.

The most significant change however, was the requirement to identify the areas of risk that our auditors consider could give rise to material misstatement in our financial statements. And how the audit scope responded to those risks.

Our audit, the risks identified were loan loss provisions, particularly important due to the change in economic levers; fair value adjustments, an important judgment as we set those provisions a few years ago when economic conditions were quite different; revenue recognition; provisions to customer remediation as a result of some legacy and current issues identified by the regulator where we had to make provision for future payments to our customers; and potential fines to the regulator.

Capitalization of costs. We're undertaking a very significant upgrade of all our business systems over the next years. With both internal and external experts, and totaling hundreds of millions of pounds.

Hedge accounting, treasury instruments where there is no active market and deferred taxation. Again, reasons articulated yesterday.

You can see from this list, the risks require the company and the auditor to exercise a high level of judgment. And all or a combination of any two or more could have a very significant impact on the report of profit and the financial position of the group. As a financial institution, those matters were seen to be useful to the understanding of our financial position.

In the Rolls Royce audit report mentioned so often in the submissions yesterday, the risks identified centered on revenue recognition, recoverability intangibles, accounting for subsidiaries and associates due to the many collaboration agreements, liabilities arising from sales financing arrangements, bribery and corruption, and presentation of underlying profit.

Very important to understanding the Rolls Royce position so tailored to that company's circumstances. But quite different from those disclosed in my financials.

So what about the audit committee and the auditor engagement? Was there any difference? Compared to previous years, there was certainly more engagement between the members of my audit committee and the auditor. This was partly due to the enhanced audit committee reporting. But also due to the changes in the audit report.

Both were new requirements in 2013. We had common interests to say what we had done and why we had done it. There was early engagement and improved dialog during the audit process. The audit committee were more engaged during the audit planning phase, focused heavily on key matters within the financial statements, and were far more engaged with management and the auditors to ensure appropriate judgments were being made and that the reporting of these judgments was appropriate.

There was more detail provided by the auditor to the audit committee as to how they had satisfied themselves on the key judgments. And there was more challenge to management.

As far as the audit team were concerned, the members were far more aware of what was important in the business. And they seemed to share a higher level of skepticism and overall challenge while doing their work.

So let me say some concluding remarks. From my experience across two audit committees with two different audit firms, I am certain that the quality of the audit was improved as a consequence of the changes brought in by the FRC. It also helped to move away from boilerplate reporting. Every company is different.

So the risks and significant matters identified need different disclosure. I don't subscribe to the notion that the auditor will revert to boilerplate. There will be refinements made in the future. But I think the auditors recognize the need to inform, not just comply.

Another added value as a result of better auditor reporting will be that across a number of years, stakeholders will be able to identify any changes in the risk profile within a company. Another helpful piece of information to all stakeholders.

Nick Land mentioned that he did not expect a change next year in the Vodafone audit report. But if there was a change and new risks were emerging, then that really is information worth having.

Another positive is in relation to identifying or helping identify sector issues. Analyzing audit reports across particular sectors can inform on emerging issues. We tend to focus on the concern of a company analysis of competitor-disclosed information. It could be that when you do the analysis, one company stands out as a outlier, thus prompting questions to be asked.

So let's focus on the positives coming out of enhanced reporting rather than have a fixation on the negatives. We need consistency however in auditor reporting irrespective of the jurisdiction where a company resides.

It would be better if we could have just one reporting model across all jurisdictions. But the current PCAOB proposals helped us move closer together. I think looking at the risks rather than looking at the effort should be considered by the PCAOB. But no one party will get everything right the first time. We will improve matters and regulation will evolve just like everything else. Darwin said evolution is a given. We should all take heed of this and evolve.

If the US does not embrace change, I'm sorry to say this, but in my view it would be nonsense if the largest capital market on earth, provided the least amount of information to the investor community on the key matters influencing the financial information on which those investors are making their decisions.

In the UK, in the rest of Europe and internationally through IAASB, the wind has changed. Let us sail in the same direction. And I would encourage the PCAB to move forward just as the rest of the world is moving forward.

MR. DOTY: Thank you. Tony Cates.

MR. CATES: Thank you Chairman. Chairman it's my guess that when Nick Land and now UK regulators chose an accelerated timetable for our review of audit reporting, that was because they wanted the UK experience to be something that others could benefit from.

So I'm very happy to be here today and to talk about what we've been doing in the UK. Let me start by saying, you know, why I think that reform was needed. The catalyst was obviously the financial crisis. But perhaps this just brought to the surface an issue that had been around for some time - a decline in shareholders' trust in companies and in audit.

Audit should have been playing a key role in creating trust between shareholders and their companies. But it became apparent that it wasn't delivering all that it could.

Now to me as an auditor, the value of an audit is very clear. But to the shareholder, the binary audit opinion, just wasn't delivering it.

So I think it was absolutely right that we needed to make a bold move on a long form audit report. To say what we thought the issues were and what we did about them. After all, auditors are for shareholders. So shouldn't we deliver more of the value that comes from our work directly to those shareholders, not just by the audit committee.

Now in terms of putting that into practice, it may be easier for the UK to do that. In UK law, our audit reports are for and addressed to shareholders as owners only, rather than as traders of shares. Using the audited accounts to hold directors to account. And that's not necessarily the case elsewhere.

Now in practice, my biggest worry was the short timetable and a very short auditing standard. Just five paragraphs. However, there was wide recognition that the regulator had laid down a challenge to use those few words to show the value of audit.

And with the UK's less fiercely litigious environment, it was easier for us than perhaps it may be here, to respond to that challenge on the basis of just five paragraphs. Essentially we did that by learning on the job on our September year-end reports. And converting that experience into firm-wide policy and guidance and rolling it out across the firm, with a central team to provide support and a measure of consistency in our approach.

So what was the critical deliverable for us? We saw that as the description of our work on the key risk areas. And it's this, not say the materiality figures which were also required, that really demonstrates the value of audit. By showing how we brought our experience and independent mindset and skepticism to bear.

That demands that we flag the key things that we have to test. So not just that we had to test the subjective assumptions in the risk area, but specifically which assumptions. And not just that you tested them, but how you applied your outsider's perspective with a bench marking against data, or against your own views of say growth potential in the sector or for the specific client.

When we did our KPMG survey of first movers, and at that point only 19 companies had reported in mid-January, this was the area where we found most variety. Not surprising for the most difficult aspect of the new UK reporting.

The UK's new reporting by describing some of our audit procedures, inevitably begs a question. What more can the report say about for example, what the auditor found in his testing? At KPMG in the UK we thought this question should not be left hanging, but should be tackled face on.

So in order to promote debate about that, about the value and about the challenges, we've tested out the idea in a very small number of reports and we've heard about that just earlier, by also giving the findings of our work in each risk area.

That debate has only just started and I'm not here today to promote any kind of position on that. But I do think that you and your stakeholders debate as you debate the way forward for the US, you might want to have one eye on the question of where it could lead in the future.

So back to the existing reporting model in the UK. Is it a challenge to do this kind of reporting? Yes, it is a challenge. Is it worth doing? Absolutely yes.

But at the same time, we shouldn't fool ourselves that better auditor reporting is the answer to preventing future financial crisis. It can only ever be part of the solution, and focusing on the adequacy of corporate reporting, of corporate governance and stewardship, are all fundamental prerequisites, without which improved auditor reporting will mean nothing.

Thank you.

MR. DOTY: Thank you. Liz Murrall.

MS. MURRALL: Thank you Chairman. And good morning. And thank you very much for inviting me here.

I very much welcome this opportunity to give an investor's perspective of the changes that the FRC introduced to audit reports in the UK, and the improved transparency around the audit process that we now have.

I'm here on behalf of the Investment Management Association, the trade body for the UK asset management industry. Our members include the asset management arms of the investment banks, the retail banks, the insurers, the managers of occupational pension schemes and independents.

We have around 220 members in total, and collectively, they have about 4.5 trillion of assets under management globally. 67 percent of those holdings however are held in companies listed outside the UK. They're held internationally.

This means that our members are major investors in companies. And they have an interest in the requirements governing the preparation and audit of these companies' accounts and the information disclosed to them as users.

So what do investors want from the annual reported accounts, and the assurance and audit of that information? Essentially the accounts are a confirmatory document published some time after the events to which they relate. They're about management's accountability to its investors. The shareholders who put up the risk capital and bear the residual risk.

Management is entrusted with shareholders' funds and corporate reports should show how those funds are put into use and performance derived from them. Accounts show the accountability with stewardship of management.

The fact that these accounts are subject to an audit is vital to investors' confidence in those companies, and the markets value the information and investors believe what they're told about their investee companies. If that presumption was exposed as faulty then the system could seize up.

Nevertheless, investors have had concerns about the quality of the audit, the auditor's accountability and transparency to investors for some time. Certainly well before the financial crisis. Many of these concerns were a product of the fact that investors felt excluded from the audit process and the real findings. They were largely invisible.

And whilst as we've heard, the binary opinion, pass or fail, is very important, the audit reports otherwise tended to focus very much on details of what the auditor did not do, rather than what they did.

It's been said that 91 percent of investors do not read audit reports. I don't think that's surprising given what's in them. But I would actually refute that. I think investors do look at the audit reports, but it's very quick. Just to see whether or not it's qualified or not and who did the audit.

All this did the profession a disservice and some investors were questioning the value of the audit. This needed to be changed and trust reestablished. Tony has mentioned trust in his opening statement.

The FRC's framework was a welcome part of that change in introducing a more enlightened audit report. This was a big leap forward. It is the most significant advance in auditor reporting in decades. And a challenge has been thrown down to auditors and a competitive edge, if you like almost, introduced into audit reporting.

And whilst the 30 or 40 examples of the new style reports are quite mixed, this is an evolving process, investors are very positive about the changes.

So what has changed? First the FRC requires auditors to disclose audit materiality. This should mean that investors are better able to assess the quality of those reports. Currently we have few indicators or no indicators of that.

Most importantly, the new audit report tells investors what the auditor assessed, as we've heard, the main risks of material misstatement. Effectively what the critical accounting policies and estimates were.

What is important here is that it's not a kitchen sink approach, but a risk-based approach. Investors don't want a laundry list of procedures. What they need to know is why something was a risk of material misstatement, what the auditor's response to that risk was, and also what the outcome was.

This information will help investors identify and understand the significant judgments in the accounts. It gives them a hook to further challenge executive management and hold the audit committee and external auditor to account.

This greater understanding should contribute to the relationship between management and investors, enhanced trust, and ultimately, in the long term, reduce the cost of capital and increase the value generated for investors and the end beneficiaries, their clients.

So what have we found? Well the requirements were effective for accounting periods starting on or after October, 2012. And I think it was commendable that certain companies adopted early. As William said, B Sky B did and also Ashmore and Vodafone. And I think Vodafone was producing annual reports in accordance with this while the ink was still drying on the revised standard.

Concerns were raised yesterday whether the information could be market sensitive. As I've said, the main role of accounts is as a confirmatory document to the market. They're historic and produced some time after the period to which they relate.

The information that is price sensitive has to be disclosed under the market abuse regime. And as for investor's decisions themselves, they're more likely to be made around the preliminary announcement or investor road shows than through the accounts.

But the key thing and the important thing is that all this information that is out there can be tied back to the accounts and that these accounts have been independently assured.

There were also concerns yesterday whether this reporting could result in mixed messaging. We don't believe that is the case and we haven't seen that to date. I think it's important to remember that the preparation of the accounts is the responsibility of the company and its Board and they should made the necessary disclosures about the company's position and performance.

As regards to the transparency we're discussing here, only the auditors can report on what they actually did and what they found. However one of the concerns that we did have is whilst the FRC's requirements tells investors of the key risks and how they were addressed in the scope, I think it's -- many of us are asking questions why it didn't go further. And ask what did you find. How aggressive or cautious did the auditor find the company's estimates or judgments.

This is something that's already subject to a dialog between the audit committee and the auditor. And investors would value this insight too. And I think we've heard that there are certain reports. And there are two that I can name, Rolls Royce and UL Resources that have actually gone that step further and reported what the auditor found.

Lastly, several standard setters are looking a proposals to change the audit report. As I said at the outset, 67 percent of all equities managed by our members are held internationally. Investors want harmonized international standards for audit reports.

And whilst we recognize there is some consistency in a number of the proposals, unintentional and unnecessary differences should be avoided. And as Philip has said, we would encourage the PCAOB to follow the steps that have been taken internationally.

To conclude, investors have had concerns about audit quality and the transparency of the audit process for some time.  Steps are being taken to address this and the FRC's package of reforms enjoys the support of the investment community - the real end client of the audit process.

Thank you.

MR. DOTY:  Before I recognize Jeanette Franzel, let me say that while delivered in a very understated British way, these four statements contain bombshells. They are in fact terrific statements.  Jeanette.

MS. FRANZEL:  Thanks for coming today and sharing your insights and experience.  This is very valuable to us.  A couple of you made comments about the need for international -- or for standards to sort of come together internationally.  And we've got KAMs, we've got CAMs, and we've got the UK approach.

And so I'd be interested on your views as to maybe the risks that we're currently facing and how can we bring all of these proposals closer together.  But also I'd like to hear about advantages and disadvantages that you've experienced from the UK approach that maybe we should think about as we move forward with our proposals. So start with Mr. Touche.

MR. TOUCHE: Looking forward to year two. I mean if you look back at year two and you've got a huge amount of variation across border, and we've got significant variation in the UK with companies or firms or partners doing different things, I think it could lead to some frustration.

So I would encourage standardization with the user in mind. And so anything you can do to harmonize and lead with all these various definitions and drive an international consensus would be very, very helpful, with the user in mind.

MS. FRANZEL: Any advantages or disadvantages from your experience that we should keep in mind?

MR. TOUCHE: I mean from the perspective of the dialog with companies which is you know, not the source of my invitation today, I think the primary responsibility for commenting on judgments, as I said earlier, should be with management.

Now as I said, we're blessed with a regime where the audit committee is required in the UK to report on judgments. And I think that regime does not exist in many parts of the world. Including perhaps as much as you would like here.

And so I would encourage some evolution of the responsibilities for audit committees to report on key judgments in relation to the financial statements as part of a package of measures.

MR. CATES: Just from my perspective, I think some commonality is a good thing. But actually we are operating in different environments. And having you know, learning from each other as we evolve, could also be seen to be a good thing.

So there would be some positive things about having slightly different approaches. I think in the UK, the short brief kind of overview standard, the five paragraphs I referred to, actually enabled us to be quite innovative in the way we were doing things. And so different partners and different firms have taken slightly different approaches. And I think that's benefitted all of us actually because it will help us evolve a much better product in the long run.

MS. MURRALL: I think in terms of trying to align the requirements internationally, I think what we've seen from the European Commission and we've seen from the IAASB and the FRC, is they're actually focusing on things like material misstatements, significant risks.

So it's getting away from ensuring that we have a sort of laundry list of issues. And I think that would be very helpful. And just the terminology itself is going to confuse -- could potentially confuse the international markets if that could be aligned.

As to the advantages and disadvantages as to what we've seen in the UK, and I think there have been a lot of advantages in terms of opening this Pandora opening this black box so that we can see what happens in the audit process. And I think that is going to help the dialog between auditors, management and investors going forward.

But the potential disadvantages is potentially as we heard yesterday, as to whether or not this could become boilerplate over time. And if it's not read, then it's not going to be any use to anybody if that does happen. I think there are various safeguards to prevent, to help that.

The fact that the standard itself is very high level and principles-based, and gives the firms a lot of flexibility in terms of what they're reporting. And also was saying a lot of sort of change in the audit process. There's been a lot of pressure and there's been sort of a regulatory proposals for mandatory rotation and tendering. So we're going to have more change of auditors. And I think that will bring a fresh pair of eyes to this reporting and change this.

And of course it is different in the UK in that we have a different sort of corporate governance regime. We operate very much with -- under company law with shareholders having certain rights to monitor and respond to what happens in companies. And a very strong role for our audit committees, which is not necessarily shared internationally.

MR. DOTY: Jay Hanson.

MR. JOHNSON: I was only just going to add a point. That when I, and Martin was also in the IAASB CAG and when they were talking about this project for ISA

700, they were coming up with all manner of things. And I think that there -- they took on board I think that the auditor can't second guess what all the stakeholders will want to see from the audit report.

And I think that is absolutely critical that what is reported is useful information. But doesn't lead people down the road through the financial statements and pinpoint certain things that you ought to look up. You have emphasis -- if something's so important, you have an emphasis matter paragraph.

But I think that you do have to be careful that you don't take away from the user, the ability to read and inquire. And that was a good move. And I think that evolved through the process.

So I would -- all I would say as far as the PCAOB is concerned, it is good not to be too prescriptive and good not to as the chairman was talking about yesterday, leading the witness.

MR. DOTY: Jay.

MR. HANSON: Question for the gentlemen that have actually had to do this one time now. It's a two part question.

One is my observation about the ability to describe the risks, the materiality and then the scope of the audit, how it addressed the risks. That for the well-organized, proactive engagement team, that could pretty much be done at the time you've completed your planning for the engagement. And look back at the end to say well gee, did anything new come up for new risk or anything unintended that we need to do to change how we describe the scope.

And so I just want your thoughts to do it -- did I get that right? That's effectively what, and setting aside maybe the first year of implementation challenges, but that's directionally what your new standard is suggesting.

But then also to connect to something that Ms. Murrall said. That that's one level of helpfulness for investors, but the more helpful thing is going to be so what? What did you find? And maybe your thoughts about the practical implications of how difficult that may be at the end of engagement, to then describe, what did you find?

MR. CATES: I think in terms of the actual risks, what we're really doing to some extent is describing the risks that we described to the audit committee at the outset of the audit. And we monitor them through the audit and we focus our attention on them. And we comment to the audit committee on them at the end of the audit.

And in some sense, it's a frustration, or has been a frustration that actually we have that focus and that debate. And really, you know focus on those risk areas through the audit. And then historically just come up with this binary audit opinion and no one really knows what we focused on.

So actually, it's been a release in a way to be able to say you know, actually these are the things that we did focus on. And ordinarily and for well-run businesses, you will find that you know what those risks you expect to be at the outset and you follow them through. But you're also ready to be flexible at the end and to be skeptical about what new risks might come up towards the end of the audit.

So I think that ties in very well with the audit committee reporting you know, for sure. Now the second part of your question related to the so what question.

And we've released -- KPMG has assigned two reports now, the Rolls Royce report and the New World Resources, which Liz mentioned, where we have put some additional commentary on.

It was with some trepidation that I authorized those approaches and it is one audit partner that has done that. And we spent a lot of time thinking about that. And I'm not really -- we didn't' do that with the intention of doing that in a more widespread way. We did that with the intention to really be bold and to start a debate.

So we haven't really decided where to go with that in the future. But clearly it has kicked off a debate. I think again, what we're doing in that situation is being even more open about the type of discussion that we have with the audit committee. Because we would always have that sort of discussion as to how you know, the level of judgment involved in provisioning and where the company sits on that.

I do feel that you know, it might be -- it will be difficult in the long -- it will be difficult in the short term should I say, to actually you know, do that with a wider number of companies. But I'm glad we've kicked off that debate at least.

MR. TOUCHE: So yes for sure in the transition year in particular. Most of our clients wanted to see what the audit report would look like before we had done the pass.

So yes, when you present your planning paper, the chances are most of our partners have also presented an outline of what it might look like. And that's just good communication. It allows the annual report to be constructed in a cohesive way.

It allows the audit committee to start thinking about how they're going to describe the key risks and judgments that they're responsible for making. So that they can start thinking about their language and so on.

So that up front communication is essential. And if there's fear in transition, that de-risks and removes quite a lot of that fear in that transition period.

Just coming back to the so what. And the commentary on individual judgments. And as Tony said, I think there is a debate to be had that's only just beginning. My -- and of course the fear is that by commenting on individual items in the financial statements, you take away from the true and fair view as a whole. It clearly provides color to that. Because there is a range of judgments that all add up.

And we were just talking with Liz earlier and you know, the problem is if you need to go down this path and you say oh, you could have done this, or you could have done that. Or it's a bit cautious, or a bit aggressive here. Investors of course will want to know well, supposing you added all that up, what would the impact be. And then you get an alternative set of numbers.

So this debate will run its course. And I hope that we'll end up with an opinion on the -- a view that reinforces the opinion on the financial statements as a whole rather than a whole list of individual opinions on individual judgment areas.

MR. JOHNSON: Can I just make one point from the audit committee experience. Certainly when we had the report from our auditors to the audit committee, they did, because of all the areas that they were covering, they did put us onto a spectrum.

So each individual item that I commented about before, whether it was loan loss provisioning, whether it was fair value, et cetera, et cetera. And certainly valuation methods and results. There was, all those were on a spectrum.

We found out as a board -- well as an audit committee and then subsequently that was taken to the board. We found that very useful to assess where we were compared to our peers. Because the auditors did have insight of what was happening in the market, what was happening in that class.

So we were much more comforted by the fact that we had that information available to us as a board. Now the question then is should that be rolled out. I am very much aligned with William, with having some caution about having a whole series of mini-opinions. The audit opinion is the financial statements as a whole.

So if we're actually -- if you, it depends how far it goes to what is described. Because I wouldn't like to be in the position where every major judgment area on my balance sheet had a mini-opinion on it.

But I think it is -- you know I think it is a debate that needs to take place. And I know that it is already started. And the interesting thing for me is that we're now only, we're six months in. That's all we are. Sixth months in. There's only been 40, 50, whatever number of reports that have taken place.

And already, the auditors are starting to talk about what more they can do. What more information that they can get, rather than go the other way around and saying well, after the first round perhaps we went a bit too far with this or a bit too far with that.

So I think that's an interesting dynamic as far as the audit firms are concerned. Is that they're looking to moving it forward even more. Whereas in the past there had been reticence to do anything.

And so I think that's encouraging. And certainly from an audit committee perspective, we like to know where we sit on that spectrum, and we don't want to be, you know we are a conservative financial institution. So we don't want to be having racy policies and racy judgments. And it does help us to ensure that we're not in that space.

MS. MURRALL: Thank you. I mean I think investors do want to know where management's judgments lie. And what the audit work was done on that and the assurance gained by it.

And if we look at the requirements as they stand, the audit committee is required to report on the significant issues on what they did. The auditor is required to report on the risks of material misstatement on what they did. But no one is required to report on what they found. Investors want that information.

MR. DOTY: Thank you. Lewis.

MR. FERGUSON: Yes, as I understand it at the present time, these requirements are limited to a subset of public companies, whether it's the FTSE 350 or whatever it is I don't know, but it's a subset.

So I have two questions. One, what do these new requirements do to audit costs and/or fees? And two, will it be and should the requirements be expanded beyond the original subset of companies? Should they be applied to all public companies for example? Or all audits?

MR. CATES: In terms of -- you're right, it's limited to companies actually that comply with the combined code which is largely the FTSE 350 and some others that comply voluntarily.

In terms of costs, I heard Nick Land say yesterday that they didn't think there was any cost. I mean I can ensure you there is some cost. The -- it's not so much getting the issues together. We've already got those issues together for the audit committee. But it's actually you know, drafting the statement and having some form of quality control over the audit opinion.

You know so at KPMG in the UK, we issued around 80 opinions in total. And some in the future. And actually we have a centralized process and we set aside not just our technical people, but some of our best client-facing partners to also review those opinions, so we could get some best practice.

So all of that costs. But it's not a huge cost.

MR. FERGUSON: Were those passed on in higher fees?

MR. CATES: And in most and many cases yes. They were passed on in higher fees. But not -- I wouldn't say that significant fees.

Should it be expanded to other companies? I think it covers the main companies that investors are invested in. It's probably more a question for Liz than me.

MS. MURRALL: Yes, I mean it covers all companies that are required to adhere to the UK corporate governance code. That is a premium listed segment in the UK. And that is the main UK listed companies.

I suppose one of the concerns that I do have is increasingly we're seeing overseas companies come to the UK to list. And they may have significant operations in countries that may not have the same auditing standards and it's how they're going to actually adhere to this going forward. I think that could be a difficulty for them. Because you need uniformity in the list.

As regards the costs themselves, as regards to investors. Auditors are scrutineers on behalf of the investor community. We don't have any issue with what it costs, although obviously we wouldn't want to see the costs should be any cost increases should be reasonable.

But I think in terms of that, particularly the increased tendering we're seeing, I think there is a concern to whether or not the audit tenders could compete on cost. And I think it's very important that that process is owned by the audit committee such that cost doesn't drive the decision and its quality. Thank you.

MR. TOUCHE: I echo what Tony has said. And I think it's worth just bearing in mind that the auditor reporting regime was introduced with a package of other measures for boards and audit committees. So that helped if you like in the whole company redesign of annual reports in the last six months, which also has been a modest additional fee. But as Tony said, not enormous.

MR. JOHNSON: Our fee went up really marginally. There was no significant increase in those costs certainly as far as the company was concerned. I don't know whether the auditors will be looking at their margins next year, having gone through the experience and how much time they did have to put into it.

But certainly from the first year that we experienced it, it didn't increase the costs. Whether it should go any broader, in the UK of course we -- there's a large number of companies other than the FTSE 350 that are subject to audit.

From a personal perspective, if you have stock listed on a stock exchange, then why shouldn't you have -- why shouldn't you give this -- why shouldn't the auditor give this information. You can easily lose money. The investor can easily lose money on small companies as they can with large companies.

So I think it's not necessarily a size - from my perspective, it's not necessarily a size issue. It's the fact that you have external shareholders investing in your company. And I think that you have to have that mindset. And a lot of the companies, if it goes down to private companies, which in the UK a number of private companies do have a foundation to have audits.

Then, when you've got management and owners, it's a small group. I don't think there is a need to do it across the whole spectrum.

MR. DOTY: Steve Harris.

MR. HARRIS: Well Mr. Touche, first of all, I commend you on your testimony. And when you say without becoming too sentimental, I don't think you were at all sentimental.

But I do think your testimony was extraordinarily powerful. Especially in light of the testimony that we've had the previous day. And the way that you grasped at the opportunity and the pride that you took in your profession. And the way that you relished the challenge to reestablish the value of the audit.

And the public interest nature of our work and how it invigorates their personal responsibility, the auditor. And how important it is what you're doing on behalf of shareholders, and if we can take the lead, we will. I think that view was shared by all of you.

But I just want to say that that is in juxtaposition to some of the comments that we've heard the previous day. And I for one very much appreciate the understated way that each of you communicated that message.

I guess I have two questions. One, you all speak about investor groups and the outreach to investor groups. And Liz let me take you out of this conversation for a moment because you are generally viewed among the investor constituency as an investor advocate. And I say that from my perspective in a very positive sense of the word.

In the United States, investors are often criticized as not having any idea really what they want. Not speaking with one voice, not having a bottom line.

And the profession being unable to glean what investors want.

Two parts of the question. One, could you describe a little bit of your investor outreach in the UK. Who are these investors and how much money do they have under management?

And second of all, do they speak with anything even remotely approaching a unified voice I terms of what they want and in terms of a bottom line.

MR. TOUCHE: First of all, thank you for your very kind comments. And I think we're all very pleased to be here to make a contribution to your debate.

Yes, we're very lucky. I mean London is you know, a very large capital market. All of us who are practicing there in London, head offices of the big four firms all located within you know probably half an hour's walk of most of the investor groups' offices. And there are probably only you know ten or a dozen people that we need to know. And we are in very regular contact with the representatives of the investor groups, of which you know, Liz is one.

So it's been very strong and open dialog both between the firms and the investors and the regulators and the investor groups. And that dialog has been not necessarily in plenary forum. It's been one-to-one. We've been exchanging messages and emails, and all the rest of it with people as this thing has evolved.

So it has encouraged an open dialog. And as far as our firm is concerned, two years ago we have -- we instituted an annual general meeting where we invite stakeholders, the public interest to come and hear what we're doing on audit quality and innovation and all those other things. We started that a couple of years ago.

That's gone down very well with the investor groups. And it's their opportunity to quiz us in the form of an annual general meeting, about what we're doing. So that's part of our public interest agenda.

As far as engagement with the companies is concerned, which I think is the other part of this question. I think this is all quite new. Liz mentioned earlier that we've had the remuneration and regulations all changed and investor groups have been very distracted by that's taking up an awful lot of time to form policy with companies.

And we are now waiting and companies are now waiting to see how investors will engage with this huge amount of additional information that they have now received. But we know in advance that for example, the corporate governance teams have been relocated in many instances to sit alongside the fund managers.

So then more integration in some of the investor houses so their joined up dialog, you know, is brought to bear with the companies.

And then the other feature about the UK regime is that we have, the FRC is also responsible for the investor code, which is the stewardship code. To encourage investor groups to reach out to their investee companies.

So we're fortunate that we have the one regulator responsible if you like for all angles in our little dynamic within our -- the city of London where we can walk to each other's offices.

MR. CATES: Just a couple of things to add for me. I mean I think things are changing. I hosted a round table of FTSE 100 audit committee chairs a couple of years ago with some investors. And actually to a person, they'd had -- no investor had ever talked to them about the audit. Where they said their remuneration committee chairs were always being asked to go and report on remuneration. They haven't had the discussions around audit.

Now that was a couple of years back. And I'm hearing now that that's changing. Part of that due to -- part about interest in audit reporting I think is changing that. And part of that is EU audit reform and rotation and tendering.

And so we're seeing investors, from my perspective at least getting much more interested in audit and what's happening in audit, which I think is a good thing. After all, it's the investors who we report to.

MR. JOHNSON: Can I just, I'd just like to pick up on, not to repeat what's been said, I'd like to pick up something that William said, and that was kind of dialog.

I think in the UK, what we have found is that over the last four or five years, perhaps even longer, that firms, investors, regulators, preparers, academics, have got together and started to talk -- and talk about the issues. And talk about resolution of issues.

And so -- and it may be because we're all in one place, i.e. in London, and we're all within half an hour's walking distance of each other. But there has to be a will for people to actually engage with each other.

And I think that in the UK we've been very fortunate that there's been that engagement. From my experience in Europe, that has not been the case in many parts of Europe. There hasn't been that dialog. There hasn't been that engagement.

And the things that have been happening as you mentioned Chairman this morning, the vote has taken place now. And so we've now got law in the European Union. On many matters relating to the audit firms and auditor reporting and even wider, that a lot of the comments that were being made during the early parts of that couldn't be made by the jurisdictions because they couldn't see the future. Because they hadn't had the dialog.

And I think it is so important that the groups do that, have that dialog. And so I would encourage as much dialog as possible in order to get all these groups facing in the same direction.

And I was also on -- and it goes wider than that, and it's looking to see what more you can deliver. What you can look at. And I was asked to be on a group, on Sir David Tweedie's institute, the ICAS. And there we were looking at assurance on management commentary.

And this was before any standards, it started two, two and a half, three years ago. And the Scottish Institute got the groups that I mentioned, but even further in the group, journalists, financial journalists. And a whole spectrum of -- and there was about 10 or 12. All from a different background. Whether you were an auditor, whether your were an investor, whether you're a journalist. Because they've got an interest and they've got an influence as well through financial journalism.

And it was really looking at where the future was and what things might change. And I think just getting people talking and having that dialog is so important if you want to get the right answer. Because there's all different groups, have different interests. And it's actually making sure that we try to take away some of the concerns, but also get to what, as much as possible, people do want from all the various different groups.

MR. HARRIS: And then Liz, I didn't want to keep you out. In the United States the fourth hitter in a baseball batting order is the power hitter. That's known as the cleanup. I want to get the three gentlemen on the record.

But if there's anything you'd like to add in terms of the, I guess the bottom line, one of the bottom line issues is do investors from your perspective know what they want in terms of the audit report and some of these issues we're dealing with?

MS. MURRALL: Investors covers quite a wide population. I mean it sometimes can be taken to include this little analyst population. Whereas the investors that I'm representing are the institutional long term investors, the people that put up the risk capital. And I think you will probably get a different perspective from long term investors to analysts preparing sort of research reports. I think it's a different focus as I think I outlined in my talk.

But also what I would highlight in terms of investors' interest and their engagement on these issues, William mentioned the stewardship code in the UK. This became -- this was introduced into what is now the FSA's rules in December, 2010. And we do, as an industry body, the monitoring on behalf of the FRC as to what adherence to the code actually means in practice.

And what I would highlight, is that in 2010, there were 80 signatures that had committed to stewardship and the code. And in 2013, there are just under about 300.

So investors are engaging on these issues and they are reaching out to companies and auditors to develop that dialog. Thank you.

MR. DOTY: The Chief Auditor has his flag up.

MR. BAUMANN: Thank you. I want to first of all share in the comments that the Board members have made about the quality and depth of your presentations and comments. So thank you very much for all of that.

Mr. Touche, in your commentary, you say a lot of the success of the regime in the UK is because at the same time, it's introducing a new regime for audit reporting. The FRC introduced new requirements for the board to report about judgments and estimates and other matters like that. No similar initiative is underway in the United States with respect to audit committee or board reporting.

So if I could ask you to speculate a little, all of you, the auditors certainly speculate. Since there's no similar initiative underway here, what, well if you didn't have a similar initiative in the UK, how would that have impacted your reports and your progress in terms of reporting, this extended auditing reporting.

And then maybe Ms. Murrall, from your perspective, what would be the perspective of the quality of the information you received if it was only the auditor report on the risk of material misstatement, but not commentary, at least from the audit committee on significant judgments and estimates in financial reporting.

So given that we don't have the two legs of this stool, how would you think it would be different?

MR. TOUCHE: I think it's quite tough and I'm sure that's why you're asking the question. I think it is quite tough. And I tried to draw that out in my commentary. I think the auditor can still comment on the areas of focus. And the real question is if the areas of focus are then commented on by the auditor in their report without findings, how are you going to get the findings presented.

And I suspect that you would find that behaviorally, if auditors do that, audit committees may well wish to comment on judgments in the MD&A, or other areas of the front half. So I suspect these things will happen naturally without the structure that we've been blessed with in the UK.

Because I -- and the questions around original information about the company and the company's conclusions. And I suspect most companies would say actually we want to earn the communications of those. And I think from my perspective, that's right and proper.

MR. CATES: Not much to add to what William said. I mean I absolutely agree with what he said.

I mean what we found in our initial survey was that by and large, the issues that the auditor raised in the audit report were the same issues that the audit committee had raised. There were one or two differences, but generally speaking, you know there was a commonality between what the audit committee said was really important and what they focused on and what the auditor said was important as well.

MR. JOHNSON: Martin, I did say in my submission that I thought it was very important that the audit committee report does move along. It's interesting, the audit committee, the report that we have, one, two, three, four, five, six pages long, and it covered the work that we'd done as an audit committee.

Interestingly, I signed it in my personal name as chairman of the audit committee. Just as William and Tony signed the audit opinion in their own name as auditors. And I think that it's all about you know, it's accountability and all the things that we talked about as I was saying.

And it would be interesting. I don't know what we would have done as an audit committee if the FRC hadn't said to us, you need to enhance the reporting. You need to do this, you need to do that. I get the sense actually, because given the amount of engagement that we have with the auditors, we actually might have wanted to write the story ourselves and put our perspective on it.

You know I can't say that that would be the case. But I just feel that you know certainly with -- I'm very fortunate, I have some very good audit committee members. But I think that the companies haven't come screaming to this table. They've actually embraced it.

And Tony mentioned that this was a collaborative approach as far as the reports that they issued. And you know, Deloitte was the first with Nick Land as chairman of the audit committee at Vodafone. And that went before it was mandated.

So I think that in the UK, there is a realization that more needs to be done in reporting. And it gave us a framework to work to from the FRC. But I actually think that we would have probably said more than we would have had to, even if it wasn't there. And I think that is useful.

MR. BAUMANN: And then from your perspective Ms. Murrall, what would be the value of the risks of material misstatements without the audit committee reporting on the judgments and estimates?

MS. MURRALL: Well I think if the auditors start to report on things that management has not reported on, I think ultimately it would drive management to report. Otherwise they'd be seen as being you know, dereliction of their own duties to set out their financial position and statement of performance.

So I think there's a strong likelihood it would actually start to drive management to disclose that whether or not the audit committee was disclosed elsewhere in the accounts.

MR. DOTY: I'm aware that I'm standing between this group and lunch. I want to observe that I was pleased to see in the ICGN letter to the IAASB, a ringing endorsement of the point that naming the engagement partner in the audit report improves transparency and provides additional accountability that you believe will foster audit quality.

One of the issues that we face and must wrestle with is how you know that investors will find information useful and why we think it's useful. Mr. Touche has I think written and spoken eloquently to the fact that the more information that is in the new FRC standard, one of the great benefits of that information being that it has improved a sense of professionalism and a sense of meaningful role for the auditor.

There are other statements shot through your -- that appear in various of your papers on this. We heard in one of the panels earlier, that there is a lot of information that investors may want. Investors always want more information. Information increases volatility.

And is it really information that protects investors, or is it merely information that gives them a desired or an imagined benefit? What I find striking about all four of your views of this subject is that first you do not seem to me to insist that investment -- that investors show that their protection requires a certain level of transparency and information.

On the other hand, you seem sure in your confidence that the information that is sought by the FRC proposal and the now European standards, will benefit investors. And it would be very helpful to our thinking if you could instruct the Board on how you know this is beneficial. And whether investors -- how will investors make good use of the information?

MR. TOUCHE: So let mention just the, go back to the one piece that the FRC and package that we haven't focused on. And that is that the company has to explain its business model and the risk inherent in the business model.

So from the very beginning of the annual report, you get a flow focused on what the core business is. What are the risks and challenges. And by the way, we've also had a very clear mandate from the FRC that the annual report is not a marketing document. It is a report about stewardship.

So it's supposed to have balance and be fair and understandable and all those other things. But you start with a business model. And then the accounting risks that we end up describing are those that flow from the company's business quite naturally.

And if you start with that framework in mind, that is the essence of what the investors would like to understand further.

MR. CATES: A couple of comments to add to that. I think the information through the audit report really has given the investor some kind of hook to discuss those risk areas with management, with the board, which it just never had before. So there is a wish, for the investor to have that type of discussion with management.

And secondly, just an observation is that in 20 odd years of auditing, I've never had so much kind of interest from investors in what I'm doing and sort of emails out of the blue from people saying this is a really positive thing.

And much more engagement with investors as a whole. Not on specific companies, but as a whole. And I can only see that as a real positive.

MS. MURRALL: I think it's disappointing if investors keep on asking for more. Because what we do want is accounts that tell a story of management stewardship of the business. And we need cohesion between the front half and the narrative reporting and the back half and the numbers.

And I think one of the requirements that the FRC introduced, which I think we very much welcomed, is the directors have to state that the accounts are fair, balanced and understandable.

And I think that that is a very good move.

Because I think in the past you could have taken a set of accounts. You could have ripped the front half away from the back half, you may have had trouble matching the two.

So I think you know, we want accounts that tell a story as to what management has done to resources entrusted to it and exercised its stewardship, and that story needs to be cohesive, not full of clutter.

So whereas there may be requirement, people may ask for other information, I think there is other information that could be disposed of in the accounts. Like do we really need to have the director's remuneration regulations in the accounts? Do we need to have all the accounting policies, where they're generally just a restatement of IFRS.

I think these things could be looked at and we could cut some of the clutter. Thank you.

MR. DOTY: Again with the profuse thanks of this Board, this institution for the distance you have traveled, and the thought you have given to helping us with what is perhaps the most challenging and the most important standard setting project that we have.

Thank you. Each of you, thank you again. And it's been wonderful to have you here.

We will adjourn for lunch and we will reconvene promptly at 1:00. Thank you.

(Whereupon, the above-entitled matter went off the record at 12:15 p.m. and resumed at 1:00 p.m.)

A-F-T-E-R-N-O-O-N S-E-S-S-I-O-N

(1:00 p.m.) Audit Tenure/Elements of Auditor's Report

MR. DOTY: Well, good afternoon.

Peter Clapman is formerly the senior vice president and chief investment officer for TIAA-CREF, chairman of the governance committee and a member of the audit committee of iPass today. He serves on the board of the National Association of Corporate Directors. He is also vice chairman of the Conference of Mutual Fund Leaders, and also a current member of the PCAOB's Standing Advisory Group.

Monty Garrett is vice president of finance at Verizon Communications. Previously, he was chief financial officer and chief accounting officer of Dooson Infracore International, the manufacturer of Bobcat construction equipment. He is currently a member of the Dooson board of directors and audit committee, and he began his career with Ernst & Young as a member of the audit practice.

Joan Amble is the president of JCA Consulting, a public company board member, NACD Council of Audit Committee Chairs at NACD, and retired executive vice president and principal accounting officer at American Express. Previously, she was with General Electric, as chief operating officer and chief financial officer for GE Capital Markets. She's a director of Booz Allen Hamilton Holding Corporation, Brown Foreman Corporation and Sirius XM Radio, Inc. She is also the co-founder and chairman of Women in America, an organization that focuses on the development of women professionals -- not chairman but chair of Women in America.

Jim Liddy is the US vice chair of audit at KPMG, where he is responsible for creating and executing the strategic vision for the US audit practice. In addition, he serves as the Regional Head of Audit, Americas, and chair of the Americas Audit Steering Committee for the firm. Prior to his current role, he served as national manager of audit for KPMG, and the national business leader of KPMG's financial services practice.

A panel that brings to bear omnicompetent experience and insight on the issues of auditor tenure and other basic elements of the audit report. Thank you all. Peter, if you will begin.

MR. CLAPMAN: Thank you very much, Mr. Chairman. And I hope I'm selected to be the keynoter of this esteemed panel on the premise that I can get things livened up after lunch, and I hope my remarks are taken in that spirit.

I'm very pleased that the PCAOB has convened this roundtable to examine very important issues that address the disclosures given to investors about the audit process. In my opinion, the disclosure system presently is flawed in material respects and improvements are necessary.

The PCAOB has advanced certain proposals that, while modest in tone and scope, would be beneficial and should be implemented. Just to complete the record, in addition to my written remarks, I note that I was -- I participated in a roundtable probably about a year and a half ago on the issue of a proposal at that time on whether mandatory auditor firm rotation was in the public interest.

My position at that time was that auditor rotation is a sound premise, should be implemented, at least to the point where companies and audit committees, after a period of years, should put out the audit assignment for rebidding, for further discussion, even allowing for the possibility that the company, the audit committee, would decide if the present auditor is the right choice, but at least make that consideration.

And my concern at that time, which is still a concern today, is that too many audit committees simply make this a routine matter, and do not, as they should, seriously consider the selection and tenure of their outside auditor. And, to me, this goes to the issue of independence.

I also applaud the PCAOB for inviting to this roundtable as many participants from other countries, in particular the UK. In terms of my own experience, as you noted, I was the chief investment lawyer for TIAA-CREF and head of its corporate governance program.

I also chaired the International Corporate Governance Network for four years between 2000 and 2004. And at that time, it was clear, and I think would generally be acknowledged by people in this field, that the governance structures and investor protections in the United States was superior to basic protections and governance practices abroad.

And I fear that this is no longer the case. And I think your participants from the UK hopefully made this clear, that they have advanced certain issues, in fact those including the audit process, which provide for greater investment protection in my view than currently exists in the United States. And, in particular, advancing the notion of whether auditor rotation is appropriate, auditor rebidding is appropriate. I'm talking about after a fair number of years, not to just be done sporadically but done consistently and with a view towards enhancing independence.

And I think including in this last panel this morning it was noted that, for example, if you do implement one of your proposals, which I strongly am in favor of, which is to have the audit report include the tenure, the number of years that the particular audit firm has audited a particular company, that that has generated in the UK, and I think it would in the United States as well, generate more interest on the part of audit committee members, and also create the impetus for investors to care more about this than they currently do.

And part of the problem, I think, for investors is that it is extremely hard or almost impractical for an investor to know for how long a particular audit firm has audited a particular company. And I think the record is clear, and it was clear a couple of years ago as well, that some audit firms have been the outside auditor for particular companies as long as decades. I heard in one case that it almost got to be close to 100 years.

So, that sort of disclosure, which I think would help generate greater interest on the part of both investors and audit committee members, I think, would be strongly beneficial and in the public interest and something that investors want.

I also particularly note that your two new proposals, first to include the tenure of the current audit firm, and then secondly to include the named lead engagement partner, involve no costs.

One of the issues always at stake on potential reforms or initiatives on the regulatory side is whether particular benefits to some parties will be overwhelmed or in some cases offset too significantly by cost to other investors. And, obviously, regulators have got to take that concern into consideration.

Again, my point about these two proposals is that they involve no costs. So, therefore, no investor is unduly burdened with costs affecting disclosures which would be extremely helpful and important to other investors that truly believe independence is a key issue, and that the current system ought to be enhanced in the favor of broader disclosures to protect investors on these audit concerns. Because currently it is very difficult with the disclosure system in place for investors to even find out how audit firms have been selected, how they are regarded in terms of continued tenure and the like, and I think these reforms would be extremely beneficial.

One final note, because I see the red light, is that in my former position at TIAA-CREF, we voluntarily did both. We both did rebidding at certain intervals, and at a certain point we did rotate audit firms. Our experience was that the costs were nominal, if any additional cost, and our audit process and the audit quality was enhanced.

And we believe that if the PCAOB adopted, first, these particular proposals and considered the broader questions, it would be both cost-worthy and protective of investors, in a way that's very much needed. And I support these proposals.

MR. DOTY: Thank you, Peter. Monty Garrett.

MR. GARRETT: Good afternoon. I appreciate the opportunity to come here today to represent Verizon on this panel. We obviously have a keen interest in matters related to auditor reporting. We also spend a great deal of time and effort communicating with existing and potential investors and finding ways to get them the information they need to make informed investment decisions.

To that end, we appreciate the efforts of the PCAOB to address investor needs, and we want to continue to work with the Board and the staff to accomplish this joint goal.

I was invited here today to provide Verizon's input on the proposal to add auditor tenure to the standard auditor's report. Our view on that specific concept is best understood in conjunction with our views on Docket No. 34 as a whole. As such, I'll discuss our view on tenure, and then expand a bit on the overall proposal.

Like many other public companies, Verizon discloses information about its audit firm, including tenure, in our annual proxy filing, where we ask shareholders to ratify the appointment of the auditors.

For the benefit of our shareholders, we also provide background on how the audit committee considers auditor tenure in connection with its evaluation of the auditor's independence, and, more broadly, auditor appointment.

In other words, we see audit firm tenure of one component of a robust governance process discussion in our proxy related to the evaluation of the auditor. Accordingly, we think that reporting of auditor tenure is most meaningful when presented within the governance context.

It's not completely clear to me what conclusion can be drawn from auditor tenure information, but if an investor finds it useful, there does not seem to be harm in providing the information in an appropriate context.

As mentioned in Appendix 5 of the proposal, the available research findings on correlation between auditor tenure and audit quality vary widely. Some researchers suggest that an auditor with a long tenure may have a higher likelihood of independence being impaired, while other researchers suggest an auditor with a short tenure may not have sufficient depth of understanding of a company to render a reliable opinion.

I believe the Board concluded that there was no analytical information to provide any really meaningful correlation. In all sincerity, I do hope to get insight today on how the tenure information is valuable, as we are always interested in transparency and a better understanding of how to anticipate our investors' needs.

To emphasize this point, we come to work every day knowing there are two groups of people that we cannot live without: our customers and our investors. We're fully committed to listening to our investors and caring for their needs, and that includes addressing concerns that have led to this proposal.

To that end, we have chosen to disclose our auditor's tenure information in our proxy statement, and we believe that's the proper home for such disclosure, rather than the auditor's report. Our view on this is a subset of our overall view that an auditor's critical role is to provide assurance that the GAAP financial statements provided by the issuer are materially accurate.

Some aspects of the proposal include discussion of critical audit matters and commentary on other information, may require the auditor to go beyond its very critical core responsibility of providing assurance. As stated in our comment letter, we're concerned with having auditors provide this commentary, as we feel that the first line of disclosure about the company should be provided by the issuer.

If the auditor deems the material misleading or inadequate, and the issuer does not rectify it, then the auditor has the means to opine accordingly. The current pass/fail opinion is clear and concise, and leaves no doubt as to the auditor's view. Free form language may not be as clear and may leave readers unsure of the audit result.

Alternatives were discussed yesterday that we think give investors the additional information on risk they're seeking while preserving the roles of issuer and auditor.

Specifically, the alternative of having the issuer expand the disclosure in Footnote 1 to cover CAM items in a more thorough fashion, along with an auditor-specific review of that disclosure, would seem to address many of our concerns.

Views on that matter were discussed at length in earlier panels. My only point is to extend our view on the issuer's and auditor's roles to the tenure information. Let the issuer provide the information to investors in the appropriate form and context. Investors will receive the information they desire, and the risk of misinterpreting auditor tenure without proper context will be avoided.

We have no issues with the other basic elements of the auditor's report included in the proposal. We're not sure if the additional wording on independence adds value, as the existing reporting format already includes reference to the auditor being independent, but we certainly see no harm in including it.

Again, thank you for the opportunity to participate in this very important process.

MR. DOTY: Thank you. Joan Amble.

MS. AMBLE: Okay, thank you. I appreciate the opportunity to participate today and for all of you taking the time to seek constituent views on these very important topics. The comments I offer are my own and do not necessarily represent the views of the organizations of which I am affiliated.

My background includes positions as an accounting instructor, an auditor, a standards-setter, and for most of my career, a senior financial officer of a major corporation. I presently serve on the boards of three public companies, and I believe you have invited me to participate because of that role.

Therefore, while my comments are informed by all of my experiences, they apply most specifically to those as audit committee chair and member. However, my perspective, similar to most, I assume, is to seek sound financial reporting with an unequivocal commitment to integrity, strong governance and transparency, as it relates to all parties involved. Company management, directors and auditors each have a role to play.

Although asked to comment on auditor tenure and other basic elements of the auditor's report, given the significance of the important topic of disclosure of critical audit matters, I feel compelled to note that I disagree with the direction the Board has taken on this proposal and do not support it as currently written.

Along with the vast majority of audit committee members with whom I've had the opportunity to discuss this matter, I believe including critical audit matters in auditor's reports would lead only to much longer but not necessarily more useful reports by including information already adequately provided by management in footnotes or MD&A.

I was pleased to see that many audit committee members, as well as the NACD, provided input to the Board to elaborate on the reasoning for this opposition.

The other subject not subject to this panel's discussion relates to the auditor's responsibility regarding other information, on which, time permitting, I will provide comment, as that too is an element of the proposed changes I do not support as currently written.

The specific areas to be addressed in my comments today are audit tenure, independence, and auditor's responsibility for financial statements and related notes and schedules and for fraud. While auditor tenure may be an interesting data point for some users of financial statements, I do not support its disclosure in the auditor's report.

Auditor tenure, when taken out of context, has the potential to unnecessarily obscure the question of audit quality and perhaps cause some to erroneously conclude a direct correlation between tenure and audit quality, which, to my knowledge, no verifiable correlation exists.

Further, I do not think auditor tenure negatively impacts audit quality or independence. People and actions do. My experience has been that the engagement team on the ground, and its ability to access specialized expertise within the firm, provides the basis for sound audit quality, not the number of years a firm has audited a company.

In addition, mandatory rotation limits the years senior members of the engagement team can audit, which provides a regular introduction of differing and fresh perspective to the audit engagement. If tenure were to be introduced as an element of governance, the placement seems better situated in the proxy statement as part of the audit committee report, or with the ratification of auditors.

I have no objection with the recommendation to expand the auditor's report regarding independence. However, having said this, I think it is important to underscore the significance of the ongoing review of audit quality by the audit committee, and the use of audit committee executive sessions and other interactions with auditors to understand the nature and the quality of the engagement, and to engage in dialogue about the independence, the integrity, the objectivity and competence of the engagement team and the firm in fulfilling its professional responsibility as the auditor.

This ongoing review of audit quality is a core responsibility of the audit committee, and provides a thoughtful basis of judgment regarding the audit quality we seek, and provides a firm foundation for continuous improvement in audit quality from the auditor.

I support the Board's proposal to enhance the auditor's report by identifying financial statements, including related notes and schedules as part of the financial statements that were audited. I also support the proposal to revise the auditor's report to recognize the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused by error or fraud.

As noted at the onset, I would like to close with my brief perspective on auditor's responsibility regarding other information. As many have noted, clarification of work done by the auditors should be provided in the auditor's report.

If the Board determines it will move forward with this proposal in some form, I encourage the Board to accept Deloitte's offer of assistance in the development of a workable model for expanded auditor involvement with other information.

I further recommend that consideration be given, first, in a phased approach, to the auditor's responsibility regarding quantitative non-GAAP measures. There are many instances when a company feels quantitative non-GAAP measures are more meaningful to users of their financial statements than GAAP measures.

However, I would venture to say that auditor involvement, in terms of evaluating the rigor around the process, the controls and testing of those non-GAAP quantitative disclosures is varied and therein lays an opportunity to clarify what the auditor's responsibility for that information should be, and how this responsibility should manifest in terms of auditor reporting. Thank you for the opportunity to speak.

MR. DOTY: Thank you. Jim Liddy.

MR. LIDDY: Thank you. Chairman Doty, Members of the Board, Chief Auditor Baumann, and other representatives of the PCAOB, SEC and FASB, I appreciate the opportunity to meet with you and share some perspectives on the PCAOB's auditor reporting model project, and more specifically to address the topic of auditor tenure and other potential changes to the auditor's report.

Speaking on behalf of KPMG, we certainly support the Board's objective to improve the auditor's reporting model and increase its relevance to financial statement users, and we are in favor of constructive and practical changes to the auditor's reporting model.

However, as we have heard in certain of the panels, including the one just before us at lunch, stakeholders are not necessarily aligned regarding the nature and extent of such changes. Investors, audit committees, auditors and preparers have differing views on what information auditors should provide.

This is an important project of great interest to many different stakeholders, and one that requires careful deliberation to develop a solution that can be practically applied. We need to take our time to figure out what the markets need relative to what auditors are able to provide. We also need to be mindful of what's happening globally, and certainly over the last day and a half we've gotten some great commentary in that particular regard.

Moreover, we need to recognize and accept that no solution in this area will meet the desires of all stakeholders. In developing possible enhancements to the auditor's report, we have been guided by a set of principles including: one, auditors should not be the original source of information about the entity. Management's responsibilities should be preserved in this regard. A fundamental shift from the auditor attesting to information prepared by management to the auditor providing original information about the company could result in unintended consequences that are not in the best interest of investors.

Secondly, any changes to the auditor's reporting model should enhance or at least maintain audit quality. On behalf of the 7,000 folks in our audit practice in the United States, I can tell you that we're focused on audit quality each and every day, and our efforts of continuous improvement, together with that of the Board, have very positively contributed to an increase in audit quality over the last dozen years or so.

Third, any changes to the auditor's reporting model should narrow, or at least not expand, the expectation gap.

Fourth, any changes to the auditor's reporting model should add value, and not create investor misunderstanding. Specifically, any revision should not require investors to sort through what we refer to as “dueling information” provided by management, the audit committee and/or the independent auditors.

And lastly, auditor reporting should focus on the objective rather than the subjective. Financial reporting matters assessed by the auditor can be highly subjective. However, it's important that auditor communications provide objective information about these matters.

As it relates specifically the topics of independence and tenure, we agree with the addition of language on auditor independence explicitly stating that the auditor is required to be independent. This is consistent with the requirement that the auditor's report be titled "Report of Independent Registered Public Accounting Firm," and provides clarification of this within the auditor's report.

We do not believe, however, that the inclusion of a sentence about the auditor's tenure within the auditor's report is appropriate. As noted in the PCAOB release, no nexus has been established between an auditor's tenure and audit quality, and requiring such information in the auditor's report might give the false impression that a correlation between the two does in fact exist.

We do, however, acknowledge that the communication of an auditor's tenure may be an item of interest to some stakeholders, and we support the communication and transparency that disclosing this information may provide. Therefore, we recommend that this information be required to be disclosed through different means, such as in Form 2, or as our other panelists today have indicated, in the audit committee's report.

Finally, with respect to the topic of addressees of an auditor's report, we do not support addressing the auditor's report to parties other than shareholders and the board of directors, or an equivalent body.

We believe this would create additional litigation risk and would not improve the communicative value of the auditor's report. Adding addressees to the auditor's report will not affect those with access to it. The auditor's report is a general use report available to all capital market participants: shareholders, bondholders, rating agencies, analysts and others, that the issuer can distribute without restriction, and to which third parties have ready access via the issuer's SEC filings.

This concludes my prepared remarks. Thank you again for the opportunity to participate in today's discussion, and I look forward to addressing any questions the Board might have on this important topic.

MR. DOTY: Thank you. Mr. Harris?

MR. HARRIS: Well, I would just agree with Jim. I think it's important to focus on the objective, narrow the expectation gap, and be mindful of what is happening globally on the audit quality. I don't have any questions. I think that I heard from the previous panel what's happening in terms of globally on the audit quality. I think it's different from what's happening here. I think the trend outside the United States is considerably different from what's been going on in the United States. So I think we do have to keep that in mind.

I think the expectation gap is huge, and I think everything ought to be done to attempt to narrow it, because I think the focus of investors versus the profession is not narrowing, it's broadening.

So I was happy to hear from the last panel that there is increased dialogue, and I agree that there ought to be a focus on the objective. So I don't have any questions, Mr. Chairman.

MR. DOTY: Lewis.

MR. FERGUSON: Yeah. I have a question, essentially, for all of you, but may be directed mostly to Ms. Amble. Because it appears as I listened to you is that your view is that the auditor, at most, should be commenting on disclosures by management, and what the management talks about risks and audit policies in its footnotes or whatever should be the source of the disclosure rather than the auditor.

We just listened to a panel from the United

Kingdom, where their model has gone in a very different direction, and as far as I could tell, the investor response to that appears to have been overwhelmingly positive. That's point one.

Point two, it looks like the IAASB is about to adopt a standard that's very similar to ours and -- so there are two questions here, really. One, what should we make of the UK experience? Is it is anomalous because it's the UK?

Number two, do we run a risk as a nation if the international standard diverges significantly in terms of what auditors should do, that we have a standard that does not really comport with that at all?

So it's two questions, but if each of you could address it, I'd appreciate it.

MS. AMBLE: In terms of -- because you're speaking to the critical audit matters at this point, and as I think about that, there's a question about what is disclosed as having been done by the auditors. But, to me, the bigger question is is the concern that there is a view that the auditors are not doing enough? And I don't know how disclosure addresses that.

It would seem to me if the issue is, number one, we think that auditors are not performing the appropriate procedures, if we think that they are somehow the source of the issues that companies have had, whether it's financial failure or accounting misstatements, then I would address that issue. And I would address that in terms of the training, the audit requirements that out there, the protocols and how they are monitored.

But disclosing it only -- as I read, you know, I read through the -- one of the reports, I think it was the Rolls Royce report on critical audit matters, and I found it to be very interesting in terms of what they did. But, honestly, I didn't see anything that was astounding in terms of audit procedures that were done. It made sense for the areas that they were auditing.

So while I found it interesting, it wasn't necessarily that enlightening to me. I did see something that was interesting, because on one of their comments, they mentioned that -- they talked about a design of control having a weakness, which, to me, is now getting at their assertions and their comments with regards to internal controls over financial reporting.

But other than that, that was the only real substantive comment on that. And, honestly, I think that's an area, if they were going to be any discussion, is worthy of more discussion, in terms of what is done to ensure that the SOX processes are designed appropriately, the internal controls over financial reporting are designed appropriately, and that there's the right corporate culture to ensure that issues are appropriately raised, and when raised are appropriately addressed.

I don't know that critical audit matters get to that in itself. I would just get to the direct part of the issue.

The second point that I would say is if there's a concern with the core responsibility of the audit committee, which is to look at the audit quality on a continual basis, not just an annual basis, then I would look to the performance of the audit committees, and whether or not there needs to be more enlightening there.

So I hear your point. Whether there's a divergence of practice, that in and of itself does not create any substantial issues for me. There's divergence in how we account for matters. So, in terms of how auditors discuss their audits, that is not disturbing to me in any way.

I just don't know whether disclosure in and of itself will improve audit quality. And if that's the desired objective, I don't know how disclosing and discussing it achieves that objective.

MR. CLAPMAN: I would try to answer your question in rather broad terms, and drawing back to my earlier point that at one point -- at one stage back in the early part of the prior decade, the US was considered the leading country in the world in terms of investor protections, which I no longer think is the case.

And I think the UK, for example, experience, shows how investor interest on particular questions gets enhanced as regulation or, in some ways, soft regulation through the manner in which Great Britain encourages these developments, really does generate a better relationship between investors and companies, audit committees and audit firms.

I don't think, in response to the last comment, that it's an issue of concern in the UK about the audit committee. I think the point, and it was raised in basically the presentation of this roundtable, that there's currently an asymmetry in terms of regulation, in terms of what the company knows its audit committee deals with and what investors know. And, in the interest of investor protection, I think this asymmetry ought to be narrowed, and I think the proposals of the PCAOB go in that direction, and that's why I support them.

MR. LIDDY: I'm going to refer back to our comment letter, because if you think about the core objective of the project at hand, you know, we do have a responsibility at present, you know, relative to the information that's in MD&A, specifically as it relates to critical accounting estimates and such.

But the practical reporting in that regard is on an exception basis, meaning if there's information therein that's materially inconsistent with the information that we've gained in the performance of the audit. We believe, actually, one of the best ways to help achieve the objective that the Board has laid out is to require auditor association with that particular information in MD&A.

Now, that would require some changes, and what I mean by that is we have to -- the SEC would have to require that the critical accounting estimates section be clearly within MD&A; they'd have to review existing interpretive guidance to determine how it fits in within the context of Regulation S-K.

But then we'd also have to, from a PCAOB perspective, look at the existing attestation standard, and see what we could do therein to more formally associate the external auditor with the critical accounting estimates section within MD&A.

MR. GARRETT: Thank you. I guess the way I look at this as an issuer is -- and maybe I shouldn't, but if the auditor is being relied on to tell the investor so much, I almost feel like I've failed in my disclosure attempts as a preparer.

It seems, in a perfect world, I should be giving all the information that's needed to the investor on the estimates and the other more difficult things to account for an audit, which would leave the auditor almost rehashing what generally-accepted auditing standards are, which is, I know, not the point of all this.

So I feel like we've got to look, as issuers, internally at where are we failing, where we need an auditor to pick up for us. Maybe that's not the way we should look at it, but that's kind of the way I hear it.

As far as the UK comment, the only thing I can say is there are differences in the environment. The accounting is fundamentally different, as we all know, between with IFRS and US GAAP. As Peter pointed out, there's differences in the role of the audit committee and the audit committee chairman.

So I think it's almost unavoidable to have some differences, not to mention, as has been pointed out, we are in a litigious society in the United States. It seems inevitable there will be some differences. But I don't think we can just accept that there will be differences and go on. We should narrow the gap.

I think the last thing I'd say to Mr. Harris is I really take what you had to say to heart. I feel like you seem almost disappointed in us. So we, as issuers of financial statements, don't want to have the PCAOB kind of throwing their hands up and not being happy with what we're doing. So I really listen to what you have to say.

MR. HARRIS: Well, I appreciate that, and we obviously want to work very closely with you.

MR. DOTY: Jay?

MR. HANSON: One primary question that is based on something that, Joan, you had in your statement, but I'm going to direct it first to Jim, and then let the rest of you comment. And then separately I've got a different question for Peter.

So, on the point you made, Joan, about the independence assertion in the audit report, and the importance of the audit committee's role in the dialogue with the auditor about their independence, their objectivity, their skepticism, their competence, it just sparked kind of a tangential question that I'll start with Jim, about what -- at KPMG, what do you do to help educate audit committees and management about their role in making sure that the auditor is independent within the specific independence rules around scope of services and things like that? Which, as some of us know, is an incredibly complex book of rules that sometimes, at least in my view, are not always easy to figure out what the right answer is.

And I'm just curious about what you do to help educate effectively the possible buyer of the services, like you educate all of your professionals as the sellers of the services. And then, Joan and Monty, your experience with -- as preparers and audit committee members.

So I'll pause for a second to let you answer. But, Peter, my question for you is just slightly different from that in that on the auditor tenure question, your three co-panelists have each suggested that, while they don't object to tenure, but it's better placed in the audit committee report. And I'm just kind of curious as to your reaction to their positions on this.

So, I'll start with Jim.

MR. LIDDY: Well, that particular question, I think we've got to recognize that when you look across the spate of public companies that we are associated with, there's different levels of maturities within those companies themselves. And you tend to find, in the larger companies in particular, that there's a level of maturity there, not only with respect to the auditor independence rules, but there is a better and more comprehensive understanding of the roles and responsibilities of management, as well as the roles and responsibilities of the auditors per se.

Now, certainly, whether it be a mature company or one that is, I want to say, less mature, there's a fair amount of dialogue obviously at different points of year, presentation of the audit plan, a very specific discussion of our responsibilities, a compare and contrast to management's responsibilities.

So, I mean, the most fundamental way it gets achieved, quite frankly, is through regular and ongoing dialogue about the auditor's responsibilities, and making sure that there's absolute transparency from an audit committee perspective.

MS. AMBLE:  In terms of -- I'll speak to what approach we've taken on audit committees.  It's really no different than when you're working in a company as well, but there's a number of different things, and there are a lot of good opportunities.

One thing which I think is very helpful is continuing education, whatever form that is; being part of different professional organizations and currently having highlighted what the responsibilities are and best practices and what people are doing.

That is very, very helpful to keep that in front of you in terms of important things to think about, particularly looking how companies are growing and are so much more complex today, which means the audit of those companies is obviously going to be more complex.

So in terms, certainly what I do on my audit committees, is I really look very seriously at whether or not the auditors being assigned have grown with the company, and their skills match the skills that are requisite for the risks inherent within the company, just as you would look at the finance organization within the organization as well.

The other thing is to look very seriously, and not to allow it be reduced to five minutes, is how you engage in the executive sessions with the auditors. That's the time when people can just really talk very clearly and you can get into issues potentially in a more in-depth way, and taking advantage of that, and how the auditors respond gives you a very good indication of independence.

I know there are a lot of independence rules in terms of the investments and so on, and I assume the firm does that very, very well. What we will look to is the character of the individual, and do they understand the culture of the company well enough so that issues are being appropriately raised, and when they are being raised, they know how to deal with the difficult conversations, if you ever have any.

I mean, that is so important to be able to do that, just as it's important for management as well.

The other thing is really the offline discussions you have as well. Anybody knows, if they're not a committee chair, that your job goes well beyond the audit meetings. There's a lot that happens in the preparatory meetings, where you meet with management in advance of the meeting to go through the agenda and the particular topics that will be addressed. But then you also meet with the auditors as well.

And, again, those discussions give you what I call the ability to have the Ouija board test, to understand the talent of the team and how seriously they're looking at things, and if they're looking at the right things.

So those are some -- certainly not all, but some of the things that I think are pretty common with audit committees and audit committee chairs.

MR. GARRETT: I am fortunate to work at a company that does have a very strong focus on governance. We have a very strong audit committee, a very strong chairman of our audit committee, and a lot of the culture flows from that.

I think, similar to Joan, we have a very robust, more offline process of discussing issues with the audit committee and getting their reaction. I think there's a healthy amount of respect between the audit firm and the company and the audit committee that also helps.

There's, I would say -- I wouldn't use the word "tension," but there is healthy challenge that goes back and forth, and it never causes a problem. Part of that is the strong governance culture.

I think, in terms of the auditor getting involved in helping the company with governance, I kind of have a different perspective on that with the company for which I'm on the audit committee, which in some ways the opposite of Verizon. It's a small private company, and there it's almost indispensable, the work that the auditor performs in helping the company understand how to govern better.

MR. CLAPMAN: If I could go immediately the questions that you posed to me. First, I thought I was actually in agreement with Monty Garrett, that disclosure is appropriate. He puts it in the proxy statement, as opposed to the auditor report, which is the focus of this discussion.

I would note that that's voluntary, that there is no requirement that Verizon or any other company do that. And the reality for the investment world is very few companies do what Verizon does do. There are some that do.

So I'll then try to address the other comments from the two panelists that oppose, for example, the inclusion of the tenure of the particular auditor in the audit report.

Here I'll start, at the risk of what you can generalize from an anecdotal experience, when I was at TIAA-CREF, we shifted from one audit firm to another, and one of the benefits to us as an organization was that the second audit firm -- which the first audit firm was high quality; they did a terrific job.

The second audit firm took a second look at some of the questions that had been seemingly resolved with the first audit firm. And in retrospect now, as I view that experience, there were a couple of instances of that. It was a healthy development to go through as an organization, somebody that has a second look at issues that were resolved one way, and see how they might be resolved in another way.

Apart from that, I do take issue with the notion that inclusion of auditor tenure could be misleading. And basically I think that is -- to make that right, you'd have to believe that investors just don't know how to use the information that's disclosed to them, and I would challenge that notion.

I think if you surveyed some of the key institutional investors, they believe that auditor tenure going to the issue ultimately of auditor independence --

and it's not just technical independence. I think there are a few instances where auditor tenure might affect a situation where auditor independence was lacking in the past.

But there's auditor independence and there's auditor independence, and getting back to the second look aspect of it, I think that's extremely valuable. So I would say that there should be more trust that investors that think it's valuable will use it appropriately; investors that think it has no value could ignore it.

It's a disclosure that you could require that imposes no costs on the investors that don't care about auditor tenure. But I believe, just like in the British experience, that once these issues get onto the table, you will find more dialogue, more interest on the part of institutional investors and other investors, and you'll have examples of where a particular audit firm has been the auditor for a particular company for decades, and that will give investors the opportunity to at least ask questions about it. And right now they don't have the information. And that's why I would strongly support the PCAOB making that disclosure a requirement.

MR. HANSON: A couple of reactions. And when I posed my question, it was really in a context I didn't describe, which is in the imaginary world that the SEC would take up the issue of making it required in a proxy statement. So it wasn't just voluntary, which as Brian has observed, we have observed lots of things on the SEC's agenda, and we have no ability to impose that on the SEC, and there might be several things that might be worthy for them to take up.

Another just reflection and a little bit of a surprise at what you've said, is that for the analyst that wants to know how long a company's been -- an audit firm has been a company's auditor, at least I'm not an expert in using the SEC's online filing search system, but in any company I've tried to figure it out, I could figure it out in about two or three minutes, the auditor changes within the last 20 years on the EDGAR system.

So it's not hard to find. So it just kind of surprised me that those that want it can't find it.

MR. DOTY: Do you want to respond to that, Peter?

MR. CLAPMAN: Yeah. There's lots of things that could be required conveniently in the way of disclosure to make the information convenient without going into an elaborate process, even if it's doable.

Again, I come back to the question that this is a costless requirement to put in information of this sort, that some investors, and I would suggest that most of the institutional investors will find this information potentially important and interesting, to make that disclosure better for them is a positive thing the PCAOB could do.

MR. DOTY: Jeanette Franzel.

MS. FRANZEL: This has been a very interesting discussion. Many of the panelists here have touched on issues which we've been hearing throughout these two days, and it's really an issue of, gee, does some of this really belong in the auditor's report? Should the auditor be reporting on original disclosures or should management be doing it? Should the audit committee be putting some of this into the audit committee report or in the proxy statement, you know?

And, unfortunately, the reality is our system of regulation over financial reporting and governance and disclosure is fragmented. So here we are at the PCAOB identifying potential disclosures that might be helpful to investors, and the only thing we can do is require that it be thrown into the auditor's report.

So I think that, in some cases, we're hearing discussion or we're hearing disagreement on certain issues that would be of great value to some investors, but the real disagreement is putting it into the auditor's report.

You know, so I guess we can always just keep requiring more and more in the audit report. But at some point, you know, some of these issues of critical accounting policies and MD&A and tweaks that maybe need to be made on management's side, so that then the auditor can take a different role, would strengthen the system, you know, in its entirety.

So I have that concern, and I would like just to hear your comments in terms of how concerned are you about that. Maybe it's not a big concern. Maybe we can compensate, you know, for all of the problems in the disclosure system by putting it all into the auditor's report.

But I think at some point the fragmentation here will cause risk, and it will cause proposals that might not be the best solutions. I guess what really caused me to go down this line of thinking was Peter's comments that, in his opinion, the disclosure system presently is flawed in material respects.

Well, if that's the case, I'm not sure we can solve it all through the auditor's report. But I'd appreciate any comments or thoughts that you all have on that, how it relates to some of the things we've been talking about, and I see I just caused Brian to raise his name card as well.

MR. GARRETT: I think it is interesting the way you described that, that it's a bit fragmented. And, you know, you have your purview over the auditor's report, and is that really the best way to address some of these things? I think our opinion is maybe not, especially with the items like the CAMs.

Again, it just feels strange to have the auditor giving information other than just their basic audit steps, which, as I think about it, aren't those really available? I mean, you have steps -- everyone uses the same steps to audit certain things. It's prescribed.

So if there's a shortfall, it seems it's up to the company to beef up the disclosures on what things. Again, if it was hard to audit, it was also hard to account for. So if that's the problem we're trying to solve, then we do need to solve it if investors are concerned about it.

To me, it doesn't seem like the audit report is the way to do that.

MR. DOTY: Jim Kroeker had his flag up first.

MS. FRANZEL: Do any of the other panelists want to comment on that?

MR. LIDDY: I guess, if I may, I'll just make one anecdotal comment, and I think back to my many years in practice, when I'd go and I'd talk to the financial management people at a particular audit client, and we would -- I would discuss as it relates to a particular transaction or estimate or policy statement or whatever, and talk about disclosure in the underlying financial statements.

And someone would invariably say, well, that's in the 10-K. Well, it's in MD&A per se, but it's not in the financial statements and we think it's particularly important that it be included in there. And I think that's an important point, because at the end of the day, when we put an audit opinion on a set of financial statements, we've got to be satisfied that there is reasonable and appropriate disclosure of all those matters that are important from an investor perspective, in terms of understanding those financial statements taken as a whole.

I'm not commenting about the disclosure framework, you know, overall. But I am talking to that I think it's a pretty important part of our job to evaluate those financial statements, and to make sure that the discussions are appropriate in the context of the financials as a whole.

MS. AMBLE: Since you brought it up, which goes outside of the topics of the discussion today, I think it would be fabulous if the SEC and the FASB and the PCAOB could be in concert on a number of things.

And I think one area -- I mean, some of the discussions and push-back that you've heard is the volume of the financial statements just becomes very substantial, and they're already very substantial.

Part of the culprit for the volume of the financial statements is there is duplication, because you do have two different bodies, the SEC and the FASB, requiring information, and you cannot cross-reference in all cases for them to be complete.

So I think anything to take away the duplication and things that add no value, in the way in which they're presented today, would be a wonderful thing.

I also think having clear line of sight of responsibilities for each of the organizations being adhered to, so that you don't bring in things that are interesting and nice to know, but really not directly under that organization's purview. I think that would be, you know, something very positive.

I also think if you were to get the MD&A and the financials more consolidated, you may also have the opportunity to have SOX oversee more than just financial controls. One of the biggest concerns I have with non-GAAP measurements is they're not under SOX. And arguably if that is more important to investors, and that moves the needle on your stock price, it would seem to me that the standards required for GAAP measurement should be at a minimum what should be required for those.

Today, they're not under SOX. And I know that because it was something that was not determined to be part of the basic financial statements. And I would disagree with that. I would think that you should have it expand to that as well.

So that's kind of going beyond your question, but getting to would it be nice for all of us standard setters to kind of coalesce? I think that would be great if they were sitting here potentially, and not us.

MR. DOTY: Peter, I'm going to get back to you, but I want to give FASB and the SEC a chance.

MR. KROEKER: Actually, your remarks are a good segue to the question I had. One, I think we do have a fabric that works well together. You know, obviously our responsibility is much narrower than the SEC's comprehensive authority with respect to accounting standards that we have. I think we do work complimentary together, but just a personal view.

But, Jim, you mentioned earlier the issue of auditing assurance, or some type of attestation around critical accounting policies, critical accounting estimates. And it occurs to me, in the vein of duplication at least potentially, and there's a lot of complaint about Footnote 1 often and how does that correspond to critical accounting policies.

One way to address that, again, speaking for one person from the FASB, would be for us to consider bringing more directly the obligations that are existing in MD&A, and we'd have to deal with staff interpretations and other things, but to bring that into the financial statements.

That could accomplish two things. One, reduction, at least, of confusion about whether there's duplication, but also then bring in directly an auditor attestation requirement specifically to things that are already often covered in the context of an audit. But I wonder if you or others had reaction on that.

MR. LIDDY: My only reaction, quite frankly, is I think, you know, we're raising it in the context that a dialogue in this vein, you know, we think is both reasonable and appropriate when you think about the core objective of the reporting model standard here.

We'd welcome a dialogue about it to figure out the best way to provide the information that's of most value to investors, and potentially the least cost to the companies themselves.

MR. CLAPMAN: If I could just have one final crack at your question, it would be that we've going to deal with the situation that we've got to deal with. That's my perspective on it. I've urged the SEC to include disclosure about auditor tenure, as Verizon voluntarily does. We might be having a different conversation if the SEC had done it or will do it.

But from an investor perspective, I think it comes back -- and you made the point earlier -- that I think there's a material flaw in the disclosure system now, and there's something that PCAOB can do about it. There's something the SEC can do about it, and I'd encourage each to move on it. That's, I guess, where I come down on your broad question.

MR. DOTY: I'm not through with you yet, Peter. Brian.

MR. CROTEAU: Thank you. I just wanted to follow on from Jeanette's remarks, and actually, Peter, your remarks, and actually some of what Jim has now just said.

Now is probably a good time just to remind you that these are my own views.

But with respect to what the SEC can or can't do, I just want to comment that, you know, in the seven or eight years that I've been now involved in this, I've been involved in making recommendations to the Commission on nearly all of the PCAOB standards that they've developed thus far. And not once have we made a recommendation, so far, that says we recommend that the Commission adopt this because you're too busy to do something that would be better or more appropriate.

I certainly don't think we should start that now, is my own view. So to the extent that -- that was the basis for my comment yesterday.

To the extent that commenters still believe that there's something the SEC should be doing, or that a disclosure would be better placed in the audit committee report, I'm glad that we're still hearing those kinds of comments and I encourage those kinds of comments, because I don't think we should start with the presumption that the Commission wouldn't do something or couldn't do something.

So I really appreciate the feedback that we're getting in that regard, and we'll continue to listen to that.

MR. DOTY: I'm mystified a bit. There's been a lot of discussion in the panels to a matter that Lewis alluded to, and that's the fact that Europe is moving ahead, and the UK is moving ahead, and the concern that we might not be right there in the vanguard of disclosure.

Whether that will translate into different costs of capital for us in the long run, we don't know. But one of the things the Board, I think, must worry about is the potential that, after some years, it will translate into some differential in the premium which our equity markets enjoy, and the charges for which capital exacts -- sources of capital exact their funds.

And the confidence that they have in the completeness of the regimen or the regime of disclosure, and the enforcement of the regime of disclosure, seems to be, if we're reading the sources correctly, if we're reading the academic research correctly, that seems to be something that does translate into cost of capital.

Verizon discloses this tenure matter for some reason. If you put aside just the fact that other advanced capital centers are making the disclosures that we have asked you comment on, and if you look at just what we are doing or not doing, it would seem to me that preparers, directors, audit committee people, auditors, are all to be concerned that if there's something we can do here that gives investors information which they have been asking for for over a decade, in some cases decades, and if we can do that without increasing a great deal of the cost of obtaining and delivering that information, we ought to seriously consider doing it.

And I would be surprised if in Jim Liddy's long and distinguished career as an auditor, Jim, if you had never seen a case in which the desire of a young auditor not to lose or vex a promising or a valued client had never prejudiced that accountant's views.

The point being, I don't think it's possible to prove the negative here and to say that there is no relationship between tenure and independence, there's no relationship between tenure and skepticism.

Therefore, I am puzzled with how you deal with

Peter Clapman's position as an investor, and as a former CREF official, that this is something that investors want. How do you face your investors and say, we think you can't handle the information, we don't believe you can use it, we don't know that it's useful, we think it may confuse you, we think you may make precipitous judgments based on tenure?

You have the entire proxy statement. You've got a lot of things available, many megaphones available to management, megaphones available to audit firms that KPMG uses regularly in the reports that they issue, on why it is that, in fact, the retention and the choice of an auditor is a complicated matter.

Many things have to be valued. Many things have to be weighed. But why would it be that we would want to deny this information to investors now, when it is in many ways the easiest, the best-known and the cheapest kind of information to include in an audit report?

And it has the risk that if we don't do this, we're actually withholding something that looks to the investor, that is perceived by the capital markets as being something that diminishes the completeness of our disclosure regime and the enforceability of our disclosure regime.

We're putting ourselves at risk, possibly, on cost of capital. Why do you want to do that? Anybody.

MR. LIDDY: If I may, I'll start. I mean, just to make it clear, I mean, this information may very well be important to investors, and we're actually supportive of the idea of communication and transparency regarding the concept of auditor tenure.

I guess our objection relates to specifically including it in the auditor's report, and it relates to a specific correlation being made between the tenure number and whether that is reflective on audit quality or not.

MR. DOTY: But, Jim, that's your most immediate communication with your stakeholders, with your investing public, is your report.

MR. LIDDY: I don't disagree with that, but, again, I think, you know, from our vantage point, we're supportive of, you know, greater transparency about it. We see a growing, growing number of companies that are, as a normal practice, disclosing it in their audit committee reports. We also think that as a matter of convenience that could be done in the Form 2 as well.

MS. AMBLE: I've actually been on both sides of the fence on this one. My initial reaction when I read the proposal was what's the problem? Putting it in doesn't cost anything.

It was really after thinking about it further that I thought, you know, it really isn't, though, an audit matter per se. It's a governance issue. I mean, if I had my druthers, I'd rather have the auditor sign the report personally.

I mean, I know that's not a very popular position to take, but to me that's more important. The individual who was responsible for that audit engagement and ensuring that everything, all of the professional responsibilities have been discharged appropriately. That is much more important to me.

I think, from an audit committee perspective, it's important to look at the duration of the audit firm. But quite frankly, whether it's one year or 30 years, it still boils down to the people with the feet on the ground, the people that are there in the engagement and how they're responding to the needs and risks of the company.

So, like I said, I think if it's deemed important for everyone to disclose it from a governance perspective, put it in the proxy. Two of my three firms where I'm on the audit committee, we do disclose it. But it's not for the gallant reasons that you just described.

I mean, one disclosed it, but they're challenging whether they want to anymore, because they thought it was a good thing to say that we've had the same auditor for a number of years, and we've developed a very positive and thoughtful relationship in ensuring quality audits. Now that they're seeing that people are seeing that tenure might connote something negative, they're wondering, gee, I wonder if that wasn't a good disclosure.

The other one had it in because we had changed auditors, because we had merged firms, and one firm had one auditor and the other had another. So you had to pick one, and so it was required to be put in, and it was just kept over for the last couple of years. So my guess is there are probably other people in that same camp as well.

So, while, you know, I think it's an interesting disclosure, I think when you speak of it in the context of how the audit committee may evaluate that, I think that's very relevant. So putting it in the proxy, I'm not objecting to at all. But there are a lot of other interesting things that you could put in the audit report that we're not talking about, that I don't think are as high a priority, personally.

MR. CLAPMAN: If I could make, Jim, one further comment. The nature of prediction, that if there is disclosure of the tenure of audit firms, I think what you will do in this country is have a healthy debate, some of which has been aired at this panel, as to whether it's important, whether it serves the interest of investors and the public interest.

But I think it's a debate that is needed, and I think if you did have that disclosure, it would encourage more dialogue and I think this would be a healthy thing for the system.

MR. DOTY: I'm afraid that, at times, Ferguson and I both evidence frustration that we're not law professors. So I hope you will forgive me for trying to push the Socratic method a little on you on the law professorial note. I think Jay did a good job of arguing with the witness, Peter, and arguing with you on this issue.

So this is a panel in which there's been a lot of give and take. Steve, do you want one more give and take?

MR. HARRIS: Yeah. Mr. Garrett, just so you understand where I'm coming from, I didn't want to leave any misimpression. The mission of the PCAOB very specifically is defined in Section 101. It's unequivocal and it's in quotes, and that's the preparation of informative, accurate and independent reports, audit reports.

So my perspective is how can we make the audit report more informative? So I want to elicit from as many people as I can, you know, a marketplace of ideas for how we improve the audit report. That's my perspective. Thank you.

MR. DOTY: We have a panel waiting, but this one has been terrific. Thank you all, and we'll see you soon.

I'll introduce the next panel as they're coming in.

Charles Pagano is a partner at WeiserMazars, and his industry experience includes broker-dealers and financial services. He's currently a member of the AICPA and the Securities Industry and Financial Markets Association, in their compliance and legal division, as well as the financial management division. He's a current member of the NYSSCPA and the Stock Brokerage Committee. He chairs the Foundation of Accounting Education's annual technical conferences on audit issues for broker-dealers, and their annual conference on the securities industry.

Michael Fehrman is a managing director and head of the Accounting Policy and Advisory Group of the Americas at Deutsche Bank. In addition to providing transaction advisory services and financial statement review, he undertakes special projects throughout the bank and participates in various valuation and control oversight committees. Previously, Michael Fehrman was a member of the accounting policy team at Goldman Sachs, and held various positions at UBS.

John Corcoran is a former vice president of MFS Investment Management. He also serves as the fund president of the MFS Funds, and fund treasurer for the MFS Meridian Funds. In his role, he manages the financial reporting, tax fund administration, custody and accounting oversight and valuation functions of MFS. Previously, he was a senior vice president of State Street, where his roles included managing the integration of Investors Bank & Trust, holding senior positions in fund administration and serving as the managing director of State Street's office in Edinburgh.

Jeff Burgess is Grant Thornton's national managing partner of professional standards. Earlier, he was the partner in charge of the firm's National Professional Practice Director Group, and the National Professional Practice Director for the Southeast Region. At Grant Thornton, he's also served as the partner in charge of the Greensboro, North Carolina office, and as the professional standards partner for the Carolinas practice.

This panel is here to discuss considerations specific to investment companies and broker-dealers, and we appreciate it. Thank you. Charles?

MR. PAGANO: Thank you, Chairman Doty, and thank you for inviting me to participate in this PCAOB public meeting. As the leader of my firm's broker-dealer practice and former two-time chair of the New York State Society of CPA Stock Brokerage Committee, and current member of that committee, I welcome the opportunity to express views on the proposal.

The Mazars Group includes 14,000 professionals in 70 countries, and WeiserMazars LLP here in the US includes 100 partners and 650 professionals in six US offices. We are the auditor for small issuers with less than .5 billion in market cap, and broker-dealers which range from small to medium-sized firms, non-clearing firms, including retail, trading, investment banking and firms with net capital ranging from $20,000 to $3 billion; employees from three to several hundred.

For purposes of this discussion, I will define small broker-dealers as those which are noted in the proposal by the PCAOB's Office of Research and Analysis, specifically those BDs which comprise approximately 2,200 of the approximately 4,200 BDs in the US, and which have a minimum net capital of only $5,000.

Also noted by ORA, 1,700 have revenues of less than a million, and only nine percent of the BDs are subsidiaries of issuers, who presumably are audited under PCAOB standards as part of the parent-subsidiary consolidations.

Only 311 of the 4,200 broker-dealers are subject to the customer protection rule, SEC Rule 15c3-3. The vast majority hold no customer funds or securities. The purpose of the proposed rule is to allow investors to enhance their ability to make investment decisions and for other financial users, which, in the case of broker-dealers, would be the regulators.

As noted in the proposal, approximately 90 percent of the BDs are directly owned by an individual or an entity that owns more than 50 percent of the broker-dealer, and approximately 75 percent have five or fewer direct owners, who, the ORA suggests, and is my experience, are often active in the business.

Investors do not invest in the broker-dealer proper. When a broker-dealer attempts to attract capital, it will look to bring in other active shareholders or subordinated lenders who are generally existing shareholders. Therefore, we believe that investor would not benefit from the proposed change, as they are not investing in the broker-dealer.

The other financial users are the regulators. The BD industry is heavily regulated, with a robust surveillance system in place that includes FINRA, the SEC, the CFTC and state regulators. There will also be additional auditing oversight under PCAOB standards for years ending after June 1st, 2014, which will allow potential referral by the PCAOB to regulators.

If enacted, many BDs will have common critical audit matters that are already addressed in other reporting areas. Disclosure and information available to users, namely the regulators, is more than adequate in areas that are common to many BDs.

For example, valuation of securities and revenue recognition, which are both addressed in comprehensive footnote disclosures; the net capital computation, which is addressed in a required supplementary schedule and is extensively audited and disclosed; and compliance with the exemptive provisions of Rule 15c3-3, the customer protection rule.

The additional costs of applying PCAOB Auditing Standard No. 7, effective June 2014, along with the implementation of other PCAOB auditing standards, have already added incremental audit costs to the small broker-dealer. A small broker-dealer will be asked to absorb additional costs if the proposed auditing standards are enacted.

A mid-size auditing firm's additional manpower costs to comply with the proposed reporting requirements for critical audit matters would include incremental time incurred by a senior manager, a partner, an EQR, an engagement quality control reviewer, in-house and possibly outside counsel and other firm experts or specialists to issue a report.

The BD is asked to issue a report within 60 days of year-end. This existing time constraint, with the possibility of additional reporting requirements, if enacted and applied to broker-dealers, is a more stringent time frame for a more significant public company, which may have a 75 or a 90-day filing requirement.

There's a concern that additional reporting with these time constraints may affect audit quality in the race to get reports issued to meet existing deadlines.

Documentation of critical audit areas and compliance with the Auditing Standard No. 3 may be more burdensome and costly. Depending on the capabilities of the auditor, given a similar fact pattern, different auditors may produce different results.

Thus, the playing field may not be level for different sized accounting firms and their clients. The August 2013 SEC report on the progress of the interim inspection program noted that of 783 accounting firms that audited BDs for the 2012 audit year, 756 or 83 percent of those firms audited only one to five broker-dealers each, while 14 firms or two percent audited 51 or more BDs.

I suspect that this might be somewhat price-driven. Some BDs may, in the interest of saving dollars, look for those auditors who can perform less costly audits, and in some cases, quality may suffer.

Given the statistics already acknowledged by the

PCAOB, including the size of the majority of the BDs, the size of the accounting firms that audit them and the likelihood that no useful additional information may be gained by additional requirements, we believe broker-dealers should be excluded from the proposed standards.

Our lack of support for certain aspects of the proposed audit standards, including their effect on issuers, as noted in our December 9th, 2013 letter to the PCAOB, primarily relate to the conviction that we should not supplant the responsibilities of management or audit committees.

We remain committed to participating in future discussions with the Board and staff to further enhance audit quality. We thank you for today's opportunity to participate.

MR. DOTY: Thank you. Mr. Fehrman.

MR. FEHRMAN: Thank you very much for the opportunity to appear today and to present Deutsche Bank's views on this topic. Deutsche Bank is a global universal bank, and one of the largest financial institutions in the world. To facilitate the products and services we offer, we have a wholly-owned broker-dealer subsidiary in the United States, Deutsche Bank Securities, Incorporated, or DBSI.

Because Deutsche Bank is an SEC registrant, our auditors are subject to inspection by the PCAOB. As DBSI is a broker-dealer, the audits of its separate financial statements are also subject to inspection.

We support the goal of enhancing the information provided to users of financial statements, but believe the information should be presented by management.

In our view, any critical audit matter would most likely be a critical accounting matter as well, and therefore already discussed by the issuer. At best, therefore, a discussion of critical audit matters would seem to be redundant. Accordingly, we do not support this proposal in its current form.

I've been asked to comment on issues that this proposal would present to broker-dealers for their financial statements. While there are certain issues related specifically to broker-dealers, I believe many of the concerns we have with the proposal would be shared by other preparers of financial statements. But I will begin with the matters that are specific to broker-dealers.

As you know, many broker-dealers do not provide a complete set of financial statements to their customers, and instead provide only a balance sheet with limited disclosures. It is highly likely that an auditor would find that there are critical audit matters resulting from income statement or disclosure information that is not included in the information provided to customers by a preparer.

Similarly, auditor comments on responsibilities regarding other information would have little meaning to the user if the information itself is not included in the report. If those comments are to be included in the customer report, it will raise confusion for the user of the report.

Clearly, the intent of this proposal is to add clarity and not confusion for the reader, and we believe this matter should be addressed during this exposure stage. We see this matter as an indication that perhaps application of a proposal to broker-dealers may not have received the same attention as for other entities.

While I very much appreciate the opportunity to comment on matters relevant to a broker-dealer, I do not believe my appearance today can adequately address the concerns of the whole industry. Accordingly, I would respectfully suggest that an additional outreach effort be made, particularly to smaller broker-dealers who may not have had the regular practice of responding to matters such as this.

Since PCAOB standards have only recently been applied to audits of broker-dealers, and given the small size and closely-held nature of many broker-dealers, I'm concerned that there could be significant matters that may be brought to light only with a more targeted effort to solicit input from the industry across all its segments.

One other aspect directly affecting broker-dealers is that the industry is already subject to significant regulation and oversight in both business practices, maintenance of capital levels and financial statement presentation.

Coupling that with the fact that broker-dealer financial statements are more often used by customers of broker-dealers rather than investors, we question whether applying this proposal to broker-dealers will yield significant benefits that are not already addressed by existing regulations and oversight.

At a minimum, we would like to suggest that the PCAOB give further consideration to excluding broker-dealers from this proposal.

There are other concerns that apply to companies in general, but may be more acute for broker-dealers. For example, complex business activities, and the related management judgments applied, are more likely to result in critical audit matters than are simple business activities.

We are concerned that certain complex matters would almost always be cited by auditors as a critical audit matter. For example, hard to value securities, such as Level 3 securities, would likely be named as a critical audit matter for many broker-dealers.

As a result, rather than adding clarity for the user, there's a risk that such matters would come to be viewed as boilerplate disclosure and be ignored by the user.

On the other hand, a user of financial statements could react very negatively to all critical audit matters, and reach an incorrect conclusion that critical audit matters are indicators of problems in the broker-dealer's business.

Given the extent of discussion of Level 3 assets in both notes to financial statements and MD&A, there seems to be little information content to be gained from having them as a critical audit matter as well.

Further, a decision that something is a critical audit matter could be the result of the individual auditor's knowledge and comfort level, rather than an assessment of the matter itself. Of course, this concern is also applicable to financial institutions in general, and is not limited to broker-dealers. There may be other examples of critical audit matters that would become either false red flags or boilerplate language that would be ignored for both financial institutions and other industries as well.

We all know that the number of pages included in both quarterly and annual reports has steadily increased in recent years. Nowhere is this more true than for financial firms of all types. Adding to the sheer volume of the material is the fact that much of the information is very complex as well.

Both the complexity of the business itself and the increasing requirements of accounting standards contribute to this increase in length and complexity of financial reports. Companies spend very substantial resources in preparing and explaining information and trying to do so in the most understandable way possible.

The result, however, is a perennial call for simplification and elimination of disclosure overload. Adding an additional view or set of commentary will certainly not help this situation.

As noted at the beginning of these remarks, we support efforts for increased transparency in providing additional useful information to users of financial statements. We do not think it should be the role of auditors to do so, and we cannot support the proposal as it currently exists. Thank you for your time.

MR. DOTY: John Corcoran.

MR. CORCORAN: Well, I'd like to thank the PCAOB for having us here today and to hear our comments. I'd also like to thank you for saving what we think is the best panel for last.

Today I'm going to focus my comments on how the proposal impacts investment companies. And to put my role into perspective, at MFS, we have over 140 US mutual funds that we're issuing financial statements on, representing $170 billion in assets under management.

US investment companies as a whole are responsible for the investment of nearly $14 trillion in assets, and most of that being in mutual funds that have 92 million shareholders. And there's approximately 10,000 investment companies that are subject to annual audit requirement, and oversight by the PCAOB and the SEC.

As we stated in our letter, in our comment letter to the PCAOB, we do understand the PCAOB's overall objective to improve the value and relevance of the audit report, and support many of the proposed changes. But there are certain aspects of the changes proposed that we do have concerns with, especially as they relate to investment companies.

So, first, let's talk about where we support the changes. Under the proposal, the auditor's report will be modified to include a statement that the auditor is registered with the PCAOB and is required to be independent. It also recommends the auditor's report more specifically articulate the auditor's responsibility with regard to fraud in notes to the financial statements.

We think these enhancements provide better clarity to investors of what the auditor's role is. It can be done without expanding the scope of an audit, and we support that.

The area that we probably have the most concerns about and do not support is the proposed introduction of critical audit matters, or CAMs. Let me take a few minutes to explain why.

We feel that in the context of an investment company, the CAMs are going to be associated to be a red flag or a sign there could be something is wrong with a fund, when in fact judgments and estimates and assumptions are an inherent part of the financial statement process.

As an investment company, we make extensive financial disclosures and make certain judgments regarding disclosures on investment valuation. We'd expect the auditor to have to cull that out as a critical audit matter. But I think it's important to note that, even though those judgments are made, the auditor is certainly able to obtain enough information to give an unqualified opinion.

In these circumstances, calling this out as a red flag, we think, could raise a red flag to investors when no problem exists. Significant disclosure is already made and the financial statement opinion is unqualified.

Given the view that we would not expect to see an audit that doesn't have CAM, we think that's going to incent an auditor to identify more CAM to show the comprehensiveness of the work that they've done and their compliance with the PCAOB's directive.

Given our concern that these CAMs could be perceived as a red flag, it could have the unintended negative consequences that investors are going to use that as an objective yardstick in determining one fund's value versus another.

Let me explain how that could play out for us.

In a large complex like MFS, we employ more than one auditor. We have a two auditor model. So when this two auditor model, and it happens, we've got substantially similar funds audited by different audit firms, each of whom is going to have their own unique thoughts on what constitutes a CAM and how to document that within the auditor's report.

So we could have a fund with the same strategy, holdings, investment performance and disclosures, and still end up with having a different description of critical audit matters. And that would have the unintended consequence of putting one fund at a disadvantage over the other one because of subjective language in an auditor's report.

When you then take that and take it outside of just one complex and put it across the universe of investment companies, you can see that that expands our concern.

We also share the concerns raised over the last couple of days about CAM creating a piecemeal opinion and putting an auditor in a position to disclose information that management may not be required to disclose. I'm not going to add anything to that today. I did in my written comments. I won't in the verbal comments today, other than to suggest that, in our context, if our financial statements and presentation over something like investments and investment valuation is not sufficient, I don't understand how an auditor is going to be able to reach an unqualified opinion on our financial statements.

The last concern I'll raise about CAM, and it's probably the one that's going to have the most impact on myself and my staff, is additional cost and time it's going to take with auditor's reports.

One could argue the level of audit evidence and audit work required to reach a qualified or unqualified opinion wouldn't change. But there will be additional effort to document conclusions of why something is or isn't a CAM, and to put documentation and non-standard language into the audit report. When non-standard language is put into the audit report, it's going to require additional review within the audit firm and within the management company, and depending on what it is, it could involve others.

The people who are doing that review are not the low level, least expensive folks. So it's definitely going to add cost to review that language. That is also going to occur when a substantial amount of the audit work is complete. So it's going to be towards the end of a very compressed schedule for us. So we do have concerns with that.

Another aspect of the proposed standard that concerned us a bit is the inclusion of audit tenure in the auditor's report. I won't repeat what was said in the last panel, but our concern is just that the auditor's report is not impacted by audit tenure.

There's also a logistical problem with investment companies. For a company like ours, we have new funds starting and merging and changing every year. And there are some times that there's going to be reports with multiple funds being reported in one book and one set of audit opinions. Each has a different start date and therefore a different logistical audit tenure. So we think that would need to be addressed. We don't have a problem with disclosing audit tenure, but we think there's probably a more appropriate place to do it than the auditor's report.

The last area of the proposed standard I would like to comment on is the clarification of the auditor's responsibility for other information. We absolutely agree it could be helpful to clarify what components of other information we want the auditor to look at and what the expected level of auditor effort is here.

We do think some more work needs to be done to actually specify exactly which areas you would like the auditors to look at and what is the expected level of effort there.

This is particularly important with an investment company. If you put it in our context, whereas a financial company may have one set of financial statements that the annual auditor's doing every year, I have a set of funds being audited every month. We have over 35 different filings annually by trusts that have multiple financial statements within them, okay? So there's definitely going to be some costs associated with that, and there's definitely going to be some logistical issues associated with that.

So we want to make sure enough study is done on that what we have the auditors look at is something that they have the expertise to look at. And that it has the appropriate cost-benefit.

So, given that, we would encourage additional outreach to be done to determine what are the areas of additional information that are of most value to investors? Of those, which of those does the auditor have the expertise to take a look at? And then have the auditor do some field testing so we can just test that the level of benefit does exceed the level of cost to do that.

So, in concluding, we do support a number of the initiatives. We certainly support the intent of what the PCAOB is doing. We thank you for having us here today, but as it relates to investment companies, there's a few things we would ask you to consider.

First, we'd ask you to reconsider the inclusions of critical audit matters in our reports, given that we think it would increase the cost of the audit and also could introduce some other notable negative unintended consequences to our funds.

We'd also ask you to consider using other public documents in the auditor's report, if you want to disclose auditor tenure, and would ask for that additional outreach to be done on other information to clarify what other information might the auditor take a look at. Thank you.

MR. DOTY: Thank you. Jeff Burgess.

MR. BURGESS: Good afternoon, and thank you for the opportunity to provide my comments related to this important topic of auditor reporting. I commend the PCAOB for organizing this roundtable, and for its continued outreach. Grant Thornton supports the Board's effort to enhance the relevance and usefulness of the auditor's report.

My comments today are focused on the applicability of the proposed new rules to investment companies. And in doing so, I'll also provide some general comments about certain of the key aspects of the proposals, primarily CAMs and other information.

The application of the PCAOB's standards should, in most circumstances, be applied uniformly to all issuers. Although we understand the view that investment companies and broker-dealers could be scoped out of the proposal, we struggle with trying to define which issuers should be included, versus those that would be exempt. Where do you draw the line?

It's difficult to distinguish the circumstances in which an issuer or group of issuers might merit a discussion of CAMs from those that would not merit such disclosure.

Second, certain aspects of the proposals would likely need further evaluation, outreach and deliberation to be applicable to many investment companies, including consideration of the various fund structures and regulatory reporting constructs such as multi-fund filings.

With respect to CAMs, we believe that providing more insight into critical audit matters can give investors and other users of the financial statements information that could be useful in evaluating the underlying financial statements.

Grant Thornton's comment letter identifies suggestions for improvement with respect to the proposal scope, filtering mechanisms and form of communication. Our suggestions are intended to address concerns we have as to how the proposal aligns with current audit processes and documentation protocols.

Concentrating on issuer investment companies, we share what seems to be the general view of many other commenters that the primary focus of CAMs will be in the valuation of investment securities. Valuation has been a significant focus of the SEC and investors in recent years, so a CAM related to this complex audit area could be relevant.

It's been our experience that audit teams are spending considerable time evaluating the sufficiency of audit evidence relating to valuing the more complex Level 2 investments, as well as the Level 3 investments.

While we acknowledge that required financial disclosures in set forth in ASC 820, combined with additional management disclosures of portfolio risks and other details around investment portfolios, provide investors with a significant amount of information, it's possible that audit commentary for certain matters around a specific investment valuation that might be included in the CAM could be useful.

Most of the challenges relating to reporting CAMs for investment companies are ones that we believe also apply to the broader population of commercial entities. We've highlighted three concerns that we've noted, and on which we've seen others comment.

The first two have been discussed at length for the last couple of days: the comparability and the issuer boilerplate language, the disclosure of original information by the auditors. The third comment relates to the ability of the information to be operational to the investor, and not just in a negative way.

And along the lines of what John said, it's essential for investors to better understand the context for how the auditor determines CAMs, and how those matters relate to the underlying financial information.

We share concerns expressed by others that investors may inappropriately look at the auditor's reporting of a CAM or multiple CAMs as a negative indicator as it relates to a fund, resulting in misinformed investment decisions.

These aren't easy issues to solve, and we suggest that further discussion and outreach, including perhaps consideration of a phase-in approach, might be a prudent way forward.

One final point on CAMs related to investment companies is the expectation included in the proposal that the auditor will rarely not identify a matter as critical. We believe that this expectation may create pressure to identify a matter, or multiple matters, when they really aren't any.

For example, a mutual fund that has a very straightforward and non-complex investment portfolio may not have matters that really meet the definition of a CAM, but the auditor might feel compelled to call certain matters CAMs just in order to report something under the proposed standard. So, in that regard, we suggest the PCAOB reconsider its view that the auditor will rarely not identify a CAM.

In response to the proposal related to auditor's responsibility regarding other information, we agree with the Board's view that investors and other users of the financial statements would benefit from understanding the auditor's responsibility for information that accompanies the auditor's report and financial statements.

Consistent with our views on CAMs, we also believe that this proposal should apply to investment companies and broker-dealers that are issuers. However, we do not agree with the change in scope of the auditor's responsibility, or in the breadth of information subject to the proposed standard.

Current standards and practice provides for a read-and-consider model. The current PCAOB proposal increases the requirement to an evaluate-and-conclude model, which we believe would lengthen the time the auditor would need to spend on such efforts, thereby increasing the costs.

We do not perceive that these increased efforts will provide sufficient benefits to investors to justify the changes proposed in the release. Additionally, the annual filing requirements for investment companies differ from those of commercial entities.

Further analysis and outreach is important and could result in meaningful application guidance for investment companies to strike the right balance between enhancing the transparency of the auditor's involvement in information outside the financials and the additional cost in providing such information.

As the Board moves forward with its proposals, we support a post-implementation review separate from the Board's inspection process that includes an evaluation of the direct and indirect efforts, effects on financial markets, regulatory scrutiny and litigation matters.

We believe it's inevitable that auditor judgments across and within firms will differ with respect to determining and describing CAMs, and as a result, there will be diversity in practice. We also believe that users of financial statements would utilize and apply the additional information to be included in the auditor's report in diverse ways to suit their specific needs.

Accordingly, monitoring the effects of the new auditor's reporting model, and whether it is not only being applied appropriately by auditors, but also has met user expectations, will be essential to achieving the objective of the proposed standards.

We're committed to providing meaningful and transparent information that's useful to investors, and doing so in a manner that will provide the most benefit while not creating a significant burden to issuers and investors in the market in general. Thanks again for the opportunity to share our views.

MR. DOTY: Thank you. Jeanette Franzel?

MS. FRANZEL: My question deals specifically with brokers and dealers, and who's using those financial statements, those audited financial statements, customers versus investors in the broker-dealer itself, and how might this be different from the discussions we've been having about investors and issuers, and how should we consider that?

MR. PAGANO: Okay. Well, as I noted, approximately 300 firms, 300 broker-dealers, are clearing or carrying-type firms, which hold customer securities and funds. In those instances, you know, there is a reporting requirement to the customer.

But on all other BDs, the majority, there is no customer statement nor ordered report that's sent to those individuals. It's not required. The securities and the funds are held by the clearing broker.

Now, there is a SEC website where even the small, introducing-type firm has to put an audited financial statement on that through the SEC website, and somebody could see the -- usually, the confidential report is not on that. Well, in some cases it is. But usually it's just a balance sheet with footnotes.

MR. FEHRMAN: I think that's correct and consistent with my understanding as well, although I would just note that for a firm such as ours, our broker-dealer is wholly owned by the parent. So we have no outside investors at all, and it would really only be customers and regulators that would use the broker-dealer financial statements.

MR. HANSON: A question related to the funds. And we have suggested in our proposal that the application, especially around CAMs, is intended to be scalable. So not over-killing it, not under-killing it, but making it be the right size for the entity.

And I've heard the comments that you're making about, gee, are there really any CAMs for most straightforward funds that invest in traded securities where there aren't the Level 3 valuation issues? And I know we've put words in the proposal that suggest that most companies will have CAMs.

And I wonder if we have an opportunity here, because I don't like the idea of carve-outs. So if we could write something that would be applicable for all types of audits, but scalable so that it's hitting the right things for the right companies.

Do you think it's possible for us to craft language that would accomplish the objectives without making a specific carve-out for a fund that would get at the scalability aspects, that it might very well that in a given fund there might not be a CAM and that's okay? Thoughts?

MR. CORCORAN: I'll defer to the auditor on how they'll interpret it. My fear would be that the auditor is going to want to demonstrate, hey, we've done a good job and there are critical audit matters. It's hard to suggest that the valuation of investments in an investment company is not a critical audit step, if nothing else.

I'd also point out that on our funds, for which we have minimal Level 3 disclosures -- I think our highest concentration of Level 3 securities in our funds are less than half of one percent. I still have, generally, three pages of disclosure on how I valued the investments. And the auditor is, as part of their audit guide, they are looking at 100 percent of the valuation of my investments, okay?

So I'd be still fearful that they're going to want to cull that out as a critical audit matter. But it's not an issue. If it were an issue, they wouldn't be able to give me an unqualified opinion. That's my concern.

MR. BURGESS: I think John's concern is fair, but at the same time I do think that you could write the standard in such a way that this could be addressed. I think it's important that the standard be clear, that it is contemplated that it wouldn't be rare that a company might have no CAMs.

You know, in the terms of an investment company, like John described, where there are no Level 3 investments -- we even have some that have mostly Level 1 investments -- I have a hard time seeing that there would be a critical audit matter relative to investments in a fund that has primarily Level 1 investments.

But I do think there is some risk that auditors will feel the need to have at least one CAM. Or if I don't, you know, I run the risk of having not met the standard in the eyes of an inspector or somebody else.

So I think you just have to be mindful of each side of that coin.

MR. CORCORAN: I'm also not sure what a CAM could draw out about an example like investment valuation that I'm not already required to disclose.

MR. HANSON: In other words, how many times do you have to say "it's hard."

MR. FERGUSON: Yeah. I have a question. And I'm struck listening to you by, obviously, the enormous diversity among broker-dealers in this country. You talk about, Mr. Pagano, clients with capital ranging from $20,000 to $3 billion, and I assume Deutsche Bank is much, much larger than that.

So these are almost too different kinds of businesses. And the question I have is if we were to consider exemptions here, where we simply exempted certain businesses from these rules, what would be the line we should draw? I mean, they're clearing and introducing brokers. I mean, should it be introducing brokers that are excluded? Should there be a capital level below which you don't need to comply with these things? What would your advice be on that?

MR. PAGANO: Well, I would say, you know, if you're involved with customer funds, I think that's something that I could see having an interest in getting some confidence that those customer funds are in a good place.

So I would say that would be my biggest driver. You know, there are some broker-dealers that are part of a public filing as the holding company is a public entity, and presumably those are audited under PCAOB standards also.

So that would be important to us. I think those two things would be crucial. And I just -- I wanted to add -- Jeanette, you had a question before. Primarily with the smaller broker-dealers, it's the SEC and FINRA that are waiting for these audited statements to be filed within 60 days, and now SIPC this year. There was a recent change this past year where SIPC gets the full report clipping, the internal control report.

MR. FEHRMAN: I'm just sort of guessing here, but I would think that in a world where this proposal has come to fruition, a reader of Deutsche Bank's consolidated financials and related audit report would probably not get much different information than a reader of the broker-dealer financial statement separately.

So I see the appeal of Mr. Pagano's comment, that perhaps broker-dealers that are a subsidiary of a company that's otherwise audited and otherwise reporting under PCAOB standards might possibly be exempted.

I think you might think about an exemption also for audits of smaller broker-dealers that are very closely held. I don't think that people look to the financial statements for safety and soundness. I think they look to the regulators for that. So I'm not sure there's much to be gained by that. They're not investing in the broker-dealer per se.

MR. FERGUSON: Do you have any experience, for example, from your customers who are customers of your broker-dealer, whether when they look at Deutsche Bank's financial statements, do they only focus on the consolidated financial statements of the Bank itself? Or are they interested about the entity actually with which they're dealing? Or do you know?

MR. FEHRMAN: I don't know the answer to that. I do know that we are required to send customers of the broker-dealer broker-dealer financial statements, and we're not required to send them consolidated financial statements. But they are certainly available. But we have not made a study of that nature.

MR. HARRIS: Mr. Fehrman, you heard Mr. Corcoran tick off a number of items in the proposed standard that he supported. Is there anything in the proposed standard that you support?

MR. FEHRMAN: I think a great deal of what's in the standard, frankly, is already being done. It's just reported to the audit committee, rather than to the public at large. In as much as the audit committee is meant to be an independent body, and is in fact an independent body, I think that they are there also to protect the users of the financial statements.

So you have the company making an honest effort to provide good disclosure, in accordance with the requirements, in a way that's understandable. You have the auditors checking that. You have the audit committee checking the auditors.

So to answer your question, no. The thing I fear is this. The financial statements in and of themselves are already a summary. You know, we have millions and millions of transactions, and we could give anybody more information -- and I jokingly said to people in the green room, we could print a copy of our trial balance and mail that out, and I would say that would detract rather than add to the information content of our annual report.

So, you know, just because the information is available and low cost, as was discussed on the previous panel, that does not make it useful information. So I have to say quite honestly, sir, that, no, I do not support this proposal.

MR. PAGANO: I'd like to add just to the auditor's responsibilities on other information. The oath or affirmation that's attached to the report, was noted in the proposal, would be subject to this. And actually I do see benefit in that the order gives some comfort on that.

MR. DOTY: Well, here's the problem. We had a financial crisis. And I take it some of the entities that fell flat were substantial banks and broker-dealers. And we had an investment company that broke the buck as a result of a concentration in the securities of the broker-dealer. Holding itself out as a money market fund, it broke the buck.

And this attracted a lot of attention, and it resulted in us being charged with creating standards, audit standards for broker-dealers. The SEC reminded broker-dealers that they had to have audited financial statements, and that included some schedules and some fairly specific information. And I share here with Jay Hanson's concern over the carve-outs.

I think there's a well-trod, well-understood path for regulators creating guidance. And perhaps if you have funds for which the auditor has satisfied themselves there really is nothing in that fund portfolio but cash, money, high-quality government securities, maybe there are times in which the guidance could indicate that critical audit matters may in fact not be so rare in a particular area or segment, if we looked at it.

But right now, we're sitting here having looked at some broker-dealers, and having reluctantly determined that many of them, some of whom are carrying, don't have audits that are independent. We have a lot of errors that we see in the preparation of books and records by the auditors. The material is in our public report.

So how do we simply say, well, notwithstanding the financial collapse, notwithstanding the instructions of Dodd-Frank, notwithstanding the statute under which we operate, which says we have to foster the interests of the public in good financial reporting. And notwithstanding the fact that we know that the SEC also wants to know, for the audits that it has a primary interest in, or that FINRA has a primary interest in, they want to know that the audit has been well-performed.

How do we do our duty by a wholesale exemption of an entire industry, which, as John points out, now has trillions of American savings in it? I guess Mr. Fehrman's position has the beauty of saying you don't think we should do any of it for anybody.

But don't we have a problem with the general carve-out? And isn't it clear that we've got to get to some kind of a mechanism for scaling the wind to the shorn lamb and treating how these different companies' business model suggest themselves to an auditor? Don't we have to do something here to fine-tune?

MR. FEHRMAN: I fully agree that things need to be done. And things have been done, I think. We have Sarbanes-Oxley, of course, which I think actually predated the crisis. But we have the Volcker rule, we have Dodd-Frank, we have increasing levels of capital requirements.

We have substantial increase in regulatory oversight, all good and necessary things that I think are past due, and we're working hard every day to comply with all those things as well. I just question whether it's specific to broker-dealers, or much more broadly, whether this helps that situation.

If the auditor's doing a good job, he's doing a good job. I question whether the reader of the critical audit matters, the reader of the report on other information, will find that useful.

I think that they would rather know that there's a team of regulators, a team of auditors from the regulator that live in our building, that are there every single day, and are working very hard to make sure, as we are, that the institution is safe and sound and will be here, I hope, for another hundred years or more. I don't think this is the right way.

MR. DOTY: The comment from the United Kingdom yesterday and today was that they have managed it there. They've managed an expanded audit report, and they've done that without having undue delay in the delivery of the report and the reporting schedule, and without some kind of a hockey stick increase in costs.

So does your British -- you all have resources there. Does your UK experience suggest that perhaps this can be done?

MR. FEHRMAN: I'm not familiar with what's going on in the UK, quite honestly. I have read the IAASB proposal, which I think is very similar to this. I think we would have a similar reaction there.

You know, again, I just have to say that I think that the regulators are doing a very diligent job, and I think that that's the appropriate place to address many of the concerns you're listing.

MR. CORCORAN: I'm by no means an expert on what changes have happened in the UK. But my understanding is they are not -- the subset that they're applying to now does not include an OEIC, an open-end investment company, which would equate to our investment company.

I do think you need to consider, for lack of a better term, the simple nature of the operations of an investment company. Every investment company really has -- they may have different objectives in terms of what type of investments they're going to go into and what not, but all the more just in turn investing money in a portfolio that is 100 percent disclosed, 100 percent validated by the auditor, and pages of the disclosure on how those valuations take place.

MR. DOTY: John, it's a fair point, up to a point. To the extent you're talking about two-auditor funds, I think this is something that is of great interest. But when you're saying that you're concerned with critical audit matters, that there's going to be an assumption of something being wrong and a tendency to -- many of your objections to the proposal would go to the kind of issuers who have been subject to it in the UK.

So I think you have in some ways narrowed the concern, when you say investment companies are a unique animal. It's a narrower subset of concerns you have when you're focusing on the peculiarities of the investment fund, of the investment company industry, it would seem to me.

MR. CORCORAN: What I'm trying to suggest is the subjective nature of an auditor being able to cull out -- two different auditors may decide something different is a critical audit matter.

In a simplified structure like an investment company, that's going to have a much different impact than if I'm talking about a multinational corporation, where you would expect that sorts of things to be different.

MR. DOTY: And I do see that as a concern, lodged just as to how the proposal might affect investment companies. But I'm saying that on the broader attack which you make on the proposal, or the broader expression of disagreement with it, you are going to many of the issues which the UK seems to have successfully confronted and dealt with.

MR. CORCORAN: I think we can probably agree to disagree as it relates to an investment company context, which is all I'm speaking about.

MR. DOTY: Well, this has been helpful and informative and we thank you.

This concludes the first roundtable on the audit reporting model, and in some ways we did save the best to last. You all did a great job. Thank you.

(Whereupon, at 2:59 p.m., the meeting in the above-entitled matter was concluded.)

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C E R T I F I C A T E

This is to certify that the foregoing transcript

In the matter of: Auditor's Reporting Model

Before: Public Company Accounting Oversight Board

Date: 04-03-14

Place: Washington, DC

was duly recorded and accurately transcribed under my direction; further, that said transcript is a true and accurate record of the proceedings.

Neal R Gross

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Court Reporter

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on June 24, 2014 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the June 24, 2014 meeting are not included in this transcript excerpt.

The Public Company Accounting Oversight Board does not certify the accuracy of this unofficial transcript, which may contain typographical or other errors or omissions. An archive of the webcast of the entire meeting can be found on the Public Company Accounting Oversight Board's website at:
http://pcaobus.org/News/Webcasts/Pages/06242014_SAG.aspx

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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TUESDAY
JUNE 24, 2014

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(...)

MR. BAUMANN:

The next item, or the last item actually on this page and the first item on the standard-setting agenda for March are the same and it deals with the auditor's reporting model. And we'll spend a little bit of time on this project over the next few minutes. This is really one of the Board's major initiatives, and it did come up before are we going to hear about this; I think it was Elizabeth that asked, and so I do want to spend some time.

So before this meeting, as part of the meeting materials sent out to SAG members -- materials related to the ARM project. And what we sent you was the Board proposed changes to the auditor's report in April -- August 13th, 2013. And the fact sheet of what we proposed is in front of you. Just as a reminder, that dealt with the requirement for the auditors to report on critical audit matters, those matters that are addressed during the audit that involve the most difficult subjective or complex auditor judgments, pose the most difficulty to the auditor in obtaining sufficient appropriate evidence and/or pose the most difficulty to the auditor in forming an opinion on the financial statements.

We also proposed changes to the responsibilities for auditors with respect to other information in an annual report filed with the SEC that's not part of the audited financial statement, but other information that management might present. The auditor has an existing responsibility to read and consider that information.

We expanded that to read and evaluate that information with specific procedures as to what we meant by evaluation and also proposed that the auditor would report if they found that there was a material misstatement of fact in the other information or if they found that the other information contained a material inconsistency with the audited financial statements.

We didn't require really additional audit evidence or evidence to be gathered around that other information, but those conclusions would be drawn based on reading it and evaluating it in the context of the audit work done and the audit of the financial statements taken as a whole.

We received 246 comment letters on the proposal during the year. We received comment at the last SAG meeting. A major portion of that was getting input from the SAG members. In addition, in April 2014; and that material is in front of you as well; and many of you here participated in that, there was a two-day public meeting on the auditor's reporting model and we covered various aspects of the various components of this, the critical audit matters, issues around other information, issues pertaining to larger firms, smaller firms, etcetera.

But we also looked at other developments that were occurring around the world. And as part of the materials that I've shared with you I've included excerpts of what's now a requirement in the United Kingdom that went into effect for financial statements filed after September 30, 2013 and periods after that. Is that right, Jessica?

MS. WATTS: Sounds right.

MR. BAUMANN: September 30th, 2013 and after that. And if you read the -- there was one page of that we took out from the U.K.'s standards was pretty principles-based. It said describe those assessed risks of material misstatements that were identified by the auditor and which had the greatest effect on the overall audit strategy, the allocation of resources in the audit and directing the efforts of the engagement team, provide an explanation of how the auditor applied the concept of materiality in performing and planning the audit and provide an overview of the scope of the audit, and few more words to that. And we've also included a couple of examples of reports that came out of the U.K. for your observation.

So as part of the meeting we had in April representatives from the United Kingdom who participated in some of these audits came over, as well as investment management professional came over, and it was a very positive report back in terms of the fact that the engagement teams felt, quote, "more engaged" in the audit and the fact that their reports were going to contain more useful information for investors.

The engagement partners felt that that was a positive impact on the audit taken as a whole and the investment management professionals who reported at that meeting felt that these more detailed reports gave the market more confidence in the work of the auditor as it spelled out some of the significant risks or critical audit matters, as we would call them here, that the auditor dealt with.

But the examples in front of you -- there's two companies. One of them is -- compared to the traditional couple-of-paragraph report we see here in the United States, there's a six-page opinion of the audit spelling out about 10 different risks of material misstatement and the auditor's responses to those risks that they found. The other one I think is about a four -- about a five-page report or so on similar type matters.

I think the main point in that and what we heard in the April meeting is from those who in the comment letter said this is a real big challenge and for a variety of reasons can't be done. It will slow down the audit, will have other negative consequences, you know, the world will come to an end. That didn't really happen in U.K. The reports were issued pretty much timely from what we observed in a sample we've looked at, pretty much issued on about the same date as they were the prior period. And we inquired about cost, and at least in general the comments that were made at the public meeting were that the additional costs were largely minor. I mean, I'm characterizing that in my own way.

I don't know, Jessica, would you say it was different? No? That's about what we heard. But that's year one, and we'll have to see how these reports come out in year two. This is just a couple of them that we shared with you just so you could see that this is occurring. Reports came out in a highly principles-based way, the standard.

Shortly after that -- just one other thing -- the European Union came out with requirements after that which have now become final and have included those requirements in just a short page as well, which is similar, that the audit opinion must now include a description of the most significant assessed risks of material misstatement including material misstatements due to fraud, risk of material misstatement due to fraud and a summary of the auditor's response to those risks. In both cases as well the auditor's reports would have to comment on other information accompanying the audited financial statements.

So we are continuing to proceed on our path with respect to reflecting on the comments on the proposal, comments from the public meeting, comments from SAG members and we're working with the Board on our next steps.

I thought I'd take -- there's a couple of cards up. But before I did that -- I see Mike Gallagher was up and Bob Herz. Before I did that, I've talked a little bit about our developments and other global developments, but clearly among those global developments are developments at the International Auditing and Assurance Standards Board, as they are also in the process of developing a new auditor's report -- and Arnold Schilder, a regular observer at our SAG meetings is here today, the Chairman of the IAASB.

And, Arnold, could you give us an update on where the IAASB is?

MR. SCHILDER: Yes, of course. Thank you very much, Marty.

We issued our third consultation audit report in July last year, and it was a very comprehensive exposure draft that included a number of new revised auditor reporting standards.

Comment period closed November 2013. A lot of reactions. And we've had some fulsome discussions with our advisory group and the National Auditing Standard Setters Liaison Group, and in both the PCAOB staff participated as well.

Our Board had a public meeting last week and I'm very pleased with the progress that we made. It was a full week. We spent over 60 percent of our time on that. And we had our first read through the suite of revised auditor reporting standards. We are track, as Jim also said, for finalizing them at our September meeting.

Our Board has 18 members, 9, as you said, practitioners, 9 including myself non-practitioners. And for approval we need at least 12 in favor.

We essentially closed off the discussions on our overarching reporting standards, ISA 700, and this now includes new requirements to make an explicit statement on independence, naming the engagement partner for listed entities, and also placing the auditor's opinion first as the overall conclusion that should be seen immediately.

A bit more specific on some key components. First, key audit matters. We've made excellent progress on this new standard, ISA 701, and that addresses the communication of key audit matters. Respondents to the exposure draft strongly supported the concept of KAM being based on matters communicated with those charged with governance, usually the audit committee, firstly focusing on matters of significant auditor attention.

However, findings from field testing and other feedback from auditors, standard setters and regulators suggested clarification was needed to ensure that there was a robust decision making framework to enhance consistency in auditor adjustment focused on topics that would likely be relevant to users. And users have told us that communications about individual methods should be as entity-specific as possible to enable them to understand key aspects of the audit.

And I should also mention that similar to the PCAOB feedback from preparers and audit committees has been less supportive regarding the concept of KAM. In their view it's their role to provide original information to users other than the auditors, and auditors and others including the IAASB itself agree to that. There's no discussion about that principle. But we found therefore the need to further clarify in the standard and in our outreach that the purpose of the auditor communicating KAM is to provide greater transparency about the audit.

We've now refined both the requirements relating to determining KAM and the application material which is guidance that is essential to the proper application of the requirements in the ISA. It has all set out conservations for the auditor in all cases focused on three areas.

First, areas of higher assessed risks of material misstatements or significant risks identified in accordance with ISA 315. And you hear of course bells ringing to what Marty just quoted. Second, significant audit adjustment relating to areas in the financial statements that involve the application of significant judgment or estimation by management. Third, the effect on the audit of significant events or transactions that occurred during the year.

We've also picked up many of the PCAOB's proposed required considerations in our guidance to help auditors focus on which of the methods that require significant auditor attention were of most significance in the audit and therefore the key audit matters.

And our most substantive Board debates to date relating to KAM have been on the possibility that the auditor might conclude in what we now call extremely rare circumstances not to communicate a matter that had been determined as a KAM in the auditor's report.

Your feedback to the exposure draft suggested this type of requirement was necessary for the Board's continuing to explore how this could best be done recognizing that it is necessary to put proper parameters around the decision not to communicate a matter and to promote disclosure in most cases.

Like you said, Marty, we have heard much positive feedback through the U.K. experience and we believe we should move forward as well recognizing that communicating KAM will require all of us to take a new and innovative approach to reporting. We are now already talking about implementation support and also post-implementation review.

Some key audit matters briefly on other information. We're also proposing auditor reporting on other information, which in our case is part of a separate project to revise that particular standard, but dealing with of course the information included in a company's in your report.

We received significant feedback to our first exposure draft and we found the need to re-deliberate the proposals to provide greater clarity on the auditor's work effort and the scope of information to be addressed. We also then had the opportunity to consider PCAOB's proposals on the topic. We re-exposed the standards April this year. Comments requested July 18, and we hope to finalize the standard 2014 or early next year.

Finally, going concern. Our exposure draft included auditor reporting on going concern. Like the PCAOB, we recognize the need to work closely with the accounting standard setters towards a more holistic approach to going concern, and we have been doing so in particular at the IASB. However, it's unlikely that changes will be made to the accounting standards of the IASB, so the IAASB has decided to revert to exception-based reporting in the auditor's report; i.e., including statements about going concern when a material uncertainty has been identified, which it will be now very close to the new legislation in Europe and I think as well where PCAOB currently is.

And our work continues to look at how it might increase auditor attention on going concern and response to calls arising from the financial crisis. And at our meeting last week we had some lively debates around the possibility of a new requirement aimed at enhancing the auditor's consideration of the adequacy of disclosures around going concern issues, including the need for and adequacy of disclosures about underlying events or conditions where a material uncertainty does not exist, the so-called close calls. And course that's of interest to the slides from the FASB in the area of significant doubt that had been alleviated by management plans.

Well, that's the area that we're discussing. We believe that it is important to help to drive behavioral changes in the way that both management and auditors approach the assessment of going concern, so it's important that we get it right.

Two closing comments: First, the IAASB started this project in 2006 with Independent Research Commission by us and the AICPA Auditing Standards Board. We then had two global rounds of consultations, 2011, 2012, and then the exposure draft in 2013. And I really would express how grateful we are for the dialogue that we had during this process with the PCAOB at various levels, the

Financial Reporting Council, but also the European Commission and European Parliament. And we appreciate that the PCAOB has to operate within confidentiality requirements, so we're very grateful for the dialogue that we could have.

And finally, in line also with what you said, Marty, does it work? Let me give you one quote from an investor from the U.K. who has often been very critical to the auditing profession, Iain Richards from Threadneedle Asset Management. Quote, "While we are clearly at a very early stage in the development of this enhanced reporting, we have been pleasantly surprised by the usefulness of some of the disclosures. There is a strong subjective element in how we as shareholders assess the stewardship of a business and the quality of its reporting and auditing and these reports provide an important medium that can contribute to that. In a world that is rarely black or white, they also help underpin the credibility and trust that needs to be inherent in the relationship between the leadership of a company and its shareholders."

Pleasantly surprised. I wonder how long ago it is that an investor was able to say that about an auditor's report. Thank you.

MR. BAUMANN: Arnold, thanks very much for that update. And as I said, there are a number of cards up. Mike Gallagher was first.

MR. GALLAGHER: Thank you, Marty. Marty, I wanted to share with this group that the Center for Audit Quality has updated its response to the project, specifically indicating the results of field tests that were recently completed with respect to the auditor's reporting model.

So the field tests focused on a couple of things: CAMs was primary focus and for the CAM field test nine audit firms participated. Fifty-one issuers participated. With respect to other information, it was a smaller size. Six firms and fifteen issuers.

Before I get into the details; and I won't get into much, I'll give a very quick high-level summary of what the field tests found, but there were clearly some limitations to the field tests, a couple of which -- and probably the most significant of which, given the desire on the part of issuers to remain confidential and not have the information go beyond the accounting firm that did the work, we were not able to get a reaction from investors.

So without getting the benefits, which is clearly what we would get from an investor perspective, you know, severe limitation, and we understand that.

The other limitation was it wasn't done under live conditions. So we looked at 2012 audits for purposes of developing the CAMs. So we didn't have the benefit of so-called game day conditions in terms of what it meant, in terms of time, when that time would occur and the impact on the audit.

That said, I think there were some useful findings that came out of the effort that should be considered as a data point. And I appreciate the time that we spent with, Marty, you and your team, and Jeanette participated from the Board perspective, a couple of weeks ago to listen to what we found in the field test.

And so at a very high level a couple of things: One, very similar to what I heard Arnold just say with respect to refining the population from what you would pick CAM, and as we talked about in previous SAG meetings we think it would be useful to refine it down from three maybe to one key source, which is information communicated to audit committees. We think that you'd capture things that are relevant there and without having to go through a larger population, which is largely redundant.

The other thing to consider there would be a materiality lens. I think materiality is implicit, but if there can be some more explicit recognition that, you know, the things that would end up in CAMs, to avoid too many CAMs, should be focused on things that are really meaningful and material. And recognizing that sometimes is in the eye of the beholder, many times in the eye of the beholder, but we make those decisions every day.

Two other things that related to documentation: One related to when auditors -- we found a pretty big range of documentation when auditors decided how many potential CAMs might there be and what's the documentation requirement. For the CAMs particularly, the CAMs are left on the cutting room floor. Making sure that we've got the right level of documentation. And even for the CAMs that go forward, how to document those going forward. Not looking for a cookie cutter, but maybe just a little bit more in terms of guidance, in terms of what the expectation would be from a documentation perspective.

And then the last item with respect to CAMs, again, a very broad range and diversity with respect to how the CAMs were written. Some in terms of the level of detail, the range of detail, just the volume. It was quite a range. And while you certainly want a certain range, you don't want these to be cookie cutter. We don't want them to be boilerplate. And that's one of the risks here. And so it's not a paint-by-numbers exercise, but perhaps there's an opportunity to put goal posts out there where you get an expected and a good range of outcomes, because I think there should be a range. And they all should not look the same, but is there an opportunity to kind of narrow the field from what we saw in the field tests.

With respect to other information, really one key finding; and again it's something we've talked about in previous SAG meetings, confusion over what "evaluate" means, and is that a higher standard than we're performing under today? Clearly, when you think about read and consider versus evaluate and report, it sure sounds like it's more. And so making sure we're capturing the intent of what the Board is trying to achieve and is "evaluate" the correct word or is there a better word that would create more clarity and consistency in terms of what the performance requirement would be.

But overall I'd go back and say -- you know, go back to the meetings that we had at the beginning of April. Very positive. I thought it was -- having the opportunity to participate, for which I was very grateful was -- I thought the meetings were terrific. I was there for the two days. And we're very supportive of the project and hopefully this is a useful data point that you can consider as it goes forward. Thank you.

MR. BAUMANN: Thanks, Mike. It is very useful, obviously any input like that that we receive to help us refine whatever our next step may be in terms of a re-proposal or whatever we do next. Hopefully we get it better. And as the IAASB has done, continue through the process of consultation, proposal, etcetera, to work through refinements to make sure we get the best product.

The auditor's report hasn't changed in the United States in about 75 years or so, so if we're going to change it, let's make sure we get as much information as we can and do it as well as we can. So thanks for that.

That letter from the CAQ I think is now up -- has been delivered to us and is available with other comment letters that we've received on our website.

The next card that I saw go up was Bob Herz.

MR. HERZ: Thank you. Again, this is on the auditor's reporting model, and for this purpose I will not include the evaluation of the other information, just the reporting on CAMs or key matters. One is an observation and one is more of a comment.

The observation is just to add to what Mike talked about, the CAQ, and this is a much less robust or scientific sample, but I had the opportunity to participate in two meetings, one in the U.S. and one in the U.K. of audit committee chairs and members.

The U.S. meeting, which was sponsored by the NACD, I think a lot of the concerns that you've been hearing about disclosure of original information potentially in the report, lack of clarity on certain things and all the other points that we discussed at a prior meeting were raised by audit committee members, or a number of audit committee members.

I was in the U.K. subsequent to that and at the point that they were -- had issued some of these reports or were working on them. And I'll reinforce that the reaction there among audit committee people there, particularly what I'll call the not-inside-baseball people, or maybe it should be not-inside football people; in other words, they didn't come from the profession, they hadn't been with one of the firms or whatever, they were people that had been in business or had been regulators or whatever, was extremely positive to the expanded reporting. And so they really started to get much better insight into what was looked at in the audit and what was found and the like.

In that regard -- and I guess kind of in the camp of you'd be disappointed if I didn't say this, Marty, but at one of the prior meetings I said when you guys had some -- a couple of examples of the kind of things that might be reported and how they might be reported, I made the observation that they kind of pointed to the area and the like, but then they didn't say, well, what did the auditor do and what did the auditor find?

And so when I read the U.K. examples; and we've got two of them here, Rolls Royce and HSBC, I thought it was very good the way they did that. It didn't leave you hanging there. It kind of wrapped it all up.

MR. BAUMANN: Yes, I think all of these experiences and field testing and IAASB's outreach and those kind of comments are helpful, which we did hear at the two-day meeting about not just what was the matter, but what happened to it. So that's come across as well, what was the auditor's response to this critical audit matter? We've heard that a number of times.

So we've gotten a lot of good input on this from a variety of -- from a lot of outreach on this project, from Jessica and team, who continue to move along on the development of our next proposal on this.

Elizabeth Mooney?

MS. MOONEY: So it sounds like the U.S. is pretty behind, I mean, 75 years, you mentioned in the U.S. And the U.K. that -- the discussion. So it's encouraging that we're continuing to look pretty hard at this. But I'm curious just on the Rolls Royce; and I don't know if there's anyone here who can speak for KPMG, but what is there response and when you've talked to them about how difficult it was for KPMG to go through this exercise for the Rolls Royce audit report, for instance? The challenges.

MR. BAUMANN: We had some people at the public meeting, but I don't think we -- do we have anybody from that firm?

Yes, Tony Cates. That's right. We had Tony Cates from that firm who talked about that experience, but we didn't have a representative of the company at the public meeting. If you're asking what the company's reaction was?

MS. MOONEY: No, I'm just asking how hard it was for KPMG to put together this audit report, if it was -- what their experience was in terms of it being -- how it was received, what challenges they faced, what they left out.

MR. BAUMANN: Jessica?

MS. WATTS: I think KPMG actually put out a survey on putting together these audit reports. And then there have been several articles about these particular KPMG audit reports. And there's this one particular auditor has done these more extended auditor's reports, Rolls Royce and then there's another that he has done. Anyway, they've -- KPMG has said that they had put out these two specific audit reports that went a little bit further than what the U.K. required. And they had done it to be provocative and try to get feedback, and the feedback had been very good about -- from investors, that they thought that this was really helpful to have the -- not only what the auditor did, but what the auditor found.

And so, the investors have liked it. And from what we understand from KPMG, it wasn't that difficult. But that was really from these articles is where we've learned it, and then from discussions with Tony Cates during the meeting.

MR. BAUMANN: What we did here during the public meetings was that -- again, I think I mentioned this, the teams were -- the engagement teams were motivated, they felt that their audit report was going to be more useful and the areas that they worked on could be more relevant potentially to investors. And the items that were disclosed, it's not as if they'd pop up at the last second. These were typically the items that were probably the most important items addressed throughout the audit, discussed probably a number of times with management and the audit committee.

So in terms of the extra effort, the extra effort seems to be in the writing of the matters, but not a matter of, well, what are we going to talk about as the critical matters? The engagement team, the company and the audit committee pretty much seems to have an idea that these are the issues we all talked about during the year. These were the real troublesome issues in terms of auditing. So not surprised at what was disclosed in the auditor's report.

Jeff Mahoney?

MR. MAHONEY: Thank you. I had a question and a comment. Elizabeth essentially took my question, but one add-on to that, to the extent that this group will have future discussions in connection with this project, I think it would be very useful to have Mr. Sikes or Mr. Tate or someone from the firm, someone from other firms that have issued these types of opinions to speak to this group so that we can ask them questions and get more insights from them. So that's my question.

My comment is that with respect to the Rolls Royce opinion, and in particular with respect to the findings paragraphs, and in particular the findings paragraph with respect to the measurement of revenue and profit in the civil aerospace business and the findings paragraph in connection with evaluation of Daimler AG's put option, that type of disclosure I think is very much in line with much of the input from the user community that was provided to the Treasury Committee a number of years ago. It's also very consistent with the Council's numerous letters on this project over the years and with many of the user investor surveys and studies, and with the PCAOB's own outreach to investors in connection with this project.

That's my comment. Thanks.

MR. BAUMANN: Yes, that finding is we found the resulting estimate was acceptable but mildly optimistic resulting in a somewhat lower liability being recorded than might otherwise have been the case, that type of language. So, interesting language. But certainly we have heard from the investor community that that type of assessment of estimates is what the investor community is interested in, in addition to a recitation of these were the most significant risks and here's how we audited it. So that's a consistent comment, Jeff, I think from the investor community over time.

Lew Ferguson, you had your card up a minute ago?

MR. FERGUSON: I just wanted to point out that one of the things that I felt was very interesting about the comments that Cates made when he said that these reports were very dramatic because they were different than anything that had ever been put out before. But he was concerned and he said in these particular companies it was likely that the companies would probably not change from year to year. So the next report might look exactly the same and people would begin to say, okay, well, here we are back to a new kind of boilerplate and this is not dramatic anymore and to sort of want ever more information.

MR. BAUMANN: Yes, that point was made and I think everybody acknowledged this is -- year one looked very interested in the U.K. and what is year two going to look like will be a very important experience.

Guy Jubb?

MR. JUBB: Speaking as a major U.K. investor, I wasn't so much pleasantly surprised by the enhanced auditor reporting, but I was certainly very encouraged by where we are going for many of the reasons that have already been discussed. But I would like to highlight in terms of feedback and therefore to help the PCAOB -- is the use of specificity in terms of the auditor reports that have been used. We have two very good examples in Rolls Royce and Barclays. I should add that the Rolls Royce one is generally regarded as the high bar in this and it wouldn't be suggested that all auditor reports in the U.K. have this transparency. But the willingness to refer to the Daimler option that Jeff mentioned earlier, that gives the investors of itself a degree of greater confidence in the audit approach that was taken.

Another example is the BP audit report where the auditor by name tells us that he went to Moscow three times to verify the accounting treatment that was used for the Rosneft interest in BP, and that enabled my firm, Standard Life, to go to the BP AGM and ask a question about that. If we had not had that disclosure, we would have not been able to ask that question and we would -- it enhances accountability.

We have also seen -- and I think we haven't referred to this here, but we have also seen a parallel improvement in audit committee reporting as well. This has been on the go for some time, but it has had a step up in terms of seeking to provide greater transparency. And when we as users are looking at the auditor report, we are also in -- on the one had have that. In the other hand we have the audit committee report. And the more that one can actually develop this framework of reporting between audit committees and auditors in a joined up way, I think that that will be valuable for investors and we'll also avoid some degree of inappropriate duplication.

Thirdly, it has enabled a dialogue to take place about audit issues. This year so far I have had discussions, face-to-face discussions with the chairman of seven FTSE 100 audit committees about their auditor report. That is seven more than I have had in my 20-year career at Standard Life in dealing with engagement. But importantly, I'm using the word "having a conversation," because this isn't about hard engagement at this stage. It's about having a conversation about what is being used.

What hasn't actually landed so well yet is disclosures about materiality. And I know that whether or not materiality should be disclosed is a sensitive issue. We have certainly found in principle it is a good disclosure. The terminology that is used has still got a high degree of technicality to it, but there's one number that keeps on resonating, and that's the number five. Everything is five percent of something. And I didn't know that until we had these auditor reports and I'm now starting in my conversations just to ask, well, -- why is it always five percent and what should it be five percent of, or what it should be of? So there's a whole dialogue that's taking place there.

Now having said all that, whilst I am having the conversations and no doubt other investors in this room are, I'm not entirely convinced that audit reports are being well communicated into the capital market system. They are not featuring in the slide decks that are used by investor relations programs in going out to see companies, and therefore I think it is a very narrow pool of people who are actually reading these auditor reports at this stage, and one of the encouragements that has to be given is how to broaden that. And I think in terms of the -- as time goes by and the engagement that the PCAOB has with audit committees it is to encourage audit committees, as I shall be, to actually get the executives to bring this into mainstream investor relations and not the narrow pool.

Two final points, if I may. It has increased interest among investors. I have been struck by the increasing number -- still quite small, but amongst the

U.K. institutional investor community. There are now more investors who are willing to step up to the plate to have a discussion about this. And when two becomes four, four becomes eight and I am confident that that will progress slowly.

And finally, the year-two issue which was being mentioned as to how this is going to be kept fresh, how it is going to be updated. I feel mildly optimistic that we'll get some useful reports coming through. It will require a little bit of hard work and to have -- the one area which I would like to see more transparency on that we have not seen referenced is the contextual factors such as any pressures that there might be on the management to meet market expectations, which should perhaps in exceptional situations sharpen the auditor's pencil or the impact of executive incentives if they are target-related and how the auditor perhaps has assessed those.

But this is part of the journey, to give this rather long comment, but while it's fresh in my mind I wanted to share it.

MR. BAUMANN: It was a long but very worthwhile comment, so thanks for that real live input from a user of these reports in the United Kingdom. That's very valuable, Guy.

Tom Selling and then Barbara Roper?

MR. SELLING: Thank you, Marty. I thought this would be an appropriate moment to make some quick observations about three topics we're talking about today, because I think they're highly interrelated. The auditor reporting model is one, revenue recognition is another, and also the root causes of the audit issues reported by IFIAR. I want to make three points and I want be extremely brief.

The first point is that one of the root causes of the problematic audits we're all concerned about may indeed be a lack of transparency about what an auditor actually does and the ARM project may help with that. I for one would be extremely pleased if the audit reports on critical audit matters would be along the lines of the samples that you gave us, Marty, even if they devolved into the boilerplate that we're speaking about or that we're concerned with.

My point is that CAM reporting is perhaps more important from a control perspective, even as important, as Guy points out, the informational perspective is. The old phrase about sunlight being the best disinfectants, I think this takes this actually to an additional degree where we're actually asking the auditor to shine the spotlight on them as they do this. And the remarks that I've heard so far seem to indicate that when an auditor does this that has an additional effect on, number one, the pride they take in the audit, as well as the quality of the audit.

My second point is that audit quality is directly related to the number of tough judgments that managers have to make and auditors have to somehow certify as reasonable. That seems to be the clear message from the IFIAR report that we'll be discussing and I found that virtually all of the audit flaws were driven by the auditor's inability to reliably state that management's estimates of future events appear reasonable.

We're going to be talking about revenue recognition, and I think it's clear from the materials we received in advance that revenue recognition will be increasing the number of judgments that auditors will be required to make. It's not clear what the PCAOB can do about this acting alone, but the question needs to be asked, and in answering we're discovering that another root cause of the flaws is our standard-setting infrastructure.

Revenue recognition as a project took 12 years, but yet today -- only today, it seems, the PCAOB is going to be asking what challenges to auditing the new judgments that will be required will present to auditors? The FASB has recently stated in Concept Statement No. 8 that cost-benefit analysis is a pervasive constraint. And when we are asking now after 12 years how auditors should respond to that new standard, I wonder and I hope we'll consider whether we're putting the cart before the horse.

My third point is that the auditor's reporting model should provide information about choices of accounting policies when non-authoritative GAAP is the source. One of the things I noticed about the Rolls Royce report is that the opinion paragraph is qualitatively different than what we have. The report separately states that the financial statements are true and fair. And separate from that the report states that the financial statements are in accordance with IFRS as adopted by the

EU.

We use the term "fairly presented" in context with the standard. In addition to that, we recently have a new codification that has changed the status of the financial statement accounting concepts and it's not clear to me that people actually know what GAAP means. Just last week I was at a meeting of the Accounting and Assurance Standards Committee of my state's CPA Society and they asked me to put together a one-hour presentation on what exactly does GAAP mean? I thought that's pretty interesting coming from a group of CPAs.

And so I think I would like to encourage us to consider when we talk about the audit reporting model what GAAP means within the context of a particular audit. When non-authoritative GAAP was relied on significantly, I think that that's part of the judgments that ought to be disclosed within the auditor's report. One of the reasons I bring that up now is because the Rolls Royce report doesn't have quite the same problem because the status of the conceptual framework within IFRS is different than it is under U.S. GAAP. Thank you.

MR. BAUMANN: Thanks, Tom. Thanks for all those comments.

We have a number of cards up. This session was scheduled to end at 2:45, then we begin discussion of audit quality indicators -- I'm sorry, audit quality initiatives. So we're going to continue for a few more minutes to try to answer -- get a few more cards up on this issue. And I have one or two more comments to make on the agenda, so we're going to try to do this in about 5 to 10 minutes, all of this, and then we're going to move on. That's going to shorten the break to about a -- maybe just grab a beverage or something as you head out to your break-out sessions. So we're taking time away from our break here, but I think the discussion is lively and worth it.

So, Barbara Roper?

MS. ROPER: So I'll be very quick. Add my voice to those who think this is very responsive to what investors have been saying for years they want to see in the audit report. I don't know that you have to be this prescriptive in how you would adopt the standard, but I found particularly useful the approach that says this is the risk, this was our response, these are our findings.

So in some ways I would hope that the standard would ensure that all of those points would be addressed in this kind of reporting. I think that in part drives the kind of specificity that makes this useful.

The risk was always that if you did this, went this route, that it would devolve into something that was so general or boilerplate as to be meaningless. I find these to be really -- I thought the samples that the Board prepared for an earlier SAG meeting were encouraging. I found these to be really very high quality useful for investors.

MR. BAUMANN: Thanks. We did, too.

Steve Buller and then Rick Murray.

MR. BULLER: Thanks, Marty. Just a couple brief comments as I also found the reports very useful and I'd encourage you to include additional examples as you find them, even between now and the next SAG meeting just because they're of great interest.

I actually found the Rolls Royce report fairly useful. The Barclays report seemed to have a lot of boilerplate and it looked a lot to me like a significant risk factors disclosure in MD&A. So if you look at some of the topics, provision for uncertain tax positions, IC systems and controls, risk of fraud and revenue, risk advancement, override of controller controls, litigation of regulatory claims, they read boilerplate. I'd be curious if when people did their examination of individual firms if those same paragraphs were recurring in reports issued by the same firm.

MR. BAUMANN: Yes, there's definitely variation in the reports, and that's -- we did put two reports in here that were I thought both interesting, but different characteristics as well in terms of the depth of one and focused more just on the significant risks in the other. But I agree with your observation.

I think we have on this subject three more cards and then we just -- you pointed to four more cards. Rick Murray, Doug Maine, Brandon Rees and Rachel Polson, and then we need to get on.

MR. MURRAY: Thank you, Marty, and just very briefly, just a quick observation. It's clear that there is considerable encouragement in the British experience with first-year exercise that needs to be pursued and understood. At the April event and subsequently we've also had a number of comments, both from the U.S. and the U.K. to be cautious about the enabling value in the U.K. of an integrated regulatory regime and a benign legal culture. I don't suggest that those would necessarily change the outcomes in the U.S., but we hadn't heard any comments about it in this discussion and they were the two most significant additional comments that came forward from April that hadn't made it to the floor and I just wanted to note that they should be considered going forward.

MR. BAUMANN: Valuable point and certainly made at the April meeting with the different legal environments.

MR. MAINE: I am an audit committee chairman and I'm generally supportive of this. Guy's point though about conversations with seven audit committee chairmen resonated with me, and I'm curious to know whether you're considering the practical consequences of this for audit committees, particularly in light of Regulation FD and where it's taboo to have selected disclosures. Does this end up with audit committee conference calls with investors I have interested in accounting and auditing issues? If so, don't know. Want to point that out.

MR. BAUMANN: Yes, I think that those are important questions. What we think is that it gives investors and audit -- investors, not audit committees, because these are things that are not new to the audit committee, we hope -- investors an idea of what were the most significant judgments the auditor had to make as part of the audit. That could trigger, I think, as in the case that Guy pointed out, investors talking to management as part of an earnings call or whatever that might have been, is to tell us a little bit more about the auditor's challenge in this area. But certainly all legal ramifications are -- all consequences are to be considered on our end as part of this, so thanks for that.

Brandon?

MR. REES: Thank you, Marty. I wanted to pick up on a comment you made in the introduction regarding the value of CAM disclosure and audit reports for proxy voting by investors, and I think this also speaks to the goal of encouraging investor audit committee dialogue.

I want to encourage the Board to think about the parallel of executive compensation disclosure, which of course we as investors get in great detail, and the adoption of say on pay advisory votes and the success of that process post Dodd-Frank in encouraging both improvements to the executive compensation process here in the United States as well as dialogues and responsiveness by compensation committees to investor concerns and contrast that with the lack of attention paid to audit firm ratification votes here in the United States.

Before this meeting I pulled the vote results from this year's proxy season for the Russell 3000, and the average vote, average ratification vote was at 99 percent, which was a largely meaningless -- in my mind, largely meaningless vote because investors have nothing to vote on. We have no information besides the level of fees and the ratio of audit to non-audit related fees to guide us on. And that's why I'm genuinely excited about the inclusion of CAMs in the audit report.

And I also want to encourage the Board to consider as a long-term goal the inclusion of audit quality indicators in the audit report or some other form of disclosure as being beneficial to that process, to use the audit vote as a mechanism to encourage both dialogue as well as accountability for effective audits.

MR. BAUMANN: I think that's very valuable input, but having said that, when I was an audit partner I took great excitement and pride in that 99 percent.

(Laughter.)

MR. BAUMANN: So now you've shattered me here. I thought it meant something about my work. Oh, well.

MR. REES: If I could just briefly respond to that. For the 50 companies that lost their say on pay vote, the sky did not fall, and in fact many of those companies have responded by improving their executive compensation process. And they are just advisory.

MR. BAUMANN: Last word on this topic, Rachel Polson.

MS. POLSON: One is a comment and one is a question. One relates to the proposed other information standard is definitely would appreciate from the auditor's perspective clarification on the steps related to evaluate what you specifically want us to do, because I can see auditors taking the approach of spending time actually doing a lot of additional audit procedures and there would be a lot of excess cost for the companies related to that.

And then the other one is more of a question. You know, we talked about the audit deficiencies reports that are out there that are being issued by the inspection reports, and is the thought that if these critical risk matters are included in the report, that that will have the auditor's reflect more closely on where the audit risks are to make sure that they do have the appropriate findings and the responses documented so that they aren't missing that information. Is that one of the outcomes you're hoping with this?

MR. BAUMANN: Yes, I think that's another benefit of the enhanced auditor reporting is by the auditor pointing out the most significant risks. I do think the auditor naturally will pay more attention to those matters, I believe, as part of their audit work. And maybe management will pay more attention to their related disclosures in those areas as well. So I think there's potential positive intended consequences that come out of enhanced auditor reporting.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on June 25, 2014 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the June 25, 2014 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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WEDNESDAY
JUNE 25, 2014

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(...)

MR. TWEEDIE: I haven't read any IASB Board papers since the day I left office, and I certainly haven't read any FASB papers. I really want to keep the will to live at the moment.

(Laughter.)

The fact that I am ignorant of the fact doesn't stop me, like any good auditor, from giving an opinion.

Basically, what I think the problem really is, it is not so much accounting standards. IAS 1 is a very old one. It is probably the first one. Well, it must be, No. 1, the first one the IASC ever issued. And it exists since 1973. So, you know, I wouldn't put too much weight on that particular standard.

I think the real problem, though, was in the crisis it was so difficult for a going concern qualification; it killed the entity. And so, they didn't go on. And yet, you got terrific criticism about these companies that received the top funding, the ones that went bust, and no going concern qualification.

I am not sure that this is going to solve that problem for you. And when you look at the UK's situation, and the one that the bank that blew up first, Northern Rock, it had no going concern qualification.

And if you looked about Note 40-something, you could see the business model, which was to borrow from the wholesale markets at three months' notice and lend out for 25 years. And 75 percent of Northern Rock's liabilities were due within three months. And so, the minute the wholesale markets froze, Northern Rock was dead.

And, you know, there was a classic case. What had they based the going concern assumption on? And the going concern was based on the wholesale market staying open.

And I rather think you want to move more towards, what is it that makes us think this is okay, rather than sort of say, is there a doubt? Because there wasn't with Northern Rock until the crisis hit, and then, it came within two or three months. Bang. Gone.

So, I am not sure you are attacking it in the right way, to be honest. I think you are going to have to look at, give people details of why is this a going concern in your opinion.

People didn't criticize the auditor in Northern Rock. Well, they did, but once it was pointed out to them. Note 40-odd, it was there.

But your new auditing reporting is suggesting -- at least a lot of investors want it -- could you draw attention to significant items in the notes and things like that? And I think this is a classic. And this one actually could save the auditors from a lot of hassle.

MR. BAUMANN: You know, that's a great point, and I appreciate your making it.

We have had a lot of discussion about that because in terms of critical audit matters and the new auditor reporting, a critical audit matter could be whether or not this company has the ability to continue as a going concern. And the auditor would describe that risk and, then, their response to that potentially under our new auditor reporting.

That has been raised oftentimes as the key issue of concern by preparers and others of, well, management determined they didn't have to report that they don't have the ability to continue as a going concern, but, yet, the auditors are reporting something to investors which is now being called original information often, that the auditor is describing their thought process as to, you know, whether they were or whether they were not in a situation of having substantial doubt about a going concern.

So, I share your point very much, and it has been one of the issues we have been debating on critical audit matters, and getting a lot of pushback that, well, yes, but you can't raise an issue that wouldn't otherwise be required to be disclosed under the accounting framework.

Now we haven't concluded that is the case. There's no law that says that. I am just saying a lot of pushback from commenters about us requiring auditors to report on critical audit matters that would be information that wasn't otherwise required to be disclosed in the financial statements.

So, excellent point and one that we are debating a lot in this issue about enhanced auditor reporting.

(...)

MR. CROTEAU: Yes, thanks very much.

A few things, and I appreciate the comments Bob is making. I think in the first instance certainly we have been staying coordinated with the FASB as they proceed. I think there is a threshold question to be asked as to whether the definition of substantial doubt in the FASB standard would satisfy the obligation in securities law. So, I think that is an important threshold question.

I guess I would just say, from my own perspective, it is fair to say from a staff perspective that if we thought it didn't, we certainly would have informed the FASB of that. Now that doesn't mean that is all investors are looking for. If investors are looking for something more, including earlier warnings, that doesn't mean that that necessarily satisfies it.

But, from the perspective of whether the definition the FASB is looking to proceed with satisfies at least the requirements of the securities law, again, I think at least speaking for myself, we would have raised our hands and said, "Hey, I don't think it does," if we didn't think it did.

I do want to mention -- and, Marty, you raised the concern that some have raised relative to original information, and I think that is part of what some have raised relative to putting the auditor in the role perhaps of reporting at a different threshold. But I think it is beyond that in this case.

I think in some situations some are concerned that it may undermine accounting criteria, if you will. So, it is not just a question of whether it is original information. But if the accounting standards define a threshold, having the auditor report at a different threshold for the same definitional term some view might undermine the accounting criteria. And so, I think it was more than just whether or not it is original information.

So, I think there are multiple things to be thought about here. The threshold question is a fair one to be asked, and, then, whether there is additional information investors need or should have.

The last point I will just make is liquidity disclosures, risk factor disclosures. There are other places in a filing that one would expect disclosures that are relevant to investors in this space as well. And so, obviously, when we think of it, we need to think of it in the broader context than just this one aspect. So, I think it is important to recall that, too.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Investor Advisory Group meeting on October 20, 2014 that relates to the Board's Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments. The other topics discussed during the October 20, 2014 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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MONDAY, OCTOBER 20, 2014

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The Advisory Group met in the Hamilton Ballroom of the Hamilton Crowne Plaza Hotel, 1001 Fourteenth Street, Northwest, Washington, D.C. at 9:00 a.m., Steve Harris, Chairman, presiding.

PRESENT

STEVE HARRIS, PCAOB staff, Chairman
BRANDON BECKER, TIAA-CREF
ROBERT T. BUETTNER, Newbrook Capital Advisors
MERCER E. BULLARD, University of Mississippi, Plancorp, LLC, and Fund Democracy, Inc.
CURTIS L. BUSER, The Carlyle Group
T. GRANT CALLERY, formerly of FINRA
JOSEPH V. CARCELLO, University of Tennessee
NORMAN J. HARRISON, FTI Consulting, Inc.
MICHAEL J. HEAD, Creighton University
PETER H. NACHTWEY, Legg Mason, Inc.
BARBARA L. ROPER, Consumer Federation of America
LAWRENCE M. SHOVER, Solutions Funds Group
DAMON A. SILVERS, AFL-CIO
TONY SONDHI, A.C. Sondhi & Associates, LLC
JUDGE STANLEY SPORKIN, U.S. District Court (Retired)
ROBERT M. TAROLA, Right Advisory, LLC
LYNN E. TURNER, LitiNomics
GARY G. WALSH, Luther King Capital Management
ANN L. YERGER, Council of Institutional Investors

ALSO PRESENT

JIM DOTY, PCAOB Director
BRIAN CROTEAU, Securities and Exchange Commission
MARTIN BAUMANN, PCAOB
LEWIS FERGUSON, PCAOB
JEANETTE FRANZEL, PCAOB
JAY HANSON, PCAOB
JAMES SCHNURR, Securities and Exchange Commission
MARY JO WHITE, Securities and Exchange Commission, Chair

MEMBER YERGER: Okay. Our first but final recommendation is urging an expanded audit report. I could almost repeat all the comments I made about the signature, this is not a new issue for the Board which is -- it's been considering the issue. It’s actually not a new issue for this committee, we have discussed it and I think supported it quite robustly. And it's not a new issue globally, as we've discussed, expanded reports are in place in other countries and as we've learned, I think the Rolls Royce example is a terrific one, actually it seems to be working in a really significant way.

So you know, the issue of the quality of the audit report really has been debated for decades and I think there is value from an investor standpoint in the current very blunt pass/fail model that's in the report. It's concise, it's clear, it's comparable. But I think it is clear today that the current auditor's report is just not satisfying the needs and interests of investors who really are the final and the ultimate customer of these products. As we surveyed the members of -- what was it -- of the investors two and a half, maybe, two years ago, three years ago, on this issue there was strong support for an enhanced audit report from the investor community. CFA Institute has similarly surveyed its members and found the same thing. So this is a space where I think investors' viewpoint is pretty consistent and clear, that they would like to know more from the auditors.

You know, we do believe there's going to be an enhancement of audit quality if the auditor's report would be expanded, but I think there are also some other real benefits for investors from an expanded report. First of all, I view auditors as independent experts who have knowledge about the company that, you know, most of us investors can't get at. I think there would be real value in gaining from some of their knowledge and expertise and it would help investors analyze and price risks and make investment decisions.

I think an expanded report would really heighten the perceived value of the audit firm work, something that Lynn discussed earlier, and I think it might give firms some leverage to effect change and enhance management's disclosures and practices. And I finally think that this expanded reporting would enhance the transparency and promote real confidence in audited financials.

In terms of cost, Steve, you brought this up earlier, I think a lot of the things that we would like to see in that expanded report, sort of what was in the

Rolls Royce report, is probably already being communicated to the audit committees, so I don't know that I see this as a really expensive undertaking in terms of disclosing to the public.

And I also note, I know that there's a lot of debate about who should this expanded information be coming from? Should it come from the audit committee? Should it come from the outside auditor? And my view is there's real value in getting the insights from the outside auditor, the independent expert that's been retained by the firm. I believe there could be better disclosures from the audit committee but I don't think that the audit committee should solely be responsible for this.

MEMBER SILVERS: First, my thanks to my colleagues for picking up after me. I was at lunch with my wife and didn't realize that I was up next. So now I've gathered my thoughts, I have a couple of things to say about this.

The first is to repeat what I guess has been -- actually what someone said earlier which is, in relation to the question of the expanded audit report, it only -- just to put a further gloss on the recommendations that are here, it only makes -- it's only going to work, I think, if there's a requirement to disclose something. Meaning that if basically the expanded audit report is a mandate to tell us, tell the public, tell investors if something is wrong. The audit firm will, of course, say nothing is wrong.

Now that requirement, that further requirement may give the audit firm some leverage in private negotiations with the issuer but it's not going to result in any new information. What will result in new information is the requirement to disclose, you know, for example, the most -- you know, every audit has matters that come up that are of concern to the auditor that are generally resolved in some fashion that's mutually acceptable. The requirement to disclose the most salient such matter, there's always one, right? And the notion that you can't say nothing seems to me to be something that would actually add value of the kind that the examples in our report outline.

MEMER CARCELLO:

And then in terms of the audit report based on some of the work that Ann and Norman and Gus Sauder, who used to be a member of this group, did a few years ago, basically what we heard from users is, although they found the audit useful, they didn't even look at the report because it had no information content. And there are other things we could come up with but at a minimum I think those three are indicative of the fact that there are issues with both audits and the communication of the audit results, that these recommendations are designed to try to be responsive to.

CHAIRMAN DOTY:

If you start thinking of what we do in terms of the disclosures that we can now implement to enhance confidence that the public is getting the facts about the audit, and certainly they are, the audit reporting model is the biggest project going in that regard, the practices in the firm that we can lobby for successfully in talking to the firms. And then the final ultima ratio of where we can say we think this responsibility comes to rest outside, those are three fairly important sticks that we have to wield. They are three fairly important devices we have for improving audit quality.

MEMBER CARCELLO:

If you look at comment letters on the expansion of the audit report, most, if not all of the institutional investors that have commented support that.

Audit committees seem to be almost unanimous in their opposition. So these are groups that are supposed to represent the interests of investors and on major policy issues are taking policy positions opposite that espoused by investors.

MR. BAUMANN:

So we've issued a proposal for the auditor to disclose critical audit matters in the audit report and also to describe what the auditor's responsibility was with respect to other information accompanying the financial statements. Some of the non-audited -- some of the non-GAAP measures and others which could be reported in the other information where the auditor has to read and consider that. But we were heightening some of the requirements there.

We also held public hearings on the expanded auditor report in April of 2014. So our plan now is to issue a reproposal on expanded auditor reporting requirements, taking into account the comments we received during the comment period as well as at the public meeting and to issue that reproposal probably in the first quarter of 2015. We are staying obviously very close to all of those global developments and have had many conversations with the IAASB and European Commission and others.

Just in terms of timing, somebody mentioned falling behind, hopefully we won't fall too far behind here. the IAASB expects to approve a standard on expanded auditor reporting at their December meeting. And that they expect to be effective for year's ending on or after December 15th, 2016 such that expanded auditor reporting would take place in 2017. So if we can get our reproposal out in the first quarter as I suggested, and hopefully move that along, maybe we can get on track.

By the way, that IAASB report that they expect to approve in December, the IAASB report, does include a requirement to disclose the name of the engagement partner in the audit report so that will be a requirement basically around the world for all those countries over 100 jurisdictions that follow international auditing standards. So again, please weigh in on that reproposal on expanded auditor reporting that we'll issue in the first quarter of 2015.

MEMBER NACHTWEY:

And then on this expanded audit report, that we get it right and that it's useful information and not just a lot of boilerplate at the end of the day, if we're going to have companies and the investors in those companies paying for that extra work.

MEMBER HARRISON:

I'll be brief because first of all some of the observations I would have offered have been covered already. I don't want to be repetitive. I'll end on the note or theme I mentioned in one of my comments earlier, and that is that I would strongly urge the Board, in everything you do, but in particular in the rulemaking in which you engage that pertains to the audit report and some of the other disclosure-oriented issues that we've mentioned today, to bear in mind that one of the things that the audit profession and audit firms can do where I think there is tremendous room for improvement is to be an additional source of valuable information that informs the investment process, as we discussed earlier.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Standing Advisory Group meeting on May 18, 2016 that relates to the reproposal, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*. The other topics discussed during the May 18-19, 2016 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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STANDING ADVISORY GROUP

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MEETING

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WEDNESDAY
MAY 18, 2016

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The Advisory Group met at the Washington Plaza Hotel, 10 Thomas Circle, Northwest, Washington, D.C., at 8:30 a.m., James R. Doty, Chairman, presiding.

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PCAOB STAFF

BRIAN DEGANO, Associate Chief Auditor
JENNIFER RAND, Deputy Chief Auditor
JESSICA WATTS, Associate Chief Auditor

MS. RAND: Good morning, everyone. This next session we'll be talking about the Auditor's Reporting Model. Specifically, the PCAOB issued a week ago today a reproposal on the Auditor's Report intended to make the Auditor's Report more relevant and informative to users.

This reproposal is hot off the presses. And today, even though we recognize it was only issued a week ago, when we're looking for comments August 15th. But even still, the Standing Advisory Group is a very important group to us and very interested in any initial reactions, comments you may have and happy to answer any questions, too.

Jessica Watts and I are going to spend a few minutes just to provide some background and overview, a little bit about the reproposal. But really we're interested in hearing from you and answering any questions you may have or providing any observations on the changes that have been made and if you think those changes are good which we're hoping we'll hear that. But again, it's up to you.

This project just for some brief background has been several years in the making. We started this back in 2010 and really some of the discussions with the

Standing Advisory Group were really informative to us and the direction of the project and looking to make some substantive changes to make the Auditor's Report more relevant and informative to users.

After we conducted a lot of outreach with the SAG, with investors, auditors, preparers and many others, the PCAOB issued a concept release, held a roundtable. Then in 2013, we issued a proposal. In 2014, had a public meeting.

There has been much academic research coming out which we've considered. Much of that is reflected in the reproposal the Board issued. And also we've been seeing changes that have been happening globally. So talking about an expanded Auditor's Report has become a reality around the world. It hasn't happened here in the United States, but we've seen changes go into effect and have been able to study how those changes have been. Have the investors found the changes helpful? What's been the effect of the audit? And so far, what we've been seeing is a lot of positive results.

As far as the proposal, as I said, the objective has been to make the report more relevant and informative to users. The audit of course involves a significant effort and auditors spend a significant amount of time in order to issue an opinion on the company's financial statements.

The report as it exists today in the United States is a pass/fail opinion. So all this work results in a pass/fail opinion which is very important. It's whether the company's financial statements are fairly presented or not.

But nonetheless investors have asked for more information from the auditor. They view the auditor as an independent third party and are interested in hearing what are really the issues that keep the auditor awake at night.

So that's what our reproposal has intended to do. What it does is it would require the auditor to communicate in the Auditor's Report critical audit matters arising from the audit that required especially challenging, subjective or complex auditor judgment and also how the auditor responded to those matters.

We believe that critical audit matters are likely to be identified in areas that investors have indicated would be of particular interest to them such as significant management estimates and judgments made in preparing the financial statements, areas of high financial statement and audit risk, unusual transactions and other significant changes in the financial statements.

The reproposed standard also includes additional improvements that are primarily intended to clarify the auditor's role and responsibilities related to the audit and to make the report easier to read.

Before I turn it over to Jessica, I'd just like to spend a couple of minutes on initiatives by the regulators and standard-setters. The IAASB, the European Union and the Financial Reporting Council in the UK have all adopted requirements for expanded auditor reporting that go beyond the pass/fail opinion. While their underlying requirements differ in the details, there is a common theme in these initiatives: communicating information about audit specific matters in the auditor's report.

We of course recognize that the regulatory market, environments and other jurisdictions are different from the United States. But even so, we carefully considered the efforts undertaken in these different jurisdictions and we think our reproposal is analogous in many respects to the requirements recently established in other jurisdictions.

We've also been monitoring quite carefully the experience in the UK. At our 2014 public meeting, we had several representatives from the UK talking about their experience. How are things going? Are investors finding this valuable? How are auditors adapting to these new requirements? Have they been able to issue their reports timely?

The FRC, that's the analogous to the PCAOB in the UK, the financial reporting. They're the audit regulator in the UK. They have published a couple of reports regarding implementation after year one and most recently year two. And they have noted that investors greatly value the information provided in expanded auditor reporting, and overall we find the experience in the UK -- and there are a couple of SAG members from the UK that may want to talk about their experience as well -- but we're finding their experience quite encouraging and we're hopeful that the changes to the report, if adopted by the PCAOB, would be well received here.

With that as an overview, I'll turn it over to Jessica just to walk through the requirements. And again we're happy and really interested in hearing your comments today. Thank you.

MS. WATTS: Thanks, Jennifer. Good morning. So as Jen has said, we are most interested in hearing from you. So I'm going to only spend a few minutes on the key aspects of the reproposal and some differences from the proposal.

As Marty did earlier, please feel free to ask questions throughout. Just put your tent card up and we will stop and call on you.

As Marty mentioned and Jen, last Wednesday the Board issued the reproposal for public comment and our comment period ends on August 15th.

I plan to describe a few key aspects of the reproposal including the requirements related to critical audit matters and key changes to these requirements from the 2013 proposal and briefly describe some additional improvements to the Auditor's Report including clarifications of the existing audit responsibilities, disclosure of the auditor tenure and some standardization of the Auditor's Report.

Most significantly, the reproposed standard would require communication of the Auditor's Report of any critical audit matters arising from the audit of the current period's financial statements. While the concept of critical audit matters has been carried forward from the 2013 proposal, the definition has been modified in a number of respects.

Under the reproposal, critical audit matters would be defined as any matter that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective or complex auditor judgment.

The source of critical audit matters has been narrowed to matters communicated or required to be communicated to the audit committee from the matters in the 2013 proposal which were documented in the engagement completion document, reviewed by the engagement quality reviewer or communicated via the audit committee.

The reproposed standard also adds a materiality component to the definition of a critical audit matter because some commenters were concerned that the auditor otherwise may be required to communicate information that management is not required to disclose. By using relates to the critical audit matter which could be a element of an account or disclosure and does not necessarily need to be the entire account or disclosure, or could be a matter that has a pervasive effect on the financial statements.

The criteria by which to determine a matter as a critical audit matter was also narrowed from the 2013 proposal which used the criteria of involved the most difficult subjective or complex auditor judgment, posed the most difficulty to the auditor obtaining sufficient appropriate audit evidence or posed the most difficulty to the auditor in forming an opinion on the financial statements.

It was narrowed to those matters that involved especially challenging, subjective or complex auditor judgment. This change reflects some commenters' concerns that the original definition could lead to the reporting of unimportant matters or to misinterpretation by financial statement users that the auditor is uncomfortable with the related accounting or disclosures.

Under the reproposed standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts and disclosures that are material, the auditor would then take into account a series of nonexclusive lists of factors when determining whether a matter involved especially challenging, subjective or complex auditor judgments.

The list of factors in reproposal is similar to those in the proposal, but has been modified. The reproposed standard includes six factors to assist the auditor in determining critical audit matters. Determination should be made in the context of the particular audit with the aim of providing audit specific information rather than a discussion of generic risks. The reproposed factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective or complex auditor judgment.

Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on only one factor, a combination of factors or other factors specific to the audit that were not in the list that we have provided.

The communication of a critical matter in an auditor's report would include identifying the critical audit matter, describing the principal considerations that led the auditor to determine that the matter is a critical audit matter, describing how it was addressed in the audit and referring to the relevant financial statement accounts and disclosures.

These are similar to the communication requirements of the proposal. However, in response to commenters' suggestions, the new requirement for the auditor to describe how the critical audit matter was addressed in the audit was added.

To meet this requirement, the auditor may describe the auditor's response or approach that was most relevant to the matter, a brief overview of procedures performed, an indication of the outcome of the auditor's procedures or key observations with respect to the matter. Many commenters also stated that the communication of critical audit matters in areas where the company had no current reporting obligation would result in the auditor being the source of original information. That is, disclosing confidential information about the company or effectively imposing a lower disclosure threshold than current management reporting requirements.

The reproposal includes a note that indicates that, when describing critical audit matters in the auditor's report, the auditors are not expected to provide information about the company that the company has not made publicly available unless such information is necessary to describe the principal considerations that led the auditor to determine the matter as a critical audit matter or describe how the matter was addressed in the audit. Additionally, if the auditor determines there are no critical audit matters, the auditor would also state that in the Auditor's Report.

Under the reproposal, auditors would be required to document whether matters that were communicated or required to be communicated to the audit committee and that related to accounts and disclosures that are material to the financial statements were critical audit matters. This documentation requirement has been narrowed from the 2013 proposal which would have required documentation for matters that appeared to meet the definition of a critical audit matter but were not reported.

Several commenters expressed concern that the documentation requirement for nonreported matters was broad and not aligned with current audit documentation requirements. The amount of documentation required would vary with the circumstances and the auditor could comply with the documentation in a variety of ways.

Under the 2013 proposal, the standard would have applied to all audits conducted under PCAOB standards. However, the reproposal contemplates that the communication of critical audit matters would not be required for audits of brokers and dealers, benefit plans or investment companies other than business development companies.

Overall, the Board considered that the communication of critical audit matters for these types of entities may not provide meaningful information in the same way as that for other issuers. However, auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

The next slide provides an overview of the key changes to critical audit matters. However, I've already gone through these throughout the other slides. So I'm not going to spend any time here.

The reproposed standard also includes additional improvements to the auditor's report such as clarifications of the existing auditor responsibilities which would enhance certain standardized language in the auditor's report. As Marty mentioned this morning, we would be adding "whether due to error or fraud" in the auditor's report that has not been there previously, although the auditor has had that responsibility.

Also another one would be tenure. We're going to add an element that would describe how long the auditor has had a relationship with the company and then a statement that the auditor is required to be independent. There is a standardized form of the auditor's report which would require the opinion be the first section of the auditor's report and then requires section titles to guide the reader throughout the auditor's report.

With that I would like to open the floor for discussion. And we are very interested in your thoughts on our new reproposal.

MS. RAND: Again, anything regarding -- you're first.

MS. MURRALL: Thank you very much. And also thank you very much for re-exposing this and pursuing the extended form audit report. It's something we've had in the UK for we're now in our third reporting cycle. And investors have been very appreciative of the moves that have been made.

I'd also thank you very much for the briefing on Friday. I think that was very helpful in advance of the meeting.

As regards the points I'd like to make about what is proposed, I suppose it comes down to the definition of critical audit matters. One of the key criteria for considering whether or not something is critical is that it's material to the financial statements.

However, the PCAOB has refrained from going that one step further and requiring the auditors to disclose that materiality. That is something that is required in the UK and it is something that we have very much welcomed. It allows us to set a sort of benchmark as to what is disclosed.

We also have a concern that the FASB I think has issued a release and it's actually putting materiality in more of a legislative and judicial context and taking away the issuer's judgment as to what users would find necessarily of value.

I also have a concern that the critical audit matters are defined in terms of context of matters that are reported to the audit committee. That, combined with materiality, we feel there is a risk that it could result in a slew of disclosures which really serve to obscure what is going on. We could be swamped by a laundry list.

What I think is very important in this is that auditors display their own judgment and that they've exercised professional skepticism and possibly addressed management's natural bias to present more favorable results.

The FRC-adopted proposals are very much a risk-based approach. We very much welcome this, the risk of material and misstatement and how the auditor addressed them. And we also particularly welcome the fact that a number of firms voluntarily -- they weren't required to do so -- went that one step further and actually described what they'd found as a result of those audit procedures.

I very much welcome what you're doing. But I just have some reservations as to how that may play out in future. Thank you.

MS. RAND: Liz, I'd just like to ask you a follow-up question. You first talked about -- I thought I heard you say two things regarding materiality. And I don't know if it was two things or one.

I know in the UK, the UK audit reports have an additional element that the PCAOB reproposal does not. So that is disclosure of the auditor's materiality.

We do talk about -- we didn't have -- I think we had one comment letter that came in on that point from our proposal. So the reproposal acknowledges that. But we don't have -- we didn't receive interest from that in the U.S. from the 2013 reproposal, the comments that came in.

I thought I heard you say an interest in a similar disclosure in the UK, or were you talking more about just the definition of the critical audit matter component? Or kind of both or -- I just wanted to clarify that point.

MS. MURRALL: In terms of determining what is a critical audit matter I think I had two concerns, A) the dependence on materiality and the fact that that is not disclosed, and B) the fact that the matter is reported to the audit committee and whether or not that could ultimately result in a laundry list and that it's not actually asking the auditor to stand back and say what in their judgment were critical audit matters and where they saw the risk of material misstatement. Does that clarify it?

MS. RAND: Yes, it does. Thank you.

MS. MURRALL: Okay.

MR. BAUMANN: I was wondering, to just maybe follow up. Could you expand a little bit because as Jennifer said we didn't get a lot of comment on the disclosure of what the auditor said as the materiality threshold and doing the audit? We didn't get a lot of comment here in the U.S. that that would be valuable input to the audit reporting model here.

You said you're finding that useful. Could you expand further in terms of that? It would be helpful to hear on the record how you find that to be useful and how you're using it.

MS. MURRALL: In the UK what we're finding is auditors are disclosing first of all how they determine materiality, whether it's percentage of turnover, pretax profit, etc., whether or not they made any adjustments to those figures when they actually determine materiality and also how materiality probably quite importantly had changed if it had changed from the prior year. This really gives investors a view on how detailed, how the auditor dived into those figures in the company, the extent of their testing, et cetera.

I think we found it exceedingly helpful particularly because we are now going into a phase in the UK where we're getting more tendering and rotation of audits to see if we can see whether that materiality changes as a consequence of that, because we think it's giving us a real indication as to the quality of the audit work that's undertaken.

MR. BAUMANN: Thanks. That's helpful and I'll be interested to see if your experience with that and the usefulness you find of that information spurs further comments from others here on our proposal about that. So thank you.

MS. WATTS: Arnold.

MR. SCHILDER: Thanks. I think I can speak for the other ways being not just for myself that we're really pleased with what you have achieved here. Delighted to see the outcome. We're very pleased with the dialogues that you could have.

I recall from the first proposal and the public comments that many noted that there was a lot of similarity between the CAMs with a C and the KAMs with a K. I think what we see now is that it has been much more close even. And I think that's in the very best interest of the users of financial statements and auditor's reports.

So we congratulate you with these efforts, Board and staff. And we thank you for the dialogue.

What we also intend to do to serve the public understanding is that, maybe on Monday, we issue a brief press release with some comments about, let's say, how close it is to what we have with the key audit matters in particular and to complement what you have done and to serve the many users.

Early this morning, Ken Goldman is not here, but he made an interesting point about auditors being proud of what they have been doing. And I thought that was exactly what we have been seeing now with the countries where there is already experience with this new-style auditor's report.

Whether it will be Jimmy Daboo in the UK or Zuleka Jaspera in South Africa that we heard last week in Paris in a panel that you attended as well or Winston Ngan in Singapore or Ron Clark in Australia, all of them express how proud they have been on their profession and what they have been able to do and how they can share it with the audience outside. These are the most complex methods, significance, judgmental, et cetera. And I think that's in the very best public interest.

We have agreed that the IAASB will a post-implementation review of these new auditing reporting standards in a couple of years' time, '18 or '19 or so. That certainly will include the topic of materiality. We have discussed it of course at length in the IAASB. We did not want to require disclosure of materiality because we didn't want to distract from the focus on relevance for users. So key audit matters or critical audit matters have to be the most relevant communications to outside users.

But what we've seen in the UK but also in my home country, the Netherlands, with materiality is quite interesting. So that's certainly something for follow-up.

And I had a brief chat with Maureen on speaking last week at an academic conference. I pointed to the research. I said, this is now a great opportunity for research, cross-border, global of what's happening and how it's going, how you can compare the reports, et cetera.

I'm particularly pleased to see how you have linked it now with the communication of the audit committee. I think that's fully in line with appropriate corporate governance. And it's a good starting point. And then also how you have linked that again with your documentation requirements. I think that is very helpful and responsive to concerns earlier expressed.

Finally, I would say what is most important and that's why it's good that Liz started is that, in particular users will get a lot of feedback on these new-style audit reports, what we have seen in the UK with the investors awards issued by your organization. I think it's very helpful. Now in a way the auditor is back in the public forum. So everybody can engage on this and that's just to encourage everybody to participate in that. So thank you very much.

MR. BAUMANN: Thanks for those comments, Arnold. And I think it goes back to a comment also, Liz, you made about the fact that we did tie our requirements to critical audit matters based upon or derived from matters that are communicated or required to be communicated to the audit committee. And I thought I heard you make a comment about that as well. If I'm wrong. I think you did.

We feel that's the right source. Certainly in the United States we feel that's the right source. And the PCAOB standards as our standard for audit committee communications is quite robust in terms of what is required by auditors to be communicated to audit committees.

So we think that critical audit matters as we envision them would certainly be within the content of what audit committees are required to hear from auditors. And I didn't know if you were expressing a concern about that scope or not in your comment.

MS. MURRALL: I can't say whether or not because it is a detailed list that you have in the AS-1301, whether or not that could actually result in a shopping-list approach to things that are disclosed. The really important thing is the auditor's judgment, not their reporting lines internally to management. But it's the auditor's judgment on the matters that they think should be communicated to investors that's really important.

MR. BAUMANN: Okay. We think that's there, but we would think that those same judgments would apply first of all to their primary responsibility to report to the audit committee, those charged with governance, about those significant matters that they addressed in the audit. So hopefully there's that same population there. That's how we see that. But thanks for that comment.

MS. WATTS: Elizabeth Mooney.

MS. MOONEY: Thanks. I have five recommendations here. Strong supporters of this proposal. And the first is to get rid of the materiality threshold, just echoing Liz's comment. And we gave feedback on some of this over the years.

But in terms of the new materiality threshold and also to get rid of that and also to state, regardless of how subjective a matter is, that if an auditor feels that an issue is important to the audit and it's documented in the memo that it be communicated to the audit committee as well as investors.

And number three, disclose how materiality is assessed. Again, that just seems like that's a must with this project. We have given direct feedback to staff, like I said, over the years with my colleagues. And we have -- the CFA Institute's commented. The IAG found overwhelming investor support for that.

We have the experience in the UK it is useful for gauging audit quality for adjustments and restatements. So I don't see how that can't be part of this proposal.

Number four, disclose whether the audits limit the ability for the audit committee or investors to recover losses. So in the engagement contract there are now alternative dispute resolution clauses being put in there. And investors really need to know if that's the case. It does impair independence by limiting their liability.

And fifth, require disclosure when, in the audit report, when the audit partner was rotated off before the mandatory rotation.

In general, I think it's really important for this proposal to be examined from the standpoint of looking at some of the Valeants, the Lending Clubs, the Chinese frauds, Chesapeake Energy. I mean the list goes on and on of recent examples where investors saw nothing ahead and see what would this audit reporting model have communicated.

I mean this is a communication piece with investors by the auditors. And they're really the real client, the real end customer of the audit report. We are very interested in this communication.

And I think it really reflects poorly on the profession to fight this transparency. So I just urge you to bring some of this to light in a conversation earlier than when the whistleblowers or the hedge funds surface things. And it's a big problem and I think these recommendations will help get us there.

MR. BAUMANN: Elizabeth, those are all interesting comments which we'll certainly take into account and I assume you'll expand on those in a written comment letter.

MS. MOONEY: Thank you.

MS. WATTS: Rick Murray.

MR. MURRAY: First, my appreciation to the staff for the extraordinary amount of effort lying behind the preparation of the proposal and the quality of the materials for the Board meeting.

Question to help put this in the context of the regulatory objective here. Assume that the proposal were to be adopted as currently presented and we are next then in subsequent inspection cycles under these terms. If the inspectors, who would then have the advantage of subsequent event insight, were to determine that the best judgment had not been made with respect to what should have been identified as CAMs but there is no evidence available to the inspectors to suggest that this was a bad-faith judgment even if severely mistaken, would that be deemed for inspection purposes to be an audit deficiency?

MR. BAUMANN: Our inspectors do not try to second guess the judgments of the auditors. They look for reasoned judgments made by auditors at the time based on the facts that they had in any audit area and evaluate the audits in that regard and not based upon hindsight looking after the fact and what they've learned later and not second guessing those judgments.

You've raised a hypothetical situation and we don't have all the facts and circumstances. But just from a principles basis, we're looking for the auditors to communicate the requirements to the audit committee under existing auditing communications standard to the audit committee, and to derive from those as defined in the new ARM proposal those matters that meet the definition of critical audit matters and disclose those and document those which they don't think met and based upon what they know at the time. I don't think that second guessing is an aspect of that.

MR. MURRAY: Marty, the proposal itself describes this as a principles-based suggestion and it may be, although it is far more prescriptive and detailed than the comparable European-based initiatives that are laid alongside this. And it has in reading it so many layers of soft terminology and required judgments that lie behind it. I totally agree with and appreciate your reply that it's not the regulatory purpose to criticize good-faith judgments made in this process.

Given the amount of prescriptive sensation that one gets in reading this, would it be appropriate and helpful if there were to be a statement in the nature, not necessarily a safe harbor, but the intention that you just described, Marty, of we aren't here to criticize good-faith judgments however regrettable they may later be seen to be?

MR. BAUMANN: Thanks for that comment and we'll take that into consideration. But the point is we agree with your point, but it's based upon the auditor's meeting the requirements based upon the facts and circumstances at the time. And it is principles-based standards. But we'll certainly take your comment into consideration. Thanks.

MS. WATTS: Philip Johnson.

MR. JOHNSON: Thank you. As you know I'm a great advocate of this, and my involvement goes back five years when I was president of the Federation of European Accountants. I was right in the middle of the debate with the European Commission with regard to the green paper looking at the auditing profession.

And almost to the week five years ago I gave a lecture in London which I entitled The Accounting Profession: Reinvent or Face Extinction. And the reason for the title was partly to get people there to listen because if it had been the future of assurance, I'm sure people wouldn't have turned up or many people would have turned up.

But more importantly what it was about was because, during that debate in Europe, it was felt by many that the auditing profession was becoming irrelevant. And we'll have this debate later on over the next few days with regard to some of the items on the agenda.

And what I'm pleased to see what happened was that the FRC in the UK did take up the initiative put down by the European Commission, and then subsequently the European Commission have brought it into legislation.

So we've heard the UK has had it for three years. The EU, it is mandated from June 2016. The Netherlands have brought it in. So I do see this as a very positive move. And I congratulate the PCAOB because I think, through the exposure and the comments that have been made and taken onboard, there are really three key areas -- the IAASB Standard FRC which is slightly different including the inclusion of the materiality and the PCAOB have come much closer together.

And I think that is to be commended because we're talking here about the global economy and reporting globally. So the fewer differences, the better.

I think that what will happen in the future is that Arnold mentioned about the post implementation review. Like I said with regard to the audit signature, I don't think it finishes with having a standard. I think these things will evolve and I would hope that matters will get closer together.

So I think we're in a good place, a much better place than probably 12 months or two years ago. So I think we're in a good place.

I was in the profession and I chair audit committees. Looking from the audit committee perspective, it's been very, very interesting to see the difference in engagement of audit committee members, the engagement of audit team members, because now there seems to be a more common purpose.

Audit committees are definitely getting more engaged on what they have to report particularly in the UK, but also what the auditors are reporting. And it comes back to the pride in the work that was mentioned before that the audit team is taking more pride. It's not just a boilerplate report. Their work is being appreciated. So I think that is a great move forward. With regard to the laundry list and whether auditors will disclose too much or too little, et cetera, et cetera, materiality has to come into this. What is important to the investor? I shared a platform with Olivia Kirtley, as you all know, who is the IFAC president, but also is chair of a number of audit committees in the U.S. And we were talking in Paris last week about the relationship between audit committees and auditors and how the role can be enhanced, the auditor's role and the audit committee's role.

Her view was -- and I'm not speaking for her. This is a known statement by her that there is nothing that would be reported that she wouldn't have expected over the years to have been discussed with audit committees. So we're not in new territory. The only new territory really is an external rather than internal focus.

Therefore, there is limited additional documentation that people have to worry about and additional cost, et cetera. I don't see that. We've not seen that in the UK because all that work has already been done. So it's not a great issue.

I and we in the UK do have the advantage as I've said before of having one regulator for governance, for financial reporting and for auditing. That's a great help because the strategic report, the new viability statement that companies have to put out and the audit committee report are mandated by the FRC on the company.

So the story has already been told about the risks within the business. The auditor report is just part of that development of better communication.

So I think, five years ago, I talked about extinction with regard to the audit profession. I think it's turned 180 degrees. Now people see, particularly the investor community, much more relevance to the auditor and the audit process. So I think this is an enormous leap forward, and I commend the PCAOB for making these changes.

MR. BAUMANN: Phil, thanks for those many comments. And I agree with you that what's really great to see as Arnold pointed out naming people, partners, around the world who stated their pride in their work and the importance of their work and providing more useful information to investors that the profession, certainly in those markets where this is already being required, a profession embracing the fact that they're adding increased value to investors through this expanded reporting.

It's great to hear, great to see. And hopefully it will be equally embraced here in the United States. Thanks for all those good comments.

MS. WATTS: Jon Lukomnik.

MR. LUKOMNIK: I wanted to add to the chorus of investors who are thanking you. So consider the chorus filled out with one more voice to the staff and the PCAOB for progressing this.

I do want to however revisit what Liz and Elizabeth said about materiality and address what you said about only getting one comment before. The 2013 release relied, as Liz said, on the professional judgment and of the auditor, as Arnold said, on the relevance judgment, which is why they did not require materiality to be disclosed.

You have now made materiality a gating issue. Once you make it a gating issue, I think we deserve to know how wide the gate is. It seems that there's a linkage that you have put here that, without knowing what the materiality is, it's hard to judge.

I also think, as Elizabeth said -- well, the other change since 2013 is we do have the UK experience. And taking away from the fact that it is a gating issue for the CAMs and therefore I do think there's an -- why would I comment on something that wasn't relevant to the proposal previously? It's now very relevant to what a CAM is. So it's not surprising that you wouldn't have gotten comments in 2013 about it.

However, I do think that the UK experience shows that there is value to disclosing the materiality standard irrespective of the linkage to CAMs. Indeed, I believe the very first investment bank report on the UK enhanced reporting by which I think was CitiCorp -- if it wasn't the first it was one of the first -- talked about how people were surprised by how large some of the materiality standards were. And it engendered a conversation in UK audit committees as to whether or not they had the right materiality standards.

I think that is very much an audit quality issue. So I see no reason not to have it disclosed. And indeed if you were going to make it a gating issue, I think this draft proposal increases the importance of having it disclosed.

MR. BAUMANN: So, Jon, thanks for the comments and we'll certainly take them into account. I do want to say there's a difference between the UK requirement for the auditor to disclose a number they have set for purposes of planning the audit for scoping and terming what is material in the planning of the audit and establishing their audit scope and doing work. That is different than, when looking at a set of financial statements and based on quantitative/qualitative assessments, determining whether matters in the financial statements are material.

There is a difference between those two. It's a subtle statement I'm making. And I think some heads are nodding yes and others maybe are looking at me questioningly.

But one is an auditor scoping decision about what is materiality threshold for trying to set tolerable misstatement and determining the scope of work they'll perform. The other is looking at looking at a set of financial statements and determining are the disclosures that are materially important there and made to the financial statements include all the necessary disclosures and then having critical audit matters pertain to matters in the financial statements that are material, i.e., material to accounts or disclosures.

So there are two different discussions almost taking place there. One is about a scope threshold and one is about linking this matter to items in the financial statements that are potentially qualitatively or quantitatively material.

Having said that, I understand the point that some of you are saying still, the disclosure of the auditor's assessment of scoping level of materiality is important in your understanding of the audit. And that's a critical additional factor you would like to see disclosed. But I do want to make the point that there is a distinction between what we're saying the auditor has to attest for a CAM versus this other point.

MR. LUKOMNIK: I accept that. Generally, the auditor's scoping materiality will be less than what is material in a financial statement. But it is a datapoint.

MR. BAUMANN: It's a datapoint. The materiality for the auditor is, set in the beginning of an audit, is a datapoint. I understand that and I understood the comment made earlier from Liz that that's an important datapoint to see how the audit is viewing that audit when they set their scope and do their plan. What are they setting as the quantitative thresholds for materiality, for scoping.

That doesn't take into account, of course -- it leaves out a big thing, though, what are many qualitative assessments and factors, and that can't really be disclosed by the auditor in that statement that's it's 2.5 percent of net income or something like that.

MR. LUKOMNIK: The fact that you find out that the CFO can't use a calculator cannot be put down. It's fact-specific, I grant you. But I think that to argue that because you can't list all the qualitative factors you shouldn't disclose the quantitative ones really is making best the enemy of better at least from my point of view.

MR. BAUMANN: Yes. I didn't mean to argue the point. We've heard a couple of people say that they'd like to see materiality threshold that the auditor sets disclosed. That's a comment you have and a number of you have made that. So thanks for that.

Brian wanted to comment on this. If I could just go to Brian.

MR. CROTEAU: Thanks. Actually, Marty, thanks for the clarification. I was actually going to make some similar remarks and just thought it would be helpful to reinforce that I think it would be beneficial in the feedback to know what materiality one is looking for for the disclosure. Is it the same materiality management the auditor looks to? And this isn't financial statement materiality which by the way is a legal framework today, looking to the Supreme Court. And nothing with FASB would do for public companies by the way, if they were to do anything, would change that. That's set by the Commission; that's longstanding relative to what the Commission looks to in thinking about materiality.

And then the audit concepts that Marty is describing relative to materiality and planning materiality are a different concept for planning and performing the audit. It would be helpful to understand any comments to the PCAOB I think what the exact recommendation would be and how it might relate to those concepts.

MR. BAUMANN: Sandy Peters.

MS. PETERS: Yes, I raised my hand back when Liz was talking about materiality and was going to echo her comments. But since then I've felt the need to add to that.

You know, I think that we as an organization have asked investors do they want materiality disclosed and the answer is resoundingly yes. But the conversation that's just happened here is one that, by not disclosing materiality, you don't even know these distinctions.

Investors don't know the subtleties of the distinction between planning and scoping and the financial statements and all of these nuances, and that disclosing the materiality in either of these several different ways facilitates that conversation.

Our fundamental problem with the lack of disclosing materiality is that the judgment is being made by people who never talk to investors. So it's being made by auditors who rarely talk to investors, who don't know how they decide whether something is material.

And certainly they can read reports of investors in the company and get a view on consensus earnings which are analyst earnings and the like.

I'm not certain how much that's actually done. But for us it's really about facilitating a conversation with respect to, do you really know what I as an investor think is material. And, oh, you have different views of materiality.

We published the results of our survey which we had done several years ago. We extracted it out in I don't know December or January in response to the FASB's materiality proposal to highlight that we think this is fundamentally a communication issue and that investors don't see it the way that auditors necessarily do.

And to our mind the disclosure of it facilitates communication and an understanding about in fact how people are making that judgment. And so we can come to a common understanding.

I think Philip's point is a good one: that that communication and all of these various communications -- to me, Liz's point is one of well you're communicating it to the audit committee, but the real issue is we want to hear directly from the auditor. And we understand that that may be exactly the same thing. And I understand that the audit is.

But it's a fundamental shift in what investors -- we're hiring management. We're hiring the auditors. We're hiring the audit committee. We want to hear from everybody separately to see if it all hangs together, I think is part of it.

But I think Philip's point of increasing the communication really does demonstrate to investors that there's relevance to the process. And I think shying away from making that communication is really detrimental to the profession because we don't want to give you any information. And I think that's the problem that investors have with the relevance of auditors right now.

MR. BAUMANN: Thanks for that additional clarification and the importance of materiality and how you would use it. Understanding why it's important to investors is very important to us as we consider comments on the reproposal and where we move forward on this particular release. And certainly I would be interested in hearing any other auditor reaction or preparer reaction to your comments and others' comments here about disclosure of materiality.

MS. WATTS: Bob Herz.

MR. HERZ: I've been a long-time supporter of this project and a great admirer of what's going on in the UK the last three years and their boldness in doing it and how I think it's really developed in a way that does help all the parties involved.

My specific comments and I think I made them on the first proposal was I think about two related points that I think Liz made. One was if I read this proposal of the description of the CAM it's kind of optional to include in that what the auditor found. I think it says you could do it. But if you do it, make sure you don't give any impression that you've giving separate assurance on that particular matter, a separate audit opinion on that particular matter.

I don't know. It just seems to me in the context of the discussion, okay, this was the issue. This is what you did. So what?

The second around that point that Liz made is the point about the color commentary and such things like management bias. I think as an audit committee member chair on those kind of matters, key questions, you ask those questions, whether management bias, the way they went about that estimate, is it consistent with how they've done it in prior periods.

I think that kind of color commentary certainly from an audit committee point of view is very important. I don't know whether if I read the proposal, since I asked it as an audit committee chair and the auditor said to me, yes, it's consistent, they're usually right in the middle of the fairway, whether that then would have to be, since it was communicated to the audit committee, would be required in the description of the CAMs?

It's more just a question. I would say my bias is it ought to just because I think that's important information also to the investors.

MR. BAUMANN: Your bias was to what, Bob?

MR. HERZ: My leanings are, if it's important to the audit committee and a good diligent audit committee who is asking those kind of questions and they're important from -- it might be important to compensation, to covenants, those kind of things, they just kind of change it from here in the fairway to here in the fairway. Those are important from an audit committee point of view.

But I could appreciate how reporting it publicly in our regime versus the Jimmy Daboo comment on the original Daimler audit report of KPMG. They said we found this estimate mildly optimistic which I'm sure was their way of signaling like yes, it was really at the fringe kind of thing.

Yet that kind of color commentary clearly, as an audit committee, is very important. I would imagine it's important to investors. I think that's what I heard Liz say. But I also recognize the challenges in our environment in being able to do that in a public report like that.

So I don't have a solution. Just the goal would be to somehow be able to do that or at least encourage it.

MR. BAUMANN: Those are all good comments. And maybe Jessica will comment in a minute. The proposal doesn't preclude the auditor from doing that. And you're precluded from giving a piecemeal opinion on the account or disclosure, or in your disclosure to give an inference that you're not giving assurance on the matter. But otherwise there are some broader words in the release that maybe you can summarize, Jessica.

MS. WATTS: So the release provides or the standard provides an ability or a requirement for the auditor to describe how the matter was addressed in the audit. And so the release goes on to say there are several ways that this could be done. And those would include the auditor's response or approach that was most relevant to the matter, a brief overview of procedures performed, an indication of the outcome of the auditor's procedures or key observations with respect to the matter.

And the critical audit matters, the example that we put into the release has a description of how the auditor responded. So in our case we put in some procedures.

(Off-microphone comment.)

Our examples did not include that. However the proposal does not preclude the auditor from doing that.

MR. BAUMANN: From making further observations, right.

MS. WATTS: Philip Johnson, I know you wanted to respond.

MR. JOHNSON: It's on this very point and this is a big issue because it's the so-what. And we do have to be very, very careful that we don't drive auditors to give a whole series of mini opinions on items on that balance sheet because that is dangerous because the opinion is on the financial statements as a whole.

I know KPMG did with the Rolls Royce example as you mentioned talked about findings. In the UK, that's not being picked up as much as perhaps we thought it might have been because auditors look for competitive advantage.

And the question was, if KPMG did that on Rolls Royce, would others be doing it on other. So you then get into almost a feeding frenzy on trying to find innovative ways of reporting, but I don't think that that has happened.

But it is something I think that we have to be mindful of. And if we give too much latitude, you could get a whole series of mini opinions which is definitely not the place we want to be.

MR. BAUMANN: Nor do we want the critical audit matter not to set piecemeal opinions or a variety of mini opinions, but we don't want it to undermine the overall opinion on the financial statements either. But nonetheless, your comments are understood and taken into account.

MS. WATTS: Sir David Tweedie.

MR. TWEEDIE: Thank you. Can I say that I'm really delighted that we've got to this stage now. I think this is most important project that PCAOB has probably ever done. Most of the others that you've done, if you like, are dealing with the mechanics of the audit. This one is the visible end of the audit. And when you talk about the audit report being the same for 75 years, I mean it's quite shocking really that it stayed that way for so long.

I'm delighted too that you've been very much aware of the international situation. I think it's very important that we take the best of what's out there and you're doing that. There are one or two issues possibly you want to investigate.

I very much agree with Bob and Philip that you looked to this area and what did you find. I thought the KPMG report was terrific and on balance, it only dealt with but five or six issues. But what it did do it gave you the impression that maybe they're overstated it slightly here or understated it there, but on balance, it's a fair presentation. And I thought that gave me great comfort in looking at that particular audit. You really got the feel of what happened in there.

I'm sorry you've had so much resistance to doing this. I remember when I first went to FASB before Bob was there and we're looking at the work program. And you had a pension standard and the timetable was eight years.

And I remember saying that I was a student at university in 1961 when President Kennedy said he'd put a man on the moon by the end of the decade. And I couldn't believe that was less important or less complicated than a pension standard. Experience proved me wrong as it turned out. Any fool can put a man on the moon but getting a pension standard out is something quite different.

So I do understand why you've been held up. But I'm glad you're pressing ahead.

I think the thing that I feel is so important is I think this is terrific for auditors. And I felt quite sorry for auditors in a way. The reason we're all here is because people didn't trust the audit.

So they put an inspection mechanism in, PCAOB, which has been copied around the world. And why was it there? Was it just that you wanted to gee them up? Was it the fact that they were getting a bit lackadaisical?

Or was it probably what people did think that they're too close to the client?

And when you look at Europe, we've had in the last few years the rotation issue. Now why is that there? Well, is it because people think a fresh pair of eyes would be useful or is it the fact that these guys are too close? And I suspect it was the latter. And that's just perception which is harder to change than fact.

And this I think is a great defense against it. Because when you're talking about I'm sorry that this great auditor which all the investors like has got to change you can see the resistance starting to come to that. The danger is if this doesn't get under way and you have another Enron, well why don't we start changing the auditors. And that's the sort of danger.

I think it's a great defense for the auditor. I don't think this is the end of it because I think -- and you heard from Liz and Elizabeth -- the things that they want to see in the audit report.

Well, that isn't a bad idea. If the auditor starts moving more towards the investors and away from the company, I think that's great.

And what do the auditors want to know? I was shocked in your papers when you really started this project to read about the audit report for a company that received a lot of the TARP funding. And the audit report if I remember right in 2008 cost -- Well, the audit cost $119,000 and it was $193,000 in 2009, $74 million. And the audit report was word for word the same.

This is going to be completely different. And I think that's why you want to know so what. You've always had a problem probably with the loan book in that case. And what did you find?

So I think this is terrific. This is changing the dynamics of the audits. And I would press on and as quickly as you can because I think this is something that is going to grow legs. And I would like to see the auditors and the investors getting closer and closer together.

And there's another aspect of this, too, which again is in the United Kingdom, the relationship between the auditor and the regulator, more on the prudential side than the securities regulators yet. But I don't know why it shouldn't be that way.

But it can be the regulator said, we're concerned about X. Make sure you have a good look at that. And that's the sort of thing that I can see the auditor's role in society getting more and more important. And this is the key to it all. And I'm delighted that you've copied the IAASB and the FRC in many aspects. More could be done, but this is a great start. Well done.

MR. BAUMANN: Thanks for that. We are going to pursue ahead very aggressively as we understand the importance of this to investors. So hopefully you'll see a final product before you fly on a plane that's on the balance sheet of the airline that you're flying on.

MR. TWEEDIE: And that took 20 years, the leasing standard.

MR. BAUMANN: Steve Harris.

MR. HARRIS: Sir David, you mentioned Enron. And there have been a number of accounting scandals, Enron, WorldCom, Savings and Loan, 2007, 2008. How would the audit reporting model and the CAMs and the key audit matters that are currently being considered have impacted, if at all, investor perceptions?

MR. TWEEDIE: I think that aspect or whatever it is when you look at an audit -- let's take I think it was

Ernest & Young one when they were dealing with BP. And one of the key issues was the relationship with a Russian joint ventures and that was something I think a lot of people were concerned about. So you know that the auditor is going in there.

Now are you happy with what he says he's done or what he's doing? I think that's the sort of thing, Steve, that can help. This is an area that the investors are concerned about or the regulators are concerned about. He's gone in and he's done this. What's he found? And do you think he's done enough? And that's an issue that can be taken up with the auditor afterwards.

I think that raises a level of the audit. It won't stop the crooks or the guys who are trying to sweep things. But it's a great help.

MS. WATTS: Tom Selling.

MR. SELLING: Like numerous others before me, I just want to start by saying that I think the proposal is a great start, that it will provide real information to users through the audit report, and if the standard is finalized, it will constitute a significant achievement by the Board.

I have two comments that are related. And this actually follows up a little bit on Steve's question. The first one is that I believe an area of CAMs that merits special attention in the standard is the selection of accounting treatments from non-authoritative GAAP.

My concern is partly in regard to the advent of the FASB GAAP codification which was a very good thing. But it changed the protocol that was formerly in auditing standards and that is now in the codification regarding the selection of accounting treatments from non-authoritative GAAP.

For example, it's more likely now that a selection of non-authoritative GAAP might not be consistent with statements of financial accounting concepts because the concepts statements no longer have a special status within that protocol. It would seem to me maybe that should be special consideration of this in the auditing standard, perhaps an illustrative example of when selection of non-authoritative GAAP becomes a CAM, how it should be discussed, and especially when there's a conflict between the accounting treatment and general concepts.

My second point is, my second comment, is that I understand why but nonetheless hoped that the changes made would be more comprehensive regarding other aspects of the auditor's report. I have in mind by this the fact that the Board chose not to reconsider the language in the opinion paragraph even though it needs to be clarified or preferably significantly revised.

I know I have limited time, but this one I'll just talk about five brief situations. Currently, situation 1, the PCAOB says that the audit report -- and I paraphrase -- opines that the financial statements are fairly presented in accordance with GAAP. That's example number one.

Example number two is that at times in the past some auditors used a different phrase. It was presented fairly and in accordance with GAAP. Steve Zeff of Rice reports that 70 years ago the leadership of Arthur Andersen decided that the firm had to straight shooters. Financial statements did not necessarily present fairly when they used accounting principles that were in his judgment not appropriate even if they were generally accepted.

Example number three. Currently, CEO/CFO certifications called for by SOX and SEC rules state that the financial statements are fairly presented in all material respects without a reference to GAAP.

Example number four. The AICPA standards on other comprehensive bases of accounting could state -- and I paraphrase -- that the financial statements are fairly presented in accordance with the modified cash basis of accounting or insert pretty much any so-called comprehensive basis even if that basis is designed by the user itself.

My fifth example. No competent economist would assert that financial data not adjusted for inflation could ever constitute a fair presentation of the data. Yet no matter how much inflation distorts financial statements, they are according to the auditor's report always somehow fairly presented.

So what does fairly presented in accordance with GAAP mean even as a term of art? I know the PCAOB has section 411 to explain fairly presented. But with all due respect, it sheds virtually no light on the investor-communications issue that I'm concerned with.

When speaking to investors, all the words used in the auditor's report should mean something. In all other respects, the PCAOB has done a commendable job in specifying requirements for an informative audit report capable of being expressed in standard English.

Yet in the key opinion paragraph, arguably the bottom line of the auditor's report, critical terms lack literal meaning and effectively construct the facade of gravitas that is inconsistent with protecting the public interest.

In conclusion, I very much commend -- I almost said condemn -- the PCAOB for the progress it's made. But I see it as incremental but important progress. But this is an area that I really feel strongly about and I hope the Board is going to revisit it sometime.

MS. WATTS: Thank you. Chuck Senatore.

MR. SENATORE: I see a number of tent cards and I know we're at lunch coming up. So let me sort of boil this down. One of the things that Elizabeth said that struck me when she talked about in essence, her second point, was if an auditor thinks something is important, let them talk about it.

My quick suggestion -- this is really on the margin, Marty, and this is something that may be very, very subtle

-- is sometimes rules have unintended consequences. And certainly a rule that could end up having an unintended consequence really should be hearing some feedback about the possibility of self-censoring because of a certain standard in a rule that would not be good thing. I'm not suggesting you haven't thought about it and I think this is a great idea.

But the only observation I would share with you -- and certainly this is probably a little bit more of a stark example -- is many times to the extent the more rules people are asked to follow that they tend to actually fit their behavior to the rule.

And the best example from my world in terms of financial services of the broker-dealer regulations you have a Code of Hammurabi of rules that people are footing to the rules, yet the outcomes aren't what they want. In fact you're seeing now kind of reversion to a notion of best practice and best interest of the investor.

So my only point is in thinking about the feedback -- and it may be just a twisted wrinkle -- to the extent that you find that there might be this unintended consequence of a self-censoring because of a gating factor. Just think carefully about it because you wouldn't want to frustrate the spirit of what an auditor could be doing in terms of the value that could be added by virtue of this opportunity with respect to this release.

MR. BAUMANN: Well, a lot of people, a number, have made that point, and I appreciate you echoing it and putting an exclamation point on it. And it is certainly something we think about a lot and we thought about a lot in connection with the reproposal. The concept that because you're required to communicate something, would that shield the communications to the audit committee such that you would avoid ultimately having to report it as a critical audit matter and all of that.

So, something we do think about a lot and we'll continue to think about those comments about self-censoring and make sure that we do achieve the goals that we intend to as part of this, ultimately, adoption when we get to that point. Thanks.

MS. WATTS: Zach Oleksuik.

MR. OLEKSUIK: Thank you. I'll be brief, given time. And first point, we submitted a comment letter in 2013 on this and I won't reiterate all the points here.

In particular, I would highlight -- well, first of all, we are very supportive of this initiative. We do believe, and I believe personally, that the reporting of critical audit matters will indeed be helpful for investors to better understand the financial statements. And this is a meaningful evolution of the audit reporting model, this market.

That said, I hope that the Board and auditors will be mindful of ensuring that the discussion of how the CAMs are addressed provides meaningful, yet not overwhelming, information to investors.

I would highlight a risk of potential boilerplate. We would imagine that there will be companies that will have recurring CAMs year over year. And so the audit report may actually begin to look very similar year over year, over time. So, thinking about ways to keep the report fresh.

But in particular I want to highlight my support, incremental to this discussion here, for the change in scope of the definition of CAM to be narrowly focused on those issues that are communicated to the audit committee. To answer one of the questions that, I think, Bob made about "so what?", as an investor, our first point of contact will be the CFO's office if we've got a question about the financial statements. But our escalation point, and I think our likely endpoint, in discussion of financial statements will be the audit committee.

I don't envision investors having meaningful engagement directly with auditors about any specific issuer. So I think that narrowing that definition is very, very helpful for investors. Thank you.

MS. WATTS: Thank you. Jeremy Perler.

MR. PERLER: Thanks. Let me also say I'm a big fan of this. And just as a bit of a tangible feedback, I work every day, I speak with large investors every day. And in showing them some of what's been coming out of the UK and the CAMs over there, it's been a really positive experience for them. They went in there and do, of course, read through the entire filing. But it was revealed to them there was definite incremental information to how they think about the risks involved or not involved with the company.

And I think that goes to Sir David's point about bringing the auditor closer to investor. I think this is an important topic.

Let me just touch briefly on materiality again. And I think of the challenge a little bit differently, and maybe I'm thinking of it inappropriately. But I understand the concept of materiality of a finite amount, or the difference between two finite amounts, when thinking about the scope of an audit.

Where the challenge in applying materiality to the CAMs arises is these are, by definition, the most complex and subjective judgments in going through the audit. So how do you assess whether a complex judgment or whether an issue that you had is material? Do you look at the entire spectrum of potential outcomes? Do you do several standard deviations away?

For example, if there is a question about applying a particular revenue recognition policy, and that's a complex issue and there are several different approaches that you could take, do you have to recalculate each? Do you think about the most aggressive versus the most conservative way in assessing materiality?

And that challenge, I think, presents itself if you make materiality a gating factor. And it makes, speaking to something like relevance, does the auditor think there's relevance, much easier to do and much more relevant.

MR. BAUMANN: Thanks, Jeremy.

MS. WATTS: Philip Santarelli.

MR. SANTARELLI: Thank you. I guess I'll somewhat timidly weigh into this materiality concept, from the auditor's viewpoint, at least, one auditor's viewpoint.

I think materiality is a datapoint. I don't think it's necessarily a high quality datapoint. I think the process that an auditor does, as you noted, Marty, for planning materiality, that is a number. It's generally a calculation. It's a benchmark. There are various methodologies that firms would use to come up with that first number.

But that's all that it is. It's the first number. And in point of fact, auditors, good auditors will go through the financial statements for individual accounts, transactions, etc., and frankly recalibrate the materiality at somewhat much lower levels, including zero materiality in particular transactions, which comes into the judgments that come around in the qualitative element.

I don't know how we can effectively communicate all of that thought process in an auditor's report without in fact in many ways perhaps losing the audience and what we're trying to communicate.

And I softly reject the concept, the statements that have been made, that lower scope or lower materiality equals a quality audit. I don't believe that. I think, through the process of evaluating audit quality indicators, there has been no empirical evidence that, in fact, that more hours, which is a surrogate or a proxy for that, in fact equals a quality audit. I think better quality hours equals a quality audit. But taking the materiality down to zero I don't think necessarily improves the audit process that much.

So I caution all that think that materiality is a really good datapoint. I'm not so sure without empirical evidence that it is.

MR. BAUMANN: Thanks for adding to that dialogue that alternative point of view.

MS. WATTS: Sri Ramamoorti.

MR. RAMAMOORTI: In the interest of full disclosure, I should say that this materiality thing is so close to me because I wrote my PhD dissertation on the topic of the psychology of auditors' materiality judgments. So I've been thinking about this for the longest time.

And all I can say to all of you is it's the heart and soul of auditing. It is equivalent of the statistical significance levels that statisticians use to make their judgments about what's important, what's significant, you know, that kind of thing, the same kind of idea.

But it is so complex that you go all the way from planning materiality to evaluating materiality to quantitative materiality to qualitative materiality to bandwidth materiality to fidelity materiality. You can keep on going. This is extremely complex.

And so any time you make a disclosure, and that, too, of a partial truth, which is this quantitative portion, I think you are likely to confuse the reader because they will not understand the complexity that is inherent. And in the interest of lunch, I'm going to stop there and leave you all hungry for more.

(Laughter.)

MR. BAUMANN: Just send around your thesis to all of us in due course and we'll look at that.

MS. WATTS: Thank you. Ken Goldman.

MR. GOLDMAN: Boy, now I'm really feeling at risk here with lunch and everything else after that comment. I don't have some of the perspectives that many in this room do. But I do have perspective of the CFO and watching this for many, many years.

And I'll start with since we just covered the materiality. That's a hard one. I see it over and over. It can change during the year given where the company is and its earnings and change in earnings. It can be different from the income statement versus the balance sheet.

I don't know how you could possibly put enough words so the investor could understand what it really means. And so I'm personally totally against putting that in the report.

I think it's one of these things where we're trying to boil the ocean here, which comes to my next point on critical audit matters and so forth. I was thinking about a good example. And to me, a simple example might be you refer to "See the material weakness on material controls relative to XYZ. It's in the report on page XYZ."

It's factual. It gets the reader to focus on that without putting a qualitative assessment as to, you know, how does the auditor feel or not feel about the weakness or whatever.

I think the more you try to put qualitative, the more we're going to be in this room for ten years arguing about this, which is the same thing we had arguing about putting the name of the auditor engagement partner on. I think the more you make it factual, practical, and get these things done, you get things done, as opposed to trying to what I said boiling the ocean and get everything in there, all the whats and ifs and so forth, which just makes it very complicated.

But I think if you can put enough to show the reader to focus on these four or five items and here's where you can find out more about it, that will get a lot accomplished. And it would be a good step.

MS. WATTS: Thank you. Liz Murrall.

MS. MURRALL: Thank you. I'll try and be quick. Neither the UK or the PCAOB have required the auditor to conclude on their findings when they're looking at critical audit areas. We've seen, in the UK, in the first year we had the new audit report, there were three audit reports that reported on the findings, the Jimmy Daboo audits, which we've heard about that.

But it's gone wider than that. The market has responded to investor demand and we saw many more firms in the second year of these audit reports. Deloitte included some conclusions on their findings. PwC did, although it was rather embedded in the work that they'd undertaken. And KPMG reported their findings on nine audit reports.

And I think, interestingly, from KPMG, we understand that they wrote to all their main audit clients. And there was pressure actually from the management of those audit clients not to take that extra step.

I think from an investor perspective that gives us rise for concern. We don't view the findings as a separate audit opinion. But the auditor does a lot of valuable work for investors and reports the report to the members, the investors. And only the auditor can really conclude on the measures that they take. But I don't think it undermines the audit report, you know, the true and fair view as itself.

In regards to the reporting materiality, we have reports from the AQRT, the review team in the UK from the FRC. And that with the increased tendering, they actually produced reports about three or four years ago now, that showed with increased tendering in response to market pressure the audit fees were being driven down and materiality up.

That was a concern. So by disclosing materiality it helps address that. And, yes, probably investors don't probably fully understand what it all means, but only if you disclose it does it give them a hook on which they can ask the questions and gain that understanding. Thank you.

MR. BAUMANN: Thanks. And it looks like, Philip, you have the -- lunch is waiting on your comments.

MR. JOHNSON: Sorry. I've got the lunch is waiting spot.

It's in regard to this -- there's been a lot of debate about materiality. I know in the UK, and we just heard Liz talk about materiality, and I do understand this issue with regard to tendering and driving audit fees down. That's a totality different debate, and I don't intend to get into that.

But from my perspective as an audit committee chair, I actually don't see materiality being disclosed as having much relevance. I mentioned, in my last intervention, when I was talking about the audit committee report, the audit committee report that we've produced basically says what did we spend our time on as an audit committee, what was our engagement with internal audit as well as external audit, what was our assessment of the effectiveness of the audit process and the auditor. But, importantly, what were the major judgments that we looked at in relation to the financial statements? And I think that's particularly important in this context.

And you would expect that there would be some similarity, in that context, between the audit committee report and the auditor's report when you're talking about what were the major judgments that were in there.

And so if we, as an audit committee, are saying what the major judgments were and what we did about them, we would expect the auditor to have a similar view ,and therefore report on what they did to satisfy themselves that those judgments were appropriate.

My audit committee did not for one moment consider materiality. They were looking at what were the key judgments. And I'm quite certain that the scope of the audit was determined through materiality by the auditors. But I don't think that that assessment of what they would report on came into the equation when they were making that report.

I don't think materiality was actually particularly relevant in the reporting process. It's relevant with regard to the scoping. But it's getting less relevant now because with data analytics, which we'll probably talk about later this afternoon, they're using materiality less in assessing that scope.

So I don't think materiality really comes into this. It might be number that investors would like to know. But I don't think it's relevant in relation to reporting.

MR. BAUMANN: Right. You've added to that distinction that I've pointed out before between scoping materiality and assessing materiality as part of the financial statements.

Well, thanks for the very lively and robust discussion of not only the audit reporting model but the other standard-setting matters that I discussed earlier, and the many items that Jim discussed earlier this morning.

So, a very lively discussion. We appreciate all the input. We heard a lot of support for the reproposal here, from those who spoke at least, and a lot of other comments for us to take into account.

With that, thanks very much, Jennifer and Jessica, as well, for the presentation, and for all the SAG members for the input. And lunch time.

**NOTICE:** This is an unofficial transcript of the portion of the Public Company Accounting Oversight Board's Investor Advisory Group meeting on October 27, 2016 that relates to the reproposal, *The Auditor's Report on an Audit of Financial Statements when the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*. The other topics discussed during the October 27, 2016 meeting are not included in this transcript excerpt.

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PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

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INVESTOR ADVISORY GROUP

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MEETING

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THURSDAY, OCTOBER 27, 2016

The Advisory Group met in the Hamilton Ballroom of the Hamilton Crowne Plaza Hotel located at 1001 14th Street, N.W., Washington, D.C., at 9:00 a.m., Steven B. Harris, Chairman, presiding.

PRESENT

STEVEN B. HARRIS, Chairman
MARY BERSOT
CURTIS BUSER
DR. JOSEPH V. CARCELLO
KEVIN G. CHAVERS
LINDA de BEER
SARAH DEANS
DR. PARVEEN P. GUPTA
NORMAN J. HARRISON
MICHAEL J. HEAD
AMY McGARRITY
PETER H. NACHTWEY
LAWRENCE M. SHOVER
DAMON A. SILVERS
ANNE SIMPSON
MICHAEL A. SMART
TONY C. SONDHI
JUDGE STANLEY SPORKIN
ROBERT M. TAROLA
LYNN E. TURNER
GARY G. WALSH

SEC REPRESENTATIVES

MARY JO WHITE, Chair
WESLEY R. BRICKER
BRIAN CROTEAU

PCAOB BOARD MEMBERS

JAMES R. DOTY, Chairman
LEWIS H. FERGUSON
JEANETTE M. FRANZEL
JAY D. HANSON

PCAOB STAFF

MARTIN BAUMANN
MARY SJOQUIST

MR. HARRIS: And, Joe, that leads us to your working group presentation.

MS. DEANS: I think at this point Joe is going to hand it over to me to do some of the talking.

Joe is that --

MR. CARCELLO: Yes.

MS. DEANS: That's the plan. Right. Great. You can click.

MR. CARCELLO: You want me to click? That sounds good.

MS. DEANS: Okay, thank you. So I'm going to try and -- try to keep quite a brief presentation and hopefully that will allow plenty of time for discussion still at this stage in the afternoon.

So we were asked to report as a working group on the proposals about the new -- the auditor's report. So the PCAOB, just to recap, re-proposed in May a standard, the auditor's report, on an audit of financial statements when the auditor expresses a unqualified opinion. And that was an original proposal back in 2013. It's been re-proposed. And as a working group we submitted a comment letter to that back in August. And I'm going to briefly, briefly go through what we covered in our comment letter then.

So, summarize the proposals, the proposed auditing standard. The intention was to enhance the form and content of the report to make it more relevant and informative to investors and other financial statement users and include a description of critical audit matters. And that's mass communicated to the Audit Committee or required to be communicated that relates to accounts or disclosures that are material to the financial statements and involved especially challenging, subjective, or complex auditor judgments.

There were also some additional improvements to the auditor's report proposed. We haven't touched on those in detail, but obviously we can discuss those afterwards. And also a requirement to dispose auditors' tenure.

Given the relatively late stage in this project, as a working group we felt it best to base our comment letter and this presentation today on the issue of critical audit matters. So the proposed rule requirements summarized here, the proposed requested audit report, identify critical audit matters, describe why the auditor reviewed this issue, the principal considerations there, and indicate how the auditor addressed these critical audit matters and refer to the relevant line items and disclosures. That's a very brief summary there, just a recap for everyone.

So the working group very much supports this proposal. We believe that the proposed auditing standard does represent a meaningful improvement from the current standard audit report. And if I refer to the mission to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports, it seems to me that clearly reports are -- then the proposed standards would be more informative. To me that seems very clear-cut and I think the working group were quite unanimous in agreeing that point, so we think it's very much clear that this would be more informative and therefore very consistent with the mission of the Board.

We take no exceptions. We put here, we don't disagree with any of the four points that were mentioned on the previous slide. We think those requirements for the critical audit matters would be helpful.

One point that we really want to emphasize here is the requirement that the disclosed critical audit matters, the discussion should be -- to be most useful, must be highly bespoke to the company. If it becomes standard boilerplate language, that is not going to be helpful to investors and we certainly believe that there will be a direct correlation between how specific that information is and how valuable it will be to the users.

Just to elaborate here a bit on this UK experience which has been referred to quite a bit already today, on this matter we've had somewhat similar requirements in the UK now for three years. So for most companies listed on the London Stock Exchange we've had three years of these extended audit reports including a discussion, not quite identical wording, but very similar intent, on the risks of material misstatement, that we've had.

I think certainly my experience as a user accounts and for many of the investors I've spoken to, we've undoubtedly found the additional information useful in the auditor's report. And where it's been very highly bespoke to the company we've found it very useful typically. As I mentioned this morning, now it's one of the first things I look at. I'll pick up annual report and go and look at the auditor's report. And that is very different from the past. So it's straightaway going and look at that.

So we said that we strongly support the proposal, but we do ask or request here perhaps the Board to consider the possibility of doing a little bit more. So one thing the Board has not done is required discussion of what the auditor found when it addressed that critical audit matter and what were the results, the procedures, and simply a disclosure of the findings. That is not required.

Now, this is a matter where we understand requiring that information could clearly be problematic. We understand that. And instantly is not required. There are other international developments requirements here. It's not required in the IAASB standard, and in fact the existing UK Financial Council standard does not require the disclosure of findings. We understand that at this late stage in the project that could be very difficult. Mandating that disclosure may not be feasible.

However, we would like to ask the Board to consider the possibility of modifying a proposal with an additional sentence that we've put here, just to state that the inclusion of informative company-specific findings could be considered best practice in auditor reporting and that that could be encouraged, although it's not required in the auditing standard. Certainly we view specific findings would undoubtedly make audit reports more informative, and that would be consistent with the Board's mission.

So to give a little bit of justification for this argument, a few things on the side here. We do regard the disclosure of critical audit matters as undoubtedly useful but incomplete without going that step further to talk about findings. A survey by KPMG found approximately 80 percent of investors argue that they should include findings, that that would be helpful.

And the UK Financial Reporting Councilors in a review of the experience of the new auditor's report requirements that investors clearly valued the additional insight offered by extended auditor reporting, and certainly investors have been particularly -- found it helpful when that included findings. So although in the UK there hasn't been a requirement to include findings, that has occurred in some cases.

And if we move on, talk about that. Thank you. And just to illustrate a little bit of how well received this has been in the UK, and we mentioned here, the IMA, the Investment Management Association, is now sponsoring an annual award for the best auditor reports. We wouldn't have had that in the past. And an example of one that the IMA recommended is the KPMG Rolls-Royce audit report, and for any of you who are not familiar with this report in the room, I thoroughly recommend it. It's a fascinating example of how an audit report can give so much more information and as the IMA said there, provided a real value-add.

And one of the things that that audit report included was findings as to whether management's judgments were balanced, or in the words of the KPMG auditor, mildly optimistic or mildly pessimistic, so giving us theories as to where in the range those judgments came, and that is something that investors, many, many investors that I've spoken to really appreciated.

There has been discussion in the UK that -- and there's been an evolution over the three years. So in the first year there was quite a lot of boilerplate information that was not so helpful. There was then a discussion about -- amongst investors and the firms as to what was useful and certainly some of the firms now, three of the four big firms have included findings in some of their reports. So that has been a big development over the three years of evolving sort of best practices.

To come back to the point about company-specific information, it's really helpful to get proper information specific to the audit and for example not just have a statement that is something that is obvious anyway from the fact that it was an unmodified audit report. So for example, it's not helpful if the firm keeps repeating that something was within an acceptable range. That's not what we mean by findings.

It has to be something that's new information. And clearly we need to get sort of set of differentiation reports. Having the same standard sort of report for everything doesn't help us. We want to get new information and find out exactly something that's relevant to understanding the critical audit matters for that audit, for that company. And we've got a couple of -- a quote there from KPMG.

What are the arguments against doing this? I find this quite hard, in a way, because to me it's so clear-cut that including critical audit matters is important, and ideally findings would be very helpful to investors. So the first point I guess is that this is moving in exceeding the auditor's mandate. Yes, perhaps that could be argued, but in my view it's so clearly an improvement that I think the fact that it's such a significant improvement should outweigh that argument.

I'm certainly told that some, particularly in the audit committee community, are questioning what investors do with this information. Well, I'm quite disappointed in a way with that comment. And certainly if you look to the UK experience, many investors in UK companies support disclosure, support the new information. They've found it helpful. And there are plenty of examples, and I'm happy to answer afterwards, if people want a couple of sort of more specific points on the kind of thing we've learned and where it's been helpful, but I don't really feel -- I think that's a question to ask investors.

Now the third point I do have some sympathy with. I think as a working group we did, that potentially the concluding findings exposes auditors to incremental legal liability. And I'm also well aware the legal environment in the US is different from that in other countries where there have been such developments. So it is something that we understand.

And what we've put here is to say that we think the fact of encouraging disclosing findings leaves it then a choice for the audit firm to weigh up the benefit of a better report against that possible cost argument in terms of legal liability. And we also in our comment letter mention potentially supporting a legal safe harbor specific to this findings point, if that was included.

So to conclude, we do clearly -- I want to reiterate the fact that we support the proposal as a working group. I think there is strong investor support. I think the international precedents are very encouraging.

And although we've had this information in the UK for three years, but it's coming now across Europe next year. So we have more to look forward to in Europe. We do think the proposal, however, could be strengthened if it could be encouraged to include findings. And so if it's possible to go a little further, as we've suggested here, that would be greatly appreciated, I believe, by many investors.

MR. HARRIS: Joe?

MR. CARCELLO: Tremendous job by Sarah, as I knew it would be. Just, you know, maybe three things to emphasize very briefly that I think are certainly consonant with what we had up there.

The first would be if we end up in a regime regardless of findings where the CAMs either initially or over time become essentially boilerplate, don't do it. So if you're not willing, PCAOB and SEC, to inspect and enforce, don't do it, because what will happen is even if audit fees don't go up -- people's time is the most valuable thing they have in their life, maybe short of their family. And these reports now will be longer. There is a cost of reading this stuff. And so if it doesn't say anything, it's actually value-destroying.

The second thing that I would say is I think the evidence out of the United Kingdom, three years of data, is that it's clear -- I think it's overwhelmingly clear that investors find specific findings highly valuable. I don't know how -- you might be able to argue against this for other reasons, but I don't think you can argue against that it's valuable. I think we have -- I think the evidence is overwhelming that it's valuable.

So then the question is if it's valuable and you're not requiring it, you're only suggesting it's best practice, there has to I think be a very compelling argument for why you wouldn't suggest this is best practice when clearly the evidence would seem to suggest that it is.

And then I think the third thing that's important to understand is around the legal liability issue. I remember when this issue was teed up, and Marty and others remember this, and there was a series of round tables, there was a series of focus groups, and I remember at one point corralling some investor people, including some of the people in the room today. And I said is this a disguised attempt to get at the auditor's wallet? Is this just a -- kind of a crafty way to grab for the wallet? And they swore up and down that it wasn't.

And when we went -- when Sarah and I went to them and said would you support a limited legal safe harbor -- which I understand is complicated. You can't do it. Probably the SEC may not even be able to do it. I'm not sure. It may involve Congress. But at least in terms of the investor folks, to a person, at least the ones we talked to, were very much willing to say if we get this information at least as it relates to this information, not everything else, but this information, findings, we would be very supportive of a legal safe harbor.

So this is not some back door way to try to increase legal liability for accounting firms.

MR. HARRIS: Jay?

MR. HANSON: Well, thanks to the working group for the work you've done on this. It was a good discussion to have today.

I want to pick up on something that Sarah said, and Joe as well, about the value. And Sarah and I talked just briefly last night about this, but I'd like to hear more from the other investors in the room that might be invested in UK stocks, or at least evaluating, with some examples of how the information translates into value.

And what I think about in this way, and I want to be educated on this to see if I'm thinking wrong, the value to me could be a new area to explore more deeply in terms of the analysis or it might be information that wasn't known from something else in the publicly available filing information, and how maybe that new information translated into something different in the analysis, maybe a change in the model, a change in the assumptions, change in the discount rate to the multiple, which ultimately affected the decision itself. And then ultimately, does that manifest itself in changes in the price or volume and the observable in the marketplace?

And so I'd just kind of like to hear some examples of that, how the good information translates into something actionable, and what's been done. Or maybe if these aren't on the list of things I should be thinking about, maybe things that you do -- how you translate that into value.

MR. HARRIS: I was going to ask pretty much the exact same question, since you led with your chin and volunteered, and that is where has it been helpful? And if you could give us more examples.

MS. DEANS: Yes.

MR. HARRIS: So first you'd answer Jay's and then give us some examples as to exactly --

MS. DEANS: Yes I'm happy to give some examples.

So I think it's an area where just in the specific nuggets -- I'll give you a couple of specific examples.

So one quite small one, but I think it was quite telling. So a company with a big pension exposure, and it had always been using or had been using a pension discount rate that looked higher than norms. And the auditor's report actually talked about that being a critical audit matter, or key audit or risk material misstatement and actually talked about how the company calculated the discount rate.

And that they were adding on an arbitrary amount on top of the normally calculated discount rate apparently for, I think it was to do with the risk and that. So they were adding on an amount to the discount rate and that was bringing a higher than average discount rate. And this had got through, apparently the amount involved was not so big as to make the overall financial statements misleading, but it was an item that the auditor commented on.

And then that was something that clearly a lot of investors pick up pension deficit numbers in their evaluations of companies that can then be picked up on and discussed as to why that company was taking that approach. And funnily enough the following year, still an important area, still an area the auditor discussed, but the discount rate had become a little more normal, within the normal range, and that comment had been dropped.

And I'm sure that pension investors had gone to the company and asked about that calculation of the discount rate and why this additional amount had been added on, or at least that's my guess. So I may -- that may be a misconception, but that's how it seemed to me.

Another example, so -- and this is a little unfair, but say for example if you took one of the very big retailers in the UK three years ago the issue of supplier income wasn't really discussed in the financial statements. If you look at the auditor's report, that did flag up as a critical audit matter, supplier income. Not really discussed elsewhere. Well, I mean, in the company, but there was subsequently an issue in that area.

And of course then it does beg the question of why the auditors were raising it as a critical audit matter and then not talking to the company about getting better disclosure around that topic, but nevertheless it had been flagged up. It was a point that investors were warned about as a potential risk of material misstatement. So that actually was flagging up a very important issue.

So those are a couple of areas where sort of I've observed there's been particularly useful information, and there are many others. I'm not sure if anyone else in the room who's looked at UK stocks has any other suggestions to contribute.

And also just to come back to the famous KPMG example with Rolls-Royce, I think if you talk about in stock, a lot of those questions that were raised there have been really debated amongst investors. It's important to understand these risks. There's actually, for those of you who haven't seen it, several pages of discussion, and some quite important matters I think have come out through there, a discussion of risks around controls in one division and so forth. And those are really of interest to investors and I've been in many meetings where those points have been discussed.

MR. HARRIS: Linda?

MS. DE BEER: Thank you, Steve. I think just to add to Sarah's point in South Africa we use international standards in auditing, and obviously the equivalent ISA standard hasn't become effective yet, ISA 701, but very many listed companies have already pushed their auditors or the auditors started insisting on early adopting it. So we've seen quite a couple of those audit reports as well.

And the one other aspect or benefit, Jay, maybe just adding onto your question, that I've certainly seen is it keeps the audit committees honest as well. Because what's happening now -- and we don't have a requirement that you have in the UK that the audit committees must have sort of reflect or mirror some of the disclosure. As you know, that's not an ISA requirement. But what audit committees now do is in their reporting or in their financial statements they sort of take a proactive step to knowing what will be the key audit methods to explain further what the governance process is all around there.

So I think automatically if you look at the key audit methods and at the audit committee reporting, there is just firstly better governance, but also better disclosure for investors to give a more holistic picture of those specific areas.

MS. DEANS: One other point, if I could just add, I think the very fact of having the auditor talking about these areas makes it very helpful as the user accounts to engage with the company because it gives you a hook of information and also if the company doesn't want to talk about it, it's much easier when you can say but your auditor has identified this as a risk. So rather than sort of, well, why are you asking about that, to be able to say the auditors are talking about this, makes it harder for a company to close down and not want to talk about the issue. You're informed. You're a more informed investor or analyst.

MR. HARRIS: Sarah, in the UK how would you say it's influenced the behavior of the auditor?

MS. DEANS: This is -- it's a little harder to say as a user of the accounts rather than an auditor, but I think it's clearly promoted interest in what investors think and feel, because we have now more of a dialogue. I mean, certainly since these have been out there it's been easier to engage with audit firms and point them to where it's been helpful, you know, and I think it's incredibly important for the audit firms to see this as an opportunity because they're able to actually show the value to investors of all their knowledge.

So in the past up until now, auditors have all these masses of information, but we had -- as users of the accounts have seen no sight of that. They're actually able to prove their value a lot more and I think that's incredibly important when there is quite a lot of skepticism, at least amongst the investors I speak to often, about the value of the audit to them.

So in terms of has it changed behavior, I'm sure it has, but we don't get a great deal of insight into that. But certainly if I was an auditor and I knew I was going to be talking about this, I think it puts maybe, I would guess, a little extra pressure to be confident of what you're saying.

MS. SIMPSON: Sharpens accountability.

MS. DEANS: Sharpens accountability, that's the best --

(Off microphone comments.)

MS. DEANS: Yes, exactly. So I think I'm sure it has changed behavior. It's certainly prompted some useful dialogue between investors and the audit firms in the UK. So I really see it as a positive. And there has sort of been a bit of competition amongst the audit firms to be perceived to be being helpful here and to actually improve the standard, which has been very constructive, I think.

MR. HANSON: Sarah, just to clarify, as an investor you're dialoguing directly with the auditors about what's in the audit report?

MS. DEANS: Just to clarify, not typically specifically on companies, but on overall what we found helpful, yes, the audit firms have been quite open to having conversations.

And in those cases, you know, investors are often maybe bringing examples, obviously there's confidentiality that they are not going to give away to us obviously inappropriate information. But certainly company examples have come up in those conversations of what's been -- typically what's been particularly helpful.

MR. CARCELLO: And, Steve, let me add one thing in following up what Sarah said about the effect on auditors. As you know, I'm sure you're in contact with the folks at the FRC and Marek Grabowski and those folks, and they have done quite a bit on measuring what's changed inside audit firms.

And we alluded to this earlier, one of the unintended consequences, in this case a good unintended consequence, is the staff are more engaged in their work, they're more excited about their work, they feel like what they do every day actually matters more because they see the fruits of their labor in a report that people will read other than a three-paragraph report, as Sarah said I think earlier and others have said, that people typically in the past didn't even read.

MR. HARRIS: Mike, and then we'll just go around. I'm sorry. Well, wait a second. Jeanette? Let's recognize the Board first.

MS. FRANZEL: Thanks, Steve. Thanks for this. And I'm wondering, Sarah, can you elaborate a bit more on the very specific issue of company-specific findings?

And I can kind of see this going in two different directions and so if you have examples of both, that would be helpful. So in one case maybe it's a difficult audit area and the auditor finds that there's just a whole lot of uncertainty and there's nothing really that anybody does about it. And what kind of -- have you seen examples of that, whereas in other cases maybe the auditor found that something needed to be refined or a disclosure needed to be expanded. Management did that. How far do they go in discussing the findings? They say, you know, this was difficult and as a result of our work management expanded its disclosure, or do they say talk about the inadequacies first of the initial disclosure and then the subsequent changes.

So anyway, examples on both types of findings and results, if you have any.

MS. DEANS: Yes, so and I guess to caveat this a little bit, clearly most of the auditor's reports yet do not include findings. The majority do not. It's very much a minority yet. And those findings, again, vary enormously from the very, very detailed examples we have at Rolls-Royce, which I'm sure you've seen, right through to some of the less helpful, you know, blander, not very company-specific that was within a reasonable range type comment that doesn't really help us.

So this is based on not a huge number, but yes, we have seen cases where, for example, it's been commented that errors were found but those were then corrected. And after they'd been -- after an error had been corrected, then the auditor was happy. But that was an insight again that was new. Whereas in other areas there is a lot of just sort of, this is the work we did and this is a risk area without -- either no finding or no very specific finding other than there wasn't anything that required -- well, they didn't say that, but there was clearly nothing that kind of further seemed to be required at that point.

If you look at most of the findings, the PwC ones tend to just be of the it was within a reasonable range and there we left it, sort of thing. If you look at some of the others, one thing actually I should comment that I found quite helpful, at least in terms of presentation, was what I liked about this most recent year's reports from Ernst & Young, from EY, had the column, this is what we reported to the audit committee.

Now having said that, some of those comments then below that are quite bland and you think, well, that must have been a boringly thing.

(Laughter.)

MS. DEANS: You didn't tell them much, but at least I like that way of framing it, that then here is the result, this is what we presented and talked to the audit committee about.

I don't know how much that answers your question, but it is still relatively early days, at least for findings.

MS. FRANZEL: Thanks.

MR. HARRIS: Mike?

MR. HEAD: One, because I was on this committee I have the insights, and this was a topic that again I was very passionate about. But the first comment on findings and results that I wanted to emphasize. We as maybe auditors or accountants our self automatically go to a finding must be an exception, versus a finding can be, they did a great job in this area and we applaud or agree with management's judgments.

Now you're not going to see that kind of wording in this kind of report, but it should be balanced about positives and potentially negatives, if there are some, without assuming it's all going to be negative.

And I correlate what I think the value is here. I think all of us would agree when you're doing what I'll call a service center type audit where you're actually auditing and saying what the state should be, what your results were, if there was any exceptions, can it be relied on? And then that type of audit, which kind of relates to where we've went on the broker-dealers with the 17(a), you know, this isn't going there, but this is going that direction. You're trying to get more color on that -- the audit process and what the results of the audit process would be. And that starts moving you down, well, did it work the way you intended during the period, not just as of a point in time?

I guess the last thing to me is I'm big on transparency. Everything we're talking about that could be including findings or results have -- are being discussed in the audit committee meetings by management, by the auditors with the audit committee members and at times at the full board. So this is not something that's not already being done privately. It's just giving the investors or the shareholders or stakeholders transparency or insight to it. So those are my thoughts, my top of mind.

MR. HARRIS: Parveen?

MR. GUPTA: Sarah and Joe, I guess what I was wondering, maybe you covered this point and I missed it as I stepped out for a few minutes, for the first couple years certainly expanded disclosures in the audit report and the information that we are talking about would be new information and useful. Was there any conversation in your working group that what discipline can be put around the fact that maybe after two, three, four years it could become a boilerplate report? And if so, how do we handle that?

Because, you know, when you go in this direction, you want to make sure that you mandate something that's going to be useful to the capital markets for the longer term rather than just couple years and then the excitement kind of dies down and it's the same report like we've seen the risk disclosures in the 10-K in the US, at least.

MR. CARCELLO: Yes, I'll give some thoughts, Parveen, and then obviously I want to hear what Sarah has to say and what she has seen.

But to me, let's say Company ABC has six critical areas and actually presents findings in years one, two, three, four and so forth. The real important information is going to be change. And if you don't -- if all you end up getting is it's the same six every year and it's the same wording every year, then essentially what you're saying is absolutely nothing changed inside that company on those six areas. That's just not believable.

So if that's the case, what it's suggesting is that there's not that kind of disclosure around change, and that would be a problem if that was the case.

MS. DEANS: Yes, and this question's been sort of talked about quite a lot in the UK. Is there a danger of this? We've had it three years. Is it just going to come -- in fact, actually so far that hasn't happened because I think the process has been evolving so much anyway that things have changed and moved on.

But certainly one of the examples of sort of best practice which some of the firms are doing, at least some of the time, is to talk about exactly that, where things have changed. So for example, if something was a key risk last year and isn't in there now, to give some explanation of what's changed. Sometimes it's obvious. That division was sold, so we're not worried about it anymore. But other times it's not.

And also when new risks have evolved. And even again, and I hate having to always give the same sort of example of best practice, but if you look at how again the Rolls-Royce most recent auditor's report, actually gives a little chart of sort of where things have moved. So this risk is actually a bit bigger this or a bit more of a concern this year versus a previous year, and this one has sort of moved down the track a bit.

So not just which ones have come on and which ones are dropped off, but actually the evolution of we're a bit more worried about this and we're a bit less worried about this now, which is again very useful and I think is an indicator of the quality of what the auditor is doing is quite an interesting one. We know which ones we're actually talking about.

Those kind of processes that they're thinking through, this has become more important. Whereas exactly if an auditor's report is just -- and so far we haven't had it that much the same as last year's and the same as the year before's. Then I think you start worrying. Do you really believe that nothing has changed or is that simply the auditor not doing a great job? So again it's helpful insight into the quality of the auditor potentially. And it's still again early days, but I think that will be interesting as we go further down this track.

So I think, yes, of course I understand there is that risk there. And absolutely, to Joe's point, if this just becomes boilerplate language and doesn't tell us anything specific and so forth, it's hopeless and it is just more pages for no purpose. And that's not what we want.

But actually I think enough does move on and if it's really the auditor's going for best practice and helping the investors understand evolution of risks, that's helpful and that's actually a useful history then of how things have moved on. There was a problem with internal controls last year in this division. Has that improved this year and has it improved so much that this is no longer a risk or is it just evolving, or is there actually still worry or even worse?

So I think there's a lot we can learn from that, so long as the process is done well.

MR. HARRIS: Robert?

MR. TAROLA: Robert Tarola. I find this quite ironic that we're -- that there's resistance to this in the auditing profession, because as I'm listening to all the analysis, this could be the solution to a couple of the problems we talked about today. It appears to me it will raise the value of the work of the auditor to their ultimate customer. It would provide the transparency that folks believe is important in reporting to outside parties for an issuer.

It should make the profession more exciting, that you would want to join. In fact, the way I think about an auditor, it's just the front end of the analysis process. It's the same person on each end. The auditor is a front-end analyst and the investor rep is the back-end analyst. They have to have the same skills, the same insights, the same knowledge of the company and business models and how they all work.

So the public accounting profession really needs a makeover in terms of its marketing. And this may be the impetus for a makeover.

MR. HARRIS: Well, being an audit committee chair and an auditor and somebody who's well versed in the profession, those are very interesting comments.

MR. TAROLA: Well, I was going to start --

MR. HARRIS: But you wear so many different hats that it's interesting.

MR. TAROLA: Well, when I wear a preparer hat or an audit chair hat, it's a bit scary --

(Laughter.)

MR. TAROLA: -- to be frank, because you're really now -- your scorecard is going to be made public as a preparer and as a, you know, governance committee of the company. So that's a bit scary.

I think the other -- I think on the auditor side I'm sure they're nervous about added liability, and I think Joe's idea is a really good one. Maybe a safe harbor for audit committees, too.

(Laughter.)

MR. HARRIS: Only for you, Bob.

(Laughter.)

MR. HARRIS: Linda?

MS. DE BEER: Thank you. Just two comments, if I may, and it's more from my experience where we debated this as the advisory group with the IAASB. Jeanette, the comment or the question you asked about the entity-specific information just triggered the thought in my mind, and there were lots of discussions at that point in time really to try and avoid industry disclosure. And I think that is a really important point that must come through.

And, Sarah, you spoke about sometimes the entity-specific information might be a little bit more bland and the range is a little bit more general, but there was, especially at the initial stages of the debate, the real concern that instead of auditors drilling in to the specific critical audit methods or key audit methods within the entity, the role they sort of talk about industry-specific, you know, this is in the platinum industry and the market is distressed.

And, you know, that sort of becomes a critical audit method because that information would certainly not be useful at all. And I think it's very important that the wording must be tight enough to avoid that sort of general disclosure, critical areas for the industry as a whole versus that company specifically.

The other point that came through very clearly as well, and Mike, when you spoke it reminded me, was that a lot of the people around the table at that advisory group felt very strongly that they're not really interested in audit procedures. They sort of want to know what the issue was and what the finding is. They couldn't really care all that much what the auditor did to get the comfort that he needed, but more sort of what the ultimate outcome or finding is.

And I think there is a risk that if auditors start disclosing a lot of procedures, it will again become really boring reports that people won't read.

MR. HARRIS: Curt, I think you had your card up next.

MR. BUSER: Thanks, Steve. So like Bob, I think this has a lot of opportunity for the whole audit profession, and from an assurance standpoint I think it's potentially a very good product.

I have a couple questions though that I'm just curious in terms of how the working group thought about it. So first, if there are no findings or they're boilerplate-type answers, does that create a false sense of assurance?

Related to that, do the critical audit matters create kind of a piecemeal opinion approach with respect to the report on the financial statements otherwise taken as a whole? How do you think about materiality and disclosure requirements around that?

And then last, as it relates to internal controls, right now we have a criteria, as least as I understand it, that obviously the material control weaknesses, they need to be disclosed and talked about, significant deficiencies, obviously talked about with the audit committee and kind of resolved.

So does this change that standard? So does this kind of enforce significant deficiencies to be publicly disclosed as a critical audit matter, or how do you then kind of say no, no, no, you don't have to talk about that, but it's a significant matter? Thanks.

MR. CARCELLO: Yes, I'll start off, but again I certainly want to hear what Sarah has to say.

Curt, these are, as I would expect, excellent issues to raise. On the first if there's no findings or if the findings are boilerplate, does that give you a false sense of assurance -- and I think if the Board decided to do what we're suggesting that they might, which is to encourage findings but not require them, I think the reality is inside the United States, and we recognize this, that at least initially there's probably not going to be a whole lot of findings.

I mean, we're not finding a whole lot of findings right now in the United Kingdom. So I don't think there's going to be a global conclusion about an issuer if there aren't findings. Now maybe down the road 10 years, 15 years, 20 years, but let's worry about that 10 years from now.

On the second issue, the piecemeal opinion, and certainly this is a concern that's been expressed, it doesn't appear to me, but I want to hear what Sarah has to say, to have been a problem in the United Kingdom.

I think the marginal investor in most stocks today is pretty sophisticated and I think they're going to understand that it's not a piecemeal opinion, but I want to hear Sarah's explanation or experience in the United Kingdom.

The significant deficiencies is maybe not a fair thing to throw to her because I don't believe there's reporting on internal control over financial reporting in the United Kingdom. This is not something we talked about, Curt. I know it's a major concern of issuers and of audit committees and of auditors, so it's a fair point and I think it would have to be looked at further.

I think to -- not to move forward in encouraging findings because of that, I think that can be solved even if that's scoped out. That's not a strong enough reason not to do it.

MS. DEANS: Okay. So to add to that, is there a risk with a sort of piecemeal opinion? I just don't think that's been perceived as a problem in practice over the three years. We understand, or at least the professional investors I speak to understand the overall audit opinion. And then this is additional helpful information. And I just don't perceive it's a problem.

I think -- was there -- sorry, was there also a question about materiality that we didn't cover there?

MR. BUSER: Yes, and if you're going to talk kind of on a piecemeal basis or call that out, I mean, how does materiality kind of play into that especially as -- if a critical audit matter how would it affect your materiality assessments?

MR. CARCELLO: Again, that didn't come up, Curt. We didn't even talk about that. Id' have to think about it more, but it's a fair point.

MS. DEANS: I guess that does -- we'll say just maybe one tab one point, which is one area where the U.K. has also gone further is actually requiring disclosure about materiality and the calculation of materiality. And I know that that has sort of fallen by the wayside a bit here, but I -- personally actually I found it very interesting. And actually if I was to put my finger on where I think practice has most been affected or things appear to have changed most as a result of extending required information in the auditor's report, I'd actually look to that because first year we had a lot of outliers taking a pretty high percentage of pre-tax profit. So that's been changing.

MR. HARRIS: Judge, you're not allowed to put your card down.

MR. SPORKIN: The only thing that -- I've listened now for this whole day and I was thinking what are we talking about?

MR. HARRIS: Judge? Judge, hit your mic.

MR. SPORKIN: What we're talking about is what you need to do in this profession as it's been done in the legal profession, medical profession is branding. If an organization has a brand that it's known that you don't get their name on it unless you've done the greatest job in the world. I mean, you don't get a Sullivan & Cromwell's name on a report unless they believe it's the right thing to do. Not the client. Sullivan & Cromwell won't put their name on something, or Korvath, Wachtell & Lipton. It's a branding. You got to get a brand that says this accounting firm you're not going to get that name on that accounting firm unless it's the report that we want to go out. You won't get a Wells Fargo -- your name on Wells Fargo unless it's right.

And they know. I mean, how do these people know? They can read the report and they can know something's right or something's wrong. They could ask the right questions. Why is it? Or you never see them getting into the kinds of problems with some of the accounting firms you're getting into. Is it trying to get minimum standards or is it trying to get the best standards? I mean, you see the commercial, people go to BDO if they got a problem. I don't know whether it means they're the best, but what I'm saying is that you want to brand your organization, that nobody gets my name unless it's the way we want it, not the way the client wants it. You can't buy our name. I don't know if that means anything, but I'll tell you that's what I see here.

MR. HARRIS: Thank you. And, Lynn?

MR. TURNER: A couple things. As one of the people in the room that's actually written critical audit matter memos at the completion of an audit having to identify those, I think it's going to take some time just based on this conversation for the investor community to really understand. Probably have to be some education because some of these CAMs do stay the same year to year. They do not change in companies, especially industry-specific. So to expect things to see change time to time to time, that's probably -- maybe some cases that will occur, but it's certainly not going to occur.

And also as I listened to that discussion earlier, it tells me there's going to have to be some education of the investor community and they're still going to have to do their homework. In fact, your earlier conversation led me to believe that probably going to need to be a lot of education of the investor community if that's what the expectation was.

The second thing is on findings I actually think better than the Rolls-Royce report in this case is the Dutch report on Aegon. I think it's an excellent report because it does get into the findings and does I think a very good job of coming back. I forget which Board member asked about the value associated with the stuff, but the Aegon report to me laid out more of the information I'd want to know with respect to the risk in the company and where some of the things were going and what the auditors did to address those. So I thought that was a pretty thing -- pretty good disclosure.

But then with respect to your notion of a legal safe harbor, I find that to be most disturbing, because you've turned around and told me this is such critical information, I need to become informed and it needs to be very good and really tell me what the auditor thinks. But on the other hand, if they mislead me, I can't hold them accountable. So I would vehemently oppose any safe harbor.

I would rather not have the CAMs than to have the CAMs with the safe harbor. I think as we saw, as we've seen in the past with some of the things, when you provide those legal protections the accountability goes away and the quality goes down, so I think the safe harbor is a disaster in waiting.

MR. HARRIS: Tony?

MR. SONDHI: Thank you. I actually did -- wanted to address that last point that Lynn was making, and I really do think that the safe harbor would be a disaster. But I also at the same time believe that -- very strongly again, that saying such and such disclosure or something is encouraged is also a very big problem for a very simple reason: I served on a committee that helped write the International Accounting Standard on the cash flow statements and very narrowly lost the fight to get the direct method. And the IASC chair at that point, David Cairns, told me that he wanted -- he agreed with me that it should be direct method. He says but he was hoping to accomplish it by encouraging.

And if you look at both the U.S. GAAP on cash flow statements and the international, they both start with the same thing in the first paragraph: you -- the direct method is better. You are encouraged. But the problem is when you go to the glossary of terms, "encouraged" is defined as you don't have to do this. And that's the definition people are using. They're not looking at it in terms of what the language tells you. So using "encouraged" I think is a problem.

I think Lynn is also right that it may take us awhile as investors to learn that some of these CAMs are going to stick around, and there is a reason for them to stick around. But I have two responses to that: One is that I am willing to learn. I would like to find out. But I'm also tired of the kind of boilerplate information that I see.

I'll give you an example. A few years ago I had found a company that in its footnotes said -- what its footnotes were saying was that the basket of currencies that they operated in were weakening against the dollar, but when I turned to the stockholder's equity where they had the cumulative adjustment, that change suggested the opposite. And I couldn't reconcile those two, so I finally called the CFO and he -- when he got -- he said I'll figure it out and get back to you. And he called me back to say that he was disappointed that I didn't understand something that simple. He says we've just simply had that disclosure for the last 10 years. We like it and that's why it's sitting in there --

(Laughter.)

MR. SONDHI: -- which I think was his way of saying, sorry, we missed something.

But the point is that these boilerplate terms, these kinds of things that get into the disclosures and they don't go out -- so there is a danger when something sticks around for too long. So but I would sort of very, very strongly suggest not to have anything that's encouraged.

MR. HARRIS: Well, Joe and Sarah, thank you very much. I think your comment letter is self-explanatory, speaks for itself, and we very much appreciate your having gotten it to us in the timely fashion that you did.

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| THE AUDITOR'S REPORT ON AN AUDIT OF FINANCIAL STATEMENTS WHEN THE AUDITOR EXPRESSES AN UNQUALIFIED OPINION<br><br>AND RELATED AMENDMENTS TO PCAOB STANDARDS | PCAOB Release No. 2017-001<br>June 1, 2017<br><br>PCAOB Rulemaking<br>Docket Matter No. 034 |

Summary: The Public Company Accounting Oversight Board ("PCAOB" or "Board") is adopting a new standard, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, that will replace portions of AS 3101, *Reports on Audited Financial Statements*. The remaining portions of AS 3101 will be redesignated as AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*. The Board is also adopting related amendments to PCAOB standards.

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## I. Summary

The Board is adopting a new auditor reporting standard, AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "final standard" or "AS 3101") and related amendments to its auditing standards that will require the auditor to provide new information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- Communication of critical audit matters—matters communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements; and (2) involved especially challenging, subjective, or complex auditor judgment;

- Disclosure of auditor tenure—the year in which the auditor began serving consecutively as the company's auditor; and

- Other improvements to the auditor's report—a number of other improvements to the auditor's report to clarify the auditor's role and responsibilities, and make the auditor's report easier to read.

The Board believes that adopting these requirements responds to the strong interest of investors for enhanced communication about the audit and is consistent with its mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[1]

The Board is adopting the final standard after more than six years of outreach and public comment, including comments from members of the Board's Standing Advisory Group ("SAG") and Investor Advisory Group ("IAG"). The Board has taken into consideration all comments and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate.

Investors are the beneficiaries of the audit and the auditor's report is the primary means by which the auditor communicates with them. Currently, however, the auditor's report conveys little of the information obtained and evaluated by the auditor as part of

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[1] Section 101(a) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), 15 U.S.C. 7211(a).

the audit. And while the auditor's report has generally remained unchanged since the 1940s, companies' operations have become more complex and global, and the financial reporting frameworks have evolved toward an increasing use of estimates, including fair value measurements. As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, but the auditor's report does not communicate this information to investors. Stated differently, the auditor's report does little to address the information asymmetry between investors and auditors,[2] even though investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for their benefit.[3] The Board believes that reducing the information asymmetry between investors and auditors should, in turn, reduce the information asymmetry between investors and management. Outside the United States, other regulators and standard setters have already adopted expanded auditor reporting.

The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed these matters. The Board believes that these matters will likely be identified in areas that investors have indicated would be of particular interest to them, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements. The final standard is designed to elicit more information about the audit directly from the auditor. The Board believes that the critical audit matter requirements will respond to requests from investors for more information from the auditor while appropriately addressing concerns raised by other commenters.

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[2] Economists often describe this imbalance, where one party has more or better information than another party, as "information asymmetry." As part of the system of financial reporting, the audit of the financial statements helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

[3] *See* PCAOB IAG survey, *Improving the Auditor's Report* (Mar. 16, 2011) ("IAG 2011 survey"). *See also* CFA Institute's *Usefulness of the Independent Auditor's Report Survey Results* (May 4, 2011), *Independent Auditor's Report Survey Results* (Mar. 31, 2010), and *Independent Auditor's Report Monthly Poll Results* (Mar. 12, 2008) ("CFA survey and poll results"). *See also* Board public meeting transcripts and participant statements (Apr. 2-3, 2014), available on the Board's website in Rulemaking Docket Matter No. 034, *Proposed Auditing Standards on the Auditor's Report and the Auditor's Responsibilities Regarding Other Information and Related Amendments* ("Docket 034").

Investors and investor advocates have suggested a variety of ways in which investors can use the information provided in critical audit matters. In the view of some investors, critical audit matters will add to the total mix of information, providing insights relevant in analyzing and pricing risks in capital valuation and allocation, and contributing to their ability to make investment decisions. Investors also stated that critical audit matters will focus their attention on key financial reporting areas and identify areas that deserve more attention, enhancing the efficiency of investors and others in the consumption of financial information. Some investors believe that critical audit matters will highlight areas that they may wish to emphasize in their engagement with the company and provide important information that they can use in making proxy voting decisions, including ratification of the appointment of auditors.

The final standard also includes a new required statement in the auditor's report disclosing the year in which the auditor began serving consecutively as the company's auditor, as well as a number of other improvements to the auditor's report, such as a statement regarding the requirement for the auditor to be independent. Requiring disclosure of auditor tenure in the auditor's report will make this information readily accessible in a timely way for investors who find it useful. The other improvements to the auditor's report are intended to enhance the user's understanding of the auditor's role and responsibilities related to the audit of the financial statements, make the auditor's report easier to read, and provide a consistent format.

The final standard will generally apply to audits conducted under PCAOB standards. However, communication of critical audit matters is not required for audits of brokers and dealers reporting under the Securities Exchange Act of 1934 (the "Exchange Act") Rule 17a-5; investment companies other than business development companies; employee stock purchase, savings, and similar plans ("benefit plans"); and emerging growth companies ("EGCs"), as defined in Section 3(a)(80) of the Exchange Act. Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily. The other requirements of the final standard will apply to these audits.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit.

The Board is adopting a phased approach to the effective dates for the new requirements to provide accounting firms, companies, and audit committees more time to prepare for implementation of the critical audit matter requirements, which are expected to require more effort to implement than the additional improvements to the auditor's report. Subject to approval by the Securities and Exchange Commission ("SEC"), the final standard and amendments will take effect as follows:

- All provisions other than those related to critical audit matters will take effect for audits of fiscal years ending on or after December 15, 2017; and

- Provisions related to critical audit matters will take effect for audits of fiscal years ending on or after June 30, 2019, for large accelerated filers; and for fiscal years ending on or after December 15, 2020, for all other companies to which the requirements apply.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

## II. <u>Background</u>

### A. Rulemaking History

Changes to the auditor's report have been discussed by several commissions and committees, including the 2008 U.S. Department of the Treasury Advisory Committee on the Auditing Profession ("ACAP").[4] ACAP recommended that the PCAOB consider improvements to the auditor's report, noting that the increasing complexity of global business operations compels a growing use of judgments and estimates, including those related to fair value measurements, and contributes to greater complexity in financial reporting. ACAP said this complexity supported improving the content of the auditor's report beyond the current pass/fail model to include a more relevant discussion about the audit of the financial statements.

The PCAOB commenced its standard-setting project on the auditor's reporting model in 2010 with outreach to different stakeholders, including investors, financial statement preparers, and auditors. During that outreach, many investors expressed dissatisfaction with the content of the existing auditor's report because it provides investors little, if any, information specific to the audit of the company's financial statements. Generally, preparers, audit committee members, and auditors were not supportive of adding company-specific information to the auditor's report, arguing that the company, through its management or audit committee, should be the primary source of the company's financial information. Changes to the auditor's report were also

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[4] *See* ACAP, *Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury* (Oct. 6, 2008) at VII:17. *See also* The 103rd American Assembly, *The Future of the Accounting Profession* (Nov. 2003); *Report of the National Commission on Fraudulent Financial Reporting* (Oct. 1987); and American Institute of Certified Public Accountants, *The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations* (1978).

discussed at the March 2011 IAG meeting.[5] Some investors who participated in that meeting suggested that expanded auditor reporting would have been helpful before and during the 2008 financial crisis.[6] Later in March 2011, the Board held an open meeting to discuss findings from its outreach.[7]

In June 2011, the Board issued a concept release to solicit comment on a number of potential changes to the auditor's report.[8] The Board received 155 comment letters on the concept release. The Board also held a public roundtable in September 2011 to obtain additional insight on the alternatives presented in the concept release.[9] Changes to the auditor's report were also discussed at the November 2011 and 2012 meetings of the Board's SAG.[10]

After considering the results of its outreach and comments on its concept release, in August 2013, the Board proposed an auditing standard that included new requirements for auditors to communicate critical audit matters, as well as additional improvements to the auditor's report.[11] The Board received 248 comment letters on the

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[5] *See* IAG meeting details and webcast (Mar. 2011), available on the Board's website.

[6] *See* IAG working group presentation, *Lessons Learned from the Financial Crisis* (Mar. 16, 2011), available on the Board's website.

[7] *See* PCAOB open Board meeting details and webcast (Mar. 22, 2011), available on the Board's website.

[8] *See Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards; Notice of Roundtable*, PCAOB Release No. 2011-003 (June 21, 2011) ("concept release").

[9] *See* PCAOB roundtable transcript (Sept. 15, 2011), available on the Board's website in Docket 034.

[10] *See* SAG meeting transcripts (Nov. 2011 and 2012), available on the Board's website in Docket 034.

[11] *See Proposed Auditing Standards—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion; the Auditor's Responsibilities Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report; and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-005 (Aug. 13, 2013) ("proposal").

proposal. Most commenters generally supported the Board's objective to improve the auditor's report to make it more informative and relevant to financial statement users, but commenters' views varied on the nature and extent of such changes, particularly as to critical audit matters.[12] Investors, analysts, and larger accounting firms generally supported communication of critical audit matters with some modifications, while many smaller accounting firms were less supportive, and preparers and audit committee members generally opposed communication of critical audit matters. Commenters generally supported the additional improvements to the auditor's report other than the disclosure of auditor tenure in the auditor's report, which investors supported and some other commenters opposed or suggested should be provided in a different document, such as the proxy statement.

In April 2014, the Board held a public meeting to obtain further input on the proposal from a diverse group of investors and other financial statement users, preparers, audit committee members, auditors, and others.[13] The proposal was further discussed at the November 2013 and June 2014 SAG meetings, and the October 2013 and 2014 IAG meetings.[14]

In May 2016, the Board issued a reproposal of the auditor reporting standard that modified the proposal in several respects.[15] In particular, the reproposal modified the source, definition, and communication requirements for critical audit matters. The Board received 88 comment letters on the reproposal. The reproposal was discussed at the May 2016 SAG meeting and October 2016 IAG meeting.[16]

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[12] *See* comment letters on the proposal, available on the Board's website in Docket 034.

[13] *See* public meeting transcripts and participant statements (Apr. 2-3, 2014), available on the Board's website in Docket 034.

[14] *See* SAG (Nov. 2013 and June 2014) and IAG meeting transcripts (Oct. 2013 and 2014), available on the Board's website in Docket 034.

[15] *See Proposed Auditing Standard—The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*; PCAOB Release No. 2016-003 (May 11, 2016) ("reproposal").

[16] *See* SAG (May 18, 2016) and IAG (Oct. 27, 2016) meeting transcripts, available on the Board's website in Docket 034.

Several commenters on the reproposal suggested that the Board engage in further outreach, field testing, or further study before finalizing the standard. One commenter suggested deferral until the SEC completes any rulemaking on its "disclosure effectiveness" initiative. However, other commenters commended the Board on the extensive outreach already performed. The Board believes that its extensive outreach provides an adequate basis to adopt the final standard.

## B. Initiatives of Other Regulators and Standard Setters

### *1. Overview of the Requirements of the IAASB, the EU, and the FRC*

The form and content of the auditor's report have undergone change globally. In recent years, several international regulators and standard setters, including the International Auditing and Assurance Standards Board ("IAASB"), the European Union ("EU"), and the Financial Reporting Council in the United Kingdom ("FRC"), have adopted requirements for expanded auditor reporting that go beyond the binary pass/fail model. While their underlying requirements for expanded auditor reporting differ in the details, there is a common theme in these initiatives: communicating information about audit-specific matters in the auditor's report. In addition to expanded auditor reporting, many of these initiatives also include other changes to the form and content of the auditor's report.

Several commenters have urged the Board to align the final standard with the requirements of other regulators and standard setters. The Board recognizes that the regulatory environments in other jurisdictions are different from the environment in the United States; the Board must address unique U.S. requirements and characteristics in its standard-setting projects. Even so, the Board has considered carefully the efforts undertaken in other jurisdictions, and, as described in more detail below, the final requirements are analogous in many respects to auditor reporting requirements established in other jurisdictions.

*IAASB*. In September 2014, the IAASB adopted changes to the requirements for the auditor's report, including a new requirement for the auditor to communicate "key audit matters" for audits of listed companies.[17] Key audit matters are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.[18] Key audit matters are selected

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[17] The IAASB changes to the auditor's report are effective for audits of financial statements for periods ending on or after December 15, 2016.

[18] *See* paragraph 8 of International Standard on Auditing ("ISA") 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

from matters communicated with those charged with governance and that required significant auditor attention in performing the audit.[19] The IAASB requires that the description of each key audit matter in the auditor's report include: (1) why the matter was considered to be a key audit matter, (2) how the matter was addressed in the audit, and (3) reference to the related disclosures, if any, in the financial statements.[20]

As part of its auditor reporting project, the IAASB also adopted additional changes to the form and content of the auditor's report. These include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit,[21] an enhanced description of the responsibilities of the auditor,[22] and requiring the auditor's opinion to be the first paragraph of the auditor's report.[23]

*EU*. In April 2014, the EU adopted legislation creating a number of new requirements, including expanded auditor reporting requirements, for audits of public-interest entities ("PIEs"), such as listed companies, credit institutions, and insurance companies.[24] Under the EU reforms, the auditor's report for a PIE is required to include a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud, as well as a summary of the auditor's response to those risks and, where relevant, key observations arising with respect to those risks. In addition, the EU reforms require a statement that the auditor remained independent of the audited entity and disclosure of auditor tenure.

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[19] *See* paragraph 9 of ISA 701.

[20] *See* paragraph 13 of ISA 701.

[21] *See* paragraph 28(c) of ISA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

[22] *See* paragraph 37 of ISA 700.

[23] *See* paragraph 23 of ISA 700.

[24] *See* Article 10, *Audit Report*, of Regulation (EU) No 537/2014 of the European Parliament and of the Council ("Regulation (EU) No 537/2014") (Apr. 16, 2014). EU member states had until June 2016 to adopt the provisions of the EU legislation into their own national laws and rules. Information on member state implementation is available in the "Audit reform in the EU" section of the European Union's webpage.

*FRC*. In June 2013, the FRC revised its auditor reporting requirements for entities that apply the UK Corporate Governance Code.[25] The auditors of those entities were required, among other things, to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team. In addition, auditors were required to provide an explanation of how the scope of the audit addressed the risks.[26]

In April 2016, the FRC adopted a final rule, which applies to all listed entities, updating its 2013 auditor reporting requirements to incorporate the EU[27] and the IAASB requirements.[28] Under the final rule, the FRC adopted the IAASB's definition of key audit matters. In the application and other explanatory material on the definition of key audit matters, the FRC identified risks of material misstatement, as determined under both its existing requirements and those of the EU, as key audit matters under that definition. When the FRC proposed these rule changes in September 2015, it stated that it did not expect the incorporation of its own requirements and those of the EU to result in an increase in the number of key audit matters communicated in the auditor's report over what would be required by the IAASB standard alone.[29]

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[25] These entities include companies with a premium listing of equity shares on the London Stock Exchange, regardless of whether they are incorporated in the U.K. or elsewhere. The changes made to the auditor's report were designed to complement other changes made to the UK Corporate Governance Code that require the audit committee to describe significant issues it considered relating to the financial statements. *See* Section C.3.8 of FRC UK Corporate Governance Code (Sept. 2012).

[26] *See* paragraphs 19A–B of ISA (UK and Ireland) 700 (Revised June 2013), *The Independent Auditor's Report on Financial Statements* ("UK ISA 700 (2013)"). The FRC 2013 requirements became effective for audits of financial statements for periods beginning on or after October 1, 2012.

[27] In response to questions about the implications of the June 2016 UK referendum decision to leave the EU, the FRC has stated: "Our regulatory framework is unchanged and we will continue to apply it." *See FRC statement following the referendum vote to leave the EU* (June 24, 2016).

[28] *See* the FRC's Final Draft, ISA (UK and Ireland) 701*, Communicating Key Audit Matters in the Independent Auditor's Report* (Apr. 2016). This rule is effective for audits of financial statements for periods beginning on or after June 17, 2016.

[29] *See* FRC, *Enhancing Confidence in Audit: Proposed Revisions to the Ethical Standard, Auditing Standards, UK Corporate Governance Code and Guidance*

*2. Comparison of the Board's Final Standard to Other Requirements*

Even though the underlying auditor reporting requirements of other regulators and standard setters are different in the details, in many respects, the initiatives are analogous to the Board's final standard. All of these initiatives result in expanding the auditor's report beyond the traditional pass/fail model to communicate information specific to the particular audit. Although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.

Sections IV and V include descriptions of the IAASB, EU, and FRC requirements that are analogous to the key provisions of the final standard. In April 2016, the FRC adopted a final rule that updated its 2013 auditor reporting requirements to incorporate the EU and the IAASB requirements, but auditor reporting under that final rule has not occurred yet. Because the FRC 2013 requirements govern the expanded auditor reporting that has occurred in the United Kingdom to date and are the subject of the FRC reports and academic studies described elsewhere in this release, the FRC 2013 requirements are used as a basis for comparison.

The IAASB's standard is most similar to the Board's final standard. It requires the auditor to communicate "key audit matters" selected from matters communicated with those charged with governance. In May 2016, the IAASB published a comparison between its standard and the Board's reproposal, which noted many similarities between the requirements of key audit matters and critical audit matters, including the framework for determination of the matters to be communicated, the considerations underlying the determination requirement, and communication requirements.[30] Many commenters on the reproposal were supportive of the Board's closer alignment with the IAASB.

The FRC, under its 2013 requirements, and the EU start with the risks of material misstatement and contemplate a different process for determining matters to be communicated than the Board's final standard. The FRC has stated that key audit matters under the IAASB standard are broadly equivalent to the assessed risks of material misstatement included in the UK ISA 700 (2013).[31] Under the Board's final

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*on Audit Committees* (Sept. 2015).

[30] *See* IAASB, *The New Auditor's Report: A Comparison between the ISAs and the US PCAOB Reproposal* (May 2016).

[31] *See* FRC, *Extended Auditor's Reports, A Further Review of Experience*

standard, the auditor's assessment of the risks of material misstatement is one of the factors for the auditor to consider in determining critical audit matters.

The IAASB and the FRC 2013 requirements are accompanied by application and other explanatory materials that provide further guidance on the standards. Because these materials are not part of the requirements, they are not addressed in the descriptions of the requirements of other regulators and standard setters presented in Sections IV and V.

## III. Overview of the Final Standard

The Board is adopting a new auditor reporting standard, which is attached as Appendix 1. The final standard retains the pass/fail opinion of the existing auditor's report but makes significant changes to the existing auditor's report, including the following:

- *Critical audit matters* (*see* chart on page 14)—requires the auditor to communicate in the auditor's report any critical audit matters arising from the current period's audit of the financial statements or state that the auditor determined that there are no critical audit matters:
    - A critical audit matter is defined as a matter that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.
    - In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor takes into account, alone or in combination, certain factors, including, but not limited to:
        - The auditor's assessment of the risks of material misstatement, including significant risks;
        - The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

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(Jan. 2016) ("FRC 2016 Report") at 7.

        - The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

        - The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

        - The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

        - The nature of audit evidence obtained regarding the matter.

    - The communication of each critical audit matter includes:

        - Identifying the critical audit matter;

        - Describing the principal considerations that led the auditor to determine that the matter is a critical audit matter;

        - Describing how the critical audit matter was addressed in the audit; and

        - Referring to the relevant financial statement accounts or disclosures.

    - The documentation of critical audit matters requires that for each matter arising from the audit of the financial statements that (a) was communicated or required to be communicated to the audit committee, and (b) relates to accounts or disclosures that are material to the financial statements, the auditor documents whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.

- *Additional Improvements to the Auditor's Report*—the final standard also includes a number of other improvements to the auditor's report that are primarily intended to clarify the auditor's role and responsibilities related to the audit of the financial statements, provide additional information about the auditor, and make the auditor's report easier to read:

    - *Auditor tenure*—a statement disclosing the year in which the auditor began serving consecutively as the company's auditor;

- o *Independence*—a statement that the auditor is required to be independent;

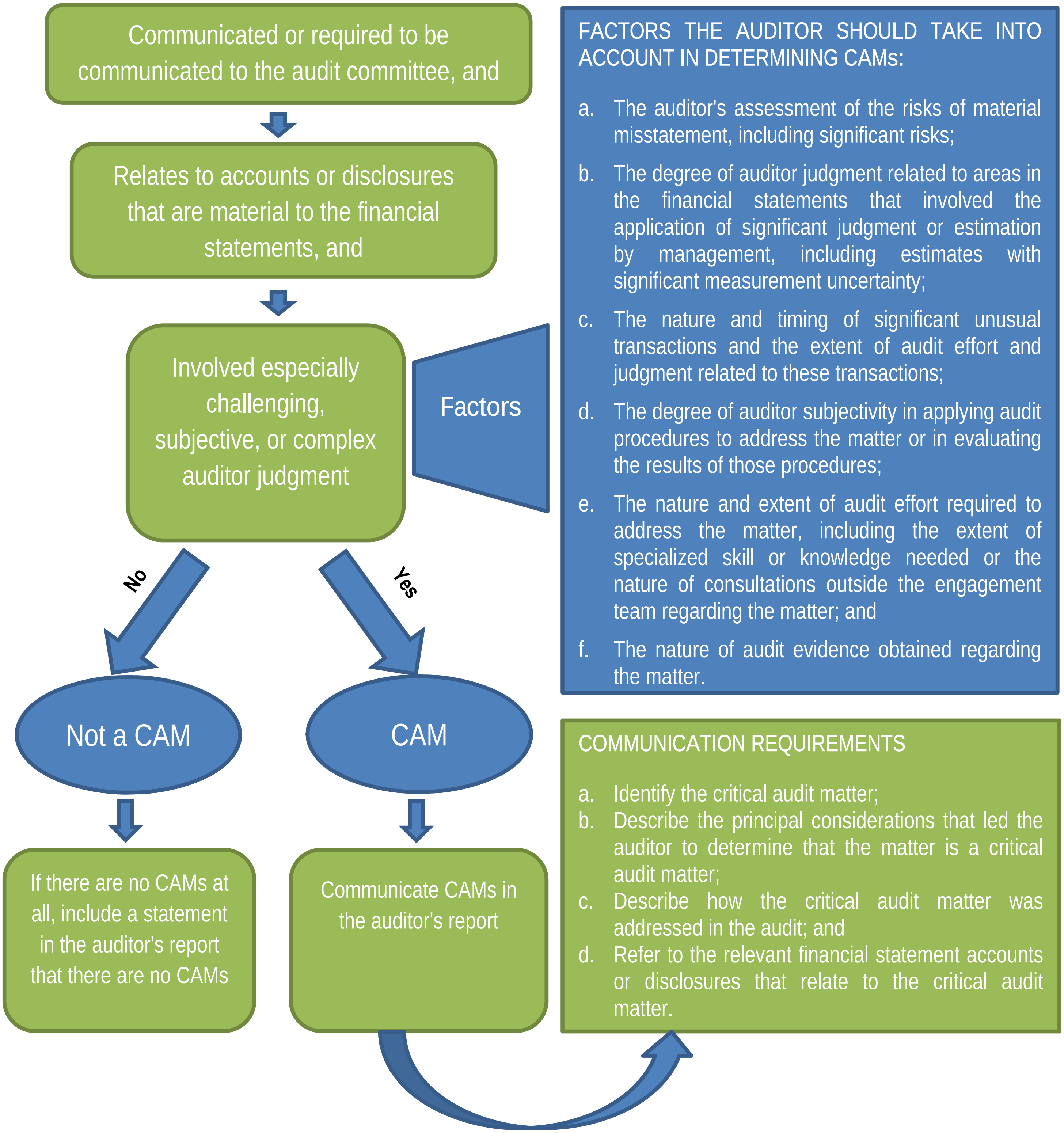
- o *Addressee*—the auditor's report will be addressed to the company's shareholders and board of directors or equivalents (additional addressees are also permitted);

- o *Enhancements to basic elements*—certain standardized language in the auditor's report has been changed, including adding the phrase *whether due to error or fraud*, when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements; and

- o *Standardized form of the auditor's report*—the opinion will appear in the first section of the auditor's report and section titles have been added to guide the reader.

The Board intends to monitor the results of implementation, including consideration of any unintended consequences.

**Determining and Communicating Critical Audit Matters ("CAMs")**



## IV. Discussion of the Final Standard

### A. Critical Audit Matters

Under the final standard, the auditor will be required to communicate critical audit matters in the auditor's report in order to provide more information about the audit and make the auditor's report more informative and relevant to investors and other financial statement users.

Investor, investor advocate, and analyst commenters generally supported the reproposed requirement to communicate critical audit matters. Some of them stated that the communication of critical audit matters would be relevant to investors and other financial statement users by informing them of issues identified in the audit that were significant to the auditor, focusing attention on issues that would be pertinent to understanding the financial statements, and enhancing investor confidence in the financial statements.

The larger and some smaller accounting firms generally supported including critical audit matters in the auditor's report with some modification of the reproposed requirements. Other commenters, including other smaller accounting firms, companies, and audit committee members, did not support the requirements. Some of these commenters asserted that critical audit matters would not provide relevant information to investors, may be duplicative of the company's disclosure, may result in disclosing information not otherwise required to be disclosed, could increase cost, or could delay completion of the audit.

Other commenters suggested that the Board align the definition of critical audit matters with the IAASB's definition of key audit matters to enhance overall consistency.

Consistent with the Board's statutory mandate under Section 101(a) of Sarbanes-Oxley and in response to the ACAP recommendation and continued investor support for expanded auditor reporting, the final standard includes the requirement to communicate critical audit matters substantially as reproposed. The Board has taken into consideration all comments, including concerns raised by some commenters, which are described in more detail below, and believes its approach responds to investor requests for additional information about the financial statement audit without imposing requirements beyond the auditor's expertise or mandate. The communication of critical audit matters will inform investors and other financial statement users of matters arising from the audit that involved especially challenging, subjective, or complex auditor judgment, and how the auditor addressed those matters.

Critical audit matters are determined using a principles-based framework and the Board anticipates that the level of auditor effort will depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

### *1. Determination of Critical Audit Matters*

#### a. Definition of Critical Audit Matter

The reproposed standard defined a critical audit matter as any matter arising from the audit of the financial statements that was *communicated or required to be communicated to the audit committee* and that *relates to accounts or disclosures that are material to the financial statements* and *involved especially challenging, subjective, or complex auditor judgment*. For the reasons explained below, the Board is adopting the definition as reproposed.

##### i. Communicated or Required to be Communicated to the Audit Committee

Most commenters agreed that matters communicated or required to be communicated to the audit committee would be the appropriate source for critical audit matters. These commenters stated that matters communicated to the audit committee are the most meaningful to users of the financial statements and using them as the source of critical audit matters would assist the auditor in determining critical audit matters in the most efficient and effective manner.

PCAOB standards require the auditor to communicate to the audit committee, among other things:

- Significant risks identified by the auditor;
- Certain matters regarding the company's accounting policies, practices, and estimates;
- Significant unusual transactions;
- Certain matters regarding the auditor's evaluation of the company's relationships and transactions with related parties; and
- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process.

Several commenters suggested revising the source of critical audit matters. Some suggested narrowing the source of critical audit matters only to matters required to be communicated to the audit committee, on the basis that this would avoid chilling communications regarding non-required matters and reduce the burden of documentation. Other commenters suggested that the Board consider, as an alternative, selecting critical audit matters only from critical accounting policies and estimates disclosed by management, which some said would eliminate the potential for the auditor to become the original source of information, as well as the potential for conflicting disclosures between the auditor and management. Some commenters also recommended not specifying the source for critical audit matters and leaving it up to auditor judgment. Other commenters suggested broadening the source of critical audit matters to include matters documented in the engagement completion document, reviewed by the engagement quality reviewer, or communicated with management and other members of the board of directors, as the Board had originally proposed in 2013.

The final standard retains the source of critical audit matters as reproposed. Critical audit matters will be drawn from matters required to be communicated to the audit committee (even if not actually communicated) and matters actually communicated (even if not required). The source will include auditor communication requirements under AS 1301, *Communications with Audit Committees*, other PCAOB rules and standards,[32] and applicable law,[33] as well as communications made to the audit committee that were not required. This approach scopes in the broadest population of audit committee communications and will not require the auditor to determine whether matters communicated to the audit committee were required to be communicated. However, it seems likely that matters that meet the definition of a critical audit matter will usually relate to areas that are required to be communicated to the audit committee, either under a specific communication requirement or the broad provisions of paragraph .24 of AS 1301, which requires communication of matters arising from the audit that are significant to audit committee oversight of the financial reporting process.

Required communications to the audit committee generally include the areas in which investors have expressed particular interest in obtaining information in the auditor's report, such as significant management estimates and judgments made in preparing the financial statements; areas of high financial statement and audit risk; significant unusual transactions; and other significant changes in the financial statements.

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[32] *See* Appendix B of AS 1301, which identifies other PCAOB rules and standards that require audit committee communication, such as AS 2410, *Related Parties*, and AS 2502, *Auditing Fair Value Measurements and Disclosures*.

[33] *See, e.g.*, Section 10A(k) of the Exchange Act, 15 U.S.C. 78j-1(k); Rule 2-07 of Regulation S-X, 17 CFR 210.2-07; and Exchange Act Rule 10A-3, 17 CFR 240.10A-3.

The final standard does not limit the source of critical audit matters to critical accounting policies and estimates because the Board does not believe this would be an appropriate starting point in light of investor interest in a broader range of topics related to the audit. Additionally, the final standard does not broaden the source, as proposed in 2013, to also include matters documented in the engagement completion document and reviewed by the engagement quality reviewer because it is unlikely that a matter that is determined to be a critical audit matter would not have already been communicated to the audit committee.

Some commenters suggested that using audit committee communications as the source for critical audit matters could impair the relationship between auditor, management, and the audit committee (e.g., chill communications, give rise to conflict, or cause auditors to communicate more than they otherwise would). However, other commenters argued that critical audit matters would enhance, not impair, communications between auditors, investors, and those charged with governance (including audit committees). For matters required to be communicated to the audit committee, the Board believes there should not be a chilling effect or reduced communications to the audit committee because the requirements for such communications are not changing. It would seem that any chilling effect would more likely relate to matters that are not explicitly required to be communicated to the audit committee, although given the broad requirements of AS 1301 (particularly paragraph .24), the Board believes that there may be few, if any, relevant communications affected by that possibility.

Some commenters suggested excluding certain required audit committee communications from the source of critical audit matters, generally because these communications relate to sensitive areas and may result in the auditor communicating information not disclosed by management. Suggestions included: corrected and uncorrected misstatements, qualitative aspects of significant accounting policies and practices, alternative treatments within generally accepted accounting principles ("GAAP") for policies and practices related to material accounts, violations or possible violations of law or regulation, independence considerations, disagreements with management, other material written communications between the auditor and management, overall planned audit strategy, delays encountered in the audit, and competency issues of management. Other commenters argued that no audit committee communications should be specifically excluded from consideration as a source of potential critical audit matters.

The final standard does not exclude any required audit committee communications from the source of critical audit matters. To the extent that any such communication met the critical audit matter definition (including that it (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment), the Board believes it will be an appropriate subject for an auditor to communicate as a critical audit matter.

ii. Relates to Accounts or Disclosures That Are Material to the Financial Statements

The materiality component of the reproposed definition of critical audit matters—that the matter "relates to accounts or disclosures that are material[34] to the financial statements"— was intended to respond to investor requests for informative and relevant auditor's reports while, at the same time, addressing other commenters' concerns regarding auditor communication of immaterial information that management is not required to disclose under the applicable financial reporting framework and SEC reporting requirements.

Some investor commenters suggested removing the materiality component of the reproposed definition of critical audit matters, arguing that it made the definition too narrow and would unnecessarily exclude relevant information. Some of these commenters observed that many cases of material accounting problems or fraud started as 'immaterial' to the financial statements and built over time, and that such matters may not meet the reproposed definition of a critical audit matter because of the materiality component.

Other commenters, primarily companies and accounting firms, argued that the reproposed definition was too broad and suggested modifying the materiality component such that a critical audit matter would itself have to be material to the financial statements as a whole, rather than relating to accounts or disclosures that are material to the financial statements. These commenters expressed concern that the phrase "relates to accounts or disclosures that are material to the financial statements" could apply to too many matters, resulting in the auditor disclosing immaterial matters that would not otherwise be disclosed by management, or give the impression of a piecemeal opinion.

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[34] The definition of materiality is established under the U.S. federal securities laws. In interpreting those laws, the U.S. Supreme Court has held that a fact is material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976). *See also Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). As the Supreme Court has further explained, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him . . ." *TSC Industries*, 426 U.S. at 450.

After consideration of comments, the Board has determined to adopt the materiality component in the final definition of critical audit matter as reproposed. In the Board's view, the purpose of the standard—making the auditor's report more useful and informative to investors—is better served by auditor communication of matters related to accounts or disclosures that are material to the financial statements. As one commenter noted, limiting the source of critical audit matters and adding a materiality component that directly relates to accounts and disclosures "would allow the auditor to emphasize the most important matters to users of the financial statements, and limit the inclusion of an overabundance of [critical audit matters] within the auditor's report that could deemphasize their importance."[35]

At the same time, in the Board's view, limiting critical audit matters to those that are, in and of themselves, material to the financial statements as a whole would not serve the intended purpose of the standard. If the auditor were required to determine that a critical audit matter itself is material, rather than related to an account or disclosure that is material, it is likely that fewer matters would meet the definition of a critical audit matter and, thus, investors would likely receive less, and less audit-specific, information than under the standard as adopted.

Accordingly, as in the reproposal, the final standard provides that each critical audit matter relates to accounts or disclosures that are material to the financial statements. Consistent with the reproposal, "relates to" clarifies that the critical audit matter could be a component of a material account or disclosure and does not necessarily need to correspond to the entire account or disclosure in the financial statements. For example, the auditor's evaluation of the company's goodwill impairment assessment could be a critical audit matter if goodwill was material to the financial statements, even if there was no impairment; it would relate to goodwill recorded on the balance sheet and the disclosure in the notes to the financial statements about the company's impairment policy and goodwill. In addition, a critical audit matter may not necessarily relate to a single account or disclosure but could have a pervasive effect on the financial statements if it relates to many accounts or disclosures. For example, the auditor's evaluation of the company's ability to continue as a going concern could also represent a critical audit matter depending on the circumstances of a particular audit.

On the other hand, a matter that does not relate to accounts or disclosures that are material to the financial statements cannot be a critical audit matter. For example, a potential loss contingency that was communicated to the audit committee, but that was

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[35] *See* letter from Dixon Hughes Goodman, LLP (Aug. 15, 2016) at 2, available on the Board's website in Docket 034 (also noting that there is a continuing risk that the auditor could disclose information about the company that was not previously disclosed by the company).

determined to be remote and was not recorded in the financial statements or otherwise disclosed under the applicable financial reporting framework, would not meet the definition of a critical audit matter; it does not relate to an account or disclosure in the financial statements, even if it involved especially challenging auditor judgment. The same rationale would apply to a potential illegal act if an appropriate determination had been made that no disclosure of it was required in the financial statements; the matter would not relate to an account or disclosure that is material to the financial statements.

For the same reason, the determination that there is a significant deficiency in internal control over financial reporting, in and of itself, cannot be a critical audit matter; such determination, in and of itself, does not relate to an account or disclosure that is material to the financial statements as no disclosure of the determination is required. A significant deficiency could, however, be among the principal considerations that led the auditor to determine that a matter is a critical audit matter.[36]

iii. Involved Especially Challenging, Subjective, or Complex Auditor Judgment

Many commenters supported including "matters that involved especially challenging, subjective, or complex auditor judgment" in the reproposed definition of a critical audit matter. Other commenters argued that the phrase "especially challenging, subjective, or complex auditor judgment" is broad and subjective and would lead to inconsistent application of the reproposed definition. For example, some commenters said that critical audit matters would vary based on the experience and competence of the auditor, even if the underlying facts and circumstances were the same. One commenter urged disclosure of the auditor's perspective on material related party transactions. Another commenter suggested that the standard include a note stating that it is expected that in most audits, financial statement matters involving the application of significant judgment or estimation by management would involve especially challenging, subjective, or complex auditor judgment.

Several commenters suggested using the IAASB's definition of key audit matters, which includes those matters that were of most significance in the audit of the financial statements and that required significant auditor attention. One commenter argued that this would avoid reliance on the auditor's determination of whether a matter involved especially challenging, subjective, or complex auditor judgment, which the commenter said would give auditors too much discretion.

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[36] *See* section IV.A.2.c.i for additional considerations related to auditor disclosure of original information.

After consideration of comments, the Board is adopting this component of the definition of critical audit matter as reproposed, namely "matters that involved especially challenging, subjective, or complex auditor judgment." This grounds the definition in the auditor's expertise and judgment, which is directly responsive to investor requests for information from the auditor's point of view. Thus, the Board believes that this definition will focus critical audit matters in areas where investors will particularly benefit from expanded reporting by the auditor.

The determination of critical audit matters is principles-based and the final standard does not specify any items that would always constitute critical audit matters. For example, the standard does not provide that all matters determined to be "significant risks" under PCAOB standards would be critical audit matters.[37] Some significant risks may be determined to be critical audit matters, but not every significant risk would involve especially challenging, subjective, or complex auditor judgment. To illustrate, improper revenue recognition is a presumed fraud risk and all fraud risks are significant risks;[38] however, if a matter related to revenue recognition does not involve especially challenging, subjective, or complex auditor judgment, it will not be a critical audit matter. Similarly, the final standard does not provide, as some commenters suggested, that material related party transactions or matters involving the application of significant judgment or estimation by management always constitute critical audit matters. The auditor must determine, in the context of the specific audit, that a matter involved especially challenging, subjective, or complex auditor judgment. In addition, focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. To the extent that critical audit matters reflect differences in auditors' experience and competence, this in itself should also be informative.

b. Factors

The reproposal included the following nonexclusive list of factors for the auditor to take into account, together with audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

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[37] A significant risk is a "risk of material misstatement that requires special audit consideration." Paragraph .A5 of AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[38] *See* AS 2110.71.

b. The degree of auditor subjectivity in determining or applying audit procedures to address the matter or in evaluating the results of those procedures;

c. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter;

d. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

e. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions; and

f. The nature of audit evidence obtained regarding the matter.

Commenters in general agreed that including such factors would assist the auditor in determining critical audit matters.

Some commenters suggested changes to better align the factors with areas of complex management judgment, to reduce the risk that the auditor would be the source of original information, to clarify the linkage of procedures performed by the auditor and sufficient appropriate audit evidence obtained in performing those procedures, and to focus the auditor on the audit procedures executed to obtain sufficient and appropriate audit evidence rather than audit strategy decisions. Some commenters suggested harmonizing the factors with the IAASB's factors for determining key audit matters.

After considering the comments received, the Board has modified the factors by reordering them and revising the factor relating to the degree of auditor subjectivity (factor b above) to refer to the application (rather than determination) of audit procedures, which focuses it more clearly on the performance of the audit rather than audit strategy.

Some commenters suggested that the factor pertaining to the nature and extent of the audit effort (factor c) be revised to relate to the nature and extent of audit effort required to obtain sufficient appropriate audit evidence to address a matter and the factor pertaining to the nature of audit evidence (factor f) be deleted to clarify that obtaining audit evidence is a component of audit effort. The final standard does not change factor c as suggested because it would inappropriately narrow the factor exclusively to considerations related to obtaining audit evidence rather than the nature of the overall audit effort. Additionally, the Board determined to retain factor f as a stand-alone factor because, as stated in the reproposal, in the limited implementation trial conducted by several accounting firms, this factor appeared to be one of the most useful in determining critical audit matters.[39]

A commenter recommended including a factor based on the extent of interaction with the audit committee. The final standard does not include this factor because the extent of interaction might not be a meaningful indicator of the complexity or subjectivity of the matter and it could create incentives to limit communication between the auditor and the audit committee.

One commenter did not agree with elimination of two proposed factors that related to the severity of control deficiencies and corrected and uncorrected misstatements. These factors were eliminated from the reproposal in response to comments that the factors would lead the auditor to determine matters as critical audit matters in areas where the company has no existing reporting obligation, or where the company has determined that the matters are not material and therefore do not require disclosure under the financial reporting framework. For these reasons, the final standard does not include these factors.

Under the final standard, once the auditor identifies a matter communicated or required to be communicated to the audit committee that relates to accounts or disclosures that are material to the company's financial statements, the auditor should take into account the following nonexclusive list of factors, as well as other audit-specific factors, when determining whether a matter involved especially challenging, subjective, or complex auditor judgment:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

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39 *See* letter from the Center for Audit Quality (June 19, 2014) at 5, available on the Board's website in Docket 034.

d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the nature of consultations outside the engagement team regarding the matter; and

f. The nature of audit evidence obtained regarding the matter.

The determination should be made in the context of the particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks. The factors provide a principles-based framework for the auditor to use in assessing whether a matter involved especially challenging, subjective, or complex auditor judgment. Depending on the matter, the auditor's determination that a matter is a critical audit matter might be based on one or more of these factors, other factors specific to the audit, or a combination.

c. Audit Period Covered by Critical Audit Matters

The reproposal would have required the auditor to communicate critical audit matters for the audit of the current period's financial statements. Because the communication of critical audit matters for prior periods might also be useful to investors and other financial statement users in certain situations, the reproposed standard provided that the auditor may communicate critical audit matters relating to a prior period when: (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

Some commenters generally supported communicating critical audit matters for only the current period's financial statements or for all periods if audited financial statements have not been made public previously. Other commenters supported communication of critical audit matters for all periods presented along with an explanation if prior year critical audit matters are not repeated in the current year. Yet another commenter stated that the auditor should be encouraged to use judgment as to whether to include critical audit matters for prior periods and not limit the consideration only to the circumstances described in the reproposal.

The final standard retains the requirement to communicate critical audit matters only for the current audit period. While most companies' financial statements are presented on a comparative basis, and thus most auditor's reports cover a similar period, requiring auditors to communicate critical audit matters for the current period, rather than for all periods presented, will provide relevant information about the most recent audit and is intended to reflect a cost-sensitive approach to auditor reporting. In addition, investors and other financial statement users will be able to look at prior years' filings to analyze critical audit matters over time. However, the auditor could choose to include critical audit matters for prior periods. The final standard clarifies that the two situations relating to a prior period are examples rather than the only situations in which a critical audit matter for a prior period may be communicated.

As noted in the reproposal, if the auditor's report is dual-dated, the auditor will determine whether the new information for which the auditor's report is dual-dated gives rise to any additional critical audit matters.

In situations in which a predecessor auditor has been asked to reissue its auditor's report, the communication of critical audit matters for the prior period need not be repeated because it is only required for the current year. However, the predecessor auditor could choose to include prior year critical audit matters in the reissued auditor's report.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* Under the IAASB's standard, "key audit matters" are defined as those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are determined using a two-step process. First, the auditor identifies the matters communicated with those charged with governance[40] that required significant auditor attention in performing the audit, taking into account:

- Areas of higher assessed risks of material misstatement, or significant risks;
- Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty; and
- The effect on the audit of significant events or transactions that occurred during the period.[41]

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[40] *See* paragraph 8 of ISA 701. *See also* ISA 260, *Communication with Those Charged with Governance*, which provides requirements for auditor communications with those charged with governance.

[41] *See* paragraph 9 of ISA 701.

Second, of the matters that required significant auditor attention, the auditor identifies those of most significance in the audit as the key audit matters.[42] The IAASB requires the communication of key audit matters for the current period only.[43]

*EU.* The EU requires the auditor to describe the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud.[44] The EU does not specify the period for which these need to be described.

*FRC*. The FRC requires the auditor to describe the risks of material misstatement that had the greatest effect on: (1) the overall audit strategy; (2) the allocation of resources in the audit; and (3) directing the efforts of the engagement team.[45] The FRC does not specify the period for which these need to be described.

*2. Communication of Critical Audit Matters*

Under the reproposal, the auditor would have been required to include introductory language in the auditor's report preceding the communication of critical audit matters and to communicate critical audit matters by identifying each matter, describing the auditor's principal considerations for determining that the matter was a critical audit matter, describing how the critical audit matter was addressed in the audit, and referring to the relevant financial statement accounts and disclosures.

Comments varied on the reproposed requirements for communication of critical audit matters and the level of detail the auditor should provide, including whether the auditor should be permitted to provide information about the company that has not been previously disclosed by the company (which commenters referred to as "original information"). Commenters generally agreed with identifying each critical audit matter and referring to the relevant financial statement accounts and disclosures. One commenter suggested removing the requirements to describe the considerations for determining that a matter was a critical audit matter and how the critical audit matter was addressed in the audit. While some commenters stated that the proposed requirements regarding auditor's communication of critical audit matters are sufficiently clear, many suggested improvements to some of the components of the communication

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[42] *See* paragraph 10 of ISA 701.

[43] *See* paragraphs 8 and 10 of ISA 701.

[44] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[45] *See* paragraph 19A of UK ISA 700 (2013).

requirements. After consideration of comments, the Board has made some enhancements to the communication requirements, as described below.

a. Introductory Language

The reproposed standard provided introductory language to be included in the "Critical Audit Matters" section of the auditor's report indicating that critical audit matters did not alter the opinion on the financial statements and that the auditor was not providing a separate opinion on the critical audit matters. Some commenters supported the introductory language on the basis that it could minimize users' potential misunderstanding of the critical audit matters.

Some commenters suggested additions to the introductory language to emphasize that critical audit matters are subjective and may not represent the most important aspects of the financial statements, to clarify that the description of procedures should not be taken as indicative of results of any individual procedure, or to limit reliance on critical audit matters by adding language similar to that used in a report on an audit of internal control over financial reporting ("ICFR").[46] The introductory language in the final standard does not include the suggested additions because such language could be interpreted as disclaiming or inappropriately minimizing the communication of critical audit matters.

Other commenters suggested minor revisions in the introductory language to refer to the "communication of critical audit matters" rather than the critical audit matters themselves. In response to this comment, the required introductory language in the final standard has been revised as follows (additions are <u>underlined</u> and deletions are struck through):

> The critical audit matters communicated below are matters arising from the current period audit <u>of the financial statements</u> that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. <u>The</u>

[46] The auditor's report on the audit of internal control over financial reporting requires a paragraph stating that, "because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate." *See* paragraph .85j of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

communication of ~~C~~critical audit matters do<u>es</u> not alter in any way our opinion on the financial statements, taken as a whole, and we ~~do~~ <u>are</u> not, <u>by communicating the critical audit matters below</u>, ~~provide~~ <u>providing</u> separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

b. Communication Requirements

The reproposal required that, for each critical audit matter, the auditor would:

- Identify the critical audit matter;
- Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;
- Describe how the critical audit matter was addressed in the audit; and
- Refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter.

As discussed in more detail below, these requirements have been adopted substantially as reproposed.[47]

*Identify the Critical Audit Matter and Describe the Principal Considerations that Led the Auditor to Determine that the Matter is a Critical Audit Matter*

Many commenters who addressed this topic supported the identification of the critical audit matter and limiting the description to "the principal considerations" that led the auditor to determine that the matter is a critical audit matter, and those aspects of the communication requirements are adopted as reproposed. The auditor's description of the principal considerations should be specific to the circumstances and provide a clear, concise, and understandable discussion of why the matter involved especially

[47] The reproposing release included two illustrative examples of the communication of critical audit matters. *See* PCAOB Release No. 2016-003, Section IV.A.2.b. Given the principles-based nature of the requirements for critical audit matters and the objective of providing tailored, audit-specific information, the examples were intended to function as illustrations of how critical audit matters could be communicated, and not as templates for how critical audit matters should be communicated. Comments received on these examples were taken into account in the Board’s consideration of the final standard. Illustrative examples do not appear in the adopting release because the Board believes auditors should provide tailored, audit-specific information when communicating critical audit matters in the auditor’s report.

challenging, subjective, or complex auditor judgment. It is expected that the communication will be tailored to the audit to avoid standardized language and to reflect the specific circumstances of the matter.

*Describe How the Critical Audit Matter was Addressed in the Audit*

The reproposed standard included a new requirement for the auditor to describe how the critical audit matter was addressed in the audit. While the standard did not specify how this should be done, the reproposing release provided four examples of potential approaches to such descriptions: (1) the auditor's response or approach that was most relevant to the matter; (2) a brief overview of the procedures performed; (3) an indication of the outcome of the auditor's procedures; and (4) key observations with respect to the matter, or some combination of these elements.[48]

Many commenters were supportive of a requirement to describe how each critical audit matter was addressed in the audit. Some commenters asserted that a description of how a critical audit matter was addressed would benefit investors by providing insights on how and on what basis the auditor developed the opinion or the rigor that underlies the audit procedures performed. For example, one investor commenter stated that including audit procedures in the description of a critical audit matter would make the auditor's report more informative and useful. Several investors suggested that the auditor should be required or encouraged to provide informative, company-specific findings when describing how the critical audit matter was addressed in the audit, such as whether management's significant accounting estimates and judgments were balanced, mildly optimistic, or mildly pessimistic.

One commenter suggested that the description of how the critical audit matter was addressed in the audit should be optional. Several commenters objected to the auditor including audit procedures in the description of critical audit matters because it would not provide any incremental value or actionable information to investors, investors may not have the expertise or context to understand audit procedures, or the description of audit procedures would become boilerplate. One commenter suggested adding a note to clarify that the purpose of describing audit procedures is to provide information about the audit but not specific details that would compromise the effectiveness of audit procedures. Other commenters suggested that only the principal audit procedures should be provided.

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[48] These elements are similar to the IAASB's elements described in paragraph A46 of ISA 701. The EU also requires that the auditor describe key observations with respect to the most significant assessed risks of material misstatement.

The final standard includes the requirement for the auditor to describe how the critical audit matter was addressed in the audit because it is consistent with the Board's objective of providing more information about the audit and, if developed with an appropriate focus on the intended audience, should be of interest to users. Similar to the reproposal, the final standard does not prescribe a specific way to meet this requirement. Several commenters suggested that the four examples provided in the reproposing release be included in the standard because they provide helpful guidance on how the requirement could be met. The final standard includes a note incorporating these examples, which should clarify the Board's expectations while providing flexibility in describing how a critical audit matter was addressed in the audit.

While the description of how the critical audit matter was addressed in the audit will require judgment, the auditor should bear in mind that the intent of communicating critical audit matters is to provide information about the audit of the company's financial statements that will be useful to investors. A brief overview of the audit procedures performed is one of the alternatives for describing how the critical audit matter was addressed. If the auditor chooses to describe audit procedures, the descriptions are expected to be at a level that investors and other financial statement users would understand. In addition, as the four examples should make clear, the objective is to provide a useful summary, not to detail every aspect of how the matter was addressed in the audit. Limiting the use of highly technical accounting and auditing terms in the description of critical audit matters, particularly if the auditor chooses to describe audit procedures, may help financial statement users better understand these matters in relation to the audit of the financial statements.

In its comment letter, a working group of the IAG stressed the importance to investors of auditor findings, which they described as "the one item that [they] believe would provide the greatest value to investors."[49] Acknowledging the difficulty of mandating reporting of findings, the working group recommended that the Board encourage auditors to include them voluntarily. Under the final standard, communication of the auditor's findings is not required; however, in describing the audit response, the auditor may choose to include findings as an indication of the outcome of audit procedures or key observations about a matter. The Board shares the working group's view that the inclusion of informative, company-specific audit findings related to critical audit matters may, in appropriate circumstances, be valuable to investors and encourages auditors to consider including such findings in their auditor's reports. However, in describing findings, the language used should not imply that the auditor is

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[49] Letter from the IAG's auditor's report working group (Aug. 15, 2016) at 1, available on the Board's website in Docket 034. The working group made a presentation regarding its comment letter at the IAG meeting in October 2016, available on the Board's website.

providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

*Refer to the Relevant Financial Statement Accounts or Disclosures that Relate to the Critical Audit Matter*

The reproposed standard would have required the auditor to refer to the relevant financial statement accounts and disclosures that relate to the critical audit matter. There were few comments on this requirement. One commenter suggested that, to avoid duplication, reference should be made only to the disclosures and not the financial statement accounts. In response to this suggestion, the final standard clarifies that the auditor could refer to either the relevant account or disclosure, rather than both, to avoid potential duplication.

The reproposal also solicited comment on whether, in addition to referring to the relevant financial statement accounts and disclosures, the auditor should refer to relevant disclosures outside the financial statements. Commenters that addressed this question generally opposed the auditor referencing disclosures outside the financial statements when describing a critical audit matter because it may incorrectly suggest that such information is audited or cause readers to misinterpret the auditor's role in relation to such information. The final standard only requires the auditor to refer to the relevant financial statement accounts or disclosures.

c. Additional Considerations Related to the Communication Requirements

i. Auditor Disclosure of "Original Information" about the Company

The reproposed standard included a note to indicate that, when describing critical audit matters in the auditor's report, the auditor is not expected to provide original information unless it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Investor commenters, including the auditor's report working group of the IAG, argued that there should not be any limitation on the auditor providing original information and that the reproposal went too far in constraining the auditor from providing original information in response to concerns expressed by other commenters (which were primarily companies and accounting firms).

Other commenters expressed the view that auditors should not provide original information about the company or should be limited to providing information about the audit and not the company. These commenters stated that the auditor providing original information about the company would be inconsistent with the traditional U.S. regulatory framework, whereby management provides information about the company and the auditor attests to compliance with the applicable financial reporting framework. However, one investor commenter noted that auditor reporting should not be limited by "original information," a term that is undefined in auditing literature.

No PCAOB standard, SEC rule, or other financial reporting requirement prohibits auditor reporting of information that management has not previously disclosed. Rather, there are areas under current law and auditing standards that require auditor reporting that goes beyond attesting to the compliance of management disclosures (e.g., substantial doubt about a company's ability to continue as a going concern[50] or illegal acts[51]). As discussed in more detail below, auditors may have professional or state law obligations to maintain client confidentiality, but these obligations should not apply to, or should be preempted by, reporting obligations arising under federal law and regulations, including under PCAOB standards.[52] Accordingly, the requirement to communicate critical audit matters is not, as some commenters have suggested, inconsistent with the existing U.S. financial reporting framework and auditors' other obligations.

Commenters also said that the role of the audit committee or management would be undermined by requiring the auditor to disclose information about the company's financial statements, since in their view it is solely management's responsibility to determine what disclosure is appropriate. Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management, and that management would likely modify its disclosure in response to the communication of critical audit matters in the auditor's report so the auditor would not be a source of original information. While some commenters said that this would improve management disclosures, others said it would be an inappropriate expansion of the auditor's role or would add significant costs. Other

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[50] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern.* The auditor is required to include a going concern explanatory paragraph if the auditor concludes that substantial doubt exists about the entity's ability to continue as a going concern for a reasonable period of time (*see* AS 2415.12). If management's disclosure with respect to the company's ability to continue as a going concern is inadequate, the auditor's reporting responsibility regarding going concern remains and the report includes either a qualified or an adverse opinion (*see* AS 2415.14).

[51] Auditors may be required, under certain circumstances, pursuant to the Private Securities Litigation Reform Act of 1995 (codified in Section 10A(b)1 of the Exchange Act), to make a report to the SEC relating to an illegal act that has a material effect on the financial statements.

[52] For a more detailed discussion of liability considerations related to critical audit matters, *see* Section IV.A.4.

commenters stated that companies could be harmed by the disclosure of confidential or competitively sensitive information. Another commenter expressed concern that investors could be confused or misled if auditor reporting lacked context or appeared to conflict with management disclosures. One commenter suggested that the auditor should disclose original information only if a disclosure matter continues to be unresolved after discussion with management and the audit committee.

The Board acknowledges these concerns and, in developing the auditor's communication requirements, has sought to strike an appropriate balance between investor demands for expanded auditor reporting and the costs and potential unintended consequences associated with providing it. While auditor reporting of original information is not prohibited, it is limited to areas uniquely within the perspective of the auditor: describing the principal considerations that led the auditor to determine that the matter is a critical audit matter and how the matter was addressed in the audit. The objective of critical audit matters—helping investors to focus on identified areas of the audit and understand how the auditor addressed them—may not be accomplished if the auditor is prohibited from providing such information. Moreover, prohibiting the auditor from providing such information could make critical audit matter communications incomplete in a way that could be confusing to or misunderstood by investors.

It seems likely, as one commenter observed, that auditors will generally not have incentives to provide information about the company that the company has not already made public. Another commenter noted that, in current practice, disclosure is already guided by an iterative process between management and the auditor, and expected that a similar process would occur for critical audit matters, reducing the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.[53] To the extent that an auditor's decision to communicate a critical audit matter incents the company to expand or supplement its own disclosure, the Board believes this may improve the quality of public disclosures, which would be an indirect benefit of the standard. However, if the company does not provide additional disclosure, and the information is necessary to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter or how it was addressed in the audit, the Board believes it is in the public interest for the auditor to include that information in the auditor's report. The final standard therefore retains the note from the reproposal explaining that the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal

[53] It should be noted, however, that critical audit matters are not a substitute for disclosures required of the company under the applicable financial reporting framework.

considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

Of course, any matter that will be communicated as a critical audit matter will already have been discussed with the audit committee, and the auditor will be required to provide a draft of the auditor's report to the audit committee and discuss the draft with them.[54] In addition, as the auditor determines how best to comply with the communication requirements, the auditor could discuss with management and the audit committee the treatment of any sensitive information.

Some commenters also stated that, in areas where there are specific reporting obligations under the applicable financial reporting framework or SEC reporting requirements but the matter falls below the disclosure threshold (for example, a significant deficiency), auditor communication could, in effect, impose a lower disclosure threshold. With regard to such areas, it is likely that the nature of a critical audit matter and its description would be broader than, for instance, focusing on a significant deficiency. In addition, while the auditor is required to describe the principal considerations that led the auditor to determine that the matter is a critical audit matter, (which may include, if relevant, information about the company's processes and controls) and how the overall matter was addressed, it is not necessary for the auditor's description to use the terminology of the other auditing standard, such as "significant deficiency" within the broader context of a critical audit matter. For example, if a significant deficiency was among the principal considerations in determining that revenue recognition was a critical audit matter, the auditor would describe the relevant control-related issues over revenue recognition in the broader context of the critical audit matter without using the term "significant deficiency."[55]

Some commenters suggested that any expanded disclosure requirements should come from the SEC and the Financial Accounting Standards Board ("FASB"), in the form of additional management disclosures, rather than from the Board expanding requirements for auditor reporting. However, investors have consistently asked to hear more from the auditor, an independent third-party expert whose work is undertaken for the investor's benefit. As one commenter noted, the auditor is best suited to provide insights on how and on what basis the auditor developed its opinion. The final standard is designed to elicit information about the audit directly from the auditor's perspective.

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[54] *See* AS 1301.21, as amended.

[55] It should be noted that the determination that a matter was a significant deficiency in internal control over financial reporting, on its own, could not be a critical audit matter. *See* Section IV.A.1.a.ii.

If auditors can adequately convey to investors the principal considerations and how the auditor addressed the matter without including previously undisclosed information, it is expected that they will. However, the standard provides that even when management has not disclosed information, the auditor is not constrained from providing such information if it is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

The Board intends to monitor implementation of the critical audit matter requirements to determine if additional guidance is needed in this area.

ii. Potential Compliance Issues Related to Critical Audit Matters

Some commenters suggested that the reporting of critical audit matters could create compliance challenges for companies.

Two commenters expressed concern that companies' SEC filings may have to be amended because of changes in the description or reporting of critical audit matters. In principle, auditors should approach errors and misstatements in the communication of critical audit matters in the same way they would approach any other error or misstatement in the auditor's report that does not affect the auditor's opinion or the ability of market participants to rely on the opinion.[56] It appears that under current practice, SEC filings have been amended solely to correct errors in auditor's reports, such as incorrect auditor's report dates or missing explanatory paragraphs.

Another commenter expressed concern that management may be asked to respond to investor questions regarding issues described in critical audit matters and may not be in a position to do so, particularly in light of their responsibilities under Regulation FD. Given the auditor's responsibility to communicate with the audit committee, and the likelihood of extensive discussions between auditors and management regarding critical audit matters, it seems likely that management will be prepared to respond appropriately and in compliance with their legal obligations (including Regulation FD), as they would with regard to any other question about information included in an SEC filing.

d. Ability to Communicate No Critical Audit Matters

The reproposal provided that the auditor could determine there were no critical audit matters and provide a statement to that effect in the auditor's report. Commenters

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[56] The final standard indicates that the auditor's communication of critical audit matters does not alter in any way the auditor's opinion on the financial statements, taken as a whole.

generally supported the auditor's ability to determine that there are no critical audit matters. Two commenters suggested that the auditor should not have to make a statement in the auditor's report that there were no critical audit matters because the absence of a critical audit matter should be sufficient without the definitive statement, similar to an emphasis paragraph. The final standard includes the possibility that the auditor could determine, and state in the auditor's report, that there are no critical audit matters.[57] The statement that there are no critical audit matters is required because unlike an emphasis paragraph, critical audit matters are a required element of the auditor's report.

The determination of critical audit matters is based on the facts and circumstances of each audit. The Board expects that, in most audits to which the requirement to communicate critical audit matters applies, the auditor will determine that at least one matter involved especially challenging, subjective, or complex auditor judgment. There may be critical audit matters even in an audit of a company with limited operations or activities. However, there may be circumstances in which the auditor determines there are no matters that meet the definition of a critical audit matter and, in those circumstances, the auditor will communicate that there were no critical audit matters.

*Requirements of Other Regulators and Standard Setters*

*IAASB.* For each key audit matter, the IAASB requires the auditor to reference the related disclosures, if any, in the financial statements and address: (1) why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter and (2) how the matter was addressed in the audit.[58] The IAASB allows the auditor to determine that there are no key audit matters to communicate in the auditor's report and, if so, requires a statement to this effect.[59]

*EU.* The EU requires the auditor to include in the auditor's report: (1) a description of the most significant assessed risks of material misstatement, including assessed risks of material misstatement due to fraud; (2) a summary of the auditor's

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[57] Since communication of critical audit matters will not be required for the audits of EGCs, brokers and dealers reporting under Exchange Act Rule 17a-5, 17 CFR 240.17a-5, investment companies other than business development companies, and benefit plans, the auditor's report for the audits of these entities will not be required to include the statement that there are no critical audit matters.

[58] *See* paragraph 13 of ISA 701.

[59] *See* paragraphs 14 and 16 of ISA 701.

response to the risks; and (3) where relevant, key observations arising with respect to the risks.[60]

*FRC.* The FRC requires the auditor, among other things, to: (1) describe those assessed risks of material misstatement that were identified by the auditor and (2) provide an overview of the scope of the audit, including an explanation of how the scope addressed the assessed risks of material misstatement.[61] The explanations of the matters set out in the auditor's report should be described in a way that: (1) enables a user to understand their significance in the context of the audit of the financial statements as a whole and not as discrete opinions on separate elements of the financial statements; (2) enables the matters to be related directly to the specific circumstances of the audited entity and are not therefore generic or abstract matters expressed in standardized language; and (3) complements the description of significant issues required to be made by the audit committee.[62]

*3. Documentation of Critical Audit Matters*

The reproposed standard required documentation of the basis for the auditor's determination whether each matter that both: (1) was communicated or required to be communicated to the audit committee and (2) relates to accounts or disclosures that are material to the financial statements, involved or did not involve especially challenging, subjective, or complex auditor judgment. Some commenters supported a documentation requirement only for matters that were determined to be critical audit matters. Some of these commenters asserted that documentation about matters determined not to be critical audit matters would add costs and primarily benefit PCAOB inspections rather than audit quality. Others stated that the requirement is not aligned with the IAASB's documentation requirement, which, in their view, focuses on rationale for inclusion as a key audit matter rather than exclusion. However, another commenter argued that the determination that a matter was not a critical audit matter would seem to be an important audit judgment that ought to be documented for review by the engagement quality reviewer. This commenter suggested that documentation be required only for matters required to be communicated to the audit committee (which would already have been documented) and not for those that are communicated otherwise. One auditor argued that the reproposed requirement would lead auditors to document all audit committee communications even if not required, and that this would disproportionately

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[60] *See* requirements in 2(c) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

[61] *See* paragraph 19A of UK ISA 700 (2013).

[62] *See* paragraph 19B of UK ISA 700 (2013).

affect smaller companies whose audit committees more commonly request information not required to be communicated under PCAOB standards.

The final standard substantially retains the approach from the reproposal of requiring the auditor to document the basis for determining critical audit matters.[63] The objective of the requirement is to document how the determination of critical audit matters (or the determination that there are no critical audit matters) was made from among the matters communicated or required to be communicated to the audit committee that relate to accounts or disclosures that are material to the financial statements. The documentation requirement will also facilitate review by the engagement quality reviewer.[64]

The amount of documentation required could vary with the circumstances. For example, the auditor's basis for the determination may be so clear for some matters that a single sentence will be sufficient. This situation may arise, for instance, when the auditor's documentation prepared in the course of the audit includes sufficient detail about whether or not the matter involved especially challenging, subjective, or complex auditor judgment. Other matters may require more extensive documentation.

As noted in the reproposing release, for matters determined to be critical audit matters, the description in the auditor's report (which, among other things, must describe the principal considerations that led the auditor to determine that it was a critical audit matter) will generally suffice as documentation.

The auditor could comply with the documentation requirement in a variety of different ways. For example, the auditor could start with the communications to the audit committee, which are already documented, identify which of those matters relate to accounts or disclosures that are material to the financial statements, and then document the basis for the auditor's determination of whether or not each matter involved especially challenging, subjective, or complex auditor judgment. In documenting the basis for the determination, the auditor may include the factors the auditor took into account. This documentation may be prepared as an extension to the audit committee documentation or the auditor may prepare separate documentation.

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[63] The language of the documentation requirements has been redrafted to improve clarity, based on a commenter's suggestion.

[64] Under the existing audit documentation requirements, audit documentation facilitates the planning, performance, and supervision of the engagement, and is the basis for the review of the quality of the work because it provides the reviewer with written documentation of the evidence supporting the auditor's significant conclusions. *See* paragraph .02 of AS 1215, *Audit Documentation*.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires the auditor to document the matters that required significant auditor attention and the rationale for the auditor's determination as to whether or not each of these matters is a key audit matter.[65] The EU does not include documentation requirements for expanded auditor reporting. The FRC does not include specific documentation requirements related to expanded auditor reporting.[66]

*4. Liability Considerations Related to Critical Audit Matters*

In both the proposal and the reproposal, the Board acknowledged that including critical audit matters would change the auditor's report in ways that could affect auditors' potential liability. As discussed in those releases, liability may be imposed on auditors under a number of different legal theories depending on the specific facts and circumstances of a particular case, including pursuant to Section 11 of the Securities Act of 1933, Section 10(b) of the Exchange Act, and various state law causes of action. The critical audit matters would themselves be new statements that could be the basis for asserted claims. In addition, information provided regarding critical audit matters could affect other aspects of securities fraud claims against either the issuer, the auditor, or both (for example, by being described in pleadings in an effort to plead fraud with particularity or as a basis to seek to undercut a claim of reliance). The Board specifically sought comment on what effect the communication of critical audit matters would have on private liability and whether there were any steps the Board could or should take to address any likelihood of an increase in potential liability in private litigation.

A number of companies and accountants responded to this request for comment. While several of these commenters noted that changes from the proposal had addressed certain of their liability concerns, most continued to express varying degrees of concern about the potential for increased liability, either for auditors or for both auditors and companies.

In particular, commenters expressed concern that investors who suffer a financial loss could assert legal claims against the auditor based on statements made in identifying and describing critical audit matters. As with the proposal, commenters expressed general concerns that communication of critical audit matters would encourage baseless litigation, would likely lead to increased audit fees, raise the

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[65] *See* paragraph 18(a) of ISA 701.

[66] General documentation requirements appear in ISA (UK and Ireland) 230, *Audit Documentation*.

settlement value of spurious claims, or potentially undermine the stringent pleading standards of the Private Securities Litigation Reform Act of 1995, which were intended to curtail non-meritorious claims against auditors and avoid the costs and burdens associated with them. Some commenters argued that auditors, to avoid being second-guessed, would have the incentive to communicate matters to the audit committee that were not otherwise required or to identify too many critical audit matters in an effort to protect themselves from liability. Several commenters expressed concern that communicating critical audit matters might compromise their ability to argue that the statements in the audit report are opinions which, one commenter argued, were "less vulnerable to challenges that they are false or misleading."[67] However, at least one of these commenters noted that the revised definition of a critical audit matter in the reproposal mitigated their concern on that point. Other commenters argued that the information communicated in describing critical audit matters could potentially be used to attack the audit by challenging the procedures performed or the adequacy of audit evidence obtained by the auditor. On the other hand, one commenter noted that the communication of critical audit matters is about disclosure of risks and challenges and expressed the belief that non-communication of such matters would be more problematic from a litigation point of view.

Some commenters argued that the risk of liability would be heightened if the auditor were providing original information about the company. In particular, several commenters contended that doing so would conflict with accountants' professional obligation to maintain client information in confidence, which could give rise to claims by the company against the auditor under state law.

Some commenters argued that critical audit matters could increase litigation risk for companies as well as the auditor because the new statements required of the auditor could form a basis for new legal claims, could be misinterpreted as acts of negligence on the part of the company, or could be used by plaintiffs as a "road map" for litigation against the company. One commenter argued that, because the underlying work papers are subject to discovery, critical audit matters would be used as a source for potential litigation against both auditors and companies.

Some of the commenters that expressed concerns about the potential for increased auditor liability also suggested changes to the reproposal that they maintained would reduce the liability impact of determining and communicating critical audit matters. For example, as previously discussed, several commenters suggested substantially similar changes to modify the materiality component of the definition of

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[67] Letter from PricewaterhouseCoopers LLP (Aug. 15, 2016) at 7, available on the Board's website in Docket 034.

critical audit matters and to prohibit or discourage auditor communication of original information.[68]

The Board has carefully considered commenters' concerns about potential liability throughout this standard-setting process, including the comments received on the reproposal. While mandating disclosure of critical audit matters will, by design, entail new statements in the auditor's report, the Board notes that any claim based on these new statements would have to establish all of the elements of the relevant cause of action (for example, when applicable, loss causation and reliance). Critical audit matters will not replace or alter the fundamental requirement that the auditor's report include the auditor's opinion that the financial statements are fairly presented in accordance with the applicable financial reporting framework, which has been, and the Board expects will continue to be, the primary statement at issue in most private securities litigation under federal law involving auditors.

Throughout this standard-setting process, the Board has carefully considered commenters' suggestions to alter the terms of its proposal to mitigate their concerns about potential liability for omitting a critical audit matter. As discussed in the reproposal, the Board limited and clarified the process for determining critical audit matters, including by narrowing the source of critical audit matters to matters communicated or required to be communicated to the audit committee, adding a materiality component to the critical audit matter definition, and refining the factors used to determine critical audit matters. Those changes, as well as the critical audit matter definition's focus on the auditor's judgment, should mitigate concerns about potential liability for omitting a critical audit matter. With respect to suggestions to further narrow the definition of critical audit matters and the related communication requirements, it is not clear, and commenters did not explain, how those changes would mitigate liability concerns other than by reducing the number and content of required communications of critical audit matters. As described above, the Board has determined not to incorporate those suggested changes because they appear likely to significantly reduce the number of potential critical audit matters and the informativeness of auditor communication of critical audit matters.

With respect to potential state law claims by companies against their auditors for disclosing original information, the Board notes that, as discussed above, it does not expect that, in general, critical audit matters will provide sensitive information that has not been disclosed by the company. With respect to the potential for a claim based on a situation in which the auditor found such disclosure necessary, the Board notes that auditors already have preexisting duties to disclose original information in certain

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68 *See* discussion at Sections IV.A.1.a.ii and IV.A.2.c above.

circumstances.[69] Commenters did not cite any specific examples in which these requirements have resulted in unwarranted claims against auditors for disclosing client confidences. Because the auditor's obligations under PCAOB standards arise under federal law and regulations, professional or state law duties of client confidentiality should not apply to,[70] or should be preempted by,[71] the obligation to communicate critical audit matters.[72]

While the Board takes seriously the prospect of potential increases in auditors' or companies' liability, the Board believes it has appropriately addressed commenters' concerns regarding liability in a manner compatible with the objectives of this

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69 For example, for at least the last 20 years, auditors have had duties to disclose in their auditor's reports when they have substantial doubt about the company's ability to continue as a going concern. *See* Section 10A of the Exchange Act and AS 2415. In addition, when in an audit of internal control over financial reporting, the auditor identifies a material weakness that has not been included in management's assessment, the auditor must modify its report to, among other things, "include a description of the material weakness, which should provide the users of the audit report with specific information about the nature of the material weakness and its actual and potential effect on the presentation of the company's financial statements . . .". *See* Note to paragraph .91 of AS 2201; *cf*. Statement of Gaylen R. Hansen, CPA, at the PCAOB public meeting (Apr. 2, 2014) ("Client confidentiality has a long-standing and important place in the accountancy profession. However, it doesn't serve investors well when it is parlayed to obfuscate the important obligation to call things as they are seen.").

70 For example, the relevant AICPA rule provides that auditors "shall not disclose any confidential client information without the specific consent of the client," but further provides that the confidentiality obligation shall not be construed "to prohibit … compliance with applicable laws and government regulations." *See* paragraphs .01 and .02 of 1.700.001 *Confidential Client Information Rule* of the AICPA Code of Professional Conduct (as of Dec. 15, 2014).

71 *See Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372-73 (2000); *New York v. FCC*, 486 U.S. 57, 64 (1988).

72 Some commenters suggested that safe harbor rules be created to protect auditors and companies from liability for statements about critical audit matters. While, as noted above, the Board will monitor the effects of critical audit matters should the requirements be approved by the SEC, the Board is not convinced at this time that any such safe harbor is necessary and, in any event, such a safe harbor is beyond the Board's authority.

rulemaking, and in view of the rulemaking's anticipated benefits. Indeed, the Board notes that at least one of the commenters that expressed concern about potential liability, noted that those concerns "should not stand in the way of moving forward" on the reproposed standard.[73] At the same time, the Board acknowledges that a variety of claims can be raised related to the statements in the audit report and that litigation is inherently uncertain. If the final standard is approved by the SEC, the Board will monitor the standard after implementation for any unintended consequences.

## B. Additional Improvements to the Auditor's Report

The reproposal provided a list of basic elements to be included in every auditor's report. Some of these basic elements, such as auditor tenure, would be new elements in the auditor's report. Other basic elements, such as the auditor's opinion, identification of the financial statements audited, and management's and auditor's responsibilities, were drawn from the existing auditor reporting standard.[74] Yet other basic elements, such as the name of the company under audit and the date of the financial statements, were incorporated from existing illustrative auditor's reports.

### *1. Auditor Tenure*

The reproposal included a required statement in the auditor's report of the year the auditor began serving consecutively as the company's auditor. The Board also sought comment on whether auditor tenure should be disclosed in Form AP, *Auditor Reporting of Certain Audit Participants* ("Form AP"), rather than in the auditor's report.[75]

#### a. Disclosure of Tenure

Investor commenters stated that information regarding auditor tenure would be useful to financial statement users, for example, in deciding whether to vote to ratify the appointment of the auditor. Investors that expressed a preference supported tenure

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[73] *See* letter from Deloitte & Touche LLP (Aug. 12, 2016) at 5, available on the Board's website in Docket 034.

[74] *See* existing AS 3101.06–.08.

[75] In December 2015, the Board adopted Form AP, which provides investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. *See Improving the Transparency of Audits: Rules to Require Disclosure of Certain Audit Participants on a New PCAOB Form and Related Amendments to Auditing Standards*, PCAOB Release No. 2015-008 (Dec. 15, 2015).

disclosure in the auditor's report, some on the basis of reducing investor search costs by ensuring a consistent location for the disclosure. One commenter representing a group of investors asserted that since the auditor's report is the primary means by which the auditor communicates with investors, it is appropriate for auditor tenure to be included in the auditor's report. This commenter further stated that disclosure of auditor tenure on Form AP would be an acceptable alternative to disclosure in the auditor's report only if the timeliness, accessibility, searchability, and overall functionality of the information disclosed on Form AP were at least equivalent to having the information disclosed in the auditor's report. Another commenter suggested that, if disclosure were required in the auditor's report, a specific location should be designated.

Currently, information about auditor tenure is not required to be communicated to investors by the auditor, management, or the audit committee.[76] However, there is a growing trend toward voluntary disclosure of auditor tenure. Recent analysis of corporate proxy statements for annual meetings of shareholders has found that a growing number of companies are disclosing auditor tenure,[77] presumably due to interest from investors. However, voluntary disclosure is not provided for a significant number of audits subject to the Board's jurisdiction. Additionally, if disclosed, such information may not be provided in the same location in the proxy statement; for

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[76] In certain instances, investors may be able to manually calculate tenure by reviewing company filings on the SEC's Electronic Data Gathering, Analysis and Retrieval system ("EDGAR") to determine when a company changed auditors. However, the information is not available prior to 1994 and may not be available for certain entities, such as investment companies and brokers and dealers, that are not required to file Form 8-K. *See* 17 CFR 249.308, Item 4.01 *Changes in Registrant's Certifying Accountant*. Accordingly, currently available information is neither complete nor a readily accessible alternative to auditor tenure disclosure.

[77] The Center for Audit Quality, together with Audit Analytics, reviewed corporate proxies filed through the end of June 2016, 2015, and 2014 of 1,500 Standard and Poor's ("S&P") Composite companies. Their analysis identified that in 2016, 2015, and 2014 auditor tenure was disclosed in the annual proxy statements of 59, 54, and 47 percent of the S&P 500 large-cap companies, respectively, 45, 44, and 42 percent of the S&P MidCap 400 companies, respectively, and 48, 46, and 50 percent of the S&P SmallCap 600 companies, respectively. *See* Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016). Separately, during their review of proxy statements of Fortune 100 companies, Ernst & Young identified that 63 percent of the companies reviewed voluntarily disclosed auditor tenure in 2016 compared to 62 percent in 2015, 51 percent in 2014, 29 percent in 2013, and 24 percent in 2012. *See* Ernst & Young, *Audit Committee Reporting to Shareholders in 2016* (Sept. 2016).

instance, some disclosures are in the audit committee report while others are in another section of the proxy.[78] Further, the proxy rules do not apply to all companies required to be audited under PCAOB standards; for example, foreign private issuers, many companies whose securities are not listed on a national securities exchange, and most investment companies are not required to prepare proxy statements.

Some commenters, primarily companies, did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors. Other companies and accounting firms raised a concern that tenure disclosure could result in inferences that, in their view, would be inappropriate about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. Some commenters also suggested that auditor tenure is a corporate governance matter and that disclosure should be provided by management or the audit committee rather than the auditor. A few commenters suggested that tenure disclosure should be addressed by SEC rulemaking or provided only voluntarily. Some commenters, many of whom generally opposed auditor tenure disclosure, suggested that Form AP would be a preferable location for disclosing tenure if the Board proceeded with requiring the disclosure.

The SEC's Investor Advocate stated that he "strongly support[s] requirements for public disclosure of auditor tenure," recognizing that there were different opinions about the best party and location to make that disclosure.[79] Noting that the SEC had issued a concept release asking whether auditor tenure should be disclosed in the audit committee report,[80] the SEC's Investor Advocate stated that he believed the SEC should ultimately decide these questions. In light of these considerations, the SEC's Investor Advocate recommended that the PCAOB act to require disclosure of auditor tenure (either in the auditor's report or in Form AP), but also consider including a contingent sunset clause such that the auditor disclosure requirement would expire if and when the SEC imposed any form of a company disclosure requirement.

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[78] *See* Center for Audit Quality and Audit Analytics, *2016 Audit Committee Transparency Barometer* (Nov. 2016).

[79] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 4, available on the Board's website in Docket 034. The letter noted that the views of the Investor Advocate do not necessarily reflect the views of the SEC, the Commissioners, or staff of the SEC, and the SEC disclaims responsibility for the letter and all analyses, findings, and conclusions contained therein. Additional information about the Office of the Investor Advocate is available on the SEC's website.

[80] *See* SEC, *Possible Revisions to Audit Committee Disclosures*, Exchange Act Release No. 75344 (July 1, 2015), 80 FR 38995 (July 8, 2015).

The Board believes that public disclosure of auditor tenure is important and in the public interest, and that it is appropriate to require disclosure in the auditor's report because it is the primary means by which auditors communicate with investors. This will ensure that the disclosure is in a readily accessible and consistent location—the auditor's report—for all companies. It will make auditor tenure information immediately available to investors upon filing with the SEC of a document containing the auditor's report. Disclosure of auditor tenure in the auditor's report will also reduce search costs for investors who are interested in auditor tenure, relative to the current environment of voluntary reporting. Disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The Board is not persuaded by commenters' concerns that disclosure of auditor tenure in the auditor's report necessarily suggests a specific correlation between auditor tenure and audit quality, or between auditor tenure and auditor independence. In the Board's view, auditor tenure is another data point about the auditor, in addition to the firm name and the office issuing the auditor's report, for which there is demonstrable investor demand.

The standard does not specify a required location within the auditor's report for the statement on auditor tenure; auditors that are concerned about the inferences readers may draw based on the placement of the disclosure in the auditor's report have discretion to present auditor tenure in the part of the auditor's report they consider appropriate. Consistent with the reproposal, the illustrative auditor's report in the final standard includes the statement on auditor tenure at the end of the report.

The Board considered disclosure of auditor tenure in Form AP, which requires disclosure of the name of the engagement partner and of the names and percentage of participation of other accounting firms in the audit for all issuer audits. Form AP was developed primarily to respond to commenter concerns about the potential liability consequences of naming persons in the auditor's report, the potential need to obtain consents from those named persons in connection with registered securities offerings, and the additional time needed to compile information about the other accounting firms. The Board's determination to require disclosure in Form AP, rather than in the auditor's report, was a means to address these concerns. Disclosure of auditor tenure does not have the same potential liability or other consequences as disclosure of the name of the engagement partner or other accounting firms, so such an approach is unnecessary in this case.

The Board acknowledges that the SEC, given its broader authority and responsibility for the financial reporting process, could in the future determine that auditor tenure should be disclosed by some other party or in some other location, in addition to or instead of in the auditor's report. Accordingly, the Board is adopting its requirement for tenure disclosure in the auditor's report today. The Board anticipates that, if the SEC undertook rulemaking for disclosure of auditor tenure, the Board would work with the SEC to ensure that PCAOB standards coordinate appropriately with any new SEC requirements.[81]

b. Determination of Tenure

The reproposal contemplated that tenure would be calculated taking into account firm or company mergers, acquisitions, or changes in ownership structure, and it included a note providing that if the auditor is uncertain as to the year the auditor became the company's auditor, the auditor should so state and provide the earliest year of which the auditor has knowledge. Some commenters objected to this approach, saying that it could confuse investors and its relevance is unclear. The Board believes that the disclosure of tenure should reflect the entire relationship between the company and the auditor, including the tenure of predecessor accounting firms and engagement by predecessors of the company under audit. No changes have been made to the note in the final standard.

Additionally, if a company went public and maintained the same auditor, auditor tenure will include the years the auditor served as the company's auditor both before and after the company became subject to SEC reporting requirements.

Because of the unique structure of investment companies, which typically includes common accounting, internal control, and oversight functions at the group level, the reproposed standard required that, for an investment company that is part of a group of investment companies,[82] the auditor's statement regarding tenure will contain the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies.[83] For example, if Firm A has been

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81 Of course, the SEC also has authority to abrogate or modify PCAOB rules at any time, to, among other things, further the purposes of the securities laws. Section 107(b)(5) of Sarbanes-Oxley, 15 U.S.C. 7217(b)(5).

82 A group of investment companies, as defined by Section 12(d)(1)(G)(ii) of the Investment Company Act of 1940 ("Investment Company Act"), means any two or more registered investment companies that hold themselves out to investors as related companies for purposes of investment and investor services. For purposes of determining auditor tenure, any tenure with other entities that may be part of an investment company complex, such as investment advisers or private investment companies, is not included.

83 The following is an example of such statement: "We have served as the auditor of one or more [Group Name] investment companies since [year]."

auditing investment companies in XYZ group of investment companies since 1980, the current auditor's report for XYZ fixed income fund, whose inception date was in 2010, will state that Firm A has served as the auditor of one or more XYZ investment companies since 1980.

A commenter asserted that measuring auditor tenure from the first year of service to the group of investment companies might confuse or even mislead the reader of the auditor's report for a new fund, especially if the auditor has served the group for several years. Another commenter supported the reproposed methodology for measuring tenure for investment companies stating that it is appropriate given the common accounting system, system of internal control over financial reporting, and board oversight for a group of investment companies.

After considering the comments received, the Board is adopting the requirement regarding auditor tenure for an investment company that is part of a group of investment companies as reproposed. The Board believes that the length of an auditor's relationship with the group is more relevant than the relationship with an individual fund, since funds can be started and merged over time but the auditor's relationship with the group continues.

*Requirements of Other Regulators and Standard Setters*

The EU requires a statement in the auditor's report that indicates the total uninterrupted engagement period, including previous renewals and reappointments of the statutory auditors or the audit firms.[84] The IAASB and the FRC do not include a similar requirement.

*2. Clarification of Existing Auditor's Responsibilities*

The reproposed standard included requirements that would enhance standardized language of the auditor's report by clarifying the nature and scope of the auditor's existing responsibilities, such as a new statement regarding auditor independence and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the reproposed standard included a requirement intended to promote uniformity with respect to the addressee of the report.

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[84] *See* requirements in 2(b) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

a. Auditor Independence

The reproposed standard included a required statement in the auditor's report that the auditor is a public accounting firm registered with the PCAOB and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC[85] and the PCAOB.[86]

Commenters generally supported the required statement regarding auditor independence. Some said that the statement would reinforce financial statement users' understanding of the auditor's existing obligations to be independent and serve as a reminder to auditors of these obligations. Some commenters preferred a more definitive statement, such as stating that the auditor is in fact independent and in compliance with applicable independence rules. A few commenters questioned whether the statement will improve an investors' understanding of the auditor's independence responsibilities, yield any incremental benefits or insight to investors, or have any impact on auditor behavior. Some of these commenters pointed out that independence is already included in the title of the auditor's report and including an additional statement in the auditor's report is redundant and unnecessary.

After consideration of comments, the statement regarding auditor independence is adopted as reproposed. The Board believes that the independence statement in the auditor's report will both enhance investors' and other financial statement users' understanding of the auditor's existing obligations to be independent, and serve as a reminder to auditors of these obligations. The statement regarding auditor independence is not intended to, and will not, affect auditor independence requirements under the securities laws, SEC rules, or PCAOB rules.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report include a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements.[87] The EU requires a statement in the auditor's report that the auditor remained independent of the audited entity in conducting the audit.[88] The FRC

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85 *See* Regulation S-X Rule 2-01, 17 CFR 210.2-01.

86 *See* PCAOB Rule 3520, *et seq*.

87 *See* paragraph 28(c) of ISA 700.

88 *See* requirements in 2(f) of Article 10, *Audit Report*, of Regulation (EU) No 537/2014.

requires the auditor to state that the auditor is required to comply with the United Kingdom's ethical standards for auditors, which include requirements regarding auditor independence.[89]

b. Addressee

Under the existing standard, the auditor's report may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[90] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[91]

To promote consistency in addressing the auditor's report to the company's investors, the reproposed standard included a requirement for the auditor's report to be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The reproposed standard stated that the auditor's report may include additional addressees.

Commenters generally supported the addressee requirement as reproposed stating that it is appropriate and will create consistency in practice. A commenter suggested limiting the required addressees to the shareowners of corporations or equivalents for companies not organized as corporations because investors are the key customers of the auditor's report. A few commenters stated that the auditor's report is intended for general use and the requirement for the auditor's report to be addressed to a specific party is not necessary. A commenter expressed concern that retaining the option for the auditor's report to be addressed to third parties could inadvertently result in increased auditor liability and cost.

In response to comments, and to promote greater uniformity in the addressees of the auditor's report, the Board is adopting the addressee requirement as reproposed. Since inclusion of additional addressees is voluntary, auditors could assess, based on the individual circumstances, whether or not to include additional addressees in the auditor's report. In addition, the Board believes that it is appropriate for the auditor's

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[89] *See* paragraph 15 of UK ISA 700 (2013).

[90] *See* existing AS 3101.09.

[91] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers and brokers and dealers.

report to be addressed to the board of directors and not just to the shareholders, because of the role of the board of directors in the governance of the company.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires that the auditor's report be addressed as appropriate, based on the circumstances of the engagement.[92] The EU does not specify the addressee of the auditor's report. The FRC requires that the auditor's report be addressed as required by the circumstances of the engagement.[93] UK auditor's reports are typically addressed to either the members or the shareholders of the company.[94]

c. Other Enhancements to the Basic Elements

The reproposal would have changed the language for certain elements in the existing auditor's report. These elements included:

- *Financial statement notes*—The identification of the financial statements, including the related notes and, if applicable, schedules, as part of the financial statements that were audited.[95] Under the existing standard, the notes to the financial statements and the related schedules are not identified as part of the financial statements.

- *Error or fraud*—A description of the auditor's responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatements, whether caused

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[92] *See* paragraph 22 of ISA 700.

[93] *See* paragraph 13 of UK ISA 700 (2013).

[94] *See* paragraph A5 of UK ISA 700 (2013).

[95] The final standard uses the term "financial statements" to include all notes to the statements and all related schedules, as used under SEC rules that apply to issuers. *See* Regulation S-X Section 1-01(b), 17 CFR 210.1-01(b), which states in part, "the term financial statements . . . shall be deemed to include all notes to the statements and all related schedules." The final standard will not apply to schedules included as supplemental information, as defined in AS 2701, *Auditing Supplemental Information Accompanying Audited Financial Statements*, because those schedules are not considered part of the financial statements. The auditor should continue to look to the requirements of AS 2701 for the auditor's reporting responsibilities regarding supplemental information accompanying audited financial statements.

by error or fraud.[96] The existing standard does not require the auditor's report to contain the phrase *whether due to error or fraud*.

- *Nature of the audit*—The description of the nature of the audit reflected the auditor's responsibilities in a risk-based audit and aligned the description with the language in the Board's risk assessment standards, including:
  - Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;
  - Examining, on a test basis, appropriate evidence regarding the amounts and disclosures in the financial statements;
  - Evaluating the accounting principles used and significant estimates made by management; and
  - Evaluating the overall presentation of the financial statements.

Commenters generally supported the reproposed language for these basic elements of the auditor's report. These elements are adopted as reproposed.

*3. Additional Basic Elements Suggested by Commenters*

In addition to the changes proposed by the Board, commenters on the reproposal suggested additional elements to be included in the auditor's report.

Several commenters suggested that the PCAOB consider additional standardized language in the auditor's report to describe the responsibilities of the auditor, management, and the audit committee. In doing so, some of these commenters suggested that the PCAOB consider additional language adopted by the IAASB, in order to promote consistency in reporting and to help users understand more fully the separate responsibilities of each of the parties with respect to the audited financial statements. In contrast, another commenter cautioned that a thorough description of everyone's roles and responsibilities would further add to repetitive boilerplate language. This commenter suggested instead that the auditor's report provide a cross reference to a more complete description of the roles and responsibilities of the auditor, management, and the audit committee. This commenter did not indicate where such cross-referenced material would appear. Given little interest from investors in such

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[96] *See* paragraph .02 of AS 1001, *Responsibilities and Functions of the Independent Auditor*.

additional language during the Board's initial outreach and the risk that it would be boilerplate, the final standard does not include these additional elements.

Two accounting firms suggested describing the meaning of reasonable assurance. The final standard requires a statement in the "Basis for Opinion" section of the auditor's report that the auditor "plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement." The auditing standards describe reasonable assurance as a high level of assurance, although not absolute assurance.[97] During the Board's initial outreach such additional language was considered, but there was no investor demand for it. As a result, the final standard does not expand the description of reasonable assurance in the auditor's report.

Some commenters also suggested that the auditor's report should include disclosure of the materiality measures used by auditors in planning the audit. These commenters asserted that it could help inform investors' proxy voting process for auditor ratification, as such disclosure could be a valuable supplement to an audit fee analysis and used to compare materiality over time to trends in restatements and adjustments. These commenters also observed that materiality disclosures are provided in the auditor's reports in the U.K. Other commenters from the Board's initial outreach stated that disclosing materiality levels in the auditor's report could have negative implications on audit quality by reducing the element of surprise necessary in an audit.[98] One commenter opposed a disclosure of materiality on the basis that it may encourage disclosure of quantitative materiality levels and ignore qualitative aspects of materiality, which cannot be described in a meaningful way in the auditor's report. The Board has decided not to include this additional element in the auditor's report at this time because disclosure may reduce the element of surprise in the audit and overstate the importance of quantitative rather than qualitative factors in the auditor's overall consideration of materiality. However, the Board will monitor the implementation of the final standard, as well as the developments of expanded auditor reporting in other jurisdictions, to determine if future enhancements to the auditor's report may be warranted in this area.

Additionally, some commenters suggested that the auditor's report should define the auditor's responsibility for other information in documents containing audited financial statements so that financial statement users have a clear understanding. The Board's proposal included another new auditing standard, *The Auditor's Responsibilities*

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[97] Paragraph .10 of AS 1015, *Due Professional Care in the Performance of Work.*

[98] *See* PCAOB Release No. 2011-003, Appendix C, for a detailed discussion of the staff's outreach regarding reporting materiality levels.

*Regarding Other Information in Certain Documents Containing Audited Financial Statements and the Related Auditor's Report*, regarding the auditor's responsibilities for other information outside the financial statements. The Board has not taken any further action since the proposal.

A few commenters suggested including other elements, such as the date when the auditor completed fieldwork, a statement that the auditor looked for material fraud, disclosure when alternative dispute resolution clauses are included in engagement letters, and disclosure of reasons for change in the engagement partner prior to mandatory rotation. The final standard does not include these elements because the Board believes they would not add meaningfully to the information already provided in the final standard or the elements go beyond what was considered in this standard-setting project and, thus, the Board is not including these elements at this time.

## C. Explanatory Language and Emphasis of a Matter

### *1. Explanatory Language Required by Other PCAOB Standards*

The reproposed standard, similar to the existing standard,[99] provided a list of circumstances in which the auditor is required to add explanatory language to the auditor's report and included references to other PCAOB standards in which these circumstances and related reporting requirements are described. These circumstances included when there is substantial doubt about the company's ability to continue as a going concern and a restatement of previously issued financial statements, among others.

The list of circumstances from the Board's reproposal did not attract much comment, although one commenter affirmed support for including the list. Commenters on the Board's proposal supported providing a list in the standard of the circumstances that require explanatory language in the auditor's report on the basis that keeping this information in a single place would facilitate consistency in execution. The final standard includes the list of explanatory paragraphs and related references as reproposed.

The reproposed standard included a requirement for the auditor to add explanatory language in cases where the company is required to report on ICFR but has determined that it is not required to obtain, and did not request the auditor to perform, an audit of ICFR.[100] The reproposed standard included a reference to a new

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[99] *See* existing AS 3101.11.

[100] This may be the case for companies that are subject to Section 404(a) of Sarbanes-Oxley, which mandates management ICFR reporting, but not Section 404(b), which mandates auditor ICFR reporting. Section 404(a) generally applies to companies

proposed requirement in AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the auditor to add such explanatory language. Some commenters were supportive of the reproposed requirement, while one commenter did not believe such a requirement was necessary but did not object to its inclusion.

The Board also sought comment on whether the requirement to include an explanatory paragraph in the auditor's report when the auditor did not perform an audit of ICFR should apply not only if company's management is required to report on ICFR, but also if management is not required to report, such as for investment companies. Several commenters supported expanding the requirement to all instances in which the auditor is not engaged to opine on ICFR, and not limit it to only when management is required to report on ICFR.

In the Board's view, it is appropriate to add explanatory language to the auditor's report when management has a reporting responsibility on ICFR but the auditor is not engaged to opine on ICFR, in order to clarify the auditor's responsibilities in this situation. For companies for which management is not required to report on ICFR, the Board does not believe that the auditor should have a separate reporting responsibility. Accordingly, the final standard retains the requirement as reproposed.[101] The auditor may, however, choose to include such a paragraph in the auditor's report voluntarily.

*Interaction between critical audit matters and explanatory paragraphs*. The reproposed standard clarified that critical audit matters are not a substitute for required explanatory paragraphs. However, there could be situations in which a matter meets the definition of a critical audit matter and also requires an explanatory paragraph, such as going concern. For these situations, the reproposal contemplated that both the explanatory paragraph and the required communication regarding the critical audit matter would be provided. The auditor could include the communication required for a critical audit matter in the explanatory paragraph, with a cross-reference in the critical audit matter section to the explanatory paragraph. Alternatively, the auditor could choose to provide both an explanatory paragraph and the critical audit matter communication separately in the auditor's report, with a cross-reference between the two sections.[102] While the information reported in a critical audit matter may overlap with

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that are subject to the reporting requirements of the Exchange Act, other than registered investment companies. Certain categories of companies that are subject to Section 404(a), such as nonaccelerated filers and emerging growth companies, are not subject to Section 404(b).

[101] *See* amendments to AS 3105.59–.60.

[102] When both an explanatory paragraph and a critical audit matter communication are provided, the critical audit matter description should not include

some of the information already provided in the explanatory paragraph, the critical audit matter would provide incremental information, such as how the matter was addressed in the audit.

Commenters were generally supportive of the interaction between the communication of critical audit matters and required explanatory paragraphs as described in the reproposed standard. Some alternative views, however, were expressed. One commenter thought that if a required explanatory paragraph is also a critical audit matter, disclosure in the auditor's report should be limited to one place in the auditor' report. The commenter suggested that the communication requirements for both a critical audit matter and an explanatory paragraph be reported in the critical audit matter section of the auditor's report with a cross reference in the explanatory paragraph section. Another commenter suggested that the PCAOB harmonize its approach with that of the IAASB, which requires a reference in the key audit matter section but waives the requirements to describe the key audit matter and how it was addressed during the audit. Finally, another commenter thought that critical audit matter communications should not be permitted to be integrated with explanatory paragraphs, on the basis that explanatory paragraphs are about matters in the financial statements to which the auditor wants to draw the reader's attention and are not necessarily critical audit matters.

The final standard retains the interaction between critical audit matters and explanatory paragraphs as reproposed. The approach provides flexibility on auditor disclosure, yet also ensures that the communication requirements are met.

*2. Emphasis of a Matter*

The reproposed standard, similar to the existing standard, provided the ability for the auditor to add a paragraph to the auditor's report to emphasize a matter regarding the financial statements ("emphasis paragraph").[103] Emphasis paragraphs are not required, but may be used by auditors to draw the reader's attention to matters such as significant transactions with related parties and unusually important subsequent events.

The reproposed standard provided a list of potential matters that the auditor may emphasize in the auditor's report, although the auditor may also decide to emphasize other matters.

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conditional language that would not be permissible in the explanatory paragraph. *See* footnote 5 of AS 2415.

[103] *See* existing AS 3101.19.

Commenters were supportive of emphasis paragraphs as described in the reproposed standard and did not suggest any additional matters to be included in the list of potential emphasis paragraphs. The final standard includes emphasis paragraphs as reproposed.

*Interaction between critical audit matters and emphasis paragraphs*. The reproposed standard stated that emphasis paragraphs are not a substitute for required critical audit matters. If a matter that the auditor considers emphasizing meets the definition of a critical audit matter, the auditor would provide the information required for critical audit matters, and would not be expected to include an emphasis paragraph in the auditor's report. Although this did not generate much comment, one commenter affirmed support for the interaction between critical audit matters and emphasis paragraphs. The final standard retains the interaction between critical audit matters and emphasis paragraphs as reproposed.

*Requirements of Other Regulators and Standard Setters*

Under the requirements of other regulators and standard setters, there are no analogous explanatory paragraphs, except for reporting on going concern. The Board's reproposed approach is similar to the IAASB's approach to the interaction between a paragraph regarding the company's ability to continue as a going concern and key audit matters, although the underlying requirements for auditor reporting on going concern vary.[104] Under the IAASB's approach, an emphasis of matter paragraph is not required for a matter that was determined to be a key audit matter.[105] The EU and the FRC have separate requirements related to going concern reporting that do not specifically address the interaction with their expanded auditor reporting.[106] The IAASB, FRC, and EU do not have requirements for reporting on ICFR.

## D. Information about Certain Audit Participants

On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide

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104 *See* paragraph A1 of ISA 570, *Going Concern*, and paragraph 15 of ISA 701.

105 *See* paragraph 8 of ISA 706, *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*.

106 *See* ISA (UK and Ireland) 570, *Going Concern*, and *see* Article 28, *Audit Reporting*, of Directive 2014/56/EU of the European Parliament and of the Council (Apr. 16, 2014).

investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers.[107] Firms will be required to file Form AP with the PCAOB for each issuer audit, disclosing this information. In addition to filing Form AP, firms will also have the choice to include this information in the auditor's report.[108] The final standard incorporates the adopted amendments to AS 3101 for situations in which the auditor decides to include information about certain audit participants in the auditor's report. The final standard requires the auditor to use an appropriate section title when providing this information in the auditor's report, but does not require a specific location in the auditor's report.

*Requirements of Other Regulators and Standard Setters*

The IAASB requires the auditor to include the name of the engagement partner in the auditor's report for audits of listed entities.[109] Under EU law, the engagement partner is required to sign the audit report in all EU countries, including the United Kingdom.[110] Unlike disclosure of the engagement partner's name, disclosure of other accounting firms that participated in the audit is not required by the IAASB, FRC, or the EU.

## E. Form of the Auditor's Report

The repropose standard required the "Opinion on the Financial Statements" section to be the first section of the auditor's report, immediately followed by the "Basis for Opinion" section. The reproposed standard did not specify an order for the remaining sections of the auditor's report, which would include explanatory paragraphs and critical audit matters. This approach allowed for consistency in the location of the opinion and basis for opinion sections, with flexibility for the other elements of the auditor's report. The reproposed standard also required titles for all sections of the auditor's report to provide consistency and assist users in identifying the individual sections of the auditor's report.

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107 *See* PCAOB Release No. 2015-008.

108 When the auditor divides responsibility for the audit under AS 1205, *Part of the Audit Performed by Other Independent Auditors*, the auditor's report must acknowledge the involvement of the other auditor.

109 *See* paragraph 45 of ISA 700.

110 Directive 2006/43/EC of the European Parliament and of the Council, Article 28, *Audit Reporting* (May 17, 2006).

Commenters were generally supportive of the proposed changes to the form of the auditor's report, because the changes will:

- Enhance the clarity and comparability of disclosures;
- Make it easier for investors to find the opinion since it will be listed first;
- Help facilitate a comparison between auditor's reports; and
- Allow for an appropriate level of flexibility and ease of use without being overly prescriptive.

Some commenters suggested the PCAOB should be consistent with other standard setters in the ordering of section titles in the auditor's report. One commenter expressed concern that the ordering of the components of the opinion and the heading of the critical audit matter section of the report may be misunderstood to imply that critical audit matter communications are separate and distinct from the auditor's opinion, which could be misinterpreted as a piecemeal opinion. In light of the commenter support described above, the Board is adopting the form of the auditor's report as reproposed. As previously discussed, the final standard includes revised introductory language in the auditor's report to avoid the potential misperception that the communication of critical audit matters provides piecemeal opinions.

*Requirements of Other Regulators and Standard Setters*

The reproposed approach with respect to the order of the sections of the auditor's report is generally consistent with that of the IAASB.[111] The EU and FRC do not specify an order to the auditor's report.

## F. Application to Other Audits Performed Under PCAOB Standards

There are situations in which an auditor may be required by law or regulation, or voluntarily agrees, to perform an audit engagement in accordance with PCAOB standards for a company whose audit is not subject to PCAOB oversight.[112] For

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111 *See* paragraphs 23–28 of ISA 700.

112 Under the Sarbanes-Oxley Act, as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act, the PCAOB oversees the audits of "issuers" and brokers and dealers reporting under Exchange Act Rule 17a-5. *See* Sarbanes-Oxley Act Section 101. An "issuer" under the Sarbanes-Oxley Act is an entity whose securities are registered under Section 12 of the Exchange Act, or that is required to file reports under Section 15(d) of the Exchange Act, or that files or has filed

example, SEC rules permit audits under PCAOB standards in connection with offerings under Regulation A and Regulation Crowdfunding.[113] In these situations, certain elements of the auditor's report required under the final standard, such as the use of "registered public accounting firm" in the title or the statement regarding independence requirements, may not apply. Additional guidance for these situations will be provided.

## V. Amendments to Other PCAOB Standards

The Board is adopting amendments to several of its existing auditing standards solely to conform to the final standard.[114] The Board is not adopting any further changes to these existing auditing standards at this time, although the Board recognizes that some of the existing auditing standards, such as the redesignated standard AS 3105, may need further updating. The Board may consider proposing further changes to these standards under separate standard-setting projects.

### A. AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

Existing AS 3101.10 and .20-.76 address departures from the auditor's unqualified opinion, such as a qualified opinion, an adverse opinion, or a disclaimer of opinion, and other reporting circumstances, such as reporting on comparative financial statements. These paragraphs are redesignated as AS 3105.[115] Commenters who addressed this topic generally supported the reproposed amendments to AS 3105, including amending the example auditor's reports to conform with the example auditor's report in the final standard. The Board also received some comments suggesting further changes to AS 3105, such as updating descriptions of and references to accounting requirements that are no longer current[116] and updating certain terminology (e.g.,

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a Securities Act registration statement that has not yet become effective and that it has not withdrawn. *See* Sarbanes-Oxley Section 2(a).

113 *See* Securities Act Form 1-A, Part F/S (b)(2) and (c)(1)(iii); Regulation Crowdfunding Rule 201(t) instruction 9, 17 CFR 227.201(t).

114 The amendments are included in Appendix 2.

115 AS 3101.01-.09 and .11-.19 are amended and restated as provided in Appendix 1.

116 The Board has issued guidance regarding the status of outdated descriptions of and references to U.S. GAAP in PCAOB standards. *See* PCAOB, *Staff Questions and Answers, References to Authoritative Accounting Guidance in PCAOB Standards* (Sept. 2, 2009). Among other things, this guidance provides that auditors

changing references from "entity" to "company"). The Board may consider such updates as part of a separate standard-setting project.

The Board is adopting final amendments to AS 3105 that are substantially similar to the reproposal. The amendments to AS 3105 are not intended to change the circumstances in which the auditor would depart from an unqualified opinion. The changes from the current standard will primarily: (1) require the communication of critical audit matters in certain circumstances; (2) revise certain terminology to align with the final standard; and (3) amend the illustrative reports for the basic elements of the final standard and the required order of certain sections of the auditor's report.

AS 3105 includes:

*Communication of Critical Audit Matters in Reports Containing Other than Unqualified Opinions*

a. *Qualified opinion*—Amendments to AS 3105 will require that when the auditor expresses a qualified opinion, the auditor's report also include communication of critical audit matters, if critical audit matter requirements apply.

b. *Adverse opinion*—The existing requirements related to an adverse opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the adverse opinion.

c. *Disclaimer of opinion*—The existing requirements related to a disclaimer of an opinion are not amended to require the auditor to communicate critical audit matters. In the Board's view, the most important matter to investors and other financial statement users in such circumstances would be the reason for the disclaimer of opinion.

*Requirements of Other Regulators and Standard Setters*

Under the IAASB's approach, a matter giving rise to a qualified, adverse, or disclaimer of opinion is by nature a key audit matter.[117] However, in such

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should disregard descriptions of and references to accounting requirements in PCAOB standards that are inconsistent with the FASB Accounting Standards Codification ("ASC").

[117] *See* paragraph 15 of ISA 701.

circumstances: (1) the matter should not be described in the key audit matter section of the auditor's report, (2) the auditor should report on the matter in accordance with applicable standards, and (3) the auditor should include a reference in the key audit matter section to the basis for modified opinion section where the matter is reported.[118] The requirements to determine and communicate key audit matters, other than the matters giving rise to the modified opinion, would still apply when the auditor expresses a qualified or adverse opinion, but not when the auditor disclaims an opinion on the financial statements.[119] The FRC and the EU do not include specific requirements for expanded auditor reporting when the auditor's report contains other than an unqualified opinion.

## B. Other Amendments to PCAOB Standards

The amendments to other PCAOB standards are substantially as reproposed. These include:

- AS 1220, *Engagement Quality Review*—amending to require the engagement quality reviewer to evaluate the engagement team's determination, communication, and documentation of critical audit matters;

- AS 1301, *Communications with Audit Committees*—amending to require the auditor to provide to and discuss with the audit committee a draft of the auditor's report;

- AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*—amending the example auditor's report to conform with the example auditor's report on the financial statements in the final standard;

- AS 2820, *Evaluating Consistency of Financial Statements*—amending to include the existing reporting requirements and illustrative explanatory language related to a change in accounting principle or a restatement that is currently in AS 3105; and

- AS 4105, *Reviews of Interim Financial Information*—amending to include the basic elements of the final standard, where applicable.

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[118] *Id*.

[119] *See* paragraph A7 of ISA 701 and paragraph 29 of ISA 705, *Modifications to the Opinion in the Independent Auditor's Report*.

Conforming amendments were also made to every PCAOB standard that refers to the auditor's report. Commenters generally supported the amendments as reproposed.

A commenter suggested revising AS 3305, *Special Reports*, to conform to the example auditor's report in the final standard. Since reports pursuant to AS 3305 are rarely filed with the SEC, as noted by this commenter, the Board does not believe these reports should be updated at this time. As described above, the Board may consider updating this standard as part of a separate standard-setting project.

## VI. Economic Considerations

The Board is committed to analyzing the economic impacts of its standard setting. The following discussion addresses the potential economic impacts, including potential benefits and costs, considered by the Board. The Board has sought information relevant to economic consequences several times over the course of the rulemaking. Commenters provided views on a wide range of issues pertinent to economic considerations, including potential benefits and costs, but did not provide empirical data or quantified estimates of the costs or other potential impacts of the standard. The potential benefits and costs considered by the Board are inherently difficult to quantify, therefore the Board's economic discussion is primarily qualitative in nature.

Commenters who discussed the economic analysis in the Board's reproposal provided a wide range of views. Some commenters pointed to academic research for the Board to consider in support of their views. One commenter asserted that the Board's release did not provide a true economic analysis of the pros and cons of mandating the reporting of critical audit matters, but only referenced academic studies on the purported benefits of such reporting. Another argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. The SEC's Investor Advocate said that the Board's economic analysis made a compelling case as to why the required reporting of critical audit matters would reduce informational asymmetries and add to the total mix of information available to investors.[120] The Board has considered all comments received and has sought to develop an economic analysis that evaluates the potential benefits and costs of the final standard, as well as facilitates comparisons to alternative Board actions.

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[120] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's website in Docket 034.

## A. Need for the Rulemaking

### *1. Critical Audit Matters*

Generally, investors and other financial statement users know less about a company's financial performance than do others closer to the financial reporting process, particularly management. This information asymmetry[121] can result in situations where capital is allocated suboptimally. The system of financial reporting in the United States, which requires periodic reporting of information, including annual financial statements, helps address the information asymmetry between investors and management. Board of directors and audit committee oversight of the financial reporting process can further reduce this information asymmetry by enhancing the quality of the information disclosed to the public. As part of this system, the audit of the financial statements also helps reduce the information asymmetry investors face by providing an independent opinion about whether the financial statements are presented fairly in all material respects.

Companies' operations continue to become more complex and global. In addition, over the last decade, there have been changes in the financial reporting frameworks relating to accounting estimates and an increasing use of fair value as a measurement attribute, together with new related disclosure requirements.[122] These estimates and fair value measurements, which are important to a financial statement user's understanding of the company's financial position and results of operations, can be highly subjective, require significant judgment, and can result in increased measurement uncertainty in financial statements.[123] The increased complexity of financial reporting, including the growing use of complex accounting estimates and fair value measurements, may contribute to the information asymmetry between investors and management, despite the fact that management is required to provide significant disclosures to investors and other financial statement users. Some commenters on the reproposal have stated that investors would find information provided by the auditor, an independent third party, particularly relevant in this setting.

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[121] Economists often describe "information asymmetry" as an imbalance, where one party has more or better information than another party.

[122] *See* PCAOB Staff Consultation Paper, *Auditing Accounting Estimates and Fair Value Measurements* (Aug. 19, 2014).

[123] *See* IAASB Project Proposal, Revision of ISA 540, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures* (Mar. 2016).

As part of the audit, auditors often perform procedures involving challenging, subjective, or complex judgments, such as evaluating calculations or models, the impact of unusual transactions, and areas of significant risk. Although the auditor is required to communicate with the audit committee regarding such matters, the auditor's report has not been expanded to provide this information to investors and generally provides only a standardized pass/fail opinion. Because the auditor's report generally does not contain audit-specific information, it provides very little of the information the auditor knows about the company, its financial reporting, and the challenges of the audit. Given the increased complexity of financial reporting, which requires the auditor to evaluate complex calculations or models and make challenging or subjective judgments, the current form of the auditor's report does little to address the information asymmetry between investors and auditors.

The Board believes that expanding the auditor's report to provide information about especially challenging, subjective, or complex auditor judgments will help investors and other financial statement users "consume" the information presented in management's financial statements more effectively. Stated in economic terms, in the Board's view, an expanded auditor's report will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Reducing information asymmetry about the company's financial reporting should lead to a more efficient allocation of capital.

Some commenters supported the reporting of critical audit matters as a means of reducing the information asymmetry between investors and auditors. Other commenters disagreed with the Board's approach and questioned whether the Board could or should attempt to reduce information asymmetry by requiring expanded auditor reporting. The Board believes that requiring expanded auditor reporting as a means of reducing the information asymmetry between investors and auditors is consistent with its statutory mandate to "protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports."[124] Investors are the intended beneficiaries of the audit, but investors do not receive information about specific work performed during the audit. The final standard seeks to enhance the form and content of the auditor's report to make it more relevant and informative to investors and other financial statement users.

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[124] Section 101(a) of Sarbanes-Oxley.

a. Increasing the Informativeness of the Auditor's Report to Address Information Asymmetry

The communication of critical audit matters will reduce the information asymmetry between investors and auditors by informing investors and other financial statement users about areas of the audit that required especially challenging, subjective, or complex auditor judgment, including the principal considerations for determining the matters and how the matters were addressed in the audit. The Board believes that auditor reporting of critical audit matters will provide investors with audit-specific information that should facilitate their analysis of the financial statements and other related disclosures. The communication of critical audit matters in the auditor's report should also help investors and analysts who are interested in doing so to engage management and the audit committee with targeted questions about these issues.[125] Ultimately, while not every critical audit matter will be useful for every investor, broadly, the Board believes that having the auditor provide investors and other financial statements users with additional information about especially challenging, subjective, or complex auditor judgments should help reduce the information asymmetry that exists between investors and management by providing additional insights on the financial statements.

The communication of critical audit matters should also assist investors in assessing the credibility of the financial statements and, in at least some instances, audit quality.[126] For example, the description of how the auditor addressed the critical audit matter will help investors understand the types of issues that the auditor grappled with in addressing these challenging, subjective, or complex areas of the audit, which should allow a deeper and more nuanced understanding of the related financial statement accounts and disclosures. Furthermore, investors have consistently stated that having the auditor rather than the company, provide this type of information would

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[125] The FRC observes that, in some instances, investors have begun to use the information provided in the expanded auditor's reports in the U.K. to engage with audit committees. *See* FRC 2016 Report.

[126] It is often not possible to observe the difference between financial reporting quality and audit quality. An academic study conceptually models the path through which the financial reporting and audit processes result in audited financial reporting outcomes. The authors postulate that although audit quality and pre-audit financial reporting quality are distinct constructs, the two processes are often inseparable in terms of observable financial reporting outcomes in archival research. *See* Lisa Milici Gaynor, Andrea Seaton Kelton, Molly Mercer, and Teri Lombardi Yohn, *Understanding the Relation between Financial Reporting Quality and Audit Quality*, 35 Auditing: A Journal of Practice & Theory 1, 1-22 (2016).

be of added value to investment decision making.[127] Commenting on the reproposal, the SEC's Investor Advocate noted that investors want to hear directly from the auditor and that this point is confirmed by surveys of professional investors, as well as by certain academic research.[128] This commenter agreed with the premise in the reproposal that, because the auditor is required to be independent, information provided by the auditor may be viewed by investors as having greater credibility than information provided by management alone.

Reporting of critical audit matters should provide insights that will add to the mix of information that could be used in investors' capital allocation decisions, for example, by:

- Highlighting the aspects of the financial statement audit that the auditor found to be especially challenging, subjective, or complex;

- Enabling comparison of these aspects of the audit across companies, for example audits of companies within the same industry; and

- Enabling comparison of these aspects of the audit for the same company over time.

Many companies commenting on the reproposal argued that the reporting of critical audit matters would not increase the informativeness of the auditor's report. For example, several of these commenters claimed that the reporting of critical audit matters would simply duplicate management disclosure without adding additional information, or that critical audit matters would not provide value-relevant information. Other commenters asserted that the reporting of critical audit matters would result in the auditor's report becoming a lengthy list of boilerplate disclosures, which would contribute to disclosure overload or run contrary to the SEC's disclosure effectiveness initiative. Several commenters said that critical audit matters could confuse investors if the information in the auditor's report was duplicative of management's disclosures but was presented in a different manner, or if the critical audit matter presented information without appropriate context.

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[127] *See* IAG 2011 survey and CFA survey and poll results.

[128] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 3, available on the Board's website in Docket 034 (citing Brant E. Christensen, Steven M. Glover, and Christopher J. Wolfe, *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?* 33 Auditing: A Journal of Practice & Theory 71, 71–93 (2014)).

By contrast, investor commenters overwhelmingly agreed that the communication of critical audit matters would make the auditor's report more informative. One commenter said that, although critical audit matters in themselves would not provide investors with all the information needed in the face of growing financial complexity, critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies, form a multifaceted understanding of them, and make informed investment decisions. Another commenter noted that, in jurisdictions where the expanded auditor's report is available, it is one of the earliest elements of the company's annual report that they read because it typically highlights the more judgmental elements of the company's accounting, which often provides insights that form a basis for discussions with management.

b. Mandated Rather than Voluntary Reporting

Auditors have not developed a practice of providing information in the auditor's report beyond what is required, even though investors have consistently requested that the auditor's report become more informative. Current standards provide a framework for auditors to provide limited additional information through emphasis paragraphs,[129] but in general these only point to a disclosure in the company's financial statements without providing any additional description of the matter and, as noted below, emphasis paragraphs are infrequent in practice. Auditor reporting about matters significant to the audit is not prohibited in an emphasis paragraph, but current standards do not encourage auditors to include such information in their report and do not provide a framework for doing so.

There are many other potential reasons why auditors are not providing information voluntarily in the auditor's report, whether about the financial statements or the audit. For example, the historical model of management disclosing information and the auditor attesting to the information may lead companies to resist voluntary additional reporting by the auditor, either through emphasis paragraphs or with respect to information about the audit, which the auditor would be better positioned to communicate than management. Further, auditors may believe that providing additional information could potentially expose them to liability[130] or that doing so could be interpreted as a disclaimer of opinion or a partial opinion as to the identified matters. Finally, in general, there may be disincentives to voluntary reporting if the disclosing party is not able to fully capture the benefits of the disclosures,[131] and parties may also

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[129] *See* existing AS 3101.19.

[130] Section IV.A.4 contains a discussion about potential auditor liability concerns stemming from expanded auditor reporting.

[131] Academic research finds that there are certain situations in which

exhibit a bias toward the *status quo.*[132] All of these factors disincentivize auditors from voluntarily providing further information about the audit, even if investors and other financial statement users would respond favorably to receiving additional information.

The Board believes that the required reporting of critical audit matters will promote more complete and consistent disclosure of audit-specific information to financial statement users who may be interested in it.[133] Mandatory disclosure can also improve the allocative efficiency of capital markets by decreasing the costs associated with gathering information, or by providing market participants with information that otherwise would have been difficult or impossible for them to gather.[134]

*2. Additional Improvements to the Auditor's Report*

The final standard requires auditors to disclose in the auditor's report the number of years they have served consecutively as the auditor for the company. Although some

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disclosure may be socially optimal but not privately optimal. Auditors and companies may resist voluntary expanded auditor reporting because of concerns that certain types of spillover effects (or externalities) may create a competitive disadvantage. For a summary of this line of research, *see* Luigi Zingales, *The Future of Securities Regulation*, 47 Journal of Accounting Research 391, 394-395 (2009). Professor Zingales is the founding director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited above was published before he joined the PCAOB.

[132] Research in behavioral economics suggests that when facing a set of decisions, individuals are more likely to stick to the known outcome (*status quo*) than would be expected based on the theory of rational decision making under uncertainty. There are a variety of reasons why individuals may choose the status quo outcome in lieu of an unknown outcome, including aversion to the uncertainty inherent in moving from the status quo to another option. *See* William Samuelson and Richard Zeckhauser, *Status Quo Bias in Decision Making*, 1 Journal of Risk and Uncertainty 7, 7-59 (1988).

[133] Academic research on disclosure explores these types of positive externalities, as well as certain negative externalities. *See, e.g.*, Ronald A. Dye, *Mandatory versus Voluntary Disclosures: The Cases of Financial and Real Externalities,* 65 The Accounting Review 1, 1-24 (1990); or Anat R. Admati and Paul Pfleiderer, *Forcing Firms to Talk: Financial Disclosure Regulation and Externalities*, 13 The Review of Financial Studies 479, 479-519 (2000).

[134] *See, e.g.*, John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 Virginia Law Review 717, 717–753 (1984).

commenters dispute the value of this information, investor commenters have indicated that the length of the relationship between the auditor and the company would be a useful data point. The growing trend toward voluntary disclosure of this information by companies suggests that increasing numbers of companies believe that the market finds the disclosure useful.[135] Further, there is a line of academic research suggesting that there is an association between auditor tenure and increases or decreases in audit quality.[136]

Although investors may be able to determine auditor tenure by, for example, reviewing past auditor's reports, for many companies the information is not readily available even through a manual search process.[137] Furthermore, while some companies voluntarily provide information about auditor tenure in the proxy statement, many do not. Many companies are also not subject to the proxy rules (for example, most investment companies, foreign private issuers, and many companies whose securities are not listed on a national securities exchange). In cases where the information is provided voluntarily, it is not provided in a consistent location. The Board believes that these issues create unnecessary search costs for investors who wish to evaluate information about auditor tenure. Mandatory disclosure of auditor tenure in the auditor's report will provide a consistent location for this information and will reduce search costs relative to the current baseline for investors who are interested in auditor tenure, especially in the case of companies that do not voluntarily provide such information or for which the information is not available through the EDGAR system. Mandatory disclosure of auditor tenure in the auditor's report may also be more likely to encourage further discussion of auditor tenure by management and the audit committee and potential disclosure in company filings.

The existing auditor's report also does not describe important aspects of the auditor's responsibilities under existing auditing standards, such as the auditor's responsibility to detect material misstatements, whether due to error or fraud; the auditor's responsibility for the notes to the financial statements; and the auditor independence requirement. This may contribute to misperceptions by investors and other financial statement users about the auditor's role and responsibilities, including with respect to these matters. Academic research suggests that there are a number of

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[135] *See* Center for Audit Quality and Audit Analytics*, 2016 Audit Committee Transparency Barometer* (Nov. 2016). *See also* Ernst & Young*, Audit Committee Reporting to Shareholders 2016* (Sept. 2016).

[136] *See* Section VI.D.2.f for a discussion of academic research regarding auditor tenure.

[137] *Supra* note 76.

ways in which investor perceptions of the role and responsibilities of the auditor may diverge from what current professional standards require.[138] In addition, the existing standards do not require a uniform approach to basic content, such as the addressee of the report and the form of the auditor's report, which may increase the time and costs of processing the information in the auditor's report. The final standard contains provisions requiring the basic elements in the auditor's report to be presented more uniformly.

Commenters generally supported the reproposed changes to these basic elements of the auditor's report. Some commenters noted that the enhanced descriptions of the auditor's responsibility to detect material misstatements would clarify the auditor's responsibilities for financial statement users, other commenters offered suggestions for refinement, such as aligning the requirements to the IAASB model or amending the description to more clearly define the auditor's role within the context of the financial reporting regulatory framework.

Commenters also generally supported including a statement on the auditor's independence requirement. For example, some commenters stated that adding a statement by the auditor on their independence would reinforce investors' understanding of the auditor's requirement to remain independent and objective in expressing the audit opinion. Other commenters said that the enhanced description of the independence requirement could provide a meaningful reminder of the importance of auditor independence. However, other commenters said that the enhanced description of auditor independence was either unnecessary, or would not have a significant impact on auditor behavior. Based on broad commenter support, the Board is adopting these additional improvements to the auditor's report as reproposed.

## B. Baseline

### *1. Critical Audit Matters*

The auditor's report in the United States today generally consists of three paragraphs that include limited audit-specific information. The existing auditor's report

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[138] *See, e.g.,* Bryan K. Church, Shawn M. Davis, and Susan A. McCracken, *The Auditor's Reporting Model: A Literature Overview and Research Synthesis*, 22 Accounting Horizons 69, 69-90 (2008); Glen L. Gray, Jerry L. Turner, Paul J. Coram, and Theodore J. Mock, *Perceptions and Misperceptions Regarding the Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors*, 25 Accounting Horizons 659, 675-676 (2011); or Theodore J. Mock, Jean Bédard, Paul J. Coram, Shawn M. Davis, Reza Espahbodi, and Rick C. Warne, *The Audit Reporting Model: Current Research Synthesis and Implications*, 32 Auditing: A Journal of Practice & Theory 323, 323-351 (2013).

identifies the company's financial statements that were audited, provides a standardized description about the nature of an audit, and provides an opinion on whether the company's financial statements are fairly presented, in all material respects, in conformity with the applicable financial reporting framework. The auditor's report is often described as a pass/fail model because the report only conveys the auditor's opinion on whether the financial statements are fairly presented (pass) or not (fail) and typically provides limited information about the nature of the work on which the opinion is based.

The Board's current standards also require that the auditor add explanatory paragraphs to the auditor's report under specific circumstances, such as when there is substantial doubt about the company's ability to continue as a going concern or a restatement of previously issued financial statements. When included, these paragraphs generally consist of standardized language that provides limited audit-specific information.

The auditor may also, at his or her discretion, include emphasis paragraphs in the auditor's report to emphasize a matter regarding the financial statements. Generally, an emphasis paragraph only points to a disclosure in the company's financial statements without providing any additional description. Under current practice, emphasis paragraphs are infrequent.[139] Auditors may also, at their discretion, include language in the auditor's report indicating that they were not engaged to examine management's assertion about the effectiveness of internal control over financial reporting.[140]

Academic research confirms the view of the Board and many commenters that the current form of the auditor's report conveys little of the audit-specific information obtained and evaluated by the auditor.[141] Academic research also finds that investors and other financial statement users refer to the existing auditor's report only to determine whether the opinion is unqualified because it does not provide much additional informational value about a particular audit.[142] These findings align with the

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[139] In the audit reports of approximately 6,350 issuers with fiscal year 2014 filings, PCAOB staff identified audit reports containing explanatory paragraphs to emphasize matters in the financial statements in approximately 2 percent of the filings.

[140] *See* paragraph .10 of AI 20, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710.*

[141] *See* Church et al., *The Auditor's Reporting Model: A Literature Overview and Research Synthesis* 69-90.

[142] *See* Gray et al., *Perceptions and Misperceptions Regarding the*

consistent call from investors, over the course of the Board's rulemaking process, for a more informative auditor's report.[143]

*2. Additional Improvements to the Auditor's Report*

The existing auditor's report is not required to have a specified addressee but it may be addressed to the company whose financial statements are being audited, its board of directors, or stockholders.[144] Under current practice, the auditor's report is generally addressed to one or more of the following: (1) the board of directors and stockholders/shareholders, or their equivalent for issuers that are not organized as corporations; (2) the plan administrator or plan participants for benefit plans; and (3) the directors or equity owners for brokers or dealers.[145]

The current auditor's report also includes the report title, the date, and the name and location of the accounting firm's office issuing the report. The auditor is not currently required to disclose in the auditor's report the number of years it has served as auditor for the company. However, as noted earlier, many larger companies have begun voluntarily disclosing auditor tenure in the proxy statement.

Currently, the title of the auditor's report, "Report of Independent Registered Public Accounting Firm," provides the only indication of the auditor's independence.

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*Unqualified Auditor's Report by Financial Statement Preparers, Users, and Auditors* 659–684; Mock et al., *The Audit Reporting Model: Current Research Synthesis and Implications* 323–351.

[143] Academic research has found that, in some instances, the inclusion of explanatory language in the auditor's report may provide investors with additional value-relevant information. A recent academic study suggests that auditor's reports containing certain types of explanatory paragraphs required under existing standards may provide information about the likelihood that financial statements will be subsequently restated. The authors argue that the inclusion of such an explanatory paragraph in the auditor's report can provide a signal to investors about the risk of misstatement of the company's financial statements. *See* Keith Czerney, Jaime J. Schmidt, and Anne M. Thompson, *Does Auditor Explanatory Language in Unqualified Audit Reports Indicate Increased Financial Misstatement Risk?* 89 The Accounting Review 2115, 2115–2149 (2014).

[144] *See* existing AS 3101.09.

[145] This information is based on a review by PCAOB staff of a random sample of 2014 fiscal year-end auditor's reports for issuers, benefit plans, and brokers and dealers.

## C. Benefits

### *1. Critical Audit Matters*

Economic theory commonly attributes two benefits to mandatory disclosure. First, the disclosure of previously unknown, value-relevant information directly benefits the market because it allows market participants to make better-informed decisions. Second, the disclosure of such information may indirectly benefit the market because some parties may change their behavior in positive ways after information is disclosed.

a. Direct Benefit: More Informative and Useful Auditor's Report

The Board believes that auditor communication of critical audit matters will reduce the information asymmetry between investors and auditors, which should in turn reduce the information asymmetry between investors and management about the company's financial performance. Some commenters on the reproposal agreed that the information provided in critical audit matters would be used by various types of investors in a number of different ways that are consistent with the framework outlined in the reproposal:

- *Informing*—Identification of the matters arising from the audit that the auditor considered especially challenging, subjective, or complex, together with a description of how the auditor addressed those matters, which should provide valuable information. For example, some commenters said that:
    - Critical audit matters would add to the total mix of information available to investors, and would contribute to their ability to analyze companies and make investment decisions;
    - Investors would use critical audit matters in the same way that they use any other financial disclosure; critical audit matters would add an additional perspective to management's disclosures;
    - Insights on critical audit matters may be relevant in analyzing and pricing risks in capital valuation and allocation;
    - Critical audit matters would inform investor models of company financial performance;
    - Critical audit matters would augment and add more dimension to the information provided by the financial statements and the critical accounting policies and estimates; and

- o The communication of critical audit matters would lower the cost of acquiring information for financial statement users.

- *Framing*—Critical audit matters should provide investors with a new perspective on the financial statements and focus their attention on the related financial statement accounts and disclosures, which should facilitate their analysis of the financial statements, and help them assess financial performance, for example by highlighting potentially relevant information or by reducing the costs to process or search for the information. For example, some commenters said that:

  - o Critical audit matters would focus investors' attention on key financial reporting issues and identify areas that deserve more attention;

  - o In jurisdictions where expanded auditor reporting is available, it focuses users' attention on issues that would be pertinent to understanding a company as a long-term investor; and

  - o Information in critical audit matters would contribute to investor understanding and consumption of information in the financial statements.

- *Monitoring*—The ability to identify and evaluate the matters identified as critical audit matters should also help investors and analysts engage management with targeted questions about these issues and support investor decisions on ratification of the auditor. For example, some commenters said that:

  - o Critical audit matters would facilitate the ability of investors to monitor management's and the board of director's stewardship of the company by highlighting accounting and auditing issues and other matters that investors may wish to emphasize in their engagement with management; and

  - o Critical audit matters would provide important information on how the auditor has addressed an issue, which investors can use in evaluating the rigor of the audit and making proxy voting decisions, including ratification of the audit committee's choice of external auditor.

Critical audit matters may be used by different types of investors in different ways. For example, retail investors (or others who may act on their behalf, such as analysts, credit rating agencies, or the financial press) may use the additional information to help them identify and analyze important aspects of the financial statements. Larger investors, on the other hand, may also use critical audit matters as a basis for engagement with management.

The communication of critical audit matters aims to provide investors and financial statement users with specific information about the audit of a company's financial statements. Some commenters were concerned, however, that the communication of critical audit matters could lead to a reduction in comparability of auditor's reports. Although differences in critical audit matters from period to period and across companies may make auditor's reports less uniform, to the extent the information provided is useful in evaluating the financial performance, highlighting these differences should contribute to the overall mix of information. Further, some commenters on the proposal said that investors are interested in information that is specific to the audit of a company's financial statements, and therefore, would expect differences in auditor's reports across companies and reporting periods. Investors also have indicated that they are accustomed to analyzing company-specific information, such as information in financial statements or MD&A that is specific to a company or a reporting period.

A body of academic research regarding the possible effects of expanded auditor reporting is emerging.[146] The Board has been monitoring this research with a view towards assessing its potential relevance to this rulemaking. The Board is mindful of several issues that limit the extent to which this research can inform its decision making. Much of this research is unpublished and at a relatively early stage. The current conclusions may be subject to multiple interpretations and it is possible that results from this research may be revised during the peer review process. Moreover, it may be difficult to generalize results outside the context of specific studies. For example, in considering the implications of academic studies based on data from other jurisdictions, differences between the Board's final standard and the requirements in other jurisdictions must be taken into account. In addition, specific characteristics of the U.S.-issuer audit market may make it difficult to generalize observations made in other markets because of differences in baseline conditions (for example, market efficiency, affected parties, policy choices, legal environment, and regulatory oversight). As to experimental research in particular, it should be noted that the experimental setting may not provide study participants with information that is representative of the information environment in which market participants actually operate; for instance, if new information appeared more salient to study participants than it would to a market participant, the impact of expanded auditor reporting would be overstated in an

[146] For a review of relevant academic research, *see* Jean Bédard, Paul Coram, Reza Espahbodi, and Theodore J. Mock, *Does Recent Academic Research Support Changes to Audit Reporting Standards?* 30 Accounting Horizons 255, 255-275 (2016).

experimental setting. In addition, some of these studies were conducted based on earlier versions of rule text that differs from the final standard, which may affect the extent to which the results can inform the Board in evaluating potential effects of the final standard.

As discussed in more detail in the economic analysis contained in the reproposal, the results from early research analyzing the informational value of expanded auditor reporting are inconclusive.[147] Some studies found that expanded auditor reporting could provide investors with new and useful information, while other studies found that the benefits attributable to expanded auditor reporting were not statistically significant, but that it could produce unintended consequences. These limited findings may be due to the fact that the results of the studies represent averages for large samples of companies. On average, investors may already have access to a variety of information sources (such as annual reports, news media, and analyst research reports) which may contain similar information about a company. However, expanded auditor reporting may be relatively more informative for companies where alternative sources of information are less available (e.g., those companies with less analyst coverage).

In response to the reproposal, two commenters submitted studies suggesting that expanded auditor reporting has increased the informative value of the auditor's report. One experimental study tested the communicative value of expanded auditor reporting by analyzing how key audit matters affected investment professionals' assessment of a company's business economics, as well as their confidence in making that assessment.[148] The authors found that specific informational content of the key audit matter affected the study participants' perceived level of trust associated with the auditor's report, which then affected the perceived level of trust associated with the financial statements and their assessment of the company's business economics. Another study analyzed whether the communicative value of auditor's reports changed following the implementation of expanded auditor reporting in the United Kingdom.[149] The author found that the readability of auditor's reports increased in the post-implementation period, and that the use of negative and uncertain words in expanded

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[147] *See* PCAOB Release No. 2016-003, Section VI.C.1.a.

[148] *See* Annette Koehler, Nicole Ratzinger-Sakel, and Jochen Theis, *Does the Reporting of Key Audit Matters Affect the Auditor's Report's Communicative Value? Experimental Evidence from Investment Professionals* (working paper submitted as comment letter No. 18, available on the Board's website in Docket 034).

[149] *See* Kecia Williams Smith, *Tell Me More: A Content Analysis of Expanded Auditor Reporting in the United Kingdom* (working paper submitted as comment letter No. 71, available on the Board's website in Docket 034).

auditor's reports captured more client-specific audit risk.[150] In addition, the author found limited evidence that the dispersion of analysts' EPS forecasts decreased following the implementation of expanded auditor reporting, suggesting an improved information environment. The author argued that expanded auditor reporting was successful at increasing the communicative value of the auditor's report, and that analyst behavior changed accordingly. In contrast, another recent experimental study found that including critical audit matters reduced the readability of the auditor's report but did not incrementally inform nonprofessional investors' valuation judgments. However, the study suggested that the reporting of a critical audit matter lowers nonprofessional investors' perceptions of management's credibility when earnings just meet analysts' expectations. The study was designed and implemented using the definition of critical audit matters and related reporting requirements from the Board's proposal, which differ from the final standard.[151]

In addition, in reviewing the experience of expanded auditor reporting in the United Kingdom, the FRC observed that investors greatly value the information provided in expanded auditor reporting.[152] This view is confirmed by UK investors that commented on the reproposal. The FRC noted that, in the two years following the implementation of the new requirements, an association of investment managers has recognized in an annual awards ceremony those specific auditor's reports found to be most clear and most innovative in providing insight into the audit of the company's financial statements.[153] In addition, the FRC notes that users of the new auditor's reports identified certain descriptions of risks that they found to be more useful—such as descriptions that are specific to the entity being audited. Further, the FRC report noted that, in the second year of implementation, a much greater proportion of risks were set out in a more meaningful and transparent way.[154] As noted above, the FRC's requirements for expanded auditor reporting are different from the final standard, and

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[150] The author uses several measures designed to assess the readability of texts which, the study notes, have been used in several other published academic studies addressing the readability of financial disclosure. *See id.* at 5.

[151] *See* Brian Carver and Brad Trinkle, *Nonprofessional Investors' Reactions to the PCAOB's Proposed Changes to the Standard Audit Report* (March 2017) (working paper, available in Social Science Research Network).

[152] *See* FRC 2016 Report.

[153] *See* FRC, *March 2015—Extended Auditor's Reports, A Review of Experience in the First Year*; and FRC 2016 Report.

[154] *Id.*

the baseline legal and regulatory environment is not the same as in the United States. Nevertheless, the Board believes that there are sufficient similarities for the UK experience to be generally informative in its decision-making.

While it is too early for the body of academic research on expanded auditor reporting to provide a conclusive answer, investors commenting during the Board's standard-setting process have consistently affirmed the usefulness of expanded auditor reporting and the FRC's observations on the early experience of investors in the United Kingdom are consistent with this view. Accordingly, the Board believes that auditor communication of critical audit matters will add to the mix of information that investors can use.

b. Indirect Benefit: Improved Audit and Financial Reporting Quality

In general, information asymmetry can lead to situations in which an agent (such as an auditor) takes actions that do not coincide with the best interests of the principal (such as an investor), if the agent's incentives are misaligned.[155] This type of problem is the result of the inability of the principal to observe or monitor the agent's behavior, which also inhibits the principal's ability to identify and reward optimal behavior, or punish sub-optimal behavior. Economic theory posits that the disclosure of information can have indirect effects that lead to changes in behavior.[156] In the context of expanded auditor reporting, the additional information provided in the auditor's report could be beneficial to investors by providing more information about the audit, which could affect their voting decisions. To the extent that this could influence the terms of the auditor's engagement, academic research suggests "any additional information about the agent's action, however imperfect, can be used to improve the welfare of both the principal and the agent."[157]

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[155] Economists use principal-agent theory to analyze situations where one party (the principal) hires another party (the agent) to perform certain tasks and decision-making ability is delegated to the agent. For a general discussion of principal-agent theory, *see, e.g.*, Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 Journal of Financial Economics 305, 305-360 (1976), or Bengt Holmstrom, *Moral Hazard and Observability*, 10 The Bell Journal of Economics 74, 74-91 (1979).

[156] *See, e.g.*, George Loewenstein, Cass R. Sunstein, and Russell Golman, *Disclosure: Psychology Changes Everything*, 6 Annual Review of Economics 391, 391-419 (2014).

[157] *See* Holmstrom, *Moral Hazard and Observability* at 75.

This suggests that making aspects of the audit more visible to investors through the communication of critical audit matters should provide some auditors, management, and audit committees with additional incentives to change their behavior in ways that may enhance audit quality and ultimately financial reporting quality. For instance, the communication of critical audit matters could lead:

- Auditors to focus more closely on the matters identified as critical audit matters;

- Audit committees to focus more closely on the matters identified as critical audit matters and to engage the auditor and management about the adequacy of the related disclosures; and

- Management to improve the quality of their disclosures because they know that investors and the auditor will be scrutinizing more closely the matters identified as critical audit matters.

The communication of critical audit matters could lead auditors to increase their focus on the matters identified in the auditor's report as critical audit matters. As suggested by commenters, the communication of critical audit matters could further incentivize auditors to demonstrate the level of professional skepticism necessary for high quality audits in the areas of the critical audit matters. Other commenters stated that the reporting of critical audit matters could result in increased audit quality. For example, auditors could feel that the potentially heightened scrutiny of the matters identified as critical audit matters may warrant additional effort to satisfy themselves that they have obtained an appropriate amount of audit evidence to support their opinion.

The communication of critical audit matters could also heighten management's attention to the relevant areas of financial statements and related disclosures. Several commenters stated that the reporting of critical audit matters would lead management to improve the quality of their disclosures or adopt more widely accepted financial reporting approaches in these areas.[158]

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[158] To substantiate this point, one commenter cited a memo prepared for the clients of an international law firm that noted management should consider revising or supplementing their own disclosures relating to issues raised in expanded auditor's reports to ensure that the totality of disclosures around the issue are complete and accurate. *See* Sullivan & Cromwell LLP, *Audit Reports, PCAOB Releases Reproposal of Amendments to Its Audit Report Standard* (May 25, 2016).

An experimental study analyzed the joint effect of expanded auditor reporting and audit committee oversight on management disclosure choices.[159] The author found that the study participants, who were currently serving as public company financial executives, chose to provide the greatest level of disclosure when they knew that the auditor's report would provide a more detailed description of the accounting estimate, and the audit committee exhibited strong oversight. The author argued that, similar to what other academic research has found regarding the resolution of audit adjustments, information presented in critical audit matters would be the outcome of a negotiation process between the auditor and management.

Increased management attention to the related aspects of the financial statement accounts and disclosures described in the critical audit matters should, at least in some cases, lead to an incremental increase in the quality of the information presented. Academic research has shown that increased quality of information could result in a reduction in the average cost of capital.[160]

In addition, the communication of critical audit matters may enhance the audit committee's oversight efforts by providing an additional incentive for the audit committee to engage with the auditor and management about the matters identified as critical audit matters and the adequacy of the company's related disclosures. Although some commenters stated that the required communication of critical audit matters would "chill" communications between the auditor and the audit committee, others said that it would enhance communications between these parties. Further, it should be noted that the final standard does not change the Board's existing requirements on audit committee communications, other than requiring the auditor to provide the audit committee with a draft of the auditor's report.

To the extent changes in the behavior of auditors, audit committees, and management occur, they could lead to an incremental increase in audit quality and financial reporting quality, which should increase investors' confidence in the reliability of the financial statements. Some commenters stated that a more transparent and informative auditor's report could heighten user confidence in the audit and the audited

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[159] *See* Stephen H. Fuller, *The Effect of Auditor Reporting Choice and Audit Committee Oversight Strength on Management Financial Disclosure Decisions* (working paper submitted as comment letter No. 49, available on the Board's website in Docket 034).

[160] *See, e.g.*, Richard A. Lambert, Christian Leuz, and Robert E. Verrecchia, *Information Asymmetry, Information Precision, and the Cost of Capital*, 16 Review of Finance 1, 1-29 (2012). Professor Leuz is an economic advisor at the PCAOB. The research cited above was published before he joined the PCAOB.

financial statements. Academic research suggests that an increase in investor confidence should decrease the average cost of capital.[161] As discussed in the economic analysis of the reproposal, some empirical studies conducted in other jurisdictions provide evidence that expanded auditor reporting increased audit quality, while other studies found that it did not have a measurable effect on audit quality.[162] The Board is not aware of any empirical studies indicating that expanded auditor reporting had a negative effect on audit quality.

c. Indirect Benefit: Differentiation among Auditor's Reports

If investors and other financial statement users perceive and respond to differences in the quality and usefulness of the information communicated by auditors regarding critical audit matters, expanded auditor reporting should serve as a potential means of greater differentiation among accounting firms and engagement partners.[163] One commenter stated that the reporting of critical audit matters would allow auditors to differentiate themselves, and that this differentiation would provide useful information to investors and other financial statement users. If expanded auditor reporting allows investors to differentiate among accounting firms and engagement partners, it should provide a more nuanced signal of audit quality and financial reporting reliability.

The FRC report also noted that there are clear differences among accounting firms in the approaches taken to implement the requirements.[164] For example, one firm went beyond the FRC's requirements by including audit findings for the risks of material misstatement in the majority of its auditor's reports in the second year of implementation, which other firms did far less frequently. The FRC's observations may

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161 *See* Luigi Guiso, Paola Sapienza, and Luigi Zingales, *Trusting the Stock Market*, 63 The Journal of Finance 2557, 2557–2600 (2008). Professor Zingales is the Founding Director of the PCAOB's Center for Economic Analysis, now known as the Office of Economic and Risk Analysis. The research cited here was published before he joined the PCAOB.

162 *See* PCAOB Release No. 2016-003, Section VI.C.1.b, footnotes 154-156 and accompanying text.

163 On May 9, 2016, the SEC approved new rules and related amendments to the Board's auditing standards, including amendments to AS 3101, that will provide investors and other financial statement users with information about engagement partners and other accounting firms that participate in audits of issuers. *See* PCAOB Release No. 2015-008.

164 *See* FRC 2016 report.

suggest that accounting firms took different approaches to expanded auditor reporting as a means of distinguishing themselves based on the quality and usefulness of the information provided in their auditor's reports. Furthermore, as discussed in the economic analysis of the reproposal, an academic study argued that investors found the auditor's reports issued by some accounting firms to be more useful than others.[165] One commenter specifically noted that mandatory auditor rotation was introduced in the UK at the same time as expanded auditor reporting, and that this may have provided accounting firms with motivation to differentiate themselves.

In addition to relying on the audit committee (which, at least for exchange-listed companies, is charged with overseeing the external auditor), in the absence of differentiation based on the auditor's report, users of financial statements may rely on proxies such as the reputation of the accounting firm issuing the auditor's report, aggregated measures of auditor expertise (for example, dollar value of issuer market capitalization audited or audit fees charged), or information about the geographic location of the office where the auditor's report was signed as signals for audit quality. Academic research finds, however, that these are imperfect signals of audit quality.[166]

The identification and description of critical audit matters should permit differentiation among auditor's reports based on investor perceptions of their informativeness and usefulness. In some instances it may also provide a signal of audit quality. Because the determination and communication of critical audit matters may reflect a variety of considerations, however, critical audit matters may not bear directly on audit quality. For example, the choice of which critical audit matters to communicate or how to describe them may reflect considerations such as the company's business environment and financial reporting choices, accounting firm methodology, engagement partner characteristics, and legal advice. Thus, a more detailed description of critical audit matters may not necessarily reflect a higher quality audit than a less informative description of such matters.

Nevertheless, informative descriptions of how the audit addressed critical audit matters should provide insight into the extent and appropriateness of the auditor's work. Moreover, it is possible that thoughtful, audit-specific, and useful critical audit matters (or, conversely, generic and uninformative critical audit matters) could affect investor

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[165] *See* PCAOB Release No. 2016-003, Section VI.C.1.b, footnote 161 and accompanying text.

[166] *See, e.g.*, Jere R. Francis, *A Framework for Understanding and Researching Audit Quality*, 30 Auditing: A Journal of Practice & Theory 125, 125–152 (2011) and Mark DeFond and Jieying Zhang, *A Review of Archival Auditing Research*, 58 Journal of Accounting and Economics 275, 275–326 (2014).

perceptions of the auditor's work and willingness to provide useful information. As a result, the communication of critical audit matters, potentially in conjunction with disclosures regarding the identity of the engagement partner and other accounting firms that participated in the audit,[167] and other relevant information should enable differentiation among engagement partners and accounting firms on that basis.

*2. Additional Improvements to the Auditor's Report*

The final standard will introduce new requirements regarding auditor tenure, the addressee of the auditor's report, and statements in the auditor's report related to auditor independence and the auditor's responsibility for reporting on ICFR.[168] In addition, the final standard contains other changes to the form of the auditor's report, which are intended to improve and clarify the language for certain elements, such as statements related to the auditor's responsibilities regarding the notes to the financial statements, and to promote a consistent presentation of this information across auditor's reports.

Investor commenters have consistently supported disclosing tenure in the auditor's report. In the Board's view, which is consistent with the views of some commenters,[169] disclosing information about auditor tenure in the auditor's report will provide a consistent location for this information and decrease the search costs, relative to the current environment of voluntary reporting, for some investors and other financial statement users who are interested in this information.

The statement regarding the auditor's existing obligation to be independent of the company is intended to enhance investors' and other financial statement users' understanding about the auditor's obligations related to independence and to serve as a reminder to auditors of these obligations. By requiring the auditor's report to be addressed to certain parties, the Board will be promoting uniformity in the addressees of the auditor's report.

Commenters were generally supportive of the reproposed changes to the form of the auditor's report. For example, some commenters stated these enhancements would

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[167] *See* PCAOB Release No. 2015-008.

[168] In circumstances where management is required to report on ICFR but the auditor is not and has not performed an audit of ICFR, the final standard requires a statement to that effect in the auditor's report.

[169] *See also* Section VI.D.2.f for a discussion of academic research regarding auditor tenure.

make the auditor's report easier to read and would facilitate comparisons between auditor's reports for different companies by providing a consistent format.

## D. Costs and Potential Unintended Consequences

### *1. Costs*

Commenters on the reproposal raised concerns that the rule would impose various types of costs, but generally did not quantify those costs. Even those that, at an earlier stage of the rulemaking, conducted limited implementation testing of the proposal were unable to provide a quantified cost estimate. Given lack of data, the Board is unable to quantify costs, but provides a qualitative cost analysis.

As an additional means of assessing potential cost implications of the final standard, PCAOB staff has reviewed data from the first year of implementation of expanded auditor reporting in the United Kingdom.[170] As discussed below, staff analyzed a variety of data points that may be associated with potential costs, including audit fees, days required to issue the auditor's report, and the content of the expanded auditor's report. It should be noted that it may be difficult to generalize observations from the UK experience. For example, the reporting and documentation requirements relating to expanded auditor's reports in the United Kingdom differ from those in the final standard, the baseline legal environments are different, and the UK requirements apply only to companies with a premium listing on the London Stock Exchange and not, for example, to smaller companies that list on London's AIM market.

#### a. Critical Audit Matters

The Board anticipates that the final requirements regarding critical audit matters will have potential cost implications for auditors and companies, including their audit committees. Such costs will likely relate to additional time to prepare and review auditor's reports, including discussions with management and audit committees, as well as legal costs for review of the information provided in the critical audit matters. In addition, auditors may choose to perform more audit procedures related to areas reported as critical audit matters (even though performance requirements have not changed in those areas), with cost implications for both auditors and companies.

For auditors, costs might represent both one-time costs and recurring costs. One-time costs could be incurred as a result of: (1) updating accounting firm audit and

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[170] *See* PCAOB, *White Paper on the Auditor's Reports of Certain UK Companies that Comply with International Auditing Standard (UK and Ireland) 700* ("PCAOB White Paper") (May 2016), available on the Board's website in Docket 034.

quality control methodologies to reflect the new reporting requirements; and (2) developing and conducting training of accounting firm personnel on the new reporting requirements. When updating methodologies, some accounting firms will likely also develop new quality control processes related to additional review or consultation on the determination, communication, and documentation of critical audit matters. One commenter suggested that the initial implementation costs could place a significant and possibly disproportionate burden on smaller accounting firms.

Recurring costs will primarily reflect additional effort expended in individual audits. The final standard does not impose new performance requirements other than the determination, communication, and documentation of critical audit matters, which will be based on work the auditor has already performed. However, there will be some additional recurring costs associated with drafting descriptions of critical audit matters and related documentation. It is likely that senior members of the engagement teams, such as partners and senior managers, will be involved in determining the critical audit matters and developing the language to be included in the auditor's report. In addition, reviews by others, such as the engagement quality reviewer and national office, will also result in recurring costs. Additional time might also be incurred by the auditor as a result of discussions with management or the audit committee regarding critical audit matters.

Companies, including audit committees, will likely also incur both one-time and recurring costs as a result of the final standard. One-time costs could be incurred, for example, in educating audit committee members about the requirements of the new standard and in developing management and audit committee processes for the review of draft descriptions of critical audit matters and the related interaction with auditors. Recurring costs will include the costs associated with carrying out those processes, as well as any increase in audit fees associated with the new reporting requirements or legal fees stemming from a review of critical audit matter communications.

If the drafting and review of critical audit matter reporting takes place towards the end of the audit, there will also be an opportunity cost associated with the time constraints on the parties involved (including, for example, management, the engagement partner, the audit committee, and the auditor's and company's respective legal counsel). The end of the audit is a busy period in which multiple issues may need to be resolved before the auditor's report can be issued. At the same time, companies and management may also be in the process of finalizing the annual report. Time spent drafting and reviewing the communication of critical audit matters could occur at the same time as other important work in the financial reporting and audit process, and would likely involve senior management that command relatively high annual salaries or experienced auditors and lawyers with relatively high hourly billing rates. In addition, the communication of critical audit matters could lead to changes in management's disclosures, which may result in more effort and cost in the financial reporting process.

Several commenters on the reproposal claimed that the required reporting of critical audit matters would lead to increased audit fees, but none provided data or estimates regarding the magnitude of the increases they expected. Commenters on the proposal had differing views about the likely magnitude of direct costs associated with auditor reporting of critical audit matters. Some commenters said that there would not be material additional costs for communication of critical audit matters, as these matters would already have been communicated to the audit committee. This may suggest that a substantial amount of the work required to communicate critical audit matters would already have been completed earlier in the audit.

One commenter argued that the changes described in the reproposal would lead to a significant increase in costs, and that no compelling case had been made that the benefits would exceed the costs. Some commenters noted that investors would be expected to ultimately bear the cost of the audit, and these commenters have voiced strong support for expanded auditor reporting since the project's inception. This suggests that they consider the benefits of expanded auditor reporting to justify the costs, and would support additional fees for additional useful information.

Audit fees do not fully reflect the cost of implementing expanded auditor reporting to the extent that accounting firms choose to absorb those additional costs and because audit fees do not reflect the impact of any additional demand on management's time associated with expanded auditor reporting. Subject to those limitations, in its review of the implementation of expanded auditor reporting in the United Kingdom, the PCAOB staff did not find evidence of statistically significant increases in audit fees following the first year of expanded auditor reporting.[171] For 53 percent of the companies analyzed, audit fees for the year of implementation remained the same or decreased as compared to the prior year's audit fees. Audit fees increased for the remaining companies. The PCAOB staff found that the average change in audit fees was an increase of approximately 5 percent, roughly consistent with the findings of academic research described in the economic analysis in the reproposal. However, the staff found that the median change in audit fees was zero. Collectively, these results seem to suggest that outlier companies with relatively large increases in audit fees drove the result for the average change in audit fees. It should be noted that the PCAOB staff's review did not analyze whether other factors, such as inflation, changes in the economic environment and corporate risk, corporate acquisitions, or the implementation of other regulatory changes, contributed to the documented increase in audit fees.

One commenter on the reproposal noted that the caveats described above are important because the inability to fully gauge the costs of expanded auditor reporting could lead the Board to underestimate the costs associated with the rule, which may

[171] *Id.*

bear disproportionately on smaller companies and their auditors. Another commenter also asserted that the costs of expanded auditor reporting are likely to be disproportionately borne by smaller companies because the reproposed rule had, in their estimation, limited scalability. The Board believes that the complexity and costs associated with determining, documenting, and communicating critical audit matters should generally depend on the nature and complexity of the audit. This would in turn depend on the complexity of the operations and accounting and control systems of the company.

b. Additional Improvements to the Auditor's Report

The changes adopted to the basic elements of the auditor's report do not represent a significant departure from the reproposal. Some of the enhanced basic elements will have cost implications for auditors, although these costs are not expected to be significant. One-time costs will primarily relate to updating methodology and training and the initial determination of the first year the auditor began serving consecutively as the company's auditor. Based on comments received, it does not appear that the changes adopted to the basic elements will impose significant recurring costs, because the year in which tenure began will not change and the other amendments involve standardized language that, once implemented, will be the same or very similar across different auditor's reports every year.

2. *Potential Unintended Consequences*

a. Time Needed to Issue the Auditor's Report

As a result of the additional effort required to determine, communicate, and document critical audit matters, some commenters said that it would take auditors longer to issue their reports. On this point, the PCAOB staff study did not find evidence that compliance with the United Kingdom's expanded auditor reporting requirements delayed the issuance of auditor's reports in the first year of implementation. Based on the study, for companies that had three years of financial statements, a new form auditor's report was issued, on average, in 63 days from the company's fiscal year end date in the year of implementation, as compared to 64 days in the prior year and 65 days two years earlier. Further, academic research cited in the economic analysis of the reproposal similarly did not find that the UK reporting requirements led to delays in financial reporting.[172]

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[172] *See* PCAOB Release No. 2016-003, section VI.D.2.a, footnote 169 and accompanying text.

b. Number and Content of Critical Audit Matters

Some commenters indicated an expectation that the auditor's report would include a long list of critical audit matters or that auditors would have incentives to communicate an overly long list of critical audit matters. For example, some commenters said that this would occur because the auditor would be motivated to communicate as much as possible in an effort to mitigate any future liability for unidentified critical audit matters, or as a means to avoid potential consequences of being second-guessed by regulators or others. Other commenters asserted that such a development could make the auditor's report overly long, contributing to disclosure overload and conflicting with the SEC's disclosure effectiveness project. Other commenters indicated that expanded auditor reporting could lead to boilerplate language that would diminish the expected value of the critical audit matters and obscure the clarity of the auditor's opinion. If auditors fail to provide audit-specific information, the communication of critical audit matters will not decrease information asymmetry about the audit, and may obscure other important information included in the auditor's report and the audited financial statements.

The final requirements aim to provide investors with the auditor's unique perspective on the areas of the audit that involved the auditor's especially challenging, subjective, or complex judgments. Limiting critical audit matters to these areas should mitigate the extent to which expanded auditor reporting could become standardized. Focusing on auditor judgment should limit the extent to which expanded auditor reporting could become duplicative of management's reporting. Also, while some commenters argued that liability concerns would increase the number of critical audit matters auditors communicate, others suggested that liability concerns would minimize the additional statements auditors make.

The PCAOB staff study did not find evidence that expanded auditor reporting in the United Kingdom resulted in a very large number of risk topics or none at all in the first year of implementation.[173] On average, the auditor's reports in the first year of implementation included descriptions of four risk topics, with total risk topics ranging from one to eight. Additionally, the descriptions of the risks of material misstatement in the auditor's reports in the first year of implementation were not presented in standardized language, but included variations in content length, description, and presentation. The most frequently described risk topics related to revenue recognition, tax, and goodwill and intangible assets. The FRC report on the first two years of expanded auditor reporting in the United Kingdom finds a similar range and average number of risk topics disclosed in both the first and second year of implementation.[174]

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173 *See* PCAOB White Paper.

174 *See* FRC 2016 Report.

The FRC report also finds disclosure of similar risk topics in the second year of implementation of expanded auditor reporting in the United Kingdom.[175]

Further, the FRC found that, in the second year of expanded auditor reporting in the United Kingdom, the discussion of risks has improved relative to the first year of implementation and that the majority of auditor's reports provided discussion of risks that were more tailored to the company under audit, thus avoiding generic or standardized wording.[176] These findings suggest that, thus far, expanded auditor reporting has not become standardized in the United Kingdom.[177]

c. Effects of Increased Attention to Critical Audit Matters

The communication of critical audit matters could lead auditors, company management, and the audit committee to spend additional time and resources on reviewing the adequacy of the work performed on the related financial statement accounts and disclosures. While this could lead to an incremental improvement in audit and financial reporting quality for the identified critical audit matters, it is also possible that there may be increased costs for auditors as a result of the requirements. For example, even though the final standard does not mandate the performance of additional audit procedures other than with respect to communication of critical audit matters, it is possible that some auditors may perform additional procedures. If that occurs, the associated costs may be passed on—in whole, in part, or not at all—to companies and their investors in the form of higher audit fees. Further, increased procedures may also require additional time from the company's management to deal with such procedures. Some commenters suggested that the increased attention on certain matters could also lead to a related decrease in audit and financial reporting quality if other material aspects of the financial statements and disclosures receive less attention.

Some commenters argued that including critical audit matters in the auditor's report would impair the relationship between auditors and management or auditors and the audit committee. Other commenters suggested that the required reporting of critical audit matters would inhibit communication among the auditor, management, and the audit committee because of concerns about what would be publicly communicated in

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[175] *Id.*

[176] *Id*.

[177] The Board finds the UK experience instructive, although it is, of course, possible that differences between the UK and US litigation and regulatory environments may influence the extent to which these findings would generalize to the US market.

the auditor's report. One commenter also suggested that auditors may include additional matters in audit committee communications out of concern that an omission could lead to regulatory sanctions or liability. Other commenters have said that it would enhance communication among the participants in the financial reporting process.

An experimental study analyzed how the strength of audit committee oversight of the financial reporting process varied with the presence of sophisticated investors and knowledge of forthcoming expanded auditor reporting.[178] The author found that study participants, most of whom were experienced audit committee members, asked fewer probing questions if they knew that the auditor would be providing a discussion of the significant accounting estimate in the auditor's report. The author argued that by asking fewer probing questions audit committee members subconsciously insulated themselves from potential challenges mounted by investors regarding the appropriateness of the company's financial reporting. The Board is not aware of evidence this has occurred in the jurisdictions that have adopted expanded auditor reporting. Moreover, it may be difficult in an experimental setting to recreate the actual legal responsibility and potential liability that audit committee members face, which may limit the extent to which the experimental results would generalize to actual behavior in real-world settings.

Similarly, as described in the economic analysis of the reproposal and asserted by at least one commenter, management may have an incentive to withhold information from the auditor in order to prevent an issue from being described in the auditor's report. It seems unlikely, however, that management would or could withhold information from the auditor on the most critical issues in the audit because it could result in a scope limitation. On the contrary, it may be just as likely that management would communicate more information to the auditor as a means of demonstrating that an issue is not challenging, subjective, or complex, and, therefore, would not need to be described in the auditor's report.

Under the final standard, critical audit matters are determined from the matters communicated or required to be communicated to the audit committee. As noted earlier, with respect to any matters already required to be communicated to the audit committee, there should not be a chilling effect or reduced communications to the audit committee. Therefore, it would seem that any chilling effect would relate to matters that are not explicitly required to be communicated to the audit committee, although, as

[178] Yoon Ju Kang, *Are Audit Committees More Challenging Given a Sophisticated Investor Base? Does the Answer Change Given Anticipation of Additional Mandatory Audit Report Disclosure?* (working paper submitted as comment letter No. 17, available on the Board's website in Docket 034).

previously described, given the breadth of current communication requirements, the Board believes there will likely be few communications affected by that possibility.

d. Potential Impact on Management Disclosure

Several commenters stated that the communication of critical audit matters would give auditors leverage to encourage disclosure of information by management. While some commenters asserted that this would be beneficial, others claimed it would be an unintended negative consequence of requiring the communication of critical audit matters. Several commenters characterized this as inappropriately expanding the role of the auditor in the financial reporting process, while undermining the role of management and the audit committee. In their view, this would be especially problematic if the final standard permitted the auditor to communicate information that was not otherwise required to be disclosed (for example, because it did not meet a specified threshold for disclosure, such as a significant deficiency in internal control over financial reporting). Commenters claimed that auditor communication of this "original information" would cause a number of unintended consequences, including significant costs, disclosure of confidential or competitively sensitive information, and potentially misleading or incomplete information.[179]

Investors and other commenters pointed out that, although expanded auditor reporting would give the auditor additional leverage over management's disclosure choices, this could result in improvements in the usability of financial statements and increases in financial reporting quality. One of these commenters cited academic research noting that, in current practice, disclosure is already guided by an iterative process between management and the auditor. This commenter reasoned that concerns regarding "original information" were misplaced because the iterative process would reduce the likelihood that the auditor would be a source of original information since critical audit matters would likely overlap with increased management disclosure.

Another commenter pointed out that auditors would not have incentives to interpret the Board's rule to require disclosure of original information in most situations. For example, concerns about the limitations of their knowledge and expertise, potential liability implications, and friction in the relationship with the company are likely to discourage auditors from going beyond management disclosures. Nevertheless, the final standard contemplates that the auditor will do so only when it is necessary to describe the principal considerations that led the auditor to determine that a matter was especially challenging, subjective, or complex and how the matter was addressed in the audit. The Board believes that this provision is needed in order to ensure that the fact

[179] For a complete discussion of these concerns, *see* Section IV.A.2.c.i.

that management did not provide a disclosure would not prevent the auditor from communicating a critical audit matter.

Although the communication of critical audit matters may lead to changes in the incentives for the auditor, company management, and the audit committee to communicate with each other, initial anecdotal evidence from the Board's outreach activities suggests that the implementation of expanded auditor reporting in the United Kingdom has not chilled such communications.

e. Changes in Perceived Assurance on the Auditor's Report, Including Perceptions of Auditor Liability

The communication of critical audit matters could have liability implications for auditors. For a more detailed discussion of liability, *see* Section IV.A.4. In addition, because the communication of critical audit matters requires auditors to discuss aspects of the audit that they found to be especially challenging, subjective, or complex, it is possible that some investors and financial statement users may misconstrue the communications to mean that auditors were unable to obtain reasonable assurance about the matters identified as critical audit matters. Some commenters have said that the communication of critical audit matters could lead to changes in the way investors and financial statements users perceive the level of assurance provided by the auditor on matters identified as critical audit matters, including that it could undermine the basic pass/fail opinion. This could lead investors to erroneously conclude that there is a problem with the audit either in the areas identified in critical audit matters or other areas, or that auditors are providing separate assurance about the presentation of the financial statements, which may have implications for perceptions of auditor responsibility in the event of an audit failure.

As discussed in the economic analysis of the reproposal, several academic papers analyze certain risks associated with communicating critical audit matters, including perception of auditor responsibility.[180] If the communication of critical audit matters were to lead to a reduction in perceived auditor responsibility, as is suggested by some academic research, and this in turn reduced auditor liability, it is possible that auditors may feel that less audit work is needed on the matters identified as critical audit matters, which could adversely affect audit quality (although the Board's other auditing standards, reinforced through firm quality control and Board inspections and enforcement activity, should provide a disincentive for auditors to decrease the amount or quality of audit work performed). It is difficult to draw generalizable conclusions based on the findings of these studies. In part, this is because their results vary and are

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[180] *See* PCAOB Release No. 2016-003, Section VI.D.2.d, footnotes 182-186 and accompanying text.

sometimes contradictory, with some studies finding that expanded auditor reporting increases perceived auditor responsibility and others finding that it decreases perceived auditor responsibility. This may suggest that the results are sensitive to the experimental design and the context in which information is presented to study participants. In addition, it is not clear how the findings would correlate with changes in auditor behavior, because perceptions of auditor responsibility may be a poor proxy for actual auditor responsibility or liability.

To address the risk that the communication of critical audit matters could result in the perception of separate assurance, the final standard requires the following statement in the auditor's report:

> The communication of critical audit matters does not alter in any way [the auditor's] opinion on the financial statements, taken as a whole, and [the auditor is not] by communicating the critical audit matters… providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

The purpose of this statement is to make clear that the communication of critical audit matters in an auditor's report should not be interpreted as altering the level of assurance on any aspect of the audit report, including the identified critical audit matters. In this regard, the Board also notes the view of some commenters that critical audit matters are likely to be used by institutional investors that are unlikely to misinterpret the information.

f. Auditor Tenure

Many commenters stated that information regarding the auditor's tenure included in the auditor's report could result in inappropriate and inconsistent assumptions about correlations between auditor tenure and/or independence and audit quality. Academic research on the relationship of tenure to audit quality has varied conclusions. For instance, some academic research indicates that engagements with short-term tenure are relatively riskier or that audit quality is improved when auditors have time to gain expertise in the company under audit and in the related industry.[181] Other academic research suggests that, at least prior to 2001, both short tenure (less than five years) and long tenure (greater than fifteen years) can have detrimental effects on audit

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[181] *See, e.g.*, Joseph V. Carcello and Albert L. Nagy, *Audit Firm Tenure and Fraudulent Financial Reporting*, 23 Auditing: A Journal of Practice & Theory 55, 55–69 (2004) and Timothy B. Bell, Monika Causholli, and W. Robert Knechel, *Audit Firm Tenure, Non–Audit Services, and Internal Assessments of Audit Quality*, 53 Journal of Accounting Research 461, 461–509 (2015).

quality.[182] Still other academic research indicates that investors are more likely to vote against, or abstain from, auditor ratification as auditor tenure increases, which may suggest that investors view long-term auditor-company relationships as adversely affecting audit quality.[183]

The disclosure of auditor tenure is intended to add to the mix of information that investors can use. However, commenters other than investors did not support disclosure of auditor tenure in the auditor's report on the basis that such disclosure would not provide value to investors or could result in false conclusions about correlations between auditor tenure and audit quality or between auditor tenure and auditor independence. Many of these commenters recommended that, if the Board determined to require disclosure of auditor tenure, it should be disclosed in Form AP rather than in the auditor's report as a means of avoiding these inferences.

## E. Alternatives Considered, Including Policy Choices under the Final Standard

After considering the comments received, the Board is adopting a new auditor reporting standard, AS 3101 and related amendments to its standards. The final standard retains the pass/fail model while expanding auditor reporting to include the communication of critical audit matters. Investor commenters have consistently asked for additional information in the auditor's report to make it more informative about the audit of the company's financial statements.

As described below, the Board has considered a number of alternative approaches to achieve the potential benefits of enhanced auditor reporting.

### *1. Alternatives Raised by Commenters*

#### a. Only Cross-Reference to Management's Disclosures

Some commenters suggested that, instead of communicating critical audit matters as reproposed, auditors should only identify the critical audit matters and provide a cross-reference to management disclosures (i.e., not describe the principal considerations that led the auditor to determine a matter is a critical audit matter or how

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[182] *See, e.g.*, Larry R. Davis, Billy S. Soo, and Gregory M. Trompeter, *Auditor Tenure and the Ability to Meet or Beat Earnings Forecasts*, 26 Contemporary Accounting Research 517, 517–548 (2009).

[183] *See, e.g.*, Mai Dao, Suchismita Mishra, and K. Raghunandan, *Auditor Tenure and Shareholder Ratification of the Auditor*, 22 Accounting Horizons 297, 297–314 (2008).

it was addressed in the audit), or refer to or list critical accounting policies and estimates as disclosed by management. The Board believes that communicating the principal considerations that led the auditor to determine that a matter is a critical audit matter and how it was addressed in the audit will provide useful information beyond simply referencing existing management disclosure, and is more responsive to investor requests for more information from the auditor's perspective.

b. Auditor Association with Other Company Disclosures

Other commenters suggested more specific auditor assurance on particular management disclosures, such as inclusion of a statement in the auditor's report that the audit included evaluation of the accounting policies and significant estimates, with a cross-reference to management's disclosures, or a statement of auditor concurrence with the critical accounting policies and estimates of the company. One commenter suggested that audit committees should disclose critical audit matters with a corresponding confirmation from the independent auditor.

Several commenters on the proposal also suggested that the Board should consider auditor association with, or attestation on, portions of MD&A, specifically management's critical accounting policies and estimates, as an alternative to expanded auditor reporting. These commenters have argued that such an association could increase the quality and reliability of the information subject to the procedures.

Some commenters on the concept release, including investors, said that they were not supportive of separate assurance by the auditor on information outside of the financial statements as an alternative to expanded auditor reporting, primarily because the related auditor reporting would have appeared in a standardized form and would not provide audit-specific information. Requiring such reporting might necessitate action by the SEC, as well as the PCAOB, to implement, including new SEC rules regarding management reporting and auditor attestation. In addition to reporting requirements, the PCAOB might have to develop new performance requirements and auditors would be required to undertake additional audit work in order to provide attestation in these areas.

Based on concerns about the complexity of such an approach, as well as the comments received as to its limited benefits, the Board determined not to pursue auditor association with portions of MD&A as an alternative to expanded auditor reporting at this time. The Board believes that this approach would fail to deliver the audit-specific information requested by investors, while also raising potential concerns about separate assurance on the identified matters.

c. No Change to Auditor Reporting Requirements

The Board considered whether changes to the existing auditor reporting requirements were needed. Auditor reporting under the current model has been criticized by many commenters as providing limited information. Auditors have not voluntarily provided more information in the auditor's report in response to investors' requests. A number of factors described above, such as potential costs and uncertainties related to voluntary auditor reporting and the potential for auditor status quo bias, may explain why voluntary reporting would not be expected to become prevalent. These factors suggest that voluntary reporting, with or without guidance to encourage it, could also create uncertainty about the content of auditor's reports because auditors would be able to choose whether to provide information about the audit, what information to provide, and the form in which to provide it. On that basis, the Board believes that standard setting is appropriate.

d. Consideration of Analogous Requirements of Other Regulators and Standard Setters

In developing the final standard, the Board took into account the requirements for expanded auditor reporting of other regulators and standard setters, such as the IAASB, the FRC, and the EU. Changes to the auditor's report that other regulators and standard setters have adopted include some commonality, such as communicating information about audit-specific matters in the auditor's report. Several commenters suggested that the Board align its requirements for expanded auditor reporting more closely with the requirements of the IAASB to provide more consistent global auditor reporting requirements.

However, the Board recognizes that the regulatory environments in other jurisdictions are different from the United States, requiring the Board to address unique U.S. requirements and characteristics in its standard-setting projects. Because the Board's standards have the force of law, the Board aims to make them as clear and easy to apply as it can. For example, the factors that the auditor considers in determining whether a matter involved especially challenging, subjective, or complex auditor judgment are included in the standard; by contrast, while the IAASB approach includes similar factors, they appear in the application and other explanatory material.

In addition, there are differences between requirements and terminology of the Board's auditing standards and those of other regulators and standard setters that may cause inconsistent application, even if the Board were to adopt the approach of another standard setter. For example, the Board's requirements for communications to the audit committee are not identical to the analogous requirements of the IAASB. Therefore, although both critical audit matters and the IAASB's key audit matters are derived from such communications, the matters ultimately discussed with the audit committee under each framework would not necessarily be the same, which could result in differences in which matters are reported even if the language in the auditor reporting standards were identical. Also, the component of the definition of critical audit matter in the final standard, namely "matters that involve especially challenging, subjective, or complex auditor judgment" grounds the definition in the auditor's expertise and judgment.

Although the processes of identifying these matters vary across jurisdictions, there are commonalities in the underlying criteria regarding matters to be communicated and the communication requirements, such that expanded auditor reporting could result in the communication of many of the same matters under the various approaches.

e. Auditor Assessment and Descriptions of Certain Financial Statement Areas

Several commenters on the concept release suggested that investors would be most interested in auditor reporting on the categories of information identified by investor respondents to the 2011 survey conducted by a working group of the IAG: (1) significant management estimates and judgments made in preparing the financial statements and the auditor's assessment of them; (2) areas of high financial statement and audit risk; (3) unusual transactions, restatements, and other significant changes in the financial statements; and (4) the quality, not just the acceptability, of the company's accounting practices and policies.[184] This request was reiterated by several commenters on the proposal, who continued to believe that this approach would provide the information investors want most. In a similar vein, other commenters on the reproposal have requested that the auditor provide a "grade" on management's significant accounting estimates and judgments.

The Board believes that the final critical audit matter definition will likely cover many of the topic areas requested by investors. For example, the auditor may communicate critical audit matters related to significant management estimates and judgments, highlight areas of high financial statement and audit risk, and discuss significant unusual transactions. However, the auditor will not be required to report on its assessment of management's significant estimates and judgments or on the quality (as opposed to merely the acceptability), of the company's accounting practices and policies or of the financial statements as a whole.

The final standard seeks to strike an appropriate balance between the value of the information being provided and the costs of providing it. Requiring auditors to report their qualitative assessments in a manner that appears very precise (for example, describing an estimate as "conservative" or "aggressive" or assigning the financial statements an "A" or a "B") may impose significantly greater costs and unintended consequences than the principles-based reporting of critical audit matters. For example, although the reporting of qualitative assessments would appear to be precise, these qualitative assessments are likely to be applied inconsistently because there is no framework for such assessments and the determinations are inherently subjective. In addition, such assessments may heighten concerns related to the perceived level of

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[184] *See* IAG 2011 survey.

assurance provided by the audit or the perception that separate assurance is being provided as to the assessed areas. Also, the reporting of such qualitative assessments may subject auditors and companies to additional litigation risk beyond what may result from the principles-based reporting of critical audit matters because the apparent precision of the reporting may facilitate plaintiffs' claims.

*2. Policy Choices*

a. Definition of Critical Audit Matters

The Board considered a variety of possible approaches to the definition of critical audit matters suggested by commenters. *See* Section IV.A.1 for a discussion of the Board's considerations.

b. Communication of Critical Audit Matters

The Board considered a variety of possible approaches to the communication requirements for critical audit matters. *See* Section IV.A.2 for a discussion of the Board's considerations.

c. Auditor Tenure

The final standard retains the reproposed requirement to include a statement in the auditor's report about auditor tenure.

In the reproposal, the Board solicited comment on whether disclosure of auditor tenure should be made on Form AP instead of in the auditor's report. Form AP was developed as a means to address commenter concerns about the potential liability implications of naming persons in the auditor's report. Because the disclosure of auditor tenure does not have the same potential liability consequences, such an approach is unnecessary in this case. In addition, some commenters preferred tenure disclosure on Form AP because of a concern that disclosure in the auditor's report could result in inappropriate inferences about correlations between auditor tenure and audit quality, or between auditor tenure and auditor independence. The Board is not persuaded by such concerns. Further, the final standard allows the auditor flexibility in the location of the auditor tenure disclosure in the auditor's report.

The Board determined that disclosure will be better achieved through the auditor's report because the information will be more readily accessible upon the filing with the SEC of a document containing audited financial statements and poses lower search costs, particularly for those investors who may prefer to have the information provided in the auditor's primary means of communication. In addition, disclosing tenure in the auditor's report will make information available earlier to investors, which may assist in their voting on auditor ratification. However, disclosing auditor tenure in the auditor's report rather than Form AP could result in higher costs to investors that wish to accumulate tenure data for a large number of companies or compare data across companies because these investors will have to acquire tenure data from each company's auditor's report separately or from a data aggregator.

*See also* Section IV.B.1 for a discussion of the Board's considerations.

d. Additional Improvements to the Auditor's Report

The final standard includes a number of requirements that will enhance the standardized content of the auditor's report by clarifying the auditor's role and responsibilities related to the audit of the financial statements. These include, for example, statements regarding auditor independence requirements and the addition of the phrase "whether due to error or fraud," when describing the auditor's responsibility under PCAOB standards to obtain reasonable assurance about whether the financial statements are free of material misstatements. In addition, the final standard includes requirements intended to promote uniformity in the form of the auditor's report. These include requirements as to the addressee, a specific order of certain sections of the auditor's report, and required section headings.

Many commenters generally supported these enhancements and suggested that such enhancements will increase the usability of the auditor's report by improving financial statement users' understanding of the auditor's responsibilities, reducing search costs for information in the auditor's report, and facilitating comparisons across auditor's reports.

## VII. Applicability of Critical Audit Matter Requirements

### A. Brokers and Dealers, Investment Companies, and Benefit Plans

The reproposed standard did not require communication of critical audit matters for audits of brokers and dealers reporting under Exchange Act Rule 17a-5, investment companies other than business development companies ("BDCs"), and benefit plans. The reproposing release described the Board's rationale, including economic considerations, for such exclusions from the critical audit matter requirements and noted that auditors of these entities would not be precluded from including critical audit matters in the auditor's report voluntarily.

Commenters generally supported these exclusions, pointing to the same or similar reasons to those described by the Board in the reproposing release. Some commenters asserted that the communication of critical audit matters should apply to all companies. One commenter supported voluntary communication of critical audit matters for the exempted entities. Another commenter disagreed with providing auditors the ability to voluntarily communicate critical audit matters for brokers and dealers and investment companies. This commenter also suggested that all broker-dealers, including broker-dealers that are issuers, should be excluded from the requirement.

After considering the comments received and evaluating benefits and costs, the final standard excludes the audits of brokers and dealers that are reporting under Exchange Act Rule 17a-5, investment companies other than BDCs, and benefit plans, from the critical audit matter requirements as reproposed.[185] Auditors of these entities may choose to include critical audit matters in the auditor's report voluntarily.

The Board's rationales for these exclusions are described below.

*1. Brokers and Dealers Reporting under Exchange Act Rule 17a-5*

Pursuant to Exchange Act Rule 17a-5, the annual reports that brokers and dealers file with the SEC are public, except that if the statement of financial condition in the financial report is bound separately from the balance of the annual report, the balance of the annual report is deemed confidential and nonpublic.[186] In this situation, the auditor would generally issue two separate auditor's reports that would have different content: (1) an auditor's report on the statement of financial condition that would be available to the public and (2) an auditor's report on the complete financial report that, except as provided in paragraph (c)(2)(iv) of Exchange Act Rule 17a-5, would be confidential and not available to the public.[187] Research by the PCAOB's Office of Economic and Risk Analysis ("ERA")[188] indicates that, for approximately half of brokers and dealers, the complete financial report and the related auditor's report are confidential and not available to the public.

In 2013, the Board adopted new standards related to brokers and dealers that enhanced the auditor's performance and reporting responsibilities for financial

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[185] The other requirements of the final standard will be applicable to audits of these entities.

[186] *See* Exchange Act Rule 17a-5(e), 17 CFR 240.17a-5(e).

[187] *See also* Exchange Act Rule 17a-5(c)(2), 17 CFR 240.17a-5(c)(2), regarding audited statements required to be provided to customers.

[188] ERA's research was conducted on brokers and dealers who filed financial statements through May 15, 2015, for fiscal years ended during 2014 that included audit reports issued by firms registered with the PCAOB.

statement audits, as well as engagements on compliance and exemption reports of brokers and dealers.[189]

Some commenters on the proposal asserted that the value of reporting critical audit matters for brokers and dealers would be significantly limited by the closely held nature of brokers and dealers; the limited number of users of their financial statements; and the fact that, in many cases, only the statement of financial condition is available publicly. Some commenters also recognized that both the SEC and PCAOB recently updated their rules to further enhance reporting by brokers and dealers and their auditors.

Research by ERA indicates that currently there are no brokers or dealers that are issuers. Rather, brokers and dealers are often owned by a holding company, an individual, or a group of individuals that holds a controlling interest. The owners of brokers and dealers are generally part of the management of the entity and therefore would have direct access to the auditor. Given that, in many cases, there is much less separation of ownership and control in brokers and dealers than in issuers, the communication of critical audit matters would provide little information about the audit that would otherwise be unobtainable by investors.

Although there may be circumstances in which other financial statement users may benefit from reduced information asymmetry about the audits of brokers and dealers, certain aspects of broker and dealer financial reporting may limit the benefits of requiring the communication of critical audit matters. For example, while other financial statement users, such as customers of brokers and dealers, may benefit from increased information about the audit, the ability for brokers and dealers to file certain financial statements and schedules confidentially would require the auditor to identify and communicate critical audit matters that apply only to the publicly available statement of financial condition. This may reduce the value of communicating critical audit matters for brokers and dealers relative to issuers. Moreover, customers of brokers and dealers may be interested in the overall financial position of the broker or dealer but may not benefit from audit-specific information in the same way as investors in an issuer.

The communication of critical audit matters may also impose additional costs on the auditors of brokers and dealers relative to the auditors of other types of companies,

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[189] *See Attestation Standards for Engagements Related to Broker and Dealer Compliance or Exemption Reports Required by the U.S. Securities and Exchange Commission and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-007 (Oct. 10, 2013) and *Auditing Standard No. 17, Auditing Supplemental Information Accompanying Audited Financial Statements and Related Amendments to PCAOB Standards*, PCAOB Release No. 2013-008 (Oct. 10, 2013).

as they would have to identify critical audit matters that apply exclusively to the publicly available financial information, which may be difficult in some situations.

After consideration of the ownership and reporting characteristics of brokers and dealers, the comments received on the proposal and reproposal, and the Board's recent standard-setting activities related to brokers and dealers, the Board does not believe that reporting of critical audit matters for brokers and dealers will provide meaningful information in the same way as for issuers. Therefore, the communication of critical audit matters is not required for audits of brokers and dealers reporting under Exchange Act Rule 17a-5. If a broker or dealer were an issuer required to file audited financial statements under Section 13 or 15(d) of the Exchange Act, the requirements would apply.

2. *Investment Companies*

The Investment Company Act generally defines an investment company as any issuer that is engaged primarily in the business of investing, reinvesting, or trading in securities.[190] Most investment companies registered under the Investment Company Act are required to file with the SEC annual reports on Form N-CSR containing audited financial statements.[191] The Investment Company Act includes specific requirements for investment companies, intended to reduce investors' risks, in areas such as an investment company's portfolio diversification, liquidity, leverage, and custody of securities.[192]

In an SEC rulemaking, the SEC observed that commenters believed the key information that investors use in deciding to invest in an investment company includes an investment company's investment objectives, strategies, risks, costs, and performance.[193] The disclosure of information about these items appears in the annual prospectus that investment companies provide to current and future investors.[194]

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[190] *See* Section 3(a)(1) of the Investment Company Act.

[191] *See* SEC Rules under Section 30(e) of the Investment Company Act.

[192] *See, e.g.,* Sections 12, 13, and 17 of the Investment Company Act.

[193] *See* SEC, *Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies*, Securities Act Release No. 8998, 74 FR 4546 (Jan. 26, 2009). *See also* Investment Company Institute, *Understanding Investor Preferences for Mutual Fund Information* (Aug. 2006) at 2–3.

[194] *See* SEC Rules under Section 30(e) of the Investment Company Act.

Changes to investment objectives and strategies require shareholder approval or disclosure.[195]

Several commenters on the proposal noted that an investor's decision to invest in an investment company is primarily based on the investment objectives, risks, performance, and fees, and critical audit matters are not expected to provide information about these items and therefore would not be relevant. These and other commenters generally stated that investment companies are designed for the sole purpose of trading in and holding investments and auditor judgment would arise primarily with respect to valuation of investments, which would tend to be repeated as a critical audit matter. One of these commenters noted that, since the strategies of investment companies do not change significantly over time, the critical audit matters identified could become standardized from one reporting period to the next and also across funds with similar objectives.

Even though the disclosures required under the Investment Company Act and other federal securities laws provide investors with useful information, they may not fully substitute for the communication of critical audit matters. The required communication of critical audit matters contemplates that auditors would provide investors with audit-specific information, which is unlikely to appear in the disclosures provided by management. In addition, some academic research documented a difference in the perceived usefulness and reliability of information depending on the location of the disclosure and whether it was disclosed by management or by the independent auditor.[196] This academic research suggests that the auditor's communication of information similar to critical audit matters may provide value to investors because it comes from the auditor, even if the same information is disclosed by management in the experimental design of the study.

The benefits of providing critical audit matters, however, may be smaller for investment companies, other than BDCs, relative to other types of companies because of their purpose and structure. Unlike companies whose business models can change over time, investment companies have specific investment mandates that are disclosed in the prospectus and rarely change. This creates the potential for critical audit matters of investment companies to become excessively repetitive, making them uninformative.

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[195] *See* Sections 8(b) and 13(a)(3) of the Investment Company Act and Investment Company Act Rule 8b-16.

[196] *See, e.g.*, Christensen et al., *Do Critical Audit Matter Paragraphs in the Audit Report Change Nonprofessional Investors' Decision to Invest?*

There may also be additional costs of applying critical audit matter requirements to audits of investment companies, other than BDCs, as compared to audits of other types of companies. For example, in some cases, annual shareholder reports of affiliated investment companies with the same fiscal year-end might be filed with the SEC in one document, which generally contains a single auditor's report that covers multiple audited investment companies. In these situations, communicating critical audit matters specific to each investment company may require the auditor to prepare separate auditor's reports. This could increase costs for these types of investment companies.

After consideration of the purpose and reporting characteristics of investment companies and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of most investment companies, although they will apply to audits of investment companies regulated as BDCs.[197] Unlike the audits of many other investment companies, auditing the valuation of BDCs' investments generally involves complexity and auditor judgments due to the nature of the BDCs' portfolios. Also, because of the more diverse operations of BDCs, such as providing managerial assistance and involvement with more complex debt and equity instruments than other investment companies, communication of critical audit matters in a BDC audit could be more informative to investors. Additionally, BDCs follow a reporting regime under the Exchange Act that is more closely aligned with that of companies to which the Board is applying the requirements for critical audit matters. For these reasons, the Board believes it is appropriate for audits of BDCs to be subject to critical audit matter requirements.

*3. Benefit plans*

Benefit plans that purchase and hold securities of the plan sponsor using participants' contributions are generally required to file with the SEC an annual report on Form 11-K[198] that includes the benefit plan's audited financial statements and the related auditor's report.[199] The audit of the financial statements included in a filing on Form 11-K is performed in accordance with the standards of the PCAOB. Benefit plans are also generally subject to the financial reporting requirements of the Employee

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197 *See* Section 54 of the Investment Company Act.

198 *See* Section 15(d) of the Exchange Act.

199 A benefit plan's audited financial statements may also be included as part of the annual report of the issuer sponsoring the benefit plan. *See* Exchange Act Rule 15d-21, CFR 240.15d-21.

Retirement Income Security Act of 1974 ("ERISA"), including the U.S. Department of Labor's ("DOL") rules and regulations for disclosure under ERISA.[200]

Participation in a benefit plan is limited to eligible employees of the plan sponsor. Each plan participant in a defined contribution benefit plan is responsible for selecting, from the investment options made available by the plan sponsor, the specific investments in which the participant's funds are invested.

Employee stock benefit plans are generally less complex than other types of companies because they are designed for the sole purpose of holding the plan's investments for the participants' benefit. A plan's financial statements reflect summary information about the plan's assets and liabilities by aggregating the balances of all plan participants. However, only the individual account statements that plan participants receive periodically provide information specific to each participant's investments.

Several commenters on the proposal suggested excluding audits of benefit plans from the requirement for reporting critical audit matters due to the unique characteristics of these entities and their differences from other types of companies. For example, some commenters indicated that benefit plans are designed for a specific purpose and, as a result, would likely have similar critical audit matters from one reporting period to the next. Other commenters noted that benefit plans are inherently less complex and entail fewer estimates and judgments.

The communication of critical audit matters could provide information about any complex issues that were identified during the audit and how the auditor addressed them. However, since a benefit plan's assets and liabilities aggregate the balances of all plan participants, the financial statements or related critical audit matters would not provide actionable information about a plan participant's specific investment. Further, given the nature of benefit plans, there is a chance that the same critical audit matters would be communicated each year. For example, the valuation of investments is likely to be the most complex area in the audit of a benefit plan and therefore may be a critical audit matter in each reporting period, making the information less useful.

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[200] ERISA Section 103(a)(3)(A) requires a plan administrator to engage an independent auditor to conduct an examination of the plan's financial statements and required schedules in accordance with generally accepted auditing standards. *See* 29 CFR 2520.103-1. Benefit plans subject to ERISA also file with the DOL an annual report on Form 5500, including audited financial statements and an auditor's report. *See also* FASB ASC 960-10-05-6.

After consideration of the structure and reporting characteristics of benefit plans and the comments received on the proposal and reproposal, the Board has determined not to require the communication of critical audit matters for audits of benefit plans.

## B. Smaller Companies

The reproposal sought comment on whether the critical audit matter requirements should not apply to audits of other types of companies, in addition to the exempted entities discussed above. Some commenters asserted that the communication of critical audit matters should apply to all companies. Other commenters recommended that the Board give consideration to not applying the critical audit matter requirements to audits of smaller reporting companies[201] and nonaccelerated filers[202] due to their smaller size and because, in the commenters' view, communication of critical audit mattes would not provide sufficient benefits for these companies to justify the costs.

Academic research suggests that smaller companies have a higher degree of information asymmetry relative to the broader population of companies. Although the degree of information asymmetry surrounding a particular issuer is unobservable, researchers have developed a number of proxies that are thought to be correlated with information asymmetry, including small issuer size, lower analyst coverage, larger insider holdings, and higher research and development costs.[203] To the extent that a

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[201] In general, a "smaller reporting company" means an issuer with less than $75 million in public float or zero public float and annual revenues of less than $50 million during the most recently completed fiscal year for which audited financial statements are available. *See* Exchange Act Rule 12b-2, 17 CFR 240.12b-2. Smaller reporting companies currently make up approximately 42 percent of Form 10-K filers. The SEC recently proposed changes to the definition of smaller reporting companies, which would increase the percentage of smaller reporting companies to approximately 52 percent of Form 10-K filers. *See* SEC, *Amendments to Smaller Reporting Company Definition*, Release No. 33-10107 (June 27, 2016), 81 FR 43130 (July 1, 2016).

[202] Nonaccelerated filers are not defined in SEC rules but are generally understood to be companies that do not meet the definition of large accelerated filer or accelerated filer.

[203] *See*, *e.g.*, David Aboody, and Baruch Lev, *Information Asymmetry, R&D, and Insider Gains*, 55 The Journal of Finance 2747, 2747-2766 (2000), Michael J. Brennan and Avanidhar Subrahmanyam, *Investment Analysis and Price Formation in Securities Markets*, 38 Journal of Financial Economics 361, 361-381 (1995), Varadarajan V. Chari, Ravi Jagannathan, and Aharon R. Ofer, *Seasonalities in Security Returns: The Case of Earnings Announcements*, 21 Journal of Financial Economics

smaller company can be characterized as exhibiting one or more of these properties, this may suggest that it has a greater degree of information asymmetry relative to the broader population of companies. This would suggest that there is a higher likelihood that critical audit matters could provide new information about a smaller company than a large one for which there already exists a variety of information sources (such as annual reports, news media, and analyst research reports).

After consideration of comments, academic research, and data regarding the number of such companies, the final standard does not exclude smaller companies from the critical audit matter requirements. However, as discussed below, the Board has determined that it is appropriate to give auditors of smaller companies additional time to implement the new requirements. If approved by the SEC, auditors of companies that are not large accelerated filers will have an additional 18 months to implement the requirements for critical audit matters and will be able to benefit from the experiences of auditors of larger companies.

*Requirements of Other Regulators and Standard Setters*

Under the IAASB's standard, the communication of key audit matters applies to listed entities.[204] The EU requirements apply to audits of PIEs, including listed companies, credit institutions, and insurance companies.[205] The FRC 2013 requirements apply to auditor's reports for entities that apply the UK Corporate Governance Code.[206]

## VIII. <u>Considerations for Audits of Emerging Growth Companies</u>

Section 104 of the Jumpstart Our Business Startups ("JOBS") Act imposes certain limitations with respect to application of the Board's standards to audits of EGCs, as defined in Section 3(a)(80) of the Exchange Act. Section 104 provides that "[a]ny

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101, 101-121 (1988), and Raymond Chiang, and P. C. Venkatesh, *Insider Holdings and Perceptions of Information Asymmetry: A note*, 43 The Journal of Finance 1041, 1041-1048 (1988).

[204] *See* paragraph 5 of ISA 701.

[205] *See* requirements in 1 of Article 2, *Audit Report* of Regulation (EU) No 537/2014.

[206] These include companies with a premium listing of equity shares on the London Stock Exchange regardless of whether they are incorporated in the U.K. or elsewhere.

rules of the Board requiring . . . a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements of the issuer (auditor discussion and analysis) shall not apply to an audit of an emerging growth company . . ."[207] Auditor discussion and analysis ("AD&A") does not exist in auditing standards. The idea was introduced in the concept release, which described AD&A as one of several conceptual alternatives for changing the auditor's reporting model.[208]

Section 104 of the JOBS Act further provides that any additional rules adopted by the Board subsequent to April 5, 2012, do not apply to the audits of EGCs unless the SEC "determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation."[209] As a result of the JOBS Act, the final standard and amendments are subject to an evaluation as to whether they could, and if so, should be applicable to the audits of EGCs.

## A. Critical Audit Matters

The reproposal solicited comment on the application of critical audit matter requirements to the audits of EGCs. Commenters on this issue generally favored applying the standard to audits of EGCs, primarily because investors in these companies would benefit from the additional information communicated in the auditor's report in the same way that investors in larger companies would. Two commenters recommended that the critical audit matter requirements not apply to audits of EGCs because there would not be sufficient benefits to justify the costs.

Three commenters addressed the legal question of whether the JOBS Act provision on AD&A would prohibit the Board from applying critical audit matter requirements to audits of EGCs. Two of these commenters suggested that this would be

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207 *See* Pub. L. No. 112-106 (Apr. 5, 2012). *See* Section 103(a)(3)(C) of Sarbanes-Oxley, as added by Section 104 of the JOBS Act.

208 *See* PCAOB Release No. 2011-003 (June 21, 2011) at 2 (describing one alternative as "a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the company's financial statements (an 'Auditor's Discussion and Analysis')"). Section IV.A., *Auditor's Discussion and Analysis,* of the proposal further described AD&A and related comments received on the concept release.

209 *Supra* note 207.

prohibited, on the basis that critical audit matters "appear substantively similar to"[210] or "closely resemble"[211] AD&A. The SEC's Investor Advocate stated that, from a policy perspective, critical audit matter requirements should apply to audits of EGCs, and recommended that the PCAOB adopt the standard for policy reasons and let the SEC determine the legal question.[212] This commenter also recommended that, "to prepare for any outcome of [the SEC's] determination," the PCAOB should "encourage auditors, on a voluntary basis, to include critical audit matter communications in the auditor's reports on EGCs."[213]

The requirements for critical audit matters share characteristics with two of the alternative approaches described in the concept release: required and expanded explanatory paragraphs and AD&A. Similar to critical audit matters, required and expanded explanatory paragraphs involved additional paragraphs in the auditor's report that would have highlighted areas of critical importance to the financial statements, with auditor comment on key audit procedures and a reference to relevant financial statement accounts and disclosure. AD&A, by contrast, envisioned a supplemental report in addition to the auditor's report that could cover a broad range of issues, including the auditor's views regarding the company's financial statements, material matters as to which the auditor believed disclosure could be enhanced, and areas where management could have applied different accounting or disclosure approaches.

However, critical audit matters go beyond the content of a required and expanded explanatory paragraph by including a discussion of the principal reasons the auditor determined that a matter was a critical audit matter. Further, although this is not required, critical audit matters could potentially include a discussion of auditor findings. These additional elements may make critical audit matters resemble AD&A in some respects. This potential similarity, together with the fact that there has been no authoritative interpretation of Section 104 of the JOBS Act, creates some uncertainty as

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[210] *See* letter from the U.S. Chamber of Commerce, Center for Capital Markets Competitiveness (Aug. 15, 2016) at 10, available on the Board's website in Docket 034.

[211] *See* letter from Robert N. Waxman (Aug. 15, 2016) at 24, available on the Board's website in Docket 034.

[212] *See* letter from Rick A. Fleming, Investor Advocate, SEC (Aug. 15, 2016) at 5-6, available on the Board's website in Docket 034 (noting that "the SEC will need to make a legal determination on whether such a requirement with respect to the audits of EGCs would accord with certain provisions of" the JOBS Act).

[213] *Id.* at 6.

to whether it is legally permissible for critical audit matter requirements to be mandated for EGC audits. In view of this uncertainty, the Board has determined not to apply the requirements regarding critical audit matters to audits of EGCs at this time.

As with other audits where critical audit matter requirements do not apply, voluntary application is permissible. EGCs and their auditors can consider whether investors would benefit from additional information about the audit from the auditor's point of view.

## B. Additional Improvements to the Auditor's Report

The additional improvements to the auditor's report contained in the final standard and amendments do not raise concerns under the AD&A provisions of the JOBS Act, but instead fall within the category of "additional rules" that may not be applied to audits of EGCs unless the SEC determines that doing so "is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation." The Board is providing this analysis to assist the SEC in making this determination.

To inform consideration of the application of auditing standards to audits of EGCs, the staff has also published a white paper that provides general information about characteristics of EGCs.[214] The data on EGCs outlined in the white paper remains generally consistent with the data discussed in the reproposal. A majority of EGCs continue to be smaller public companies that are generally new to the SEC reporting process. This suggests that there is less information available to investors regarding such companies (a higher degree of information asymmetry) relative to the broader population of public companies because, in general, investors are less informed about companies that are smaller and newer. For example, smaller companies have very little, if any, analyst coverage which reduces the amount of information made available to financial statement users and therefore makes markets less efficient.[215]

The reproposal solicited comment on whether the elements of the reproposed standard and amendments other than the requirements for critical audit matters should apply to the audits of EGCs. As noted above, one commenter supported application of the entire standard and amendments to EGCs (without differentiating between critical audit matters and other elements), and one commenter opposed application of the

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[214] *See White Paper on Characteristics of Emerging Growth Companies as of November 15, 2016* (Mar. 28, 2017), available on the Board's website in Docket 034.

[215] *See* SEC, *Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission* (Apr. 23, 2006) at 73.

entire standard and amendments. In addition, one commenter supported applying some of the reproposed improvements to the auditor's report to audits of EGCs (the requirement as to addressee and the clarifications of existing auditor responsibilities, as well as a modified version of the statement regarding auditor independence), but generally opposed the other aspects of the reproposal for both EGCs and other companies.

As described in Section VI.C.2. above, the additional improvements to the auditor's report are intended to provide a consistent location and decrease search costs with respect to information about auditor tenure, enhance users' understanding of the auditor's role, make the auditor's report easier to read and facilitate comparison across companies by making the format consistent. As described in Section VI.D.1.b. above, the costs associated with these changes are not expected to be significant and are primarily one-time, rather than recurring, costs.

For the reasons explained above, the Board believes that the additional improvements to the auditor's report contained in the final standard and amendments are in the public interest and, after considering the protection of investors and the promotion of efficiency, competition, and capital formation, recommends that the final standard and amendments should apply to audits of EGCs. Accordingly, the Board recommends that the SEC determine that it is necessary or appropriate in the public interest, after considering the protection of investors and whether the action will promote efficiency, competition, and capital formation, to apply the final standard and amendments, other than the provisions relating to critical audit matters, to audits of EGCs. The Board stands ready to assist the SEC in considering any comments the SEC receives on these matters during the SEC's public comment process.

## IX. Effective Date

The reproposal sought comment on how much time auditors would need to implement the standard, if adopted by the Board and approved by the SEC. The reproposal also solicited input on whether the Board should consider a delayed compliance date for the reproposed standard, or for certain parts of the reproposed standard, for audits of smaller companies and, if so, what criteria the Board should use in its consideration.

Commenters suggested a wide range of effective dates for the standard. Some commenters encouraged expeditious adoption of the final standard. One of these commenters suggested an effective date for audits of financial statements for periods ending on or after December 2017. Some commenters recommended that the effective date be a year after approval by the SEC, but no earlier than for auditor's reports issued on or after December 15, 2018. Other commenters suggested that the effective date be no earlier than for audit periods ending two years after approval by the SEC, primarily because of the audit firms' need to develop and implement training and quality control processes to support expanded auditor reporting. One commenter suggested that the Board delay the effective date until after the implementation of FASB ASU No. 2014-09, *Revenue from Contracts with Customers* (which, for issuers, will apply for fiscal years beginning after December 15, 2017).

Many commenters supported phased implementation of the final standard, or of the portion of the standard related to communication of critical audit matters, suggesting that implementation start with large accelerated filers[216] and a year later become effective for other companies in order to allow auditors of smaller companies to benefit from the experience of the audits of large accelerated filers.

After considering the comments received, the Board has chosen a phased approach to the effective date for the new requirements. If approved by the SEC, the final standard and related amendments to auditing standards will take effect as follows:

- All paragraphs of the final standard and related amendments, except the paragraphs in the Critical Audit Matters section of the standard (paragraphs .11 through .17) and amendments related to those paragraphs: audits of fiscal years ending on or after December 15, 2017.

- All paragraphs in the Critical Audit Matters section of the final standard and amendments related to those paragraphs:

    - *For audits of large accelerated filers*: fiscal years ending on or after June 30, 2019; and

    - *For audits of all other companies to which the requirements apply*: fiscal years ending on or after December 15, 2020.

A phased approach to the effective date will provide investors and other financial statement users with the new form auditor's report, other than the communication of critical audit matters, as soon as reasonably practicable. The later effective dates for the communication of critical audit matters provide accounting firms, companies, and audit committees more time to prepare for implementation of the requirements that are expected to require more effort to implement than the additional improvements to the auditor's report.

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216 In general, "large accelerated filer" means an issuer with a public float of $700 million or more that has been subject to Exchange Act periodic reporting requirements for at least one year and has filed at least one annual report. *See* Exchange Act Rule 12b-2, 17 CFR 240.12b-2.

In selecting the effective date of the critical audit matter requirements for audits of large accelerated filers, the Board considered commenter suggestions that large accelerated filers and their auditors[217] generally have more resources to address the new requirements to help establish best practice as compared to smaller companies and their auditors. Further, the Board did not choose a calendar year-end effective date to allow auditors of large accelerated filers to gain experience implementing the critical audit matter communications at a time when fewer audits are being completed, outside of the busy calendar year-end reporting cycle.[218]

In response to comments, the effective date of the final standard with respect to the communication of critical audit matters is delayed by 18 months for audits of companies that are not large accelerated filers. In determining to adopt the effective date for these audits, the Board agreed with commenter input that auditors of smaller companies, which are often smaller audit firms, could benefit from the experience of the audits of large accelerated filers. In addition, the phased effective date may facilitate any post-implementation review of the impact of the final standard.

Auditors may elect to comply before the effective date, at any point after SEC approval of the final standard.

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[217] Research by ERA indicates that approximately 79 percent of the large accelerated filers that filed audited financial statements with the SEC during the 18 months prior to December 31, 2016 are audited by the four largest US audit firms (measured by number of issuer audits); 6 percent are audited by other annually inspected US firms; and the rest are audited by triennially inspected firms—13 percent by non-US affiliates of the six largest US firms (measured by number of issuer audits) and 2 percent by other US firms.

[218] Research by ERA indicates that approximately 11 percent of the large accelerated filers that filed audited financial statements with the SEC during the 18 months prior to December 31, 2016 have year ends between June 30 and November 30.

On the 1st day of June, in the year 2017, the foregoing was, in accordance with the bylaws of the Public Company Accounting Oversight Board,

ADOPTED BY THE BOARD.

/s/ Phoebe W. Brown

Phoebe W. Brown
Secretary

PCAOB
Public Company Accounting Oversight Board

## APPENDIX 1

## AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

### *Introduction*

.01 The auditor's report contains either an expression of opinion on the financial statements,[1] taken as a whole,[2] or an assertion that an opinion cannot be expressed. This standard establishes requirements regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report").[3]

.02 The auditor is in a position to express an unqualified opinion on the financial statements when the auditor conducted an audit in accordance with the standards of the Public Company Accounting Oversight Board ("PCAOB") and concludes that the financial statements, taken as a whole, are presented fairly, in all material respects,[4] in conformity with the applicable financial reporting

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[1] This standard uses the term "financial statements" as used by the U.S. Securities and Exchange Commission ("SEC") to include all notes to the statements and all related schedules. *See* Regulation S-X Rule 1-01(b), 17 CFR 210.1-01(b). This and other PCAOB standards often refer to the notes as disclosures; *see*, *e.g.*, AS 2110, *Identifying and Assessing Risks of Material Misstatement*.

[2] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[3] Paragraphs .85-.98 and Appendix C, *Special Reporting Situations*, of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting.

[4] AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* describes the basis for an auditor's responsibility for forming an opinion on whether the company's financial statements are presented fairly in conformity with the applicable financial reporting framework.

framework.[5]

.03 When the auditor conducts an audit of financial statements in accordance with the standards of the PCAOB, some circumstances require that the auditor express a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements and state the reasons for the departure from the unqualified opinion. AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to departures from unqualified opinions and other reporting circumstances.

## *Objectives*

.04 The objectives of the auditor when the auditor concludes that an unqualified opinion is appropriate are to:

a. Issue a written report that expresses an unqualified opinion on the financial statements and describes the basis for that opinion; and

b. Communicate in the auditor's unqualified report **critical audit matters,**[6] when required, relating to the audit of the financial statements or state that the auditor determined that there are no critical audit matters.

## *The Auditor's Unqualified Report*

.05 The auditor's unqualified report includes:[7]

a. The basic elements,[8] as described in paragraphs .06-.10;

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[5] The auditor should look to the requirements of the SEC for the company under audit with respect to the accounting principles applicable to that company.

[6] This term is defined in Appendix A, *Definitions*, and is set in **boldface type** the first time it appears.

[7] Appendix B provides an illustrative auditor's unqualified report.

[8] Laws, rules, and forms may contain requirements for auditor's reports of different types of companies. *See*, *e.g.,* Sections 30(g) and 32(a)(4) of the Investment Company Act; Regulation S-X Rule 2-02, 17 CFR 210.2-02; and

b. Communication regarding critical audit matters relating to the audit of the current period's financial statements, as described in paragraphs .11-.17, unless such requirements do not apply;

Note: Communication of critical audit matters is not required for audits of (1) brokers[9] and dealers[10] reporting under Exchange Act Rule 17a-5; (2) investment companies registered under the Investment Company Act of 1940 ("Investment Company Act"),[11] other than companies that have elected to be regulated as business development companies;[12] (3) employee stock purchase, savings, and similar plans;[13] and (4) emerging growth companies.[14] Auditors of these entities may consider voluntarily including communication of critical audit matters as described in this standard.

c. Other explanatory language (or an explanatory paragraph), as appropriate in the circumstances, as described in paragraphs .18-.19; and

d. Information about certain audit participants, if the auditor decides to provide this information in the auditor's report, as described in paragraph .20.

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Securities Exchange Act of 1934 ("Exchange Act") Rule 17a-5, 17 CFR 240.17a-5. Auditor's reports on financial statements filed with the SEC are subject to all such applicable requirements.

9 *See* PCAOB Rule 1001(b)(iii).

10 *See* PCAOB Rule 1001(d)(iii).

11 *See* Section 8 of the Investment Company Act.

12 *See* Section 54 of the Investment Company Act.

13 *See* Exchange Act Rule 15d-21, 17 CFR 240.15d-21.

14 *See* Section 3(a)(80) of the Exchange Act.

## Basic Elements

*Title*

.06 The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

.07 The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Financial Statements*

.08 The first section of the auditor's report must include the section title "Opinion on the Financial Statements" and the following elements:

a. The name of the company whose financial statements were audited;

b. A statement identifying each financial statement and any related schedule(s) that has been audited;[15]

c. The date of, or period covered by, each financial statement and related schedule, if applicable, identified in the report;

d. A statement indicating that the financial statements, including the related notes and any related schedule(s), identified and collectively referred to in the report as the financial statements, were audited; and

e. An opinion that the financial statements present fairly, in all material respects, the financial position of the company as of the balance

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[15] Various SEC rules and forms require that companies file schedules of information and that those schedules be audited if the company's financial statements are audited. *See*, *e.g.,* Regulation S-X Rules 5-04, 6-10, 6A-05, and 7-05, 17 CFR 210.5-04, 210.6-10, 210.6A-05, 210.7-05. *See generally*, Regulation S-X Rule 12-01, 17 CFR 210.12-01, et seq., which address the form and content of certain SEC-required schedules.

sheet date and the results of its operations and its cash flows for the period then ended in conformity with the applicable financial reporting framework.[16] The opinion should also include an identification of the applicable financial reporting framework.

*Basis for Opinion*

.09 The second section of the auditor's report must include the section title "Basis for Opinion" and the following elements:

a. A statement that the financial statements are the responsibility of the company's management;

b. A statement that the auditor's responsibility is to express an opinion on the financial statements based on the audit;

c. A statement that the audit was conducted in accordance with the standards of the PCAOB;

d. A statement that PCAOB standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud;

e. A statement that the audit included:

(1) Performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks;

(2) Examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements;

(3) Evaluating the accounting principles used and significant estimates made by management; and

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[16] The terms used in the Opinion on the Financial Statements section, such as financial position, results of operations and cash flows, should be modified, as appropriate, depending on the type of company and financial statements being audited.

(4) Evaluating the overall presentation of the financial statements;

f. A statement that the auditor believes that the audit provides a reasonable basis for the auditor's opinion; and

g. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

*Signature, Tenure, Location, and Date*

.10 The auditor's report must include the following elements:

a. The signature of the auditor's firm;[17]

b. A statement containing the year the auditor began serving consecutively as the company's auditor;[18]

Note: For purposes of this subparagraph, references to the auditor include other firms that the auditor's firm has acquired or that have merged with the auditor's firm. If there is uncertainty as to the year the auditor began serving consecutively as the company's auditor, such as due to firm or company mergers, acquisitions, or changes in ownership structure, the auditor should state that the auditor is uncertain as to the year the auditor became the company's auditor and provide the earliest year of which the auditor has knowledge.

c. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued;[19] and

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[17] *See* Regulation S-X Rule 2-02(a), 17 CFR 210.2-02(a).

[18] For an investment company that is part of a group of investment companies, the statement contains the year the auditor began serving consecutively as the auditor of any investment company in the group of investment companies. *See* Section 12(d)(1)(G)(ii) of the Investment Company Act.

d. The date of the auditor's report.[20]

## Critical Audit Matters

*Determination of Critical Audit Matters*

.11 The auditor must determine whether there are any critical audit matters in the audit of the current period's financial statements. A critical audit matter is any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment. Critical audit matters are not a substitute for the auditor's departure from an unqualified opinion (i.e., a qualified opinion, adverse opinion, or disclaimer of opinion on the financial statements as described in AS 3105).

.12 In determining whether a matter involved especially challenging, subjective, or complex auditor judgment, the auditor should take into account, alone or in combination, the following factors, as well as other factors specific to the audit:

a. The auditor's assessment of the risks of material misstatement, including significant risks;

b. The degree of auditor judgment related to areas in the financial statements that involved the application of significant judgment or estimation by management, including estimates with significant measurement uncertainty;

c. The nature and timing of significant unusual transactions and the extent of audit effort and judgment related to these transactions;

d. The degree of auditor subjectivity in applying audit procedures to address the matter or in evaluating the results of those procedures;

e. The nature and extent of audit effort required to address the matter, including the extent of specialized skill or knowledge needed or the

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[19] *See* Regulation S-X Rule 2-02(a).

[20] *See* AS 3110, *Dating of the Independent Auditor's Report*.

nature of consultations outside the engagement team regarding the matter; and

f. The nature of audit evidence obtained regarding the matter.

Note: It is expected that, in most audits, the auditor would determine that at least one matter involved especially challenging, subjective, or complex auditor judgment.

*Communication of Critical Audit Matters*

.13 The auditor must communicate in the auditor's report critical audit matters[21] relating to the audit of the current period's financial statements or state that the auditor determined that there are no critical audit matters.

Note: When the current period's financial statements are presented on a comparative basis with those of one or more prior periods, the auditor may communicate critical audit matters relating to a prior period. This may be appropriate, for example, when (1) the prior period's financial statements are made public for the first time, such as in an initial public offering, or (2) issuing an auditor's report on the prior period's financial statements because the previously issued auditor's report could no longer be relied upon.

.14 For each critical audit matter communicated in the auditor's report the auditor must:

a. Identify the critical audit matter;

b. Describe the principal considerations that led the auditor to determine that the matter is a critical audit matter;

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[21] Critical audit matters are not a substitute for required explanatory language (paragraphs) described in paragraph .18. If a matter that meets the definition of a critical audit matter also requires an explanatory paragraph, such as a matter related to going concern, the auditor may include the information required under paragraph .14 in the explanatory paragraph with a cross-reference in the critical audit matters section of the auditor's report to the explanatory paragraph. Alternatively, the auditor may include the explanatory paragraph and critical audit matter communication separately in the auditor's report and add a cross-reference between the two sections.

c. Describe how the critical audit matter was addressed in the audit; and

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

d. Refer to the relevant financial statement accounts or disclosures that relate to the critical audit matter.

Note 1: Language that could be viewed as disclaiming, qualifying, restricting, or minimizing the auditor's responsibility for the critical audit matters or the auditor's opinion on the financial statements is not appropriate and may not be used. The language used to communicate a critical audit matter should not imply that the auditor is providing a separate opinion on the critical audit matter or on the accounts or disclosures to which they relate.

Note 2: When describing critical audit matters in the auditor's report, the auditor is not expected to provide information about the company that has not been made publicly available by the company unless such information is necessary to describe the principal considerations that led the auditor to determine that a matter is a critical audit matter or how the matter was addressed in the audit.

*Language Preceding Critical Audit Matters in the Auditor's Report*

.15 The following language, including the section title "Critical Audit Matters," should precede critical audit matters communicated in the auditor's report:

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Note: If the auditor communicates critical audit matters for prior periods, the language preceding the critical audit matters should be modified to indicate the periods to which the critical audit matters relate.

.16 In situations in which the auditor determines that there are no critical audit matters, the auditor should include the following language, including the section title "Critical Audit Matters," in the auditor's report:

Critical Audit Matters

Critical audit matters are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. We determined that there are no critical audit matters.

*Documentation of Critical Audit Matters*

.17 For each matter arising from the audit of the financial statements that:

a. Was communicated or required to be communicated to the audit committee; and

b. Relates to accounts or disclosures that are material to the financial statements;

the auditor must document whether or not the matter was determined to be a critical audit matter (i.e., involved especially challenging, subjective, or complex auditor judgment) and the basis for such determination.[22]

[22] Consistent with the requirements of AS 1215, *Audit Documentation*, the audit documentation should be in sufficient detail to enable an experienced auditor, having no previous connection with the engagement, to understand the determinations made to comply with the provisions of this standard.

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## Explanatory Language Added to the Auditor's Report

.18 Other standards of the PCAOB require that, in certain circumstances, the auditor include explanatory language (or an explanatory paragraph) in the auditor's report, while not affecting the auditor's opinion on the financial statements. These circumstances include when:

a. There is substantial doubt about the company's ability to continue as a going concern;[23]

b. The auditor decides to refer to the report of other auditors as the basis, in part, for the auditor's own report;[24]

c. There has been a change between periods in accounting principles or in the method of their application that has a material effect on the financial statements;[25]

d. There has been a change in a reporting entity, unless the change in the reporting entity results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit;[26]

e. A material misstatement in previously issued financial statements has been corrected;[27]

f. The auditor performs an integrated audit and issues separate reports on the company's financial statements and internal control over financial reporting;[28]

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[23] *See* AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*.

[24] *See* paragraphs .06-.09 of AS 1205, *Part of the Audit Performed by Other Independent Auditors.*

[25] *See* paragraphs .08 and .12-.15 of AS 2820, *Evaluating Consistency of Financial Statements*.

[26] *See* AS 2820.06.

[27] *See* AS 2820.09 and .16-.17.

g. Management is required to report on the company's internal controls over financial reporting but such report is not required to be audited,[29] and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of the company's internal control over financial reporting;[30]

h. Certain circumstances relating to reports on comparative financial statements exist;[31]

i. Selected quarterly financial data required by Item 302(a) of Regulation S-K is not appropriately presented, has been omitted, or has not been reviewed;[32]

j. Supplementary information required by the applicable financial reporting framework has been omitted, the presentation of such information departs materially from the requirements of the applicable financial reporting framework, the auditor is unable to complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to the requirements of the applicable financial reporting framework;[33]

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[28] *See* AS 2201.88. AS 2201 provides additional circumstances in which the auditor includes an explanatory paragraph. If the combined report is issued, AS 2201 notes that the auditor should consider those circumstances as well.

[29] *See* Item 308 of Regulation S-K.

[30] *See* AS 3105.59-.60.

[31] *See* AS 3105.52-.53 and .56-.58.

[32] *See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.

[33] *See* paragraphs .03 and .08 of AS 2705, *Required Supplementary Information*.

k. There has been a change in an investee year end that has a material effect on the company's financial statements;[34] and

l. Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements.[35]

## Emphasis of a Matter

.19 The auditor may emphasize a matter regarding the financial statements in the auditor's report ("emphasis paragraph").[36] The following are examples of matters, among others, that might be emphasized in the auditor's report:[37]

a. Significant transactions, including significant transactions with related parties;

b. Unusually important subsequent events, such as a catastrophe that has had, or continues to have, a significant effect on the company's financial position;

c. Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period;

d. An uncertainty relating to the future outcome of significant litigation or regulatory actions; and

e. That the entity is a component of a larger business enterprise.

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[34] *See* paragraph .32 of AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*.

[35] *See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.

[36] Emphasis paragraphs are never required and are not a substitute for required critical audit matters described in paragraphs .11-.17.

[37] It is not appropriate for the auditor to use phrases such as "with the foregoing [following] explanation" in the opinion paragraph when an emphasis paragraph is included in the auditor's report.

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If the auditor adds an emphasis paragraph in the auditor's report, the auditor should use an appropriate section title.

## Information about Certain Audit Participants

.20 The auditor may include in the auditor's report information regarding the engagement partner and/or other accounting firms participating in the audit that is required to be reported on PCAOB Form AP, *Auditor Reporting of Certain Audit Participants*.[38] If the auditor decides to provide information about the engagement partner, other accounting firms participating in the audit, or both, the auditor must disclose the following:

a. *Engagement partner*—the engagement partner's full name as required on Form AP; or

b. *Other accounting firms participating in the audit*:

i. A statement that the auditor is responsible for the audits or audit procedures performed by the other public accounting firms and has supervised or performed procedures to assume responsibility for their work in accordance with PCAOB standards;

ii. *Other accounting firms individually contributing 5% or more of total audit hour*s—for each firm, (1) the firm's legal name, (2) the city and state (or, if outside the United States, city and country) of headquarters' office, and (3) percentage of total audit hours as a single number or within an appropriate range, as is required to be reported on Form AP; and

iii. *Other accounting firms individually contributing less than 5% of total audit hours*—(1) the number of other accounting firms individually representing less than 5% of total audit hours and (2) the aggregate percentage of total audit hours of such firms as a single number or within an appropriate range, as is required to be reported on Form AP.

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[38] If the auditor decides to include information regarding certain audit participants in the auditor's report, the auditor should use an appropriate section title.

## *APPENDIX A – Definition*

A1. For purposes of this standard, the term listed below is defined as follows:

A2. Critical audit matter – Any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment.

> Note: Required audit committee communications are set forth in PCAOB standards, including AS 1301, *Communications with Audit Committees*, and Appendix B of that standard which refers to other PCAOB rules and standards.

## *APPENDIX B – An Illustrative Auditor's Unqualified Report Including Critical Audit Matters*

**Report of Independent Registered Public Accounting Firm**

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*], for each of the three years in the period ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company *as of* [*at*] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 20X2, in conformity with [*the applicable financial reporting framework*].

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

[*Include critical audit matters*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

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## APPENDIX 2

### *Amendments to Other PCAOB Standards Related to the Proposed Standard*

In connection with a new auditor reporting standard AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "final standard"), the Board is adopting related amendments to several of its other auditing standards as set out below. Language that is deleted by the amendments is struck through. Language that is added is underlined. Language that is moved without being modified, such as changes to the illustrative auditor's report to conform to the required order in the final standard, is double underlined.

## Contents

## I. Amendments to AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*

~~**AS 3101: Reports on Audited Financial Statements**~~ **AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances***

## Introduction

~~.01 This section applies to auditors' reports issued in connection with audits[1] of historical financial statements that are intended to present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. It distinguishes the types of reports, describes the circumstances in which each is appropriate, and provides example reports.~~

~~Note: When performing an integrated audit of financial statements and internal control over financial reporting, the auditor may choose to issue a combined report or separate reports on the company's financial statements and on internal control over financial reporting. Refer to paragraphs .85-.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201, for direction on reporting on internal control over financial reporting. In addition, *see* AS 2201.86-.88, which includes an illustrative combined audit report.~~

~~[1] An audit, for purposes of this section, is defined as an examination of historical financial statements performed in accordance with the standards of the PCAOB in effect at the time the audit is performed. In some cases, regulatory authorities may have additional requirements applicable to entities under their jurisdiction and auditors of such entities should consider those requirements.~~

~~.02 This section does not apply to unaudited financial statements as described in AS 3320, *Association with Financial Statements*, nor does it apply to reports on incomplete financial information or other special presentations as described in AS 3305, *Special Reports*.~~

~~.03 Justification for the expression of the auditor's opinion rests on the conformity of his or her audit with the standards of the PCAOB and on the findings. This section is concerned primarily with the relationship of the requirements in paragraph .04 to the language of the auditor's report.~~

~~.04 The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be~~

~~expressed. When an overall opinion cannot be expressed, the reasons therefor should be stated. In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.~~

~~.05 The objective of the requirements in paragraph .04 is to prevent misinterpretation of the degree of responsibility the auditor is assuming when his or her name is associated with financial statements. Reference in paragraph .04 to the financial statements "taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement (for example, to a balance sheet) for one or more periods presented. (Paragraph .65 discusses the requirements in paragraph .04 as it applies to comparative financial statements.) The auditor may express an unqualified opinion on one of the financial statements and express a qualified or adverse opinion or disclaim an opinion on another if the circumstances warrant.~~

~~.06 The auditor's report is customarily issued in connection with an entity's basic financial statements—balance sheet, statement of income, statement of retained earnings and statement of cash flows. Each financial statement audited should be specifically identified in the introductory paragraph of the auditor's report. If the basic financial statements include a separate statement of changes in stockholders' equity accounts, it should be identified in the introductory paragraph of the report but need not be reported on separately in the opinion paragraph since such changes are part of the presentation of financial position, results of operations, and cash flows.~~

## ~~The Auditor's Standard Report~~

~~.07 The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with the standards of the PCAOB.~~

~~.08 The auditor's standard report identifies the financial statements audited in an opening (introductory) paragraph, describes the nature of an audit in a scope paragraph, and expresses the auditor's opinion in a separate opinion paragraph. The basic elements of the report are the following:~~

> ~~*a.* A title that includes the word *independent*~~[3]

~~[3] This section does not require a title for an auditor's report if the auditor is not independent. *See* AS 3320 for guidance on reporting when the auditor is not independent.~~

~~*b.* A statement that the financial statements identified in the report were audited~~

~~*c.* A statement that the financial statements are the responsibility of the Company's management[4] and that the auditor's responsibility is to express an opinion on the financial statements based on his or her audit~~

~~[4] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility.~~

~~*d.* A statement that the audit was conducted in accordance with the standards of the PCAOB and an identification of the United States of America as the country of origin of those standards (for example, the standards of the Public Company Accounting Oversight Board (United States))~~

~~*e.* A statement that those standards require that the auditor plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement~~

~~*f.* A statement that an audit includes~~

~~(1) Examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements~~
~~(2) Assessing the accounting principles used and significant estimates made by management~~
~~(3) Evaluating the overall financial statement presentation[5]~~

~~[5] Paragraphs .03 and .04 of AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles,"* discuss the auditor's evaluation of the overall presentation of the financial statements.~~

~~*g.* A statement that the auditor believes that his or her audit provides a reasonable basis for his or her opinion~~

~~*h.* An opinion as to whether the financial statements present fairly, in all material respects, the financial position of the Company as of the balance sheet date and the results of its operations and its cash flows for the period then ended in conformity with generally accepted accounting principles. The opinion should include an identification of the United States of America as the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles)~~

~~*i.* The manual or printed signature of the auditor's firm~~

~~*j.* The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued[6A]~~

~~[6A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

~~*k.* The date[7] of the audit report~~

~~[7] For guidance on dating the auditor's report, *see* AS 3110, *Dating of the Independent Auditor's Report*.~~

~~The form of the auditor's standard report on financial statements covering a single year is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheet of X Company as of December 31, 20XX, and the related statements of income, retained earnings, and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20XX, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~The form of the auditor's standard report on comparative financial statements[8] is as follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the accompanying balance sheets of X Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.~~

~~In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of X Company as of [at] December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[*Signature*]~~

~~[*City and State or Country*]~~

~~[*Date*]~~

~~[8] If statements of income, retained earnings, and cash flows are presented on a comparative basis for one or more prior periods, but the balance sheet(s) as of the end of one (or more) of the prior period(s) is not presented, the phrase "for the years then ended" should be changed to indicate that the auditor's opinion applies to each period for which statements of income, retained earnings, and cash flows are presented, such as "for each of the three years in the period ended [date of latest balance sheet]."~~

~~*l.* When performing an integrated audit of financial statements and internal control over financial reporting, if the auditor issues separate reports on the company's financial statements and on internal control over financial reporting, the following paragraph should be added to the auditor's report on the company's financial statements:~~

> ~~We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of X Company's internal control over financial reporting as of December 31, 20X3, based on [identify control criteria] and our report dated [date of report, which should be the same as the date of the report on the financial statements] expressed [include nature of opinions].~~

~~.09 The report may be addressed to the company whose financial statements are being audited or to its board of directors or stockholders. A report on the financial statements of an unincorporated entity should be addressed as circumstances dictate, for example, to the partners, to the general partner, or to the proprietor. Occasionally, an auditor is retained to audit the financial statements of a company that is not a client; in such a case, the report is customarily addressed to the client and not to the directors or stockholders of the company whose financial statements are being audited.~~

.01~~0~~ The auditor's report contains either an expression of opinion on the financial statements, taken as a whole,[1] or an assertion that an opinion cannot be expressed. This standard ~~section~~ ~~also~~ discusses the circumstances that may require the auditor to depart from the ~~standard~~ auditor's unqualified report[2] and provides reporting guidance in the following circumstances: ~~This section is organized by type of opinion that the auditor may express in each of the various circumstances presented; this section describes what is meant by the various audit opinions:~~

- ~~*Unqualified opinion*. An unqualified opinion states that the financial statements present fairly, in all material respects, the financial position,~~

~~results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. This is the opinion expressed in the standard report discussed in paragraph .08.~~

- ~~*Explanatory language added to the auditor's standard report*. Certain circumstances, while not affecting the auditor's unqualified opinion on the financial statements, may require that the auditor add an explanatory paragraph (or other explanatory language) to his or her report.~~

- *Qualified opinion*. A qualified opinion states that, except for the effects of the matter(s) to which the qualification relates, the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .02 -.39.

- *Adverse opinion*. An adverse opinion states that the financial statements do not present fairly the financial position, results of operations, or cash flows of the entity in conformity with generally accepted accounting principles. *See* paragraphs .40 -.43.

- *Disclaimer of opinion.* A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. *See* paragraphs .44 -.47.

~~These opinions are discussed in greater detail throughout the remainder of this section.~~ This standard also discusses other reporting circumstances, such as reports on comparative financial statements.

[1] "Taken as a whole" applies equally to a complete set of financial statements and to an individual financial statement with appropriate disclosures.

[2] AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, establishes requirements for the auditor regarding the content of the auditor's written report when the auditor expresses an unqualified opinion on the financial statements (the "auditor's unqualified report"), including when explanatory language is added. Paragraphs .85–.98 of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, and Appendix C, *Special Reporting Situations*, of AS 2201 address the form and content of the auditor's report when the auditor performs an audit of internal control over financial reporting. *See also* AS 2201.87, which includes an illustrative combined audit report.

## ~~Explanatory Language Added to the Auditor's Standard Report~~

~~.11 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add an explanatory[9] paragraph (or other explanatory language) to the standard report.[10] These circumstances include:~~

~~[9] Unless otherwise required by the provisions of this section, an explanatory paragraph may precede or follow the opinion paragraph in the auditor's report.~~

~~[10] *See* footnote 3.~~

- ~~*a.* The auditor's opinion is based in part on the report of another auditor (paragraphs .12 and .13).~~
- ~~*b.* There is substantial doubt about the entity's ability to continue as a going concern.[11]~~

~~[11] AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern*, describes the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time and, when applicable, to consider the adequacy of financial statement disclosure and to include an explanatory paragraph in the report to reflect his or her conclusions.~~

- ~~*c.* There has been a material change between periods in accounting principles or in the method of their application (paragraphs .17A through .17E).~~
- ~~*d.* A material misstatement in previously issued financial statements has been corrected (paragraphs .18A through .18C).~~
- ~~*e.* Certain circumstances relating to reports on comparative financial statements exist (paragraphs .68, .69, and .72 through .74).~~
- ~~*f.* Selected quarterly financial data required by SEC Regulation S-K has been omitted or has not been reviewed. (*See* paragraph .50 of AS 4105, *Reviews of Interim Financial Information*.)~~
- ~~*g.* Supplementary information required by the Financial Accounting Standards Board (FASB), the Governmental Accounting Standards Board (GASB), or the Federal Accounting Standards Advisory Board (FASAB) has been omitted, the presentation of such information departs materially from FASB, GASB, or FASAB guidelines, the auditor is unable to~~

~~complete prescribed procedures with respect to such information, or the auditor is unable to remove substantial doubts about whether the supplementary information conforms to FASB, GASB, or FASAB guidelines. (*See* paragraph .02 of AS 2705, *Required Supplementary Information*.)~~

~~*h.* Other information in a document containing audited financial statements is materially inconsistent with information appearing in the financial statements. (*See* paragraph .04 of AS 2710, *Other Information in Documents Containing Audited Financial Statements*.)~~

~~In addition, the auditor may add an explanatory paragraph to emphasize a matter regarding the financial statements (paragraph .19).~~

**~~Opinion Based in Part on Report of Another Auditor~~**

~~.12 When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, he or she should disclose this fact in the introductory paragraph of his or her report and should refer to the report of the other auditor in expressing his or her opinion. These references indicate division of responsibility for performance of the audit. (*See* AS 1205, *Part of the Audit Performed by Other Independent Auditors*.)~~

~~.13 An example of a report indicating a division of responsibility follows:~~

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the related consolidated statements of income, retained earnings, and cash flows for the years then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets of $_______ and $________ as of December 31, 20X2 and 20X1, respectively, and total revenues of $_______ and $_______ for the years then ended. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require~~

~~that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits and the report of other auditors provide a reasonable basis for our opinion.~~

~~In our opinion, based on our audits and the report of other auditors, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of ABC Company and subsidiaries as of December 31, 20X2 and 20X1, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.~~

~~[.14-.15] [Paragraphs deleted.]~~

**~~Lack of Consistency~~**

~~.16 The auditor should recognize the following matters relating to the consistency of the company's financial statements in the auditor's report if those matters have a material effect on the financial statements:~~

~~*a.* A change in accounting principle.~~

~~*b.* An adjustment to correct a misstatement in previously issued financial statements.~~

**~~Change in Accounting Principle~~**

~~.17A As discussed in AS 2820, *Evaluating Consistency of Financial Statements*, the auditor should evaluate a change in accounting principle to determine whether (1) the newly adopted accounting principle is a generally accepted accounting principle, (2) the method of accounting for the effect of the change is in conformity with generally accepted accounting principles, (3) the disclosures related to the accounting change are adequate, and (4) the company has justified that the alternative accounting principle is preferable.[12] A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph following the opinion paragraph. If the auditor concludes that the criteria in this paragraph have been met, the~~

~~explanatory paragraph in the auditor's report should include identification of the nature of the change and a reference to the note disclosure describing the change.~~

~~[12] The issuance of an accounting pronouncement that requires use of a new accounting principle, interprets an existing principle, expresses a preference for an accounting principle, or rejects a specific principle is sufficient justification for a change in accounting principle, as long as the change in accounting principle is made in accordance with the hierarchy of generally accepted accounting principles. *See* FASB Statement 154, paragraph 14.~~

~~.17B Following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has changed its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].~~

~~.17C Following is an example of an explanatory paragraph when the company has made a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:~~

> ~~As discussed in Note X to the financial statements, the company has elected to change its method of accounting for [*describe accounting method change*] in [*year(s) of financial statements that reflect the accounting method change*].~~

~~.17D The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.~~

~~.17E If the auditor concludes that the criteria in paragraph .17A for a change in accounting principle are not met, the auditor should consider the matter to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or adverse opinion.~~

**~~Correction of a Material Misstatement in Previously Issued Financial Statements~~**

~~.18A Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory~~

~~paragraph following the opinion paragraph.[13] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the company's disclosure of the correction of the misstatement. Following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements.~~

> ~~As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.~~

~~[13] The directions in paragraphs .68-.69 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.~~

~~.18B This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.~~

~~.18C The accounting pronouncements generally require certain disclosures relating to restatements to correct a misstatement in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the lack of disclosure as discussed beginning at paragraph .41.~~

**~~Emphasis of a Matter~~**

~~.19 In any report on financial statements, the auditor may emphasize a matter regarding the financial statements. Such explanatory information should be presented in a separate paragraph of the auditor's report. Phrases such as "with the foregoing [following] explanation" should not be used in the opinion paragraph if an emphasis paragraph is included in the auditor's report. Emphasis paragraphs are never required; they may be added solely at the auditor's discretion. Examples of matters the auditor may wish to emphasize are~~

- ~~That the entity is a component of a larger business enterprise.~~
- ~~That the entity has had significant transactions with related parties.~~
- ~~Unusually important subsequent events.~~

- ~~Accounting matters, other than those involving a change or changes in accounting principles, affecting the comparability of the financial statements with those of the preceding period.~~

## Departures From Unqualified Opinions

### Qualified Opinions

.02~~0~~ Certain circumstances may require a qualified opinion. A qualified opinion states that, *except for* the effects of the matter to which the qualification relates, the financial statements present fairly, in all material respects, financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when—

*a.* There is a lack of sufficient appropriate evidential matter or there are restrictions on the scope of the audit that have led the auditor to conclude that he or she cannot express an unqualified opinion and he or she has concluded not to disclaim an opinion (paragraphs .05~~22~~–.17~~34~~).

*b.* The auditor believes, on the basis of his or her audit, that the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, and he or she has concluded not to express an adverse opinion (paragraphs .18~~35~~–.39~~57~~).

.03 When the auditor expresses a qualified opinion, the auditor's report must include the same basic elements and communication of critical audit matters, if requirements of critical audit matters apply, as would be required in an unqualified auditor's report under AS 3101.

.04~~21~~ When the auditor expresses a qualified opinion, he or she should disclose all of the substantive reasons for the qualified opinion in one or more separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the auditor's report. The auditor should also include, in the opinion paragraph, the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph that discloses all of the substantive reasons for the qualified opinion. A qualified opinion should include the word *except* or *exception* in a phrase such as *except for* or *with the exception of*. Phrases such as *subject to* and *with the foregoing explanation* are not clear or forceful enough and should not be used. Since accompanying notes are part of the financial statements, wording such as *fairly presented, in all material respects, when read in conjunction with Note 1* is likely to be misunderstood and should not be used.

Note: The auditor should refer to AS 3101 to determine if the matter for which the auditor qualified the opinion is also a critical audit matter.

**Scope Limitations**

.05~~22~~ The auditor can determine that he or she is able to express an unqualified opinion only if the audit has been conducted in accordance with the standards of the PCAOB and if he or she has therefore been able to apply all the procedures he considers necessary in the circumstances. Restrictions on the scope of the audit, whether imposed by the client or by circumstances, such as the timing of his or her work, the inability to obtain sufficient appropriate evidential matter, or an inadequacy in the accounting records, may require the auditor to qualify his or her opinion or to disclaim an opinion. In such instances, the reasons for the auditor's qualification of opinion or disclaimer of opinion should be described in the report.

.06~~23~~ The auditor's decision to qualify his or her opinion or disclaim an opinion because of a scope limitation depends on his or her assessment of the importance of the omitted procedure(s) to his or her ability to form an opinion on the financial statements being audited. This assessment will be affected by the nature and magnitude of the potential effects of the matters in question and by their significance to the financial statements. If the potential effects relate to many financial statement items, this significance is likely to be greater than if only a limited number of items is involved.

.07~~24~~ Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors.[3]~~[14]~~ Another common scope restriction involves accounting for long-term investments when the auditor has not been able to obtain audited financial statements of an investee. Restrictions on the application of these or other audit procedures to important elements of the financial statements require the auditor to decide whether he or she has examined sufficient appropriate evidential matter to permit him or her to express an unqualified or qualified opinion, or whether he or she should disclaim an opinion. When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements.

[3]~~[14]~~ Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include a reference to the omission of the procedures or the use of alternative procedures. It is important to understand, however, that AS 2510, *Auditing Inventories*,

states that "it will always be necessary for the auditor to make, or observe, some physical counts of the inventory and apply appropriate tests of intervening transactions."

.08~~25~~ When a qualified opinion results from a limitation on the scope of the audit or an insufficiency of evidential matter, the ~~situation~~ auditor's report should ~~be~~ describe~~d~~ the basis for departure from an unqualified opinion in a~~n~~ ~~explanatory~~ separate paragraph ~~preceding~~ immediately following the opinion paragraph and refer~~red~~ to that description in both the ~~scope~~ Basis for Opinion section and opinion paragraph~~s~~ of the auditor's report. It is not appropriate for the scope of the audit to be explained in a note to the financial statements, since the description of the audit scope is the responsibility of the auditor and not that of the client.

.09~~26~~ When an auditor qualifies his or her opinion because of a scope limitation, the wording in the opinion paragraph should indicate that the qualification pertains to the possible effects on the financial statements and not to the scope limitation itself. Wording such as "In our opinion, except for the above-mentioned limitation on the scope of our audit . . ." bases the exception on the restriction itself, rather than on the possible effects on the financial statements and, therefore, is unacceptable. An example of a qualified opinion related to a scope limitation concerning an investment in a foreign affiliate (assuming the effects of the limitation are such that the auditor has concluded that a disclaimer of opinion is not appropriate) follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

~~[*Same first paragraph as the standard report*]~~

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of ~~such~~ the adjustments, if any, as might have been determined to be necessary had we been able to examine evidence regarding the foreign affiliate investment and earnings, as described below, the financial statements ~~referred to in the first paragraph above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

We were unable to obtain audited financial statements supporting the Company's investment in a foreign affiliate stated at $_______ and $_______ at December 31, 20X2 and 20X1, respectively, or its equity in earnings of that affiliate of $_______ and $_______, which is included in net income for the years then ended as described in Note X to the financial statements; nor were we able to satisfy ourselves as to the carrying value of the investment in the foreign affiliate or the equity in its earnings by other auditing procedures.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as discussed ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures included~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also include~~s~~d ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.10~~27~~ ***Other scope limitations.*** Sometimes, notes to financial statements may contain unaudited information, such as pro forma calculations or other similar disclosures. If the unaudited information (for example, an investor's share, material in amount, of an investee's earnings recognized on the equity method) is such that it should be subjected to auditing procedures in order for the auditor to form an opinion with respect to the financial statements taken as a whole, the auditor should apply the procedures he or she deems necessary to the unaudited information. If the auditor has not been able to apply the procedures he or she considers necessary, the auditor should qualify his or her opinion or disclaim an opinion because of a limitation on the scope of the audit.

.11~~28~~ If, however, these disclosures are not necessary to fairly present the financial position, operating results, or cash flows on which the auditor is reporting, such disclosures may be identified as *unaudited* or as *not covered by the auditor's report*. For example, the pro forma effects of a business combination or of a subsequent event may be labelled unaudited. Therefore, while the event or transaction giving rise to the disclosures in these circumstances should be audited, the pro forma disclosures of that event or transaction would not be. The auditor should be aware, however, that AS 3110, *Dating of the Independent Auditor's Report,* states that, if the auditor is aware of a material subsequent event that has occurred after the completion of fieldwork but before issuance of the report that should be disclosed, the auditor's only options are to dual date the report or date the report as of the date of the subsequent event and extend the procedures for review of subsequent events to that date. Labelling the note unaudited is not an acceptable alternative in these circumstances.

.12~~29~~ ***Uncertainties and scope limitations.*** A matter involving an uncertainty is one that is expected to be resolved at a future date, at which time conclusive evidential matter concerning its outcome would be expected to become available. Uncertainties include, but are not limited to, contingencies covered by Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*, and matters related to estimates covered by Statement of Position 94-6, *Disclosure of Certain Significant Risks and Uncertainties*.

.13~~30~~ Conclusive evidential matter concerning the ultimate outcome of uncertainties cannot be expected to exist at the time of the audit because the outcome and related evidential matter are prospective. In these circumstances, management is responsible for estimating the effect of future events on the financial statements, or determining that a reasonable estimate cannot be made and making the required disclosures, all in accordance with generally accepted accounting principles, based on management's analysis of existing conditions. An audit includes an assessment of whether the evidential matter is sufficient to support management's analysis. Absence of the existence of information related to the outcome of an uncertainty does not necessarily lead to a conclusion that the evidential matter supporting management's assertion is not sufficient. Rather, the auditor's judgment regarding the sufficiency of the evidential matter is based on the evidential matter that is, or should be, available. If, after considering the existing conditions and available evidence, the auditor concludes that sufficient evidential matter supports management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, an unqualified opinion ordinarily is appropriate.

.14~~31~~ If the auditor is unable to obtain sufficient evidential matter to support management's assertions about the nature of a matter involving an uncertainty and its presentation or disclosure in the financial statements, the auditor should consider the need to express a qualified opinion or to disclaim an opinion because of a scope limitation. A qualification or disclaimer of opinion because of a scope limitation is appropriate if sufficient evidential matter related to an uncertainty does or did exist but was not available to the auditor for reasons such as management's record retention policies or a restriction imposed by management.

.15~~32~~ Scope limitations related to uncertainties should be differentiated from situations in which the auditor concludes that the financial statements are materially misstated due to departures from generally accepted accounting principles related to uncertainties. Such departures may be caused by inadequate disclosure concerning the uncertainty, the use of inappropriate accounting principles, or the use of unreasonable accounting estimates. Paragraphs .28~~45~~ to .32~~49~~ provide guidance to the auditor when financial statements contain departures from generally accepted accounting principles related to uncertainties.

.16~~33~~ ***Limited reporting engagements.*** The auditor may be asked to report on one basic financial statement and not on the others. For example, he or she may be asked to report on the balance sheet and not on the statements of income, retained earnings or cash flows. These engagements do not involve scope limitations if the auditor's access to information underlying the basic financial statements is not limited and if the auditor applies all the procedures he considers necessary in the circumstances; rather, such engagements involve limited reporting objectives.

.17~~34~~ An auditor may be asked to report on the balance sheet only. In this case, the auditor may express an opinion on the balance sheet only. An example of an unqualified opinion on a balance-sheet-only audit follows (the report assumes that the auditor has been able to satisfy himself or herself regarding the consistency of application of accounting principles):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statement

We have audited the accompanying balance sheet of X Company (the "Company") as of December 31, 20XX, and the related notes [*and schedules*] (collectively referred to as the "financial statement"). In our opinion, ~~the balance sheet referred to above~~ the financial statement presents fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20XX, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

This financial statement is the responsibility of the Company's management. Our responsibility is to express an opinion on this financial statement based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the ~~balance sheet~~ financial statement is free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statement, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures included~~s~~ examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the ~~balance sheet~~ financial statement. ~~An~~ Our audit also ~~includes~~ included assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall

~~balance sheet~~ presentation of the financial statement. We believe that our audit of the ~~balance sheet~~ financial statement provides a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Departure From a Generally Accepted Accounting Principle**

.18~~35~~ When financial statements are materially affected by a departure from generally accepted accounting principles and the auditor has audited the statements in accordance with the standards of the PCAOB, he or she should express a qualified (paragraphs .19~~36~~ through .39~~57~~) or an adverse (paragraphs .40~~58~~ through .43~~60~~) opinion. The basis for such opinion should be stated in the report.

.19~~36~~ In deciding whether the effects of a departure from generally accepted accounting principles are sufficiently material to require either a qualified or adverse opinion, one factor to be considered is the dollar magnitude of such effects. However, the concept of materiality does not depend entirely on relative size; it involves qualitative as well as quantitative judgments. The significance of an item to a particular entity (for example, inventories to a manufacturing company), the pervasiveness of the misstatement (such as whether it affects the amounts and presentation of numerous financial statement items), and the effect of the misstatement on the financial statements taken as a whole are all factors to be considered in making a judgment regarding materiality.

.20~~37~~ When the auditor expresses a qualified opinion, he or she should disclose, in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph ~~of the report~~, all of the substantive reasons that have led him or her to conclude that there has been a departure from generally accepted accounting principles. Furthermore, the opinion paragraph ~~of the report~~ should include the appropriate qualifying language and a reference to the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion.

.21~~38~~ The ~~explanatory~~ paragraph(s) immediately following the opinion paragraph that describe the substantive reasons that led the auditor to conclude that there has been a departure from generally accepted accounting principles should also disclose the principal effects of the subject matter of the qualification on financial position, results of operations, and cash flows, if practicable.[4~~15~~] If the effects are not reasonably determinable, the report should so state. If such disclosures are made in a note to the financial statements, the ~~explanatory~~ paragraph(s) that describe the substantive reasons for the qualified opinion may be shortened by referring to it.

[4~~15~~] In this context, practicable means that the information is reasonably obtainable from management's accounts and records and that providing the information in the report does not require the auditor to assume the position of a preparer of financial information. For example, if the information can be obtained from the accounts and records without the auditor substantially increasing the effort that would normally be required to complete the audit, the information should be presented in the report.

.22~~39~~ An example of a report in which the opinion is qualified because of the use of an accounting principle at variance with generally accepted accounting principles follows (assuming the effects are such that the auditor has concluded that an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects of not capitalizing certain lease obligations as discussed in the ~~preceding~~ following paragraph, the financial statements referred to above present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying balance sheets, certain lease obligations that, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______ and $_______, long-term debt by $_______ and $_______, and retained earnings by $_______ and $_______ as of December 31, 20X2 and 20X1, respectively. Additionally, net income would be increased (decreased) by $_______ and $_______ and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the years then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.23~~40~~ If the pertinent facts are disclosed in a note to the financial statements, a separate paragraph (~~preceding~~ immediately following the opinion paragraph) of the auditor's report in the circumstances illustrated in paragraph .22~~39~~ might read as follows:

As more fully described in Note X to the financial statements, the Company has excluded certain lease obligations from property and debt in the accompanying balance sheets. In our opinion, accounting principles generally accepted in the United States of America require that such obligations be included in the balance sheets.

.24~~41~~ ***Inadequate disclosure.*** Information essential for a fair presentation in conformity with generally accepted accounting principles should be set forth in the financial statements (which include the related notes). When such information is set forth elsewhere in a report to shareholders, or in a prospectus, proxy statement, or other similar report, it should be referred to in the financial statements. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express a qualified or adverse opinion because of the departure from those principles and should provide the information in the report, if practicable,[5~~16~~] unless its omission from the auditor's report is recognized as appropriate by a specific PCAOB standard.

[5~~16~~] *See* footnote 4~~15~~.

.25~~42~~ Following is an example of a report qualified for inadequate disclosure (assuming the effects are such that the auditor has concluded an adverse opinion is not appropriate):

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the omission of the information discussed in the ~~preceding~~ following paragraph, . . .

The Company's financial statements do not disclose [*describe the nature of the omitted disclosures*]. In our opinion, disclosure of this information is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.26~~43~~ If a company issues financial statements that purport to present financial position and results of operations but omits the related statement of cash flows, the auditor will normally conclude that the omission requires qualification of his opinion.

.27~~44~~ ~~The auditor is not required to prepare a basic financial statement (for example, a statement of cash flows for one or more periods) and include it in the report~~ ~~i~~If the company's management declines to present ~~the statement~~ a basic financial statement (for example, a statement of cash flows for one or more periods)~~.~~ ~~Accordingly, in these cases~~, the auditor should ordinarily qualify the report in the following manner:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of operations and stockholders' equity for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements").~~income and retained earnings for the years then ended.~~ In our opinion, except that the omission of a statement of cash flows results in an incomplete presentation as explained in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company declined to present a statement of cash flows for the years ended December 31, 20X2 and 20X1. Presentation of such statement summarizing the Company's operating, investing, and financing activities is required by accounting principles generally accepted in the United States of America.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.28~~45~~ ***Departures from generally accepted accounting principles involving risks or uncertainties, and materiality considerations.*** Departures from generally accepted accounting principles involving risks or uncertainties generally fall into one of the following categories:

- Inadequate disclosure (paragraphs .29~~46~~ and .30~~47~~)
- Inappropriate accounting principles (paragraph .31~~48~~)
- Unreasonable accounting estimates (paragraph .32~~49~~)

.29~~46~~ If the auditor concludes that a matter involving a risk or an uncertainty is not adequately disclosed in the financial statements in conformity with generally accepted accounting principles, the auditor should express a qualified or an adverse opinion.

.30~~47~~ The auditor should consider materiality in evaluating the adequacy of disclosure of matters involving risks or uncertainties in the financial statements in the context of the financial statements taken as a whole. The auditor's consideration of materiality is a matter of professional judgment and is influenced by his or her perception of the needs of a reasonable person who will rely on the financial statements. Materiality judgments involving risks or uncertainties are made in light of the surrounding circumstances. The auditor evaluates the materiality of reasonably possible losses that may be incurred upon the resolution of uncertainties both individually and in the aggregate. The auditor performs the evaluation of reasonably possible losses without regard to his or her evaluation of the materiality of known and likely misstatements in the financial statements.

.31~~48~~ In preparing financial statements, management estimates the outcome of certain types of future events. For example, estimates ordinarily are made about the useful lives of depreciable assets, the collectibility of accounts receivable, the realizable value of inventory items, and the provision for product warranties. FASB Statement No. 5, *Accounting for Contingencies*, paragraphs 23 and 25, describes situations in which the inability to make a reasonable estimate may raise questions about the appropriateness of the accounting principles used. If, in those or other situations, the auditor concludes that the accounting principles used cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

.32~~49~~ Usually, the auditor is able to satisfy himself or herself regarding the reasonableness of management's estimate of the effects of future events by considering various types of evidential matter, including the historical experience of the entity. If the auditor concludes that management's estimate is unreasonable (*see* paragraph .13 of AS 2810, *Evaluating Audit Results*) and that its effect is to cause the financial statements to be materially misstated, he or she should express a qualified or an adverse opinion.

~~[.50]~~

.33~~51~~ ***Departures from generally accepted accounting principles related to changes in accounting principle***. Paragraph .07 ~~.17A~~ of AS 2820, *Evaluating Consistency of Financial Statements*, ~~states~~ includes the criteria for evaluating a change in accounting principle. If the auditor concludes that the criteria have not been met, he or she should consider that circumstance to be a departure from generally accepted accounting principles and, if the effect of the accounting change is material, should issue a qualified or adverse opinion.

.34~~52~~ The accounting standards indicate that a company may make a change in accounting principle only if it justifies that the allowable alternative accounting principle is preferable. If the company does not provide reasonable justification that the alternative accounting principle is preferable, the auditor should consider the accounting change to be a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, should issue a qualified or adverse opinion. The following is an example of a report qualified because a company did not provide reasonable justification that an alternative accounting principle is preferable:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the change in accounting principle discussed in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

As disclosed in Note X to the financial statements, the Company adopted, in 20X2, the first-in, first-out method of accounting for its inventories, whereas it previously used the last-in, first-out method. Although use of the first-in, first-out method is in conformity with accounting principles generally accepted in the United States of America, in our opinion the Company has not provided reasonable justification that this accounting principle is preferable as required by those principles.[6~~17~~]

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[6~~17~~] Because this paragraph included in the example presented contains all of the information required in a~~n~~ ~~explanatory~~ separate paragraph on consistency, an ~~separate~~ explanatory paragraph (immediately following the opinion paragraph) as required by ~~paragraphs .17A thorough .17E of this section~~ AS 2820.08 and .12-.15 is not necessary in this instance. A separate paragraph that identifies the change in accounting principle would be required if the substance of the disclosure did not fulfill the requirements outlined in these paragraphs.

.35~~53~~ Whenever an accounting change results in an auditor expressing a qualified or adverse opinion on the conformity of financial statements with generally accepted accounting principles for the year of change, the auditor should consider the possible effects of that change when reporting on the entity's financial statements for subsequent years, as discussed in paragraphs .36~~54~~ through .39~~57~~.

.36~~54~~ If the financial statements for the year of such change are presented and reported on with a subsequent year's financial statements, the auditor's report should disclose his or her reservations with respect to the statements for the year of change.

.37~~55~~ If an entity has adopted an accounting principle that is not a generally accepted accounting principle, its continued use might have a material effect on the statements of a subsequent year on which the auditor is reporting. In this situation, the independent auditor should express either a qualified opinion or an adverse opinion, depending on the materiality of the departure in relation to the statements of the subsequent year.

.38~~56~~ If an entity accounts for the effect of a change prospectively when generally accepted accounting principles require restatement or the inclusion of the cumulative effect of the change in the year of change, a subsequent year's financial statements could improperly include a charge or credit that is material to those statements. This situation also requires that the auditor express a qualified or an adverse opinion.

.39~~57~~ If the auditor issues a qualified or adverse opinion because the company has not justified that an allowable accounting principle adopted in an accounting change is preferable, as described in paragraph .34~~52~~, the auditor should continue to express that opinion on the financial statements for the year of change as long as those financial statements are presented and reported on. However, the auditor's qualified or adverse opinion relates only to the accounting change and does not affect the status of a newly adopted principle as a generally accepted accounting principle. Accordingly, while expressing a qualified or adverse opinion for the year of change, the independent auditor's opinion regarding the subsequent years' statements need not express a qualified or adverse opinion on the use of the newly adopted principle in subsequent periods.

**Adverse Opinions**

.40 When the auditor expresses an adverse opinion, the auditor's report must include the opinion as described in paragraph .41 and the same other basic elements as would be required in an unqualified auditor's report under AS 3101, modified appropriately.

> Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor expresses an adverse opinion.

.41~~58~~ An adverse opinion states that the financial statements do not present fairly the financial position or the results of operations or cash flows in conformity with generally accepted accounting principles. Such an opinion is expressed when, in the auditor's judgment, the financial statements taken as a whole are not presented fairly in conformity with generally accepted accounting principles.

.42~~59~~ When the auditor expresses an adverse opinion, he or she should disclose in a separate ~~explanatory~~ paragraph(s) ~~preceding~~ immediately following the opinion paragraph of the report (*a*) all the substantive reasons for his or her adverse opinion, and (*b*) the principal effects of the subject matter of the adverse opinion on financial position, results of operations, and cash flows, if practicable.[7]~~[18]~~ If the effects are not reasonably determinable, the report should so state.[8]~~[19]~~

[7]~~[18]~~ *See* footnote 4~~15~~.

[8]~~[19]~~ When the auditor expresses an adverse opinion, he or she should also consider the need for an explanatory paragraph under the circumstances identified in ~~paragraph 11, subsection (*b*), (*c*), (*d*), and (*e*) of~~ AS 3101.18 ~~this section~~.

.43~~60~~ When an adverse opinion is expressed, the opinion paragraph should include a direct reference to a separate paragraph that discloses the basis for the adverse opinion.~~,~~ An example of this is ~~as~~ shown below:

Report of Independent Registered Public Accounting Firm

> To the shareholders and the board of directors of X Company
>
> Opinion on the Financial Statements
>
> We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes

[*and schedules*] (collectively referred to as the "financial statements"). In our opinion, because of the effects of the matters discussed in the ~~preceding~~ following paragraphs, the financial statements ~~referred to above~~ do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, or the results of its operations or its cash flows for the years then ended.

As discussed in Note X to the financial statements, the Company carries its property, plant and equipment accounts at appraisal values, and provides depreciation on the basis of such values. Further, the Company does not provide for income taxes with respect to differences between financial income and taxable income arising because of the use, for income tax purposes, of the installment method of reporting gross profit from certain types of sales. Accounting principles generally accepted in the United States of America require that property, plant and equipment be stated at an amount not in excess of cost, reduced by depreciation based on such amount, and that deferred income taxes be provided.

Because of the departures from accounting principles generally accepted in the United States of America identified above, as of December 31, 20X2 and 20X1, inventories have been increased $_______ and $_______ by inclusion in manufacturing overhead of depreciation in excess of that based on cost; property, plant and equipment, less accumulated depreciation, is carried at $_______ and $_______ in excess of an amount based on the cost to the Company; and deferred income taxes of $_______ and $_______ have not been recorded; resulting in an increase of $_______ and $_______ in retained earnings and in appraisal surplus of $_______ and $_______, respectively. For the years ended December 31, 20X2 and 20X1, cost of goods sold has been increased $_______ and $_______, respectively, because of the effects of the depreciation accounting referred to above and deferred income taxes of $_______ and $_______ have not been provided, resulting in an increase in net income of $_______ and $_______, respectively.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**Disclaimer of Opinion**

.44~~61~~ A disclaimer of opinion states that the auditor does not express an opinion on the financial statements. An auditor may decline to express an opinion whenever he or she is unable to form or has not formed an opinion as to the fairness of presentation of the financial statements in conformity with generally accepted accounting principles. If the auditor disclaims an opinion, the auditor's report should give all of the substantive reasons for the disclaimer.

.45~~62~~ A disclaimer is appropriate when the auditor has not performed an audit sufficient in scope to enable him or her to form an opinion on the financial statements.[~~20~~9] A disclaimer of opinion should not be expressed because the auditor believes, on the basis of his or her audit, that there are material departures from generally accepted accounting principles (*see* paragraphs .18~~35~~ through .39~~57~~). When disclaiming an opinion because of a scope limitation, the auditor should state in a separate paragraph or paragraphs all of the substantive reasons for the disclaimer. He or she should state that the scope of the audit was not sufficient to warrant the expression of an opinion. The auditor should not identify the procedures that were performed nor include the paragraph describing the characteristics of an audit (that is, the scope paragraph of the auditor's standard report); to do so may tend to overshadow the disclaimer. In addition, the auditor should also disclose any other reservations he or she has regarding fair presentation in conformity with generally accepted accounting principles.

[~~20~~9] AS 3320.05 provides guidance to an accountant who is associated with the financial statements of a public entity, but has not audited such statements.

.46 When the auditor disclaims an opinion, the auditor's report must include the basic elements as would be required in an unqualified auditor's report under AS 3101, modified as follows:

a. The first section of the auditor's report must include the section title "Disclaimer of Opinion on the Financial Statements" and the following elements:

   (1) The name of the company whose financial statements the auditor was engaged to audit;

(2) A statement identifying each financial statement and any related schedule(s) that the auditor was engaged to audit;

b. The second section of the auditor's report must include the title "Basis for Disclaimer of Opinion."

c. Elements in paragraphs .09b-f of AS 3101 should be omitted.

Note: The requirements as to critical audit matters described in AS 3101 do not apply when the auditor disclaims an opinion.

.47~~63~~ An example of a report disclaiming an opinion resulting from an inability to obtain sufficient appropriate evidential matter because of the scope limitation follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Disclaimer of Opinion on the Financial Statements

We were engaged to audit the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows for the years then ended~~, and the related notes [*and schedules*] (collectively referred to as the "financial statements").[10]~~[21]~~ ~~Since~~ As described in the following paragraph, because the Company did not take physical inventories and we were not able to apply other auditing procedures to satisfy ourselves as to inventory quantities and the cost of property and equipment, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements ~~the scope of our work was not sufficient to enable us to express~~, and we do not express, an opinion on these financial statements.

The Company did not make a count of its physical inventory in 20X2 or 20X1, stated in the accompanying financial statements at $________ as of December 31, 20X2, and at $_________ as of December 31, 20X1. Further, evidence supporting the cost of property and equipment acquired prior to December 31, 20X1, is no longer available. The Company's records do not permit the application of other auditing procedures to inventories or property and equipment.

Basis for Disclaimer of Opinion

These financial statements are the responsibility of the Company's management. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

[~~*Second paragraph of standard report should be omitted*~~]

[*Signature*]

We have served as the Company's auditor since [ *year* ].

[*City and State or Country*]

[*Date*]

[10]~~[21]~~ The wording in the ~~first paragraph of the auditor's standard report is changed in a disclaimer of opinion because of a scope limitation. The~~ first sentence now states that "we were engaged to audit" rather than "we have audited" since, because of the scope limitation, the auditor was not able to perform an audit in accordance with the standards of the PCAOB. In addition, the ~~last~~ sentence ~~of the first paragraph is also deleted, because of the scope limitation, to eliminate the~~ that references ~~to~~ the auditor's responsibility to express an opinion is deleted.

### Piecemeal Opinions

.48~~64~~ Piecemeal opinions (expressions of opinion as to certain identified items in financial statements) should not be expressed when the auditor has disclaimed an opinion or has expressed an adverse opinion on the financial statements *taken as a whole* because piecemeal opinions tend to overshadow or contradict a disclaimer of opinion or an adverse opinion.

### Reports on Comparative Financial Statements

.49~~65~~ The report shall ~~Paragraph .04 requires that an auditor's report contain~~ either contain an expression of opinion regarding the financial statements *taken as a whole* or an assertion to the effect that an opinion cannot be expressed. Reference ~~in paragraph .04~~ to the financial statements *taken as a whole* applies not only to the financial statements of the current period but also to those of one or more prior periods that are presented on a comparative basis with those of the current period. Therefore, a continuing auditor[11]~~[22]~~ should update[12]~~[23]~~ the report on the individual financial statements of the one or more prior periods presented on a comparative basis with those of the current period.[13~~24~~] Ordinarily, the auditor's report on comparative financial statements should be dated as of the date of completion of fieldwork for the most recent audit. (*See* AS 3110.01.)

[11~~22~~] A *continuing auditor* is one who has audited the financial statements of the current period and of one or more consecutive periods immediately prior to the current period. If one firm of independent auditors merges with another firm and the new firm becomes the auditor of a former client of one of the former firms, the new firm may accept responsibility and express an opinion on the financial statements for the prior period(s), as well as for those of the current period. In such circumstances, the new firm should follow the guidance in paragraphs .49~~65~~ through .53~~69~~ and may indicate in its report or signature that a merger took place and may name the firm of independent auditors that was merged with it. If the new firm decides not to express an opinion on the prior-period financial statements, the guidance in paragraphs .54~~70~~ through .58~~74~~ should be followed.

[12~~23~~] An updated report on prior-period financial statements should be distinguished from a reissuance of a previous report (*see* AS 3110.06 through .08), since in issuing an updated report the continuing auditor considers information that he or she has become aware of during his or her audit of the current-period financial statements (*see* paragraph .52~~68~~) and because an updated report is issued in conjunction with the auditor's report on the current-period financial statements.

[13~~24~~] A continuing auditor need not report on the prior-period financial statements if only summarized comparative information of the prior period(s) is presented. For example, entities such as state and local governmental units frequently present total-all-funds information for the prior period(s) rather than information by individual funds because of space limitations or to avoid cumbersome or confusing formats. Also, not-for-profit organizations frequently present certain information for the prior period(s) in total rather than by net asset class. In some circumstances, the client may request the auditor to express an opinion on the prior period(s) as well as the current period. In those circumstances, the auditor should consider whether the information included for the prior period(s) contains sufficient detail to constitute a fair presentation in conformity with generally accepted accounting principles. In most cases, this will necessitate including additional columns or separate detail by fund or net asset class, or the auditor would need to modify his or her report.

.50~~66~~ During the audit of the current-period financial statements, the auditor should be alert for circumstances or events that affect the prior-period financial statements presented (*see* paragraph .52~~68~~) or the adequacy of informative disclosures concerning those statements. (*See* AS 2810.31.) In updating his or her report on the prior-period financial statements, the auditor should consider the effects of any such circumstances or events coming to his or her attention.

**Different Reports on Comparative Financial Statements Presented**

.51~~67~~ Since the auditor's report on comparative financial statements applies to the individual financial statements presented, an auditor may express a qualified or adverse opinion, disclaim an opinion, or include an explanatory paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements presented. Following are examples of reports on comparative financial statements ~~(excluding the standard introductory and scope paragraphs, where applicable)~~ with different reports on one or more financial statements presented.

**~~Standard~~ The Auditor's Unqualified Report on the Prior-Year Financial Statements and a Qualified Opinion on the Current-Year Financial Statements**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, except for the effects on the 20X2 financial statements of not capitalizing certain lease obligations as described in the ~~preceding~~ following paragraph, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

The Company has excluded, from property and debt in the accompanying 20X2 balance sheet, certain lease obligations that were entered into in 20X2 which, in our opinion, should be capitalized in order to conform with accounting principles generally accepted in the United States of America. If these lease obligations were capitalized, property would be increased by $_______, long-term debt by $_______, and retained earnings by $_______ as of December 31, 20X2, and net income and earnings per share would be increased (decreased) by $_______ and $_______, respectively, for the year then ended.

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

**~~Standard~~ The Auditor's Unqualified Report on the Current-Year Financial Statements With a Disclaimer of Opinion on the Prior-Year Statements of Income, Retained Earnings, and Cash Flows**

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of ABC Company (the "Company") as of December 31, 20X2 and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for the year ended December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the balance sheets of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the related statements of income, retained earnings, and cash flows for the year ended December 31, 20X2, present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the year ended December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America. Because of the matter discussed in the ~~preceding~~ following paragraph, ~~the scope of our work was not sufficient to enable us to express~~ we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the results of operations and cash flows, and we do not express, an opinion on the results of operations and cash flows for the year ended December 31, 20X1.

We did not observe the taking of the physical inventory as of December 31, 20X0, since that date was prior to our appointment as auditors for the Company, and we were unable to satisfy ourselves regarding inventory quantities by means of other auditing procedures. Inventory amounts as of December 31, 20X0, enter into the determination of net income and cash flows for the year ended December 31, 20X1.[14]~~[25]~~

Basis for Opinion [~~Same first paragraph as the standard report~~]

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

Except as explained ~~in the following paragraph~~ above, we conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform our audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also ~~includes assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [ *year* ].

[*City and State or Country*]

[*Date*]

[14]~~[25]~~It is assumed that the independent auditor has been able to satisfy himself or herself as to the consistency of application of generally accepted accounting principles. *See* AS 2820 for a discussion of consistency.

**Opinion on Prior-Period Financial Statements Different From the Opinion Previously Expressed**

.52~~68~~ If, during the current audit, an auditor becomes aware of circumstances or events that affect the financial statements of a prior period, he or she should consider such matters when updating his or her report on the financial statements of the prior period. For example, if an auditor has previously qualified his or her opinion or expressed an adverse opinion on financial statements of a prior period because of a departure from generally accepted accounting principles, and the prior-period financial statements are restated in the current period to conform with generally accepted accounting principles, the auditor's updated report on the financial statements of the prior period should indicate that the statements have been restated and should express an unqualified opinion with respect to the restated financial statements.

.53~~69~~ If, in an updated report, the opinion is different from the opinion previously expressed on the financial statements of a prior period, the auditor should disclose all the substantive reasons for the different opinion in a separate explanatory paragraph(s) ~~preceding~~ immediately following the opinion paragraph of his or her report. The explanatory paragraph(s) should disclose (*a*) the date of the auditor's previous report, (*b*) the type of opinion previously expressed, (*c*) if applicable, a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period, (*d*) the circumstances or events that caused the auditor to express a different opinion, and (*e*) if applicable, a reference to the company's disclosure of the correction of the misstatement, and (*f*) the fact that the auditor's updated opinion on the financial statements of the prior period is different from his or her previous opinion on those statements. The following is an example of ~~an explanatory~~ a report ~~paragraph~~ that may be appropriate when an auditor issues an updated report on the financial statements of a prior period that contains an opinion different from the opinion previously expressed:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying balance sheets of X Company (the "Company") as of December 31, 20X2 and 20X1, the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for each of the years then ended, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of December 31, 20X2 and 20X1, and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our report dated March 1, 20X2, we expressed an opinion that the 20X1 financial statements did not fairly present financial position, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America because of two departures from such principles: (1) the Company carried its property, plant, and equipment at appraisal values, and provided for depreciation on the basis of such values, and (2) the Company did not provide for deferred income taxes with respect to differences between income for financial reporting purposes and taxable income. As described in Note X, the Company has changed its method of accounting for these items and restated its 20X1 financial statements to conform with accounting principles generally accepted in the United States of America. Accordingly, our present opinion on the 20X1 financial statements, as presented herein, is different from that expressed in our previous report. [15]~~[26]~~

Basis for Opinion

[~~*Same first and second paragraphs as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

[15~~26~~] *See* footnote 6~~17~~.

## Report of Predecessor Auditor

.54~~70~~ A predecessor auditor ordinarily would be in a position to reissue his or her report on the financial statements of a prior period at the request of a former client if he or she is able to make satisfactory arrangements with the former client to perform this service and if he or she performs the procedures described in paragraph .55~~71~~.[16~~27~~]

[16~~27~~] It is recognized that there may be reasons why a predecessor auditor's report may not be reissued and this section does not address the various situations that could arise.

### Predecessor Auditor's Report Reissued

.55~~71~~ Before reissuing (or consenting to the reuse of) a report previously issued on the financial statements of a prior period, when those financial statements are to be presented on a comparative basis with audited financial statements of a subsequent period, a predecessor auditor should consider whether his or her previous report on those statements is still appropriate. Either the current form or manner of presentation of the financial statements of the prior period or one or more subsequent events might make a predecessor auditor's previous report inappropriate. Consequently, a predecessor auditor should (*a*) read the financial statements of the current period, (*b*) compare the prior-period financial statements that he or she reported on with the financial statements to be presented for comparative purposes, and (*c*) obtain representation letters from management of the former client and from the successor auditor. The representation letter from management of the former client should state (*a*) whether any information has come to management's attention that would cause them to believe that any of the previous representations should be modified, and (*b*) whether any events have occurred subsequent to the balance-sheet date of the latest prior-period financial statements reported on by the predecessor auditor that would require adjustment to or disclosure in those financial statements.[17~~28~~] The representation letter from the successor auditor should state whether the successor's audit revealed any matters that, in the successor's opinion, might have a material effect on, or require disclosure in, the financial statements reported on by the predecessor auditor. Also, the predecessor auditor may wish to consider the matters described in paragraphs ~~AS 1205~~.10 through .12 of AS 1205, *Part of the Audit Performed by Other Independent Auditors*. However, the predecessor auditor should not refer in his or her reissued report to the report or work of the successor auditor.

[17]~~[28]~~ *See* AS 2805, *Management Representations*, appendix C [paragraph .18], "Illustrative Updating Management Representation Letter."

.56~~72~~ A predecessor auditor who has agreed to reissue his or her report may become aware of events or transactions occurring subsequent to the date of his or her previous report on the financial statements of a prior period that may affect his or her previous report (for example, the successor auditor might indicate in the response that certain matters have had a material effect on the prior-period financial statements reported on by the predecessor auditor). In such circumstances, the predecessor auditor should make inquiries and perform other procedures that he or she considers necessary (for example, reviewing the working papers of the successor auditor as they relate to the matters affecting the prior-period financial statements). The auditor should then decide, on the basis of the evidential matter obtained, whether to revise the report. If a predecessor auditor concludes that the report should be revised, he or she should follow the guidance in paragraphs .52~~68~~, .53~~69~~, and .57~~73~~ of this section.

.57~~73~~ A predecessor auditor's knowledge of the current affairs of his former client is obviously limited in the absence of a continuing relationship. Consequently, when reissuing the report on prior-period financial statements, a predecessor auditor should use the date of his or her previous report to avoid any implication that he or she has examined any records, transactions, or events after that date. If the predecessor auditor revises the report or if the financial statements are adjusted, he or she should dual-date the report. (*See* AS 3110.05.)

**Predecessor Auditor's Report Not Presented**

.58~~74~~ If the financial statements of a prior period have been audited by a predecessor auditor whose report is not presented, the successor auditor should indicate in the ~~introductory~~ paragraph immediately following the opinion paragraph of his or her report (a) that the financial statements of the prior period were audited by another auditor,[18]~~[29]~~ (b) the date of his or her report, (c) the type of report issued by the predecessor auditor, and (d) if the report was other than an ~~standard~~ unqualified report, the substantive reasons therefor.[19]~~[30]~~ An example of a successor auditor's report when the predecessor auditor's report is not presented is shown below:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Opinion on the Financial Statements

We have audited the accompanying balance sheet of ABC Company (the "Company") as of December 31, 20X2, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows for the year then ended~~, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~ In our opinion, the 20X2 financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~ABC~~ the Company as of December 31, 20X2, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The financial statements of ~~ABC~~ the Company as of December 31, 20X1, were audited by other auditors whose report dated March 31, 20X2, expressed an unqualified opinion on those statements.

Basis for Opinion

[~~*Same second paragraph as the standard report*~~ *Same basic elements as the Basis for Opinion section of the auditor's unqualified report in AS 3101*]

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

If the predecessor auditor's report contained an explanatory paragraph or was other than an ~~standard~~ unqualified report, the successor auditor should describe the nature of and reasons for the explanatory paragraph added to the predecessor's report or the opinion qualification. Following is an illustration of the wording that may be included in the successor auditor's report:

> . . . were audited by other auditors whose report dated March 1, 20X2, on those statements included an explanatory paragraph that described the change in the Company's method of computing depreciation discussed in Note X to the financial statements.

If the financial statements have been adjusted, the ~~introductory paragraph~~ Opinion on the Financial Statements section should indicate that a predecessor auditor reported on the financial statements of the prior period before the adjustments. In addition, if the successor auditor is engaged to audit and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the adjustments, he or she may also include the following paragraph in the auditor's report:

> We also audited the adjustments described in Note X that were applied to restate the 20X1 financial statements. In our opinion, such adjustments are appropriate and have been properly applied.

[18][~~29~~] The successor auditor should not name the predecessor auditor in his or her report; however, the successor auditor may name the predecessor auditor if the predecessor auditor's practice was acquired by, or merged with, that of the successor auditor.

[19][~~30~~] If the predecessor's report was issued before the effective date of this section and contained an uncertainties explanatory paragraph, a successor auditor's report issued or reissued after the effective date hereof should not make reference to the predecessor's previously required explanatory paragraph.

## Management Reports on Internal Control Over Financial Reporting

.59 In situations in which management is required to report on the company's internal control over financial reporting but such report is not required to be audited, and the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should refer to the auditor's responsibilities regarding other information in documents containing audited financial statements and the independent auditor's report under AS 2710, *Other Information in Documents Containing Audited Financial Statements.*

.60 In situations described in paragraph .59, the auditor must include statements in the auditor's report that:

- The company is not required to have, nor was the auditor engaged to perform, an audit of its internal control over financial reporting;

- As part of the audit, the auditor is required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting; and

- The auditor expresses no such opinion.

Following is an example of the Basis for Opinion section in the auditor's report that contains such statements:

> [Basis for Opinion]
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.
>
> Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

## ~~Effective Date and Transition~~

~~.75 This section is effective for reports issued or reissued on or after February 29, 1996. Earlier application of the provisions of this section is permissible.~~

~~.76 An auditor who previously included an uncertainties explanatory paragraph in a report should not repeat that paragraph and is not required to include an emphasis paragraph related to the uncertainty in a reissuance of that report or in a report on subsequent periods' financial statements, even if the uncertainty has not been resolved. If the auditor decides to include an emphasis paragraph related to the uncertainty, the paragraph may include an explanation of the change in reporting standards.~~

## II. Amendments to Other Auditing Standards

### AS 1205, *Part of the Audit Performed by Other Independent Auditors*

* * *

.07 When the principal auditor decides that he will make reference to the audit of the other auditor, his report should indicate clearly, in ~~both the introductory, scope and opinion paragraphs~~ the Opinion on the Financial Statements and Basis for Opinion sections, the division of responsibility as between that portion of the financial statements covered by his own audit and that covered by the audit of the other auditor. The report should disclose the magnitude of the portion of the financial statements audited by the other auditor. This may be done by stating the dollar amounts or percentages of one or more of the following: total assets, total revenues, or other appropriate criteria, whichever most clearly reveals the portion of the financial statements audited by the other auditor. The other auditor may be named but only with his express permission and provided his report is presented together with that of the principal auditor.[3]

* * *

.09 An example of appropriate reporting by the principal auditor indicating the division of responsibility when he makes reference to the audit of the other auditor follows:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of X Company

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheet of X Company (the "Company") and subsidiaries as of December 31, 20...., and the related consolidated statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income and retained earnings and cash flows~~ for the year then ended, and the related notes [*and schedules*] (collectively referred to as the "consolidated financial statements"). In our opinion, based on our audit and the report of the other auditors, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~X~~ the Company as of [at] December 31, 20...., and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

We did not audit the financial statements of B Company, a wholly-owned subsidiary, which statements reflect total assets and revenues constituting 20 percent and 22 percent, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for B Company, is based solely on the report of the other auditors.

*Basis for Opinion*

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit~~s~~. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our audit included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. ~~An audit~~ Such procedures ~~includes~~ included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also ~~includes~~ ~~assessing~~ included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit and the report of the other auditors provide a reasonable basis for our opinion.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

When two or more auditors in addition to the principal auditor participate in the audit, the percentages covered by the other auditors may be stated in the aggregate.

* * *

**Other Auditor's Report Departs From ~~Standard~~ the Auditor's Unqualified Report or Includes an Explanatory Paragraph**

.15 If the report of the other auditor is other than ~~a standard~~ an auditor's unqualified report or includes explanatory language, the principal auditor should decide whether the reason for the departure from the ~~standard~~ auditor's unqualified report or the explanatory language is of such nature and significance in relation to the financial statements on which the principal auditor is reporting that it would require recognition in his own report. If the reason for the departure is not material in relation to such financial statements and the other auditor's report is not presented, the principal auditor need not make reference in his report to such departure. If the other auditor's report is presented, the principal auditor may wish to make reference to such departure and its disposition.

**Restated Financial Statements of Prior Years Following a Pooling of Interests**

.16 Following a pooling-of-interests transaction, an auditor may be asked to report on restated financial statements for one or more prior years when other auditors have audited one or more of the entities included in such financial statements. In some of these situations the auditor may decide that he has not audited a sufficient portion of the financial statements for such prior year or years to enable him to serve as principal auditor (*see* paragraph .02). Also, in such cases, it often is not possible or it may not be appropriate or necessary for the auditor to satisfy himself with respect to the restated financial statements. In these circumstances it may be appropriate for him to express his opinion solely with respect to the combining of such statements; however, no opinion should be expressed unless the auditor has audited the statements of at least one of the entities included in the restatement for at least the latest period presented. The following is an illustration of appropriate reporting on such combination that can be presented in an additional paragraph of the auditor's report following the opinion paragraph ~~standard introductory, scope and opinion paragraphs~~ covering the consolidated financial statements for the current year:[*]

* * *

**AS 1210, *Using the Work of a Specialist***

* * *

**Effect of the Specialist's Work on the Auditor's Report**

.13 If the auditor determines that the specialist's findings support the related assertions in the financial statements, he or she reasonably may conclude that sufficient appropriate evidential matter has been obtained. If there is a material difference between the specialist's findings and the assertions in the financial statements, he or she should apply additional procedures. If after applying any additional procedures that might be appropriate the auditor is unable to resolve the matter, the auditor should obtain the opinion of another specialist, unless it appears to the auditor that the matter cannot be resolved. A matter that has not been resolved ordinarily will cause the auditor to conclude that he or she should qualify the opinion or disclaim an opinion because the inability to obtain sufficient appropriate evidential matter as to an assertion of material significance in the financial statements constitutes a scope limitation. (*See* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

.14 The auditor may conclude after performing additional procedures, including possibly obtaining the opinion of another specialist, that the assertions in the financial statements are not in conformity with GAAP. In that event, the auditor should express a qualified or adverse opinion. (*See* AS 3105~~1~~.18~~35~~, .19~~36~~, and .24~~41~~.)

**Reference to the Specialist in the Auditor's Report**

.15 ~~Except as discussed in paragraph .16 the auditor should not refer to the work or findings of the specialist. Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended. Further, there may be an inference that the auditor making such reference performed a~~

~~more thorough audit than an auditor not making such reference.~~ Reference to the use of a specialist may be made in the auditor's report in the following situations:

a. *Critical Audit Matters*—If such a reference will facilitate an understanding of the matter, the principal considerations that led the auditor to determine that the matter was a critical audit matter, or how the critical audit matter was addressed in the audit;[7] or

b. *Explanatory language or departure from an unqualified opinion*—If such a reference will facilitate an understanding of the reason for the explanatory paragraph or departure from an unqualified opinion.

Otherwise the auditor should not refer to the work or findings of the specialist in the auditor's report.

[7] Critical audit matters are described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~.16 The auditor may, as a result of the report or findings of the specialist, decide to add explanatory language to his or her standard report or depart from an unqualified opinion. Reference to and identification of the specialist may be made in the auditor's report if the auditor believes such reference will facilitate an understanding of the reason for the explanatory paragraph or the departure from the unqualified opinion.~~

* * *

**AS 1220, *Engagement Quality Review***

* * *

.10 In an audit, the engagement quality reviewer should:

* * *

j. Based on the procedures required by this standard, evaluate the engagement team's determination, communication, and documentation of critical audit matters in accordance with AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

* * *

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**AS 1301, *Communications with Audit Committees***

* * *

**~~Departure from the Auditor's Standard Report~~ The Auditor's Report**

.21 The auditor should ~~communicate~~ provide to and discuss with the audit committee ~~the following matters related to~~ a draft of the auditor's report~~:~~.

~~a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and~~

b. ~~When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.~~

* * *

Note: Difficulties encountered by the auditor during the audit could represent a scope limitation,[39] which may result in the auditor modifying the auditor's opinion or withdrawing from the engagement.

[39] *See* paragraphs .05~~22~~-.15~~32~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for a discussion of scope limitations.

* * *

**AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements***

* * *

## Reporting on Internal Control

.85 The auditor's report on the audit of internal control over financial reporting ~~must~~ includes the following elements[18] -

*Title*

.85A The auditor's report must include the title, "Report of Independent Registered Public Accounting Firm."

*Addressee*

.85B The auditor's report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The auditor's report may include additional addressees.

*Opinion on the Internal Control over Financial Reporting*

.85C The first section of the auditor's report on the audit of internal control over financial reporting must include the section title "Opinion on Internal Control over Financial Reporting" and the following elements-

~~a. A title that includes the word *independent*;~~

a. The name of the company whose internal control over financial reporting was audited; and

b. ~~k.~~ The auditor's opinion on whether the company maintained, in all material respects, effective internal control over financial reporting as of the specified date, based on the control criteria.

*Basis for Opinion*

.85D The second section of the auditor's report on the audit of internal control over financial reporting must include the section title "Basis for Opinion" and the following elements:

a~~b~~. A statement that management is responsible for maintaining effective internal control over financial reporting and for assessing the effectiveness of internal control over financial reporting;

b~~c~~. An identification of management's report on internal control;

c~~d~~. A statement that the auditor's responsibility is to express an opinion on the company's internal control over financial reporting based on his or her audit;

d. A statement that the auditor is a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and is required to be independent with respect to the company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB;

ef. A statement that the audit was conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~;

fg. A statement that the standards of the PCAOB ~~Public Company Accounting Oversight Board~~ require that the auditor plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects;

gh. A statement that an audit includeds obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances; and

hi. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;.

*Definition and Limitations of Internal Control Over Financial Reporting*

.85E The third section of the auditor's report on the audit of internal control over financial reporting must include the section title "*Definition and Limitations of Internal Control Over Financial Reporting* " and the following elements:

ae. A definition of internal control over financial reporting as stated in paragraph .A5;

bj. A paragraph stating that, because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

*Signature, Location, and Date*

.85F The auditor's report must include the following elements:

al. The ~~manual or printed~~ signature of the auditor's firm;[18A]

bm. The city and state (or city and country, in the case of non-U.S. auditors) from which the auditor's report has been issued; and

cn. The date of the audit report.

[18A] *See* Regulation S-X Rule 2-02(a).

* * *

.87 The following example combined report expressing an unqualified opinion on financial statements and an unqualified opinion on internal control over financial reporting illustrates the report elements described in this section.

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of W Company

[~~*Introductory paragraph*~~] *Opinions on the Financial Statements and Internal Control over Financial Reporting*

We have audited the accompanying balance sheets of W Company (the "Company") as of December 31, 20X8 and 20X7, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, stockholders' equity and comprehensive income, and cash flows~~ for each of the years in the three-year period ended December 31, 20X8, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). We also have audited ~~W~~ the Company's internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)."*].

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of ~~W~~ the Company as of December 31, 20X8 and 20X7, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 20X8 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, ~~W~~ the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 20X8, based on [*Identify control criteria, for example, "criteria established in Internal Control - Integrated Framework: (20XX) issued by ~~the Committee of Sponsoring Organizations of the Treadway Commission (COSO)~~."*].

Basis for Opinion

[~~*Scope paragraph*~~]

~~W~~ The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying [*title of management's report*]. Our responsibility is to express an opinion on ~~these~~ the Company's financial statements and an opinion on the ~~c~~Company's internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements.~~,~~ Our audits also included evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, ~~and~~ as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

~~[~~*Definition and Limitations of Internal Control Over Financial Reporting ~~paragraph~~*~~]~~

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

~~[*Inherent limitations paragraph*]~~

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters [if applicable]

*[Include critical audit matters]*

[*Signature*]

We have served as the Company's auditor since [*year*].

[*City and State or Country*]

[*Date*]

.88 If the auditor chooses to issue a separate report on internal control over financial reporting, he or she should add the following paragraph (immediately following the opinion paragraph) to the auditor's report on the financial statements –

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 20X8, based on [ *identify control criteria* ] and our report dated [ *date of report, which should be the same as the date of the report on the financial statements* ] expressed [ *include nature of opinion* ].

The auditor also should add the following paragraph (immediately following the opinion paragraph) to the report on internal control over financial reporting –

> We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the [ *identify financial statements* ] of the Company and our report dated [ *date of report, which should be the same as the date of the report on the effectiveness of internal control over financial reporting* ] expressed [ *include nature of opinion* ].

* * *

.B16 In situations in which the SEC allows management to limit its assessment of internal control over financial reporting by excluding certain entities, the auditor may limit the audit in the same manner. In these situations, the auditor's opinion would not be affected by a scope limitation. However, the auditor should include, either in an additional explanatory paragraph or as part of the ~~scope paragraph~~ Basis for Opinion section in his or her report, a disclosure similar to management's regarding the exclusion of an entity from the scope of both management's assessment and the auditor's audit of internal control over financial reporting. Additionally, the auditor should evaluate the reasonableness of management's conclusion that the situation meets the criteria of the SEC's allowed exclusion and the appropriateness of any required disclosure related to such a limitation. If the auditor believes that management's disclosure about the limitation requires modification, the auditor should follow the same communication responsibilities that are described in paragraphs .29 through .32 of AS 4105, *Reviews of Interim Financial Information*. If management and the audit committee do not respond appropriately, in addition to fulfilling those responsibilities, the auditor should modify his or her report on the audit of internal control over financial reporting to include an explanatory paragraph describing the reasons why the auditor believes management's disclosure requires modification.

* * *

.C4 When disclaiming an opinion because of a scope limitation, the auditor should state that the scope of the audit was not sufficient to warrant the expression of an opinion and, in a separate paragraph or paragraphs, the substantive reasons for the disclaimer. The auditor should not identify the procedures that were performed nor include the statements describing the characteristics of an audit of internal control over financial reporting (paragraph .85D f, g, and h~~, and i~~); to do so might overshadow the disclaimer.

* * *

**AS 2405, *Illegal Acts by Clients***

* * *

.21 The auditor may be unable to determine whether an act is illegal because of limitations imposed by the circumstances rather than by the client or because of uncertainty associated with interpretation of applicable laws or regulations or surrounding facts. In these circumstances, the auditor should consider the effect on his report.[2]

[2] *See* AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2410, *Related Parties***

* * *

***Assertions That Transactions with Related Parties Were Conducted on Terms Equivalent to Those Prevailing in Arm's-Length Transactions***

.18 If the financial statements include a statement by management that transactions with related parties were conducted on terms equivalent to those prevailing in an arm's-length transaction, the auditor should determine whether the evidence obtained supports or contradicts management's assertion. If the auditor is unable to obtain sufficient appropriate audit evidence to substantiate management's assertion, and if management does not agree to modify the disclosure, the auditor should express a qualified or adverse opinion.[20]

[20] *See* AS 2805.06l, which requires the auditor to obtain written representations from management if the financial statements include such an assertion. Representations from management alone are not sufficient appropriate audit evidence. *See also* paragraphs .18~~35~~–.19~~36~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2415, *Consideration of an Entity's Ability to Continue as a Going Concern***

* * *

.03 The auditor should evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time in the following manner:

* * *

> *c.* After the auditor has evaluated management's plans, he concludes whether he has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes there is substantial doubt, he should (1) consider the adequacy of disclosure about the entity's possible inability to continue as a going concern for a reasonable period of time, and (2) include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), in his audit report to reflect his conclusion. If the auditor concludes that substantial doubt does not exist, he should consider the need for disclosure.

.12 If, after considering identified conditions and events and management's plans, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time remains, the audit report should include an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to reflect that conclusion.[4] The auditor's conclusion about the entity's ability to continue as a going concern should be expressed through the use of the phrase "substantial doubt about its (the entity's) ability to continue as a going concern" [or similar wording that includes the terms substantial doubt *and* going concern] as illustrated in paragraph .13.

[4] The inclusion of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report contemplated by this section should serve adequately to inform the users of the financial statements. Nothing in this section, however, is intended to preclude an auditor from declining to express an opinion in cases involving uncertainties. If he disclaims an opinion, the uncertainties and their possible effects on the financial statements should be disclosed in an appropriate manner (*see* paragraph .10), and the auditor's report should give all the substantive reasons for his disclaimer of opinion (*see* paragraphs .44-.47 of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

.13 An example follows of an explanatory paragraph (immediately following the opinion paragraph) in the auditor's report describing an uncertainty about the entity's ability to continue as a going concern for a reasonable period of time.[5]

> [*Appropriate Title*]

> The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note X. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

.14 If the auditor concludes that the entity's disclosures with respect to the entity's ability to continue as a going concern for a reasonable period of time are inadequate, a departure from generally accepted accounting principles exists. This may result in either a qualified (except for) or an adverse opinion. Reporting guidance for such situations is provided in AS 3105~~1,~~ ~~*Reports on Audited Financial Statements*~~.

.15 Substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time that arose in the current period does not imply that a basis for such doubt existed in the prior period and, therefore, should not affect the auditor's report on the financial statements of the prior period that are presented on a comparative basis. When financial statements of one or more prior periods are presented on a comparative basis with financial statements of the current period, reporting guidance is provided in AS 3105~~1~~.

* * *

**AS 2503, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities***

* * *

.32 There may be a time lag in reporting between the date of the financial statements of the investor and that of the investee. A time lag in reporting should be consistent from period to period. If a time lag between the date of the entity's financial statements and those of the investee has a material effect on the entity's financial statements, the auditor should determine whether the entity's management has properly considered the lack of comparability. The effect may be material, for example, because the time lag is not consistent with the prior period in comparative statements or because a significant transaction occurred during the time lag. If a change in time lag occurs that has a material effect on the investor's financial statements, an explanatory paragraph, including an appropriate title, should be added to the auditor's report because of the change in reporting period.[15]

[15] *See* ~~paragraphs .16–.18 of AS 3101,~~ ~~*Reports on Audited Financial Statements*~~ AS 2820, *Evaluating Consistency of Financial Statements.*

* * *

**AS 2505, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments***

* * *

.13 A lawyer's refusal to furnish the information requested in an inquiry letter either in writing or orally (*see* paragraphs .09 and .10) would be a limitation on the scope of the audit sufficient to preclude an unqualified opinion (*see* paragraphs .05~~22~~ and .06~~23~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).[7] A lawyer's response to such an inquiry and the procedures set forth in paragraph .05 provide the auditor with sufficient evidential matter to satisfy himself concerning the accounting for and reporting of pending and threatened litigation, claims and assessments. The auditor obtains sufficient evidential matter to satisfy himself concerning reporting for those unasserted claims and assessments required to be disclosed in financial statements from the foregoing procedures and the lawyer's specific acknowledgement of his responsibility to his client in respect of disclosure obligations (*see* paragraph .09*g*). This approach with respect to unasserted claims and assessments is necessitated by the public interest in protecting the confidentiality of lawyer-client communications.

.14 A lawyer may be unable to respond concerning the likelihood of an unfavorable outcome of litigation, claims, and assessments or the amount or range of potential loss, because of inherent uncertainties. Factors influencing the likelihood of an unfavorable outcome may sometimes not be within a lawyer's competence to judge; historical experience of the entity in similar litigation or the experience of other entities may not be relevant or available; and the amount of the possible loss frequently may vary widely at different stages of litigation. Consequently, a lawyer may not be able to form a conclusion with respect to such matters. In such circumstances, the auditor ordinarily will conclude that the financial statements are affected by an uncertainty concerning the outcome of a future event which is not susceptible of reasonable estimation, and should look to the guidance in AS 3105~~1~~.28~~45~~ through .32~~49~~ to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AS 2510, *Auditing Inventories***

* * *

.15 For a discussion of the circumstances relating to receivables and inventories affecting the independent auditor's report, see paragraphs .07~~24~~ and .51~~67~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

**AS 2610, *Initial Audits—Communications Between Predecessor and Successor Auditors***

* * *

[9] *See* paragraphs .54~~70~~ through .58~~74~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for reporting guidance.

* * *

**AS 2705, *Required Supplementary Information***

* * *

.03 Some entities may voluntarily include, in documents containing audited financial statements, certain supplementary information that is required of other entities. When an entity voluntarily includes such information as a supplement to the financial statements or in an unaudited note to the financial statements, the provisions of this section are applicable unless either the entity indicates that the auditor has not applied the procedures described in this section or the auditor includes in an explanatory paragraph, including an appropriate title, in his report on the audited financial statements a disclaimer on the information. The following is an example of a disclaimer an auditor might use in these circumstances:

> [*Appropriate Title*]
>
> The [*identify the supplementary information*] on page XX (or in Note XX) is not a required part of the basic financial statements, and we did not audit or apply limited procedures to such information and do not express any assurances on such information.

* * *

.08 Since the supplementary information is not audited and is not a required part of the basic financial statements, the auditor need not add an explanatory paragraph to the report on the audited financial statements to refer to the supplementary information or to his or her limited procedures, except in any of the following circumstances:[7] (*a*) the supplementary information that GAAP requires to be presented in the circumstances is omitted; (*b*) the auditor has concluded that the measurement or presentation of the supplementary information departs materially from prescribed guidelines; (*c*) the auditor is unable to complete the prescribed procedures; (*d*) the auditor is unable to remove substantial doubts about whether the supplementary information conforms to prescribed guidelines. Since the required supplementary information does not change the standards of financial accounting and reporting used for the preparation of the entity's basic financial statements, the circumstances described above do not affect the auditor's opinion on the fairness of presentation of such financial statements in conformity with generally accepted accounting principles. Furthermore, the auditor need not present the supplementary information if it is omitted by the entity. The following are examples of additional explanatory paragraphs, including appropriate titles, an auditor might use in these circumstances.

* * *

**AS 2710, *Other Information in Documents Containing Audited Financial Statements***

* * *

.04 Other information in a document may be relevant to an audit performed by an independent auditor or to the continuing propriety of his report. The auditor's responsibility with respect to information in a document does not extend beyond the financial information identified in his report, and the auditor has no obligation to perform any procedures to corroborate other information contained in a document. However, he should read the other information and consider whether such information, or the manner of its presentation, is materially inconsistent with information, or the manner of its presentation, appearing in the financial statements.[2] If the auditor concludes that there is a material inconsistency, he should determine whether the financial statements, his report, or both require revision. If he concludes that they do not require revision, he should request the client to revise the other information. If the other information is not revised to eliminate the material inconsistency, he should communicate the material inconsistency to the audit committee and consider other actions, such as revising his report to include an explanatory paragraph, including an appropriate title, describing the material inconsistency, withholding the use of his report in the document, and withdrawing from the engagement. The action he takes will depend on the particular circumstances and the significance of the inconsistency in the other information.

* * *

**AS 2801, *Subsequent Events***

* * *

.09 Occasionally, a subsequent event of the second type has such a material impact on the entity that the auditor may wish to include in his report an ~~explanatory~~ emphasis paragraph directing the reader's attention to the event and its effects. (*See* paragraph .19 of AS 3101, ~~*Reports on Audited Financial Statements*, ~~*The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*)

* * *

**AS 2805, *Management Representations***

* * *

[15] *See* paragraph .55~~71~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[18] *See* AS 3105~~1~~.05~~22~~–.17~~34~~.

* * *

**AS 2810, *Evaluating Audit Results***

* * *

[7] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

.31

* * *

Note: According to AS 3105~~1~~, if the financial statements, including the accompanying notes, fail to disclose information that is required by the applicable financial reporting framework, the auditor should express a qualified or adverse opinion and should provide the information in the report, if practicable, unless its omission from the report is recognized as appropriate by a specific auditing standard.[18]

[18] AS 3105~~1~~.24~~41~~–.27~~44~~.

* * *

.35 If the auditor has not obtained sufficient appropriate audit evidence about a relevant assertion or has substantial doubt about a relevant assertion, the auditor should perform procedures to obtain further audit evidence to address the matter. If the auditor is unable to obtain sufficient appropriate audit evidence to have a reasonable basis to conclude about whether the financial statements as a whole are free of material misstatement, AS 3105~~1~~ indicates that the auditor should express a qualified opinion or a disclaimer of opinion.[21]

[21] AS 3105~~1~~.05~~22~~–.17~~34~~ contains requirements regarding audit scope limitations.

* * *

**Appendix B**

[1] If the financial statements contain material misstatements, AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, indicates that the auditor should issue a qualified or an adverse opinion on the financial statements. AS 3105~~1~~.18~~35~~ discusses situations in which the financial statements are materially affected by a departure from the applicable financial reporting framework.

* * *

**Appendix C**

[2] Denial of access to information might constitute a limitation on the scope of the audit that requires the auditor to qualify or disclaim an opinion. (*See* AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements,* and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.)

* * *

**AS 2815, *The Meaning of "Present Fairly in Conformity with Generally Accepted Accounting Principles"***

.01 An independent auditor's report contains an opinion as to whether the financial statements present fairly, in all material respects, an entity's financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. An identification of the applicable financial reporting framework ~~country of origin of those generally accepted accounting principles also~~ is required (*see* ~~paragraph .08*h* of AS 3101~~paragraph .08e of the AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*).

The purpose of this section is to explain the meaning of "present fairly" as used in the phrase "present fairly . . . in conformity with generally accepted accounting principles." In applying this section, the auditor should look to the requirements of the Securities and Exchange Commission for the company under audit with respect to the accounting principles applicable to that company.

* * *

[1] The concept of materiality is inherent in the auditor's judgments. That concept involves qualitative as well as quantitative judgments (*see* AS 2105, *Consideration of Materiality in Planning and Performing an Audit*, and AS 3105~~1~~.19~~36~~).

* * *

**AS 2820, *Evaluating Consistency of Financial Statements***

* * *

.06 The auditor should evaluate and report on a change in accounting estimate effected by a change in accounting principle like other changes in accounting principle.[5] In addition, the auditor should recognize a change in the reporting entity[6] by including an explanatory paragraph, including an appropriate title, in the auditor's report, unless the change in reporting entity results from a transaction or event. A change in reporting entity that results from a transaction or event, such as the creation, cessation, or complete or partial purchase or disposition of a subsidiary or other business unit does not require recognition in the auditor's report.

* * *

.08 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements. If the auditor concludes that the criteria in paragraph .07 have been met, the auditor should add an explanatory paragraph, including an appropriate title, to the auditor's report, as described in ~~AS 3101, *Reports on Audited Financial Statements*~~ paragraphs .12-.15 of this standard. If those criteria are not met, the auditor should treat this accounting change as a departure from generally accepted accounting principles and, if the effect of the change in accounting principle is material, issue a qualified or an adverse opinion ~~address the matter as described in AS 3101~~.[8A]

> Note: If a company's financial statements contain an investment accounted for by the equity method, the auditor's evaluation of consistency should include consideration of the investee. If the investee makes a change in accounting principle that is material to the investing company's financial statements, the auditor should add an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph), to the auditor's report, as described in ~~AS 3101~~ paragraphs .12-.15.

[8A] AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*, describes reporting requirements related to a qualified or an adverse opinion.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.09 The correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title, as described in ~~AS 3101~~ paragraphs .16 and.17 of this standard.

.10 The accounting pronouncements generally require certain disclosures relating to restatements to correct misstatements in previously issued financial statements. If the financial statement disclosures are not adequate, the auditor should address the inadequacy of disclosure as described in paragraph .31 of AS 2810, *Evaluating Audit*

*Results,* and AS 3105~~1~~, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

**Change in Classification**

.11 Changes in classification in previously issued financial statements do not require recognition in the auditor's report, unless the change represents the correction of a material misstatement or a change in accounting principle. Accordingly, the auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change also is a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications in previously issued financial statements, such as reclassifications of debt from long-term to short-term or reclassifications of cash flows from the operating activities category to the financing activities category, might occur because those items were incorrectly classified in the previously issued financial statements. In such situations, the reclassification also is the correction of a misstatement. If the auditor determines that the reclassification is a change in accounting principle, he or she should address the matter as described in paragraphs .07,~~ and~~ .08, and ~~AS 3101~~ .12-.15. If the auditor determines that the reclassification is a correction of a material misstatement in previously issued financial statements, he or she should address the matter as described in paragraphs .09,~~ and~~ .10, ~~and~~ ~~AS 3101~~ .16 and.17.

**Reporting on Consistency of Financial Statements**

**Change in Accounting Principle**

.12 A change in accounting principle that has a material effect on the financial statements should be recognized in the auditor's report on the audited financial statements through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph). The explanatory paragraph should include identification of the nature of the change and a reference to the note disclosure describing the change.

.13 The following is an example of an explanatory paragraph for a change in accounting principle resulting from the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has changed its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*] due to the adoption of [*name of accounting pronouncement*].

.14 The following is an example of an explanatory paragraph for a change in accounting principle other than a change due to the adoption of a new accounting pronouncement:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the Company has elected to change its method of accounting for [*describe accounting method changes*] in [*year(s) of financial statements that reflect the accounting method change*].

.15 The explanatory paragraph relating to a change in accounting principle should be included in reports on financial statements in the year of the change and in subsequent years until the new accounting principle is applied in all periods presented. If the new accounting change is accounted for by retrospective application to the financial statements of all prior periods presented, the additional paragraph is needed only in the year of the change.

**Correction of a Material Misstatement in Previously Issued Financial Statements**

.16 Correction of a material misstatement in previously issued financial statements should be recognized in the auditor's report through the addition of an explanatory paragraph, including an appropriate title (immediately following the opinion paragraph).[10] The explanatory paragraph should include (1) a statement that the previously issued financial statements have been restated for the correction of a misstatement in the respective period and (2) a reference to the note disclosure describing the correction of the misstatement. The following is an example of an appropriate explanatory paragraph when there has been a correction of a material misstatement in previously issued financial statements:

> [*Appropriate Title*]
>
> As discussed in Note X to the financial statements, the 20X2 financial statements have been restated to correct a misstatement.

[10] AS 3105.52-53 apply when comparative financial statements are presented and the opinion on the prior-period financial statements differs from the opinion previously expressed.

.17 This type of explanatory paragraph in the auditor's report should be included in reports on financial statements when the related financial statements are restated to correct the prior material misstatement. The paragraph need not be repeated in subsequent years.

*** * ***

**AS 3110, *Dating of the Independent Auditor's Report***

.06 An independent auditor may reissue his report on financial statements contained in annual reports filed with the Securities and Exchange Commission or other regulatory agencies or in a document he submits to his client or to others that contains information in addition to the client's basic financial statements subsequent to the date of his original report on the basic financial statements. An independent auditor may also be requested by his client to furnish additional copies of a previously issued report. Use of the original report date in a reissued report removes any implication that records, transactions, or events after that date have been examined or reviewed. In such cases, the independent auditor has no responsibility to make further investigation or inquiry as to events which may have occurred during the period between the original report date and the date of the release of additional reports. However, *see* AS 4101 as to an auditor's responsibility when his report is included in a registration statement filed under the Securities Act of 1933 and *see* paragraphs .54~~70 -~~.57~~73~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, for the predecessor auditor's responsibility when reissuing or consenting to the reuse of a report previously issued on the financial statements of a prior period.

*** * ***

**AS 3305, *Special Reports***

.01 This section applies to auditors' reports issued in connection with the following:

*** * ***

*e.* Financial information presented in prescribed forms or schedules that require a prescribed form of auditor's reports (paragraphs .32 and .33)

Note: In situations in which an auditor's report described in this section is filed with the U.S. Securities and Exchange Commission, the auditor is required to include in the auditor's report the basic elements and, for reports under subparagraph .01a, communication of critical audit matters, as would be required in an unqualified auditor's reporting under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*. For qualified, adverse, and disclaimer of opinion reports, see requirements of AS 3105, *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

[2] In some instances, a document containing the auditor's report may include a statement by management regarding its responsibility for the presentation of the financial statements. Nevertheless, the auditor's report should state that the financial statements are management's responsibility. However, the statement about management's responsibility should not be further elaborated upon in the auditor's ~~standard~~ report or referenced to management's report.

* * *

.06 Unless the financial statements meet the conditions for presentation in conformity with a "comprehensive basis of accounting other than generally accepted accounting principles" as defined in paragraph .04, the auditor should modify his or her report ~~use the standard form of report (*see* paragraph .08 of AS 3101, Reports on Audited Financial Statements) modified as appropriate~~ because of the departures from generally accepted accounting principles (*see* AS 3105).

* * *

.12 When expressing an opinion on one or more specified elements, accounts, or items of a financial statement, the auditor should plan and perform the audit and prepare his or her report with a view to the purpose of the engagement. ~~With the exception of the requirement in AS 3101.08*h*, t~~The standards of the PCAOB are applicable to any engagement to express an opinion on one or more specified elements, accounts, or items of a financial statement. ~~AS 3101.08*h*, which requires that the auditor's report state whether the financial statements are presented in conformity with generally accepted accounting principles, is applicable only when~~ If the specified elements, accounts, or items of a financial statement are intended to be presented in conformity with generally accepted accounting principles, the requirements for the auditor's report, as described in AS 3101 and AS 3105, are applicable.

* * *

.14 The auditor should not express an opinion on specified elements, accounts, or items included in financial statements on which he or she has expressed an adverse opinion or disclaimed an opinion based on an audit, if such reporting would be tantamount to expressing a piecemeal opinion on the financial statements (*see* AS 3105~~1~~.48~~64~~). However, an auditor would be able to express an opinion on one or more specified elements, accounts, or items of a financial statement provided that the matters to be reported on and the related scope of the audit were not intended to and did not encompass so many elements, accounts, or items as to constitute a major portion of the financial statements. For example, it may be appropriate for an auditor to express an opinion on an entity's accounts receivable balance even if the auditor has disclaimed an opinion on the financial statements taken as a whole. However, the report on the specified element, account, or item should be presented separately from the report on the financial statements of the entity.

**Reports on One or More Specified Elements, Accounts, or Items of a Financial Statement**

.15 When an independent auditor is engaged to express an opinion on one or more specified elements, accounts, or items of a financial statement, the report should include—

*** * ***

b. A paragraph that—

(1) States that the specified elements, accounts, or items identified in the report were audited. If the audit was made in conjunction with an audit of the company's financial statements, the paragraph should so state and indicate the date of the auditor's report on those financial statements. Furthermore, any departure from the ~~standard~~ auditor's unqualified report on those statements should also be disclosed if considered relevant to the presentation of the specified element, account or item.

(2) States that the specified elements, accounts, or items are the responsibility of the Company's management and that the auditor is responsible for expressing an opinion on the specified elements, accounts or items based on the audit.

* * *

.17 The auditor should consider the effect that any departure, including additional explanatory language because of the circumstances discussed in AS 3101.18~~1~~, from the ~~standard~~ auditor's unqualified report on the audited financial statements might have on the report on a specified element, account, or item thereof.

* * *

.21 When an auditor's report on compliance with contractual agreements or regulatory provisions is included in the report that expresses the auditor's opinion on the financial statements, the auditor should include a paragraph, ~~after the opinion paragraph~~ in the Opinion on the Financial Statements section, that provides negative assurance relative to compliance with the applicable covenants of the agreement, insofar as they relate to accounting matters, and that specifies the negative assurance is being given in connection with the audit of the financial statements. The auditor should also ordinarily state that the audit was not directed primarily toward obtaining knowledge regarding compliance. In addition, the report should include a paragraph that includes a description and source of any significant interpretations made by the entity's management as discussed in paragraph .20d as well as a paragraph that restricts the use of the report to the specified parties as discussed in paragraph .20e. Following are examples of reports that might be issued:

* * *

.31 Certain circumstances, while not affecting the auditor's unqualified opinion, may require that the auditor add additional explanatory language to the special report. These circumstances include the following:

*a.* *Lack of Consistency in Accounting Principles.* If there has been a change in accounting principles or in the method of their application,[35] the auditor should add an explanatory paragraph, including an appropriate title, to the report (immediately following the opinion paragraph) that describes the change and refers to the note to the financial presentation (or specified elements, accounts, or items thereof) that discusses the change and its effect thereon [36] if the accounting change is considered relevant to the presentation. Guidance on reporting in this situation is contained in ~~AS 3101.16 through .18~~ AS 2820, *Evaluating Consistency of Financial Statements*.

*b.* *Going Concern* Uncertainties. If the auditor has substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time not to exceed one year beyond the date of the financial statement, the auditor should add an explanatory paragraph, including an appropriate title, after the opinion paragraph of the report only if the auditor's substantial doubt is relevant to the presentation.[39]

*c.* *Other Auditors.* When the auditor decides to make reference to the report of another auditor as a basis, in part, for his or her opinion, the auditor should disclose that fact in the introductory paragraph of the report and should refer to the report of the other auditors in expressing his or her opinion. Guidance on reporting in this situation is contained in ~~section AS 3101.12 and .13~~ AS 1205, *Part of the Audit Performed by Other Independent Auditors*.

d. *Comparative Financial Statements (or Specified Elements, Accounts, or Items Thereof).* If the auditor expresses an opinion on prior-period financial statements (or specified elements, accounts, or items thereof) that is different from the opinion he or she previously expressed on that same information, the auditor should disclose all of the substantive reasons for the different opinion in a separate explanatory paragraph ~~preceding~~ immediately following the opinion paragraph of the report. Guidance on reporting in this situation is contained in AS 3105~~1~~.52~~68~~ and .53~~69~~.

* * *

**AS 3310, *Special Reports on Regulated Companies***

* * *

.02 The basic postulates and broad principles of accounting comprehended in the term "generally accepted accounting principles" which pertain to business enterprises in general apply also to companies whose accounting practices are prescribed by governmental regulatory authorities or commissions. (For example, public utilities and insurance companies.) Accordingly, the requirement in paragraph .08e~~h~~ of AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, is equally applicable to opinions on financial statements of such regulated companies presented for purposes other than filings with their respective supervisory agencies; and material variances from generally accepted accounting principles, and their effects, should be dealt with in the independent auditor's report in the same manner followed for companies which are not regulated.[1] Ordinarily, this will require either a qualified or an adverse opinion on such statements. An adverse opinion may be accompanied by an opinion on supplementary data which are presented in conformity with generally accepted accounting principles.

* * *

.04 When financial statements of a regulated entity are prepared in accordance with a basis of accounting prescribed by one or more regulatory agencies or the financial reporting provisions of another agency, the independent auditor may also be requested to report on their fair presentation in conformity with such prescribed basis of accounting in presentations for distribution in other than filings with the entity's regulatory agency. In those circumstances, the auditor should ~~use the standard form of report (*see* AS 3101.08),~~ ~~modified~~ modify the auditor's report as appropriate (*see* paragraphs .18-.43 of AS 3105~~1.35–.60~~, *Departures from Unqualified Opinions and Other Reporting*

*Circumstances*) because of the departures from generally accepted accounting principles, and then, in an additional paragraph to the report, express an opinion on whether the financial statements are presented in conformity with the prescribed basis of accounting.

* * *

**AS 3315, *Reporting on Condensed Financial Statement and Selected Financial Data***

* * *

.02 In reporting on condensed financial statements or selected financial data in circumstances other than those described in paragraph .01, the auditor should follow the guidance in paragraphs .24~~41~~ through .27~~44~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, AS 3305, *Special Reports*, or other applicable PCAOB standards.[2]

* * *

.06 The following is an example of wording that an auditor may use in the circumstances described in paragraph .01(*a*) to report on condensed financial statements that are derived from financial statements that he or she has audited and on which he or she has issued ~~a standard~~ an auditor's unqualified report:

Report of Independent Registered Public Accounting Firm

> We have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*]~~income, retained earnings, and cash flows~~ for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated financial statements is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

.07 A client might make a statement in a client-prepared document that names the auditor and also states that condensed financial statements have been derived from audited financial statements. Such a statement does not, in itself, require the auditor to report on the condensed financial statements, provided that they are included in a document that contains audited financial statements (or that incorporates such statements by reference to information filed with a regulatory agency). However, if such a statement is made in a client-prepared document of a public entity that is required to file, at least annually, complete audited financial statements with a regulatory agency and that document does not include audited financial statements (or does not incorporate such statements by reference to information filed with a regulatory agency), ~~[6]~~ the auditor should request that the client either (*a*) not include the auditor's name in the document or (*b*), include the auditor's report on the condensed financial statements, as described in paragraph .05. If the client will neither delete the reference to the auditor nor allow the appropriate report to be included, the auditor should advise the client that he does not consent to either the use of his name or the reference to him, and he should consider what other actions might be appropriate.[7]

~~[6] If such a statement is made in a client-prepared document that does not include audited financial statements and the client is not a public entity that is required to file complete audited financial statements with a regulatory agency (at least annually), the auditor would ordinarily express an adverse opinion on the condensed financial statements because of inadequate disclosure. (*See* AS 3101.41 through .44) The auditor would not be expected to provide the disclosure in his report. The following is an example of an auditor's report on condensed financial statements in such circumstances when the auditor had previously audited and reported on the complete financial statements:~~

~~Report of Independent Registered Public Accounting Firm.~~

> ~~We have audited the consolidated balance sheet of X Company and subsidiaries as of December 31, 20X0, and the related earnings, and cash flows for the year then ended (not presented herein). These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion. The condensed consolidated balance sheet as of December 31, 20X0, and the related condensed statements of income, retained~~

~~earnings, and cash flows for the year then ended, presented on pages xx-xx, are presented as a summary and therefore do not include all of the disclosures required by accounting principles generally accepted in the United States of America. In our opinion, because of the significance of the omission of the information referred to in the preceding paragraph, the condensed consolidated financial statements referred to above do not present fairly, in conformity with accounting principles generally accepted in the United States of America, the financial position of X Company and subsidiaries as of December 31, 20X0, or the results of its operations or its cash flows for the year then ended. [Footnote revised, October 2000, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 93.]~~

* * *

.10 The following is an example of an additional paragraph included in the Opinion on the Financial Statements section of the auditor's report ~~that includes an additional paragraph~~ because ~~he~~ the auditor is also engaged to report on selected financial data for a five-year period ended December 31, ~~19~~20X5, in a client-prepared document that includes audited financial statements:

~~Report of Independent Registered Public Accounting Firm~~

~~We have audited the consolidated balance sheets of ABC Company and subsidiaries as of December 31, 19X5 and 19X4, and the related consolidated statements of income, retained earnings, and cash flows for each of the three years in the period ended December 31, 19X5. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.~~

~~We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provided a reasonable basis for our opinion.~~

Opinion on the Financial Statements

*[Same basic elements in the Opinion on the Financial Statements section as the auditor's unqualified report in AS 3101]*

In our opinion, the consolidated financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of the ~~ABC~~ the Company and subsidiaries as of December 31, 20X5 and 20X4, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 20X5, in conformity with accounting principles generally accepted in the United States of America.

We have also previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheets as of December 31, 20X3, 20X2, and 20X1, and the related statements of [*titles of the financial statements, e.g., income, comprehensive income, stockholders' equity, and cash flows*] for the years ended December 31, 20X2, and 20X1, and the related notes [*and schedules*] (collectively referred to as the "20X3, 20X2, and 20X1 consolidated financial statements") (none of which are presented herein); and we expressed unqualified opinions on those 20X3, 20X2, and 20X1 consolidated financial statements. In our opinion, the information set forth in the selected financial data for each of the five years in the period ended December 31, 20X5, appearing on page xx, is fairly stated, in all material respects, in relation to the consolidated financial statements from which it has been derived.

* * *

### AS 3320, *Association with Financial Statements*

* * *

.04 An accountant may be associated with audited or unaudited financial statements. Financial statements are audited if the accountant has applied auditing procedures sufficient to permit him to report on them as described in AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion,* and AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. The unaudited interim financial statements (or financial information) of a public entity are reviewed when the accountant has applied procedures sufficient to permit him to report on them as described in AS 4105, *Reviews of Interim Financial Information*.

* * *

**AS 4101, *Responsibilities Regarding Filings Under Federal Securities Statutes***

* * *

.11 A registration statement filed with the Securities and Exchange Commission may contain the reports of two or more independent auditors on their audits of the financial statements for different periods. An auditor who has audited the financial statements for prior periods but has not audited the financial statements for the most recent audited period included in the registration statement has a responsibility relating to events subsequent to the date of the prior-period financial statements, and extending to the effective date, that bear materially on the prior-period financial statements on which he reported. Generally, he should

*a.* Read pertinent portions of the prospectus and of the registration statement.

*b.* Obtain a letter of representation from the successor independent auditor regarding whether his audit (including his procedures with respect to subsequent events) revealed any matters that, in his opinion, might have a material effect on the financial statements reported on by the predecessor auditor or would require disclosure in the notes thereto.

The auditor should make inquiries and perform other procedures that he considers necessary to satisfy himself regarding the appropriateness of any adjustment or disclosure affecting the prior-period financial statements covered by his report (*see* AS 3105~~1~~, ~~Reports on Audited Financial Statements~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*).

* * *

**AS 4105, *Reviews of Interim Financial Information***

* * *

**Form of Accountant's Review Report**

* * *

.37 The accountant's review report accompanying interim financial information ~~should consist of~~ must include the title, "Report of Independent Registered Public Accounting Firm."

.37A If the accountant's review report is included in a filing with the SEC or another regulatory agency, the report must be addressed to the shareholders and the board of directors, or equivalents for companies not organized as corporations. The accountant's review report may include additional addressees.

.37B The first section of the accountant's review report must include the section title "Results of Review of Interim Financial Information" and the following elements:

> ~~a. A title that includes the word independent.~~
>
> a. The name of the company whose interim financial information was reviewed.
>
> b. A statement that the interim financial information identified in the report was reviewed.
>
> c~~g~~. A statement about whether the accountant is aware of any material modifications that should be made to the accompanying interim financial information for it to conform with generally accepted accounting principles. The statement should include an identification of the country of origin of those accounting principles (for example, accounting principles generally accepted in the United States of America or U.S. generally accepted accounting principles).

.37C The second section of the accountant's review report must include the section title "Basis for Review Results" and the following elements:

> a~~c~~. A statement that the interim financial information is the responsibility of the entity's management.
>
> b~~d~~. A statement that the review of interim financial information was conducted in accordance with the standards of the PCAOB.
>
> c~~e~~. A description of the procedures for a review of interim financial information.
>
> d~~f~~. A statement that a review of interim financial information is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB, the objective of which is an expression of an opinion regarding the financial statements taken as a whole, and accordingly, no such opinion is expressed.
>
> e. A statement that the auditor is a public accounting firm registered with the PCAOB (United States) and is required to be independent with respect to the

company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the SEC and the PCAOB.

.37D The accountant's review report must include the following elements:

a~~h~~. The ~~manual or printed~~ signature of the accountant's firm.[24A]

b~~i~~. The city and state (or city and country, in the case of non-U.S. auditors) from which the accountant's review report has been issued.[24~~A~~B]

c~~j~~. The date of the review report. (Generally, the report should be dated as of the date of completion of the review procedures.[25])

In addition, each page of the interim financial information should be clearly marked as unaudited.

[24A] *See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).

[24~~A~~B] *Id.*~~*See* SEC Rule 2-02(a) of Regulation S-X, 17 C.F.R. § 210.2-02(a).~~

.38 The following is an example of a review report:[26]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.39 An accountant may be engaged to report on a review of comparative interim financial information. The following is an example of a review report on a condensed balance sheet as of March 31, 20X1, the related condensed statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and a condensed balance sheet derived from audited financial statements as of December 31, 20X0, that were included in Form 10-Q. [27]

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the condensed consolidated balance sheet of ABC Company (the "Company") and subsidiaries as of March 31, 20X1, and the related condensed consolidated statements of income and cash flows for the three-month periods ended March 31, 20X1 and 20X0, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our reviews, we are not aware of any material modifications that should be made to the condensed financial statements referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the consolidated balance sheet of ~~ABC~~ the Company and subsidiaries as of December 31, 20X0, and the related consolidated statements of income, retained earnings, and cash flows for the year then ended (not presented herein); and in our report dated February 15, 20X1, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 20X0, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.[28]

Basis for Review Results

These financial statements are the responsibility of the Company's management. We conducted our review in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

[28] If the auditor's report on the preceding year-end financial statements was other than unqualified, referred to other auditors, or included an explanatory paragraph because of a going-concern matter or an inconsistency in the application of accounting principles, the ~~last~~ second paragraph of the illustrative report in paragraph .39 should be appropriately modified.

.40 The accountant may use and make reference to another accountant's review report on the interim financial information of a significant component of a reporting entity. This reference indicates a division of responsibility for performing the review.[29] The following is an example of report including such a reference:

Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of ABC Company

Results of Review of Interim [*Financial Information or Statements*]

We have reviewed the accompanying [*describe the interim financial information or statements reviewed*] of ABC Company (the "Company") and consolidated subsidiaries as of September 30, 20X1, and for the three-month and nine-month periods then ended, and the related notes [*and schedules*] (collectively referred to as the "interim financial information or statements"). Based on our review and the report of other accountants, we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.

We were furnished with the report of other accountants on their review of the interim financial information of DEF subsidiary, whose total assets as of September 30, 20X1, and whose revenues for the three-month and nine-month periods then ended, constituted 15 percent, 20 percent, and 22 percent, respectively, of the related consolidated totals.

Basis for Review Results

This (These) interim financial information (statements) is (are) the responsibility of the Company's management. We conducted our reviews in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"). A review of interim financial information (statements) consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board~~, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

[*Signature*]

[*City and State or Country*]

[*Date*]

.41 The accountant's report on a review of interim financial information should be modified for departures from generally accepted accounting principles,[30] which include inadequate disclosure and changes in accounting principle that are not in conformity with generally accepted accounting principles. The existence of substantial doubt about the entity's ability to continue as a going concern or a lack of consistency in the application of accounting principles affecting the interim financial information would not require the accountant to add an additional paragraph to the report, provided that the interim financial information appropriately discloses such matters. Although not required, the accountant may wish to emphasize such matters in a separate explanatory paragraph of the report. *See* paragraphs .44 and .45 of this section for examples of paragraphs that address matters related to an entity's ability to continue as a going concern.

~~[30] If the circumstances contemplated by Rule 203, *Accounting Principles*, are present, the accountant should refer to the guidance in paragraph .15 of AS 3101, Reports on Audited Financial Statements.~~

.42 *Departure from generally accepted accounting principles.* If the accountant becomes aware that the interim financial information is materially affected by a departure from generally accepted accounting principles, he or she should modify the report. The modification should describe the nature of the departure and, if practicable, should state the effects on the interim financial information. Following is an example of such a modification of the accountant's report.

> [~~*Concluding paragraph*~~]
>
> Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.
>
> [~~*Explanatory third paragraph*~~]
>
> Based on information furnished to us by management, we believe that the company has excluded from property and debt in the accompanying balance sheet certain lease obligations that we believe should be capitalized to conform with accounting principles generally accepted in the United States of America. This information indicates that if these lease obligations were capitalized at September 30, 20X1, property would be increased by $______, long-term debt by $______, and net income and earnings per share would be increased (decreased) by $________, $_________, $________, and $________, respectively, for the three-month and nine-month periods then ended.

* * *

.43 *Inadequate disclosure*. The information necessary for adequate disclosure is influenced by the form and context in which the interim financial information is presented. For example, the disclosures considered necessary for interim financial information presented in accordance with the minimum disclosure requirements of APB Opinion No. 28, paragraph 30, which is applicable to summarized financial statements of public companies, are considerably less extensive than those necessary for annual financial statements that present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.[31] If information that the accountant believes is necessary for adequate disclosure in conformity with generally accepted accounting principles[32] is not included in the interim financial information, the accountant should modify the report and, if practicable, include the necessary information in the report. The following is an example of such a modification of the accountant's report:

> ~~[*Concluding paragraph*]~~
>
> Based on our review, with the exception of the matter(s) described in the ~~preceding~~ following paragraph(s), we are not aware of any material modifications that should be made to the accompanying interim financial information (statements) for it (them) to be in conformity with accounting principles generally accepted in the United States of America.
>
> ~~[*Explanatory third paragraph*]~~
>
> Management has informed us that the company is presently contesting deficiencies in federal income taxes proposed by the Internal Revenue Service for the years 20X1 through 20X3 in the aggregate amount of approximately $_____, and that the extent of the company's liability, if any, and the effect on the accompanying information (statements) is not determinable at this time. The information (statements) fail(s) to disclose these matters, which we believe are required to be disclosed in conformity with accounting principles generally accepted in the United States of America.

.44 *Going-concern paragraph was included in the prior year's audit report; conditions giving rise to the paragraph continue to exist.* If (*a*) the auditor's report for the prior year end contained an explanatory paragraph indicating the existence of substantial doubt about the entity's ability to continue as a going concern, (*b*) the conditions that raised such doubt continued to exist as of the interim reporting date covered by the review, and (*c*) there is adequate and appropriate disclosure about these conditions in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report, ~~after the concluding paragraph,~~ including an appropriate title (immediately following the paragraph describing the results of the review), emphasizing the matter disclosed in the audited financial statements and the interim financial information. The following is an example of such a paragraph.

> [Appropriate Title]
>
> Note 4 of the Company's audited financial statements as of December 31, 20X1, and for the year then ended discloses that the Company was unable to renew its line of credit or obtain alternative financing at December 31, 20X1. Our auditor's report on those financial statements includes an explanatory paragraph referring to the matters in Note 4 of those financial statements and indicating that these matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 3 of the Company's unaudited interim financial statements as of March 31, 20X2, and for the three months then ended, the Company was still unable to renew its line of credit or obtain alternative financing as of March 31, 20X2. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

.45 *Going-concern paragraph was not included in the prior year's audit report; conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern.* If (*a*) conditions or events exist as of the interim reporting date covered by the review that might be indicative of the entity's possible inability to continue as a going concern, and (*b*) there is adequate and appropriate disclosure about these conditions or events in the interim financial information, the accountant is not required to modify his or her report. However, the accountant may add an explanatory paragraph to the review report~~, after the concluding paragraph~~, including an appropriate title (immediately following the paragraph describing the results of the review), emphasizing the matter disclosed in the interim financial information. The following is an example of such a paragraph.

> [Appropriate Title]
>
> As indicated in Note 3, certain conditions indicate that the Company may be unable to continue as a going concern. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

* * *

.50 The auditor ordinarily need not modify his or her report on the audited financial statements to refer to his or her having performed a review in accordance with this section or to refer to the interim financial information accompanying the audited financial statements because the interim financial information has not been audited and is not required for the audited financial statements to be fairly stated in conformity with generally accepted accounting principles. The auditor's report on the audited financial statements should, however, be modified in the following circumstances:

* * *

c. The selected quarterly financial data required by item 302(a) of Regulation S-K is omitted. The auditor should add an explanatory paragraph, including an appropriate title, to the report, ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) is omitted. The following is an example of such a paragraph.

> [Appropriate Title]
>
> The company has not presented the selected quarterly financial data specified in item 302(a) of Regulation S-K that the Securities and Exchange Commission requires as supplementary information to the basic financial statements.

d. The selected quarterly financial data required by item 302(a) of Regulation S-K has not been reviewed. The auditor should add an explanatory paragraph, including an appropriate title, to the report, ~~The following is an example of a paragraph that should be added to the auditor's report~~ if the selected quarterly financial data required by item 302(a) has not been reviewed. The following is an example of such a paragraph.

> [Appropriate Title]
>
> The selected quarterly financial data on page xx contains information that we did not audit, and, accordingly, we do not express an opinion on that data. We attempted but were unable to review the quarterly data in accordance with the standards of the Public Company Accounting Oversight Board because we believe that the company's internal control for the preparation of interim financial information does not provide an adequate basis to enable us to complete such a review.

* * *

**AS 6101, *Letters for Underwriters and Certain Other Requesting Parties***

* * *

.27 When the report on the audited financial statements and financial statement schedules included (incorporated by reference) in the registration statement ~~departs from the standard report~~ includes one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements, ~~for instance, where one or more explanatory paragraphs or a paragraph to emphasize a matter regarding the financial statements have been added to the report,~~ the accountants should refer[18] to that fact in the comfort letter and discuss the subject matter of the paragraph.[19] In those rare instances in which the SEC accepts a qualified opinion on historical financial statements, the accountants should refer to the qualification in the opening paragraph of the comfort letter and discuss the subject matter of the qualification. (*See also* paragraph .35*f*.)

* * *

.30 An underwriter may also request that the accountants comment in their comfort letter on (*a*) unaudited interim financial information required by item 302(a) of Regulation S-K, to which AS 4105 pertains or (*b*) required supplementary information, to which AS 2705 pertains. AS 4105 and AS 2705 provide that the accountants should expand the ~~standard~~ auditor's unqualified report on the audited financial statements to refer to such information when the scope of their procedures with regard to the information was restricted or when the information appears not to be presented in conformity with generally accepted accounting principles or, for required supplementary information, applicable guidelines. Such expansions of the ~~accountants' standard~~ auditor's unqualified report in the registration statement would ordinarily be referred to in the opening paragraph of the comfort letter (*see also* paragraph .35*f*). Additional comments on such unaudited information are therefore unnecessary. However, if the underwriter requests that the accountants perform procedures with regard to such information in addition to those performed in connection with their review or audit as prescribed by AS 4105 and AS 2705, the accountants may do so and report their findings.

* * *

.35

* * *

*f.* When the report on the audited financial statements and financial statement schedules in the registration statement departs from the auditor's ~~standard~~ unqualified report, and the comfort letter includes negative assurance with respect to subsequent unaudited condensed interim financial information included (incorporated by reference) in the registration statement or with respect to an absence of specified subsequent changes, increases, or decreases, the accountant should consider the effect thereon of the subject matter of the qualification, explanatory paragraph(s), or paragraph(s) emphasizing a matter regarding the financial statements. The accountant should also follow the guidance in paragraph .27. An illustration of how this type of situation may be dealt with is shown in example I [paragraph .64].

* * *

## III. Amendments to Auditing Interpretations

### AI 11, *Using the Work of a Specialist: Auditing Interpretations of AS 1210*

* * *

.21 *Interpretation*—When other relevant evidential matter exists, the auditor should consider it before reaching a conclusion about the appropriateness of management's accounting for a transfer.[14] However, since the isolation aspect of surrender of control is assessed primarily from a legal perspective, the auditor usually will not be able to obtain persuasive evidence in a form other than a legal opinion. In the absence of persuasive evidence that a transfer has met the isolation criterion, derecognition of the transferred assets is not in conformity with generally accepted accounting principles and the auditor should consider the need to express a qualified or adverse opinion in accordance with paragraphs .18~~35~~ through .43~~60~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*. However, if permission for the auditor to use a legal opinion that he or she deems otherwise adequate is not granted, this would be a scope limitation and the auditor should consider the need to express a qualified opinion or to disclaim an opinion in accordance with AS 3105~~1~~.05~~22–~~.09~~26~~ and AS 3105~~1~~.44~~61–~~.47~~63~~.

* * *

### AI 16, *Auditing Accounting Estimates: Auditing Interpretations of AS 2501*

* * *

.03 *Required Information Presented*—When an entity discloses in its basic financial statements only information required by FASB Statement No. 107, the auditor may issue an ~~standard~~ unqualified opinion (assuming no other report modifications are necessary). The auditor may add an emphasis-of-matter paragraph describing the nature and possible range of such fair value information especially when management's best estimate of value is used in the absence of quoted market values (FASB Statement No. 107, paragraph 11 [AC section F25.115D]) and the range of possible values is significant (*see* paragraph .19 of AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*). If the entity has not disclosed required fair value information, the auditor should evaluate whether the financial statements are materially affected by the departure from generally accepted accounting principles.

* * *

**AI 17, Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments: Auditing Interpretations of AS 2505**

* * *

.23 If the auditor is uncertain as to the meaning of the lawyer's evaluation, he should request clarification either in a follow-up letter or a conference with the lawyer and client, appropriately documented. If the lawyer is still unable to give an unequivocal evaluation of the likelihood of an unfavorable outcome in writing or orally, the auditor should look to the guidance in paragraphs .28~~45~~ through .32~~49~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, to determine the effect, if any, of the lawyer's response on the auditor's report.

* * *

**AI 20: *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of AS 2710***

* * *

.08 *Interpretation*—If the auditor has been engaged to ~~examine and report on management's assertion, the guidance in AT section 501, *Reporting on an Entity's Internal Control Over Financial Reporting*, should be followed~~ perform an audit of management's assessment of the effectiveness of internal control over financial reporting, the auditor should follow the requirement of AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*.

.09 If the auditor has not been engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting ~~examine and report on management's assertion~~, the auditor should follow the requirements in AS

3105.59-60. ~~guidance in AS 2710, which states that "the auditor has no obligation to perform any procedures to corroborate other information contained in [such] a document." Under AS 2710, the auditor is required to read the report by management and consider whether it is materially inconsistent with information appearing in the financial statements and, as a result, he or she may become aware of a material misstatement of fact.[5]~~

~~[5] Unless information on internal control over financial reporting appears in the financial statements, which is not common, a management assertion on the effectiveness of internal control over financial reporting could not be inconsistent with information appearing in financial statements.~~

~~.10 Although not required, the auditor may consider adding the following paragraph to the standard auditor's report: "We were not engaged to examine management's assertion about the effectiveness of [*name of entity's*] internal control over financial reporting as of [*date*] included in the accompanying [*title of management's report*] and, accordingly, we do not express an opinion thereon."~~

* * *

**AI 23, ~~Reports on Audited Financial Statements: Auditing Interpretations of AS 3101~~ Departures from Unqualified Opinions and Other Reporting Circumstances: Auditing Interpretations of AS 310~~1~~5**

* * *

.01 *Question*— Paragraph .07~~24~~ of AS 310~~1~~5, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that "Common restrictions on the scope of the audit include those applying to the observation of physical inventories and the confirmation of accounts receivable by direct communication with debtors. . . ." A footnote to that paragraph states: "Circumstances such as the timing of the work may make it impossible for the auditor to accomplish these procedures. In this case, if the auditor is able to satisfy himself or herself as to inventories or accounts receivable by applying alternative procedures, there is no significant limitation on the scope of the work, and the report need not include reference to the omission of the procedures or to the use of alternative procedures." Outside firms of nonaccountants specializing in the taking of physical inventories are used at times by some companies, such as retail stores, hospitals, and automobile dealers, to count, list, price and subsequently compute the total dollar amount of inventory on hand at the date of the physical count. Would obtaining the report of an outside inventory-taking firm be an acceptable alternative procedure to the independent auditor's own observation of physical inventories?

* * *

.36 ~~Examples of~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report~~s~~ on single year financial statements in the year of adoption of liquidation basis follows:[1A] ~~with such an explanatory paragraph follow.~~

~~*Report on Single Year Financial Statements in Year of Adoption of Liquidation Basis*~~

Opinion on the Financial Statements

~~"~~We have audited the statement of net assets in liquidation of XYZ Company (the "Company") as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2~~.~~, ~~In addition, we have~~ and audited the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the net assets in liquidation of ~~XYZ~~ the Company as of December 31, 20X2, the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the results of its operations and its cash flows for the period from January 1, 20X2 to April 25, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below. ~~in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audit included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audit provides a reasonable basis for our opinion.

[1A] The auditor's report must include the same basic elements and communication of critical audit matters as would be required in an unqualified auditor's report under AS 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*.

~~*Report on Comparative Financial Statements in Year of Adoption of Liquidation Basis*~~ An example of the Opinion on the Financial Statements and the Basis for Opinion sections of an auditor's report on comparative financial statements in the year of adoption of liquidation basis follows:[1B]

Opinion on the Financial Statements

~~"~~We have audited the balance sheet of XYZ Company (the "Company") as of December 31, 20X1, the related statements of income, retained earnings, and cash flows for the year then ended, and the statements of income, retained earnings, and cash flows for the period from January 1, 20X2 to April 25, 20X2, and~~. In addition, we have~~ audited the statement of net assets in liquidation as of December 31, 20X2, and the related statement of changes in net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, and the related notes [*and schedules*] (collectively referred to as the "financial statements"). ~~"~~In our opinion, the financial statements ~~referred to above~~ present fairly, in all material respects, the financial position of ~~XYZ~~ the Company as of December 31, 20X1, the results of its operations and its cash flows for the year then ended and for the period from January 1, 20X2 to April 25, 20X2, its net assets in liquidation as of December 31, 20X2, and the changes in its net assets in liquidation for the period from April 26, 20X2 to December 31, 20X2, in conformity with accounting principles generally accepted in the United States of America applied on the bases described below.~~ in the preceding paragraph."~~

~~"~~As described in Note X to the financial statements, the stockholders of ~~XYZ~~ the Company approved a plan of liquidation on April 25, 20X2, and the Company commenced liquidation shortly thereafter. As a result, the Company has changed its basis of accounting for periods subsequent to April 25, 20X2 from the going-concern basis to a liquidation basis.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

~~"~~We conducted our audits in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. Our ~~An~~ audits included~~s~~ performing procedures to assess the risk of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence ~~supporting~~ regarding the amounts and disclosures in the financial statements. ~~An~~ Our audits also included~~s~~ ~~assessing~~ evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements ~~presentation~~. We believe that our audits provide a reasonable basis for our opinion.

[1B] *Id.*

* * *

**12. Reference in Auditor's ~~Standard~~ Unqualified Report to Management's Report**

.51 *Question*—One of the basic elements of the auditor's ~~standard~~ unqualified report is a statement that the financial statements are the responsibility of the Company's management. That statement is required in the auditor's report even when a document containing the auditor's report includes a statement by management regarding its responsibility for the presentation of the financial statements. When an annual shareholders' report (or other client-prepared document that includes audited financial statements) contains a management report that states the financial statements are the responsibility of management, is it permissible for the auditor's report to include a reference to the management report?

.52 *Interpretation*—No. The statement about management's responsibilities for the financial statements required by AS 3101, ~~*Reports on Audited Financial Statements*~~ *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*, should not be further elaborated upon in the auditor's ~~standard~~ unqualified report or referenced to management's report. Such modifications to the ~~standard~~ auditor's unqualified report may lead users to erroneously believe that the auditor is providing assurances about representations made by management about their responsibility for financial reporting, internal controls and other matters that might be discussed in the management report.

* * *

**14. Reporting on Audits Conducted in Accordance with the Standards of the PCAOB and in Accordance with International Standards on Auditing**

* * *

.56 *Question*—AS 3101 requires ~~states that a basic element of the auditor’s report is~~ a statement that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~. If the auditor conducts the audit in accordance with the standards of the PCAOB and in accordance with the International Standards on Auditing promulgated by the International Auditing and Assurance Standards Board ~~Practices Committee~~ of the International Federation of Accountants, may the auditor so indicate in the auditor’s report?

.57 *Interpretation*—Yes. AS 3101 requires that the auditor indicate in the auditor’s report that the audit was conducted in accordance with the standards of the PCAOB ~~and an identification of the United States of America as the country of origin of those standards~~; however, AS 3101 does not prohibit the auditor from indicating that the audit also was conducted in accordance with another set of auditing standards. If the audit also was conducted in accordance with the International Standards on Auditing, in their entirety, the auditor may so indicate in the auditor's report. To determine whether an audit was conducted in accordance with the International Standards on Auditing, it is necessary to consider the text of the International Standards on Auditing in their entirety, including the basic principles and essential procedures together with the related guidance included in the International Standards on Auditing.

* * *

.59 An example of reporting on an audit conducted in accordance with the standards of the PCAOB and in accordance with International Standards on Auditing follows:

> Basis for Opinion
>
> These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audit. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.
>
> We conducted our audit in accordance with the standards of the PCAOB ~~Public Company Accounting Oversight Board (United States)~~ and in accordance with International Standards on Auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. ~~An~~ Our audit included~~s~~ performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding ~~supporting~~ the amounts and disclosures in the financial statements. ~~An~~ Our audit also included~~s~~ evaluating ~~assessing~~ the accounting principles used and significant estimates made by management, as well as evaluating the overall ~~financial statement~~ presentation of the financial statements. We believe that our audit provides a reasonable basis for our opinion.

* * *

.61 *Interpretation*—If the prior-period audited financial statements are *unchanged*, pursuant to AS 3105~~1~~.58~~74~~ the successor auditor should indicate in the ~~introductory~~

~~paragraph~~ Opinion on the Financial Statements section of his or her report (*a*) that the financial statements of the prior period were audited by another auditor, (*b*) the date of the predecessor auditor's report, (*c*) the type of report issued by the predecessor auditor, and (*d*) if the report was other than ~~a standard~~ an auditor's unqualified report, the substantive reasons therefor. The successor auditor ordinarily also should indicate that the other auditor has ceased operations. Footnote 18~~29~~ of AS 3105~~1~~ indicates that the successor auditor should not name the predecessor auditor in the report. An example of the reference that would be added to the ~~introductory paragraph~~ Opinion on the Financial Statements section of the successor auditor's report is presented as follows:

> The financial statements of ABC Company as of December 31, 20X1, and for the year then ended were audited by other auditors who have ceased operations. Those auditors expressed an unqualified opinion on those financial statements in their report dated March 31, 20X2.

A reference to the predecessor auditor's report should be included even if the predecessor auditor's report on the prior-period financial statements is reprinted and accompanies the successor auditor's report, because reprinting does not constitute reissuance of the predecessor auditor's report.

* * *

.63 When the prior-period financial statements have been restated, the successor auditor may be engaged either to reaudit the prior-period financial statements or to audit only the restatement adjustments. If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. (The auditor also may use the guidance on alternative language contained in paragraph .71, below.) In determining the nature, timing and extent of procedures, the successor auditor should consider that a predecessor auditor who has ceased operations cannot perform the procedures to evaluate the appropriateness of the restatement adjustments as described in AS 2905, *Subsequent Discovery of Facts Existing at the Date of the Auditor's Report*.

* * *

.71 If the successor auditor is engaged to audit only the restatement adjustments and applies sufficient procedures to satisfy himself or herself as to the appropriateness of the restatement adjustments, the successor auditor may report on the restatement adjustments using the guidance in AS 3105~~1~~.58~~74~~. Alternatively, the successor auditor may wish to make it clear that he or she did not audit, review, or apply other procedures to the prior-period financial statements beyond the procedures applied to the restatement adjustments. Accordingly, he or she may include the following paragraph in his or her report:

* * *

.74 *Question*—If the prior-period financial statements audited by a predecessor auditor who has ceased operations have been subsequently restated, but the successor auditor has not yet completed an audit of current-period financial statements, can the successor auditor report on the restatement adjustments pursuant to 3105~~1~~.58~~74~~?

.75 *Interpretation*—No. AS 3105~~1~~.58~~74~~ is only applicable when the prior-period financial statements are presented for comparative purposes with current-period audited financial statements. If the prior-period financial statements have been restated, and the successor auditor is requested to report on those financial statements without also reporting on current-period audited financial statements, the successor auditor would need to reaudit the prior-period financial statements in order to report on them.

* * *

**AI 24, *Special Reports: Auditing Interpretations of AS 3305***

* * *

[10] Generally accepted accounting principles require the use of current-value accounting for financial statements of certain types of entities (for example, investment companies, employee benefit plans, personal financial statements, and mutual and common trust funds). This interpretation does not apply to reports on current-value financial statements of such entities. The auditor engaged to report on current-value financial statements of such entities should follow the guidance in AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*.

* * *

.83 *Interpretation*—No. An offering memorandum generally is a document providing information as the basis for negotiating an offer to sell certain assets or businesses or to raise funds. Normally, parties to an agreement or other specified parties for whom the special-purpose financial presentation is intended have not been identified. Accordingly, the auditor should follow the reporting guidance in AS 3105~~1~~.18~~35–~~.27~~44~~ and .40~~58–~~.43~~60~~.

* * *

.86 If there is no such agreement, the auditor should follow the guidance in AS 3105~~1~~.18~~35–~~.27~~44~~ and .40~~58–~~.43~~60~~.

* * *

***AI 25, Association with Financial Statements: Auditing Interpretations of AS 3320***

* * *

.15 *Question*—Paragraph .01~~.04~~ of ~~AS 3101, *Reports on Audited Financial Statements*,~~ AS 3320, *Association with Financial Statements*, states in part: "In all cases where an auditor's name is associated with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking." ~~Paragraph .03 of~~ AS 3320.03~~, Association with Financial Statements,~~ states that "An accountant is associated with financial statements when he has consented to the use of his name in a report, document, or written communication containing the statements." Is the auditor "associated" with condensed financial data when he is identified by a financial reporting service as being a company's independent auditor or when his report is reproduced and presented with such data?

* * *

**AI 28, *Evidential Matter Relating to Income Tax Accruals: Auditing Interpretations***

* * *

.10 Auditing standards require the auditor to obtain sufficient appropriate evidential matter through, among other things, inspection and inquiries to afford a reasonable basis for an opinion on the financial statements. Paragraph .35 of AS 2810, *Evaluating Audit Results*, requires the auditor to obtain sufficient appropriate evidential matter about assertions in the financial statements of material significance or else to qualify or disclaim his or her opinion on the statements. Paragraph .07~~24~~ of AS 3105~~1~~, ~~*Reports on Audited Financial Statements*~~ *Departures from Unqualified Opinions and Other Reporting Circumstances*, states that, "When restrictions that significantly limit the scope of the audit are imposed by the client, ordinarily the auditor should disclaim an opinion on the financial statements." Also, AS 2805, *Management Representations,* requires the auditor to obtain written representations from management. AS 2805.06

states that specific representations should relate to the following matters, "availability of all financial records and related data," and AS 2805.08 states that a materiality limit does not apply to that representation. AS 2805.13 states that "management's refusal to furnish a written representation" constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

* * *

**White Paper on Characteristics of Emerging Growth Companies**

**as of November 15, 2016[1]**

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[1] This white paper was prepared by PCAOB staff and provides general information about certain characteristics of emerging growth companies. The views expressed herein are those of the authors and do not necessarily reflect the views of the Board, individual Board members, or PCAOB staff.

SUMMARY

This white paper provides general information about certain characteristics of emerging growth companies ("EGCs")—a group defined by the Jumpstart Our Business Startups Act ("JOBS Act"). The information is derived from the most recent available U.S. Securities and Exchange Commission ("SEC") filings and data from third-party vendors through November 15, 2016, the most recent measurement date.

The white paper includes the following key observations as of November 15, 2016:

- There were 1,951 companies that identified themselves as EGCs in at least one SEC filing since 2012 and have filed audited financial statements with the SEC in the 18 months preceding the measurement date ("EGC filers").[2]

- There were 742 EGC filers (or 38%) that have common equity securities listed on a U.S. national securities exchange ("exchange-listed"). These EGC filers represented 15% of the 4,797 exchange-listed companies and approximately 1% of total market capitalization of exchange-listed companies.

- Many EGC filers that were not exchange-listed had limited operations. Approximately 50% of the non-listed EGC filers reported zero revenue in their most recent filing with audited financial statements and 23% of non-listed EGCs that filed periodic reports disclosed that they were shell companies.

- Approximately 51% of EGC filers, including 74% of those that were not exchange-listed, received an explanatory paragraph in their most recent auditor's report expressing substantial doubt about the company's ability to continue as a going concern.

- Among the 1,951 EGC filers, 1,262 provided a management report on internal control over financial reporting in their most recent annual filing. Of those 1,262 companies, approximately 47% reported material weaknesses.

- Approximately 96% of EGC filers were audited by accounting firms that also audited issuers that are not EGC filers, including 39% of EGC filers that were audited by firms that provided audit reports for more than 100 issuers and were required to be inspected on an annual basis by the PCAOB.

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[2] The 1,951 EGC filers do not include companies that were not reporting as EGCs as of the measurement date, as follows:

(i) 200 companies that ceased to qualify as EGCs because of their annual revenue or large accelerated filer status,
(ii) 465 companies that ceased to be SEC registrants, and
(iii) 414 companies that did not file audited financial statements with the SEC in the 18 months preceding the measurement date ("inactive EGCs").

CONTENTS

## I. BACKGROUND & METHODOLOGY

*Background*

Title I of the JOBS Act focuses on reducing regulatory burdens on EGCs in order to facilitate capital raising through public markets.[3] As relevant to this white paper, the JOBS Act generally provides that new PCAOB standards will not apply to the audits of EGCs unless the SEC determines that applying such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.[4] To implement this provision, upon adoption of a rule subject to this determination, the PCAOB recommends to the SEC whether the rule should apply to audits of EGCs, and submits information and analysis in its adopting release to assist the SEC in making a determination. This white paper provides general data about EGCs to inform the analysis contained in PCAOB rulemaking releases regarding the impact of applying new standards to the audits of EGCs.

PCAOB staff anticipates updating the white paper semiannually, based on the most recent data available as of May 15 and November 15 in each year.

Generally, a company qualifies as an EGC if it had less than $1 billion in annual revenues in its most recently completed fiscal year and had not sold common equity securities on or before December 8, 2011, pursuant to a registration statement under the Securities Act of 1933 ("Securities Act").[5] The company retains its EGC status until the earliest of:

(i) the last day of the first fiscal year in which the company's annual gross revenues are $1 billion[6] or more;

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[3] Pub. L. No. 112-106 (April 5, 2012). *See* Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley Act"), 15 U.S.C. 7213(a)(3), as added by Section 104 of the JOBS Act.

[4] *See* Section 103(a)(3)(C) of the Sarbanes-Oxley Act of 2002, as added by Section 104 of the JOBS Act, which provides:

> Any rules of the Board requiring mandatory audit firm rotation or a supplement to the auditor's report in which the auditor would be required to provide additional information about the audit and the financial statements (auditor discussion and analysis) shall not apply to an audit of an emerging growth company, as defined in section 3 of the Securities Exchange Act of 1934. Any additional rules adopted by the Board after [April 5, 2012] shall not apply to an audit of an emerging growth company, unless the Commission determines that the application of such additional requirements is necessary or appropriate in the public interest, after considering the protection of investors, and whether the action will promote efficiency, competition, and capital formation.

[5] *See* Section 3(a)(80) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 101(d) of the JOBS Act.

[6] The $1 billion annual gross revenue threshold is indexed for inflation every five years to reflect the change in the Consumer Price Index.

(ii) the date on which the company is deemed to be a "large accelerated filer" under the Exchange Act (generally, an issuer with a public float of $700 million or more that has been subject to Exchange Act periodic reporting requirements for at least one year and has filed at least one annual report);
(iii) the date on which the company has issued more than $1 billion in non-convertible debt during the prior three year period; or
(iv) the last day of the fiscal year after the fifth anniversary of the company's first sale of common equity securities under an effective Securities Act registration statement.

*Methodology*

PCAOB staff identified the population of EGCs using commercial vendor data about companies that, as of the most recent measurement date, self-identified as EGCs in at least one SEC filing since 2012.[7] The analysis excludes 465 companies that, as of the most recent measurement date, had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness, and, in each case, did not subsequently file audited financial statements with the SEC. The analysis also excludes 200 companies that were identified in a later SEC filing as no longer qualifying as EGCs (for example those that reported $1 billion or more in annual revenues) and companies whose financial statements may be, but are not required to be, audited under PCAOB standards. Using this methodology, the PCAOB staff identified 1,951 companies that have identified themselves as EGCs in at least one SEC filing since 2012 and have filed audited financial statements with the SEC in the 18 months preceding the measurement date ("EGC filers"). An additional 414 companies had previously identified themselves as EGCs but did not file audited financial statements with the SEC in the 18 months preceding the measurement date ("inactive EGCs").

The financial information presented is derived from the most recent annual financial statements filed with the SEC as of the measurement date. This data is obtained using commercial vendor data, supplemented with manually collected data from SEC filings, when necessary.

The white paper describes characteristics of EGC filers and inactive EGCs separately. The analysis focuses primarily on EGC filers, for which information is more current and reflects a more recent experience of an audit conducted under PCAOB standards. Because available information regarding inactive EGCs is potentially stale, the analysis of these is more limited.

The growth in the number of EGC filers and inactive EGCs is presented in Section II. Sections III through VII address EGC filers. Appendix A provides additional information about the population of EGC filers, while Appendix B provides additional information about inactive

[7] The PCAOB staff used commercial vendor data to identify the population of EGCs from SEC filings. SEC filings used to determine the population of companies that self-identified as an EGC include all Securities Act registration statements, Regulation A offering statements where a concurrent Exchange Act registration is filed, Exchange Act registration statements, and Exchange Act periodic reports. Not all companies that are EGCs identify as EGCs in all SEC filings.

EGCs. Appendix C provides information about companies that are no longer EGC filers because of annual revenue in excess of $1 billion or large accelerated filer status. Appendix D provides information about companies that are no longer EGC filers (or inactive EGCs) because they are no longer SEC registrants.

In various cross sectional analyses in this document, the population of EGC filers is further divided between companies that have at least one class of common equity securities listed on a U.S. national securities exchange ("exchange-listed" EGC filers)[8] and those that do not ("non-listed" EGC filers).[9] PCAOB staff identified 742 exchange-listed EGC filers and 1,209 non-listed EGC filers as of November 15, 2016.

To compare the exchange-listed EGC filer population with the broader public equity market, the analysis below also presents a benchmark derived from commercial vendor data on other exchange-listed companies. The benchmark population is limited to exchange-listed companies that are not investment companies[10] and that have filed audited financial statements with the SEC in the 18 months preceding the most recent measurement date. From a total population of 4,797 exchange-listed companies, the 742 exchange-listed EGC filers are excluded to allow for comparison of companies that are EGCs to those that are not. Using this methodology, PCAOB staff identified 4,055 companies in the benchmark population ("other exchange-listed companies") as of November 15, 2016. These exchange-listed companies tend to be larger and generally have a longer reporting history than EGC filers; these attributes may also correlate with other characteristics described in this paper.

The paper does not present a similar benchmark population or data on market capitalization for non-listed EGC filers. Market data may not be reliable or even regularly available with respect to issuers whose securities are quoted on the over-the-counter market or are otherwise illiquid. In addition, issuers whose only publicly-traded securities are debt securities do not have equity market capitalizations. These inherent limitations of available data limit our ability to make useful comparisons among non-listed EGC filers.

The above methodology is applied as of each measurement date. This paper focuses on data as of the most recent measurement date (November 15, 2016) but also provides time series data about the population of EGCs as of previous measurement dates.

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[8] The PCAOB staff obtained exchange-listed company information as of the measurement date derived from Standard & Poor’s Xpressfeed data on all active issue types of "common-ordinary," "units with a common share component," and "depository receipts" where the exchange is a U.S. national securities exchange with available market capitalization data. As of November 15, 2016, EGC filers had primary listings of common equity securities on the following U.S. national securities exchanges: the New York Stock Exchange LLC, Nasdaq Stock Market LLC, NYSE MKT LLC, and NYSE Arca, Inc.

[9] Non-listed EGC filers include companies whose securities are traded over-the-counter or have no public market.

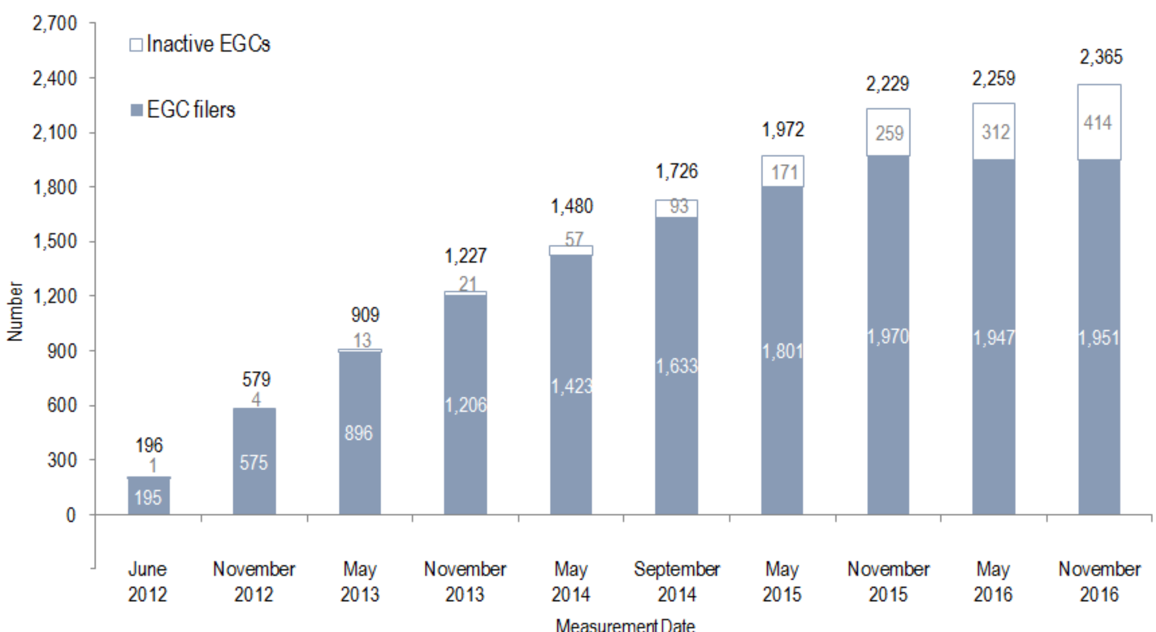
[10] Registered investment companies (other than business development companies) do not qualify as emerging growth companies. *See* SEC Division of Corporation Finance, Jumpstart Our Business Startups Act Frequently Asked Questions, Q. 20.

As previously indicated, the EGC filer and inactive EGC populations are derived using data from a commercial vendor based on companies' self-identification as EGCs in filings with the SEC. Self-identification data may understate or overstate these populations if companies fail to self-identify or self-identify erroneously. In addition, the populations will be overstated if there are companies that no longer qualify as EGCs but are not excluded from the population of EGCs identified by the third-party vendor (for example, because of a lack of known information about a change in status). Accordingly, the population of companies that meet the statutory definition of "emerging growth company" as of a specific measurement date may be larger or smaller than the population analyzed in this white paper.

## II. GROWTH IN THE NUMBER OF EGC FILERS AND INACTIVE EGCS

The number of EGC filers has grown since the enactment of the JOBS Act, but has stabilized recently. The number of inactive EGCs has also grown. Figure 1 depicts each of these populations at specific measurement dates used by PCAOB staff to analyze the populations between June 2012 and November 2016. The sum of EGC filers and inactive EGCs, as of each measurement date, is also presented.

**Figure 1: Growth in the number of EGC filers and inactive EGCs**




*Source: Audit Analytics and Strategic Insight*

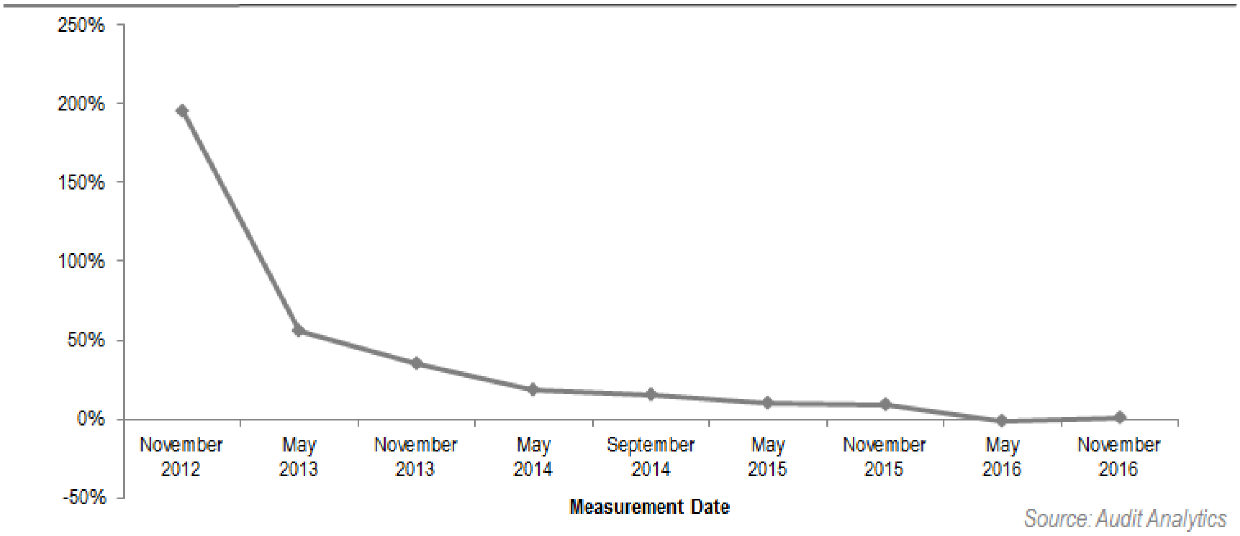
Changes in the populations of self-identified EGCs depicted above are affected by EGCs entering the population and EGCs leaving the population. From April 5, 2012 through November 15, 2016 there were 200 companies that ceased to qualify as EGCs because of their annual revenue or large accelerated filer status.[11] Further information on the industries of these companies is included in Appendix C. Additionally, there were 465 companies that previously identified as EGCs but then ceased to be SEC registrants. Specifically, these 465 companies had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness, and, in each case, did not subsequently file audited financial statements with the SEC. Further information on the industries of these companies is included in Appendix D.

The number of EGC filers has stabilized recently – it increased by less than 1% at the November 15, 2016 measurement date. Between May 15, 2016 and November 15, 2016, 207 companies became EGC filers[12] and 203 ceased to be EGC filers. The 203 companies include:

- 136 companies that became inactive EGCs,
- 4 companies that ceased to qualify as EGCs because of their annual revenue or large accelerated filer status, and
- 63 companies that previously identified as EGCs but then ceased to be SEC registrants.

The trend in the rates of change between successive measurement dates is depicted in Figure 2.

**Figure 2: Rate of change in the number of EGC filers between each successive measurement date**




[11] PCAOB staff observed that the overwhelming majority of SEC registrants that ceased to qualify as EGCs did so because their annual revenue exceeded $1 billion or they became a large accelerated filer rather than only because of issuance of more than $1 billion in non-convertible debt.

[12] See Table A.7 in Appendix A for information on form types used to identify the 207 new EGC filers.

As of November 15, 2016, there were 414 inactive EGCs, compared to 312 as of May 15, 2016.

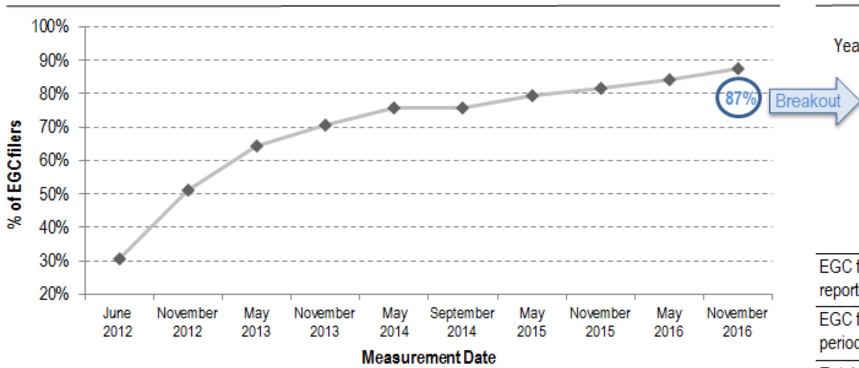
The discussion in sections III through VII and Appendix A focuses primarily on EGC filers.

## III. SECURITIES REGISTRATION AND EQUITY OFFERINGS BY EGC FILERS

*Periodic Reporting*

The population of EGC filers includes both (i) EGCs that have filed periodic reports with the SEC and (ii) EGCs that have filed registration statements but have not yet filed periodic reports. As shown in Figure 3, the percentage of EGC filers that have filed periodic reports has been increasing.[13] As of November 15, 2016, approximately 87% of the 1,951 EGC filers have filed periodic reports. The remaining 13% (or 248) have filed audited financial statements in registration statements but have not yet filed periodic reports.

**Figure 3: Percentage of EGC filers that have filed periodic reports**




*Source: Strategic Insight and Audit Analytics*

**Table 1: First year of periodic reporting as of November 15, 2016**

| Year of First Periodic Reporting | Number of EGC Filers | % |
|---|---|---|
| 2016 | 269 | |
| 2015 | 424 | |
| 2014 | 360 | |
| 2013 | 260 | |
| 2012 | 160 | |
| 2012 or later | 1,473 | 75% |
| 2011 or prior | 230 | 12% |
| EGC filers that have filed periodic reports | 1,703 | 87% |
| EGC filers that have not yet filed periodic reports | 248 | 13% |
| Total EGC filers | 1,951 | 100% |

*Source: Strategic Insight and Audit Analytics*

As of November 15, 2016, 75% of EGC filers had filed their first periodic report in 2012 or later. (See Table 1.) The length of time an EGC has been filing periodic reports provides an approximation of the length of time since the EGC completed a public offering.[14]

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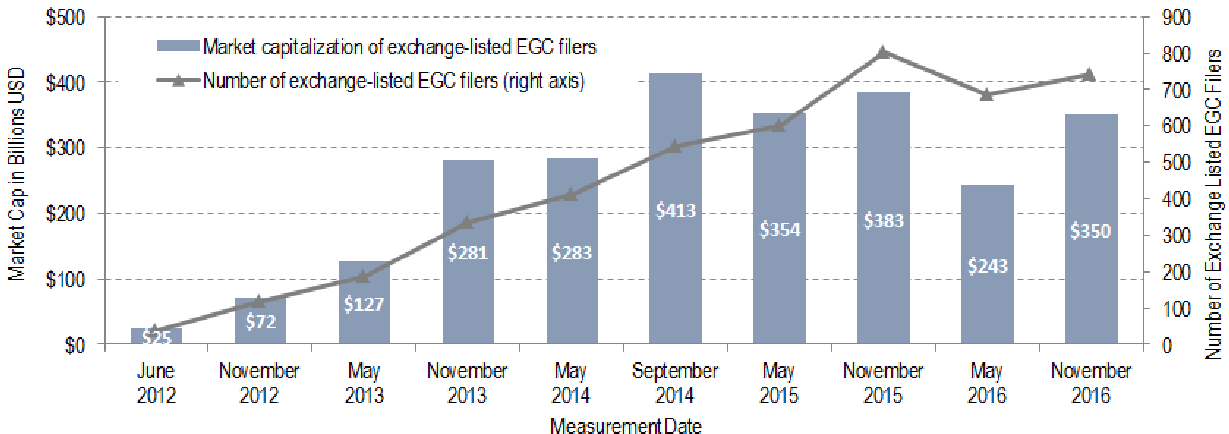
13 For the purpose of identifying EGCs that filed periodic reports as noted in Figure 3, PCAOB staff used commercial vendor data to identify companies that filed the following SEC Form submission types: 10-K, 10-Q, 20-F, and 40-F.

14 Companies that completed a registered public offering of equity securities on or before December 8, 2011, are not eligible to be EGCs. A company that qualifies as an EGC may have filed periodic reports prior to December 8, 2011 if the company had previously

*Exchange-Listed EGC Filers*

Approximately 38%, or 742, of the 1,951 EGC filers are exchange-listed. These 742 EGC filers represent 15% of all exchange-listed companies. As Figure 4 shows, total market capitalization for exchange-listed EGC filers has fluctuated with changes in the population of exchange-listed EGC filers and changes in their market value. All references to market capitalization represent global market capitalization in the case of companies that are listed on exchanges in multiple countries.

**Figure 4: Market capitalization and number of exchange-listed EGC filers**




*Source: Audit Analytics and Standard & Poor's*

As of November 15, 2016, the 742 exchange-listed EGC filers had $350 billion in market capitalization. These exchange-listed EGC filers represented 1% of the market capitalization of all exchange-listed companies. The market capitalization of exchange-listed EGC filers increased from $243 billion at May 15, 2016 to $350 billion at November 15, 2016. The 207 companies that became EGC filers between May 15, 2016 and November 15, 2016 accounted for approximately 14% of the total market capitalization of exchange-listed EGC filers.

Additional information on the number of EGC filers and exchange-listed companies by filer status under SEC rules (e.g., accelerated filer and large accelerated filer) is included in Table A.1 in Appendix A.

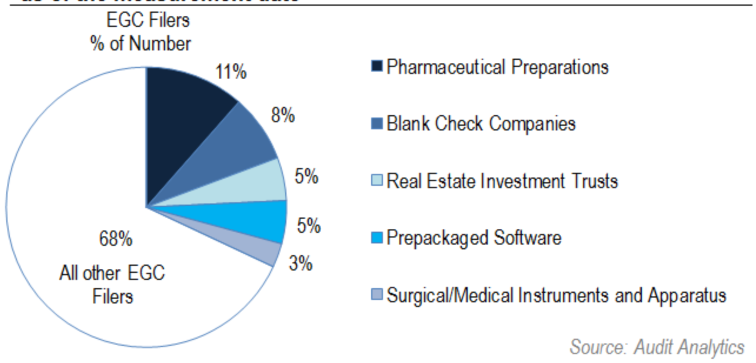
registered its securities under the Exchange Act without completing a public offering or had publicly issued only debt securities.

## IV. INDUSTRY AND FINANCIAL CHARACTERISTICS OF EGC FILERS

*Industry*

EGCs operate in many industries. Overall, the five most common Standard Industrial Classification ("SIC") codes reported for EGC filers as of the measurement date are: (i) pharmaceutical preparations; (ii) blank check companies;[15] (iii) real estate investment trusts; (iv) prepackaged software; and (v) surgical/medical instruments and apparatus. The proportion of EGC filers reporting the five most common SIC codes is summarized in Figure 5. Sixty-eight percent of EGC filers did not report being in these top five industries, including 65% of EGC filers that reported other SIC codes and 3% that did not report a SIC code in their SEC filings.

**Figure 5: Top five industries, by number, reported by EGC filers as of the measurement date**




Source: Audit Analytics

See Table A.2 in Appendix A for more detailed industry data on exchange-listed EGC filers, non-listed EGC filers, and other exchange-listed companies. Exchange-listed EGC filers are more concentrated in their top five industries than other exchange-listed companies. Larger proportions of exchange-listed EGC filers, as compared to other EGC filers and other exchange-listed companies, are concentrated in SIC codes related to health and life sciences, including: (i) pharmaceutical preparations and (ii) biological products.

The five SIC codes with the highest total assets as a percentage of the total assets for the EGC filer population as of the measurement date are: (i) real estate investment trusts; (ii) state commercial banks; (iii) pharmaceutical preparations; (iv) federally chartered savings institutions; and (v) crude petroleum and natural gas. Total assets of EGC filers reporting these five SIC codes represent approximately 50% of the total assets of EGC filers. Figure 6 provides a summary of this information as well as an analogous summary by revenue. See Tables A.3 and A.4 in Appendix A for more detailed industry data for EGC filers, exchange-listed EGC filers, non-listed EGC filers, and other exchange-listed companies.

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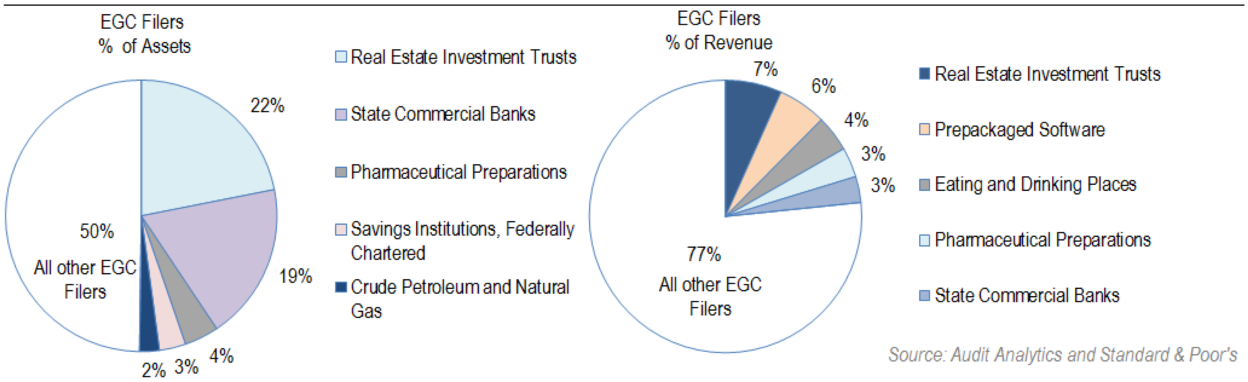
15 The classification of "blank check company" generally means a development stage company that has no specific business plan or purpose or has indicated that its business plan is to engage in a merger or acquisition with an unidentified company or companies, or other entity or person. *See* Securities Act Rule 419, 17 CFR 230.419.

**Figure 6: Top five industries, by assets and revenue, reported by EGC filers as of the measurement date**

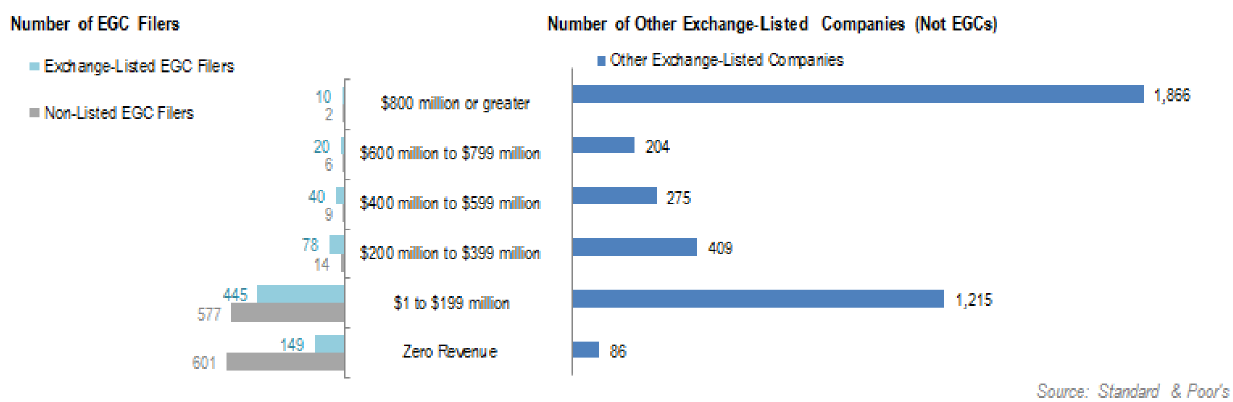



*Assets and Revenue*

The assets reported by EGC filers ranged from zero to approximately $19.4 billion. The average assets were approximately $245.9 million, while half of EGC filers reported assets of less than $5.9 million.

The annual revenue reported by EGC filers ranged from zero to approximately $978.5 million. The average revenue was approximately $56.6 million, while half of EGC filers reported revenue of less than $140,000. The distribution of revenue among EGC filers and exchange-listed companies is shown in Figure 7.

**Figure 7: Distribution of revenue reported by EGC filers and exchange-listed companies**




Additional information summarizing the distribution of revenue and assets reported by EGC filers, exchange-listed EGC filers, non-listed EGC filers, and other exchange-listed companies is presented in Tables A.5 and A.6 in Appendix A.

*Internal Control over Financial Reporting*

EGC management is generally required to report on the effectiveness of internal control over financial reporting ("ICFR") starting with the second annual report filed by the company, although auditor attestation is not required.[16] Among the 1,951 EGC filers, 1,262 provided a management report on ICFR in their most recent annual filing. Of those companies that provided a management report on ICFR, approximately 47% reported material weaknesses. Exchange-listed EGC filers reported material weaknesses at lower rates (13%). Table 2 shows that other exchange-listed companies reported material weaknesses at lower rates (7%) than the EGC filers.

**Table 2: Rates of material weakness in ICFR**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| # of companies | 1,951 | 1,209 | 742 | 4,055 |
| # with management reports on ICFR | 1,262 | 790 | 472 | 3,969 |
| # with material weakness reported by management | 594 | 534 | 60 | 263 |
| % of ICFR reports with material weakness | 47% | 68% | 13% | 7% |

*Source: Audit Analytics*

While auditor attestation on the effectiveness of ICFR is not required for EGCs, 34 EGC filers, or 2% of EGC filers, voluntarily provided an auditor's report on ICFR. Of these 34 EGC filers, 33 reported assets larger than the median assets of EGC filers, and 26 were exchange-listed. Further, 16 of these 34 EGC filers were audited by firms required to be inspected on an annual basis by the PCAOB.

## V. SHELL COMPANIES AND LIMITED OPERATIONS AMONG EGC FILERS

A total of 774 EGC filers reported zero revenue, self-identified as shell companies in periodic filings, or both.[17] Table 3 and Table 4 show that these two attributes are less common

[16] *See* Instruction 1 to Item 308(a) of Regulation S-K. EGCs that have not yet filed at least one annual report are not required to provide a management report on ICFR. EGCs are exempt from the requirement for auditor attestation of ICFR. *See* Section 404(b) of the Sarbanes-Oxley Act, as amended by Section 103 of the JOBS Act.

[17] Generally, a company is a shell company if it has no or nominal operations and at least one of the following attributes: (i) no or nominal assets; (ii) assets consisting solely of cash and cash equivalents; or (iii) assets consisting of any amount of cash and cash equivalents and nominal other assets. *See* Exchange Act Rule 12b-2, 17 C.F.R. 240.12b-2. Blank check companies (discussed in Section IV) would generally be considered shell companies until they

among exchange-listed EGC filers as compared to non-listed EGC filers. The tables also show that these attributes are even less common among other exchange-listed companies.

Table 3 below presents data on the proportion of companies that reported zero revenue in their most recent annual audited financial statements included in SEC filings, which include Securities Act registration statements, Exchange Act registration statements, and Exchange Act periodic reports.

**Table 3: Reporting of zero revenue**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Total # of companies | 1,951 | 1,209 | 742 | 4,055 |
| # reporting zero revenue | 750 | 601 | 149 | 86 |
| % reporting zero revenue | 38% | 50% | 20% | 2% |

*Source: Standard & Poor's*

Table 4 presents shell company disclosure by companies that have filed periodic reports, some of which also reported zero revenue.

**Table 4: Shell company disclosure in periodic reports**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Total # of companies that filed periodic reports | 1,704 | 991 | 713 | 4,043 |
| # with shell company disclosure in periodic reports | 266 | 231 | 35 | 6 |
| % with shell company disclosure in periodic reports | 16% | 23% | 5% | 0% |

*Source: Audit Analytics*

*EGC Filers That Reported Zero Revenue in 2013: Where are They Now?*

As shown in Table 3, 38% of EGC filers reported zero revenue as of November 15, 2016. The population of EGC filers reporting zero revenue has changed over the last three years. Specifically, the percentage of EGC filers reporting zero revenue decreased from 50% at November 20, 2013 to 38% at November 15, 2016. (See Figure A.1 in Appendix A.) The following analysis explores the extent to which the declining trend in reporting zero revenue reflects EGC filers that began to generate revenue and EGC filers that left the EGC population.

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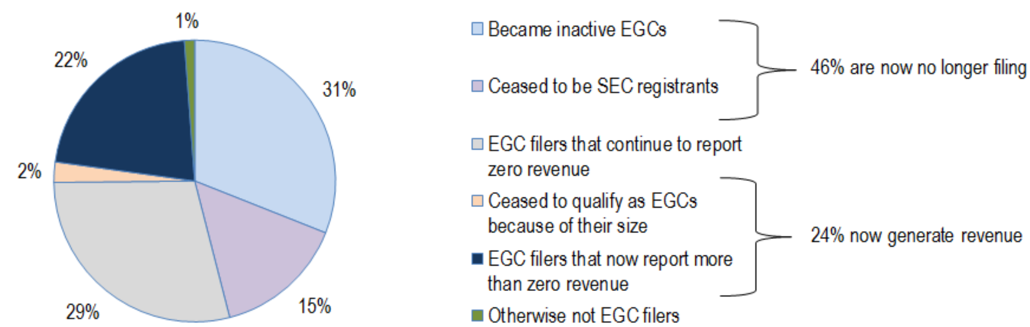
acquire an operating business or more than nominal assets. *See* SEC Release 33-8407, *Use of Form S-8 and Form 8-K by Shell Companies* (Apr. 15, 2004) at n. 20.

Specifically, we analyzed the 601 EGC filers reporting zero revenue at November 20, 2013 and categorized them based on their most recent reporting three years later. As of November 15, 2016, these 601 companies can be categorized as follows:

- 187 (31%) became inactive EGCs (and are therefore no longer EGC filers),
- 93 (15%) ceased to be SEC registrants (and are therefore no longer EGC filers),
- 173 (29%) are EGC filers that continue to report zero revenue,
- 130 (22%) are EGC filers that now report more than zero revenue,
- 14 (2%) ceased to qualify as EGCs because of their annual revenue or large accelerated filer status, and
- 4 (0.6%) other companies that were no longer EGC filers.[18]

This analysis indicates that 280 (46%) of the 601 EGC filers that reported zero revenue at November 15, 2013 were not filing with the SEC as of three years later, including 187 (31%) that went inactive and 93 (15%) that ceased to be SEC registrants. On the other hand, 144 (24%) of the 601 began reporting more than zero revenue, including 14 (2%) that ceased to qualify as EGCs because of their size. Figure 8 illustrates these findings.

**Figure 8: Classification, as of November 15, 2016, of the 601 EGC filers that reported zero revenue at November 15, 2013**




*Source: Audit Analytics and Standard & Poor's*

## VI. GOING CONCERN PARAGRAPHS IN AUDIT REPORTS OF EGC FILERS

For 51% of EGC filers, the most recent auditor's report included an explanatory paragraph expressing substantial doubt about the company's ability to continue as a going concern ("going concern paragraph"). EGC filers that are not exchange-listed received an auditor's report with a going concern paragraph at a substantially higher rate (74%) than exchange-listed EGC filers (12%). In addition, EGC filers received an auditor's report with a going concern paragraph (51%) at a substantially higher rate than other exchange-listed companies (3%).

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[18] Such companies include, for example, companies that identified themselves as an EGC in an SEC filing but eliminated that disclosure in a subsequent amended SEC filing.

**Table 5: Rate of going concern paragraphs**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Companies with going concern paragraphs | 987 (51%) | 900 (74%) | 87 (12%) | 131 (3%) |

*Source: Audit Analytics*

The data in Table 6 shows that 58% of the EGC filers with going concern paragraphs in their auditor's report reported zero revenue. Only 15% of other exchange-listed companies with going concern paragraphs reported zero revenue.

**Table 6: Going concern paragraphs and revenue information**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| # reporting zero revenue with going concern paragraphs | 575 (58%) | 536 (60%) | 39 (45%) | 20 (15%) |
| # reporting revenue >0 with going concern paragraphs | 412 (42%) | 364 (40%) | 48 (55%) | 111 (85%) |
| Total companies with going concern paragraphs | 987 (100%) | 900 (100%) | 87 (100%) | 131 (100%) |

*Source: Audit Analytics*

## VII. AUDITORS OF EGC FILERS

The 1,951 EGC filers were audited by 273 registered public accounting firms. Approximately 96% of EGC filers were audited by accounting firms that also audit issuers that are not EGC filers.

Approximately 39% of the 1,951 EGC filers were audited by firms required to be inspected on an annual basis by the PCAOB.[19] The remaining 61% were audited by firms required to be inspected at least once in every three years.[20]

Approximately 14% of EGC filers were audited by non-U.S. firms, including 9% that were audited by affiliates of annually inspected firms.

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19 These are firms that have issued auditor's reports for more than 100 issuer audit clients in a given year and therefore are required to be inspected on an annual basis by the PCAOB.

20 These are firms that have issued auditor's reports for 100 or fewer issuer audit clients in a given year and therefore are required to be inspected at least once every three years by the PCAOB.

## Appendix A: Additional Information on EGC Filers

This appendix includes tables with more detailed information on attributes discussed in the paper**.**

**Figure A.1 Percent of EGC filers reporting zero revenue as of various measurement dates**

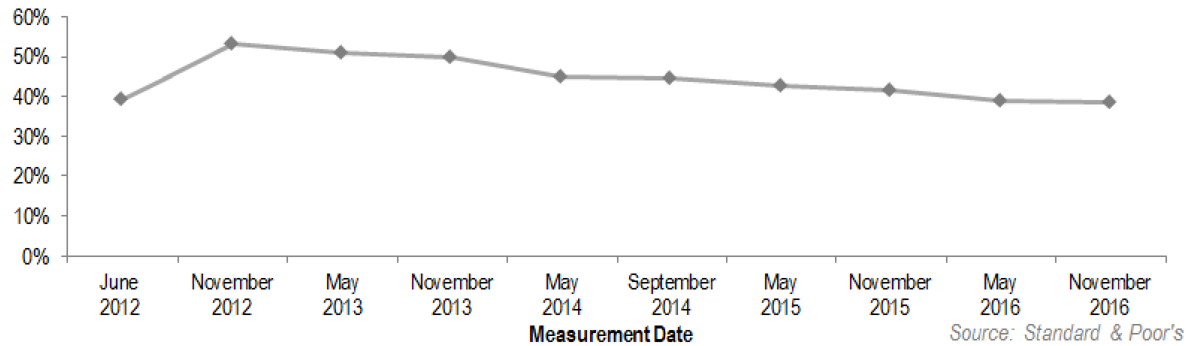


**Table A.1 Filer status from periodic reports**[21]

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Large accelerated filers | 0 | 0 | 0 | 2168 |
| Accelerated filers | 317 | 21 | 296 | 1,119 |
| Non-accelerated filers | 1,387 | 970 | 417 | 756 |
| Total companies that filed periodic reports | 1,704 | 991 | 713 | 4,043 |
| Companies that did not file periodic reports[22] | 247 | 218 | 29 | 12 |
| Total companies | 1,951 | 1,209 | 742 | 4,055 |

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[21] This data is derived from periodic reports with check boxes to indicate filer status, primarily Form 10-K, Form 10-Q, and Form 20-F. In general, "large accelerated filer" means an issuer with a public float of $700 million or more that has been subject to Exchange Act periodic reporting requirements for at least one year and has filed at least one annual report and "accelerated filer" means an issuer with a public float of $75 million or more, but less than $700 million, that has been subject to Exchange Act periodic reporting requirements for at least one year and has filed at least one annual report. *See* Exchange Act Rule 12b-2, 17 CFR 240.12b-2. The subset of companies summarized in Table A.1 as "non-accelerated filers" are those that filed periodic reports and did not identify themselves as "large accelerated filers" or "accelerated filers."

[22] As of the measurement date, there were 247 EGC filers that had filed audited financials in a Securities Act or Exchange Act registration statement in the preceding 18 months but did not file periodic reports.

**Table A.2 Top five industries reported by EGC filers and exchange-listed companies by number**
(Numbers of only the top five in each noted population are displayed)

| SIC industry description (code) | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Pharmaceutical Preparations (2834) | 224 (11%) | 59 (5%) | 165 (22%) | 212 (5%) |
| Blank Check Companies (6770) | 152 (8%) | 122 (10%) | | |
| Real Estate Investment Trusts (6798) | 97 (5%) | 64 (5%) | 33 (4%) | 184 (5%) |
| Prepackaged Software (7372) | 97 (5%) | 52 (4%) | 45 (6%) | |
| Surgical/ medical instruments and apparatus (3841)[23] | 54 (3%) | | 31 (4%) | |
| Business Services (7389) | | 42 (3%) | | |
| State Commercial Banks (6022) | | | 32 (4%) | 168 (4%) |
| Biological Products, Except Diagnostic Substances (2836)[23] | | | 31 (4%) | |
| Crude Petroleum and Natural Gas (1311) | | | | 120 (3%) |
| National Commercial Banks (6021) | | | | 104 (3%) |
| Total in Top 5 (for each column presented) | 624 (32%) | 339 (28%) | 337 (45%) | 788 (19%) |
| Not in Top 5 | 1,327 (68%) | 870 (72%) | 405 (55%) | 3,267 (81%) |
| Total Companies | 1,951 (100%) | 1,209 (100%) | 742 (100%) | 4,055 (100%) |

*Source: Audit Analytics*

23 Tied for fifth with the same number of exchange-listed EGC filers disclosing the SIC codes 3841 and 2836.

**Table A.3 Top five industries reported by EGC filers and exchange-listed companies by % of assets**
(Amounts for only the top five in each noted population are displayed)

| SIC industry description (code) | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Real Estate Investment Trusts (6798) | 22% | 48% | 14% | |
| State Commercial Banks (6022) | 19% | | 23% | 6% |
| Pharmaceutical Preparations (2834) | 4% | | 5% | |
| Savings Institutions, Federally Chartered (6035) | 3% | 7% | | |
| Crude Petroleum and Natural Gas (1311) | 2% | 2% | | |
| Finance Services (6199) | | 6% | | |
| Equipment Rental and Leasing, NEC (7359) | | 4% | | |
| Prepackaged Software (7372) | | | 3% | |
| National Commercial Banks (6021) | | | 3% | 17% |
| Commercial Banks, NEC (6029) | | | | 20% |
| Life Insurance (6311) | | | | 7% |
| Security Brokers, Dealers, and Flotation Companies (6211) | | | | 5% |
| Total in Top 5 | 50% | 68% | 48% | 55% |
| Not in Top 5 | 50% | 32% | 52% | 45% |
| Total Companies | 100% | 100% | 100% | 100% |

*Source: Audit Analytics and Standard & Poor's*

**Table A.4 Top five industries reported by EGC filers and exchange-listed companies by % of revenue**
(Amounts for only the top five in each noted population are displayed)

| SIC industry description (code) | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Real Estate Investment Trusts (6798) | 7% | 17% | 4% | |
| Prepackaged Software (7372) | 6% | | 7% | |
| Eating and Drinking Places (5812) | 4% | | 5% | |
| Pharmaceutical Preparations (2834) | 3% | 5% | 3% | |
| State Commercial Banks (6022) | 3% | | 4% | |
| Sporting and Athletic Goods, NEC (3949) | | 5% | | |
| Telephone Communications, Except Radiotelephone (4813) | | 5% | | 4% |
| Engineering Services (8711) | | 4% | | |
| Petroleum Refining (2911) | | | | 7% |
| Crude Petroleum and Natural Gas (1311) | | | | 5% |
| Motor Vehicles and Passenger Car Bodies (3711) | | | | 4% |
| Variety Stores (5331) | | | | 4% |
| Total in Top 5 | 23% | 36% | 23% | 24% |
| Not in Top 5 | 77% | 64% | 77% | 76% |
| Total Companies | 100% | 100% | 100% | 100% |

*Source: Audit Analytics and Standard & Poor's*

**Table A.5 Reported revenue (Millions USD)**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Minimum | 0.0 | 0.0 | 0.0 | 0.0 |
| Maximum | 978.5 | 978.5 | 976.1 | 482,130.0 |
| Average | 56.6 | 17.3 | 120.5 | 4,938.3 |
| Median | 0.1 | 0.0 | 37.7 | 635.1 |

*Source: Standard & Poor's*

**Table A.6 Reported assets (Millions USD)**

| | (1) All EGC Filers | (2) Non-listed EGC Filers | (3) Exchange-Listed EGC Filers | (4) Other Exchange-Listed (Not EGCs) |
|---|---|---|---|---|
| Minimum | 0.0 | 0.0 | 0.0 | 0.0 |
| Maximum | 19,352.7 | 13,244.9 | 19,352.7 | 2,603,865.1 |
| Average | 245.9 | 86.6 | 505.4 | 19,119.0 |
| Median | 5.9 | 0.2 | 161.5 | 1,418.2 |

*Source: Standard & Poor's*

**Table A.7 SEC filing types used to determine newly identified EGC filers**

| **Filing Type** | **Number of EGC Filers** |
|---|---|
| Securities Act Registration Statements | 163 |
| Exchange Act Registration Statements | 34 |
| Exchange Act Periodic/Current Reports | 8 |
| Other | 2 |
| Total | 207 |

*Source: Audit Analytics*

## Appendix B: Inactive EGCs

The information presented below about inactive EGCs[24] is the most recent available information through November 15, 2016.

Approximately 21% of the 414 inactive EGCs are blank check companies, according to the SIC code reported in the companies' most recent SEC filings. This is the most common SIC code reported among the inactive companies; the next most common SIC code (3%) is metal mining (the remaining SIC codes each represent less than 3%).

Approximately 81% of the 414 inactive EGCs had an explanatory paragraph included in the last auditor's report stating that there is substantial doubt about the company's ability to continue as a going concern.

Approximately 14% of the 414 inactive EGCs were audited by firms required to be inspected on an annual basis by the PCAOB and the remaining 86% were audited by firms required to be inspected at least once in every three years.

Approximately 7% of the inactive EGCs were audited by non-U.S. firms, including 4% that were audited by non-U.S. firms that are affiliates of annually inspected firms.

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[24] Inactive EGCs discussed in this white paper are those companies that had previously identified themselves as EGCs in at least one SEC filing since 2012 but have not filed audited financial statements with the SEC in the 18 months preceding November 15, 2016. The 414 Inactive EGCs do not include the 465 companies that ceased to be SEC registrants as described in Appendix D

## Appendix C: Companies that are no longer EGC filers because of their annual revenue or large accelerated filer status

From April 5, 2012 through November 15, 2016 there were 200 companies that ceased to qualify as EGCs because of annual revenue in excess of $1 billion or large accelerated filer status. For the 200 companies, the five most common industries by SIC code were:

(i) pharmaceutical preparations,
(ii) prepackaged software,
(iii) real estate investment trusts,
(iv) computer processing and data preparation, and
(v) crude petroleum and natural gas.

Forty percent of these 200 companies reported operating in these industries.

## Appendix D: Companies that are no longer EGC filers because they are no longer SEC registrants

From April 5, 2012 through November 15, 2016, there were 465 companies that previously identified as EGCs but ceased to be SEC registrants and therefore were no longer EGC filers or inactive EGCs. Specifically, these 465 companies had (i) terminated their Exchange Act registration, (ii) had their Exchange Act registration revoked, or (iii) withdrawn their registration statement before effectiveness, and, in each case, did not subsequently file audited financial statements with the SEC. For the 465 companies, the five most common industries by SIC code were:

(i) blank check companies,
(ii) pharmaceutical preparations,
(iii) prepackaged software,
(iv) metal mining, and
(v) crude petroleum and natural gas.

Thirty-five percent of these 465 companies reported operating in these industries.